INFORMATION

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Outlook for Japanese and Overseas Economies during Fiscal 2002-2003

(Revised from the forecasts made in December 2001)

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Overview

Japanese economy emerging from the worst period of recession

The Japanese economy entered into recession in Fiscal 2001 due to the largest decline in exports experienced since the 1970s, but it is now showing signs of a slight improvement toward the end of the fiscal year. First of all, the slump in the U.S. economy caused by the bursting of the IT bubble is almost over, stopping a decline in exports of IT-related products from Japan. Furthermore, as a result of the assiduous adjustment of production, the bottoming out of production activity is around the corner as the inventory ratio has started declining. There still remain negative factors such as a declining trend in capital spending, no eradication of financial instability, and so forth, but it can be considered that the recession has entered into its final stage.

The Japanese economy will start a mild recovery from the middle of Fiscal 2002. Exports can, if anything, be regarded as an engine of the economy, but the aftermath of a sharp decline in exports in the previous fiscal year is still having a negative effect on consumer and capital spending, so the economic recovery will be a mild one. Specifically, negative factors are that the exports of electrical machinery will tend to show a small rate of growth due to the existence of excess investments in IT-related products centered in the U.S. and that consumer spending will inevitably show a slow recovery due to a slow rate of increase in wage earners' income caused by corporations endeavoring to cut personnel expenses. However, capital spending will pick up to a full scale from around the end of Fiscal 2002 supported by the recovery of corporate earnings. The rate of growth in consumer spending will increase due to the expansion of employment and an increase of bonus payments. Thus, the rate of economic growth will begin to accelerate. With a backdrop of the economic recovery, the credibility of the yen will be enhanced and will trend to a higher value. The rate of economic growth in Fiscal 2002 is forecasted to be 0.2% (0.1% predicted in December 2001), and in Fiscal 2003, 2.7% (2.0% predicted in December).

The U.S. economy will move into a mild recovery from the beginning of 2002 due to the end of adjustment of investment in IT-related equipment and also to the effect of continuing stimulative economic policies. Thanks to the financial and monetary support, the recession in the U.S. was limited to a mild and short-term one, but the adjustment of the two structural problems, a gigantic current account deficit and sharply increased debts due to the IT bubble, was postponed. As a result, the rate of economic growth in 2003 after the effect of policy measures disappears will be limited to a low level as the second year of the economic recovery. The rate of economic growth in 2002 and 2003 is forecasted to be 1.8% (0.2% predicted in December 2001) and 2.5% (2.7% at the same time) respectively.

I. The Japanese and U.S Economies in the second half of Fiscal 2001

The Japanese economy in Fiscal 2001 is expected to post a negative growth rate of 1.4%, the poorest performance since the 1970s, but it is beginning to show a slight improvement in the second half of this fiscal year. First, exports, which have suffered a sharp decrease so far, are beginning to show signs of stopping their decline. The rate of decline of the index in the volume of exports in the 4th quarter in 2001 narrowed sharply to 3.1% from the previous quarter on an annual basis, from 10.9% in the 3rd quarter, 20.7% in the second quarter and 12.1% in the 1st quarter. Furthermore, the volume of exports in January 2002 sharply increased by 10.1% from the previous month due to an increase of exports of steel and chemical products shipped to Asian countries. The basic factor for exports to hit the bottom should be the fact that a decrease in demand for IT-related equipment in the U.S. (which caused the decrease of exports from Japan) is almost over. Besides, East Asian countries such as South Korea and Taiwan, which suffered the negative impact of a slump in the U.S. IT industry more than Japan, have completed the adjustment of inventory for materials and parts, causing exports from Japan to begin to increase.

Second, the inventory adjustment in Japan is finally in progress. In response to a sharp decline in exports, Japanese manufacturers had cut production from the 1st quarter of 2001, but the rate of decline in demands proved to be larger than anticipated, causing the inventory ratio to stay relatively high until the autumn of last year. However, the rate of decrease in inventory became high in the 4th quarter, increasing the inventory ratio to start declining. Thus, the production adjustment has entered into the final stage.

Third, the uneasiness of the financial market is being dissipated. It has been feared that the turmoil of the financial market caused by the outflow of deposits from some financial institutions before the lifting of the ban on "payoffs" (i.e. removing of blanket guarantee on bank deposits) with effect from April and a decline in stock prices caused by the cancellation of cross-shareholdings might have negative effect on the real economy. In response, the Financial Services Agency endeavored to stabilize the financial market in Fiscal 2001 by taking such measures as the disposition of the failure of more than 50 small and medium financial institutions whose bad loans problems were serious, the implementation of special inspections of large banks in connection with their major customers, and the reinforcement of regulations on a short selling. As a result, the Nikkei 225, in particular, has been moving around the 11,000 level in March, giving some comfort to the financial market.

On the other hand, there still exist unstable factors such as uncertain prospects for consumer and capital spending. Regarding consumer spending, corporations continue to make efforts to reduce personnel expenses, causing wage earners' income to decrease, and the rate of growth in consumer spending remains barely flat. If the bankruptcy of a large corporation occurs, consumer sentiment may immediately deteriorate further. Regarding capital spending, the rate of decline of machinery orders, a leading index of capital spending, has not stopped while fluctuating widely month by month and it has not yet moved into a recovery trend. Capital spending in the non-manufacturing sector, which had continued to show strength until the 1st half in 2001, appears to be weakening.

In the meantime, prices have continued their decline, and the consumer price index in February within the wards of Tokyo Metropolis showed the largest decline ever of 1.7% from the same month of last year since the 1960s. However, the further decline in prices in recent months was attributable to a decline in the price of perishable food, and it cannot be said that the so-called deflation spiral has caused prices to be pushed lower. The Japanese yen weakened from 120-125 to 130-135 yen per US dollar from December 2001 until January 2002 when overseas investors became most pessimistic about the Japanese economy. However, the yen thereafter returned to 125-130 yen per US dollar at the beginning of March due, in part, to widespread optimism about the prospect for the domestic and overseas economies. 10-year JGBs are trading most recently at the proper level of about 1.5% after the correction of an excessively low yield.

The prospects for the U.S. economy have changed greatly after the terrorist attacks on September 11, but most people are now optimistic. The optimism results from the fact that the real GDP growth rate in the 4th quarter 2001 was 1.4% on an annual basis, better than expected by a majority of observers. Furthermore, auto sales and new housing starts have maintained a high level since beginning of 2002. The level of non-farm payroll employment increased 70,000 in February, the first increase in 7 months, indicating that the employment adjustment is most likely over. The sharp decline of IT-related investment which caused the slump in the economy this time is about over. All of these factors are supporting the optimism. It is, however, not so surprising for the U.S. economy to have succeeded in escaping from a genuine recession taking into account the income tax cut of as much as US$ 40 billion implemented last summer, the lowered income tax rate in the lowest income bracket (from 15 to 10%) effective January 2002 and the effect of economic policies such as extremely aggressive monetary easing. In conclusion, the rate of economic growth in 2002 stood at plus 1.2%, avoiding a full-scale recession. Furthermore, CPI inflation dropped to 2.8% in 2001 from 3.4% in the previous year due to a slowdown in the economy and a decline in energy prices.

In the meantime, Asian economies are recovering slightly ahead of the U.S. Asian NIEs, which were suddenly put into recession due to a sharp decrease of exports of IT-related devices, hit the bottom in the autumn of 2001 and have since been on the recovery phase due to a series of stimulative policies for the respective economies and steady consumer spending in addition to the end of the slump in the U.S. IT industry. Some Asian countries still suffer from bad debt problems and deflation as in Japan, but these have not become decisively negative factors for the recovery of the economies. The European economy is shaking off the negative impact of a slump in the U.S. IT industry. Positive developments are the end of the adjustment of capital investment and a decrease of the negative impact of a sharp rise in energy prices on the economy.

II. Japanese and U.S. Economies in Fiscal 2002 and 2003

A. Forecast for the Japanese economy

The Japanese economy is forecasted to recover from the middle of Fiscal 2002. However, due to the aftereffects of the largest decline of external demand since the World War II, the level of the economic recovery will only be mild during Fiscal 2002, and a full-scale recovery is anticipated to come in Fiscal 2003. The rate of economic growth will be slightly positive - 0.2% - in Fiscal 2002 and it will increase to 2.7% in Fiscal 2003, exceeding the potential growth rate of about 2%.

Japanese corporations are making serious efforts, never seen before, in order to recover their earnings, confronted with a decrease of corporate profit of as much as nearly 20% in Fiscal 2001 from the previous fiscal year and stiff competition from overseas producers. Above all, the reduction or curtailment of personnel expenses has become drastic as witnessed in large companies' policy to award no increase in base salaries or to freeze the system for an automatic rise in annual salary. It is certain that no increase in the payment of summer bonus will be made. Accordingly, the move to cut employment will slow down, but wage earners' income will continue to decrease 0.9% in Fiscal 2002 following a decrease of 1.6% in Fiscal 2001. This stagnant growth in wage earners' income will bring about a long-term slump in consumer spending. However, since the employment adjustment has been already made to a large extent, the sense of unease about employment will be gradually relaxed, causing consumer sentiment to gradually improve and thereby preventing consumer spending from falling.

In the meantime, the curtailment of capital spending will continue during Fiscal 2002 similar to that of personnel expenses. Thanks to an increase of exports, production will expand slightly and corporate cash flows remain high, but with a backdrop of a continued low operating ratio and the fragile financial market, corporations will maintain their stance to give priority to the repayment of borrowing by appropriating surplus fund. Besides, housing and public investments, intentionally increased by stimulative economic policies in 1990s, have been slowing down to a sustainable level, working as a negative factor on the economy. Regarding housing investment, in particular, the high level of construction activities for high-rise condominiums in the center of Tokyo will hit the peak in the second half of fiscal 2001 to show a slowdown in Fiscal 2002.

In this severe economic environment, exports are almost the only factor to lead the economy in Fiscal 2002. Exports mainly to Asian countries will begin to expand from the beginning of Fiscal 2002, and gradually accelerate. The expansion of exports will result from the Japanese yen's expected move above 110 yen to a US dollar during Fiscal 2002, which is considered a breakeven rate for the Japanese manufacturers. This will directly increase profits in the manufacturing sector, which will gradually improve corporate sentiment.

In Fiscal 2003, housing and public investments will return to the level experienced in the middle of 1980s while at the same time, the aftereffects of a slump caused by the bursting of the IT bubble will almost disappear, and the Japanese economy will regain an economic cycle to move in a normal linkage between production, employment, income and consumption. From this point of time on, it is capital investment that will lead the Japanese economy. An increase of cash flows arising from the expansion of profits will be appropriated to capital investment instead of the repayment of borrowing as the financial environments are normalized. Japanese corporations curtailed capital investment all through 1990s due to continued uncertain economic environment, which has generally made overall capital equipment obsolete. In other words, they did not fully make necessary renewal investment. Such pent-up demand for renewal investment will be released on a full-scale in Fiscal 2003. Besides, positive investment in the information and communication-related sectors and the development of new products will begin to increase. However, it is inevitable that a continued shift of production to China by manufacturers with low value-added products will slightly weaken the force of domestic capital investment.

A rise in the strength of capital investment will lead to the expansion of employment and personal income after some timelag, increasing consumer spending on a full-scale. While a move to reduce employment in the manufacturing sector slows down, the employment of service and distribution industries will begin to increase again, reducing the rate of unemployment to about 4.5% at the end of Fiscal 2003. As earnings recover, bonus payments will increase. The nominal level of the present bonus payment is considerably lower than the average in 1990s, leaving companies much room to increase bonuses. Regarding consumer spending, a pent-up demand for upgrading new passenger cars for old ones and for goods of higher grade will be released as the income environment improves.

The rate of decline of consumer price index will become much smaller from the second half of fiscal 2002 due to a rise in reaction to a downtrend in the price of perishable foods and a slowdown in the inflow of low-priced imported textiles and home electrical appliances into the market. The so-called deflationary trend will diminish, but the rate of rise in wage cost (Rate of growth in wages – Rate of growth in productivity) will continue to be negative, and thus, extremely stable prices will be maintained. The rate of increase in consumer price index will be -0.6% in Fiscal 2002 and -0.2% in Fiscal 2003. On the other hand, the current account surplus will remain as much as about 12 trillion yen. The major factor for the Japanese current account surplus shifted from trade surplus to income surplus at the end of the 1990s. While the trade surplus has shrunk due to increased imports from Asian countries such as China, a major exporter, income surplus from overseas investment has been expanding as the local production of Japanese companies started to generate profits.

The Japanese economy has found it very difficult for the last decade or so to escape from the spell cast by the bursting of the bubble. The failure to escape from this quagmire is considered to be attributable mainly to the following two factors, namely the failure of the strategy to postpone the solution of the bad debt problem until the economy recovers and a delay in rationalizing the hugely bloated public sector. Furthermore, the negative effect of the bursting of the IT bubble in the U.S. further worsened bad debt problems in Japan. As a result, the Japanese economy has entered into its worst recession since the World WarⅡ. However, market forces have compelled the acceleration of the solution of the bad debt problems in Fiscal 2001. Furthermore, the Koizumi Administration has begun to bring about shrinkage in the public sector on a full-scale. Although the administration has not achieved a consensus of opinion on various issues such as how to respond to the aging society, the fundamentals of the Japanese economy can be regarded as having become better than before. Thus, Fiscal 2002 is most likely to be a turning point for the Japanese economy.

B. Forecast for overseas economies

The U.S. economy is forecasted to continue growing 1.8% in 2002 and 2.5% in 2003. Thanks to aggressive policy initiatives, the U.S. economy seems to be able to escape smoothly from the slump caused by the bursting of the IT bubble. However, an imbalance in the economy has not adequately adjusted. The rate of growth in the economy in 2002 will not go higher than expected due to the gradual disappearance of the effect of the tax cut and a reduction of interest rates. Specifically, the temporary rise in demand for autos by zero-interest loans and housing investment due to low interest rates will show a slowdown from the middle of 2002. Capital investment cannot be expected to show an explosive growth as witnessed at the end of 1990s due to excess equipment existing in the long-distance communication related sector. This trend will continue in 2003, limiting the rate of growth to a relatively low rate considering the second year in the economic recovery.

It has been already pointed out that the structural problems of the U.S. economy consist of a low savings rate and a huge current account deficit. In the 1990s, the current account deficit in the U.S. was financed by the inflow of voluntary investment from overseas with a backdrop of the booming economy. The inflow of capital into the U.S. cannot be said to have narrowed even at present because of the weak economic conditions both in Japan and Europe. However, it cannot be denied as well that investors will drastically change their view on investment if the rate of economic growth between the U.S. and Japan continues to be reversed for about two years. Besides, as is being demonstrated by the Enron problems, the excessive debts accumulated by the U.S. corporations in 1990s are problems yet to be solved. Under these circumstances, it will likely be in 2004 or thereafter that a decline of the US dollar triggers the adjustment of the U.S. economy again.

Asian countries, as the worldwide production base for labor-intensive products, will be able to maintain a high rate of economic growth for the time being. The European economy is expected to show a relatively high growth rate in 2003 and after since there is still room for interest rates to be reduced and as the effects of the integration and expansion of EU are enhanced.

III. Forecast for Interest and Exchange Rates

A. Interest rates in Japan

The Bank of Japan will maintain a zero-interest policy throughout Fiscal 2003. This is based on the clear statement at the Bank's Financial Policy Decision Meeting that the zero-interest policy must be maintained until the rate of consumer price index rises decisively above zero %. The long-term rate is expected to rise from the middle of 2002 to the beginning of 2003, confirming the economy bottoming out, but the magnitude of the rise will remain small, as the tempo of economic recovery should be modest. The Japanese yen will strengthen thereafter to make the long-term rate remain flat regardless of a genuine recovery of the economy, so the rate will start to show a substantial rise from the end of Fiscal 2003.

B. Interest rates in the U.S.

The easy monetary policy adopted by the FRB finished at the end of last year. The FRB is expected to gradually raise short-term interest rates from their ultra-low, emergency evacuation rate, to the neutral level (3-4%) after the autumn in 2002 when the economic recovery is confirmed. In the meantime, long-term rates will gradually rise supported by the bottoming out of the economy from the middle of 2002, but the magnitude of the rise will be smaller than for the short-term rate, shrinking interest rate differentials between short-term and long-term rates.

C. Yen rate

The Japanese yen will gradually strengthen from the spring of 2002 supported by the economic recovery in Japan. However, in order to avoid excessively high yen weakening recovery of the economy, the yen will stop rising at around 120 yen per US dollar. The Yen will start strengthening again in Fiscal 2003, confirming a genuine recovery of the economy and accelerate its rise to reach around 100 yen per US dollar at the end of Fiscal 2003 with a backdrop of a further widened differential in current accounts between Japan and the U.S. The Euro will show a gradual rise in line with the recovery of the European economy and as the credibility of ECB is enhanced, its rise will accelerate in 2003. The average Yen-US dollar rate is predicted as 122 yen in Fiscal 2001 and 108 yen in Fiscal 2002.

End

Outlook for Japanese Economic Indicators

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

GDP-Related Indicators

	FY2001 (estimate)	FY2002 (forecast)	FY2003 (forecast)
GDP (real)	528.2 (-1.4)	529.2 (0.2)	543.6 (2.7)
Private consumption	289.2 (-0.3)	290.3 (0.4)	298.5 (2.8)
Residential investment	18.3 (-9.4)	17.2 (-6.3)	17.3 (0.6)
Non-residential investment	87.9 (-1.6)	86.9 (-1.1)	94.4 (8.7)
Government consumption	89.9 (2.8)	90.9 (1.1)	91.7 (0.9)
Public investment	35.2 (-5.9)	35.5 (0.7)	32.8 (-7.7)
Increase in inventories	-2.0 [-0.1]	-0.7 [0.2]	0.3 [0.2]
Net exports of goods & services	9.6 [-0.6]	9.2 [-0.1]	8.8 [-0.1]
Exports	54.4 (-9.1)	53.9 (-0.9)	55.8 (3.5)
Imports	44.9 (-4.8)	44.7 (-0.2)	47.1 (5.2)
GDP (nominal)	498.6 (-2.8)	494.0 (-0.9)	503.8 (2.0)
GDP Deflator	94.4 (-1.4)	93.3 (-1.1)	92.7 (-0.7)
Industrial production index	94.3 (-10.0)	92.9 (-1.5)	95.9 (3.2)
Wholesale price index (overall)	97.0 (0.1)	96.3 (-0.6)	94.3 (-2.1)
Consumer price index	98.9 (-1.0)	98.3 (-0.6)	98.1 (-0.2)

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.*

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

Balance of Payments Indicators

	FY2001 (estimate)	FY2002 (forecast)	FY2003 (forecast)
Current account balance	11.3	12.1	12.2
Trade balance	7.9	7.9	8.2
Exports	45.6 (-8.5)	45.2 (-0.7)	43.9 (-3.0)
Imports	37.9 (-0.9)	37.4 (-1.4)	35.7 (-4.5)
Services	-5.0	-4.7	-4.8
Income	9.6	10.1	10.0
Current transfers	-1.1	-1.2	-1.1
Yen-dollar rate	125.0	122.0	107.8

Customs Clearance Volume Index

(100 for 1995)

	FY2001 (estimate)	FY2002 (forecast)	FY2003 (forecast)
Exports volume index	109.6 (-11.1)	111.6 (1.8)	116.7 (4.6)
Imports volume index	120.5 (-3.9)	122.4 (1.6)	128.1 (4.6)

Outlook for US Economic Indicators

GDP-Related Indicators

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

	2001 (actual)	2002 (forecast)	2003 (forecast)
GDP (real)	9,332.3 (1.2)	9,504.9 (1.8)	9,746.7 (2.5)
GDP (nominal)	10,205.6 (3.4)	10,487.4 (2.8)	10,911.1 (4.0)
Personal consumption	6,449.8 (3.1)	6,584.0 (2.1)	6,749.1 (2.5)
Residential investment	376.8 (1.5)	376.4 (-0.1)	387.6 (3.0)
Non-residential investment	1,308.6 (-3.1)	1,222.5 (-6.6)	1,272.5 (4.1)
Government consumption & investment	1,628.6 (3.6)	1,681.9 (3.3)	1,717.2 (2.1)
Federal	560.4 (2.7)	580.1 (3.5)	591.2 (1.9)
State & local	1,067.4 (4.0)	1,101.8 (3.2)	1,126.0 (2.2)
Increase in inventories	-61.8 [-1.2]	16.3 [0.8]	46.3 [0.3]
Net exports of goods & services	-410.2 [-0.1]	-437.0 [-0.3]	-494.8 [-0.6]
Exports	1,080.8 (-4.6)	1,016.4 (-6.0)	1,048.6 (3.2)
Imports	1,491.0 (-2.7)	1,453.5 (-2.5)	1,543.5 (6.2)
Industrial production index	140.1 (-3.8)	137.7 (-1.7)	141.7 (2.9)
Producer price index	140.7 (2.0)	138.4 (-1.6)	139.6 (0.8)
Consumer price index	177.1 (2.8)	178.9 (1.1)	182.3 (1.9)

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)

	2001 (actual)	2002 (forecast)	2003 (forecast)
Balance on current account	-417.4	-417.6	-473.1
Balance on goods and services	-347.8	-344.2	-399.4
Balance on goods	-426.6	-408.4	-462.7
Exports	720.8 (-6.7)	663.7 (-7.9)	696.3 (4.9)
Imports	1,147.4 (-6.3)	1,072.2 (-6.6)	1,159.0 (8.1)