Yoshino, Toshihiko

Article

The Japanese economy and its problems

Intereconomics

JAPAN

The Japanese Economy and Its Problems

by Toshihiko Yoshino, Tokyo *

For some time the Japanese Government has been heavily urged upon to adopt expansionary measures and thus contribute via increased imports to the economic recovery of Japan's trading partners. Against this background, the following article analyses the present state of the Japanese economy and the prospects of removing the country's huge current account surplus by appropriate policies.

Today, the Japanese economy is suffering from many problems but the basic reason behind all these problems can be found in the oil crisis. Since autumn of 1972 commodity prices had already risen at a fairly high rate reflecting a rising trend of business condition, and at the end of 1973, due to the oil crisis, prices began to rise at an accelerated rate. In February 1974, inflation hit a peak, when wholesale and consumer prices rose by 37.0 % and 26.3 % respectively over the year-before month. Also, the current account of Japan's balance of payments, which had recorded a surplus of US $ 6.6 bn in 1972, marked a deficit of US $ 4.7 bn in 1974 mainly because of the huge increase in oil import payments.

To cope with this galloping inflation and the deterioration in the balance of payments, the Japanese Government and the Bank of Japan jointly introduced restrictive fiscal and monetary policies. These measures were successful in checking the sharp rise in prices, and the slowdown in the advance of wholesale prices on a year-before basis was particularly remarkable. In December 1974 the level of wholesale prices as compared with the same month of the previous year was up by around 10 %, but by February 1975 it slowed down to a single-digit figure and in November 1977 actually registered a minus figure. The slowdown in the rising rate of consumer prices was not as notable as that of wholesale prices but, even so, it dropped to the single digit level in October 1975 and in December 1977 to as low as 4.8 % on a year-before basis. Meanwhile the deficit in the current account gradually shrank and in 1976 a surplus of US $ 3.7 bn was recorded. In 1977, this surplus exceeded US $ 11.0 bn.

In this way the Japanese economy was able to overcome the problems of inflation and the deterioration in its international balance of payments within a relatively short period. On the other hand, however, the stringent deflationary measures led to a serious recession.

Shift to a Low Growth Stage

For the first time since the end of World War II, the real economic growth rate for 1974 recorded a minus of 1.2 % compared to the preceding year. With Japan's life-time employment system it was possible to avoid, unlike the US and European countries, a huge rise in unemployment figures. Nevertheless, the unemployment rate, which had remained at slightly above 1 % during the high economic growth period, rose above the 2 % line at the end of 1975. Furthermore, the earnings of Japanese corporations declined substantially, and the recurring profit of firms listed on the Tokyo Stock Exchange marked a drop of 71 % in the September period of 1975 compared to the peak recorded in the September period of 1973. This enormous decline in corporate earnings was attributable not simply to cyclic factors but also to the large volume of idle production facilities as the Japanese economy shifted from a high to a low growth stage with the oil crisis as the turning point. Typical examples include such industries as the open hearth steel, aluminium smelting, and shipbuilding industries which all carried out large-scale equipment expansion programs just before the oil crisis. In addition, the business performance of the textile industry, as well as other industries which are being surpassed by

* Executive Vice President, Director General, Yamaichi Research Institute of Securities and Economics, Inc.

their competitors in developing countries where low wages prevail, has become notably stagnant. These industries are in such a serious recession that they cannot be restored by ordinary stimulative measures. Accordingly, it is forecasted that their serious situation will be prolonged and consequently they are being considered as structurally-depressed industries.

At the beginning of 1976 it appeared that such recessionary phenomena would improve somewhat, but in the second half of the same year the business conditions again worsened. The Japanese Government implemented positive measures to raise the real economic growth rate in fiscal 1977 to 6.7 % but it gradually became clear that this was infeasible and the Government was recently forced to revise its target downward to 5.3 %. In actual fact the real economic growth rate for 1977 was 5.1 %. Nonetheless, this rate is higher than those of the US and European countries. The controversial point, however, is that this growth depended upon increased exports and stagnant imports. As much as 30 % of the 1977 economic growth was accounted for by the surplus of the nation in the current account which totalled US $ 11 bn. At the outset, the Government had projected a deficit of US $ 700 mn in the current account for fiscal 1977, but in September 1977 this was raised to a surplus of US $ 6.5 bn and recently it was revised again to US $ 10.0 bn.

Strengthening of the Yen

Of course, this huge surplus in the current account triggered a sharp floating up of the yen. The yen against the US dollar continued to appreciate throughout 1977. It started the year at around Y 292 to the dollar and closed at Y 240, thereby showing a rise of 22 %. Ordinarily, such a large appreciation would contribute to reduce the surplus in the current account but, for various reasons this was not the case.

Of course, the strengthening of the yen dealt a blow to many sectors of Japanese exporting industries. However, the products of major durable consumer goods industries, particularly the automobile industry, possess strong non-price competitive power such as high quality, quick delivery, and excellent after-sale services. Therefore, it was possible for these industries to raise US dollar-denominated export prices without preventing the export growth rate of these items from rising even further.

On the other hand, the business conditions of export-related industries other than the automobile industry suffered a blow from the rising yen and their production growth slowed down. Therefore, the import of raw materials and fuel which account for 64 % of Japan's total imports remained stagnant.

It is not desirable for Japan to maintain the large surplus trend in its balance of payments while numerous other countries continue to mark a deficit as a result of the higher oil prices and are consequently unable to adopt expansionary economic measures. Therefore, the Japanese Government and the Bank of Japan have adopted various measures to reduce the current account surplus.

Reduction of the Current Account Surplus

Firstly, voluntary restraints have been imposed on their exports in view of the trouble arising from massive shipments by Japan's steel, automobile, and color TV set industries to the US and European markets. Consequently, the export growth rate of these industries abated considerably in 1977, and some of their products even showed a decline from the preceding year. In the autumn of 1976 the US color TV industry stressed that it had suffered a loss from rising imports from Japan. As a result, negotiations regarding this matter were held between the Japanese and US Governments and it was agreed to put into practice a quantitative restriction on shipments of Japanese color TV sets to the US market from July 1977.

Secondly, the Bank of Japan allowed the yen to appreciate. In the past, the Bank of Japan was frequently criticized for suppressing the rise of the yen through intervention in the foreign exchange market. Actually, however, the Bank of Japan had only taken measures to smooth wild fluctuations in the yen rate and had refrained from taking excessive interventional action. Therefore, the sharp appreciation of the yen continued, reflecting a huge surplus in Japan's current account accumulated during 1977.

Thirdly, tariff rates were lowered. In December 1977, prior to the commencement of the Tokyo Round, the Japanese Government decided to reduce the tariff rates on 318 items as of April this year to promote the import of foreign products into Japan.

Fourthly, there is the decision by the Japanese Government to ease the restrictions on the import of agricultural products. In December 1977, there was the partial liberalization on the import of 11 items including smoked herring, etc. In addition, the Government decided in January 1978 to greatly expand the import quotas on beef, oranges and fruit juice for fiscal 1977 (ending in March 1978). As the international competitiveness of Japanese agricultural products is weak, there was strong opposition to this easing of import restrictions. From the standpoint of maintaining the free trade principles, however, it is well known that the existence of various import barriers is not appropriate and, thus, in spite of the opposition from the domestic side, the Japanese Government effected the liberalization of farm product imports, though not on an overall basis.

Expansion in Fiscal Spending

Along with such direct measures to reduce the surplus in the current account, the Government introduced a fiscal expansionary program to increase domestic demand. This is important in that an increase in domestic demand will ease the export drive and stimulate the growth in import demand for fuel, raw materials and manufacturing products. The result should be a reduction in the current account surplus. The general budget for fiscal 1977 was 17.4 % larger than the original fiscal 1976 general budget and the Treasury investment and loan program was 18.1 % larger. The pillars of the Government's stimulative fiscal policy were the expansion in public works expenditures and the promotion of residential constructions. In fiscal 1977 the budget of public works expenditure was up 21.4 % over the original fiscal 1976 budget. The Government also sharply increased the allocation of public funds to the Housing Loan Corporation. Furthermore, in an effort to magnify the effects of the expansionary fiscal spending, the Government decided to conclude 73 % of public works contracts covered by the fiscal 1977 budget in the first half of the fiscal year.

This expansion in fiscal spending, however, failed to stimulate the private demand recovery, and, in fact, the concentration of contracts in the first half of the fiscal year led to concern that a shortage in fiscal investments would arise in the second half of fiscal 1977. Therefore, the first supplementary budget was formed in September 1977 to increase public expenditures which would add new demands of about Y 2 trillion. Despite the implementation of these measures, however, the yen began to appreciate at an even greater pace in and after October 1977 than before and business confidence shrank away.

As a result, fears arose that this pessimism would diminish the effects of the additional public spending. Therefore in December the Government announced a so-called 15-month super stimulative budget incorporating the 2nd supplementary budget for fiscal 1977 with the big-scale fiscal 1978 budget. Up until then, it had been the Government's policy to keep the flotation of government bonds within 30 % of the annual general budget revenues so as to avoid an excessive increase in the outstanding amount of government bonds. With the announcement of the 15-month budget, however, the authorities were forced to abandon this restraint. After the formation of the 2nd supplementary budget, the ratio of government bonds to the fiscal 1977 general budget revenues rose to 34 %. Also, the initial fiscal 1978 general budget is 20.3 % larger than that of fiscal 1977 with the ratio of government bonds to the total revenues in the original fiscal 1978 general budget at 32 %.

In the future, an expansion in exports should not be relied upon to bring about a business recovery so as to contribute to the world's economic recovery. Furthermore, with the yen at its present high level, it would be difficult to increase overseas shipments even if efforts were made in this direction. On the other hand, it cannot be expected that a recovery in private domestic demand including personal consumption and private equipment investments will stimulate the economy, as the fear of unemployment is rising among workers and the capacity utilization ratio has marked a big drop. Accordingly, the Government believes that there is no alternative but to expand the economy through increased fiscal expenditures. However, economic expansion through public investments alone will only benefit certain industries where government orders will be concentrated. As a result, there is concern that prices of construction materials will rise. It cannot be denied that bottlenecks, such as a shortage of planning engineers, will be created. In this context the Government's decision to effect an income tax rebate of Y 300 bn to satisfy the strong demands of the opposition parties must be appreciated.

Monetary Policy

Next, a few words about the monetary policy. To reinforce the Government's stimulative fiscal policy, the Bank of Japan promoted the lowering of interest rates. In 1977, the official discount rate was reduced three times and by September 1977 it was down to 4.25 %. This rate is the same level which was in effect between June 1972 and April 1973 and is the lowest in the postwar period [1]. Despite the drop in interest rates, however, there is almost no hope of a recovery in private capital spending but it is forecasted that lower rates will

[1] The article was written before March 16, 1978, when a further reduction by the Bank of Japan of its official discount rate to 3.5 % became effective.

help to alleviate the pressure from rising labor costs and ease the rising uncertainty over unemployment.

Irrespective of these fiscal and monetary policies the economy is continuing to be stagnant and at the moment no signs of a rapid reduction in the current account surplus can be detected. Although some progress has been marked in inventory adjustments by private corporations, it is still insufficient as a whole and therefore the stimulative effects of the enlarged public investments on private demand have not shown up clearly yet. Quite recently, however, considerable progress in inventory adjustments has been recorded by certain industries including cement, iron and steel, etc., and the effects of public investments are beginning to show to some extent. Accordingly, if the Government continues its active attitude, it is possible that the economic growth rate will be greater than 1977 and the current account surplus will shrink gradually.

By raising the real economic growth rate target for fiscal 1978 to 7 % at the end of 1977, the Japanese Government attempted to increase imports and reduce the surplus in the current account to US $ 6.0 bn. According to this scenario, if fiscal spending is substantially expanded and concentrated in the first half of fiscal 1978, it will become a pump primer to complete inventory adjustments; and in the second half of the fiscal year, it will be possible to expect a considerable gain in personal consumption, private capital spending, and private inventory investments.

Main Issues for 1978

In comparison to this official outlook, many private research institutions forecast that although inventory adjustments of cement and other construction materials directly connected with public works expenditures will be promoted, it will still be difficult for inventory adjustments in general terms to be finished in the first half of fiscal 1978. Therefore, it will be difficult for private demand to grow at the rate envisioned by the Government and, as a result, the real economic growth will remain at about 4 % or 5 % while the current account surplus will drop to around US $ 8 to US $ 9 bn.

Accordingly it can be said that the two main economic issues facing Japan in 1978 will be (1) whether or not inventory adjustments will be completed in the first half of fiscal 1978 and (2) whether or not the expansion of public works will act as a pump primer to increase private demand in the second half of the same year. It can also be said that the key to achieving a 7 % growth in fiscal 1978 can be found in these issues. If the Government wants to realize its goal in view of both domestic and overseas requirements, it has no alternative but to introduce further fiscal measures. From this point of view, it will be important to concentrate appropriation of public works expenditures in the first half of the fiscal 1978. If the inventory adjustments are delayed, the Government must consider additional fiscal steps such as the preparation of a supplementary budget at an early date in fiscal 1978.

No Guarantee for Increased Imports

Even if these measures are implemented effectively and the Government succeeds in realizing a 7 % real economic growth target, it will not necessarily mean that the current account surplus will be reduced to US $ 6 bn. This is because the capacity utilization ratio is still low and the inventory level of imported materials is still high. When these factors are considered, there is no guarantee that a rise in the economic growth as well as in industrial production will immediately lead to a huge increase in import demand. Accordingly, there will be a need to stimulate domestic demand and simultaneously take additional direct measures like increasing the import and stockpiling of energy resources and other materials in order to reduce the surplus in the current account.

The US and European countries are looking forward to seeing a deficit in Japan's current account in the very near future. Frankly speaking, however, it will be difficult to register such a deficit within a short period.

Japan has many export products possessing strong non-price competitiveness as a result of efforts paid to the modernization and rationalization of manufacturing methods over many years and Japanese goods have become appealing items to overseas consumers. Since the Japanese economy has now switched from a high to a low economic growth period, it will be difficult to increase imports rapidly even if desired by overseas countries. Therefore, it seems that the only alternative is to bring about the equilibrium in the basic balance of international payments which is a combination of the current balance and long-term capital balance. In 1977, the long-term capital balance showed a deficit of US $ 3.2 bn reflecting the low interest rates in Japan and it will be necessary for this deficit to swell further by increasing the issue of yen-denominated foreign bonds as well as monetary aid to developing nations.