

## Economic Outlook for FY2003 and FY2004

November 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 Jul-Sep quarter of 2003 by the Cabinet Office. The key points of the outlook are as follows.

### <The Overseas Economies>

The global economy will remain on a recovery track in 2004. The strong recovery of the US economy stemming from an upturn of both the inventory and capital stock cycles will serve as the main driver of global growth. However, structural adjustment pressures and restrictions upon fiscal stimulus will be a drag upon the euro zone economy. Strong growth is expected in China and the Asian economies.

### <The Japanese Economy>

The Japanese economy will stay on a recovery path from the second half of FY2003 to FY2004, powered by exports and capital investment. Although structural problems and lingering deflationary pressures will hamper a full-blown recovery, the Japanese economy may emerge out of a prolonged period of stagnation if efforts at reform in the private sector and appropriate policy management by the government succeed in setting forth sanguine prospects toward future growth.

#### Real GDP Growth

(%)

	2002 (Actual)	2003 (Forecast)	2004 (Forecast)
Japan	1.6	2.7 (1.2)	2.3 (0.5)
US	2.4	2.9 (2.3)	3.9 (3.2)
Euro zone	0.9	0.6 (0.6)	1.8 (1.8)
Asia	6.0	5.6 (5.1)	6.3 (6.0)

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 August.

This English-language translation is based upon the outlook in Japanese released on November 19, 2003. This publication 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

The overseas economies posted unexpected strong growth in the Jul-Sep quarter of 2003 with the US economy recording the fastest pace of growth in 20 years. Although the collapse of the information technology (IT) bubble in 2000 triggered a global economic slump accompanied by the curtailment of capital investment, there are clear signals indicating that the global economy has entered a recovery phase with the US economy at the lead in the second half of 2003. The euro zone economy, which has been lagging in recovery so far, also recorded positive growth for the first time in four quarters in the Jul-Sep quarter. The economies of Asia are also showing definite signs of recovery despite a temporary slowdown due to the negative impact of the severe acute respiratory syndrome (SARS).

Looking forward to the year 2004, MHRI predicts that that overseas economies will fundamentally remain on a steady recovery path. In the US, (1) the cyclical recovery of capital investment, (2) prospects of a mild recovery of employment and (3) expectations of monetary policy measures to buttress the economy provide us with reasons to believe that the economy will remain on a recovery track. MHRI forecasts that US gross domestic product (GDP) in real terms will grow 2.9 percent in 2003 and 3.9 percent in 2004.

Chart 1: Forecast of the US Economy

	(%)									
	2002	2003	2004	2002		2003		2004 (Forecast)		
	(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half (Forecast)	1st-half	2nd-half	
GDP	2.4	2.9	3.9	3.5	2.7	1.9	5.2	3.7	3.0	
Personal consumption	3.1	3.1	3.7	3.5	3.0	2.4	4.7	3.7	2.8	
Housing investment	3.9	8.0	2.2	6.7	3.5	9.0	10.6	-0.3	-0.8	
Capital investment	-5.7	2.3	9.1	-6.3	-0.5	0.1	9.8	8.6	9.2	
Inventory investment (\$100 million)	52	-97	318	-120	223	-64	-129	250	385	
Government expenditures	4.4	3.2	1.8	5.7	3.0	3.4	3.1	1.3	1.4	
Net exports (\$100 million)	-4,886	-5,337	-5,964	-4,670	-5,101	-5,282	-5,392	-5,811	-6,117	
Exports	-1.6	1.2	6.2	2.6	4.2	-2.4	5.8	5.9	7.4	
Imports	3.7	3.8	8.1	8.1	8.7	0.7	5.3	9.2	8.5	
Domestic final consumption	2.4	3.3	3.8	2.9	2.6	2.7	5.2	3.5	3.1	
Consumer prices (y-o-y % change)	1.6	2.3	1.7	1.4	2.5	2.6	1.8	1.7	1.7	
Current account balance (\$100 million)	-4,809	-5,647	-6,352	-2,296	-2,513	-2,789	-2,858	-3,132	-3,220	
<as a percentage of nominal GDP>	-4.6	-5.2	-5.5	-4.4	-4.8	-5.2	-5.5	-5.5	-5.5	

Note: 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.

The euro zone economy should also remain on an export-driven recovery. Nevertheless, it should be noted that in the euro zone economy, the belated progress in reducing excess labor and the debt overhang in the corporate sector is making it difficult for the rise of exports to ripple through to capital investment and employment. We are thus inclined toward the view that a strong recovery led by private-sector demand is unlikely for the time being. We expect real GDP growth in the euro zone economy to stand at 0.6 percent in 2003 and 1.8 percent in 2004.

Chart 2: Forecast of the Euro Zone Economy

(%)

	2002 (Actual)	2003 (Forecast)	2004 (Forecast)	2003		2004	
				1st-half (Actual)	2nd-half (Forecast)	1st-half (Forecast)	2nd-half (Forecast)
G Euro zone	0.9	0.6	1.8	0.0	0.7	1.2	0.5
D Germany	0.2	-0.0	1.4	-0.3	0.3	0.9	0.8
D France	1.3	0.2	1.6	-0.2	0.4	1.0	0.9
P Italy	0.4	0.5	1.6	0.0	0.4	1.1	0.6
P Spain	2.0	2.1	2.6	1.1	0.9	1.5	1.3
UK	1.7	1.9	2.3	0.7	1.2	1.2	1.2
Euro zone consumer prices	2.2	2.0	1.7	2.1	2.0	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.

Sources: EUROSTAT, ECB, ONS.

We look forward to strong growth of the Asian economies reflecting the upturn of the IT sector in the US and the domestic investment boom in China. The South Korean economy - dragged down so far by slumping consumer spending - will most likely start to follow an export-driven recovery path. We expect real GDP growth in the Asian economies to reach 5.6 percent in 2003 and 6.3 percent in 2004.

Chart 3: Forecast of the Asian Economies

(%)

	2002 (Actual)	2003 (Forecast)	2004 (Forecast)
Asia (average)	6.0	5.6	6.3
NIEs (average)	4.5	2.6	4.2
S. Korea	6.3	2.9	4.8
Taiwan	3.6	3.2	4.0
Hongkong	2.3	1.6	2.7
Singapore	2.2	1.3	4.1
ASEAN (average)	4.3	4.6	4.9
Thailand	5.3	6.0	6.1
Malaysia	4.1	4.5	4.6
Indonesia	3.7	3.8	4.2
Philippines	4.4	4.3	4.5
China	8.0	8.5	8.5

Notes: 1. Real GDP growth (change over the previous year).  
2. Weighted average on the basis of each country's nominal GDP in 2000.  
Source: Government data provided by each of the relevant countries.

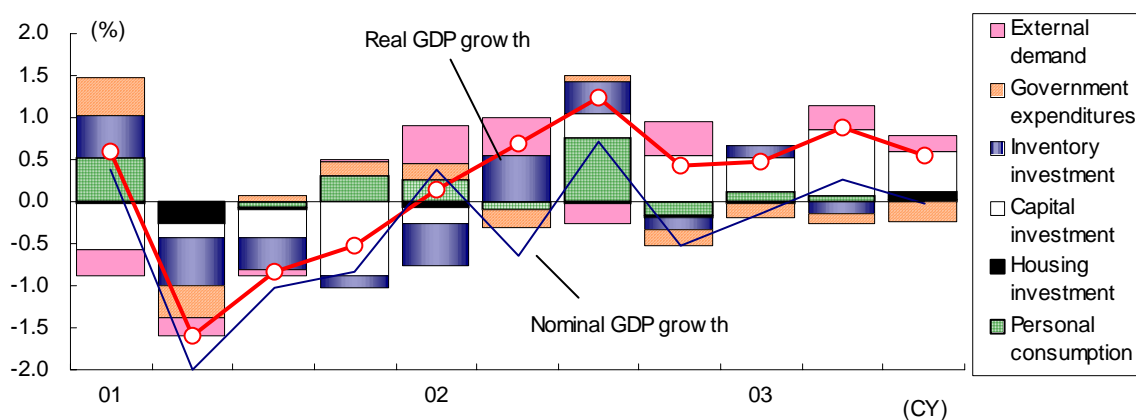
## II. The Japanese Economy

### 1. The current state and key points of the forecast on the Japanese economy

**The Japanese economy grew above expectations, shifting once again into an export-driven recovery**

Japan's real GDP rose 0.6 percent q-o-q (translated into an annualized rate of 2.2 percent) in the Jul-Sep quarter of 2003, marking the seventh consecutive quarter of positive growth (Chart 4). Exports and capital investment were the main drivers of the economy. Industrial production, despite a belated recovery so far, also rose 1.3 percent q-o-q in the Jul-Sep quarter backed by export growth. Exports should remain on an upward trajectory in the Oct-Dec quarter given the strong growth of the US economy. Furthermore, trends in machinery orders provide us with reason to believe that business fixed investment may slow down in the Oct-Dec quarter but regain momentum in the Jan-Mar quarter of 2004. Although the slow improvement of labor market conditions makes a sharp rise of personal consumption unlikely, we do not expect consumer spending to lose momentum. The Japanese economy, which had been pausing on the landing from the second half of FY2002 to the first half of FY2003, should gather momentum again toward the end of the fiscal year (March 31, 2004).

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



Note: The bars represent the degree of contribution by each of the components to the rate of real GDP growth.

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

**Capital investment rises among manufacturers given the shift of the inventory cycle into reverse mode triggered by export growth, corporate restructuring efforts and the quantity effect.**

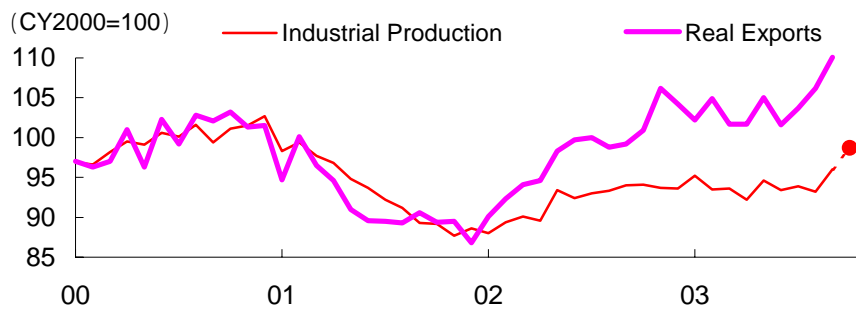
Several factors are accountable for the signs of renewed vigor in the Japanese economy.

The first factor is the stronger-than-expected recovery of the US economy.

The rate of US real GDP grew far above consensus forecasts and reached 8.2 percent q-o-q p.a. in the Jul-Sep quarter. US economic growth led to the rise of US-bound exports from the East Asian countries, which in

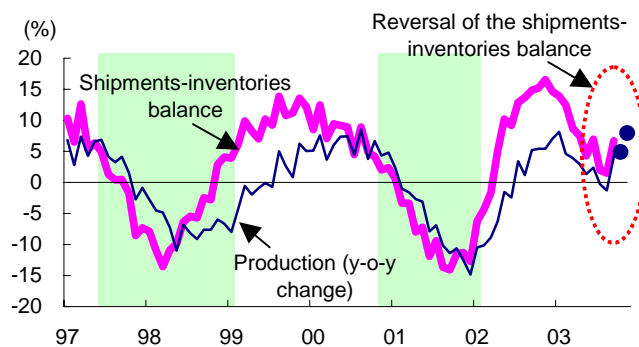
turn bolstered Japan's industrial shipments as a result of indirect exports via the rest of East Asia. We are inclined toward the view that the rise of exports along with the expansion of the US economy – coupled with the restraints upon production due to the unseasonable cool summer weather – has minimized the possibility of a potential inventory adjustment in Japan. Although the shipments-inventories balance indicates that Japan was at the brink of an inventory adjustment phase, conditions have been improving rapidly since September (Chart 6). Up to the previous *Economic Outlook for FY2003 and FY2004*, MHRI took a cautious view on the economy in the second half of FY2003 due to our belief that the inventory cycle would cause a mild production adjustment. However, the odds are high that these potential adjustment pressures are abating due mainly to the increase of exports stemming from the expansion of the US economy. Looking forward, the US and overseas economies should remain on a steady recovery path. The short-term economic cycle – defined by the inventory cycle – is slated for an upturn.

Chart 5: Trends in Production and Real Exports



Note : Data on industrial production in October and November are based on *Survey of Production Forecast (METI)*.  
 Sources: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, *Survey of Production Forecast*, Bank of Japan, *Real Exports and Real Imports*.

Chart 6: The Shipments-Inventories Balance

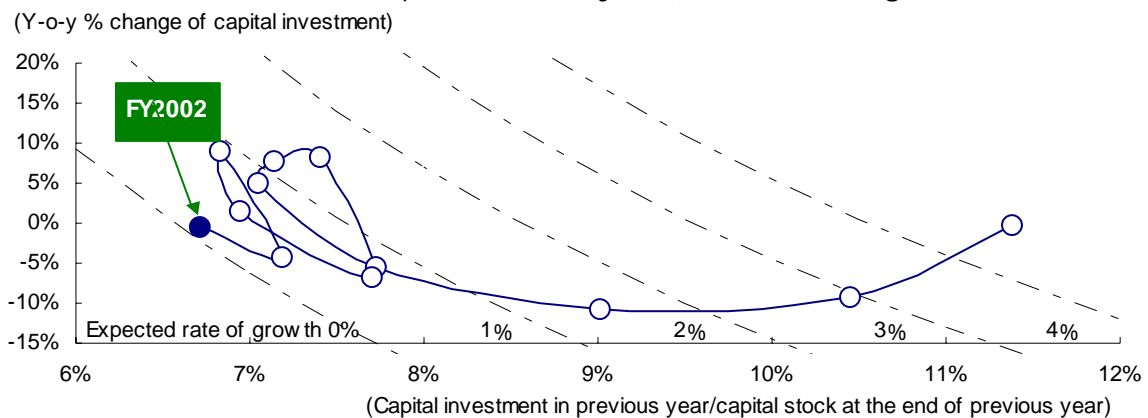


Notes: Data on industrial production (y-o-y change) in October and November are based upon *Survey of Production Forecast*.  
 Sources: Ministry of Economy Trade and Industry, *Indices of Industrial Production*.

Secondly, the corporate sector (mainly the manufacturing sector) is about to emerge out of a capital stock adjustment phase.

Although Japanese companies have been reducing their capital stock during the recession following the collapse of the information technology (IT)-bubble, the capital stock cycle shows that the adjustment process has more or less run its course (Chart 7). In particular, a key factor is the investment behavior of large manufacturers which have been improving their profitability and balance sheets through restructuring efforts. The export-driven rise of demand is coaxing these large manufacturers to renew plant and equipment which have been rendered obsolete as a result of past cutbacks upon capital investment. Although investment activity thus far is comprised mainly of investments to renew existing facilities, we are inclined to believe that capital investment has entered a cyclical recovery.

Chart 7: The Capital Stock Cycle (Manufacturing Sector)



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

**MHRI has upgraded its main scenario of the Japanese economy ~ the maintenance of a mild recovery**

From a cyclical perspective, the inventory cycle which determines the short-term economic cycle and the capital investment cycle - the key determinant of the mid-term cycle of the economy - are both shifting into recovery mode. Although Japan's economy appeared to be falling into an adjustment phase at one point, we now expect the economy to follow a recovery path powered by exports and capital investment. Thus, MHRI has upgraded its main scenario on the Japanese economy from our previous outlook that the economy would regain strength after a temporary slowdown in the second half of FY2003 to "the maintenance of a mild recovery in FY2003 and FY2004". Along with this upgrade, we have also revised upward our forecast on the rate of real GDP growth in FY2003 and FY2004.

As discussed more fully in the following pages, the Japanese economy is still facing various structural problems making it uncertain whether the current nascent upturn will develop into a full-blown economic recovery. However, MHRI does not rule out entirely the possibility that the continuation of the current recovery may lead to the mitigation of structural problems and the recovery of expectations toward growth and pull the Japanese economy out its prolonged slump.

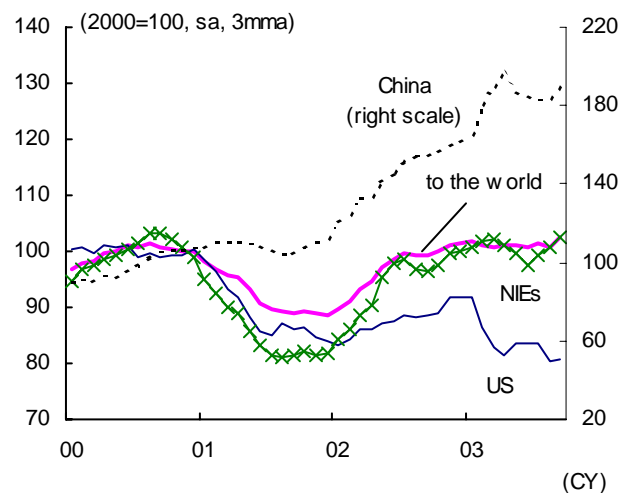
## 2. External demand

### The recovery of the economy is driven by exports

The current recovery of the Japanese economy is driven by exports reflecting the recovery of the US and overseas economies.

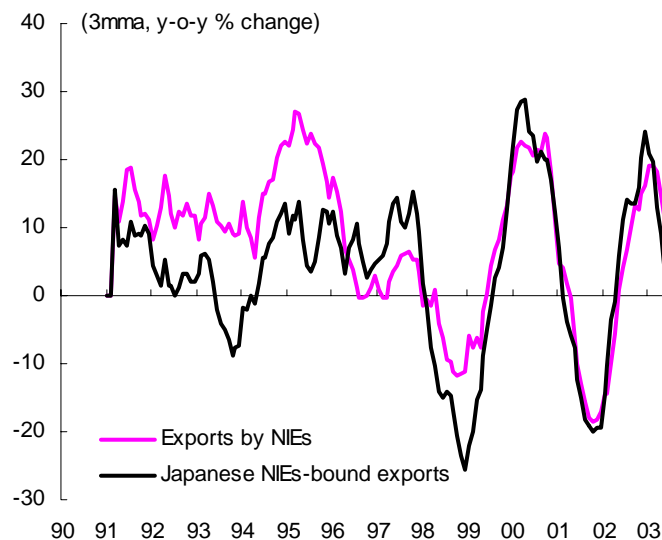
Exports in real terms grew 2.8 percent q-o-q in the Jul-Sep quarter of 2003. The fading impact of the war in Iraq and the severe acute respiratory syndrome (SARS) upon exports and the expansion of global trade mainly with respect to IT-related merchandise amid the growth of the US economy led to the rise of exports. While the weakness of domestic demand in South Korea was a source of concern, NIEs-bound exports (mainly IT-related merchandise) remain strong (Chart 9) and exports toward China (IT-related merchandise and materials and machinery for the improvement of infrastructure) are continuing to grow rapidly.

Chart 8: Exports (by geographic destinations)



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

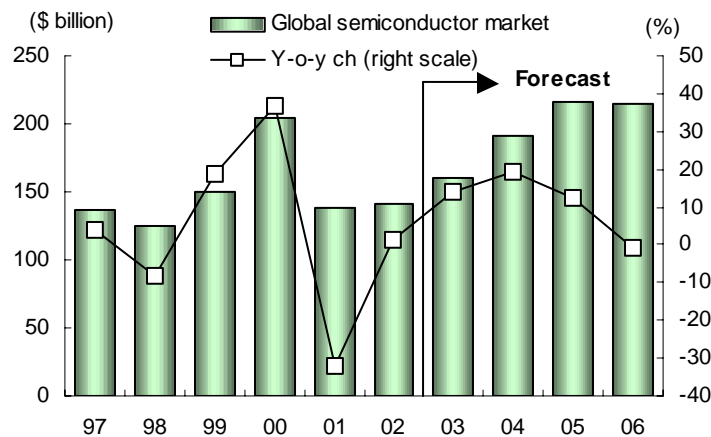
Chart 9: Export Linkage Between Japan and the NIEs



Sources: Ministry of Finance, the governments of S. Korea and Taiwan.

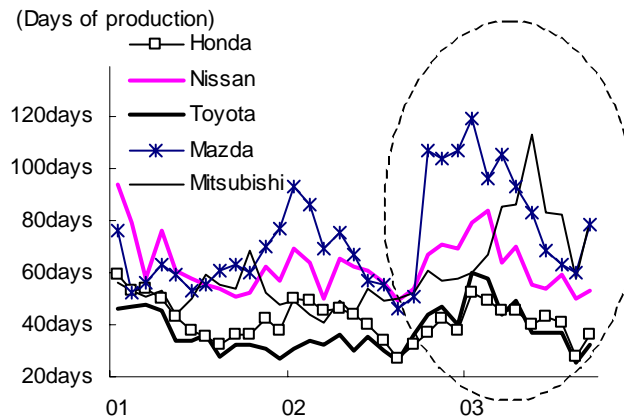
Looking forward, exports should remain on an upward trajectory given the recovery of the overseas economies. Viewed in terms of goods, the global demand for IT-related merchandise is recovering and should underpin exports. The global growth of semiconductor sales – which temporarily slowed in early 2003 – is starting to recover. According to forecasts by the World Semiconductor Trade Statistics (WSTS), global demand for semiconductors will pick up in 2004 as a result of economic recovery and the use of semiconductors in a wider range of products (Chart 10). Since the growth of IT-related demand will tend to ripple through to materials and machinery exports, we are inclined to believe that the rise of exports will be more broad-based. Furthermore, in view of the fact that Japanese automakers have reduced their US inventories to appropriate levels, it now appears that they have shifted into an inventory build-up phase along with the seasonal introduction of new models in early autumn (Chart 11). Exports should remain on a mild recovery as long as risk factors such as an overseas economic slowdown and a sharp appreciation of the yen do not materialize. Judging from the foregoing, we expect real exports to grow 8.0 percent y-o-y in FY2003 and 8.8 percent y-o-y in FY2004.

Chart 10: Forecast on the Global Semiconductor Market



Source: World Semiconductor Trade Statistics.

Chart 11: US Automotive Inventories of Japanese Automakers



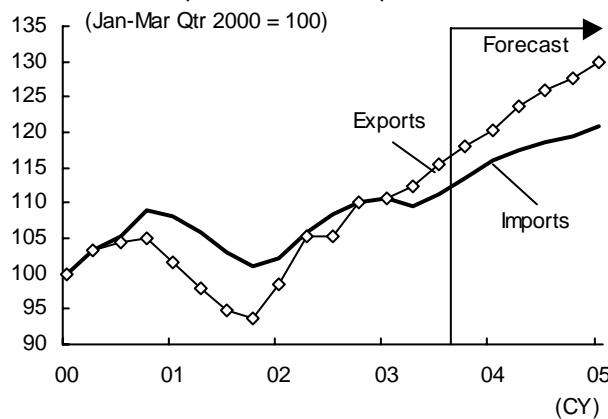
Source: Automotive News.



**Relatively mild import growth**

Imports increased 1.7 percent q-o-q in the Jul-Sep quarter of 2003, rising for the first time in two quarters. The expansion of intra-industry trade in the IT sector and the increase of services imports along with the fading impact of SARS contributed to the upturn. Looking forward, imports should remain on a mild recovery in tandem with the recovery of Japan's domestic economy and the expansion of intra-industry trade in East Asia. Even so, the pace of import growth will be slower than that of exports given the slow pace of recovery of domestic demand for the time being (Chart 12). We expect real imports to grow 3.6 percent y-o-y in FY2003 and 5.8 percent y-o-y in FY2004.

Chart 12: Exports and Imports in Real Terms

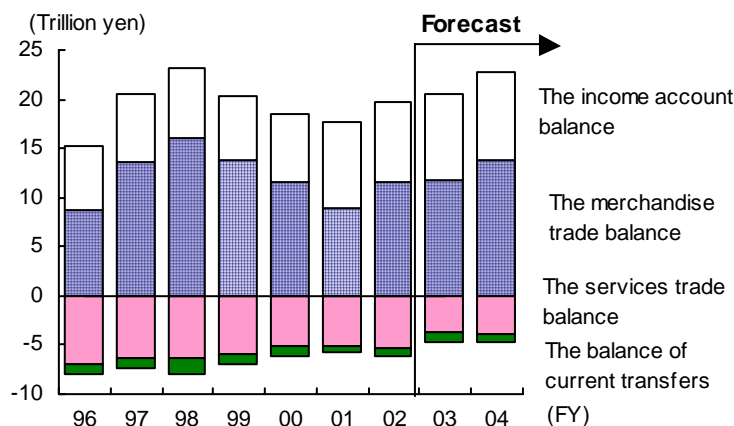


Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**The current account surplus will expand**

Japan's current account surplus will grow mildly based upon forecasts that exports will surpass imports. Furthermore, the investment income account should continue to improve reflecting the recovery of the global economy and the improvement of the investment environment, leading to the expansion of the current account surplus (Chart 13). Japan's current account balance should stand at 15.8 trillion yen (3.2 percent of nominal GDP) in FY2003 and 18.0 trillion yen (3.6 percent of nominal GDP) in FY2004.

Chart 13: The Current Account Balance



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

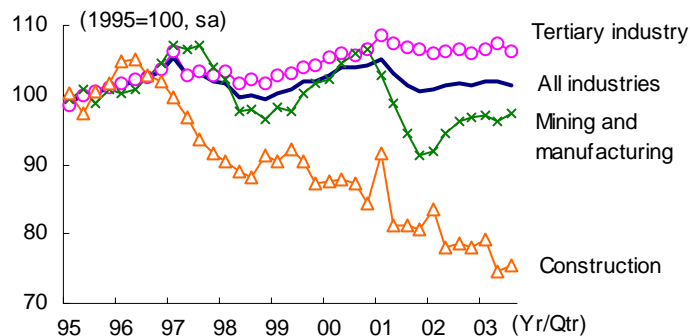
### 3. The corporate sector

**Renewed production activity mainly among manufacturers**

The growth of exports examined above will lead to the rise of production and corporate earnings, serving as impetus for more capital investment in the corporate sector. The increase of corporate investment and plant and equipment is the other main engine of the impending recovery of the Japanese economy.

Although production activity in Japan's corporate sector has been slumping since early 2003 due to the stagnation of exports stemming from the war in Iraq and SARS, we expect a dramatic rise of industrial production in the Oct-Dec quarter reflecting the recent growth of exports (Chart 14). We expect production mainly in the IT sector and export-related sectors such as transportation machinery to grow strongly backed by the rise of exports reflecting the steady recovery of the global economy (Chart 15).

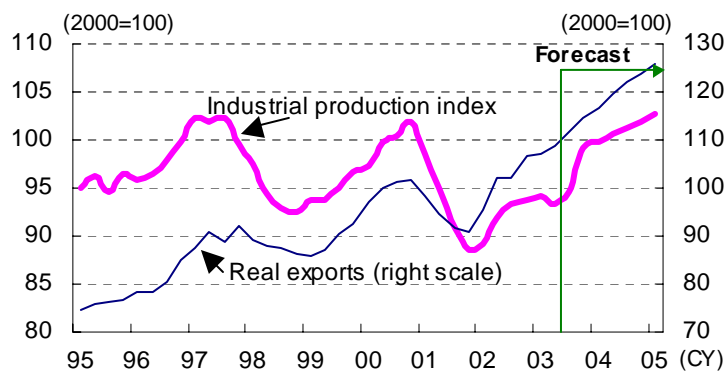
Chart 14: The All-Industries Activity Index



Note: Data on the Jul-Sep qtr (except for mining and manufacturing) are July and August averages.

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

Chart 15: Forecast on Exports and Industrial Production



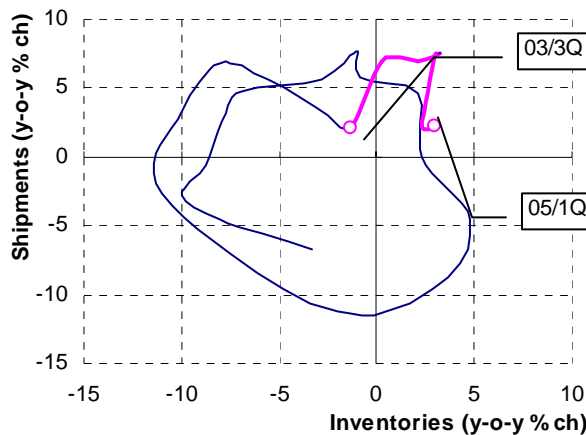
Sources: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

The ripple effect of demand in the manufacturing sector should lift the flat growth among non-manufacturers into a mild recovery. Nevertheless, a full-fledged recovery is unlikely given the lack of buoyancy of personal consumption which comprises the major part of demand. The decline of activity in the construction industry will probably go unhampered in FY2004 as the government slashes public investment.

**Inventory stock will rise along with the recovery of economic conditions**

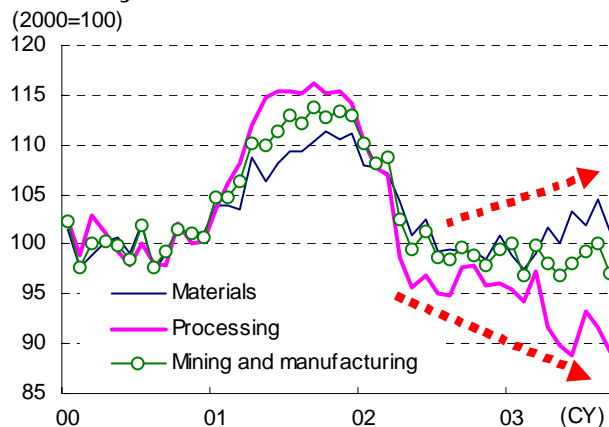
During the recovery phase from February 2002, companies were extremely cautious regarding the accumulation of inventory stock. This stems from a demand-side factor that the pace of shipments recovery was sluggish from the second half of FY2002 onward in addition to the prevailing behavior among corporations trying to minimize appraisal losses arising from the fall of inventory prices under a deflationary environment. Thus, although inventories should have increased along with the growth of shipments in a normal inventory cycle, this did not happen in the current recovery phase (Chart 16). Looking forward, forecasts that companies will start to build up inventories in tandem with the pace of economic recovery and that appraisal gains are generated as a result of the global rise of materials prices provides us with reasons to believe that the growth of inventory stock will enter positive territory (Chart 17). Nevertheless, we do not expect a significant change in the cautious stance toward inventory accumulation among corporations in view of the fact that the price of products are still falling in the processing industry and that an inventory overhang will also lead directly to the fall of prices in the materials industry. Although inventory stock will begin to build up, the rise of inventories should remain mild.

Chart 16: The Inventory Cycle



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

Chart 17: Inventory Ratios in the Materials and Processing Industries



Source: Compiled by MHRI on the basis of *Indices of Industrial Production* (Ministry of Economy, Trade and Industry).

**Corporate earnings continue to improve mainly among manufacturers**

Corporate earnings in general will remain on a moderate recovery track from FY2003 to FY2004 (Chart 18). However, a closer look at different sectors reveal mixed results on corporate earnings because the Japanese economy is not yet in a full-blown recovery. In the manufacturing sector, we expect a steady recovery of earnings along with the rise of revenues in the materials industry given its success in mitigating excessive competition and bringing prices back to normal levels. In the processing industry, earnings will continue to improve among IT-related companies since they will benefit from a quantity effect and reap greater results from enhancing the added value of their products as a result of export growth. In contrast, non-manufacturers will still be dependent upon restructuring efforts in order to secure earnings since the pace of demand growth among non-manufacturers will be slower than manufacturers. The lag in recovery among non-manufacturers compared to manufacturers will persist in FY2004.

Chart 18: Corporate Earnings Forecast

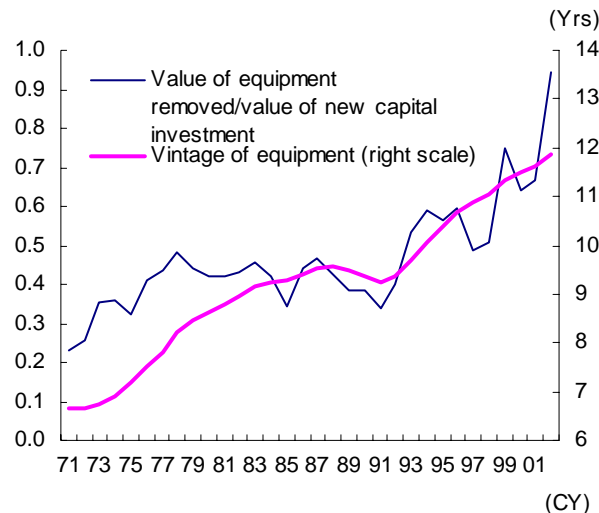
		(Y-o-y % ch)			
		FY2001 (Actual)	FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)
All industries	Sales	-3.3	-5.6	0.5	0.0
	Current profits	-19.6	7.2	6.9	3.9
Manufacturers	Sales	-6.4	-0.5	2.9	0.6
	Current profits	-42.5	32.8	15.5	3.4
Non-manufacturers	Sales	-1.9	-7.6	-0.6	-0.2
	Current profits	-1.3	-4.6	1.4	4.2
Large enterprises	Sales	-3.9	-0.4	1.4	0.3
	Current profits	-23.6	23.6	9.9	4.4
Manufacturers	Sales	-5.6	1.9	3.6	0.9
	Current profits	-41.2	40.6	18.8	3.9
Non-manufacturers	Sales	-2.6	-2.1	-0.1	-0.1
	Current profits	-0.6	10.4	1.2	5.0
Small and medium enterprises	Sales	-2.8	-8.9	-0.2	-0.2
	Current profits	-15.7	-7.1	3.4	3.2
Manufacturers	Sales	-7.5	-3.7	1.9	0.2
	Current profits	-44.8	18.8	8.3	2.2
Non-manufacturers	Sales	-1.6	-10.3	-0.8	-0.2
	Current Profits	-1.8	-14.1	1.5	3.7

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

**Strong capital investment – mainly due to replacement of obsolete equipment**

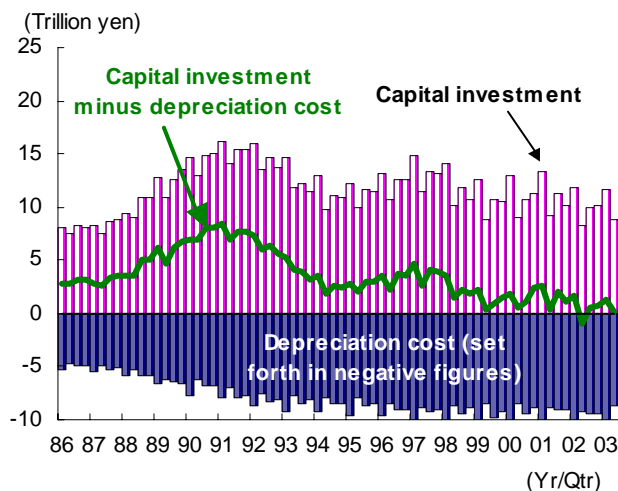
The ongoing recovery of capital investment since the second half of FY2002 is mainly due to the replacement of obsolete equipment. As a result of cutbacks upon capital investment during the recession from the second half of FY2000, capital stock vintage has been aging at above-trend rates, rendering manufacturing facilities obsolete (Chart 19). Based upon the foregoing, we are inclined toward the view that there is substantial pent-up demand for replacement investment in the corporate sector. Furthermore, since the amount of corporate capital investment has sunk to levels equivalent to the cost of depreciation, businesses would be able to secure necessary funds for replacement of capital stock without dipping into new earnings (Chart 20).

Chart 19: Vintage and Renewal of Equipment (among manufacturers)



Source: Compiled by MHRI on the basis of material released by the Cabinet Office.

Chart 20: Capital Investment and Depreciation Cost



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

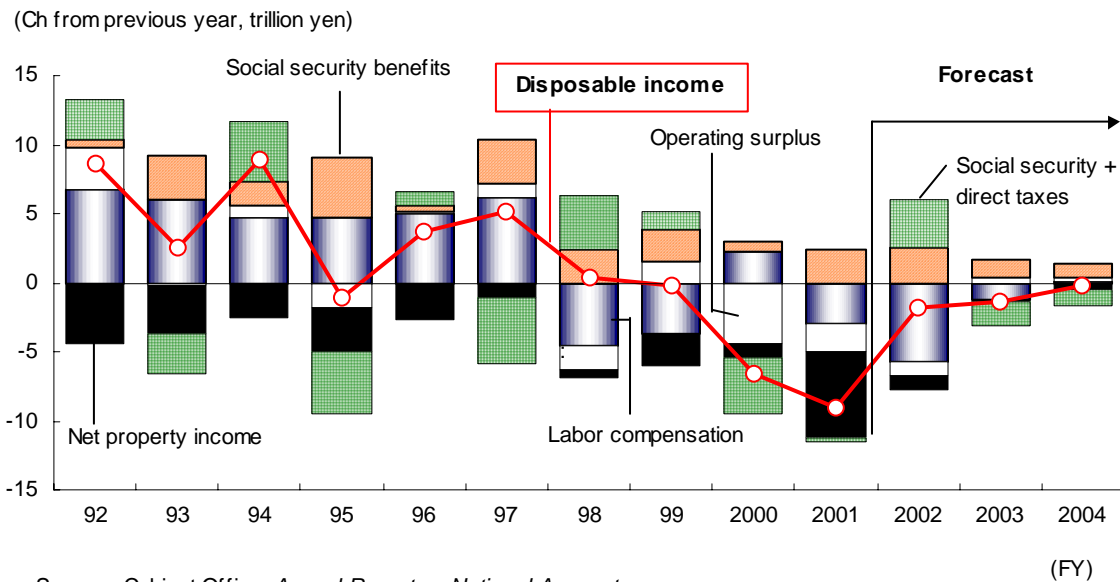
Judging from the foregoing – namely the existence of demand for replacements, the rise of the capacity utilization rate and the recovery of corporate incentive to invest in plant and equipment amid the growth of earnings – we do not expect the current capital investment momentum to wane for some time. Although the growth of capital investment may stall temporarily in the Oct-Dec quarter because of sluggish production up to the first half of FY2003, investment will most likely recover again in Jan-Mar quarter of 2004. In FY2004, capital investment will most likely remain on an uptrend mainly for maintaining and replacing existing facilities. We expect capital investment to grow 11.5 percent y-o-y in FY2003 and 6.8 percent y-o-y in FY2004.

## 4. The household sector

### A sluggish recovery of labor market conditions

The recovery of exports and the corporate sector will eventually ripple through to the household sector through the improvement of labor market conditions. However, we believe that the ripple effect of the recovery from the corporate sector to the household sector will be limited for the time being. Our view stems from the fact that (1) non-manufacturers – carrying a heavy weight in employment – will still be pressed to restructure and cut costs in order to generate earnings, and (2) there will be no significant change in the stance to cut labor costs by substituting regular employees with non-regular employees even among manufacturers which are poised for recovery. Although labor market conditions have stopped deteriorating, a sharp improvement is unlikely. While we expect a slight rise of nominal labor compensation from –0.5 percent y-o-y in FY2003 to +0.0 percent y-o-y in FY2004, this will fall short of a full-fledged rebound. Furthermore, the rise of burdens stemming from the reform of Japan’s public pension system and tax system will suppress the growth of household income on a medium-term perspective. We expect household disposable income on a nominal basis to stand at –0.4 percent y-o-y in FY2003 and –0.1 percent y-o-y in FY2004 and remain on a downward trajectory (Chart 21).

Chart 21: Disposable Income



### Only a mild improvement in consumer spending

A sharp rise of personal spending is unlikely reflecting the income trends discussed above. Certain developments such as the rise in per-unit consumption and brisk sales of big-ticket items suggest a change in the underlying trend. Although there may be positive factors in the background such as the provision of attractive new products by companies emerging out of the general trend to slash prices, these developments are not lifting consumption expenditures as a whole since we also suspect that the trend is the result of a rebound among consumers who have grown tired of a spendthrift mode, spending at home by consumers who have cancelled plans to travel overseas and a wider income disparity among households reflecting the bipolarization of the employment and income environment.

Consumer spending has been relatively strong in comparison to income growth because of (1) a “ratchet effect” amid the fall of income, (2) the increase in real value of financial assets due to price falls, and (3) temporary income accompanying the maturity of high interest-bearing postal savings from FY2000. Looking forward, the impact of these factors should gradually fade as income conditions start to recover and price falls come to a pause. If the current discussions on public pension reform start to materialize and trigger the rise of concerns regarding future pensions, consumers may be more inclined to replenish their savings, thus gradually lowering the propensity to consume in FY004.

Judging from the foregoing, although personal consumption will remain on a moderate recovery commensurate to the increase in number of households, the pace of increase will most likely be slower than in the past. We expect private-sector real consumption expenditures to rise 0.8 percent y-o-y in FY2003 and 1.0 percent y-o-y in FY2004 (Chart 22).

Chart 22: Personal Consumption

	FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)
<i>Shunto</i> (spring labor offensive) wage hike rate	1.66	1.63	1.70
Labor compensation	-2.1	-0.5	0.0
Per worker	-1.6	-0.6	-0.3
No. of workers employed	-0.5	0.2	0.4
Disposable income	-0.6	-0.4	-0.1
Real disposable income	0.7	1.1	1.3
Nominal consumption expenditures	0.1	-0.7	-0.2
Private sector consumption expenditure deflator	-1.3	-1.5	-1.4
Real consumption expenditures	1.4	0.8	1.2
Propensity to consume	93.9	93.6	93.4
Change from previous year (% point)	0.5	-0.4	-0.2

Notes: 1. All items other than the *shunto* wage hike rate and 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. FY2003 figures are actual results.

Sources: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey*, Cabinet Office, *Annual Report on National Accounts*.

## Housing investment will continue to slump

MHRI's forecast on private-sector housing investment is as follows: 0.6 percent y-o-y in FY2003 and 1.0 percent y-o-y in FY2004 (Chart 23).

Chart 23: Housing Investment

		FY2002 (Actual)	FY2003 (Forecast)	FY2004 (Forecast)
New housing starts	(10,000 units)	114.6	114.3	113.1
	(Y-o-y % ch)	-2.4	-0.3	-1.1
Owner-occupied houses	(10,000 units)	36.6	37.3	37.5
	(Y-o-y % ch)	-3.1	2.1	0.6
Houses for rent	(10,000 units)	45.5	44.3	43.0
	(Y-o-y % ch)	2.8	-2.6	-3.0
Houses built for sale	(10,000 units)	31.6	31.8	31.7
	(Y-o-y % ch)	-8.1	0.6	-0.3
Private-sector housing investment (nominal)	(Y-o-y % ch)	-4.1	0.4	-1.2
Deflator	(Y-o-y % ch)	-1.3	-0.2	-0.1
Private-sector housing investment (real)	(Y-o-y % ch)	-2.9	0.6	-1.1

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

A breakdown of housing demand by different modes of ownership reveals that the scale-down of tax breaks on mortgages from January 2004 (in this Outlook, we assume that the current maximum benefit will be reduced from 5 million yen to around 4 million yen) will have a negative impact upon owner-occupied houses and houses for sale. However, the mild improvement of labor market conditions and forecasts of higher interest rates ahead may push up demand in this segment of the housing market. Houses for rent on the other hand may be subject to negative pressures since the construction rush for rental housing has mitigated the shortage of supply and expectations of higher interest rates will make it less profitable to lease housing. Furthermore, in view of the declining population in the younger age bracket which will lead to a fall in demand for rented housing on a mid- to long-term perspective and the reaction to a mini-boom thus far, we are inclined toward the view that demand for rented housing will continue to decline from FY2003.



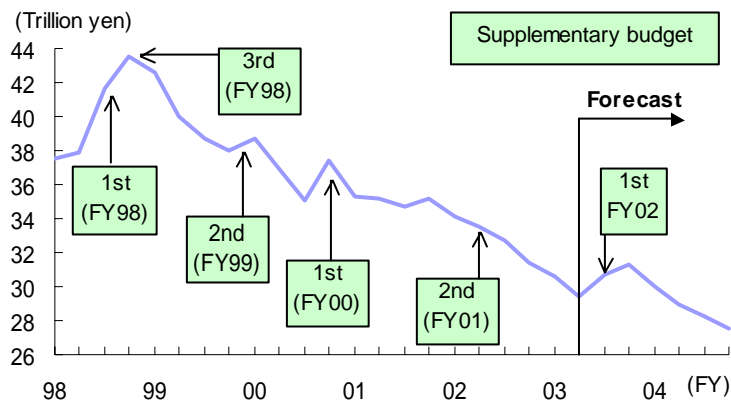
## 5. The public sector

**Government expenditures will fall, leading to an ongoing fall of public investment amid the government's pursuit of a structural reform agenda.**

Demand in the government sector will continue to follow a downward path.

Public works-related expenditures in the FY2004 general account budget is expected to shrink by more than three percent from FY2003 because of: (1) more stringent screening standards for the selection of projects, (2) cost cuts through steps such as bringing per-unit prices down to appropriate levels, and (3) review of subsidized projects. On the local government level, we also expect a sharp budget cut close to 10 percent - roughly equivalent to the FY2003 budget. The absence of demand-boosting economic measures in FY2003 will also serve to depress public investment further. As a result, we are inclined to believe that nominal public investment will continue to fall sharply in both FY2003 (-9.1 percent y-o-y) and FY2004 (-8.8 percent y-o-y). In real terms, public investment should stand at -7.0 percent y-o-y in FY2003 and -6.5 percent in FY2004.

Chart 24: Public Investment

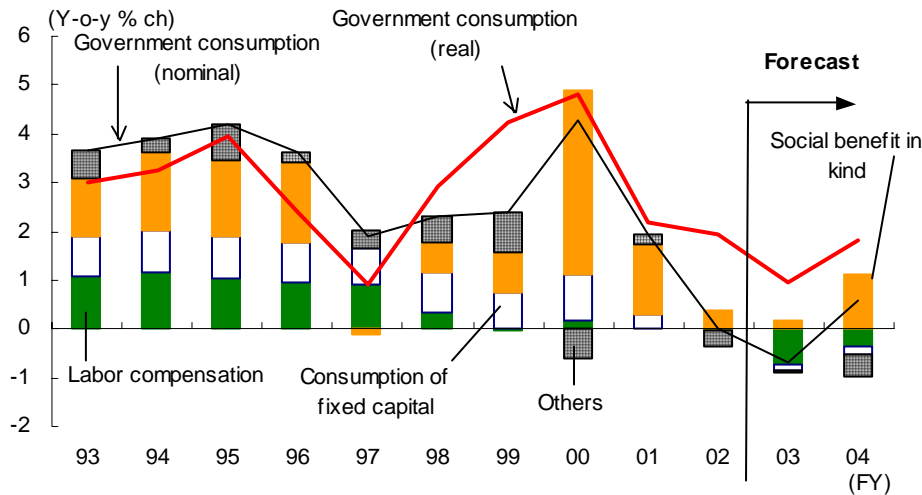


Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

According to MHRI's forecast, government final consumption expenditures will reach 0.9 percent in FY2003 and 1.4 percent in FY2004 (Chart 25). In FY2003, we predict that the growth of government consumption would slow sharply due to factors such as 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 consumption of fixed capital will most likely decline due to last year's cuts upon public investment, this may serve as fresh restraints upon government consumption.

Furthermore, while public servants' wages are poised for reduction in both FY2003 and FY2004, it should be noted that this will be adjusted by the GDP deflator and thus will not serve as a factor for lower real government consumption.

Chart 25: Government Consumption



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

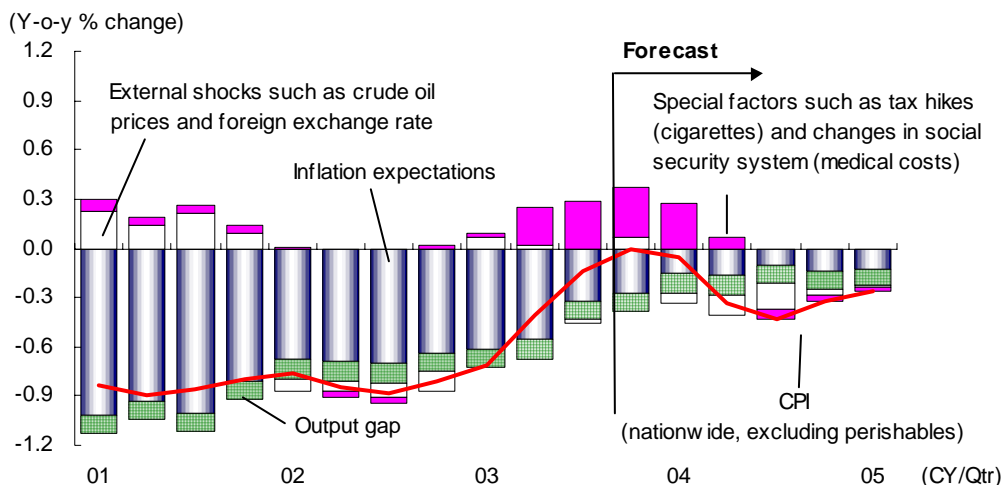
## 6. Inflation rate

**The year-on-year fall of the CPI is narrowing sharply**

The rise of expectations on economic recovery and a slower pace of price decline is currently fueling a popular belief that Japan might be able to emerge out of a prolonged period of deflation. Judging from an objective point of view however, the chances are remote that the Japanese economy will be able to dispel deflationary pressures by FY2004.

First of all, the fall of consumer prices is decelerating at the moment due mainly to one-off factors such as the increase of medical costs shouldered by patients, the tax hike on cigarettes and a higher price of rice because of the unseasonable cool summer weather this year. Therefore, price falls should grow steeper once the impact of these special factors faded in FY2004 (Chart 26).

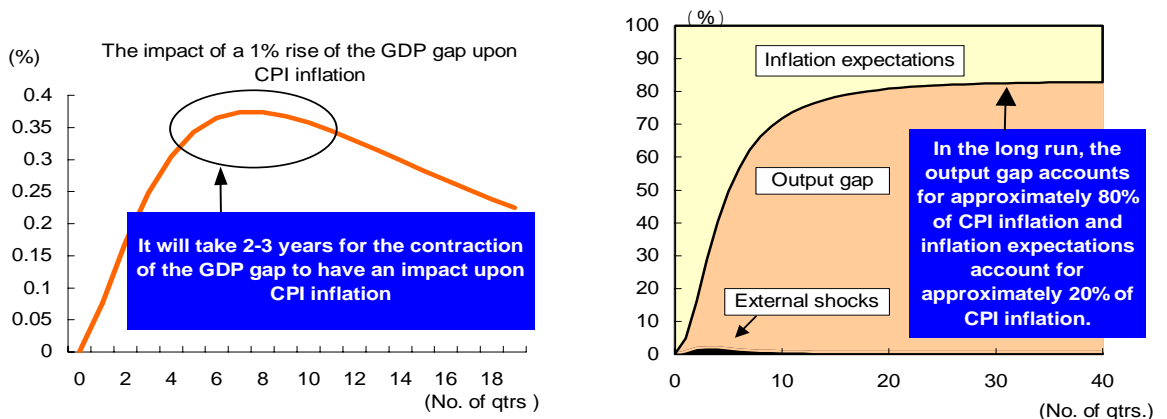
Chart 26: The Consumer Price Index (excluding perishables)



Notes: 1. The bars represent the degree of contribution to the line (CPI inflation).  
 2. Regression of CPI inflation (nationwide excluding perishables) by the output gap, inflation expectations and rise of import prices (the residual was added to inflation expectations). The contribution to CPI inflation by special factors were added to the regression results.

Secondly, changes in consumer prices are determined largely by the GDP gap (approximately 80 percent on a long-term basis). Furthermore in the event the GDP gap shrinks as a result of economic recovery, there is a time lag of approximately two to three years for the contraction of the GDP gap to ripple through to the rise of consumer prices (Charts 27, 28). Based upon this analysis, the contraction of the GDP gap stemming from the economic recovery from FY2002 will start to affect consumer prices around FY2005 to FY2006. From the perspective of the GDP gap, it should be noted that the GDP gap will contract at a slower pace than the pace of economic recovery since the odds are high that the improvement of productivity stemming from corporate restructuring efforts will raise the potential growth rate.

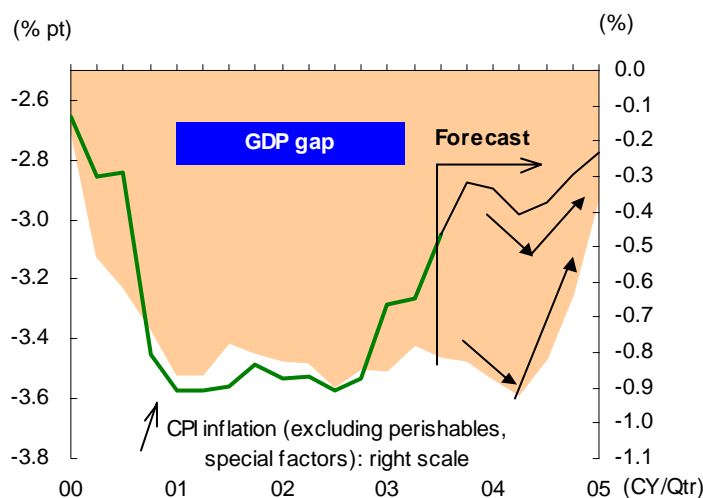
Chart 27: The GDP Gap and CPI Inflation



Notes: 1. Based upon VAR model (impulse response) using three variables: CPI inflation (excluding perishables and special factors), GDP gap and rise of import prices.  
 2. Estimate period: 85Q1-03Q2, 2-yr lag according to Akaike's Information Criteria.  
 Sources: Bank of Japan, Cabinet Office and others.

Notes: 1. A breakup of the error in CPI forecast in the chart on the left.  
 Sources: Bank of Japan, Cabinet Office and others.

Chart 28: Forecast on CPI Inflation on the Basis of the GDP Gap



Note: The GDP gap is based upon MHRI estimates. The past three years have been weighted using the timing correlation coefficient.  
 Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications.

There is a remote possibility that deflation will come to an end if expectations on inflation rise completely out of touch with the real economy. In fact, this possibility may not be ignored given the fact that expectations on inflation possess a large impact upon the rise of prices in the short run as indicated in Chart 27. However, price fluctuations diverging from reality will have more of a negative impact by destabilizing the money and capital markets rather than having a positive effect upon the real economy by putting an end to deflation. We are thus inclined to believe that the Japanese government and the Bank of Japan will keep in check any expectations on inflation which are out of touch with reality.

Given the foregoing, it is difficult to anticipate the emergence of the Japanese economy out of deflation by FY2004. Although price falls will narrow steadily along with the recovery of the economy, we may not look forward to a sustained rise of prices above zero percent. MHRI forecasts that the consumer price index (core prices) will fall 0.2 percent y-o-y in FY2003 and drop 0.3 percent y-o-y as a result of the positive effect of economic recovery offset by the fading impact of the temporary factors.

## 7. Forecast of the Japanese economy FY2003 and FY2004

**MHRI has upgraded its forecast on real GDP growth to 2.7 percent in FY2003 and 2.3 percent in FY2004**

On the basis of a comprehensive analysis of the factors discussed above, MHRI's outlook on the Japanese economy is as set forth below.

In FY2003, the Japanese economy will revive out of a plateau up to the summer season and return to an export-driven recovery trajectory. In the current Oct-Dec quarter, production activity and corporate earnings will regain momentum reflecting the rise of exports. Capital investment will start to recover once again from the Jan-Mar quarter of 2004. While the inventory cycle was once at the brink of an adjustment phase, it should shift into expansion mode from early autumn. MHRI has upgraded its forecast on the rate of Japan's real GDP growth in FY2003 to 2.7 percent (up from 1.2 percent in our previous forecast in August).

In FY2004, Japan's economic recovery will continue to be driven by exports and corporate capital investment. While the recovery should gradually spread to the household sector toward the year-end, the fragile recovery of income conditions and social welfare system reforms provide us with reasons to doubt that personal consumption will serve to propel the economy. MHRI has upgraded its forecast on the rate of Japan's real GDP growth in FY2004 to 2.3 percent (up from 0.5 percent in our forecast in August).

In nominal terms, MHRI forecasts that Japan's GDP growth will stand at - 0.1 percent (up from 0.9 percent in our forecast in August) in FY2003 and reach 0.3 percent (up from - 1.1 percent in our forecast in August) in FY2004, recording positive growth for the first time in four years.

Chart 29: Forecast of the Japanese Economy

	FY2002	FY2003	FY2004	FY2003		FY2004		FY2003	FY2004
	(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.6	2.7	2.3	1.4	1.1	1.2	1.2	-	-
Domestic demand	0.8	2.1	1.9	1.1	0.9	0.9	1.0	2.1	1.8
Private sector demand	1.2	3.1	2.6	1.8	0.9	1.4	1.5	2.3	1.9
Personal consumption	1.4	0.8	1.2	0.3	0.5	0.7	0.6	0.4	0.7
Housing investment	-2.9	0.6	-1.1	1.2	0.6	-2.0	1.5	0.0	-0.0
Capital investment	-0.1	11.5	6.8	7.5	1.6	3.8	4.0	1.8	1.2
Public sector demand	-0.3	-1.2	-0.5	-1.4	1.2	-0.6	-0.9	-0.3	-0.1
Government consumption	1.9	0.9	1.4	0.2	0.7	0.7	0.7	0.1	0.2
Public investment	-6.4	-7.0	-6.5	-6.4	3.3	-4.9	-5.6	-0.4	-0.4
Net exports (contribution)	0.8	0.6	0.6	0.4	0.2	0.3	0.2	0.6	0.6
Exports	12.2	8.0	8.8	3.1	4.6	4.8	3.2	0.9	1.1
Imports	5.5	3.6	5.8	-0.0	4.0	2.8	1.8	-0.3	-0.5
GDP (nominal)	-0.7	-0.1	0.3	0.2	-0.5	0.7	-0.2		
Industrial production	2.8	3.8	5.1	0.1	5.9	1.4	1.3		
Unemployment rate	5.4	5.3	5.0	5.3	5.3	5.2	4.9		
Current account balance (trillion yen)	13.4	15.8	18.0	8.4	7.4	9.2	8.8		
as a percentage of nominal GDP	2.7	3.2	3.6	3.4	3.0	3.7	3.5		
Corporate goods prices	-1.6	-0.8	-0.7	-0.9	-0.6	-0.6	-0.8		
Consumer prices	-0.8	-0.2	-0.3	-0.3	0.0	-0.4	-0.3		
Long-term interest rate (%)	1.11	1.17	1.75	0.90	1.45	1.65	1.85		
Nikkei stock average (yen)	9,582	10,000	11,750	9,178	10,800	11,500	12,000		
Exchange rate (yen/dollar)	121.9	113.5	107.5	118.0	109.1	107.0	108.0		
Crude oil price (dollar/barrel)	29.1	29.5	28.5	29.6	29.5	29.0	28.0		

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. Consumer prices = nationwide (excluding perishables).  
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-yr 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*.

## 8. Risk factors in the outlook of the Japanese economy and the importance of policy initiatives

**Despite the cyclical recovery of the economy, the basic underpinnings of the economic recovery are still fragile**

As set forth above, MHRI predicts that the cyclical recovery of the Japanese economy will continue in FY2003 and FY2004. However, it is necessary to keep in mind that the current recovery is subject to various weaknesses.

First of all, the current recovery of the economy is still dependent on external demand. Therefore, there is a perpetual risk that a loss of momentum of the overseas economies or a sharp appreciation of the yen would trigger a slowdown of exports and lead directly to the deceleration of the entire Japanese economy. While the dollar/yen exchange rate around the current level would not be a significant downside risk, a sharp appreciation of the yen to around 100 yen to the dollar would serve as a major risk factor to the Japanese economy (Chart 30).

Chart 30: How the Appreciation of the Yen, Higher Interest Rates and Stock Market Fall Would Affect Economic Growth

**10% stock market decline**

	1st quarter	2nd quarter	3rd quarter	4th quarter	5th quarter	6th quarter	7th quarter	8th quarter
Real GDP growth rate	-0.06	-0.09	-0.12	-0.15	-0.18	-0.20	-0.21	-0.22
Personal consumption	-0.10	-0.15	-0.18	-0.19	-0.20	-0.21	-0.22	-0.22
Capital investment	-0.03	-0.10	-0.22	-0.38	-0.55	-0.70	-0.81	-0.89
Housing investment	-0.02	-0.06	-0.13	-0.20	-0.24	-0.27	-0.26	-0.26

**1% rise of long-term interest rate**

	1st quarter	2nd quarter	3rd quarter	4th quarter	5th quarter	6th quarter	7th quarter	8th quarter
Real GDP growth rate	-0.08	-0.20	-0.37	-0.51	-0.58	-0.60	-0.57	-0.52
Capital investment	-0.90	-1.75	-2.85	-3.74	-4.42	-4.85	-5.01	-4.99
Housing investment	-0.11	-0.16	-0.26	-0.49	-0.71	-0.87	-0.89	-0.68

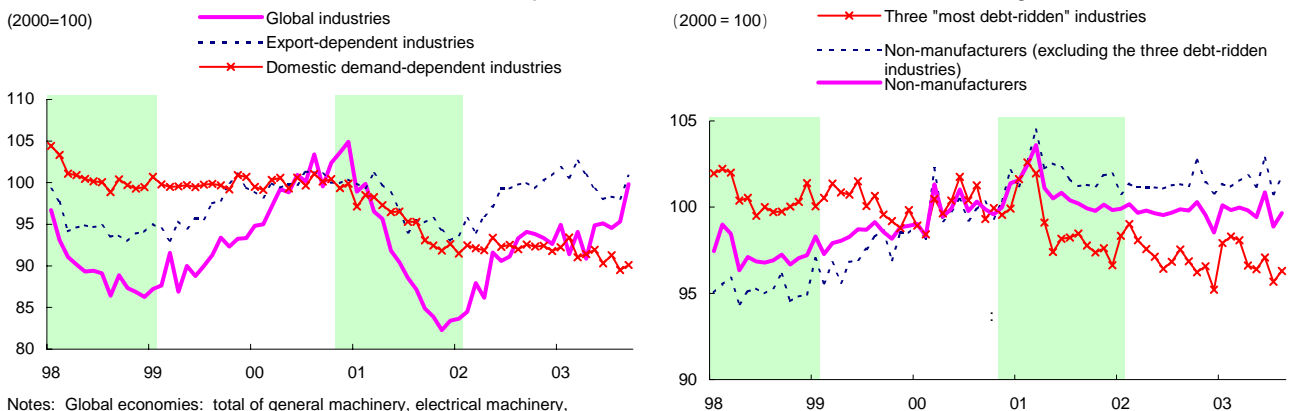
**10-yen appreciation of the yen**

	1st quarter	2nd quarter	3rd quarter	4th quarter	5th quarter	6th quarter	7th quarter	8th quarter
Real GDP growth rate	-0.14	-0.22	-0.29	-0.34	-0.39	-0.43	-0.46	-0.51
Capital investment	-0.24	-0.42	-0.64	-0.73	-0.84	-0.88	-0.89	-0.94
Exports	-0.85	-1.28	-1.68	-2.01	-2.25	-2.39	-2.47	-2.51
Imports	0.09	0.13	0.15	0.22	0.36	0.57	0.84	1.13

Source: Simulation using Mizuho Research Institute Macro Model.

The second risk factor is that the current recovery of the Japanese economy is limited to the manufacturing sector and that the waves of demand have not yet rippled to the non-manufacturing sector (Chart 31). In contrast to manufacturers who have achieved great progress in working out their debt and capacity overhang, non-manufacturers are still subject to adjustment pressures in these areas. Therefore, even if production and earnings increase as a result of the rise of demand, it would be difficult for the upturn to lead directly to forward-looking capital investment and employment. Moreover, the bipolarization of the industrial sector in terms of corporate size is still prevalent as exemplified by the recovery of production and earnings among large enterprises in contrast to the belated recovery among small firms. While the bipolarization should be mitigated by a sustained recovery, a wide gap will still remain.

Chart 31: The Bipolarization of Industrial Activity



Notes: Global economies: total of general machinery, electrical machinery, information & communication, electronic parts & devices, transportation equipment and precision instruments.  
 Export-dependent industries: total of iron & steel and chemicals.  
 Domestic demand-dependent industries: total of metal products, ceramics, oil & coal products, plastic products, pulp & paper, food & cigarettes and others.

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

Notes: Non-manufacturers: weighted average of tertiary industry activity index and construction industry activity index.  
 Three "most debt-ridden" industries: total of construction, real estate, wholesale and retail trade.

Source: Ministry of Economy, Trade and Industry, *Indices of Tertiary Industry Activity*.

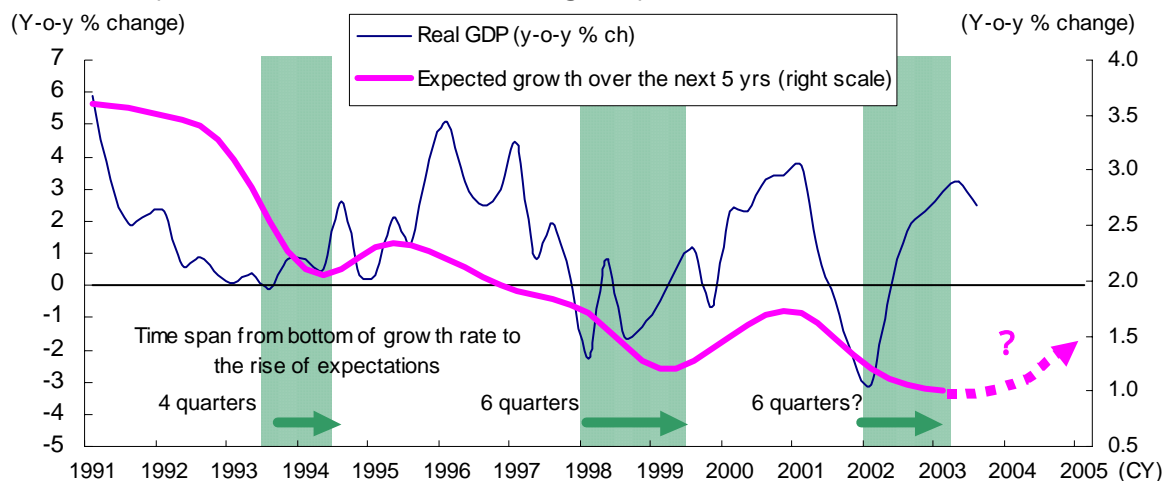
Thirdly, the deflation of asset prices (a plunge in land and stock prices) and the deflation of general prices (a fall in product prices) are still negatively affecting the Japanese economy. Admittedly, the stock market rebound since early FY2003 is a favorable impact upon both corporate business sentiment and balance sheets and expectations toward the alleviation of deflationary pressures are starting to emerge along with the recovery of the economy. Negative pressures stemming from the deflation of asset prices and the deflation of general prices may indeed be abating. Nevertheless, the damage done to corporate balance sheets because of the plunge of land prices is still a major problem mainly among non-manufacturers. Furthermore, in the absence of definite signs that general prices are bottoming out, it is unlikely that corporations will disregard the fall of interest rates in real terms and the reduction of real debt burdens and start to invest in more forward-looking projects and endeavors.

Finally, Japan's declining birthrate and aging population may be a drag upon the recovery of demand in the household sector. Depending upon the course of debate on pension and tax system reform, there is a risk that the rise of concerns regarding the future will dampen household spending incentives.

In the light of all these downside risks, it is difficult to conclude that the current upturn of the economy will lead directly to a full-blown recovery. Even so, it is also true that the maintenance of the current upturn will alleviate the negative pressures stemming from these structural problems and provide economic entities with more confidence toward future growth expectations (Chart 31). Although there is no room for unabashed optimism, the current upturn may lead Japan out of its prolonged slump if efforts at reform in the private sector and appropriate policy management (including a vision on the future) by the government succeed in setting forth sanguine prospects toward future growth. FY 2004 will serve as a decisive test on the medium-term recovery of the Japanese economy.

**FY2004 will serve as a decisive test on whether the current upturn of the economy will develop into a full-blown economic recovery**

Chart 32: Expected Rate of Growth Among Corporations and Rate of GDP Growth in Reality



Note: The expected rate of growth was processed on the basis of surveys in January every year with the use of Spline interpolation. Source: MHRI (on the basis of data released by the Cabinet Office).

**MIZUHO**

The logo for Mizuho, featuring the word "MIZUHO" in a bold, dark blue, sans-serif font. Below the text is a red, curved swoosh that underlines the letters.