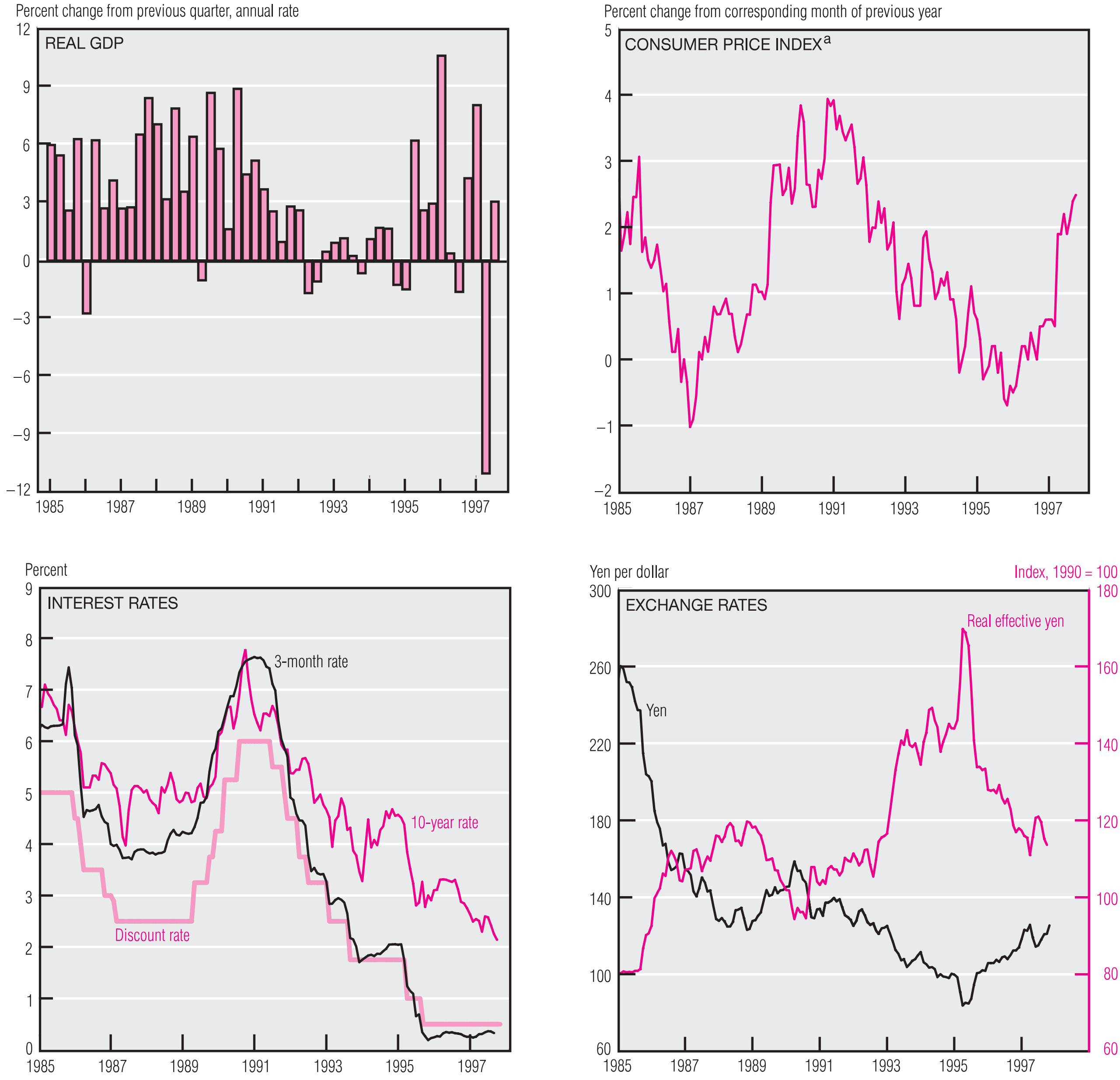
Japan’s Economic Recovery



a. Sales taxes imposed in April 1997 account for the recent jump in year-over-year price changes.
SOURCES: International Monetary Fund, *International Financial Statistics*; and DRI/McGraw–Hill.

The Asian financial crisis has cast a pall over Japan’s already fragile economic prospects. Most directly, the Asian problem will crimp the demand for Japanese exports. Approximately 40% of Japan’s overseas shipments go to its newly industrialized neighbors. Less directly—but just as importantly—exposures in these countries may force Japanese banks to restrict their domestic lending.

Since the onset of recession in 1992, the Japanese economy has grown at an average annual rate of only 1.2%, less than half the pace experienced between 1984 and 1991. This year’s third-quarter rebound was smaller than expected, and residential investment plummeted. Although net exports declined slightly, the effects of Asia’s financial problems have hardly had time to filter into the data. Inflation is essentially nonexistent, and interest rates are at unprecedented lows.

The slow pace of recovery owes much to the weak state of the financial sector. Japanese banks remain reluctant to write down or to provision against the problem loans that continue to haunt their portfolios. Furthermore, they now face added burdens from their exposure to neighboring countries’ financial troubles and from the spillover effects on their own economy. The capital ratios of Japanese banks, already low by international norms, could weaken further.