SA127

Short-Term Forecast of the Japanese Economy (2006/7-9--2008/1-3)

Senior Economist, Nobuyuki ICHIKAWA

The Japanese economy has recently been experiencing a balanced recovery. However, for fiscal 2007, with the effects of a decelerating US economy and an impending IT-related inventory adjustment, the economy is expected to mark a gradual slowdown. Still, the economy will continue to grow at a rate of between 1.5 and 2% -- a level considered to be Japan's potential growth rate – and the slowing of the economy in fiscal 2007 can be safely viewed as a slight correction ahead of further stable growth. On the price side, the fact that the economy is out of deflation will become clearer.

The real Gross Domestic Product (GDP) in the April-June quarter of 2006 grew at an annualized rate of 0.8%. This low rate is in stark contrast to the rates of growth of 4.4% two quarters ago, and 2.7% last quarter.

However, if we take the following four points into consideration, we can see that steady growth in fact continues: 1) The change to a negative contribution of external demand and inventory investment– that is a factor we consider to be only temporary – took place in the April-June slowdown. 2) The two domestic pillars of growth, personal consumption and business fixed investment continue to expand steadily, and overall,the Japanese economy has been showing real growth for the past six quarters from the January-March quarter of 2005. 3) There have been factors leading to negative consumer and business sentiment such as the rise of fears of a slowdown in the US economy, and a global correction in stock prices. 4) Unusual weather has led to curbed spending.

As the economy continues to grow in the April-June quarter, the general view seems to be that "the Japanese economy will continue along its self-sustaining growth path led by private demand." However, regarding the marked deceleration in exports, two views coexist. One is that it is due to the slowdown in the US economy and the other is that the deceleration is only temporary.

Furthermore, some are concerned that the pressure towards inventory adjustment in the IT-related sector is getting stronger, and some of them hold the view that "in the near future, the Japanese economy will see itself at the third 'standstill' of this recovery".

In this short-term economic forecast, we took the most recent economic conditions into account and reviewed our economic forecast to the end of fiscal 2007. The results of this forecast can be summarized in the following five points.

Business fixed investment will accelerate during fiscal 2006

First, the US economy will have a successful soft landing, and China and the EU will grow at rates above their potential growth rates until 2007. For the US, whose annualized growth rate has fallen to 2.5% in the April-June quarter, residential investment is expected to cool as a result of the 17 consecutive interest rate hikes, and the slower rise of housing prices will become a negative factor to consumption through weaker wealth effects. As a result of the above, the deceleration in the US economy is expected to continue until about the first half of 2007, when the correction in housing supply and demand will be completed.

However, the FRB (Federal Reserve Board) did not raise interest rates in August, and the fear of "overkill" (over-tightening of monetary policy) has receded somewhat as a result. We feel it is possible for the US economy to avoid stalling and instead slow down gradually towards its potential growth rate, provided monetary policy continues to be implemented appropriately.

Second, Japanese exports that have been dependent on expansion in overseas economies are expected to continue an overall high rate of growth until fiscal 2007. Though some deceleration will be inevitable as the US economy will slow down, we expect the continued stable exports to China, and the sustained lower yen on a real basis will provide support to Japanese exports.

Third, our results show that production overall will not be subject to any large-scale correction in the forecast period. Though there will be a slowdown in fiscal 2007, a relatively high rate of growth should be maintained. The slowdown in exports and the stronger pressure towards inventory adjustment in some of the IT-related sectors will lead to a gradual slowdown in production in fiscal 2007. However, the inventory adjustment in the raw materials related sectors have just about been completed, and there is little risk that the same pressure will spread to the manufacturing industry overall.

Fourth, after slightly accelerated growth in fiscal 2006, business fixed investment is expected to decelerate sharply in fiscal 2007. This is because from now through fiscal 2007, corporate profits are anticipated to be lacklustre due to the slowdown in sales growth and the increase in wages. At the same time, the rise in nominal interest rates may result in an increase in the cost of capital and can also lead to constrained spending on business fixed investment.

Therefore, as an overall trend, we expect business fixed investment to slow gradually. During fiscal 2006, healthy exports will lead to a higher capacity utilization rate, and with a rise in expected growth rates, business fixed investment will grow at a slightly higher rate than fiscal 2005 actual figures (that were also very favourable). In fiscal 2007 there will be stronger pressure for correction from a stock cycle perspective, and it will slow down quite significantly.

Fifth, although personal consumption may not be quite the driver of the economy, it will continue to grow enough to contribute to the steady growth of the economy. By fiscal 2007, there will be some system changes resulting in increases in some tax and social insurance costs. As this will work to check the growth of household disposable income, personal consumption will also see an inevitable slowdown. On the other hand, the growth in employee compensation and improvements in consumer sentiment resulting from an improved employment environment will to some degree support personal consumption.

The reversal of real and nominal growth rates will be corrected in fiscal 2007

As a result of the above, real GDP growth rates are forecast to be 2.4% in fiscal 2006, then 1.8% in fiscal 2007. Though a slowdown in economic growth cannot be avoided, the economic recovery will steadily continue at around the rate of potential growth, even in fiscal 2007. In other words, the slowdown in fiscal 2007 will be within the boundaries of what can be interpreted as a correction, while still heading towards stable growth. As for the nominal growth rate, in fiscal 2006 it will be 2.0% and still be lower than the real rate of growth. However in fiscal 2007, the reversal of real and nominal growth rates will be corrected as the nominal growth rate will be 2.3% and higher than the real rate of growth.

As stated above, the Japanese economy will likely grow at a real rate surpassing the potential growth rate for at least fiscal 2006. Thus, the GDP gap – that is currently in an excess demand situation – will broaden even further. Reflecting this macroeconomic tightness in supply-demand, the year-on-year increase in the consumer price index (CPI, nationwide, excluding fresh food) is expected to rise slightly in fiscal 2007. (In this forecast, we have not taken into account the effects of the revision in the CPI standards).

In fiscal 2006 the GDP deflator decreased by a much smaller rate. In fiscal 2007, we expect the change to be positive. In addition, the unit labour cost (nominal employee compensation ÷ real GDP) on a fiscal year basis, will turn to rise in fiscal 2006 over the previous year due to both a slower growth in real GDP and a rise in nominal employee compensation. In fiscal 2007, it will increase by a larger rate. (Figure)

As a result, in fiscal 2007, the four indicators that are used to estimate the state of deflation will all show that deflation is being eliminated. This will become clearer as time goes on.

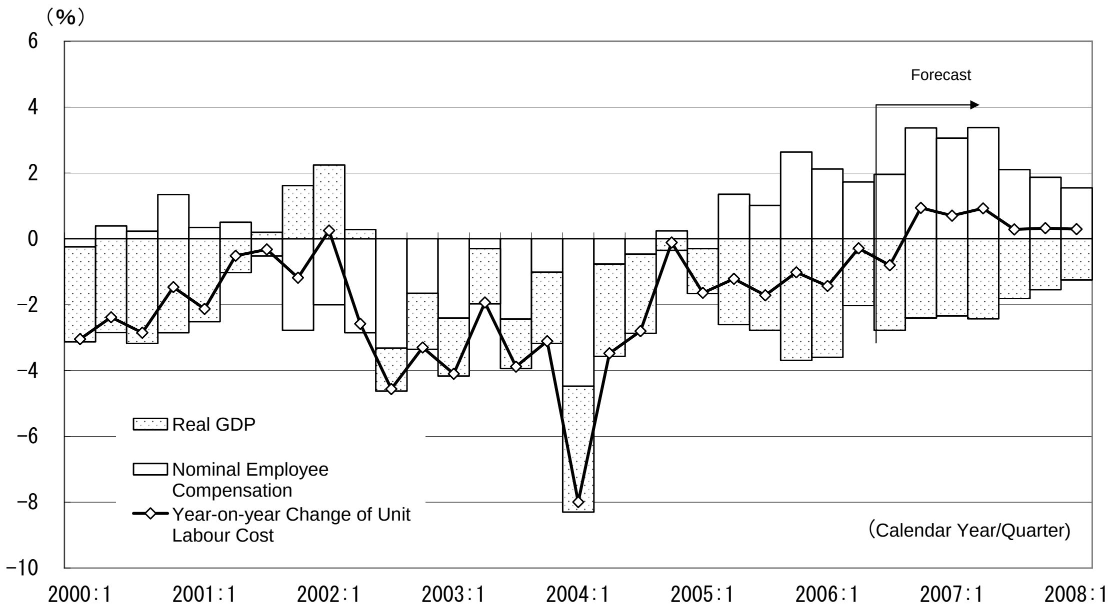
Risk factors are slowdown in the US economy and appreciation of the yen

The factors that could jeopardize the stable and sustainable growth in this main scenario are as follows: a rapid slowdown in the US economy, a large-scale inventory correction in the IT-related industries, another marked rise in oil prices, a rapid appreciation of the yen, and a further correction of stock prices on a global scale.

The current economic recovery has continued thanks to a high level of export growth in an environment of strongly performing overseas economies, and a continuing depreciation of the yen on a real basis. Thus, a sharp slowdown in the US economy or a rapid appreciation of the yen can have grave results for the Japanese economy. At this stage, we are not yet at a level where we can comfortably say that a self-sustaining growth can be achieved solely on the strength of the domestic economy.

Therefore, monetary policy must be implemented with the utmost care so that a rise in interest rates by the Bank of Japan does not trigger a rapid appreciation of the yen. At the same time, the recovery in domestic demand to this point has been supported by the low real interest rates, and so the Bank of Japan must exercise extra caution -- while watching price increases -- not to rush into unnecessary interest rate hikes.

Figure. Changes in Unit Labor Cost
(Contribution of Factors to Year-on-year Changes)



Note: Unit Labour Cost = Nominal Employee Compensation / Real GDP
Source: "Preliminary Quarterly Estimates of GDP", Cabinet Office

Table. The Outlook for Japanese Economy

Forecast

	FY2005 1st Qtr	2nd	3rd	4th	FY2006 1st Qtr	2nd	3rd	4th	FY2007 1st Qtr	2nd	3rd	4th	FY2005 Actual	FY2006 Forecast	FY2007 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	1.4	0.2	1.1	0.7	0.2	0.8	0.7	0.6	0.3	0.2	0.5	0.3	3.2	2.4	1.8
Real gross domestic expenditures (year-on-year)	2.6	2.8	3.7	3.6	2.0	2.8	2.4	2.3	2.4	1.8	1.5	1.2			
Private final consumption (qtr.-to-qtr.)	0.7	0.4	0.6	0.2	0.5	0.6	0.6	0.2	0.4	0.2	0.2	0.1	2.3	1.9	1.3
Private housing investment (qtr.-to-qtr.)	-1.5	1.9	1.8	0.7	-2.7	3.3	1.5	0.1	-2.2	1.1	1.0	0.2	-0.2	2.4	0.8
Private plant and equipment investment (qtr.-to-qtr.)	1.9	1.8	0.3	3.3	3.8	-0.1	0.9	1.7	0.9	0.3	0.5	0.6	7.5	7.8	3.3
Private inventory investment (contribution)	0.4	-0.5	0.1	0.1	-0.2	0.2	-0.0	0.0	0.0	0.0	-0.0	-0.0	0.2	-0.1	0.1
Government final consumption (qtr.-to-qtr.)	0.4	0.2	0.2	0.0	-0.2	0.4	0.3	0.5	0.1	0.2	0.4	0.4	1.5	0.5	1.2
Public fixed capital formation (qtr.-to-qtr.)	1.4	0.3	-2.7	-0.6	-4.6	0.6	-0.5	-0.3	-3.1	-2.5	-1.2	-2.2	-1.4	-6.1	-6.3
Public inventory investment (contribution)	-0.0	0.0	-0.0	-0.0	0.0	-0.0	0.0	-0.0	0.0	-0.0	0.0	-0.0	0.0	-0.0	0.0
Domestic demand (contribution)	1.1	0.2	0.5	0.7	0.3	0.8	0.6	0.5	0.2	0.1	0.3	0.1	2.7	2.2	1.3
Net exports of goods and services (contribution)	0.3	0.0	0.6	0.0	-0.1	0.1	0.2	0.1	0.0	0.0	0.2	0.2	0.5	0.4	0.3
Exports of goods and services (qtr.-to-qtr.)	3.6	3.1	3.8	2.2	0.9	2.3	2.1	2.0	1.4	1.5	2.2	2.0	9.1	8.7	7.4
Imports of goods and services (qtr.-to-qtr.)	1.9	3.3	-0.6	2.5	1.8	1.9	1.2	1.4	1.5	1.4	1.3	1.1	6.5	6.7	5.7
Nominal gross domestic expenditures (qtr.-to-qtr.)	1.0	-0.1	0.7	0.4	0.3	0.8	0.6	0.7	0.5	0.6	0.5	0.5	1.8	2.0	2.3
Domestic corporate goods price index (year-on-year)	1.7	1.7	2.2	2.8	3.1	2.6	2.3	2.0	0.9	0.5	0.1	-0.1	2.1	2.5	0.4
Consumer price index (year-on-year)	-0.1	-0.1	0.1	0.5	0.6	0.6	0.6	0.9	0.8	0.9	0.8	0.8	0.1	0.7	0.8
Yen : Dollar exchange rate (yen / dollar)	107.7	111.2	117.3	116.9	114.4	116.0	115.7	115.4	115.1	114.9	114.6	114.4	113.3	115.4	114.7
Unemployment rate (%)	4.3	4.3	4.5	4.2	4.1	4.0	4.0	3.9	3.9	3.9	3.9	3.9	4.4	4.1	3.9
Indices of Industrial Production (qtr.-to-qtr.)	-0.1	-0.5	2.8	0.6	0.9	0.9	1.1	1.0	0.6	0.4	0.6	0.7	1.6	4.1	2.9
Current account / Nominal GDP (%)	3.4	3.5	4.2	4.0	3.3	3.4	3.5	3.6	3.7	3.9	4.2	4.6	3.8	3.5	4.1
Real GDP of U.S.A (qtr.-to-qtr.)	3.3	4.2	1.8	5.6	2.5	2.2	2.4	2.8	3.0	3.1	3.4	3.4	3.2 (C.Y.)	3.3 (C.Y.)	2.8 (C.Y.)

[Notes] 1. Figures in percentage changes; contribution is contribution to real GDP growth.

2. Figures for items comprising national expenditures are at chained (2000) yen.

3. Figures for Indices of industrial production, consumer price index and domestic corporate goods price index are at 2000 base.

4. Figures for GDP components, unemployment rate, indices of Industrial Production, current account are seasonally adjusted.

5. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2000) dollars.