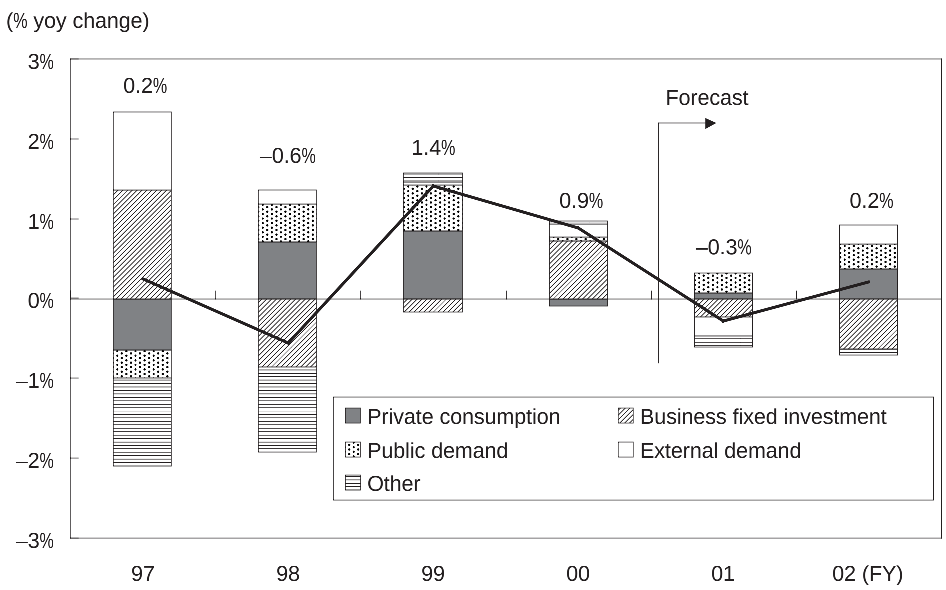
Revised Economic Forecast for Fiscal 2001 — The Japanese Economy Confronts Structural Reform

By Koichi Haji
Economic Research Group

Due to the inevitable decline in business fixed investment amid the recession, and a consumption slump resulting from structural reforms, we predict that Japan's economy will post -0.3 percent real growth in fiscal 2001.

While prospects for economic recovery rest on structural reforms, the Koizumi government needs to pay closer attention to the demand side. Key issues include the speed of fiscal deficit reduction, stimulating consumption growth through social security reforms, and keeping unemployment at bay.

Figure 1 Real GDP Growth Rate



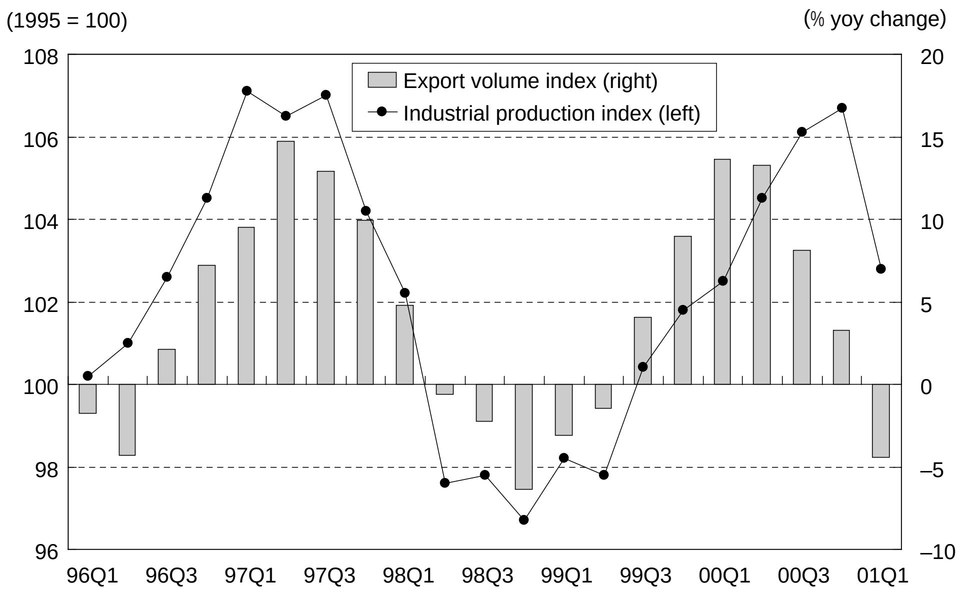
Source: Economic and Social Research Institute, *Preliminary Quarterly Estimates of GDP*.

1. The Economy in Fiscal 2000 — The Interrupted Recovery

Although the economy began to recover in spring 1999, the corporate sector's strength failed to ignite the household sector, while the U.S. slowdown dampened exports and interrupted the recovery. Entering 2001, the economy posted negative growth as sluggish exports significantly impacted industrial production, while consumption slumped in the January-March quarter despite a minor buying rush ahead of the home appliance recycling law, and business fixed investment was weak in the non-manufacturing sector. From the April-June quarter, we expect consumption to be hit hard by the recycling law as well as by the deteriorating job and income environment. Business fixed investment in the manufacturing sector, one of the few bright spots of the economy, is certain to decline, judging from the sharp slowdown in its leading indicator, machinery orders. The economy is thus heading into a full-fledged recession.

Recovery hopes in fiscal 2000 had rested on the following scenario: corporate earnings would grow thanks to cost cutting efforts and export growth to the U.S. and Asia, spurring growth in business fixed investment, while improvement in incomes and employment would stimulate consumption, boosting corporate revenues, production and earnings. Admittedly, corporate earnings growth failed to translate quickly into wage growth, since the high allocation to labor since the bubble economy has prompted companies to cut labor costs by curtailing hiring and wages. Nonetheless, as manufacturing production expanded, overtime hours and allowances increased, and summer bonuses finally rose year-on-year in 2000 against the backdrop of double-digit earnings growth. Unfortunately, before improvements in employment and income could spill over into consumption, the U.S. economy slowed down, and the threat to corporate earnings growth prompted companies to cut winter bonuses in 2000 (year-on-year). As a result, consumption failed to recover.

Figure 2 Industrial Production and Export Volume



Sources: METI, *Industrial Production Indices*; Ministry of Financial Affairs, *Summary Report on Trade of Japan*.

The anticipated recovery scenario — corporate earnings growth leading to household income growth

— has thus been abandoned. Judging from the downturn in effective ratio of job openings to seekers, the job environment has also stalled, dashing hopes for a recovery in personal consumption. Meanwhile, the export slowdown suppressed corporate earnings growth in the second half of fiscal 2000. Moreover, machinery orders (private demand excluding ships and electric power) fell 7.0 percent sequentially in the January-March 2001 quarter following a 1.3 percent increase in the previous quarter, pointing to a slowdown in business fixed investment. Should the U.S. economy recover, there will still be a time lag before Japan's exports and business fixed investment pick up. But given that the U.S. is not expected to recover quickly, the outlook for business fixed investment is bleak, which means that Japan is heading into a prolonged recession.

2. The Severe External Environment

After enjoying a period of strong growth, the U.S. economy decelerated to a 1.0 percent annual growth rate in the fourth quarter of 2000, and kept a 1.3 percent pace in the first quarter of 2001. While Europe's economy has been stronger, it too has been affected by the weakening U.S. economy, and both have in turn impacted the Asian economies, who were finally about to recover from the currency crisis.

In the U.S., despite a deteriorating job and income environment, strength in consumption has kept the economy in better condition than feared. However, since it has created an unsustainable negative household savings rate, consumption must eventually decline to restore a normal relationship with income. Tax cuts that will be put into effect at yearend are expected to prop up consumption, leading to a gradual economic recovery starting from the end of the year. A quick recovery is unlikely. We predict that the U.S. economy will slow down from its 5.0 percent pace in 2000 to 1.7 percent in 2001, and recover moderately to a 2.8 percent growth rate in 2002.

Europe will bottom out shortly after the U.S. and begin accelerating in mid 2002. However, the growth rate will be moderate.

3. Japan in Fiscal 2001 — Stimulative Policies to Provide Little Relief

(1) Assumptions Regarding Economic Policy

In a policy speech, Prime Minister Junichiro Koizumi stated that an economic recovery is impossible without structural reform, and that he intended to pursue reforms despite the inevitable pain. Thus he appears ready to accept the possibility that the economy may not achieve the government's economic forecast of 1.7 percent growth for fiscal 2001.

If the ruling coalition wins the upper house election in July and the Koizumi Cabinet pursues its reform agenda, despite the strong likelihood of negative growth in fiscal 2001, the government is less likely to implement fiscal measures such as tax cuts or additional public works spending through a supplementary budget. Considering that financially strapped local governments are slashing local public works projects, public fixed capital formation in fiscal 2001 will post negative real growth unless a supplementary budget is implemented. Thus it will be difficult to seek relief from fiscal policy.

It will also be difficult to seek additional stimulation from monetary policy. While the Bank of Japan initiated a quantitative easing policy in March by declaring a five-trillion yen target for current account balances at the BOJ, no tangible effects have been detected as yet. Pressure for further monetary easing should emerge as the looming recession and structural reforms weigh down the economy. Specific policy options include raising the five-trillion yen target for current account balances, and increasing open market purchases of long-term government bonds, which have averaged 400 billion yen per month. Although additional quantitative easing should reduce long-term interest rates, doing so will have practically no stimulative impact on the economy. The BOJ is likely to adopt additional easing measures in the July-September 2001 quarter, which we predict will reduce the long-term interest rate (yield on 10-year JGBs) from 1.3 percent at present to approximately 1.1 percent.

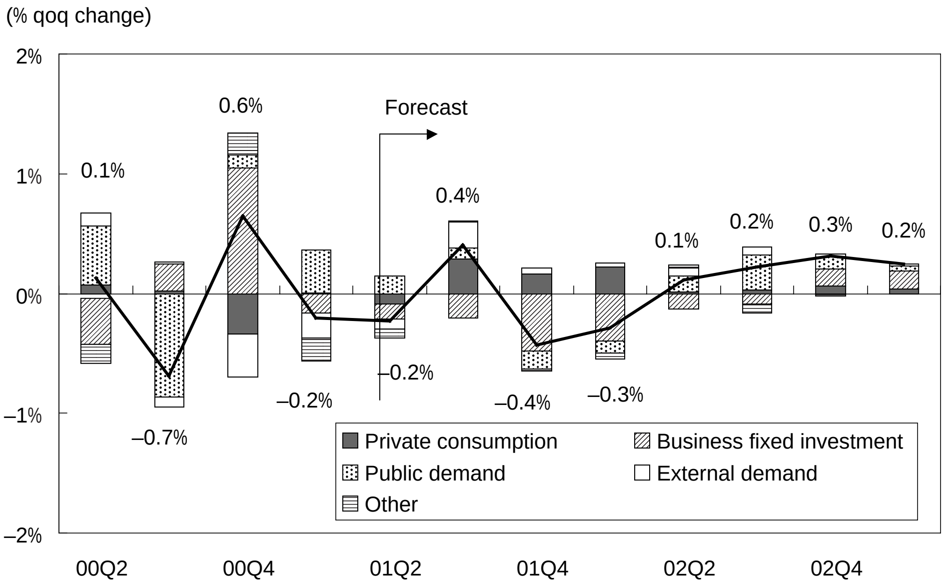
Some advocates of quantitative easing seek a weaker yen, even if intervention is necessary in the foreign exchange market. But there is already a large risk that the yen will weaken in the recessionary economy as imports decrease and the current account surplus resumes expanding. Although further quantitative easing will lower interest rates and temporarily weaken the yen, we predict that the yen will exhibit strength during fiscal 2001. In mid 2002, the bottoming out of the U.S. economy will balance out pressures on the yen, ending the yen’s rising tendency. Resorting to a weak yen policy to revive the economy will impede a sustained recovery by increasing imports, expanding the trade surplus, and raising business expectations, thereby strengthening the yen. But above all else, due to the sheer size of Japan’s economy and current account surplus, Japan’s trading partners will strongly oppose concerted intervention to weaken the yen, since they would be adversely affected by what would amount to a beggar-thy-neighbor policy.

(2) The Economy in Fiscal 2001

In the January-March 2001 quarter, business fixed investment declined 1 percent sequentially due to a slump in the non-manufacturing sector, while the manufacturing sector remained firm. However, the downturn in machinery orders in the same period due to a decrease in exports to the U.S. suggests that investment in the manufacturing sector will decline as well. Consumption, which rose ahead of the implementation of the new home appliance recycling law, is likely to plunge in the April-June quarter. Thus following on the January-March quarter, the real growth rate will be negative for the second straight quarter. Looking ahead, since the weak economy and structural reforms will cause the job environment to deteriorate, consumption is not predicted to improve, while investment growth will remain negative centered around the manufacturing sector. As a result, the economy's growth rate will continue to remain lackluster.

The economy is without doubt already in recession. Even if the U.S. economy bottoms out later this year, thereby stimulating Japan's exports, and leading to more investment and sustained growth in production, Japan's recovery will not start until the second half of 2002.

Figure 3 Real GDP Growth Rate



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

4. The Koizumi Administration's Structural Reforms

(1) Bad Loan Disposal and Employment

The bad loans held by financial institutions have weighed heavily on the economy since the collapse of the bubble economy. One of the emergency economic measures announced in April called for accelerating the final disposal of bad loans (by making banks remove bad loans from their balance sheets), which is a major step toward resolving the problem. In the process, unemployment will inevitably rise at least temporarily as corporate borrowers undergo restructuring or go out of business. The disposal of bad loans and the impact on jobs are a problem that must be dealt with at some point. Yet causing too much pain will run the risk of souring the public's optimism toward structural reform. To avoid this problem, jobs must be transferred as smoothly as possible so that the displacement from structural reforms is minimized. Still, regardless of what labor mobility measures are taken, temporarily displaced workers will not be readily absorbed into new growth industries. Thus the unemployment rate, now at 4.8 percent, will inevitably rise to over 5.5 percent by fiscal 2002.

(2) Fiscal Structural Reforms

Fiscal structural reforms consist of both qualitative and quantitative factors — improving the quality of the content of fiscal expenditures, and reducing the quantity of the fiscal deficit. Although improvement of fiscal expenditures can negatively affect individual companies and industries, it will not significantly affect the balance of the overall economy. However, deficit reduction can cause serious problems unless due consideration is given to the macroeconomic balance. While Mr. Koizumi has set a target in the fiscal 2002 budget to limit the government's bond issuance to 30 trillion yen, this target should not be taken too seriously; since the ordinary account can be manipulated to show a reduction in the fiscal deficit, doing so will only worsen matters later and should not be tried.

By definition, the aggregate investment-savings balance of the government, corporate and household sectors is equivalent to Japan's current account balance. Reducing the deficit in the government sector thus causes some combination of the following: increase in the corporate sector's fund shortage, increase in the current account surplus, or decrease in excess household savings.

Given its excess liabilities, the corporate sector is not likely to accommodate the reduction in fiscal deficit by financing significantly more business fixed investment. Even if companies do expand investment in the flagging economy by an amount equal to the improvement in fiscal balance, the overall economy will run the risk of a decline in capital efficiency.

In the January-March 2001 quarter, the current account surplus was 2.3 percent of nominal GDP. This gives little leeway in the current account surplus to accommodate a fiscal deficit reduction.

The remaining possibility is for a decrease in excess savings in the household sector — possible if the propensity to consume rises to increase consumption. This means that for the economy to achieve stable growth over the medium term, households will need to save less and consume more.

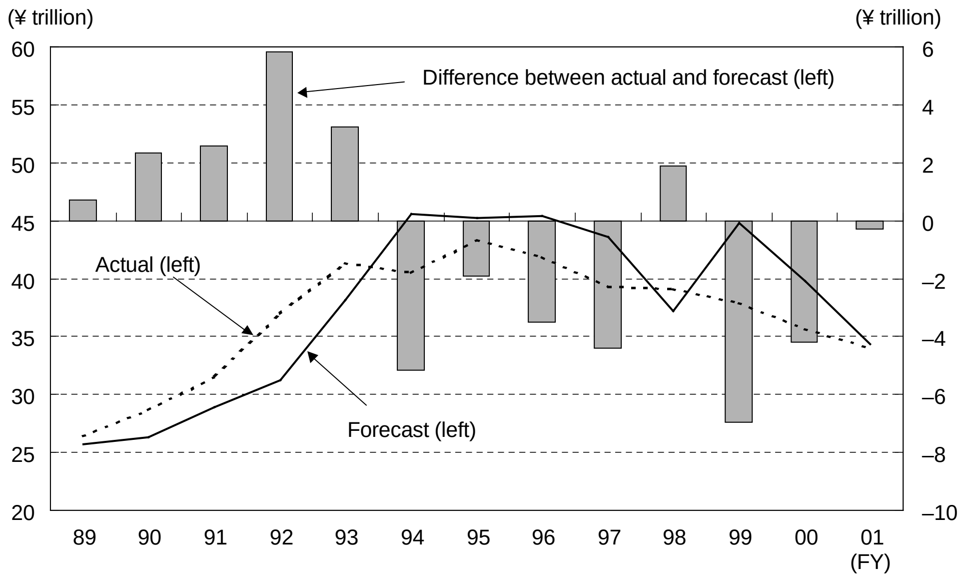
(3) Lessons from Fiscal 1997

To avoid the disastrous reform attempts of the Hashimoto Administration, the Koizumi Administration needs to learn from those mistakes. At the same time that the national government is trying to reduce its fiscal deficit, local governments are also adjusting their fiscal balances by slashing locally financed public works projects. Unless these local expenditure cuts are accurately monitored, the pace of total fiscal spending cuts at the national level cannot be controlled, thus putting the nation's economy at risk of becoming destabilized. While the Hashimoto Administration's failed reforms can be partly attributed to circumstantial factors such as the Asian currency crisis and major financial failures in Japan, an important factor was that since national and local governments were unable to coordinate efforts to control the pace of fiscal deficit reduction, reformers had to focus too much on this matter.

In the government's initial economic forecast for fiscal 1997, public works spending was predicted to grow at a nominal rate of 0.5 percent. But the actual result was a 6.3 percent decrease (68SNA basis). The main cause of this error was that forecasters misread the pace of fiscal restructuring among local governments, and thus failed to accurately predict the decrease in locally funded public works projects.

Again in the initial economic forecast for fiscal 2000, public fixed capital formation was predicted to grow at a nominal rate of 0.7 percent and real rate of 0.9 percent. However, the actual result was a substantial decline of 7.4 percent nominally and 6.1 percent in real terms. Indeed, since the collapse of the bubble economy, the government's forecasts have consistently overestimated public fixed capital formation by a significant margin. Since preliminary GDP statistics are notoriously inaccurate on public fixed capital formation, the government's poor grasp of public works investment data should come as no surprise. But considering that the unexpectedly large decrease in public works contributed to the economy's stumble in fiscal 1997, the government needs to gain a better grasp of public works volume. Only then can it track the speed of fiscal restructuring, and make adjustments if necessary.

Figure 4 Disparity Between Forecasts and Actual Results for Public Works Projects



Notes: 68SNA data is used through fiscal 1999. For fiscal 2000, forecast is 68SNA, and actual result is 93SNA. Fiscal 2001 is 93SNA, forecast is by NLI Research Institute.

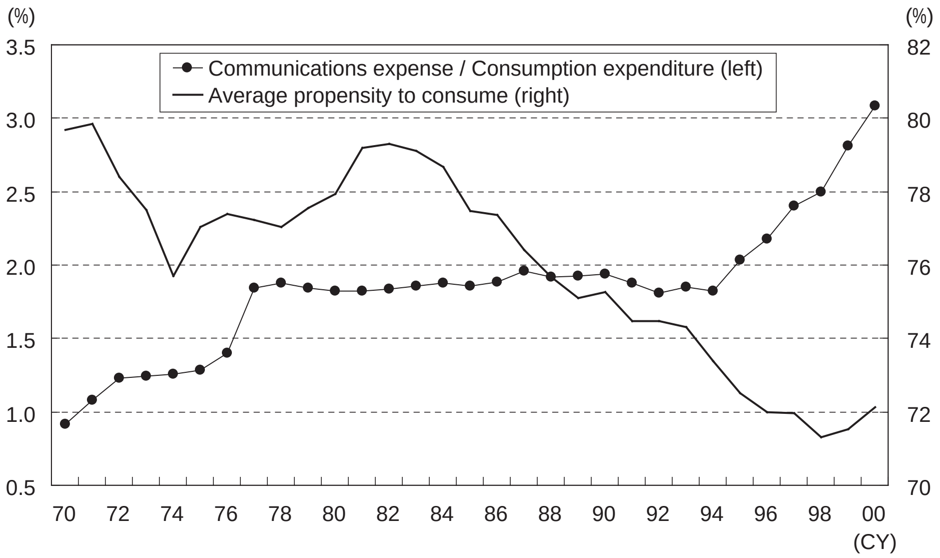
Sources: Cabinet Office, *Economic Outlook and Basic Policy Stance on Economic Management; Annual Report on National Accounts*.

5. Are Expectations for IT Excessive?

Although the economic recovery that began in fiscal 1999 is said to have been led by information technology and the new economy, the driving force was actually an expansion in the old economy — production of IT-related components and equipment, and the fixed investment to enable this production. Thus contrary to popular conception, the recovery was not characterized by the adoption of IT throughout the economy and a resulting productivity growth.

While IT-related demand will surely grow in the future, we should not set our expectations too high. It is true that the *Family Income and Expenditure Survey* shows the proportion of communications expenses growing in household expenditures, and that IT-related consumption has grown significantly. Communications expenses, which comprised slightly under 2 percent of household spending during the 1980s, surged to over 3 percent in 2000 due to the growth of cellular phones and Internet usage in homes. Considering the price decline in this area in the past few years, the real growth is quite substantial. However, we must note that this growth has not caused overall consumption to increase. In fact, despite the growth in communications spending, the propensity to consume has significantly decreased, not increased, during this period.

Figure 5 Communications Expenditures and the Average Propensity to Consume



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Family Income and Expenditure Survey* (annual reports).

This dispels the popular perception that consumption can be stimulated simply by providing more attractive products; attractive products may sell, but will not necessarily stimulate overall consumption. Clearly, growth in household consumption is crucial to a sustained economic recovery led by domestic demand, and to consume more, households will have to save less. What prevents households from consuming more is the need to save for retirement, which is aggravated by uncertainties in the pension system. Thus although pension and social security reform may seem unrelated to economic policy and structural reform, it is actually a crucial policy issue from the perspective of stimulating consumption, as well as restoring the macroeconomic balance through fiscal deficit reduction.

Forecast for the U.S.

	1999 (a)	2000 (a)	2001 (f)	2002 (f)	2001 Q1 (a)	Q2 (f)	Q3 (f)	Q4 (f)	2002 Q1 (f)	2001 (prev. forecast)
	(%)				(% sequential change, annualized)					(%)
Real GDP	4.2	5.0	1.7	2.8	1.3	1.2	1.6	2.6	3.2	1.4
Personal consumption	5.3	5.3	2.7	3.1	2.9	1.5	1.9	2.9	3.4	2.4
Business fixed investment	9.2	9.3	1.3	1.9	2.3	– 0.8	– 1.1	2.2	3.5	2.6
Inventory investment	– 0.4	0.2	– 0.6	0.3	– 3.1	1.1	0.4	0.3	– 0.5	– 0.2
Government expenditure	3.3	2.8	0.5	1.7	4.7	– 4.1	– 5.6	3.8	6.3	3.5
Net exports	– 1.0	– 0.9	0.1	– 0.2	1.3	– 0.0	1.1	– 0.8	– 0.3	– 0.4
Nominal GDP	5.8	7.1	3.8	4.6	4.6	2.3	2.8	4.5	5.2	4.0
Producer price index	1.8	3.7	2.5	1.8	5.5	1.4	1.7	1.5	1.8	2.4
Consumer price index	2.2	3.4	2.8	2.5	4.2	2.2	2.3	2.3	2.4	2.8
Unemployment rate	4.2	4.0	4.6	4.8	4.2	4.5	4.7	4.8	4.8	4.4
Current account balance ($ bil.)	–331	–435	–429	–446	–435	–436	–415	–432	–437	–422

✻ Inventories and net exports are expressed as contributions. 2001 Q1 current account balance is estimate.

Forecast for the Euro Area

	Unit	99	2000	2001 (Forecast)	2002	2001 Q1	2001 Q2 (Forecast)	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3	2002 Q4
Real GDP	% yoy chg.	2.5	3.4	2.1	2.2	2.5	2.1	2.0	1.9	1.9	2.1	2.3	2.4
Domestic demand	% contrib.	3.1	2.8	1.9	2.1	1.5	2.0	2.0	2.0	2.1	1.8	2.2	2.4
Private final consump. exp.	% yoy chg.	3.0	2.6	1.9	2.4	1.7	1.6	1.9	2.3	2.5	2.4	2.4	2.5
Govt. consumption exp.	% yoy chg.	1.5	1.9	1.7	1.8	1.4	1.6	1.9	1.7	1.8	1.8	1.8	1.8
Fixed capital formation	% yoy chg.	5.2	4.5	1.1	2.0	1.0	1.1	0.9	1.2	2.3	2.0	1.8	1.9
External demand	% contrib.	–0.5	0.6	0.2	0.0	1.0	0.1	–0.1	–0.1	–0.2	0.3	0.1	–0.0
Nominal GDP	% yoy chg.	4.5	4.7	4.2	4.3	4.1	4.1	4.2	4.5	4.5	4.5	4.2	4.1
Consumer prices (HICP)	% yoy chg.	1.1	2.4	2.7	1.7	2.6	3.0	2.8	2.5	2.3	1.6	1.5	1.5
Unemployment rate	%	10.0	8.9	8.3	8.1	8.4	8.3	8.3	8.3	8.2	8.1	8.0	8.0
Current account balance	GDP ratio	–0.1	–0.4	–0.3	0.1	–0.5	–0.5	–0.2	–0.1	0.0	0.0	0.1	0.1
ECB refinancing rate	%	3.00	4.75	4.00	4.00	4.75	4.50	4.25	4.00	4.00	4.00	4.00	4.00

Note: Interest rate is at end of period.

Forecast for Japan

(Unit: %)

	FY 00 (a)	FY 01 (f)	FY 02 (f)	2001/4–6	7–9	10–12	2002/1–3	4–6	7–9	10–12	2003/1–3	Previous forecast Mar. 2001 FY 01
Real GDP	0.9	–0.3	0.2	–0.2	0.4	–0.4	–0.3	0.1	0.2	0.3	0.2	0.2
				–0.9	1.6	–1.7	–1.2	0.5	0.9	1.3	1.0	
				–0.4	0.6	–0.7	–0.7	0.1	–0.4	0.2	0.9	
Domestic demand (contrib.)	(0.7)	(–0.1)	(–0.0)	(–0.1)	(0.2)	(–0.5)	(–0.3)	(0.0)	(0.2)	(0.3)	(0.2)	(0.5)
Private demand	(0.7)	(–0.3)	(–0.3)	(–0.3)	(0.1)	(–0.3)	(–0.2)	(–0.1)	(–0.1)	(0.2)	(0.2)	(–0.0)
Public demand	(0.1)	(0.2)	(0.3)	(0.1)	(0.1)	(–0.2)	(–0.1)	(0.1)	(0.3)	(0.1)	(0.0)	(0.5)
External demand (contrib.)	(0.2)	(–0.2)	(0.2)	(–0.1)	(0.2)	(0.1)	(0.0)	(0.1)	(0.1)	(0.0)	(–0.0)	(–0.2)
Private final consump. exp.	–0.2	0.1	0.7	–0.2	0.5	0.3	0.4	0.0	0.0	0.1	0.1	0.6
Private residential investment	–1.9	–5.3	–1.0	–3.0	–0.7	–0.5	–0.2	0.9	–1.9	–0.3	0.7	–2.2
Business fixed investment	4.6	–1.4	–4.0	–0.8	–1.2	–3.0	–2.5	–0.8	–0.6	0.9	1.0	–2.1
Govt. final consump. exp.	3.3	2.8	2.5	0.8	1.4	0.5	0.2	0.5	1.2	0.5	0.3	3.1
Public fixed capital formation	–6.1	–2.9	–1.6	0.2	–2.0	–3.3	–2.1	0.7	1.3	0.2	–0.2	0.0
Exports	9.3	–3.8	2.7	–2.1	0.5	0.2	0.6	0.6	1.1	0.8	0.9	–1.5
Imports	9.8	–2.1	0.7	–1.7	–1.8	–0.4	0.3	0.0	0.6	0.6	1.2	0.8
Nominal GDP	–0.6	–1.4	–0.7	–0.8	–0.7	–0.7	0.5	–0.1	–0.8	–0.1	0.7	–0.8

Notes: ① For real GDP, top number is sequential change, middle is sequential change annualized, and bottom is yoy change. All other demand components are expressed as sequential change.
② Forecast assumptions: Exchange rate to average ¥120 in FY01, ¥115 in FY 02. Quantitative easing to become pronounced during 2001.
Crude oil price to average $25.40 per barrel in FY01, $22.30 in FY02.

Major economic indicators

(Unit: %)

	FY 00	FY 01	FY 02	2001/4–6	7–9	10–12	2002/1–3	4–6	7–9	10–12	2003/1–3	Previous forecast FY 01
Industrial production (seq. change)	4.0	–6.8	–0.6	–3.4	–1.1	–0.9	–0.4	0.2	–0.1	0.2	0.7	–4.9
Domestic WPI (yoy change)	0.0	–1.2	–1.0	–1.0	–1.2	–1.2	–1.5	–1.4	–1.3	–0.7	–0.3	–0.9
CPI (yoy change)	–0.5	–0.3	–0.2	–0.4	–0.4	–0.3	–0.3	–0.2	–0.1	–0.2	–0.1	–0.2
Current acct. balance (¥ tril.)	12.1	11.3	11.8	11.4	11.0	10.9	12.0	12.6	12.4	11.2	11.1	11.2
(as ratio of nominal GDP)	(2.4)	(2.3)	(2.4)	(2.2)	(2.2)	(2.2)	(2.4)	(2.5)	(2.5)	(2.3)	(2.2)	(2.2)
Unemployment rate	4.7	5.1	5.5	4.9	5.0	5.1	5.3	5.4	5.5	5.6	5.6	5.0
Housing starts (millions)	1	1	1	1.17	1.17	1.19	1.15	1.16	1.14	1.14	1.15	1.19
Yield on 10-year JGB	1.7	1.2	1.1	1.3	1.2	1.1	1.1	1.1	1.1	1.1	1.2	1.0
Exchange rate (¥)	111	120	115	122	121	120	118	116	115	115	115	120

Sources: ESRI, *Preliminary Report on National Accounts*; METI, *Industrial Production Indices*; MPMHAPT, *Consumer Price Indices*.