2002 Expansion to Set a Postwar Record—Short-term Economic Forecast (FY 2006～2007)

By Koichi Haji

Economic Research Group

haji@nli-research.co.jp

Real economic growth slowed to a 0.2% sequential pace (0.8% annualized) in the third quarter of 2006. As consumption decreased, the main contributor to growth shifted from private demand to net exports. Consumption has failed to take the place of investment-led growth due to the low growth of wages. In the first half of fiscal 2007, exports and nonresidential investment will decelerate as the U.S. economy weakens. But the economy will perk up in the second half as exports and output recover and investment regains momentum. We predict the economy will grow 1.8% in fiscal 2006 and 1.6% in fiscal 2007. Risk factors include the sudden slowdown of the U.S. economy and sharp depreciation of the dollar.

1. The Expansion Continues

(1) Longest Postwar Expansion

In May 2006, the expansion that began in January 2002 surpassed the 51-month long bubble era expansion from 1986. Judging from available economic indicators, the expansion is still going, and will have surpassed the 57-month long *Izanagi* expansion as of November, becoming the longest postwar expansion.

The current expansion differs remarkably from previous long-running expansions. The *Izanagi* expansion symbolized the postwar rapid growth era. The bubble era expansion was turbocharged by skyrocketing equity and land prices. By comparison, the current expansion occurred in the wake of a significant structural shift—the labor force has started to decline—and thus bears little semblance to previous expansions.

For instance, despite its record length, the current expansion leaves many people skeptical even as to whether the economy is actually recovering. The reason is clear when we compare real growth rates—the *Izanagi* expansion averaged 11.5% growth per year, while the current expansion has yet to top 2.0% as of Q3 (July-September) 2006. In the rapid growth era, the economy averaged 10% growth per year, and never saw this level even in recession. As a result, four and one-half years into the *Izanagi* expansion, real GDP had increased 1.7 times, compared to only 1.1 times in the current expansion.

Moreover, due to sluggish wage growth, households have yet to meaningfully share in the prosperity. Unemployment has dropped an impressive 1.5-percentage points from the peak, compared to the 0.6-percentage point decline in the *Izanagi* expansion. But in the *Izanagi* expansion, unemployment peaked at only 1.6%, compared to 5.5% when the current expansion began in the wake of the bubble's collapse. With the unemployment rate now standing in the low 4% range, the sense of labor shortage is not as acute as in the *Izanagi* expansion.

(2) Net Exports Lead Q3 Growth

While the economy achieved its seventh

consecutive quarter of real sequential growth in Q3 2006, the pace edged down to 0.2% (0.8% annualized) from 0.3% in the second quarter. The main source of growth returned from private demand to net exports. Private consumption expenditures turned from a 0.5% increase in Q2 to a -0.9% decrease, while nonresidential investment decelerated from 3.2% to 1.5%. Meanwhile, net exports contributed 0.4% to the economic growth rate, up from -0.1% in Q2, to lead economic growth. Japan's export growth rose from 0.7% in Q2 to 2.5% even though the U.S. economy slowed in Q3 to a 2.2% annual pace .The export growth is attributed to the healthy economies in Europe and Asia, and to the yen's depreciation.

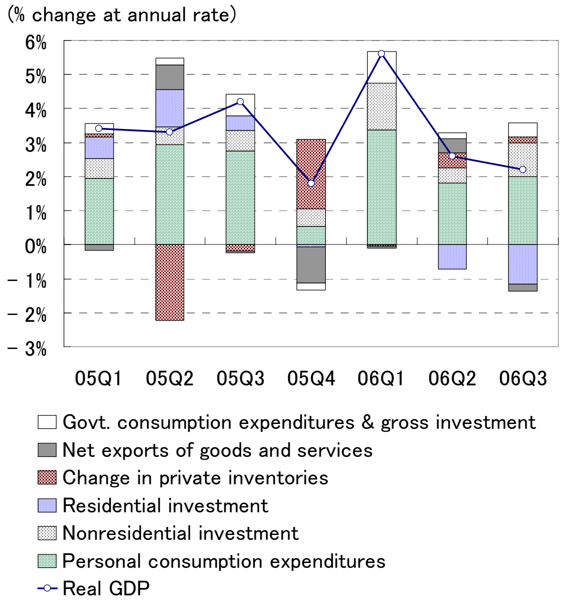
Although the change in GDP deflator remains negative year-on-year, the decline shrank from -1.1% in Q2 to -0.7%. Meanwhile, the domestic demand deflator turned positive to 0.2% (yoy). But with the GDP deflator needing more time to turn positive, the economy's nominal and real growth rates will remain inverted in fiscal 2006.

The CPI base year revision announced at the end of August sharply reduced the year-on-year CPI inflation rate, prompting the government to delay declaring the end of deflation. The feeble CPI increase, along with fiscal restructuring goals that rely on low interest rates and high economic growth, suggest that the declaration will not occur very soon.

In the U.S., the economy slowed from a 2.6% real annual rate in Q2 to 2.2% in Q3. The decline in residential investment widened, while house prices turned downward. In the past, rising house prices enabled households to take on high debt levels, fueling consumption to such an extent that the personal saving rate turned negative in 2005. The concern now is that if the bottom falls out of house prices, households will be forced to cut spending, putting the economy in dire straits.

Meanwhile, soaring oil prices having stabilized somewhat, and the recent downturn of gasoline prices has partly alleviating concerns about weak consumption. The prevailing view now calls for a soft landing slightly below the potential growth rate, which will spare Japan from a severe economic shock.

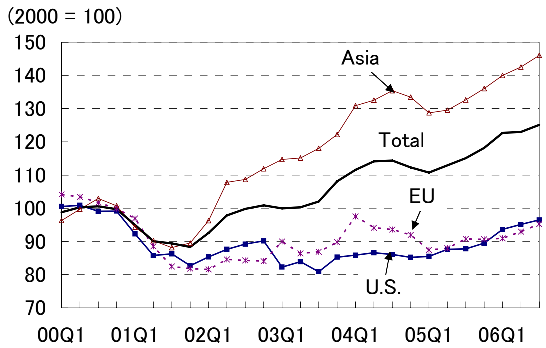
Exhibit 1 Slowdown of U.S. Economy



Source: U.S. Department of Commerce

Thus far, despite the U.S. slowdown, Japan's exports have grown steadily against the backdrop of the weak yen, expansion of Asian economies, and strong EU economy. But since the U.S. slowdown will inevitably affect economies in Asia and elsewhere, Japan's exports will gradually feel the impact.

Exhibit 2 Export Volume by Destination



Source: Ministry of Finance, *Trade Statistics of Japan.*

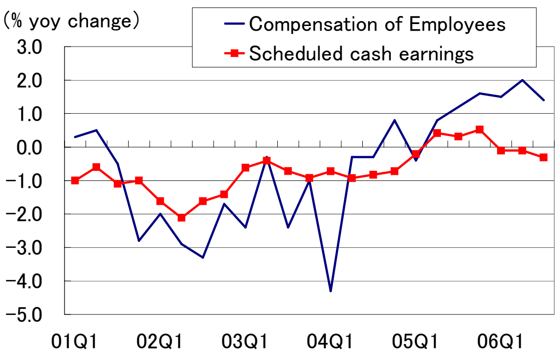
2. 1.6% Growth in FY 2007—Slowdown Followed by Recovery

(1) Low Wage Growth Delays Shift from Investment to Consumption-led Growth

In fiscal 2006, nonresidential investment is estimated to post 7.9% real growth, outpacing the previous year. However, machinery orders in Q3 2006 (excluding shipbuilding and electric power) dropped -11.1% from the previous quarter. While orders are expected to rise 5.7% in Q4, the level of orders will still be below that reached in Q2. Nonresidential investment, which slowed in Q3 according to GDP data, is likely to decelerate in the future as well.

Amid the softening of nonresidential investment, consumption had been expected to take over as the economy's growth driver. Unfortunately, consumption has been weak due to sluggish income growth. Although the recovery has expanded payrolls, employee compensation remains stagnant amid the lack of wage growth per worker. Other sources of household income—interest and dividend income—are expected to grow, but not enough to boost consumption.

Exhibit 3 Wage Growth is Sluggish



Source: ESRI, *Annual Report on National Accounts*; MHLW, *Monthly Labour Survey*.

The weakness of consumption in Q3 2006 is evident from the GDP data, which shows a -0.9% real decline from the previous quarter. Employee compensation, which had posted negative year-on-year growth since 1998, finally turned positive in 2005, but still remains quite low. According to the *Monthly Labour Survey*, while scheduled cash earnings rose 0.2% in 2005 from the previous year (for business establishments with five or more persons), growth has been consistently negative in 2006. Growth of private final consumption expenditures in Q4 2006 should be positive, partly due to a rebound from the dip in Q3. But unless wage growth starts to rise, consumption growth will be limited in the future.

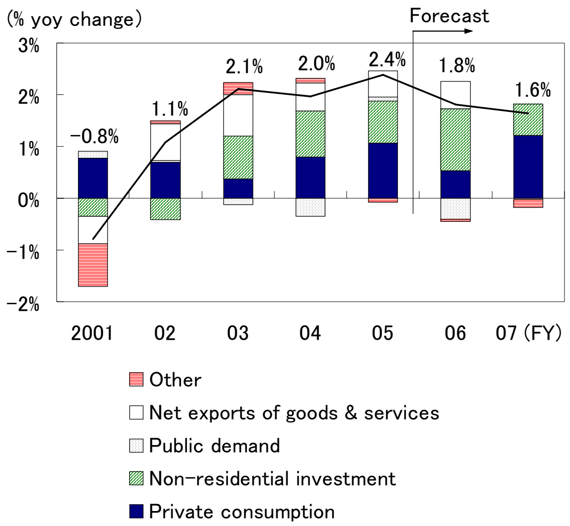
However, as labor market conditions improve, part-time wages are on the rise. If the labor market keeps tightening, the stagnation in wage growth per worker should gradually change. According to the MHLW's *Basic Survey on Wage Structure*, starting wages rose 0.2% in 2005 for new high school, vocational school and junior college graduates, but fell -0.6% for college graduates. However, in 2006, starting wages for all new graduates rose approximately 1%. The growth of starting wages is expected to accelerate as baby boomers retire and younger workers decrease in number. Although the rise of starting wages will not cause a parallel upward shift of the wage curve, average wages should rise to maintain the wage balance between starting and existing workers.

(2) Moderate Slowdown, Then Recovery

The U.S. slowdown will dampen Japan's exports and industrial production, and the economy will visibly decelerate from the end of fiscal 2006 to the first half of fiscal 2007. But with the Federal Reserve expected to cut interest rates from the spring of 2007, the U.S. economy should recover by yearend. By yearend, Japan's economy will also perk up on the strength of exports and industrial production, accompanied by a resurgence in nonresidential investment.

In fiscal 2007, as wage growth edges upward, consumption will remain stable, growing 2.2% in real terms. Nonresidential investment growth will drop to 3.8% from 7.9% in fiscal 2007. In the fiscal 2007 budget, since public works spending is slated for another 3% cut from the previous fiscal year, public investment will decrease -0.4%. However, since government consumption will grow, public demand will still contribute approximately zero percent to economic growth. Due to the U.S. slowdown, net exports will contribute approximately zero percent to economic growth, down from 0.5% in fiscal 2006. As a result, the economy's real growth rate will drop from 2.4% in fiscal 2005 to 1.8% in fiscal 2006, and to 1.6% in fiscal 2007.

Exhibit 4 Real GDP Growth Rate



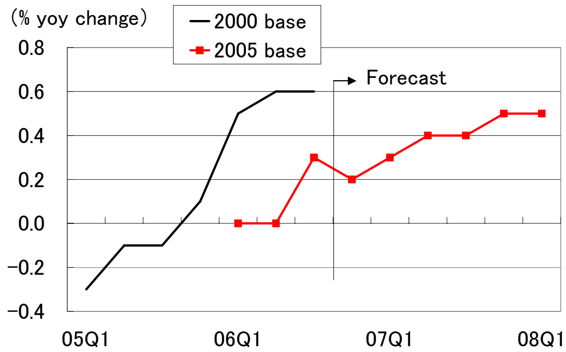
Source: ESRI, *Quarterly Estimates of GDP*.

(3) BOJ Seeks Swift Normalization

In November 2006, Bank of Japan Governor Toshihiko Fukui remarked that unlike fiscal restructuring, normalization of monetary policy should not be extended over a period as long as five years. Considering that quarterly rate hikes of 0.25% would bring interest rates to the neutral level within a two to three-year time span, his statement suggests an inclination toward swift normalization.

Due to the CPI base-year revision in August, the CPI inflation rate (excluding fresh foods) in the first half of 2006 was slashed from 0.5–0.6% to practically zero percent. It subsequently rose to 0.1 – 0.3% from June. Having ended the quantitative easing policy in March 2006, the BOJ need not be bound by CPI considerations. But since inflation will likely remain low in the future, interest rate hikes in the medium term will need to proceed much slowly than Governor Fukui suggests.

Exhibit 5 CPI Inflation Outlook (excluding fresh food)



Source: MIC Statistics Bureau

(4) Shrinking U.S.-Japan Interest Rate Spread to Strengthen Yen

Large interest rate spreads with the U.S. and Europe have kept the yen weak against both the dollar and euro. In particular, the yen's exchange rate against the euro has depreciated sharply past ¥150, boosting Japan's exports to Europe and at the same time widening the profit margin of exporters.

Looking ahead, if the U.S. cuts interest rates as expected, the smaller spread with Japan is likely to strengthen the yen against the dollar. The BOJ attributes the growth of the yen carry trade (borrowing yen at a low interest rate, selling the yen for dollars, and investing in higher-yielding dollar assets) to Japan's low interest rates and weak currency, and worries that expectations of a narrower spread could trigger a sharp turnaround and dramatically strengthen the yen.

The Democrats' victory in the U.S. midterm election should lead to more attention on employment issues and renewed U.S. pressure on China to revalue the yuan. China's foreign reserves have continued to surge after surpassing Japan's as the world's largest, topping $1 trillion. The composition of reserves is gradually shifting from dollar assets to euro assets. Other countries have also begun shifting reserves away from dollar assets, and if this trend accelerates the dollar's depreciation may be hastened. The expected soft landing of the U.S. (growth in the 2% range, or slightly below the potential growth rate), combined with China's reluctance to radically revalue the yuan, suggest that the dollar can avoid a sharp plunge. But the risk remains of a major U.S. slowdown or plunge of the dollar, which would drag Japan's economy into recession.

Short-term Forecast for the U.S. (FY 2006－2007)

(% as noted)

		2005	2006 (f)	2007 (f)	2006				2007			
					I	II	III (f)	IV (f)	I (f)	II (f)	III (f)	IV (f)
Real GDP	(annual rate)	3.2	3.3	2.3	5.6	2.6	2.2	2.1	2.3	2.2	2.7	2.9
Personal consumption expenditures	〃	3.5	3.1	2.5	4.8	2.6	2.9	2.5	2.3	2.2	2.5	2.7
Nonresidential fixed investment	〃	6.8	7.8	5.4	13.7	4.4	10.0	5.3	4.7	4.2	4.8	5.2
Residential investment	〃	8.6	−3.5	−7.2	−0.3	−11.1	−18.0	−10.5	−5.9	−2.8	−0.5	1.4
Change in private inventories	(contrib)	−0.3	0.3	−0.0	−0.0	0.4	0.2	0.1	−0.1	−0.1	−0.1	−0.1
Net exports	(contrib)	−0.3	−0.1	0.1	−0.0	0.4	−0.2	−0.0	0.0	0.0	0.2	0.2
Consumer price index	(yoy)	3.4	3.2	1.9	3.7	4.0	3.3	2.0	2.2	1.5	1.4	2.4
Unemployment rate	(avg)	5.1	4.6	4.6	4.7	4.6	4.7	4.5	4.5	4.6	4.7	4.7
Federal funds rate target	(end)	4.25	5.25	4.75	4.75	5.25	5.25	5.25	5.25	5.00	4.75	4.75
10-year Treasury note yield	(avg)	4.3	4.8	4.5	4.6	5.1	4.9	4.6	4.5	4.3	4.4	4.6

Short-term Forecast for the Euro Area (FY 2006－2007)

(% unless otherwise noted)

		2005	2006 (f)	2007 (f)	2006				2007			
					I	II	III (f)	IV (f)	I (f)	II (f)	III (f)	IV (f)
Real GDP	(yoy)	1.4	2.7	1.9	2.2	2.8	2.7	2.9	2.4	1.8	1.7	1.7
Domestic demand	(contrib)	1.6	2.4	1.8	2.2	2.6	2.4	2.1	2.2	1.7	1.7	1.8
Private consumption	(yoy)	1.4	1.0	0.9	1.8	1.8	0.0	0.4	0.1	0.2	1.7	1.6
Gross fixed investment	(yoy)	2.7	4.3	2.3	4.0	5.3	3.9	4.0	3.4	1.6	2.1	2.0
Net exports (goods & services)	(contrib)	−0.3	0.3	0.1	0.0	0.3	0.3	0.8	0.2	0.2	0.0	−0.1
HICP	(yoy)	2.2	2.2	2.0	2.3	2.5	2.2	1.8	1.9	1.9	2.0	2.0
Unemployment rate	(avg)	8.6	7.9	7.6	8.2	7.8	7.8	7.7	7.6	7.6	7.6	7.6
ECB policy interest rate	(ending)	2.25	3.50	3.75	2.50	2.75	3.25	3.50	3.75	3.75	3.75	3.75
USD/EUR exchange rate	(avg)	$1.24	$1.25	$1.26	$1.20	$1.26	$1.27	$1.30	$1.30	$1.28	$1.28	$1.26
EUR/JPY exchange rate	(avg)	¥137	¥146	¥135	¥141	¥144	¥148	¥152	¥147	¥141	¥134	¥132

Short-Term Forecast for Japan (FY 2006－2007)

(% as noted)

		2005 FY	2006 FY (f)	2007 FY (f)	FY 2006 4-6 (f)	FY 2006 7-9	FY 2006 10-12 (f)	FY 2006 1-3 (f)	FY 2007 4-6 (f)	FY 2007 7-9 (f)	FY 2007 10-12 (f)	FY 2007 1-3 (f)
Real GDP	(seq)	2.4	1.8	1.6	0.3	0.2	0.8	0.4	0.2	0.3	0.4	0.5
	(annual rate)				1.1	0.8	3.4	1.6	0.9	1.4	1.8	2.1
	(yoy)				2.1	1.6	1.6	1.9	1.6	2.0	1.3	1.6
Domestic demand	<contrib.>	<1.9>	<1.3>	<1.6>	<0.3>	<-0.2>	<1.0>	<0.5>	<0.2>	<0.3>	<0.4>	<0.4>
Private sector	<contrib.>	<1.8>	<1.7>	<1.7>	<0.5>	<-0.1>	<1.0>	<0.5>	<0.2>	<0.3>	<0.4>	<0.5>
Public sector	<contrib.>	<0.1>	<-0.4>	<-0.0>	<-0.2>	<-0.1>	<0.0>	<-0.0>	<0.0>	<0.0>	<-0.0>	<-0.0>
Net exports	<contrib.>	<0.5>	<0.5>	<-0.0>	<-0.1>	<0.4>	<-0.2>	<-0.1>	<-0.0>	<0.0>	<0.0>	<0.1>
Private consumption	(seq)	1.9	0.9	2.2	0.5	-0.9	1.4	0.7	0.4	0.4	0.5	0.6
Private residential investment	(seq)	-1.0	0.2	0.2	-2.1	-0.3	1.4	0.8	-0.6	-1.0	0.4	0.2
Private non-residential investmer	(seq)	5.8	7.9	3.8	3.2	1.5	1.3	0.8	0.3	0.9	1.2	1.6
Government consumption	(seq)	0.9	0.9	0.9	0.7	0.7	0.3	-0.2	0.3	0.4	0.3	-0.2
Public investment	(seq)	-1.4	-11.7	-4.0	-6.9	-5.3	0.1	0.7	-1.3	-1.6	-1.4	-0.4
Exports of goods & services	(seq)	9.0	7.4	3.0	0.7	2.5	0.5	0.3	0.5	0.6	1.1	1.5
Imports of goods & services	(seq)	6.0	4.7	4.0	1.3	-0.5	2.3	1.2	0.7	0.7	1.2	1.2
Nominal GDP	(seq)	1.0	1.3	1.9	0.0	-0.0	1.1	0.6	0.4	0.3	0.3	0.6

Major indicators

(As noted)

		2005 FY	2006 FY (f)	2007 FY (f)	FY 2006 4-6	FY 2006 7-9	FY 2006 10-12 (f)	FY 2006 1-3 (f)	FY 2007 4-6 (f)	FY 2007 7-9 (f)	FY 2007 10-12 (f)	FY 2007 1-3 (f)
Industrial production (IIP)	(% seq)	1.6	3.9	2.3	0.9	1.0	1.1	0.3	0.2	0.5	0.8	1.1
Domestic CGPI	(% yoy)	2.1	2.9	0.0	3.1	3.5	2.8	2.2	0.8	-0.4	-0.3	0.0
CPI	(% yoy)	-0.1	0.3	0.3	0.2	0.6	0.3	0.3	0.2	0.2	0.4	0.5
Core CPI (excl. fresh food)	(% yoy)	0.1	0.2	0.5	0.0	0.3	0.2	0.3	0.4	0.4	0.5	0.5
Current account balance	(¥ tril)	19.1	19.0	18.8	17.3	18.9	20.2	19.5	19.0	17.9	18.9	19.3
(% nominal GDP)	(%)	3.8	3.7	3.6	3.4	3.7	4.0	3.8	3.7	3.5	3.6	3.7
Unemployment rate	(%)	4.3	4.0	3.9	4.1	4.1	4.0	3.9	3.9	4.0	3.9	3.9
Housing starts	(million)	125	128	127	130	127	128	127	127	127	127	128
Unsecured overnight call rate	(end, %)	0.00	0.50	0.75	0.00	0.25	0.50	0.50	0.50	0.50	0.50	0.75
10-year JGB yield	(avg, OTC)	1.4	1.8	2.1	1.9	1.8	1.7	1.8	1.8	2.0	2.2	2.3
USD/JPY exchange rate	(avg)	¥113	¥115	¥106	¥114	¥116	¥117	¥113	¥110	¥105	¥105	¥105
CIF crude oil price	(avg, $/bbl)	$56	$63	$61	$65	$71	$58	$58	$61	$61	$61	$61
Current profit	(% yoy)	8.4	9.1	2.2	10.1	15.5	7.4	5.0	2.8	0.7	2.5	2.7

Note: Data is current as of October 2006.
Sources: ESRI, *Annual Report on National Accounts*; METI, *Indices of Industrial Production*; MIC Statistics Bureau, *Consumer Price Index*; MOF, *Financial Statements Statistics of Corporations by Industry*; others.