

# O utlook for The Japanese Economy

By Nobuyoshi Namiki



The year 1988 will be one of economic turmoil for Japan and the world. That would seem a foregone conclusion simply from the worldwide collapse in stock prices following the October 19 crash on Wall Street. Yet a rerun of 1929 is out of the question. The world economy in the latter half of the 20th century is structurally different from that of the first half. The Japanese economy, despite global economic uncertainties, is expected to achieve GNP growth of the order of 3.0-3.5% in the year ahead. Indeed, a growth rate of some 3.5% is likely over the longer term.

This analysis of the Japanese economy is in three parts, starting with the position of the 1988 economy in the post-oil crisis period. The second part offers an explanation as to why the "structural recession" caused by the yen's rapid rise after the G-5 agreement of 1985 has had such a relatively mild impact. It concludes with a discussion of some of the problems affecting the economy in 1988 and beyond.

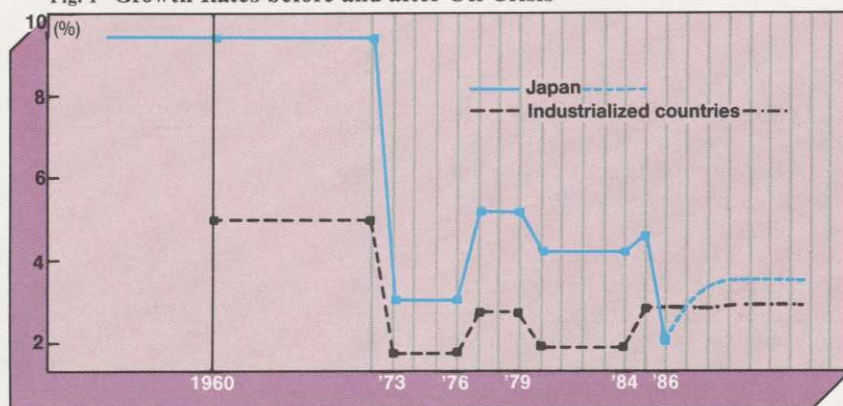
## The position of the 1988 economy in the post-oil crisis years

GNP growth rates in Japan and other industrialized nations as a whole for given periods before, during and after the oil crisis clearly illustrate some of the year-to-year trends in the industrialized economies (Fig. 1).

As shown in Fig. 1, the second half of the 20th century has been a period char-



Fig. 1 Growth Rates before and after Oil Crisis



acterized by high economic growth and an oil crisis. The period of oil crisis in its narrowest sense lasted 11 years from 1974 to 1984. We are now in the post-oil crisis period which began in 1985.

Yet even the present period is not immune to the effects of the oil crisis period. We are still in the oil crisis period in a broader sense. This period is likely to continue virtually unchanged until around 2000. A new economic cycle will likely begin in the 21st century.

The economic cycles underlying modern society can be divided into three periods. The first, from 1825 to 1913, saw panic and recession as well as growth. The second period, lasting from 1914 to 1946, saw two world wars and the Great Depression. The third period, starting in 1947, is our own, marked by high growth and the oil crisis. In each period, economic structure and the rules governing economic development have varied. From this naturally flows the conclusion that a violent upheaval like the Great Depression will not, and cannot, be repeated in the present period.

Few economists in Japan or abroad have espoused this view. If the aim of economics is to describe how economic structure and the laws governing its development change over time, then it has failed to achieve its goal. While Joseph Alois Schumpeter and John Maynard Keynes based their analyses on the Great Depression, they cannot be said to have analyzed the economic characteristics of the second period. Schumpeter borrowed the conventional analytical tools developed during the first period, and Keynes merely supplemented this by explaining the reasons for unemployment. Unemployment existed in the first period, but was ignored by economists then analyzing cycles. Thus even the most noted economists of the times have failed to analyze the second period, and all we have with respect to the third period are descriptions of what happened. There is no fundamental analysis. Milton Friedman's explanation of the oil crisis period is wrong.

In the high growth period (Fig. 1) the GNP growth rate averaged 9.5% in Japan and 5% in the industrialized countries

overall. In the oil crisis period, however, the growth rate dropped to 4% in Japan and 2% in the industrialized countries, just 40% of the rates in the preceding period.

The slowdown was due to a lack of technological innovations and the way in which industrialized countries reacted to the oil crisis—through downward “stock adjustment.” Stock adjustment in this case meant that corporations affected by the energy crunch restricted capital spending and cut back on inventories, while consumers postponed home construction and purchases of durable goods like cars, furniture and electrical appliances. Once the storm was over, both corporations and consumers scrambled to stock up. The result was a sharp rebound after the first and second oil shocks (Fig. 2). But inevitably this was followed by slower growth.

The developing and centrally planned economies were governed by different laws of development. Economists around the world believe the “deflationary gap” theory, but this fails to explain developments in these economies. Only the stock adjustment theory can explain the movements in Fig. 2. It was this pattern of sharp fluctuations in the growth rate that characterized the economic cycle during the oil crisis period in the narrow sense. Such a fluctuating pattern had not existed in previous times.

As for medium-term growth rates after 1985, Fig. 1 projects an average rate of 3.0% in industrialized countries generally and 3.5% in Japan. In Japan's case, however, the real growth rate was 2.6% in fiscal 1986, while the rate for fiscal 1987 is estimated at 3.2%. This was due to the impact of the sharp rise of the yen follow-

ing the G-5 agreement of September 1985 which set the stage for a correction in the overvalued dollar. This “structural recession” caused by the rising yen kept the growth rate below the 3.5% estimate. For fiscal 1988 the economy is expected to achieve growth of 3.0–3.5%.

The 3.0% rate forecast for 1985 and beyond in the industrialized countries as a whole is based on the assumption that the 3.0% average growth achieved in 1977–79 will be maintained in the post-oil crisis period. In Japan's case, a downward correction is in order because of the artificially high growth achieved during the oil crisis period. Japan's GNP grew by 5.2% in 1977–79 as a result of large-scale deficit financing. That rate was too high, and should go down in the post-oil crisis period. In other words, the 3.0% and 3.5% forecasts represent a kind of “natural” growth rate.

### The mild impact of the strong yen

The average yen rate for fiscal 1985 was ¥221 to the dollar. In fiscal 1986, however, the rate shot up to ¥160, while the average for fiscal 1987 is estimated at slightly less than ¥140. The yen's sharp appreciation has posed a serious challenge to the Japanese economy. In 1986, for instance, the growth rate in Japan dropped below the average for the industrialized nations (Fig. 1).

In 1987, however, Japan's growth rate is believed to have exceeded the average for the industrialized nations, a pattern that is expected to continue in 1988. This is a fairly good performance, given that the yen has risen about 15% more against the dollar than have other currencies. As a result, Japan's exports dropped 3.2% in real



terms in fiscal 1986, and a similar decline of some 3% is expected for fiscal 1987. In fiscal 1988, real exports are likely to fall about 3% as the yen rate continues to rise.

The average yen rate for fiscal 1988 should be slightly below ¥130 as the current account balance of payments will register a large surplus during the fiscal year of the order of \$85 billion. The U.S. current account deficit will also show little improvement. Japan's trade surplus with the United States will probably decline slightly in fiscal 1988.

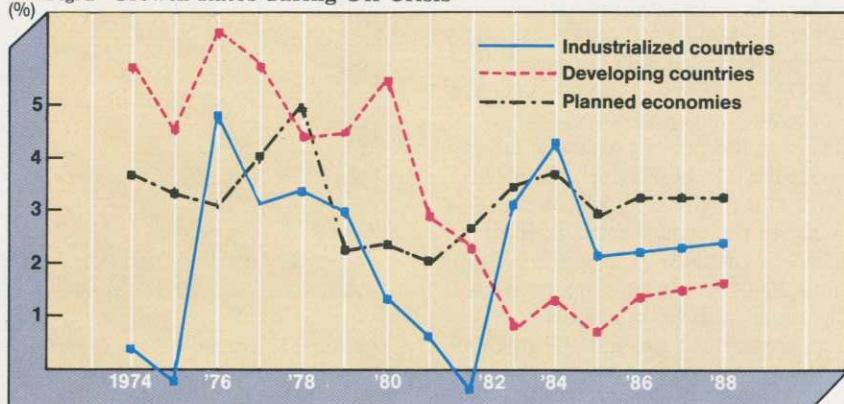
Meanwhile, Japan's imports are expected to rise steadily through both fiscal 1987 and 1988. On current estimates, imports will expand 15.7% in value in fiscal 1987 over the year before to \$145 billion. In fiscal 1988, they will increase a further 9.0%, to ¥158 billion. The slower rate of increase in the value of imports is due to slower increases in import prices. In quantitative terms, the rate of growth is expected to climb from slightly below 6% to a little below 7%.

Despite lower export volume and higher import volume, Japan's real rate of GNP growth is expected to rise. The reason, of course, will be continuing expansion of domestic demand. The underlying factor contributing to this expansion of internal demand and the easing of the "structural recession" induced by the high yen is capital gains from stock investment and rising land prices.

The main thrust of growth in domestic demand is being provided by household spending, expanded housing construction and the rise in public investment. Private capital investment is also on the upswing. This is somewhat surprising, considering the structural recession brought on by the yen's rapid ascent.

Household spending increased 3.0% in fiscal 1986 and is forecast to rise 3.3% in fiscal 1987. An increase of the same order is expected in fiscal 1988. Payroll income is leveling off, and a similar trend is predicted for the year ahead. But the propensity to consume will rise in both fiscal 1987 and 1988, thanks to increases in the appraised value of assets. Increases in stock and land prices from fiscal 1986 to 1987 are estimated to reach 1.1 to 1.4 times the value of GNP. Gains from these

Fig. 2 Growth Rates during Oil Crisis



higher values are thus pushing up household spending.

This is part of the reason behind the strong expansion of residential construction. Housing starts reached 1.4 million units in fiscal 1986 and are expected to rise further to 1.6 million in fiscal 1987. This strong trend is expected to continue into fiscal 1988. Supporting the brisk demand for housing construction is the building of rental units, which are expected to reach 830,000 in fiscal 1987. It is doubtful, however, whether this can continue in fiscal 1988, as the stock market upheavals in October 1987, by reducing asset values, may dampen spending. Land prices are expected to rise only moderately in 1988 compared with the previous year, and stock price rises are also likely to be limited.

Public investment, which will increase an estimated 12% in fiscal 1987, will likely gain 10% in fiscal 1988, since the need to stimulate domestic demand will remain strong. Private-sector capital spending is also expanding in the nonmanufacturing sector, making up for the slowdown in manufacturing industries. Such investment is estimated to rise a little less than 6% in fiscal 1987, and should grow even faster in fiscal 1988.

### Problems for the Japanese economy in 1988 and beyond

Three major problems face the Japanese economy in 1988 and beyond.

The first concerns trends in asset in-

vestment. If capital gains from stock and land price increases are no longer assured, consumption, investment and tax revenue could all decline.

The second problem relates to the twin deficits in the United States. How will cuts in the budget deficit affect U.S. economic expansion? Will foreign investors lose confidence in the dollar if the current-account deficit remains disturbingly large, with little progress being made toward significant reductions? And how will rising interest rates in the United States affect the U.S. and world economies? When will these effects manifest themselves? What, for instance, will be the psychological impact of the seemingly unavoidable drop in private savings?

The third problem is that of the debt crisis in developing countries. This potentially destabilizing situation remains unresolved.

These three problems, despite their severity, are not likely to have very much effect on the Japanese economy in 1988. Depending on how they develop, they could, however, make it difficult for Japan to achieve the forecast 3.5% growth rate. Yet over the longer term, these problems notwithstanding, Japan should be able to achieve 3.5% average economic growth.

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