

Is It Safe to Stop Worrying About Deflation?

By Hamano Takayoshi

In the early summer of 1995 there were widespread fears that collapsing prices would cause Japan's economy to lapse into recession and deflation, but anxiety over deflation subsided when the exchange rate stabilized and the economy began to show signs of a rebound, enabling the government to forecast growth of around 2.5% in fiscal 1996.

Even so, is it really safe to stop worrying about recession and deflation?

The bright side of the economy

According to the economic forecast compiled by the government at the end of 1995, GDP will grow at a nominal rate of 0.9% in fiscal 1995 and a real rate of 1.2% after adjusting for inflation. Projections are that the actual rate will exceed nominal GDP for a second consecutive year and that deflationary conditions will continue. However, it calls for 2.7% nominal growth and around 2.5% actual growth in fiscal 1996.

The government has also outlined its perceptions of current economic conditions in its monthly economic bulletin and in the January 1996 report it dropped the phrase "bearish tendency," switching to "we have entered a stage in which there are signs that the economy is coming out of its stagnancy." In early July, average leading stock prices had fallen to ¥14,295 on the Tokyo Stock Exchange, then stock prices rose to the ¥20,000 mark at the end of the year, giving credence to the notion of a rosier future for the economy. Additional evidence of a rebound cited are an October 1995 Ministry of International Trade and Industry (MITI) survey that projected that fiscal 1995 private capital investment would increase for the first time in four years, topping the previous year by 9.1% and that the diffusion index, the key indicator officially announced by the Economic Planning

Agency, also shows current economic improvement. Data compiled from the Bank of Japan's quarterly corporate *tankan* (*tanki keizai kansoku chosa*: Short-term Economy Observation Survey) survey also indicated corporate confidence that the state of the economy had improved somewhat in November compared to the previous poll in August, profits other than those at financial institutions and securities companies had dropped marginally at the September 1995 midterm close, but ordinary profits (an indicator of earnings during the period) substantially increased by about 20% compared to the same period the previous year, and consumer spending on new cars and home appliances—such as PCs and air conditioners—steadily increased.

Of course, the government's economic forecasts have mostly missed the mark for the last several years. The initial forecast was for real growth at 2.8% in fiscal 1995, but this figure was slashed to 1.2%. Perhaps its too early in the game for optimism about this year's economy.

A mountain of unease

Although the government's economic forecast depicts growth primarily driven by domestic demand without dependence on exports (external demand) in fiscal 1996, other developed nations' economies will decelerate in 1996 and some are of the opinion that there will be even less overseas demand than the government envisions.

As far as employment is concerned, the government's forecast calls for a record jobless rate of 3.2% in 1995 and 3.1% unemployment in fiscal 1996. Three years of near zero economic growth followed the burst of the "bubble" in Japan, but an expansion of about 1% will finally be achieved in fiscal 1995. Even though indications are that real growth at 2% can be anticipated this year for the first time in five years the situation is severe enough not to

allow a recovery in employment. This means that companies will continue to restructure, not hiring even after the economy picks up, and it does not appear that employment prospects for new university graduates will readily improve.

Because Japanese financial institutions have been saddled with huge amounts of bad debts since the collapse of the bubble economy, there is a strong belief that the economy will not improve until there is some sign that the Japanese financial system has revived. Important to the stabilization of the economy is the course that the exchange rate takes in 1996, already showing signs of having stabilized at around the ¥100 to the dollar level.

And in this era of intense global competition, additional increases in cheap imports from Asian nations with low overhead costs are possible. Retail prices will continue to nose-dive in Japan, with expectations that deflationary tendencies will gather steam in certain sectors. Deflationary fears steadily began to subside in Japan from autumn 1995 when the yen began moving slightly downward from the ¥80 to the dollar level and following the government announcement in September of a ¥14 trillion economic stimulus package, the benefits of which are expected to become apparent this year. However, many private sector research firms predict that deflationary trends will persist, some even forecasting only 1.2% growth due to a faltering economy in the latter half of fiscal 1996. The issue is still open to conjecture.

Structural reform main concern

It is important to be aware, though, that not everything about the price collapse phenomenon is completely negative. It would be a different story if it was authentic deflation in which demand fails to rebound even when

prices fall, corporate profits decline, and prices are again slashed, but if income levels instead remain the same and prices fall 10%, for example, the result is a 10% rise in real income.

Generally, commodity price levels tend to rise as income levels increase, but the Organization for Economic Cooperation and Development (OECD) notes that among nations with similar income levels, the U.S., for example, has low price levels while in Japan, on the other hand, commodity prices are relatively high compared to income levels. It could be concluded that special factors are at work in pushing prices higher in Japan.

Inefficiency in non-trade commodity sectors that do not involve trade transactions and are subject to some form of government regulation—such as transportation, telecommunications, public utilities, financial services, and insurance—has been cited as the largest of these factors.

The government has consequently announced action plans to correct high structural costs and revitalize 10 sectors, including physical distribution, energy, marketing, telecommunications, financial services, and agricultural production, within the new economic program (1995-2000) passed by cabinet resolution in December 1995. This action plan sets targets designed to aid in cutting costs and sparking the economy. To achieve these goals it also outlines specific policies such as deregulation, active development of competitive strategies, and modification of business practices, delineating, to the extent possible, time frames for their implementation. To cite an example of an action plan objective in the energy sector, gasoline price levels "are to bear comparison with those of other nations." Gasoline is heavily taxed, but it still costs more in Japan than in other countries even after taxes have been deducted, meaning that the tax-freed price



Women particularly feel the crunch as prospective university grads struggle with job placement—scene from a job fair held at the Tokyo Dome last autumn.

should be reduced to a comparably lower level. "Labor productivity, around 60% in manufacturing industries, is to be raised to international standards" has been set as a target for the distribution industry. Internationally, productivity is 67% in the U.S., 69% in Germany, and 83% in France.

There are fears that competitive manufacturers will move out of Japan if high structural costs are not rectified, leading to a hollowing out of domestic manufacturing industries, but, for all the uproar, not much real progress has been made in deregulation.

Noting that little progress has been made in deregulation, the Administrative Reform Committee's Subcommittee on Deregulation, headed by Shiina Takeo, chairman of IBM Japan, which audits progress in governmental deregulation, proposed liberalization plans for 53 selected categories to former Prime Minister Murayama Tomiichi at the end of last year. In spite of this, a decision regarding the issue of abolishing the

resale price maintenance system that manufacturers use to maintain the retail prices of newspapers, books, and other "literary works" when contracting with retailers was deferred. Public opinion is strongly opposed to the abolishment of this system, but the Fair Trade Commission is urging a review. More important than whether the system should or should not be abolished, some have disparaged newspaper companies for urging fast action on deregulation and then mounting an impressive campaign against deregulation when it concerns their own business.

Even if the Japanese economy is headed for a recovery in 1996, one has the undeniable impression that much still needs to be done if structural reforms are to be sustained over the long term.

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