Japanese Economy Enters a Difficult Phase

By Tani Sadafumi

In early December 2000, the Economic Planning Agency (now integrated into a Cabinet Office) announced that Japan's gross domestic product (GDP) had grown by 0.2% in the July-September quarter (preliminary estimate) as compared with the previous quarter (April-July), which is 1.0% when converted to an annual growth rate. While the GDP recorded negative growth in the July-September and October-December quarters of 1999, it has now recorded positive growth for three quarters in succession. Superficially, this provides evidence that the economy continues to follow a "gentle recovery trend" but private sector economists are divided as to whether they take an optimistic or a pessimistic view of this. In his final remarks at a press conference following the GDP announcement, Sakaiya Taichi, the previous Director General of the Economic Planning Agency (who resigned when the cabinet was reshuffled), said, "Though corporate profits and capital expenditure are picking up, with bankruptcies increasing and falling stock prices, we find ourselves in a maelstrom (of positive and negative factors)."

The Bank of Japan's survey of short-term corporate sentiment (*Tankan*) released later in December 2000 showed that the sentiment of the corporate sector, which had been supporting the economy, had stopped improving. It is now certain that GDP growth for July-September will be revised downwards so Japan's economy is entering a difficult phase.

The economy has recently been supported by an improvement in corporate earnings. Also, exports have been buoyant and surplus funds from cost savings due to restructuring (reductions in work force, debts, etc.) have become available for capital expenditure. As for the remaining major factors that we have to pay attention to, since investment in public works projects has slowed down somewhat, all eyes will be on consumption as this is the major GDP issue that has not been resolved. The Bank of Japan is advocating a "dam theory" under which corporations are upstream of the dam and consumers downstream of it. Under this analogy, if corporations continue to improve, much "water" will collect behind the dam and when it overflows, the "water" will reach consumers. Though the Government is distancing itself from the dam theory, it still views consumption as the key to keeping its pledge "to achieve an economic recovery led by private sector demand early in 2001."

Analyzing the GDP figures for July-September, we see that public capital formation focusing on public works projects decreased by 10.7% compared to the previous period, representing a steep fall as was forecast. Consumption, the main concern at present, leveled off while corporate capital expenditure grew at a healthy 7.8%, which supported the economy overall. Incidentally net exports (surplus obtained by subtracting imports from exports) dropped by 3.5%.

The reason was not too difficult to understand. The "water" which had accumulated behind the dam on the upstream side (corporations) was not flowing smoothly to the downstream side (consumers). In other words, the mechanism by which consumption should have been stimulated by an improvement in corporate earnings through resulting increases in capital expenditure, overtime, employment and incomes had not been operating. Is it simply a problem of timing? Or is there a break in the forward chain of the economy? Economists fall into two groups as regards these ideas, those who support them strongly and those who do not support them very much.

The release of the Bank of Japan's *Tankan* (survey of short-term corporate sentiment) in December was a further blow. The diffusion index (DI; calculated by subtracting the proportion of corporate managers who feel that things are not getting any better from those who feel that things are picking up) was plus 10 for large manufacturing enterprises, about the same level as for the previous survey in September. Corporate sentiment for the next three months shows increasing caution with regard to the future due to the slowdown in the US economy and low stock prices, and from it a 3-point deterioration in the index is predicted for the March survey. The DI for non-manufacturing companies among large enterprises and for both manufacturers and non-manufacturers among medium and small-size enterprises continued to be negative showing that many managers have not changed their view since the last survey.

Of particular concern for the future is that the DI among manufacturers of electrical equipment worsened for the first time in two years. Electrical equipment manufacturers had been investing much in IT, a powerful force supporting the economy, and any change in this can only slow down the pace of economic recovery. In addition, companies relying heavily on exports, for example, auto makers and chemical companies, have started to show caution due to the slowdown in the US economy. It was such companies that had been actively investing in plant and equipment.

Actually, the Government has admitted that it is in the process of revising the GDP figures for the July-September quarter downwards, even though they have just been announced. This is because statistics published after the GDP figures were released showed that growth in capital investment had not been that high after all. According to government sources, it is inevitable that capital investment growth will be much less than the 7.8% quarter-quarter growth announced early in December. As the contribution of capital investment to GDP is 1.2, the greatest among demand parameters, even the smallest downward adjustment could make the 0.2% GDP growth recorded for July to September negative.

Shimanaka Yuji, Head of Investment Research Department at Sanwa Research Institute and Consulting Corporation, has consistently held a severe view of the economy. He points out that with capital spending running out of steam and a slowdown in the world economy, the sentiment of managers is taking a backward turn and says, "The economy is bound to falter." He also warns, "There is concern that the deflationary spiral in which falling prices dragged down the economy will reappear." Kirishima Kazutaka, Senior Chief Researcher of the Sumitomo-Life Research Institute, warns, "With the US economy in an adjustment phase, there will be a drop in exports affecting both capital spending and incomes."

However, the majority of economists see a slightly brighter scenario. In his outlook, Makabe Akio, Chairman of the Dai-ichi Kangyo Research Institute, says, "Overall the economy is at a standstill but it is not likely to stumble." Ueno Yasunari, Chief Market Economist of Mizuho Securities Co., feels that there are concerns about the outlook for capital expenditure but says, "IT investment has not reached the same level of saturation as in the US and Europe so, following a period of adjustment, there should be stable growth in the semiconductor market." On the matter of consumption, Kono Ryutaro, Chief Economist of BNP Paribas Securities (Japan) Ltd., Tokyo Branch expects things to get better saying, "With the increase in employment since the autumn, household incomes have been steadily improving so consumption should pick up."

In the economic forecasts of the major private sector think tanks, real GDP growth for fiscal 2000 (April 2000 - March 2001) ranges from 1.6% (Chuo Mitsui Trust and Banking Company) to 2.4% (Industrial Bank of Japan), with the average at 1.9%. Owing to the higher degree of uncertainty in fiscal 2001 (April 2001 - March 2002), there is a greater variation in the forecasts with the lowest at 1.2% (Sumitomo-Life Research Institute) and the highest at 2.8% (Fukoku Mutual Life Insurance Company). The average is 2.0%.

At 1.2% for fiscal 2000 and 1.7% for fiscal 2001, government forecasts are lower than those of the private sector. The Government is undeniably leaning towards prudence in its forecasts having experienced failure in making an upbeat forecast in 1997 which, regardless of the fact that the economy was showing signs of slowing down, gave precedence to fiscal restructuring and resulted in a nationwide recession. It is perhaps more appropriate to think of the reason behind the setting of such conservative forecasts as resulting from the slowdown in exports amid the gloomy prospects for the US and other major overseas economies as exports had been driving the recovery. In the words of a senior official of the Economic Planning Agency, "Exports are slowing down faster than expected."

It is difficult for the Government to make a policy response under such circumstances. The Government has supported the economy through lavish fiscal spending in the last few years, and as a result, the total debt held by central and local governments together has risen to 120% of GDP, the highest among the advanced nations. The Government's scenario is first to get the economy on the road to a full-scale recovery and then tackle the issue of fiscal restructuring.

However, given the current state of the economy, many economists are of the view that fiscal support could not be withdrawn abruptly. Sakaiya Taichi, previous Director General of the Economic Planning Agency emphasizes this point saying, "If we try to achieve success in fiscal restructuring too quickly, it may be very painful. It is still important to follow policies towards economic rehabilitation in the future." In line with this view, despite a decrease in the general account for the first time in six years, the provisional budget for fiscal 2001 will continue to focus on stimulating the economy with general expenditure (policy expenditure) comprising public works, social security and other policy expenditure rising to an all-time high.

However, the fiscal deficit is now on dangerous ground where it could produce interest rate rises and other ripple effects and there is no room for large supplementary budgets to be drawn up during the fiscal year. Further, public works projects are already running at a high level and the effect of new ones in propping up the economy would be minimal. There is also a high chance that they would have a negative effect on GDP.

There would certainly be stronger demands for the enactment of monetary policies if it seemed that a consumer demand-led economic recovery was not happening. Nakahara Nobuyuki, a council member of the Bank of Japan, declared publicly that, "The ending of the zero interest rate policy was premature." Nakahara was one of the council members voting against the lifting of the zero interest rate policy in August 2000 when the vote was 7 to 2 in favor. Though he is viewed as a maverick on account of his continual criticism of the Bank of Japan executive, there are many economists who endorse his appraisal of the economy.

Despite the lifting of the zero interest rate policy, with the official discount rate at 0.5% and the target for short-term interest rates at 0.25%, interest rates are still at ultra-low levels. Though the Bank of Japan would probably like to raise interest rates one stage further, this could not even be considered unless the economy is able to completely break out of what Bank of Japan Governor Hayami Masaru has termed a "plateau." JJTI

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