

# Medium-Term Economic Forecast (FY 2002 ~ FY 2007)

by the Economic Research Group

## 1. Global Disinflation and Japan's Lost Decade

The global economy of the 1990s was characterized by disinflation. As globalization progressed and planned economies were converted into market economies, the sudden surge of countries and companies into markets pushed prices downward. This trend was accentuated by investment flows from industrialized economies into emerging markets. The resulting increase in global capacity and inexpensive imports triggered a virtuous cycle that kept inflation at bay while domestic economies grew.

Japan, however, failed to participate in this virtuous cycle. Real economic growth dropped from a heady 4.1% in the 1980s to a paltry 1.4% in the 1990s. Japan's performance in the 1990s trailed behind the G7 economies, and marked the biggest contrast from the 1980s. Moreover, from 1998 to 2001, Japan posted a 0.8% economic growth rate accompanied by a consumer price deflation rate of 0.6%. Thus while other industrialized economies thrived under deflationary conditions in the 1990s, Japan alone struggled in what has come to be called the "lost decade." Japan's unique experience of the 1990s can be attributed to domestic factors, in particular the aftermath of the bubble economy.

Figure 1 Inflation and GDP Growth Rate of Industrialized Economies

	Average annual CPI inflation rate (%)				Annual real GDP growth rate (%)			
	1970s	1980s	1990s	98~01	1970s	1980s	1990s	98~01
Japan	9.0	2.5	1.2	-0.6	4.4	4.1	1.4	0.8
U.S.	7.0	5.5	3.0	2.8	3.6	3.0	3.0	3.1
U.K.	12.5	7.4	3.7	2.1	2.4	2.4	2.1	2.5
Germany	4.9	2.9	2.3	1.7	2.9	1.8	2.9	1.9
France	8.9	7.3	1.9	1.3	3.3	2.3	1.7	3.1
Canada	7.3	6.5	2.2	2.3	4.8	3.1	2.2	3.5
Italy	12.3	11.0	4.1	2.3	3.9	2.4	1.5	2.1

Notes: Average real economic growth rates for Japan were calculated from *Annual Report on National Accounts* (Cabinet Office). 1970s data is 68 SNA, 1980s data is 93 SNA.

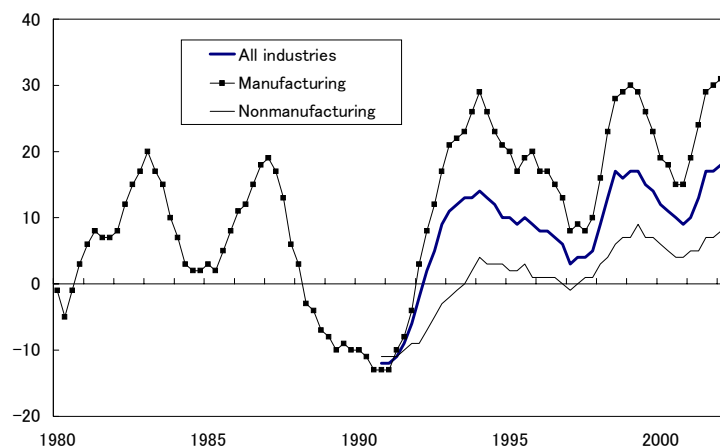
Source: IMF, *International Financial Statistics*.

## (1) Aftermath of the Bubble Economy

The direct cause of Japan's long-term stagnation in the 1990s was the aftermath of the bubble economy. After the bubble collapsed, Japanese companies were saddled with the three problems of excess capacity, employment, and debt. From the perspective of the overall economy, these excesses have created conditions of excess supply and weak demand, both of which have persisted and become serious impediments. This has resulted in rising unemployment, declining capacity utilization and capital efficiency, increasing nonperforming debt, and mounting deflationary pressures. Alleviating these conditions and achieving sustained growth requires that the excesses be alleviated.

With regard to reducing the excess capacity and employment, short-term cyclical fluctuations have helped only to a limited extent; no overall improvement has been seen after the bubble's collapse. One indicator of excess employment, the allocation to labor, has risen at an accelerated pace after the collapse due to delayed adjustment of high bubble-era wages. In recent years, employee compensation has declined due to smaller bonuses, other wage restraints, and rising unemployment, while the high allocation to labor by historical standards indicates that companies are still saddled with high labor costs.

**Figure 2 Production Capacity**  
(Diffusion index of "Excessive Capacity" minus "Insufficient Capacity")

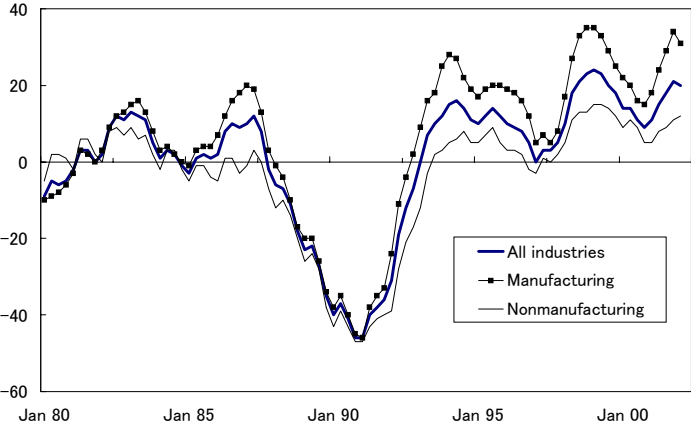


Source: BOJ

From a macroeconomic perspective as well, demand in the economy remains significantly smaller than supply. Even though individual industries and companies are experiencing shortages in capacity and labor, the overall economy is burdened with excess capacity and labor, and growth in capital investment and wages remains elusive. Since the economy's actual growth rate remains below its potential real growth rate of slightly above 1%, we predict that the excess capacity and employment problems will not be alleviated. And with no

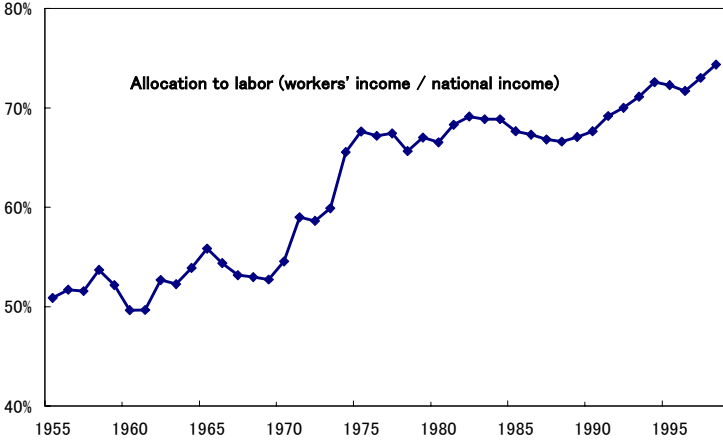
improvement expected in labor or capital efficiency, the excesses will continue to burden the economy ahead.

**Figure 3 Diffusion Index of Employment  
(% with excess minus % with shortage; aggregate)**



Source: BOJ

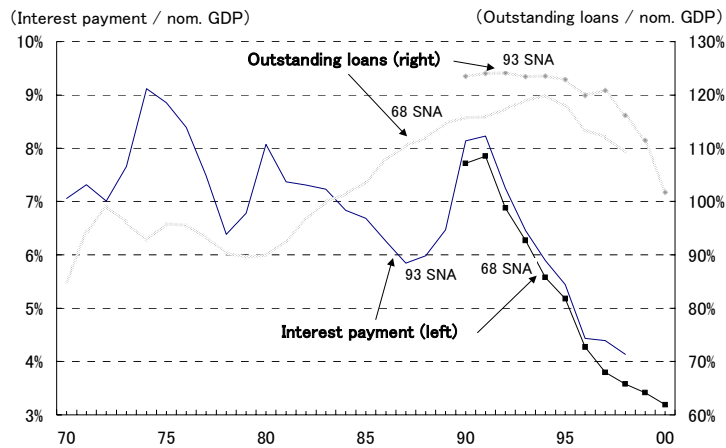
**Figure 4 Allocation to Labor**



Source: Cabinet Office

The disposal of excess debt has proceeded apace. The excess debt problem has two aspects: a stock problem of too much debt as a ratio to sales or profit, and a flow problem of burdensome interest payments. Since 1991, however, interest rates have dropped to very low levels due to financial deregulation, and as a result interest payments have fallen to approximately 3% of nominal GDP. While the stock problem is slower to improve, the ratio of debt to nominal GDP declined to approximately 100% in fiscal 2000, close to the pre-bubble level.

**Figure 5 Excess Debt Situation**



Source: Cabinet Office

If outstanding debt continues to decline at the present pace, corporate balance sheets will improve enough to allow expansion in capital investment. However, despite low loan interest rates, companies are sure to constrain investment spending as long as the risk of failure remains high. The large gap between supply and demand in the economy suggests that this risk cannot be easily dismissed, and that growth in capital investment will be limited.

## (2) Limits of Economic Growth Led by the Corporate Sector

A peculiar phenomenon of the post-bubble economy has been the corporate sector's surplus of funds. Ordinarily, the corporate sector has a deficit of funds, and must borrow capital for investment from the household sector. While surpluses have occasionally occurred in the corporate sector, this condition is extremely rare and limited to extreme cases such as depressions. Profits have been squeezed by the high allocation to labor (an indicator of excess employment), which rose after the bubble's collapse and has not fallen significantly since.

However, a combination of declining interest payments due to ultra-low interest rates, declining dividend and other asset income payments by the corporate sector, and a lower tax burden have helped boost corporate savings. Moreover, depreciation costs from the excess investment of the bubble era may have hurt profits, but contribute positively to corporate savings. Meanwhile, the surplus has been augmented by a decline in investment activities such as capital spending and land purchases. Since the funds are being used to pay off debt, if the fund surplus continues to grow, the corporate sector's debt ratio to GDP could decline even lower than before the bubble.

The resulting improvement in corporate balance sheets, together with lower opportunity costs from ultra-low interest rates, could possibly spur capital investment, thereby

alleviating the corporate sector's extraordinary fund surplus, and possibly even allaying deflation.

To what extent can growth in capital investment help sustain economic growth?

Given the lower expected growth rates of companies, capital investment for new capacity will not grow significantly. Prospects for labor-saving and streamlining investment are also restricted since companies must recover their investment by cutting costs. In the miracle growth years, the ratio of investment to nominal GDP reached 20%, falling to 15% in the second oil shock. The ratio recovered to 20% during the bubble era, but this level proved to be excessive. Although economic growth is possible amid the declining population growth rate, the high growth rates of the past are not. Since investment opportunities have decreased, prospects for growth in the investment to GDP ratio are limited.

## **2. Medium-Term Forecast (Fiscal 2002~2007)**

### **(1) Forecast Summary**

In fiscal 2002, Japan will recover on the strength of the U.S. recovery, but the recovery will be fragile. Not only are fiscal and monetary policies ineffective in stimulating domestic demand, but the bubble's legacies—excess capacity, employment, and debt—will continue to cripple domestic private demand. These conditions preclude either policy-induced growth or growth led by sustained domestic demand. The growing current account surplus will push the yen upward, causing the contribution of external demand to turn negative in fiscal 2003, and cooling the economy down noticeably. Thus the present recovery is likely to be weak and short-lived.

In the second half of the forecast period, while the U.S. recovery and moderate improvement in external demand will stimulate recovery, growth will be constrained by continued weakness in capital investment and consumer spending.

### **(2) Medium-Term Forecast for Overseas Economies**

#### *1. U.S.*

While consumer spending appears to have firmly bottomed out, capital investment is negative and continues to weigh on the economy. The poor investment climate stems from

excesses in the 1990s centered around IT, and while manufacturing production and orders appear to be recovering, capacity utilization rates remain low and corporate profits slow to recover. Capital investment will recover in the future, but only moderately, due to persistent stock adjustments in IT related industries.

Consumer spending is not expected to contribute significantly to growth. With the delayed recovery in employment, wage growth remains low, while the savings rate, after dropping during the 1990s, shows no sign of improvement. The stock market, which had produced a wealth effect and encouraged consumption in the past, has plummeted due to weak corporate earnings, corporate accounting scandals, and the threat of more terrorism. If the market continues to decline, the possibility arises of a reverse wealth effect.

Thanks to the quick response of policy makers in effecting tax cuts and interest rate cuts, the present recession appears to be short-lived and mild in light of the robust 6.1% growth in the first quarter. However, because of ongoing adjustments in the economy as described above, we predict the economy will grow a modest 3% in the forecast period—2.3% in 2002 and 2.9% in 2003.

## *2. Europe*

While recovering overall, the pace of recovery is patchy throughout the region. In the euro area, although production continues to recover due to progress in inventory adjustment and the improving export environment, the modest strength of the U.S. economy will limit growth to 1.2% in 2002. The recovery will grow full-fledged in 2003, after which growth will be sustained at near the potential growth rate in the mid 2% range.

Progress in reforming labor market rigidity and harmonizing institutional differences in the single currency area will remain critical to the euro area's economic vitalization. During the forecast period, we predict the euro will maintain a firm bottom due to the decreasing disparities in interest rates and economic growth with the U.S., and alleviation of pressure from balance of payments factors such as the current account deficit and capital outflows.

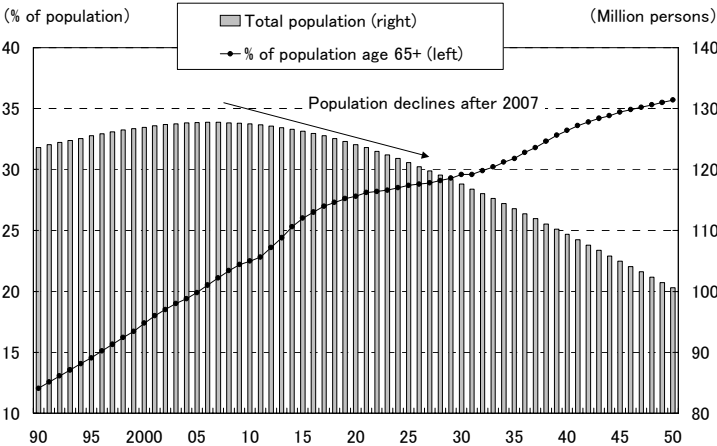
### **(3) Medium-Term Forecast for Japan**

#### *1. Decline in the Demand-Supply Gap Due to Aging*

According to projections by the National Institute of Population and Social Security Research, while Japan's population will start declining in fiscal 2007, the productive population of persons age 15-24 has already begun declining due to aging. The problems of excess supply

and insufficient demand described above will be alleviated by aging and the resulting decline of the economy’s supply side. By 2025, when the productive population will have declined by 16.3% from 2000 (from 72.33 million to 36.38 million), the economy will be in exactly the opposite situation from today—insufficient supply and inflation. Of course, the long wait alone makes this an untenable solution to deflation. In addition, the implied result is a contracting equilibrium, which is far from optimal for the general population.

**Figure 6 Aging and Population Decline**

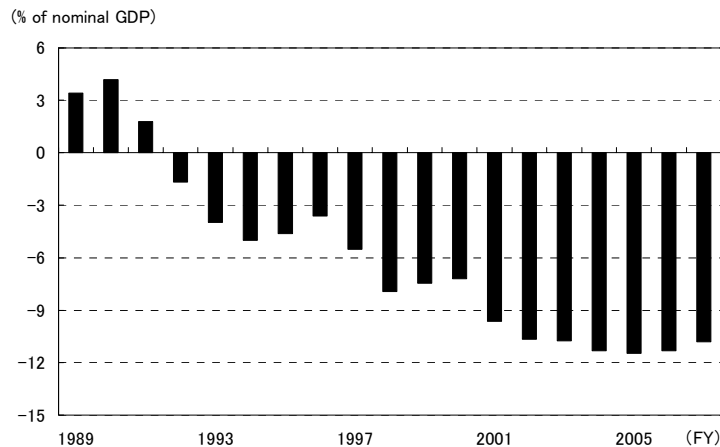


Notes: Shows actual values up to 2000, and median projections from 2001 (as of January 2002).  
 Source: National Institute of Population and Social Security Research

Japan’s potential growth rate plummeted in the 1990s, averaging in the low 2% range. But since the actual growth rate averaged 1.7% for the decade, the GDP gap (actual minus potential GDP growth rate, divided by potential growth rate) grew to 10.7% in fiscal 2002. As for the potential growth in the first half of the 2000 decade, due to the declining labor force and accelerating pace of work hour reduction, labor input will negatively impact the potential growth rate. Due to balance sheet adjustments, capital investment will increase, causing the capital stock to continue growing. The economy’s overall efficiency is predicted to increase due to IT investment, which will partially compensate for the negative contribution of labor, but the potential GDP growth rate will decline on average to 1% during the forecast period.

In fiscal 2003, a recession will reduce the economic growth rate again to near zero, causing demand and supply conditions to deteriorate further. But in fiscal 2006, the GDP gap will start shrinking again as the economy recovers to its potential growth rate of approximately 1%, and shrink another 0.5 percentage-point in fiscal 2007. As a result, deflationary pressures will be subsiding toward the end of the forecast period.

Figure 7 GDP Gap



Source: Compiled by NLI Research Institute

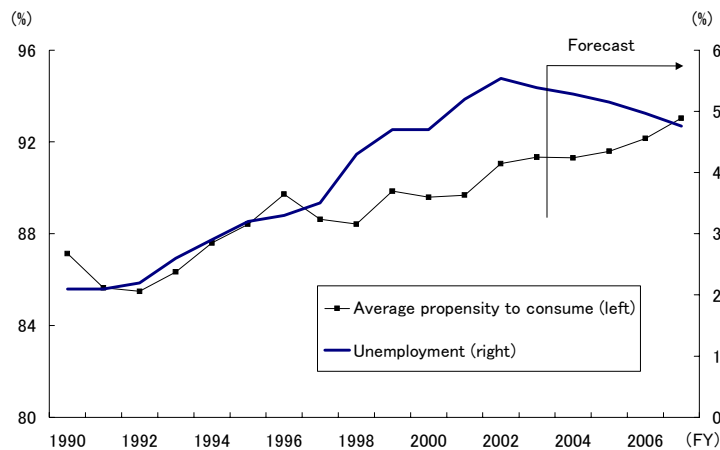
## 2. Sector Trends

**Household sector**— Household income growth will be sluggish. Due to the persistently high allocation to labor, employee compensation growth will remain low during the forecast period. Moreover, persistent deflationary conditions will restrain interest income growth. On the other hand, the propensity to consume, which declined in the late 1990s, is expected to improve slightly in the future. The declining propensity to consume in the late 1990s can be attributed to growing anxieties, consisting of short-term risks such as unemployment and corporate failures, and the sustainability of the social security system. During the forecast period, we predict that the unemployment rate will peak at 5.4% in fiscal 2002 and subsequently trend downward. In addition, the pension actuarial recalculation slated for 2004 should reduce social security anxieties by clarifying the extent of benefit cuts and premium increases. Due to these factors, we predict that the propensity to consume will rise in the second half of the forecast period. Private consumption expenditure will average a real growth rate of only 0.6%, increasing to 1.0% in fiscal 2007.

We predict that residential investment will be sluggish overall. In addition to weak household income, demographic factors such as the declining population will contribute negatively. Moreover, housing demand, which has been pushed forward by the stimulation to residential investment from low interest rates and tax measures, is expected to subside. During the forecast period, residential investment will remain largely unchanged, with an average real growth rate of -0.1%.



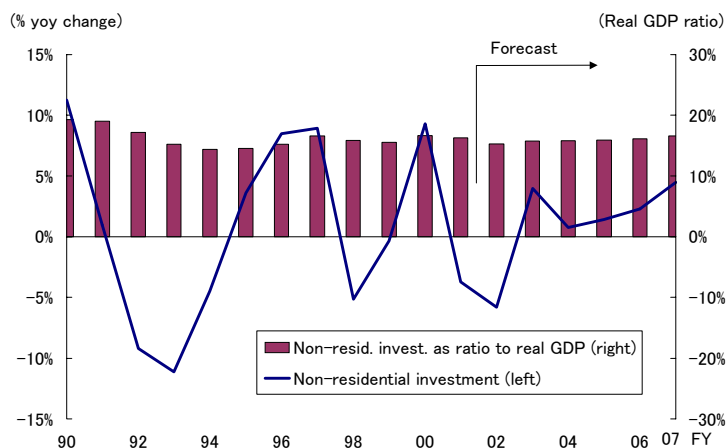
**Figure 8 Average Propensity to Consume and the Unemployment Rate**



Sources: Cabinet Office and others; forecast by NLI Research Institute.

*Corporate sector*—After posting negative growth in fiscal 2002 and 2002, private non-residential investment is predicted to grow 4.0% in fiscal 2003. Investment growth will plunge to 0.8% in fiscal 2004 due to recession, but increase to 4.5% in fiscal 2007 as the economy recovers. However, as indicated by the sector’s continued positive savings-investment balance, capital investment will lack strength and grow at an average real rate of only 2.6% during the forecast period. While the ratio to nominal GDP will rise to 14.7% in fiscal 2007 from 13.9% in fiscal 2002, investment levels will remain low by historical standards.

**Figure 9 Non-Residential Investment**



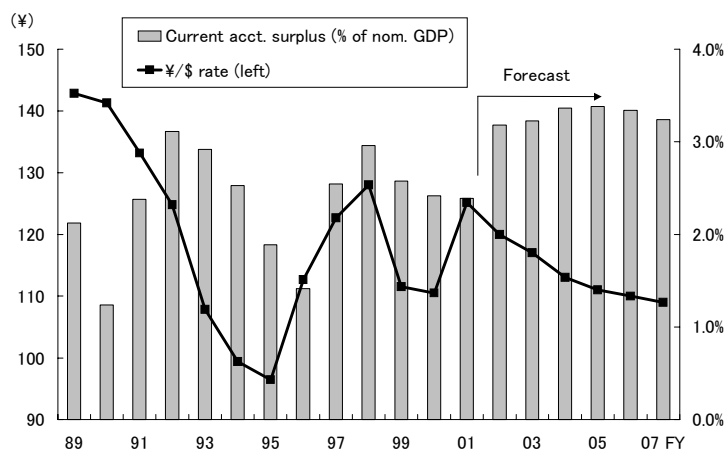
Sources: Cabinet Office; forecast by NLI Research Institute

*Current account surplus*—During the forecast period, as deflation causes the purchasing power parity exchange rate to decline, the yen’s actual exchange rate will follow suite. Meanwhile, judging from the current account deficit of the U.S., the dollar will trend

downward. Thus we predict that the yen will strengthen against the dollar, with the average dollar rate moving from ¥120 in fiscal 2002 to ¥109 in fiscal 2007.

We predict that Japan's current account surplus, which stood at ¥11.95 trillion in fiscal 2001 (2.4% of nominal GDP), will expand in fiscal 2002 to ¥15.75 trillion (3.2% of nominal GDP) due to growth in exports to the U.S. In fiscal 2003, as Japan's economy shows signs of a slowdown, export growth will remain positive, causing the current account surplus to expand further, reaching ¥16.72 trillion (3.4% of nominal GDP) in fiscal 2005. By fiscal 2007, import growth due to domestic demand expansion, along with the strong yen (¥110 in fiscal 2006) will rein in growth in the current account surplus.

**Figure 10 Current Account Surplus and the Yen-Dollar Rate**



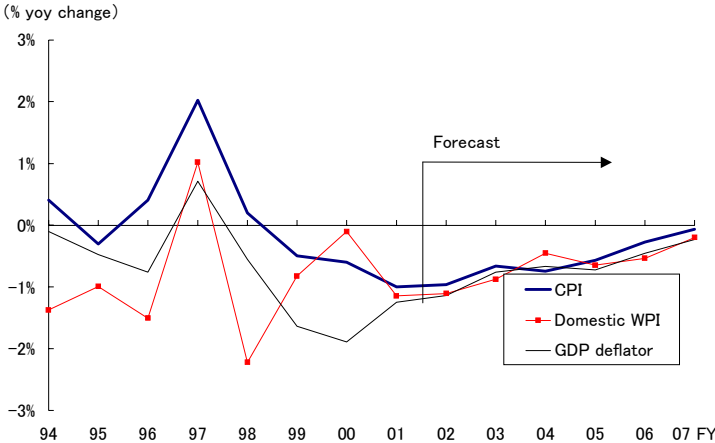
Sources: Cabinet Office, BOJ, MOF; forecast by NLI Research Institute.

**Monetary policy and interest rates**—Toward the end of the forecast period, as the economy's gap between supply and demand starts to shrink, the deflation rate will also decrease. By fiscal 2007, the economy will be on the verge of shrugging off deflation, with the GDP deflator at  $-0.2\%$  consumer price inflation at  $-0.1\%$ . However, this still fails to satisfy the BOJ's condition for discontinuing quantitative monetary easing—consumer price inflation (national, excluding fresh foods) that is stable and at least zero percent on a year-on-year basis—leaving us to predict that quantitative easing will continue after fiscal 2007, and that short-term interest rates will be maintained at ultra-low levels.

With over ¥100 trillion in government bonds being issued per year (including refinancing bonds) and corporate demand for funds being weak, household savings will continue to be channeled through financial institutions into JGBs. We predict that in fiscal 2006, when the economic recovery becomes apparent and the economy's supply-demand gap starts to shrink, the long-term interest rate, fluctuating at 1.3%, will rise in anticipation of the end of

quantitative easing in the next few years. In fiscal 2007, as the economic growth rate increases, the long-term interest rate will rise further to approximately 1.6%.

**Figure 11 Inflation Rate**



Sources: Cabinet Office, BOJ; forecast is by NLI Research Institute.

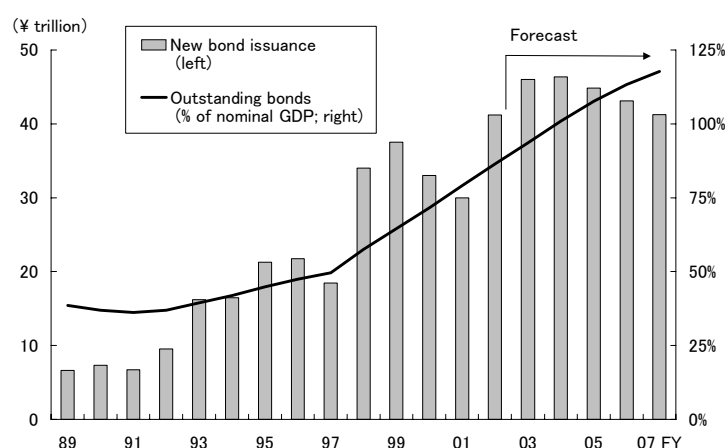
**3. Continued Fiscal Deficits are Unavoidable**

While spending cuts are assumed to continue under the modest fiscal restructuring program, tax revenues are not expected to grow, causing the fiscal deficit to expand slightly during the forecast period. New bond issuance, limited to ¥30 trillion in fiscal 2001, will increase annually, reaching ¥41.2 trillion in fiscal 2007. The value of outstanding bonds will reach ¥593.4 trillion in fiscal 2007, or 117.7% of nominal GDP.

From the perspective of the economy’s savings-investment balance, it is impossible to reduce the fiscal deficit alone while the rest of the economy remains out of balance. With private demand not recovering until the second half of the forecast period, we see no possibility of drastic spending cuts or revenue increases through tax hikes.

Attempting to slash the fiscal deficit under these conditions could produce the same disastrous consequences as the fiscal structural reforms of fiscal 1997, which included a consumption tax hike and abolition of the special tax cut. As that case showed, undoing the damage requires extensive measures that would put the government’s fiscal condition in even greater jeopardy.

**Figure 12 Newly Issued and Outstanding JGBs**



Sources: Cabinet Office, others; forecast is by NLI Research Institute.

### 3. Risk Factors Confronting the Economy

#### (1) Higher Interest Rates

We must be fully aware of the risk that long-term interest rates could surge during the forecast period. First, with short-term interest rates being kept low under the BOJ's monetary easing policy, if the corporate sector suddenly reverts to its normal situation of a fund deficit, the large demand for financing in the private sector could push long-term interest rates upward. Second, as the massive issuance of JGBs continues and the holding risk becomes a concern even domestically, panic could trigger a massive sell-off. Third, when deflation abates and the end of the zero-interest rate policy is in sight, financial institutions could sell off bonds en masse to avoid the risk of higher interest rates.

The market's ability to absorb massive bond issuances throughout the 1990s can be attributed to two factors: (1) low interest rates, and (2) incentives to hold JGBs such as the BIS standards. The early 1990s saw a sharp increase in JGB holdings by the public sector, while in the late 1990s, JGB holdings surged among private financial institutions due to the persistent slump in lending.

While part of the interest rate risk of these holdings was hedged using swaps and futures, private financial institutions were undoubtedly exposed to a considerable amount of risk compared to the past.

If interest rates start rising, we predict that private financial institutions will seek to avoid

capital losses by becoming net sellers. Moreover, the BOJ will shift gears from supplying more money to supplying less by selling JGBs. Given the continued issuance of massive amounts of new bonds, an increase in interest rates poses the risk of turmoil in both the primary and secondary markets. Thus the BOJ, who controls the flow of JGBs, needs to agree on a compatible JGB management policy with the MOF, who manages the stock of JGBs.

**(2) Weakening Dollar**

The U.S. current account deficit, which grew in the early 1980s, declined temporarily in the early 1990s. However, the deficit rose again from the late 1990s, reaching \$410 billion in 2000, or 4.2% of nominal GDP. The recent combination of a strong dollar and growing current account deficit has also occurred in the 1980s. At that time, though, the dollar’s strength was corrected by the Plaza Accord of September 1985.

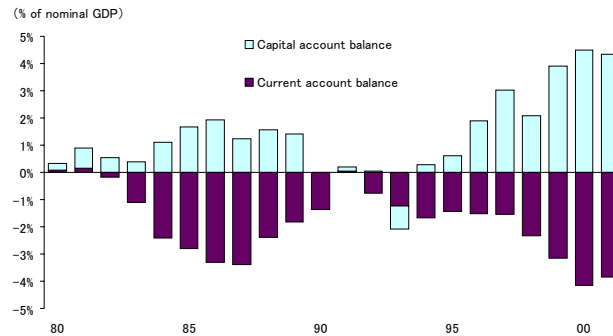
**Figure 13 Effective Dollar Rate  
(Real rate vs. major currencies; March 1973 = 100)**



Source: FRB

Comparing the situations at the time of the Plaza Accord with today, we can find similarities such as a high real effective dollar rate and growing current account deficit. On the other hand, U.S. interest rates today are lower and more stable than in the 1980s. This difference can be explained as follows: under the twin-deficit situation of the early 1980s, financing of the fiscal deficit kept long-term interest rates persistently high; however, fiscal surpluses under the Clinton administration reduced long-term interest rates and added flexibility to fiscal policy. Under the Bush administration, while tax cuts and increased defense spending following September 11 have propelled an economic recovery, the likelihood of recurring fiscal deficits is a major source of concern.

**Figure 14 U.S. Current Account and Capital Account Balances**



Source: Dept. of Commerce

The growing U.S. current account deficit poses the risk of a sudden decline in the dollar. This is because the stock market's volatility has reduced the massive fund inflows for corporate acquisitions and stock purchases, making it difficult to finance the large current account surplus. Since U.S. interest rates are already below Europe's, the U.S. could lose control of a weakening dollar if deteriorating financial and economic conditions make it necessary to cut interest rates.

Although the yen was significantly undervalued in 1985, such is not the case today. Moreover, since Japan's contribution to the U.S. trade deficit is small compared to 1985, any appreciation of the yen against the dollar should not reach 1985 levels.

Exchange rate volatility can be avoided if the corporate accounting scandals clear up quickly, the stock market stabilizes, and the economy recovers. But if these events fail to occur, the dollar is at risk of plunging against the yen.

## Medium-Term Forecast for Japan

(% yoy change unless otherwise noted)

(Fiscal year)	2000	2001	2002	2003	2004	2005	2006	2007	Average annual rate		
	act.	act.	forecast						92~97	02~97	02~07
<b>Nominal GDP</b>	-0.3	-2.5	-1.1	0.1	-0.2	0.0	0.6	1.2	-1.5	-1.0	0.4
(¥ trillion)	(513.0)	(500.2)	(494.9)	(495.6)	(494.5)	(494.7)	(497.8)	(504.0)			
<b>Real GDP</b>	1.7	-1.3	0.1	0.9	0.4	0.8	1.1	1.5	-1.5	0.3	0.9
(¥ trillion)	(535.7)	(528.9)	(529.3)	(534.1)	(536.5)	(540.6)	(546.5)	(554.6)			
Domestic demand	1.5	-0.8	-0.6	1.1	0.5	0.8	1.1	1.5	-1.5	0.2	1.0
Private demand	1.8	-1.1	-1.0	1.4	0.2	0.6	1.1	1.8	-1.3	-0.2	1.0
Final consumption expenditure	-0.1	0.3	0.6	0.5	0.1	0.4	0.8	1.0	-1.5	0.8	0.6
Residential investment	-1.5	-8.5	-5.4	0.1	0.2	-0.7	0.5	-0.5	1.4	-4.3	-0.1
Non-residential investment	9.3	-3.7	-5.8	4.0	0.8	1.4	2.3	4.5	-0.8	-1.3	2.6
Public demand	0.6	0.1	0.6	0.3	1.3	1.3	1.1	0.8	-2.4	1.3	0.9
Govt. final consumption exp.	4.4	2.8	2.7	2.4	2.7	2.6	2.3	2.1	-2.7	3.4	2.4
Public investment	-7.4	-5.8	-5.2	-5.5	-2.7	-2.7	-3.2	-3.8	-1.8	-3.5	-3.6
Net exports <contrib.>	<0.2>	<-0.5>	<0.7>	<-0.2>	<-0.0>	<0.0>	<0.0>	<0.0>	<-0.0>	<0.1>	<-0.0>
Exports	9.4	-8.0	5.7	1.2	1.4	1.7	2.1	2.3	-4.7	1.6	1.7
Imports	9.6	-4.7	-1.4	3.6	2.2	2.2	2.5	2.8	-6.0	0.4	2.6
Domestic WPI	-0.1	-1.1	-1.1	-0.9	-0.5	-0.6	-0.5	-0.2	1.0	-1.1	-0.5
CPI	-0.6	-1.0	-1.0	-0.7	-0.7	-0.6	-0.3	-0.1	-0.8	-0.6	-0.5
Unemployment rate (%)	4.7	5.2	5.5	5.4	5.3	5.2	5.0	4.8	3.1	4.9	5.1
Current account bal. (¥ tril.)	12.4	11.9	15.7	16.0	16.6	16.7	16.6	16.3	11.3	13.7	16.5
(% nominal GDP)	(2.4)	(2.4)	(3.2)	(3.2)	(3.4)	(3.4)	(3.3)	(3.2)	(2.3)	(2.7)	(3.3)
Dollar rate (¥) avg.	110.5	125.1	120.0	117.0	113.0	111.0	110.0	109.0	107.8	119.0	112.0
Call rate (%) avg.	0.15	0.01	0.00	0.00	0.00	0.00	0.00	0.00	1.3	0.1	0.0
Long-term interest rate avg.	1.6	1.4	1.3	1.3	1.3	1.3	1.4	1.6	3.2	1.5	1.4

Sources: Economic and Social Research Institute (Cabinet Office), *Annual Report on National Accounts*; Statistics Bureau (Ministry of Public Management, Home Affairs, Posts and Telecommunications), *Consumer Price Index*, and *Labor Force Survey*; Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*; others.

## Medium-Term Forecast for the U.S.

(% yoy change unless otherwise noted)

	2000	2001	2002	2003	2004	2005	2006	2007	5-year avg.
Real GDP	4.1	1.2	2.3	2.9	3.0	3.0	3.0	3.0	3.0
Domestic demand <% contrib.>	< 4.8>	< 1.3>	< 2.8>	< 3.1>	< 3.1>	< 3.1>	< 3.1>	< 3.1>	< 3.1>
Consumption expenditure	4.8	3.1	3.0	2.6	2.7	2.8	2.8	2.8	2.7
Non-residential fixed investment	9.9	- 3.2	- 6.7	3.5	4.5	4.8	5.0	5.2	4.6
Residential investment	0.8	1.5	3.4	1.2	1.8	1.8	1.6	1.6	1.6
Inventory investment <% contrib.>	<- 0.1>	<- 1.1>	< 0.7>	< 0.4>	< 0.0>	<- 0.2>	< 0.1>	< 0.0>	< 0.1>
Government expenditure	2.7	3.6	4.8	2.4	2.2	1.7	1.5	1.5	1.9
External demand <% contrib.>	<- 0.8>	<- 0.1>	<- 0.4>	<- 0.2>	<- 0.1>	<- 0.1>	<- 0.1>	<- 0.1>	<- 0.2>
Exports	9.5	- 4.5	- 3.3	4.7	4.4	4.4	4.4	4.4	4.5
Imports	13.4	- 2.7	0.4	4.6	4.0	4.0	4.0	4.0	4.1
CPI	3.4	2.8	1.6	2.2	2.4	2.6	2.7	2.7	2.5
Current account bal. (% of nom. GDP)	- 4.2	- 3.9	- 4.2	- 4.2	- 4.1	- 4.0	- 3.8	- 3.7	- 4.0
Federal funds target rate (avg)	6.2	3.9	1.8	2.4	3.0	3.5	3.8	3.8	3.3
10-year Treasury yield (avg.)	6.0	5.0	5.0	5.1	5.2	5.3	5.4	5.4	5.3

Notes: Domestic & external demand, inventory investment are expressed as contributions. 5-year average is forecast from 2003.

Source: U.S. Department of Commerce

## Medium-Term Forecast for Europe

		2000	2001	2002	2003	2004	2005	2006	2007	5-year avg.
	(unit)	actual	actual	forecast	→					
Real GDP	% yoy	3.5	1.4	1.2	2.8	2.5	2.5	2.5	2.5	2.3
Domestic demand	% contrib.	2.9	0.8	0.5	2.6	2.3	2.3	2.2	2.3	2.0
Private final consumption exp	% yoy	2.5	1.7	1.3	2.6	2.3	2.3	2.3	2.3	2.2
Non-residential fixed invest.	% yoy	4.7	- 0.5	0.5	3.3	2.9	2.9	2.8	2.9	2.5
External demand	% contrib.	0.6	0.7	0.8	0.3	0.2	0.3	0.2	0.2	0.4
Consumer price index (HICP)	% yoy	2.4	2.5	2.2	2.2	2.2	1.7	1.8	1.8	2.0
Current account balance	% nom GDP	0.5	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
ECB policy rate	%	4.75	3.25	3.75	4.25	3.5	3.5	3.5	3.5	3.67
10-year govt. bond yield	%	5.3	4.8	5.0	5.1	4.9	4.8	4.9	4.9	4.9
Euro/dollar rate	\$	0.92	0.90	0.95	1.01	1.05	1.08	1.09	1.11	1.0
Euro/yen rate	¥	100	109	118	119	119	120	120	121	119.5

Notes: For the 12-country euro area. 10-year government bond yield is for Germany. 5-year average is forecast from 2002.

Sources: Eurostat, ECB.