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 stepping up high-tech investments aimed at technological innovations and by reorienting themselves toward domestic demand through diversification into new fields. Second, the return on total assets began to rise in the second half of fiscal 1987 while procurement costs dropped markedly. These developments applied strong "leverage" to investment. Third, expectations of a higher growth rate accelerated the pace of investment.

Strong measures to expand domestic demand were taken during fiscal 1987 in response to mounting calls, both at home and abroad, for a higher rate of domestic growth. These measures proved effective, with production and sales expanding rapidly from mid-1987 on. Businesses became more confident about economic prospects than at any time in the past several years.

Investment falloff

How will the economy fare in fiscal 1989? To state the conclusion first, the rate of GNP growth is likely to fall from the 5% or so that has been registered in the past two years to about 3.5%. The main reason for the slowdown is an expected falloff in corporate investment. Thus far, the growth of domestic demand has been fairly rapid; the growth of short-term supply, particularly production, has been even more rapid. As a result, business inventories are reaching high levels.

Accelerating the growth in inventories is the rapid influx of imports of manufactured goods. The surge of domestic demand has, as expected, encouraged imports. What is more, the sharp appreciation of the yen has substantially reduced the relative prices of imports. In the first half of 1988 the volume of manufactured imports expanded more than 30%. Given the high elasticity value of such imports to income, estimated at about 1.8, more than half the volume increase can be ascribed to the price factor. From this it can be reasonably inferred that imports of manufactured goods will continue to expand substantially unless their prices go up markedly.

A resulting glut of manufactured goods in the market is likely to force domestic producers to cut back on inventories and production. With domestic producers expected to start inventory adjustment from the early part of 1989 onward, production growth will get slower. Signs of a slowdown in production will show up in softening commodity markets. How much inventories will be reduced depands largely on how bad the supply-demand balance turns out to be.

What about the capital investment that has continued to expand rapidly? On the demand side, the rate of growth is likely to halve, from an estimated 16% in fiscal 1988 in real terms to about 8% in fiscal 1989. Of the three factors described above as contributing to the investment surge, the medium- and long-term need to cope with the high yen, in other words the need for a restructuring oriented toward domestic demand, remains a strong incentive for investment.

But the other two factors are expected to gradually lose their stimulatory effects. This is in part because the return on total assets is expected to start falling after reaching a peak in the second half of fiscal 1988. In addition, businesses are expecting a lower rate of economic expansion in fiscal 1989 than in fiscal 1988. This makes it unlikely that investment will accelerate in the year ahead.

All in all, corporate investment—the sum of inventory investment and capital investment—is expected to contribute a modest 1.5 percentage points, compared with less than 4 points in fiscal 1988, to GNP growth for fiscal 1989.

What will be the impact of capital investment on supply capacity? According to a survey by the Bank of Japan covering major manufacturing companies, investment designed to increase productive capacity and expand sales accounts for about 30% of total investment. The other types of investment include that concerned with R&D, rationalization and restructuring. One view holds that even a 40% rise in capacity-building investment would not lead to any substantial increase in overall capacity. In reality, however, investments other than this type also lead to the expansion of total capacity by improving efficiency and diversification. In the case of small businesses and non-manufacturing firms, it is generally believed that capacity-building investment carries greater weight in total investment than is the case with major manufacturing companies.

In Japan, it usually takes three to four quarterly periods for investment to translate into productive capacity. The recent increase in investment is thus expected to show up in the form of expanded capacity during the second half of fiscal 1988. Such capacity expansion is expected to reach a peak in fiscal 1989. The annual rate of increase in capacity is estimated to rise about 2% in fiscal 1989 over and above that for the preceding year.

Supply-demand gap

While supply capacity is expected to expand faster, the demand-inducing effect of investment is estimated to bring the GNP down by more than 2 points. Naturally, this would create a supply-demand gap. Part of the gap could be eliminated through an expansion of external demand, or a combination of upward pressure on exports and downward pressure on imports. In view of the pesent world economic situation, however, this would be extremely difficult.

The supply-demand gap could also be reduced through an expansion of real consumption, which would be achieved through reductions in producer prices. If the gap was not completely eliminated, the rate of capacity utilization would drop. And if the drop was sharp, capital investment itself might begin to shrink.

Let us look at the export picture first. In fiscal 1986, exports declined in volume terms due to the steep appreciation of the yen. In 1987, however, the downtrend came to a halt, and in 1988 the uptrend became more pronounced. One reason for this is that the yen rate remained more or less stable for more than a year. During this period, export-oriented companies gradually regained their competitive edge. Another reason is that the world economy continued to expand steadily, leading to the robust expansion of world trade as well.

The future course of exports hinges on at least three factors. The first is the pro-

Consumer spending is likely to provide the main thrust of economic growth in the year ahead, indicating that the economy has reached a higher stage of maturity.

spects for the world economy, particularly the U.S. economy, which has a close bearing, directly and indirectly, on exports from Japan. The second is the impact of increased supply capacity in Japan. And the third is the exchange rate.

The pace of economic expansion in the United States is likely to slow somewhat in 1989. It is notable that during the past decade or more the Japanese and American economies have become increasingly synchronized. A comparison of production trends in the two countries' manufacturing industries shows that the two economies have moved more or less in parallel, with the United States one or two quarters ahead of Japan.

Japan's exports to the United States make up about a third of its total exports. Including exports to Southeast Asia and other regions that are strongly affected by developments in the U.S. economy, more than half of Japan's exports are under the influence of the U.S. economy in one way or another: An economic slowdown in the U.S., particularly a production slowdown in the manufacturing sector, can have a major restrictive impact on exports from Japan.

As for the impact of supply capacity expansion, it should be noted that the gap between growth of capital stock in the manufacturing sector (aggregate productive capacity) and growth of domestic demand is closely related to the trade balance. If the capital stock expands much faster than domestic demand, the trade surplus as a percentage share of GNP will increase. The reverse is also true.

In fiscal 1989 domestic demand is expected to slow down a little while the capital stock in the manufacturing sector is expected to expand. As a result, the supply-demand gap would widen. The excess of supply over demand would apply upward pressure on exports and downward pressure on imports. This would cause the trade surplus as a percentage of GNP to increase.

An increase in the surplus would be likely to result in further adjustments in the yen-dollar exchange rate, pushing the yen higher and the dollar lower. Such exchange rate adjustments would help to limit the widening of the trade imbalance. Otherwise protectionist pressures would mount, putting the free trade system in jeopardy.

Seen in this light, it is likely that the growth of Japan's exports will slow in fiscal 1989. Net exports, or exports minus imports, are expected to make a less negative contribution to GNP growth than they did in fiscal 1988, but such an incremental increase in external demand would be far too small to make up for the slowdown in investment demand.

Consumption trend

It has been stated that part of the supply-demand gap can be filled through increased consumption induced by lower producer prices. Unfortunately, this effect would be offset by increases in the unit labor cost. Individual consumption is expected to follow a solid trend (a real gain of 4.5% is forecast for both fiscal 1988 and 1989), due partly to the fact that the high yen is having extensive effects on prices. This effect of expanded consumption would be too weak to take up the slack in investment, however.

Based on the factors described above it is estimated that the real rate of GNP growth will drop from 5% in fiscal 1988 to about 3.5% in fiscal 1989, provided the current policy stance remains unchanged in the year ahead. It is also estimated that the yen will appreciate against the dollar by an additional 6–7% in fiscal 1989. On that assumption, the percentage share of the trade surplus in the GNP will shrink from 3.4% in fiscal 1988 to 3.1% in fiscal 1989, and the share of the current-account surplus from 2.8% to 2.6%. In dollar terms, however, the trade surplus is estimated to reach about $100 billion in both years. The current-account surplus is also expected to remain at a high level of about $80 billion.

In the meantime, wholesale prices are expected to remain flat while consumer prices are expected to rise about 1%. Thus a marked degree of price stability will be maintained.

Given the shape of the economy described above, what will be the fiscal and monetary policy of the Japanese government? Considering only the situation in which Japan finds itself, and not developments in the world economy, the rate of growth will slow somewhat, but the overall economic situation is likely to be more or less satisfactory. It can be reasonably expected, therefore, that the present policy stance will be maintained.

Japan is in a position, however, to help ensure stable growth worldwide and thereby correct economic imbalances. From this point of view, Japan will have to take further measures to expand domestic demand–and quickly–if signs of a slowdown develop in the world economy. If the United States should take expansionary measures, that would increase inflationary pressures. Resultant interest rate increases would impose a greater financial burden on the heavily indebted developing countries.

Japan, at least for now, is the least liable to inflation. But a further easing of credit would be difficult, if only because the monetary authorities are reluctant to cut the discount rate any further. The most likely policy options would be to increase government spending and to invigorate private-sector activity through deregulation. These options as they stand have serious drawbacks, however. In the case of fiscal policy, there is the problem of a "recognition lag," meaning that it usually takes an unreasonably long time before the need for additional spending is officially recognized. The result is often an undue delay in action. As for deregulation, the problem may be described as a "practice lag," or a long delay in implementation. In both cases, prompter action is called for.

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