A Look at the Japanese Economy

BY KEN WU

It has been a while since anyone had anything promising to say about the Japanese economy. An economic malaise that has lasted for more than a decade had observers writing Japan off as an increasingly irrelevant, or even burdensome, country in the world economy. True, Japan did experience short periods of growth throughout the 1990s, only to fall back into economic stagnation, or on three occasions (four depending on who is doing the counting), into a recession. So why has reports of Japan's recent economic growth (up an annualized 3.9% during the second quarter of 2003) not been waved off by economic analysts as another mirage? Many legitimate reasons have been given, but to appreciate the changes in the Japanese economy, it is necessary to understand the fundamental problems that have ailed the Land of the Rising Sun since the Japanese economic miracle came crashing down in 1989.

PHOTO COURTESY OF Nick Foard

The Shinjuku District of Japan has suffered along with the rest of Japan's struggling economy.

The Diagnosis

The following four sources have done much to contribute to Japan's economic misery: the non-performing banks, an unresponsive monetary policy, an irresponsible fiscal policy, and the lack of restructuring in corporate Japan.

First, critics have long targeted Japanese banks as one of the greatest obstacles to economic recovery, and with good reason. During the glory years of the 1980s, the banks loaned out money to firms without giving much thought to how capable the borrowers would be in returning the loans. With the economic bust that followed in the 1990s, Japanese banks, once the envy of the world, were saddled with so many bad loans that they became debt-ridden themselves. C. Fred Bernstein at The Institute of International Economics estimates up to half of the banks today are insolvent. With no money themselves, the Japanese banks could not make out any more loans to firms and households, and without the money to make investments, corporate and private spending fell. Since then, the Japanese have been wary of borrowing any money from their banks, knowing that most of them could go under anytime. The Japanese government's reluctance in forcing banks into bankruptcy has not helped, allowing "zombie" banks to exist alongside financially sound banks.

Second, the Bank of Japan (BoJ) has been slow to enact monetary policies that could have checked Japan's deflationary spiral. Even though the BoJ has set interest rates at nearly zero percent for the past years, that has not stimulated demand because deflation has exacerbated the banks' debt problems and put a lid on consumer consumption as people waited for prices to fall further. The BoJ's previous governors, Yasuo Matsushita and Yasushi Mieno, along with their successors, have been too conservative in their measures, leaving Japan's contractionary monetary policy as an ineffective tool in turning the economy around.

Third, Japan's fiscal policy has also been under fire for much of the past decade. The Japanese government believed it could spend its way out of economic stagnation by spending trillions of yen on public works, but throwing money away on useless infrastructure was clearly not the answer to Japan's economic woes. As a result of the central government's penchant for spending, the size of the gross public debt is now 158% of Japan's GDP. High taxes have also contributed to the sluggish economy, although most economists do not consider taxes to be a major problem. Sharp increases in taxes killed a promising recovery in 1997, as high tax rates prompted Japanese consumers to curb spending. Public investment also took a hit after the tax hikes.

Lastly, unproductive companies, especially in the construction, retail, and transportation sectors, have been dragging the Japanese economy down. While the world marvels at the success of Toyota, Honda, Sony, and other export-oriented brands, poorly managed firms in Japan continue to survive and choke potentially profitable companies. Restructuring the companies in the lagging industries has never been a high priority for the Japanese government, as it is not in the interests of the ruling Liberal Democratic Party (LDP) to do so. The LDP backs and subsidizes many of the so-called "zombie" firms in return for support in elections, which partially explains why, other than for a short period in 1993, the LDP has remained in power throughout the 1990s.

Phoenix Economy?

In light of the major difficulties that have beset the Japanese economy for over ten years, why then are economists and major publications such as The Economist hopeful that the lat-

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est data coming out of Japan signals a sustainable economic recovery is on the way? To be sure, these same economists are showing a cautious hope, the kind where they have their fingers crossed that this resurgence is for real. Others, like the International Monetary Fund (IMF), have wisely warned the Japanese still have to deal with plenty of structural problems within the economy. Sustainable or not, there are four reasons why Japan's economy has been recovering: revitalized banks, an active Bank of Japan, notable accomplishments in restructuring, and Prime Minister Junchiro Koizumi's deft political skills.

First, according to a report by Kathy Matsui, the chief equity strategist at Goldman Sachs Tokyo, there has been signs that many of the banks have succeeded in slashing bad loans to the point they can lend money again. Firms and households thus can loan money for investments once again, providing a crucial stimulus to the Japanese economy and ending years of suppressed demand.

THE JAPANESE STILL HAVE TO DEAL WITH PLENTY OF STRUCTURAL PROBLEMS

The government has also played a part in raising confidence in the banks. This past May, the government bailed-out Resona, a major regional bank. Peter Tasker and The Economist believe the Resona rescue represents a shift in the government's attitudes and policies towards the banking industry. Last November, in an interview with Newsweek, Heizo Takenaka, the controversial economics minister and Financial Services Agency (FSA) chief, warned that no bank was too big to fail. During the Resona bailout however, the banking regulators were very generous; all it took was a weekend to complete the negotiations, shareholder equity was left unharmed, and the government made no promises this bail-out would be the last one. Resona received so much government money that it is now one of the most financially sound banks in Japan. Compare Resona's rescue with the nationalization of LTCB and NCB back in 1998 - the negotiations were long and difficult, shareholders had to take a beating, the regulators promised there would be no more bank rescues, and everyone knew those two banks were, as The Economist put it, "complete dogs."

The Resona rescue however, has not dampened Mr. Takenaka's desire to reform the banks. The FSA promised in August that it would punish any one of 15 banks with government intervention in management if a bank remained in the red for the third straight year. This threat has prompted major banking groups such as Mizuho Financial Group, Sumitomo Mitsui Financial Group, UFJ Holdings, and Mitsui Trust Holding Inc to take measures to improve their financial health.

Second, the Bank of Japan has done its share to spark the Japanese economy as well. Under the new governor, Toshihiko Fukui, the BoJ has bought shares from banks, giving them much needed capital. It has also upped its reserves from twenty trillion yen to twenty-seven trillion yen, set up a one trillion yen loan for smaller firms, and pumped ten trillion yen into the money supply. These measures will do much to trigger inflation and raise inflationary expectations, bringing hopes that the deflationary spiral that has plagued the Japanese economy since 1998 will finally come to an end.

Third, the profits of non-financial firms listed on the Nikkei Stock market are actually thirty percent higher now than when there were in 1989, the year the bubble burst. This suggests that corporate restructuring has occurred, and that it has made enough of a difference to allow Japanese companies to become profitable once again. This improvement has gone hand in hand with the reduction of listed companies with shares valued under one hundred yen, which means they are close to bankruptcy. In January, there were two hundred such companies. Eight months later, there are less than thirty. Clearly, the Japanese corporations must be doing something right to earn the confidence of shareholders. Indeed, the Nikkei has been trading at its highest levels (10,990-11,000) in a year, and has been the best performer amongst the major stock markets. This stock market run differs from previous gains in one crucial area – domestic investors are returning to market in levels not seen since the late 1980s. This is welcome news to economists who knew foreign investors, not the Japanese, were responsible for previous rises in the Nikkei.

Lastly, Koizumi, the reform-minded Prime Minister of Japan, has been adroit in outmaneuvering his foes in his own party, the ruling LDP. As explained above, the LDP has entrenched interests in inefficient industries, particularly in the construction and the agricultural sectors. The LDP Old Guard, in order to protect their supporters, has attempted to stifle Koizumi's reforms, many of which, in the short-term, will increase unemployment in the heavily subsidized industries. The Old Guard establishment reviles Koizumi and his policies so much that Shizuoka Kamei, a LDP presidential candidate and a staunch Old Guard, has said, "I advocate doing the exact opposite of virtually everything Koizumi proposes." Kamei's words may be campaign rhetoric, but it reflects the difficulties Koizumi has had to battle since becoming Prime Minister in September 2001.

In spite of the Old Guard opposition, the silver-haired 61-year-old Koizumi succeeded in being re-elected as LDP president (and thus remain Prime Minister of Japan), and investors have responded warmly to Koizumi's new and more reform-minded cabinet. Koizumi was elected with relative ease thanks to his skill in splitting opposing factions. If those factions had united against Koizumi, the re-election campaign would have been far tougher for the Prime Minister. Koizumi also wields one political weapon that none of his peers possesses – popular support. He enjoys a 58% support rating from the Japanese people, an unheard of figure for a modern Japanese politician who has been in office as long as Koizumi has.

With the re-election of Koizumi as the head of the LDP, the party will be better positioned to win the next mandatory parliamentary elections. A newly unified opposition promises to make things tough for the LDP, but should the LDP win, Koizumi is poised to stay on as the head of state until 2006. This could give Koizumi the time to push forward with his much-needed reforms - changes that could revive the sagging fortunes of the long-suffering Japanese economy. As for the current recovery and its durability, The Economist may have said it best – "finger's crossed."

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