Recession Looms Ahead as Weak External Demand and Consumption Reduce Economic Growth to 0.3% —FY 2003 Revised Economic Forecast

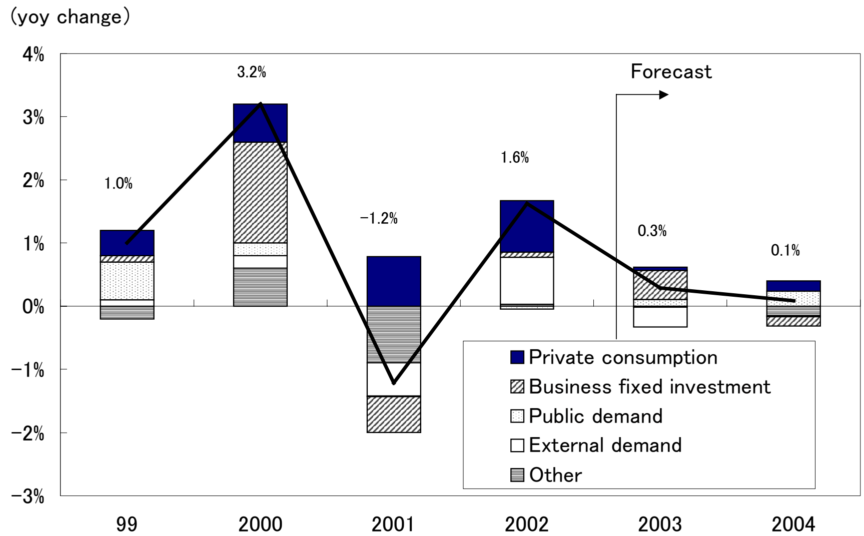
by the Economic Research Group

While real economic growth in fiscal 2002 rose to 1.6% from minus 1.2% in fiscal 2001, nominal growth remained negative at –0.7%. The decline in the GDP deflator widened, indicating that deflation has become even more pronounced.

In fiscal 2003, the economy will head into recession as external demand and consumption weaken. We predict that real economic growth will decline to 0.3%, and with no improvement in sight with respect to deflation, nominal economic growth will decline further to –1.5%.

Measures to stabilize the stock market such as the restriction of stock sales related to the reversion of the contracted-out portion of the Employees' Pension Fund to the government will help mitigate (temporarily) the vicious cycle of economic weakness and declining stock prices. To prevent deflation during this period, the overemphasis on monetary policy urgently needs to be corrected.

Real GDP Growth Rate



Source: Economic and Social Research Institute (Cabinet Office), *Preliminary Quarterly GDP*.

1. The World Economy After the Iraq War

(1) Uncertainty Lingers Despite War's Quick End

Although the Iraq war ended more quickly than most people had expected, the sense of uncertainty that has loomed over the world economy has not lifted.

According to preliminary GDP data released in April, the U.S. economy grew at an annual growth rate of only 1.6% in the first quarter of 2003, showing little improvement from 1.4% in the October-December quarter. Personal spending, which had slowed to 1.7% in the fourth quarter, failed to rebound, sinking to 1.4% due partly to concerns about the Iraq war. Capital investment, which had turned positive in the fourth quarter, returned to negative territory at –4.2%, revealing weakness in the corporate sector's recovery.

Oil prices, which climbed before the start of the war, fell once the war began in anticipation of a quick resolution. This minimized the potentially deleterious impact of high oil prices on the world economy. However, the Conference Board's consumer confidence index, which had plunged in March due to war tensions, improved significantly to 81.0 after the war's end, indicating that consumer confidence had improved. Still, this failed to lead to a recovery in consumer spending, as retail sales dropped –0.1% from the previous month amid sluggish auto sales. Moreover, the ISM index, which measure business sentiment (manufacturing), fell to 46.2 in March, and edged down again to 45.4 in April. The geopolitical uncertainty looming over the U.S. economy lifted somewhat after the Iraq war ended, but the economy still fails to meet expectations for recovery.

While the Iraq war has ended at least on the battlefield, the threat of terror still lingers. As seen by the suicide bombings in Saudi Arabia and Morocco in May, and the ongoing terrorist incidents in Israel, terrorism can erupt anywhere at any time. The world economy is still under threat from terrorism.

(2) New Threat of SARS

The SARS problem, which was overshadowed at first by the Iraq war, has grown into a major problem as the disease continues to spread quickly. Vietnam has successfully clamped down on the spread of infection, while Singapore and Hong Kong appear to have gained a handle on containing the disease, but the situation in Taiwan is not yet under control. The Asia Development Bank estimates that SARS will heavily impact economies that depend on tourism such as Hong Kong and Singapore, but have only a limited effect on other Asian economies. Based on these assumptions, we calculate that the decrease in exports to Asia will reduce Japan's GDP growth rate by 0.1%. While the decline in tourists from abroad will impact tourism and other industries in Japan, the overall impact on the economy will be limited, in part because more Japanese tourists will also choose to stay in Japan.

However, it is still unclear how long containment of SARS will take. Moreover, once contained, the disease could erupt again at any time. By making the international exchange of technical staff more difficult, SARS could impede technology transfer and curb economic growth in Asia. Not only Japanese firms but European and U.S. companies will have difficulty maintaining the existing international division of labor. As the economic impact of SARS deepens, economies could deteriorate, reducing Japan's exports.

Furthermore, as seen by the case in which a tourist from Taiwan entered Japan before his disease became evident, the rapid movement of people makes it difficult to stop infections at ports of entry. If the disease enters Japan and people start avoiding public places such as theaters and department stores, consumption is sure to decrease. In addition, if infection spreads to factories, factories will have to close down at least temporarily, halting industrial production. Thus the disease could potentially have serious repercussions.

(3) Stock Market Instability

Stock prices have continued to slide even after the so-called annual March crisis period at the fiscal yearend. On April 28, the Nikkei average fell to 7,607.88, precipitously close to the psychologically important 7,600 threshold. On May 14, the government held a cabinet level meeting on ways to invigorate the securities markets, and announced a set of policies for structural reform and invigoration of securities markets. While the thrust of the policies is commendable—they address the problem of stock sales accompanying the reversion of the contracted-out portion of the Employees' Pension Fund, and sale of shareholdings of banks—they do not go far enough.

The decline in stock prices following the collapse of the asset bubble occurred against the backdrop of a struggling economy. Moreover, efforts by the government to sustain stock prices failed to trigger a sustained recovery. Now a vicious cycle exists in which falling stock prices hurt corporate balance sheets by reducing corporate pension plan assets and expanding cross-shareholding losses, which stifles corporate activity, and in turn causes stock prices to fall further. Unless the vicious cycle is broken, the situation threatens to worsen and go out of control.

On May 17, the government convened the Financial Crisis Council, which decided to inject public funds into Resona Bank. The immediate cause of the crisis was a sharp decline in the bank's capital adequacy ratio due to stricter accounting rules for deferred tax credits. However, in the background was the bank's deteriorating financial condition as deflation triggered more bad loans, and prices declined for stocks, land and other asset holdings. Unless the vicious cycle of falling asset prices and deteriorating economy is broken, other financial institutions are at risk of facing the same dilemma.

The government needs to address the problem of stock sales accompanying the reversion of the contracted-out portion of the Employees' Pension Fund, and the sale of bank shareholdings—both of which distort supply and demand in the stock market—to break the vicious cycle of deterioration between the stock market and economy, while at the same time reducing the inordinate emphasis on monetary policy as a means to halt deflation.

2. Deflationary Tone Grows in Fiscal 2002 Economy

(1) Real Economy Grew 1.6% in Fiscal 2002

The real economy grew 1.6% in fiscal 2002, with growth being driven by external demand and consumption. As the U.S. economy recovered and growth in Asia increased, Japan's real exports grew an impressive 11.8%, and external demand contributed 0.7% to the real economic growth rate. Despite sluggishness in household income due to a –2.1% decrease in the nominal income of employed persons, falling prices and a recovery in consumer confidence prompted by the economic recovery increased the propensity to consume. As a result, private demand benefited from a 1.5% increase in real private final consumption expenditure, and the contribution of private demand improved significantly from –0.7% in fiscal 2001 to 0.9% in fiscal 2002.

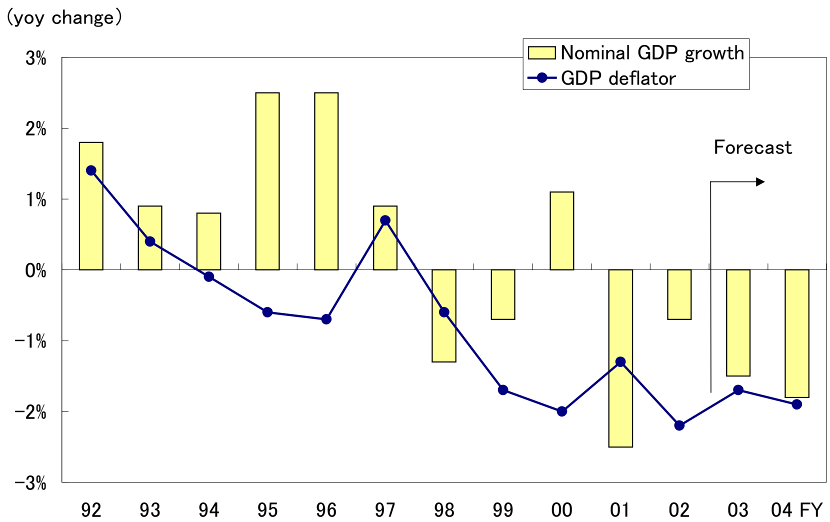
Export growth to the U.S. helped the economy initiate a recovery in early 2002, but the recovery lost momentum as industrial production, which had turned positive in late 2001, began to slow by the summer. As seen from the gradual decline in sequential real GDP growth from 1.3% in the April-June 2002 quarter to 0.0% in January-March 2003, the economy is losing strength.

(2) Deflation Becomes More Pronounced

Although real business fixed investment growth improved from –3.4% in fiscal 2001 to 0.5% in fiscal 2002, nominal growth remained negative at –3.5% because of an increase in the investment deflator from –2.8% to –4.0%. The GDP deflator, which reflects domestic inflationary factors and excludes the effect of import prices, decreased –2.2% in fiscal 2002, compared to –1.3% in fiscal 2001. More recently, the deflator decreased –3.5% year-on-year in the January-March quarter of 2003, compared to a –0.8% decrease in the same quarter of

2002. While this is partly attributed to a revision of the compensation system for public employees (the March bonus is being phased out), deflation is clearly worsening.

Figure 2　Nominal GDP Growth Rate and the GDP Deflator

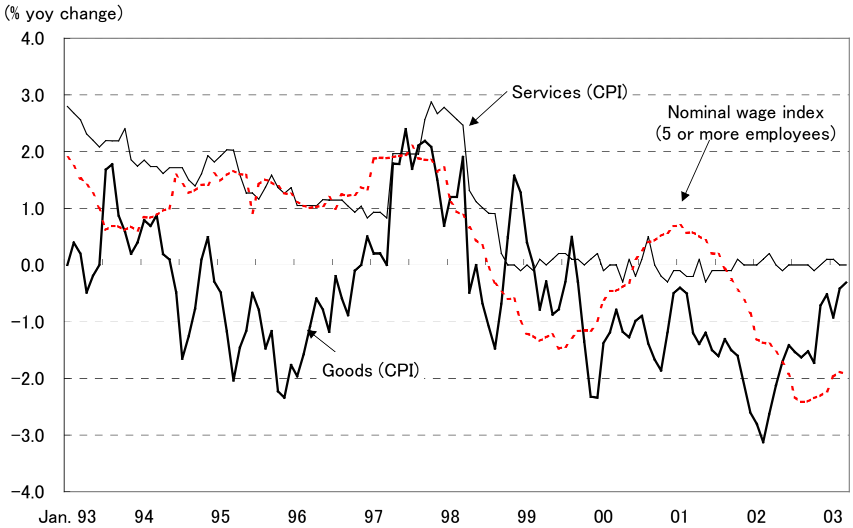


Source: ESRI, *Preliminary Quarterly GDP*.

Separating consumer prices into goods and services, we see that until 1998 the price of goods declined while that of services continued to rise. More recently, however, the price of goods has been falling, while that of services has been unchanged or falling as well. This reflects how wages increased until around 1997, but began falling from 1998.

Corporate earnings improved significantly in fiscal 1999 and 2002 due to restructuring. Cutting wage costs, which comprise a large proportion of the cost of providing services, allowed the price of services to decline. The simultaneous decline of the price of services and wages tends to pull down wages, and declining wages in turn pull down prices, thus increasing the risk of falling into a deflationary trap. In fiscal 2002, despite a decline in nominal wages, the rising propensity to consume helped prop up consumption. However, this condition cannot be expected to continue in light of the decline in consumer confidence. And according to the MHLW's monthly wage statistics, the wage decline widened from –1.6% in fiscal 2001 to –2.1% in fiscal 2002, while GDP data for income of employed persons also show a widening decline from –1.1% to –2.1%. Thus we see the potential threat of a vicious cycle that could decrease consumption.

Figure 3　Decline in Price of Services



Note: Nominal wage index shows change from year earlier as a trailing 12-month moving average.
Sources: Ministry of Public Management, Home Affairs, Posts & Telecommunications; Ministry of Health and Labor.

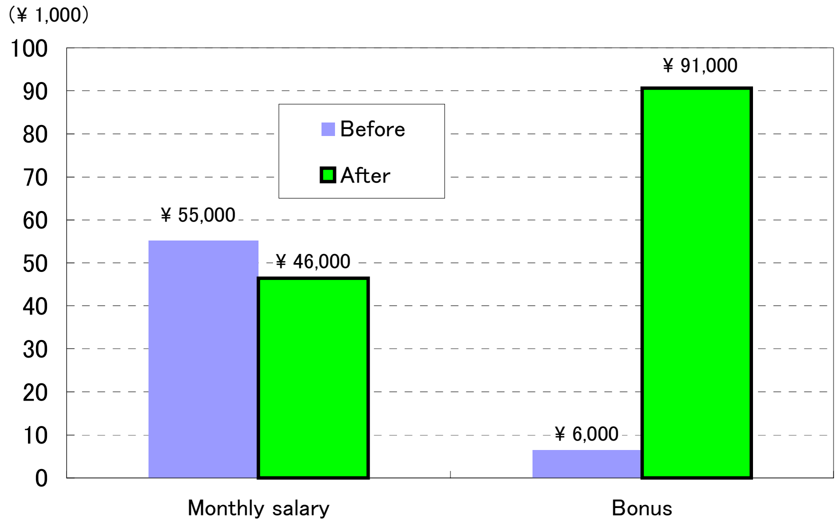
3. Recession in Fiscal 2003

(1) Consumption Concerns in Bonus Season

While external demand and consumption supported the economy in fiscal 2002, these two components appear shaky in fiscal 2003.

Taxes and social insurance premiums are slated to increase in the fiscal year, including long-term care insurance premiums and the tax on low-malt bear and cigarettes. The impact on the domestic economy will not merely come from the increased burden, but from the possibility that consumption patterns could change drastically with the transition to a new premium calculation method based on total compensation for pensions and health insurance. For example, consider a monthly income of ¥400,000, for which the typical summer and winter bonuses are two month's salary. For the Employees' Pension Plan and national health insurance plan premiums, participants will pay ¥9,000 less out of monthly salary, while the payroll deduction at bonus time will increase ¥85,000.

Figure 4　Social Insurance Premiums Before and After New Calculation Method



Source: NLI Research Institute

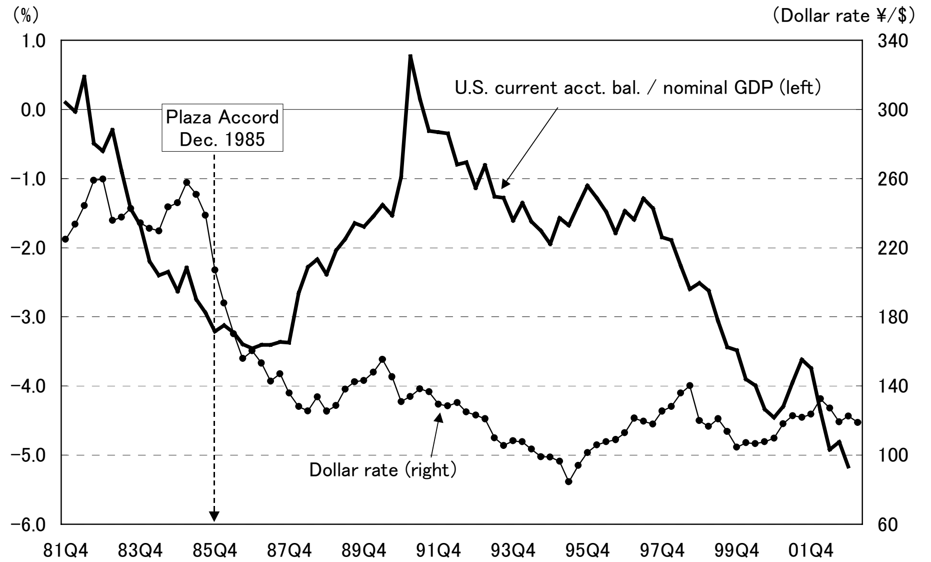
In this way, despite the increase in overall burden of LTC and health insurance premiums, payments in non-bonus months tend to decrease slightly, which will help prop up consumption in the April-June quarter. However, not all consumers will adjust their consumption activity to the sharp increase in social insurance premiums at bonus time. Since bonus payments, which are already declining, will be whittled down further by hefty payroll deductions for premiums, consumption is likely to dip in the July-September quarter. Consumption will also probably drop for the same reason in the winter bonus season in the October-December quarter.

(2)　Growing Risk of a Weak Dollar

The U.S. trade deficit in March ballooned to $43.4 billion, the second largest on record following last December. In the fourth quarter of 2002, the current account deficit amounted to 5.2% of nominal GDP, eclipsing by far the 3% peak in 1985 that was considered unsustainable and led to the dollar's sharp revision in the Plaza Accord. For the massive deficit to decline, either the dollar must drop again radically, or the U.S. economy will need to nosedive.

The U.S. economy's sustained expansion in the late 1990s triggered inflation amid tight supply and demand conditions, coupled with wage growth under high employment. The usual remedy for inflation is to tighten monetary policy and rein in the economy. However, since import prices fell as the dollar strengthened, inflation could be controlled without slowing down the economy. In addition, the strong dollar attracted funds from abroad, which propped up stock prices and stimulated household consumption through the wealth effect. In light of all these benefits, maintaining a strong dollar served the national interest well.

Figure 5 Ratio of Current Account Balance to Nominal GDP (U.S.) and the Dollar Rate



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

However, conditions have changed so radically that even cutting the federal funds rate from 6.5% to 1.25% has failed to revive the economy. With oil prices declining after the Iraq war, inflation is no longer the key concern; following the FOMC meeting on May 6, the FRB released a statement hinting at the possible risk of deflation. Given the incentives to weaken the dollar—a weak dollar would boost exports and reduce imports, thereby reducing the balance of payments deficit and contributing to economic recover—a gradual decline in the dollar will probably be condoned by the U.S.

The euro, which had continued to slide since its inception, at one point climbed to $1.17 against the dollar. While proponents of a strong euro argue that it will suppress inflation, the strong euro will actually hurt Germany's economy most by dampening exports, and delay economic recovery of the euro zone. Given the euro's sustained strength amid the strong yen and weak dollar, even the yen has weakened against the euro, making Japan's exports to Europe increasingly profitable. However, given the weakness of economic recovery in the euro zone, we predict that the euro's appreciation against the dollar will moderate. We also predict that the yen will appreciate modestly against the dollar to ¥110 at the end of fiscal 2004, and appreciate slightly against the euro as well.

With a slow recovery expected for the U.S., growth in private demand for funds is unlikely to cause a surge in long-term interest rates even with large sustained fiscal deficits. On the other hand, if the U.S. stock market grows pessimistic about economic recovery, and fewer funds flow into the U.S., long-term interest rates will probably decline by less than short-term interest rates regardless of monetary easing. In the worst case scenario, the danger is that fund inflows to the U.S. dry up, and the dollar plunges while long-term interest rates rise, further crippling the economic recovery.

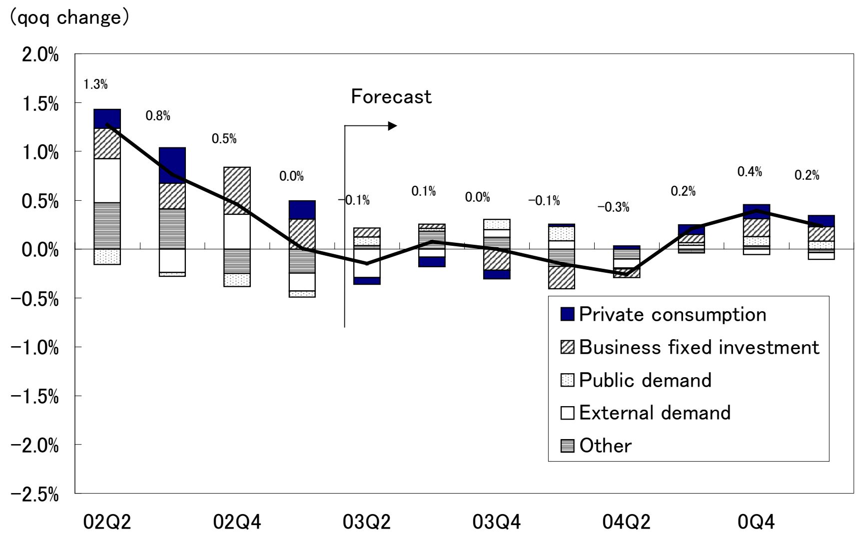
(3) Economy to Slow to 0.3% Real Growth Rate in FY 2003

The fact that the U.S. economy is not recovering as rapidly as expected following the quick end to the Iraq war, along with the impact of SARS on Asian economies, will cause Japan's exports to continue slowing down, bringing the export-led recovery to an end. Moreover, as mentioned earlier, consumption growth can no longer be counted on to support economic growth. The economy will peak out in the April-June quarter, and then inescapably head toward recession. The recovery that began in early 2002 will thus end abruptly after one and a half years, making it the shortest recovery of the postwar era. Since the usual inventory buildup and excessive capital investment of past economic recoveries will not occur, post-recovery adjustments will be minor barring any external shocks such as the spread of SARS or a dollar plunge, and internal shocks such as renewed financial system instability. The economy should start to turn upward again around summer 2004.

In fiscal 2003, as external demand weakens, export growth will turn negative to –1.0%, down from 11.8% in fiscal 2002, while domestic demand will suffer as consumption endures sluggish income growth, higher taxes, and higher social insurance premiums. We thus predict the economy's growth rate will slow to 0.3%. The economy will stop slowing in fiscal 2004, but achieve real growth of only 0.1%. Unemployment will increase again, reaching 6% at the end of fiscal 2003, and 6.3% at the end of fiscal 2004.

As wages and bonuses continue to fall in fiscal 2003, we predict real household income will shrink in both nominal and real terms. In addition, rising social premiums will reduce real disposable income, limiting consumption growth to only 0.1%. Amid sluggish income growth, residential investment will continue to struggle, declining –3.5%. Business fixed investment will grow 2.9% in real terms, while the nominal decline of –1.5% will be smaller than in fiscal 2002. While GDP data for the April-June 2003 quarter will be positive due to technical factors, no end is in sight for deflation, and the economy's nominal growth rate will be negative for the third and fourth straight year in fiscal 2003 and 2004 at –1.5% and –1.8% respectively.

Figure 6　Real Quarterly GDP Growth Rate



Source: ESRI, *Preliminary Quarterly GDP.*

(4) Quantitative Monetary Easing—Direction and Limitations

Since March 2001, the Bank of Japan has strengthened its quantitative monetary easing policy—without the expected results. There has been a significant increase in paper currency and other cash, and current account deposits held at the BOJ—one of the BOJ's policy targets—and the monetary base (high-powered money) has grown substantially. However, the closely followed money supply indicator of M2+CD fell 1.4% year-on-year in April.

While we remain skeptical that continued quantitative easing alone will overcome deflation, this policy is strongly supported by international organizations such as the IMF as well as economists in Japan and abroad. Thus we expect the BOJ to continue pursuing quantitative easing. However, we think that expanding the purchase of long-term JGBs has reached a point of becoming detrimental.

The interest rate on long-term (10-year) JGBs, which stood at slightly under 0.9% at the beginning of this year, fell below 0.6% in May. The interest rate on 30-year JGBs also fell below 1%, so that all JGB interest rates are now below 1%. As investment opportunities shrink, declining interest rates are forcing financial institutions to shun short-term bonds in favor of the higher returns of long-term bonds. This investment behavior is based on the expectation that the long-term interest rate will not rise for the time being because the BOJ is increasing the purchase of long-term JGBs.

Typically, long-term interest rates are thought to reflect average predicted short-term rates in the future; the yield curve thus reveals the future short-term interest rate path predicted by market participants. According to recent yield curves, the market apparently predicts that the short-term interest rate will rise to only about 1.5% in the next twenty years. This means that Japan's economy is not expected to break out of the post-bubble slump for the next twenty years. However, we believe Japan is likely to recovery more quickly.

If Japan manages to overcome deflation, the long-term interest rate will rise. This will generate capital losses for long-term JGBs and deal a severe blow to the financial system. This type of risk will grow if the BOJ pursues quantitative easing solely by increasing purchases of long-term JGBs. Critics argue that diversifying into other types of assets will cause distortions in the respective markets. However, considering the magnitude of risk in quantitative easing that is limited to the purchase of long-term JGBs, the BOJ needs to study the potential problems that could emerge in other markets, and aggressively seek to diversify asset purchases.

(A revised economic forecast reflecting the second quarterly estimate of GDP scheduled for release on June 11 will be issued on June 13. Our detailed forecast for Europe and the U.S. will be issued on June 20.)

Forecast for the U.S.

		2002	2003	2004	2003				2004			
					1–3	4–6	7–9	10–12	1–3	4–6	7–9	10–12
		act.	fore.	fore.	act.	fore.	fore.	fore.	fore.	fore.	fore.	fore.
Real GDP	% seq. chg., annualized	2.4	2.1	2.9	1.6	1.9	2.8	3.0	3.1	2.9	2.8	2.7

Forecast for the Euro Zone

	Unit	2002	2003	2004	2003				2004			
					1–3	4–6	7–9	10–12	1–3	4–6	7–9	10–12
		act.	fore.	fore.	act.	fore.	fore.	fore.	fore.	fore.	fore.	fore.
Real GDP	% yoy change	0.8	0.7	1.6	0.8	0.6	0.5	0.8	1.3	1.6	1.8	1.9

Forecast for Japan

(Unit: %) Previous (Mar. 03)

	FY 02 actual	FY 03 forecast	FY 04 forecast	2003/4-6 forecast	7-9 forecast	10-12 forecast	2004/1-3 forecast	4-6 forecat	7-9 forecast	10-12 forecast	2005/1-3 forecast	FY 03
Real GDP	1.6	0.3	0.1	-0.1	0.1	0.0	-0.1	-0.3	0.2	0.4	0.2	0.4
				-0.6	0.3	0.0	-0.6	-1.0	0.8	1.6	1.0	
				1.1	0.4	-0.1	-0.2	-0.3	-0.2	0.2	0.6	
Domestic demand (contrib.)	(0.9)	(0.6)	(0.1)	(0.1)	(0.2)	(-0.1)	(-0.2)	(-0.2)	(0.2)	(0.5)	(0.3)	(0.4)
Private demand	(0.9)	(0.5)	(-0.1)	(0.1)	(0.1)	(-0.2)	(-0.4)	(-0.2)	(0.1)	(0.4)	(0.2)	(0.2)
Public demand	(-0.0)	(0.1)	(0.2)	(0.1)	(0.0)	(0.1)	(0.1)	(-0.0)	(0.0)	(0.1)	(0.1)	(0.2)
External demand (contrib.)	(0.7)	(-0.3)	(-0.0)	(-0.3)	(-0.1)	(0.1)	(0.1)	(-0.1)	(0.0)	(-0.1)	(-0.1)	(0.0)
Private final consumption exp.	1.5	0.1	0.3	-0.1	-0.2	-0.2	0.0	0.1	0.2	0.3	0.2	-0.2
Private residential investment	-2.9	-3.5	-0.0	-1.9	-0.6	0.6	-0.4	0.0	-0.1	0.5	-0.6	-1.4
Private business fixed invest.	0.5	2.9	-0.9	0.5	0.3	-1.3	-1.4	-0.5	0.5	1.1	0.9	0.6
Govt. final consumption expend.	2.2	2.0	1.9	0.4	0.1	0.6	1.0	0.0	0.4	0.7	0.7	2.0
Public investment	-6.5	-4.0	-1.4	0.3	0.1	0.1	-0.3	-0.3	-0.7	-0.3	-0.7	-2.4
Exports	11.8	-1.0	0.3	-2.1	-1.3	0.5	0.6	-0.5	0.7	-0.1	-0.1	2.1
Imports	5.7	2.2	0.6	0.5	-0.8	-0.3	-0.2	0.3	0.5	0.5	0.6	2.2
Nominal GDP	-0.7	-1.5	-1.8	0.3	-0.5	-0.9	-1.0	0.2	-0.5	-0.4	-0.7	-1.1

Note: For real GDP, top number is sequential change, middle number is sequential change annualized, bottom is yoy change. All other demand side numbers are sequential change.

Major Indicators

(Unit, %) Previous

	FY 02	FY 03	FY 04	2003/4-6	7-9	10-12	2004/1-3	4-6	7-9	10-12	2005/1-3	FY 03
Industrial production (consec.)	2.6	0.2	-0.2	0.2	-0.7	-0.4	-0.7	-0.2	0.5	0.7	0.5	-0.1
Domestic wholesale price (yoy)	-1.6	-1.4	-1.9	-0.9	-1.2	-1.5	-2.0	-2.2	-2.1	-1.8	-1.7	-0.8
Consumer price (yoy)	-0.6	-0.7	-1.0	-0.3	-0.5	-0.8	-1.0	-1.0	-1.0	-0.9	-0.8	-0.7
Consumer price (ex. fresh food)	-0.8	-0.7	-1.0	-0.5	-0.6	-0.7	-0.9	-1.0	-1.0	-1.0	-0.9	-0.7
Current acct. balance (¥ tril.)	13.3	11.1	9.8	12.0	11.2	10.4	10.9	11.4	10.3	9.1	8.3	12.6
(ratio to nominal GDP)	(2.7)	(2.3)	(2.0)	(2.4)	(2.3)	(2.1)	(2.2)	(2.3)	(2.1)	(1.9)	(1.7)	(2.6)
Unemployment rate (%)	5.4	5.7	6.2	5.5	5.5	5.7	6.0	6.1	6.2	6.3	6.3	5.8
Housing starts (million)	115	1.11	1.08	1.12	1.11	1.11	1.09	1.09	1.08	1.09	1.08	1.11
10-yr govt. bond yield (OTC)	1.1	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7
Exchange rate (¥/$)	122	116	111	118	117	115	114	112	110	110	110	119
Oil price ($/barrel)	27	24	21	26	24	23	22	21	21	21	21	24

Sources: ESRI, *Quarterly Estimates of GDP*; METI, *Industrial Indices*, MPMHAPT, *Consumer Price Indexes*; other.