Japan's 'demand management' and yen rate in the global crisis

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First of two parts

In the latest World Economic Outlook (WEO) published in early October, the International Monetary Fund notes that achieving sustained healthy growth over the medium term depends critically on rebalancing the pattern of global demand.

The IMF calls on many current account surplus economies that have followed export-led growth strategies to rely more on domestic demand growth to offset likely subdued domestic demand in deficit economies that have undergone asset price busts. It also argues that many external deficit countries would need to rely less on domestic demand and more on external demand. How should the recent performance of the Japanese economy be assessed in this context?

Japan's economic expansion between 2002 and 2007, the longest in the postwar history, was indeed propelled by sharp advances in exports that accounted for about two-thirds of real GDP growth. Export growth was supported by the yen's fall and growing demand in other Asian countries. In particular, China, a major source of external demand, was boosting Asia's share of Japanese exports to almost half.

Export advances, in turn, led to buoyant business investment growth, accounting for a third of the rise in Japan's output. Total output increased at an annual rate of 2.1 percent during the expansion, while private consumption remained weak and underlying inflation negative. Japan's economic expansion stumbled by late 2007, and in the context of the global economic crisis, it has been trapped in the deepest recession of the postwar era.

Initially, the impact of the global crisis on the Japanese economy was expected to be limited because Japanese banks and other financial institutions were relatively insulated from financial turmoil. However, between the third quarter of 2008 and the first quarter of this year, Japan's exports fell at an annual rate of some 55 percent in volume terms, the sharpest among countries of the Organization for Economic Cooperation and Development (OECD) and double the area's average rate of decline.

While exports have rebounded since then, the IMF projects a decline in Japan's net exports (gross exports minus gross imports) for this year as a whole, making a significant negative contribution to domestic output, which is forecast to amount to 2.4 percent of real GDP. As a result of this and a sharp drop in domestic demand, real GDP this year is projected to decline by 5.4 percent.

On the other hand, for the United States, the epicenter of the global financial crisis, the IMF projects its net exports to make a positive 1.2 percentage point contribution to real GDP growth this year, the same amount as last year. Thus, despite a sharp contraction of domestic demand, the decline in U.S. GDP is forecast to be limited to 2.7 percent, just half of the output decline projected for Japan this year.

For the United Kingdom, another source of the financial crisis, the IMF projects net exports to make a positive 0.8 percentage point contribution to real GDP growth this year, after a positive 0.4 percentage point contribution last year, thus limiting a contraction of U.K. real GDP to 4.4 percent.

While the IMF expects a negative output contribution of net exports for the euro area this year, it is forecast to amount to 0.8 percent of GDP, just one-third of the equivalent number for Japan.

As a result of such rebalancing, the contribution of net exports to real GDP growth in Japan for the 10-year period of 2000-2009 as a whole is expected to average just 0.1 percentage point annualized while real GDP growth is forecast to average 0.6 percent annualized, according to the OECD Economic Outlook 85 database.

Japan will thus most likely enter the second decade of this century as an OECD country that, at the very least, has not worsened global imbalances.

In passing, let us note that the contribution of Japan's net exports to real GDP growth was 0.3 percentage point at an average annual rate in the 1980s and 0.1 percentage point in the 1990s.

Note also that the equivalent numbers for the 10-year period of 2000-2009 are 0.4 percentage point for Germany, 1.3 percentage points for China and just 1 percentage point for South Korea.

It is also important to note that even with no changes in net export volumes, Japan's huge foreign investment income helps to maintain its current account position in surplus, unless oil and other primary commodity price hikes and other terms of trade changes inflate Japan's external payments in dollar terms.

Looking ahead, the IMF in its latest WEO notes that the turnaround in the global manufacturing cycle is expected to raise current account surpluses for Germany and, to a lesser extent, for Japan. Indeed, it projects Germany's surplus as a ratio to its GDP to rise to 3.6 percent in 2010 from 2.9 percent in 2009 (compared with 7.5 percent in 2007 and 6.4 percent in 2008).

Japan's surplus as a ratio to its GDP, which amounted to 4.8 percent in 2007 and 3.2 percent in 2008, is projected to decline to 1.9 percent this year and then rise slightly to 2.0 percent in 2010.

The positive contribution of net export volumes to real GDP is projected to amount to 1.2 percent of GDP for Germany in 2010 after a negative 3.6 percentage contribution in 2009, and to 0.7 percent of GDP for Japan in 2010 after a negative 2.4 percent in 2009. In this context, it is important to note that the most recent rise in the Japanese yen — not reflected in the WEO — by itself should work to reduce Japan's net export surplus projected for next year.

Over the medium to long term, as the drag on economic growth from population aging increases, sustaining improvements in living standards in Japan will depend crucially on accelerating labor productivity growth through structural reform.

But in the shorter term, the most important issue is how to run demand management policy to achieve faster aggregate demand growth to narrow the existing wide output gap and stem deflationary pressure.

On the fiscal front, with government debt having reached the highest level ever recorded in the OECD area, Japan is becoming increasingly vulnerable to a rise in the long-term interest rate from its current low level of around 1 1/2 percent. The task of supporting demand, therefore, falls heavily on the shoulders of the Bank of Japan.

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