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A Note on the Current State of the Japanese Economy

Teizo Taya
Member of the Policy Board
Bank of Japan

1. A Decade of Adjustment and Low Growth

In Japan, last ten years were a period of adjustment and low growth. Since an asset bubble burst at the beginning of the 1990s, land and stock prices continued to decline and did not show any clear signs of recovery (Charts 1 and 2). During the decade, economic growth was generally minimal, with a cyclical upturn in the middle of the period (Chart 3).

There were three factors that led to the extremely low economic growth. Firstly, balance sheet adjustments by banks, non-financial corporations, and households were delayed. The decline in prices of stocks and land reduced their value on the balance sheets, while the book value of liabilities did not change. Sales of assets to reduce liabilities were delayed, hoping for an asset price recovery. However, asset prices continued to decline beyond anyone's expectations. This, coupled with stagnant economic conditions, forced banks to make continuous and large-scale write-offs of bad loans, since most bank loans used land as collateral.

Secondly, like in any other countries, globalization of the economy and the IT (information technology) revolution put pressure on the economic structure to change. However, deregulation was not comprehensive enough to facilitate the changes. Important areas of deregulation include finance, telecommunications, distribution, and the labor market. Certain significant changes have only recently occurred in these areas.

Thirdly, a system built on the premise of high economic growth was subject to change when the economy reached a matured stage following the end of the process of catching up with front-runners and the country entered an aged society. Reforms of the social security system and the fiscal structure were not sufficiently comprehensive to wipe out concern or uncertainty about the future, leading to defensive attitudes of consumers.

The extent to which balance sheet adjustments have progressed may be seen from banks' balance sheets. Major commercial banks (city banks, long-term credit banks, and trust banks) whose share in total bank lending was about 60 percent disposed of non-performing loan by ¥50 trillion, which was 16 percent of their loans, in the last eight years. As of the end of March this year, they still had loans under special risk review amounting to ¥18 trillion or 5.8 percent of their loans (Chart 4). (During the period, the amount of disposal by all banks of non-performing loans totaled ¥83 trillion, which was equivalent to 16-17 percent of loans or of annual value of gross domestic products, while the amount outstanding of loans under special risk review was still as large as ¥29 trillion or 5.8 percent of loans outstanding as of end-March.) It will take a few more years for banks to clean up their balance sheets, although a critical situation has already been behind us. Some 20 major commercial banks appear to be in a process to merge into 4 or 5 groups, with three of them having failed.

Non-financial corporations have also carried out balance sheet adjustments, and have tried to cope with rapid progress in information and communications technology and to take advantage of opportunities created by deregulation. Since around 1995, corporations have been said to be divided into winners and losers in the stock market. Winners are corporations that are successful in adjusting themselves to a new environment. It appears that corporate restructuring has recently accelerated and progressed, reflected in an increase in merger and acquisition deals (Chart 5), an increase in foreigners' investment in Japanese equities (Chart 6), and an increase in foreigners' inward direct investment (Chart 7).

2. Recent Developments

Since around spring last year, the economy has started to recover slowly. At first, production started to recover (Chart 8), helped by an increase in public investment and consumption, the latter of which was stimulated by tax reductions. The increase in production and corporate efforts to reduce personnel expenses have helped corporate profits to increase (Chart 9), contributing to an improvement in business sentiment (Chart 10) and in turn to a recovery of business fixed investment (Chart 11).

Private consumption has not yet recovered despite the improvement of the corporate sector. It will take a little more time before consumption fully recovers, since an important factor behind the recovery of corporate profits has been a reduction of employment and wages (Charts 12 and 13). As long as a recovery of the corporate sector continues, it may be a matter of time before a recovery of consumption through an improvement in wage income and employment is observed, given a recent improvement in consumer sentiment (Chart 14). But it may take some time before it is actually observed, since employees' compensation is likely to be further curtailed.

Hence, the current recovery process is likely to remain slow. Support from fiscal and monetary policies will be limited. The fiscal balance has deteriorated substantially as a result of a series of economic stimulus measures in the past (Chart 15). With regard to monetary policy, money market rates have remained at around zero (Chart 16). Even without further policy support, however, the economy appears to be able to continue a slow but self-sustained recovery process (Charts 17, 18, and 19, regarding economic growth, prices, and exchange rates, respectively).