

Monthly Report of Prospects for Japan's Economy

November 2009

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

<http://www.jri.co.jp/thinktank/research/>

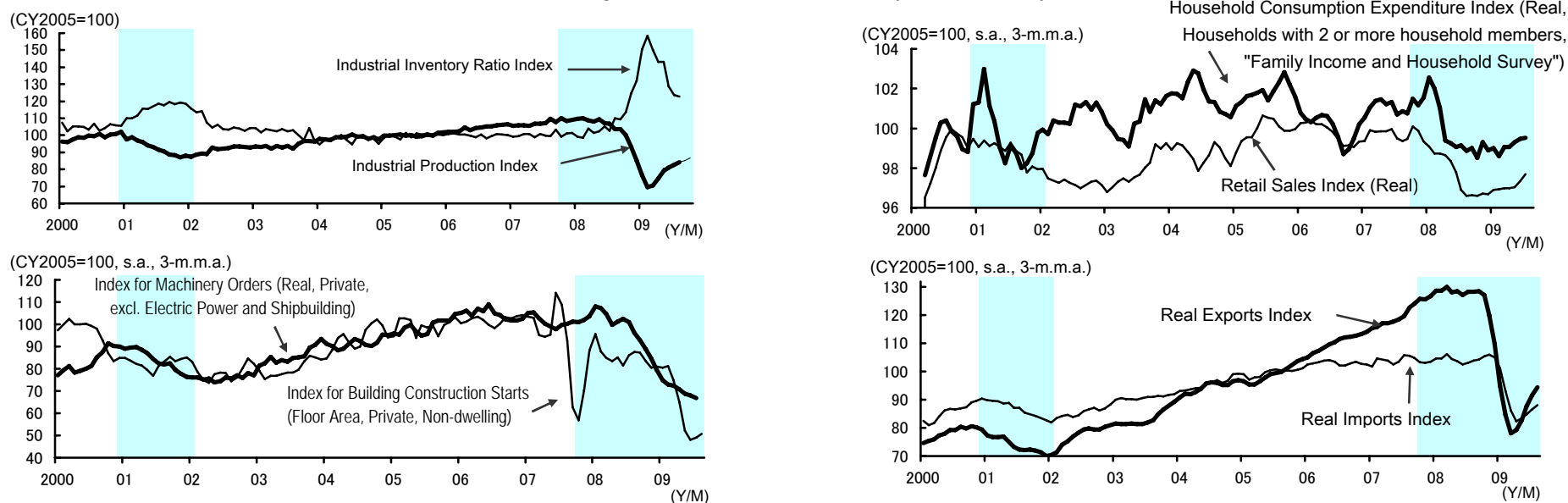
This report is the English version of the October 2009 issue of the original Japanese version.

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 August, the sixth consecutive monthly rise. The forecast of industrial production for September and October also indicated an increase. If the forecast materialises, industrial production in the July-September period would have increased by 7.0 per cent over the previous quarter, the second considerable quarterly rise in a row. A third successive quarterly increase is also likely in the October-December period. In addition, exports have been continuing a recovery trend, driven by those to Asia. Private consumption has been recovering mildly, led by the solid expenditure on durable goods. 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. Employment and income environments continue a worsening trend. Also, machinery orders and building construction starts have been declining considerably, which implies a prolonged adjustment in business fixed investment. Housing starts continue to fall significantly 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 September and October 2009 is based on METI forecasts. 3: Shaded areas indicate periods of recession according to the Cabinet Office.

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Business conditions in Tankan – Have improved mainly in large manufacturing

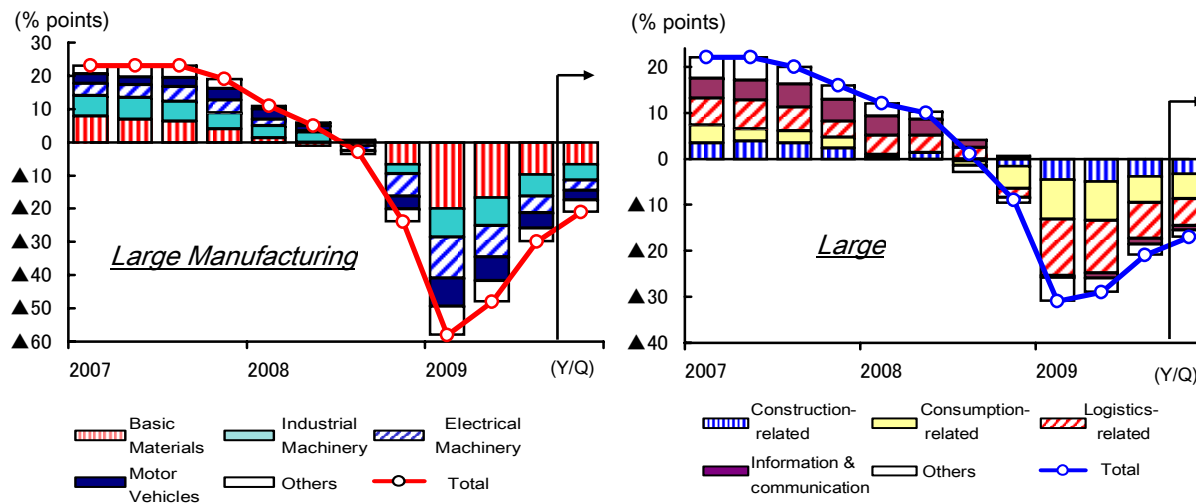
The Tankan September 2009 survey showed that the corporate sector was following a recovery path. However, it also indicated that the survey results of the business conditions were still at a negative level, and domestic demand lacked the strong power for recovery.

The diffusion index (DI) for business conditions (shown as "favourable" minus "unfavourable") in large manufacturing improved by 15 percentage points from the June survey result. The DIs showed an advance in the industries such as electrical machinery, motor vehicles, chemical products and nonferrous metals. Nevertheless, the improvement was not seen in a wide range. The DIs in large nonmanufacturing and small and medium-sized enterprises improved only slightly, compared with large manufacturing. This seems to reflect the situation where domestic demand continues to stagnate on an underlying basis, while industrial production is picking up due to a temporary recovery of overseas demand and an increase in sales of durable goods boosted by various incentives.

The survey results also showed that a sense of both excess production capacity and excess employment stayed at a high level. Therefore, a downside risk to domestic demand is expected, due to a downswing in business fixed investment and through a cut in personnel expenses. In addition, a further downside risk to corporate profits is also predicted because of a worsening in the output / input price ratio, reflecting a lowering of selling prices due to decreased domestic demand and a rise in purchase prices due to resource prices rising again.

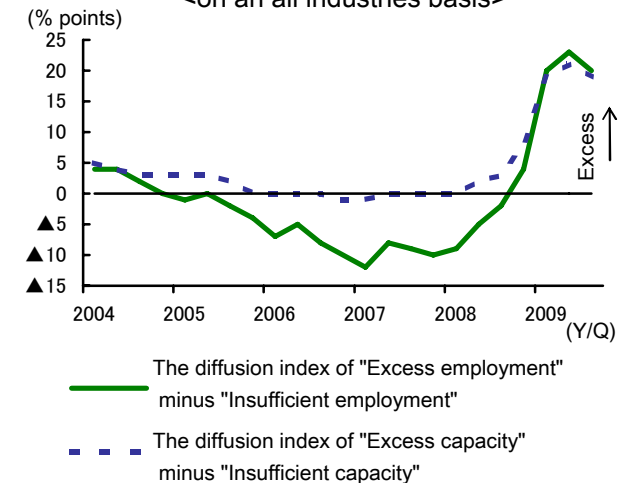
Figure 2-1 Contributions to Business Conditions Diffusion Index by Industry

<diffusion index of "favourable" minus "unfavourable", and percentage point contribution to the total DI points>



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan September 2009 Survey".

Figure 2-2 A Sense of Excess Production Capacity and Excess Employment <on an all industries basis>



Source: The Bank of Japan, "The Tankan Surveys".

Recent recovery – Negative factors also have been materialising gradually

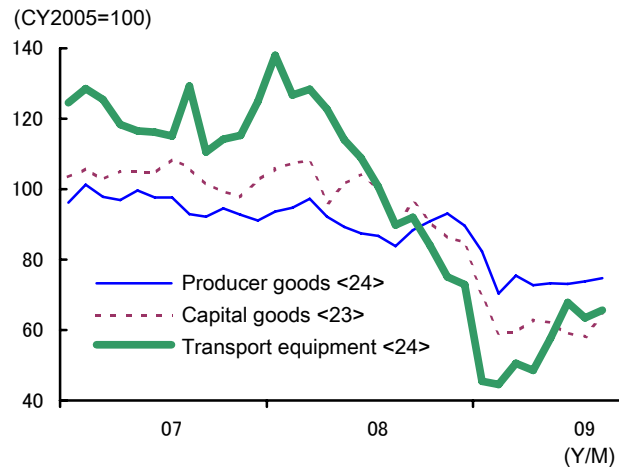
While the economy has been recovering recently, the indicators that show weak economic situations also become to be seen more obviously:

(1) Exports. Exports to the US and European countries are slowing down apparently. Exports of capital goods and producer goods to manufacturing in these countries continue to stagnate, and shipments of motor vehicles are levelling off and could falter.

(2) Production. The revision ratio in the production forecast index in manufacturing has turned negative in many industries. This indicates a likely downward revision to the rates of increase in actual production in this September and October, although the rates are estimated to continue to be positive. The expected downward trend in production in passenger cars and liquid crystal TVs is an especially anxious factor, as the boosting effects of various incentives for purchasing these durable goods will begin to peter out soon.

(3) Private consumption. The sluggish situation in sales of summer goods is proving to be more serious due to the unseasonable weather. Also, a further spread of swine flu has started to weigh on households' expenditure on services.

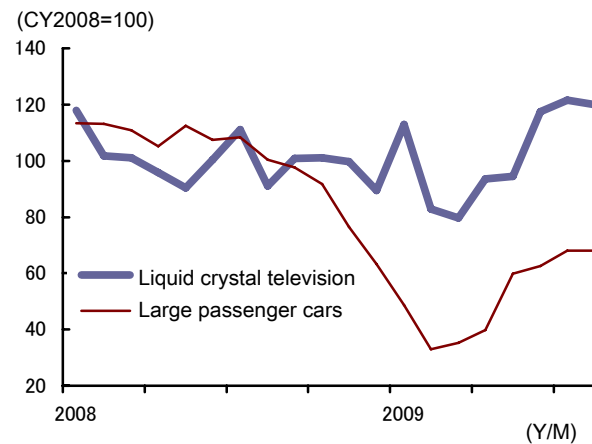
Figure 3-1 Japan's Real Exports to the US
<seasonally adjusted>



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

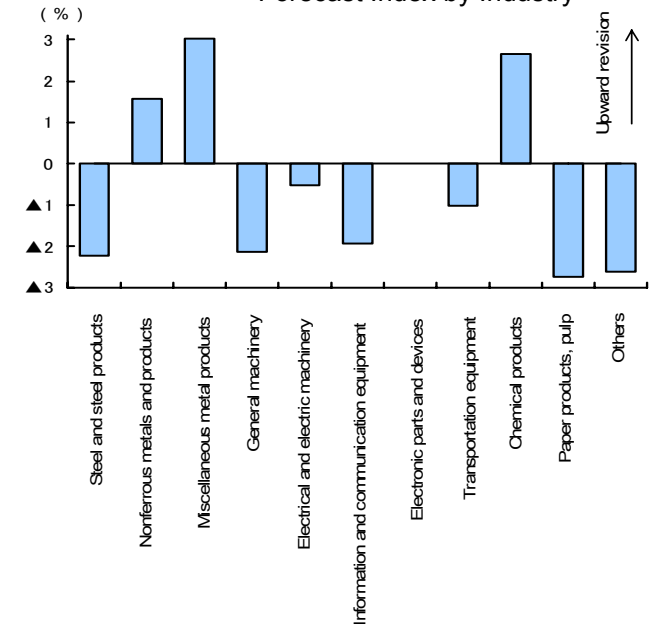
Note: The figures in angle brackets in the legend indicate the share of each type in total exports to the US in FY2008.

Figure 3-2 Shipments of Durable Goods
<seasonally adjusted>



Source: The Ministry of Economy, Trade and Industry.

Figure 3-3 Revision Ratio in Production Forecast Index by Industry



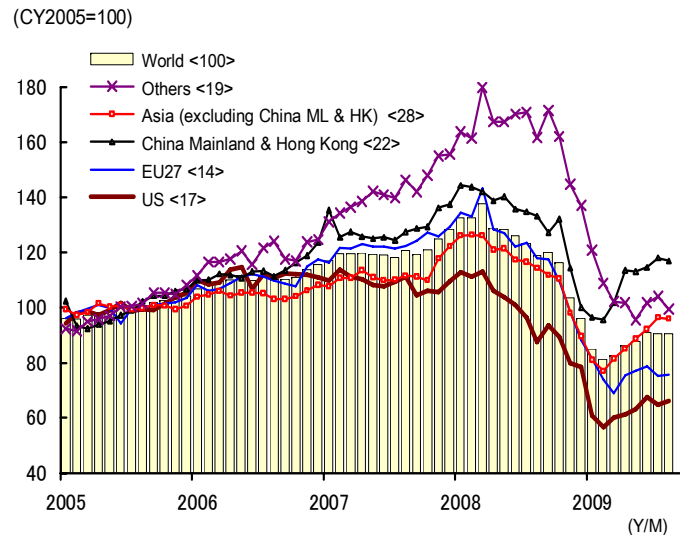
Source: The Ministry of Economy, Trade and Industry.

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, they could face a risk of stagnating again from the second half of this fiscal year onwards. It can hardly be expected that exports will keep their momentum, taking into consideration the following three factors:

- (1) Exports to the US are showing signs of weakening again, reflecting its protracted economic downturn. Especially, shipments of motor vehicles and industrial machinery for business fixed investment are levelling off and could falter.
- (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 producer 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 appreciation of the yen since last autumn will be materialising more strongly hereafter. The lag between the start of the appreciation of the yen and the materialisation of its influences is estimated to be around one year.

Figure 4-1 Japan's Real Exports by Region
<seasonally adjusted>

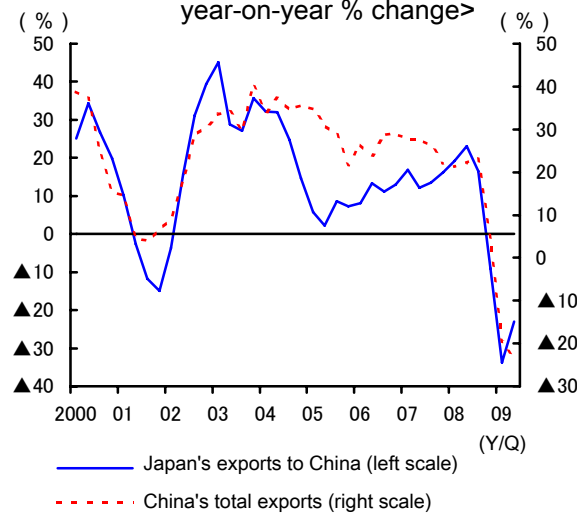


Source: The Ministry of Finance, The Bank of Japan.

Note 1: The figures in angle brackets in the legend indicate the share of each region in total nominal exports of Japan in FY2008.

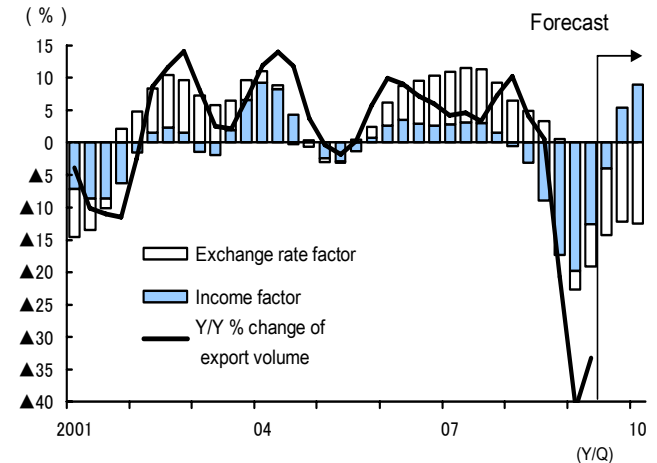
2: Others: Middle Eastern countries, South American countries, Russia and so on.

Figure 4-2 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 4-3 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

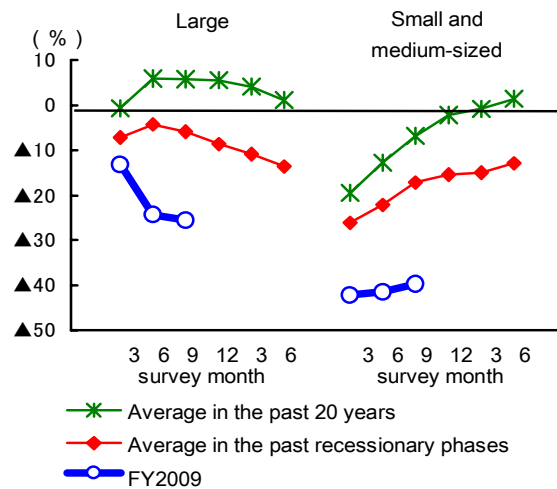
Adjustment pressure (1) - Business fixed investment to fall due to heightened sense of excess

The Tankan surveys indicated a very cautious attitude of enterprises towards business fixed investment during FY2009, compared with that in past recessionary phases. It is probable that business fixed investment in both large and small and medium-sized manufacturing will decline by around 30 per cent in FY2009. This reflects a heightened sense of excess capacity. The sense of excess capacity in manufacturing is at the highest level ever. 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.

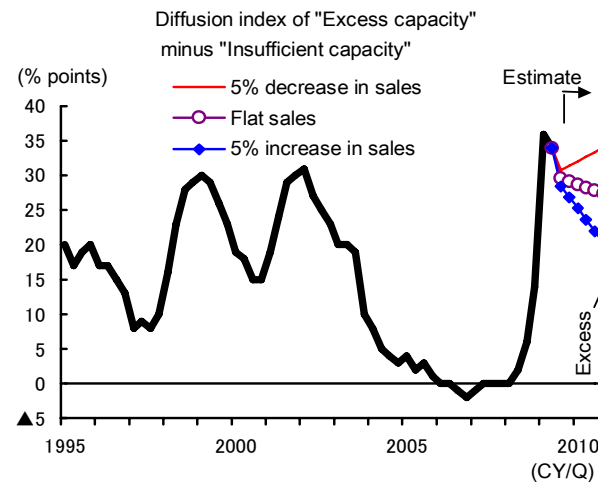
There is a downside risk in business fixed investment in nonmanufacturing as well. It is expected that the attitude of nonmanufacturing towards business fixed investment will be more cautious, mainly in the retailing and services industries, against the background of sluggish domestic demand.

Figure 5-1 Revision Patterns of Business Fixed Investment <manufacturing, year-on-year % change>



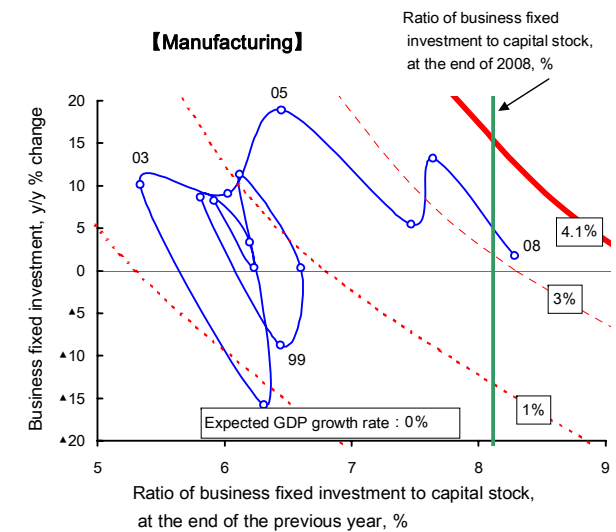
Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan surveys".
Note: Including land, and excluding software investment.

Figure 5-2 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 5-3 Business Fixed Investment and Capital Stock



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

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Adjustment pressure (2) - The decline in employment and wages to continue

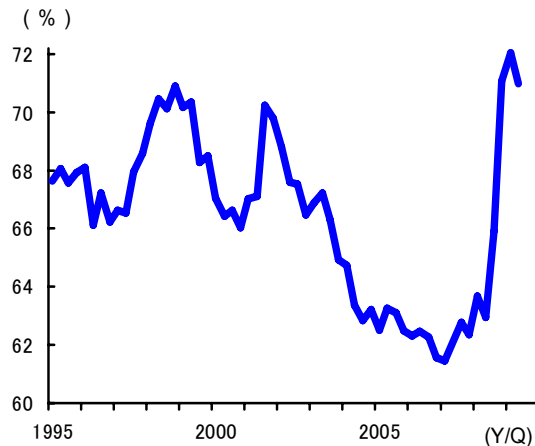
A sense of excess employment has intensified rapidly, against the background of a sharp rise in labour's share. This indicates the situation where a further cut-down in personnel expenses is needed for enterprises, as the current pace of decline in personnel expenses is still slower than that of the fall in sales amount. Accordingly, the tendency in enterprises to curtail labour costs is likely to be prolonged:

(1) Employment. The move to reduce employment will be spreading from the firing of temporary workers to a reduction in regular employees. It is also expected that the unemployment rate will stay at a high level.

(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.

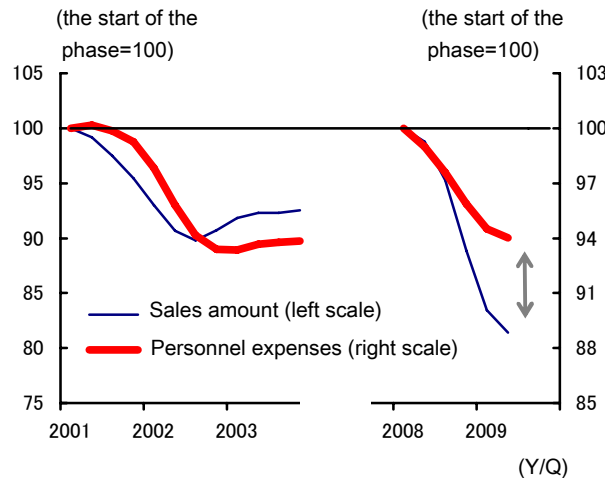
It is predicted that the pace of decline in the total cash earnings of employees will accelerate rapidly hereafter through the end of this year, mainly due to a significant decrease in wages per employee. Therefore, private consumption expenditure will stagnate again from the second half of this fiscal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

Figure 6-1 Labour's Share



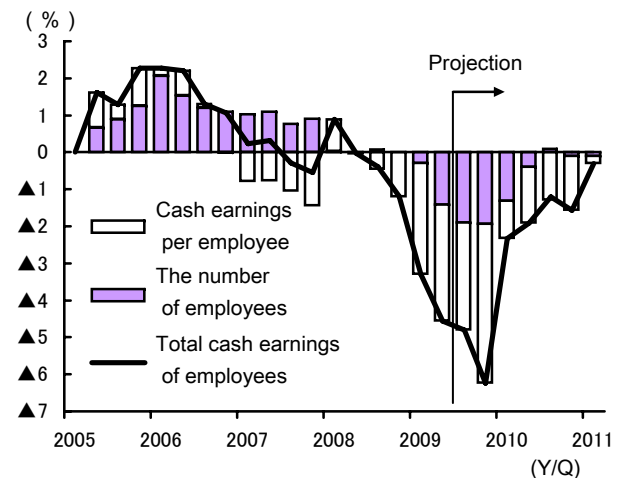
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Figure 6-2 Sales Amount and Personnel Expenses in Recessionary Phases



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

Figure 6-3 Total Cash Earnings of Employees <year-on-year % change>



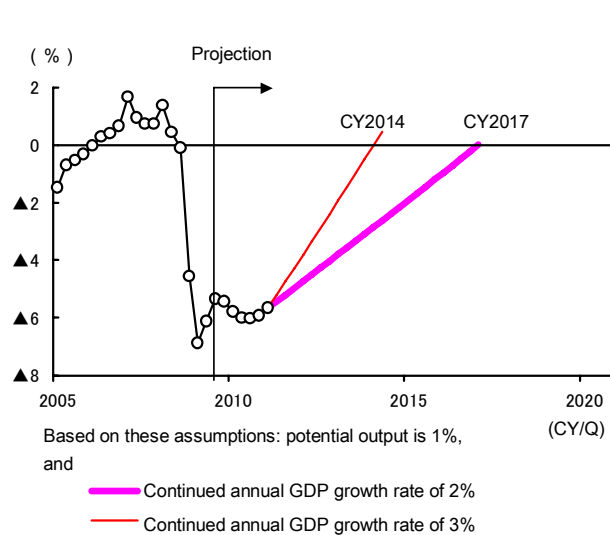
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

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.

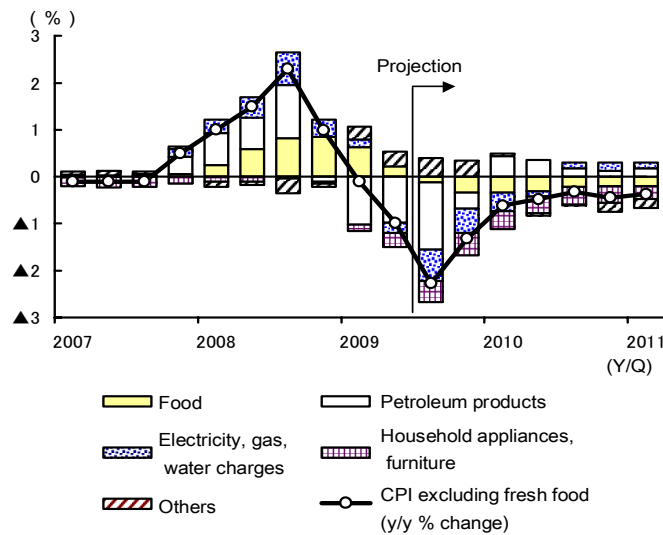
The trend of deflation appears to have a net negative influence on the economy in the aggregate. It is estimated that the positive effect of the deflationary trend to boost real private consumption expenditure is exceeded by the negative effect to weigh down domestic demand as a whole. In the corporate 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, and the tendency of households to put off their purchases could be more noticeable.

Figure 7-1 Long-range Estimate of Supply-Demand Gap Shown as a Percentage of GDP



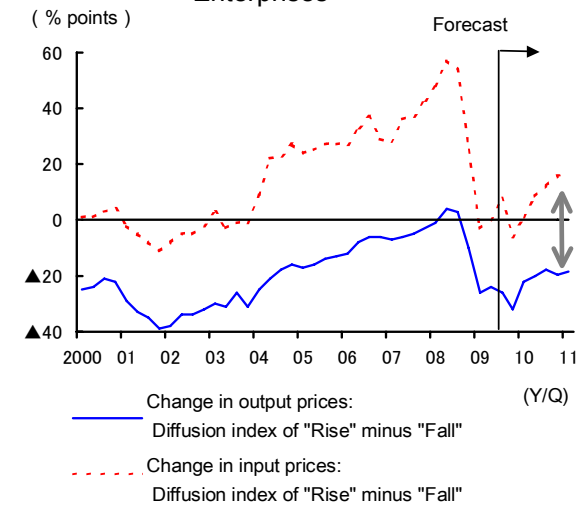
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office,

Figure 7-2 Change in Consumer Price Index on CY2005-base <year-on-year, excluding fresh food>



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

Figure 7-3 Change in the Diffusion Index for Input and Output Prices of Enterprises



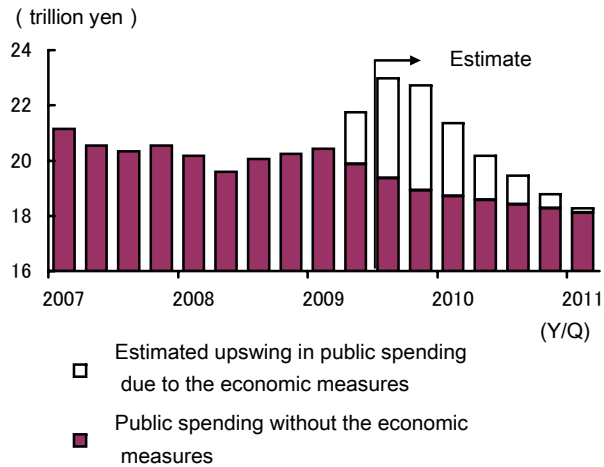
Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "Tankan Surveys."

Japan's economy - Likely to undergo a double dip, with a risk of worsening considerably

It is expected that domestic demand will continue an underlying stagnation, against the background of the three adjustment pressures which are mentioned in previous pages, as the driving force of overseas demand will also keep decreasing. The bolstering effects of the economic stimulus measures taken in the first half of FY2009 will peter out. Especially, public investment is predicted to decline considerably. Therefore, it is likely that Japan's economy will undergo a double dip. There are also the following downside risks:

(1) The reduction in the supplementary budget. If the Hatoyama administration ceases executing the remaining amount of the first supplementary budget in FY2009, it could be a weighing-down factor for the economy by way of a decline in public investment and government consumption expenditure. (2) 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. It could lead to a decrease in corporate profits and lower real purchasing power of households. (3) 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 Okinawa and Kanto areas declined considerably this August, when the swine flu spread there.

Figure 8-1 The Upswing in Public Investment due to the Economic Measures
<nominal, seasonally adjusted, annualised>



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

Figure 8-2 The Situation of the Execution of the First Supplementary Budget

(100 million yen)	
The total amount	152,927
The amount that has been executed	69,599
The amount that has not yet been executed	83,328
The Ministry of Health, Labour and Welfare	25,256
The Cabinet Office	23,932
The Ministry of Land, Infrastructure and Transport	18,612
The Ministry of Education, Culture, Sports, Science and Technology	5,537
The Ministry of Economy, Trade and Industry	439
The Ministry of Agriculture, Forestry and Fisheries	45
Others	9,507

Source: The Japan Research Institute, Ltd. based on the data of various media resources.

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 continue 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 is 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 power for the recovery 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 appreciation of Japanese yen would be materialising gradually. Therefore, it is expected that Japan's exports will decelerate 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 projected that business fixed investment will be declining considerably, especially in the export industries such as motor vehicles and electronic devices, reflecting a rapid decline in capacity utilisation. The household sector would also feel the pressure of adjustment more strongly, due to worsening income environments and sluggish 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 will 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 end of this year and push down the overall real GDP growth rate to a large extent. A reduction in the remaining amount in the execution of the supplementary budget by the 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 continue a 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 October 2, 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)	(Projection)	(Projection)
	(Actual)	(Actual)		(Projection)		(Projection)				(Projection)	(Actual)	(Projection)	
Real GDP	▲ 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 GDP	▲ 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 GDP	▲ 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	▲ 2.3	▲ 1.9	▲ 0.6	▲ 0.5	▲ 0.3	▲ 0.5	▲ 0.4	1.2	▲ 1.3	▲ 0.4
Industrial Production Index	▲ 14.8	▲ 34.6	▲ 27.8	▲ 19.3	▲ 6.5	20.2	11.4	5.2	2.1	2.4	▲ 12.6	▲ 10.9	5.1
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	3.76	3.02	4.43	3.10	4.03	3.54	4.86	12.34	14.29	15.53
Share of Nominal GDP (%)	1.4	2.2	2.6	3.2	2.4	3.9	2.7	3.5	2.9	4.3	2.5	3.0	3.3
Exchange Rates (JY/US\$)	96.1	93.6	97.0	93.6	91.0	90.0	90.0	88.0	90.0	92.0	93.6	92.9	90.0
Import Price of Crude Oil (US\$/barrel)	79	44	53	71	73	76	79	81	84	87	90	68	83

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 -2.8% in the US, -4.0% in the euro area and +7.7% in China.