MIZUHO Mizuho Financial Group

February 2003

Economic Outlook for FY2002 and FY2003

⬢ The Overseas Economies

Despite the stagnation of the US economy in the first half of 2003 stemming from uncertainties regarding attacks upon Iraq, the upturn of capital investment toward the second half of the year should drive the economy into a moderate recovery cycle. However, momentum for a recovery in capital spending is likely to be weak, and, therefore, insufficient to place the US economy on a steady recovery track. We predict that real gross domestic product (GDP) will expand 2.5 percent in 2003, remaining below the potential growth rate of the US economy.

Activity in the euro zone should also be sluggish with a flagging German economy acting as a drag on overall economic growth. In the second half of 2003, the Asian and Latin American economies are expected to enter a moderate expansionary phase given the rebound of the US economy.

[Real GDP Growth]

(%)

	2001 (Actual)	2002 (Forecast)	2003 (Forecast)
US	0.3	2.4	2.5
Euro zone	1.4	0.8	1.3
Asia	3.7	5.8	5.8
Latin America	0.2	- 0.9	1.8

⬢ The Japanese Economy

Although the Japanese economy has been in a cyclical recovery driven by exports from early 2002, it is now pausing on the landing due to a loss of momentum stemming from a slowdown of consumer spending.

In spite of a contraction of the investment cycle and the difficulty to define a clear direction of the economic cycle, the risks of the Japanese economy falling sharply into recession are abating because of a speedy adjustment of inventories and employment. Nevertheless, the economy will most likely slide into a recession in the second half of 2003 due to the lack of sanguine expectations toward future growth serving as an obstacle to the creation of a positive economic cycle and downward pressures from structural problems of the Japanese economy.

We expect the Japanese economy to grow 1.5 percent in FY2002 and 0.3 percent in FY2003. Since the growth rate would be virtually zero when excluding the contribution by the FY2002 supplementary budget, economic activity will sink into negative territory in FY2004 unless the government implements new measures to buoy the economy.

[GDP Growth Rate and Degree of Contribution]

(%)

	FY2001 (Actual)	FY2002 (Forecast)	FY2003 (Forecast)
GDP (real)	- 1.2	1.5	0.3
Contribution: domestic demand	- 0.7	0.8	0.6
Contribution: external demand	- 0.5	0.7	- 0.3
GDP (nominal)	- 2.5	- 0.6	- 1.2

This outlook was originally released on February 21, 2003 in Japanese.

MIZUHO RESEARCH INSTITUTE
http://www.mizuho-ri.co.jp/

* This report is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments.

I. The Overseas Economies

1. The Iraq crisis and crude oil is the largest risk factor in the first half of 2003

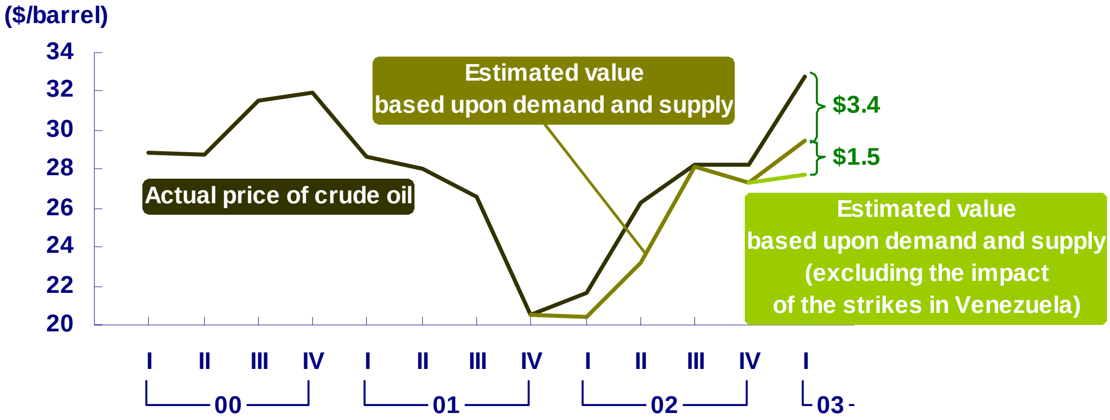
The Iraq crisis poses the largest risk to the global economy in the first half of 2003. Current developments surrounding Iraq are nebulous with the US and Britain taking an increasingly hard-line stance against Iraq while other countries such as France, Russia and Germany retain a cautious posture due in part to crude oil interests in Iraq. In addition to uncertainties regarding the Iraq crisis, a deepening rift among the countries of the West is also spreading dark clouds over the global economic horizon. Still, it appears inevitable that the US will in time launch attacks upon Iraq as indicated by a clearer stance by US President George W. Bush that the US would strike Iraq even without a resolution of the United Nations Security Council if Iraq under Saddam Hussein fails to disarm completely. While this *Economic Outlook for FY2002 and FY2003* is based upon the assumption of a short war (no longer than one month) in Iraq commencing with attacks in March, a longer war lasting approximately three months would have a graver impact upon the US and global economies than predicted herein.

In connection with the Iraq crisis, the focus of attention is gathering around the price and supply of crude oil. Amid heightening tensions surrounding Iraq, the sharp reduction of Venezuelan crude oil exports in December pinned the price of crude oil at a high level far above $30 per barrel (nearest term contract for WTI crude futures). As a result of simulations regarding the impact of the Iraq crisis and the reduction of Venezuelan crude oil on the basis of certain preconditions, the Mizuho Research Institute estimates that the Iraq premium upon crude oil prices is approximately $3.4/barrel and that the impact of the strikes in Venezuela is equivalent to approximately $1.5/barrel (Chart 1). Based upon comparisons with the Gulf War and forecasts on demand and supply, we are inclined to believe that crude oil prices will rise temporarily to $40/barrel in the event attacks are launched upon Iraq. However, the high probability that the attacks upon Iraq will end in a short time period and that the increase of output by the OPEC nations will be sufficient to cover the shortfall from Venezuela and the temporary suspension of output in Iraq leads to our view that a sustained surge of crude oil prices should be averted. Crude oil prices will gradually descend along with Iraq's return to the crude oil market and the recovery of production in Venezuela (Jan-Mar quarter of 2004: approximately $25/barrel, Chart 2).

Meanwhile, in the event of a prolonged war in Iraq and the spread of damages to Kuwaiti oil fields, the risks of an ongoing surge of crude oil

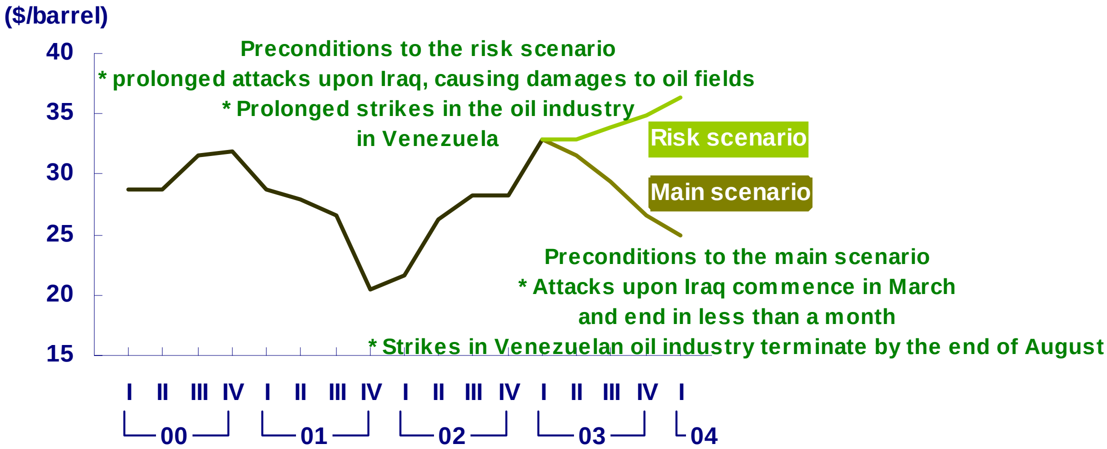
prices may not be ruled out since the odds are high that the shortage of supply may not be covered even with a further increase of output by the OPEC nations. Its impact upon the global economy will be discussed in more detail under Section 6. (3) herein.

Chart 1 Crude Oil Prices and the Iraq Premium



Note: The price of crude oil in the first quarter of 2003 is represented as the actual price of crude oil in January 2003.
Sources: IEA, Oil Market Report, Datastream, and others.

Chart 2 Forecast of Crude Oil Prices



Note: Forecasts by the Mizuho Research Institute.
Sources: IEA, Oil Market Report, Datastream, and others.

2. The US economy will enter a mild recovery after stagnating in the first half of 2003

(1) Personal spending will slow down but will not suffer a major loss of momentum

The US economy grew at a sluggish pace of 0.7 percent per annum on a quarter-on-quarter (q-o-q) basis in the Oct-Dec quarter of 2002 (Jul-Sep quarter: 4.0 percent q-o-q), dragged down by the slowdown of personal consumption. The household sector (personal consumption and housing investment) which propelled the US economy thus far is showing signs of deceleration given the fall of consumer confidence due to the lack of a clear recovery of the employment and income environment, slumping stock prices and uncertainties regarding the launch of attacks upon Iraq.

Looking forward, we are inclined to believe that personal consumption will glide into a mild recovery from around mid-year in consideration of the following factors: (1) improvement of consumer confidence as a result of the settlement of the Iraq crisis, (2) forecasts that the Federal Reserve will not tighten monetary policy in 2003 and thus low interest rates will keep on buttressing the economy, (3) the emergence of the positive impact of the Bush administration's economic stimulus measures in the second half of 2003 in addition to the stability of residential prices which is offsetting a significant portion of the reverse asset effect stemming from the fall of stock prices.

(2) The growth of capital investment will remain moderate

Viewing capital investment from a cyclical perspective, excess capital stock is gradually being eliminated given the progress of stock adjustment as a result of a sharp reduction of capital investment in 2001 and 2002. Furthermore, while the capacity utilization rate still remains low, it has turned course, paving the way toward the growth of capital investment. Even in such an improved environment, business enterprises are restraining capital investment since uncertainties stemming from the Iraq crisis are dragging down business sentiment.

Although capital investment should grow to a certain degree after the settlement of the Iraq crisis, structural factors hampering the expansion of capital investment will most likely linger, thus making the pace of growth extremely slow in comparison to past recovery cycles.

(3) The US economy will grow 2.5 percent y-o-y in 2003

We expect the US economy to avert a major loss of momentum in spite of a slowdown of the household sector toward mid-year and start to follow a mild recovery as the corporate sector starts to pick up in the second half of the year. However, since the momentum for a recovery in capital investment will most likely be extremely weak, we do not expect the economy to recover at a steady pace to reach the potential rate of growth of the US economy estimated to be around the lower half of the 3 percent level. The odds are high that the US economy in real terms will grow 2.5 percent on a year-on-year (y-o-y) basis in 2003, remaining below its potential economic growth rate.

Chart 3 Forecast of the US Economy in FY2003

(%)

(real, % ch, q-o-q, p.a.)		2001	2002	2003	2002 (Actual)		2003 (Forecast)	
		(Actual)	(Actual)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half
Personal consumption		2.5	3.1	2.3	3.5	2.8	2.2	2.3
Housing investment		0.3	3.8	2.3	6.6	2.9	3.7	- 1.0
Capital investment		- 5.2	- 5.8	2.4	- 6.3	- 0.6	2.6	5.1
Inventory investment	($ 100 million)	- 614	- 5	135	- 120	111	73	198
Government expenditures		3.7	4.4	3.5	5.7	3.0	3.7	3.6
Net exports	($ 100 million)	- 4,159	- 4,822	- 5,219	- 4,670	- 4,975	- 5,134	- 5,303
Exports		- 5.4	- 1.3	4.3	2.6	5.3	3.4	5.2
Imports		- 2.9	3.5	5.5	8.1	7.8	4.4	5.6
Domestic final consumption		1.6	2.3	2.6	2.9	2.5	2.5	2.7
GDP		0.3	2.4	2.5	3.5	2.5	2.3	2.7
<% change from 4Q of previous year>		0.1	2.8	2.3	1.8	3.0	2.4	2.5
Consumer prices (y-o-y % change)		2.8	1.6	2.4	1.3	1.9	2.4	2.3
Current account balance	($ 100 million)	- 3,934	- 4,930	- 5,130	- 2,401	- 2,530	- 2,520	- 2,610
<as percentage of nominal GDP>		- 3.9	- 4.7	- 4.7	- 4.6	- 4.8	- 4.7	- 4.8

Notes: 1. Yr = rate of change from the previous year. Half-year term = rate of change p.a. from the previous term (half-year term figures in the second line under GDP = rate of change from the previous year).
2. Current account balace for 2002 and 2nd-half of 2002 are forecasts.
Sources: US Department of Commerce, US Department of Labor.

3. The euro zone economy is dragged down by the German economy

Although the economy in the euro zone has been following a mild recovery path so far, activity is stagnating along with mounting tensions surrounding Iraq. As shown by the ongoing fall of capital investment and the sharp slowdown of consumer spending accompanying the deterioration of the employment environment and stock market slump, we may not expect much of a contribution by domestic demand. The euro zone economy may be portrayed as fragile, with a high degree of dependence upon external demand. While activity in the euro zone should return to a mild export-led recovery cycle along with the upturn of the US economy in the second half of 2003, the odds are high that economic growth will remain tepid because of the weakness of the German economy, which accounts for about 30 percent of GDP in the

euro zone, due in part to fiscal restraints stemming from the Growth and Stability Pact. We expect the rate of real economic growth in the euro zone to remain at 1.3 percent y-o-y in 2003.

Chart 4 Forecast of the Euro Zone Economy in 2002 and 2003

(%)

			2001 (Actual)	2002 (Estimate)	2003 (Forecast)
GDP	Euro zone		1.4	0.8	1.3
		Germany	0.6	0.2	0.9
		France	1.8	1.0	1.6
		Italy	1.8	0.4	1.4
		Spain	2.7	2.0	2.2
	UK		2.0	1.7	2.2
Euro zone consumer prices			2.5	2.2	1.8

Note: Rate of real GDP growth (rate of change over the previous year).
Sources: EUROSTAT, ECB, ONS.

4. The Asian economies should start to expand after leveling out in the first half of 2003

Growth in Asian economies is expected to stagnate slightly until mid-2003 along with the peak-out of exports and personal spending, which served as the main engines of growth. From the second half of 2003, the Asian economies should return to a mild export-led expansion cycle along with the recovery of the US economy. Moreover, the Chinese economy will most likely continue to grow at the 7 percent level helped by foreign direct investment and the strength of independent demand within Asia. We expect the average growth rate of the Asian economies to reach 5.8 percent y-o-y in both 2002 and 2003.

Chart 5 Forecast of the Asian Economies in 2002 and 2003

(%)

	2001 (Actual)	2002 (Estimate)	2003 (Forecast)
Asia (average)	3.7	5.8	5.8
NIEs (average)	0.5	4.0	4.5
S. Korea	3.0	5.8	5.7
Taiwan	- 2.2	3.1	3.8
Hongkong	0.6	2.0	2.9
Singapore	- 2.0	2.2	3.9
ASEAN (average)	2.3	4.3	4.1
Thailand	1.9	5.0	4.4
Malaysia	0.4	3.8	5.1
Indonesia	3.3	3.7	3.5
Philippines	3.2	4.7	3.8
China	7.3	8.0	7.5

Notes: 1. Real GDP growth (change over the previous year).
2. Weighted average on the basis of each country's nominal GDP in 2000.
3. Year 2002 data on Singapore, the Philippines, Indonesia and China are actual results.
Source: Government data provided by each of the relevant countries.

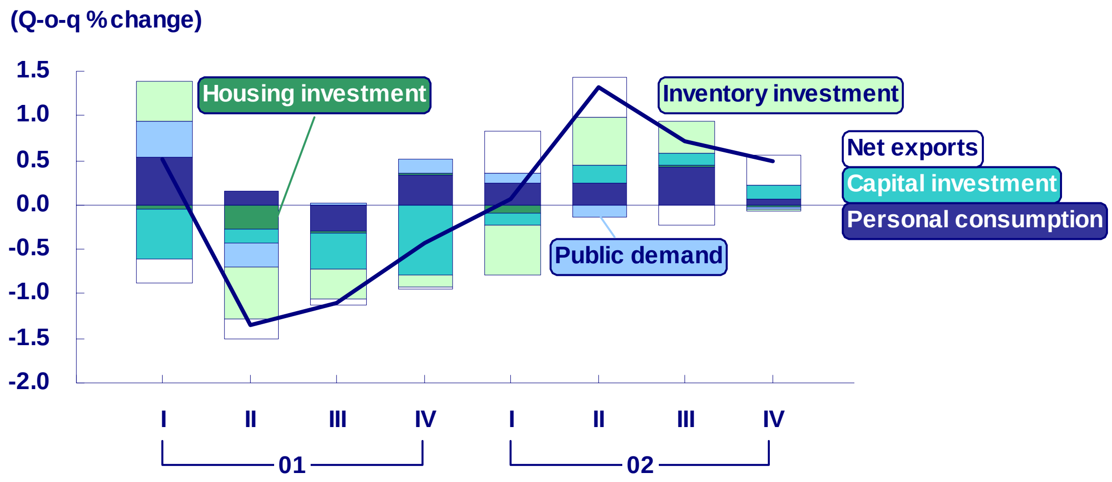
II. The Japanese Economy

1. The momentum for recovery recedes along with the slowdown of domestic demand

(1) Slowdown of domestic demand drags down economic growth

Japan's real GDP expanded marginally by 0.5 percent q-o-q in the Oct-Dec quarter of 2002 and 2.0 percent on an annualized basis, barely maintaining positive growth for the fourth consecutive quarter, according to the *Preliminary Quarterly Estimates of GDP* released on February 14th. Despite a sharp slowdown of domestic demand mainly in personal consumption (degree of contribution in the Jul-Sep quarter: 0.9 percent → Oct-Dec quarter: 0.2 percent), the contribution by external demand rose into positive territory again (degree of contribution in the Jul-Sep quarter: -0.2 percent → Oct-Dec quarter: 0.3 percent) along with the growth of exports, thus pushing up the overall economy. However, the state of the economy is more serious in nominal terms, which provides a closer sense of actual conditions. Although the rate of GDP growth turned positive again in real terms (0.3 percent), the rate of growth remains deep in negative territory in nominal terms (-1.4 percent) in the calendar year 2002. The domestic demand deflator stood at –1.8 percent over a year ago in the Oct-Dec quarter in comparison to –1.9 percent in the Jul-Sep quarter, indicating that while deflation is not accelerating, the state of the economy is not moving toward its eradication.

Chart 6 Real GDP Growth and Degree of Contribution by Major Demand Components



Source: Cabinet Office, *Preliminary Quarterly Estimate of GDP*.

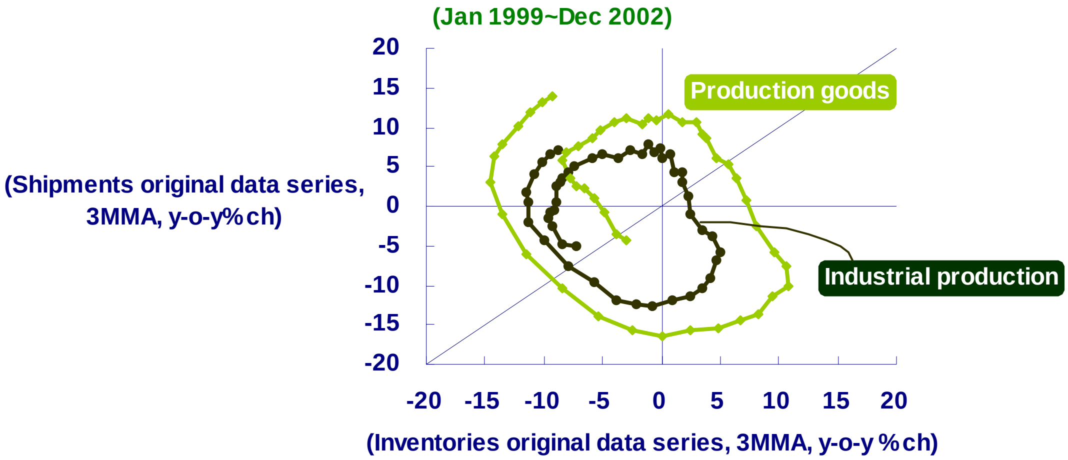
(2) Japan's economic recovery cycle will be short-lived due to lackluster growth expectations

The momentum for recovery is receding sharply after the Japanese economy entered a cyclical recovery in early 2002. The inventory and capital investment cycles, which define the economic cycle, are contracting sharply at this juncture. Movements in inventory adjustment in the present recovery cycle indicate that the inventory build-up phase will most likely turn out to be extremely short-lived (Chart 7). Since companies stock up inventories on the basis of expectations toward the future growth of demand, it is important to note that business enterprises possess an extremely pessimistic outlook on future demand under the present cycle and moreover their expectations are about to peak out. A cautious stance by business enterprises in stockpiling inventories is keeping production activity subdued.

The same is applicable with respect to the capital investment cycle. Capital investment grew for three quarters in a row up to the Oct-Dec quarter of 2002 after recovering in the Apr-Jun quarter of 2002 from a sharp adjustment (-3.4 percent y-o-y) in FY2001. However, the breadth of the upturn is a mere 1 percent, indicating that the cycle in capital investment is also very small (Chart 8). Business fixed investment is marginal at the moment, growing just enough to supplement supply capacities in response to actual demand growth in tandem with the recovery of production activities among companies. Under normal circumstances, business enterprises invest in more fixed equipment in order to enhance their production capacity along with the rise of expectations toward the future growth of demand. At the same time, since capital investment itself is a component of demand, it results in a larger investment cycle. The capital investment cycle will remain extremely small given dwindling expectations toward the future in the corporate sector.

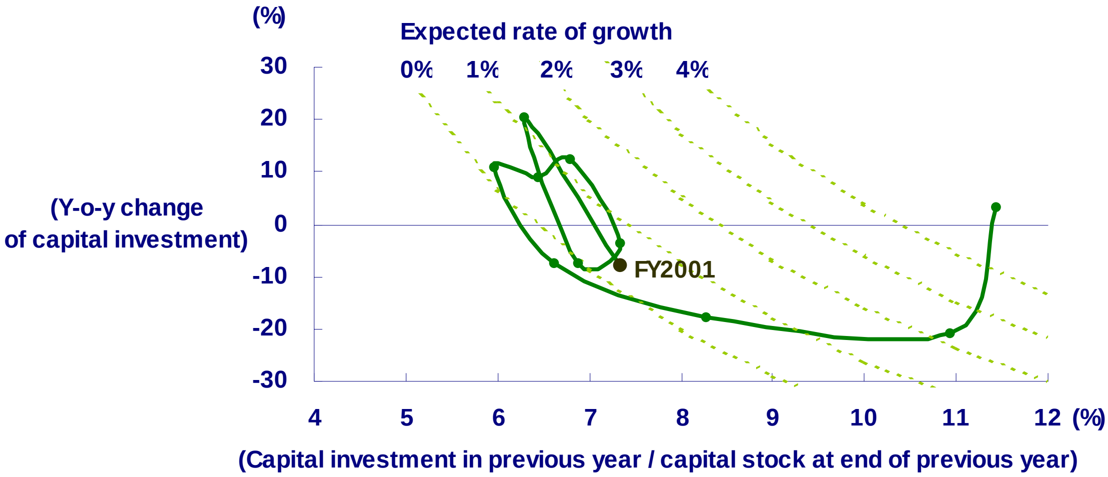
The vital question in providing an outlook on the Japanese economy in FY2003 is whether the economy will keep on expanding or fall in to recession after pausing in the first half of 2003 due to external factors such as the Iraq crisis. The key to finding an answer to this question is whether or not expectations toward future growth will rise in the entire Japanese economy.

Chart 7 Inventory Cycles



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*.

Chart 8 Inventory Stock Cycles in the Manufacturing Industry



Source: Cabinet Office, *Gross Capital Stock of Private Enterprises*.

2. External demand: its contribution to economic growth will most likely turn negative

Although exports should start to grow again as a result of a rebound of the overseas economies in the second half of 2003, the surge of crude oil imports in the first half of the year leads to our view that the contribution by external demand to real GDP growth will fall into negative territory in FY2003 (degree of contribution to real GDP growth: 0.7% point in FY2002, -0.3% point in FY2003).

(1) Exports will return to an upward trajectory in the second half of 2003 but the pace of growth will be slower than in FY2002

After a surge in the first half of FY2002 along with a global trend to replenish inventories, Japanese exports remain on an upward trajectory helped by firm exports bound for Asia and auto-exports to the US (Chart 9). Nevertheless, we expect a slowdown of exports in the first half of 2003 as uncertainties spread over the Iraq crisis. While exports should rebound along with the recovery of the global economy, the pace of growth will be slower than in FY2002.

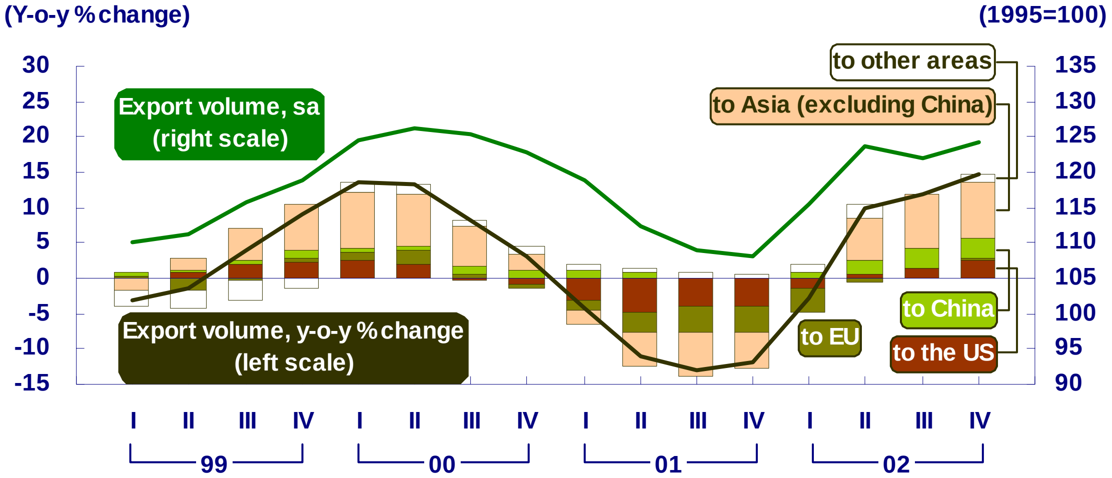
(2) Imports will increase along with the surge of crude oil imports but will be dragged down by slumping domestic demand in the second half of FY2003

Japanese imports remain weak reflecting the ongoing stagnation of domestic demand. However, the surge of crude oil imports accompanying the shut down of nuclear power plants should contribute to the rise of imports from the second half of FY2002 to the first half of FY2003, leading to a stronger growth of imports toward the summer when the demand for electricity reaches a peak. From then onward, we expect the growth momentum to weaken along with the stagnation of domestic demand. Even so, the firm growth of imports in information-related areas (in particular electrical machinery-related areas where there is a clear division of labor) which moves in tandem with global demand, provides us with reason to believe that the pace of import slowdown will be moderate.

(3) Japan’s current account surplus in FY2003 will contract due to a slower growth of exports

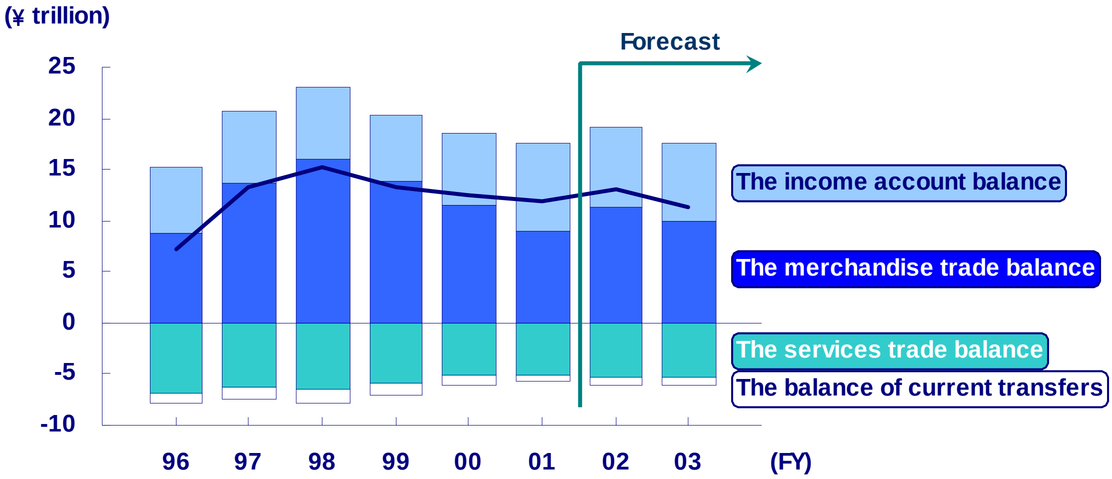
Japan’s trade surplus rose to 11.3 trillion yen in FY2002, increasing for the first time in four years as a result of the surge of exports driven by a global replenishment of inventories. In view of slower export growth ahead, we expect the trade surplus to shrink to 10.0 trillion yen in FY2003. While we also expect the trade surplus to drive up the current account surplus to 13.0 trillion yen (2.6 percent of nominal GDP) in FY2002, the current account surplus will most likely contract slightly to 11.4 trillion yen (2.3 percent of nominal GDP) in FY2003 because of a smaller trade surplus, sluggish growth in the income account and the deterioration of the services trade balance because of a growing deficit in overseas travel (Chart 10).

Chart 9 Export Volumes



Source: Ministry of Finance, *The Summary Report on Trade of Japan*.

Chart 10 Current Account Balance



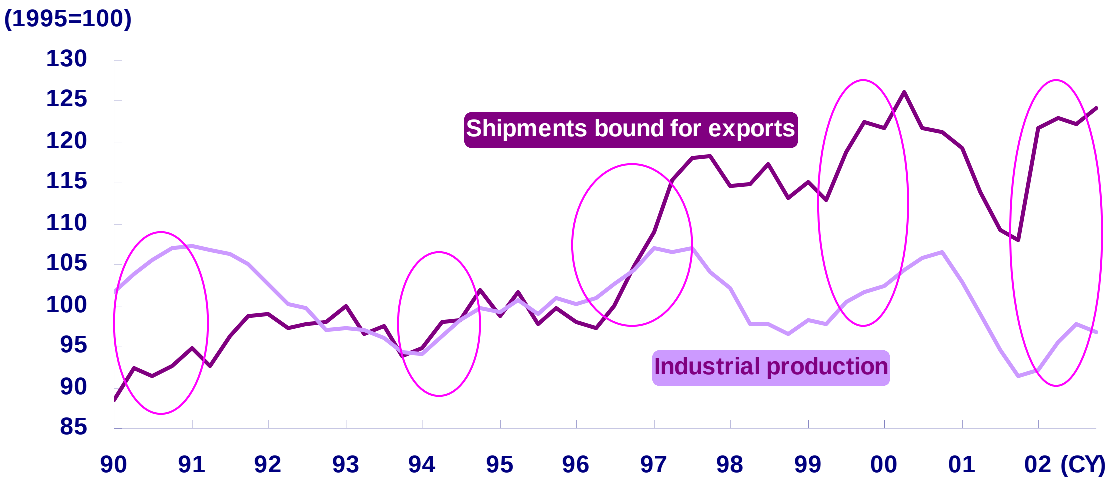
Source: Ministry of Finance, *Balance of Payments Statistics*.

3. The corporate sector: capital investment will increase for the first time in three years in FY2003 but will begin to slow toward the end of the fiscal year

(1) Production activity will pick up in the first half of 2003 but gradually slow down in the second half of the FY2003

Japan's industrial production turned course and began to decline for the first time in four quarters in the Oct-Dec quarter of 2002 and is exhibiting more signs of stagnation at the moment. Production activity is driven in the initial stages by the growth of exports (Chart 11). Thereafter, the rebound of corporate activity accompanying the rise of export-oriented production ripples through to the improvement of jobs and income and the growth of capital investment, thus leading to a gradual increase of production of goods bound for the domestic market. Once production activity is initially generated, it is defined largely by domestic demand. Although the rise of exports led to the growth of production in the first half of 2002 in the present cycle, its positive impact upon domestic demand remained subdued because of its weak ripple effect upon the improvement of the employment and income environment and growth of capital investment.

Chart 11 The Ripple Effect of Exports Upon Industrial Production



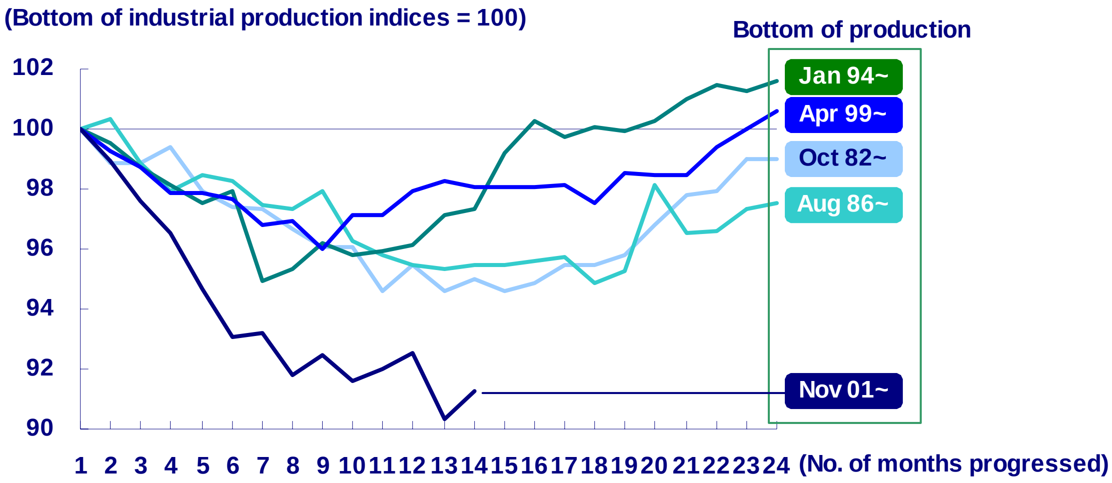
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*.

Even if exports rebound in the second half of 2003 reflecting the recovery of the global economy, it is difficult to envisage an increase of production activity as in the first half of 2002 given the current fragility of the mechanism transferring the growth of exports to industrial production. A more realistic scenario is that the weakness of domestic demand will overwhelm the positive impact of export growth, leading thereby to a gradual slowdown of production activity.

Provided however, barring sudden external shocks, we do not expect a major adjustment of production activity in the light of extremely low inventory levels as well as the fact that inventory cycles are growing increasingly short and concentrated as a result of advanced inventory management methods and pessimistic outlooks on future demand among business enterprises (Charts 12, 13). Although the previous inventory cycle was extremely large because of a global move to stockpile inventories of information technology (IT)-related goods, enterprises are tightening its reins upon the buildup of inventories in the present cycle. While production activity will lack momentum, stemming from the absence of an inventory buildup phase, we expect

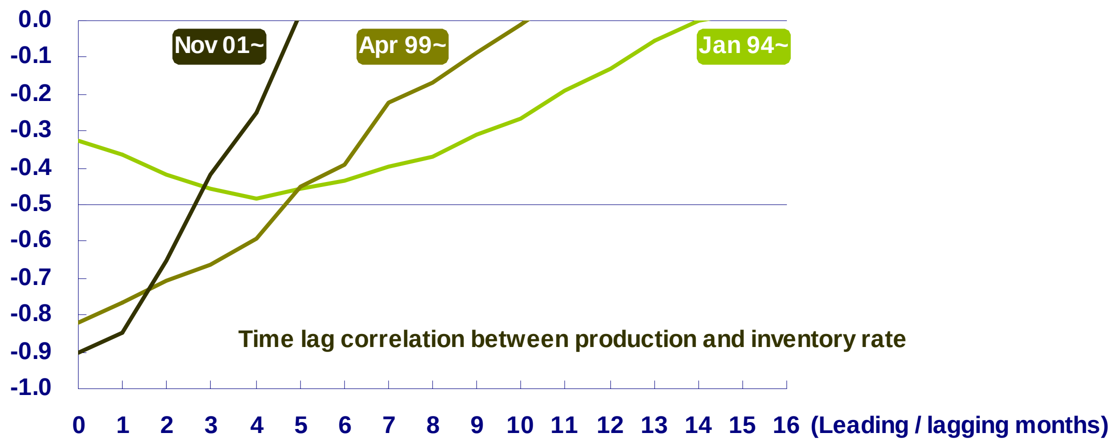
production activity to slow gradually from the second half of 2003 without falling into a sharp slowdown.

Chart 12 Inventory Indices



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*.

Chart 13 Inventory Adjustment Grows Shorter and More Concentrated



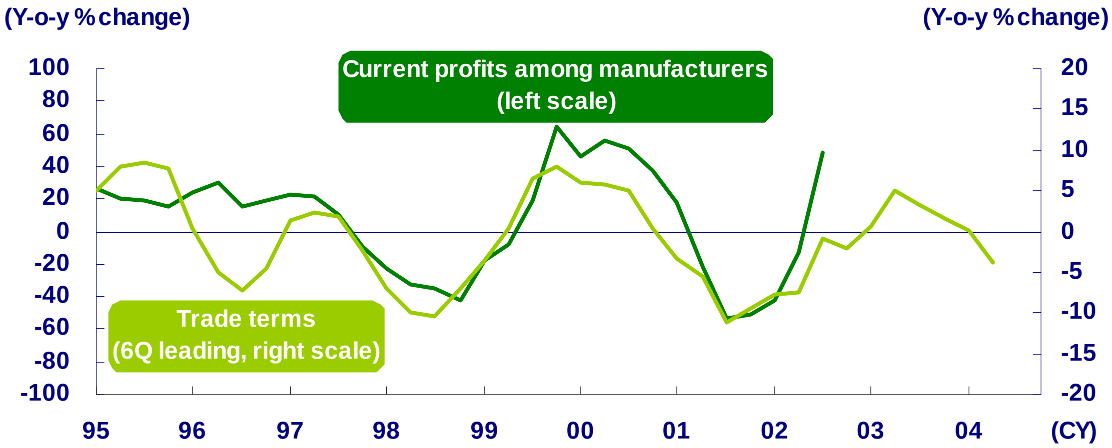
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*.

(2) The surge of the global commodities market will serve as a drag upon profits for Japanese companies which are losing pricing control

While the corporate sector is suffering from dwindling sales under intensifying deflationary pressures, both manufacturers and non-manufacturers are expected to secure major profit growth in FY2002 as a result of drastic cuts in employees' payroll costs in the case of manufacturers and restructuring efforts comprised mainly of cuts upon sales management costs in the case of non-manufacturers. However, profit growth in FY2003 will slow sharply among business enterprises losing pricing control under deflation since the surge of

the commodities market including crude oil will serve as negative pressures upon profits through the deterioration of trade terms (Chart 14). Furthermore, medium and small-sized enterprises lacking pricing control in comparison to large enterprises will have to face a profit decline, leading to concerns regarding growing disparities among enterprises of different sizes.

Chart 14 Correlation Between Trade Terms and Profits



Sources: Ministry of Finance, *Statistical Survey of Incorporated Enterprises*, and Bank of Japan, *Corporate Goods Price Index*.

Chart 15 Corporate Profit Forecast

(Y-o-y % change)

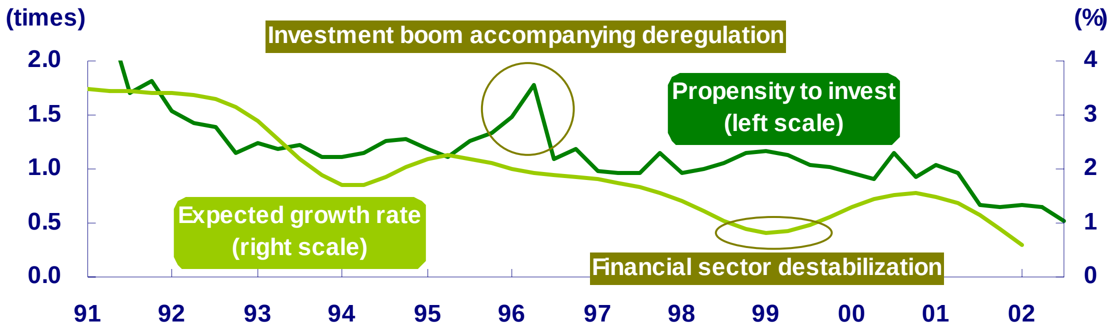
		FY2001	FY2002 (Forecast)	FY2003 (Forecast)
All industries	Sales	- 3.3	- 5.3	- 0.0
	Current profits	- 19.6	7.5	1.9
Large enterprises	Sales	- 3.9	- 1.5	0.6
	Current profits	- 23.6	18.5	4.0
Manufacturers	Sales	- 5.6	- 0.5	0.8
	Current profits	- 41.2	30.4	5.1
Non-manufacturers	Sales	- 2.6	- 2.2	0.4
	Current profits	- 0.6	9.3	3.0
Small and medium-sized enterprises	Sales	- 2.8	- 7.8	- 0.5
	Current profits	- 15.7	- 2.1	- 0.4
Manufacturers	Sales	- 7.5	- 4.7	0.1
	Current profits	- 44.8	16.3	1.2
Non-manufacturers	Sales	- 1.6	- 8.6	- 0.6
	Current profits	- 1.8	- 7.1	- 0.9

Source: Ministry of Finance, *Corporate Goods Price Index*.

(3) Although capital investment will grow 0.7 percent y-o-y in FY2003, turning positive for the first time in three years, the trend will not accelerate

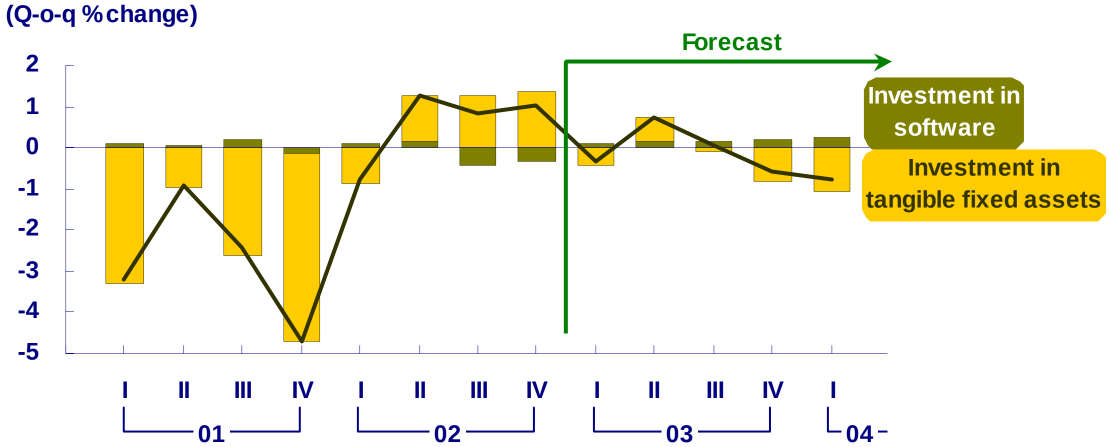
While capital investment has been growing for the third straight quarter since the Apr-Jun quarter of 2002, the rate of growth is merely 1 percent or so, revealing that business enterprises are increasing business fixed investment only by a marginal degree to meet the growth of demand. Although capital investment recovered in concert with an improvement in cash flows in past business cycles, its correlation with cash flow is fading. The decline of the expected rate of economic growth among enterprises is pushing down the propensity to invest (or the proportion of capital investment to cash flow) resulting in a condition where business investment has become virtually insensitive to rise in cash flows (Charts 16, 17). Measures to raise the expected rate of economic growth in the corporate sector are necessary in order to spur capital investment.

Chart 16 Investment Propensity and the Expected Rate of Economic Growth



Notes: 1. 4Q moving average.
2. The expected rate of economic growth is processed with the use of spline interpolation of economic forecasts for the coming three years.
3. Cash flows are based upon the *Statistical Survey of Incorporated Enterprises*.
4. Propensity to invest = investment cash flow/operating cash flow.
Sources: Ministry of Finance, Cabinet Office.

Chart 17 Forecast on Capital Investment



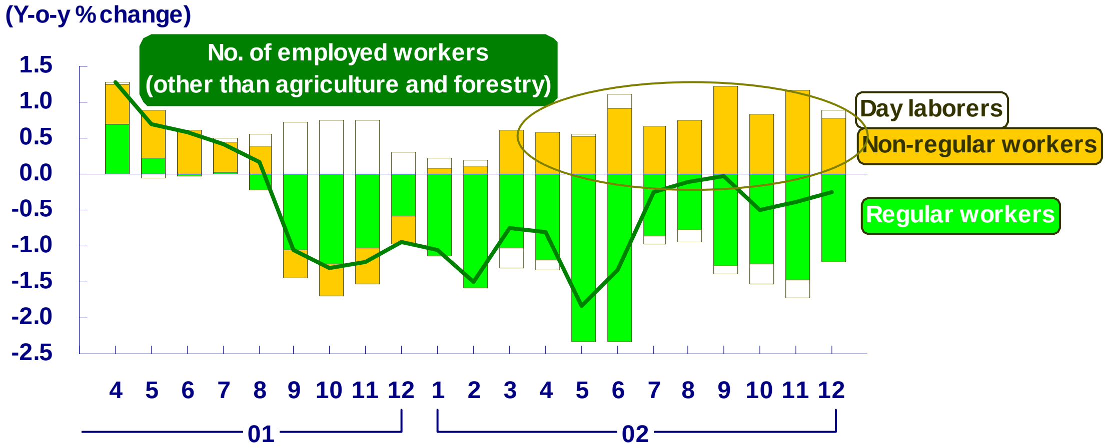
Sources: Cabinet Office, *Preliminary Quarterly Estimate of GDP*, *Gross Capital Stock of Private Enterprises*.

4. The household sector: the momentum for a recovery in personal consumption is weak

(1) Employment: the income environment remains sluggish

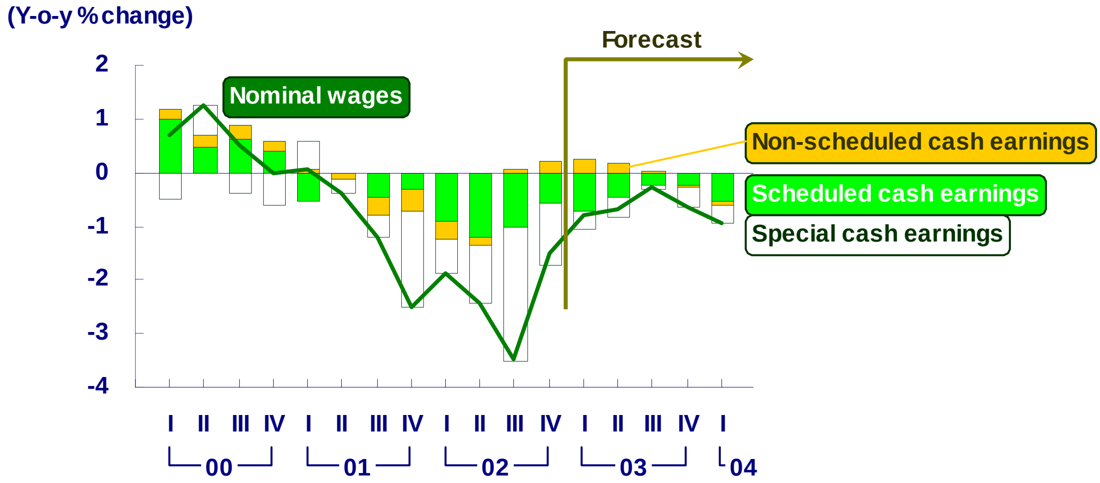
The number of new job offers is increasing in a wide range of businesses, revealing a marginal improvement of the environment for employment. However, the increase of job offers is concentrated in non-regular jobs which are readily adjustable, reflecting a cautious outlook on future demand in the corporate sector. Coupled with a widening mismatch between the skills of job seekers and those sought in the job market, the increase in number of employed workers remains subdued (Chart 18). However, given the speedy adjustment of labor in comparison to past business cycles where labor adjustment lagged changes in economic conditions, adjustment pressures are already peaking out. Meanwhile, as enterprises continue to shed labor costs and the *shunto* spring labor-management negotiations will most likely result in a historical low wage hike rate of 1.55 percent by reviewing regular wage hikes, we are inclined toward the view that downward pressures upon the income environment will linger (Chart 19). Since special cash earnings, or bonus payments, will stop falling along with the recovery of corporate business performance, the breadth of the fall of nominal labor compensation is expected to narrow (FY2002: -1.9 percent → FY2003: -0.3 percent).

Chart 18 Number of Employed Workers



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey*.

Chart 19 Nominal Wages



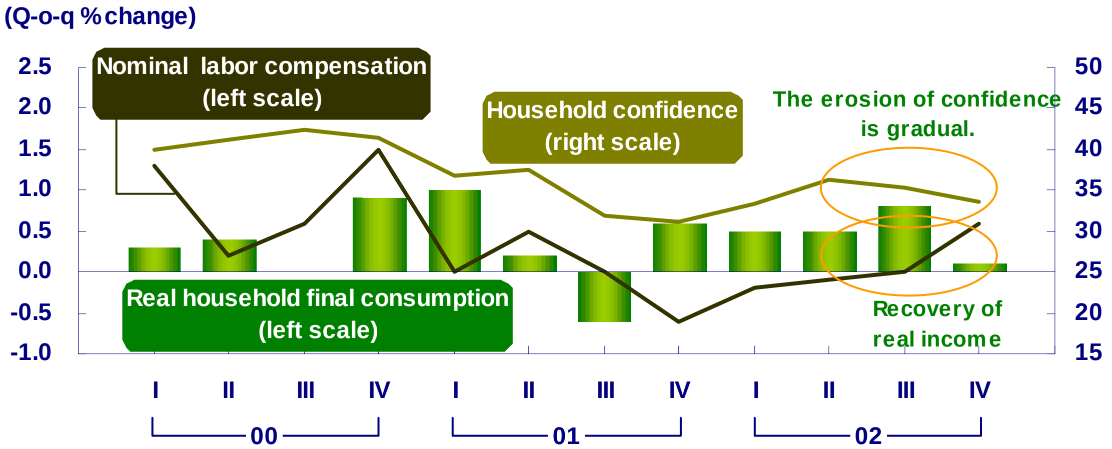
Source: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*.

(2) The momentum for a recovery in personal consumption is weak

Although personal consumption has been increasing for the fifth consecutive quarter, buoyed by an improvement of consumer confidence, indicators reveal signs of an ebb in personal spending at this juncture (Chart 20). While price falls due to deflation and a cyclical bottoming of labor compensation provide us with reasons to believe that personal consumption in real terms will avoid a precipitous fall, the momentum for a recovery in personal consumption is slowing sharply due to a lack of definite expectations toward the recovery of the income environment in the household sector. The growth of personal consumption in FY2003 is expected to remain virtually flat at 0.5 percent y-o-y, when excluding the

contribution by imputed rent (approximately 0.3 percent), thus falling sharply below the potential growth of consumption estimated on the basis of demographic trends.

Chart 20 Final Household Consumption



Note: Household confidence figures exclude price indicators.
Source: Cabinet Office, *Annual Report on National Accounts*, *Consumers' Behavior Survey*

Chart 21 Forecast on Personal Consumption

(%)

	FY2001	FY2002 (Forecast)	FY2003 (Forecast)
Shunto wage hike rate	2.01	1.66	1.55
Labor compensation	- 1.1	- 1.9	- 0.3
Per worker employed	- 0.8	- 1.5	- 0.4
No. of workers employed	- 0.3	- 0.4	0.1
Disposable income	- 3.0	- 1.7	- 0.3
Household consumption expenditure deflator	- 2.0	- 1.9	- 1.8
Real disposable income	- 1.0	0.2	1.5
Nominal consumption expenditures	- 0.2	0.1	- 0.9
Private sector consumption expenditure deflator	- 1.6	- 1.3	- 1.3
Real consumption expenditures	1.4	1.4	0.5
Propensity to consume	93.4	94.7	93.6
Change from previous year (% point)	2.7	1.3	- 1.1

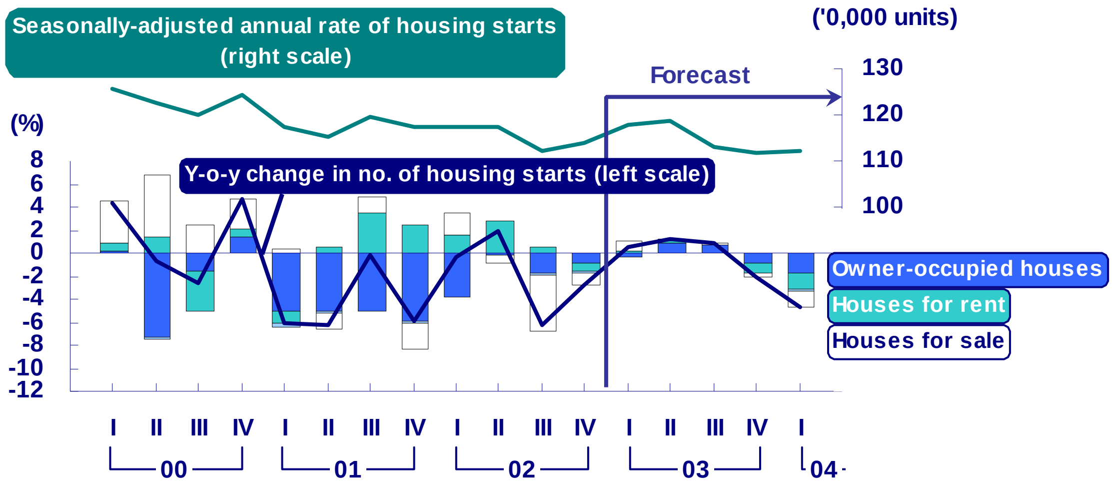
Notes: 1. All items other than the propensity to consume are represented as the percentage change from the previous year.
2. The *shunto* wage hike rate is based upon major corporate entities. FY2002 figures are actual results.
3. Household consumption expenditure deflator excluded imputed rent.
Source: Cabinet Office, *Annual Report on National Accounts*, and others.

(3) Housing investment will continue to decline although the pace of decline will slow due to a rush to buy new homes before the current programs of housing tax cuts expire

In the first half of FY2003, we expect the emergence of new residential demand due to a rush among would-be home owners to take advantage of the current programs of housing tax cuts before its expiration (Chart 22). Nevertheless, coupled with the dire *shunto* wage hikes, it is difficult to dispel worries regarding the future fall of income in the

household sector. Thus, unless qualitative improvements are achieved such as the stabilization of the employment environment, the chances are slim that there will be a definite upturn of housing investment. In FY2003, while last-minute purchases of homes in the first half of the fiscal year should slow the pace of decline in housing investment, we do not expect the downtrend to come to a halt.

Chart 22 Housing Starts



Source: Ministry of Land, Infrastructure and Transportation, *New Dwellings Started* .

Chart 23 Forecast on Housing Investment

		FY2001	FY2002 (Forecast)	FY2003 (Forecast)
Housing starts	('0,000 units)	117.3	115.3	114.0
	(annual % change)	- 3.3	- 1.8	- 1.0
Owner-occupied houses	('0,000 units)	37.7	36.7	36.5
	(annual % change)	- 13.9	- 2.6	- 0.6
Houses for rent	('0,000 units)	44.2	45.1	44.5
	(annual % change)	5.8	1.9	- 1.3
Houses for sale	('0,000 units)	34.4	32.6	32.2
	(annual % change)	- 0.7	- 5.2	- 1.1
Nominal private-sector housing investment	(annual % change)	- 9.1	- 3.9	- 1.6
Deflator	(annual % change)	- 1.2	- 1.4	- 1.2
Real private-sector housing investment	(annual % change)	- 8.0	- 2.6	- 0.4

Sources: Cabinet Office, *Preliminary Quarterly Estimate of GDP*,
and Ministry of Land, Infrastructure and Transport, *New Dwellings Started*.

5. The government sector: the contribution to growth from public demand will expand by approximately 0.2 percent

Despite a slowdown of the growth of government consumption, we expect public investments in FY2003 to increase for the first time since FY1998, lifting the contribution to growth from public demand because of the impact of the FY2002 supplementary budget.

(1) Public investment will grow slightly for the first time in five years

In December 2002, the Japanese government set forth the additional economic stimulus measures discussed since the autumn season of 2002 in the form of a *Program to Accelerate Reforms* (Chart 24). While the size of the budget related to public investment reaches a total of 2.6 trillion yen (national expenditures: 1.5 trillion yen, local government expenditures: 1.1 trillion yen), the "real-water" portion of the budget (possessing a direct impact upon GDP growth) is slightly above 2 trillion yen in consideration of local government spending excluding expenses to purchase land (which does not have a direct impact upon demand).

Chart 24 Outline of the *Program to Accelerate Reforms*

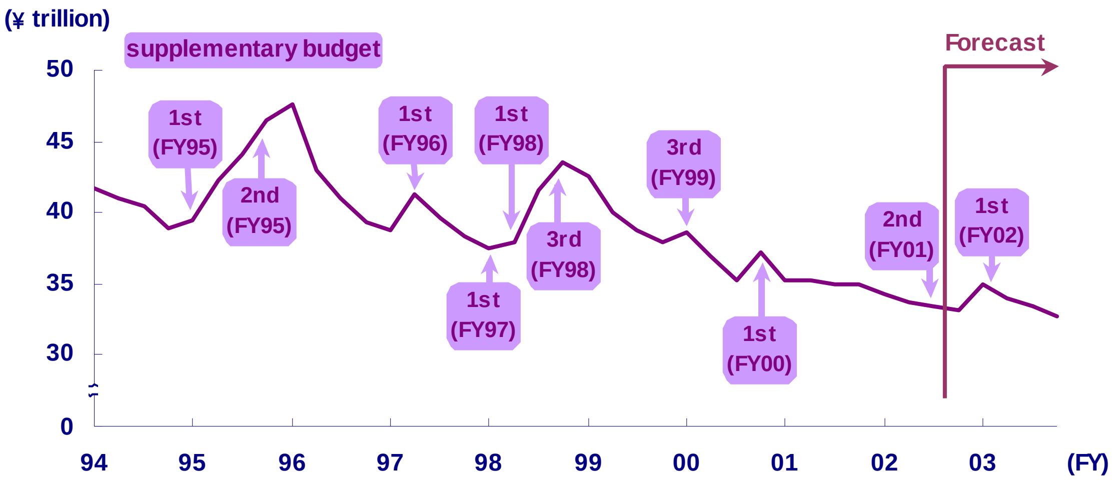
(¥ trillion)

	Scale of projects	National expenditures	Local expenditures etc.	Financing etc.
Building of safety nets in preparation for Japan's economic and social structural transformation	12.2	1.5	0.3	10.4
Strengthen employment measures	0.5	0.5		
Expand measures for small and medium-sized enterprises	10.9	0.5		10.4
Support entrepreneurship and new business start-ups (cultivate new industries)	0.3	0.3		
Establish fair and secure society addressing aging society and declining birthrates	0.5	0.2	0.3	
The encouragement of public investment promoting structural reform	2.6	1.5	1.1	
Promote urban renaissance efforts and the upgrading of urban functions that encourage such efforts	0.6	0.3	0.3	
Provide infrastructure geared toward attractive cities and regional revitalization	1.0	0.6	0.4	
Respond to environmental problems and other urgent issues	1.0	0.6	0.4	
Total	14.8	3.0	1.4	10.4

Note: In the "scale of projects", "local expenditures etc." refer to expenditures by local government entities and public corporations and "financing etc." refer to credit and guarantee facilities by public financial institutions.
Source: Cabinet Office.

The funds necessary for the *Program to Accelerate Reforms* are earmarked in a FY2002 supplementary budget passed in January 2003 and should push up the rate of real GDP growth in the first half of FY2003 (degree of contribution in the first half of FY2003: 0.2 percent, Chart 25). However, since expenditures in the draft FY2003 budget are kept below the previous year level and public works related expenditures are slashed almost 4 percent from the previous year, we expect the contribution by public investment to revisit negative territory in the second half of the fiscal year.

Chart 25 Public Fixed Capital Formation



Source: Cabinet Office, *Preliminary Quarterly Estimate of GDP*.

(2) Government consumption will slow reflecting heavier burden of the cost of medical treatment for patients and the reduction of public investment

Labor compensation in the public sector will stop falling due to a planned increase in employment for new public services. Social benefits in kind, which have been growing against a backdrop of rising medical care benefits, are expected to slow because of (1) the increase of medical care expenses to be shouldered by patients pursuant to the revisions of the medical care system for the elderly in October 2002 and the medical insurance system in FY2003, and (2) the downward revision of medical fees in FY2002. In addition, consumption of fixed capital is also declining along with the reduction of capital investment. As a result of the foregoing, we expect growth in government consumption to ease from 2.1 percent y-o-y in FY2002 to 1.3 percent y-o-y in FY2003.

6. Japan's economic outlook: policy packages aimed at raising "growth expectations" are necessary

(1) Japan's real GDP will grow 1.5 percent y-o-y in FY2002 and 0.3 percent y-o-y in FY2003

Japan's economy has been following a cyclical recovery driven by exports from early 2002. Although the rise of exports triggered a positive domestic economic cycle in the past, the ripple effect is starting to fade in just four quarters.

In the current cycle, the increase of exports led to an upturn of industrial production and gave rise to a marginal increase of employment such as the recovery of new job offers and the improvement of consumer confidence. We believe that the improved sentiment led to the recovery of the household sector in the first half of FY2002, particularly in personal consumption. In contrast, the corporate sector is still mired despite the recovery of capital investment due to a pickup in production activity. This is attributed to the spread of pessimistic outlooks regarding the future, or in other words, the decline of the expected rate of economic growth. Even if corporate profits recover temporarily as a result of restructuring efforts and other measures, it would not lead to the rise of corporate enterprises' expected rate of growth because of persisting deflationary pressures hampering the recovery of sales. The decline of the expected rate of economic growth is serving as a drag upon investment propensity in the corporate sector, resulting in a prolonged slump of capital investment. Given its curb upon stock growth, the stagnation of capital investment is lowering the potential rate of economic growth, thus leading to a further fall of the expected rate of growth.

Since corporate restructuring efforts become routine when business enterprises are shrouded by pessimism, consumer spending boosted by a temporary improvement of consumer confidence will not develop in to a sustainable upswing. Furthermore, we note that the environment for employment and income will remain under downward pressures amid the continuation of bad loan disposals.

In contrast to FY2002 (real GDP growth forecast: 1.5 percent) when exports exerted its full effect in driving the initial stage of economic recovery, we predict the rate of real GDP growth in FY2003 to slow sharply to 0.3 percent, barely managing to maintain positive growth. The GDP deflator is also predicted to remain deep in negative

territory (-1.5 percent) in FY2003, revealing the difficulty to dispel deflationary pressures.

(2) Full mobilization of monetary and fiscal policy measures to raise expectations for the future is extremely important

Although measures to accelerate bad loan disposals pursuant to the government's *Financial Revitalization Program* are progressing, the pace is slowing slightly due in part to considerations toward its impact upon the real economy. Even so, the negative impact of these measures upon the real economy is predicted to intensify from FY2003 onward, making negative economic growth inevitable in FY2004 under the current conditions. In order to keep the rate of FY2004 GDP growth from falling into negative territory, it is necessary to (1) carry out additional fiscal spending of approximately 4 trillion yen (the volume of spending necessary to maintain the growth of public investment in FY2004 at previous-year levels) so as to narrow the output gap, and (2) raise "growth expectations" by generating capital investment through the expansion of industrial frontiers. Furthermore, it is vitally important to compile and implement comprehensive policy packages by mobilizing the full range of possible measures, such as monetary policies supporting fiscal policies.

Chart 26 Forecast of the Japanese Economy for FY2002 and FY2003

(%)

	FY2001	FY2002	FY2003	FY2002		FY2003		FY2002	FY2003
				1st-half	2nd-half	1st-half	2nd-half	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	- 1.2	1.5	0.3	1.7	0.5	0.1	- 0.1	—	—
Domestic demand	- 0.7	0.9	0.6	1.2	0.5	0.5	- 0.3	0.8	0.6
Private sector demand	- 0.9	1.1	0.5	1.6	0.7	0.3	- 0.3	0.8	0.4
Personal consumption	1.4	1.4	0.5	1.0	0.2	0.1	0.4	0.8	0.3
Housing investment	- 8.0	- 2.6	- 0.4	- 1.5	- 0.7	1.1	- 2.2	- 0.1	- 0.0
Capital investment	- 3.4	- 1.0	0.7	1.3	1.2	0.6	- 0.9	- 0.2	0.1
Public sector demand	- 0.0	0.2	1.0	- 0.2	0.1	1.2	- 0.4	0.1	0.2
Government consumption	2.2	2.1	1.3	0.8	0.9	0.4	1.0	0.3	0.2
Public investment	- 4.9	- 4.5	0.3	- 2.9	- 1.7	3.4	- 4.0	- 0.3	0.0
Net exports (contribution)	- 0.5	0.7	- 0.3	0.6	0.0	- 0.4	0.2	0.7	- 0.3
Exports	- 7.2	11.9	1.8	9.8	4.2	- 0.9	1.4	1.2	0.2
Imports	- 3.2	6.7	6.1	5.3	5.2	3.7	- 0.3	- 0.6	- 0.6
GDP (nominal)	- 2.5	- 0.6	- 1.2	0.3	- 0.6	- 0.2	- 1.4		
Industrial production	- 10.2	2.8	0.4	5.3	0.4	0.6	- 0.7		
Unemployment rate	5.2	5.4	5.6	5.4	5.5	5.5	5.7		
Current account balance (¥trillion)	11.9	13.0	11.4	14.4	11.9	11.2	11.4		
as percentage of nominal GDP	2.4	2.6	2.3	2.9	2.4	2.3	2.3		
Corporate goods prices	- 2.4	- 1.6	- 0.9	- 2.1	- 1.2	- 0.7	- 1.1		
Consumer prices	- 1.0	- 0.6	- 0.6	- 0.9	- 0.4	- 0.5	- 0.8		
Long-term interest rate (%)	1.4	1.1	0.8	1.3	0.9	0.8	0.9		
Nikkei stock average (¥)	11,311	9,600	8,800	10,500	8,700	9,000	8,600		
Exchange rate (yen/dollar)	125.1	122.1	125.0	123.1	121.0	123.0	127.0		
Crude oil price (WTI)	24.1	29.3	28.1	27.3	31.3	30.4	25.8		

Notes: 1. FY = rate of change from the previous year. Half-year term = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over the same period a year ago.
3. Half-year unemployment rate and half-year current account balace are adjusted for seasonal factors.
4. Crude oil price = nearest term contract for WTI crude futures. The long-term interest rate = newly-issued 10-year government bonds.

Sources: Cabinet Office, *Annual Report on National Accounts*,
Ministry of Economy, Trade and Industry, *Production, Shipment and Inventory Indexes*,
Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey*, *Consumer Price Index*, Ministry of Finance, *Balance of Payments Statistics*, Bank of Japan, *Balance of Payments Statistics*, *Corporate Goods Price Index*.

(3) The global economy will most likely slide into low growth in the event of a prolonged war in Iraq

Our outlook for FY2002 and FY2003 is based upon a scenario whereunder attacks upon Iraq will end in a short time period lasting less than a month and that crude oil prices will start to decline thereafter. However, in the event the attacks upon Iraq last longer, it would lead to a sustained surge of crude oil prices and serve as further downside risks upon the global economy. Thus, we have examined the impact of a prolonged war in Iraq upon the overseas economies as well as the Japanese economy.

If the attacks upon Iraq last longer for approximately three months, and damages spread to the oil fields of Iraq and Kuwait, we predict that the price of crude oil will continue to rise throughout FY2003 and reach a level above $36/barrel in the Jan-Mar quarter of 2004 (refer to Chart 2). In such event, the growth of the US economy in FY2003 would be mired at 1.4 percent y-o-y (main forecast: 2.5 percent y-o-y) due to a fall of consumer spending stemming from the erosion of consumer confidence. A slowdown of activity in the US - the main driver of the global economy – would severely drag down growth in other areas in comparison to 2002: the euro zone 0.6 percent y-o-y (main forecast: 1.3 percent y-o-y), Asia 5.0 percent y-o-y (main forecast: 5.8 percent y-o-y), Latin America 0.2 percent y-o-y (main forecast: 1.8 percent y-o-y). The rate of Japanese economic growth would also plunge to –0.5 percent y-o-y (main forecast: 0.3 percent y-o-y) since the slowdown of exports and the deterioration of trade terms along with the rise of crude oil prices would undermine growth in the corporate sector. If the attacks upon Iraq causes larger-than-expected damages upon the oil fields, sending crude oil prices even higher, the possibility of the global economy falling into stagnation may not be ruled out. In such event, the Japanese economy would fall into extremely severe conditions including a dive deep into negative territory.

Chart 27 Forecast on Economic Growth in the Event of a Prolonged War in Iraq

(Y-o-y %)

	Main forecast	Prolonged war in Iraq and surge of crude oil prices	Breadth of decline
US	2.5	1.4	- 1.1
Euro zone	1.3	0.6	- 0.7
Asia	5.8	5.0	- 0.8
Latin America	1.8	0.2	- 1.6
Japan	0.3	- 0.5	- 0.8

Note: Forecasts on GDP growth in the calendar year 2003. Data on Japan pertain to FY2003.