# Deflation Will Boost Japan's Real Economic Growth Rate—Economic Forecast for Fiscal 2004

by the Economic Research Group

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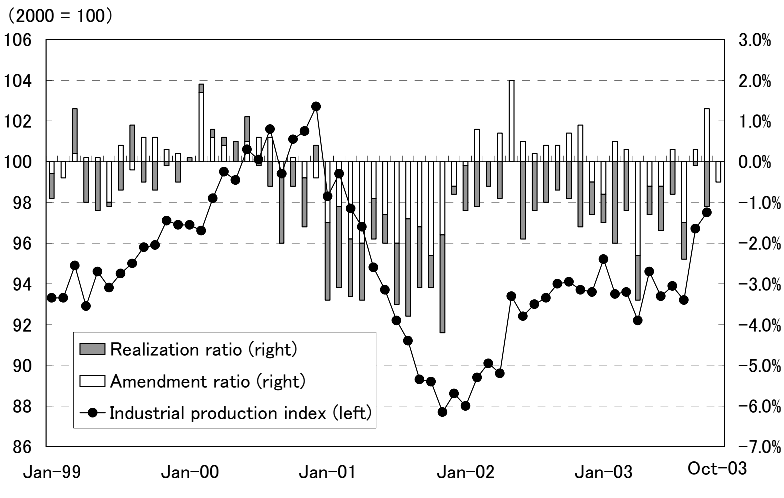
## 1. Economy Continues to Recover

### 1. Economy Rides Out the Cold, Wet Summer

In early 2003, Japan's economy was challenged by the mounting tension in Iraq and SARS outbreak. But these effects proved to be minor, and the real economy steadily improved as the stock market rose from May. The economy managed to ride out the cold, wet summer and smaller summer bonuses due to the new calculation method for social insurance premiums, and continues to recover at present.

The Nikkei 225 average dropped to around 7,600 in late April, but recovered to the 10,000 level with the successful bailout of Resona Bank, improving U.S. stock market, and expectations of Japan's economic recovery. Japan's improving stock market has helped ease financial system instability and boost business and consumer confidence. The unemployment rate is still high, but the job and income environment have shown signs of improvement—the number of employed persons stopped declining in early 2003, while wages, which had been sliding due to longer unscheduled work hours, are growing year on year. Industrial production, which had been slow to recover, finally showed signs of improvement, shifting from a 0.7% sequential decrease in April-June 2003 to a 1.3% gain in July-September.

**Figure 1 Industrial Production Index**



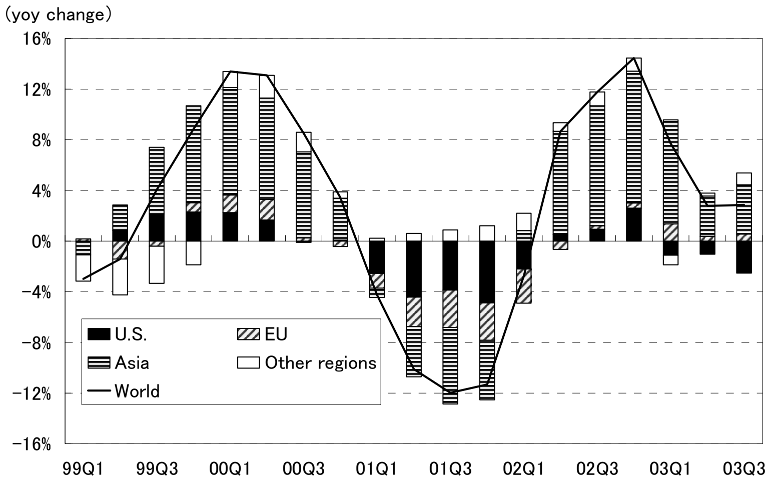

Source: METI, *Indices of Industrial Production*.

## 2. U.S. Drives the World Economy

According to data released in late November, the U.S. posted a phenomenal 8.2% real economic growth in the third quarter of 2003. This was achieved due to significant tax cuts ad an ultra-low interest rate policy. However, new problems have arisen as a result—the tax cut, combined with the hefty burden of Iraqi reconstruction, caused the fiscal deficit to balloon, while low interest rates spurred household borrowing and pushed up household debt to $1.9722 trillion in September. Non-farm payrolls rose 570,000 in November from the previous month for the fourth straight monthly increase. Moreover, the employment situation is improving, with the jobless rate dropping to 5.9%, but concerns remain whether the tax cuts and low interest rates can work long enough produce income growth and sustainable economic growth.

Due in part to SARS, export growth to Asia slowed in the second quarter of 2003, but regained momentum in the third quarter, and overall export growth is recovering. But exports to Asia are recovering even as direct exports to the U.S. have actually been decreasing year-on-year. In fact, exports to Asia are driven by the sustained strength of Asian economies, which in turn is based on the growth of Asian exports to the U.S. Thus the underlying scheme of the U.S. driving the world economy has not changed. However, the U.S. current account deficit has grown as a result, increasing the downside risk for the dollar.

**Figure 2 Japan's Real Export Growth by Destination**




Note: Real exports are calculated by applying the export price index to export value.

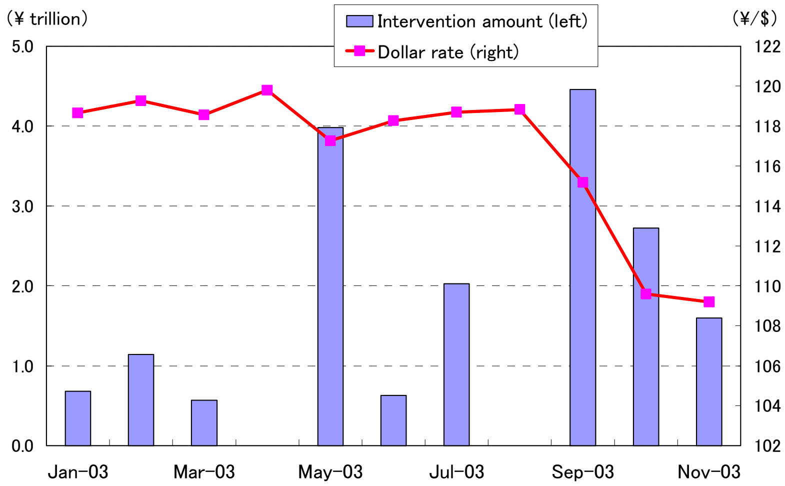
# 2. The Strong Yen and Its Effect

## 1. Massive Currency Market Intervention

To offset the yen's strength, the government and Bank of Japan have continually intervened in the foreign currency market by selling yen in large volume. The amount of yen sold this year through November has exceeded ¥17 trillion, bringing the foreign currency reserve to $644.6 billion. Combined with previous borrowings for intervention, the government's off-budget account for foreign currency transactions is approaching the ¥79 trillion borrowing limit of the fiscal 2003 budget. For this reason, proposals have emerged to sell foreign currency to the BOJ or to expand the borrowing limit in the supplementary budget. Given that the economic recovery is being driven by external demand, further yen appreciation threatens to destroy the scenario for economic recovery. Moreover, as BOJ Deputy Governor Kazumasa Iwata has stated, supplying liquidity through interventions in the foreign currency market has the same effect as purchasing foreign currency-denominated assets, a method proposed by economists.

Thus we do not expect strong opposition to BOJ purchases of foreign currency from the off-budget account to stabilize the exchange rate, or to increasing the account's borrowing limit in the supplementary budget. But holding large amounts of foreign-denominated assets would expose the government and BOJ to significant exchange rate risks. Although studies have found that intervention in the 1990s netted large profits, the risk of losses in the future cannot be ignored. While Japan's deflationary economy would benefit from a weaker yen, continued intervention would not only generate criticism from abroad, but be prohibitively expensive.

**Figure 3 Currency Market Intervention**



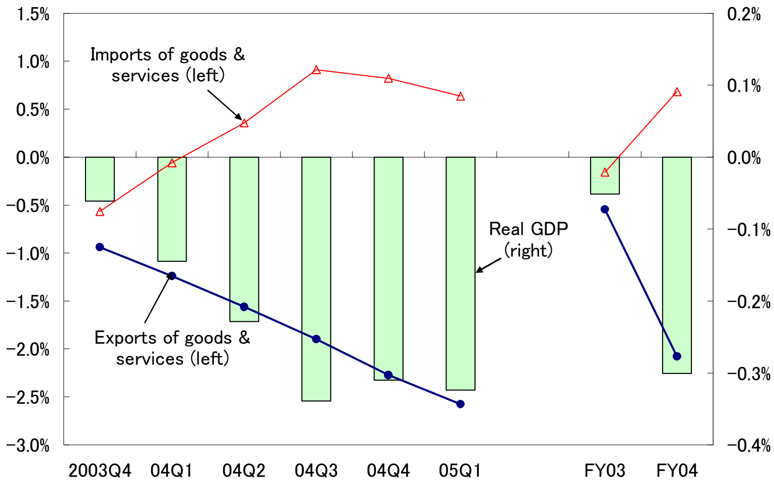

Source: Ministry of Finance

At present, market intervention has not yet been hampered by the borrowing limit of the off-budget account. But should the market suspect the government's capability to intervene, the yen could suddenly move upward. Since more leeway is clearly needed in policy actions, it is likely that either BOJ foreign currency purchases will be increased, the borrowing limit will be raised in the supplementary budget, or both.

### 2. Effect of the Strong Yen

The Group of Seven's September 20 statement from Dubai implicitly criticized fixed exchange rate systems and artificial exchange rate intervention, saying that said "flexibility in exchange rates is desirable for major countries or economic areas." Amid speculation that this would discourage sustained and large-scale yen selling, the yen quickly appreciated past ¥110. According to our macroeconomic model, a 10% yen appreciation in October-December 2003 would impact GDP growth only slightly in fiscal 2003, but the impact would gradually expand and cause a –0.3% reduction in GDP growth for fiscal 2004. Thus we predict that the yen's recent strength will affect economic growth only slightly in fiscal 2003, but have a negative effect on economic growth in the second half of fiscal 2004.

**Figure 4 Simulated Effect of a 10% Yen Appreciation**



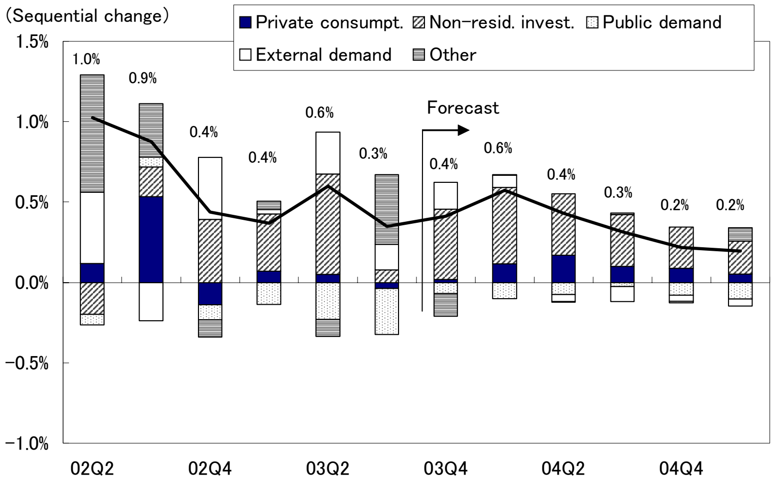

Notes: Shows divergence from the baseline scenario if the yen appreciates 10% from October-December 2003. The impact on real GDP includes ripple effects to domestic demand components such as consumption and non-residential investment.

## 3. Economic Forecast for Japan

### 1. 2.0% Real Growth for Fiscal 2003

In October-December 2003, real GDP will grow 0.4% from the previous quarter. Consumption will remain unchanged, as the new calculation method for social insurance premiums cuts into winter bonuses, while non-residential investment will improve from the second quarter slump of the non-manufacturing sector. While growth was driven by external demand in fiscal 2002, the economy will achieve 2.0% real growth in fiscal 2003 centered around private demand, and non-residential investment in particular. However, nominal growth rate will remain below real growth and negative at –0.2% as deflation persists and the deflator continues to decline.

**Figure 5 Real GDP Growth Rate**




Source: ESRI, *Quarterly Estimates of GDP*.

## 2. Monetary and Fiscal Policies

Amid the economic recovery, structural reforms are causing a conspicuous decrease in public demand. Public investment in July-September plunged 5.6% in real terms from the previous quarter, marking a 15% cumulative decrease over the past year and a half. The economy has continued to recover despite these cuts because public investment comprises only 5% of nominal GDP, the effect of cuts has diminished. As the proportion of replacement investment in public investment grows, there will be less room for future cuts.

Barring a sharp appreciation of the yen or a sudden slowdown of the U.S. economy, Japan could experience a recovery in fiscal 2004 as well. But the environment surrounding financial markets is unstable, including the stock market, which shows increasing signs of adjustment. Remembering the policy mistakes of fiscal 1997, when a sudden burden increase combined with spending cuts derailed the budding recovery, next fiscal year's burden increase and spending cuts need to be implemented in a moderate fashion.

In fiscal 2004, households will face a planned increase of approximately ¥1 trillion in burdens, including abolition of the special deduction for spouses, and premium hike for employees' pension insurance in the second half. Furthermore, the proposed fiscal 2004 tax reform is likely to contain tax increases such as a cut in the public pension deduction and per capita increase of the inhabitant tax. However, the new burdens will not immediately affect households or the economic forecast for fiscal 2004—the reduction in public pension deduction takes effect in January 2005, while the per capita increase in inhabitant tax takes effect from June 2005.

These tax increases are predicated on the assumption that the economic recovery will continue on course to fiscal 2005. However, our forecast predicts that the recovery will weaken in the second half of fiscal 2004 due to the strong yen, increased burdens, and slowing expansion of the U.S. economy. Given the recovery's tenuous condition under the increased burden, the implementation of these measures including their timing will need to be flexibly adjusted to prevailing conditions.

At its monetary policy board meeting on October 10, the BOJ raised the target balance of current accounts to the range of ¥27-32 trillion. The future prospects in the *Outlook and Risk Assessment of the Economy and Prices* released on October 31 indicated a slight overall improvement from the standard scenario of the previous release in April. However, according to the forecast of the majority of policy board members, the consumer price index (excluding fresh foods) will deflate 0.5% to 0.2% in fiscal 2004, which means that the end of quantitative easing is not yet in sight.

We also forecast that consumer prices will edge down 0.4% in fiscal 2004, and with the economy expected to continue a modest recovery, we see little reason for further easing. However, if massive yen selling continues due to market intervention, the total current account balance will continue to expand, and the target level may have to be raised.

The long-term interest rate (yield on 10-year JGBs) started 2003 at slightly under 0.9%, then dropped to 0.43% in May, and surged from mid June to its present level in the mid 1% range. However, the long-term rate has not entered a phase of sustained increase; rather, the decline to 0.43% was excessive, and the present level is consistent with long-term forecasts. Since the BOJ is not predicted to tighten its quantitative easing policy, we do not expect the long-term rate to surge for the time being.

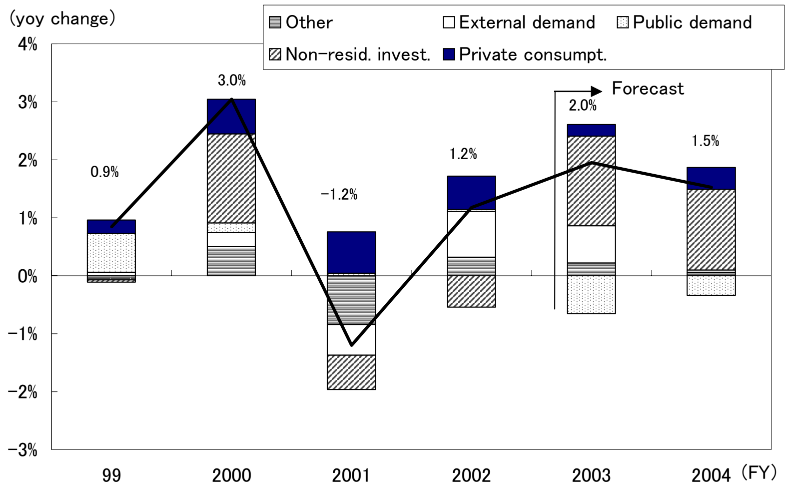
### 3. Forecast by Demand Component

Since the number of employed persons appears to have stopped decreasing, and improving corporate profits have stopped the slide in bonuses, employee compensation will increase. If the additional burden on individuals is limited to our forecast assumptions, we predict disposable income to edge up, and consumption to grow 0.7%. Residential investment will decrease 1.6% due to last-minute demand prompted by tax breaks in fiscal 2003, and structural factors such as the declining growth rate of households.

Corporate profit growth, though slowing from fiscal 2002 and 2003, will grow 3.0% in fiscal 2004. This, combined with price decreases, will keep business fixed investment growing strong at 8.3%. With the U.S. driving the world economy, Japan's exports will maintain a 6.5% growth rate led by exports to Asia and Europe. However, external demand will contribute 0.0% to economic growth, down from 0.6% in fiscal 2003, due to the growth of imports, strong yen, and gradual slowdown of the U.S. economy.

Fiscal structural reform is proceeding at the local and national levels, government consumption will stay unchanged from fiscal 2003, while public investment will decrease 6.9%.

**Figure 6 Composition of Real GDP Growth by Component**




Source: ESRI, *Quarterly Estimates of GDP*.

### 4. Real Economic Growth Slows to 1.5% in Fiscal 2004

The U.S. economy, having posted an astonishing 8.2% real growth rate in the third quarter of 2003, is predicted to continue strong growth at 3.1% in 2003 and 4.2% in 2004. As a result, Asian and European economies will continue to expand driven by exports, and Japan's exports are expected to show strong growth as well.

Indications are that the economy will decelerate in the second half of fiscal 2004 due to the ¥1 trillion increase in pension premiums and taxes, the gradual effect of the yen's appreciation from September 2003, and slowdown of the U.S. economy from almost 4% to around 3% in late 2004. As a result, Japan's economy will slow down from 2.0% in fiscal 2003 to 1.5% in fiscal 2004. Since the GDP deflator will continue to decline due in part to the declining capital investment deflator, the nominal growth rate will be negative at –0.3%.

If the yen strengthens even further, or if the boost to the U.S. economy from tax cuts and ultra-low interest rates wanes, the scenario for an export-led recovery—business fixed investment would recover, the job environment would improve, employee compensation would stop decreasing, and consumption would expand—falls apart.

As the economic structure changes, GDP data that had previously been useful can become problematic in understanding present conditions. One such case is the expanding decrease of the capital investment deflator of GDP. Currently, GDP data has 1995 as the base year, which is already eight years ago. In the past, since product cycles were longer, updating the base year after five years was sufficient for the data to accurately reflect changes in economic structure. But economic changes have accelerated, and the GDP data has not kept pace. Thus GDP data must be redesigned to accommodate the accelerating changes in economic structure, such as by adopting the U.S. chain weighted deflator, or by speeding up data releases necessary for revising the GDP base year in a more timely manner.

## Figure 7 Economic Forecast for Japan

(% sequential change, 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | actual | forecast | forecast | actual | actual | forecast | forecast | forecast | forecast | forecast | forecast |
| Real GDP seq. chg. | 1.2 | 2.0 | 1.5 | 0.6 | 0.3 | 0.4 | 0.6 | 0.4 | 0.3 | 0.2 | 0.2 |
| annualized seq. chg. | | | | 2.4 | 1.4 | 1.7 | 2.3 | 1.7 | 1.3 | 0.9 | 0.8 |
| yoy chg. | | | | 2.3 | 1.9 | 1.5 | 2.1 | 1.8 | 1.7 | 1.4 | 1.3 |
| Domestic demand (contrib.) | (0.4) | (1.3) | (1.5) | (0.3) | (0.2) | (0.2) | (0.5) | (0.5) | (0.4) | (0.3) | (0.2) |
| Private demand | (0.4) | (2.0) | (1.8) | (0.6) | (0.5) | (0.3) | (0.6) | (0.5) | (0.4) | (0.3) | (0.3) |
| Public demand | (0.0) | (-0.7) | (-0.3) | (-0.2) | (-0.3) | (-0.1) | (-0.1) | (-0.1) | (-0.0) | (-0.1) | (-0.1) |
| External demand (contrib.) | (0.8) | (0.6) | (0.0) | (0.3) | (0.2) | (0.2) | (0.1) | (-0.0) | (-0.1) | (-0.0) | (-0.0) |
| Private consumption | 1.0 | 0.4 | 0.7 | 0.1 | -0.1 | 0.0 | 0.2 | 0.3 | 0.2 | 0.2 | 0.1 |
| Private residential investment | -2.1 | 0.2 | -1.6 | 0.0 | 3.1 | -1.9 | 0.9 | -1.3 | -0.2 | -0.7 | -1.1 |
| Private non-residen. investment | -3.3 | 9.9 | 8.3 | 3.9 | 0.5 | 2.6 | 2.8 | 2.2 | 1.8 | 1.4 | 1.1 |
| Government consumption | 2.1 | 0.3 | 0.0 | -0.1 | 0.2 | -0.2 | -0.2 | -0.0 | 0.4 | -0.0 | -0.3 |
| Public investment | -5.0 | -11.4 | -6.9 | -3.9 | -5.6 | -0.3 | -0.9 | -2.3 | -2.0 | -1.6 | -1.2 |
| Exports of goods & services | 12.0 | 8.8 | 6.5 | 1.3 | 3.0 | 3.1 | 2.1 | 1.2 | 1.0 | 0.8 | 0.6 |
| Imports of goods & services | 5.5 | 4.2 | 8.4 | -1.1 | 2.2 | 2.4 | 2.1 | 2.1 | 2.3 | 1.4 | 1.3 |
| Nominal GDP | -0.7 | -0.2 | -0.3 | 0.3 | 0.1 | -0.5 | -0.1 | 0.4 | -0.1 | -0.3 | -0.5 |

### 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Industrial production (seq. chg.) | 2.8 | 3.3 | 5.4 | -0.7 | 1.3 | 3.2 | 2.1 | 1.0 | 0.7 | 0.5 | 0.2 |
| Domestic corporate goods prices (yoy) | -1.6 | -0.8 | -1.2 | -1.0 | -0.7 | -0.5 | -0.9 | -1.3 | -1.4 | -1.2 | -1.1 |
| Consumer prices (yoy) | -0.6 | -0.1 | -0.4 | -0.3 | -0.2 | -0.0 | -0.1 | -0.3 | -0.4 | -0.4 | -0.4 |
| Consumer prices (excl. fresh foods) | -0.8 | -0.1 | -0.4 | -0.4 | -0.1 | 0.0 | 0.0 | -0.3 | -0.4 | -0.4 | -0.4 |
| Current account balance | ¥13.4 tr. | ¥16.3 tr. | ¥14.1 tr. | ¥15.8 tr. | ¥17.7 tr. | ¥15.6 tr. | ¥16.1 tr. | ¥15.6 tr. | ¥14.4 tr. | ¥13.3 tr. | ¥12.9 tr. |
| (ratio to nominal GDP) | (2.8) | (3.3) | (2.8) | (3.2) | (3.6) | (3.2) | (3.3) | (3.1) | (2.9) | (2.7) | (2.6) |
| Unemployment rate | 5.4 | 5.1 | 4.9 | 5.4 | 5.2 | 5.1 | 4.9 | 4.8 | 4.8 | 4.9 | 5.0 |
| New housing starts | 115 | 1.14 ml. | 1.10 ml. | 1.20 ml. | 1.12 ml. | 1.13 ml. | 1.12 ml. | 1.11 ml. | 1.11 ml. | 1.10 ml. | 1.08 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 |
| Exchange rate (¥/$) | 122 | ¥113 | ¥106 | ¥118 | ¥118 | ¥109 | ¥107 | ¥106 | ¥106 | ¥105 | ¥105 |
| Crude oil price ($/barrel) | 27 | $29 | $26 | $29 | $29 | $30 | $29 | $27 | $26 | $26 | $26 |
| Current profits (yoy) | 7.2 | 9.3 | 3.0 | 13.6 | 9.4 | 8.1 | 7.3 | 4.4 | 3.9 | 2.5 | 1.6 |

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