Economic Outlook for FY2003 and FY2004

August 2003

The Mizuho Research Institute (MHRI) has revised its economic outlook for FY2003 and FY2004 subsequent to the release of the *Preliminary Quarterly Estimates of GDP* for the Apr-Jun quarter of 2003 by the Cabinet Office. In this English-language translation, we shall comment mainly upon our forecast of the Japanese economy.

<The Overseas Economies>

Although the collapse of the information technology (IT) bubble in 2000 dragged the global economy into the doldrums accompanying a curtailment of capital investment, the US economy will drive the overseas economies into a cyclical recovery in the second half of 2003. Nevertheless, lingering structural adjustment pressures will keep the recovery momentum from rising fully during the year 2003. In particular, a full-blown recovery will be delayed until 2004 in the euro zone and the newly industrialized economies (NIEs) of Asia.

<The Japanese Economy>

The Japanese economy will initially peak out in the Jul-Sep quarter of FY2003 and gradually start to slow down toward the second half of FY2003. Even so, prospects that exports will turn upward reflecting the recovery of the overseas economies from around the New Year and that the recent stock market rally will serve to ease structural adjustment pressures lead to our view that the slowdown from the second half of FY2003 will turn out to be benign. MHRI expects the Japanese economy to regain strength in FY2004.

Real GDP Growth

(%)

	2002 (Actual)	2003 (Forecast)		2004 (Forecast)	
Japan	1.6	1.2	(0.6)	0.5	(-0.1)
US	2.4	2.3	(2.1)	3.2	(3.0)
Euro zone	0.8	0.6	(0.8)	1.8	(1.8)
Asia	6.0	5.1	(5.3)	6.0	(5.9)

Notes: 1. The figures pertaining to Japan are on a fiscal year basis and the rest are on a calendar year basis.

2. The figures in parentheses are forecasts in MHRI's previous *Economic Outlook for FY2003 and FY2004* in May.

Mizuho Research Institute

I. The Overseas Economies

Although the collapse of the IT bubble in 2000 dragged the global economy into the doldrums accompanied by the curtailment of corporate capital investment, we now look to a US-led cyclical recovery of the global economy in the second half of 2003. Nevertheless, lingering structural adjustment pressures will keep the recovery momentum from rising fully during the year 2003. In particular, a full-blown recovery will be delayed until 2004 in the euro zone and Asian NIEs. The following is an overview on each of these areas.

We have upgraded our forecast on the rate of US gross domestic product (GDP) in real terms to 2.3 percent in 2003 (up 0.2 percentage point from our previous forecast in May) and 3.2 percent in 2004 (up 0.2 percentage point). Capital investment will emerge out of a stock adjustment phase and enter a cyclical recovery. Nevertheless, we do not expect capital investment to grow strongly in view of the tepid recovery of production and profits, the rise of upward pressures upon capital cost and lingering balance sheet adjustment pressures. Personal consumption will most likely remain resilient and continue to buttress the economy. Even so, the rise of consumer spending will remain moderate because of the fading effect of policy measures such as tax cuts despite the improvement of the jobs and income environment. As for the year 2004, the downturn of housing investment stemming from high long-term interest rates will serve as a drag upon GDP growth.

Chart 1 Forecast of the US Economy

(%)

	2002	2003	2004	2002 (Actual)		2003		2004 (Forecast)	
	(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half (forecast)	1st-half	2nd-half
GDP	2.4	2.3	3.2	3.5	2.7	1.7	3.1	3.1	3.4
Personal consumption	3.1	2.7	3.3	3.5	3.0	2.3	3.3	3.2	3.3
Housing investment	3.9	5.8	0.6	6.7	3.5	8.9	2.2	0.2	-0.1
Capital investment	-5.7	1.6	8.1	-6.3	-0.5	0.0	7.0	7.9	9.4
Inventory investment ($100 million)	52	-81	303	-120	223	-66	-96	167	439
Government expenditures	4.4	3.1	1.8	5.7	3.0	3.2	3.2	1.3	1.4
Net exports ($100 million)	-4,886	-5,515	-6,330	-4,670	-5,101	-5,320	-5,710	-6,112	-6,547
Exports	-1.6	0.4	4.9	2.6	4.2	-2.9	3.4	4.7	6.5
Imports	3.7	4.3	8.2	8.1	8.7	0.8	7.3	8.1	9.4
Domestic final consumption	2.4	2.8	3.3	2.9	2.6	2.5	3.6	3.2	3.4
Consumer prices (y-o-y % change)	1.6	2.4	2.3	1.4	2.5	2.6	2.0	2.4	2.3
Current account balance ($100 million)	-5,034	-5,835	-6,682	-2,402	-2,632	-2,778	-3,057	-3,268	-3,414
<as percentage of nominal GDP)	-4.8	-5.4	-5.9	-4.6	-5.0	-5.2	-5.7	-5.8	-5.9

Note: 1. Yr = rate of change from the previous year. Half-year term = rate of change p.a. from the previous term.
Sources: US Department of Commerce, US Department of Labor.

MHRI now forecasts real GDP growth in the euro zone to reach 0.6 percent in 2003 (down 0.2 percentage point from the previous forecast) and 1.8 percent in 2004 (unchanged). Although activity in the euro zone is generally sluggish at the moment, the rise of exports along with the recovery of the US economy should trigger an upturn of the euro zone economy by the end of 2003. While the growth rate should rise in 2004, the recovery momentum will likely remain tenuous because of lingering adjustment pressures upon corporate balance sheets and labor costs in Germany.

Chart 2 Forecast of the Euro Zone Economy

(%)

			2002	2003	2004	2003 (Forecast)		2004 (Forecast)	
			(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half
G	Euro zone		0.8	0.6	1.8	0.1	0.4	1.0	1.2
		Germany	0.2	0.2	1.4	-0.3	0.6	0.7	0.8
D		France	1.2	0.8	2.0	0.3	0.5	1.0	1.5
		Italy	0.4	0.5	1.7	0.0	0.5	0.9	1.2
P		Spain	2.0	1.8	2.3	0.8	0.9	1.2	1.4
	UK		1.9	1.7	2.1	0.5	0.9	1.1	1.2
Euro zone consumer prices			2.3	1.9	1.7	2.2	1.5	1.6	1.8

Notes : 1. Rate of real GDP growth. Yr = rate of change over the previous year. Half-year term = rate of change over the previous term. Consumer prices = rate of change over the previous year.

2. Figures regarding 2003 and 2004 are forecasts.

Sources: EUROSTAT, ECB, ONS.

Real GDP growth in the Asian economies is expected to stand at 5.1 percent in 2003 (down 0.2 percentage point from our previous forecast) and 6.0 percent in 2004 (up 0.1 percentage point). The Asian economies should turn around from the second half of 2003, driven by the rise of US-bound exports. However, the recovery momentum will likely remain tepid during 2003 due to the negative impact of SARS (severe acute respiratory syndrome, the "negative impact" refers to its multiplier effect from the fall of tourist revenues and weak consumption) and the cyclical adjustment of the Asian NIEs. We are also inclined toward the view that the pace of Asian economic recovery will only start to pick up from 2004. MHRI's forecast is based upon the premise that the much-debated decision to raise the yuan rate will not materialize during the forecast horizon.

Chart 3 Forecast of the Asian Economies

(%)

			2002 (Actual)	2003 (Forecast)	2004 (Forecast)
Asia (average)			6.0	5.1	6.0
	NIEs (average)		4.5	2.8	4.5
		S. Korea	6.3	3.7	5.5
		Taiwan	3.5	2.8	3.8
		Hongkong	2.3	1.1	2.7
		Singapore	2.2	1.3	4.1
	ASEAN (average)		4.3	4.2	4.6
		Thailand	5.3	5.0	5.1
		Malaysia	4.1	4.0	4.5
		Indonesia	3.7	3.5	4.2
		Philippines	4.4	4.3	4.5
	China		8.0	7.5	7.7

Notes: 1. Real GDP growth (change over the previous year).
2. Weighted average on the basis of each country's nominal GDP in 2000.

Source: Government data provided by each of the relevant countries.

II. The Japanese Economy

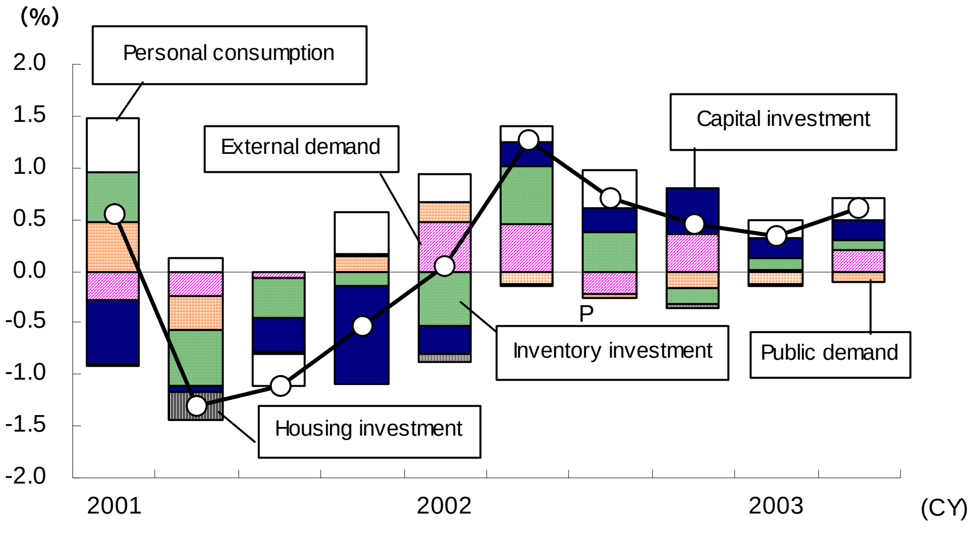
1. The current state and key issues regarding the economy

Pessimism on the Japanese economy is abating

Despite cautious outlooks on Japan's economy during the past few months, negative views on the Japanese economy are starting to recede, giving way to expectations on an impending recovery.

Turning to the economy's actual performance, while the Japanese economy bottomed out in January 2002 driven by export growth, the recovery momentum thereafter has been extremely sluggish. In particular, the economy has been repeating an ebb-and-flow pattern since the second half of FY2002. Although Japan's real GDP grew 0.6 percent q-o-q (translated into an annualized rate of 2.3 percent) in the Apr-Jun quarter of 2003, the growth rate was overly inflated by temporary factors, providing us with reason to believe that the genuine strength of the economy – discounting these temporary factors – only grew approximately 0.3 percent, remaining at the same level as the Jan-Mar quarter (Chart 4). Moreover, it should be noted that industrial production fell 0.6 percent q-o-q in the Apr-Jun quarter, declining for the first time in seven quarters.

Chart 4 Real GDP Growth and Degree of Contribution by Major Demand Components



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

Three factors behind the ebb of pessimism

The ebb of negative views on the economy in spite of the absence of a major recovery of the Japanese economy may be attributed to following factors.

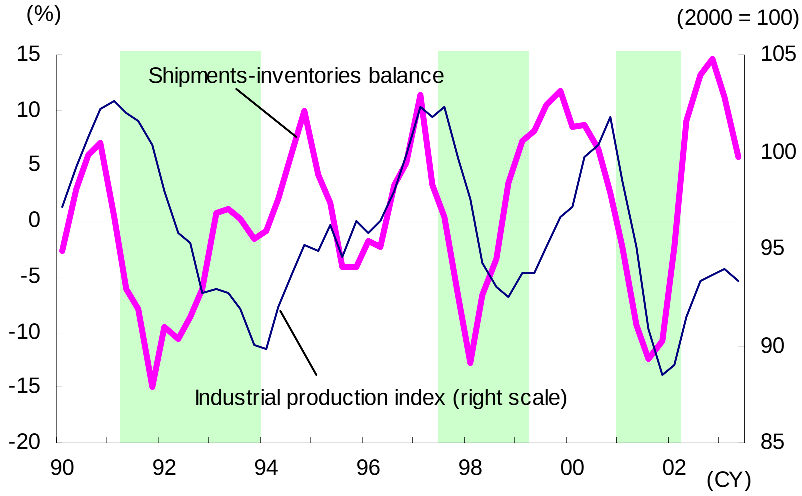
Firstly, the negative impact of the war in Iraq and the SARS epidemic in East Asia was contained within a relatively limited scope. Despite worries that these downside factors would depress exports and trigger a recession, real exports grew 1.0 percent q-o-q in the Apr-Jun quarter. The second factor is the rise of expectations toward US economic recovery. In the Apr-Jun quarter, US real GDP grew 2.4 percent q-o-q, up from 1.4 percent q-o-q in the previous quarter from January to March. Looking closer at the components, the GDP figures confirm a recovery of capital investment. The US economic recovery is spurring expectations toward an export-led recovery of the Japanese economy. Finally, the recent stock market rally is expected to have a favorable impact upon financial conditions and sentiment among corporate enterprises.

Nevertheless, there are numerous indicators signaling a slowdown of the recovery momentum

The foregoing factors paint a decidedly positive outlook of the Japanese economy, leading to our view that the risks of a recession have been averted at least for the time being.

However, it is also true that numerous economic indicators point to a slowdown of the cyclical recovery. The year-on-year growth of real GDP and industrial production has already peaked out, underscoring the weakening recovery momentum. As evident from the shipments-inventories balance (the y-o-y change in shipments minus the y-o-y change in inventories), the inventory cycle – defining the short-term economic cycle – is nearing an adjustment phase, thus presaging Japan’s slide into recession (Chart 5). The momentum of capital investments (the y-o-y change in shipments minus the y-o-y change in production capacity) is also trailing a definite downtrend, indicating the possibility of slower capital investments ahead (Chart 6). Judging from the composite index of lagging indicators and the terms of trade index, the odds are high that corporate profits will peak out and start to decline in the second half of FY2003. Given these indicators, we believe that the Japanese economy will enter an adjustment cycle in the near future.

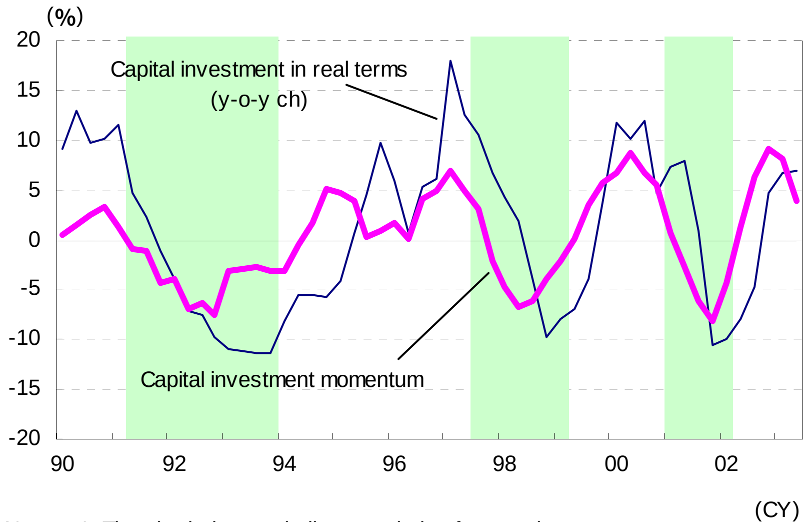
Chart 5 The Shipments-Inventories Balance and Industrial Production Index



Notes: 1. The shaded areas indicate periods of recession.
2. Shipments-inventories balance = shipments index (y-o-y ch) minus inventories index (y-o-y ch).

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

Chart 6 Capital Investment Momentum and Capital Investment



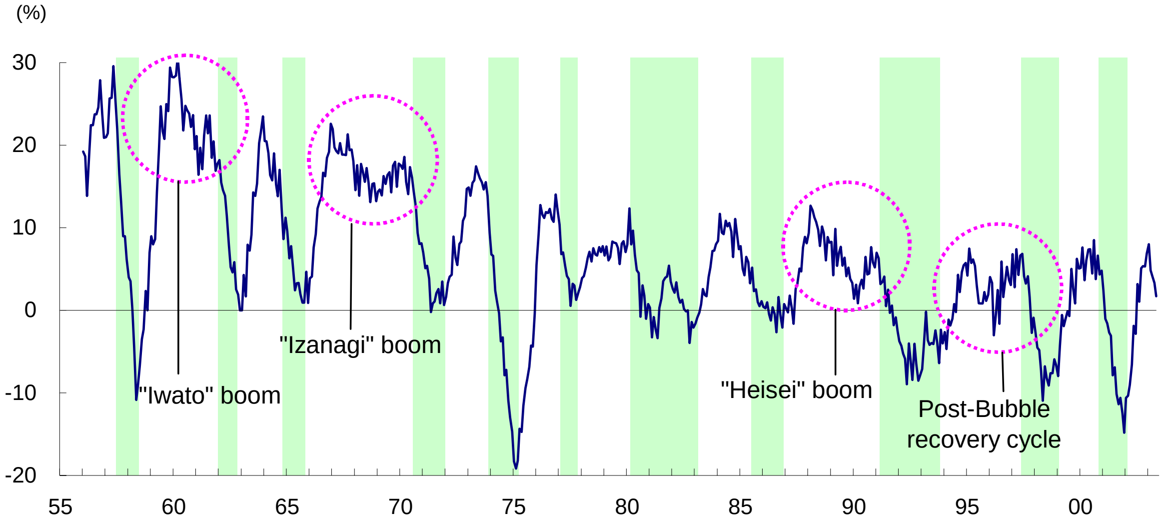
Notes: 1. The shaded areas indicate periods of recession.
2. Capital investment momentum = shipments index (y-o-y ch) minus production capacity index (y-o-y ch).

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

The question then is how to interpret this mixed bag of positive and negative indicators. Looking retrospectively at past economic cycles in the post-War era, there are several instances in which a sharp slowdown of the recovery momentum did not culminate in a full-blown recession. Namely, they are the "Iwato" boom (July 1958~December 1961), the "Izanagi" boom (November 1965~July

1970), the “Heisei” boom (December 1986~February 1991) and the post-Bubble recovery cycle (November 1993~May 1997). All these periods are characterized by a twin peak of industrial production – a deep plunge in the course of economic recovery followed thereafter by a sharp peak (Chart 7).

Chart 7 Industrial Production



Note: The shaded areas indicate periods of recession.
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

Searching for a clue to the movement of industrial production in such a twin-peak pattern, we note that there was a shift of monetary policy to a tightening stance in the Iwato, Izanagi and Heisei booms. Forecasts of higher interest rates ahead spurred corporate fixed investment and housing investment, leading to the second peak in production. However, we may not hope for events to unravel in the same fashion at the current juncture. In the recovery cycle following the collapse of the bubble economy, flexible macroeconomic policies in response to the risks of economic slowdown succeeded in avoiding an economic recession. We are referring to the twofold monetary easing decisions in 1995, which at the time, comprised an unprecedented economic stimulus package. While the stimulation of demand by policy initiatives is still a viable option today, the chances are slim that the government and Bank of Japan will take a step toward massive fiscal spending or unconventional monetary policies.

The economy will peak out and slide into an adjustment phase in the second half of the fiscal year

Reiterating the foregoing, there have been cases in the past where a definite slowdown of the economic recovery momentum did not result in a peak-out of the economy. In all these instances however, the economy was driven by some form of additional demand. Although we may look forward to the growth of exports along with the recovery of the overseas economies, MHRI believes that the level of demand generated by the forthcoming growth of exports will be insufficient to keep the economy from peaking out. As we shall explain later in more detail, while Japan's exports will rise along with the recovery of the overseas economies, the upward momentum will remain subdued in FY2003 with a full-blown growth of exports delayed until FY2004. Meanwhile, judging from leading economic indicators, the odds are high that the economy will peak out in the Jul-Sep quarter. We are thus inclined toward the view that the economy will slide into an adjustment cycle in the second half of FY2003.

Even so, the adjustment will be benign

Meanwhile, it appears that the degree of adjustment after the peak-out will not be as serious as MHRI had initially forecasted in its *Economic Outlook for FY2003 and FY2004* in May 2003. Although the economy will peak out as stated above, the growth of exports reflecting the recovery of the overseas economies will most likely support the economy. Furthermore, the adjustment pressures upon the corporate sector and the money/capital markets – serving as downside risks upon the economy – are abating helped by the recent stock market rally. The current low level of inventories and the likelihood that manufacturers have finished reducing their overhang of inventories will also keep the economy from falling into a serious adjustment cycle. Thus, the odds are high that the adjustment cycle from the second half of FY2003 will turn out to be benign and will not be perceived as a recession.

The FY2003 and FY2004 growth forecasts are upwardly revised

MHRI has revised upward its forecast on Japan's economic growth in this *Economic Outlook for FY2003 and FY2004* of August 2003 on the basis of the foregoing assessment. More specifically, we expect Japan's rate of real GDP growth to reach 1.2 percent (up from 0.6 percent in our previous forecast in May 2003) in FY2003 and 0.5 percent (up from –0.1 percent in the May 2003 forecast). The Japanese economy will reach an initial peak in the Jul-Sep quarter and start to show signs of deceleration in the second half of the fiscal year. Nevertheless, the economic slowdown from the second half of the year will remain benign and start to follow an export-led recovery in FY2004.

The following provides a more detailed examination of each of the demand components and key issues involved in our forecast.

2. External demand

Exports will remain the key engine of the economy

Exports comprise the most important component of demand in forecasting the future course of the economy. Although exports will surge along with the recovery of the overseas economies, we must wait until FY2004 for a full-blown export recovery.

Export growth in real terms stood at 1.0 percent q-o-q in the Apr-Jun quarter. Despite the smaller-than-expected negative impact of the SARS epidemic upon China-bound exports, the decline of exports to Korea and Taiwan - which are currently undergoing an adjustment cycle - and sluggish US-bound exports due to the Iraq war served as downside factors.

In the ensuing months, we expect exports to the US to follow an upward path along with the recovery of the US economy. Meanwhile, Asia-bound exports will remain lackluster due to the economic adjustment in Korea and Taiwan. Exports bound for the euro zone do not appear promising either because of a pause in the appreciation of the euro and the slow recovery of the euro zone economies. Although exports will remain on an uptrend in FY2003, the rate of growth will fall short of spectacular. While exports will serve to buttress the economy, it will be insufficient to buoy the entire economy. We are inclined to believe that export growth will start to lift the entire economy in FY2004 along with a US-led recovery of the global economy.

Imports sag in FY2003, reflecting weak domestic demand and the decline of overseas travel

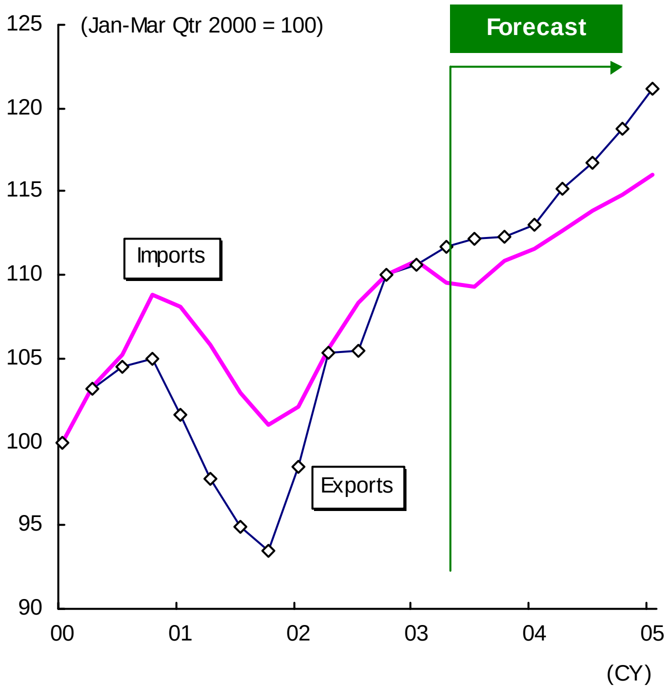
Imports will basically move in tandem with domestic economic trends. In the second half of FY2003, imports will slow down due to the stagnation of domestic demand. In FY2004 however, the upturn of the domestic economy should contribute to the rise of imports. Furthermore, we expect that a closer network of the international division of labor with the countries of East Asia in areas such as information and telecommunications, leading to a greater linkage between exports and imports, will serve as factors generating the rise of imports in FY2004.

Turning to total demand in terms of its contribution to GDP, it should be noted that the sharp fall of overseas travel reflecting the war in Iraq and the spread of SARS will result in higher GDP growth in FY2003. While imports in real terms fell 1.1 percent q-o-q in the Apr-Jun quarter, declining for the first time in seven quarters, this was due mainly to a contraction of the trade deficit in services as a result of the decline of overseas travel. The impact should linger until the Jul-Sep quarter.

Judging from the foregoing, we expect exports and imports to grow 4.1 percent y-o-y and 1.5 percent y-o-y respectively in FY2003. In

FY2004, we expect exports to grow 5.0 percent y-o-y and imports to rise 3.6 percent y-o-y (Chart 8). The degree of contribution by external demand (exports minus imports) to real GDP growth should reach 0.3 percent in both FY2003 and FY2004.

Chart 8 Exports and Imports in Real Terms

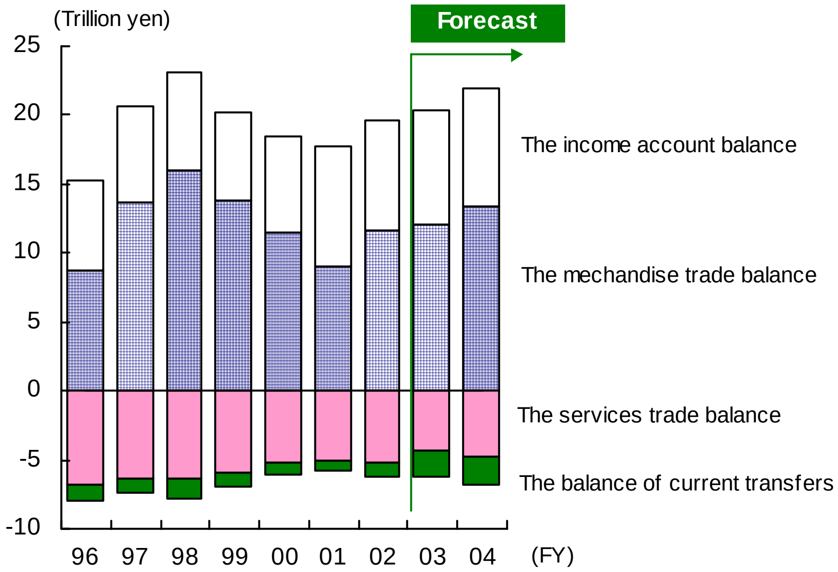


Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

The current account surplus will continue to expand

At this point, we shall comment briefly upon Japan's current account surplus. In FY2002, Japan's current account surplus expanded for the first time in four years. This was due to the contraction of the surplus on the investment income account along with the fall of direct investments and securities investment profits while the trade surplus expanded as a result of the sharp rise of exports. From FY2003 to FY2004, we are inclined to believe that the current account surplus will expand from a mild expansion of the trade surplus and the recovery in the investment income account reflecting the upturn of the overseas economies and investment climate (Chart 9). As far as FY2003 is concerned, the decline of overseas travel due to the war in Iraq and SARS contributed to the expansion of the current account surplus via the reduction of the deficit on services trade (the travel account).

Chart 9 Current Account Balance



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

3. The corporate sector

Industrial production will remain slow in FY2003 but will start to pick up in FY2004

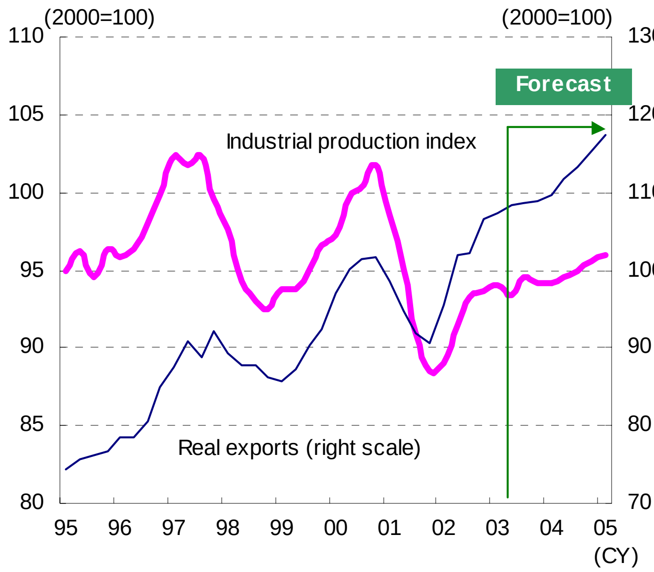
The trends in external demand examined above define the course of corporate capital investment through production and profits, thereby affecting household consumption behavior as a result of changes in employment and wages.

Reflecting the slowdown of exports, corporate production activity is coming to a standstill. Industrial production dropped 0.6 percent q-o-q in the Apr-Jun quarter of 2003, falling for the first time in seven quarters due to the stagnation of exports.

Looking forward, industrial production will most likely continue to ebb and flow given the less-than-spectacular growth of exports in FY2003 (Chart 10). The Japanese economy may not help but rely upon exogenous demand such as exports in order to revive production because deflation and the loss of growth expectations are hampering the autonomous recovery mechanism of private demand. However, exports would have to grow at an annualized rate of 2.5 percent or more for exports to propel industrial production (refer to MHRI's *Economic Outlook for FY2003 and FY2004* of May 2003). Since we would have to wait until FY2004 for real export growth to reach this level, the chances are remote that an export-led recovery of production will materialize during FY2003.

In the production recovery cycle from 2002, corporate enterprises took an extremely cautious stance in accumulating inventories and thus, to date, corporate inventories are held at a low level. Therefore the risks of having to pare down production activity in order to reduce inventories are minimal. Furthermore, in the absence of an inventory overhang, we expect the growth of exports reflecting the recovery of economies overseas to lead directly to the rise of production.

Chart 10 Real Exports and Industrial Production



Sources: Ministry of Economy, Trade and Industry, *Indices of Industrial Production,* Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

Corporate performance will worsen initially because of deflation and lackluster demand

Corporate profits will most likely fall off from the recovery path it has been following thus far (Chart 11). Given persistent deflation and the ongoing weakness of demand, sales volumes will continue to shrink from FY2003 to FY2004. Corporate enterprises have been able to improve their profit performance even in the midst of sagging sales volumes because of corporate restructuring efforts to cut labor and other costs. The positive impact of these restructuring efforts is already wearing away. Coupled with the decline of sales due to the stagnation of exports, companies will be compelled to take an even more aggressive restructuring stance.

Chart 11 Corporate Profit

(Y-o-y % change)

		FY2001 (Actual)	FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)
All industries	Sales	-3.3	-5.6	-0.4	-1.5
	Current profits	-19.6	7.2	6.6	-2.0
Large enterprises	Sales	-3.9	-0.4	-0.8	-1.0
	Current profits	-23.6	23.6	9.2	1.1
Manufacturers	Sales	-5.6	1.9	-0.2	0.0
	Current profits	-41.2	40.6	7.3	4.1
Non-manufacturers	Sales	-2.6	-2.1	-1.2	-1.7
	Current profits	-0.6	10.4	11.1	-1.7
Small and medium-sized enterprises	Sales	-2.8	-8.9	-0.2	-1.9
	Current profits	-15.7	-7.1	3.6	-5.7
Manufacturers	Sales	-7.5	-3.7	0.1	-0.9
	Current profits	-44.8	18.8	5.3	0.9
Non-manufacturers	Sales	-1.6	-10.3	-0.2	-2.1
	Current profits	-1.8	-14.1	2.9	-8.3

Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry.*

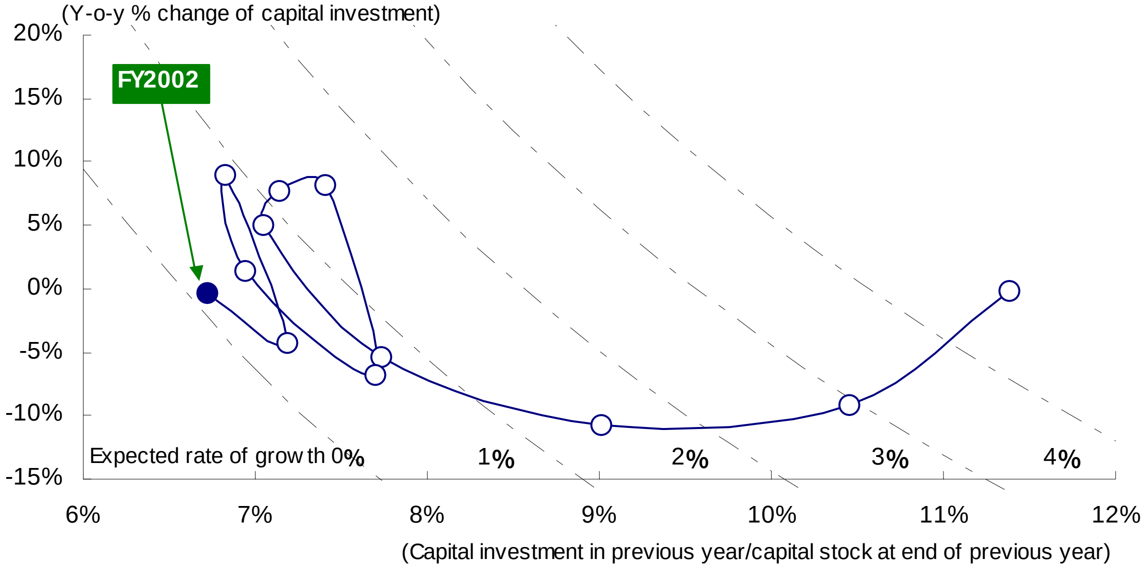
From FY2003 to FY2004, we expect a wider disparity in profit recovery among different industries. The manufacturing sector should be able to maintain relatively solid profits given the positive impact of export growth and the growth of global IT demand. In contrast, in addition to a steep uphill task for the non-manufacturing sector to emerge out of a prolonged stagnation amid the weakness of domestic demand, it also needs to reduce its debt overhang. The foregoing provides us with reasons to believe that the non-manufacturing sector will face dire profits.

Capital investment will start to pick up again after emerging from a mild adjustment cycle up to the first half of FY2004

Capital investment from FY2003 onward will reflect the trends in exports, production and corporate profits set forth above.

Recent patterns in business fixed investment reveal that manufacturers are investing in plant and equipment to meet the rise of exports in the manufacturing sector because drags upon capital investment are being alleviated as a result of progress in areas such as reducing the debt overhang. Furthermore, as a result of restraints upon capital investment thus far, we believe that the adjustment of excess stock in the capital stock cycle has run its course (Chart 12). The absence of a substantial rise of capital investment in spite of these conditions is due largely to the weakness of growth expectations in the corporate sector. Unless companies may look forward to solid profit gains stemming from the future rise of demand, they will be reluctant to engage in major investments in a bid to augment their capacity. Despite scattered evidence of positive capacity-boosting investments in the IT sector, we are inclined toward the view that it will still take more time for such stirrings to spread throughout the industry. Moreover, since the non-manufacturing sector is still subject to intense structural adjustment pressures such as the need to reduce the debt overhang under deflation, companies are still refraining from investing in plant and equipment.

Chart 12 Capital Stock Cycles



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

The environment surrounding capital investment remains largely unchanged. Judging from emerging signs that the recovery of capital investment is slowing down, business fixed investment in the manufacturing sector should fall into an adjustment phase as a result of sluggish exports and production in the second half of FY2003. We do not expect a significant increase of capital investment outside the IT sector where demand should remain strong. Although capital investment will continue to grow above the previous year on an all-year basis in FY2003, the figures will most likely ebb and flow in the second half of the fiscal year. In FY2004, capital investment among manufacturers should turn the corner along with the upturn of exports. Nevertheless, we do not expect a surge in incentive to invest in plant and equipment given lackluster corporate growth expectations reflecting the slim chances of a recovery in business performance. We expect capital investment to grow 3.6 percent y-o-y in FY2003 and 0.1 percent y-o-y in FY2004.

4. The household sector

The deterioration of the environment surrounding jobs and income and the increase of social welfare burdens dampen personal consumption

Although personal consumption has thus far served to buttress the economy, we expect this component of demand to slow from the second half of FY2003. As causes for the slowdown of consumption, we suspect the three following factors.

Firstly, labor compensation will most likely take another dip (Chart 13).

Employment-related statistics are currently improving reflecting the upturn of production and profits continuing from last year - as exemplified by the number of workers and nominal wages in the Apr-Jun quarter growing positive from the previous year. However, the improvement is evident only in marginal areas such as non-regular and part-time workers and the amount of bonus payments (special cash earnings). Since the mid-1990s, companies with surplus workers have been reducing regular employees and coping with the need to raise output by employing part-timer workers. As a result of this trend, the level of labor compensation is responding much quicker to changes in economic conditions. Moreover, companies suffering from stagnant sales must still depend upon corporate restructuring in order to secure profits. Thus, in the event of further economic malaise, corporations will be inclined at once to cut labor costs. Although nominal labor compensation should rise 0.3 percent y-o-y in FY2003, turning positive for the first time in three years, we expect it to fall into negative territory (-1.3 percent y-o-y) again in FY2004.

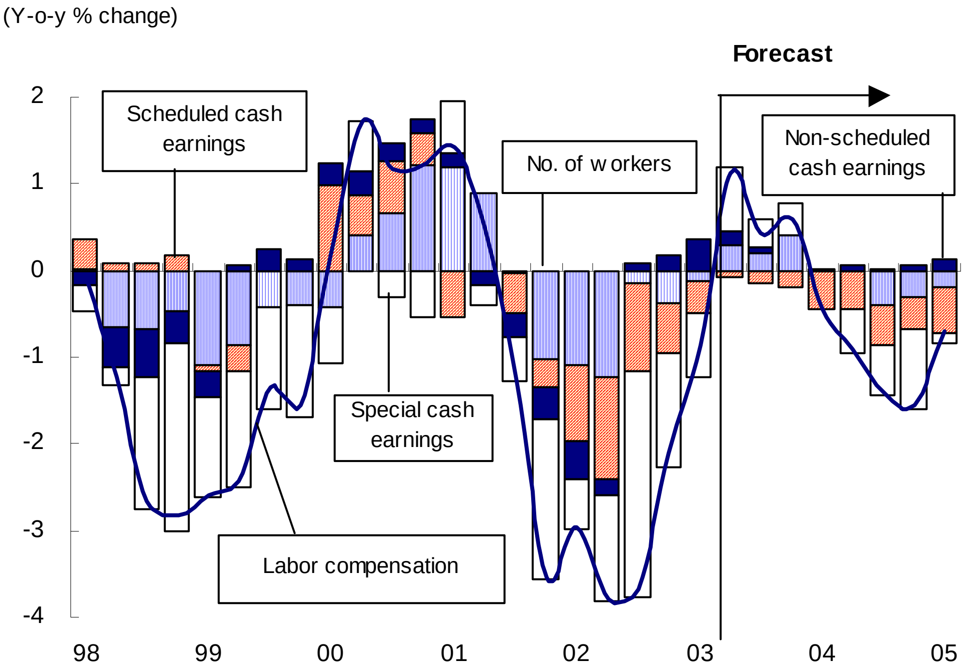
Secondly, the increase of social security burdens accompanying various amendments in the social security system are weighing heavily upon household income (Chart 14).

From FY2003 to FY2004, Japan's social security system will undergo a number of amendments, which will lead to a greater burden upon the household sector. Among the amendments implemented so far are: (i) the increase of the portion of medical costs shouldered by patients (from April 2003) and (ii) the reduction of pension benefit payouts in tandem with consumer price levels (also from April 2003). Looking forward, the minimum taxable limit regarding income and inhabitants taxes will be raised (from January 2004 and January 2005 respectively) and the employees' pension insurance premium will be raised in October 2004. From the period from FY2001 to FY2002, an automatic stabilizer was in effect where the reduction of social security burdens served to alleviate the drop of labor compensation. Given the high probability that the automatic stabilizer will not function properly from FY2003 to FY2004 due to the various social security amendments, we are inclined to believe that the decline of labor compensation will lead directly to the fall of disposable income.

Thirdly, we may no longer expect consumption propensity to rise as strongly as in the past. Up to FY2002, consumer spending remained resilient in comparison to income because of: (i) a "ratchet effect" amid lackluster income, (ii) the higher purchasing power of assets due to deflation (the "Pigou Effect"), and (iii) temporary income accompanying the maturity of high interest-bearing postal savings from FY2000.

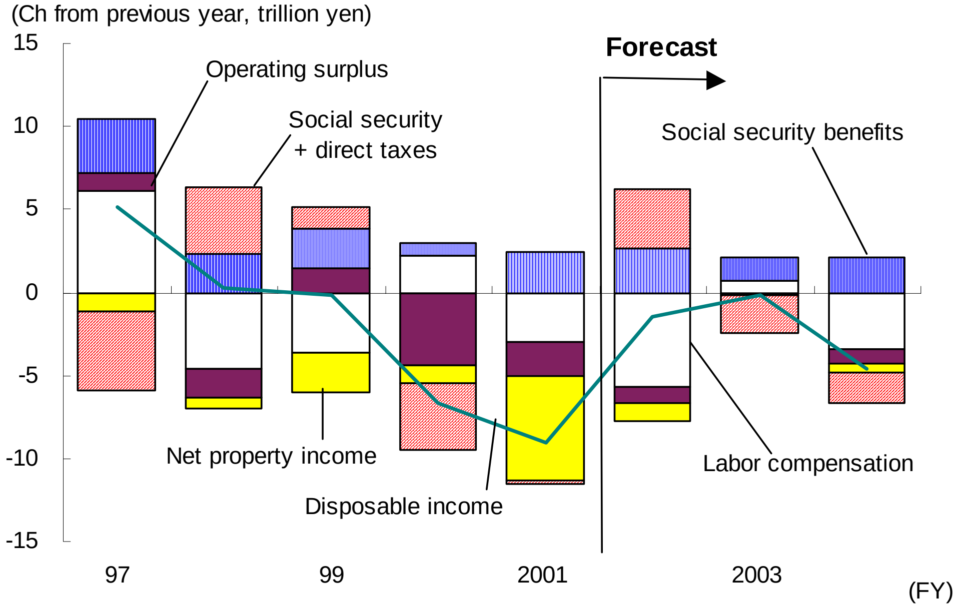
From FY2003 onward, it will be difficult for these factors to prop up income in the household sector. Moreover, the various amendments from this fiscal year are starting to undermine the strength of elderly households - the main beneficiaries of (ii) and (iii) above and the sole driver of consumer spending. Since middle-aged and younger households do not have much spending power because of stagnant income growth and greater real debt burdens, the odds are high that personal consumption as a whole will lose momentum along with the slowdown of consumption among elderly households.

Chart 13 Labor Compensation



Sources: Ministry of Health, Labor and Welfare, *Monthly Labor Survey,*
Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey.*

Chart 14 Disposable Income



Source: Cabinet Office, *Annual Report on National Accounts.*

Personal consumption will grow 0.7 percent y-o-y in FY2003 and 0.4 percent y-o-y in FY2004

The foregoing provides us with reasons to believe that personal consumption will start to ebb from the second half of 2003 and remain sluggish in FY2004. Consumer spending will only start to revive from around the end of FY2004. We expect private-sector real consumption expenditures to rise 0.7 percent y-o-y in FY2003 and 0.4 percent y-o-y in FY2004 (Chart 15).

Chart 15 Personal Consumption

(%)

	FY2001 (Actual)	FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)
Shunto (spring labor offensive) wage hike rate	2.01	1.66	1.55	1.36
Labor compensation	-1.1	-2.1	0.3	-1.3
Per worker employed	-0.8	-1.6	0.0	-1.0
No. of workers employed	-0.3	-0.5	0.2	-0.2
Disposable income	-3.0	-0.5	0.0	-1.6
Household cosumption expenditure deflator	-1.6	-1.5	-1.5	-1.5
Real disposable income	-1.4	1.0	1.4	-0.1
Nominal consumption expenditures	-0.1	0.1	-0.8	-1.1
Private sector consumption expenditure deflator	-1.6	-1.3	-1.5	-1.5
Real consumption expenditures	1.5	1.4	0.7	0.4
Propensity to consume	93.4	93.9	93.1	93.5
Change from previous year (% point)	2.7	0.4	-0.8	0.4

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 exdpenditure deflator excluded imputed rent.

Source: Cabinet Office, *Annual Report on National Accounts,* and others.

Private-sector housing investment will remain weak in FY2003 (-1.3 percent y-o-y) and FY2004 (-1.9 percent y-o-y)

The deterioration of employment and income will serve to dampen housing investment. In the absence of sanguine prospects regarding future income, we do not expect a rise in incentive to purchase homes. While the currently debated extension of the tax breaks on mortgages may succeed in mitigating a reactionary drop, the extension itself would not be sufficient to cause a surge in demand for new housing if there are no fundamental changes in the tax system and level of tax cuts since much of the potential demand has been exhausted already as a result of a rush to purchase new homes before the expiration of the aforementioned tax breaks. The reduction of inventories of built-for-sale condominiums will also curb the rise of housing starts.

Turning to houses for rent, construction has been brisk in response to new demand generated by recent lifestyle changes. However, in view of the fact that the demand for rental housing has been climbing for three years already, a stock adjustment may be around the corner. We expect housing investment to decline 1.3 percent y-o-y in FY2003 and fall 1.9 percent y-o-y in FY2004 (Chart 16).

Chart 16 Housing Investment

		FY2001 (Actual)	FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)
Housing starts	('0,000 units)	117.4	115.1	115.3	113.0
	(Y-o-y % change)	-4.6	-1.9	0.2	-2.0
Owner-occupied houses	('0,000 units)	38.7	36.8	36.8	35.8
	(Y-o-y % change)	-14.3	-4.9	0.1	-2.8
Houses for rent	('0,000 units)	43.8	45.0	45.9	45.5
	(Y-o-y % change)	4.0	2.7	2.0	-1.0
Houses for sale	('0,000 units)	33.9	32.4	31.6	30.8
	(Y-o-y % change)	-1.8	-4.4	-2.5	-2.5
Nominal private-sector housing investment	(Y-o-y % change)	-9.1	-4.1	-1.8	-2.8
Deflator	(Y-o-y % change)	-1.2	-1.3	-0.5	-0.9
Real private-sector housing investment	(Y-o-y % change)	-8.0	-2.9	-1.3	-1.9

Sources: Cabinet Office, *Annual Report on National Accounts,*
Ministry of Land, Infrastructure and Transport, *New Dwellings Started.*

5. The public sector

Public investment continues to decline reflecting the government's fiscal structure reform agenda

As far as the second half of FY2003 is concerned, the growth of exports will be subdued. Likewise on the domestic front, we do not expect a significant rise of capital investment and personal consumption. Under these circumstances, the focus of attention is whether the government and Bank of Japan (BOJ) will implement expansionary macroeconomic policies. However, the chances are slim that the economy will be driven by macroeconomic policies from the second half of the fiscal year in view of the fact that the government and BOJ has already run out of conventional fiscal and monetary policy options and there are no signs of a policy shift by the ruling coalition at the current juncture.

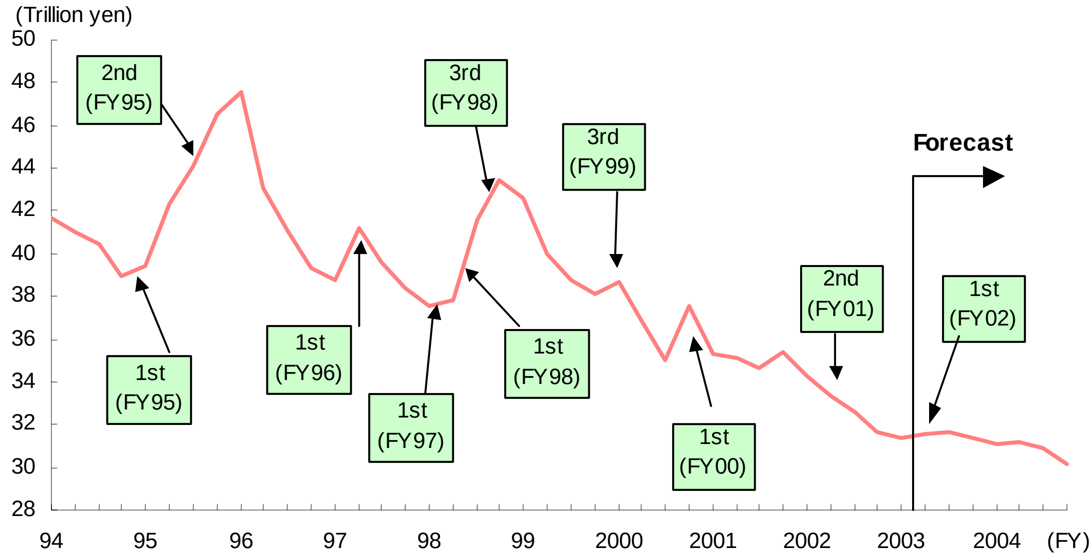
We are thus inclined to believe that public investment will remain a drag upon the economy in FY2003 and FY2004.

Despite initial expectations regarding the progress of public works projects in last fiscal year's supplementary budget, public investment turned out to shrink 0.9 percent q-o-q in the Apr-Jun quarter of 2003. Even with the implementation of the public works projects earmarked in the supplementary budget, the downturn was due to a sharp reduction of public works-related expenditures in the FY2003 initial budget.

In the FY2003 initial budget, public works-related expenditures will most likely be slashed 3.9 percent y-o-y in the national government and approximately 10 percent y-o-y among local governments. Likewise in FY2004, the odds are high that public works-related expenditures will be reduced around 3 percent y-o-y on the national level and approximately 5 percent y-o-y among local governments. In MHRI's *Economic Outlook for FY2003 and FY2004*, we assume a supplementary budget of around two trillion yen on a "real water basis" ("real water" refers to the portion of the budget possessing a direct impact upon real GDP growth"). However, even if these public works projects are carried out, we are skeptical that they will generate sufficient additional demand to support the economy from FY2003 through FY2004.

We expect public fixed capital formation to drop in both FY2003 (-4.1 percent y-o-y) and FY2004 (-2.2 percent y-o-y) (Chart 17).

Chart 17 Public Investment



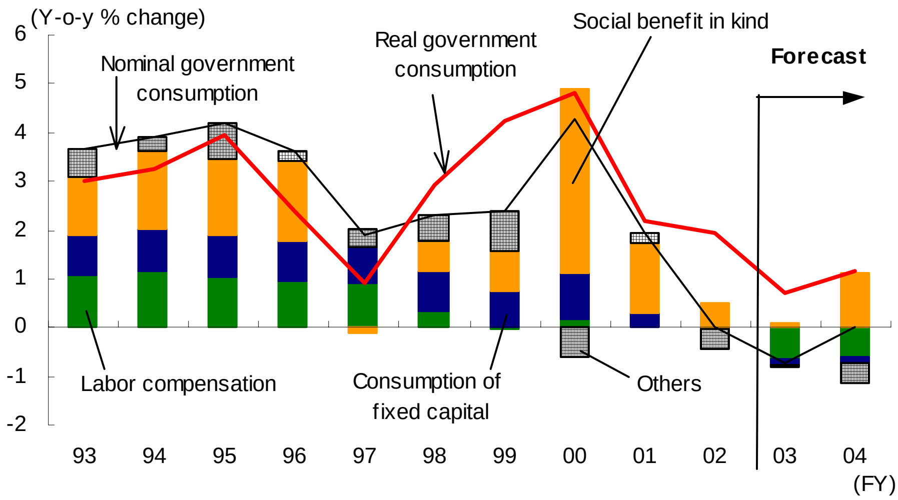
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

Government consumption will also slow sharply

MHRI's forecast on government consumption is as follows: FY2003 (0.7 percent y-o-y) and FY2004 (1.2 percent y-o-y) (Chart 18).

In FY2003, the growth of government consumption will slow sharply due partially to one-off factors such as the cuts upon public servants' wages and the transfer of social benefit in kind to private-sector consumption along with the amendment to raise the burden of medical costs shouldered by patients from April 2003. Since the impact of these factors will fade in FY2004, the growth of government consumption will rise slightly in comparison to FY2003. Meanwhile, since the consumption of fixed capital will most likely decline reflecting last year's cuts upon public investment, this may well serve as a suppressant upon new government consumption.

Chart 18 Government Consumption



Note: The breakdown of the FY2002 figures are MHRI estimates.
Source: Cabinet Office, *Annual Report on National Accounts*.

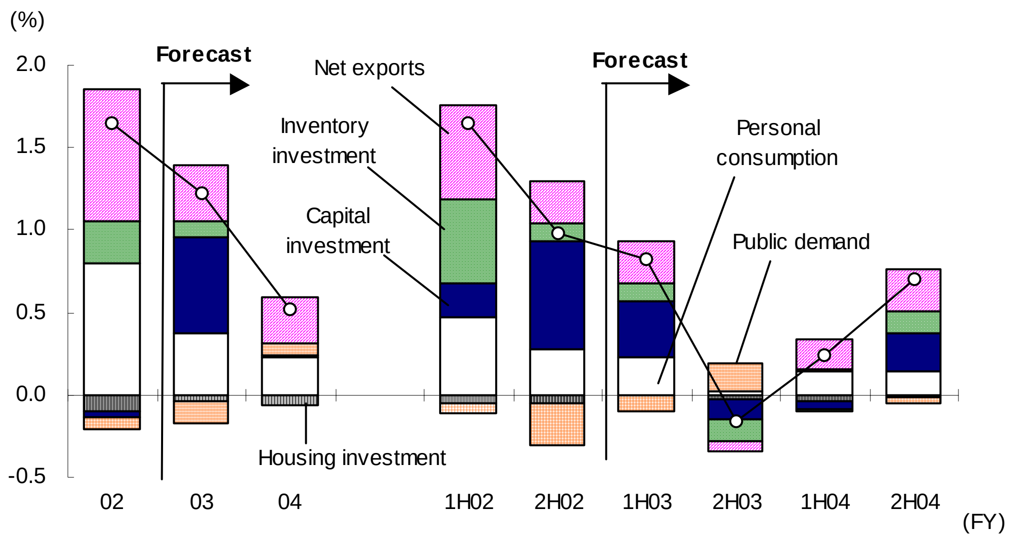
6. Forecast of the Japanese economy in FY2003 and FY2004

Although Japan's real GDP will expand 1.2 percent in FY2003, economic growth may dip into negative territory in the second half of the fiscal year

MHRI's outlook on the Japanese economy in FY2003 and FY2004 is as set forth below (Charts 19 and 20) on the basis of a comprehensive analysis of the factors discussed above.

We expect Japan's economy to reach a cyclical peak in the first half of FY2003 and start to show signs of adjustment in the fiscal year second half. In addition to a quarter-on-quarter decline of capital investment reflecting the weakness of exports from the second half of FY2002, pressures upon corporations to cut labor costs to cope with the peak-out of profits lead to our view that personal consumption will be sluggish. The chances are also remote that the government will implement adequate macroeconomic policies to offset the stagnation of private demand. Thus, the economy should grow satisfactorily in the first half of the year but slip into negative territory on a semi-annual comparison in the second half of the fiscal year. We expect Japan's real GDP in FY2003 to grow 1.2 percent (MHRI's previous forecast was 0.6 percent).

Chart 19 Forecast on Real GDP Growth on a Half-Year Basis



Sources: Cabinet Office, Mizuho Research Institute.

In FY2004, Japan's real GDP will grow 0.5 percent, with the growth rate picking up in the second half of the fiscal year

MHRI looks for an export-led recovery in FY2004. The rise of exports will trigger the rise of production and corporate profit, which in turn will lead to renewed strength of corporate capital investment. Furthermore, a halt to the fall of production and corporate profit should alleviate pressures upon companies to restructure and thereby stem the deterioration of the employment and income in the household sector in the second half of the fiscal year. The rate of Japan's economic growth should gradually pick up toward the fiscal year second half. In FY2004, MHRI forecasts Japan's real GDP to expand 0.5 percent (MHRI's previous forecast was –0.1 percent).

MHRI's has upgraded its economic outlook for following reasons

MHRI has upgraded its economic outlook for FY2003 and FY2004 from its previous outlook in May 2003 due to the following reasons: (i) exports managed to keep on an uptrend in the Apr-Jun quarter of 2003 as a result of a smaller-than-expected impact of SARS upon exports and production, (ii) a faster-than-expected turnaround of the US economy, and (iii) a downward revision of MHRI's estimate on the degree of labor and capacity reduction in the corporate sector (equivalent to an upward revision of personal consumption and capital investment) from the second half of FY2003 on the back of an upgrade of the forecast on exports and production stemming from factors set forth under (i) and (ii) above and the alleviation of balance sheet adjustment pressures due to the rise of stock prices.

Despite our previous forecast that the Japanese economy would fall into recession from the second half of FY2003, there is a growing possibility that even in the event the economy slides into an adjustment cycle, it will turn out to be extremely benign and fall short of an "economic recession" judging from its scope and duration.

Chart 20 Forecast of the Japanese Economy

(%)

	FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)	FY2003 1st-half (Forecast)	FY2003 2nd-half (Forecast)	FY2004 1st-half (Forecast)	FY2004 2nd-half (Forecast)	FY2003 (Contribution) (Forecast)	FY2004 (Contribution) (Forecast)
GDP (real)	1.6	1.2	0.5	0.8	-0.2	0.2	0.7	-	-
Domestic demand	0.9	0.9	0.2	0.6	-0.1	0.1	0.5	0.9	0.2
Private sector demand	1.2	1.4	0.2	0.9	-0.3	0.1	0.7	1.0	0.2
Personal consumption	1.4	0.7	0.4	0.4	0.0	0.3	0.3	0.4	0.2
Housing investment	-2.9	-1.3	-1.9	-0.1	-0.8	-1.2	-0.6	-0.0	-0.1
Capital investment	-0.2	3.6	0.1	2.1	-0.7	-0.3	1.5	0.6	0.0
Public sector demand	-0.3	-0.6	0.3	-0.4	0.7	0.1	-0.2	-0.1	0.1
Government consumption	1.9	0.7	1.2	0.0	1.0	0.4	0.5	0.1	0.2
Public investment	-6.3	-4.1	-2.2	-2.0	0.2	-1.2	-1.9	-0.3	-0.1
Net exports (contribution)	0.8	0.3	0.3	0.3	-0.1	0.2	0.3	0.3	0.3
Exports	12.2	4.1	5.0	1.5	0.6	2.9	3.5	0.5	0.6
Imports	5.6	1.5	3.6	-0.9	1.6	1.9	1.9	-0.1	-0.3
GDP (nominal)	-0.7	-0.9	-1.1	0.0	-1.4	-0.0	-0.6		
Industrial production	2.6	1.1	1.3	0.1	0.2	0.6	1.1		
Unemployment rate	5.4	5.4	5.5	5.4	5.3	5.5	5.6		
Current account balance (trillion yen)	13.4	14.1	15.1	16.2	12.6	14.4	16.3		
as percentage of nominal GDP	2.7	2.9	3.1	3.2	2.6	2.9	3.3		
Corporate goods prices	-1.6	-0.9	-1.3	-0.9	-0.9	-1.2	-1.3		
Consumer prices	-0.6	-0.4	-0.7	-0.3	-0.4	-0.6	-0.7		
Long-term interest rate (%)	1.11	0.87	0.95	0.78	0.95	0.90	1.00		
Nikkei stock average(yen)	9,582	9,500	10,750	9,000	10,000	10,500	11,000		
Exchange rate (yen/dollar)	121.9	120.1	123.5	118.7	121.5	123.0	124.0		
Crude oil price (dollar/barrel)	29.1	29.1	27.5	30.0	28.3	28.0	27.0		

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 balance 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,*
Bank of Japan, *Balance of Payments Statistics, Corporate Goods Price Index.*

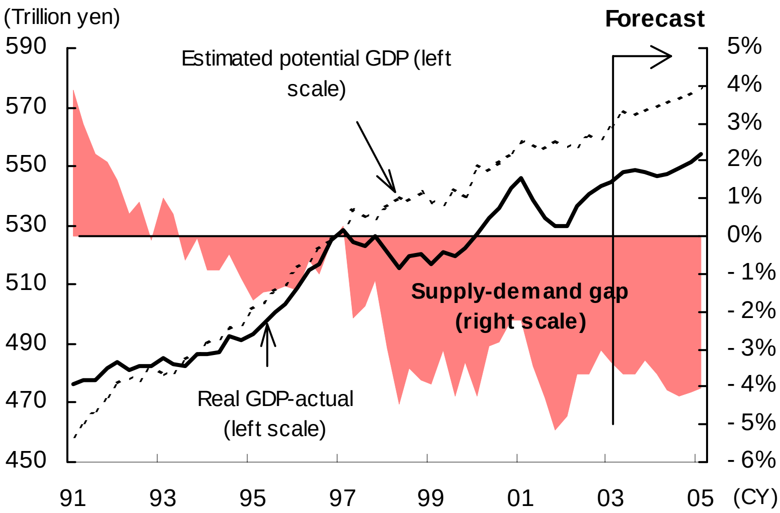
MHRI's evaluation of Japan's economic recovery from FY2004

Nevertheless, the foregoing does not represent a change in our view on the intrinsic weakness of the Japanese economy. Japan's fundamental ailment is that deflation, asset deflation and the loss of growth expectations are all undermining the autonomous recovery mechanism of the economy. While this bottleneck serves as a drag upon the rate of economic growth in a recovery cycle, it also presents risks of the economic slowdown being magnified in a cyclical downturn.

It is unlikely that these frailties of the Japanese economy will be eliminated during the forecast horizon. We may not hope for the elimination of deflationary pressures (Chart 21) since the deflationary gap will likely widen because the performance of the economy will remain below the potential rate of growth during the forecast period. Japan's nominal GDP has been declining since its peak in FY1997, and we expect the growth rate in nominal terms to remain in negative territory from FY2003 to FY2004. Turning to asset deflation, although we expect a slight upturn of the stock market, the price of land will most likely continue to fall. Furthermore, the chances are slim that the government will make a dramatic policy shift to eradicate deflation and stimulate the rise of corporate growth expectations.

Judging from the foregoing, the economic upturn expected from the second half of FY2004 may be too feeble to be labeled a recovery. To drive the economy into a full-blown recovery path, Japan will have to orchestrate a delicate policy mix combining both macroeconomic policies to put an end to deflation and structural reforms to raise the growth expectations among corporations.

Chart 21 Economic Growth Forecast and the GDP Gap



Note: Estimates by MHRI.
Sources: Cabinet Office,
Ministry of Economy, Trade and Industry,
Ministry of Public Management, Home Affairs, Posts and Telecommunications.