Economic Forecast for FY 2003—The Recovery Stalls as Economic Growth Slows to 0.1%

by the Economic Research Group

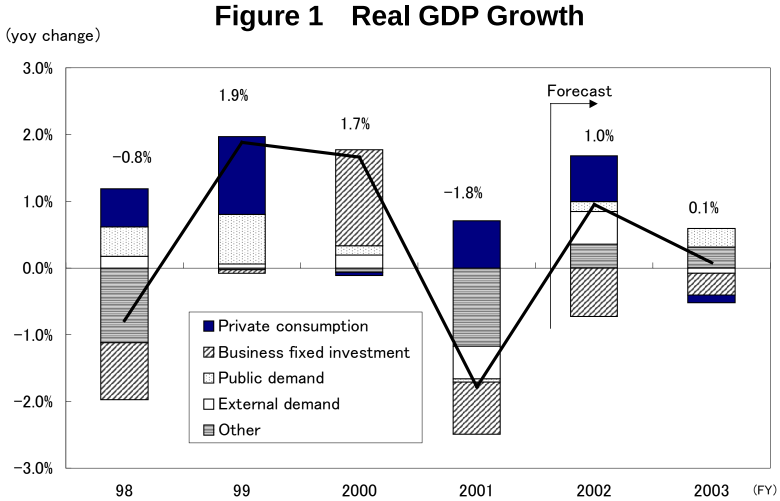
Growth to Slow from 1.0% in FY02 to 0.1% in FY03 as External Demand Wanes

1. External demand, the driving force behind Japan's modest recovery, will wane before capital investment can gain momentum. As a result, the economy is likely to peak out.

2. The economy will achieve real growth of 1.0% in fiscal 2002, but slow to 0.1% in fiscal 2003 due in part to mounting deflationary pressure from the disposal of bad loans. With prices still declining, nominal growth will remain negative at –0.6% in fiscal 2002 and –1.2% in fiscal 2003.

3. To prevent the economy's downward spiral, we need a supplementary budget in the present fiscal year and stronger anti-deflation measures in the next fiscal budget. Deficit spending growth is thus inevitable.

Figure 1 Real GDP Growth

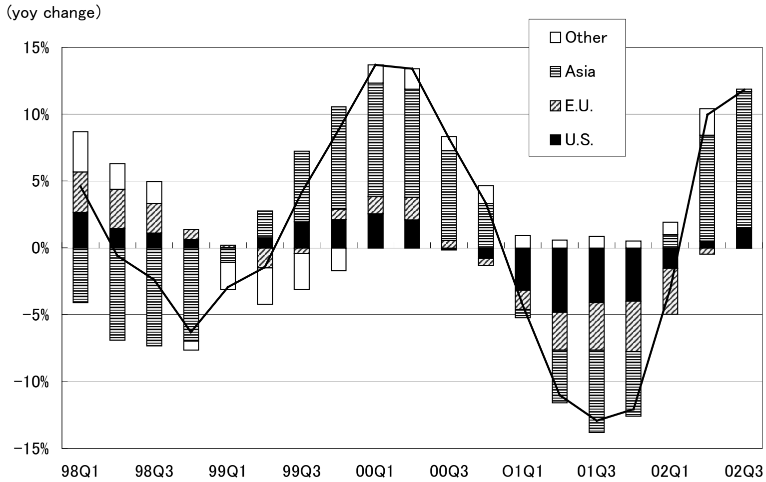


Source: Economic and Social Research Institute, Cabinet Office, *Preliminary Estimates of National Expenditure*.

1. U.S. Weakness Dampens Japan's Export-Led Recovery

Although Japan's economy bottomed out late last year, the recovery has been weak despite a sharp recovery in industrial production. This stems from the economy's dependence on export growth, and serious concerns remain regarding the sustainability of domestic demand. However, with exports to the U.S. and Asia slowing, and the export recovery to the E.U. stalled, overall export growth is peaking out.

Figure 2 Real Export Growth by Destination



Note: Real exports were calculated by adjusting export value with the export price index.
Source: MOF, *Trade Statistics*.

The U.S. economy slowed to a 1.3% annual rate in the second quarter due sluggish consumption growth and worsening external demand as imports rose. In the third quarter, despite a positive turnaround in capital investment to 0.6% and a consumption surge of 3.1% (helped by strong auto sales due to zero-interest loans), the recovery remains sluggish. Consumption growth, the economy's driving force thus far, appears unsustainable, and the slow improvement in employment indicates that the risk of a consumption slump cannot be ignored. With business and consumer confidence indicators declining conspicuously, the economy is likely to slow to the 1% range in the fourth quarter. Uncertainties also linger in the international situation, including the ongoing threat of terrorism and plans to invade Iraq. As the U.S. recovery slows, so too are Europe's export recovery and production, and signs of economic stagnation have started to appear.

Although Iraq has accepted the U.N. resolution on inspections, the U.S. is still poised to take military action if implementation is delayed. In the event of invasion, America's domestic demand will contract, sending repercussions to Japan's export-led economy. In looking at the possible economic impact of an invasion, the invasion of Afghanistan provides little reference because of the substantial effect of the September 11 terrorist attacks. As for the Gulf War, durable goods spending and residential investment both declined noticeably, but then quickly recovered when the multilateral forces put a quick end to the war. In the present case, if the invasion is concluded quickly, the economy will only slow down temporarily, and the impact on Japan will not be severe. However, a prolonged invasion not only puts the U.S. economy at risk, but threatens the global economy with surging oil prices, in which case the impact on Japan would be quite severe.

Figure 3　Contribution of Demand Components to U.S. GDP Growth

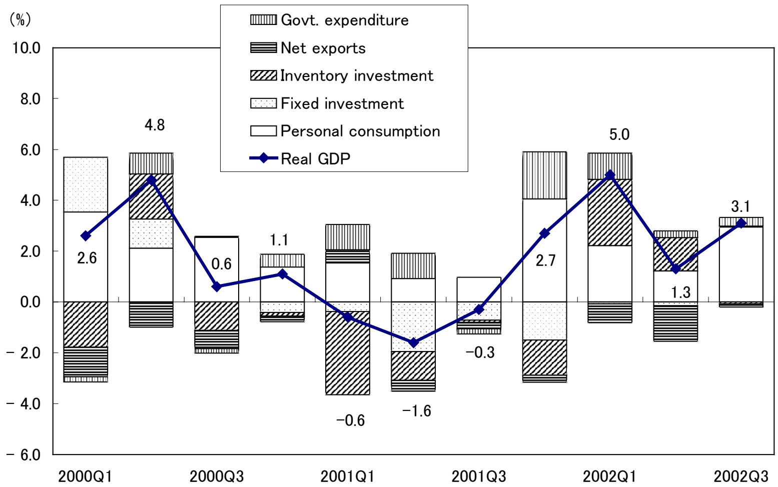
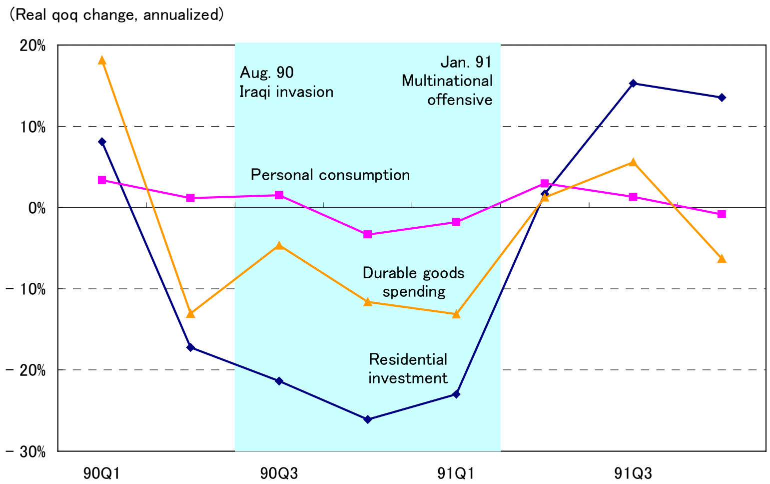


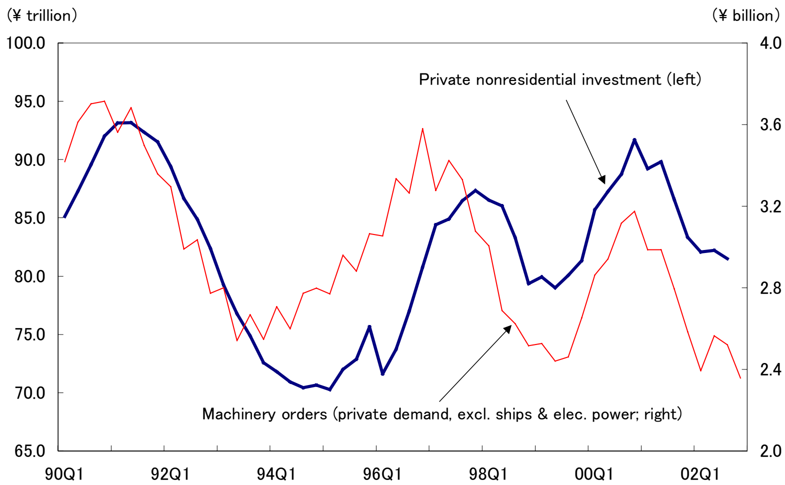
Figure 4　Contraction of Demand From the Gulf War



2.　Recovery Scenario for Capital Investment Looks Bleak

Capital investment began dropping in the first quarter of 2001, and the rate of decline slowed entering 2002 before turning positive in the second quarter to 0.2% year-on-year. However, machinery orders (private demand excluding ships and electric power)—a leading indicator for capital investment—rose 7.1% in the second quarter from the previous quarter, and then declined 1.7% in the third quarter, and is predicted to fall 6.5% in the fourth quarter. In the BOJ *Tankan* survey for September, planned capital investment at large manufacturing companies, which is usually revised upward during recovery, fell from the June survey, indicating that investment intentions remain weak. Corporate earnings are predicted to rise significantly in fiscal 2002, but gains could be pared back by an export slowdown in the second half of the year combined with losses from asset price declines. Weak external demand is spoiling the scenario in which industrial production leads to a recovery in capital investment.

Figure 5 Machinery Orders and Capital Investment



Note: Machinery orders for 02Q4 is a prediction.
Sources: ESRI, *Preliminary Estimates of National Expenditure*, and *Orders Received for Machinery*.

3. Sustainability of Consumption is Doubtful

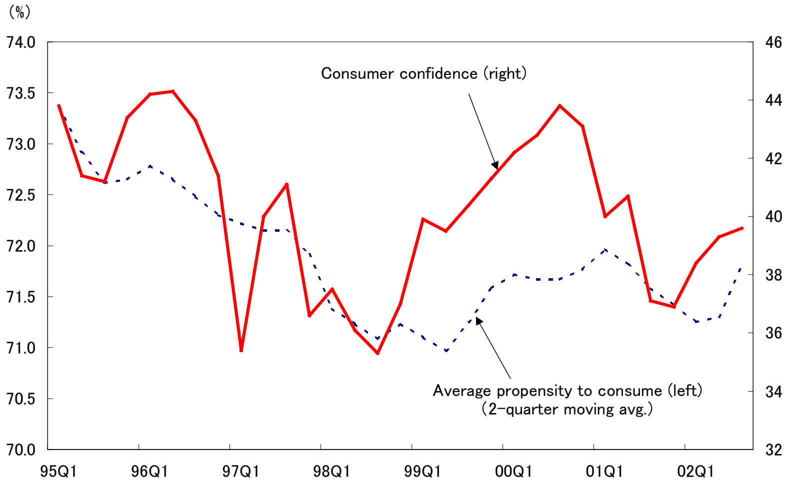
With unemployment rising and income stagnating, consumption growth will be limited ahead. Employee compensation has been declining year-on-year since Q3 of 2001 on a nominal basis, and since Q4 on a real basis.

Nonetheless, real private final consumption expenditure has risen persistently, which can be attributed to a rising propensity to consume. This occurred against the backdrop of rising consumer confidence based on favorable employment expectations in an improving economy. According to the Cabinet Office, the consumer confidence index bottomed out in December 2001 and has continued to rise since then, due largely to the jump in employment expectations from 19.8 to 30.6. More recently, in the September 2002 survey, consumer confidence improved again by 0.3 from June, this time because price expectations rose from 44.0 to 47.5, while employment expectations fell 1.6. During phases when prices are rising, a declining inflation rate tends to boost consumption intentions. But under today's deflationary conditions, since improvement in price expectations will not necessarily stimulate consumption intentions, there is a large possibility that consumer confidence is deteriorating.

Figure 6　Income Stagnates While Consumption is Firm

Source: ESRI, *Preliminary Estimates of National Expenditure*.

Figure 7　Consumer Confidence Index and Average Propensity to Consume



Sources: Ministry of Public Management, Home Affairs, Post and Telecommunications, *Family Income and Expenditure Survey*; ESRI, *Consumer Confidence Survey*.

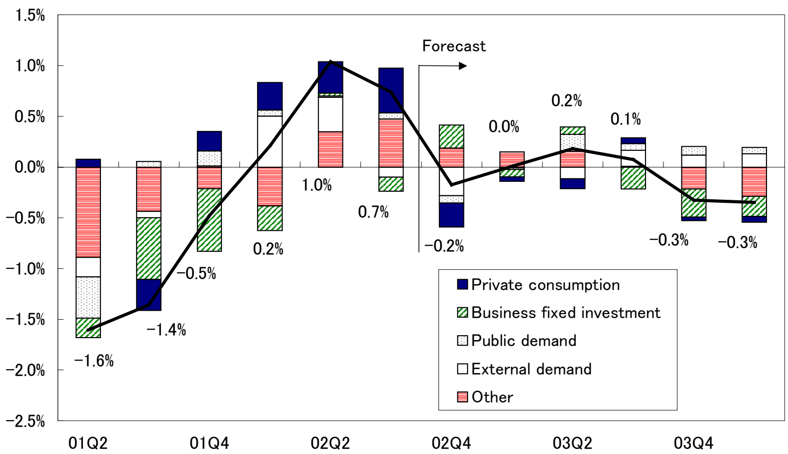
Summer bonuses fell by 5.9% from the previous year, and winter bonuses are also expected to drop significantly. Overall employee compensation will continue to fall as salaries decline at private companies and also induce declines for public employees at the national and local level. In addition, with increases scheduled for employment insurance and other social security burdens, growth in household disposable income will be restrained. In fiscal 2003, we expect companies to remain committed to cost reductions by cutting wages, and as long as the job environment fails to improve, wages will continue decreasing. Thus household income will act to restrain consumption.

4.　Economy to Grow 1.0% in Fiscal 2002

In fiscal 2002, Japan's exports of goods and services will grow an impressive 7.2% in real terms on the strength of the U.S. recovery and export growth to Asia. External demand is clearly driving the economy, contributing 0.5 percentage point to real economic growth. But as external demand weakens and exports slow, capital investment will fail to gain momentum, and fall 4.5% in real terms. With the economic recovery in early 2002 boosting consumer confidence, consumption continued to grow sequentially in the first half of fiscal 2002. However, consumption will turn negative in the October-December quarter due to smaller winter bonuses and a murky economic outlook. Residential investment, which has been declining on a year-on-year basis partly because of waning stimulus measures, is predicted to decline 1.8% for the fiscal year. Inventory adjustment, which contributed negatively to economic growth in fiscal 2001, will actually boost the economy in fiscal 2002 as the pace of adjustment eases. Private demand will grow 0.4%, contributing 0.3 percentage point to real economic growth, but with inventory investment contributing 0.4 percentage point, the growth is more fragile than it appears.

We expect the supplementary budget for the current fiscal year to augment the shortfall in tax revenue, establish a safety net in connection with the fallout from the accelerated disposal of bad loans, and provide an additional outlay of approximately ¥1 trillion for social infrastructure. Because the actual execution of most public works projects will be carried over into the next fiscal year, we predict that public investment will decline 5.2% in fiscal 2002. Despite stable growth of government consumption expenditure, public demand will contribute only 0.1 percentage point to real GDP growth.

Figure 8 Components of Real GDP Growth



Source: ESRI, *Preliminary Estimates of National Expenditure*.

2. Accelerated Bad Loan Disposal—Deflationary Pressure to Hamper Recovery

With Japan's economic recovery about to peak out and the possible invasion of Iraq complicating the U.S. economic outlook, the government on October 30 announced new Comprehensive Measures to Accelerate Reforms. While the media mistakenly refers to it as a comprehensive deflationary policy, the package actually aims to accelerate the disposal of bad loans through a Program for Financial Revival, and lacks measures that would directly impact deflation.

Due to persistent stagnation and deflation, Japan's ratio of bad loans to GDP is higher than in other countries, and so the effect of accelerating disposal on the real economy will be considerably larger. Moreover, in countries that have successfully dealt with bad loan disposal such as Sweden and Korea, large amounts of public funds were used in the process, and currencies were also depreciated significantly to boost exports and help support the economy. Japan has a large current account surplus, while its largest trading partner, the U.S., has a larger current account deficit than at the time of the Plaza Accord. And since Japan's economy is larger than that of Sweden or Korea, a major yen depreciation and export surge would seriously impact other economies, making this option unrealistic. Under these conditions, the massive disposal of bad loans could have unacceptably severe consequences for the economy.

In practice, since the new office for industrial revitalization seeks to revive companies gradually, deflationary effects would also be dispersed over time. We thus predict that the policy will contribute approximately -0.2 to -0.3 percentage point to economic growth in fiscal 2003, and push the unemployment rate up 0.2%. As external demand weakens, the risk of an economic downturn will loom large.

The additional deflationary pressure created by accelerated bad loan disposal, while partially alleviated by the supplementary budget and other measures, would still be enough to break the back of the already weak recovery. Since a deteriorating economy will generate new bad loans, progress in the bad loan problem will be more modest than the government's plan: to reduce the bad loan ratio of major banks to approximately half by fiscal 2004.

3. Near Zero Growth Predicted for Fiscal 2003

1. Economy to Peak Out

With external demand waning and consumption stagnating due to sluggish income growth and rising cost burdens, final demand will be lackluster. Even factoring in the scheduled corporate tax cut in the next fiscal year, the leveling off of production is likely to cause capital investment to resume its decline. Moreover, even if the supplementary budget this fiscal year contains additional public works spending, deflationary pressure accompanying bad loan disposal in fiscal 2003 will dampen the economy's growth from 1% in fiscal 2002 to near zero in fiscal 2003. The economic recovery will probably peak out in the spring of 2003, and unemployment will resume rising, reaching 5.9% by the end of fiscal 2003.

While capital investment temporarily stopped declining in mid 2002, investment intentions remain weak judging from machinery orders, a leading indicator for investment. In fiscal 2003, we predict that as external demand worsens and production peaks out, capital investment will decline 2.1%. Since wages and bonuses will continue falling as the unemployment rate rises and job environment deteriorates, both nominal and real household income will decline despite deflation. Moreover, with social security cost burdens also rising, real disposable income will decrease, causing consumption to decrease 0.2%. Amid the weak income environment, residential investment will remain almost level, declining 0.2%. Despite fiscal spending cuts to alleviate the fiscal imbalance, government consumption will continue to grow 2.4% due in part to rising medical costs associated with the aging society. Meanwhile, public investment will decrease 2.3% as local public works projects are curtailed. Given the fragile nature of the U.S. recovery, exports will dampen further, remaining almost unchanged at -0.3%. Despite a lower import growth rate of 0.5% due to the slowing economy, external demand will clearly wane, contributing -0.1 percentage point to the economy's growth rate.

2. Deflationary Policy

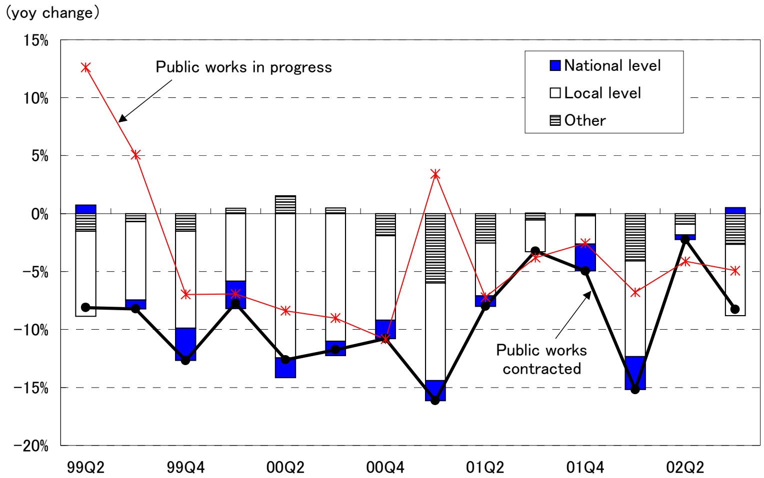
As deflation continues in fiscal 2003, we expect the Bank of Japan to implement even stronger quantitative easing measures. We predict that the BOJ will increase open market purchases of long-term JGBs from the present level of ¥1.2 trillion per month, and raise the target for deposits held at the BOJ from the present level of ¥15-20 trillion. As a result, interest rates will remain near zero in fiscal 2003. The quantitative easing policy, which has been gradually stepped up since March 2001, is not seen as having had a noticeable impact on deflation, nor is it expected to in the future. Despite growing pressure to adopt additional measures such as inflation targeting and purchases of foreign-denominated assets and stocks, the BOJ appears unlikely at present to undertake such action.

With regard to fiscal policy, we predict that the government will issue approximately ¥4-5 trillion yen of JGBs in the fiscal 2002 supplementary budget to augment the tax revenue shortfall, establish a jobs policy and other elements of a safety net, and fund approximately ¥1 trillion in additional social infrastructure spending. In the fiscal 2003 budget, a corporate tax cut will be implemented to spur capital investment. We assume that public investment spending, slated to be cut 3% in the initial budget request, will remain unchanged due to the severity of economic conditions in the next fiscal year. However, since public works spending at the local level will keep declining due to the poor fiscal conditions, even if public investment stops falling at the national level, total public investment in fiscal 2003 will still decline 2.3%.

Without the support of fiscal spending in the fiscal 2002 supplementary budget and fiscal 2003 budget, the economy faces significant risk of negative growth in fiscal 2003. Because the JGB issuance limit of ¥30 trillion has been abandoned, government debt will expand further.

However, this is inevitable if the economy is to avert a downward spiral.

Figure 9　Public Investment



Note: Bar graph shows composition of public works under contract.
Source: Ministry of Land, Infrastructure and Transportation, *Construction Statistics;* other.

Economic Forecast for Japan

(Unit: %)

	FY 2001 actual	FY 2002 forecast	FY 2003 forecast	02 Q2 actual	Q3 actual	Q4 forecast	03 Q1 forecast	Q2 forecast	Q3 forecast	Q4 forecast	04 Q1 forecast	Previous forecast (Sep. 2002) FY 2002
Real GDP (seq. chg.)	−1.8	1.0	0.1	1.0	0.7	−0.2	0.0	0.2	0.1	−0.3	−0.3	0.3
(seq. chg. annualized)				4.2	3.0	−0.7	0.0	0.7	0.3	−1.3	−1.4	
(yoy change)				−0.5	1.7	1.4	1.3	0.9	0.2	−0.5	−0.3	
Domestic demand (contrib.)	(−1.3)	(0.5)	(0.2)	(0.7)	(0.8)	(0.1)	(0.0)	(0.3)	(−0.1)	(−0.4)	(−0.5)	(−0.6)
Private	(−1.2)	(0.3)	(−0.1)	(0.7)	(0.8)	(0.2)	(0.0)	(0.1)	(−0.1)	(−0.5)	(−0.5)	(−0.7)
Public	(−0.1)	(0.1)	(0.3)	(0.0)	(0.1)	(−0.1)	(−0.0)	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)
External demand (contrib.)	(−0.5)	(0.5)	(−0.1)	(0.3)	(−0.1)	(−0.3)	(−0.0)	(−0.1)	(0.2)	(0.1)	(0.1)	(0.9)
Private final consumption exp.	1.3	1.2	−0.2	0.5	0.8	−0.4	−0.1	−0.2	0.1	−0.1	−0.1	0.8
Private residential investment	−8.0	−1.8	−0.2	−0.9	−0.2	−0.2	0.1	0.7	−0.7	−0.7	−0.8	−3.2
Business fixed investment	−4.7	−4.5	−2.1	0.2	−0.9	1.5	−0.5	0.5	−1.4	−1.8	−1.3	−3.9
Govt. final consumption exp.	2.6	2.7	2.4	0.6	0.9	0.8	0.8	0.5	0.3	0.7	0.5	2.5
Public investment	−6.7	−5.2	−2.3	−1.5	−1.6	−3.4	−2.4	1.4	0.2	−0.7	−0.3	−5.3
Exports	−8.0	7.2	−0.3	5.9	0.5	−2.1	−0.0	−0.6	0.7	0.9	0.8	10.1
Imports	−4.7	3.1	0.5	3.4	1.8	0.5	0.1	0.6	−0.8	−0.2	−0.5	2.3
Nominal GDP	−2.7	−0.6	−1.2	0.3	0.3	−0.5	−0.8	0.4	−0.1	−0.9	−1.2	−1.0

Major Economic Indicators

(Unit: %)

	FY 2001	FY 2002	FY 2003	2002 Q2	Q3	Q4	03 Q1	Q2	Q3	Q4	2004 Q1	Previous forecast FY 2002
Industrial production (seq.)	−10.2	3.2	−0.1	3.8	2.2	0.3	0.2	0.2	−0.6	−0.8	−1.5	3.1
Dom. wholesale prices (yoy)	−1.1	−0.9	−1.0	−1.2	−1.0	−0.7	−0.7	−0.8	−1.0	−1.0	−1.2	−1.2
Consumer price index (yoy)	−1.0	−0.8	−0.6	−0.9	−0.8	−0.8	−0.8	−0.6	−0.6	−0.6	−0.7	−0.8
CPI (excluding fresh foods)	−0.8	−0.9	−0.7	−0.9	−0.9	−0.8	−0.8	−0.6	−0.6	−0.7	−0.7	−0.8
Current account bal. (¥ tril.)	11.9	13.5	12.9	15.0	13.7	13.4	12.0	12.5	12.6	13.3	13.1	14.9
(ratio to nominal GDP)	(2.4)	(2.7)	(2.6)	(3.0)	(2.8)	(2.7)	(2.5)	(2.5)	(2.6)	(2.7)	(2.7)	(3.0)
Unemployment rate (%)	5.2	5.4	5.7	5.3	5.4	5.4	5.4	5.5	5.7	5.8	5.9	5.4
Housing starts (million)	1.17	1.13	1.12	1.17	1.13	1.13	1.11	1.12	1.12	1.11	1.11	1.14
10-yr JGB yield (OTC quot.)	1.4	1.1	0.9	1.4	1.2	1.0	1.0	1.0	0.8	0.8	0.8	1.4
Exchange rate (¥/$)	125	122	119	127	119	122	120	120	119	119	119	121
Oil price ($/barrel)	24	26	22	25	26	27	26	24	22	21	20	27

Economic Forecast for the U.S.

		2001 actual	2002 forecast	2003 forecast	2002 Q2 actual	Q3 actual	Q4 forecast	2003 Q1 forecast	Q2 forecast	Q3 forecast	Q4 forecast	2004 Q1 forecast	2002 forecast
Real GDP	(seq. ch. annualized)	0.3	2.3	2.1	1.3	3.1	0.9	1.9	2.5	2.9	2.9	3.1	2.3