

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Prospects for Japan's Economy in 2002

by Mr. Shigeru Sugihara, Senior Economist, the Japan Center for Economic Research

Business Conditions to Undergo a Phase of Overall Correction

Japan's economic adjustment, which began with a slowdown in exports and the production of Information Technology (IT)-related goods, has already had a ripple effect, not only on corporations but also on household finances. An overall business correction has resulted.

When compared to the same period for the previous year, actual GDP growth was negative for two consecutive quarters (April-June and July-September 2001). When demand side is examined item by item, it is clear that in addition to a continued reduction in exports, there was a considerable falloff in consumption by individuals. As a

result of falling production and corporate profits, overall income levels have deteriorated. Although equipment investment and public fixed capital formation have increased, this is probably only temporary – it is hard to identify factors capable of sustaining the economy in the future.

Real GDP growth rate for fiscal year 2001 will be a minus 1.1 percent. Exports shrunk by 9.7 percent, the main cause for the slowdown, while industrial production dropped by 11.0 percent and corporate profits decreased by 18.4 percent, resulting in an overall decline. This grim economic correction is expected to continue into fiscal year 2002. Prospects for sustainable recovery in domestic demand are slim, so therefore Japan's economic recovery will have to await an upswing in the U.S. economy. A negative growth rate, compared with previous periods, is expected to continue until the third quarter of 2002.

The US economy is expected to recuperate in the third quarter of 2002, which should prompt a revival in Japanese production and exports and pull Japan out of recession.

An improvement in the growth rate won't manifest until fiscal year 2003. By then, compared to the

past, exports will have shrunk by only 3.6 percent, equipment investment will show a reduction of 3.9 percent, industrial production will continue to show a still-significant decline of 4.8 percent, while corporate profits will still show a slight reduction of 0.4 percent.

As a part of economic structural reform, an attempt is being made to restrain public investment expenditures. According to the basic budget policy for fiscal year 2002, public works-related expenditures decreased by 10 percent over the previous year. Even if a major portion of public works investment (¥4 trillion, of which ¥2.5 trillion will come from the central government) is added in the second supplemental budget and carried out during fiscal year 2002, public works would decrease by 4.7 percent.

This forecast is based on the annual expenditures for fiscal year 2002 indicated in the basic policy. But because tax revenues will decline considerably due to the business recession, the government will have no choice but to issue bonds – likely more than ¥30 trillion. This will be so even if an attempt is made to supplement tax revenues by additional sales of NTT stocks, etc. In order to avoid the additional issuance of bonds,

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either a further reduction in expenditures or an increase in revenues will be necessary.

With Japan's recession continuing, the unemployment rate will continue to rise, reaching 6.6 percent by the end of fiscal year 2002. Even though business will probably recover toward the latter half of the year, it will be into fiscal year 2003 before any meaningful job creation begins.

Since economic growth rate will remain negative, in terms of the GDP gap the "minus margin" will increase. A "minus GDP gap" exists when the attainable supply level with full employment and capacity exceeds demand, exerting downward pressure on prices. Consumer prices (excluding fresh produce) will continue to decline significantly (a drop of 1.7 percent in fiscal year 2002.) Due to economic recovery, the minus margin for the GDP gap will decline slightly toward the latter half of the fiscal year, but a considerable gap will still remain at the period's close. The deflationary trend is expected to continue for some time, even after fiscal year 2003.

Slowness in Corporate Efficiency Improvement Hinders Investment Recovery

According to this scenario, Japan's business climate is entirely dependent on U.S. economic

trends. But isn't there any possibility that Japan's economy can recover on its own? In short, probably no.

An self-sustained Japan's domestic recovery would result either from improvements in corporate efficiency, IT-led investment revitalization, or from a recovery of consumer spending through psychological encouragement. The economic downturn, coupled with rising unemployment, makes boosted consumer psychology unlikely.

As for equipment investment, faced with a situation in which corporate efficiency is not progressing, such an upsurge cannot be expected to take place on its own. For one thing, current profitability is low. The decline in sales has greatly reduced current profits. In fiscal year 2001, while sales are forecast to fall by 4 percent, profits are expected to decline by more than 18 percent.

When one examines the forecast for settlement of accounts for fiscal year 2001 for corporations listed on the Tokyo stock exchange (particularly for those engaged in the steel, electric machinery, and transport machinery) many businesses have been hard-hit by the

recession. Profits do not appear to have risen as a result of enhanced efficiency. Unless more companies can increase their incomes even when faced with economic contractions, or can secure increased profitability even though their income declines, corporate profits and equipment investment will repeat their cyclical fluctuations.

One other factor that hinders a self-sustained equipment investment recovery is high corporate debt. Land and stock prices have fallen during the 1990s, reducing the market value of assets held by corporations. However, the corresponding debts are fixed at their nominal levels. As a result, the debts are excessive compared with the market value of the assets. When such excessive debt is calculated based on the debt/asset market value ratio during the early 1980s, the amount is ¥150 trillion, primarily affecting the non-manufacturing sectors. Such a disparity on the balance sheet heightens the risk of bankruptcy. Not surprisingly, many companies are therefore reluctant make potentially risky investments. Indeed, in recent years corporations have applied their cash flows to paying off debt while restricting equipment investment.

"The deflationary trend is expected to continue for some time, even after fiscal year 2003."

Due to a considerable increase in consumer spending as a result of strong automobile sales during October, some predict that the U.S. economy may start to recover beginning in the early part of this year, but that is too optimistic.

The sudden increase in US automobile sales in October was due to "zero-interest" loans, and is therefore a temporary phenomenon. Short term interest rates lowered to zero due to credit easing undoubtedly sustained the US economy briefly. But in the face of slowing growth in disposable income, consumer psychology will be affected and consumer spending will slow. And the recently-enacted tax cuts will likely prompt Americans to save more of their disposable income, rather than spend it.

Another point concerning the U.S. economy is the timing of the recovery in equipment investment. That will depend entirely upon corporate profitability, which is evidencing a considerable reduction. The traditional profitability recovery mechanisms are reductions in hiring, reductions in interest payments due to lower interest rates or lower crude oil prices, and reductions in the cost of materials. Past experience indicates that if corporate profits decline, reduced hiring contributes greatly toward a recovery

in corporate profitability after about one and a half years. If that model holds true, US corporate profitability, which began to decline at the end of 2000, will recover by the middle of 2002. However, the demand for IT products fell very sharply, so it is not

certain that such mechanisms will be adequate. Thus, the predicted timing for a recovery in U.S. equipment investment and in the overall U.S. economy may be overoptimistic. If the US economic recovery is delayed, then Japan's business recession will be prolonged.

Clarification of Path to Structural Reform

The final disposition of delinquent loans and the resolution of excessive debt, leading to a reduction in bank lending, cannot be ignored. This can be dealt with only by a smooth transfer of sound loans to sound banks following the collapse of a bank or through the establishment of loss-sharing "schemes" such as depositor payoffs and public funding.

As for anxiety about government default, reductions in expenditures, including public works, can help in

allaying excessive reaction by the financial markets. Markets hate uncertainty. Clarity regarding structural reforms will help prevent markets from panicking.

If, as a part of reform of Fiscal Investment and Loan Program, the Expressway Construction Plan of

"If the US economic recovery is delayed, then Japan's business recession will be prolonged."

the Japan Road Public Corporation were reviewed, public works would be further reduced. Theoretically, if expressway construction were cut by 40 percent, the actual GDP growth rate would each year be suppressed by 0.16 percent. Still, it would be possible to accept this as a part of the pain involved in financial structural reform. Even if the government provides no highway funding and the Japan Road Public Corporation were privatized, unless the Expressway Construction Plan is reviewed, there would be no reduction in the level of public works investment. A thorough review of the improvement plan is therefore vital.

However, the ¥30 trillion limit on new bond issues should be dealt with in a flexible manner. Higher deficits resulting from reduced taxes during a recession should be accepted as a built-in

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Table: The Outlook for Japanese Economy

Source: The Japan Center for Economic Research

	FY2000 4th	FY2001 1st Qtr	2nd	3rd	→ FORECAST							
					4th	FY2002 1st Qtr	2nd	3rd	4th	FY2000 FORECAST	FY2001 FORECAST	FY2002 FORECAST
Real gross domestic expenditures (qtr.-to-qtr.)	1.0	-1.2	-0.5	-0.3	-0.3	0.0	-0.1	0.1	0.4	1.7	-1.1	-0.5
Real gross domestic expenditures (year-on-year)	1.2	-0.4	-0.5	-1.4	-2.2	-0.9	-1.0	-0.3	0.4			
Private final consumption (qtr.-to-qtr.)	1.9	-1.1	-1.7	1.8	-0.1	-0.3	-0.2	-0.1	0.1	-0.1	-0.1	-0.2
Private housing investment (qtr.-to-qtr.)	-4.1	-6.4	1.0	-1.8	-0.8	-0.3	-0.0	1.5	2.9	-1.5	-8.9	-0.3
Private plant and equipment investment (qtr.-to-qtr.)	-2.7	2.6	1.1	-8.8	-0.8	-0.6	-0.3	1.8	2.4	9.3	-1.8	-3.9
Private inventory increase (contribution)	0.0	0.0	-0.1	-0.1	-0.0	-0.0	-0.0	0.0	0.1	-0.0	-0.1	-0.1
Government final consumption (qtr.-to-qtr.)	1.1	1.6	0.1	1.0	1.3	1.0	0.9	0.9	0.9	4.4	3.5	3.9
Public fixed capital formation (qtr.-to-qtr.)	8.9	-10.3	3.2	-0.4	-0.3	3.0	-2.9	-6.3	-8.1	-7.4	-5.2	-4.7
Public inventory increase (contribution)	0.0	-0.0	-0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.0	0.0
Domestic demand (contribution)	1.2	-0.9	-0.6	-0.5	-0.0	0.1	-0.2	0.0	0.3	1.5	-0.6	-0.5
Net exports of goods and services (contribution)	-0.2	-0.3	0.1	0.2	-0.2	-0.1	0.1	0.1	0.1	0.2	-0.5	0.0
Exports of goods and services (qtr.-to-qtr.)	-1.8	-4.9	-3.3	-1.0	-3.8	-1.0	0.7	1.2	1.8	9.4	-9.7	-3.6
Imports of goods and services (qtr.-to-qtr.)	-0.4	-2.6	-4.6	-3.6	-1.8	-0.5	-0.3	0.6	1.1	9.6	-6.1	-4.5
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.5	-1.5	-0.8	-0.8	-1.0	-0.2	-0.3	-0.8	0.0	-0.3	-2.7	-2.2
Domestic wholesale price index (year-on-year)	-0.4	-0.6	-0.9	-1.4	-1.7	-1.9	-2.1	-2.0	-1.9	-0.0	-1.2	-2.0
Consumer price index (year-on-year)	-0.8	-0.9	-0.8	-1.3	-1.5	-1.7	-1.8	-1.7	-1.6	-0.5	-1.1	-1.7
Unemployment rate (%)	4.8	4.9	5.1	5.5	5.8	6.0	6.3	6.5	6.6	4.7	5.3	6.4
Industrial production index (qtr.-to-qtr.)	-3.7	-4.1	-4.3	-3.3	-2.2	-0.9	0.1	0.4	1.0	4.0	-11.0	-4.8
Current account / Nominal GDP (%)	2.3	1.6	2.4	2.5	2.4	2.4	2.4	2.5	2.6	2.4	2.1	2.4
Real GDP of U.S.A (chained 1996) dollars)	1.3	0.3	-1.1	-0.1	-0.4	-0.1	2.1	2.6	2.5 (C.Y.)	4.1 (C.Y.)	1.1 (C.Y.)	0.2

[Notes] 1. Figures in percentage changes; contribution is contribution to real GDP growth.

2. Figures for items comprising national expenditures are at 1995 prices.

3. Figures for consumer price index are at 2000 prices.

4. Figures for national expenditures, unemployment rate, industrial production index, current account and real GDP of U.S.A are seasonally adjusted figures.

“The Challenges of Uneven Globalization”

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by Dr. Ellen Frost, Visiting Fellow, Institute for International Economics

Globalization is a rapid and uneven expansion of cross-border flows in networks – not only of goods, services, capital, and technology but, also equally as important, of ideas, information, culture, religion, values, and people.

One of the striking features of the global era is that thanks to digital technology, regions such as the Asia-Pacific Economic Forum (APEC) have acquired new and important identities. National governments themselves have begun using information technology (IT) to communicate with their citizens. Localities, sub-regions, and individuals have all become empowered by this new technology. As a direct result of the information and communications revolution, many more actors have become political players, enormously complicating the problem of governance.

In the last twenty years, two revolutions have occurred simultaneously – the IT revolution and the transportation revolution. Working together, these revolutions have enabled companies to disperse the production of goods and services around the world. But as we have seen from the terrible events of September 11th, the process of global empowerment or global mobilization has taken many differ-

ent forms that pose dangers as well as opportunities.

What Are the Challenges of Globalization?

In our era of economic and technological globalization, old problems like migration and crime and new problems like water shortages and HIV/AIDS threaten political stability. Thus far, institutional means to deal with many of these threats are absent or inadequate. Sometimes the very process of mobilizing new political actors can lead to internal conflicts with which governments are ill prepared to cope.

One institution that has advanced quite far in resolving problems and disputes is the World Trade Organization (WTO). As a result of the Uruguay Round of trade negotiations that ended in 1993, the dispute settlement process is now compulsory. Governments accused of violating another WTO member's rights cannot escape a process of investigation by a panel of experts selected from around the world. Strictly speaking, the findings are not binding and compliance may take several forms. But nations tend to conform to the dispute settlement system because they see compliance as being in their best interest.

Unfortunately, there is a tendency today, given the absence of most other international institutions, to push the WTO to address labor problems, environmental pollution, human rights and other issues highlighted by globalization. Anti-globalization activists – who ironically are themselves highly globalized – have legitimate concerns, but they are attacking an institution that is responsible for a great deal of growth in poor countries as well as in rich.

A better solution would be to strengthen other international institutions, such as the International Labor Organization (ILO), or perhaps to create new forums, such as one on the environment. Regional, national and local authorities must think very creatively, not about erecting new global bureaucracies, but about ways they can cooperate to respond to new challenges.

Uneven Globalization

Over the last 20 or 25 years, certain countries have benefited from globalization far more than others. Progress seems most pronounced in democracies and quasi-democratic states. With some exceptions, these states have established a stable security framework, the rudiments of a market-oriented

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economy, a participatory political system, a rules-based system of justice, and a certain minimal level of civic trust. Even among them, economic integration and conflict resolution are not perfect, and in some cases, they are maturing only after centuries of conflict.

But there is also a large group of nations, stretching from the former Soviet Union southward to the Middle East, parts of Central Asia, South Asia, and most of sub-Saharan Africa. By many indices, the digital divide included, they are adjusting poorly to globalization. The governments that have not put adequate policies in place to ease the adjustment to globalization find themselves threatened. In fact, they use the Internet to crack down on their populations, or they try to control the Internet to prevent political opponents from communication with each other and the outside world.

Generally speaking, markets demand open information, investors like the protection of the law, and people who enter into contracts want to know that they can be protected. So from a very simple economic point of view, a free flow of information is essential to the functioning of a market. But that same flow of information also opens the door to new political ideas, cross-border resistance movements, and the like. As a result, governments

that allow cartels to flourish, monopolies to benefit the rich, companies to inadequately disclose information, and supervisory organs to look the other way, face a particular challenge from globalization. This is especially true if these governments lack a so-called social “safety net” that protects people who suffer economic hardship as a result of globalization.

In these countries, corruption is an enormous problem that has distorted the allocation of resources, discouraged foreign investment, and undermined economic development. Legitimacy is very hard to maintain in a government that practices or tolerates massive corruption. The scale of corruption and other criminal activity has been expanded, thanks in part to the use of computers, cell phones, and other forms of communication.

The end of the Cold War propelled most countries formerly under communist, or at least nominally communist, rule to seek integration into the global economy recently. The United States, Japan and the European Union together must cooperate to ease their transi-

tion and help these countries make a successful adaptation to globalization.

A crucial test will take place within the WTO. Japan, and especially the European Union and the United States, worked closely to define the conditions under which China could enter the WTO. China’s demands for special treatment greatly complicated the entry negotiations. Ultimately, Japan, the EU, and the US cooperated in establishing tough conditions for China’s WTO accession, and appropriately so. Continued cooperation is essential so that the inevitable trade fights involving China do not undermine the global trading system.

China has an enormous problem – how should subsidies be defined, for example? How can the rule of law be instituted in a system that is still controlled by the Chinese Communist Party? Next year, a whole new group of leaders will assume senior government positions. But there is still reluctance on the part of the Party to relinquish its political control. And there is an enormous contradiction between an increasingly modern economy in

“The governments that have not put adequate policies in place to ease the adjustment to globalization find themselves threatened.”

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China – especially in the eastern and southern regions – and an increasingly archaic and out-of-date political system. How China resolves this contradiction will have great bearing on its regional and global role.

At this point, Russia is internally preoccupied and does not pose any kind of trade threat. But in security terms, it is still one of the major players. But, although the communist party rule is a thing of the past, Russian economic reformers face many of the same problems affecting China.

Closing the Digital Divide

Would working to close the so-called “digital divide” provide at least a partial answer to uneven globalization? It could, for two reasons – one humanitarian and the other economic. In the first place, there is clear evidence that rising levels of access to information correspond fairly closely to rising per capita income, and therefore to a bigger pie to divide, including among the poor.

The economic reason goes beyond increased global demand for goods and services that boosts economic growth. Openness to information, flexibility, connectedness with global norms, and other manifestations of peaceful and democratic behavior are also associated with information technology. For that reason, addressing the digital divide is squarely in the security interest of both Japan and the United States.

Is Education the Answer to Uneven Globalization?

For economies in transition, education is often the answer, not only to the digital divide, but more generally to the problem of poverty. Education is essential, especially for girls and women; I say that not from a feminist perspective, but from an economic one. The World Bank has extensive data on health, population, and the like, which proves the linkage.

At the same time, education clearly mobilizes people by making

them politically aware and politically active. In the absence of other institutional features such as the rule of law, accountability, open information, and the like, education can sometimes foster radical political movements. Many of the terrorists identified in the wake of September 11 were in fact highly educated.

So along with education, we should encourage the development, not necessarily of democracy as we know it in the United States and Japan, but at least responsive and open participatory forms of government, as well as free markets. That way, educated and empowered people can find a place in their own society. ■

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Japan Business Dialogue

KKC's monthly program featuring Japanese experts on the economy.

"How Japan's Private Sector Views the Japanese Economy"

By virtually all indicators, Japan's economic outlook is decidedly glum, said Kiyoto Ido, Minister for Financial Affairs at the Embassy of Japan, at the November 29, 2001, Japan Business Dialogue meeting.

Japan's still-growing national debt, which stands at 130 percent of GDP, is "not sustainable." Moreover, in the face of depressed domestic consumption, corporate earnings, sales, and business investment decreasing.

As a result, Minister Ido explained, the Koizumi government has prepared a supplemental budget of one trillion yen to boost

employment, to help small- and medium-sized enterprises, and to accelerate structural reforms.

On the other hand, resolving the non-performing loan (NPL) problem is the greatest challenge facing Prime Minister Koizumi. The ratio of NPLs to total loan is 6.58 percent in 2001, which is bigger than the worst ratio of U.S., 5.47 percent in 1991. There is urgent need for the banks to improve their asset quality.

According to the basic time-framed policies introduced in June 2001, major banks should remove NPLs from their balance sheets within 2 years for existing NPLs and 3 years for newly generated NPLs. And in order to promote sales of NPLs from banks, it is con-

sidered that RCC (Resolution and Collection Corporation) will buy credits at market prices.

Finally Mr. Ido stressed, of course the clean-up of NPLs is absolutely crucial for Japan's economic recovery, but it will not solve all problems. It is also important to vitalize Japanese industries and make them attractive through deregulation and structural reform. ■

Next Japan Business Dialogue: KKC, January 31, 2002 - 12:00 noon

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stabilizer. And, in the face of rising unemployment, safety nets such as unemployment compensation should be generously increased. It would be more meaningful if the Second Supplementary Budget, which is under presently under deliberation, were to be used to ease the pain of such structural reforms, rather than for public works investment.

It will be difficult to restrict the level of new bond issues to less than ¥30 trillion during fiscal year

2002. But considering Japan's dire economic circumstances, a limited increase in bond issuance should not necessarily be judged as a failure of the Koizumi reforms. ■

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KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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