

# Prospects for a Record Boom

By Shoji Numakawa

**J**apan's economy has now absorbed the shock dealt it by the sharp appreciation of the yen following the Plaza Accord of 1985. The yen's rise set in motion a process of restructuring to transform the export-oriented economy into one led by domestic demand in order to reduce the enormous external imbalances. That process did, in fact, create a major boom in the domestic economy. By November this year the boom will have lasted 36 months.

The economy has experienced 10 booms, including the current one, since the end of World War II, but the expansion now under way is one of the longest yet. It is indeed the first time since the 1965-1970 boom that the expansionary phase has lasted more than 30 months. The questions is how long the present boom will last (Table 1).

The 1965-1970 boom is the longest period of expansion since the end of the war, lasting as it did as many as 57 months, from October 1965 to July 1970. This followed two lesser booms (1954-1957 and 1958-1961) that lasted more than 30 months each. All three booms took place in the high-growth period from the 1950s

to the early 1970s, a period in which the economy expanded at double-digit rates with exports providing the main thrust of growth.

The expansion of exports led to the expansion of business investment, and the resultant increases in income and employment provided the motive power of consumption. This expansion was made possible by the stable world economic system maintained under the leadership of the United States.

The world economy, however, underwent radical changes in the wake of convulsions in the world monetary system and two oil crises in the 1970s. In Japan, the high rate of growth supported by the development of the heavy and chemical industries and progress in mass-production technology came to a grinding halt.

As a result, the growth of GNP, which had averaged nearly 10% a year, slowed to about 4%. According to government economic white papers and other official reports, the period from the first oil crisis in 1973 to the latest round of yen appreciations in 1985 was a "period of stable growth."

It seems that the phrase "stable

growth" reflected an expectation that economic adjustment would be easier when the economy was expanding at half the pre-oil crisis rates of 10% or more and that Japanese society would become more stabilized at such moderate rates of economic expansion. In reality, however, this period witnessed radical changes not only in the world economy but also in the Japanese economy. The economy's expansion was frequently interrupted by the oil crises and the yen's appreciation. Under these circumstances it was simply impossible to have a large-scale boom lasting more than 30 months.

The current expansionary phase is notable for a number of reasons. First, it is the most sustained boom since the high-growth period. Second, it is the first major boom supported primarily by the expansion of domestic demand, in striking contrast to the previous booms, which were all fueled by the expansion of exports. Third, it is based on structural changes in Japan's economy, not merely on cyclical factors.

## Structural changes

Some of the structural changes that have taken place since the Plaza Accord are analyzed below both in macroeconomic and microeconomic terms.

First, the macroeconomic changes. The annual rate of GNP growth was 3.9% in the stable-growth period from fiscal 1974 to fiscal 1985 and 4.3% in the post-Plaza period from fiscal 1986 to fiscal 1988. Thus there was not much difference in the rate of economic expansion before and after the yen's rise. The contribution of domestic demand to growth increased sharply, however, by some 80%, from 3.2% in the stable-growth period to 5.6% in the post-Plaza period. On the other hand, the contribution of external demand was reversed, from 0.7% in the stable period to minus 1.3% in the post-Plaza period (Table 2).

Thus the post-Plaza economy devel-

Table 1 Business Cycles in Postwar Japan

Business cycle	Standard date		Duration		Major cause of contraction
	Trough	Peak	Expansion (months)	Contraction (months)	
1st	Oct. 1951	Jan. 1954	27	10	International payments deficit
2nd	Nov. 1954	June 1957	31	12	
3rd	June 1958	Dec. 1961	42	10	
4th	Oct. 1962	Oct. 1964	24	12	
5th	Oct. 1965	July 1970	57	17	Inflation caused by economic overheating
6th	Dec. 1971	Nov. 1973	23	16	First oil crisis
7th	Mar. 1975	Jan. 1977	22	9	First yen crisis
8th	Oct. 1977	Feb. 1980	28	36	Second oil crisis
9th	Feb. 1983	June 1985	28	17	Second yen crisis
10th	Nov. 1986	—	—	—	
Average duration of business cycles 1st — 9th (excl. 2nd, 3rd and 5th)			31	15	
			25	17	

Source: Diffusion Indexes, Economic Planning Agency

Table 2 Changes in Growth Pattern

(%)

	1st half, high-growth period FY1955-64	2nd half, high-growth period FY1965-73	Stable-growth period FY1974-85	After yen appreciation FY1986-88
<b>Real growth rate</b>	9.7	9.1	3.9	4.3
<b>Domestic demand contribution</b>	9.6	10.0	3.2	5.6
Individual consumption	5.5	5.3	2.0	2.3
Housing investment	0.6	0.9	-0.1	0.7
Business investment	1.4	1.8	0.7	2.0
Government spending	1.8	1.6	0.5	0.2
<b>External demand contribution</b>	0.1	-0.9	0.7	-1.3
Exports and other factors	0.9	1.0	1.0	0.7
Imports and other factors	-0.8	-1.9	-0.3	-2.0
<b>Ratio of current account balance to nominal GNP</b>	-0.3	1.1	0.8	2.4

oped, through the expansion of domestic demand, a new growth pattern oriented toward domestic demand, a pattern in which imports increased markedly while exports expanded moderately. The contribution of domestic demand increased to the 6% level in fiscal 1987 and 1988, years in which the economy achieved comprehensive expansion. Thus GNP continued to grow by more than 5% annually for two successive years, despite the negative contribution of external demand.

Domestic demand consists of a variety of components, such as individual consumption, housing investment, business investment and public investment. Not all these demand components have played an equal role in the latest boom.

When the expansion was still weak, with individuals and corporations taking a cautious attitude, fiscal policy was activated to stimulate demand. Thus, in May 1987 the government put together a package of "emergency economic measures" to substantially expand public investment. On the other hand, the easier-credit policy pursued as part of efforts to promote international economic cooperation sent land and stock prices soaring. And the sharp rise in the value of these assets triggered a rush of housing starts and a consumption boom among the wealthy.

The expansion of public and housing investment was followed by a steady rise in business investment. The boom in individual consumption benefited not only wealthy people but also a wide segment of salaried workers, thanks to growth in wages and employment.

## New ventures

The shift to the new pattern of economic growth led by domestic demand was accompanied, of course, by major changes in the circumstances surrounding Japanese corporations. On the domestic market, many companies ventured into new fields of business, and enterprises in the same industries focused increasingly on internal demand.

Furthermore, stepped-up efforts by foreign companies to expand exports to

Japan or gain access to the Japanese market intensified competition at home. On overseas markets, meanwhile, the export competitiveness of Japanese corporations improved rapidly despite the yen's appreciation, thanks to their positive efforts to adapt to the shifts in currency exchange rates.

In order to avoid economic friction and promote global marketing strategies on a long-term basis, however, Japanese companies will have to continue efforts to establish themselves solidly in foreign markets through local production, without expanding their export share too much. At the same time they need to make further efforts to use more imported products. In the changing situation at home and abroad, as described above, Japanese companies are aiming to boost their overall strength through "conglomeration" and "globalization."

The basic approach to conglomeration is to expand main lines of business through development of higher value-added products and improvement or expansion of information networks. Where mainstream operations have already reached stages of maturation, however, dramatic expansion in the future is difficult. Therefore, companies with such mature operations are also making positive efforts to launch new projects and thereby diversify their operations, particularly in areas on the periphery of technologies and markets related to mainstream activities.

At the same time, Japanese corporations are moving vigorously toward de-

veloping more articulate globalization strategies. Direct investment abroad aimed at building overseas production bases has continued to expand, raising concern in some quarters that domestic industries involved could become "hollowed out" as shrinking production at home would throw many people out of work and erode their competitive position.

This view, however, seems unfounded. Rather, stepped-up overseas manufacturing activities should be grasped as an integral part of the ongoing moves to reorganize and consolidate domestic operations. As for utilization of imports, Japanese enterprises are also continuing positive efforts, such as sending buying missions to foreign countries and concluding technology licensing agreements with foreign enterprises.

Thus Japanese corporations are stepping up activities both at home and abroad in response to the structural changes in the Japanese economy. There is an interactive relationship between macroeconomic and microeconomic changes, with the former giving an impetus to the latter and with the latter strongly supporting the former.

## Pattern of payments

In the high-growth period, Japan's balance of international payments followed a common pattern—that is, it slipped into deficit when the economy became overheated, forcing the government to adopt a tight-money policy. There are no such in-



The construction site of a new exhibition center near Tokyo. Japan's current economic prosperity is led by domestic consumption, in contrast with the last economic boom which was predominantly due to exports.



Strong domestic demand is helping maintain Japan's current economic performance.

ternational payments constraints now, because the country continues to run large surpluses on current account.

In the stable-growth period, the economy went into a tailspin as a result of the oil price rises and the sharp appreciation of the yen. Such external shocks are not likely in the foreseeable future.

In the area of exchange rates, the currency adjustments since the Plaza Accord have proved more or less effective in cutting the U.S. budget deficit, and the United States, which promoted that accord, does not want any further sharp upward adjustment in the dollar rate, because it is increasingly concerned about rising inflation at home. It is expected, therefore, that the framework of international cooperation in exchange rate stabilization will be essentially maintained.

As for world oil prices, OPEC, which has learned hard lessons from its past experiences, believes it is unwise to seek drastic price hikes. In fact, its basic strategy is to keep its 1987 official price—\$18 a barrel—for the time being.

Seen in this context, sustained expansion of domestic demand and long-term price stability are essential conditions for the continuation of the current boom. This is obvious, since it would be practically impossible to make up for a slackening in domestic demand through export-led expansion—the same growth pattern that has been repeated in the past. Indeed, such economic management would be impermissible internationally, given the pressing need for Japan to correct its large external imbalances. Should Japan follow such a mercantilist policy again, it would have quite destabilizing effects on the world economy.

How will the Japanese economy develop for the rest of fiscal 1989? On the domestic front, individual consumption and business investment will continue to provide the main thrust of growth.

The current solid growth of individual consumption will continue for two reasons. The first is that the large net tax cut of ¥1 trillion (after deducting the burden imposed by the new consumption tax) will spur consumer spending. The second reason is that last spring's wage increases averaging 5% or more will give a further stimulus to employment.

Investment in plant and equipment will expand strongly, buoyed by stepped-up business activities. Investment in the manufacturing sector, which began expanding rapidly in fiscal 1988, will keep up about the same rate of growth—more than 20%—in fiscal 1989. It is unlikely, however, that such investment will bring about a sharp increase in productive capacity, except in certain high-growth areas. Therefore, the problem of overcapacity is equally unlikely to arise.

This is in part because investment is aimed largely at promoting restructuring efforts, such as developing products of higher value-added and strengthening the ability to compete. Another reason is that investment is partly designed to replace existing superannuated facilities.

### Price stability

How about the prospects for price stability? Wholesale prices had stayed extremely stable up to fiscal 1988, posting negative rates on a year-to-year basis. Since the start of fiscal 1989, however, the monthly price index has been on an up-

ward trend, recording year-on-year rises of about 3%, due to the firmness in the dollar rate, the rise of oil prices and the introduction of a consumption tax in April.

Unlike export and import prices, domestic prices are not directly affected by changes in exchange rates and oil prices. Excluding the effect of the consumption tax as added on to retail prices, year-to-year rates of price increase have been of the order of only 1%. Oil prices have softened since the spring, reflecting OPEC's desire to boost production. Regarding exchange rates, a further rise in the dollar—which would mean a further fall in the yen—is undesirable both to Japan and the United States in the context of the economic fundamentals.

It is undesirable because such a currency move would widen the differentials in the rate of inflation and the trade imbalance between the two nations. It is likely, therefore, that if the current framework of international economic policy coordination is firmly maintained, the mood in the foreign exchange market will change sooner or later.

As two basic conditions for the continuation of the current boom—expansion of domestic demand led by individual consumption and business investment, and price stability—are being achieved, the inflation-adjusted GNP growth rate for fiscal 1989 will reach an estimated 5.3%.

Domestic demand will continue to contribute positively to growth, generating a 6.2% increment in the GNP. But external demand will continue to contribute negatively, lopping 0.9 point off GNP growth.

It is quite unlikely, therefore, that the present expansion, supported as it is by structural changes in the economy and dynamic business activities, will lose steam anytime soon. If the boom lasts until May 1990, it will be the second-longest expansion in Japan's postwar history, along with the 42-month-long 1958–1961 boom. Judging from the way the economy is growing, it could even outlast that.

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