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SA147 Short-Term Forecast for the Japanese Economy (2011/7-9—2013/1-3)

Clouds Hang Over a Vigorous Recovery
–Economic Slowdowns Overseas and the Strong Yen Present Concerns
–Structural Reform Must Be Done Immediately

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- A quick recovery in the July–September quarter fueled by resumed production, special demand, and defensive purchases

- Economic slowdowns cannot be averted in the United States and Europe, nor in China

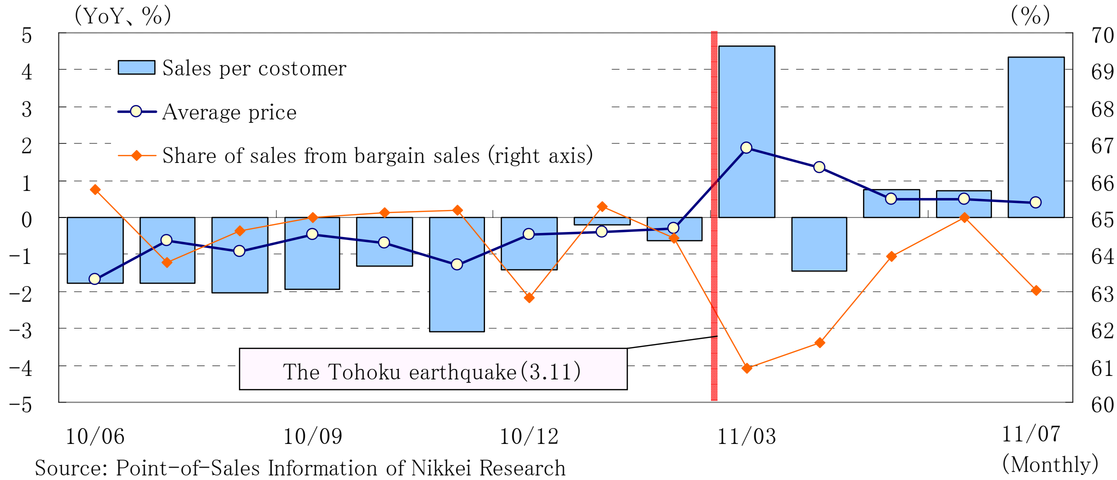
- The strong yen to pursue overseas investments, mergers, and acquisitions energetically

Five and a half months have now passed since the Great East Japan Earthquake, a once-in-a-millenium event. Thanks to the strenous efforts of corporate personnel, production lines were soon repaired, and output and exports are recovering more quickly than expected. At the same time, however, business trends overseas have become a cause of mounting concern, as can be read from the recent plummeting of stock prices. Considering such positive and negative factors, the Japan Center for Economic Research reexamined the prospects for domestic business and updated its forecast for the period through fiscal 2012 (April 2012 to March 2013).

First, let us confirm Japan's current economic situation. Real gross domestic product (GDP) recorded negative growth in the April–June quarter, the third consecutive quarter of contraction, mainly due to sharp slowdowns in net exports and consumer spending in March and April. Supply chains were restored to a functional status faster than had been thought possible, however, making a quick recovery in the July–September quarter a strong possibility. Indeed, when we calculate the quarter's index of industrial production, which is needed for cabinet office to project GDP, using Indices of Production Forecast, we find that it is likely to show record-setting growth of 8.2% over the April-June level. The trade balance, moreover, shifted to a surplus position as early as June.

Personal consumption is recovering as the mood of self-restraint is weakening. Recent consumer spending is distinguished by large components of demand sparked by special circumstances, such as the response to the March 11 earthquake and tsunami, and by defensive purchases to safeguard daily life. The special demand is fueling brisk sales of household appliances and food, including ecological products, digital terrestrial TVs, and energy-saving appliances, as well as air conditioners to cope with hot summer weather. The defensive purchases involve stocking up on necessities in response to both

Figure 1. Bargain sales before and after the Tohoku earthquake



Source: Point-of-Sales Information of Nikkei Research

supply constraints following natural diasters and the situation after the nuclear power accident. Looking at the point-of-sales information of Nikkei Research, which collects data from supermarkets, cooperatives, and other stores, we find that even though sellers held back on offering bargain sales following the disaster, sales have expanded, with a boost from an increase in sales per customer (figure 1).

Reconstruction demand, which is receiving a lift from the government's supplementary budgets, is now gaining momentum. Once the effects of such temporary factors wear off, however, the economy will lose speed, returning to the slow-growth track of the past. The reason lies in the economic structure, which is slanted toward development led by a corporate sector heavily reliant on external demand.

Japan was hit by several "negative productivity shocks" over the course of its two lost decades, as a result of which its potential growth rate dropped to the vicinity of 0.5%. First the financial system ceased to function when the bubbles of the second half of the 1980s deflated, while at the same time the demographic structure moved toward a larger share of senior citizens and smaller share of children. Then, in the second half of the 1990s, the financial system went through a crisis. The erosion of the nation's economic power sparked a decline in the anticipated growth rate and a rise in unease about the future, and both companies and households cut back on domestic expenditures. Now additional negative productivity shocks have hit in the form of the earthquake, tsunami, and nuclear catastrophe.

Because of the Japanese economy's heavy reliance on external demand, overseas growth serves as its lifeline. The impression at present, however, is that economic growth abroad is rapidly losing steam. Looking first at the United States, we find that bearish views are suddenly spreading because real GDP in the second quarter of 2011 undershot expectations, and market participants were also disappointed by the July results for the Institute for Supply Management's PMI (purchasing managers' index), an indicator of business confidence. The JCER has also been taking a cautious view of the US economy, and we have now revised our forecast for it further downward.

Over the short term, the US economy should still follow the scenario we have posited. That is, it will succeed in extricating itself from the current soft patch, which is due to such factors as (1) elevated gasoline prices, (2) sluggish automobile sales resulting from severed supply chains, and (3) tornado and flood damage in the South and Midwest. After that, however, the prospects do not look good. Still hobbled by the pressure to balance household budgets, which suffered losses when the housing bubble collapsed, the economy has seen its potential growth rate drop to the 1%–2% range. At the end of 2011, moreover, such stimulus measures as the payroll tax cut and the extension of unemployment insurance benefits are scheduled to run out. The US government now needs to work even harder on reducing federal budget deficits, arranging measures to accompany the agreement on raising the nation's debt ceiling.

Bearish views are also conspicuous in the euro zone. While Germany has been acting to prop up business in the zone, Greece and some other peripheral countries are struggling under heavy government debts, and exports have been hurt by sluggish growth in major trade partners, such as the United States and China.

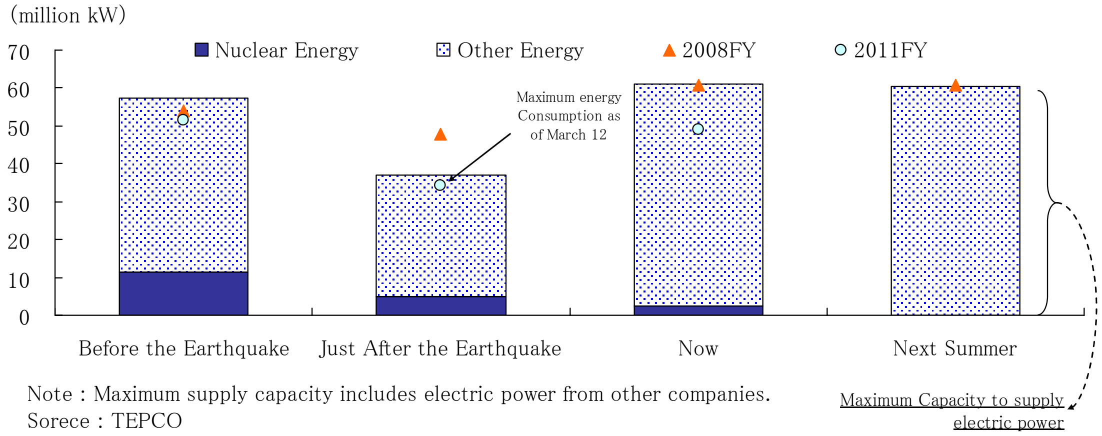
In China, meanwhile, it is likely that growth will further decelerate moving into 2012. With the inflation rate at a high level, the authorities have no choice but to maintain a tight monetary stance. Even if inflation peaks during this summer, enabling a shift toward monetary easing, the outlook will remain basically unchanged because of the time lag between a tighter policy and the impact of that policy on the real economy.

In and after the second half of fiscal 2011, the Japanese economy will enter a phase in which growth, having been freed from supply constraints, is lifted by reconstruction demand. Following this rise in the growth rate, the economy will gradually transition to a cruising speed matching its actual power. If we make the assumption that the government enacts a third supplementary budget around September, government spending will pick up starting in the January–March quarter next year as a result of this budget as well as expenditures under the first and second supplementary budgets.

With reconstruction demand providing fuel, plant and equipment investment will accelerate moving into fiscal 2012. Companies have become more keenly aware of the importance of risk management for coping with earthquakes, and they will be spending money on power generation facilities, data centers, and other backup measures. In fact, moves of this sort are already evident in the statistics on machinery orders in June: Major increases turned up in such machinery categories as motors and heavy electric equipment.

Housing starts are also picking up at present. Partly this is a result of a rush to get construction started quickly, before the "Flat 35S" residential loan, which is for primary housing and offers a preferential interest rate over a certain period, is discontinued

Figure 2. Electric power consumption and maximum supply capacity of TEPCO



Note : Maximum supply capacity includes electric power from other companies.
Sorece : TEPCO

ahead of schedule. Under the circumstances, growth of housing investment for all of 2011 will only be modest. But brisk investment is to be expected in and after 2012 as a result of reconstruction demand.

Once the effect of the special demand for consumer products has worn off, consumption is likely to be sluggish in an unfavorable income environment. The Real Export Index is likely to peak in the July–September quarter, when overseas companies will no longer be under pressure to replenish their inventories, and export growth after that will be dampened by slowdowns in other countries and the strong yen. In this context, consumer prices should remain flat. A projection based on the revised consumer price index shows year-on-year change in the neighborhood of 0%.

From the foregoing, we can understand that growth in Japan heading into fiscal 2012 will be held back by economic downturns overseas and the strong yen. The six-year expansion that began in 2002 was sustained by three props—fast growth in emerging countries, housing bubbles in the West, and a weak yen—but now two of the props have been removed, leaving only the robust demand from emerging markets.

Let me add a word about risk factors. To begin with, there is apprehension that electricity shortages will occur. As of August 19, Japan had 15 nuclear reactors in operation nationwide. It is required that they be shut down once every 13 months for a regular inspection. What would happen if they were not started up again after going out of service? In the area covered by Tokyo Electric Power Co., electricity supply is expected to be tight from late August into September and again in the summer of 2012 (figure 2). We are told that it should be possible to cover shortages in one way or another, making use of thermoelectric plants and other alternative energy sources, but clearly Japan is in a serious situation demanding strenuous efforts to conserve electricity.

In other areas, risks are inherent in the market destabilization resulting from Western governments' delays in coming to grips with their debt problems, in the slowdowns that are likely in other countries, and in the possibility that Japan's government bonds will be further downgraded. If the high-flying yen soars yet higher, moreover, the export industry will take an even harder hit, and that could lead to a decline in domestic investment and production.

But the risk I am most worried about is that the Japanese government and companies may postpone structural reform. There must be no delay in moving forward on structural reform, as is plainly evident from the other risks on the horizon and from the need for progress on related fronts, including crisis management by electric power companies, restoring public finance to health in both Western countries and Japan, and reforming business operations to enable Japanese firms to respond to changes in the external environment.

Might it not be possible to change the direction of the yen's movement through intervention in currency markets? In the light of the reality that markets have the final say about currency values, the best that can be hoped for is a "smoothing intervention," one that dampens volatility in exchange rates. The fact is that despite the yen's ascent, Japan's terms of trade for capital goods have actually turned for the better as a result of its world-famous technological might. And the transportation equipment industry, which had been intent on expanding production overseas, is now increasing its domestic investment and employment. Rather than hunkering down behind hopes for currency intervention, should we not be thinking about how to turn difficulties into opportunities, moving energetically to make investments and arrange mergers and acquisitions in other countries?

The earthquake, tsunami, and strong yen have placed the Japanese economy in the most difficult position it has ever faced. Recovery and reconstruction are at a turning point between simply restoring the nation to its former state or creating a new and bright future. Our ability to act is now being put to the test.

(The original Japanese article posted in the August 25, 2011 issue of the Nikkei)

Table. The Outlook for Japan's Economy

Forecast →

	FY2010 1st Qtr	2nd	3rd	4th	FY2011 1st Qtr	2nd	3rd	4th	FY2012 1st Qtr	2nd	3rd	4th	FY2009 Actual	FY2010 Actual	FY2011 Forecast	FY2012 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.1	1.0	-0.6	-0.9	-0.3	1.3	0.6	1.0	0.5	0.2	0.0	0.4	-2.4	2.3	0.4	2.1
Real gross domestic expenditures (year-on-year)	3.1	5.0	2.1	-1.0	-1.0	-0.5	0.7	2.6	3.4	2.2	1.7	1.1				
Private final consumption (qtr.-to-qtr.)	-0.4	0.9	-0.9	-0.6	-0.1	0.5	0.0	0.3	-0.0	0.3	0.3	0.4	-0.0	0.8	-0.3	0.8
Private housing investment (qtr.-to-qtr.)	-0.1	2.1	2.8	0.2	-1.9	0.6	0.1	0.5	0.2	0.8	1.0	0.9	-18.2	-0.3	0.7	2.0
Private non-residential investment (qtr.-to-qtr.)	2.4	1.1	0.1	-1.4	0.2	3.4	1.3	1.9	1.4	1.3	0.8	0.5	-13.6	4.2	3.2	5.9
Public fixed capital formation (qtr.-to-qtr.)	-5.3	-2.2	-5.8	-1.0	3.0	4.5	2.0	6.7	3.0	-3.0	-4.2	-1.8	14.2	-10.0	4.7	5.1
Domestic demand (contribution)	-0.5	1.2	-0.6	-0.7	0.4	0.9	0.6	1.0	0.4	0.1	-0.1	0.3	-2.7	1.4	1.1	1.8
Net exports of goods and services (contribution)	0.3	-0.2	-0.1	-0.2	-0.8	0.5	0.0	-0.1	0.1	0.1	0.1	0.1	0.3	0.9	-0.6	0.3
Exports of goods and services (qtr.-to-qtr.)	6.7	0.7	-1.0	0.0	-4.9	5.2	2.2	1.9	1.9	1.2	1.1	1.0	-9.6	17.0	0.1	7.5
Imports of goods and services (qtr.-to-qtr.)	4.9	2.6	-0.6	1.5	0.1	3.0	2.8	3.3	1.9	0.8	0.3	0.4	-11.0	11.0	6.2	7.5
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.9	0.6	-1.0	-1.5	-1.4	2.1	0.4	0.5	-0.1	0.5	-0.1	0.5	-3.7	0.4	-1.0	1.5
Indices of Industrial Production (qtr.-to-qtr.)	0.7	-1.0	-0.1	-2.0	-4.0	7.7	2.8	1.3	0.7	0.6	0.4	0.2	-8.8	8.9	1.5	5.6
Unemployment rate (%)	5.1	5.0	5.0	4.9	4.8	4.8	4.8	4.7	4.7	4.7	4.6	4.5	5.2	5.0	4.8	4.6
Compensation of employees (year-on-year)	1.2	1.2	0.9	0.6	0.1	-0.0	-1.3	0.3	-0.2	0.3	0.4	0.6	-3.6	1.0	-0.3	0.3
Newly issued government bonds yield 10-years (%)	1.271	1.044	1.045	1.246	1.175	1.052	1.155	1.144	1.134	1.176	1.218	1.260	1.359	1.150	1.132	1.197
Nikkei Stock Average (yen)	10,346	9,356	9,842	10,285	9,609	9,419	9,534	9,449	9,365	9,711	10,057	10,402	9,976	9,951	9,503	9,884
Yen : Dollar exchange rate (yen / dollar)	92.0	85.8	82.5	82.3	81.7	78.1	78.8	79.7	80.2	81.6	82.9	84.3	92.9	85.7	79.6	82.3
WTI Crude oil price (dollar / barrel)	78.1	76.2	85.2	94.6	102.3	94.5	90.3	91.6	92.8	93.5	93.5	93.5	70.7	83.5	94.7	93.3
Domestic corporate goods price index (year-on-year)	0.2	-0.2	1.0	1.7	2.4	2.6	2.0	1.1	0.3	0.7	0.9	0.7	-5.2	0.7	2.0	0.6
Consumer price index (excluding fresh food ; year-on-year)	-1.0	-1.1	-0.8	-0.8	-0.2	0.0	0.2	-0.0	-0.3	-0.1	0.0	0.1	-1.6	-0.9	-0.0	-0.1
Current account / Nominal GDP (%)	3.3	3.7	3.6	2.8	1.6	2.3	2.4	1.8	1.5	1.7	2.3	2.4	3.3	3.4	2.0	2.0
Real GDP of U.S.A. (qtr.-to-qtr.)	3.9	3.8	2.5	2.3	0.4	1.3	2.7	2.4	2.1	2.1	2.4	2.6	-3.5	3.0	1.8	2.2
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real GDP of China (year-on-year)	10.3	9.6	9.8	9.7	9.5	8.8	8.4	8.3	8.7	9.1	9.1	9.0	9.2	10.3	9.0	8.8
													(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 2010 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.
8. The figure of unemployment rate for 4th quarter 2010 is derived by multiplying the 47 prefecture based Jan.-Feb. average by the ratio of the 44 prefecture based 1st quarter average to Jan.-Feb. average.
9. The figures from unemployment rate for 1st quarter 2011 are derived from year-on-year percentage change of the 44 prefecture based series.

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