The Recovery's Sustainability Will be Challenged —Revised Economic Forecast for FY 2004

by the Economic Research Group

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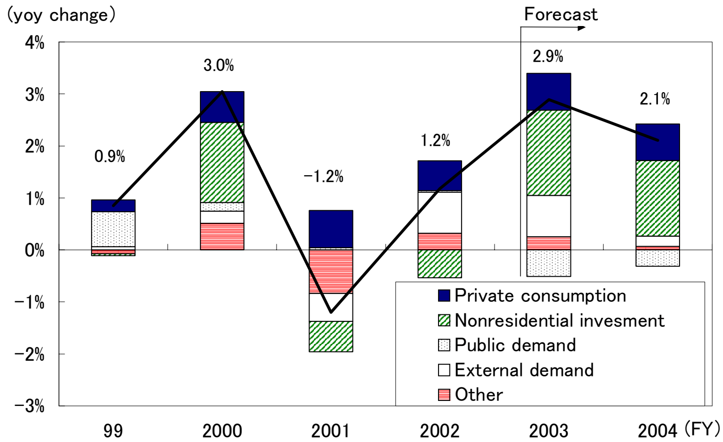
FY 2004 Economy to Grow 2.1% Amid Limited Consumption Growth

As seen by the economy's 7.0% real annualized growth rate in October-December 2003, the recovery is continuing apace. The job environment has improved, lifting consumer confidence and bringing hopeful signs of recovery to the household sector. For fiscal 2003, we predict real economic growth of 2.9%, and the first positive nominal growth of 0.4% since fiscal 2000.

In fiscal 2004, however, the economy will gradually slow down due to the effects of the strong yen and other factors. If the yen appreciates at an accelerating pace, the recovery itself will be put at risk. We predict real economic growth of 2.1%, and nominal growth of zero to a slightly negative figure.

The current recovery's sustainability will be challenged by the inevitable weakening of external demand in fiscal 2004. Despite encouraging signs, consumption growth will be limited by low income growth and rising tax and social security burdens. To expand consumption, a major impediment—the instability in the social security system—urgently needs to be addressed with fundamental reforms.

Figure 1 Real GDP Growth Rate



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

1. Encouraging Signs in the Household Sector

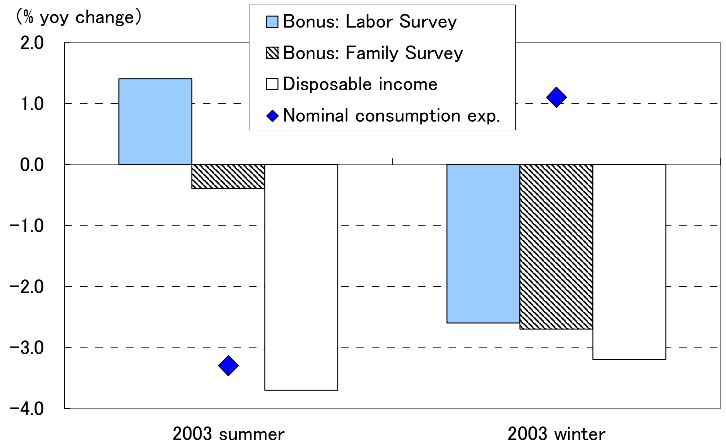
(1) Strong 1.7% Growth in October-December

The current economic recovery, which began in early 2002, wavered temporarily from early 2003 amid factors such as the growing tension in Iraq and SARS outbreak. However, the economy picked up again led by export growth when the U.S. resumed its recovery in July-September with a real GDP growth rate of 8.2%.

In October-December 2003, the economy surged at a strong sequential real growth rate of 1.7% (7.0% annualized). The private sector contributed 1.3% to the growth rate on the strength of a 5.1% sequential increase in nonresidential investment, while external demand contributed 0.4% due to export growth. Private final consumption expenditure also grew 0.8%, indicating that the recovery is gaining momentum and spreading beyond the corporate sector to the household sector.

While the recovery has been led by growth in external demand and in capital investment fueled by external demand, consumption has also performed well considering the harsh income environment. Social insurance premiums have increased as a result of the new calculation method that includes bonuses in total income, significantly decreasing disposable income in the 2003 bonus seasons from the previous year. As a result, consumption by working households plunged in the 2003 summer bonus season. However, in the winter bonus season, working households actually increased consumption despite a similar drop in disposable income.

Figure 2 Consumption and Income of Working Households



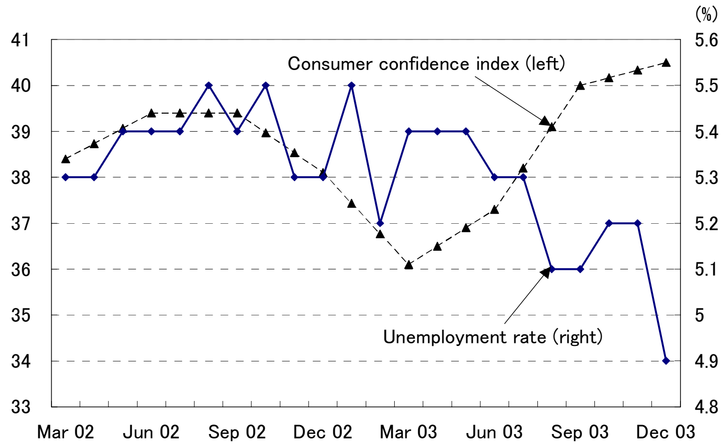
Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Family Income and Expenditure Survey*; Ministry of Health, Labor and Welfare, *Monthly Labor Survey*.

(2) Improving Job Environment and Consumer Confidence

The change in household consumption can be attributed to the improving job environment and its effect of boosting consumer confidence. The consumer confidence index, which fell to 36.1 in March 2003, climbed back to 40.5 in December primarily due to a perceptible improvement in the job environment. The unemployment rate in December, while still high at 4.9%, finally managed to break through the 5% threshold. The ratio of active job openings to applicants rose to 0.78, a considerable improvement from the 0.51 level in early 2002. The year-on-year decline in number of employed persons, which had been large and persistent until early 2003, narrowed and then turned to an increase in December.

Though slower to improve than the job environment, the household income environment has improved markedly since experiencing large and persistent declines in late 2001 and into 2002. Cash earnings decreased 2.4% in 2002, but were almost unchanged at -0.4% in 2003.

Figure 3 Improvement in Consumer Confidence



Source: Cabinet Office, *Consumer Confidence Survey*; MPMHAPT Statistical Bureau, *Labour Force Survey*.

2. U.S. Economy Remains Strong

(1) U.S. Drives the World Economy

At first glance, Japan's strong performance in October-December 2003 appears to be attributable to the large 1.3% contribution of domestic demand to the 1.7% economic growth rate. But the growth in capital investment, being fueled by export growth, is also attributable to export growth. Japan's export growth in turn is largely attributed to the growing Asian economies, particularly China. However, here again appearances are misleading. While China's 9.1% real economic growth rate in 2003 was achieved by sustained export growth in the neighborhood of 30%, the source of the high export growth for China and other thriving Asian economies has been the U.S. economy. Thus the world economy is actually being driven by the U.S.

In the U.S., the annual real economic growth rate declined to 1-2% from late 2002 to early 2003 due to the mounting tension in Iraq and other factors, but has since been sustained at a high rate of 8.2% in July-September 2003 and 4.0% in October-December. Stock prices have climbed, helped by the Fed's loose monetary policy of keeping the federal funds rate at 1%, and by improvement in corporate earnings due to restructuring. On the other hand, employment continues to be a weak point in the ongoing economic recovery, although consumption remains firm partly due to the tax cuts. However, with the federal budget deficit is predicted to bulge to almost 500 billion dollars due partly to spending on Iraq reconstruction, policymakers have almost no options left for further fiscal stimulus.

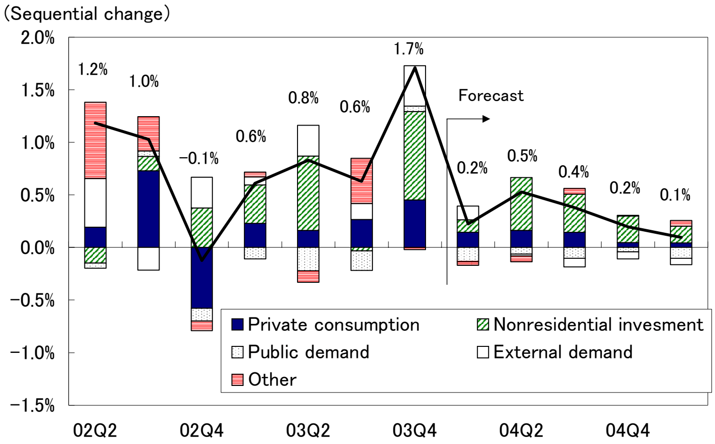
The structure of the world economy, relying as heavily as it does on U.S. imports for growth, has raised a serious problem: the U.S. current account deficit has grown to approximately 5% of nominal GDP, far exceeding the level thought sustainable at the Plaza Accord. Europe's recovery has been sustained by export growth to the recovering U.S. economy. However, against the backdrop of the U.S. current account deficit, the euro has appreciated to almost $1.30, pushing Germany's economic growth rate into negative territory in 2003 and dampening Europe's recovery pace. Since many Asian currencies are closely tied to the dollar, pressure from the dollar's weakness is being vented on the euro, posing a large risk that a disgruntled Europe will step up criticism of currency market interventions for the Chinese yuan and Japanese yen.

3. Japan in Fiscal 2004

(1) Economy to Grow 2.1% in FY 2004

In fiscal 2003, external demand, supported by export growth, will contribute 0.8% to the economic growth rate. This will stimulate double-digit growth of 10.5% in nonresidential investment led by large export manufacturers. Along with the improving corporate sector, the household sector is benefiting from the economic recovery, and consumption is expected to grow 1.3%. The economy will grow at a real growth rate of 2.9%. The nominal growth rate, though positive for the first time since fiscal 2000, will be significantly lower at 0.4% because of the GDP deflator's continued decline centered around the private nonresidential investment deflator component.

Figure 4 Quarterly Real GDP Growth



Source: ESRI, *Quarterly Estimates of GDP.*

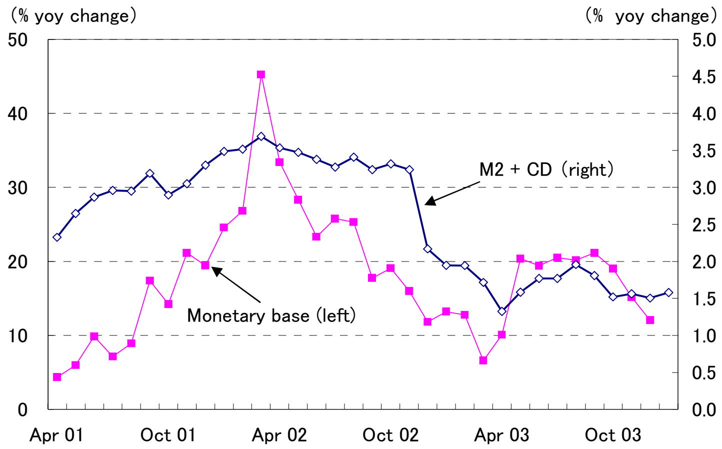
In fiscal 2004, although real nonresidential investment will continue growing at 8.6%, the contribution of external demand will plunge to 0.2% as the strong yen reins in export growth and stimulates import growth. Real growth in private final consumption expenditure will remain at 1.3% from fiscal 2003, but the growth pace will slow in the second half. As a result, the economy's overall real growth rate will decline to 2.1%.

(2) Direction of Fiscal and Monetary Policy

With the economy in recovery, public demand has contracted conspicuously due to the structural reform policies. Government consumption will continue to grow moderately despite payroll cuts, due to rising health care and long-term care insurance expenditures associated with the aging population. In real public investment, while the decline narrowed in October-December to –0.2% from the previous quarter, declines are predicted to widen significantly to –11.1% in fiscal 2003 and –9.4% in fiscal 2004 as local governments tighten budgets in response to the so-called trinity of fiscal reforms (decrease in subsidies from the central government, transfer of taxing power to local governments, and review of budget allocations to local governments). Since public investment comprises only approximately 5% of nominal GDP, the economic impact of the decline is smaller than in the past. However, this does not mean that the role for fiscal policy has diminished in any way. The expenditure structure needs to be made more efficient with well planned budget allocations so that resources are reallocated to areas with the greatest stimulative effect.

On January 20, the Bank of Japan Policy Board decided at its Monetary Policy Meeting to raise the target range for the outstanding balance of current accounts at the Bank from around 25 to 30 trillion yen, to 30 to 35 trillion yen. While many view this as a preparatory measure for the yen's appreciation, the *Change in the Guideline for Money Market Operations* states otherwise: "the Bank judged it appropriate to raise the target balance of current accounts held at the Bank in order to reaffirm its policy stance to overcome deflation and ensure a continued recovery." That is, while the real economy has grown almost 3% in fiscal 2003, money supply growth has stagnated in the mid 1% range from year ago levels. Hard pressed to ignore the argument that money supply must grow faster than the real economy to overcome deflation, the Bank is in our view thus quite likely to strengthen its quantitative easing stance even as the economy continues to recover.

Figure 5 Money Supply Growth



Source: BOJ

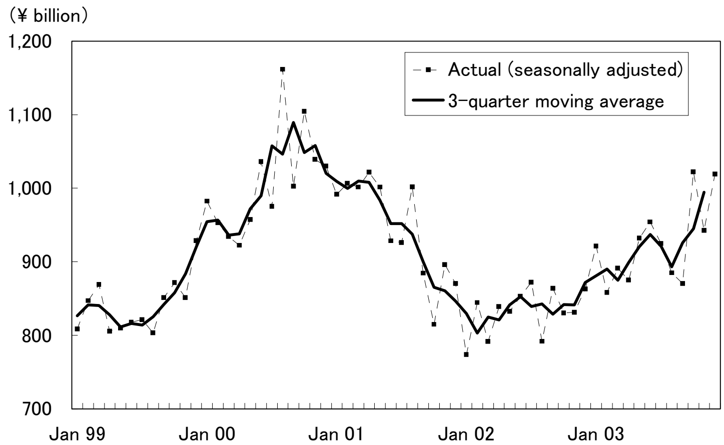
Since we predict consumer prices (excluding fresh foods) in fiscal 2004 will continue to decline albeit gradually at –0.3%, we do not anticipate quantitative easing to be lifted soon; rather, it is more likely to be strengthened. If the massive yen-buying intervention continues, current account balances at the Bank will continue to grow, and the Bank may decide to raise the target range for current account balances again as it did in January. Regarding other policy themes, the Bank will explore new ways to supply liquidity, as has been pursued by BOJ Governor Fukui since assuming his post. However, if criticism from Europe prevents the Bank from buying yen, thereby significant increasing concerns that the monetary base will expand more slowly, the Bank may increase monthly purchases of long-term government bonds above the 1.2 trillion yen level set back in October 2002. In this event, a sustained increase in the long-term interest rate will be unlikely for the time being.

(3) Sustainability of the Recovery

In fiscal 2004, government spending will continue to decline due to the Koizumi administration's structural reforms, while we predict that external demand will soften as the yen's sharp appreciation since fall 2003 gradually works through the economy. The recovery's sustainability will thus hinge on the performance of nonresidential investment and consumption.

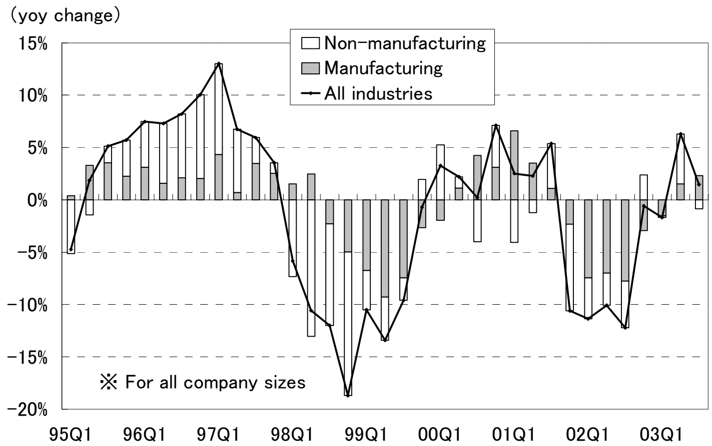
Nonresidential investment has fluctuated widely, dropping –0.2% in July-September from the previous quarter, and then surging 5.1% in October-December. This volatility has been caused by investment swings in the non-manufacturing sector. According to quarterly data on investment in plant and equipment from *Financial Statements Statistics of Corporations by Industry*, the non-manufacturing sector shows wide positive and negative swings from the year earlier. Meanwhile, the manufacturing sector has improved steadily: after plunging over 20% in mid 2002, the declines gradually narrowed, and investment turned positive in fiscal 2003. Machinery orders (private demand excluding ships and electric power), a leading indicator for investment, surged 11.3% in October-December from the previous quarter, and is predicted to continue growing in fiscal 2004 centered around IT-related investment. Barring a sudden appreciation of the yen or downturn in overseas economies, we predict that capital investment is not likely to encounter a sudden slowdown.

Figure 6 Private Sector Machinery Orders (excl. ships & electric power)



Source: ESRI, *Orders Received for Machinery*.

Figure 7 Nonresidential Investment



Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

However, we are strongly concerned about the sustainability of consumption growth. In fiscal

2004, cash earnings are predicted to grow 0.8%, following on a –0.1% decline in fiscal 2003. On the other hand, in addition to the elimination of the special tax deduction for spouses, premium increases are scheduled for long-term care insurance in April, and for the employees' pension plan in October. These factors will limit the growth in disposable income and, we predict, reduce consumption growth toward the end of the fiscal year.

As the strong yen dampens export growth and consumption growth slows, industrial production will gradually decline. By the end of fiscal 2004, the economy will reach the crossroads between recovery and recession. The chances of an early onset of recession will increase if the yen's appreciation can no longer be prevented by massive intervention, or if the U.S. economy or China's suspected bubble economy slow down.

(4) Integrated Reform is Desirable for Social Security and Taxation

Along with the slump in income, another factor that constrains household consumption is anxiety regarding retirement. Under the present pension reform, the government has tried to dispel this anxiety by capping the premium rate of the employees' pension plan at 18.3%, and setting the minimum benefit at 50% of income prior to retirement. However, if the birthrate continues to decline or the economic environment deteriorates beyond expectations, both the premium rate cap and minimum benefit will become unsustainable. In fact, pension finance calculations are based on the 2002 population projection, which assumes total fertility rates of 1.34 in 2001 and 1.33 in 2002. However, actual rates were lower (1.33 in 2001 and 1.32 in 2002), raising substantial concerns that the rate will continue to decline by more than expected. If conditions persist and the premium rate and benefit level need to be revised again in five years, the government will have failed to dispel anxieties toward the public pension.

With the long-term care insurance system also scheduled for review in fiscal 2005, an integrated review of benefits is needed covering the pension, long-term care and health care systems. Moreover, as exemplified by the tax exemption for social security premiums, tax and social security burdens also need to be examined from an integrated perspective. In the past, these systems have been dealt with separately due to the vertical organization of public administration. We hope the Council on Economic and Fiscal Policy and others adopt a comprehensive approach to reform that covers all systems supporting the aging society.

Figure 8 Economic Forecast for the U.S.

(% seq. change, annualized)

	2002 actual	2003 actual	2004 forecast	2003/1-3 actual	4-6 actual	7-9 actual	10-12 actual	2004/1-3 forecast	4-6 forecast	7-9 forecast	10-12 forecast
Real GDP	2.2	3.1	4.4	2.0	3.1	8.2	4.0	4.3	4.1	3.5	3.2

Figure 9　Economic Forecast for the Euro Area

(% yoy change)

	2002 actual	2003 estimate	2004 forecast	2003/1-3 actual	4-6 actual	7-9 actual	10-12 actual	2004/1-3 forecast	4-6 forecast	7-9 forecast	10-12 forecast
Real GDP	0.9	0.4	1.7	0.7	0.1	0.3	0.6	1.0	1.6	1.8	2.1

Figure 10　Economic Forecast for Japan

(% seq. change, unless otherwise indicated)

	FY 2002 actual	FY 2003 forecast	FY 2004 forecast	2003/4-6 actual	7-9 actual	10-12 actual	2004/1-3 forecast	4-6 forecast	7-9 forecast	10-12 forecast	2005/1-3 forecast	Previous forecast Dec. 2003 FY 2004 forecast
Real GDP sequential change	1.2	2.9	2.1	0.8	0.6	1.7	0.2	0.5	0.4	0.2	0.1	1.5
annualized seq. chg.				3.4	2.5	7.0	0.9	2.1	1.5	0.8	0.4	
yoy change				2.3	2.0	3.6	3.6	3.1	2.9	1.2	1.3	
Domestic demand (contribution)	(0.4)	(2.1)	(1.9)	(0.5)	(0.5)	(1.3)	(0.1)	(0.5)	(0.5)	(0.3)	(0.2)	(1.5)
Private demand	(0.4)	(2.6)	(2.2)	(0.8)	(0.7)	(1.3)	(0.2)	(0.6)	(0.6)	(0.3)	(0.3)	(1.8)
Public demand	(0.0)	(−0.5)	(−0.3)	(−0.2)	(−0.2)	(0.1)	(−0.1)	(−0.1)	(−0.1)	(−0.0)	(−0.1)	(−0.3)
External demand (contribution)	(0.8)	(0.8)	(0.2)	(0.3)	(0.2)	(0.4)	(0.1)	(−0.0)	(−0.1)	(−0.1)	(−0.1)	(0.0)
Private consumption	1.0	1.3	1.3	0.3	0.5	0.8	0.3	0.3	0.3	0.1	0.1	0.7
Private residential investment	−2.1	0.4	−0.4	−0.1	2.9	−1.0	0.6	−0.9	0.4	−0.8	−0.2	−1.6
Private non-residetial investment	−3.3	10.5	8.6	4.4	−0.2	5.1	0.7	2.9	2.1	1.4	0.9	8.3
Government consumption	2.1	1.0	1.0	−0.1	0.7	0.5	−0.1	0.0	0.5	0.4	0.1	0.0
Public investment	−5.0	−11.1	−9.4	−3.7	−5.1	−0.2	−1.5	−2.3	−4.0	−2.4	−2.5	−6.9
Exports of goods & services	12.0	9.8	7.1	1.6	3.2	4.2	2.4	1.3	0.9	0.6	0.3	6.5
Imports of goods & services	5.5	3.9	7.5	−1.2	2.6	1.4	1.9	2.0	2.1	1.6	1.1	8.4
Nominal GDP	−0.7	0.4	−0.0	0.6	0.3	0.7	−0.8	0.7	0.1	−0.7	−0.9	−0.3

Major Indicators

(% unless otherwise indicated)

	FY 2002	FY 2003	FY 2004	2003/4-6	7-9	10-12	2004/1-3	4-6	7-9	10-12	2005/1-3	Previous forecast Dec. 2003 FY 2004
Industrial production (seq. chg.)	2.8	3.1	4.4	−0.7	1.3	3.7	0.6	0.9	0.8	0.4	0.3	5.4
Domestic corporate goods prices (yoy)	−1.6	−0.5	−0.4	−1.0	−0.7	−0.4	0.1	−0.2	−0.4	−0.4	−0.5	−1.2
Consumer prices (yoy)	−0.6	−0.3	−0.4	−0.3	−0.2	−0.3	−0.4	−0.3	−0.3	−0.4	−0.4	−0.4
(excl. fresh foods)	−0.8	−0.1	−0.3	−0.4	−0.1	0.0	−0.1	−0.2	−0.3	−0.4	−0.4	−0.4
Current account balance	¥13.4 tr.	¥16.4 tr.	¥14.3 tr.	¥15.8 tr.	¥17.5 tr.	¥16.7 tr.	¥15.8 tr.	¥15.8 tr.	¥14.9 tr.	¥13.9 tr.	¥12.5 tr.	¥14.1 tr.
(ratio to nominal GDP)	(2.7)	(3.3)	(2.9)	(3.2)	(3.5)	(3.3)	(3.2)	(3.1)	(3.0)	(2.8)	(2.5)	(2.8)
Unemployment rate	5.4	5.1	4.8	5.4	5.2	5.1	4.9	4.8	4.7	4.8	4.9	4.9
New housing starts	1.15 ml.	1.16 ml.	1.14 ml.	1.20 ml.	1.12 ml.	1.17 ml.	1.16 ml.	1.15 ml.	1.15 ml.	1.14 ml.	1.14 ml.	1.10 ml.
10-year JGB yield (OTC quote)	1.1	1.1	1.3	0.6	1.2	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Exchange rate (¥/$)	¥122	¥113	¥103	¥118	¥118	¥109	¥106	¥104	¥103	¥103	¥103	¥106
Crude oil price ($/barrel)	$27	$30	$29	$29	$29	$30	$34	$32	$30	$28	$28	$26
Current profits (yoy)	7.2	11.9	6.0	13.6	9.4	11.9	12.5	11.2	8.2	5.0	1.5	3.0

Sources: ESRI, *Quarterly Estimates of GDP*; METI, *Indices of Industrial Production*; MPMHAPT, *Consumer Price Index*; MOF, *Financial Statements Statistics of Corporations by Industry.*