JRI news

Keeping Structural Reform on Track

— An Economic Forecast for FY2002 and Outlook for FY2003 Onwards —

November 29, 2001

The Japan Research Institute, Limited

Economics Department, Economic Research Center

http://www.jri.co.jp/research

For more information on the content of this report, please contact

Hideki Matsumura Tel: 03-3288-4524

or

Hisashi Yamada Tel: 03-3288-4245

Economics Department, Economic Research Center

The Japan Research Institute, Limited

The Japanese economy entered a recession phase at the end of 2000 and, in September 2001, as the recession deepened, especially in the business sector, the terrorist attacks in the United States increased the risk of a further economic downturn.

Under these conditions, the three key issues in any economic forecast must be, (i) how will the world change in the wake of the terrorist attacks on the United States, and, within this context, what course will the US economy take, now that the IT bubble has burst? (ii) what will be the impact of the rise of the Chinese economy on Japanese industry, and (iii) how will the Koizumi Administration's proposed structural reforms fare in an of economic recession?

The rapidly growing uncertainty raised by the recent acts of terrorism in the United States will have a range of negative effects on the global economy, including (i) increasingly cautious behavior by economic entities and a contraction of the global flow of funds, and (ii) a rise in safety-related costs, including the cost of strengthening security measures. Meanwhile, given developments such as China's joining the WTO, the current of globalism itself is likely to continue.

The US economy will continue to face harsh conditions for some time, but, from the spring of 2002 onwards, the recession should bottom out, thanks to (i) the waning of the effects of the terrorist attacks, (ii) policy measures such as interest rate cuts and increased government spending taking effect, and (iii) lower inflation. Meanwhile, residual pressures for adjustment mean that the growth rate will remain low for some time, and even after the current adjustment phase comes to an end, the US economy is unlikely to see a return to the rapid economic growth of the 1990s and the era in which the US provided the pulling power for global economic expansion is at an end.

China is making rapid advances in technology and the substantial wage gap has led to a decline in the cost competitiveness of Japanese products, and has been the chief cause of increased penetration by Chinese imports in recent years. The rapid inflow of Chinese products has resulted in a contraction of Japan's labor-intensive manufacturing base and made a significant contribution to deflation. In a sense, it is the fate of developed nations to be caught up with by newly industrialized nations. If anything, the true reason for the rapid contraction of Japan's manufacturing base is its failure to change a high cost structure and inflexible industrial and employment systems, and its slowness to foster new industries and respond to the IT revolution.

Although these developments should be taken into account, Japanese companies are implementing radical business reforms in an effort to survive, and their profitability is gradually improving. However, the process of adjustment with a view to improving profitability is not yet complete and will continue to have a strong negative impact on the economy in the short term. Companies with strong potential for growth are stepping up the development of their overseas operations, and if this trend persists, the hollowing-out of Japanese industry will continue, and Japan may slip into a pattern of profitability improvement with a balanced contraction of the economy.

Within the context of quantitative restraint, fiscal policy should aim to maximize the productivity enhancing effect and demand creating effect of government spending, through qualitative changes, including (i) a review of the distribution of public investment, and (ii) the energetic pursuit of the reform of special status corporations. In this sense, the Koizumi Administration's approach deserves some praise, but over-zealous insistence on keeping to the limit of ¥30 trillion on issuance of government bonds could undermine its own efforts to rebuild public finance.

The plan is that all non-performing loans (from "risk loans" downwards) should be removed from the balance sheets of major banks within 3 years. Meanwhile, the principal reason for the bad debt problem is the emergence of new bad debts due to the prolonged economic recession, and to prevent such new bad debts from arising, it will be necessary to rebuild the Japanese economy through a radical program of structural reform.

Given these facts, the recession phase is basically likely to continue during fiscal 2002. In the first half of the year, exports and industrial production will continue to fall and household and business confidence will decline, so that the economic downturn is likely to become more severe. In the second half of fiscal 2002, a gradual recovery of the US economy and a rise in share prices should halt the deterioration of the economy, but given that there is little hope of a recovery led by exports of the kind seen in the past, the potential for recovery is low owing to the persisting negative impact of structural reform.

Turning to the outlook for fiscal 2003 onwards, continued adjustments in Japanese industry in conjunction with the rise of the Chinese economy, the continued drive for structural reform, and the end of the era in which the US economy led the global economy, Japan should expect to see an average of zero economic growth over the next 2-3 years. However, unintended structural adjustments, such as a decline in public investment, have been under way for some years, and the deflationary pressure of the reforms should not be overestimated. Moreover, the improving profitability of Japanese businesses in recent years means that they have become less vulnerable to the deflationary pressure that will accompany structural reform.

The root causes of economic recession since the 1990s are Japan's high cost structure and the inflexibility of its traditional systems, and, in recent years, the rise of the Chinese economy has made the decline in the cost competitiveness of the Japanese economy more obvious than ever before. In this light, it is clear that the present deflation and negative nominal growth and continued nominal contraction constitutes a process of correction of a domestic price structure that is too high by international standards, and that Japan will have to tolerate it as an "unavoidable adjustment". It is possible for the real economic growth rate to be positive even if the nominal economic growth rate is negative, and, if anything, in the short term, economic policy should be to lead the economy in this direction, while making all possible haste with structural reform and ensuring that the real standard of living is maintained and improved.

Meanwhile, given the negative action of external factors at present, and the undeniable risk that the deflation spiral will accelerate, driving even sound economic entities to failure, it is important to calm the speed of nominal contraction. What is important with regard to the government's undertaking to keep issuance of government bonds in fiscal 2002 to ¥30 trillion is to respect the true intention of this undertaking, namely to cut inefficient expenditure with a view to effecting a qualitative change in public investment that will stimulate the latent economic growth rate. In this sense, it is the target of "cutting existing expenditure by ¥5 trillion" in the framework for the drafting of the fiscal 2002 budget already published to which the government should stick. The government should not be called to task even if issuance of government bonds substantially exceeds ¥30 trillion owing to a fall in tax revenue in conjunction with an unexpectedly rapid deterioration of the economy or an accumulation of expenditure to support structural reform that will truly facilitate the achievement of the objectives of structural reform. At the same time, the government should aim to (i) maintain fiscal discipline through the medium-term objective of achieving a primary balance in the first half of the 2010s and (ii) set a target for individual fiscal years of reducing existing expenditure and, depending on the economic trend, allow additional expenditure to support structural reform within limits that make it possible to attain medium-term targets, thereby revising the structure of expenditure and maintaining the minimal stabilizer function of public finance.