Japan tick, tick, tick

There is no single solution to its woes

By Invitation

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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 Center, Columbia Studios and the Pebble Beach golf course.

But since the asset bubble burst in the early 1990s, annual growth in Japan has averaged less than 1%, the deepest slump in any developed economy since the Great Depression.

Consider that the Nikkei 225 is on the verge of a 20 year low — down 75%, from a peak of 38,900 to below 9,000.

In Japan, land prices have declined for 11 years in a row — 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.

Other bad signs? Unemployment stands at 5.3%, just below the post-war peak of 5.6%. Interest rates are close to zero. Enormous fiscal injections by the government have resulted in the government budget moving from a surplus of 2% of GDP in 1990 to a deficit of 8% of GDP and government debt of 140% of GDP, compared to 60% in the US.

Japan's sovereign credit-risk rating is Aa3 with a negative outlook, the same rating as Poland and South Africa.

Japan faces the twin risks of deflation and economic contraction. It's a vicious circle. 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 public is spending less as jobs are less secure.

The result? Companies have large inventories and losses, causing them to chalk up more bad debts, a problem deterring banks from lending to new business. Worse even, small and medium-sized enterprises which are doing well are being denied new credit.

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 is 42 times bigger than Thailand — Japan has savings of $11 trillion. But the total on- and off-balance sheet claims — household, corporate and government — are estimated at $30 trillion, or six times Japan's gross domestic product. In contrast, US total private and public debt is $19 trillion, or two times GDP. These ratios are made worse month by month, year by year, as deflation in Japan is 4% a year.

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 such as US Treasury bills and bank loans to Europe.

If Japanese banks were panicked into calling 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, a bank with assets of $80 billion, Japanese financial institutions pulled $118 billion out of the global economy, mostly Asia — expanding Thailand's problem into a regional crisis and bankrupting South Korea, the world's 10th largest economy.

Consider this quote by London's *Independent Strategy*: "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."

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 bank problem mirrors 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.

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 banks' books were wiped clean tomorrow, new bad debts would continue to pile up at a rate of $50 billion to $75 billion a year.

While there is always a range of opinion about the direction of any major economy, the divergent views in Japan are notable for being so polar — even among mainstream economists and academics. They include:

◆ **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.

◆ **Excess capacity (structural trap):** Others argue 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 with overcapacity in many industries such as construction and retailing.

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 purposes.

◆ **A dual economy:** Others argue 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 new 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.

In a more open society new entrants would 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.

Bizzare as it may appear to outsiders, Japanese policies have been driven by two rationale objectives — first, to finance industry, and second, to ensure economic autonomy and ensure political stability.

It worked; Four decades after war, the country boasted the most formidable industrial machine.

There is no single solution to Japan's ills. The government needs to do all of these, over a period of years. All of the measures will be painful.

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