External Demand Drives Japan's Fragile Recovery to Near-Zero Growth—Revised Economic Forecast for FY 2002

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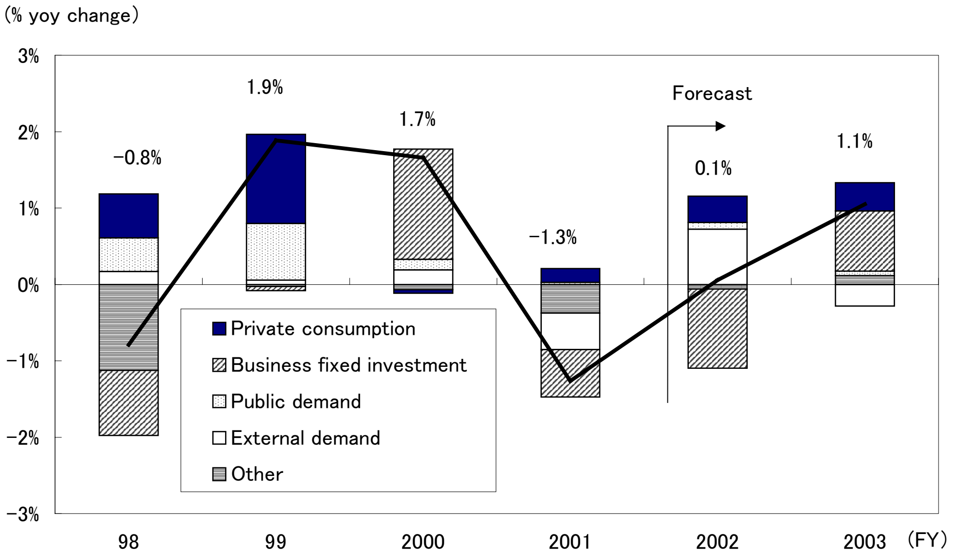
FY 2002 Economy to Grow 0.1% Based on External Demand

1. In fiscal 2002, while exports to the recovering U.S. economy will continue to lead Japan's modest recovery, weak domestic demand including the decline in business fixed investment will keep the economy's real growth rate near zero at 0.1%. Due to persistent deflation, the nominal growth rate will be negative at –1.0%. In fiscal 2003, real growth will improve to 1.1%, while nominal growth will hover near zero at 0.3%.

2. The recovery is fragile in that it is driven solely by external demand. Many hurdles impede a sustained expansion, including the sustainability of the U.S. recovery and risk of renewed financial system instability in Japan. Thus any attempt to slash the fiscal deficit poses a large risk of ending the recovery prematurely.

Figure 1 Contribution to Real GDP Growth



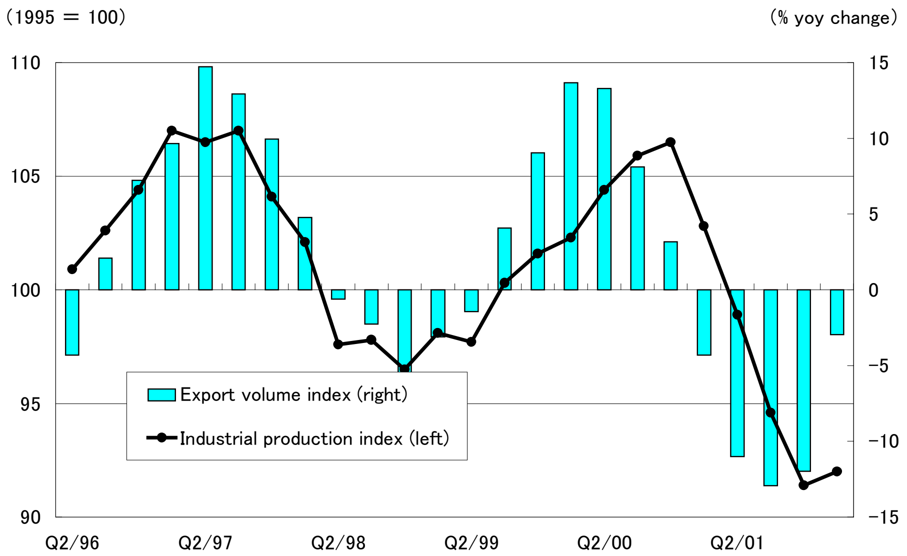
Source: Economic and Social Research Institute, *Preliminary Quarterly GDP Estimates.*

1. Japan's Economy Heads Toward Recovery

1. Economy Bottomed Out in Q1 2002

After deteriorating sharply in 2001, the economy bottomed out in the January-March quarter (Q1) of 2002. While exports slid during 2001 amid the severe U.S. slowdown, the U.S. economy recovered faster than anticipated from the September 11 attack at an impressive 5.6% rate in Q1 2001. This has pulled the global economy toward recovery and revived Japan's export growth. As a result, industrial production, which plunged in 2001, turned slightly positive to 0.7% in the quarter.

Figure 2 Export Volume Recovers, and Production Turns Upward



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

In Q1 2002, the economy surged 1.4% from the previous quarter in real terms (5.7% annualized). While consumption rose 1.6% from the previous quarter to boost private demand, external demand contributed as much as 0.7% to the growth rate as exports turned strongly upward by 6.4%. However, the strength in consumption is attributed to unusually high consumption growth among single-person households (according to the *Family Income and Expenditure Survey*), and thus may be misleading. We believe that the apparent strong growth in Q1 2002 is actually part of a modest growth trend over Q1 and Q2, and thus not indicative of a V-shaped recovery.

In addition to adopting a new preliminary GDP estimation method in the April-June quarter, ESRI plans to release results one month earlier than in the past. Details of the new estimation method have not yet been announced, but the extensive use of supply-side statistics promises to speed up the release of quarterly data and also improve their accuracy. Thus the new method could significantly affect quarterly data, while leaving annual GDP data unchanged. For instance, the strong growth in Q1 2002, caused by the unusual consumption growth among single-person households, is likely to be revised downward when the new estimation method is adopted.

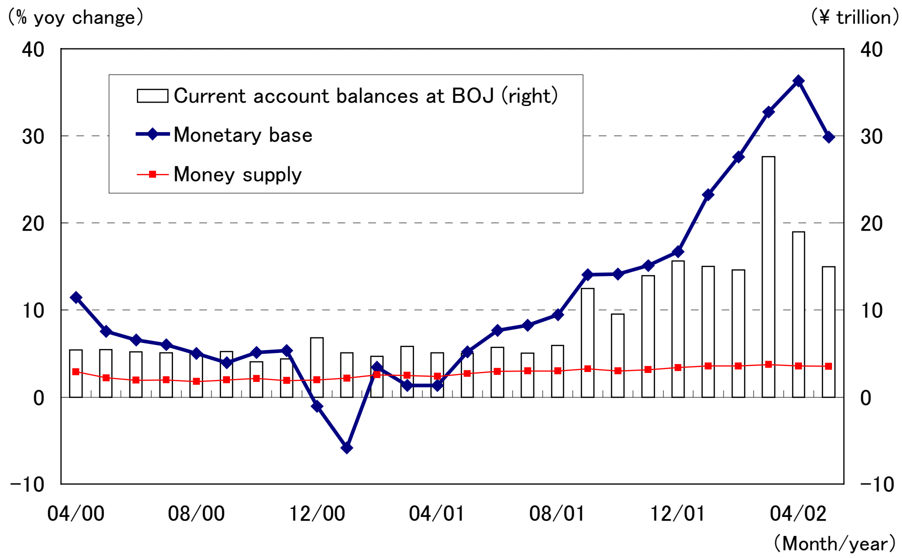
Since the new method focuses more strongly on supply-side statistics than the present method, quarterly GDP data should also reflect supply-side fluctuations more closely. For instance, one such currently available index, the *Analysis of All Industrial Activities* released by METI, declined from April-June 2001 for three quarters before rising a modest 0.6% in January-March 2002. Under the present GDP estimation method, this would be registered as a large 1.4% increase in Q1 2002, followed by a –0.5% decline in Q2. But the new method is likely to show modest growth for both quarters. Thus the new quarterly GDP estimation method may leave annual GDP growth rates unaltered, but significantly change how we perceive quarterly movements. The high GDP growth estimate for Q1 2002 should thus be regarded with skepticism.

2. Quantitative Easing—Results of the First Year

Since last March, when the Bank of Japan implemented its quantitative easing policy, current deposits at the BOJ have expanded from four trillion yen to 10-15 trillion yen at present. Open market purchases of long-term JGBs have also increased from 400 billion yen per month last March to one trillion yen at present. During the period, growth in the monetary base rose from 10.4% year-on-year in Q3 2001 to 15.6% in Q4 2001, and over 20% in Q1 2002. Nonetheless, money supply (M2+CD) growth has remained in the mid 3% range. Since the effects of monetary policy take considerable time to become apparent, judgment of the new policy is still premature at this time. However, considering that the monetary easing done thus far has been absorbed by a declining credit multiplier and not even affected money supply growth, no discernible effects have yet reached the real economy.

With strong pressure to implement additional easing measures, the BOJ will explore other easing policies such as diversifying the methods of money supply operations, and inflation targeting. However, these measures will have only a limited effect in triggering inflation or stimulating the economy. During fiscal 2002, we see very little probability for above-zero inflation in consumer prices, and short-term interest rates will thus not rise significantly above zero.

Figure 3 Effects of Quantitative Easing



Source: BOJ

2. Global Recovery Depends on the U.S.

1. Forecast for Europe and the U.S.

The U.S. economy went into recession in Q2 2001, and slowed to a real annualized sequential rate of –1.3% in Q3 2001. Fortunately, the damage caused by the September 11 attack cleared up more quickly than anticipated. In Q3 2001, the economy outperformed predictions of negative growth and grew 1.7% (annualized), followed by an impressive 5.6% performance in Q1 2002. We predict that the economy's growth rate will steadily pick up from 1.2% in 2001 to 2.5% in 2002 and 3.0% in 2003.

While consumption has been firm, government spending contributed significantly to growth in Q4 2001 and Q1 2002, raising serious concerns that the fiscal surplus could return to a large deficit. In addition, the household saving rate, which declined during the 1990s, could return to its historical norm and dampen consumption in the process, while corporate profits have been slow to improve. Still, recent economic indicators point to a steady recovery, with no obvious obstacles in the way. But as seen by the recent decline in the Dow Industrials to the 9500 level and Nasdaq to the 1400 level, not all concerns have been cleared away.

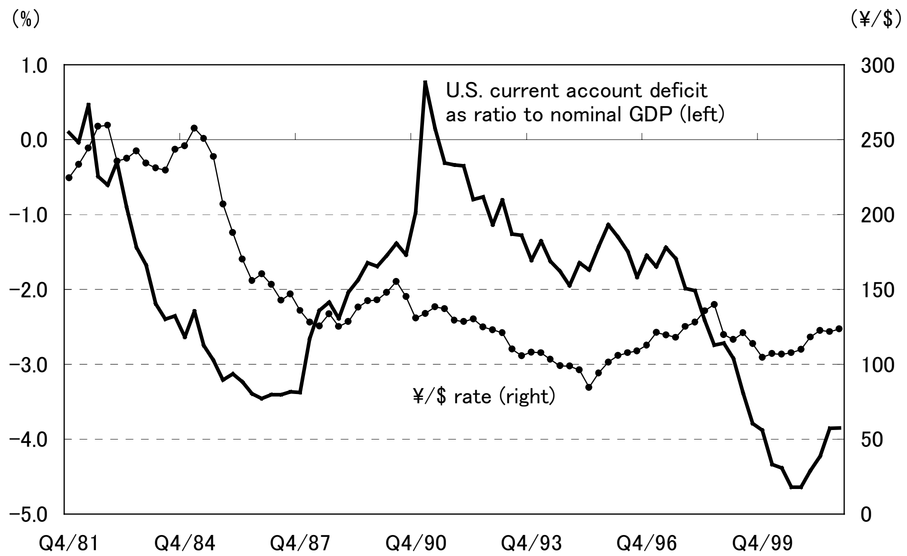
Thanks to the U.S. recovery, Europe's economy turned upward in Q1 2002 on the strength of external demand. With inflation edging upward and wages increasing, we predict that monetary policy will be tightened. The euro's appreciation against the dollar will restrain inflation by reducing import prices, thereby helping the economy expand. Europe's economy appears to have bottomed out in Q4 2001, and will remain weak in the first half of 2002, but start to show strength in the second half. Real economic growth in the euro area will decline from 1.5% in 2001 to 1.1% in 2002, but rise to 2.8% in 2003.

2. The Limits of Export-Dependent Recovery

With the global economy dependent on the strength of the U.S. recovery, America's growing current account deficit is a serious concern. As Japan's recovery continues to be led by external demand in fiscal 2002, Japan's current account surplus as a ratio to nominal GDP has grown from 1.8% in Q2 2001 to 3.1% in Q1 2002, and should stay above 3% until early 2003. By comparison, the U.S. current deficit exceeds $500 billion, or over 4.5% of GDP—higher even than at the time of the Plaza Accord.

With the yen weakening from the end of 2001, the dollar rate rose to the mid 130s before turning around in late February as Japan's stock market gained some vigor, and fell in May to a low of 123 at one point. The dollar has been weakened by corporate accounting scandals that have shaken investors' confidence in the U.S. stock market, and by ongoing concerns of terrorism. For Japan, a weak dollar poses a dilemma for its export-dependent recovery—if exports continue to grow and the current surplus expands, the yen will strengthen further and thereby threaten the recovery.

Figure 4 U.S. Current Account Deficit, and the Yen/Dollar Exchange Rate



Sources: Bureau of Economic Analysis, U.S. Dept. of Commerce; IMF.

For the U.S., since inflation is not an important concern, the dollar's gradual depreciation is actually beneficial to reducing the large current deficit. And for Europe, the euro's appreciation against the dollar after coming off a rocky start will help control inflation. This leaves Japan alone in wanting to halt the dollar's decline, the chances of concerted intervention are low. We thus predict that the present strong dollar tendency will be corrected.

3. Near-Zero Growth for the Economy in FY 2002

1. The Recovery's Fragile Foundation

Relying as heavily as it does on the U.S. upturn, Japan's recovery will be weak. No further stimulation can be expected from monetary or fiscal policies, and the post-bubble excesses plaguing the economy—excessive debt, capacity, and employment—will continue to constrain private sector demand. Deprived of economic policies and autonomous domestic demand, the recovery must rely solely on external demand.

Of greatest concern in the external environment is the strength of the U.S. Japan's scenario for a sustained economic expansion rests on export growth, which will fuel industrial production, improve corporate earnings, and consequently boost investment. For this, the sustained growth of the U.S. economy is essential. If the U.S. recovery fails to gain momentum or else ends prematurely, Japan stands little chance of a successful recovery.

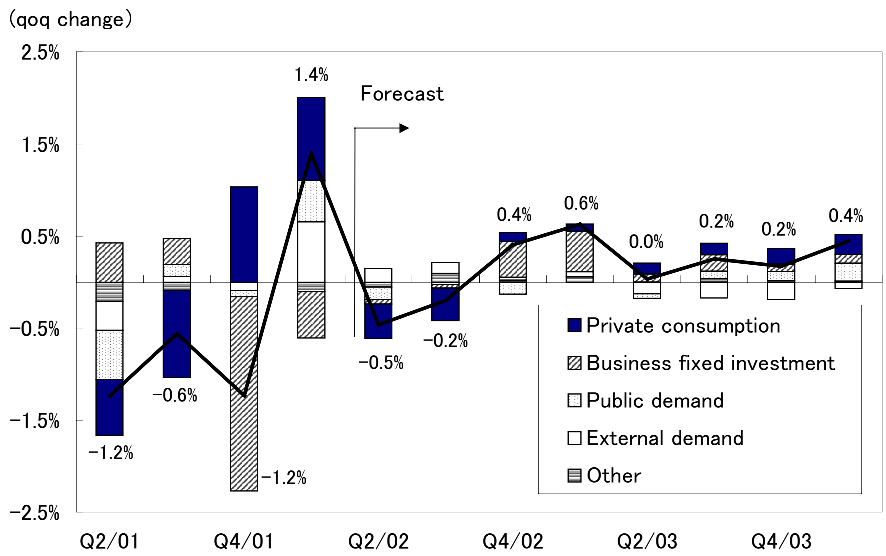
Domestically, a number of risk factors threaten to derail the recovery—the financial system instability that repeatedly surfaces at each interim and fiscal yearend, dampening economic prospects; the failure of smaller financial institutions due to the end of the payoff system; and the declining stock market. The export-led recovery itself poses a risk in that the current surplus would increase fund flows into Japan, strengthening the yen and thus impeding recovery. And if economic policies now supporting the economy are curtailed to reduce the fiscal deficit, we could re-experience the disastrous recovery of fiscal 1997.

2. Domestic Demand Remains Sluggish

According to the MOF's *Quarterly Financial Statements Statistics of Corporations by Industry*, although sales have continued to decline, current profits bottomed out in Q4 2001, raising the hope that export growth, by boosting production and earnings, will trigger a recovery in business fixed investment. However, machinery orders (private demand excluding shipbuilding and electric power), a leading indicator for business fixed investment, fell 7.4% in January-March 2002 from the previous quarter, and are predicted to decline another 0.3% in April-June. Thus due to ongoing adjustments, business fixed investment will post a real decline of 6.4% for the fiscal year even with a turnaround in the second half.

Despite signs of improving consumer confidence, consumption will be constrained by sluggish growth in household income. This year's summer bonus will be meager due to dismal corporate earnings in fiscal 2001, while the Spring labor offensive netted the smallest wage increase on record. Moreover, although unemployment is edging downward, the number of both employed and self-employed persons continues to decline. The slight improvement in the job environment could boost consumer confidence, but the sluggish income growth will rein in private consumption expenditure in fiscal 2002 to a nominal decline of 0.5%, and factoring in deflation, a modest 0.6% real increase. We predict that with private residential investment also continuing to decline by 4.5% in real terms, private sector demand will decline 1.0%.

Figure 5　Contribution to Real GDP Growth



Source: ESRI, *Preliminary Quarterly GDP Estimates*.

Amid fiscal spending cuts at the local level and fiscal structural reforms at the national level, public fixed capital formation in fiscal 2002 will decline 5.6% in real terms. While the economy's real growth rate will improve to almost zero at 0.1%, the nominal growth rate will remain negative at –1.0% due to the continued decline in the GDP deflator. On a quarterly basis, the uneven growth portrayed by the present preliminary GDP estimation method—strong growth in January-March, followed with negative growth in April-June—will be replaced by a smooth moderate growth trend under the new estimation method thanks to its focus on supply-side statistics.

2. The Economy in Fiscal 2003

Although the Fiscal System Council has proposed slashing public works spending in the fiscal 2003 budget, such major spending cuts pose the risk of derailing the fragile recovery. While the government is intent on reducing spending, limitations in its ability to make spending cuts lead us to predict that public fixed capital formation in fiscal 2003 will be reduced by 5.5%, roughly the same as in fiscal 2002.

For fiscal 2003, if the economic expansion and earnings growth continue, we predict that business fixed investment will grow 5.2%, while consumption will need more time to respond. In the economic expansion of 1999, observers hoped that rising corporate earnings would eventually lead to higher household income and consumption, but were proven wrong. We predict that the economic expansion will lead to a recovery in business fixed investment during or toward the end of fiscal 2002. Considering the high allocation to labor at present, household income is not likely to increase even in fiscal 2003, limiting real consumption growth to a modest 0.7%. The economy will continue to expand but fall short of a full-fledged recovery, and with the growing current account surplus pushing the yen upward, external demand will contribute negatively to economic growth in the second half of the fiscal year, drawing the export-dependent recovery to an end.

Forecast for the U.S.

		2001	2002	2003	2002 Q1	Q2	Q3	Q4	2003 Q1	Q2	Q3	Q4
		actual	forecast	→	actual	forecast	→	→	forecast	→	→	→
Real GDP	(seq. at annual rate)	1.2	2.5	3.0	5.6	2.5	2.6	2.9	3.0	3.1	3.1	3.3
Domestic demand	(contrib.)	1.3	3.0	3.2	6.6	2.5	2.8	3.0	3.2	3.4	3.3	3.6
Private final consump. exp.	(contrib.)	2.1	2.1	1.8	2.3	1.4	1.7	1.7	1.8	1.9	1.8	1.9
Fixed investment	(contrib.)	− 0.3	− 0.8	0.5	− 0.4	− 0.4	0.2	0.5	0.5	0.6	0.6	0.7
External demand	(contrib.)	− 0.1	− 0.5	− 0.2	− 1.1	− 0.0	− 0.2	− 0.2	− 0.2	− 0.2	− 0.2	− 0.3
Consumer price index	(yoy)	2.8	1.6	2.2	1.3	1.3	1.7	2.3	2.5	2.1	2.0	2.0
Unemployment rate	(average)	4.8	5.7	5.7	5.6	5.9	5.8	5.7	5.7	5.7	5.6	5.6
10-year Treasury bond yield	(average)	5.0	5.2	5.5	5.1	5.2	5.3	5.4	5.4	5.5	5.5	5.5

Forecast for the Euro Area

(%)

		2001	2002	2003	2002 Q1	Q2	Q3	Q4	2003 Q1	Q2	Q3	Q4
		actual	forecast	→	actual	forecast	→	→	forecast	→	→	→
Real GDP	(yoy)	1.5	1.1	2.8	0.1	0.5	1.2	2.4	2.9	3.0	2.9	2.6
Domestic demand	(contrib.)	0.8	0.6	2.9	−0.8	0.0	0.9	2.2	3.4	3.2	2.9	2.3
Private final consump. exp.	(yoy)	1.7	0.8	2.6	0.3	0.2	0.8	1.7	2.6	2.8	2.6	2.4
Fixed capital formation	(yoy)	−0.5	−0.5	3.2	−2.4	−1.3	0.2	1.7	3.2	3.5	3.3	3.0
External demand	(contrib.)	0.7	0.5	−0.1	0.8	0.5	0.3	0.2	−0.5	−0.1	−0.0	0.3
Consumer price index (HICP)	(yoy)	2.5	2.2	2.2	2.6	2.1	2.1	2.2	2.1	2.1	2.3	2.3
Unemployment rate	(%)	8.3	8.5	8.3	8.4	8.5	8.5	8.4	8.4	8.3	8.2	8.2
ECB policy rate	(%)	3.25	3.75	4.25	3.25	3.25	3.25	3.75	4.00	4.25	4.25	4.25

Note: Policy rate is quoted at end of period.

Forecast for Japan

(%)

	FY 2001	FY 2002	FY 2003	FY 2002				FY 2003				Previous forecast Mar. 2002 FY 2002
	actual	forecast →		Apr–Jun forecast →	Jul–Sep	Oct–Dec	Jan–Mar	Apr–Jun forecast →	Jul–Sep	Oct–Dec	Jan–Mar	
Real GDP (sequential)	−1.3	0.1	1.1	−0.5	−0.2	0.4	0.6	0.0	0.2	0.2	0.4	−0.4
(seq. at annual rate)				−1.8	−0.8	1.6	2.5	0.1	1.0	0.7	1.8	
(year–on–year)				−0.6	−0.3	1.3	−0.2	0.9	1.4	1.0	0.9	
Domestic demand (contribution)	(−0.8)	(−0.7)	(1.3)	(−0.6)	(−0.3)	(0.4)	(0.6)	(0.2)	(0.4)	(0.4)	(0.5)	(−0.8)
Private sector	(−0.8)	(−0.8)	(1.3)	(−0.5)	(−0.3)	(0.5)	(0.6)	(0.2)	(0.3)	(0.3)	(0.3)	(−1.0)
Public sector	(0.0)	(0.1)	(0.1)	(−0.1)	(−0.0)	(−0.1)	(−0.0)	(−0.0)	(0.1)	(0.1)	(0.2)	(0.2)
External demand (contribution)	(−0.5)	(0.7)	(−0.3)	(0.1)	(0.1)	(0.0)	(0.1)	(−0.1)	(−0.2)	(−0.2)	(−0.1)	(0.4)
Private consumption	0.3	0.6	0.7	−0.7	−0.6	0.2	0.1	0.2	0.2	0.3	0.4	0.1
Private residential investment	−8.5	−4.5	−0.5	−3.6	1.2	−0.8	1.2	−1.5	0.2	−0.2	0.9	−1.2
Private non–residential investment	−3.7	−6.4	5.2	−0.3	−0.2	2.6	2.9	0.5	1.1	0.5	0.6	−6.4
Gopvernment consumption	2.8	2.6	2.3	0.7	0.6	0.3	1.3	−0.1	0.6	0.7	1.4	3.0
Public investment	−5.8	−5.6	−5.5	−3.8	−2.0	−3.0	−3.7	−0.4	−0.3	−0.4	−0.9	−5.3
Exports	−8.0	6.9	1.0	1.8	1.7	1.2	1.0	0.1	−0.7	−0.8	−0.1	0.5
Imports	−4.7	−0.1	4.6	0.6	0.8	1.2	0.7	1.7	1.1	1.1	0.7	−3.6
Nominal GDP	−2.5	−1.0	0.3	−0.8	−0.6	0.2	0.2	0.2	−0.0	0.0	−0.0	−1.9

Major Indicators

(%)

		FY 2001	FY 2002	FY 2003	FY 2002				FY 2003				Previous forecast FY 2002
					Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar	
Industrial production	(seq.)	−10.2	1.8	3.0	2.5	1.3	0.8	0.9	0.8	0.5	0.4	0.6	−1.5
Domestic wholesale price index	(yoy)	−1.1	−1.0	−0.6	−1.3	−1.0	−0.9	−0.8	−0.7	−0.7	−0.5	−0.6	−1.1
Consumer price index	(yoy)	−1.0	−0.8	−0.5	−1.0	−0.9	−0.7	−0.6	−0.4	−0.5	−0.5	−0.5	−0.8
CPI excl. fresh foods	〃	−0.8	−0.8	−0.5	−0.8	−0.8	−0.7	−0.7	−0.5	−0.5	−0.5	−0.5	−0.8
Current account balance	(¥ trillion)	11.9	15.0	14.0	14.5	15.2	15.8	14.7	14.9	14.6	13.8	12.7	13.3
Ratio to nominal GDP	〃	(2.4)	(3.0)	(2.8)	(2.9)	(3.1)	(3.2)	(3.0)	(3.0)	(2.9)	(2.8)	(2.6)	(2.7)
Unemployment rate	(%)	5.2	5.4	5.3	5.3	5.4	5.5	5.4	5.4	5.3	5.3	5.2	5.8
Housing starts	(million)	1	1.14	1.11	1.15	1.16	1.14	1.13	1.10	1.11	1.10	1.11	1.16
10–year JGB yield (OTC quotation)	(%)	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.6
Exchange rate	(¥/$)	125	124	119	127	125	123	121	120	119	118	118	128

Forecast assumptions: U.S. economic growth rate of 2.5% in 2002, 3.0% in 2003; ¥/$ exchange rate of ¥124 in FY02, ¥119 in FY03; oil price of $26.00/barrel in FY02, and $24.30 in FY03.

Sources: ESRI (Cabinet Office), *Preliminary Quarterly GDP Estimates*; METI, *Indices of Industrial Production*; MPMHAPT, *Consumer Price Index*; others.