

March 2001

Forecast for the Japanese Economy in Fiscal 2001

SRIC Corporation
Economic Research Department

Outlook for the Japanese Economy in Fiscal 2001

<Summary>

1. Slowdown Spreading through the Economy

The Japanese economy recorded 0.8% real GDP growth over the previous quarter in the October-December period of 2000, the first positive figures in two quarters. The GDP deflator fell 1.7%, reflecting continued deflationary pressures, and nominal GDP was up 0.2%, thus returning to the positive range.

However, the corporate sector, which had led the recovery, is showing signs of a slowdown. As a result of the decline in growth in the United States and other parts of the world economy and the fall in the value of the euro up to that point, exports from Japan declined on a volume basis, thus having a negative impact on industrial production. From the inventory cycles, it appears the industrial sector has moved from a period of “intended inventory investment” to “unintended inventory investment.” Industrial production will decline in the January-March quarter of 2001. Similarly, although private non-residential investment continues to recover, orders for machinery and equipment (excluding the shipping and electric power industries from private-sector orders), which are a leading indicator of investment, are expected to decline in the January-March quarter, thus generating concern about future trends in investment.

Recovery in the household sector is lagging behind that in the corporate sector. Private consumption on a GDP basis continued to remain level since the April-June quarter of 2000 and recorded a decline of 0.6% from the previous quarter in the October-December quarter of 2000. Factors accounting for this are the lagging recoveries in the employment and income environments. It appears that, contrary to expectations, the winter bonus for 2000, which had been expected to rise above the level of the previous year along with the increase in corporate profits, declined. The unemployment rate remains at historically high levels. And according to latest data the increase in the number of employed persons is shrinking. Judging from the employment and income environments, there is also cause for concern about future trends in consumption.

2. Outlook for Japanese Economic Growth in Fiscal 2000: Two Consecutive Years of Positive Real GDP Growth of 1.4%

Positive growth over the previous quarter is expected to continue in the January-March period of 2001. A major factor is the supplementary government budget passed in fall 2000, which boosted public investment. On the other hand, the rise in private, non-residential investment, which sustained growth in the October-December quarter, was relatively small. As a result of the slowdown in the world economy, growth in exports has stagnated, and the contribution of the external sector is expected to be negative. The employment and income environments are severe, but personal consumption is expected to remain relatively firm. The upward trend in new automobile registrations is expected to continue, and, prior to the enactment of the electrical appliance recycling law, sales of four types of appliances, to which this new law will be applicable, are expanding. Also, as a result of the weakening of the impact of the tax reduction for residential loan payments, private residential investment is expected to slow

down. We are forecasting that real GDP growth will exceed the government's outlook (1.2%) and rise to 1.4%.

3. Outlook for Japanese Economic Growth in Fiscal 2001: Continuing Positive Growth of 1.0%, Slower than in Fiscal 2000

We are forecasting that real GDP in fiscal 2001 will fall below the government's estimate of 1.7% and will amount to 1.0%. The economy will remain flat in the first half of fiscal 2001. In the corporate sector, stagnation will continue. Exports will decline because of the deceleration in the world economy, leading to a drop in industrial production. This will lead to a decrease in capital investment accompanied by deterioration in corporate profitability. This stagnation in the corporate sector will most likely have a negative impact on the household sector. Corporations will be more strongly motivated to reduce personnel costs, and wages are likely to show slower growth. As the employment environment grows more severe once again, there is concern that consumer confidence may wane. In addition, private residential investment will probably trend downward as condominium construction fails to gather momentum.

The economy will begin to recover again in the second half of fiscal 2001.

The reason for this will be the commencement of a recovery in the world economy. Especially in the United States, interest rate reductions will take effect and allow the economy to bounce back. The recovery in external demand will expand production, and inventory adjustments will be completing. Moreover, the increase in production will bring recovery in corporate profitability, and capital investment—which will have weakened in the first half of fiscal 2001—will begin to expand again. The improvement in corporate profitability will have a positive impact on individual incomes. But companies are likely to maintain quite strong restraints on wages so that the recovery will be limited. For this reason, personal consumption will remain firm; however, a robust recovery cannot be expected. Instead, consumption will remain, at best, a support for the economy. Even though the economy will begin to improve, the recovery in demand will be weak, and deflationary pressures will continue throughout the fiscal year.

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. Slowdown Spreading through the Economy

The Japanese economy recorded 0.8% real GDP growth over the previous quarter in the October-December period of 2000, the first positive figure in two quarters and a substantial margin of increase. The GDP deflator fell 1.7%, reflecting the continued deflationary pressures. Even so, nominal GDP was up 0.2%, thus moving slightly into the positive range. Real growth for calendar 2000 was 1.7%, greater than that for 1999 (0.8% growth), and contributors to this expansion were private non-residential investment (4.5% over the previous year) and external demand (contributing 0.4 percentage point). Personal consumption (0.5% over the previous year) and residential investment (up 1.2%) also contributed to growth, but recovery in the household sector is lagging compared with that of the corporate sector.

However, the corporate sector, which had led the recovery, is showing a slowdown. As a result of the decline in growth, especially in the United States, as well as in other parts of the world economy, and the fall in the value of the euro up to that point, exports from Japan decreased on a volume basis. This had a negative impact on industrial production. At the same time, from inventory cycles it appears that the industrial sector has moved from a period of “intended inventory investment” to “unintended inventory investment”. Industrial production rose a low 0.4% over the previous quarter in the October-December period, and will decline in the January-March quarter of 2001.

Private non-residential investment continues to recover and showed a rapid expansion of 6.8% over the previous quarter in the October-December period. One of the factors boosting the investment has been the surge in retail store construction accompanied by the implementation of a law governing the location of large-scale retail outlets. Moreover, IT-related capital investment in electric equipment and other areas is expected to remain strong during the fiscal year. However, orders for machinery and equipment (excluding the shipping and electric power industries from private-sector orders), which are a leading indicator of capital investment, are expected to decline in the January-March quarter for the first time in seven quarters, thus generating concern about future trends in capital investment.

Recovery in the household sector is lagging behind that in the corporate sector. Private consumption on a GDP basis rose sharply in the January-March quarter of 2000 but thereafter remained at the same level. However, consumption recorded a decline of 0.6% from the previous quarter in the October-December quarter of 2000. Factors accounting for this include the lagging recovery in the employment and income environments. It appears that, contrary to expectations, the winter bonus for 2000, which had been expected to climb above the level of the previous year along with the increase in corporate profits, declined. The rise in scheduled earnings is small, and the slowdown in production caused non-scheduled earnings to diminish. Moreover, the unemployment rate continues to be at historically high levels, and the increase in the number of employed persons, according to the latest data, is shrinking. Judging from the employment and income environments, there is also cause for concern about future trends in personal consumption.

2. Outlook for Japanese Economic Growth in Fiscal 2000: Two Consecutive Years of Positive Real GDP Growth of 1.4%

Positive growth over the previous quarter is expected to continue in the January-March period of fiscal 2001. The growth rate for fiscal 2000 is expected to be 1.4%, higher than the government's forecast of 1.2%. The principal factor accounting for the recovery in the January-March quarter is public investment. Additional public works projects will be implemented following the passage of a supplementary government budget in fall 2000. Thus, public investment will increase substantially in the January-March quarter. On the other hand, the rise in private non-residential investment, which sustained growth in the October-December quarter, will decline. The surge in construction set off by the implementation of the law related to the location of large-scale retail stores will subside, and, while IT-related investments will remain at a high level, their momentum will diminish. In addition, as concerns rise about the prospects for the economy, there is a possibility that capital investment among fast-responding small and medium-sized companies will fall below planned levels. As the slowdown in the world economy continues, exports will be flat, and the contribution of external demand will become negative.

The employment and income environments are severe, but personal consumption is expected to remain relatively firm. Growth in sales of personal computers has paused, but the upward trend in new automobile registrations is continuing, and, prior to the enactment of the electrical appliance recycling law, sales of four types of appliances to which this new law will apply, including washing machines and refrigerators, are expanding. Also, as the impact of the tax reduction for residential loan payments diminishes, private residential investment is expected to slow down.

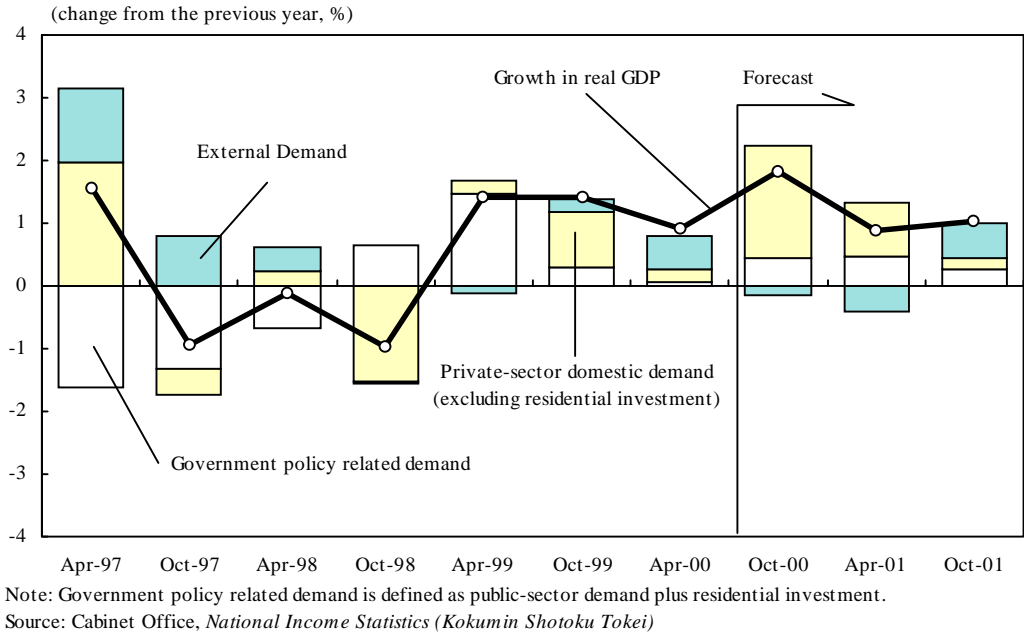
3. Outlook for Japanese Economic Growth in Fiscal 2001: Continuing Positive Growth of 1.0%, Slower than in Fiscal 2000

We are forecasting that real GDP in fiscal 2001 will fall below the government's estimate of 1.7% and will amount to 1.0%. The slowdown in the economy will persist in the first half of 2001. In the corporate sector, stagnation will continue. Exports will decline because of the deceleration in the world economy, leading to a drop in industrial production. This will lead to a decrease in capital investment accompanied by deterioration in corporate profitability. This stagnation in the corporate sector will most likely have a negative impact on the household sector. Corporations will be more strongly motivated to reduce personnel costs, and wages are likely to show slower growth. As the employment environment grows more severe once again, there is concern that consumer confidence may wane. In addition, private residential investment will probably trend downward.

The economy will begin to recover again in the second half of fiscal 2001. The reason for this will be the commencement of a recovery in the world economy. Especially in the United States, interest-rate reductions will take effect and allow the economy to bounce back. The recovery in external demand will expand production, and inventory adjustments will be completing. Moreover, the increase in production will bring recovery in corporate profitability, and capital investment—which has weakened

in the first half of fiscal 2001—will begin to expand again. The improvement in corporate profitability will have a positive impact on individual incomes. But companies are likely to maintain such strong restraints on personnel costs that the recovery will be limited. For this reason, personal consumption will remain firm; however, a robust recovery cannot be expected. Instead, consumption will, at best, remain a support for the economy. Even though the economy will begin to improve, the recovery in demand will be weak, and deflationary pressures will continue throughout the fiscal year.

Exhibit 1: Trends in the Japanese Economy through Fiscal 2001

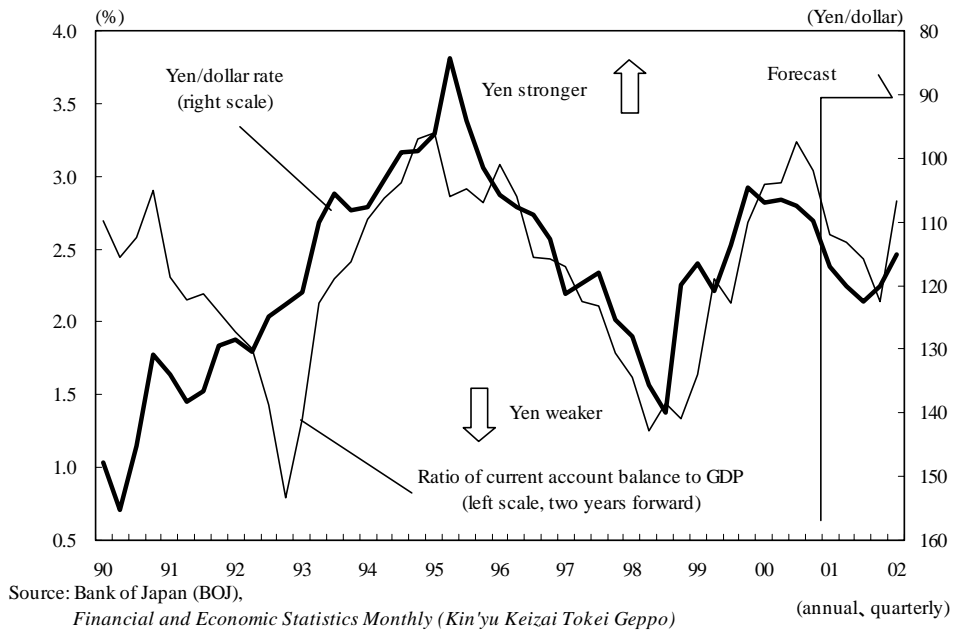


Assumptions Underlying the Forecasts

We made the following assumptions in the preparation of our forecasts:

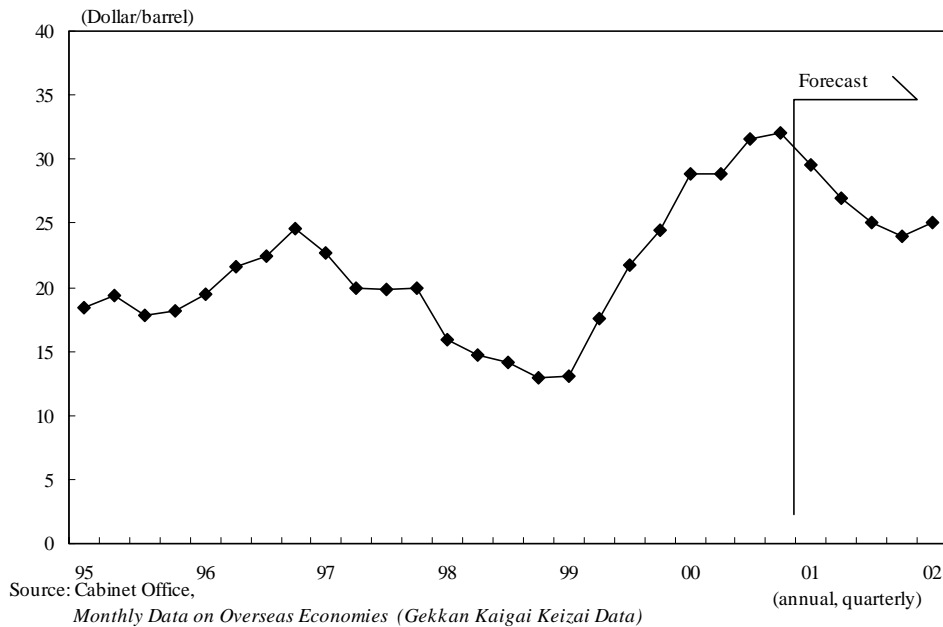
- (1) The U.S. economy will grow 1.6% in real terms in 2001, a substantial deceleration from the previous year. However, the economy will move gradually toward recovery in the second half of the year. (Please refer to the last section of this article, *Outlook for the U.S. Economy*.) A slowdown is also expected in the other economies of Asia, with the newly industrializing economies (NIEs) showing a decline in growth (to 6% for 2001). The European economies are also assumed to show lower growth, although the rate of decline in growth will not be as sharp as in the United States.
- (2) The yen will continue to weaken against the U.S. dollar. The economies of both Japan and the United States will slow down, and both are expected to adopt easier monetary policies. Nevertheless, investors are expected to be more prone to sell the yen because of concern about Japan’s delayed response to the problem of the bad loans of domestic financial institutions and other structural problems. When the Japanese economy begins to recover in the latter half of fiscal 2001, the decline in the value of the yen may bottom out, but for the fiscal year as a whole it is forecast to fluctuate around ¥120 to the dollar.

Exhibit 2: Outlook for the Yen/Dollar Exchange Rate



- (3) Crude oil prices are expected show a downward trend as the world economy slows. Although there is a possibility that the West Texas Intermediate (WTI) crude oil price may drop temporarily to between \$20 and \$25 per barrel, thereafter, as the world economy begins to recover, prices will bottom out. We are assuming an average price for the fiscal year of \$25/barrel.

Exhibit 3: Outlook for Crude Oil Prices



- (4) The Japanese government will adopt a supplementary budget in fall 2001, which will provide about ¥3 trillion in pump-priming expenditures, including budgetary allocations for IT-related infrastructure.
- (5) In response to the economic slowdown and deflationary pressures, there is a strong likelihood that further measures will be taken to ease monetary policy. In addition to the “zero interest rate policy” of the Bank of Japan, quantitative measures will be taken to expand the money supply (through an expansion in purchases of Japanese government bonds from the market) to support the final disposal of bad loans in the financial sector.

Trends in Components of Final Demand

Corporate Sector: Following Deceleration in the First Half of the Fiscal Year, Recovery to Begin in the Second Half

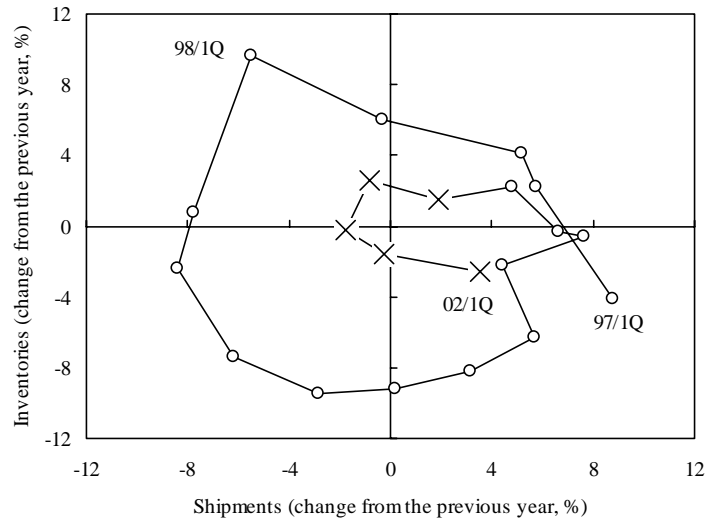
Production: Declines in the First Half owing to Production/Inventory Adjustments and

Falling Exports

The index of industrial production is showing a slowdown. Prospects currently are for the first decline in industrial production in seven quarters during the January-March quarter of 2001. First, inventory adjustments will restrain production. The industrial sector is now moving from a period of “intended inventory investment” to “unintended inventory investment.” Thus, adjustments in production will continue in the first half of the fiscal year.

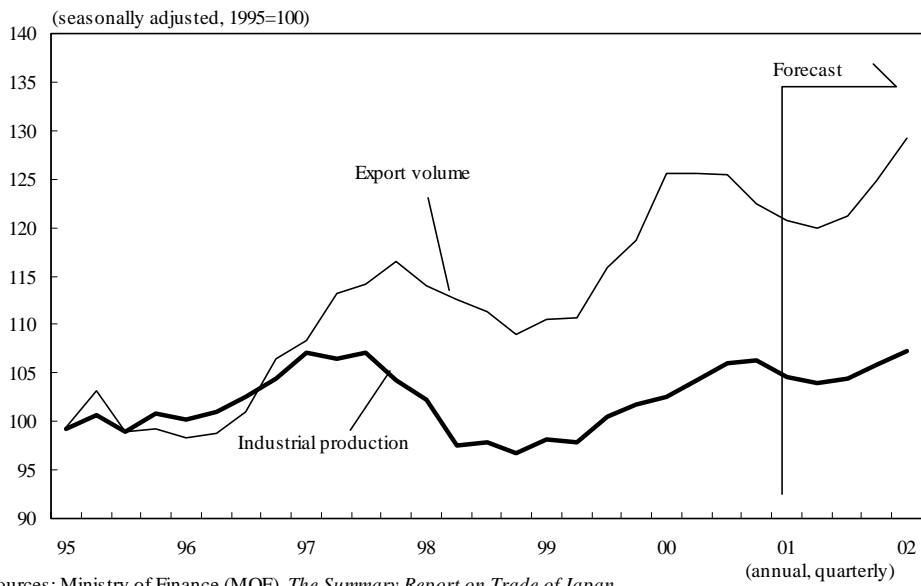
However, before significant inventory accumulation occurs, companies are cutting back on production, and the time needed for adjustments in inventories is not expected to be very long. Of course, depending on trends in final demand, especially in exports, which have provided support for expansion in production thus far, there is a possibility that inventory adjustments could be prolonged. Exports on a volume basis to Europe and the United States as well as Asia are beginning to decline. While such factors as the decline in growth of the U.S. economy, the weakening of the euro, and the slower rate of expansion in IT-related demand are bringing about a slowdown in production at manufacturing bases in Asia, the real key will be the future trends in the U.S. economy. It appears likely that reductions in interest rates in the United States at the beginning of the year will gradually take effect, and, as the U.S. economy moves toward recovery, exports will recover, and production will pick up speed.

Exhibit 4: Inventory Cycle Movements



Note: Inventories are for the end of the period.
 Data points marked with an "X" are forecast.
 Source: Ministry of Economy, Trade and Industry (METI),
Indexes of Production, Shipments, and Inventories
 (Seisan, Shukka Zaiko Shisu)

Exhibit 5: Outlook for Industrial Production and Exports



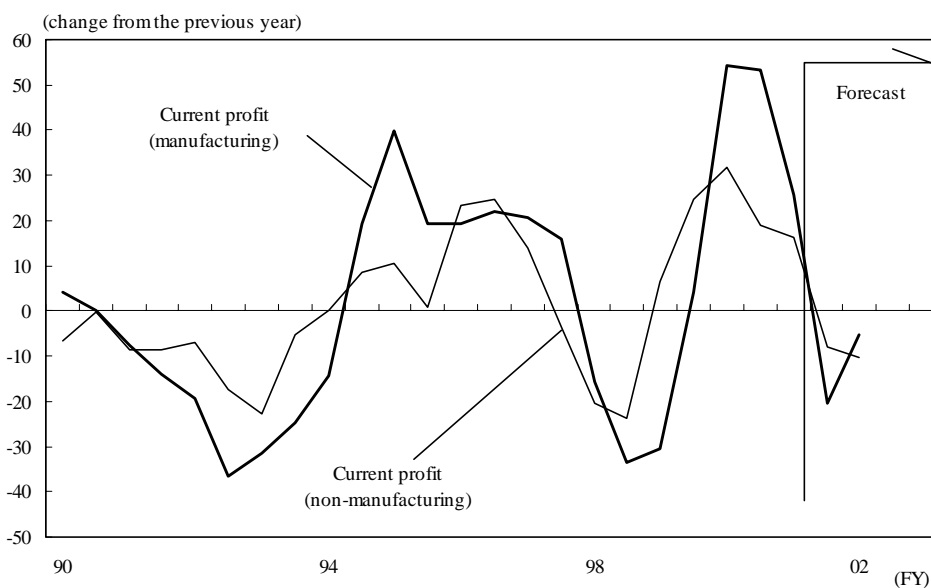
Sources: Ministry of Finance (MOF), *The Summary Report on Trade of Japan*
 ; METI, *Indexes of Production, Shipments, and Inventories* (Seisan, Shukka Zaiko, Shisu)

Profitability: Possibility of Declines as Production Drops

Corporate profits recorded a marked recovery in fiscal 2000 owing to the expansion in exports and production, but profits are expected to drop sharply in the first half of fiscal 2001. In the manufacturing sector, the decline in exports and cutbacks in production arising from inventory adjustments will squeeze profits. Moreover, if corporations increase employment levels gradually and raise wages, then this will lead to increases in personnel and other fixed costs. Also, the expansion in capital investment in the previous fiscal year will lead to higher depreciation costs. The decline in the value of the yen will bring improvement in the profitability of exporters, but this will not be strong enough to raise the overall level of profitability in the manufacturing sector. In the second half of fiscal 2001, the recovery in exports and production will bring a bottoming out of corporate profits, but there is a possibility that, for the fiscal year as a whole, profits will decline.

Since the trend toward slower growth centered on the corporate sector will have an impact on the household sector, sales of services to the business and household sectors as well as sales of products to the wholesale and retail sectors will slow. In addition, as prices are likely to continue to decline, the operating environment will make it difficult to improve profitability. For this reason, the non-manufacturing sector is expected to show a decline in profitability beginning in the first half of fiscal 2001, and this sector will show weaker momentum toward recovery in the second half than the manufacturing sector.

Exhibit 6: Outlook for Corporate Performance

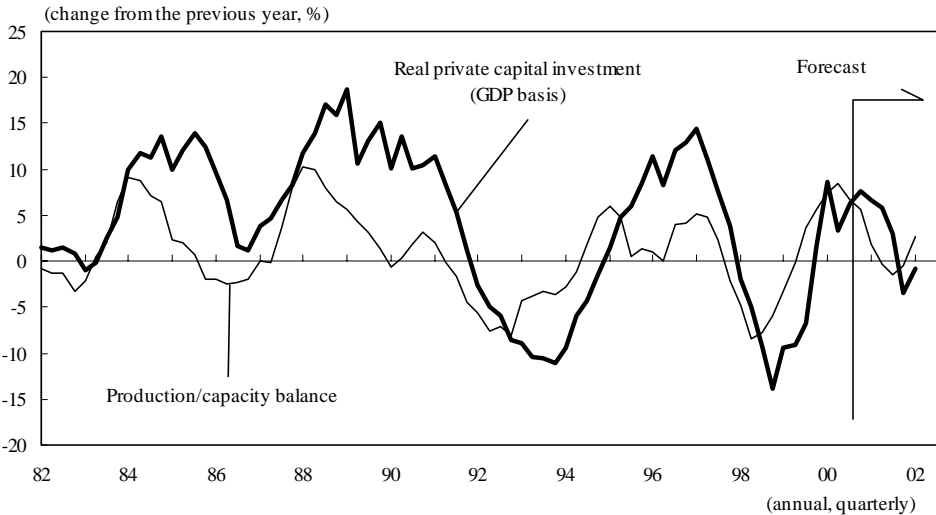


Source: MOF, *Quarterly Statistics on Incorporated Enterprises (Hojin Kigyo Tokei Kiho)*

Private Non-Residential Investment: Marked Slowdown as Current Round of IT-Related Investments Is Completed

The rate of expansion in private capital investment in the manufacturing sector—which was a driving force for the economy in fiscal 2000—is expected to drop substantially as production slows and corporate profitability weakens. Investment in IT-related industries, such as semiconductors, is likely to drop sharply, in part because of a reaction to the steep increases in investments in fiscal 2000. However, the latent demand for the replacement and renewal of older production facilities is believed to be continuing, and, as production and corporate profitability recover in the second half of the fiscal year, private non-residential investment is expected to rise again. Capital investment in the non-manufacturing sector is also likely to slow in the first half of fiscal 2001. However, the recovery momentum in this sector will be weaker than in the manufacturing sector. For the whole of fiscal 2001, overall growth in private non-residential investment will drop to 0.8%, substantially lower than for the previous year.

Exhibit 7: Production/Capacity Balance and Capital Investment



Note: The production/capacity balance is computed by subtracting the change in production capacity over the previous year from the change in production over the previous year.
 Sources: METI, *Indexes of production, Shipments, and Inventories*
 ; Cabinet Office, *National Accounts*

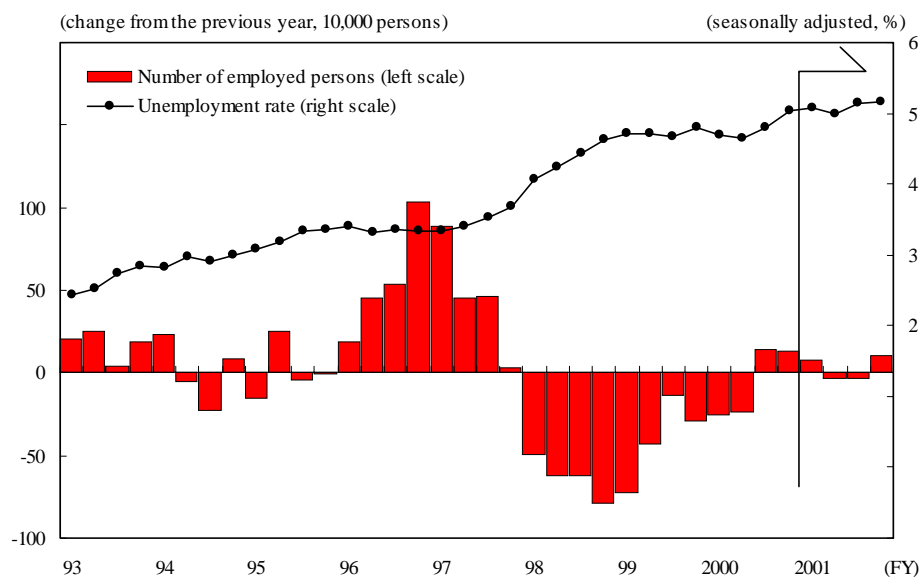
Household Sector: Expected to Provide Support for the Economy but Show Only Minor Improvement

Employment and Income Environment

Since passing a low point in April 1999, the environment for employment and incomes has shown a gradual recovery. But it lagged behind the economy as a whole. The number of job openings has increased, and the most recent data show a rise in the number of employed persons year on year. Nevertheless, the unemployment rate remains at the highest level ever recorded, and the recovery momentum of employment remains weak. In addition, there are signs that the rise in the number of job openings is nearing a peak. If a pronounced trend toward a slowdown in the economy emerges, there is concern that the employment environment may deteriorate once again.

Turning to incomes, it appears that the percentage of the annual spring wage increase will be higher than in the previous year, but the rise in scheduled earnings is likely to be marginal. As production is declining, growth in non-scheduled earnings is slowing, and this trend is expected to continue for the time being. Moreover, as corporate profitability is on a downward trend, little increase is expected in bonuses. As this suggests, growth in per capita earnings is expected to be low. But, because the number of employed persons is rising, total employment income will increase. However, as the ratio of the increase in total persons employed accounted for by part-time employees is expected to continue to rise, the margin of increase in employment income is likely to remain small.

Exhibit 8: Unemployment Rate and Number of Persons Employed

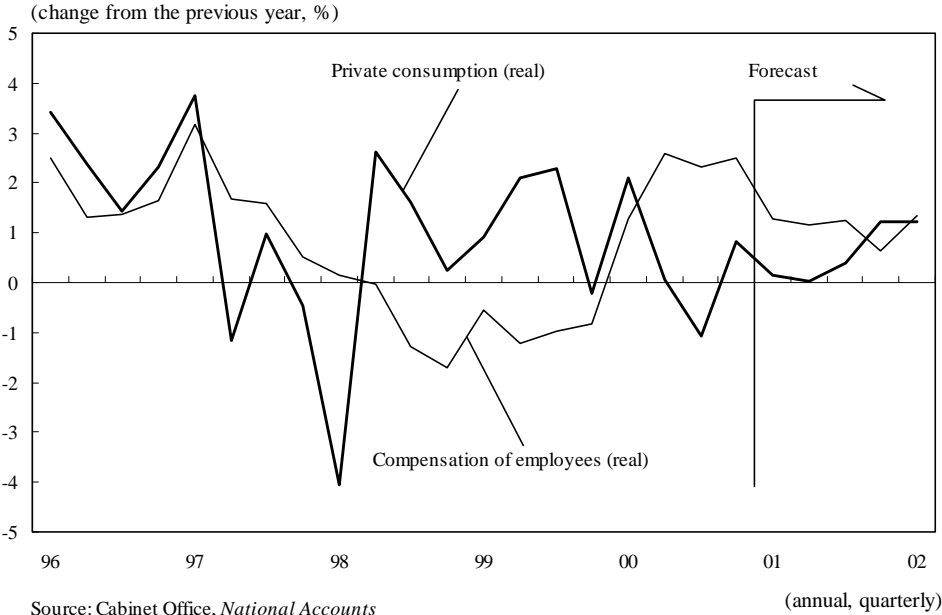


Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey (Rodoryoku Chosa)*

Private Consumption

In view of the marginal increase in compensation for employees, only a gradual recovery of 0.7% is expected in personal consumption. There is a possibility that automobile sales will remain firm for the time being, but there is likely to be a downward reaction to the surge in sales of those appliances that accompanied the implementation of the previously mentioned new appliance recycling law. Moreover, as the economy slows in the first half of fiscal 2001, and anxiety about future trends grows, concerns have been raised that consumer confidence may take a turn for the worse. Even if the economy accelerates again following the slowdown, the improvement in consumer confidence may be limited. Nevertheless, in contrast to the slowdown in the corporate sector, trends in the household sector should remain firm and provide support for the economy.

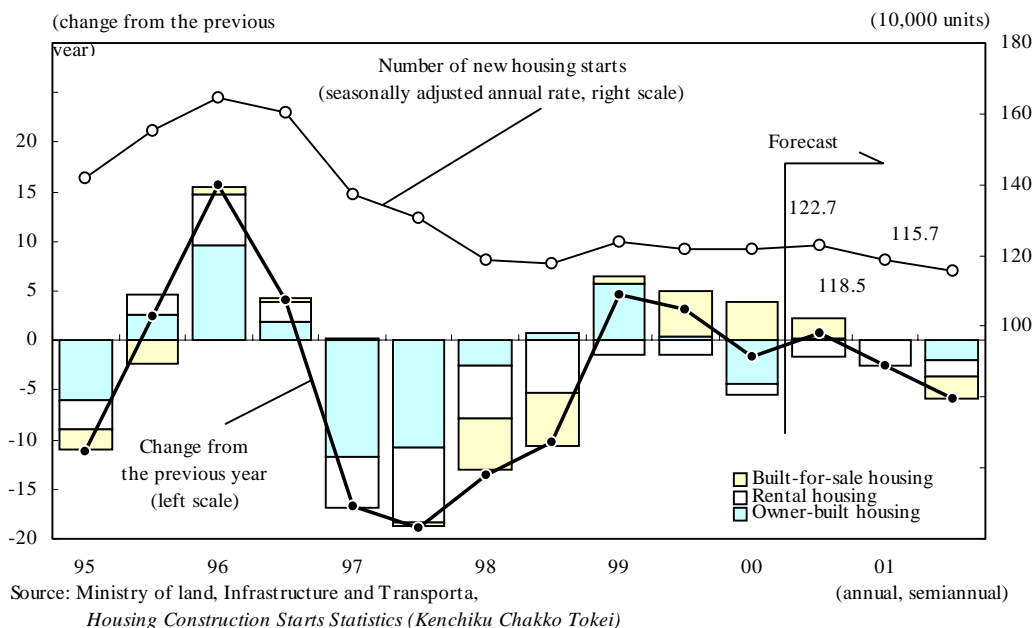
Exhibit 9: Private Consumption and Worker Incomes



Residential Investment

The decline in private residential investment will continue, with this component of final demand dropping 5.4% in fiscal 2001. Construction of condominiums and owner-built housing expanded in fiscal 1999, boosted by the introduction of special tax-reduction measures for housing loans. But, as time has passed since the introduction of these measures, the impact has faded, and total housing starts in fiscal 2000 are now forecast to decrease from those of the previous year. The housing loan tax measures were extended to cover loans for houses that owners would occupy no later than December 31, 2003, but it appears that latent demand for rebuilding existing homes and purchasing new housing units has run its course. Continued low interest rates are a positive factor for residential investment, but we believe the downtrend in housing starts will continue in fiscal 2001. Although the number of new condominium starts will show little or no growth over the previous year, it will remain at a high level. However, homes built for sale, owner-built homes, and homes built for rental will continue at a relatively low level.

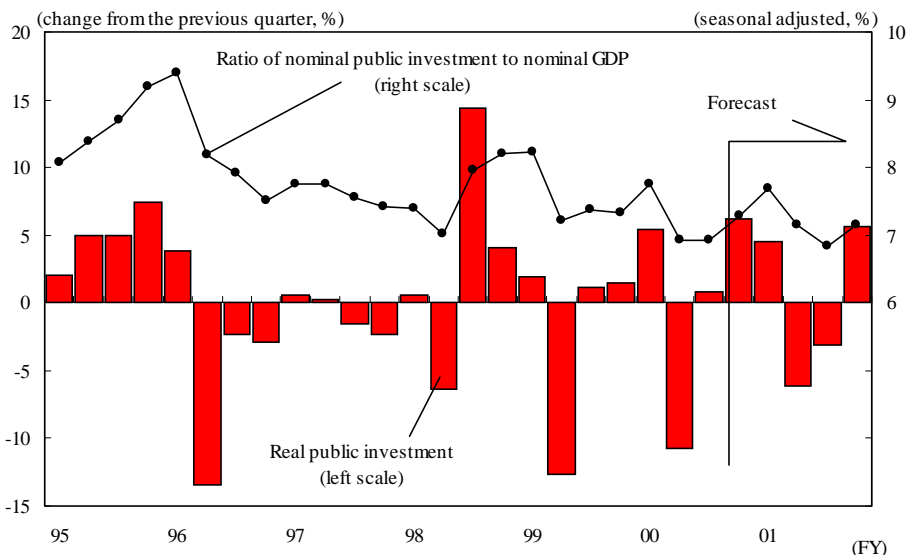
Exhibit 10: Outlook for Housing Starts



Government Economic Stimulus Packages to Continue

The impact of the public works spending contained in the supplementary budget passed in fall 2000 is expected to come on stream in the April–June quarter of 2001. When these budgetary allocations are spent, public investment will drop. However, as the slowdown in the economy becomes more apparent, the government is viewed as likely to pass another supplementary budget in fiscal 2001. If we assume that pump-priming measures in the form of additional public works spending amounting to about ¥3 trillion come on stream in the first half of calendar 2002, the possibility exists that government public works spending for fiscal 2001 will show a slight increase of 1.5% over the previous fiscal year.

Exhibit 11: Outlook for Public Works Investment



Source: Cabinet Office, National Accounts

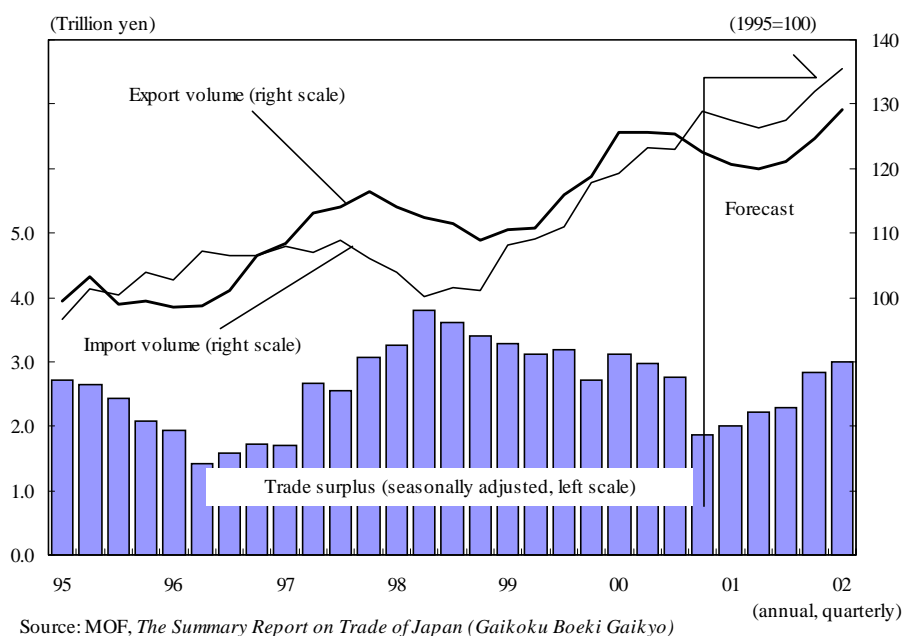
Recovery in External Demand Will Be a Key Point in the Second Half of Fiscal

2001

As a result of the impact of the slowdown in the world economy and the decline in the value of the euro, Japan's exports to Europe and the United States as well as Asia are declining. In particular, the stagnation in overseas demand for IT-related goods, such as semiconductors, which were making a major contribution to growth in exports, is now accelerating the drop in exports. Depreciation in the value of the yen will bring about an improvement in the export environment, but, in the first half of fiscal 2001, the slowdown in the world economy will prolong the stagnation in exports. In the latter half of fiscal 2001, however, the reduction in interest rates at the beginning of calendar 2001 is expected to bring about an economic recovery in the United States and contribute to a recovery in Japan's exports.

Imports are showing trends similar to those in exports, and, as global production systems spanning many countries become more common, this trend will likely become more pronounced. As an underlying trend, the penetration of imports into the Japanese economy is rising, making it easier for imports to increase, but, because domestic demand is weak owing to the slowdown in the economy and the yen is declining in value, growth in imports in volume terms is not expected to rise to a high level. As a result, the contribution of external demand to growth is expected to be a slight plus on balance.

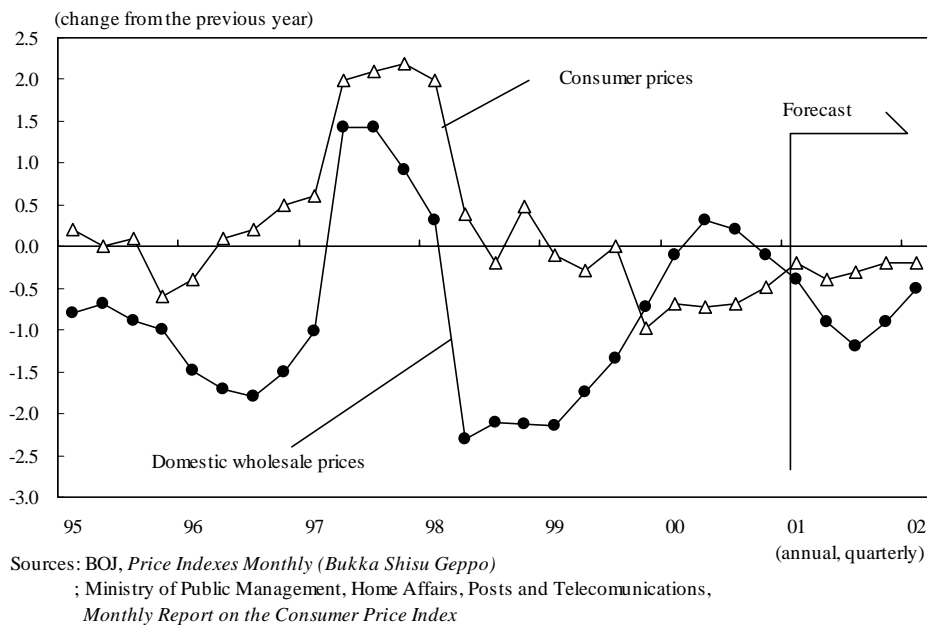
Exhibit 12: Outlook for Trade



Deflationary Pressures to Continue

Crude oil prices are forecast to decline, and prices of other commodities are expected to remain relatively weak as the world economy shows slower growth. For this reason, domestic wholesale prices are forecast to decline 0.9%. Also, consumer prices are forecast to decline 0.2% as a combined result of the decline in wholesale prices and the deflationary impact of the deceleration in demand. Supply-side factors, namely technological progress and deregulation, are also expected to contribute to downward pressure on the price level. The GDP deflator is also anticipated to remain on a declining trend, and real GDP growth will exceed nominal growth. In fiscal 2001, we are forecasting virtually zero growth of 0.2% in nominal GDP.

Exhibit 13: Outlook for Prices



4. Conclusion: The Meaning of the Decline in Japan's Stock Prices

Views of the Japanese economy become rapidly more pessimistic. A symbol of this growing pessimism is the drop in stock prices. Even though some observers point out that there may be problems of discontinuities in the Nikkei stock price average due to technical factors—namely, changes in stocks covered by the index—the index has fallen below the lowest point reached thus far following the collapse of Japan's bubble economy and now stands at mid-1980 levels. The drop in stock prices suggests some messages for us.

The first message is that the IT boom, principally in the United States, has run its course for the time being. Of course, there has been a major trend toward the application of information technologies that goes back many years, and these technologies will remain a major impact on economies and societies. Nevertheless, the short-term boom in the demand for information-related equipment—which swelled

upward suddenly and boosted the economy by expanding exports, production, and capital investment—appears to have run its course for now. Exports and production are already slowing, and leading indicators suggest that a slowdown in capital investment is unavoidable.

The second message is that there are concerns regarding future scenarios for economic recovery. Specifically, the future recovery of the Japanese economy may be fragile, as it is heavily dependent on trends in the United States and the rest of the world economy. The reduction in U.S. interest rates at the beginning of this year should have a positive impact, when we think back to typical periods of downturn during the times of peace after World War II. Also there is a strong possibility that the economy will begin to recover in fall 2001. However, if we look at movements in U.S. stock prices, especially the sharp decline in the NASDAQ market, we sense that there is a possibility that there may have been a change in the medium- to long-term trend toward the application of information technology and the expansion of necessary capital investment. If this is true, the impact of the reduction in interest rates will be limited, and this, in turn, gives rise to anxiety that the downturn in the U.S. economy may be more prolonged than would be normal.

The third message is that Japan's structural problems, including above all the bad loans' problems of domestic financial institutions, have not been solved. If we trace the causes of the lack of demand and deflationary pressures, the final conclusion is that finding solutions for Japan's structural problems has been postponed. Although 10 years have passed since the collapse of the bubble economy, financial institutions still have an enormous amount of bad debts on their books. If we look beyond these bad debts, we see a host of debtor companies that have excess labor, capacity, and debts. Even if the economy shows some recovery as a result of the IT boom, this will not solve the structural problems. If the bad loans are not disposed of, the economy will stall, and land prices will continue to slide; this, in turn, will create more bad loans. Moreover, as financial institutions cannot escape from their dependence on stock prices, the fall in share values will increase the concern regarding bad loans, thus leading to further declines in stock prices.

Of these three messages, the first has already become a reality, and it is essential to be aware of this as a fact. The second and third messages suggest risk factors that may become realities. In our forecasts, we look at the second and third messages as possible risk factors that could lead to worse-than-forecast scenarios. Let us consider briefly how the risks suggested by the second two messages can be dealt with. The point to consider first is that the Japanese economy has been cited before as being fragile because of its dependence on external demand. Boosting net exports—or in other words the contribution of external demand—is, of course, difficult, but an expansion in gross exports will lead to higher production and an improvement in corporate profitability. This, in turn, may contribute to a recovery in household income and increase the recovery momentum in the economy as a whole. In this sense, Japan's reliance on external demand is still high. Nevertheless, there are instances where a high dependence on external demand is positive for the economy. Whether the economy is more externally dependent or more reliant on domestic demand is a question of long-term strategy. In as much as Japan's external dependence is high, it must live and cope with the concomitant risks.

One of the reasons why reliance on domestic demand does not increase is the delay in addressing structural problems, the third message. If bad loans were fully disposed of, this would lead to increased downward pressure on the economy as financial institutions reported losses, companies went bankrupt, and unemployment rose. It is probably illusory to believe that if thoroughgoing measures were adopted

to deal with structural problems, this would lead to brighter prospects and an increase in stock prices. It will be first and foremost impossible to solve structural problems without a worsening of economic conditions. There cannot be structural reform without some degree of pain. To lessen the pain, some observers have expressed the view that it would be best to implement a relaxation of monetary policy, including a revival of the zero interest rate policy and a quantitative expansion in the money supply, in parallel with policies to deal with bad loans. However, we do not believe that enough consideration has been given to such basic issues as the degree of deflationary pressures that will be created along with the disposal of bad loans and the effectiveness of a further relaxation of monetary policy. Even if the zero interest rate policy is continued until long-term rates decline, this will only have the effect of lowering fund-raising costs. Regarding a quantitative expansion, it is necessary to have an ample supply of funds to prevent a shortage of money in financial institutions, but it is difficult to imagine how supplying funds in excess of this necessary amount will lead to an expansion in the real economy. Therefore, it appears to be better not to believe that combining additional monetary policies with policies to deal with bad loans will lead to a lessening of the pain of structural reform. In our forecasts, we are assuming some further steps will be taken to relax monetary policy, but we believe this will have virtually no positive effect on the economy.

Moreover, we are also assuming that additional pump-priming fiscal allocations amounting to about ¥3 trillion will be approved, but we are not actively presenting this as a proposal for policy. Public works investment is extremely important, and the required standards for such expenditures are to use these funds effectively to provide and upgrade the necessary social capital. What is most important is that the budget be discussed thoroughly and then decided; additions should not be made in a willy-nilly fashion afterwards. Expansion of public investment will steadily increase the growth rate, but the effects will be temporary. Fiscal expenditures should be used efficiently and where they are really needed; otherwise, they only increase the fiscal deficit.

The stock market sends us messages about the current state of and outlook for corporate profits and the economy as a whole, but it cannot encourage us to use specific policies. The first to respond to declining stock prices must be individual companies themselves. The issue of bad debts is one that should be dealt with by banks and companies themselves. Of course, if the problems become as serious as they are now, the government cannot refrain from becoming involved. But, without strong will among private companies to deal with their bad debts, we cannot begin to solve the problem. When stock prices decline, we immediately hear calls for policies to do something about it; when the government responds with an “emergency policy,” that is a problem in itself. Also, regarding the content of policies, even though discussions of how to deal with bad loans have made little progress, we see that active discussions have begun on policies that are said to relieve the pain. It is important that, before asking the government for assistance, companies themselves take the initiative and make progress toward solving their problems.

Summary of Forecasts for the Japanese Economy

	Forecasts \								
	(change from the previous quarter, %)								
	FY1999		FY2000		FY2001		FY1999	FY2000	FY2001
	First half	Second half	First half	Second half	First half	Second half	(actual)	(forecast)	(forecast)
Nominal GDP	0.0	▲ 0.3	▲ 0.7	0.4	▲ 0.1	0.4	▲ 0.2	▲ 0.2	0.2
Real GDP	1.4	1.4	0.9	1.8	0.9	1.0	1.4	1.4	1.0
Contribution of domestic demand	1.7	1.2	0.3	2.2	1.3	0.4	1.4	1.2	0.9
Private consumption	2.2	0.9	▲ 0.5	0.5	0.2	1.2	1.5	0.0	0.7
Residential investment	3.8	6.6	▲ 2.9	1.1	▲ 2.6	▲ 8.4	5.1	▲ 1.0	▲ 5.4
Non-residential investment	▲ 6.0	3.6	3.0	7.1	4.3	▲ 2.1	▲ 1.0	5.2	0.8
Government spending	5.6	▲ 0.2	1.0	1.4	2.5	2.5	2.5	1.2	2.5
Public investment	9.0	▲ 7.2	▲ 4.6	▲ 1.5	2.5	0.7	▲ 0.7	▲ 2.9	1.5
Contribution of external demand	▲ 0.1	0.2	0.6	▲ 0.2	▲ 0.4	0.6	0.0	0.2	0.1
Exports of goods and services	1.2	9.4	13.3	6.1	▲ 0.7	6.9	5.3	9.5	3.1
Imports of goods and services	3.1	9.4	9.9	9.7	3.6	2.0	6.2	9.8	2.8
Current account (trillion yen)	6.5	6.1	6.8	4.6	5.5	6.3	12.6	11.4	11.8
Trade balance (trillion yen)	7.2	6.6	6.7	4.8	5.7	6.6	13.8	11.5	12.3
Industrial production	1.2	5.5	6.2	3.1	▲ 1.1	2.2	3.4	4.6	0.1
Wholesale price index (WPI)	▲ 3.8	▲ 1.0	▲ 0.3	0.6	0.7	▲ 0.4	▲ 2.5	0.2	0.2
Domestic WPI	▲ 1.5	▲ 0.4	0.3	▲ 0.3	▲ 1.1	▲ 0.7	▲ 1.0	0.0	▲ 0.9
Consumer price index (CPI)	▲ 0.1	▲ 0.8	▲ 0.7	▲ 0.2	0.0	▲ 0.4	▲ 0.5	▲ 0.4	▲ 0.2
Yen-dollar exchange rate (yen/dollar)	117	106	107	113	121	118	112	110	119
Crude oil purchase price (\$/barrel)	16.8	26.7	30.2	30.8	26.0	24.5	23.2	30.5	25.3
U.S. real GDP									
(annual rate, CY)	3.8	5.5	5.9	2.8	0.7	2.5	4.2	5.0	1.6
Spring wage increase	—	—	—	—	—	—	2.21	2.06	2.10

Note: Spring wage increases were compiled from data on the 290 companies listed on the first sections of the Tokyo and Osaka stock exchanges that have a labor union and capital of 2 billion yen or more as well as 1,000 or more employees.
(compiled by the Ministry of Health, Labour and Welfare)

【Exports and Imports】

Forecast ↘

(change from the previous year, %)

	FY1999		FY2000		FY2001		FY1999	FY2000	FY2001
	First	Second	First	Second	First	Second	(actual)	(Forecast)	(Forecast)
Exports (yen basis)	▲ 7.8	4.7	8.4	5.8	4.9	10.0	▲ 1.8	7.1	7.4
Volume	1.3	11.3	10.7	▲ 0.5	▲ 3.9	4.4	6.2	4.9	0.2
Imports (yen basis)	▲ 5.1	11.9	14.5	18.0	12.3	2.9	3.0	16.3	7.4
Volume	9.1	13.3	11.9	8.2	3.1	4.3	11.3	10.0	3.7
Exports surplus	6.3	5.8	5.8	3.8	4.6	5.7	12.1	9.6	10.3

【Income and Employment】

Forecast ↘

(change from the previous year, %)

	FY1999		FY2000		FY2001		FY1999	FY2000	FY2001
	First	Second	First	Second	First	Second	(actual)	(Forecast)	(Forecast)
Cash earnings of employees *	▲ 1.2	▲ 0.4	0.8	0.0	0.1	0.2	▲ 0.8	0.4	0.2
(per capita)									
scheduled cash earnings	▲ 0.1	0.5	0.6	0.3	0.4	0.3	0.2	0.4	0.3
non-scheduled	2.2	3.5	5.3	3.2	▲ 1.7	▲ 0.4	2.9	4.2	▲ 1.0
Number of employees	▲ 0.6	▲ 0.4	0.5	1.1	0.7	0.2	▲ 0.5	0.8	0.4
Compensation of employees	▲ 1.6	▲ 1.0	1.4	1.2	0.9	0.5	▲ 1.3	1.3	0.7

(Forecast)

Spring wages increase **	—	—	—	—	—	—	2.21	2.06	2.10
Unemployment rate (seasonally adjusted)	4.7	4.7	4.7	4.9	5.0	5.1	4.7	4.8	5.1

Notes:

* Figures for establishments with five employees or more.

** Figures are spring wage increases compiled from data on the 290 companies listed on the first sections of Tokyo and Osaka stock exchanges that have a labor union and capital of 2 billion yen or more as well as 1,000 or more employees.

(Compiled by the Ministry of Health, Labour and Welfare)

【New Housing Starts】

(10,000 units)

【Summary Comparison with Previous Outlook】

	FY1999	FY2000	FY2001	Previous Outlook		Modification		Current Outlook	
	(actual)	(Forecast)	(Forecast)	FY2000	FY2001	FY2000	FY2001	FY2000	FY2001
Number of new housing starts	122.6	122.0	116.9	1.9	1.3	▲ 0.5	▲ 0.3	1.4	1.0
(change from the previous year)	(4.0)	(▲0.5)	(▲4.2)	0.6	1.6	▲ 0.6	▲ 0.9	0.0	0.7
Owner-built housing	47.6	44.9	43.8	▲ 2.8	▲ 3.6	1.8	▲ 1.8	▲ 1.0	▲ 5.4
Rental housing	42.6	41.0	38.4	5.6	1.4	▲ 0.4	▲ 0.6	5.2	0.8
Built-for-sale housing	31.2	34.9	33.6	▲ 3.0	0.7	0.1	0.8	▲ 2.9	1.5
	(10.7)	(11.8)	(▲3.8)	0.4	▲ 0.1	▲ 0.2	0.2	0.2	0.1
				5.2	0.8	▲ 0.6	▲ 0.7	4.6	0.1

Outlook for the U.S. Economy

1. Current State of the Economy

In 2000, the U.S. economy recorded strong growth of 5.0%. But this was largely due to the rapid expansion in the first half of the year. Through the end of last year, the U.S. economy underwent a dramatic slowdown. In the October-December quarter of 2000, the annualized quarter-to-quarter growth rate of real GDP fell suddenly to 1.1%. As a result of concerns about the performance of high-technology companies and other factors, the NASDAQ composite index, which hit highs of more than 5,000 around March 2000, had dropped to about 2,500, half the previous high, at the end of 2000. As a result of the decline in stock prices, especially for high-tech issues, the balance of household financial assets began to decline and became one of the factors pushing personal consumption downward. In addition, the slowdown in the economy put the brakes on corporate profits, and private capital investment has shown signs of slowing.

2. Outlook for 2001

The Federal Reserve Board (FRB) lowered interest rates a total of 1.0 percentage point during January 2001. Nevertheless, even after these reductions, the downward trend in the U.S. stock market continued, and in March the NASDAQ composite dropped temporarily below 2,000, the lowest level since December 1998. The fall in stock prices has accelerated the decline in consumer confidence, and the sentiment among corporations about the economy has also deteriorated. Along with the increasing anxiety, consumer spending in the first half of 2001 so far appears to have been stagnant, in part because of the influence of employment adjustments, especially in the manufacturing sector. Accompanying the decrease in corporate profitability, capital investment has slowed, and growth in the first half of the year compared with the previous half year is expected to drop to 0.7%, or virtually zero growth.

Nevertheless, the economy is forecast to move toward a recovery in the second half. The FRB is viewed as likely to make further reductions in interest rates totaling between 0.75 and 1.0 percentage point. These monetary policy measures are viewed as likely to bring recovery in demand that is sensitive to interest rates, including private residential investment and certain durable goods. In addition, compared with downturns in the past, the manufacturing sector, in particular, has made quick progress toward adjustments in inventories and employment. Inventory adjustments are viewed as likely to be completed during the first half of calendar 2001. Moreover, President George W. Bush has proposed a reduction in income taxes amounting in total to \$1.6 trillion over the 10-year period from 2002 to 2011 and is aiming to implement a portion of this tax cut ahead of schedule in 2001. The tax cut will be a factor boosting consumer psychology in the second half of the year. Growth in the second half of 2001 is forecast to rise to 2.5% at an annualized rate compared with the previous six-month period. Although the increase in the second half will not be robust, it will represent recovery from the slow pace of expansion in the first half. Growth for 2001 as a whole is forecast to be 1.6%, the lowest rate of expansion since 1991.

The rate of consumer price inflation will drop to 2.6% in 2001 compared with 3.4% in 2000, as the impact of higher energy prices, especially those for crude oil, begins to diminish.

Summary of the Outlook for the U.S. Economy

	CY2000 (actual)		CY2001 (forecast)		CY1999 (actual)	CY2000 (actual)	CY2001 (forecast)
	First	Second	First	Second			
Nominal GDP*	8.6	4.7	3.2	4.0	5.8	7.1	3.6
Real GDP*	5.9	2.8	0.7	2.5	4.2	5.0	1.6
Private consumption	6.0	3.7	1.3	2.3	5.3	5.3	2.1
Residential investment	2.0	▲ 6.0	▲ 1.6	4.0	6.4	▲ 0.5	▲ 1.4
Private capital investment	16.4	7.1	▲ 1.2	2.8	10.1	12.6	1.8
Inventory investment**	▲ 0.1	0.2	▲ 0.3	0.1	▲ 0.4	0.2	▲ 0.1
Net exports**	▲ 0.9	▲ 1.0	▲ 0.2	▲ 0.2	▲ 1.2	▲ 1.0	▲ 0.4
Esports	9.3	8.6	▲ 2.7	3.3	2.9	9.1	1.5
Imports	13.3	12.6	▲ 0.9	3.9	10.7	13.6	3.5
Consumer price index	3.3	3.5	2.8	2.3	2.2	3.4	2.6
Unemployment rate	4.0	4.0	4.4	4.5	4.2	4.0	4.5
Fiscal balance***	—	—	—	—	1244	2362	2044
Ratio to GDP (%)	—	—	—	—	1.4	2.4	2.0
Trade balance	▲ 2085	▲ 2258	▲ 2273	▲ 2304	▲ 3288	▲ 4343	▲ 4577
Ratio to GDP (%)	▲ 4.2	▲ 4.5	▲ 4.4	▲ 4.4	▲ 3.5	▲ 4.4	▲ 4.4

Notes:

* Figures are annual rates computed from quarterly changes in percent.

** Figures are percentage contributions.

*** Figures are for the U.S. fiscal year, running from October through September of the following year.