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SA149 Short-Term Forecast for the Japanese Economy (2012/1-3—2014/1-3)

# Upturn Stabilizing with Budgetary Support
## –An Early Rebound Expected in the West
## –The Strong Yen May Sap Domestic Demand

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- The supplementary budget will produce results in and after the January–March quarter
- With Western economies stabilizing, export growth will resume in the second half of fiscal 2012
- Expecting too much of monetary policy will lead to excessive liquidity

Despite recovering from the earthquake and tsunami of March 2011, the Japanese economy has remained at a standstill because of difficulties that include stagnant growth overseas, the strong yen, and last year's serious floods in Thailand. The outlook now is that business should soon take a turn for the better as spending under the supplementary budget gathers momentum. The winding down of this spending is likely to have a depressing effect in and after the second half of fiscal 2012 (April 2012 to March 2013), but fresh momentum should come from exports, which are currently still in decline but should recover soon. Having studied the latest data, the Japan Center for Economic Research (JCER) has now performed a new short-term economic forecast for the period through fiscal 2013 (see the table).

Two key factors affect this forecast: reconstruction demand and the prospects of overseas economies. For reconstruction demand, we assumed that it will begin to boost gross domestic product (GDP) in the January–March quarter but then lose steam in the second half of fiscal 2012. The expected paycut for lawmakers and other government officials was taken into account in assessing government consumption. .

Although exports fell by more than 3% for the October–December period compared to the previous quarter, we assume they will regain momentum as we enter the second half of fiscal 2012. This assumption is premised on our outlook for overseas economies, so let me discuss that next.

In Europe, where credit is increasingly tight against the background of the government debt crisis, corporate activity suffered dramatic slowdown until the end of last year. Looking just at the most recent indicators, however, the various steps taken by the authorities seem to have had a positive effect, resulting in stronger market confidence and improved business optimism. The aggressive policy adopted by the European

Central Bank (ECB) to supply liquidity was particularly effective at reassuring the markets, and worries about Greek and Italian government bonds, large portions of which fall due in the February–April period, are now receding. Based on this reading of the current situation, the JCER remains of the opinion that European economies will gradually recover moving into the second half of 2012.

In the case of the United States, the employment environment is steadily improving, and there are signs of an end at last to the drawn-out slump in the housing market, such as upward movement in the business confidence index of builders. Even so, the collapse of the housing bubble put a big dent in household budgets, and the squeeze on household spending is unlikely to end anytime soon. This pressure will continue to shackle consumption, canceling out the asset effect of rising stock prices. Thus while real GDP registered an impressive gain in the last quarter of 2011, we expect the US economy to slow down early in 2012, thereafter growing gradually at a rate of about 2%.

A soft landing seems likely for the Chinese economy, which should register growth of about 8.5%. Last December the People's Bank of China, the nation's central bank, relaxed its fiscal policy by reducing the required reserve ratio for commercial banks. Because it is still on guard against renewed inflation, however, any further movement in the direction of monetary relaxation is likely to be slow.

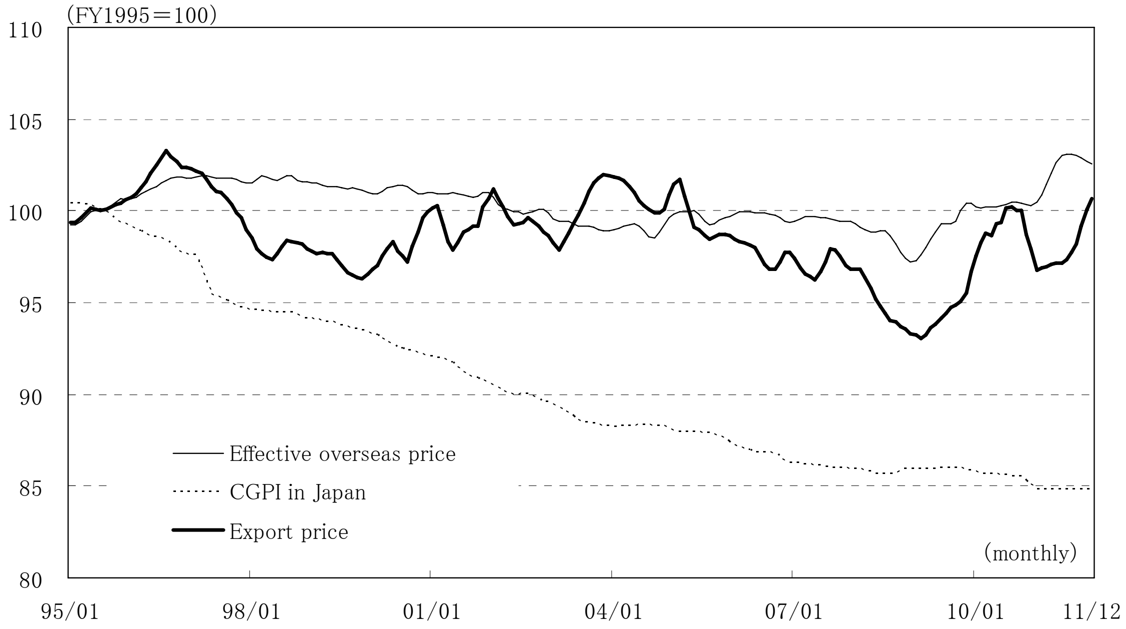
What about domestic demand in Japan? The JCER expects capital and housing investment, which had been rather sluggish, to recover gradually as reconstruction demand gains prominence. Consumer spending should also hold steady, given a slight but continuing improvement in the income picture. For our projection, we assumed that the rate of the consumption tax will be raised from 5% to 8% in April 2014. We estimate that real GDP will get a lift of about 0.5 percentage points during fiscal 2013 from the rush to make purchases before the new rate takes effect. This will generate extra demand in such categories as personal consumption and housing investment.

At the same time, a number of risk factors must not be ignored. In the case of exports, the growth trend could be either positive or negative. Needless to say, the main downside risk is the possibility that the debt crisis in Europe will get worse. At a fundamental level, the problems have been caused by an imperfect single currency system and will not go away until reforms are pushed through. A true resolution will probably take years, given the need to devise and implement radical measures such as integrating fiscal management. In the meantime, the markets will inevitably swing back and forth between bullish and bearish assessments of the situation. No doubt we should see the current improvement in market confidence as just one stage on this long road ahead.

But an upward turn is also possible. With many countries continuing to relax fiscal policy, business confidence overseas is improving faster than anticipated. If economies in other countries recover more quickly than expected, external demand could become a positive component in Japan's GDP breakdown for fiscal 2012, rather than a negative component as previously assumed. Automakers in particular would push overseas sales aggressively, seeking to recover the ground lost owing to the earthquake in Japan and the flooding in Thailand. If this scenario unfolds, it is possible that with brisk auto sales leading the way, overall exports will need to be revised upward.

The volume of auto exports is relatively resilient to the strong yen. The accompanying table shows the price index for exported autos (based on contract currencies), the domestic corporate goods price index, and the price index for autos in China, Europe, and the United States (adjusted for the weight of Japan's exports to each market). Together, these figures provide a measure of effective overseas prices. As can be seen, auto export prices move independently from domestic prices; instead, they are linked to the relevant prices in overseas markets. In other words, when Japanese automakers set prices for their exports, they do so after taking prices in destination markets into consideration. Accordingly, auto exports will expand if demand grows in export markets, regardless of how fluctuations in the exchange-rate value of the yen.

Figure 1 Pricing strategy of Japanese automakers




Note: Effective overseas prices are calculated as weighted averages of car prices in US, China and Euro area.
Sources: BOJ, Ministry of finance, CEIC Data Company Ltd.

The figure also suggests two other important points. One is that a stronger yen, can easily create deflationary pressure in Japan as a result of deteriorating corporate profits. Since exporters are influenced by local market prices in their decisions on export pricing, it is difficult for them to increase prices when the yen appreciates. Their profitability therefore suffers a blow if there is a fall in their yen receipts, and this can lead them to cut back on plant and equipment investment and personnel costs.

Numerous studies have shown that Japan has many companies in this position. Indeed, many listed companies are still revising their projected profits for the current business term down. We must therefore acknowledge that within our latest short-term forecast, there is a risk of a downturn in the figures we arrived at for corporate investment and other components of domestic demand.

The other point is that at least in the case of automobiles, there is no rule of uniform price, which states that all identical goods will have the same price no matter where they are sold. The figure makes it clear that different methods are used to determine prices in Japan and overseas markets. It is often claimed that because deflation leads naturally to a stronger yen, action must be taken to end deflation. This argument is based on a misunderstanding, however, since it assumes that exchange rates will move so as to uphold the law of one price for the same goods sold at home and overseas.

In that case, some argue, we must pin our hopes on further monetary relaxation, since something must be done to correct the high-flying yen. Monetary policy is not, however, the correct tool for implementing an exchange rate policy. In the middle of the 1980s the authorities went too far in the direction of easy money in an attempt to stop the yen from rising, and the result was the inflation of Japan's bubble economy. Learning a lesson from this, the government amended the Bank of Japan Law in 1998 to strengthen the central bank's autonomy. Deflation and the strong yen must not be used as excuses for going slow on structural reform. Expecting too much from monetary policy is a recipe for excessive liquidity, which would only cause new bubbles to form. It is difficult to avoid the conclusion that the risk of this kind of eventuality is increasing around the world.

(The original Japanese article posted in the February 21, 2012 issue of the Nikkei)

**Table. The Outlook for Japan's Economy**

Forecast →

| | FY2011 1st Qtr | 2nd | 3rd | 4th | FY2012 1st Qtr | 2nd | 3rd | 4th | FY2012 1st Qtr | 2nd | 3rd | 4th | FY2010 Actual | FY2011 Forecast | FY2012 Forecast | FY2013 Forecast |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Real gross domestic expenditures (qtr.-to-qtr.) | -0.4 | 1.7 | -0.6 | 0.6 | 0.4 | 0.4 | 0.3 | 0.2 | 0.3 | 0.3 | 0.6 | 1.3 | 3.1 | -0.5 | 1.5 | 1.5 |
| Real gross domestic expenditures (year-on-year) | -1.7 | -0.5 | -1.0 | 1.3 | 2.1 | 0.8 | 1.7 | 1.4 | 1.2 | 1.1 | 1.3 | 2.4 | | | | |
| Private final consumption (qtr.-to-qtr.) | 0.3 | 1.0 | 0.3 | 0.2 | 0.1 | 0.2 | 0.2 | 0.3 | 0.2 | 0.2 | 0.1 | 2.2 | 1.5 | 0.6 | 0.9 | 1.2 |
| Private housing investment (qtr.-to-qtr.) | -2.5 | 4.5 | -0.8 | 0.0 | 0.4 | 1.1 | 0.8 | 0.4 | 0.1 | 2.4 | 4.9 | 7.4 | 2.3 | 3.6 | 2.4 | 7.3 |
| Private non-residential investment (qtr.-to-qtr.) | -0.2 | -0.0 | 1.9 | 1.1 | 0.8 | 0.7 | 0.6 | 0.5 | 0.4 | 0.4 | 0.5 | 0.6 | 3.5 | 0.0 | 3.5 | 2.0 |
| Public fixed capital formation (qtr.-to-qtr.) | 6.6 | -1.6 | -2.5 | 1.9 | 6.5 | 2.5 | -0.8 | -2.1 | -3.5 | -3.2 | -2.7 | -1.6 | -6.8 | 0.9 | 7.2 | -8.7 |
| Domestic demand (contribution) | 0.6 | 0.9 | 0.1 | 0.8 | 0.5 | 0.3 | 0.1 | 0.1 | 0.1 | 0.3 | 0.5 | 1.2 | 2.4 | 0.5 | 1.6 | 1.1 |
| Net exports of goods and services (contribution) | -1.0 | 0.8 | -0.6 | -0.2 | -0.0 | 0.1 | 0.2 | 0.1 | 0.2 | -0.0 | 0.1 | 0.0 | 0.8 | -1.0 | -0.1 | 0.4 |
| Exports of goods and services (qtr.-to-qtr.) | -6.2 | 8.6 | -3.1 | -0.1 | 0.7 | 1.4 | 1.6 | 1.0 | 1.4 | 0.4 | 1.1 | 0.7 | 17.2 | -1.9 | 3.2 | 4.4 |
| Imports of goods and services (qtr.-to-qtr.) | 0.3 | 3.4 | 1.0 | 1.4 | 1.2 | 0.7 | 0.6 | 0.5 | 0.4 | 0.5 | 0.7 | 0.5 | 12.0 | 5.2 | 4.5 | 2.1 |
| Nominal gross domestic expenditures (qtr.-to-qtr.) | -1.5 | 1.5 | -0.8 | 1.0 | 0.1 | -0.1 | 0.0 | -0.1 | 0.4 | 0.3 | 0.5 | 1.3 | 1.1 | -2.3 | 0.8 | 1.1 |
| Indices of Industrial Production (qtr.-to-qtr.) | -4.0 | 4.3 | -0.4 | 3.4 | 0.6 | 0.6 | 0.6 | 0.2 | 0.4 | 0.1 | 0.4 | 1.0 | 8.9 | -2.1 | 4.9 | 1.5 |
| Unemployment rate (%) | 4.6 | 4.4 | 4.5 | 4.4 | 4.4 | 4.4 | 4.3 | 4.3 | 4.2 | 4.2 | 4.2 | 4.2 | 5.0 | 4.5 | 4.4 | 4.2 |
| Compensation of employees (year-on-year) | 0.3 | -0.2 | 0.2 | -0.3 | 0.1 | 0.5 | 0.5 | 0.4 | 0.6 | 0.4 | 0.3 | 0.5 | 0.5 | 0.1 | 0.4 | 0.5 |
| Newly issued government bonds yield 10-years (%) | 1.175 | 1.044 | 1.000 | 0.982 | 1.020 | 1.059 | 1.097 | 1.135 | 1.176 | 1.217 | 1.258 | 1.299 | 1.150 | 1.050 | 1.078 | 1.237 |
| Nikkei Stock Average (yen) | 9,609 | 9,246 | 8,581 | 9,010 | 9,367 | 9,433 | 9,647 | 10,019 | 10,144 | 10,264 | 10,383 | 10,557 | 9,951 | 9,112 | 9,617 | 10,337 |
| Yen : Dollar exchange rate (yen / dollar) | 81.7 | 77.7 | 77.3 | 77.5 | 77.7 | 78.5 | 79.3 | 79.6 | 80.3 | 81.1 | 81.9 | 82.6 | 85.7 | 78.6 | 78.8 | 81.5 |
| WTI Crude oil price (dollar / barrel) | 102.3 | 89.5 | 94.1 | 103.4 | 105.5 | 107.5 | 109.6 | 111.7 | 113.8 | 115.8 | 117.9 | 120.0 | 83.5 | 99.0 | 108.6 | 116.9 |
| Domestic corporate goods price index (year-on-year) | 2.5 | 2.6 | 1.5 | 0.4 | -0.7 | -0.5 | 0.6 | 0.6 | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 | 1.8 | -0.0 | 0.7 |
| Consumer price index (excluding fresh food ; year-on-year) | -0.2 | 0.2 | -0.1 | -0.1 | -0.1 | -0.1 | 0.0 | 0.1 | 0.2 | 0.2 | 0.2 | 0.3 | -0.8 | -0.0 | -0.0 | 0.2 |
| Current account / Nominal GDP (%) | 2.8 | 1.6 | 2.3 | 1.5 | 0.9 | 1.0 | 1.4 | 1.6 | 1.4 | 1.8 | 1.9 | 2.0 | 3.4 | 1.5 | 1.2 | 1.6 |
| Real GDP of U.S.A. (qtr.-to-qtr.) | 1.3 | 1.8 | 2.8 | 2.3 | 2.3 | 2.2 | 2.5 | 2.0 | 2.4 | 2.9 | 3.0 | 2.8 | 3.0 | 1.7 | 2.3 | 2.4 |
| | | | | | | | | | | | | | (C.Y.) | (C.Y.) | (C.Y.) | (C.Y.) |
| Real GDP of China (year-on-year) | 9.5 | 9.1 | 8.9 | 8.5 | 8.5 | 8.5 | 8.3 | 8.5 | 8.5 | 8.3 | 8.2 | 8.1 | 10.4 | 9.2 | 8.4 | 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 (2005) 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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