Economic Forecast for FY 1998

The Bubble's Legacy Continues to Impede Recovery

by the Economic Research Dept.

Introduction

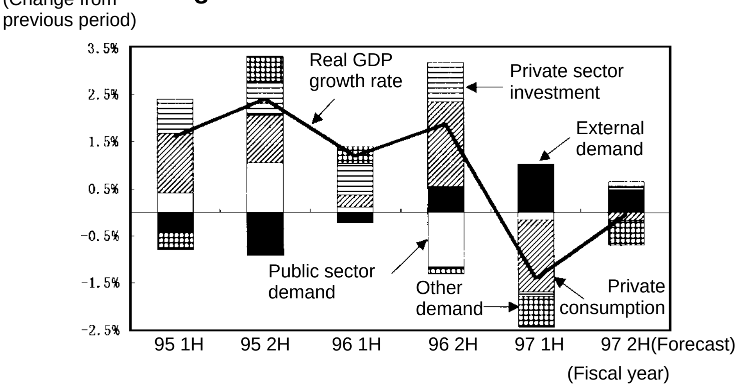
The economy entered a recession in early fiscal 1997 due partly to larger burdens imposed on the household sector. The situation worsened as more financial institutions failed in November and consumption chilled further. For the fiscal year, we predict -0.4 percent growth, which would be the worst performance since fiscal 1974. While the large stimulus package should halt the economy's decline, the negative legacies from the collapsed bubble economy continue to weigh down the economy. For fiscal 1998, we predict that the economy's weak undertone will persist, limiting real growth to 0.7 percent.

1. The Domestic Economy—From Bad to Worse in Fiscal 1997

(1) Present Status

Higher burdens including the consumption tax hike in April 1997 helped dampen consumption and pull the economy down into recession from its peak in the spring. Consumption showed signs of recovering during the summer and fall, but chilled again with the string of financial failures led by Yamaichi Securities in November. Even capital investment growth, sustained since fiscal 1995, slowed down and then began decreasing in undertone.

Figure 1 Growth Pattern of Real GDP

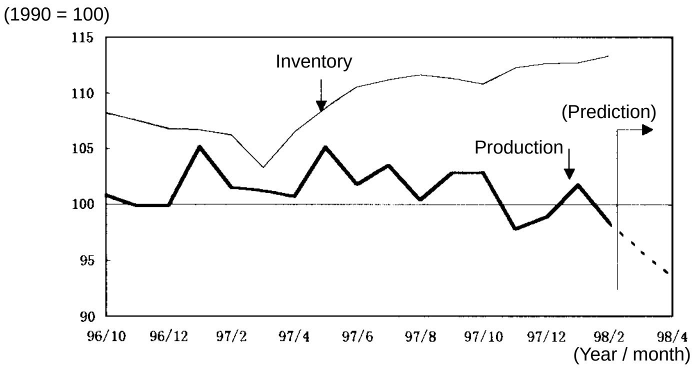


Source: EPA, *Annual Report on National Accounts.*

In addition to weak private sector demand, public works spending also declined, causing domestic demand to decline sharply. The economy was propped up by external demand as the current account surplus ballooned.

Industrial production remained level in the April-June quarter due to inventory building following the demand surge. However, as final demand declined more than expected, inventories rose, and by Autumn production adjustments had moved upstream from final goods to raw materials. With the production downturn being amplified by inventory adjustments, and external demand dampened by Asia's economic crisis, corporate activity has become cautious.

Figure 2 Industrial Production Index (Seasonally Adjusted)

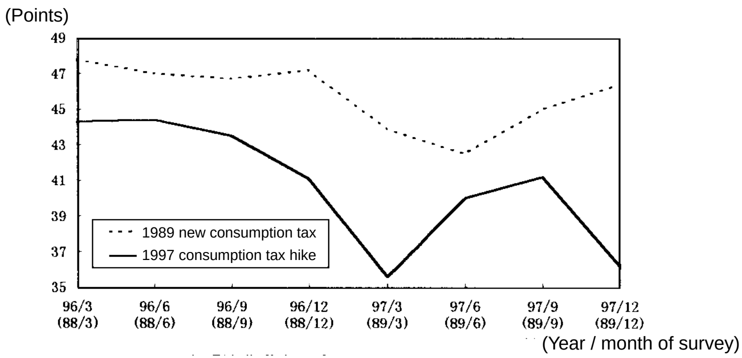


Source: MITI, *Industrial Statistics Monthly.*

1) Weak Consumer Spending

Consumption was seriously hurt by the consumption tax hike in April. This was due not only to the decline in real income, but to a displacement effect that caused demand to surge prior to the tax hike and then plunge afterwards.

Figure 3 Comparison of Consumer Attitudes Index



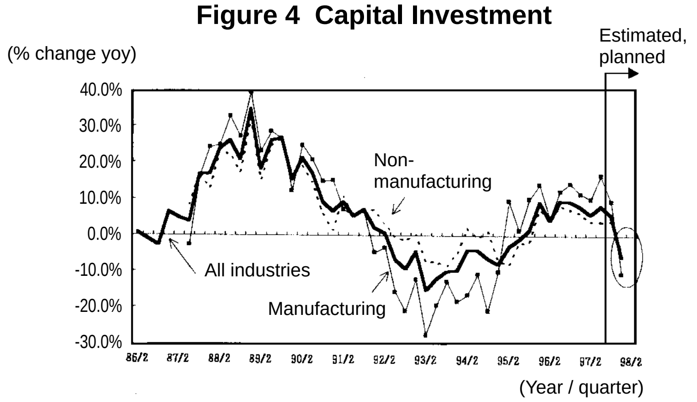
Source: EPA, *Consumer Behavior Survey.*

Consumer sentiment, which deteriorated from around Spring 1997 due to the consumption tax hike, later showed signs of moderate improvement. Compared to the introduction of the consumption tax hike in 1989, the decline and subsequent recovery in consumer sentiment following the recent tax hike were not very pronounced, although the general level of sentiment was low due to the weak economy. However, the series of financial failures in November and post-war high in the unemployment rate caused consumer sentiment to decline again in December due mainly to employment anxiety, thereby dampening consumption. The propensity to consume also declined as consumers have become restrained in their purchasing behavior.

2) Deceleration in Capital Investment

Capital investment's sustained growth since fiscal 1995 showed signs of slowing down as fiscal 1997 began. Since 1995, the cyclical growth in capital investment was initially led by semiconductor-related investment, followed by mobile communications with the deregulation in PHS and cellular phones. In fiscal 1996, the weak yen boosted earnings among exporters and stimulated investment in automobile and other industries. Just when this investment activity was abating, the weak economy dampened overall corporate activity, and capital investment has slowed down across all sectors of the economy.

Figure 4 Capital Investment



Source: EPA, *Survey of Incorporated Enterprises*

Due to declining prices, the nominal ratio of capital investment to GDP has declined from a bubble-period peak of 19.6 percent in 1991 to 15.8 percent in 1997. However, on a real basis, the decline from 19.8 percent to 17.6 percent is less pronounced. With the weak economy causing corporate earnings to turn downward, and export demand to Asia ailing, companies have become conservative in their investment activity. This trend is expected to worsen in the future.

3) Reduced Fiscal Spending and the Asian Crisis

Another drag on the economy in fiscal 1997 was the reduction in fiscal spending. While the government's economic forecast had estimated a 0.5 percent increase in (nominal) public capital spending, the result is expected to be a substantial decrease of 5.7 percent.

In addition, Asia's economic crisis has grown and persisted longer than expected. Thus far, while exports to Asia have been affected, imports from Southeast Asia have declined due to sluggish demand in Japan. However, if the initial stage of crisis is contained, weak currencies will help boost exports to Japan, thereby reducing the effectiveness of external demand in propping up the economy.

(2) Assumptions and Key Points of the Forecast

1) Assumptions

1. Public expenditures: Public works spending in the economic stimulus measures is estimated at 16 trillion yen. Thus nominal public fixed capital formation will be equivalent to the fiscal 1997 level.
2. Taxation: A 2 trillion yen additional tax reduction will be implemented as part of the economic stimulus measures.
3. Exchange rate: The average exchange rate was 123 yen to the dollar for fiscal 1997, and will be 125 yen for fiscal 1998.
4. Official discount rate: Unchanged at 0.5 percent.

2) Expected Impact of Economic Package

We estimate that the economic stimulus measures will consist of 5 trillion yen in (effective) additional spending on new public works projects, and 2 trillion yen in additional special tax cuts. Due to significant cutbacks in the original fiscal 1998 budget allocation for individual local projects, the stimulus package will bring the volume of public works projects in line with fiscal 1997. This will neutralize the negative impact of fiscal tightening, but not be enough to boost economic growth. The tax cut will also have a limited impact.

3) Legacies of the Bubble Economy and Financial System Instability

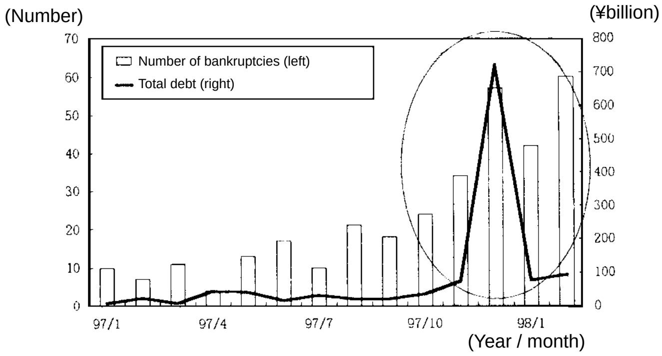
Although the collapse of the bubble economy occurred quite long ago, its negative legacy continues to burden the economy due to the lack of substantive countermeasures. Companies have yet to clear off their losses, and have not recovered enough to pursue bold restructuring plans and invest in new businesses. This legacy continues to impede recovery and cloud the economic outlook.

Moreover, since Autumn 1997 concern has grown that the introduction of prompt corrective actions for banks in April 1998 would intensify an already tight credit situation. The BOJ Tankan Report and other sources indicate that the corporate DI for lending has deteriorated and that financing problems are rising.

Thus far, the slowdown in capital investment can be attributed to cyclical factors and lower business confidence amid uncertain economic prospects, while financing constraints have not had a substantial direct impact. However, as the economy heads toward recovery, there is a risk that financing problems could discourage or constrain investment and impede recovery.

While the number of business failures attributable to lack of financing remains a small fraction of overall failures, it has surged since late 1997 and will cause companies to act conservatively. Public funds have been channeled into financial institutions with the intent of increasing the supply of credit, but this measure has brought scant relief to small and mid-size companies.

Figure 5 Bankruptcies Due to Credit Unavailability



Source: Teikoku Data Bank, *Aggregate of Bankruptcies Nationwide.*

To remove the instability of the financial system, financial institutions need to dispose of their bad loans and regain their strength. Those that cannot do so must be dealt with decisively through restructuring using public funds. As to the problem of credit tightening, rather than providing symptomatic relief, Japan's financial system must move away from an excessive reliance on indirect finance and toward fully functioning financial markets.

(3) Forecast for FY 1998

1) The Economy

The large-scale economic package will ensure that the economy does not worsen. However, with the bubble period's negative legacy substantially intact, the economy is not likely to achieve a strong recovery during fiscal 1998. We predict the economy's weak condition will remain unchanged.

Due to the weak economy, growth in employed workers is slowing down, and the unemployment rate will reach approximately 4 percent by the end of fiscal 1998. As production slows, overtime hours and hence pay will decrease. The 1998 spring labor offensive is predicted to produce the lowest historical wage increase of 2.6 percent, while weak corporate earnings will keep bonuses from rising. Thus although fiscal 1998 will have no major tax or other increases such as in fiscal 1997, sluggish income growth will restrict consumption growth.

Capital investment will begin decreasing pause in autonomous investment and increasingly conservative corporate activity. However, since the investment growth since 1995 was not excessive, investment will not plunge as it did following the bubble burst.

While exports to Europe and the U.S. will grow, overall export growth will slow down due to Asia's economic crisis. On the other hand, imports will remain steady despite weak domestic demand as Asian countries take advantage of their weak currencies to push exports. Thus the external surplus, while high, will not increase. We predict a current account surplus for fiscal 1998 of 14.4 trillion yen, or 2.8 percent of nominal GDP. Prices will continue to be extremely stable in fiscal 1998. Lower global demand due to Asia's economic crisis has caused the price of oil and other primary goods to decline. With falling import prices, the absence of any domestic factors such as the consumption tax hike in 1997, and weak domestic demand, there are practically no signs of inflationary pressure. Although money supply growth is rising slightly due to extremely loose monetary policies, deflation is of greater concern than inflation.

Table 1 Forecast Summary for Japan (% change yoy)

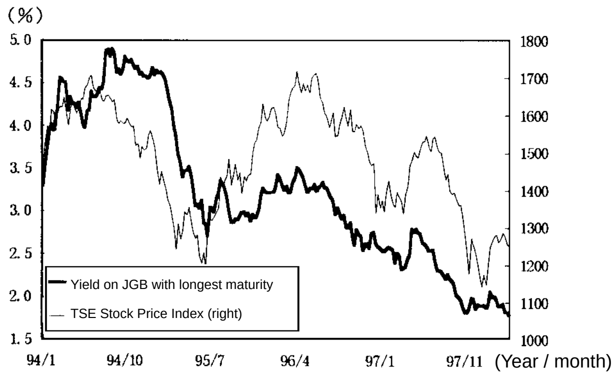
	FY 1996	FY 1997			FY 1998			Previous forecast	
		forecast	1st half	2nd half	forecast	1st half	2nd half	FY 1997	FY 1998
Real GDP growth rate (yoy change)	3.2 -	-0.4 -	-1.4 <0.6>	-0.0 <-1.3>	0.7 -	0.2 <0.2>	1.0 <1.2>	-0.1 -	0.5 -
(Contribution of domestic demand)	(3.5)	(-2.0)	(-2.4)	(-0.5)	(0.6)	(0.4)	(0.9)	(-1.4)	(0.6)
(from private sector)	(3.7)	(-1.4)	(-2.3)	(-0.6)	(0.4)	(0.3)	(0.7)	(-0.9)	(0.7)
(from public sector)	(-0.2)	(-0.6)	(-0.1)	(0.0)	(0.2)	(0.1)	(0.2)	(-0.5)	(-0.2)
(Contribution of external demand)	(-0.4)	(1.6)	(1.0)	(0.5)	(0.1)	(-0.2)	(0.0)	(1.3)	(-0.1)
Private consumption expenditure	2.8	-1.2	-2.6	-0.3	1.4	0.9	1.3	-0.7	1.7
Private residential investment	13.7	-21.5	-17.6	-9.9	-5.0	0.3	0.3	-20.5	-4.7
Private capital investment	9.1	2.1	-0.5	0.7	-1.0	-1.4	0.1	2.5	-0.0
Public capital investment	-2.7	-7.4	-0.6	-2.1	0.8	1.7	0.2	-6.3	-2.9
Exports of goods & services	5.1	10.2	5.7	1.9	1.6	-0.1	1.5	9.5	2.7
Imports of goods & services	8.7	-2.5	-2.6	-2.0	1.3	1.6	1.5	-1.3	4.0
Industrial production growth rate	4.0	1.6	1.0	-3.0	-3.9	-2.7	0.4	2.2	-1.4
Overall wholesale price inflation rate	0.4	1.2	2.0	0.5	-1.8	-2.0	-1.6	2.0	-0.1
Consumer price inflation rate	0.4	2.1	2.0	2.1	-0.2	-0.1	-0.3	2.0	0.2
Current account balance (¥trillion)	7.2	13.2	11.9	14.5	14.4	14.8	13.9	12.1	11.3
Ratio to nominal GDP	1.4	2.6	2.4	2.9	2.8	2.9	2.7	2.4	2.2

Notes:The previous forecast was released December 12, 1997.
For overall wholesale and consumer price inflation rates, half-year values are expressed as % change yoy.
Sources: Actual values are from EPA, *Preliminary Report on National Accounts;* others.

2) Forecast for Interest Rates and Foreign Exchange Rates

Almost three years have passed since September 1995, when monetary authorities lowered the official discount rate and induced the unsecured call rate downward. During this time, the long-term interest rate has fallen consistently. On October 1, 1997, the JGB benchmark yield fell below the historical low among major countries since the 19th century (1.85 percent, 1941 in the U.S.). The interest rate continued to fall with the global stock market decline originating in Hong Kong and string of financial failures. In December, despite the formulation of a financial stabilization policy and re-implementation of special tax cuts, the interest rate reached new lows fueled by persistent pessimism and economic malaise.

Figure 6 Long-term Interest Rate and Stock Prices



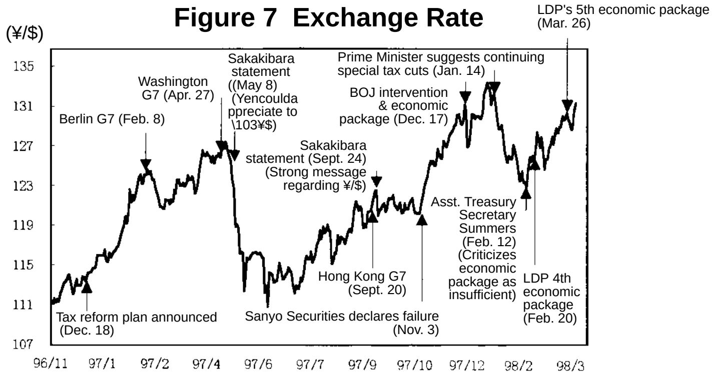
Source: BOJ, *Economic Statistics Monthly;* others.

Due to the economy's persistent weakness in fiscal 1998, we predict that the ultra-low interest rate policy will be continued. Long-term interest rates will remain level because (1) short-term interest rates will remain level in the weak economy, and the bond market is also in good condition, and (2) the weak yen will undergo a moderate correction.

The stock market was firm until last summer, but then softened due to a perceived peaking out of the U.S. stock market and failures among listed construction companies. Prompted by the global stock market decline in late October and major failures among banks and securities companies in November, foreign investors continued to reduce their positions in blue chip stocks. Entering 1998, the stock market continued to decline as fears of financial instability resurfaced, but the Nikkei recovered to approximately 17,000 yen with the passage of two financial laws. The market fluctuated widely in anticipation of early passage of a supplementary budget, but has settled in the 16,000 yen range amid factors such as an LDP statement in early March that raised anticipation of fund flows to Postal Savings and Postal Insurance Fund, anticipation of economic measures, and infusion of public funds into financial institutions. However, while limited progress can be expected on stabilizing the financial system and other issues, we predict that the stock market will stay level or edge down.

The exchange rate accelerated to 134 yen to the dollar amid the economy's perceived weakness since July 1997, ailing stock market due to financial system instability since November, and Asia's worsening currency crisis. Despite 2 trillion yen in special tax cuts and BOJ intervention, the yen remains under strong downward pressure. This pressure will be partly alleviated from the second half of fiscal 1998 by the economy's bottoming out, large external surplus, and improved stability of the financial system.

Figure 7 Exchange Rate



Source: BOJ, *Economic Statistics Monthly.*

2. Overseas Economies

(1) North America (U.S. and Canada)

1) U.S.

The U.S. economy will slow down from 3.8 percent growth in 1997 to 2.5 percent growth in 1998 due to slower growth in personal consumption and capital investment, and a deterioration in net exports.

Results for the first quarter of 1998 are expected to show domestic demand to be steady and net exports substantially down. Consumer spending remains steady, as seen by the strong growth in retail sales. Capital investment should show strong growth from rebounding after a decline in the previous period, and from a recovery in orders for information-technology (IT) equipment. Meanwhile, the trade deficit expanded significantly in January, indicating that the impact of the Asian crisis has started to surface.

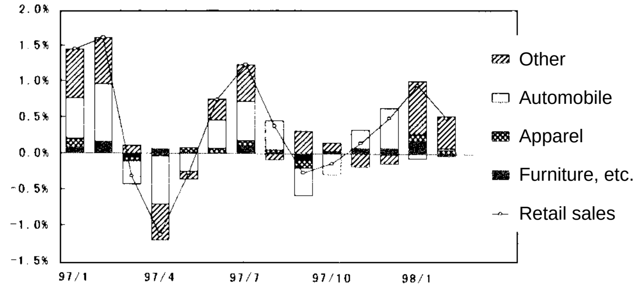
We predict that the U.S. economy will slow down as domestic demand weakens and the impact of the Asian crisis spreads. With the unemployment rate declining and labor costs starting to rise, the economy will have less vigor to create new jobs. Consumer spending should cool down partly in reaction to the strong growth thus far.

Capital investment fell in the fourth quarter of 1997 for the first quarter-on-quarter decline in six years. This is attributed to weak growth in IT-related investment, which has been the strongest area of capital investment. In manufacturing orders, while IT-related orders have recovered, growth in capital equipment has been sluggish overall. In the future, the moderate growth pace is expected to slow down. The impact of the Asian crisis on net exports has already begun to appear with exports to Asia plunging, a trend which should continue in the near future.

Inflation will remain stable. Due partly to falling energy prices, consumer prices declined 1.4 percent in February from a year ago and should maintain a stable undertone for the time being. However, as seen by the rising employment cost index, labor costs have gradually begun rising and should continue rising moderately through the end of 1998.

% change from previous month

Figure 8 Retail Sales

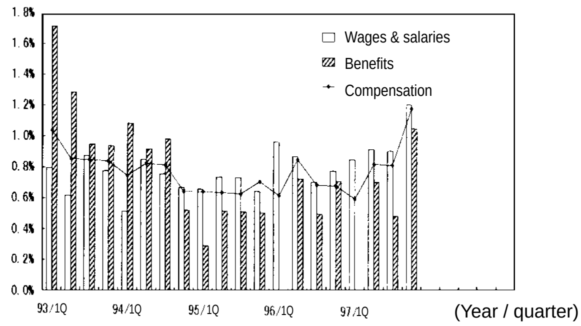


Source: U.S. Dept. of Commerce

While remaining wary of the tightening labor market, monetary policy should remain unchanged during 1998 in light of the negative impact of the Asian economic crisis and effect of falling import prices in checking inflation. However, monetary easing may be implemented in 1999 if the economy slows down.

Figure 9 Employment Cost Index

% change qoq



Source: U.S. Dept. of Labor

2) Canada

The Canadian economy will slow down to 3.0 percent growth in 1998, with a good balance between domestic and external demand due to the emphasis on domestic demand in 1997. As the labor market tightens further in 1998, the consumer price inflation will rise above 1.6 percent in 1997, but meet the central bank's target range of 1.5 to 3.0 percent due to slightly tight monetary policy.

(2) Europe (U.K. and Germany)

1) Growth in the 2% Range for the U.K. and Germany

The U.K. economy will slow down from 3.3 percent in 1997 to 2.2 percent in 1998. In 1997, consumption was slightly overheated due to rising employment and income levels, and to the one-time income from the conversion of housing loan companies into stock companies. As the temporary income effect fades and interest rates rise, the economy should slow down centered around consumption. The BOE raised its policy rate in November 1997 to 7.25 percent. Creeping inflation should prompt the central bank to raise the rate again during 1998. However, it will be the final rate hike.

Germany will maintain its economic expansion and grow 2.2 percent in 1998. In 1997, expansion was led by external demand against the backdrop of a weak mark, while domestic demand struggled as consumption suffered from a deteriorating employment and income situation including a postwar high unemployment rate. In 1998, consumption is expected to recover as employment bottoms out, and the driving force of the economy will gradually shift from external demand to domestic demand.

Although the Bundesbank raised the repo rate in October 1997, expectations of further monetary tightening have ebbed with the recent decline of the inflation rate and slowing economy. However, due to the requirement for convergence of short-term interest rates, the policy rate may be raised slightly in the second half.

Table 2 Real GDP Growth Forecast

(% change yoy)	1997	1998	1st half	2nd half
U.K.	3.3	2.2	2.3	2.0
Germany	2.3	2.2	2.2	2.1

2) EMU Developments

Membership in the EMU (Economic and Monetary Union, slated to begin January 1999) will be determined at the special summit conference in London in May 1998. Eleven EU nations excluding the U.K., Denmark, Sweden and Greece are expected to become members. The Blair Administration, in foregoing initial participation, asserted that the U.K. cannot realistically participate until the current parliamentary session ends in the spring of 2002. Thus participation will occur after 2002 based on public sentiment. In March 1998, Greece joined the ERM, a precursor to the EMU, and aims to join the EMU by 2002.

After membership is decided in May 1998, the EMU will shift to a fixed exchange rate system in January 1999 and set the exchange rates of member countries. Meanwhile, monetary policy making will shift from each country's central bank to the European Central Bank (ECB), who will conduct a unified monetary policy. In January 2002, national currencies will be recalled and euro notes and coins will be issued, making the euro the sole currency in both form and substance.

Table 3 EMU Timetable

○ Phase A (May 1998)
- -Determine participating nations
- 11 EU countries are slated to join
  - The following will not participate: U.K., Denmark (both meet economic convergence targets, but decline for political reasons), Sweden (not participating in ERM), Greece (fails to meet economic convergence targets for fiscal deficit and deficit ratio)
- -Announce method for setting exchange rates among members.

○ Phase B (January 1999 - December 2001)
- -Irrevocably set exchange rates between EMU member currencies and the euro.
- -Unify monetary policy through the ECB.

○ Phase C (January 2002 - June 2002)
- -Start circulation of euro notes and coins.
- -Complete collection of notes and coins of national currencies.

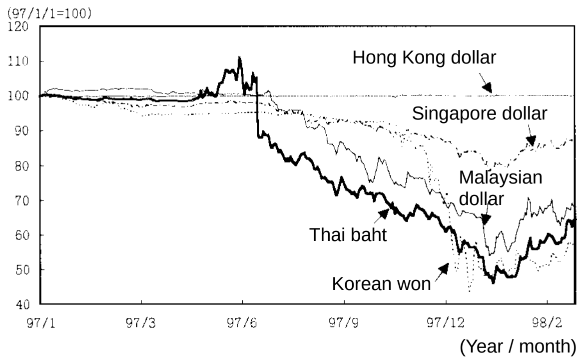
(3) Asia

The Asian currency crisis, which pummeled the Thai baht in July 1997, Korean won in November, and Indonesian rupiah in January 1998, has stabilized temporarily since January. However, the danger of a recurrence still looms as major problems have yet to be solved, including the cumulative increase in foreign debt that must be repaid, and destabilization of domestic financial systems that are dependent on foreign funds.

Excluding the Hong Kong dollar and Chinese yuan, the real effective exchange rates of Asian currencies are already well below their levels prior to appreciating in April 1995. However, exchange rates have continued to fall due to ailing domestic economies and financial instability. In addition, there has been some interplay between the Asian crisis and Japan's stagnant economy and financial system instability.

Three factors lie in the backdrop to Asia's currency crisis: (1) high real effective exchange rates (the real effective exchange rates of Asia's dollar-pegged currencies rose as the dollar appreciated against the yen since 1995); (2) expansion of current account deficits and increase in short-term foreign loans; and (3) financial system instability resulting from the collapse of asset bubbles. These factors are shared to some degree by Asian countries with current account deficits. This is apparent from their domestic financial structures, which have depended on foreign fund inflows based on the stability of dollar-pegged rates. In the end, the pursuit of strong currencies based on the dollar peg failed. The problem is that the currency devaluations have the repayment of foreign debt, which in turn promotes financial instability and leads to further currency devaluations.

Figure 10 Exchange Rates of East Asian Currencies (vs. U.S. $)



Asian countries can be categorized into four groups based on the extent of currency devaluation, status of current account balance, and condition of financial crisis: (1) Korea, Thailand, and Indonesia, who have avoided an international liquidity crisis due to financial aid led by the IMF; (2) Malaysia and the Philippines, who have similar problems but have not received IMF aid; (3) Hong Kong and Singapore, with current account surpluses and whose currencies have avoided large devaluations; and (4) Hong Kong and China, with currencies whose dollar exchange rates have been unaffected by the currency crisis.

The first two groups need to recover international confidence and bring their currency devaluations to a halt. To do this, they must improve external demand, while bringing their foreign debt back to sustainable levels by trimming expenditures and other means. Since higher import prices will stimulate inflation, strict austerity will be required. In addition, financial systems must recover stability by establishing a framework for the sound management of financial institutions, including supervisory agencies.

Table 4 Forecast for 1998 (% change yoy)

	Real GDP	Consumer price index
Australia	2.9	1.7
Korea	-1.0	8.0
Hong Kong	3.5	6.0
Singapore	3.0	2.5
Thailand	-4.0	12.0
Malaysia	2.0	6.0

These reforms will require time. Recovery led by external demand will cause growth to fall well below potential economic growth rates. In 1998, Korea, Thailand, and Indonesia will have negative growth rates. However, it is an inevitable part of the process of recovering their growth potential.