Monthly Report of Prospects for Japan's Economy

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Macro Economic Research Centre
Economics Department

The Japan Research Institute, Limited
http://www.jri.co.jp/thinktank/research/

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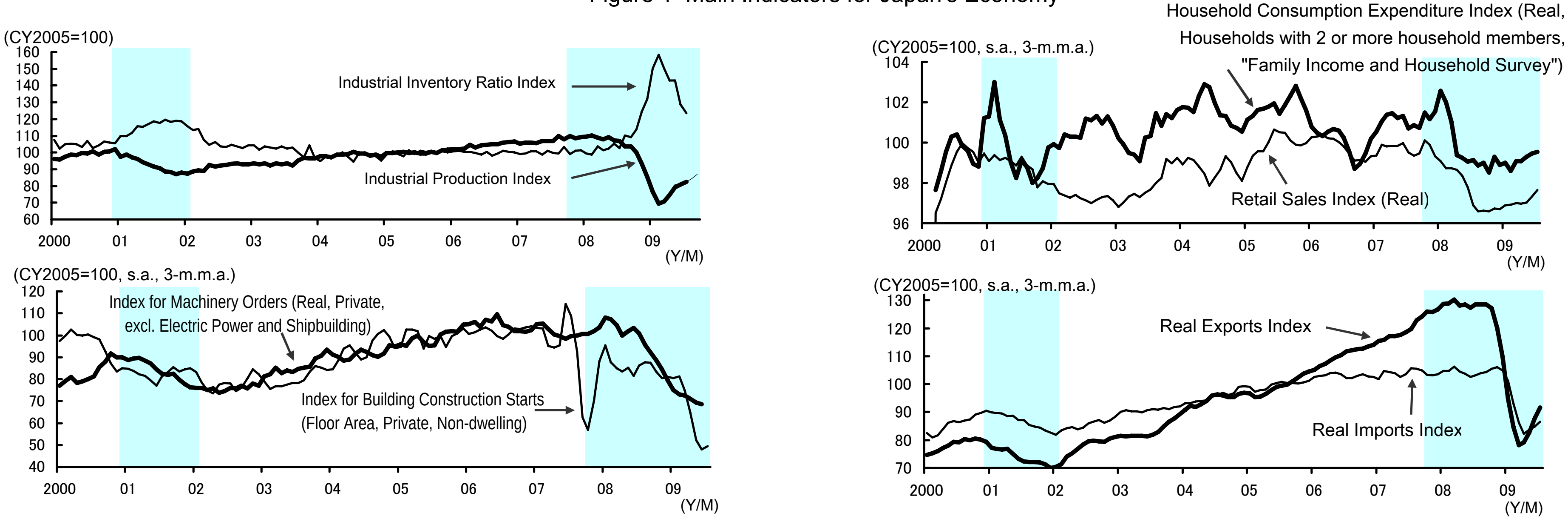
Current situation of Japan’s economy – Continued picking-up mainly in manufacturing

A picking-up continues to be seen in Japan's economy, mainly in manufacturing, although it is still at a low level. Industrial production increased in July, the fifth consecutive monthly rise. The forecast of industrial production for August and September also indicated an increase. If the forecast materialises, industrial production in the July-September period would increase by 8.4 per cent over the previous quarter, the second considerable quarterly rise in a row. In addition, exports have been continuing a recovery trend, driven by those to Asia. The diffusion index for current conditions in the Economy Watchers Survey also continues to show an improving tendency. Reflecting these favourable trends, it is likely that Japan's real GDP in the July-September period will be seen to have grown at a slightly faster pace, as seen in the April-June quarter.

However, downward pressures on the economy still persist. Private consumption on a "Family Income and Household Survey" basis appears to lag behind in recovery, reflecting worsening employment and income environments. Also, machinery orders and building construction starts have been declining considerably, which implies a prolonged adjustment in business fixed investment. Housing starts continue a significant fall as well, chiefly in condominiums.

Figure 1 Main Indicators for Japan's Economy



Source: The Ministry of Economy, Trade and Industry, The Ministry of Internal Affairs and Communications, The Cabinet Office, The Ministry of Land, Infrastructure and Transport, The Bank of Japan.

Note 1: Indices of industrial production and industrial inventory ratio are seasonally adjusted on a monthly basis. Others are calculated as seasonally adjusted and 3-month moving averages.

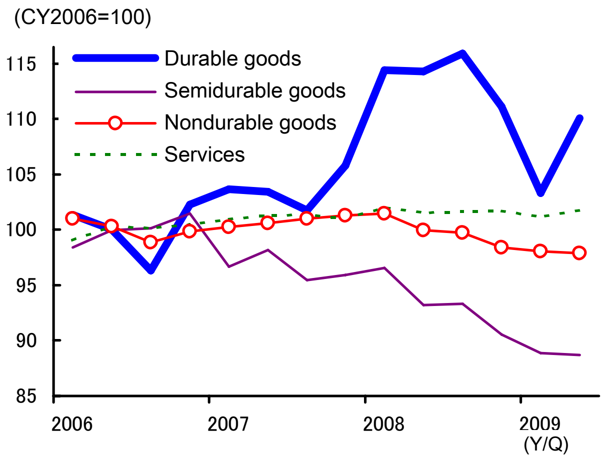
2: The industrial production index in August and September 2009 is based on METI forecasts. 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Recent recovery – Appears to be largely due to economic stimulus measures

It should be noted that the power of autonomous recovery of final demand is still very limited in the recent economic recovery phase. The recovery appears to be, rather, largely due to economic stimulus measures at home and abroad: (1) Private consumption. Demand for durable consumer goods has been expanding sharply, thanks to tax cuts for environmentally-friendly cars and the "eco-points" programme for household appliances. However, demand for other goods has stayed stagnant. (2) Public investment. Public investment has been increasing, reflecting a front-loading execution of the budget for this fiscal year as well as the supplementary budget for last fiscal year. (3) Exports. Exports to Asia of materials for fixed asset investment and of electronic devices for household appliances have been expanding, supported by the economic stimulus measures taken in China.

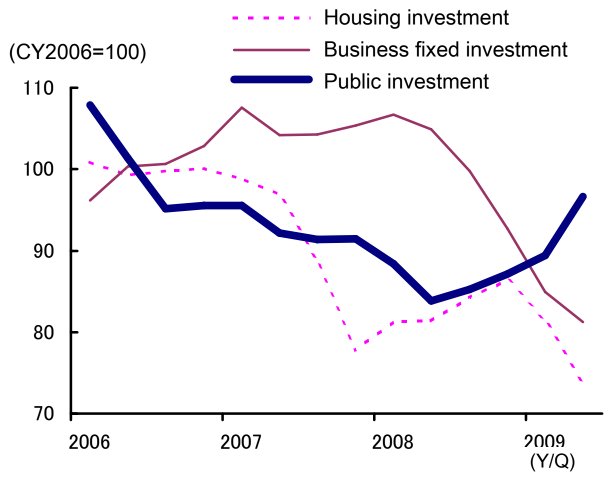
The boosting effect of the economic stimulus measures on the economy is clearly shown in the GDP statistics for this April-June period. It is estimated that the contribution of the measures amounted to 6.1 percentage points in the total real GDP growth rate during the period, 3.7 per cent in the first preliminary GDP estimate (revised to 2.3 per cent in the second estimate). This indicates that the real GDP growth rate has been lifted considerably, although temporarily, by the measures, while Japan's economy continues to follow an underlying downward trend.

Figure 2-1 Private Consumption by the Type of Expenditure Item <real, seasonally adjusted>



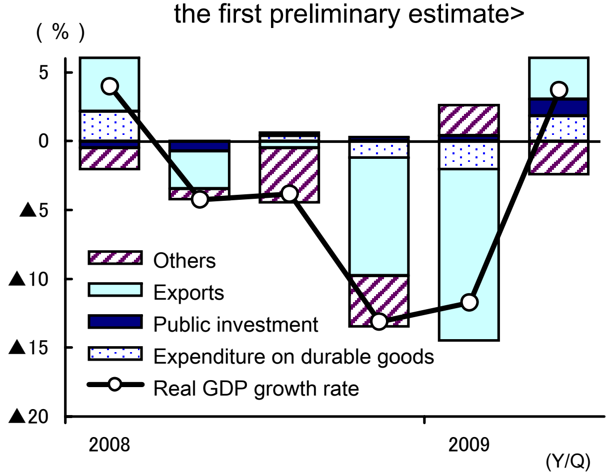
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

Figure 2-2 Fixed Capital Investment by Type <real, seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

Figure 2-3 Contributions to Real GDP Growth <seasonally adjusted, annualised quarter-on-quarter % change, the first preliminary estimate>



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

Exports - Have been bottoming out, yet could be stagnating again

Japan's exports, which had declined rapidly, have been bottoming out. This is mainly due to a recovery in exports to Asia, largely to China.

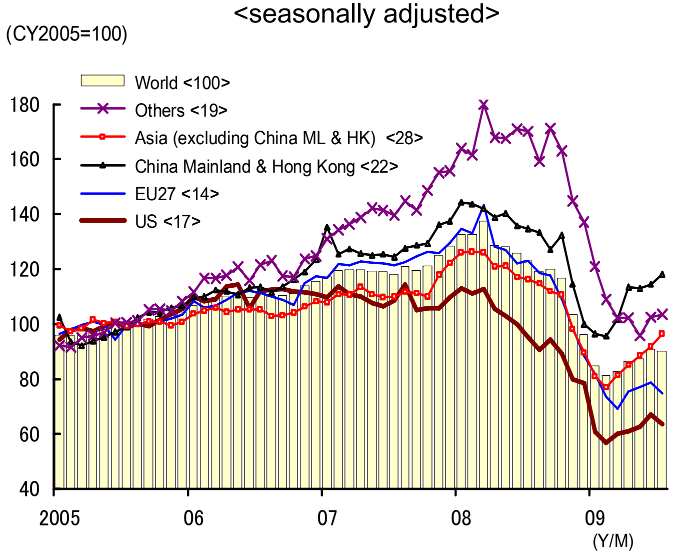
However, even if exports see a slight recovery for the time being, they could face a risk of stagnating noticeably in the second half of this year. It can hardly be expected that exports would turn to a visibly increasing trend, taking into consideration the following three factors:

(1) Exports to the US and European countries seem to be flattening out, yet their momentum is likely to peter out, reflecting protracted economic downturn in these countries. Especially, shipments of industrial machinery for business fixed investment could be falling significantly.

(2) Exports to China, which have been recovering recently, could not be expected to make such a remarkable contribution to Japan's economic recovery as is hoped. Japan's main commodities exported to China are producers' goods (parts) and capital goods. Therefore, if China's exports of manufactured goods to the US and European countries do not recover, Japan's exports to China will not recover in earnest.

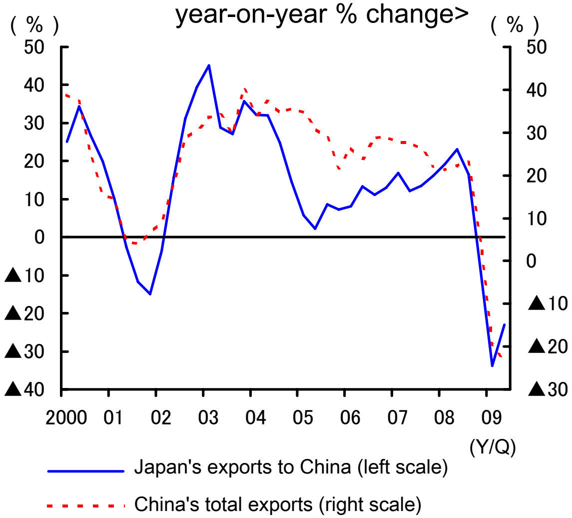
(3) It is expected that negative influences of the yen appreciation since last autumn would be materialising more strongly hereafter. The lag between the start of the yen appreciation and the materialisation of its influences is estimated to be around one year.

Figure 3-1 Japan's Real Exports by Region
<seasonally adjusted>



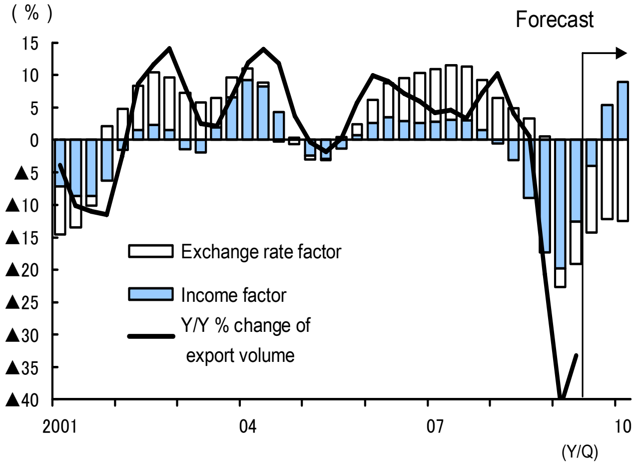
Source: The Ministry of Finance, The Bank of Japan.
Note 1: The figures in angle brackets in the legend indicate the share of each region in total nominal exports of Japan in FY2008.
2: Others: Middle Eastern countries, South American countries, Russia and so on.

Figure 3-2 China's Total Exports and Japan's Exports to China
<denominated in US dollars, year-on-year % change>



Source: The National Bureau of Statistics of China, The Ministry of Finance of The People's Republic of China

Figure 3-3 Estimate of Export Volume Function
<on a year-on-year % change basis>

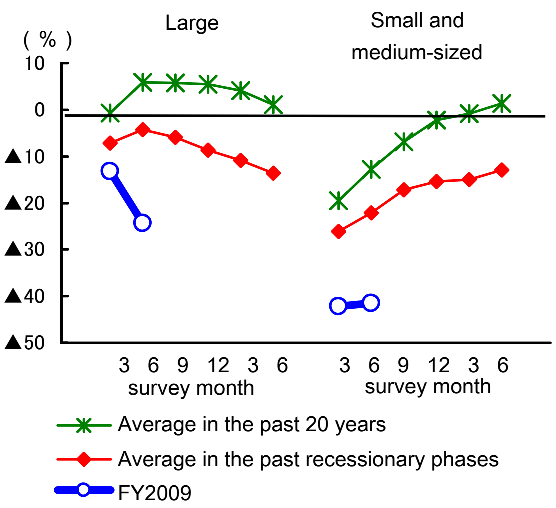


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The OECD, and so on.
Note : The exchange rate factor; the real effective exchange rate of the yen, the income factor; the OECD economic indicator. The assumptions of forecast are by JRI projections

Adjustment pressure (1) - Business fixed investment to decline by heightened sense of excess

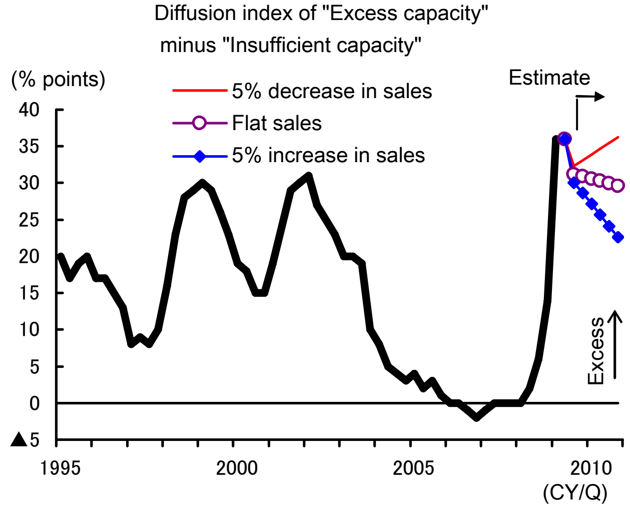
The Tankan June survey indicated a very cautious attitude of enterprises towards business fixed investment during FY2009, compared with that in past recessionary phases. It is expected that business fixed investment will decline by around 30 per cent in FY2009 in both large and small and medium-sized manufacturing. This reflects a heightened sense of excess capacity. The sense of excess capacity in manufacturing is at the highest level ever. Especially, the level of capacity utilisation in transport equipment and general machinery is as low as half of its peak. As it would take a long period of time for the sense of excess to reduce to nearly zero, it is highly likely that the stagnation of business fixed investment will be protracted. An estimate based on a capital stock cycle also indicates the prolonged sluggish situation of business fixed investment. As the expected GDP growth rate has declined sharply, a reduction of excessive capital stock is now needed. For example, given the current level of capital stock, an expected growth rate of zero per cent in GDP in manufacturing implies a decline of 36 per cent year-on-year in business fixed investment. There is a downside risk in business fixed investment in nonmanufacturing as well. It is expected that the attitude of nonmanufacturing towards business fixed investment will be more cautious, mainly in the retailing and services industries, against the background of sluggish domestic demand.

Figure 4-1 Revision Patterns of Business Fixed Investment <manufacturing, year-on-year % change>



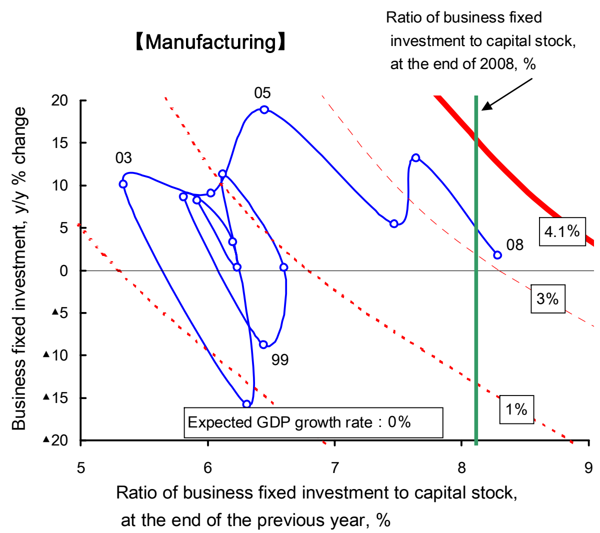
Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan surveys".
Note: Including land, and excluding software investment.

Figure 4-2 Estimate of a Sense of Excess Capacity <manufacturing>



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, The Ministry of Finance

Figure 4-3 Business Fixed Investment and Capital Stock



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

Adjustment pressure (2) - The pace of decline in employment and wages to accelerate

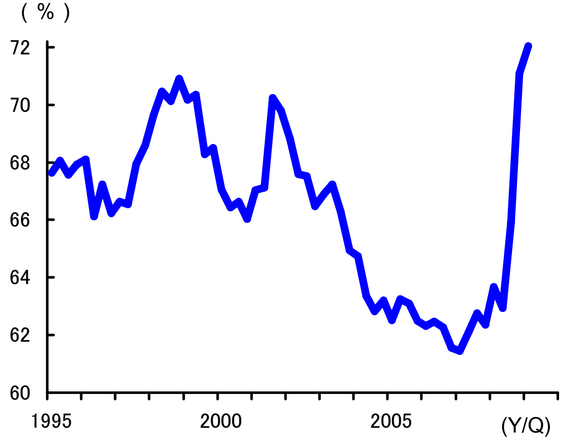
A sense of excess employment has intensified rapidly, against the background of a sharp rise in labour's share. It is, accordingly, expected that a cut-down in personnel expenses in enterprises will be taking place in earnest:

(1) Employment. It is estimated that the excess personnel will reach around two million persons in one year from now, reflecting a recession. The move to reduce employment will be spreading from the firing of temporary workers to a cut in regular employees.

(2) Wages. The amount of bonuses will decrease considerably by two years from now, because of a significant decline of corporate profits. The regular salary payments would also be under considerable downward pressure.

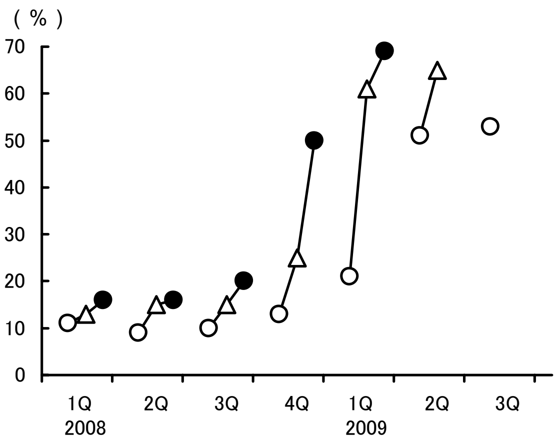
It is predicted that the pace of decline in the total cash earnings of employees will accelerate rapidly hereafter, mainly due to a significant decrease in wages per employee. Therefore, private consumption expenditure will stagnate again from the second half of fiscal year 2009, as the boosting effects of the economic stimulus measures by the government fade out.

Figure 5-1 Labour's Share



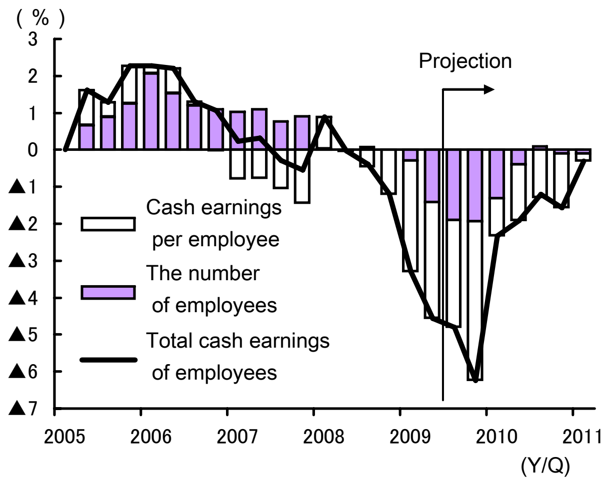
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Figure 5-2 Ratio of Enterprises that Adjusted Employment <manufacturing>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare.
Note: The ratio of enterprises that are planning (○), are to do (△), and actually did (●) an employment adjustment.

Figure 5-3 Total Cash Earnings of Employees <year-on-year % change>



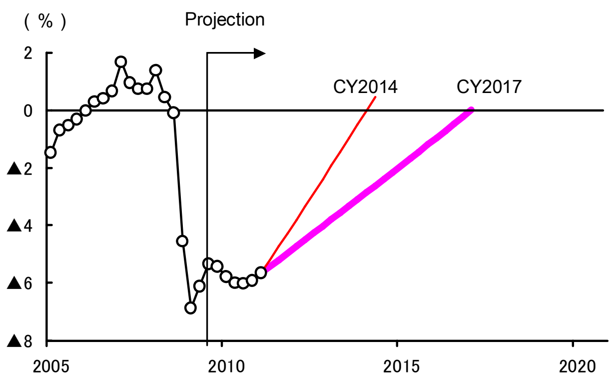
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

Adjustment pressure (3) - The CPI change rate in negative territory; deflationary trend prolonging

The estimated supply-demand gap shown as a percentage of GDP has expanded to over minus 6 per cent recently. Reflecting considerably insufficient demand, it is projected that the year-on-year change rate of the Consumer Price Index excluding fresh food (the core CPI) will continue to stay in negative territory. Further, it is highly likely that the deflationary trend will persist for a long period of time. The long-range estimate shows that the time when the supply-demand gap narrows to zero would be 2014 at the earliest. As long as the gap exists, the downward pressure on prices caused by insufficient demand is also expected to remain.

The trend of deflation appears to have a net negative influence on the economy in the aggregate. It is estimated that the positive effect of the deflationary trend to boost real private consumption expenditure is exceeded by the negative effect to weigh down domestic demand as a whole. In the corporate sector, a fall in selling prices reduces corporate profits, which leads to a decrease in compensation of employees and a decline of business fixed investment. In the household sector, the trend of deflation increases the amount of outstanding debt in real terms, which could lead to the tendency of households to put off their purchases.

Figure 6-1 Long-range Estimate of Supply-Demand Gap Shown as a Percentage of GDP



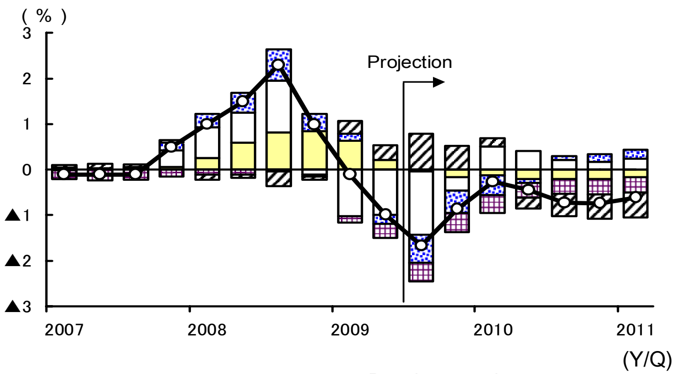
Based on these assumptions: potential output is 1%, and

Continued annual GDP growth rate of 2%

Continued annual GDP growth rate of 3%

Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office,

Figure 6-2 Change in Consumer Price Index on CY2005-base <year-on-year, excluding fresh food>



Food

Petroleum products

Electricity, gas, water charges

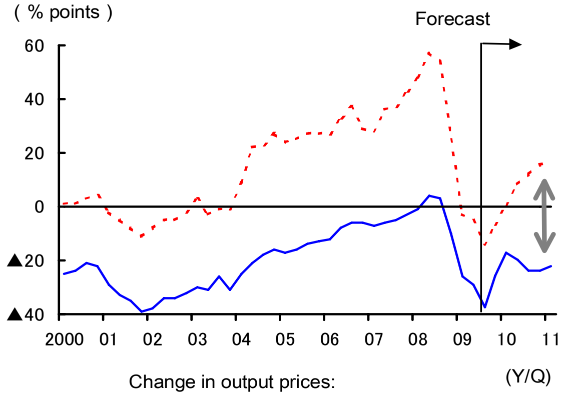
Household appliances, furniture

Others

CPI excluding fresh food (y/y % change)

Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications.

Figure 6-3 Change in the Diffusion Index for Input and Output Prices of Enterprises



Change in output prices: Diffusion index of "Rise" minus "Fall"

Change in input prices: Diffusion index of "Rise" minus "Fall"

Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, 'Tankan Surveys.

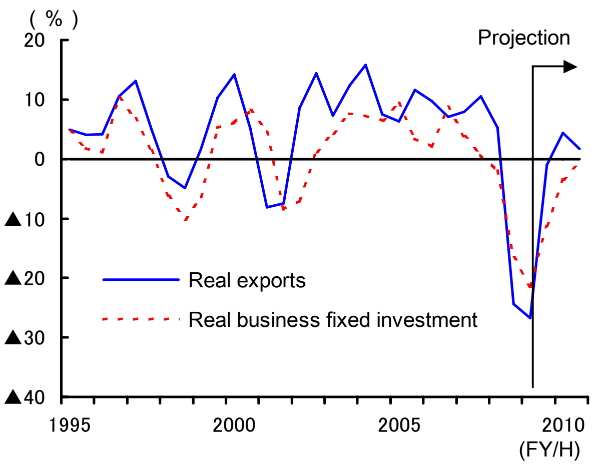
Japan's economic recovery - To depend largely on that of US and European economies

It is basically said that Japan's economy is highly dependent on overseas demand. Business fixed investment and compensation of employees tend to be correlated with exports. Accordingly, the recovery of exports in earnest is the necessary condition for Japan's economy to pick up. In order to see the recovery of exports, an improvement in the US economy especially is needed. The completion of adjustments in the US economy is, therefore, being keenly awaited.

As for the economic measures by the government, these measures should not be expected to have too much effect, taking the following into account: (1) although they have been boosting the economy, their effects are temporary and are expected to fade out before long, and (2) they are insufficient to make up for a recent supply-demand gap of a considerable 6 percentage points of GDP.

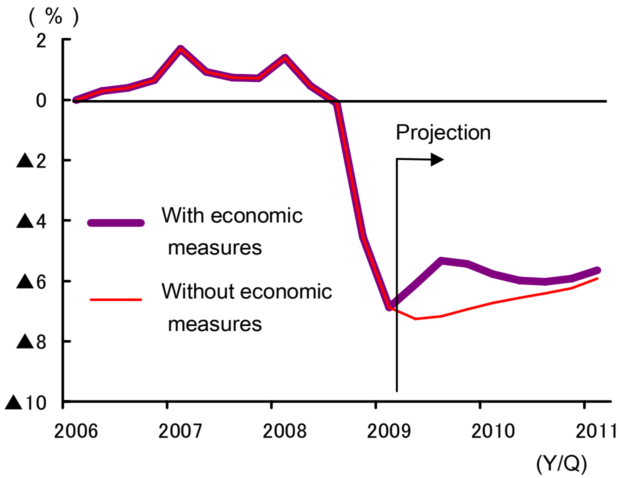
However, it should be noted that the main cause of this sharp downturn of Japan's economy lies in a rapid and significant decline of final demand. The corporate sector has still been maintaining an historically high level of strength in its financial conditions. Therefore, once the US and European economies recover, it is possible that the Japanese economic situation will be improving rapidly.

Figure 7-1 Correlation between Japan's Exports and Business Fixed Investment <in real terms, year-on-year % change>



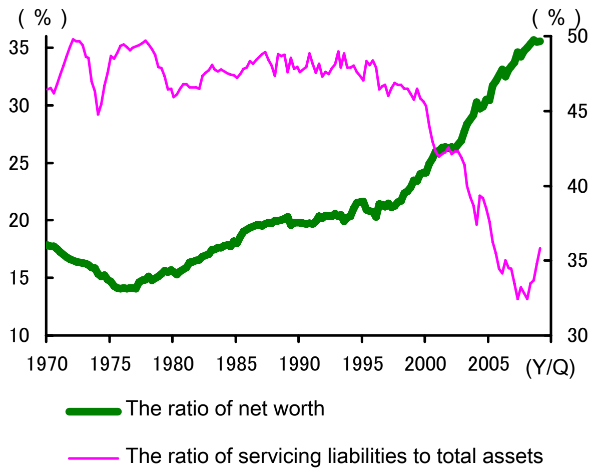
Source: The Cabinet Office,

Figure 7-2 Change Brought About by Economic Measures <supply-demand gap shown as a percentage of GDP>



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office,

Figure 7-3 Financial Conditions of Japanese Enterprises



Source: The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry: Quarterly".

Japan's economic situation- A risk of worsening considerably

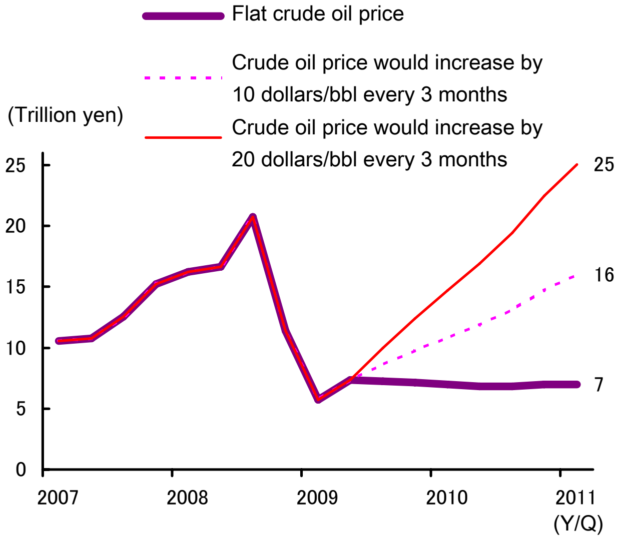
There is a risk that Japan's economic situation could worsen considerably due to the following factors:

(1) A re-rise of the crude oil price. A continued rise of the crude oil price could increase an income shift from Japan to oil-producing countries by a rise in the payment amount for imports. Reflecting weak domestic demand, it appears to be difficult for enterprises to pass the increased costs onto the final product prices. As a result, it is likely that almost all of the increased costs due to the oil price rise would be borne by the corporate sector and, accordingly, would lead to a decrease in corporate profits. Although a certain part of the increased costs would be passed onto the consumer prices of products such as petrol, the shift could lower the real purchasing power of households.

(2) Influences of swine flu. It is possible that a spread of swine flu could impose a significant constraint on movements of people and lead to a sharp decrease in private consumption expenditure. This is implied by the fact that business conditions in the Economy Watchers Survey in the Kinki area, including Kobe and Osaka, declined considerably this May, when the swine flue spread there.

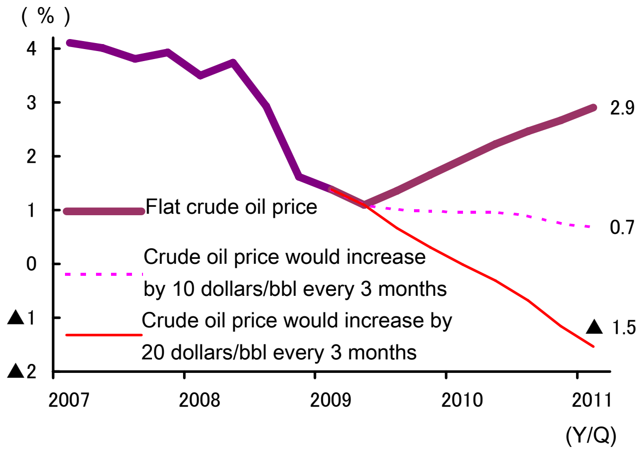
(3) A further sharp deterioration of the US economy. Also, (4) a further appreciation of the Japanese yen.

Figure 8-1 Estimate of the Total Value of Imported Crude Oil <annualised amount>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Figure 8-2 Estimate of the Impact of Crude Oil Price on the Ratio of Current Profits to Sales Amount



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Note: The assumptions for the estimate: The 80% in the total increased costs due to the oil price rise would be borne by enterprises.

Figure 8-3 Estimate of the Impact of a 10% Yen Appreciation on Real GDP, Profits and Price

(%)

	The first year	The second year
Real GDP	-0.4	-0.6
Exports	-1.9	-1.6
Imports	0.9	1.4
Business fixed investment	-0.5	-1.4
Current profits	-4.4	-2.6
Consumer prices	-0.1	0.0

Source: Simulation by The Japan Research Institute, Ltd.

Prospects for Japan's economy - Projected real GDP change; -3.5% in FY2009 and -0.1% in FY2010

(1) A picking-up will be seen more clearly in the Japanese economy, as real GDP in the July-September period will have grown at a slightly faster pace, as seen in the April-June quarter, leading to positive growth for two successive quarters. However, it should be noted that final demand still appears to be fragile, because the recent recovery moves are only a reflection of the boosting effects of economic measures by the government and of the effects brought about by the coming end of inventory adjustment. Accordingly, as these effects peter out, it is projected that the quarterly real GDP growth rate from this October-December period through the second half of next year will follow a quarterly trajectory at a pace considerably below its potential output growth rate, without any strong driving force for the economy. This will lead to minus 3.5 per cent in the real GDP change rate in FY2009, a significant shrinking for two consecutive fiscal years.

(2) A main cause of sluggish economic growth appears to be the stagnation in Japan's exports. The recovery power of exports is expected to remain weak, because exports to the US and European economies, which are under persisting adjustment pressure, would be stagnating again and the negative effect of the Japanese yen appreciation would be materialising gradually. Therefore, it is expected that Japan's exports will be decelerating considerably from this October-December quarter onwards, as the effects of the economic stimulus measures abroad die out.

(3)The unfavourable move in exports is expected to continue having a negative impact on domestic demand. In the corporate sector, it is expected that business fixed investment will be declining considerably, especially in the export industries such as motor vehicles and electronics devices, reflecting a rapid decline in capacity utilisation. The household sector would also feel the pressure of adjustment more strongly, due to sluggish income environments and worsened consumer sentiment. Nominal private consumption expenditure is predicted to see a noticeable decline because of factors such as a decrease in wages, especially in bonuses, growing anxieties about the future employment situation reflecting a sharp increase in unemployment, and so on.

(4) Taking these factors into consideration, it is likely that Japan's economy would undergo a double dip, as the effects of economic stimulus measures at home and abroad fade out. Especially, it is expected that public investment will decline sharply from the beginning of next year and push down the overall real GDP growth rate to a large extent. The reduction in the remaining amount in the execution of the supplementary budget by the new Hatoyama administration could also be a declining factor in the public sector.

(5) The deflationary trend would be seen more visibly. It is projected that the Consumer Price Index excluding fresh food (the core CPI) will see a further year-on-year decline, reflecting a fall in import prices and a widening supply-demand gap.

Figure 9 Projections for GDP Growth and Main Indicators of Japan (as of September 11, 2009)

(seasonally adjusted, annualised % changes from the previous quarter)

	CY2008	CY2009				CY2010				CY2011	FY2008	FY2009	FY2010
	10～12	1～3	4～6	7～9	10～12	1～3	4～6	7～9	10～12	1～3			
	(Actual)	(Actual)		(Projection)		(Projection)				(Projection)	(Actual)	(Projection)	
Real G D P	▲ 12.8	▲ 12.4	2.3	2.8	▲ 0.4	▲ 1.2	▲ 0.7	0.2	0.8	1.5	▲ 3.2	▲ 3.5	▲ 0.1
Private Consumption Expenditure	▲ 2.9	▲ 4.6	3.0	1.9	▲ 0.3	0.2	0.5	0.6	0.7	0.6	▲ 0.5	▲ 0.2	0.5
Housing Investment	10.8	▲ 21.1	▲ 33.0	▲ 19.8	▲ 8.8	0.8	3.4	4.5	5.6	5.9	▲ 3.1	▲ 16.3	0.3
Business Fixed Investment	▲ 25.7	▲ 30.1	▲ 17.9	▲ 7.2	▲ 4.2	▲ 3.3	▲ 2.1	▲ 1.0	0.9	2.5	▲ 9.6	▲ 17.0	▲ 2.0
Private Inventories (percentage points contribution)	(2.4)	(▲ 1.2)	(▲ 2.7)	(▲ 0.1)	(0.2)	(0.0)	(0.0)	(0.1)	(0.2)	(0.4)	(0.0)	(▲ 0.7)	(0.1)
Government Consumption Expenditure	5.5	0.4	▲ 1.3	1.8	0.8	0.4	0.4	0.3	0.2	0.2	0.3	0.8	0.5
Public Investment	8.8	10.5	33.6	21.2	▲ 2.4	▲ 22.9	▲ 21.0	▲ 11.6	▲ 8.6	▲ 3.9	▲ 4.4	12.8	▲ 13.0
Net Exports (percentage points contribution)	(▲ 9.6)	(▲ 6.0)	(5.2)	(2.2)	(0.2)	(▲ 0.0)	(▲ 0.0)	(0.1)	(0.2)	(0.4)	(▲ 1.2)	(▲ 0.8)	(0.2)
Exports of Goods and Services	▲ 44.2	▲ 63.9	28.1	20.4	3.4	1.2	0.4	1.5	2.1	3.9	▲ 10.2	▲ 16.3	2.7
Imports of Goods and Services	10.3	▲ 47.7	▲ 18.9	2.1	2.3	1.8	1.0	0.5	1.1	1.3	▲ 3.7	▲ 14.4	1.3
											(% changes from the same quarter of the previous year)		
Real G D P	▲ 4.3	▲ 8.7	▲ 7.2	▲ 5.5	▲ 2.0	0.9	0.2	▲ 0.5	▲ 0.3	0.4	▲ 3.2	▲ 3.5	▲ 0.1
Nominal G D P	▲ 3.6	▲ 7.8	▲ 6.7	▲ 5.0	▲ 3.3	▲ 2.1	▲ 2.1	▲ 2.1	▲ 2.2	▲ 1.4	▲ 3.5	▲ 4.3	▲ 2.0
GDP deflator	0.7	0.9	0.5	0.6	▲ 1.4	▲ 3.0	▲ 2.3	▲ 1.7	▲ 1.8	▲ 1.7	▲ 0.3	▲ 0.8	▲ 1.9
Consumer Price Index (excluding fresh food)	1.0	▲ 0.1	▲ 1.0	▲ 1.7	▲ 0.9	▲ 0.3	▲ 0.4	▲ 0.7	▲ 0.7	▲ 0.6	1.2	▲ 0.9	▲ 0.6
Industrial Production Index	▲ 14.8	▲ 34.6	▲ 27.8	▲ 18.9	▲ 6.3	20.4	11.7	4.6	2.1	2.4	▲ 12.6	▲ 10.7	5.0
Unemployment Rate (%)	4.0	4.5	5.2	5.8	5.8	5.9	5.9	5.9	5.8	5.8	4.1	5.7	5.9
Current Account Balances (trillion JY)	1.77	2.54	3.08	3.90	3.28	4.41	3.06	3.90	3.49	4.60	12.34	14.68	15.06
Share of Nominal GDP (%)	1.4	2.2	2.6	3.3	2.6	3.8	2.6	3.4	2.8	4.1	2.5	3.1	3.2
Exchange Rates (JY/US$)	96.1	93.6	97.3	94.0	93.0	92.0	90.0	90.0	92.0	94.0	100.6	94.0	91.5
Import Price of Crude Oil (US$/barrel)	79	44	53	72	69	73	77	82	86	90	90	67	84

Source: The Cabinet Office, The Ministry of Internal Affairs and Communications, The Ministry of Economy, Trade and Industry, The Ministry of Finance.
The projection figures are based on those of The Japan Research Institute, Ltd.

Note: The assumptions on overseas economies: the real GDP growth rate during CY2009 would be -2.9% in the US, -4.2% in the euro area and +7.5% in China.