Economic Recovery and New Policy Issues

By Sasaki Takeshi

AN increasing number of people argue that the Japanese economy is on the road to recovery. In particular, real economic growth for the fourth quarter of 2003 (October-December) reached a surprising annualized 7% increase over the previous period, the highest increase since the bubble economy. People have often pointed out that this figure is not reflected in their daily lives, and one reason given for this is that the figure for the real growth rate is "forced upward" by statistical factors. In other words, due to a fall in commodity prices, the growth rate is significantly boosted. In fact, it has not put the brakes on the decline of GDP deflators.

At the same time, however, no one denies that the Japanese economy has escaped from the worst period since the collapse of the bubble economy. Actual growth has already been positive for the past several years, but the nominal growth rate has remained low and it has been emphasized that it is still in negative territory. But the fourth quarter 2003 figure of 0.9% was a shift into positive territory. The upward trend in the nominal growth rate can surely be seen, after a low of -3.9% during the first quarter of 2002 (January-February). Consumer spending also rose 3.3% over the previous period. Favorable sales of digital home appliances are indicative of this increase. Some point to seasonal factors in the general rise of consumer spending at the year's end, but in December 2003 the unemployment rate dropped below 5% for the first time in two and a half years, making it impossible not to notice a general turn for the better in the economic climate.

Economic growth is particular to certain sectors. Half of the high real growth rate results from capital investment in manufacturing industry which is rapidly increasing exports to the United States and China. The non-manufacturing industries, where deflation has prevented the expansion of sales, seem unable to escape from the long-term sales slump. In this sense, there is a great unevenness in the economic recovery, resulting in polarities in many areas. This accounts for the great gap in business confidence between large enterprises and small and medium-sized enterprises, as well as the great difference between the economic situation in Tokyo and that in rural districts. This polarization is a manifestation of the dissolution of middle-class society in Japan.

The rate of the decrease in compensation of employees, which is the economic basis for consumer spending, has slowed, but it remains at -0.2%. Therefore, the fundamentals of consumer spending cannot be said to have made a strong recovery. Even in the automobile industry, which is prospering, there are no signs of a vast increase in wages. On top of that, the government is planning to increase both taxes and social insurance payments in the near future, and it is not easy to construct a scenario based on growth spearheaded by domestic demand. There is little room for further fiscal or monetary measures, and the general indications are that the only hope is to rely on measures to stop the strengthening of the yen. Skepticism regarding sustainability of growth is dominant.

Twice during the 1990s the Japanese economy showed indications of recovering, but it is said that due to the failure of fiscal and monetary policies growth could not be sustained. Over the past several years, the Japanese government has learned lessons from the past and carried out cautious measures, but this year, basic changes have been made in economic policies. This point is connected with what I wrote in the previous article in this series, but indications of a new crisis are appearing in the rapid weakening of the financial foundations of regional governments. The Koizumi administration declared the reform of the relationship between the central and local governments, describing it as a "three-pronged initiative" to decentralize fiscal controls. The sources of tax revenue which the central government has until now reserved for itself are to be handed to the local administrations, and simultaneously, the central government will reduce various types of financial assistance and subsidies to local governments. The aim of this reform is based on the argument that the self-reliance of regional governments should be increased and the centralized system of power ought to be re-examined. This attempt at reform is highly complex and presupposes scrupulous care in implementation, and as was feared, it has brought about a large number of unexpected effects. Since the end of January, as the content of the central government's draft budget has become clearer, there have appeared a number of local governments which cannot draft fiscal budgets because of the drastic cuts in central government subsidies. It is reported that at the level of the 39 prefectures, there is a deficit in revenue sources of some ¥1.9 trillion. Mutual distrust between the central and regional governments has increased to unprecedented levels.

As a consequence, faced with major cutbacks in annual expenditures, the local governments are taking frantic measures, including increasing the burden placed on their citizens. Local governments are across the board beginning to cut costs at the educational institutions they themselves have established. In particular, these governments are making major cuts in construction projects which are not receiving support from the central government. Some regional governments have resolved to reduce their budgets by as much as 30% compared to the previous year. The construction industry is a prominent base of support for the Liberal Democratic Party (LDP), and with the election for the House of Councilors coming up this summer, misgivings are increasing within the LDP

Photo: The Mainichi Newspapers

Prime Minister Koizumi Junichiro pledges to reform the relationship between the central and local governments at a regional assembly

regarding the political consequences of this crisis in local financial administration. Further, regional financial institutions are in the same boat as the regional governments; the financial crisis of regional governments is a crisis for the regional financial institutions, adding to the deepening crisis they already face as a result of non-performing loans (NPLs). The issue of NPLs, which had appeared to be calming somewhat, may flare up again, this time at the local level.

Accordingly, the central government began considering allowing the local governments to issue new bonds, but this brought forth concerns regarding what the central government would do to guarantee the bonds. The matter of who would bear responsibility for repaying the funds received from such a flotation by local governments is a significant issue affecting the bonds' creditability and ratings. It is estimated that the financial obligations of the central and local governments will total some ¥700 trillion by the end of this year. Holders of such debt will continue to be sensitive to the degree of bond credibility. It is not rare for financial institutions to seek to negotiate discounts for bonds issued by local governments, and there have been some instances where major financial institutions have decided not to purchase local bonds. In response to the insistence by local governments that there will be no defaulting on such issuance, analysts are harboring doubts regarding the responsibility and participation of the central government.

The movement toward economic recovery is giving birth to a new problem. This is the concern that a rise in interest rates – anticipated to accompany a revival of the economy – could result in a steep decline in national bond values. The fact that the total outstanding government debt has grown so enormous is due to the necessity for the government to take active measures to revitalize the economy, but as the goal of economic recovery is gradually approached, there is a possibility that the stability of the bond market cannot be maintained. At present, 10-year national bonds return an extremely low 1.2%, and if the rates start to rise, public debt will become even more serious. To prevent this, it is necessary to prevent domestic holders of such instruments from selling out, and maintaining, as well as expanding, the bond-holding segment is becoming a major concern on the part of the government. The situation has reached a point where the government has to be still more sensitive to the tendencies of the bond market within the overall context of the economic recovery.

Over the past few years, the enormous system in which the central government "borrows" and in turn "lends" large amounts of capital has taken deep root in Japan. This system, which is commonly referred to as "financial socialism" has proliferated repeatedly under the reforms touted by the Koizumi Cabinet. Financial institutions, local governments and even business firms are dependent on this massive system, and at last it would seem that a start has been made toward economic growth. The system has existed in a relationship with severe deflationary conditions, and as the goal of conquering deflation comes into sight, its fragility becomes more apparent. However, one cannot surrender to the desire to sustain deflation and keep interest rates down. Economic recovery brings on the foreboding sentiment that a new dilemma in policymaking will present itself.

Government policy preparations are essential in determining whether this dilemma can be overcome without major economic side effects. Compared with this issue, the problem of whether or not to assist local governments is one which belongs to the past. One vaguely sees the intention of the government to solve the dilemma by means of tax increases, but public debt has increased far beyond the level where such policies would be effective. In this sense, Japan's financial and monetary policies would appear to be entering a new phase. JS

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