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Outlook for the Japanese Economy During Fiscal 2001-2002

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Overview

Japanese Economy at the Crossroads -- A Crucial Point for Takeoff

The Japanese economy has sustained a gradual recovery in 2000, supported mainly by capital investment. But it has not improved enough to give people the feeling of sustained growth. This has been influenced by bankruptcies still continuing at a high rate, and consumer and corporate sentiments still remain shriveled. As the economy enters fiscal 2001, however, consumer spending will begin showing full-scale expansion because of an improved employment situation and a rise in wages. Moreover, capital investment will continue a high rate of growth supported mainly by IT-related and renewal investments resulting from abundant cash flows. It may, however, take some time for the Japanese economy to fully take off in a favorable circle occurring between the consumer and corporate sectors. If such incidents as a sharp increase in bankruptcies, the U.S. economy entering into a recession, and the recurrence of problems of nonperforming assets in Asian countries were to occur before the take off, the economy would most likely again enter a recession. A key to growth will be timing of the recovery of consumer spending.

In fiscal 2002, once the favorable cycle starts, the economy is expected to be in an ideal situation where its growth rate will accelerate while the stability of prices can be sustained. The consumers' purchases of durables such as autos will begin on a full scale, and a demand for the next generation's information and communication services will explosively expand. Capital spending is also expected to increase, and this will lead to investments to raise productive capacity to provide products and services with high-tech conveniences. If the Japanese economy succeeds in taking off, the economic growth rate will be 2.5% in fiscal 2001 (3.0% predicted in September) and 3.2% in fiscal 2002.

Meanwhile, the U.S. economy has begun to show a distinct sign of economic slowdown in the second half of 2000. It was fully affected by an increase in interest rates and the unexpected decline in stock prices, thus showing a slowdown in consumer and capital spending. However, the United States has enough room to take both monetary and financial measures, and should show a higher rate of economic growth in 2002 after a temporary adjustment. The growth rate of the U.S economy will be 2.3% (3.2% predicted in September) in 2001 and 3.2% in 2002. The European economy is expected to continually recover because of tax cuts to be implemented in each country in 2001. The Asian economies, however, will never be able to avoid a temporary slowdown in 2001 because of the aftermath of problems arising from nonperforming assets.

I. Present Status of the Japanese Economy

The Japanese economy in 2000 has been experiencing gradual economic recovery supported by capital investment. It cannot be denied, however, that it has entered a phase in the second half of 2000 in which its growth decelerates because of a slowdown in export growth and a decline in public spending while the effect of economic measures already taken is disappearing. Furthermore, the frequency of corporate bankruptcies, which have consumed the strength as a result of harsh competition in industry, remains high, and a deteriorating business sentiment, especially in the nonmanufacturing sector, and stock prices have shown no sign of stopping their decline since spring. Consumer spending has been in a trend of low growth as a result of stagnant income growth, but a sign of recovery has been indicated in some segments by increased sales of high-priced goods. Capital spending, notably in the manufacturing sector, has sustained a high growth supported by abundant cash flows, but the nonmanufacturing sector has slowed its investments as a result of a large debt burden incurred in the past, together with a curtailment of investments by electric power companies. Growth on exports to Asian countries has been decelerating since midyear, and housing investment will at best be able to sustain a sideways movement. Public spending, amid an environment of depressed public finance conditions, has begun to lose part of the spending accumulated as economic measures.

In the financial market, long-term interest rates, after moving almost sideways, shifted to a lower level toward the end of this year in fear of a slowdown in the economy. On the other hand, short-term rates have been on a gradual rise since the BOJ canceled the zero interest rate policy, and the rise was also affected by interbank transactions to be transferred to " Real Time Gross Settlement" (RTGS) from the beginning of 2001. The rate of the yen weakened to the lower end of 110/US$ at the end of November, a result of the deteriorating Japanese economy, after about a year since its last fall from the 100 level. The rate of rise in consumer prices has continued to decline by 1% compared with the previous year, in part because of food and clothing imports from China.

II. Prospect for the Japanese Economy

1. The Japanese Economy in Fiscal 2001

The self-sustained economic recovery almost achieved in fiscal 2000 will continue, but economic recovery on a full scale remains to be seen because public spending will enter into a slowdown phase in a midterm perspective, and a slowdown in the U.S. and Asian economies will possibly incur a slower rate of growth in exports. If, however, an increased number of bankruptcies occurs, if the U.S. economy enters a hard landing phase, and if the bad debt problems of Asian countries--brought to a head in the latter half of fiscal 2000 as the Japanese economy muddled through--reoccur, the domestic economy may return to recession. If a self-sustained recovery enters into one on a full scale, the rate of economic growth (in real terms, the same hereinafter) will be 2.5%, a high since the 3.4% registered in fiscal 1996.

(Consumer Spending)

A key to the realization of sustained economic growth will be the timing of renewed consumer spending. The number of employees in Japan has been on the rise since the middle of fiscal 2000, with a gradual increase in disposable income as bonus payments turned positive. Consumer sentiment seems to be improving some, as witnessed in the greatly increased sales of electrical appliances with new, solid functions--such as digital BS televisions, cordless cleaners, and digital cameras--and of high-quality women's clothing. In this respect, the rate of income growth will most likely lead to a recovery in consumer spending. The rate of growth in disposable income is usually supported by an increase of employees and larger bonuses in the service, wholesale, and retail industries, together with an increase of interest income after the effect of a lower interest rate is over. An improvement in corporate earnings can be said to be leading to an increase of individual incomes. Under these circumstances, the rate of growth in consumption lags slightly behind that of income, which will raise the rate of savings

(Housing Investment)

The number of housing starts has remained at a level of about 1.2 million units since the beginning of 1999 because of a tax cut in housing loans and a low interest rate. Sales of condominiums are doing well because of a new demand for residences for the aged and an increased demand for condos with cheaper prices. The sales of detached houses is also in steady demand, supported by a demand for rebuilding houses. Meanwhile, the demand for building houses to rent has continued sluggish because of a boom in the sale of condominiums and no brakes yet being put on a declining trend of house rents, which is expected to continue in fiscal 2001. A tax cut in housing loans has been decided to remain intact, though the rate was reduced, but the effect of the tax cut will gradually be weakened. But housing starts will be sustained at the same level of 1.2 million units recorded in fiscal 2000 because of a demand for housing in anticipation of a rise in interest rates.

(Investment in Plant and Equipment)

The rate of growth in capital investment is expected to continue to increase, to 7.5%, in fiscal 2001. The nonmanufacturing sector will join the manufacturing sector in making investments on a full scale. In the manufacturing sector, the rate of growth in capital investment in semiconductors and in the electrical machinery industry will slow down, but investment activity by the materials industry will become active, supported by earnings improvement and an increased demand. Thus the rate of growth in overall capital investment of the manufacturing sector will be sustained at the same level as in fiscal 2000. In the nonmanufacturing sector, capital investment will start to increase for these reasons: a) The curtailment of investments by electrical power companies has ended; b) IT-related investments will be carried out on a full scale in the wholesale, retail, and service industries; and c) Capital investment in the next generation cellular-phone-related businesses and in the high-speed communications network related to the communications industry remains high. Rich cash flows and improved earnings will continue to support corporations' willingness to make capital investment.

(Public Investment and Finance)

The amount of public spending in fiscal 2001 will decrease 3.7% from the previous year. This results from the full effect of curtailment in public spending policy with a view to the reconstruction of public finance, and there will be no additional public spending by a supplementary budget.

(Exports and Imports)

In fiscal 2001, the rate of growth in the volume of exports will decrease to 2.7%, from 7.4% in fiscal 2000, which will impose a heavy drag on the economy. This will be caused by a slowdown of the rate of growth in exports to Asian countries from the high level achieved after a financial crisis in the region and by the decelerating rate of growth in exports to the United States. The exports of semiconductors and communications equipment will especially show a decelerating rate of growth.

Meantime, the rate of growth in imports will very likely decline to 4.6% in fiscal 2001, from 8.6% in fiscal 2000. The background for this decline will be a saturation in the market for imported electrical appliances and clothing.

(International Trade Balance)

The current account surplus for fiscal 2001 will amount to 13.2 trillion yen, almost the same amount of 13.3 trillion yen as in fiscal 2000. The trade account surplus has been in a decreasing trend in a midterm perspective because of a continued increase in imports centering on cheap finished goods from Asian countries and the commencement of local production on a full scale in Europe and the United States. On the other hand, the deficit of service account is decreasing because of a reduction in other payments, including various expenses for overseas offices and payments for transportation expenses; the balance of income surplus is on a gradual rise, followed by an expansion of Japanese external investment. Therefore a shrinkage of the balance of trade account is being canceled out by an improvement of service and income accounts; thus the current account surplus has been stabilized at about 13 trillion yen since fiscal 1999.

(Price)

The rate of increase in consumer prices will become zero, finally terminating a deflationary trend. Although no change should occur in a situation where the expanded imports from China such as vegetables, textile products, home electrical appliances, and miscellaneous goods contribute to the stability of prices, unit labor cost will turn from negative growth to positive, initiating pressures to raise prices.

2. The Japanese Economy in Fiscal 2002

In fiscal 2002, the Japanese economy will reach a so-called prosperous condition as pending problems such as excess debts and nonperforming assets are almost solved. The sentiment of corporate managers will turn for the better for capital investment to be made to expand capacity. Meanwhile, more time will be needed for excess labor problems to be solved, keeping the rate of unemployment from falling.

(Consumer Spending)

Consumer spending in fiscal 2002 will enter a full-scale recovery phase. Although the rate of growth in disposable income will be about the same as in fiscal 2001, a time lag between the growth of consumption and that of income will shrink, resulting in a higher rate of growth in individual consumption. This will become obvious, in particular, in a substitution demand for new passenger cars, a demand that will appear from fiscal 2001. Here are the reasons: a) All autos purchased in the bubble economy will be at least 10 years old; b) The automobile license tax for passenger cars 13 years or older will be 10% higher from fiscal 2002 because of the introduction of a green tax; and c) Auto companies will continue to introduce new types of cars. Furthermore, there should be a sharp rise in the rate of diffusion of next-generation cellular phone service and superspeed communications circuit service from fiscal 2001 on, and digital BS TV will be sold on a full scale at cheaper prices.

(Housing Investment)

The number of housing starts will stand at 1.18 million units in fiscal 2002, a slightly lower level compared with the previous year. This results from a reversal of housing starts in advance, occurring in fiscal 2001, and investments in rental housing continue to decrease. However, housing investment will sustain a slightly positive growth because of an increase in demand for remodeling.

(Investment in Plant and Equipment)

The rate of growth in capital investment will be as high as 10.2% in fiscal 2002, supported by a sustained investment cycle of the manufacturing and nonmanufacturing sectors. Capital investment will expand even into small companies. In the manufacturing sector, the electrical machinery industry, having been in an investment lull in fiscal 2001, will once again start increasing investments, centering on semiconductors and liquid crystal. Furthermore, autos and general machinery companies will carry out investments as they expand production capacity for products with advanced technology because of specialization in production among Asian countries. The nonmanufacturing sector will increase investments because of an increase in demand for new construction and the remodeling of small and midsized buildings amid an environment of higher demand for office space.

(Public Investment and Finance)

Public spending will continue to decrease in fiscal 2002. Moreover, no public investment will be carried over from fiscal 2001 (because there is no supplementary budget), resulting in the rate of reduction being 5.5% from the previous year, which exceeds that recorded in fiscal 2001.

(Exports and Imports)

The volume of exports will grow 4.3%, slightly exceeding the 2.7% to be registered in fiscal 2001. The rate of growth in exports to Asian countries and the United States will continue low, but exports to Europe will grow at a higher rate because of a weaker yen expected versus the Euro. The rate of growth in the volume of imports will increase to 6.6% in fiscal 2002, from 4.6% in fiscal 2001, supported by the materialization of a full-scale economic recovery. Chemical goods and machinery equipment to be imported from Asian countries where production capacity has been expanded will characterize the increase of imports.

(International Trade Balance)

The current account surplus in fiscal 2002 will continue to maintain a steady trend by recording 13.9 trillion yen, though it is slightly larger than in fiscal 2001. The reason for the slight increase will be a reduction in imports because of a decline in crude oil prices.

(Prices)

The rate of price increases in fiscal 2002 will turn to a plus 0.3%. Although the rate of rise in unit labor cost will be almost the same as in the previous year, the ratios of many imported goods will reach highs; thus the effect of price cuts for domestic products will be weakened. A high yen versus the U.S. dollar will to some extent be offset by a weak yen versus the euro to weaken the effect of a high yen on the reduction of prices.

III. Projections for Interest and Exchange Rates

1. Trends in Interest Rates

Since cancellation of the zero interest rate policy, the Bank of Japan has taken no move to monitor economic trends until the middle of fiscal 2001. The BOJ will raise short-term interest rates to a neutral level after confirming that self-sustainable growth has fully materialized. This will be implemented from fall in 2001 until the beginning of 2002; thus the short-term market rate will rise to a range of between 1.0% to 1.5%. The Bank of Japan will thereafter maintain a posture of carefully monitoring economy and price trends, and it will start discussing preventive money-tightening measures at about the beginning of 2003 when the rate of economic growth exceeds 3% and prices start to rise.

The long-term interest rates will remain lower than 2% until the uncertainty about prospects for the economy is wiped out in spring 2001. The long-term rates will thereafter be on a gradual rise throughout fiscal 2001, confirming the economic recovery, and it will reach about 3%, which is regarded as the average level in a midterm perspective. In fiscal 2002, the rate will continue to move sideways, regardless of an accelerated pace in economic growth, because of a higher yen expected versus the U.S.

dollar and the reduced volume of government bond issues. This situation will be maintained until the Bank of Japan takes measures for preventive money tightening, and the long-term rate will thereafter again be on the rise.

2. Yen Exchange Rate

The yen will be on the rise versus the U.S. dollar from about summer 2001, confirming a slowdown in the U.S. economy and a takeoff of the Japanese economy. The dollar will weaken against all major currencies, such as the euro and the yen, as the inflow of capital into the United States peaks. The weak dollar will continue until mid-2002, when the suspension of an expansion in the U.S. current account deficit is confirmed, and it will move sideways thereafter. The average rate of yen/U.S. dollar exchange is expected to be 106/$ in fiscal 2001 and 96/$ in fiscal 2002.

Outlook for Japanese Economic Indicators

GDP-Related Indicators

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

	FY2000 (forecast)	FY2001 (forecast)	FY2002 (forecast)
GDP (real)	535.2 (1.8)	548.4 (2.5)	565.7 (3.2)
Private consumption	292.8 (1.2)	300.6 (2.7)	310.4 (3.2)
Residential investment	20.1 (-2.2)	20.4 (1.5)	20.4 (0.3)
Non-residential investment	84.4 (4.1)	90.7 (7.5)	99.9 (10.2)
Government consumption	85.8 (3.2)	86.7 (1.0)	87.6 (1.0)
Public investment	38.2 (-5.5)	36.8 (-3.7)	35.0 (-5.0)
Increase in inventories	0.1 [0.1]	0.7 [0.1]	0.8 [0.0]
Net exports of goods & services	13.8 [0.4]	12.6 [-0.2]	11.7 [-0.2]
Exports	59.9 (9.6)	60.4 (0.9)	62.8 (4.0)
Imports	46.0 (7.1)	47.8 (3.8)	51.1 (7.0)
GDP (nominal)	514.8 (0.2)	526.3 (2.2)	542.7 (3.1)
GDP Deflator	96.2 (-1.6)	96.0 (-0.2)	95.9 (0.0)
Industrial production index	106.0 (5.1)	109.3 (3.2)	112.9 (3.3)
Wholesale price index	96.6 (0.0)	96.1 (-0.5)	94.5 (-1.6)
Consumer price index	101.5 (-0.5)	101.5 (0.0)	101.8 (0.3)

Notes Real gross domestic products and real gross national products are in 1995 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)

	FY2000 (forecast)	FY2001 (forecast)	FY2002 (forecast)
Current account balance	13.3	13.2	13.9
Trade balance	13.0	12.7	12.9
Exports	50.1 (7.2)	50.4 (0.6)	49.6 (-1.6)
Imports	37.1 (12.7)	37.7 (1.5)	36.6 (-2.7)
Services	-5.0	-5.0	-4.9
Income	6.6	6.8	7.1
Current transfers	-1.2	-1.3	-1.2
Yen-dollar rate	108.5	105.5	96.3

Customs Clearance Volume Index

(100 for 1995)

Exports volume index	126.4 (7.4)	129.8 (2.7)	135.4 (4.3)
Imports volume index	124.2 (8.6)	129.9 (4.6)	138.5 (6.6)

Outlook for US Economic Indicators

GDP-Related Indicators

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

	2000 (estimate)	2001 (forecast)	2002 (forecast)
GDP (real)	9,328.7 (5.1)	9,542.2 (2.3)	9,848.1 (3.2)
GDP (nominal)	9,978.8 (7.3)	10,391.4 (4.1)	10,842.6 (4.3)
Personal consumption	6,297.0 (5.3)	6,484.7 (3.0)	6,658.1 (2.7)
Residential investment	366.0 (-0.6)	350.2 (-4.3)	361.7 (3.3)
Non-residential investment	1,420.6 (13.2)	1,475.3 (3.9)	1,554.3 (5.4)
Government consumption & investment	1,579.6 (2.9)	1,629.0 (3.1)	1,693.8 (4.0)
Federal	549.2 (1.7)	564.7 (2.8)	581.5 (3.0)
State & local	1,030.4 (3.5)	1,064.3 (3.3)	1,112.3 (4.5)
Increase in inventories	64.7 [0.2]	65.5 [0.0]	58.0 [-0.1]
Net exports of goods & services	-411.1 [-1.0]	-462.4 [-0.5]	-477.8 [-0.2]
Exports	1,138.8 (10.2)	1,224.7 (7.5)	1,296.6 (5.9)
Imports	1,550.0 (14.4)	1,687.1 (8.8)	1,774.4 (5.2)
Industrial production index	147.3 (5.8)	151.1 (2.6)	155.7 (3.0)
Producer price index	137.9 (3.7)	140.3 (1.7)	142.3 (1.4)
Consumer price index	172.3 (3.4)	176.7 (2.6)	180.6 (2.2)

Notes "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)

	2000 (estimate)	2001 (forecast)	2002 (forecast)
Balance on current account	-436.3	-464.9	-477.1
Balance on goods and services	-369.3	-393.8	-403.1
Balance on goods	-450.6	-477.8	-489.6
Exports	781.3 (14.2)	857.6 (9.8)	922.1 (7.5)
Imports	1,232.0 (19.6)	1,335.3 (8.4)	1,411.7 (5.7)