Japan/U.S.A. Macro Economic Report

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	Japan	U.S.A.
1. Macroeconomic Outlook	**Short Term：** Recovery has been seen in the Japanese economy. The real GDP growth rate in April–June 2003 recorded annualized +3.9% quarter-on-quarter gain, accelerated from annualized +2.4% increase in January–March 2003. In the corporate sector, as profits (for all industries and scales) in fiscal 2003 based on the Bank of Japan's "Tankan"(September) survey are expected to increase +10.4% over previous year, following the +16.4% rise in fiscal 2002, adjustment of excessive debts and employment has progressed markedly, mainly in large companies, and assets effectiveness in the corporate sector has begun to improve. According to the same survey, the large companies are planning to increase their business fixed investment considerably in fiscal 2003, particularly in the manufacturing industry (+11.1% year-on-year), the telecommunications industry (+16.0%), and the service industry (+5.5%). We expect the Japanese economic recovery will continue, pulled by the rebounds in corporate sector that started with an increase in exports. Up to fiscal 2004, however, excessive debts and employment adjustments process continues, mainly in small and medium-sized companies. A return to a full, private demand-centered recovery cannot be expected, and resolution of deflation may also be difficult.	**Short Term:** The basic trend of US economic recovery has strengthened. Real GDP growth in July-September 2003 was +7.2% at an annual rate, after +3.3% growth in April-June, the highest increase since January-March 1984. Personal consumption is the largest growth engine. After the end of the Iraq war, large-sized durable goods—automobiles and household furniture—recovered rapidly. Consumption of other goods widened even further after July. According to NRF-BTM Retail Executive Opinion Survey, business managers have had an increasingly upbeat view. In the corporate sector, capital investment has begun to show some signs of recovery, and inventory adjustments of firms will result in a small, temporary adjustment. This will be due to production cut backs, mainly by the automobile sector. Since it may be expected that the effects of the tax cuts will continue, personal consumption will grow steadily, and it is highly probable that corporate sector increases of inventories and recovery of capital investment will gradually appear. Therefore the deflationary gap will gradually shrink and disinflation will be restrained.
	Middle and Long Term: After fiscal 2005, the adjustment pressures of excessive debts and employment will lighten, and the positive effects of structural reform will gradually materialize. Accordingly, we anticipate that the Japanese economy would enhance its growth, and get back to a full, private sector-demand centered recovery trend. Moreover, effects of structural reform, including the deregulation of employment agencies and temporary employment, will be actualized, and a labor shift from low- to high-productivity sector will lead to an improvement in the labor productivity.	**Middle and Long Term:** While it is assumed that investment on capital equipment (mainly IT-related investments) will be restored gradually, there will not be great changes in the trend toward increased productivity. The US economy may continue greater than 3% expansion, led by final demand. Due to structural factors, however, such as excess production capacity and the hollowing-out of manufacturing industries, even if the pace of domestic-demand expansion strengthens, GDP growth rate will be moderate due to increased imports, and there will be little job-creation. In addition, such risk factors as a sharp drop in the dollar exchange rate or a sharp rise in the long-term interest rate will remain, due to the growing budget and current account deficits.

2. Disposal of Non-performing Loans and Creation of New Business	The outstanding balance of remaining loans disclosed in accordance with the Financial Reconstruction Law for all banks amounted to ¥43.2 trillion (8.4% of non-performing loans ratio) in March 2002 fiscal year, was reduced by 19%, to ¥35.3 trillion (7.4%) at the end of March 2003. The disposal has accelerated. Moreover, movement towards corporate revival has intensified at the same time as the disposal of non-performing loans progresses. Private financial institutions have made reconstruction efforts including investing in Corporate Reconstruction Funds, and Industrial Revitalization Corporation of Japan has also started its operation. Adjustment of excessive corporate debts has progressed steadily. The estimate of excessive debts from the ratio of outstanding balance of interest bearing debts to nominal GDP peaked at ¥190 trillion in 1994, but had reduced to ¥23 trillion at the end of June 2003. Large manufacturing companies have already resolved these issues, and simple calculation shows that excessive debts issues will be resolved in a little over the year. The number of companies opening business has not increased since the 1990s, while the number of companies that closed operations has surged at a pace exceeding those starting business. The number of newly listed companies increased considerably in fiscal 2000, when markets for start-up companies (such as high-growth and emerging stocks, i.e., Mothers) opened, but has been decreasing gradually. Reinforcement of business creation, such as deregulation to encourage new businesses and the improvement of incubators' functions, has become an urgent issue.	As of the end of June 2003, FDIC-insured commercial banks' noncurrent loans amounted to US$56.8 billion (1.32% of the outstanding loans), which was slightly less than the US$58.4 billion (1.47%) at the end of June 2002. On the other hand, the Shared National Credit review showed that as of April-June 2003 the ratio of classified credit* to total commitments of 1.6trilllion dollars rose to 9.3 percent from 8.4 percent of 2002, close to the previous peak in 1991, while among entity types, the classification rate for U.S. bank holdings fell to 5.8 percent from 6.4 percent in 2002. Against the background of a stock-price slowdown, initial public offerings have declined since 2001, in both number and value. Although the number and value of venture capital investments has also been reduced since 2001, there have recently been signs that this reduction is ending. Meanwhile, the narrowing of credit spreads in the bond market has continued since autumn 2002, and according to FRB's Senior Loan Officer Opinion Survey, credit standards toward medium and small size companies are likely to ease. Considering with these factors, the funding climate for creating new businesses is improving. Small companies' demand for funds has bottomed out, and recovery appears more obvious. * Classified credit is a total of "substandard", "doubtful" and "loss". In Japan, this is equivalent to loans requiring special attention and below.
3. Trend of Capital Markets and Individual Investors	The Nikkei Stock Average bottomed-out at ¥7,600 at the end of April this year, and has recently risen above ¥10,000. With cross-shareholding among companies and banks being unwound, however, foreign investors have continued to play a main role in the buying stocks, accounting for 18% of shares held. Although investment trusts and annuities holdings are increasing slightly, the share of individual holdings declined to lowest-ever 18% at the end of fiscal 1999, and even 20.6% at the end of fiscal 2002. An urgent task is to create an environment that facilitates investment of household financial assets into the equity market. In fiscal 2003, under the slogan of "From Savings to Investment", the tax reforms are carried out and taxes on stock dividends and transfer profits will be reduced from 20% to 10% over the next five years.	Against the background of retreating uncertainty about the Iraq situation, stock prices (S&P500 index) rose from a bottom of nearly 800 in the early spring, and at present they fluctuate at around 1000. Of the outstanding balance of stocks issued, due to increase of annuities, insurance, and mutual funds, household holdings have continued to steadily fall from 1950s levels of up to 90%, to less than 40%. Approximately10% of stocks are held by foreign investors.
4. China	After China's entry into the WTO (December 2001), Japan's exports to China have increased, because, a) with the accumulation of production bases in China, capital and production equipment exports from Japan are easily be induced, and b) China's household income has risen, and exports of Japanese consumption goods have increased. On the other hand, however, the hollowing-out of domestic manufacturing has had a negative effect on the Japanese economy, mainly in employment. It is therefore necessary for Japan to increase compartmentalization with China, by fostering more value-added high-technology industrial sectors.	The share of US import from China expanded to 11% in 2002 (from 3% in 1990), exceeding imports from Japan. The share of exports to China was only 3% (up from 1%). China has been the country with which the US has had the largest trade deficits for three consecutive years since 2000. Accordingly, although there are concerns about increasing job losses due to competition with Chinese products in some manufacturing industries (textiles and others), the US electrical and electronics manufacturing industry has made efforts to peacefully coexist with China through foreign direct investment to China. Although there have been some discussions about renminbi appreciation, their economic effects have differed according to line of business, and it cannot be considered that it will always have a great effect on improving the US current-account balance.

5. Energy Issues	In 2000, Japan's 51.8% reliance on oil greatly exceeded coal (17.9%), natural gas (13.1%), and nuclear power (12.4%). OPEC countries such as the United Arab Emirates (24.0%) and Saudi Arabia (22.2%) have made up 87% of Japan's total oil imports. Diversification of oil-source countries (e.g., non-OPEC countries), such as Russia, will be an issue to be resolved. Although skyrocketing crude oil prices arising from the Middle East are an unfavorable factor for Japan, if compared with the 1970s oil crisis, energy efficiency has developed considerably due to energy conservation. In addition, thanks to the diversification of energy supplies, Japan's reliance on oil has fallen substantially, from approximately 80% in the 1970s, to approximately 50%. Stockpiles have expanded nearly twofold (to up to 170 days). Therefore, if surge in crude oil prices comes to an end in the short time, the negative effects on the Japanese economy will be limited. Following the troubles involving in power companies' maintenance of nuclear power plants, their operations that supply power to the Tokyo metropolitan area were suspended, raising concerns about a lack of electrical power this summer. Although there were no large problems, due to an unusual cool summer, major issues remain concerning the credibility of nuclear power plants.	The US's energy demands as of 2000 were as follows: petroleum 39%, natural gas 24%, coal 23%, and nuclear power 8%. Approximately one-third of crude-oil is produced domestically. Crude-oil imports as of 2002 were led by Saudi Arabia (17%), followed by such diverse sources as Canada (16%), Mexico (16%), and Venezuela (13%). Dependence on Arab OPEC nations is only 25%, and dependence on Russian crude oil is only 1%. Steep rises in crude-oil prices, persistently high prices, arising from the situation in the Middle East, and rising prices of natural gas arising from environmental regulations and supply shortages, have a greater effect on the US economy than they do in Japan, where energy efficiency is superior. The major power failure on the East Coast in August of this year, following electrical power supply issues in California, have raised issues relating to competition and management, deregulation, and aging facilities.
6. Real Estate Prices	The overall appraisal value of land in 2003 fell for the twelfth consecutive year. With the population inflow into the Tokyo metropolitan area, and the reduction of public investment, there are some districts there where residential and commercial land prices have risen. In other, mainly in rural area, land prices have continued to fall. For industrial land prices, the hollowing-out of manufacturing industry has steepened the drop irrespective of area. The total amount of land prices to nominal GDP had fallen to approximately 2.9 times by 2001, to the pre-bubble era levels. Considering the hollowing-out of manufacturing industry and the slowdown in the population to strengthen the downward pressures, however, further drops in the overall land prices will probably continue. To slow the pace of falling land prices, it is important to tackle real problem to improve land productivity, such as by urban renewal and the revival of local economies. At the same time, measures for directly improving the usability of land, such as by reducing purchase and ownership costs, are also required.	Rises in housing prices generated bubble-like conditions in some regions, and some property prices have already fallen. Overall, however, housing prices have remained steady, for the following reasons: a) low interest rates, b) growing population, c) increased ability to acquire housing, d) lack of supply in some regions, and e) favorable treatment of real estate taxes and tax reductions. The rise in housing prices almost meets the increase of the population and income, and cannot be considered a bubble economy of a scale like Japan's around 1990. Even if housing demand falls due to a rise in long-term interest rates, there is little possibility of a long-term drop in real estate prices like in Japan. Due to rising housing prices and falling interest rates, however, household budgets in the US have spent the additional funds acquired from home equity and loan refinancing on consumption. When house prices rises finally stop and then drop, or if interest rates rise sharply, it will be necessary to monitor the risk of a negative effect on consumption.
7. Treasury Budget and Current-Account Balance	Japan's current account surplus (2.7% of GDP in fiscal 2002) and budget deficit (7.7% in fiscal 2002) are results for excessive savings in the household sector and restraint investment in the corporate sector. With the progress in excessive debts and employment costs adjustments that obstruct forward-looking economic activity since the collapse of the bubble economy, it is now necessary to enhance expected economic growth in the private sector and to expand domestic private-sector demand, such as personal consumption and business fixed investment, by accelerating structural reforms on tax, regulation, and social security.	The current account deficit in 2002 amounted to US$480.9 billion, equal to 4.6% of GDP. It will grow further with the recovery of the US domestic demand. The budget balance also turned to a deficit in fiscal 2002, and expanded to US$374.0billion (preliminary, 3.5% of GDP) in fiscal 2003. According to the Office of Management and Budget estimate, the budget deficit will shrink after 2005. It might not decrease, however, because of the growing medical and security expenses. Although this has been a restoration of the "Twin Deficit", the credibility of the US dollar as a key currency has not wavered. Over the long term, however, the current account deficit will be close to a level impossible to maintain. A soft landing will be necessary, through making efforts to reduce budget deficits, by reform of medical systems and gradually raising the savings rate.