

# Monthly Report of Prospects for Japan's Economy

## January 2012

Macro Economic Research Centre  
Economics Department



The Japan Research Institute, Limited

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

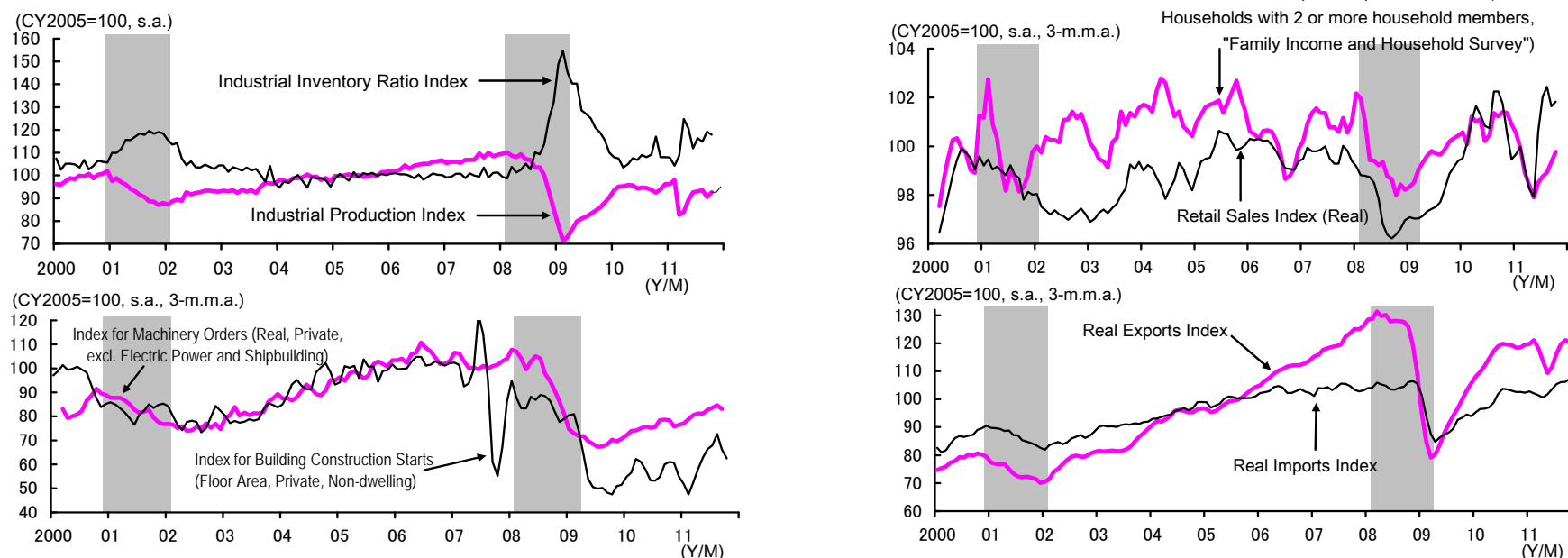
This report is the English version of the December 2011 issue of the original Japanese version.

## Current situation of Japan's economy – Economic activity is on a slowdown trend

Japan's economy has recovered sharply from its fall after the Great East Japan Earthquake and tsunami disaster. Real GDP in the July-September quarter 2011 grew by 5.6 per cent on a seasonally adjusted, annualised percentage change from the previous quarter basis (the second preliminary estimates), a considerable positive growth rate. Industrial production has picked up to the level near that before the disaster, as constraints of supply on production are removed. The level of real private consumption expenditure, shown in the Family Income and Household Survey, has continued a moderate recovery trajectory, reflecting the improvement of consumer sentiment. Machinery orders have been firm, and little effect of the earthquake and tsunami disaster has been seen in their statistical figures.

However, recent economic activity is on a slowdown trend. Exports have flattened out, due to a deceleration in overseas economies and the appreciation of the yen, as the diffusion index of overseas demand conditions for products worsens. The pace of industrial production has decelerated visibly since last summer, and the industrial inventory ratio has risen.

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 November and December 2011 is based on METI forecasts. 3: Shaded areas indicate periods of recession, the first according to the Cabinet Office, and the latter to JRI.

## Real GDP – Has recovered to the level before the quake and tsunami disaster

Japan's economy has recovered sharply from its considerable fall after the Great East Japan Earthquake and tsunami disaster. Real GDP in the July-September quarter 2011 grew by 5.6 per cent on a seasonally adjusted, annualised percentage change from the previous quarter basis (the second preliminary estimates), a positive growth rate for the first time in three quarters. As a result, real GDP has returned to the level before the disaster.

The worrying factors have nearly all been removed, such as the tendency of consumers to refrain from spending that could wait due to a mood of voluntary self restraint, and the decline in production activity caused by the cut off of supply chains.

In the household sector, business conditions in department stores and other services have recovered to the level near that before the disaster. In the corporate sector, production and sales of automobiles have picked up remarkably. Production of automobiles has kept its increasing trend on the whole, as the negative effect of floods in Thailand on domestic automobile production seems to be limited. The level of sales of automobiles is now higher than before the disaster. Machinery orders have maintained their firm pace, although machinery orders in manufacturing have tended to weaken slightly.

Figure 2-1 Real GDP  
<seasonally adjusted,  
annualised>

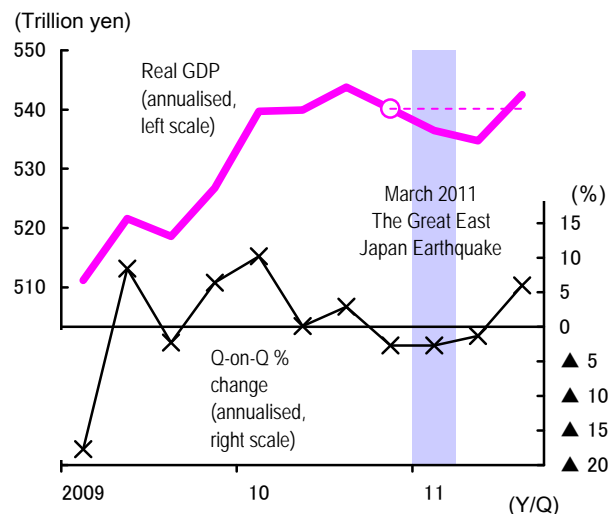


Figure 2-2 Business Conditions by  
Industry in The Economy  
Watchers Survey

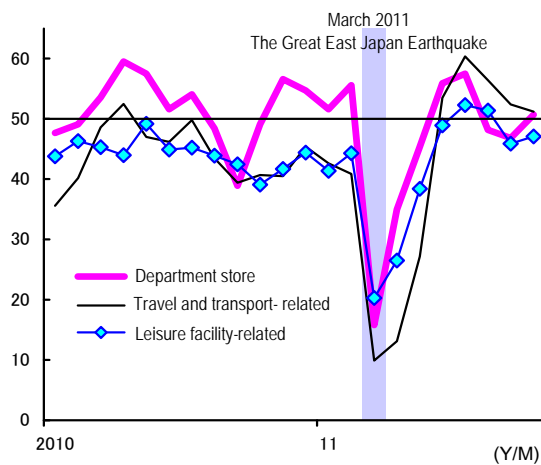
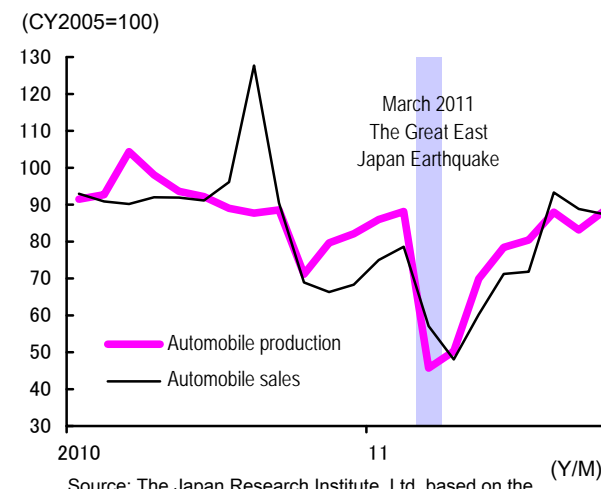


Figure 2-3 Automobile Production and Sales  
<seasonally adjusted>



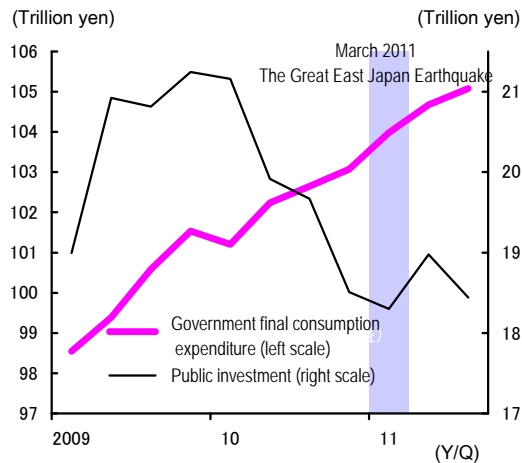
## Several negative factors have been materialising

It should be noted that several negative factors to the economy have been materialising. One of such factors is the fact that reconstruction activities including public investment have yet to start in earnest, as it is taking a longer time than expected to remove such a huge quantity of debris. Furthermore, sales of TV sets have shown a sharp reactionary fall after the rushed increase before the changeover to digital broadcasting last year.

In addition, the pace of industrial production has decelerated visibly since last summer. Although the index of industrial production increased last October by 2.2 per cent, the index is estimated to have decreased again last November by 0.1 per cent. The main reason for the deceleration in industrial production is the flattening out in exports. The slowdown in overseas economies and the appreciation of the yen have been weighing factors for Japan's exports. The PMI (Purchasing Managers' Index), which exhibits business conditions in manufacturing, has been weakening in the US, the eurozone and China.

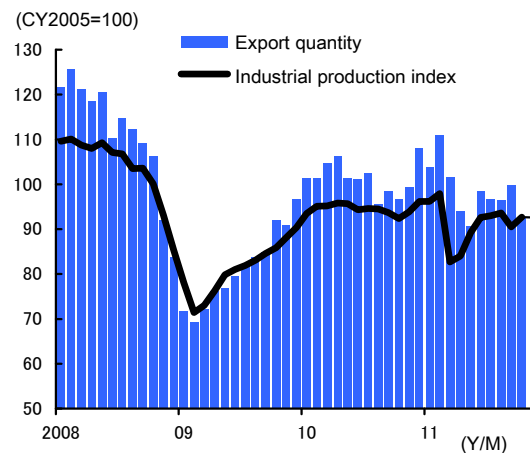
The key points to the prospects for Japan's economy are the degree of negative effect of the slowdown in overseas economies on overseas demand, and the extent of the strength of domestic demand as the driving force for the economy.

Figure 3-1 Government Final Consumption Expenditure and Public Investment <seasonally adjusted, annualised>



Source: The Cabinet Office.

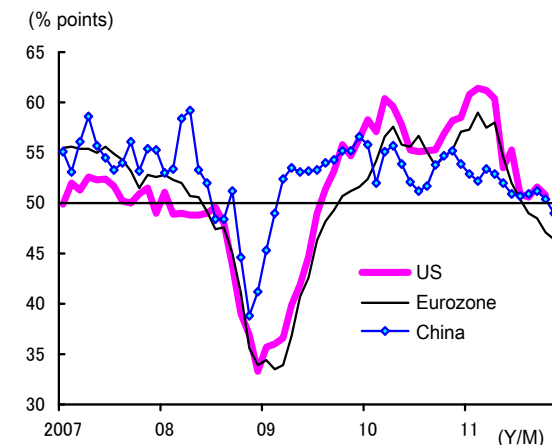
Figure 3-2 Industrial Production Index and Export Quantity <seasonally adjusted>



Source: The Ministry of Economy, Trade and Industry, The Ministry of Finance.

Note: The forecast is based on the production forecast index.

Figure 3-3 The PMI in Manufacturing <seasonally adjusted>



Source: Institute for Supply Management, Markit, China Federation of Logistics and Purchasing.

## Overseas demand – The effect of the slowdown in overseas economies would be limited

It is expected that the US economy will maintain its moderate recovery trend, as an increase in exports and solid corporate profits bolster economic activity. It is predicted that the Chinese economy will be supported by its domestic demand, although the pace of increase in exports is tending to slow down.

On the other hand, European economies as a whole are projected to see a slightly negative figure in the real GDP change rate through the early part of this year, due to austerity budgets, worsening employment and income environments, and so on. However, the negative effect of the deterioration in European economies on Japan's economy would be limited, because the share of exports to the EU in total exports is 15.3 per cent on a value basis in FY2010, which is smaller than that of exports to the US or China. Also, as long as European economies do not fall into a deep recession, the indirect negative effect of the slowdown in China's exports to the EU, which have a larger share viewed by destination, on Japan's exports to China would be limited, .

However, if a worsening of the European debt crisis leads to a global financial crisis just like the Lehman shock in 2008, the adverse effect of a deterioration in the world economy on Japan's economy could be more significant.

Figure 4-1 Exports and Corporate Profits in the US  
<year-on-year % change>

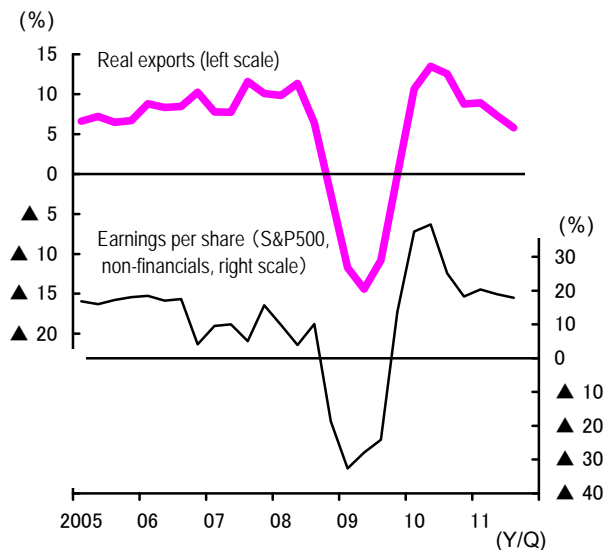


Figure 4-2 The CPI and Base Lending Rate in China

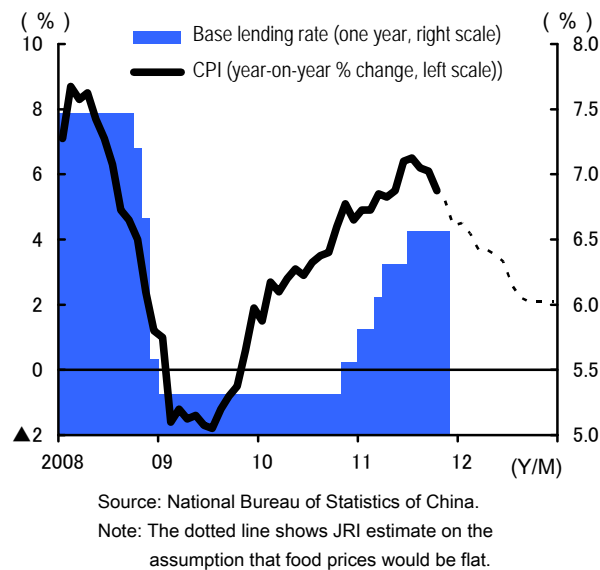
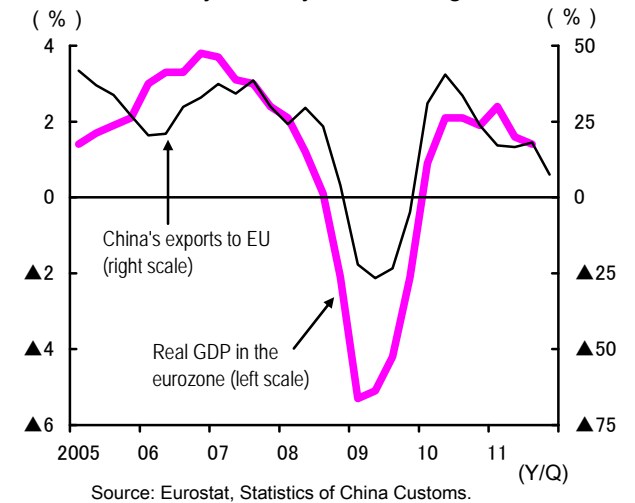


Figure 4-3 Real GDP Growth Rate in the Eurozone and China's Exports to the EU  
<year-on-year % change>



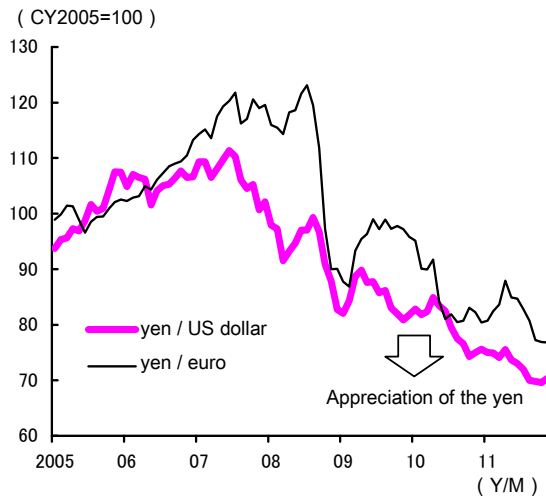
## Overseas demand – The strong yen continues to lower profits and exports

The recent exchange rates of the yen against the US dollar and the euro, which have appreciated further, are well beyond the rates assumed by Japanese enterprises. It is expected that the continued strong yen will have a significant negative effect on corporate profits and exports.

Especially, the highly appreciated yen is likely to reduce considerably the corporate profits of the machinery sector, which is one of Japan's main industrial sectors, through exchange rate losses. The JRI estimates show that corporate profits in the machinery sector, which includes automobiles and general machinery, will be reduced by 490 billion yen in the second half of FY2011, if the exchange rate of the yen against the US dollar remains 75 / dollar and that against the euro 100 / euro.

Looking at Japan's trade value which is settled in US dollars, the value of imports is more than that of exports, which suggests net exchange rate gains in the total. The basic materials sector, for example, which imports materials denominated in dollars, enjoys the advantage of the strong yen. However, the highly appreciated yen is predicted to lower the quantity of exports. Further, the strong yen has continued against Asian currencies such as the Korean won as well. Taking these unfavourable factors into consideration, it is predicted that downward pressure on corporate profits will strengthen and a strong sense of deceleration will be felt in Japan's exports.

Figure 5-1 Indices for the Exchange Rates of the Yen  
<rebased, CY2005=100>



Source: Bloomberg L.P.

Figure 5-2 Estimates of the Effect of Appreciation of the Yen on Profits of the Machinery Sector in the Second Half of FY2011

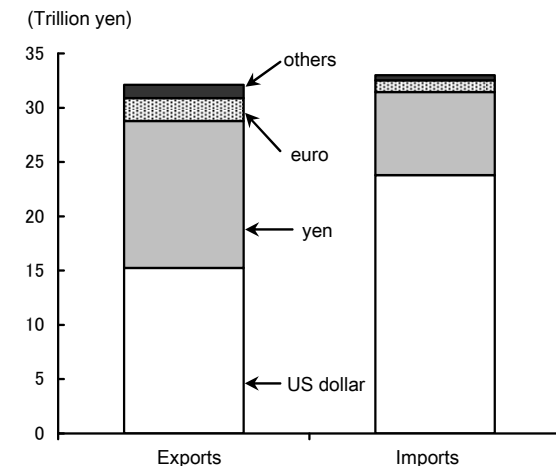
(100 billion yen)

		yen / US dollar				
		80	75	70	65	60
yen / euro	110	- 0.8	- 3.9	- 7.0	- 10.1	- 13.3
	105	- 1.3	- 4.4	- 7.5	- 10.6	- 13.8
	100	- 1.8	- 4.9	- 8.0	- 11.1	- 14.3
	95	- 2.3	- 5.4	- 8.5	- 11.6	- 14.8
	90	- 2.8	- 5.9	- 9.0	- 12.2	- 15.3

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

Note: The machinery sector includes general machinery, electrical machinery, transport equipment, and so on.

Figure 5-3 Trade Value by the Currency for Settlement <the first half of CY2011>



Source: The Ministry of Finance.

Monthly Report of Prospects for Japan's Economy January 2012  
The Japan Research Institute, Limited

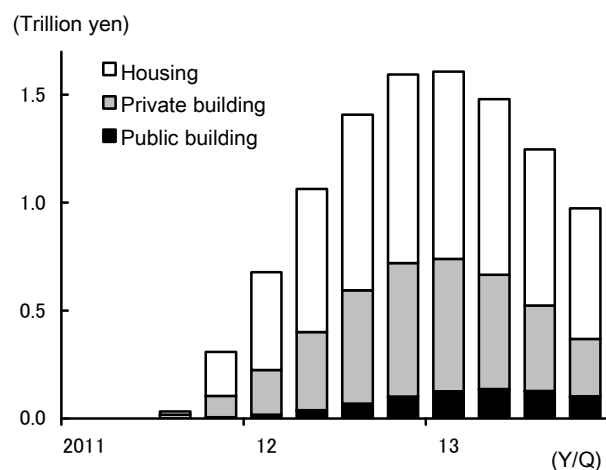
## Domestic demand – Reconstruction demand would materialise in earnest in CY2012

It is expected that demand stemming from reconstruction will boost the economic activity from now on. Based on the JRI forecast which was made on the basis of the restoration pattern after the Great Hanshin Awaji Earthquake disaster in 1995, reconstruction demand related to building including housing is predicted to expand from early this year onwards.

The third supplementary budget in FY2011, which was approved in the Diet last November, amounted to a total of 12.1 trillion yen, 9.2 trillion yen of which was related to the reconstruction. It is currently forecast that the third supplementary budget will be implemented in order from the start of this year onwards. Around 6 trillion yen, after excluding items such as loans, support for employment and subsidiaries, from the 9.2 trillion yen is counted as the amount which can boost the real GDP growth rate directly. Based on this analysis, it is estimated that this around 6 trillion yen would lift the real GDP growth rate by around 1 per cent in FY2012.

However, uncertainty still remains as to whether the reconstruction projects would be implemented rapidly and smoothly and bolster the economic activity or not, as the removal of debris will take a long time, as will drawing up new city planning in the affected areas.

Figure 6-1 Forecast about Reconstruction Demand related to Building <annualised>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport, the forecast by JRI.

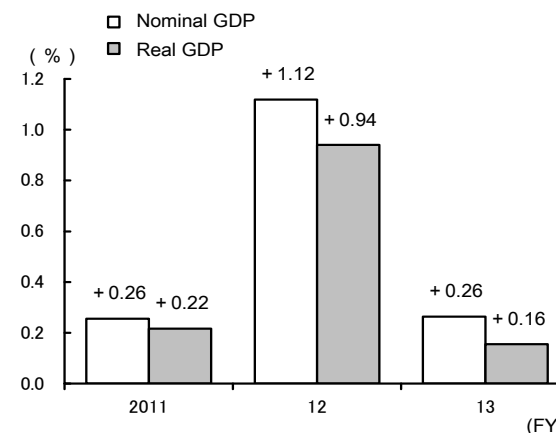
Figure 6-2 The Outline of The Third Supplementary Budget in FY2011

(100 million yen)

Expenses related to the Great East Japan Earthquake	<b>92,438</b>
Disposal of debris	3,860
Additional public works	14,734
Expenses related to reconstruction from the nuclear disaster	3,558
National disaster prevention measures	5,752
Disaster relief, Disaster-related public financing programs	7,656
Local allocation tax grants	16,635
The Great East Japan Earthquake reconstruction grants	15,612
Other expenses related to the Great East Japan Earthquake	24,631
Compensation for extraordinary financing from pension fund	24,897
Expenses for disaster recovery related to Typhoon No.12, etc.	3,210
Expenses related to payments to patients of type-B hepatitis	480
<b>Total</b>	<b>121,025</b>

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

Figure 6-3 The Boosting Effect of The Third Supplementary Budget on Real GDP <macro model simulation>



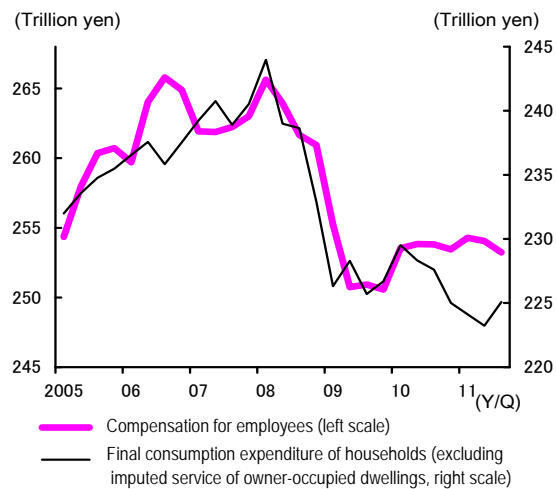
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

## Domestic demand – Private consumption expenditure will recover as sentiment improves

It should be noted that the decline in private consumption expenditure after the Great East Japan Earthquake and tsunami disaster has been due to a decline in consumer sentiment, while the drop after the Lehman shock was caused by the decrease in compensation for employees. Accordingly, it is very likely that private consumption expenditure will recover to a level in proportion to that of income, as consumer sentiment improves. It can be said that consumer sentiment is already on a recovery trend, as shown in the fact that the consumer confidence index has picked up sharply.

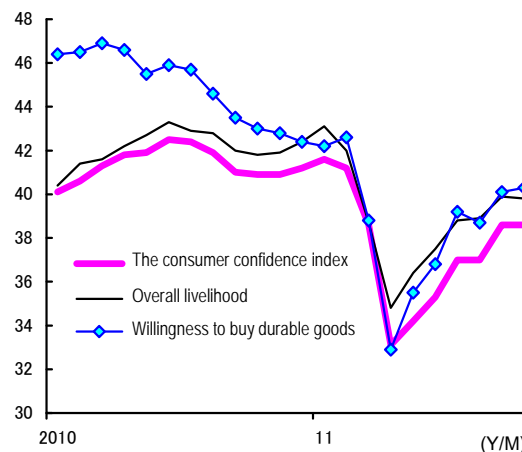
Meanwhile, the floods in Thailand might be a downswing factor to private consumption expenditure. Constraints on the supply of HDDs (hard disk drives) are expected to be prolonged, as the largest production strongholds are located in Thailand. The price of HDDs has risen sharply after the flooding, because of the rapid decline in production and anxiety that the inventory could be wiped out. The rise in the price of HDDs could have a negative effect on year-end sales of digital products loaded with HDDs. Sales of automobiles, the production of which has also been affected by the floods in Thailand, are estimated to have weakened in the October-December period last year due to the decline in production. However, sales of automobiles are predicted to recover in the January-March quarter as normal production has already resumed.

Figure 7-1 Compensation for Employees and Private Consumption Expenditure



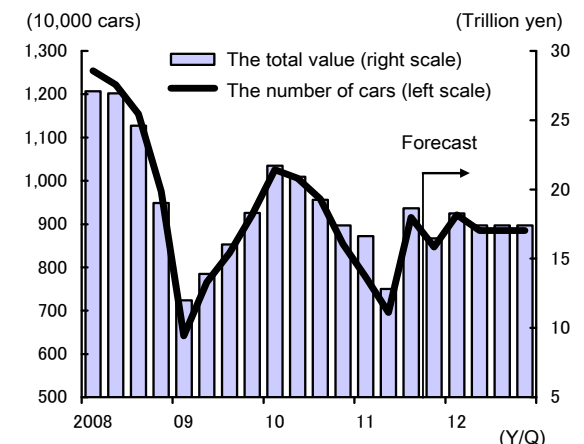
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

Figure 7-2 Consumer Sentiment <seasonally adjusted>



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

Figure 7-3 Automobile Production <seasonally adjusted, annualised>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Economy, Trade and Industry, The Bank of Japan, the forecast by JRI.

Monthly Report of Prospects for Japan's Economy January 2012  
The Japan Research Institute, Limited



## Domestic demand - The increase in the financial burden on households

It is highly likely that the financial burden on households will rise because the government is expected to have to increase revenues for reconstruction. As the period during which income tax is raised for reconstruction was decided to be 25 years, the financial burden on households per year will be light. On the other hand, a further reduction of tax exemptions for dependents as the revenue for child allowances, and a rise in pension premiums will be a heavy financial burden on households. As a result, net benefit to households in FY2012 is expected to decrease by one trillion yen from the previous fiscal year. The decrease in net benefit is predicted to be a downswing factor to private consumption expenditure through a decline in disposable income of households. The JRI macro economic model simulation shows that a decrease in disposable income by one trillion yen will lower private consumption expenditure ultimately by 700 billion yen.

In the forecast, it is assumed that the consumption tax will be raised from FY2013 onwards. If the consumption tax is raised in April 2013, it is likely that a rushed increase in demand for housing and durable consumer goods in the main will be seen in the second half of FY2012. Also, it is predicted that an increase in prices caused by the rise in the consumption tax will lower private consumption expenditure in real terms through a decline in purchasing power of households.

Figure 8-1 Financial Burden on and Benefit to Households

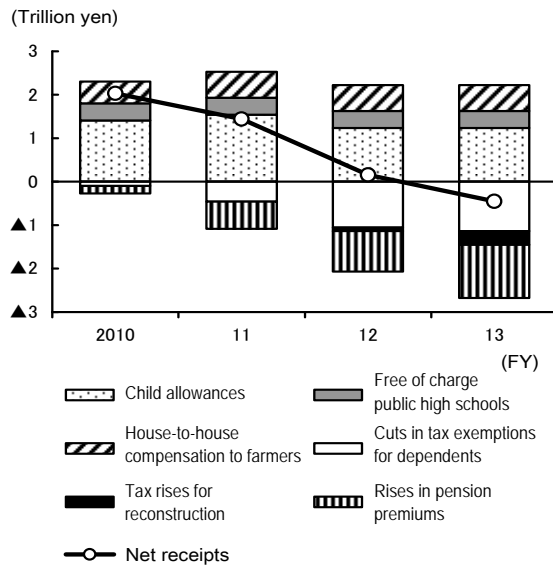


Figure 8-2 The effect of Decrease in Disposable Income by One Trillion Yen <annualised> <macro economic simulation>

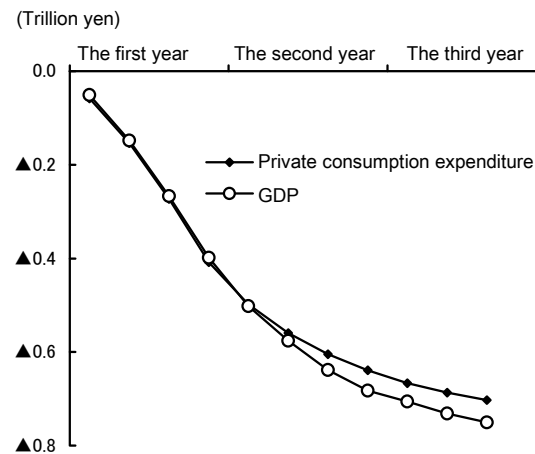
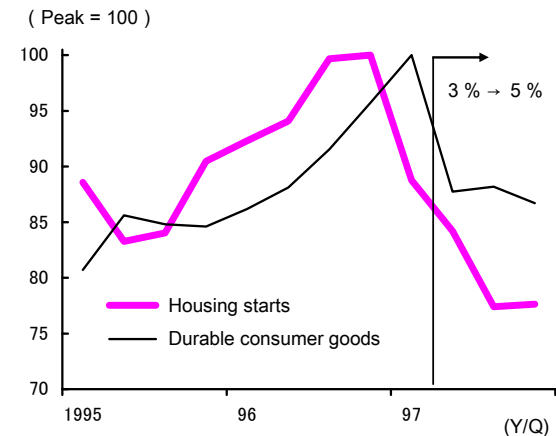


Figure 8-3 Household Expenditure Before and After the Rise in Consumption Tax <1995-1997>



Source: The Cabinet Office, The Ministry of Land, Infrastructure and Transport.

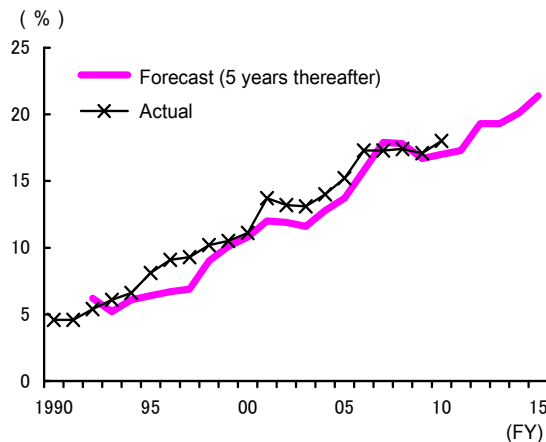
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The Japan Research Institute, Limited

## Domestic demand – The shift of production strongholds to overseas sites

The increasing trend in Japan's manufacturers' shift of their production strongholds to overseas sites has extended over a long period of time. In recent years, in addition to the strong yen, they have gone into foreign sites in order to acquire local expanding demand, as emerging economies led by those in Asia continue their high economic growth rates. Furthermore, not only emerging economies but also Korea, which is a country with a mature economic structure like Japan, is an attractive candidate for the sites where Japan's manufacturers consider shifting their strongholds. The factors which make Korea an attractive place are an active free trade policy shown in the conclusion of FTAs (free trade agreements) with major advanced economies, the low rate of corporate tax, the weak Korean won, inexpensive electricity charges, and so on. These business environments seem to contrast sharply with those in Japan since the earthquake and tsunami disaster.

If the situation where advantages of domestic production are being lost is left as it is, it is probable that the pace of Japan's manufacturers shifting their production strongholds to overseas sites will accelerate, as they seek more favourable business environments. If the situation deteriorates into the hollowing out of industry, Japan's medium and long term economic growth rate could decline, as business fixed investment continues to stagnate in the longer term.

Figure 9-1 Overseas Production Ratio in Japanese Manufacturing

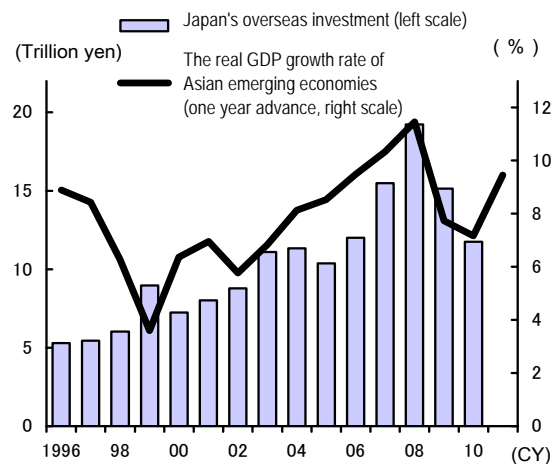


Source: The Cabinet Office.

Note: the overseas production ratio =  

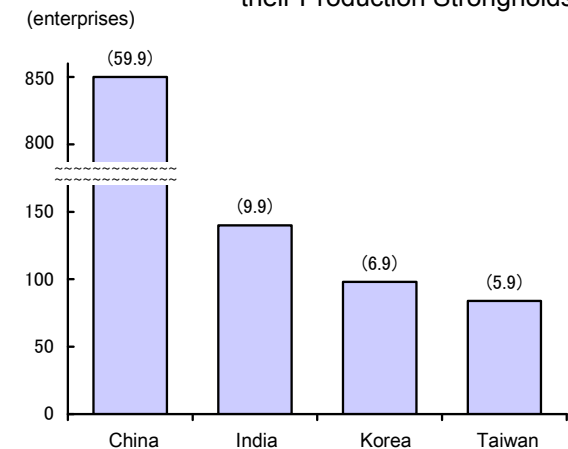
$$\frac{\text{the value of overseas production}}{\text{the total value of domestic and overseas production}}$$

Figure 9-2 Overseas Direct Investment of Japan



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

Figure 9-3 Countries where Japanese Manufacturers have shifted their Production Strongholds



Source: Teikoku Databank, Ltd. .

Note: The figure in parentheses shows the share in the total.

## Prospects for Japan's economy - Projected real GDP change; - 0.2% in FY2011 and 1.8% in FY2012

(1) Japan's real GDP in the July-September quarter last year grew by 5.6 per cent on a seasonally adjusted, annualised percentage change from the previous quarter basis (the second preliminary estimates). In this issue of the Monthly Report, the estimated growth rate of real GDP in FY2011 was revised downwards from 0.6 per cent to minus 0.2 per cent, and the forecast growth rate of real GDP in FY2012 starting April 2012 was also revised downwards from 1.9 per cent to 1.8 per cent. This reflects the change in the benchmark year in GDP statistics from 2000 to 2005 and subsequent downward revisions in the actual figures in the past, although the main scenario of continued recovery during the forecast period is unchanged.

(2) Looking at the prospects for the economy from the October-December quarter last year onwards, it is predicted that a sense of deceleration will intensify, because of negative factors such as a slowdown in exports reflecting a deceleration in overseas economies and the strong yen, and a flattening out in domestic business fixed investment caused by the accelerating shift of production strongholds to overseas sites.

However, the situation where the economy falters will be able to be avoided for the following reasons:

- 1) Firm emerging economies, led by China, are expected to bolster Japan's exports.
- 2) It is predicted that demand stemming from reconstruction will materialise in earnest from the first of this year onwards, and housing investment and public demand will increase.
- 3) Private consumption expenditure is expected to pick up gradually, as employment and income environments improve moderately.

(3) On the other hand, there is a significant risk that the pace of economic recovery could decelerate even further, caused by the following factors:

- 1) If a worsening of the European debt crisis leads to a global financial crisis just like the Lehman shock in 2008, the adverse effect of a deterioration in the world economy on Japan's economy could be more significant.
- 2) Although it is currently assumed that the third supplementary budget in FY2011 would be implemented in order from the start of this year onwards, the implementation of reconstruction projects could lag considerably, as the removal of debris will take a long time, and drawing up new city planning in the affected areas is still partly undecided .

(4) Meanwhile, the year-on-year change rate of the Consumer Price Index excluding fresh food (the core CPI) is expected to stay in negative territory, because the deflationary pressure is difficult to wipe out as shown in the declining trend in prices of household appliances, as resource prices are predicted to stay flat.

Figure 11 Projections for GDP Growth and Main Indicators of Japan ( as of December 9, 2011 )

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

	CY2011				CY2012				CY2013	FY2010	FY2011	FY2012
	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3			
	(Actual)		(Projection)		(Projection)				(Projection)			
Real GDP	▲ 6.6	▲ 2.0	5.6	1.2	2.3	2.0	1.7	0.9	0.4	3.1	▲ 0.2	1.8
Private Consumption Expenditure	▲ 4.9	1.1	3.0	0.5	1.3	0.8	0.7	0.7	0.6	1.6	0.3	0.9
Housing Investment	7.3	▲ 7.8	22.4	▲ 3.5	3.9	3.7	8.7	1.2	▲ 3.9	2.3	4.6	4.0
Business Fixed Investment	▲ 3.5	▲ 2.1	▲ 1.6	1.9	2.4	3.2	4.0	3.0	2.6	3.5	▲ 1.3	2.7
Private Inventories (percentage points contribution)	(▲ 2.9)	(▲ 0.0)	( 1.1)	(▲ 0.3)	( 0.2)	( 0.2)	( 0.2)	( 0.1)	( 0.1)	( 0.8)	(▲ 0.3)	( 0.1)
Government Consumption Expenditure	1.9	2.9	0.9	1.9	1.5	1.1	0.4	1.2	1.2	2.3	1.9	1.1
Public Investment	▲ 7.2	29.8	▲ 3.9	8.1	18.2	13.0	3.5	▲ 4.4	▲ 9.8	▲ 6.8	5.2	6.1
Net Exports (percentage points contribution)	(▲ 0.6)	(▲ 3.9)	( 2.3)	(▲ 0.0)	(▲ 0.1)	(▲ 0.0)	( 0.0)	(▲ 0.0)	(▲ 0.1)	( 0.8)	(▲ 0.7)	( 0.1)
Exports of Goods and Services	▲ 0.2	▲ 21.7	32.7	2.2	4.7	4.1	4.1	3.2	2.5	17.2	▲ 0.0	5.2
Imports of Goods and Services	4.5	1.7	14.9	2.3	4.9	3.9	3.8	3.3	3.2	12.0	5.1	4.4

(% changes from the same quarter of the previous year)

Real GDP	▲ 0.2	▲ 1.7	▲ 0.7	▲ 0.3	1.9	2.7	1.9	1.5	1.3	3.1	▲ 0.2	1.8
Nominal GDP	▲ 2.2	▲ 4.0	▲ 2.9	▲ 1.7	0.6	2.3	1.5	1.3	0.8	1.1	▲ 2.0	1.5
GDP deflator	▲ 1.9	▲ 2.4	▲ 2.2	▲ 1.4	▲ 1.3	▲ 0.4	▲ 0.5	▲ 0.2	▲ 0.5	▲ 2.0	▲ 1.8	▲ 0.4
Consumer Price Index (excluding fresh food)	▲ 0.8	▲ 0.2	0.2	▲ 0.1	▲ 0.1	▲ 0.3	▲ 0.4	▲ 0.3	▲ 0.3	▲ 0.9	▲ 0.0	▲ 0.3
Industrial Production Index	▲ 2.6	▲ 6.8	▲ 2.1	▲ 1.5	3.6	8.8	5.7	5.9	3.9	9.0	▲ 1.8	6.0
Unemployment Rate (%)	4.7	4.6	4.4	4.2	4.2	4.2	4.1	4.1	4.0	5.0	4.4	4.1
Current Account Balances (trillion JY)	3.99	1.54	2.98	2.60	2.88	2.34	3.14	2.50	3.00	16.13	9.99	10.98
Share of Nominal GDP (%)	3.5	1.3	2.6	2.1	2.5	2.0	2.7	2.0	2.6	3.4	2.1	2.3
Exchange Rates (JY/US\$)	82	82	77	77	78	79	80	80	80	86	79	80
Import Price of Crude Oil (US\$/barrel)	97	115	114	110	110	110	110	110	110	84	112	110

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 1: "▲" indicates minus.

2: The assumptions on major overseas economies shown as the real GDP growth rates: the US 1.7% in CY2011, 1.9% in CY2012; the euro area 1.6% in CY2011, ▲ 0.0% in CY2012; China 9.3% in CY2011, 8.8% in CY2012.