

Newsletter



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The Revival of Japan, is it real?¹

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After the burst of the asset-price bubble in early 90's Japan has suffered a decade-long trauma of despair, frustration and humiliation. Sometimes it was argued that the country was so hopeless that it couldn't solve obvious problems, and sometimes it was viewed as the most serious risk for the global economy. The list of Japanese problems is long. I would argue that the following seven were the most relevant.

- (1) Fragility of financial institutions
- (2) Prolonged deflation
- (3) Fiscal deficit
- (4) Poor corporate governance
- (5) Excess regulation
- (6) Political rigidity
- (7) Aging of population

Indeed, these problems were not newly discovered. They are known for years and actually successive Prime Ministers made their best efforts to address them. Regrettably, however, none of them could claim a decisive victory. In hindsight, the unsatisfactory result was due to following reasons. First, although the collapse of the asset price brought about serious deterioration of balance sheet of many corporations and households the damage was concealed for several years by the continued financing by banks which, in turn, deteriorated the quality of bank's assets. What happened, therefore, was the unwarranted complacency. We failed to recognize the true degree of seriousness of the situation. Most of us wishfully thought that a robust growth will come back as it did in the past and wipe out the bad debt. There was a serious lack of the sense of urgency and, as the result, bold decisive measures were not taken.

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Because of the gravity of the asset deflation and because of the policy mistake we had to suffer a decade-long economic stagnation and its psychological fallout.

However, since last year there have been increasing signs which hint the ultimate turnaround of the macro-economic situation. Production, inventory, operating ratio, investment are improving. Consumption and employment are holding on. GDP growth in real term, after having registered 1.6% for 2002, has recovered to 2.4% and 3.9% in the first and second quarter this year. The IMF forecasts Japan's growth in 2003 at 2.0% which compares with 2.7% for the US and 0.6% for the Euro Zone. Corporate profit is improving thanks to the strenuous effort of cost-cutting. Reflecting the substantial improvement in the macro-economic situation and the market sentiment the stock price has been recovering strongly and recouped the loss of last two years. Overall business and consumer sentiments have improved considerably, and the gain on economic front has rendered the strong political support to the Prime Minister Koizumi.

How real is the recovery? Does the seeming improvement provide solid and sustainable basis with which Japan can break loose from the trauma of the decade-long stagnation? We will be able to answer the question only after we have checked seven problems I mentioned at the outset to verify if there was valid improvement.

(1) Financial sector rehabilitations

The impasse of the financial institutions was the root-cause of Japan's economic quagmire. After the burst of the bubble in early 90's Japanese banks were loaded with bad loans which, at the peak, amounted to probably 20% of the total loan asset. The falling stock price has damaged the bank's reserves. The lackluster business failed to generate adequate profit. As the result, many banks suffered the dwindling capital base and the Government had to inject ¥20 trillion tax money to keep them afloat. Nevertheless, throughout the 90's banks wrote off ¥70 trillion worth of bad loans using profits and reserves.

It is safe to say that there is no systemic risk in the Japanese banking sector now. The government is applying strong pressure on banks to expedite the disposal of bad loans and increase the profitability of business. At the same time, the government has made it known that, if needed, it would not hesitate to nationalize banks.

On the part of banks, they are indeed stepping up restructuring, accelerating the disposal of bad loans, introducing new business model with the view to enhancing profitability, and beefing up the capital. The recovery of the stock market and the improvement of overall business climate have certainly provided a strong tail wind for bank's efforts. Now all major banks are voicing their confidence that they can meet the Government's request to reduce the bad loan to the level of 3 to 4% of the total loan assets by the end of March 2005. Indeed, credit rating of major banks have recently been upgraded.

If I am asked, however, if the problem of Japanese banks is behind us my answer is not yet. I can certainly argue that the process of recovery has started with greater momentum and seriousness than before and certain result was already achieved. Yet, the profitability is still far from enough. Banks need to secure wider profit margin and establish new business model which relies less on the traditional lending business but more on the fee-based business. Banks need to continue their strenuous efforts to strengthen capital base. We need to see the fundamental reversal of their strategy from the one of contraction and defense to the one of expansion and aggression. It is still a long way for Japanese banks to regain the role of global financial player.

(2) Is deflation a serious threat?

The Japanese economy has long been in the state of deflation. The GDP deflator has continuously been negative since 1994, except only 1997. Inevitably, there is a serious concern in and out of Japan that the chronic deflation will eventually ruin the Japanese economy with vicious contagion effect on the rest of the world. Those who are seriously worried about deflation make two points. One is that deflation does ruin the economy because it raises the level of real interest rate. It discourages investment and consumption, thus erodes corporate profit and employment, and it will initiate a vicious deflationary cycle. They argued that the Japanese economy had already shown signs of entering such deadly process. The second point of the anti-deflation argument is that deflation is a pure monetary phenomenon. Therefore, the only cure of deflation is to generate inflationary expectation by injecting liquidity abundantly and consistently into the economy so that the market will be convinced that the price will go up. In order to achieve the goal they urge the central bank to use whatever unorthodox policy instruments such as the mandatory inflation targeting, monetization of the government debt, and even taxation on the currency holding. The demand for anti-deflation policies was quite strong until last spring and the central bank was under a heavy pressure.

It was an intriguing phenomenon that in spite of the forceful academic arguments and also the evidence of a progressing deflation there was no broad consensus in Japan to support bold anti-deflationary measures. Government, the central bank, political parties, the mainstream academia and the business were all skeptical about the effectiveness of drastic anti-deflationary policies. In my view, the reason of the timidity was not necessary the risk-averse character of the Japanese society. The Japanese people were simply not convinced of the two assumptions. The first was whether the slow and gradual deflation, at a rate of 1 to 2 percent a year, as the one existing in Japan now, will unavoidably lead to an economic disaster. Indeed, the deflation is hurting some business, but consumers are enjoying lower prices. The real interest rate has not risen as the nominal rate was falling as well. The second doubt is whether the current Japanese deflation is simply a monetary phenomenon. People are convinced that the Japanese economy is now in the

process of removing many structural rigidities so that the efficiency and the competitiveness could be restored.

Thus, they perceive the current deflation as a phenomenon which represents the necessary correction process of many structural excesses in the Japanese economy.

Also, it is obvious that the current Japanese deflation is a part of the global disinflation which was brought about by the global excess of supply created mainly by the industrial revolution in the emerging world, notably China. All in all, the concern about deflation has been considerably reduced in Japan, and the main attention is focused on how to expedite the structural reform process.

(3) Is fiscal melt-down inevitable?

As the result of the futile effort to stimulate the sagging economy by the huge injection of money into public works the fiscal situation has deteriorated enormously during the 90's. 40% of the government expenditure needs to be financed by the borrowing and the outstanding debt of the government amounts to 140% of the nations' GDP. This is one of the worst situation among major industrial countries. Not a few people insist that the situation is unsustainable and it will inevitably destroy the credibility of the Japanese economy, pushing up the long-term interest rate and forcing the government to opt to a hyper-inflationary policy. There is no doubt that the fiscal situation is serious. It has deprived the maneuverability of fiscal policy almost completely and it has distorted the efficient financial flow. However, it is a different question whether there is a near-term risk of a fiscal melt-down. First of all, all Japanese government bonds are denominated in the Japanese yen, and more than 95% of them are held by Japanese nationals. Japan is running a large external current account surplus and amassing \$500 billion worth of official reserves. Including the private sector assets Japan is the largest external net creditor of \$1.5 trillion. In other words, almost entire amount of the government debt is financed by domestic savings.

In that sense, the situation is quite different from other governments. In fact, the yield on the government bond is still very low at 1.5% p.a. and there is still adequate demand for it. Thus, it is fair to argue that the Japanese fiscal situation is not the one which poses a near-term danger. Having said that, however, it is also true Japan should not allow further deterioration of the situation. Japan needs to arrest the deterioration and come up with a credible long-term prospect of its improvement.

The government has set the goal of restoring the primary balance in early 2010's. The goal must be achieved by strenuous effort to streamline public works spending and by implementing a major reform of tax and revenue system.

(4) Is corporate restructuring progressing?

It is now clear that one of the major causes of the economic stagnation of 90's was the delayed

response by many Japanese industries and corporations to the immensely changed domestic and global market condition. It cannot be denied that the Japanese industrial structure and the corporate governance, which prevailed until 70's, were maintained too long much outliving their effectiveness. In a nutshell, they were grossly spoiled by the sense of complacency that high growth of 5-6% could continue for long. As the result, uncompetitive industries, i.e. domestic market oriented manufacturing and service industries, were allowed to survive by protection and subsidy. Corporations continued to vie for a larger domestic market share rather than for a higher profitability and efficiency. They accumulated excessive equipment, employment and debt. The management's primary concern was not to increase shareholder value but to increase the benefit for the direct family members of the corporation. Since the 80's under the irreversible trend of globalization and IT revolution the global business paradigm underwent a historic change. Transparency, accountability, and shareholder value became the key word. Compared with Anglo-Saxon markets Japan might have wasted well over a decade to adapt itself to the new paradigm. The memory of the past success was too haunting. The sharp decline of the international status of the Japanese economy in the face of the strong revival of American supremacy, emergence of a great China and the remarkable achievement made by European Union has woken up Japanese business to the stark reality. The earnest efforts have started on the part of business and government.

Active corporate restructuring, reform of commercial code and anti-monopoly regime, change of accounting and auditing rules, strengthening of shareholder right, expanded role of market mechanism, etc have all been put in motion during last two years. In this respect, one thing we have to understand fully is that the width and breadth of the change needed for Japan is so enormous. It is not confined in the economic arena it requires parallel changes in political, social and even cultural spheres. It is inevitable that the speed of the change seems to be too slow. I believe, however, that the process of change which has occurred in the corporate sector during last two years is genuine and positive. It will certainly take several more years to be completed, but most of the Japanese know it is an irreversible process.

(5) Will a smaller government be realized?

Excessive regulation and government interference were the typical complaint placed by those doing business in Japan. Indeed, compared with Anglo-Saxon market Japan was notorious for the lack of freedom for private business initiative. It certainly was the legacy of the sort of developmental authoritarianism which ruled and led the Japanese economy since the 1930's. Most of the regulation was maintained for economic purpose, but some were justified for social and cultural reasons. Now, as I stressed earlier, the recovery of the international competitiveness became the primary national goal and deregulation and privatization are placed at the top of the

reform agenda items under the Koizumi administration. A number of public corporations, including Postal Savings, Housing Finance, Highway Construction and others, are scheduled to be privatized in several years time. In the fields of agriculture, education, medical care, employment, etc where the official involvement was quite heavy private business is now allowed wider and freer entry first on the regional basis and then expanding to national level. While the process of deregulation and privatization is clearly progressing it needs to be stressed that it is the area where the resistance is strongest. Because the issue is directly related to the matter of employment vested interest groups are staging diehard resistance at political and social front. Also, it is important to recognize that in most of the developed countries, including the US and Europe, after the international terrorist attacks and the series of corporate scandals, there has been a clear trend toward an increased involvement of public sector. In a sense, it has become a global problem posed to all societies whether a nation should choose a big government as the price for certain kinds of social benefit or not. In the case of Japan today, because it started from a status of heavy regulation, the main trend in the society is still clearly toward a continued and accelerating deregulation and privatization.

(6) Will political dynamics change?

For the last half a century the Japanese political scene was characterized by the rule of dominant LDP (Liberal Democratic Party). LDP is composed of several factions led by powerful senior politicians who have strong fund-raising capability as well as dominant influence over the government and certain sectors of the industry. In other words, the iron-triangle of politician, bureaucrat and business, based upon a relationship of mutual dependence, has constituted the basic structure of the policy making process. In a structure like this the LDP politicians wielded decision-making power stronger than that of the Executive Branch although they are not accountable to the Parliament. As the result, on many occasions national policy was decided reflecting not the will of enlightened voters but the wish of strong interest groups.

Any legislation or budget could not be presented by the government to the Parliament unless they are endorsed by the relevant bureaucracy and LDP. The greatest achievement of Prime Minister Koizumi was that he succeeded to drive in the wedge into the established practice. He created his own councils in the Prime Minister's Office with the mandate to formulate basic policies minimizing the interference of bureaucrats and LDP politicians. He picked cabinet Ministers of his own choice not those recommended by faction leaders of LDP. In other words, with his strong leadership character and shrewd political skill Koizumi has succeeded to emasculate the formidable clout of LDP factions and bureaucrats. For the first time in Japanese political history the Prime Minister has started to conduct the business with top-down fashion rather than bottom-up fashion. Although the change has not yet been duly appreciated at home and abroad, and although it is

certainly premature to conclude that Koizumi has finished his job I believe it is the most remarkable event occurred during the entire post-war period.

(7) Will aging population kill Japan?

It is well known that Japan has the fastest aging and the longest living population in the world. By 2015 one out of four Japanese will be over 65 years old. The situation will become serious because if the current trend continues it will reduce the growth potential of the country and it will make the burden of social security unbearable. In my view, the problem needs to be tackled on four fronts. First, encourage child bearing. Second, reform the social security system. Third, make elders work longer. Fourth, attract immigrants.

- 1) It is a fact that fewer young women are anxious to marry and have a family. The trend is caused by many factors some of which are not changeable quickly. However, it is also true that there are many impediments which discourage young women. Some of them are financial, some legal and some social. I have to argue, however, that none of them is impossible to remove if there is a wide consensus in the society. We need to create an environment in which young women can feel comfortable to raise children with or without legal matrimony. Financial support may be necessary. Legal system must protect all working mothers and children equally. Society must be friendly and must not discriminate against working mothers and children.
- 2) As you know, social safety network consists of four elements, i.e. pension, nursing care insurance, medical treatment insurance, and unemployment insurance. On the whole it is my view that the benefit of social security in Japan today is a bit too generous. There is a considerable room to streamline the benefit. Also, those who can afford should bear more cost of the benefit.
- 3) Average Japanese have the longest life expectancy in the world. Yet only 23% of the population above the age of 65 are working. Elders should be encouraged to work in jobs which require their maturity and experience, and they can pay tax and insurance premium.
- 4) Immigration is indeed a tricky issue for any society. However, it must be recognized that Japan is one of the most closed society for immigrants. It needs to be more open. We need badly a large number of IT related specialists, medical and nursing care staff and hard working manual laborers. I am sure if these steps are taken the problem caused by the aging population can be alleviated considerably.

I have tried to check seven problems which Japan is faced with by describing their current status and assessing the prospect of their solution. Although I tried to be as objective as I can, I cannot tell what is your impression. It is obvious that none of them is easy to solve because they are tied to the basic element of our economic, social and political structure in some way or other. So I have to be cautious. While I am pretty sure that the Japanese economy has passed the worst moment, it is too early to predict a quick and strong recovery. The future is very much depending upon our ability to maintain momentum and also on the global environment. One thing I would argue,

though, is that the recent sign of improvement is not merely a facet of cyclical development but it is the product of a change which has been taking place at the deepest level in our economic, social and political system. I cannot underestimate its importance and sincerely hope the march forward will continue.

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