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Forecast for the Japanese Economy
In Fiscal 2002 and Fiscal 2003

 **UFJ Institute**

Economic Research Department

1. Current State of the Japanese Economy

During the April–June quarter of 2002, the Japanese economy recorded 0.6% growth in real GDP over the previous quarter, the first increase in five quarters. In August, a new estimation method using supply side data was adopted, and figures for previous quarters were recalculated. However, even using the new method, GDP figures confirm that since the beginning of this year, the economy has shown a gradual recovery.

By demand component, first, the contribution of external demand in the April–June quarter rose 0.4% over the previous quarter and, as during the previous quarter, pushed the growth rate upward, thus suggesting that the recovery is being led by exports. In addition, private consumption rose 0.3% over the previous quarter and, while this was a relatively small increase, represented the third consecutive quarterly rise and showed that, despite the difficult employment and income conditions, consumption remains steady. Although private capital investment declined 0.4% from the previous quarter, thus posting the sixth consecutive quarterly decline, the margin of decline is diminishing. Private residential investment was down 0.8% from the previous quarter, the second consecutive quarter-to-quarter drop. Although there are signs that owner-built housing investment is beginning to level out, condominium starts are weakening. Public works investments slipped 1.9% from the previous quarter, and, while this was a relatively small decline, it represented the second consecutive quarterly decrease and reflected the absence of any beneficial impact from the government's supplementary budget that was passed in fall 2001.

As these GDP results suggest, there are clear signs that the Japanese economy has been recovering since the beginning of the year. First, although exports had been on a declining trend, along with the recovery in the world economy, Japan's exports stopped declining in December 2001 and have begun to increase, especially to the Asia and the United States. Along with the recovery in exports, industrial production reached bottom in November 2001 and has been on a rising trend subsequently; inventory adjustments were completed during the April–June quarter. Corporate profits have ceased their decline, reflecting the positive impact of

restructuring measures, and earnings estimates are being revised upward as exports are expanding at a faster rate than anticipated. Private capital investment is continuing to decline, but the margins of decline are shrinking, and orders for machinery equipment, which are a leading indicator for capital investment, have begun to bottom out.

The employment and income environments are unlikely to show any further deterioration. Unemployment rates remain at historically high levels, and the number of employees continues to be substantially below the level for the previous year. However, along with the upward trend in production, overtime compensation is recovering, and active opening rate (the ratio of job offers to job seekers) has increased slightly. Private consumption remains relatively steady, despite the severity of the employment and income environments. Factors supporting consumer spending are the recovery in consumer confidence since the end of last year, which has accompanied the recovery trend, and the mitigating effect of deflation on the severity of the income environment, as lower prices bring increased real purchasing power.

As these comments suggest, the trend toward recovery in the real economy is continuing but lacks robustness. Even if industrial production increases, expansion in sales remains weak in a deflationary environment, and this restrains recovery in corporate profits. Moreover, companies still have structural problems, including too many employees and excess production capacity. Thus, even if profitability improves, this will not likely bring significant improvement in the employment and income environments and recovery in capital investment will be limited. In addition, declining stock market prices may bring a rekindling of instabilities in the financial system, while strengthening of the yen may create concerns about a decline in profitability among exporters. These factors are prone to generate concerns about future trends in the economy.

2. Outlook for Fiscal 2002 and 2003

(1) Fiscal 2002 (Real GDP: +0.4%; Nominal GDP: -0.7%)

Possibility of Low, but Positive, Real Growth

Gradual recovery is likely to continue during fiscal 2002, and the economy will attain low, but positive, real growth. The U.S. economy is expected to slow, and exports to Asia, which are currently holding strong, will begin to decelerate, but Japan's exports will remain at a relatively high level. Along with the recovery in domestic industrial production, imports will also rise, but, for the fiscal year as a whole, external demand will make a positive contribution. Supported by high levels of exports, industrial production is expected to continue to rise, and the year-on-year rate of increase is expected to peak in the January–March quarter of 2003. Corporate profits, which are currently beginning to bottom out, are likely continue to recover due to contributions from the positive impact of restructuring and increases in sales. Following the recovery in production and profitability, capital investment is expected to show improvement, led principally by replacement investment and IT-related investment.

Recovery in employment and income conditions will lag the overall recovery in the economy. Along with the expansion in production, overtime compensation will continue to rise, but regular compensation and bonuses will remain below their levels of the previous year. The margin of decline year on year in the number of employees will diminish, but employment levels will not increase and the unemployment rate will remain high. As these comments suggest, the employment and income environments will continue to be severe, and private consumption will remain virtually flat. In the residential investment, although investment in owner-built homes will strengthen, condominium starts, which have been strong, will decline, thus bringing an overall decreasing trend. Public works investment will show further declines as the government moves forward with structural reforms in its finances.

(2) Fiscal 2003 (Real GDP: +1.2%; Nominal GDP: +0.5%)

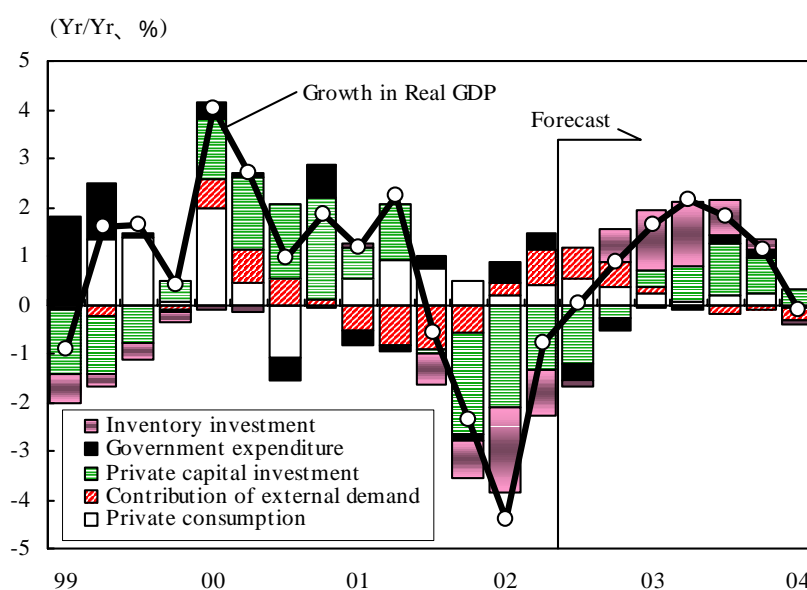
Positive Growth Will Continue but Will Slow in the Latter Half

Fiscal 2003 will begin with the recovery momentum of the previous fiscal year, and, while growth for the year will be positive, the rate of economic expansion is expected to decline gradually. The recovery in the United States and the world economy will continue, and exports will make a positive contribution to Japan's growth. However, along with recoveries in domestic demand and industrial production, imports will begin to rise at a faster pace, thus making the contribution of the external sector negative for the full fiscal year. As inventories rise over the previous year, the pace of increase in industrial production will diminish, and production levels in the second half of fiscal 2003 may drop below those of the first half. As the rate of expansion in production weakens, corporate profits may begin to stagnate, and current profit may drop below the levels of the previous year during the latter half of fiscal 2003. As production and profits decelerate, private capital investment may also decline. Consideration is being given to reductions in corporate taxes, including a tax cut linked to capital investment, and the possibility is growing that some kind of tax reduction will be implemented in fiscal 2003. However, the expansion in corporate cash flows owing to the tax reduction will not emerge until fiscal 2004, and the effect in fiscal 2003 is expected to be marginal.

The recovery in employment and income conditions is expected to strengthen in fiscal 2003. Regular compensation and bonuses are likely to rise above the previous fiscal year, reflecting the recovery in corporate profitability. In addition, although the number of self-employed workers is expected to continue to decline, the total number of employed persons will rise over the previous year, boosted by a higher level of employed workers. However, in the second half of the fiscal year, activity in the corporate sector is expected to begin to slow, and, as a result, recovery in the employment and income environments may be short-lived. In addition, disposable income will decline due to such factors as an increase in health insurance premiums accompanying reforms in the health care system and reductions in pension benefits. Therefore, despite the recovery in the overall economy, the income environment will not show significant

improvement, and this is likely to cause private consumption to remain level. There is a possibility that there may be a small surge in housing starts, principally in owner-built homes, prior to the expiration of the housing loan tax reduction provisions in December 2003, but this surge will be followed by a reactionary drop, and private residential investment will continue on a downward trend. Moreover, since the government is expected to move forward with its program of structural reforms in its finances, public works investment will also continue to decline.

Exhibit 1: Real GDP Growth through Fiscal 2002 and Fiscal 2003



Source: Cabinet Office, Annual of National Income Statistics

3. Outlook for Components of Final Demand

(1) Assumptions Underlying the Forecast

The following assumptions have been made in preparing this outlook.

(a) World Economy

It appears the U.S. economy entered an expansionary phase at the beginning of calendar 2002, but the pace of recovery in employment conditions and private capital investment has been slow, and growth for the year is expected to be about 2.3%. In 2003, growth is forecast to rise to

2.5% as the economy shows a strong recovery trend led by private capital investment supported by the emergence of demand for replacing the stock of IT-related capital equipment.

The economies of Europe's eurozone are forecast to begin to expand as the world economy improves and inventory adjustments are completed, but real growth is expected to amount to only 1.2% in 2002. In 2003, recovery in domestic demand, owing to improvement in the employment environment and other factors, is forecast to bring growth of 2.3%.

In Asia outside Japan during 2002, China is expected to continue to show high rates of growth above 7%, while Korea, Taiwan, and the other NIEs will recover as their exports expand. These developments will bring recovery in growth to 5.6% for the nine economies of the region. In 2003, strong external demand will have a positive impact on private consumption and capital investment, thus bringing higher growth of 6.1%.

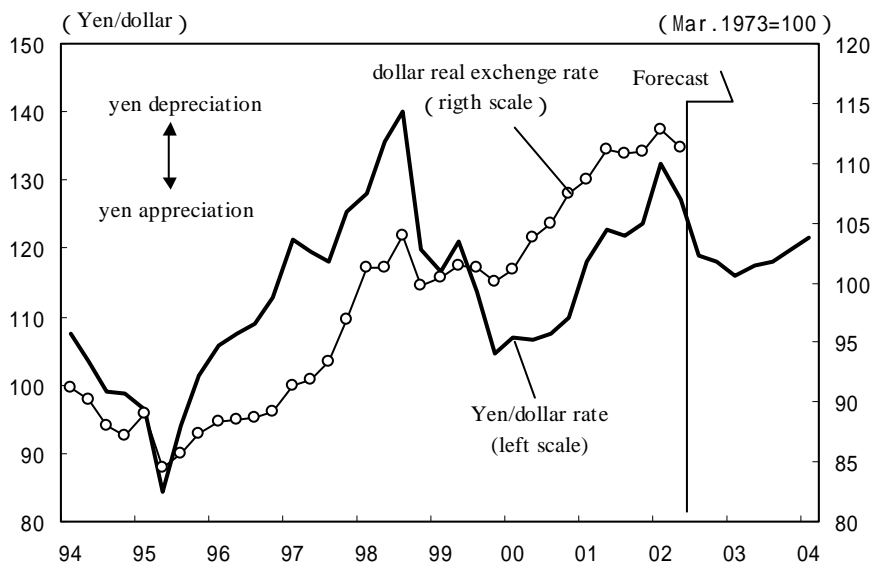
(b) Exchange Rates

The yen/U.S. dollar exchange rate, which had been fluctuating around ¥130 to the U.S. dollar, appreciated temporarily to ¥122 in the end of May 2002, owing to expectations of economic recovery in Japan versus concerns about future trends in the United States. Thereafter, the yen moved to the mid-¥120s, owing to intervention by Japan's monetary authorities a total of seven times from the end of May through the end of June. However, after the beginning of September, even though Japanese stock prices dropped sharply, growing tensions in the Middle East, the expansion in the U.S. current account deficit, and other factors prompted the sale of dollars, and the yen moved into the ¥117 to ¥118 range.

During the remainder of fiscal 2002, as uncertainty about economic trends in the United States grows and the recovery trend in Japan becomes clearer, we forecast the yen will remain strong. In fiscal 2003, we anticipate that the upward trend in the United States will strengthen as the pace of expansion in Japan begins to slow in the second half of the fiscal year. For this reason, we forecast the yen may begin to weaken, but we forecast the

yen to remain mainly in the ¥116 to ¥122 range without major fluctuations.

Exhibit 2: Outlook for the Yen-Dollar Exchange Rate



Sources: Bank of Japan, Financial and Economic Statistics Monthly, Monthly Balance of Payments Statistics of Japan; Cabinet Office, Annual of National Income Statistics

(c) Crude Oil Prices (West Texas Intermediate (WTI), following month futures price)

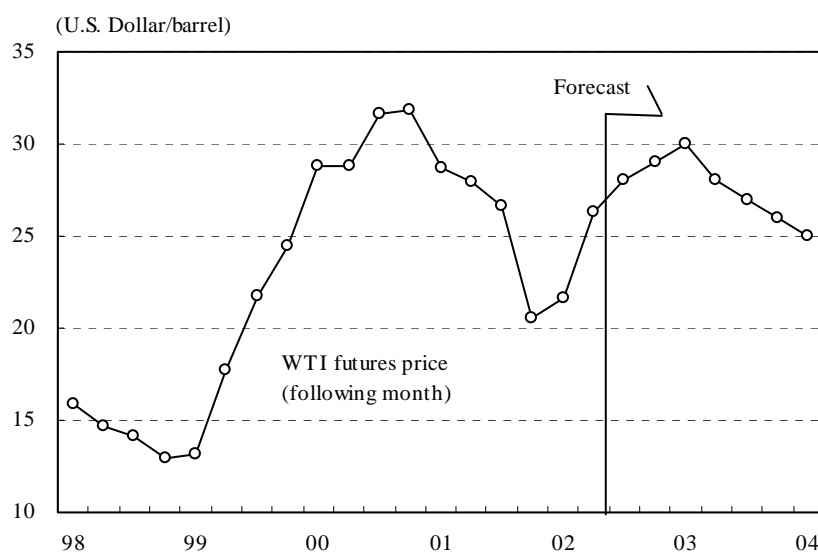
Crude oil prices (WTI) began to rise gradually beginning in early spring 2002, boosted by cooperative production cutbacks by OPEC and non-OPEC oil producers and expectations of a recovery in the world economy. Subsequently, some non-OPEC producers abandoned the cooperative arrangements, and oil prices jumped temporarily to \$30 a barrel in August due to the impact of the Israeli attacks on Palestine and concerns about U.S. military action against Iraq. Tensions between the United States and Iraq are continuing, and oil prices have remained high, in the upper half of the \$20 to \$30 range.

Views have been expressed that the timing of any attack on Iraq would be some time between the end of 2002 and early 2003, but the hurdles to be overcome before an attack can be mounted on Iraq are high. These include

the difficulties the United States faces in gaining the support of its allies, the concern that an attack on Iraq would ignite anti-U.S. sentiment in Arab countries, and voices of caution even within the United States. In forecasting future oil prices, we assume that there will be no major, prolonged attack on Iraq. Regarding the timing of a relaxation of OPEC's production cutbacks, it appears that some OPEC members are already breaking ranks and increasing production. According to the International Energy Agency(IEA), production by 10 OPEC countries in July was already about 1.5 million barrels per day over the production limit. We believe that a decision will be made at the OPEC general meeting in December to recognize current production increases.

Since expectations of an attack on Iraq around the beginning of 2003 may grow, oil prices may rise toward \$30 a barrel, but provided the military action is not large-scale or prolonged, oil prices are likely to settle down in 2003 as the flow of speculative funds temporarily boosting oil prices subsides. From the perspective of supply and demand, although demand is expected to expand along with the recovery in the world economy in 2003, growth in supply—owing to increases in OPEC production and expanded production capacity in non-OPEC countries—is expected to exert downward pressure on crude oil prices.

Exhibit 3: Outlook for WTI Crude Oil Price



(d) Government Fiscal Policy

We assume that the Japanese government will not add to its public works investments through a supplementary budget in fiscal 2002 as it did in the previous fiscal year. In fiscal 2003, we expect the government to maintain a stringent fiscal budget, involving not only cuts in discretionary expenditures, such as public works spending and ODA but also reductions in non-discretionary expenditures, which will require systemic changes, such as social welfare and the funding of certain local government expenditures. Prime Minister Junichiro Koizumi has announced plans for an accelerated tax cut on the one hand, but he has not changed his basic stance of restructuring government finances, including a neutral tax structure in the medium term. As the economic recovery is making progress, it would be difficult to imagine additions to fiscal expenditures for the foreseeable future. National government expenditures will, therefore, continue to be restrained, along with those of local governments, which are also experiencing difficult financial conditions.

(e) Tax Reform

Prime Minister Koizumi has announced his intention to implement a tax reduction of more than ¥1 trillion in fiscal 2003. It is expected that the tax cut will be implemented primarily for corporations, and two specific proposals have been announced. One, submitted by private-sector and other members of the Council on Economic and Fiscal Policy, calls for a reduction in the effective corporate income tax rate, and the other, originating from the Government Tax Commission, is an R&D and capital investment linked scheme that would allow companies to deduct a specified amount of their expenditures for R&D and capital investment from their tax payment obligations. For our current forecast, we have assumed that an R&D and investment linked tax credit will be introduced for a period limited to three years beginning in fiscal 2003, with effective tax reductions amounting to more than ¥1 trillion in each of these years. We have selected the tax credit as our assumption because we believe Koizumi will maintain his policy of restructuring government finances and because there is a strong possibility that lowering the effective corporate tax rate

would become a permanent measure. Among other tax relief measures, other than those for the corporate sector, measures are under consideration to encourage parents to transfer a portion of their assets during their lifetimes to their children. For example, if a person 65 years of age or older transfers assets to a wife or husband and children prior to death, the exemption for donation tax will be increased, and, after heirs receive their inheritances, donation tax paid during the lifetime of the giver will be deducted from inheritance tax. This would effectively combine the donation and inheritance taxes. In addition, a reduction in the maximum inheritance tax rate is viewed as a measure likely to be enacted. We have assumed for our current forecast that, beginning in fiscal 2003, the combination of donation and inheritance taxes and the reduction in inheritance tax rates will be implemented.

In fiscal 2003, prospects are that certain tax increases will also be carried out along with tax reductions. First, for households, the Government Tax Commission is considering the elimination of the special exemption for spouse and the simplification of various measures for increasing and adding deductions for specified dependents. If the special exemption for spouse and deductions for specified dependents are completely eliminated, this is expected to amount to an effective tax increase of about ¥1 trillion (according to data issued by the Government Tax Commission). However, since a sudden increase in the tax burden might have a negative effect on the economy, there is a strong possibility that these various deductions will be reviewed and phased out step by step. For our current forecast, we have assumed that any increase in taxes resulting from the review and revision of deductions in fiscal 2003 will be limited to ¥100 billion. In addition, for corporations, consideration is being given to lowering the minimum for exemption from the payment of consumption taxes. The exemption of companies with a certain minimum level of sales has been criticized as giving smaller business the opportunity to collect the consumption tax but imposes no obligation on them to pay the taxes they collect to the government. Prospects are for the reduction of the minimum level of sales for exemption from payment from ¥30 million at present to ¥10 million in fiscal 2003, thus increasing the tax burden on smaller companies.

(f) Monetary Policy

The Bank of Japan (BOJ) is continuing its policy of quantitative relaxation of the monetary base, which was adopted at the Monetary Policy Meeting held on March 19, 2001. At the December 19, 2001, Monetary Policy Meeting, the target for current deposits was increased to between ¥10 trillion and ¥15 trillion, and this target remains unchanged. However, concerns are growing about the stability of the management of financial institutions and the financial system because of the sharp drop in stock prices since the beginning of the year. For this reason, on February 28, 2002, it was decided at the BOJ's Monetary Policy Meeting to substantially increase liquidity in excess of the target level, with the objective of maintaining stability in financial markets as the calendar year-end approaches. At the same time, the decision was made to increase the amount of purchases of long-term Japanese government bonds (JGBs) from ¥800 billion to ¥1 trillion per month. Subsequently, along with the recovery in the economy, the balance of BOJ current deposits has returned to its upper target limit of ¥15 trillion. Along with this development, requests for further monetary easing by the BOJ have receded.

Consumer prices (excluding fresh foods) are expected to continue their declining trend year on year, and the monetary policy of quantitative relaxation will continue throughout fiscal 2003. At present, just prior to the end of the interim accounting period in September, the margin of decline in stock prices is beginning to widen again, and there is a possibility of a reignition of uncertainty about the financial system. For this reason, requests for additional monetary relaxation may grow strong once again. In addition, from the perspective of the real economy, when growth begins to slow in the latter half of fiscal 2003, there will also be a possibility of stronger requests for a further relaxation of monetary policy. Specifically, further monetary relaxation measures may include raising the BOJ's current deposit target, increasing purchases of JGBs from the market, introducing inflation targeting, and purchasing assets other than JGBs, such as commercial paper, corporate bonds, and foreign securities. One or more of these policies may actually be adopted, but while this may have an impact on financial markets, the impact on the real economy will be marginal.

(2) Trends in Demand by Category

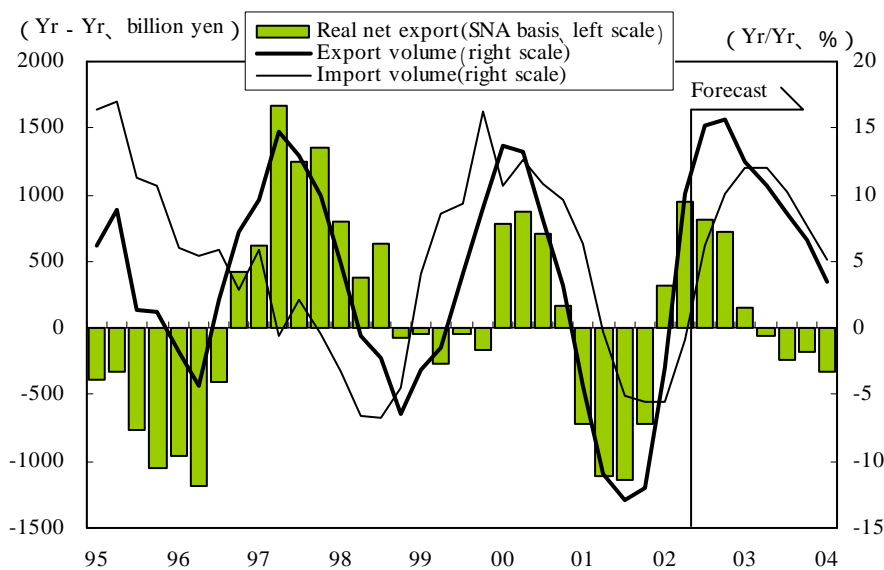
(a) Exports Will Remain at a High Level, and Recovery Will Be Led by External Demand. The Contribution of the External Sector Will Gradually Diminish as Imports Expand.

Exports at present are on an upward trend, led especially by shipments to the rest of Asia. The increase in exports to Asia is accounted for not only by shipments of intermediate goods to overseas subsidiaries of Japanese companies but also by exports of final demand goods boosted by strong domestic demand in Korea, China, and other Asian countries. Moreover, exports to North America, especially transportation equipment, are holding firm. The total value of exports is expected to remain on an upward trend throughout fiscal 2002, supported by strong exports to Asia and North America. After the beginning of fiscal 2003, although a moderate upward trend will continue, a major surge is not expected, in part because of the appreciation of the yen in fiscal 2002. In the latter half of fiscal 2003, growth will slow.

Recovery in imports has lagged that of exports because of weakness in domestic demand, but as domestic demand gains strength and industrial production expands, this will bring an increase in imports of intermediate goods, and, in the latter half of fiscal 2002, a rising trend in imports is expected to emerge. This upward trend is expected to continue throughout fiscal 2003. Structural factors, such as the rising penetration of imports and the increase in imports from Japanese production facilities overseas (reverse imports), will also work to boost imports.

The contribution of external demand will rise substantially from -0.5% in fiscal 2001 to $+0.5\%$ in fiscal 2002, as the recovery in exports precedes the rise in imports. In fiscal 2003, the contribution of external demand will drop to a small negative figure, -0.1% , in fiscal 2003 because of the increase in imports.

Exhibit 4: Outlook for Trade



Source:MOF,The Summary Report on Trade of Japan

(b) Corporate Sector to Remain Firm but Slow in the Latter Half of Fiscal 2003

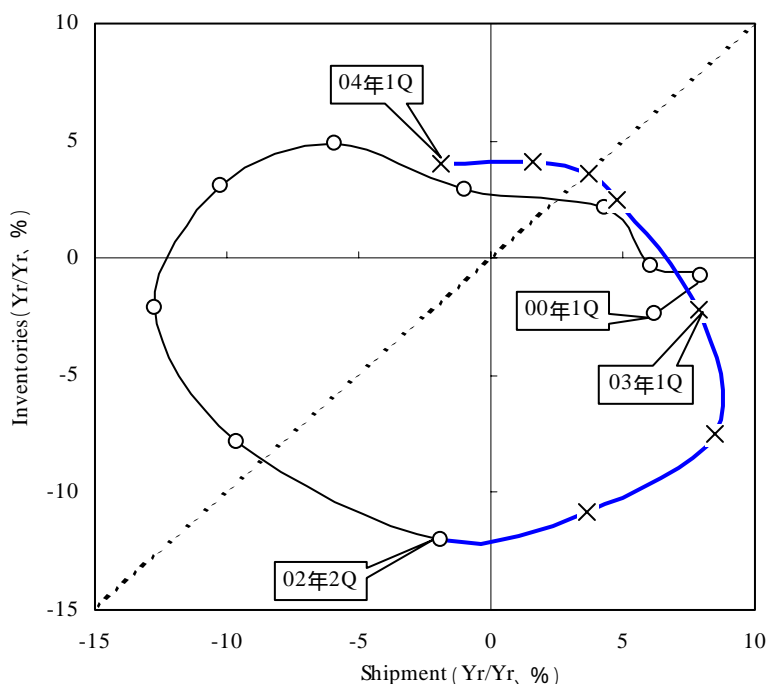
Production: Tempo to Slow but the Upward Trend Will Continue

Growth in exports, especially to Asia, is continuing to be firm, and recovery in production led by external demand is proceeding. Industrial production rose 3.8% from the previous quarter in the April–June period of 2002, the second consecutive quarterly increase. Inventory adjustments have already been completed, and companies are experiencing unintended inventory depletion. However, since domestic demand still lacks robustness, there is a possibility that the pace of recovery may become more moderate, but we expect a continued rise in production supported by the restocking of inventories and the impact of the bottoming out of capital investment. In addition, although production of semiconductors and other IT-related goods staged an early recovery and acted as a driving force, the recovery trend is spreading to other industries.

Moving into fiscal 2003, however, production will slow once again. Since private consumption and capital investment lack strong recovery momentum, there will be limitations to recovery in production led by external demand because the economy will enter a cyclical adjustment

phase. In the latter half of fiscal 2003, there is a possibility that production levels may show a decline from the first half and inventories will begin to accumulate.

Exhibit 5: Inventory Cycle Movements



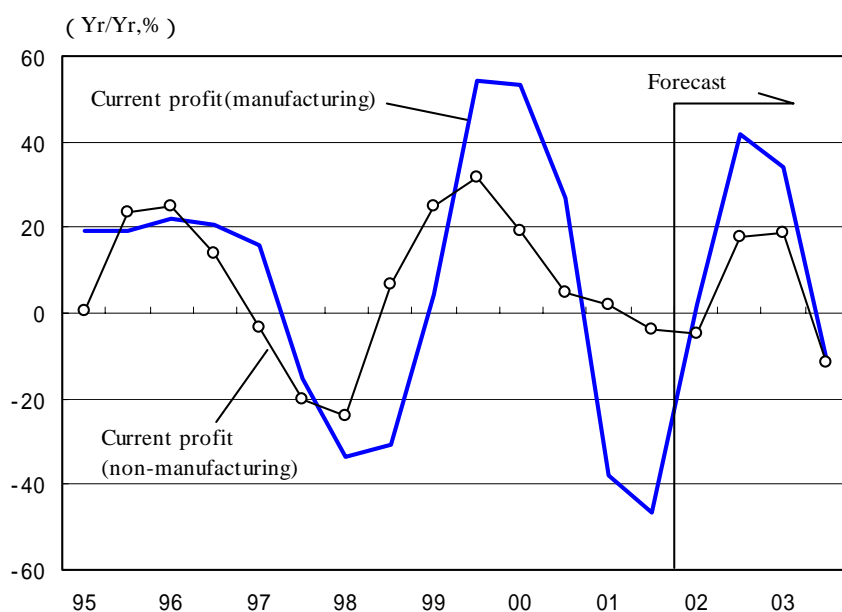
Note: Figures from the first quarter of 2002/3Q are forecasts.
 Source: Ministry of Economy, Trade and Industry (METI), Economic and Industrial Statistics

Corporate Profits: Fast Recovery in the Latter Half of Fiscal 2002

Profitability is recovering in both the manufacturing and non-manufacturing sectors. Current profits (according to Financial Statements of Corporations by Industry issued by the Ministry of Finance) in the April–June quarter of 2002 were three consecutive quarters of increases in the manufacturing sector and down slightly two consecutive quarters of gains in the non-manufacturing sector. Although prices are continuing to decline in the manufacturing sector, increases in volume are contributing to an overall recovery in sales. Moreover, the positive impact of restructuring measures, including cutbacks in personnel costs in both manufacturing and non-manufacturing sectors, is contributing to improved profitability. Recovery in corporate profits is forecast to continue

throughout fiscal 2002, and increases in net sales and net income are both likely to be substantial. This upward trend will continue through the first half of fiscal 2003. However, during the second half of fiscal 2003, sales growth may begin to slow because of weakness in domestic demand, and corporate profits will begin to decline. The burden of fixed expenses, including personnel costs, will rise, putting pressure on profitability.

Exhibit 6: Outlook for Corporate Performance



Source:MOF,Quarterly Statistics on Incorporated Enterprises

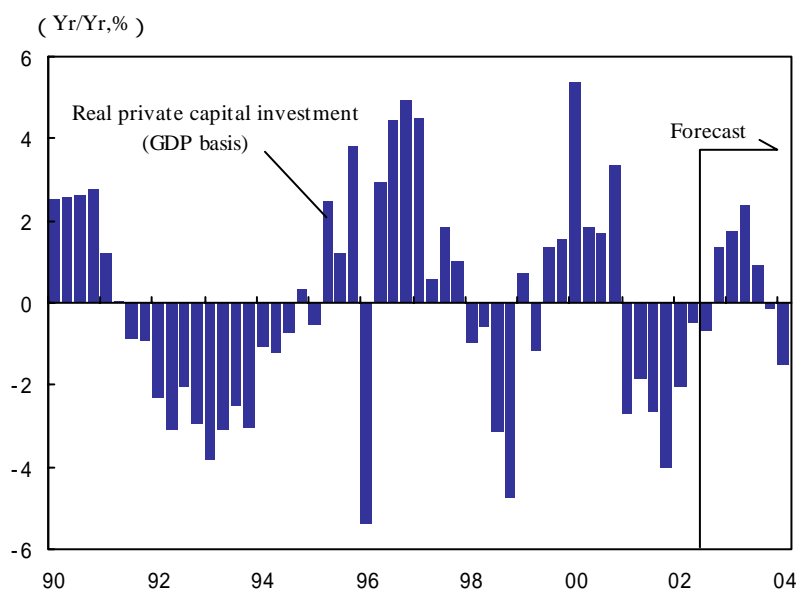
Private Capital Investment: Recovery Trend to Emerge in the Latter Half of Fiscal 2002, but Recovery Momentum Will Be Weak

There are signs of a bottoming out in capital investment. Orders for machinery and equipment (excluding private-sector orders from the shipping and electric power industries), which are a leading indicator for capital investment, rose 7.1% in the April–June period over the previous quarter. Excluding one quarter when machinery orders were virtually level, this was the first increase since the October–December period of 2000. The prospect for orders in the July–September quarter of 2002 is for a decline of 3.9%. Although this might appear to be a return to a declining trend, as data for machinery and equipment orders during previous bottoming-out periods shows, there is a possibility that actual orders may exceed the prospect.

Recovery in capital investment is expected to continue through the first half of fiscal 2003. However, as domestic demand lacks robustness, we suppose corporations will continue to show caution in expanding production capacity, and there is a possibility that investment may be largely confined to the replacement of existing facilities and IT-related capital outlays. Even if companies undertake investment in new plant and equipment, they may make these investments at overseas production basis, principally in Asia outside Japan. In addition, corporations may use their cash flow generated by improvements in profitability to repay outstanding debt. As production slows and corporate profitability weakens in the latter half of fiscal 2003, corporations are likely to adopt a more conservative stance toward capital investment, suggesting that the rise in investment may be small in scale and rather brief.

Regarding the impact of the proposed tax credit for capital investment, the related measures will be implemented in fiscal 2003, but the full effect will not emerge until fiscal 2004, when corporations begin to experience an increase in cash flows from this tax measure. In fiscal 2003, there may be some boost in anticipation of the tax-saving effect, but we estimate that this will amount to only about 0.3% point increase in investment for the fiscal year.

Exhibit 7: Private Capital Investment



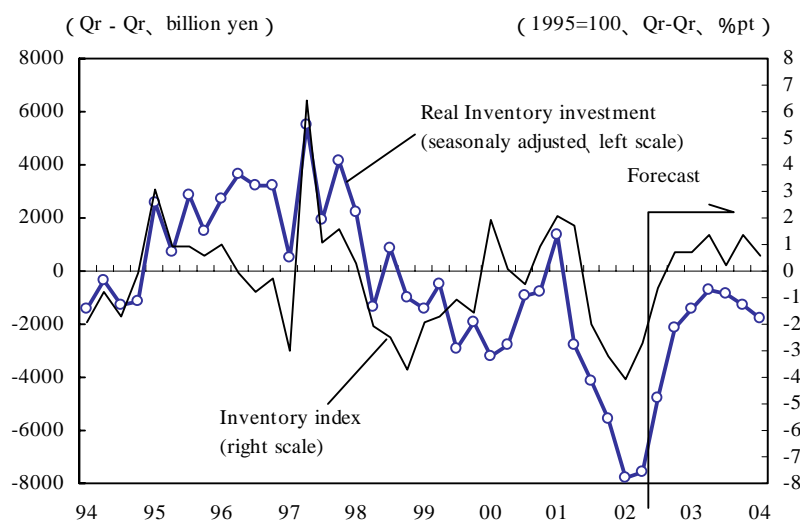
Inventory Investment: Positive Contributions to Growth in Fiscal 2002 and 2003

As a result of the introduction of new methods for GDP estimation, private inventory investment, which had shown only small movements in the past, now has a greater impact on the overall GDP. For example, under the previous method of estimation, the contribution of inventory investment in fiscal 2001 was only -0.1% , but using the new method, this figure was adjusted downward to -0.8% .

During the first half of fiscal 2002, unintended inventory depletion continued in the manufacturing sector, but as the rate of decline in inventories has slowed, inventory investment made a positive contribution compared with the previous six-month period. For the second half of fiscal 2002, we expect companies to step up their accumulation of inventories, leading to a further decline in the rate of inventory depletion. As a result, the contribution of inventory investment for fiscal 2002 as a whole will rise to $+0.2\%$.

Moving into fiscal 2003, because of weakness in domestic demand, companies will begin to experience the unintended accumulation of inventories, and a trend toward adjusting inventory levels may emerge. However, since reducing inventories will take time, the contribution of inventory investment for fiscal 2003 as a whole will rise above the previous fiscal year, to $+0.5\%$.

Exhibit 8: Inventory Investment



Sources: Cabinet Office, Annual of National Accounts;
METI, Economic and Industrial Statistics

(c) The Employment Environment Will Improve, but Recovery in the Household Sector Will Be Marginal.

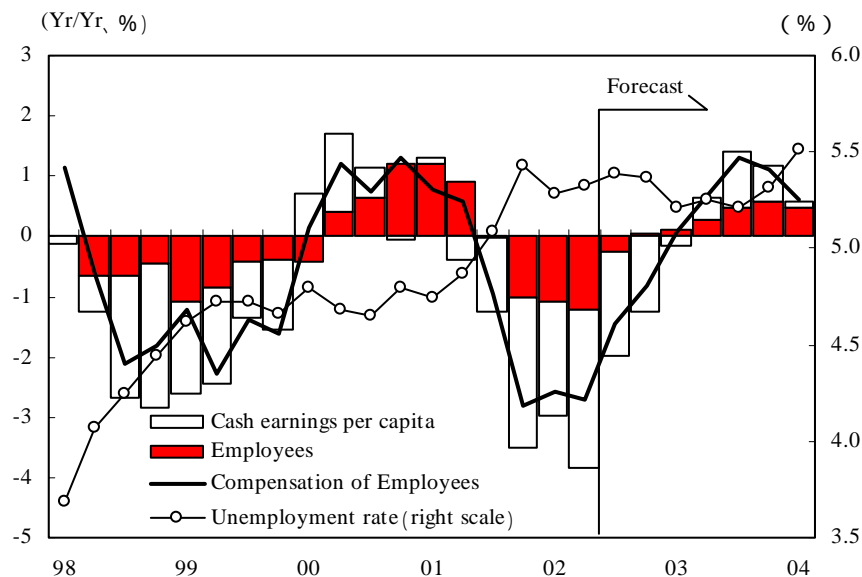
Employment and Income Environments: Somewhat Better but No Major Improvement

At present, the employment environment remains severe. The number of employees is continuing to decline, principally in the manufacturing and construction industries. The total number of employed workers, including self-employed workers and family workers, is continuing to decline and is down by a large margin of about 800,000 compared with the previous year. Although the unemployment rate has shown some slight improvement, it remains just above 5%. Looking forward, the employment environment is expected to show some marginal improvement as the economy recovers. The number of employees is likely to rise as production in the manufacturing sector increases and as demand in the service industries remains steady. Therefore, the number of employees at the end of fiscal 2002 should regain the level of the previous year. However, companies are continuing to maintain strong restraints on personnel costs, and the structural problem of the mismatching of labor supply versus demand by age category and occupation remains. As a result, even after the beginning of fiscal 2003, the pace of improvement in the number of employees will most likely continue to be slow. Even though the number of employees may improve along with the economic recovery, persons who had suspended their search for jobs may return to the labor market, and, although the economy will recover, unemployment will remain above 5%.

Regarding wages, regular compensation and bonuses continue to be below the previous year, but, along with the recovery in production, overtime compensation has recovered to the level of the previous year. During fiscal 2002, wage conditions, principally overtime compensation, will continue to recover, and accompanying the rise in corporate profitability, regular compensation should also show improvement. In fiscal 2003, regular compensation is expected to rise above the levels of the previous fiscal year. Also, reflecting the gains in corporate profitability in the current fiscal year, bonuses in fiscal 2003 are expected to recover to the previous year's levels. Cash earnings per capita in fiscal 2003—when

bonuses will show recovery—are expected to show an upward trend.

Ehibit9: Unemployment Rate and Compensation of Employees



Note: 'Non-employees' consists of 'Self employed' and 'Family workers'.

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

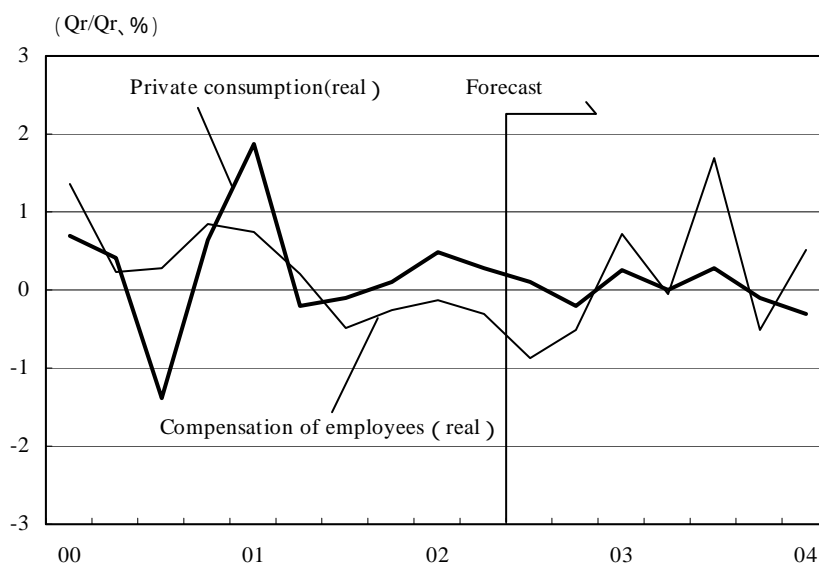
Private Consumption: Despite Improvement in Employment and Income Environments, Consumption to Remain Virtually Flat

Private consumption has continued to be firm since fall 2001 despite severe conditions in the income environment. Until that time, such factors as the reactionary decline following the surge in spending preceding the enactment of the Electric Appliance Recycling Law, the drop in stock prices, and uncertainty regarding employment conditions caused a deterioration in consumer confidence that restrained consumer demand. However, as signs of economic recovery began to appear, demand began to emerge again. Consumer confidence reached a low point at the end of 2001 and thereafter began to show improvement. On a GDP basis, real private consumption rose for three consecutive quarters through the April–June period of 2002. Even during the summer when severe income conditions persisted, as evidenced by bonuses below the previous year and other factors, sales of automobiles and living expenditures (as reported in the Survey of Households) remained steady.

During the latter half of fiscal 2002 as well, recovery in incomes is expected to be weak, as suggested by prospects for winter bonuses below the levels of the previous year and other factors. Therefore, a high rate of growth in consumption is not anticipated. However, as the fiscal year-end approaches, the recovery in the corporate sector is expected to have an impact on the household sector. As incomes begin to increase gradually, this will provide support for private consumption.

With the beginning of fiscal 2003, although incomes will begin to rise over the previous year's levels, disposable incomes of households will be pushed downward because of increases in healthcare insurance premiums, reductions in pension stipends (as consumer price level related adjustments are made to reflect declines in prices), and revisions are made in the system for income tax deductions. Although consumption is likely to receive a slight boost in summer 2003—when bonuses are expected to begin to rise again over the previous year's levels—as evidence of an economic slowdown emerges in the latter half of fiscal 2003, consumer confidence may take a cautious turn, and the momentum of consumption is forecast to weaken.

Exhibit10: Private Consumption and Workers Incomes



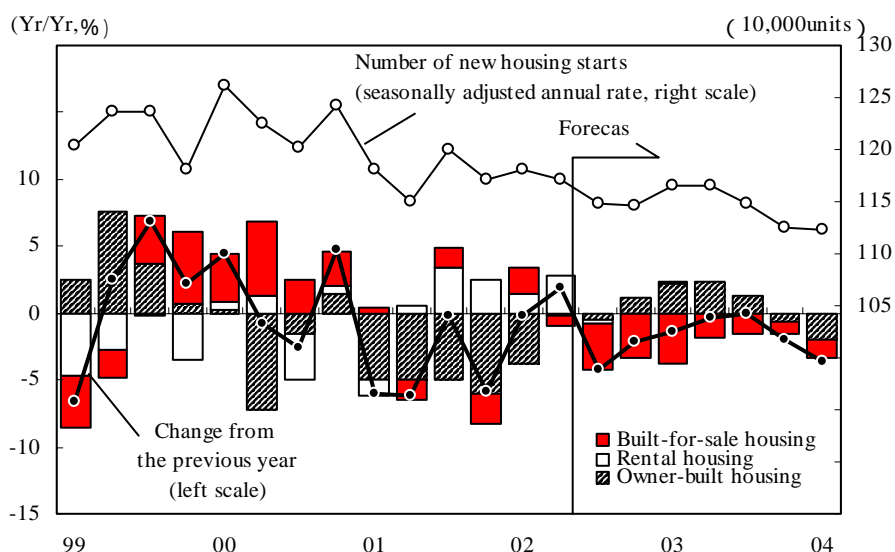
Source: Cabinet Office, National Accounts

Private Residential Investment: Condominium Starts and Overall Housing Investment to Show a Declining Trend

Private residential investment will show a slight decline from the previous year in fiscal 2002. The number of housing starts since last fiscal year has been running at a rate of about 1.15 to 1.2 million, but this is forecast to decline slightly in the second half of fiscal 2002. Although owner-built housing starts will rise gradually along with the recovery in the economy, developers are expected to hold back on additional condominium starts, which have been running at a high level. In addition, further expansion in rental housing starts, which continue to be firm, seems difficult. We are forecasting total housing starts of 1.155 million in fiscal 2002.

The decline in private residential investment is expected to continue in fiscal 2003. While the income environment recovers gradually, the housing loan tax relief measure now in effect will approach its expiration date (December 31, 2003). For this reason, there is a possibility of a small surge in housing starts, principally owner-built and built-for-sale homes. However, during the latter half of fiscal 2003, there will be a decline in reaction to this temporary surge and, in parallel with this, the economy will decelerate. This is expected to bring a decline in housing starts as well. In addition, the market is somewhat oversupplied with condominiums, and we forecast that starts in this area will fall below the previous year's levels. Overall, we forecast that the level of housing starts will drop to 1.139 million for fiscal 2003. Please note, as mentioned previously, the tax burden on donations passed on during the life of the giver is likely to be reduced, but only certain high net worth households are expected to benefit from this measure, and the impact on housing starts, overall, is expected to be virtually nil.

Exhibit 11: Outlook for Housing Starts



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

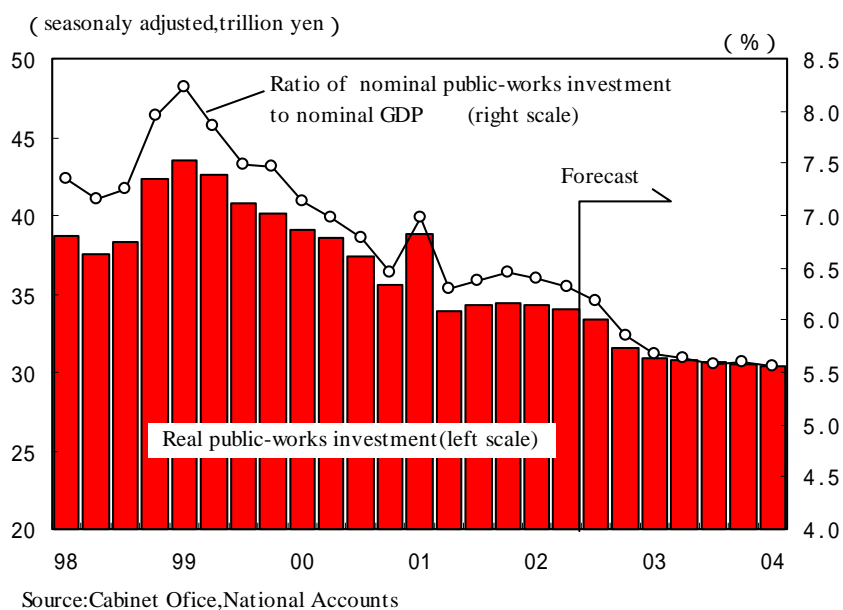
(d) Public Works Investment to Continue on a Downward Trend

The government budget for fiscal 2002 calls for a substantial cutback of 10.7% in public works investment. Projects of local governments undertaken on their own initiative are also expected to be reduced about 10% (on a regional fiscal plan basis), but real public works spending in the April–June quarter of 2002 was down only 1.9% because of the impact of expenditures provided for in the supplementary budget passed in fiscal 2001. Although some support for public works investment can be expected from the previous supplementary budget through the summer, fiscal constraints on both national and local governments are severe, and substantial declines will be unavoidable thereafter. Depending on economic trends, there may be requests for additional public works investment through the passage of a supplementary budget, but the government is expected to maintain its stance of restraining fiscal expenditures and forego the passage of additional economic stimulus package.

In fiscal 2003, the restraints on public works investment are likely to continue. But in the case of national government investment, under the budget request guidelines for the initial budget for fiscal 2003, public

works investment is scheduled to decline 3%, which is a substantially slower pace of decline than in fiscal 2002. In local areas, requests for public works spending as an economic stimulus package remain strong, but we forecast local public works investment will continue to decline, reflecting the severe financial condition of local governments.

Exhibit 12: Outlook for Public-works Investment

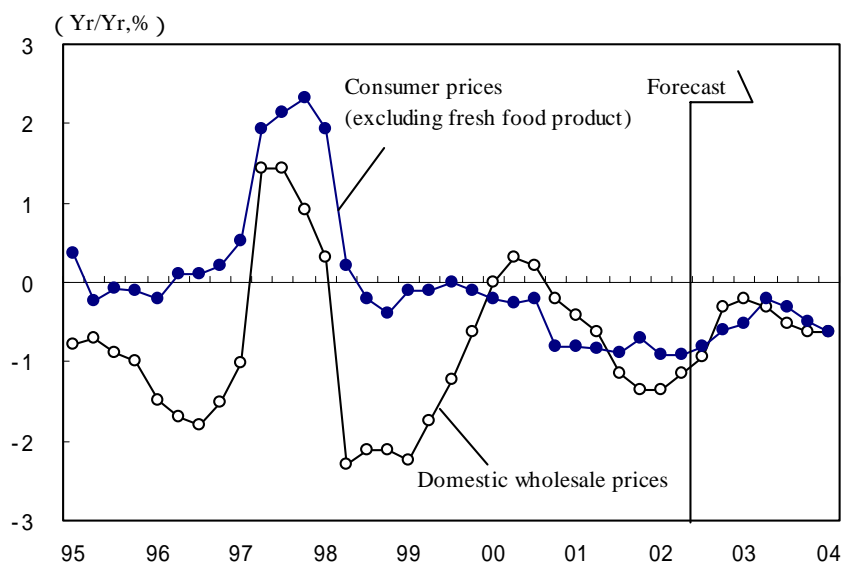


(e) Price Levels: Easing of Deflationary Pressures Likely to Be Temporary

Appreciation of the yen exerts downward pressure on domestic price levels, but, on the other hand, crude oil prices continue at a high level and accompanying the recovery in the world economy, other commodity prices are holding strong. Also, since demand will expand along with the recovery in production, deflationary pressures from the demand side will gradually weaken. For this reason, the margin of decline in domestic wholesale prices is likely to shrink. However, the slowdown in production in fiscal 2003 will tend to push prices downward and may lead to larger margins of decline in domestic wholesale prices. Our forecast is for a decline of 0.7% in domestic wholesale prices in fiscal 2002 and a decline of 0.5% in fiscal 2003.

The margin of decline in consumer prices is expected to shrink as service prices remain virtually level and the margin of decline in wholesale prices also shrinks. As a result of stronger recovery momentum in demand, there will be somewhat less pressure on corporations to reduce prices to generate demand for their goods and services. However, price competition will continue to be strong, and a shift to an inflationary scenario can be ruled out. In fiscal 2003, as in the case of wholesale prices, the margin of decline in consumer prices will widen. However, the increase in the medical expense burden on households as health care system reforms are implemented will move the consumer price index up 0.2% point. As a result, the consumer price index (overall, excluding fresh foods) will decline 0.7% year on year in fiscal 2002 and drop 0.4% in fiscal 2003.

Exhibit 13: Outlook for Price



Sources: Bank of Japan(BOJ), Price Indexes Monthly
; Ministry of Public Management, Home Affairs, Post and Telecommunications, Monthly on Price Indexes

Economic Outlook for Fiscal2002/2003

	Foreca →						Yr / Yr, % (half / half, %)		
	FY2001		FY2002		FY2003		FY2001	FY2002	FY2003
	First half	Second half	First half	Second half	First half	Second half	(Actual)	(Forecast)	(Forecast)
Nominal GDP	-1.7 (-2.6)	-3.9 (-1.2)	-1.3 (0.2)	-0.2 (0.7)	1.1 (1.0)	-0.2 (-1.1)	-2.8	-0.7	0.5
Real GDP	-0.4 (-2.3)	-3.4 (-1.0)	-0.4 (0.6)	1.2 (0.7)	2.0 (1.2)	0.5 (-0.6)	-1.9	0.4	1.2
Contribution of domestic demand	0.5	-3.2	-1.1	0.9	1.9	0.8	-1.4	-0.1	1.4
Private consumption	1.5 (0.3)	0.6 (0.3)	0.9 (0.6)	0.5 (-0.0)	0.2 (0.3)	0.2 (-0.1)	1.1	0.7	0.2
Housing investment	-7.8 (-8.1)	-8.2 (-0.4)	-2.9 (-2.4)	-2.2 (0.3)	2.6 (2.3)	-4.0 (-6.2)	-8.0	-2.5	-0.7
Private capital investment	3.2 (-5.6)	-11.8 (-6.3)	-7.7 (-1.8)	0.2 (1.9)	5.8 (3.7)	3.2 (-0.4)	-4.8	-3.8	4.4
Inventory investment	-0.3	-1.2	-0.5	0.9	1.0	0.1	-0.8	0.2	0.5
Government expenditure	-0.9 (-0.6)	0.4 (1.1)	1.7 (0.3)	-1.2 (-1.2)	-0.2 (0.5)	-0.8 (0.5)	-0.2	0.2	0.3
Public investment	-9.9 (-5.1)	-4.1 (0.8)	-0.7 (-1.9)	-9.9 (-7.3)	-8.6 (-1.5)	-2.9 (-0.7)	-6.7	-6.0	-5.4
Government final consumption expenditure	2.7 (1.4)	2.6 (1.2)	2.4 (1.2)	2.4 (1.1)	2.4 (1.3)	2.3 (1.0)	2.7	2.4	2.4
Contribution of external demand	-0.9	-0.2	0.7	0.3	-0.1	-0.2	-0.5	0.5	-0.2
Export of goods and services	-8.2 (-7.5)	-8.4 (-1.0)	7.8 (8.9)	11.3 (2.2)	8.8 (6.5)	5.4 (-1.0)	-8.3	9.6	7.1
Import of goods and services	-0.7 (-4.9)	-8.4 (-3.7)	1.7 (5.2)	10.0 (4.7)	12.6 (7.3)	8.9 (1.5)	-4.7	5.8	10.7
Current account balance (trillion yen)	4.9	7.0	7.2	6.3	6.6	5.9	11.9	13.5	12.4
balance on goods (trillion yen)	4.2	4.7	6.4	4.8	6.1	4.4	9.0	11.1	10.5
balance on service (trillion yen)	-3.0	-2.2	-2.7	-2.1	-2.9	-2.5	-5.1	-4.8	-5.4
balance on income (trillion yen)	4.1	4.6	4.0	4.2	3.9	4.4	8.7	8.2	8.3
Industrial production	-8.2 (-7.5)	-12.2 (-5.2)	0.1 (5.4)	8.8 (3.3)	5.1 (1.7)	-0.3 (-2.0)	-10.2	4.4	2.3
Wholesale prices	0.6	-0.7	-1.0	-0.9	-0.9	-0.3	0.0	-1.0	-0.6
Domestic wholesale prices	-0.8	-1.4	-1.1	-0.3	-0.4	-0.6	-1.1	-0.7	-0.5
Consumer prices	-0.7	-1.2	-0.9	-0.5	-0.4	-0.7	-1.0	-0.7	-0.5
excluding freshfood	-0.8	-0.8	-0.9	-0.6	-0.3	-0.6	-0.8	-0.7	-0.4
Yen/U.S.Dollar	122.2	128.1	123.1	117.0	117.8	120.8	125.1	120.0	119.3
Crude oil price (U.S.dollar/barrel) (WTI following month futures price)	27.3	21.1	27.1	29.5	27.5	25.5	24.2	28.3	26.5
U.S. Real GDP (CY) (seasonally-adjusted annual rate)	-0.4	0.1	3.5	2.0	2.5	3.2	0.3	2.3	2.5

【Exports and Imports】

		Forecast						(Yr/Yr, %)		
		FY2001		FY2002		FY2003		FY2001	FY2002	FY2003
		First half	Second half	First half	Second half	First half	Second half	Actual	Forecast	Forecast
Exports (yen basis)		-6.2	-7.1	8.0	7.8	6.4	5.7	-6.6	7.9	6.0
	Volume	-11.9	-7.5	12.7	14.0	9.6	5.1	-9.8	13.4	7.3
Imports (yen basis)		4.7	-8.6	-1.3	9.6	9.7	8.7	-2.3	4.1	9.2
	Volume	-2.6	-5.6	2.7	11.1	11.2	6.4	-4.1	6.8	8.7
Exports surplus (trillion yen)		3.3	3.8	5.5	3.8	5.1	3.3	7.1	9.3	8.4

【Income and Employment】

		Forecast						(Yr/Yr, %)		
		FY2000		FY2001		FY2002		FY2001	FY2002	FY2003
		First half	Second half	First half	Second half	First half	Second half	Actual	Forecast	Forecast
Cash earnings of employees (per capita)		-0.8	-2.3	-2.2	-0.8	0.6	0.4	-1.5	-1.5	0.5
	Regular compensation*	-0.3	-0.8	-1.4	-0.5	0.4	0.2	-0.5	-1.0	0.3
	Overtime compensation	-4.1	-7.4	-0.8	5.6	5.7	0.7	-5.8	2.4	3.1
Number of employees		0.4	-1.1	-0.7	0.1	0.4	0.5	-0.3	-0.3	0.4
Compensation of employees**		-0.2	-2.7	-2.1	-0.4	1.0	0.9	-1.5	-1.3	0.9
								Actual	Forecast	Forecast
Spring wage increase * *		-	-	-	-	-	-	2.01	1.66	1.60
Unemployment rate		5.0	5.4	5.4	5.5	5.4	5.4	5.2	5.4	5.4

Notes:

* Figures are for establishments of five employees or more, Ministry of Health, Labour and Welfare, 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 labor union and capital of 2billion 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)		
		FY2001	FY2002	FY2003
		Actual	Forecast	Forecast
Number of new housing starts		117.3	115.5	113.9
(change from the previous year)		-3.3	-1.5	-1.4
	Owner-built housing	37.7	38.4	38.8
	Rental housing	44.2	45.0	44.5
	Built-for-sale housing	34.4	31.2	29.6
		-13.9	1.9	1.1
		5.8	1.7	-1
		-0.7	-9.3	-5.1

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