

## JAPAN

## 2003 SOLID RECOVERY

A year ago, Japan's economic recovery looked temporary and fragile. In the second half of 2003 recovery was solid. With continuous and accelerating growth of exports and related business investment, real GDP showed modest growth in the third quarter (2.4% at annual rate) but jumped to 7% in the fourth quarter.

The latest *Tankan* (a business survey conducted by the Bank of Japan) shows that the majority of business firms in service and manufacturing sectors felt conditions were 'getting better'. Among small enterprises, more felt conditions were 'getting better' than 'getting worse'. Labour market conditions also improved. Unemployment has been dropping since the middle of 2003 and fell below 5% for the first time since the summer of 2001 in January 2004.

## INVESTMENT LED BY EXPORTS AND CONSUMPTION

Recently, exports and domestic business fixed investment have moved closely together. Growth of exports tends to bring about an upward wave of business equipment investment. Export growth has been the major source of business fixed investment so far. Facing a new international division of labour, Japan's major exporting industries are planning to improve competitiveness through further investment in new hi-tech equipment and research and development resources. The recent

strength of domestic consumer electronics demand has pushed up business investment. A survey of corporate investment conducted by the Ministry of Finance shows a 5% increase in investment outlays in fourth quarter 2003, and corporate outlook for the first quarter 2004 is strong.

There seems to be a change in the business fixed investment strategy of major Japanese corporations. While they continue to expand overseas production and investment, they are concerned with establishing domestic production and research and development activities by fixed investment in selected fields of core technology. In this way, the present trend of strong business investment is likely to continue to 2005.

## DUAL STRUCTURE OF RECOVERY FADING

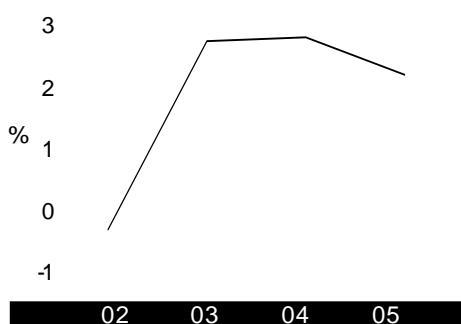
The dual-dimensional recovery (the exporting sector led by major Japanese manufacturing corporations versus the lagging domestic sector) is fading away. Even though some of the domestic sectors are still under the pall of financial distress and the write-off of bad debts by banks is still on the way, a major financial crash was avoided and the amount of outstanding bad debts is declining.

Stock prices recovered substantially (a 50% increase within one year from March 2003). This has produced a strong lift for banks and insurance companies, who raised their own-

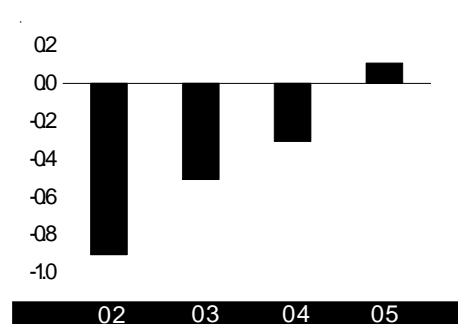
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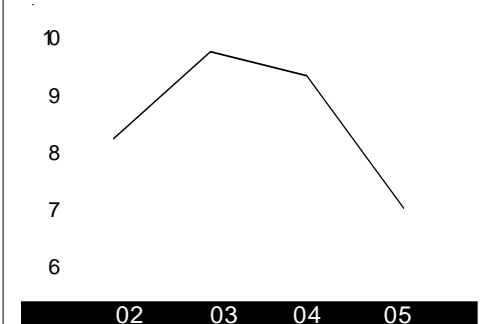
GDP growth



CPI inflation



Export growth



capital ratio and solvency ratio. The improvement of the banks' financial situation pushed up banking stock prices. The vicious cycle of stock prices and the economy seems to have turned around into a virtuous cycle.

### END OF DEFLATION

The consumer price index is still falling, but the rate of decline is diminishing. Several symptoms seem to suggest that the end of the deflation era is near. International commodity prices are on the rise; the domestic surplus inventory pressure is fading away; price-cutting competition in retail clothing, fast-food restaurant and others have come to a halt; and, reflecting the situation in the labour market, the wage rate has ceased falling.

Steelmakers have recently succeeded in raising the price of steel plates sold to automakers. High input prices are likely to bring about profit squeeze for a while, but as the recovery process remains steady, higher output prices will prevail within a year or two, and Japan will get rid of price deflation.

### WHEN WILL BANK OF JAPAN POLICY CHANGE?

The Bank of Japan declared two years ago that the zero-interest policy would continue as long as the inflation rate (as measured by CPI) remains negative. Now it is the time for economists to speculate when the BOJ will change gears. Supply of base money has expanded enormously; it was accelerated by its strong

intervention in the foreign exchange market. The Treasury provided the Central Bank with ample resources for buying up dollars and dollar-denominated assets with a tacit agreement with IMF and other Central Banks that Japan needed a stable yen rate for export-led recovery to get rid of deflationary spiral.

In view of solid domestic economic recovery the exchange authority seems to have discarded their intervention policy. The yen rate appreciated above the target level of intervention (110 yen per US dollar) since March. How soon will the Bank of Japan terminate its zero-interest policy? Or when will interest rates and the yen rate begin to rise? We do not expect the yen rate to undergo drastic appreciation soon. First of all, it will take time for price deflation to end. The low interest rate is expected to continue until the end of 2004. Second, because the US economy has been showing clear signs of expansion, the US monetary authority is expected to raise the official rate shortly. Thus, it is predicted that the present rate (105–103 yen per US dollar) will prevail this year and appreciation of 3–5% will occur in 2005.

### OUTLOOK FOR 2004 AND 2005

The strong growth of fixed capital investment is likely to continue throughout 2004, while the digital consumer electronics boom has just begun. Although household income growth remains slow, personal consumption expenditure will maintain a positive 1% growth rate.

Personal disposable income is expected to be non-growing due to the following factors: the coverage of medical care insurance is to be reduced; some of the temporary income tax cut measures are to be lifted; and old-age pensions will be cut in accordance with CPI deflation.

Demand has been pulled by new digital home electronics goods. The growth of domestic private demand seems to be steady, while the government sector will continue to reduce public spending, especially on older-style public works projects. Central and local government spending will continue to downsize public works. 2003 recorded a large decline of public spending (10% drop in real terms). The signs are that this downsizing pace will continue for some time.

Economic recovery began in early 2002 and, after initial hesitancy, the pace of recovery has become solid. The recovery process is characterised by an 'anti-Keynesian' fiscal policy and high dependence on exports. The private sector finally discarded its deflationary process, and consumer demand is picking up. After a 2.6% growth this year, a modest expansion of 2% will continue in 2005. However, the private sector got rid of its deflationary process finally, and consumer demand is picking up. After a 2.6% growth this year, a modest expansion of 2% will continue in 2005.

## Japan's regional breakdown of export and import growth in 2003

Japan's exports to China increased by 43% in 2003. Exports to ANIES and ASEAN economies increased to 15%. Exports to Oceania increased by more than 20%. Exports to Russia have also surged.

