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Annual Review of Monetary and Economic Developments in Fiscal 1997

Summary

Japan's economic growth slowed during fiscal 1997.[1] The economy, which had been on a recovery path, began to decelerate with the turn of the new fiscal year in April 1997, and became increasingly sluggish toward the end of the fiscal year.

Final demand deteriorated toward the end of fiscal 1997. Until recently, net exports generally followed an upward trend and underpinned Japanese economic activities. In detail, real exports expanded, reflecting firm business conditions overseas - particularly in Europe and the United States - and also by the depreciation of the yen, while real imports remained virtually unchanged. However, net exports peaked out toward the end of fiscal 1997, owing to a decrease in exports to other Asian countries against the background of the ongoing economic adjustments in the region. Meanwhile, public-sector investment basically trended downward because of tight budgets at both the central and the local government levels. Business fixed investment maintained a gradual increase during the first half of fiscal 1997, particularly in the manufacturing industry. However, in the second half of the fiscal year, it seemed to have peaked out reflecting factors such as deterioration in corporate profits. Private consumption and housing investment were depressed from April 1997 mainly in reaction to the surge in demand ahead of the rise in the consumption tax rate from 3 to 5 percent.[2]

The stagnation became evident from autumn 1997 partly against the background of the deterioration in household confidence despite a moderate recovery temporarily observed around summer 1997. The stagnation in final demand adversely affected production, corporate profits, and employment condition. Accumulation of inventories was followed by an adjustment in production, resulting in a decrease in output in the last two quarters of fiscal 1997. Inventories in final-demand goods, including construction goods and consumer durables, began to accumulate in spring 1997, and this development expanded to producer goods in autumn 1997. Corporate profits plunged in the second half of fiscal 1997 resulting in a turn to decline for the fiscal year as a whole. Profits declined even at large manufacturing firms that had maintained steady growth up until that time. Under these circumstances, corporate sentiment worsened rapidly across a wide range of firms especially during the second half of the fiscal year, as indicated by the Bank's *Tankan* - Short-Term Economic Survey of Enterprises in Japan and other statistics. Labor market conditions deteriorated in fiscal 1997. The number of new job offers turned to a decline particularly in the manufacturing and construction industries. The unemployment rate reached and remained around a historically high level in line with the increase in involuntary unemployment. In the meantime, the growth in wages and salaries, particularly overtime compensation and bonuses, decelerated, reflecting reduced production and worsening corporate profits.

Consequently, the positive cycle of production, income, and expenditures that had supported the economic recovery during fiscal 1996 weakened from the beginning of fiscal 1997, exerting downward pressure on the overall Japanese economy. With respect to final demand components, the primary factor that weakened this positive cycle was the sluggishness of household expenditures.

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[1] Fiscal year starting in April and ending in March.
[2] The consumption tax rate was raised on April 1, 1997.

Household expenditures began to show a clear downward trend in early autumn 1997 despite a slight rebound in summer 1997 after fluctuations resulted from the rise in the consumption tax rate in April 1997. The decline in real disposable income due to the rise in the consumption tax rate and the discontinuation of the special income tax reduction can be cited as a factor behind the sluggish household expenditures. In the past, when constraints on household income intensified, a mechanism often functioned whereby growth in expenditures was maintained by the increase in the households' propensity to consume (the ratio of expenditures to household income). This time, however, household expenditures were restrained reflecting cautious household sentiment, and this added to the sluggishness in final demand, leading to excessive inventory and its adjustment in the corporate sector. This development worsened labor market and income conditions in the household sector. It is difficult to quantify and verify the factors that have weakened household confidence. However, it is likely that the following factors contributed: (1) mounting anxiety regarding the future employment and income conditions as a result of a series of large financial institution failures; and (2) growing uncertainty regarding the future burden on households amid the recent active debate on the budget deficit and the reform of national pension systems.

The stagnation of household expenditures also affected corporate sentiment and business fixed investment through the sluggish domestic final demand and deteriorating corporate profits due to inventory adjustment. Prior to the collapse of the "bubble" economy, brief periods of stagnant domestic demand were overcome through (1) active export drives by firms especially in manufacturing industry, which compensated for the weak domestic demand; and (2) an improvement in cash flow as a result of monetary easing and the positive lending attitude of financial institutions, which facilitated corporate financing and business fixed investment especially in nonmanufacturing industry. However, after autumn 1997, business conditions became severe due to the economic turmoil in other Asian economies, especially in Korea and the ASEAN nations, and the cautious lending attitude of financial institutions, due in part to weak stock prices and market concerns regarding credit risk.[3]

In addition to the weak household expenditures, various strong and persistent structural adjustment pressures on the economy can be cited as another fundamental factor in the economic stagnation. With such pressures, the economy, unable to resume a self-sustained recovery which started in fiscal 1996, stagnated, a result that was triggered directly by factors such as fiscal restraint and cautious household sentiment. The attitude toward expenditure and investment at large manufacturing firms facing so-called "mega-competition" remained selective. Nonmanufacturing firms were pressed to boost their productivity - which was said to be behind that of the manufacturing sector - amid the ongoing deregulation in addition to the balance-sheet adjustment following the collapse of the "bubble" economy. Turning to the industrial structure, the Japanese economy seemed to be still in the process of transition. There appeared to be no leading industry raising productivity and thereby creating additional employment, while in some industries employment adjustment pressure was intensifying.

Prices (excluding the effects from the rise in the consumption tax rate) remained stable on the whole during fiscal 1997, although they softened slightly during the second half.[4] Import prices rose sharply in 1996 but turned to a decline in the first half of 1997 reflecting the fluctuations in crude oil prices and the exchange rate of the yen. The prices remained relatively stable until the end of 1997, but began to trend downward once again reflecting the weakening of international commodity prices due to the economic crisis in Asian economies. Domestic wholesale prices seemed to be bottoming out during the second half of 1996 and the first half of 1997. Prices then softened from summer 1997, reflecting the weakening market conditions in materials-related

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[3] ASEAN comprises Thailand, Malaysia, Singapore, Indonesia, the Philippines, Brunei, Vietnam, Cambodia, and Laos.

[4] Price data presented in this report exclude the effects of the rise of the consumption tax rate from 3 to 5 percent effective from April 1, 1997.

goods due to stagnant domestic final demand and the accumulation of inventories, in addition to the fall in import prices. Corporate service prices in fiscal 1997 narrowed their rate of decline following the ongoing downward trend and have recently moved around zero compared to the level of a year earlier. Consumer prices (nationwide, excluding perishables) increased at a slightly higher rate during the first half of fiscal 1997. This is because commodity prices declined more slowly as a result of a decelerated influx of low-priced foreign goods. In the second half of fiscal 1997, however, the softening of commodity prices reflecting the decline in domestic wholesale prices dampened the increase. Furthermore, the 12-month increase in consumer prices has recently fallen almost to zero, excluding the effects of the rise in medical service charges caused by the medical insurance system reform of September 1997.

With respect to factors affecting prices, the price decline phase of the second half of fiscal 1997 differed from that of around 1994-1995. During the 1994-1995 period, downward pressure on the overall prices of import-competing domestic goods intensified owing to the rapid increase in the penetration ratio of imports, particularly in manufactured goods. This occurred against the background of the industrialization of Asian countries other than Japan and the continued appreciation of the yen. On the other hand, in the second half of fiscal 1997, downward pressure on overall prices resulted mainly from the stagnant domestic final demand. There did exist downward pressure on domestic wholesale prices caused by the drop in import prices, owing to the price declines in international commodity markets triggered by the crisis in Asian economies. However, the penetration ratio of imports did not increase since the value of the yen was significantly lower on the whole than it was in 1994-1995. As for the effects of price declines on corporate activities, the decline in the prices of crude oil and other raw materials in international commodity markets in the second half of 1997 worked rather favorably for Japanese firms by improving their terms of trade, unlike the first period during which the import penetration ratio of final goods increased. It should be noted, however, that there were signs of a squeeze on corporate profits as unit labor costs and labor’s relative share in income distribution increased against the background of the exceptionally low nominal GDP growth rate, and the expansion of the domestic output gap accelerated due to the stagnation of final demand. It therefore became important to carefully monitor the effects of the sluggish domestic demand on corporate activities and employment conditions.

As for land prices, commercial land prices generally showed a smaller decline as a clear distinction in profitability existed between land whose price had stopped falling and land whose value continued to fall from fiscal 1996 through the first half of fiscal 1997. Meanwhile, residential land prices virtually stopped declining. In the second half of fiscal 1997, however, commercial and residential land prices both began to weaken slightly once again, reflecting the stagnant economy.

As for financial developments, while the Bank maintained its easy stance in monetary policy, some disturbances occurred in the financial system. Causes of the disturbances included the further drop in stock prices affected by a number of failures of banks and securities companies in November against the background of the prolongation of the efforts to dispose of nonperforming loans. As a result, there were some unstable developments in the market such as the rise in some interest rates reflecting pressure coming from intensified market concerns over credit and liquidity risks. Around the fiscal year-end, however, the market gradually regained stability as a result of an ample supply of funds injected by the Bank and implementation of financial system stabilization measures involving the use of public funds worth ¥30 trillion.

Developments in market interest rates showed that both short and long-term interest rates increased slightly for a while after the beginning of the fiscal year and then turned to a decline through the summer, as the outlook for the economy became increasingly unclear. Then, in November 1997, market awareness of credit risk heightened sharply with a number of failures of banks and securities companies. Fund-raising costs of private-sector institutions - namely, interest rates on CDs and CP in the markets, and corporate bond yields in the capital markets - increased reflecting the expansion of the risk premium. On the other hand, yields on safer assets such as government bonds declined. The difference between rates offered in the interbank market also expanded according to banks' creditworthiness, and the so-called "Japan premium" was imposed on Japanese banks in overseas markets. In response to such a rapid rise in interest rates, the Bank provided ample funds to the market in an effort to stabilize interest rates through various operations including the new bond-borrowing ("repo") operations introduced in late November. As a result, the overnight call rate (uncollateralized, weighted average) regained stability at the end of November and interest rates on term instruments began to decline from late February. Yields on long-term government bonds, on the other hand, declined to a historical low of 1.49 percent in late March reflecting releases of weak economic indicators. During the same period, stock prices (Nikkei 225 Stock Average) fell around early January once marking ¥14,664, reflecting the cautious economic outlook and mounting uncertainty about the future. Stock prices later rebounded with fluctuations and recovered to ¥16,527 at the end of March 1998, reflecting implementation of the government's stimulus measures including the use of public funds.

Financial indicators such as monetary aggregates and lending also showed erratic movements after November 1997 reflecting intensified awareness of credit and liquidity risks among firms and households. The growth of M_2+CDs, a representative indicator of monetary aggregates in Japan, remained stable at around the annual growth rate of 3 percent until early autumn, but rose sharply after November, marking an annual increase of 5 percent in February 1998, the first time in the approximately seven years.[5] This reflected the shift of funds into M_2+CDs from financial assets outside M_2+CDs such as investment trusts, and also the buildup of corporate deposits as firms deposited the funds raised in advance by bonds and CP to secure liquid funds. From early March, however, the annual growth in M_2+CDs fell slightly. Meanwhile, private-sector financial institutions showed stronger movement to reduce risk assets including lending in the second half of fiscal 1997, as capital constraints were intensified by the fall in stock prices just when risk management was being strengthened prior to the introduction of the Prompt Corrective Action. Nevertheless, a massive reduction in lending did not occur with a slight pickup in stock prices and the decisions on the injection of public funds toward the end of the fiscal year. The amount outstanding of private bank lending, however, decreased substantially after March, partly due to loan write-offs and liquidation.

With respect to corporate financing, a rapid contraction in overall fund-raising by firms did not occur owing partly to the increase in fund-raising in the capital markets by firms with good business performances. However, from a microeconomic perspective, the unbalanced allocation of funds among firms intensified. In particular, firms with low ratings and small firms that are usually unable to access the capital market were considered to have experienced tighter financial conditions partly due to deteriorating business performances reflecting the staggering economy. As for lending by private-sector financial institutions, the lending attitude became increasingly restrictive due partly to intensified constraints on capital in view of capital adequacy requirements, and as a result exerted downward pressures on the economy through its effects on corporate sentiment and firms' investment and spending activities. The significant influence of financial factors on the economy was one of the characteristics of the economic developments in fiscal 1997.

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[5] M_2+CDs = cash currency in circulation + deposit money + quasi-money + certificates of deposit.
(Cash currency in circulation = the amount of bank notes issued and coins in circulation - the amount of cash currency held by financial institutions surveyed.
Deposit money = the total of demand deposits among private and public deposits with financial institutions surveyed - the checks and bills held by these institutions.
Quasi-money = the total of private deposits, public deposits less demand deposits with financial institutions surveyed.
Certificates of deposit = those of private corporations, individuals and the public with financial institutions surveyed.)

In the “Annual Review of Monetary and Economic Developments in Fiscal 1996,” the Bank pointed out that the momentum of the economic recovery firmed gradually during fiscal 1996, but this was not necessarily accompanied by an improvement in private-sector confidence.[6] In fiscal 1997, in addition to the fiscal drag, the Japanese economy experienced diverse negative impacts such as failures in the financial system and the financial and economic crises in Asian economies. Thus, the recovery which had been proceeding since the end of 1993 was interrupted. It cannot be denied that economic entities’ confidence was damaged further. Results of various business surveys indicated that the recovery of economic entities’ confidence was further delayed. Factors behind the weak recovery in the private sector’s confidence were anxiety and uncertainty regarding the economic and social systems of the country, in addition to factors related to persistent aftereffects of the collapse of the “bubble” economy such as the financial institutions’ nonperforming-loan problem. The anxiety related to whether the current systems can adapt to the major structural changes facing the Japanese economy - such as intensified global competition and demographic changes in Japan toward fewer children and an increasing aged population - and the growing uncertainty caused by the unclear direction of future economic developments.

In light of the above, there are several issues which must be dealt with for the Japanese economy to regain a self-sustaining growth. First, the critical task for the Japanese economy to be dealt with without delay is to avoid falling into a deflationary spiral induced by decrease in demand. In view of this aim, the government set out a comprehensive economic package on April 24, 1998 including special income tax reductions. Expeditious implementation of these measures and significant results are expected.

The second task is to solve various problems that surfaced after the bursting of the economic “bubble” as quickly as possible and to restructure and enhance the mechanism of Japan’s financial system. During fiscal 1997, the government implemented measures to stabilize the Japanese financial system, which included the use of public funds. In addition, the recently announced comprehensive economic stimulus package incorporated measures to enhance asset securitization and real estate liquidation, and a systematic framework for the disposal of nonperforming loans was consolidated. Also, the Japanese “Big Bang” financial deregulation is being implemented beginning with the amendment of the law on foreign exchange and foreign trade, which came into effect on April 1, 1998. Under these circumstances, it is imperative for financial institutions to dispose expeditiously of their nonperforming loans as well as to reallocate their resources, in order to efficiently provide financial services that meet the needs of firms and households. Along with the efforts to review and to improve the indirect financing system, it is necessary to reinforce direct financing through the expansion of risk capital offered in the capital markets, thereby encouraging the optimal allocation of funds in the economy. Thus, the infrastructure for corporate accounting, disclosure of information, the system of taxation for financial services, and payment and settlement systems must be reviewed and improved expeditiously.

The third task is to make steady progress in the reform of Japan’s economic structure through measures such as deregulation and revision of the taxation system. The relaxation and abolition of various economic regulations would bring about higher productivity and economic growth rates in the long run by creating demand and promoting effective resource allocation among industries and firms. Also, a revision of the taxation system aimed at improving the return on investment and supporting the optimal allocation of capital should have positive effects on the overall economy. Restructuring of other economic systems is also required in order to smoothly shift resources. For example, the current employment system should be reviewed to promote mobility in the labor market. In addition, while efforts should be made to achieve greater efficiency in the public

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[6] For details, see “Annual Review of Monetary and Economic Developments in Fiscal 1996” in the Bank of Japan’s *Annual Review* 1997.

sector, a nationwide consensus regarding the direction of the social security system reform should be reached as quickly as possible to ease the deep-rooted concerns in the household sector over the future burden of social security costs.

The diverse events that the Japanese economy experienced in fiscal 1997 demonstrated the importance of influencing expectations of various economic entities and to gain confidence among market participants in managing economic policy. In this regard, policy makers should strive to reduce the uncertainty concerning the outlook for the economy through improved transparency and consistency in their policy, while initiating effective measures in order to support economic activities of private-sector entities.