May 2008

SA134 Short-Term Forecast for the Japanese Economy (2008/4-6—2010/1-3)

Slow growth and high prices to continue for present

Earnest recovery in FY2009-2010, but monetary authorities face treacherous path

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- High resource prices draining national income and lifting prices of goods
- FY2008: Shrinking corporate earnings undercutting investment growth
- FY2009: Exports to pick up again on US economic recovery

In the January-March quarter of 2008, real gross domestic product (GDP) grew at an annualized pace of 3.3% quarter-to-quarter (Q/Q), exceeding the potential growth rate (generally regarded as 1.5%-2% annualized) as it did in the October-December 2007 quarter (in which it advanced by 2.6% annualized). The robust pace of growth in the January-March quarter may be attributed primarily to such factors as resurgent exports (mainly) to emerging and resource-rich nations and to the strongest growth in personal consumption in five quarters fueled by a year-on-year rise in nominal wages resulting from a higher ratio of regular employees and other factors.

However, one could also say that the strength of the GDP data is inconsistent with the figures on industrial production (which suggest that the economy has entered a soft patch), as well as various polls showing that both consumers and business managers have grown more pessimistic in their economic outlook. No doubt growth was in part lifted somewhat by special factors such as the impact of the leap year and the fading of turmoil associated with the enforcement of the amended Building Standards Act. At the same time, private nonresidential investment declined for the first time in three quarters, reflecting the deterioration of corporate earnings owing to the high cost of raw materials and fuel.

One more factor may be cited as contributing to the divergence between the real GDP growth rate and economic sentiment, namely the fact that much of the nation's domestic income has flowed out of the country due to rising prices for imported fuel and raw materials and to the deteriorating profitability of exports following from the stronger yen. A look at Japanese companies overall shows they are paying more and more to overseas suppliers of crude oil and other commodities due to rising prices for imports. Due to the stronger yen, meanwhile, yen-denominated export prices obtained from overseas are declining.

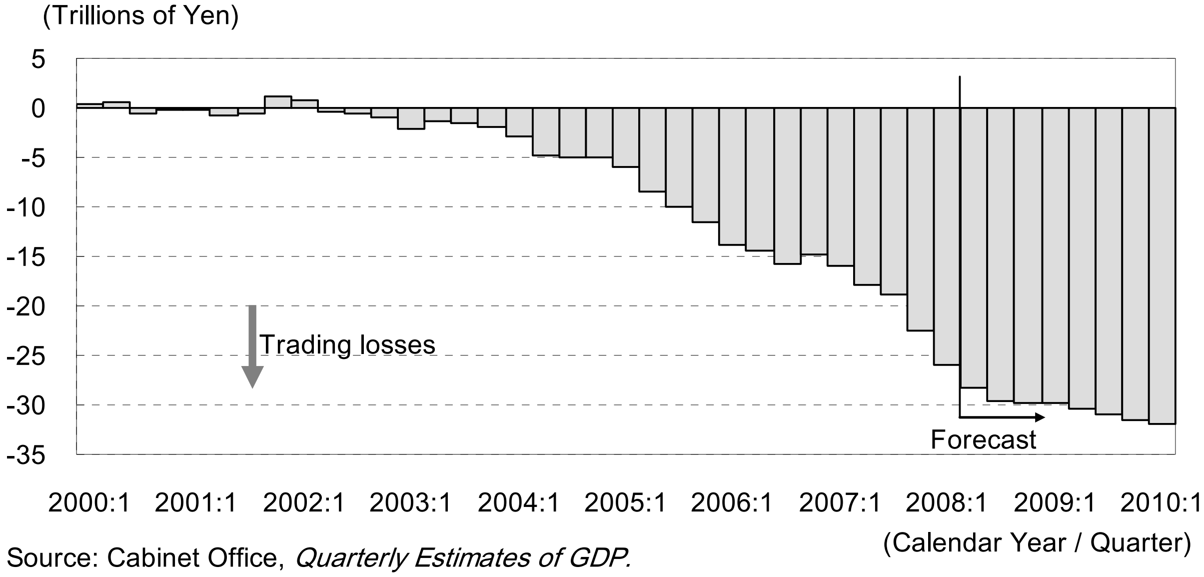
Such changes in payments to and from foreign sources which arise from changes in import and export prices are known as trading gains or losses. As Figure 1 shows, Japan experienced an annualized net outflow of 25.9 trillion yen in the January-March quarter, which amounts to 4.6% of real GDP. In short, a look at the Japanese economy as a whole shows that income valued at just under 5% of real GDP was drained out of the country in the January-March quarter owing to the strong yen and rising prices for imported raw materials and fuels. Corporate earnings have also been pressured in direct proportion.

In addition, rising import costs caused by the spike in the price of imported fuels and raw materials and the decline in the prices for Japanese exports associated with the stronger yen have pushed down the GDP deflator. The margin of year-on-year decline in the GDP deflator therefore grew further in the January-March quarter (see Figure 2). As a result, the nominal growth rate (1.5% annualized), which is regarded as more closely correlated to economic sentiment, fell well below the real growth rate.

Given the present economic climate and changes in the environment affecting the economy, we have reviewed our forecast for the Japanese economy through fiscal year 2009 (April 2009-March 2010). Compared with our forecast as of last February, we have also raised our projection for the price of oil in FY2008 and FY2009 by just under thirty dollars per barrel.

As a result, net outflows representing trading losses in FY2008 are much higher compared to our previous forecast. Meanwhile, since the higher cost of raw materials and fuel will eventually be passed on in the form of higher prices, the margin of

Figure 1. Trading Gains and Losses



Source: Cabinet Office, *Quarterly Estimates of GDP.*

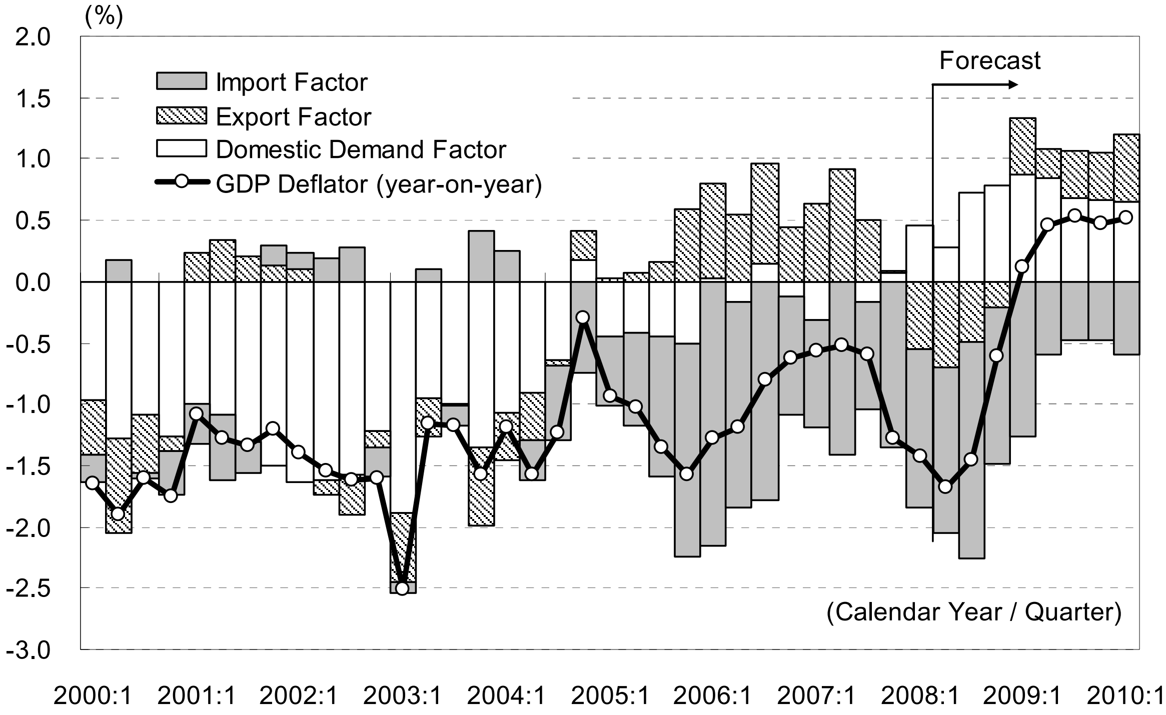
year-on-year increase in the domestic demand deflator for FY2008 is much larger compared to our previous forecast. The hallmark of our present forecast lies in its severe assessment: even as the drain of income out of Japan in FY2008 has greatly increased, bringing substantial downside pressures to bear on the economy, the rising trend of domestic prices is increasingly pronounced.

In our previous forecasts, we anticipated an increase in the consumption tax rate from 5% to 8% in April of 2010, which would lift real GDP in FY2009 by a tenth of a percentage point as consumers stepped up consumption ahead of the hike. In view of the recent political climate, however, we have abandoned any expectation of a hike in the consumption tax this time around.

Our present forecast may be summarized as follows: (1) the real growth rate will likely rise from 1.5% in FY2007 to just 1.6% in FY2008 and 1.8% in FY2009, within the economy's potential rate of growth. (2) The nominal growth rate will rise from 0.6% in FY2007 to 2.3% in FY2009. (3) The pace of increase in consumer prices (nationwide prices as a whole, ex-fresh foods) will rise from 0.3% in FY2007 to 1.1% in FY2008 and then slow to 0.8% in FY2009.

From our forecast of the real economic growth rate, it may appear that stable growth will continue in FY2008 and FY2009. However, the contribution of the overhang from the close of FY2007 to the real economic growth rate for FY2008 will be

Figure 2. Contributions to GDP Deflator by Components (Y/Y Changes)



Source: Cabinet Office, *Quarterly Estimates of GDP.*

substantial (meaning that FY2008 growth could be as much as 1.1% even if the future growth rate remains flat), which implies that the growth rate within FY2008 as a whole is not likely to rise much. Since the nominal growth rate will also remain sluggish (0.7% in FY2008), sentiment about the outlook for growth in FY2008 is likely to further deteriorate.

We anticipate, however, that oil prices will stop rising, and that the year-on-year growth rate of the GDP deflator will turn positive in the January-March quarter of 2009. As a result, the inversion of nominal and real growth rates will correct (with the rate of nominal growth once again exceeding that of real growth) as the economy mounts a solid growth track.

Based on the above forecast, we believe central banks around the world will remain on hold for about the next year, after which time they will switch to a moderately tightening mode. For while there may be some variance among them, central banks in Japan, the US and Europe are concerned about the dilemma presented by slowing economies amid rising prices.

Reflecting the belief that the Federal Reserve is now on hold, we anticipate that the yen will weaken against the dollar gradually.

Our forecasts for GDP components and other major factors are as follows.

First, personal consumption in the US is clearly slowing against a background of falling real purchasing power caused by deteriorating employment conditions and rising energy prices. In addition, the correction in the housing market will necessarily be drawn out. Although economic sluggishness will therefore continue, the US economy will gradually regain its footing again towards the end of 2008, helped by the impact of easing by the Fed, tax cuts, and rising exports on the weaker dollar.

Second, economies will gradually begin to slow not only in Europe and China but in emerging and resource-rich countries as well as monetary authorities become more hawkish in the face of rising inflation fears in 2008. However, given the large overhang from FY2007, Japanese exports will still grow at the rate of 5.4% in FY2008 in real terms even if they remain flat from and after the April-June quarter, and partly for this reason, they will maintain a higher rate of growth in FY2008 as well. Exports are likely to pick up steam in FY2009 as the US economy regains its footing.

Third, after turning down in FY2007, private nonresidential investment will grow slowly in FY2008 and FY2009 as corporate earnings in FY2008 decline for the first time in seven years. As with employment and inventories, however, the pressure for retrenchment in private nonresidential investment will be mild, and a continued advance will be maintained.

Fourth, personal consumption in the first half of FY2008 will stabilize after pulling back in reaction to the previous term. However, it will not accelerate owing to the decline in real purchasing power resulting from sluggish growth in nominal wages and price increases in frequently purchased items.

In addition to the present weakness in industrial production, there is a mounting plethora of potential downside risks to the economy, including the possibility of further rises in crude oil prices, extended weakness in the US economy, a return to a stronger yen and falling stock prices, increased reluctance by business firms regarding private nonresidential investment and wages as they face deteriorating earnings, and a possible rapid slowdown in emerging and resource-rich economies owing to tighter monetary policy. Considering all these threats, one could say the chances for a recession have increased. However, so long as these downside risks to the economy do not actually transpire, the present slowdown will remain just a "soft patch," and the economy should be able to avoid recession.

But given the rise in the prices of imported raw materials such as grains and of fuels such as crude oil, the nation now simultaneously faces downside pressure on the economy and upward pressure on prices, two kinds of pressure which normally require incompatible responses. If the downside pressures on the economy strengthen, the BoJ would need to relax monetary policy, but if that should result in excessive liquidity flooding the economy, it could flow into commodity futures markets, push up the prices of crude oil and grain and in turn exacerbate downward pressure on the economy and upward pressure on prices. Japanese monetary authorities will therefore need to steer an ever more judicious course through increasingly treacherous waters.

Table. The Outlook for Japanese Economy

Forecast →

	FY2007 1st Qtr	2nd	3rd	4th	FY2008 1st Qtr	2nd	3rd	4th	FY2009 1st Qtr	2nd	3rd	4th	FY2007 Actual	FY2008 Forecast	FY2009 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.6	0.3	0.6	0.8	0.2	0.2	0.5	0.2	0.4	0.4	0.8	0.7	1.5	1.6	1.8
Real gross domestic expenditures (year-on-year)	1.8	1.7	1.7	1.0	1.9	1.8	1.7	1.1	1.3	1.6	1.8	2.3			
Private final consumption (qtr.-to-qtr.)	0.2	0.0	0.4	0.8	0.1	0.1	0.4	0.3	0.4	0.2	0.5	0.5	1.4	1.2	1.4
Private housing investment (qtr.-to-qtr.)	-4.5	-8.0	-9.2	4.6	4.1	4.2	1.8	-0.2	-0.9	0.2	1.2	0.7	-13.3	4.3	1.7
Private non-residential investment (qtr.-to-qtr.)	-3.1	0.9	0.9	-0.9	0.3	0.5	0.8	0.5	0.6	0.7	1.1	0.8	-0.5	1.3	2.8
Private inventory investment (contribution)	-0.1	-0.1	0.1	-0.1	-0.0	0.0	0.0	0.0	-0.0	0.0	-0.0	0.0	0.0	-0.0	0.0
Government final consumption (qtr.-to-qtr.)	0.1	0.2	0.8	-0.8	0.8	0.2	0.7	-0.7	0.4	0.2	0.7	-0.7	0.6	1.0	0.6
Public fixed capital formation (qtr.-to-qtr.)	-3.7	-1.4	0.6	1.5	-2.4	-4.0	-1.2	2.5	-1.2	-2.7	-0.9	0.9	-1.7	-4.3	-3.2
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)	-0.7	-0.2	0.3	0.3	0.2	0.1	0.5	0.2	0.3	0.2	0.5	0.4	0.3	1.0	1.3
Net exports of goods and services (contribution)	0.1	0.5	0.3	0.5	-0.0	0.0	0.0	0.0	0.1	0.2	0.3	0.3	1.2	0.6	0.5
Exports of goods and services (qtr.-to-qtr.)	1.2	2.9	2.6	4.5	0.1	0.5	0.7	1.0	1.6	2.1	2.6	3.1	9.7	6.5	6.6
Imports of goods and services (qtr.-to-qtr.)	0.7	-0.0	1.0	2.0	0.4	0.6	0.9	1.4	1.4	1.2	1.6	2.0	2.3	3.7	5.4
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.8	0.1	-0.1	0.4	-0.1	0.2	0.7	0.5	0.4	0.5	0.9	1.0	0.6	0.7	2.3
Domestic corporate goods price index (year-on-year)	1.8	1.6	2.4	3.4	3.2	2.8	2.7	1.9	1.4	1.2	1.3	1.5	2.3	2.7	1.3
Consumer price index (year-on-year)	-0.1	-0.1	0.5	1.0	1.2	1.1	1.0	1.0	0.9	0.7	0.8	0.8	0.3	1.1	0.8
Call rate (Uncollateralized, Overnight, %)	0.51	0.50	0.50	0.51	0.50	0.50	0.50	0.50	0.62	0.75	0.86	1.00	0.50	0.50	0.81
WTI Crude oil price (dollar / barrel)	65.0	75.2	90.5	97.8	117.7	120.1	117.6	117.9	116.5	120.7	117.0	114.5	82.1	118.3	117.2
Yen : Dollar exchange rate (yen / dollar)	120.8	117.9	113.2	105.2	103.7	103.8	104.5	105.0	105.0	106.4	107.4	108.7	114.2	104.2	106.8
Unemployment rate (%)	3.8	3.8	3.8	3.8	3.8	3.7	3.8	3.8	3.8	3.6	3.6	3.6	3.8	3.8	3.7
Indices of Industrial Production (qtr.-to-qtr.)	0.6	1.7	0.9	-0.7	0.2	0.2	0.8	0.8	0.8	0.7	1.0	1.0	2.6	1.3	3.2
Current account / Nominal GDP (%)	5.0	4.9	4.9	4.4	4.3	4.3	4.6	4.7	4.7	4.8	4.6	4.7	4.8	4.4	4.7
Real GDP of U.S.A. (qtr.-to-qtr.)	3.8	4.9	0.6	0.6	0.2	0.6	0.9	1.7	1.9	2.3	2.8	3.5	2.2 (C.Y.)	1.2 (C.Y.)	1.5 (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 consumer price index, domestic corporate goods price index and indices of industrial production are at 2005 base.
4. Figures for GDP components, unemployment rate, indices of industrial production and current account are seasonally adjusted.
5. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2000) dollars.

(The original Japanese article appeared in the May 23, 2008 issue of the Nihon Keizai Shimbun)

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