32. JAPAN

Recovery on the back of rising exports

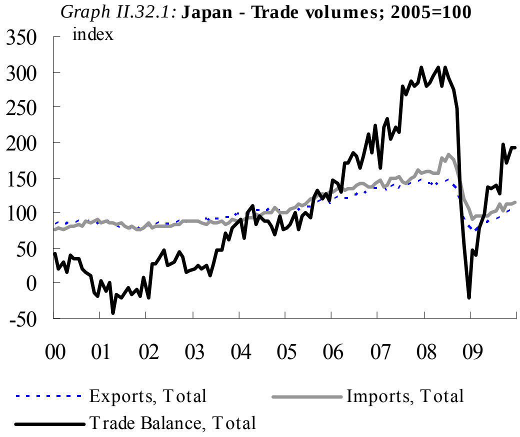
Deflation, fiscal woes but growth resumes

After the near-stagnation following the burst of the asset bubbles in 1990-91, the Asian crisis in 1997-98 prolonged this situation. Following this and the burst of the dotcom bubble in 2000, the Japanese economy entered its longest post-war expansionary phase, which lasted from early 2002 until early 2008. As a result, Japan was the only G3 country which posted negative growth in 2008 (-1.2%). Starting with the second quarter of 2008, i.e. well before the Lehman shock, Japan posted four consecutive quarters of negative GDP growth, resulting in an 8.9% y-o-y decline of GDP in the first quarter of 2009.

Compared to other large industrial countries, Japan managed to emerge from the crisis earlier. Already in the second quarter of 2009 GDP grew by 1.5% q-o-q. Following a soft patch (-0.1% q-o-q) in the third quarter, growth resumed in the fourth quarter of 2009 (0.9% q-o-q). Exports, one of the two components which had driven down GDP until early 2009 and had slumped by 36.5% y-o-y in the first quarter of 2009, staged a strong rebound from the second quarter of 2009 onwards. Private non-residential investments, which fell by around a quarter from its peak in the 18 months until the third quarter of 2009 improved later than exports but seem to have finally bottomed out and grew in the fourth quarter of 2009 (0.9% q-o-q).

Partly due to a strong base effect, exports were up very strongly by 43.5% y-o-y in March, in particular exports to Asia grew by 52.9% y-o-y. Exports to Indonesia almost doubled in the year to March 2010. Despite the recent recovery in exports the export value in March 2010 was still 22% below the peak reached two years earlier. On the back of the projected brisk growth in many Asian economies, Japanese exports to them are expected to post further strong growth in 2010. Rising exports to Asia are also seen as the main reason behind a projected strong increase in exports and are set to contribute significantly to growth in 2010. The recent emphasis by Prime Minister Hatoyama on increased cooperation and openness towards Asia might further support this trend by making disrupting frictions less likely and by improving operational conditions for Japanese companies. It is remarkable that the rebound in exports occurred although the yen was relatively strong towards most currencies in 2009. Exports could therefore not benefit so far from the same tailwinds as existed in 2006 and 2007 when Japanese exports grew strongly.

Graph II.32.1: **Japan - Trade volumes; 2005=100**

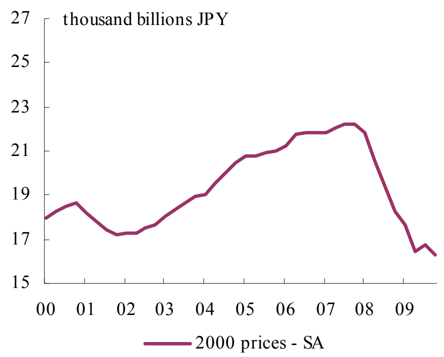


Terms of trade are expected to deteriorate significantly in 2010 after a marked improvement in the previous year. Strongly falling import prices contributed to reinstating the deflationary trend in Japan which appeared to be finally overcome just before the crisis started. With its perilous effects on allocation and investment decisions entrenched deflationary expectations are a major risk in Japan. While deflation is unlikely to be overcome in the course of the year, a much milder and therefore less distorting deflation is expected compared to last year, when the magnitude and effect were more damaging.

Investment may have bottomed out

A number of factors make it likely that private non-residential investments have finally bottomed out. Large manufacturing companies, from which the bulk of these investments originate, face an improved profit situation. The capital stock has been declining slightly in recent months, indicating that current investments are below replacement level. In the same period the decline in outstanding credit reflected base effects, a lack of interesting investment opportunities and for large companies better access to finance other than bank credit. The improved financing situation of large companies is another illustration of a slowly improving investment outlook. Before the crisis many large manufacturing companies had reached relatively slim staff structures and some further shedding of labour happened during the crisis.

Graph II.32.2: **Japan - Gross Capital Formation, Non-residential Investment**



Some hiring and investment is likely this year. After some shedding of labour during the crisis, as the recovery gains traction, more companies will face a shortage of labour. Investments will be supported by fierce competition with Asian competitors. Those competitors are quickly moving up the value chain and Japanese producers depend more than ever on success in export markets. This leaves them with no choice but to innovate and make production processes more efficient. Still, a return to the almost 5% average annual growth of non-residential investment between 2002 and 2007 is unlikely, given the high capital stock combined with the slump in long-term investor confidence during the crisis.

Wages do not support consumption

While employment held up better than expected during the crisis nominal wages declined by 4% in 2009. The usually delayed reaction of wages to economic developments, ongoing structural developments in the labour market (the still growing number of temporary workers) and the replacement of many highly-paid workers born in the late 1940s by younger and less qualified workers, all point to a further decline in nominal wages in 2010. But a further reduction is likely to be much smaller than in 2009. Nominal wage developments in Japan since the crisis started demonstrate that the concept of "sticky wages" is not useful in the case of Japan. Against the backdrop of a large bonus component, nominal wages have always been more flexible than in other industrial countries. The recent marked decline even points to increased flexibility, maybe on the back of "deflation expectations" on the side of the employees. In this context the steep price decline of "highly visible goods", such as durable goods, and the significant shift of consumption to those products with falling prices might have influenced workers' perceptions and made nominal wage expectations more flexible. Further reasons for this development are the still relatively weak social safety net, the social stigma which goes along with unemployment and the relatively high transaction costs which a change of job brings about for Japanese employees. The negative impact of deflation on allocation and consumption decisions is somewhat lower in Japan because of this flexibility of nominal wages than it otherwise would be.

In 2010, consumption will be supported by rising social expenditure and other stimulating measures which will gain steam in the course of the year. The bleak prospects for household income and the already low saving rate limit consumption growth. The significant deflation in 2009 also means that owners of cash or bank deposits had a relatively good real return after taxes last year (compared to previous years), which might generate a small positive wealth effect. Households have incurred limited losses in the financial crisis and should not refrain from consuming. With this in mind and with employment prospects improving somewhat it seems reasonable to expect slightly rising consumption in 2010. This assumption is further supported by the fact that private consumption declined for two consecutive years in 2008 and 2009 and (following past behaviour) households will try to recapture some of the lost consumption. A factor that further complicates the outlook for consumption is the worsening pension outlook for workers in their forties and fifties. Not only do they see the reserves of the social security scheme dwindling, but they also cannot count on generous lump-sum payments upon retirement as just a few years ago. Government consumption is likely to rise in 2010, partly reflecting ageing, automatic stabilizers, as well as discretionary social spending decisions by the new government. Public investments on the other hand will likely fall, but maybe less than projected by the government.

In 2011 private and government consumption are expected to grow steadily but gradually. Private investments are expected to grow after several years of weak performance. Public investment is expected to subtract from growth. Exports will continue to grow, but due to a stronger rise in imports, growth in net exports will be limited.

Risks are relatively balanced. Household consumption has limited potential to surprise on the upside. Even in upswings household consumption rarely rose briskly over the last two decades. There are few conceivable reasons why that pattern should change this time around, as people feel more insecure than before and thrift became much more fashionable than only a few years ago. In 2010 major surprises regarding government spending are unlikely as long as the pace of moderate recovery continues. Consumption might be flat or even slightly negative, if incentives for non-durable items vanish, or saturation for certain goods arises, or fewer technical innovations appear which would cause consumers to open their purse. It is also conceivable that the first new government which intends to pursue policy changes in more than half a century causes households to take a more cautious attitude towards consumption. An unforeseen tightening of fiscal policy, leading to lower GDP growth than anticipated, is another downside risk. A further appreciation of the yen coupled with a less brisk demand for investment goods from Asia could result in a much less buoyant export performance than projected. Such a scenario would most likely also result in lower profits for companies and in a further decline in investments.

On the upside, exports to Asia have the potential to grow even more than expected in 2010, if growth in Asia remains strong and inflation pressures remain contained. Stronger-than-expected investments represent another upside risk. As investments tend to move in cycles the fact that investment seems to have bottomed out has a bearing on future prospects. After the deep slump in investment over the last few quarters, a relatively healthy financial situation of companies, improving access to finance and a better business outlook are all elements that could support a shift in business sentiment, which could bring about better investment results than projected.

For 2011 the crucial question is whether or not an improved situation of large manufacturing companies with rising exports and rising investments has sufficient impact on the employment situation and on wages to improve households' income situation and sentiment, to raise consumption and kick-start a more home-grown and sustainable growth pattern.

Table II.32.1:

Main features of country forecast - JAPAN

	2008			Annual percentage change						
	bn YEN	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP		505113.9	100.0	1.1	2.0	2.4	-1.2	**-5.2**	**2.1**	**1.5**
Private consumption		291750.7	57.8	1.2	1.5	1.6	-0.7	**-1.0**	**1.2**	**0.9**
Public consumption		93374.6	18.5	2.7	0.4	1.5	0.3	**1.6**	**1.1**	**0.9**
Gross fixed capital formation		117755.3	23.3	-0.7	0.5	-1.2	-2.6	**-14.8**	**-1.7**	**2.7**
of which : equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		88493.0	17.5	5.0	9.7	8.4	1.6	**-24.2**	**21.5**	**7.7**
Imports (goods and services)		87758.0	17.4	4.1	4.2	1.6	0.9	**-17.1**	**8.2**	**8.4**
GNI (GDP deflator)		521861.8	103.3	1.2	2.5	2.9	-1.2	**-5.8**	**2.1**	**1.4**
Contribution to GDP growth :	Domestic demand			0.9	1.0	0.9	-0.9	**-3.5**	**0.6**	**1.2**
	Inventories			0.0	0.2	0.3	-0.4	**-0.3**	**0.0**	**0.0**
	Net exports			0.2	0.8	1.1	0.1	**-2.0**	**2.0**	**0.3**
Employment				-0.2	0.4	0.4	-0.3	**-1.6**	**-1.0**	**-0.2**
Unemployment rate (a)				4.0	4.1	3.9	4.0	**5.1**	**5.3**	**5.3**
Compensation of employees/head				0.1	0.2	-1.1	-0.4	**-3.1**	**-0.1**	**0.9**
Unit labour costs whole economy				-1.2	-1.4	-3.0	0.4	**0.5**	**-3.1**	**-0.8**
Real unit labour costs				-0.6	-0.5	-2.3	1.3	**1.5**	**-2.0**	**-1.5**
Savings rate of households (b)				-	-	9.2	9.3	**9.5**	**9.6**	**9.2**
GDP deflator				-0.6	-0.9	-0.7	-0.8	**-0.9**	**-1.2**	**0.8**
General index of consumer prices				-	0.3	0.0	1.4	**-1.4**	**-0.5**	**-0.4**
Terms of trade of goods				-1.1	-8.0	-4.3	-10.9	**13.6**	**-11.1**	**-1.8**
Trade balance (c)				2.6	1.9	2.4	0.8	**0.9**	**1.0**	**0.8**
Current account balance (c)				2.7	3.9	4.8	3.2	**2.8**	**3.1**	**2.5**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				2.6	3.8	4.7	3.1	**2.7**	**2.9**	**2.4**
General government balance (c)				-5.5	-1.6	-2.5	-2.0	**-6.9**	**-6.7**	**-6.6**
Cyclically-adjusted budget balance (c)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (c)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				127.2	191.3	187.8	172.0	**189.2**	**193.5**	**194.9**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.