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Outlook for Japanese and Overseas Economies during Fiscal 2001-2002

(Revised from the forecasts made in July 2001)

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Overview

Japanese economy suffering from a drastic decline in exports

In Fiscal 2001, The Japanese economy is being forced to enter into recession due to the largest decline in the volume of exports since 1970s. This resulted from a sharp shrinkage in demand for IT-related equipment in the U.S., and throughout the world. Besides, the unfavorable effect of simultaneous attacks by terrorists in the U.S. on the economy will be unavoidable, though temporary. The rate of growth in the world economy in 2001 is most likely to be the lowest since the early 1990s.

Under these unfavorable circumstances, the Japanese economy continues to find itself in a severe situation, but nevertheless, consumption and capital spending in the non-manufacturing sector appear relatively steady. The reasons are the following: (a) The non-manufacturing sector is maintaining an increase in earnings thanks to a restructuring effect and other factors, creating a steady trend in capital investment and employment, and (b) the decline in exports being concentrated on electrical machinery, limiting the negative effect to be spread over other industries. In this environment, Nikkei 225 Index declined below 10,000 in September due to investors' fears of the earnings of the manufacturing sector deteriorating together with the worsened relationships between supply and demand for stocks by unwinding cross-shareholdings.

In Fiscal 2002, the Japanese economy will make a turn to recovery as exports stop declining, gradually creating a favorable environment. In the meantime, capital spending in the non-manufacturing sector will continue to show a steady growth centering on the communication-related sector including the next generation of cellular phone. Consumer spending will also gradually show an increased rate of growth directly affected by the expansion of consumers' income. As a result, the rates of growth in the Japanese economy in Fiscal 2001 and 2002 are estimated as negative 0.2% (0.7% predicted in July 2001) and 1.6% (2.1% at the same time) respectively.

In the meantime, the U.S. economy in 2002 will move into a gradual recovery because the adjustment of capital investment made in IT related equipment is over and the effect of a reduction of interest rates will be fully felt in the economy. The U.S. economy will be able to avoid recession supported by both financial and monetary policies, but the rate of economic growth will continue to be low since it will take some time for capital investment to recover due to an unfavorable effect from a sharp rise in debts associated with the bursting of the bubble and a decline of stock prices. The rates of growth in the economy in 2001 and 2002 are estimated to be 1.1% (2.1% predicted in July 2001) and 1.6% (2.6% at the same time) respectively.

I. The Japanese and U.S Economies in Fiscal 2001

The Japanese economy in 2001 is being forced to enter into recession due to a sharp decline in exports. The volume index of exports has already declined nearly 17% from the peak reached last summer, highest level since 1970s. The reduction in volume of exports in electrical machinery was particularly drastic, nearly 35% from the peak. This resulted from a decrease in demand for IT related equipment in the U.S. and a worldwide slowdown in demand for cellular phone and PCs. A typical export shock on a scale never seen before attacked the Japanese economy, which had just begun to seize the chance to finally recover. These effects are beginning to work as a negative factor for capital spending in the manufacturing sector related to electrical machinery.

In the meantime, consumer spending and capital spending in the non-manufacturing sector are unexpectedly solid. For instance, the annualized number of passenger cars sold in the first quarter was 4.3 million, rising to 4.5 million cars recently, and the sales of department stores in the Tokyo district showed a positive growth compared to those in the same month last year for three months in a row until this last August. Machinery orders from the non-manufacturing sector, a leading indicator for the trend of investment by the sector, were on the rise, though fluctuating, until this last July. As mentioned, a drastic decline in exports has directly hit the manufacturing sector centered on electrical machinery, but these negative effects have not surprisingly affected other sectors in the economy.

The reasons are the following:

First, this results from the characteristics of the electrical machinery industry. The electrical machinery industry is a highly self-contained industry the fluctuation of whose demand has a considerable influence over peripheral business and overseas suppliers but does not have a large negative effect on the non-manufacturing and other manufacturing sectors. Accordingly, a collapse in the bubble of the IT industry in the U.S. almost simultaneously shocked the IT related industry in the U.S. and electrical machinery makers in Japan, but it is still hard to find a ripple effect on the manufacturing sector less related to the IT industry and the non-manufacturing industry in Japan.

Second, the favorable earnings of the non-manufacturing sector are supporting consumer spending and capital spending. The earnings of the non-manufacturing industry continued to increase smoothly until the second quarter of 2001, likely resulting from the effect of restructuring appearing after a time lag. Accordingly, companies in the non-manufacturing industry have a willingness to steadily increase employment, preventing the labor market from greatly deteriorating regardless of the progress of restructuring now going on in the manufacturing industry. This is also contributing to steady consumer spending. Besides, abundant cash flows from earnings will, needless to say, work favorably for capital spending. Housing and public investments are already in a downtrend because the effect of economic measures taken by the government has been gradually disappearing. However, additional public spending of 3.5 trillion yen by the supplementary budget in FY 2000 was mostly carried forward into FY 2001, causing the dip in public spending in FY 2001 to become temporarily small. Regarding housing investment, investment in detached houses showed a relatively large decline. Considering the economic factors mentioned above, the rate of growth in the economy will be a negative 0.2%, the first time since FY 1998 when a negative growth of 0.6% was recorded.

In the meantime, prices are on a continuous decline trend due to a reduction of rent and an influx of cheap industrial goods from China, further increasing the rate of decline in consumer price index to a negative 0.8% in FY 2001 from 0.5% in FY 2000. Turning to the financial market, the stock market has not stopped falling since spring last year due to the certainty of a quick deterioration of earnings in the manufacturing industry as well as the unwinding of cross-shareholdings going on, and the Nikkei Index finally fell below the critical level of 10,000 on September 12, immediately after the terrorism attacks. The Bank of Japan adopted a marginally easier monetary policy in August and September to cope with the serious situation of the economy entering into recession after restoring the actual zero- interest rate policy on March 19. The Yen-Dollar rate started to move toward a stronger yen in August after the slowdown in the U.S. economy was confirmed and reached the level of 116 yen in the middle of September.

The sentiment of the slowdown of the U.S. economy has quickly gathered momentum since the middle of 2001 due to an unexpectedly large decline in demand for IT related equipment.

The background of the fast decline in demand for IT related equipment is the following:

First, demand artificially expanded by vendor finance was suddenly lost. Vendor finance is what communication equipment makers and others give to mid- and long-term accounts receivable held by communication-related companies. In the last few years, those communication-related companies refinanced funds for capital investment on a large scale by credit accommodated by the communication equipment makers. The latter was strongly expected in the stock market to increase sales and they tried to raise sales by vendor finance knowing the inherent risk. Although the total amount of vendor finance in the U.S. has not been calculated, bad debts totaling as much as a few trillion yen are likely to occur across the industry considering that one major communication equipment maker alone posted accounts receivable amounting to several hundred billion yen. The moment the prospects for the future demand for communication equipment started to be questioned, the artificial creation of demand by vendor finance had to shrink all at once.

Second, it can be pointed out that a slowdown in the rate of growth in demand for cellular phones and PCs affected the IT industry. Cellular phone and PC makers, which had given tentative orders to parts makers premised on a higher growth in sales, promptly reduced parts orders under the necessity of adjusting inventories by revising downward the rate of growth in demand.

Third, two court decisions in a row in 2000 created a chill over optimism for the future prospects of the IT industry. The first case was that the court decision ordering Microsoft Co. to correct its business including splitting of the company (the U.S. Department of Justice gave up splitting in September 2001), and the second one was the provisional order to Napstar in July to suspend its business services. The former was regarded as a general warning against obtaining unfair profit using a monopolistic position in the information and communication areas and the latter was construed as an increase in demand for information arising from the exchange of music information between individuals (in practice, the exchange of music CDs) to become strictly restricted with a view to protecting copyright. The rosy future prospects in the information-related business in general were drastically reconsidered by these two cases.

The bubble of demand for IT-related equipment promptly burst as a result of these factors, causing the demand to decrease about 40% from the peak in June last year on a machinery order basis. Such sharp decline in demand for the IT-related equipment has driven the U.S. and worldwide economy into near recession. A sharp decrease in demand for IT-related equipment has begun to have a negative impact on consumer spending and capital spending other than IT-related equipment through the deterioration of employment and corporate earnings. The income tax cut of near US$ 40 billion and the reduction of short-term interest rates are expected to have their full impact on the economy after September, but it is unavoidable that the terrorism attacks will have an unfavorable influence, though temporarily, over consumer and capital spending. As a result, the rate of economic growth for 2001 is expected to be limited to 1.1%, the lowest since 1991. It is highly likely that the FRB will further cut interest rates to cope with stock price declines and the deteriorated sentiment in business. The rate of rise in the consumer price index is, however, expected to decline to 3% (from 3.4% in 2000) due to a slowdown in the rate of economic growth and a decline in energy prices.

The European economy has been forced to decelerate its growth rate due to the effect of the worldwide slump in IT-related equipment, but its rate of decline is limited compared to the Japanese and U.S. economies, thanks to the favorable effect of tax cuts implemented in the beginning of this year and other factors. The Asian economy has fast become even more stagnant due to the recurrence of bad debts problems and political uncertainties in addition to a sharp decline in the exports of IT-related equipment.

II. Japanese and U.S. Economies in Fiscal 2002

A. Forecast for the Japanese economy

Exports will continue to decrease until the beginning of 2002 and capital spending in the manufacturing sector will unavoidably fall during the entire Fiscal 2001. However, exports will move sideways in 2002 as the decline in the worldwide IT demand runs its course, and capital spending of the manufacturing sector will hit bottom after a certain timelag. In the meantime, the economy will be able to barely avoid a serious slowdown because consumer spending will maintain a gradual expansion in parallel with the rate of growth in income and because capital investment in the non-manufacturing sector will be steady. In other words, the Japanese economy will hold its ground just before a vicious chain reaction in the reduction of production, employment, income and consumption occurs. We cannot exclude a risk of the U.S. economy slowing down, but compared to the IT-related demand, the negative impact of a decrease of U.S imports caused by consumer spending and capital spending other than in IT-related equipment on exports from Japan will be insignificant, and we should not be overly pessimistic. Furthermore, the central banks in Japan, U.S and Europe have begun to keep pace with each other to adopt an easy money policy since this September, enabling us to expect the effect of lower interest rates to fully appear from the beginning of 2002. The very fact that the bursting of the IT-related bubble in the U.S., the largest risk the Japanese economy had faced for the last few years, has occurred has instead dissipated other risks for the time being.

Exports will gradually start to recover in the beginning of the fiscal year 2002, and consumer spending and capital spending in the non-manufacturing industry will, step by step, gather momentum to accelerate their expansion. Concerning consumer spending, the unemployment rate is expected to peak at the end of Fiscal 2001, improving consumer sentiment and linking income growth directly to an increase of consumer spending. A demand for passenger cars and IT-related equipment will continue to be steady. Capital spending in the non-manufacturing industry is expected to maintain its momentum because investments related to the next generation cellular phone and in broadband will be carried out on a full scale and because investment in the distribution industry will begin to recover from a bottom hit by a reactionary decline from a rush for investments at the end of 2000. Capital investment in the manufacturing industry will begin to recover from around the middle of 2002 centering on replacement investment. The level of investment in the beginning of Fiscal 2002 in the manufacturing and non-manufacturing industries will still be 15% below the peak in 1997, with a little downside fluctuation and a large room for the recovery of investment. Besides, the rate of capital investment against cash flows is far below 1.00, indicating a large room for capital expansion by corporations.

In the meantime, a decrease in housing and public investments seems unavoidable. The reason for this is that stimulative measures taken through government spending continue to shrink under the Koizumi Administration. However, housing centering on condominiums has a good showing as a result of a success in constructing condos with a favorable location in the center of the Metropolitan Tokyo. Besides, the public investment of about 1.5 trillion yen to be added by the supplementary budget for Fiscal 2001 will be mostly spent in Fiscal 2002. The rate of growth in exports will start to recover from the second half in 2002, but it will be limited to 1-2 % due to a slow recovery in overseas economies and a gradual rise in the Yen. The rate of growth in imports will be also limited to 2% or little more as the increase in the imports of goods from China will gradually slow down. The rate of growth in Fiscal 2002 will be 1.6%.

The current account surplus will slightly increase to 8.2 trillion yen in Fiscal 2002 after a sharp fall from 12.1 trillion yen in Fiscal 2000 to 7.3 trillion yen in Fiscal 2001. The rate of change in consumer price index will continue to be negative through Fiscal 2002 compared to the same month in the previous year. With a backdrop of the progress of the high Yen, prices will continue to be depressed until they start to rise in or after 2003. The solving of bad debts problems will not become a decisively negative factor to the economy because the self-help measures of financial institutions will gradually progress together with government support.

B. Forecast for overseas economies

It is unavoidable for consumer and capital spending in the U.S. to be negatively affected by the terrorism attacks in the fourth quarter of 2001, but entering into 2002, their negative influence over personal consumption will be considerably alleviated. The only disaster in an advanced country comparable to these attacks since World War II would probably be the Hanshin Earthquake in January 1995 and the Tokyo

Subway Sarin Attack in March the same year. The number of persons directly killed by the Hanshin Earthquake totaled 5,500, and according to Hyogo Prefecture, the amount of damages was estimated to be around 10 trillion yen. Besides, the Subway Sarin Attack as indiscriminate terrorism in March provoked acute fears among the Japanese. It was said at the time that the incidents of this nature and magnitude would unavoidably worsen consumer sentiment, but in reality, personal consumption was almost unaffected by the two incidents. Its can naturally be considered that the simultaneous terrorists attacks have given the U.S population a greater shock than that of the Hanshin Earthquake and Sarin Attack combined, but it may be dangerous to overestimate the aftereffect of the incidents on the economy.

However, it is feared that a slump in capital investment centered on aircraft and large buildings will be prolonged compared to personal consumption, by which the favorable effect of earnings improvement due to a reduction of interest rates may be partly offset. But, there appear indicators to show signs of IT-related investment bottoming out as early as in the fall of 2001 and most likely starting to increase, though gradually, in the second half of 2002. Since the U.S. economy had continued to experience around 4% growth for 5 years in a row until 2000, there still remains some parts in the economy such as the low savings rate, and the enormous current account deficit, etc. that need to be adjusted. It is hard to say that the U.S. economy will deteriorate to the extent that the Japanese one experienced in the 1990s, but the rate of growth in the economy will be forced to be low for some time to come, most likely to create the economic pattern of U shape or L shape with a prolonged bottom. The rate of growth in 2002 will be 1.6%.

The European economy is very likely to return to a growth trend more smoothly than in the U.S. once the worldwide IT-related slump is over. Capital spending within and around EU countries will be activated much more than before. Conversely, it will take more time for the Asian countries to recover from the IT-related slump than in Japan.

III. Forecast for Interest and Exchange Rates

A. Interest rates in Japan

The Bank of Japan will be forced to continue, in substance, a zero interest-rate policy through Fiscal 2002. This has resulted from the Bank’ s statement that the zero interest-rate policy would remain intact until the rate of rise in the consumer price index steadily exceeds 0%. The long-term interest rate will start to rise around the fall of 2002 after confirming the bottom in the economy, but the pace of rise will be limited, as a deflationary trend cannot be easily changed.

B. Interest rates in the U.S.

The FRB will implement additional reductions of short-term rates in order to prevent the economy from further deterioration, pushing down the real short-term interest rate almost to zero. The FRB will thereafter maintain low interest rates until the fall of 2002 when the economic recovery can be confirmed. In the meantime, the long-term interest rate will continue to decline this year due to a reduction of short-term interest rates and the lower rate of inflation caused by worsened economic conditions. However, the magnitude of decline will be smaller than for the short-term rate and thus, the spread between long- and short-term rates will widen to near the level we witnessed in the early 1990s. Long-term rates will gradually rise after the bottom in the economy in the middle of 2002.

C. Yen rate

The Japanese Yen will be on the steady rise from around the end of 2001 since a slump in the U.S. economy seems to be likely. However, the Yen will rise only at a slow pace against a backdrop of a shrinkage in the current account surplus due to a slump in exports, the restoration of zero interest rate policy, a sentiment of uncertainty held by overseas investors, and other factors. The Euro will maintain a steady trend against other currencies because the European economy is expected to recover more smoothly than the U.S. economy. The Yen-US dollar rate is predicted to be 121 yen for one dollar in Fiscal 2001 and 113 yen for Fiscal 2002.

End

Outlook for Japanese Economic Indicators

GDP-Related Indicators

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

	FY2000 (actual)	FY2001 (forecast)	FY2002 (forecast)
GDP (real)	530.7 (1.0)	529.8 (-0.2)	538.4 (1.6)
Private consumption	289.4 (-0.0)	292.0 (0.9)	297.5 (1.9)
Residential investment	20.1 (-1.9)	18.5 (-8.0)	19.1 (3.2)
Non-residential investment	84.9 (4.6)	85.9 (1.3)	89.3 (3.9)
Government consumption	86.0 (3.3)	87.6 (1.9)	88.9 (1.5)
Public investment	37.9 (-6.1)	37.0 (-2.4)	35.9 (-3.1)
Increase in inventories	-0.0 [0.1]	-0.1 [-0.0]	0.0 [0.0]
Net exports of goods & services	12.5 [0.2]	8.8 [-0.7]	7.7 [-0.2]
Exports	59.7 (9.3)	55.8 (-6.5)	56.5 (1.3)
Imports	47.2 (9.8)	47.0 (-0.5)	48.8 (3.9)
GDP (nominal)	510.8 (-0.6)	501.1 (-1.9)	505.6 (0.9)
GDP Deflator	96.3 (-1.5)	94.6 (-1.7)	93.9 (-0.7)
Industrial production index	104.9 (4.0)	95.8 (-8.6)	96.4 (0.6)
Wholesale price index (overall)	96.8 (0.2)	97.4 (0.6)	96.2 (-1.2)
Consumer price index	99.9 (-0.5)	99.1 (-0.8)	98.7 (-0.4)

Notes Real gross domestic products and real gross national products are in 1995 prices.
Industrial production index and wholesale price index: 100 for 1995.
Consumer price Index: 100 for 2000.
**[ ] = contribution to changes.*

Balance of Payments Indicators

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

	FY2000 (actual)	FY2001 (forecast)	FY2002 (forecast)
Current account balance	12.1	7.3	8.2
Trade balance	11.5	7.1	7.5
Exports	49.8 (6.6)	46.8 (-6.1)	45.0 (-3.8)
Imports	38.3 (16.1)	39.7 (3.8)	37.5 (-5.5)
Services	-5.2	-6.1	-6.0
Income	6.7	7.7	7.9
Current transfers	-0.9	-1.3	-1.2
Yen-dollar rate	110.5	120.7	112.5

Customs Clearance Volume Index

(100 for 1995)

Exports volume index	123.4 (4.8)	110.4 (-10.5)	112.1 (1.5)
Imports volume index	125.5 (9.8)	122.9 (-2.0)	125.8 (2.4)

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)	9,224.0 (4.1)	9,329.6 (1.1)	9,483.6 (1.6)
GDP (nominal)	9,872.9 (6.5)	10,206.0 (3.4)	10,511.2 (3.0)
Personal consumption	6,257.8 (4.8)	6,431.4 (2.8)	6,558.7 (2.0)
Residential investment	371.4 (0.8)	376.4 (1.4)	353.8 (-6.0)
Non-residential investment	1,350.7 (9.9)	1,299.9 (-3.8)	1,265.5 (-2.6)
Government consumption & investment	1,572.6 (2.7)	1,626.0 (3.4)	1,665.3 (2.4)
Federal	545.9 (1.7)	556.1 (1.9)	569.7 (2.4)
State & local	1,026.3 (3.2)	1,069.5 (4.2)	1,095.7 (2.4)
Increase in inventories	50.6 [-0.1]	-15.1 [-0.7]	42.5 [0.6]
Net exports of goods & services	-399.1 [-0.9]	-409.9 [-0.1]	-414.7 [-0.1]
Exports	1,133.2 (9.5)	1,113.0 (-1.8)	1,121.0 (0.7)
Imports	1,532.3 (13.4)	1,522.9 (-0.6)	1,535.7 (0.8)
Industrial production index	147.5 (5.6)	143.9 (-2.4)	144.3 (0.3)
Producer price index	138.0 (3.7)	141.5 (2.5)	142.2 (0.5)
Consumer price index	172.3 (3.4)	177.4 (3.0)	181.2 (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 (actual)	2001 (forecast)	2002 (forecast)
Balance on current account	-444.7	-423.5	-418.1
Balance on goods and services	-375.7	-359.1	-350.3
Balance on goods	-452.2	-437.9	-435.1
Exports	772.2 (12.8)	744.1 (-3.6)	746.9 (0.4)
Imports	1,224.4 (18.9)	1,182.0 (-3.5)	1,181.9 (-0.0)