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SA131 Short-Term Forecast of the Japanese Economy (2007/7-9--2009/1-3)

Private demand to maintain steady recovery

Exports to continue rising near term but financial market volatility remains lurking risk

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The Japanese economy is presently growing at a lethargic pace partly in reaction to the rapid pace of growth seen in the second half of fiscal year 2006 (April 2006-March 2007) and partly on the impact of the sharp slowdown in economic activity in the United States at the beginning of this year. Nevertheless, continued strength has been maintained in the two mainstays of domestic demand, namely personal consumption and private non-residential investment, both of which are likely to fuel a gradually rising pace of private demand going forward. So long as the recent volatility in financial and capital markets doesn't lead to a severe credit crunch, Japanese economic growth will likely reach the 2% level in both FY2007 and FY2008.

In the April-June quarter, the nation's real gross domestic product (GDP) grew at an annualized rate of 0.5% compared to the January-March quarter, below the economy's potential growth rate (generally regarded as 1.5%-2% annualized) for the first time in three quarters. This rapid slowdown in the pace of growth may be attributed primarily to the sharp slowdown in exports in the wake of diminishing exports to the United States (slowing from +3.4% Quarter-to-Quarter (Q/Q) for the January-March 2007 quarter to +0.9 Q/Q for the April-June 2007 quarter) and a halving of the pace of growth in personal consumption (slowing from +0.8% Q/Q to +0.4 Q/Q over the same period).

Growth trend to remain on the strong side

To a considerable degree, however, this recent lackluster growth reflects a pullback from the two sequential quarters of rapid growth the economy posted in the October-December quarter of 2006 (+5.4% annualized) and the January-March quarter of 2007 (+3.2% annualized), so on the whole, one can say that the trend of growth should continue basically strong. Since the Japanese economy has continued expanding for ten sequential quarters since the January-March quarter of 2005, we can safely conclude that it continues on a firm recovery track.

Nominal economic growth for the April-June quarter also came in at an annualized rate of 1.1% Q/Q, topping the real growth rate for the first time in two quarters. One factor in this reversal was the fact that the domestic demand deflator turned positive over the year before, which may be welcomed as a half a step toward the nation's extrication from deflation.

The recent economic and price trends described above may be seen as basically in line with the projections of the Bank of Japan (BoJ). However, volatility continues to plague financial and capital markets at the present time (, and indeed, the BoJ left rates unchanged at its Monetary Policy Meeting of August 23). Our present outlook assumes that the BoJ will raise the overnight call rate by a quarter-point at its Monetary Policy Meeting of September 18-19, and that the Bank will continue to tighten rates at a modest pace of about once every six months thereafter, given the slow pace of recovery by small and midsize companies which typically rely heavily on borrowings. (That is, we expect the BoJ to raise the overnight call rate by a quarter-point at each of its Monetary Policy Meetings in March and September 2008 and March 2009).

Rising non-residential investment led by non-manufacturing industries

Our present near-term economic outlook re-evaluates our projections through the end of FY2008 in light of these recent developments. In sum, we now expect the economy to grow at a rate of 2.3% in real terms in both FY2007 (ending March 2008) and FY2008 (ending March 2009), thus continuing stable above 2%. The rate of nominal economic growth is expected to reach 2.1% in FY2007 and 2.8% in FY2008. The nominal growth rate continued to lag behind the real growth rate in FY2007 but is expected to top the real growth rate in FY2008. This anomalous inversion of the real and nominal growth rates is expected to be resolved in FY2008.

Also, given the results of the House of Councilors election, our current projections abandon the assumption that the consumption tax will be raised from 5% to 8% in April of 2009. They also now assume the government will, for the time being, somewhat relax its stance toward holding down public investment spending, mainly involving local public non-subsidized projects. This means that public spending is not likely to be cut back to such a degree in FY2007 and that, since we no longer anticipate a hike in the consumption tax in FY2009, there will be no associated surge in consumer spending in FY2008.

On a quarterly basis, our outlook indicates that personal consumption is likely to be lackluster in the July-September quarter of 2007 due partly to sluggish growth in disposable income, but increases in housing investment and other factors should sustain domestic demand while exports regain footing, such that, overall, the Japanese economy should grow in line with its potential growth rate. Thereafter, in the second half of FY2007, the economic growth rate is expected to recover, led by domestic demand mainly in the form of personal consumption and private non-residential investment. After the beginning of FY2008, the Japanese economy is expected to grow at a stable pace of about 2% annualized each quarter.

The primary grounds and context underlying our outlook may be summarized in the following five points.

First, US employment and consumption continue firm, while the corporate sector is gradually regaining footing. Owing to weak housing prices and increasingly stringent screening of housing loans, the correction in the US housing market is expected to be drawn out.

However, (1) the number of new applications for unemployment insurance remains low, and there is no sign that employment conditions are likely to deteriorate significantly; (2) gasoline prices are also on the decline, and consumer confidence is on the mend; and (3) owing to continuing adjustments in inventories, mainly in the auto industry, conditions in the manufacturing industry continue to recover. In addition to these factors, inflationary fears have retreated. This has given the Federal Reserve more leeway to ease credit. As a result, it still appears that the US economy may experience a soft landing. (In addition to the Fed's lowing of the discount rate on August 17, our current projections assume that the Fed will lower its targeted market interest rate twice within the year.)

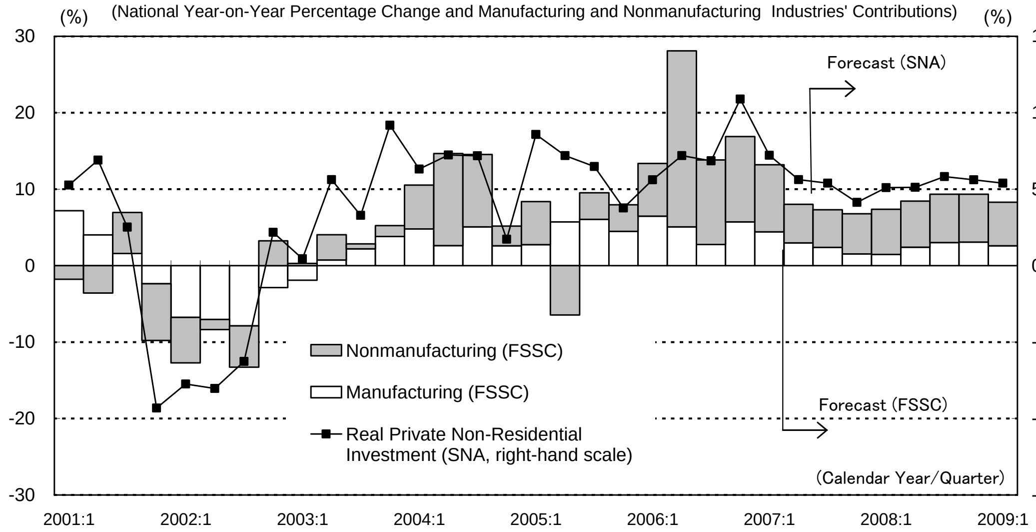
Second, there's been a steady increase in Japanese exports to emerging economies such as China and resource-producing nations such as those in the Middle East. Emerging economies and resource-producing countries are taking in a rapidly increasing share of Japan's exports, and brisk economic growth in these nations is expected to continue for the time being. Meanwhile, although the Japanese currency has strengthened sharply recently, selling pressure on the yen associated with foreign currency-denominated asset management remains strong, such that, for the present, the yen should remain undervalued, with exports experiencing only limited pressure from the strength of the yen.

Third, there are increasing signs that long-delayed inventory adjustments are nearing completion in the information technology (IT) industry. Brisk non-residential investments in the IT industry have resulted in a rapid increase in production capacity, which has made it difficult for inventory adjustments to move ahead. Nevertheless, inventory adjustments have nearly run their course in the closely linked IT industries of South Korea and Taiwan, meaning that inventory adjustments will soon also begin making steady progress in Japan's IT industry as well, leading to recovery of production in the manufacturing sector overall.

Fourth, private non-residential investments continue to rise, reflecting increases in the non-manufacturing industries, which account for considerable weight (see figure). Machinery orders (private demand excluding shipping and electric power), a leading indicator, has been declining of late, and in the manufacturing sector, rising adjustment pressure relating to the capital stock cycle will slow the growth of capital outlays. In the near term, however, support will come from replacement investment needed in power stations and transmission facilities in the electric power industry, as well as construction investment in the retail industry as department stores and other retailers build new stores and expand floor space (both are not reflected in machinery orders).

Figure: Private Non-Residential Investment

(National Year-on-Year Percentage Change and Manufacturing and Nonmanufacturing Industries' Contributions)



Notes: Manufacturing and nonmanufacturing contributions are based on nominal investment data (corrected for discontinuity arising fom changes in the sample every fiscal year) from *Financial Statements Statistics of Corporations by Industry (FSSC)* . The year-on-year percentage change of real Private Non-Residential Investment is from SNA and its data on 2nd quarter 2007 is actual.

Sources: Cabinet Office, *Quarterly Estimates of GDP* ; Ministry of Finance, *Financial Statements Statistics of Corporetions by Industry.*

Fifth, although personal consumption may be sluggish in the near term, in its fundamental trend, it will gradually gain increasingly firm support from strong employment conditions. Recent personal consumption has lacked vigor as consumer sentiment soured amid rising prices for gasoline and other items as well as a higher residence tax burden arising from the localization of tax sourcing and the scrapping of the fixed-rate across the board tax cut.

Still, considering the considerable extent that improvements in wage indicators have been delayed, recent personal consumption has nevertheless remained firm on balance. There are indications that one technical factor behind these developments has been the fact that, in addition to the downward pressure on average wages associated with large numbers of retiring baby boomers (whose salary levels are relatively high), factors such as the lump-sum retirement benefits paid to these baby boomers, rising dividend and interest income received by households, and the bottoming and upturn of land prices have resulted in a wealth effect which has sustained consumption.

In addition to these supporting factors, a gradual recovery of wage indicators reflecting improvements in the unemployment rate and the job offer/applicant ratio will contribute to rising consumption.

Severe credit crunch could batter real economy

The largest risk factor threatening the realization of this standard scenario of steadily increasing real growth of over 2% would be the outbreak internationally of a severe credit crunch precipitated by defaults on housing loans to individuals with low credit standing (subprime loans) in the United States, leading to severe repercussions for the real economy. If, in tandem with the adjustment of excess liquidity, credit risks are reassessed and nothing more, the impact should be limited.

However, if a severe global credit crunch develops on such factors as collapsing hedge funds, there could be a drop in equity prices worldwide and a rapidly appreciating yen in the wake of the unwinding of yen carry (yen borrowing) transactions, while business firms could find it difficult to obtain financing.

In this context, if mounting geopolitical risks lead to a sharp rise in crude oil prices, for example, it would be difficult for the economy to avoid being tipped into a major downturn. The present projections assume that the impact of the subprime loan problem on the real economy will be limited in scope. This point should be borne carefully in mind when assessing the results of these projections.

Table. The Outlook for Japanese Economy

Forecast →

	FY2006 1st Qtr	2nd	3rd	4th	FY2007 1st Qtr	2nd	3rd	4th	FY2008 1st Qtr	2nd	3rd	4th	FY2006 Actual	FY2007 Forecast	FY2008 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.4	0.1	1.3	0.8	0.1	0.4	0.7	0.8	0.5	0.5	0.4	0.4	2.1	2.3	2.3
Real gross domestic expenditures (year-on-year)	2.1	1.4	2.2	2.5	2.3	2.7	2.1	2.1	2.5	2.5	2.2	1.8			
Private final consumption (qtr.-to-qtr.)	0.4	-0.9	1.1	0.8	0.4	0.2	0.4	0.6	0.5	0.3	0.2	0.1	0.7	1.7	1.6
Private housing investment (qtr.-to-qtr.)	-1.5	0.1	1.7	-0.8	-3.5	1.2	1.0	1.3	-2.1	0.5	0.0	0.1	0.4	-1.5	0.1
Private non-residential investment (qtr.-to-qtr.)	2.9	1.1	2.8	0.3	1.2	1.0	1.5	1.3	1.2	1.7	1.3	1.1	8.0	5.0	5.5
Private inventory investment (contribution)	0.0	0.1	-0.1	-0.0	-0.1	0.0	0.1	0.0	-0.0	-0.1	0.0	0.0	0.0	-0.1	0.0
Government final consumption (qtr.-to-qtr.)	0.8	0.5	0.1	-0.2	0.3	0.4	0.4	0.4	0.0	0.0	0.0	0.1	0.9	1.0	0.8
Public fixed capital formation (qtr.-to-qtr.)	-5.9	-4.9	3.7	-1.3	-2.1	-2.7	-1.4	-1.3	-1.4	-1.0	-1.0	-0.7	-9.6	-5.5	-5.1
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)	0.5	-0.3	1.2	0.4	0.1	0.3	0.6	0.7	0.4	0.4	0.3	0.3	1.3	1.8	1.8
Net exports of goods and services (contribution)	-0.1	0.4	0.1	0.4	0.0	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.8	0.7	0.5
Exports of goods and services (qtr.-to-qtr.)	0.7	2.2	0.9	3.4	0.9	1.5	2.0	2.3	1.8	1.6	1.6	1.6	8.2	7.3	7.5
Imports of goods and services (qtr.-to-qtr.)	1.3	-0.4	-0.1	0.9	0.8	1.1	1.6	1.8	1.4	1.5	1.3	1.0	3.3	3.4	5.9
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.2	-0.1	1.4	0.4	0.3	0.2	0.8	1.1	0.7	0.5	0.6	0.6	1.4	2.1	2.8
Domestic corporate goods price index (year-on-year)	3.1	3.6	2.6	1.9	2.3	2.0	2.9	3.4	2.3	1.6	1.3	1.2	2.8	2.6	1.6
Consumer price index (year-on-year)	0.0	0.3	0.1	-0.1	-0.1	-0.1	0.1	0.3	0.4	0.2	0.2	0.3	0.1	0.1	0.3
Yen : Dollar exchange rate (yen / dollar)	114.4	116.1	117.7	119.4	120.8	119.3	117.3	116.3	115.3	114.1	113.0	112.0	116.9	118.4	113.6
Unemployment rate (%)	4.1	4.1	4.0	4.0	3.8	3.7	3.7	3.7	3.6	3.5	3.5	3.5	4.1	3.7	3.5
Indices of Industrial Production (qtr.-to-qtr.)	1.3	1.3	2.2	-1.3	0.2	1.0	1.3	1.6	0.8	0.5	0.4	0.5	4.8	2.4	3.5
Current account / Nominal GDP (%)	3.6	3.8	4.5	4.4	5.1	4.2	4.5	4.6	4.9	4.8	5.3	5.1	4.1	4.6	5.1
Real GDP of U.S.A. (qtr.-to-qtr.)	2.4	1.1	2.1	0.6	3.4	3.3	3.3	3.1	3.1	3.0	3.3	3.2	2.9 (C.Y.)	2.1 (C.Y.)	3.2 (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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