INFORMATION

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Outlook for Japanese and Overseas Economies during Fiscal 2002-2003

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Overview

Uncertainties amidst the recently-started economic recovery

In the fiscal year ending March 2002, the Japanese economy was compelled to post a decrease in GDP growth of 1.3%, its worst economic performance since the 1970s, caused by a sharp decrease in exports due to the collapse of the IT bubble in the U.S. This adversely affected profits in the manufacturing sector and caused a slump in consumer spending and housing investment, and the curtailment of capital spending. However, the negative effects of the collapse of the IT bubble had almost disappeared by the end of 2001, and exports to Asian countries and the U.S. have begun to pick up since the beginning of 2002, resulting in the economy bottoming out.

In the first half of fiscal 2002, growth in the Japanese economy will remain flat due to the aftereffects of the economic slump in Fiscal 2001. However, in the second half, the rate of growth in the economy will begin to rise due to an improvement in corporate earnings, leading to a pick-up in capital spending and also an improvement in the employment situation, increasing consumer spending and resulting in a slightly positive rate of economic growth of 0.1% for the 2002 fiscal year as a whole.

In Fiscal 2003, the tempo of economic growth will gradually accelerate due to growing corporate earnings which will directly affect an increase of capital investment and consumer spending. Capital spending, such as renewal investment which has been curtailed since the 1990s, and investment in new business areas will expand supported by abundant corporate cash flows. Consumer spending will enter into a full-scale recovery due to an improvement in employment and an increase in bonus payments. In the meantime, prices will remain stable due to the Japanese yen strengthening against the U.S. dollar, reflecting an increased imbalance in the current accounts of Japan and the U.S., and the remained excess production capacity.

However, the international economic environment still needs to be watched closely. First, the tempo of economic recovery in Asian countries such as China and South Korea appears to be too fast. Careful attention must be paid to an increase of Budget Deficit in China caused by the expansion of public spending and the like, and the occurrence of a consumer spending spree caused by an increase in consumer loans in South Korea. In addition, a slowdown in the U.S. economy after the middle of 2002 when the effects of economic stimulus policies such as a reduction of interest rates and tax cuts are phased out cannot be ruled out, and besides, increasing mistrust of the corporate sector in the aftermath of the Enron shock may have a negative impact on the economy through a decline in stock prices and the exchange rate.

Ⅰ. Present state of the Japanese and overseas economies

1. Present state of the Japanese economy

The Japanese economy was compelled to post a negative rate of GDP growth of 1.3% in the fiscal year ending March 2002, its worst economic performance since the 1970s, as a result of an economic recession caused by the collapse of the IT bubble in the U.S. However, the economy bottomed out at the beginning of 2002 due to a recovery in exports. The latest economic slump clearly resulted from the collapse of the IT bubble in the U.S., which sharply reduced worldwide demand for communications equipment, causing Japanese exports to continue falling from July 2000 to December 2001, posting a post-war record rate of decline of 18.8%. In particular, the volume of exports for electrical machinery decreased as much as 34.8% during the period. The Japanese economy naturally experienced a serious slump because of this sharp decline in exports, and this prompted fast moves for employment restructuring and curtailment of investment mainly in the electric machinery industry. Electric machinery makers, confronted by the first full-scale slump in the post-war period, launched drastic restructuring in employment and investment, which has affected other industries with a slight time-lag. A slower rate of growth in employee income due to cuts in working hours, employment and wages has brought a slump in consumer spending and housing investment, and depressed corporate earnings have made the curtailment of capital investment inevitable.

However, the negative effects of the collapse of the IT bubble had almost disappeared by around the end of 2001. The value of worldwide sales for semiconductors hit bottom in February 2002, and has gradually been on the rise since then. This has been supported by completion of inventory adjustment for communications equipment and parts, and adjustment in IT-related investments on a worldwide basis. Furthermore, the U.S. and Asian countries have already begun to show a strong economic recovery since the end of 2001 due to positive measures taken to bolster their economies, and together with the negative effects of the collapse of the IT bubble running its course, demand for Japanese products (exports from Japan) has been increasing. In particular, the volume of auto exports to the U.S. and electric machinery parts and materials to Asian countries increased sharply in the first quarter of 2002, posting annualized growth of 29.5% by volume base. Furthermore, the increase in the volume of exports to Asian countries has already exceeded a previous peak recorded in 2000. As a result, domestic production is recovering, for the present bringing a pause to the restructuring in employment and investment.

Nonetheless, the aftereffects of the slump this time still affect the Japanese economy which, although having hit bottom, continues to be sluggish in the first half of 2002. With respect to consumer spending, ordinary profits in Fiscal 2001 decreased 20.0% from the previous fiscal year, and corporations mainly in the manufacturing sector are continuing efforts to cut personnel expenses, so causing the rate of growth in employee income to be slow. Corporate earnings are expected to grow in Fiscal 2002, but corporations will continue to restrain personnel expenses until increased earnings are realized. As a result, consumer spending and housing investment continues to be sluggish. However, new-model passenger cars, famous European and U.S. branded goods and upgraded plasma display TVs are selling well, indicating that consumers are not necessarily always reluctant to spend.

Capital spending will inevitably remain weak in the first half of this fiscal year, influenced by the continued decline in machinery and construction orders, leading indicators of capital spending, in the second half of the fiscal year ending March 2002. These orders are expected to recover in the first half of Fiscal 2002, but the actual impact of the increase of capital spending will occur in the second half of this fiscal year. Capital spending by large corporations, occupying a high ratio in large-scale continuous works, will be compelled to show a negative growth, whereas that by small- and medium-size companies sensitive to the bottoming out of the economy is moving toward recovery. Besides, housing investment still continues to decrease although the rate of year-to-year decline has become less than in Fiscal 2001. Overall demand for housing is weak due to the worsened income environment together with the reaction to termination of the special tax cut for housing loans. However, sales of high-rise condominiums located in the center of Tokyo, which have succeeded in attracting new customers, remain brisk.

The rate of decline in the consumer price index is gradually decelerating due to such factors as stabilizing food prices, changes in the price-reduction strategy of the dining-out industry, and others. If prices of home electric appliances and daily goods which continue to be influenced by Chinese exports, and rent which is closely linked to a decline in land prices, are excluded, downward pressures on prices have become weaker than before, reflecting the improvement in the current economic trend.

With respect to the financial market, an ultra-low interest rate situation has continued since 1999. During this period, the Bank of Japan shifted its policy measures from uncollateralized overnight call rate (a kind of inter-bank short-term interest rates) to outstanding balance of the current accounts at the Bank of Japan (on March 19, 2001), which does not seem to have had a great impact on the actual economy because the relaxed supply/demand situation in the financial market remains the same before and after that date. Besides, successive downgrading of the credit rating of Japanese government bonds has resulted in no change to the long-term interest rate.

Stocks showed a continuous decline from May 2000 in line with a slowing down in the economy, and the Nikkei 225 dipped below 9,500 in February 2002. The Nikkei 225 turned around as the economy bottomed out, recovering to nearly 12,000 yen at the end of May, but then backed down again to almost 10,000 yen in June in step with the decline of the U.S. stock market. A series of measures taken by the Financial Services Agency from February to March to regulate short selling may be regarded as proper in order to prevent stock prices from falling too far in the climate of very uncertain investor sentiment then prevailing during the worst economic conditions.

The Japanese yen rate moved almost in step with economic performance. The exchange rate for the Japanese yen against the U.S. dollar began to weaken from the end of 2000 at 105–110 yen to the dollar to a low of 134 yen to the dollar at the beginning of January 2002, but rates turned around to move back to 119 yen to the dollar at the end of June. If prospects for the U.S. economy become uncertain and the Japanese economy bottoms out while the imbalance in current accounts of Japan and the U.S. continues to widen, it will be inevitable for the U.S. dollar to weaken or the Japanese yen to strengthen.

Lastly, the so-called "March Crisis" was avoided, and the negative influence of non-performing loan problems is gradually weakening. Non-performing loans have the following two problems; firstly, there is the burden to be borne by financial institutions in disposing of newly-occurring bad debts, and secondly, there is the potential burden of completely disposing of existing bad debts. The burden in disposing of newly-occurring bad debts is lessening because the economy has bottomed out. This is reflected in decreasing trends in the number and total value of bankruptcies from this last March. In the meantime, the potential burden of completely disposing of existing bad debts appears to have been considerably lessened due to a special inspection of major banks conducted by the Financial Services Agency and the resultant increase in their reserves for disposing of bad debts. If part of the regional financial institutions are excluded, reserves against existing bad debts have become much more secure than a few years ago. As with deflation problems, bad debt problems are the result of the economic recession, but not the cause thereof.

2 . Present state of overseas economies

The world economy is coming out of the recession in the first half of 2002, which was triggered by the collapse of the IT bubble in the U.S. The U.S. and East Asian economies are presently leading the recovery in the world economy.

The U.S. economy has succeeded in smoothly exiting the slump caused by the collapse of the IT bubble. It posted a growth rate of 1.2% for 2001, sharply down from 4.1% in 2000, but compared to past recessions with negative growth rates, the decline in the economy proved to be mild thanks to the implementation of extremely good timing of highly positive economic policies. A large-scale income tax cut totaling as much as US$40 billion was implemented from summer to autumn of 2001, when the entire U.S. economy began to feel the effects of a decrease in IT-related capital investment. Additionally, due to the terrorists attacks of September 11, 2001, the discount rate was reduced by 1.75% as an urgent and temporary measure, in addition to the 3% reduction already in place from the beginning of 2001. This drastic stimulation of the economy of a kind not seen since the beginning of 1980s contributed to a recovery in consumer spending as early as the 4th quarter of 2001, and almost completely absorbed negative shocks resulting from a sharp decrease in capital spending. Furthermore, a second round of tax cuts amounting to US$70 billion, part of the Bush Tax Cuts of last June, was implemented in January 2002. These all contributed to the U.S. economy posting a high annualized rate of growth of 5.6% in the first quarter in 2002. The exercise of such positive Keynesian economic policies limited the decline of the actual economy to a minimum, whereas the adjustment of the two structural problems occurring in the booming economy of the 1990s, namely a gigantic current account deficit and excess debts held by corporations, has been postponed.

However, the financial market has already given warning of the dangers in delaying tackling these two structural problems. The New York Dow recovered smoothly from the low of 8,236, recorded on September 21, 2002 soon after the terrorist attacks, to 10,635 on March 19, 2002, but thereafter started to fall to as low as 9,100 at the end of June. Starting with last December's failure of Enron, an integrated energy company, a series of bankruptcies in large corporations such as Global Crossing, a major communications company, K Mart, a major discount store, etc., occurred. Some large companies are regarded as potentially bankrupt. What these bankrupt companies have in common is excess investment through an increase of interest-bearing liabilities (borrowing plus corporate bonds) made in the booming economy of the end of the 1990s. The poor performance of stock prices can be understood as investor distrust toward companies providing inadequate and inaccurate information on their financial condition. In the meantime, the U.S. dollar has since last April been experiencing all-out weakness against other currencies due to a move toward the re-expansion of the U.S. current account deficit and increased distrust of U.S. corporations by overseas investors.

Meanwhile, East Asian countries other than China experienced the strongest negative impacts of the collapse of the U.S. IT bubble, but those economies have been recovering fastest when the negatives created by the collapse of the IT bubble disappear. The best example among these is South Korea, whose economy has been recovering since the end of 2001 due to a pick-up in exports and also stimulative economic policies. Consumer spending, particularly for passenger cars, is strong, but a good showing in consumer spending is being supported by increased credit to consumers, particularly increased loans by use of credit cards. The tempo of expansion in the economy seems to be slightly in excess of normal due to the aforementioned factors. The Chinese economy is expanding smoothly as a worldwide production base for mass-produced goods, but in the lead up to a change in personnel of the Communist Party's chief executive to take place in the fall of 2002, the government seems to be intent on maintaining a higher than normal rate of growth in the economy at present. Budget Deficit is expected to reach 3% of nominal GDP in Fiscal 2002 due to expansion of public spending, and there should be concern over unsolved problems of bad debts held by national enterprises.

The European economy is also gradually moving toward recovery. However, there exists a slight difference between France and Britain, whose economies have a good showing, and Germany and Italy, which are still taking time to enter recovery. The difference seems to stem from the extent of the effects of the collapse of the IT bubble in the U.S. and their own economies, and the extent of progress in structural reform centering on the labor market. Germany is experiencing negative effects of the collapse of the IT bubble in both the U.S. and domestically, whereas in Italy labor unions implemented large-scale strikes in March and April to protest reform of the Labor Act (deregulation permitting dismissal of workers) to be made by the Berlusconi government, significantly affecting on the economy.

Ⅱ．Prospects for the Japanese economy

1．The Japanese economy in the second half of Fiscal 2002

In the second half of fiscal 2002, the Japanese economy will be in a situation where the aftereffects of the recession begin to slowly thin out as an economic recovery triggered by an increase in exports gradually spreads to the entire economy. For this reason, the tempo of this recovery may not accelerate quickly. In specifics, the manufacturing and construction sectors will continue to cut employment in order to finalize employment restructuring, bringing no growth in winter bonus payments. Also, time needed to bring about a full-scale recovery in capital spending and the continuing decrease in public spending will all put a brake on the acceleration of the economic recovery. The annualized rate of growth in the economy in the second half will rise as high as 2.2% (that for the first half being minus 0.2%), but the average growth rate in Fiscal 2002 is expected to be limited to 0.1%.

（Consumer spending）

Consumer spending will gradually increase its growth speed. However it will not regain full vigor because employee income growth remains relatively low due to continued caution on the part of corporations. The annualized rate of growth in the real consumer spending in the second half of 2002 is anticipated to be 1.7% (0.8% in Fiscal 2002).

First, employment, which has the largest effect on consumer spending, will gradually move into positive growth. Whereas the tempo of expansion of employment in the service industry will increase, the speed in employment cuts in the manufacturing and distribution industries will decelerate. Besides, a ripple effect resulting from a large-scale cut in employment in the electric machinery industry occurring in the second half of fiscal 2001 will almost disappear, while a shift of production into China is peaking out, which will work positively for employment. In the meantime, low growth in wages and working hours continues. The rate of growth in wages is expected to remain almost flat due to agreements on zero growth in annual salaries and no growth in bonus payments resulting from the severe stance taken by corporations. With respect to working hours, a mildly decreasing trend remains intact due to a move to shorten working hours within the hours stipulated by corporations and a rise in the ratio of part-timers in the labor market. In conclusion, the rate of growth in employee income will become positive as employment recovers, but the curtailment of wages and working hours will continue, limiting employee income to a low rate of growth.

In the meantime, a recovery trend in demand for consumer durables, which experienced a slump in sales in Fiscal 2001, will be sustained from the first half of this fiscal year. With respect to passenger cars, carmakers' efforts to introduce new models and other factors will increase demand for the replacement purchase of cars bought in the late 1980s, which will put a slight brake on a shift to mini cars. Large-size plasma TVs and LCD TVs will become increasingly familiar to consumers due to makers' full-scale efforts to bolster sales of such items, and the number of units will be on the rise. Increased consumer appreciation of upgraded features in digital electric home appliances such as digital TVs and car navigation systems will lead to increased market penetration. On the other hand, growth in demand for PCs and cellular phones which are already owned by a larger number of people remains stagnant. Demand for video will decrease as a shift towards DVD, etc., continues. Consumers have become sensitive to quality rather than price due to a series of problems about food contamination and falsification of origin, increasing the need for high-quality goods.

(Housing investment)

Housing starts in Fiscal 2002 are expected to decrease from 1,170,000 units in Fiscal 2001 to 1,130,000 units, posting a negative rate of growth of 4.7% on housing investment in real terms. However, the decrease in the demand for housing will center on the first half and the real annual growth rate in the second half is anticipated to remain almost flat at 0.7%. Demand for housing has become far more closely related to economic conditions than before, which is particularly noticeable in single-family houses which occupy about half of housing investment. The number of visitors to housing exhibition centers has been on the rise from the beginning of 2002, but considering the time-lag to contract, housing starts will bottom out and then turn around in the second half of this fiscal year. In the meantime, the number of houses for rent and condominium sales, which maintained a relatively high level in Fiscal 2001 thanks to providers' efforts, will continue to experience a mildly reactionary decrease throughout Fiscal 2002. In particular, housing starts for high-rise condominiums located in the center of Tokyo which are attracting new clients such as retirees are continuing to have a good showing, whereas a weakening of demand for medium-height condominiums in the suburbs is noteworthy.

(Capital spending)

The rate of growth in capital spending in the first half of Fiscal 2002 is expected to show an annualized rate of decrease of 0.5%, but recover to 6.4% in the second half, resulting in a negative growth of 5.1% for Fiscal 2002 over the previous fiscal year, this being caused by a sharp decline in capital spending in the second half of Fiscal 2001 (a base effect from this negative growth, so-called negative *geta*, is minus 7.9%). Corporate earnings have been on a recovery since the end of the 2001 fiscal year due to benefits realized from restructuring efforts and the bottoming out of the economy, but considering the time-lag of about 6 months from an increase of corporate earnings to actual increase in capital spending, a pick-up in capital spending is expected to occur in the second half of this fiscal year. Capital investment expected to increase in Fiscal 2002 will center on renewal investments needing a limited amount of capital, which include investments in machine tools, trucks, injection molding machines for plastics, some remodeling of stores, etc. With the uncertain prospects for overseas economies, corporate managers' sentiment has not become that bullish, although they have abundant cash flows.

(Public spending)

Public spending in the first half of Fiscal 2002 will show a slight increase at an annualized rate of 2.0%, but in the second half, it will return to a decreasing trend to post a negative growth of 6.5%. The annual rate of growth is expected to be minus 0.1%. A major part of the increase in public spending in the first half will be supported by additional spending slated in the second supplementary budget in Fiscal 2001, which was brought forward to the first half of this fiscal year, and a decreasing trend in public spending caused by the government's policy of curtailing public spending will become clear again in the second half. Additional public spending of about 1 trillion yen was expected to be implemented in Fiscal 2002, but for many projects spending will be postponed until Fiscal 2003.

(Exports and imports)

The rate of growth in the volume of exports in Fiscal 2002 will be 6.9%, to recover from a negative growth of 9.9% recorded in the previous fiscal year, the largest rate of decline since the 1970s. In terms of items, exports of electric machinery will increase 9.8% from a decrease of 24.2% in the previous year, which determines a general trend in overall exports. In terms of areas, exports to the U.S. and Asian countries, which suffered a sharp decrease in Fiscal 2001, will increase, but if prospects for exports in the first and second half are examined, the annualized rate of growth will post 10.5% in the first half, whereas the tempo of growth will gradually decelerate in the second half to 4.4%. This will result from the following: (1) a deceleration in the rate of increase in actual demand for communication-related equipment which is temporarily surging due to progress in inventory adjustment; (2) a decrease of the presently constant levels of exports of autos to the U.S. due to slowing of brisk demand for passenger cars; (3) the rapid recovery in Asian economies will pause; and (4) the recent shift of the exchange rate from a weak yen to a strong yen will gradually erode the effects of weak yen. A strong overseas demand exists for Japanese products which have a good balance between quality, function and price, and exports will show a generally smooth increase in line with the recovery of the world economy.

In the meantime, the rate of growth in the volume of imports will increase 2.4% in Fiscal 2002 from minus 4.2% in the previous fiscal year. The overall trend in imports will be also determined by imports of general machinery including electric machinery. The penetration of imports into the Japanese market advanced in the 1990s to further strengthen the link between imports and domestic demand, and a constant growth in imports will be maintained while the economy shows a gradual recovery. However, imports of clothing and home electrical appliances from China which are found in many Japanese homes will make it difficult for imports to show increases as sharp as those experienced in the late 1990s. Besides, the yen will not strengthen sufficiently to bring a sharp increase in imports, and thus, the rate of growth in the volume of imports will be less than that of exports.

(International balance of payments)

The Japanese current surplus in Fiscal 2002 will return to a historic high of 15.0 trillion yen from 11.9 trillion yen in Fiscal 2001. The main factor for such expansion is a sharp expansion in the trade surplus due to a sharp increase in the export, which will increase from 9 trillion yen in Fiscal 2001 to 12.6 trillion yen in this fiscal year. However, if the trade surplus for each half is examined, a sharp increase will center in the first half, and the surplus will show a limited growth in the second half. There should be no big change in balances in services and incomes, but if a general trend existing since the late 1990s is confirmed, the deficit in service balance has become smaller because it is transitioning from a constant level to a decrease, due, in part, to a decline in transportation costs. On the other hand, the income balance is on the rise due to an increase in profits remitted from overseas subsidiaries established in the shift to overseas production. In addition, the deficit in the current transfer balance will increase sharply from 0.6 trillion yen in

Fiscal 2001 to 1.2 trillion yen this fiscal year, which is in fact a return to a normal level after a temporary dip caused by compensation for damages received in Fiscal 2001 in connection with so-called Princeton Bond and repayment of loans extended when the economic crisis of East Asian countries occurred.

(Prices)

The rate of increase in the consumer price index for Fiscal 2002 will continue to show a decline of 0.6%, a four-year consecutive decline, but the tempo of the decline will slow slightly. This will largely result from flattening out of the fall in food prices. One reason for this is that problems concerning traces of agricultural chemicals in Chinese vegetables will put a sharp brake on imports of food from China. However, it can be generally said that a shift in Japanese food prices to international ones, which has been in progress since the middle of 1990s, is more-or-less over. The rate of increase in the wholesale price index will show a decline of minus 1.1% in Fiscal 2002, from minus 0.0% in the previous fiscal year, due to the exchange rate turning from a weak to a strong yen.

2 . The Japanese economy in Fiscal 2003

In Fiscal 2003, the unfavorable effects of the collapse of the IT bubble will disappear and the problem of excess debt depressing capital spending will be solved to a certain extent, and so improvement in corporate managers' sentiment will bring about full-scale capital spending to start the economic recovery. Due to revitalized corporate activities, the tempo of rises in personal income will accelerate and consumer spending will expand. Without any big change in the U.S. and East Asian economies, the Japanese economy would enjoy a full-scale economic expansion for first time since the 1980s. Even if the U.S. and East Asian economies are compelled to enter recession again, and the start of such recession is postponed to the middle of 2003, the Japanese economy is already in a self-propelled expansionary phase and will likely be able to sustain its growth.

(Consumer spending)

Consumer spending in Fiscal 2003 will move into full-scale expansion. The basic reason for such expansion is that the rate of growth in disposable income will turn from a decrease of 0.6% in Fiscal 2002 to an increase of 1.7% in Fiscal 2003, due to an increase in numbers of employed persons and a hike in wages. An improvement in consumer sentiment as well as an improved employment environment will work for an increase in consumer spending.

Numbers of employed persons will show a positive increase for first time in 6 years of 0.6%, from a negative growth of 0.5% in Fiscal 2002, because the tempo of employment restructuring in the manufacturing sector will slow down, whereas employment in the retail industry will expand, reflecting a pick-up in consumer spending and a continued increase in employment at service industry companies. A shift of domestic employment to China will peak from Fiscal 2001 to Fiscal 2002, immediately after China's participation in WTO, and it is hard to imagine further acceleration in the shift of employment from that period and beyond. The rate of unemployment will decline from 5.2% in Fiscal 2001, 5.1% in Fiscal 2002 to 4.9% in Fiscal 2003, but as long as the employment mismatch phenomenon continues to exist, the relatively high rate of unemployment will continue. The number of unemployed increased about by one million compared to numbers for the middle of the 1990s, and how to get these one million unemployed back to work will become an important policy issue.

Wages will increase about 1% in Fiscal 2003 because bonus payments in the summer of 2003 and after will increase over the previous year supported by prospects of corporate profits increasing for two years in succession. The ratio of labor's share, which rose at the beginning of the 1990s, has returned to a long-term trend in 2001 – 2002, which facilitates corporations accepting wage increases. An increase of income supported by such expansion of employment and a rise in wages will directly affect the expansion of brisk consumer spending which has not been seen in the past decade or so.

With respect to consumer spending, demand for replacement purchase of passenger cars will further expand and demand for replacement buying of cellular phones and PCs will also surge due to the introduction of full service for the next generation of cellular phones and high-speed communication networks. Replacement purchase of white goods (non AV-related home electric appliances), which has been in a slump, is expected to increase again if people have surplus income. Demand for tourism and service-related consumption will show a higher rate of growth, and above all, high-priced services will show a higher growth than others. The consumer shift to quality goods and services will remain intact.

(Housing investment)

Housing starts in Fiscal 2003 will remain flat at 1,130,000 units compared to the previous fiscal year. Improvement in income environment will limit a decrease of the number of housing starts for single-family houses, but the number of houses for rent with tenant guarantee constructed and guaranteed by prefabricated housing makers and medium-height condominiums in suburbs will be on the decrease. Thus, the number of overall housing starts will remain unchanged. The present housing loan tax cut will be terminated in December 2003, which may have only a small impact on housing starts because the system will most likely be maintained thereafter in one form or another. Living space in single-family houses has almost peaked at 140 ㎡, and considering future decreases in the number of family members per household, the living space may be reduced.

Demand for new housing investment is expected to keep decreasing as the vacancy ratio has exceeded 10%. Strategies for smooth rebuilding programs for 30- to 40-year-old houses and for improvements in the living environment after rebuilding will determine housing investment in the future.

(Capital investment)

Capital investment in Fiscal 2003 will enter a full-scale upward trend, posting an increase of 9.1% from the previous fiscal year due to improved sentiment among corporate managers toward investment supported by increased profits started from the previous fiscal year. Depending on economic performance, the rate of growth will most likely be revised upward. Capital investment will be supported by the following: a) due to the recovery in their earnings, corporations will have their largest ever surplus fund enabling them to make additional capital investment without resorting to outside fundraising; b) big projects postponed in the electric machinery industry, retail industry and materials industry are to be resumed; c) renewal investment that has been on hold for the last 10 years or so is to be resumed full-scale; d) investment in urban redevelopment will turn to an increase; and e) the absolute level of capital investment and its ratio of nominal GDP at the end of Fiscal 2003 will not exceed the previous peaks recorded in Fiscal 2000. A shift of production to China will continue, but the major part of the production shift is to meet increased overseas demand. An increase in domestic demand will basically be met by domestic production, and thus, if it becomes certain that domestic demand will increase, an expansion in domestic capital investment will inevitably occur.

Looking at the trend in the ratio of interest-bearing liabilities held by corporations in nominal GDP, the ratio at the end of 2001 declined to the level of 1987–88, and it is certain that the ratio in Fiscal 2003 will be near the level recorded at the beginning of the 1980s. The effect of excess debts holding back capital investment will almost disappear.

(Public spending)

Public spending in Fiscal 2003 will accelerate its rate of decline to minus 6.0%. Additional public spending as a result of the supplementary budget amounted to 3 trillion yen in Fiscal 2001, and is expected to be 1 trillion yen in Fiscal 2002 and zero in Fiscal 2003. Almost all public spending from the supplementary budget in Fiscal 2001 and 2002 will be carried forward into the following fiscal year, indicating that an effect of negative public spending of 2 trillion yen from the supplementary budget will appear in Fiscal 2003. This is the main cause of a decrease in public spending in Fiscal 2003. Since cuts in public spending have continued since the peak in Fiscal 1995, nominal public spending at the end of fiscal 2003 will return to the same level as in the middle of 1980s, and the tempo of cutting public spending will slow in Fiscal 2004 and beyond.

Budget deficit in Fiscal 2003 will decrease to 27 trillion yen from 30 trillion yen in Fiscal 2002. Personal and corporate income tax will sharply increase due to the expansion of personal and corporate income. Due to the natural increase in revenues, budget deficit may shrink to almost 20 trillion yen in the future, but the financial reconstruction thereafter must be tackled by a combination of tax increases, cuts in expenditures and sales of national assets.

(Exports and imports)

The volume of exports in Fiscal 2003 will slow its rate of growth to 3.8% from the previous fiscal year. The reasons are a reactionary decline from a surge in exports in Fiscal 2002, the effect of a strong yen, and a slowdown of the U.S. and Asian economies. In terms of items, exports of electric machinery will sustain a higher rate of growth than originally expected due to a recovery in worldwide communications investment, but the rate of growth for exports of passenger cars to the U.S. and of materials to Asian countries will be compelled to decelerate due to a slowdown in the expansion of the respective economies. Furthermore, the annual average rate of 107 yen to the U.S. dollar is close to a break even rate for Japanese exporters which is not sufficient to considerably reduce exports. On the other hand, the rate of growth in the volume of imports will show a smooth increase of 4.5% supported by the expansion in domestic demand. A situation where imports grow nearly 5% while domestic demand increases 2% can be considered normal. Imports of daily goods from China will show a high rate of growth in place of textile goods and home electric appliances.

A strong yen from the beginning of Fiscal 2002 will work in favor of imports and against exports, but its effect has become smaller than in the 1980s and 1990s. The reasons for this are as follows: export products have shifted from general consumer durables and materials to high-quality consumer durables, capital goods and parts, which are much less affected by price changes resulting from a strong yen (higher prices being acceptable), and almost all Japanese alternatives to imported goods have been driven out of the market and Japanese households already hold sufficient levels of imported goods.

(International balance of payments)

The Japanese current account surplus in Fiscal 2003 will gradually continue to decrease, but remain at 14.5 trillion yen, posting a slight decrease over the previous fiscal year. A decrease of yen-denominated profits from overseas investments due to a strong yen is the largest factor in the decrease in the surplus. The surplus of income from overseas has exceeded the trade surplus since Fiscal 2000, and a strong yen has proved to affect income balance first rather than trade balance.

(Prices)

The rate of change in the consumer price index in Fiscal 2003 will post a decrease of 0.2%, further decelerating the rate of decline. However, prices of industrial products will continue to decline due to the progress of a strong yen, and the rate of year-to-year change in the consumer price index will not turn positive during Fiscal 2003. Besides, due to a rise in labor productivity, the rate of rise in unit labor cost remains at around minus 1% in spite of wages being on the rise, and thus, it is hard to imagine seeing prices rise from the viewpoint of cost.

III . Prospects for overseas economies

2002 will see the world economy as a whole make a soft landing and get on track toward stable growth. The world economy will gradually move toward recovery as the unfavorable effects of the collapse of the IT bubble run their course, and the effects of easing of monetary policy simultaneously taken by major world economies take effect. However, the tempo of the recovery will be somewhat unsatisfactory because uncertain factors remain in the U.S. and East Asian countries and economic activity in Europe is slightly sluggish. In 2003, the Japanese and European economies will enter a trajectory for recovery, in which IT-related investment will show a full-scale expansion, and thus, the rate of growth in GDP will exceed the average rate of growth seen in recovery phases in the past.

1 . Trends in the U.S. economy

The U.S. economy will continue to show a mild recovery after the second quarter of 2002. The rate of economic growth is anticipated to be 2.5% in 2002 and 2.7% in 2003 respectively. Needless to say, the improvement of sentiment regarding the economy will remain somewhat disappointing compared with the period in the late 1990s when the U.S. economy achieved a growth rate of around 4% for 5 years in succession. In contrast to an ordinary economic recovery phase, the relatively low rate of economic growth projected for 2002 – 2003 can be attributed to the following: First, the U.S. government has already exercised almost all its large-scale stimulative economic policies in 2001. Interest rate levels are the lowest since the 1950s, and the scale of the Bush tax cut decided in June 2001 was the largest since the Reagan tax cut of the early 1980s. These large scale stimulative economic policies succeeded temporarily in increasing consumer spending and housing investment from the end of 2001 to the beginning of 2002, but this, however, does not seem to have brought an increase in sustainable supply capacity and a rise in incomes, resulting in a depressed rate of growth in demand for the second quarter of 2002 and beyond by an amount certain to equal the demand originally created by such policies (about 1 – 2%).

Second, the U.S. cannot expect voluntary inflow of capital from overseas. The U.S. corporate sector was able to raise abundant funds overseas in terms of corporate bonds and M&A related activities, and utilize such funds for capital investment and other purposes in the late 1990s. The rate of growth in capital investment continued to show about 10% for 8 years in a row from 1993 to 2000, which was partly attributable to the capital inflow from overseas. However, U.S. corporations will not be able to raise much in the way of funds overseas in the future. The Enron shock has triggered overseas investors’ distrust in the corporate governance of U.S. companies and particularly in the U.S. accounting system, leading them to view U.S. corporations as being a large investment risk. Besides, the possibility of all-out weakness of the U.S. dollar against other currencies cannot be ruled out in a situation where the value of U.S. current account deficits already exceeds 4% of nominal GDP and is certain to approach 5% in 2003. As the result of the reduced scale of fundraising overseas, the rate of growth for U.S. capital investment will continue to be at a low level.

The U.S. economy is still full of vitality compared to other advanced economies, and it seems possible that the U.S. economy will sustain the rate of economic growth of 2% or better in this decade, supported by earnings recovery due to low interest rates and brisk consumer confidence. However, for the reasons mentioned previously, it is difficult for the U.S. economy to expect a return to the rate of growth achieved in the 1990s. Furthermore, the possibility of the U.S. economy entering into a recession again in 2003 cannot be ruled out. Interest-bearing liabilities held by U.S. corporations centering on IT-related companies sharply increased from about US$5 trillion in 1995 to around US$8 trillion in 2001, the nominal GDP ratio for which is approaching the level seen at the end of 1980s. Due to failures of companies with excess debts, the financial market has become so sensitive that corporations may find it difficult to raise funds even in the domestic market.

Besides, a decline in asset values which may possibly depress consumer spending cannot be ruled out either. If stock prices stay at current levels and house prices do not suffer a large decline of about 10 – 20%, there would be no large change in consumer spending. However, if both stock and house prices were to simultaneously fall more than 10%, negative impacts on consumer spending would be unavoidable. In particular, a decline in house prices will bring a reduction in available collateral power on consumer loans and most likely cool consumption. It will be necessary to watch the situation in the U.S. economy carefully for the time being.

2 . Trends in the European economy

The European economy appears to be gradually accelerating the tempo of its recovery toward 2003. The average rate of growth in the EU seems to have declined from more than 3% in 2000 to about 1.5% around both in 2001 and 2002, and then to rise again to a little less than 3%

in 2003. The reasons for the gradual acceleration in the rate of growth in the European economy toward 2003 are as follows: a) the aftereffects of a slump caused by the collapse of the IT bubble will gradually abate; b) corporations have found it easier than before to increase employment due to progress in reform of the labor market; c) the integration of the EU will buoy economic activities, thereby increasing expectations for capital spending to rise in the future; and d) the effect of a rise in prices caused by taking advantage of the introduction of the euro cash in January 2002 will lessen.

The European economy is clearly more self-sustaining than the Japanese and other Asian economies, and the impact of the trends in the U.S. economy on the European economy is smaller than that on the Japanese and other Asian economies. Besides, it takes longer for a pick-up in the U.S. economy to affect the entire European economy. Accordingly, the EU will be compelled to show a slow economic recovery to start with, but once the economic recovery gathers momentum, growth in the economy will tend to be sustained for a long period of time.

3 . Trends in the Asian economies

The Asian economies have a somewhat accelerated the tempo of economic recovery in the first half of 2002 and are most likely to show a temporary slowdown from the second half of 2002 to the first half of 2003. The negative impact of the collapse of the IT bubble on the economies has run its course and besides, policies taken by Asian governments to stimulate their economies have brought a much faster-paced economic recovery than expected. However, a temporary deceleration in the rate of recovery in their economies seems to be unavoidable for the following reasons: a) Asian NIEs are considered as still having excess production capacity for IT-related equipment; b) the tempo of the economic recovery in the U.S. will not step up in the second half of 2002 and after; and c) the effect of their economic policies will run its course. However, from the viewpoint of the mid-term perspective, the role played by Asian countries as a production base for consumer durables and IT-related equipment is seen as continuing to expand in the future, and besides, IT-related investment will turn to re-expansion during 2003 due to settlement of the excess production capacity problem. Thus, it seems the economic recovery of the Asian countries will not be interrupted halfway.

With respect to the Chinese economy, the question is how economic policies will be operated after a change in personnel of the Communist Party’s chief executive to take place in the September 2002. If the incumbent members intervene in economic policies to exercise their influence over the new leaders, the current economic policy of giving top priority to economic growth will likely become confused. In such a case, long-discussed problems such as the excess debts held by national enterprises and budget deficit may become suddenly apparent and hinder management of the economy. Besides, if the U.S. economy deteriorates, causing consumer spending to enter into a full-scale adjustment, China will not be able to ignore the effects of this either.

4 . Trends in prices of primary products

The average price of crude oil on a WTI basis in 2001 stood at 24 dollars a barrel, and is anticipated as reaching 25 dollars a barrel in 2002 and returning to 24 dollars a barrel in 2003. The present supply/demand situation for crude oil is somewhat one of oversupply, and continuous reduction of production by OPEC has enabled the price of crude oil to be kept at around 25 dollars a barrel. Demand for crude oil will gradually increase in the future, but the resultant pressure for higher oil prices will be resisted by the initiation of an increase in production by oil producing countries including OPEC. Thus, the crude oil price is likely to stay at around 25 dollars a barrel. With respect to the Israel/Palestinian problem, a worst-case situation will be avoided through mediation by the U.S. and others and have not significant influence on the crude oil price. The prices of other primary products will remain unchanged for the time being and move to a slight upward trend thereafter in line with the recovery of the world economy.

Ⅳ．Projection for interest rates and exchange rates

1．Trend of interest rates in Japan

The Bank of Japan will basically maintain its present stance of easy monetary policy throughout Fiscal 2003. This is based on its express statement that "growth rate of the consumer price index will remain steadily above zero %" as a condition under the change in monetary policy. The Bank of Japan will not likely show its intention to change monetary policy during Fiscal 2002, but the Bank may begin to seek an opportunity to raise short-term interest rates in Fiscal 2003. However, the Bank will not likely take specific measures as a strong yen continues and uncertainty may exist in the U.S. and East Asian economies.

In the meantime, long-term interest rates will stay at an ultra-low rate of a little above 1% until the middle of 2002 and will start a gradual rise from the autumn of 2002, when the uncertainties in the economy are slowly wiped out, to reach 1.5 – 2.0%. However, due to an accelerated rise in the yen in Fiscal 2003 and the confirmation of budget deficit peaking out, long-term interest rates will remain flat during Fiscal 2003.

2．Trend of interest rates in the U.S. and Europe

The FRB will maintain a policy stance of monitoring the effect of easy monetary policy until around the autumn of 2002, and if the recovery of the economy is fully confirmed and if the rate of increase in consumer price index exceeds 2% again around the end of 2002, the FRB will begin to shift its policy from a low interest rate emergency evacuation type policy to a policy of normal monetary easing. Against such a backdrop, short-term interest rates in the U.S. (TB 3 months) will turn upward from the end of 2002 to the spring of 2003 returning to a level of 3 – 4%. The FRB will push up the rate to a level just before the occurrence of the September 11 terrorist attacks and thereafter maintain a stance of watching the economic trend until the summer of 2003. In the latter half of 2003, uncertainties over a slowdown in the economy will be almost wiped out, and the FRB will shift its policy from monetary relaxation to a neutral stance to see short-term interest rise above 4%.

In the meantime, long-term interest rates in the U.S. (10-year government bonds) will remain at the present level of around 5% until the middle of 2002, and thereafter, ahead of a rise in short-tem interest rates, long-term rates will enter into a gradual uptrend from the autumn of 2002 to exceed 6% at the end of 2003. Budget surplus will turn into deficit, but due to prices remaining more or less stable, the tempo in the rise in long-term rates will be relatively milder than in normal recovery phases as the past.

The monetary policy of the ECB will take steps from the latter half in 2002 to raise short-term interest rates from the present level of around 3.0 – 3.5% to a neutral level of 4.5%, resulting in short-term rates exceeding 4% at the end of 2003. Long-term interest rates will turn upward in line with short-term rates, but the scope of the rise will be less than that for short-term rates. Long-term rates will rise from the present level of around 5% to near 6% at the end of 2003. Basically speaking, long-term rates in the U.S. and Europe will stay at almost the same level due to progress in the liberalization of portfolio investment.

3．Exchange rate movements

The Japanese yen will begin to strengthen against the U.S. dollar from the beginning of fiscal 2002 due to the increase of imbalance in the current accounts of the two countries, and also due to the Japanese economy bottoming out and turning on to a recovery track while uncertainties exist in the U.S. economy. However, confidence in the Japanese economy both inside and outside of Japan will not significantly improve during Fiscal 2002, and the yen is anticipated to rise slowly to reach nearly 120 yen to the U.S. dollar at the end of Fiscal 2002. In Fiscal 2003, confirming the smooth recovery of the Japanese economy, the yen will continue its momentum to reach near the 100 yen to the US dollar at the end of Fiscal 2003. However, due to a differential in the rate of rise in consumer price indexes between Japan and the U.S., the purchasing power parity between the two currencies annually moves about 3% in favor of the Japanese yen, and thus, the rate of 100 yen to the U.S. dollar is not necessarily an excessively high level, and is likely to see a rise further in fiscal 2004. The average yen rate against the U.S. dollar stood at 125 yen in Fiscal 2001, and is anticipated to be 121 yen in Fiscal 2002 and 107 yen in Fiscal 2003. The Euro/U.S. dollar rate will gradually show a corrective trend from oversold euros to reach about 1.1 euros to the US dollar at the end of 2003. Fund flows from the EU to the U.S. have already been shrinking, and considering the gigantic current deficits in the U.S. which is causing investors grave concern, the US dollar will likely experience all-out weakness against other major currencies.

Outlook for Japanese Economic Indicators

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

GDP-Related Indicators

	FY2001 (actual)	FY2002 (forecast)	FY2003 (forecast)
GDP (real)	528.9 (-1.3)	529.5 (0.1)	544.1 (2.8)
Private consumption	291.1 (0.3)	293.4 (0.8)	301.4 (2.7)
Residential investment	18.5 (-8.5)	17.6 (-4.7)	17.8 (0.9)
Non-residential investment	86.0 (-3.7)	81.6 (-5.1)	89.0 (9.1)
Government consumption	90.0 (2.8)	91.3 (1.5)	92.1 (0.9)
Public investment	35.3 (-5.8)	35.3 (-0.1)	33.1 (-6.0)
Increase in inventories	-2.1 [-0.1]	-0.7 [0.3]	0.3 [0.2]
Net exports of goods & services	10.2 [-0.5]	11.0 [0.2]	10.4 [-0.1]
Exports	55.1 (-8.0)	56.8 (3.2)	58.4 (2.7)
Imports	44.9 (-4.7)	45.8 (2.0)	47.9 (4.7)
GDP (nominal)	500.2 (-2.5)	497.1 (-0.6)	506.9 (2.0)
GDP Deflator	94.6 (-1.2)	93.9 (-0.7)	93.2 (-0.8)
Industrial production index	94.0 (-10.2)	93.6 (-0.4)	96.7 (3.2)
Wholesale price index (overall)	96.8 (-0.0)	95.7 (-1.1)	93.8 (-2.0)
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 (actual)	FY2002 (forecast)	FY2003 (forecast)
Current account balance	11.9	15.0	14.5
Trade balance	9.0	12.6	12.5
Exports	46.2 (-7.3)	47.4 (2.6)	45.9 (-3.2)
Imports	37.2 (-2.8)	34.7 (-6.6)	33.4 (-4.0)
Services	-5.1	-5.0	-4.9
Income	8.7	8.5	8.1
Current transfers	-0.6	-1.2	-1.1
Yen-dollar rate	125.1	120.8	107.3

Customs Clearance Volume Index

(100 for 1995)

	FY2001 (actual)	FY2002 (forecast)	FY2003 (forecast)
Exports volume index	111.2 (-9.9)	118.9 (6.9)	123.4 (3.8)
Imports volume index	120.2 (-4.2)	123.1 (2.4)	128.7 (4.5)

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)	9,333.8 (1.2)	9,567.8 (2.5)	9,822.1 (2.7)
GDP (nominal)	10,208.1 (3.4)	10,553.7 (3.4)	10,955.0 (3.8)
Personal consumption	6,450.3 (3.1)	6,645.8 (3.0)	6,805.3 (2.4)
Residential investment	376.9 (1.5)	377.6 (0.2)	386.1 (2.2)
Non-residential investment	1,308.0 (-3.2)	1,224.4 (-6.4)	1,274.8 (4.1)
Government consumption & investment	1,628.6 (3.6)	1,702.5 (4.5)	1,745.7 (2.5)
Federal	560.3 (2.7)	593.7 (6.0)	605.7 (2.0)
State & local	1,067.5 (4.0)	1,108.7 (3.9)	1,140.0 (2.8)
Increase in inventories	-61.7 [-1.2]	14.8 [0.8]	46.3 [0.3]
Net exports of goods & services	-408.7 [-0.1]	-455.2 [-0.5]	-501.9 [-0.5]
Exports	1,081.7 (-4.5)	1,041.1 (-3.8)	1,081.1 (3.8)
Imports	1,490.4 (-2.7)	1,496.3 (0.4)	1,583.0 (5.8)
Industrial production index	140.1 (-3.9)	139.9 (-0.2)	144.8 (3.5)
Producer price index	140.7 (2.0)	139.4 (-0.9)	140.8 (1.0)
Consumer price index	177.1 (2.8)	180.3 (1.8)	184.0 (2.0)

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	-393.4	-439.3	-503.2
Balance on goods and services	-358.3	-387.7	-457.4
Balance on goods	-427.2	-443.4	-515.8
Exports	718.8 (-6.9)	668.4 (-7.0)	708.5 (6.0)
Imports	1,145.9 (-6.4)	1,111.7 (-3.0)	1,224.3 (10.1)