The End of Deflation Approaches—
Short-Term Economic Forecast (FY2005–2006)

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In fiscal 2005, Japan's economy will grow 2.8% in real terms, led by domestic demand growth in consumption and nonresidential investment. Due partly to FRB interest rate hikes, the U.S. economy will slow to its potential growth rate of 3% by late 2006. While this will moderately ease the large current account imbalance, there is a growing risk of a sudden correction to the economy. In fiscal 2006, Japan's real economic growth rate will decline to 1.7% as exports slow, and nominal economic growth will edge up to 1.5%. While the core CPI inflation rate will climb to 0.3%, quantitative easing is not likely to be lifted earlier than summer 2006 due to the government's cautious stance.

1. Domestic Demand Still Driving Growth

In the July-September 2005 quarter, the economy posted 0.2% real growth from the previous quarter (1.0% annualized), slowing from 1.2% (5.0% annualized) in April-June, but enough to sustain a string of three consecutive growth quarters. Domestic demand was firm, as private consumption and nonresidential investment both continued to expand. Residential investment rose for the first time since October-December 2004, and public investment increased due to reconstruction activity following the Niigata earthquake in late 2004. On the other hand, external demand made a slightly negative contribution, as exports slowed to 2.7% sequential growth while imports accelerated to 3.3% growth.

The GDP deflator declined by a widening margin of -1.4% year-on-year from -1.2% in April-June. However, this can be attributed to higher oil prices pushing the import deflator up and the GDP deflator down. The deflator for domestic demand is declining more slowly than before, indicating that deflation continues to weaken its grip.

The labor market is also firming up. The increase in employees, which had come from part-time employees until late 2004, now comes from full-time employees, indicating that a higher quality of employment. Growth in corporate earnings boosted bonuses 2.2% year-on-year in winter 2004 and 1.3% in summer 2005, and the winter 2005 bonus is expected to follow suite. Scheduled cash earnings in the *Monthly Labour Survey* have continued to grow in fiscal 2005. As a result, employee compensation in the GDP data rose 1.6% year-on-year in April-June, and another 1.3% in July-September. The retirement of baby boomers in 2007 is fueling corporate hiring intentions, which will keep the labor market on track in the near term. Reflecting the improved job and income environment, consumption will remain firm.

Real private nonresidential investment rose 1.6% sequentially in July-September, slightly less than the 2.4% growth recorded in April-June, but is likely to pick up in the second half of fiscal 2005. Indications are that investment will continue to grow—the BOJ *Tankan* survey finds that corporate investment intentions are strong, while a leading indicator for investment, machinery orders (private demand excluding shipbuilding and electric power), rose 2.1% in July-September, and is predicted to rise 6.2% in October-December.

The regular five-year update of base year for

GDP data was carried out in December. Compared to data calculated for base year 2000, nominal GDP for fiscal 2004 was revised downward approximately 9 trillion yen. The revision for non-residential investment was particularly large, causing it to drop 1 percentage point as a ratio to nominal GDP.

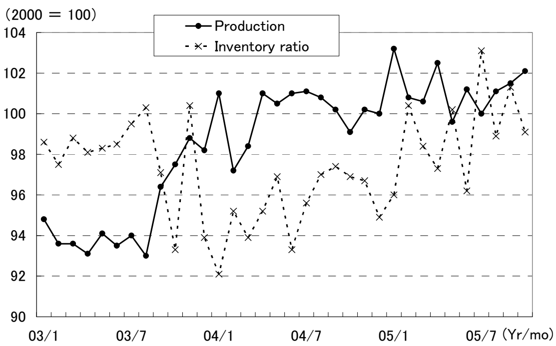
2. FY2005 Real Growth Rate—2.8%

Despite concerns about the massive hurricane damage, the U.S. economy accelerated from a 3.3% annualized real growth rate in April-June 2005, to 4.3% in July-September. But robust growth has also resulted in higher oil prices and rising housing prices. Since June 2004, the FRB has preemptively raised the federal funds target rate from 1.0% to 4%. This has led to signs of softening in housing prices and concerns of weakening consumption. But reconstruction demand, including the approval of $62.3 billion in emergency funds for Gulf Coast states, will boost the economy in the near term.

In China, amid concerns of overheating in investment and the economy, tightening policies were expected to cool down the economy from mid 2004. But the economy resumed high growth in 2005, achieving real year-on-year growth rates of 9.4% in January-March, 9.5% in April-June, and 9.4% in July-September. From January to October, fixed investment in buildings, housing and factories in urban areas rose 27.6% year-on-year, significantly outpacing the economy and sustaining its high growth. Reflecting these conditions, the volume of Japanese exports to China dipped in mid 2004 before rebounding in spring 2005.

As for Japan, despite a higher real economic growth rate in 2005, industrial production has wavered for the past few years. The index plunged in 2001 when the IT bubble burst in the U.S., turning upward in early 2002, but stalling in early 2003 and again in the summer of 2004. The index rose 1.7% in January-March 2005, but fell -0.4% in April-June, and -0.2% again in July-September. However, the monthly production index in October rose 0.6% from the previous month, while the production forecast index rose 4.6% in November and 0.6% in December. Thus even though forecast realization rates have recently been negative, production is likely to break out of the plateau.

Figure 1 Industrial Production & Inventory Ratio Indices



Source: METI, *Indices of Industrial Production*.

In fiscal 2005, domestic demand growth in consumption and nonresidential investment is fueling economic growth. Despite 7.4% growth in real exports, the import surge from growing domestic demand will reduce the contribution of external demand to 0.1%, down from 0.5% in fiscal 2004. Nonresidential investment growth will pick up from 5.4% in fiscal 2004 to 8.4% in fiscal 2005, and consumption growth from 1.7% to 2.0% respectively as the job and income environment improves. In addition, public demand will grow 1.0% in fiscal 2005, up from -1.4% in fiscal 2004, due to the supplementary budget of late fiscal 2004, which boosted public investment growth to -0.6%, up from -12.4% in fiscal 2004. Overall, domestic demand will contribute 2.7% to the economy's growth rate in fiscal 2005, up from 1.3% in fiscal 2004.

Combined with the smaller contribution of external demand, the real economy will grow 2.8% in fiscal 2005, up from 1.7% in fiscal 2004. Since higher oil prices push up the import deflator and push down the GDP deflator, the

GDP deflator's decline will expand to -1.3% from -1.2% in fiscal 2004, while the domestic demand deflator's decline will shrink to -0.5% from -0.7% in fiscal 2004. The nominal GDP growth rate will rise to 1.4%, up from 0.5% in fiscal 2004.

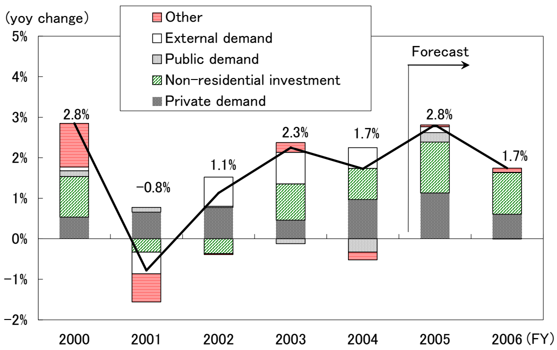
3. FY2006 Real Growth Rate—1.7%

(1) Domestic Demand Still Drives Growth

In fiscal 2006, consumption will continue to grow amid the improving job and income environment. However, disposable income growth will suffer from the smaller fixed-rate tax deduction, reducing consumption growth to 1.1% from 2.0% in fiscal 2005. Reflecting slower corporate earnings growth, nonresidential investment will also slow to 6.6% growth, down from 8.4% in fiscal 2005. Thus domestic demand will slow but still drive the economy.

Overseas, major concerns are the effect of high oil prices on economies in Asia and Europe, and China's overheating economy. As for the U.S., hurricane aftereffects will hamper the economy in Q4 2005, but reconstruction demand will boost growth in the first half of 2006. After that, however, the cumulative interest rate hikes will start to moderate the economy's growth, reducing the pace of imports from Japan in 2006. As a result, we predict that Japan's economy will decelerate to 1.7% real growth in fiscal 2006, down from 2.8% in fiscal 2005.

Figure 2 Real GDP Growth Rate



Source: ESRI, *Preliminary Estimate of Quarterly GDP*.

(2) Risk Factors in Fiscal 2006

The greatest risk facing the economy in fiscal 2006 is an economic downturn overseas. While the dollar rate recently topped ¥120, this can be attributed to the repatriation of corporate earnings under the American Jobs Creation Act of 2004, and to expectations of a widening interest rate gap with the U.S. However, the flow of funds into the U.S. will contract when the provision expires in December 2005. Moreover, the FRB could halt further interest rate hikes in May. If this coincides with the end of quantitative easing in Japan, expectations will swing to a shrinking interest rate gap, triggering dollar selling and a stronger yen. Another possibility is that the U.S. will resort to a major exchange rate correction to alleviate the twin deficit problem.

Second, households will carry a heavier tax burden when the fixed-rate tax deduction is cut in fiscal 2006 and eliminated in fiscal 2007. The extra burden is estimated at approximately ¥2 trillion for fiscal 2006. We predict that it can be fully absorbed by wage growth as the job and income environment improves, but remain concerned about the impact on consumption.

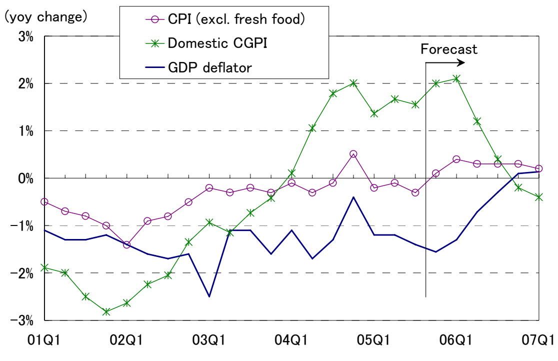
A third factor is the slowdown in corporate earnings, which could dampen nonresidential investment. Lower labor costs have been contributing to earnings, but could start to rise, crimping earnings and possibly constraining investment. In addition, slower earnings growth could also distress the stock market, impairing confidence in business and household sectors. While the stock market recently went through a correction due to the disarray over misplaced orders, the Nikkei average has remained above 15,000. Earnings have failed to keep pace with the market's surge since autumn. Considering that market prices already factor in strong earnings performance, a poor performance may trigger a major market correction.

(3) Exit for Quantitative Easing

Special factors that have held down the core CPI (excluding fresh food) are abating, leading us to predict a 0.1% year-on-year increase in October-December 2005, followed by a 0.4% increase in January-March 2006. In fiscal 2006, special factors that we expect will depress the CPI are electric rate cuts and revision of health care fees. But as the economy continues to outpace its estimated 1% potential growth rate in fiscal 2006, the gap between demand and supply will shrink, making conditions more conducive to inflation. The declining unemployment rate will push up wages, putting upward pressure on service prices, while effects of high oil prices will gradually surface. We thus predict that CPI inflation will average 0.3% for fiscal 2006.

Fulfilling the exit condition for quantitative easing—achievement of a stable and positive year-on-year increase in core CPI—will depend partly on the effect of the CPI base year update slated for August 2006. The update is expected to revise the CPI downward, just as the previous base year update from 1995 to 2000, which decreased the inflation rate by 0.2 to 0.3 percentage point.

Figure 3 Inflation Forecast



Sources: METI, *Consumer Price Index*; BOJ, *Corporate Goods Price Index*; ESRI, *Preliminary Estimate of Quarterly GDP*.

The CPI's expected downward revision will be mitigated by the addition of personal computer printers and Internet connection fees to the CPI basket in 2003, which was done apart from the regular five-year revision. According to the *Bank of Japan Review* (November 2005), this revision and other factors have reduced the upward bias in CPI measurement error, suggesting that the BOJ may lift quantitative easing without waiting for revision results. However, despite the addition of these relatively influential constituents, the 2003 revision was less extensive than previous revisions, and weightings are bound to change as a result. Thus the base year update will produce repercussions too large to ignored by monetary policymakers.

In the official CPI index, household expenditure weights are set in the base year. For reference, the government also releases CPI data computed by the Laspayres' chain index method (with weights that change every year), and the midpoint-year basket method (with weights taken from a year between the base year and current year).

Compared to the official CPI index, these other indices show the consumer price inflation rate to be 0.1% to 0.2% lower (indicating a larger price decline). Thus unless the CPI inflation rate rises significantly above zero, the base year update will have a mixed impact on the quantitative easing decision. Despite the BOJ's aggressive stance to end quantitative easing, we predict the government will take an increasingly cautious stance on monetary policy changes due to the GDP deflator's widening decline, even if it is attributable to higher oil prices. Thus the exit to quantitative easing is likely to occur no earlier than summer, after the effect of the CPI base year update has clearly surfaced.

Short-term Forecast for Japan

(%)

		2004	2005	2006	FY 2005				FY 2006			
		FY	FY	FY	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
		(a)	(f)	(f)	(a)	(a)	(f)	(f)	(f)	(f)	(f)	(f)
Real GDP	(seq.)	1.7	2.8	1.7	1.2	0.2	0.4	0.5	0.5	0.4	0.4	0.3
	(seq. annualized)				5.0	1.0	1.7	2.2	1.9	1.8	1.5	1.3
	(yoy change)				2.6	2.9	3.1	2.7	1.6	2.0	1.6	1.7
Domestic demand	(contrib.)	1.3	2.7	1.7	1.1	0.3	0.4	0.5	0.5	0.5	0.4	0.4
Private sector	contrib.	1.6	2.5	1.8	1.0	0.2	0.5	0.5	0.5	0.5	0.4	0.3
Public sector	(contrib.)	-0.3	0.2	-0.0	0.1	0.1	-0.0	-0.0	-0.0	0.0	-0.0	0.1
External demand	(contrib.)	0.5	0.1	0.0	0.2	-0.0	-0.0	0.1	0.0	-0.0	-0.1	-0.0
Private consumption	(seq.)	1.7	2.0	1.1	0.7	0.4	0.2	0.2	0.3	0.3	0.3	0.2
Private residential investment	(seq.)	1.7	-0.5	1.0	-2.1	1.6	2.1	0.2	-0.4	-0.5	0.3	0.1
Private nonresidential investment	(seq.)	5.4	8.4	6.6	2.4	1.6	2.1	2.5	1.7	1.2	0.9	0.7
Government consumption	(seq.)	1.8	1.6	1.4	0.2	0.6	0.0	0.4	0.2	0.5	0.4	0.4
Public investment	(seq.)	-12.4	-0.6	-5.3	1.1	0.3	-0.7	-2.0	-1.5	-1.6	-1.6	-0.2
Exports	(seq.)	11.4	7.4	6.2	3.1	2.7	1.6	2.1	1.6	1.2	0.8	0.5
Imports	(seq.)	8.7	7.9	7.6	2.2	3.3	2.0	2.0	1.8	1.8	1.5	0.9
Nominal GDP	(seq.)	0.5	1.4	1.5	0.9	-0.2	0.2	0.2	0.7	0.4	0.6	0.1

Major indicators

(%)

		2004	2005	2006	FY 2005				FY 2006			
		FY	FY	FY	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
		(a)	(f)	(f)	(a)	(a)	(f)	(f)	(f)	(f)	(f)	(f)
Industrial production	(seq.)	4.1	1.3	3.2	-0.4	-0.2	1.5	1.2	0.8	0.6	0.4	0.3
Domestic CGPI	(yoy change)	1.5	1.8	0.2	1.7	1.6	2.0	2.1	1.2	0.4	-0.2	-0.4
CPI	(yoy change)	-0.1	-0.1	0.3	-0.1	-0.3	-0.4	0.3	0.3	0.3	0.3	0.2
CPI (excluding fresh food)	(yoy change)	-0.2	0.1	0.3	-0.1	-0.1	0.1	0.4	0.3	0.3	0.3	0.2
Current account bal.	(¥ trillion)	18.2	16.7	15.7	17.2	17.1	15.8	16.5	15.3	15.0	15.8	16.5
(% nominal GDP)	(%)	3.7	3.3	3.1	3.4	3.4	3.1	3.3	3.0	2.9	3.1	3.2
Unemployment rate	(%)	4.6	4.2	4.0	4.3	4.3	4.2	4.2	4.1	4.0	4.0	4.0
Housing starts	(million units)	1.19	1.25	1.24	1.19	1.28	1.27	1.26	1.25	1.24	1.23	1.23
10-year JGB yield	(avg. OTC quote)	1.5	1.4	1.8	1.3	1.3	1.5	1.7	1.7	1.8	1.8	1.8
Exchange rate (¥/$)	(average)	¥107	¥113	¥110	¥108	¥111	¥118	¥116	¥114	¥112	¥109	¥106
Oil price ($/barrel)	(average)	$39	$54	$53	$49	$56	$56	$56	$55	$53	$53	$50
Current profit	(yoy change)	24.6	6.2	1.2	12.9	6.6	4.9	1.9	1.8	1.5	0.6	0.8

Sources: ESRI, *Preliminary Estimate of Quarterly GDP*; METI, *Indices of Industrial Production*; MIC, *Consumer Price Index*; MOF, *Statistics of Financial Statements of Incorporated Enterprises*.

Short-term Forecast for the U.S.

(%)

		2004	2005 (f)	2006 (f)	2005 I	2005 II	2005 III (f)	2005 IV (f)	2006 I (f)	2006 II (f)	2006 III (f)	2006 IV (f)
Real GDP	(seq. annualized)	4.2	3.6	3.5	3.8	3.3	4.3	3.2	3.8	3.4	3.1	3.0
Personal consumption exp.	(seq. annualized)	3.9	3.6	3.0	3.5	3.4	4.2	1.4	3.3	3.1	3.1	3.0
Nonresidential fixed invest.	(seq. annualized)	(9.4)	(8.9)	(9.1)	5.7	8.8	8.8	8.7	11.7	8.5	7.3	6.7
Change in private inventories	(contrib.)	0.4	−0.3	0.2	0.3	−2.1	−0.4	1.3	0.3	0.2	0.1	−0.0
Net exports	(contrib.)	−0.7	−0.3	−0.2	−0.4	1.1	−0.3	−0.8	−0.2	−0.2	−0.3	−0.2
CPI	(yoy change)	2.7	3.4	2.5	2.4	4.2	5.1	3.6	1.6	1.4	1.4	1.5
Unemployment rate	(average)	5.5	5.1	4.9	5.3	5.1	5.0	5.0	4.9	4.9	4.9	4.9
Federal funds rate target	(ending)	2.3	4.3	4.8	2.8	3.3	3.8	4.3	4.8	4.8	4.8	4.8
10-year Treasury note yield	(average)	4.3	4.3	4.9	4.3	4.2	4.2	4.5	4.7	4.9	5.0	5.0

Short-term Forecast for the Eurozone

(%)

		2004	2005 (f)	2006 (f)	2005 I	2005 II	2005 III (f)	2005 IV (f)	2006 I (f)	2006 II (f)	2006 III (f)	2006 IV (f)
Real GDP	(yoy change)	1.8	1.5	1.9	1.2	1.2	1.6	1.9	2.0	2.1	1.8	1.8
Domestic demand	(contrib.)	1.7	1.5	1.7	1.5	1.7	1.5	1.2	1.7	1.6	1.6	1.9
Private consumption expen.	(yoy change)	(1.4)	(1.3)	(1.5)	1.3	1.4	1.5	1.0	1.3	1.5	1.5	1.7
Fixed investment	(yoy change)	1.7	2.4	2.7	1.3	1.9	3.1	3.1	3.5	3.2	2.1	2.2
External demand	(contrib.)	0.1	−0.0	0.2	−0.3	−0.5	0.1	0.6	0.3	0.5	0.2	−0.1
HICP	(yoy change)	2.1	2.2	2.1	2.0	2.0	2.3	2.4	2.3	2.2	2.0	2.0
Unemployment rate	(average)	8.9	8.5	8.1	8.8	8.6	8.4	8.3	8.2	8.1	8.0	8.0
ECB policy interest rate	(ending)	2.00	2.25	2.50	2.00	2.00	2.00	2.25	2.50	2.50	2.50	2.50
Euro exchange rate	(average)	$1.24	$1.24	$1.20	$1.31	$1.26	$1.22	$1.18	$1.18	$1.19	$1.20	$1.22