

PREFACE: THE J-CURVE EFFECT

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The US Federal Reserve Board (FRB), which had embarked on an expansionary monetary policy to fight the coronavirus recession since March 2020, quickly changed its stance in the beginning of 2022, and vigorously started squeezing the monetary base and raising interest rates to curb the high inflation. Unfortunately, however, Russia's invasion of Ukraine in February 2022 brought about a global surge in energy and food prices, which in turn exerted further upward pressure on inflation in the US. As a result, the US inflation rate hit 9.1% in June 2022. Thanks to the restrictive monetary policy measures, it gradually declined to 7.1% as of November 2022. However, the aggressive contractionary monetary policy in such a short time period has posed a threat to financial markets of a possible recession in 2023. Stock markets stagnated throughout 2022, which suggests investors are divided as to whether the US economy will be able to make a successful soft landing or fall into a recession in 2023.

The solid appetite for spending by US consumers and companies, as seen during the past 6 years under the Trump and Biden administrations, seems to provide support for the cautiously optimistic view that the US economy might not enter a recession in year 2023. Even if it does, it is likely to be a mild one.

In contrast to the relatively optimistic US economy, China's abandonment of its so-called "Zero COVID-19 Policy" is now creating social unrest in many of its cities. The widespread turmoil will certainly have an adverse effect on both spending and production. In addition to this ongoing problem, there are some other factors which decelerate the Chinese economic growth trend in the future.

First, the Trump administration in the US imposed higher tariff rates on imported goods from China in 2019, and the Biden administration is sticking to this policy. In addition, the US government has also imposed restrictions on exports to China with regard to AI technology, telecommunications, semiconductors and other products. They are also imposing the same restrictions on foreign manufactures, which make use of US technology. All these measures are making technological spillovers to China increasingly difficult.

Second, the US and other G7 members have been getting increasingly cautious toward China. For example, some manufactures in the US and other G7 countries have reduced their direct investments in China and have started diversifying their production bases. This will decrease employment and income in China.

Furthermore, the average income of Chinese people has already dramatically increased as a result of China's remarkable economic growth in the 21st century. The higher income erodes China's global labor cost advantage. All of the above is likely to cause a deceleration in China's economic growth rate.

Turning to the next major economy, the Eurozone is facing the same problem as the US - severe inflation and a possible future recession at the same time. Additionally, EU members are determined to reduce their reliance on energy from Russia for security reasons, implying that they have to pay higher prices for energy from now on. Although certainly understandable, this decision will put a heavy burden on their economic growth.

As explained in the above, the overall economic environment surrounding Japan is not good. However, the US contractionary monetary policy since the beginning of 2022 has led to a depreciation of the yen against the US dollar. The exchange rate dropped from 115 yen per dollar at the end of 2021 to 132 yen per dollar at the end of 2022, corresponding approximately to a 15% depreciation.

Generally, currency depreciation initially worsens a country's trade balance and its production. However, with some time lag, net exports and production improve significantly, provided that net exports are sufficiently elastic with respect to changes in the exchange rate. This empirical macroeconomic phenomenon is called the "J-curve effect".

In 2022, the initial unfavorable phase of the J-curve effect has dominated, as seen by the Japanese trade balance. However, we expect that the second favorable part of the J curve will start taking effect in 2023 or 2024, and it will boost the Japanese economy.

Part I of this year's Economic Outlook discusses the economic status quo in the major countries along the Pacific Rim surrounding Japan. Part II outlines the performance of the Japanese economy in general, as well as that of the Kansai area in particular. Given that Osaka-Kansai Expo is going to be held in 2025, we have added a chronology of events related to the Expo in Part III for your convenience. Although this Economic Outlook is an abridged English-language version of the original Economic Outlook 2022 published by APIR in Japanese, some of the authors have updated their manuscripts in order to provide readers with the latest information.