THE ECONOMIC OUTLOOK FOR JAPAN

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The Japanese economy is vitally important to the Asian economic recovery in many ways. Japan's economy is large, amounting ¥491 trillion in FY1998, or $4 trillion. Japan is actively engaged in the economies of the region, with trade amounting to ¥30 trillion or $250 billion per year, and accumulated direct investment in Asia of roughly $100 billion.

Japan is expected to be the locomotive to pull the other Asian economies out of the present economic crisis. However, the Japanese economy shows very little signs of a self-sustained recovery and it will remain stagnant for the near future in spite of recent government efforts and in spite of improvement in some economic indicators.

The background for this pessimistic view is the structural problems that exist in Japan. In our opinion, the Japanese economy has still not resolved the structural problems that materialized during the period of low economic growth in the 1990s: (1) excess supply capacity in the non-financial corporate sector and (2) non-performing loans at financial institutions and the resulting credit crunch.

The outlook for the Japanese economy in FY1999 and beyond will definitely be determined by the ways in which the public and private sectors tackle these problems.

1. Current Economic Trends

We have seen an improvement in some economic indicators since the 4th quarter of 1998. For example, industrial production, which had been falling sharply through the first half of 1998, has been trending sideways since last summer. And recently industrial inventories have been declining very sharply. Similarly, the number of corporate bankruptcies, which rose nearly 30% year-on-year in the first half of 1998, has shown remarkable improvement since last November. On top of this, there are also some episodes of demand recovery such as strong sales of PCs, mini cars, and residential condominiums in Tokyo. Also the recent buoyancy in the Tokyo stock market is giving the economy some breathing space.

These improvements are definitely the result of the economic policy measures taken by the government last year. The government provided additional public works spending of ¥24 trillion, which was the largest economic stimulus package ever, and it made available ¥20 trillion in loan guarantees against the credit crunch for small and medium-sized businesses. These measures are contributing effectively to the current economic situation and the improvements actually taking place. Based on such observations, the EPA (Economic Planning Agency) reports that the recession is close to bottoming out and that the economy should begin to recover soon.

2. Economic Outlook

However, private economists, including us, see these improvements as basically only transitory and believe that the Japanese economy requires more structural adjustment, which should come from now on.

According to our estimation, the current fiscal stimulus is large enough to raise public investment in the first half of this fiscal year by about 20% (year-to-year basis), but these effects will evaporate totally in the second half of this fiscal year. Without additional stimulus measures, year-to-year growth of the economy will be almost zero, and on a half-year basis it will even be negative.

3. Private Sector

Private sector demand will remain weak. The current improvement in consumption and housing investment has not been accompanied by improvement in household income and employment. Indeed, the unemployment rate in Japan exceeds the level in the U.S., and it recorded its highest level in history, 4.6%, in February 1999. The unemployment rate is very likely to climb even higher.

Cost-cutting efforts of companies have reached the point where two pillars of post-war "Japan, Inc." are no longer sacrosanct, namely lifetime employment and automatic salary base-ups.

As Japanese households still have little faith in their future income and job security, it is unlikely that expansion of private consumption could outpace income growth, which will be a modest 0.1% in terms of disposable income. Despite a planned ¥4 trillion tax cut in FY1999 and distribution of ¥700 billion worth of consumption vouchers, household consumption is unlikely to lead the Japanese economic recovery.

Low inflation or even deflation will boost real consumption a little, but the effect will be very limited.

On the corporate side, restructuring has just begun. Pressure to reduce labor cos t and capital spending has been intensifying. The improvement in the number of bankruptcies is supported by government policy measures, but it may be only temporary. The credit crunch situation will continue for some time, as loans extended by banking institutions have been shrinking by 5 or 6% per year. And the interest spread between corporate bonds and Japanese government bonds is widening, suggesting that the business sector still has difficulty finding operating funds.

Under these circumstances private investment, which has been declining sharply, will become even weaker in the coming quarters. Because of the existing excess capacity and lower expected potential growth of the economy, there is no way for businesses to take positive action on investment, particularly in the traditional manufacturing industries. According to our model calculation, given an expected future annual growth rate of 1.5%, private capital spending will decline by about 10% in fiscal 1999, after declining about 15% in the last fiscal year.

The government has announced plans to strengthen the supply side and to stimulate the emergence of the information technology industry. However, Japan's existing industries still have vast excess capacity that should be reduced first in order to restore their profitability.

4. Banking Problems

Since the end of last year the government started to tackle the structural problems of the troubled banking sector. Banking reform is taking place under two new pieces of legislation, the Financial Revitalization Law (FRL) and the Bank Re-capitalization Law (BRL).

Under the FRL the government is to close problem banks or to establish bridge banks to put them under special public control. Since October 1998, two banks, LTCB and JCB, have been nationalized following the processes prescribed by the FRL.

Under the BRL the government is to use public funds to re-capitalize banks that have not yet failed and are considered capable of remaining in business. Fifteen leading banks have applied for ¥7.46 trillion in capital injections from public funds. With the addition of ¥2 trillion in private capital, nearly ¥10 trillion will be injected into the major banks. However, it is still doubtful whether the re-capitalization program is large enough to restore banks' balance sheets.

A self-assessment in September 1998 by Japan's 17 major banks reported ¥44.1 trillion in non-performing loans. According to the Financial Supervisory Agency the volume of non-performing loans amounted to ¥49.5 trillion out of a total loan portfolio of ¥395.2 trillion at the end of September 1998. Although the write-off of non-performing loans in FY1998 is estimated at more than ¥9 trillion, this is not as large a write-off as the market has been calling for.

The injection of public funds into the financial system is expected to have a definite impact, but it will not be enough to clear all the bad loan problems.

5. Exports

An additional factor affecting Japan's economic outlook is the likelihood that overseas demand will fall due to the rapid rise in the value of yen against dollar since the autumn of 1998. Thus, net exports will not work as a traditional stimulus measure.

6. Government Debt

All the worse, private risk has been transformed into public risk through repeated stimulus measures. The government's fiscal deficit has grown to unprecedented proportions. As a result, long-term interest rates are rallying. The ballooning fiscal deficit and the rise of long-term interest rates could mean that the government will no longer be able to put off tackling the economy's fundamental structural problems.

7. Forecast

While the government is predicting a positive growth rate of 0.5% for FY1999, we forecast real GDP growth of minus 1.3% for this fiscal year. We forecast that the economy will stop shrinking around the end of 1999 as adjustments in domestic private-sector demand run their course. However, even if this were the case, the Japanese economy would in all likelihood not improve enough to allow anything more than modest growth of 0.2% in FY2000.

8. Japan's Role in Asia

The Asian economies have experienced severe crisis in the past two years. Some economies in the region have already shown signs of recovery and some are still in a prolonged recession. The causes of the Asian crisis are generally attributed to several distorting factors created during the process of rapid economic growth, including the dollar-linked exchange rate mechanism and the huge and unstable inflow of foreign investment. Delays in undertaking structural reforms, including in the financial sector, are also considered partly responsible for exacerbating the crisis in these economies.

The relationship between Japan and Asia has become even stronger since the onset of the crisis. Japan has always been recognized as a big market for Asian products and as a supplier of goods and technology, but this crisis highlighted the importance of Japan as a source of capital. Japan has played a major role in providing financial stability.

In August 1997, the IMF arranged $4 billion in international financial assistance to help Thailand cope with the crisis. In parallel with the IMF, Japan immediately extended another $4 billion package to that country. Following this, Japan arranged similar packages for Indonesia and Korea and by the autumn of 1998 (with the New Miyazawa Initiative) its financial support of this type to the region amounted to $44 billion.

The New Miyazawa Initiative announced October 1998 was to provide an additional $30 billion on top of previous funds to further help the Asian economies. Of this $30 billion, $15 billion is in swap agreements with Asian central banks in response to immediate funding needs while another $15 billion is prepared to purchase Asian sovereign bonds directly or to guarantee sovereign issuers for international fund-raising. Japanese funds were effective in lowering the credit risk premium the market required on issuers during the turmoil.

These packages were aimed at revitalizing the Asian economies and their industries and at assisting structural reforms including in the financial sector and managing bad debts. They also are intended to provide for human resource development and to help socially vulnerable sectors. In the long run, one of Japan's major contributions is in regard to the issue of how to bring currency stabilization to Asia, and the internationalization of the yen has again become a big policy issue not only for Japan but also for Asia.

Japan is expected to play a more important role to support the emerging recovery in the regional economy. Revitalization of Japan's economy itself would provide very strong support for the region, however it is unlikely that Japan will recover quickly from its prolonged recession. Thus, Japan's immediate contribution to help the Asian economies to escape from the financial crisis is expected to be providing more direct support in the financial area.

In the future, Japan is expected to take greater initiative to establish the Asian Monetary Fund, which would complement the current role of the IMF. The success of such an arrangement would depend not only on Japan but also on the participation and cooperation of other Asian countries.

Japan has much to contribute to Asia in the human as well as the financial area. To support Asia in this way, Japan should maintain an ongoing, lively interchange with the countries in the region, particularly by providing opportunities for international exchange of people and ideas.