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Forecast for the Japanese Economy in Fiscal 2000 and 2001

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Outlook for the Japanese Economy in Fiscal 2000 and 2001

< Summary >

1. Growth Forecast Revised Upward to +1.9% for Fiscal 2000

In view of the faster-than-expected pace of recovery evident in recent data for the Japanese economy, including firm increases in personal consumption, we have revised our forecast for real GDP growth in fiscal 2000, ending March 31, 2001, from +0.9% to +1.9%. The driving force in the economy continues to be private capital investment. Corporate sentiment regarding the economy is continuing to improve, and, during the current fiscal year, the range of industries expanding their investments is expected to broaden, especially in IT-linked sectors. In addition, improvement in corporate performance is gradually beginning to bring recovery in employment incomes, and the upward trend in personal consumption is continuing. Government public works investment seems likely to contribute to boosting the economy in the first half of the current fiscal year but will clearly lose momentum in the latter half. The government is viewed as certain to formulate a supplementary budget before the end of calendar 2000, and we have therefore changed our outlook for “additional pump-priming expenditures of ¥3 trillion in fiscal 2001” to additional expenditures of this same magnitude that will begin to take effect from the end of fiscal 2000 into the beginning of fiscal 2001.

2. Continued Positive Growth of 1.6% in Fiscal 2001

We are forecasting real GDP growth of 1.6% in fiscal 2001, the third consecutive year of positive growth. However, we expect a cyclical decline in production due to inventory adjustments in the first half of the fiscal year, which will bring a slight decline in growth compared with the previous fiscal year. Moreover, we believe the current strong pace of recovery in corporate performance may begin to slow gradually, owing to deterioration in the terms of trade accompanying the increase in the price of crude oil and other factors. As a result, growth in private capital investment, which will have been the driving force up to that time, will likely weaken. On the other hand, since household incomes will continue to increase gradually, personal consumption is expected to remain firm and provide support for the economy. We also believe employment conditions will continue to improve but at a slow pace. Inventory adjustments will be virtually completed in the second half of fiscal 2001. We therefore expect stronger trends in production and a return to higher rates of growth in private capital investment.

Views expressed, forecasts presented, and other information in this report may contain judgments based on data available at the time of preparation and may be subject to revision without prior notification.

1. Current State and Outlook

Expansion Continues

Based on growth in real GDP—which recorded a substantial rise, to 2.5%, on a quarter-to-quarter basis in the January–March period of 2000 then grew another 1.0% in the April–June quarter—the Japanese economy is continuing on a firm expansionary trend. Public-sector demand contributed 0.9 percentage point to overall growth as the positive impact of the Economic Rebirth policies began to emerge and public works investments staged a strong comeback in reaction to a decline in the previous quarter. The private sector contributed only 0.2 percentage point of growth for the quarter, but there was evidence that the recovery is gaining strength, including firm growth in personal consumption. There are signs that consumer spending, particularly for durable goods, is picking up, owing to a bottoming out of incomes and improvement in consumer confidence. Even after stripping away the effect of the extra day in the leap year, personal consumption rose for the second consecutive quarter. In addition, although private capital investment fell in the April–June quarter, this appears to have been largely due to a special factor, namely a reaction to the surge in demand for construction accompanying the implementation of changes in legislation governing the location of large-scale retail outlets. Judging from the strength of capital investment, especially in IT-related areas in recent quarters, we believe private capital investment will begin to expand again.

Industrial production continues to be strong, especially in IT-related sectors, and the employment environment is showing gradual improvement along with the improvement in performance in the corporate sector.

Growth Forecast Revised Upward to +1.9% for Fiscal 2000

In view of the faster-than-expected pace of recovery evident in recent data for the Japanese economy, including firm increases in personal consumption, we have revised our forecast for real GDP growth in fiscal 2000, ending March 31, 2001, from +0.9% to +1.9%. However, deflationary conditions persist, as evidenced by lower rates of growth in nominal than in real GDP, which appears to explain why there has been relatively little increase in the feeling that the economy is recovering.

The driving force in the economy continues to be private capital investment. Corporate sentiment regarding the economy is continuing to improve, and, during the current fiscal year, the range of industries expanding their investments is expected to broaden, especially in IT-linked sectors. Moreover, although high unemployment rates are expected, owing to the continuing mismatch in age groups and job types between people seeking employment and available job offers, improvement in corporate performance is gradually beginning to bring recovery in employment incomes, and the upward trend in personal consumption is continuing. Government public works investment will contribute to boosting the economy in the first half of the current fiscal year but will clearly lose momentum in the latter half. The government is viewed as certain to formulate a supplementary budget before the end of calendar 2000, and we have therefore changed our outlook for “additional pump-priming expenditures of ¥3 trillion in fiscal 2001” to additional expenditures of this same magnitude that will begin to take effect from the end of fiscal 2000 into the beginning of fiscal 2001.

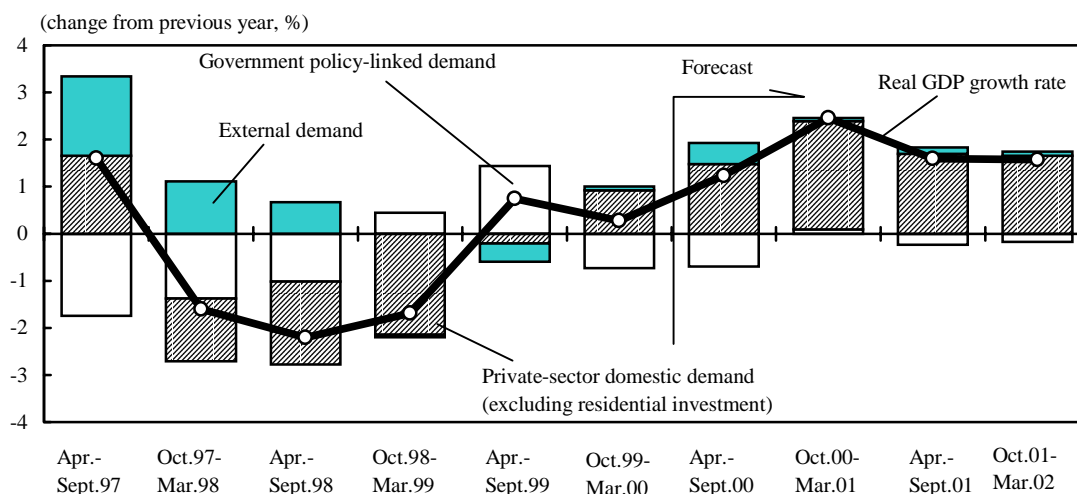
Continued Positive Growth of 1.6% in Fiscal 2001

We are forecasting real GDP growth of 1.6% in fiscal 2001, the third consecutive year of positive growth. However, we expect a cyclical decline in production due to inventory adjustments in the first half of the fiscal year, which will bring a slight decline in growth compared with the previous fiscal year. Moreover, we believe the current strong pace of recovery in corporate performance may begin to slow gradually, owing to deterioration in the terms of trade accompanying the increase in the price of crude oil and other factors. As a result, growth in private capital investment, which will have been the driving force up to that time, will continue to expand in fiscal 2001 but may show slower growth temporarily. While some industries, including IT-related sectors, will continue to make firm increases in their investments, other sectors still burdened by excess capacity will be more cautious in making investments. Therefore, an increase in private capital investment across all industries that is substantially in excess of the increase in cash flow is not expected.

On the other hand, since household incomes will continue to increase gradually, personal consumption is expected to remain firm and provide support for the economy. We also believe employment conditions will continue to improve but at a slow pace.

Inventory adjustments will be virtually completed in the second half of fiscal 2001. We therefore expect stronger trends in production and a return to higher rates of growth in private capital investment (Exhibit 1).

Exhibit 1: 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)

2. Trends by Component of Demand

Production: Continued Uptrend despite Temporary Inventory Adjustments

The most recent data show expansion in industrial production for four consecutive quarters, and the manufacturing sector has moved from an “unintended decline in inventories” to an “increase in

inventories” phase. Among various sectors, electrical machinery, including electronic components and other IT-related items, is the overall driving force for expansion. Judging from the forecast index for industrial production, output is expected to sustain an upward trend in the July–September quarter, and remain strong for the time being (Exhibit 2).

The industrial sector is expected to enter a cyclical inventory adjustment phase in the first half of fiscal 2001, and output is expected to slow temporarily. In addition, the boosting effect of exports is expected to weaken as the rate of expansion in the U.S. economy slows and growth in other Asian economies begins to cool. However, domestic demand, including personal consumption, is likely to remain firm. Therefore, the adjustment should be completed in a relatively short time frame and expansion will resume in the second half of fiscal 2001.

Exhibit 2: Outlook for Industrial Production and Inventories

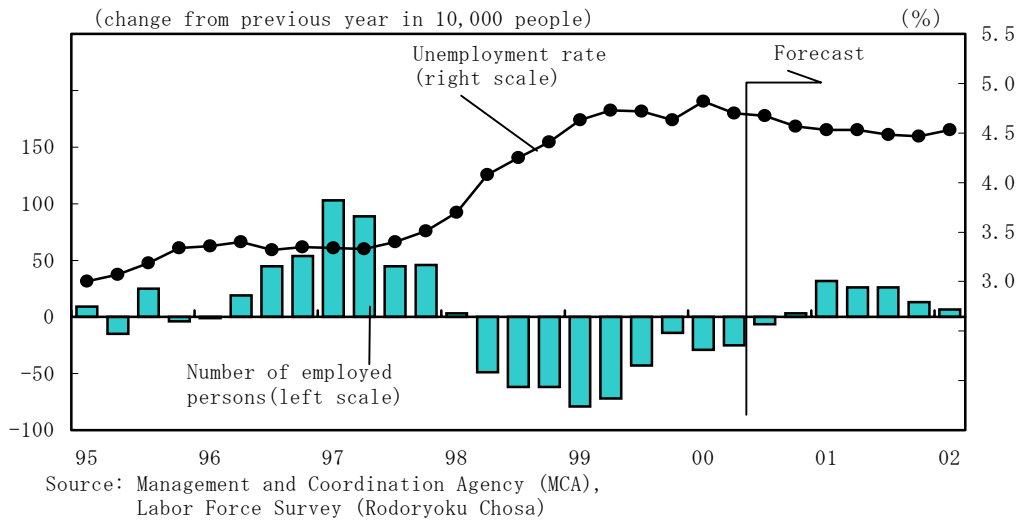


Source : Ministry of International Trade and Industry (MITI), Industrial Statistics (Tsusan Tokei)

Personal Consumption: Firm Trend to Continue Supported by Improvement in Employment and Income Conditions

As industrial production continues firm, the employment environment is expected to undergo gradual improvement. The unemployment rate is believed to have already peaked out, and the number of employed persons is beginning to rise (Exhibit 3). Good conditions in the corporate sector are expected to spread gradually to the household sector, bringing a continued rise in employment incomes.

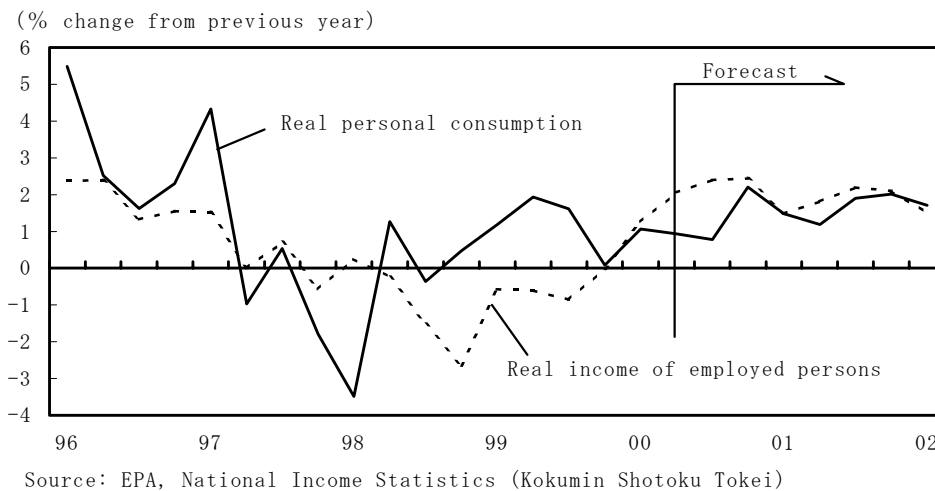
Exhibit 3: Outlook for Unemployment



However, the mismatching in age groups and job types between people seeking employment and available job offers is expected to remain, and, in some sectors, a feeling of overstaffing is likely to continue. Therefore, the pace of improvement in employment conditions will have to remain slow. In addition, corporations will continue their efforts at restructuring, and most new jobs will be for part-time workers. Accordingly, the increase in employment incomes is expected to be relatively slower than in previous periods of economic expansion.

Consumption expenditures on automobiles and IT-related items are high and remaining firm. The absence of expectations of any sudden increase in incomes will tend to restrain consumer spending. However, since a gradual increase in incomes is likely to continue, along with a recovery in consumer confidence, we believe personal consumption is likely to continue to rise and provide support for the economy (Exhibit 4).

Exhibit 4: Outlook for Personal Consumption

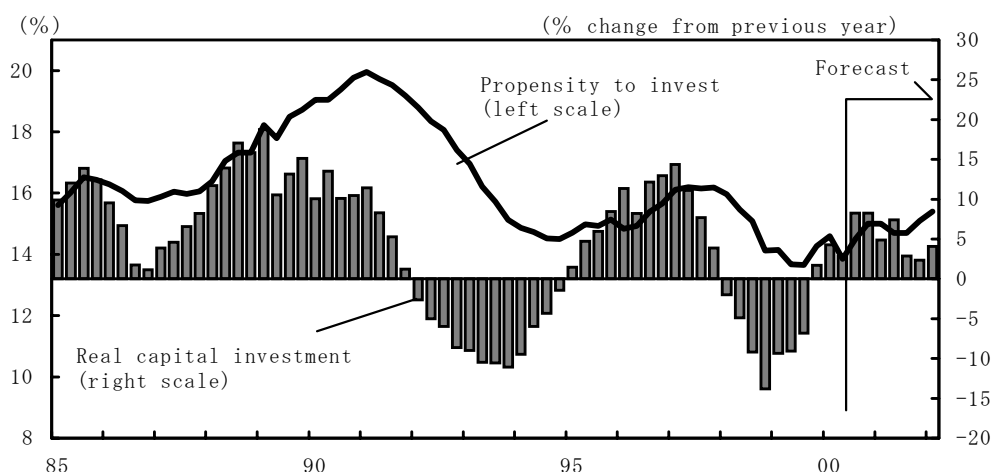


Private Capital Investment: Upward Trend to Continue but with Temporary Slowdown

Capital investment is especially strong in electric machinery, telecommunications, and other IT-related areas and is the driving force in the economy (Exhibit 5). Judging from the ongoing steady recovery in corporate performance and high rates of growth in orders for machinery (private sector, excluding shipping and electric power industries), a firm upward trend in capital investment is expected to continue. Moreover, the rise in investment is likely to spread gradually to a broader range of industries.

Nevertheless, growth in private capital investment may slow temporarily in the first half of fiscal 2001. Although IT-related investment will continue strong, a number of factors are expected to bring this slower growth. These include deterioration in the terms of trade accompanying the rise in crude oil prices, which may bring a pause in the improvement in corporate performance, and relatively limited growth in the nonmanufacturing sector, where dealing with high levels of borrowings has been relatively slow. However, in view of the strength of domestic demand, capital investment is likely to begin to increase again in the latter half of the fiscal year.

Exhibit 5: Outlook for Private Capital Investment

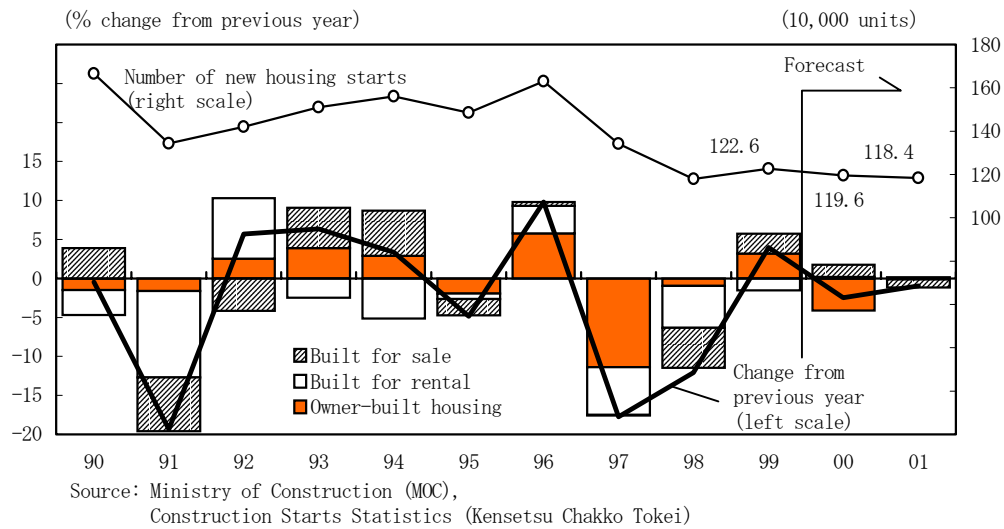


Note: Propensity to invest = Nominal capital investment/Nominal GDP * 100
Source: EPA, National Income Statistics (kokumin Shotoku Tokei)

Housing Investment: Continuing Downtrend despite Extension of Tax Measures

Housing investment is forecast to decline in both fiscal 2000 and 2001 in reaction to the increase in fiscal 1999, which was stimulated by the introduction of favorable tax treatment of housing loans. At present, sales of condominium apartments are strong, but, despite the likelihood that the favorable tax measures will be extended, demand has run its course for the present. Therefore, in view of the rise in housing loan interest rates and other factors, an increase in housing investment is believed to be unlikely for the time being (Exhibit 6).

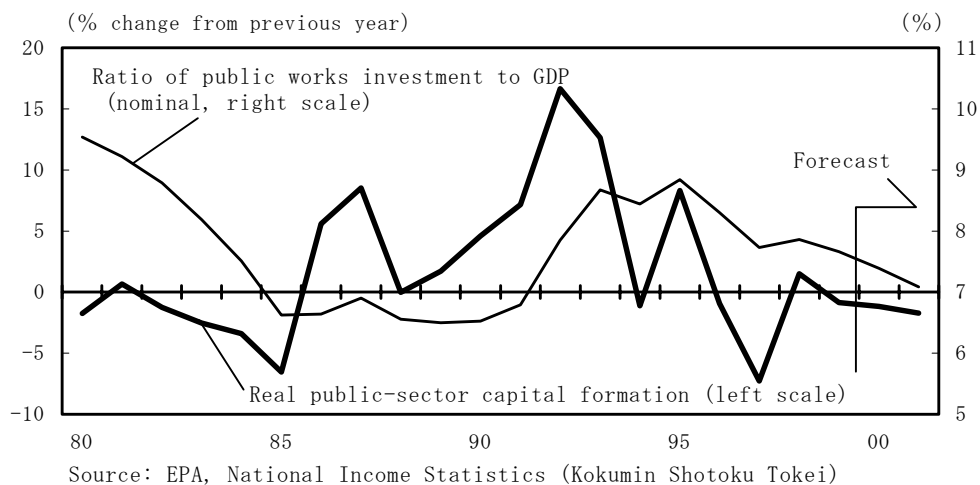
Exhibit 6: Outlook for Housing



Public Works Investment: Third Consecutive Year of Decline

In the first half of fiscal 2000, the impact of the Economic Rebirth policies adopted in the previous year is expected to provide support for the economy, but, in the latter half, the momentum will weaken. The passage of a supplementary budget for fiscal 2000 is virtually certain, and ¥3 trillion in pump-priming expenditures will be included. The actual impact of these additional budgetary allocations is expected to come in the January–March and April–June quarters of 2001. In addition, because of fiscal constraints, the government will not be in a position to adopt decisive fiscal measures, and regional governments will reduce the level of public works projects undertaken on their own initiatives. As a result, public works investment is forecast to decline for the third consecutive year (Exhibit 7).

Exhibit 7: Outlook for Public Works Investment

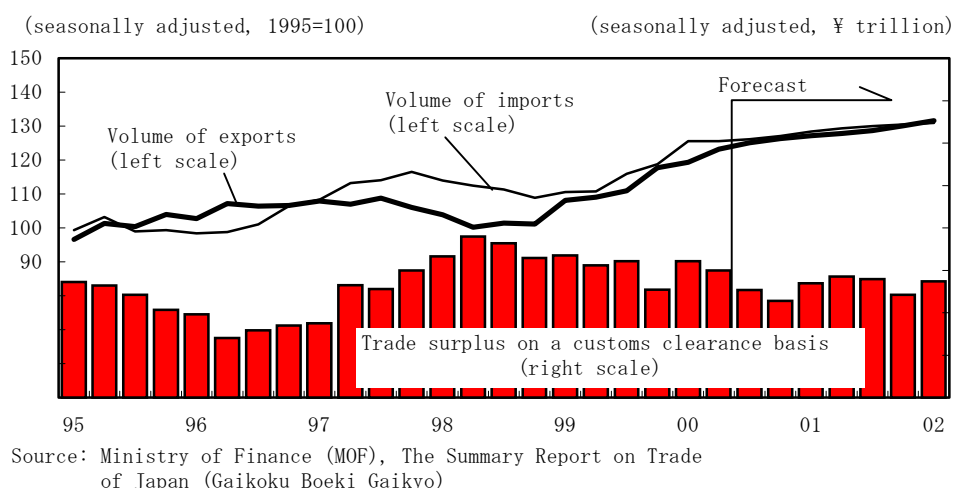


External Demand: Gradually Declining Positive Impact

Exports to other Asian countries will continue to increase but at a slower speed. And exports to the United States, where slower growth is forecast, and to Europe, where the euro is at historically low levels, are expected to slow. Overall, therefore, Japan's exports will show a gradual slowing trend. On the other hand, the value of imports will be pushed upward by higher crude oil prices, and the volume of imports will rise along with increasing domestic demand. As a consequence, overall imports will continue firm, leading to a declining trend in Japan's trade surplus in fiscal 2000. In fiscal 2001, stabilization of oil prices should bring a decline in imports and an increase in the trade surplus (Exhibit 8).

The positive contribution of external demand will shrink as growth in exports slows while imports show a firm increase.

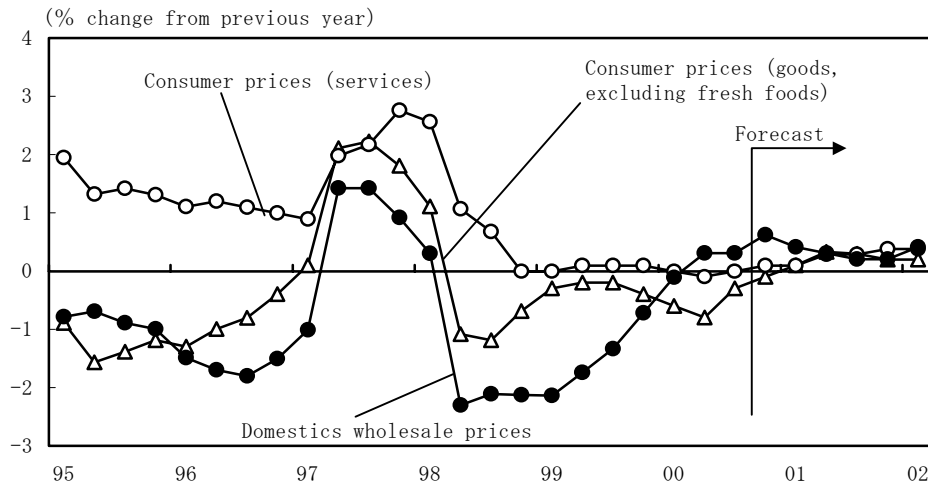
Exhibit 8: Outlook for Trade



Price Levels: Deflationary Pressures to Remain

Prices will begin to rise gradually. However, this will be due more to higher crude oil prices than to the firmness in domestic demand, and deflationary pressures will not have been eliminated. In both fiscal 2000 and 2001, growth in nominal GDP will continue to be lower than growth in real GDP (Exhibit 9).

Exhibit 9: Outlook for Prices



3. In Conclusion

Continuing Causes for Uncertainty

There are a number of causes for uncertainty about whether the economy can sustain the current firm trend through the latter half of fiscal 2000. Depending on how developments unfold, these could put downward pressure on economic conditions.

First, there is the issue of rising oil prices. While the increase in OPEC crude oil production is relatively small, demand is expanding worldwide, suggesting the risk that oil prices may increase sharply as the winter season, when demand is high, approaches. Higher oil prices will not only cause a decline in the performance of domestic companies but also have a detrimental impact on the world economy. Especially if the other economies of Asia, which are showing strong export performance, should experience a slowdown, there is a possibility that Japan's exports may also be adversely affected.

In addition, the repercussions of a prolonged period of a stronger yen cannot be ignored. In particular, the yen is continuing to reach record highs against the euro, and the impact on exports to Europe is already beginning to emerge. Little can be expected from reliance on external demand to support Japan's economy as in the past. If the yen becomes substantially stronger, this will have a serious impact on corporate performance and might become a factor leading to lower stock prices.

Another factor causing uncertainty is the risk of higher interest rates. The Bank of Japan has ended its zero interest rate policy, and certain credit rating agencies have announced a downgrading of Japanese government bonds. Nevertheless, the increase in long-term interest rates has been relatively small. However, if Japan continues to increase its fiscal deficit, a sharp rise in long-term interest rates would not be surprising if there is a further substantial deterioration in the demand/supply balance in financial markets.

Moreover, as the speed of improvement in the employment environment is gradual, there are lingering doubts about whether the recent firmness in consumer spending will be sustained. Corporate performance is definitely improving, but corporations are continuing to restructure their operations. Therefore, the extent to which improved profitability will lead to increases in overall employment income is unclear. In addition, although corporate performance is improving at the macroeconomic level, the shake-out of weaker companies is proceeding, as evidenced by the historically high level of bankruptcies. Accordingly, the environment for personal consumption has some dark areas. When the stimulating effect on consumption of this year's hot summer weather fades as fall approaches, we must pay attention to the risk of consumer spending moving into another slump.

Economic Outlook for Fiscal 2000 & 2001

(Yr/Yr,%)	Forecast ↘								
	FY1999		FY2000		FY2001		FY1999	FY2000	FY2001
	First half	Second half	First half	Second half	First half	Second half			
Nominal GDP	0.1	▲ 1.3	▲ 0.4	1.6	1.4	1.2	▲ 0.7	0.6	1.3
Real GDP	0.7	0.2	1.2	2.5	1.6	1.6	0.5	1.9	1.6
Contribution of domestic demand	1.2	0.2	0.8	2.4	1.5	1.5	0.6	1.6	1.5
Private consumption	1.8	0.6	0.9	1.8	1.5	1.9	1.2	1.3	1.7
Housing investment	4.3	7.1	▲ 4.0	▲ 2.9	▲ 2.1	0.5	5.6	▲ 3.5	▲ 0.8
Private capital investment	▲ 7.9	2.7	5.6	6.5	5.1	3.2	▲ 2.5	6.1	4.1
Government expenditure	6.8	▲ 5.4	▲ 2.9	1.2	▲ 0.9	▲ 1.1	0.1	▲ 0.7	▲ 1.0
Public investment	14.4	▲ 11.7	▲ 5.9	3.0	▲ 1.6	▲ 1.9	▲ 0.9	▲ 1.2	▲ 1.7
Contribution of external demand	▲ 0.4	0.1	0.5	0.1	0.1	0.1	▲ 0.2	0.3	0.1
Exports of goods and services	1.7	10.2	14.1	7.8	5.4	3.1	5.9	11.0	4.3
Imports of goods and services	5.6	11.7	13.0	8.7	5.5	3.0	8.7	10.9	4.3
Current account balance (trillion yen)	6.5	6.1	6.1	5.7	6.2	6.0	12.6	11.7	12.1
Trade balance (trillion yen)	7.2	6.6	6.6	6.1	6.8	6.3	13.8	12.7	13.1
Industrial production	1.4	4.9	6.3	4.4	1.5	2.0	3.2	5.3	1.7
Wholesale prices	▲ 3.8	▲ 1.0	▲ 0.2	0.7	0.3	0.7	▲ 2.5	0.2	0.5
Domestic wholesale prices	▲ 1.5	▲ 0.4	0.3	0.5	0.2	0.3	▲ 1.0	0.4	0.3
Consumer prices	▲ 0.1	▲ 0.8	▲ 0.5	0.2	0.4	0.2	▲ 0.5	▲ 0.1	0.3
Yen/U.S.Dollar	117	106	107	105	106	111	112	106	109
Crude oil purchase price (\$/barrel)	16.8	26.7	30.0	31.0	29.0	28.0	21.7	30.5	28.5
U.S. Real GDP (CY)									
(seasonally-adjusted annual rate)	3.8	5.5	5.8	3.6	2.6	2.9	4.2	5.2	2.9

Income and Employment

(Yr/Yr,%)	Forecast ↘		
	FY1999	FY2000	FY2001
Income per capita	▲ 0.8	1.2	1.2
Regular compensation	0.2	0.5	0.7
Overtime compensation	3.0	4.6	3.0
Number of people employed	▲ 0.5	0.4	0.5
Compensation of employees	▲ 1.3	1.9	2.1
Unemployment rate (%)	4.7	4.6	4.5

New Housing Starts

(Thousand units)	Forecast ↘		
	FY1999	FY2000	FY2001
Number of new housing starts	1,226	1,196	1,184
(Yr/Yr,%)	(4.0)	(▲2.5)	(▲1.0)
Owner-built housing	476	425	427
Rental housing	426	428	427
Built-for-sale housing	312	332	319