

Monthly Report of Prospects for Japan's Economy

February 2007

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

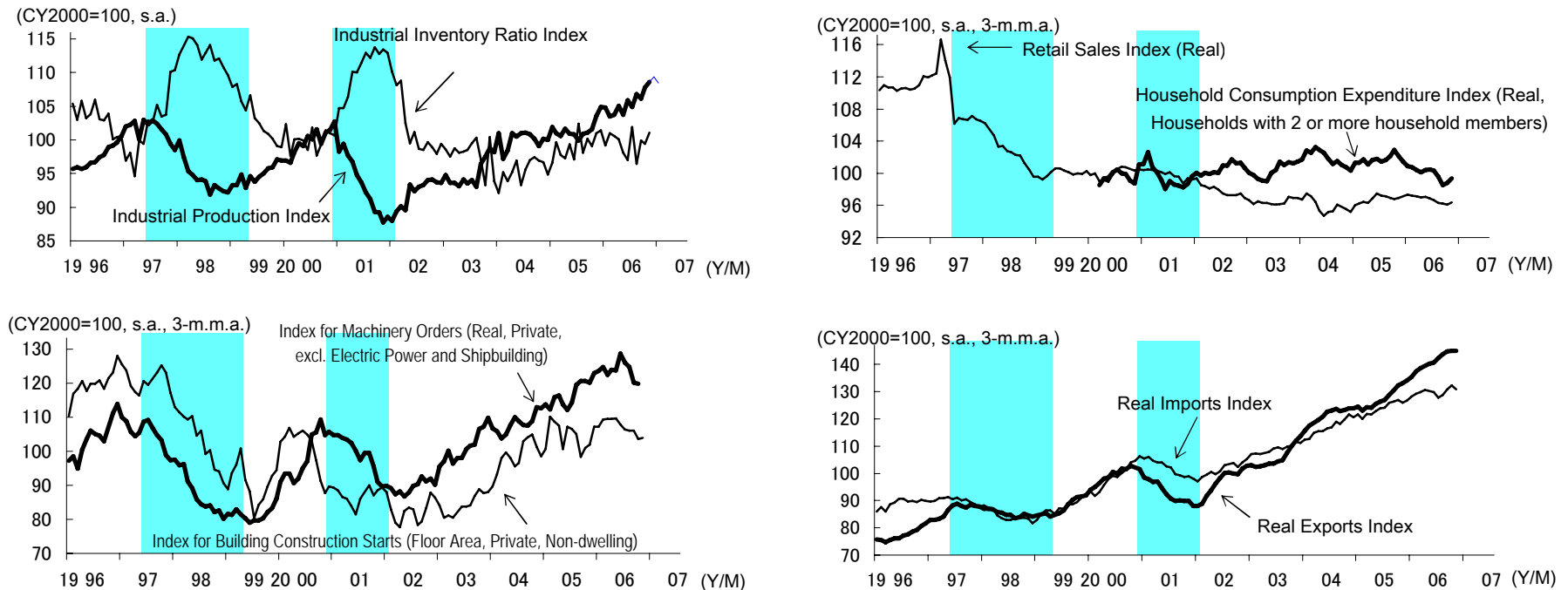
<http://www.jri.co.jp/thinktank/research/>

This report is the English version of the January 2007 issue of the original Japanese version.

Current situation of Japan's economy – Continuing recovery trend

Japan's economy as a whole is following its recovery path, and it extended the post-war record length (58 months) of economic recovery in November last year. This tendency is bolstered especially by brisk business activities in the corporate sector. The industrial production index, which indicates the direction and the level of economic activity, set a monthly record in November last year, a second consecutive monthly rise. However, uncertainties surrounding a future economic path are also seen and need a closer watch. These include a sign of slowing down in exports, growing inventory in the IT sector such as electronic parts and devices, lack of momentum in private consumption, and a softening move in a few leading indicators for business fixed investment.

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 Household Consumption Expenditure, Retail Sales, Machinery Orders, Building Construction Starts, Exports, and Imports are calculated as seasonally adjusted and 3-month moving averages.
 Note 2: The Industrial Production Index in December 2006 and January 2007 is based on METI forecasts. Note 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Business sentiment – Solidity becoming more broadly based

BOJ's Tankan Survey in December 2006 is confirming a sure and steady expansion in business activity, with the solidity becoming more broadly based, although enterprises are still cautious in their forecasts. Especially, the business conditions Diffusion Index (DI) exhibited an improvement among basic material industries as well as small and medium-sized enterprises, reflecting an easing of oil prices and positive ripple effects of the brisk activities of large enterprises. Under these circumstances, enterprises' projection of current profits during the first half of FY2006 in the December survey was revised upward considerably to a year-on-year 12.8% increase, a 10.4 percentage point upward revision from the previous survey. The predicted figure for the whole fiscal year was a modest 4.7% increase in the survey. However, it is expected that current profits in FY2006 as a whole would increase by around 10%, taking account of a past revision pattern and a higher level of the assumed yen-dollar exchange rate (of 113.40yen/\$ among large manufacturing enterprises) than the actual rate thus far.

Figure 2-1 Business Conditions Diffusion Index in BOJ's Tankan Survey

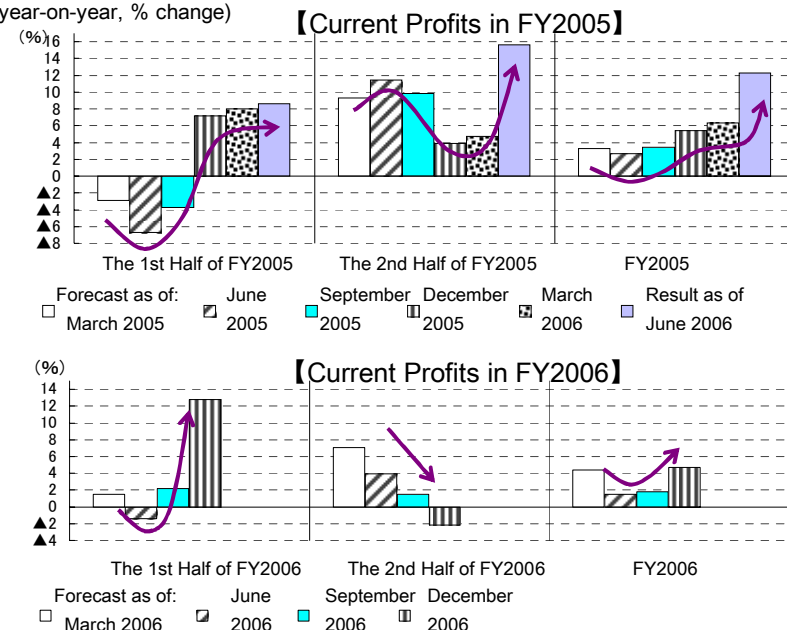
		"Favourable" minus "Unfavourable", % points				
		06/6	06/9	06/12	07/3	07/3
		(Actual Result)		(Forecast)	(Actual)	(Forecast)
【Large Enterprises】 All Industries		20	22	20	23	20
Manufacturing		21	24	21	25	22
Nonmanufacturing		20	20	21	22	20
Manufacturing	Basic Materials	18	21	22	24	22
	Chemicals	↓ 16	16	20	↗ 24	23
	Petroleum & Coal Products	↓ 15	↗ 25	25	25	↓ 15
	Iron & Steel	↓ 39	↗ 53	51	↓ 41	43
	Processing	23	25	↓ 20	25	23
	Industrial Machinery	↗ 46	↗ 52	↓ 44	49	↓ 44
	Electrical Machinery	23	↗ 28	↓ 22	25	22
	Motor Vehicles	35	↓ 30	27	33	34
	Retailing	14	15	19	13	13
	Services for Individuals	9	13	↗ 21	10	14
Restaurants & Accommodations	↗ 24	↓ 18	16	19	18	
Services for Businesses	↓ 14	↗ 20	24	↗ 32	↓ 22	
Transportation	17	15	14	↗ 21	18	
【Small & Medium-sized Enterprises】 All Industries		▲2	▲3	▲3	0	▲4
Manufacturing		7	6	7	10	↓ 5
Nonmanufacturing		▲6	▲8	▲9	▲6	▲10
【All Enterprises】 All Industries		6	6	6	8	5
Manufacturing		12	13	12	16	12
Nonmanufacturing		2	1	1	2	▲1

Source: The Bank of Japan

Note 1: The forecast DIs are for the three months before.

2: An arrow indicates that the figure is 5% points more or less than the previous survey result.

Figure 2-2 Projection Development of Current Profits < Tankan, all industries > (year-on-year, % change)



Source: The Bank of Japan

Note: This graph indicates the revision pattern of current profits in the surveys. The horizontal axis represents the point of time when the survey is conducted for each period.

Namely, the first survey for each period (March survey) is at the far left, and the last survey (June survey of the following year; actual result) is at the far right.

Monthly Report of Prospects for Japan's Economy February 2007

The Japan Research Institute, Limited

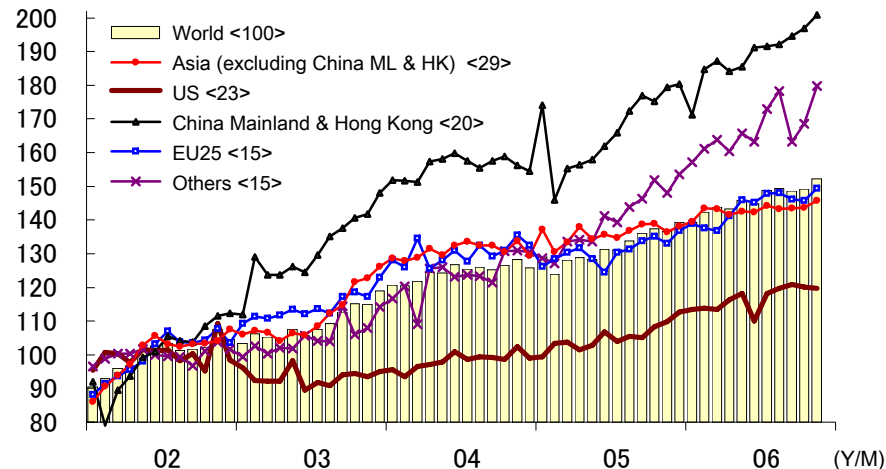
Exports – Expected to decelerate

Japan's economy is on a recovery track. However, looking at the economic phase for the present, the pace of the recovery would see a moderate slowdown mainly because the impact of a slowing of the US economy will start to be felt in earnest. Also, there may be a possible adjustment of the rapid production pace thus far in the IT sector.

As for exports, real exports of motor vehicles to the US and resource-rich countries especially held strong, as well as exports of production goods including electronic devices to China. However, looking at recent moves by region and commodity, exports to the US and exports of capital goods seem to have begun to lose momentum. Looking further, brisk exports to resource-rich countries could continue to bolster the growth in real exports in the aggregate. In addition, the leading Japanese products worldwide such as motor vehicles and digital household appliances do have strong non-price competitiveness. Judging from these factors, it is unlikely that exports as a whole would turn downward, although they may well decelerate for the moment, reflecting a slowdown in the US economy and a curbing of investment in China.

Figure 3-1 Japan's Real Exports by Region
< seasonally adjusted >

(CY2002=100, s.a.)

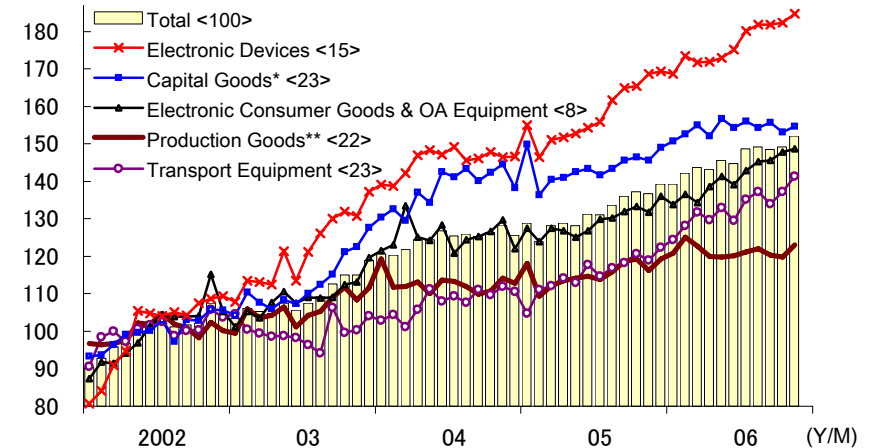


Source: The Ministry of Finance, The Bank of Japan

- Note 1: The figures in angle brackets in the legend indicate the share of each region in total nominal exports of Japan (JY 68.3 trillion in FY2005).
 2: Others: Middle Eastern countries, South American countries, Russia and so on.
 3: Percentage discrepancy due to rounding of figures.

Figure 3-2 Japan's Real Exports by Goods
< seasonally adjusted >

(CY2002=100, s.a.)



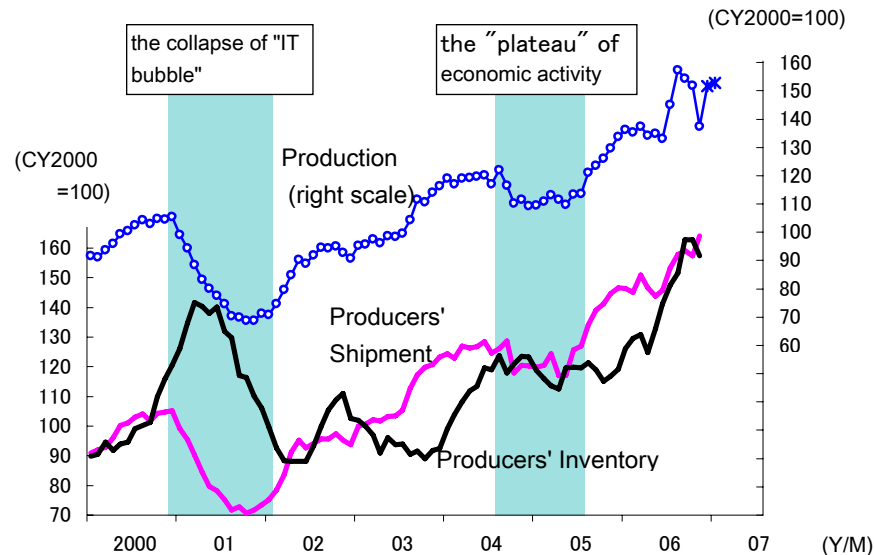
Source: The Ministry of Finance, The Bank of Japan

- Note 1: *excluding Transport & OA Equipment, **excluding Devices
 2: The figures in angle brackets in the legend indicate the share of each group of goods in total nominal exports of Japan (JY 68.3 trillion in FY2005).
 3: Percentage discrepancy due to the share of other goods.

One of the downside risks to watch – Adjustment in the IT sector

An adjustment in the IT sector, especially in the electronic parts and devices sector, could be one of the downside risks to the economy. The recent fast growth in the inventories of electronic parts and devices could be seen as a "temporarily" rapid increase in inventory, which is partly attributable to demand for new mobile phones after the introduction of a market-wide number portability system, as well as to the start of sales of new video game consoles. Yet it is obvious that the current level of producers' inventory in this sector is still above the peak in the "IT bubble" era. Given the factors that year-end sales are now over and an improvement in the overseas supply-demand conditions has come to a halt, a production adjustment seems to be likely. Accordingly, an even closer watch is needed as to whether the final results of year-end sales of IT-related products in the domestic and overseas markets would be a disappointment, and subsequently the adjustment pressure in the IT sector could accumulate over this year, or not.

Figure 4-1 Indices of Industrial Production, Shipments and Inventories in the Electronic Parts and Devices Sector

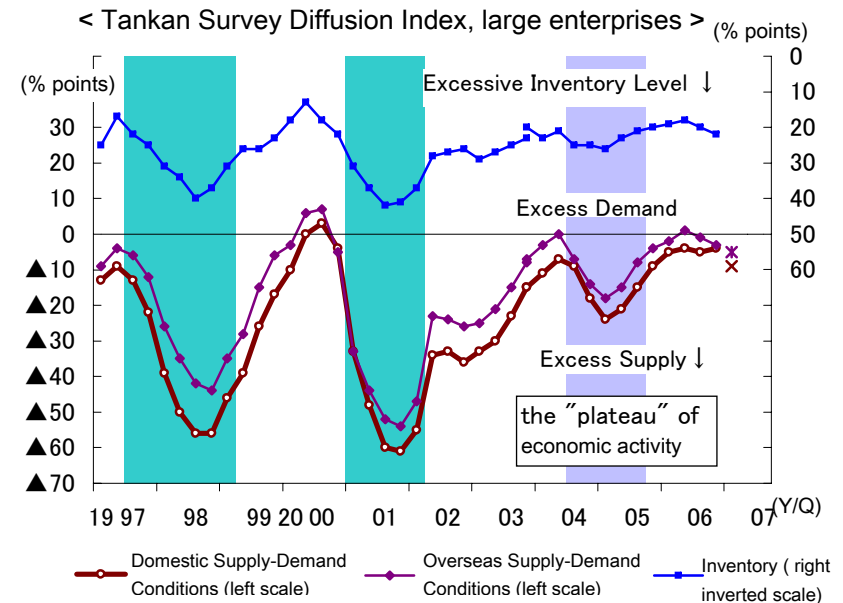


Source: The Ministry of Economy, Trade and Industry

Note 1: The Industrial Production Index (x) in December 2006 and January 2007 is based on METI forecasts.

Note 2: The recent "plateau" of economic activity is indicated as the shaded area from August 2004 to July 2005.

Figure 4-2 Responses of Electrical Machinery Enterprises on Supply-Demand Conditions and Inventories



Source: The Bank of Japan, "The Tankan December 2006 Survey"

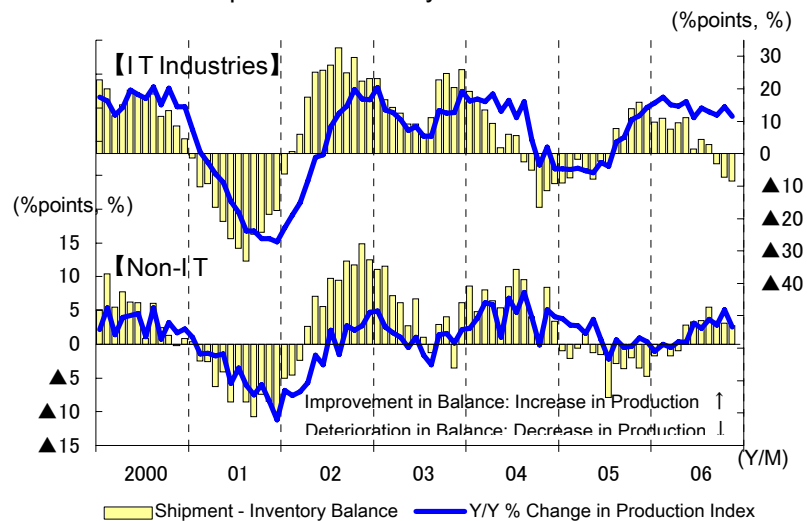
Note 1: Shaded areas (CY1997-99 and CY2001-02) indicate periods of recession according to the Cabinet Office.

Note 2: The Supply-Demand Diffusion Index at March 2007 (domestic x, overseas *) is the forecast as of December 2006.

Appreciable ability to absorb shocks – Backdrop of continuous recovery

It is widely recognised that Japan's economy would retain appreciable abilities to absorb shocks, which differs from those observed during the time of the collapse of the "IT bubble" or during the temporary slack period in 2004. This seems to constitute the reason there is a low risk that the recovery trend of the economy could falter in the short run. The main abilities seen are as follows: (i) The improvement in shipment-inventory balance in non-IT sectors, for a short-term factor. Even if pressure for adjustments arises in the IT sector, the non-IT sectors such as motor vehicles would bolster demand and a major production adjustment across all sectors of manufacturing industry could be avoided. (ii) The dissipation of structural adjustment pressures in the corporate sector as well as abundant liquidity as its financial strength, for a medium-to-long-term factor. Statistics show, for example, that the ratio of current profits in sales in nonfinancial enterprises rose to a record 4.11% in Q3 last year. With the management focus shifting from the "adjustment of excessive labour, capital equipment and debt" to "active business expansion aiming at survival against fierce global competition", the positive attitude toward business fixed investment as well as employment would continue.

Figure 5-1 Inventory Adjustment Shown as Change in Shipment - Inventory Balance and Production



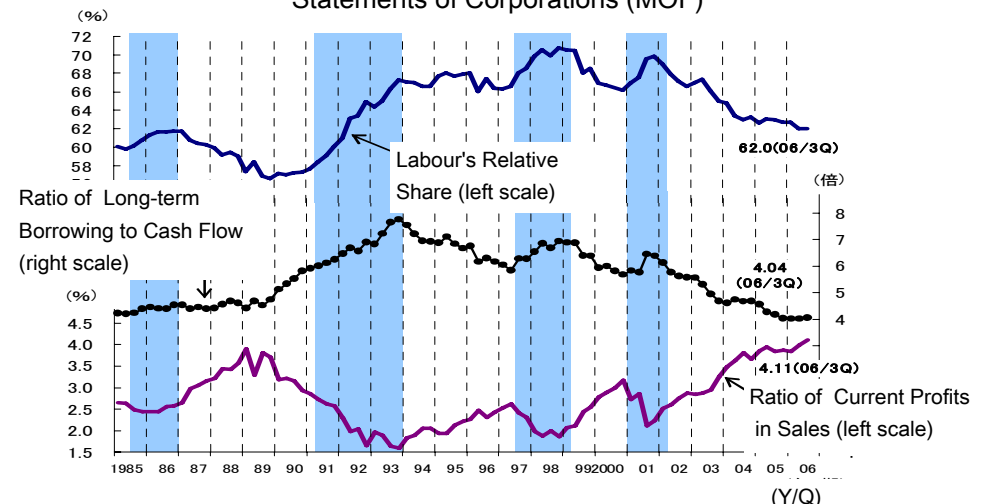
Source: The Ministry of Economy, Trade and Industry

Note 1: Shipment - Inventory Balance = Y/Y % Change in Shipments - Y/Y % Change in Inventory

2: IT Industries: Electrical machinery, Information and communication electronics equipment, Electronic parts and devices, Precision instruments

3: The weight of IT industries in the total in the Industrial Production Index is 25% (FY2005).

Figure 5-2 Main Indicators based on Financial Statements of Corporations (MOF)



Source: The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry: Quarterly"

Note: Labour's relative share = Personnel expenses / (Personnel expenses + Depreciation expenses + Interest expenses + Current profits)

Ratio of Long-term borrowing to Cash flow = (Bonds + Long-term borrowing) / (Current profits x 0.5 + Depreciation expenses)

Monthly Report of Prospects for Japan's Economy February 2007

The Japan Research Institute, Limited

Business fixed investment - Continuing solid expansionary trend

According to the BOJ's Tankan December 2006 survey, enterprises forecast that their business fixed investment as a whole would accelerate in the second half of FY2006, partly due to the surge in investment brought forward from the first half among the motor vehicles and financial institutions sectors. Looking further, business fixed investment would continue a firm tendency over FY2007 as well, led in the main by projects with medium-to-long-term perspectives, such as those related to research and development (R&D), as well as product and/or service development. This positive prospect is against the background of the favourable factors which include a continuing tendency of improvement in business fixed investment efficiency, an expected firm trend of corporate profits, and abundant liquidity as the financial strength of enterprises.

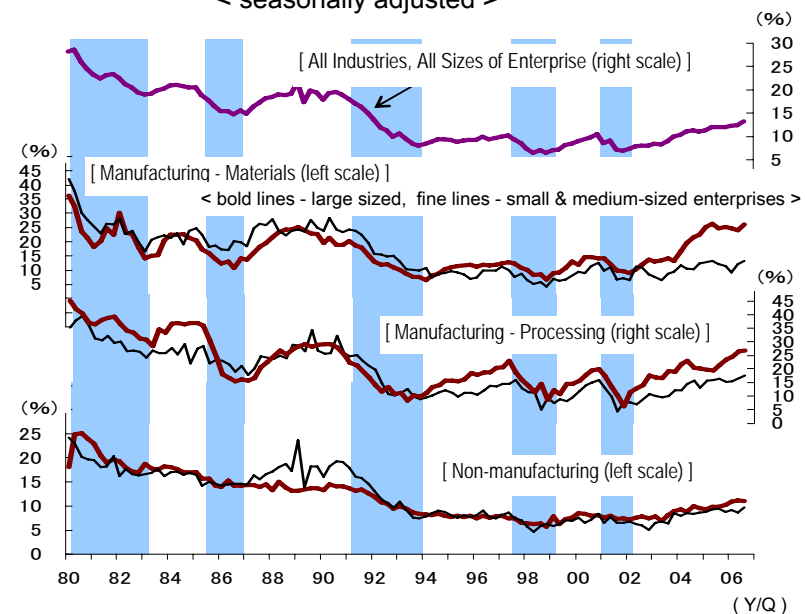
Figure 6-1 Annual Projections of Business Fixed Investment
< The BOJ's Tankan December 2006 Survey >

(% change, on a year-on-year basis)								
	Weight (FY2005)	H1 FY05 (actual)	H2 FY05 (actual)	H1 FY06 (estimate)	H2 FY06 (forecast)	FY2005 (actual)	FY2006 (forecast)	FY2007 (forecast, as of Dec. 05)
[Large Enterprises]	64.6	7.9	5.9	7.7	15.5	6.8	12.0	11.3
All Industries (excluding Financial)								
Manufacturing	23.1	14.9	12.0	11.1	20.8	13.3	16.4	17.6
Chemicals	2.8	16.8	10.7	5.3	20.4	13.5	13.3	20.7
Iron & Steel	1.4	41.5	30.8	32.7	52.4	35.5	43.4	36.7
Electrical Machinery	6.1	▲ 1.8	1.7	11.8	18.9	0.0	15.6	3.3
Motor Vehicles	5.0	40.2	23.0	▲ 11.5	11.5	30.1	1.2	32.6
Nonmanufacturing (excluding Financial)	41.5	4.4	2.7	5.8	12.6	3.5	9.5	8.1
Leasing	15.2	5.2	▲ 3.1	▲ 3.1	1.8	0.8	▲ 0.6	2.7
Information & Communications	8.7	16.2	17.0	9.5	8.2	16.6	8.8	15.8
Transportation	4.9	0.8	▲ 0.9	15.8	32.4	▲ 0.2	25.9	10.5
Electric & Gas Utilities	4.3	▲ 1.9	8.0	7.7	17.7	3.9	13.7	18.0
Wholesaling & Retailing	4.3	0.9	6.9	8.3	12.3	4.0	10.4	9.1
Construction & Real Estate	2.1	6.2	▲ 16.8	16.8	52.6	▲ 7.8	36.6	10.9
[Small & Medium-sized Enterprises]	15.7	11.3	14.3	8.2	3.3	12.8	5.7	9.3
All Industries (excluding Financial)								
Manufacturing	4.2	10.1	0.9	7.0	24.5	5.0	16.2	4.8
Nonmanufacturing (excluding Financial)	11.5	11.8	20.2	8.6	▲ 4.6	16.0	1.8	11.1
[All Enterprises]	100.0	8.5	8.8	7.9	12.9	8.7	10.6	11.3
All Industries (including Financial)								
Manufacturing	32.1	13.9	11.1	10.9	20.1	12.4	15.9	15.4
Nonmanufacturing (excluding Financial)	64.5	6.2	7.8	6.4	7.6	7.1	7.0	9.0
Financial Institutions	3.4	4.5	5.5	7.1	46.1	5.1	29.3	18.6

Source: The Bank of Japan

Note: The figures include software investment and exclude land purchase expenses

Figure 6-2 Business Fixed Investment Efficiency by Industry
< seasonally adjusted >



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

Note 1: Business Fixed Investment Efficiency is calculated as:

Operating Profits / Operating Tangible Fixed Assets (average outstanding balance)

Operating Tangible Fixed Assets = Tangible Fixed Assets - Construction in Progress

2: Shaded areas indicate periods of recession according to the Cabinet Office.

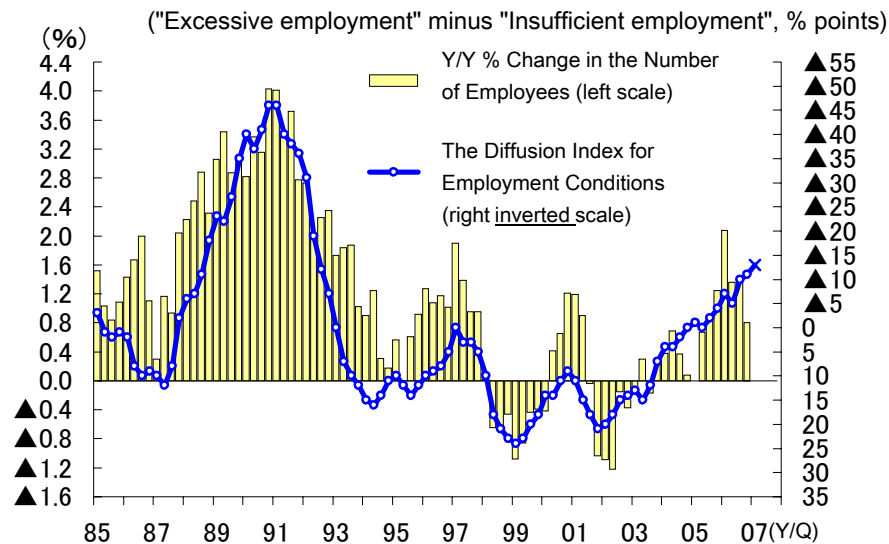
Monthly Report of Prospects for Japan's Economy February 2007

The Japan Research Institute, Limited

Employment situation - Continuing improvement in labour demand

The employment situation continues to be improving in a steady manner. This trend is against the backdrop of a solid expansion of business activities, as well as the increasing necessity of enterprises to make sure of and to nurture enough talented employees, in anticipation of the mass retirement of the baby-boomer generation. The Tankan Survey last year continued to see the Diffusion Index (DI) on employment conditions staying in the excess "insufficient employment" area, which shows tightness in the labour market, among both large enterprises and small and medium-sized enterprises. Under these circumstances, the number of employees has maintained an around 1.0 per cent growth rate, mainly led by an increase in full-time regular employees, and is expected to do so for the time being.

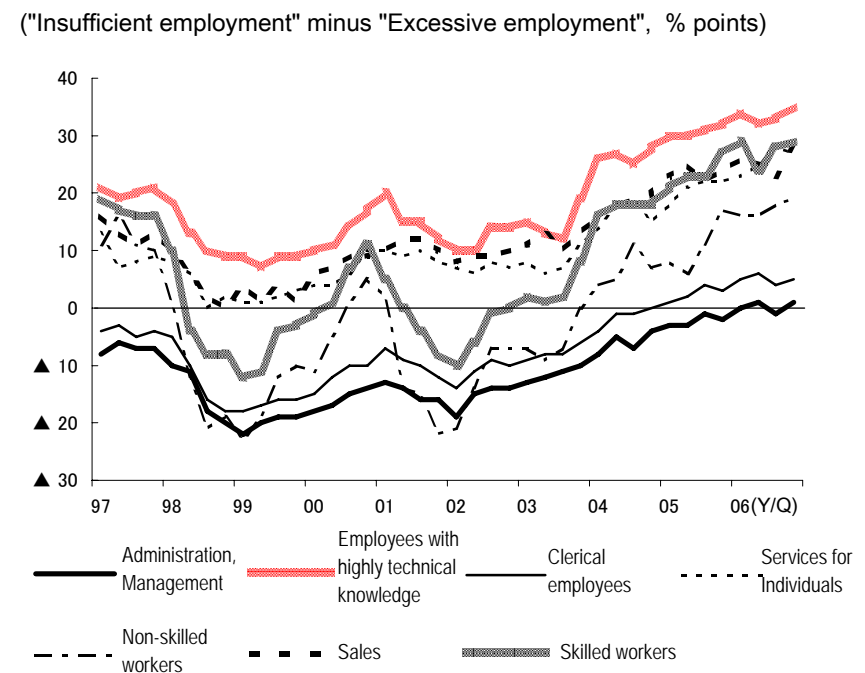
Figure 7-1 Employment Conditions < Diffusion Index in BOJ's Tankan Survey, all industries > and the Number of Employees



Source: The Bank of Japan, The Ministry of Internal Affairs and Communications

- Note 1: The Employment Condition Diffusion Index is figured on an all-industries basis.
 2: The figure of Y/Y % change in the number of employees in Q4 2006 is for October and November 2006.
 3: The DI figure in March 2007 (at × mark) is based on the forecast in the December 2006 survey.

Figure 7-2 Employment Conditions Diffusion Index by the Sort of Occupation



Source: The Ministry of Health, Labour and Welfare, "Survey of Labour Economic Trends"

Corporate profits – Contributed to by slow wage growth recovery

It is expected that corporate profits would maintain a positive growth tendency, mainly supported by an increasing trend of sales as well as enterprises' unsparing attitudes to curtail fixed costs, with certain fluctuations due to a temporary slowdown in overseas demand. In addition, a fallback in oil prices since autumn last year would ease the downward pressure on profits somewhat at the moment. Our estimate indicates that a deceleration in an oil price increase from 18% to 5% would lessen the negative impact on assumed current profits in FY2007 from minus 4.1% to minus 1.1%, with a difference of 1.6 trillion yen annually. However, in the medium-to-long-term, it is unlikely that the basic upward trend of natural resource prices would reverse, given the excess demand factors such as the high pace of economic growth in emerging economies. In addition, it would take considerable time for enterprises to make enough improvements in the unfavourable output/input price ratio situation. Accordingly, the tendency of enterprises to restrain costs by curbing personnel expenses, especially those per capita, would be more noticeable, as they would try to maintain a certain extent of profit growth under persisting disadvantageous circumstances.

Figure 8-1 Impact of Increase in Import Price of Oil on Corporate Current Profits < Our Estimate >

Rate of increase in Oil Price	5%	10%	15%	20%
(Import Price of Crude Oil)	(67\$/bl.)	(70\$/bl.)	(74\$/bl.)	(77\$/bl.)
* Net Impact on Assumed Current Profits in FY2007	▲1.1%	▲2.3%	▲3.4%	▲4.5%
	(▲0.6 trillion JY)	(▲1.2 trillion JY)	(▲1.9 trillion JY)	(▲2.5 trillion JY)

【Reference】

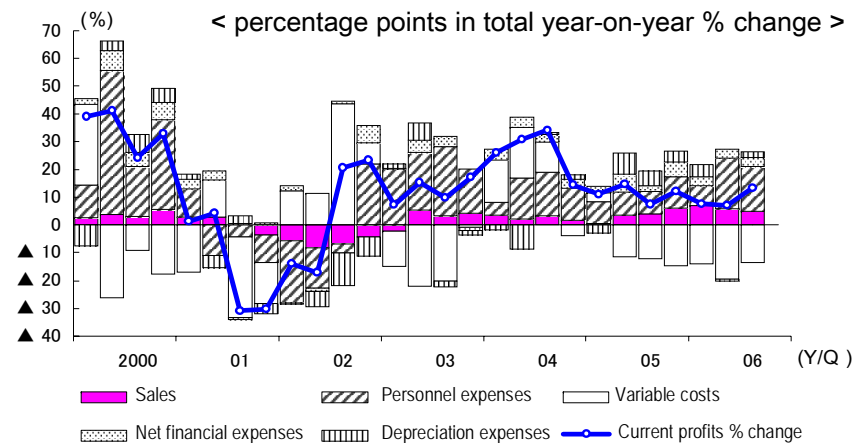
Necessary Change in Personnel Expenses to offset above *	▲0.3%	▲0.6%	▲0.9%	▲1.2%
Necessary Change in Sales to offset above *	+0.2%	+0.4%	+0.6%	+0.8%
	(+3.2 trillion JY)	(+6.4 trillion JY)	(+9.6 trillion JY)	(+12.9 trillion JY)

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

Note 1: The impact of the change in oil price is calculated as the total amount of (i) an increase in costs caused by higher oil prices and (ii) the amount of the costs which enterprises would have passed through to the household sector.

2: The figures in the net impact on assumed current profits in FY2007 are calculated on the precondition that the average import price of crude oil (on a CIF basis) in FY2006 is \$64/barrel and the average of JY/\$ exchange rate in the same period is 117JY/\$.

Figure 8-2 Contribution to Change in Current Profits < all industries except financial > < percentage points in total year-on-year % change >



Source: The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry; Quarterly"

Note: The equation for this analysis is as follows:

$$\Delta \pi / \pi_{-1} = \Delta S \cdot (1 - v - w - r - d) / \pi_{-1} - S \cdot \Delta v / \pi_{-1} - S \cdot \Delta w / \pi_{-1} - S \cdot \Delta r / \pi_{-1} - S \cdot \Delta d / \pi_{-1}$$

π ... Current profits S ... Sales v ... Ratio of variable costs to sales
 w ... Ratio of personnel expenses to sales r ... Ratio of net financial expenses to sales
 d ... Ratio of depreciation expenses to sales Δ ... Difference from the previous year

Monthly Report of Prospects for Japan's Economy February 2007

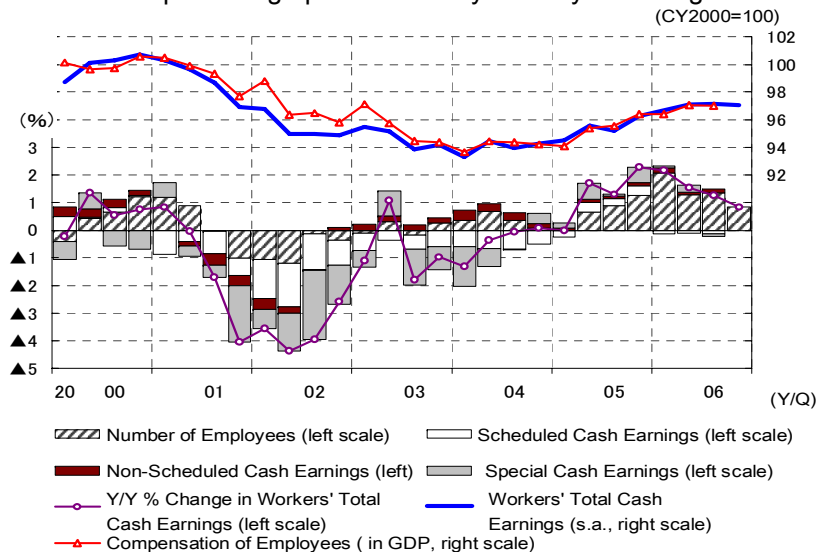
The Japan Research Institute, Limited

Private consumption – Lacking in momentum, yet sustainable

Private consumption, which is seen as one of the points in the economy, is still lacking in momentum. Looking further, it is likely that the growth rate of private consumption would continue to be curbed by sluggish wage growth recovery and be affected adversely by the scheduled increases in the financial burden on households. It could fluctuate, moreover, by factors such as weather conditions, stock price moves, and changes in tax system*. However, it is predicted that private consumption could be sustainable as an underlying trend, basically bolstered by an improving employment situation, as well as a mild upward tendency in stock prices supported by firm corporate profits. It is, furthermore, expected that an increase in the total amount of lump-sum retirement allowances accompanied by the mass retirement of the baby-boomer generation would start to boost private consumption in the aggregate from the middle of the year. It is estimated that the total amount of the retirement allowances in this year would increase by 2 trillion yen compared with that of last year.

*The transfer of tax revenue sources of 3 trillion yen from national Income Tax to Local Inhabitant Tax during this year, which is aimed at promoting devolution, may well cause the fluctuation in private consumption because the time of imposing the tax differs between the two, although the total amount of burden on households is unchanged.

Figure 9-1 Contribution to Change in Workers' Total Cash Earnings
< percentage points in total year-on-year change >

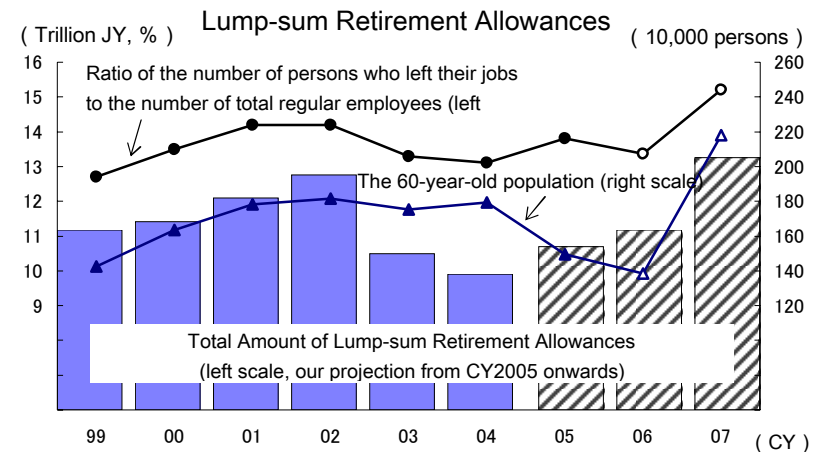


Source: The Ministry of Health, Labour and Welfare, The Ministry of Internal Affairs and Communications, The Cabinet Office

Note 1: Workers' Total Cash Earnings = Index of Total Cash Earnings × Number of Employees

2: The figures in Q4 2006 are for October 2006.

Figure 9-2 Estimate and Projection of Total Amount of



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare, The National Institute of Population and Social Security Research, The Ministry of Internal Affairs and Communications.

Note 1: The total amount of lump-sum retirement allowances is for the amount of employers' imputed social contributions in national accounts.

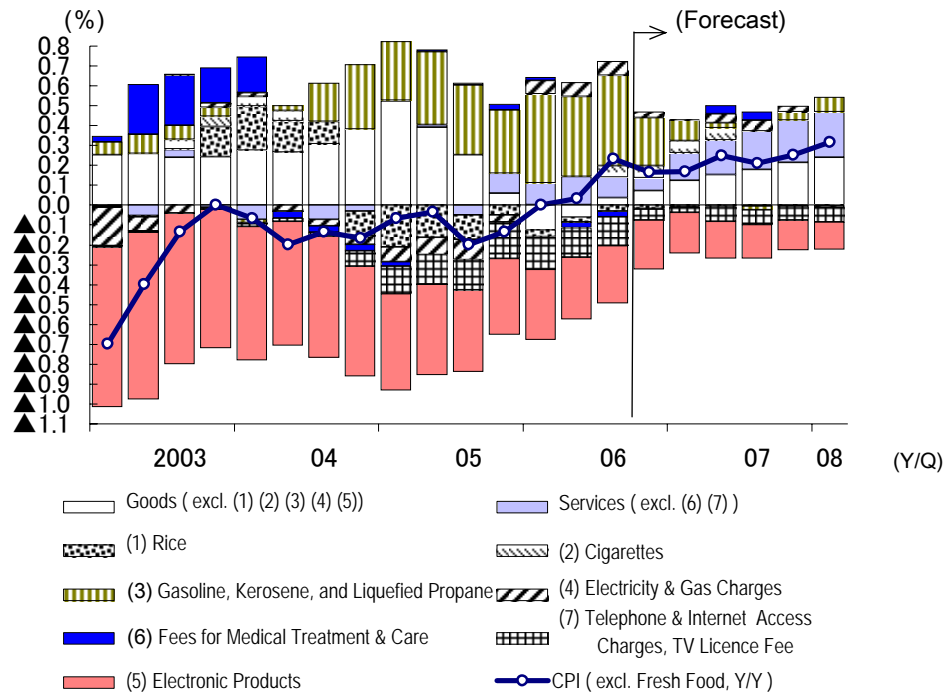
2: The ratio from CY2006 and the amount from CY2005 above are our estimates.

3: The 60-year-old population from Cy2006 is adjusted by our estimate, on a basis of the central projection by The National Institute of Population and Social Security Research.

Consumer price index – Very mild rate of increase to continue

It is forecast that the CPI excluding fresh food, that is the core CPI, would maintain a stable trend in positive territory at around the current, very mild rate of increase. The factors putting downward pressure on the moves of the index include: (i) annual growth of unit labour costs is expected to stay negative, influenced by the recent sluggish trend of wage growth recovery, and (ii) the upward pressure from high petroleum product prices would ease in response to the recent decrease or decelerating pace of the increase. On the other hand, the aggregate supply-demand gap would continue to narrow gradually, which could have a bolstering effect on the prices of products.

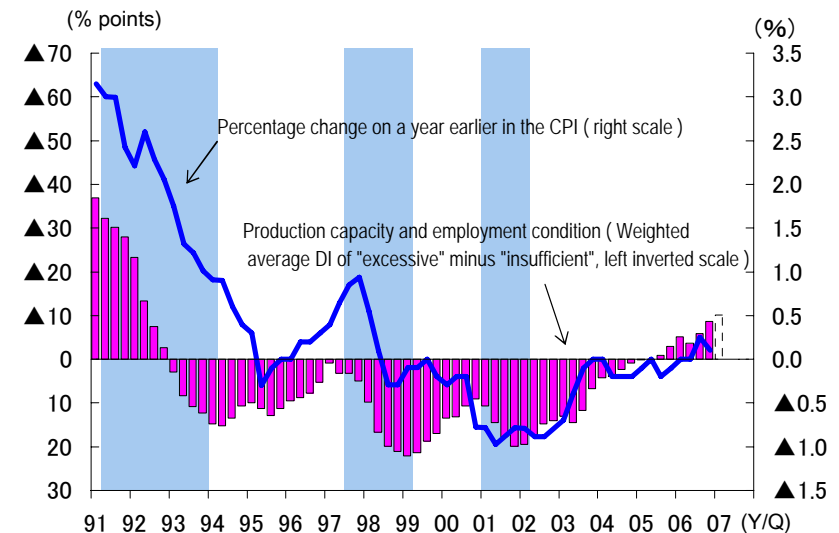
Figure 10-1 Change in Consumer Price Index on CY2005-base
<Year-on-Year, Excluding Fresh Food>



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

Note: The assumed average price of imported crude oil (on a CIF base) is \$64/barrel in FY2006, \$67/barrel in FY2007 (the actual result in FY2005 was \$55/barrel)

Figure 10-2 Supply and Demand Conditions <Diffusion Index in BOJ's Tankan Survey, all industries> and Increase Rate of CPI



Source: The Bank of Japan, The Ministry of Internal Affairs and Communications

Note 1: Weighted average DI of production capacity and employment condition

= Production capacity DI x (1 - Labour's relative share)

+ Employment condition DI x Labour's relative share

Labour's relative share is fixed as 0.73 (average FY1990-2004, SNA).

2: The impact of a rise in the VAT rate is adjusted in the CPI figures in FY1997.

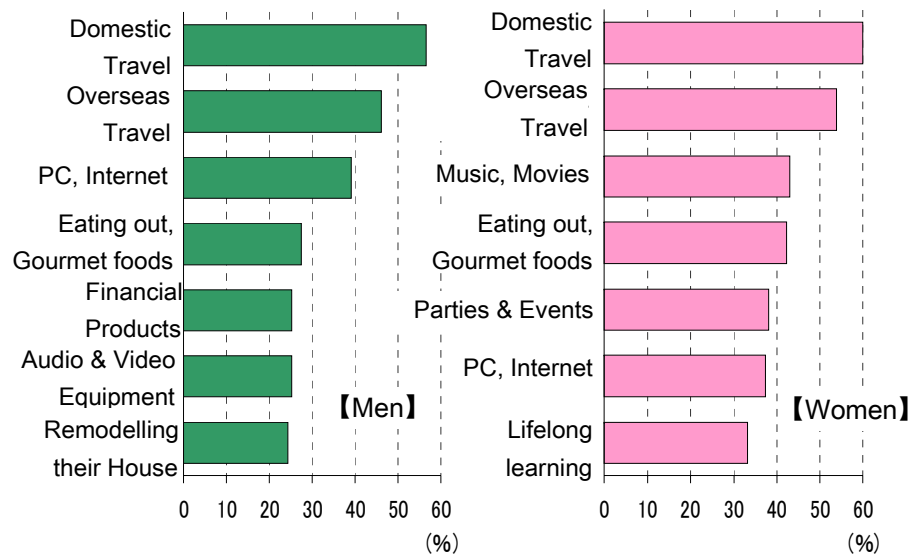
3: The CPI in Q4 2006 is for October and November 2006.

4: The DI in March 2007 is the forecast in the December 2006 survey.

The GDP growth rate – Maintaining recovery trend

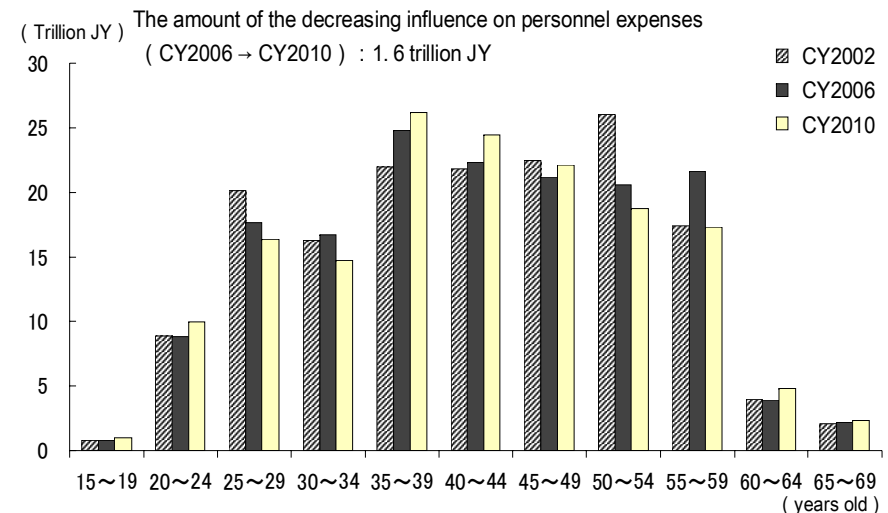
Taken all in all, Japan's economy should continue to recover and maintain a sustainable underlying trend, although the pace of the economic recovery would see a mild slowdown for the present. According to our projection, the GDP during FY2006 is expected to grow at 1.8 per cent in real terms. It is also projected that the real GDP growth rate in FY2007 would accelerate to around 2.3 per cent as a whole, with the pace over the second half of the fiscal year accelerating further. This would be due to the favourable influence of the re-acceleration in the US economy, as well as the emerging positive impact of the mass retirement of the baby-boomer generation. As for the latter, it is expected to have a gradual impact on the economy mainly through the following two channels: (i) the boosting effect of the increase in the total amount of lump-sum retirement allowances on private consumption as mentioned in its forecast, and (ii) the enhancing influence of the decrease in personnel expenses on corporate profits.

Figure 11-1 Survey on Baby-boomer Generation's Spending Choices After Retirement < Conducted by HAKUHODO Inc., Elder Business Development Division >



Source: HAKUHODO Inc., Elder Business Development Division, HOPE Report XIX, "The Baby-boomer Generation - A Survey on the Life-style after Retirement"
 Note : The above are the top seven items for both men and women.

Figure 11-2 Estimate of the Decreasing Influence on Corporate Personnel Expenses of the Mass Retirement of the Baby-boomer Generation



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare, The National Institute of Population and Social Security Research

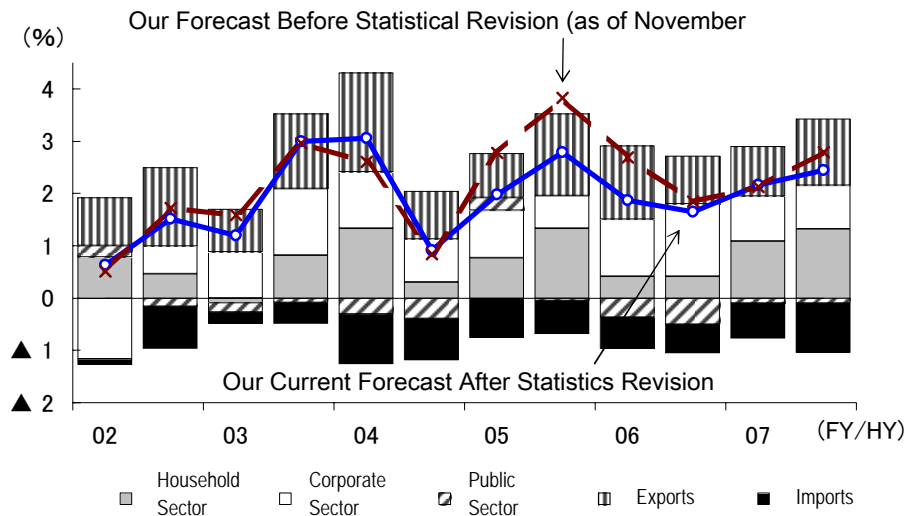
Note : This figure is based on the total expenses of regular employees. The amount of the decreasing influence is adjusted with the estimation of the effect of the increasing number of employees other than regular ones.

[Reference] – Revision to GDP Statistics and FY2007 Tax Reform

Our projection of real GDP growth rate in FY2006 has been revised down to 1.8% from 2.3%, and that in FY2007 to 2.3% from 2.5% since the January Issue of this report. This is due to the statistical revision of the GDP figures in national accounts which was conducted in December 2006 by The Cabinet Office. However, our views on the central projection per se have not basically changed.

In the FY2007 Tax Reform put forward by the Abe administration, the change to the depreciation system from the point of view of establishing the basis for growth of Japan's economy is regarded as one of the main points. As far as the short-run impact of this policy on the economy is concerned, the degree of stimulus would be limited, given the situation that the ratio of business fixed investment to cash flow among enterprises still remains at a low level. This policy should be, rather, assessed from the medium-to-long-term view, such as being one of the strategies aimed at promoting innovation and inviting investment globally.

Figure 12-1 Real GDP Growth Rates Before and After Revision of National Accounts including Our Projections



Source: The Cabinet Office, Forecast is by The Japan Research Institute.

Note 1: Contribution of each sector is based on the current forecast after statistical revision.

2: Household Sector = Private Consumption + Housing Investment

Corporate Sector = Business Fixed Investment + Private Inventories

Public Sector = Government Consumption + Public Investment + Public Inventories

Figure 12-2 Short-term Positive Impact of the Change in Depreciation System on the Economy < our estimate >

Tax reducing effects = Cash flow improving effects	about 400 billion yen	
Ratio of business fixed investment to cash flow	0.76	The past one year average in MOF's "Financial Statements Statistics of Corporations by Industry: Quarterly"
Induced new investment amount (ratio in nominal business fix investment)	about 300 billion yen 0.40%	Business fixed investment : 75.0 trillion yen,
(ratio in nominal GDP)	0.06%	Nominal GDP: 503.4 trillion yen in FY2005
Gross value added inducement coefficient of business fixed investment	1.874	Based on the CY2000 Input-Output Tables (Inter-Industry Relations Tables) for Japan
Impact on GDP growth rate, including ripple effects	about 0.11%	

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

Note 1: About 400 billion yen of tax reducing effects is for the data of The Ministry of Finance.

Other estimated figures are by our calculation based on the above amount.

2: The main points of the FY2007 Tax Reform regarding the change in depreciation system are:

(i) For depreciable assets acquired on or after April 1, 2007, the final depreciable limit (currently 95% of their acquisition costs) will be abolished.

(ii) The statutory useful life for certain equipment such as manufacturing facilities of flat panel displays will be shortened to 5 years from 8 - 10 years.

Prospects for Japan's economy - Re-acceleration into FY2007

(1) Projection for economic growth

Japan's economy should continue to recover and maintain a sustainable underlying trend, although the pace of the economic recovery would see a mild slowdown for the present.

(i) A predicted temporary slowdown over the second half of FY2006 would be due to starting in earnest to feel the impact of a slowing of the US economy as well as a possible adjustment of the rapid production pace thus far in the IT sector. According to our projection, the GDP during FY2006 as a whole is expected to grow at 1.8 per cent in real terms.

(ii) Looking further, the real GDP growth rate would accelerate to around 2.3 per cent in FY2007, with the pace over the second half accelerating further. This would be due to the favourable influence of the re-acceleration in the US economy, and the emerging positive and gradual impact of the mass retirement of the baby-boomer generation.

(iii) As for prices, the rate of increase in the CPI excluding fresh foods would stay positive, and remain very modest, reflecting a mild narrowing of the aggregate supply-demand gap. Intense market competition and an easing in natural resource prices are expected to make a move in the CPI more moderate and stable.

(2) Factors which would make the recovery period longer

It is also widely recognised that Japan's economy would retain appreciable abilities to absorb shocks, which differs from those observed during the time of the collapse of the "IT bubble" or during the temporary slack period in CY2004. The main abilities seen are as follows:

(i) The improvement in shipment-inventory balance in non-IT sectors, for a short-term factor. Even if pressure for adjustments arises in the IT sector, the non-IT sectors would bolster demand and a major production adjustment across all sectors of manufacturing industry could be avoided.

(ii) The dissipation of structural adjustment pressures in the corporate sector as well as abundant liquidity as its financial strength, for a medium-to-long-term factor. With the management focus shifting from the "adjustment of excessive labour, capital equipment and debt" to "active business expansion aiming at survival against fierce global competition" as well as "securing human resources with developed abilities", with a view to the retirement of the baby-boomer generation and a full-scale decrease in population, the positive attitude toward business fixed investment and employment would continue.

(3) Uncertainties in the trajectory of economic growth

The downside risks to the central projection would be (i) an unpredicted steep rise in oil and other resource prices due to increased geopolitical risks, and (ii) an unwelcome offsetting of positive "baby-boomer generation effects" by more curbed wage growth caused by uncertainties surrounding enterprises. The upside risk would be an undesirable boom of inefficient business fixed investment, which could lead to considerable capital stock adjustment pressure from FY2009 onwards.

Figure 13 Projections for GDP Growth and Main Indicators of Japan

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

	CY2006				CY2007				FY2005	FY2006	FY2007
	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12			
	(Actual)				(Projection)				(Actual)	(Projection)	
Real G D P	2.7	1.1	0.8	2.8	1.8	2.3	2.5	2.7	2.4	1.8	2.3
Private Consumption Expenditure	▲ 0.2	2.0	▲ 3.7	4.3	1.9	2.0	2.1	2.4	1.9	0.8	2.0
Housing Investment	3.8	▲ 8.1	▲ 1.1	▲ 0.2	1.7	1.8	2.0	2.2	▲ 1.0	▲ 0.6	1.5
Business Fixed Investment	15.2	13.6	6.1	6.6	4.7	4.5	4.3	4.2	5.8	8.1	4.8
Private Inventories (percentage points contribution)	(0.7)	(▲ 0.6)	(0.7)	(▲ 0.3)	(0.0)	(0.1)	(0.1)	(0.2)	(▲ 0.1)	(0.0)	(0.1)
Government Consumption Expenditure	▲ 0.6	2.9	3.0	0.3	0.6	0.7	0.7	0.7	0.9	0.9	0.8
Public Investment	▲ 7.3	▲ 25.0	▲ 19.7	▲ 7.2	▲ 5.0	▲ 5.0	▲ 5.0	▲ 5.0	▲ 1.4	▲ 13.2	▲ 6.0
Net Exports (percentage points contribution)	(0.5)	(▲ 0.2)	(1.7)	(▲ 0.1)	(0.0)	(0.4)	(0.6)	(0.5)	(0.6)	(0.6)	(0.4)
Exports of Goods and Services	9.6	2.9	10.4	4.2	3.0	7.2	9.0	8.8	9.0	7.8	6.8
Imports of Goods and Services	8.0	5.4	▲ 2.0	6.4	3.6	5.6	6.6	7.0	6.0	4.2	5.3

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

Real G D P	2.9	2.1	1.6	1.4	1.9	2.0	2.4	2.2	2.4	1.8	2.3
Nominal G D P	1.6	1.0	1.0	1.1	1.6	2.1	2.5	2.3	1.0	1.2	2.5
Consumer Price Index (excl. fresh food)	0.0	0.0	0.2	0.2	0.2	0.2	0.2	0.3	▲ 0.1	0.2	0.3
Industrial Production Index	3.2	4.1	5.4	4.8	2.8	2.6	2.8	2.0	1.6	4.2	2.8
Unemployment Rate (%)	4.2	4.1	4.1	4.0	4.0	3.9	3.9	3.8	4.4	4.1	3.8
Current Account Balances (trillion JY)	5.52	3.97	5.31	5.20	4.50	4.65	4.63	4.95	19.12	18.99	18.69
Share of Nominal GDP (%)	4.5	3.1	4.3	3.9	3.6	3.6	3.6	3.6	3.8	3.7	3.6
Exchange Rates (JY/US\$)	116.9	114.4	116.2	117.8	118.0	118.0	115.0	113.0	113.3	116.6	114.0

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) A slowdown in the US economy is expected to be levelling off to re-acceleration beginning in spring 2007 (the projected real GDP growth rate is 3.3% in CY2006 and 2.6% in 2007).

(2) The assumed average price of imported crude oil is \$64/barrel in FY2006 and \$67/barrel in FY2007 (the actual result in FY2005 was \$55/barrel).