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Economic policies required of incoming Abe administration

Four prescriptions for rehabilitating Japan's economy

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Summary

- **Economic policies required of incoming Abe administration:** The election of the 46th House of Representatives held on 16 December 2012 has set the stage for the Liberal Democratic Party leader Shinzo Abe to form a coalition government with New Komeito. In this report, we analyze economic policies the incoming Abe administration will need to firmly pursue to restore the economy, centering on four points: (1) there should be consistent policies based on a firm vision (national vision and philosophy) of the top leaders, (2) instead of focusing only on domestic demand and the demand side, economic policies should be implemented that are well balanced and that embrace foreign demand and the supply side, (3) government finances should be rebuilt by raising the consumption tax and reducing expenditures centering on social security costs, and (4) the government and the Bank of Japan (BOJ) should work together more closely. Regarding the last, based on an analysis using the Granger causality test, a weaker yen and higher stock prices ensuing from further monetary easing by the BOJ would be effective in ending deflation.
- **Economic outlook revised upward:** In light of the second preliminary Jul-Sep (3Q) 2012 GDP report (Cabinet Office), we have revised our economic growth outlook upward. We now forecast real GDP growth of +1.0% y/y for FY12 (previous forecast: +0.7%) and +1.1% for FY13 (+0.9%). Factoring in the annual revision of FY11 GDP, released along with the second preliminary 3Q 2012 GDP report, we have revised our outlook for public works spending substantially upward.
- **Our main scenario and risks facing Japan's economy:** With the worsening of foreign economies, it is highly probable that Japan's economy peaked in March 2012 and has slipped into recession. Despite the existence of downside risks, as our main scenario we believe that Japan's economy will follow a path of gradual recovery in 2013 and beyond, supported by three factors: (1) pickup of the US and Chinese economies, (2) reconstruction demand related to the Great East Japan Earthquake, and (3) further monetary easing by the BOJ. Risks that will need to be borne in mind for Japan's economy are: (1) any deepening of the European sovereign debt crisis, (2) worsening of Japan-China relations, (3) the US fiscal cliff, and (4) a surge in crude oil prices stemming from geopolitical risk.

1. Economic Policies Required of Incoming Abe Administration

The 46th election of the House of Representatives held on 16 December 2012 has set the stage for Liberal Democratic Party (LDP) leader Shinzo Abe to form a coalition government with New Komeito. In this report, we analyze economic policies required of the incoming Abe administration.

The new administration will need to firmly pursue economic policies to restore the economy centering on four points: (1) there should be consistent policies based on a firm vision (national vision and philosophy) of the top leaders, (2) instead of focusing only on domestic demand and the demand side, economic policies should be implemented that are well balanced and that embrace foreign demand and the supply side, (3) government finances should be rebuilt by raising the consumption tax and reducing expenditures centering on social security costs, and (4) the government and the BOJ should work together more closely. Regarding the last, based on an analysis using the Granger causality test, a weaker yen and higher stock prices ensuing from further monetary easing by the BOJ would be effective in ending deflation.

1.1 Consistent policies based on firm vision of top leaders

Policy responses from deductive approach the key

First, it will be of utmost importance to implement consistent policies backed by a firm vision (national vision and philosophy).

In the 2009 House of Representatives election, the Democratic Party of Japan (DPJ), the opposition party at the time, won a landslide victory and formed a coalition government with parties other than the LDP. It was the first time in Japan's history for power to pass from a ruling to opposition party with the overwhelming support of voters in a national election.

However, not a few influential individuals thought DPJ's manifesto was patchy as a result of overly paying attention to the voice of voters. The manifesto was criticized for seemingly to be just a list of policy measures to oppose those of the LDP, and, as a result, lacked consistency, it was also unclear in terms of priority, and some policy measures conflicted with each other.

After taking office, the DPJ failed to adequately read public opinion. Indeed, in polls taken during its administration, many voiced the opinion that thorough review of the manifesto was necessary. People voted for the DPJ in the 2009 election because they disliked the management of the post-Koizumi LDP government, not because they actively supported the DPJ's policy measures. However, the DPJ mistook the election result for public approval of its measures. Thus, it adhered to the idea that they were unalterable.

The reasoning process can take either a deductive or inductive approach. In the deductive method, logical reasoning is used to derive individual conclusions from general and universal principles. Contrasting with this, the inductive approach begins with individual cases to develop general and universal principles. It goes without saying that a nation's policies should be developed through deductive reasoning. A sound approach is to start from the general principles of a firm national vision to develop individual policies to put into practice. Based on such thinking, the Abe administration would be well advised to specify a work schedule of new policies backed by a clear vision.

1.2 Well-balanced economic policies that also embrace foreign demand and the supply side

Reinforcement of growth strategy the key

Second, the key to rehabilitating Japan's economy is to implement well-balanced economic policies that not only focus on domestic demand and the demand side but also embrace foreign demand and the supply side.

Economic policies can be broadly divided into the four quadrants of supply-side policies, demand-side policies, domestic demand, and foreign demand. The DPJ administration, in part as an antithesis to the LDP that gave some thought to the supply side and foreign demand, placed considerable weight on demand-side and domestic-demand policies. In the DPJ manifesto for the House of Representatives election of 2009, payment of a child support subsidy to address a declining birth rate, employment measures, and reform of the pension and social security systems were positioned as major policies. In reality, reform of the pension and social security systems, the most important of these policies, flagged, and policies centering on the child support subsidy were made the centerpiece of the administration (to be eligible for the subsidy a household income threshold was reintroduced in FY12).

As a result, many foreign investors, key players in Japan's stock market, came to view the DPJ administration as not being well balanced and as being tilted toward the demand side of domestic demand centered on the child support subsidy—in other words, with an interest in only one quarter of the economy. At the Inward Investment Promotion Round Table (Chair: Minister of Economy, Trade and Industry; held under the direction of Prime Minister Naoto Kan), Japanese business leaders identified five factors that were “evicting” Japanese companies from Japan and that were abetting the hollowing out of the economy. The so-called five “eviction factors” were a strong yen, slowness in concluding EPAs, environmental regulations, labor regulations, and a heavy corporate tax rate. By ignoring these issues, the DPJ administration was roundly criticized as being anti-business.

Clearly, we must go beyond the pointless contest between supply side and demand side and implement policies that are balanced between the two.

There would be no better way to stimulate the economy than to have the Abe government forsake DPJ's anti-business stance and to clearly adopt a pro-business stance. Specifically, it will be of utmost importance to focus on both domestic and foreign demand and to strengthen such policies as practical growth strategies, deregulation, reduction of the corporate tax, promotion of the Trans-Pacific Strategic Economic Partnership Agreement, promotion of free trade agreements and economic partnership agreements, adjustment of the industrial structure, and government and industry working together to win major foreign contracts (expressways, water and sewerage facilities, next-generation transmission grids, water treatment plants, etc.).

Priority areas are the environment and services centering on health care and long-term care

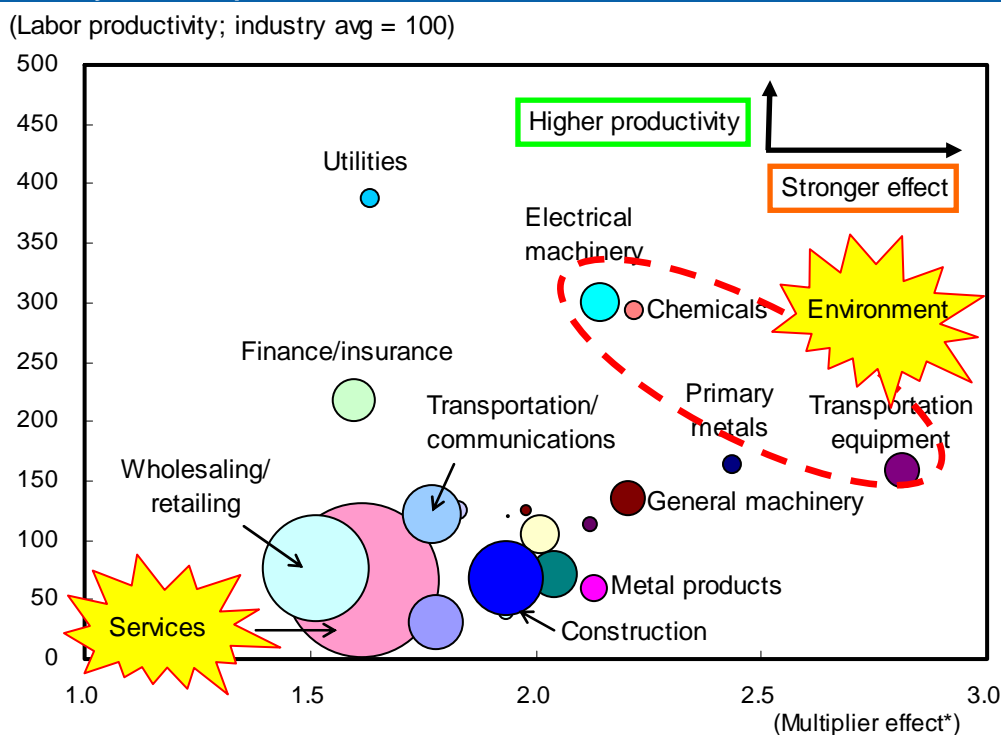
As illustrated in Chart 1, in view of Japan's industrial structure, priority areas are likely to be (1) the environment, which promises efficiency, ripple effects to other industries, and high growth prospects, and (2) services centering on health care and long-term care which have a large capacity to create jobs.

In the chart, the size of circles indicates number of employees. The capacity to create jobs is limited for environment-related industries (electrical machinery, chemicals, and transportation equipment). Manufacturing industries only account for 26% of GDP. Therefore, to increase jobs, it is indispensable to stimulate services (centering on health care and long-term care; located in the lower left corner in the graph).

In growth strategy discussions, the pointless contest between supply side and demand side or that between foreign demand and domestic demand often continues endlessly. While manufacturing industries and foreign demand promise efficiency and ripple effects to other industries, service industries and domestic demand have a large capacity to create jobs. Thus, the key to Japan's economic growth will be to first determine the potential advantages of each and then to implement strategies to fortify industries/demand on both sides as optimally as possible.

Labor Productivity and Multiplier Effect

Chart 1



Source: Ministry of Economy, Trade and Industry; CAO; compiled by DIR.

*DIR estimate for some industries.

Size of circles indicates number of employees.

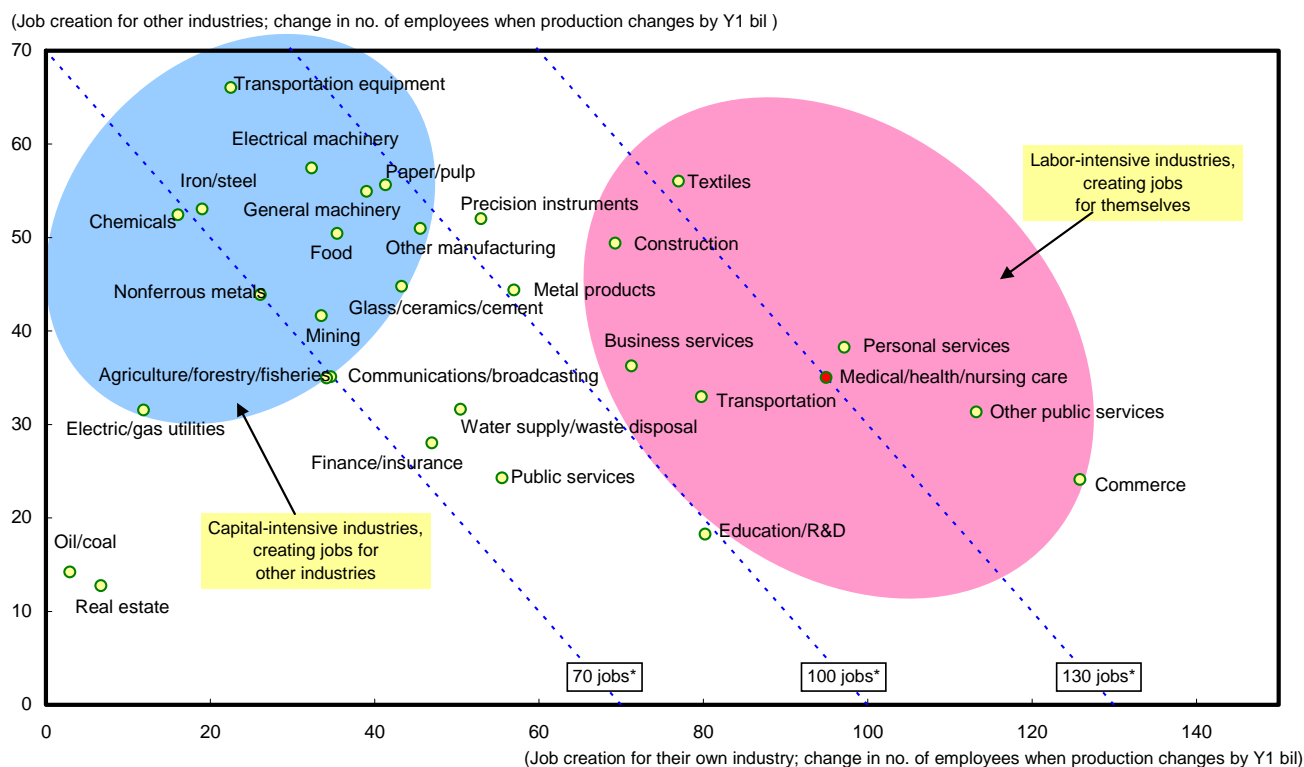
Job creation effect of major industries

Chart 2 portrays the job creation effect of major industries. The vertical axis shows the employment inducement effect for other industries and the horizontal axis the employment inducement effect for their own particular industry when production changes by Y1 billion. Dotted lines from the upper left to the lower right indicate the combined employment inducement effect for their own industry and other industries.

The service sector, centering on medical care, health care, and nursing care, is generally located on the right side in the category of labor-intensive industries with immediate job creation. In contrast, manufacturing industries, centering on transportation equipment and electrical machinery (the so-called environmental area), are placed on the left side with capital-intensive industries whose job creation has large ripple effects for other industries. This chart also underscores the importance of expanding a dual strategy of (1) employment measures involving the service sector centering on medical and nursing care and (2) a growth strategy involving the manufacturing sector centering on the environment.

Job Creation Coefficient

Chart 2



Source: Ministry of Health, Labour, and Welfare; compiled by DIR.

1.3 Restoring government finances to health

The third issue the Japanese government must address is without question the restoration of government finances.

Maintaining that there are things to do before raising taxes might seem like a sound argument (economic growth and cutting expenditures should come first). However, ever since then Prime Minister Ohira at the time failed in his attempt to introduce a general consumption tax in the 1970s, the same point has been repeated for more than 30 years. In other words, to argue that there are things to do before raising taxes is just an attempt to delay by diffusing the discussion. When facing the three political issues of economic growth, reducing expenditures (rationalizing social security), and increasing the consumption tax, claiming that there is absolutely no alternative to pursuing all three at the same time will, in practical terms, mean that government finances can never be rebuilt. The repeated delays caused by such discussions have endowed Japan with the world's worst fiscal deficit.

In Chart 3, we represent our simulation result of the FY20 primary fiscal balance.

What will be important for Japan going forward is to begin a national debate in a year and a few months before the consumption tax is raised in April 2014 on how to promote economic growth and reduce expenditures (rationalization of social security) in a resolute manner.

FY20 Primary Fiscal Balance (% of GDP)

Chart 3

Scenario	1	2	3	4	5	6	7	
GDP growth rate FY16-20 (annualized); through FY15, see assumptions								
Nominal GDP	+3.0%	+2.0%	+1.5%	+1.0%	+0.0%	-1.1%	-2.2%	
Real GDP	+2.0%	+2.0%	+1.0%	+1.3%	+0.6%	-0.1%	-0.7%	
FY20 primary fiscal balance (central/local governments; % of nominal GDP)								
Social security expenditure (central/local governments): growth rate FY16-20 (annualized); through FY15, see assumptions	4%	-3.0	-3.4	-4.1	-4.2	-4.9	-5.8	-6.6
	3%	-2.6	-2.9	-3.6	-3.6	-4.4	-5.2	-6.0
	2%	-2.1	-2.5	-3.1	-3.2	-3.9	-4.7	-5.4
	1%	-1.7	-2.0	-2.7	-2.7	-3.4	-4.2	-4.9
	0%	-1.3	-1.6	-2.2	-2.2	-2.9	-3.7	-4.4
	-1%	-0.9	-1.2	-1.8	-1.8	-2.5	-3.2	-3.9
	-2%	-0.5	-0.8	-1.4	-1.4	-2.0	-2.7	-3.4
	-3%	-0.1	-0.4	-1.0	-1.0	-1.6	-2.3	-2.9
	-4%	0.2	-0.0	-0.6	-0.6	-1.2	-1.8	-2.5

Source: Compiled by DIR based on various materials.

Major assumptions

- 1) Nominal and real GDP growth rate through FY15 are DIR estimates. From FY16 to FY20, those for scenarios 1 and 3 are respectively from “goal of policy effort” in *Strategy for Rebirth of Japan* by the National Policy Unit, 24 Dec 2011, and the “cautious scenario” in “Medium- to long-term economic and fiscal policies and outlook for the next ten years” by the Cabinet Office, 24 Jan 2012 (only in Japanese). Those for others are DIR estimates.
- 2) Elasticity of tax revenue vs. nominal GDP assumed to be 1.1.
- 3) Real revenues other than taxes assumed to be flat.
- 4) Growth rate of social security expenditure through FY15 based on “estimation of impact of FY11 budget on revenue and expenditure in following years” by the Ministry of Finance, Jan 2012.
- 5) Public gross fixed capital formation through FY13 is DIR estimate and we assumed it to grow at the same rate as nominal GDP thereafter.
- 6) Interest payment = outstanding balance of public debt x long-term interest rate.
- 7) Other expenditure assumed to be flat in real terms.

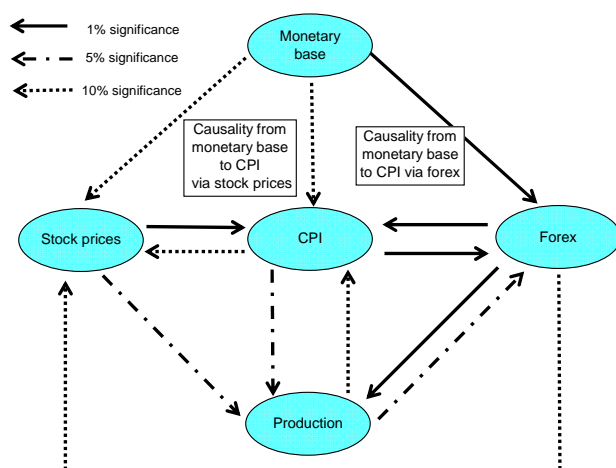
1.4 Closer coordination between the government and BOJ

Importance of BOJ aiming to influence stock prices and exchange rates

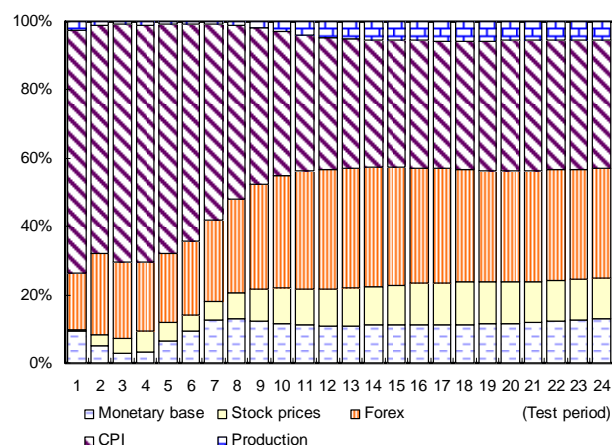
The fourth issue for Japan is to have the government and the BOJ work more closely together. Based on an analysis using the Granger causality test, we believe a weaker yen and higher stock prices ensuing from further monetary easing by the BOJ will be effective in ending deflation.

Chart 4 presents a five-variable-model Granger causality test. To define Granger causality, variable X is viewed as Granger-causing Y when past information about variable X is useful in improving the forecast of variable Y. The analysis we performed suggests the possibility that expansion of the monetary base influences CPI through stock prices and forex. Also, a variance analysis of CPI points to the possibility of forex having a certain effect on prices.

Conceptual image of five variable causality



Variance decomposition of CPI



Model description

Sampling period	Mar 2006-Feb 2011	
Lag	Quartic lag based on Akaike information criterion	
Variables	Monetary base	Avg outstanding balance, adjusted for reserve requirement ratio, seasonally adjusted
	Stock prices	Nikkei 225 (monthly avg)
	Forex	Nominal effective exchange rate (2010 benchmark; BIS regulation basis)
	Production	All-industry Activity Index (excl agriculture/forestry/fisheries & public service; 2005 benchmark; seasonally adjusted)
	CPI	Major category items (excl. fresh food; nationwide; 2010 benchmark)

Source: Bank of Japan, Ministry of Finance, Ministry of Internal Affairs and Communications, Ministry of Economy, Trade and Industry, *Nikkei*; compiled by DIR.

Pressure on BOJ intensifying

Pressure on the BOJ from the government and all parties has intensified over the months. On 14 February, the BOJ introduced *de facto* inflation targeting, deciding that “the price stability goal in the medium to long term” would be +1% for the time being, which is easy to understand compared with “understanding of medium- to long-term price stability” in previous statements.

The BOJ decided to implement monetary easing measures for the second consecutive month in October. At the same time, the central bank decided to establish a framework for fund-provisioning measures to stimulate bank lending (Stimulating Bank Lending Facility), and released *Measures Aimed at Overcoming Deflation* with the government,

Three tasks for BOJ

While the BOJ’s recent easing stance was looked upon very favorably, the BOJ will be pressed to deal with the following three tasks:

(1) Improve skills in communicating with the market

We often hear foreign investors making comments such as “the BOJ always takes a hawkish position,” or “the BOJ always worries about inflation despite the fact that the economy is experiencing deflation.” Such remarks are sometimes because of miscommunication. If asked, the BOJ would likely reply that such views were a misunderstanding. However, the BOJ is responsible for making its monetary policy stance clear to all, including investors overseas. There is thus considerable room for improvement in the way the BOJ provides information to foreign investors.

(2) Raise price stability goal to +2% growth

The second task is to raise the price stability goal from growth of 1% to 2%. The latter figure is on par with the US monetary policy goal. Japan's price figures are often said to have an upward bias of about 1%. The market sometimes points out that actual price growth could be lower than statistical figures by 1 percentage point or so. Taking this bias into account, it is perhaps worth considering raising the price stability goal to growth of +2%.

(3) Change policy wording from “goal” to “target”

In Japan, it would perhaps be feasible to oblige the BOJ to also meet a given inflation target within a certain period of time as is the case in the UK.

2. Economic Outlook Revised Upward

In light of the second preliminary Jul-Sep (3Q) 2012 GDP report (Cabinet Office), we have revised our economic growth outlook upward. We now forecast real GDP growth of +1.0% y/y for FY12 (previous forecast: +0.7%) and +1.1% for FY13 (+0.9%). Factoring in the annual revision of FY11 GDP, released along with the second preliminary 3Q 2012 GDP report, we have revised our outlook for public works spending substantially upward.

Real GDP saw an annualized slide of 3.5% in the second preliminary estimate of 3Q 2012 GDP

In the second preliminary estimate of 3Q 2012 GDP, real GDP posted a slide of 0.9% q/q, annualized at -3.5%, slightly short of the market consensus (down 0.8%; down 3.3%) but remaining flat from the first preliminary estimate.

By demand component, capex saw a minor upgrade from the first preliminary estimate (from down 3.2% q/q to down 3.0%), as capex posted a better figure in Financial Statements Statistics of Corporations by Industry for 3Q 2012 (Ministry of Finance; basic statistics for estimating GDP) than that assumed in the first preliminary estimate. Factoring in the same statistics, inventory investments also saw a minor upgrade (contribution to real GDP growth: from up 0.2 points to up 0.3 points). Personal consumption saw a minor upgrade as well (from down 0.5% to down 0.4%).

In contrast, public works spending saw a downgrade (from up 4.0% to up 1.5%), factoring in the synthetic construction indexes for September (Ministry of Land, Infrastructure, Transport and Tourism; basic statistics for estimating GDP; only in Japanese). Thus, real GDP growth remained flat from the first preliminary estimate.

Meanwhile, the GDP deflator declined 0.8% y/y, downgraded from the first estimate (down 0.7%).

What will prompt economic recovery in Japan?

With the worsening of foreign economies, it is highly probable that Japan's economy peaked in March 2012 and has slipped into recession. A review of past periods when Japan's economy recovered reveals that since the 1990s the driving force of recoveries has clearly shifted from fiscal and monetary measures to exports. In the current downturn, it is highly probable that the growth of exports, such as through the recovery of foreign economies, will trigger the bottoming out of Japan's economy. Despite the existence of downside risks, as our main scenario we believe that Japan's economy will follow a path of gradual recovery in 2013 and beyond, supported by three factors: (1) pickup of the US and Chinese economies, (2) reconstruction demand related to the Great East Japan Earthquake, and (3) further monetary easing by the BOJ.

How should the future direction of the world economy be understood?

The key to anticipating the direction of the world economy is the degree to which sluggish domestic demand in Europe, the US, and other advanced economies will be offset by the policy responses of emerging economies. We therefore undertook a quantitative simulation of the world economy with (1) domestic demand in advanced economies and (2) the policy responses of emerging economies serving as exogenous variables. Our simulation indicates that emerging economies aggressively implementing fiscal and monetary measures has the potential of offsetting to some degree sluggish domestic demand in advanced economies. However, should multiple risk factors materialize at the same time, such as further deepening of the European sovereign debt crisis and the US fiscal cliff, the policy responses of emerging economies alone would not be sufficient to support the world economy.

Will China's economy face a hard landing?

In our simulation of the impact worsening relations between Japan and China would have on Japan's economy, such worsening is estimated to place downward pressure of about 0.1% to 0.4% on Japan's GDP for FY12 and FY13 combined. We anticipate that effects of fiscal and monetary measures in China will enable the Chinese economy to gradually improve for the time being. In the medium to long term, however, there is a risk that China will face the massive adjustment of capital stock. The possibility should be entertained of the potential growth rate of China's economy slowing significantly to the 5% level toward 2030.

Risks facing Japan's economy

Risks that will need to be borne in mind for Japan's economy are: (1) any deepening of the European sovereign debt crisis, (2) worsening of Japan-China relations, (3) the US fiscal cliff, and (4) a surge in crude oil prices stemming from geopolitical risk.

Outlook for Japanese Economy, Interest Rates **Chart 5**

Indicator	2011	2012				2013		FY10	FY11	FY12	FY13
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar					
	Actual				DIR estimates		Actual		DIR estimates		
Real GDP											
Q/q %, annualized	0.3	5.7	-0.1	-3.5	-0.3	1.7					
Y/y %	-0.2	3.4	3.9	0.5	0.5	-0.6	3.4	0.3	1.0	1.1	
Current account balance											
SAAR (Y tril)	6.7	5.9	6.1	3.7	3.4	3.5	16.7	7.6	4.2	4.2	
Unemployment rate (%)	4.5	4.5	4.4	4.2	4.3	4.4	5.0	4.5	4.3	4.3	
CPI (excl. fresh foods; 2010 prices; y/y %)	-0.2	0.1	-0.0	-0.2	-0.0	-0.0	-0.9	-0.0	-0.1	-0.1	
Unsecured overnight call rate											
(period end; %)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
10-year JGB yield											
(period average; %)	1.03	0.97	0.85	0.78	0.75	0.80	1.13	1.05	0.79	1.00	

Source: Compiled by DIR.

Note: Estimates taken from DIR's *Japan's Economic Outlook No. 175 (Update)*.