
- Japan's Economy: Tackling Risks -

Summary

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This material has been tentatively prepared to explain the “Annual Report on the Japanese Economy and Public Finance.” For quotation and other purposes, please refer to the text of the “Annual Report on the Japanese Economy and Public Finance.”
Chapter 1 World Economic Developments and the Japanese Economy

Section 1: Present Economic Conditions

- Economic recovery since early 2002 has included some lulls, indicating its weaknesses. Driven by exports, however, average real economic growth has exceeded 2%.
- In the present lull like the past ones, exports and production have eased due to overseas shocks.

**Figure 1-1-1 Real GDP Growth and Breakdown by Component**

Economic recovery that has continued since early 2002 has come to a lull.

(Percentage change from the previous year or quarter)

Source: “National Accounts,” Cabinet Office

**Figure 1-1-2 (1) Production during Recovery Lulls**

Production weakens during lulls

Source: “Industrial Production,” Ministry of Economy, Trade and Industry

**Figure 1-1-3 Exports during Recovery Lulls**

Exports weaken during lulls.

Source: “Trade Statistics,” Ministry of Finance
Shocks from overseas are reflected in corporate earnings. Recurring profit has turned downward on hikes in variable costs including crude oil and other raw materials prices. The yen's appreciation, while easing the impact of import price hikes, has worked to lower export prices and to affect earnings at export-oriented companies.

Among employment situation data, the unemployment rate and the number of employees had steadily been improving until beginning to level off in mid-2007.

**Figure 1-1-4 Trends of Corporate Earnings**

Corporate earnings have been falling

**Figure 1-1-5 Employment Trends**

The employment situation remains severe with improvement coming to a lull.

The amended Building Standards Law, which took effect in June 2007, worked to substantially reduce gross domestic product in the second half of 2007. Housing starts are recovering and making positive contributions to boosting GDP in 2008. But housing demand has weakened.

Consumer sentiment has deteriorated as hikes in prices of such goods as petroleum products and foods have worked to lower real income. Under such situation, consumer spending has been leveling off.

**Figure 1-1-8 Impact of Housing Investment Plunge on Real GDP Growth**

Housing investment plunged due to the amended Construction Standards Law.

**Figure 1-1-9 Trends of Construction Starts**

Both housing starts and construction start floor space (nonresidential space for the private sector) declined considerably.

**Figure 1-1-11 Trends of Consumer Spending**

Consumer spending and income have almost leveled off.

Note: Consumer price index and Ream employee income made by Cabinet Office.

Sources: “National Accounts,” Cabinet Office (right figure)  
“Building Construction Started,” Ministry of Land, Infrastructure and Transport (left figure)
• No excess is felt for employment or fixed investment and economic cycle factors indicate their firmness. But attention should be paid to a suspended upward revision to anticipated growth and growing inventory adjustment pressures on information-related capital goods.

• Whether the present lull would end up as a temporary one like the past two lulls would depend on overseas economic factors including the future course of the U.S. economy. We must take note of the possibility that downside risks to the economy may emerge if the lull is prolonged on the U.S. economy's plunge into a recession or prices of crude oil and other raw materials continue rising.

Figure 1-1-5 (2) Employment Diffusion Index

No excess is felt for employment or fixed equipment. investment

Figure 1-1-10 (3) Fixed Investment Diffusion Index

An upward revision to anticipated economic growth has been suspended.

Figure 1-1-12 (3) Shipments' gap with Inventories for Information-related Capital Goods

Shipments' gap with inventories for information-related capital goods is negative.

Source: “Short-term Economic Survey of Enterprises in Japan,” Bank of Japan

Source: “Annual survey of Corporate Behavior,” Cabinet Office

Source: “Indices of Industrial Production,” Ministry of Economy, Trade and Industry
Section 2: Structural World Economy Changes, Subprime Mortgage Problem and Japan's Economy

- Behind the subprime mortgage problem, advanced financial technologies have been used to pour funds into the United States to finance the huge current account deficit of the largest consumer in the world.
- As financial technologies, though dispersing risks, have failed to reduce overall risks, however, residential price declines have led credit risks to emerge rapidly.
- The subprime mortgage problem has led to a decline in the risk tolerance of investors in the world and prompted them to shift funds to safer and simpler assets, helping push up prices of crude oil and other commodities.

Figure 1-2-5 Present U.S. Economic Situation

1. Mechanism for funds to concentrate in the United States

- Japan
  - Low interest rates
  - Yen's decline
  - Current account surplus

- Emerging/resources-rich countries
  - Asian countries’ expanding surplus
  - Fund surplus in resources-rich countries

- EU
  - Oil money intermediation

- U.S.
  - Home price hikes (bubble)
  - Progress in securitization of mortgages

2. Changes in Flow of Funds after Emergence of Subprime Mortgage Problem

- Japan
  - Fears of impact on Japanese economy
  - Stock price decline
  - Fears of U.S. recession

- Emerging/resources-rich countries
  - Crude oil spikes
  - Sovereign wealth funds’ recapitalization of U.S. financial institutions

- EU
  - Booking subprime losses

- U.S.
  - Stock price and dollar weakness
  - Collapse of subprime mortgage market
  - Flow into U.S. government bonds

Abundant money and loose risk assessment

Advanced risk dispersion (securitization)

Yen carry trade

Expansion of sovereign wealth funds

Limited capital inflow from overseas

U.S. collapse of subprime mortgage market

Shift to safer assets

Stock price and dollar weakness

Unwinding of yen carry trade to cause dollar's decline against yen

Crude oil spikes

Sovereign wealth funds' recapitalization of U.S. financial institutions

Flow into U.S. government bonds

Stock price decline

Withdrawals of funds

Fears of U.S. recession
Japanese stock prices have plunged in response to overseas financial market turmoil. Behind such phenomenon, foreign investors' moves determine the direction of the Japanese stock market while Japanese investors who can buy shares on decline to support the market are limited.

In the future, risk money from Japanese households should be provided at home and abroad through Japan's financial and capital markets. At the same time, Japan should receive investment from abroad to secure two-way flow of funds. Japan is thus required to deepen its financial markets and enhance its financial sector's competitiveness.

Figure 1-2-13 Stock Price Changes in Major Countries
Stock prices have fallen in all major countries including Japan with the biggest drop.

Figure 1-2-14 (2) Foreign Investors' Stock Transactions in Japan
Foreign investors capture a large share of stock transactions in Japan.

Figure 1-2-15 Relations between Each Investor Category's Transactions and Stock Prices
Stock prices fluctuate in line with foreign investors' trading actions.

Figure 1-2-17 Shares for Foreign Firms Listed on Major Stock Exchanges
Only a few foreign firms are listed on the Japanese stock market.

Note: Made by Tokyo Stock Exchange, Inc., etc.
• While Japan's economic recovery has been led by exports, its export growth has been relatively lower than world trade growth. Japan's portion of labor force growth supporting world trade has been small. Japan has fallen short of benefiting fully from economic globalization, while being exposed externally to fierce competition.

• As the world's collaboration has been enhanced through international trade, the so-called decoupling of the world economy should be considered prudently. Although trade in Asia has been expanding, Asian countries' exports to the United States account for a large share of their total exports and have already been slowing down. If any U.S. recession is short-lived, however, Asian countries may maintain their high economic growth supported by their strong domestic demand.

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**Figure 1-2-21 Changes in Japanese and World Trade**

Japan's trade growth has been slower than world trade growth.

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**Figure 1-2-22 World Export-Weighted Labor Force**

World labor growth related to exports to Japan has been weaker than overall growth.

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**Figure 1-2-23 U.S.-Bound Exports' Shares of Asian Countries' Total Exports**

U.S.-bound exports' shares of Asian countries' total exports have been shrinking but still high.

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**Figure 1-2-24 Changes in Asian Exports to U.S.**

Asia's U.S.-bound exports have been slowing down.
Japanese companies have increased their overseas production's shares of their total output amid their globalization. Roughly a half of their profit on overseas production is sent home as dividend and another half is left overseas as internal reserves (for reinvestment). Direct investment profit, a combination of such dividend and internal reserves, for Japanese companies is smaller than for U.S. or British firms. Japanese firms' direct investment profit rate is also smaller.

Some companies have recently been shifting production bases from foreign countries to Japan. Production bases in Japan use cutting-edge technologies to turn out higher value-added products. Overseas bases produce products for local sales.

Figure 1-2-31 International Comparison of Direct Investment Profit

Direct investment profit for Japanese companies is smaller than for U.S. or British firms.

(1) Japan
(2) U.S.

(3) Britain

Notes: 1. Direct investment profit = Dividend + Profit for reinvestment
2. The thin line indicates profit's ratio to outstanding direct investment (profit ratio).
Section 3: Crude Oil and Other Raw Material Price Spikes and Japan's Prices and Wages

- Terms of trade for Japan have deteriorated fast on crude oil price spikes, while those for the United States and the euro area have avoided substantial deterioration. Japanese import prices have been vulnerable to crude oil prices spikes while export prices have yet to rise.
- One reason for the absence of export prices even amid the yen's appreciation is yen-denominated exports' low share of Japan's overall exports. Another reason is that Japanese companies are hesitant to raise export prices in consideration of their controls on overseas prices and their price competition with other Asian firms.

**Figure 1-3-7 Import/Export Prices and Terms of Trade**

Terms of trade have deteriorated.

**Figure 1-3-8 Changes in Import/Export Price Indexes**

Import and export prices in yen have been pushed down on the yen's appreciation.


Notes: 1. Export and import prices are denominated in dollars.
2. Note that Asia includes Hong Kong, the Republic of Korea, Singapore, Indonesia, Thailand, the Philippines, Malaysia and India and excludes China.

Source: “Corporate Goods Price Index,” Bank of Japan
- Japan's trading loss on the current crude oil price spikes is smaller than that on each of the past oil crises, but it is the largest since the latest oil crisis.
- While final demand goods prices have changed little, wages and profit have been curbed. Households and companies have shared the cost of the terms of trade deterioration.

**Figure 1-3-11 (1) Changes in Overseas Income Transfers**

Overseas income transfers are the largest since the latest oil crisis.

![Graph](image)

Source: “National Accounts,” Cabinet Office
Seasonally adjusted

**Figure 1-3-12 Sharing of Oil Spike Cost in Japan**

Wages rose substantially on the first oil crisis, igniting home-made inflation. This time, households and companies have shared the cost of oil spikes, limiting inflation.

![Graph](image)

Source: “National Accounts,” Cabinet Office
Note: Profit = GDP - Employee compensations (wages)
Economic recovery has yet to spill over to households as high-level corporate earnings have fallen short of leading to wage hikes. Real wage growth has slipped below labor productivity growth.

The labor share has fallen at export-related manufacturers, while labor productivity growth has been high. They have curbed regular wage growth as global competition has increased pressures on them to keep wages at low levels. Instead, they have increased bonuses to help pass robust earnings to employees.

In the meantime, nonmanufacturing industries have secured earnings apparently by curbing wages including bonuses.

Figure 1-3-16 Labor Productivity and Wages

(1) Breakdown of Changes in Labor Share
Real wage growth has slipped below labor productivity growth.

(2) Changes in Sector-by-Sector Labor Shares
The labor share has fallen at export-related manufacturers.

Figure 1-3-17 Sector-by-Sector Wage Changes
While regular wages have failed to rise, export-related manufacturers raised bonuses reflecting robust earnings.

Notes: 1. Data have been estimated by the Cabinet Office based on “Monthly Labour Survey,” Ministry of Health, Labour and Welfare
2. Bonuses = Total wages - regular wages. The estimation covers business establishments with at least 30 employees.
3. Export-related manufacturers cover steel products, nonferrous metals, ordinary machines, electrical machines, information and communications machines, electronic parts, and precision machines.
4. Non-export-related manufacturers cover foods and tobacco, textiles, clothing, timber, and wooden products, furniture and fittings, pulp and paper, printing and relevant services, chemicals, oil and coal, plastics, rubber products, tannages, and ceramic, clay, and stone products.
• The consumer price index has posted a clearer year-to-year rise as prices of foods and other products familiar with consumer have risen since the second half of 2007.
• In the meantime, the GDP deflator (unit value added) has posted a negative year-to-year change due to import prices’ fast rise. The unit labor cost turned up in the January-March quarter, while the unit operating surplus has been curbed.
• The GDP gap has narrowed slowly. If the supply/demand relationship tightens for goods and labor, both wages and prices may rise.

Figure 1-3-27 Trends of Price Indicators

Price indicators other than the GDP deflator have turned up.
Section 4 Fiscal and Monetary Policy Conduct

- The government has powerfully promoted fiscal consolidation efforts including thorough expenditure reforms in a bid to achieve a primary budget surplus. Improvements in the budget balance as a percentage of GDP since FY 2003 can mostly be explained by those in the primary budget balance.
- The conduct of monetary policy is particularly required to pay attention to downside risks to the economy as corporate cash flow has deteriorated on uncertainties over overseas economies, financial and capital markets and crude oil prices.

Figure 1-4-1 Trends of Cyclical and Structural Budget Balances at Central and Local Levels
Primary budget balance improvements have contributed much to overall budget balance improvements.

Figure 1-4-3 Financial Institutions' Lending Attitude as Seen by Companies and Cash Flow Situation and Corporate Cash Flow Conditions
Cash flow assessments and financial institutions' lending attitude have weakened recently.

Source: “Short-term Economic Survey of Enterprises in Japan,” Bank of Japan