

# Japanese Economy and Policy Tasks

By Chikao Tsukuda

Since the economy does not move in accordance with the calendar, economic situations do not change abruptly at the turn of the year except by chance. Many problems facing the Japanese economy in 1986 will be carried over into 1987. Nevertheless, it is of significance to discuss economic trends in the new year in that the prevailing economic conditions are confirmed, those elements that will continue into the coming year and those that are expected to change are identified, and ways of coping with them in the national economy and by business are considered.

What was most characteristic of the Japanese economy in 1986 is that the effect of the yen's sharp appreciation gradually spread from trade goods to nontrade goods, with the impact of sagging foreign demand steadily felt in production, corporate profits, capital spending and employment. The deflationary effect of the higher yen will continue in 1987. We ought to consider the possibility of its negative impact worsening on the employment front in particular. On the other hand, the stronger yen has one positive aspect—boosting real purchasing power through improved terms of trade. In order for this effect to result in actual expansion of spending by business and households, it is necessary that price declines on imported goods are passed to the final consumption stage without being absorbed in the distribution process and that corporate and household prospects for the future improve. As for the latter condition, it is difficult to foresee a visible improvement in future prospects. It is my judgment, therefore, that few benefits of the yen's rise can be expected to materialize.

Policy tasks expected to assume greater importance in 1987 are international coordination of economic policies externally and, domestically, adjustment of the economic structure.

The joint statement issued by Finance Minister Kiichi Miyazawa and U.S. Treasury Secretary James Baker at the end of October 1986 was welcomed as an agreement contributing to exchange rate stability in line with bilateral policy coordination since the "Plaza Agreement" in September 1985. It is not clear what measures the two countries have agreed to take to substantiate the statement. I

think it an underestimation to say that the statement is aimed simply at a psychological effect. But it is also wrong to play it up as demonstrating establishment of a "target zone" designed to limit rate swings between the yen and the dollar to a certain range. It should be considered as an agreement having—and aimed at—the effect of exchange rate stability within a range to be determined by the economic fundamentals of the two countries. Given the weight of Japan and the United States in the world economy and their bilateral relations, policy coordination by the so-called G-2 is natural and desirable. The task to be tackled is to explore ways of orchestrating such coordination on a multilateral basis.

The main causes of the continued expansion of Japan's trade surplus in dollar value despite the yen's sustained appreciation in 1986 were the "J-curve" effect and declining crude oil prices. The surplus is expected to begin shrinking as the J-curve effect runs its course and crude oil prices recover. But the question of the external imbalance cannot be expected to ease visibly in a short period of time in view of sluggish domestic demand and strong competitiveness of Japanese industry in aspects other than price, such as product quality. It is necessary to continue policy efforts to expand domestic demand. But there are no prac-

tically feasible policies that contribute to improving the external imbalance to the tune of several billion dollars in a short period.

This leaves us the last choice—structural adjustment—which will be spotlighted in 1987. But it is not a *deus ex machina* for the present external imbalance issue, but rather should be viewed in the medium- and long-term contexts. What is important in discussing policies for restructuring is not to reduce the effects of exchange rate adjustments, but to aim primarily for their smooth penetration into the economic system. Furthermore, in my view, the centerpiece of restructuring policies is to prepare a climate that will permit the economy to maximize its self-adjustment mechanism and for this it is very important to promote relaxation and abolition of government regulations. One primary consequence of the yen's appreciation is expansion of direct overseas investment by business and increased purchases of parts and raw materials from abroad. This is not only a natural choice by business, but is expected to contribute to structural improvement of the Japanese economy and correction of the external imbalance. The so-called industrial hollowing is a source of anxiety over a possible decline in Japan's economic vitality as a result of expansion of overseas corporate production and procurement, which is the outcome of nothing more than a display of business energy. This will probably be one of the most important issues in and after 1987. It requires searching discussions, but the effect of structural improvement must not be forgotten in doing so. ●

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## Strong Yen, Slow Growth

By William P. Sterling

The Japanese economy faces major challenges in 1987. With the clear prospect for continued strength of the yen and sluggish growth abroad, Japan's business leaders and government policymakers are painfully aware of the need to reorient the economy toward domestically led growth. However, despite ambitious visions such as that of the Maekawa Report of April 1986, the transition from export growth to domestically

led growth is likely to be slow and somewhat painful. Accordingly, we expect 1987 to be a year of sluggish growth, continued trade friction and stagnant industrial production and employment.

Our current forecast anticipates real GNP growth of only 2.0% in 1987, with the yen strengthening to ¥145 per dollar and the unemployment rate rising to 3.6% by the year's end. We expect large trade surpluses to be a continuing source



Continued trade friction, yen appreciation, a rising unemployment rate and sluggish growth are major challenges for Japan's economy in 1987.

of trade friction throughout 1987 and anticipate a current account surplus of nearly \$70 billion for the year. This outlook implies continued upward pressure on the yen, since it represents only a modest improvement from a projected surplus of about \$85 billion for 1986. The forecast assumes oil prices averaging in the range of \$15 to \$16 per barrel and a 1.9% rate of GNP growth for the United States.

Stagnation in the export-oriented manufacturing sector is likely to remain a major drag on growth. Japanese industrial leaders have compared the severity of the "yen shock" of September 1985 with the oil crises of the 1970s, given the depressing impact of the yen's rise on export sales and corporate profitability. With the yen having appreciated by approximately 50% against the dollar since 1985, Japan can no longer look for another export drive to provide a successful engine of growth, and its domestic industries face growing pressure from imports. At the same time, structural features of the economy such as the complex distribution system and government regulations work against a rapid passing on of the benefits of the yen's rise to consumers.

The major risk to the economy in 1987 is that the deflationary impact of the yen's rise will continue to act as a drag on growth. Private capital spending, for example, has been anemic in 1986, and shows signs of deteriorating further in 1987 as manufacturing firms respond to decreased cash flow and unfavorable export prospects. Major surveys of capital spending plans for the fiscal year beginning in March 1987 project changes in investment spending ranging from an increase of about 1% to a decrease of nearly 2%. Spending cuts are projected in virtually all industrial categories in

the manufacturing sector, while only modest increases are projected for non-manufacturing.

Consumer spending, which served as a support for growth in 1986, is at risk if wage and bonus increases are squeezed and working hours reduced further to restore corporate profitability. Because of the pressure on corporations to reduce costs to cope with the yen's rise, we expect that wage increases will be held to the 2% range during the 1987 *shunto* (spring offensive) round of nationwide bargaining, compared with an average increase of 4.4% in 1986. In addition, the prospect of unemployment reaching 3.6% as layoffs and hiring freezes occur raises the possibility of an increase in the savings rate—i.e., reduced consumption—in response to economic uncertainty.

Construction should remain the one bright spot amidst generally lackluster economic performance. Residential construction, which has grown at double-digit rates during 1986, should continue to benefit from low interest rates and supportive government policy. In particular, a continuation of the downward trend in interest rates and an expansion of the government's subsidized mortgage program should support a high level of activity in residential construction. Downward pressure on building materials prices due to the yen's rise should also contribute to a favorable climate for residential construction. While the slowdown in private capital spending makes the outlook less certain for nonresidential construction, a gradual acceleration in public works spending should pick up much of the slack.

Given the strong majority position of the ruling Liberal-Democratic Party, we expect few surprises in government policy in 1987. Monetary policy should continue to be cautiously accommodative as the Bank of Japan attempts to keep credit conditions sufficiently relaxed to promote growth without risking future inflation. This implies a discount rate in the range of 2.50% to 3.00% and growth in the broad money supply (M2+CDs) of 8% to 9%. With respect to fiscal policy, we expect stagnation of the industrial sector to put continued pressure on the government for a modest acceleration in government spending. The prospect of strong demands for increased government spending combined with reduced growth of revenues due to a sluggish economy suggests that the government's program to eliminate its deficit by 1990 may be temporarily put on hold.

We expect Japan to enact major tax reform legislation in early 1987, though significant implementation of reform is not likely until 1988. Major elements of the reform are likely to include:

- Reduction of the maximum personal tax rate (combined national and local) from 88% to 65%.
- Reduction of the effective corporate tax rate from 52.9% to a little below 50.0%.
- Introduction of a broad-based value-added tax, applied at virtually all stages of production and distribution at a 4-5% rate.
- Abolition of the tax-exempt savings system and introduction of a uniform 15-20% withholding tax on most interest income.

The reform is designed to be "revenue neutral" so that the total value of personal and corporate tax cuts—about ¥4.5 trillion—will be exactly offset by new value-added taxes and taxes on interest income. Accordingly, reform is not expected to boost the economy significantly. Instead, the basic intent is apparently to secure a flexible source of revenue to meet future government obligations for providing social security and enhancing the nation's infrastructure.

Japan's economy has demonstrated a remarkable capability to respond to external shocks in recent years. Given the diligence and resourcefulness of its people, Japan can also be expected to adapt successfully to the yen shock after some period of adjustment. However, there is an important difference between the current yen shock and the oil crises of the 1970s. Japan responded to both oil crises with successful export drives, supported by (1) export-oriented economic policies and institutions and (2) expansionary fiscal policy abroad.

Under current circumstances, export-led growth no longer appears to be an option due to both the strength of the yen and protectionist pressures from abroad. At the same time, significant expansionary policy abroad is unlikely since fiscal policy in major industrial nations is constrained by political pressures for a balanced budget, just as it is in Japan. Thus, adjustment to the yen shock will require a fundamental reorientation of Japan's economic policies and institutions. The major question now facing Japan is how quickly its industries can restructure to produce for domestic markets. From this perspective, 1987 will provide an important challenge to the legendary adaptability of Japanese management and the Japanese economy. ●