THE JAPANESE ECONOMY AND THE AFTERMATH OF ITS UNUSUAL RECESSION

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About a year ago at this time, while East Asia was steadily growing, there were two notable exceptions: one was China, whose problem was overheating; and the other Japan, whose problem was either underheating or overcooling. Now, while China's problems remain unsettled, the Japanese economy at long last seems to have bottomed out, although its upturn is expected to be moderate. Since spring of this year there have been a number of positive signs emerging in the Japanese economy, particularly in connection with public expenditure, housing investment, and personal consumption.

There are a number of factors responsible for the end of the deterioration of the Japanese economy and the beginning of its improvement: the progress of inventory adjustment, both in the corporate sector and in the household sector; a very hot summer which induced large purchases of summer goods; income tax reduction which finally took place early this summer; decline in prices of many goods due to appreciation of the yen and the stimulative impact of the deflated prices; and finally, the renewed rise of Japanese exports to the United States and East Asia reflecting the stronger performance of these economies.

Despite these positive factors, however, it is widely agreed in Japan that the recovery will be very moderate, particularly in view of the continued weakness of capital spending and the absence of readily available and effective policy measures, with the exception of the recently agreed upon extension of the income tax reduction. According to most private forecasters, after negative growth during the April-June quarter, real growth for fiscal 1994 will be approximately 1 percent, followed by about 2 percent real growth in fiscal 1995. The Japanese government alone sticks to its original forecast of 2.4 percent for fiscal 1994.

In addition, we cannot overlook a number of serious problems which continue to overshadow the Japanese economy. Problem one is the aftermath of asset inflation and asset deflation since the late 1980s. Because of ample liquidity, low interest rates, falling purchases and official support, the deterioration of the stock market in Japan has come to a halt. But the market remains very stagnant, reflecting the continued corporate profit squeeze and the liquidation or unloading of traditional cross shareholdings between major companies. Also, land prices continue to decline. According to standard price statistics, prices dropped about 8 percent in Tokyo from 1993 to 1994, and the commercial property market is especially depressed. This situation presents difficult problems for financial institutions, particularly smaller ones. Luckily, larger banks have made some progress in restructuring their balance sheets, due to more favorable tax treatment for writing off bad assets. Under the circumstances, bankers are very cautious with new lending, and anyway, demand for credit is very moderate; the growth of bank credit has been almost nil for the past few months. Bitter experience during the years of excessive boom and bust continues to discourage the adoption of drastic measures for asset markets. It will take several more years to overcome the aftermath of wide fluctuations of asset prices.

Problem two is the stimulative impact of deflated prices. During the oil crisis, the inflated price of oil finally depressed the demand for it. At present in Japan an opposite trend is emerging. Prices are down due to the prolonged recession and the sharp appreciation of the Japanese yen in the exchange market. These depressed prices have stimulated consumer demand--one of the factors of the recovery. As far as the consumers are concerned, the rise of consumer demand due to lower prices should be welcome. But from the point of view of domestic producers, things are not that simple. In the past, whenever consumer demand began to strengthen, domestic producers were able to expect higher prices and larger profits over time. But now, if they try to raise the prices of their products prematurely, foreign goods whose prices are also depressed by the yen's appreciation will penetrate the Japanese market, since it is more open to foreign products than ever before, or consumer demand will recede. In other words, for the first time in Japan's recent history, it is possible that strengthened consumer demand will not automatically increase profits of domestic producers unless they also manage to improve their productivity. This phenomenon is the combined result of import penetration and the greater price consciousness of Japanese consumers.

Problem three is the impact of the sharp appreciation of the Japanese yen. At 100 yen per U.S. dollar, the exchange rate has already exceeded the level considered acceptable by many economists and industrialists in Japan. This sharp rise is due to at least three factors. First is the continuation of Japan's large current account surplus due to the renewed rise of exports despite the steady rise of imports. Second is the continued reluctance of Japanese institutional investors to invest in foreign currency denominated securities because of their concern about possible exchange losses. Japanese institutional investors suffered from enormous exchange losses in the 1980s when the yen started to rise and the dollar started to decline. Those exchange losses were covered by capital gains in the Tokyo stock market. But today, in view of the stagnant stock market, Japanese institutional investors do not have any buffer which could cover the possible exchange losses. Third is the unfortunate perception in the markets that any intensification of trade frictions between Japan and its trading partners, particularly the United States, is almost automatically interpreted as a sign that the yen will become stronger in the exchange markets.

While the appreciated yen is reducing import prices and increasing import volume, it is also delaying the recovery of the Japanese economy. In addition, many Japanese manufacturing industries have been forced to shift their operations to other countries. Furthermore there are signs of the shift of financial service activities from Japan to other more liberalized financial centers, not necessarily because of the high yen but rather because of delayed deregulation, higher taxes, and the higher cost of living and operations in Japan. And the ratio of overseas operations of Japanese industries is much smaller than that of their American and European counterparts. Thus it is possible that many leading Japanese industries will invest more and more in foreign countries rather than in Japan. Such an outward shift is likely to be concentrated in East Asia because these countries are closer, more familiar, and more promising to Japanese investors than other areas, and will appear as further Asianization of Japanese industries or Japanese industrial expansion in Asia. While such a trend will make a positive contribution to the further growth of our Asian neighbors as well as help capable Japanese industries and companies to survive by shifting their operations abroad, it will also lead to a hollowing out of Japan proper. This hollowing out will have a serious impact on the domestic employment situation, which is already a major problem due to the downsizing of Japanese industries following the prolonged recession. Of course, Japan's employment situation is still much better than that of many other countries, with the unemployment level holding steady at 3 percent.

Problem four is whether Japanese traditional business practices will have to be modified, if not completely abandoned, during the present process of adjustment. I will address two such practices: lifetime employment and cross shareholding. During the recent recession, Japanese companies first tried to adjust inventory by cutting production. Then they tried to adjust equipment by cutting capital spending plans, thereby postponing employment adjustment.

However, since late 1992, they have been forced to begin some types of employment adjustment, first by cutting part-time workers, reducing bonuses and cutting over-time pay. Since last year, these companies have moved to another stage, in which they are narrowing the entry of new labor by reducing the number of new recruits and enlarging the exit of old labor by encouraging older employees to retire earlier or shifting them to lower paying subsidiaries while retaining their well-trained, middle-aged employees. In the meantime, the seniority system which used to be linked very closely with the lifetime employment practice has already been modified. Views are divided among executives of leading companies. The majority believe that even if modified, the lifetime employment practice should be and will be maintained since it is the foundation of Japan's peaceful, cooperative management and business relations. There are those, however, who believe that drastic changes in Japan's employment practices will be necessary in order to survive keener international competition.

Until recently the bulk of shares of major companies in Japan were owned by other major companies. In this way they were able to avoid sudden hostile takeovers. Since tradeable shares were therefore limited, their prices were kept high, one of the reasons for relatively high stock prices in the past. Now after the prolonged recession, many companies have been forced to unload or liquidate some of their shares of other companies. Such unloading seems to be linked to the level of stock prices. When the Nikkei index went below 19,000 yen, unloading increased and depressed stock prices further, thereby accelerating further unloading. But once stock prices recovered to the 19,000 or 20,000 level, the unloading appeared to stop. Again views are divided. Recently the chairman of one of the leading securities houses in Japan told the foreign press in Tokyo that cross shareholding will not be maintained. In my opinion, all will depend on the pace of the recovery and the situation of the Japanese stock market.

In conclusion, special attention should be paid to the following three points when looking at the Japanese economy in the coming months: first, the pace of the recovery of the Japanese macroeconomy as well as corporate performance, and also the pace of the balance of payments adjustment--my short answer is that both will be slow and moderate; second, whether the current adjustment process of the Japanese economy will force Japanese industries, including banks, to modify their traditional business practices such as lifetime employment and cross shareholding--my short answer is that some modification will be inevitable; third, the impact of Japanese industrial restructuring on the economy of the Asia Pacific region--in my view, Japan's slow recovery may not necessarily mean the slower growth of the region, partly because of the outward shift of Japanese industry operations and partly because of the autonomous nature of the growth of our neighbors at present.