COUNTRY REPORT

Japan

Japan at a glance: 2002-03

OVERVIEW

The outlook for the political scene in 2002-03 remains uncertain. The position of the prime minister, Junichiro Koizumi, looks secure for the time being, although Japan‘s worsening economic situation is likely to erode his popularity somewhat in the coming months. The Economist Intelligence Unit expects the economy to contract further in 2002, as domestic demand remains subdued and the global environment poor. The response of the Bank of Japan (the central bank) to intensifying deflationary pressures will remain inadequate, and, as sentiment about the economy deteriorates, yen movements will tend to be volatile.

Key changes from last month

Political outlook

- The foreign affairs minister, Makiko Tanaka, was sacked from the cabinet at the end of January following a scandal in which two non-governmental organisations were barred from the recent Afghanistan conference in Tokyo.

Economic policy outlook

- At the end of January parliament passed the second supplementary budget for fiscal year 2001/02 (April-March), worth ¥2.5trn (US$18.7bn).

Economic forecast

- At end-January the yen was trading in a narrow band around ¥134:US$1 and looked as if it could weaken further over the short term, particularly as concerns over the state of the banks intensify in the run-up to the end of the fiscal year. We nevertheless maintain our forecast for the resumption of yen appreciation from the second half of 2002, as Japan slowly moves out of recession on the back of firming world economic growth.

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The Economist Intelligence Unit
15 Regent St, London SW1Y 4LR
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The Economist Intelligence Unit

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London
The Economist Intelligence Unit
15 Regent St
London
SW1Y 4LR
United Kingdom
Tel: (44.20) 7830 1007
Fax: (44.20) 7830 1023
E-mail: london@eiu.com

New York
The Economist Intelligence Unit
The Economist Building
111 West 57th Street
New York
NY 10019, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: dantecantu@eiu.com

Hong Kong
The Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

Website: www.eiu.com

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Outlook for 2002-03

Political outlook

Domestic politics

The outlook for the Japanese political scene in 2002-03 remains uncertain. The position of the prime minister, Junichiro Koizumi, nevertheless currently looks secure. This mainly reflects the lack of credible alternatives within his party, the Liberal Democratic Party (LDP). He also remains hugely popular, with public support for his administration running in excess of 70%, although this may change following the sacking at end-January of his most popular minister, the foreign affairs minister, Makiko Tanaka. His programme of radical economic and political reform has, however, won him few friends on his party's conservative wing, who, with reason, see his policies as directly threatening their own interests. Mr Koizumi's reform programme also threatens to alienate New Komeito, the second-largest party in the tripartite ruling coalition, which is close to the largest of the LDP's conservative factions, the Hashimoto faction.

The continued stability of Mr Koizumi's administration will depend largely on his ability to maintain high levels of public support. This in turn generates two likely scenarios. The optimistic scenario suggests that Mr Koizumi remains popular and that, owing to this support, the LDP continues to win by-elections and local elections. This electoral success erodes support within the LDP for the old guard, particularly for the Hashimoto faction and its ally, the Eto-Kamei faction, so strengthening intra-party support for Mr Koizumi and prolonging the life of his administration, perhaps even beyond our forecast period. Such longevity would be almost unprecedented by recent Japanese standards.

The pessimistic, and more likely, scenario suggests that the worsening economic situation—Japan is currently in its third and deepest recession in less than ten years—erodes Mr Koizumi's popularity in the coming months, persuading his enemies in the LDP to step up their campaign to bring him down, or at least to hobble his administration by blocking reform initiatives where they can. One means of accomplishing this would be to force Mr Koizumi to appoint conservatives to senior positions in future cabinets, thus turning him into little more than a figurehead prime minister. Doubtless aware of this, Mr Koizumi has so far resisted calls from within the LDP for him to reshuffle his current cabinet, despite its often lacklustre performance since its appointment in April 2001.

If his position as prime minister were directly under threat, Mr Koizumi would probably not hesitate to call a snap lower-house election on an explicitly reformist platform in order to isolate his enemies in the LDP, particularly if he and his allies remained popular enough to win. Such an outcome would almost certainly split the LDP and could result in Mr Koizumi and his supporters in the party forging a new grouping with allies in the largest opposition party, the Democratic Party of Japan (DPJ), many of whose members originally hail from the LDP, having left when the party first split in 1993. This would certainly usher in a renewed period of political instability, something which, given the dire state of its economy, Japan could ill afford.

International relations

Japan's most important bilateral relationship in 2002-03 will remain that with the US. Nevertheless, the relationship will also remain one of the most fraught. Although common security interests will continue to underpin the relationship between the two countries, particularly in the light of the continuing military threat from North Korea and rising tensions in Central Asia, unease between the two on defence issues will persist. These will include growing calls within Japan for a reduction in its financial support for US forces stationed in Japan as well as louder calls from the US for Japan to assume a larger role in its own defence.

Japan's political relations with its two closest neighbours, China and South Korea, will also remain difficult. To a large extent this will reflect Japan's ambiguous attitude towards atrocities committed by its military in both countries in the first half of the 20th century. The Chinese and South Korean governments are also certain to regard with concern the passage through both houses of parliament in late October 2001 of a bill allowing Japan's *de facto* military, the Self-Defence Force (SDF), to give non-combat and humanitarian support to the US and its allies in its operations in and around Afghanistan. Formerly the SDF was only allowed to go abroad under UN auspices and only after hostilities had ceased.

Economic policy outlook

Policy trends

Japan's prime minister, Junichiro Koizumi, came to power in April 2001 on an explicitly reformist platform. The main thrust of his administration's economic strategy is fourfold: to cap annual Japan government bond (JGB) issuance at ¥30trn (US$246bn at an exchange rate of ¥122:US$1) from fiscal year 2001/02 (April-March); to privatise the post office operations, including, most contentiously, the vast pool of post office savings; to force private-sector banks to write off all bad debt within two to three years; and to accelerate the implementation of structural economic reforms even at the price of a period of slow economic growth. Although radical by Japan's recent standards, Mr Koizumi has made little attempt to provide details of how he intends to realise his policies. This reflects both uncertainty within the government over how they can be implemented against a background of slowing economic growth, as well as an unwillingness to antagonise powerful anti-reformers in the Liberal Democratic Party (LDP). The Economist Intelligence Unit's economic forecast assumes that Japan's slip back into recession will in effect make radical reforms of the kind promised by Mr Koizumi all but impossible in 2002-03.

Fiscal policy

At end-2001 the government announced its proposed initial budget for 2002/03. As expected, the budget proposal was contractionary, with overall spending expected to fall by 1.7% compared with the initial budget for 2001/02, to ¥81.2trn (US$629.5bn at an exchange rate of ¥129:US$1). If implemented, this would be the first cut in spending in four years. General expenditure, which excludes debt-servicing costs and tax grants to local governments, is projected to fall by 1.1% in the coming fiscal year, to ¥47.6trn. Within this category, the largest cut is that slated for public works, spending on which will be reduced by 10.7% to ¥8.4trn. Social welfare spending, meanwhile, is set to rise by 3.8%, to

¥18.3trn, reflecting the rising pressure on the public purse from increasing numbers of elderly and rising unemployment. On the revenue side, the government posits a 3.9% fall in tax revenue and has set JGB issuance for the fiscal year at Mr Koizumi's original stated target of ¥30trn.

Although the proposed budget allows Mr Koizumi to claim that his fiscal reform programme is still on track, it also raises a number of areas of concern. Not least among these are the optimistic assumptions underpinning the budget. The government expects, for example, nominal GDP to contract by 0.9% and real GDP to stagnate in 2002/03. Given that real GDP is expected to continue contracting in the first quarter of 2002, and to be lacklustre at best in the second quarter, the recovery in succeeding quarters will have to be an unusually strong one if the forecast is to be met. This suggests in turn that Mr Koizumi's self-imposed limit on net new JGB issuance of ¥30trn will be breached in 2002/03. The government also expects consumer price deflation to moderate in the coming fiscal year, to 0.8% from an estimated 1.1% in 2001/02. However, deflationary pressures are currently continuing to build, so this forecast too may prove unrealistic.

Also of concern is the government's use of accounting sleight of hand to increase non-tax revenue in order to allow the government to claim that it can meet its ¥30trn JGB issuance target in the new fiscal year. It proposes to appropriate funds from a number of special accounts, in some cases requiring legal changes, to raise non-tax revenue by 22.2%, to ¥4.4trn. This echoes the government's avoidance of new JGB issuance to fund the planned second supplementary budget of 2001/02 by appropriating cash originally earmarked for redeeming JGBs and meeting bond interest payments. Such creative accounting does little to raise the credibility of the government's pledged cap on JGB issuance or to enhance fiscal transparency. In the same vein the government's assumption that debt-servicing costs will fall by 2.9%, to ¥16.7trn, also looks odd, in view of the increase in the absolute size of the total debt stock. Although in part this may reflect the assumption that interest rates will remain at historical lows, it is more likely the result of further deft accounting measures, such as extending the maturity of certain government-related borrowing that would otherwise have had to be redeemed in 2002/03.

Monetary policy

Monetary policy will remain among the most contentious areas of Japan's macroeconomic policy in 2002-03. Relations between many officials in the government and the Ministry of Finance (MOF) on the one hand, and the Bank of Japan (BOJ, the central bank) on the other, will remain tense, undermining confidence more generally in the quality of macroeconomic policy formation in Japan. Friction between the two sides will primarily centre on the BOJ's refusal to consider unorthodox policy measures, such as setting an explicit inflation target, to combat building deflationary pressures. Given that the official discount rate (ODR, the rate at which the BOJ lends to commercial banks) is hovering just above 0%, that the uncollateralised call rate is, in effect, at the 0% level, and that the target for private bank current-account balances held with the BOJ is set at a high level of ¥10trn-15trn, the BOJ has few tools in its orthodox policy arsenal with which it can loosen policy further. Whether the BOJ succumbs to outside pressure to target inflation will probably depend on how long the current governor, Masaru Hayami, remains in his position and, if he leaves, who replaces him. Mr Hayami strongly opposes calls to set an inflation target and is unlikely to change his mind while he remains in office.

Economic forecast

Forecast summary

(% unless otherwise indicated)

	2000[a]	2001[b]	2002[c]	2003[c]
Real GDP growth	2.2	–0.4	–1.4	1.4
Industrial production growth	5.7	–9.3	–5.1	3.1
Gross fixed investment growth	3.2	–0.5	–2.0	0.5
Unemployment rate (av)	4.7	5.0	5.6	5.4
Consumer price inflation (av)	–0.7	–0.7	–1.2	–0.5
Short-term interbank rate	1.4	1.4	1.4	1.4
Government balance (% of GDP)	–6.3	–7.5	–8.2	–9.0
Exports of goods fob (US$ bn)	459.5	382.2	355.1	397.9
Imports of goods fob (US$ bn)	342.8	311.5	284.6	329.5
Current-account balance (US$ bn)	116.9	89.4	97.0	103.8
% of GDP	2.5	2.1	2.5	2.6
Exchange rates				
¥:US$ (av)	107.8	122.0	129.0	124.0
¥:€ (av)	99.55	109.28	123.84	125.86
¥:US$ (year-end)	114.9	131.0	126.0	122.0
¥:€ (year-end)	106.9	109.5	125.2	121.2

[a] Actual. [b] EIU estimates. [c] EIU forecasts.

International assumptions

The outlook for Japan's external environment is discouraging in 2002, although it is considerably brighter in 2003. The environment in the medium term will be heavily influenced by the uncertainties surrounding the US economy in the aftermath of the September 11th terrorist attacks in 2001. World trade growth will accelerate modestly in 2002, to 1%, from the estimated low of 0.4% in 2001, and rise again to 6.9% in 2003. This will mainly reflect slightly faster growth in the US in 2002, and then a deepening recovery in 2003, which will help to drive a pick-up in Japanese export volume growth.

World oil prices (dated Brent Blend) will fall back sharply in annual average terms in 2002 as reduced US growth and low worldwide aviation demand dampens oil consumption. Faster world economic growth will, however, help to lift oil prices in 2003. Lower oil prices in 2002 will help to moderate Japan's import bill in both years—Japan is a major oil user, and imports account for nearly all of its requirements. US dollar prices for manufactured goods will rise in 2002-03. Although this will benefit Japan's exporters, many firms may prefer to hold prices down in order to maintain market share in the face of competition from South Korean rivals in particular.

International assumptions summary

(% unless otherwise indicated)

	2000	2001	2002	2003
Real GDP growth				
World	4.7	2.2	2.4	4.2
US	4.1	0.9	1.1	3.8
EU	3.3	1.5	1.3	2.5
Exchange rates (av)				
US$ effective (1995=100)	121.1	127.7	126.3	121.4
US$:€	0.924	0.896	0.960	1.015
SDR:US$	0.758	0.785	0.771	0.751
Financial indicators				
US$ 3-month commercial paper rate	6.32	3.59	1.71	4.88
Euro 3-month interbank rate	4.48	4.28	3.13	4.60
Commodity prices				
Oil (Brent; US$/b)	28.5	24.3	18.3	20.2
Gold (US$/troy oz)	279.3	268.8	255.0	250.0
Food, feedstuffs & beverages				
(% change in US$ terms)	–6.1	–1.0	11.9	13.4
Industrial raw materials				
(% change in US$ terms)	13.4	–9.7	1.3	14.8

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Economic growth

The Economist Intelligence Unit expects real GDP to contract by 1.4% in 2002, after an estimated 0.4% contraction in 2001, and to grow by 1.4% in 2003. In nominal terms the performance will be even worse, with a contraction of 2.7% in 2002 followed by stagnation in 2003. By 2003, in nominal terms, the Japanese economy will be 5.4% smaller than at its peak in 1997. The real contraction expected in 2002 will mainly reflect continued weak domestic demand in the US, which accounts for around one-third of Japanese export revenue. The slowdown in the US will also be the main factor behind continued modest growth in other important markets in Asia, particularly Taiwan and South Korea. We expect exports of goods and services to fall by 4.1% in 2002, after an expected contraction of 6.5% in 2001. More rapid growth in the US and elsewhere in Asia from the latter part of 2002 and thereafter will facilitate export volume growth of 5.6% in 2003. Some support to export volumes in both years will come from increased competitiveness owing to the yen’s relative weakness against the US dollar.

Domestic demand will remain weak into 2003. As unemployment is set to remain at a post-war high of well over 5% and real wages are expected to remain more or less stagnant in 2002-03, there is little prospect of a strong rebound in private consumption over the forecast period. Depressed consumer demand, flagging export growth, continuing deflationary pressures and increasing pressure on private-sector banks to cut lending to weaker companies will combine to weaken corporate sentiment over the short term; we expect private-sector investment in plant and equipment to contract by 2.2% in 2002, after estimated growth of 2.8% in 2001. Faster export growth will help to lift this investment component in 2003, albeit by just 0.5%. More generally, business investment performance over the forecast period is also likely to be undermined by an acceleration in the relocation of production facilities abroad, particularly in China since its admission to the

World Trade Organisation (WTO) at end-2001. Government investment, hitherto one of the few drivers of economic activity, will contract in 2002-03. Although the government will introduce a second fiscal stimulus package containing public-works spending at the beginning of 2002, the dire state of public finances suggests that the extra spending will be too small to lift public investment significantly.

Gross domestic product by expenditure

(¥ trn at constant 1995 prices; % change year on year in brackets unless otherwise indicated)

	2000[a]	2001[b]	2002[c]	2003[c]
Private consumption	289.2	288.8	280.9	283.1
	(0.3)	(–0.1)	(–2.7)	(0.8)
Public consumption	86.7	89.5	91.5	93.2
	(4.6)	(3.3)	(2.2)	(1.9)
Gross fixed investment	146.5	145.8	142.8	143.4
	(3.2)	(–0.5)	(–2.0)	(0.5)
Final domestic demand	522.3	524.0	515.2	519.8
	(1.8)	(0.3)	(–1.7)	(0.9)
Stockbuilding	–1.7	–2.0	–1.4	1.0
	(0.0)[d]	(0.0)[d]	(0.1)[d]	(0.5)[d]
Total domestic demand	520.6	522.0	513.8	520.8
	(1.8)	(0.3)	(–1.6)	(1.4)
Exports of goods & services	59.6	55.7	53.4	56.4
	(12.4)	(–6.5)	(–4.1)	(5.6)
Imports of goods & services	–46.1	–45.7	–42.6	–45.2
	(9.6)	(–1.0)	(–6.6)	(6.0)
Foreign balance	13.5	10.1	10.8	11.2
	(0.5)[d]	(–0.6)[d]	(0.1)[d]	(0.1)[d]
GDP	534.0	532.1	524.6	532.0
	(2.2)	(–0.4)	(–1.4)	(1.4)

[a] Actual. [b] EIU estimates. [c] EIU forecasts. d Contribution to real GDP growth.

Inflation

Consumer prices will fall by an average of 1.2% in 2002 and by a further 0.5% in 2003. By 2003 Japanese consumer prices will have been falling for five consecutive years. Our forecast for sustained price falls mainly reflects our bearish view of Japanese economic growth prospects in 2002-03. In 2002 the inflationary effects of a weaker yen will be muted by the impact of subdued domestic demand, continuing (albeit sporadic) deregulatory reform in areas such as services and distribution, and technology-driven productivity gains. Lower world oil prices and continued problems in the domestic banking system will also add to downward pressure on consumer prices.

Exchange rates

At the time of writing the yen was trading in a narrow band around ¥133-134:US$1, compared with the range of ¥120-124:US$1 that it held for the greater part of 2001. This is the yen’s lowest level since late 1998. The slippage reflects a number of factors, including large net securities outflows as a result of renewed concern about Japan’s economic outlook in general and the solvency of the domestic banking system in particular, and suggestions that the Japanese government may be encouraging yen weakness in order to boost economic growth and mitigate deflationary pressures.

There is every likelihood that the yen's trajectory over the first half of 2002 will be quite volatile, reflecting the continued muted short-term economic outlook and growing concerns about the state of the banking system. One trigger for renewed currency weakness could be further bankruptcies among weaker domestic banks around April 2002, when the government is scheduled to remove the current blanket guarantee on time deposits at private banks. We expect the yen to average ¥130:US$1 in the first half of 2002, before appreciating thereafter as the current recession ends and the economic recovery deepens.

External sector

We expect large current-account surpluses to be recorded over the forecast period, equivalent to 2.5% of GDP in 2002 and 2.6% of GDP in 2003. The merchandise trade surplus (fob-fob) will remain at around US$70bn in 2002-03, a level only slightly lower than that estimated for 2001. These will be small surpluses by recent standards. The slippage will reflect a number of factors, including the poor outlook for mainstay electronics exports and the yen's relative weakness against the US dollar, which will raise the cost of many imported goods. The services deficit will remain at around US$45bn in 2002-03, partly reflecting continued high levels of outward tourism, which will keep services debits stubbornly high. The income surplus will rise to US$80bn in 2002, from an estimated US$77.3bn in 2001, and to not far off US$90bn in 2003. Income credits will stagnate in 2002 at the level reached in 2001, as muted world economic growth depresses inflows of interest, profits and dividends.

Current-account balance
(US$ bn unless otherwise indicated)

	2000[a]	2001[b]	2002[c]	2003[c]
Goods: exports fob	459.5	382.2	355.1	397.9
Goods: imports fob	–342.8	–311.5	–284.6	–329.5
Trade balance	116.7	70.6	70.5	68.3
Services: credit	69.2	63.1	63.8	69.7
Services: debit	–116.9	–113.0	–109.1	–113.6
Services balance	–47.6	–49.9	–45.3	–43.9
Income: credit	206.9	212.0	212.4	232.9
Income: debit	–149.3	–134.7	–132.7	–145.3
Income balance	57.6	77.3	79.7	87.6
Current transfers: credit	7.4	6.5	5.9	6.2
Current transfers: debit	–17.2	–15.0	–13.8	–14.4
Current transfers balance	–9.8	–8.6	–7.9	–8.2
Current-account balance	116.9	89.4	97.0	103.8
% of GDP	2.5	2.1	2.5	2.6

[a] Actual. [b] EIU estimates. [c] EIU forecasts.

Editors: Robert Ward (editor); Sophie Lewisohn (consulting editor) Editorial closing date: January 29th 2002
All queries: Tel: (44.20) 7830 1007 E-mail: london@eiu.com Next report: Full schedule on www.eiu.com/schedule

