TICK, TICK, TICK

ROHIT GUPTA

HOW HAS JAPAN FALLEN FROM ITS POSITION AS ONE OF THE TOP INDUSTRIAL ECONOMIES TO ONE ON THE BRINK OF RUIN?

In the late 1980s Japan, if not set to conquer the world, was certainly set to buy it! Japan Inc. invested $650 billion abroad, nearly half of it in the US, buying such icons as the Rockefeller Centre, Columbia Studios and the Pebble Beach golf course. However, since the burst of the asset bubble in the early 1990s the annual growth rate in Japan has averaged less than one percent, the deepest slump in any developed economy since the Great Depression.

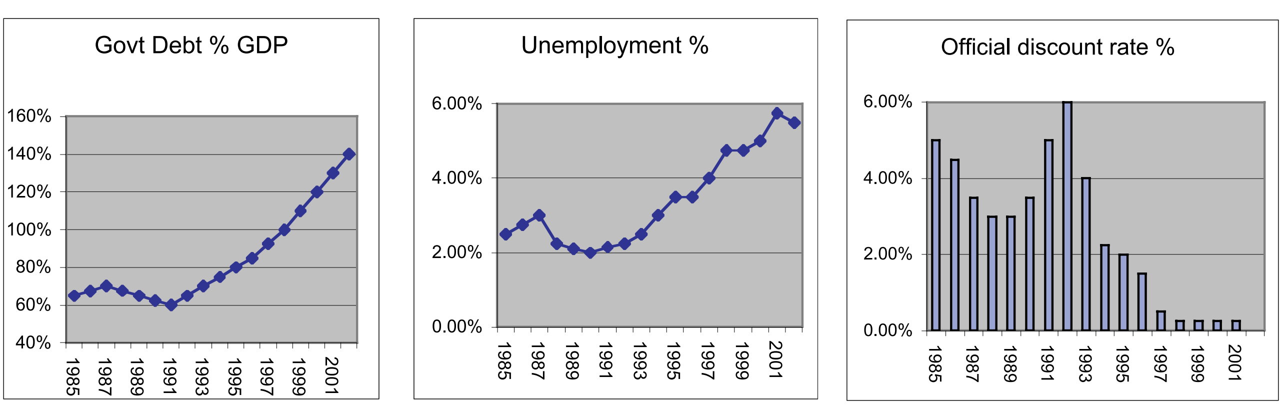
The list of ailments includes the following:

- The Nikkei 225 is on the verge of a 20-year low, down 75 percent from a peak of 38,900 to below 9000. These levels were last seen in 1982, when Michael Jackson's Thriller ruled the pop charts and the musical Cats first opened on Broadway! The Nikkei is below the Dow for the first time since 1957, in contrast to the 1980s when it had briefly stood at 14 times the Dow.
- Land prices have declined for 11 years in a row and are now down to one-fifth of their late-1980s peak. During the 1980s the theoretical value of Tokyo's Imperial Palace grounds exceeded that of the whole of California.
- Unemployment stands at 5.3 percent, just below the post-war peak of 5.6 percent.
- Interest rates are down to almost zero.
- Enormous fiscal injections have resulted in the Government budget moving from a surplus of two percent of GDP in 1990 to a deficit of eight percent of GDP and Government debt of 140 percent of GDP (versus 60 percent in the US).
- Sovereign credit risk rating of Aa3 with a negative outlook, the same rating as Poland and South Africa.

The country now faces the twin risks of deflation and economic contraction. It's a vicious circle that goes like this:

1. Prices are falling due to tepid consumption; companies have to produce less and sell more cheaply, causing them to cut back on staff and capacity. The people are spending less as they face unemployment uncertainties.
2. The result is that companies have large inventories and losses, causing them to chalk up more bad debts. The bad debt problem is holding banks back from lending to new business. Worse, even SMEs which are doing well are being denied new finance.

WHAT AILS JAPAN?



Source: *The Economist,* "What ails Japan"?, Nov 14th 2002 (OECD; EIU, BOJ)

HOW OVERLEVERAGED IS JAPAN? JUST COMPARE.

Japan's debts as % of GDP	
National debt	143
Off-balance-sheet claims on Japanese Government	280
Bank loans (corporate and consumer)	132
Nonbank-loan corporate debt	54
TOTAL	609
US debts as % of GDP	
National debt	37
State and local governments	14
Household debt	77
Business debt	70
TOTAL	198

Source: Forbes Global, 18 Feb 2002 (Goldman Sachs, Daiwa Securities)

CRISIS, WHAT CRISIS?

What about the theory that Japan is so rich that it can buy its way out of a financial collapse? After all, the huge debt overhang is a case of Japan owning itself. This is not Argentina or Russia or Thailand.

No it's not. It is potentially something far worse.

Japan has savings of $11 trillion. But the total on-and-off balance sheet claims (household, corporate and government) are estimated to be about $30 trillion – six times Japan's $5 trillion GDP. (In comparison, US total private and public debt is $19 trillion – two times GDP.)

These ratios are made worse month by month, year by year, with deflation running at four percent p.a.

At the same time that Japan faces a debt bomb, it is also the world's largest creditor. It has $3 trillion in overseas assets (much of it in liquid assets – US Treasury Bills and bank loans to Europe). If Japanese banks were panicked into calling in overseas loans an economic contraction would sweep the globe.

Consider what happened on a far smaller scale in 1997. Within three months of the collapse of Hokkaido bank (with assets of $80 billion), Japanese financial institutions pulled $118 billion out of the global economy, mostly from Asia, catapulting Thailand's problem into a regional crisis and bankrupting South Korea, the worlds 10th largest economy.

London's *Independent Strategy* says, "There is no record of any government ever being able to repay debts equal to several times the annual output of its country in real money. Japan will be no exception."

A TWO-LEGGED BEAST

You can't put the economy on a stable footing without fixing the banks; similarly, you can't fix the banks without reflating the economy. The banks' problems mirror the economy's problem: companies cannot make a profit. There is no solution to the bad-debt problem without a solution to Japan's basic economic problems.

IMPEDIMENTS TO COMPETITION

Sea of subsidies

The Government provides subsidy, guaranteed loans and tax incentives to tiny 'mom-and-pop' stores. These account for 55 percent of employment (vs 19 percent in US and 26 percent in France).

Barriers to entry

In food processing tariffs are levied at the differential between the price of imported meat and vegetables and the domestically controlled price.

FEUDAL JAPAN

Chu-sho kigyo

Small to medium-size companies make up more than 99 percent of Japanese industry. According to MOF statistics there are roughly two million registered joint stock corporations in Japan. Of these over 75 percent are capitalised at under $70,000!

Keiretsu

Daiei, the troubled retailer, operates eight restaurants, seven hotels and a baseball team. The company has $17 billion in debt and survives on a life-line from its banks. In February 2002 they pumped in an additional $4 billion and in October 2002 another $500 million.

IF JAPANESE BANKS WERE PANICKED INTO CALLING IN OVERSEAS LOANS AN ECONOMIC CONTRACTION WOULD SWEEP THE GLOBE.

Banks eliminate bad debt year after year; but companies have been defaulting ever faster, leaving the country's financial institutions with more debt than before. Since 1992 Japanese banks have taken $660 billion of bad debt losses. In that time, the amount of bad debt remaining has increased from $103 billion to $340 billion. This has created the illusion that banks are doing nothing. Even if the banks' books are wiped clean of bad debts tomorrow, new bad debts would continue to pile up at a rate of $50–$75 billion a year.

THE SOLUTION

While there is always a range of opinions about the direction of any major economy, the divergent views in Japan are notable for being so polarised, even among mainstream economists and academics. Some of the views put forward are indicated below.

1. Lack of demand (liquidity trap). The more conventional view is that the economy is floundering because of a lack of domestic demand. People don't spend enough so the Government should spend more to fill the gap.

The prescribed cure? Borrow, tax or print enough money that should stop deflation by making prices rise again.

2. Excess capacity (structural trap). This argues that Japan suffers from an outdated economic structure too reliant on manufacturing and artificially propped up by near-zero interest rates. Along with slumping demand, Japan is now beset by overcapacity in many industries such as construction and retailing. Many of these companies can never be profitable but because the banks continue to prop them up they avoid going bankrupt. This sustains overcapacity as unprofitable firms are kept alive, and locks resources into low-return sectors such as construction and retailing.

To overcome this problem, Japan needs a reduction in capacity, and the most elegant way to do that is to raise interest rates. Inefficient companies won't be able to afford to service their debts and banks would be forced to foreclose, releasing labour and capital for more productive enterprises.

3. A dual economy. Another view is that today's woeful economic performance is not so much a reversal of fortune as a revelation of the hollowness of Japan's success in the 1980s. Even then Japan suffered from a 'dual economy': a small group of world-beating exporters that everyone knew about, and a large group of laggardly locals hidden from view. The performance of the locals is so poor that it swamps the excellence of the high performers.

Today the illusion that made this possible lies shattered. Japan's leading automobile and electronics industries have already shifted most of their operations to lower-cost regions outside Japan. Left behind are the same old troubled, uncompetitive companies that cannot survive without subsidies that the country now cannot afford.

A RATIONALE (AND THE TRAP?)

In a more open society new entrants would enter the market and drive all these inefficient domestic players out of the market. Yet the Japanese economy is far from open. In a misguided effort to protect jobs and maintain stability, the Government subsidises the inefficient players and blocks the entry of competitors

Bizarre as it may appear to outsiders, Japanese policy has been driven by two objectives – to finance industry and to ensure economic autonomy and political stability. And it worked. Four decades after war had left Japan in ruins, the country boasted the most formidable industrial machine. And a constant flow of subsidies to powerful political groups – farmers, small shop owners, construction companies – has brought 50 years of political peace.

THE WAY FORWARD

There is no single solution to Japan's ills. A depreciating yen, monetary expansion by BOJ, fiscal reform, nationalisation of the banks, privatisation, deregulation, or mass bankruptcies of zombie companies – none of these will bring Japan's economy leaping back to productive life. The Government needs to do all of these, but over a period of years – and all of these measures will be painful. **NA**

GOING FORWARD

- Japan can muddle through, with one or two years of contraction accompanied by steady economic restructuring and a recovery starting in 2004.
- Japan could simply continue decaying until it reaches developing-country status, much as Argentina did after WWII.
- Japan could face the danger of a Russian-style collapse.

CAN JAPAN TURN AROUND?

Analysis by Mckinsey Global Institute suggests that that if the impediments to competition are removed productivity can grow by as much as 4.7 percent p.a. for the next 10 years. Assuming that the workforce will decline by 0.5 percent because of Japan's aging population, GDP per capita can still increase by a robust four percent p.a.

Rohit Gupta PNA is vice president of Citibank, Singapore. He can be contacted at rohit.gupta1@citicorp.com.