

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## The Japanese Economy Likely to Recover Steadily by Late 2010

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The Japanese economy is on a recovery track thanks to improving production levels, despite the fact that growth rates are still low and deflationary concerns still abound. Most assessments of the business cycle in Japan are based on the Cabinet Office's coincident composite index. The CI hit bottom in March 2009 and has been rising for eight consecutive months since. And the three-month backward moving average, which indicates trends in the coincident index, rose over the preceding month for seven straight months between May and November 2009.

### Recession hit bottom in march 2009

The seven-month backward moving average, which shows the firmness of the recovery trend, has been above the benchmark deviation of 0.51 (the average for January 1980 to December 2008) for four consecutive months. The above-average figures indicate that the economy is on the upswing. Based on these statistics, the Cabinet Office, in announcing the indices of business conditions for September 2009,

described the situation as “signaling a possible turning point” and upgraded its assessment the following month to “improving.”

Real growth in gross domestic product has been positive for two consecutive quarters over the preceding three months, and the economy has clearly been in a recovery phase since the April–June quarter of 2009.

Both the ratio of leading to coincident indicators (leading indicator divided by coincident indicator) and that of coincident to lagging indicators (coincident indicator divided by lagging indicator) have been climbing, showing that the uptrend in the leading CI will likely remain quite firm; the two ratios are thought to indicate trends further ahead than the leading CI itself.

Assessment regarding whether or not the economy is in an expansionary phase, in the strictest sense, is based on the following three criteria: (1) the coincident indicator of the historical diffusion index, which spreads out irregular changes, exceeds 50% for five or more months; (2) the diffusion index approaches 100%, with most sectors in the economy feeling a recovery; and (3)

the rate of the coincident CI's rise from the point considered the trough is not lower than past expansionary phases.

### Ten months of expansion

The current state of the Japanese economy fulfills all three criteria. When, then, did the economy bottom out? Of the 11 items making up the coincident indicator, the trough is considered the point where a majority of 6 items hit bottom. Five items, such as the production index, bottomed out in February 2009, while 3 items, including electricity use, registered a low in March. This is the reason that the trough is considered to have occurred in March 2009. Five or more straight months of recovery from the following month are needed for the formal assessment to be made, and this, too, has been cleared. The last remaining item—the effective ratio of job offers to job seekers—also hit bottom in August,

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so with the diffusion index at 100%, the recovery is now being felt in all sectors. The speed of the rise over the eight months following the trough, moreover, is faster than any of the seven earlier expansionary phases.

While the diagnosis is still a preliminary one, the economy can be said to have bottomed out in March 2009 and to have been expanding for 10 consecutive months, as of January 2010.

### A strong rebound

Since around November 2008, immediately following the Lehman shock, I projected that the recession would bottom out by the first quarter of the following year. The main reason for my diagnosis was that I learned early on that China's crude steel production and business confidence among manufacturers had bottomed out in October 2008 and that major Japanese automakers were planning to significantly boost production, month on month, after March 2009.

Another reason relates to the principles of dynamics. I realized that while production would tumble from the end of 2008 through the first quarter of the following year, because of the extremely rapid pace of the slowdown, the economy would probably hit the ground quickly as well.

This has been buoyed by trends in the real economy, as the United States, China, Europe, and Japan drafted large-scale stimulus packages, generating new demand and helping bolster the economy. This helped fuel a recovery in production that has continued to this day.

### No "double dip"

The March 2009 projection turned out to be correct, but there is some confusion in recent discussions. One factor has been the issue of level. As described above, signs of a recovery are now quite clear, but it has been propelled largely by external demand, and domestic conditions are still quite weak; there are large gaps between large and small companies—and between large cities and outlying areas—in the level of economic activity. The Bank of Japan *Tankan* (Short-term Economic Survey of Enterprises in Japan) bears this out, as confidence remains particularly low among small and medium-sized enterprises.

Another factor has been concerns about a "double dip" recession. When the Yukio Hatoyama administration put on hold parts of the initial supplementary budget for fiscal 2009, coupled with the appreciation of the yen in November 2009 and deflation

fears, sentiment among domestic companies turned bearish toward the year's end, triggering concerns that the economy would quickly fall back into recession. Indeed, the November Cabinet Office Economy Watchers Survey and the December survey of business sentiment among SMEs showed a decline in the diffusion index of coincident and leading factors, as well as of net sales, raising the specter of a double dip, but the figure for the former survey turned up by December.

The term, as it is widely used in Japan, though, is largely a misnomer. A questionnaire survey of 100 corporate presidents conducted by the *Nikkei*, whose results were reported in the morning edition of the business daily's December 21, 2009, issue under the headline, "Half Warn of a Double Dip," found that 47.2% of surveyed managers were on alert for a possible return to recession—a rise of 10 points from the same survey conducted in September. Business conditions certainly do appear bleak, as domestic demand remains weak, deflation has not been overcome, and neither employment nor wages have yet to recover. Be that as it may, fears of a double dip are unwarranted, since the economy is already in a veritable phase of expansion. If things do go down, it will simply mean that the "boom" was

short-lived and that the economy had entered a period of contraction—which invariably follows an expansion. There are no legitimate justifications for calling it a double-dip.

## The role of the BOJ

Despite growing anxieties about a double-dip recession, the conditions are in place for recovery during 2010 and beyond. One oft-cited cause of the yen's appreciation and lower share prices is the decline in the monetary base (Bank of Japan notes plus commercial banks' current account balances at the BOJ). A December 1, 2009, decision by the central bank to supply ¥10 trillion to the market was followed on December 18 with a significant announcement of its "understanding of medium- to long-term price stability," in which it established an inflation target of sorts of a 0% to 2% rise in consumer prices (excluding fresh foods). There is the possibility of additional government bond purchases by the BOJ during fiscal 2009, moreover, and the money supply that had been shrinking should swing dramatically to expansion.

The BOJ's policy of monetary relaxation has halted the yen's rise and the decline in share prices, and deflationary pressures should gradually

ease as the markets for crude oil and commodities move upward.

The global economy, too, is likely to register firm growth in 2010, led by the China, whose economy is expected to expand robustly in real terms by 10.8% (8.4% in 2009). China's industrial production jumped 17.7% in October and November 2009 over the same period the preceding year. Business confidence among manufacturers has rebounded since hitting a low in October 2008, and consumer confidence hit bottom six months later in April 2009, with further increases likely as China prepares to host Expo 2010 in Shanghai from May. Exports have returned to growth, moreover, and the Organization for Economic Cooperation and Development's leading indicator—an index four months ahead of Chinese exports—has been rising rapidly, suggesting that exports will also recover quickly. Fixed asset investment had been the driving force of China's growth, but with exports and personal consumption also rising, the economy can expect to make very strong gains.

## Good prospects for 2010

The United States can expect to continue enjoying high growth thanks to an aggressive fiscal policy and monetary relaxation. The stimulus

package for fiscal 2010 (October 2009 to September 2010) announced by Washington amounts to \$399.4 billion, the biggest ever adopted. An additional \$24 billion in home purchase deductions, an extension of unemployment benefits, and tax breaks through the carrying over of corporate losses was subsequently adopted, and a separate \$200 billion stimulus package of tax breaks for SMEs that expand employment, public works spending, and breaks for energy-saving housing is also being drafted.

With these additional steps, Washington's stimulus measures during 2010 will reach 4.2% of GDP, pushing up economic growth during 2010 to 3.2% (up from a 2.5% contraction in 2009).

Economic conditions in countries around the world are recovering and getting stronger, meaning that Japan's exports will continue to enjoy receptive markets. Early in 2010, moreover, a stimulus package of ¥4.2 trillion in fresh spending (the second supplementary budget for fiscal 2009) will be implemented in the form of subsidies for eco-friendly cars, an extension of the "eco point" system for home appliances, and the introduction of "eco points" for private homes. Additional stimulus should come from

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the ¥3.8 trillion in child allowance and other programs during fiscal 2010. The impact of these measures should begin showing up in statistics for personal consumption, housing investment, and other items.

A number of major international events are on schedule during the year, such as the Olympic Winter Games in Vancouver, the FIFA World Cup in South Africa, and the Shanghai Expo, resulting in positive economic benefits. On the political agenda are a House of Councillors election in Japan and a midterm election in the United States. These and other events should result in higher expenditures worldwide.

In such a context, the recovery of the Japanese economy will no doubt endure throughout 2010. Real growth during fiscal 2010 is projected at

1.9% (2.1% for the calendar year), compared with a contraction in fiscal 2009 of 2.8% (5.4% for the calendar year).

Fiscal 2010 will thus likely see a steady recovery; in fiscal 2011, however, growth is projected to ease to 1.3% (1.1% for the calendar year), as the terms of trade deteriorate in the form of rising crude oil prices, major international events come to a close, the impact of US stimulus measures wears out, and an exit strategy is launched for Washington's monetary policy from around the third quarter of 2010.

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# A Somber 2010 as Taxpayers Face Up to Cost of War on Recession

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*Recovery is hard work and the heavy lifting in 2010 must come from self-sustaining growth in the private sector. At the peak of the crisis in early 2009, governments took on the gargantuan task of steering the massive global downturn to a halt but their resources are now severely constrained and policy tightening looms. The European Central Bank (ECB) sees near zero interest rates and easy money as a potential risk that needs to be reined in to avoid speculative bubbles in markets and currencies—although the euro will come under pressure if the ECB acts without the United States Federal Reserve, which will be reluctant to raise rates as long as turbulence continues in the property and banking sectors. The US fiscal package also continues into 2010 but European governments are under pressure to reassert control over deficits and debt, in line with EU policy targets. The bill for the war on recession will start to arrive in 2010.*

Policy efforts succeeded in taming the recession and generating at least a modest pick-up in growth in the second half of 2009. There is nothing like a massive slump in demand in the world's leading economies for driving synchronization in the global economic cycle but also creating a show of G20 policy cooperation and more funding for bailouts. But the next phase of

the recovery will have quite different characteristics. It will be far slower and more uneven than the plunge into recession, and policymakers will give more priority to picking their own exit strategies, adding to the risks ahead. Indeed, the ECB and the Fed are starting to rein in liquidity and, in the UK, competing exit strategies are already center stage in the political campaign preparing for the election expected in late spring.

Yet it is clear that the world economy is still a long way from full recovery. Compared with a year ago, the mood has changed from panic-stricken to simply somber, but recovery euphoria is distinctly lacking. Economic performance remains fragile and risk-prone in most countries—in fact, even the developing world looks less buoyant if high-fliers China and India are stripped out. Europe faces a particularly tough situation—emerging Europe has seen the worst slump of any region in the world, while the euro area recession has been far deeper than expected in spite of costly support programs. The outbreak of financial crises in some euro states, for example Greece at the end of 2009 and Ireland earlier in the year, may not lead to a break-up of the euro area (as some suggest) but it will tarnish its reputation. The

emergence of these problems reveals previously poor assessments of country risk.

The next stages of recovery must rely on self-sustaining growth in the private sector, yet EU consumers face a tougher year in 2010 as inflation returns and unemployment is set to rise. Many companies are struggling to reverse the slump in revenues and avoid job cuts, leaving little scope for investment spending. And there are threats from further shock waves in the financial system as well as post-crisis policy tightening—taxpayers are waiting for the inevitable bill for the war on recession. This year is likely to be a bumpy ride—there is only a slim chance of a smooth return to growth after such a troubled recession.

## Risk of turbulence as markets react to policy tightening?

Near zero policy rates are beginning to look unhealthy to hawkish central bankers, especially as deflation has come to an end in Europe and the United States, and there is rising concern about the impact of cheap money on asset prices and exchange rates. Speculative investments such as carry trade (that is, borrowing in a cheap currency such as the dollar to

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invest in high-yielding currencies) may boost profits in parts of the banking sector but this will backfire if it fuels bankers' profits and pay rather than supporting the wider economy, for example through credit to small- to medium-sized enterprises. Inflows of speculative money have already caused Brazil to put a tax on foreign capital because of fears that the exchange rate will appreciate faster and further than the economy can withstand. Easy money has been criticized for fuelling a bubble in equity and commodity markets as well as currencies. These concerns all point to central banks reining in liquidity in 2010. And either the ECB alone or the ECB along with the Fed will take the first step in raising interest rates earlier rather than later in 2010. This could cause tremors in the financial system and currency markets.

Adding to the threat of turbulence are the three original drivers of the financial crisis: property, debt and banks. They are all interlinked. Property market failures continue to play havoc, as highlighted by recent news from Dubai and also tremors in some parts of emerging Europe, still reeling from the aftermath of the abrupt halt to credit-fuelled growth. In the United States, many fear that

the housing sector could suffer a relapse linked to a new wave of foreclosures while the damage in the commercial property sector is only just emerging, raising concerns about a further round of non-performing loans and banking failures.

Even without any new problems, many leading European banks are seen as starting the year in a relatively weak position, having substantial bad debts to write off, high levels of leverage and low capital adequacy: some fear that these factors could exacerbate the credit crunch in Europe in 2010. There is continued resistance to proposed regulatory reforms to strengthen the banking sector but the return to 'business as usual' in terms of profits and bonuses has kept the banks squarely in the public spotlight and more steps are likely to be taken to curb what many in Europe see as a dangerous bonus culture in the financial sector.

### Reining in public debt

While central bankers ponder the timing of the first rise in policy rates, governments must face up to the task of regaining control over public finances as both deficits and debt have risen sharply. Fiscal policy is likely to take longer than monetary policy

to adjust as policymakers vacillate between concern about fiscal prudence and the threat of voter distress over the economy and jobs. But the direction is clear. Governments have little scope to take on more debt—in Europe they will start to cut expenditure and raise taxes sooner rather than later. Indeed, some EU member states, such as Greece and the Baltic States, are battling to cope with tough adjustments to the post-crisis reality. The problems are not only in the small states.

Taxpayers will ultimately be responsible for repaying the cost of efforts made to combat recession and limit the short-term damage to their economies: a less deep recession has been won at the cost of a long period of below-trend growth. Excessive rigor might lead to voter rebellions—even to defaults—and therefore easy repayment terms are more likely, spreading the burden over as much as a decade rather than just a few years. This main flaw in this strategy is the risk of another downturn during the payback period, adding renewed stress to public finances. Governments will not have the capacity to spend their way out of two recessions in a decade. This is why regaining fiscal authority may be a race against time over the next cycle.

## Hard work ahead to achieve recovery

In summary, there are too many problems still to be addressed for 2010 to be anything other than a very difficult year. Growth will almost certainly be mildly positive for 2010 as a whole, as it will be measured against the depths of the 2009 recession, but there is an uncomfortably high probability of instability—that is, a W-shaped recovery. After picking up in late 2009, economies will relapse unless momentum can be built up and turned into sustainable growth.

The key sectors that will have to do the heavy lifting in 2010 will be services and industries, such as information and communication technology, this is demonstrated by the trends seen in 2009. Provided these sectors can continue to boost growth and create jobs, then the prospects for more troubled cyclical sectors such as investment goods and construction will gradually improve. This will be essential to pave the way towards a new round of innovation and higher productivity growth in the advanced countries and world economy over the longer run.

Will the United States or the European Union be the first to achieve a true

recovery to self-sustaining growth? The answer to this question matters as it will probably dictate the course of the dollar by late 2010 and the sustainability of recovery into 2011 and beyond.

The European Union is clearly struggling with disparate problems across member states, hoping that individual responses will meet each challenge while Brussels and the ECB impose a tough policy framework to meet public sector debt and monetary stability targets. In contrast, the United States is likely to keep central policies as easy as possible to support the worst-affected regions and sectors—and in so doing to spread the effect of low-cost borrowing around the country and the world. The ultimate aim should be to restore sustainable growth, whatever adjustment method is preferred, soft-touch US or EU sanctions-led.

Historically, it has been the US economy that has rebounded most strongly from recessions, pulling Europe along. The soft touch, while controversial, won the recovery race (e.g. in the early 1980s and 1990s), typically initiating a dollar rebound as well. Confidence is too low for a positive US scenario to be taken for granted but consumption is improving

and efforts are underway to engineer a positive response from the corporate sector. Another important deciding factor is that, for all the talk about imbalances and alternatives to the dollar, the United States is able to boost growth under a stronger dollar whereas the euro area simply buckles under a stronger currency, highlighting its excessive dependence on exports as the engine of growth and inability to mobilize its own consumers. The United States has to be the winner of the recovery race. Effectively, Europe can never be the driver of global growth—it will always be the follower unless it changes its internal dynamics.

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