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SAI33 Short-Term Forecast for the Japanese Economy (2008/1-3—2010/1-3)

Gradual Recovery to Follow Current Slowdown

As consumption stalls, policy coordination may calm markets

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Although the Japanese economy displayed resilience in the second half of 2007, deteriorating corporate earnings and slower Japanese exports in the wake of the US economic slowdown have pressured private nonresidential investment even as eroding real purchasing power has undercut growth in personal consumption. As a result, the Japanese economy is likely to slow in the first half of 2008. From the second half of the year, however, the economy should gradually recover as the US economy regains its footing and Japanese exports again pick up momentum.

The nation's real GDP for the October-December quarter of 2007 grew at an annualized pace of 3.7% Q/Q, picking up speed over the July-September quarter (1.3% Q/Q) and substantially exceeding the economy's trend growth rate (generally regarded as 1.5%-2% annualized) on an annualized basis. Although residential investment and business construction investment fell in the second half of 2007 as housing starts were rolled back following enforcement of the amended Building Standards Act, the economy remained fairly resilient. However, strong growth in exports and private nonresidential investment accounted for the lion's share of this growth, and there has been no improvement in sharply contracting residential investment or the flaccid growth of personal consumption. As corporate earnings increasingly worsen on the high cost of natural resource prices and fuel, this brisk pace of private nonresidential investment is unlikely to continue. Conditions are such that, for the present, the nation's economy will have to rely on external demand mainly from emerging nations and resource-rich nations.

Consumer prices up by narrow margin

Although nominal consumer prices managed to keep rising in the October-December quarter, advancing at an annualized rate of 1.2% Q/Q, they decelerated sharply in real terms. The data show that the economy's emergence from deflation will be further delayed.

Based on these most recent data, our forecast through the end of fiscal year 2009 (April 1, 2009 through March 31, 2010) is as follows. Considering the increased risk of

economic deterioration at home and abroad, we have assumed that the only shift in monetary policy by the Bank of Japan during the forecast period will come when the BoJ likely tightens its policy target from 0.5% to 0.75% in May of 2009. Meanwhile, we have assumed that the Fed will ease its Federal Funds target from the present 3% to 2% by June of 2008. With this in mind, we believe the yen will strengthen in the first half of 2008 but slowly weaken from the second. We see the price of West Texas Crude (WTI) varying within a cyclical band of \$87 to \$92 per barrel on a quarterly average basis.

Our forecast may be summarized as follows. (1) Although the economy's real growth rate has remained above 2% for four consecutive years since FY2003 (April 1, 2003-March 31, 2004), we see it slowing modestly to between 1.5% to 1.6% in FY2007 and FY2008. (2) Owing to stubborn deflationary pressures, we now believe the anomalous inversion of the nominal versus real growth rates will not correct until FY2009. (3) The growth rate of consumer prices will return to a marginally positive trend after the temporary upturn on currently higher oil and food prices runs its course. Our forecast also anticipates a hike in the consumption tax from 5% to 8% in April of 2010, meaning that demand in anticipation of the hike will be a factor in helping growth recover the 2% level in FY2009. Specifically, we believe such anticipatory demand will contribute two tenths percent to year-on-year growth in personal consumption and one tenth percent to real growth in FY2009.

On a quarterly basis, the economic slowdown is likely to intensify in the January-March quarter of 2008, for three main reasons. First, in the wake of the US economic slowdown, there will be a decline in exports not only to the US but to Asia and Europe as well. Second, business firms will cut back on capital outlays due mainly to deteriorating earnings. Third, with no improvement on the employment and wage fronts, growth in personal consumption is likely to continue weak as consumers remain averse to higher prices on frequent purchase items such as gasoline, kerosene and food.

From US stabilization to resurgent Japanese exports

In the first half of FY2008, the economy will basically remain under pressure, but the pace of growth will pick up steam on special factors such as resurgent residential investment and business investment in construction. From the second half of FY2008, the Japanese economy should gradually return to a recovery track as exports regain momentum with the stabilization of the US economy.

Our forecasts for major economic considerations and GDP components are as follows.

First, although the US economy will continue growing slowly in the first half of 2008, it will gradually begin to recover in the wake of sharp cuts in interest rates and taxes. Amid major declines in residential investment, personal consumption

expenditures have been falling since the October-December quarter of 2007 in the context of falling housing prices, tumbling stock prices and slowing employment. Given these circumstances, the Fed will likely move quickly to slash the Federal Funds rate to 2% as it aims for a negative policy target in real terms. To this will be added the impact of a tax cut totaling up to \$168 billion, such that the US economy should gradually recover from the second half of 2008.

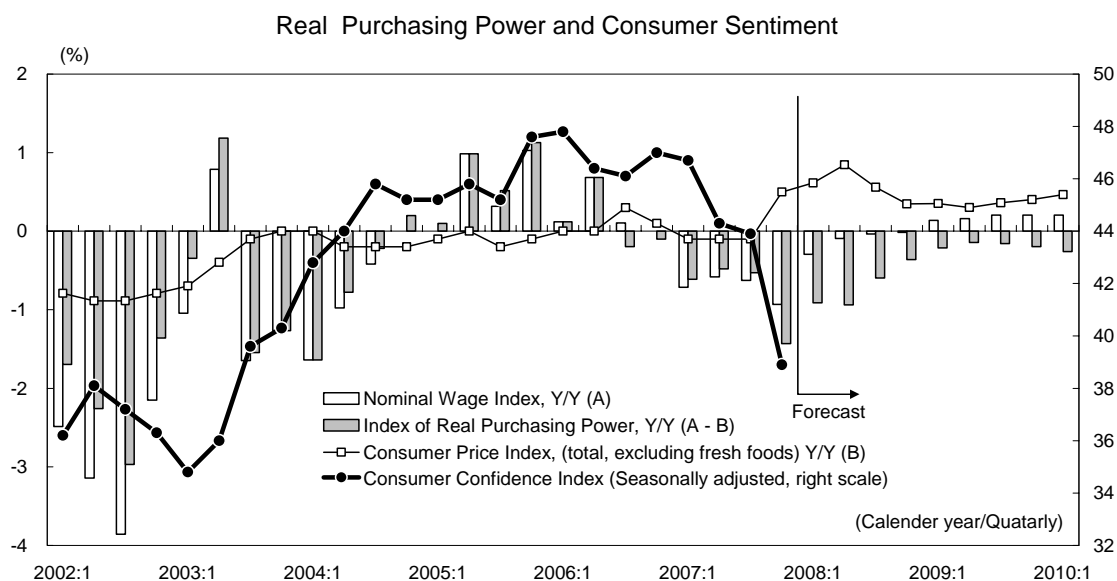
Second, although Japanese exports will inevitably slow modestly in FY2008, they should gradually recover in FY2009. As European and Chinese exports weaken and the global economy slowly loses momentum in 2008, the strong yen will add to the headwinds pressuring Japanese export growth in FY2008. However, exports primarily of transport and construction machinery to emerging and resource-rich nations should remain firm enough to keep exports rising. Exports should accelerate further with the recovery of the American economy in FY2009.

Third, after a the rapid slowdown of FY2007, private nonresidential investment should gradually recover. It will basically remain under pressure in FY2008 as earnings of small and medium size firms in particular continue deteriorating. But since corporate construction investment is seen bouncing back, the pace of growth in FY2008 will be comparatively high. The turnaround in private nonresidential investment will become all the more salient in FY2009 as growth picks up in exports and production in tandem with an economic recovery in the United States.

Fourth, personal consumption continues to grow slowly on the ongoing decline in real purchasing power. While the year-on-year erosion in nominal wages per person continues to intensify, prices on frequent purchase items continue rising. The index of real purchasing power of households is defined as the difference between the year-on-year change in nominal wages versus the year-on-year change in consumer prices (ex-perishables), and recently it has been deteriorating rapidly. A look over the long term, moreover, shows that the consumer sentiment index, which gauges the economic attitude of consumers, has been moving in tandem with the household real purchasing power index (see diagram).

According to our forecast, nominal wages will turn up marginally from FY2008, but the gain will not be sufficient to offset the rise in prices. Real purchasing power will therefore continue to fall. As a result, any improvement in consumer sentiment will be limited, and any growth in personal expenditures from and after FY2007 will be modest.

Fifth, the rebound in residential investment from the sharp decline in FY2007 will not be significant. A bounce in residential investment has been evident in the first half of FY2008, but reflecting such factors as the sluggish sales of condominiums, the size of this rebound will be small. At most residential investment will no longer be a negative factor in growth in FY2008 and will only contribute to growth from FY2009.



Note: A rise in the Consumer Sentiment Index indicates an improvement in economic sentiment while a decline indicates a deterioration.

Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*;
Ministry of Health, Labor and Welfare, *Monthly Labor Survey*; Cabinet Office, *Consumer Confidence Survey*.

Monoline rescue and possible government bailout

Production activity will be stagnant during the near-term slowdown, but we expect this to be of short duration and see only a small chance of the Japanese economy entering a formal recession. Nevertheless, that possibility is indeed increasing owing to mounting risks, including a possible recession in the US, sharply higher crude oil prices, further strength in the yen or weakness in equity prices, increased pressure on wages, or a slowdown in the Chinese economy after the Beijing Olympics owing to excessively tight credit. In the United States recently in particular, there have been concerns about possible downgrades of credit ratings of monoline insurance companies and the financial products which they guarantee, undermining any idea as to when losses associated subprime loans (mortgage loans to individuals with poor credit) by financial institutions will ultimately be resolved. It is therefore necessary to remain vigilant against the risk that financial market turmoil associated with these problems may not only adversely impact the economy but, through the movement of investment capital, exacerbate problems such as the strong yen, weak equity prices and high crude oil prices.

Avoiding such a scenario will require that monetary authorities in the major industrialized nations maintain coordinated efforts to calm international financial markets by ensuring adequate liquidity and other means. Considering the fact that the monoline insurers guarantee a large number of municipal bonds, one option in the event of significant adverse impact may unavoidably be for the US government to mobilize taxpayer funds to shore up the capital of monoline insurers in a manner that avoids creating any moral hazards.

Table. The Outlook for Japanese Economy

	Forecast												FY2006 Actual	FY2007 Forecast	FY2008 Forecast	FY2009 Forecast
	FY2007 1st Qtr	2nd	3rd	4th	FY2008 1st Qtr	2nd	3rd	4th	FY2009 1st Qtr	2nd	3rd	4th				
Real gross domestic expenditures (qtr.-to-qtr.)	-0.4	0.3	0.9	-0.1	0.4	0.4	0.5	0.5	0.4	0.5	0.5	0.9	2.4	1.5	1.6	2.0
Real gross domestic expenditures (year-on-year)	1.7	1.7	2.0	0.7	1.5	1.7	1.2	1.9	1.8	1.8	1.9	2.3				
Private final consumption (qtr.-to-qtr.)	0.2	0.1	0.2	0.3	0.4	0.2	0.1	0.4	0.3	0.2	0.0	0.9	1.7	1.2	1.0	1.1
Private housing investment (qtr.-to-qtr.)	-4.4	-8.3	-9.1	-2.9	6.1	1.4	0.9	1.3	0.3	0.6	1.2	3.1	0.2	-14.7	-1.8	4.0
Private non-residential investment (qtr.-to-qtr.)	-1.5	1.1	2.9	0.4	0.4	0.5	1.1	1.2	1.0	1.1	0.9	1.2	5.7	1.5	3.7	4.2
Private inventory investment (contribution)	-0.1	-0.1	0.1	-0.1	0.0	0.1	0.1	-0.0	0.0	-0.0	0.0	-0.0	0.2	-0.1	0.0	0.0
Government final consumption (qtr.-to-qtr.)	0.3	0.1	0.8	-0.1	0.2	0.4	0.4	0.2	0.1	0.2	0.3	0.1	0.1	0.9	1.1	0.9
Public fixed capital formation (qtr.-to-qtr.)	-4.2	-1.9	-0.7	-0.3	-0.2	-0.9	-1.5	0.1	-0.3	-0.6	-0.4	-2.0	-9.1	-2.5	-2.6	-2.3
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	0.0
Domestic demand (contribution)	-0.5	-0.2	0.5	-0.0	0.5	0.3	0.4	0.5	0.3	0.3	0.2	0.7	1.6	0.4	1.2	1.5
Net exports of goods and services (contribution)	0.1	0.5	0.4	-0.0	-0.0	0.1	0.1	0.0	0.0	0.2	0.3	0.2	0.8	1.1	0.4	0.5
Exports of goods and services (qtr.-to-qtr.)	1.1	2.9	2.9	0.0	0.5	1.6	1.7	1.2	1.0	1.8	2.1	2.3	8.4	8.6	5.2	6.2
Imports of goods and services (qtr.-to-qtr.)	0.5	-0.1	0.5	0.4	1.1	1.3	1.6	1.5	1.1	0.9	0.9	1.7	3.1	1.5	3.9	4.9
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.5	0.1	0.3	-0.3	0.7	0.4	0.5	0.6	0.5	0.5	0.6	1.1	1.6	0.7	1.4	2.2
Domestic corporate goods price index (year-on-year)	1.7	1.6	2.3	2.5	1.4	0.8	0.6	0.8	0.9	0.8	0.6	0.6	2.1	2.0	0.9	0.7
Consumer price index (year-on-year)	-0.1	-0.1	0.5	0.6	0.8	0.6	0.3	0.4	0.3	0.4	0.4	0.5	0.1	0.2	0.5	0.4
Yen : Dollar exchange rate (yen / dollar)	120.8	117.9	113.2	107.0	104.4	105.5	107.3	108.2	108.6	108.3	109.6	111.1	116.9	114.7	106.4	109.4
Unemployment rate (%)	3.8	3.8	3.9	3.9	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.6	4.1	3.8	3.8	3.7
Indices of Industrial Production (qtr.-to-qtr.)	0.2	2.2	1.3	-1.1	0.0	1.0	1.4	1.1	0.5	0.2	0.8	1.6	4.8	2.6	2.1	3.3
Current account / Nominal GDP (%)	5.1	4.8	5.1	4.1	4.2	4.3	4.8	4.5	4.6	4.7	5.2	5.0	4.1	4.8	4.5	4.9
Real GDP of U.S.A. (qtr.-to-qtr.)	3.8	4.9	0.6	0.9	1.1	1.6	2.4	2.7	3.1	2.7	2.8	3.0	2.9	2.2	1.8	2.5
													(C.Y.)	(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 is at 2000 base.
 4. Figures for consumer price index (general, excluding fresh foods) and domestic corporate goods price index are 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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