INFORMATION

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Outlook for Japanese and Overseas Economies during Fiscal 2000-2001

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Overview

Pickup in Individual Consumption Key to True Recovery

Japan's economy registered a solid annualized growth rate of 10.0% in the first quarter of 2000, with individual consumption and investment in plant and equipment as key factors. Of particular note is the fact that investment in plant and equipment began to expand, spurred on by a recovery in corporate revenue in the fourth quarter of 1999, and that this was followed by a rise in individual consumption as well. In fiscal 2000 this trend will continue unabated, and the ongoing expansion in individual consumption and investment in plant and equipment will cause the annual growth rate to rise from the 0.5% of 1999 to 2.4%. Individual consumption will continue to rise steadily due to expansion in personal income, because bonuses have bottomed out and employment is gradually recovering, and also because consumers are becoming tired of frugality and their worries about employment have passed their peak. Investment in plant and equipment will expand from the negative 2.5% of fiscal 1999 to positive growth of 4.9% thanks both to serious investment in upgrades, which have been put off until now, as well as growth in investment in computer and communications related equipment. Together with individual consumption, investment in plant and equipment will be a key engine for growth. In fiscal 2001 the rate of increase in both individual consumption and investment in plant and equipment will accelerate further, but at the same time there will be a significant reduction in public works spending, aimed at rebuilding the nations' finances, and external demand will begin to drop due to a stronger yen combined with an economic slowdown overseas. Together, these factors will result in economic growth in fiscal 2001 of 2.8%, only a slight increase over fiscal 2000.

I. Present Status of the Japanese Economy

During the latter half of 1999 the Japanese economy was forced into a temporary halt on its road to recovery. Factors contributing to this included individual consumption, which continued to be stagnant due in part to a reduction in the size of bonuses paid to employees, a temporary drop in housing investment and public works spending during the gap between the periods when the effects of different government policies were felt, and continued rapid growth in imports. However, individual consumption began to expand in the first quarter of 2000 as the downward trend in wages bottomed out, and investment in plant and equipment recorded a substantial rise led mainly by small and medium-sized businesses in the non-manufacturing sector. These factors combined to create an annualized growth rate of 10.0% in this quarter. Even setting aside the "leap-year effect," the growth rate certainly reached a level of between 6 and 7%. Monetary policy during this period was characterized by a continuation from February 1999 onward of a "zero interest rate policy." As a result, both short- and long-term interest rates remained extremely low. Stock prices were on an upward trend through early April. They, led by high-tech issues, began a decline from mid-April through early May due to the effects of adjustments in the NASDAQ market in the United States.

II. Prospects for the Japanese Economy

1. The Japanese Economy in Fiscal 2000

The growth rate in fiscal 2000 will be 2.4%, and the recovery will become self-sustaining. Individual consumption and investment in plant and equipment, the key elements in private-sector demand, will both enter periods of solid growth. Housing investment and public works spending are already entering a period of decline, but this trend will not be sufficient to hinder a self-sustaining recovery. Hopeful prospects for issues such as bad loans, excess capacity, and over employment are the factors that needed to be in place in order for the recovery of the business climate to become self-sustaining.

(Individual Consumption)

Growth in real individual consumption will expand from the 1.2% of fiscal 1999 to 2.3% in fiscal 2000. The size of bonuses and interest income will both switch from negative to positive growth. This will result in growth in disposable income rising from almost zero to approximately 2%. In addition, the unfavorable employment situation has begun to ease, and throughout fiscal 1999 consumer confidence has been steadily improving. In this environment, a rise in income will lead directly to growth in consumption. The already high rate of growth in communications related products (such as personal computers and mobile phones) will be followed by increased purchases of automobiles by consumers who had been putting off replacing their current models. Demand for price-sensitive items such as clothing and travel packages will also continue to grow.

In addition, trends such as heightening competition among large-scale retail outlets and the advent of practical e-commerce will advance, and this fierce struggle to attract customers will further spur individual consumption.

(Housing Investment)

The move-in deadline for a special tax credit for housing investment has been extended to June 2001. This has shifted the peak in demand for new homes, which was expected in the latter half of fiscal 1999, to the first half of fiscal 2000, and housing investment will therefore experience a temporary rise. However, the number of housing starts accounted for by condominiums, which require a considerable amount of time to be constructed, will drop in the latter half of fiscal 2000, with the result that overall housing investment in fiscal 2000 will remain at approximately the same level as in fiscal 1999. Also, a portion of those consumers who live in rented housing will purchase condominiums, attracted by lower prices. As a result, the total number of rental housing starts will drop as demand for rental housing continues to decrease. The number of new housing units built in fiscal 2000 will be 1.22 million. (The figure for fiscal 1999 was 1.23 million.)

(Investment in Plant and Equipment)

Investment in plant and equipment began to expand at the end of fiscal 1999, and in fiscal 2000 the growth rate will reach 4.9%. This recovery in investment in plant and equipment will be lead by computer and communications related upgrade purchases and replacement demands by small and medium-sized companies. Japanese manufacturers in the semiconductor field will experience a sudden upward surge in demand for their products as a side effect of the worldwide boom in mobile telephone products as well as steadily expanding demand for personal computers and electric home appliances. This will result in a situation in which investment to expand production capacity will be essential. Also, investment related to new generation mobile phone systems will get underway in earnest in fiscal 2000. Small and medium-sized companies had been forced to suddenly scale back investment in the latter half of fiscal 1997 and in fiscal 1998 because of the abrupt worsening of the business climate and an atmosphere of financial instability. But they had already begun to expand their investment in plant and equipment from around the middle of fiscal 1999, once their profits began to recover and the financial instability dissipated. Specifically, demand is expanding for items such as plastic molding equipment, numerically controlled machine tools, and trucks. Since fiscal 1999 the free cash flow of companies has risen to more than 10 trillion yen. In this situation, the decision to expand investment in plant and equipment is an easy one for companies to make.

(Public Investment and Finance)

In fiscal 2000 public investment will shrink by 2.3%. This will occur because most of the funds provided in the supplementary budget of November 1999 will be exhausted during the first half of fiscal 2000. Full-scale constriction in the amount of public works spending will begin in the latter half of the fiscal year. As the recovery in the economic climate moves toward self-sustainability, the financial situation of both the central government and regional governments will worsen, and criticism of "profligate" public works spending will become more conspicuous. It is not believed that any supplementary budget to allow for huge additional public spending will be passed during fiscal 2000.
Also, an increase in tax revenues, especially corporate taxes, will result in the value of government bonds issued during fiscal 2000 reaching 34 trillion yen, down from the peak of 39 trillion yen recorded in fiscal 1999.

(Exports and Imports)

The volume of exports in fiscal 2000 will grow by the comparatively high rate of 8.1%, continuing on the heels of the 6.2% growth recorded in fiscal 1999. The growth rate of the world economy will continue to climb in 2000, carrying on the trend that prevailed in 1999. By region, the growth rate for exports to Central and South America, and to Western Europe, will rise. Being this trend will be, in the case of Central and South America, economic recovery, and in the case of Western Europe, the conclusion of a cycle of the negative effects of the weak Euro. Broken down by product types, the growth in exports of electrical equipment and general machinery will be high, reflecting the high degree of demand for computers and communications related products as well as a recovery in equipment investment overseas.
Nevertheless, the rate of growth in import volume will drop from the 11.3% recorded in fiscal 1999 to 5.7%. Rapid growth in imports will continue from the latter half of fiscal 1999 through the first half of fiscal 2000. This trend will be evident in areas such as food and clothing, which are readily affected by the strong yen; computers and communications related products, the production of which is split between Japan and many other Asian countries; and energy, as stock is accumulated. In the latter half of fiscal 2000 this expansion trend will experience a temporary pause.

(International Trade Balance)

The trade account surplus will drop to 13.6 trillion yen from the 13.8 trillion yen figure for fiscal 1999. This will occur because due to increases in the prices of crude oil and primary industrial products the value of imports will increase at a rate of 8.5%, which will substantially exceed the rate of increase for exports of 5.5%. Also, much of the balance on income surplus will be cancelled out by an increase in the deficit experienced by the service account as a result of growth in the number of persons traveling overseas. Consequently, the current account surplus will rise slightly to 12.9 trillion yen from the 12.6 trillion yen figure for fiscal 1999.

(Prices)

Prices will remain stable. Competition in the distribution industry will continue to be fierce, and prices of items such as processed foods, clothing, electric home appliances, and general merchandise will fall still further. However, factors such as a reversal in the downward trend in prices of fresh foods seen in fiscal 1999 and a rise in energy prices will result in consumer prices decreasing by only 0.1% in fiscal 2000, rather than the 0.5% drop seen in fiscal 1999.

2. The Japanese Economy in Fiscal 2001

In fiscal 2001 both individual consumption and investment in plant and equipment will grow at an even faster pace than in the preceding year. However, the growth rate will not rise suddenly, stopping at about 2.8%, as the effects of government policy on housing investment and public works spending begin to fade substantially and the strong yen produces a reduction in external demand. In addition, there will be a need to be on the alert for negative effects on Japan's economy as the U.S. economy enters a major slowdown.

(Individual Consumption)

In fiscal 2001 some companies, though few in number, will still be struggling to deal with surplus employees. This will prevent the number of employed persons from growing by more than 0.5%. Nevertheless, the size of bonuses and interest yields will increase, causing disposable income to rise by around 3%. Also, the increase in disposable income will be joined by a slight decrease in the savings rate, due to increased consumer confidence. These factors will combine to produce a rise of 3.4% in the growth rate for real individual consumption. This in turn will result in a recovery in demand for automobiles, personal computers, and mobile phones, as well as items such as electrical home appliances and food products. However, the situation through fiscal 2001 will be one of "jobless growth," as in the United States in the early nineties. There will be no sudden jump in personal consumption for this reason.

(Housing Investment)

Housing investment will drop by 5.2% in fiscal 2001. Investment in housing has entered a medium-term period of contraction due to stagnant growth in the number of households. There is a large pool of potential demand among homeowners wishing to rebuild their homes. However, since many of those who considered it necessary to take such a step already rebuilt their homes during the latter half of the nineties, the level of housing starts seen in the first half of fiscal 2000 can be expected to continue during fiscal 2001. On the other hand, following a large increase in the supply of high-quality condominiums in urban areas, made possible by sell-offs of unused real estates by corporations, etc., it is inevitable that both demand and supply will weaken somewhat over a period of several years. There will also continue for some time to be contraction in the area of rental housing due to an ongoing worsening in profitability brought on by oversupply. The number of new housing units built in fiscal 2001 will be 1.16 million. This is less even than the figure of 1.18 million for fiscal 1998, which was the previous low record year for the decade preceding 2001.

(Investment in Plant and Equipment)

Investment in plant and equipment will grow at the quite high rate of 9.0% in fiscal 2001. Through growth in such investment by small and medium-sized businesses will cool down somewhat, investment in plant and equipment by large corporations as well as by tiny companies will become quite active. It is normal for periods of adjustment by large corporations to investments in plant and equipment to occur after analogous periods involving small and medium-sized businesses, and the same goes for decisions to increase such investment. In this case, investment will become more active from fiscal 2001 onward, once the period of financial restructuring has passed. Growth in investment in plant and equipment among large corporations will be concentrated in maintenance and upgrading, while in the non-manufacturing sector it will be focused on the areas of computer and communications related investment as well as remodeling of retail outlets. Furthermore, a rebound from the rush to invest that followed the implementation of the Large-Scale Retail Stores Location Law will be evident in fiscal 2001, but its effects will be cancelled out by an end of the contraction by the electrical power industry on equipment investment. Tiny companies will finally start investing in equipment upgrades once they are certain that the business climate have truly recovered.

(Public Investment and Finance)

Public investment will have entered a period of substantial contraction in the latter half of fiscal 2000. A further drop of 6.0% will occur in fiscal 2001. However, this will still be a higher level of public spending than that, which obtained during the mid-eighties. It is highly probably that this contraction in public investment will continue through fiscal 2003. Due to an increase in tax revenue accompanying the recovery of the business climate, the value of government bonds issued during fiscal 2001 will be only 29 trillion yen, down 5 trillion yen from the preceding year. Still, this represents a high level of public borrowing, and the road to eventual fiscal soundness will be a long one. It will not be possible to erase the public debt using the natural increase in tax revenue combined with a decrease in public spending alone. Also, the tax burden as a percentage of GDP has dropped to a low level, and serious discussion of the possibility of raising the consumption tax rate could get underway as early as fiscal 2001.

(Exports and Imports)

The volume of exports will grow by only 3.0% due to the effects of the strong yen and the slowdown of the U.S. economy. There will also be a rebound from the rapid increase in exports of electrical equipment and general machinery that will have occurred in fiscal 2000. A rebound from the rapid increase in import volume during the second half of fiscal 1999 and first half of fiscal 2000 will occur, and as a result import volume will grow only 3.8%, less than the 5.7% figure for fiscal 2000. This will be the case in spite of the effects of the strong yen and the solid trend toward recovery of the Japanese economy. In particular, developmental imports such as food products and clothing will settle down for the time being.

(International Trade Balance)

The current account surplus will rise slightly to 13.3 trillion yen from the 12.9 trillion yen figure for fiscal 2000. The trade account surplus will remain at roughly the same level, while the balance on income surplus will further increase due to rising interest rates.

(Prices)

Downward pressure on prices will be fading. The rate at which wages rise will move upward, causing the unit labor cost to rise slightly, in contrast to the drops seen in both fiscal 1999 and fiscal 2000. This will serve as a fundamental cause of changes in pricing conditions.

III. Projections for Interest and Exchange Rates

1. Trend in Interest Rates

Moves to abolish the "zero interest rate policy" will begin in autumn of 2000, once it is clear that the economy is on its way to a self-sustaining recovery. Preceding this development somewhat, long-term interest rates will begin to rise. After the Bank of Japan has raised short-term rates to between 0.25 and 0.5% they will remain at that level for approximately six months. Then in fiscal 2001, when the economic recovery gets underway in earnest, the Bank of Japan will try raising them to a neutral level. However, if the slowdown in the U.S. economy occurs more rapidly than anticipated, the decision to raise rates to a neutral level may be postponed.

On the other hand, once it becomes clear that economic recovery has taken off long-term interest rates will rise continuously for a year or so, finally reaching about 3% at the end of fiscal 2001. The nominal growth rate will grow from the negative 0.7% of fiscal 1999 to 1.7% in fiscal 2000 and 2.5% in fiscal 2001. This will make it impractical to maintain long-term interest rates of around 1.5%.

However, private sector demand of funds for capital investments will remain weak and the government will be reducing the value of the bonds it issues, so long-term interest rates will not experience a sudden increase.

2. Yen Exchange Rate

The United States is continuing its tight-money policy, so throughout the year 2000 the yen may periodically show a tendency to weaken. However, the current account imbalance with the U.S. is large, so the weakening of the yen will not accelerate. A substantial strengthening of the yen against the dollar will begin in mid-2001, once a slowdown in the U.S. economy has become apparent and U.S. interest rates have passed their peak. If the correction of the weak Euro is delayed, the yen may suddenly rise rapidly. We forecast a yen-dollar exchange rate of 107 for fiscal 2000 and 100 for fiscal 2001.

Outlook for Japanese Economic Indicators

GDP-Related Indicators

(In trillions of yen; percentage growth over previous year in parentheses)

	FY1999 (actual)	FY2000 (forecast)	FY2001 (forecast)
GDP (real)	482.4 (0.5)	493.8 (2.4)	507.6 (2.8)
Private consumption	286.3 (1.2)	292.8 (2.3)	302.8 (3.4)
Residential investment	19.1 (5.6)	19.2 (0.5)	18.2 (-5.2)
Non-residential investment	79.4 (-2.5)	83.3 (4.9)	90.8 (9.0)
Government consumption	46.3 (0.7)	46.8 (1.1)	47.0 (0.4)
Public investment	39.5 (-0.9)	38.6 (-2.3)	36.3 (-6.0)
Increase in inventories	0.3 [0.1]	0.6 [0.1]	0.7 [0.0]
Net exports of goods & services	11.5 [-0.2]	12.5 [0.2]	11.7 [-0.2]
Exports	68.9 (5.9)	74.2 (7.7)	76.0 (2.4)
Imports	57.5 (8.7)	61.7 (7.3)	64.3 (4.2)
GDP (nominal)	493.8 (-0.7)	502.4 (1.7)	515.1 (2.5)
GDP Deflator	102.4 (-1.1)	101.7 (-0.7)	101.5 (-0.2)
GNP (real)	488.0 (0.3)	499.8 (2.4)	514.0 (2.8)
Industrial production index	100.8 (3.4)	102.9 (2.0)	105.0 (2.1)
Wholesale price index	96.6 (-2.5)	97.2 (0.6)	96.6 (-0.6)
Consumer price index	102.0 (-0.5)	101.9 (-0.1)	102.1 (0.2)

Note Real gross domestic products and real gross national products are in 1990 prices.
Industrial production index, wholesale price index, and consumer price Index: 100 for 1995
**[ ] = contribution to changes.*

Balance of Payments Indicators

(In trillions of yen; percentage growth over previous year in parentheses)

	FY1999 (actual)	FY2000 (forecast)	FY2001 (forecast)
Current account balance	12.6	12.9	13.3
Trade balance	13.8	13.6	13.7
Exports	46.7 (-2.0)	49.3 (5.5)	49.2 (-0.1)
Imports	32.9 (3.8)	35.7 (8.5)	35.5 (-0.5)
Services	-6.0	-6.0	-6.3
Income	5.9	6.4	6.9
Current transfers	-1.1	-1.1	-1.1
Yen-dollar rate	111.5	107.3	99.8

Customs Clearance Volume Index

(100 for 1995)

Exports volume index	117.7 (6.2)	127.2 (8.1)	131.1 (3.0)
Imports volume index	114.3 (11.3)	120.8 (5.7)	125.5 (3.8)

Outlook for US Economic Indicators

GDP-Related Indicators

(In billions of US Dollar; percentage growth over previous year in parentheses)

	1999 (actual)	2000 (forecast)	2001 (forecast)
GDP (real)	8,848.2 (4.2)	9,286.5 (5.0)	9,594.1 (3.3)
GDP (nominal)	9,256.1 (5.7)	9,874.8 (6.7)	10,386.4 (5.2)
Personal consumption	5,983.6 (5.3)	6,310.1 (5.5)	6,516.6 (3.3)
Residential investment	376.1 (7.4)	380.3 (1.1)	357.8 (-5.9)
Non-residential investment	1,215.8 (8.3)	1,347.1 (10.8)	1,414.0 (5.0)
Government consumption & investment	1,534.1 (3.7)	1,583.5 (3.2)	1,645.1 (3.9)
Federal	540.8 (2.8)	544.0 (0.6)	563.8 (3.6)
State & local	993.1 (4.2)	1,039.5 (4.7)	1,081.3 (4.0)
Increase in inventories	42.2 [-0.4]	45.9 [0.0]	45.3 [0.0]
Net exports of goods & services	-323.0 [-1.2]	-386.2 [-0.7]	-384.6 [0.0]
Exports	1,042.3 (3.8)	1,125.9 (8.0)	1,227.1 (9.0)
Imports	1,365.4 (11.7)	1,512.2 (10.7)	1,611.7 (6.6)
Industrial production index	137.1 (3.6)	143.6 (4.8)	148.4 (3.3)
Producer price index	133.0 (1.8)	137.0 (3.0)	139.5 (1.8)
Consumer price index	166.6 (2.2)	171.9 (3.1)	176.8 (2.9)

Note "Real" estimates are in chained(1996)dollars.
Industrial production index: 100 for 1992, Producer price index: 100 for 1982.
Consumer price index: 100 for 1982-84.
**[ ] = contribution to changes.*

Balance of Payments Indicators

(In billions of US Dollar; percentage growth over previous year in parentheses)

	1999 (actual)	2000 (forecast)	2001 (forecast)
Balance on current account	-331.5	-424.0	-454.6
Balance on goods and services	-265.0	-355.3	-370.6
Balance on goods	-345.6	-440.4	-475.0
Exports	684.4 (2.1)	760.0 (11.0)	840.5 (10.6)
Imports	1,029.9 (12.3)	1,200.3 (16.5)	1,315.5 (9.6)