SA128
Short-Term Forecast of the Japanese Economy (2006/10-12--2008/1-3)

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Personal Consumption to Underpin Growth

The Japanese economy in fiscal 2007 is expected to gradually slow down due to slower growth in exports and business fixed investment, resulting from the deceleration in the US economy and the inventory adjustment in the IT (information technology) related sector. However, the recovery in employment will continue and the improvement in wages will gradually pick up pace and so personal consumption in fiscal 2007 will accelerate. Thus, the household sector will be the main force pushing growth in the economy to the potential growth rate (of between 1.5-2.0% on an annualized basis).

The real GDP in the July-September quarter of 2006 grew at an annualized quarterly rate of 2.0%, marking the seventh consecutive quarter of growth starting from the January-March quarter of 2005. Moreover, the rate of growth was also higher than the potential growth rate for the first time in two quarters. However, some weak economic indicators such as the large decline in machinery orders have been noticeable, and some economists fear the economy may be reaching a plateau. Yet, from the preliminary estimates of this past quarter's figures, we believe that it is fair to say that the Japanese economy is continuing along a steady growth path.

However, if we look at the contributions of the demand factors, the contribution of domestic final demand is negative and the factors behind the July-September growth were largely inventory investment and external demand. The positive contribution of business fixed investment (that is growing fairly rapidly) is being offset by personal consumption (that has marked a large decline), and public investment that has declined remarkably for two consecutive periods also contributed negatively to growth.

Thus, we are not necessarily without concern regarding the sustainability of the economy, considering such factors as the rapid increase in inventory of electronic parts and devices that could eventually lead to downward pressure on growth through inventory adjustment, and the possible future slowdown in exports that would result from a slowdown in the US economy.

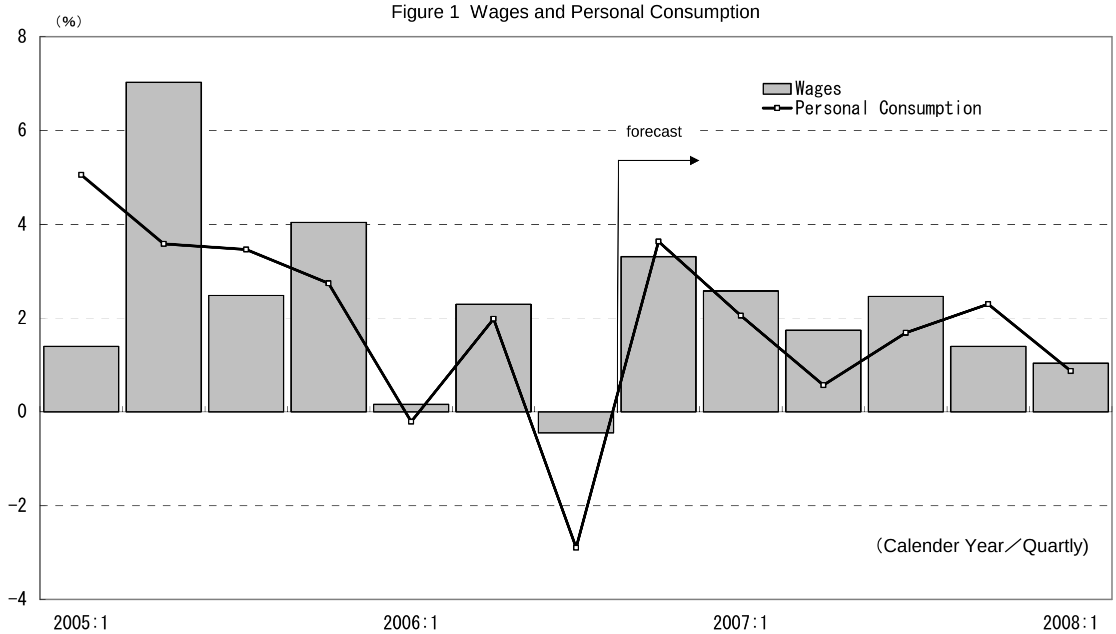
Personal consumption -- declined this quarter, but to recover in future

In this short-term economic forecast, we took these current conditions into account and reevaluated our forecast to the end of fiscal 2007. The results that were obtained are summarized in the five points below. The major difference between the earlier forecast and this one is the results of personal consumption as described in the first point.

First, though personal consumption shows a marked decline in fiscal 2006, in fiscal 2007, it will recover somewhat and becomes a force to support the growth of the economy. The decline in personal consumption in the July-September period is due to some temporary factors such as the rise in gas prices leading to a negative sentiment on consumers, and the unseasonably bad weather, but we view the main reason to be the delay in the improvements in wages (Figure 1).

The recovery in employment overall has been continuing. However, companies are still in a restraining mode in terms of personnel expenses, and nominal wages are not growing. In the July-September period, real employee compensation fell for the first time in seven quarters (by 0.1% over the previous period). Yet, in the

Figure 1 Wages and Personal Consumption



[sources] Cabinet Office,*Quartly Estimates of GDP*

October-December period, we are expecting personal consumption to turn to rise as the year-end bonuses are expected to show a solid increase.

From then, as employment continues to improve, the actual unemployment rate is expected to fall below the structural rate of unemployment (currently at about 4.0%, and defined as the rate when the number of vacancies and the number unemployed are equal). When this happens, we will see the improvement in wages, and the personal consumption growth should also recover. In fact, the large steel companies will be raising their wages for the first time in six years next spring. If companies in other industries follow suit, the scenario of personal consumption growth and recovery is even more likely to be realized.

Second, the US economy is expected to achieve a soft landing, and China and European countries are expected to continue to grow at relatively high rates for the time being. The US economy is recently showing stronger signs of a slowdown due largely to a large decline in residential investment. However a soft landing is still considered possible due to the following factors: household income is robust due to healthy corporate profits, with lower gas prices the real purchasing power of the household is increased (purchasing power for consumption of goods other than gas), consumer sentiment is solid with higher stock prices, and the interest repayment burden on the household and corporate sectors are lower thanks to the stability of long-term interest rates at low levels.

Third, Japanese exports are expected to sustain high growth rates overall through to the end of fiscal 2007 due to the strength of overseas economies and the current exchange rate whereby the yen is undervalued on a real basis. With this trend expected in exports, though industrial production growth may slow through fiscal 2007, it will still show healthy growth. Furthermore, the non- IT related industries, in particular the materials industry, are largely already into their inventory accumulation stage and so it is unlikely that the inventory adjustment in the IT related sectors will spread into the industrial sectors as a whole.

Fourth, business fixed investment in fiscal 2006 is expected to rise further, to be followed by a large deceleration in fiscal 2007. That is, for fiscal 2006, business fixed investment is expected to accelerate further due to the increase in capacity utilization arising from the healthy exports, the higher expected growth rates of companies, and accumulated cash flow. In contrast to this, in fiscal 2007, there will be pressure for correction from a capital stock cycle perspective, and restrained corporate profits due to slower sales growth and higher personnel costs. Also, the rise in nominal interest rates will result in a higher cost of capital, and these factors will curb the growth of business fixed investment.

Fifth, regarding public demand, public investment will fall greatly in fiscal 2006 and will put downward pressure on the growth rate of real GDP. However, in fiscal 2007, the decline in public investment will be smaller and will have little effect on its growth rate.

Elimination of deflation progressing

As a result of the factors above, the real GDP is forecast to grow at rates of 2.3% in fiscal 2006 and 1.9% in fiscal 2007. Our standard scenario can be summarized as follows:

- In fiscal 2006, though personal consumption will slow quite dramatically, exports and business fixed investment will drive the growth of the Japanese economy, and so it will grow at above the potential growth rate.
- In fiscal 2007, a deceleration in exports and business fixed investment will make a slower growth rate inevitable, but growth will be supported by the recovery in personal consumption stemming from an improvement in wages, and so growth in the Japanese economy should be secured at around the the potential rate.

Thus, the growth model will change somewhat in that it will be led by the household sector (personal consumption), rather than the corporate sector (exports, business fixed investment). Because in fiscal 2006, the real growth rate will surpass the potential growth rate, the GDP gap, already in an excess demand position will expand.

Due to the tightness in the macro supply-demand profile, the change in the GDP deflator that showed a much lower rate of decline in fiscal 2006, will turn to a positive in fiscal 2007. As a result, the nominal growth rate in fiscal 2006 will be 1.8% and continue to be smaller than the real rate of growth, but it will be 2.0% and larger than the real rate in fiscal 2007, thus marking the end of the reversal of nominal and real rates.

Reflecting the recent revisions in the tabulation of the Consumer Price Index and the delay we are seeing in wage improvement, the timing of the GDP deflator and the unit labor cost (nominal employee compensation ÷real GDP) turning to year-on-year positive changes may be somewhat delayed. However, there is no change in our view that the economy appears to be continuing out of deflation

Focal points are wages and monetary policy

Factors that may prevent our standard recovery scenario of sustained stable growth from being realized continue to be:

- a rapid slowdown in the US economy,
- a stronger inventory adjustment in the IT related sector,
- oil prices turning to rise once again, and
- a rapid appreciation of the yen.

However, as we are assuming that a stable growth in fiscal 2007 is contingent upon a recovery in personal consumption arising from improvement in wages, the one mechanism that we need to work is for the improved employment environment to lead to an improvement in wages. That is, if companies are more rigid than expected in their stance to restrain wages, then even if employment improves, this may not lead to improved wages. Then personal consumption may not recover.

One other focal point is the direction of monetary policy. Recent growth has been stronger than expected, and another hike in interest rates is expected to be imminent. However, it is possible that another interest rate hike may trigger an appreciation of the yen , when we take into account the likelihood of the US lowering interest rates, and the grumblings in Europe and Asia about the low value of the yen. Moreover, if another hike in interest rates leads to a rise in the floating rate of housing loans, the repayment burden will increase and will dampen the effects of an improvement in wages on a recovery in personal consumption. Monetary policy will need to continue to be carefully considered and executed.

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.)	1.3	0.5	1.0	0.8	0.4	0.5	0.4	0.5	0.4	0.4	0.6	0.4	3.3	2.3	1.9
Real gross domestic expenditures (year-on-year)	2.7	2.9	3.8	3.9	2.6	2.7	2.1	1.8	1.9	1.8	1.9	1.8			
Private final consumption (qtr.-to-qtr.)	0.9	0.9	0.7	-0.1	0.5	-0.7	0.9	0.5	0.1	0.4	0.6	0.2	2.6	1.0	1.4
Private housing investment (qtr.-to-qtr.)	-1.4	1.5	1.6	1.2	-2.5	0.1	1.4	1.1	-1.9	0.2	0.9	0.7	-0.2	0.6	0.5
Private plant and equipment investment (qtr.-to-qtr.)	2.3	1.1	0.2	3.7	3.5	2.9	0.5	1.2	1.3	1.1	0.2	1.0	7.3	9.6	4.4
Private inventory investment (contribution)	0.1	-0.3	0.1	0.2	-0.0	0.3	-0.2	-0.1	0.0	-0.1	0.1	0.0	0.2	0.2	-0.1
Government final consumption (qtr.-to-qtr.)	0.3	0.3	0.1	0.0	0.2	0.1	0.2	0.2	0.2	0.0	0.2	0.3	1.4	0.5	0.7
Public fixed capital formation (qtr.-to-qtr.)	1.3	1.5	-3.6	-0.8	-6.5	-6.7	-1.4	-0.6	-0.6	-0.7	-0.6	-1.0	-1.4	-13.8	-4.5
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)	1.0	0.6	0.4	0.7	0.4	0.1	0.4	0.5	0.3	0.3	0.5	0.3	2.8	1.7	1.5
Net exports of goods and services (contribution)	0.3	-0.1	0.6	0.1	-0.0	0.4	0.0	0.0	0.1	0.0	0.1	0.1	0.5	0.6	0.3
Exports of goods and services (qtr.-to-qtr.)	3.6	2.9	3.7	2.5	0.9	2.7	1.3	1.5	1.4	1.3	1.6	1.7	9.1	8.6	6.2
Imports of goods and services (qtr.-to-qtr.)	1.7	3.9	-0.8	2.4	1.4	-0.1	1.7	1.3	0.8	1.2	1.3	1.4	6.5	4.8	4.5
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.7	0.2	0.6	0.5	0.2	0.5	0.6	0.8	0.4	0.3	0.5	0.5	1.8	1.8	2.0
Domestic corporate goods price index (year-on-year)	1.7	1.7	2.2	2.8	3.1	3.5	2.7	2.0	0.8	-0.4	-0.1	0.1	2.1	2.8	0.1
Consumer price index (year-on-year)	0.0	-0.2	-0.1	0.0	0.0	0.3	0.3	0.3	0.4	0.2	0.3	0.4	0.1	0.2	0.3
Yen : Dollar exchange rate (yen / dollar)	107.7	111.2	117.3	116.9	114.4	116.1	117.9	117.0	115.8	114.5	113.2	111.7	113.3	116.4	113.8
Unemployment rate (%)	4.3	4.3	4.5	4.2	4.1	4.1	4.2	4.1	4.0	3.9	3.9	3.8	4.4	4.1	3.9
Indices of Industrial Production (qtr.-to-qtr.)	-0.1	-0.5	2.8	0.6	0.9	1.0	0.6	0.6	0.5	0.5	0.6	0.6	1.6	3.8	2.4
Current account / Nominal GDP (%)	3.4	3.5	4.2	4.0	3.4	3.7	4.2	4.6	4.4	4.3	4.7	4.8	3.8	4.0	4.6
Real GDP of U.S.A (qtr.-to-qtr.)	3.3	4.2	1.8	5.6	2.6	1.6	2.6	2.5	2.7	2.8	2.8	3.0	3.2 (C.Y.)	3.3 (C.Y.)	2.5 (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 and domestic corporate goods price index are at 2000 base.

4. Cosumer price index is at 2005 base, and the year-on-year percentage changes are calculated based on the average of monthly figures.

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.