CHAPTER 12
JAPAN

Introduction. Once again, the economic news in Japan is bad.

- After a decade of economic stagnation, a deflationary spiral appears to be intensifying.
- On 1 February 2002, the Nikkei stock index closed below the U.S. Dow Jones Index for the first time in 45 years.
- Unemployment is at a post-World War II record of 5%.
- Retail sales have fallen for a record five consecutive years.
- Consumer confidence is at a record low.
- The trade surplus is at an 18-year low.
- Long-term growth will remain elusive until Tokyo gets more serious about reform.

Enter Koizumi. New charismatic Prime Minister Koizumi has replaced Prime Minister Mori. So there's hope. Key Questions:

- Can Koizumi lift the world's second largest economy out of its decade long slump?
- Can one man make a difference?

Problems

One thing is certain. The problems are daunting. The problems are twofold in nature:

- First, Japan faces a downward, cyclical problem of weak domestic and external demand.
- Second, Japan faces fundamental weaknesses in its economic foundations. In fact, Japan's essential challenge is a structural one.
- Worst of all, garden variety attempts to solve the cyclical problems tend to frustrate attempts to solve the structural problems.
- Let's turn first to the cyclical problem.

Economy is Worsening. Virtually all economic indicators are negative.

- GDP contracted 0.8% in 2Q 2001.
- The news bolstered fears that Japan may already be in recession.
- The Asian and U.S. recession is hurting the manufacturing sector in Japan.

Figure 12-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	4812.1	4089.9	4078.9	4677.1
Purchasing Power	3076.0	2927.9	3042.9	3317.7
Real Growth (%)	1.9	-1.1	0.8	1.5
Inflation (%)	1.7	0.7	-0.3	-0.8
Exports	421.1	388.0	419.2	477.3
To U.S.	124.3	125.1	134.1	149.5
Imports	338.6	2812	310.7	377.2
From U.S.	65.7	57.9	57.7	64.5
FDI from U.S.	35.6	38.1	49.4	55.6
In U.S.	125.0	134.3	1553.1	163.2
Cur Account /GDP %	2.2	3.1	2.4	..
Fiscal Balance /GDP %	-3.2	-4.5	-6.8	-7.9
External Debt /GDP %	..	..	..	..

Sources: IMF, World Bank, U.S. Dept of Commerce

Figure 12-B

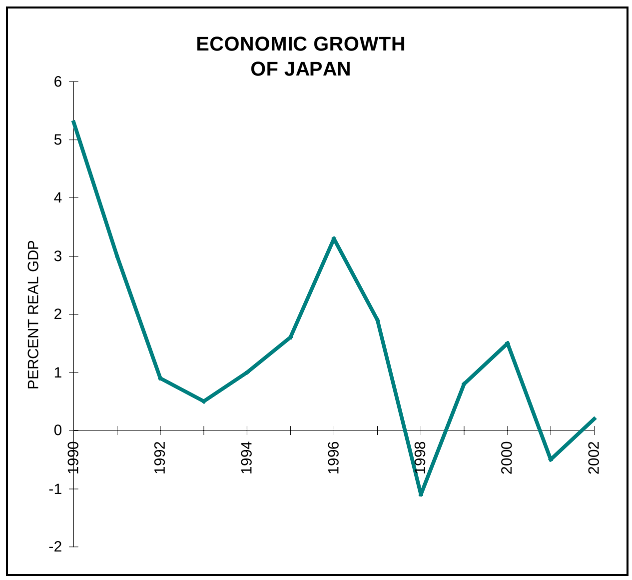
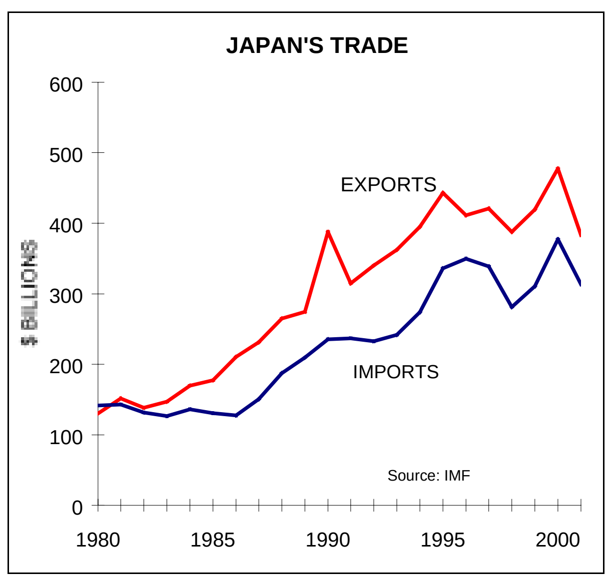


Figure 12-C



- Industrial production fell in August at its fastest annual rate since the 1973.

Grim Legacy. Japan faces an uphill struggle to leave behind the legacy of an asset price bubble that burst more than a decade ago. As Japanese stocks and land prices crashed in the early 1990s,

- Consumers stopped spending,
- Businesses stopped investing, and
- Banks became crippled with bad debt.

Weak Corporate Demand. Corporate demand remains weak. Why?

- Business inventories are at cyclical highs and investment is tumbling.
- Retail sales fell 3.5% in August 2001 year on year, their fifth consecutive month of decline. These weak sales are causing inventories to rise.
- As a result, Japanese companies have been cutting back production.

Weak Consumer Demand. Consumer demand also remains weak. Why?

- Production cutbacks are worsening the jobless rate, now at post-WW2 record 5%.
- This higher unemployment predictably worsens consumer confidence.
- Consumers are afraid of losing their jobs.
- Personal incomes are also falling, thus hurting purchasing power.
- Japanese consumers are also burdened with the highest housing costs, electricity rates and phone charges in the world.
- The result? Consumers are saving for bad times and are not spending.

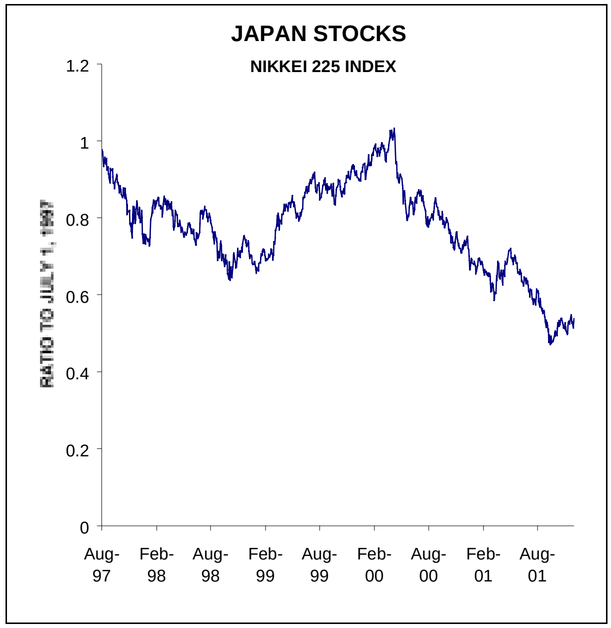
U.S. Slowdown/Export Woes. The U.S. slowdown can only worsen Japan's stagnation.

- Japanese exports to the United States are plunging with the U.S. slowdown.
- Japan's trade surplus shrank in September 2001 as exports to the United States had their biggest decline in two years.
- In July, the current account surplus contracted for the eighth straight month.
- In the first half of FY2001, the trade surplus recorded its biggest drop in 23 years.
- The U.S. slowdown will continue to reduce Japanese exports to the United States and therefore weaken Japanese economic growth.

Stocks Crash. The stock market fell 30% from a peak of 14500 in May 2001. By year's end the Nikkei was at its lowest point in 18 years.

- Industrial production fell in August at its fastest annual rate since the 1973.

Figure 12-D



Banking and Finance

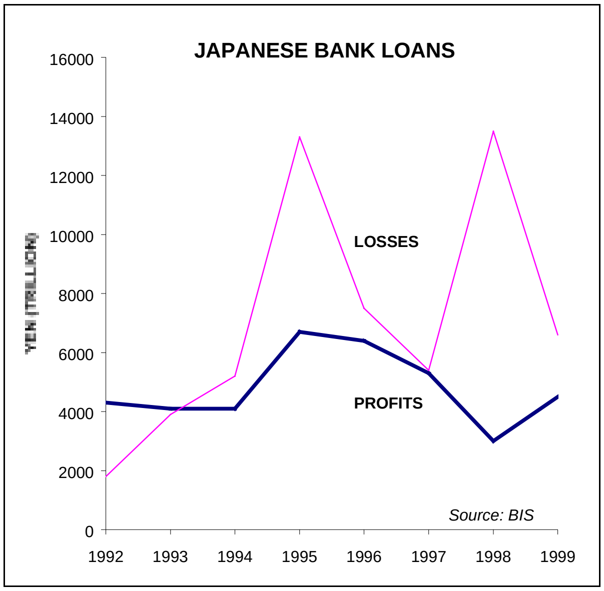
Banking Woes. The falling stock market spells trouble for Japan's embattled banks.

- The banks are wallowing in a sea of losses from bad loans. (See Figure 12-E.)
- The banks are among the biggest holders of collapsing stocks.
- The stock market crash has therefore reduced the Japanese banks' capital.
- As a result, the banks lack the resources to tackle their bad loans by themselves.

Bank Clean-Up? Why doesn't the government just clean up the banks?

- Actually, the government has made sporadic efforts to clean up the banks.
- Tokyo has nationalized a few banks.
- It has injected public funds into the rest.

Figure 12-E



Bad Loans Rising. In other words, this clean-up was left half done—and this is where the danger lies for insolvency.

- While the banks have been slowly writing off their bad loans—making more than Y70,000B of provisions to date—they have been reluctant to push companies into bankruptcy.
- This has meant the bad loan total has kept rising.
- The banks' non-performing loans (NPLs) now total Y32,500B according to the government's figures—a record 7% of all outstanding lending.
- Investors say Tokyo refuses to let the IMF examine the real books because the NPL problem is far worse than the alarming official numbers show.
- The real bank story would send bank stocks south.

Dither. Consequently, Tokyo's financial behavior indicates that it still is not operating a free market financial system.

- In this regard, Japan combines a weak government with a culture that does not allow for corporate or banking failure.
- So instead of biting the bullet of recession and bankruptcy, the Japanese dither.
- Problems are often papered over, not solved.

Moral Hazard. Meanwhile, potential investors in Japanese banks are turned off by what they call moral hazard.

- Government bailouts reward bad behavior.
- Bailouts lock in bad banking habits.
- So reckless loans and over-borrowing continue unabated.

Financial Socialism. Therefore, resolving these financial woes is a Herculean task that involves not just the "clean up" of a few banks.

- What's needed is a fundamental overhaul in the core philosophy that is used to allocate money across the economy.
- The reason is that during most of the past five decades, Japan has not been operating with a "capitalist" system.
- Capital has not been allocated according to free-market forces or a rational sense of price and risk.
- Instead, the banks have tended to lend money to favored companies according to a sense of national duty.
- And almost half of all the financial flows have been channeled through state-controlled organizations, such as the postal savings network.

Reckless Speculation. As the economy reached maturity, the banks made increasingly unwise lending decisions, extending vast loans to reckless real estate projects during the 1980s asset price bubble.

- When the real estate and land market bubble popped, banks were saddled with a mountain of bad loans.
- If Japan had been a truly capitalist country, this might have triggered a spell of "creative destruction."
- Asset prices would have fallen to clearing levels, and under-capitalized banks and over-leveraged borrowers would collapse.
- Capital would then transfer to promising entrepreneurs in greener pastures.
- But the socialist nature of Japanese finance has created a state of suspended rot for an entire decade.
- The financial rot has become progressively worse as the economy has stagnated—and as price deflation gathered pace.

Financial Reform? The Koizumi government claims it is cleaning up this problem.

- Tokyo claims it wants to create a more truly "capitalist" system, in which free market forces—and the capital markets—play a greater role in allocating money.
- But this tortuous process is likely to take up to seven more years before the banks' non-performing loans fall towards international standards.

Policy Assessment. Is Tokyo cleaning up its financial act? The move towards a more "capitalist" economy remains extremely patchy.

Off Starting Blocks. To be fair, free-market forces are taking root in some sectors of the financial system. Why?

- Japan is increasingly part of the global market system.
- Banks are also slowly starting to price their loans to reflect borrower risk.
- Large corporations are raising more finance in capital markets—a trend which means that bank loans have fallen to about 90% of GDP, compared with almost 110% a decade ago.
- Foreigners now own a fifth of all Japanese shares, up from 5% a decade ago, and are exerting greater shareholder pressure.
- Perhaps, most importantly, companies, bureaucrats, and pensioners increasingly realize they have to raise the meager level of investment returns they receive.

Opposition to Change. But for every sign of change, there is also stubborn resistance to change.

- For instance, the vast state-controlled financial institutions have barely reformed—and the proportion of financial flows passing through these state bodies is rising, not falling.
- The private banks still feel compelled to support politically-important companies, such as construction groups.
- And most consumers continue to place their savings in bank deposits or state institutions.

Of Two Minds. Japan's financial world has a schizophrenic feel.

- In this regard, Tokyo faces an extremely difficult task in cleaning up the financial system.
- On the one hand, bankers are under some pressure from the bank's shareholders to behave "rationally" and clean up bad loans to create a profitable bank.
- On the other hand, bankers also know that if they try to cut these bad loans, and make favored borrowers bankrupt, they would face severe opposition from powerful Japanese political and corporate stakeholders.
- Tragically, the Japanese may never manage to square this circle.

Other Structural Challenges. The Japanese economic picture also has numerous other structural problems.

- The old system that created the post-war Japan miracle cannot tackle the problems associated with an aging population.
- Far too much of Japan's public sector spending is directed at inefficient rural, infrastructure projects.
- There is excess capacity in the industrial base.
- Businesses over-invest due to cheap financing by the banks.
- Although the auto and electronic sectors are world-class, too many other sectors are highly protected and uncompetitive.
- Most alarming of all, the pension scheme is ill-equipped to meet the funding needs of aging workers.

Solutions

These problems demand drastic solutions:

- Many business sectors, such as construction and retailing, need to be restructured.
- The financial system needs a radical overhaul to allocate capital more effectively.
- Public sector spending has to be redirected.
- Social security and pensions framework needs to be overhauled.

- In short, what Japan needs is a burst of "creative destruction" to remove the swathes of dead wood in the economy.

No Pain, No Gain. However, any attempt to impose these reforms is likely to be painful. Why?

- Reforms would involve a flood of bankruptcies
- Unemployment will soar.
- Economic growth will go down in the short term.

Difficult Transformation. Rhetorically at least, the government is committed to implementing all the necessary structural reforms. However, such reform measures could be unpleasant and politically difficult to implement for two reasons.

- First, Japan is tumbling into a cyclical downturn, and this is before Mr. Koizumi unleashes any serious reforms.
- Second, some government officials claim Japan has already exhausted the obvious macroeconomic policy tools that could offset a domestic contraction.

On the fiscal side they are correct because Tokyo is dangerously over-borrowed. On the monetary side they are ill-advised. Let's turn first to monetary policy.

Monetary Situation. On the surface, the Bank of Japan would appear to have done almost everything it can to stimulate the economy.

- Overnight interest rates are virtually zero.
- The Bank cut the discount rate to an unprecedented low level of 0.1%.

Not Enough. Unfortunately, these low nominal rates are still too high.

- With prices falling from 2% to 3% over the past three years, real interest rates are much higher than nominal rates and still too high.
- That means BOJ must take even more aggressive monetary actions to attack stagnation and deflation.

Fighting Wrong War. Mr. Masaru Hayami, governor of the Bank of Japan, is still reluctant to take more drastic measures to loosen monetary policy.

- On 9 October 2001 Mr. Hayami BOJ rejected the option, claiming it would trigger hyperinflation.
- Mr. Hayami keeps fighting the last war against inflation.
- The economic battlefield has shifted and the new war is against severe price deflation.
- Consumer prices have fallen for 23 straight months!

Recommended Monetary Action. A more promising course of action would be to weaken the yen, restore confidence, relieve the credit crunch, and stimulate its economy.

- BOJ needs to opt for quantitative easing of the money supply. (In layman terms this means to print a lot more yen and inject this cash into the marketplace).
- The best way to do this is to buy up ten-year Japanese Government Bonds (JGBs), which are still flooding the market. That will start to close the gap between actual and potential GDP.
- BOJ also needs to opt for an inflation target between 0% and 2%. This psychological signal would reassure markets that Tokyo was truly committed to attacking the real enemy, which now is deflation.

Failing Fiscal Policy. But if Tokyo needs to loosen its monetary policy even more, it needs to tighten its fiscal policy, notwithstanding the normal drill of easing fiscal policy in a recession. Why?

- Over the last ten years, Tokyo has tried in vain to use fiscal policy to "jump start an over-regulated economy.
- On 16 October Prime Minister Koizumi, like his predecessors, once again announced a supplemental budget to "boost" the economy, this time worth a trillion yen.
- But this seemingly endless string of Keynesian stimulus packages is not working. Why not?
- The day of reckoning for numerous fiscal stimulus packages is finally here. Japan is in the midst of a fiscal crisis.
- If mismanaged, this crisis could potentially turn into a global financial crisis.

Financial Turmoil. To cut to the chase, Japanese public sector debt is now exploding.

- The official public sector debt is currently around 130% of GDP. Japan's debt to GDP is on track to reach 175% of GDP by 2005.
- If unfunded pension liabilities are included, as they should be, the government is already running a public sector debt well above 200% of GDP.
  - The Maastricht criterion for financial stability calls for public sector debt under 60% of GDP.
- The Japanese are running a budget deficit of 6% to 7% of GDP.
  - The Maastricht criterion calls for budget deficits under 3% of GDP.
- In response, Moody's and Standards & Poor's have both downgraded Japan's government debt, correctly arguing that public debt is financially unstable.

Time-bomb. With high and sustained growth unlikely, Japan is on course for ever-rising debt levels relative to GDP.

- And it is a big problem: the largest debt in the world. The debt is larger than that held by the United States or all of Europe.
- There's no chance of stabilizing the debt ratio and even less of bringing it down.
- Exploding debt means higher real interest rates and a tendency—even in Japan—for savings to look for safety and growth offshore.

Social Insecurity. Because of the rapidly aging of Japan's population, the public medical insurance system as well as the public pension system are in big trouble.

- Both may collapse in the near future, unless drastic action is taken.

What's presently preventing financial chaos? Previously, Japan's investors have held Japanese government bonds at virtually no return. They simply roll over the debt when it becomes due at very low interest rates.

- If savers choose to hold and roll over debt, where is the problem? It emerges only when they try to get liquid and opt out with cash.
- What if confidence disappears and Japanese savers want to redeem the bonds for cash and invest overseas for an actual return on their investment? When that happens there's a rendezvous with public sector bankruptcy.
- And if Japan melts down, a world financial crisis is not far off.

Solutions to Fiscal Crisis? Unfortunately, there are no readily available good solutions to this balance sheet disaster. Despite Koizumi's reform instincts, the political dominance of the non-reformist LDP rules out a growth miracle. Other possibilities include massive inflation to wipe out the real value of the debts, heavy taxation or selective repudiation of the debt.

Possible Courses of Action (COAs):

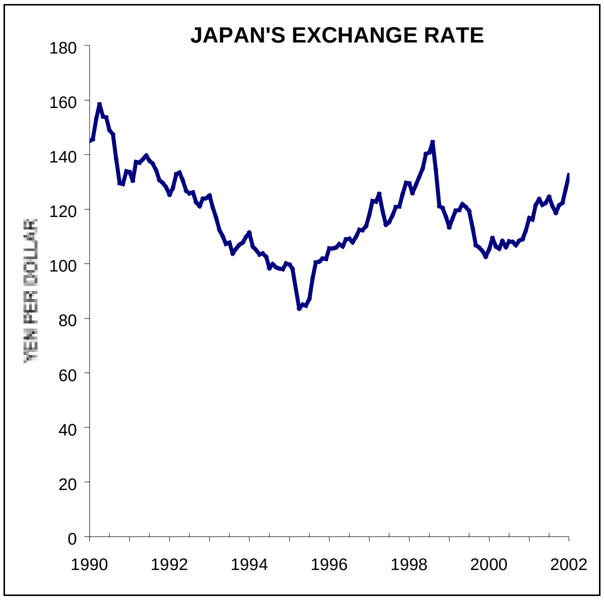
- ***Inflation.*** Inflating away debt carries grave risks. Households, already old and seriously losing wealth, will save more to make up the loss—and hence precipitate a depression of economic activity.
- ***Taxation.*** Heavy taxation to achieve a balanced budget was tried a few years ago. It immediately pushed the economy into recession and would do the same this time around.
- ***Default.*** Debt repudiation does not easily fit the Japanese social model. With its aging population, Japan finds it difficult to reform its entitlement rules.

Is there any other way out of this financial hole?

Yes. Controls. Or as Churchill would say: the worst possible option—except for all the others.

- Tokyo may well require savers to hold and roll over debt. The solution, fully in line with Japanese thinking and practice, is to paper over the problems by returning to repressed finance and capital controls.
- Compared with Japan's troubled experience with open capital markets, capital controls and repressed domestic finance seem low-cost and workable.
- In short, Japan may well opt to close down its capital accounts. If so, this action would end the hope of a world of open, deregulated, and efficient capital.

Figure 12-F



Falling Yen. Meanwhile, the fate of the yen mirrors that of the Japanese economy as a whole.

- After trading in the 115 to 125 yen/dollar range for most of 2001, the yen fell by 7% in December 2001, to 132 yen, the lowest level in three years.
- Is a falling yen good or bad for the Japanese economy?
- It's a mixed bag:

Positive Impact**.** On the one hand, a weaker yen offers some hope to lift the economy. A weaker yen makes:

- Japanese exports more attractive.
- Raises import prices, thus curbing Japan's serious problem of price deflation.
- As price deflation subsides, real interest rates drop, which acts as a de facto monetary policy stimulus.
- In this sense, a weaker yen is a necessary condition for a sustained Japanese recovery.

Negative Impact. But the political and economic risks of further depreciation may well outweigh the benefits.

- In particular, the speed of the yen's deterioration has alarmed its neighbors as well as Washington.
- A free falling yen is bad.
- In December 2001, Beijing, Kuala Lumpur and Seoul told Tokyo that they view a weak yen as a direct threat to their exports.
- The Chinese and South Koreans have warned Tokyo that a sharp fall of the yen risks tit-for-tat devaluations in the region, thus triggering financial instability throughout a region still recovering from the 1997 financial crisis.
- Similarly, negative diplomatic reactions could trigger rising trade protectionism in the region.
- The weak yen also risks exporting deflation to a global economy far more vulnerable than it was prior to 9-11.
- In addition, there's the danger that the private sector will become more risk-adverse:
  - For instance, if foreign investors become convinced the yen was in permanent decline they would pull more funds out of the already depressed stock market.
  - Such sustained capital flight would push up interest rates, further damaging indebted Japanese companies and their creditor banks.
- The danger of a spillover effect on other Asian countries is then very large.

Conclusion

Since the Japanese economy is the foundation for Japan's national security strategy, the USG is vitally interested in Tokyo's ability to dig itself out of their ten-year slump and financially unstable condition. After of decade of economic stagnation, Japan's new Prime Minister Koizumi enters 2002 focused on an economy lurching from recession to near depression. In essence, the Japanese economic problems are twofold: both cyclical and structural in nature.

Obviously the U.S. downturn and the events of 9-11 have only served to worsen the weak economic performance in Japan as well as the rest of Asia. On the structural side, a chief concern is the socialist banking sector that is weighed down with bad loans and that recklessly misallocates capital.

While there are promising efforts to move away from financial socialism, not enough is being done to implement a free market banking system. Given the severe price deflation in Japan, real interest rates are still too high for a country in a prolonged slump.

In addition, the Japanese government debt—at 130% of GDP and rising fast—is dangerously high. Japan would be in a much stronger position to work with the United States to assume an expanded military role in Asia if its mountains of bad loans and government debt did not weigh it down.

Finally, Tokyo needs to orchestrate an orderly fall in the yen, which helps lift the economy via stronger exports and imported inflation to offset. But Tokyo must avoid a free-falling yen that would raise political and economic risks, thus outweighing the benefits cited above.