

JAPAN

2002: RECESSION POSTPONED

The Japanese economy looked weak as of the middle of 2002, and most economists predicted that it would enter recession in the fourth quarter. But the data released in February in 2003 revealed four successive quarters of positive growth in 2002.

Strong export growth was the leading factor mitigating against recession.

The outcome was influenced by a revision of the national income and product accounts (NIPA) system. First, the statistics on household consumption expenditure were revised and new data showed a 1.5 per cent growth in 2002. Second, the statistics for business fixed investment were revised with respect to IT-related expenditures (particularly the purchase of software and development of in-house software).

Positive growth in 2002 was supported by the link between East Asian trade and Japanese FDI and by the changed statistics of household consumption expenditure.

A continuous effort is being made to reduce public spending. Public fixed investment shrunk by 4.4 per cent last year, and this trend is expected to prevail for a while.

Japan avoided entering into recession in spite of problems with non-performing bank loans (NPLs), rising unemployment, and the ongoing deflation.

A hard or soft landing? In October 2002, Mr. Koizumi appointed Mr. Takenaka as Chief of the Financial Bureau to take charge of the non-performing loan situation. The goal is

to reduce the size of NPLs to half current levels within two years. If carried through, bankruptcies of indebted firms in the three big depressed industries (construction, real estate and large retailers) will accelerate, creating a new wave of unemployment of up to 600,000 people (pushing up the unemployment rate by nearly one per cent).

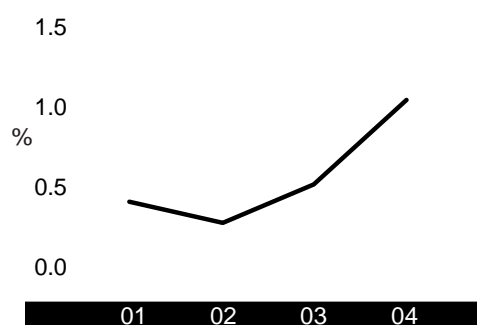
Through 2002, the stockmarket was stunned by this rising probability of a hard-landing. Banking stock prices tumbled. The CEOs of four major banks appealed to the public by saying that Mr Takenaka's proposal for assessing banks' NPLs as 'changing rules in the middle of a game'. But an upward revision of the assessment of NPLs occurred and banks enhanced their own capital by issuing new stock. In the case of Mizuho Financial Group, hundreds of borrower firms agreed to buy new stocks, contributing 1.5 trillion yen as a whole to their 'main bank'.

Another view is that an urgent operation to deal with financial problems would only aggravate current deflation, producing new non-performing loans. A massive anti-deflation policy is recommended because ongoing deflation depresses expenditure. The hard-landing policy camp seems to have lost ground in the face of this argument. **Changed monetary policy.** The new President of the Bank of Japan, Mr. Fukui, seems to be more understanding of the need to explore flexible monetary policy. For the time being, the supply of reserve money is being expanded, and the Bank may consider adopting extraordinary measures to expand money supply in the near future.

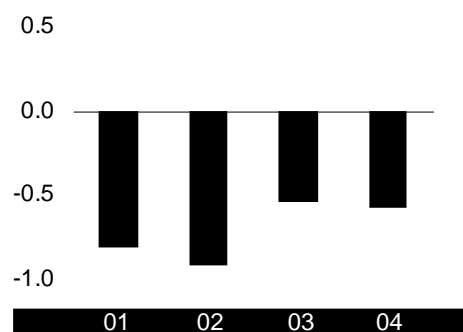
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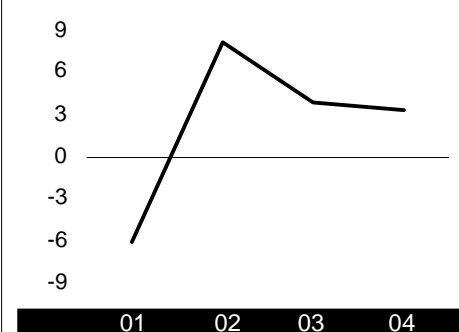
GDP growth



CPI inflation



Export growth



Fall in employment to continue.

Unemployment rose to 5.5 per cent in October 2002 and has stayed at this level since. The female unemployment rate has declined, but male unemployment reached 5.9 per cent—a new high. So-called lifetime job security and income guarantees for older (or more experienced) employees were features of the Japanese economy. Rising unemployment among those over 50 years old is a sign of the traditional system's collapse.

Anticipating the potentially severe impact of a 'hard-landing', corporate managers are preparing to restructure employment further.

As of the end of September 2002, the 500 firms listed on the Tokyo Stock Exchange cut nearly half a million employees, or 9.1 per cent of total employees, in 12 months. Department stores, which laid off the most employees, recorded a drop of 21.2 per cent, followed by the steel industry (14.9 per cent) and the finance and insurance sector (11.7 per cent).

The high saving rate of households is related to job insecurity. Young households on average now save 10 per cent more than their parents did at the same age. Stagnant consumption expenditure is expected to continue.

Manufacturing firms are cautious with investment spending since the export outlook for the US market is not bright. Besides, they now tend to invest overseas. Japan's annual foreign direct investment into other countries is as large as 8 to 10 per cent of its total domestic private fixed investment.

Among the components of total domestic final demand, demand from the public sector is shrinking, and

personal consumption expenditure is growing at less than 1 per cent per annum. Inventories have been squeezed in recent quarters, recording a significant negative rate of change—inventory growth reached 0.5 per cent of GDP in the first half of 2002. If exports were not growing, business fixed investment would probably remain stagnant. This is the medium-term outlook for the demand side of the Japanese economy.

Japan's supply capacity is still way too large. The construction industry ought to be trimmed down by 30 per cent. Large retail stores are probably overstaffed by about 20 per cent and have 10 per cent oversupply of capital stock. The banking and insurance sector, where mergers and acquisitions are common, will have to reduce the huge number of redundant branch offices, which occupy major corners of downtown or business districts.

Suppression of the supply side brings about suppressed demand. That is what has been taking place in the Japanese economy for the past 10 years. What does it imply for the hard-landing scenario? The reform and adjustment necessary in Japan is a severe process of reducing supply capacity. The work is half done. It will take some more years before Japan sees renewed growth if the present reform policy fails in bringing about additional new demand through IT-related innovation in the consumer goods and services sectors.

2003–04: LITTLE GROWTH

There is no room for expanding the fiscal deficit further, even though Mr. Koizumi caved in on his public claim that the fiscal authority would maintain

a 30 trillion yen cap on the ever-swelling deficit. Fiscal year 2002 is likely to have recorded a deficit as large as 36 trillion since a supplementary budget has been passed in the Diet. Even then it will only reduce income tax by 1.5 trillion yen. The budget of 2003 will include tax cuts on corporate investment and personal dividend income. Reduction of the tax on inheritance and bequests is being discussed as a way of activating household spending.

The economy is running along a narrow path of non-negative near-zero growth. It has avoided entering into recession in 2002. In 2003, the weak US economic outlook poses a negative risk. Personal consumption expenditure will remain stagnant and business fixed investment will not recover in 2003. Japan's FDI to China will keep increasing. Previous concerns about the effects of the war in Iraq and the developments in markets for oil have now diminished.

A bright side is the strengthening of links among Japan, China and East Asia as key elements of a world supply centre. Japan's exports to East Asia will help the economy avoid moving back to negative growth, but the likelihood of slow growth remains, with the downside risk coming from the threat of the hard-landing scenario.

Main drivers of GDP growth, 2002

Exports of goods and services were the main drivers of growth in 2002. Firm investment and consumption expenditure remained weak.

