



JRI news release

**Mid-Year Revised Economic Forecast
— Outlook for Fiscal 2002-2003 —**

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Overview

1. On the strength of a recovery in exports, the Japanese economy bottomed out in the January-March quarter of 2002. However, private capital investment and consumer spending remain sluggish and the persistent pressure for a variety of structural adjustments means that recovery potential of the domestic sector of the economy remains weak.

2. The cyclical recovery of the US economy is set to continue to the end of 2002, albeit at a decelerating pace. From early 2003, however, with inventories accumulating and the asset effect tailing off, the deceleration is likely to become more pronounced. Against this background, Japanese exports are set to see continued growth for the present, but are likely to start losing their pulling power from early on in fiscal 2003, reflecting the deceleration of overseas economies as well as the strengthening of the yen. However, it is important to be aware of the

risk that the poverty effect stemming from the fall in stock prices in the US, in the wake of the recent accounting scandals, will break the back of the economic trend before the end of the year.

3. The persistent pressure for adjustments in many sectors of the domestic economy means that the recovery potential is likely to remain low.

(1) Although corporate profits will rise sharply in fiscal 2002 on the strength of restructuring measures, including the cutting of personnel expenses, the continued stagnation of turnover means that the pace of profit growth is likely to slow in fiscal 2003. In addition to these income-related factors, the movement to transfer production to overseas bases, which has been gathering momentum in recent years, will also have a significant restrictive effect on the recovery of capital investment.

(2) While there are signs that deflation is slowing, given the continued influx of imported goods and the pressure for price cuts in service industries, it is likely that the deflationary mood itself will persist. The deflationary trend has also spread to wages. A survey of *shunto* wage settlements produced a high ratio of "zero" wage hike offers, and the movement to restructure wage systems themselves is also gathering momentum. These factors are likely to exert a downward pressure on consumer spending, from the income side.

(3) Given the clearly stated government policy objective of reducing expenditure, the sharp downward trend of spending on public works is expected to continue, with the risk of a severe negative impact on regional economies, in particular.

(4) The movement to assess credit risk in more realistic terms is likely to spread, with financial institutions revising loan rates and gaps emerging in the yield on local government bonds issued by different local government authorities.

Although, in the short term, this will tend to weaken the recovery potential of the economy by reducing the volume of business done by less sound companies and increasing the pressure to cut public spending, in the medium-to-long term, it will help to rationalize the distribution of economic resources.

4. Given these conditions in the domestic sector, the trend of external demand will have a significant influence on the future of the Japanese economy as a whole. Depending on the strength of pulling power furnished by external demand, there are two possible scenarios for the future.

- **Standard scenario: a gentle recovery until the first half of fiscal 2003**

If the US economy continues to recover, then, although the recovery of domestic private demand remains gentle in fiscal 2002, the Japanese economy enjoys a continued recovery, driven by external demand. From the beginning of fiscal 2003, the recovery in corporate profits begins to filter through into capital investment and employee incomes, leading to a slight acceleration in the pace of recovery of domestic private demand. In the second half of fiscal 2003, however, a slowdown in exports and the growth of business profits leads to a spreading sense of economic deceleration.

- **Sub-scenario: a new economic low in the second half of fiscal 2002**

If the US economy loses momentum earlier, then, not only do exports, the only source of pulling power for the Japanese economy, decline, but, against a background of falling stock prices and deteriorating business and consumer

confidence, the decline in domestic private demand continues. As a result, Japan records negative growth up to the end of fiscal 2003, the third consecutive year.

5. The Japanese economy is currently in the midst of a cyclical recovery phase, but given that traditional industries whose growth potential has fallen have not yet managed to extract themselves from a pattern of backward-looking structural adjustments, and that the rise of the Chinese economy, among others, is reducing international competitiveness and encouraging the movement to transfer production bases overseas, it is to be feared that the fundamentals of the Japanese economy have begun to follow a downward path. Although the situation calls for radical structural reforms, tax system reform to date has placed greater emphasis on achieving neutrality of tax revenues than on stimulating the economy, and practical measures in key areas such as deregulation, administrative reform, the reform of the social security system and the structural reform of public finance have yet to be taken.

Japan should change its priority from "rebuilding public finance" to "stimulating innovation", and policy management systems should be subjected to a full-scale review. Within this policy framework, the government needs to draw up a policy package that makes clear distinctions between short-term, medium-term and long-term objectives.