Introduction: Overview of Japanese Economic Trends

This book describes fiscal and monetary policy over two decades - FY1972 to 1990.

The period preceding this is commonly known as the “High-Growth” Period, when Japan enjoyed a real economic growth rate of nearly 10% annually since around 1955, after a ten-year postwar reconstruction period. Although the Japanese standard of living increased dramatically and the economy was able to catch up with advanced countries owing to such high growth, the economy fluctuated sharply in the process. On the other hand, in the period treated in this Volume 2, the phase of rapid growth had ended and the growth rate had dropped by half - about 4% on average - and the fluctuation in the growth rate was moderate compared to the preceding period. So we might call this the “Stable-Growth period”. The direction of economic policy management also shifted from the former premise of high growth, to one of stable growth. However, the economy as a whole did not show stability, but encountered challenges one after another, as is described in the following

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For reference, an overview of the economic trends in the stable growth period is given below.

1. Overview of Economic Situation in each period

Fiscal Year 1972 - 1979: We divided the period from FY 1972 to 1990 into three periods (See Figure-1).
The first period is from FY1972 to 1979.

In August 1971, due to the so-called “Nixon Shock”, or “Dollar Shock”, the fixed exchange rate system of ¥360/$, which had been the foundation of the long-continued postwar high growth, came to an end. Fiscal and monetary stimulation policies were taken to cope with this challenge, while inflationary pressure and speculation fever on real estate continued to grow.

Figure-1 Growth Rate of Real Gross National Expenditure

(Source) Economic and Social Research Institute, Cabinet Office, Government of Japan, *(Chōki Sokyū Shuyō Keiretsu Kokumin Keizai Keisan Hōkoku (Report on National Accounts* from 1955 to 1998)

It was at this point that the first Oil Crisis occurred in 1973, triggering skyrocketing inflation and speculation. With a restraint policy for curbing inflation, excess investment in plants and equipments was revealed, so that the Japanese economy faced its worst recession in the postwar period. The growth rate recorded a minus in FY1974 for the first time since the war.

Such a series of shocks and confusions led to the end of the high growth period of the Japanese economy. It is not simple to explain why the high growth ended. If the end of the growth was due to only external factors, such as the Oil Crisis or the surge in resource prices, it would be hard to explain why the irreversible downward shift occurred, since the oil prices dropped dramatically again afterwards. Therefore, one cannot help but conclude that a mechanism for high economic growth, which included domestic conditions, also vanished in this period. At the time, there was a decrease in suitable locations available for heavy industry (especially in coastal areas), a decline in the ripple effect of large scale investment mainly by such heavy industry, labor shortages (although labor had once been abundant) and a decrease of the consumption expansion effect due to the increase in households which had accompanied the labor shift from rural areas to big cities. All the factors described above emerged at the same time and were mutually relating: they acted to push the path of growth downward. Accordingly, we might say that the external shock merely triggered the negative shift in the Japanese economy. As described above, this trend also reflects a wider change in the social structure.

Figure 1 shows the decline of the growth rate to a little under 5% in the late 1970s, which was half of that of the high growth period. At the same time, at this point there was a period of transition to a low growth path, which was therefore accompanied by social frictions caused by the “streamlining” of management, through the cutting of labor, saving of stock and money, and by the change in the industrial structure from a high “resource consuming” to a “resource saving” structure.

Meanwhile, as the growth pattern changed from “plant and equipment investment-led type” to “export-led type”, the trend in trade and current balance shifted to one of gaining surplus. Yen rates kept rising (yen appreciation) after the introduction of the floating exchange rate system in 1973. Then the GDP on a dollar basis rapidly increased, in spite of the decrease in the growth rate, thanks to yen appreciation. Japan’s national income per capita on a dollar basis was only $211 in 1955 and $1,586 in 1970, then $3,652 in 1975, $8,851 in 1985, and eventually reaching $18,268 in 1988. With the rapid increase in exports of motor vehicles and electric appliances, the presence of the Japanese economy in the world market was heightened during this period. Under these circumstances, the world looked to Japan to be the “driving force (locomotive)” of the world economy, together with West Germany, so that the fiscal deficit and balance of the government bonds progressively increased since stimulatory fiscal actions were taken as being “locomotive”.

Fiscal Year 1980 - 1984: We have designated FY1980－1984 as the second period.

By around 1978 to 1979, as the economic fluctuation after the turmoil gradually settled down, Japan seemed to be back on track again for stable growth. However, when the second Oil Crisis occurred during these years, the resource prices surged again. “Stagflation” - the concurrence of stagnation and inflation - occurred in the early 1980s, and the negative impact on the economy was even more severe than in the first Oil Crisis. However, while the magnitude of the negative impact on the Japanese economy due to the Oil Crisis was the most severe of the advanced countries at time of the first shock (1973), it was the most slight at time of the second one (1978). There are two reasons for this. One is that flexible policy measures, such as a monetary tightening policy, were taken by the Bank of Japan at an early stage to curb inflation during the second Oil Crisis, which was a lesson learned from the first Oil Crisis. The second was the smooth economic adjustment that occurred in the private sector. For example, private management introduced new technologies to save energy and production resources and reorganized their industrial structure in response to the change in the comparative price system, and their labor also voluntarily refrained from making wage increase requests, to avoid a negative spiral of prices and wages. This proved the high ability of the Japanese economy to adjust, and gained attention from the rest of the world.

However, Japan’s economic growth remained low, at around 3%, affected by the world wide recession from FY 1980 to 1983 (although it showed a slight recovery in FY 1984 and 1985). The notable economic features were dollar appreciation and yen depreciation. Although the yen broke through 200 yen (per U.S. dollar), and even reached ¥170/$, it recovered to ¥200/$ in 1980. The yen depreciation was the reverse side phenomenon of the high interest rate for curbing inflation and the dollar appreciation arising from the “Strong Dollar” policy. As for the United States, on the one hand, domestic demand increased with a large scale tax reduction based on the economic policy known as “Reaganomics”. While, on the other hand, the deficit of trade and current balance of payments increased sharply together with the dollar appreciation, as Japan was the largest trade surplus country to the United States, and the export-led economic growth pattern was further intensified. With the background of the trade imbalance, economic friction was generated and the United States, especially, demanded the correction of the trade imbalance.

As for the philosophy regarding economic policy management at the time, the Thatcher Administration in Great Britain and the Reagan Administration in the United States sought “Small Government”: liberalization and deregulation, reliance on economic benefit through market competition and the strengthening of the private sector’s vitality. The philosophy of “Big government” - represented by Keynesianism or the welfare state policy - was criticized severely. At this time, the Japanese government set the reduction of the increased fiscal deficit as the primary target of its economic policy.

Fiscal Year 1985 - 1990: The third period described is from FY 1985 to 1990.

In 1985, the United States changed to a “Strong Dollar” policy. At the G5 meeting (the Group of Five Ministers of Finance and Central Bank Governors’ meeting) in September 1985, the U.S. government obtained agreements and implemented an adjustment of foreign exchange rates, such as dollar depreciation and yen and mark appreciation through international cooperation (the “Plaza Accord”), and put these into effect. The yen was appreciated from ¥240/US.$ to ¥150/US.$ by the Plaza Accord in the following year. Accordingly, the “Yen Appreciation Recession” occurred in 1986, but in 1987 the appreciated exchange rate in turn began to give rise to some economic merits, such as the cost reduction of imported raw materials, which increased the cash reserve of companies. When this excessive liquidity, or funds, flowed into the asset market, such as the real-estate and stock market, asset prices were boosted. Furthermore, increased real-estate related loans by banks led to speculative asset trading. The Bank of Japan had continued its easy money policy and kept the interest rate low from the viewpoint of this being a measure against the yen appreciation recession, the adjustment of yen-dollar exchange rate, and saw “domestic demand expansion” as a countermeasure against the current account imbalance and a measure against the world-wide sharp drop in stock prices in October 1987 (so-called Black Monday). This monetary policy eventually accelerated asset speculation.

The “bubble economy” is thought to have emerged in Japan in 1987-1990. By definition, an economic “bubble” means that asset prices are booming beyond a reasonable price level from the viewpoint of fundamentals. Excessive confidence and expectation regarding the Japanese economy was also the cause of the surge in speculation. This was followed by a sharp rise in land prices, making it difficult for people to purchase their own houses, which became a social issue eventually. The gap between the haves and have-nots was also further widened.

There was not only monetary expansion and an asset bubble at this time. A boom in the real economy emerged as well. As shown in Figure-1, the growth rate in this period recovered to 5% from fiscal year 1987 to 1990 after a drop in 1986. Equipment investment also increased to a high level; private consumption, including that on luxury goods, expanded. Employment increased as well. This boom is often called the “Bubble Economy”. As tax revenue also increased, the issuance of deficit-bonds was zero in 1989.

However, the bubble economy then burst, and the boom turned into economic stagnation. This happened in 1990 and 1991, at the end of the period referred to in this paper. In contrast to the bubble economy, asset prices dropped sharply, and investment in equipment and consumption of durable goods decreased, while employment was cut. As the same time, the balance sheets of companies were getting worse due to excess debt, and there was an accumulation of bad loans in the banking sector and stock appraisal loss due to the drop in stock prices. “Balance sheet adjustment” - in other words, preferential debt repayment by companies and loss disposition by financial institutions - further hindered the flow of funds, and the vicious spiral continued. In particular, since the financial system had been damaged for the first time since the War, it was felt as a great burden to Japanese economy. Thus, the serious recession lasted for a long time.

The following describes the economic trends in each of the periods with numerical data relating to the following areas: public finance, money and finance, prices, asset prices, trade, international balance of payments and foreign exchange rate.

2. Public Finance

In this section, we briefly look at the trends in the fiscal situation.

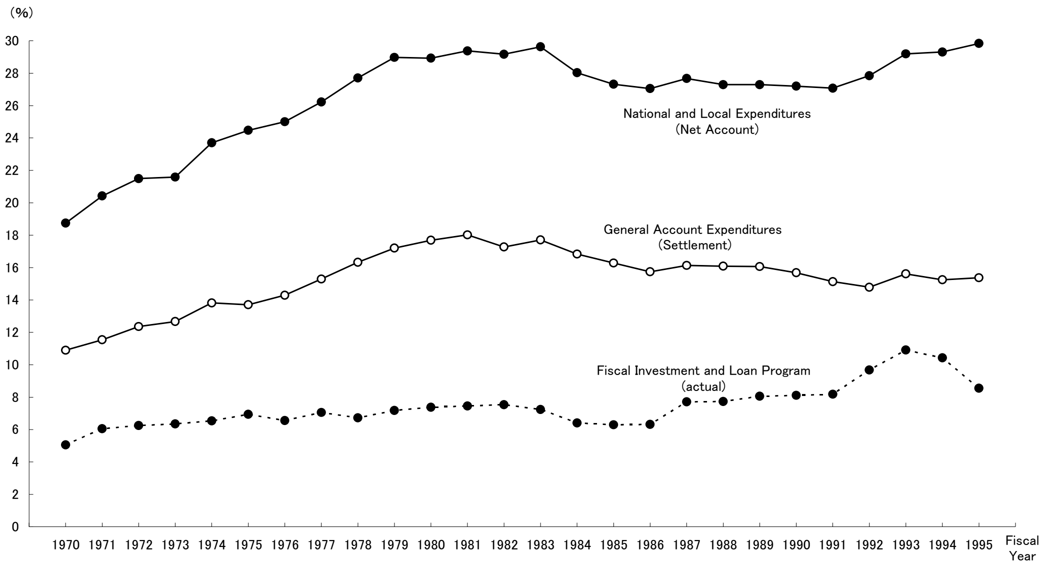
Figure-2 shows the scale of public finance in the ratio to GNE (equivalent to GNP). The General Account expenditure (on a final result basis) was only 11% in FY 1970 but it exceeded 18% in FY 1981, which means it nearly doubled in this period. This was due to the continuous increase in social security-related expenditures and the increase in public works as an economic stimulus measure. As a growing sense of crisis regarding the rise of bond dependency ratio developed, an Ad Hoc Commission on Administrative Reform (the 2nd) was formed in 1981 and a zero ceiling system was introduced as a tool for fiscal reform in the FY1982 budget compilation process. Under this policy, the bond dependency ratio began to decrease gradually and went down to 14% in 1992 (it began to rise again under the following recession).

The net amount of national and local expenditures shifted in a similar manner. The ratio to GNE was over 18% in FY1970, and surged to about 30% in FY1983, but in turn gradually decreased to about 27% in FY1991. The increase was even more rapid than that of the General Account of national finance during the above period.

As for a comparison with other advanced countries in this period, Japan's fiscal scale was as small as that of the United States. It was also characteristic that the ratio of investment expenditures had been high.

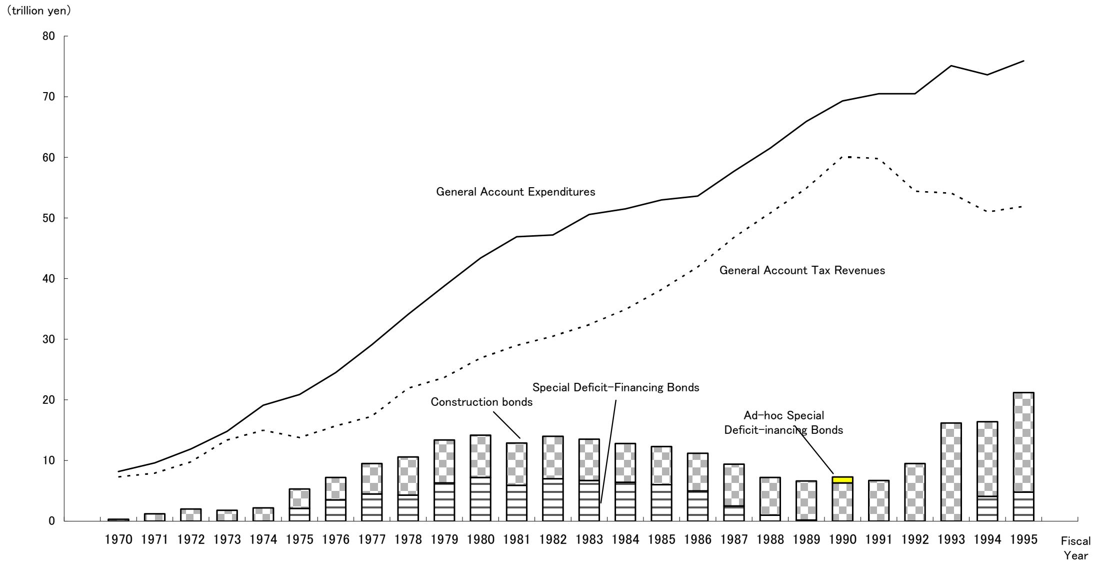
The ratio of the Fiscal Investment and Loan Program (FILP) to GNE increased from about 5% in FY 1970 to about 8% in FY 1982, and then started to decrease in FY 1983. It began to rise again in FY 1987 but the curve is different from the one for expenditures, as described above.

Figure-2 Macro Fiscal Index (to GNE Ratio)



(Source) Economic and Social Research Institute, Cabinet Office, Government of Japan, (Chōki Sokyū Shuyō Keiretsu Kokumin Keizai Keisan Hōkoku [Report on National Accounts from 1955 to 1998] Mininstry of Finance, Zaisei Kinyū Tōkei Geppō [Ministry of Finance Statistics Monthly] No. 372, 541 and 543.

Figure-3 General Account Revenue/Expenditures



Source: Research Division, Budget Bureau, Ministry of Finance "*Zaisei Toukei*" [Budget Statistics] each year, Research and Inte0rnational Division, Secretary Geneeral Secretariat, Board of Audit of Japan, *Kessan Toukei* [Settlement Statistics] Fiscal Year 1989 – 1993 and 1994 – 1998.

Figure-3 is a graph of the national General Account expenditures, tax revenues and government bond issuance. The expenditures increased at a high pace until FY1981, and then slowed down from FY1982 to FY1986, but increased rapidly again from FY1987. On the other hand, tax revenues showed a sluggish increase after FY1975. Therefore, the government started to issue deficit-bonds in FY1975 and kept increasing the issue amount. Construction bonds also increased in the same way. Tax revenue slightly increased after around FY1985, but government bond issuance gradually decreased after FY1983 and it achieved its policy objective of zero deficit-bonds in FY1990. However, due to the collapse of the bubble economy, tax revenue started to decrease from FY1991, and government bond issuance began to increase again.

Table-1 shows the change in expenditure by item in the national General Account budget. It shows a drastic rise in debt servicing costs. Although this rise led to the reduction of other ratios, local government finance-related expenditures and social security-related expenditures relatively increased, and public works related expenditures, expenditures on education and the promotion of science, and other expenditures, showed a tendency to decrease. Among other expenditures, foodstuff control expenditures decreased sharply from 5.6% in FY1970 to 0.6% in FY1990.

Table－1. General Accounting Budget by Major Expenditure Program

(%)

	FY1970	FY1975	FY1980	FY1985	FY1990
Social Security	14.1	19.4	18.9	18.5	16.6
Education and Science	11.7	12.7	10.5	9.2	7.7
National Debt Service	3.5	5.3	12.6	19.1	20.7
Local Finance	21.6	16.2	17.9	18.2	22.9
National Defense	7.2	6.6	5.2	6.0	6.1
Public Works	17.2	15.9	15.6	13.0	10.1
Others	24.7	23.9	19.3	16.0	15.9
Total	100.0	100.0	100.0	100.0	100.0

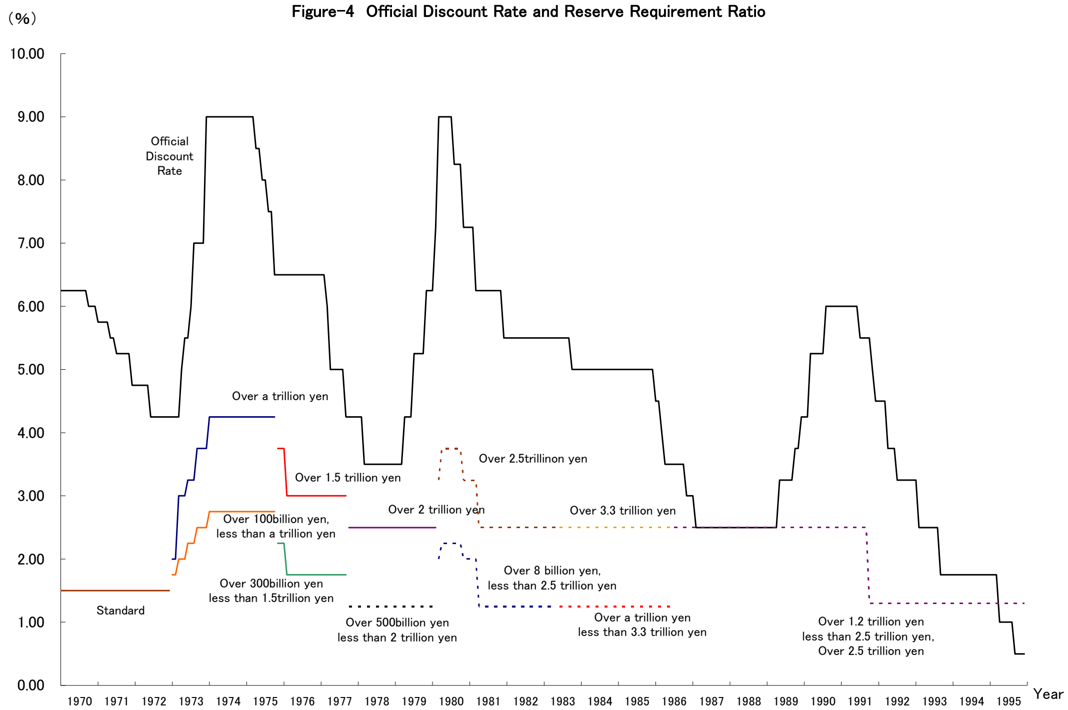
Source: Research Division, Budget Bureau, Ministry of Fiance, *Zaisei-Tōukei* [Budget Statistics] 1991.

3. Money, Prices and Asset Prices

Next is a summary of the trends in money and finance, prices and asset prices. Figure-4 shows the change in monetary policy.

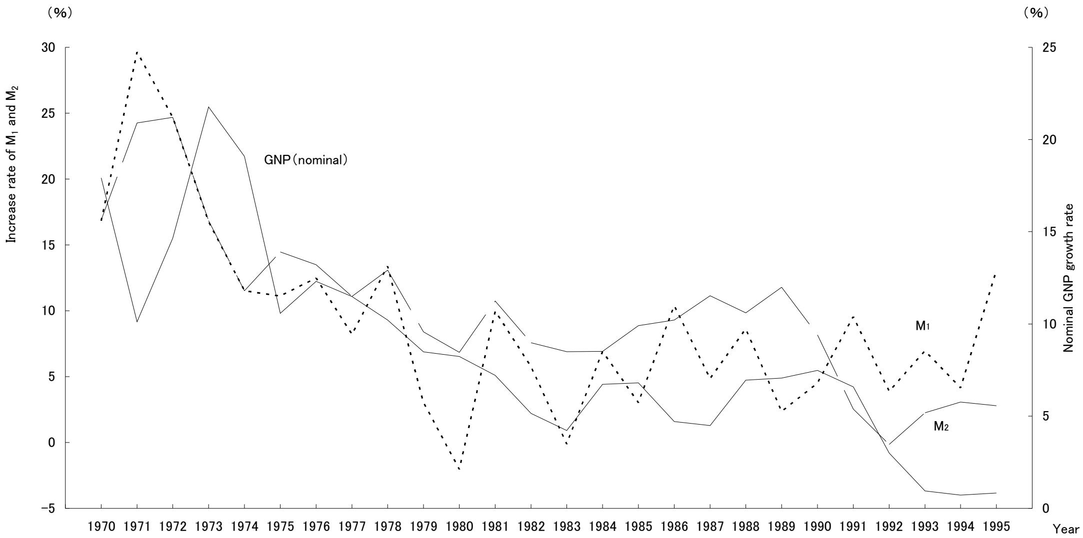
After the monetary easing policy, such as the official discount rate cut which was made in the pessimistic outlook after the 1971 recession and Dollar Shock, monetary policy shifted to a tight stance after 1972, by taking measures which included increasing the official discount rate, raising reserve requirements, and restricting bank loans by the Bank of Japan, in the face of severe economic conditions such as a sharp rise in price levels, real estate speculation and the occurrence of the first Oil Crisis. This monetary easing policy was taken and continued from 1975 to 1978 as the severe recession prevailed and yen appreciation advanced. However, in the period between 1978 and 1979, monetary tightening policy was again adopted, including raising the official discount rate to 9%, in order to control inflation caused by the second Oil Crisis. The monetary easing policy after 1980 aimed at taking measures against potential recession under the global economic slowdown and expanding the domestic demand to cancel the trade imbalance and external trade friction. The policy further continued as a measure against the drastic yen appreciation after the Plaza Accord in 1985, the economic slump resulting from yen appreciation in 1986 and the domestic demand expansion that followed in 1986, as well as to maintain the low interest rate to cope with Black Monday in 1987. Under these circumstances, as the bubble economy overheated, severe monetary tightening was implemented, which began with the official discount rate rise in May 1989 followed by “quantitative restrictions on the expansion of real estate related loans” in March 1990. However, many argue that this should have been done at least one year earlier. Although a series of unprecedented monetary easing measures were taken after the collapse of the bubble economy, the long and deep economic slump continued.

Figure-4 Official Discount Rate and Reserve Requirement Ratio



(Source) Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō* [Economic Statistics Annual] 1997
(Note) The reserve requirement ratios above refers to deposits (except time deposits) of banks, long term credit banks and foreign exchange bank. The reserve requirement ratio is for the deposit balance over 100 billion yen for 1972 and before, but it is for the top 2 rank of the deposit balance for 1973 and after.

Figure-5 Percent changes from previous year of Money Supply and GNP

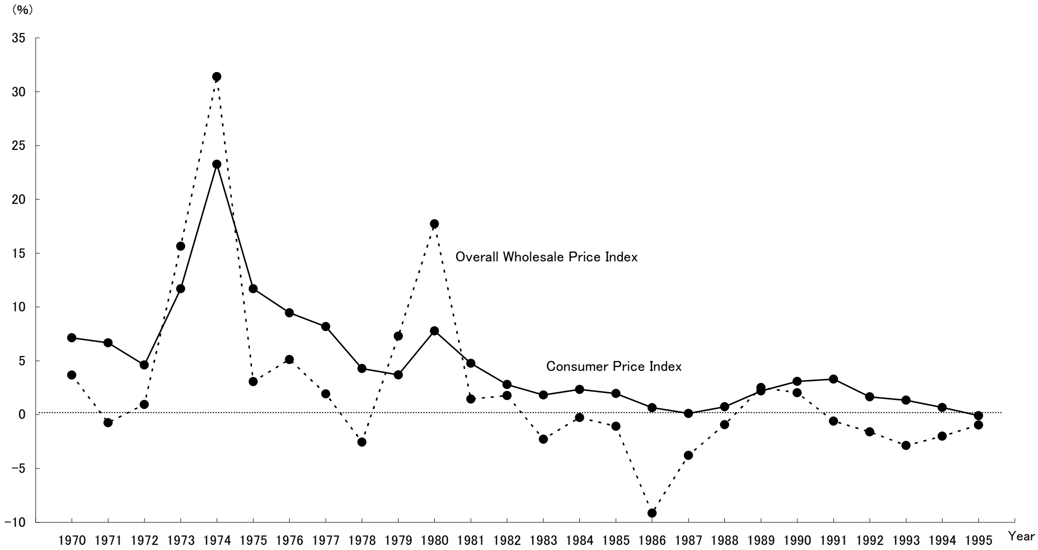


(Source) Economic and Social Research Institute, Cabinet Office, Government of Japan, *Chōki Shokyū Shuyō Keiretsu Kokumin Keizai Keisan Hōkoku* [Report on National Accounts from 1955 to 1998] Research and Statistics Department, Bank of Japan, *Keizai Tōkei Nenpō*. [Economic Statistics Annual], 1995

Money supply under this monetary policy was as is shown in Figure-5. While there is a slight difference in the movement of M_1 and M_2, the figure shows the surge in 1971 and 1972 of an over 20% increase compared with the previous year. Then the increase rate declined, particularly at the time of the second Oil Crisis. The next peak appeared during the bubble economy from 1987 to around 1989. M_2 showed a 10% increase compared to the previous year.

The trend in price levels (Figure-6) reached a peak in 1974 due to the first Oil Crisis. Wholesale prices hiked by over 30%, while consumer prices rose by over 20% compared to the previous year, and remained stable afterwards. In 1980, there was another upturn phase due to the second Oil Crisis, and consumer prices showed only a modest rise as compared to the first one. Prices in the following years became quite stable so that Japan was regarded as an “Honor Student of Prices”. It should be noted that general price levels remained stable even during the bubble economy. This made it difficult for the Bank of Japan to take steps toward a monetary tightening policy.

Figure-6 Wholesale/Consumer Price Index (percent changes from previous year)

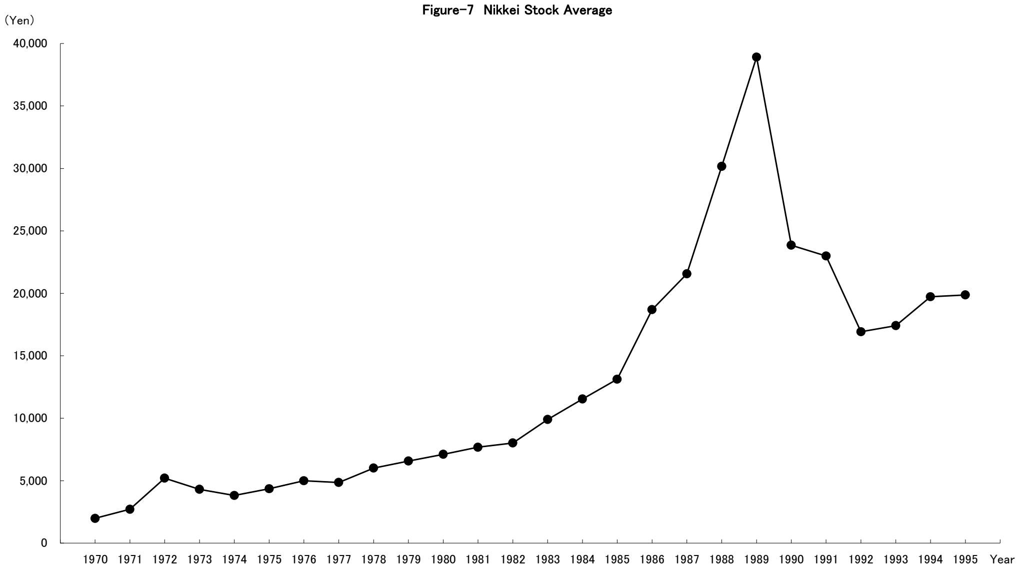


Source: Statictics Bureau, Ministry of Internal Affairs and Communications,*Shōhisha Bukka Shinshū Nenpō* [Consumer Price Index Annual Report] 1995
Note: 1990 average=100

Meanwhile, Figure-7and Figure-8 show the peak in stock prices in 1972 and in land prices in 1973 and 1974. In the bubble economy, stock prices soared to triple between 1985 and 1989, and land prices in 1989 showed another sharp rise of about three times since 1986 (in the 6 largest city areas/commercial and residential areas).

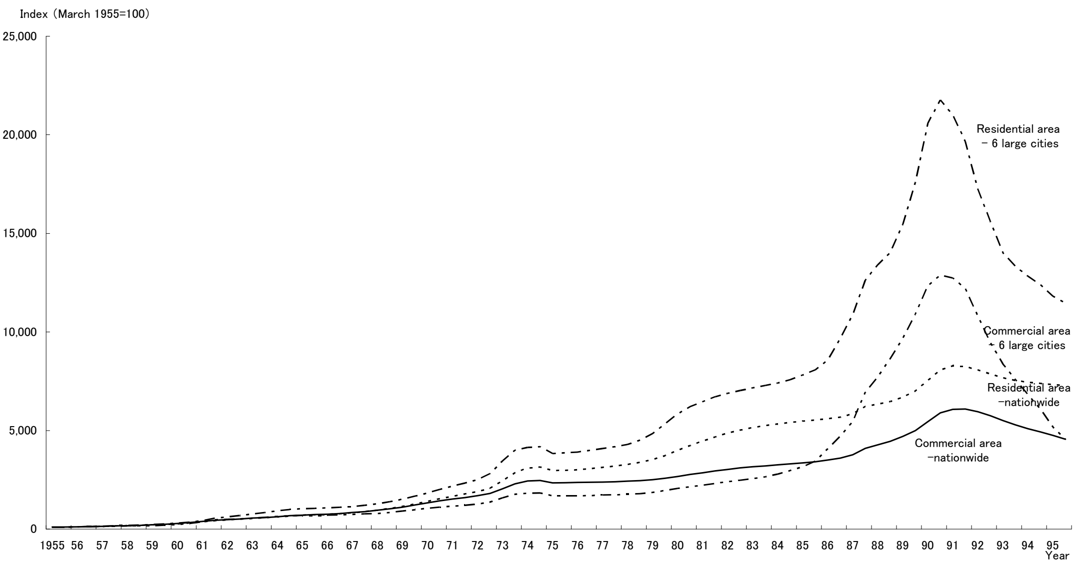
It can be said that the money supply increase in this period caused asset transaction overheating by flowing mainly into asset markets, without raising general price levels.

Figure-7 Nikkei Stock Average



Source: Research and Statistics Department, Bank of Japan., *Keizai Tōkei Nenpō* [Economic Statistics Annual], 1995

Figure-8 Urban Area Land Price Index



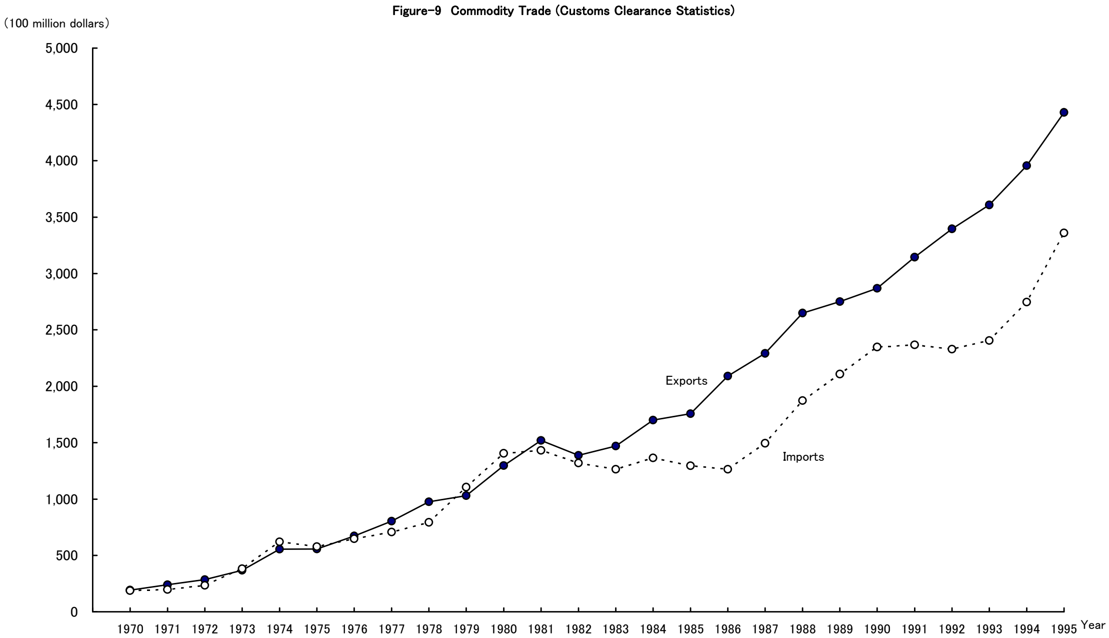
Source: Japan Real Estate Institute, *Shigaichi Kakaku Shisu*, [(Urban Area Land Price Index as of the end of September 1995]

4. International Trade, Balance of Payments and Foreign Exchange Rates

Figure-9 shows the strong increase in exports in this period. Import growth, however, remained low, even though it increased briefly during the two oil crises. These trends eventually led to the increase of trade surplus. Then, imports increased, except from 1990 to 1993.

Export items from Japan mainly comprised of machinery, and particularly centered on the products of high-tech industries. The ratio of finished goods among total imports increased, while that of raw materials such as crude oil decreased. After the drastic yen appreciation in 1985, foreign direct investment from Japan to the United States and East Asia sharply increased, so that a multilateral division of labor among East Asian countries developed and the intra-regional trade ratio began to rise.

Figure-9 Commodity Trade (Customs Clearance Statistics)

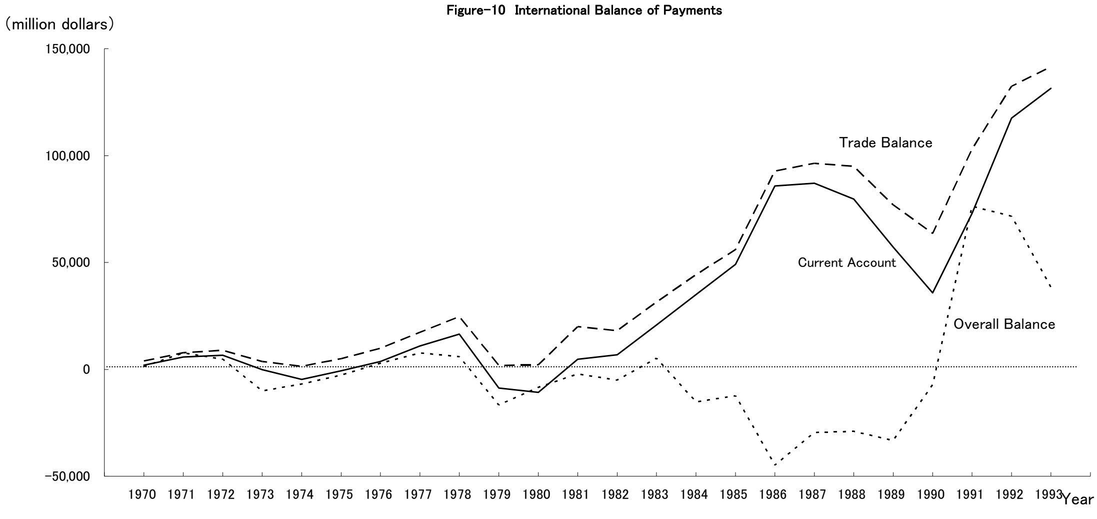


Source: Japan Tariff Association, *Gaikoku Boeki Gaikyo* [The Summary Report on Trade of Japan] January 1996

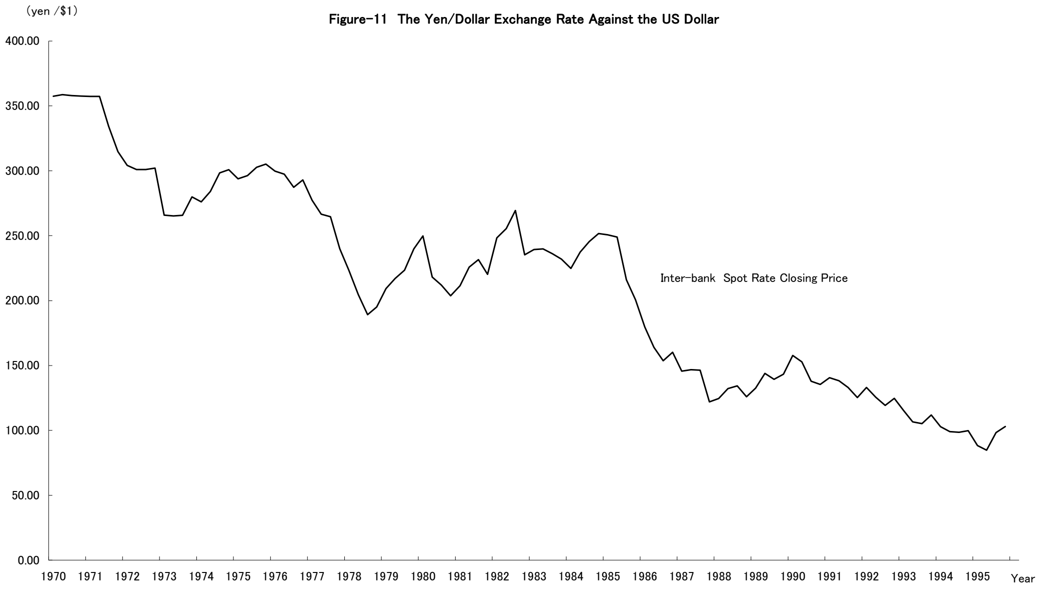
The international balance of payments (Figure-10) showed a trend of an increase of surplus, except for current account deficit periods - from 1973 to 1975 and from 1979 to 1980 - due to the sharp rise in the price of crude oil caused by the two oil crises. In particular, the sharp increase in surplus was dramatic after 1983 and it brought about trade friction. The current account surplus shrank briefly under the bubble economy, but soon reverted to an increase trend. Capital account deficit (capital exports) expanded in turn.

As for the yen-dollar exchange rate (Figure-11), after Japan's withdrawal from the fixed exchange rate system of ¥360/US.$ in August 1971, it was briefly fixed as ¥308/US.$ (16.88% appreciation of the yen) in December of the same year, under the Smithsonian Agreement. However, this could not be maintained and Japan decided to shift to a floating exchange rate system in February 1973. Although the yen rate against the U.S. dollar appreciated from 1977 to 1978 and the yen reached ¥200/$, the yen then depreciated, to around ¥200-250/$ until 1985, because of dollar appreciation due to the

Figure-10 International Balance of Payments



Source: Research and Statistics Department, Bank of Japan, *Keizai Tokei Nenpo* [Economic Statics Annual], 1994



Source: Research and Statistics Department, Bank of Japan, *Keizai Tokai Nenpo* [Economics Statistics Annual], 1994.

capital inflow that accompanied the high interest rate in the United States. After the Plaza Agreement in September 1985, there was a sharp appreciation of the yen. Although the yen depreciated in around 1990, it appreciated again, and hit a record high of ¥79.75/US.$ in 1995.