

Monthly Report of Prospects for Japan's Economy

March 2007

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

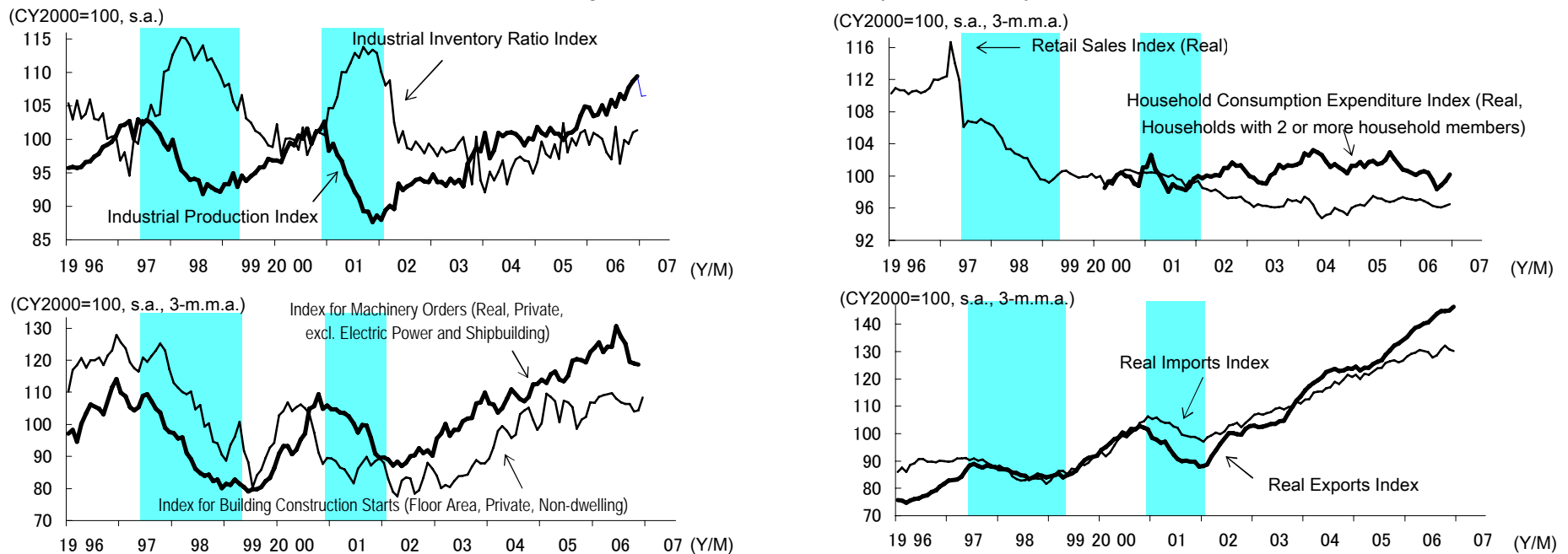
<http://www.jri.co.jp/thinktank/research/>

This report is the English version of the February 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, rose 2.6 per cent in Q4 CY2006 over the previous quarter, a fifth consecutive quarterly rise, setting a record. Also, private consumption rebounded in the same quarter after a substantial decline in Q3 last year. However, the pace of recovery seems to be decelerating as seen on a half-yearly average basis, reflecting a slowing in exports and a tailing-off of the surge in business fixed investment due to large-scale projects. In addition, growing inventory in the IT sector, such as electronic parts and devices, as well as lack of momentum in private consumption are among the uncertainties surrounding a future economic path and need a closer watch.

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.

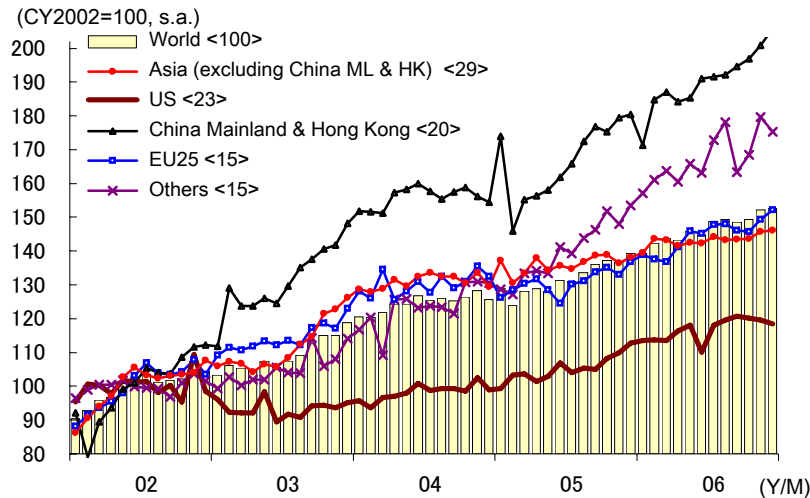
Note 2: The Industrial Production Index in January and February 2007 is based on METI forecasts. Note 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Exports – Projected to decelerate for the moment

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. Moreover, 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 of production goods to China, especially electronic devices, held strong. However, looking at recent moves by region, exports to the US 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 as well as digital household appliances and gadgets 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 2-1 Japan's Real Exports by Region
< seasonally adjusted >



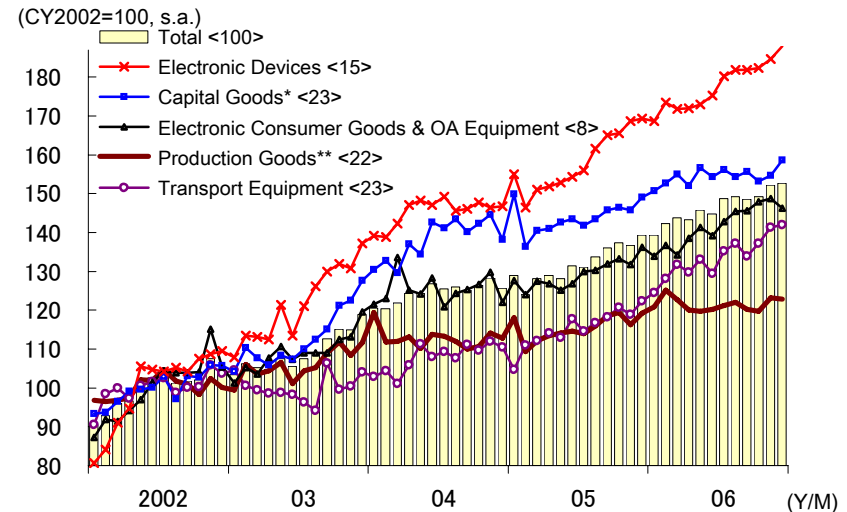
Source: The Ministry of Finance, The Bank of Japan

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



Source: The Ministry of Finance, The Bank of Japan

Note 1: *excluding Transport & OA Equipment, **excluding Devices

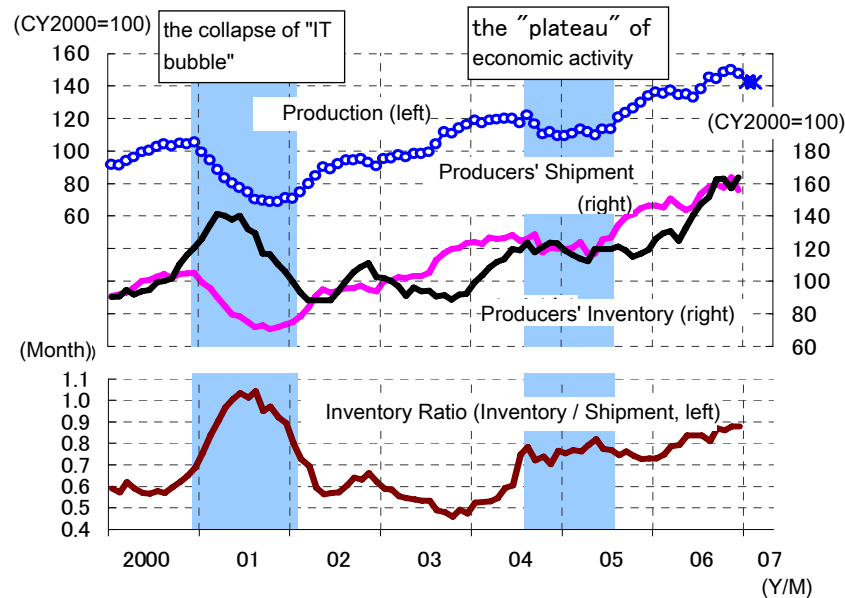
2: The figures in angle brackets in the legend indicate the share of each group of goods in total nominal exports of Japan (JY 68.3 trillion in FY2005).

3: Percentage discrepancy due to the share of other goods.

The IT devices sector – Predicted slowdown in rapid pace of the production

In the electronic parts and devices sector, of which moves are important for economic predictions, a rapid pace of the production is expected to decelerate further, mainly due to a tailing-off of the surge in inventory in the run-up to the year-end and new-year sales. Looking further at the IT sector as a whole, especially from this spring onwards, it is probable that production would require only a minor adjustment given the earlier appropriate measures corresponding to the inventory situation. This projection is also against the backdrop that the latest demand both for final IT products and for IT parts and devices has kept solid, as well as that recent inventory ratio (inventory / shipment) in leading products in the parts and devices sector has hit its ceiling or maintained a low level. However, a close watch would be still needed as to how long that adjustment would continue, especially in the production of important products such as liquid crystal devices and charge coupled devices (CCD, IC parts for digital cameras), because the move largely depends on the future sales situation of the final products such as liquid crystal TVs and mobile phones.

Figure 3-1 Indices of Industrial Production, Shipments and Inventories in the Electronic Parts and Devices Sector

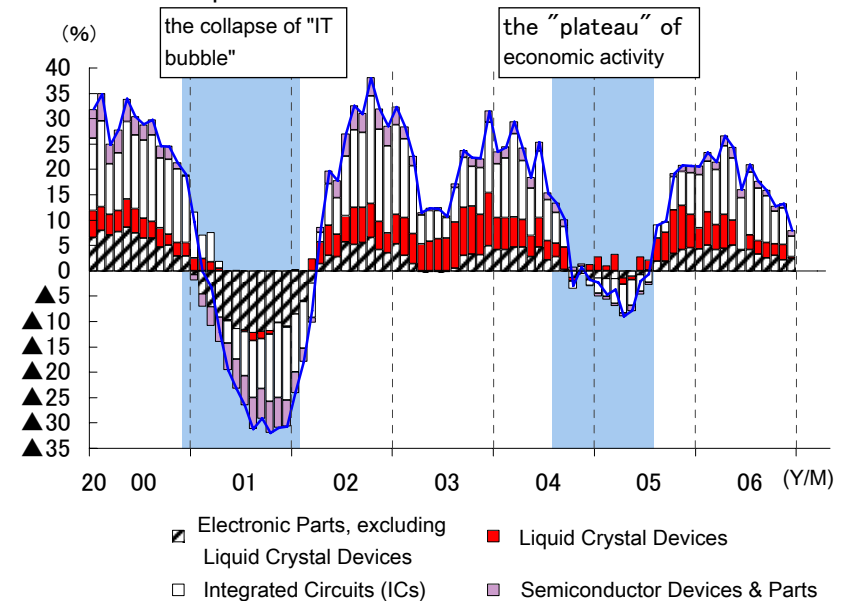


Source: The Ministry of Economy, Trade and Industry

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

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

Figure 3-2 Contribution of Each Product to Total Year-on -Year Change of Shipment in the Electronic Parts and Devices Sector



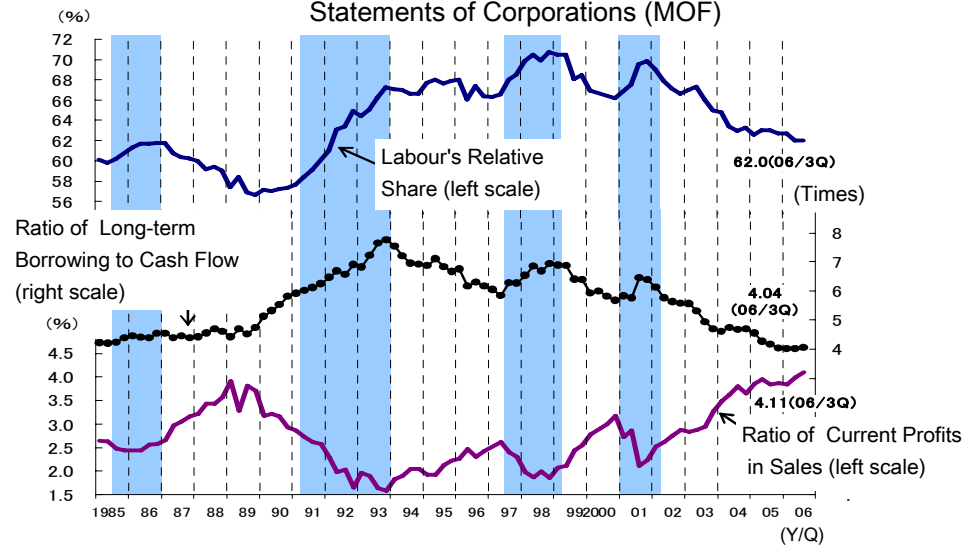
Source: The Ministry of Economy, Trade and Industry

Note 1: The recent "plateau" of economic activity is indicated as the shaded area from August 2004 to July 2005.

Appreciable ability to absorb shocks – Backdrop of continuous recovery

It is widely recognised that Japan's economy would retain appreciable abilities to absorb shocks. 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 advantages seen are as follows: (i) A low level of inventory ratio in manufacturing industry except the IT parts and devices sector, for a short-term factor. Among those, the ratio in the metal and machinery sectors maintains the lowest level ever. Therefore, even if the IT parts and devices sector requires an adjustment, 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 per cent in Q3 last year, and that net financial assets in nonfinancial enterprises amounted to 137.8 trillion yen at the end of September last year, which is the equivalent of 2.7 times total current profits during FY2005. 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 4-1 Main Indicators based on Financial Statements of Corporations (MOF)

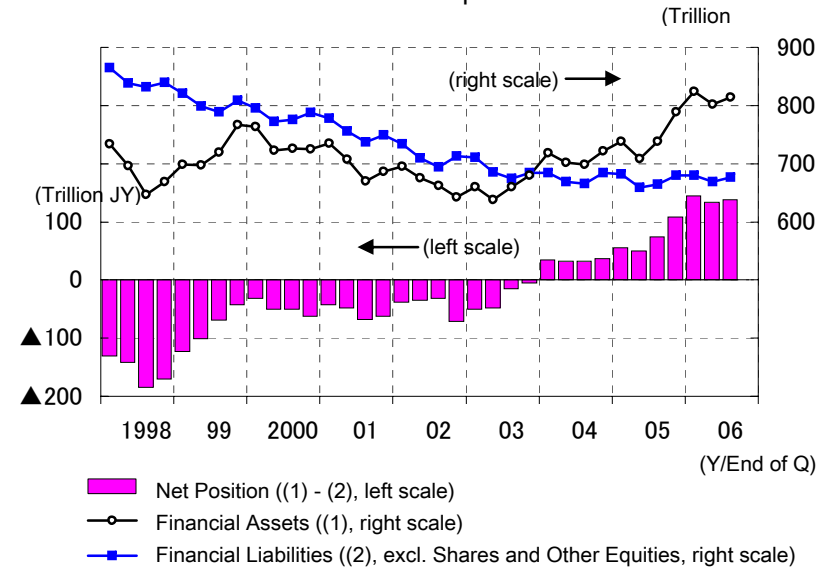


Source: The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry: Quarterly"

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)

Figure 4-2 Net Position in Financial Assets and Liabilities of Nonfinancial Enterprises



Source: The Bank of Japan

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.

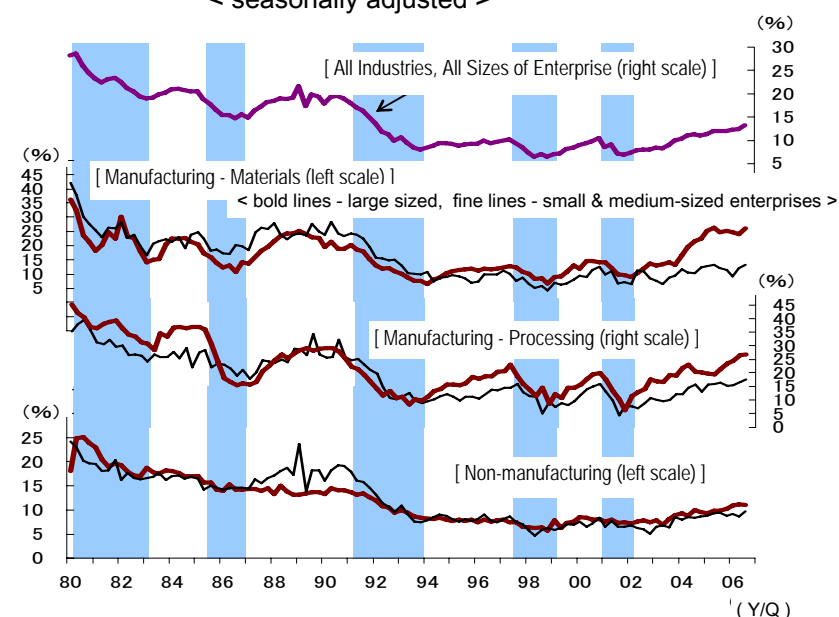
Figure 5-1 Annual Projections of Business Fixed Investment
< The BOJ's Tankan December 2006 Survey >

	Weight (FY2005)	(% change, on a year-on-year basis)				FY2006		FY2005 (forecast, as of Dec. 05)
		H1 FY05 (actual)	H2 FY05 (actual)	H1 FY06 (estimate)	H2 FY06 (forecast)	(actual)	(forecast)	
[Large Enterprises]								
All Industries (excluding Financial)	64.6	7.9	5.9	7.7	15.5	6.8	12.0	11.3
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]								
All Industries (excluding Financial)	15.7	11.3	14.3	8.2	3.3	12.8	5.7	9.3
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]								
All Industries (including Financial)	100.0	8.5	8.8	7.9	12.9	8.7	10.6	11.3
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 5-2 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.

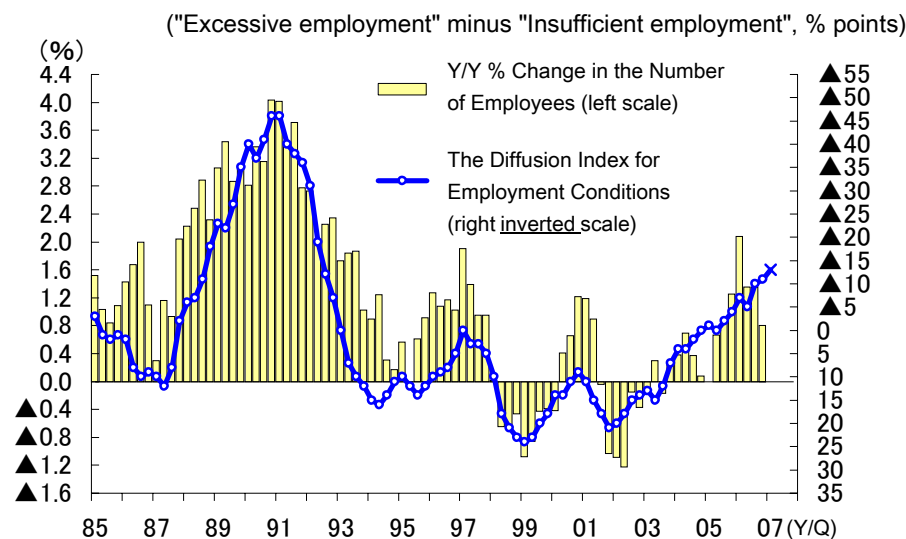
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Employment situation - Continuing improvement in labour demand

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 a growth rate above the 1.0 per cent mark, mainly led by an increase in full-time regular employees, and is expected to do so for the time being.

Figure 6-1 Employment Conditions < Diffusion Index in BOJ's Tankan Survey, all industries > and the Number of Employees



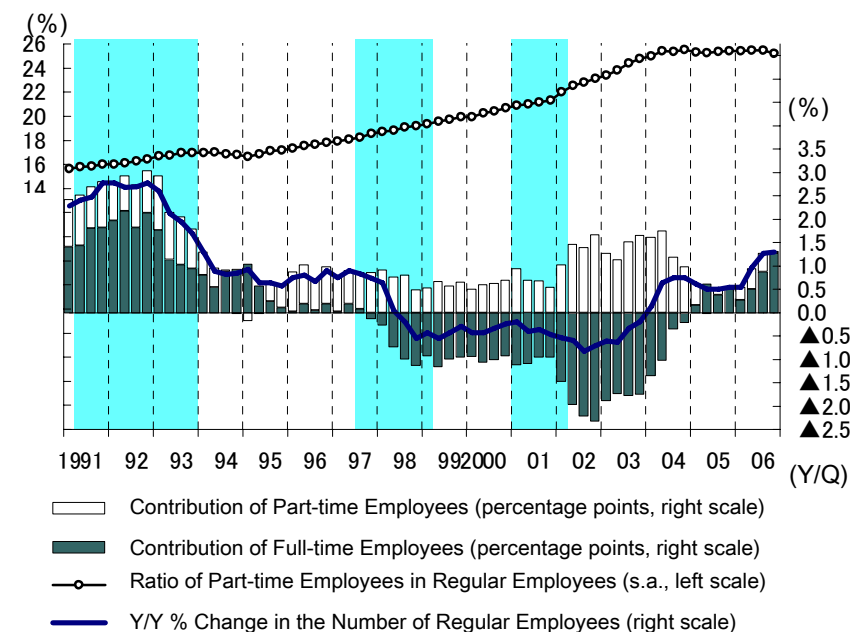
Source: The Bank of Japan, The Ministry of Internal Affairs and Communications

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 6-2 Contributions to Annual Percentage Change in the Number of Regular Employees by Employment Terms

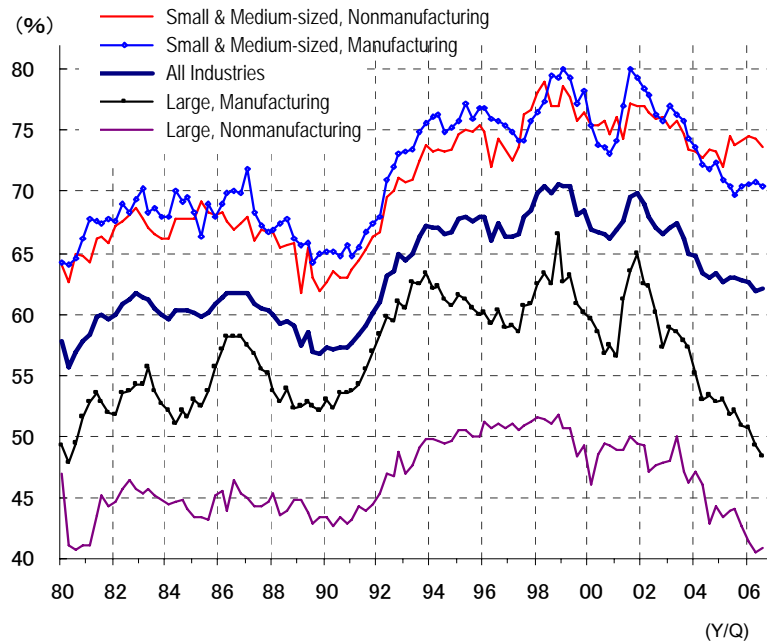


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare

Wage situation (1) - Labour's relative share as a matter of wide concern

With regard to the wage situation, it is a matter of wide concern whether labour's relative share would be raised or not in the annual round of wage bargaining this spring. In order to predict the outcome, it seems to be important to examine its recent trend in enterprises by size and type of industry in a longer perspective. Statistics show that labour's relative share among large enterprises has decreased to the lowest level since the 1980s in both manufacturing and nonmanufacturing. On the other hand, the figure among small and medium-sized enterprises has still remained at a higher level than that in the 1980s, which implies insufficient room for raising the share. In addition, recent survey results show that management continues to give higher priority in its current profits distribution to business fixed investment, internal reserves and payment of a dividend. Taking these trends and survey results into consideration, it is rather difficult to say at present whether labour's relative share in the aggregate would start to indicate an upward tendency in the foreseeable future.

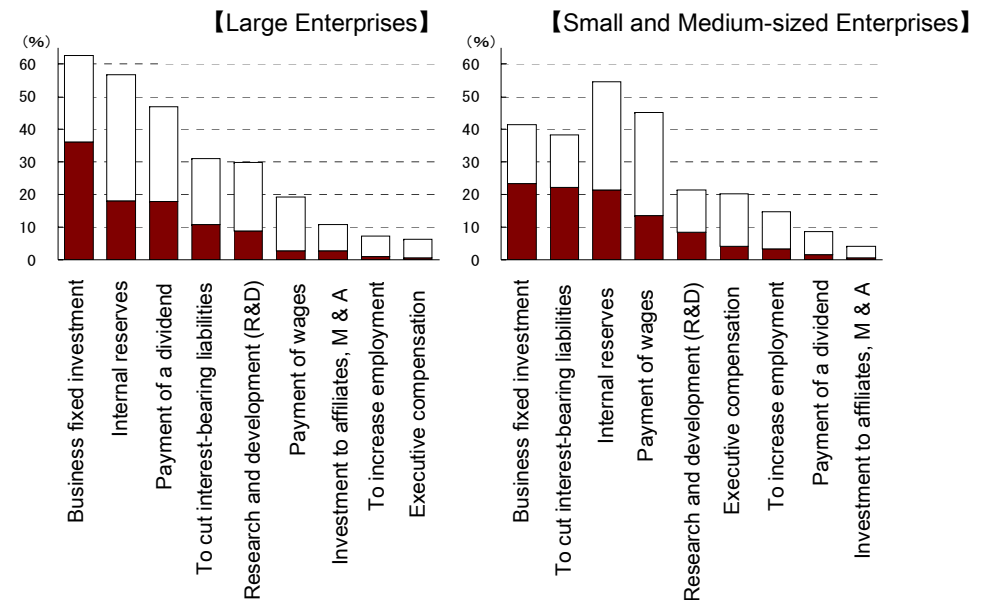
Figure 7-1 Labour's Relative Share by Size and Type of Industry



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)

Figure 7-2 Enterprises' Priority in their Current Profits Distribution
< Survey by Ministry of Finance and Cabinet Office, as of November 2006 >



Source: The Ministry of Finance, The Cabinet Office, "Business Outlook Survey"

Note 1: Share of each response in the total with plural answers to the questionnaire.

Each respondent could choose three or less among the responses.

2: Darkened area indicates the share of the response made as their top priority.

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Wage situation (2) - Possible fair wind from softening oil prices

Even if labour's relative share does not increase, or rather follows a downward path, it is possible that softening oil prices would bring about scope for an improvement in wage growth. Our estimate shows that a 19% increase in import oil price seems to have eroded current profits by 2.2 trillion yen in FY2006. However, it is probable that a weighing effect on current profits will ebb in FY2007, assuming that the oil price during that period would likely remain at a level similar to that in the last year. In recent years, enterprises have absorbed an impact of the increase in the ratio of variable costs to sales largely caused by an oil price increase through decreasing the ratio of personnel expenses to sales, in order to maintain a certain extent of profit growth. Accordingly, it is the centre of attention in the wage situation this year how far softening movements, or rather declines under certain circumstances, in the price of oil would reverse this recent tendency and result in a wage growth improvement.

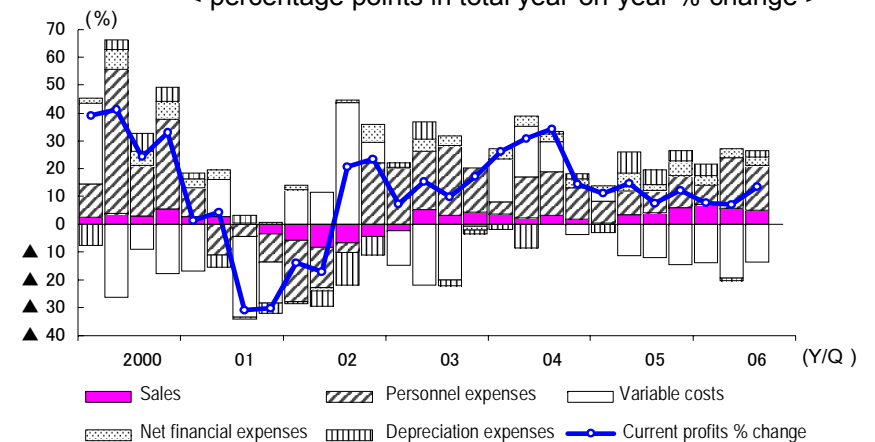
Figure 8-1 Impact of Increase in Import Price of Oil on Corporate Current Profits < Our Estimate >

	FY2006 <estimate>	FY2007 <simulation>				
Rate of Increase in Oil Price	+19%	▲ 10%	▲ 5%	±0%	+5%	+10%
Import Price of Crude Oil (CIF)	64\$/bl.	58\$/bl.	61\$/bl.	64\$/bl.	67\$/bl.	70\$/bl.
Assumed JY/\$ Exchange Rate	117JY/\$	117JY/\$				
* Net Impact on Assumed Current Profits in Each FY	▲ 4.3%	+2.3%	+1.1%	±0.0%	▲ 2.3%	▲ 1.1%
	(▲ 2.2 tril.JY)	(+1.2 tril.JY)	(+0.6 tril.JY)	(±0.0 tril.JY)	(▲ 0.6 tril.JY)	(▲ 1.2 tril.JY)
Share of above * in Personnel Expenses	▲ 1.1%	+0.6%	+0.3%	±0.0%	▲ 0.3%	▲ 0.6%

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.

Note 2: The figures in the net impact on estimated current profits in FY2006 are calculated on the assumption that the average import price of crude oil (on a CIF basis) in Q1 CY2007 is \$59/barrel and the average of JY/\$ exchange rate in the same period is 121JY/\$.

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

Private consumption (1) – Avoided slipping into a downward trend in Q4 last year

Private consumption, which is seen as one of the key points in the economy, rebounded in the final quarter last year after a considerable decline in Q3, so it avoided slipping into a downward trend. The favourable effects on consumers' attitude such as a recovery of the weather from bad conditions in summer, a bounce-back of stock prices as well as a continuing gradual advance in the employment situation seem to have contributed to the rebound of private consumption during that period, albeit a still sluggish wage growth improvement. Viewing by consumption items, expenditure on services such as travel and telecommunications rose firmly and the pace of the increase in spending on digital household equipment including liquid crystal TVs and plasma TVs accelerated compared with the previous quarter. In addition, expenditure on food in real terms, which shrank sharply during Q3 reflecting the surge in fresh food prices on account of the unseasonable weather, recovered in Q4 to a level in the first half of CY2006. Looking at the move at present, a certain number of uncertainties seem to still remain, which include the aspects that there are some items adversely affected by this mild winter such as clothes and heating apparatus, as well as that there is mixed demand among items largely due to the highly price selective attitude of consumers.

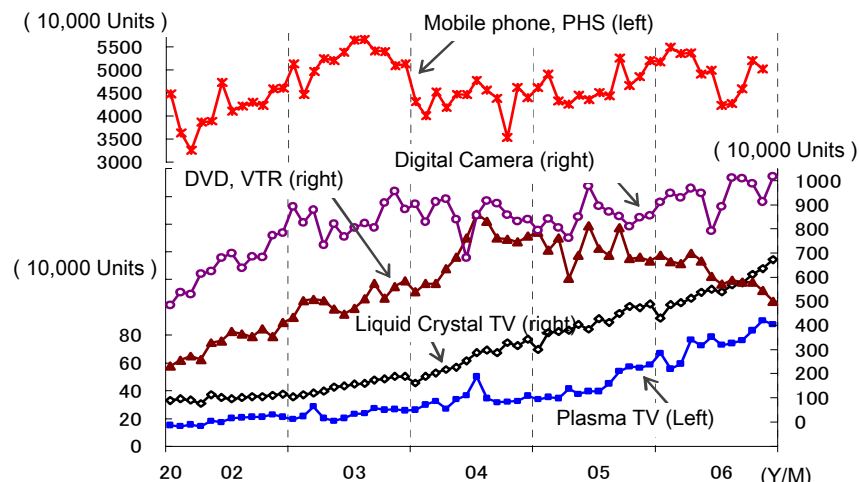
Figure 9-1 Diffusion Index for Current Economic Condition
by Household Activity-Related Industry
< the Economy Watchers Survey by the Cabinet Office >

	(points)										
	Sep 05	Dec 05	Mar 06	Jun 06	Jul 06	Aug 06	Sep 06	Oct 06	Nov 06	Dec 06	
Household activity-related	44.2	50.0	51.5	43.5	42.3	45.3	44.8	44.9	43.3	43.7	
Retail	44.0	49.4	49.8	41.3	39.9	44.3	44.8	43.1	40.8	40.1	
Shopping area, High street shop	39.9	43.9	46.9	40.7	36.1	37.3	40.4	40.5	38.9	39.8	
Department store	48.5	64.2	60.1	40.7	43.6	50.7	57.5	45.0	46.4	38.2	
Supermarket	42.7	56.3	44.7	47.5	46.1	55.5	51.2	46.6	45.4	43.1	
Convenience store	45.2	40.1	41.8	42.6	36.3	48.3	44.6	46.6	43.4	44.2	
Clothing shop	41.5	48.4	45.5	34.5	39.1	35.6	35.8	38.3	32.6	33.8	
Electrical appliance retailer	53.5	62.5	57.1	48.8	44.2	46.3	44.2	47.5	43.2	43.9	
Automobile	48.0	36.9	58.2	37.5	36.7	37.3	38.6	40.1	35.4	35.9	
Others	39.4	47.2	47.1	40.2	39.2	43.3	42.6	42.8	38.9	42.7	
Food and beverage	41.0	48.0	52.1	42.6	44.1	40.4	36.7	38.0	40.4	43.8	
Services	45.5	53.7	55.2	48.0	46.4	48.2	45.7	49.6	48.9	51.6	
Travel, transportation	44.3	55.4	55.5	47.0	45.9	47.1	45.0	51.8	50.0	51.5	
Telecom company	52.2	59.9	59.7	52.9	53.7	47.7	49.2	54.6	51.9	53.8	
Leisure facility operator	44.5	48.0	55.0	46.9	40.5	53.9	48.0	49.2	52.0	52.7	
Other services	42.7	47.8	48.5	46.6	45.7	45.6	41.1	38.4	39.2	48.0	
Housing	43.7	42.2	50.9	45.5	44.8	46.8	48.1	47.4	44.2	42.2	

Source: The Cabinet Office

Note: Shaded area indicates figures above the total average in each period.

Figure 9-2 Shipment of Household Electronic Equipment
to the Domestic Market < seasonally adjusted >

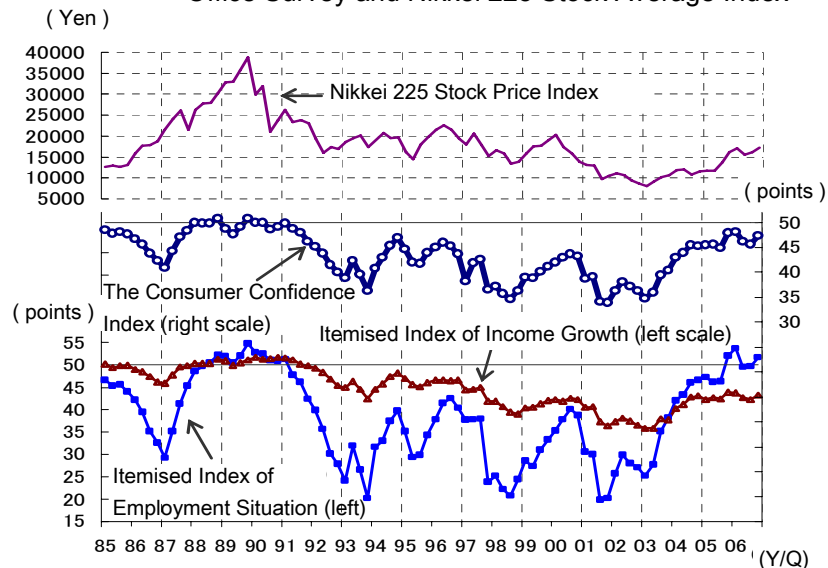


Source: Seasonally adjusted by The Japan Research Institute, Ltd. based on the data of Japan Electronics and Information Technology Industries Association (JEITA) and Camera & Imaging Products Association (CIPA).

Private consumption (2) – Expected to strengthen recovery trend in the medium term

Private consumption would have a "now advancing" and "now retreating" movement for the time being, reflecting the situation where the positive factors and negative ones continue to contend with each other. The former includes an improvement in employment environments as well as a rebound of stock prices, while the latter is that labour's relative share is curbed among enterprises and there will be an expected increase in the financial burden in households. In the short run, a possibility could be added as a favourable element that softening oil prices would bring about scope for an improvement in wage growth. Looking further, it is likely that boosting aspects would gradually rise to predominance over weighing aspects, that is, private consumption would have an upward tendency in the medium term. This is against the background that the impacts accompanied by the mass retirement of the baby-boomer generation, such as an increase in the total amount of lump-sum retirement allowances as well as much room for an improvement in wage growth of the active generation, would start to be incorporated as a private consumption boosting factor in the aggregate.

Figure 10-1 Consumer Confidence Index in the Cabinet Office Survey and Nikkei 225 Stock Average Index

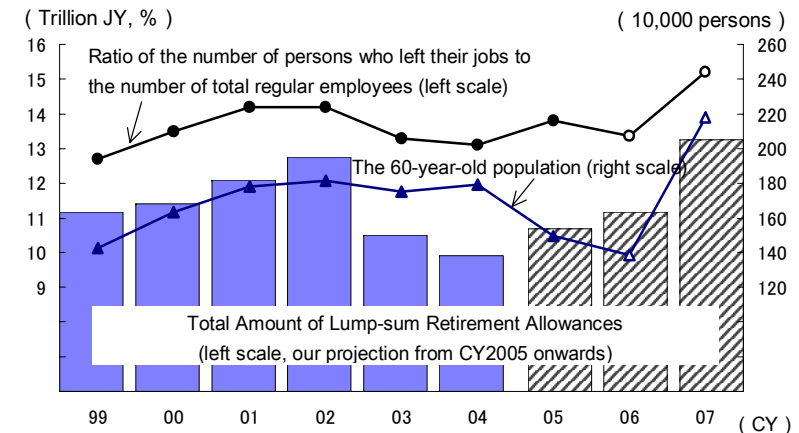


Source: The Cabinet Office, The Nikkei Shimbun

Note: The figures of the Consumer Confidence Index are seasonally adjusted.

The figures of the Nikkei 225 Stock Average Index are monthly averages in March, June, September and December in each year.

Figure 10-2 Estimate and Projection of Total Amount of Lump-sum Retirement Allowances



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.

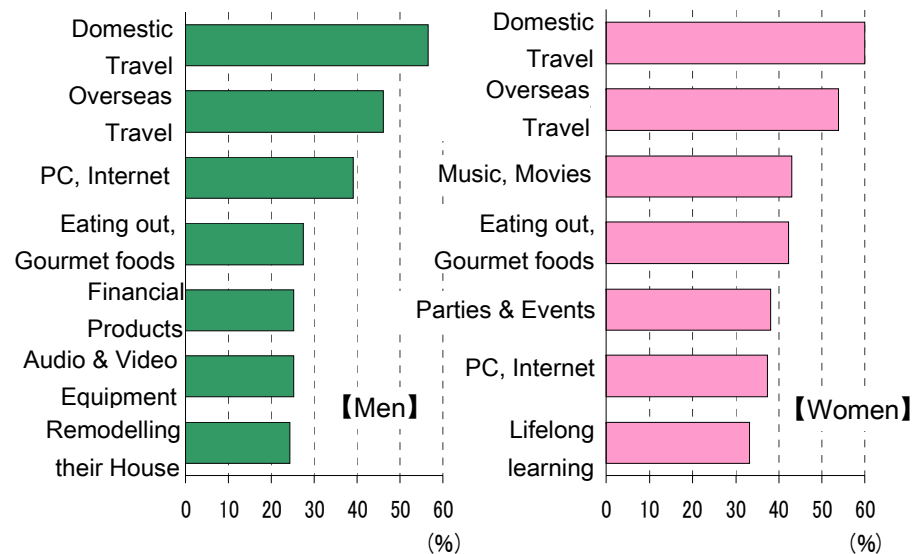
2: The ratio from CY2006 and the amount from CY2005 above are our estimates.

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

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 2.0 per cent in real terms in the aggregate, a fourth consecutive fiscal yearly reaching of the 2.0 per cent mark. 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, given its soft landing, 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 the forecast, and (ii) the enhancing influence of the decrease in personnel expenses on corporate profits, which could give scope for a wage improvement for the younger generation.

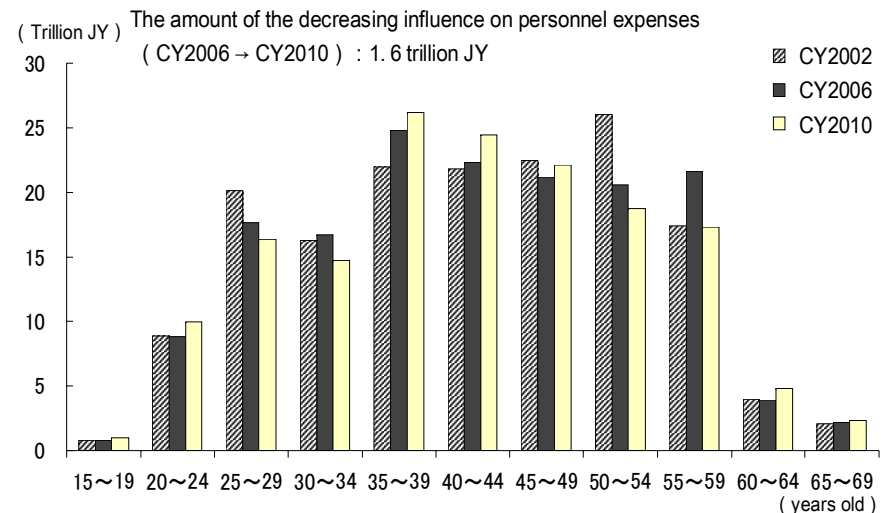
Figure 11-1 Survey on the Baby-boomer Generation's Spending Choices After Retirement < Conducted by HAKUHODO Inc. >



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



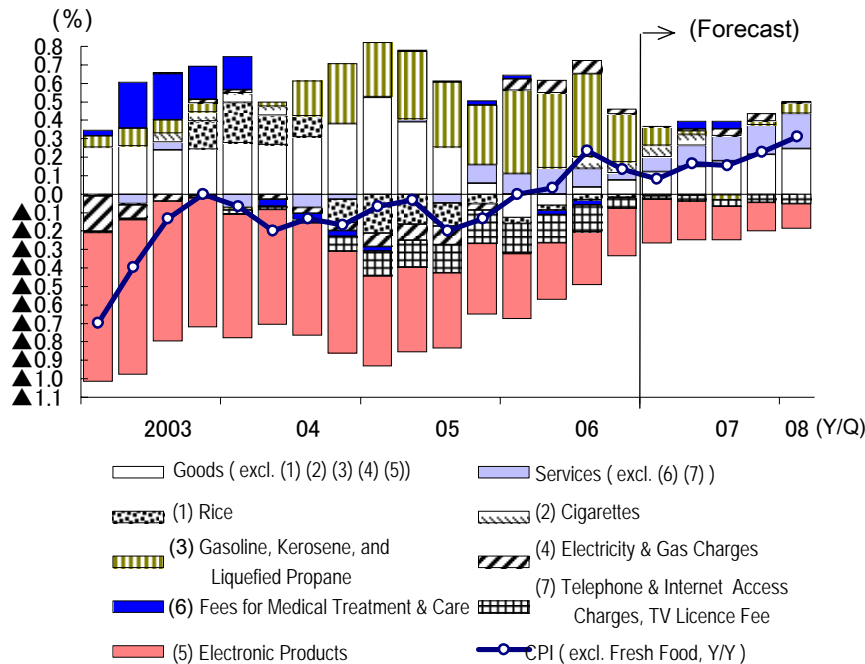
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare, The National Institute of Population and Social Security Research

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.

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.

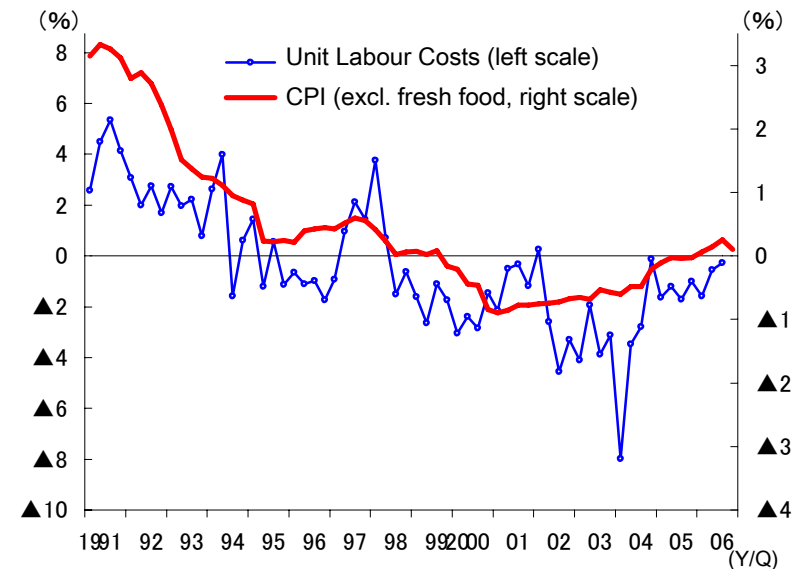
Figure 12-1 Change in Consumer Price Index on CY2005-base
<year-on-year, excluding fresh food>



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 both in FY2006 and FY2007 (the actual result in FY2005 was \$55/barrel)

Figure 12-2 Change in Unit Labour Costs and Consumer Price Index (excluding fresh food)
<year-on-year>



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

Note 1: Unit Labour Costs = Nominal Compensation of Employees / Real GDP

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

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 2.0 per cent in real terms. 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 as stated below.

(ii) 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 seems to lead to a lowering of the risk that the recovery trend of the economy could falter in the short run. The main abilities seen are as follows:

(i) A low level of inventory ratio in manufacturing industry except the IT parts and devices sector, for a short-term factor. Among those, the ratio in the metal and machinery sectors maintains the lowest level ever. Therefore, 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", the positive attitude toward business fixed investment and employment would continue.

(3) Prospects for private consumption in both short- and medium-term

(i) Private consumption would have a "now advancing" and "now retreating" movement for the time being, reflecting the situation where the positive factors and negative ones continue to contend with each other. The former includes an improvement in employment environments as well as a rebound of stock prices, while the latter is that labour's relative share is curbed among enterprises and there will be an expected increase in the financial burden in households. In the short run, a possibility could be added as a favourable element that softening oil prices would bring about scope for an improvement in wage growth.

(ii) Looking further, it is likely that boosting aspects would gradually rise to predominance over weighing aspects, that is, private consumption would have an upward tendency in the medium term. This is against the background that the impacts accompanied by the mass retirement of the baby-boomer generation, such as an increase in the total amount of lump-sum retirement allowances as well as much room for an improvement in wage growth of the active generation, would start to be incorporated as a private consumption boosting factor in the aggregate.

Figure 13 Projections for GDP Growth and Main Indicators of Japan

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

	CY2006			CY2007				CY2008	FY2005	FY2006	FY2007
	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3			
	(Actual)			(Projection)					(Actual)	(Projection)	
Real GDP	1.4	0.3	4.8	1.4	2.0	2.3	2.5	2.7	2.4	2.0	2.3
Private Consumption Expenditure	2.3	▲ 4.2	4.4	1.5	1.9	2.1	2.3	2.4	1.9	0.7	1.9
Housing Investment	▲ 8.1	▲ 0.3	8.2	0.8	1.0	1.3	1.8	2.1	▲ 1.0	0.5	2.0
Business Fixed Investment	13.7	3.4	9.2	5.4	4.2	4.0	3.8	3.6	5.7	8.0	4.8
Private Inventories (percentage points contribution)	(▲ 0.7)	(0.8)	(▲ 0.5)	(▲ 0.2)	(0.1)	(▲ 0.1)	(0.1)	(0.3)	(▲ 0.1)	(0.0)	(▲ 0.0)
Government Consumption Expenditure	3.0	2.6	0.1	0.6	0.6	0.6	0.5	0.5	0.9	0.9	0.6
Public Investment	▲ 22.9	▲ 17.8	11.3	▲ 7.0	▲ 6.0	▲ 5.4	▲ 5.0	▲ 4.8	▲ 1.4	▲ 10.3	▲ 4.8
Net Exports (percentage points contribution)	(▲ 0.2)	(1.6)	(0.6)	(0.2)	(0.4)	(0.7)	(0.5)	(0.5)	(0.6)	(0.7)	(0.5)
Exports of Goods and Services	2.8	10.0	4.3	3.3	6.0	9.0	8.8	8.6	9.0	7.8	6.6
Imports of Goods and Services	5.7	▲ 1.8	▲ 0.1	2.8	4.8	5.8	7.2	7.7	6.0	3.4	4.1

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

Real GDP	2.1	1.5	2.1	2.3	2.2	2.8	1.9	2.5	2.4	2.0	2.3
Nominal GDP	1.0	0.8	1.5	2.0	2.2	2.9	2.2	2.7	1.0	1.3	2.5
Consumer Price Index (excl. fresh food)	0.0	0.2	0.1	0.1	0.2	0.2	0.2	0.3	▲ 0.1	0.1	0.2
Industrial Production Index	4.1	5.4	5.7	3.5	2.8	3.0	1.8	3.8	1.6	4.7	2.8
Unemployment Rate (%)	4.1	4.1	4.1	4.0	3.9	3.9	3.8	3.8	4.4	4.1	3.8
Current Account Balances (trillion JY)	3.97	5.29	5.27	5.22	5.17	5.16	5.03	4.72	19.12	19.76	20.07
Share of Nominal GDP (%)	3.1	4.2	4.1	4.1	4.0	4.0	3.8	3.6	3.8	3.9	3.8
Exchange Rates (JY/US\$)	114.4	116.2	117.8	121.0	121.0	118.0	116.0	114.0	113.3	117.3	117.2

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 around the middle of CY2007 (the projected real GDP growth rate is 3.4% in CY2006 and 2.8% in CY2007 after the actual result of 3.2% in CY2005).
- (2) The assumed average price of imported crude oil is \$64/barrel both in FY2006 and FY2007 (the actual result in FY2005 was \$55/barrel).