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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

Japan's Economy Struggling in the Phase of Global Risk-Off Holidays, etc.

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1.Overview Macroeconomic and Financial Risks (Trends & Topics)

 # Japan's Economy Struggling in the Phase of Global Risk-Off Holidays (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Since late February, the global risk-off trends have gradually subsided. This trend has continued over the last month as the US FRB (Federal Reserve Board) remains in a dovish stance and provided a strong indication of postponing the interest rate hike during the April FOMC (Federal Open Market Committee) meeting. This ease-off has also been supported by the fact that the decelerating Chinese economy has finally begun to show signs of bottoming out, and crude oil prices have risen on the backdrop of an expected agreement on production output increase among oil-producing countries (however, the meeting held on April 17th in Qatar did not reach an agreement only to produce a temporary fall in crude oil price). Consequently, the asset prices such as in the US have further increased, while Chinese and other emerging countries' currencies are appreciating against the US dollar. Also, some emerging countries now have more room to cut the interest rate to underpin the economy; thanks to stabilized inflation. As we pointed out last month, recent market's calmness can indicate that a considerable amount of severe problems have been delayed to be solved in the future, thus, we cannot be complacent with current situation. Nonetheless, 'buying the time' to deal with a serious problem itself is not a bad thing, as long as we do not mismanage the time.

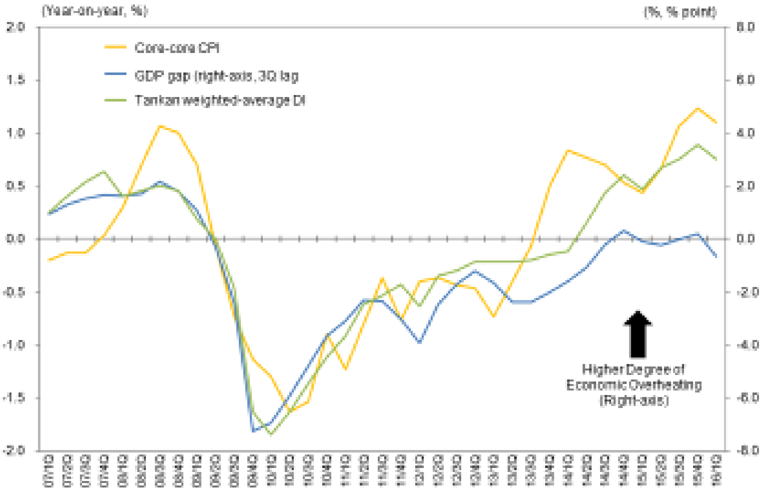
In the mist of all changes for the better, there is one country faced with stronger market pressures and a severe predicament in the macro economy. That country is Japan. The Japanese economy continues to struggle as both income growth and personal consumption figures remain sluggish. Furthermore, recent rapid appreciation of Yen has not only induced adverse impacts on exports, but also on corporate earnings and uncertainties in the future, thereby induced further downward pressures on capital investments and stock prices. On the backdrop of a stronger Yen lies the expanding current account surplus and postponement of FRB interest rate hike in the US, which withered the expectation of US-Japan interest rate differentials. Therefore, good news for many of the emerging countries can be ironically an opposite situation for Japan.

In addition, the recent declines of foreign investors' confidence toward Abenomics are also another concerns. Partly due to the approaching summer election, the painful structural reforms have been delayed over and over, leading to the increasing concerns that Japanese economy will continue to lose its vitality in the future. According to Chart 1, the supply and demand gap indicators that have shown a strong correlation with Weighted-average Tankan DI (Diffusion Index of the use of capital stock and human resources) and core-core CPI (total composite index, include foods, but exclude alcohol, and energies) in the past have diverged from them since the late 2013. The supply-demand gap has moved sideways over the past two years, which is consistent of the recent continued near 0% growth rate. On the other hand, the Bank of Japan Tankan and core-core CPI indicate the increasing tightness in the use of capital stock and labour market. In fact, job to applicant ratio have reached to the level as high as the bubble-era. In addition, 2015 corporate earnings have reached the historical peak level. They might indicate that in a sense Japanese economy is currently running with a top gear. Those seemingly contradictory situation might be addressed with the consistent way if we would change our conventional wisdom of an important economic indicator, that is, potential growth rate of Japanese economy.

The potential growth rate in Japan is estimated to be currently hovering between the first half and middle of 0% level. However, if the rate drops into the negative territory, we can explain the situation in which the growth rate itself continues to be around zero or negative even though the Japanese economy is expanding at full speed. If we could assume that the true supply-demand gap is close to the level indicated by the BOJ Tankan, the true potential growth rate could be about 0% to -0.5%. Ultimately, the recent situation of 'Japan being the only loser' might indicate that Japan can no longer solely rely on monetary and fiscal policy to reduce the supply-demand gap, but rather need to focus more on structural reforms that underpin the potential growth rate.

Chart 1.

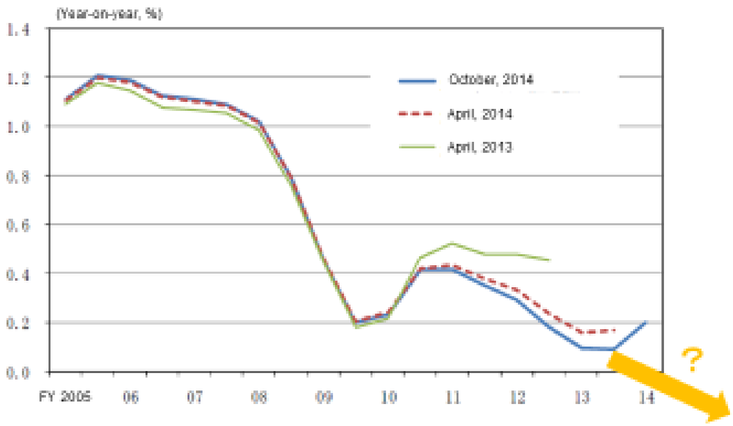
Japan's economy is currently running at a 'full speed', yet somehow cannot escape the path of low growth rate



Source: Bank of Japan, Deloitte Touche Tohmatsu LLC.

Potential growth rate has already slipped into negative territory?

Potential Growth Rate (Bank of Japan Estimate)



Source: Bank of Japan Board Member Ms. Shirai's presentation.
*The orange arrow is marked by presenter Ms. Shirai.