Annual Report on the Japanese Economy and Public Finance 2010

—Strong Economic Growth Achieved through Demand Creation—

Summary

July 2010

Cabinet Office
Government of Japan

Contents

Chapter 1　Japanese Economy on a Steady Pickup

Section 1　Real Economic Trends

- Exports and consumption have driven the economic pickup.
- An inventory rebound in reaction to the sharp liquidation in destination countries gave a boost to Japanese exports, which have then increased in line with demand growth.

Figure 1-1-1 (1)　Real GDP Growth Rate

Exports and consumption are driving the economic pickup.

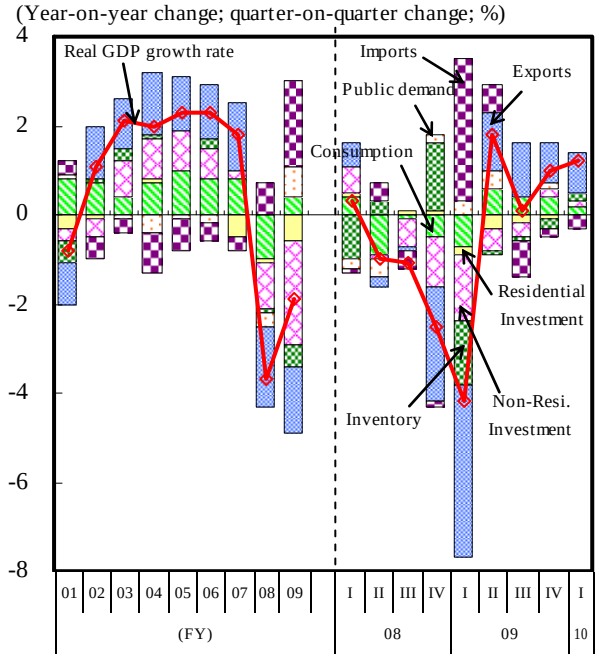
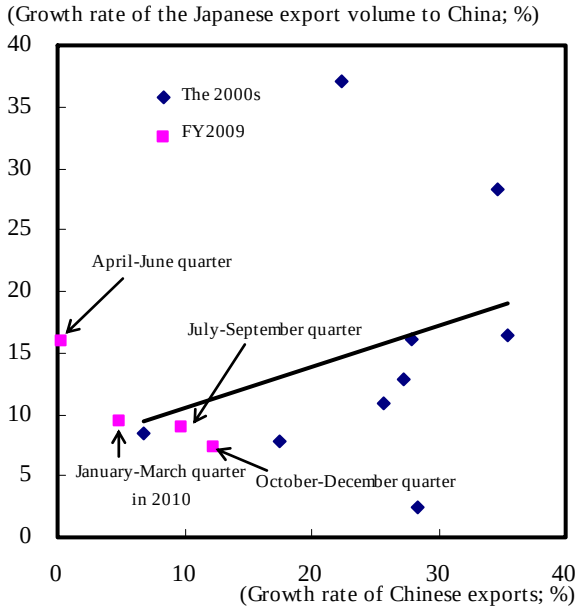


Figure 1-1-8 (4)　Japanese Exports to China and Chinese exports

Japanese exports to China expanded in line with increasing Chinese exports.
Brisk results for April-June 2009 are likely due to an inventory rebound after a period of liquidation



- Caution should be paid to downward risks for the economy, including overseas factors and the influence of deflation.
- In the past, the driver of the economic recovery shifted from public investments to private demand as the economic pickup progressed.

Figure 1-1-9 (4)　Trend in Crude Oil Prices after the Economic Trough

The rising pace of crude oil prices is more or less the same as that seen in the prior pickup phase.

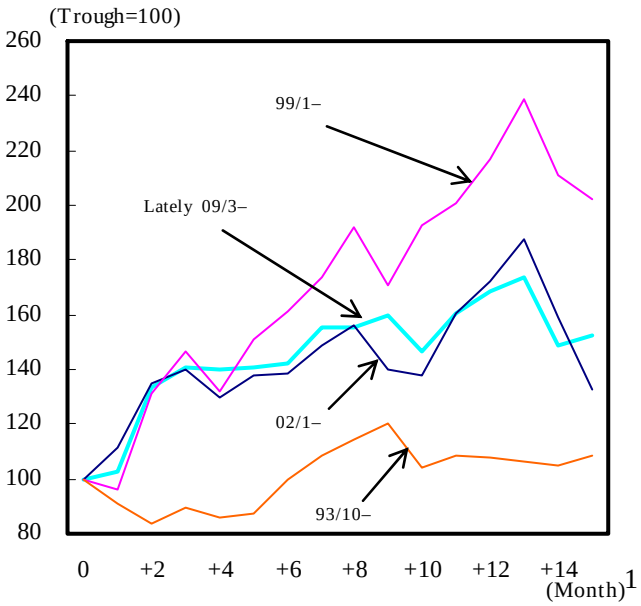
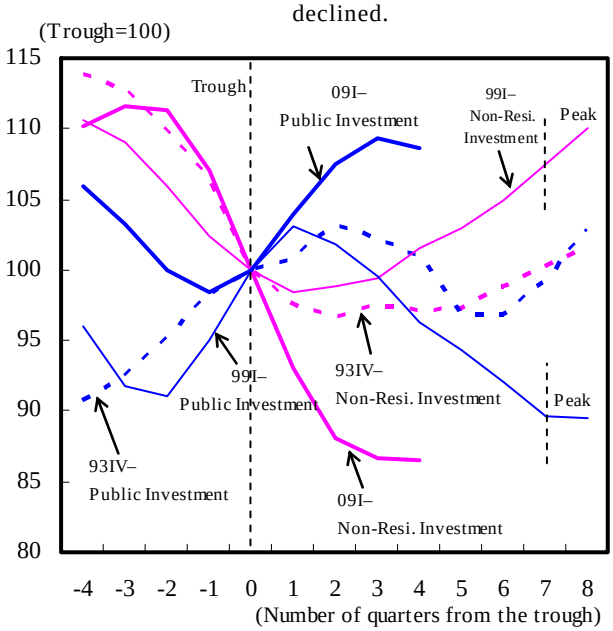


Figure 1-1-10　Movement Seen While Public Investment is Declining in the Economic Pickup Phase

Non-Resi. investment bottomed out as public investment declined.



- The capacity utilization rate indicates that capital investment is nearing the bottom level seen in the past.
- A pickup in the expected growth rate is the key to a medium- to long-term recovery of capital investment.
- After the collapse of Lehman Brothers, the demand outlook has increasingly varied across industries. It is likely that the demand structure has changed.

Figure 1-1-18 Capacity Utilization Index and Capital Investment

The capacity utilization rate rises to a level indicating that capital investment is to hit the bottom.

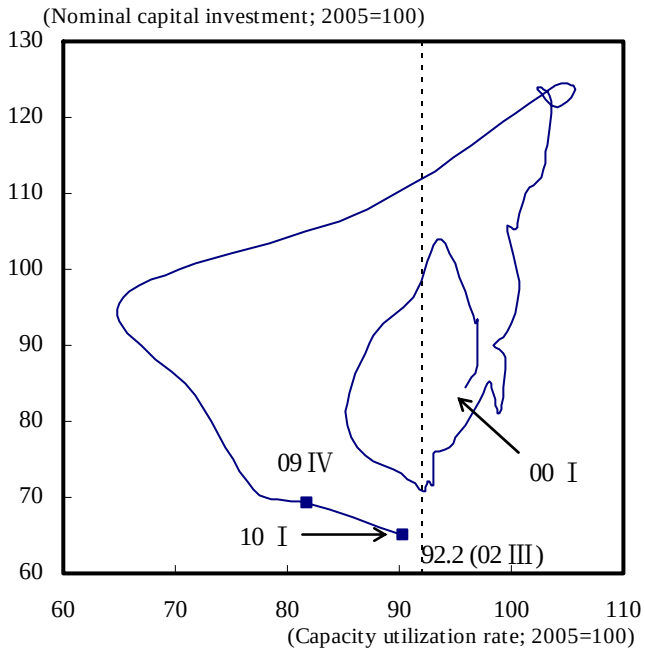
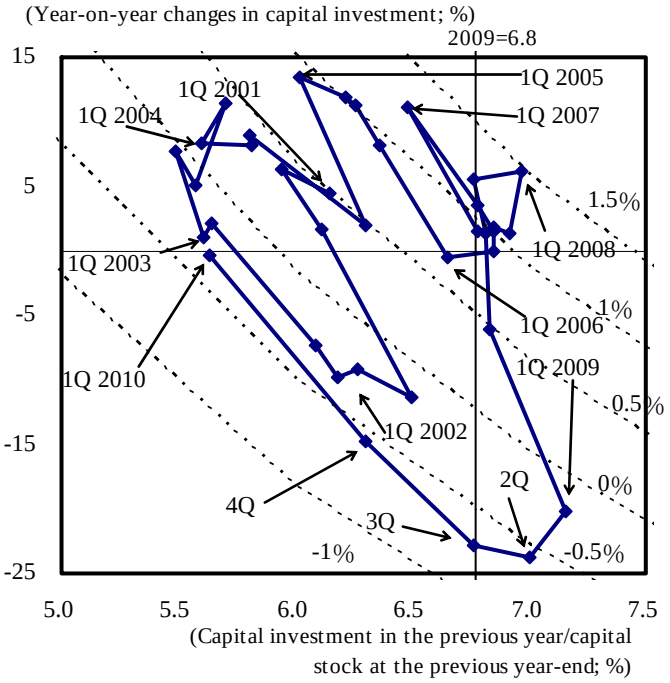


Figure 1-1-19 (1) Capital Stock Cycle (All Industries)

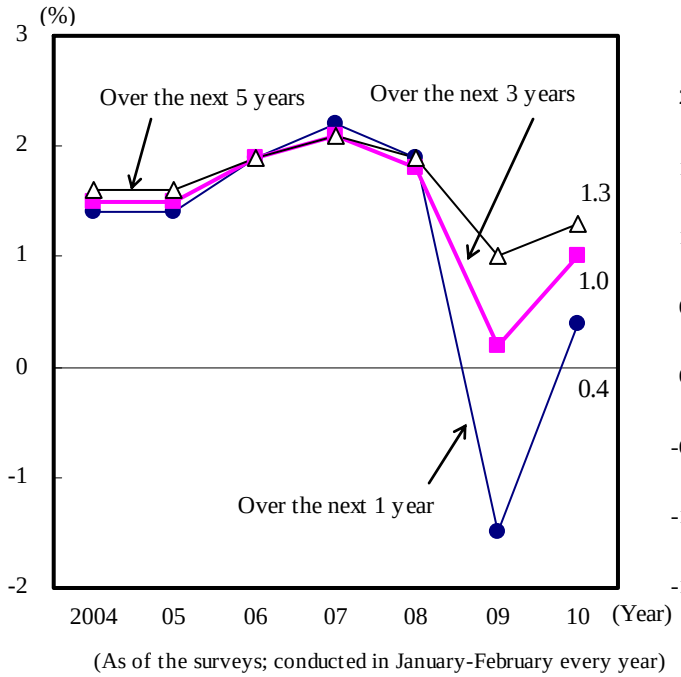
A rise in the expected growth rate is the key to a capital investment recovery.



(Note) Both capital investment and capital stock are in real terms. The dotted lines are hyperbolic curves of the two variables concomitant with the expected growth rate.

Figure 1-1-19 (2) Expected Growth Rate

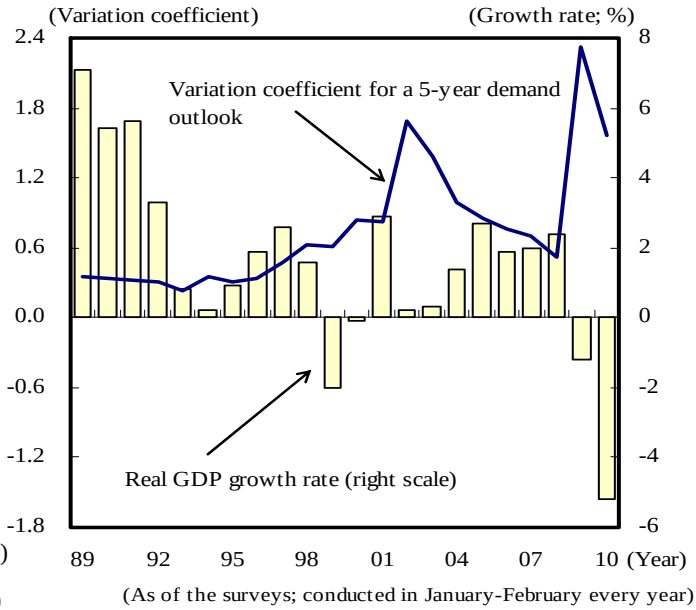
The expected growth rate remains low.



(As of the surveys; conducted in January-February every year)

Figure 1-1-19 (3) Industrial Variance in Demand Outlook

The demand outlook varies from industry to industry; the demand structure is likely to have changed.



(As of the surveys; conducted in January-February every year)

- Consumer spending has increased buoyed by strong demand for consumer durables.
- Measures to support household budgets are expected to boost household disposable income.

Figure 1-1-7 Consumer Spending

Consumer spending is increasingly driven by strong demand for consumer durables.

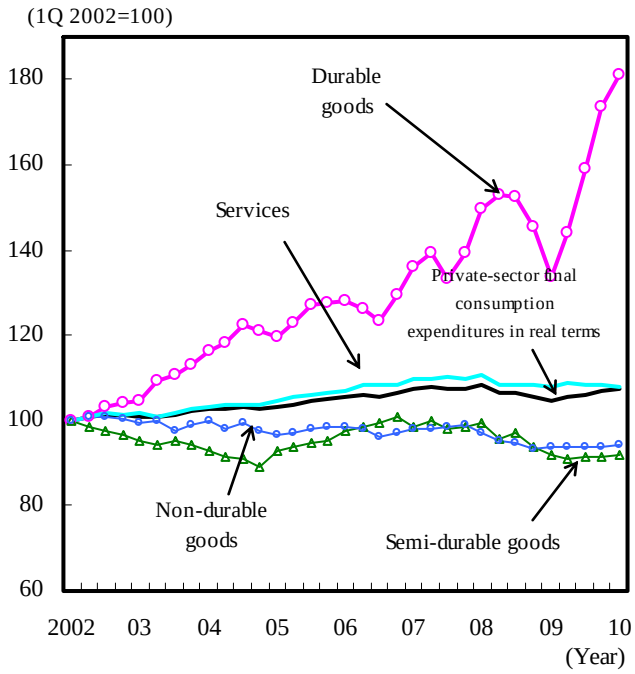
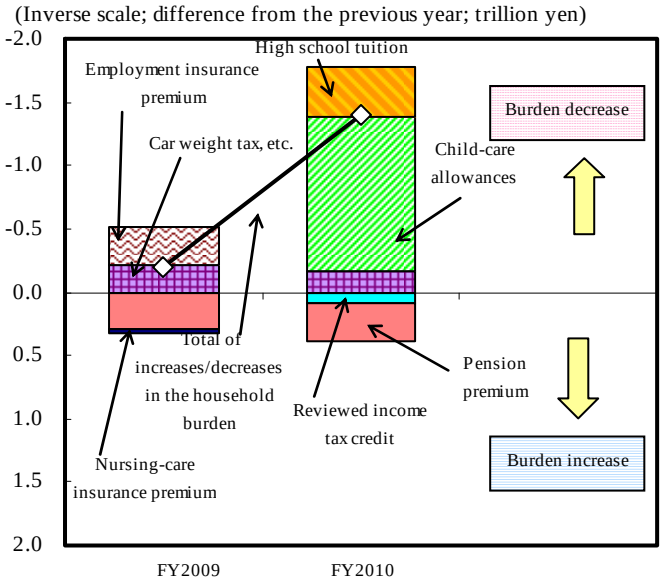


Figure 1-1-22 Increase/Decrease in the Household Burden Due to Major Institutional Changes

A decreasing burden aided by various measures is likely to boost household disposable income.



- Due to falling house prices and interest rates, housing affordability has been improving.
- Although employment adjustment pressure has weakened, it is still lingering and thus requires caution.

Figure 1-1-28 Housing Affordability Index

Although it has been following an upward path, housing affordability has recently shown a slight dip.

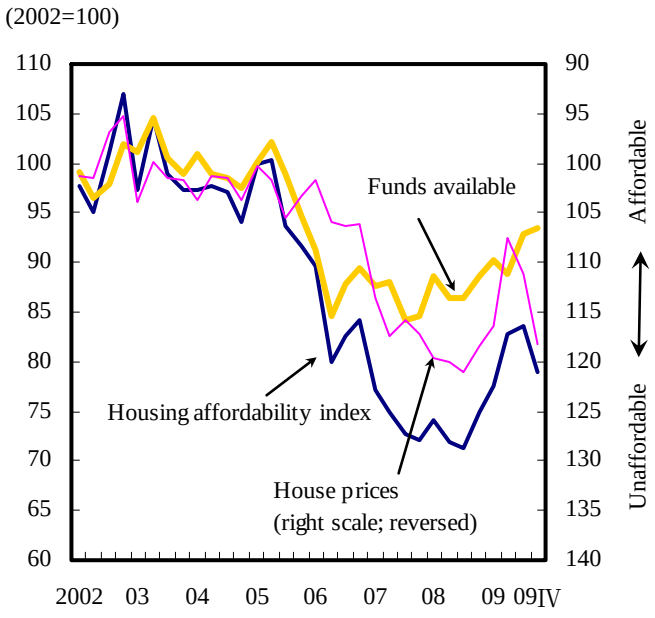
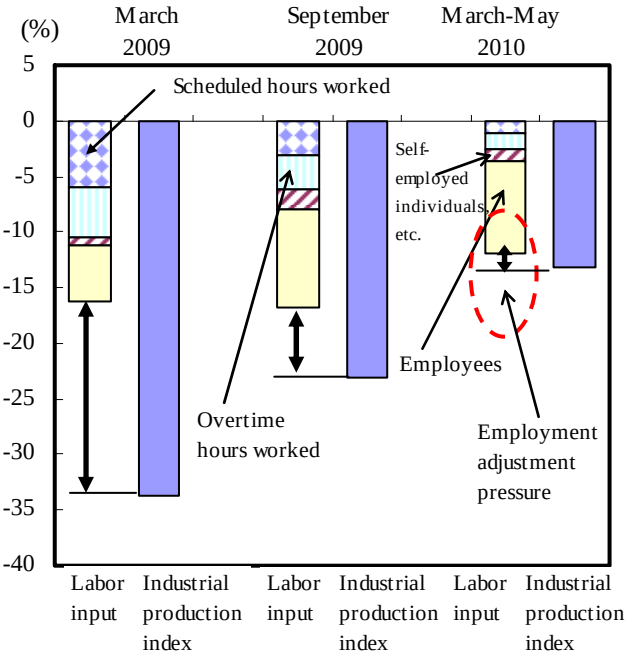


Figure 1-1-25 (2) Employment Adjustment Pressure

The employment adjustment pressure has become less in terms of output and labor input.



(Note) Rate of change from the previous economic peak (October 2007)

- The employment surplus felt by industries has fallen to the level seen around 2003, when the previous economic expansion phase started.
- The medium-term corporate outlook for employment is more optimistic at present than in 2003, mainly that of non-manufacturers.

Figure 1-1-25 (1) Employment Surplus Felt by Industries

The employment surplus felt by all industries has fallen to the level seen around 2003.

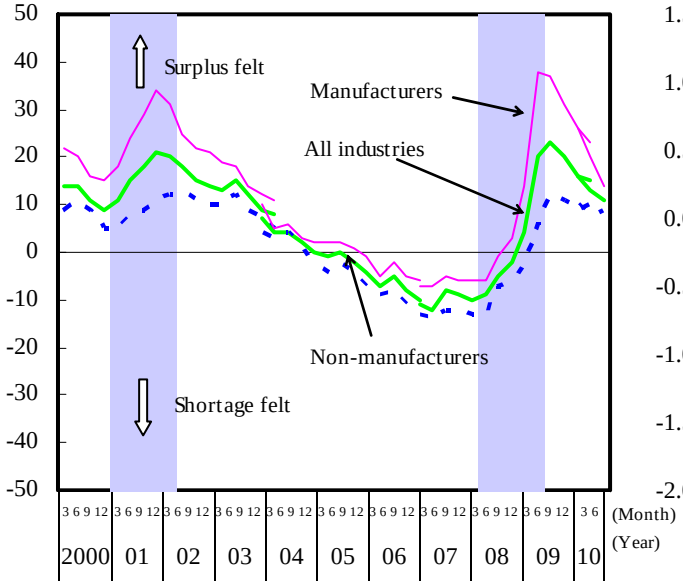
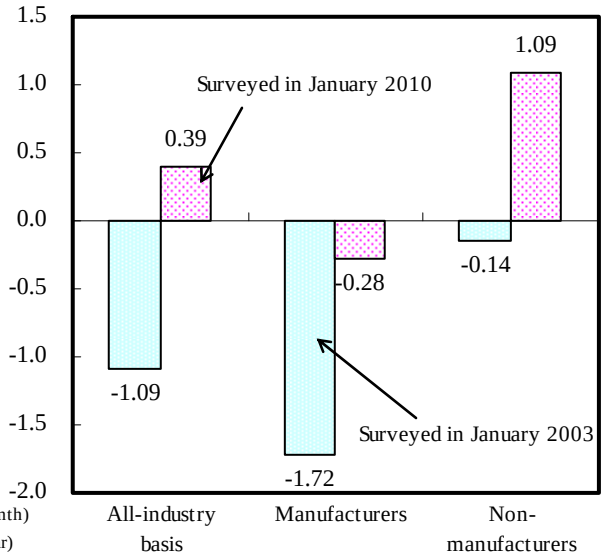


Figure 1-1-25 (3) Employment Outlook for the Next Three Years

The corporate employment outlook is more optimistic than the results of the 2003 survey, mainly that of non-manufacturers such as those in the services industry.

(Rate of change in average employment of the fiscal year; %)



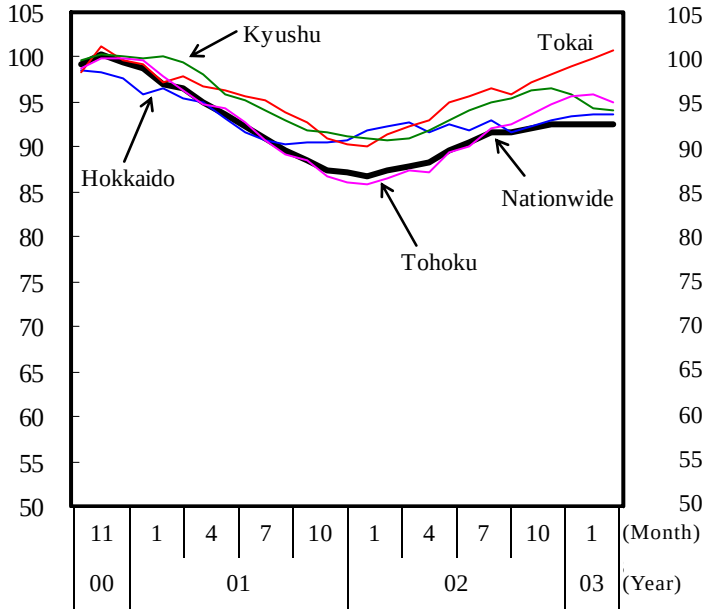
- Regional differences in terms of industrial production have gradually been narrowing.

Column Figure 1-2 Industrial Production by Region

Recent regional movement is more or less the same, but regions highly dependent on exports have experienced sharper drops and rises.

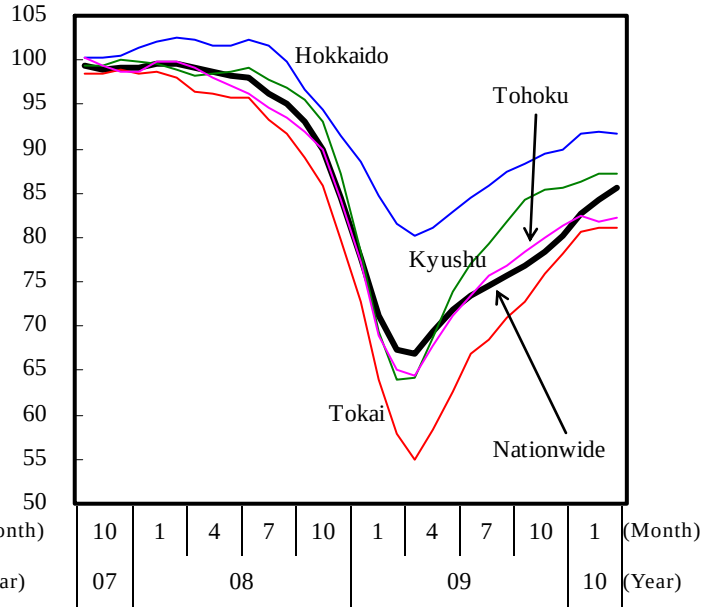
Before and after the previous economic trough

(November 2000=100)



Before and after the recent economic trough

(October 2007=100)



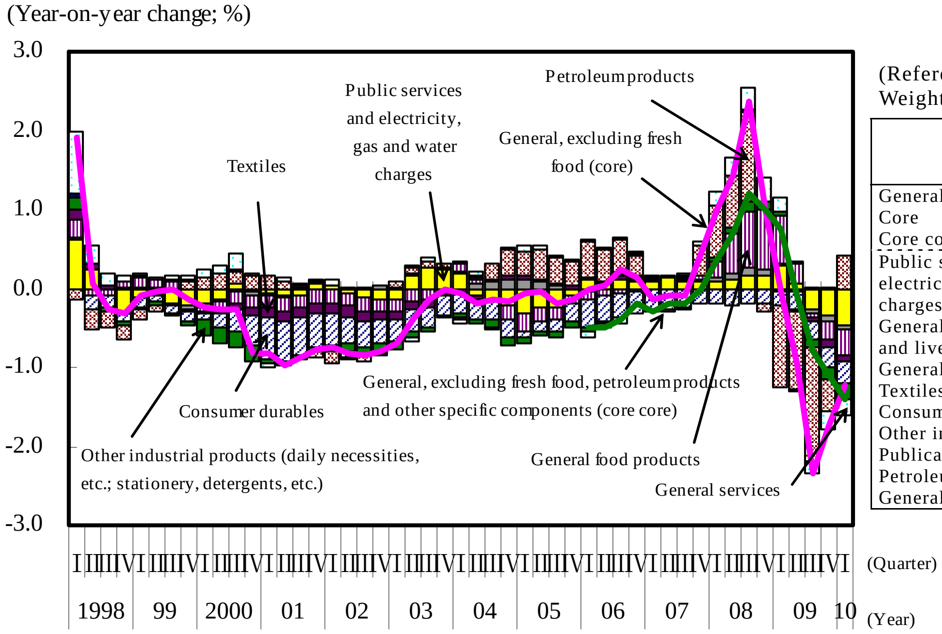
(Note) Three-month backward moving average.

Section 2　Price Trends and the Financial and Capital Markets

- In the recent deflation, the prices of a wider array of items including those of services have declined.

Figure 1-2-1　Year-on-Year Change in Consumer Prices (Excluding Fresh Food)

The prices of a wide range of items, including those of services, have fallen.



(Reference)
Weight and year-on-year change by item

Item	Weight	Year-on-year change (%) (2010I)
General	10000	-1.2
Core	9588	-1.2
Core core	8222	-1.4
Public services and electricity, gas and water charges	1845	-2.4
General fresh agricultural and livestock products	215	-2.0
General food products	1439	-2.1
Textiles	466	-1.5
Consumer durables	547	-5.8
Other industrial products	780	-2.5
Publications	167	0.4
Petroleum products	355	11.5
General services	3775	-0.5

- In deflationary times, the rise in real interest rates curtails capital investment.
- Households predicting future price declines tend to put off the purchase of consumer durables.

Figure 1-2-7　Capital Investment Curtailed by Deflation

Rise in real interest rates and other factors has depressed capital investment.

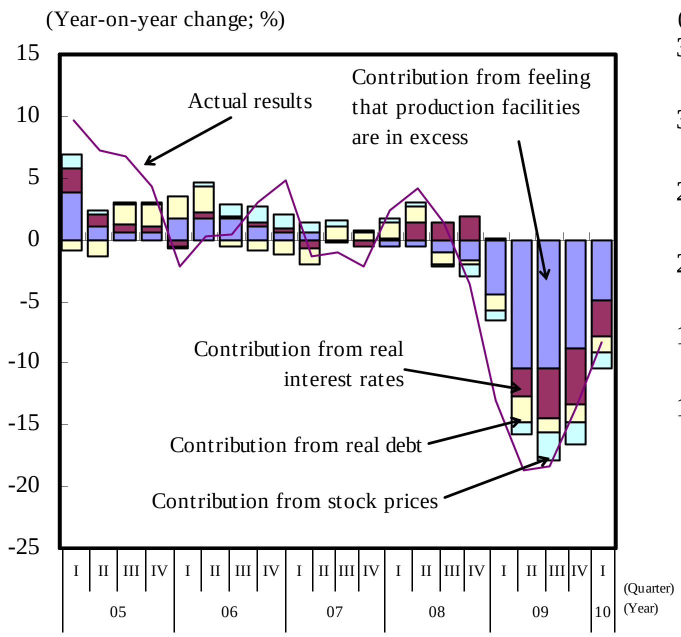
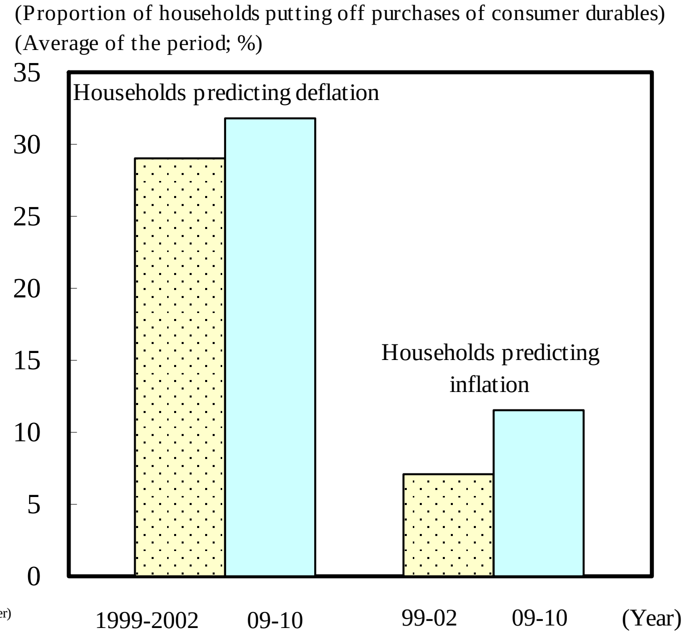


Figure 1-2-8 (1)　Postponement of Purchases of Consumer Durables

Households predicting deflation tend to put off purchases of consumer durables.



(Note) Households predicting deflation/inflation are those expecting prices to decrease/increase over the next half year (for 1999-2002 data) or a year ahead (for 2009-2010). The proportion of households putting off purchases of consumer durables consists of those households expecting the prices of durable goods to reduce over the next half year of the total number of respondent households.

- Japan's inflation rate having remained low is largely attributable to: 1) the protracted period of short demand; and 2) the low expected inflation rate.
- After the collapse of the bubble economy in the 1990s, Japan's output gap has been on a negative trend.

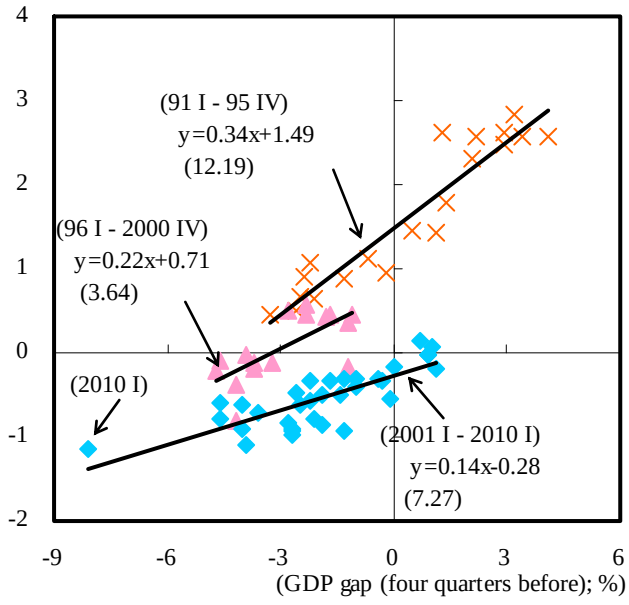
Figures 1-2-11, 12 Relationship between the Output Gap and the Inflation Rate

Japan

Even if the output gap comes to zero, prices are unlikely to rise.

(Low expected inflation)

(Year-on-year change in consumer prices; %)



US

If the output gap comes to zero, prices are likely to rise about 2%.

(Positive expected inflation)

(Year-on-year change in consumer prices; %)

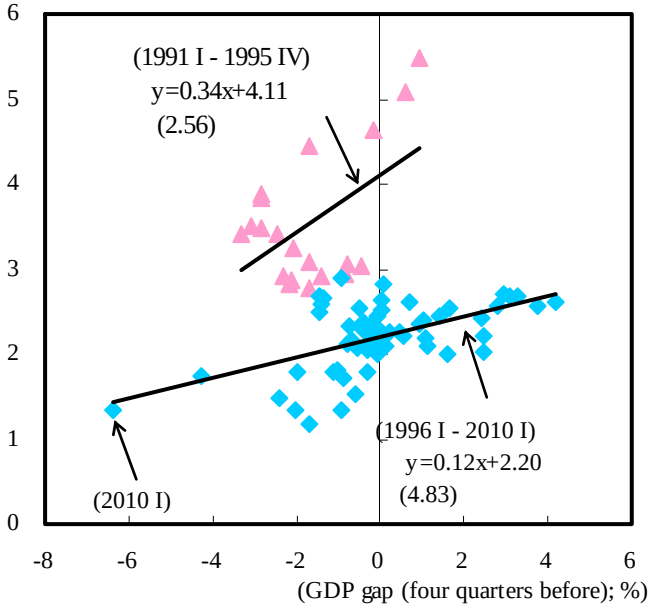
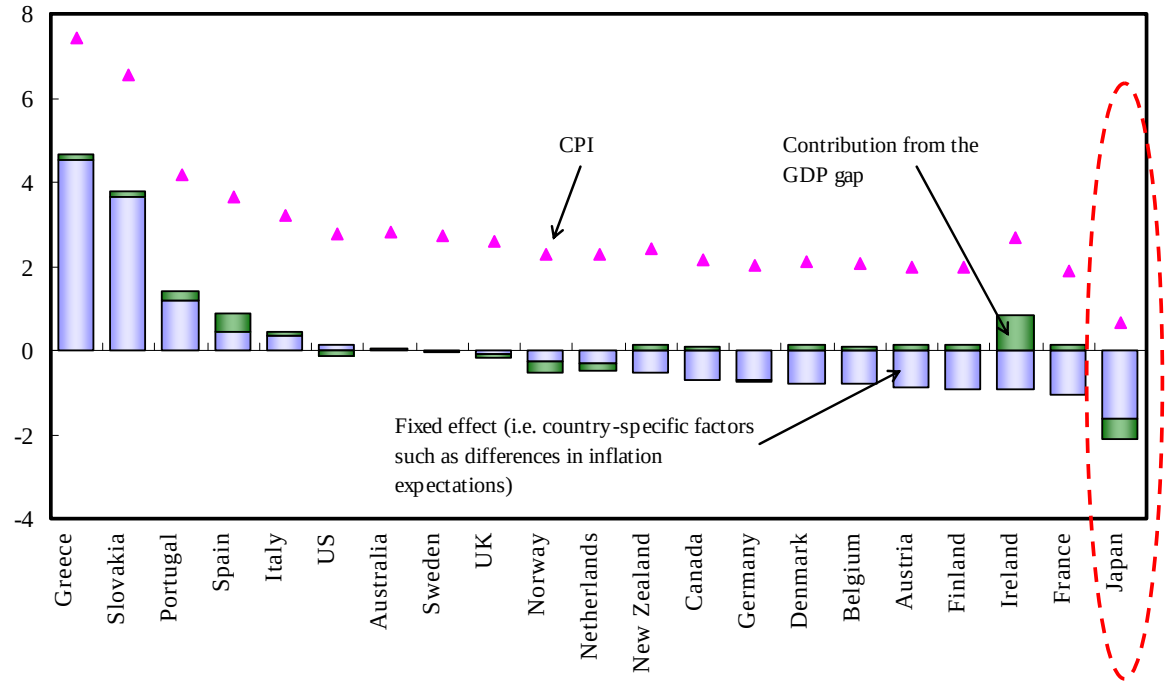


Figure 1-2-13 Output Gap and the Inflation Rate in OECD Countries (1990 – 2009)

In Japan, the output gap has been on a negative trend since 1990, which has kept prices from rising.

(Year-on-year change; %)



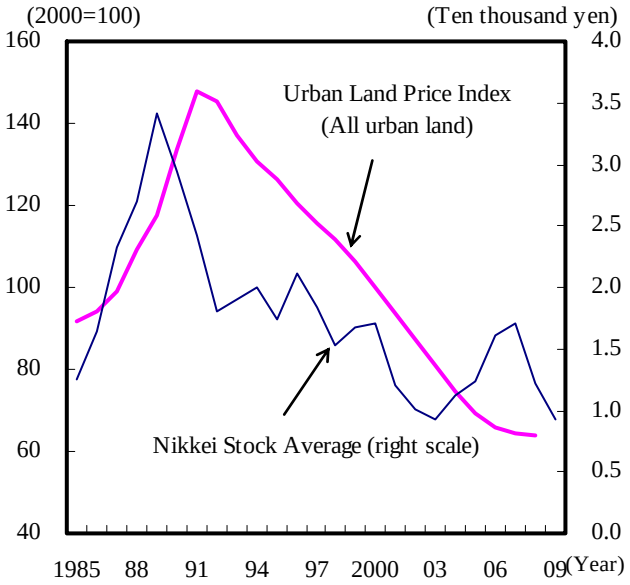
(Note) The CPI shows the average rate of increase (general; data for Japan excludes fresh food). The estimation used is: $CPI=2.78+0.33*GAP_{-1}$+fixed effect. Constant terms common to the countries are not included in the figure.

- The reason behind the Japanese economy having been unable to grow out of the deflation for a long while is the chronic demand shortfall due to a protracted period of economic adjustment, including asset price declines, after the collapse of the bubble economy.

Figure 1-2-14 Stock and Land Prices, Money Stock and Consumer Prices

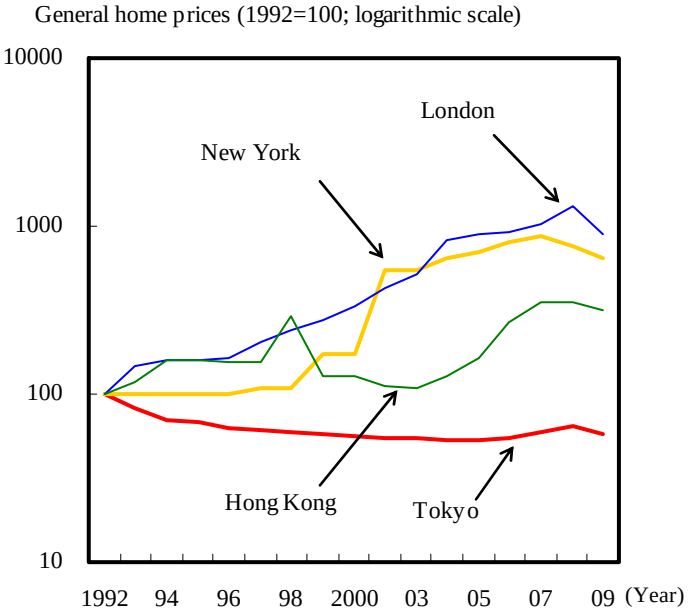
(1) Stock and land prices

After the collapse of the bubble economy, asset prices plunged sharply.



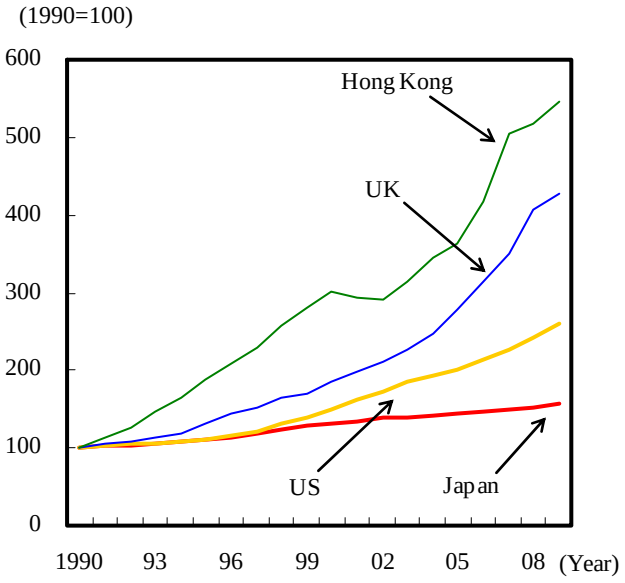
(2) Land prices in major cities

Land prices in Tokyo have followed a downward path.



(3) Money stock

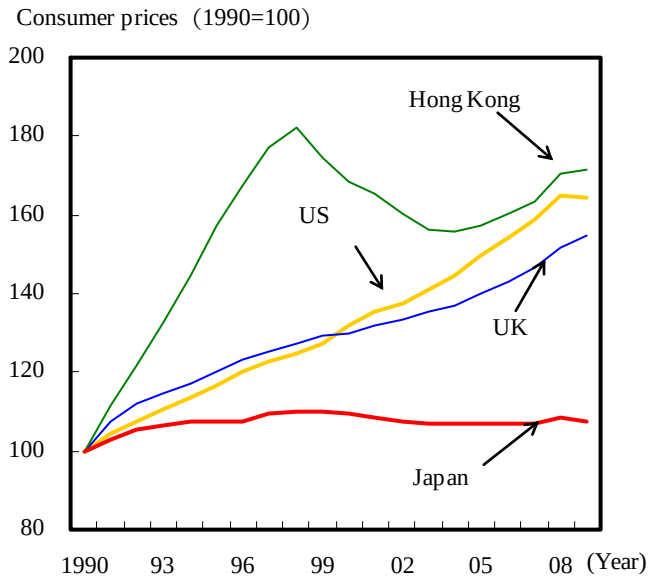
Japan's money supply has not grown substantially; money flows tend to be sluggish.



(Note) Data for Japan, the US, Hong Kong are M2, while those for the UK are M4.

(4) Consumer prices

Since 1990, prices have remained at low levels in Japan.



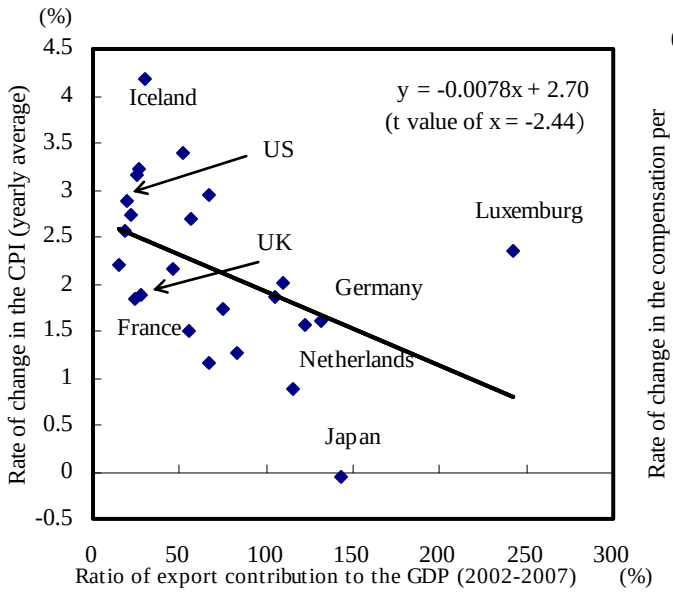
(Note) Data for Japan are core CPI, while those for the US, the UK and Hong Kong are general CPI.

- Countries whose economic growth is highly dependent on exports tend to see their rate of increase in prices and wages depressed by competition with their export destination countries.

Figure 1-2-15 Contribution of Exports to the GDP and the Rate of Increase in Prices and Wages

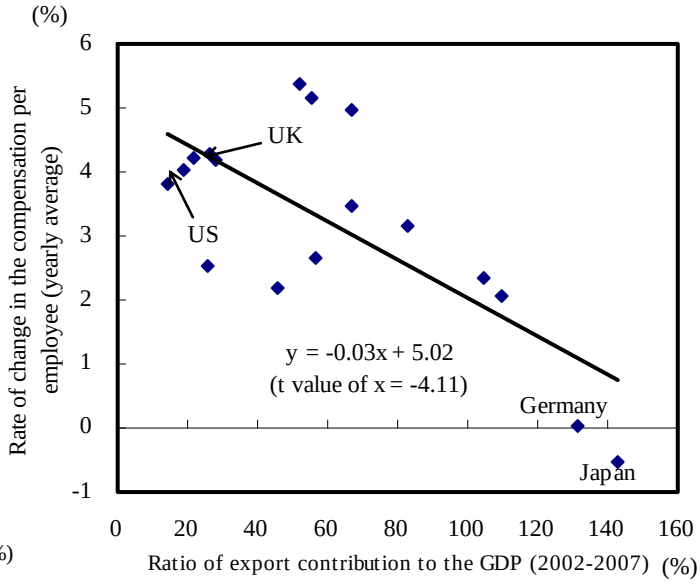
(1) Contribution of exports to the GDP and the rate of increase in prices

The larger the contribution a country's exports make to its GDP, the lower the rate of increase in prices it tends to have.



(2) Contribution of exports to the GDP and the rate of increase in wages

The larger the contribution a country's exports make, the lower the rate of increase in wages it also tends to have.

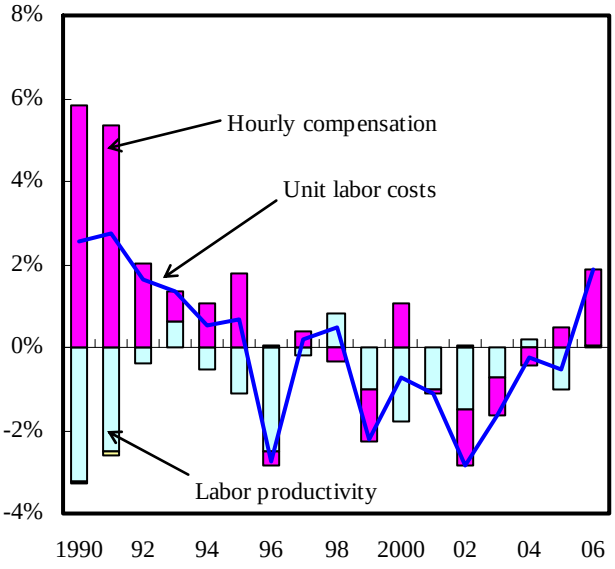


- Japan tends to adjust labor costs through flexible wage changes.

Figure 1-2-19 Comparative Analysis of Factors Contributing to Unit Labor Costs between Japan and the US (Services Industries)

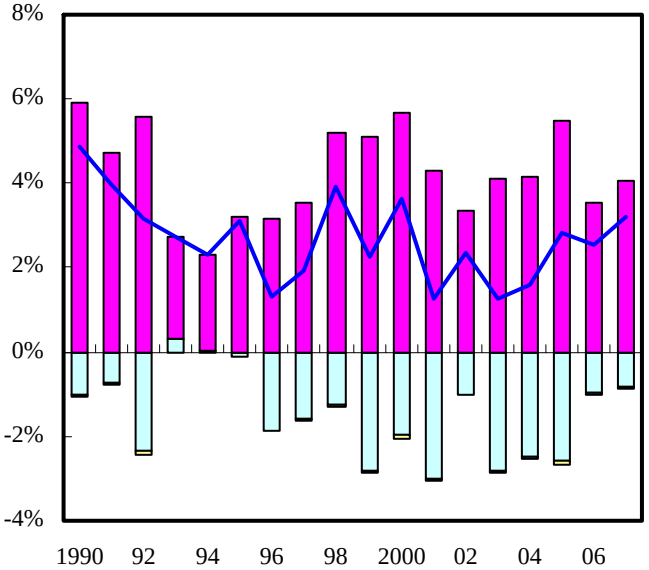
In Japan, wages change flexibly.

Japan



The rates of increase in wages have remained positive in the US during the survey period.

US



(Note) Compiled based on data from EU-KLEMS. Services industries under the classification of the International Standard Industrial Classification, including civil services, are the subject of the survey.

- Corporate fund-raising through capital markets such as stock markets has recovered.
- The declining pace of loans has slowed owing to measures to support corporate financing, including government guarantee schemes.

Figure 1-2-23 (1) Breakdown of Debts Held by Private Non-Financial Corporations

Fundraising through capital markets has recovered.

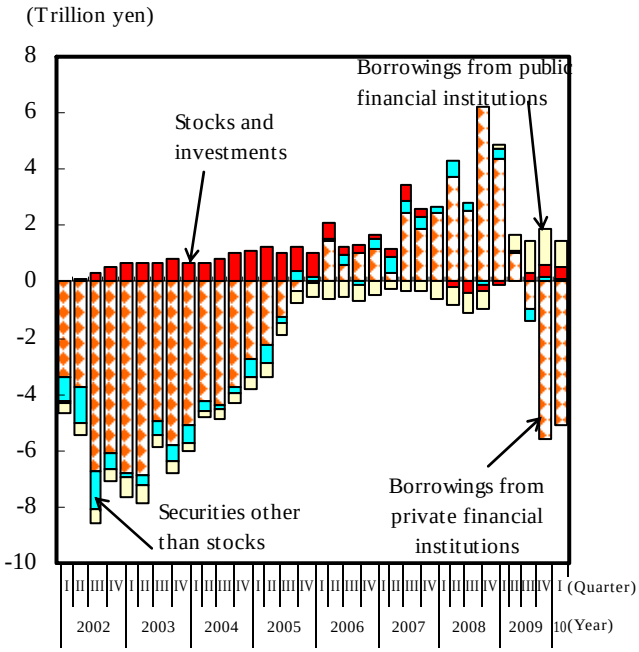
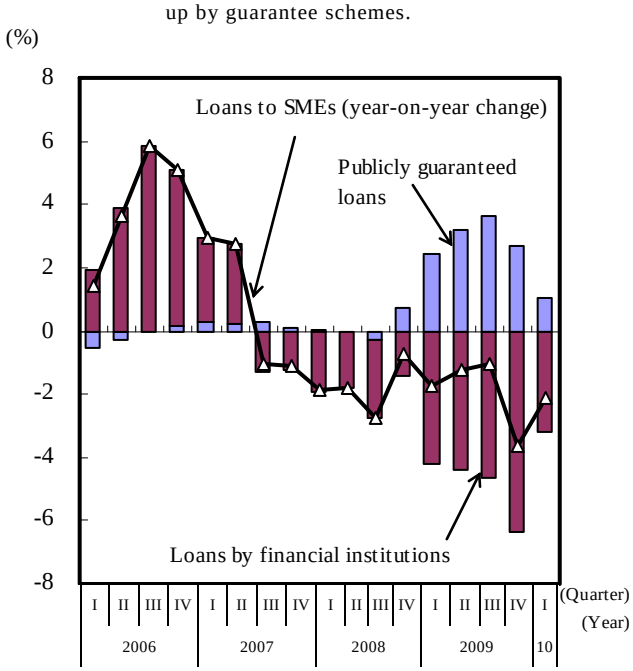


Figure 1-2-23 (2) Loans to Small and Medium-Sized Enterprises (SMEs)

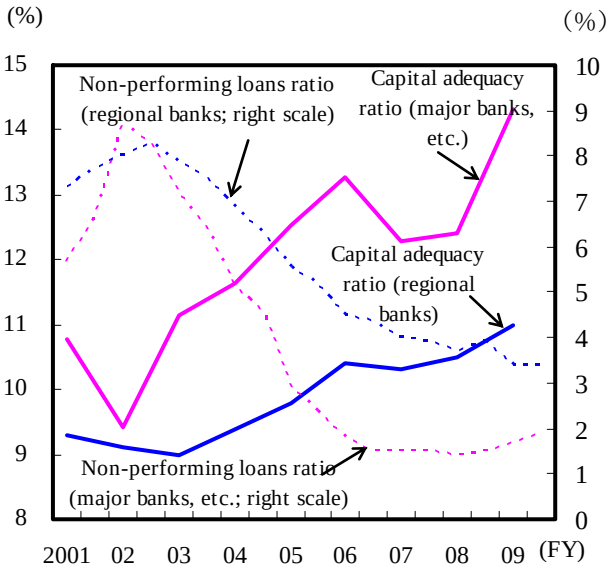
Although they are declining, loans to SMEs have been propped up by guarantee schemes.



- Despite a rise in the capital adequacy ratio of financial institutions, it should be noted that major banks and others have seen their non-performing loans ratio edging up slightly in recent years.

Figure 1-2-25 (2) Capital Adequacy Ratio

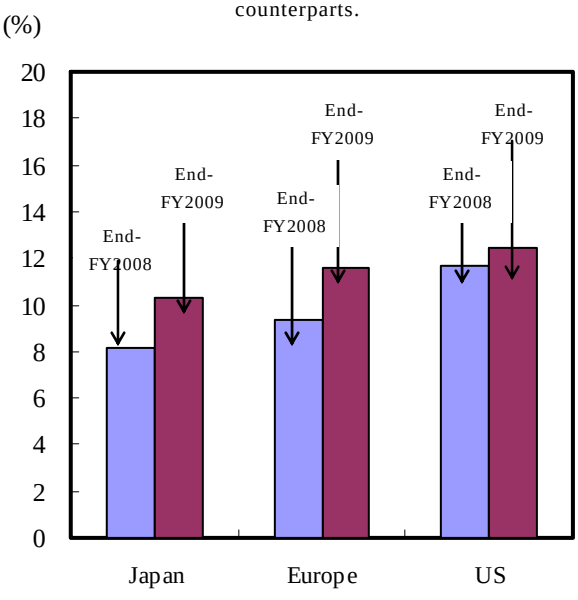
Capital adequacy ratios have been on the rise.



(Note) Data for FY2009 are based on half-year results up to September.

Figure 1-2-25 (3) Comparison of Tier 1 Ratios

The Tier 1 ratios of Japanese financial institutions are relatively low compared with those of their European and US counterparts.



(Note) Tier 1 is the total of common stocks and others (common stocks and retained earnings), preferred stocks and preferred investment securities.

Section 3 Issues Surrounding Public Finances

- Japan's fiscal balance has resumed deteriorating since FY2008.
- With outstanding debt continuing to increase, the sustainability of public finances has deteriorated sharply.
- The first step that should be taken to recover their sustainability is to improve the primary balance.

Figure 1-3-1 National and Local Governments' Cyclical and Structural Budget Balance

The fiscal deficit has expanded in terms of both cyclical and structural components.

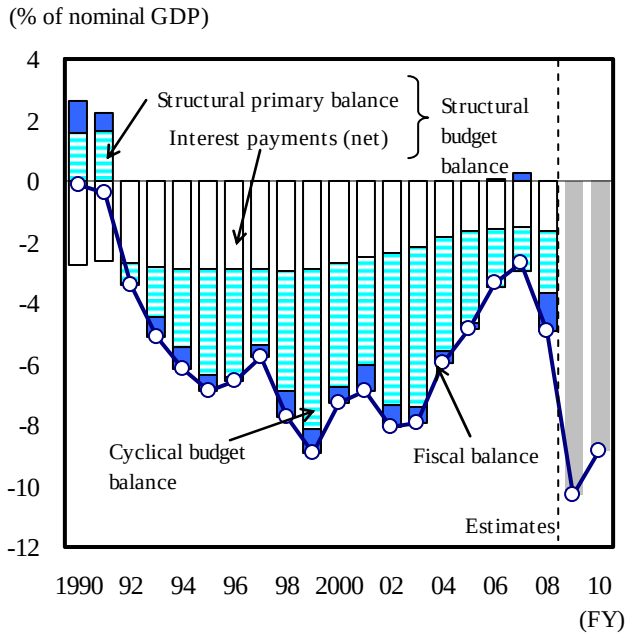


Figure 1-3-4 Components of the Outstanding Debt to the Nominal GDP Ratio

Improvement of the primary balance is the key to the containment of outstanding debt.

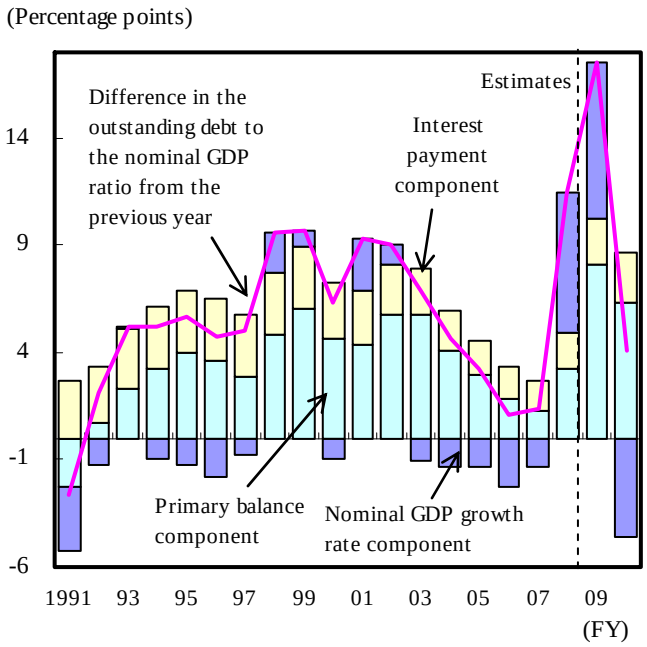
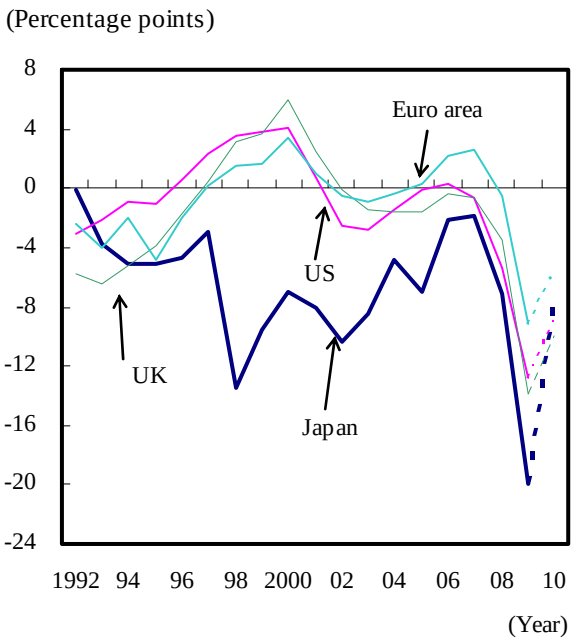


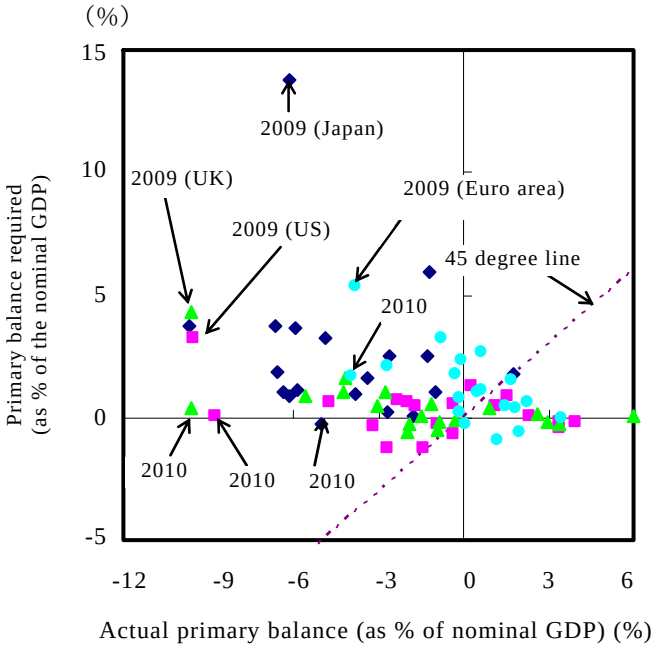
Figure 1-3-8 Difference between the Primary Balance Required to Stabilize the Outstanding Debt and the Actual One

The sustainability of public finances has deteriorated sharply after the collapse of Lehman Brothers.



(Note) Trend in the difference between the actual primary balance and the primary balance required to stabilize the outstanding debt to nominal GDP ratio at a certain level.

With the economic growth rate remaining far below interest rate levels in Japan, a significant amount of primary surplus is required to stabilize the outstanding debt.



- Long-term interest rates have remained low in Japan due to low growth and inflation rates.
- Although the fiscal deficit has an effect of raising long-term interest rates, significant domestic savings reduce its impact.

Figure 1-3-13 Factors Determining Long-Term Interest Rates

The weak economy and the low inflation rate depress interest rates.

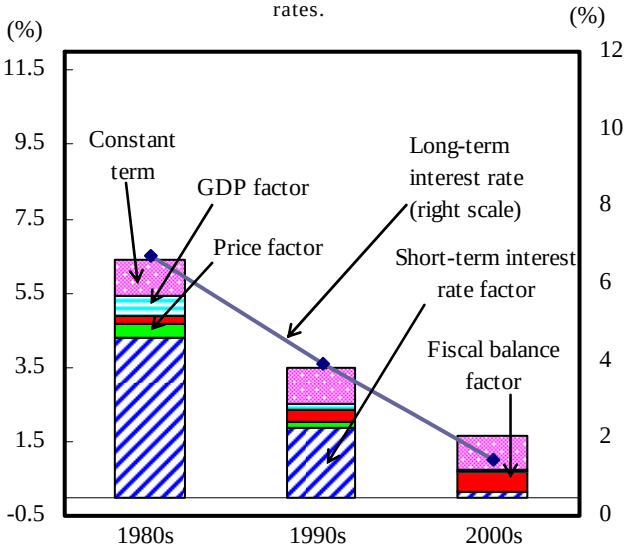
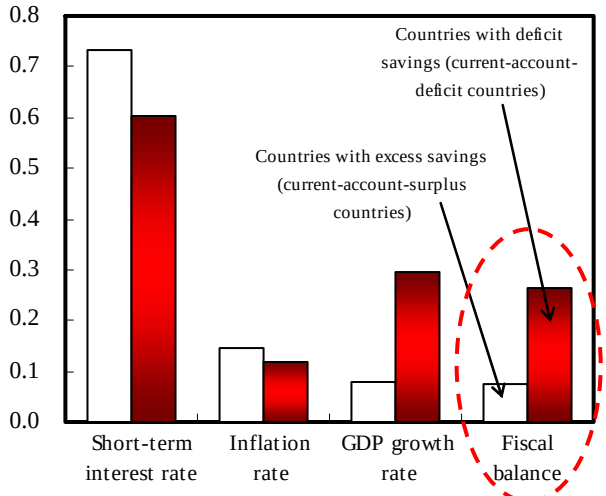


Figure 1-3-14 Difference between Countries with Excess Savings and those with Deficit Savings

In countries with excess savings, the fiscal deficit is less likely to raise interest rates.

(Impact on long-term interest rates; percentage points)



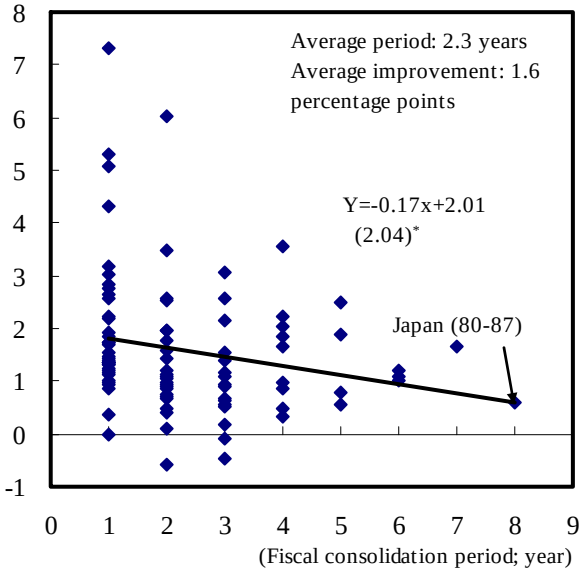
(Note) The estimated period is from 1980 through 2008. In the right figure, out of 28 OECD countries, countries that posted a current account surplus (or deficit) in 80% or more of the years during the estimated period are accounted for as countries with excess savings (or deficit savings). Seven countries, including Japan and the Netherlands, are accounted for as current-account-surplus countries, while seven countries, including the US and the UK, as current-account-deficit countries. The circled part denotes the impact on long-term interest rates of a percentage point deterioration in the fiscal deficit to GDP ratio.

- It is imperative to implement fiscal consolidation at a moderate pace and over a long period of time. Efforts to reform public finances will help long-term interest rates stabilize at low levels. Nevertheless, economic circumstances should be taken into consideration for exit strategies.

Figures 1-3-16, 18 The Sustainability and Improving Pace of Fiscal Consolidation and its Relationship with Long-Term Interest Rates

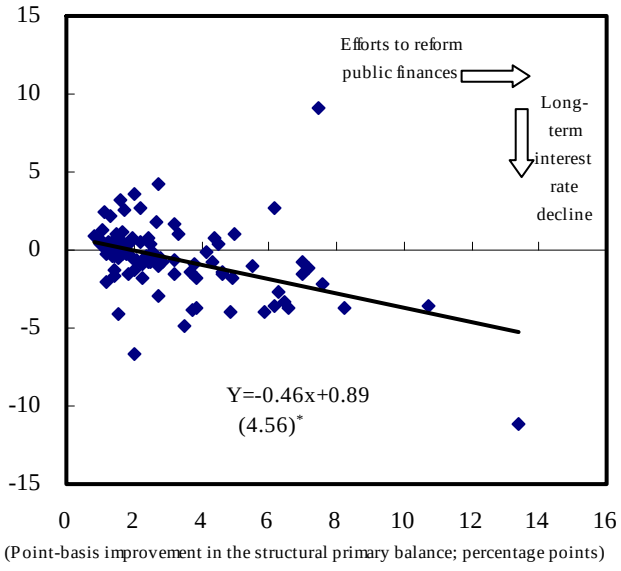
Fiscal consolidation should be implemented at a moderate pace and over a long period of time.

(Yearly average of the improvement in the fiscal balance as a percentage of the GDP; percentage points)



There is a correlation between efforts to reform public finances and the decline in long-term interest rates.

(Point-basis change in long-term interest rates; percentage points)



(Notes) 1. The fiscal consolidation period is determined as follows: it commences in the year when the structural primary balance to potential GDP ratio improved one percentage point or more from one year before, or the second year of two years during which the ratio improved one percentage point or more (however, a year-on-year improvement of 0.5 percentage points or more required in the first year); and it ends in the year when the ratio dropped from one year before or increased only 0.2 percentage points or less and then dropped in the following year.

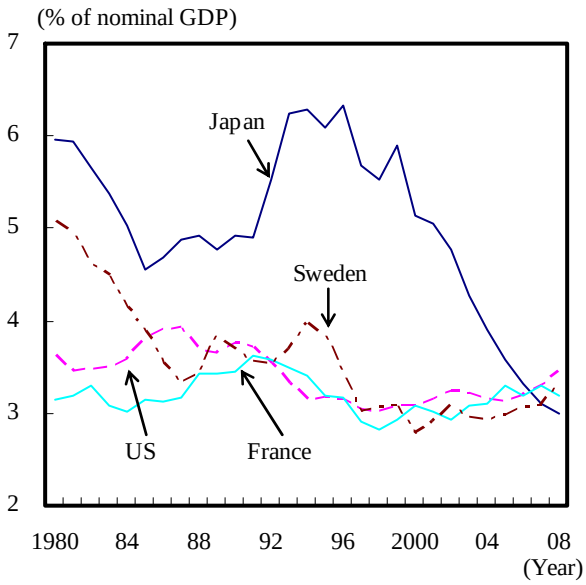
2. In Japan, the periods corresponding to the above definition are 1980-1987, 2001, 2004, and 2006.

- In Japan, while the public investment to GDP ratio has dropped, the social security-related expenditures to GDP ratio has been on the rise.

Figure 1-3-22 International Comparison of Budget Expenditure Structures

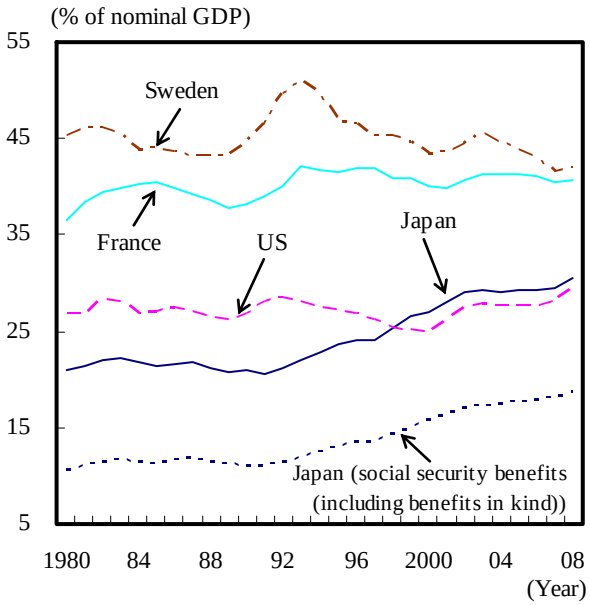
(1) Gross fixed capital formation by government

Japan's gross fixed capital formation has been on the decline.



(2) Government final consumption expenditures + social security benefits

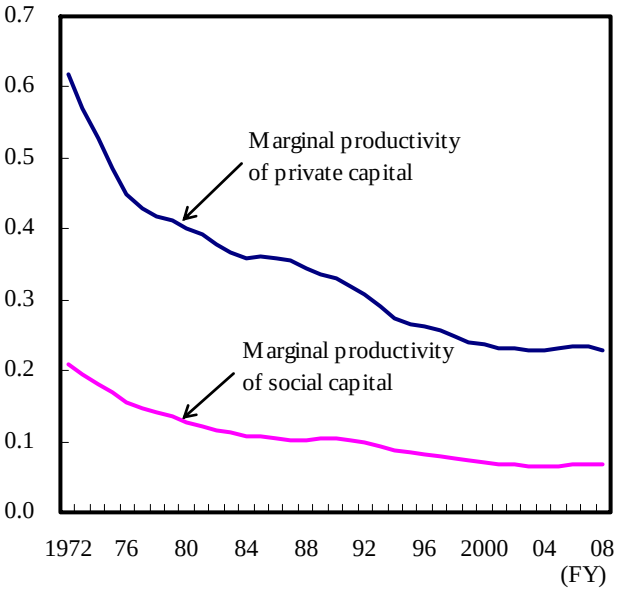
Social security-related expenditures have been on the rise.



- At a regional level, decreased public investment is complemented to some extent by social security expenditures.
- After declining, the productivity of social capital has been stable.

Figure 1-3-26 Productivity of Social Capital

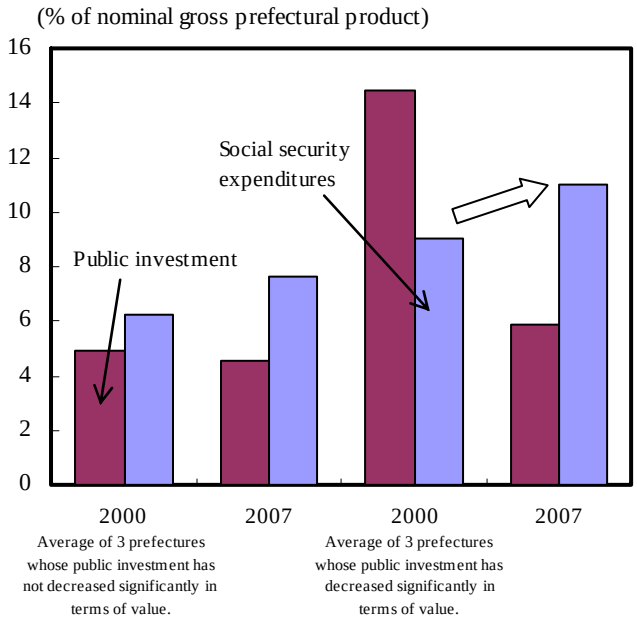
After declining, marginal productivity has largely been stable.



(Note) Marginal productivity is an increase in the real GDP resulting from an increase in capital by one unit.

Figure 1-3-28 Decreasing Public Investment and Increasing Social Security Expenditures

Increasing social security expenditures mitigate the negative impact of decreasing public investment.



(Note) Social security expenditures refer to pension and medical care-related social insurance benefits paid by prefectural governments. The three prefectures that did not see their public investment decline sharply in terms of value in the 2000-2007 period are Shizuoka, Fukui and Tokyo, while those whose public investment reduced significantly in terms of value during the period are Miyazaki, Kochi and Mie.