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# Japan's Economy: Monthly Review

## *Signs of economic recovery intensifying*

### Effects of Abenomics steadily spreading

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#### Summary

- **Signs of economic recovery intensifying:** Effects of Abenomics have been steadily felt in Japan. The Bank of Japan (BOJ) revised its view on economy upward to “Japan’s economy is starting to recover moderately” on 11 July, the first affirmation of economic recovery in two and a half years. The government is likely to revise its assessment of the economy in the *July Monthly Economic Report*.
- **Main scenario for Japan’s economy:** Japan’s economy slipped into recession after peaking in March 2012. It now appears to have hit bottom in November 2012 and to have bottomed out. It is expected to continue expanding, supported by (1) the recovery of foreign economies, (2) the continuation of reconstruction demand and a large-scale supplementary budget, and (3) the ongoing depreciation of the yen and the rise in stock prices accompanying the BOJ’s bold monetary easing. With regard to the last, we anticipate that the yen will gradually weaken against the US dollar. Also, in comparison to the real economy, it still cannot be said that stock prices are overvalued at their current levels.
- **Risks facing Japan’s economy:** Risks that will need to be borne in mind regarding Japan’s economy are (1) a reigniting of the European sovereign debt crisis, (2) the worsening of Japan-China relations, (3) the US fiscal issue, and (4) a surge in crude oil prices stemming from geopolitical risk.

# 1. Signs of Economic Recovery Intensifying

## *Effects of Abenomics have been steadily felt*

Signs of economic recovery have intensified. Effects of Abenomics have steadily spread in Japan. The BOJ revised its view on the economy upward to “Japan’s economy is starting to recover moderately” on 11 July, the first affirmation of economic recovery in two and a half years. The government is likely to revise its assessment of the economy in the *July Monthly Economic Report*.

## *June results of BOJ’s Tankan Survey were favorable*

The upward revision of BOJ’s assessment of the economy owes much to the *June Tankan Survey* of corporate sentiment. In the survey, business sentiment improved substantially as a whole and over a broad range of industries, confirming a turnaround of the economy. While the sentiment of small companies did not turn around in the previous survey, it improved in the June survey. In addition, the capex projection overshot market expectations.

# 2. Main Scenario for Japan’s Economy

## 2.1 Japan’s economy on a recovery path since November 2012

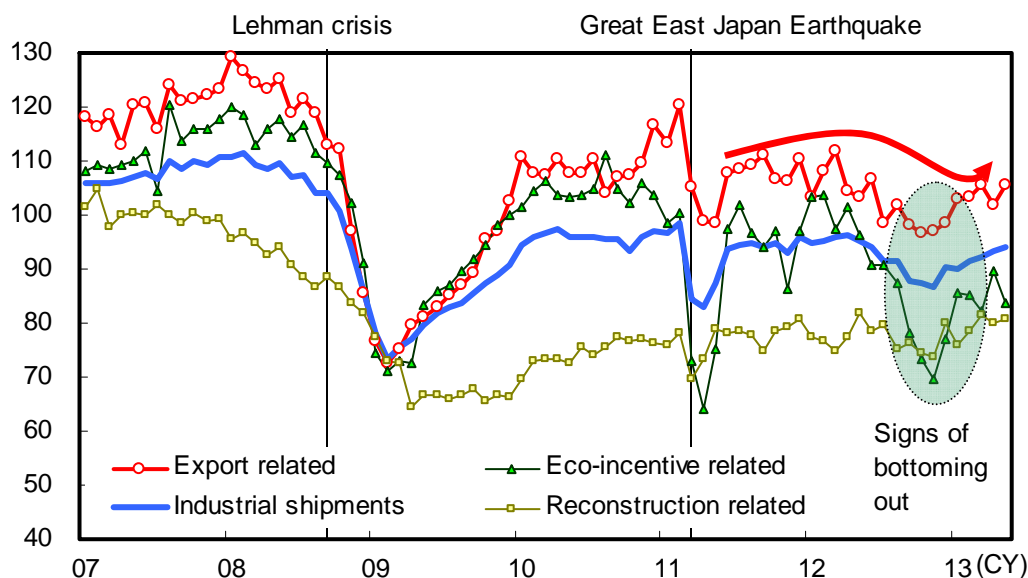
### *Japan’s economy to continue to trace recovery path*

After peaking in March 2012, Japan’s economy slipped into recession, impacted by the worsening of foreign economies. Since November 2012, however, the economy appears to be on a path toward recovery.

### *Economy to gradually gain momentum in FY13*

Chart 1 provides a breakdown of industrial shipments in Japan. Here we can verify the reasons for the economy slipping into recession after peaking in March 2012. First, eco-incentive-related shipments, in other words, domestic consumer durables that are eligible for eco-car tax breaks and eco-point programs, greatly slowed. In addition, export-related shipments declined on account of the sluggishness of foreign economies, centering on Europe and China. In contrast, reconstruction-related shipments, such as construction materials and capital goods (excl. transportation equipment) trended firmly for the most part. Thus, reconstruction demand appeared to be the sole source of support for Japan’s economy.

Following the adverse impact of the expiration of eco-car tax breaks having run its course, eco-incentive-related shipments overall have greatly improved since end-2012. Automobile sales will likely remain steady going forward, reflecting the wealth effect accompanying the ascent of stock prices. Also, export-related shipments, the driver behind Japan’s economy, are beginning to bottom. Furthermore, Japan’s economy is expected to accelerate gradually in FY13, given that (1) reconstruction-related shipments have increased, (2) public works projects are expected to increase, following approval of the FY12 supplementary budget, and (3) front-loaded demand will likely emerge prior to the expected consumption tax hike in April 2014, supporting housing investment and personal consumption.



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

Notes: 1) Eco-incentive related: Durable goods for the domestic market that are eligible for eco-car subsidies/tax breaks and eco-point programs.

2) Reconstruction related: Construction materials and capital goods (excl. transportation equipment).

### ***Transition from domestic demand to foreign demand likely in FY14***

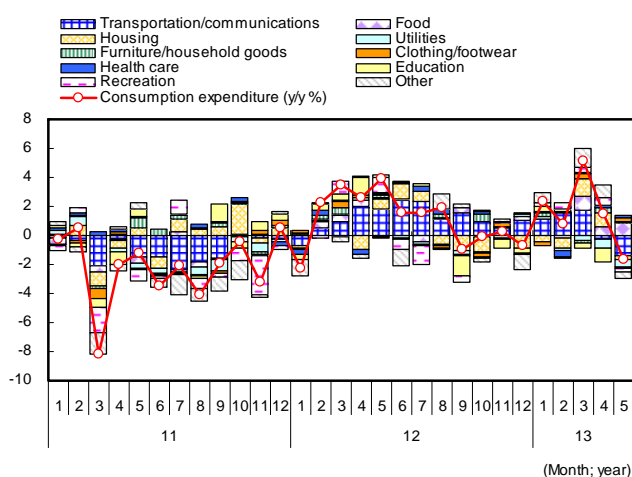
We believe that the driving force behind Japan's economy will shift from domestic demand to foreign demand in FY14. Following the likely consumption tax hike in FY14, domestic demand, centering on personal consumption and housing investment, is expected to slump temporarily. We, however, anticipate that exports will grow firmly for such reasons as (1) the expansion of foreign economies centering on the US and (2) the depreciation of the yen beginning to have a positive effect on export volume with a lag of about one year.

### ***Personal consumption steady***

In the first preliminary estimate of Jan-Mar 2013 GDP, personal consumption increased 0.9% q/q, a rise for the second quarter in a row. At the same time, real employee compensation increased 0.6% for the first time in two quarters. However, the growth tempo of the former was larger than the latter, thanks to improved consumer sentiment. While a boost in sales of high-end products has often been reported in the media, Jan-Mar GDP data shows that personal consumption began to show a broad-based gain, regardless of type of goods/services.

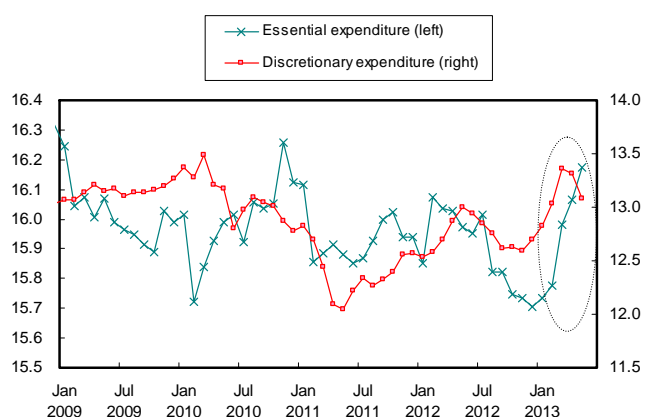
A breakdown of consumption expenditure (all households; real) is provided in Chart 2. Here we see that consumption is increasing for a broad range of items, such as "transportation and communications" supported by the firm sales of mini-vehicles and "food" driven by higher spending on eating out. Chart 3 examines personal consumption in terms of "discretionary expenditure" corresponding to luxury items and "essential expenditure" corresponding to basic items. March figures for consumption value indicate that essential expenditure has risen sharply, boosting overall consumption. As epitomized by the higher spending on eating out, it is quite probable that the improvement in consumer sentiment is gradually leading to the increased consumption of everyday items. Going forward, it may be important to monitor whether consumption as a whole expands rather than focusing on the trend of the consumption of big-ticket items.

**Real Household Consumption Expenditure**  
(all households; y/y %) **Chart 2**



Source: Ministry of Internal Affairs and Communications; compiled by DIR.

**Household Consumption by Type of Expenditure**  
(¥10,000) **Chart 3**



Source: Ministry of Internal Affairs and Communications; compiled by DIR.  
Note: 3M MA; seasonally adjusted by DIR.

## 2.2 Three positives supporting Japan's economy

### **Positive 1: Pickup of foreign economies**

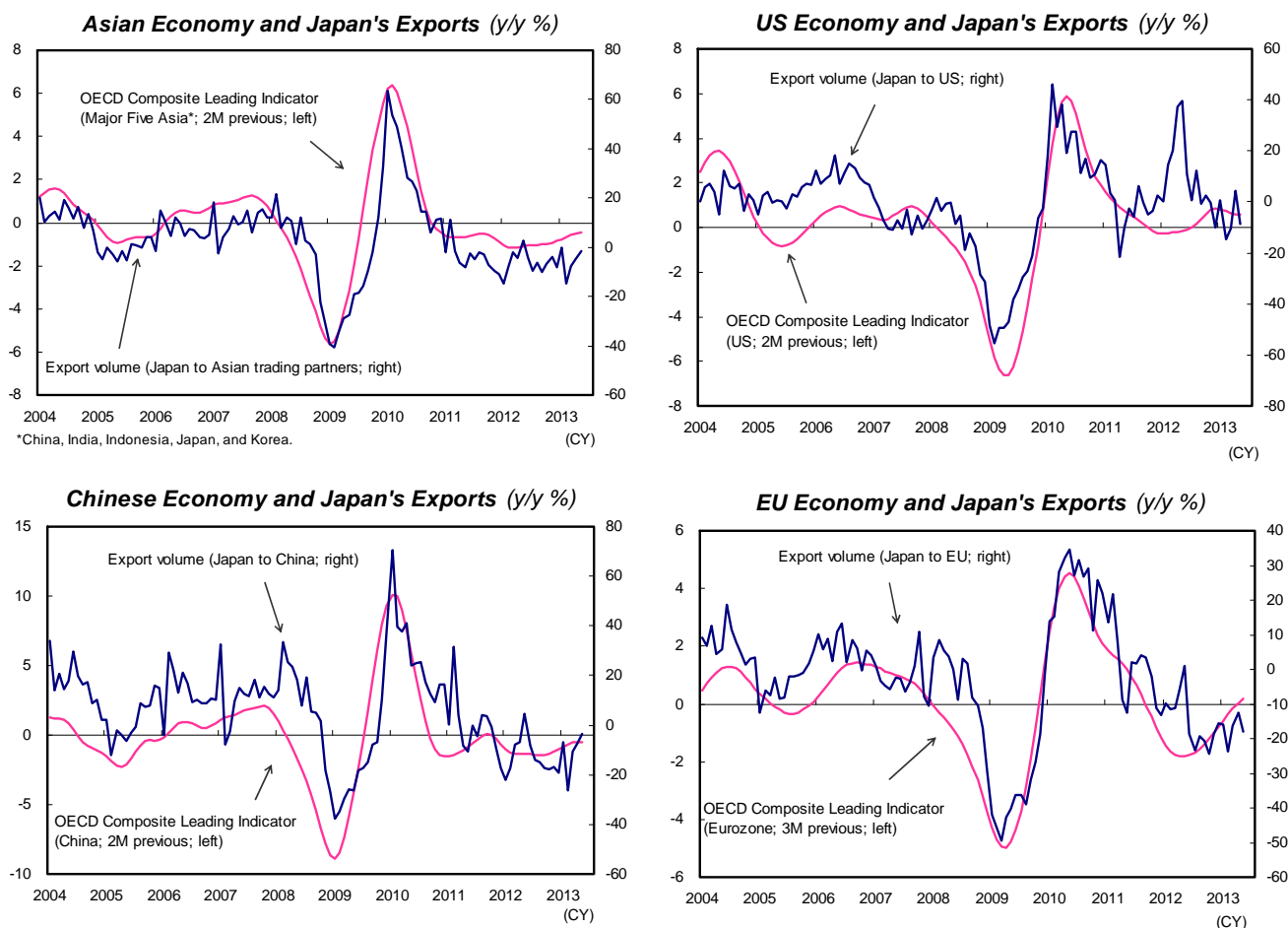
#### *Signs that foreign economies are gradually bottoming out*

As our main scenario, we believe that the expansion of Japan's economy will continue, supported by three factors: (1) pickup of foreign economies, (2) ongoing reconstruction projects and a large-scale supplementary budget, and (3) the ongoing depreciation of the yen/ascent of stock prices accompanying the BOJ's adoption of inflation targeting.

The first factor that will support Japan's economy going forward are prospects that foreign economies will recover centering on the US. Chart 4 illustrates the trend of Japanese exports by trading partner. OECD Composite Leading Indicators (CLIs) for respective partners tend to lead the volume of Japanese exports to the corresponding region by two to three months. OECD CLIs of major regions are showing signs of gradually bottoming out, a positive development for Japanese exports. Regarding the direction of the world economy, we assume that (1) Eurozone economies will stagnate due to the sovereign debt crisis, (2) the US economy will slowly recover, and (3) China's economy will not fall into a recession for the time being, although it has decelerated to some extent.

## Japan's Exports by Trading Partner

Chart 4



Source: OECD, Ministry of Finance; compiled by DIR.

### *Three conditions determining long-term structural recession—possibility of the US experiencing so-called Japanization limited*

First of all, we would like to emphasize that the US is not slipping into a long-term structural recession similar to the Great Depression of the 1930s or Japan's Heisei recession. Chart 5 offers a comparison of the Great Depression, Japan's Heisei recession, and the current situation of the US and Europe. Currently in the US, (1) policy responses have been rapid, (2) the labor market is flexible, and (3) financial system uncertainties have abated. Hence, the three basic conditions determining a long-term structural recession shared by the Great Depression and Japan's Heisei recession are not presently seen in the US. Therefore, we believe that the US will avoid a long-term structural recession accompanied by a deflationary spiral (so-called "Japanization"). In the case of European nations, since (1) policy responses have been slow, (2) labor markets are rigid, and (3) financial system uncertainties remain, some attention should be given to the risk that Europe will slip into a long-term structural recession.

## Conditions Determining Protracted Structural Recession

Chart 5

	Great Depression	Heisei Recession	Current status of US economy	Current status of European economy
① Failure of policy responses	✓	✓	X	0
② Real wages remaining high resulting in prolonged stagnation of capex	✓	✓	X	0
③ Impairment of financial system	✓	✓	X	0

Source: Compiled by DIR.

✓=Yes, 0=to some degree, and X=No.

### ***China's economy will not fall into a recession***

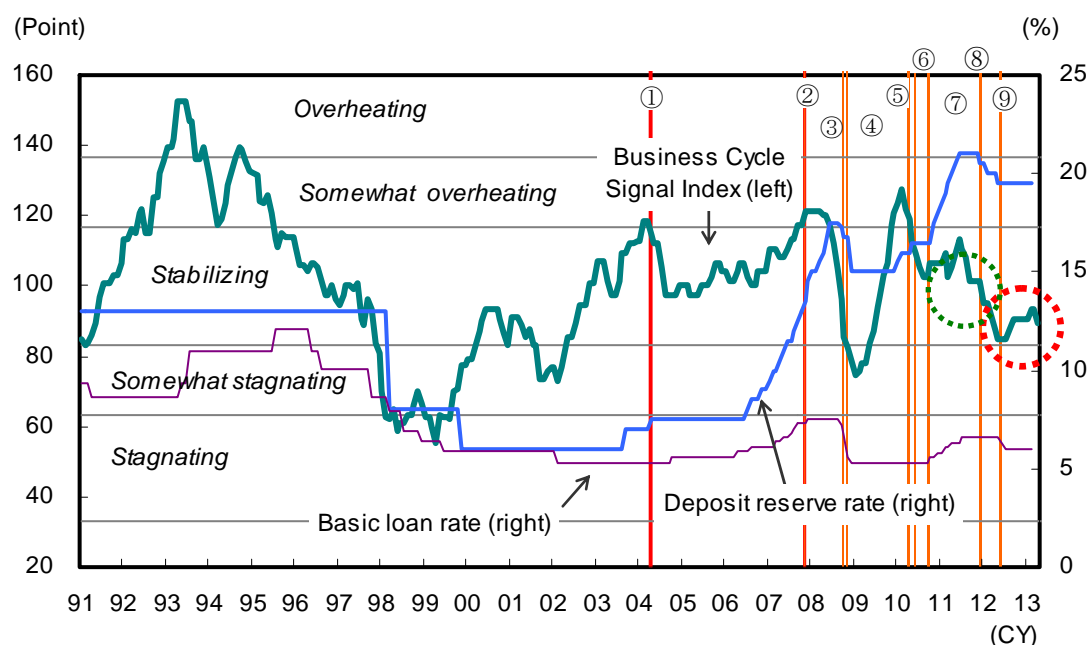
Next, we examine the future direction of China's economy. Although China's economy has decelerated to some extent, it will not fall into a recession for the time being. We believe that China's real GDP will increase 7.6% in 2013 and 7.2% in 2014.

### ***Business Cycle Signal Index to firm up gradually***

Chart 6 presents the Business Cycle Signal Index for China. According to this index, China's economy has slowed significantly. After peaking at 123.3 in February 2010, the index fell to 84.7 in August 2012, sinking to the low side of the stable zone between 83.33 and 116.66. Similar to previous instances when the economy has slowed to this extent, the authorities have implemented stimulus measures, such as monetary easing, since last year. As a result, the index is showing signs of rebounding.

### ***Key phrases are "socialist market economy," "collective leadership," and "gradualism"***

China being a socialist market economy rather than a pure capitalist economy may also become a factor offering economic support for the time being. During the change in political leadership that occurs once every 10 years, and which we have just witnessed, it is natural for desires to come into play to circumvent as much as possible the rapid deceleration of the economy. There is no question that China is burdened with many medium- to long-term challenges. However, since its economy is not a pure capitalist system, problems can always be deferred for at least one or two more years one way or another. Politically speaking, collective leadership and a policy of gradualism should also be factors that will preclude a short-term relapse of the Chinese economy.



Source: National Bureau of Statistics of China, People's Bank of China, CEIC Data; compiled by DIR.

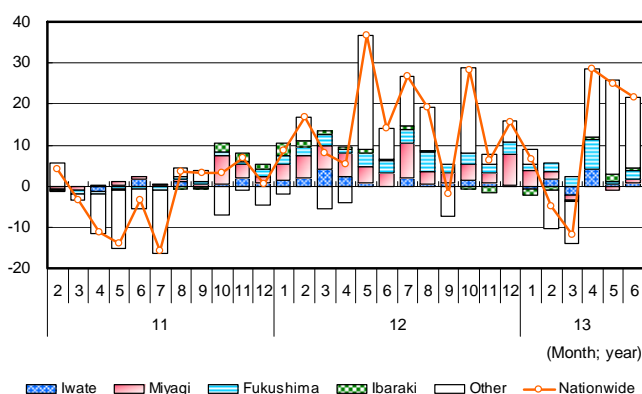
1. Apr 2004: Restrictions on aggregate loans strengthened
2. Oct 2007: Restrictions on aggregate loans strengthened
3. Oct 2008: Restrictions on aggregate loans eased
4. Nov 2008: Stimulus package of 4 tril yuan announced
5. Apr 2010: Real estate regulations strengthened
6. Jun 2010: More flexible regime for control of yuan exchange rate
7. Oct 2010-Jul 2011: Period of loan rate hikes
8. From Dec 2011: A series of deposit reserve rate lowering moves began
9. From Jun 2012: A series of loan rate cuts began

## **Positive 2: Reconstruction demand/large-scale supplementary budget**

### ***Large-scale supplementary budget will support the economy***

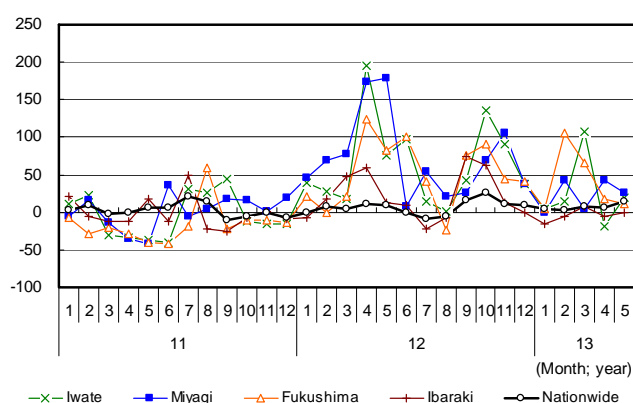
The second factor that will support Japan's economy going forward are prospects for the continuation of reconstruction projects related to the Great East Japan Earthquake and this being attended by the large-scale supplementary budget of the Abe administration. As shown in Chart 7, the yen amount of prepayment guarantees for public works projects has increased since 2H11, with a significant contribution being provided by increases related to the three disaster-affected prefectures. At the same time, it began to surge in the beginning of FY13 reflecting approval of the FY12 supplementary budget by the Diet at end-February 2013. Despite the Jan-Mar GDP report confirming that public investment decelerated to some extent, it is very likely to accelerate again. Meanwhile, as shown in Chart 8, new housing starts by prefecture are continuing to grow firmly, centering on disaster-affected areas.

**Prepayment Guarantees for Public Works by Prefecture (y/y %)** Chart 7



Source: East Japan Construction Surety, West Japan Construction Surety, Hokkaido Construction Surety; compiled by DIR.

**New Housing Starts by Prefecture (y/y %)** Chart 8



Source: Ministry of Land, Infrastructure, Transport and Tourism; compiled by DIR.

**Estimation of impact of reconstruction demand related to Great East Japan Earthquake and reconstruction surtaxes**

Chart 9 provides an estimation of the effect on Japan’s GDP of developments related to reconstruction demand and also of reconstruction surtaxes. Given that the supplementary budget for FY12 has been factored into public works spending, GDP is anticipated to receive a boost of around 1.5% in FY13. At the present moment, higher public works spending is not causing the long-term interest rate to rise, and personal consumption, housing investment, and capex can be expected to increase as the economy expands.

**Impact of Reconstruction Demand and Change in Taxation on Real GDP (% deviation from base scenario)** Chart 9

	FY11	FY12	FY13	FY14	FY15
Real GDP	0.1	0.9	1.5	0.4	-0.3
Household consumption expenditure	0.0	0.1	0.3	0.2	-0.4
Private housing investment	0.1	1.2	3.3	3.7	1.3
Private capex	0.1	1.2	3.2	3.3	0.9
Government consumption expenditure	0.0	0.0	-0.1	-0.3	-0.4
Public fixed-capital formation	3.3	19.3	32.1	8.5	0.8

Source: Cabinet Office, media reports; compiled by DIR.

Notes: 1) DIR estimate based on Daiwa short-term macroeconomic model.

2) Income tax raised by 2.1% pt over 25 years from Jan 2013.

3) Inhabitants tax assumed to be raised Y1,000/person from Jun 2014.

4) 10% inhabitants tax reduction for those receiving retirement benefit abolished from Jan 2013.

5) Due to return to stricter child care allowance system (revival of income threshold for receiving allowance, etc.), aggregate income (incl. child care allowance) assumed to decline by Y0.5 tril a year from FY12.

**Positive 3: Ongoing depreciation of the yen/ascent of stock prices accompanying BOJ’s adoption of inflation targeting**

**Yen’s depreciation against the dollar will continue**

The third factor that will support Japan’s economy going forward is the ongoing depreciation of the yen and ascent of stock prices accompanying BOJ’s adoption of inflation targeting. We anticipate the yen will gradually weaken against the US dollar. Also, in comparison to the real economy, it still cannot be said that stock prices are overvalued at their current levels.

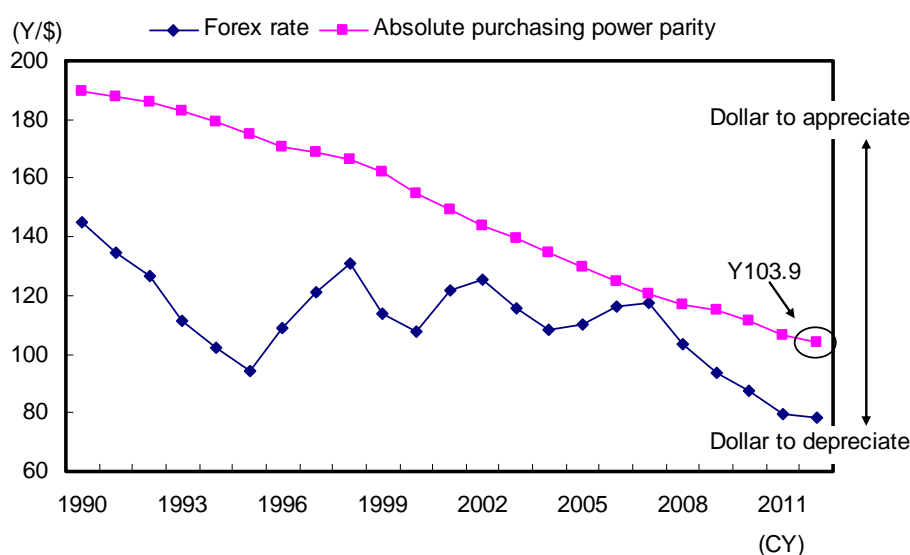


It is reasonable to think that the ongoing gradual depreciation of the yen against the dollar will continue, considering (1) prospects that the BOJ will maintain the current highly accommodative monetary policy, (2) the Fed beginning to consider an exit strategy in light of the steady recovery of the US economy, (3) Japan's trade balance turning negative, and (4) limited criticism of the strong yen at G7 meetings for the time being.

Chart 10 depicts absolute purchasing power parity (PPP) of the yen against the dollar estimated by the OECD, which is currently Y103.9/\$. Absolute PPP is a mechanism that shows the equilibrium level of prices for equivalent goods. Absolute PPP estimated by the OECD takes into account a broad range of goods and services that constitute GDP. However, it is not an indicator that shows the price trend of tradable goods, which should not be overlooked. However, absolute PPP should always be borne in mind as an indicator followed by global financial market participants.

Absolute Purchasing Power Parity and Forex Rate

Chart 10



Source: OECD; compiled by DIR.

### 3. Risks Facing Japan's Economy

#### *Four risks facing Japan's economy*

There are four risk factors facing Japan's economy: (1) any deepening of the European sovereign debt crisis, (2) any worsening of Japan-China relations, (3) the US fiscal issue, and (4) a surge in crude oil prices stemming from geopolitical risk.

#### *In the worst case, an impact comparable to the Lehman crisis*

Of risks (1) to (4) above, there is no question that the greatest tail risk is (1). Chart 11 depicts the results of simulating the impact of the European sovereign debt crisis on Japan's economy. Specifically, we established three scenarios for the size of the haircuts given to the sovereign debt of European nations and calculated the core capital shortfall that major European banks would face in each scenario. We then estimated how the resulting credit crunch would influence the world economy, factored in a possibility of yen appreciation from the base scenario in our current outlook because of less alternative currency selection, and calculated how Japan's real GDP would be affected. In the worst case (Case 3), Japan's real GDP has the potential of experiencing downward pressure of more than 4%. It goes without saying that calculation results will need to be viewed with considerable

latitude. Even so, should the European sovereign debt crisis see any worsening, such as by Greece leaving the euro, there is risk that Japan would sustain a blow comparable in size to the Lehman crisis.

### Impact of European Sovereign Debt Crisis on Japanese Economy

Chart 11

	% discount of respective nation's sovereign bonds						European banks		Impact		
	Belgium	Greece	Ireland	Italy	Portugal	Spain	Tier 1 capital shortfall (€ 100 mil)	Risk asset write-off matching half capital shortfall (% of overall risk assets)	Bank loans worldwide (\$)	Nominal GDP worldwide (\$)	Japan's real GDP (yen)
Case 1	0%	60%	40%	10%	40%	10%	1,274	7.0%	-1.7%	-1.6%	-0.6%
Case 2	15%	80%	50%	30%	50%	30%	2,233	13.9%	-3.4%	-3.2%	-2.2%
Case 3	30%	100%	60%	50%	60%	50%	3,240	24.9%	-6.0%	-5.7%	-4.1%

Source: World Bank, European Banking Authority, Cabinet Office; compiled by DIR.

Assumptions: 1) Ratio of risk asset write-off to overall risk assets corresponds to that of loan cutbacks to overall loans.

2) Case 1: the yen remains flat; Case 2: 5% appreciation; Case 3: 10% appreciation; all against the dollar.

Note: Estimated based on elasticity approach, which warrants some latitude.

### Outlook for Japanese Economy, Interest Rates

Chart 12

Indicator	2012	2013				2014	FY11	FY12	FY13	FY14
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual	DIR estimates				Actual	DIR estimates			
<b>Real GDP</b>										
Q/q %, annualized	1.2	4.1	3.0	4.1	4.4	5.9				
Y/y %	0.4	0.4	1.2	3.1	3.9	4.2	0.2	1.2	3.1	0.7
<b>Current account balance SAAR (Y tril)</b>	4.3	2.9	4.6	5.4	6.0	6.9	7.6	4.3	5.7	12.5
<b>Unemployment rate (%)</b>	4.2	4.2	4.1	4.1	4.0	4.0	4.5	4.3	4.1	3.9
<b>CPI (excl. fresh foods; 2010 prices; y/y %)</b>	-0.1	-0.3	-0.1	0.3	0.5	0.6	-0.0	-0.2	0.3	2.9
<b>Unsecured overnight call rate (period end; %)</b>	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
<b>10-year JGB yield (period average; %)</b>	0.76	0.66	0.77	0.90	1.00	1.00	1.05	0.76	0.92	1.05

Source: Compiled by DIR.

Note: Estimates taken from DIR's *Japan's Economic Outlook No. 177 Update*.