

Japanese Economy Losing Momentum

By Masaru Takagi

The expansionary phase of the Japanese economy that began in December 1986 continued through fiscal 1990, supported by the growth of domestic demand in two key areas: consumer spending and business investment. Real GNP grew at an annual rate of 5.7% in the year ended March 31, 1991, extending the period of expansion to more than four years.

Recent developments indicate, however, that the economy has lost some of the upward momentum. It slowed down markedly in the second half of fiscal 1990, with the annual rate of GNP growth falling to 2.1% in the October-December quarter. That is less than half the 4.6% for the July-September quarter and the 5% plus for previous quarters.

The deceleration of GNP growth in the last quarter of 1990 was due largely to the fact that consumer spending dropped for the first time in many months despite a continued rise in capital spending. More recent developments have indicated weakness in both the household and business sectors. In fact, various indicators all point to a significant slowdown in economic activity.

Slump in sales

In the household sector, aggregate household consumption expenditure, adjusted for inflation, has either dropped or stayed flat on a year-to-year basis since October 1990. In the October-December quarter it fell 1.4%.

New car registrations slumped in September from a year earlier and continued to fall from year-before levels during the rest of fiscal 1990.

Sales at large retail stores have also turned sluggish, with the growth rate dropping to 6% in the October-December quarter from the two-digit level of previous quarters. Although the trend stayed positive on a year-to-year basis, the kind of strong growth that had prevailed in previous quarters was no longer evident.

The falloff in retail sales was due in part to the mild winter. But it also reflected a slump in sales of luxury items, such as paintings and precious metals.

Outstanding bank note issues, another useful gauge of consumer spending trends, fell off, too. The growth rate, which stayed in the two-digit range through April-June, dropped to the single-digit level in the following quarters, hitting a new low of 3.8% in the January-March quarter of 1991. It may be said that the slowdown of consumption expenditure caused a drop in the demand for bank notes (Table 1).

Surveys on consumer perceptions indicated that consumer confidence was waning. The confidence index declined in July-September and again in October-December, although it advanced slightly in January-March 1991. The surveys clearly showed that consumers were beginning to tighten their purse strings. Contributing factors were, among other things, uncertainty over economic prospects and the impact of higher interest rates. The weakening of spending enthusiasm dimmed the prospects for consumption in the months ahead.

In the business sector, the expansion of investment in new plant and equipment

had continued until the January-March quarter of this year, though the prospects for fiscal 1991 look uncertain. Growth rate projections range from 1% to 4.4%, according to various surveys of capital spending plans. Perhaps the figures should be regarded with some reservations, because the polls were conducted during the Persian Gulf war, which had dampened business confidence. Even so, there is little doubt that the underlying trend of investment has weakened.

Corporate tax revenue is also tapering off, with the cumulative total of business tax receipts for the period from April 1990 through February 1991 dropping 6% from a year earlier. This was clearly a reflection of the corporate profit squeeze. It is certain that all-industry average earnings for fiscal 1990 will register a minus growth rate compared with fiscal 1989.

Another negative factor is sharply increasing business failures. The total amount of debt in April 1991 reached five or six times the figure for the year before. Most of the bankruptcies stemmed from financial engineering and real estate speculation. In fiscal 1991, however, bankruptcies are seen likely to occur in a broader range of fields.

Then comes diminishing business con-

Table 1 Major Economic Indicators

(% change from year before)

	1990			1991			
	Apr.-June	July-Sept.	Oct.-Dec.	Jan.-Mar.	Jan.	Feb.	Mar.
Real household consumption expenditure (all households)	3.0	1.2	-1.4	-	0.1	0.1	-
New passenger car registrations	2.1	3.4	-3.4	-3.4	-6.6	-7.6	-7.8
Large retail store sales	12.7	8.6	6.0	-	8.2	5.7	-
Outstanding note issues	10.8	7.7	6.5	3.8	4.8	3.2	3.2
Business failures	-21.8	-9.1	24.9	49.0	41.8	51.1	53.8

Note: New passenger car registrations include minicars.

Table 2 Gross National Expenditure and Prices

(% change from year before)

	FY 1989	FY 1990	FY 1991 (forecast)
Real gross national expenditure	4.8	5.7	3.5
Consumer spending	4.1	3.5	3.3
Housing investment	0.7	10.2	-5.8
Equipment investment	14.1	13.6	4.9
Government expenditure	1.8	2.4	2.6
Exports, etc.	15.6	7.7	7.8
Imports, etc.	20.2	7.0	4.8
Wholesale prices	3.5	1.6	1.0
Consumer prices	2.9	3.3	2.9

confidence. Particularly disquieting is the fact that confidence plummeted among small and medium-sized businesses. The composite index of leading economic indicators stayed below the 50% boom or bust dividing line for six consecutive months, from September 1990 to February 1991, pointing to the possibility of a recession.

The latest trend is raising fears that the expansionary phase will come to an end, perhaps in the April-June quarter of this year, giving way to a downturn in overall economic activity.

Record unlikely

The current economic growth, if it continues through September, will become the longest in the postwar period at 58 months, topping the current postwar record of 57 months that lasted from October 1965 until July 1970. Whether this will happen is uncertain, given the prevailing circumstances. But it is more likely than not that the boom will stall before September.

A government projection put the fiscal 1991 GNP growth rate at 3.8%, much lower than the 5.7% originally estimated for fiscal 1990. A growth rate of between 3% and 3.5% is very low by Japanese standards, since the economy has expanded much more rapidly in most of the postwar

period. Such a growth rate has been recorded only when the economy was slowing down. If history is any guide, it suggests that the economy is again entering a mild slump (Table 2).

There are three major reasons to believe that an end to the long-running expansion is around the corner. The first is the tightening of credit. As a result of five increases in the official discount rate since May 1989, bank lending rates and other interest rates have gone up markedly, with short-term money rates reaching a high of about 8%. Credit lines for commercial banks were tightened. In January-March 1991 the ceiling on commercial bank lending was lowered by 32.9% from the level of a year earlier, which itself had been reduced from the same period of 1989. This demonstrates how deep were the cuts in lending volume. The higher rate of interest and the restriction of bank lending made less credit available for business investment and home ownership, putting a heavy damper on the growth of demand.

The second factor is the slump in the stock market. Stock prices continued to fall in 1990, with the Nikkei Stock Average reaching a low of ¥20,221 on October 2. In recent months the Nikkei index has climbed back up to the ¥25,000-¥26,000 level. But given the fact that the peak price recorded at the end of 1989 was as

high as ¥38,915, the turnaround is not strong enough to suggest that the slump is over. Our view is that no sharp recovery is likely in the near future and that the slump will continue for some time.

The stagnation in the stock market has created a "wealth effect in reverse," cutting off flows of funds that would normally go into business investment and consumption through the sale of shares. At the same time, equity financing, an important means of raising money on the stock market, has come to a near standstill. From April through December 1990 the total amount of money raised in this way was down 80% from the same period a year earlier. The virtual halt in equity financing is likely to have a considerable impact on capital spending by large and medium-sized businesses.

Thirdly, the United States is not making a very fast recovery from recession. While economists remain divided on when the recession will end, we hold the view that there will be no strong recovery in 1991 and that a full-dress recovery will begin in 1992. The U.S. recession will certainly affect Japan's exports to that country. It will have a greater impact on other Asian nations and Latin American countries that depend more heavily on the U.S. economy than does Japan. This will likely affect, indirectly, Japan's exports to those countries.

These factors could combine to result in the Japanese economy peaking out in fiscal 1991, with the GNP growth rate dropping to 3.5%.

Projection for spending

How will consumer spending and business investment develop in fiscal 1991? Our projection is that consumer spending will increase about 3.3%. That is a fairly good figure, but it seems too small to pull the economy along, considering that such spending has in the past increased more than 5% per year and in the latest recovery period served as one of the engines of growth.

We believe consumer spending will not increase much, partly because wages are expected to rise at a slower pace. The average rate of wage increases for fiscal

1991 is likely to drop slightly to between 5.5% and 5.6% from 5.9% in fiscal 1990. Smaller gains are also expected in bonus payments, reflecting a downturn in economic activity. The same goes for overtime allowances. Slower growth in personal income will affect consumer spending, of course. In particular, it threatens to bring a pause in the purchase of luxury items, one of the recent trends in consumer spending, and in leisure-related consumption, such as foreign travel. In this kind of situation we can hardly expect consumer spending to continue to provide a major impetus to growth.

Business investment in fiscal 1991 is projected to rise a moderate 4.9% from the year before, according to our surveys. At such a relatively low rate of growth, capital spending is not likely to lead the economy as it has in the past.

Surveys indicate, however, that corporate enthusiasm for investment remains unabated, reflecting a strong desire to in-

vest in research and development, product development, business diversification and labor-saving equipment—in short, a desire to beat mounting competition.

Unfortunately, the business environment is not favorable, as is indicated, for example, by growing moves to draw down liquidity on hand, the cap on bank lending and the slump in equity financing. These factors are certain to limit fund availability despite strong investment sentiment.

With the economy in a downturn and with people and business having less of an economic pie to share in, the business manager's ability will be put to the test: a company will succeed or fail depending on how it is managed.

Now, let us see how things will develop in the area of finance in fiscal 1991. As noted already, the Bank of Japan has maintained a tight credit policy for the past two years. Never before has the central bank restricted money supply over

such a long period and so strictly. Five successive discount rate increases sent commercial interest rates soaring to a punitively high level. "Window guidance," designed to regulate bank lending, was tightened. Moreover, an overall cap was put on real estate lending, beginning in April 1990. These measures are rapidly permeating the economy.

The impact of the tight monetary policy manifested itself in the sharply reduced growth of money supply. The year-to-year rate of growth dropped to only 3.7% in April 1991 from 13.2% in both April and May of 1990. As shown in Fig. 1, the steep fall in the growth rate of money supply reflected a sharp slowdown in bank lending.

Cash flow problems

The restrictive credit policy also showed its effect in corporate cash flows. As indicated in Fig. 2, the number of businesses with cash flow problems exceeds that of businesses without such problems. By the same token, businesses experiencing a "credit crunch"—banks' reluctance to lend—outnumber those not experiencing such difficulties. The chart is based on a survey by the Bank of Japan, conducted to find out how businesses felt about their ability to meet their financial needs and about the lending attitude of financial institutions.

What is particularly notable about the chart is that the perceived cash flow problem worsened rapidly among big companies, which are supposed to be financially better off than smaller companies. This has much to do with the sharp increase in business failures. As noted earlier, most of the failures stemmed from the money game and speculation in the property market. But the direct cause of most of these bankruptcies was cash flow difficulties arising from the tight credit policy.

The question that remained was the timing of a shift in the monetary policy. The discount rate was cut by half a point to 5.5% on July 1, after the stage had been set for monetary relaxation. As already seen, the economy has slowed down sharply, and business has been hit hard, perhaps too hard, by the tight credit poli-

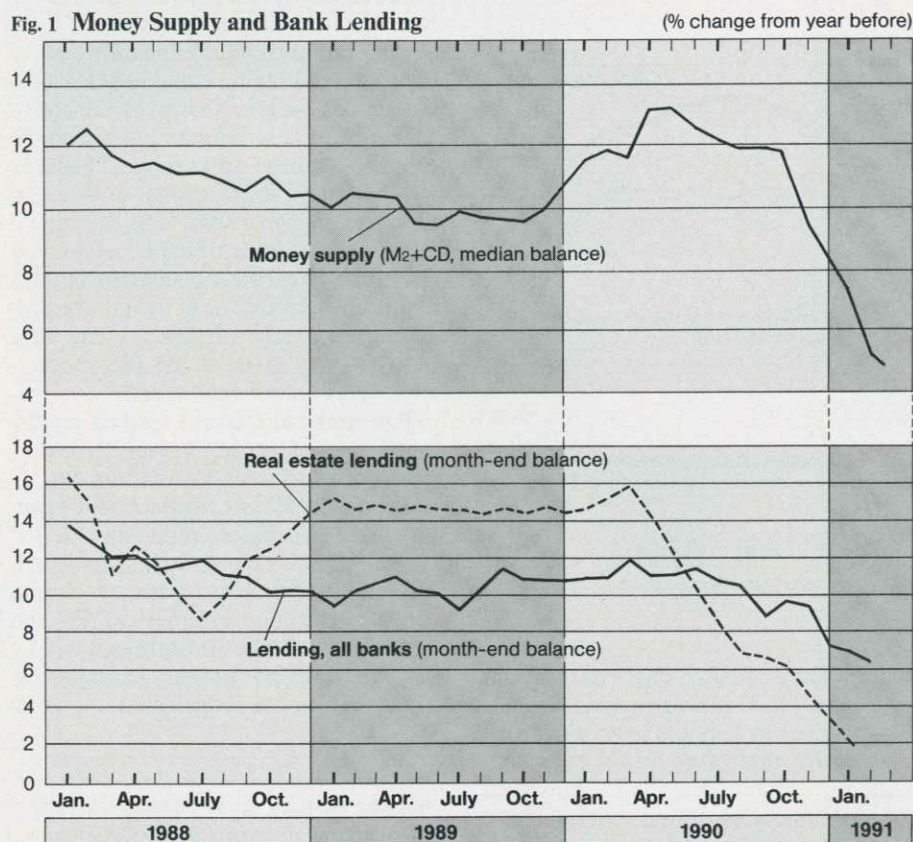
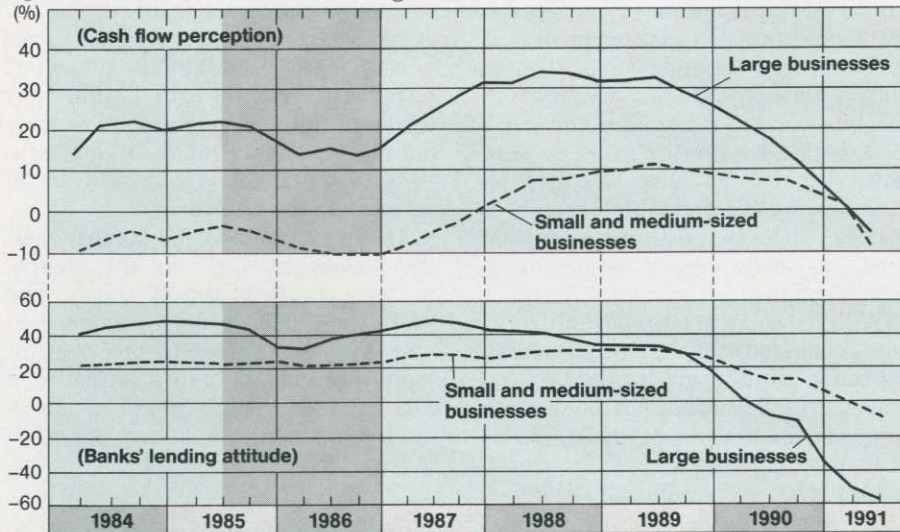
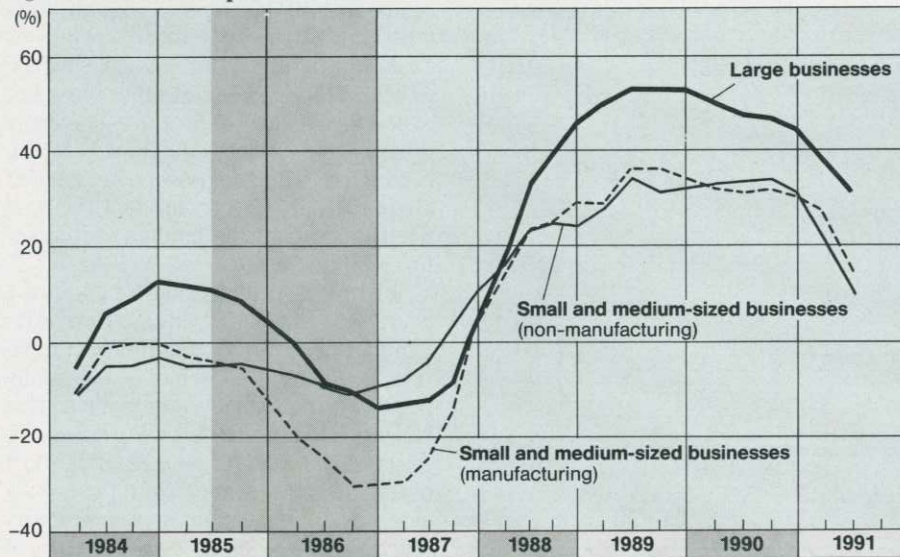


Fig. 2 Cash Flows and Banks' Lending Attitude



Notes: 1. Cash flow perception index shows percentage of "well-off" businesses minus percentage of "hard-pressed" businesses. Lending attitude perception index shows percentage of businesses with "generous" perception minus percentage of businesses with "severe" perception.
 2. Shaded section indicates period of economic slowdown.

Fig. 3 Business Perception Index



Notes: 1. Index as percentage of businesses with "good" perception minus percentage of businesses with "bad" perception.
 2. Shaded section indicates period of economic slowdown.

cy of the past two years. Besides, inflation is falling, except for land prices, although it is not enough to warrant optimism.

The land price trend requires continued attention as the current fall in land prices is the result of lending squeezes by financial institutions. There is no doubt

that the Bank of Japan's tight money policy took effect. However, monetary policy is conducted, as it should be, from a broad perspective that takes into account not only inflation but also other factors such as economic growth and exchange-rate stability. Land price problems must be

addressed separately in combination with other measures, such as revision of the tax system and of the building standards and urban planning laws.

Bearing in mind the argument about the way in which monetary policy should be conducted, it would be wrong to continue the tight policy simply because land prices do not come down. What is needed is a discontinuation of tight credit, and the sooner this is done the better, because the current expansion will likely peak out in the April-June quarter. An early cut in the discount rate was preferable, since it usually takes a year before a shift to credit relaxation shows its effect in the real economy.

It needs to be remembered, however, that a switch to easier credit does not mean that banks will start lending money generously. On the contrary, they are likely to remain more or less cautious. Indeed, there is even a strong possibility that the credit crunch will occur due, above all, to the new capital regime of the Bank for International Settlements (BIS) which requires internationally active banks to hold capital equal to at least 8% of their risk-weighted assets by the end of March 1993. This requirement will not be easy for Japanese banks to meet because they maintain lower capital-to-asset ratios than foreign banks. The 8% capital adequacy can be achieved by expanding the capital base by a wide margin, but this approach is unrealistic in light of the prevailing economic conditions. The only practical way to meet the BIS requirement is to reduce total assets.

For banks to increase lending rapidly on the back of fat capital reserves, as they have done in the past, would be exactly the opposite of asset contraction. Consequently, an easing of credit will not, and cannot, lead to a rapid expansion of lending volume. The slow expansion of credit is likely to limit growth in fiscal 1991 and beyond. In such circumstances it will be extremely difficult to see a strong recovery even over the longer haul.

Masaru Takagi is the chief economist and general manager of the Economic Research Division, Fuji Research Institute Corporation.