June 2001

Forecast for the Japanese Economy in Fiscal 2001 and 2002

SRIC Corporation
Economic Research Department

Outlook for the Japanese Economy in Fiscal 2001 and 2002

<Summary>
1. Current State: Growing Concern about a Downturn

Real GDP growth in fiscal 2000 was +0.9%; although small, this represented the second consecutive year of positive growth for the Japanese economy. Nevertheless, the economy began to show signs of decelerating in the latter half of fiscal 2000, and, as a result of a slowdown in the United States and elsewhere in the world economy, exports from Japan began to lose momentum. Since the beginning of 2001, the pace of decline in industrial production has quickened. The rate of growth in corporate profits slowed in the January–March quarter, and growth in private capital investment has also weakened. In addition, the income and employment environments are becoming severer, and personal consumption is weak.

2. Outlook for Fiscal 2001 (+0.3% Real GDP Growth): Slowdown to Continue in First Half Followed by Recovery in the Second Half

The downtrend in the economy is likely to continue in the first half of fiscal 2001. First, the slide in exports will continue as the world economy slows. Inventory adjustments are already in progress, and the decline in industrial production will continue during the first half of the fiscal year, while private capital investment will be restrained. Since growth in wages will remain stagnant, personal consumption will remain virtually level. Private housing investment is forecast to decline, as the number of owner-built housing starts continue downward.

The economy is expected to bottom out in the second half of fiscal 2001. This will be because the world economy will begin to recover as the effects of the relaxation of monetary policy are felt in the United States. The recovery in export demand is expected to bring an increase in production and the adjustment in inventories within reach. As a result of the expansion in production, the utilization of capital equipment will rise, and corporate profitability will recover gradually, and, for these reasons, private capital investment will begin to expand again. Even if corporate profitability recovers, however, restraints on personnel costs are expected to remain strong, and recovery in individual incomes will be limited. Nevertheless, personal consumption will recover gradually and provide support for the recovery.

Compared to our March forecast, we have lowered the rate of growth for fiscal 2001 from +1.0% by 0.7 percentage point, to 0.3%, for the following reasons: (1) Since the slowdown in the world economy came more quickly than expected, we have reduced the contribution of external demand by 0.2 percentage point. (2) We have reduced the contribution of public investment 0.3 percentage point because of a change in the underlying assumption in the previous forecast, which was that the government would prepare a package of economic policies that would include ¥3 trillion in pump-priming expenditures, half of which would be spent during fiscal 2001. In addition, since deflationary pressures will continue, GDP in nominal terms is forecast to drop 0.7%, the fourth consecutive year of declines in nominal GDP.

3. Outlook for Fiscal 2002 (+2.2% Growth): Recovery in Domestic Private Demand but a Slowing in the Second Half

As during the latter half of fiscal 2001, in fiscal 2002, expansion in exports will bring increased production, and the economic recovery will continue. Capital investment will also rise, propelled by replacement investment, and, along with the recovery in incomes, private consumption will increase, thereby bringing economic recovery led by domestic private demand. Growth in nominal GDP will rise to +1.3%, the first positive figure in five years. However, the recovery in private capital investment on a year-on-year basis will peak in fiscal 2002, and there is a possibility that the economy will slow in the latter half of fiscal 2002.

4. Performance of Overseas Economies a More Important Risk Factor for Economic Downturn than Domestic Structural Reforms

The view is growing stronger that such measures as the restructuring of government finances, the final disposal of nonperforming loans in the banking sector, and other structural reforms will place deflationary pressures on the economy. Clearly, as a result of the failure to implement another economic stimulus package (with about ¥3 trillion in pump-priming expenditures), simulations show that real economic growth in fiscal 2001 will be 0.3 percentage point lower than it would have been with the package. However, public investment has been on a downward trend for the past several years, and it can be said that a continuation of this decline will lead to fiscal restructuring. The final disposal of nonperforming loans (by removing them from the balance sheets of financial institutions) is in progress. There is a possibility that this process of final disposal may be accelerated, but nothing completely new is about to begin. The risk of a downturn seems likely to be more closely linked to trends in overseas economies than to progress toward structural reform in Japan.

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: Growing Concern about a Downturn

Real GDP growth in fiscal 2000 was +0.9%; although small, this represented the second consecutive year of positive growth for the Japanese economy but fell below the government's forecast of +1.2%. In the first half of the fiscal year, exports expanded—owing to the recovery in the world economy and the rise in IT-related demand, including requirements for semiconductors—and industrial production rose. Higher production was accompanied by improvement in corporate profitability, and private capital investment rose toward the latter half of fiscal 2000. Private consumption did not show much recovery compared to trends in the corporate sector but, even so, remained firm through the second half of the fiscal year and provided support for the economy.

Nevertheless, the economy began to show signs of decelerating in the latter half of fiscal 2000, and, as a result of a slowdown in the United States and elsewhere in the world economy, exports from Japan began to lose momentum and industrial production peaked in summer 2000 and began to slow. Since the beginning of 2001, the pace of decline in industrial production has quickened. The rate of growth in corporate profits slowed in the January–March quarter, and growth in private capital investment has also weakened. As activity in the corporate sector has slowed, the income and employment environments are becoming severer, and personal consumption is weakening. Moreover, GDP growth in nominal terms in fiscal 2000 was –0.6%, the third consecutive year of negative growth. The GDP deflator has also recorded its third year of decline, and deflationary pressures are continuing.

Reflecting this deceleration in the economy in the January–March quarter of 2001, GDP dropped 0.2% from the previous quarter. By component of GDP, as a result of the decline in exports, the contribution of the external sector slipped 0.2%, the second consecutive quarterly decline. Private capital investment, which increased substantially in the previous fiscal quarter, dropped 1.0%, especially in the nonmanufacturing sector, in the January–March quarter of 2001, representing the first decline in three quarters. Private consumption showed 0.0% change from the previous quarter in the January–March period, after posting a decline in the previous quarter. This reflects the influence of slow growth in incomes, but it appears that the consumption of single-person households, in particular, slumped. Residential investment, especially owner-built housing starts, dropped a marked 5.2%, as the impact of tax-relief measures for housing loans continued to decline. In contrast to the weakness in external demand and private-sector demand, public investment expanded a substantial 5.2% and was the only major component of demand contributing to growth; this reflected the additional expenditures made under the supplementary government budget passed in fall 2000.

2. Outlook for Fiscal 2001 and Fiscal 2002

(1) Outlook for Fiscal 2001 (+0.3% Real GDP Growth): Slowdown to Continue in First Half Followed by Recovery in the Second Half

We are forecasting real GDP growth of +0.3% in fiscal 2001. The downtrend in the economy is likely to continue in the first half of fiscal 2001. First, the corporate sector will continue to be stagnant. Along with the deceleration of the world economy, the slide in exports will continue. Inventory adjustments are already in progress, and the decline in industrial production will continue during the first half of the fiscal year. Along with the decline in production, corporate profitability will continue to deteriorate, and private capital investment is forecast to decline. This weakening of conditions in the corporate sector will most likely have negative impact on the household sector. As corporate profits worsen, companies will adopt stricter policies to restrain personnel expenditures. Since wages will show little increase, personal consumption will remain virtually level. Similarly, residential investments, particularly starts of owner-built housing units, are forecast to decline.

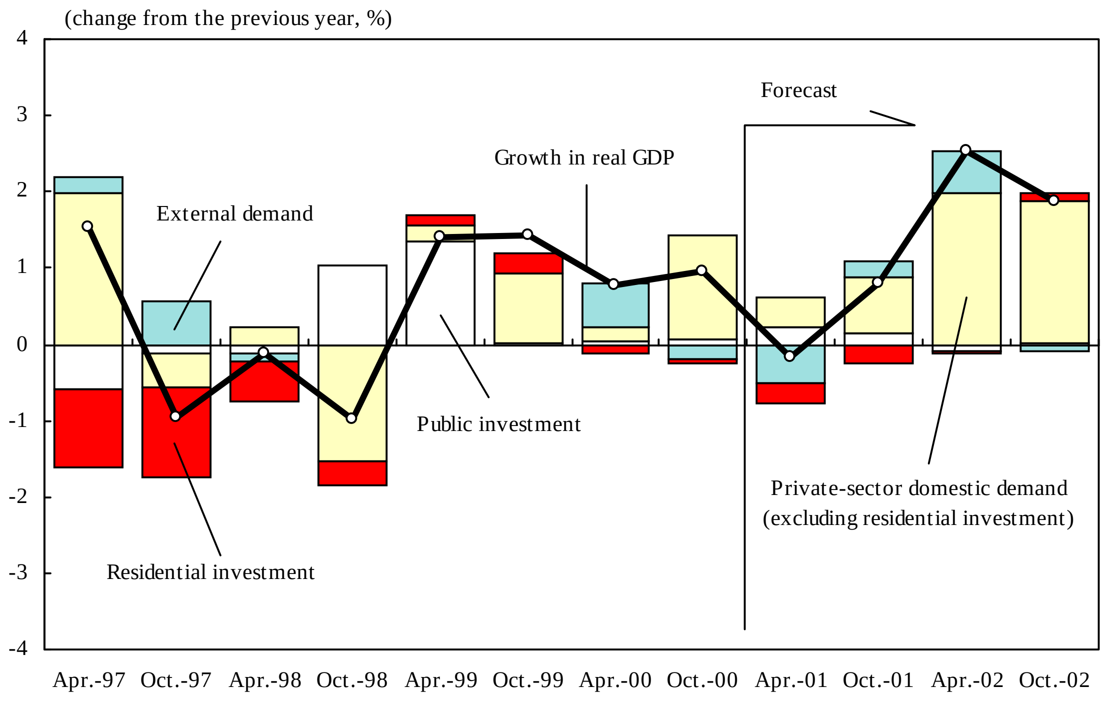
The economy is expected to bottom out in the second half of fiscal 2001, because the world economy will begin to recover as the effects of the relaxation of monetary policy are felt in the United States. The recovery in export demand is expected to cause an increase in production and bring the adjustment in inventories within reach. As a result of the expansion in production, the utilization of capital equipment will rise, and corporate profitability will recover gradually, and, for these reasons, private capital investment will begin to expand again. Even if corporate profitability recovers, however, restraints on personnel costs are expected to remain strong, and recovery in individual incomes will be limited. Nevertheless, personal consumption will recover gradually and provide support for the recovery.

Although the economy will begin to recover in the latter half of the fiscal year, the recovery momentum in demand will be weak, and deflationary pressures will continue over the course of the fiscal year. For this reason, nominal GDP is forecast to fall 0.7%, the fourth consecutive year of decline. In addition, compared to our March forecast, we have lowered the rate of growth for fiscal 2001 from +1.0% by 0.7 percentage point, to +0.3% for the following reasons: (1) Since the slowdown in the world economy came more quickly than expected, we have reduced the contribution of external demand by 0.2 percentage point. (2) We have reduced the contribution of public investment 0.3 percentage point because of a change in the underlying assumption in the previous forecast, which was that the government would prepare a package of economic stimulatory policies that would include ¥3 trillion in pump-priming expenditures, half of which would be spent during fiscal 2001.

(2) Outlook for Fiscal 2002 (+2.2% Growth): Recovery in Domestic Private Demand but a Slowing in the Second Half

We forecast real GDP growth of +2.2% in fiscal 2002. As during the latter half of fiscal 2001, in fiscal 2002, expansion in exports will bring increased production, and the economic recovery will continue. The contribution of external demand is expected to become positive again. In addition, private capital investment will rise, propelled by replacement investment, and, along with the recovery in incomes, private consumption will increase, thereby bringing economic recovery led by domestic private demand. Although deflationary pressures will continue, and growth in real GDP will remain above growth in nominal GDP, the latter will rise to 1.3%, the first positive figure in five years. However, the recovery in private capital investment on a year-on-year basis will peak during fiscal 2002, and there is a possibility that the economy will slow in the latter half of fiscal 2002.

Exhibit 1: Real GDP Growth through Fiscal 2002



Source: Cabinet Office, *Annual of National Income Statistics*

3. Outlook for Components of Final Demand

(1) Assumptions Underlying the Forecasts

We have made the following assumptions in the preparation of these forecasts:

① *The World Economy*

In the United States, although real growth in fiscal 2001 will drop substantially to 1.6%, the effect of relaxation of monetary policy and tax reductions will begin to emerge by the year-end, and the economy will move toward recovery. However, since pressures for stock adjustments will remain strong, a sharp recovery is not expected, and real growth of 2.5% is forecast for fiscal 2002. (Please refer to section Outlook for the U.S. Economy at the end of this report.)

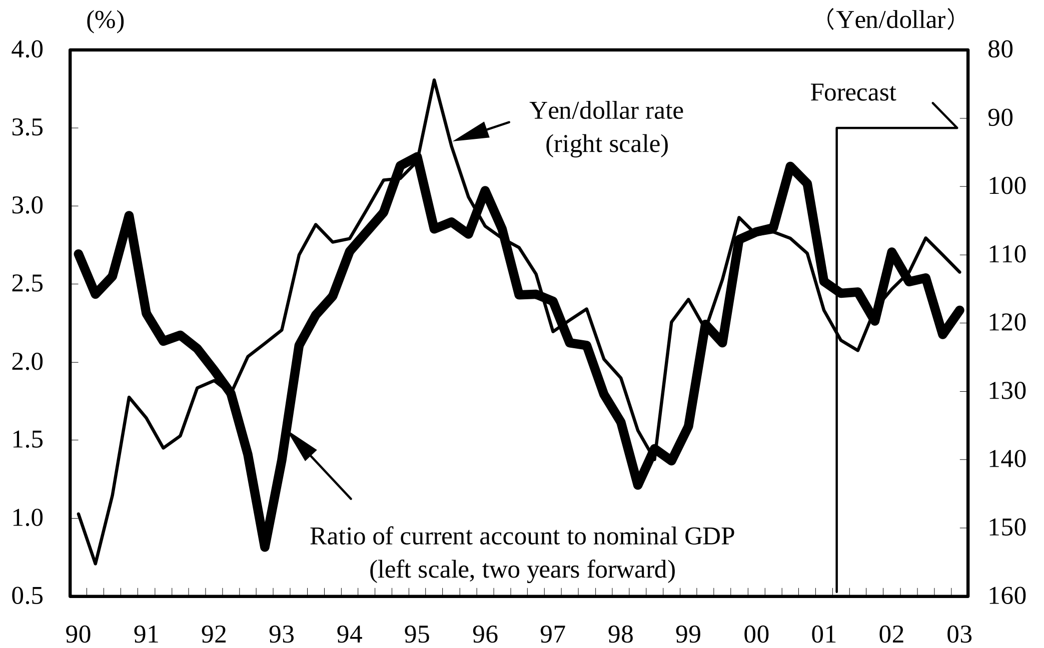
In Asia, the NIEs in particular, which have a high dependence on IT, are expected to show slower growth in 2001, and the nine countries and economies of the area are forecast to show real growth in the 5% to 5.5% range. In 2002, however, as a result of the improvement in the U.S. economy and other factors, annual growth will rise to the 6%-to-6.5% range.

The downturn in European economies is viewed as likely to be milder than in Japan and the United States. At present, although economic growth is slowing somewhat, the bottoming out of the world economy and the completion of inventory adjustments are expected to bring recovery in Europe from the end of 2001 and the continuation of strong conditions in 2002.

② *Foreign Currency Exchange Rates: ¥120 in Fiscal 2001 and ¥111 in Fiscal 2002*

The yen is likely to be relatively weak in the first half of fiscal 2001. Japan and the United States are expected to adopt additional monetary policy measures, but in contrast to the United States, which is nearing the final stage of the relaxation of monetary policy, Japan is expected to take further substantial measures to relax monetary policy. Since the Japanese economy is expected to show signs of recovery in the latter half of fiscal 2001, pressures to a stronger yen will rise, and, during the first half of fiscal 2002, the yen will continue to appreciate. However, the ratio of the current account balance of payments surplus to GDP will continue to decline, and we are expecting the yen to weaken again in the latter half of fiscal 2002.

Exhibit 2: Outlook for the Yen/Dollars Exchange Rate

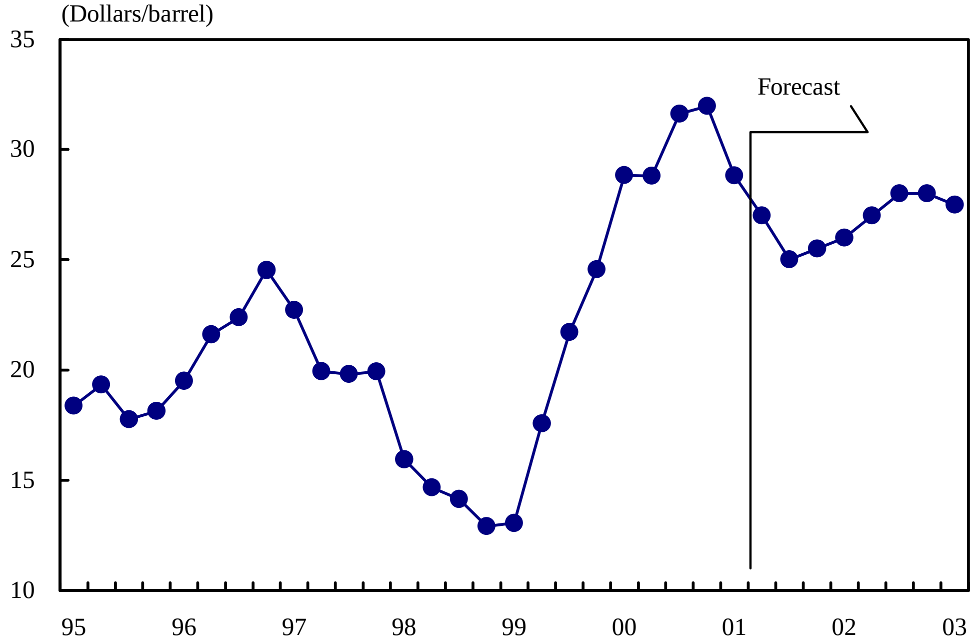


Sources: Bank of Japan, *Finacial and Economic Statistics Monthly, Monthly Balance of Paymens Statistics of Japan*; Cabinet Office, *Annual of National Income Statistics*

③ *Crude Oil Prices (WTI): $25.9/Barrel in Fiscal 2001 and $27.6/Barrel in Fiscal 2002*

Because of shortage of refining capacity, gasoline prices in the United States are rising, but, owing to the slowdown in the world economy, there is an excess of supply of crude oil, which is expected to lead to a weakening of oil prices. During the period of strongest demand in the October–December quarter of 2001, oil prices are expected to rebound, boosted by the bottoming out of the world economy, and continue to rise thereafter. However, development investment, which expanded during the period of sharp rises in oil prices, will bring a gradual increase in supply capacity. For this reason, crude oil prices are likely to be constrained in 2003. Although there will be certain factors disturbing the market, such as the suspension of oil exports by Iraq, as a result of the effect of the introduction of a price band system by OPEC, oil prices are expected to fluctuate generally within a narrow range.

Exhibit 3: Outlook for Crude Oil Price



Source: Cabinet Office, *Monthly Data on Overseas Economies* (annual, quarterly)

④ *Fiscal Policy*

Under the administration of Japan's Prime Minister Junichiro Koizumi, the trend toward the restructuring of government finances will gain momentum. In our previous forecast released in March, we assumed that the government would adopt additional economic measures to stimulate the domestic economy that would include ¥3 trillion in pump-priming expenditures. But, in this forecast, we have changed this assumption and assumed instead that no additional economic stimulus measures will be adopted. In addition, we have made the assumption that the issuance of new government bonds will be held to ¥30 trillion or lower in the budget for fiscal 2002.

⑤ *Monetary Policy*

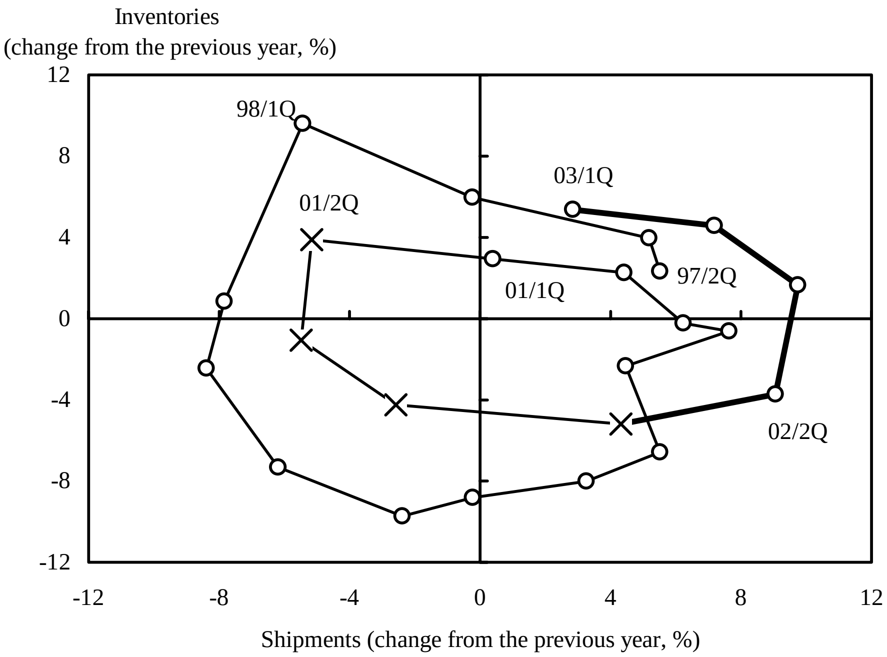
There is a possibility that additional measures aimed at the quantitative relaxation of monetary policy may be taken with the stated aim of dealing with the slowdown in Japan's economy or responding to the deflationary pressures arising from the disposal of nonperforming loans in the financial sector and the restructuring of government finances. This may imply that the Bank of Japan's objective for the balance of outstanding current account balances would be raised from the current ¥5 trillion into the ¥6 trillion to ¥7 trillion range. As a result, there is a possibility of a temporary rise in stock prices and a decline in the value of the yen, but the impact on the real economy is expected to be marginal.

(2) Trends in Components of Final Demand

① *Corporate Sector to Begin Recovery from the Latter Half of Fiscal 2001*

After current cutbacks, production will begin to rise in the latter half of Fiscal 2001. At present, industrial production is on a declining trend and is expected to fall for the second consecutive quarter in the April–June period. For fiscal 2001 at a whole, a decline of 2.6% is expected. Under the typical inventory cycle, even if production is restrained, since demand may fall more than expected, inventories rise and the industrial sector enters a period of “unintended increases in inventories.” Especially, manufacturers in semiconductors and steel as well as other industries have adopted policies of reducing output, and it appears that inventory adjustments have already begun in certain products. For the industrial sector as a whole, although production will be restrained because of inventory adjustments in the first half of fiscal 2001, output is likely to begin to increase again in the second half. If the slump in exports—which is the principal reason for the drop in production—continues, there is a risk that the inventory adjustment will be prolonged, but the U.S. economy, which has a major influence on exports, is expected to bottom out because of the favorable impact of interest rate reductions. As the U.S. economy begins to grow more rapidly, we believe Japan’s exports will recover and trends in industrial production will firm up.

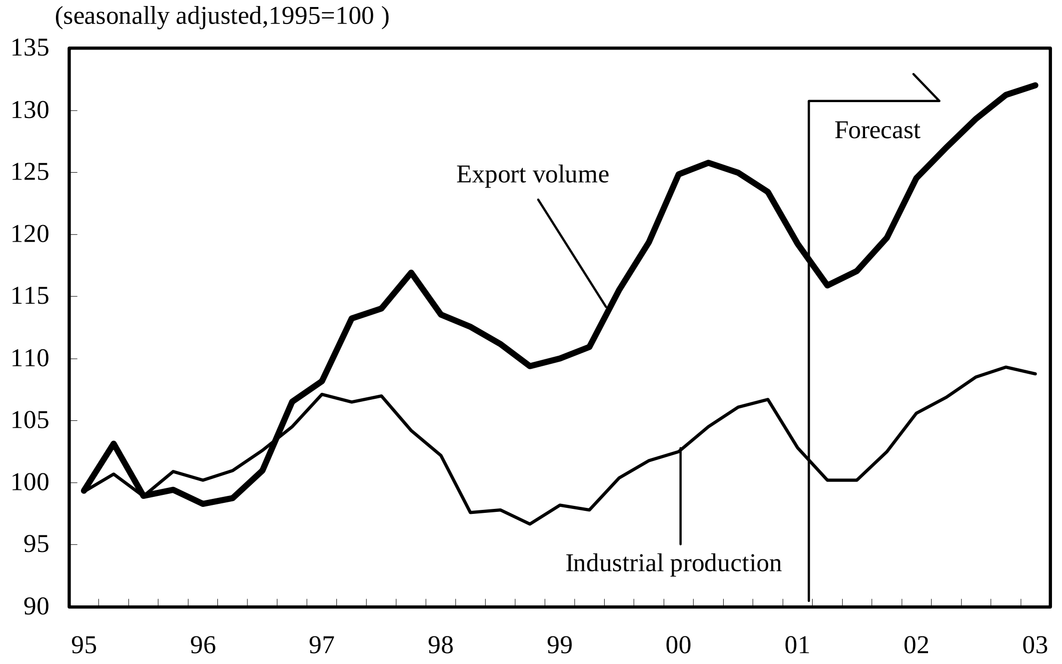
Exhibit 4: Inventory Cycle Movements



Note: Inventories are for the end of period. Figures from the second quarter of are forecasts.
Source: Ministry of Economy, Trade and Industry (METI), *Economic and Industrial Statistics*

Recovery in industrial production in fiscal 2002 will continue to be export-led, and, in midyear, the momentum for recovery in private capital investment, private consumption, and other components of domestic demand will increase, and the rate of increase in industrial production should rise. We are forecasting 6.1% growth in Japan's industrial production in fiscal 2001. However, in the latter half of the fiscal year, there is a possibility that signs of cyclical inventory investment may emerge.

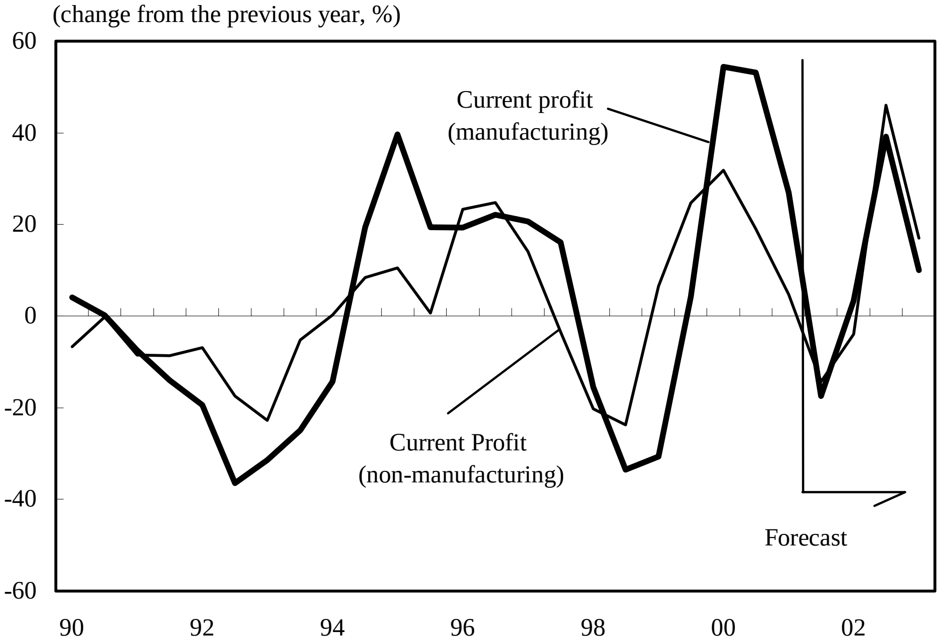
Exhibit 5: Outlook for Industrial Production and Exports



Sources: Ministry of Finace (MOF), *The summary Report on Trade of Japan* ; METI, *Economic and Industrial Statistics*

Corporate profitability will recover from the latter half of fiscal 2001, and companies will report higher sales and income for fiscal 2002. In fiscal 2001, corporations are forecast to show declines in sales and income. In the manufacturing sector, industrial production will drop in volume terms, owing to the decline in exports and inventory adjustments, and sales prices will fall because of deterioration in market conditions, thus leading to a marked drop in profitability. However, in the latter half of fiscal 2001, profitability will rise year on year as a result of the recovery in exports and industrial production. In the nonmanufacturing sector, the restraints on expenditures in the corporate sector and slow growth in incomes in the household sector will bring stagnant sales principally in services for the corporate and household sectors and in wholesaling/retailing. During the latter half of fiscal 2001 as well, corporations will find it difficult to increase profitability because of the continuing decline in prices, and there is a possibility that recovery in performance may lag behind that of the manufacturing sector.

Exhibit 6: Outlook for Corporate Performance



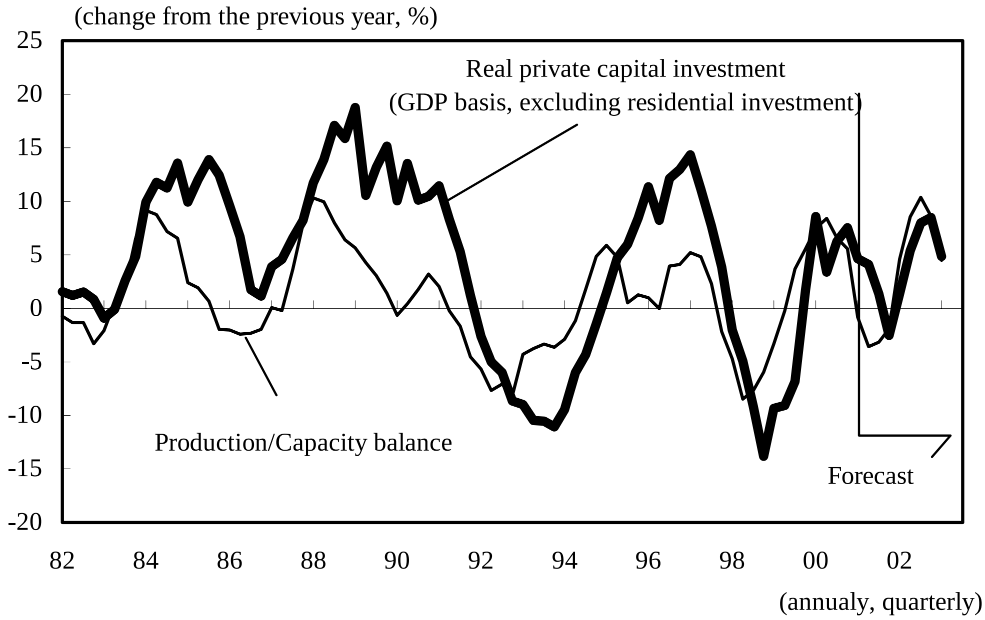
Source: MOF, *Quarterly Statistics on Incorporated Enterprises*

In fiscal 2002, both manufacturing and nonmanufacturing sectors are expected to show increases in sales and income. Although declines in prices will continue, sales in volume terms will rise. Cost-control efforts by corporations will have a positive impact and are likely to result in relatively high rates of growth in income.

Private capital investment to slow substantially in fiscal 2001 but show a higher rate of growth in fiscal 2002. In addition to the sudden drop in IT-related investments, including those in the semiconductor and other industries, small and medium-sized companies have become cautious about investing in plant and equipment. Capital investment in fiscal 2001 will therefore show a substantial decline compared with the previous year (to +0.9%). However, latent requirements for investment to replace production facilities are believed to remain high, especially in the manufacturing sector, and, as production and corporate profitability recover in the latter half of fiscal 2001, private capital investment is forecast to strengthen.

Recovery in private capital investment will continue in fiscal 2002 and the rate of growth will rise (to 6.7%). The demand for replacement of existing facilities, especially in the manufacturing sector, will continue, and, together with the bottoming out of the economy as a whole, is likely to bring a movement toward the expansion of private capital investment more broadly among small and medium-sized enterprises and companies in the nonmanufacturing sector. However, expansion in production is expected to peak during fiscal 2002, and, for this reason, the recovery in private capital investment, principally replacement investment, is likely to lose momentum in the latter half of the fiscal year.

Exhibit 7: Production/Capacity Balance and Capital Investment

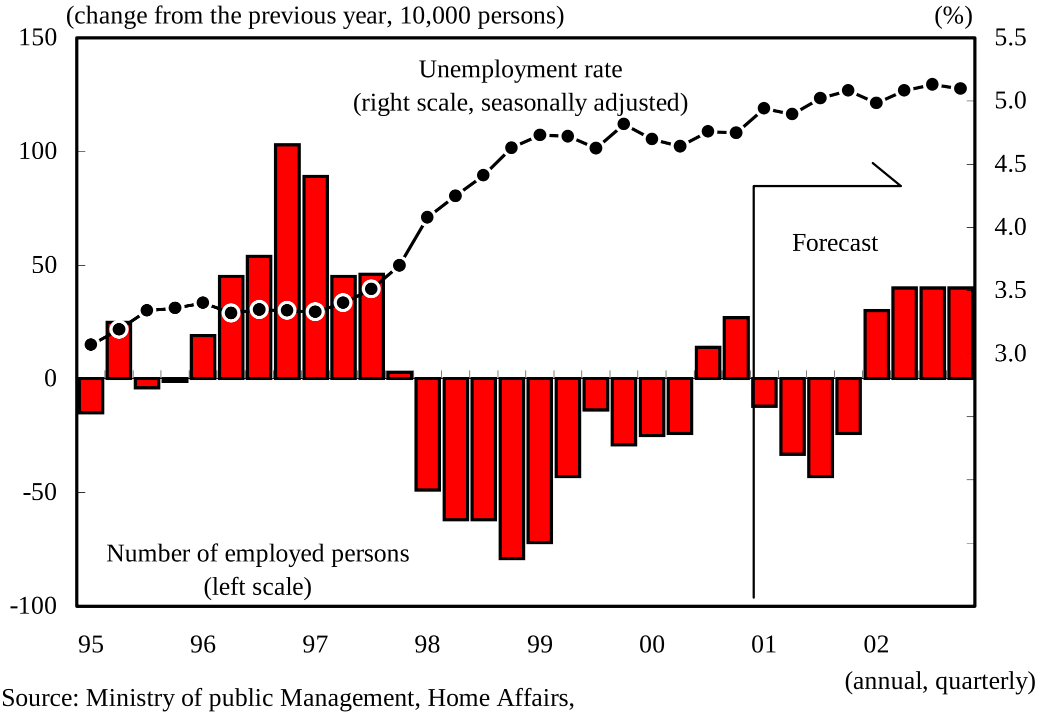


Note: Production/capacity balance is computed by subtracting the change in production capaci over the previous year from the change in production over the previous year.
Sources: Cabinet Office, *Annual of National Acounts* ;
METI, *Economic and Industrial Statistics*

② *Private Consumption to Gain Recovery Momentum*

Environment for employment and incomes Although the environment for employment and incomes had been on a gradual recovery trend, conditions have become severer again because of the sharp deceleration in the economy after the beginning of the year. Unemployment rates continue at historically higher levels. Most recent data show an increase in persons employed, principally part-time workers, but the ratio of active job openings to active job applicants has begun to decline again, and the employment environment during fiscal 2001 is expected to deteriorate as evidenced by declines in the number of persons employed and other indicators.

Exhibit 8: Unemployment Rate and Number of Persons Employed



Source: Ministry of public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey*

Corporations are taking a hard line toward employee compensation, and, even when corporate profits recover, this may not lead to growth in incomes. In particular, even though employee bonuses have become increasingly linked to corporate performance, the rate of increase in bonuses continues to be below the rate of growth in profits. Scheduled wages may rise slightly over the previous year and thus provide support for income levels, but non-scheduled compensation will be linked to production levels and may therefore decline. For this reason, total compensation may not begin to rise again until fiscal 2002 or thereafter.

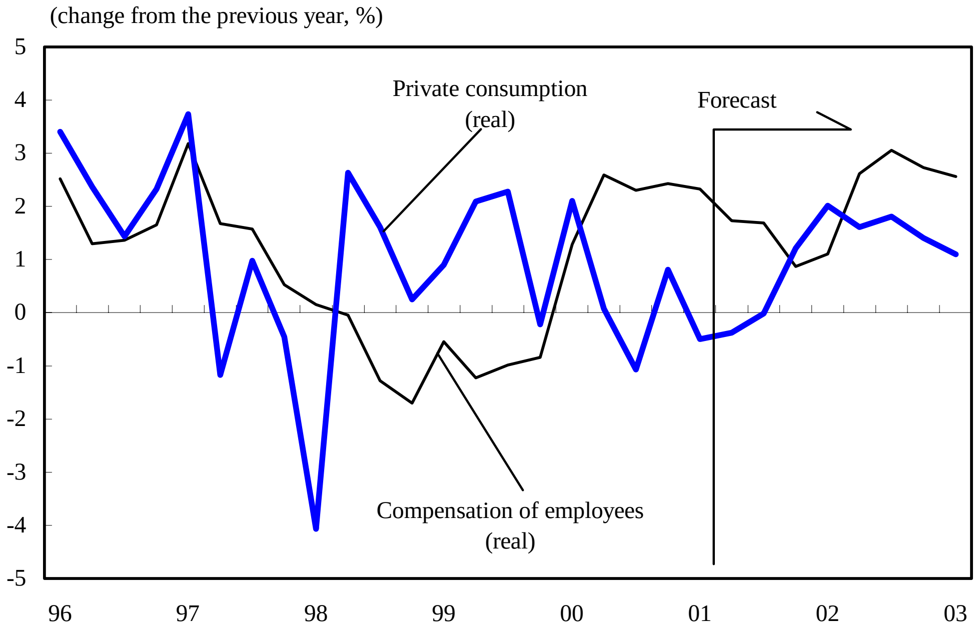
The share of labor may rise through the first half of fiscal 2001 because of the sudden deterioration in economic conditions, but as the economic recovery proceeds, corporate profits should rise, and, moving into fiscal 2002, the share of labor may decline, and the feeling that companies are overstaffed may be ameliorated.

Private consumption Stagnation in private consumption is expected to continue in the first half of fiscal 2001, as the margin of increase in incomes diminishes and the rebound following the surge in spending in anticipation of the implementation of the Household Appliance Recycling Law emerges. Ongoing concern about future economic prospects and the deterioration in consumer's sentiment are expected to put a brake on consumer spending. However, in the latter half of fiscal 2001, as industrial production bottoms out and signs of improvement in the economy emerge, consumer's sentiment is expected to brighten gradually, and signs of recovery in private consumption will be clearer and provide support for the economy as a whole.

In addition, as deflationary pressures continue, lower prices will increase real purchasing power and have a position impact on consumer spending.

Throughout fiscal 2002 as a whole, private consumption should remain firm, but the pace of improvement in employment conditions will weaken, and growth in consumer spending is expected to be within the limits of the increase in incomes.

Exhibit 9: Private Consumption and Worker incomes

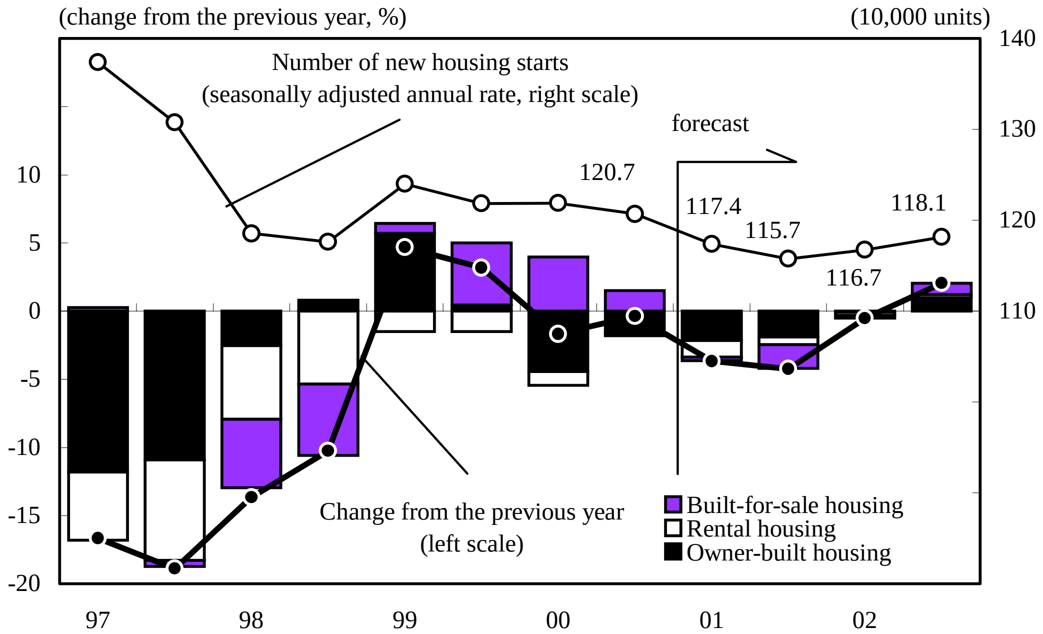


Source: Cabinet Office, *National Accounts* (annual, quarterly)

Residential investment In fiscal 2001, residential investment is expected to show a continued decline. The introduction of favorable tax treatment for housing loans beginning in fiscal 1999 boosted starts of condominiums and owner-built housing, but as time has passed since the introduction of these special tax measures, their effectiveness has diminished. The tax reduction for housing loans has been extended to cover those households that move into their new homes by the end of December 2003, but it is believed that latent demand for rebuilding of existing homes and purchasing new homes has been satisfied for the time being. We are therefore forecasting a continued decline in the number of housing starts in fiscal 2001. Although starts of condominiums will not drop significantly in the first half of the fiscal year, because of continued brisk sales at present, starts in the second half of the fiscal year will fall year on year. Starts of owner-built, built-for-rental, and built-for-sale home will remain at a relatively low level during the fiscal year.

In fiscal 2002, the level of housing starts should begin to rise along with economic recovery, and starts in the first half are forecast to move above those of the same period a year earlier. In addition, starts of condominiums will recover because of the continuing demand for prime properties and starts of owner-built homes, which have been restrained, will begin to rise again as incomes recover.

Exhibit 10: Outlook for Housing Starts



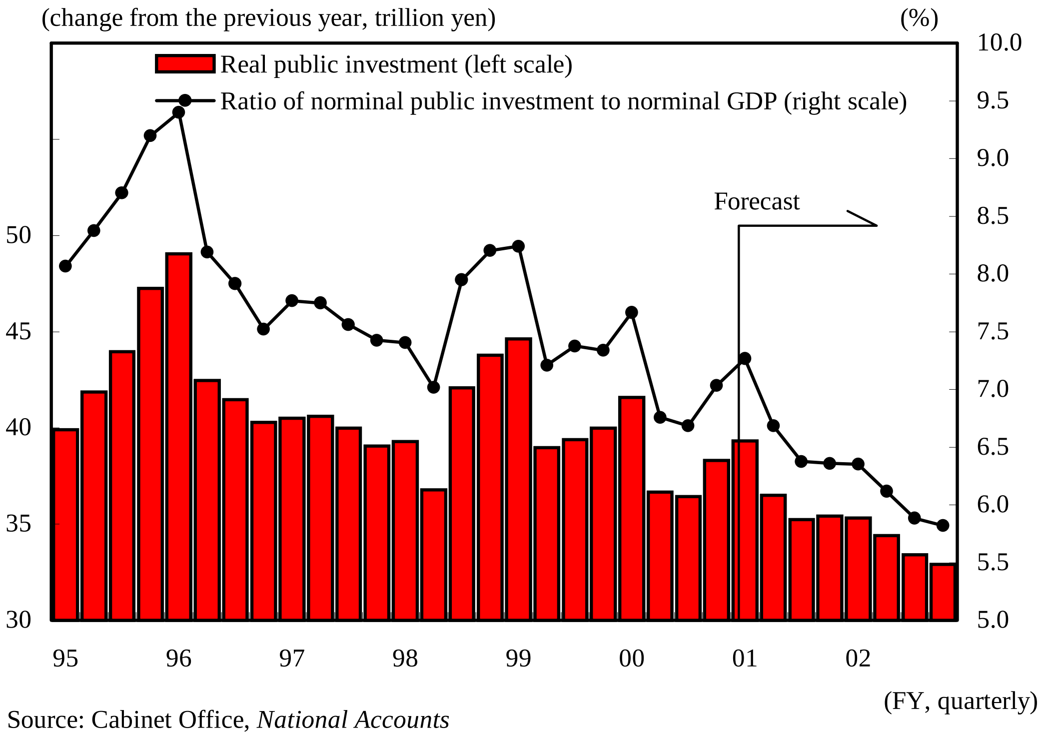
Source: Ministry of Land, Infrastructure and Transport, *Housing Construction Starts Statistics*

(annaul, semiannual)

③ *Public Investment Not Expected to Provide Support for the Economy*

Public investment During fiscal 2001, the effects of the supplementary budget passed in fall 2000 will run their course during the April–June quarter of 2001 and decline in the latter half of the fiscal year. Since the feeling of deceleration in the economy will become stronger, there are likely to be voices raised in favor of another economic stimulus package, but the Koizumi administration has set a goal of reducing the ratio of public investment to GDP in the medium-to-long term. For this reason, we have assumed that a supplementary budget would not be formulated to stimulate the economy. Accordingly, public investment will not increase toward the end of the year but will decline 4.2% for the fiscal year as a whole. Conditions at the local government level remain severe, and the decline in public investments commissioned by local government will continue. However, progress is being made to paring and focusing such investments through the cancellation of new projects, and, since a recovery in tax revenues is foreseen, the margin of shrinkage in local public investments may diminish in size.

Exhibit 11:Outlook for Public Works Investment



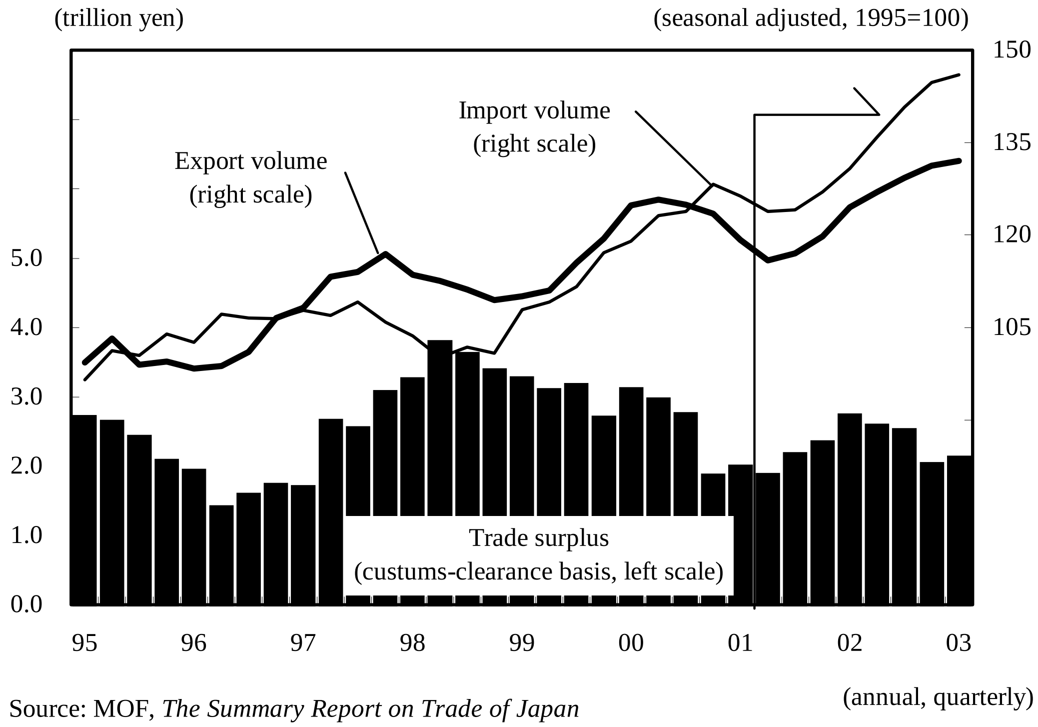
Source: Cabinet Office, *National Accounts*

To attain the government's goal of restraining new issues of national government bonds to ¥30 trillion in fiscal 2002, cutbacks in public investments will be unavoidable. For this reason, there is a possibility that the drop in public investments in fiscal 2002 will be the largest in postwar history (minus 6.8%).

④ *Contribution of External Demand to Be Negative in Fiscal 2001 but Positive in Fiscal 2002*

As demand in overseas economies weakens, Japan's exports, at present, are declining substantially. In particular, a major development is the stagnation in IT-related demand, including semiconductors, which previously had made a significant contribution to export growth. We forecast that exports will show little growth in the first half of fiscal 2001. In the latter half of the fiscal year, the effects of the relaxation of monetary policy will emerge in the U.S. economy, leading to improvement in conditions. Also, the boosting effect linked with the weakening of the yen since last year on export volumes will emerge, and exports are likely to recover. In fiscal 2002, although the yen may begin to strengthen, firm economic trends in the United States, Europe, and Asia will lead to a continuation of the increase in Japan's exports.

Exhibit 12: Outlook for Trade



Source: MOF, *The Summary Report on Trade of Japan*

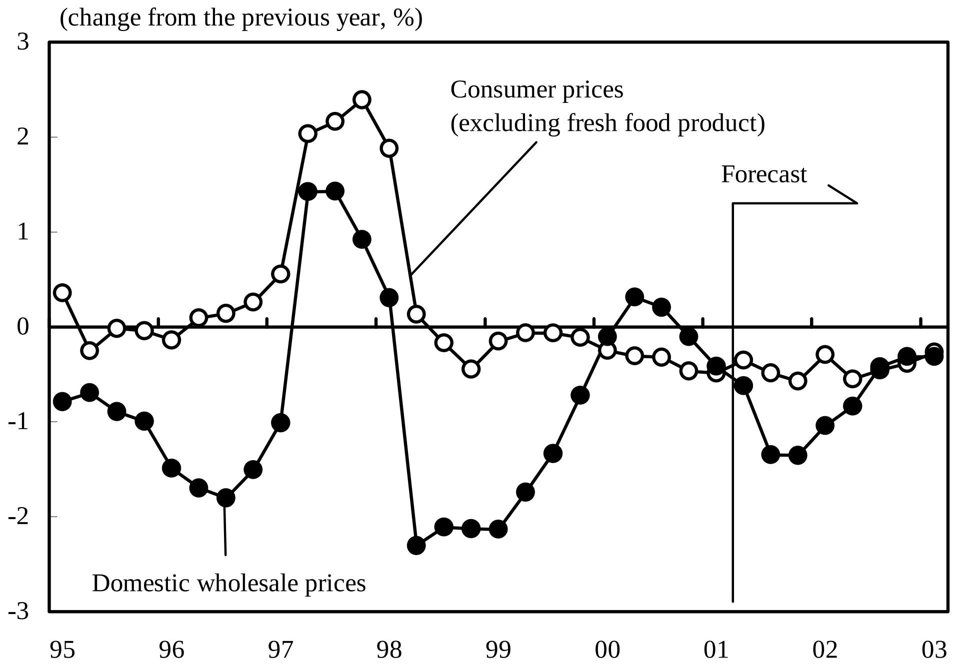
Imports will show movements similar to those in exports, and this trend will become even stronger as corporations move increasingly toward production systems that bestride national borders and undertake production in several areas. Although the underlying trend is for imports to make increasingly deeper inroads into the Japanese economy, thus facilitating further growth in imports, during the first half of fiscal 2001, imports are also expected to slow as the Japanese economy decelerates and the yen weakens. However, during the latter half, imports are likely to recover rapidly, due to firmer industrial production and other factors. In fiscal 2002, strong domestic demand and a strengthening of the yen will provide further impetus to the rise in imports.

The contribution of external demand in real terms in fiscal 2001 will be minus 0.1%, reflecting the sharp drop in exports. In fiscal 2002, as a result of the firm conditions in overseas economies, the contribution from external demand will become positive, but because of strong domestic demand in Japan, the contribution to real GDP will not be substantial, standing at an estimate +0.2%.

⑤ *Continued Deflationary Pressures*

The price of crude oil will remain at a high level in comparison with the 1990s, but market conditions for other commodities will be weak, owing to the deceleration of the world economy. As a consequence, the decline in domestic wholesale prices is expected to continue (–1.1% in fiscal 2001 and –0.5% in fiscal 2002). The consumer price index (nationwide, excluding fresh food products) will also continue to decline because of the drop in wholesale prices and weakness of demand (–0.4% in fiscal 2001 and –0.4% in fiscal 2002). Advances in technology, deregulation, the rise in low-cost imports, and other supply-side factors will give further impetus to the decline in prices. The GDP deflator will also continue to decline, and the rate of nominal GDP growth will remain below the real rate of expansion.

Exhibit 13: Outlook for Prices



Sources: BOJ, *Price Indexes Monthly*
; Ministry of Public Management, Home Affairs, Post and Telecommunications, *Monthly on Price Indexes*

4. Conclusion

Concern about a downturn in the Japanese economy is rising. This is because the slowdowns in the United States and the world economy as well as the drop in IT-related demand are having a negative effect on the Japanese economy. These trends were anticipated, but the rate of deceleration, at present, is faster than anticipated. As a consequence, it appears that the adjustment in the economy is likely to be greater than in 1995, when the adjustment in inventories did not lead to an economic downturn. Nevertheless, the current inventory adjustment will probably not be as large as the one in 1998, which resulted in a serious economic downturn. In 1998, inventories of both producers' and final demand goods had built up, but this time, although inventories of producers' goods have risen, those of final demand goods have not piled up.

The recent slowdown occurring in the Japanese economy has been due in substantial measure to the weakening of IT-related demand. Other sectors, at present, are not experiencing a sudden deterioration, partly because they have not benefited from recovery thus far. In production and private capital investment, the IT-related sector has led the slowdown; when the adjustment is completed, signs of a bottoming out in the economy should emerge. Moreover, when the world economy begins to recover, the economic recovery scenario in the latter half of fiscal 2001 should begin to seem more realistic.

Separate from these cyclical movements, progress toward structural reforms, including the restructuring of government finances and the final disposal of nonperforming assets, is increasingly being viewed as likely to increase deflationary pressures in the domestic economy. Certainly, as this forecast has also shown, if no additional economic measures (with about ¥3 trillion in pump-priming expenditures) are adopted, real economic growth in fiscal 2001 will be 0.3 percentage point lower than in the scenario where such measures are adopted. Nevertheless, public investment expenditures have been declining for several years already. Local public investment, which accounts for more than half of total public-sector investment, is continuing to decline, but as a result of the implementation of a series of major economic stimulus packages, expenditures at the national level have made up for the decline in local government project expenditures. Looking forward, public investment at the national level will fall, but the upper limit of ¥30 trillion on new issues of national government bonds is not sufficiently strict to bring a dramatic decline in public investment at the national level. On the other hand, the margin of decline in local government projects may, in fact, be reduced to some degree since construction projects have already been focused more clearly. The impact of the restructuring of government finances will be to bring a continuation in ongoing cutbacks in public investment, and we believe this will only result in a slight acceleration of these reductions.

Moreover, we cannot deny that final disposal of nonperforming assets carries with it the risk of bringing a sharp deterioration in the economy, but we believe this risk is probably not that serious. Financial institutions are already in the midst of making the final disposal of nonperforming assets (removing them from the balance sheet). The top 16 Japanese banks are being asked to make their final disposal of ¥11.6 trillion (as of

March 31, 2001) in distressed assets over a period of two years, but they disposed of ¥4.4 trillion in such assets during the latter half of fiscal 2000 alone. There is a possibility that the speed of disposing of these bad assets may increase, but the banks are not about to embark on some completely new course of action. Since the disposal of nonperforming loans will take place in parallel with corporate bankruptcies, if final disposal proceeds, the number of bankruptcies will rise and unemployment will increase. However, this does not mean that all employees in these companies will become unemployed. Some companies whose loans are written off may be restructured with the assistance of creditors, and the employees of some companies going out of business may be hired by companies in the same industry. On the other hand, some employees of companies that continue in operation may lose their jobs because of restructuring.

The crux of the problem is that, even if the bad assets are disposed of, the balance of nonperforming assets does not decline. In other words, as some bad assets are written off, others go sour and take their place. However, the point is not that new nonperforming assets emerge because other bad loans are disposed of, but that other loans become nonperforming because the economy does stage a robust recovery and land prices continue to drop. In short, future trends in the economy depend to a major extent on how much unemployment increases in the economy as a whole, rather than on the degree of progress toward the resolution of the nonperforming loan problem. In this sense, the risk of an economic downturn appears to be more closely linked with trends in overseas economies than on progress toward structural reforms in Japan.

【Summary of Forecasts for the Japanese Economy】

Forecasts

(change from the previous year, %)

	FY2000 First half	FY2000 Second half	FY2001 First half	FY2001 Second half	FY2002 First half	FY2002 Second half	FY2000 Actual	FY2001 Forecast	FY2002 Forecast
Nominal GDP	-0.8	-0.5	-1.5	0.0	1.6	1.0	-0.6	-0.7	1.3
Real GDP	0.8	1.0	-0.2	0.8	2.5	1.9	0.9	0.3	2.2
Contribution of domestic demand	0.1	1.4	0.4	0.6	1.9	2.0	0.7	0.5	2.0
Private consumption	-0.5	0.2	-0.2	1.6	1.7	1.3	-0.2	0.7	1.5
Residential investment	-2.8	-1.0	-6.4	-6.9	-0.7	3.1	-1.9	-6.6	1.2
Non-residential investment	3.0	6.0	2.6	-0.5	6.8	6.6	4.6	0.9	6.7
Government Spending	0.5	0.0	1.2	0.4	0.1	-0.1	0.2	0.8	0.0
Public investment	-6.5	-5.9	-2.8	-5.3	-7.8	-6.1	-6.1	-4.2	-6.8
Contribution of external demand	0.6	-0.2	-0.5	0.2	0.6	-0.1	0.2	-0.1	0.2
Exports of goods & services	13.3	5.5	-2.8	3.0	12.4	6.9	9.3	0.1	9.5
Imports of goods & services	9.9	9.6	2.2	1.4	9.2	9.5	9.8	1.8	9.4
Current account (trillion yen)	6.8	5.3	6.4	6.0	6.3	6.0	12.1	12.5	12.3
Trade balance (trillion yen)	6.7	4.8	5.2	6.1	6.2	5.5	11.6	11.3	11.7
Industrial production	6.3	2.5	-4.8	-0.7	7.5	4.8	4.0	-2.6	6.1
Wholesale price index (WPI)	-0.3	0.7	0.8	-0.9	-1.6	-0.5	0.2	-0.1	-1.1
Domestic WPI	0.3	-0.3	-1.0	-1.2	-0.7	-0.4	0.0	-1.1	-0.5
Consumer price index (CPI)	-0.7	-0.3	-0.2	-0.4	-0.7	-0.4	-0.5	-0.3	-0.5
CPI (excluding fresh foods)	-0.3	-0.5	-0.4	-0.4	-0.5	-0.3	-0.4	-0.4	-0.4
Yen-dollar exchange rate (yen/dollar)	107	114	123	117	110	111	111	120	111
Crude oil purchase price (dollars/barrel)	30.2	30.4	26.0	25.8	27.5	27.8	30.3	25.9	27.6
Spring wage increase	—	—	—	—	—	—	2.06	2.06	2.08

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

【Exports and Imports】

Forecast

(change from the previous year, %)

	FY2000 First half	FY2000 Second half	FY2001 First half	FY2001 Second half	FY2002 First half	FY2002 Second half	FY2000 Actual	FY2001 Forecast	FY2002 Forecast
Exports (yen basis)	8.4	6.0	1.5	5.1	8.7	7.5	7.2	3.3	8.1
Volume	10.7	-0.6	-7.1	0.7	10.0	7.8	4.8	-3.3	8.9
Importrs (yen basis)	14.5	18.3	10.1	0.5	5.8	12.7	16.4	5.1	9.3
Volume	11.9	7.8	0.3	1.3	11.7	12.8	9.8	0.8	12.2
Exports surplus (trillion yen)	5.8	3.8	4.2	5.0	5.2	4.2	9.6	9.2	9.4

【Income and Employment】

Forecast

(change from the previous year, %)

	FY2000 First half	FY2000 Second half	FY2001 First half	FY2001 Second half	FY2002 First half	FY2002 Second half	FY2000 Actual	FY2001 Forecast	FY2002 Forecast
Cash ernings of employees (per capita)	0.8	0.0	-0.4	-0.7	0.6	0.6	0.4	-0.6	0.6
Scheduled cash ernings*	0.6	0.0	0.1	0.1	0.3	0.3	0.3	0.1	0.3
Non-scheduled	5.3	3.0	-3.1	-0.5	6.0	4.0	4.1	-1.8	5.0
Number of employees	0.5	1.1	0.9	0.3	1.0	1.1	0.8	0.6	1.1
Compensation of employees**	1.4	1.2	0.6	-0.2	1.5	1.7	1.3	0.2	1.6
								Forecast	Forecast
Spring wage increase	—	—	—	—	—	—	2.06	2.06	2.08
Unemployment rate	4.7	4.8	4.9	5.1	5.0	5.1	4.7	5.0	5.1

Notes:

* Figures are for establishments of five employees or more, Ministry of Health, Labour and Welfair, Monthly Labour Statistics.

** Figures are spring wage increases compiled from data on the 290 companies listed on the First sections of the Tokyo and Osaka stock exchanges that have a lavor union and capital of 2billion yen or more as well as 1,000 or more employees.
(Compile dby the Ministry of Health, Labour and Welfare)

【New Housing Starts】

(10,000 units)

	FY2000 Actual	FY2001 Forecast	FY2002 Forecast
Number of new housing starts (change from the previous year)	121.3 (-1.1)	116.5 (-3.9)	117.3 (0.7)
Owner-built housing	43.8 (-8.0)	41.3 (-5.6)	41.8 (1.2)
Rental housing	41.8 (-1.8)	40.7 (-2.6)	40.7 (-0.1)
Built-for-sale housing	34.6 (11.0)	33.4 (-3.4)	33.8 (1.0)

【Summary Comparison with the Previous Ooutlook】

	Previous FY2001	Modification FY2001	Current FY2001
Real GDP	1.0	-0.7	0.3
Private comsumption	0.7	0.0	0.7
Residential investment	-5.4	-1.2	-6.6
Non-residential investment	0.8	0.1	0.9
Public investment	1.5	-5.7	-4.2
Contribution of external demand	0.1	-0.2	-0.1
Production	0.1	-2.7	-2.6

Outlook for the U.S. Economy

1. Monetary Policy and Tax Reduction to Bring Recovery toward the Year-End

Since the end of 2000, growth in the U.S. economy has slowed substantially. Real GDP growth in the October–December quarter of 2000 was 1.0% and then 1.3% in the January–March quarter of 2001, low by recent standards. Corporations have cut back production to make inventory adjustments, and mining and manufacturing production has fallen steadily since October 2000. Demand for labor has weakened significantly relative to supply, and unemployment has risen to 4.4% in May, compared with 3.9% in October. Similarly, profitability has declined and funding has become more difficult, while the margin of decline in private capital investment has widened.

The Federal Reserve Board (FRB) has adopted measures to relax monetary policy five times since the beginning of the year, and the target for the Federal funds rate has been lowered 2.5 percentage points. In addition, there is a strong possibility that a further reduction of 0.25 percentage point will be approved at the meeting of the Federal Open Market Committee (FOMC) scheduled for June 26 and 27.

The results of these monetary policies should emerge gradually, and a portion—$55.0 billion—of the $1.35 trillion reduction in income taxes approved for the next 10 years will be implement during 2001. These monetary and fiscal measures are expected to move the U.S. economy toward recovery toward the end of the year. Compared with previous periods of inventory adjustment, the manufacturing sector made production cutbacks at an earlier date, and reduction in excess inventories is proceeding steadily thus far. These developments suggest that production will bottom out during the summer and then begin to recover. The growth rate in the latter half of the year is forecast to rise to 1.7%, somewhat higher than the 1.0% recorded in the first half. Real GDP growth for the full year is estimated at 1.6%.

2. Outlook for 2002: Economy to Lack Strong Growth Momentum because of Lingering Pressures for Stock Adjustments

The temporary effect of the tax cut will push private consumption upward through the beginning of 2002. However, thereafter, the economy is forecast to lack strong growth momentum because pressures will remain for adjustments in the stock of consumer durable goods and IT-related capital stock. The stock of consumer durables of households (as of the end of 2000) appears to have recorded the highest rate of growth since the 1970s (according to estimates prepared by SRIC). If full-scale consumer durable stock adjustment begins, many simulations suggest that the flow of demand for consumer durables will be weak for two-to-three years. In addition, corporate IT investment rose substantially from 1999, just prior to the Year 2000 computer problem, through the first half of 2000. A full-scale recovery in IT-related investments is therefore not likely until the equipment purchased during this period is in need of replacement. As private consumption and capital investment will lack strong momentum because of these lingering pressures for stock adjustments, real GDP growth in 2002 will stand at only 2.5%, implying that growth in the U.S. economy will remain below its estimated potential of between 3.5% and 4.0% for two consecutive years.

＜Summary of the Outlook for the U.S. Economy＞

	CY2000(actual)		CY2001(forecast)		CY2002(forecast)		CY2000	CY2001	CY2002
	First half	Second half	First half	Second half	First half	Second half	Actual	Forecast	Forecast
Nominal GDP*	8.6	4.7	3.8	3.7	5.2	4.1	7.1	4.0	4.6
Real GDP*	5.9	2.7	1.0	1.7	2.8	2.7	5.0	1.6	2.5
Private consumption	6.0	3.7	2.4	1.6	2.7	1.7	5.3	2.5	2.2
Residential investment	2.0	-6.0	0.3	0.8	3.4	5.0	-0.5	-1.2	3.2
Private capital investment	16.4	7.3	-0.3	-2.3	1.7	4.4	12.6	1.0	1.3
Inventory investment**	-0.1	0.1	-1.7	0.4	0.3	0.3	0.2	-0.7	0.3
Net exports**	-0.9	-1.0	0.5	0.1	-0.2	0.1	-1.0	0.1	0.0
Exports	9.3	8.5	-3.0	1.1	2.5	5.0	9.0	0.8	2.8
Imports	13.3	12.5	-5.3	0.1	3.0	3.2	13.5	0.2	2.3
CPI (change from the previous year,	3.3	3.5	3.2	2.9	2.7	2.5	3.4	3.1	2.6
Unemployment rate (%)	4.0	4.0	4.3	4.7	4.6	4.6	4.0	4.5	4.6
Fiscal balance***	—	—	—	—	—	—	2362	2081	2240
Ratio to GDP (%)	—	—	—	—	—	—	2.4	2.0	2.1
Trade balance ($100 million)	-2085	-2262	-2099	-2024	-2092	-2117	-4347	-4123	-4209
Ration to GDP (%)	-4.2	-4.5	-4.1	-3.9	-3.9	-3.9	-4.4	-4.0	-3.9

Notes:
* Figures are annual rates computed from quarterly change in percent.
** Figures are percentage contributions.
*** Figures are a for the U.S. fiscal year, running from Octber through September of the following year.