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SA152 Short-Term Forecast for the Japanese Economy (2012/10-12—2015/1-3)

Japan's Economy in A Recession, with External Demand Slumping
- Considerable Downward Revisions in Capital Investment Plans Likely
- Recovery Expected in Fiscal 2013

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- Second consecutive quarter of negative growth unavoidable
- Despite a deceptively impressive growth rate, the economy remains weak
- Concerns over a recoil from last-minute spending before the consumption tax hike in 2014

Japan's real gross domestic product (GDP) shrank at an annualized rate of 3.5% during the July–September quarter of 2012. Given the size of this contraction, the view is spreading in markets that the economy has entered a recession. What is the likely outlook for the immediate future? After examining the latest indicators, we at the Japan Center for Economic Research (JCER) have updated our forecast (see table) and the overview through March 2014 is provided in this article.

Let me begin my comments on the October–December quarter with an explanation of "carry-over" effect of the growth rate. Carry-over is a raised platform upon which growth begins over a specified period. For example, setting the average level over the July–September quarter at 100, let us suppose that the level for September alone was 110. In this case, growth during the October–December period will get off to a start on "carry-over." Even if there is no growth during the period, it will finish at the 110 level. This translates into 10% growth from the third quarter to the fourth quarter. In other words, quarter-on-quarter growth measurements will be inflated by 10%.

In fact, growth in the last quarter of this year began on negative carry-over. Most of the indicators used for GDP measurement were unusually low, following a major contraction in September. Among the components of consumer spending, the aggregate domestic supply of durable consumer goods suffered negative growth of 8.2% in September. The aggregate supply of capital goods, a basic statistic used for calculating capital investment, declined by 4.3%, and real exports shrank by 2.6%. The situation is serious, since in each of these categories, considerable growth would be needed for October, November, and December in order to move the average indices for the fourth quarter into positive territory.

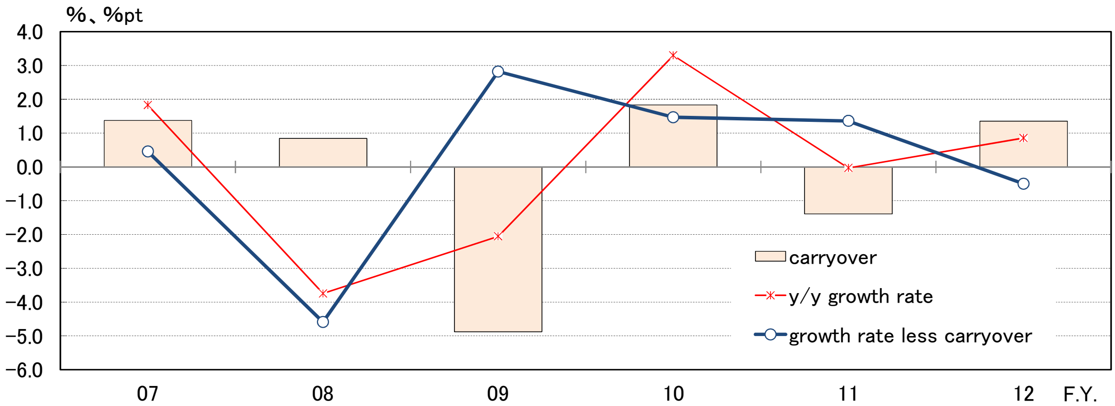
In the category of consumer durables, the subsidies for energy-efficient automobiles came to an end, causing a drag on demand that began in September and is continuing to depress sales during the October–December quarter. In the area of capital investment, a quick rebound is unlikely for reasons I will discuss later. Exports to Europe are expected to continue to decline as a result of the ongoing economic downturn in that region. Exports to China have slumped as a result of China's business slowdown, and their prospects will only grow dimmer if, as expected, Japan-China relations continue to deteriorate.

Such factors make it highly likely that real GDP will suffer a second straight quarter of contraction in the October–December quarter. When we take into account the deterioration in business-cycle indicators, we should probably conclude that the economy has been in a recessionary phase since early spring 2012.

Even if 2012 ends on a negative note, however, we expect a return to positive growth in the first quarter of 2013. Exports to the United States and China should gain momentum, and the GDP results for January-March should get a boost from government spending of reserve funds. The drag caused by the ending of the green-car subsidies should also be less pronounced in 2013. The aftereffects of the two quarters of contraction will linger, however, dragging down the overall real growth rate for fiscal 2012 (April 2012 to March 2013) to a sluggish 0.9%. At a time when the Japanese economy's potential growth rate is said to be only around 0.5%, a growth rate of 0.9% may seem relatively high. But this is a misperception.

The fact is that fiscal 2012 began with a carry-over boost to growth of 1.4%. This came about because growth in the last quarter of fiscal 2011 rose to a high annualized rate of 5.2% on the strength of fiscal stimulus under the third supplementary budget for fiscal 2011. If you remove the effect of the carry-over (1.4%) from the fiscal 2012 growth rate (0.9%), you arrive at negative growth of 0.5%. This measure of growth reflects the change within the year (see figure 1). In light of this, it is even possible that neither the JCER nor the market has adequately assessed the negative aspects of the current business climate. What happens next in terms of capital investment and exports to China will be crucial.

Figure1 Real GDP growth rate and the contribution of carryover



Notes: 1. Carryover = (GDP for the last quarter of the previous year) / (annual <average> GDP for the previous year) ×100 −100

2. Year on year growth rate for F.Y. 2012 is forecast by JCER.

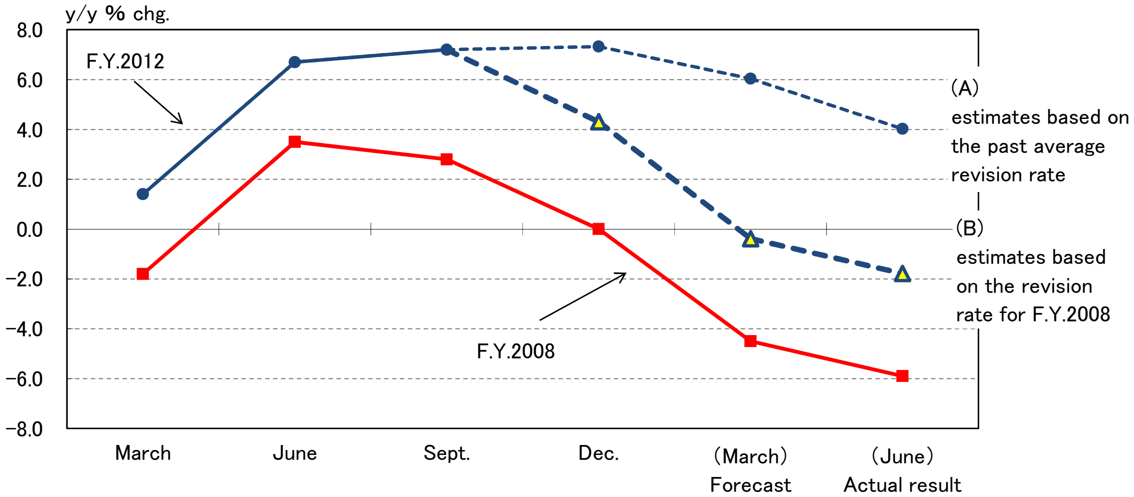
Source: Cabinet Office, "Quarterly Estimates of GDP";

A variety of surveys including the Bank of Japan's quarterly tankan (Short-Term Economic Survey of Enterprises in Japan) have suggested that companies had fairly ambitious plans for investment in plants and equipment during fiscal 2012. In fact, however, the results for the first half of the fiscal year were disappointing: an annualized 3.2% contraction in the GDP figure for real private capital investment. A return to positive growth has probably begun in the second half, but the question is how far the recovery will go.

Figure 2 tracks the revisions to capital investment plans as revealed in each tankan survey. In the average year, the forecasts in the September survey undergo downward revisions in subsequent surveys, starting with the December survey. In fiscal 2012, the September tankan forecast year-on-year growth of 7.2% for fixed investment including software investment (but excluding land-purchasing expenses). If the plans are revised in line with normal patterns, actual growth will be around 4%. It is quite likely, however, that the downward revision will be sharper this year than normal, as a result of a steep drop in profits and an assortment of uncertainties, including worsening Japan-China relations and the "fiscal cliff" in the United States. Although it is unlikely that forecasts will be scaled back as dramatically as they were in the aftermath of the financial crisis in 2008, it would not be surprising to see growth drop virtually to zero.

A cloud of uncertainty also hangs over exports to China. Intermediate goods, capital goods, and parts account for a large share of these exports, and there are signs that the latest wave of anti-Japanese protest is having a more dramatic effect on these sectors than has been the case in previous outbursts of anti-Japanese sentiment in China. Chinese trade data for October show that while overall imports were up on the previous year, imports from Japan were down by about 10%.

Figure2 Revision patterns of Fixed Investment Forecasts (All Enterprises, All Industries: Tankan survey)



Source: Bank of Japan, "*Tankan*, Short-term Economic Survey of Enterprises in Japan."

Despite these risks, the Japanese economy is likely to make a gradual recovery as we move into fiscal 2013.

First, external demand will prop up growth. Although business in Europe will continue to be sluggish for the time being, the US housing market is showing clear signs of genuine recovery. Four years on from the bursting of the housing bubble, house prices have returned to year-on-year growth. Despite the constraining factor of the fiscal cliff, the US economy can be expected to register growth of around 2%–3%. The Chinese economy is also likely to bottom out at a comfortable growth rate in the 7.5%–8.0% range. The effects of the diplomatic tensions in Japan-China relations are also likely to dissipate with time.

Capital investment should also help to contribute to growth, with significant funds held over from fiscal 2012. In the second half of fiscal 2013 the economy should enjoy a temporary lift from a surge in consumer spending and housing investment, as people rush to make purchases before the rate of the consumption tax goes up from 5% to 8% in April 2014. Under the circumstances, we project real growth of 1.2% for fiscal 2013. But because second-half growth is likely to be driven by this last-minute spending, a corresponding rebound in demand is likely to act as a drag on the economy in FY 2014.

But this does not mean that the tax hike should be avoided. Last June the JCER conducted an informal poll of the general public. We found that those who opposed the shift to the new 8% rate are motivated more by mistrust of the government and uncertainty about where the revenue will go than by concern that the hike will hurt the economy. This suggests that authorities should be able to win public acceptance for the measure if they make sincere and thorough efforts to explain the change, rein in the spending spree, and limit the effects of any reaction after the new rate is introduced.

(The original Japanese article was posted in the November 23, 2012 issue of the Nikkei)

Table. The Outlook for Japan's Economy

Forecast →

	FY2012 1st Qtr	2nd	3rd	4th	FY2013 1st Qtr	2nd	3rd	4th	FY2014 1st Qtr	2nd	3rd	4th	FY2011 Actual	FY2012 Forecast	FY2013 Forecast	FY2014 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.1	-0.9	-0.2	0.7	0.2	0.2	0.7	0.9	-2.1	0.4	0.3	0.4	-0.0	0.9	1.2	-0.5
Real gross domestic expenditures (year-on-year)	3.3	0.1	0.3	-0.3	-0.2	1.0	1.9	2.2	-0.3	-0.1	-0.5	-1.1				
Private final consumption (qtr.-to-qtr.)	-0.1	-0.5	-0.2	0.1	0.3	0.0	0.7	2.0	-4.0	1.0	0.2	0.2	1.2	1.0	1.0	-1.4
Private housing investment (qtr.-to-qtr.)	1.5	0.9	1.1	0.5	1.0	4.2	4.7	0.2	-7.4	-8.2	-2.9	2.7	3.8	3.0	7.9	-10.7
Private non-residential investment (qtr.-to-qtr.)	0.9	-3.2	0.9	2.6	0.8	0.2	0.7	1.1	0.4	0.3	0.3	0.3	1.1	1.0	3.2	2.1
Public fixed capital formation (qtr.-to-qtr.)	2.6	4.0	0.9	1.0	-4.5	-2.0	-1.5	-1.7	-0.3	-0.5	-0.4	-0.3	2.9	8.7	-5.0	-3.5
Domestic demand (contribution)	0.2	-0.2	0.0	0.5	0.1	0.1	0.7	0.9	-2.3	0.3	0.2	0.2	1.0	1.6	1.2	-0.9
Net exports of goods and services (contribution)	-0.1	-0.7	-0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	-1.0	-0.7	0.1	0.4
Exports of goods and services (qtr.-to-qtr.)	1.3	-5.0	-1.3	1.4	1.0	1.1	1.2	1.1	1.3	1.3	1.3	1.4	-1.4	-0.5	1.8	5.0
Imports of goods and services (qtr.-to-qtr.)	1.8	-0.3	0.1	0.3	0.4	0.5	0.6	0.8	0.7	0.8	0.7	0.7	5.6	4.7	1.6	2.8
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.3	-0.9	-0.5	0.5	-0.2	-0.0	0.8	0.8	-1.1	0.2	0.4	0.3	-2.0	0.1	0.3	0.3
Indices of Industrial Production (qtr.-to-qtr.)	-2.0	-4.2	-3.2	1.0	0.6	0.6	1.1	1.8	-2.1	0.9	0.3	0.4	-1.0	-4.0	0.1	0.8
Unemployment rate (%)	4.4	4.2	4.4	4.3	4.3	4.3	4.3	4.2	4.2	4.2	4.2	4.1	4.5	4.3	4.3	4.2
Compensation of employees (year-on-year)	-0.4	0.1	-0.3	-1.2	-1.0	-1.2	-0.3	-0.2	-0.4	-0.2	-0.4	0.1	0.1	-0.4	-0.7	-0.2
Newly issued government bonds yield 10-years (%)	0.879	0.789	0.844	0.897	0.930	0.962	0.995	1.036	1.078	1.119	1.160	1.206	1.049	0.852	0.981	1.141
Nikkei Stock Average (yen)	9,026	8,886	8,893	9,208	9,618	9,841	10,158	10,387	10,543	10,929	11,305	11,667	9,183	9,003	10,001	11,111
Yen : Dollar exchange rate (yen / dollar)	80.1	78.6	79.6	79.5	80.7	81.2	82.4	83.5	84.6	85.7	86.8	87.9	79.0	79.5	82.0	86.3
WTI Crude oil price (dollar / barrel)	93.4	92.2	87.2	92.9	94.6	95.6	96.5	97.5	98.5	99.5	100.5	101.5	97.2	91.4	96.1	100.0
Domestic corporate goods price index (year-on-year)	-1.0	-1.9	-0.8	-1.2	-1.1	-0.1	0.3	1.0	3.8	3.8	3.5	3.1	1.4	-1.2	0.0	3.5
Consumer price index (excluding fresh food ; year-on-year)	0.0	-0.2	0.0	-0.4	-0.1	0.2	0.3	0.5	2.5	2.5	2.4	2.4	0.0	-0.2	0.2	2.5
Current account / Nominal GDP (%)	1.3	0.8	0.8	1.0	1.0	0.9	1.3	1.2	1.4	1.3	1.7	1.6	1.6	1.0	1.2	1.6
Real GDP of U.S.A. (qtr.-to-qtr.)	1.3	2.0	2.3	0.8	2.1	2.2	2.3	1.1	2.5	2.5	2.6	1.7	1.8 (C.Y.)	2.2 (C.Y.)	1.8 (C.Y.)	2.0 (C.Y.)
Real GDP of China (year-on-year)	7.6	7.4	7.9	8.3	8.3	8.0	7.9	7.9	7.8	7.7	7.7	7.6	9.3 (C.Y.)	7.8 (C.Y.)	8.1 (C.Y.)	7.8 (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 domestic corporate goods price index and consumer price index are at 2010 year basis.
4. Figures for 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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