February 2013

SA153 Short-Term Forecast for the Japanese Economy (2013/1-3—2015/1-3)

Supplementary Budget and Correction of Strong Yen Will Boost Recovery
- Growth Reversal Possible Late in Fiscal 2013
- To Overcome Deflation, Improving Fixed Wages Will Be Crucial

Nobuyasu Atago
Chief Forecaster, Japan Center for Economic Research

- Exports expected to expand with an improved overseas business climate and the yen's correction

- The demand surge of housing before the consumption tax hike will be alleviated substantially

- The government needs a growth strategy and a push for deregulation rather than relying on supplementary budgets

The October–December quarter of 2012 saw real gross domestic product (GDP) shrink at an annualized rate of 0.4%, making it the third consecutive quarter of contraction. Since Prime Minister Shinzō Abe's new government came to office, however, the overly strong yen suddenly entered a phase of correction, and stock prices began to climb again. Hopes are high for the new administration's policy program. Can we now look confidently forward to a business upturn and an escape from deflation, as the market is expecting?

The chances are good that the January–March quarter of 2013 will indeed see a shift to positive growth. When the Japan Center for Economic Research (JCER) made its latest forecast of the Japanese economy's performance in fiscal 2013 (April 2013 to March 2014), we found that the real growth rate should recover to a level just over 2% (see table). Four background factors will help to bring this about. These are (1) the effect of yen correction and stock price growth, (2) an improved business climate overseas, (3) the impact of economic stimulus measures, and (4) a rush to make purchases before the consumption tax is hiked from 5% to 8% in April 2014. Let us consider them in turn.

Real growth in fiscal 2013 should get a boost of about 0.5 percentage points from the weaker yen and higher stock prices. The yen's correction, which will improve the export picture, will provide most of this lift. As the profits of exporters recover, corporate confidence will strengthen, leading to stepped-up capital investment. The upturn in the performance of businesses should also lead to rising wages and expanding consumption. Improved consumption will be supported by the asset effect of higher share prices and stronger consumers confidence.

But the effects on capital investment and consumer spending are limited in Japan's economy. Reasons for this include the low growth rate anticipated for the economy, a strong corporate inclination to minimize payroll costs, and the small proportion made up by stocks in the financial assets of households.

Economic upturns in overseas economies will contribute to the export expansion. In the United States, it has become clear that the housing market is on the mend. There are also hopes that productivity will be enhanced by the "shale revolution," which will enable increased production from newly unlocked natural gas and oil reserves. Accordingly, the American economy should become more resilient moving forward. A recovery of European economies is not expected until in the second half of this year at the earliest, but it is likely that the Chinese economy has already bottomed out. These recoveries overseas should work together with the yen's correction to drive an increase in exports, which will help to drive the economy during fiscal 2013.

The new government has announced plans for reviving the economy by means of emergency economic measures, which will also give growth a boost. The effects of the supplementary budget soon to be enacted with about ¥5 trillion earmarked for public works should kick in during the April–June quarter and lift the real growth rate for fiscal 2013 by about 0.6 point. The termination of the fiscal stimulus may trigger a reversal around the first quarter of 2014, but that should be offset by the extra demand from last-minute spending before the consumption tax hike.

The FY 2013 tax reform will extend tax breaks for housing loans and increase the size of the deductions. As a result, the rush to complete purchases before the higher tax goes into effect will be alleviated substantially. For families with an outstanding loan balance exceeding ¥30 million, who account for about half of those who purchase houses, the size of the tax break will exceed the increased costs accompanying the lifting of the consumption tax (in the case of a male employee in his forties with a wife who is a full-time homemaker, children who are 15 or younger, and a down payment amounting to 20% of the purchase price). In the area of privately built homes and detached houses built for sale, the JCER calculates that this will cut in half the extent of the rush to complete housing purchases that might otherwise have resulted. The housing loan tax breaks are not available for housing built for rental, however, and a spurt in demand is expected in that sector, probably on the same scale as the housing rush when the consumption tax was last hiked in April 1997.

The foregoing factors should be sufficient for lifting the real growth rate in fiscal 2013 just above 2%, but they will not be enough for vanquishing deflation. To be sure, Japan's measure of the core consumer price index, which excludes fresh foods, will take a small year-on-year step into positive territory in fiscal 2013 thanks to rising energy prices. But the so-called core-core CPI, which excludes energy as well as foods, will remain below zero.

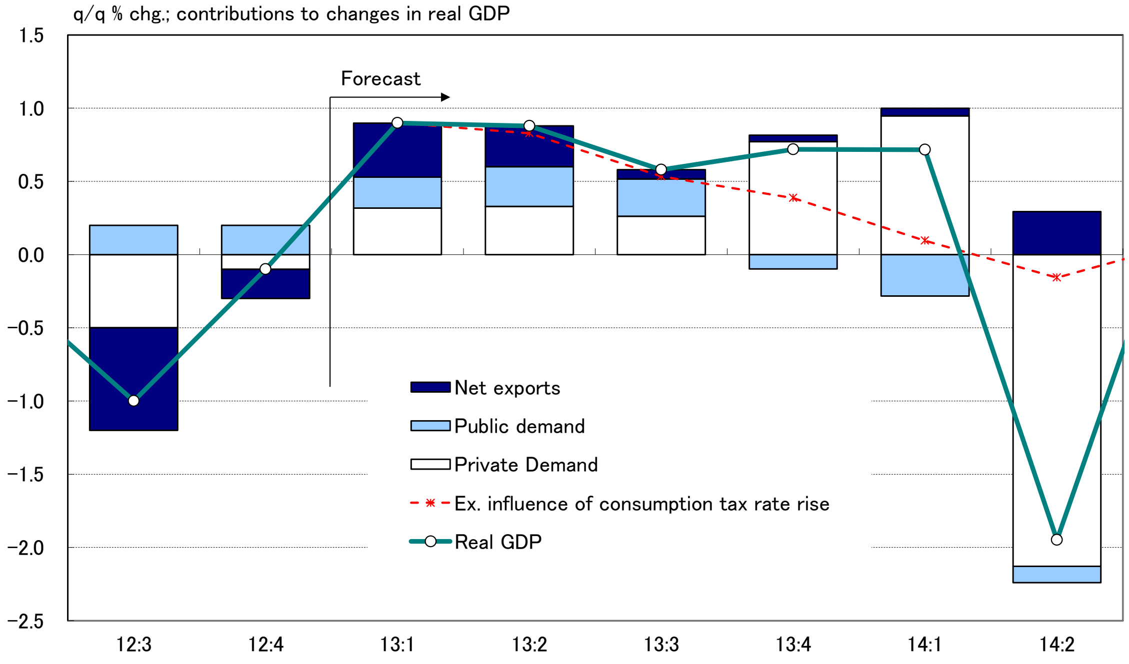
The inflation target of 2% that the Bank of Japan recently set represents a very high hurdle. Not once since Japan's bubble economy collapsed at the start of the 1990s have prices risen that fast. During the six-year expansionary phase that began in January 2002, exports and corporate profits grew with help from a weakening yen, and in fiscal 2007 the gap between supply and demand reversed to an excess of demand. But the recovery failed to have a knock-on effect on household spending, and for many ordinary people there was no tangible sense that the good times had returned. Wages rose only sluggishly, and with resource prices soaring, import prices increased. Under the circumstances, even in fiscal 2007 the core-core CPI shrank by 0.2%.

A larger pipeline from the corporate sector to the household sector is needed to bring deflation to a halt. For this reason, I am in agreement with the view that wages are the key. At the same time, however, it is not hard to understand why companies are reluctant to grant large wage hikes. They cannot easily raise their prices because they have become exposed to global competition with companies in emerging economies. They are also unable to count on sustained expansion in domestic demand. Raising wages, they fear, would only inflate their fixed costs.

Without a sustained business upturn on the horizon, the best companies can do to pass on their improved profits is to make one-time payments to employees in the form of bonuses. But this will probably not be sufficient to get prices moving upward. The precondition for putting deflation to rout is a higher anticipated growth rate coupled with hikes in fixed wages, which are closely correlated with prices. In this light, monetary easing and short-term fiscal stimulus are not enough. The government must also map out a growth strategy, and be bold enough to implement it.

There is another reason for viewing a growth strategy as indispensable. There is a danger that the aggressive monetary and fiscal policies of the new administration represent a double-edged sword. This could end up denting confidence in Japan's currency. The market at present is favorably inclined toward the new administration's stance, sensing that deflation may finally be vanquished. But if market players become doubtful about the realism of the policy program and the determination of the government to push it through, high hopes could turn into disappointment. This could lead to a shift in sentiment from "buy Japan" to "sell Japan." Which way the wind will blow may be determined in the second half of fiscal 2013.

【Forecast of Real GDP Growth Rate and Its Breakdown】



Source: Cabinet Office, "National Accounts."

The JCER has assumed that when the extra spending under the supplementary budget peaks and starts declining in the second half of fiscal 2013, last-minute buying before the consumption tax is hiked will make up for the drop in demand. But what would happen in the absence of a large spurt in spending prior to the hike? The dotted line in the above figure shows our projection of this scenario. As can be seen, the growth rate would sharply decelerate in the second half of fiscal 2013. Of course, the government could take the easy course of enacting another supplementary budget just before the tax goes up, but that would be just one more makeshift policy measure. If the government is to nourish the bullish market mood, it must work quickly to introduce a full-fledged growth strategy and deregulatory program. It needs to show that it is serious about bringing deflation to an end.

(The original Japanese article was posted in the February 22, 2013 issue of the Nikkei)

Table. The Outlook for Japan's Economy

Forecast →

	FY2012				FY2013				FY2014				FY2011	FY2012	FY2013	FY2014
	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.)	-0.2	-1.0	-0.1	0.9	0.9	0.6	0.7	0.7	-1.9	0.6	0.4	0.3	0.3	1.0	2.2	-0.2
Real gross domestic expenditures (year-on-year)	3.8	0.4	0.3	-0.4	0.7	2.3	3.1	2.9	0.0	0.1	-0.2	-0.6				
Private final consumption (qtr.-to-qtr.)	0.0	-0.5	0.4	0.2	0.1	0.0	0.8	2.1	-3.9	1.1	0.4	0.2	1.5	1.4	1.3	-1.0
Private housing investment (qtr.-to-qtr.)	2.2	1.6	3.5	0.6	2.2	2.1	1.8	-1.2	-4.9	-3.9	-1.0	2.6	3.7	4.9	7.1	-7.1
Private non-residential investment (qtr.-to-qtr.)	-0.2	-3.6	-2.6	1.1	1.1	1.2	1.5	1.1	0.3	0.2	0.5	0.8	4.1	-1.5	1.5	2.8
Public fixed capital formation (qtr.-to-qtr.)	6.1	2.5	1.5	3.3	5.8	5.1	-2.2	-6.1	-3.2	-2.9	-0.7	-0.6	-2.3	14.5	11.0	-10.0
Domestic demand (contribution)	0.0	-0.3	0.1	0.5	0.6	0.5	0.7	0.7	-2.2	0.5	0.2	0.2	1.3	1.8	1.9	-0.8
Net exports of goods and services (contribution)	-0.3	-0.7	-0.2	0.4	0.3	0.1	0.0	0.1	0.3	0.2	0.1	0.1	-1.0	-0.8	0.3	0.6
Exports of goods and services (qtr.-to-qtr.)	0.0	-5.1	-3.7	3.0	3.0	1.5	1.5	1.4	1.3	1.3	1.4	1.6	-1.6	-2.0	4.3	5.7
Imports of goods and services (qtr.-to-qtr.)	1.7	-0.5	-2.3	0.6	1.3	1.2	1.4	1.2	-0.6	0.4	0.6	1.2	5.3	3.5	2.4	2.3
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.5	-1.1	-0.4	0.4	0.8	-0.0	0.6	0.7	-0.8	0.5	0.3	0.2	-1.4	0.1	1.1	0.6
Indices of Industrial Production (qtr.-to-qtr.)	-2.0	-4.2	-1.9	3.4	2.4	0.5	0.6	1.5	-1.7	0.8	0.4	0.4	-1.0	-2.8	4.0	0.7
Unemployment rate (%)	4.4	4.2	4.2	4.3	4.1	4.1	4.1	4.1	4.1	4.0	4.0	4.0	4.5	4.3	4.1	4.0
Compensation of employees (year-on-year)	-0.4	0.1	-0.6	-0.3	0.3	0.1	0.3	0.4	0.3	0.1	-0.2	-0.5	0.6	-0.2	0.3	-0.1
Newly issued government bonds yield 10-years (%)	0.879	0.789	0.749	0.767	0.815	0.863	0.911	0.941	0.989	1.037	1.085	1.133	1.049	0.796	0.882	1.061
Nikkei Stock Average (yen)	9,026	8,886	9,209	11,091	11,365	11,711	11,974	12,172	12,350	12,554	12,810	13,146	9,183	9,553	11,806	12,715
Yen : Dollar exchange rate (yen / dollar)	80.1	78.6	81.0	91.7	92.1	92.4	93.5	94.0	94.3	94.7	95.8	96.8	79.0	82.9	93.0	95.4
WTI Crude oil price (dollar / barrel)	93.4	92.2	88.2	96.2	99.8	100.6	100.6	101.2	102.2	103.2	104.2	105.2	97.2	92.5	100.5	103.7
Domestic corporate goods price index (year-on-year)	-1.0	-1.9	-0.8	-0.7	-0.2	0.9	1.4	1.4	4.1	3.8	3.4	3.1	1.4	-1.1	0.9	3.6
Consumer price index (excluding fresh food ; year-on-year)	0.0	-0.2	-0.1	-0.4	0.2	0.4	0.4	0.6	2.5	2.5	2.4	2.4	0.0	-0.2	0.4	2.5
Current account / Nominal GDP (%)	1.3	0.8	0.6	0.8	0.9	0.8	0.9	0.9	1.3	1.4	1.6	1.6	1.6	0.8	0.8	1.3
Real GDP of U.S.A. (qtr.-to-qtr.)	1.3	3.1	-0.1	1.8	2.3	2.5	2.5	1.8	2.7	2.7	2.7	2.8	1.8	2.2	1.8	2.4
													(C.Y.)	(C.Y.)	(C.Y.)	(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	7.8	8.1	7.8
													(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 (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.
9. Estimates for real GDP of U.S.A. and that of China start after 2012.

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
http://www.jcer.or.jp/