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SA145 Short-Term Forecast for the Japanese Economy (2011/1-3—2013/1-3)

With Weak Household Consumption, Growth Will Rely on External Demand

- Consumption Should Be Encouraged to Spread a Sense of "True" Economic Recovery

- Risk of a Price Hike in Oil and Commodity Prices Resurfaces

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- Economies are acquiring momentum even in developed countries, and companies are regaining earning power

- Employment and income are improving gradually, but real purchasing power will decline due to the price hike

- Give households the impression that they are getting a good deal to stimulate consumption

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Japan's economy has exited from the standstill that began last fall and is returning to a recovery path.

Despite the pause of economic recovery, the expansion in business fixed investment and household expenditures has continued albeit moderately, and in addition, exports and production are picking up again. In the United States, stock prices have been spurred by a bold monetary policy known as QE2, the second round of quantitative easing. With further help from large-scale tax cut plans, fears of a double-dip recession have been dispelled. In Japan as well, the sentiment of previously cautious companies and consumers have improved. In light of Japan's severe fiscal circumstances, there may have been no need for the government to assemble a supplementary budget last autumn for fiscal 2010 (April 2010 to March 2011).

Given the current situation, the Japan Center for Economic Research (JCER) has updated its forecast for the period through fiscal 2012 (see Table). We expect the economy to continue to improve gradually, supported by the strong performances of overseas economies and a healthy domestic corporate sector.

On the overseas front, solid growth should continue in emerging countries. As developing countries achieve a sustained economic expansion, an increasing demand for goods will precede demand for services. Households will buy consumer durables, and companies will procure equipments and machineries. These are fields in which Japanese companies are able to apply their strengths. The surging growth in Asian countries is also favorable, since they are geographically close to Japan. Even if higher interest rates slow down growth in emerging countries, a more balanced global economic growth is likely to be achieved due to improved business conditions in developed countries.

Exports are expanding in the United States, owing to strong overseas economies and a weak dollar. The situation, in which exports are spurring an upturn in business fixed investments, is similar to Japan’s economic boom that started in 2002, which I have named the “Dejima Expansion”. This is in reference to Dejima Island, Nagasaki, which was Japan’s sole place of trade with the outside world, during the historical period of national seclusion. In a Dejima Expansion, economic recovery was attained mainly by exporting companies, which draw on global demand by means of trade. Therefore, the revival in the United States might be called an American version of the Dejima Expansion. By putting downward pressure on the dollar, QE2 is displaying a beggar-thy-neighbor behavior, and by accelerating capital flows into emerging countries, the policy has been “exporting” inflationary pressure from developed countries to emerging countries. Nevertheless, the American monetary authorities have gone ahead with implementing QE2, presumably because they are more concerned about preventing a double-dip recession or deflation. The monetary easing, which also has a wealth effect on consumption through rising stock prices, appears at present to be producing positive results. However, it has complicated the process of developing an exit strategy, one that also takes fiscal management into account.

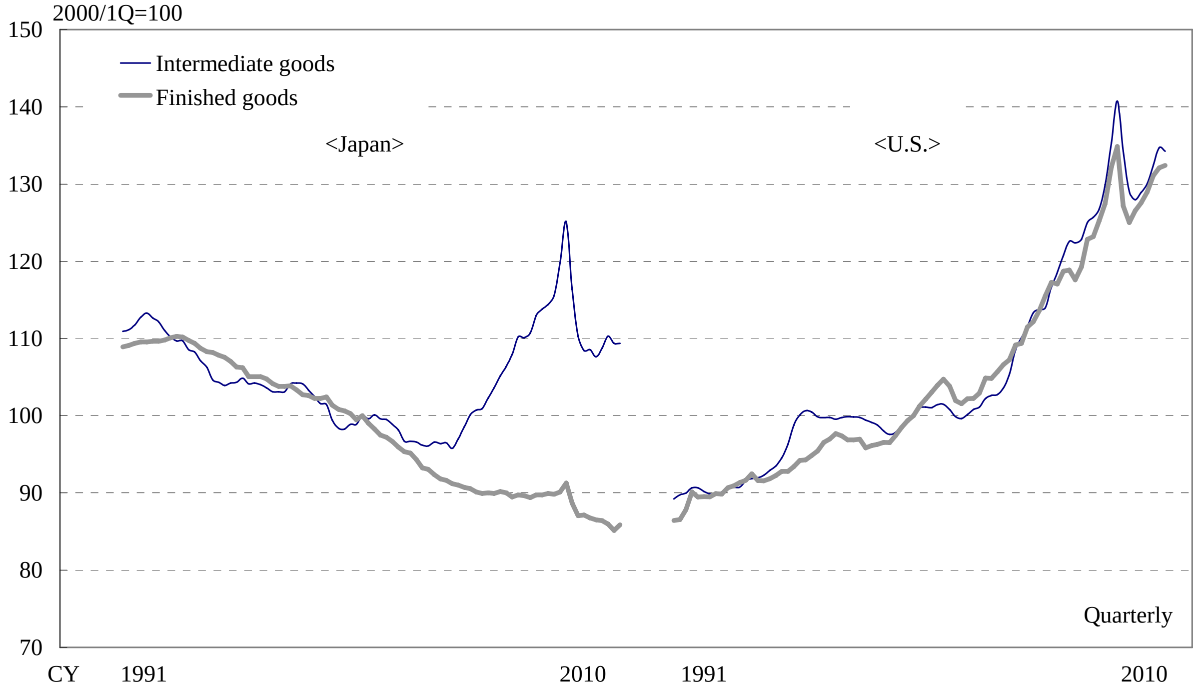
In Japan, the corporate sector’s recovery has created a strong foundation for the recovery of overall economy. Companies have made a variety of efforts to rationalize operations, which has increased profitability. Indeed, many firms have upgraded their expected business results for fiscal 2010, causing people to forget their concerns last autumn over how the strong yen was going to hurt corporate earnings. Sufficient reserves of corporate savings have built up, greatly improving financial soundness.

In this way, external developments have translated smoothly into positive developments in the corporate sector, but once again they have had little effect on the household sector. In a situation with only modest improvements in income, real purchasing power is declining due to rising food prices, larger electricity and heating bills and other increases in immediate expenses. Furthermore, the tax burden is expected to gradually increase, as revisions are due to be made on deductions taxpayers can claim. With the outlook for the future still uncertain, household consumption will continue to be frugal. Since the economic upturn is being led by exports and is centered on the corporate sector, the outlook demonstrates a “Dejima expansion II” pattern.

While apprehension about the strong yen has diminished, rising primary product prices have emerged as a new risk factor. Concern over inflation is growing in emerging countries, and the low-income groups of North African and Middle Eastern countries are becoming increasingly poverty-stricken, leading to political unrest.

Japanese companies are absorbing a substantial portion of the increasing upstream prices for

Figure 1. Producer Price Indexes by Stage of Processing: Japan and U.S.



Source: OECD

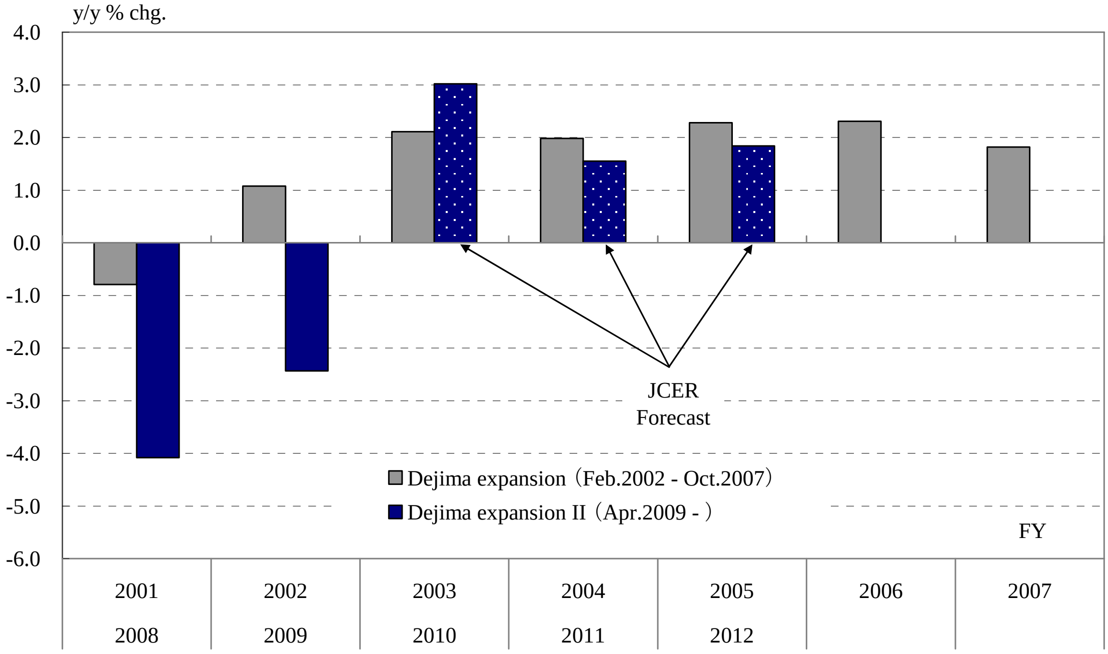
raw materials and other inputs internally, instead of passing them on to final goods downstream (Figure 1). In the current phase where there is a wide gap between supply and demand, it has become even more difficult to translate higher costs into higher prices, and this is putting pressure on corporate profits. In fact, the initial Dejima Expansion ended about a year before the September 2008 Lehman Crisis. Rising prices in oil and other procurements caused companies to run “busy but unprofitable” businesses. As for the country as a whole, a portion of income amounting to 1% of gross domestic product (GDP) ended up flowing overseas.

During the initial Dejima Expansion (February 2002 to October 2007), the economy grew at a rate close to 2% over a five-year period starting in fiscal 2003 (Figure 2). This time (“Dejima expansion II”), though, the speed of the expansion is not expected to be quite as fast for the following three reasons.

First, even if the global economy continues to expand, the increase of Japanese exports will not be as rapid as during the initial Dejima expansion. In the previous expansion, exports received a lift from a weak-yen bubble, whereas this time, the yen has appreciated by approximately 30% over the past three years. Export competitiveness is also being blunted by Japan’s delayed start in arranging free trade agreements (FTAs). With the international competition increasing, especially vis-à-vis South Korean companies, which are closing the gap in technology and other fields, Japanese companies would lose their share in the overseas markets.

Second, even if companies are able to draw on global demand, the shift of production overseas means they will less likely have a positive effect on domestic investment and employment. During the earlier Dejima Expansion, companies shifted their production bases back to Japan from overseas.

Figure 2. Real GDP Growth in the Last Two Expansion Periods



Source: Cabinet Office, "Quarterly Estimates of GDP "

However, the favorable conditions of that period, such as the weak yen and the deregulation on dispatching temporary workers to the manufacturing sector, are disappearing. In light of the gap between domestic and external growth rates, companies that were previously anxious of an overseas leakage of their advanced technologies no longer have compelling reasons for keeping production in Japan.

Emerging economies have grown in scale, and this has made local production more effective than production in Japan. In addition, with the creation of FTA networks, countries in Asia appeal as production bases for exports to third countries. While the offshore shift to Asia's low-wage least developed countries is not surprising, plans to move production plants to South Korea have come as a shock. The accelerated relocation of processing industries overseas will add momentum to full-fledged overseas operations in the materials and energy industries, which are part of the processing sector. Expansion overseas was a major consideration behind the recently announced plan for a merger of two of Japan's major steelmakers.

The planned reduction of the corporate tax rate by 5% is too small to be meaningful. We estimate that the corporate tax cut, along with measures to expand the taxation base, would boost corporate investment by only about 0.6%.

Third, Japan's working-age population is shrinking, and the country's fiscal situation is worsening. Expectations of growth are being lowered, and that will further constrain domestic demand.

Though the performance of overseas economies is strong, Japan's growth will be stagnant. In short, there are limits to what can be accomplished by relying on external demand. Consequently, an increase in consumer spending is required, which can be achieved by the following strategies.

First, a boost is needed in earned income, which accounts for the most part of income. Spring wage negotiations will probably have little effect, since managers will maintain a stern attitude. Many of the Japanese companies insist that they keep cautious stance on wage hike mainly because the profits have reached only 70% of their past peak. Truly, it seems a plausible justification, but the hurdles to be cleared for wage hikes are somewhat too high. During the last expansionary phase, corporate results were inflated by the credit bubble in the United States as well as the weak yen. Some observers say that even if wages are increased, people will only channel more money into savings. However, if managers do not give back their earnings to household sector, the question lies in whether they are ready to devote available funds to additional investment.

Companies have reasons for being cautious about raising wages and hiring new graduates. Because the age-based pay and lifetime employment systems remain prevalent, moves to increase the basic wage rate and increase the number of recruits would impose a burden in the future. For this reason, companies are expected to put off any across-the-board base wage hikes. Up until a certain point in time, these long-established labor practices contributed to minimizing personnel management costs and, in turn, assisting business expansions, but now they have become outdated. Both labor and management should be prepared to discuss shifting toward “performance-based” pay systems if they are to prevent the spring wage negotiations from turning into a meaningless affair, and the employment ice age from lasting into the future.

Second, concerns about the future need to be alleviated and the accumulation of precautionary savings should be prevented. Making use of an integrated reform of the tax and social security systems, authorities should raise the consumption tax and suppress social security costs, thereby developing a system that will remain sustainable. It is crucial that this be a reform providing a solid sense that further changes will be unnecessary; a temporal and roughly planned reform would be meaningless.

Third, additional measures for stimulating consumption should be considered. The problem is not that households have no money to spend but only that they have tightened their purse strings. The subsidies and tax breaks the government offered for buying eco-friendly cars and household appliances, and the “eco-point system for housing”, that offers points for the renovation or building of energy-efficient, eco-friendly housing, have made a strong impact. Japanese consumers have a tendency to be attracted to a “good deal”. Large electronics retail stores are successfully promoting sales by guaranteeing to match the lowest available prices, a tactic that effectively takes advantage of such consumer behavior. The introduction of a new eco-point system targeted at, for example, personal computers, washing machines or tourism, deserves consideration. Unlike with consumer durables, setting tourism as a target would lessen concern about fluctuation in sales, and it would also contribute to revitalizing regional economies.

Let us hope that companies, households and the government will resolve to take action to achieve a perceptible economic recovery.

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Table. The Outlook for Japanese Economy

Forecast →

	FY2010 1st Qtr	2nd	3rd	4th	FY2011 1st Qtr	2nd	3rd	4th	FY2012 1st Qtr	2nd	3rd	4th	FY2009 Actual	FY2010 Forecast	FY2011 Forecast	FY2012 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.5	0.8	-0.3	0.5	0.4	0.4	0.4	0.6	0.3	0.5	0.4	0.5	-2.4	3.0	1.5	1.8
Real gross domestic expenditures (year-on-year)	3.1	4.9	2.2	1.6	1.5	1.1	1.8	1.9	1.8	1.9	1.9	1.8				
Private final consumption (qtr.-to-qtr.)	-0.0	0.9	-0.7	0.1	-0.1	0.1	0.1	0.5	-0.1	0.2	0.2	0.3	-0.0	1.2	0.2	0.7
Private housing investment (qtr.-to-qtr.)	-0.3	1.8	3.0	0.8	2.2	0.9	1.4	0.7	1.7	1.8	1.9	1.2	-18.2	-0.3	6.4	5.8
Private non-residential investment (qtr.-to-qtr.)	2.9	1.5	0.9	0.4	1.1	1.3	1.4	1.3	0.9	1.1	1.0	1.0	-13.6	5.3	4.4	4.6
Public fixed capital formation (qtr.-to-qtr.)	-4.1	-2.1	-5.8	1.2	0.0	-1.7	-1.2	-0.5	-0.3	-0.2	-0.2	-0.2	14.2	-8.4	-4.5	-2.1
Domestic demand (contribution)	0.3	1.0	-0.2	0.3	0.3	0.3	0.3	0.5	0.2	0.4	0.3	0.4	-2.7	1.7	1.2	1.3
Net exports of goods and services (contribution)	0.3	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.3	1.3	0.4	0.5
Exports of goods and services (qtr.-to-qtr.)	5.3	1.5	-0.7	1.8	2.1	1.6	1.6	1.8	2.0	1.6	1.4	1.8	-9.6	17.5	6.0	7.2
Imports of goods and services (qtr.-to-qtr.)	4.0	2.9	-0.1	1.2	1.7	1.3	1.5	1.8	1.5	1.4	1.3	1.6	-11.0	10.8	5.4	6.1
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.6	0.6	-0.6	0.1	0.2	0.2	0.2	0.5	0.3	0.4	0.4	0.4	-3.7	1.0	0.5	1.4
Indices of Industrial Production (qtr.-to-qtr.)	1.5	-1.8	-1.6	6.1	0.6	1.0	0.7	1.1	0.8	1.0	0.8	0.8	-8.9	10.4	5.3	3.6
Unemployment rate (%)	5.2	5.1	5.0	4.9	4.8	4.7	4.7	4.6	4.6	4.5	4.5	4.3	5.2	5.0	4.7	4.5
Compensation of employees (year-on-year)	1.2	1.2	0.7	0.9	0.5	0.3	0.3	0.3	0.3	0.5	0.7	0.9	-3.6	1.0	0.4	0.6
Newly issued government bonds yield 10-years (%)	1.271	1.044	1.045	1.247	1.285	1.324	1.362	1.401	1.444	1.483	1.522	1.561	1.359	1.152	1.343	1.503
Nikkei Stock Average (yen)	10,346	9,356	9,842	10,473	10,751	11,027	11,311	11,590	11,843	12,062	12,278	12,492	9,976	10,004	11,170	12,169
Yen : Dollar exchange rate (yen / dollar)	92.0	85.8	82.5	82.3	83.3	84.7	86.3	88.0	89.1	90.2	91.5	92.3	92.9	85.7	85.6	90.8
WTI Crude oil price (dollar / barrel)	78.1	76.2	85.2	89.0	94.5	96.6	97.6	98.0	98.0	98.0	98.0	98.0	70.7	82.1	96.7	98.0
Domestic corporate goods price index (year-on-year)	0.2	-0.1	1.0	1.6	1.1	1.6	1.4	0.5	0.4	0.4	0.5	0.6	-5.2	0.7	1.2	0.5
Consumer price index (excluding fresh food ; year-on-year)	-1.2	-1.0	-0.5	-0.2	0.3	0.2	0.1	0.2	0.2	0.4	0.4	0.4	-1.6	-0.8	0.2	0.4
Current account / Nominal GDP (%)	3.2	3.7	3.5	3.2	2.9	3.2	3.2	3.2	3.1	3.3	3.3	3.3	3.3	3.4	3.1	3.2
Real GDP of U.S.A. (qtr.-to-qtr.)	1.7	2.6	3.2	2.8	3.1	3.2	2.8	2.4	2.4	2.6	2.8	3.0	-2.6 (C.Y.)	2.9 (C.Y.)	2.9 (C.Y.)	2.7 (C.Y.)
Real GDP of China (year-on-year)	10.3	9.6	9.8	9.5	9.3	8.9	8.6	8.8	9.3	9.6	9.5	9.7	9.2 (C.Y.)	10.3 (C.Y.)	9.0 (C.Y.)	9.4 (C.Y.)

[Notes] 1. Figures are shown in percentage changes, and contribution means contribution to real GDP growth.
2. Figures for GDP components are at chained (2000) yen.
3. Figures for consumer price index, domestic corporate goods price index and indices of industrial production are at 2005 year basis.
4. Figures for GDP components, unemployment rate, indices of industrial production and current account are seasonally adjusted.
5. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2005) dollars.
6. Japan's fiscal year is April 1 to March 31.
7. Figures for Long-term interest rates, Stock price, Oil price, Exchange rate, and Unemployment rate are shown in average terms for corresponding periods.

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