INFORMATION

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Outlook for Japanese and Overseas Economies during Fiscal 2001-2002 (Revision of Forecast in December 2000)

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Overview

Challenge to stable economic growth by overcoming a decrease in exports

The Japanese economy has suddenly stopped growing due to a sharp decline in exports in the second half of fiscal 2000. The fall in exports resulted from a slowdown in Asian economies still plagued by problems of dealing with non-performing assets together with an unexpectedly large reversal in the IT boom in the US economy. Besides, a decline in the US stock market has triggered worldwide weakness in stock prices, making business sentiment among corporations more cautious.

The Japanese economy is expected to be subject to such a difficult environment in fiscal 2001, but it will likely be able to maintain a slow recovery trend supported mainly by individual consumption and capital investment. The reasons are the following: (1) A negative growth in exports is considered to peak in the second half of fiscal 2000 and it is expected to diminish when the economy enters fiscal 2001; (2) Consumer spending will increase as a growth in income materializes; and (3) Corporate sentiment on capital investment has not drastically changed.

Needless to say, the possibility that Japan may fall into a serious economic slump in fiscal 2001 cannot be eliminated, given concern over the US economy entering into recession and the risk of non-performing assets becoming uncontrollable in Japan. However, the decline in stock prices over the last few months helped us to better understand the problems associated with the risk and to prepare countermeasures. The Japanese economy may be better prepared to avoid the worst situation compared to the situation last summer. Besides, a genuine recovery in consumer spending (which is eagerly awaited) is expected to happen together with an improvement in consumer sentiment as the economy enters fiscal 2001. The growth rate in the economy is forecasted to be 1.8% in fiscal 2001 (a previous forecast of 2.5% in December 2000) and 2.7% in fiscal 2002 (previously 3.2%).

In the meantime, the US economy will be able to avoid recession by fiscal and financial support, but the growth rate will most likely continue to be low for a while because the effect of stock price decline will cause the economy to confront two structural problems, namely a negative savings rate and a huge current account deficit. The economy will, according to recent analysis, most likely have an L-shape recovery instead of a V- or U-shape. The US economy is forecast to grow 2.2% in 2001 (a previous forecast was 2.3%) and 2.1% in 2002 (previously 3.2%).

I. Present Status of the Japanese and US Economies

The Japanese economy entered into a temporary stagnant phase in the second half of fiscal 2000 due to the absence of growth in consumer spending and a sharp decline in export although capital spending kept expanding. However, it must be remembered that GDP statistics for expenditures is likely to underestimate consumer spending, in particular. Consumer spending registered a slight negative growth due to the lack of improvement in consumer sentiment caused by a high level of bankruptcies and an unabated decline in stock prices. There was also a very slow growth in income as a result of a slightly negative growth in bonus payments in the winter of 2000. Growth in exports has been decelerated much more suddenly than in the past due to a reversal of the sharp increase occurring from fiscal 1999 to the first half of fiscal 2000 together with the effect of an abrupt slowdown in the US economy. Export of all main products such as electrical machinery, chemical, metal and automobile are declining significantly. Exports to the U.S., Asia and Europe are all falling. With a backdrop of improving corporate earnings, capital spending has been faring well, but machinery orders, a so-called leading indicator of capital spending, are showing signs of slowing due to a worsened business sentiment.

In the financial market, the BOJ, responding to widespread concern about economic stagnation, has taken measures to increase monetary supply in quick succession since February 9, and in fact decided to revert to the "zero interest rate policy" on March 19. This made it clear that the BOJ was determined to avoid recession by setting stricter conditions than previously (when it cancelled the zero interest rate policy.) The interest rate on 10-year government bonds started to decline again under this monetary relaxation policy and it reached almost 1% at the end of March. In the meantime, the Nikkei 225 Index has rebounded from a temporary dip below 12,000. The yen weakened to a level of 120-124 to the US dollar at the end of March due to the rapid shrinkage in the current account surplus caused by a slump in exports together with the decline in interest rates in Japan.

In the meantime, the annual growth rate of the US economy decelerated from 5.9% in the second half of 2000 to 2.8% in the first half in 2001, indicating the strong brakes being put on the economy. The slowdown seems to have been caused by the negative effect of a series of monetary tightening moves and a rise in the crude oil price occurring after a slight time-lag, and the reversal of the too rapid economic growth occurring from the second half of 1999 to the first half of 2000. However, various economic indicators released so far in 2001 have shown solid economic activity giving no sign of the economy being about to enter into recession. In response to the unexpectedly fast slowdown in the economy and the weak stock market, FRB took aggressive measures to increase the monetary supply, reducing the discount rates by a total of 1.5% since this January.

The growth rate of the European economy decelerated somewhat in the second half in 2000 due to the negative effect of monetary tightening and a rise in crude oil prices, but the extent of deceleration is milder than that in Japan and the U.S. In the meantime, Asian economies have shown stronger signs of stagnation due to the recurrence of bad debts problems, increased political uncertainty, together with a slump in export to the U.S.

II. Prospects for the Japanese and US Economies

A. Prospects for the Japanese Economy

The realization of a self-sustained recovery of the Japanese economy was postponed to the second half in fiscal 2001 due to an unexpected fall in exports. The growth rate will remain at a low level during the first half of fiscal 2001 caused by the lingering negative effect of a decline in exports. The growth rate will gradually start to increase mainly supported by a recovery of consumer spending. In fiscal 2002, consumer and capital spending will continue to expand steadily while public spending is cut back, thus the pace of recovery will not likely accelerate immediately. Bad debts problems will be almost over in fiscal 2001.

Consumer spending will pick up at long last because of improvements in the labor market, as corporations become active in hiring new university graduates and as bonus payments increase effective the summer of 2001. Demand for automobiles and the IT related equipment, in particular, will stay solid. However, the corporate stance on the curtailment of personnel expenses remains intact, which causes a growth in employment and wages to continue to moderate even in fiscal 2002. Therefore, personal consumption is unlikely to grow at a rapid pace.

Housing investment has moved sideways since fiscal 2000 as the tax cut ran its course. As interest rates continue to stay low, the demand for rebuilding houses owned by individuals will remain solid, supporting the entire housing construction sector until the first half of fiscal 2002. But the number of housing starts will start to decrease as a result of a rise in interest rates in the second half of fiscal 2002.

Capital investment in the first half of fiscal 2001 will temporarily decelerate its growth rate due to corporations' temporary postponement of their investment plans caused by a sharp decline in exports and a fall in stock prices. However, the IT related investment as well as for equipment replacement will gather momentum again supported by abundant cash flows in the second half of fiscal 2001 after confirmation of sustained economic recovery. In fiscal 2002, the rate of growth in capital investment will accelerate by full-scale in the areas of the next generation cellular phone related and high-speed communication networks, in addition to increasing capital spending by electric power companies after the adjustment period of investment.

Public investment in fiscal 2001 will be only slightly lower than in fiscal 2000 supported by the government policy giving priority to economic recovery being supplemented with the budget of about 3 trillion yen. In fiscal 2002, the government is likely to launch measures for curtailing, in a full scale, spending to reconstruct public finance, and thus, public spending will be sharply reduced.

Exports will continue to slightly decrease in the first half of fiscal 2001 centering on electrical machinery products, resulting from the adjustment of excess orders received arising from the overheated IT boom occurring worldwide. Furthermore, automobile exports will decrease as a result of the increased overseas production of autos. In the second half of fiscal 2001, exports will increase as the preceding temporary factors dissipate and the advantage of weak yen takes effect. However, due to a prolonged adjustment in the US economy and the yen strengthening during fiscal 2002, the pace of recovery in exports will be moderate.

In the meantime, the rate of growth in imports will significantly decelerate in fiscal 2001 due to the reaction to the sharp increases in fiscal 1999 and 2000 and the effect of the weak yen in the second half of fiscal 2000. However, imports will not likely decline because Japanese corporations' production in and imports from east-Asian countries such as China have been firmly introduced into the Japanese economy. In fiscal 2002, the rate of import growth will gradually rise as the pace of economic recovery accelerates and the yen strengthens.

The current account surplus will sharply decrease due to a decelerated rate of growth in exports from the second half of fiscal 2000 to the first half of fiscal 2001 temporarily reaching about 7 trillion yen on an annualized basis. Exports will pick up thereafter to maintain a level of more than 7 trillion yen until the end of fiscal 2002.

The rate of growth in the CPI will become positive in the summer of 2002. The analysis of the negative growth in consumer prices in fiscal 2000 led to the conclusion that it was greatly affected by a reduction in communication charges and by cheap imports from China. Communication companies' competition to reduce charges to maintain market share will be virtually over in the middle of 2001. The negative effect of imports from China on prices will be less threatening in the beginning of 2002 because of cost cutting by domestic companies and because the penetration of Chinese goods into the Japanese market will have run its course by that time.

Bad debt problems will be almost solved during fiscal 2001 by the measures taken by financial institutions themselves coupled with government support. Drastic steps are not desirable even from the economic viewpoint as well as being difficult to materialize politically, but some difficult decisions may have to be taken before lifting of the ban on payoffs in April 2002.

B. Prospects for the US Economy

The slowdown in the US economy in the second half of 2000 was much severe than generally expected. Stock prices, in particular, have shown an unabated decline, causing uncertainty among people inside and outside the U.S. In the first half of 2001, the rate of growth in the economy will temporarily become higher due to a reaction to the somewhat excessive slowdown which occurred in the second half of 2000. But after the second half of 2001, the US economy will have to fully correct structural imbalances created in the period of high economic growth in 1990s, which continue to work to depress the economy. Specifically, a negative savings rate has to be gradually normalized to become positive since the asset effect was reversed by a decline in stock prices, and the current account deficit amounting to nearly US$400 billion has to be reduced by weaker US dollars. Under these circumstances, aggressive easing of monetary policy will be implemented by the fall of 2001 and fiscal stimulus through the tax cut will be provided in the winter of 2001. These successive steps should prevent the economy from entering into recession. The size of tax cut will reach almost US$200 billion annually in 2002 because the tax cut proposed by President Bush is implemented in advance. In such an economic environment, a decelerated rate of growth in consumer spending and a reduction in housing investment will become evident, but capital investment will remain solid supported by the high level of corporate earnings. However, the ratio of capital investment against nominal GDP has reached a new high since the early 1980s, and thus the possibility that an adjustment of capital investment will occur cannot be discounted. If that happens on a full scale, the US economy will inevitably enter into recession, but a reduction in capital investment is considered avoidable taking into account the high level of corporate earnings sustained by lower interest rates and the recurrence of investment in the IT-related sector after a temporary adjustment phase.

Some economists predict a V-shape recovery in the US economy on condition that the US economy has the potential rate of growth of about 4%. No one can deny that the potential growth rate for the US economy somewhat increased by virtue of IT technology, but it cannot be simply said that the potential rate of growth which was widely believed to be in the range of 2% in 1980s suddenly shot up to 4% only because of IT technology. Besides, the high economic growth achieved in late 1990s was largely brought by a spending boom for such traditional high price products as autos and housing, and in a reaction of this boom, US auto makers are being forced to undergo severe restructuring. The US economy will not experience such a poor performance as witnessed in Japan in 1990s, but the U.S will be forced to have a low rate of economic growth for a while, being most likely to have an economic recovery in a U-shape with a long bottom or in an L-shape.

III. Projections for Interest and Exchange Rates

A. Trend in Japanese Interest Rates

The BOJ will be forced to maintain the zero interest rate policy for about one year and half until the summer of 2002. This results from BOJ's public announcement made after the Monetary Policy Decision Meeting held on March 19 that the BOJ will maintain the zero interest rate policy until Japanese consumer prices stabilize and start rising. The BOJ will begin to seek a chance to raise interest rates after the fall of 2002 associated with the increase of the long-term interest rates, but the raise will be gradual and limited as the BOJ is afraid of giving a shock to the market. The long-tern interest rate at the end of fiscal 2002 is anticipated to be about 2.5%.

B. Trend in the US Interest Rate

With a backdrop of the economy slowing down at an unexpectedly fast pace and the adjustment of the bubble in stock prices remaining yet to be seen, FRB will maintain an aggressive easing of monetary policy by the summer of 2001 to reduce short-term interest rate to around 3%. Short-term interest rates will stay thereafter about 3% by the end of 2002 due to a slow growth in the economy. In the meantime, long-term interest rates will gradually decline by the beginning of 2002 with low rates of economic growth and inflation and also with the decreasing amount of government bonds outstanding. 10-year US government bonds will decline to about 4.5%.

C. Yen Exchange Rate

The yen will continue to weaken by the summer of 2001, temporarily break 130 yen to a US dollar due to a shrinkage in the current account surplus caused by a slump in exports, the revival of the zero interest rate policy and the reduced credibility of Japan. However, after confirming a pick-up in the Japanese economy and no possibility of V-shape recovery in the U.S., the yen will start to strengthen to reach about 100 yen to US dollar at the end of fiscal 2002. The Euro will be kept high, as the European economy is maintained relatively strong as compared to the U.S. The yen to US dollar rate is anticipated to be 123 yen in fiscal 2001 and 106 yen in fiscal 2002.

End

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Outlook for Japanese Economic Indicators

GDP-Related Indicators

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

	FY2000 (estimate)	FY2001 (forecast)	FY2002 (forecast)
GDP (real)	532.4 (1.3)	542.0 (1.8)	556.7 (2.7)
Private consumption	289.5 (0.0)	295.7 (2.1)	305.7 (3.4)
Residential investment	20.3 (-1.1)	20.3 (0.2)	20.4 (0.3)
Non-residential investment	84.9 (4.7)	90.6 (6.7)	98.2 (8.5)
Government consumption	86.1 (3.4)	87.1 (1.3)	88.0 (1.0)
Public investment	39.3 (-2.8)	38.9 (-1.0)	36.0 (-7.4)
Increase in inventories	0.1 [0.1]	0.7 [0.1]	0.8 [0.0]
Net exports of goods & services	12.2 [0.1]	8.7 [-0.7]	7.5 [-0.2]
Exports	59.8 (9.6)	58.3 (-2.5)	59.1 (1.3)
Imports	47.6 (10.7)	49.7 (4.3)	51.6 (3.9)
GDP (nominal)	511.1 (-0.5)	516.8 (1.1)	530.6 (2.7)
GDP Deflator	96.0 (-1.7)	95.4 (-0.7)	95.3 (-0.0)
Industrial production index	105.8 (5.0)	108.0 (2.1)	111.2 (2.9)
Wholesale price index (overall)	96.8 (0.2)	97.4 (0.7)	96.1 (-1.4)
Consumer price index	101.4 (-0.6)	101.2 (-0.2)	101.3 (0.1)

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 (estimate)	FY2001 (forecast)	FY2002 (forecast)
Current account balance	11.4	7.6	7.3
Trade balance	11.3	7.2	6.5
Exports	49.8 (6.5)	48.8 (-2.0)	46.9 (-3.9)
Imports	38.5 (16.8)	41.5 (8.0)	40.3 (-2.9)
Services	-5.0	-5.1	-5.0
Income	6.3	6.7	7.0
Current transfers	-1.2	-1.3	-1.2
Yen-dollar rate	110.3	122.5	106.3

Customs Clearance Volume Index

(100 for 1995)

Exports volume index	123.4 (4.8)	118.1 (-4.3)	120.0 (1.6)
Imports volume index	125.4 (9.7)	127.8 (1.9)	131.7 (3.1)

Outlook for US Economic Indicators

GDP-Related Indicators

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

	2000 (actual)	2001 (forecast)	2002 (forecast)
GDP (real)	9,318.6 (5.0)	9,526.3 (2.2)	9,723.2 (2.1)
GDP (nominal)	9,962.7 (7.1)	10,375.6 (4.1)	10,712.2 (3.2)
Personal consumption	6,294.4 (5.3)	6,476.1 (2.9)	6,578.6 (1.6)
Residential investment	366.3 (-0.5)	359.0 (-2.0)	331.3 (-7.7)
Non-residential investment	1,413.3 (12.6)	1,463.0 (3.5)	1,523.5 (4.1)
Government consumption & investment	1,579.0 (2.8)	1,623.9 (2.9)	1,688.7 (4.0)
Federal	548.1 (1.5)	560.5 (2.2)	577.2 (3.0)
State & local	1,030.3 (3.5)	1,063.5 (3.2)	1,111.5 (4.5)
Increase in inventories	61.8 [0.2]	65.5 [0.0]	58.0 [-0.1]
Net exports of goods & services	-412.7 [-1.0]	-461.4 [-0.5]	-457.0 [0.0]
Exports	1,126.5 (9.1)	1,167.7 (3.7)	1,204.9 (3.2)
Imports	1,539.2 (13.6)	1,629.1 (5.8)	1,661.9 (2.0)
Industrial production index	147.5 (5.7)	147.9 (0.3)	149.4 (1.0)
Producer price index	138.0 (3.7)	140.5 (1.8)	142.0 (1.1)
Consumer price index	172.3 (3.4)	176.8 (2.6)	181.1 (2.4)

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 (actual)	2001 (forecast)	2002 (forecast)
Balance on current account	-435.4	-447.6	-439.7
Balance on goods and services	-368.5	-395.2	-387.1
Balance on goods	-449.5	-467.6	-463.7
Exports	773.3 (13.0)	811.7 (5.0)	845.2 (4.1)
Imports	1,222.8 (18.7)	1,279.3 (4.6)	1,308.9 (2.3)