Japan/U.S.A. Macro Economic Report

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Research Office

	Japan	U.S.A.
1. Macroeconomic Outlook	**Short Term：** Japan's economy achieved year-on-year growth of over 3.0 percent last year, and has steadily increased the pace of growth this year. In the beginning of this growth, the main contributors to expanding Japan's economy were increased exports supported by powerful US economic growth and China's overheating economy. Corporate confidence has improved in many sectors, including among small and medium-sized enterprises, and has had a spillover effect on the household sector. The recovery of corporate performance, increased stock prices, and improved employment helped bolster consumer confidence, which increased consumer spending in the first half of this year. Japan's economy is expected to enter an adjustment phase in the future, with a transition from the high growth in last year's second half and this year's first half, to a moderate growth of 1.5–2.0 percent. There are signs of sluggishness in external demand, due to economic deceleration in the US and in China. Consumer spending has slowed down because increases in household income have been slow, reflecting corporate policies of cutting employment costs. It is possible that the global risk of a sharp rise in oil prices may decrease external demand, which may have a serious effect on Japan's economy. In light of these factors, ending deflation needs some more time, so deflation will not be eliminated until 2006, at the soonest.	**Short Term:** The US economy has steadily recovered from the burst of the IT bubble. It has achieved robust business expansion since last year, thanks to aggressive, expansionary fiscal and monetary policies. The US economy is now making a transition from rapid, policy-affected growth, to more moderate growth. It is believed that this reflects the end of the benefits of large tax breaks, which significantly boosted private consumption last year. Centering manufacturing, the corporate sector is regaining production and making steady progress. Since the collapse of the IT bubble, the corporate sector has successfully adjusted balance sheets and reactivated capital investments. The leading role of the US economy is being transferred from the household sector to the corporate sector. This is expected to improve employment, contributing to increasing household incomes. This favorable circulation ensures the vibrant growth of the US economy. Improvements in employment are sluggish, however, compared to those encouraged by recuperative strengths in past economic recoveries. Enhanced labor productivity is curbing increases in employment. The focal point is how long the corporate sector can sustain positive business confidence and performance. Further rises in oil prices are cited as a major risk factor. It is necessary to be cautious about the risk that oil price rises may decrease consumption and profit margins, which will have an adverse effect on business confidence.
	Medium and Long Term: The private sector's structural problems—primarily excessive debts, over-capacity, and over-employment—have almost been resolved by painful self-help efforts. The ratio of the corporate sector's total liabilities to GDP has decreased to levels equal to before the Japanese economic bubble, due to which balance-sheet adjustments have come to an almost complete end. There is little concern about the recurrence of financial-system turmoil in Japan, thanks to progress made in bad-loan disposal and decreases in the bad-debts ratio. In the corporate sector, machinery, equipment, and other facilities are aging, and replacement demands are growing because Japanese companies have long refrained from capacity investments. The return on total assets has recovered to levels seen in the latter 1980s. Employment adjustment has passed through a critical phase, and unemployment has at last begun to decline. Japan's economy is proceeding toward expanding equilibrium from diminishing equilibrium. Here are seen increases in new businesses, helped by deregulation, and a return of Japanese manufacturing to Japan. It is expected that labor productivity will increase, due to a shift of labor to higher-productivity industries. If increases in labor productivity generate steady momentum for wage increases, it will ensure the end of deflation. Expanded fiscal deficits are cited as long-term risks in Japan. Structural reforms in the government sector are only half completed.	**Medium and Long Term:** It is said that the US economy has almost resolved deflation risks, as well as the risk that its post-IT-bubble adjustments could become chronic. Future increases in its significantly enhanced productivity will be lower, but the US economy will probably maintain growth at 3.0–4.0 percent. The government should address ending the aggressive, expansionary fiscal policies and normalizing budget deficits. The low interest rate policy is on the way to be revised. It is necessary to look for the potential risk that the unprecedented prolongation of low interest rates may distort resource allocation. Meanwhile, rapid policy change may raise the risk that they will have unexpected negative effects on business. It is likely that the inflow of funds from abroad will be sluggish, due to foreign investors' concerns about growing fiscal and current account deficits. As a result, it is necessary to be careful about the risk that the weak dollar may coexist with increases in long-term interest rates.

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2. Current Account Balance and Fiscal Balance	The current account surplus reached 3.4 percent of GDP in 2003, and has continued to increase this fiscal year. In terms of savings-and-investments balance, excessive savings in the corporate sector are the main factor to yield the current account surplus. These excessive savings have been brought on by debt repayments based on abundant cash flows on one side, and by investment restraints on the other side. Meanwhile, the household sector's excess savings are decreasing. The fiscal deficit reached –7.3 percent of GDP in 2003, and it remains high due to a large shortage of tax revenue. Japan's increased trade surplus, fueled by Asian trade, constitutes the main portion of the current account surplus, which is expected to gradually decline after the completion of structural adjustments and by making the transition to a domestic-demand-led economy. Toward that end, deregulation and tax reform are essential to enhancement of the private sector's expected growth. The household sector requires the reform of social security systems, which is expected to ease uncertainty over the future. It is likely that the transition to a domestic-demand-led economy and a reduction of the current account surplus will trigger fiscal deficit problems. Curtailment of macro excess funds (i.e., savings) and the revitalization of corporate investment will change the funds flow, giving rise to the risk that the government's financing for lack of funds (i.e., fiscal deficits) may hit obstacles. Fiscal deficits continue to increase, even though the government has refrained from public investments. Despite the advantages of low interest rates, the risks of budgetary inflexibility and large interest payments are growing. If the adverse effects of fiscal deficits and expanded domestic demand cause increases in long-term interest rates, it may hinder the private sector's business development. It is necessary to work on an economic soft landing with avoiding deflation. Simply raising taxes must be avoided. The government must work hard on further budget flexibility and efficiency in public spending, and on revenue enhancement by further deregulation and by revitalization of the private sector.	The budget and current account deficits are rapidly expanding. In 2003 the current account deficit reached a record-high of US$530 billion, equal to 4.8 percent of GDP. It is unlikely that these deficits will decrease easily. The main factor for the increased US current account deficit is its relatively high economic growth among advanced countries; the growth gap between internal and external economies provides a backdrop for the current account deficits. The high US economic growth has been supported by the government's emergency policies of taking aggressive fiscal measures. In fiscal 2003, the budget deficit sharply increased to US$375 billion, equal to 3.5 percent of GDP, mainly helped by increased military spending for the war in Iraq. Increases in these twin deficits raise strong concerns about the further depreciation of the US dollar's value, although confidence in the dollar is not yet weak. The dollar has depreciated since 2002, but this is believed to be within the scope of price adjustment expected when it was overvalued. Fiscal deficits have not yet had on the US economy such adverse effects as increases in long-term interest rates in real terms. Inflows of foreign funds are increasing thanks to a pause in the dollar's depreciation, concerns about inflation have been pushed into the background, and low interest rate policies carry on. All these factors contribute to holding down long-term interest rates. Nevertheless, future changes in economic conditions may make fiscal deficits harmful. The market's unease about unsustainable fiscal and current account deficits has not been dispelled. Markets always put pressure on the US dollar to depreciate, and on long-term interest rates to increase. It is important to reduce the fiscal deficit, to curb the current account deficit by gradual increases in savings, and to seek an economic soft landing. Although the Office of Management and Budget expects fiscal deficits to decrease eventually, healthcare expenditures are likely to increase while security-related spending is unlikely to decrease. It is therefore necessary to find out what specific measures will be devised to reduce the fiscal deficit, and to monitor their expected results.

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<tr><td rowspan="2">3. China</td><td colspan="2">General Conditions: China’s economy continues to grow at an annual rate of over 8 percent, leading Asia’s economic expansion for the last several years. China’s economy has overheated since last year, however, and is showing some signs of a bubble economy. Investments in real estate, equipment, and other fixed assets (mainly by manufacturing industries in coastal areas) are particularly overheating. On the other hand, agriculture and rural villages at inland areas lag behind in economic development, and disorderly development is reducing agricultural land, and producing environmental pollution and other problems there.
Alleviation of developmental misalignment is the first priority for the Chinese government, due to which it has clearly shifted policy focus from rapid economic development to harmonious development, by eliminating discrepancies among regions and industrial sectors. The government is now taking selective, strong measures to curb business overheating, although these are not based on market principles and mechanisms. It is also taking a policy initiative in the optimal allocation of resources. The main scenario is to achieve an economic soft landing. There are risks, however, that such measures may be ineffective in cooling off the economy, or may overkill the economy. The volatility of the Chinese economy will raise concerns throughout Asia. Along with implementing cooling-off policies, the Chinese government must also make efforts to improve bad-loan disposal and financial-system stability. The government’s main urgent tasks include the relaxation of capital controls and a transition to a more flexible foreign exchange system. Considering the uncertainty about the Chinese economy, it is advisable that the government perform such tasks in concert with economic conditions. China is expected to continue to grow over the long term, and to become a leading country to create demand in the global economy. The best scenario is that economic growth in Asia—centering Japan and China—will contribute to correcting global economic imbalances, and to help eliminate the US’s current account deficits in terms of savings-and-investments balance.</td></tr>
<tr><td>Japan has had a trade-balance surplus with China (including Hong Kong) since 2002, which was accelerated by China’s accession to the WTO. China’s emergence is not perceived as a threat to Japanese companies, but rather as a source of business opportunities. Arguments against the adverse effects of business with China on employment, accompanied by the hollowing-out of Japanese industries, have recently been pushed into the background. Instead, arguments for China’s favorable contribution to Japan’s economic recovery and expansion are now conspicuous because exports of electricity, machinery, and other production and capital goods increased thanks to the expansion of manufacturing bases in China. Exports of steel and other materials also sped up, owing to overheated fixed investments. Exports of high-value-added consumer goods increased due to rises in income.
In the future, however, exports to China are expected to decelerate with the calming of the overheated economy. Nevertheless, in the long run, exports to China are expected to rise thanks to its ever-expanding economy. China’s economic growth will benefit the Asian economy, which will be indirectly favorable to Japan’s economy.
Imports from China are expected to increase, but Chinese products will be relatively low-value-added goods. Japanese companies are concentrating production resources on high-value-added and high technology fields, so a division of manufacturing is proceeding between Japan and China; some Japanese manufacturers are returning their equipment investments from China to Japan.</td><td>The trade balance with China shows deficits, which continue to increase. Imports from China account for 12 percent of the US’s total imports. This share exceeds that of Japan. Since 2000, China has retained the top share of the total trade deficits of the United States among US’s trade partners. In 1999, the trade deficit with China reached US$68.7 billion, which further increased to US$124.1 billion in 2003. In the trade balance with China, the benefits to the US from China’s economic expansion are relatively small, compared to those received by Japan. With sluggish US employment, expanded trade deficits with China have raised arguments that China is a threat. Since a very small portion of Chinese products are actually competitive with American-made products, it seems to be an over-reaction that workers perceive China as an economic threat, or that Chinese products take away US jobs. The division of manufacturing between China and the US, centered on electric and electronic industries, is proceeding in the same way as it does for Japan. It is still unknown whether the appreciation of Chinese yuan will help reduce the huge trade deficit with China.</td></tr>
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<tr><td rowspan="2">4. Energy Issues Focused on the Oil Problem</td><td colspan="2">General Conditions: Oil prices have increased steeply to over 50 dollars per barrel. On the demand side, this was caused by the world’s cyclical economic expansion and the long-term economic growth of emerging countries (including China). On the supply side, oil prices rose due to poor spare production capacity, geopolitical risks, and the shutdown of some production sites in Russia and the United States. The steep rise in oil prices has fortunately had no serious effects on economic affairs, yet, mainly because oil prices in real terms (deflated by the general price increases) are still relatively low compared to those at the time of the oil crisis in the 1970s, and because energy efficiency in advanced countries has increased remarkably. Nonetheless, a marginal increase in oil prices is large, so it is necessary to monitor price fluctuations and their effects on business. The steep rise in oil prices is ill proportioned to the actual supply-and-demand gap, so it is necessary to strengthen monitoring of excessive hikes encouraged by inflows of speculative funds.</td></tr>
<tr><td>Crude oil constitutes about 50 percent of Japan’s energy supplies, the biggest share. Japan imports crude oil mainly from the United Arab Emirates and Saudi Arabia. Each of these countries has an over-40-percent share of Japan’s crude-oil imports. Japan relies heavily on the Middle East for its crude-oil imports, with an almost 90-percent dependence. Suppliers who export crude oil to Japan are concentrated in the Middle East, raising high risks in Japan’s energy policies. For energy security, it is a primary task for Japan to disperse and diversify suppliers. It is said that sharp increases in crude-oil prices have less effect on Japan’s economy than on the US economy, because oil prices in Japanese yen are still half those at the time of the second oil crisis, thanks to the current strong yen against the US dollar. In terms of energy efficiency, the amount of crude-oil imports for one GDP unit is now 0.44, below one-half the 1.11 of the 1970s. Increased oil prices will generally have a limited impact on Japanese companies, because most of them believe that increases in sales and improvements in productivity will set them off. Nevertheless, it is likely that adverse effects will emerge in logistics and other industrial sectors. The effects that oil-price rises have on Japan’s household sector are apparently less than those in the US, because the household sector’s consumption of oil products constitutes 2.3 percent of the total family expenditures in Japan, which is less than one-half the 4.8 percent in the US. But indirect effects of oil-price rises on the Japanese economy via decreased external demand will probably be larger than those on the US economy. The International Energy Association has estimated the adverse effects of rises in oil prices on China’s economy and Asia’s economy, showing that a 10-dollar increase in oil prices decreases their economic growths by 0.8 percent.</td><td>Crude oil constitutes 40 percent of energy supplies, the biggest share. The rest comes from natural gas, coal, and other resources. The US government diversifies energy supplies. Domestically produced oil can accommodate about 30 percent of crude-oil consumption. For the rest, crude oil is imported from Saudi Arabia, Canada, Mexico, and Venezuela with an equal amount from each. There are no serious security concerns about the procurement of crude oil, but the US is not free from the adverse effects of oil-price rises. These effects are minor compared to those of the 1970s, thanks to enhanced energy efficiency, just as the same applies to Japan. Rises in oil prices have not yet had a serious impact on the household sector in terms of family spending, of which energy-related expenditures constitute only 5 percent, below the average level of the 1990s. The negative effects of oil-price rises on consumer prices have been limited, thanks to enhanced share of services and to the difficulty in shifting oil-price rises to consumer prices. There are concerns about aggravation to consumer sentiment; if a marginal increase in oil prices continues, it will cause the risk of adverse effects to the entire economy.</td></tr>
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