

7 JAPAN

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2004: THE RECOVERY PAUSES

Japan's prolonged stagnation came to an end in early 2002¹. Since the first quarter of 2002, the beginning of the latest recovery phase, exports regained their strength, then non-residential investment and finally private consumption reignited along with an improvement in labour market conditions. The trend continued to the middle of 2004. Consumer expenditure on digital home electronics was booming.

However, the momentum was lost in the latter half of 2004 when export growth slowed in the US and Chinese markets. In the semiconductor market, there were signs of a rising inventory/sales ratio. Strong competition among home electronics giants caused over-supply of digital home appliances. Prices of PDP and LDC TV screens kept falling and the electronics industry became cautious about new investment. Thus the seemingly-solid recovery that began in 2002 turned out to be short-lived. So, has Japan entered into recession again? The answer is "not yet." As we see in the movement of gross domestic expenditure (GDE) and components, consumer expenditure did not keep increasing, but the rate of decline in Q3 and Q4 was small: indeed we had an extraordinarily warm November and December which dampened winter retail sales.

Japan was hit by an unusual number of typhoons from June to October, and earthquakes that hit central Japan caused some delay in production activity in that area. Considering these natural disasters, Japan's macroeconomic performance was not so bad. Housing investment kept increasing, though the rate was low. Business fixed investment dropped in Q1, but it recovered and kept increasing afterwards. One could say the private sector of the economy performed well. There were two factors that worked negatively on GDE from Q2 to Q4. One was the continuing contraction of public works, with its contraction at more than an annual rate of 10%. Another factor was an accelerating increase in imports which pulled down real net exports.

The monthly manufacturing production index showed fluctuating movements, but the recent January index gave a surprise: it increased by 2.1% over the previous month, well above a consensus rate of 1.6%. The labour market situation is also improving. As of January the unemployment rate was 4.5%, a full percentage point improvement since January 2003. The number of regular workers is turning around as firms plan for the anticipated mass retirement of baby-boomers starting in 2007.

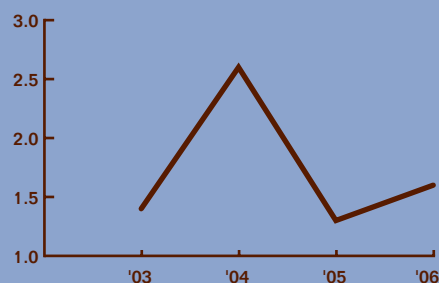
The policy authorities (the Bank of Japan as well as the Koizumi administration) maintain their position that the economy is on a recovery

track. The present "soft patch," they insist, will be replaced by solid economic growth in the latter half of this year. This view seems realistic.

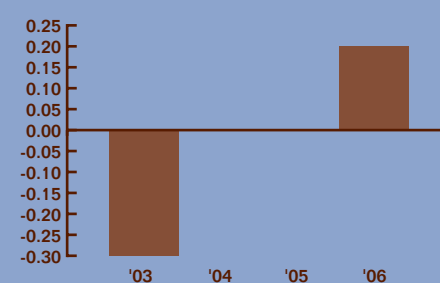
NEW TRENDS IN EXPORTS AND INVESTMENT

So far Japan's economic recovery has basically relied on exports. With the steady strong growth of China's economy, Japan's total trade with China, including Hong Kong, surpassed that with the US during 2004. Meanwhile, the unified and growing European Union is absorbing Japan's manufactured goods. Now it is well-recognized that China is the world's largest supplier of industrial goods, and the Asian Triangle of China, Japan and South Korea form a new division of labour in the world trade market. Japan and Korea export capital goods and hi-tech electronics parts to China. Chinese factories export finished products to the US and other industrialized countries. Japan's bilateral trade balance with the US is shrinking, while China's balance with the US exceeds that of Japan and is rising fast. When Japan's exports to the US or to EU increase, Japan's business fixed investment should increase. However, when Japan's exports to China increase, it may not work the same way. Rather, Japan's capital investment in China may increase and its domestic investment may well be reduced.

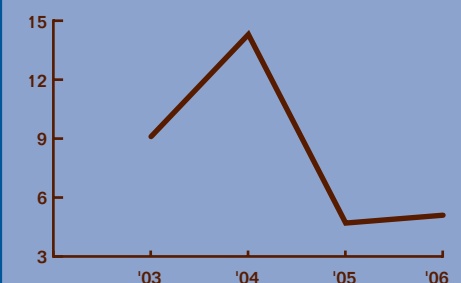
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)





THE RISING REAL VALUE OF FINANCIAL ASSETS

The labour market situation is improving generally and workers' sentiment over job security has remarkably improved. This has been helped by wage rates beginning to increase in the growing industrial sectors, and particularly in the service sector. The continuing innovation in consumer electronics keeps stimulating household demand. In addition to this, we should like to point out two new factors that will further promote household spending. One is the general increase in purchasing power of financial assets. During the past decade of deflation, households have accumulated enormous financial assets while real estate prices fell precipitously. While the banking sector struggled with non-performing loans, household savings at banks remained intact. Thus the real purchasing power of financial assets (that is to say, money in a broad sense) has notably increased. The second factor is a change in the tax system: the tax rate on "gifts" is very high, but the rate has been reduced so that the pre-inheritance transfer of assets to a younger generation is encouraged². The main purpose of this new measure is to encourage property transfer from wealthy elderly parents to the younger generation who are potentially heavy spenders. When the baby-boomers retire with large

retirement bonuses, the new tax measure will have an impact on personal consumption and housing investment.

OUTLOOK FOR 2005

The economy is expected to register positive growth at a little over 1% this year. Exports are likely to accelerate from their recent weak trend as the US economic growth outlook is revised upward from 3.5%, and China's growth rate stays around 9%. The inventory/sales ratio in the semiconductor market is likely to improve and domestic production and business fixed investment will maintain positive trends. The yen exchange rate seems to have stabilized in the range of ¥103-108 per US dollar. Japan's trade surplus is slowly shrinking and the interest rate differential between the two countries is widening as the Federal Reserve maintains a consistent stance of raising interest rates, while the Bank of Japan will likely stick to a zero interest policy for some time to come. Household expenditure will be steady. Job market conditions will improve further, and wage income is likely to increase. Even though personal disposable income may not rise (the three-year income tax rebate is to be lifted and the social security burden will be heavier), consumer spending and housing investment could register positive growth given the rising purchasing power of household financial assets

previously mentioned.

This year has there are certain *ad-hoc* positive influences at work on domestic private demand: an international airport has just opened in Nagoya (called Centrair), and the large Aichi World Exposition has opened near Nagoya. International tourism as well as domestic travel will certainly be encouraged and have some impact on Japan's GDE.

UNCERTAINTIES

As we look ahead at 2005 and 2006, there are some uncertainties. On the political front, Prime Minister Koizumi will step down by the summer of 2006. While his reform plan for public agencies like the Post Office remains incomplete, a strong fiscal drag is likely to take place: the present 5% consumption tax is likely to be hiked to 8-10%. Even though the Asia Pacific economy has returned to a new growth phase, Japan's growth path is likely to be unimpressively low – around 1-1.5%. On the external side, higher energy prices and a sharp yen appreciation must be considered. Higher input prices and yen will squeeze corporate profits and trim investment, although their impacts on Japan's economy are not so large, as shown by simulation experiments³.

¹ According to the official business cycle dating committee, the latest trough in the business cycle was January 2002.

² Japan's inheritance tax rate is perhaps the world's highest. And pre-inheritance property transfer has been heavily taxed. Recently the government introduced a new scheme of tax-free property transfer. Tax is exempted until the time of inheritance.

³ According to the ESRI's Japanese short-term econometric model (2003 year version) simulation, a 10% appreciation of the yen against the US dollar decreases real GDP by 0.14% from the baseline in the first quarter and by 0.2% for the year average.

INCREASE IN FREE CASH FLOW MAY ALLOW WAGE INCREASE

