

## 32. JAPAN

### Huge economic challenges for the new government

#### More than one 'lost decade'?

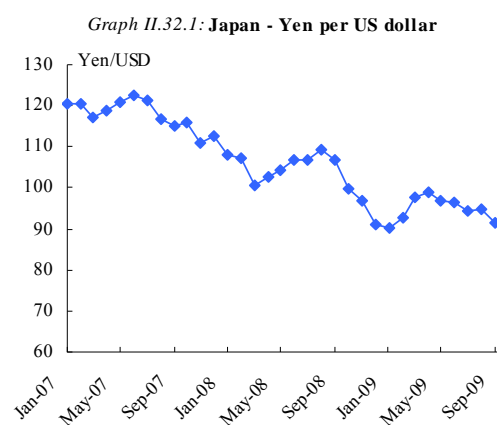
Following the bursting of asset bubbles in 1989-90 Japan had been going through a period of very low annual GDP growth, the so-called 'lost decade.' The lack of reduction in existing overcapacities in industry and banking and the slow resolution of problems in the banking sector led to a period of anaemic growth coupled with deflationary developments. This drove Japan into a recession in 1998, when the unfortunate timing of the rise in the sales tax coincided with the outbreak of the Asian financial crisis. To each crisis, the LDP-led government reacted with huge fiscal stimulus plans focused on construction projects. In a highly developed country like Japan, this not only led to 'cathedrals in the desert', but also induced a fast rise in the country's debt burden, bringing the gross debt-to-GDP ratio to the highest among G7 countries. The economy took another hit when the global IT bubble burst in 2001.

Japan's experience in tackling this long crisis period is noteworthy. Economic developments only turned better, when in the same year the newly appointed government started to implement some overdue structural reforms. The problems related to non-performing loans of the banking sector were resolved through the injection of considerable budgetary means into the banks' capital (however, this did not change the chronic inefficiency of most of Japan's banking sector). Furthermore, the successive governments in the years 2001 to 2006 implemented strong cuts in the construction budget(s) and the country's pension system, which succeeded in bringing to a halt the fast rise in the debt ratio. Structural labour market reforms were enacted, which led to a rapid increase in the share of non-regular employment in overall employment. The favourable global developments and a Yen weakened by carry-trades supported an export-driven recovery, which for the first time since 1990 led to considerable recovery in land prices in Tokyo, Nagoya and Osaka, underlining the rising regional discrepancies in economic development. In the final phase, deflation was overcome and nominal GDP was finally clearly higher than in 1990. Private consumption also started to perform well, driven not least by a considerable decline in the country's saving rate.

Following the Prime Minister's resignation in 2006, however, the reform process stalled, leaving Japan relatively unprepared for the current Great Recession, in spite of the low exposure of the country's banks to toxic assets.

#### The downturn was precipitous

In spite of this low exposure and of the rising importance of other Asian markets for Japanese exports - China's share in Japanese exports (19.1%) is now clearly higher than the US share (15.8%) or the EU one (11.4%) - Japan was hit early by developments in the US. Following the rising problems of the financial sector in the US, carry-trades reversed as Japanese investors repatriated funds into Japan's safe haven. As a consequence, the Yen appreciated strongly, rising from an average monthly rate of Yen 122.7 to the US dollar in June 2007 to Yen 112.5 in December 2007, and Yen 106.7 in September 2008. On a relative effective basis, the negative impact of exchange rate developments was worsened by the fact that in July 2008 China de facto re-pegged its currency to the US dollar and that neighbouring countries like Korea saw their currency decline strongly against the US dollar.



Following the failure of Lehman Brothers in September last year, the already ongoing decline in Japan's growth accelerated clearly and a second-wave of Yen repatriation started, driving the Yen up to Yen 91 per US dollar in December 2008 and Yen 88.3 at the point of writing. This time, the Yen also appreciated strongly against the euro,

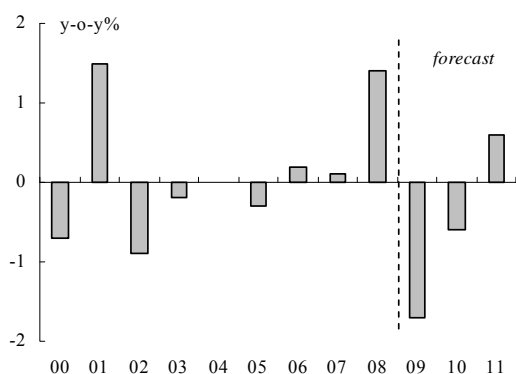
rising from an average of Yen 153 to the euro in September 2008 to Yen 123 in December last year.

With exports down by 13.6% in the fourth quarter of last year (in volume and seasonally-adjusted terms), and by 22.5% in the first quarter - while imports proved more resilient - GDP declined by 3.5% q-o-q in the fourth quarter of 2008 and by another 3.1% in the first quarter of 2009. Supported by the government's stimulus package, in the second quarter both public investment and private consumption contributed positively to the quarterly growth rate of 0.6% as did net exports.

Trade as a whole, however, continues to underperform. Exports in August were still down by 37.1% on the year (in value terms), following a decline by 37.6% in July and imports in August declined by 42.8% (following a drop by 41.2% in July and by 43.8% in June). In the first seven months of this year, the current account surplus has declined further, due to the ongoing decline in income from abroad.

Given the strong appreciation of the Yen and the rising (negative) output gap, it does not surprise that the growth of consumer prices has also turned negative again. In August, the core index (i.e. excluding volatile fresh food prices) was down by 2.2% on the year, the sharpest drop since comparable data was first recorded in 1971. As growth is expected to remain weak in the short-term and on the basis of our exchange-rate assumptions, it seems likely that deflationary developments will continue for some time and that the 2010 inflation rate will still be negative.

Graph II.32.2: Japan - Consumer prices



### Subdued growth in the short-term

The short-term outlook for the Japanese economy has improved compared to the quarterly projections of the spring forecast. With public investment in particular and final demand as a whole expected to be higher than assumed in spring, growth in the second half of the current year is likely to be higher than forecast in spring. Industrial production in the third quarter has increased regularly and the short-term outlook for industrial production for October remains positive, with METI (Ministry for Economy, Trade and Industry) forecasting a rise by 2.2% on the month. Furthermore, the Tankan, the most accurate leading indicator for the Japanese economy has also continued to improve in September, rising from minus 48 in the June survey to minus 33 among large manufacturers and from minus 29 in June to minus 24 in September among large non-manufacturers. Nevertheless, given the worse-than-projected performance in preceding quarters, the expected GDP growth rate for the current year as a whole has deteriorated from -5.3% in spring to -5.9% now.

Regarding the year 2010, the improved outlook for the second half of this year also implies a slightly higher positive overhang into next year. Combined with the improved outlook for the US, this induces a higher growth in the order of 1% compared to a forecast of 0.1% in spring.

Risks to the forecast are relatively balanced. On the one hand, private consumption could perform worse than anticipated, as unemployment is at record levels and nominal wages are falling. On the other hand, growth in China, in particular in 2010, could turn out even higher than forecast, implying a better Japanese export performance than currently anticipated. Furthermore, the technical assumption of this forecast, i.e. a stable nominal exchange-rate of the Yen could turn out to be relatively 'pessimistic' for exports.

The outlook both for 2010 and 2011, however, is particularly uncertain, given the first clear election victory by an opposition party against the LDP since the LDP's foundation in 1955 on 30 August 2009. In its election manifesto, the victorious Democratic Party of Japan (DPJ) has inter alia announced higher spending on child allowances and education to be financed by the elimination of waste and the ending of "unnecessary and non-urgent projects", e.g. in infrastructure. In line with this announcement, the new government, which

was formed after the election of Y. Hatoyama as Japan's new Prime Minister on 16 September, has stopped many projects contained in this fiscal year's supplementary budgets (FY 2009). Furthermore, on 29 September, the government has asked for fresh requests from ministries and agencies for the budget for the FY 2010 (starting on 1 April 2010) until 15 October to "redraft the state budget from scratch".

While the new government's insistence on changing Japan's growth model from business and export-orientation towards private demand ("put people's life first") is encouraging for consumption in coming quarters and welcome globally, it remains to be seen whether this policy orientation will be able to withstand the huge challenges the country is facing, especially the fast ageing and the demographic decline. Overall, given the information that we have at this stage, a dynamic rebound of the Japanese economy appears unlikely.

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		507569.4	100.0	1.1	2.0	2.3	-0.7	-5.9	1.1	0.4
Private consumption		293433.6	57.8	1.2	1.5	0.7	0.6	-1.2	0.9	1.0
Public consumption		94076.3	18.5	2.7	0.4	1.9	0.8	0.8	0.7	0.9
Gross fixed capital formation		117168.2	23.1	-0.7	0.5	0.8	-5.0	-12.3	0.2	-0.3
of which : equipment		-	-	-	-	-	-	-	-	-
Exports (goods and services)		88473.8	17.4	5.0	9.7	8.4	1.8	-26.6	7.9	3.1
Imports (goods and services)		87758.5	17.3	4.1	4.2	1.5	0.9	-16.7	2.9	7.6
GNI (GDP deflator)		524316.7	103.3	1.2	2.5	2.8	-0.7	-6.9	1.0	0.3
Contribution to GDP growth :										
Domestic demand				0.9	1.0	0.9	-0.7	-3.2	0.7	0.7
Stockbuilding				0.0	0.2	0.3	-0.2	-0.3	-0.3	0.0
Foreign balance				0.2	0.8	1.1	0.2	-2.4	0.7	-0.4
Employment				-0.2	0.4	0.4	-0.4	-3.0	-1.2	-0.2
Unemployment rate (a)				4.0	4.1	3.9	4.0	5.8	6.3	7.0
Compensation of employees/head				0.1	0.4	-0.4	0.5	-0.8	0.5	0.9
Unit labour costs whole economy				-1.1	-1.2	-2.3	0.8	2.2	-1.8	0.3
Real unit labour costs				-0.6	-0.3	-1.7	1.7	1.5	-0.8	0.8
Savings rate of households (b)				-	-	10.4	10.1	11.1	10.5	9.3
GDP deflator				-0.6	-0.9	-0.7	-0.9	0.7	-1.0	-0.5
General index of consumer prices				-	0.3	0.0	1.4	-1.2	-0.4	0.3
Terms of trade of goods				-1.1	-8.0	-4.4	-11.0	14.8	-2.0	-1.8
Trade balance (c)				2.6	1.9	2.4	0.8	0.6	0.9	0.5
Current account balance (c)				2.7	3.9	4.8	3.2	1.8	2.0	1.0
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				2.6	3.8	4.7	3.1	1.7	1.9	0.9
General government balance (c)				-5.5	-1.6	-2.5	-3.8	-8.0	-8.9	-9.1
Cyclically-adjusted budget balance (c)				-	-	-	-	-	-	-
Structural budget balance (c)				-	-	-	-	-	-	-
General government gross debt (c)				127.2	191.3	187.7	173.1	189.8	197.6	206.0

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