

Japan economic outlook FY02~03

Economic lull dead ahead

■ Real GDP grew 0.7% year on year in July-September, marking the third consecutive quarter of growth and affirming that Japan's economic recovery remains intact. While external demand detracted from growth for the first time in a year, its negative contribution was offset by growth in domestic demand, chiefly consumer spending. The economy consequently maintained a steady growth trajectory in July-September.

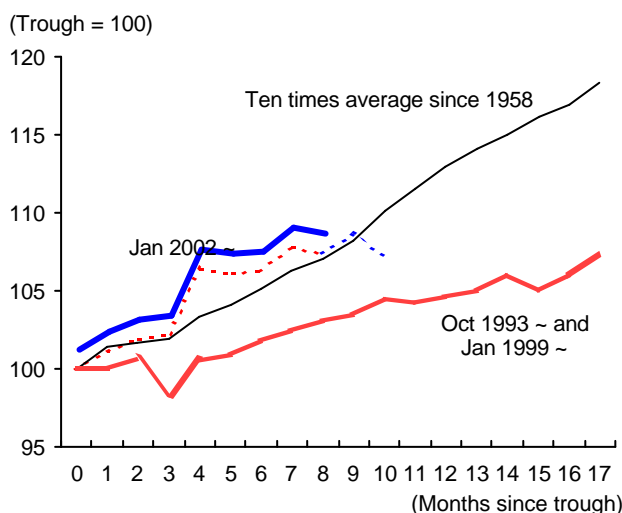
■ However, this favorable economic environment will very likely change dramatically from October-December. We expect the export-led recovery that has been under way since the start of this year to give way to a period of near-zero growth.

■ Industrial production statistics clearly indicate, in our view, that Japan's recovery trend is losing momentum. Corporations are curtailing production in direct response to the slowdown in exports, reflecting an aversion to inventory accumulation in the current deflationary environment. We cannot rule out the possibility of a consensus emerging that the economic recovery will be cut short by a modest inventory correction in manufacturing industry between now and mid-2003.

■ Nonetheless, we see little risk an imminent relapse into a full-blown recession, for three reasons: (1) inventories are at extremely low levels; (2) we expect the US economy to avert a renewed recession; and (3) we expect domestic demand to continue to recover, albeit anemically.

■ The export slowdown may dampen expectations of an improvement in the employment environment, pressuring consumers to retrench temporarily. Such an eventuality could interrupt the hitherto unexpectedly solid recovery in consumer spending. The export slowdown will also likely forestall a recovery in capital spending, the downtrend in which has recently been tapering off.

The recovery in industrial production is slowing down



Note: Figures for Oct and Nov 2002 (dotted line) are based on the results of the manufacturing industry forecast survey.
Source: Nomura, based on Ministry of Economy, Trade & Industry data

Date

21 November 2002

Japanese original

19 Nov

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On the bright side, a rising propensity to consume is stabilizing consumer spending, while replacement investment is bolstering aggregate capital spending. Against such a backdrop, we expect exports to regain a stable footing and domestic demand to re-embark on a moderate recovery in the second half of 2003.

■ While the economic ramifications of a faster nonperforming loan cleanup process continue to bear careful monitoring, we have concluded that under current conditions, an acceleration of the cleanup process would not have a major incremental deflationary effect. We project about a ¥1-trillion increase in public-works spending in the FY02 supplementary budget.

■ We forecast real GDP growth of +0.9% in FY02 and -0.1% in FY03. On a nominal basis, we project GDP growth of -0.7% in FY02 and -1.5% in FY03, which would be the fourth straight year of nominal GDP contraction.

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Summary of our forecasts for the Japanese economy

(% y-y, unless stated otherwise)

		Latest (19 November)			Previous (27 September)		
		FY01	FY02E	FY03E	FY01	FY02E	FY03E
Gross domestic product (A)	Real GDP growth	-1.8	0.9	-0.1	-1.9	0.2	0.6
	Contribution of domestic demand (% point)	-1.3	0.3	-0.2	-1.4	-0.5	0.7
	Private-sector demand (% point)	-1.2	0.2	-0.2	-1.3	-0.8	1.1
	Public-sector demand (% point)	-0.1	0.1	0.0	-0.1	0.3	-0.4
	Contribution of external demand (% point)	-0.5	0.6	0.1	-0.5	0.7	-0.2
	Private-sector consumption	1.3	1.6	0.1	1.1	0.5	0.3
	Private-sector housing investment	-8.0	-4.3	-2.4	-8.0	-2.8	0.5
	Private-sector capital expenditure	-4.7	-4.4	-0.2	-4.8	-3.9	3.9
	Change in private-sector inventories (¥ trn)	***	***	***	***	***	***
	Government consumption	2.6	2.8	2.9	2.7	1.7	1.6
	Public fixed capital formation	-6.7	-5.9	-7.4	-6.6	-0.6	-10.5
	Goods/services exports	-8.0	8.1	1.6	-8.3	9.8	1.5
	Goods/services imports	-4.7	3.1	0.4	-4.7	3.9	4.1
	Nominal net exports (as a % of nominal GDP)	0.8	1.2	1.4	0.8	1.3	1.1
	Nominal GDP growth	-2.7	-0.7	-1.5	-2.8	-1.3	-0.6
Production/prices (B)	Industrial production	-10.2	2.9	-0.6	-10.2	3.2	2.1
	Wholesale price index	-0.0	-1.1	-1.0	-0.0	-1.2	0.4
	Domestic demand goods	-0.9	-0.8	-0.8	-1.1	-0.8	-0.1
	Consumer price index	-1.0	-0.8	-0.6	-1.0	-0.8	-0.7
	Excluding fresh foods	-0.8	-0.8	-0.6	-0.8	-0.8	-0.7
	Unemployment rate (%)	5.2	5.5	6.0	5.2	5.5	5.7
External balances (C)	Customs cleared trade balance (¥ trn)	7.1	9.3	9.7	7.1	10.6	10.3
	Trade balance (¥ trn)	9.0	11.2	11.6	9.0	12.4	12.0
	Trade/services balance (¥ trn)	3.9	6.1	6.8	3.9	6.4	5.7
	Current account balance (¥ trn)	11.9	13.3	14.7	11.9	13.4	13.6
	Current account balance (\$ bn)	94.5	108.4	117.4	94.5	109.5	108.9
	As a % of nominal GDP	2.4	2.7	3.0	2.4	2.7	2.8

Note: Year-on-year figures for FY01 GDP are based on figures for FY01 that have been calculated using the new method and figures for FY00 that have also been calculated using the new method, for reference purposes.

Source: Nomura

Assumptions on which our economic forecasts are based

(¥ trillion)

	FY99	FY00	FY01	FY02E	FY03E
Additional public works spending (actual boost to GDP)	5.2	5.0	3.5	3.5	1.0
Of which, FY98 1st supplementary budget	1.5				
FY98 3rd supplementary budget	3.7				
FY99 supplementary budget		5.0			
FY00 supplementary budget			3.0		
FY01 1st supplementary budget			0.5	0.5	
FY01 2nd supplementary budget			0.0	3.0	
FY02 supplementary budget					1.0
¥/\$ rate (FY average)	111.4	110.6	125.1	122.9	125.0
ODR (at FY end)	0.50	0.25	0.10	0.10	0.10
Crude oil price (FY average, \$/barrel)	20.8	28.2	23.8	27.0	24.3
Spring wage hike	2.2	2.1	2.0	1.7	1.5

Note: Figures for additional public-works spending are for spending actually carried out.

Source: Nomura

Quarterly forecasts of real GDP, industrial production and prices					(¥ billion, unless noted otherwise)			
	4~6	7~9	10~12E	03/1~3E	4~6E	7~9E	10~12E	04/1~3E
Private sector final consumption	295,477.8	297,803.6	298,399.2	297,802.4	296,998.3	297,592.3	297,889.9	298,485.7
(% q-q)	0.5	0.8	0.2	-0.2	-0.3	0.2	0.1	0.2
(% y-y)	0.8	2.2	2.0	1.3	0.5	-0.1	-0.2	0.2
Private sector housing	18,543.4	18,511.6	17,863.7	17,613.6	17,701.7	17,861.0	17,878.8	17,360.4
(% q-q)	-0.9	-0.2	-3.5	-1.4	0.5	0.9	0.1	-2.9
(% y-y)	-2.7	-2.3	-6.4	-5.9	-4.5	-3.5	0.1	-1.4
Private sector corporate capex	82,224.1	81,482.8	81,156.9	80,588.8	80,830.5	80,992.2	81,154.2	81,560.0
(% q-q)	0.2	-0.9	-0.4	-0.7	0.3	0.2	0.2	0.5
(% y-y)	-8.2	-5.1	-2.6	-1.8	-1.7	-0.6	0.0	1.2
Change in private sector inventories	-5,909.4	-3,365.1	-4,700.0	-6,000.0	-6,500.0	-6,300.0	-5,800.0	-5,100.0
(% q-q)	***	***	***	***	***	***	***	***
(% y-y)	-32.0	***	-25.2	***	10.0	***	23.4	***
Government final consumption	90,645.4	91,471.7	92,203.5	93,217.7	93,870.2	94,339.6	94,622.6	95,190.3
(% q-q)	0.6	0.9	0.8	1.1	0.7	0.5	0.3	0.6
(% y-y)	2.1	2.8	2.9	3.4	3.6	3.1	2.6	2.1
Public fixed capital formation	33,358.8	32,840.3	31,953.6	30,483.7	30,544.7	30,269.8	29,573.6	28,627.2
(% q-q)	-1.5	-1.6	-2.7	-4.6	0.2	-0.9	-2.3	-3.2
(% y-y)	-2.2	-3.6	-6.2	-10.0	-8.4	-7.8	-7.4	-6.1
Change in public inventories	105.8	108.5	50.0	45.0	45.0	40.0	40.0	40.0
(% q-q)	105.0	2.6	-53.9	-10.0	0.0	-11.1	0.0	0.0
(% y-y)	***	***	57.2	-12.8	-57.5	-63.1	-20.0	-11.1
Net exports	14,054.0	13,538.7	13,187.8	12,856.2	13,657.7	14,017.2	14,360.6	14,628.1
(% change in contribution)	0.3	-0.1	-0.1	-0.1	0.2	0.1	0.1	0.1
(% q-q)	14.6	-3.7	-2.6	-2.5	6.2	2.6	2.4	1.9
(% y-y)	44.6	37.6	36.5	4.8	-3.0	3.4	8.8	14.1
Goods and services exports	59,492.7	59,793.4	59,673.8	59,435.1	59,910.6	60,270.1	60,752.2	61,177.5
(% q-q)	5.9	0.5	-0.2	-0.4	0.8	0.6	0.8	0.7
(% y-y)	5.8	9.5	11.3	5.8	0.7	0.8	1.8	2.9
Goods and services imports	45,438.7	46,254.7	46,486.0	46,578.9	46,252.9	46,252.9	46,391.7	46,549.4
(% q-q)	3.4	1.8	0.5	0.2	-0.7	0.0	0.3	0.3
(% y-y)	-1.9	2.9	5.7	6.0	1.8	0.0	-0.2	-0.1
GDP	528,500.0	532,392.2	530,114.7	526,607.4	527,148.2	528,812.1	529,719.7	530,791.7
(% q-q)	1.0	0.7	-0.4	-0.7	0.1	0.3	0.2	0.2
(% q-q annualized)	4.2	3.0	-1.7	-2.6	0.4	1.3	0.7	0.8
(% y-y)	-0.5	1.7	1.6	0.7	-0.3	-0.7	-0.1	0.8
Industrial production (1995 = 100)	95.5	97.5	97.7	96.5	96.0	96.1	96.3	96.6
(% q-q)	3.8	2.1	0.2	-1.2	-0.5	0.1	0.2	0.4
(% y-y)	-3.5	3.5	6.8	4.9	0.5	-1.5	-1.4	0.1
Wholesale price index (2000 = 100)	96.5	95.7	95.5	95.2	95.1	94.9	94.6	94.4
(% q-q)	-0.2	-0.8	-0.3	-0.3	-0.1	-0.2	-0.3	-0.2
(% y-y)	-1.0	-1.3	-0.6	-1.6	-1.5	-0.9	-0.9	-0.8
Exports	97.7	93.4	93.4	92.5	93.4	93.0	92.5	91.8
(% q-q)	-2.0	-4.4	0.0	-0.9	0.9	-0.4	-0.5	-0.7
(% y-y)	0.6	-2.5	-2.0	-7.2	-4.4	-0.5	-0.9	-0.7
Imports	114.3	110.4	110.7	110.8	110.9	110.0	108.9	108.0
(% q-q)	0.5	-3.4	0.3	0.1	0.1	-0.8	-1.0	-0.8
(% y-y)	-1.0	-2.4	0.7	-2.5	-3.0	-0.4	-1.6	-2.5
Domestic demand goods	94.4	94.3	94.1	93.8	93.6	93.5	93.4	93.3
(% q-q)	0.0	-0.1	-0.2	-0.3	-0.3	-0.1	-0.1	-0.1
(% y-y)	-1.1	-1.1	-0.5	-0.6	-0.9	-0.9	-0.8	-0.5
Consumer prices (seas. adj., 2000 = 100)	98.5	98.4	97.8	97.7	98.0	97.8	97.3	97.1
(% q-q)	0.0	-0.1	-0.6	-0.1	0.3	-0.2	-0.6	-0.2
(% y-y)	-0.9	-0.8	-0.8	-0.8	-0.4	-0.6	-0.6	-0.7
Excluding fresh food	98.4	98.3	98.0	97.8	97.9	97.7	97.5	97.2
(% q-q, seasonally adjusted)	-0.3	-0.1	-0.3	-0.2	0.1	-0.2	-0.3	-0.3

Note: (1) Figures to 02/7~9 are actual results. Figures from 10~12 are estimates by Nomura. (2) *** indicates that the actual figure in the previous quarter or year was zero or negative and thus growth rates were not calculated.

Source: Cabinet Office, Ministry of Economy, Trade and Industry, Nomura

Exports appear poised for a pullback

The contribution of net exports to July-September real GDP growth was -0.1 percentage point, its first negative reading in four quarters

The contribution of net exports (exports less imports) to July-September real GDP growth was -0.1 percentage point, its first negative reading in four quarters. July-September real export growth was 0.5% quarter on quarter, a marked slowdown from April-June's 5.9% growth. In contrast, real imports maintained a relatively brisk pace, rising 1.8% in July-September following 3.4% growth in April-June. External demand, which has been the engine of the economy in 2002, has started to cloud the economic outlook after contributing 0.5 percentage point to growth in January-March and another 0.3 percentage point in April-June.

By region, Asia-bound exports have slowed markedly

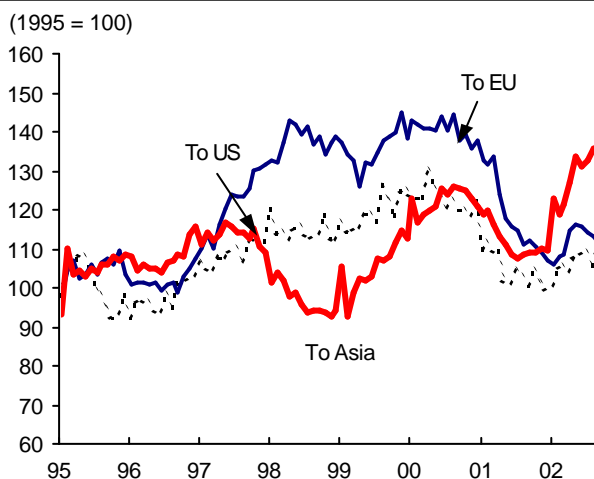
By region, Asia-bound exports have slowed markedly. Since peaking at +10.9% quarter-on-quarter growth in January-March, our seasonally adjusted index of exports to Asia dropped rapidly to +2.8% in July-September following a +8.2% reading in April-June. By contrast, our index of US-bound exports has remained relatively stable, edging down to +1.8% in July-September from +2.9% in April-June.

The slowdown in Asia-bound exports could conceivably be attributed to several factors, including the fact that global inventory rebuilding appears to be running its course. Another plausible explanation is that the export slowdown is in part the laggard impact of the yen's appreciation against the Chinese yuan and other dollar-pegged Asian currencies. Another contributing factor, in our view, is China's recently implemented safeguards against steel imports.

To compound matters, the outlook for hitherto buoyant US-bound exports also has turned murky

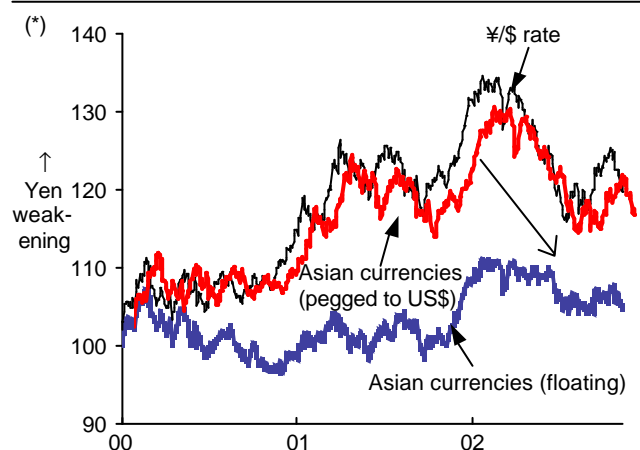
To compound matters, the outlook for hitherto buoyant US-bound exports also has turned murky. We think US consumer spending is at an increasing risk of a slump in the wake of the stock market downturn. Auto sales, in particular, are showing signs of waning momentum, though they remain high in absolute terms. Although declining interest rates may support auto sales going forward, we view the recent slowdown in such sales as a major cause for concern, since automobiles account for some 40% of Japanese exports to the US.

Import volume by region (monthly)



Note: Seasonal adjusted by Nomura using X-12ARIMA
Source: MOF

¥/\$ rate



Note: (1) (*): ¥/\$ rate and Asian currencies indexed vs. yen taking 4 Jan 00 as 100. (2) Figures for Asian currencies are averages weighted by exports from Japan in 2001. (3) Pegged currencies: CNY, NTD, HK\$, MYR; floating currencies: W, Rp, SGD, P, Bht. Source: BOJ, Asian Wall Street Journal, etc

We now think it highly likely that GDP-basis real exports will decline modestly from late this year through early 2003...

...though absolute downside is limited

In light of such, we now think it highly likely that GDP-basis real exports will decline modestly from late this year through early 2003.

Even so, exports are unlikely to fall off substantially. The steep drop in exports from mid-2000 through 2001 was largely due to a downturn in US final demand. US real final demand for goods (ie, real GDP less service demand, inventory investment, and building investment) had been consistently growing at a 5-6% annualized rate through early 2000. Since April-June 2000, however, growth in real final demand for goods has averaged barely over 1% in the aftermath of the bursting of the equity market bubble. We attribute the sharp deceleration in growth to a steep drop in IT investment, among other factors.

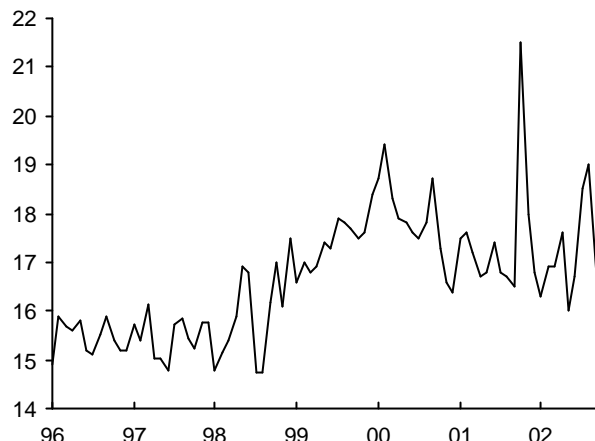
This slowdown in US final demand triggered a sharp unintended buildup in inventories not only in the US but globally as well, followed by drastic inventory liquidation and a contraction in trade.

We look for real exports to slow precipitously over the near term but then resume growing at a moderate 2-3% annualized rate from the second half of 2003

By virtue of the recent major wave of inventory liquidation, inventories are still low in both the US and Asia. We do not anticipate a resumption of drastic inventory liquidation on a global basis, barring a further drop in final demand. In our view, the US is unlikely to relapse into recession. We look for real exports to slow precipitously over the near term but then resume growing at a moderate 2-3% annualized rate from the second half of 2003.

US motor vehicle sales

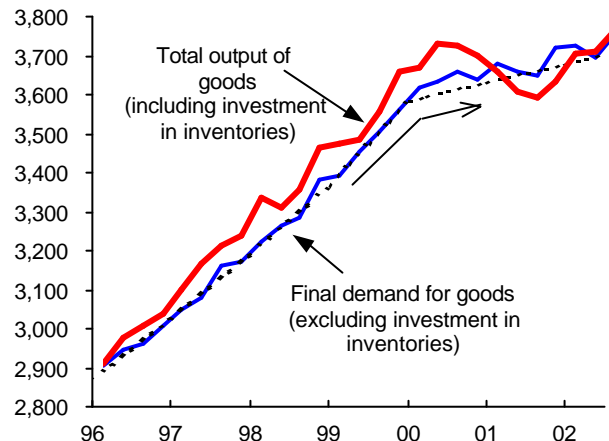
(Seas. adj. annualized; mn vehicles)



Source: US Department of Commerce

US GDP

(Chained-dollar estimates, base year = 1996, \$ bn)



Source: US Department of Commerce

Industrial production likely to level off

In our opinion, industrial production is heading toward a period of no growth at the end of the year

After a rapid recovery in the first six months of the year, industrial production is now growing at a slower pace. Industrial production shrank by 0.1% in September, its first decline in three months, and average growth for July-September eased to +2.2% quarter on quarter, after growing at +3.8% in April-June. According to the *Survey of Industrial Production*, manufacturers are projecting month-on-month growth in production of +1.2% in October and -1.4% in November. Based on this, we forecast October-December production growth of +0.8% quarter on quarter. Since actual production has consistently fallen short of company forecasts over the past two years, October-December production could conceivably be flat quarter on quarter. In our opinion, industrial production is heading toward a period of no growth at the end of the year.

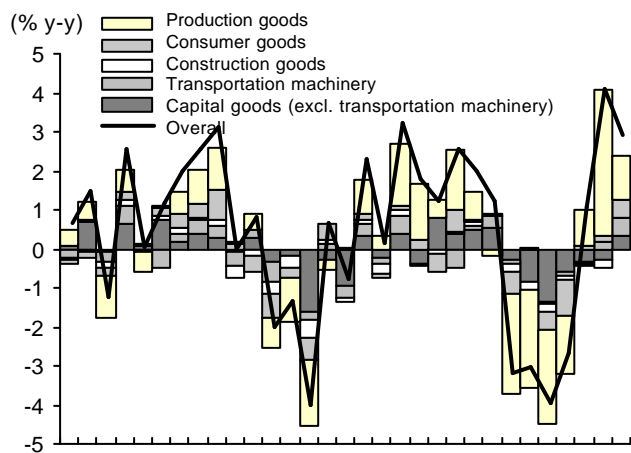
We attribute this in part to the slowdown in export growth caused primarily by the stuttering US economy

We attribute this in part to the slowdown in export growth caused primarily by the stuttering US economy. Looking at the contribution to overall industrial production by segment, the contribution from industrial materials, which are heavily tied to exports, fell sharply from April-June to July-September and became a drag overall. Since the deflationary environment is encouraging companies to minimize inventories, we believe the slowdown in exports is directly linked to cutbacks in the production of materials tied to exports. Meanwhile, the contribution from final-demand goods, including durable goods and consumer goods, turned positive or increased for July-September. We believe this reflects the moderate recovery during the same period in domestic-demand factors, including business investment and consumption.

We think downward pressures will remain modest, in view of low inventory levels

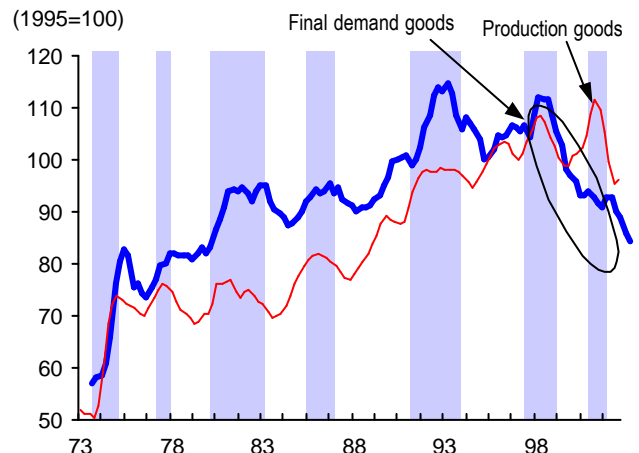
As we explain later, exports may decline temporarily late this year and early next year. If this were to have an impact on domestic demand, which underpinned growth in July-September, then manufacturing industry would be forced to adjust and we would expect production to shrink. If this occurs and thereby highlights manufacturing industry's traditional bias toward short-term fluctuations, the prevailing opinion may come to view the economic recovery as having ended early. Even if there is a temporary pullback in production, however, we believe a drastic slowdown will be avoided. Manufacturing inventories remain low, and the economy's current position on the inventory cycle is prior to the midpoint on the up cycle. Deflation has neutralized the ability of inventories to act as a buffer against fluctuations in demand, thus explaining the direct link between the slowdown in exports and

Contribution by segment to industrial production



Source: Ministry of Economy, Trade and Industry

Inventory levels



Note: Shaded areas indicate recessions

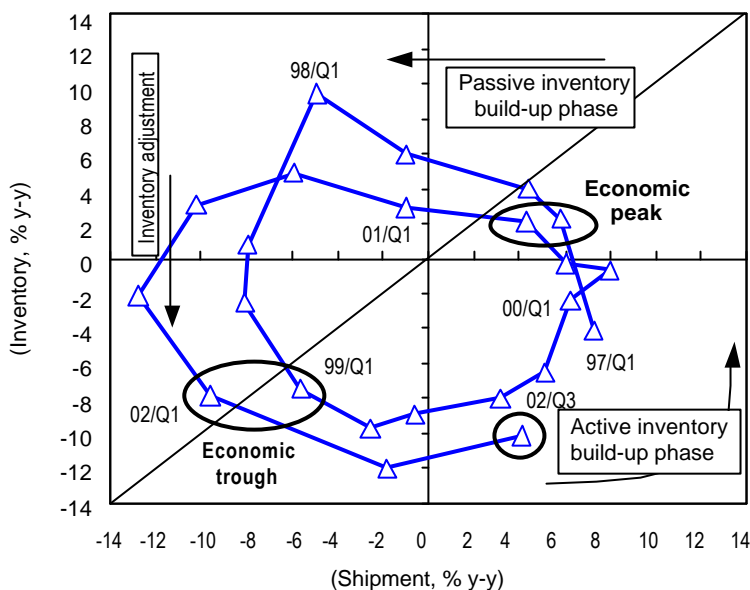
Source: Nomura, based on Ministry of Economy, Trade and Industry

slowing production, but this also suggests that downward pressures will remain modest, in view of low inventory levels.

This leveling in industrial production should continue for the time being

This leveling in industrial production should continue for the time being. Assuming, however, that the US economy is able to avoid a double-dip recession and that exports can thereby regain their footing, we expect this pullback in production to be short-lived and production to return to a moderate recovery track in the latter half of next year.

The inventory cycle



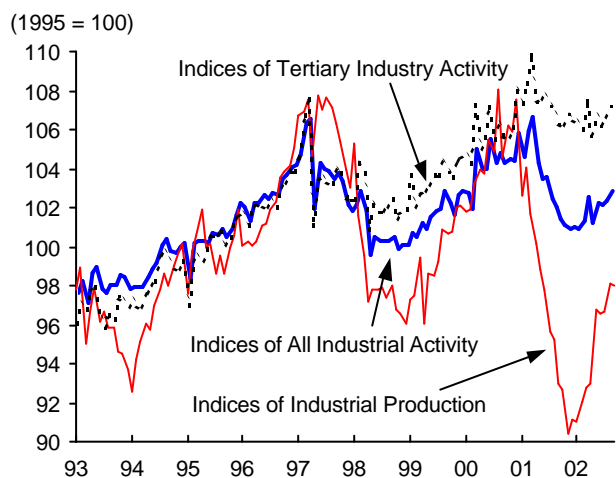
Source: Ministry of Economy, Trade and Industry's *Indices of Industrial Production*

Despite export slowdown, no relapse into recession

We find it encouraging that nonmanufacturing activity has picked up since the summer even as manufacturing production has steadily lost momentum

When we broaden our focus on the economy in aggregate, including nonmanufacturing industry, the economic picture looks somewhat different. The composite *Index of All Industrial Activity*, which corresponds to GDP measured from the supply side, rose on average in July-August by 0.7% relative to its level of the preceding quarter, an improvement from its 0.2% quarter-on-quarter rise in April-June. This improvement reflects upticks in both the *Construction Industry Activity Index* and *Indices of Tertiary Industry Activity*. In July-August, the former was up 0.2% from April-June, having stabilized, albeit at a depressed level, since plunging 8% quarter on quarter in April-June. The latter likewise exhibited a substantial improvement in July-August, rising 0.6% from April-June after declining 0.4% quarter on quarter in April-June. We find it encouraging that nonmanufacturing activity has picked up since the summer even as manufacturing production has steadily lost momentum.

Indices of All Industrial Activity



Source: Nomura

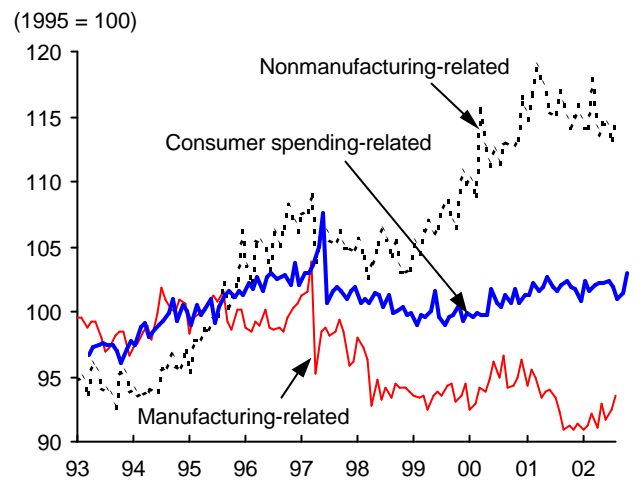
The Indices of Tertiary Industry Activity are on a long-term upward trend, in stark contrast to the Indices of Industrial Production, which were flat throughout the 1990s in a hangover from the preceding

era of ever-increasing production growth. Among tertiary industries, the mobile communication industry has expanded notably amid the rapid proliferation of mobile phones.

Excluding the mobile communication sector from the Indices of Tertiary Industry Activity (and also excluding sectors where activity is estimated based on the Family Income & Expenditure Survey, which we think is of questionable accuracy), we classified the remaining sectors as: (1) consumer-related sectors, which provide services to the household sector; (2) manufacturing-related sectors, which are closely tied to manufacturing industry; and (3) nonmanufacturing-related sectors (for a list of the specific sectors, see the notes to the accompanying exhibit). This analysis reveals that since 1993: (1) activity in manufacturing-related sectors has been contracting while (2) activity in consumer-related sectors has held firm, and (3) activity in nonmanufacturing sectors have been on an upward trend.

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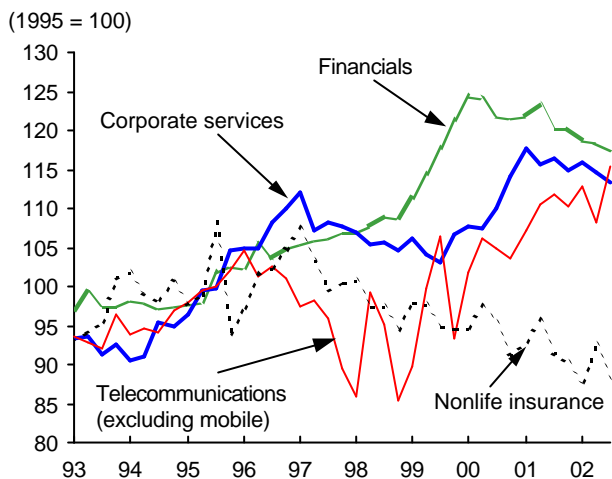
Breakdown of Indices of Tertiary Industry Activity



Note: (1) Consumer spending-related = gas + passenger transportation + travel + retail + eating out + life insurance + real estate trading/intermediary + personal services (excluding business estimated in the household spending survey) + public services. (2) Manufacturing-related = electricity + goods transportation + warehouses + provision of road transportation facilities + wholesale. (3) Nonmanufacturing-related = telecommunication (excluding mobile) + financials + nonlife insurance + corporate services.

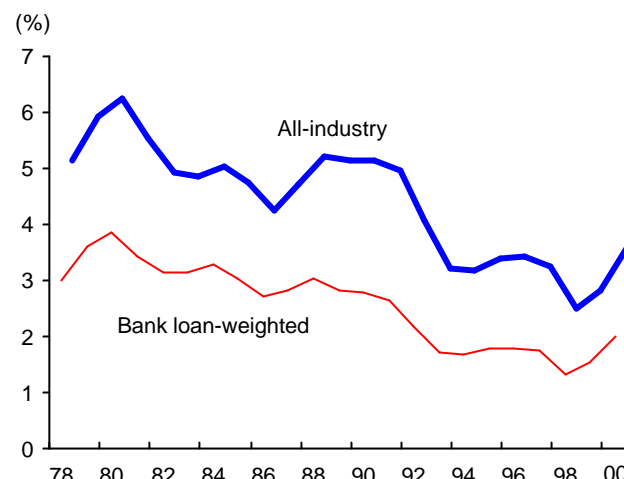
Source: Ministry of Economy, Trade & Industry

Breakdown of nonmanufacturing-related sectors



Source: Ministry of Economy, Trade & Industry's *Indices of Tertiary Industry Activity*

ROA



Note: Covers manufacturing, construction, utilities, transportation/telecommunications, wholesalers/retailers, and services.
Source: Nomura, based on MOF and BOJ data

We attribute the downturn in manufacturing-related sectors to the end of the long-term upward trend in manufacturing industry production and cost-cutting by manufacturers

We attribute the downturn in manufacturing-related sectors to the end of the long-term upward trend in manufacturing industry production and cost-cutting by manufacturers, among other factors. Among consumer-related sectors, activity generally held steady in most cases. Notable exceptions include the restaurant/bar sector, which has enjoyed consistent growth, and the public services sector, which continues to grow as medical expenses increase in tandem with the aging of Japanese society. Among other nonmanufacturing sectors, the telecom sector has grown in the wake of the Internet's widespread popularity, while sectors involved in outsourcing (eg, leasing) have likewise enjoyed growth.

The composite Index of All Industrial Activity has been on a gradual upward trend driven by service industry growth even amid progressive deflation

The composite *Index of All Industrial Activity* has been on a gradual upward trend driven by service industry growth even amid progressive deflation, which suggests that the Japanese economy could maintain a modest growth trajectory going forward. Since (1) the business cycle itself strongly tends to be driven by manufacturing industry and (2) activity has yet to recover in other nonmanufacturing sectors that had been growing consistently, the economy's future course will depend largely on the trend in manufacturing production. Yet, we do not see much risk of a major downturn in Japan's overall economy, including the service sector, provided that the US economy avoids a double dip and domestic industrial production does not slip into a sharp downtrend.

The deflationary impact of accelerating the nonperforming loan cleanup should be limited

The NPL cleanup process poses the risk of triggering corporate bankruptcies and exacerbating unemployment

We estimated the magnitude of the deflationary impact that would be unleashed through the process of halving the major banks' NPL ratio by end-FY04

The *Program for Financial Revival* unveiled by the government on 30 October sets a target of reducing the major banks' nonperforming loan (NPL) ratio by 50% by FY04. Since bank lending is heavily tilted toward sectors with relatively low profitability, we expect the acceleration of the final disposition of NPLs to lead to improved efficiency throughout the entire economy. Near term, however, the process poses the risk of triggering corporate bankruptcies and exacerbating unemployment.

In order to assess this risk, we estimated the magnitude of the deflationary impact that would be unleashed on the economy through the process of halving the major banks' NPL ratio by end-FY04. At end-FY01, the major banks (city banks, long-term credit banks, trust banks) reported that, pursuant to the *Financial Reconstruction Law*, their NPLs totaled approximately ¥28.4 trillion out of roughly ¥327 trillion in total credit outstanding, which equates to an NPL ratio of 8.7%. Assuming that: (1) total NPLs continue to grow at their FY01 rate of ¥8.4 trillion annually and (2) total credit outstanding declines 2% annually, in line with the trend of the past three years, we estimate that the major banks will have to annually dispose of ¥13.4 trillion in NPLs in FY02-04 to reduce their aggregate NPL ratio by 50% by end-FY04 (FY01's large increase in total NPLs was largely the result of special bank inspections, meaning that assumption (1) above is quite conservative).

If the banks dispose of the full ¥13.4 trillion in NPLs by liquidating them, we estimate that approximately 570,000 employees of the borrower companies would lose their jobs each year, equivalent to a 0.3-percentage-point rise in unemployment per annum, assuming that a certain percentage of the newly unemployed will be rehired elsewhere or leave the work force. We estimate the resultant impact on GDP growth at approximately -0.2 percentage point annually. By contrast, assuming that the percentage of NPLs disposed of through liquidation is roughly 10% (in fact, liquidation accounted for 10.6% of NPLs disposed of in

Economic impact of final disposal of nonperforming loans

		Reference
Final disposal amount (¥ trillion)	13.4	
Borrowing from banks nationwide by target companies	20.7	Estimated from the ratio of borrowing from major banks to borrowing from all banks
Total liabilities at target companies	41.5	Estimated from the ratio of borrowing from banks by bankrupt companies to total liabilities
Number of job leavers (1,000)	569.3	Estimated from the ratio of number of employees of bankrupt companies to liabilities (in ¥ trillion)
Re-employment ratio: number who find new jobs / number of job leavers (%)	40.0	Assumption
Decline in employment (1,000 people)	341.6	Number of job leavers x (100% - re-employment ratio)
Per-capita monthly wages (¥1,000)	345.5	
Decline in household income (¥ trillion)	1.4	Disposable household income is around ¥310 trillion/year
Decline in consumer spending (%)	0.25	Consumer spending income elasticity = 0.552
Decline in capital investment (%)	0.43	As a result of declines in sales
Decline in GDP (%)	0.21	As proportions of GDP: consumer spending: 57%, capital investment: 15%
(if 10% of bankrupt companies targeted for NPL disposal are liquidated)		Assumes personnel cut of 100% if companies targeted for NPL disposal are liquidated and 35.3% in other cases
Rise in unemployment: (% points)	0.25	Assuming number of unemployed people / number of job leavers = 30%
(if 10% of bankrupt companies targeted for NPL disposal are liquidated)	0.11	The working population numbers around 67 million

Source: Nomura, based on data from Teikoku Databank, the Cabinet Office, the Ministry of Public Management, Home Affairs, Posts and Telecommunications, the Ministry of Health, Labor and Welfare, the BOJ, and *kessan tanshin* of major banks

In our current judgment, NPL disposal in accordance with the Program for Financial Revival will not have a major deflationary impact on the economy

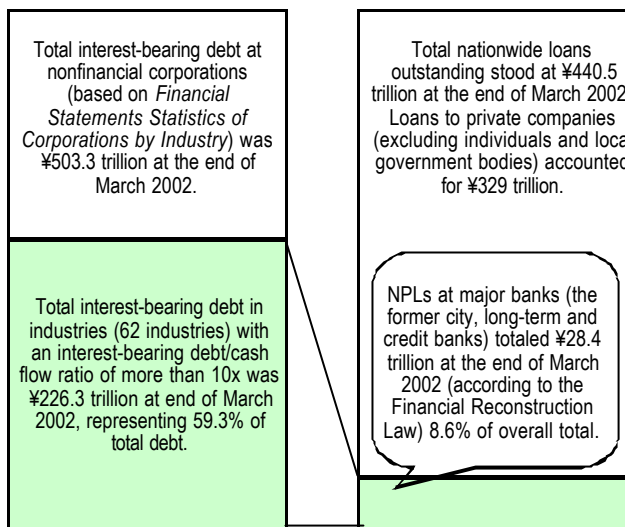
The flip side of the coin, however, is that such a scenario is unlikely to lead to a radical change in industry structure

the second half of FY01), we estimate that the annual rise in unemployment would be limited to 0.1 percentage point and the impact on GDP growth would likewise be reduced to -0.1 percentage point annually. In our current judgment, NPL disposal in accordance with the *Program for Financial Revival* will not have a major deflationary impact on the economy.

The flip side of the coin, however, is that such a scenario is unlikely to lead to a radical change in industry structure. Using MOF's *Financial Statement Statistics of Corporations by Industry*, we classified companies by industry and size into a total of 62 categories.

In 30 of these 62 categories, the constituent companies collectively fail to meet the government's tentative eligibility criterion for revival of technically insolvent companies, with the said criterion being that debt does not exceed 10x cash flow. The companies in these 30 categories collectively account for nearly 60% of the aggregate debt of the companies covered by the statistics. In contrast, the major banks' NPLs targeted for cleanup by the *Program for Financial Revival* total a mere 8.6% of their loans to the corporate sector. Though the government advocates integration of corporate/industrial revival and NPL disposal, we have to conclude that it will fall short of this goal if it narrows its focus to only the major banks' NPLs as it is currently doing.

Balance between NPL disposal and revitalization of corporations and industry



Source: Nomura, based on BOJ and MOF data

Decline in capital spending is tapering off

The downtrend in capital spending appears to be generally tapering off.

Going forward, capital spending is highly unlikely to embark on a distinct uptrend over the near term

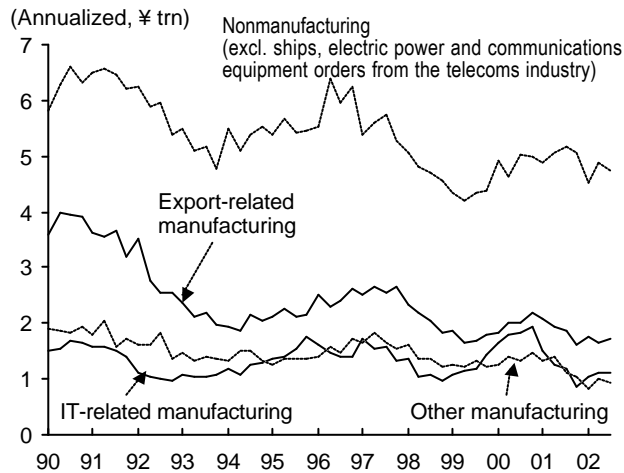
Nonetheless, we see little risk of a resumed sharp decline in capital spending, barring a major downturn in exports

The downtrend in capital spending appears to be generally tapering off. According to the most recent GDP statistics, capital investment was down 0.9% quarter on quarter in July-September after growth resumed by a slim margin (0.2%) in April-June. Machinery orders (private demand excluding orders for ships and from electric power companies), a leading indicator of capital spending, declined 1.7% quarter on quarter in July-September, a modest setback in comparison to their 7.1% growth rate in April-June.

Going forward, capital spending is highly unlikely to embark on a distinct uptrend over the near term. Capacity utilization is still low despite having rebounded somewhat. With industrial production on the verge of a lull, we do not foresee a substantial improvement in capacity utilization anytime soon. Machinery makers' composite forecast for October-December calls for a steep 6.5% quarter-on-quarter drop in orders. Though these forecasts tend to have a large margin of error, the October-December forecast attests to the continuing hazy outlook for capital spending.

Nonetheless, we see little risk of a resumed sharp decline in capital spending, barring a major downturn in exports. Among the companies covered by the *Business and Investment Survey of Incorporated Enterprises*, planned FY02 second-half capex is 6.3% below FY01 second-half capex, an improvement from the first half's 10.0% year-on-year decline. This trend was corroborated by the September *Tankan*, which revealed that planned FY02 capex had been revised upward by 0.6% since June. We look for capital investment to mark time for a while, in line with the trend in production, before embarking on a gradual uptrend from April-June 2003.

Machinery orders breakdown



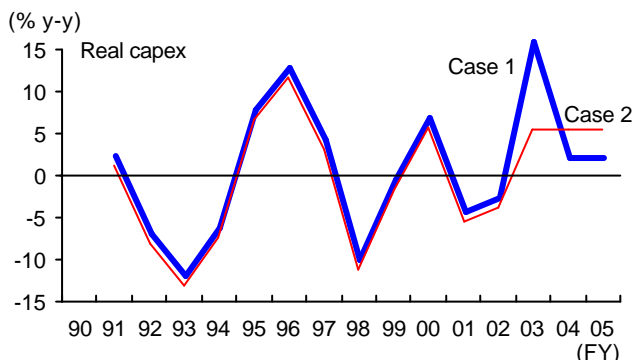
Note: (1) IT-related manufacturing = ceramics + nonferrous metals + electrical machinery + precision equipment. (2) Export-related = chemicals + steel + autos + ships + other transportation machinery.
Source: Cabinet Office machinery orders data

Replacement investment alone can drive growth in capital spending

We believe it is not unrealistic to assume that corporations will maintain the capital stock at its current level

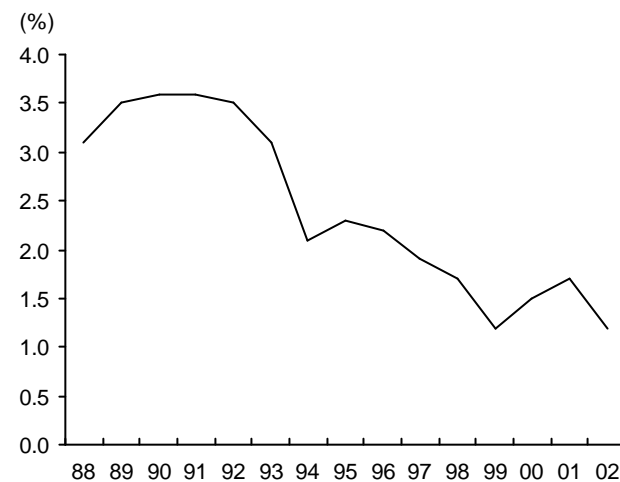
Some are no doubt skeptical that modest growth in production will be enough to induce an increase in capital spending, in view of the corporate sector's current preference for repaying debt and limiting capital spending to within the parameters of cash flow. Such skepticism is unfounded, however, according to an NRI simulation that demonstrated that replacement investment to maintain the capital stock's status quo could very well drive growth in aggregate capital spending. A Cabinet Office survey of 1,200 publicly traded companies projects average economic growth of +1.2% per annum over the next five years. Though lackluster, it is nonetheless a positive growth rate. In light of such, we believe it is not unrealistic to assume that corporations will maintain the capital stock at its current level.

Capex simulation



Note: (1) Simulation based on the assumption that capital investment will be limited to net exclusions and depreciation expenses up until FY05. (2) Assumes that the annual average change in depreciation expenses from FY98 to FY01 (-1.2%) continues from FY02 to FY05. (3) Assumes that the average for net exclusions from FY98 to FY01 continues from FY02 to FY05. (4) Deflator used when calculating real capital investment is on a GDP basis. Assumes that the annual average change from FY98 to FY01 (-1.9%) continues from FY02 to FY05. (5) Nomura latest forecasts (GDP basis) used to calculate FY02 nominal and real capital investment growth rates. Case 1 assumes that capital investment will catch up with net capital exclusions + depreciation expenses in FY03. Case 2 assumes that capital investment will gradually catch up with net capital exclusions + depreciation expenses by FY05
Source: Nomura

Outlook for the average real economic growth rate over the next five years



Source: Cabinet Office survey of corporate activity

Employee income remains in the doldrums

On the employment front, the improvement trend has started to gradually broaden out

On the employment front, the improvement trend has started to gradually broaden out. Job offers, a leading indicator, grew 2.4% quarter on quarter in July-September after rising 3.1% in April-June. Employment likewise rose 0.2% quarter on quarter in July-September, its first uptick in seven quarters. The unemployment rate has been holding steady at 5.4%. The job offers-to-applicants ratio registered a 0.55 reading in September, having risen steadily since bottoming at 0.50 in February.

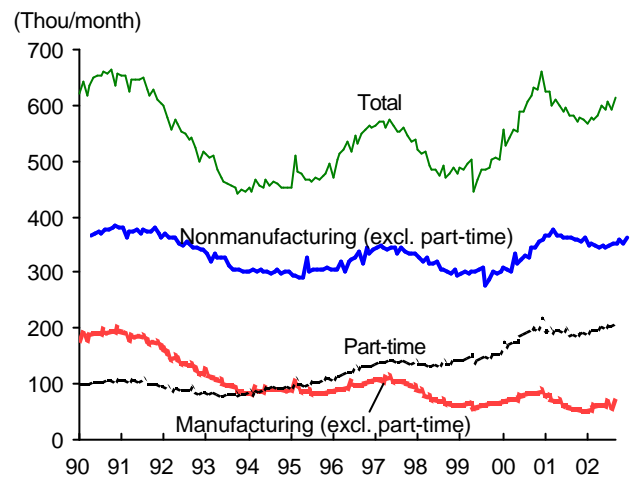
Despite such improvement, income per worker remains in the doldrums

Despite such improvement, income per worker remains in the doldrums. According to the *Monthly Labor Survey*, contractual cash earnings were down 1.0% year on year in July-September, a major improvement from their 1.7% drop in April-June. The improvement reflects a rebound in overtime earnings stemming from an increase in overtime hours. On a quarter-on-quarter basis, contractual cash earnings were up 0.3% in July-September, their first rise in eight quarters. Meanwhile, summer bonuses were down 5.9% year on year, their biggest drop on record (ie, since 1991). We attribute the drop in bonuses to companies' continued focus on reducing labor costs. We expect household income to continue to decline.

Based on NRI forecasts, we project that employee compensation will decline 2.1% in FY02 and 1.9% in FY03.

Our prognosis of declining incomes is not limited to private-sector workers. We project that national and municipal civil servants' compensation will decline by nearly ¥700 billion in FY02 as a result of the decision to fully implement National Personnel Authority recommendations, including cuts in monthly salaries and bonuses. Based on NRI forecasts, we project that employee compensation will decline 2.1% in FY02 and 1.9% in FY03.

Job offers



Note: (1) Excluding recent graduates. (2) Seasonal adjustment by Nomura

Source: Ministry of Health, Labor and Welfare

Bonus payments

(% y-y)

Summer

	1997	1998	1999	2000	2001	2002
Monthly labor statistics	1.5	-2.1	-3.6	0.6	-1.0	-5.9
Nikkei	3.49	0.39	-5.96	0.74	3.40	-4.48
Nikkeiren	3.73	1.40	-4.78	-1.25	1.96	-1.02
Institute of Labor Administration	2.6	-1.2	-8.3	0.1	2.1	(-6.1)

Winter

	1997	1998	1999	2000	2001	2002
Monthly labor statistics	-0.1	-2.9	-3.0	-1.2	-3.7	
Nikkei	2.84	-2.90	-3.77	0.84	1.67	
Nikkeiren	3.70	-1.61	-2.82	0.53	-0.01	(-2.42)
Institute of Labor Administration		1.5	-4.1	-5.6	-0.3	-0.7

Note: (1) Institute of Labor Administration 2002 summer figures are those for companies that decided the amount of this summer's bonuses last year, as well as last winter's bonuses, and also for those companies that decided the amount of this summer's bonuses at the time of the spring round of wage negotiations. (2) Nikkeiren figures for winter 2002 are interim estimates.

Source: Nomura

Drop in disposable incomes likely to be mild

However, we project that household disposable incomes will not fall as much as employee compensation

However, we project that household disposable incomes will not fall as much as employee compensation, chiefly by virtue of a reduced income tax burden. Indeed, income tax revenues fell a substantial 24.2% year on year in the first half of FY02. A comparison of the historical trend in household tax payments and employee income reveals that the former has declined in tandem with the latter. It is well known that a flat-rate taxation regime has a built-in stabilizer mechanism whereby tax payments automatically decrease during recessions, thereby bolstering the economy.

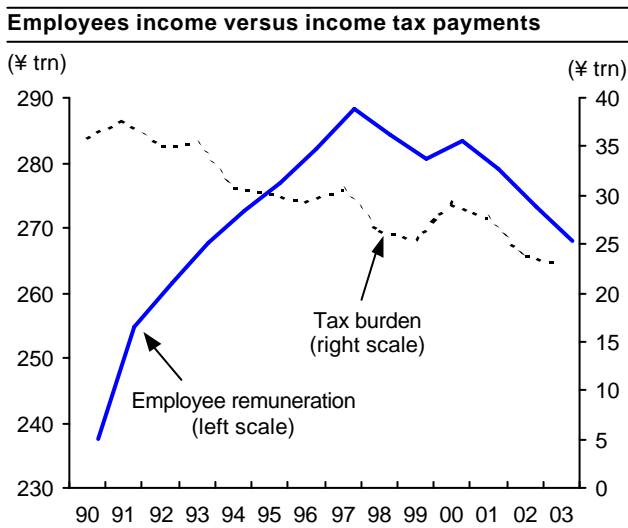
One concern is that social insurance reform will result in an increase in the household sector's burden

One concern is that social insurance reform will result in an increase in the household sector's burden. The unemployment insurance premium was already raised by 0.2% last month pursuant to an adjustment provision in the existing law. In FY03, we expect an additional 0.2% hike in the premium rate as a result of an amendment of the Employment Insurance Law. We also expect unemployment benefits to be curtailed in FY03 through reduction of benefits at the upper end of the income scale. Additionally, a recent amendment to the National Health Insurance Law increases premiums and copayments effective FY03. Other statutory amendments expected to go into effect in FY03 include: (1) an increase in long-term care insurance premiums to cover increased usage of long-term care services; (2) reinstatement of CPI-indexing of public pension benefits; and (3) a reduction in severance pay for national civil servants. As a result of these changes, we estimate that aggregate household disposable income will decline in nominal terms by ¥768 billion in FY02 and ¥1,878 billion in FY03 relative to what it would have been in the absence of the above changes.

We note, however, that social insurance payments are being increased because benefit payments to households are growing in tandem with the aging of Japan's population

It is important to note, however, that social insurance payments are being increased because benefit payments to households are continuously growing in tandem with the progressive aging of Japan's population. Back in 2000, the erstwhile Ministry of Health and Welfare projected that social insurance payments to the government (not including the government's share of social insurance costs) will grow by an average of ¥2.8 trillion annually between 2001 and 2005 while social insurance benefits grow by an average of ¥4.4 trillion annually.

We estimated FY02-03 social insurance benefits and payments assuming that, if there were no legislative amendments, benefits to households would grow an average of ¥2.6 trillion annually in FY01-03 while insurance payments from households to the government would grow ¥1.4 trillion annually on average (we took into account that (1) payments for medical treatment and long-term care insurance benefits are deemed to be in-kind benefits and not included in disposable income and (2) the increase in social insurance payments will be split roughly 50/50 between employers and workers). Then, factoring in the above legislative amendments, we estimated that social insurance payments to the government will increase ¥1.5 trillion in



Note: Estimates by Nomura from FY01.

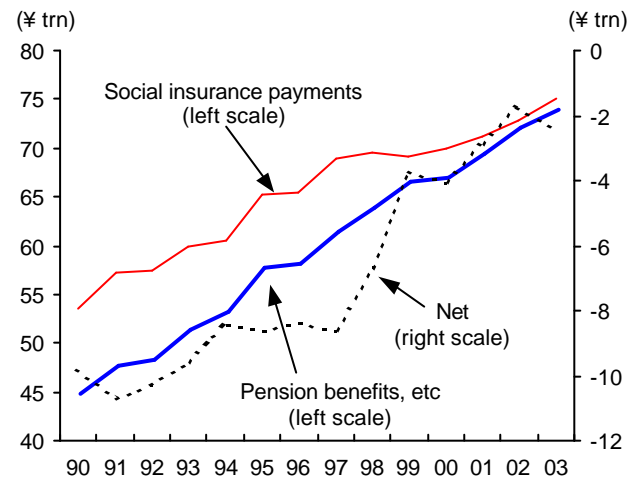
Source: Cabinet Office, Nomura

We do not share concerns that the increase in households' social insurance burden will be a major drag on consumer spending

FY02 and ¥2.4 trillion in FY03 as social insurance benefits grow ¥2.6 trillion and ¥1.8 trillion, respectively. As a result, the household sector's net social-insurance-related inflows will grow ¥1.1 trillion in FY02 before declining by a comparatively modest ¥600 billion in FY03. In sum, concerns that the increase in households' social insurance burden stemming from the aforementioned legislative amendments will be a major drag on consumer spending are overblown, in our view.

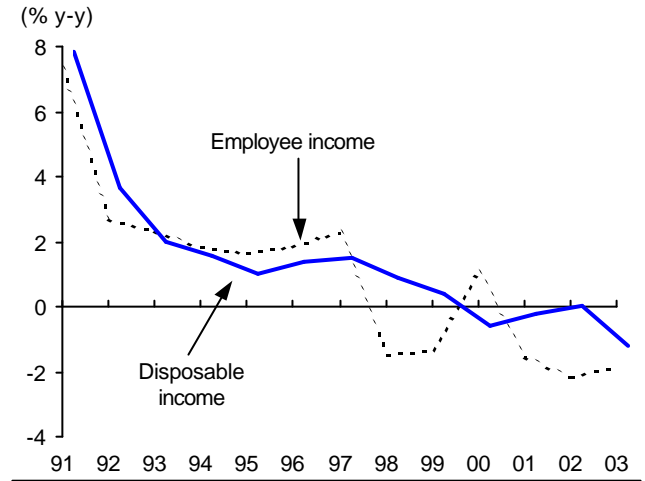
Assuming, in addition to the above, that households' net miscellaneous income (eg, net interest income) remains constant, we estimate that the household sector's nominal disposable income will fall 0.3% in FY02 and 1.5% in FY03, following a 0.5% decline in FY01. Although the rate of decline is projected to increase in FY03, the increase will be partially offset by deflation. On balance, the decline in real income should be minor.

Household social contributions versus benefits



Note: Estimates by Nomura from FY01.
Source: Cabinet Office, Nomura

Projected trend in disposable income



Note: Estimates by Nomura from FY01.
Source: Cabinet Office, Nomura

Consumer spending is holding firm, bolstered by service expenditures

Household consumption expenditures have remained surprisingly firm so far this year

Household consumption expenditures have remained surprisingly firm so far this year. In July-September, real consumer spending (GDP basis) grew for the fourth consecutive quarter, rising 0.8% quarter on quarter (it grew 0.5% in April-June, 0.5% in January-March, and 0.3% in October-December 2001). Such buoyancy in aggregate consumer spending appears to be at odds with the ongoing slump in sales among department stores, supermarkets, and other retailers. Indeed, real retail sales (converted to real terms by Nomura) declined in July-September, though by only 0.5% quarter on quarter, per the *Commercial Sales Statistics*.

Consumer spending on services has been steadily growing

The key to understanding the apparent discrepancy noted above is that service expenditures account for over 40% of household consumption expenditures. When we analyzed the breakdown in per-capita nominal core consumption expenditures (excluding certain categories of expenditures that tend to be highly variable (eg, automobiles)) between goods and services based on *Family Income & Expenditure Survey* data, we confirmed that while consumer spending on goods has been declining since around 1998, consumer spending on services has been steadily growing. Moreover, its growth has accelerated since the start of 2002.

Services that have enjoyed particularly robust growth in demand include information/communication services (eg, mobile phone service, Internet service, satellite TV broadcasting) and educational/recreational services (eg, travel, self-refinement classes).

We think the structure of Japanese consumer spending is changing

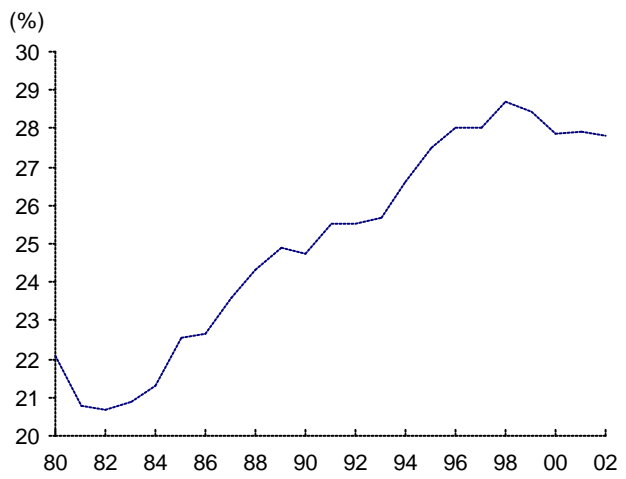
We can thus say that the structure of Japanese consumer spending is changing as households curtail spending on goods and increase spending on services.

Household core consumption expenditure breakdown (per capita, working households)



Note: Seasonal adjustment by Nomura.
 Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications *Family Income & Expenditure Survey*

Propensity to save (Family Income & Expenditure Survey basis)



Note: 2002 saving ratio estimated based on the seasonally adjusted average through September.
 Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications

Declining propensity to save is bolstering consumer spending

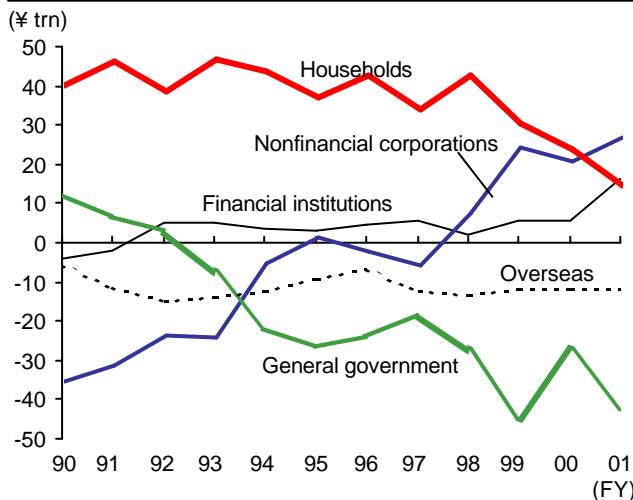
The personal savings rate is declining

We believe that the disparity between incomes and consumption in households represents a declining propensity to save and a rising propensity to consume

In addition to the shift in consumer spending from goods to services, there is another conspicuous change in household consumption behavior. Namely, the personal savings rate is declining.

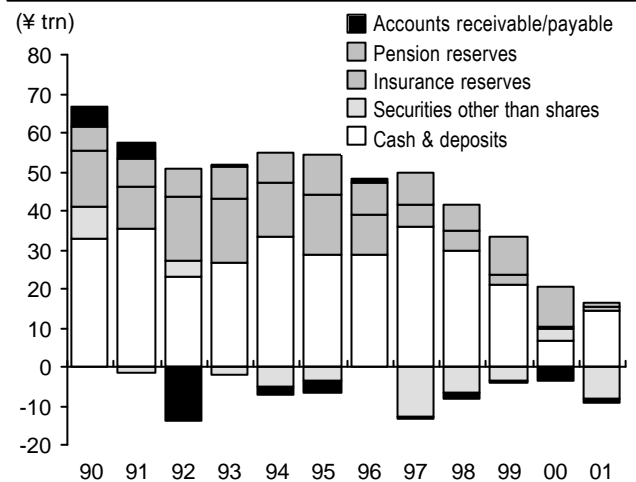
As noted above, disposable income (take-home pay) is not declining as rapidly as employee income (white-collar workers' compensation). Yet, the fact that consumer spending is holding firm despite a weak income environment suggests that households' propensity to save is declining or, conversely, that their propensity to consume is increasing. We believe that the disparity between incomes and consumption in households represents a declining propensity to save and a rising propensity to consume. According to the *Family Income & Expenditure Survey*, the household propensity to save rose steadily following the collapse of Japan's bubble economy before peaking in 1998. From 1998 through 2001, however, households' propensity to save has declined. Next, we looked at the Bank of Japan's *Flow of Funds* data to determine the financial surplus or deficit in the household sector. According to the BOJ, households' surplus funds peaked at ¥38.8 trillion (7.6% of nominal GDP) in FY98 and had fallen to ¥10.8 trillion (2.2% of nominal GDP) by FY01. "Surplus/shortage of funds" is a concept used to measure the change in the financial assets (financial assets – liabilities); in the household context, it approximates to disposable income minus spending and residential investment. With residential investment weak in both FY01 and the first half of FY02, we believe the falling household financial surplus can be attributed to a declining propensity to save.

Fund situation at economic units



Note: Adjusted to eliminate the impact of the transfer of former JNR liabilities to the government in FY98.
Source: BOJ

Changes in household financial assets



Note: Equities and other items with small increases omitted.
Source: BOJ

Households are cutting back on saving in favor of consumption

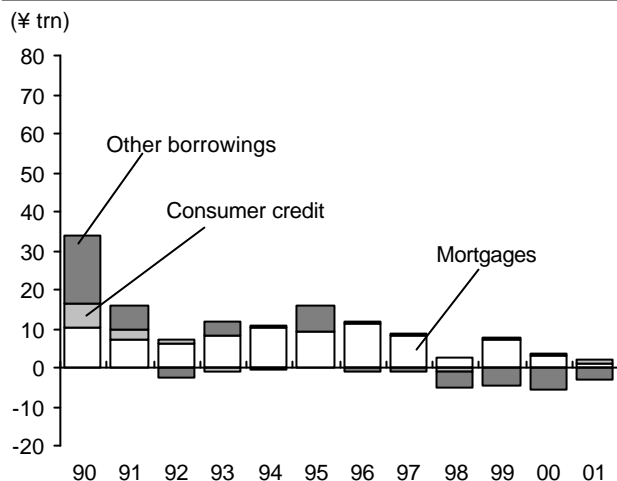
If consumer spending is indeed being bolstered by a decline in households' propensity to save, what are the factors behind this trend?

Consumers have not borrowed to finance their consumption

Analysis of trends in household liabilities from the BOJ's *Flow of Funds* data shows consumer credit almost unchanged since the collapse of the bubble, indicating that consumers have not borrowed to finance their consumption. The BOJ data also confirm that growth in household financial assets slowed steadily from FY98 through FY01. In other words, households either saved less or drew down existing savings during this period.

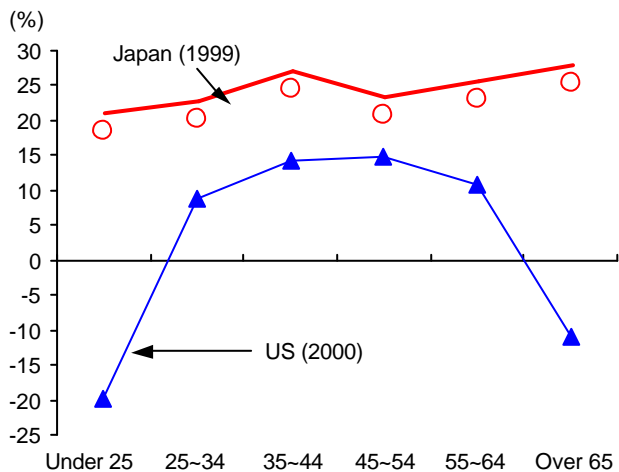
According to the standard life-cycle hypothesis, the aging of society is supposed to reduce the average household's savings rate as older individuals draw down savings accumulated during their prime. Japan differs from the US, however, in that senior citizens actually have a higher propensity to save than workers. Thus, this hypothesis cannot explain the falling savings rate.

Change in household liabilities



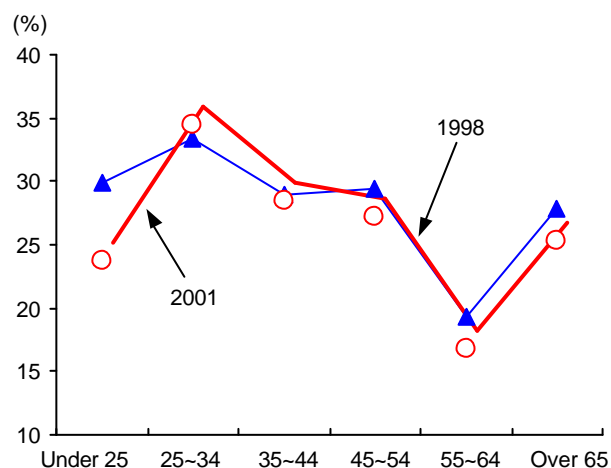
Source: BOJ

Saving rates in Japan and the US, by age group



Source: Ministry of Finance *National Survey of Family Income & Expenditure*, US Department of Labor *Consumer Expenditure Survey*

Changes in propensity to save for heads of households (Japan)



Note: Nuclear families only.

Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications *Family Income & Expenditure Survey*

The savings rate is declining among the younger generation

We think the decline in household savings rates has been led by the young and the old

We focused our analysis on nuclear families, who make up some 70% of all salaried employee households, and observed how the propensity to save changed with head of household age. We found that between 1998 and 2001, the propensity to save fell sharply among families headed by individuals under the age of 30. The propensity to save also declined in families led by those 50 and older. Meanwhile, no changes were observed in families headed by individuals in their 30s and 40s. In our view, this suggests that the decline in household savings rates has been led by the young and the old.

The reasons behind the increased propensity to consume (ie, the declining propensity to save) differ with age

We next looked at the changes in the propensity to consume (= 1.0 – propensity to save) from 1998 to 2001 for various age groups and spending categories. A positive contribution indicates either that the percentage decline in outlays was less than the corresponding percentage decline in disposable income, or that outlays actually increased. Clearly, the reasons behind the increased propensity to consume (ie, the declining propensity to save) differ with age.

(1) Among households headed by people in their 20s, most spending categories had the effect of increasing the propensity to consume. Housing, automobile-related expenses, and telecommunications made especially large contributions. Younger households spend more on automobiles and mobile phone charges without cutting back on other expenditures, pushing up their overall propensity to consume (and pushing down their propensity to save). It may be that young Japanese no longer view saving as a virtuous activity.

(2) In households headed by individuals aged 50–59, spending on food, housing, utilities, and other daily necessities pushed up the overall propensity to consume. Notably, spending on foods—which was a significant negative contributor for all households under the age of 50, reflecting lower food prices—showed a positive contribution to propensity to consume. In other words, spending on foods and related services (including restaurants, etc.) remains comparatively strong in these households. One reason may be the sharp increase in youth unemployment since 1998. Young people who lose their jobs often move in with their parents and depend on them for living expenses. In our view, this may be one of the reasons why expenditures on daily necessities in this group have not fallen to the extent that incomes have. Another factor contributing to a rising propensity to spend is allowances sent to children who have left home. Again, this probably reflects increasing financial assistance for children who have lost their jobs or are unable to find work, in our view.

Change in propensity to consume by age and category (1998 ~ 2001)

	Average	Under 29	30~39	40~49	50~59	60~64
Food	-0.4	-0.1	-1.0	-0.8	0.4	0.0
Housing	0.2	1.0	0.2	0.1	0.4	0.0
Fuel, light and water charges	0.3	0.5	0.2	0.2	0.4	0.4
Furniture and household utensils	0.0	0.2	0.0	-0.2	0.2	-0.1
Apparel and footwear	-0.3	0.1	-0.4	-0.4	-0.3	-0.1
Medical care	0.1	0.3	0.0	0.3	0.1	0.1
Transport	0.0	0.1	0.0	0.0	0.0	0.1
Auto-related spending	0.2	1.6	-0.1	0.8	-0.1	-0.6
Telecommunications	0.7	1.5	0.8	0.8	0.5	0.3
Education	0.1	-0.1	0.0	0.4	0.3	0.0
Leisure	0.2	0.1	-0.2	0.4	0.1	1.2
(of which goods)	0.2	0.2	0.0	0.3	0.3	0.5
(of which services)	0.0	-0.1	-0.2	0.1	-0.1	0.7
Other	-0.4	1.1	-0.7	-1.2	0.2	1.2
(of which remittances from parents)	-0.1	-0.1	0.0	-0.6	0.4	-0.5
Total	0.8	6.2	-1.1	0.3	2.2	2.5

Note: Nuclear families (ie, wife and husband only or wife, husband and unmarried children).

Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications *Family Income & Expenditure Survey*

(3) In households led by individuals aged 60 and older, leisure-related expenditures have risen sharply. In our view, married couples, finding themselves with more free time now that their children have left home, are spending more on leisure. This is consistent with the anecdotal evidence of significant numbers of middle-aged and senior couples embarking on luxurious round-the-world cruises. In short, older households are showing themselves more willing to spend than in the past.

The decline in savings rates appears to have a variety of causes

To summarize, we believe it may be a growing willingness to consume that is pressuring the savings rate among households led by people in their 20s and 60s. At households headed by individuals aged 50–59, however, falling savings rates may be the result of a response to growing unemployment among their children. Thus, the decline in savings rates appears to have a variety of causes.

Consumer spending appears due for a brief retrenchment

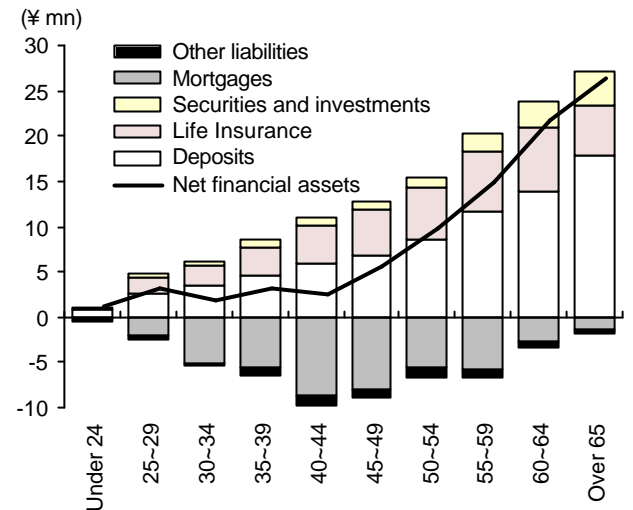
Households are thus very likely serving as a buffer for the overall economy in that they are maintaining consumption expenditures by decreasing their savings rate

Households are thus very likely serving as a buffer for the overall economy in that they are maintaining consumption expenditures by decreasing their savings rate, thereby partially offsetting the impact of declining incomes. Households headed by individuals aged 50 and older have substantial financial assets. They presumably have the financial latitude to maintain a constant level of consumer spending by drawing down their savings. The household savings rate consequently could continue to decline over the medium to long term.

Near term, however, we look for consumer spending to temporarily weaken in early 2003

Near term, however, we look for consumer spending to temporarily weaken in early 2003. The looming lull in production activity may exacerbate job insecurity. The resultant deterioration in consumer sentiment will likely dampen consumer spending temporarily by curbing the decline in the propensity to save.

Per-household financial assets and liabilities by age (1999)



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications Saving Trend Survey

Japanese fiscal policy is still highly deflationary

LDP members are calling for a large supplementary budget

Because of fears that accelerated nonperforming loan (NPL) disposals will result in further deflation, as well as fears of another recession, LDP members are increasingly calling for a large supplementary budget with increased public-works spending.

It now looks as if tax revenues in FY02 will be around ¥2.8 trillion less than the initial budget forecast

The government looks likely to announce plans to finalize its proposals for an FY02 supplementary budget in the near future. The need for a supplementary budget has arisen because a substantial shortfall in tax revenues is now expected. The economic slump has led to a decline in corporate tax revenues and, largely as a result of this, tax revenues on the general account in FY01, the level of which was confirmed at the end of July 2002, were ¥1.7 trillion less than figure in the initial budget. In addition, on the basis of tax revenues in FY01, it now looks as if tax revenues in FY02 will be around ¥2.8 trillion less than the amount forecast in the initial FY02 budget.

The FY02 supplementary budget is likely to involve additional public-works spending

It is becoming increasingly likely that the FY02 supplementary budget will involve additional public-works spending, as well as measures to address the problem of the shortfall in tax revenues. It may be that, as fears of another recession grow, the government feels it can no longer hold out against calls for fiscal measures to stimulate the economy.

We estimate that JGB issuance will be around ¥4 trillion higher than the initial budget forecast of ¥30 trillion

In practice, the government may wish to implement so-called “safety net” measures costing around ¥1 trillion at the very most, because of fears relating to an acceleration of the rate of NPL disposals. We think it highly likely that the government, while doing its utmost to avoid the kind of old-style public-works projects that many LDP members are calling for, will announce public-works projects aimed at urban revitalization and the creation of urban infrastructure, which coincide with its policy of structural reform. If the government announces a supplementary budget involving a total increase in expenditure of around ¥2 trillion, as well as measures aimed at plugging the shortfall in tax revenues, we estimate that JGB issuance will be around ¥4 trillion higher than the forecast of ¥30 trillion contained in the initial budget.

However, nominal fixed capital formation in FY03 is likely to be down by around 10% year on year

We expect the supplementary budget to be submitted to the ordinary session of the Diet and believe that the majority of the additional public works will be carried out in FY03. However, nominal fixed capital formation (as part of GDP) in FY03 is likely to be down by around 10% year on year. As the substantial decline in tax revenues will squeeze the source of funds for local allocation taxes, a sharp fall in local allocation tax funding may prove to be unavoidable in FY03, thus further squeezing public-works spending by local governments. We therefore believe that the government’s fiscal policy is still “deflationary”.

Whether or not there will be any substantial fiscal spending in FY03 will depend on the political situation

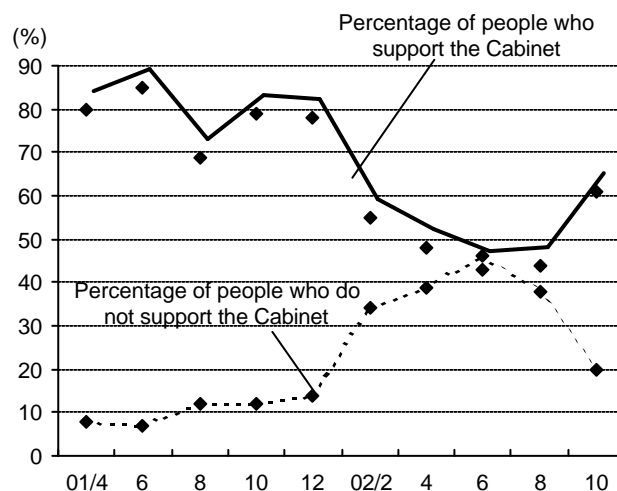
Whether or not there will be any substantial fiscal spending—mainly in the form of public-works spending—in FY03 is likely to depend largely on the political situation. If, in the run-up to the local elections in April 2003 and the election for the LDP president in September 2003, public support for the Cabinet falls substantially, the government may change its policy of fiscal restraint and move towards more fiscal spending. We think this is unlikely to happen at the moment, however, as, despite low share prices and fears of another recession, support for the Cabinet is growing.

For the same reason, we believe that the government will stick to its line of “tax cuts that exceed ¥1 trillion by as much as possible” on a net basis (ie, tax cuts minus tax hikes). We think that net tax cuts will probably total only around ¥1 trillion, made up mainly of cuts in corporate taxes (an increase in the amount of R&D costs that can be written off against taxable income, and a reduction in the tax on investments).

Our forecasts for the FY02 supplementary budget

	Initial budget	After supplementary budget	Change	Reasons for our forecast
Expenditure				
JGB redemption & coupon payment	16.7	16.7	0.0	
Distribution of local allocation tax, etc	17.0	16.0	-1.0	We have reduced the figure in proportion to the decline in tax revenues
General expenditure	47.5	49.5	2.0	
Social security costs	18.3	18.3	0.0	
Public works costs	8.4	9.4	1.0	(With the exception of extraordinary local allocation taxes and additional grants.)
Other	20.8	21.8	1.0	We have assumed that government measures to stimulate employment and small and medium-sized enterprises will lead to an extra ¥1.0 trillion of spending.
Total	81.2	82.3	1.0	
Revenues				
Tax revenues	46.8	44.0	-2.8	
Other revenues	4.4	4.4	0.0	Based on comments made by Finance Minister Masajuro Shiokawa.
JGB issuance	30.0	33.8	3.8	
Total	81.2	82.3	1.0	

Source: Nomura

Rate of public support for the Cabinet (based on surveys carried out by the *Nikkei*)

Note: The dots represent the months in which surveys were carried out.

Source: *Nihon Keizai Shimbun* newspaper

Our forecasts of the details of the forthcoming tax cuts and tax hikes

		Details	Impact
Tax cuts	Corporate tax	The tax treatment of R&D costs Switch from system where any increase in R&D costs is tax-deductible to a system where a fixed proportion of the R&D costs is tax-deductible	(Currently ¥32.0 billion) If the fixed percentage for R&D costs is 10%, this means a tax cut of around ¥1 trillion.
		Increase in special tax breaks for capital investment	(Currently ¥292.0 billion)
	Inheritance/ gift tax	Increase in the maximum tax-free amount of donations to ¥10 million	
		Reduction in maximum tax rate and changes to tax exemptions	If the maximum inheritance tax rate is lowered to 50% this means a tax cut of around ¥50.0 billion (according to calculations by NRI)
	Other	Changes to the land tax system	
Tax hikes	Income tax/ individual residents' tax	Reduction in special tax breaks for spouses	(If all tax breaks for spouses are abolished) Income tax: +¥0.5 trillion Residents' tax: +¥0.3 trillion
		Reduction in tax breaks for dependents, etc.	(If all tax breaks for dependents are abolished) Income tax: +¥0.5 trillion Residents' tax: +¥0.2 trillion
	Consumption tax	Review of simplified tax system and consumption tax exemption for small businesses	
	Other	Increase in tax on cigarettes and low-malt beer	A ¥2 hike in the tax per cigarette will result in an increase of ¥0.4 trillion
	Other	Simplification of the securities tax system	

Source: Various reports

Monetary policy has little impact on the real economy

On 30 October, the BOJ announced further monetary easing

At its monthly Monetary Policy Meeting (MPM) on 30 October, the BOJ decided to implement further monetary easing—it raised the target for the outstanding balance of current accounts at the BOJ to ¥15~¥20 trillion, and increased its monthly JGB outright purchase (*rinban*) operations to around ¥200.0 billion. We believe there are two main reasons for this additional monetary easing: (1) the BOJ needed to demonstrate its policy coordination with the government's comprehensive anti-deflation package; and (2) financial institutions were bolstering their cash and cash equivalents because of uncertainty surrounding government policy on the disposal of NPLs, thus heightening instability in some quarters of the short-term money markets.

However, the funds supplied by the BOJ are likely to stay in the interbank market and to have no effect in terms of increasing lending to companies

While additional monetary easing in the form of raising the target for the outstanding balance of current accounts at the BOJ may be effective in terms of quelling fears regarding liquidity in the short-term markets, it is highly unlikely to result in an increase in credit creation by financial institutions. Last December, monetary easing put an end to the liquidity squeeze, and yields declined sharply on safe assets, such as FBs (Financing Bills, a type of government debt exclusively of short duration, used by the government to smooth out its cash flow). Yields on other instruments, such as CP issued by companies, also declined, although more slowly than FB yields. Nevertheless, we believe that increasing the balance of current accounts at the BOJ and stepping up its long-term JGB outright purchase operations will have virtually no direct impact on the real economy. As Japan's financial institutions are, without exception, growing even more risk-averse, the funds supplied by the BOJ are likely to stay in the interbank market and to have no effect in terms of increasing lending to companies.

We think that the BOJ is likely to add to the list of assets that can be used as collateral for its operations

In the press release announcing its change of policy, the BOJ also stated that it "plans to consider whether or not there are other means it can use to ensure that companies' fund-raising activities run smoothly." This may be an indication that the BOJ is aware that current monetary policy is having little impact on companies' fund-raising activities, which are outside of the interbank market. We think that the BOJ is likely to add to the list of securities that can be used as collateral for its operations—by, for example, including asset-backed

Changes in BOJ policy

Monetary Policy Meeting date	Call rate (%)	ODR (%)	Account balance (¥ trn)	Long-term JGB outright purchase operations (¥ trn)
2001				
19 January				
9 February		0.5 —0.35		
28 February	0.25—0.15	0.35 —0.25		
19 March	(0.15 —0)(*)		5	
14 August			5 —6	0.4 —0.6
18 September		0.25 —0.1	6—6+	
19 December			6+ —10-15	0.6 —0.8
2002				
28 February				0.8 —1.0
18 September		BOJ decides to buy banks' shares		
30 October		10-15 —15-20	1.0 —1.2	

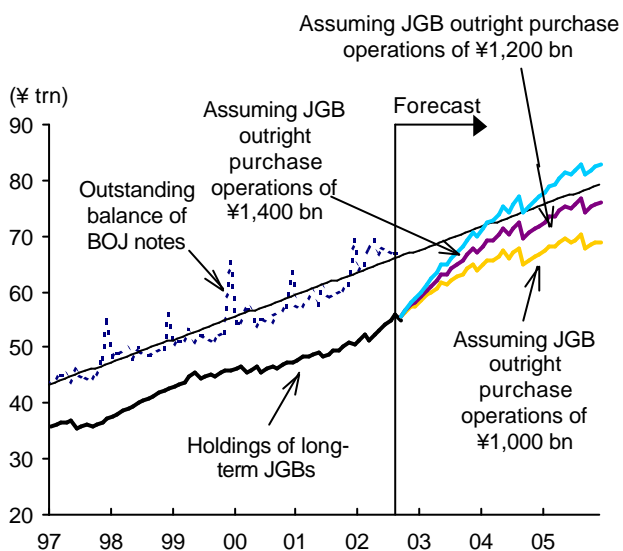
Note: (1) (*) = the BOJ effectively guided the call rate to 0%. (2) The Monetary Policy Meeting date is either the date on which the meeting ended or the date on which the change in policy was announced. Source: Nomura, from materials provided by the BOJ

securities with low credit ratings. However, the truth is that up to now increases in the list of assets that can be used as collateral for the BOJ's operations have not necessarily contributed to an increase in companies' fund-raising channels by boosting the liquidity of asset-backed securities.

It is becoming increasingly likely that the BOJ will be forced to adopt policies that are outside the framework of policies it has used up to now

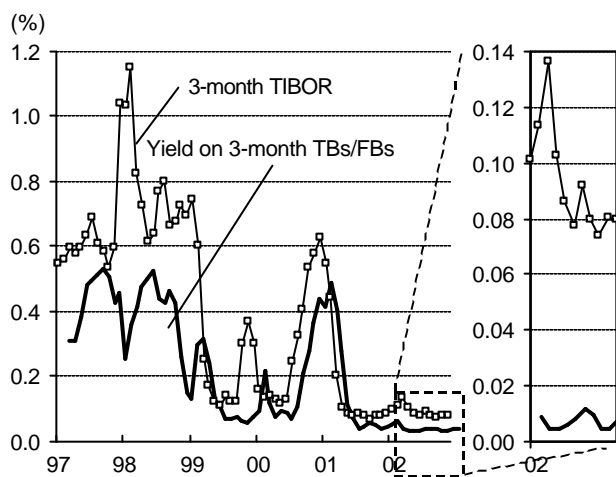
Even since the change in monetary policy at the end of October, there have still been calls, both at home and overseas, for further monetary easing. Economy and financial services minister Heizo Takenaka is demanding a thorough investigation into the use of inflation targets. Even though the BOJ insists that its decision to buy stocks held by banks is not a monetary policy, we believe it is becoming increasingly likely, that, over the medium to long term, the BOJ will be forced to implement policies that are outside the framework of policies it has used up to now.

The outstanding balance of BOJ notes and the BOJ's holdings of JGBs



Note: (1) Redemptions have been taken into account. We have assumed that the proportion of the BOJ's total outright JGB purchases made up of bonds of each maturity is the same as the historical average. (2) Our forecast for the outstanding balance of BOJ notes is simply an extension of the trend line for the actual figures from 1997 to August 2002.
Source: BOJ

Short-term market interest rates



Source: Japan Bond Trading, Japanese Bankers' Association