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SA132 Short-Term Forecast of the Japanese Economy (2007/10-12--2009/1-3)

Economy to Remain Flat Longer

US Economy uncertain, but Japanese growth likely at 2% in FY2008

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The Japanese economy is likely to continue moving sideways in the second half of the present fiscal year (ending March 31, 2008) owing to sluggish exports following from a slowdown in the US economy, delayed residential investment and non-residential (construction) investment reflecting the longer inspection period resulting from the amendment of the Building Standards Act, as well as the impact of higher crude oil prices, the stronger yen and weak stock prices. In fiscal year 2008 (April 1, 2008-March 31, 2009), the US economy is likely to regain its footing, and the Japanese economy should gradually return to a path of recovery.

Real GDP for the July-September 2007 quarter grew at an annualized rate of 2.6% Q/Q, marking positive growth for the first time in two quarters. The pace of growth exceeded the economy's potential growth rate (generally regarded as 1.5%-2% annualized). Since the summer, international financial markets have suffered volatility originating in problems relating to the US subprime loans (defaults in mortgage loans to individuals with low credit ratings). There is increased concern about what impact the weak dollar, falling stock prices, high oil prices and other factors will have on the real economy, but one may safely say that the impact on the Japanese economy in the July-September quarter was limited.

Housing starts falling, Domestic demand pulls back

Nevertheless, coming immediately after a quarter of negative growth, the growth rate in the July-September quarter did not represent a strong rebound, and a look at the first half of fiscal year 2007 (April 1, 2007-March 31, 2008) on average shows that growth has been sluggish. Also, a look at the respective contribution of internal and external demand to real economic growth in the July-September quarter shows that external demand accounts for two thirds of the total owing to continued strong exports to emerging and resource-rich nations. Domestic demand has not been the driver in real economic growth.

A look at the components of domestic demand shows that growth in personal consumption was marginally higher, while private nonresidential investment also turned up for the first time in three quarters. However, residential investment fell

sharply reflecting delays in housing starts associated with the amendment of the Building Standards Act. This reduced the contribution of domestic demand to economic growth. A look at GDP data including the construction in progress shows that the impact of the sharp decline (36.9% Q/Q) in housing starts in the July-September quarter will appear after a lag, strongly indicating that domestic demand may remain under pressure for a while longer.

Meanwhile, nominal growth in the July-September quarter was 1.4% Q/Q annualized, turning positive, but it once again fell under the real growth rate. The positive margin of the domestic demand deflator over the year before narrowed, while the negative margin of unit labor costs versus the year before widened. Given these and other factors, it seems clear that the economy's emergence from deflation will be further delayed.

In the present short-term economic forecast, we have reviewed our outlook through the end of FY2008 (April 1, 2008-March 31, 2009) in light of these most recent developments. First, we now believe that the real economic growth rate will likely slow to the lower end of the potential growth rate range (1.5%) in FY2007 but then regain the 2% level again in FY2008, rising to 2.1%. Second, although the nominal growth rate at 0.8% should fall below the real economic growth rate in FY2007 owing to the delay in the economy's emergence from deflation, we see it rising by the same level or about 2.1% in FY2008. Third, we see consumer prices (overall ex-perishables) turning positive in the October-December quarter of 2007 on a year-on-year basis before advancing by 0.3% in FY2008.

We have assumed that the Bank of Japan's next policy shift will come in July of 2008, after it becomes possible to confirm that the US economy will not sink into recession. At that time, we see the BoJ raising interest rates by a quarter point. We have assumed that the BoJ will then continue raising rates at a slow and steady pace while taking into consideration the worsening performance of small and medium sized enterprises (SMEs), which depend heavily on borrowing and have not been able to quickly reflect higher raw material prices in prices of their products. (Following the presumed July, 2008 hike, we have only assumed the BoJ will tighten by another quarter point in January of 2009.)

Aversion to higher prices, Worsening consumer sentiment

In the October-December quarter of 2007, economic growth is likely to be sluggish, and well below the potential growth rate, for a number of reasons. First, export growth will slow substantially owing to a slowdown in the US economy. Second, the marked decline in residential investment will continue owing to the impact of amendments to the Building Standards Act. Third, the impact of amendments to the Building Standards Act will extend to construction spending by business firms, and private nonresidential investment will slow. Fourth, reflecting worsening earnings by SMEs,

seasonal bonuses in the private sector overall are expected to fall on a year-on-year basis for the first time in four years while consumers remain averse to higher prices for gasoline and foodstuffs, meaning that deteriorating consumer sentiment and other factors will cause growth in personal consumption to be sluggish.

As for FY2008, our forecast points to strong growth in the first half but a slowdown in the second. In the first half, exports should accelerate once more as the US economy regains its footing and delayed residential and private nonresidential investment rebound. In the second half, meanwhile, export growth is likely to again turn sluggish as the economies of regions such as China and Europe gradually slow after the beginning of 2008, while the impact of the rebound in residential and private nonresidential investment will wane.

The following presents our forecasts by major economic environment and GDP component.

First, the global economy will be strong on the whole but will slow heading into 2008. After having maintained a strong pace of growth at nearly 4% annualized for two quarters, the US economy will also slow from and after the October-December quarter as personal consumption retreats owing to declining home prices, weak stock prices and aversion to higher prices for gasoline, and as the sharp decline in residential investment continues on the impact of stricter screening for home loans and other factors, the US economy will doubtless grow sluggishly through the first half of 2008.

Nevertheless, US exports will continue strong thanks to the weaker dollar, and the Federal Reserve has further leeway for additional interest rate cuts. The US economy is thus not likely to fall into recession, and the pace of economic growth should gradually recover in the second half of 2008.

Like the United States, regions such as China and Europe have been growing strong, but due in part to the recent strength in the euro and the yuan, as well as the impact from a slowing US economy, the pace of exports from these regions will gradually slow in 2008. Moreover, since prices are rising faster than central bank inflation targets, monetary policy will favor tightening, which will mean a gradually slowing rate of economic growth through 2008.

Second, although Japanese exports will have to slow, export growth will not slow by all that much. Given the gradual slowdown of the world economy and the sharp appreciation of the yen recently, export growth will gradually slow going forward. However, the weight of emerging nations and resource-rich nations as destinations for Japanese exports is rising, and as domestic demand in these nations strengthens while raw materials prices rise, economic growth in these nations is likely to continue strong for the time being, meaning that Japanese exports will be able to maintain a comparatively high pace of growth.

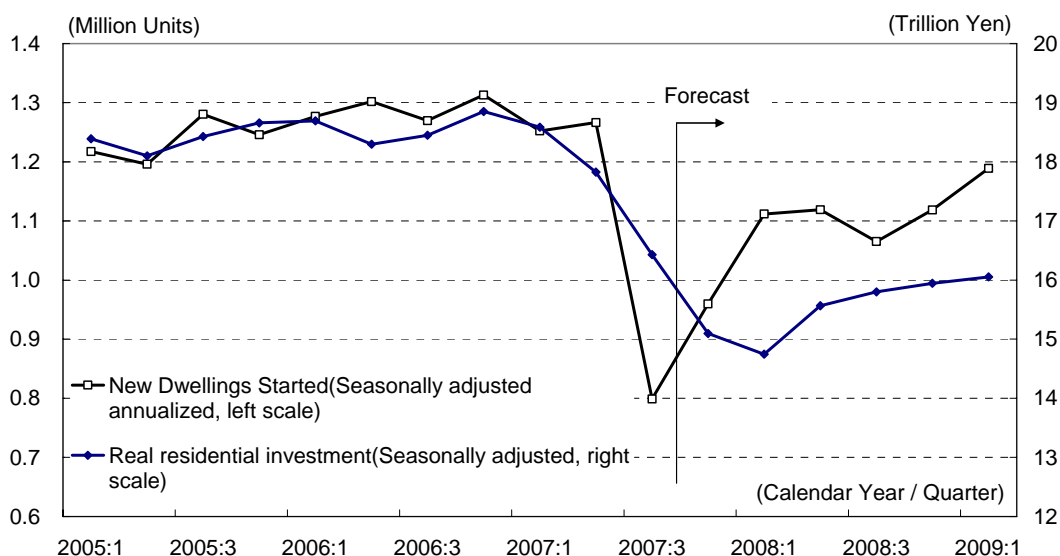
Third, after slowing sharply in FY2007, private nonresidential investment will return to a brisk pace of growth in FY2008. As inventory adjustments in information

technology-related industries have progressed and production in manufacturing industries recovered, private nonresidential investment, which showed the first rise in three quarters in the July-September quarter, will remain strong going forward, given also the fact that the trend of machinery orders (private demand ex-shipping and electric power), a leading indicator for investment in machinery, has turned up again. Construction investment has been delayed in the wake of amendments to the Building Standards Act, and the result will be an exaggerated pattern of slower private nonresidential investment in FY2007 but reacceleration again in FY2008.

Fourth, personal consumption will continue to grow sluggishly, but on a fiscal year basis on average, it will continue growing at a rather fast pace in both FY2007 and FY2008. Reflecting the deterioration in earnings by SMEs, the pace of improvement in employment will slow somewhat, meaning that improvements in wages will be further delayed. But with the beginning of 2008, nominal wages will likely turn higher on a year-on-year basis. Through both fiscal years, moreover, personal consumption will be supported by rising household dividend and interest income as well as lump-sum severance packages paid to retiring baby boomers.

Fifth, while residential investment will push down the growth rate in FY2007, it will have virtually no effect on growth in FY2008. Although residential investment will continue to slow on a sequential basis throughout FY2007, owing to the delayed impact of amendments to the Building Standards Act, it should rebound in the first half of FY2008. However, the trend of residential investment has been weak since even before the amendments. As a result, any rebound is not likely to be large, with the (negative) carryover impact of the previous year's decline having particularly strong effect (see figure).

Figure: New Dwellings Started and Real Residential Investment



Sources: Ministry of Land, Infrastructure and Transport, *Building Construction Started*;
Cabinet Office, *Quarterly Estimates of GDP*.

Main risks lie in overseas developments and wages

The risks to the Japanese economy may be identified as originating in such factors as a possible recession in the United States, an increasingly stronger yen or increasingly weak stock prices, stubbornly high crude oil prices, tighter pressure to hold down wages, and further disruptions associated with the amendment of the Building Standards Act.

If the US economy turns down, the result will not only be a decline in Japanese exports to the US. The negative impact would also extend, for example, to exports of production goods to Asian regions which themselves export finished products to the United States. Since early November, moreover, there has increasingly been a "triple flight" phenomenon. Spooked by revelations of mounting losses by financial institutions associated with the subprime mortgage problem, investors have taken refuge in low-risk assets in a flight to quality (low-risk assets), a flight away from dollar-denominated assets, and a flight to real assets such as crude oil and gold. As a result, the danger exists of bearish stock prices worldwide, further appreciation of the yen against the dollar, and higher oil prices.

Meanwhile, a look at Japan's domestic situation shows that, notwithstanding the strength in the earnings of major corporations, if pressure on wages continues, the pressures to lift the price level will fail to strengthen in terms of both labor cost and consumer demand, further delaying the Japanese economy's extrication from deflation. Moreover, there is a real danger that further turmoil associated with the amendments to the Building Standards Act will hurt SMEs. In this way, many risks have recently appeared pointing to a possible downturn in the economy. As a result, the Bank of Japan will have to be very judicious in its timing of further interest rate hikes.

Table. The Outlook for Japanese Economy

	FY2006				FY2007				FY2008				FY2006 Actual	FY2007 Forecast	FY2008 Forecast
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th			
Real gross domestic expenditures (qtr.-to-qtr.)	0.5	-0.0	1.3	0.7	-0.4	0.6	0.2	0.4	0.9	0.5	0.2	0.3	2.0	1.5	2.1
Real gross domestic expenditures (year-on-year)	2.0	1.5	2.2	2.4	1.5	2.1	1.1	0.8	2.2	2.1	2.1	1.9			
Private final consumption (qtr.-to-qtr.)	0.5	-1.0	1.1	0.8	0.2	0.3	0.2	0.5	0.6	0.2	0.2	0.7	0.7	1.6	1.6
Private housing investment (qtr.-to-qtr.)	-2.1	0.8	2.2	-1.4	-4.1	-7.8	-8.1	-2.3	5.6	1.5	0.9	0.7	0.4	-13.6	-1.1
Private non-residential investment (qtr.-to-qtr.)	3.7	0.9	2.3	-0.3	-2.1	1.7	1.4	2.1	1.6	1.7	0.1	-0.1	7.7	1.5	5.7
Private inventory investment (contribution)	-0.0	0.1	-0.1	-0.0	-0.1	0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0	-0.0	0.0
Government final consumption (qtr.-to-qtr.)	0.8	0.6	0.1	-0.2	0.4	0.3	0.4	0.1	0.2	0.2	0.2	0.2	0.9	0.9	0.9
Public fixed capital formation (qtr.-to-qtr.)	-6.0	-4.9	3.7	-1.1	-2.7	-2.6	1.0	-0.6	-1.3	-1.4	-1.0	-1.3	-9.6	-4.6	-3.7
Public inventory investment (contribution)	-0.0	0.0	-0.0	-0.0	0.0	-0.0	0.1	-0.1	0.0	0.0	0.0	-0.0	-0.0	0.0	0.0
Domestic demand (contribution)	0.6	-0.4	1.2	0.2	-0.4	0.2	0.2	0.5	0.8	0.4	0.2	0.4	1.2	0.8	1.9
Net exports of goods and services (contribution)	-0.1	0.4	0.2	0.4	0.0	0.4	0.0	-0.1	0.1	0.2	0.0	-0.1	0.8	0.8	0.3
Exports of goods and services (qtr.-to-qtr.)	0.6	2.3	1.0	3.4	0.9	2.9	0.4	0.4	2.4	2.6	0.8	0.2	8.2	7.1	6.2
Imports of goods and services (qtr.-to-qtr.)	1.2	-0.2	-0.2	0.9	0.8	0.5	0.5	1.2	2.5	2.2	0.9	1.4	3.4	2.2	6.3
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.3	-0.2	1.4	0.3	-0.3	0.3	-0.2	0.4	1.2	0.4	0.3	0.4	1.3	0.8	2.1
Domestic corporate goods price index (year-on-year)	3.1	3.6	2.6	2.0	2.4	2.0	2.3	2.4	1.0	0.5	0.8	1.0	2.8	2.3	0.9
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	0.2	0.1	0.1	0.3
Yen : Dollar exchange rate (yen / dollar)	114.4	116.1	117.7	119.4	120.8	117.9	113.0	111.8	111.4	111.2	110.5	110.1	116.9	115.9	110.8
Unemployment rate (%)	4.1	4.1	4.0	4.0	3.8	3.8	3.9	3.8	3.8	3.7	3.7	3.7	4.1	3.8	3.7
Indices of Industrial Production (qtr.-to-qtr.)	1.3	1.3	2.2	-1.3	0.2	2.2	0.4	0.6	0.9	0.9	0.3	0.5	4.8	2.7	3.2
Current account / Nominal GDP (%)	3.6	3.8	4.5	4.4	5.1	4.8	4.5	4.3	4.5	4.5	4.7	4.4	4.1	4.7	4.7
Real GDP of U.S.A. (qtr.-to-qtr.)	2.4	1.1	2.1	0.6	3.8	3.9	1.9	2.0	2.1	2.4	2.9	3.1	2.9	2.1	2.4
													(C.Y.)	(C.Y.)	(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, 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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