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SA146 Short-Term Forecast for the Japanese Economy (2011/4-6—2013/1-3)

Business Should Bounce Back from this Fall Onward

- Electricity Shortages pose an Obstacle to Early Recovery

- Reconstruction and Economic Reform must be Tackled Simultaneously

Junichiro Takeuchi

Chief Forecaster, Japan Center for Economic Research

- The recovery phase of the last two years has come to an end
- Spend time on drafting concrete reconstruction plans, allowing local residents to take the lead
- Fiscal consolidation and the resolving of other outstanding issues must not be put off

Japan's economy has been set back by the supply-side constraints caused by the Great East Japan Earthquake of March 11, and by the consequent slump in demand. Real gross domestic product (GDP) in the January–March period of 2011 contracted for a second consecutive quarter, mainly due to the chaotic aftermath of the disaster. An even larger downturn is expected in the April–June quarter. For the time being, limited production will act as a constraint on the economy; this will in turn hamper the country's main growth engine, external demand. The production slowdown will gradually affect expenditure through a decline in income (corporate profits and wages). Cumulatively, it is fair to judge that the recovery phase that began in April 2009 has come to a close.

The primary cause of the supply-side constraints is the damage wrought by the earthquake and tsunami to plant facilities, distribution networks, and infrastructure such as ports, harbors and roads in the affected regions. The secondary cause is the halt in parts and components supplies from the disaster-stricken areas; supply chains were disrupted, and the production slowdown spread to other regions. In March, Japan's industrial production fell by more than 15% from the previous month, and even in the Chubu region located far from the Tohoku area, the contraction was greater than 18% on a month-on-month basis. This is typical evidence that disruptions in the supply chains of parts and materials affected production not only in disaster-stricken areas but also in a wide range of non-affected areas.

On the demand side, a variety of factors are constraining purchasing activities in the affected region. The disaster also seriously damaged business sentiment and consumer confidence across Japan; attitudes of self-restraint and frugality spread, causing expenditure to be curbed. Furthermore, the lack of supplies has placed a direct cap on demand in some fields, such as automobiles sales.

Worries about radiation contamination spread widely, with rumors fanning such fears; the impact extended to exports and also triggered a substantial decline in tourists from overseas.

Based on this view of the current situation, the Japan Center for Economic Research has revised its economic forecast for the period through fiscal 2012 (April 2011 to March 2013; see the table and Figure 1). I would caution that this particular short-term forecast rests on a foundation of numerous uncertain factors. It is hard to say when the aftershocks will come to an end or the safety of the Fukushima Daiichi Nuclear Power Station will be assured. Other uncertainties include the temperature levels this summer, the scale of the second supplementary budget the government is preparing to draft and the funding for it.

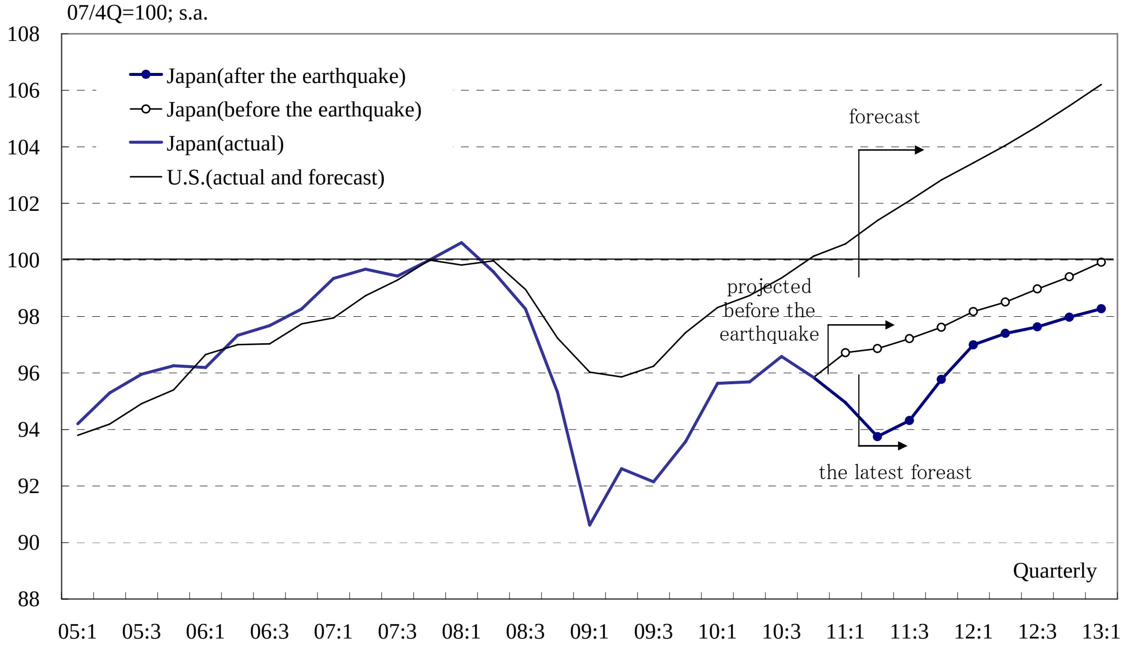
We now predict a contraction in real GDP of 0.6% in fiscal 2011, a large downward revision from an earlier projection of 1.5% growth. Economic activity will remain stagnant through the first half of the fiscal year, largely due to supply-side constraints. Production will return to normal in the second half, and as a result, exports will resume against the background of solid demand from overseas. Demand for reconstruction should also move into full swing. The tempo of the recovery is likely to slow during fiscal 2012, but real GDP can still be expected to achieve 2.7% growth, considerably larger than our forecast before the disaster (1.8% growth). This reading of the economic outlook seems generally in line with the predictions of other forecasting institutes, but differs in the following two respects.

The first difference lies in the timing of the recovery. Most expect a turnaround in the July–September quarter, whereas we think it will be in the October–December quarter. On the supply side, since a 15% cutback in power consumption, in response to the shortfall in power, has been targeted for the summer, such electricity shortages are likely to hamper production increases. The shutdown of the Hamaoka Nuclear Power Station of Chubu Electric Power Co. has reduced the risk of another nuclear power crisis, but this has also lead to the expanding of further areas facing potential electricity shortages. Concerns over such power shortfalls during the summer months are causing the manufacturing sector to formulate conservative production plans. According to anecdotes by firms and other sources, expectations will mount for the somewhat earlier than expected restoration of supply chains. However, for automobiles and other key industries with a broad production base, rebuilding production systems to meet demand is likely to take until this fall.

If reconstruction demand recovers first, imports will surge, and it is possible that prices will rise. However, such concerns are probably needless, since demand for restoring capital stock is not likely to gain substantial momentum until the October–December quarter. It will take a large amount of time to clear away the great mounds of rubble and re-establish the infrastructure in the affected areas. Until that is accomplished, the first steps toward a return to normal life in the devastated communities cannot be taken. These steps will involve drawing up plans to rebuild communities involving local residents with a consensus-based approach.

The reconstruction blueprints released by those associated with the government show some rationality, such as constructing disaster-resistant housing on high ground from where fishers can “commute” to their ports. However, these are proposals that were “made in Tokyo”, and they have

Figure 1. Real GDP of Japan and U.S.



Sources: Cabinet Office, ″Quarterly Estimates of GDP″; U.S. Department of Commerce

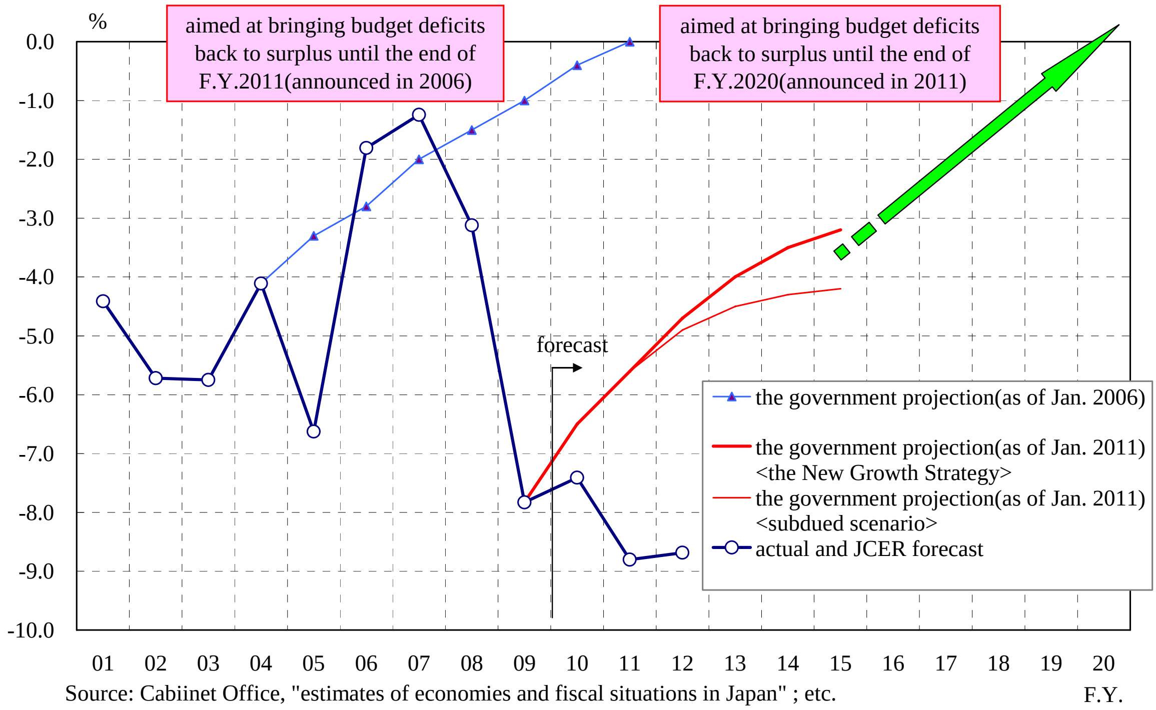
not yet taken the views of the disaster victims into account. Planners will need to listen closely to the voices of those directly affected. The drafting of blueprints should not be seen disapprovingly as a time-consuming procedure, but rather as a process in which a certain amount of time should be allocated to, to be properly accomplished. Unlike in the case of the Great Hanshin Earthquake of 1995, construction investment does not have good prospects for a V-shaped recovery.

The second distinctive feature in our forecast is that we take a more cautious view than other forecasting institutes in the recovery tempo after the economy bottoms out. While demand associated with the reconstruction process is expected to be vigorous particularly in the corporate sector, the production slowdown in the disaster’s aftermath will cause other components of demand to lag behind, through deterioration in income.

In the household sector, demand will swell in the affected regions for housing, automobiles, furniture, electric appliances and daily necessities. However, the macroeconomic income situation will be severe. Over the short run, days off work will increase, and working hours will shorten. Bonus payments, which lag behind trends in corporate performance, will be reduced in this year’s winter season through next year’s summer season. Rising prices for everyday items and tax hikes will have a “headwind effect” on households.

Reconstruction demand to get the corporate sector’s production back on track will pick up more quickly than that of the household sector. Managers will be motivated by the fear that if the supply disruption lasts too long, their customers may desert them and consider Japan “unlisted” as a supply source; they also have a strong sense of duty to get supplies of goods and services moving smoothly. In addition, a sound financial position makes it possible for the corporate sector to make investments. Electric power companies will be investing in safety measures, while business corporations will

Figure 2. Primary balance of central and local government of Japan



Source: Cabiinet Office, "estimates of economies and fiscal situations in Japan" ; etc.

devote more funds to installing independent power generation facilities, to making earthquake-resistance improvements and to measures that ensure the continuity of their operations.

Yet companies face a difficult earning environment. As well as the problem of reduced sales, the yen remains strong, and resource prices are high and rising. The corporate tax rate cuts that were planned before the disaster will likely be postponed. Given these circumstances, businesses will carefully screen all investments other than those aimed at restoring operations. Due to uncertainty over power supplies, rising electricity costs, and the possibility of further earthquakes and other natural disasters, it is not strange for Japanese companies to perceive Japan as becoming a riskier and more costly place for business operations. In the aftermath of the tragedy, the government seemed to make poor ad hoc responses at times; the situation can be likened to the government-related risks Japanese corporations have encountered when expanding business in developing countries. Thus there are plenty of factors that could cause an accelerated hollowing out of Japan’s industrial base.

The first supplementary budget of this fiscal year has been enacted, with a value of ¥4 trillion, and attention has now shifted to the second one. The scale of government spending will definitely have to be expanded, and there is talk of ¥20 trillion in new spending. Given the downturn in corporate performance, there is no way to avoid a shortfall in tax revenue. Keeping the limit of new government bonds issued at ¥44.3 trillion, the amount agreed to when the original fiscal 2011 budget was drafted, will be difficult.

It was only 10 years ago when the government, in its “Basic Policies for Economic and Fiscal Management and Structural Reform 2001”, established a target of keeping the government bonds issued under ¥30 trillion. Then, in 2006, the government promised that by fiscal 2011 it would achieve a surplus in the “primary balance” (the general account balance excluding debt servicing and new borrowing) of the central and local governments combined. These goals were set in the light of the full-fledged pension payments to the baby-boom generation that will begin in fiscal 2012.

So what is the situation now? If we assume that the second supplementary budget will be on the scale of ¥6.7 trillion, the primary balance in fiscal 2011 is projected to be minus 9% of GDP for the year (Figure 2). That would mean another “lost decade” for Japan, in public finance. Of course, during this time, Japan did encounter a “once-in-a-century” global financial crisis triggered by the bankruptcy of Lehman Brothers in 2008, and was subsequently hit by a “once-in-a-millennium” natural disaster. Despite this, we should probably adopt the view that fundamentally we are now paying the price for failing to restrain government spending and putting off a future-oriented tax reform.

Looking back, we can see that 2006, when the business climate was at its best in recent years, was a turning point for Japan. It was a time of improvements and increases in land prices, consumer prices, corporate performance, and personal income; a sense of relief spread amongst people, and the opportunity for reform slipped away. Instead, complaints were made about widening inequalities, and politicians responded immediately to the issue. Since that point, government policies switched from promoting growth to redistributing income. The schemes to eliminate expressway tolls and distribute child allowances may have been the outcome of the public’s sentiment at the time.

In the disaster-stricken areas, huge public and private efforts are being put into the reconstruction process. The assistance pouring in from other parts of Japan and the world is encouraging. A commercial aired on television said it well: “The road ahead may be a long one, but if we all do our best, we will definitely manage to complete the journey.”

Still, the post-reconstruction outlook for the Japanese economy remains unclear. There are numerous outstanding issues to be dealt with, including the decline in the working-age population, the increase in social security costs from an aging society and the drop in corporate competitiveness (due to high taxes and a delay in arranging free trade agreements). These are not problems that will spontaneously resolve themselves while our minds are focused exclusively on reconstruction. Moreover, the earthquake and tsunami have presented some new issues, such as updating the mid- to long-term energy policy and correcting the present lopsided concentration on Tokyo. While our top priorities must be to support the disaster victims and get the nuclear power reactors under control, we need to adopt a posture of simultaneously addressing other issues as mentioned above.

It is unlikely that Japan will find itself driven into the kind of situation in Greece, where interest rates rose rapidly. Yet credit-rating agencies and other overseas observers are holding increasingly harsh views on Japan. Their understanding is that Japan has ample room to increase its consumption tax. The key question is whether we, acting on our own initiative, can sort out the long-standing challenge of fiscal consolidation.

Nobody can say what may happen in the future. However, we have to stop putting off addressing immediate issues and seriously examine what needs to be done. In this regard, we should not leave everything to the politicians; rather, each of us should face the issues, consider them as our own problems, and then act to solve them.

（The original Japanese article posted in the May 27, 2011 issue of the Nikkei）

Table. The Outlook for Japan's Economy

Forecast →

	FY2010				FY2011				FY2012				FY2009	FY2010	FY2011	FY2012
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	Actual	Actual	Forecast	Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.1	0.9	-0.8	-0.9	-1.3	0.6	1.5	1.3	0.4	0.2	0.4	0.3	-2.4	2.3	-0.6	2.7
Real gross domestic expenditures (year-on-year)	3.1	5.0	2.2	-1.0	-2.0	-2.3	-0.1	2.2	3.9	3.5	2.3	1.3				
Private final consumption (qtr.-to-qtr.)	-0.2	0.8	-1.0	-0.6	-0.7	0.5	0.5	0.7	-0.2	0.2	0.3	0.3	-0.0	0.8	-0.7	1.0
Private housing investment (qtr.-to-qtr.)	-0.6	1.9	3.2	0.7	-0.5	-1.0	-0.2	1.3	0.9	0.4	0.8	1.3	-18.2	-0.2	1.5	2.5
Private non-residential investment (qtr.-to-qtr.)	2.7	1.1	0.1	-0.9	1.0	2.0	2.4	1.2	1.1	1.0	0.8	0.7	-13.6	4.5	3.7	5.2
Public fixed capital formation (qtr.-to-qtr.)	-4.5	-2.5	-6.0	-1.3	2.0	3.5	7.5	2.7	1.5	-1.2	-1.2	-1.3	14.2	-10.0	4.3	6.2
Domestic demand (contribution)	-0.2	1.1	-0.7	-0.8	-0.3	0.8	1.3	1.1	0.3	0.1	0.2	0.1	-2.7	1.4	0.5	2.1
Net exports of goods and services (contribution)	0.2	-0.1	-0.1	-0.2	-0.9	-0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.9	-1.1	0.7
Exports of goods and services (qtr.-to-qtr.)	5.2	1.6	-0.8	0.7	-4.6	0.2	3.2	2.8	2.4	1.9	1.8	2.0	-9.6	17.0	-1.7	9.2
Imports of goods and services (qtr.-to-qtr.)	4.1	2.9	-0.3	2.0	1.7	2.3	2.0	1.9	1.8	1.1	1.0	1.1	-11.0	10.9	7.2	6.6
Nominal gross domestic expenditures (qtr.-to-qtr.)	-1.0	0.6	-1.1	-1.3	-2.1	0.6	1.6	1.3	0.2	0.2	0.4	0.5	-3.7	0.4	-2.0	2.6
Indices of Industrial Production (qtr.-to-qtr.)	0.7	-1.0	-0.1	-2.0	-3.2	0.7	4.0	3.6	1.4	0.6	1.3	1.1	-8.8	8.9	-1.6	7.8
Unemployment rate (%)	5.1	5.0	5.0	4.7	4.9	5.0	5.0	4.9	4.9	4.8	4.7	4.6	5.2	5.0	5.0	4.7
Compensation of employees (year-on-year)	1.2	1.2	0.8	0.3	-0.9	-1.2	-2.4	-0.6	-0.9	-0.0	0.3	0.5	-3.6	0.9	-1.3	-0.0
Newly issued government bonds yield 10-years (%)	1.271	1.044	1.045	1.246	1.182	1.248	1.280	1.304	1.330	1.354	1.381	1.410	1.359	1.150	1.253	1.369
Nikkei Stock Average (yen)	10,346	9,356	9,842	10,285	9,693	9,886	10,285	10,747	11,012	11,251	11,538	11,837	9,976	9,951	10,153	11,410
Yen : Dollar exchange rate (yen / dollar)	92.0	85.8	82.5	82.3	81.8	82.3	83.3	84.9	86.2	87.3	88.6	89.7	92.9	85.7	83.1	88.0
WTI Crude oil price (dollar / barrel)	78.1	76.2	85.2	94.6	103.3	104.4	104.8	104.5	104.2	104.2	104.2	104.2	70.7	83.5	104.3	104.2
Domestic corporate goods price index (year-on-year)	0.2	-0.2	1.0	1.7	2.4	2.7	2.2	1.2	0.2	0.5	0.6	0.6	-5.2	0.7	2.1	0.5
Consumer price index (excluding fresh food ; year-on-year)	-1.2	-1.0	-0.5	-0.2	0.3	0.5	0.7	0.4	0.4	0.3	0.3	0.5	-1.6	-0.8	0.5	0.4
Current account / Nominal GDP (%)	3.3	3.7	3.6	2.6	1.1	0.8	1.1	1.0	1.2	1.4	1.7	1.7	3.3	3.3	1.0	1.5
Real GDP of U.S.A. (qtr.-to-qtr.)	1.7	2.6	3.1	1.8	3.3	2.8	2.9	2.4	2.4	2.6	2.8	2.9	-2.6	2.9	2.6	2.7
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real GDP of China (year-on-year)	10.3	9.6	9.8	9.7	9.4	8.8	8.5	8.5	9.2	9.6	9.5	9.7	9.2	10.3	9.0	9.3
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)

[Notes] 1. Figures are shown in percentage change, 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, Compensation of employees, 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 rate, at chained (2005) dollars.
6. Japan's fiscal year is April 1 to March 31.
7. Figures for Long-term interest rate, Stock price, Oil price, Exchange rate, and Unemployment rate are shown in average term for corresponding period.

Japan Center for Economic Research (JCER)
Nikkei Inc. Bldg. 11F 1-3-7 Otemachi, Chiyoda-ku, Tokyo 100-8066, Japan
Phone: +81-3-6256-7710 / FAX: +81-3-6256-7924