



**JRI news release**

**A Revised Economic Forecast for FY 2003-2004: Making the Transition from  
Dealing with the Negative Legacy of the Past to Creating New Industries**

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**The Japan Research Institute, Limited**

**Economics Department, Economic Research Center**

**<http://www.jri.co.jp/>**

Tokyo Head Office: 16 Ichiban-cho, Chiyoda-ku, Tokyo 102-0082, Japan

Tel: +81 (0)3-3288-4700 (switchboard)

Osaka Head Office: 1-5-8 Shinmachi, Nishi-ku, Osaka 550-0013, Japan

Tel: +81 (0)6-6534-5111 (switchboard)

For more information on the content of this report, please contact

Hideki Matsumura or Hisashi Yamada, Economics Department

Tel: 03-3288-4524/4245

E-Mail: [matsumura.hideki@jri.co.jp](mailto:matsumura.hideki@jri.co.jp)

[yamada.hisashi@jri.co.jp](mailto:yamada.hisashi@jri.co.jp)

Due to the slowing of export growth, the Japanese economy has been treading water since early 2003. Moreover, given the slow recovery of the US economy and the persistence of the negative effects of the SARS epidemic, the future trend of exports is also uncertain. Domestic private-sector demand, although not strong, has remained unexpectedly firm, largely on the strength of capital investment.

Judging from the movements of foreign economies, there is little hope, in the short term, that exports will provide the pulling power for economic growth. Although the US economy is likely to turn upwards as autumn begins, thanks to tax cuts and the recovery of the business sector, considering the weak labor market, the mounting level of debt in the household sector and the peaking in rises of housing prices, the pace of economic recovery is likely to be slow. The euro zone economies are expected to see low growth in the short term due to the deterioration of export conditions, including the strengthening of the euro. In East Asia, besides a slowing of export growth, the persistent effects of the SARS epidemic mean that full-scale economic recovery is likely to take some time.

Although the rate of deflation has slowed in recent months, the continued existence of a substantial supply-demand gap and the impact of the inflow of cheap imports mean that the deflationary trend is likely to become long-term. The persistence of this deflationary trend makes it difficult for the economic recovery mechanism whereby recovery of profit and incomes leads to growth of capital investment and consumption to function, and hampers economic recovery.

However, it is unlikely that the economy will suffer a slump on the scale seen in 1998 or 2001. In the business sector, because pressure for inventory adjustments has fallen substantially and the rise in profit rates is likely to continue, capital investment is unlikely to see a sharp fall. In the personal sector, although income conditions continue to deteriorate, partly due to the raising of social insurance contributions, the boost to consumption provided by the rise in real asset values as a result of deflation and the stimulation of propensity to consume by the introduction of new products including digital consumer electronics should help to support consumer spending.

Given this perception of the issues, the outlook is that, in the short term, the Japanese economy will see little growth, largely as a result of the decreased pulling power of external demand. As fiscal 2004 approaches, assuming no major crises among foreign

economies, the economy will begin to recover at a gentle pace, on the strength of firm capital investment and consumer spending, led by a recovery in business profits.

Over the past few years, Japanese companies have been making steady progress in responding to economic deterioration and, gradually, conditions are being established that will allow them to begin to respond in a more forward-looking manner. Improvements in profitability now mean that it is possible to secure a profit even when sales fall and, in some industries, there are signs of a movement to maintain and expand domestic production so as to take advantage of Japan's unique strengths.

However, the work of strengthening profitability is still in progress, and, owing partly to regulation, it is still difficult for the business sector as a whole to make the transition to a forward-looking stance. The key to resolving these problems, lie in a full-scale drive to achieve business revitalization, through the agency of the Industrial Revitalization Corporation of Japan (IRCJ), and the promotion of deregulation, using special zones for structural reform as a foothold.

Given this view of the situation, it is clear that the Japanese economy is now at a stage where the government should implement powerful measures to promote business revitalization with a view to completing the task of dealing with the "negative legacy of the past" and simultaneously, seek to make the transition from an approach that focuses on dealing with the "negative legacy of the past" to one that focuses on "creating new industries". Moreover, given that deflation is highly likely to become a long-term phenomenon, it is urgent that the government take radical action to allay fears over the future by redesigning Japan's systems and infrastructure, including the social security system, to ensure that they are sustainable even in a climate of deflation.

On the macroeconomic policy front, given the persistent tendency of the economy to weaken, it is vital that government maintain a basically neutral stance, and be prepared to take a more expansive stance should the risk of a further economic downturn increase.