June 2000

Forecast for the Japanese Economy in Fiscal 2000 and 2001

SRIC Corporation

Economic Research Department

Outlook for the Japanese Economy in Fiscal 2000 and 2001

Summary

1. Positive Growth in Fiscal 1999, the First in Three Years
Japan's GDP rose 0.5% in real terms in fiscal 1999, the first increase in three years. This movement back into the plus range suggests the economy is continuing to recover despite instabilities on the demand side. Industrial production began to trend upward beginning in spring 1999, led principally by IT-related items, thus corporations moved from a period of reducing unintended inventories to a period of inventory investment. In addition, private capital investment began to rise in the October–December quarter of 1999 and continued on an upward trend for the second quarter in the January–March period of 2000, driven by IT-related investments. However, the economy has just entered the stage where it is building a foothold for self-sustaining recovery. Indicators such as the sharp rise in bankruptcies—which had been on the decline—and continued high unemployment rates, suggest the economy has not escaped from the restraining effects of structural adjustments.

2. Fiscal 2000: Capital Investment to Lead Second Year of Positive Growth
Real GDP in fiscal 2000 is expected to show the second consecutive year of positive growth as expansion in private capital investment leads the recovery, but growth will remain at a low 0.9%. Excluding capital investment and net exports, other components of final demand are expected to remain weak. GDP at current levels is already 0.8% above the average level of Fiscal 1999, suggesting that the recovery trend this fiscal year will remain weak. In addition, since the momentum of recovery will still be weak because of the decline in public investment in the second half of the fiscal year, concern about future trends may grow toward the end of the fiscal year.

Private capital investment, especially in electrical equipment, is expected to remain firm for the time being and will provide the driving force for the economy as a whole. Nevertheless, many corporations still have excessive levels of borrowings, implying that a sharp rise as in previous recovery periods is unlikely. Moreover, there appear to be limits to the degree that the increase in capital investment can bring higher levels of production and employment and push incomes and consumption upward.

3. Fiscal 2001: Third Consecutive Year of Positive Growth
Real GDP is expected to grow 1.3% in fiscal 2001, the third consecutive year of expansion. However, during the first half of fiscal 2001, production may experience a cyclical downtrend due to inventory adjustments. Growth in consumption will remain low because of the slow expansion in incomes. In addition, private capital investment, the driving force for the recovery, will remain strong in fiscal 2001, but the rate of expansion will decline.

Consequently, the government is believed likely to make an allocation of ¥3 trillion in pump-priming expenditures as an additional economic measure, which will boost real growth by 0.5 percentage point. And also, the government is likely to extend the favorable tax treatment for new housing purchases to June 2002. This extension of the favorable tax treatment for new housing may bring a surge in demand for housing construction toward the end of the fiscal year.

Although economic growth will be positive in fiscal 2001, economic policies will be compensating for slow growth in domestic private demand. This suggests that it will be difficult to describe this growth as self-sustaining in the true sense. There are limitations on economic growth that is dependent on private capital investment. As the recovery will not be supported by growth in consumption based on improvements in employment and incomes, the pace of economic recovery will continue to be slow.

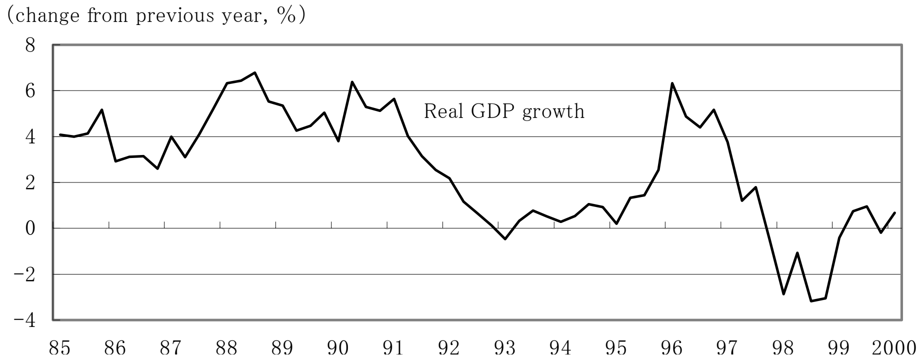
4. Conclusion

For the Japanese economy to achieve a true self-sustaining recovery, it will be necessary for individual corporations to take further steps toward reducing their “three excesses,” namely excess capital equipment, high levels of borrowings, and excess workforce. Progress is being made toward reducing equipment and borrowings, but relatively little headway has been made toward eliminating excess employment. To achieve recovery that is truly self-sustaining and robust, however, this problem must be addressed, even if it is accompanied by temporary adjustment pains.

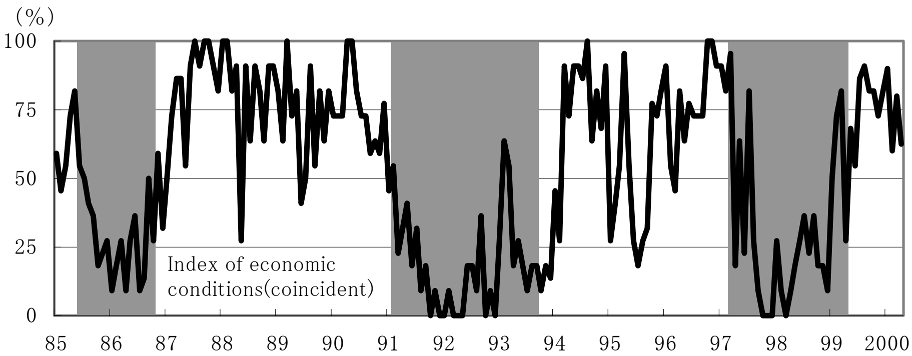
1. Positive Growth in Fiscal 1999, the First in Three Years

Following significant declines in Japan's real GDP in the July–September and October–December quarters of 1999, growth moved back to the positive range, rising 2.4% in the January–March quarter of 2000 (Exhibit 1). For fiscal 1999 as a whole, ended March 31, 2000, the economy expanded 0.5% in real terms, the first positive growth rate in three years. This movement back to the plus range suggests the economy is continuing to recover despite instabilities on the demand side. Industrial production began to trend upward beginning in spring 1999, led principally by IT-related items, thus corporations moved from a period of reducing unintended inventories to a period of inventory investment. In addition, corporate profitability began to improve and the business sentiment began to recover steadily. However, the economy has just entered the stage where it is building a foothold for self-sustaining recovery. Certain indicators, such as the sharp rise in bankruptcies—which had been on the decline—and continued high unemployment rates suggest the economy has not escaped from the restraining effects of structural adjustments.

Exhibit 1: Real GDP Growth Rates and Coincident Indexes of Business Conditions



Source: Economic Planning Agency(EPA), National Income Statistics (Kokumin Shotoku Tokei)



Note: The shaded portions are periods of economic downturn (as determined by the EPA).
Source: EPA, Indexes of Business Conditions (Keiki Doko Shisu)

Examining trends by demand component, as excess capital stock has gradually been reduced, private capital investment has increased for two consecutive quarters beginning in the October–December period of 1999. IT-related investments are the driving force behind capital investment, and, while it is difficult to confirm that the upward trend is spreading to other sectors, investment is expected to expand in the coming quarters. Among indicators of employment and incomes, overtime hours and the number of new job offers are rising. In addition, regular wages is also recovering gradually, suggesting that the downtrend in employment and incomes has ended. However, conditions remain severe, and the momentum of recovery in consumption is still clearly weak.

Private residential investment rose in fiscal 1999 as a consequence of the positive impact of low interest rates on housing loans provided by the Japan Housing Loan Corporation and the favorable tax treatment of housing loans. At present, although residential investment is below the peak in the previous fiscal year, the impact of favorable tax treatment is continuing as overall investment remains firm supported by strong sales of condominium apartments.

Public investment at present is declining sharply because the effects of the Policy Measures for Economic Rebirth have not emerged sufficiently. However, related projects will very likely be implemented in the first half of fiscal 2000 and are expected to provide support for the economy. External demand is also continuing to support the economy as exports to the rest of Asia remain strong. On the other hand, imports are also expanding as domestic demand for IT-related products and reverse imports are increasing.

In forecasting economic trends in fiscal 2000 and fiscal 2001, we have made the following assumptions about government policies.

- Concerning fiscal policy, we assume the government will implement a supplementary allocation of ¥500 billion during fiscal 2000 and make a further allocation of ¥3 trillion for pump-priming expenditures. However, at present the recovery trend in the economy is continuing, therefore discussions of additional allocations will probably not emerge until the latter half of fiscal 2000 when public investment slows, thus bringing a feeling of overall deceleration in the economy.
- The favorable tax treatment for new housing construction currently applies to households that move into their new homes no later than the end of June 2001. We assume this deadline will be extended to the end of June 2002.
- The Bank of Japan will continue its current zero interest rate policy until the private sector has returned to the path of self-sustaining recovery and concern about deflation has been eliminated. At present, the Policy Committee of the Bank of Japan is considering the appropriateness of ending the zero interest rate policy as the economy continues to recover and there is a possibility that the policy may be ended in fall 2000. However, the actual recovery trend in the economy is not sufficiently strong, therefore we assume that the zero interest rate policy will be continued through fiscal 2000 and forecast that it will not end until sometime in the latter half of fiscal 2001 or later.

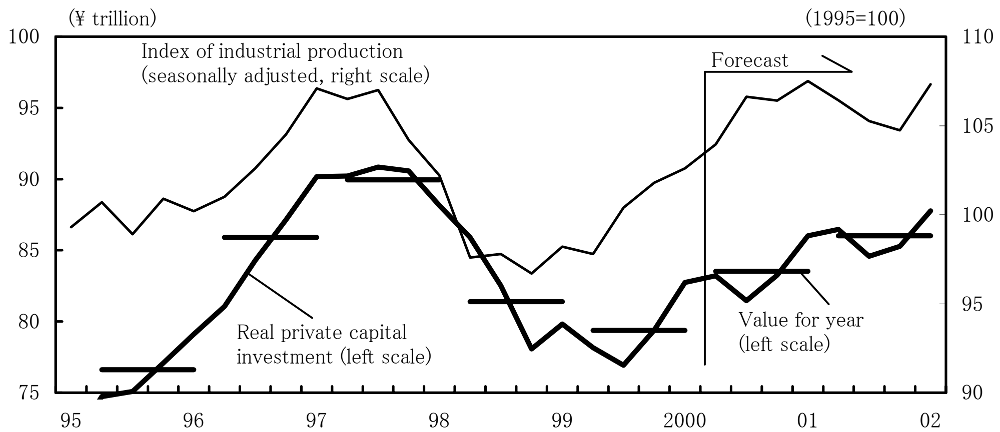
2. Fiscal 2000: Capital Investment to Lead Second Year of Positive Growth Resulting in 0.9% Real Growth

In fiscal 2000, real growth in GDP is expected to be positive for the second consecutive year, as the economic recovery continues led by private capital investment, but will remain at a relatively low 0.9%. Components of final demand other than private capital investment and external demand will continue to be generally weak. GDP at current levels is already 0.8% above the average level of Fiscal 1999, suggesting that the recovery trend this fiscal year will still be weak. In addition, although the economy will be relatively firm in the first half of the fiscal year, because of the decline in public investment in the second half of the fiscal year and other factors, concern about future trends may grow toward the end of the fiscal year.

(1) Private Capital Investment to Lead the Economy

Private capital investment, especially in electrical equipment is expected to remain firm for the time being and will provide the driving force for the economy as a whole (Exhibit 2). Demand for IT-related investments will continue strong, thereby boosting overall investment levels, and accompanying the expansion in industrial production, the upward trend in capital investment should spread to other industrial sectors. Moreover, a surge of investment in the wholesale and retail industries is now under way prior to the implementation of a new regulation law related to large-scale retail outlets. Therefore, a reactionary decline in investments in this area may occur in the second half of fiscal 2000. A number of factors are stimulating the expansion in capital investment, including the recovery in corporate performance, the progress toward reducing excess capital stock, and the improvement in corporate sentiment regarding the economy. Nevertheless, many corporations still have excessive levels of borrowings, and, as a sharp rise in domestic demand is not expected, corporations must remain cautious in their investment behavior. Accordingly, a sharp rise in capital spending, as in previous recovery periods, is unlikely. Moreover, there appear to be limits to the degree that the increase in capital investment can bring higher levels of production and employment and thereby push incomes and consumption higher.

Exhibit 2: Outlook for Real Private Capital Investment and the Index of Industrial Production



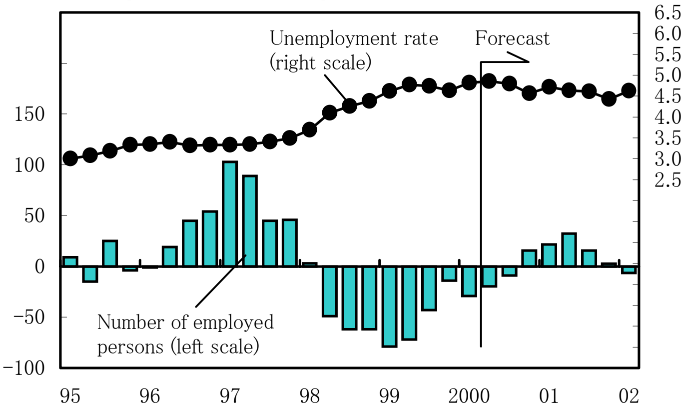
Note: Figures for real capital investment are seasonally adjusted and on an annualized basis.
Source: Ministry of International Trade and Industry(MITI), Industrial Statistics (Tsusan Tokei);
EPA, National Income Statistics (Kokumin Shotoku Tokei)

(2) Delayed Improvement in Employment and Income Conditions to Prolong Weakness in Consumption

The pace of improvement in employment and income conditions is expected to remain extremely slow. Accompanying the improvement in industrial production and corporate profitability, some increase in the number of employed persons is expected, but the mismatching of demand and supply by age and job category will continue and unemployment will still be high (exhibits 3 and 4). For this reason, although employee incomes will be heading toward improvement, the margin of improvement will be small compared to past levels and will not stimulate a drive to consume

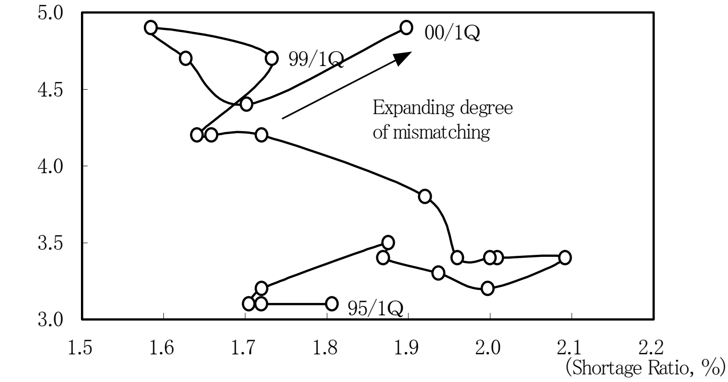
(Exhibit 5). As a result, there will be a limit to any increase in the propensity to consume, and private consumption will lack robustness throughout the fiscal year (Exhibit 6).

Exhibit 3: Rate of Unemployment and Number of Unemployed Workers



Source: Management and Coordination Agency(MCA), Labor Force Survey(Rodoryoku Chosa)

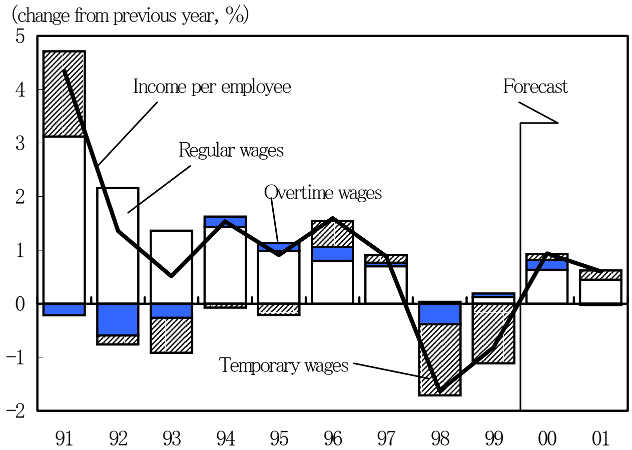
Exhibit 4: Expansion in Employment Supply and Demand Mismatching



Note: The shortage ratio is computed as follows: (Number of job applicants − Number of persons newly employed) / (Number of job applicants − Number of persons newly employed + Number of persons employed)

Source: MCA, Labor Force Survey(Rodoryoku Chosa); Ministry of Lavor(MOL), General Job Introduction Statistics(Ippan Shokugyo Shokai Jokyo)

Exhibit 5: Outlook for Incomes of Employed Workers



Source: MOL, Monthly Labor Statistics (Maitsuki Kinrou Tokei Chosa)

Exhibit 6: Outlook for Private Consumption

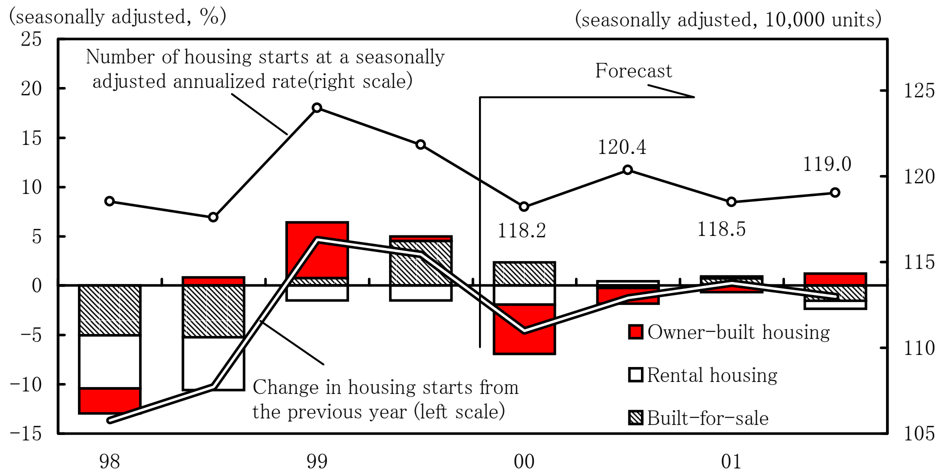
Source: EPA, National Income Statistics (Kokumin Shotoku Tokei)

(3) Slump in Residential and Public Investment

Residential investment is expected to decline over the course of fiscal 2000 (Exhibit 7) in part due to a reaction to the strong surge in demand in the previous fiscal year that accompanied the favorable tax treatment of housing loans. The favorable tax treatment (currently scheduled to terminate at the end of June 2001) will most likely be extended and provide support for the level of housing starts, but its impact will be weaker than when it was originally introduced. In addition, as a result of the extension of the tax break, there is a possibility that the surge in demand may be pushed forward.

Public investment is expected to remain firm in the first half of the fiscal year as the impact of the government's Policy Measures for Economic Rebirth becomes apparent. Thereafter, a supplementary allocation of ¥500 billion is likely to be implemented, but public investment will weaken in the second half of the fiscal year. However, at present economic recovery is continuing, implying that additional policy measures are not likely to be forthcoming at an early date. For this reason, public investment is expected to record a second consecutive year of decline.

Exhibit 7: Outlook for Residential Investment

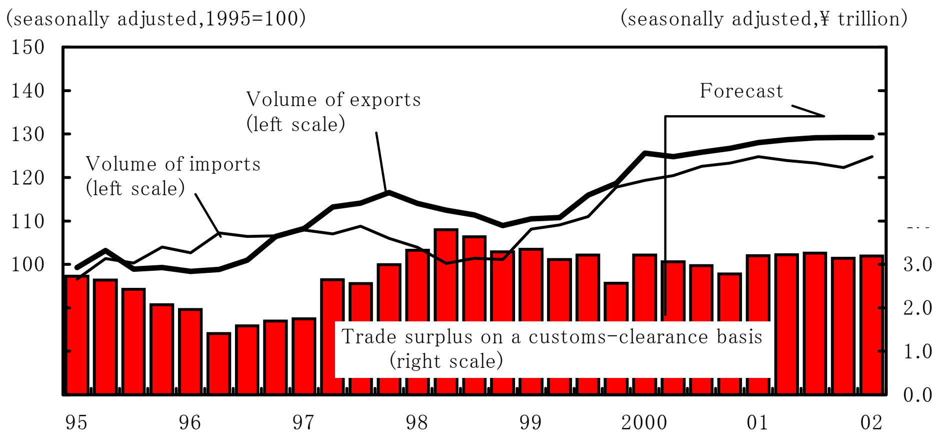


Source: Ministry of Construction (MOC), Housing Construction Starts Statistics (kenchiku Chakko Tokei)

(4) External Demand to Remain Firm

Growth in exports to the U.S. and Europe is expected to decline as the U.S. economy slows and the strength of the yen against the euro has a dampening effect on exports to Europe. However, exports to the rest of Asia are likely to remain strong—as economies in that region continue to expand—and provide support for the Japanese economy. Also, as a result of the rising demand for IT-related products in Japan and the structural factor of an increase in reverse imports, Japan's imports are forecast to continue on an upward trend. Nevertheless, growth in exports will exceed that of imports, and net external demand will have a positive impact on the Japanese economy (Exhibit 8).

Exhibit 8: Outlook for External Demand

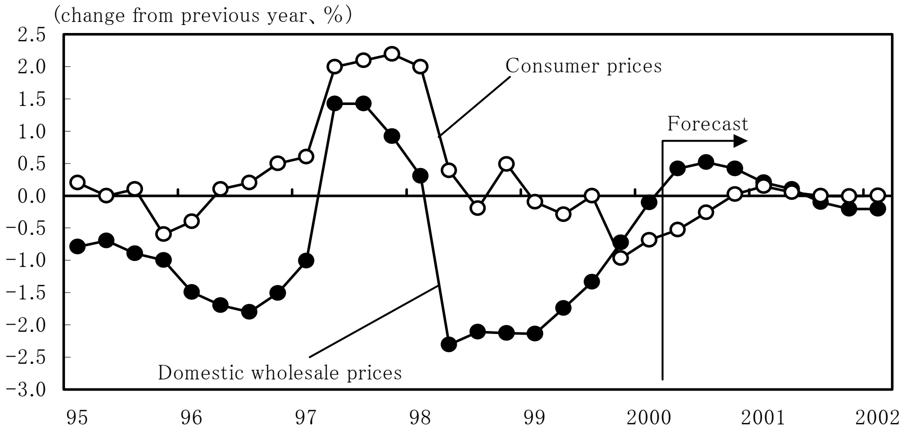


Source: Ministry of Finance(MOF),The Summary Report on Trade of Japan (Gaikoku Boeki Gaikyo)

(5) Deflationary Pressures to Continue

Although Japan's import prices will rise as crude oil prices remain high and prices of other international commodities increase, reflecting the worldwide increase in demand, deflationary pressures in Japan will continue. Factors accounting for this will be the lack of a robust upward trend in domestic demand, rising imports of lower-price goods from the rest of Asia, and downward pressure on the price of services as price competition becomes more intense and corporations restrain personnel costs. As a result, any upward pressure on domestic prices will remain weak. For this reason, domestic wholesale prices may show a slight increase in fiscal 2000 owing to the rise in crude oil prices, but, thereafter, wholesale prices are expected to decline. The consumer price index is forecast to show virtually no change during the fiscal year (Exhibit 9).

Exhibit 9: Outlook for Domestic Wholesale and Consumer Prices

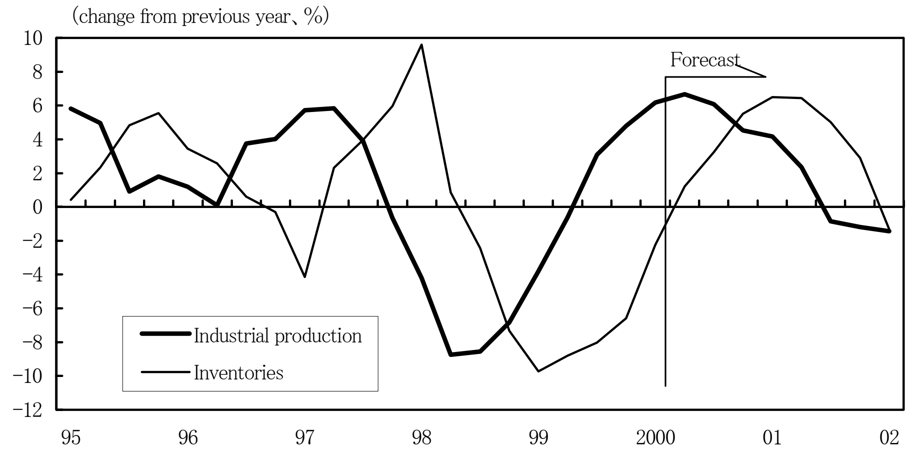


Source: Bank of Japan (BOJ) , Price Indicator Monthly (Bukka Shisu Geppo) ; MCA, Price Statistics Monthly (Bukka Tokei Geppo)

3. Fiscal 2001: Third Consecutive Year of Positive Growth

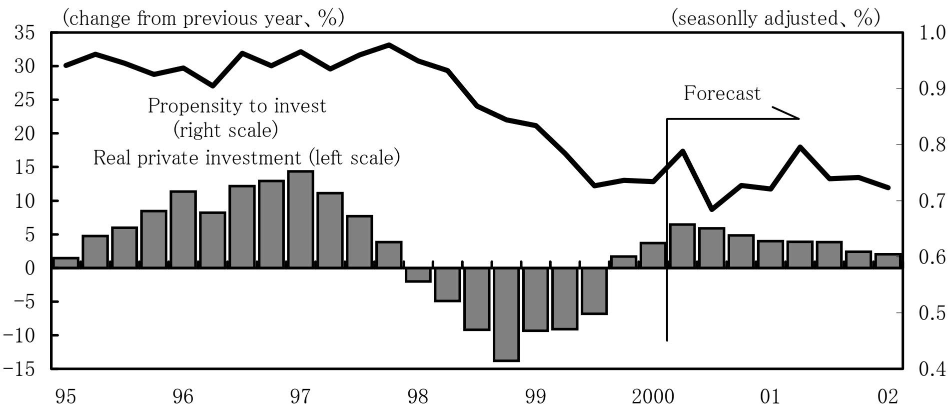
Real GDP is expected to grow 1.3% in fiscal 2001, the third consecutive year of expansion. However, during the first half of fiscal 2001, production may experience a cyclical downtrend due to inventory adjustments (Exhibit 10). Growth in consumption will remain low because of the slow expansion in incomes. In addition, private capital investment, the driving force for the recovery, will remain strong in fiscal 2001, but investment substantially in excess of corporate cash flow is unlikely in an environment where domestic demand lacks a robust upward trend. The propensity to invest will therefore remain unchanged, and the rate of expansion in capital investment is expected to decline (Exhibit 11).

Exhibit 10: Outlook for Indexes of Industrial Production and Inventories



Source: MITI, Industrial Statistics (Tsusan Tokei)

Exhibit 11: Outlook for Real Private Capital Investment and the Propensity to Invest



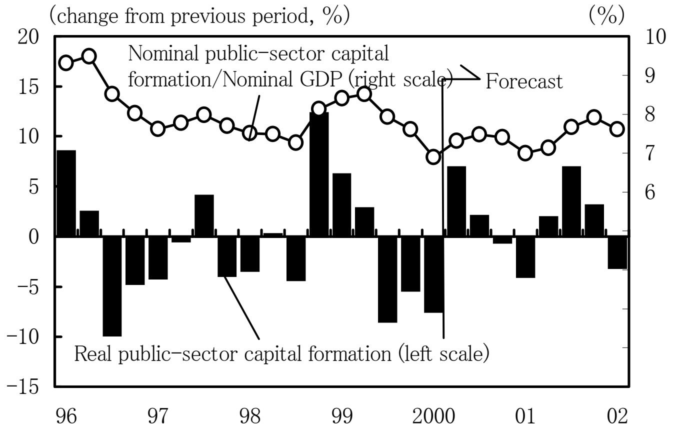
Note: The propensity to invest is calculated as follows: Private capital investment/Cash flow.
Cash flow is defined as follows: Current income × (1.0−effective corporate tax rate) + Depreciation

Source: MOF,Corporate Enterprise Statistical Quarterly (Hojin Kigyo Tokei Kiho);
EPA, National Income Statistics (Kokumin Shotoku Tokei)

Since the pace of growth in overseas demand, particularly in the United States, will gradually diminish, increases in exports will be constrained. On the other hand, the rise in reverse imports centering around imports of electrical machinery and the strong demand in Japan for IT-related products will generate firm demand for imports. The contribution of external demand in fiscal 2001 will therefore diminish compared to the previous year.

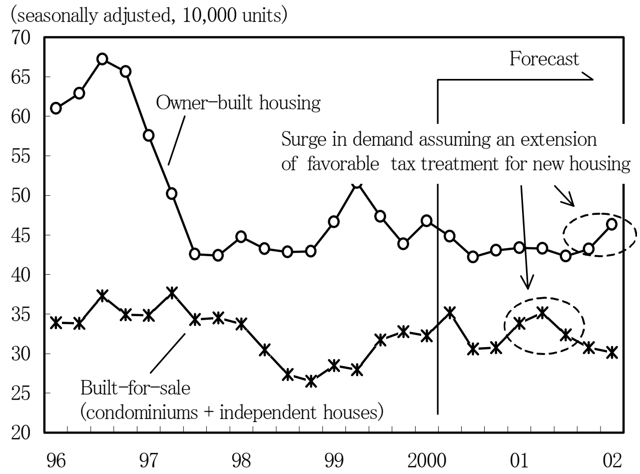
Public investment will compensate for the stagnation in domestic private-sector demand, making a significant slowdown in the economy avoidable. If the government economic policies mentioned previously are implemented, this will raise economic growth 0.5 percentage point in real terms in fiscal 2001 (Exhibit 12). In addition, if the favorable tax treatment for housing is extended, this should lead to a surge in housing starts around the end of fiscal 2001 (Exhibit 13).

Exhibit 12: Outlook for Public-Sector Capital Formation (Public Investment)



Source: Surety Association for Construction Companies, Statistics on Guarantees Provided for Prepayments for Public Works Construction (Kokyo Koji Maebaraikin Hosho Tokei); EPA, National Income Statistics (Kokumin Shotoku Tokei)

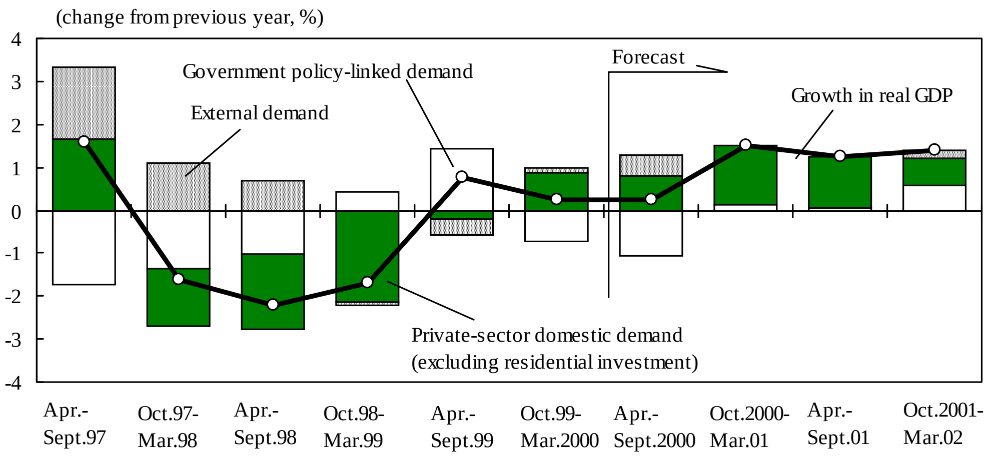
Exhibit 13: Outlook for Housing Starts



Source: MOC, Housing Construcion Starts (Kenchiku Chakko Tokei)

Fiscal 2001, therefore, will be the third consecutive year of growth for the Japanese economy, and the rate of expansion will exceed that of the previous fiscal year. However, examination of growth by GDP demand component shows that, while private capital investment will continue on an upward trend and lead the economy toward self-sustaining recovery, government spending will compensate for slow growth in other components of domestic private-sector demand. This will be difficult to describe as self-sustaining growth in the true sense (Exhibit 14). Near the end of fiscal 2001, inventory adjustments will be nearly completed, and industrial production should strengthen. Accordingly, the margin of increase in capital investment should begin to rise again. However, there are limitations on economic growth that is dependent on private capital investment. Unless the recovery is supported by growth in consumption based on improvement in employment and incomes, the pace of economic recovery will continue to be slow.

Exhibit 14: The Japanese Economy through Fiscal 2001



Note: Government policy-linked demand here is defined as public demand plus residential investment.
Source: EPA, National Income Statistics (Kokumin Shotoku Tokei)

4. Conclusion

For the Japanese economy to achieve true self-sustaining recovery, too much reliance must not be placed on policy "quick fixes" that provide temporary expansion in demand. It will be necessary for individual corporations to take further steps toward reducing their "three excesses," namely excessive equipment, borrowings, and workforce. Progress has been made from a macroeconomic perspective toward reducing excess equipment, although there are differences by industry. There has also been gradual progress toward reducing excess borrowings, although it is still too early to warrant optimism. Factors contributing to this have been the beneficial impact of the prolonged zero interest rate monetary policy, the improvement in corporate profitability, the efforts of individual companies to reduce their indebtedness, the improvements in efficiency through mergers and alliances among companies, and the weeding out of corporations with massive debt burdens. At present, corporations are still not aggressively investing their cash flow in new capital equipment, but, as the impact of restructuring emerges, their investments are likely to become more active.

Compared to the progress made thus far in reducing excess equipment and borrowings, activities to reduce excess personnel have been markedly slower. Efforts are continuing to create new jobs through deregulation and provision of support for venture businesses, but these activities often do not lead immediately to expansion in employment opportunities. Eliminating excess personnel may mean that Japanese employment practices, such as lifelong employment and wages determined by seniority, may have to be changed. This presents difficult problems for management. For this reason, measures to reduce personnel tend to move more slowly when signs of economic recovery appear. However, to achieve self-sustaining recovery that is truly sustainable and robust, this problem must be addressed. To solve both the problem of reducing excess personnel and the problem of the mismatching of labor market demand and supply, it will be necessary to train more personnel with professional skills while also increasing overall labor mobility to allow qualified personnel to move to the jobs they are best suited to perform. To realize the benefits of increased productivity resulting from the IT revolution as in the United States, Japan must escape from management practices that support excess employment and effectively condone declining productivity. Elimination of excess personnel may be accompanied by temporary pain, but it is an issue that can no longer be postponed.

Economic Outlook for Fiscal 2000 & 2001

Forecast

(Yr/Yr,%)	FY1999		FY2000		FY2001		FY99	FY2000	FY2001
	First half	Second half	First half	Second half	First half	Second half			
Nominal GDP	0.1	▲ 1.3	▲ 1.1	1.1	0.6	0.8	▲ 0.7	0.1	0.7
Real GDP	0.7	0.2	0.2	1.5	1.2	1.4	0.5	0.9	1.3
Contribution of domestic demand	1.2	0.2	▲ 0.3	1.5	1.2	1.2	0.6	0.7	1.2
Private consumption	1.8	0.6	▲ 0.3	1.0	1.0	0.5	1.2	0.3	0.7
Housing investment	4.3	7.1	▲ 6.4	▲ 0.7	▲ 0.3	▲ 2.1	5.6	▲ 3.6	▲ 1.2
Private capital investment	▲ 7.9	2.7	6.2	4.4	3.9	2.2	▲ 2.5	5.2	3.0
Government expenditure	6.8	▲ 5.4	▲ 4.4	0.8	0.4	3.9	0.1	▲ 1.4	2.1
Public investment	14.4	▲ 11.7	▲ 9.7	2.1	1.6	8.3	▲ 0.9	▲ 3.2	5.5
Contribution of external demand	▲ 0.4	0.1	0.5	0.0	▲ 0.0	0.2	▲ 0.2	0.3	0.1
Exports of goods and services	1.7	10.2	12.7	6.3	4.4	1.3	5.9	9.4	2.9
Imports of goods and services	5.6	11.7	11.0	7.3	5.4	0.1	8.7	9.1	2.7
Current account balance (trillion yen)	6.5	6.1	6.7	6.3	6.8	6.8	12.6	13.0	13.6
Trade balance (trillion yen)	7.2	6.6	7.2	7.0	7.7	7.4	13.8	14.2	15.0
Industrial production	1.4	4.9	6.2	4.7	0.5	▲ 0.9	3.2	5.4	▲ 0.2
Wholesale prices	▲ 3.8	▲ 1.0	0.2	1.0	0.5	0.5	▲ 2.5	0.6	0.5
Domestic wholesale prices	▲ 1.5	▲ 0.4	0.5	0.3	0.0	▲ 0.2	▲ 1.0	0.4	▲ 0.1
Consumer prices	▲ 0.1	▲ 0.8	▲ 0.4	0.1	0.0	▲ 0.0	▲ 0.5	▲ 0.2	0.0
Yen/U.S.Dollar	117	106	106	109	109	114	112	108	111
Crude oil purchase price ($/barrel)	16.8	26.7	27.5	26.5	25.5	25.0	21.7	27.0	25.3
U.S. Real GDP (CY) (seasonally-adjusted annual rate)	3.8	5.1	5.4	3.2	2.6	2.5	4.2	4.8	2.7

Income and Employment

Forecast

(Yr/Yr,%)	FY99	FY2000	FY2001
Income per capita	▲ 0.8	0.9	0.6
Regular compensation	0.2	0.8	0.6
Overtime compensation	1.3	3.7	▲ 0.4
Numbar of people employed	▲ 0.5	0.1	0.2
Compensation of employees	▲ 1.3	1.5	1.4
Unemployment rate (%)	4.7	4.7	4.6

New housing starts

Forecast

(thousand units)	FY99	FY2000	FY2001
Number of new housing stars	1226	1189	1184
(Yr/Yr,%)	(4.0)	(▲3.0)	(▲0.4)
Owner-built housing	476	434	437
Rental housing	426	416	413
Built-for-sale housing	312	326	321