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A Revised Economic Forecast for FY 2003-2004

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Recovery Set to Become Clearer as Second Half of Fiscal Year Begins

In the short term, owing to the cool weather during the July-September quarter, among other factors, it is highly likely that the economy will slow for a time. However, the continued growth of domestic private sector demand, centering on capital investment, and the increased pulling power of exports due to the recovery of foreign economies suggest that the economic recovery is set to become clearer, once more, as the second half of the fiscal year begins.

- Owing largely to the fall in the prices of capital goods such as computers, the capital investment deflator has seen a sharp fall, which continues to provide a substantial boost to capital investment on a real basis. Against the background of a recovery in business profits and firm domestic private demand, it is possible that capital investment will also recover on a nominal basis.

- As the deterioration of employment and income conditions bottoms out, consumer spending is holding steady overall, helped by a recovery in consumer confidence, among other factors.

- The number of housing starts is likely to rise as autumn approaches, due to a demand rush ahead of the deadline for preferential tax treatment of housing loans and the rise in interest rates. This increased level of housing construction is set to provide a boost to the economy for the remainder of the fiscal year and, in late 2003/early 2004, when the completion of construction work will be concentrated, demand for consumer durables is likely to rise.

- Thanks the recovery of the US, European and Asian economies, exports to those destinations are likely to turn upwards, and exports of plant to the Middle East, from which the level of orders has risen in recent months, are also likely to pick up in earnest. The boost to capital investment in the manufacturing sector provided by this recovery in exports is likely to become apparent from early 2004.

This economic recovery scenario is basically set to continue in fiscal 2004. However, the growth rate is likely to slow due to (i) the slowing of the growth of investment in computers, which drove economic recovery in fiscal 2003, (ii) a fall in the number of housing starts, in the wake of the 2003 demand rush and (iii) the slowing of the pace of recovery of foreign economies.

There are two major reasons for this substantial upward revision of the forecast of economic growth as compared with two months ago (as of July 4, the forecast was for 0.4% growth in 2003 and 0.8% growth in 2004):

(i) Domestic private demand has avoided moving into an adjustment phase, and the recovery of foreign economies has been faster than expected. On the domestic private demand side, the growth of sales of cellular phones and digital consumer electronics and of spending on services in the household sector has accelerated while, in the corporate sector, orders for machinery, which were expected to fall in the April-June quarter, have seen a substantial upward revision. The recovery of the US economy has started to accelerate thanks to the substantial boost to consumer spending provided by tax cuts, among other factors.

(ii) Another important factor, besides this recovery in the real economy, is the acceleration of the weakening of deflators, which has boosted the real growth rate. In other words, owing partly to the improvements in quality, centering on computers, which have contributed to the weakening of the deflators (a rise in real value being equivalent to a fall in price) and partly to the recovery of IT-related investment, the deflators have seen a substantial fall, especially in capital investment (nominal and real GDP have moved far apart). For this reason, it is important to remember that the real growth rate tends to appear higher than it is in reality.[1]

The key factor to be considered when examining the prospects for a sustained recovery of the Japanese economy is the fact that the emphasis in capital investment by Japanese companies has shifted from “quantity” to “quality”. For an increasing number of companies the first priority is to increase their return on capital investment by boosting IT-related investment as a proportion of all capital investment, focusing on high-return business areas and high-performance equipment, and disposing of obsolete equipment. It is increasingly clear that the rise in the number of companies that have shifted the emphasis of their investment activities to “quality” is leading to a “polarization” in capital investment, between “growth areas” (manufacturing industry) and “receding areas” (non-manufacturing industry).

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[1] See “Reasons for the Unexpectedly High Level of Real GDP — The need for economic policy to take nominal GDP into consideration —“ (September 2, 2003).

Looking to the future, it is highly likely that the recovery potential of consumer spending, which holds the key to the recovery of the “receding areas” (non-manufacturing industry), will remain low, and that the polarization between a strong manufacturing sector and a weak non-manufacturing sector will persist. Against a background of continued deflation, it is likely that the recovery of confidence in the economy in the non-manufacturing sector will be limited, and even possible that the pattern of recovery will be a “jobless” one, i.e. that employment conditions will be slow to improve. This weakness in the economy constitutes an ever-present risk that an external shock, such as a slowdown among foreign economies, will bring the present recovery phase to an untimely end.

To achieve a full-scale recovery in capital investment, it is vital that Japan make a renewed effort to transform the structure of its industry, especially the non-manufacturing sector, and make all possible haste in building a stronger economy, capable of withstanding external shocks.[2]

[2] See “Structural Changes in Capital Investment Behavior and the Prospects for Full-Scale Economic Recovery — A ‘jobless recovery’ with capital investment firm on a real basis but weak on a nominal basis —“ (September 11, 2003).