expand domestic demand. It is unlikely, therefore, that the government will pursue a policy of achieving fiscal balance on a short-term basis. Instead it is likely to adopt a positive public investment policy in order to stimulate growth.

Shape of recovery

All these factors considered, it is unlikely that the economy's expansion will continue to decelerate for an extended period of time. As shown in the table, consumption will maintain a firm trend. Housing investment will also pick up once the stock correction is over. Inventory investment will continue to drop. Public investment will be stepped up. Exports will expand more rapidly while imports will stagnate. The current-account surplus will keep growing, further pushing up the yen rate.

Most important is the future trend of business capital investment. My prediction is that it will decline further in 1992. According to a survey conducted by the *Nihon Keizai Shimbun* in November 1991, many companies plan to cut back on capital spending in the year ahead.

The government's initial forecast of GNP growth for fiscal 1991 is 3.8%. My estimation, however, is that the growth rate will drop to 3.3%, as I mentioned at the outset of this article. The economy will continue to stagnate in the first half of fiscal 1992 but will begin to recover in the second half. Consequently, the growth rate for all of fiscal 1992 is likely to be 3.5%, slightly higher than that for fiscal 1991.

The coming year will be a period of economic adjustment, as was 1991. The economy will mark time only temporarily; in the longer term, it still maintains strong growth potential. My projection is that GNP growth will rise again to its more customary level of 4% to 5%, beginning in 1993.

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The Global Sick Ward

By Johsen Takahashi

The new Miyazawa administration, which took office last November, faces more than just a mountain of problems. It faces an entire mountain range of problems, many of them totally new to Japan and not amenable to easy solution. Not only are there the urgent issues of reforming the political system and opening the rice market, but also the road ahead is strewn with such land mines as how to restructure Japan-U.S. relations in the wake of the end of the Cold War, how to conceptualize Japan's relations with the rest of Asia, how to develop a coordinated international contribution including support for the former Soviet Union, and many, many more.

It is also time the government started work on devising a grand design for Japanese foreign policy in this new era. Nor is there any time to lose in coming up with policies to deal with global stagflation, the worldwide capital crunch and other economic issues. It will obviously be extremely difficult to respond to all of these issues without at least a few missteps, but I doubt if there are any easy answers even for just the economic issues. The Japanese economy is like someone beset with a host of degenerative diseases, and we do not even have a clear diagnosis of what is wrong, much less efficacious medicine.

Having grown for about four and a half years to record the second-longest boom in Japan's postwar history, the economy entered a correction phase in the middle of 1991.

The automotive, housing and real estate, semiconductor, home appliance and other industries all report that demand peaked out in the second half of 1990 and that they are fighting to stay alive today. Textiles, paper and pulp, chemicals and other industries were in the dumps even before that, getting the wind knocked out of their sails in early 1990. Although companies serving the strong capital investment demand were doing well until recently, the machine tool industry saw its orders fall off until it had less work on the books in mid-1991 than it did in mid-1990, and pessimism seems to be the order of the day. As a result, 1991 steel shipments have also been less than in 1990 from August on, and the whole industry is being forced to cut back on production.

With this sluggishness in demand, production has also been off since early last year, and by the summer of 1991 production was back down to about the same levels as the summer of 1990. Yet despite these production cutbacks, inventories continue to pile up and there is a decided sense that inventory levels—which by summer were 10% over those of the summer of 1990—are too high.

Fears of stagflation

Having come to power in this inhospitable climate, Miyazawa is being looked to to do something dramatic for the economy. In the summer of 1986, Miyazawa took over the Ministry of Finance at a time when the economy was languishing and managed to pull the economy's chestnuts out of the fire with bold Keynesian initiatives. Thus it is that many people look to Miyazawa to work his magic once more and to get the economy back on its feet. Yet this is a recession of a different color, and it is essential that it be dealt with not with yesterday's tried-and-true remedies but with new approaches geared to the new imperatives.

The first thing to remember is that, even though the economy is deteriorating rapidly, this deterioration has not made much of a dent in the painful labor shortages or the near-capacity operating rates. Even though the economy is losing steam, we are still at full employment of both labor and equipment. This is stagflation in the true sense of the term.

Given the circumstances, strong stimulative medicine could very well provoke a vicious bout of inflation. Conversely, not doing anything for fear of inflation could well let the economy sink deeper into recession. This means Miyazawa is "damned if he does and damned if he doesn't." The Japanese economy has achieved the Keynesian goal of full employment, but it has also demonstrated the limitations to the Keynesian approach. Keynes is not the answer for the Japanese economy today.

Table 1 Japanese International Balance of Payments Figures ($ billion)

	Trade account	Current account	Long-term capital account
January-September 1990	+45.1	+27.6	−42.3
January-September 1991	+71.8	+48.3	+33.5

Source: Bank of Japan's *Balance of Payments Monthly* and *Balance of Payments Interim Statistics*

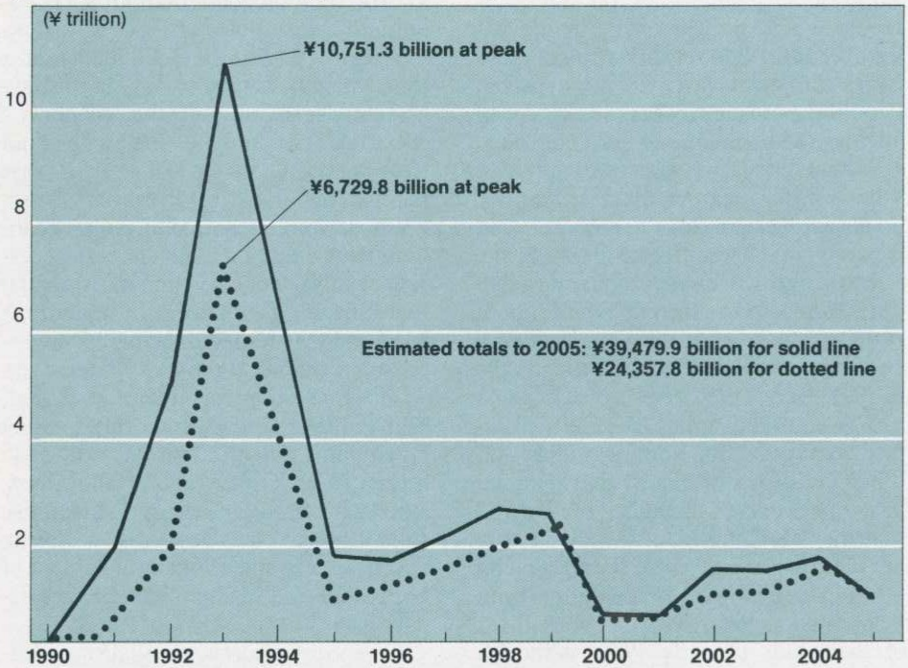
International financial disharmony

The second point that the government will have to beware of is that the economy has been puffed up by expansionary expectations for so long that it is due for a major correction in 1992. Yet puncturing these expectations could also have catastrophic effects for the non-speculative economy as well.

To be very blunt, the prolonged expansion from the end of 1986 until just recently was powered primarily by what might charitably be called asset inflation. Specifically, the massive windfall profits accruing from soaring land and stock prices spurred people and companies alike to frenzies of speculative and non-speculative activity. Akin to the great tulip bubble of 1634 to 1637 and the South Sea Bubble of 1720, this Japanese real estate bubble took the economy with it as it wafted upward on the winds of hope.

Now the bubble has burst, and Japan is experiencing a vicious round of asset disinflation. While this is already showing up in the non-speculative economy as weaker demand for housing and other real estate or for big-ticket consumer goods, the even bigger question is what to do about the hole it has left in the financial sector and how all of the convertible and warrant bonds are to be refinanced, for one false step could prove fatal.

Fig. 1 Equity Financing Coming Due for Redemption (estimated)



Note: The solid line is the total for all convertible and warrant bonds outstanding and falling due in the year indicated, and the dotted line the total for all convertible and warrant bonds that would be valued at less than redemption price even if the Nikkei stock average was around ¥30,000, which means that the difference between the two lines is the amount expected to be converted to shares.
Source: NLI Research Institute

When the speculation was as its peak from 1987 to 1989, companies raised a total of nearly ¥40 trillion in easy money by issuing seemingly painless convertible and warrant bonds. But now that the good times are over and the economy is sober again, investors are demanding that these convertible and warrant bonds be redeemed not with below-value stock shares but with cash. The crunch will come in 1992 and 1993, and it is anybody's guess how the companies that issued all of these equity bonds are going to come up with the cash to redeem them (Fig. 1).

Even if these companies were able to provide the kind of collateral that would be necessary−which is unlikely given the way the bottom has fallen out of the real estate market−trying to raise the capital in Japan would be bound to create a capital crunch. As a result, Japanese companies are going offshore to raise capital in other markets.

Japanese corporations were active issuers on the Euromarkets and other markets in 1991, and they are moving now to bring the capital thus raised back to Japan. As a result, the long-term capital account for January to September 1991 showed a net inflow of $33.6 billion. By contrast, the long-term capital account for January to September 1990 showed a net outflow of $42.4 billion, meaning that the capital flow has now turned around completely and Japan is taking more capital out of international markets than it is putting in (Table 1). As noted earlier, the peak in refinancing this equity finance will come in 1992 and 1993, and these long-term capital trends will thus become especially conspicuous this year and next.

However, Japan is the only country that still has a solid surplus in its current account, and it is vital to global financing that this Japanese current account surplus be recycled throughout the international economy. Yet Japan's long-term capital account has also moved into the black as Japanese companies have sought to bring money home to settle their equity financing and other responsibilities, thus creating a reverse flow of international capital. Left to run its course, this can only mean major misalignments in international finance and ultimately the need for a drastic correction. Because this correction could take the form of defaults by the biggest debtor countries—defaults that would have disastrous consequences for the world economy—it is imperative that policy steps be taken now to deal with this situation.

Photo: Kyodo News Service

Due to the bursting of the economic bubble, land values have dropped dramatically, leading to a number of resort companies and developers filing for bankruptcy. One casualty of the downturn is this luxury hotel and golf course, now left unfinished.

Financial recession

The next point that needs to be considered is the fact that there are conspicuous signs of a financial recession in Japan as well as in the United States. This is best demonstrated by the slow growth in the money supply.

While it is true that part of this sluggish growth in the Japanese money supply is explainable by the lethargic capital demand from companies cutting back in the face of recessionary expectations, by the shift as savers move their money away from standard bank accounts to better-yield postal accounts, and by other factors, it is also very much influenced by the banks' deteriorating asset positions as the stock and real estate markets have gone into their tailspins, by the reluctance of banks to lend actively when they need to stay above the BIS (Bank for International Settlements) 8% capital adequacy standard, and other factors on the banks' side as well. As a result, even a financial loosening by the Bank of Japan is unlikely to take hold and to yield much economic stimulation.

Although stimulative policy will have to rely even more on financial policy given the government's own budgetary problems, financial policy itself is a very weak lever, and it will be hard to find ways to stop the economy's slide.

At the same time, the costs of writing off all of those debts and assets that have ceased performing now that the bubble has burst will start to show up on this year's balance sheets, putting considerable pressure on the banks' 1992 results. As a result, this is another factor impeding any major expansion of bank lending, and there is a very real danger that the recession and deteriorating bank earnings could create a vicious circle that would savage the economy. It would be unrealistic to look at the financial recession in the United States and claim it cannot happen in Japan.

Given all of the problems in the Japanese economy, it is as if someone who was badly overweight with fatty bubbles had gone on a crash diet and the result was that the frailties of the digestive tract, circulatory system, respiratory system and everything else had all come to the fore at once. As a result, the doctors hardly know where to start and cannot prescribe massive dosages of anything for fear of adverse side effects. All they can do is a little bit of this and a little bit of that in a patchwork effort to keep the patient alive until his own basic good health revives and the body heals itself.

Nor is Japan the only patient in this ward. The United States, Germany and the other industrial countries are also just as sick, and all of the world's economic leaders are bedridden. And because it is contagious, deterioration in one economy means deterioration in the others as well. Yet at the same time, radical measures to cure one patient could have the opposite effect of endangering the other patients. It is thus imperative that each country's economic doctors be willing, to some extent, to let the sickness run its course and that all of the doctors get together and work out a balanced program that will get the whole ward back on its feet.

Johsen Takahashi, a chief economist and senior fellow of Mitsubishi Research Institute, a leading private think tank, writes and speaks widely on macroeconomic issues.