

Chapter 1 Overview of the Capacity for Economic Recovery

[Section 1 Bottoming Out of the Economy]

(1) The economy has bottomed out

- Background to the bottoming out

1) External factor <export growth> ← (i) Recovery of the U.S. economy; (ii) recovery of the Asian economy; (iii) depreciation of the yen

2) Domestic factor <end to inventory adjustment> ← Rapid and drastic production adjustment

- Features of this phase = The slump in exports and production and the subsequent rebounding were significant. However, the expected growth rate has dropped further.

(2) Current state of deflation

- The general price deflation continues to aggravate. ← Domestic wholesale prices remain at the same level due to a rise in import prices caused by the depreciation of the yen and an improvement in the demand-and-supply balance. However, consumer prices remain weak due to increased import penetration. The decline of the GDP deflator indicates that the current deflation is “home-made.”

- Asset prices (land prices and stock prices) decreased sharply after the burst of the economic bubble, and have remained on a downward trend ever since. Capital losses in Japan as a whole since the 1990s have accumulated to over 1,100 trillion yen.

- Contributing factors to the drop in asset prices are: 1) the slump of anticipated earnings; and 2) the rise of risk premiums. With regard to land prices, the collapse of the myth of ever-higher land prices and the shift of emphasis from “ownership to utility value” are also affecting the decline.

- The impacts of the asset price deflation on the real economy are felt through:

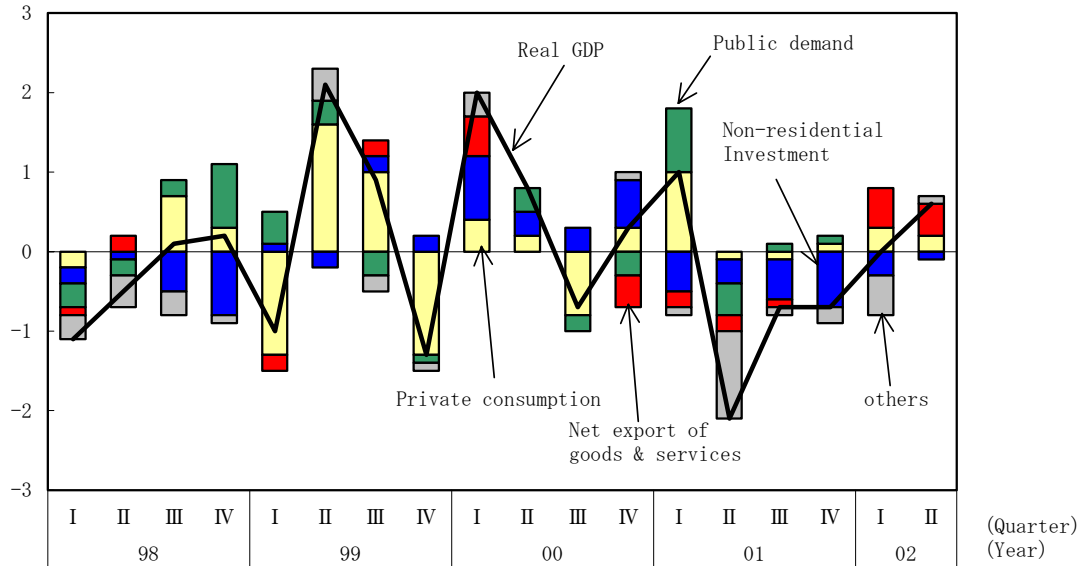
1) deterioration of balance sheets (unchanged value on the liability side; decrease of value on the asset side); and

2) increased difficulty in corporate financing (fall of collateral value and stock value)

Real GDP Growth and Contribution by Components

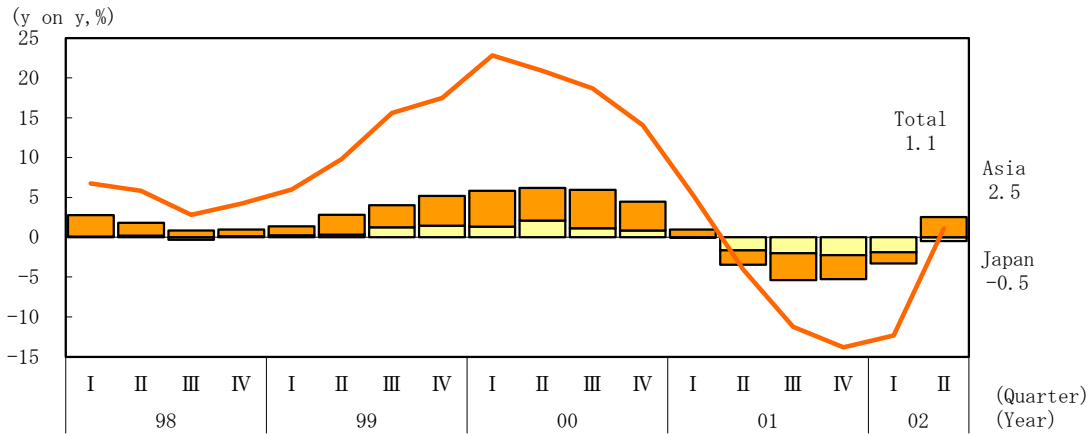
The economy has bottomed out

(comparison with previous quarter, %)



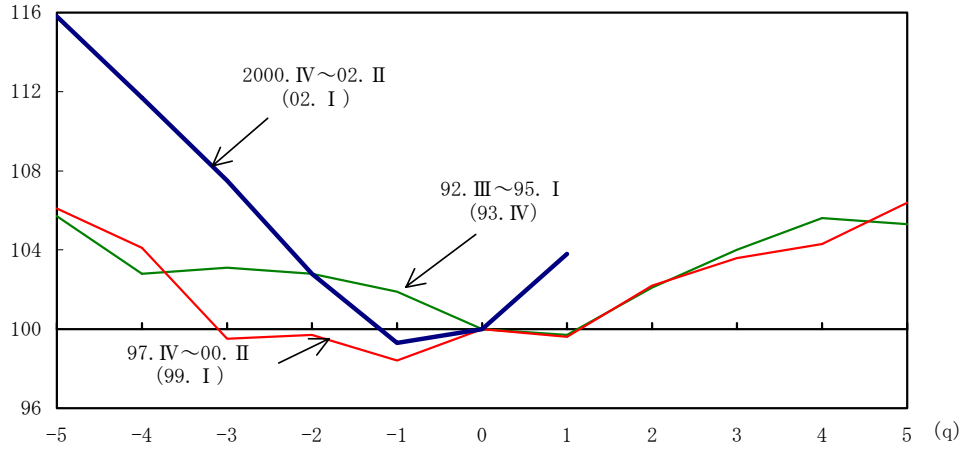
U.S. Import Growth and Contribution by Regions

Contribution of Asia is large

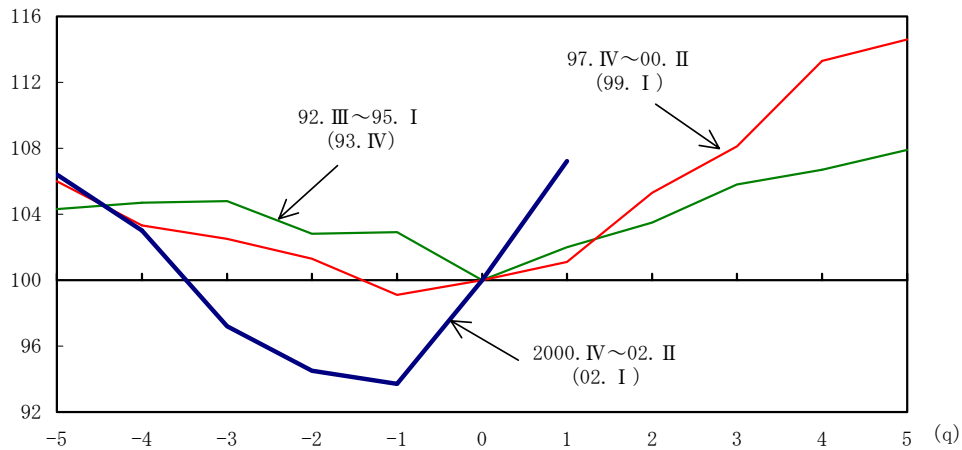


Comparison of Recent Business Cycles

Sharp reduction in production and exports, and rebound is also large this time
 (Industrial production, bottom=100)

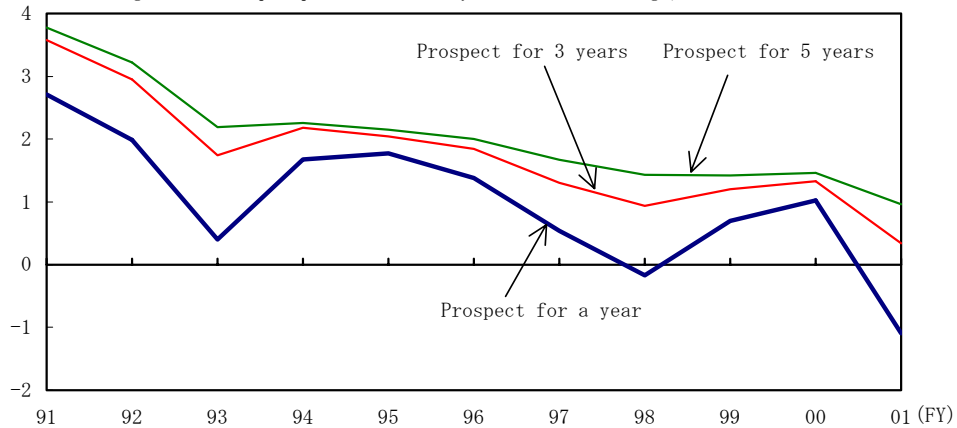


(Export, bottom=100)

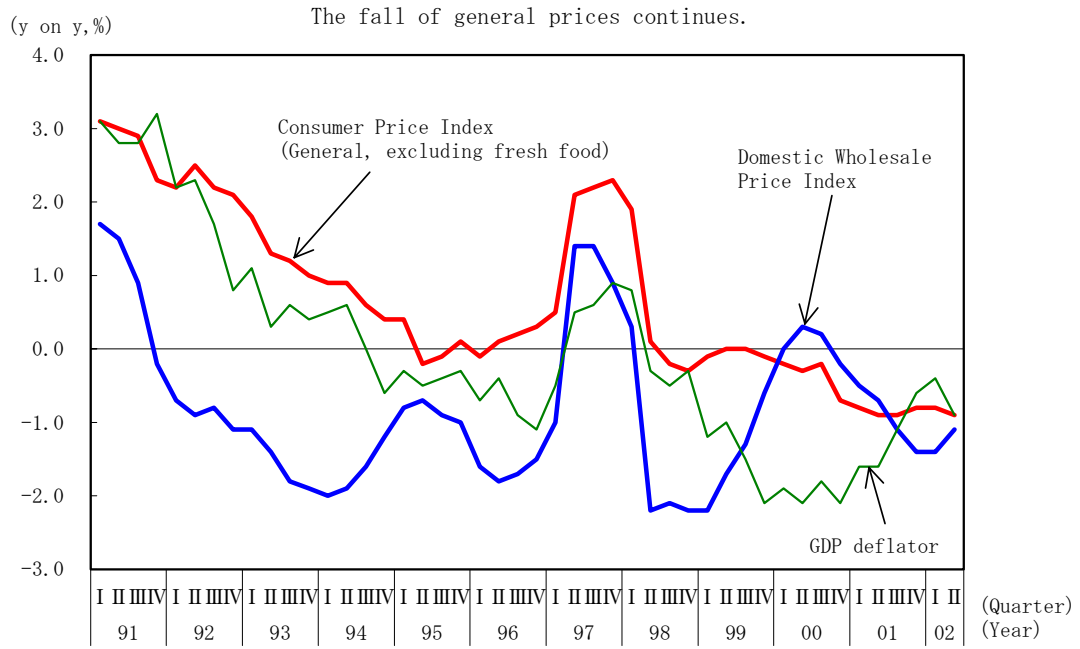


The growth rate prospect falls further.

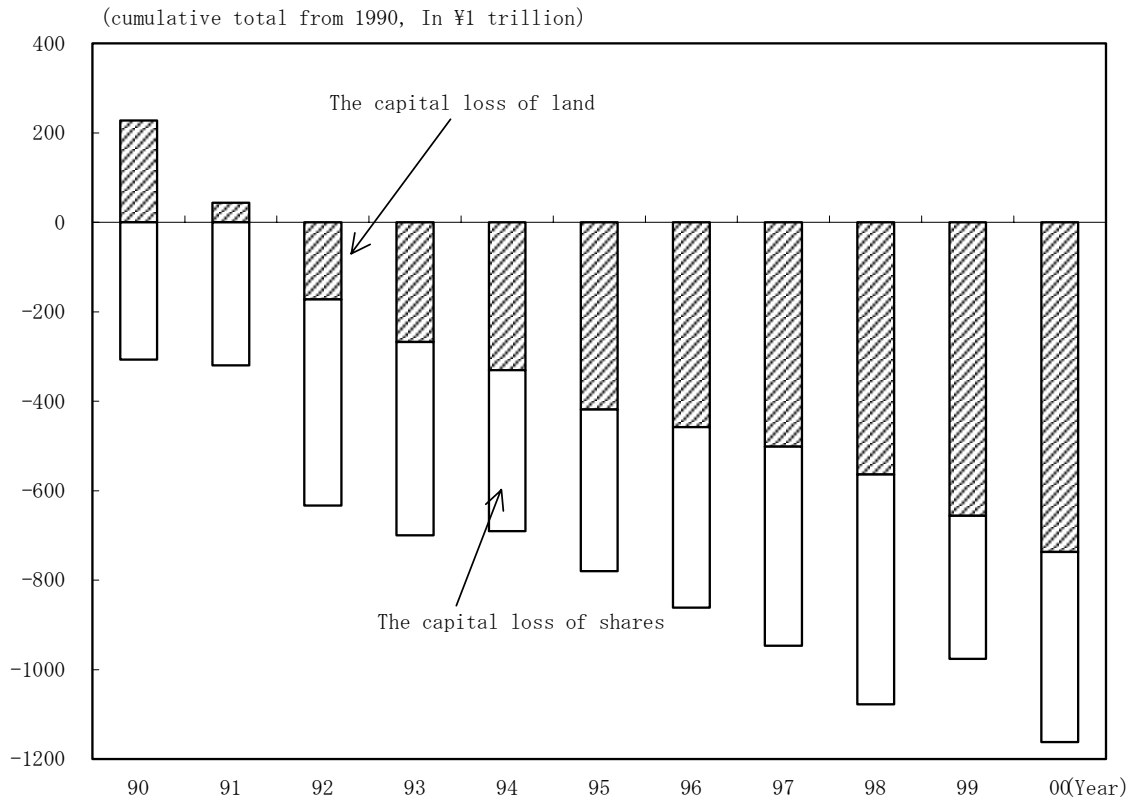
(The real growth rate prospect of industry demand, FY average, %)



Prices



The Capital Loss of Land and Shares



[Section 2 Activities of the Corporate, Banking, and Household Sectors under Deflation]

(1) Corporate sector

- Corporate earnings decreased dramatically; in particular, net income ran into the red for listed companies due to corporate restructuring.
- Inventory adjustment ended as a result of dramatic production adjustment. This was the domestic factor behind the bottoming out of the economy.
- Balance sheet adjustment, capital stock adjustment, and employment/wage adjustment are pushing down the economy.

(2) Banking sector

- Banks' outstanding amount of non-performing loans and disposal expenses for such loans increased considerably in FY 2001. As stock prices also fell, banks' earnings have been deteriorating dramatically and their business strength (total of equity capital and unrealized capital gain) has decreased.
- Banks are expected to carry out fundamental disposal of non-performing loans at an early stage and to focus more on loans to areas with high growth potential.

(3) Household sector

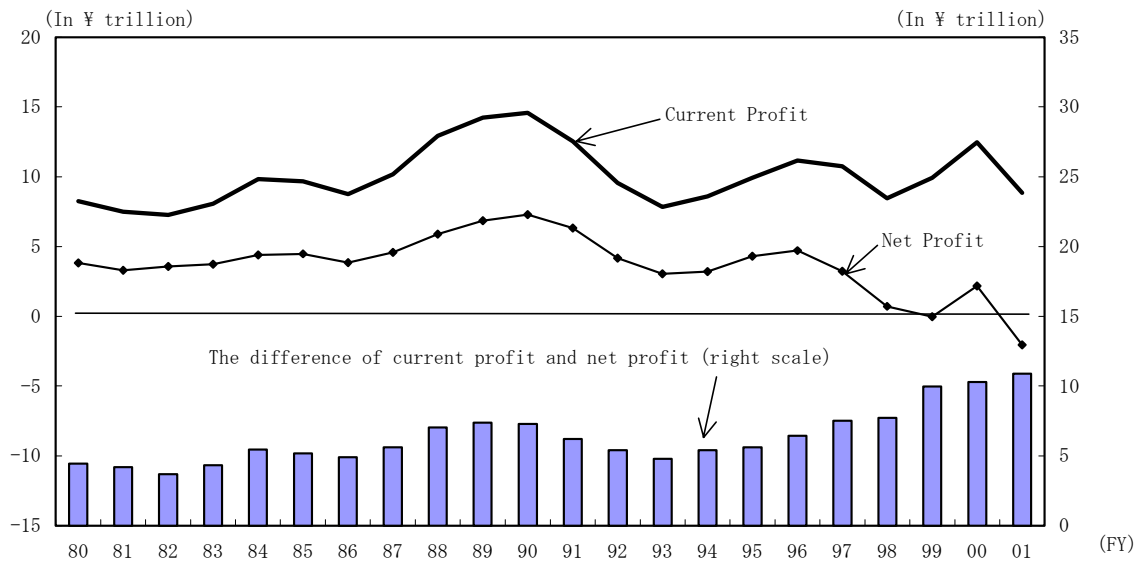
- Consumption was sluggish in 2001. ← 1) Decreased disposable after-tax household income; 2) increased payment burden, such as housing loans; 3) deteriorated consumer confidence; 4) decreased equity holdings due to the fall in stock prices.

Firmness has been partially observed in 2002 resulting from improved consumer confidence.

- Some underpinning factors are found for consumer spending. ← 1) Increased number of households; 2) consumption by the elderly; 3) a part of service consumption showing strength.
- Housing construction has remained at the same level. Although promoted stock adjustment is propping up the decline, future uncertainties caused by such factors as increased unemployment rate are suppressing housing construction (particularly construction of privately-owned houses).

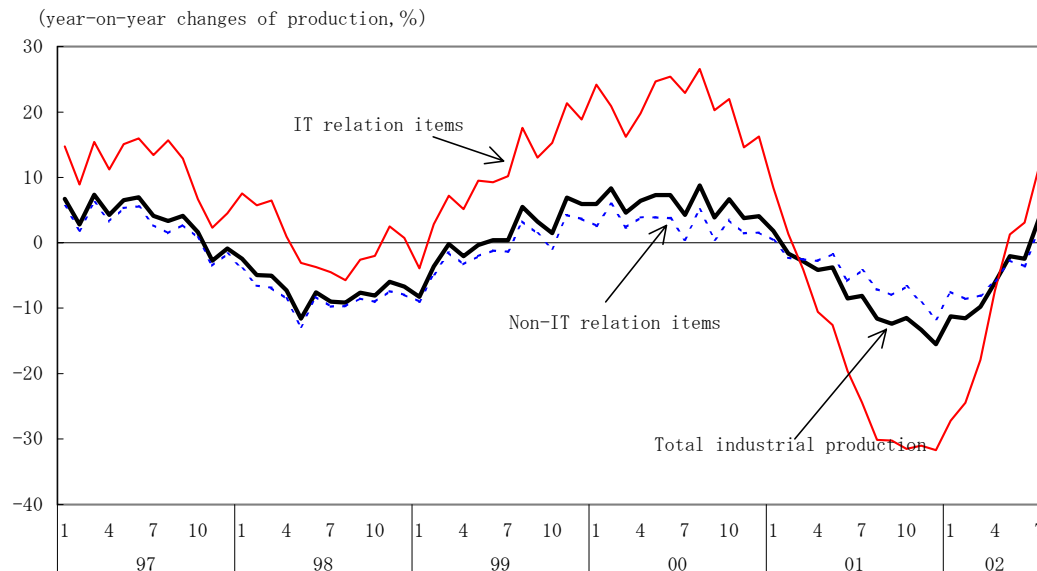
Changes of Corporate Profit

(1) Ordinary Profit and Current Income

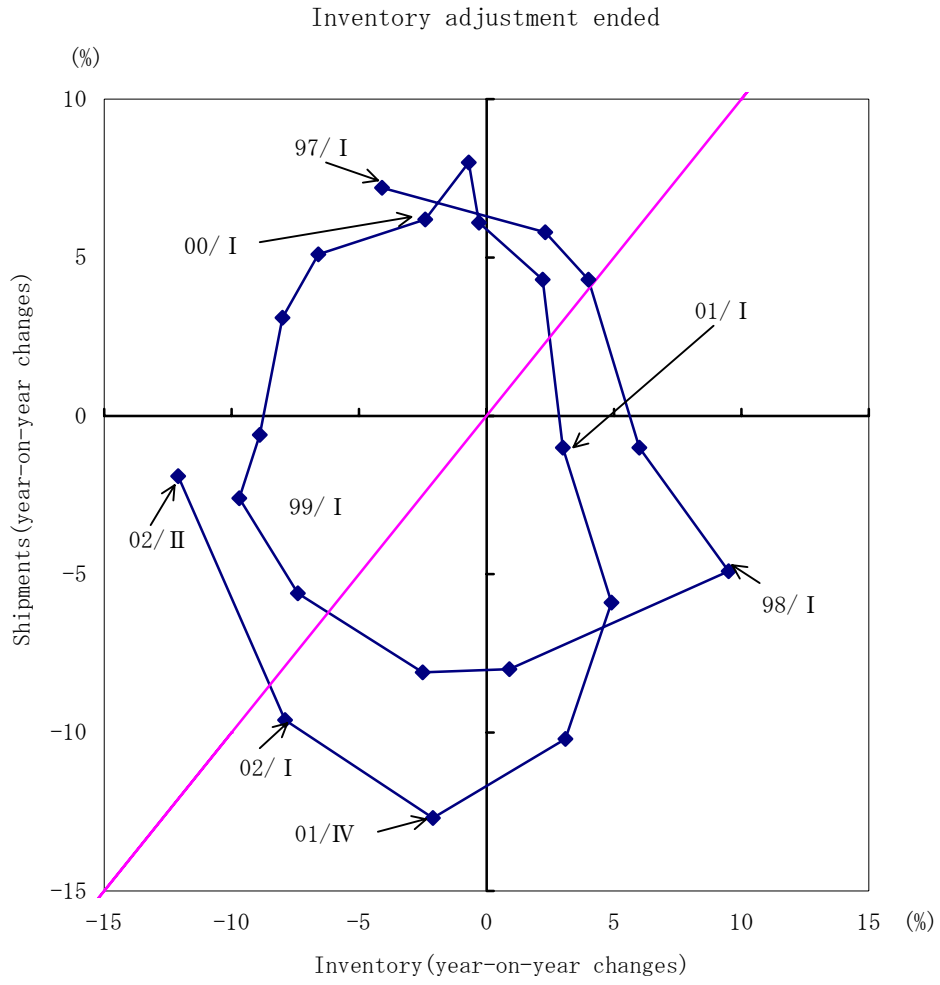


Trend in Production Activities

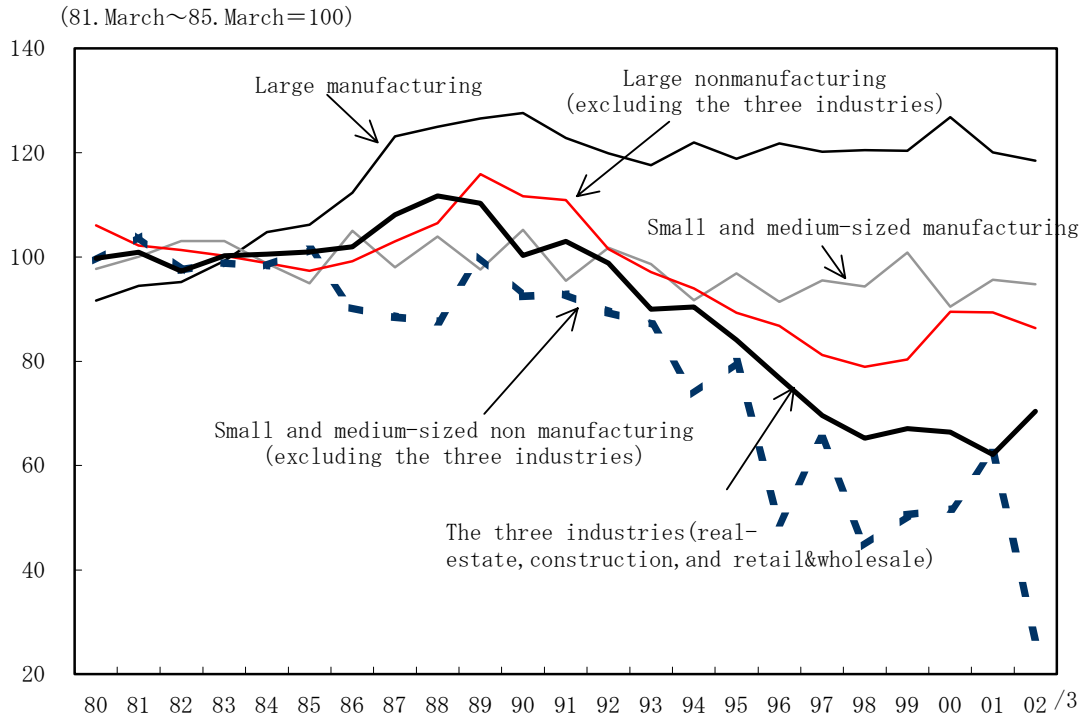
IT related items are dominant in production adjustment



Inventory Cycle

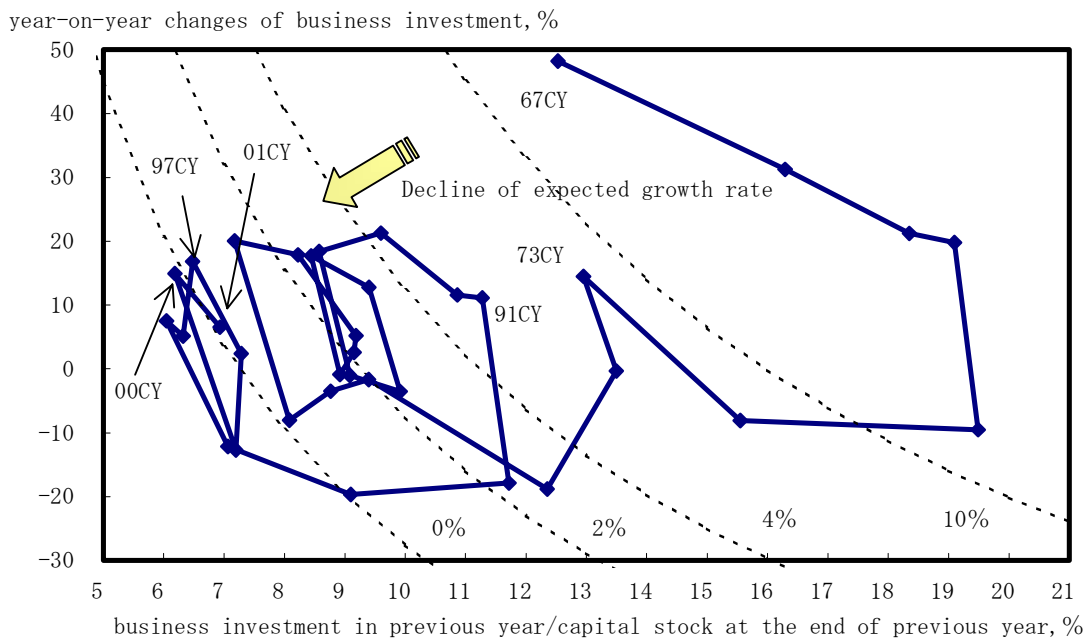


Changes of Capital Ratio (assets evaluated at current prices)

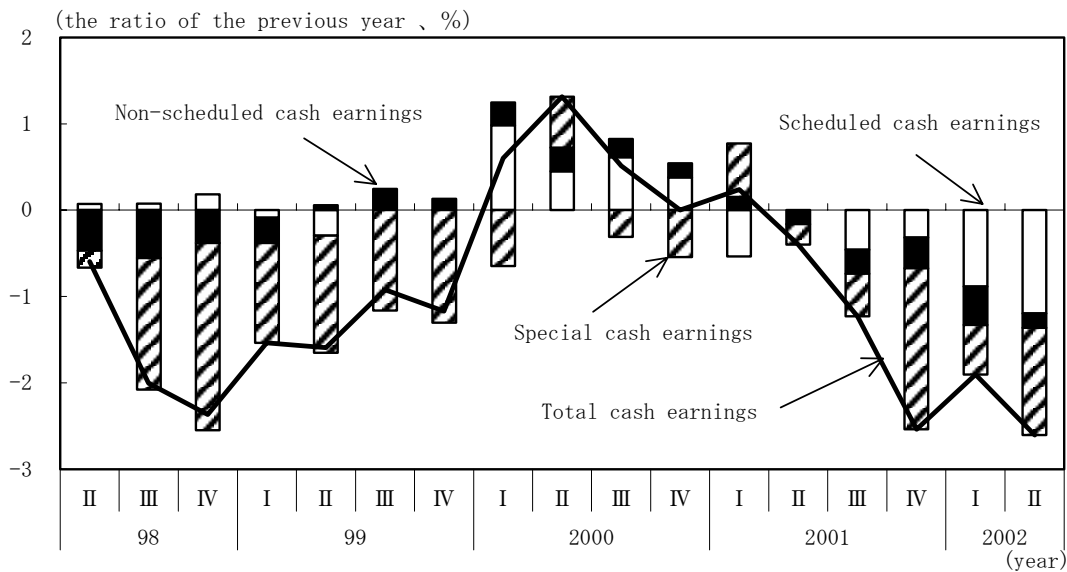


The stock adjustment of business investment (manufacturing)

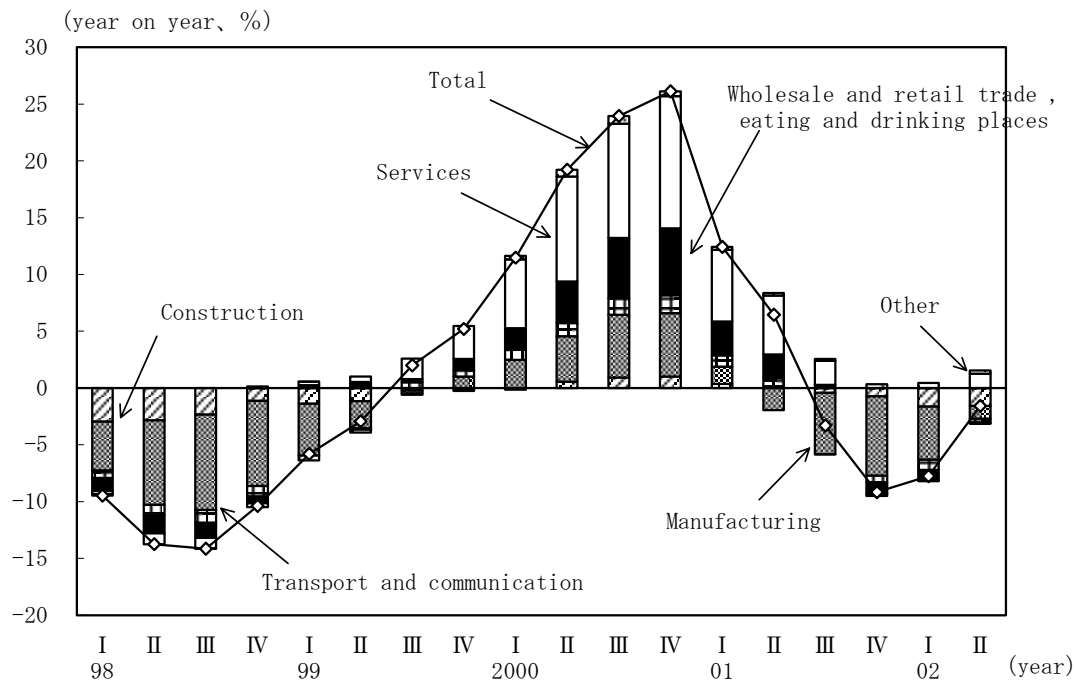
Business investment decreasing due to decline in expected growth rate



Changes in Wages and Contributions by Components



Changes of New Job Offers

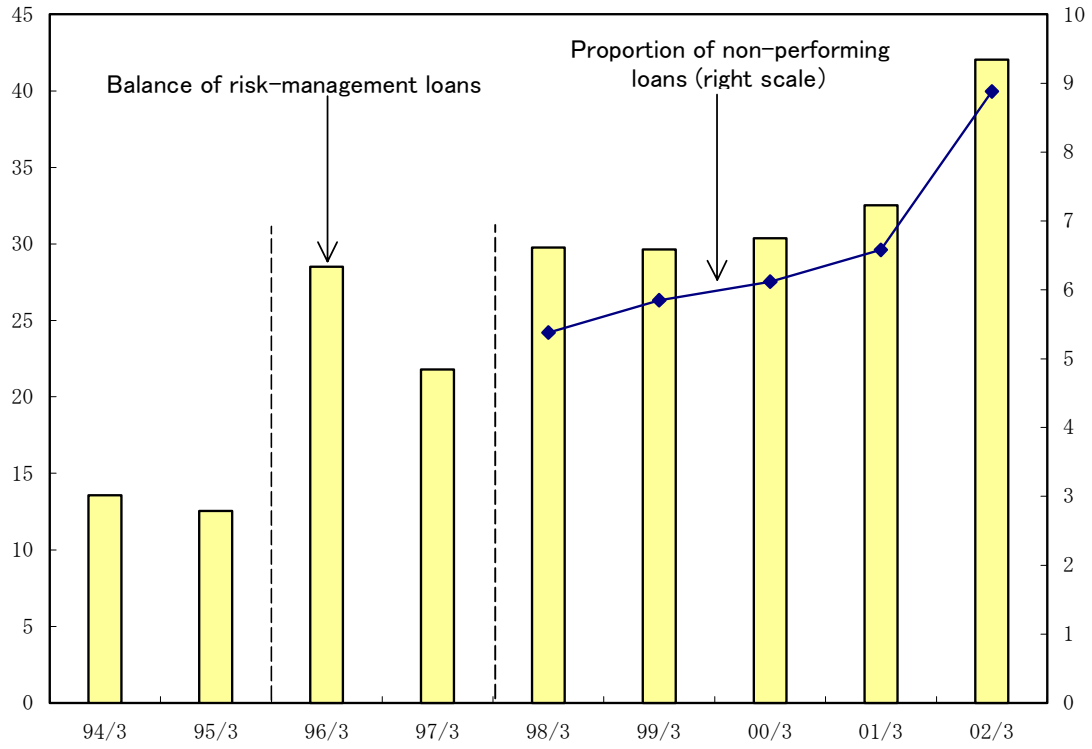


Amount of Non-Performing Loans

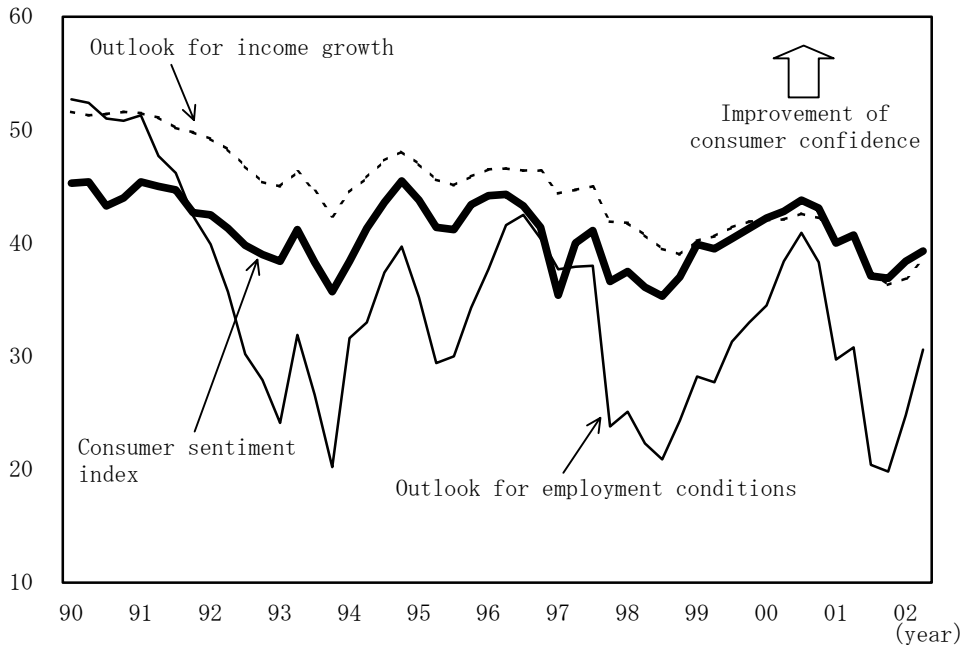
(In ¥1 trillion)

non-performing loans increase

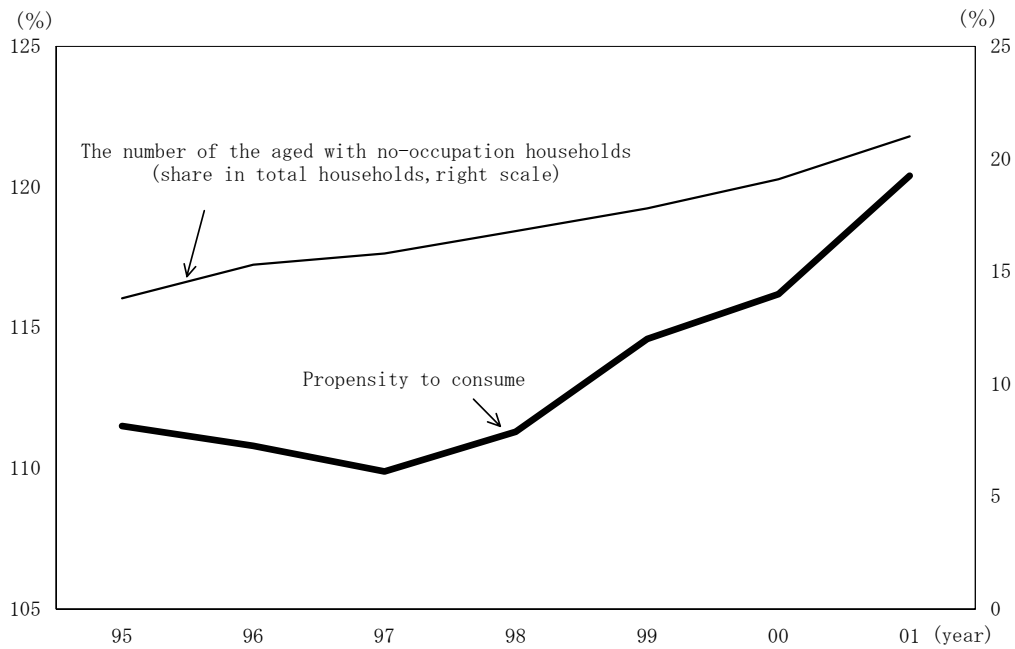
(%)



Consumer Confidence

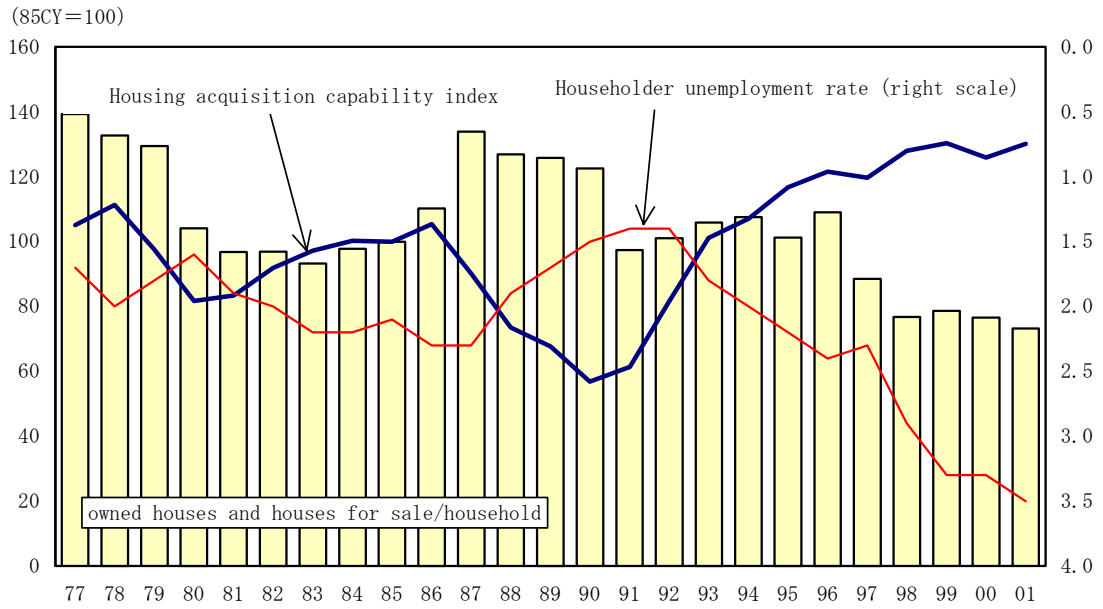


Changes in the Propensity to Consume and The Number of The Aged with No-Occupation Households



Housing Acquisition Capability Index, Unemployment Rate and Starts of Owned Houses and Houses for Sale

In spite of high housing acquisition capability, starts of owned houses hang low from uncertainty over the future.



[Section 3 Development of Fiscal and Monetary Policies]

(1) Fiscal structural reform

- Although the government's annual expenditure in the initial budget has been cut and public investment has been decreasing due to the fiscal structural reform, overall fiscal spending of the general government is currently leveling off mainly due to increased social security-related expenditure. Spending remains at almost the same level even when combining public investment, and government consumption, which are themselves part of final demand and considered to have a relatively large spillover effect.
- On the other hand, the budget deficit is expected to have slightly increased in FY 2001, due to decline in tax revenue. → It is not considered to have had a considerable negative impact on the macro economy in the short term.
- When dividing the budget deficit in FY 2001 into cyclical balance (affected by business cycles) and structural balance (balance excluding the cyclical balance), structural deficit seems to have decreased slightly, whereas cyclical deficit expanded. ← effect of the built-in stabilizer
- The main contents of the fiscal structural reform are: 1) drastic reduction of budget deficit; and 2) review of the content of fiscal spending. It is important to promote the reform while closely watching its impact on the macro economy.

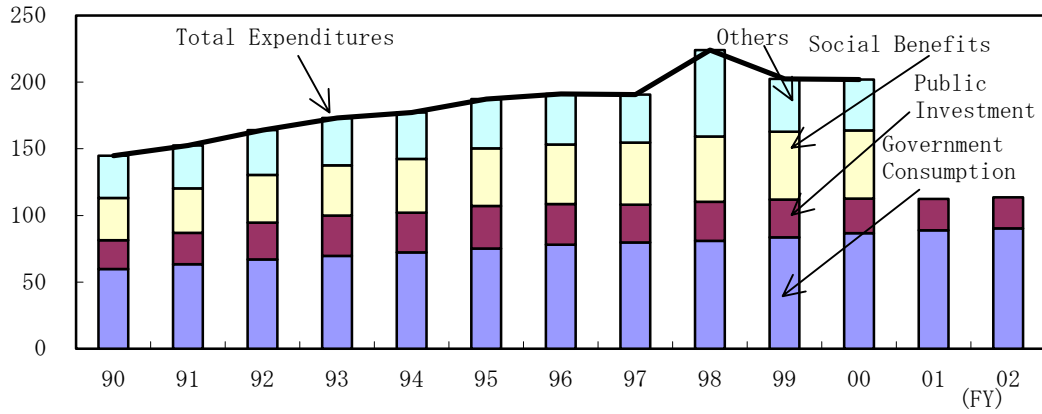
(2) Quantitative easing

- The monetary base dramatically increased after the Bank of Japan implemented quantitative easing. However, growth of the money supply is low and the GDP remains at a low level.
- Behind the sharp decline of the money multiplier (ratio between the money supply and the monetary base) are the preference for cash in portfolio and the decline in bank loans. Lack of GDP growth, despite the increased money supply, may also be due to increase in monetary demand aside from that for transaction needs.
- The quantitative easing might have had the effect of depreciating the yen instead of boosting bank loans.

General Government's Expenditures

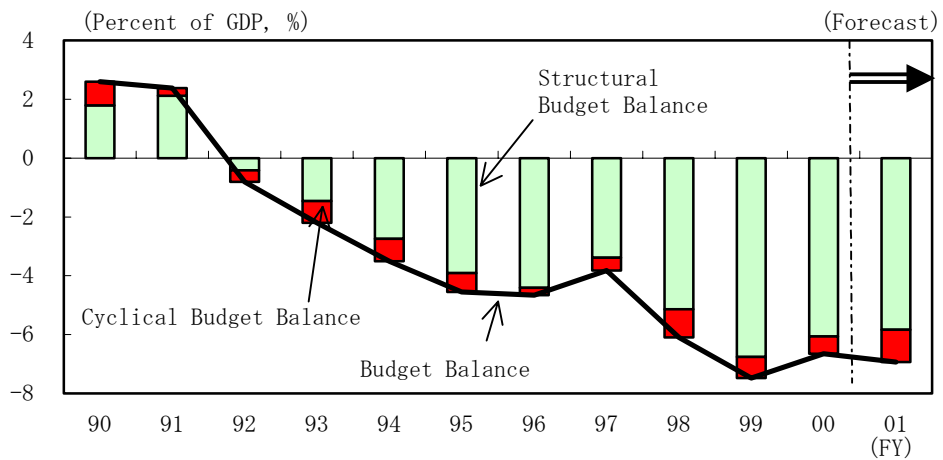
Public investment + government consumption remains at the same level

(Trillion yen)



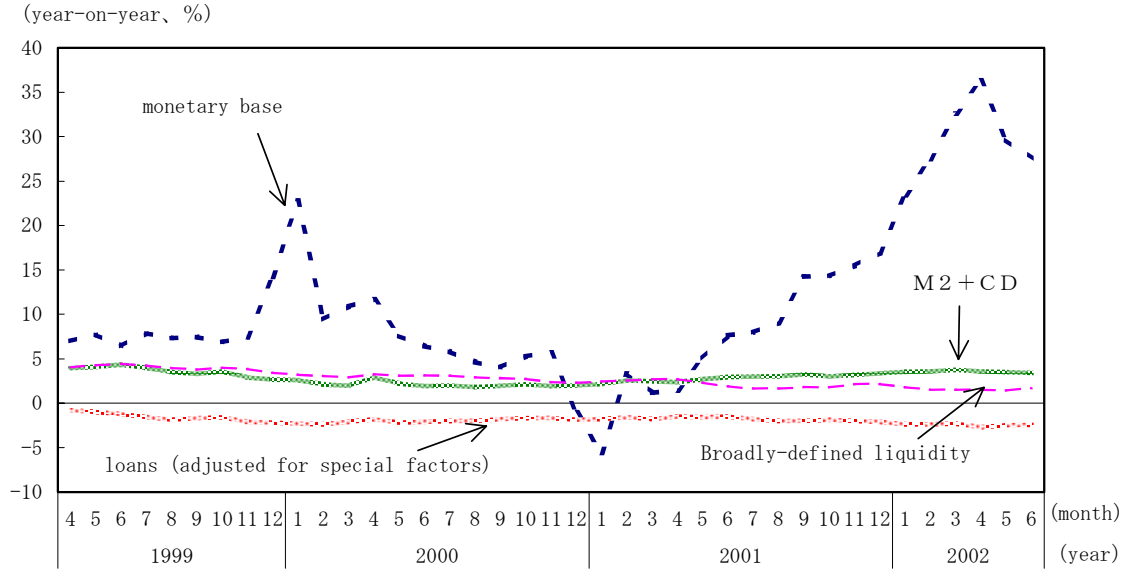
Structural and Cyclical Budget Balances of General Government

Cyclical budget deficit increased for the FY2001



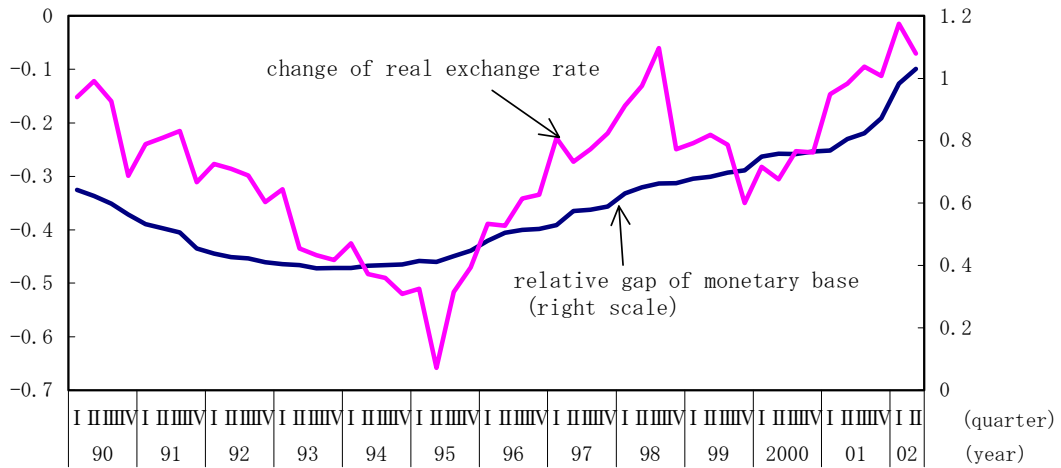
Change of Money Supply

Monetary base shows high growth while money supply shows only low growth



Change of Real Exchange Rate and Relative Gap of Monetary between Japan and U.S.

Monetary base increases relatively and real exchange rate depreciates



[Section 4 Future of the Economy]

(1) Basic scenario

- Due to the influence of export growth and the upturn in production, corporate earnings and the employment/income environment will gradually improve, further spilling over to turn around private demand, and the economy will slowly recover.

(2) Risks

- For a while private demand will have a weak recovery capacity and be fragile to external shocks.

→ The basic scenario presupposes that the global economy will continue to make a slow recovery. However, the plunge in stock prices in the United States at the beginning of FY 2002 triggered a worldwide fall of stock prices and drastic depreciation of the dollar.

→ Japan's exports and the earnings of export companies are likely to be subject to downward pressure.

→ The possibility that Japan's economic recovery will stall cannot be ruled out if the U.S. economy turns sluggish.

(3) Trend by item

- The capacity for recovery of plant and equipment investment will be weak for a while because the expected growth rate is stagnant, and the adjustment of excessive debt as well as the deflation will serve as downward pressures, especially for the non-manufacturing industry and small and medium enterprises.

- Consumer spending and housing investment are likely to recover extremely slowly, if at all, since the employment/income environment will continue to be severe.

- With respect to fiscal spending, public investment is expected to decrease, but overall fiscal spending is not likely to decrease dramatically due to the increase of social security expenditure pertaining to the aging of the society.

- The general price deflation is very likely to continue for a while. As for monetary policy, quantitative easing is expected to be continued.

(4) Necessity of structural reform

- In order to link the cyclical recovery to a robust recovery, it is necessary to promote structural reform and revitalize the economy.