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The Japanese Economy: Recovery or Sclerosis?

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The Japanese economy has overcome the severe manufacturing slump that it experienced at the height of the global financial crisis and economic slowdown. It had been hit severely by the decline in global demand for advanced manufacturing products — such as motor vehicles, information technology and machinery — which constituted a larger share of production and exports for Japan than for other G-7 economies. Business investment weakened with deteriorating financial conditions. But with the gradual revival of global manufacturing activity and an improvement of global and Japanese financial conditions, the Japanese economy expanded 4.6% in the fourth quarter of 2009 — with net exports contributing to nearly half of the growth — after a flat third quarter.

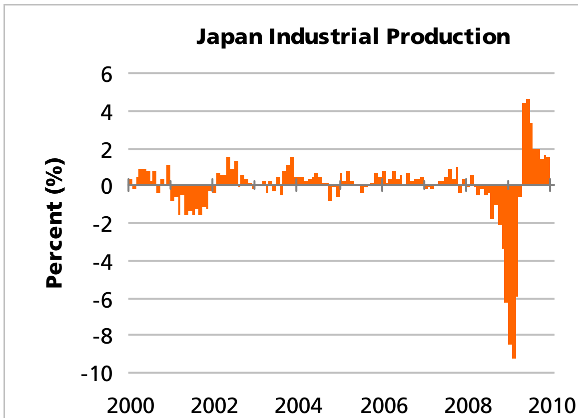
Japan has experienced an era of slow growth and stagnation since the mid-1990s. From 1996–2009 real GPD grew at an average rate of less than 1.0% per quarter on a seasonally adjusted annualized basis, down from an impressive rate of 3.6% between 1980–95. Unless policymakers take effective measures to stimulate aggregate demand and enact the structural reforms that Japan needs to improve its growth prospects, the recent upturn in economic activity could end up a mere cyclical blip. A close look at the drivers of economic activity in Japan and the various structural issues facing the country leads us to be skeptical of the prospects for a sustained recovery.

Drivers of Japanese Economic Activity

Consumers. Consumer activity has been tepid in Japan, and retail sales have been soft in spite of some improvements in consumers' outlooks. Real employee compensation has been declining for the past six quarters. Households have been reducing their outstanding debt and are saving more despite the recent uptick in consumer confidence, as the weak labor market and the lack of real income growth has inspired caution on the personal expenditures front.

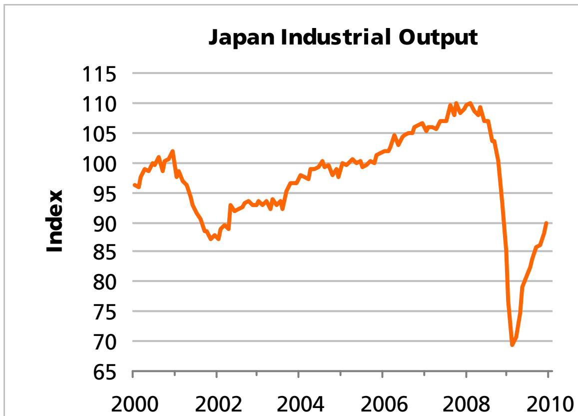
Industry. As shown in the charts below, industrial output remains well below its early 2008 peak, while industrial activity bottomed in mid-2009 but only recently turned positive on a year-over-year basis. New orders for machinery and machine tools are also well below their peaks, though orders have improved markedly in recent months. However, business investment and sentiment remain bleak, as evidenced by the central bank's Tankan Survey; without increased business investment, the prospects for productivity gains and continued economic growth do not appear promising.

Japanese industrial production has rebounded...



Source: Reuters EcoWin

...But industrial output is well below its peak



Source: Reuters EcoWin

Exports. Exports are growing, having risen in the past three quarters. Undoubtedly, Japan is benefiting from the revival of global trade activity and particularly from the China-led resilience in the East Asia region. The impact has been mitigated, however, by the appreciation of the yen, which has reduced the competitiveness of Japanese exports globally. Over the past year or so, the exchange rate with the U.S. dollar has appreciated from ¥100/$ to about ¥90/$. The yen also experienced periods of appreciation against the euro — both in early 2008 and again but more mildly in early 2010. The strength of the yen could hurt the prospects of export-led recovery.

Labor. Japan has been shedding employment since early 2008; the unemployment rate has risen to around 5% as of late 2009 from less than 4% at the beginning of 2008. While a one percentage point increase in unemployment is mild compared to recent experiences in the U.S. and various other developed countries, it is significant by Japanese standards, as firms are generally reluctant to lay off employees. Japanese corporations responded to the recent downturn mainly by reducing cash compensation for employees. In addition, the ratio of job offers to applicants is declining, implying that hiring has not yet resumed.

The labor force itself has been shrinking, which — combined with low fertility rates and a declining population — bodes ill for Japan's economic prospects. Despite the reliance of economic growth on an expanding and productive labor pool, Japan has been quite reluctant to open its borders to foreign workers, skilled or unskilled. Whether Japan can attract and retain the workers needed to retain a competitive manufacturing base — and whether Japanese policymakers and society would be willing to do so — remain to be seen. Productivity growth requires sustained business investment, innovation and sustenance of talent, and Japanese corporations have been unable to replicate their success of the 1970s and 1980s.

Deflation. In the meantime, the Japanese economy is mired in serious deflation. Various measures of headline and core inflation — such as core CPI and the implicit deflator for private final consumption expenditure — show prices falling almost every year since the turn of the century. Deflationary pressures became quite pronounced last year; core consumer prices declined despite an expanding monetary base, reflecting the weakness of aggregate demand in the economy. Deflationary pressures also have a negative impact on consumer spending; households delay planned purchases, particularly of durable consumer goods, if they expect deflation to continue to drive prices lower.

Due to weak consumption, tepid business investment, an appreciating yen and a soft labor market, the prospect of self-sustained growth in Japan following the cyclical upturn is fairly limited.

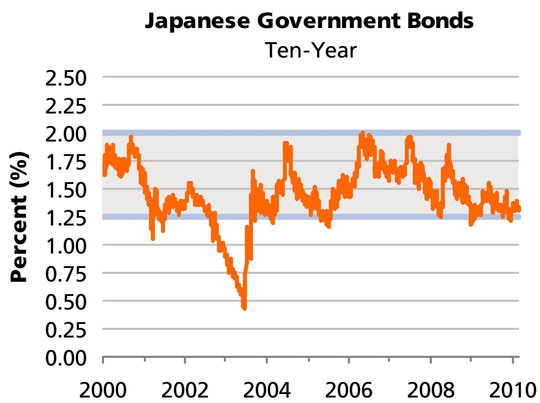
Japan's Fiscal Position and Government Bonds

Japan's fiscal position is weak due not only to large general government gross debt but also to large general government net debt and to persistently large fiscal deficits. Japan's general government net debt is larger than that of other G-7 countries, and its public-debt-to-GDP ratio is expected to remain elevated above that of other G-7 countries in the coming years. Japanese authorities have undertaken a number of substantial stimulus efforts during the decade of stagnation; while these promoted public spending, the overall effect on growth has been limited.

Usually, increased government spending and higher public debt leads to upward pressure on government bond yields. However, due to sizeable pool of household savings, large and stable domestic institutional investors and strong home country bias, the yields of Japanese government bonds (JGBs) have remained low, resulting in a manageable interest payment burden on the public exchequer. Domestic investors hold the bulk of JGBs: the Japanese public sector (including the Bank of Japan) holds about 13%, domestic financial institutions hold more than 64% and households directly hold more than 5%. Foreigners hold only about 7% of outstanding JGBs. These substantial domestic holdings of government debt and control of their own monetary policy are two important factors separating Japan from various euro zone countries with large public-debt-to-GDP ratios — such as Greece and Portugal.

As shown in the chart below, ten-year JGB yields have been fairly range-bound since 2006, trading mostly between 1.25% to 2.00%, and have traded sideways since early 2009. While nominal yields on ten-year JGBs have remained range-bound, real yields have increased due to deflation. Two-year JGBs, meanwhile, have rallied since the Bank of Japan lowered its policy rate in late 2008, resulting in a steepening JGB yield curve.

Ten-year JGB yields have remained range-bound



Source: Reuters EcoWin

Though Japan has large fiscal deficits and its public-debt-to-GDP ratio is quite high compared to other G-7 nations, JGBs are unlikely to sell off sharply in the near future barring some shocks to the economic and financial system, though there would be moderate upward pressures on yields over the longer horizon. The large financial surpluses of the Japanese corporate sector in recent years have provided funds through the banking system and kept JGB demand strong. In the near term, some additional fiscal stimulus will be needed to foster recovery; thereafter, however, Japanese authorities shall need to undertake fiscal consolidation as the economy recovers.

Going forward, the domestic market's capacity to absorb Japanese public debt is likely to diminish, as the aging population reduces its savings inflows. Indeed, the household saving rate in Japan has declined noticeably in the past few years. The conditions that have kept JGB yields low — such as large domestic holdings and Japan's large current account surplus — are likely to diminish, which could gradually strengthen the link between JGB yields and the country's high public-debt-to-GDP ratio. ■