

Monthly Report of Prospects for Japan's Economy

December 2008

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

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

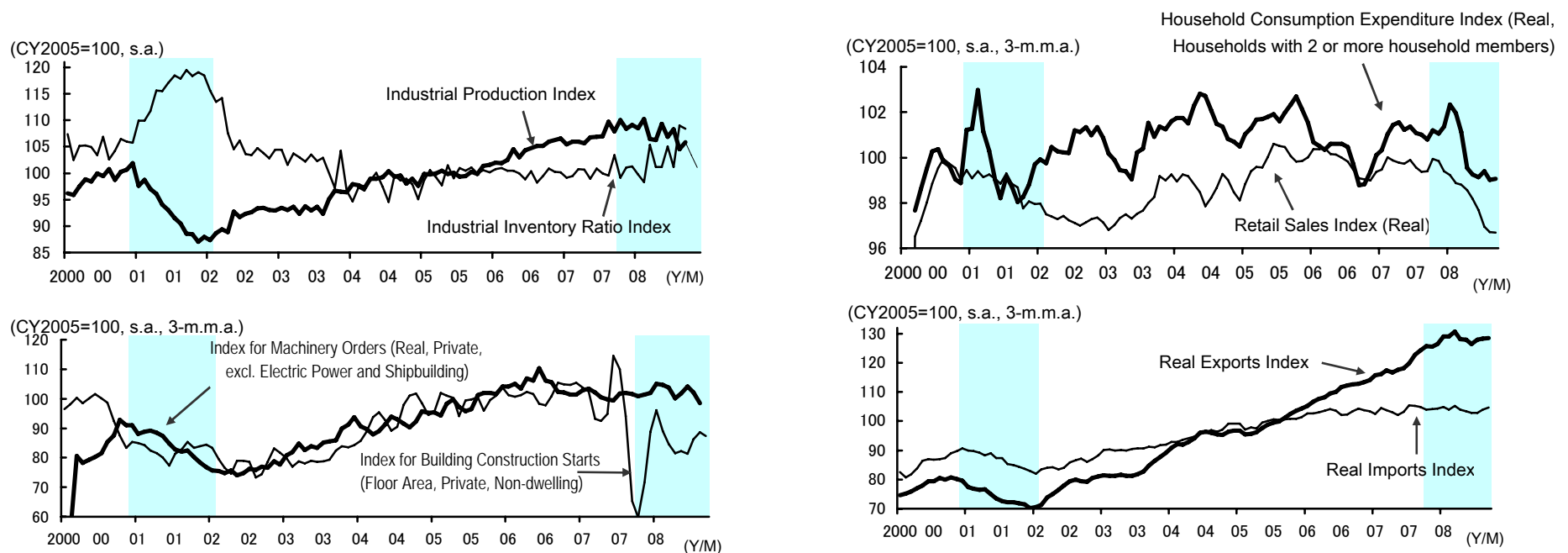
This report is the English version of the November 2008 issue of the original Japanese version.

Current situation of Japan's economy – On downward trend both in corporate and household sector

Japan's economy is currently on a downward trend. In the corporate sector, exports are softening mainly due to a decrease in shipments to the US and European countries. Accordingly, the driving force of exports for the economy is very limited. Business fixed investment also has a lot of uncertainties, judging from a significant downswing in shipments of capital goods since July. Reflecting these moves, industrial production is apparently entering a declining phase.

The household sector is also in a sluggish situation. Private consumption is at a "low-flying" level due to a decrease in real purchasing power because of consumer price rises. A boost in private consumption due to a heat wave in July was temporary and very limited. The diffusion index for current conditions in the Economy Watchers Survey by the Cabinet Office also continues to indicate this declining tendency.

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.

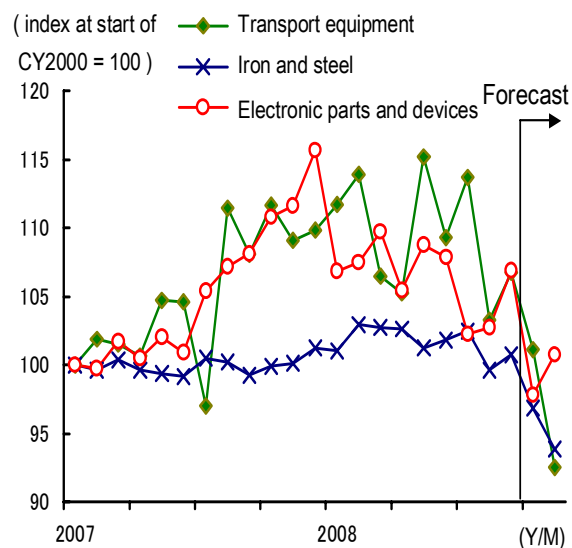
Note 2: The industrial production index in October and November 2008 is based on METI forecasts. Note 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Production in manufacturing – Has been visibly on declining trend; further downside risk remains

It is more visible that the production index in manufacturing has been entering a declining trend, judging from the forecast indices in October and November which show two consecutive declines. Accordingly, it is likely that the production index in the October-December period will see a more significant decline over the previous quarter, also the fourth consecutive quarterly decline. Viewed by industry, the noticeable contributors to the total fall have been transport equipment, electronic parts and devices, and iron and steel, against the following background: (i) Transport equipment. A sharp decrease in exports of motor vehicles to the US. (ii) Electronic parts and devices. A decrease in exports, in addition to a decline in sales of mobile phones as a whole and a pause in the market expansion of liquid crystal TVs and digital still cameras. (iii) Iron and steel. A further reduction of production due to a rapid decline in demand in the market at home and abroad.

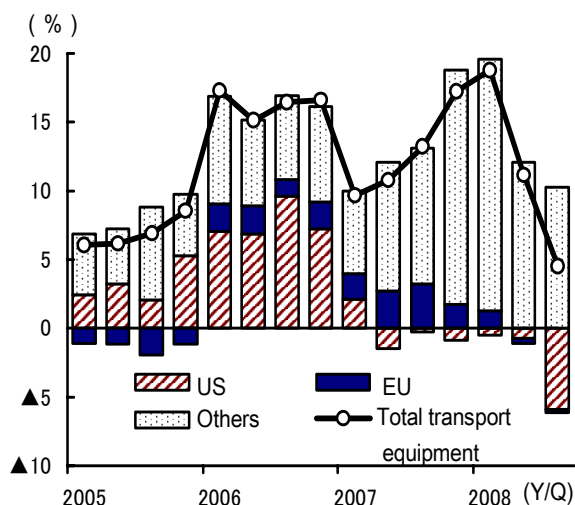
Further, it should also be noted that the amendment ratio was noticeably minus for four months running. Therefore, there would be significant risk that actual manufacturing production could be revised downwards further from the forecast.

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



Source: The Ministry of Economy, Trade and Industry.

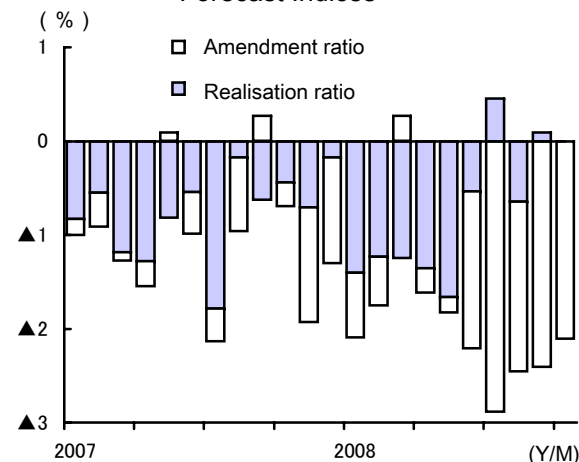
Figure 2-2 Real Exports of Transport
Equipment by Destination
<year-on-year % change>



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

Note: The figure in Q3 in 2008 is for July 2008.

Figure 2-3 Revision Ratios in Production
Forecast Indices



Source: The Ministry of Economy, Trade and Industry.

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

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

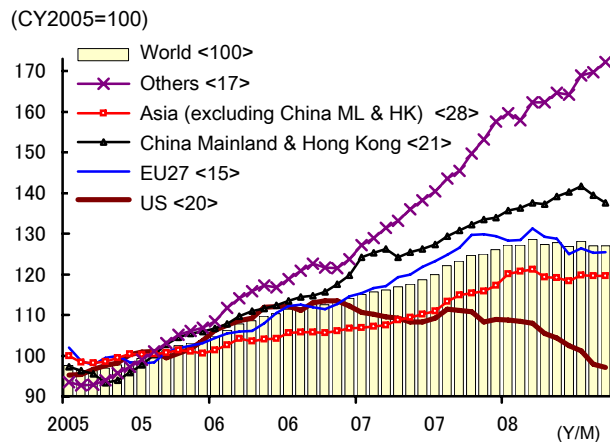
Exports - Lowered driving power for the economy, mainly due to decrease to US and Europe

As for the prospects for Japan's economy, it is expected that the economy will continue its worsening trend, mainly due to a downswing of the US and European economies.

Japan's exports, which had been a bolstering power for the economy, have been almost flattening out since the start of this year, and accordingly, their driving force for the economy has obviously weakened. This is mainly due to a decrease in exports to the US and European countries, reflecting the intensifying deceleration of economic growth of these countries. The trends viewed by commodity are: (i) Transport equipment. A decrease in exports to the US and the EU, against the background of the high price of petrol and the worsening income situation in those countries. (ii) Capital goods. A reflection of a slowdown of business fixed investment in the EU countries and Newly Industrialising Economies (NIEs). (iii) Producer goods. A decrease in exports to the US and NIEs, against the background of a decline in demand in the US.

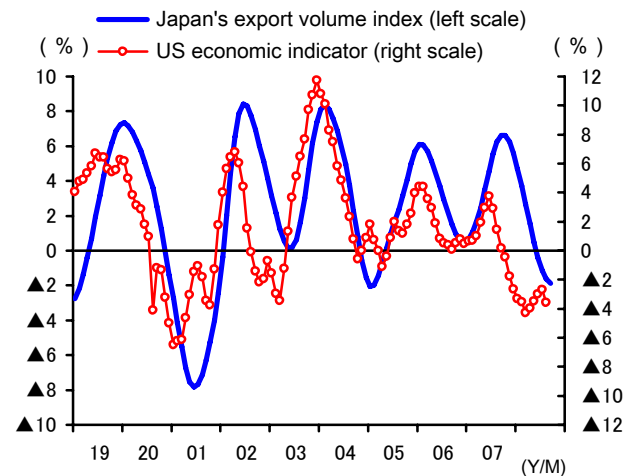
Looking further, it is expected that the softening situation in Japan's exports could be prolonged, because the US and the EU economies appear likely to continue a sluggish pace of growth. However, it is unlikely that exports as a whole will see a continued significant decline because exports to emerging and resource-rich countries are expected to maintain a relatively firm trend.

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



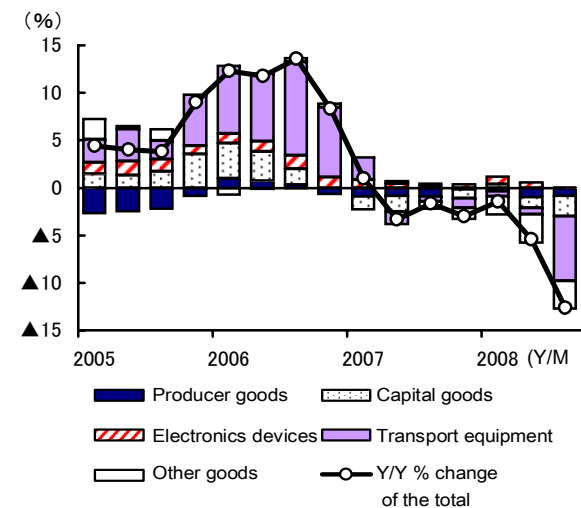
Source: The Ministry of Finance, The Bank of Japan.
Note 1: The figures in angle brackets in the legend indicate the share of each region in total nominal exports of Japan in FY2007.
2: Others: Middle Eastern countries, South American countries, Russia and so on.

Figure 3-2 Change in US Economic Indicator and Japan's Export Volume Index
<annualised % change over six months before>



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

Figure 3-3 Japan's Real Exports to the US by Commodity
<contribution to the total year-on-year % change>



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

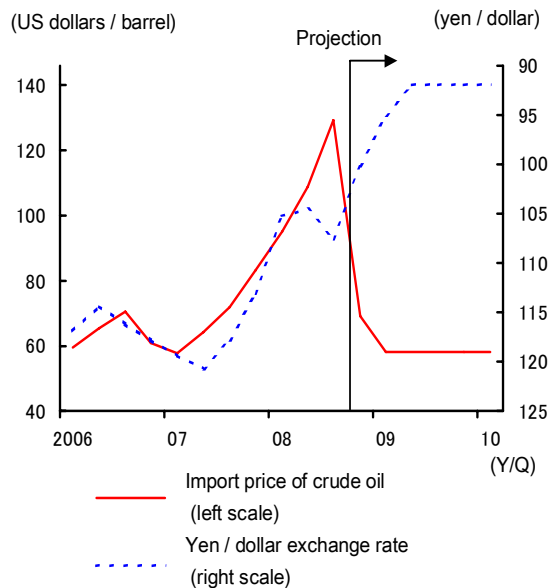
The impact of sharp decline of resource prices - From income outflow to income inflow

Resource prices, which had continued to rise rapidly, have fallen sharply since this summer. Further, it is expected that resource prices would stay at a low level, as the world economy will decelerate considerably.

Accordingly, income shift from Japan to resource-rich countries peaked in the July-September period this year. As the pace of the decline of import prices has been speeding up, income flow is estimated to have turned from income outflow to overseas to income inflow to Japan since this October-December period.

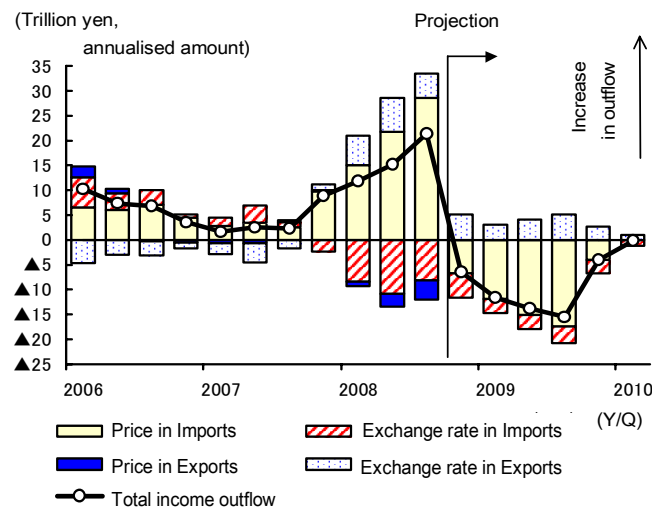
As a result, it is projected that the extent of the decline of GDP deflator will be lesser. This change of trend will also put the brakes on declining real GDI (Gross Domestic Income), which indicates real GDP with adjustment of an income increase or decrease due to the change of terms of trade.

Figure 4-1 Import Price of Crude Oil and Japanese Yen / US Dollar Exchange Rate



Source: The Nikkei Shimbun.

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

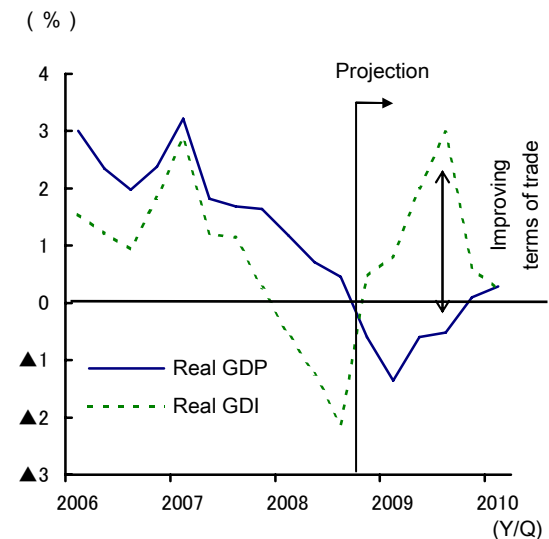


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.

Note 1: Prices are on a contract currency basis.

2: Plus figures indicate income outflow to overseas, and minus figures indicate income inflow from overseas.

Figure 4-3 Real GDP Growth Rate and Real GDI Growth Rate



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

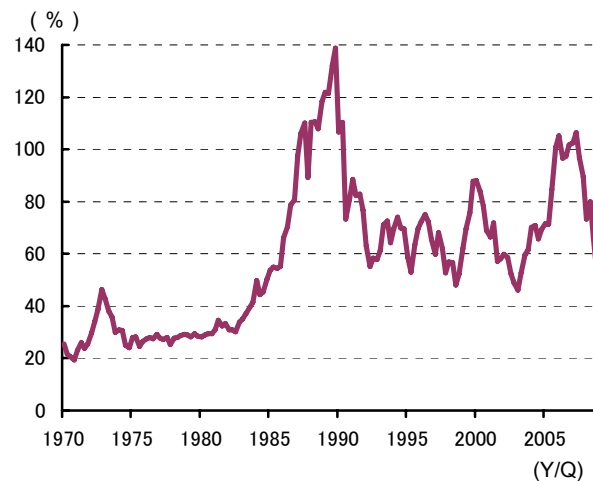
Falling stock prices - Adverse effects on households, enterprises and financial institutions

The fall in stock prices has been accelerating since the latter half of September. The ratio of the total market value of Tokyo Stock Exchange to nominal Gross Domestic Income (GDI) has declined to the lowest level in the past twenty years.

The falling stock prices are likely to have adverse effects on the economy through the following three routes:

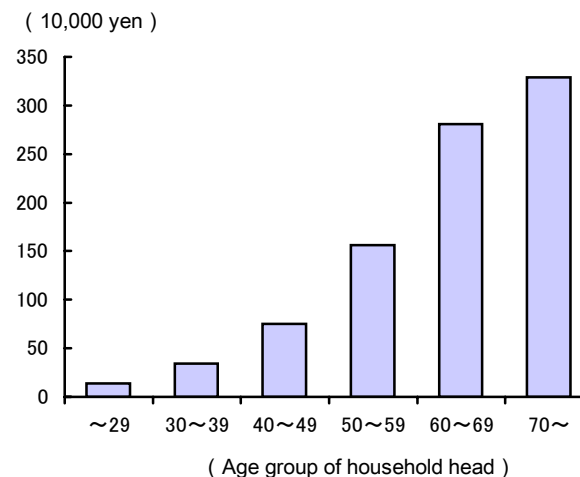
- (i) Households. Estimated negative influences on private consumption expenditure, because an adverse wealth effect is estimated to intensify on the households in higher income brackets and/or those with elderly persons as their household heads.
- (ii) Enterprises. Worsened corporate profits, reflecting appraisal losses due to the fall of the prices of the stocks held. The deteriorating corporate profits could weigh heavily on business fixed investment and compensation of employees.
- (iii) Financial institutions. Stricter lending attitude of financial institutions, reflecting a decrease in unrealised profits or an increase in unrealised losses of the stocks held.

Figure 5-1 Ratio of Total Market Value of Tokyo Stock Exchange to Nominal Gross Domestic Income (GDI)



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, Tokyo Stock Exchange.
Note: The figure in Q4 in 2008 is for October 2008.

Figure 5-2 Amounts of Stocks Held per Household by Age Group of Household Head (all households, including unit trust)



Source: The Cabinet Office, "Annual report of the family income and expenditure survey 2007".

Figure 5-3 Estimated Influence of Change in Stock Prices and the Exchange Rate on Real GDP Growth Rate of Japan (the one year period from October 2008)

		The J. Yen / US Dollar Exchange Rate				
		110	105	100	95	90
The Nikkei 225 Stock Average	14,000	0.1	-0.1	-0.2	-0.4	-0.5
	13,000	-0.0	-0.2	-0.3	-0.5	-0.6
	12,000	-0.1	-0.3	-0.4	-0.5	-0.7
	11,000	-0.2	-0.3	-0.5	-0.6	-0.8
	10,000	-0.3	-0.4	-0.6	-0.7	-0.9
	9,000	-0.4	-0.5	-0.7	-0.8	-1.0
	8,000	-0.5	-0.6	-0.8	-0.9	-1.1
7,000	-0.6	-0.7	-0.9	-1.0	-1.1	

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

Note: Comparison between real GDP growth rate during one year to September 2008 and that to September 2009. Each set of the levels of the Nikkei 225 and the exchange rate is assumed to be kept during one year to September 2009.

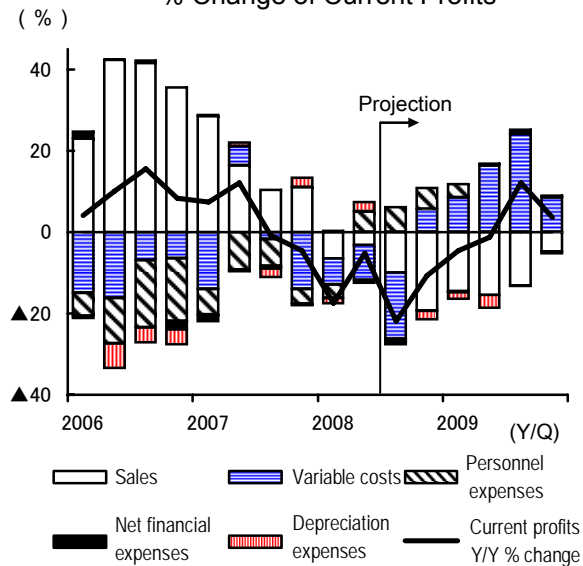
Profit fall could bring business fixed investment to adjustment phase

It is projected that the diminishing pressure of resource price rises will put the brakes on falling corporate profits. However, an unfavourable factor of a decrease in sales could be strengthening downward pressure on current profits. Accordingly, it is unlikely that corporate profits would settle steadily in positive growth territory.

It is expected that the cautious attitude to business fixed investment among enterprises will be intensifying, reflecting the poor situation of corporate profits and lower capacity utilisation. Although the Tankan September 2008 survey indicated that an increase was forecast by large manufacturing in business fixed investment in FY2008, it is probable that the forecast will be revised downwards in the coming Tankan surveys.

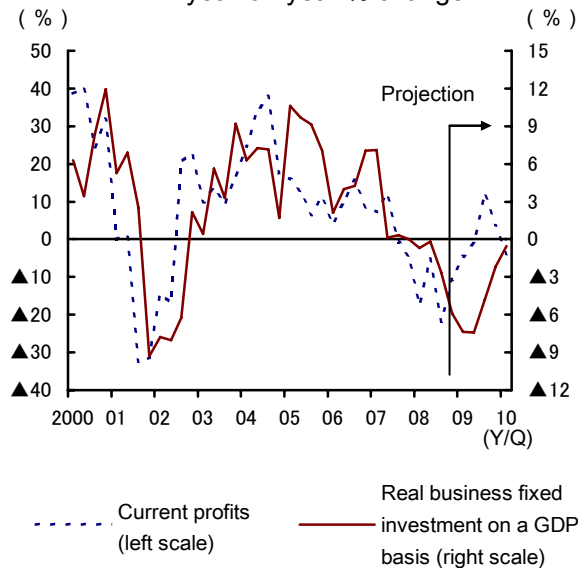
In addition, it is expected that business failures will increase, mainly among small and medium-sized enterprises.

Figure 6-1 Contribution of Sales and Expenses to Year-on-year % Change of Current Profits



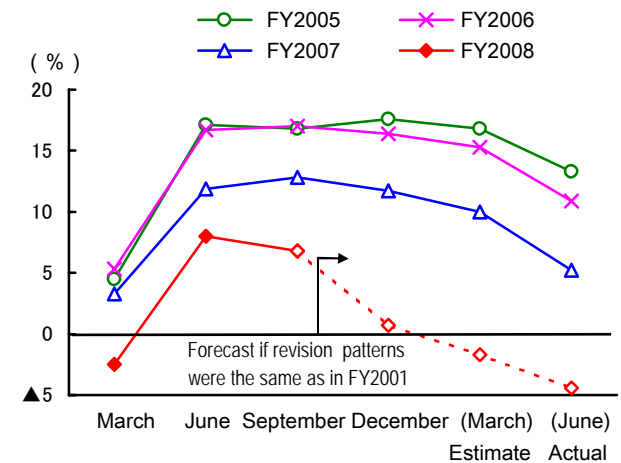
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, "Financial Statements Statistics of Corporations by Industry: Quarterly".

Figure 6-2 Current Profits and Real Business Fixed Investment <year-on-year % change>



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

Figure 6-3 Revision Patterns in Forecast of Business Fixed Investment in Large Manufacturing <year-on-year % change>



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

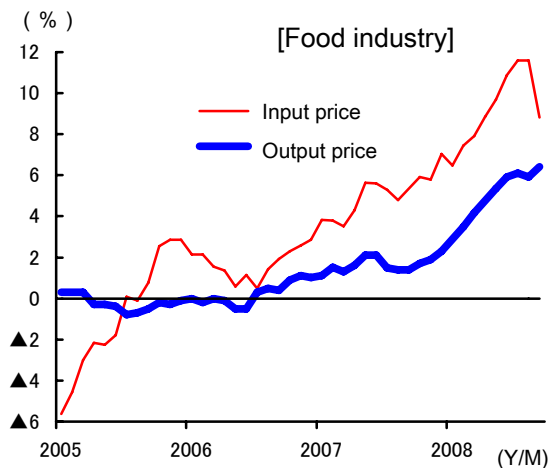
Note 1: Including software investment and excluding land purchase expenses.
 Note 2: The horizontal axis represents the point of time when the survey is conducted for each fiscal year. The first survey for each year (March survey) is at the very left, and the last survey (June survey of the following year, actual result) is at the very right.

The rate of increase in the CPI - To lessen gradually due to fall of resource prices

The room for enterprises to absorb increased costs appears to be reaching the limit. Therefore, it is likely that moves of price rises will still remain for the time being mainly in electricity and gas charges, food and so on.

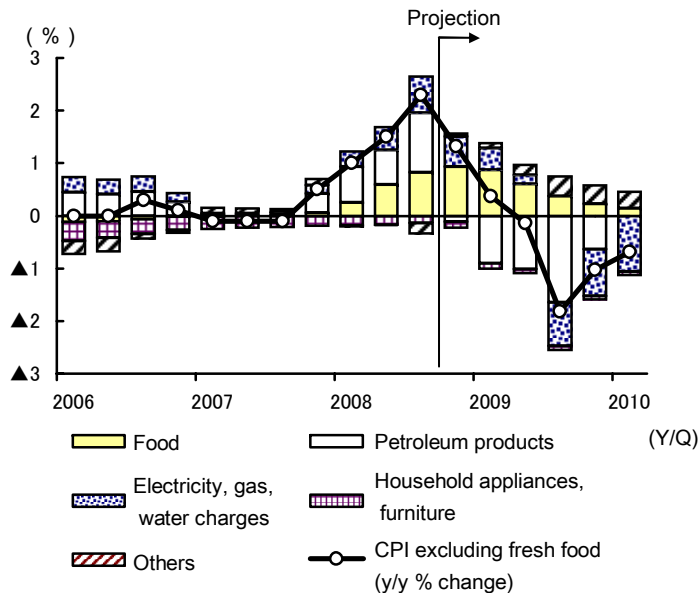
However, it is probable that the rate of increase in the Consumer Price Index excluding fresh food (the core CPI) will be lower, because the price of petroleum products will be falling sharply reflecting a considerable decline in the price of crude oil. It is projected that the year-on-year change in the core CPI will turn minus around next spring, and will be further negative from that time onwards.

Figure 7-1 Input and Output Prices in Food Industry <year-on-year % change>



Source: The Bank of Japan, "Input-Output Index of the Manufacturing Industry by Sector".

Figure 7-2 Change in Consumer Price Index on CY2005-base <year-on-year, excluding fresh food>



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

Figure 7-3 Room to Fall in Product and Service Prices by Industrial Sector due to the Decline of Crude Oil Price <estimate during FY2009> (%)

Manufacturing	Food	- 1.3
	Textiles	- 1.8
	Wooden products	- 1.3
	Paper products, pulp	2.5
	Chemical products	- 6.7
	Petroleum products	- 23.9
	Ceramic, stone and clay	- 2.4
	Steel and steel products	- 2.0
	Nonferrous metals and products	- 2.5
	Miscellaneous metal products	- 1.3
	General machinery	- 1.0
	Electrical and electric machinery	- 1.2
	Transportation equipment	- 1.1
	Precision machinery	- 0.9
Other manufactured products	- 1.6	
Nonmanufacturing	Agriculture and fishing	- 1.7
	Mining	- 5.1
	Construction	- 1.4
	Electricity and gas	- 9.1
	City water supply	- 1.4
	Wholesale and retail trade	- 0.8
	Financial service and insurance	- 0.3
	Transport	- 3.0
	Communication and broadcasting	- 0.5
	Public service	- 0.9
Other services	- 0.8	

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

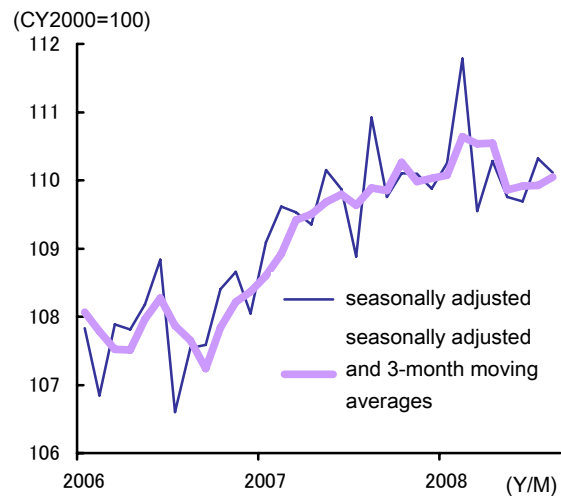
Note: This estimate is on the assumption that the import price of crude oil would be decline by 43% on average in FY2009.

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

It is expected that private consumption will continue a "low-flying" trend against the following background:

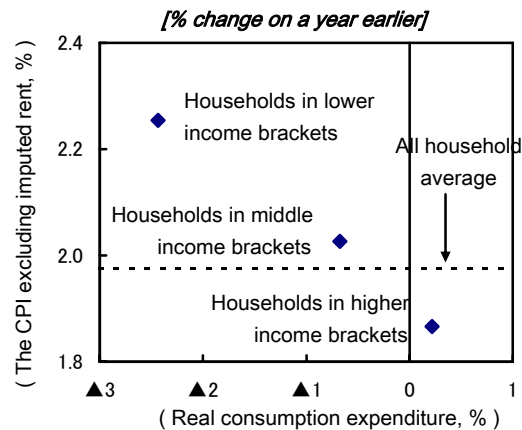
- (i) The worsening income situation due to a deterioration of corporate profits. It is estimated that the bonus amount in the aggregate this winter will decrease further.
- (ii) Although the pace of increase in the CPI is expected to decelerate, the CPI will continue to increase for the time being. Thus, remaining moves of price rises could weigh on real purchasing power of households, mainly in the lower income brackets.
- (iii) The fall in stock prices could continue to have an adverse wealth effect on households, especially those in higher income brackets and/or those with elderly persons as their household heads.

Figure 8-1 Index of Private Consumption Integrated Estimates by the Cabinet Office
<seasonally adjusted>



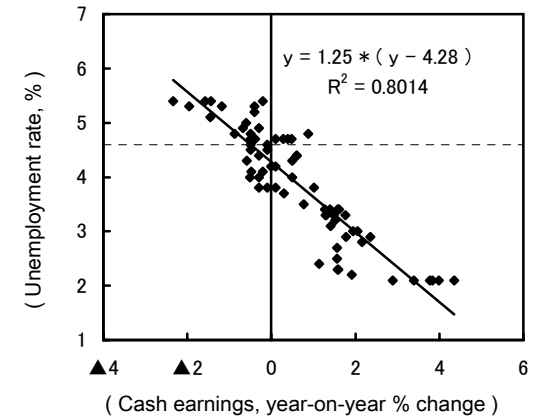
Source: The Cabinet Office.

Figure 8-2 Change in the CPI excluding Imputed Rent and Real Consumption Expenditure <in the April- August 2008 period, % change on a year earlier>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications.
Note: Households in higher income; higher 40% rank in the total, households in lower income; lower 20% rank in the total.

Figure 8-3 Unemployment Rate and Change in Nominal Wages <year-on-year>



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

Note 1: Data are quarterly figures from 1991 to 2008.

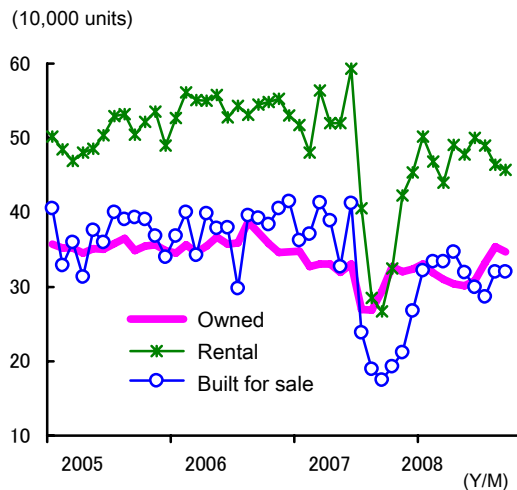
2: The dotted line indicates the figures forecast by the JRI.

Housing investment - Continued softening trend due to worsened environments

Housing starts continue to stagnate and have yet to recover fully from a considerable decline due to the implementation of the amended Building Standards Law with stricter building confirmation procedures for safety in June 2007. Especially, housing starts of rental and built-for-sale houses are still at a low level. It can be pointed out as background that a headwind against the housing market has been intensifying both on the supply side and on the demand side as seen in a rise in land price, an increase in construction costs, and a worsening of the income situation.

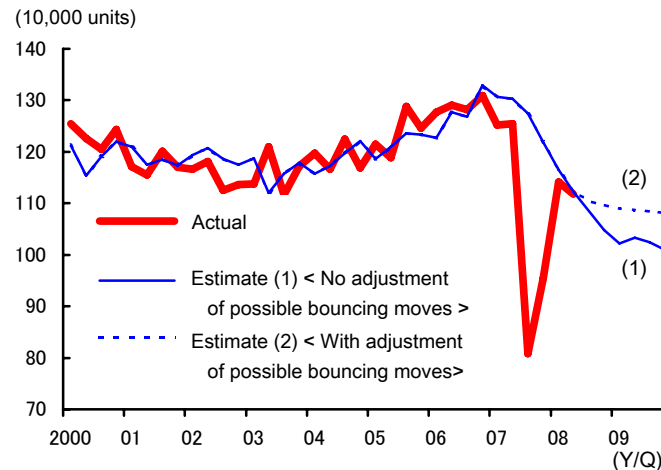
Looking further, it is expected that housing starts will continue to follow a softening path because the cost of building materials would continue to stay up and real income could decrease further due to falling corporate profits and consumer price rises. Above all, the stagnation in demand for condominiums in Tokyo and neighbouring prefectures is serious as shown in a trend that the ratio of purchase agreements to sales has been falling rapidly and the units available have been piling up sharply.

Figure 9-1 Housing Starts by Type of Dwellings <seasonally adjusted, on an annualised basis>



Source: The Ministry of Land, Infrastructure and Transport.

Figure 9-2 Estimate of Housing Starts <seasonally adjusted, on an annualised basis>

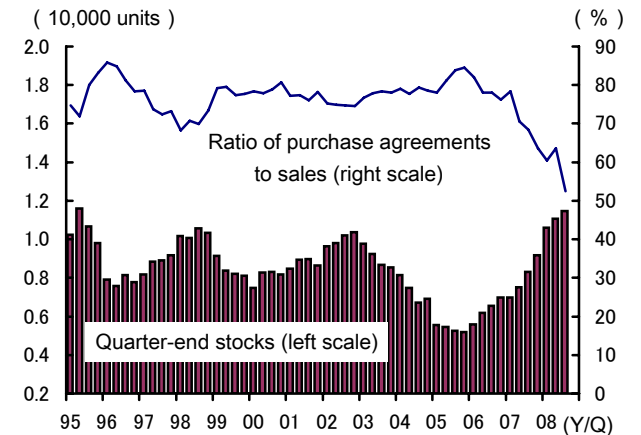


Source: Estimate by The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport.

Note 1: The factors such as income, prices and interest rates are taken into account in the estimate by type of dwellings.

2: The assumptions of the estimate are by JRI projections.

Figure 9-3 Condominiums in Tokyo and Three Neighbouring Prefectures <seasonally adjusted>



Source: Real Estate Economic Institute, Ltd.

Note: The figure in the July-September quarter in 2008 is for July 2008.

Prospects for Japan's economy - Projected real GDP change; -0.5% in FY2008 and -0.2% in FY2009

(1) It is expected that a sense of adjustment will be felt more strongly in Japan's economy and the sluggish situation will be prolonged due to a downswing of the US and European economies.

In the corporate sector, it is expected that Japan's exports will continue to be softening. This is due to the prolonged sluggish situation of the US and European economies, lowered driving power for Japan's economy of exports to emerging and resource-rich countries, and a materialising of the adverse effect of the Japanese yen appreciation. Also, a declining trend in business fixed investment would be more visible, reflecting lowering capacity utilisation. In the household sector, it is expected that private consumption will continue a "low-flying" trend, against the background of stagnant income environments in addition to an adverse wealth effect of falling stock prices.

(2) As a result, it is projected that Japan's real GDP during FY2008 will see four consecutive quarters of contraction, on a seasonally adjusted and quarterly annualised rate over the previous quarter basis. Further, it is expected that the economy will follow a quarterly trajectory at a pace considerably below its potential output growth rate during FY2009. This will lead to minus 0.5 per cent in FY2008 and minus 0.2 per cent in FY2009.

(3) As for a favourable factor, the fall of resource prices appears to have put the brakes on the income shift from Japan to overseas, and income flow is estimated to have turned from income outflow to overseas to income inflow to Japan since this October-December period. This move will be an uplifting factor to the rate of change in the GDP deflator and nominal GDP, and moreover, will be an improving factor to corporate profits and purchasing power of households.

(4) The pace of increase on a year earlier in the Consumer Price Index excluding fresh food (the core CPI) will slow down sharply, reflecting a rapid decline of the price of crude oil and spreading price competition among retailers. It is projected that the year-on-year change in the core CPI will turn minus around next spring, and will be further negative from that time onwards.

Figure 10 Projections for GDP Growth and Main Indicators of Japan (as of November 17, 2008)

(seasonally adjusted, annual % changes from the previous quarter)													
	CY2007	CY2008				CY2009				FY2006	FY2007	FY2008	FY2009
	10~12	1~3	4~6	7~9	10~12	1~3	4~6	7~9					
	(Actual)				(Projection)				(Actual)		(Projection)		
Real GDP	1.8	2.5	▲ 3.7	▲ 0.4	▲ 1.4	▲ 0.8	0.3	0.4	2.5	1.7	▲ 0.5	▲ 0.2	
Private Consumption Expenditure	1.0	2.4	▲ 2.2	1.1	0.5	1.6	1.5	1.3	1.8	1.7	0.4	1.3	
Housing Investment	▲ 33.8	21.9	▲ 11.9	17.0	9.7	▲ 3.0	▲ 2.0	▲ 0.6	0.2	▲ 13.3	▲ 3.0	1.1	
Business Fixed Investment	2.1	▲ 1.0	▲ 5.5	▲ 6.7	▲ 10.8	▲ 8.7	▲ 3.0	▲ 1.2	5.6	▲ 0.1	▲ 4.3	▲ 4.6	
Private Inventories (percentage points contribution)	(0.2)	(▲ 0.8)	(▲ 0.2)	(0.2)	(▲ 0.2)	(▲ 0.3)	(▲ 0.0)	(▲ 0.0)	(0.2)	(▲ 0.0)	(▲ 0.1)	(▲ 0.0)	
Government Consumption Expenditure	3.3	▲ 1.8	▲ 0.4	0.3	0.9	0.6	0.6	0.4	0.1	0.7	0.2	0.5	
Public Investment	0.8	4.2	▲ 20.2	1.5	2.1	▲ 2.0	0.3	▲ 0.9	▲ 9.1	▲ 1.8	▲ 4.8	▲ 0.5	
Net Exports (percentage points contribution)	(1.2)	(1.7)	(▲ 0.4)	(▲ 0.4)	(▲ 0.3)	(▲ 0.1)	(▲ 0.2)	(▲ 0.2)	(0.8)	(1.2)	(0.4)	(▲ 0.2)	
Exports of Goods and Services	11.0	14.5	▲ 10.2	2.8	▲ 7.3	▲ 4.2	▲ 3.7	▲ 1.8	8.4	9.5	1.1	▲ 3.1	
Imports of Goods and Services	4.1	5.0	▲ 11.5	7.9	▲ 8.5	▲ 5.2	▲ 4.1	▲ 1.2	3.1	2.0	▲ 1.8	▲ 2.5	
(% changes from the same quarter of the previous year)													
Real GDP	1.8	1.4	0.7	▲ 0.1	▲ 0.9	▲ 1.6	▲ 0.6	▲ 0.4	2.5	1.7	▲ 0.5	▲ 0.2	
Nominal GDP	0.4	▲ 0.1	▲ 0.9	▲ 1.7	0.4	▲ 0.3	0.9	1.0	1.7	0.7	▲ 0.6	0.2	
GDP deflator	▲ 1.3	▲ 1.5	▲ 1.6	▲ 1.6	1.3	1.3	1.5	1.4	▲ 0.8	▲ 1.0	▲ 0.1	0.3	
Consumer Price Index (excluding fresh food)	0.5	1.0	1.5	2.3	1.4	0.1	▲ 0.5	▲ 2.2	0.1	0.3	1.3	▲ 1.2	
Industrial Production Index	3.3	2.3	1.0	▲ 1.3	▲ 6.5	▲ 7.9	▲ 7.8	▲ 6.9	4.6	2.6	▲ 3.8	▲ 4.5	
Unemployment Rate (%)	3.8	3.9	4.0	4.1	4.4	4.6	4.6	4.6	4.1	3.8	4.3	4.6	
Current Account Balances (trillion JY)	5.50	6.58	3.88	4.56	6.54	6.23	4.66	5.15	21.15	24.54	21.16	21.05	
Share of Nominal GDP (%)	4.1	5.2	3.0	3.7	4.8	4.9	3.6	4.1	4.1	4.8	4.1	4.1	
Exchange Rates (JY/US\$)	113.1	105.2	104.5	107.6	100.1	95.0	92.0	92.0	116.9	114.2	101.8	92.0	
Import Price of Crude Oil (US\$/barrel)	83	95	109	129	69	58	58	58	64	78	91	58	

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 assumptions that real GDP growth rate of the US would be 1.3% in CY2008 and - 1.0 in CY2009 and that of the euro area 1.0% in CY2008 and - 0.8% in CY2009.