No Relief for Japan’s Struggling Economy

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Overview

2002 saw the Japanese economy once again emerge from a recession—the most recent downturn in a decade that saw a repeated cycle of economic setbacks. This recovery, like its recent siblings, has been tempered by a poor investment climate, uncertain job market prospects, and this time a weaker-than-expected American market for Japanese goods.

The heart of Japan’s weakness still lies in the same set of structure problems that have plagued the economy for a decade: faltering competitiveness, overcapacity in key industries, and unresolved bad debt problems for the banking and commercial sectors. Until these issues are resolved, they will continue to weigh on the overall economy.

Recent Economic Performance

Since the end of Japan’s bubble economy in 1991, the country has struggled to emerge from its most persistent slump since World War II. After expanding at about a 4% rate through the 1980s, real GDP grew only 1% on average in the 1990s. There have been a number of cyclical recoveries, notably in 1995-96, and again in 1999, but the economy has repeatedly faltered. Even poorer economic performance would have been likely were it not for strong government stimulus over much of the decade. Among the factors that retarded Japanese recovery in the 1990s were banking system weakness, inconsistent macroeconomic policy and periods of unfavorable external conditions.

In Japan these days there is talk of the country’s “Every Six Month Crisis,” that rarely a half-year goes by without another setback on the road to sustained growth. The most recent crisis emanated from the stock market, where equity price declines have brought the market to its lowest level in 19 years. (The Nikkei has traveled from approximately 40,000 to just over 8,000 over the past decade.)

While Japan’s recent stock market troubles are common to global markets, in Japan they have exacerbated the country’s long-standing bad debt problems. Because Japanese banks hold equity stake in corporations, declining equity prices directly reduce the value of bank assets as well as creating repayment problems for many of their debtors. The value of Japan’s bad debts has con-
continued to rise to $430 billion. While the government has allocated substantial sums of public money for debt restructuring, banks have been reluctant to take advantage of these programs because of the substantial write-downs they require.

Japan has also been impacted by global economic developments. Japan shared in the 2001 downturn, with output contracting for three quarters, 2001Q2 through 2001Q4. According to recent data revisions, Japan’s recession was not as severe as earlier reported; real GDP rose a slight 0.4% for 2001 as a whole. A moderate recovery began in the first quarter of last year, and output grew at a compound annual rate of more than 2.5% throughout the year. Because part of this represents a rebound from the recession in 2001, total output finished the year just 0.3% higher than the year before.

As in the United States, consumption spending has held up better in the last few years than have other sectors of the economy. In 2001 and 2002, consumption rose 1.7 and 1.4 percent respectively. Still, the increasing rate of job layoffs in recent years, income uncertainty and the historically high unemployment rate (it hit a record 5.5% in January) have restrained consumption well below rates seen in the past. For the fourth quarter of last year, consumption expanded just 0.3%.

Business investment remains weak, but has probably bottomed out. Nonresidential fixed investment has expanded since the second quarter of last year, but still remains about 7% below its year 2000 peak. Residential investment is also weak. Net export sales, which had been very weak in 2001, contributed to growth for the year as a whole, but the slow pace of the global recovery and a relatively strong yen have held back exports in recent months.

Industrial production also shows a bottoming out, but no decisive upturn. The index reversed its year-long slide in December 2001 and rose 8% through August. Since then, it has moved sideways. Business confidence has improved for the past three quarters, but remains negative overall.

Japan’s price experience is a clear testament to the extent of economic weakness. Consumer prices have fallen for four consecutive years, undermining corporate profits, slashing property values and stock portfolios, increasing real debt burdens and delaying spending. The Bank of Japan demonstrated its concern in dramatic fashion in...
Japan’s Prospects and Remaining Challenges

Japan’s short-run prospects are weak. Most worrisome is the outlook for consumption, which has taken a decided turn for the worse in recent months. As in the U.S., consumer confidence is down, and that is now showing up in weaker retail sales and in aggregate measures of consumption. A resolution of international political uncertainty would benefit Japan as it would the global economy.

A substantial resumption of investment may be further off. Business fixed investment spending appears to have bottomed out, but recent surveys suggest that corporations are further trimming their capital spending plans compared with estimates made earlier in the year. Generally, surveys of business sentiment are sending very mixed signals about prospects for Japan in coming months. According to the Tankan outlook survey, the outlook of manufacturing businesses continued to improve in the December survey, the third straight quarter of improvement. But it is still in negative territory, standing at -9 in December compared with -14 September. (The business conditions survey subtracts the percent of business respondents expecting “unfavorable” conditions from those expecting “favorable” conditions.) And the sentiment of non-manufacturers fell further, reflecting a generally less favorable sales outlook in the domestic Japanese economy.

These forecasts of tentative recovery reflect the extent of the difficulties that Japan faces over the next several years. Japan has only recently begun to work down the excess capacity built up during the last decade-and-a-half. Firms have both more machinery and more labor than they can profitably use. This process of restructuring will be ongoing and will tend to keep investment low and unemployment high.
Efforts to work down bad debt may finally be accelerating. While this is good news in the long run, it will represent a drag on the economy in the near term. The government’s economy and banking head Heizo Takenaka announced an ambitious plan in October to reduce bad debt by half in the next year-and-a-half. If implemented that will mean more closed firms and more laid off workers, although it should restore remaining banks to better financial health.

The government continues to support recovery, but it has tended to show more concern about the debt implications of these efforts. Japan’s government budget deficit has been running at a rate of 7-8% of GDP, and it has accumulated debt of perhaps 150% of GDP (more than double the upper limit set by the European Union). This limits the efforts that the government can undertake to stimulate the economy and address structural problems. In mid-December, the government announced a new spending package of $35.6 billion in new public works spending and a larger amount of lending and credit guarantees for firms.

Some observers are cautioning that a “double dip” recession may now be beginning. While that strikes me as somewhat premature, clearly Japan’s short-term growth prospects have worsened in the past few months. I expect Japanese real GDP to expand by less than 1% in 2003, rising to the 1.5-2% range over the next several years. The possibility of negative global fallout from a war with Iraq could set back even this modest scenario, and there is little prospect of a more robust growth path in the near term.

All in all, Japan’s outlook is more of the same. It provides little room for optimism about a healthier role for Japanese visitors in Hawaii over the next several years.