Economic Outlook for Japan 2012 & Beyond

Japan's Path to Restoration against the Backdrop of a Troubled Global Economy

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Global Economic Outlook

The current global economy overall presents a rather grim feature, judging from the OECD leading indicators shown in *Chart 1*. As *Chart 2* shows, the major economies, except Japan, also face inflation concerns due to increases in the price of oil and commodities, which could act as a drag on the pace of economic growth. Although the emerging economies' growth still seems to qualify as "high economic growth," the increasing risk of inflation applies to them as well.

According to the OECD Economic Outlook, which was released in November 2011, output growth in the OECD area, which accounts for about half of the world economy, is expected to slow from 1.9% in 2011 to 1.6% in 2012, due to weaker growth in the euro-zone. Indeed, a recession in the euro-zone is projected to reduce its growth to only 0.2% in 2012. Japan's economic growth rate will rebound sharply from the negative figure in 2011, thanks to newly-created demand stemming from the reconstruction of the Tohoku region following the earthquake and tsunami on March 11, 2011. The BRICs and the East Asian economies are likely to continue to lead the global economy, in contrast to the reduced contribution from the EU due to the euro crisis. The European crisis, on which I will deliver my thoughts later, will certainly be a negative factor for global growth. However, it is not the only risk that could push the whole world economy into recession or lower growth: an increase in energy and food prices could also provoke global inflation.

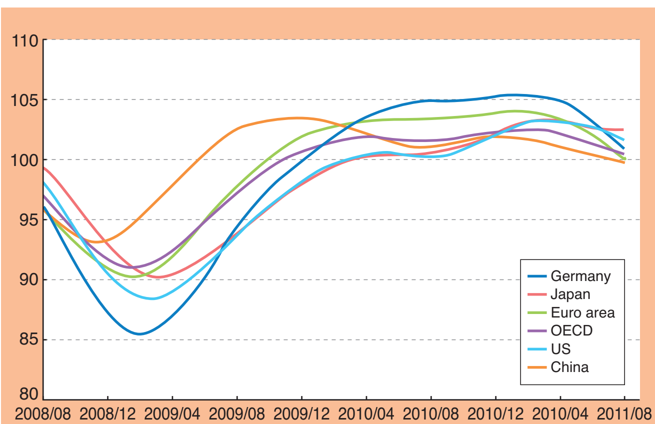
With this summary of the global economic growth perspective, I will provide a brief description of each region's or country's outlook.

Firstly, the US economy, though in the process of recovering from the financial crisis in 2008, is still weak in the aftermath of the Lehman shock. Growth was only 1.3% in the second quarter of 2011, in the context of political constraints on further fiscal stimulus, the rise of energy prices and stagnant private consumption growth. Although the pick-up in real GDP growth to 1.8% and 3.0%, respectively, in the third and fourth quarters of 2011 improved the employment situation, the unemployment rate is still high at 8.2%. In particular, the unemployment rate is higher among young people than in the past business recoveries. This is a principal factor in keeping private consumption growth weak, since income growth is limited by the high unemployment rate. Housing investment remains at a low level, as the household sector still suffers from a high debt ratio relative to disposable income. Consumers are trying to reduce debt by refraining from spending money on housing, as well as on other durable goods, such as automobiles. Such behavior is keeping private consumption growth weak and thus further slowing down the US economy and eventually the global economy. To restore US private consumption, which used to be a locomotive of the US economy and the global economy, consumers in the US need to reduce their debt to the pre-Lehman shock trend line. This will take another couple of years at least to achieve.

The EU economy is facing the most critical situation due to the euro crisis provoked by the fiscal crisis in some of its member countries. Both consumers and businesses are refraining from spending money due to an increasing concern about the instability of the EU economy, in particular due to the growing fiscal problem in

CHART 1

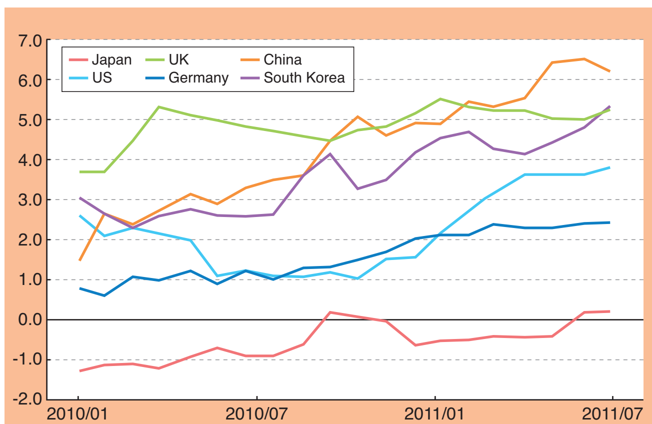
OECD leading indicators



Source: RIETI

CHART 2

Trends of CPI of the major economies



Source: RIETI

EU member countries such as Greece and Spain. In addition, the CPI inflation rate in the euro-zone continues to increase largely due to the rise of energy prices. With such negative impacts on economic growth, the GDP growth rate in the euro-zone has fallen into negative territory, compared to the growth rate of around 3% in the first quarter of 2011 and 0.8% in the second quarter of 2011.

Greece, Italy, Ireland and Spain, which have recorded large fiscal deficits, need fiscal consolidation to reduce public debt. In these countries, the debt-to-disposable income ratio of households is also increasing. Consequently, households in these countries are limiting consumption to reduce debt. Financial institutions are also naturally obliged to reduce their debts, possibly caused by their undisciplined portfolio management. A simultaneous structural adjustment process in the three sectors would lead to low economic growth. A very serious euro crisis seems to have been avoided for the time being by the EU political decision to expand the financial support of the European Financial Stability Facility (EFSF) for weak economies such as Greece, Italy and Spain. However, the above-mentioned efforts to reduce debt in the relevant sectors should be the essential solution pursued by those countries, not only in the short run but also in the long run.

Could the BRIC economies, in particular China, save the world from a recession? As in *Table 1*, it is certainly true that those economies will lead global economic growth in 2012. However, the next question is whether their economic growth is sustainable. Their economic growth, particularly in China, has been supported by exports and investment (public and private), rather than by private consumption. However, the international political situation does seem to make it rather difficult to sustain export-oriented growth and continuing large trade surpluses for a long time. It would also be difficult to keep increasing supply capacity by investment, since the level of capacity in those countries has already reached saturation point.

On the other hand, income differences between the rich and the poor and between urban and local areas are now significantly expanding, making it difficult to achieve sustainable growth in private consumption and domestic demand.

For all these reasons, it would be not be reasonable to expect China and the other emerging economies to lead the global economy in the long run.

TABLE 1

World economic outlook

(September, 2011) (%)

			2010	2011	2012	Change from the outlook issued in June, 2011	
			Achieved	Outlook	Outlook	2011	2012
World			5.1	4.0	4.0	▲0.3	▲0.5
US			5.1	1.5	1.8	▲1.0	▲0.9
Europe	Euro area		3.0	1.6	1.1	▲0.4	▲0.6
		Germany	3.6	2.7	1.3	▲0.5	▲0.7
		France	1.4	1.7	1.4	▲0.4	▲0.5
		Italy	1.3	0.6	0.3	▲0.4	▲1.0
	UK		1.4	1.1	1.6	▲0.4	▲0.7
Japan			4.0	▲0.5	2.3	0.2	▲0.6
AsiaNIEs			8.4	4.7	4.5	▲0.4	0.0
ASEAN5			6.9	5.3	5.6	▲0.1	▲0.1
China			10.3	9.5	9.0	▲0.1	▲0.5
India			10.1	7.8	7.5	▲0.4	▲0.3
Russia			4.0	4.3	4.1	▲0.5	▲0.4
Brazil			7.5	3.8	3.6	▲0.3	0.0
Middle East			4.4	4.0	3.6	▲0.2	▲0.8

Source: IMF

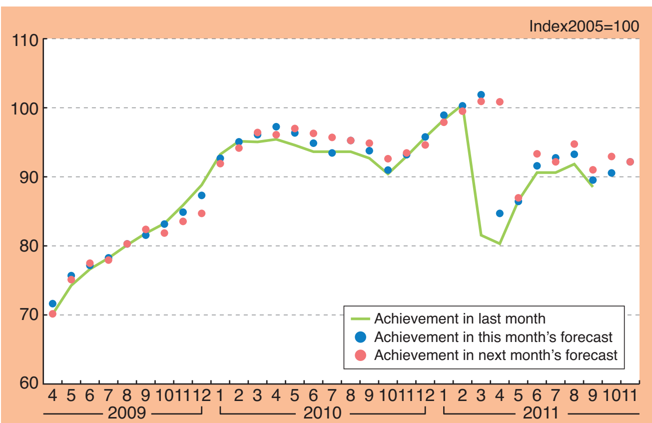
Outlook for the Japanese Economy in 2012

After the disaster on March 11, 2011, the Japanese economy has been recovering from this supply-side shock. Japanese economists agreed that this shock caused by the disaster was much less serious than the Lehman shock in 2008. As reconstruction efforts for the Tohoku and Kanto regions most seriously affected by the disaster continue, the Japanese economy is now returning to its normal growth track. *Chart 3* shows that the Japanese IIP (Index of Industrial and Mining Production) is recovering and *Charts 4 & 5*

CHART 3

Indices of production forecast

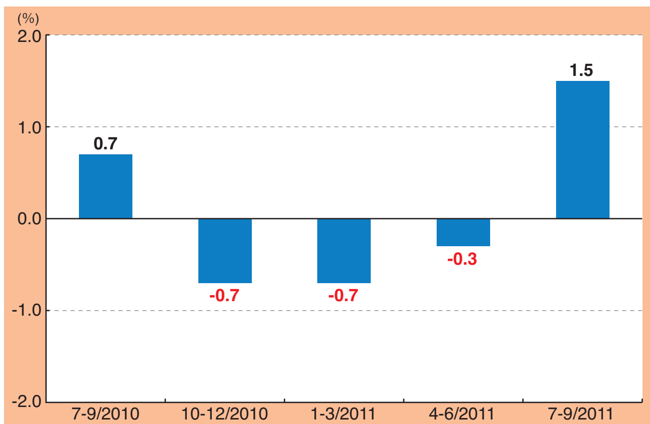
(Seasonal adjustment index)



Source: METI

CHART 4

Real GDP growth rate of Japan



Source: Quality estimates of GDP, Cabinet Office, Japan show that the recently announced GDP quarterly growth for the third quarter of 2011 was very robust and reached 7% at an annual rate. As in *Chart 5*, almost 70% of the growth then was led by domestic demand, indicating progress in restoring the domestic economy. The steady restoration of the supply side, accomplished through the restoration of supply chains in the manufacturing sector between the parts and components sector and final assembly, has also improved consumers' confidence, thus pushing up private consumption growth and eventually domestic demand.

Before the disaster, the Japanese economy was growing relatively slowly, at significantly lower rates than during the high economic growth era of the 1960s-70s.

Since the disaster, which provoked a temporary decline in GDP, the Japanese economy has been returning to its low growth track thanks to the restoration of supply chains, as if nothing extraordinary had happened.

However, sustaining this post-crisis rebound will be difficult, in part due to the weaknesses in the global economy summarized in the previous section. The decline in GDP growth at a 2.3% rate in the fourth quarter of 2011, mainly due to a decline in external demand growth, shows us this will be most likely.

Chart 6 summarizes economic forecasts for the GDP growth of Japan in 2012 made by major Japanese economic research institutes. Most of them recently lowered their growth estimates, reflecting the latest signs of a global economic slowdown. In August, many forecasters raised their pre-crisis projections made in March. However, in October, because of concern about a global recession, most lowered their estimates to around the level of the pre-disaster forecasts. Therefore, many economists think that it would be almost impossible for the Japanese economy to achieve a fundamental economic revitalization by a complete restoration of the damaged regions. This is not surprising as the damaged regions only accounted for around 5% of Japanese GDP prior to the disaster. The stagnant world economy and the yen's appreciation brought about by Japan's continuing trade surplus would make it difficult to stimulate export growth, one of Japan's important growth engines.

According to the OECD outlook, the real GDP growth rate in Japan in 2012 was projected to be 2.0%. In recent years, 2.0% growth has been considered somewhat higher than Japan's potential growth rate which is estimated to be less than 1% by the Bank of Japan and some other economists. Therefore, the OECD shares the consensus of Japanese economists that output growth will come back to the originally projected growth track in 2012.

The next question is whether this 2% growth is sustainable and can be maintained beyond 2012. Innovation is a key to achieving high sustainable growth in the long run. In particular, during the past two decades, we have not had any extraordinary new products or inventions either in Japan or the rest of the world. The world is moving towards an age of saturation of products and technology. We should work on the most effective way to promote innovation.

Apart from the question of innovation, there are two major concerns about the sustainability of Japan's economic growth. One is a concern about the snowballing fiscal debt and the other is a concern about the increasing possibility of the hollowing-out of Japanese industries by relocation of their production sites from Japan to overseas due to the yen's continuing appreciation and a possible rise in energy costs brought about by unstable supply of nuclear power in the post-Fukushima period.

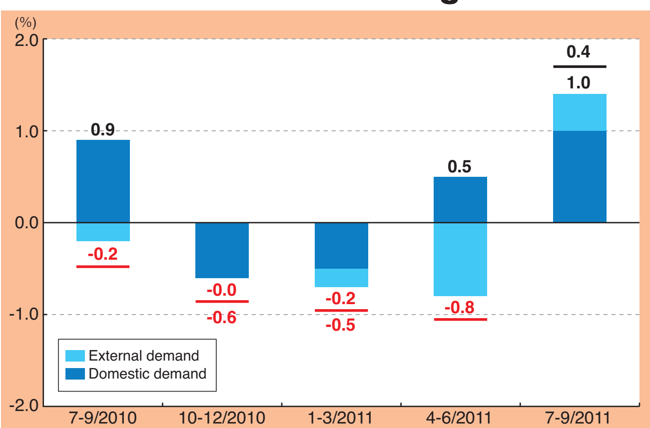
I will touch upon these two issues in the following sections.

Does a Fiscal Deficit Have a Positive or Negative Impact on Economic Growth?

According to a recently published book titled *This Time Is Different* written by Carmen Reinhart and Kenneth Rogoff, after financial crises economies only grow at trend and never recover the GDP lost in the crisis due to below-trend growth. *Chart 7* from the Reinhart-Rogoff analysis shows that as the risk of default caused by increasing domestic debt comes closer, the GDP growth rate slows down. After a default, it would take only three years for the economy

CHART 5

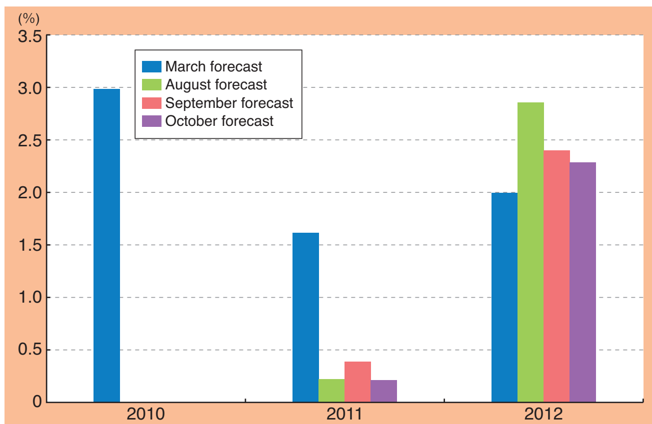
Contribution of domestic & external demand to GDP growth rate



Source: Quality estimates of GDP, Cabinet Office, Japan

CHART 6

Real GDP growth rate forecast for Japan



Source: This Time Is Different by Rogoff and Reinhart to regain its original trend growth rate four years before the default. Thus, according to their analysis, when we have a snowballing fiscal debt in our public sector, our economy will most likely slow down and any Keynesian policy attempting to stimulate a stagnant economy by expanding government spending and eventually the fiscal deficit will end up in discouraging economic growth rather than encouraging it. This is caused by the psychological effect of snowballing government debt on consumers and businesses.

As in *Chart 8*, the developed nations today share the same challenge of significantly growing government debt, with negative consequences for their economic performance in some countries. In particular, Japan is now facing the risk of the highest level of government debt. The government debt of Japan will grow even more because of the increased spending for reconstruction of the disaster-stricken areas. It would not be possible to maintain even the current growth track in the face of a growing government debt, enhancing uncertainty over the economy and thus dragging on growth, according to the Reinhart-Rogoff analysis. In addition, the further aging of Japan in the coming decades will increase the need for social welfare expenditure. Japan would need to raise its consumption tax rate to meet such policy needs, as well as try to reduce its fiscal deficit as soon as possible.

The hands of most developed nations are tied by a growing debt-to-GDP ratio, thus limiting the scope for fiscal stimulus, so we may need international macropolicy coordination. *Chart 9* shows that in terms of structural primary budget balance, the IMF projects that the developed nations' deficit relative to potential GDP will remain high despite efforts to reduce their fiscal deficit through the rationalization of government spending. In contrast, the emerging countries' primary imbalance would be kept low. This means that the emerging nations could have room for stimulating their domestic demand through further fiscal stimulus and thus try to prevent the whole world from falling into a recession. We need international organizations to play a positive role in achieving such policy coordination among the developed nations and the emerging countries.

Concern about a Possible Hollowing-Out of Japanese Industries

METI's latest statistical survey on Japanese manufacturing firms' overseas subsidiaries shows that these companies predict a robust increase in their overseas activities in the immediate future.

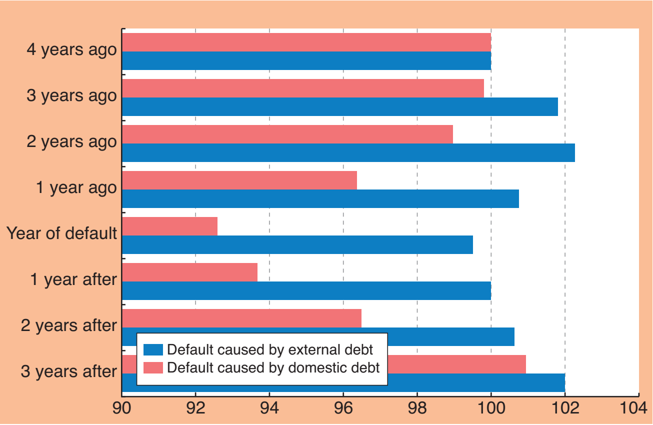
Table 2, a summary of this latest survey for their business activities during April-June 2011, tells us that although the total sales, physical investment, and employee levels in the first and second quarters of 2011 either declined or remained unchanged, their DIs (the firms' own predictions for July-September and October-December 2011) of these items all increased significantly relative to the previous quarter's survey. Their DIs for October-December 2011 also showed an even stronger increase. In particular, the DIs of the transportation machinery industry significantly increased from the negative figure in the previous survey, which was taken during the January-March quarter.

In other words, many Japanese manufacturing companies predict a significant rise in their overseas affiliates' business activities. Assuming that the regional economic outlooks in the world are not so optimistic, as we have already seen, this strongly positive prediction of the Japanese overseas subsidiaries' activities means that Japanese manufacturing companies now intend to be earnestly engaged in expanding their overseas affiliates' business. This seems to imply that they are interested in relocating their business bases including production. This interpretation of the statistics suggests that in the future the Japanese manufacturing industry could hollow out due to its increasing relocation of production bases from Japan to overseas.

Although the Japanese economy seems to be picking up steadily since the disaster, Japanese firms appear to be already thinking about relocating their production bases overseas, possibly due to a continuing strong yen against the US dollar and concerns over a possible rise in energy costs.

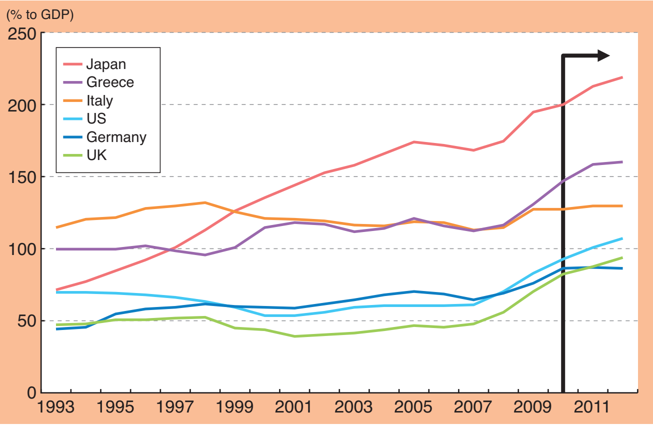
In 2009, the cumulative stock of Japanese overseas FDI was 15%

CHART 7
Real GDP before & after a default



Source: This Time Is Different by Rogoff & Reinhart

CHART 8
Government debt stock (gross)



Source: RIETI

of nominal GDP, much lower than the 29% for the US, 78% for the UK and 40% for Germany. Therefore, Japan still has the potential to increase its FDI, including by the relocation of production bases, etc. There is also evidence of a positive correlation between FDI and domestic business growth. Since FDI would lead to a decline in production costs and a rise in competitiveness through rationalization of the industries' business activities (including through the relocation of production bases), it is in many cases instrumental in promoting domestic physical investment, R&D and domestic employment as well. This analysis was done for both Japanese and US companies.

On the other hand, we see a rapid increase in Japan's surplus on investment income. This implies that today the long period of current balance surpluses has brought Japan a large stock of external net assets and it consequently has a large surplus in the income balance from its accumulated net assets. Japan still enjoys the status of a current surplus nation today, although it had a trade deficit in 2011 due to a decline in exports caused by the disaster. (Current account balance = Trade balance + Income balance.)

However, as the economy becomes more mature, the examples of the developed economies such as the US and the UK show us that the trade balance will eventually fall into deficit. And as its deficit grows and exceeds at some point the surplus in the income balance, then the current account balance will have a deficit and net external assets will start to decline. This is economics based upon empirical facts.

The US and the UK followed exactly this path. Both countries are now in the final stage of the economic development described above, with current account deficits and net external debts. However, both are successful in maintaining their surplus in the investment income balance. Moreover, they receive significant capital inflows that finance the current account deficit. Portfolio investment in the stock market is encouraged by their well-developed financial markets.

A current account balance is the result of saving and investment decisions taken across the economy by firms and households and it is not really a target that the government can achieve. Further relocation of production bases and increased FDI may lead to a trade deficit and that is not necessarily bad. Through the following measures Japan can achieve further internationalization as well as strengthen its domestic economy.

Firstly, Japan should redouble its efforts to invite more internal investment from overseas, thereby reducing the significant imbalance between the FDI outflows and inflows.

Secondly, following the disaster on March 11 in 2011, we learned that in our restoration process our social solidarity is very strong, thereby promoting interregional or intersectoral cooperation and even cooperation among competitors has been accomplished. Such Japanese solidarity could be helpful in promoting close cooperation between corporate headquarters and overseas subsidiaries, thus helping to avoid a hollowing-out of the headquarters' functions.

Thirdly, as German companies do, Japanese companies should pursue concentration in some "niche" products in which they have an overwhelming comparative advantage.

Fourthly, it is not to be ignored that Japan has a big domestic market ($5 trillion and 120 million inhabitants) and new markets can be further exploited as aging advances. There will be newly emerging markets for elderly people in Japan and industries should tailor their supplies to their needs and tastes.

And finally, high-value added services can be further developed in Japan as it advances in creating a knowledge economy. Professional services such as business consultants, lawyers, and venture capitalists would have to be expanded and increase their share of the service sector in Japan. JS

* This article was completed with invaluable advice and comments from Dr. Randall Jones, head of Japan/Korea Desk, OECD.

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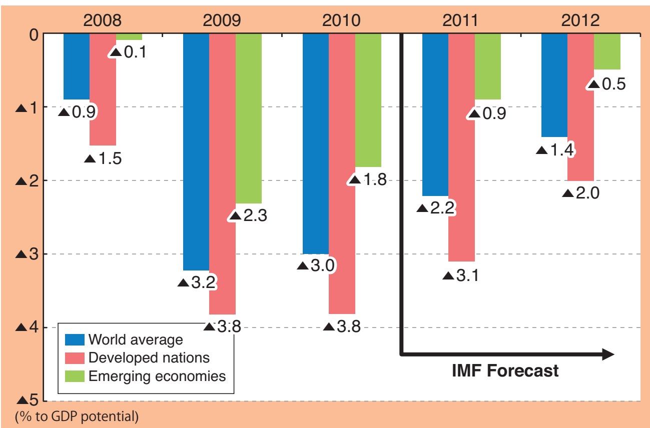
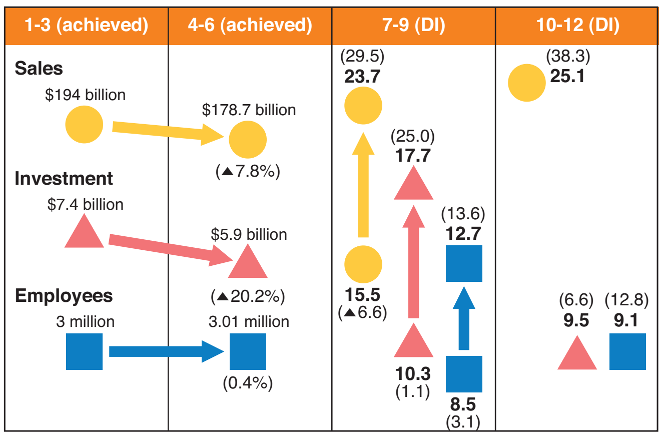
CHART 9
Structural primary balance



Source: Fiscal Monitor, IMF

TABLE 2
Business activity of Japanese overseas subsidiaries in 2011



Note: DIs in ( ) are for transportation machinery.
Source: METI