

The Global Financial Crisis and the Japanese Economy

The subprime crisis in the United States and the subsequent turmoil of the global economy are now having a significant impact on the Japanese economy. **Takao Komine** comments.

Prior to the subprime crisis, the Japanese economy had been expanding since January 2002.

The Japanese economy often grows in three stages: in the first stage, production increases on the back of exports; in the second stage, corporate earnings and capital expenditures increase; and in the third stage, employment and wages improve, and personal consumption expands.

It is possible to apply these three steps to the economic growth in Japan from 2002 onward. The economy was in the first stage in 2002 as exports increased substantially, and this triggered a great leap in production. The economy entered the second stage in 2003 when corporate earnings climbed significantly and capital expenditures began to rise. It went into the third stage in 2005, when the impression of having surplus employees was eliminated and employment conditions improved.

Economic growth after 2002 can be characterized by the following two trends.

The first trend is that the growth was moderate and lasted for a long period of time. The cyclical pickup did not show a significant upsurge, with the average annual growth rate from 2002 to 2007 only 1.8%, although the growth continued for a significant amount of time. It set a new record in November 2006, with the expansion period the longest in the postwar era.

The second feature is that the growth was underpinned by the expansion of the global economy and the weak yen. According to the IMF, the average annual growth rate of real GDP in the global economy rose from 2.9% for the term from 1990 to 1999

to 3.9% during the period from 2002 to 2007. From 2005 to 2007, in particular, the global economy grew robustly at an average annual growth rate of around 5%. Above all, the Asian economy enjoyed especially high growth at nearly 10%. Such strong growth in the global economy increased exports from Japan and therefore the profits of Japanese companies that went abroad, resulting in the expansion of the Japanese economy.

The yen also remained generally weak. Looking at the movements of the real effective exchange rate of the yen, which takes price changes and the weights of trade partners into account (calculated by the Bank of Japan with March 1973 being 100—the smaller the number, the weaker the yen) to see a long term trend, we notice that it had been consistently declining since April 1995 (165.5) and dropped to 91.2 in July 2007, which was close to its level before the Plaza Accord (89.8 in December 1984). The weak yen also helped increase the earnings of exporters.

I will now discuss these developments in relation to the subprime crisis.

The global economy had been expanding steadily before the subprime crisis. Housing investment in the United States increased substantially, supported by subprime mortgage loans. Home equity loans also increased following the rise in house prices, which stimulated private consumption. Investment banks selling securities that incorporated subprime mortgage loans earned higher income, and investors who purchased these securities increased their interest income. Supported by the U.S. economy, the global economy grew.

Looking at these developments

from the flow of funds perspective, emerging countries that enjoyed high export-centered growth supported by the strong growth of the global economy saw their trade surplus increase and domestic savings become excessive. The surplus and savings excess flowed into European countries and the United States as investment funds. In Japan, as the weak yen and low interest rates continued over a long period of time, the so-called yen carry trade increased, where foreign investors procure yen funds with low interest rates to invest in assets overseas. As such, ultra-low interest rates in Japan also became an important source of funds for investments overseas.

With the above mechanism working, the global economy prior to the subprime crisis progressed so that almost all players were satisfied. Japan also benefited from the buoyant global economy in the form of economic expansion.

Recession in Japan

The Japanese economy entered a recession around October–December of 2007. This recession can also be summarized in three stages.

The recession entered the first stage at the end of 2007. Export volumes began to decelerate around October–December of 2007, and industrial production also peaked out at the same time.

Almost simultaneously, the economy entered the second stage. According to the Financial Statements Statistics of Corporations by Industry of the Ministry of Finance, the ordinary profits in all industries have been declining year on year since the July–September quarter. Private capital expenditures (on a GDP basis, in real terms) have also been negative on a year-on-year basis since the January–March quarter.

In addition, employment condi-



AFLD

According to the government economic outlook published in December 2008, real economic growth is forecast to be -0.8% for the 2008 fiscal year and zero for the 2009 fiscal year. In the ESP Forecast Survey of thirty-eight economists in the private sector, the average (monthly) forecast for economic growth as of December 2008 was -0.5% for the 2008 fiscal year and -0.4% for the 2009 fiscal year.

tions have been deteriorating since mid-2008. Although the unemployment rate did not change significantly in November, the labor market has been worsening, with companies beginning to curb the recruitment of new graduates.

The recession was attributable to the sluggish global economy following the subprime crisis. The subprime crisis is having an impact on the Japanese economy in the following three ways.

The first is a decline in exports. The U.S. and European economies slowed substantially because of the occurrence of the subprime crisis. As a result, exports from Japan to the United States and Europe have been

decreasing. Although the Japanese economy has been driven by exports since 2002, the slowdown of exports aggravates the Japanese economy.

The second aspect is the appreciation of the yen. The exchange rate of the yen against the dollar was around 110 yen in early 2008, but dropped to less than 90 yen in December.

There are two factors that can be seen as the reasons for the stronger yen. One is that the impact of the subprime crisis on Japan was considered to be lower than in the United States and Europe. This was because Japanese financial institutions did not purchase as many securities that incorporated subprime loans, and were therefore not as seriously damaged as

their U.S. and European counterparts. The other reason is that the so-called yen carry trade of raising yen funds with low interest rates to invest in assets overseas flowed back to Japan.

The appreciation of the yen undermines the profitability of export-dependent Japanese manufacturing. It is said that a one-yen appreciation of the yen against the dollar will cause annual operating income to decline by 20 billion yen for Toyota, nine billion yen for Honda, and two billion yen for Sony (*Nihon keizai shimbun*, December 13, 2008).

The third aspect is the impact on the financial market. In particular, the effect of falling share prices is significant. The Nikkei Stock Average, a

leading stock index in Japan, was approximately 14,700 yen at the beginning of 2008 but fell considerably after the bankruptcy of Lehman Brothers to around 7,200 yen at the end of October.

The stock market dive is having a negative impact on the Japanese economy in a number of areas. The fall in stock prices decreases the value of shares owned by banks and causes their balance sheets to deteriorate. Although the willingness of Japanese banks to lend has not yet fallen off significantly, balance sheet deterioration has become a serious problem for some regional banks.

Falling share prices also affect household assets negatively. According to the Flow of Funds Accounts of the Bank of Japan, at the end of September 2008 the amount of assets owned by the household sector had fallen by 81 trillion yen from a year ago. Of the drop, 67 trillion yen resulted from falling share prices.

Future Outlook and Policy Response

It is expected that the Japanese economy will continue to experience difficult conditions for at least the whole of 2009. According to the government economic outlook published in December 2008, real economic growth is forecast to be -0.8% for the 2008 fiscal year and zero for the 2009 fiscal year. In the ESP Forecast Survey, which surveys the forecasts of thirty-eight economists in the private sector on a monthly basis, the average forecast as of December 2008 was -0.5% for the 2008 fiscal year and -0.4% for the 2009 fiscal year.

Against the backdrop of these sluggish forecasts, the government has been implementing policy measures as a matter of course. In its fiscal policy, the government has compiled three stimulus packages. The first was the emergency economic package in August 2008. This consists primarily of programs for social security and small companies, to which 11.5 trillion yen will be allocated. The second was an additional stimulus package to protect people's lifestyles with the payment of household benefits and fi-



The Aso Administration has compiled three stimulus packages since August 2008 including tax cuts, funding for care of the children and elderly, and loans for small businesses.

ancial stability measures, to which 26.9 trillion yen will be allocated. The third package was emergency measures for protecting lifestyles, consisting mainly of steps for employment and the financial market to ensure the cash management of companies, to which approximately 10 trillion yen will be appropriated.

As a monetary policy, the Bank of Japan lowered the policy interest rate from 0.5% to 0.2% and took measures to facilitate the supply of funds in October 2008. In December, the policy interest rate was cut by a further 0.2 points to 0.1% and additional financial steps were taken, including the introduction of a system for purchasing commercial papers.

While these short-term measures were taken, it is also important to hold on to a long-term perspective. The following two aspects are particularly meaningful.

One is to maintain a structural policy for strengthening long-term growth potential. It is particularly important to build up a flexible system to shift capital, human resources, management resources, and research and development resources to growth areas. If employment and management

are maintained from a short-term perspective, this will give rise to a problem whereby the distribution of time frames to existing areas will be fixed. It is necessary to establish a system to relocate resources more flexibly, while maintaining the societal safety net.

The second aspect is to review the social security system. Even if the economy is stagnant, Japan will continue to progress toward becoming one of the world's most rapidly aging societies. Given this fact, it will be difficult to maintain the pension, medical and other social security systems as they are. Many people feel insecure in this regard. If a stable institutional design for the social security system including pension and medical services is presented from a long-term perspective, it will have a significant impact in terms of eliminating people's anxiety about the future, and this will have a favorable effect on the economy through improvement in consumer confidence. To that end, it is essential for political parties to reach a bipartisan agreement that extends beyond their factional interests. □

Takao Komine is a professor in the Graduate School of Regional Policy Design at Hosei University.