JRI news release

The Outlook for the Japanese Economy in Fiscal 2003-2004

- Breaking Out of the Deflation-Credit Crunch Cycle -

December 5, 2002

The Japan Research Institute, Limited
Economics Department
http://www.jri.co.jp/

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

Hideki Matsumura or Hisashi Yamada
Tel: 03-3288-4524•4245 (Economics Department)
E-mail: matsumura.hideki@jri.co.jp or yamada.hisashi@jri.co.jp

Overview

Since the summer of 2002, the Japanese economy has begun to show signs of losing momentum due to a slowing of the growth of exports and industrial production. Moreover, since the autumn, when the government announced its intention of speeding up the disposal of non-performing loans, share prices have fallen sharply, giving grounds for concern that business and consumer confidence may be weakening.

Given these facts, the three key points to be considered in any attempt to forecast the future trend of the Japanese economy are (i) the trend of foreign economies, particularly those of the United States and Asia, and whether or not the export-led growth of the Japanese economy can be sustained, (ii) amidst fears that deflation will become a long-term phenomenon, whether or not domestic demand in Japan will gain momentum, and (iii) the direction of economic policy (disposal of non-performing loans, revitalization of industry, restoration of soundness to public finance, etc.) and its effects.

In the US, (i) the attenuation of the asset effect due to the rise in housing prices, (ii) the prolonged adjustment phase in capital investment and (iii) the slim hopes of a full-scale recovery in employment conditions, among other factors, will tend to have a negative impact and the deceleration of the US economy is likely to become more apparent from early 2003 onwards.

Although the Asian economies remain relatively firm, the effects of the slowdown in the US economy will eventually filter through and the growth of production within the Asian region will slow, centering on electrical machinery products. As a result, the economic pulling power of Japan's exports is likely to diminish.

The fundamental causes of Japan's prolonged bout of deflation lie not in a shortage in the money supply but in the real economy. With the newly developing countries of Asia beginning to catch up, it is the delay in developing new growth frontiers and the gradual expansion of the macro supply-demand gap that have triggered deflation, and without a solution to these two problems, it will be difficult to overcome deflation.

With no immediate prospect of escaping the clutches of deflation, it is likely that domestic demand will remain sluggish. Given (i) that business performance is deteriorating, (ii) that the reduction of debt and assets is taking priority in the allocation of cashflow, (iii) that the movement to transfer production activities to overseas bases is gathering momentum, capital investment is likely to continue falling.

Although consumer spending has held firm in some areas, the fact that income conditions continue to deteriorate owing to the contraction of business activities and the fact that consumer confidence is expected to weaken means that it can no longer be expected to underpin the economy in the way it has over the past few years.

The principal cause of the sluggishness of the Japanese economy today is not so much the "negative legacy" of the bubble period as the fact that the economy has entered a new adjustment phase, characterized by a substantial fall in the expected growth rate and by long-term deflation.

An evaluation of the government's present policies from this perspective suggests (i) that as the problem of non-performing loans is, to a considerable extent, the result of deflation, it will be difficult to resolve in the absence of a truly effective

scheme for industrial revitalization, and (ii) that as the "gentle economic recovery" on the assumption of which the government's objective of restoring soundness to public finance is based, has collapsed, sticking obstinately to numerical targets could cause untold damage.

Looking to the future, the conditions described above suggest that, amidst continued stagnation of share prices, the increasing impact of negative factors such as (i) the decline in the economic pulling power of exports owing to the deceleration of overseas economies, (ii) the growing tendency to postpone capital investment against a background of deteriorating business performance, ongoing transfer of production activities to overseas bases and withdrawal from unprofitable sectors, and (iii) the weakening of consumer confidence amidst deteriorating employment conditions, suggests that the present recession is likely to continue for some time. The economy is unlikely to bottom out until the second half of fiscal 2004, when the growth rate of the US economy should begin to rise and an export-led pattern of recovery is re-established.

Amid the declining growth potential of Japan's economy, a radical disposal of non-performing loans, with the inadequate business revitalization measures, would lead to an increase in the number of problem companies destined to liquidation, and in turn accelerate deflation and a rise in fresh non-performing loans, creating a vicious cycle.

Given that the root cause of the decline in economic vitality is deflation, it is the revitalization of industry and the promotion of economic growth that should be the objectives at the heart of government policy, and the government should undertake a radical reconstruction of its policy framework in line with these objectives.

For the three years or so before the benefits of these policy measures begin to emerge, the government should take steps to ensure that the Japanese economy does not slip into a deflationary spiral and should aim for neutrality in the management of its macroeconomic policies.