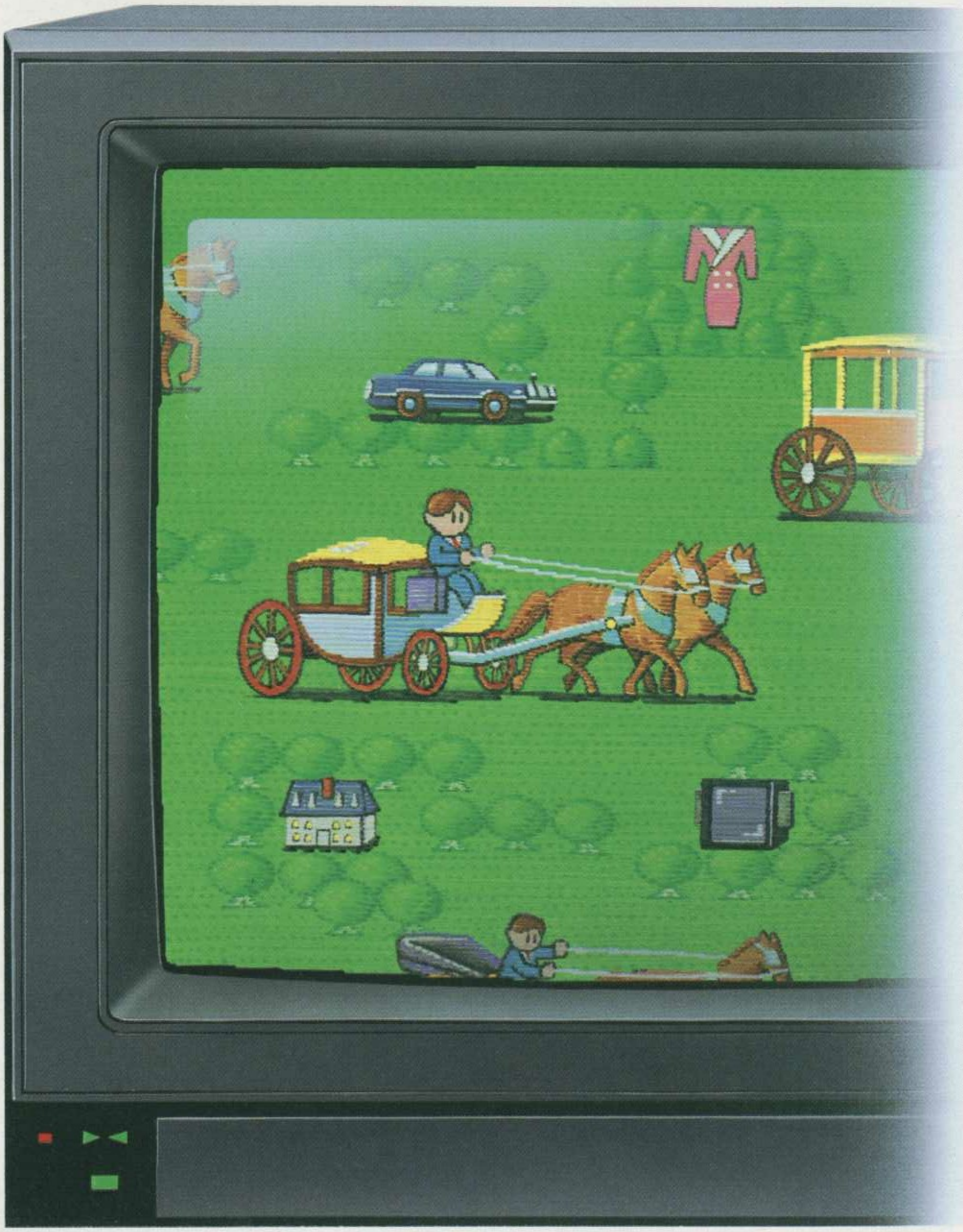
# The Japanese Economy In 1989

## Constraints And Challenges

By Yutaka Kosai



The Japanese economy is expected to enter its third consecutive year of expansion in 1989, sustaining the steady growth led by domestic demand that began in late 1986. The economy started expanding rapidly in all the key areas of domestic demand–consumption, plant and equipment investment, inventory investment, housing construction and public works investment–from 1986 to 1987.

In 1988, however, the pace slowed in three of the five areas–public works investment, housing construction and inventory investment. This was because no expansionary supplemental budget was compiled that year. Extra spending budgets of this type had been prepared in the autumn of 1986 and again in the spring of 1987. Tax cuts propped up consumption, but residential construction lost some steam in 1988.

One conceivable reason is that the land price spiral had reached a peak. Previously, housing starts had reached an annual rate of 1.8 million units, exceeding the level in the United States, which has a population twice as large as that of Japan. Demand in this area had spurted against a backdrop of soaring land prices and a historically low level of interest rates.

Inventory replenishment had been held down before the economy entered an expansionary phase, but it picked up momentum as demand followed an upward trend. After more than a year of economic expansion, the inventory buildup reached a sufficiently high level to support the economy's growth. At such a stage inventory investment can be maintained at a lower rate of expansion, a rate corresponding to the growth of production. As a result, such investment begins to slow down. That is what happened in 1988.

The economy of 1987 may be likened to a cart drawn by five horses. In 1988, however, three of the five horses retired, so to speak, with only the remaining two left drawing the cart. It was thought that the rate of economic growth consequently would fall considerably in the ensuing year. In fact, however, the economy as a whole continued to expand vigorously in 1988, despite the slowdown of demand in some key areas. The reason for this is that two demand components–consumption and plant and equipment investment–expanded faster than before. Moreover, exports began expanding in the middle of the year, thus contributing further to the growth of GNP.

Consumption and investment trends will have an important bearing on the economic situation in fiscal 1989 and the rising trend of consumption can be reasonably expected to continue.

## Demanding raises

The marked rise in corporate earnings is likely to strengthen wage demands from unions. The unemployment rate has continued to drop, with job offers through public employment offices exceeding applications. Strong demand in the job market is likely to put upward pressure on the rate of wage increases. The growth of employment is expected to become more pronounced since corporate efforts to meet increasing labor requirements through overtime work are reaching the limit. Under these circumstances, worker income is expected to rise at an accelerated pace. Given, moreover, the almost certain prospect of continued price stability, it is likely that consumption in real terms, after allowing for inflation, will expand even more strongly than it did in 1988.

Spending on consumer durables showed marked growth in 1987–88 in reaction to self-imposed restraint in the first half of the 1980s. The rate of increase will probably slow a bit in the year ahead but will stay at a high level nonetheless. As for spending on nondurable goods, the rate of increase is expected to accelerate.

Business spending on new plant and equipment will likely continue at a high level in 1989, but it is doubtful that the rate of growth will exceed that for 1988. Consumption, not capital investment, is likely to provide the main thrust of economic growth in the year ahead. This means that the growth pattern of the Japanese economy is reaching a higher stage of maturity.

Exports, which contributed positively to economic expansion in 1988, are expected to slow down in the year ahead. An expansion of exports would slow the contraction of the current-account surplus, exerting greater pressure for further appreciation of the yen. A higher yen rate, however, would not have a negative impact on the economy as a whole because it would help to stabilize domestic prices and increase real income.

Thus the Japanese economy is expected to continue its steady expansion in fiscal 1989. The economy will stay on course even if the rate of growth drops below that for fiscal 1988. All things being equal, GNP will probably grow anywhere between 4.5% and 5.0% in fiscal 1988, ending March 1989, and between 4.0% and 4.5% in fiscal 1989.

Developments in the world economy, however, particularly in the U.S. economy, could destabilize the Japanese economy. The U.S. economy, in line with that of the world as a whole, followed an expansionary course in 1988. Still, two major challenges loom up ahead. One is the prospect of inflation. The task here is to combat inflation and higher interest rates resulting from it. The other challenge concerns the twin U.S. deficits. The critical question here is how the new U.S. administration will tackle the enormous trade and budget deficits.

## Fearing inflation

Inflationary fears in the United States cannot be ruled out, given the low jobless rate and the high rate of capacity utilization. Thus far inflationary expectations have not come true, partly because the inflationary mood was suppressed by preemptive interest rate rises, and partly because the world price of oil followed a downward trend. But an economy that is moving too fast runs the risk of triggering a wave of reactionary interest rate hikes. It is desirable, therefore, that the expansionary pressure on the demand side should be eased through a gradual reduction of the budget deficit.

The hope is that the deficit will be drastically reduced by the early 1990s, as stipulated in the Gramm-Rudman budget-balancing law. An abrupt change to a tight fiscal policy, however, would have a deflationary impact on the U.S. economy. A resultant recession would cause shortfalls in federal tax revenue and could further inflate the deficit.

In the long term, though, there is a good possibility that the United States will regain fiscal health, for two reasons. First, the growth in military expenditures will reach a peak. Second, social security contributions will increase. For this regained fiscal health to become a reality, however, it is essential that the new U.S. administration formulate an effective program to achieve steady budget cuts and succeed in averting either an overheating of the economy or a recession.

A resurgence of inflation or a recession in the United States would inevitably have serious effects on the world economy, and the Third World and the newly industrializing economies (NIEs) in Asia would be hit particularly hard.

How should Japan respond to such developments? The answers are clear enough. First, Japan should defuse the danger of global inflation by expanding its supply capacity. The Asian NIEs can play a similar role, albeit to a lesser extent. An increased supply of Japanese funds would apply the brake on moves toward interest rate rises worldwide, as in fact it did in the summer of 1988. A global recession can be avoided if Japan creates more import demand through expansion of domestic demand and further liberalization of the domestic market, much as the U.S. market has absorbed imports from other parts of the world in the past. In short, Japan should be the bastion of stable economic growth in the world. That is why the expansion of the Japanese economy led by domestic demand must be continued in 1989. In fact, this is a task which the Japanese economy is now in a good position to achieve.

Japan's economy is following a course of self-sustaining expansion. Should the world economy slide into recession, Japan would be able to ease the impact through a mix of appropriate policy responses including increased government spending. The budget deficit has decreased rapidly during the past two years of economic expansion, which has substantially increased tax revenue. As a result, the Japanese government now has more elbowroom in the conduct of fiscal policy.

## Playing a role

The Japanese economy, as described above, is in a position to provide the underpinning of stable growth in the world economy. In the longer term, Japan also has a major role to play in maintaining the free trade system. History shows that it is difficult to promote free trade unless the leading surplus nation is willing to make positive efforts in that direction. This is exactly the kind of role Japan must play now and in the future.

America and Canada have concluded a free trade agreement designed to eliminate tariffs between the two countries 10 years from now. Meanwhile, the European Community plans to remove internal trade barriers through the creation of a single market in 1992. These moves have created the impression in Japan that the country is "missing the bus." In fact, many informed people see Japan as being left behind in the global trend toward economic regionalism. They argue that in order to keep abreast of the trend of the times Japan should form its own economic bloc with countries in Asia and the Pacific. Such a desire to avoid "isolation" is understandable.


Photo: JETRO

A fair promoting imports from the NIEs, which together with Japan form the fastest-growing economic region in the world.

It is premature to think, however, that the U.S.-Canada agreement and economic integration of the EC will lead to the breakup of the world economy into regional blocs. Japan and the neighboring NIEs in Asia comprise the fastest-growing economic region of the world. It would be in no one's interests to isolate this region from the rest of the world economy. Japan and the Asian NIEs ought to have greater self-confidence. Trade between Japan and the EC is expanding as rapidly as trade between Japan and the NIEs. The fact is that trade relations worldwide are becoming closer than ever before. America and Western Europe should know full well that they would gain nothing from isolating the high-growth Asia-Pacific region.

The growth potential of this region lies in its diversity. Asia consists of nations in different stages of economic development, from one highly industrialized country to others that are rapidly industrializing and yet others which are only now beginning to industrialize. The region also includes a great continental country, archipelagic countries, peninsular countries and a city state. The existence of such diverse and interacting economies is the key to economic growth in Asia.

Integration of the EC variety, for example, would have little meaning in this region. It would be far better if the region's diversity was put to constructive use through a combination of free competition and multilateral cooperation.

Japan's economy is increasing its weight in the world economy as the 1990s approach. This makes it all the more important for Japan to maintain its steady growth, with domestic demand in the lead, and make positive efforts to promote the free trade system. In fact, the Japanese economy is in a good position to meet this challenge as it moves into the final year of the 1980s.

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# Growth Rate Set for a Slowdown

By Kazuaki Harada

The yen appreciated against the dollar about 100% in the three years following the Plaza Accord of September 1985. Initially, the yen's rapid rise created fears of a recession. As it turned out, the economy practically absorbed the deflationary impact of the high yen by the end of 1986 and entered a recovery phase in 1987, and that set the stage for a period of sustained growth that has continued ever since.

The real rate of growth of GNP, adjusted for inflation, climbed from 2.6% in fiscal 1986 to 4.9% in fiscal 1987. On current estimates, the rate of growth for fiscal 1988 will be about 5%. This continued growth has been made possible through the expansion of domestic demand. Interesting changes have occurred in the composition of demand, and it is important to take note of these changes in looking at the Japanese economy in the year ahead.

In fiscal 1987, the first year of recovery, public works investment and private housing investment—two demand components strongly affected by public policy—made up 2.1 percentage points of the 4.9% GNP growth. Individual demand in the form of consumer spending and housing investment contributed 3.4 points to the overall growth. Thus individual demand gained from the continuing appreciation of the yen and thereby provided the main pillar of the economy in fiscal 1987. In addition, supportive action on the fiscal and monetary sides helped to sustain the expansion.

In contrast, in fiscal 1988 it was business investment that pulled the economy along. Of the estimated GNP growth for the year of 5%, nearly 4 percentage points is expected to be generated through increases in capital investment and inventory investment. Thus economic expansion in fiscal 1988 has been supported chiefly by corporate investment.

Three reasons can be given for the surge of private-sector investment. First, businesses have been responding positively to the yen's appreciation by step-