

Monthly Report of Prospects for Japan's Economy

August 2008

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

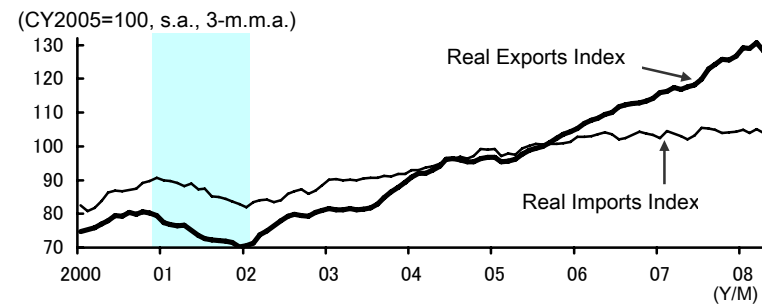
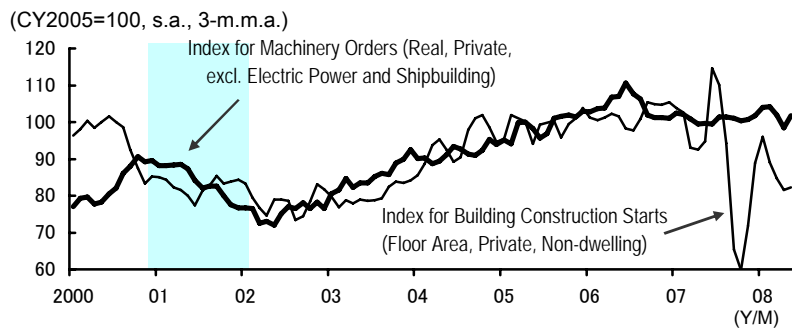
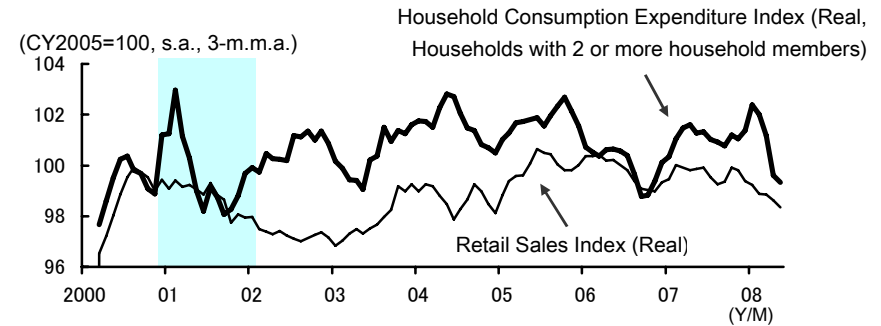
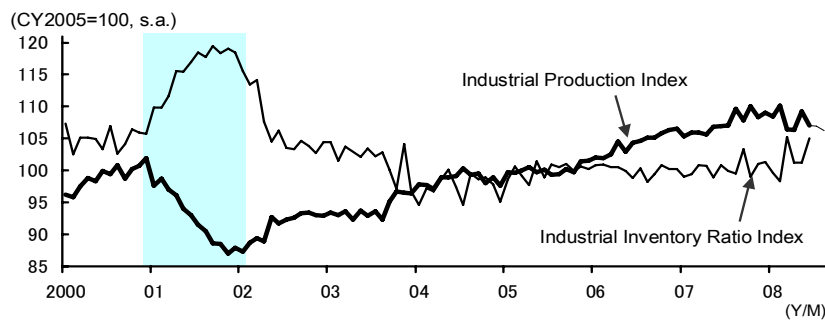
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This report is the English version of the July 2008 issue of the original Japanese version.

Current situation of Japan's economy – Decelerating visibly in corporate and household sector

The recent trend of deceleration of Japan's economy has become more noticeable both in the corporate sector and in the household sector. It is estimated that the real GDP growth rate during the second quarter of this year fell to a level of slightly above zero. This appears to be reflecting the following factors: (i) a softening of private consumption expenditure against the background of price rises. The diffusion index for current conditions in the Economy Watchers Survey by the Cabinet Office also continues to indicate the declining tendency. (ii) A slowdown in the pace of increase in exports as a whole, mainly due to a deceleration in exports to the US and European countries. (iii) A decrease in business fixed investment, reflecting a fall in corporate profits.

Figure 1 Main Indicators for Japan's Economy



Source: The Ministry of Economy, Trade and Industry, The Ministry of Internal Affairs and Communications, The Cabinet Office, The Ministry of Land, Infrastructure and Transport, The Bank of Japan.

Note 1: Indices of industrial production and industrial inventory ratio are seasonally adjusted on a monthly basis. Others are calculated as seasonally adjusted and 3-month moving averages.

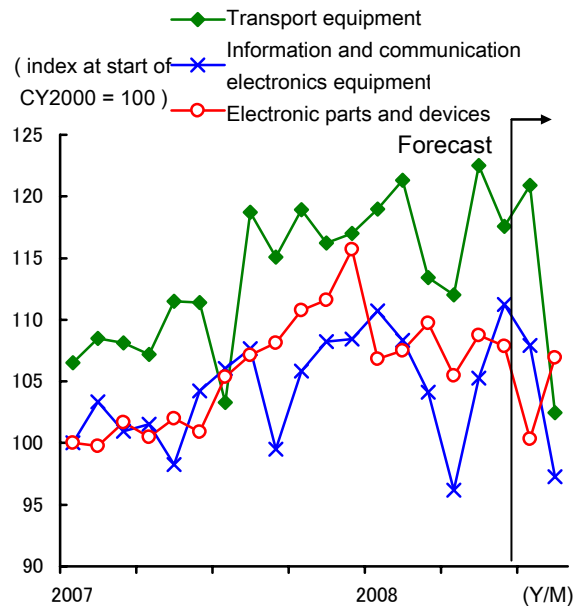
2: The industrial production index in July and August 2008 is based on METI forecasts. 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Production in manufacturing – Has been softening; futher downside risk remains

The production index in manufacturing declined in the April-June period over the previous quarter, a second consecutive quarterly decline. In addition, the forecast index for July and August indicates a slight decline. Therefore, it is possible that manufacturing production will see a further decline in the July-September quarter as well. Viewed by industry, a noticeable fall has been seen in transport equipment, information and communication electronics equipment, and electronic parts and devices, against the following background: (i) a lowered driving force of digital appliances. The production of liquid crystal TVs and digital still cameras has been levelling off. Also, (ii) a slowdown of exports of motor vehicles against the background of the high price of petrol.

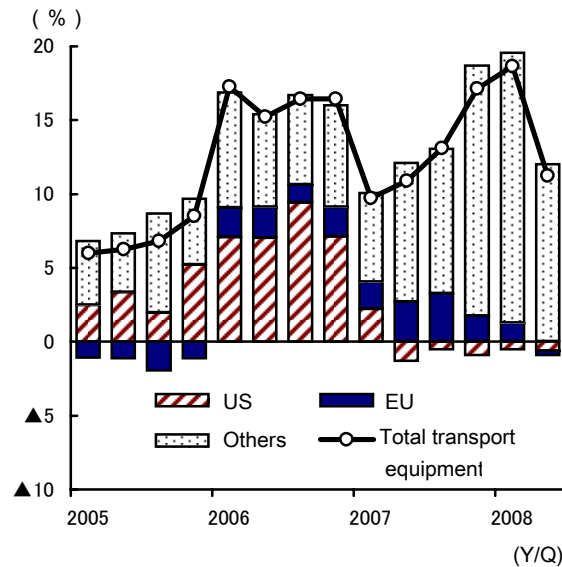
Further, it also should be noted that the amendment ratio for July was considerable. Accordingly, there could be significant risk that actual manufacturing production could be revised downwards further from the forecast.

Figure 2-1 Industrial Production by Industry
<seasonally adjusted>



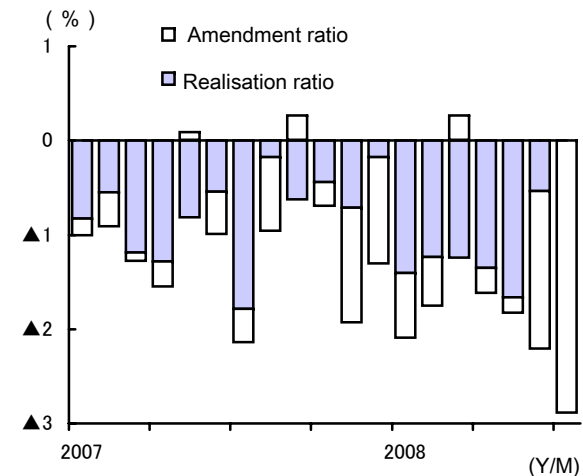
Source: The Ministry of Economy, Trade and Industry.

Figure 2-2 Real Exports of Transport Equipment by Destination
<year-on-year % change>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.

Figure 2-3 Revision Ratios in Production Forecast Indices



Source: The Ministry of Economy, Trade and Industry.

Note : Realisation ratio = Actual figure of the previous month in the current survey / Estimate of the previous month in the previous survey × 100 - 100

Amendment ratio = Estimate of the current month in the current survey / Estimate of the current month in the previous survey × 100 - 100

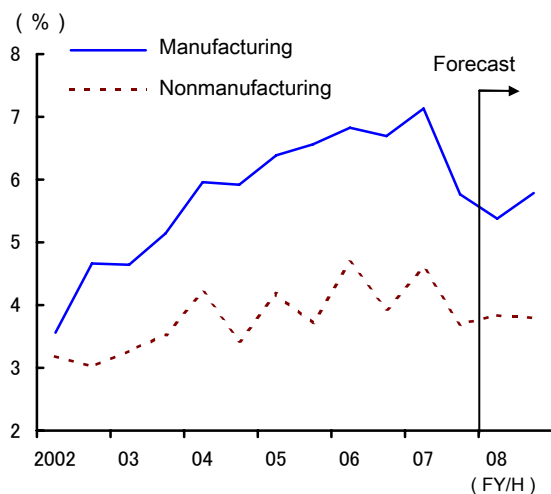
Business conditions in Tankan survey – Worsened sentiment, yet still firmness in demand

The Tankan June 2008 survey by the BOJ indicated that business sentiment continued to deteriorate. This is mainly due to the negative trend that further rises in raw materials prices have been weighing on corporate profits heavily. The pace of increase in raw materials prices has been so rapid that the ratio of current profits in sales has fallen sharply, although a certain number of enterprises have been passing on the increased costs to their final product prices gradually and their sales amount has tended to increase.

Viewed by industry, the diffusion index (DI) of "favourable" minus "unfavourable" for current business conditions deteriorated significantly in manufacturing. The DIs in basic materials such as iron and steel and petroleum products, which have been directly hit by resource price rises, worsened especially. The DIs in the processing industry also declined, mainly in motor vehicles reflecting a price rise in steel products.

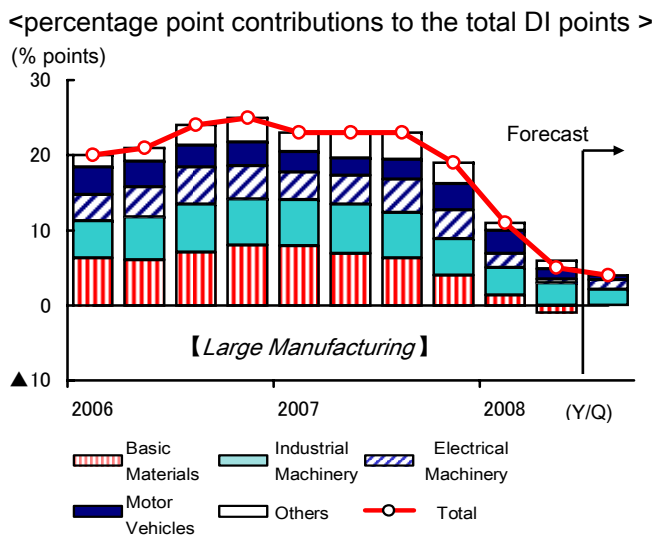
In spite of deteriorating business sentiment, the Tankan survey also showed a firmness in domestic and overseas demand as a whole. The DIs of "excess demand" minus "excess supply" for supply and demand conditions for products both in the domestic market and the overseas market have been almost flattening out. In addition, the share of enterprises in total large manufacturing which responded "unfavourable" to the current business conditions survey was still at a low level compared with those in past recessionary phases.

Figure 3-1 Ratio of Current Profits in Sales in Large Enterprises by Type of Industry



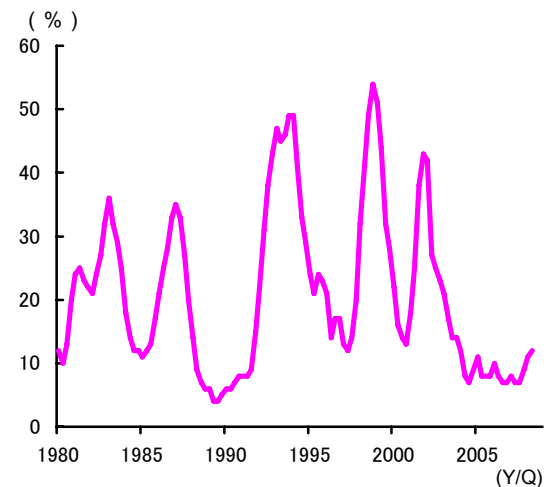
Source: The Bank of Japan, "Tankan Surveys".

Figure 3-2 Contributions to Business Conditions Diffusion Index by Industry



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan June 2008 Survey".

Figure 3-3 Share of Enterprises which Responded "Unfavourable" to Business Conditions Survey in Total Large Manufacturing



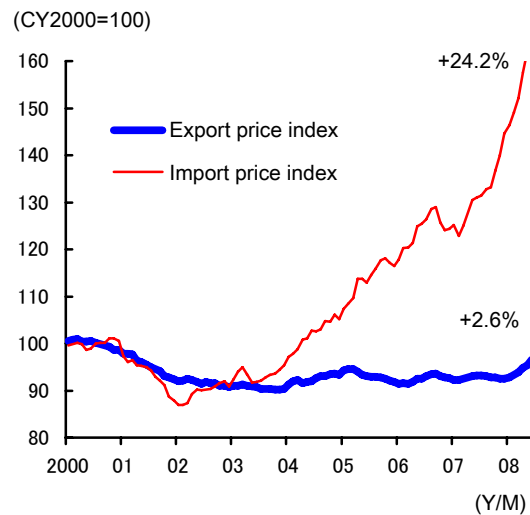
Source: The Bank of Japan, "Tankan Surveys".

Higher resource prices - Increasing income shift to overseas due to import price rises

Higher resource prices have been bringing about an increasing income shift from Japan to overseas due to import price rises. The shift is estimated to have reached an annualised 12 trillion yen during the January-March quarter this year, the equivalent of 2.4 per cent of nominal GDP. The shift amount will likely continue to increase because the oil price is still rising.

The increase in the income shift would have the following influences on the economy: (i) a decrease in trade surplus. Although real net exports are at a considerably positive level, trade surplus has shown a shrinking trend. Also, (ii) a weakened virtuous circle for the economy. Almost all of the increased costs caused by import price rises are estimated to be absorbed in the corporate sector, because the degree to which enterprises can pass on the costs to their final product prices appears to be limited in the aggregate. This has caused a sharp decline in the ratio of current profits in sales. Moreover, the move could undermine a virtuous circle for the economy such as "an increase in corporate profits → an increase in workers' total cash earnings and business fixed investment", which could lead to a lag in the recovery pace of private consumption and business fixed investment.

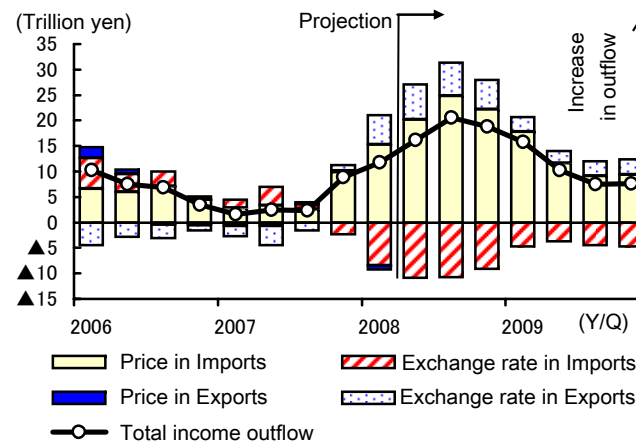
Figure 4-1 Export and Import Price Indices
<on a contract currency basis>



Source: The Bank of Japan.

Note: The figure above each line is the year-on-year percentage change for May 2008.

Figure 4-2 Contribution of Each Factor of Price and Exchange Rate Changes to Total Income Shift to Overseas
<on an annualised % change basis>

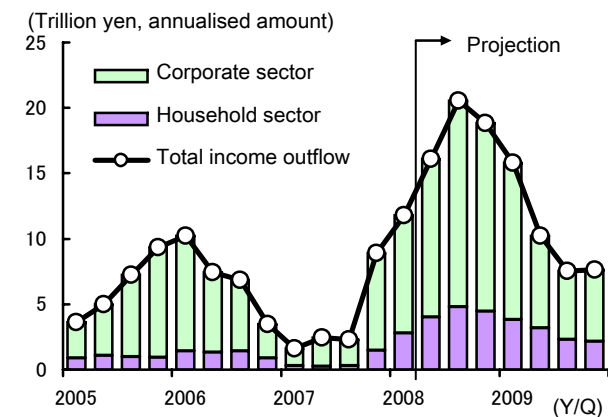


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.

Note 1: Prices are on a contract currency basis.

2: Plus % change indicates income outflow to overseas, and minus % change indicates income inflow from overseas.

Figure 4-3 Contribution of the Financial Burden of Each Sector to Total Income Shift to Overseas
<on a seasonally adjusted, annualised basis>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan, The Ministry of Internal Affairs and Communications.

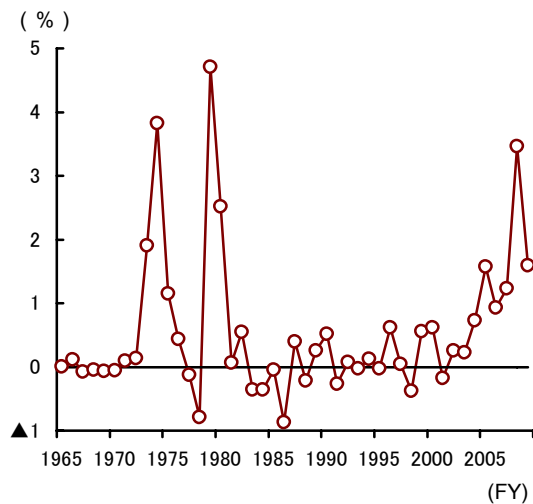
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Higher resource prices - Worsening terms of trade (export prices / import prices)

Just taking into account the following two is enough to predict that the coming moves in resource prices will have significant influences on the prospect of Japan's economy: (i) an estimated considerable impact. Viewed by the ratio to nominal GDP of the amount of income shift to overseas due to import price rises, the total magnitude during the FY2005 to FY2009 period is estimated to exceed that of the period of both the first oil shock and the second oil shock. (ii) A relatively serious negative influence. Japan has a high import dependence of resources, which could bring about a more significant worsening of terms of trade (export prices / import prices) due to resource price rises than other developed countries. This condition could make the negative influence on the domestic economy more serious.

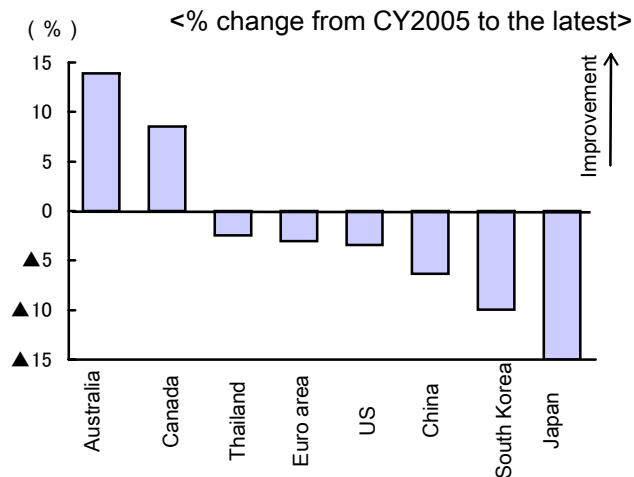
Accordingly, it is important to pay more attention to the following indices which can reflect more directly the influences of resource price rises on the economy, while real GDP is on a quantity basis and has kept a relatively firm trend: (i) nominal GDP. It is projected that Japan's nominal GDP will not grow during the two fiscal years to come, against the background of a considerable decline in the GDP deflator mainly due to a rise in the deflator of imports. (ii) Real GDI (Gross Domestic Income). It is projected that the real growth rate of GDI, which indicates real GDP minus an income increase or decrease due to the change of terms of trade, will turn negative during the same period.

Figure 5-1 The Ratio of Total Income Shift to Overseas to Nominal GDP of Japan



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

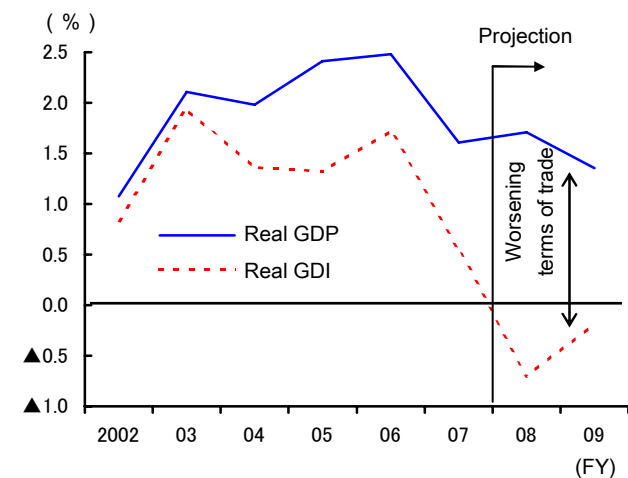
Figure 5-2 The Change in Terms of Trade (export prices / import prices)



Source: The Japan Research Institute, Ltd. based on the data of the statistics of each country.

Note: The figure of China is based on a customs clearance basis. Others are based on a GDP basis.

Figure 5-3 Real GDP Growth Rate and Real GDI Growth Rate



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

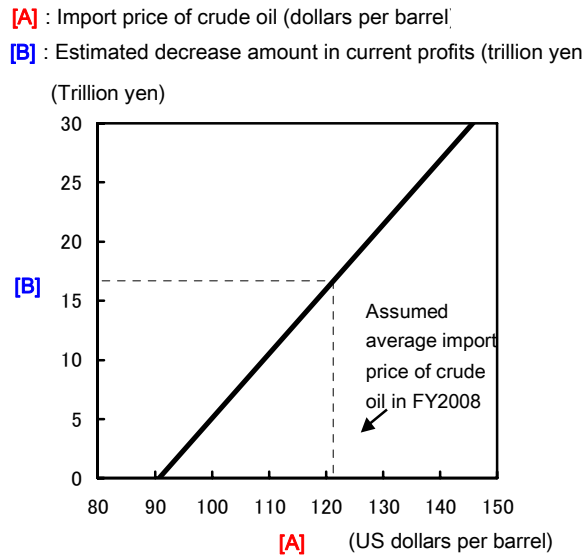
Higher resource prices - Profit fall could bring business fixed investment to adjustment phase

Almost all of the increased costs caused by the rise in raw material prices are estimated to be absorbed in the corporate sector as almost all enterprises have difficulty passing on the increased costs to their final product and service prices, although a certain number of enterprises have been passing on the costs gradually. In addition to the increased costs, sales amount growth in the aggregate is expected to decelerate. Therefore, it is projected that current profits will fall further on a year-on-year basis. Especially, it is expected that profits among small and medium-sized enterprises, the profit base of which is still fragile compared with large enterprises, could decline considerably.

Further, the profit fall could bring business fixed investment into a mildly declining phase, reflecting a cautious attitude of enterprises to investment. In addition, it is expected that business failures will increase, mainly among small and medium-sized enterprises.

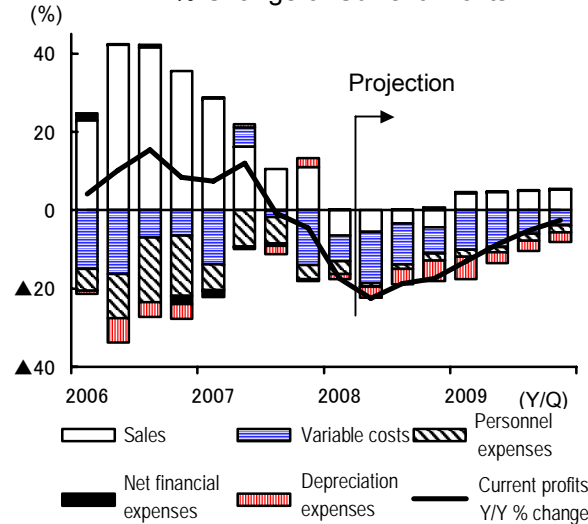
Moreover, a sharper rise than currently expected in the price of crude oil could bring about more serious negative influences. It is estimated, for example, that the situation where the crude oil price continues to stay at a level of 150 dollars a barrel could halve the total current profit amount of Japan's enterprises during FY2008.

Figure 6-1 Estimate of Sets of Crude Oil Price Level and Decrease Amount in Current Profits <during FY2008 ending March 2009>



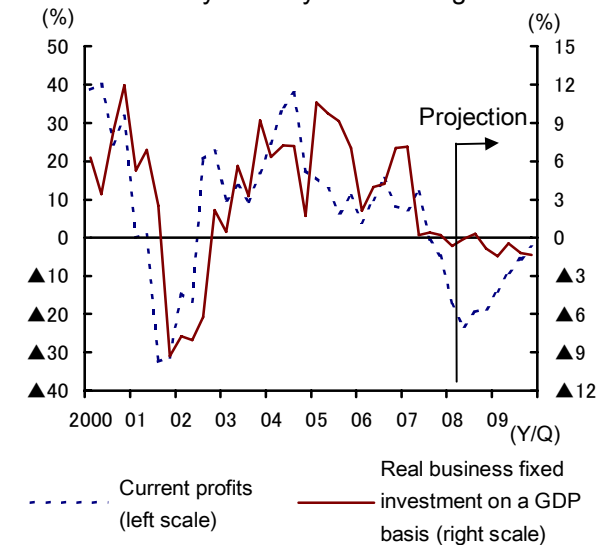
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Figure 6-2 Contribution of Sales and Expenses to Year-on-year % Change of Current Profits



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry: Quarterly".

Figure 6-3 Current Profits and Real Business Fixed Investment <year-on-year % change>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Cabinet Office.

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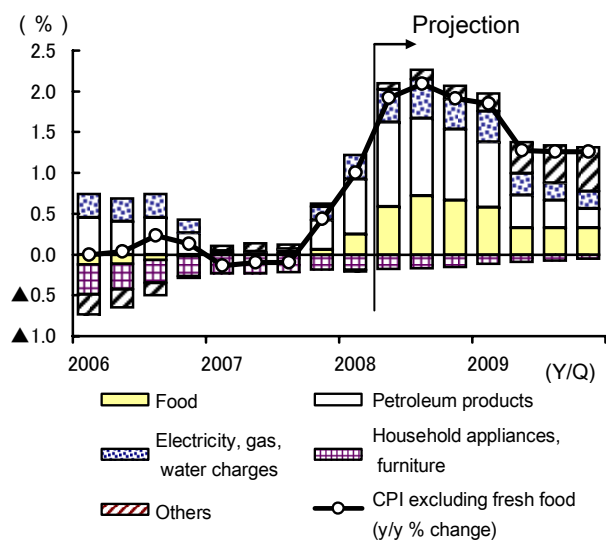
Higher resource prices - Further increase in the CPI due to petrol and food price rises

The consumer price index excluding fresh food, that is, the core CPI, has maintained a rising trend due to continued resource price rises. It is expected that the boosting force of the increases in petrol prices and electricity and gas charges to the increase of the core CPI will strengthen, judging from a recent sharp rise in the price of crude oil.

Further, moves of rising prices are recently spreading into other areas of products and services. Especially, the contribution of the price rise of food to the total year-on-year percentage increase of the CPI tends to get larger. It can be pointed out that the tendency shows the situation where room for enterprises' absorbing the increased costs is reaching the limit.

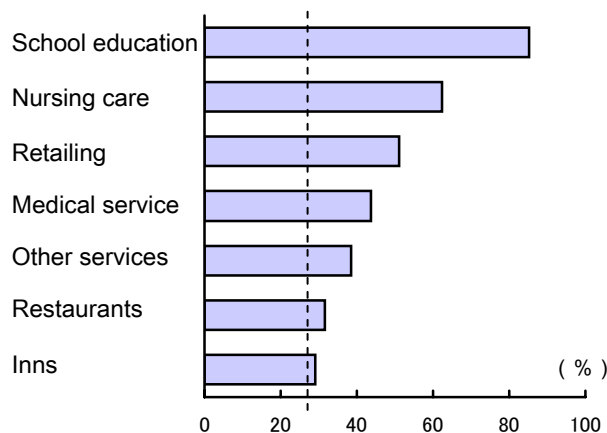
However, it is unlikely that the recent rapidly rising trend of prices would continue and lead to full-scale inflation. It is not expected that a chain reaction such as "price rises → wage increases → price rises" will be caused, because curbing pressure on wages will intensify reflecting falling corporate profits. Especially, upward pressure on prices in the service industry would be limited. In addition, there would be enough room to absorb the increased costs in such industries as electric and electronics machinery in which technological innovation and productivity improvement have been advancing very rapidly.

Figure 7-1 Change in Consumer Price Index on CY2005-base <year-on-year, excluding fresh food>



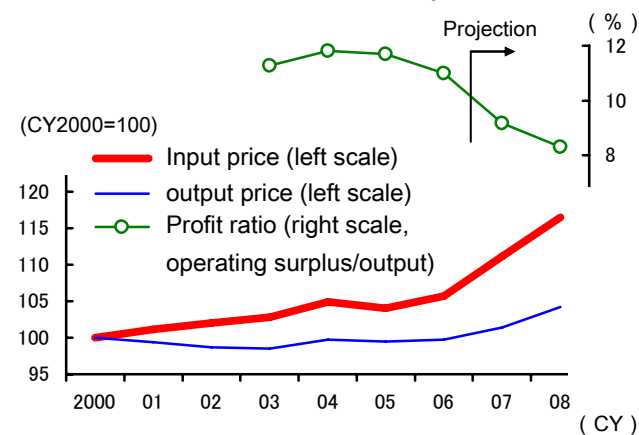
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications.

Figure 7-2 The Ratio of Employees' Compensation to Each Domestic Production by Industry



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Economy, Trade and Industry, "The 2006 Simplified Extended Input-Output Table".
Note: The dotted line indicates the average of all industries.

Figure 7-3 Profit Environments in Food Industry



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, The Ministry of Economy, Trade and Industry, "The 2006 Simplified Extended Input-Output Table".

Note: The figure in CY2008 is for the average in January-March 2008.

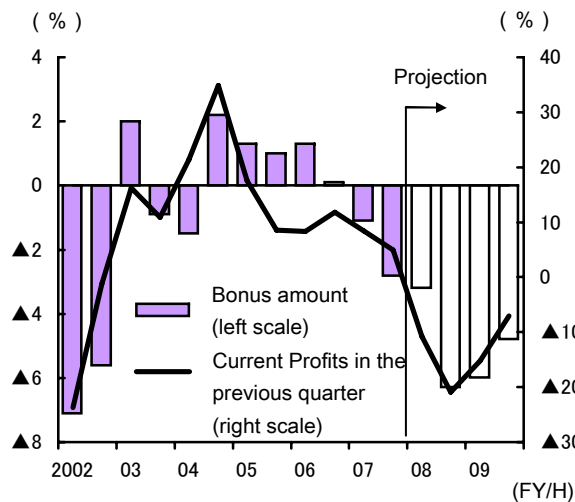
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Higher resource prices - "Low-flying" consumption due to sluggish income and price rises

It is estimated that resource price rises had negative influences on households through the following two routes: (i) a downswing of workers' total cash earnings. Reflecting deteriorating corporate profits, the moves among enterprises to curb personnel expenses are expected to intensify further. Especially, it is likely that the bonus amount in the aggregate will decrease from this winter onwards. (ii) An increase in financial burden of households because of consumer price rises. The increase in the burden not only due to a petrol price rise but also due to a food price rise tends to increase. The increased aggregate amount of the financial burden in households is estimated to have reached an annualised 2.8 trillion yen during the January-March period this year.

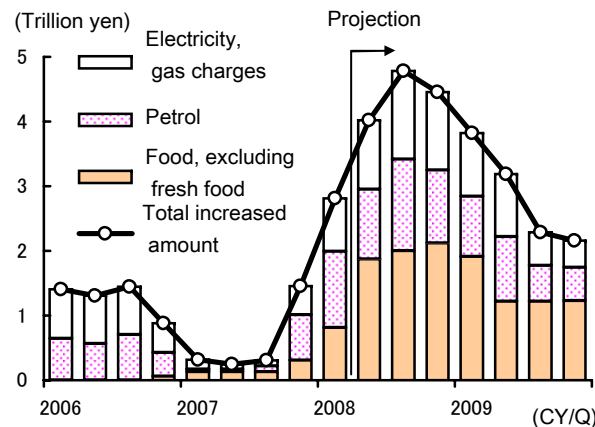
The real purchasing power of households is expected to decline by more than one per cent in FY2008 as a whole, against the background of the sluggish income situation and the increased burden due to price rises. Especially, the adverse effect could be felt more strongly in lower income bracket than higher income bracket households as noticeable price rises are seen mainly in necessities. Also, the households in the provinces with the higher ratio of petrol in their total expenditure could be more adversely affected than those in urban areas.

Figure 8-1 Current Profits and Bonus Amount
<year-on-year % change>



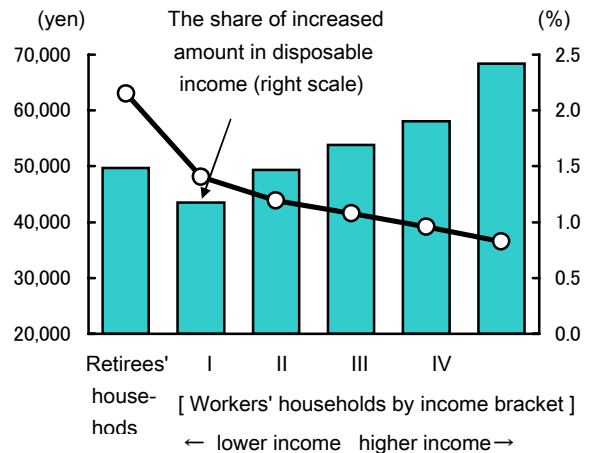
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare, The Ministry of Finance, The Cabinet Office, The Ministry of Internal Affairs and Communications.

Figure 8-2 Contribution of Each Item to Total Estimated Amount of Increase in Household Burden



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, The Ministry of Internal Affairs and Communications.

Figure 8-3 Estimated Amount of Increase in Household Burden due to Food and Energy Price Rises by Income Bracket <in FY2008>

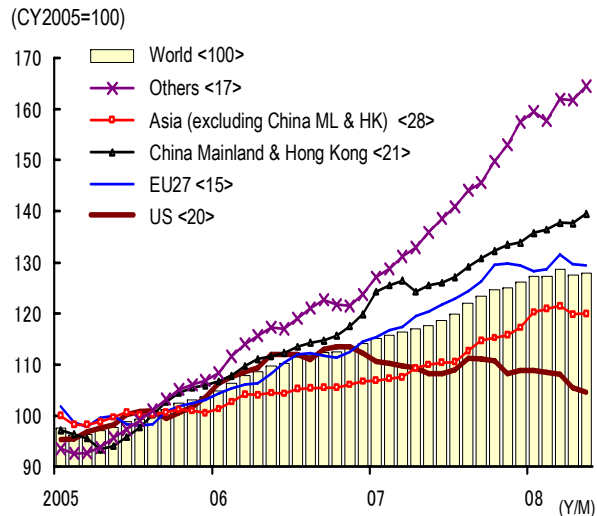


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications.

Exports - Solid exports to resource-rich and emerging countries to continue

It is projected that Japan's exports will maintain positive growth without any significant decline, judging from the following factors, although the pace of increase as a whole has been decelerating: (i) a continued high pace of increase in exports to resource-rich countries such as the Middle Eastern countries and Russia. Especially, the contribution of exports of motor vehicles to the year-on-year increase in exports to these countries has reached about 70 per cent. (ii) An expansion in exports for domestic demand of emerging economies such as China. For example, the purchasing manager index in manufacturing in China indicates a continued firmness of its domestic demand. Also, (iii) moves of Japan's enterprises to increase exports in order to make up for a decrease in domestic demand.

Figure 9-1 Japan's Real Exports by Region
<seasonally adjusted>
<3-month moving averages>

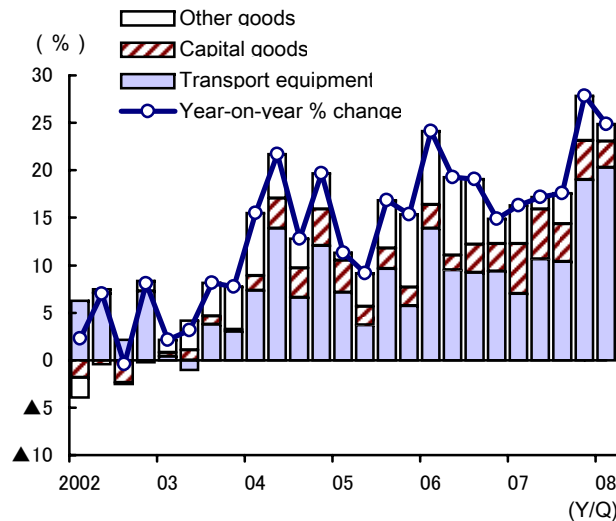


Source: The Ministry of Finance, The Bank of Japan.

Note 1: The figures in angle brackets in the legend indicate the share of each region in total nominal exports of Japan in FY2007.

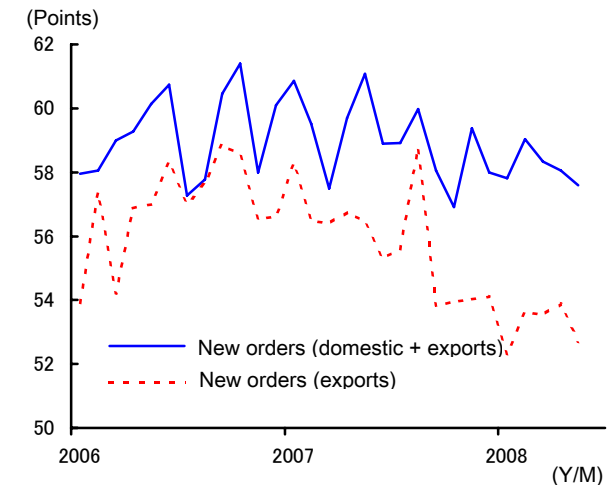
2: Others: Middle Eastern countries, South American countries, Russia and so on.

Figure 9-2 Contribution by Commodity to Year-on-year
% Change of Japan's Exports to Middle
East, South America, Russia, etc. (Countries
indicated as "Others" in Figure 7-1)



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance and The Bank of Japan.

Figure 9-3 Purchasing Manager Index
in Manufacturing in China
<seasonally adjusted>



Source: The National Bureau of Statistics of China

Prospects for Japan's economy - Projected 1.7% real GDP growth in FY2008 and 1.4% in FY2009

(1) It is expected that a sense of adjustment will be felt more strongly in Japan's economy for the time being owing to these two factors:

(i) A continuing price rise in primary products such as crude oil, iron ore, and wheat. The move could lower real purchasing power of households through consumer price rises such as petrol and food amid the sluggish income situation. It could also continue to erode corporate profits of enterprises which have difficulty passing on the increased costs to their final product and service prices. The fall in corporate profits could lead to a decline in business fixed investment.

(ii) Prolonged negative influences of the financial turmoil triggered by the US subprime mortgage problem. Japan's exports as a whole are expected to slow down reflecting the deceleration of the world economy. Also, unstable moves in the financial markets could make business sentiment worse.

(2) As for the economic growth rate, it is projected that Japan's real GDP during FY2008 will follow a quarterly growth trajectory at a pace of 1 per cent or slightly more on a seasonally adjusted and annualised basis over the previous quarter, a series of mild increases. This will lead to 1.7 per cent growth in FY2008. However, a sense of economic recovery could hardly be felt because nominal GDP is projected to see a slight quarterly decline during the period. This move is reflecting a further fall in the GDP deflator mainly due to a continuing price rise in imported primary products.

(3) Looking further, it is projected that the real GDP growth rate will decelerate to 1.4 per cent in FY2009 to March 2010. Business fixed investment would continue to follow a declining path due to a continued decrease in corporate profits amid still rising primary product prices. Private consumption expenditure is expected to continue to lack a sense of picking-up.

(4) The GDP deflator is expected to maintain a declining trend on the year earlier, because passing on the increased costs to the prices of final products and services has shown little advance amid the further price rise of primary products. Therefore, there is little scope of the nominal GDP growth rate exceeding the real rate for the time being.

Figure 10 Projections for GDP Growth and Main Indicators of Japan (as of July 31, 2008)

(seasonally adjusted, annual % changes from the previous quarter)

	CY2007		CY2008						CY2009			
	7~9	10~12	1~3	4~6	7~9	10~12	1~3	4~6	FY2006	FY2007	FY2008	FY2009
	(Actual)		(Projection)						(Actual)		(Projection)	
Real GDP	0.9	2.9	4.0	0.3	1.5	1.1	1.3	1.3	2.5	1.6	1.7	1.4
Private Consumption Expenditure	0.2	1.5	3.3	▲ 0.6	0.5	0.8	0.7	0.7	1.8	1.4	0.9	0.7
Housing Investment	▲ 28.4	▲ 31.9	19.5	18.3	11.7	4.1	▲ 1.2	0.3	0.2	▲ 13.3	3.0	1.3
Business Fixed Investment	3.3	4.8	0.7	▲ 4.8	0.9	▲ 0.5	▲ 0.8	▲ 1.2	5.7	0.0	▲ 0.3	▲ 1.1
Private Inventories (percentage points contribution)	(▲ 0.3)	(0.4)	(▲ 0.4)	(0.4)	(▲ 0.2)	(▲ 0.1)	(0.1)	(0.0)	(0.2)	(▲ 0.0)	(0.0)	(0.0)
Government Consumption Expenditure	0.4	3.4	▲ 1.7	1.2	1.0	0.9	0.3	0.8	0.1	0.7	0.7	0.6
Public Investment	▲ 5.4	2.3	5.5	▲ 5.5	▲ 4.5	▲ 3.8	▲ 2.0	▲ 1.5	▲ 9.1	▲ 1.8	▲ 2.2	▲ 1.7
Net Exports (percentage points contribution)	(1.8)	(1.2)	(2.0)	(0.5)	(1.0)	(0.8)	(1.0)	(1.0)	(0.8)	(1.2)	(1.1)	(1.0)
Exports of Goods and Services	11.9	10.8	17.1	4.2	6.5	5.3	6.2	6.5	8.4	9.5	8.5	6.5
Imports of Goods and Services	▲ 0.2	3.9	5.6	1.3	0.4	0.9	0.5	0.8	3.1	2.1	2.0	0.7

(% changes from the same quarter of the previous year)

Real GDP	1.7	1.7	1.3	2.0	2.1	1.6	1.1	1.3	2.5	1.6	1.7	1.4
Nominal GDP	1.1	0.3	▲ 0.2	▲ 0.1	▲ 0.3	0.1	▲ 0.5	0.3	1.7	0.6	▲ 0.2	0.4
GDP deflator	▲ 0.6	▲ 1.3	▲ 1.5	▲ 2.0	▲ 2.4	▲ 1.5	▲ 1.6	▲ 1.1	▲ 0.8	▲ 1.0	▲ 1.9	▲ 1.0
Consumer Price Index (excluding fresh food)	▲ 0.1	0.4	1.0	1.4	2.2	1.9	2.2	1.8	0.1	0.3	1.9	1.3
Industrial Production Index	2.6	3.3	2.3	1.0	▲ 1.3	▲ 1.4	▲ 0.5	0.6	4.6	2.6	▲ 0.6	1.9
Unemployment Rate (%)	3.8	3.8	3.9	4.0	3.9	3.8	3.8	3.8	4.1	3.8	3.9	3.8
Current Account Balances (trillion JY)	6.86	5.50	6.59	4.93	4.39	4.18	4.78	4.00	21.15	24.55	18.28	17.62
Share of Nominal GDP (%)	5.5	4.1	5.2	3.8	3.5	3.1	3.8	3.4	4.1	4.8	3.6	3.4
Exchange Rates (JY/US\$)	117.8	113.1	105.2	104.5	106.0	102.0	100.0	98.0	116.9	114.2	103.1	96.0
Import Price of Crude Oil (US\$/barrel)	72	86	95	110	125	130	135	140	64	78	125	148

Source: The Cabinet Office, The Ministry of Internal Affairs and Communications, The Ministry of Economy, Trade and Industry, The Ministry of Finance.

The projection figures are based on those of The Japan Research Institute, Ltd.

Note: The projections are made based on the following assumptions;

- (1) The US economy is expected to decelerate considerably for the moment (real GDP growth rate would be 1.6 per cent in CY2008).
- (2) The Euro area economy is also expected to slow down (real GDP growth rate would be 1.7 per cent in CY2008).