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*SA130 Short-Term Forecast of the Japanese Economy (2007/4-6--2009/1-3)*

## ***Economy to accelerate after breather***

***Capital outlays still rising***

***Deflation shackles coming off slowly***

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Although Japan's economy has been steaming along at a fast clip, led by personal consumption spending, underlying support from household income has been meager. For this reason, the economy is likely to take a breather in the first half of FY2007 (April 2007-March 2008). In the second half of the fiscal year, however, strong employment conditions should boost wages, setting the economy on a path of stable growth led by strong personal consumption spending. The rising trend in capital outlays is set to continue. The pace of the nation's emergence from deflation, meanwhile, is likely to remain slow.

Japan's real gross domestic product (GDP) for the January-March 2007 quarter grew at an annualized rate of 2.4% versus the October-December quarter, chalking up its ninth quarter of sequential positive growth. It was also the second straight quarter in which the pace of economic growth exceeded the economy's potential growth rate, generally regarded as 1.5%--2% annualized. Continued strength in personal consumption expenditures and renewed acceleration in exports may be cited as underlying the results.

Growth has been driven by capital expenditures, which turned down for the first time in five quarters. One reason for the decline was that production facilities acquired from and after FY2007 may be treated as expenses in their entirety, and some companies postponed capital outlays with the aim of benefiting from changes in the tax treatment of depreciation which will help lower their taxes.

### ***Consumption spending key to sustained expansion***

Rising personal consumption spending has been supported partly by special factors, including the mild winter and lighter income tax burdens resulting from the shift in tax revenue sourcing to localities. During this period, the momentum of nominal employee compensation has slowed, meaning that the strong growth in consumption spending cannot be attributed to rising incomes. As for the hefty acceleration in exports, strong exports to emerging countries (including China) and oil exporting countries offset slower exports to the United States. There is some concern that exports as a whole will

suffer if the U.S. economy slows further.

In view of the foregoing, future optimism is not necessarily justified merely by the fact that the GDP growth rate for the January-March quarter exceeded market forecasts at the time of the previous projection. Greater sustainability of the economic recovery and expansion will almost certainly be impossible without a shift to growth driven by personal consumption spending, itself backed by improvements in income.

Bearing the foregoing conditions in mind, the present short-term economic forecast re-examines the outlook through the close of FY2008. Projections resulting from this analysis show that, having reached 1.9% in FY2006, real economic growth is likely to gradually accelerate to 2.0% in FY2007 and then to 2.2% in FY2008. However, this outlook assumes that the consumption tax will be raised from 5% to 8% in April of 2009, and the projected acceleration in the growth rate for FY2008 reflect the possible impact from last-minute demand just ahead of the tax increase. It is estimated that such last-minute demand will raise personal consumption spending in FY2008 by two tenths of a percentage point over the year before, in turn lifting the real growth rate by one tenth of a percentage point.

Breaking the estimates down by individual quarter, consumption spending has shown above-trend growth and will likely slow in the April-June 2007 quarter, at which time the full impact from slowing U.S. economic conditions and inventory adjustments in the information technology (IT) industry will also be felt, in turn forcing the Japanese economy to take a breather. However, the economy will likely return to its potential growth rate in the July-September quarter, with business conditions reaccelerating in the latter half of FY2007. In the main, the following five factors may be cited as underlying these projections.

### *Undervalued yen to shore up exports*

First, exports will continue growing strong for the time being even as the U.S. economy slows. The reason is that, for the present, the yen will remain undervalued, shoring up exports as they shift toward fast-growing emerging countries, oil-producing countries and Europe.

Second, the Fed is likely to achieve a soft landing in the United States, with Japanese exports modestly accelerating as a result. Recently, the adverse impact on the U.S. economy from supply and demand adjustments in the housing market and inventory adjustments in the manufacturing industry, mainly auto manufacturing, has been greater than anticipated. As a result, the real economic growth rate has fallen well below prior market projections. Inflationary pressures have also been unexpectedly stubborn, dimming hopes of any economic stimulus from a cut in interest rates. The U.S. economy is thus at a delicate juncture.

That said, inventory adjustments in the automobile and other manufacturing industries have for the most part run their course. Reflecting the strength of corporate

earnings, capital investments have remained on a rising course. Adjustments in the housing market will peak as housing starts recover footing, with personal consumption remaining strong on good employment conditions. In this environment, the U.S. economy will likely return to a growth track of around 3% in the second half of 2007.

Third, although production has recently begun slowing, there is little risk that industrial production adjustments overall will be prolonged or intensified. Industrial production recently began to slow on the impact of inventory adjustments in IT-related industries and temporary production cutbacks by auto manufacturers. However, inventory ratios for industry overall remain low, and production adjustments in the automobile industry have nearly run their course.

Fourth, although capital outlays have begun slowing recently, the basic trend remains upward. Concern over the outlook for capital investment has also increased because orders for machinery (excluding shipping and electric power), a leading indicator, have also been weak. However, the outlook for machinery orders in the April-June quarter fell sharply largely under the influence of a statistical quirk and does not necessarily reflect the actual trend. If anything, the backlog of machinery orders is likely to continue rising, and the present backlog is indeed large, meaning that companies are in fact probably finding it more difficult to meet orders (see diagram).

Considering FY2007 capital investment plans as given in the Bank of Japan's March Tankan report and the growth rate (recovering the 2% level) expected by companies according to the Cabinet Office's Annual Survey of Corporate Behavior for FY2006, there is likely room for capital investments to expand further.

Fifth, growth in personal spending has recently been sluggish, but backed by strong employment conditions, underlying support for the basic trend is gradually firming. To be sure, growth will be listless for a while because there is unlikely to be any near-term increase in nominal wages and particularly regular salaries, which are closely tied to fixed costs. The residence tax burden will also rise from June owing to the shift of tax revenue sourcing to localities.

As is clear from the findings of the March Tankan survey, however, corporations are now much more disposed to hire new employees, meaning that the unemployment rate and the effective job offer to job applicant ratio should begin to show improvement once again. In tandem, a rising trend will gradually become discernable in wages, mainly in bonuses and other special payments and regular salaries.

Other factors making consumers more positive include lump-sum severance packages for baby boomers, rising dividend and interest income, and the wealth effect from land prices, which have stopped falling and begun to recover.

### ***BOJ must act prudently, given weak position of smaller firms***

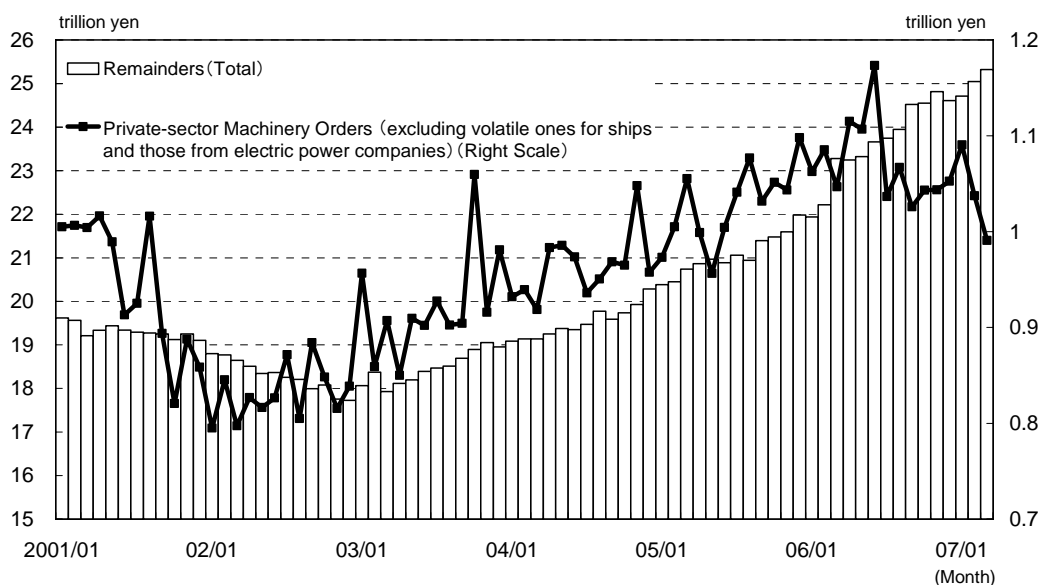
The nominal growth rate is expected to reach 2.1% in FY2007 and 2.6% in FY2008,

exceeding the real growth rate in both years. This means that the present inversion of nominal versus real rates of growth will normalize in FY2007, adding one more factor to confirm that deflation is being overcome. That said, the personal consumption deflator and unit labor costs seem to be somewhat late in improving on a year-on-year basis, suggesting that the pace at which the Japanese economy is escaping deflation remains agonizingly slow.

Several risk factors may be cited as possible threats to this standard scenario of gradually accelerating growth. These continue to include an excessively sharp slowdown in the U.S. economy, intensification of inventory adjustments in IT-related industries, a spike in crude oil prices, a sharp appreciation of the yen, contagion among falling stock markets worldwide, stubborn control of wages by business firms, and a poorly timed interest rate hike by the Bank of Japan (BOJ). With regard to further hikes in interest rates, hastening the pace of further tightening should probably be avoided for the time being given the sluggish momentum of recovery on the part of small and midsize firms, heavily dependent as they are on borrowings.

According to news reports, however, following its review of the treatment of depreciation in its FY2007 tax system reforms, the government is considering streamlining the statutory useful-life classifications applicable to capital facilities and expanding the scope of high technology facilities qualifying for a shorter statutory useful-life designation. By easing the clerical work associated with taxation and lightening the tax burden itself, these efforts will not only strengthen the international competitiveness of Japanese companies but possibly lift the growth rate as well.

**Figure: Orders Received for Machinery and Remainders (Seasonally adjusted)**



Source: Cabinet Office, *Orders Received for Machinery*.

Table. The Outlook for Japanese Economy

	Forecast															
	FY2006				FY2007				FY2008				FY2005	FY2006	FY2007	FY2008
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	Actual	Actual	Forecast	Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.3	0.1	1.2	0.6	0.2	0.4	0.6	0.6	0.4	0.6	0.5	1.1	2.4	1.9	2.0	2.2
Real gross domestic expenditures (year-on-year)	2.1	1.4	2.2	2.0	2.1	2.4	1.7	1.7	2.0	2.2	2.1	2.6				
Private final consumption (qtr.-to-qtr.)	0.6	-1.0	1.1	0.9	0.3	0.3	0.4	0.5	0.3	0.4	0.4	1.4	1.9	0.8	1.8	1.9
Private housing investment (qtr.-to-qtr.)	-1.9	-0.3	2.2	-0.3	-0.2	0.0	0.6	0.1	0.6	0.4	0.1	0.9	-1.0	0.4	0.9	1.6
Private plant and equipment investment (qtr.-to-qtr.)	2.6	0.9	2.3	-0.9	1.8	0.7	1.4	1.0	0.5	1.4	1.0	1.1	5.8	7.2	4.0	4.1
Private inventory investment (contribution)	-0.1	0.2	-0.1	-0.1	-0.0	0.0	-0.0	-0.0	0.0	0.0	0.0	-0.0	-0.1	-0.0	-0.1	0.0
Government final consumption (qtr.-to-qtr.)	0.7	0.6	0.1	-0.1	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.1	0.9	0.9	1.1	0.8
Public fixed capital formation (qtr.-to-qtr.)	-6.2	-4.7	4.0	-0.1	-3.3	-3.0	-2.3	-1.3	-0.5	-0.4	-0.2	-0.7	-1.4	-9.2	-6.3	-3.9
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	-0.0
Domestic demand (contribution)	0.4	-0.3	1.1	0.2	0.4	0.3	0.4	0.4	0.3	0.5	0.4	1.0	1.9	1.2	1.7	1.8
Net exports of goods and services (contribution)	-0.1	0.4	0.1	0.4	-0.3	0.1	0.1	0.2	0.1	0.1	0.0	0.0	0.5	0.8	0.4	0.3
Exports of goods and services (qtr.-to-qtr.)	0.8	2.3	0.8	3.3	0.4	1.5	1.6	2.2	1.5	1.8	1.6	2.4	9.0	8.3	6.5	7.3
Imports of goods and services (qtr.-to-qtr.)	1.4	-0.4	-0.1	0.9	2.2	1.1	1.1	1.4	1.3	1.6	1.8	2.4	6.0	3.4	4.5	6.0
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.2	-0.1	1.3	0.3	0.4	0.4	0.6	0.7	0.5	0.7	0.5	1.1	1.0	1.3	2.1	2.6
Domestic corporate goods price index (year-on-year)	3.1	3.6	2.6	1.9	2.0	1.1	1.6	1.9	1.1	1.0	1.1	1.1	2.1	2.8	1.6	1.1
Consumer price index (year-on-year)	0.0	0.3	0.1	-0.1	-0.1	-0.1	0.0	0.2	0.3	0.3	0.3	0.4	0.1	0.1	0.0	0.3
Yen : Dollar exchange rate (yen / dollar)	114.4	116.1	117.7	119.4	119.5	117.6	116.4	115.4	113.9	112.0	110.4	110.3	113.3	116.9	117.2	111.7
Unemployment rate (%)	4.1	4.1	4.0	4.0	3.9	3.9	3.8	3.8	3.7	3.6	3.5	3.5	4.3	4.1	3.9	3.6
Indices of Industrial Production (qtr.-to-qtr.)	1.3	1.3	2.2	-1.3	1.1	0.3	0.6	0.9	1.0	0.9	0.8	0.7	1.6	4.8	2.3	3.3
Current account / Nominal GDP (%)	3.6	3.8	4.5	4.5	4.3	4.2	4.5	4.8	4.8	4.7	5.1	5.2	3.8	4.2	4.6	5.1
Real GDP of U.S.A (qtr.-to-qtr.)	2.6	2.0	2.5	1.3	2.3	2.8	2.9	3.0	3.1	3.2	3.3	3.5	3.2 (C.Y.)	3.3 (C.Y.)	2.1 (C.Y.)	3.0 (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 consumer price index is at 2005 base.  
5. Figures for GDP components, unemployment rate, indices of Industrial Production, current account are seasonally adjusted.  
6. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2000) dollars.

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