Economic Forecast for Fiscal 2000
— Resolving the Divergence of the Household and Corporate Sectors

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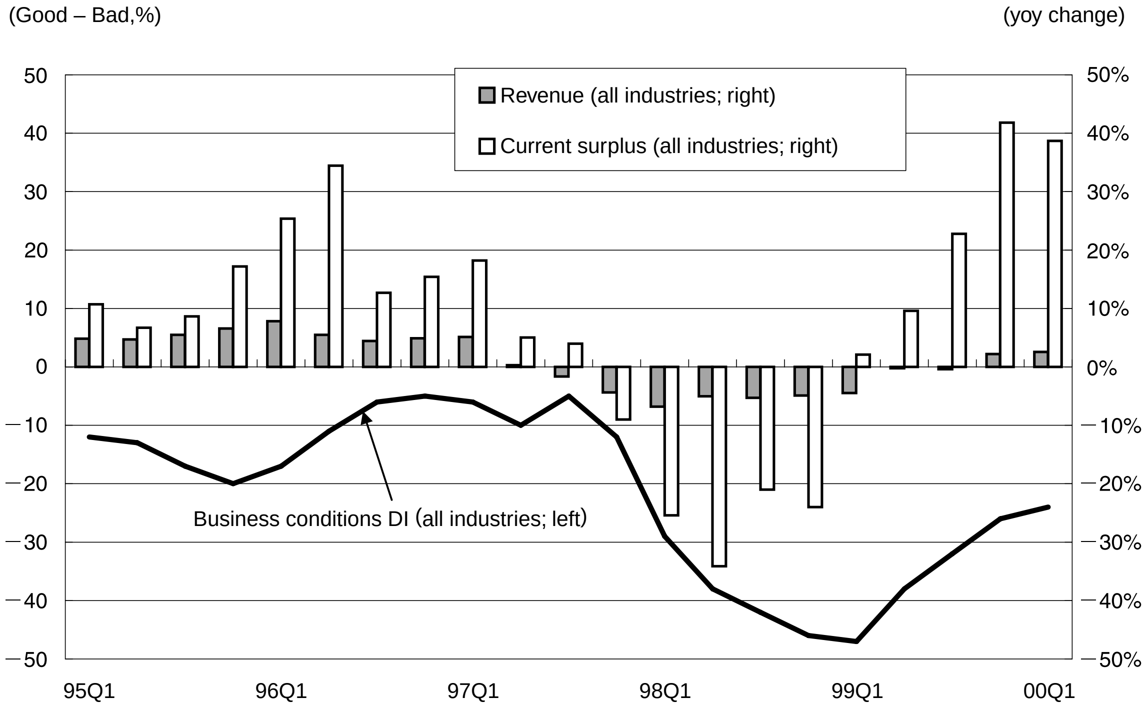
1. The Economy Averts a Deflationary Spiral

The economy managed to overcome its dismal performance of –1.9% in fiscal 1998 and achieve a real economic growth rate of 0.5% in fiscal 1999. Since bottoming out in April 1999, the economy has been on a moderate recovery track as industrial production steadily improves. In March, the year–on–year change in domestic wholesale prices turned upward, indicating a significant improvement from the deflationary concerns of declining demand and prices.

The post–bubble economy has suffered from the three excesses of employment, capacity, and debt. Because of the corporate sector's excess debt and weak demand for funds, money supply growth has flagged despite the zero–interest rate policy in effect since February 1999. Meanwhile, while some sectors continue to struggle with excess capacity, corporate investment has turned positive led by the electrical equipment industry, which is enjoying a demand increase due to the IT revolution. While companies with swollen payrolls have improved earnings by cutting fixed costs, high unemployment and sluggish income growth have taken a toll on the household sector and dampened consumption. Corporate revenues have turned around, current profits have improved significantly, and business sentiment is significantly better. This has boosted investment intentions, leading to positive growth in private nonresidential fixed investment in the second half of fiscal 1999. On the other hand, corporate restructuring has hurt employment, wage growth and bonuses, thus reducing earned incomes and dragging down consumption from late 1999. Thus we are seeing a divergence as the corporate sector advances while the household sector retreats.

Figure 1 Improvement in Corporate Earnings and Business Sentiment



Source: BOJ, *Tankan Survey* ; MOF, *Quarterly Statistics of Incorporated Enterprises*.

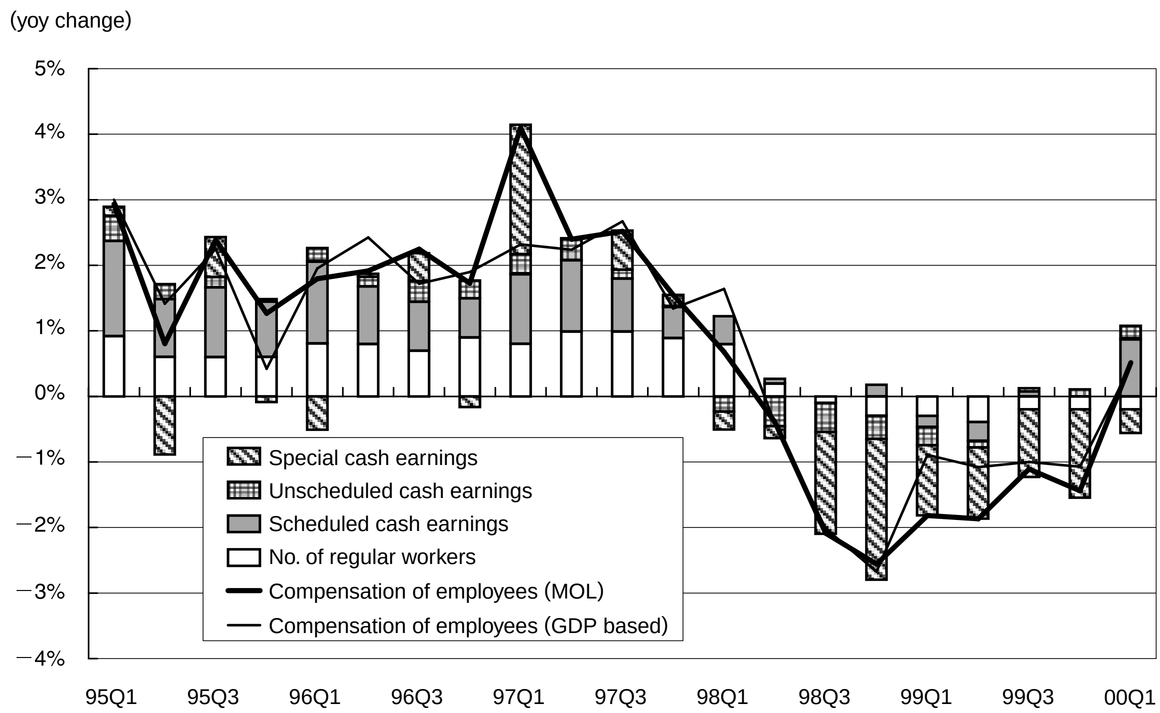
2. The Economy in Fiscal 2000

Supported by improving corporate results, the upturn in corporate investment will continue to expand steadily centered around IT for the time being. However, if consumption fails to pick up, investment will eventually peak out due to insufficient demand, and quite likely bring the recovery to a premature end. In fiscal 2000, the economy will depend on whether consumption can expand despite the excess employment weighing down companies.

(1) Factors Stimulating Consumption

Since consumer confidence today is stronger than in late 1997 and 1998 —when bankruptcies in the financial sector created job uncertainty and muzzled consumption — consumption will depend heavily on income growth. Despite excess employment, rising production has boosted overtime pay and increased employee incomes 0.5% in the first quarter of 2000 from the previous year. Consumption statistics have edged up in 2000 including a recovery in automobile sales. Since summer bonuses are expected to equal if not better last year's performance, the income environment will gradually improve and consumption will pick up in the fourth quarter of 2000, helping to sustain the recovery. Furthermore, the massive amount of Postal Savings time deposits that began to mature this April is expected to contribute to consumption by boosting the liquidity of households.

Figure 2 Compensation of Employees

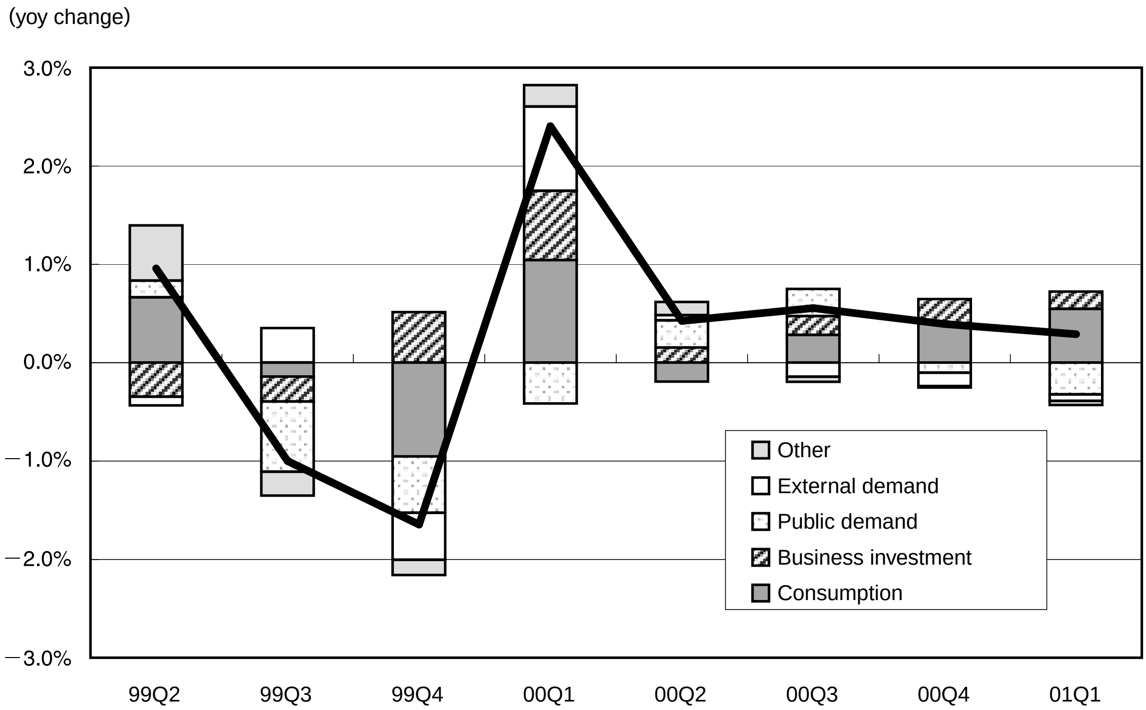


Source: MOL, *Monthly Labor Survey*; EPA, *Preliminary Report on National Accounts*.

(2) The Economic Picture in Fiscal 2000

The recovery will be sustained in fiscal 2000 as improvements in the corporate sector lead to consumption growth. Capital investment growth will slow but remain firm, recording the first positive growth of 7.2% in two years. Residential investment will turn negative, dipping to –0.3% in fiscal 2000 due in part to a pullback following the policy–induced surge. Due to the strong yen and recovery–driven import growth, external demand will contribute negatively to sequential economic growth toward the end of the fiscal year. Public works spending will fade as private demand begins to drive economic growth.

Figure 3 The Economy in FY 2000



Source: EPA, *Annual Report on National Accounts*.

Although we expect the official discount rate to stay unchanged during the forecast period, the BOJ may end its zero–interest rate policy and guide the call rate upward. The economic preconditions for lifting the zero–interest rate policy could be in place as early as this fall if a sustained recovery in consumption is confirmed. But other factors could impede a policy shift during the fiscal year, including fiscal tightening measures to reduce the deficit and political factors such as foreign pressure to increase money supply growth. However, regardless of the timing of a policy shift, long–term rates will gradually rise as markets take into account the improving economy and possibility of a change in the direction of monetary policy.

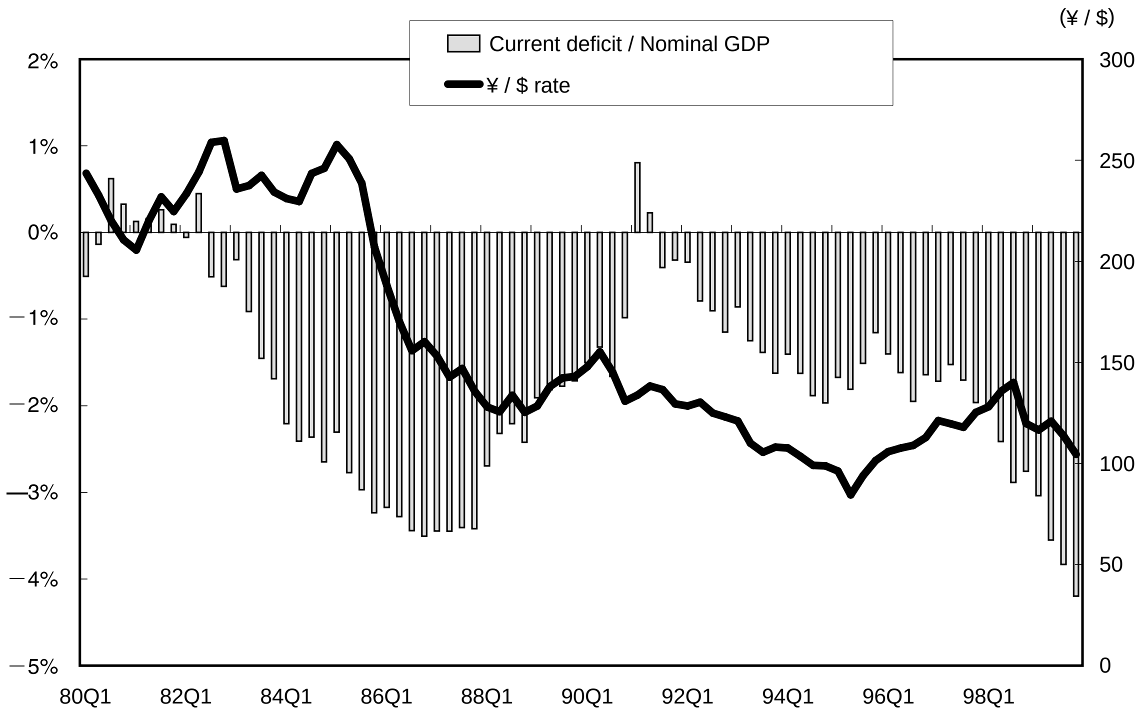
Because private demand will lead the economic recovery, we do not anticipate fiscal policies or a large supplementary budget containing additional public investment spending. With the gap in economic fundamentals between Japan and the U.S. shrinking, the yen will continue to appreciate moderately against the dollar from ¥111.5 in fiscal 1999 to ¥105.5 in fiscal 2000.

3. Risk Factors

(1) The Growing U.S. External Deficit

The steady household consumption supporting the U.S. economy has occurred against the backdrop of a declining savings rate and the strong stock market, causing the balance of payments deficit to widen. The economy appears to be slowing in response to monetary tightening, and as it continues to slow down, the external deficit will decline slightly from its high level.

Figure 4 The Growing U.S. External Deficit



Source: Dept. of Commerce

The stock market is being buoyed by excessive corporate earnings growth expectations and is overvalued. There is the risk that the market may over–correct and severely slow down the economy. If this occurs, the dollar's sharp fall and sharp decline in imports would significantly impact the global economy. But considering the fiscal surplus and other leeway to implement effective fiscal and monetary policies, a hard landing will be avoidable with the appropriate policy response.

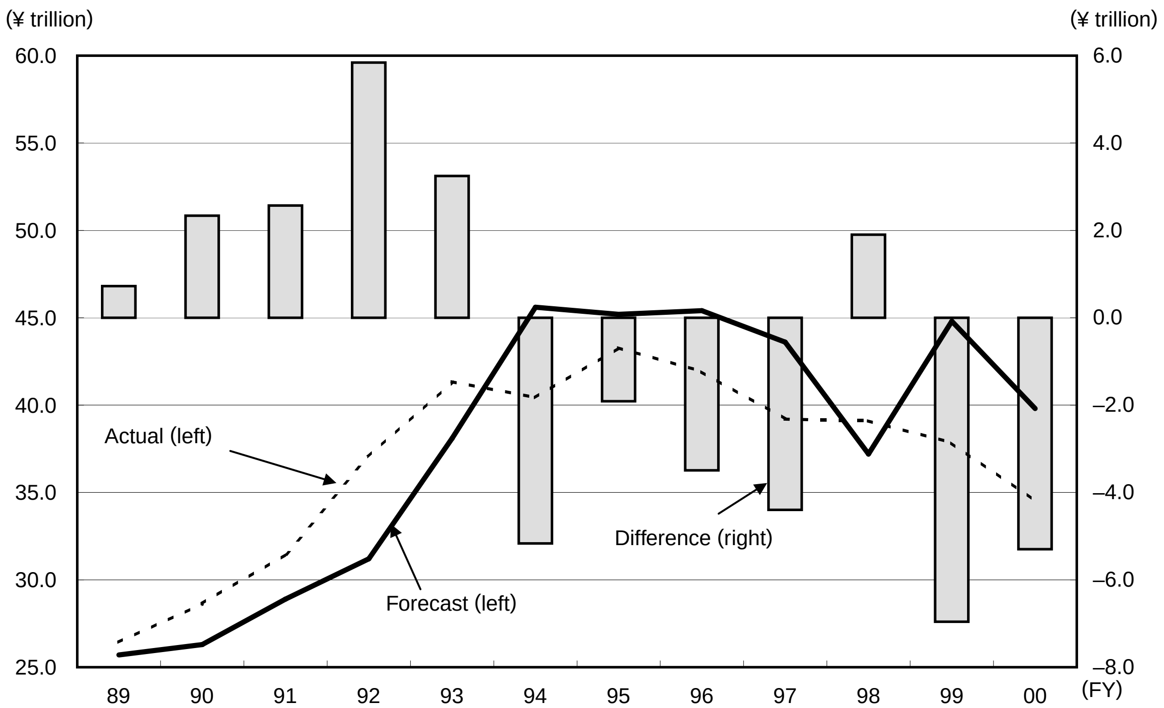
(2) Fiscal Deficit Reduction and the Economy

GDP statistics released on June 9 show that instead of a predicted increase from the second supplementary budget, Japan's real public works spending (public fixed capital formation) actually plunged

7.5% in the January–March quarter from the previous quarter. For fiscal 1999, public fixed capital formation thus fell short by ¥1.7 trillion of the government's own economic forecast released in January. Since the government's forecast is supposed to reflect the intended public works spending of the government's own fiscal policy, the large disparity between the predicted and actual results is a serious problem for private companies who rely on the forecast to plan ahead. In addition, it also suggests that the government cannot accurately track the execution status of public works spending.

While fiscal deficit reduction requires that the massive public works spending be reined in, a sharp decrease threatens to derail the recovery, much like the Fiscal Structural Reform Law's effect from fiscal 1997 to 1998. A recovery in private demand in fiscal 2000 should eliminate the need for a supplementary budget containing significant public works spending increases. But acute reductions in public works projects at the local level may necessitate a supplementary budget. In either case, unless the government collects sufficient data on national and local public works spending for the fiscal year, policy makers run the risk of misjudging the need for additional spending or its scale.

Figure 5 Disparity Between Actual and Predicted Public Works Spending

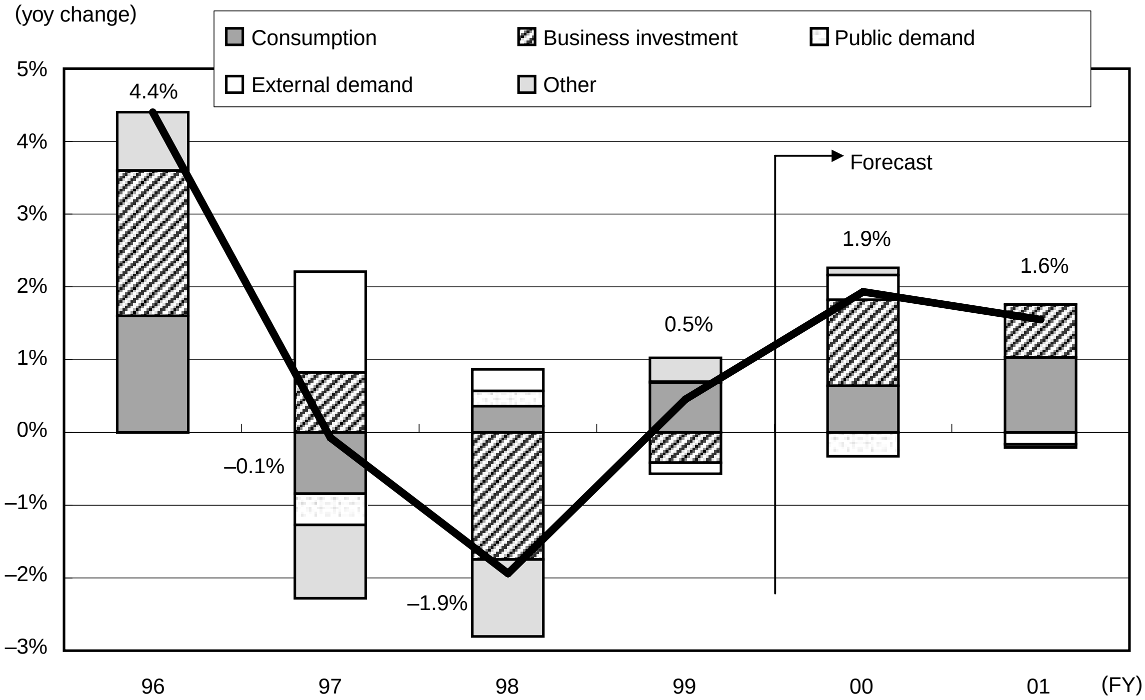


Note: For fiscal 2000, the actual value is an estimate by NLI Research Institute.
Sources: EPA, *Basic Stance Toward the Economic Forecasting and Management of the Economy, and Annual Report on National Accounts*.

4. Issues for Japan's Economy

During fiscal 1998 and 1999, the economy relied heavily on fiscal and monetary policies to prevent a deflationary spiral. The 0.5% real growth rate achieved in fiscal 1999 suggests that these measures had some effect. In fiscal 2000, while a deflationary spiral poses little threat, the economy will still be far from reaching its potential growth rate of 2%. Of course, 2% growth might be attainable by resorting to fiscal measures such as additional public works spending. But such measures would clearly be inappropriate, since they would not open the way to sustainable 2% growth led by private demand in the future.

Figure 6 Actual and Predicted Real GDP Growth Rates



Source: EPA, *Annual Report on National Accounts*.

Japan has averted immediate danger and recovered enough now to begin dealing with structural impediments that hold back the economy from achieving the elusive 2% potential growth rate. Economic policy needs to shift from the "crisis aversion" mindset up to now and set its sights on achieving sustainable growth in the longer term. Unless the short–sighted policies of the past are abandoned, the economy will never return to a sustainable growth track, while the government's cumulative debt problem will only grow more serious.

In fiscal 2000, the key policy issues are deregulation to increase corporate activity, and social security and other reforms to stimulate consumption.

Figure 7 Economic Forecast for Japan

(% sequential change)

	FY 99 actual	FY2000 forecast	FY 2001 forecast	2000/4-6	7-9	10-12	2001/1-3	4-6	7-9	10-12	2002/1-3	Previous forecast FY 00
Real GDP	0.5	1.9	1.6	0.4	0.6	0.4	0.3	0.2	0.5	0.5	0.6	1.0
				1.7	2.2	1.6	1.2	0.9	2.0	2.1	2.4	
				0.4	1.7	3.7	1.7	1.4	1.4	1.5	1.9	
Domestic demand	(0.6)	(1.6)	(1.7)	(0.4)	(0.7)	(0.5)	(0.4)	(0.3)	(0.5)	(0.4)	(0.4)	(0.8)
Private sector	(0.6)	(1.9)	(1.7)	(0.1)	(0.4)	(0.6)	(0.7)	(0.2)	(0.3)	(0.4)	(0.4)	(1.4)
Public sector	(0.0)	(-0.3)	(0.0)	(0.3)	(0.3)	(-0.1)	(-0.3)	(0.1)	(0.2)	(0.0)	(-0.0)	(-0.6)
External demand	(-0.2)	(0.3)	(-0.2)	(0.1)	(-0.1)	(-0.1)	(-0.1)	(-0.1)	(-0.0)	(0.1)	(0.2)	(0.2)
Private consumption	1.2	1.1	1.8	-0.3	0.5	0.7	0.9	0.2	0.3	0.2	0.4	0.6
Residential investment	5.6	-1.3	-1.9	0.5	-3.1	-0.4	-0.8	-1.5	-0.3	2.5	1.1	-4.4
Nonresidential fixed invest.	-2.5	7.2	4.2	0.9	1.1	1.5	1.0	0.8	1.1	1.1	1.0	6.7
Public fixed capital formation	-0.9	-7.1	-1.0	1.3	3.6	-0.5	-4.0	0.5	2.0	-0.5	-0.8	-7.0
Exports	5.9	13.8	5.0	5.3	1.9	1.3	1.4	1.0	1.1	1.1	1.5	6.7
Imports	8.7	13.8	7.3	6.1	3.5	2.5	2.2	1.9	1.5	0.7	0.4	6.5
Nominal GDP	-0.7	0.5	1.3	-0.6	0.7	0.3	0.5	-0.5	0.9	0.5	0.6	-0.0

Notes: 1. For real GDP, top number is sequential change, middle number is sequential change annualized, and bottom number is yoy change.
2. Forecast assumptions — Official discount rate 0.5% (unchanged); oil price \$27.80/barrel (FY 2000), \$26.90 (FY 2001); permanent tax cut of ¥4 trillion in FY 2000

Source: EPA, *Annual Report on National Accounts*.

Major Economic Indicators

(%)

	FY 99	FY 00	FY 01	2000/4-6	7-9	10-12	2001/1-3	4-6	7-9	10-12	2002/1-3	Previous forecast FY 00
Industrial production (seq.)	3.4	5.2	1.8	1.1	1.7	1.5	0.3	0.3	0.1	0.3	-0.4	4.1
Domestic wholesale prices (yoy)	-1.0	0.3	-0.1	0.4	0.5	0.1	0.1	-0.0	-0.2	-0.2	-0.2	0.7
Consumer prices (yoy)	-0.5	-0.4	-0.1	-0.6	-0.5	-0.4	-0.2	-0.2	-0.1	-0.1	-0.0	0.1
Current account balance	¥12.6 tr.	¥10.7 tr.	¥10.4 tr.	¥11.9 tr.	¥ 11.4 tr.	¥ 9.4 tr.	¥ 10.0 tr.	¥ 9.8 tr.	¥ 10.7 tr.	¥ 9.5 tr.	¥ 11.8 tr.	12.3
(ratio of GDP)	(2.6)	(2.2)	(2.1)	(2.4)	(2.3)	(1.9)	(2.0)	(2.0)	(2.1)	(1.9)	(2.3)	(2.5)
Unemployment rate	4.7	4.7	4.2	4.8	4.7	4.6	4.6	4.5	4.3	4.2	4.0	4.8
Housing starts	1.23 mil.	1.21 mil.	1.19 mil.	1.24 mil.	1.21 mil.	1.20 mil.	1.19 mil.	1.18 mil.	1.17 mil.	1.20 mil.	1.21 mil.	119
JGB long-term interest rate	1.8	1.9	2.2	1.8	1.9	2.0	2.0	2.1	2.2	2.2	2.4	1.9
Exchange rate (¥/$)	112	105	102	107	106	105	104	103	102	101	100	105

Sources: MITI, *Industrial Statistics Monthly*; BOJ, *Price Indexes Monthly*; MACA, *Monthly Report of Retail Prices*; MOC, *Monthly Construction Statistics*; others.

Figure 8(a) U.S. Economic Forecast

(%) Previous forecast

	1999 actual	2000 forecast	2001 forecast	2000 Q1 actual	Q2 forecast	Q3 forecast	Q4	2001 Q1	2000
Real GDP (sequential)				5.4	3.8	3.4	3.5	3.1	
(year-on-year)	4.1	4.9	3.1	5.0	5.5	5.0	4.0	3.5	3.9
Personal consumption	5.3	5.7	3.4	6.5	5.0	4.0	3.3	3.3	4.4
Nonresidential fixed investment	8.3	10.2	5.8	21.6	8.0	7.0	6.0	5.8	5.6
Residential investment	7.4	0.5	-1.9	6.7	-2.5	-4.5	-3.5	-2.0	-1.1
Inventory investment	-0.4	-0.2	0.0	-1.6	-0.5	0.2	0.2	-0.2	-0.2
Government spending	3.7	2.6	1.2	-1.1	2.0	1.2	1.2	1.2	5.1
Net exports of goods and services	-1.2	-0.7	-0.1	-1.5	-0.2	-0.2	0.1	0.1	-0.4
Exports	3.8	5.6	6.2	-0.2	6.0	5.0	6.0	6.5	7.4
Imports	11.7	8.7	5.1	9.5	6.0	5.0	4.0	4.0	7.9
Nominal GDP	5.7	7.1	6.2	8.2	6.2	5.8	5.8	5.5	6.0

Note: Nominal GDP and demand components are expressed as an annualized sequential rate.

Major Economic Indicators

(%)

	1999	2000	2001	2000 Q1	Q2	Q3	Q4	2001 Q1	2000
Industrial production (yoy)	3.5	2.0	0.5	4.1	3.0	0.9	0.0	-0.2	3.0
Producer price index (yoy)	1.8	3.5	1.5	3.8	3.7	3.3	3.0	2.0	2.5
Consumer price index (yoy)	2.2	3.4	2.8	3.2	3.5	3.5	3.3	3.0	2.6
Current acct. bal. (annualized)	-$339 bil.	-$370 bil.	-$320 bil	-$390 bil.	-$375 bil.	-$360 bil.	-$355 bil.	-$320 bil.	-$370 bil.
(as ratio to nominal GDP)	- 3.7	- 3.7	- 3.0	- 4.0	- 3.8	- 3.6	- 3.5	- 3.1	-3.8
Unemployment rate	4.2	4.3	4.8	4.1	4.3	4.4	4.5	4.6	4.6

Source: Dept. of Commerce, *Survey of Current Business.*

Figure 8(b) Economic Forecast for Asia

(% change yoy)

	Size of economy	1997 actual	1998 actual	1999 actual	2000 forecast
China	37.3%	8.8	7.8	7.1	7.0
Korea	18.0%	5.0	-5.8	10.7	7.0
Taiwan	11.5%	6.8	4.8	5.7	6.5
Hongkong	7.1%	5.3	-5.1	2.9	5.0
Singapore	3.9%	9.0	0.3	5.4	5.5
Thailand	6.2%	-1.8	-10.0	4.1	5.0
Indonesia	8.7%	4.7	-13.2	0.2	3.0
Malaysia	4.0%	7.5	-7.5	5.4	6.0
Philippines	3.3%	5.2	-0.5	3.2	3.0
9 countries	**100.0%**	**6.2**	**-0.5**	**6.3**	**6.2**
8 countries (excl. China)	62.7%	5.1	-4.8	5.9	5.7
NIES 4	40.4%	6.0	-2.2	7.6	6.4
ASEAN 4	22.3%	3.5	-9.4	2.7	4.1

Note: Size of economy is calculated from nominal GDP for 1997.
Sources: Government statistics, Asia Development Bank, OECD.

Economic Forecast for Europe

(% change yoy)

		1997 actual	1998 actual	1999 actual	2000 forecast
Real GDP		2.5	2.7	2.4	3.2
	Germany	1.6	2.0	1.4	2.8
	England	3.5	2.2	2.1	3.0
Consumer price index		1.7	1.3	1.2	1.8
	Germany	1.9	1.0	0.6	1.7
	England	2.8	2.7	2.2	2.5
Current account balance		1.4	0.9	0.2	0.1
	Germany	-0.1	-0.2	-0.5	-0.2
	England	0.8	-0.1	-1.4	-1.0

Notes: Covers 15 EU countries; current account balance is expressed as GDP ratio.
U.K. consumer price index excludes residential mortgage interest payments.
Sources: European Commission; U.K. Office of National Statistics; EPA, *Overseas Economic Data*.