Economic Forecast for Fiscal 2005 and 2006—Corporate and Household Sectors Cross Paths

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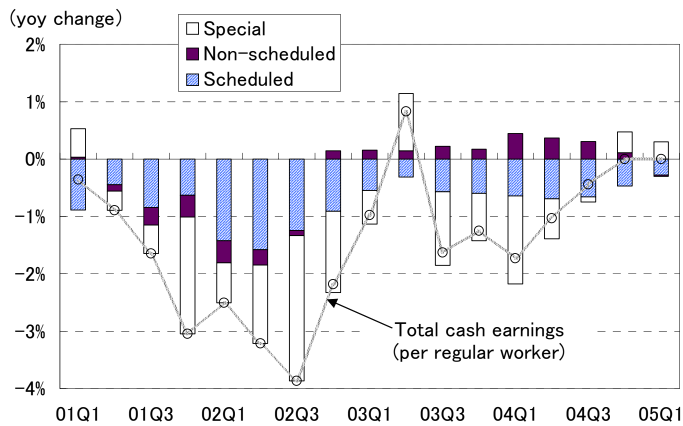
1. Outlook Brightens for Households, but Dims for Corporate Sector

In a refreshing change from its lackadaisical performance in 2004, the economy cruised to a 1.2% real sequential growth rate (4.9% annualized) in January-March 2005. Consumption spending shook off a long slump with an impressive 1.1% gain, while nonresidential investment surged 2.4%, together boosting private demand by 1.6%. Nominal GDP growth was also positive for the second straight quarter at 0.6% (2.2% annualized). The GDP deflator dipped from -0.4% in October-December to -1.0% in January-March, but this reflects the waning of special one-time factors and does not signal stronger deflationary pressures ahead. However, there are two causes for concern: real exports declined -0.4% sequentially, and private inventories contributed 0.3% to the economic growth rate.

In the past, corporate earnings growth fueled capital investment, while household incomes and consumption languished. After bottoming out in January 2002, the economy encountered turbulence in the first half of 2003 but has been recovering. The corporate sector's prospects appeared to brighten in fiscal 2004, while the household sector remained sluggish.

Figure 1 Income Environment Improves



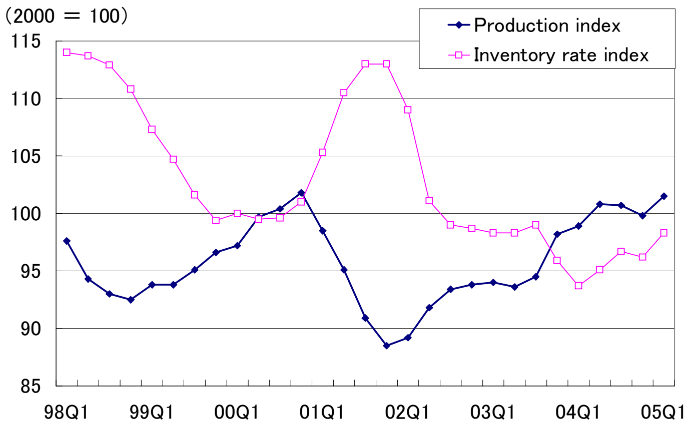
Source: Ministry of Health, Welfare and Labor, *Monthly Labor Survey*.

However, households are starting to see improvement. On the employment scene, the jobless rate has dropped from the mid 5% range in early 2003 to the mid 4% range in early 2005, while the ratio of job offers to seekers is rising. And according to the *Monthly Labor Survey*, incomes are recovering—total cash earnings per person stopped sliding year on year, and last year's winter bonus grew for the first time.

But the corporate sector appears to be slowing down. In the Bank of Japan's *Tankan Survey*, the diffusion index of large manufacturing companies declined in December and again in March.

The industrial production index has risen since early 2002, despite faltering in early 2003 due to the Iraq war and SARS, and again since last summer. The index edged down for two straight quarters in July-September and October-December, leading some observers to comment that production had peaked out last summer and was headed downward. But production rose 3.2% in January from December and hit an even higher peak, making the 2004 contraction scenario improbable. Still, the index rose only 1.7% in January-March since January's surge was followed by two straight declines of -2.3% in February and -0.2% in March. Thus the economy apparently has yet to pull out of a soft patch. Although real production rose 1.9% in April from March, production planned by manufacturers fell -2.3% for May and then rose 1.4% for June (*Survey of Manufacturing Industry Production Forecast*). Recently, the regular occurrence of negative realization rates (where real production falls short of planned production) suggests that industrial production must be carefully monitored in the future.

Figure 2　Troubling Rise in Inventory Rate Index



Source: Ministry of Health, Welfare and Labor, *Monthly Labor Survey*.

Growth in private inventories, despite boosting real economic growth in January-March, is probably not a positive sign for the future. The government and BOJ have commented that the economy should resume growth once IT industries complete inventory adjustment. But the inventory rate index has risen since last year, suggesting that inventories are mounting in other industries as well.

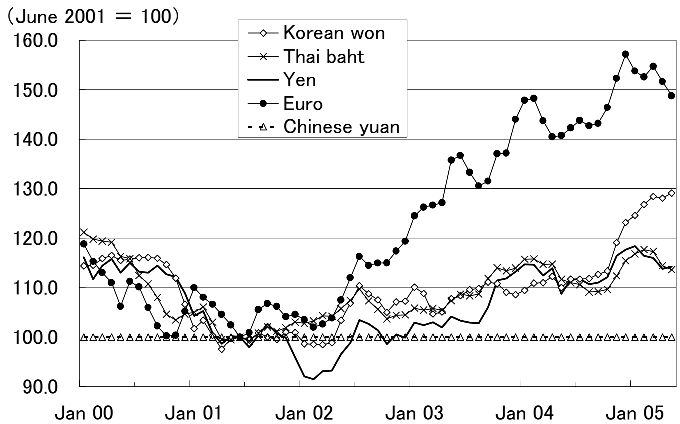
2. Forecast—0.8% Growth in FY2005, and 1.1% in FY2006

1. On the Revaluation of China's Yuan

One possible remedy for America's massive twin deficit problem (federal and current account deficits) is a sharp depreciation of the dollar, which would rein in the economy and curb imports. In January-March 2005, the real economy edged down to a 3.5% annualized sequential pace from 3.8% in October-December 2004. If the FRB continues to raise interest rates, the economy will gradually decelerate and reduce import growth. In China, where investment demand is overheating, real GDP has been soaring 9.5% (yoy) in both October-December 2004 and January-March 2005, while domestic demand appears to be slowing. Japan's exports to China are also slowing down. If both the U.S. and Chinese economies decelerate to alleviate their respective problems, they will both curb their import growth.

The U.S. trade deficit in April expanded from the previous month to $57 billion (BOP basis, seasonally adjusted). For the January-April period, the trade deficit is already 22.1% ahead of last year's record-setting pace. In 2004, bilateral trade with China comprised $162.0 billion of the $651.5 billion trade deficit in goods (Census Bureau). Discontent is mounting in the U.S. because China continues to peg the yuan firmly to the dollar despite repeated large trade surpluses with the U.S. In the first quarter of 2005, China posted a $16.6 billion trade surplus, compared to a $8.6 billion deficit a year earlier, as exports surged 34.9% while imports slowed to 12.1% growth (from 42.4% a year earlier). If China reins in the economy to prevent overheating, imports will slow further and push the trade surplus higher, exacerbating U.S. pressure on China to revalue the yuan.

Figure 3 Asian Currencies Lag Behind the Euro

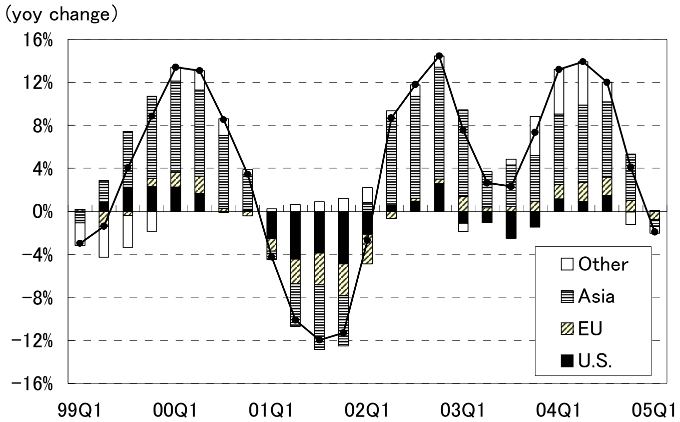


Source: *The Asian Wall Street Journal*; others.

Comparing currency movements since mid 2001, the yen and other Asian currencies have appreciated sluggishly against the dollar compared to the euro. This is due in large part to the dollar peg of the yuan. Should the yuan be revalued, other Asian currencies will follow suite, thereby normalizing their relationship with the eruo.

In the trade data, year-on-year growth of Japan's exports by volume peaked out last summer and has slowed. This is attributed to a downturn in Asia's formerly robust demand led by China. In the GDP data, real January-March exports fell -0.4% sequentially, the first decline in 13 quarters. Despite slower import growth of 0.5%, external demand made a negative contribution of -0.1% to real economic growth in the third consecutive quarter, indicating that external demand is waning as a driving force. Looking ahead, two factors suggest that external demand will remain weak: (1) as U.S. and Chinese economies soften, demand for Japan's exports will slow; and (2) if the yuan is revalued, the yen is like to respond by appreciating against both the dollar and euro.

Figure 4 Trend in Japan's Export Volume by Destination



Note: Export volume is calculated as export value divided by export price.
Source: Ministry of Finance, *Trade Statistics*.

2. Can Consumption Offset the Weakness in Capital Investment?

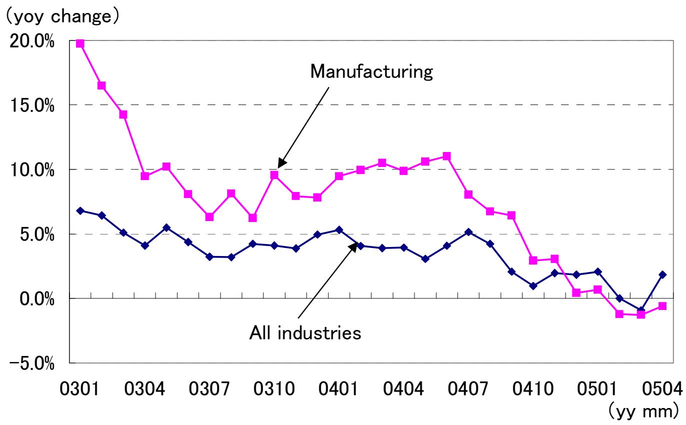
Reflecting strong profit growth, capital investment has been rising. According to the *Financial Statements Statistics of Corporations by Industry* released on June 6, investment in plant and equipment grew 3.0% (yoy) in October-December, and accelerated to 6.9% in January-March. But the profit outlook has started to dim—current profit growth for all industries fell from over 30% in the first half of fiscal 2004 to the teens in the second half, and is expected to plummet in fiscal 2005. Looking ahead, if lackluster exports aggravate the downtrend in profit growth, capital investment is sure to slow down.

In the GDP data, real non-residential investment (qoq) was unchanged in July-September and October-December due partly to typhoons and bad weather, but grew 2.4% in January-March. Machinery orders (private demand excluding shipbuilding and electric power), a leading indicator of capital investment, rose a healthy 5.7% (qoq) in October-December but only 0.7% in January-March, and is estimated to fall -3.1% in April-June. The mixed signals make it unclear whether capital investment will continue to grow.

The absence of consumer price inflation despite higher oil and raw materials prices indicates that profit margins are being squeezed at companies in the middle. Weak export growth is a vital concern in that if companies cannot offset low profit margins with higher sales volume, their profits will deteriorate.

The problem is whether household consumption growth can compensate for the weakening corporate sector. Weak industrial production has trimmed growth in non-scheduled hours worked (yoy), reducing the impact of overtime pay on household income. In addition, higher corporate profits are reflected only in special cash earnings and not in substantive wage increases. Thus in fiscal 2005, we predict limited growth in household income—not something that supports the economic recovery by offsetting the export slowdown and resulting fall in capital investment.

Figure 5 Declining Growth in Non-Scheduled Hours Worked

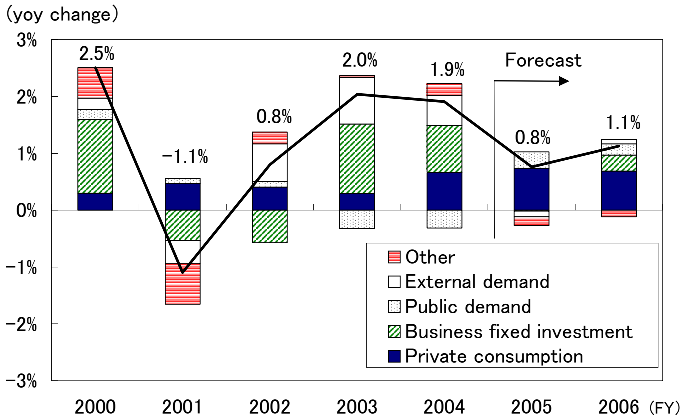


Note: Covers establishments with five or more persons.
Source: MHLW, *Monthly Labor Survey*.

3. Economy Remains Sluggish in FY 2005

In fiscal 2005, lower export growth will cause external demand to contribute negatively, dragging real economic growth down by -0.1%, compared to a 0.5% positive contribution in fiscal 2004. Cost increases from higher oil prices will also squeeze corporate profits, reducing real capital investment modestly each quarter, for a decline of -0.1% in fiscal 2005, compared to 5.3% growth in fiscal 2004. Consumption will increase to 1.3% from 1.2% in fiscal 2004 as employment and income environments improve. Public demand will shift from a -1.4% decline in fiscal 2004 to a 1.3% increase in fiscal 2005 because of smaller spending cuts. Nonetheless, we predict that real economic growth will decrease to 0.8% in fiscal 2005 from 1.9% in fiscal 2004. While deflation measured by the GDP deflator will improve to -0.8% in fiscal 2005 from -1.1% in fiscal 2004, nominal economic growth will decline to 0.0% from 0.8%.

Figure 6 Trend in Real GDP Growth



Source: Economic and Social Research Institute,

4. Recovery to Come in Fiscal 2006

As the overseas economic environment worsens from fiscal 2004 to 2005, slower export growth will put Japan's economy at risk of recession. However, the downturn abroad will not continue into fiscal 2006. While China's economy is expected to slow down to prevent overheating, the World Bank predicts only a minor deceleration from 9.4% growth in 2004 to 8.3% growth in 2005. In view of China's sustained high growth rate, exports to China will slump temporarily but resume growing. The U.S. economy is predicted to slow down from 4.4% real growth in 2004 to 3.1% in 2006. But here again, the U.S. economy would merely be converging to its potential growth rate of around 3%, and thus not actually slowing down.

As a result, Japan's exports will slow down in fiscal 2005, but continue growing moderately. Due to aging and the decreasing labor force, unemployment will not be a major problem even if the economy stumbles. We predict that consumer confidence will dip only slightly and that consumption will not plummet. Capital investment will make minor adjustments due to the export slowdown in fiscal 2005, but turn around and improve 1.8% in fiscal 2006. We predict that real economic growth will reach 1.1% in fiscal 2006. Although consumer price inflation (CPI excluding perishables) will turn slightly positive (yoy) in mid fiscal year, this will not satisfy the BOJ's condition for ending the quantitative easing policy (no more expected deflation). But signs of deflation's imminent demise—sustained positive nominal economic growth, and bottoming out of consumer prices—will cause long-term interest rates to continue rising moderately. The yen will continue to appreciate moderately as the current account surplus persistently exceeds 3% of nominal GDP, as as Japan's economy recovers.

Economic Forecast for the U.S.

(%)

	Unit	FY 2004 actual	FY 2005 forecast	FY 2006 forecast	2005 Q1 forecast	Q2 forecast	Q3 forecast	Q4 forecast	2006 Q1 forecast	Q2 forecast	Q3 forecast	Q4 forecast
Real GDP	seq. chg.	4.4	3.5	3.1	3.5	3.3	3.2	3.1	3.1	3.0	2.9	2.9
Personal consumption expenditures	seq. chg.	3.8	3.6	3.1	3.6	3.3	3.2	3.1	3.1	3.0	2.9	2.9
Nonresidential priv. dom. investment	seq. chg.	10.6	8.8	6.4	3.5	8.7	7.6	6.3	6.1	5.7	6.3	6.3
Private inventory investment	contrib.	0.4	0.0	−0.2	0.8	−0.6	−0.3	−0.3	−0.2	−0.1	0.1	−0.1
Net exports of goods and services	contrib.	−0.6	−0.6	−0.1	−0.7	−0.1	−0.2	−0.2	−0.2	−0.0	0.1	0.1
Consumer price index	yoy chg.	2.7	3.1	2.2	3.0	3.1	3.2	2.8	2.7	2.0	2.0	2.1
Unemployment rate	average	5.5	5.2	5.1	5.3	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Federal funds target rate	period end	2.25	3.75	3.75	2.75	3.25	3.50	3.75	3.75	3.75	3.75	3.75
10-year Treasury note yield	average	4.3	4.3	4.7	4.3	4.2	4.3	4.5	4.6	4.7	4.8	4.8

Economic Forecast for the Euro Zone

(%)

	Unit	FY 2004 actual	FY 2005 forecast	FY 2006 forecast	2005 Q1 forecast	Q2 forecast	Q3 forecast	Q4 forecast	2006 Q1 forecast	Q2 forecast	Q3 forecast	Q4 forecast
Real GDP	yoy chg.	1.7	1.4	1.8	1.3	1.3	1.4	1.7	1.7	1.8	1.9	1.9
Domestic demand	contrib.	1.6	1.2	1.6	1.5	1.4	1.0	1.0	1.5	1.6	1.7	1.7
Private final consumption expen.	yoy chg.	1.2	1.5	1.7	1.3	1.5	1.6	1.4	1.6	1.7	1.8	1.7
Fixed capital formation	yoy chg.	1.4	0.9	1.9	1.0	1.1	1.0	0.6	1.8	1.8	1.9	2.0
External demand	contrib.	0.1	0.2	0.2	−0.1	−0.2	0.4	0.7	0.2	0.2	0.2	0.2
Consumer price index	yoy chg.	2.1	2.0	1.9	2.0	2.0	2.1	2.0	2.0	1.9	1.8	1.8
Unemployment rate	average	8.9	8.9	8.8	8.9	8.9	8.9	8.8	8.8	8.8	8.8	8.8
Federal funds target rate	period end	2.00	2.00	2.50	2.00	2.00	2.00	2.00	2.25	2.50	2.50	2.50
Dollar rate	average	$1.24	$1.25	$1.25	$1.31	$1.26	$1.21	$1.23	$1.24	$1.24	$1.25	$1.26

Economic Forecast for Japan

(% seq. change, unless otherwise indicated)

		FY 2004 actual	FY 2005 forecast	FY 2006 forecast	2004 Q4 actual	2005 Q1 actual	2005 Q2 forecast	Q3 forecast	Q4 forecast	2006 Q1 forecast	2006 Q2 forecast	Q3 forecast	Q4 forecast	2007 Q1 forecast
Real GDP	sequential change	1.9	0.8	1.1	0.1	1.2	−0.0	−0.1	−0.1	0.2	0.3	0.4	0.5	0.6
	annualized seq. chg.				0.2	4.9	−0.1	−0.3	−0.4	1.0	1.1	1.8	1.9	2.3
	yoy change				0.6	1.3	1.0	1.1	1.0	−0.1	0.4	0.9	1.3	1.9
Domestic demand (contribution)		(1.4)	(0.9)	(1.1)	(0.1)	(1.3)	(−0.0)	(−0.1)	(−0.1)	(0.2)	(0.2)	(0.5)	(0.5)	(0.5)
Private demand		(1.8)	(0.6)	(0.9)	(0.0)	(1.2)	(−0.1)	(−0.1)	(−0.2)	(0.1)	(0.3)	(0.4)	(0.4)	(0.4)
Public demand		(−0.3)	(0.3)	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)	(0.0)	(0.0)	(−0.0)	(0.1)	(0.1)	(0.1)
External demand (contribution)		(0.5)	(−0.1)	(0.1)	(−0.1)	(−0.1)	(0.0)	(−0.0)	(0.0)	(0.1)	(0.0)	(−0.0)	(0.0)	(0.0)
Private consumption		1.2	1.3	1.2	−0.4	1.1	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.3
Private residential investment		2.1	−0.7	−0.1	0.6	−1.3	−0.5	0.1	0.7	−0.5	−0.5	0.4	0.1	0.2
Private non-residential investment		5.3	−0.1	1.8	−0.1	2.4	−0.7	−0.6	−0.9	−0.3	0.8	1.0	1.2	1.3
Government consumption		2.7	2.3	1.9	0.6	0.6	0.7	0.6	0.5	0.5	0.2	0.7	0.6	0.8
Public investment		−15.1	−2.4	−3.4	−0.3	−0.6	−0.0	−0.8	−1.2	−1.1	−1.2	−0.6	−0.5	−0.2
Exports of goods & services		11.9	2.0	2.5	1.3	−0.4	0.5	0.6	0.7	0.9	0.5	0.5	0.6	0.7
Imports of goods & services		9.3	3.5	2.5	2.1	0.5	0.5	0.8	0.6	0.6	0.4	0.9	0.6	0.7
Nominal GDP		0.8	0.0	1.0	0.2	0.6	−0.1	−0.1	−0.2	−0.4	0.9	0.5	0.4	0.1

Major Indicators

(% unless otherwise indicated)

	FY 2004	FY 2005	FY 2006	2004 Q4	2005 Q1	2005 Q2	Q3	Q4	2006 Q1	2006 Q2	Q3	Q4	2007 Q1
Industrial production (seq. chg.)	4.1	−0.5	1.2	−0.9	1.7	−0.3	−1.0	−0.6	0.2	0.6	0.6	0.7	0.9
Domestic corporate goods prices (yoy)	1.5	0.5	−0.3	2.0	1.4	1.8	0.8	0.0	−0.5	−0.4	−0.5	−0.2	−0.1
Consumer prices (yoy)	−0.1	−0.3	0.1	0.5	−0.2	−0.2	−0.3	−0.5	−0.2	−0.1	0.1	0.1	0.1
(excl. fresh foods)	−0.2	−0.2	0.1	−0.2	−0.4	−0.3	−0.3	−0.2	−0.1	−0.1	0.1	0.1	0.2
Current account balance	¥18.3 tr.	¥15.8 tr.	¥16.7 tr.	¥18.3 tr.	¥18.2 tr.	¥15.7 tr.	¥16.0 tr.	¥15.4 tr.	¥16.2 tr.	¥16.1 tr.	¥16.8 tr.	¥16.4 tr.	¥17.6 tr.
(ratio to nominal GDP)	(3.6)	(3.1)	(3.3)	(3.6)	(3.6)	(3.1)	(3.2)	(3.1)	(3.2)	(3.2)	(3.3)	(3.2)	(3.4)
Unemployment rate	4.6	4.7	4.7	4.6	4.6	4.6	4.6	4.7	4.8	4.9	4.9	4.7	4.5
New housing starts	1.19 ml.	1.18 ml.	1.17 ml.	1.17 ml.	1.21 ml.	1.18 ml.	1.18 ml.	1.18 ml.	1.17 ml.	1.17 ml.	1.17 ml.	1.17 ml.	1.17 ml.
10-year JGB yield (OTC quote)	1.5	1.4	1.7	1.4	1.4	1.3	1.3	1.4	1.5	1.6	1.7	1.7	1.7
Exchange rate (¥/$)	¥107	¥106	¥102	¥106	¥104	¥108	¥107	¥106	¥104	¥102	¥102	¥101	¥101
Crude oil price ($/barrel)	$39	$45	$42	$41	$41	$48	$46	$44	$43	$42	$42	$42	$40
Current profits (yoy)	24.6	−1.0	4.6	17.6	15.8	0.2	−0.6	−2.3	−1.2	−0.7	2.3	4.7	10.4

Note: 10-year JGB yield, exchange rate, and oil price are expressed as the average level during the period.
Sources: ESRI, Quarterly Estimates of GDP; METI, Indices of Industrial Production; MPMHAPT, Consumer Price Index; MOF, Financial Statements Statistics of Corporations by Industry..