December 2011

SA148 Short-Term Forecast for the Japanese Economy (2011/10-12—2014/1-3)

The Supplementary Budget Will Prop Up the Recovery
–Stability in Europe Is Crucial for Japan
–Downward Revisions in Capital Investment Present a Risk

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- The recovery will slow for a while with the end of the surge in exports, consumption, and housing investment
- Full-fledged reconstruction demand next year should offset the downturn in external demand
- With no end in sight to the European debt crisis, uncertainties abound

Real gross domestic product (GDP) in the July–September quarter recorded a large annualized expansion of 6.0% over the preceding quarter, returning the Japanese economy to the level it had reached before the earthquake and tsunami of March 11, 2011. The latest indicators show, however, that demand generated by special circumstances for such items as digital terrestrial TVs is now drying up and that slower growth overseas and the strong yen are also exerting a negative impact. With uncertain factors proliferating, can the basic tone of recovery be sustained? Addressing this question, the Japan Center for Economic Research (JCER) performed a new short-term economic forcast, this time covering the period through fiscal 2013 (April 2013 to March 2014) (see the table).

Industrial production in July–September 2011 returned to positive growth for the first time in five quarters, moving 4.3% above the level a quarter earlier, but after an unusually large expansion in May and June, it has now lost some steam. Production growth in the October–December quarter was initially estimated to reach 1.4% based on a forecasting index compiled from data on the outlook among manufacturers, but that calculation did not factor in the flooding in Thailand. Taking production slowdowns of automakers into account, we now estimate that the industrial production index will fall in the October–December quarter by a maximum of 2%.

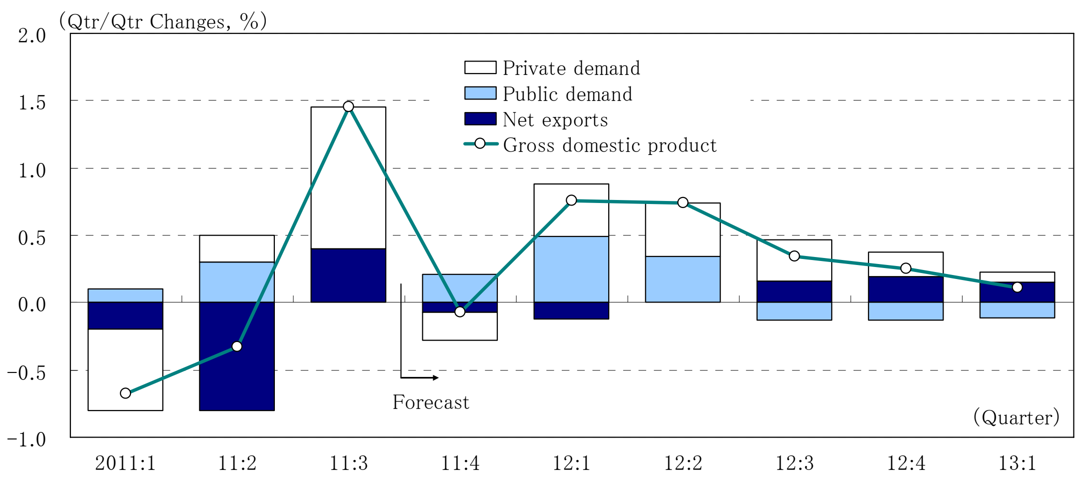
As a result of the deceleration in economies overseas, a downtrend has begun in forecasting indices for electronic parts and devices and telecommunications equipment. Exports are also slumping in the categories of automobile-related products and capital goods and parts. Accordingly, there is a strong likelihood that—although production surged in the July–September quarter—growth will be greatly diminished in the October–December quarter.

One leading indicator for capital investment is orders for machinery (private demand, excluding ships and electric power). In its forecast for the October-December quarter, the Cabinet Office foresees a contraction in machinery orders for the first time in four quarters. Housing investment, meanwhile, is falling back to earth with the end of the "Flat 35S residential loans," which offered preferential interest rates and sparked a housing boom. September saw a month-on-month drop of 20.2% in the number of housing starts. With the boom in special demand for such items as digital terrestrial TVs and energy-conserving appliances tapering off, the private consumption integrated estimates which produces an approximate reading of private consumption in GDP, began a month-on-month decline in July, and it has now lasted three months. Under the circumstances, it is highly likely that the real growth rate will greatly decelerate in the last quarter of 2011.

We nonetheless expect growth to pick up speed in the first quarter of 2012, when public demand will be providing stimulus. On reviewing the content of the third supplementary budget, which was approved by the National Diet on November 21, we estimate that its direct contribution to GDP will be on the scale of ¥6.5 trillion (about ¥1.5 trillion in government final consumption expenditures and ¥5 trillion in public fixed capital formation). Much of the final consumption spending will be for clearing away rubble and decontaminating radioactive materials, and because the government is likely to make these expenditures early on, public spending overall should provide a strong boost to GDP starting in the January–March quarter. Once the cleanup is underway and progress gets going on dispersing budget allowances, not just public spending but also private housing and capital investment should increase.

In the view of the JCER, the real growth rate will be pushed up in the first half of 2012 by full-fledged implementation of the third supplementary budget and the emergence of reconstruction demand, which will offset the weakness of external demand (see the figure).

Figure 1 Contributions to Real GDP Growth by Components



Source: Cabinet Office, *Quarterly Estimates of GDP*

This external demand is a cause for concern. Looking at the situation overseas, we find that the euro-zone economies, which have been hobbled by European debt problems, are moving under a darkening cloud and that the Chinese economy, which is feeling the effects of monetary tightening and other factors, is also losing speed. The euro zone in particular is in poor shape. Because of the sharp decline in the Institute for Supply Management's PMI (purchasing managers' index), an indicator of business confidence, the view is spreading that the region's economies will slip into negative growth in the October–December quarter. The US economy has escaped from the soft patch it encountered in the first half of 2011, but consumption is still being held back by the pressure to straighten out household budgets, which suffered a blow from the housing bubble's collapse.

The foremost concern in the European debt drama at present is whether Greece will be able to redeem its government bonds. There are three hurdles to be cleared on the road to redemption (repurchase of principal amounts). The first will be faced in March 2012 (€14.4 billion), the second in May (€8.0 billion), and the third in August (€7.7 billion). The JCER assumption is that the problems will be surmounted, in one way or another, possibly with the help of financing from the European Union (EU) and the International Monetary Fund (IMF). In that case, the euro-zone economies now facing a growing danger of deceleration should be able to gradually regain their feet in and after the second half of 2012, which will in turn slowly lift the growth rates in China, the United States, and other countries that send many of their exports to Europe.

What this means for Japan is that in and after the second half of fiscal 2012, when the economy will no longer be getting a boost from the third supplementary budget, the downward pressure will be offset this time by renewed growth in external demand. In this scenario, we may expect the flight of funds into yen-denominated assets to reverse direction as the European situation settles down. A trend of moderate yen depreciation would then take hold, adding momentum to Japanese export growth.

With the replacement of domestic demand by external demand as the main engine of growth, the Japanese economy should once again return to the pattern of growth driven by private enterprises and reliant on external demand, particularly in emerging markets and resource-rich countries. It will inevitably be a phase of slow growth, however, as it will invite hikes in prices for energy and raw materials, which will obstruct the functioning of the mechanism by which income and expenditures circulate from the corporate sector into the household sector.

During this period, the overall consumer price index (excluding perishable foods) should rise slightly in fiscal 2013, narrowing the negative gap between supply and demand. Higher prices for energy will be one of the factors involved in the CPI increase.

Finally, I would like to say a word about two risk factors. One concerns future developments in the European debt crisis. At present, yields on Italian government bonds are soaring. No end to the crisis is yet in sight, and that has added a large measure of uncertainty to the premises underlying my analysis in this text.

If Europe's debt problems grow even more serious, the region will encounter a sovereign risk, or a crisis of confidence in government debt. In that case, investors may rush to buy yen, which would present the risk of yen appreciation beyond the boundaries we now anticipate. The JCER forecast assumes that yen appreciation of 10% would depress real GDP by about 0.4%–0.5% over one year. Moreover, a worsening European debt situation would not just influence exchange rates but also throw cold water on overseas economies. And if the contagion spread to France and other key countries, the global financial system could even be destabilized.

The second risk factor is the possibility of a downturn in Japanese capital investment. The Bank of Japan's quarterly tankan (Short-Term Economic Survey of Enterprises in Japan), which provides data on the revisions companies make in their capital investment plans, reveals a pattern of downward revisions in the first half of the fiscal year followed by upward revisions in the second half. Looking at the September 2011 tankan, however, we find that this year companies are making unusually large revisions, indicating that many investment projects have been put off to the second half of fiscal 2011. The amount of spending for the full fiscal year will, accordingly, be strongly influenced by the business climate in the second half.

The business environment has been growing increasingly severe, however, and many companies have made downward revisions in their latest announcements about profit projections for October–December. With the growing uncertainty about the outlook for the European debt crisis and the possibility that the yen will become stuck at a high level, there is a chance that companies have begun to behave even more cautiously. In this situation, capital spending in the second half of fiscal 2011 is not likely to proceed according to the original plans. We will need to keep a close watch on changes in the business environment, as there is a risk that domestic investments will be scaled down in response to future developments.

(The original Japanese article posted in the November 22, 2011 issue of the Nikkei)

Table. The Outlook for Japan's Economy

	FY2011		Forecast →		FY2012				FY2013				FY2010	FY2011	FY2012	FY2013
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	Actual	Forecast	Forecast	Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.3	1.5	-0.1	0.8	0.7	0.3	0.2	0.1	0.2	0.3	0.3	0.3	2.4	0.2	2.1	1.0
Real gross domestic expenditures (year-on-year)	-1.1	-0.0	0.4	1.8	2.9	1.8	2.1	1.4	0.9	0.9	1.0	1.2				
Private final consumption (qtr.-to-qtr.)	0.2	1.0	0.0	0.2	0.1	0.2	0.2	0.3	0.2	0.2	0.1	0.2	1.0	0.3	0.9	0.7
Private housing investment (qtr.-to-qtr.)	-1.1	5.0	-2.0	0.1	0.3	0.8	0.6	0.6	0.0	-0.4	-0.5	-0.4	-0.2	4.0	1.6	0.3
Private non-residential investment (qtr.-to-qtr.)	-0.5	1.1	0.1	1.0	1.7	0.8	0.7	0.7	0.6	0.6	0.5	0.4	4.2	-0.2	3.9	2.4
Public fixed capital formation (qtr.-to-qtr.)	3.7	-2.8	3.1	5.9	6.8	-2.9	-3.2	-3.5	-2.1	-1.7	-1.5	-1.5	-9.8	0.2	7.2	-9.2
Domestic demand (contribution)	0.5	1.0	0.0	0.9	0.7	0.2	0.1	-0.0	0.1	0.2	0.2	0.2	1.5	0.9	1.8	0.5
Net exports of goods and services (contribution)	-0.8	0.4	-0.1	-0.1	0.0	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.9	-0.6	0.3	0.5
Exports of goods and services (qtr.-to-qtr.)	-5.0	6.2	0.3	0.3	0.6	2.1	2.0	1.7	1.2	1.0	0.8	0.8	17.1	-0.3	5.6	5.5
Imports of goods and services (qtr.-to-qtr.)	0.1	3.4	1.1	1.5	0.7	1.5	1.1	1.1	0.8	0.5	0.2	0.1	10.9	5.2	5.3	3.1
Nominal gross domestic expenditures (qtr.-to-qtr.)	-1.5	1.4	-0.0	0.6	0.8	0.1	0.1	-0.2	0.2	0.2	0.3	0.2	0.4	-1.5	1.6	0.5
Indices of Industrial Production (qtr.-to-qtr.)	-4.0	4.3	-0.9	4.1	1.3	0.9	0.4	0.4	0.3	0.2	0.2	0.1	8.9	-2.2	5.9	1.3
Unemployment rate (%)	4.8	4.6	4.5	4.4	4.3	4.3	4.3	4.3	4.2	4.2	4.1	4.1	5.0	4.6	4.3	4.2
Compensation of employees (year-on-year)	0.2	-0.2	-0.1	0.3	0.5	0.8	0.9	0.6	0.3	0.1	0.3	0.2	1.0	0.0	0.7	0.2
Newly issued government bonds yield 10-years (%)	1.175	1.044	0.985	1.021	1.057	1.094	1.130	1.170	1.211	1.252	1.292	1.336	1.150	1.056	1.113	1.273
Nikkei Stock Average (yen)	9,609	9,246	8,587	8,993	9,469	9,659	9,993	10,297	10,476	10,644	10,785	10,970	9,951	9,109	9,854	10,719
Yen : Dollar exchange rate (yen / dollar)	81.7	77.7	76.7	77.5	77.8	78.4	79.3	79.9	81.3	82.3	83.7	84.7	85.7	78.4	78.9	83.0
WTI Crude oil price (dollar / barrel)	102.3	87.1	85.4	87.8	87.9	88.0	89.1	89.2	89.2	89.2	89.3	89.4	83.5	90.6	88.6	89.3
Domestic corporate goods price index (year-on-year)	2.5	2.6	1.9	0.7	-0.4	-0.2	0.4	0.5	0.6	0.7	0.8	0.9	0.7	2.0	0.1	0.7
Consumer price index (excluding fresh food ; year-on-year)	-0.2	0.2	-0.1	-0.2	-0.3	-0.3	-0.1	0.1	0.2	0.3	0.4	0.4	-0.8	-0.1	-0.1	0.3
Current account / Nominal GDP (%)	1.6	2.2	2.0	1.6	1.8	2.1	1.8	1.6	2.0	2.2	1.9	1.7	3.4	1.9	1.8	1.9
Real GDP of U.S.A. (qtr.-to-qtr.)	1.3	2.5	2.4	2.3	2.3	2.2	2.5	2.0	2.4	2.9	3.0	2.8	3.0	1.8	2.3	2.4
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real GDP of China (year-on-year)	9.5	9.1	8.3	8.1	8.6	8.9	9.2	9.1	8.6	8.2	8.0	8.0	10.4	9.0	8.8	8.4
													(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 are at 2010 year basis.
4. Figures for domestic corporate goods price index and indices of industrial production are at 2005 year basis.
5. Figures for GDP components, Compensation of employees, unemployment rate, indices of industrial production and current account are seasonally adjusted.
6. Figures for real GDP of U.S.A. are seasonally adjusted annual rate, at chained (2005) dollars.
7. Japan's fiscal year is April 1 to March 31.
8. Figures for Long-term interest rate, Stock price, Oil price, Exchange rate, and Unemployment rate are shown in average term for corresponding period.

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