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SA154 Short-Term Forecast for the Japanese Economy (2013/4-6—2015/1-3)

Yen Correction and Rising Stock Prices Boost Economic Recovery
- Risk that wealth effect will exacerbate fluctuations in the economy caused by last-minute spending

Nobuyasu Atago
Chief Forecaster, Japan Center for Economic Research

· With share prices rising, the resulting wealth effect and improved consumer confidence should boost household spending

· It remains unclear whether predictions of "a virtuous cycle of production, income, and spending" and inflation expectations will materialize as hoped

· A possible recoil after the tax hike in fiscal 2014, plus decreased liquidity of government bonds caused as a side effect of monetary easing, continue to present risks

During the period January–March 2013, real GDP grew by 0.9% over the previous quarter, up from a 0.3% increase in the previous quarter. This was due to an upswing in exports, helped by steps to correct the high value of the yen and a surge in consumption spurred by a buoyant stock market. Although these patterns are broadly in line with our March forecast, we have made substantial revisions to our exchange rate and share price forecasts in order to take the latest developments into account. We have also revised our real growth rate forecast upwards.

The overly strong yen entered a phase of correction and share prices have been surging since last November 14 when the previous Prime Minister Yoshihiko Noda announced his intention to dissolve the House of Representatives. Improvements in the European debt crisis situation have led investors to abandon euro-selling positions. Foreign investors, particularly US hedge funds, have flocked to the "Abe trade" (sell yen/ buy Japanese stocks) that has come about since Shinzō Abe's government unveiled its "three arrows" policy designed to spur economic growth. This trend of foreign investors buying Japanese stocks has not changed after the Bank of Japan decided at its first Monetary Policy Meeting (April 3, 4) under its new leadership to introduce a "Quantitative and Qualitative Monetary Easing (QQE)" policy.

The bank exceeded market expectations by unveiling a QQE program that was far larger than expected, described as "monetary easing on a different dimension." As the bank's new governor Haruhiko Kuroda said at a press conference after the meeting: "We have taken all the necessary measures at this time."

Following the implementation of QQE, bond market prices have been volatile, with some investors worried that massive purchases by the Bank of Japan might kill off market liquidity in government bonds. There are also concerns about the details of the bank's schedule for its bond purchases. The yield curve for government bonds is in a bear-flattening phase—contrary to the BOJ's intentions. The bank is trying to control the confusion by making smaller but more frequent interventions but these steps have not yet succeeded in completely restoring market stability.

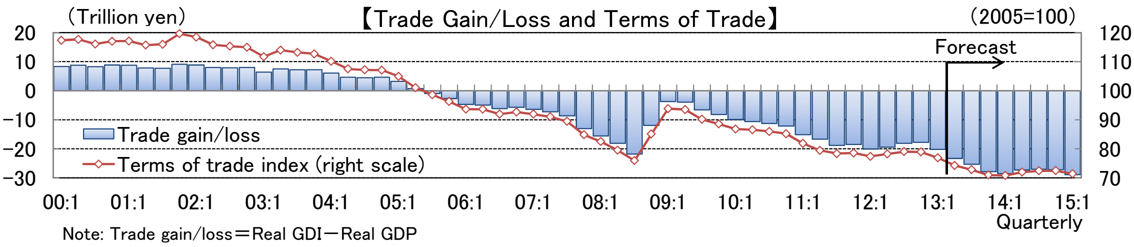
Despite these concerns, the cheaper yen and high share prices spurred by QQE are having a positive effect on company profits and consumer confidence, and these positive effects are outstripping the side effects of increasing long-term interest rates. With more clear-cut differences on easing likely to emerge between the BOJ, determined to press ahead with its QQE policy, and the Federal Reserve Board, where discussions on an exit strategy have already begun, the trend toward a cheaper yen is unlikely to end in the immediate future.

Based on this view, it is likely that share prices will continue to rise. Therefore, as well as revising our forecast for the yen exchange rate downward by around ¥8, we have also decided to revise our predictions for the Nikkei average upward by around ¥2,000 in this forecast. Consequently, an upturn in exports, capital spending, and personal consumption, has led to a rise in the baseline real growth rate excluding the effect of the upcoming consumption tax hike in April 2014. This is the main reason why we have made an upward revision to our forecast for the real growth rate.

Let us take a closer look at the main demand components. First, real export figures turned positive in the January–March period. This was largely due to economic recovery in export destinations, particularly the United States, and a cheaper yen. We expect this trend to continue. However, there have recently been some less promising signs. Real GDP in the Eurozone fell for the sixth consecutive quarter in the January–March period, and in China, the real economy remains weak compared to the expanding money supply. In light of this, we have slightly revised our expectations for the world economy downward. This is why our forecasts for real exports have not increased by much, even though we now expect a substantially cheaper yen. In fact, a cheaper yen does not bring an immediate boost to exports. In many industries such as the auto industry, one of the central pillars of Japanese exports, prices are determined with reference to market prices in importing countries. A cheaper yen does not necessarily result in a dramatic reduction in local retail prices at point of sale.

Capital spending, as already mentioned, is likely to continue to increase, as a result of pent-up demand coming into fiscal 2013 (April 2013 to March 2014), the recent earnings recovery, and expectations of increased profits in fiscal 2013. In the Tankan (Short-term Economic Survey of Enterprises in Japan) issued in March, a 5.9% increase in profits is predicted for fiscal 2013 for businesses of all sizes in all industries. Fixed investment (including land purchasing expenses) has made an adequate start, down by 3.9% on the previous year—the same level as was seen in 2003 and 2004, immediately after the bottoming-out of the economy. From now on, how proactive companies will be on capital spending will depend on whether there is any upturn in expected growth rates. In this sense, the contents of the growth strategy report due to be published in June, along with the extent and quality of government leadership, will be crucial.

Personal consumption is also likely to recover, owing to the wealth effect brought about by a buoyant stock market and improving consumer confidence. The extent of this recovery depends on whether the economy can escape from the bind of losses through negative terms of trade. During the six-year economic recovery from 2002, Japan's real GDP grew at an annual rate of 1.7% on average, and the GDP gap, which was -3.3% in fiscal 2001, became +1.1% in fiscal 2007. However, the boom in the newly emerging economies led to higher oil prices, and a continued surge in the price of imports. This caused Japan's trade losses (the transfer of revenue to resource-producing countries) to increase. Competition with the newly emerging economies also made it difficult for companies to increase payroll spending. This meant that real income did not increase, so the economic recovery brought few tangible benefits to most ordinary people.



Note: Trade gain/loss＝Real GDI－Real GDP

Terms of trade index＝Export deflator / Import deflator × 100

Source: Cabinet Office, "Quarterly Estimates of GDP"

This time, there is no similar boom underway in the emerging economies, and the shale gas revolution is keeping a cap on oil prices. This time around, however, a cheaper yen means higher prices for yen-denominated imports. The government, having learned from experience, has exceptionally asked business leaders to carry out wage increases. This fact, along with the recent upward turn in profits, creates favorable conditions for wage increases; this summer, bonuses are expected to be higher than last year—the first time this has happened in three years. However, the question remains: Will Japan succeed in escaping from the bind of losses through negative terms of trade?

On this topic, we continue to be cautious. Wage increases are particularly difficult for Japan's SMEs, which have high purchasing prices. Even if SMEs go ahead with wage increases, this is unlikely to happen until after the economic recovery, driven by the major export companies, begins to have a ripple effect on their own profits. Therefore, although the pace of consumer recovery will increase somewhat, it is unlikely to deviate substantially from previous recovery patterns.

On the outlook of consumer prices based on the core CPI, we expect the year-on-year growth to be positive from around the middle of fiscal 2013, and that this positive growth will gradually become more pronounced after that. Key factors in this include better balance between supply and demand brought about by the improving economy, and higher energy prices resulting from a cheaper yen. In fiscal 2013, the CPI is expected to be 0.5% higher than last year. In fiscal 2014, this is expected to increase to a 2.6% rise on the previous year. Once we exclude the effect of the tax hike, however, the increase is likely to stand at 0.6%.

Like many economists, we are more cautious in our forecasts than the BOJ's Outlook Report, published in April. This can be accounted for by differences of opinion regarding the likely effectiveness of the "virtuous circle of production, income, and spending" and inflation expectations.

This "virtuous circle" was one of the key terms used during the previous economic recovery in the early 2000s. However, as noted above, at that time terms of trade losses meant that the mechanism did not function effectively, and although the GDP gap moved from negative to positive, this was not enough to lift the economy out of its deflationary spiral. This time too, import prices have been increasing dramatically because of the cheaper yen, and trade losses have deteriorated to the same level as in fiscal 2007.

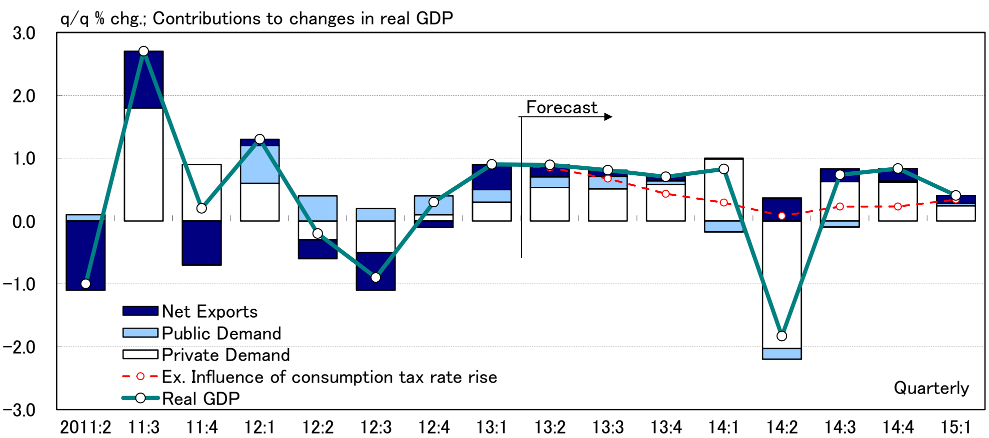
There are doubts about inflation expectations too: do expectations cause inflation, or does actual inflation uplift expectations? The answer is unclear. Further, even if inflation expectations increase along with the consumption tax rate hike, companies will probably find it difficult to make up even for the amount of the tax rate hike alone. Whether any price increases beyond that will be possible remains doubtful. Whatever the case, the forecasts in the Outlook Report should probably be interpreted as a hopeful, optimistic view of what might happen if all the BOJ's policies produce the intended results.

Finally, two points regarding risks. The first concerns the risk of an economic downturn in fiscal 2014. Much uncertainty remains concerning the last-minute demand prompted by the consumption tax hike and the effect of the supplementary budget. If the wealth effect of high stock prices pushes last-minute demand beyond expected levels, the rebound effect of that spending will inevitably be greater. This might well cause a slump in the economy from fiscal 2014 onward. If this is accompanied by a fiscal drag from the supplementary budget, the economic slump could become more serious.

A second concern is the side effects of excessive monetary easing. As noted earlier, the bond markets are already seeing a fall in liquidity in government bonds. At present, the increase in long-term yields is still relatively mild, but if there is large-scale portfolio rebalancing as the economic recovery becomes clearer and investors start to shift their assets from government bonds to company stocks, a steep rise in long-term yields is quite conceivable. In fact, the value-at-risk sell-off crisis of 2003 was triggered by a sluggish response to a new issue of 20-year government bonds against a backdrop of soaring share prices. The BOJ was implementing increasingly aggressive quantitative easing policies at the time.

There is also the risk of a build-up of financial imbalances—which could easily cause a financial bubble. If it takes time to achieve the BOJ's "price stability target" and the QQE continues for longer than anticipated, or if monetary easing is increased beyond the levels we have already seen, this could increase the risk of overheating in the real estate or credit markets. The process by which asset prices suddenly inflate because of a continued policy of excessive monetary easing in the context of limited CPI growth exactly mimics the conditions that led to the real estate bubble of the late 1980s. If an overzealous pursuit of consumer price stability leads to a sharp increase in asset prices, this could have the unintended effect of destabilizing consumer prices.

【Forecast of Real GDP Growth Rate and Its Breakdown】



Source: Cabinet Office, "National Accounts"

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	Actual	Forecast	Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.2	-0.9	0.3	0.9	0.9	0.8	0.7	0.8	-1.8	0.7	0.8	0.4	0.2	1.2	2.6	0.4
Real gross domestic expenditures (year-on-year)	4.0	0.3	0.5	0.2	1.1	2.9	3.3	3.3	0.5	0.4	0.5	0.1				
Private final consumption (qtr.-to-qtr.)	0.2	-0.4	0.4	0.9	0.2	0.1	0.5	2.1	-3.9	1.2	1.0	0.1	1.5	1.6	1.9	-0.7
Private housing investment (qtr.-to-qtr.)	2.3	1.5	3.5	1.9	2.7	2.7	1.8	-0.8	-4.4	-3.2	-1.6	2.5	3.7	5.3	9.3	-6.0
Private non-residential investment (qtr.-to-qtr.)	-0.3	-3.3	-1.5	-0.7	1.7	1.7	1.6	1.5	0.2	0.3	0.6	0.8	4.1	-1.5	2.0	3.2
Public fixed capital formation (qtr.-to-qtr.)	6.3	3.4	2.8	0.8	2.5	4.0	1.0	-3.6	-5.0	-3.0	-0.5	0.1	-2.2	15.2	8.2	-8.5
Domestic demand (contribution)	0.1	-0.3	0.3	0.5	0.7	0.7	0.6	0.8	-2.2	0.5	0.6	0.3	1.3	2.0	2.3	-0.3
Net exports of goods and services (contribution)	-0.3	-0.6	-0.1	0.4	0.2	0.1	0.1	0.0	0.4	0.2	0.2	0.1	-1.0	-0.8	0.4	0.7
Exports of goods and services (qtr.-to-qtr.)	-0.0	-4.4	-2.9	3.8	2.5	2.0	1.9	1.6	1.5	1.5	1.6	1.6	-1.6	-1.3	5.6	6.6
Imports of goods and services (qtr.-to-qtr.)	1.8	-0.3	-2.2	1.0	1.4	1.6	1.7	1.8	-0.8	0.3	0.5	1.0	5.3	3.8	3.5	2.4
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.6	-1.0	0.1	0.4	0.3	0.3	0.3	0.6	-0.4	1.1	0.8	0.1	-1.4	0.3	0.9	1.6
Indices of Industrial Production (qtr.-to-qtr.)	-2.0	-4.2	-1.9	2.2	0.8	1.7	1.1	1.7	-1.7	1.0	0.8	0.7	-1.0	-3.4	2.6	1.8
Unemployment rate (%)	4.4	4.3	4.2	4.2	4.2	4.1	4.1	4.0	4.0	4.0	4.0	3.9	4.5	4.3	4.1	4.0
Compensation of employees (year-on-year)	-0.4	0.1	-0.7	-0.1	0.3	0.1	0.4	0.2	0.3	0.1	0.3	0.2	0.6	-0.3	0.3	0.2
Newly issued government bonds yield 10-years (%)	0.879	0.789	0.749	0.702	0.657	0.796	0.836	0.875	0.914	0.952	1.040	1.127	1.049	0.781	0.791	1.008
Nikkei Stock Average (yen)	9,026	8,886	9,209	11,458	14,061	14,256	14,623	14,866	14,287	14,912	15,240	15,361	9,183	9,612	14,451	14,950
Yen : Dollar exchange rate (yen / dollar)	80.1	78.6	81.0	92.4	99.4	101.8	102.2	103.3	103.7	104.8	105.2	105.6	79.0	82.9	101.7	104.8
WTI Crude oil price (dollar / barrel)	93.4	92.2	88.2	94.4	94.2	93.5	92.3	92.1	91.6	91.0	90.5	90.3	97.2	92.0	93.0	90.9
Domestic corporate goods price index (year-on-year)	-1.1	-2.0	-0.9	-0.3	1.9	3.7	4.4	3.9	5.2	3.9	3.4	3.2	1.4	-1.1	3.4	3.9
Consumer price index (excluding fresh food ; year-on-year)	0.0	-0.2	-0.1	-0.3	0.2	0.5	0.6	0.7	2.6	2.6	2.6	2.7	0.0	-0.2	0.5	2.6
Current account / Nominal GDP (%)	1.3	0.8	0.9	0.6	0.3	0.1	-0.3	-0.3	0.2	0.6	0.8	0.8	1.6	0.9	-0.0	0.7
Real GDP of U.S.A. (qtr.-to-qtr.)	1.3	3.1	0.4	2.5	1.4	2.2	2.5	2.2	3.0	3.0	3.0	3.1	1.8	2.2	1.9	2.5
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real GDP of China (year-on-year)	7.6	7.4	7.9	7.7	7.8	7.6	7.5	7.8	7.8	7.7	7.8	7.8	9.3	7.8	7.7	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.

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/