October 30, 2002
Bank of Japan

Outlook and Risk Assessment of the Economy and Prices (October 2002)*

Outlook for economic and price developments

1. In the second half of fiscal 2002, the pace of increase in both exports and production is likely to slow down significantly compared to the first half. Accordingly, it is difficult to foresee a pickup in domestic private demand. Therefore, Japan's economy is not expected to demonstrate clear signs of recovery during the remainder of fiscal 2002 (Chart 1).

   In our standard scenario for fiscal 2003, based on the assumption that a gradual recovery of overseas economies will continue, Japan's economy will start to recover in the first half. In this scenario, against the background of the resumption of growth in exports and production, capital spending will finally start to recover and private consumption will gradually gain more resilience. Even in this case, however, the expected recovery will be quite modest reflecting the pace of recovery in overseas economies. The recovery will also be constrained by the persistence of excess debt and labor against the background of the weak growth prospects for Japan's economy (Chart 2 and 3).

   Prices will probably continue to decline gradually in fiscal 2002 and 2003 as the output gap is not likely to narrow.

2. The outlook for respective demand components is as follows.

   Currently available information indicates that public investment will probably decline further in fiscal 2003 following a fall in fiscal 2002. The sharp increase in exports in the first half of fiscal 2002, which reflected global restocking in IT-related industries, has moderated in recent months and is not likely to resume growth in the second half of the fiscal year. In fiscal 2003, however, exports will accelerate again so long as modest

* As determined by the Policy Board at the Monetary Policy Meeting held on October 30, 2002.

growth in overseas economies continues as assumed.

With respect to domestic private demand, assuming the above described export developments, production and corporate profits are likely to remain on a recovery trend, albeit with a temporary slowdown. Accordingly, uncertainty regarding prospects for demand will gradually diminish and capital spending is expected to recover in fiscal 2003. As a reduction in labor cost is expected to proceed notably in fiscal 2002, real income adjusted for price changes will stop declining by degrees and private consumption will gradually gain more resilience in fiscal 2003. Due to the persistence of excess debt and labor, however, growth momentum arising from the recovery of production and corporate profits is not likely to smoothly spread to domestic private demand. Consequently, the expected recovery in capital spending will be limited (Chart 4) and private consumption will recover only modestly. Private consumption will also be affected by a decline in disposable income resulting from the increasing burden associated with social security reform.

3. Regarding financial developments, under the aggressive liquidity provision by the Bank of Japan, extremely easy monetary conditions are likely to continue in financial markets. However, it is difficult to expect monetary easing to lead to an increase in credit demand from the corporate sector against the background of stagnant aggregate demand as described above as well as continuous efforts in the corporate sector to reduce excess debt. On the other hand, in order to improve their financial condition, financial institutions are expected to continue efforts to reprice lending rates so as to more accurately reflect the risks and profitability associated with each borrower. Consequently, commercial bank lending is likely to continue decreasing.

   Against the background of extremely low interest rates and concern over the state of the financial system, financial asset allocation by economic agents, including business firms and households, is witnessing the increasing holding of credit risk-free assets such as cash, demand deposits, and government debt (Chart 5). Consequently, the level of the monetary base will remain high in relation to economic activity.

   The growth of money stock is expected to stay at the current level and remain relatively high compared to economic growth (Chart 6). This reflects a substantial increase in demand deposits under the low interest rate environment as well as more investment in Japanese government debt by financial institutions, which are motivated to realize profits in the face of declining loan demand.

4. Downward pressure on prices is likely to persist. Looking at demand-supply conditions, despite a decline in the short-term growth rate of supply capacity of Japan's economy to around one percent on a year-on-year basis, the output gap will probably stop widening but will not go further to narrow in fiscal 2003. In addition, wage developments are likely to be weak and exert downward pressure on service prices. Supply-side factors such as technological advances and deregulation will also keep pushing down prices.

   On the other hand, downward pressure on prices will be mitigated to some extent because it appears that more business firms are abandoning the once prevailing low-price strategy. In addition, medical system reform scheduled in the next fiscal year will raise medical fees.

   Reflecting the above factors, various price indexes are expected to continue to gradually decline. The year-on-year rate of change in both the domestic Wholesale Price Index and the Consumer Price Index (excluding fresh food) will probably continue to be negative in fiscal 2002 and 2003.

   With such developments in the economy and prices, nominal income growth will probably continue to register a negative rate.

Risk assessment

5. The above standard scenario with respect to the economy and prices entails both upside and downside risks which are more significant than in a usual situation. Major risk factors, which will be regularly assessed in monetary policy deliberations, are as follows.

   The first risk factor stems from <u>developments in overseas economies, especially the United States.</u>

   The above standard scenario expects that growth momentum arising from the recovery of production and corporate profits will gradually spread to domestic private demand assuming that the US-led gradual recovery in overseas economies will continue.

   However, the two pillars of the US recovery scenario, the expected recovery of capital spending and continuous resilience of private consumption, are not immune to an asset price decline or deterioration in the confidence of the business and household sectors. If these US-related risks materialize, the associated decline in exports to the US is likely to drag down economic activity in Europe as domestic demand is already weak. East Asian economies as a whole are also likely to decelerate as a result of the decline in exports to the US although a self-sustained demand increase could somewhat mitigate the damage in some economies. Furthermore, geopolitical developments could exert downward pressures on the global economy through volatility in oil prices and financial markets.

6. The second is uncertainty regarding the <u>strength of domestic private demand</u> such as private consumption and capital spending.

   The standard scenario expects that, in fiscal 2003, household income adjusted for price changes will stop declining by degrees and private consumption will gradually gain more resilience. However, private consumption entails downside risks because the more severe adjustment of employment and wages could prolong the ongoing income decline and consumer sentiment could be adversely affected for various reasons such as increasing uncertainty about the future.

   The standard scenario expects capital spending will at last recover in fiscal 2003 following the increase in production and corporate profits. Even in this case, the recovery is likely to be modest as the recovery of cash flow will only give a limited boost to capital spending. At the same time, it should be noted that the strength of the recovery could vary as investment decisions by firms are made considering the extent of improvement in capacity utilization and corporate profits, prospects for the recovery of demand, and comparative benefits of domestic investment vis-à-vis overseas investment.

7. The third risk factor is <u>progress in dealing with non-performing loans and the effects</u>.

   For Japan's economy to return to a stable and sustainable growth path, it is indispensable to overcome the non-performing loan (NPL) problem and to stabilize and strengthen the financial system. For this purpose, it is crucial that a comprehensive approach be taken including a more appropriate evaluation of NPLs, the promotion of their quick disposal based on such evaluation, and the enhancement of earning power on the part of both firms and banks. In addition, it is important to preemptively prevent a financial crisis from arising and to prepare an environment which is conducive to the steadfast resolution of the NPL problem.

Faster progress in dealing with the NPL problem has both positive and negative effects on economic activity and its net impact depends on how and when those effects will emerge. In general, the impact of dealing with the NPL problem on the economy depends on various factors such as the scope of borrowers to be dealt with, financial institutions' lending policy including pricing, and the outcome of corporate rehabilitation plans. There is certainly a risk, however, that dealing with the NPLs will result in an increase in corporate bankruptcies and unemployment in the short run. Such a negative impact on the economy could be mitigated to some extent depending on what kind of safety nets will become available in the area of corporate finance and employment and how they will be implemented.

On the other hand, markets, both at home and abroad, may gradually start to react positively to such progress, perceiving it as a positive move to stabilize and strengthen the functions of the financial system. Once markets start to react in that way, it could have a positive impact on the economy through various channels. In particular, if the financial intermediation function is restored, it would help make the aggressive liquidity provision by the Bank of Japan already in place become more effective. If structural reform of the economy proceeds in tandem with the resolution of the NPL problem, it will induce the consolidation and revival of firms and stimulate corporate activity in promising areas through the reallocation of human resources and capital, thereby contributing to productivity growth.

8. The fourth risk is <u>the impact of fiscal developments, including fiscal reform, on the economy</u>.

   The serious review of the composition of government outlays and taxation with a view to stimulating private demand could have a positive impact on the economy. On the other hand, if a decline in fiscal expenditures continues, it would work to reduce aggregate demand. Furthermore, in the case where weaker-than-expected growth results in a decline in tax revenues, whether fiscal policy would be conducted utilizing built-in automatic stabilizers or not would affect economic developments.

9. The fifth risk factor is <u>financial market developments</u>.

   Stock prices in Japan, as in major markets abroad, have been volatile reflecting growing concern over economic prospects both domestically and overseas. A stock price decline could affect spending by the corporate and household sectors through various channels. Due to market risk pertaining to the shareholdings of financial institutions, the decline could also threaten the stability of financial markets and the financial system.

The level of government debt outstanding in Japan is among the highest in industrial countries and financial institutions hold the bulk. Therefore, although long-term interest rates have been broadly stable, it should be noted that financial institutions are vulnerable to the risk of interest rate volatility.

Given considerable uncertainties regarding the global economy, careful monitoring is warranted with respect to international capital flows and their effects including those on foreign exchange rates. In this context, attention is also needed with respect to instability in emerging markets, especially in Latin America, and the impact on the economy and financial markets in developed countries.

Forecasts of the Majority of Policy Board Members

(Y/y % change)

	Real GDP	Domestic WPI	CPI (excluding fresh food)
Fiscal 2002	+0.2 to +0.5 (–0.5 to +0.1)	–0.8 to –0.7 (–1.0 to –0.5)	–0.9 to –0.7 (–1.0 to –0.8)
Fiscal 2003	+0.4 to +1.0	–0.7 to –0.4	–0.6 to –0.4

Note: The forecasts of Policy Board members are based on the assumption that there will be no change in monetary policy. Figures in parentheses are forecasts made in April 2002.

Forecasts of the majority of Policy Board members are shown as a range, with the highest and lowest figures excluded. The forecasts of all Policy Board members are as follows.

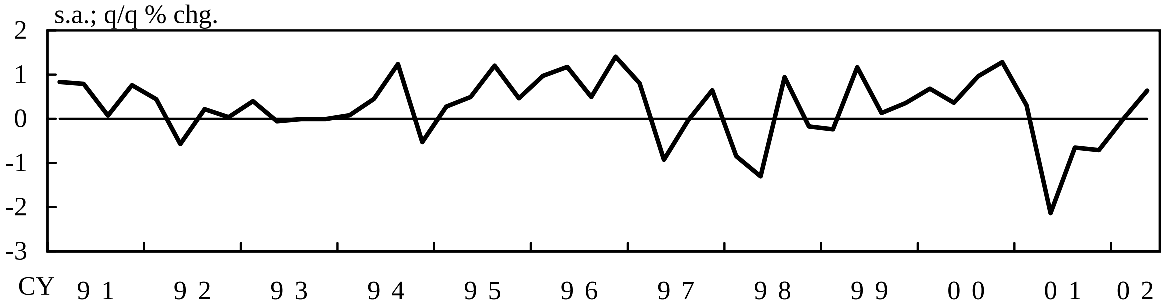
(Y/y % change)

	Real GDP	Domestic WPI	CPI (excluding fresh food)
Fiscal 2002	+0.1 to +0.7 (–0.5 to +0.2)	–0.9 to –0.6 (–1.0 to –0.3)	–0.9 to –0.5 (–1.1 to –0.5)
Fiscal 2003	+0.4 to +1.5	–0.8 to 0.0	–0.7 to –0.3

Note: Figures in parentheses are forecasts made in April 2002. The new methodology of GDP estimation was introduced in August 2002 and the time series data since fiscal 2001 were revised accordingly.

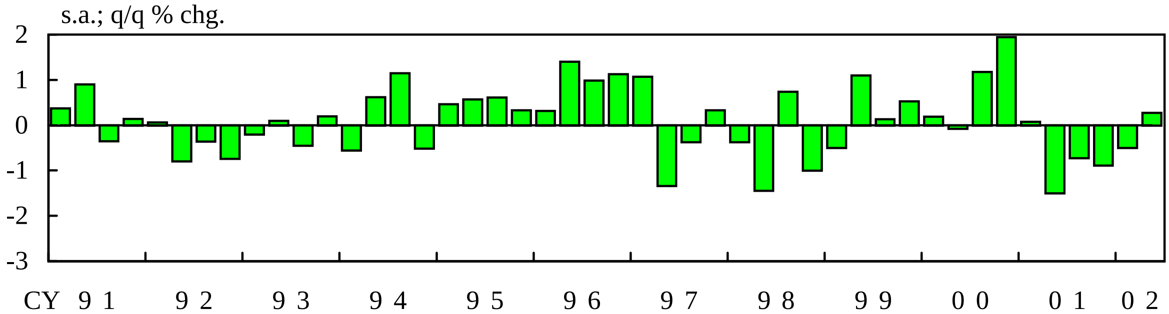
Real GDP

(1) Changes from the previous quarter

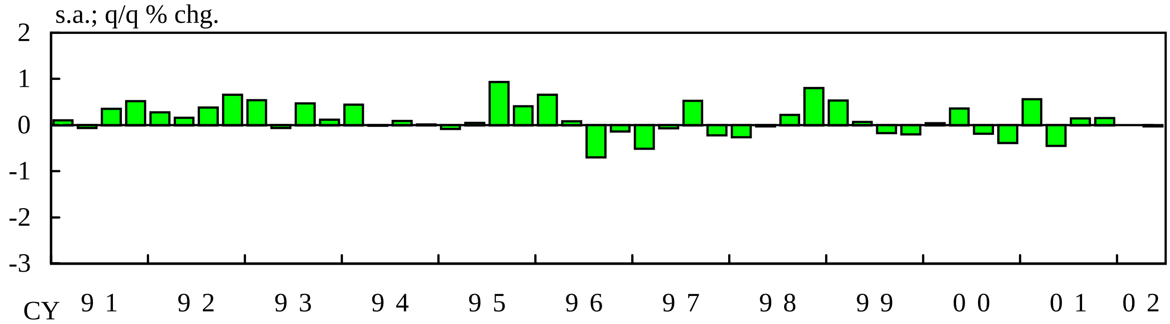


(2) Each component's contribution to changes in real GDP

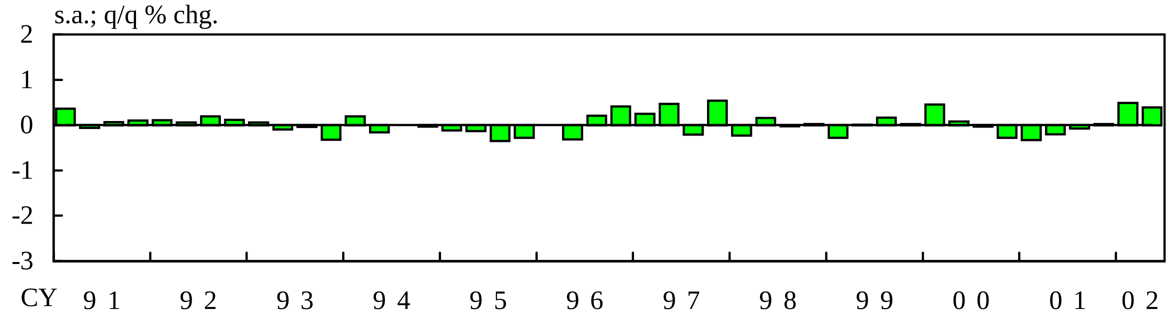
(a) Domestic Private Demand



(b) Public Demand



(c) Net Exports of goods and services

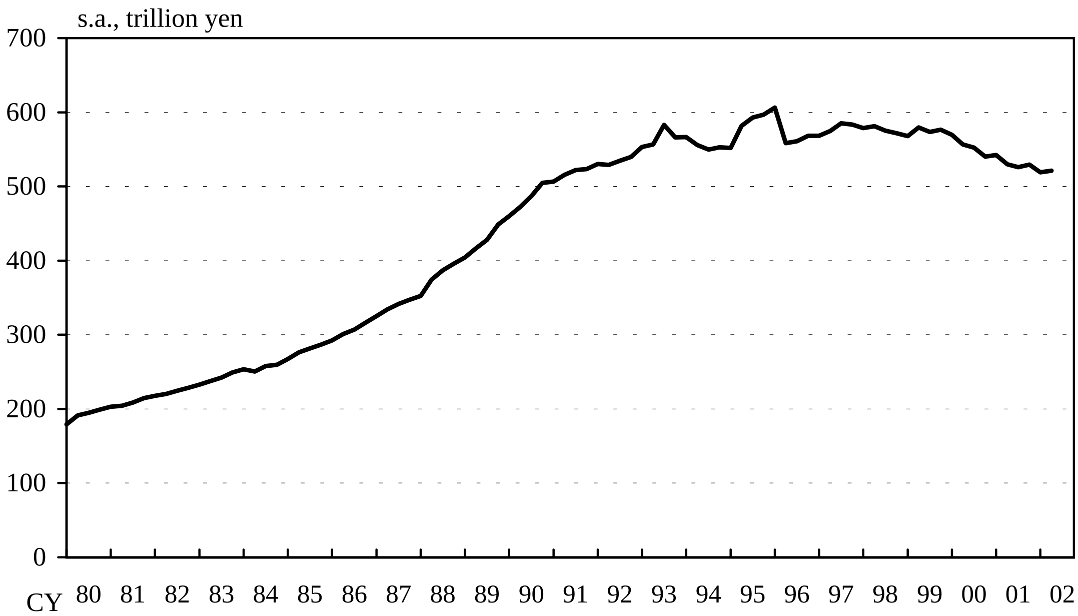


Note: Figures for 1994/Q1 onward are estimated based on the new method published in August 2002.

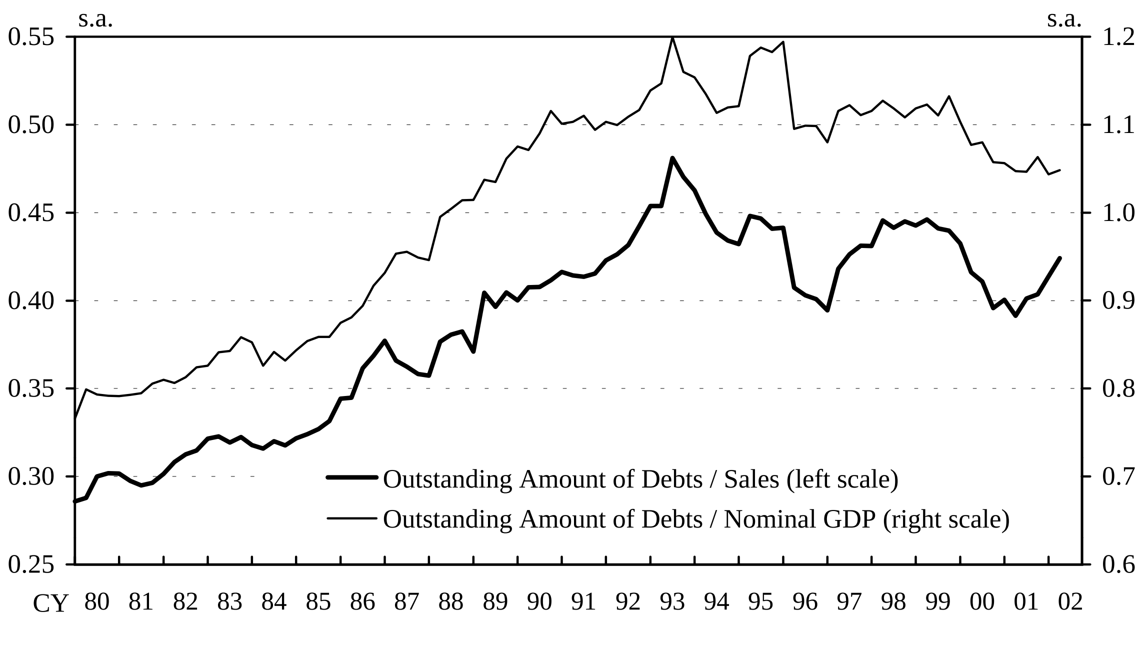
Source: Cabinet Office, "National Accounts."

Pressures arising from Firms' Excess Debts

(1) Outstanding Amount of Debts



(2) Ratio of Debts to Sales and Nominal GDP

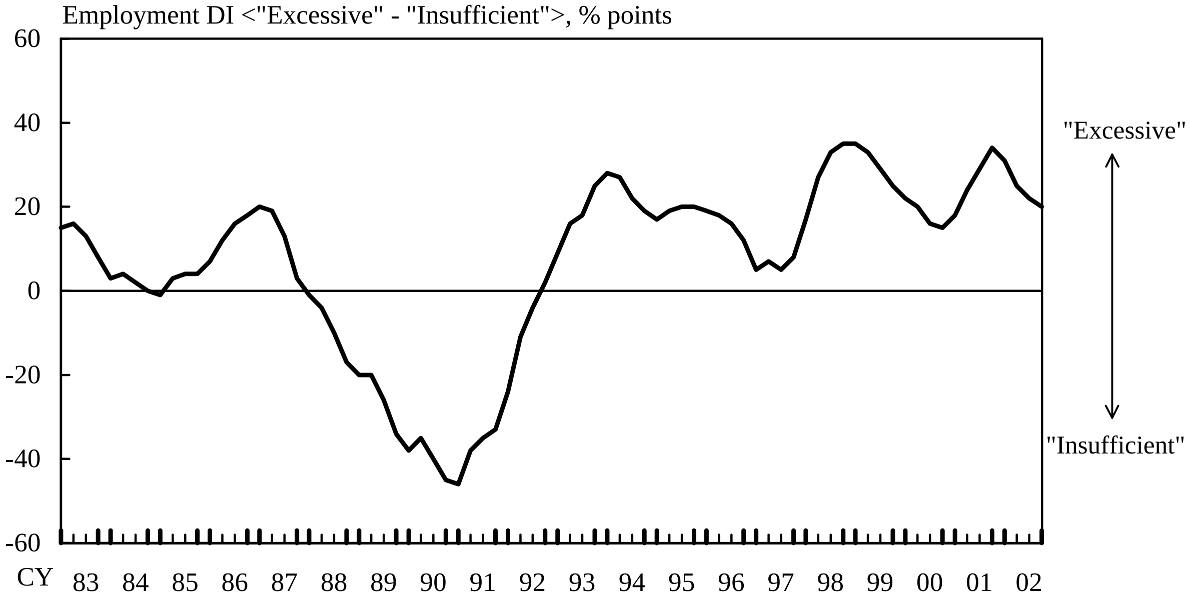


Note: Debts = Long-term and Short-term Borrowings + Corporate Bonds + Bills Discounted

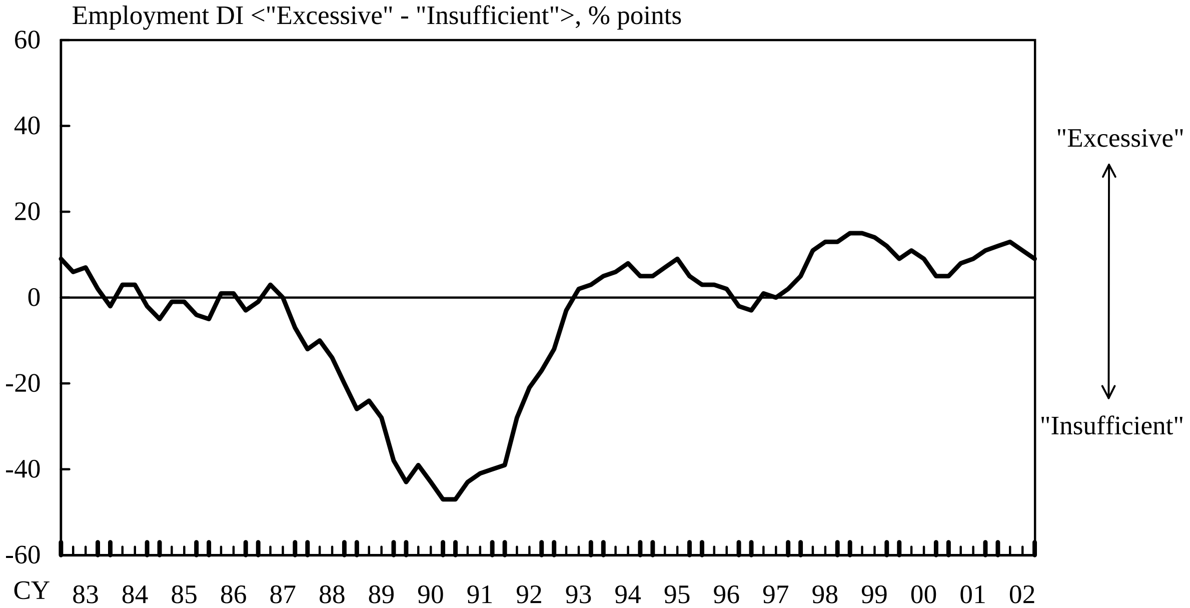
Sources: Cabinet Office, "National Accounts";
Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly."

Pressures arising from Excess Labor

(1) Manufacturing



(2) Nonmanufacturing

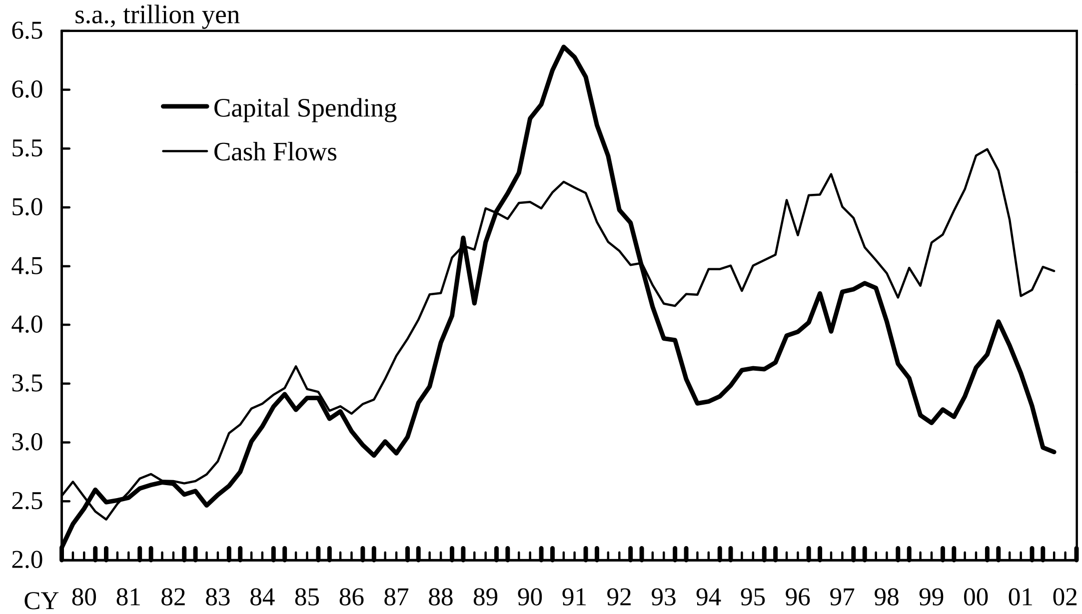


Note: Figures for 2002/Q4 are forecasts made by enterprises.

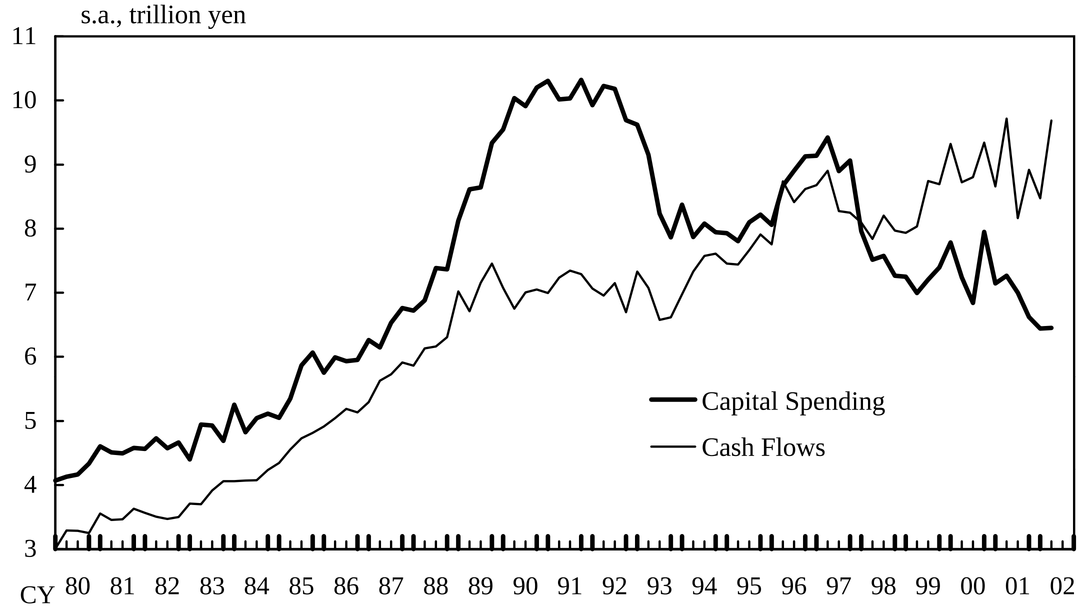
Source: Bank of Japan, "*Tankan* , Short-term Economic Survey of Enterprises in Japan."

Cash Flows and Capital Spending

(1) Manufacturing



(2) Nonmanufacturing



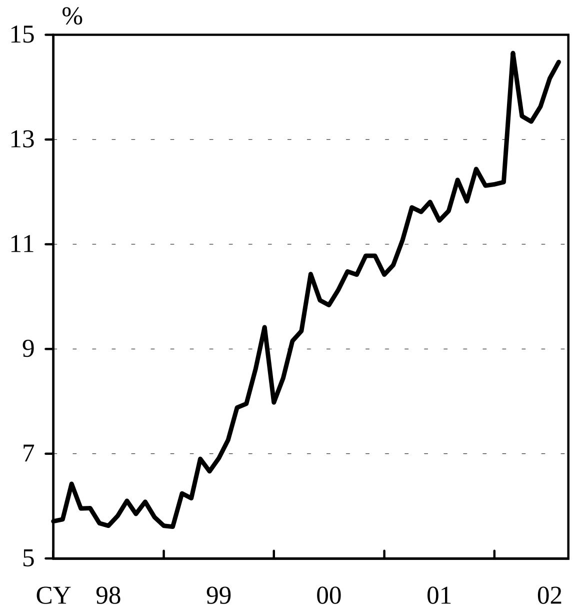
Notes: 1. Large firms of other services industry are excluded from nonmanufacturing firms.
2. Cash Flows = Current profits / 2 + Depreciation expense

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly."

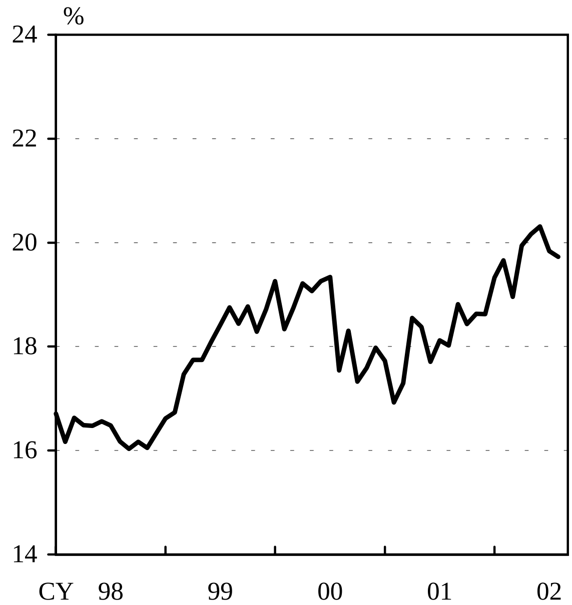
Chart 5

Ratio of Risk-free Assets to Total Assets

(1) Domestically Licensed Banks



(2) Life and Non-life Insurance Companies



(3) Households

(4) Private Nonfinancial Corporations

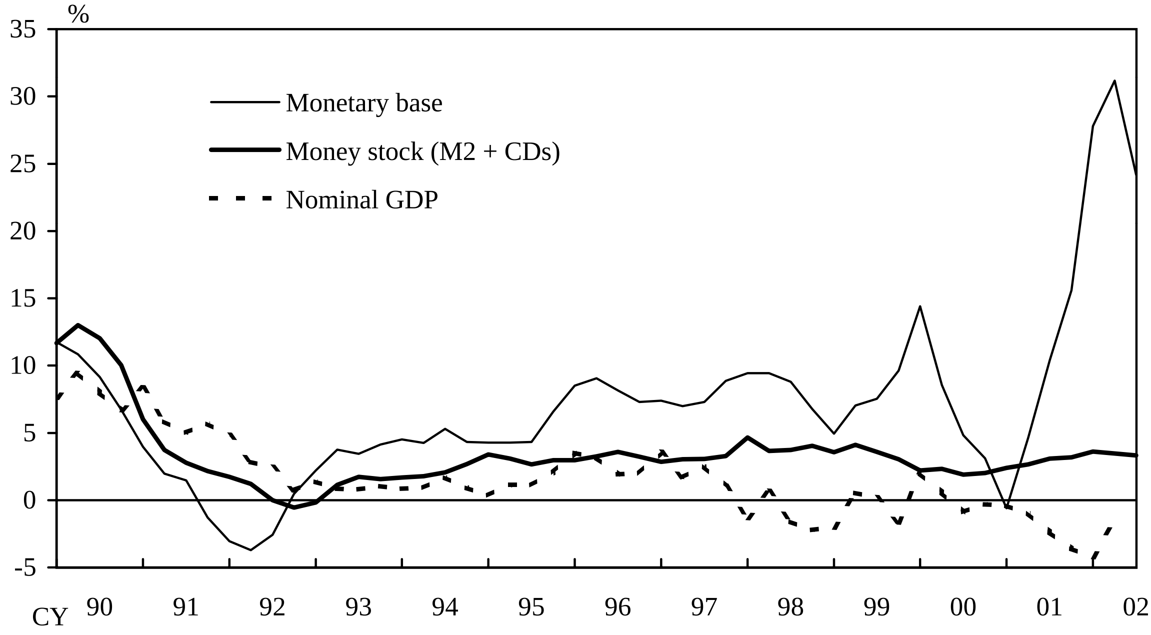
Note: Each sector's ratio of risk-free assets to total assets is calculated as follows:

Domestically Licensed Banks: (Cash + Current Account Balances + Government Bonds)/Total Assets
Life and Non-life Insurance Companies: (Cash and Deposits with Others + Government Bonds)/Total Operating Funds
Households and Private Nonfinancial Corporations: (Currency + Transferable Deposits + Central Government Securities)/Total Financial Assets

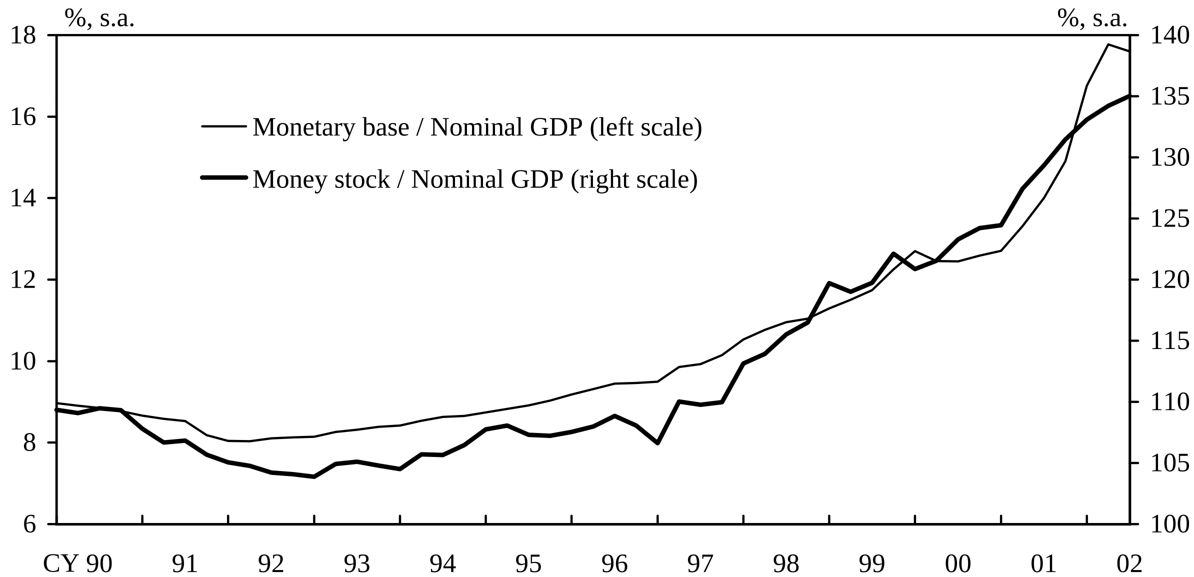
Sources: Life Insurance Association, Marine and Fire Insurance Association of Japan, Bank of Japan.

Monetary Indicators and Economic Activity

(1) Changes from a Year Earlier



(2) Ratio to Nominal GDP



Note: Nominal GDP in 2002/Q3 is assumed to be unchanged from the previous quarter.

Sources: Cabinet Office, "National Accounts"; Bank of Japan.