

Japan's Economy: Current Situation and Outlook

By Wakatsuki Mikio

In the fourth quarter of 1993, Japan's economy contracted at a 2.2% annual rate, the largest quarterly decline in the current recession which began in May 1991. As a result the real GDP for 1993 grew by a meager 0.1%, the worst performance since the first oil crisis of 1974 when it registered a negative 0.6% growth. Two major demand components—private fixed investment and net exports—declined by 8.4% and 27.1% respectively, indicating that the major driving forces of the economy have stalled.

What has gone wrong with the once seemingly invincible Japanese economy? A simple explanation is that the economy grew too rapidly in the latter half of the 1980s and now payment is due. But what has amplified the ups and downs is perhaps overconfidence of the Japanese in their economy. During the "bubble" period, overconfidence prevailed and there was the illusion that the expansion would last forever. When the "bubble" imploded, the same overconfidence was still there; policy makers, as well as businesspeople, thought they

could make a soft-landing because, in their view, the Japanese economy was different and resilient.

One manifestation of this overconfidence is the fact that fixed investment continued to increase by 3.5% in FY 1991, this even after the bubble had burst. Likewise, the overwhelming majority of banks continued to pay the same dividends as previously for the sake of keeping up with the Joneses, even in the face of mounting bad loans.

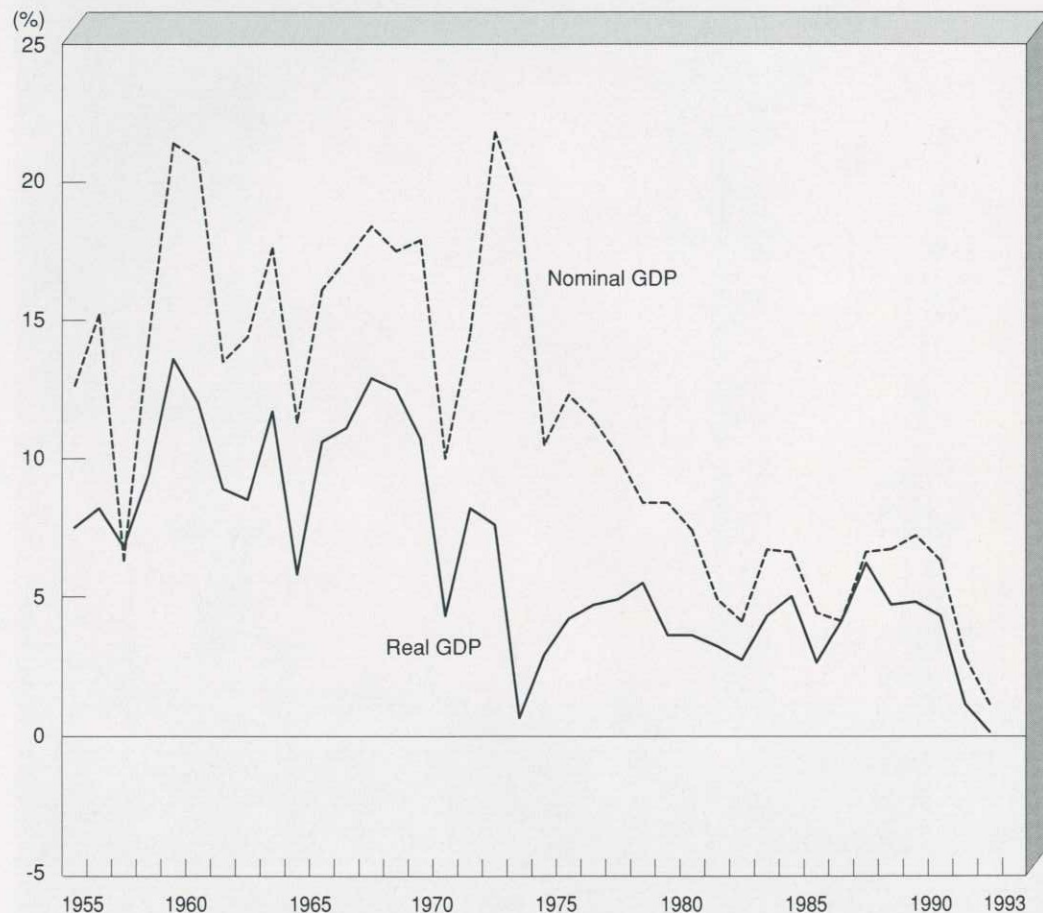
To be fair, policy makers were not merely sitting idle. Two months after the expansion had reached its peak (April 1991), the Bank of Japan began lowering the official discount rate, from 6.0% to 1.75% in seven actions, the lowest rate in history and in the world. The government adopted three economic packages amounting to ¥30 trillion (\$270 billion) to bolster the sagging economy. But all of these policy efforts have so far been overwhelmed by the magnitude of the adjustment needed.

New features

In addition to this cyclical phenomenon, the current recession contains at least three new features not familiar in past Japanese business cycles.

Since the implosion of the bubble, asset prices declined sharply. Stock prices (as measured in the Nikkei index) declined more than 60% at one time and are hovering at around half the peak level. Land prices also declined sharply, by 30% to 50%, and are still declining in major cities, though prices of residential properties have almost hit bottom. The crash

Trends in Japan's GDP Growth Rate (% change on year earlier, calendar year)





Wakatsuki Mikio, Japan Research Institute, Ltd. chairman

of asset prices undermined the blind faith in ever-rising land and stock prices, and changed the basic assumption in investment and spending. Many businesses have had to revise their management method which had previously been based on "hidden reserves" or "unrealized profits."

Secondly, since World War II banks have been regarded as the stable pillar of the economy. Indeed, throughout postwar business cycles banks have been the least affected. But following the bubble implosion, a number of banks have been affected by the deterioration in the quality of their lending. Due to mounting bad loans and shrunken "hidden reserves," a number of banks are perceived to be in trouble. With their reduced capital position, banks have become increasingly cautious in extending new credit as their capacity to take risks has diminished. Though the current situation is different from "credit crunch," it is obvious that banks are much less aggressive in wooing customers as compared to previous periods of monetary ease.

In addition, since the beginning of 1993, the yen appreciated sharply, from ¥125 to close to ¥100/\$. Such a rapid appreciation rendered a heavy blow to Japanese export industries in three ways.

The appreciation of the yen came at a time when export industries were over-extended. They had over-invested and over-employed, and hence their break-even point rose considerably. Unlike previous cases, the yen has appreciated not only vis-a-vis the dollar, but also vis-a-vis European and Asian currencies as well. In the latter half of the 1980s, it was the dollar which sharply depreciated against major currencies.

Furthermore, the yen's appreciation came at a time when the domestic economy was shrinking. There is practically no room to absorb the reduced exports, and industries were forced to cutback production and capacity utilization decreased steeply.

Unlike the 1980s, U.S. manufacturers, especially automakers, have rebounded with strong competitive products. The increase in export prices has meant a considerable loss of market share as non-price competitiveness, such as quality and maintenance service, is reduced. Also, many Asian countries have made remarkable progress in improving the quality of their manufactured goods, and the appreciating yen has made them very competitive on the Japanese market.

Therefore, Japan's export industries, once regarded as very competitive and almost unrivaled, are now in a difficult situation.

Three adjustments

Alan Greenspan, chairman of the Federal Reserve Board, stated three years ago that the U.S. economy was faced with 50 m.p.h. head winds which protracted the recession and hampered the effects of an easy money policy. He cited the problems of balance sheet adjustment, restructuring, and reduction in the budget deficit as the main causes. Currently, similar head winds are now hitting the Japanese economy in the form of three adjustments.

Fixed investment continued to increase very strongly in the latter half of the 1980s, and in 1990 it comprised 20% of the total GNP. As a result, the rate of increase in capital stock reached close to 9% in 1991. With the decline in demand and profit, fixed investment

decreased during the past two years and the rate of increase in capital stock decreased to around 4%, a rate usually regarded as the threshold where fixed investment resumes. But with capacity utilization continuing to decline, and recovery in profits not yet realized, there is no incentive to resume capital investment. In addition, many businesses are now wondering whether they should invest in Japan or abroad—China, Indonesia or the Philippines. Construction spending, which comprises one-third of capital investment, is in a serious slump.

Financial institutions, the real estate industry and construction companies are the biggest casualties of the economic recession. At first it was thought that other industrial companies were less affected by the "bubble," but in actuality a number of those companies engaged in financial engineering and real estate-related business through their subsidiaries and many were hit hard. The hardest hit have been banks, which at first took a gradualist approach, spreading losses over a number of years awaiting recovery. But with the protracted slump, the BIS capital adequacy requirement and the market rating problem, they have started to expedite consolidation and to write off bad loans. However, since the real estate market is practically dead and illiquid, progress is regrettably slow.

Companies are now seriously struggling with adjusting over-inflated cost structure by reducing frequency of model changes, realigning product arrays, and streamlining the production process. One big headache is employment. As recently as two years ago, Japanese companies, concerned about a labor shortage, desperately tried to secure a work force.

Now the problem is just the opposite, i.e., excess labor. But in Japan, reduction of the work force through layoffs is regarded as a last-resort option, since it is usually taken as a breach of the tacit understanding of lifetime employment. There is concern that with the rapid aging of society a new era of labor shortage will arise in not too distant future. Thus, many businesses are faced

with the agonizing decisions of layoffs and prolonged adjustment. To date, they have resorted to a number of measures other than layoffs—reducing overtime, eliminating temporary and seasonal workers, shifting work assignments, suspension of new recruits, temporary recess of factories with government subsidies, etc. But if the recession continues to protract, they may be forced to take the other option. Whether massive layoffs can be avoided or not is a key factor in preventing another dip in the economy.

All of these adjustments take time but are necessary for the economy to resume a sustainable recovery and a sound expansion.

There is another adjustment that needs to be completed, that is political adjustment. After the demise of the LDP regime, which lasted for nearly four decades, the Japanese political situation remains unstable and liquid. The political instability inevitably affects formulation of the budget and other fiscal policies. Uncertainty over the U.S.-Japan trade issues arising from political impasse shakes business confidence. In view of the fact that the former LDP regime was firmly established only after two general elections, it appears likely that at least one general election is needed to have a more stable and clearer political picture. In the meantime, the economy has to live with this nagging instability.

Outlook for 1994

In early February, the government announced the official outlook of the Japanese economy and policy stance for FY 1994. The outlook places estimated real GDP growth at 2.4%, with a private consumption increase of 2.4% and a 0.1% private fixed investment increase. Exports are estimated to increase by 3.7%, and imports to rise by 7.9%. The policy stance emphasizes an early return to sustainable growth during fiscal 1994.

In pursuit of this objective, the government also announced a comprehensive economic package, involving expenditures and financing totaling ¥15.3 trillion. This was the fourth package in the current recession and the

Government Economic Forecast

(% change on year earlier)

	FY91	FY92	FY93	FY94
Real GDP	3.6	0.4	0.2	2.4
Personal consumption	2.6	1.1	0.9	2.4
Housing investments	-12.1	-3.6	8.5	5.2
Capital investments	3.5	-5.7	-7.2	0.1
Real GNP	3.6	0.7	0.2	2.6
Current account surplus as % of GNP	2.6	3.4	3.1	2.8
Exports (based upon international balance of payments)	1.9	1.6	-8.7	3.7
Imports (based upon international balance of payments)	-12.5	-8.2	-8.3	7.9

Note 1: FY93 and FY94 are government results estimate and forecast, respectively

Note 2: International balance of payments for exports and imports based upon yen value

largest in terms of money contained. The main features included an income and inhabitant's tax cut of ¥6 trillion; public works expenditures of ¥7.2 trillion; and a ¥1.4 trillion expansion in public financing.

According to the Economic Planning Agency, the package is expected to increase the nominal GNP by 2.2% in fiscal 1994. The 2.4% real rate of GDP growth expressed in the official outlook is, strictly speaking, neither an objective estimate nor an official target. It is in fact of an eclectic nature, an estimate which contains some normative elements. That is to say, the government is obliged to try and achieve the stated goals.

Most private sector economists and institutions are less sanguine than the government in their forecasts. The central tendency of those forecasts ranged from zero to 1% real GDP growth for fiscal 1994. They are also more conservative in estimating the effect of the economic package, i.e., an increase of the real GDP by around 1 to 1.2 percentage points, as the package includes land purchases which does not create new demand and public financing which otherwise would be provided by financial institutions.

Signs of recovery

Since the turn of the year, several incipient signs of recovery have surfaced. The Bank of Japan's short-term survey (known as "TanKan"), conducted in February, shows that the deterioration of business confidence has finally abated. Industries production showed a moderate increase in the first quarter of 1994. More pronounced are consumption-related indicators, with household consumption expenditures increasing from October to December; sales of electric consumer durables such as audio sets, VTRs and kitchen goods recovering since the end of last year; and the strong rise in housing starts and buoyant condominium sales, all of which are encouraging signs.

Recovery in private consumption is reflected in the macro-economic data. Though the decline of GDP in the fourth quarter of 1993 was disappointing, it was better than what most economists expected. The major factor which contributed to the better-than-expected result was private consumption which showed a steady increase of 3% over the preceding quarter, a consecutive increase after a 1.8% growth in the third quarter.

These encouraging developments have raised the feeling that the worst is over and the recession is coming to an end. But negative indicators abound as well, although the degree of negativity appears to be diminishing. Even in the bright indicators, there are overriding factors: prices are falling where sales are good; the rebound in sales of consumer durables is largely in the cheaper end product lines; the buoyant sales in condominiums are concentrated in those units whose price tag is about 20% lower than the average of two years ago; and, while the number of domestic and international tourists increased appreciably, their average spending is less than that of last year.

The mixture of bright and somber signs is telling in that it is still premature to declare the end of the recession at this stage. The experience of last year also suggests that end-of-fiscal-year factors could exhibit false signs of recovery. The EPA declared the end of the recession a year ago May, but this was quickly betrayed by dips in many key indicators.

Nevertheless, it is often the case that when there is a mixture of contradictory signs the end of a recession is approaching. Against this background and with the full implementation of the economic package, negative factors will gradually recede and the economy will hit bottom by this summer, barring unexpected developments. But the problem is the strength of the recovery and its sustainability.

Consumption-led recovery

Unlike previous business cycles, two strong dynamos—private fixed investment and exports—are missing. Various surveys recently conducted indicate that private fixed investment will decline in fiscal 1994 for the third straight year. With the sharp appreciation of the yen and the existence of a large external surplus, there is not much room for strong export expansion. As a consequence, the major driving force for a recovery needs to come from private consumption, a rare experience in our postwar business history. Unfortunately, given the low increase in wages and the bleak

employment situation, this dynamo will not be as powerful as hoped. The spring wage negotiations ended with an increase of around 3% this year, nearly 1% point less than last year's outcome of 3.9%. The unemployment rate stood at 2.9% in February, 0.6% higher than a year ago.

On the other hand, there are a few positive factors which may support increased consumption. First, prices are decreasing. The CPI stands at about 1.3% higher over a year ago and the WPI is even below last year's level, standing at minus 3.2%. Proliferation of discount stores, outlets and the so-called "category-killers" (such as Toys"R"Us) presumably have made the real price level even lower. Secondly, consumer confidence is improving, as the worst is seen as passing over. Consumers are becoming a little less apprehensive about the future and their spending attitudes a little more positive. Third, the tax cut will give a boost in disposable income, though it is expected that half of the tax refunds will go to savings.

Another supporting engine is housing investment. The decline in land prices, low interest rates and government financing subsidies are helping housing starts. In 1993, they reached 1.49 million units, an increase of 5.9% over the previous year, and they will exceed 1.5 million in 1994.

Inventory adjustment is also in its final stages. Unless there is a large decline in shipments in the April-June quarter due to the end of the fiscal year factor, there will be a moderate recovery in production. Public works and exports to Asian countries will also contribute to supporting the economy.

While these are positive developments in the cyclical adjustment, completion of the above-mentioned three adjustments will take time, possibly another two years. Therefore, the Japanese economy is now in a tug-of-war phase between positive cyclical elements and dragging structural adjustments, but on balance, the head winds will be strong for some time, even after the economy hits bottom. In some ways it is easier to end a recession than it is to resume a sustainable autonomous

recovery. The economy may continue to be in need of support in the form of public demand. Therefore, it is likely that the real GDP growth for fiscal 1994 would not be much higher than 1.0%.

A possible downward risk is the yen's sharp appreciation beyond ¥100/\$, which not only renders a heavy blow to export industries but also seriously affects business sentiment as a whole. Though this possibility cannot be excluded entirely, the chances seem to be rather slim as economic fundamentals such as interest rate differentials and growth rates are moving to favor the United States.

Policies to be pursued

Against this background, what the government must do is clear. Uncertainty regarding the income tax cut issue must be eliminated and the tax cut installed on a permanent basis, rather than an ad hoc one-year basis. Also needed is to expedite the passage of the budget for fiscal 1994 and the implementation of the stimulatory economic package. An additional economic package must be prepared and launched, including the expansion of social infrastructure expenditures as and when necessary.

Efforts in promoting structural policies, such as deregulation and market opening measures, must be stepped up in order to stimulate the economy as well as to reduce external imbalance. At the same time it is apparent that the private sector has to play a key role in reinvigorating the economy. Business firms must expedite restructuring with bolder and more imaginative moves. Banks should tackle bad loan problems with more decisiveness and realism. It is incumbent upon the government to prepare a freer environment through deregulation, but to make use of such an environment with more aggressive and revitalized entrepreneurship is entirely the responsibility of private firms. ■

Wakatsuki Mikio, chairman of the Japan Research Institute, Ltd., until July 1993 worked for the Bank of Japan for nearly 40 years.