Monthly Report of Prospects for Japan's Economy

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Economics Department

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

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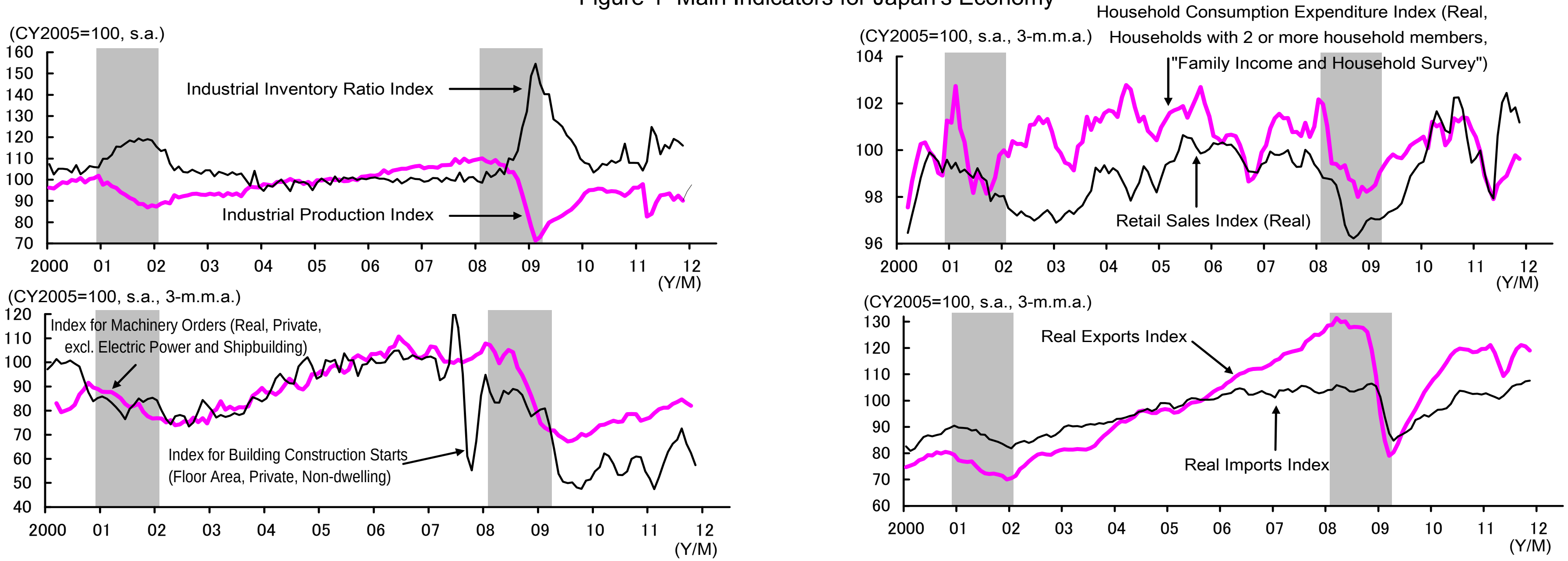
Current situation of Japan’s economy – Economic activity is on a decelerating trend

Japan's economy is currently on a decelerating trend. Industrial production has visibly slowed since last summer. Industrial shipments have levelled off, and the level of industrial inventory remains high. The industrial inventory ratio is still higher than that before the Great East Japan Earthquake and tsunami disaster, which suggests the situation where inventory adjustment pressure persists for the time being. Real private consumption expenditure, shown in the Family Income and Household Survey, has flattened out, reflecting the fact that the improvement in consumer sentiment has taken a breather recently. Exports have declined lately, due to the deceleration in overseas economies and the supply shock stemming from the floods in Thailand.

A stronger sense of deceleration will be felt in the prospects for Japan's economy, as the negative effects of the deceleration of overseas economies and the strong yen on the economy could continue for a while. The leading index in the Indices of Business Conditions, which indicates a future economic situation, declined for three consecutive months.

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 December 2011 and January 2012 is based on METI forecasts. 3: Shaded areas indicate periods of recession, the first according to the Cabinet Office, and the latter to JRI.

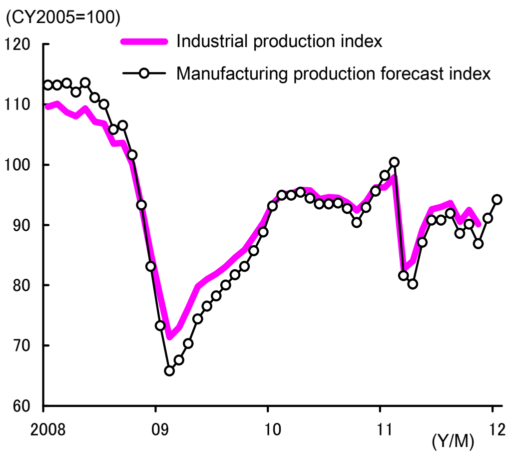
Industrial production has been slowing down

Although industrial production had recovered sharply from its fall after the Great East Japan Earthquake and tsunami disaster in Mach 2011, it has been on a decelerating trend since September last year. Industrial production decreased by 2.7 per cent over the previous month in November, a monthly decline for the first time in two months.

The backgrounds to this trend of industrial production flattening out seem to include a deceleration in overseas economies and a lag in the materialisation in earnest of reconstruction demand from the disaster. The PMI (Purchasing Managers' Index), which exhibits business conditions in manufacturing, has been weakening in the US, the eurozone and China. Reconstruction demand on the whole is still at a low level, although the year-on-year change rate in construction value in the disaster hit Tohoku area has turned positive since last summer.

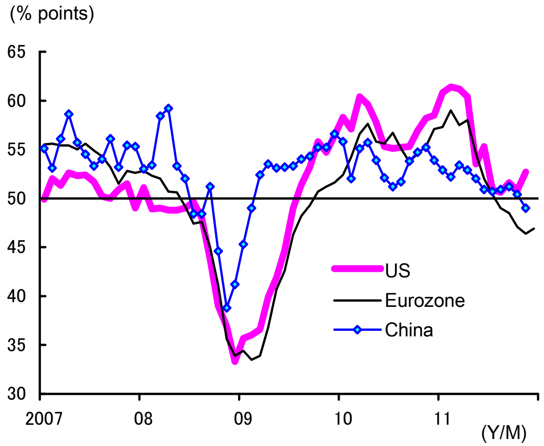
Reflecting the above mentioned situation, industrial inventory is on an increasing trend, as industrial shipments have decreased among most industries including general machinery and basic materials, except for transport equipment. There is anxiety that industrial production could have a downswing due to the inventory adjustment.

Figure 2-1 Industrial Production Index and Production Forecast Index <seasonally adjusted>



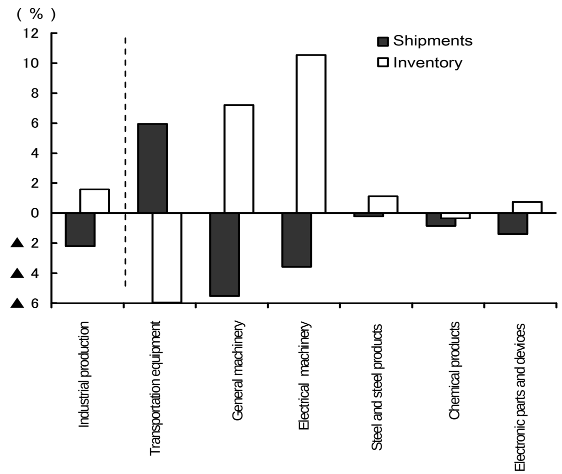
Source: The Ministry of Economy, Trade and Industry.

Figure 2-2 The PMI in Manufacturing <seasonally adjusted>



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

Figure 2-3 Shipments and Inventory by Industry <compared with 3 months before>



Source: The Ministry of Economy, Trade and Industry.

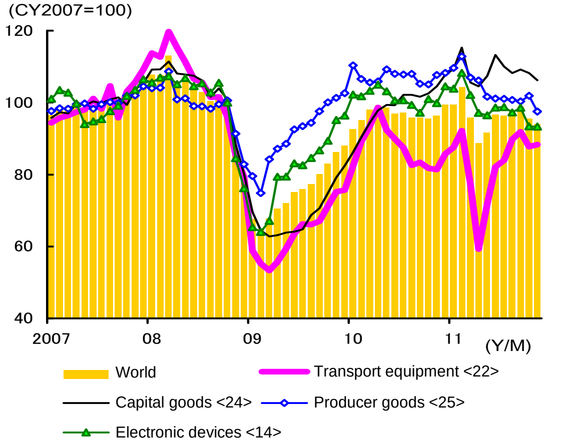
Demand in the overseas and household sectors has weakened

Exports have declined recently due to a slowdown in overseas economies and the supply shock caused by the floods in Thailand. Viewed by type of goods, not only electronic devices, the market conditions of which continue to stagnate, but also capital goods and transport equipment have weakened.

However, it is likely that the negative effect of the supply shock caused by the floods in Thailand will be temporary. Based on the survey conducted by The Ministry of Economy, Trade and Industry, the production of around 20 per cent of Japanese-owned enterprises there has already recovered to the level before the floods. The production of around 60 per cent of other enterprises is expected to recover within half a year.

Economic conditions in the household sector have also softened recently. The diffusion index (DI) for current economic conditions in the Economy Watchers Survey shows that household-related DIs have weakened after the sharp recovery from the quake and tsunami disaster. There is no sign of recovery in the sales of TV sets, which have shown a rapid reactionary decline after the rushed increase before the changeover to digital broadcasting last summer.

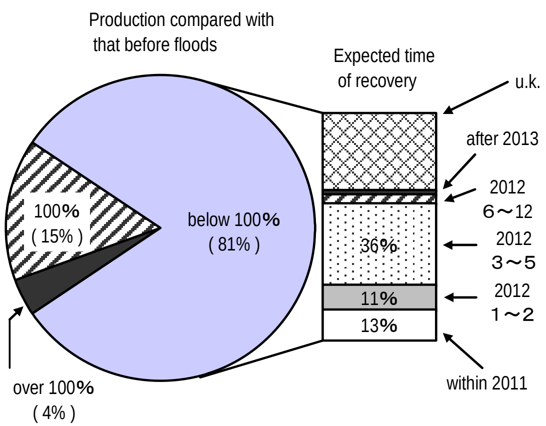
Figure 3-1 Real Exports by Type of Goods <seasonally adjusted>



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

Note: The figure in the angle bracket shows the share in FY2010.

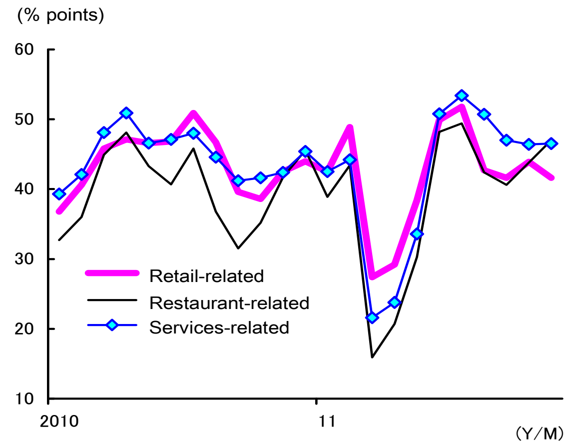
Figure 3-2 Production Conditions of Japanese Enterprises in Thailand



Source: The Japan Research Institute, Ltd. based on the survey conducted by The Ministry of Economy, Trade and Industry.

Note: The survey period is November 30 - December 7, 2011.

Figure 3-3 The Diffusion Index for Current Economic Conditions in the Economy Watchers Survey



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

Business conditions in Tankan have weakened again in manufacturing

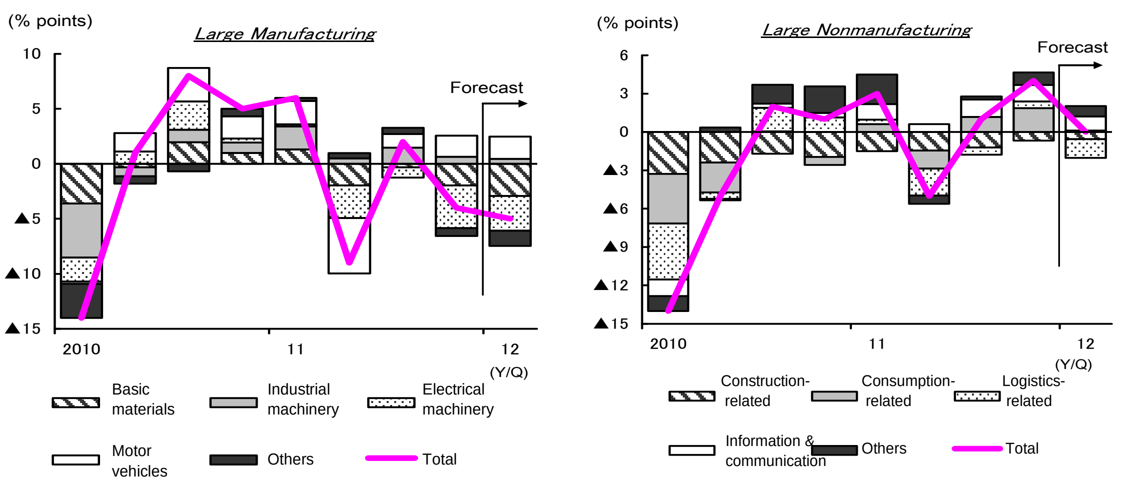
In the Tankan December 2011 Survey, the diffusion index (DI) for business conditions (shown as "favourable" minus "unfavourable") in large manufacturing declined to minus 4 percentage points, which was 6 percentage points down from the previous Survey, and a minus figure for the first time in two quarters. Viewed by industry, the DIs for electrical machinery and basic materials worsened, reflecting a slowdown in overseas economies and the strong yen. On the other hand, the DI for automobiles improved, due to the continued recovery from the cuts in supply chains caused by the quake and tsunami disaster, although their production has been affected adversely by the floods in Thailand.

The DI for business conditions in large nonmanufacturing improved to plus 4 percentage points, which was 3 percentage points up from the previous Survey. Viewed by industry, the DIs for accommodations, eating and drinking services, and services for individuals, which had lagged visibly in recovery from the disaster, showed improvement. In addition, the DI for construction, in which reconstruction demand is expected to materialise in earnest, advanced as well.

The Tankan Survey also showed that enterprises, both manufacturing and nonmanufacturing, were cautious about future business conditions. This seems to reflect the situation, especially in manufacturing, shown by the diffusion index for demand conditions for products, where the DIs for both overseas and domestic demand for products worsened.

Figure 4-1 Contributions to Business Conditions Diffusion Index by Industry

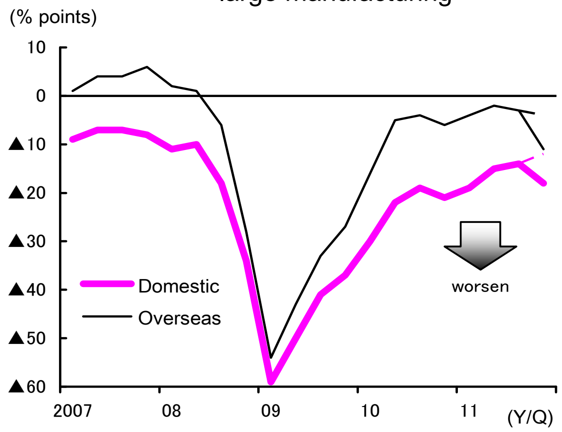
<diffusion index of "favourable" minus "unfavourable", and percentage point contribution to the total DI points>



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan December 2011 Survey".

Figure 4-2 The Diffusion Index for Demand Conditions for Products

<large manufacturing>



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

Note: The upper line indicates the forecast in the previous survey.

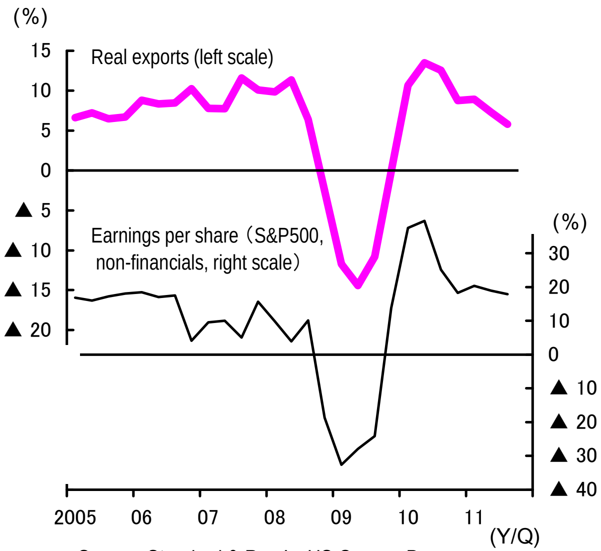
The effect of the slowdown in overseas economies would be limited

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 as the monetary tightening tends to change, 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 middle 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 Japan's total exports is smaller than that of exports to the US or China on a value basis. Also, as long as European economies do not fall into a deep recession, a considerable deceleration in the Chinese economy will be able to be avoided, and 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, .

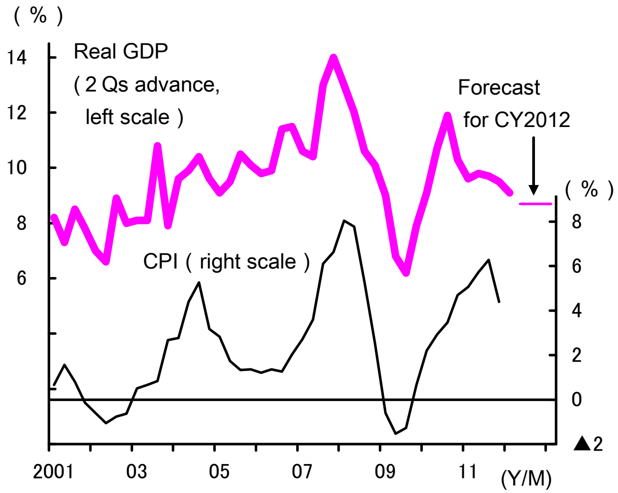
However, if a worsening of the European debt crisis leads to a global financial crisis just like the Lehman shock in 2008, the adverse effect of a deterioration in the world economy on Japan's economy could be more significant.

Figure 5-1 Exports and Corporate Profits in the US
<year-on-year % change>



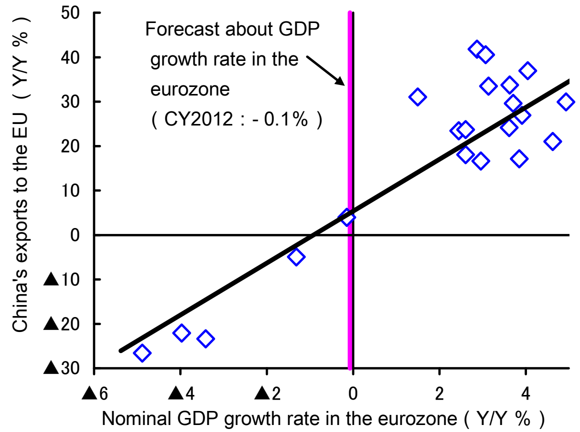
Source: Standard & Poor's, US Census Bureau.

Figure 5-2 China's Real GDP and CPI
<year-on-year % change>



Source: The Japan Research Institute, Ltd. based on the data of National Bureau of Statistics of China.

Figure 5-3 GDP Growth Rate in the Eurozone and China's Exports to the EU
<year-on-year % change>



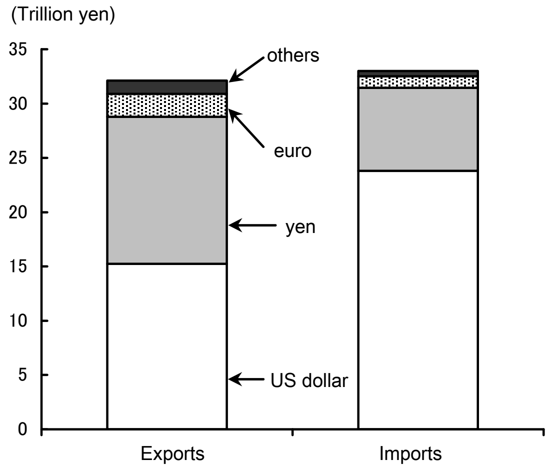
Source: Eurostat, Statistics of China Customs.

The strong yen continues to lower profits and exports

The recent exchange rates of the yen against the US dollar and the euro are continuing their high levels. 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 total. In euros, the value of exports is more than that of imports, which suggests net exchange rate losses in total, and lowered corporate profits.

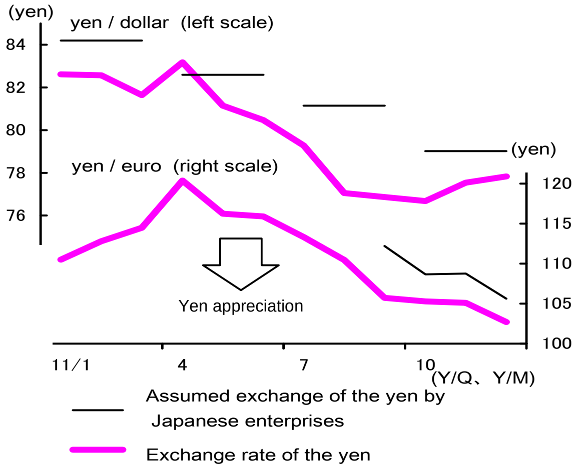
The highly appreciated yen continues to reduce the corporate profits of the machinery sector especially, which is one of Japan's main exporting industrial sectors, through exchange rate losses. It should be noted that assumed exchange rates, which are a basis for corporate profit planning by Japanese enterprises, have been revised to levels near the actual rates. This tendency makes an additional negative effect of the strong yen on profits seem to be limited. The JRI estimates show that corporate profits in the machinery sector, which includes automobiles and general machinery, will be reduced by 16 billion yen in the second half of FY2011, if the exchange rates of the yen against the US dollar and the euro remain at monthly average rates in December 2011. It is expected that a negative effect of the highly appreciated yen on the quantity of exports will be felt strongly hereafter. The strong yen will lower the quantity of exports through deteriorated competitiveness. Also, the downswing in profits in the machinery sector has an adverse ripple effect on those in other sectors, and that negative effect could materialise in earnest.

Figure 6-1 Trade Value by the Currency for Settlement <the first half of CY2011>



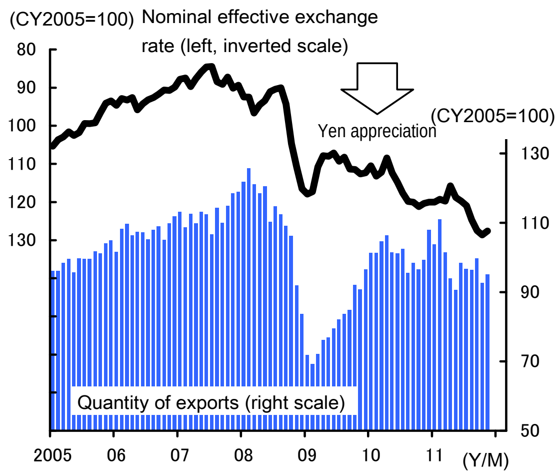
Source: The Ministry of Finance.

Figure 6-2 Exchange Rates of the Yen and Assumed Exchange Rates by Japanese Enterprises



Source: The Bank of Japan, Nikkei QUICK.

Figure 6-3 Effective Exchange Rate and Quantity of Exports



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

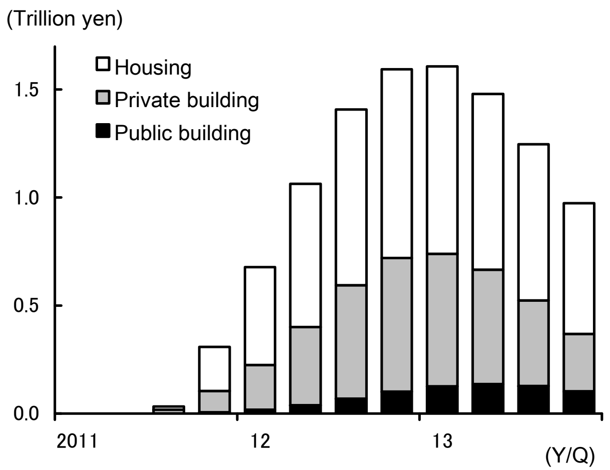
Reconstruction demand would materialise in earnest in CY2012

It is expected that demand stemming from reconstruction will boost 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 value of contracts for public works, which is a leading indicator for public investment, increased on a year earlier for four consecutive months.

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.

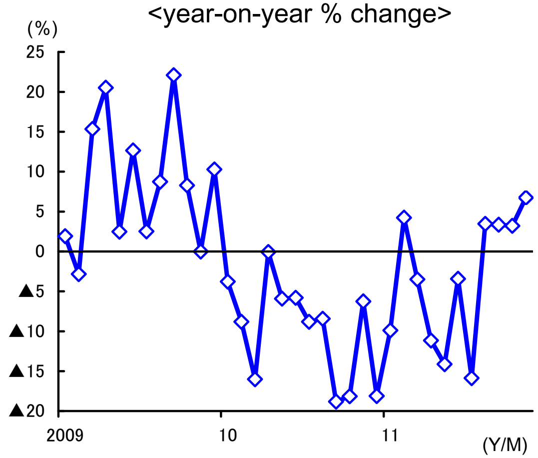
However, uncertainty still remains as to whether the reconstruction projects would be implemented rapidly and smoothly and bolster the economic activity or not, as the removal of debris will take a long time, as will drawing up new city planning in the affected areas.

Figure 7-1 Forecast about Reconstruction Demand related to Building <annualised>



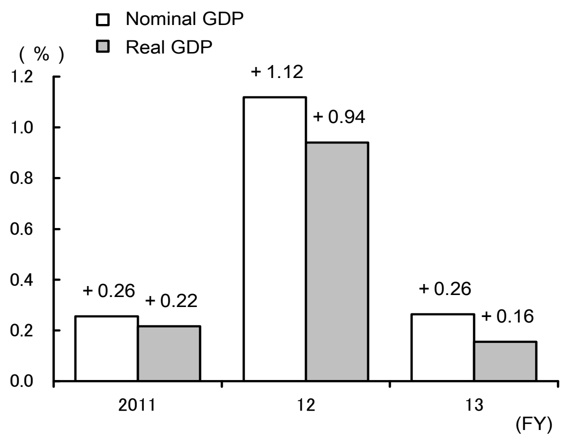
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport, the forecast by JRI.

Figure 7-2 Value of Contracts for Public Works <year-on-year % change>



Source: Hokkaido Construction Surety Co., Ltd., East Japan Construction Surety Co., Ltd., West Japan Construction Surety Co., Ltd..

Figure 7-3 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.

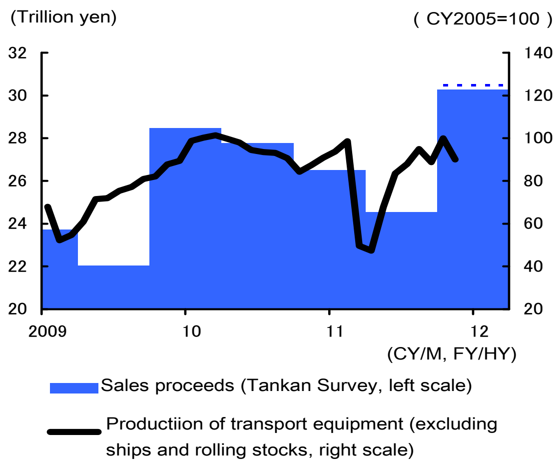
Private consumption expenditure is expected to maintain its increasing trend

It is estimated that private consumption expenditure will have weakened temporarily in the October-December period, partly reflecting the negative effect of the floods in Thailand. The automobile industry is likely to have seen weak sales during that period, due to the adverse effect of the cuts in supply chains after the floods.

However, it is predicted that private consumption expenditure will play a moderate bolstering role for the economy from early this year onwards, as the negative effect of the floods in Thailand peters out. It is likely that automobile sales will recover again in the January-March quarter. This forecast is based on the fact that almost all of the Japanese automobile manufacturers in Thailand resumed their production, and that the Tankan December 2011 Survey shows they forecast a considerable increase in car sales in the second half of FY2012, although the figure was revised downward slightly from the September Survey. Further, it is expected that subsidiaries for eco-cars incorporated in the fourth supplementary budget, and tax cuts for eco-cars, the period of which was extended, will support private consumption expenditure for the time being.

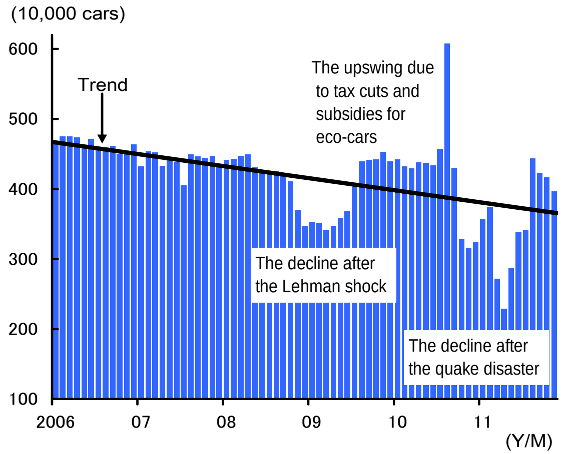
In addition, a sense of excessive employment in enterprises is tending to ease. Judging from the diffusion index for employment conditions in the Tankan Survey as a leading indicator for the number of employees, it is likely that employment will be firm for a while.

Figure 8-1 Production and Sales Proceeds in the Automobile Sector



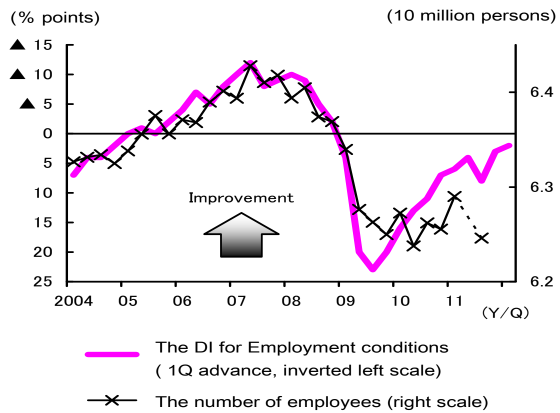
Source: The Bank of Japan, The Ministry of Economy, Trade and Industry.
Note: The dotted line in the second half of FY2011 indicates the Survey result as of September 2011.

Figure 8-2 The Number of Automobile Sales <seasonally adjusted, annualised>



Source: The Japan Research Institute, Ltd. based on the data of Japan Automobile Dealers Association, Japan Mini Vehicles Association.

Figure 8-3 The DI for Employment Conditions and the Number of Employees



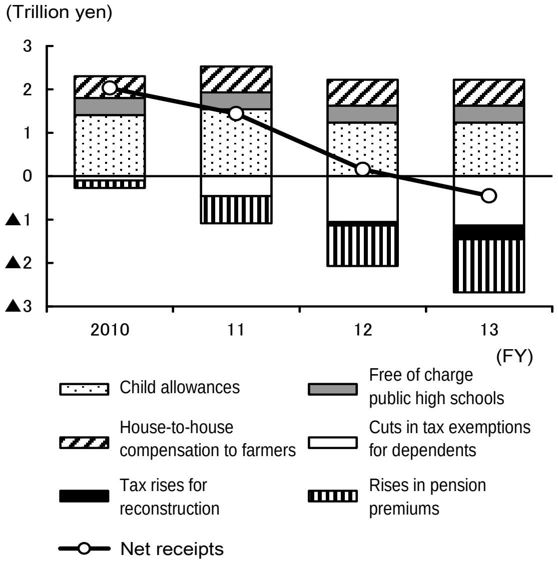
Source: The Bank of Japan, The Ministry of Internal Affairs and Communications
Note: The diffusion index (DI) of "excessive employment" minus "insufficient employment".

The increase in the financial burden on households could weigh on consumption

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.

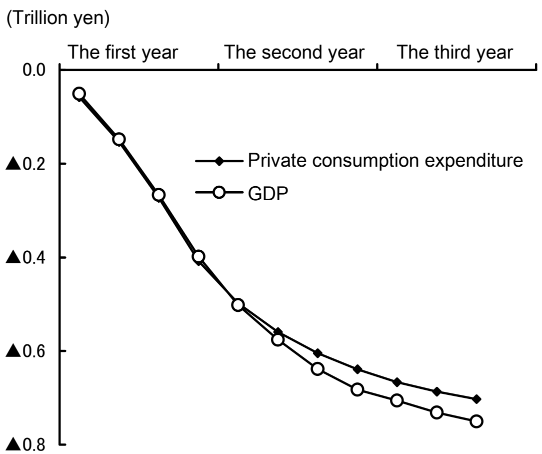
In the forecast, it is assumed that the consumption tax will be raised from FY2013 onwards. If the consumption tax is raised in October 2013, it is likely that a rushed increase in demand for housing and durable consumer goods in the main will be seen from early 2013 onwards. Also, it is predicted that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

Figure 9-1 Financial Burden on and Benefit to Households



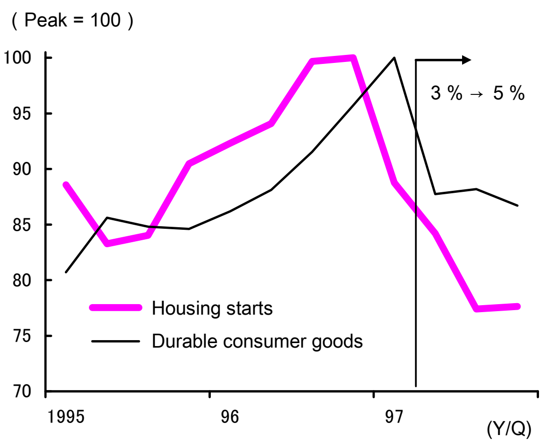
Source: The Japan Research Institute.

Figure 9-2 The effect of Decrease in Disposable Income by One Trillion Yen <annualised> <macro economic simulation>



Source: The Japan Research Institute.

Figure 9-3 Household Expenditure Before and After the Rise in Consumption Tax <1995-1997>



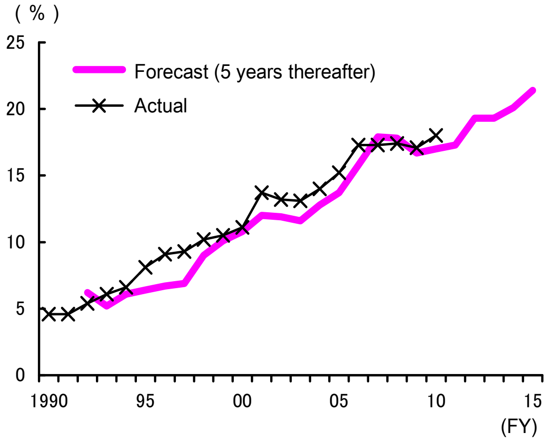
Source: The Cabinet Office, The Ministry of Land, Infrastructure and Transport.

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.

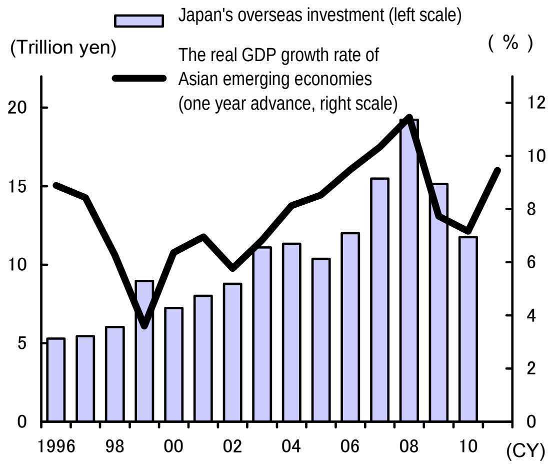
If the situation where advantages of domestic production are being lost is left as it is, it is probable that the pace of Japan's manufacturers shifting their production strongholds to overseas sites will accelerate, as they seek more favourable business environments. If the situation deteriorates into 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 10-1 Overseas Production Ratio in Japanese Manufacturing



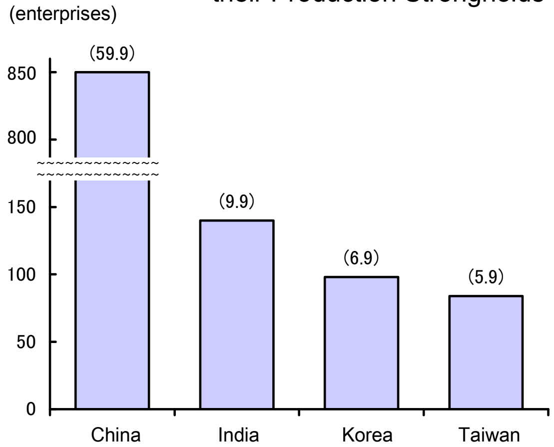
Source: The Cabinet Office.
Note: the overseas production ratio = the value of overseas production / the total value of domestic and overseas production

Figure 10-2 Overseas Direct Investment of Japan



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

Figure 10-3 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) It is estimated that the growth rate of Japan's real GDP in the October-December period last year will have decelerated, due to the negative effect of the floods in Thailand, in addition to a slowdown in overseas economies and the strong yen.

(2) Looking at the prospects for the economy from early this year onwards, it is predicted that factors such as an increase in housing investment and public demand due to a materialising in earnest of demand stemming from reconstruction, and a recovery in automobile sales will boost economic activity, as the negative effect of the floods in Thailand peters out.

(3) However, it is predicted the economic recovery could lack strong momentum for the following reasons:

1) Continued stagnation in exports due to a slowdown in overseas economies and the strong yen.

2) A flattening out in business fixed investment due to a downswing in corporate profits and the accelerating shift of production strongholds to overseas sites.

As a result, it is projected that the growth rate of real GDP in FY2012 will be 1.8 per cent, a figure which is still below 2 per cent.

(4) Also, there is risk that the deceleration in economic activity will intensify, caused by downswing factors such as deepening anxiety about the global financial system because of a worsening of the European debt crisis, a possible delay in implementation of the supplementary budgets, and so on.

(5) 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 12 Projections for GDP Growth and Main Indicators of Japan (as of January 4, 2012)

(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)	(Actual)	(Projection)	
Real G D P	▲ 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 G D P	▲ 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 G D P	▲ 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	▲ 0.2	▲ 0.4	▲ 0.4	▲ 0.3	▲ 0.3	▲ 0.9	▲ 0.1	▲ 0.3
Industrial Production Index	▲ 2.6	▲ 6.8	▲ 2.1	▲ 2.6	3.1	8.1	5.0	6.1	3.7	9.0	▲ 2.1	5.7
Unemployment Rate (%)	4.7	4.6	4.4	4.5	4.3	4.3	4.2	4.1	4.1	5.0	4.4	4.2
Current Account Balances (trillion JY)	3.99	1.54	2.98	2.22	3.14	2.32	2.72	2.23	2.93	16.13	9.88	10.20
Share of Nominal GDP (%)	3.5	1.3	2.6	1.8	2.7	2.0	2.3	1.8	2.5	3.4	2.1	2.1
Exchange Rates (JY/US$)	82	82	77	77	78	79	79	80	80	86	79	79
Import Price of Crude Oil (US$/barrel)	97	115	114	111	111	111	111	111	111	84	113	111

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, ▲ 0.8% in CY2012; China 9.3% in CY2011, 8.8% in CY2012.