

# Private Think Tanks Predict Possible Deflation in 1998

By Sakamoto Sakae

With economic growth in Japan for the 1997 fiscal year (April 1997–March 1998) likely to be zero, many private think tanks are making even more dismal predictions for fiscal 1998 (April 1998–March 1999). This gloomy outlook can be attributed to reduced business earnings, weak capital investment, low consumer spending, limited public investment, low stock prices, an unstable financial system, and the Asian economic crisis.

## A deflationary spiral possible

The Nomura Research Institute Ltd. (NRI) of Nomura Securities Co. Ltd. is predicting that actual gross domestic product (GDP) will show zero growth for fiscal 1997 over the previous year, and that 1998 will see only minimal growth of 0.7%. According to the NRI, the widening gap between domestic supply and demand, the Asian currency crisis, and instability in the domestic financial system will cause 1998 wholesale prices to drop to  $-0.8\%$  compared to the previous year, thus resulting in a nominal GDP growth rate of zero. This explains the high likelihood of deflation in the Japanese economy in fiscal 1998.

The NRI report entitled "Recoverability of the Struggling Financial Structure—Zero Growth into the Next Fiscal Year," says that "Over the past few years, domestic demand has been raised through positive fiscal policy measures, the revenues of financial institutions have been driven up by lending at ultra-low interest rates, and as a result of efforts to support stock prices, manifestations of the instability of the Japanese economy have been avoided."

However, since the autumn of 1997,



Hoping for business prosperity, the traditional "TORI NO ICHI" event took place in Asakusa, Tokyo. What will the economic situation be this year?

when such policy measures by the government and financial agencies had reached their limits, several of the largest banks and securities firms, such as the Hokkaido Takushoku Bank and Yamaichi Securities, have failed, seriously destabilizing the financial system. Also, as is evidenced in the case of the "Japan Premium," international confidence in the Japanese financial system is falling. The NRI paints a rather bleak picture of the situation, stating that "if this destabilization of the financial system is not brought under control, additional companies will go bankrupt due to the lack of public confidence: It is impossible to ignore the danger of a deflationary spiral in which companies fail, consumption wanes further, and the cycle repeats itself."

## Export competition with South Korea will heat up

The Nikko Research Center Ltd. (NRC) of Nikko Securities Co. Ltd. is no more optimistic. The NRC predicts an actual GDP growth rate of  $-0.1\%$  for fiscal 1997, and  $0.2\%$  for fiscal 1998.

The high probability of deflation in the Japanese economy becomes even clearer when these figures are expressed in nominal terms of a  $0.1\%$  GDP growth rate in fiscal 1997, but a  $-0.1\%$  growth rate for fiscal 1998. Should this occur, it will be the first time the nation will have posted a negative GDP since the Great Depression of the late 1920s to early 1930s.

The NRC points to "Asian economic disturbances," "financial system insta-

bility," and "low household income" as causes of the forecasted deflation. With particular emphasis on the effect of the devalued Asian currencies, the NRC suggests that "the economic crisis in the ASEAN countries has spread like wildfire to South Korea, and in spite of loans by the IMF, the won is being undersold at about half of its value at the end of March 1997. As currency depreciation in the Asian nations increases, their export price competitiveness, rising domestic interest rates, and tightly controlled domestic demand (under IMF assistance terms) may lead to worldwide deflation."

As is evident in the 1997 Japanese economy, if a country's currency depreciates, that country's export competitiveness increases. In Asia, sharply decreasing domestic demand and a gap in supply and demand resulting from over-investment may be added to the factors causing depreciation, thus making it very likely that Asian nations will see export sales as a feasible path to take in pursuit of economic recovery. Japanese exports will certainly suffer from the severe depreciation of Asian currencies. Fierce competition with South Korea, with whom Japan shares similar export goods and customers, can be expected.

The NRC points out that "South Korea, plagued by a scarcity of foreign exchange reserves and decreasing domestic demand, is undoubtedly going to wage a fierce battle for export sales. Japan and South Korea are involved in many overlapping export industries, including raw materials such as iron, steel and chemicals, as well as semiconductors, electronics and shipbuilding, all of which are Japan's main export items. South Korea's export strategy increases the possibility that foreign demand, one of the sources of Japanese industry's stable revenues, will experience a serious fall."

## The economy worsens, failed businesses pile up

The outlook prepared by the Daiwa Research Institute (DRI) of Daiwa Securities Co. Ltd. is somewhat

brighter than those suggested by the NRI and NRC, predicting nominal GDP of 0.4% and an actual GDP of 0.3% for fiscal 1998 (0.7% and 0.5%, respectively, for fiscal 1997). However, the DRI suggests that "the Japanese economy has been in a downturn since it peaked in the first quarter of 1997," and that the situation in fiscal 1998 will be even worse than that in fiscal 1997. Reflecting the long-term effects of the current problems, the 3.4% unemployment rate in the third quarter of 1997 is expected to rise to 4.1% by the first quarter of 1999.

The DRI suggests that the factors threatening to worsen the situation are "the possibility of a severe loss of credibility" and "fears of significant employment adjustments." Japanese financial institutions are beginning to restrict their assets (loans) to meet the minimum requirements for fulfilling the shareholders' equity requirement ratio regulations of the Bank for International Settlements (BIS) and the Ministry of Finance.

This may cause businesses to lose credibility, but the DRI suggests that "the greater risk factor threatening the financial situation is the vicious cycle that would occur should banks become unwilling to lend, thereby causing mass bankruptcies, and leading to stock price plunges, increasing bad credit, and to further unwillingness of banks to lend. This would virtually paralyze businesses' ability to establish credibility. This would have a terribly negative impact on the situation."

With regard to employment adjustments, the DRI finds that "the fact that the number of employees continued to increase amidst the economic downturn of early 1990 suggests the possibility that businesses are still absorbing the effects of over-employment. Should a prolonged period of economic sluggishness occur in which over-employment cannot be maintained, it is very possible that employment adjustments will rapidly be made. In this case, unemployment would rise drastically, causing a further worsening of the overall situation." Also, "although it can be expected that companies will first reduce their number of part-time

employees, there is a distinct possibility that companies will behave in a manner typical of Japanese businesses and avoid making any serious employment adjustments affecting full-time employees until the businesses become insolvent or go bankrupt."

## Government forecasts are optimistic

The government's economic forecast for 1998 is more optimistic than those suggested by the private sector, suggesting actual growth of GDP for fiscal 1998 of 1.9% (0.1% for fiscal 1997), and nominal GDP of 2.4% (0.9% for fiscal 1997). According to the head of the Economic Planning Agency, the reason for the discrepancy between government and private forecasts is that "the private outlooks published between early and mid-December do not take into account ¥200 million in special tax cuts (an income tax cut to be implemented in February and resident tax cut to be implemented in June) and ¥1 billion worth of measures to strengthen the financial system (public investment in improvements to the deposit insurance structure and the equity capital of financial institutions)."

If each item of the government's forecast is considered individually, its results clearly reject the pessimistic outlook presented by the private sector. "Personal consumption will recover, as incomes increase, and the reactionary effects of heightened demand prior to the consumption tax increase levied in the spring of 1997 diminish. As business revenues continue to improve, private capital investment will gradually increase, especially in the manufacturing industry. The worldwide economy will generally expand, and export growth, while less than in fiscal 1997, will increase."

Only time will tell which of the forecasts will prove more accurate. ■

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