

Monthly Report of Prospects for Japan's Economy

December 2007

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

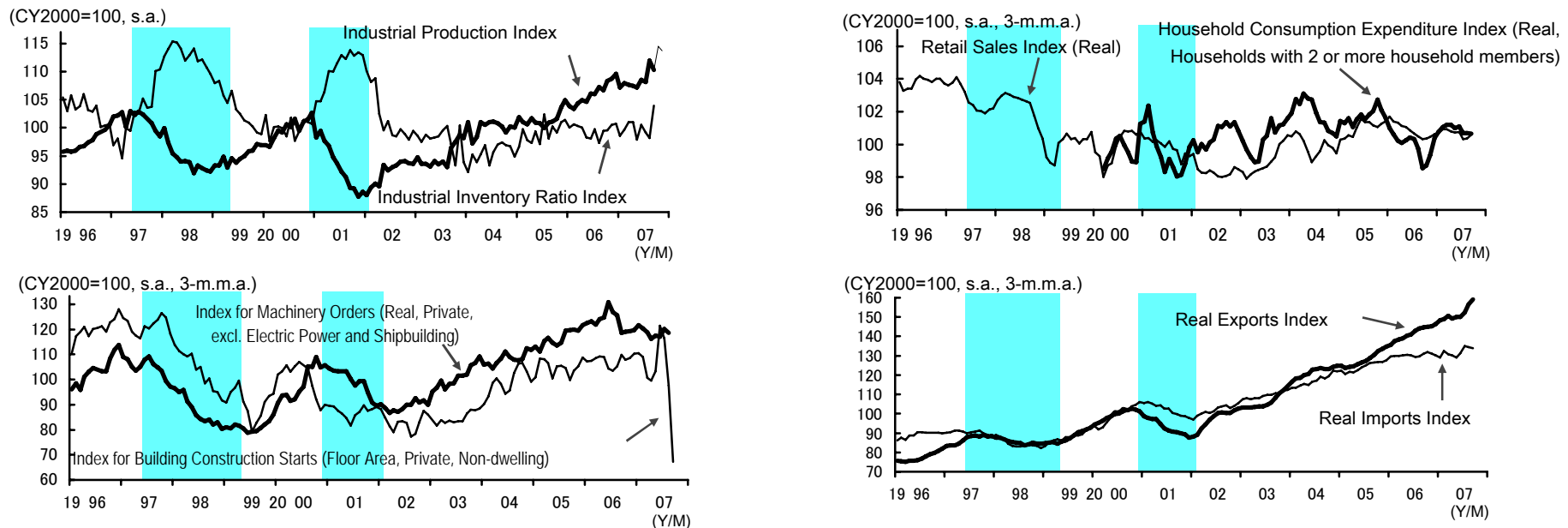
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This report is the English version of the November 2007 issue of the original Japanese version.

Current situation of Japan's economy – Improved by corporate sector, yet decelerating as a whole

Japan's real GDP rebounded to 2.6 per cent in the July-September quarter on an annualised basis from a fall of 1.6 percent in the previous quarter, confirming the continuing economic recovery led by the corporate sector, especially net exports. A recent upward tendency of industrial production and machinery orders has shown the underlying recovery trend in manufacturing. However, the economy as a whole appears to be decelerating as downward factors are currently intensifying, such as (i) a continuing large decline in building starts. September this year saw a marked fall not only in new housing starts (minus 44.0 per cent) but also in building construction starts (minus 54.2 per cent) due to stricter safety regulations. (ii) A further rise in the prices of crude oils, wheat, and so on, which could erode corporate profits, especially those of small and medium-sized enterprises. In addition, price increases in a certain number of final products are considered to be reducing to an extent the real purchasing power of consumers. (iii) Softening stock prices in the financial turmoil triggered by the US subprime mortgage problem, which could make business and consumer sentiment worse.

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.

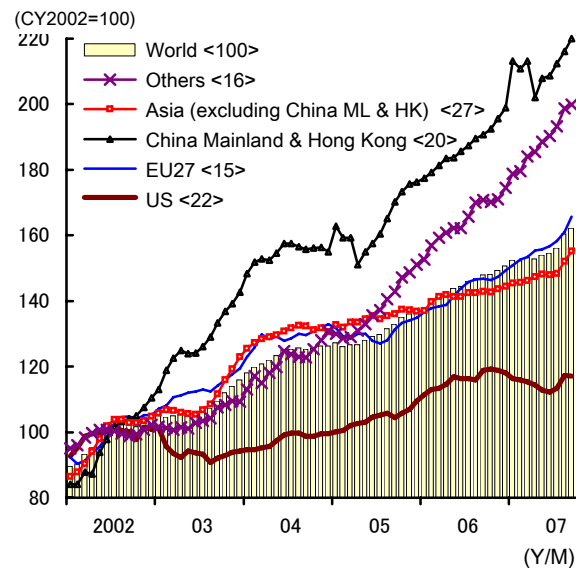
Note 1: Indices of industrial production and industrial inventory ratio are seasonally adjusted on a monthly basis. Others are calculated as seasonally adjusted and 3-month moving averages.

Note 2: The industrial production index in October and November 2007 is based on METI forecasts. Note 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Key favourable factors – The economy to maintain underlying recovery trend despite fluctuations

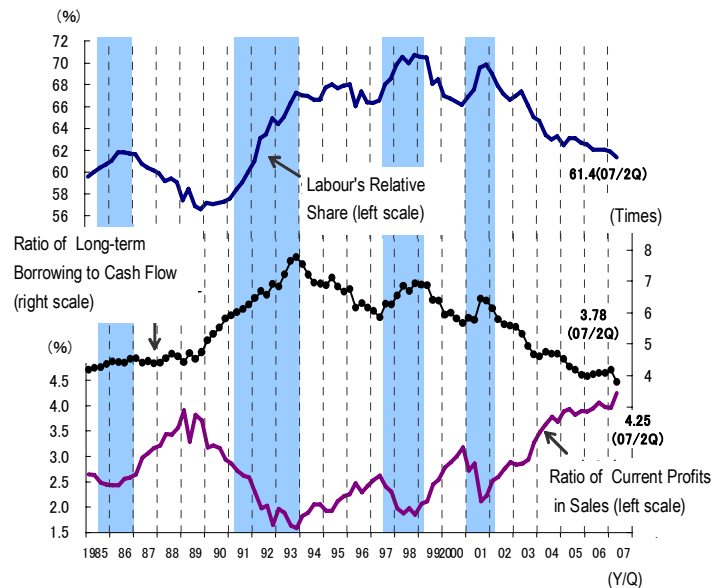
It is likely that Japan's economy would maintain an underlying recovery trend, despite quarterly or half-yearly fluctuations caused by moves in housing investment and enterprises' building investment as well as subsequent investment in equipment (see page 7), taking into consideration the following key advantages mainly related to the corporate sector: (i) a continuing solid expansion in exports to emerging and resource-rich countries. (ii) The continuing sound corporate financial situation in the aggregate shown in such figures as the highest ever level of ratio of current profits in sales. (iii) Also a maintained expansionary trend of production in the electronic parts and devices sector where the inventory adjustment has almost been completed, with a still low level of inventory ratio in manufacturing as a whole.

Figure 2-1 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 (JY 77.5 trillion in CY2006).
 2: Others: Middle Eastern countries, South American countries, Russia and so on.

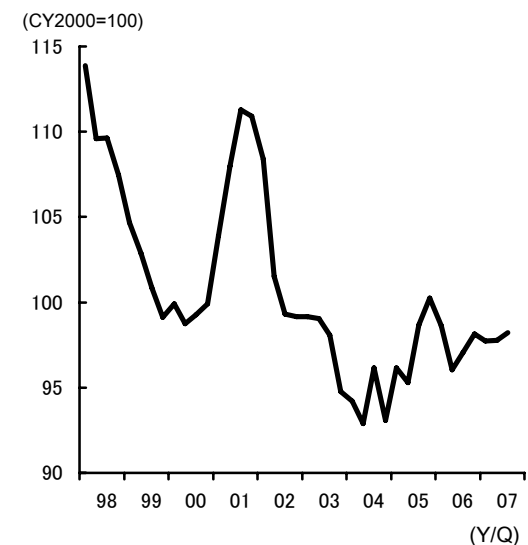
Figure 2-2 Main Indicators based on Financial Statements of Corporations by Industry
<nonfinancial, seasonally adjusted>



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 2-3 Industrial Inventory Ratio Index
<excluding the electronic parts and devices sector>

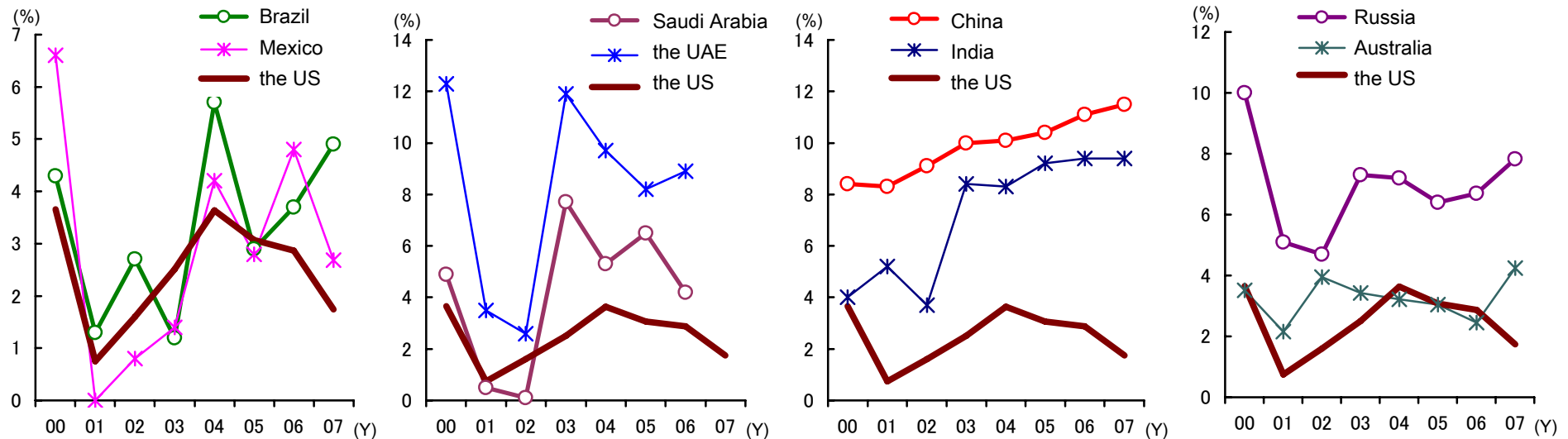


Source: The Ministry of Economy, Trade and Industry.

Exports to emerging and resource-rich countries – Expected to maintain an expansionary trend

It is considered that the market turmoil triggered by the US subprime mortgage problem could influence Japan's economy through the following: (i) a direct route effect where exports to the US would decelerate or decrease reflecting a slowdown of the US economy, and (ii) an indirect route effect where exports to other destinations might decelerate because the slowing of the US economy could adversely affect those economies. Accordingly, it is useful to examine correlations between the change in the growth rate of the US economy and that of the economies of Japan's export destination countries, especially emerging and resource-rich countries, exports to which have recently been a driving force for Japan's exports as a whole. The results appear to show three types: (a) correlation between the US economy can be seen: Mexico; (b) little or no visible correlation can be seen -- (b-1) little correlation, reflecting huge benefits brought by a rise in resource prices: the Middle Eastern countries; (b-2) no correlation because the high pace of the economy is continuing in spite of a slowdown of the US economy: China, India and Russia. This examination suggests that it is expected that exports to emerging and resource-rich countries will maintain a solid trend and bolster Japan's economy, judging from the large share of the above mentioned (b) countries in the total nominal exports.

Figure 3 Correlation between Real GDP Growth of the US and that of Emerging and Resource-rich Countries



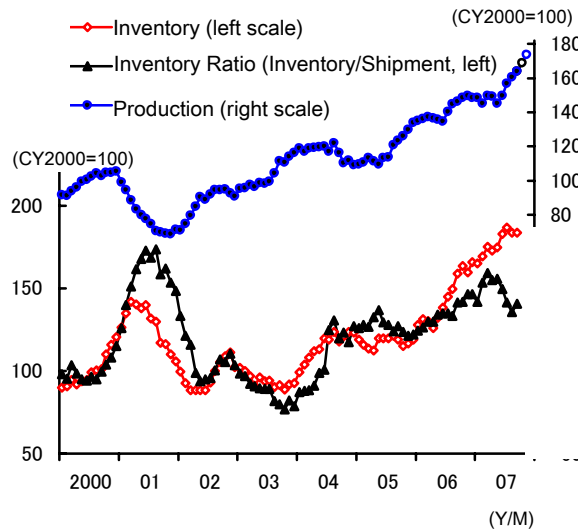
Source: The Japan Research Institute, Ltd. based on statistics of each country.

Note: The figure in year 2007 is for January-June 2007.

IT devices sector – Entering into recovery phase, after the completion of inventory adjustment

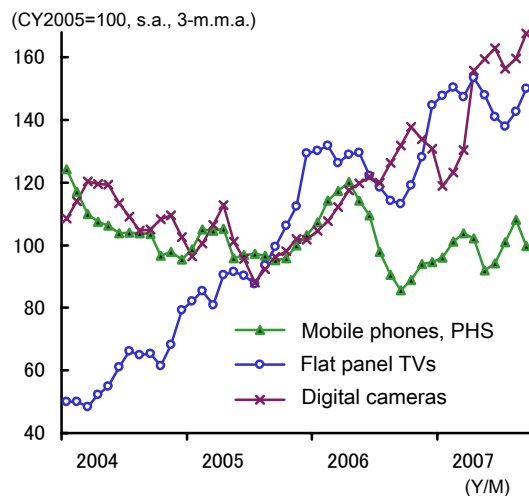
In manufacturing, there recently seems to be further heightened prospects for the completion of the inventory adjustment in the electronic parts and devices sector, which had been seen since the end of last year as one of the anxieties about the steady economic recovery. The industrial production index in this sector rose 2.1 per cent in September over the previous month, the fourth consecutive rise, having reached a level about 10 per cent higher than that of four months before. In addition, the forecast index indicated that production in the sector would expand further at a solid pace during this October-November period. The inventory ratio (inventory / shipment) in the sector exhibits a downward tendency, against the backdrop of the expansionary trend of demand for consumer digital products at home and abroad. Production in the electronic parts and devices sector appears to have been entering into a recovery phase, judging from the present position in the inventory cycle diagram.

Figure 4-1 Indices of Industrial Production and Inventories in the Electronic Parts and Devices Sector <seasonally adjusted>



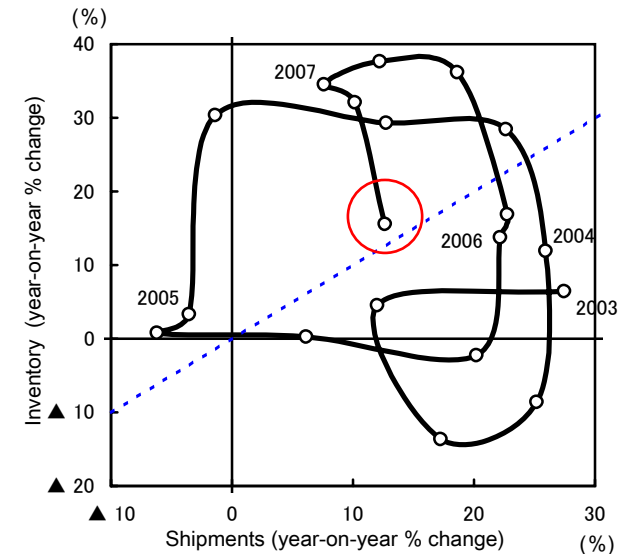
Source: The Ministry of Economy, Trade and Industry.
 Note: The Industrial Production Index (○) in September and October 2007 is based on the forecast index by The Ministry of Economy, Trade and Industry.

Figure 4-2 Shipment Indices for Consumer Digital Equipment



Source: The Ministry of Economy, Trade and Industry.
 Note: Figures are calculated as seasonally adjusted and 3-month moving averages.

Figure 4-3 Inventory Cycle in the Electronic Parts and Devices Sector

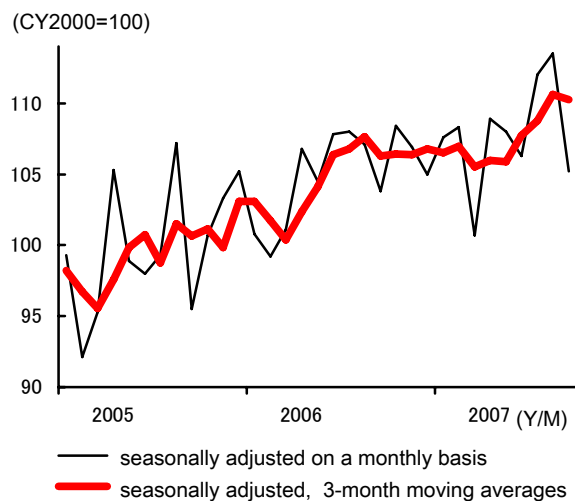


Source: The Ministry of Economy, Trade and Industry, the Cabinet Office.
 Note 1: Year-on-year percentage change in inventory is calculated on an end-of-quarter basis.
 2: The figure in Q3 2007 is for July-August 2007.

Business fixed investment - Expected bounce in Q3, chiefly led by nonmanufacturing

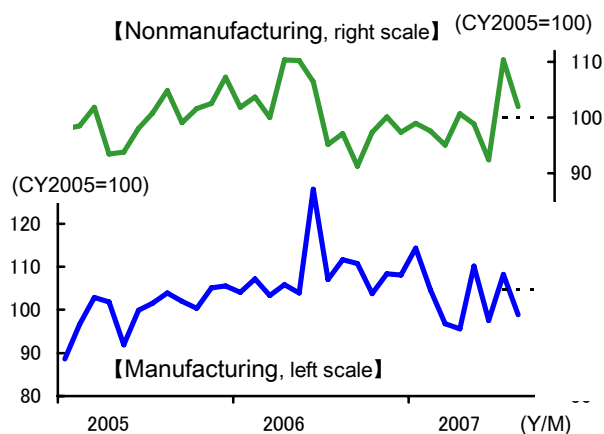
It is likely that business fixed investment will rebound in the third quarter, taking into consideration the following: (i) the index of shipments of capital goods has started to follow a rising trend since July. The level of the index excluding transport equipment in the July-September period was 2.3 per cent higher than in the April-June period this year. (ii) The index for machinery orders increased during the July-August period in nonmanufacturing mainly led by mining, transport and financial institutions. It is projected that the index will increase moderately during Q3 over the previous quarter both in manufacturing and nonmanufacturing. (iii) Enterprises forecast that business fixed investment will increase in fiscal year 2007 according to business surveys in this August and September. However, fluctuations in business fixed investment are expected from then on. A continuing large decline in building construction starts due to stricter safety regulations suggests that enterprises' real investment on buildings would fall considerably until the first quarter of next year. A fall in real building investment could reduce investment on equipment within this fiscal year, and then a recovery of building construction starts would bring a delayed bounce of real building investment and investment on equipment in the second half of next year (see page 7).

Figure 5-1 Index of Shipments of Capital Goods excluding Transport Equipment



Source: The Ministry of Economy, Trade and Industry.

Figure 5-2 Index for Machinery Orders excluding Electric Power and Shipbuilding



Source: The Cabinet Office.

Note 1: The dotted line in recent months shows forecast in Q3 2007.

2: Nonmanufacturing excluding electric power and shipbuilding.

Figure 5-3 Actual Results and Forecasts of Business Fixed Investment in Large Enterprises

(year-on-year % change)

	[A]	[B]	[C]
	<actual>	<forecast>	<forecast>
Period of investment	April-June 2007	fiscal 2007	fiscal 2007
Number of respondents	5,178	2,544	2,459
Date of release	3-Sep	2-Aug	2-Oct
All industries	1.5	11.0	10.7
Manufacturing	5.9	13.5	13.8
Nonmanufacturing	▲ 1.4	9.2	8.9

Source: [A]: The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry: Quarterly".

[B]: The Development Bank of Japan, "Survey on Planned Capital Spending for FY2007".

[C]: The Bank of Japan, "The Tankan September 2007 Survey".

Note 1: Respondents are large enterprises capitalised at 1 billion yen or more

2: [A] excludes software investment and [C] excludes both software investment and land purchase expenses.

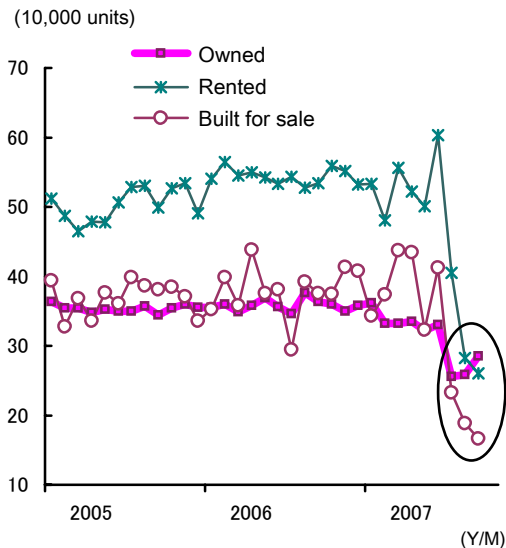
Monthly Report of Prospects for Japan's Economy December 2007

The Japan Research Institute, Limited

Main weighing factors – The economy expected to feel deceleration intensifying as a whole

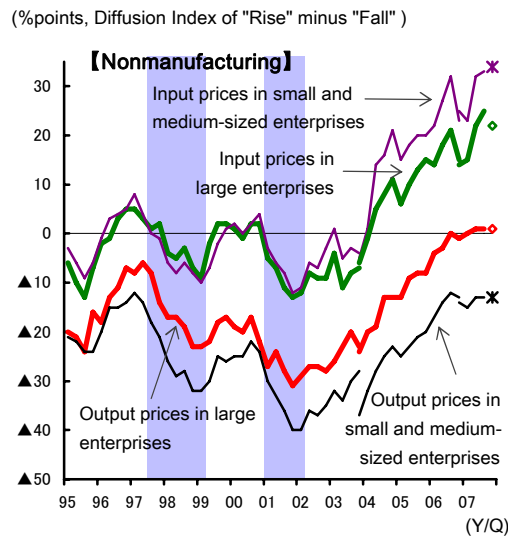
Although Japan's economy should maintain an underlying recovery trend, it is likely that the economy would feel a deceleration in growth intensifying for the time being, largely due to the following factors: (i) a continuing large decline in building starts. The marked fall in housing starts and building construction starts could bring about a considerable contraction in housing investment, (factory) building investment and subsequent investment in equipment. In addition, these moves could have an adverse effect on private consumption as well through such routes as a decline in durable goods purchases and worsening income and employment conditions. (ii) A continuing rise in crude oil prices. Most of the increased costs are projected to be absorbed in the corporate sector, which would erode corporate profits, especially those among small and medium-sized enterprises. A corporate behaviour to maintain profit ratios would lead to a further restraint on wage payments, which could be weighing more on income growth and private consumption expenditure. (iii) Softening stock prices in the financial turmoil triggered by the US subprime mortgage problem, which could dent business and consumer confidence.

Figure 6-1 Housing Starts by Type of Dwellings <seasonally adjusted, on an annualised basis>



Source: The Ministry of Land, Infrastructure and Transport.

Figure 6-2 Price Conditions in BOJ's Tankan Survey <changes in output and input price conditions>



Source: The Bank of Japan
Note : The marks, * and ◊ indicate the forecast DIs.

Figure 6-3 Estimate of the Influence of Change in the Nikkei 225 Stock Average and JY / US Dollar Exchange Rate on Real GDP Growth Rate of Japan

[A]: Change in the Nikkei 225 Stock Average on average for one year to come (▲: fall)
[B]: Change in the JY per US dollar exchange rate on average for one year to come (▲: appreciation of the yen)
(percentage point)

	Stock Prices [A]	Exchange Rate [B]
Real GDP	▲ 0.5	▲ 0.2
Private Consumption	▲ 0.6	+ 0.0
Business Fixed Investment	▲ 1.3	▲ 0.2
Exports	+ 0.1	▲ 1.3
Imports	▲ 0.4	+ 0.2

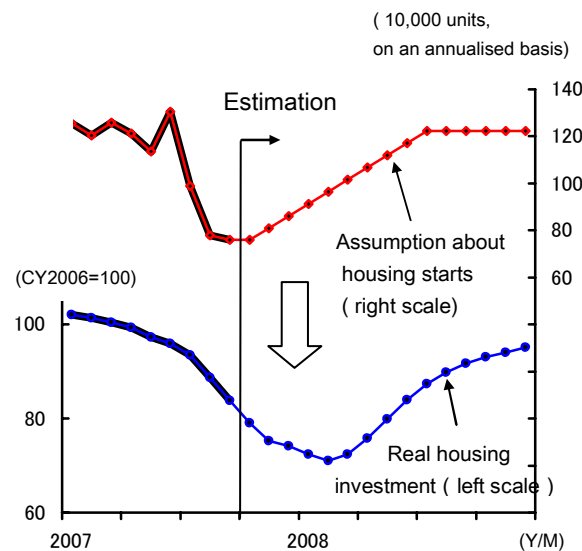
Source: The Japan Research Institute, Ltd. based on the Nikkei NEEDS macro economic models.

Monthly Report of Prospects for Japan's Economy December 2007
The Japan Research Institute, Limited

A cause of economic growth fluctuation - Fall and recovery in housing and building construction starts

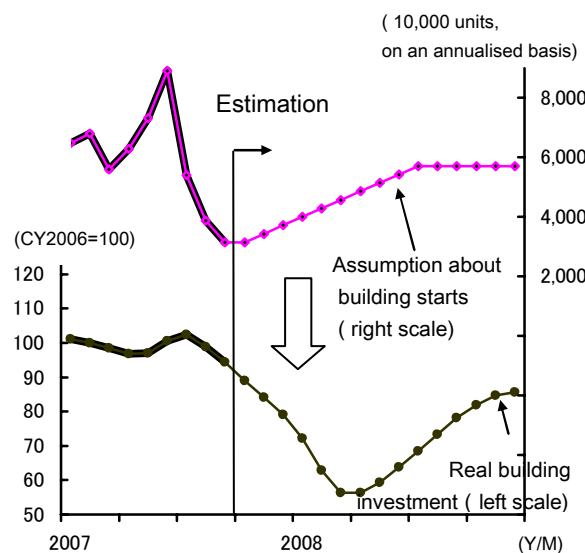
The amended Building Standards Law with stricter building confirmation procedures for safety came into effect on June 20 this year. This has been, worryingly, bringing about a marked decline in housing starts and enterprises' building construction starts since July. It is probable that the declining trend will continue for the time being, with measures taken by the Ministry of Land, Infrastructure and Transport having effects only very gradually. It is, therefore, likely that contraction in real housing investment and real building investment caused by this trend will be a fluctuating factor to the economy, with these investments decreasing for half a year to one year. Further, it is probable that a fall in real investment in housing and enterprises' building will lower real private consumption as well through such routes as: (i) a decline in durable goods purchases which are closely related to home purchases, and (ii) worsening income and employment conditions caused by a cut in wages and an increase in unemployment in the construction industry, financial results of which are expected to be adversely affected.

Figure 7-1 Estimated Real Housing Investment



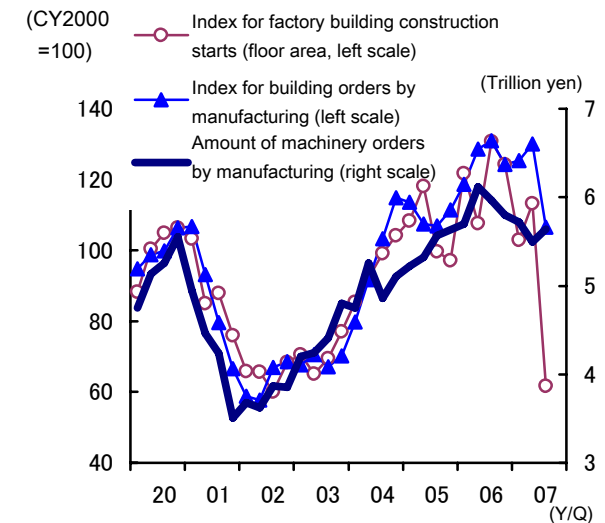
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport.
 Note: The estimation is on the assumption that housing starts will recover to the level of 1.22 million units, estimated potential demand for homes, by July 2008.

Figure 7-2 Estimated Real Building Investment



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport.
 Note: The estimation is on the assumption that building starts will recover to the level of 57.13 million sq. m., estimated potential demand for floor area, by July 2008.

Figure 7-3 Factory Building Construction Starts and Machinery Orders in Manufacturing
 <seasonally adjusted, on an annualised basis>

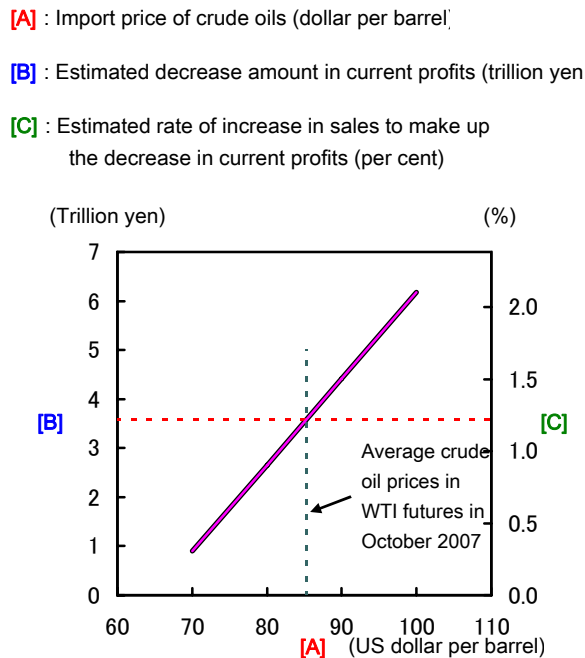


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport, The Cabinet Office.

Factor to put steady economic growth at risk – Continuing rise in crude oil prices

A continuing rise in crude oil prices would also be a downside risk factor to the economy. In the aggregate, it is likely that enterprises would maintain the positive growth trend in profits as long as crude oil prices stay within the range of 80 to 90 dollars per barrel, even on the assumption that all of the increase in costs caused by an oil price increase are absorbed in the corporate sector. However, among small and medium-sized enterprises which are lagging in improvement towards strengthened corporate profits, it is likely that downward pressure on their profits will be intensified by a rise in oil prices. With the oil price rise continuing further, it is expected that business failures would increase, and further moves to curb personnel expenses would be widely seen among small and medium-sized enterprises. These unfavourable phenomena could make the situation in private consumption, which currently has little momentum, much worse.

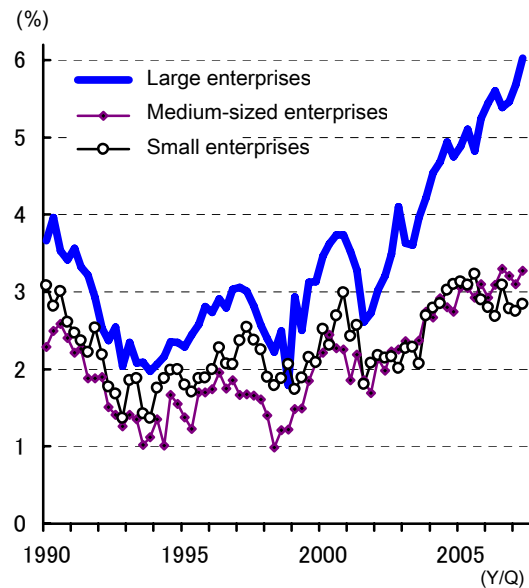
Figure 8-1 Estimate of Sets of Crude Oil Price Level and Decrease Amount in Current Profits



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

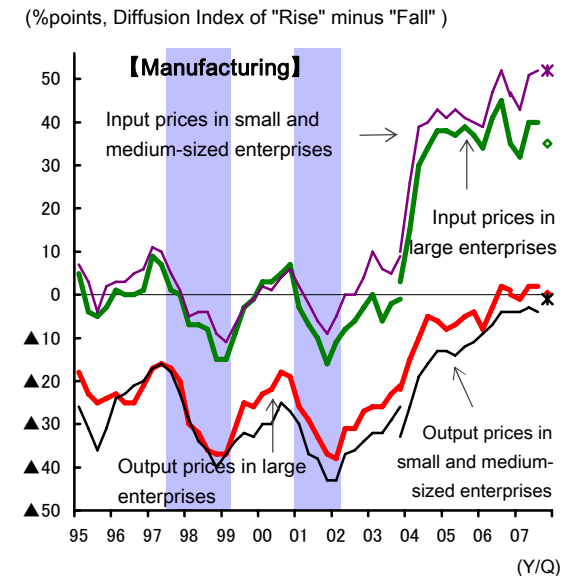
Note : Estimates on the assumption that all of the increase in costs caused by a crude oil price rise are absorbed in the corporate sector.

Figure 8-2 Ratio of Current Profits in Sales by Size of Industry



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

Figure 8-3 Price Conditions in BOJ's Tankan Survey <changes in output and input price conditions>



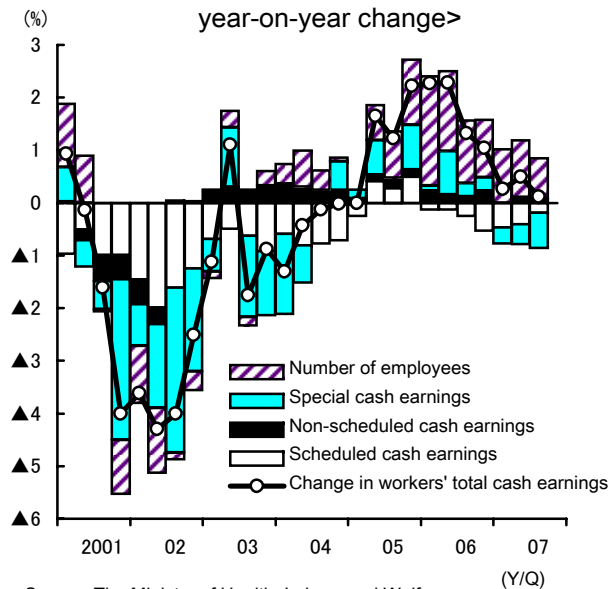
Monthly Report of Prospects for Japan's Economy December 2007
The Japan Research Institute, Limited

Modest momentum for private consumption recovery / Weak pace of increase in the CPI

The pace of the increase in workers' total cash earnings has been decelerating since the start of the year with the level of earnings almost flattening out over the previous year. This is because cash earnings *per employee* have declined on a year-on-year basis, although the increase in the number of employees has contributed positively to the total. Especially, special cash earnings fell largely against the background of sluggish bonus payments among small and medium-sized enterprises. Judging from the bleak wage growth prospects reflecting enterprises' stance to curb personnel expenses, it is expected that momentum of private consumption towards recovery will still be modest. In addition, a large decline in housing and building construction starts could have an adverse effect through a number of routes.

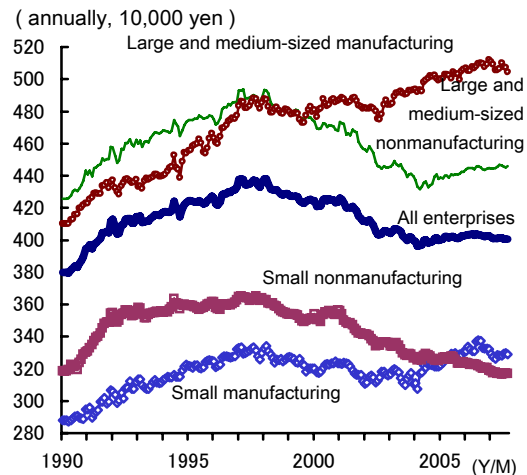
Meanwhile, the Consumer Price Index excluding fresh food, that is, the core CPI, would turn positive within the year against the background of a rise in the prices of gasoline, kerosene, and food other than fresh food. However, the pace of the increase in the core CPI is expected to remain weak and approach zero towards the end of FY2008 reflecting the re-deceleration of the economic recovery during that period.

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



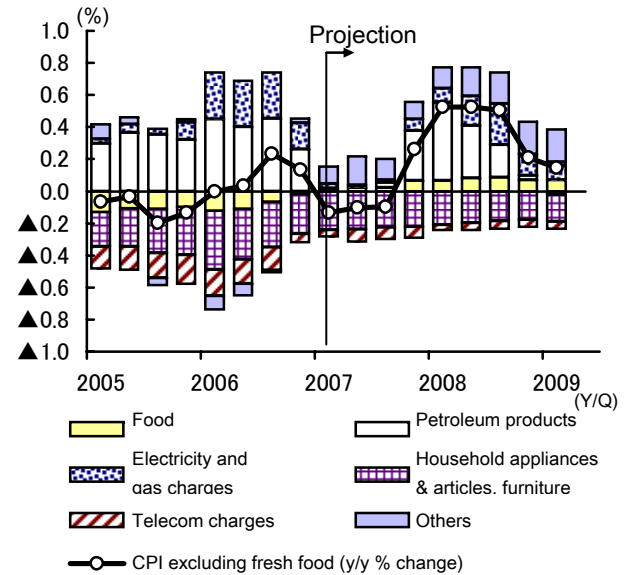
Source: The Ministry of Health, Labour and Welfare, The Ministry of Internal Affairs and Communications.

Figure 9-2 Total Cash Earnings by Size and Type of Industry < seasonally adjusted, annual amount per regular employee >



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare
 Note : Large enterprises are establishments with 30 employees or more. Small and medium-sized enterprises are establishments with from 5 to 29 employees.

Figure 9-3 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.
 Monthly Report of Prospects for Japan's Economy December 2007

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Prospects for Japan's economy - Expected further deceleration in FY2007 and rebound in FY2008

(1) It is likely that Japan's economy would maintain an underlying recovery trend, despite quarterly or half-yearly fluctuations caused by moves in housing investment and enterprises' building investment as well as subsequent investment in equipment, taking into consideration the following key advantages mainly related to the corporate sector: (i) a continuing solid expansion in exports to emerging and resource-rich countries. (ii) The continuing sound corporate financial situation in the aggregate shown in such figures as the highest ever level of ratio of current profits in sales. (iii) Also a maintained expansionary trend of production in the electronic parts and devices sector where the inventory adjustment has almost been completed, with a still low level of inventory ratio in manufacturing as a whole.

(2) However, it is likely that the economy would feel a deceleration in growth intensifying for the time being, largely due to the following factors: (i) a continuing large decline in building starts. The marked fall in housing starts and building construction starts could bring about a considerable contraction in housing investment, (factory) building investment and subsequent investment in equipment. In addition, these moves could have an adverse effect on private consumption as well through such routes as a decline in durable goods purchases and worsening income and employment conditions. (ii) A continuing rise in crude oil prices. Most of the increased costs are projected to be absorbed in the corporate sector, which would erode corporate profits, especially those among small and medium-sized enterprises. A corporate behaviour to maintain profit ratios would lead to a further restraint on wage payments, which could be weighing more on income growth and private consumption expenditure. (iii) Softening stock prices in the financial turmoil triggered by the US subprime mortgage problem, which could dent business and consumer confidence. Taking these factors into consideration, it is expected that real GDP would grow 1.0 per cent in FY2007, with the second half of the fiscal year decelerating considerably. The figure in this central projection is well below that of the 1.7 per cent in the previous issue of The Monthly Report.

(3) Looking further, it is expected that the economy would regain its solid growth momentum from next spring onwards on the assumption that building starts would have been recovering gradually since this November. It is, therefore, projected that the economy would grow 2.2 per cent in real terms in FY2008, with the growth rate in the July-September and October-December quarters reaching around 4.0 percent, on the assumption of a bounce of housing investment and enterprises' building investment from Q2 next year onwards. Even that case implies that such a recovery would be made mainly by materialising pent-up demand thus far and, accordingly, would hold a sense of fragility to some extent in regaining momentum both in the household sector and in the corporate sector.

(4) The rate of the increase in the Consumer Price Index excluding fresh food, that is, the core CPI, would turn positive within the year against the background of a rise in the prices of gasoline, kerosene, and food other than fresh food. However, the pace is expected to remain weak and approach zero towards the end of FY2008 reflecting the re-deceleration of the economic recovery during that period.

(5) As for a sub-projection to the above mentioned central projection, it is possible that the economy would enter into a recession by further intensifying downward pressures at home and abroad, on the assumption that building starts would continue to decline over the longer period and the US subprime mortgage problem would have more serious influences than expected in the central projection.

Figure 10 Projections for GDP Growth and Main Indicators of Japan (as of November 13, 2007)

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

	CY2007			CY2008				CY2009	FY2005	FY2006	FY2007	FY2008
	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3				
	(Actual)			(Projection)				(Actual)				
Real GDP	▲ 1.6	2.6	▲ 1.1	0.6	2.7	4.1	3.6	2.1	2.4	2.0	1.0	2.2
Private Consumption Expenditure	0.9	1.3	1.1	0.9	0.7	1.0	1.1	1.2	1.9	0.7	1.6	1.0
Housing Investment	▲ 15.4	▲ 27.8	▲ 63.5	▲ 14.3	61.1	94.5	48.4	1.1	▲ 1.0	0.4	▲ 20.0	11.8
Business Fixed Investment	▲ 8.1	7.1	▲ 2.4	▲ 4.8	2.1	10.6	9.1	6.0	5.7	7.7	▲ 0.4	3.3
Private Inventories (percentage points contribution)	(▲ 0.2)	(0.4)	(0.5)	(0.4)	(0.2)	(▲ 0.5)	(▲ 0.3)	(▲ 0.2)	(▲ 0.1)	(0.0)	(0.1)	(0.1)
Government Consumption Expenditure	1.5	1.2	1.2	1.5	1.0	0.6	0.6	0.7	0.9	0.9	0.9	1.0
Public Investment	▲ 10.4	▲ 10.0	▲ 6.0	▲ 5.0	▲ 5.5	▲ 4.5	▲ 4.0	▲ 4.0	▲ 1.4	▲ 9.6	▲ 6.3	▲ 5.2
Net Exports (percentage points contribution)	(0.2)	(1.6)	(0.7)	(0.7)	(0.7)	(0.6)	(0.7)	(0.6)	(0.6)	(0.8)	(1.0)	(0.7)
Exports of Goods and Services	3.6	12.2	5.8	3.9	5.1	6.3	7.8	7.5	9.0	8.2	7.8	6.1
Imports of Goods and Services	3.1	2.0	1.4	▲ 0.8	1.2	3.5	4.9	5.2	6.0	3.4	1.8	2.0

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

Real GDP	1.5	2.1	0.4	0.2	1.1	1.6	2.7	3.2	2.4	2.0	1.0	2.2
Nominal GDP	1.2	1.8	0.0	▲ 0.1	1.0	1.5	2.5	3.1	1.0	1.3	0.7	2.0
GDP Deflator	▲ 0.3	▲ 0.3	▲ 0.3	▲ 0.3	▲ 0.2	▲ 0.1	▲ 0.1	▲ 0.1	▲ 1.3	▲ 0.7	▲ 0.3	▲ 0.1
Consumer Price Index (excluding fresh food)	▲ 0.1	▲ 0.1	0.4	0.7	0.7	0.7	0.5	0.1	▲ 0.1	0.1	0.2	0.5

Exchange Rates (JY/US\$)	120.7	117.8	111.9	112.0	110.0	108.0	108.0	108.0	113.3	116.9	116.3	108.5
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[For reference: GDP growth rate on the assumption of no particular fluctuations in housing and building investment moves]

S.A., Annualised % changes from the previous quarter	▲ 1.6	3.6	2.3	2.0	1.6	1.5	1.3	1.2	--	--	--	--
Percentage changes on a year earlier	1.5	2.4	1.5	1.7	2.3	1.9	1.5	1.4	2.4	2.0	1.8	1.8

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 our following assumptions;

- (1) The projected real GDP growth rate is 1.9% in CY2007 and 2.8% in CY2008.
- (2) The assumed average price of imported crude oil is \$80/barrel in FY2007 and \$90/barrel in FY2008.
- (3) It is assumed that the Bank of Japan will postpone raising its target interest rate until the second half of next fiscal year.