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Revised Economic Forecast for Fiscal 2003

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The Economy Today: Clear Signs of Economic Stagnation as 1st Quarter Brings Zero Growth

The growth rate for January-March 2003 was 0.0%, confirming perceptions that the economy has been treading water. Closer examination reveals that, although capital investment rose for a fourth consecutive quarter, buoying the economy to some extent and consumer spending somehow or other managed to maintain a positive trend, the fact that negative exports made a negative contribution for the first time in two quarters and the acceleration of the downward trend in public investment and housing investment exerted downward pressure on the growth rate. The movements of the major elements of demand were as follows.

(i) Consumer Spending

Although income conditions continued to deteriorate and consumer confidence weakened, sales of passenger cars remained at a high level on the strength of the demand rush ahead of impending changes to the "Green Tax" system and sales of cellular phones with built-in cameras and new digital consumer electronics, etc., were firm, leading to a slight overall rise in consumer spending.

(ii) Capital Investment

Thanks to a recovery in equipment utilization ratios and business results and the bottoming out of the decline in software investment and other IT-related investment, figures for capital investment rose for a fourth quarter. However, owing to the decline in the pulling power of redevelopment projects in the metropolitan area (office building and subway construction, etc.), the growth rate slowed to some extent.

(iii) External Demand

Although exports to Asia saw continued growth, centering on electronic devices and capital goods, exports of automobiles to the United States fell sharply, and overall export figures fell for the first time in five quarters. Amidst signs of a recovery in domestic private-sector demand, the rise in procurement from Asia brought continued import growth.

Risk Factors: the Impact of SARS

The SARS epidemic has affected the Japanese economy as follows.

(i) On the negative side, although the impact of the fall in exports as factories in regions where there have been SARS outbreaks have been forced to suspend production or reduce their output is expected to be relatively small, there are considerable grounds to fear a fall in exports due to the sharp fall in local consumer spending. Although consumption goods account for only a small proportion of exports to Asia, it is highly likely that the fall in consumer spending will exert a downward pressure on Japan's exports by leading to a slump in business activity and a fall in exports of capital goods and components.

(ii) On the positive side, it is possible that the fall in demand for travel to Asia will be offset by a rise in demand for domestic travel. However, as the fall in the volume of overseas travel is also affecting the sales of Japanese travel agents, airlines, etc., and the demand for domestic travel in place of overseas travel would be equivalent to only around 0.2% of GDP, there is little hope of a major boost to the economy.

Looking to the future, the deceleration of the economy due to the fall in income from overseas travel to Asia and the fall in consumer spending within Asia are likely to reduce exports to Asia by 2.5% (negative impact on GDP: 0.1%).

In the medium-to-long term, it is likely that the business sector will begin to reconsider its exclusive focus on China as a location for overseas bases. A number of Japanese companies have already delayed the start of local production. Direct investment in China has peaked and there are grounds to fear that the economic pulling power of capital investment and industrial output by foreign companies will decline. It is even possible that some Japanese firms will judge that the risk of establishing bases in China is too high and will sacrifice low costs by reverting to domestic production and procurement, leading to a fall in the import penetration ratio.

However, although the rush to establish bases in China may see a temporary reversal, the huge growth potential of the market means that China remains a highly attractive target for investment. In the long term, it is likely that the developed nations, including Japan, will continue to invest in China at a steady pace.

Outlook: Japanese Economy Likely to Remain Weak in 1st Half of Fiscal Year, but Avoid Significant Deterioration

Looking to the future, it is likely that the Japanese economy will remain weak in the short term, for the following three reasons.

(i) The continued deflationary trend and decline in the expected growth rate make it difficult for the economic recovery mechanism whereby earnings and income growth leads to increased capital investment and consumer spending to operate.

(ii) Amidst continued stagnation of share prices and growing uncertainty as to the future trend of the financial markets, business and consumer confidence remain weak.

(iii) The fall in consumer spending throughout Asia, amidst rapidly spreading fears over SARS, has accentuated the economic slowdown, and the economic pulling power of exports to Asia is declining.

However, the business sector has made a sustained effort to restructure in recent years. Ratios of operating profit to sales are at their highest level since the bursting of the bubble economy, and business efficiency is improving steadily. In the household sector, efforts to develop new products on the part of manufacturers and the rise in real incomes due to deflation (the "Pigou effect") are helping to keep consumer spending steady. Given these considerations, as long as external shock factors do not increase in severity, it is likely that Japan will be able to avoid the kind of sharp economic downturn it suffered in 1998 and 2001.

Turning to the second half of fiscal 2003, assuming that business income continues to rise on the strength of enhanced profitability, it is possible that the economy will see the beginnings of a gentle recovery. However, depending on the trend of share prices and the SARS epidemic, there is still a risk that the economy will slip into recession.