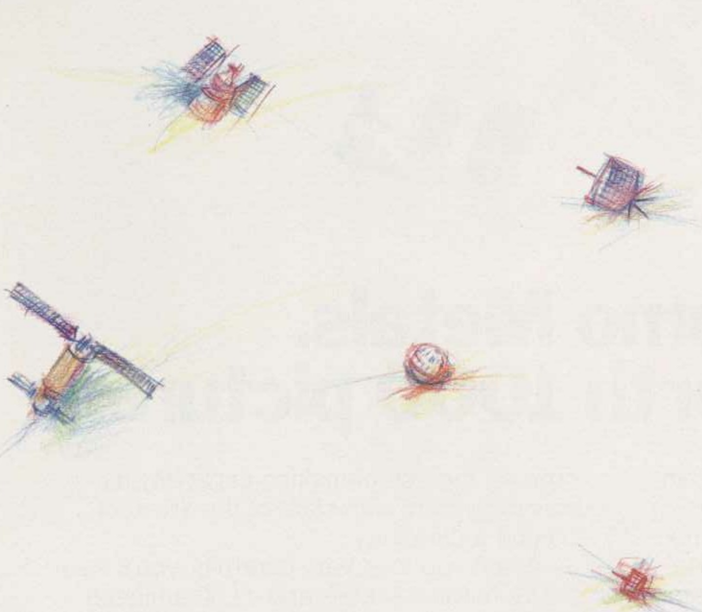
# Bouncing Back

*Hisao Kanamori is president of the Japan Economic Research Center. He was formerly an official with both the Ministry of International Trade and Industry and the Economic Planning Agency (EPA). He assumed his current post in 1973 after resigning as deputy director of EPA's Economic Research Institute.*

By Hisao Kanamori

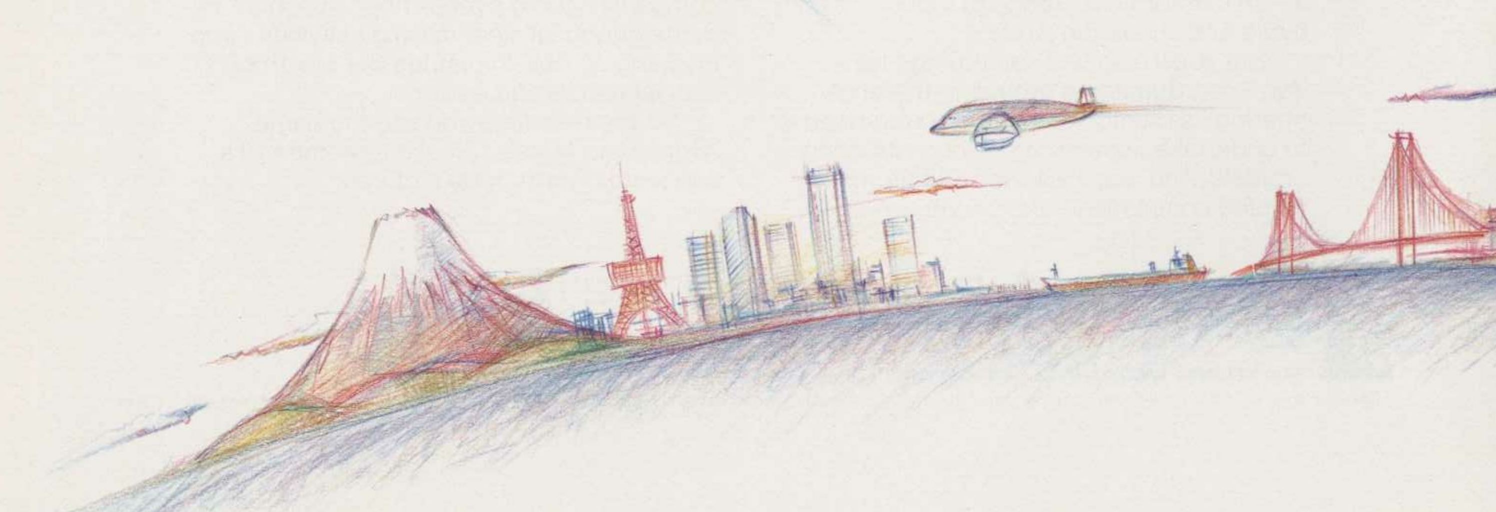


## Review of fiscal 1986

Japan's economy in fiscal 1986 (April 1985–March 1986) has been characterized by two distinct features: a significant slowing of growth and considerable divergence in performance among different sectors.

Since fiscal 1986 when Japan's economy was still growing at a rate of 5.0%, the nation's economic growth has been slowing down, dropping to 4.2% in fiscal 1985 and estimated at only around 2% for fiscal 1986. By sector, nonmanufacturing industries have been doing much better than manufacturing industries, with housing, public works, nonmanufacturing capital investment and consumption remaining relatively strong while capital investment in the manufacturing sector has been sluggish.

These developments in the fiscal 1986 Japanese economy can be directly traced



to the yen's rapid appreciation against the dollar and the sudden drop in oil prices on international markets. The yen has soared from ¥240/$ immediately prior to the Plaza Accord of September 1985 to ¥150–60/$ in August 1986, an appreciation of more than 50% in less than a year. As a result, import prices have fallen and industries dependent on raw material imports have reaped major benefits. Oil prices also fell, from $27 per barrel in December 1985 to only $10 per barrel by August 1986, generating windfall profits for electric power, gas and oil refinery companies. Export-dependent industries, on the other hand, saw their profits plunge as they were forced to lower their export prices. Yet while there were both winners and losers, the overall impact of the yen's appreciation has been very negative for the economy as a whole.

## Forecast for fiscal 1987

Where does the Japanese economy go from here? Opinion is basically divided into two camps. One view is pessimistic, predicting that the deflationary effects of the yen's appreciation will continue to spread and that things will get worse. The other, more optimistic, view is that the worst will be over by the end of this fiscal year and that things will be looking up by the start of the new year. There are so many factors, domestic and international, to consider that it is difficult to say who is right. Nevertheless, it is worth looking at the main factors that will come into play, including world economic trends, particularly U.S. economic trends, oil price movements and currency exchange rates.

**The world economy**

The Japanese economy has always been especially sensitive to the American economy and other fluctuations in the world economy. In the United States, forecasts for 1986 had been somewhat optimistic, assuming that the dollar's devaluation would boost exports and that lower interest rates would stimulate capital investment and housing starts for 4% economic growth overall. However, exports have not increased and capital investment remains sluggish. American economic growth is unlikely to exceed 2.5% in 1986, and this sluggishness may well continue into 1987. Consumption was strong in 1986, but this was largely because of excessive expansion in consumer credit, and 1987 is likely to see consumption growth stymied. With heavy deficits in both its international balance of payments and the federal budget, there is little the U.S. government can do to stimulate the economy. There is thus little reason to hope that the Japanese economy will be able to ride the American economy's coattails to recovery.

What of the other major economies? Last year (1986) was a fairly good year for the nations of Europe, and their expansion is likely to continue into this year. There are also strong expectations of robust growth in the Southeast Asian countries. Both lower oil prices and the yen's strengthening against the dollar (and dollar-linked currencies) have proved major stimuli for South Korea and Taiwan, and these economies are expected to show 1986 economic growth rates of 10% and 9%, respectively. In 1987, it is predicted that this economic recovery will spread to Hong Kong, Malaysia, Singapore and Thailand as well. Even in China, handicapped as it is by its lack of foreign currency, the latter half of 1986 was a time of renewed economic vigor; and the Soviet economy is shaking off its lethargy under the leadership of Mikhail Gorbachev.

Still the world economy is a mixed bag, and there are numerous causes for concern. The American economy is in the doldrums, the drop in oil prices has crippled the Middle Eastern economies, and little improvement has been seen in the developing countries' external debt service problems. In fact, the inability of some Latin American countries to pay the interest on their debts, let alone the principal, has the potential for sparking a major crisis in international finance. While the IMF has recently announced that it expects 3.1% growth in the world economy in 1987, a slight increase over the 2.8% growth of 1986, I feel this outlook is a bit optimistic. For Japan, at least, the international environment will be just as difficult in 1987 as it was in 1986.

**Oil prices**

The sudden fall in oil prices since late 1985 has been a boon to Japan, given its heavy energy dependency on imported oil, as the CIF price of oil imports plunged from $27 per barrel in January 1986 to $10 per barrel by August 1986 as a result of the price cutting that ensued after OPEC failed to establish quotas or to coordinate production at the end of 1985. However, these same OPEC nations were able to reach a tentative agreement on production quotas at their July 1986 meeting, and the price of oil has since risen to $15 per barrel as a result.

Nevertheless, opinion in Japan is divided on whether oil prices will continue to rise to close to $20 per barrel or whether the OPEC agreement will come unglued and oil prices will again slip back down to around $10. Personally, I do not see any major price increase for the near future, since the industrial countries have abundant oil reserves and the OPEC countries remain at sixes and sevens with one another. Nor, however, will there be any major deterioration in oil prices, since the individual oil-producing countries are likely to curtail production on their own to hold prices stable at around $15 per barrel for the time being.

**Currency exchange rates**

The dramatic fluctuations in exchange rates were the primary cause of confusion in the Japanese economy in 1986. After climbing to close to ¥150/$ in early August, the yen remained at this level

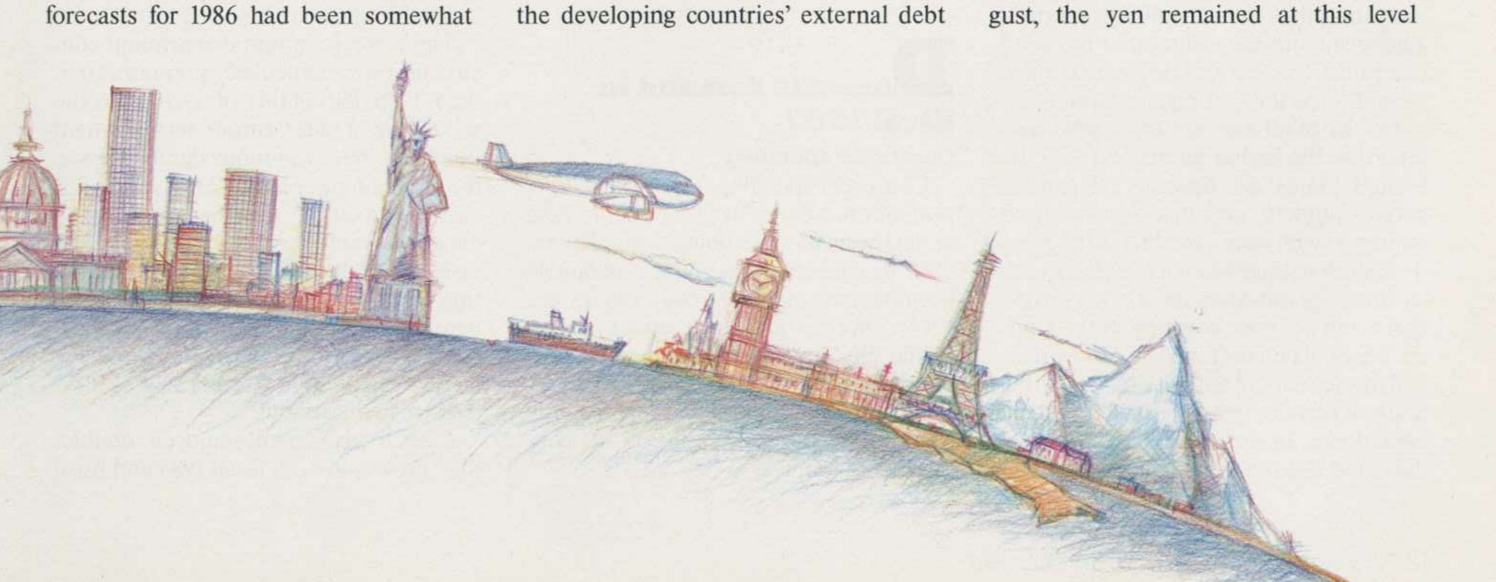
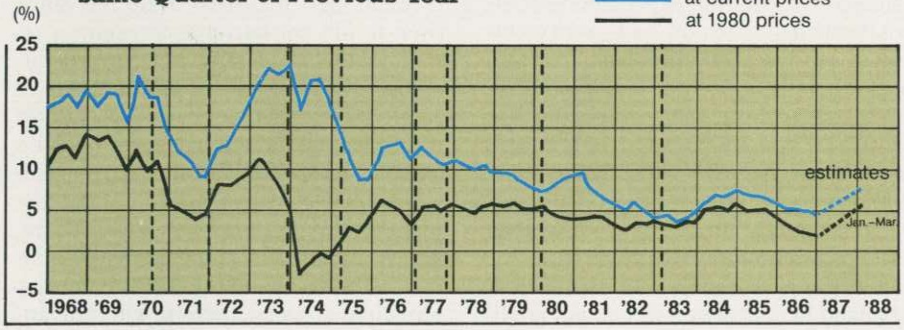


**Table 1 Economic Growth over Previous Year** (%)

| | FY 1982 | FY 1983 | FY 1984 | FY 1985 | FY 1986 (estimate) | FY 1987 (forecast) |
|---|---|---|---|---|---|---|
| Private final consumption expenditures (real) | 4.2 | 3.1 | 2.6 | 2.7 | 4.0 | 4.5 |
| Private housing investments (real) | 1.2 | –9.0 | 0.4 | 3.7 | 8.0 | 6.0 |
| Corporate capital investments (real) | 2.0 | 4.9 | 10.9 | 12.6 | 5.0 | 7.0 |
| Private inventory increases (real) | –28.7 | –16.9 | 86.0 | –10.9 | –60.0 | 60.0 |
| Government final consumption expenditures (real) | 1.4 | 3.5 | 2.3 | 2.6 | 5.0 | 5.0 |
| Public fixed capital formation (real) | 0.1 | –2.2 | –3.0 | –6.9 | 8.0 | 7.0 |
| Public inventory increases (real) | –66.5 | 44.8 | 169.8 | 93.1 | –12.0 | –12.0 |
| Exports, etc. (real) | 0.7 | 8.7 | 15.8 | 2.2 | –6.0 | 0.0 |
| Imports, etc. (real) | –2.5 | –0.5 | 10.0 | –1.7 | 4.0 | 7.0 |
| Gross national expenditures (real) | 3.2 | 3.7 | 5.0 | 4.2 | 2.8 | 4.3 |
| Gross national expenditures (nominal) | 4.9 | 4.3 | 6.7 | 5.9 | 3.5 | 5.0 |

Source: Economic Planning Agency, *Annual Report on National Accounts*, 1986 edition

**Fig. 1 Changes in Gross National Expenditures as Compared to Same Quarter of Previous Year**




Source: Economic Planning Agency, *Annual Report on National Accounts*, 1986 edition

through the end of October. While there is some disagreement on whether the yen will continue to go up or start to decline, the majority view is that it will continue to strengthen, primarily because of the continuing surplus in Japan's current account. In the six months from April through September 1986, Japan's current account surplus went up to $47.3 billion, indicating that the yen still has room to appreciate and suggesting that the need to reduce this current account surplus should force the yen up some more.

On the other side are those who contend that the higher interest rates in the United States are drawing off Japan's surplus liquidity and that overseas fund managers who were investing in the Japanese stock market when it was rising took their money out when the market turned down and are now investing in the United States. The combination of Japanese and foreign capital outflows to the United States is certain, they say, to push the yen back down. In fact, this capital outflow did cause the yen to drop a bit at the end of October 1986 to around ¥160/$. On October 31, Japanese Finance Minister Kiichi Miyazawa and U.S. Treasury Secretary James Baker released a joint statement saying that the yen-dollar exchange rate had reached an acceptable level, and this statement has been eagerly seized upon by those who argue against further appreciation.

## Domestic demand in fiscal 1987

### Consumer spending

Consumer spending stagnated in fiscal 1985 but picked up in fiscal 1986 to help arrest the economy's downswing. The revival in consumer spending was largely because real incomes rose even as the yen's appreciation kept prices stable. While this increase in real incomes was not that large in fiscal 1986, only about 4% in nominal terms, it was significantly more than the zero increase in the consumer price index.

I believe this trend will continue into fiscal 1987. Although it is true that the annual spring wage increases are a major factor in nominal income growth and that this spring's wage increases will probably be held to about 3% in view of the bleak outlook for corporate profits, the past year's yen appreciation should keep consumer prices down, and hence real income up, for at least this year. As long as prices are stable, consumer spending will continue to increase.

Although there is the danger that recession could lead to greater unemployment and thus hold incomes to zero or negative growth overall, it looks as though it will be possible to avoid this situation and its consequent decline in consumer spending. Shipbuilding, steel, mining and a few other industries may suffer from serious unemployment, but this will be offset by increased employment in the service industries, construction and a number of other sectors to check any major rise in unemployment in the nation as a whole. There is a clear consumer shift away from tangible goods toward intangible services, and, despite the slump, services, construction and other domestic market-oriented industries are hiring more people. As a result, total employment in fiscal 1986 is 1% more than in fiscal 1985.

### Housing starts

Housing construction has long been a fairly sluggish sector, but there was marked recovery in fiscal 1986, with September 1986 housing starts up 20% from September 1985. One major contributing factor was the concerted effort by the government to stimulate housing construction by, *inter alia,* providing expanded financing from the Housing Loan Corporation. Even before this government effort, however, higher income levels had already provoked a strong surge of home buying among people who finally had the wherewithal to move up to better and more spacious housing.

The increase in rental apartment construction was particularly pronounced in fiscal 1986. Part of this, of course, was the rebuilding of older, run-down apartment buildings, but even more significant was the fact that lower interest rates and preferential taxation treatment made the yield from building or buying rental properties more attractive than that from letting money sit in the bank. Given that the demand for better-quality housing is expected to continue unabated, housing starts will continue strong in fiscal 1987.

### Capital investment

Capital investment enjoyed double-digit growth in both fiscal 1984 and fiscal

1985 as manufacturing industries invested heavily in the plant and equipment needed to meet increasing export demand. By fiscal 1986, however, the slowdown in exports was putting a damper on capital investment.

This has hit manufacturing especially hard, and manufacturing plant and equipment investment is likely to be down across the board, with particularly sharp declines in machinery and steel. Yet capital investment continues healthy in the nonmanufacturing sector for a number of reasons. Electric power and gas utilities have responded to government pleas by stepping up their capital investment; the growing demand in real estate has stimulated increased investment by real estate and construction companies; and the rise in consumer spending has spurred investments by hoteliers, wholesalers, retailers and other service-related sectors.

A September 1986 Japan Development Bank survey of capital investment plans concluded by predicting 5.4% overall growth as the 12% increase in the nonmanufacturing sector more than offsets the 3.6% decrease in the manufacturing sector. Other surveys of capital investment plans have yielded comparable figures. I believe that nonmanufacturing capital investment will remain stable in fiscal 1987 while manufacturing capital investment will begin to recover.

Reeling from the drop in exports and the resultant profit deterioration, manufacturing industries understandably cut back on capital investment in fiscal 1986. However, these industries will have to increase their capital investment and upgrade productivity if they are to cope effectively with the negative effects of the yen's appreciation and to remain competitive internationally. Capital investment by these industries should therefore pick up again in fiscal 1987 as money gets easier and interest rates go lower.

### Inventory investment

Inventory investment was not nearly as big a problem in fiscal 1986 as it should have been given the economy's sluggishness. Although one would expect inventories to pile up with the slow sales inherent to a recession, mining and manufacturing production was down 3.0% in August 1986 and inventories were down 1.9% in August 1986 as compared with August 1985. In large part, this nonballooning of inventories was because industry had foreseen the sales slump and cut back on production accordingly. There is thus no need for abrupt production and inventory adjustments and the hard landing they would entail for the economy. As a result, there should be a gradual spreading of the recessionary ripples in the latter half of fiscal 1986 and a gradual recovery starting in fiscal 1987, but no major fluctuation stemming from inventory adjustment.

## Trade and the international balance of payments

### Exports

Fiscal 1986 exports did much better than most economists had predicted they would. Theoretically, the yen's rapid appreciation should have caused export volume to drop and should have reduced the dollar-denominated value of Japan's exports by the latter half of fiscal 1986 at latest. Yet export volume was still on the rise as late as September 1986, up 3% over September 1985, and the dollar-denominated value of these exports had actually gone up by 29%. While this continued export strength helped to alleviate the appreciation's deflationary impact, it also left intact the problem of Japan's trade imbalance.

I see four reasons why exports increased despite the yen's appreciation.

First, Japanese export products are highly competitive in international markets, and demand is not strictly price elastic. Consequently, it has proved possible to increase export volume even as prices have had to be raised. Dollar-denominated prices on Japanese exports rose by around 20% in 1986, yet export volumes continued to grow for such internationally popular consumer products as automobiles and electrical appliances.

Second, Japanese companies have been willing to cut their yen-denominated export prices in order to maintain export volume, keep their plants operating at near capacity and hence hold down fixed costs per unit. While dollar-denominated export prices have gone up 24%, yen-denominated prices dropped 19% in September 1986.

Third, Japanese exports to Europe have gone up. The European economies are doing well and the appreciation of the mark and other European currencies has helped to keep Japanese exports competitive there despite the loss of price competitiveness in dollar-bloc countries. In 1986, Japanese exports to Europe increased by about 60% over the preceding year.

Fourth, exports to South Korea and Taiwan have also gone up. As South Korea and Taiwan have expanded their exports to the United States, there has been a corresponding increase in these countries' demand for capital equipment and parts from Japan. Japanese exports to South Korea and Taiwan were up by roughly 60% over the past year.

As a result, Japanese export volume maintained its previous level through the autumn of 1986 but should drop off as the effects of the yen's appreciation make themselves felt. At the same time, export profits are hurting from the roughly 20% drop in yen-denominated export value.

### Imports

The dollar-denominated value of imports overall remained fairly stable throughout fiscal 1986. There was, however, considerable disparity by import item.

Imports of manufactures were up. Because the yen's appreciation made foreign-manufactured clothing, automobiles, machinery, chemical products, steel and other products cheaper, imports of these products increased. There was also a major increase in gold imports, but this was a one-shot blip specifically due to the Japanese government's purchase of gold from the United States for the minting of coins to commemorate the 60th year of the Emperor's reign.

The value of oil imports dropped sharply by virtue of the collapse in oil prices. Imports of other natural resources and raw materials were also off compared with the previous year as commodity prices were down and import volumes fell reflecting the economic sluggishness. The combined effect of all of these factors was to keep the dollar-denominated value of fiscal 1986 imports slightly lower than it had been in fiscal 1985.

### International balance of payments

With exports up and imports down, Japan's trade balance for fiscal 1986 threatens to end up with a surplus of nearly $100 billion. Compounding this, Japan's invisible trade balance of payments deficit has shrunk.

Japan's international balance of payments has traditionally had a surplus in trade and a deficit in nontrade transactions, but now that Japan is a major creditor nation, interest and dividend payments have reduced the nontrade deficit. The result has been a current account surplus in excess of $90 billion.

Side by side with this, there has been a considerable capital outflow. Japanese corporations have been channeling funds to the United States, foreign investors have been repatriating their money as Japanese stock market prices fell, and there has been increasing direct investment for overseas manufacturing in response to the yen's rapid appreciation.

**Table 2 Major Economic Indicators**

| | FY 1984 | FY 1985 | FY 1986 (estimate) | FY 1987 (forecast) |
|---|---|---|---|---|
| Nominal gross national expenditures (¥ billion) | 303,156 (6.7) | 321,065 (5.9) | 332,302 (3.5) | 348,917 (5.0) |
| Real gross national expenditures | (5.0) | (4.2) | (2.8) | (4.3) |
| Index of mining and manufacturing output (1980=100) | 118.2 (9.9) | 122.3 (3.5) | 120 (−2.0) | 125 (4.0) |
| Wholesale price index (1980=100) | 100.8 (0.3) | 97.9 (−2.9) | 86.0 (−12) | 86.0 (0) |
| Consumer price index (1980=100) | 112.7 (2.2) | 114.8 (1.9) | 113 (−2.0) | 115 (2.0) |
| Wage-earner income | (5.3) | (5.1) | (4.0) | (4.0) |
| Corporate earnings | (11.5) | (1.4) | (−7.0) | (10.0) |
| Unemployment rate (%) | 2.67 | 2.65 | 2.80 | 2.90 |
| Average interest rate on all bank loans (%) | 6.619 | 6.476 | 5.84 | 5.70 |
| Exports (customs-clearance basis) ($ million) | 169,612 (11.1) | 182,655 (7.7) | 219,000 (20.0) | 230,000 (5.0) |
| Imports (customs-clearance basis) ($ million) | 134,546 (4.0) | 130,086 (−3.3) | 130,000 (−) | 143,000 (10.0) |
| Current account balance ($ million) | 37,015 | 55,069 | 95,000 | 90,000 |
| Long-term capital balance ($ million) | −54,197 | −73,137 | −100,000 | −90,000 |
| Exchange rate (yen to dollar) | 244.19 | 221.09 | 158 | 145 |
| Oil prices CIF ($/barrel) | 29.14 | 27.31 | 14.00 | 14.00 |

Note: Figures in parentheses represent growth rate over previous year (%).

As long as the American economy remains sluggish and the yen strong, exports are unlikely to increase by very much in fiscal 1987. Imports of manufactures, on the other hand, should continue to grow. This will reduce the current account surplus somewhat, albeit by no means eliminate it. More and more Japanese companies can be expected to opt for direct overseas investments.

### Economic policies

Japanese government economic policies for fiscal 1985 and 1986 pursued seemingly contradictory paths. While advocating austerity to rein in government spending and reduce the national deficit, the government has also endeavored to stimulate domestic consumption to reduce the international balance of payments surplus. In fact, the priority was on reducing the national debt, and government spending was actually cut. Unfortunately, the yen's appreciation exacerbated the domestic recession while the nation's international balance of payments surplus continued to soar. To counter this, the government announced in November 1986 that it would seek to rev up the domestic economy with a ¥3.6 trillion pump-priming package. Yet of this ¥3.6 trillion, new government bond issues will be required for only ¥550 billion for disaster relief and ¥150 billion for general public works; the remainder is to come from subsequent-year disbursements, local government budgets, an increase in funding for the Housing Loan Corporation and additional capital investment by the private-sector electric power and gas utilities. Expansionary policies will probably continue in fiscal 1987.

Tax policy is one of the most important means at the government's disposal for stimulating the economy. In the general elections for both Houses of the Diet in the summer of 1986, the ruling Liberal-Democratic Party campaigned on a platform of major personal income and corporate tax cuts. Opinion is sharply divided, however, on how to pay for the tax cut. Among the proposals being advanced are plans to abolish the interest tax exemption on small-amount savings and to introduce value-added taxes. Thus even though personal and corporate taxes may be reduced, this would be offset by a new value-added tax or some other tax increase, with the result that the package is revenue neutral and hence stimulation neutral.

Financial policy has also been marshaled to the cause of economic stimulation and the official discount rate has been lowered four times since the beginning of 1986—the latest 0.5% cut taking it to 3%, the lowest it has ever been. Although the Bank of Japan had been leery of lowering interest rates too much in view of the liquidity-fueled rocketing land prices and rampant speculation in the stock market, pressure from the United States and fears of domestic recession combined to push the bank to lower the discount rate 0.5% in November 1986.

## The Japanese economy in fiscal 1987

Looking ahead, I predict that the American economy will remain in its present slump, oil prices will stabilize at their current low levels, and the yen will continue to advance against the dollar. Given these conditions, what directions can the Japanese economy be expected to take?

The current recession is likely to worsen in the latter half of fiscal 1986 (October 1986–March 1987). Export industries will be ravaged by the yen's appreciation, production will be curtailed, and unemployment will increase. However, the effects of the official discount rate cut and the government's economic stimulation package (both November 1986) should begin to show up in fiscal 1987. We should also see significant benefits from lower yen-denominated prices for oil and other commodities. Consequently, the recession should bottom out and the economy pick up in the first half of fiscal 1987 (April–September 1987).

This is not to imply that there are no problems. For one thing, Japan will continue to run a balance of payments surplus and trade friction will persist. The United States, for example, is unlikely to stop complaining about its trade deficit with Japan, and Japan will have to make greater efforts to further open its markets, including agricultural products.

Another problem is that the yen's rapid appreciation is forcing contraction in shipbuilding, steel, coal and a host of export-oriented small business sectors. Inevitably, the massive industrial restructuring that ensues will take its toll in bankruptcies and unemployment. This will, however, be largely offset as prices remain stable and the terms of trade improve as a result of the yen's continuing strength and oil prices' continuing weakness. There should also be a wave of technological innovation centering on electronics and a mushrooming of new service industries.

With the worst over in the difficult process of adjusting to yen appreciation by the end of fiscal 1986, fiscal 1987 should be a year of recovery in the Japanese economy. While growth is unlikely to be much more than 2.5% in fiscal 1986, it should be possible to achieve 4% growth in fiscal 1987. ●