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The Medium-Term Outlook for the Japanese Economy (FY 2004-2008)
— Establishing a New Pattern of Sustained Growth —

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Overview

The Japanese economy entered a recovery phase early in 2002 and, although slowing for a time, has basically maintained a gentle pace of recovery ever since. The basic scenario is the same as in the last recovery phase: delayed recovery of the nominal growth rate but a rise in the real growth rate due to a sharp fall on the part of the GDP deflator. However, a salient characteristic of the present recovery is that it was triggered by a rise in private sector demand rather than by large-scale fiscal mobilization.

Over the next five years or so, the attenuation of the various negative factors that have obstructed self-sustaining recovery for the past decade attenuate is likely to halt the downward trend of the economy, allowing Japan to take tentative steps towards the establishment of a new growth trend.

Until now, the industrialization of Asia has tended to have a detrimental effect on the Japanese economy, contributing to a contraction of Japan's manufacturing base and a rise in the ratio of reverse imports. However, as Japanese companies have established a relative advantage in "matching and combination techniques" the negative impact of the first wave of full-scale industrialization in Asia has abated. In future, Asia's industrialization is likely, if anything, to have an increasingly positive effect, leading to the establishment of a "new growth pattern" in which the rapid economic growth of the region contributes to the expansion of Japan's exports. The financial situation of Japanese companies is improving, especially among big companies and in the manufacturing sector. Balance sheets show a substantial reduction in the level of excess debt and capital equipment, and the ratio of ordinary profit to sales is at its highest since the collapse of the bubble

economy. The supply-demand gap is narrowing, general price deflation is gradually abating and the decline of average wages is slowing. With share prices and some land prices in city centers showing signs of recovery, the problem of asset deflation also seems to be receding. Thanks to the fall in deflationary pressure, banks have overcome the worst of the problem of non-performing loans.

As to the course of the Japanese economy in fiscal 2004-2008, the recovery is likely to continue during the first half of fiscal 2004, particularly in the corporate sector, which is likely to see profits improve thanks to the firm performance of overseas economies and the effects of restructuring. In the second half of fiscal 2004 and 2005, the economy is likely to undergo a degree of adjustment as the US and Chinese economies decelerate. However, the growth of trade within Asia and the improved financial standing of Japanese companies means that basic conditions will remain favorable, and a major slump is likely to be avoided. For fiscal 2006-2008, although the continued drive to rebuild public finances will reduce public sector demand and have a negative impact, the various structural pressures for adjustment are gradually diminishing and the economy is basically set to follow a gentle upward trend. Deflationary pressures will remain, but will gradually weaken and the nominal growth rate should turn positive by around 2006. Consumer prices (excluding consumption tax) are likely to pull out of their downward trend in fiscal 2008.

Thus, on a real GDP basis the economy is set to maintain a gentle upward trend, but on a nominal GDP basis it is likely to remain at much the same level so that perception of the economy as recovering is likely to remain weak among small and medium sized companies and in the household sector. There are still many problems to be resolved if the rising trend of the next five years is to become

established and last for ten years. One precondition of continued growth is that Japan should take advantage of the economic dynamism of Asia, and to this end it is important that Japan work towards the creation of an Asian free trade zone by actively promoting the formation of FTAs (free trade agreements). However, agriculture is proving to be a bottleneck and is currently obstructing the conclusion of FTAs. The growth of the service industry is vital for sustained employment growth, but deregulation is proceeding only slowly in the "public sector" (medicine, healthcare, etc.), which is the focus of great expectations as a source of employment. Against the backdrop of a growing fiscal deficit and a fall in the household savings ratio, if the regeneration of the corporate sector is accompanied by a recovery in demand for funding, there is a danger that upward pressure on interest rates will grow, dealing a blow to small and medium sized companies, whose finances have been slow to improve. Moreover, if a vicious circle is established in which growth of interest payments on government bonds leads to a rise in the balance of government bonds outstanding, there is even a risk that the fiscal deficit will snowball and, from around 2010, that the current account surplus will diminish sharply, as compared with the savings and investment balance, and that interest rates will soar.

Given these issues, the government will need to implement a range of measures over the five-year period 2004-2008, centering on (i) the building of the framework of an Asian free economic zone, (ii) general measures to help Japan become a leader in technology, (iii) the revitalization of the services sector through deregulation, tax reform and the creation of infrastructure, (iv) measures for the regeneration of industry and employment under local leadership, (v) the establishment of a sustainable and reliable total livelihood assurance system, (vi) the restoration of soundness of money flow through the creation of a robust

market, (vii) the restoration of a primary balance through tax system and fiscal reform. The government should draw up and implement without delay a "Five Year Plan for the Regeneration of the Japanese Economy" indicating specific measures and their timing.

In terms of fiscal and monetary policy, the issue is "fine-tuning to help ensure a smooth exit from deflation". Specifically, the government should (i) adopt a "flexible and neutral" fiscal stance, and (ii) implement monetary policies for the stabilization of long-term interest rates.