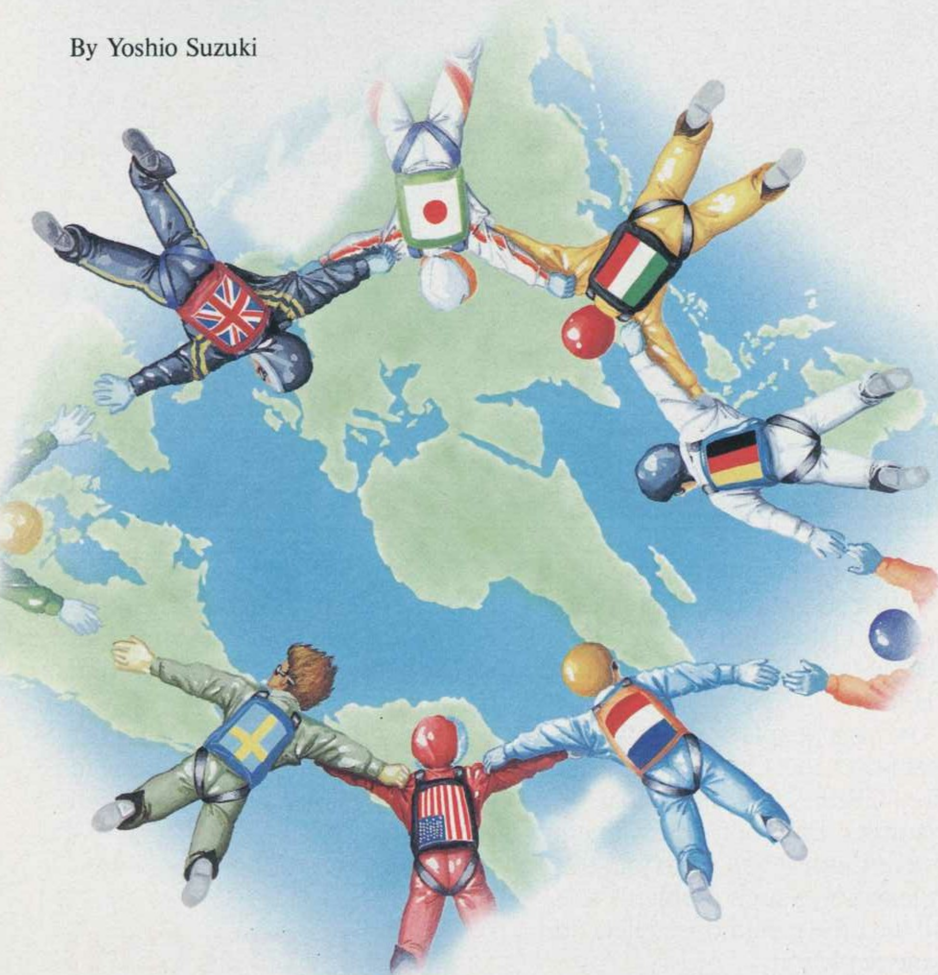
A Comfortable Pace In 1991

By Yoshio Suzuki



There are three main points to be considered in looking at the Japanese economy in 1991: the Gulf crisis, Bank of Japan policy and the world economic climate. As a result of the crisis sparked by Iraq's invasion of Kuwait, oil prices have soared and this may cause inflation in Japan, which in turn would trigger Bank of Japan policies to produce an offsetting deflationary impact.

In 1989, the Bank of Japan raised the official discount rate three times. In 1990, it raised it twice more–making a total of five hikes and pushing Japanese interest rates very high.

The international economic environment is the third question. There is a strong likelihood that the United States will be in a recession, and Germany will also see its growth rate slowed as it tries to digest the five provinces that used to be East Germany. This is unlikely to be offset by stronger growth in the rest of Europe.

Impact of Gulf crisis

Looking first at the Gulf crisis, oil prices jumped to over $40 a barrel but subsequently fell to around $30. The reason they topped $40 was that traders were worried about the possibility of a military clash that would destroy oil facilities and generate shortages. This was a speculative jump. The basic supply-demand balance argues for prices around $20 a barrel, and there are no fundamental reasons for going to $40. Oil was less than $20 a barrel for the last three years of the 1980s, and OPEC was making an effort to get prices back to at least $21 a barrel when the crisis erupted. Iraq argued for $25, but most of the other producers pushed for $21. Either way, somewhere in the $21–25 range seems reasonable.

Because the producing countries still have considerable excess capacity and the consuming countries have strong reserves, the world can get along without Iraqi and Kuwaiti oil and the economic

blockade can work. Even though those two countries were exporting four million barrels a day, Saudi Arabia and the other producing countries are able to meet 80, 90 or even 100% of the shortfall. So the supply-demand balance argues for between $20 and $30. Even when the spot market was topping $40, the price for one-year futures was $26.

Right now, it looks as though it might be possible to settle the Gulf crisis peacefully, in which case oil will hold at under $30 a barrel. If—and this is an unlikely if—there is a shooting war, it could still be over in a couple of weeks without that much damage to the oil facilities if the United States used its modern military technology. The facilities that were damaged could be put back in operating condition fairly quickly, and oil would come back to under $30—even though it would probably be much higher while the fighting was going on. So in looking at the economy for 1991, I think we can assume that oil will be priced between $20 and $30 a barrel.

Assuming an average of about $25 and plugging that number into the economy—bearing in mind that the average price of oil in 1988 was $18 a barrel—the wholesale price index would be up 1.0 point and the consumer price index 0.5 point. Even if oil goes up to $30, we are still talking about a wholesale price increase of 1.8 point and a consumer price index up 0.9 point. Since the wholesale price index was up 0.6% on a year-to-year basis right before the outbreak of trouble in the Gulf, this would still be only 2.0% or so on a year-to-year basis even if the price of oil went up to $25 or $30. Likewise, consumer prices (not counting perishables) were up around 2.2% on a year-to-year basis right before the crisis, so an oil price of $25 to $30 would put it around 3%.

There are a number of reasons why higher oil prices have so little impact, but the biggest one has to be that the price hikes themselves are much smaller than they were during the two oil crises of the 1970s. Then oil prices were up three- and even four-fold. This time it is between 40% and 70%. The other reason is that Japan has made considerable advances in oil conservation. Taking 1973 as 100, oil consumption per unit GNP was 79.6 in 1979 during the second oil crisis and 46.3 in 1989. In effect, Japan is now able to achieve the same growth with less than half as much oil as it needed in 1973—and 40% less than it needed in 1979.

At the same time, the yen is also appreciating, which tends to stabilize domestic prices in Japan. Even if oil goes up to $25/barrel, this is offset if the yen rises to ¥135/$. Since the yen was ¥150/$ when the Gulf crisis broke out, ¥123/$ would cancel out the average price hikes even if oil went to $30 a barrel. So the question is what the yen will do this year. If it is around ¥120/$, average domestic prices will decline to the same level even with $25-30/barrel as they were before the invasion of August 2, 1990.

War and inflation

Japanese interest rates started to come down at the end of October 1990. The market yield on the government index bond had been up to 8.5%, but fell to 7.7% in October. Likewise, the long-term prime rate came down from a peak of 8.9% in October to 8.3% in November. This decline in interest rates is premised on the assumptions that it will be possible to find a peaceful solution to the Gulf crisis, that oil prices are unlikely to go much higher than $30/barrel, and that higher oil prices will be offset by the yen's exchange strength.

There is, of course, considerable uncertainty over what will happen in the Middle East, but the current outlook is for higher oil prices to have virtually no impact on the Japanese economy in 1991. There are, however, two reservations.

One is the lingering danger of a military clash—especially the possibility that the United States will be unable to deliver a quick knockout punch and that the conflict will develop into a protracted quagmire including massive destruction of Middle East oil fields. All bets are off in this worst-case scenario. If this happens, oil will stay at more than $30/barrel and higher prices will have considerable impact on the Japanese economy. While I think this is a less-than-10% probability, it cannot be entirely ruled out.

Inflation is the other reservation. Although I do not think there will be much inflation as a result of higher prices overseas, there is the danger that they could trigger inflationary forces in Japan. Because the Japanese economy is doing so well, it does not have much excess capacity and there are some companies and industries suffering from labor shortages.

In 1990, the Japanese economy achieved 5% or better growth for the fourth straight year. Although the July-September figures are the latest ones available as of this writing, they were already 4.6% over the fiscal 1989 level. So even if things just held steady for the remaining two quarters, fiscal 1990 would show 4.6% growth—and in fact it is bound to be better than just holding steady. The

Recent Economic Statistics

	1990						
	May	June	July	Aug.	Sept.	Oct.	Nov.
Oil prices (Dubai in Tokyo) ($/barrel)	14.11	13.72	17.13	24.0	35.15	30.35	28.60
Industrial production (% increase over the year)	4.3	3.0	7.0	5.5	5.3	7.6	
Yen/dollar exchange rate (¥)	151.75	152.85	147.5	144.5	137.95	129.35	130.15
Market yield of index government bond (%)	6.93	7.34	7.58	8.13	8.68	7.76	7.42
Consumer prices (Tokyo) (% increase over the year)	2.7	2.3	2.5	3.0	2.8	3.1	

Photo: Kyodo News Service

A vote in the U.N. Security Council. Japan continues its own internal debate on how it should contribute to U.N. peacekeeping activities.

trend is accelerating. For example, industrial output for October increased by 2.5% over the previous month. Even if the growth rate decelerates in the second half of the fiscal year, we are assured of 5% or better growth in 1990–both calendar year 1990 and fiscal 1990.

Japan's medium-term growth path is 4.0 to 4.5% per year. The average for the 1980s was 4.1%. Four years of strong growth has produced labor shortages, tight supplies and other problems. Unless these issues are addressed, we could well have either wage-push inflation if wages go up or demand-pull inflation if production does not grow 5%. To avoid this, we have to bring the growth rate down to its potential growth path of 4.0 to 4.5%. Thus it was that the Bank of Japan raised the official discount rate five times–although the last time was also in part to head off the inflationary impact of the Gulf crisis. A lot will depend on how effective these rate hikes are. If the growth rate cannot be brought down enough, we are in for a bout of domestically inspired or "homemade" inflation and still-higher interest rates, the upshot being that the economy may go into recession sometime in late 1991.

If consumer prices are up more than 3% over the previous year, the spring wage negotiations will probably see labor demanding higher wage hikes to offset these price hikes. And management may well give in to these demands. If so, this would come back to push consumer prices higher after April 1991, which would have an impact on the 1992 wage negotiations to put us in a wage-price spiral leading to creeping inflation. The 3% line is critical here. If consumer prices are up less than 3%, the labor unions are not going to make a big issue of this in their spring wage offensive. But if it is over 3%, this becomes an issue.

But with the yen's exchange strength, I do not see how imported inflation would push consumer prices up past the 3% level. Rather, the only thing that would push us over the 3% line and trigger creeping inflation would be homemade inflation–in which case the Bank of Japan would be forced to act and interest rates would go up. But if these five rate hikes to date and the higher interest rates that have resulted can bring the growth rate down to a normal 4.0 to 4.5%, there will be no need for further tightening and the economy can keep going as it is. This is the best-case scenario.

International economic climate

The third factor is the 1991 external economic climate. Looking first at the United States, U.S. economic growth was a feeble 0.4% in the April-June quarter before the Gulf crisis. With the Gulf crisis, the price of oil has gone up and the U.S., not being as oil-conservative as Japan is and having shut down a lot of its high-cost domestic wells when oil was under $20/barrel, has become more dependent on imported oil than it used to be. Higher oil prices are having a stronger impact on U.S. consumer prices than they are on Japanese consumer prices. U.S. real purchasing power is declining as prices go up and real domestic demand can be expected to slow.

There were already signs of recession before the Gulf crisis, and now it looks even worse. I would not be surprised to see negative growth in the October-December 1990 quarter and the January-March 1991 quarter. Two consecutive quarters of negative growth, of course, is the definition of recession. But I doubt if things will keep getting worse. First, the dollar's depreciation will make U.S. exports cheaper and help export growth. And imports will be down in the face of recession. Both of these factors will serve to sustain U.S. demand, so the recession will not be that deep. The second reason is that it will prove impossible to make radical cuts in the fiscal deficit. This is cause for concern over the medium term, but in the short term it means that demand will also be sustained by government fiscal policy.

There are thus two supports–one the benefits of higher exports and lower im-

ports, and the other the continuing public-sector demand. There is a strong likelihood of recession, but little likelihood of a deep recession. Inflation will probably be under control by the second half of the year, interest rates will start down around the turn of the year, and the economy will start to recover in the second half of 1991.

Looking at Europe, West Germany had been maintaining very strong growth, creating problems of tight supplies and a tight labor market. For 1990, growth was about 4%. In 1991, it is expected to be around 3.5%. But now that they have united with what used to be East Germany, things are different. East German manufacturing was not competitive, and a lot of plants have been shut down there. Manufacturing output is probably down to about half what it was. As a result, the growth rate for united Germany will probably be 3% or less. The rest of Europe–Britain, France, Italy and the rest–are also likely to see slower growth. So the overall overseas climate will be worse in 1991 than it was in 1990.

The question is what impact this will have on the Japanese economy. It is bound to have some, but there are two mitigating circumstances. The first is that Japan is not as dependent on exports as it used to be. Japanese growth is domestic demand-led, and the external demand contribution to growth is already negative. The second factor is that domestic demand is already too strong and we are worried about homemade inflation. So the deterioration in the overseas climate could actually have a beneficial impact on the Japanese economy by decelerating growth and thus prolonging the expansion. The deterioration in the overseas climate is nothing to worry about in 1991.

The only serious concern for Japan is that if the U.S. goes into recession and prices keep going up, interest rates will also stay high, meaning a sharp deterioration in U.S. corporate earnings. In the 1980s, U.S. companies were active players in the M&A (mergers and acquisitions) game. This is coming home to roost. These companies are heavily leveraged, and if interest rates stay high even as the economy slips into recession, you will see a lot of interest pressure on profits. You will see bank balance sheets deteriorating. Not only will this hurt Latin American economies where the U.S. banks are heavily exposed, but it will also threaten the U.S. banking system.

The banking system is already under pressure from the S&L (savings and loan) crisis, and this would be additional pressure. If worse comes to worst, you might see a market crash or a credit crunch in the United States. This would force Japan to lower interest rates, if only temporarily, to prevent the dollar free-falling and market chaos. We would be back to October 1987's Black Monday, but this time in spades. This is a very real concern, but it is my only concern about the overseas climate in 1991.

Which scenario?

Which scenario will it be? I suspect the growth rate will decelerate starting in the October-December quarter and going into 1991. Interest rates have already turned the corner. Personally, I suspect the interest pendulum has swung too far, and I would not be surprised to see index bonds around 8.0% and the long-term prime around 8.5% again in 1991. These rates are bound to put a crimp in the expansion in plant and equipment investment. Right now, capital investment plans call for 15% growth–about the same as the previous year. This has to come down a little.

Lending is also down, both because the Bank of Japan has told the banks to cut back on their lending and because the banks are having to scale back to meet the BIS (Bank for International Settlements) capital adequacy requirements. In addition, the Bank of Japan and Ministry of Finance have started regulating real estate-related lending. As a result, in the July-September quarter, the money growth rate over the previous period was down to 6.5%. This 6.5% is a very slow growth, and the main reason is the pressure to hold down lending. This is also having an impact on capital investment and housing investment.

And third is the psychological factor that, with the five official discount rate hikes and the tense situation in the Gulf, companies are becoming more cautious in the face of uncertainty over what the future holds.

With these three factors, capital investment is gradually coming down from 1989's 15% growth. For fiscal 1990, capital investment will probably be only about 12 to 13%. For fiscal 1991, it will probably be down to about 7 to 8%.

Housing investment is another important consideration, and this is also expected to go down gradually. But there are also a number of very strong areas, one of which is personal consumption. As seen in the sales of department stores nationwide, personal consumption in September was up a strong 9.6% over the previous September. Because Japanese personal consumption is not that credit-dependent, higher interest rates and slower lending do not have much of an impact. Personal consumption is far more influenced by the growth in employment and steady wage increases, and these factors are unlikely to change in 1991. Even if the growth rate goes down a bit, it will still be sustained by strong personal consumption, and 4.0 to 4.5% is a very reasonable range.

This is the scenario I like. If it errs anywhere, I suspect it is on the cautious side. I cannot see growth being any lower than this, but it might be higher. If the growth rate does not decelerate enough and we face a round of homemade inflation, that would force the Bank of Japan to raise interest rates again in 1991 and the result would be recession going into 1992. Still, there is zero chance of a recession in the first half of 1991. Right now, we are in the second-longest expansion in postwar history, and I would be very surprised if this did not pass the old record in August 1991. If, contrary to expectations, the growth is slower than it should be, then public-works investment would come into play. This is just one more reason why it is so very unlikely that we will have a recession in 1991.

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