> "For now Japan is too integrated into the world financial system and too big to fail. . . . But a time of reckoning is coming if changes are not made."

Japan's Slow-Moving Economic Avalanche

SCOTT B. MACDONALD AND JONATHAN LEMCO

Ten years ago, a favorite topic for American media pundits was the perceived economic threat from a mighty Japan. Japanese investors, whose financial resources seemed limitless, had bought American icons such as Rockefeller Center, the Pebble Beach Golf Course, and Universal Studios. Representative Helen Bentley (R.-Md.) could muse that the United States was "rapidly becoming a colony of Japan." Japan's strong political leadership, close government–private sector coordination, and high-tech export-led growth were pronounced as the new model for economic growth in Asia, the source of the "Asian Miracle."

A decade later the United States is the economic powerhouse. Rockefeller Center and Pebble Beach are again in American hands. More important, the Japanese economy, although still the second largest in the world, is in decline.

Does this decline signal depression, mass unemployment, and catastrophe? In the short term it does not. For now Japan is too integrated into the world financial system and too big to fail. Instead, we should expect an acceleration of unemployment, widening economic inequality, unprecedented domestic debt levels, deflationary pressures, and feeble political efforts to address these problems (Prime Minister Junichiro Koizumi is the first unabashed reformer in high office in recent memory, although his popularity has declined recently). But the good news is that Japan's foreign currency reserve capacity is so substantial (over $200 billion) that it can withstand internal and external shocks for two or more years before it is forced to act.[1] Japan also maintains substantial savings. Equally important, most of the country's debt is held by local investors, who traditionally have rarely pursued other options than investing in what has proved to be safe (thus far): Japanese government bonds. But a time of reckoning is coming if changes are not made.

SUMMING UP JAPAN'S CHALLENGES

What are Japan's major challenges?

• Too much debt (public debt is 135 percent of GDP—$5.6 trillion—and rising). This is up from 61 percent 10 years ago. The United States peak was 76 percent in 1993. Debt servicing alone consumes 35 percent of all budgetary outlays. Many private-sector analysts expect that public-sector debt will surpass 200 percent of GDP within the next two years, imposing an even greater drag on the Japanese economy.

• Negative economic growth (down 2.1 percent as of September 2001). The Organization for Economic Cooperation and Development and the International Monetary Fund both expect that the Japanese economy will continue to contract in 2002 and 2003 and show only marginal growth in 2004.

• Unemployment is on the rise and will stay that way. Reflecting the structural problems of the Japanese economy, unemployment reached a postwar high of 5.6 percent in February 2002.

• Deflation is becoming pervasive in all sectors of the economy. It is eroding the government's revenue base, which is contributing to the fiscal imbalance. Consumer prices fell 0.7 percent in 2001, the fastest decline in 30 years. There is a strong sense of stagnation in economic policy. Indeed, as the international rating agency Moody's Investors Service stated in February 2002: "The longer it takes for the government to fashion an effective policy response to deflation, the more complicated solving other economic problems becomes."

SCOTT B. MACDONALD, *the director of research at Aladdin Capital, and* JONATHAN LEMCO, *an analyst working in the financial services industry, are the authors of the forthcoming* Soldiers, Holy Men, and Mandarins in Twenty-First Century Asia.

---

[1]For an exhaustive historical analysis of how Japan found itself in its current predicament, see Richard Katz, *Japan: The System that Soured—The Rise and Fall of the Japanese Economic Miracle* (Armonk: N.Y.: M. E. Sharpe, 1998).

• Weak and technically insolvent banks. Many banks have so many nonperforming loans (NPLS) that they just will not lend. The government conservatively puts NPLS at 4.3 trillion yen or 8 percent of GDP. Private-sector analysts believe this number is much higher. The NPL problem has crippled conventional monetary policy and limited the benefits of aggressive government spending.

• An ineffective and inequitable taxation system. The country's corporate and individual taxes are high; even the ministry of economy, trade, and industry acknowledges that heavy taxes are the largest factor prompting major companies to shift manufacturing offshore.

• Many corporations have suspect financial strength but are sustained by government subsidies. The government continues to be reluctant to allow companies to fail, especially those in the agricultural, construction, and retail sectors. These "walking dead" or "zombie" companies are another substantial drag on the economy.

• The government tends to prefer state-guided solutions to business problems rather than market-driven resolutions. In early 2002, Snow Brands, a struggling dairy and food company, was unable to overcome a mislabeling scandal. As the company went through its third restructuring plan, it came under pressure for considering a friendly takeover bid from Swiss multinational Nestlé, with which it has a joint venture. Instead, the government guided three of the country's agricultural cooperatives to help Snow Brands, while it was suggested that its banks forgive or generously restructure debt. Although the ministry of agriculture was to later reverse its position about foreign equity involvement, the tendency remains for government guidance in finding a solution.

• The government seems resigned to a stock market slide, although in a measured fashion. The downturn in the economy, a lack of investor confidence, and poor (albeit improving) transparency and disclosure in the corporate world clearly are negative influences on the stock market. The government has established a fund to buy shares on the market to slow the process of stock market decline and help provide support for banks that sell stock to improve their financial situation. While this creates a brake for a stock market collapse, it still does not address the fundamental structural problems facing the Japanese economy.

• The Japanese currency, the yen, may be the world's strongest, but it also has a more dubious distinction: it may also buy the least amount of goods. Japanese consumers live in the world's most expensive country. Labor and other costs are extremely high, which provides a further disincentive for international investment in Japan. Indeed, even Japanese companies are leaving Japan for cheaper labor costs in countries such as China and Mexico. Although the yen is likely to weaken (possibly to Y150 to US$1 by the end of 2002) as the Japanese government tries to help slow the decline of the current account surplus and rekindle export growth, it will remain one of the world's strongest currencies.

The many challenges facing Japan are daunting. Yet the government apparently will not make any dramatic policy moves until the economy or the financial system actually reaches what it considers the "danger point." Officials have repeatedly pledged radical action in the case of a crisis while denying that a crisis exists at present. In fact, senior public servants frequently see it as in their interest to stifle the reform effort. Consequently, the policy track is characterized by tinkering, while the macroeconomic fundamentals steadily grow worse.

The long list of challenges Japan faces is slowly eroding confidence inside the country. A new twist is that the Japanese people are now second-guessing the government. The price of gold, the favored instrument of those fearing downward volatility, was at a two-year high in February 2002. According to stories in the Japanese press, growing numbers of Japanese are buying gold and taking it home as a hedge against possible bank failures. Many Japanese believe that gold stored under the mattress is probably a safer investment than money or gold in a bank, which could fail in the not-too-distant future. The collapse of the mid-sized Ishikawa Bank in December 2001 clearly spooked many Japanese and made gold appear a safe option.

The international investment community is well aware of Japan's problems. In February 2002, Moody's Investors Service put Japan's Aa3 yen-denominated debt on watch for a possible downgrade, possibly to as low as A2. If this were to occur, the world's second-largest economy would be rated at the same level as such second- or third-tier economies as Cyprus, Greece, Latvia, and Mauritius.[2]

[2]Moody's singled out the yen rating and not the foreign currency rating, which is Aa1 and stable, because the bulk of Japan's debt is in yen and held by Japanese investors. This is an important distinction, especially since Japanese investors have remained willing to buy Japanese government bonds despite the economic deterioration, as opposed to foreigners, who have in the past more easily panicked and dumped troubled securities.

THE CORE PROBLEM

Japan's many challenges reflect a core problem: the Gordian knot of special-interest politics at the center of a system based on coordination and stability. The Liberal Democratic Party's long period of rule from the 1950s to the present with only a few short interruptions has stemmed from its ability to provide stability based on policy coordination between the public and private sectors. This has appealed to many Japanese, especially those in parts of the economy that sought and received protection from outside competition: retail companies, construction firms, and agriculture. In all fairness, the system initially worked well, providing strong economic growth from which everyone benefited. It was difficult to argue that the 9.3 percent annual growth rate in the 1956–1973 period and the 4.1 percent growth rate in the 1975–1991 period were bad.

Yet, while some economic sectors were pushed to compete in the rough-and-tumble international markets, the protected areas were allowed to plod along, never developing competitive instincts. As Japan became a world leader in automobiles and electronics, it maintained an inefficient retail sector, a high-cost and consumer-unfriendly agricultural sector, and a bloated construction sector, highly dependent on the public sector for ongoing largesse. The banks were an important component of this system, providing loans and keeping many weaker companies afloat by loose accounting standards. Banks were willing to keep the "zombie" companies from bankruptcy by providing even more loans or not categorizing the companies as troubled. These government-guided bailouts continue today because Tokyo is unwilling to handle the alternative: mass joblessness in a nation with a mediocre social safety net. Cleaning up all the bad borrowers would swell the ranks of the unemployed by 3 million to 4 million people, or 6 percent of the total workforce. Of course, the current policy of "muddling through" has already cost 2 million jobs since 1997.

The LDP's ability to raise considerable cash from its key supporters was another key element in the coordination and stability system. As political historian Richard L. Sims notes, the "LDP, either as a party or through its various factions and Diet members, acquired enormous funds—far beyond the amounts which rival parties could raise—notably from big business, the construction industry, and numerous small businesses which owed gratitude to LDP politicians or sought their aid."[3]

Today we are seeing the gradual fragmentation of the coordination and stability system. The end of the bubble economy (the period during the 1980s that witnessed a massive rise in stock market and real estate prices) left the Japanese economy in a weakened condition, increasingly less able to handle the demands of the protected economy. At the same time, international competition has grown, demands for less protection of the Japanese domestic market have increased (including a Sino-Japanese trade dispute in late 2001 and early 2002 over the access of Chinese agricultural goods), and the banking system threatens to collapse unless propped up by government assistance.

KOIZUMI'S PROMISE

In April 2001, Prime Minister Koizumi took office with strong public support, a call for reform, and a hopeful international audience. His reform program aimed to remodel Japan into a more powerful, competitive, and taxpayer-friendly economy. Along these lines he advocated fiscal rehabilitation (addressing the budget deficit and growing public-sector debt), dealing with the nonperforming loans in the banking system, and public corporation reform. The last included the abolition or privatization of 62 public corporations out of a total of 163. It also entailed reform of the postal banking system, long one of the major repositories for Japanese savers.

Koizumi and his team of reformers faced considerable opposition from within the LDP, the bureaucracy, and those businesses that would be affected by the reduced government largesse incorporated in fiscal reform. Consequently, Koizumi was forced to make a number of compromises with the conservatives and party fence-sitters to pass legislation, which subsequently was watered down and less effective than initially envisioned. For example, only 17 corporations are to be abolished and 45 others privatized, but over lengthy periods of time. At the same time, the banking sector continued to have massive problems with bad loans. Despite an improvement in dealing with old bad debt, new bad loans multiplied as the economy shifted in late 2001 into its third recession in five years (that is, for the third time in five years, Japan experienced two consecutive quarters of negative economic growth).

While the reform effort was to restructure the economy, the central bank pledged on February 10,

[3]Richard L. Sims, *Japanese Political History since the Meiji Renovation, 1868–2000* (London: Hurst and Company, 2000), p. 337.

2002 to loosen monetary policy. But because the discount rate is zero percent and the Bank of Japan has already extended so much cheap credit, the banking sector cannot absorb any more. The banks, saddled with many troubled loans, have little appetite to lend. Moreover, potential customers have other options: foreign banks (for the large and still financially sound companies), local finance companies, and new nonbank finance institutions.

THINKING POST-KOIZUMI?

Prime Minister Koizumi sought to break with Japan's system of coordination and stability and move the country to a more open, more market-driven economy. This also implied a shift in the country's political life to greater transparency and careful weighing of public opinion. But Koizumi increasingly appears boxed in by conservative LDP factions that oppose his reform plan. He can expect little support from his coalition partners, New Komieto and the New Conservative Party, or from the largely ineffectual opposition.

Despite the gloom and doom hanging over the Japanese landscape, the private sector offers a glimmer of hope.

It was because of the efforts of conservative LDP members that Foreign Minister Makiko Tanaka left Koizumi's cabinet earlier this year, dealing another blow to the fragile unity of the Koizumi team. Highly popular with women voters and in her electoral region, Tanaka, the daughter of one of Japan's former prime ministers and long-dominant political players, was brought to the foreign ministry to refashion Japan's foreign policy and clean it up. The foreign ministry since January 2001 has been the focus of several investigations, initiated by a scandal involving the long-running embezzlement of discretionary funds by a ministry official. Other scandals had followed. Tanaka, however, was disliked by foreign ministry bureaucrats, who had little intention of lending their support to a cleanup of the ministry. Moreover, powerful members of the LDP, in particular, Muneo Suzuki, thought little of interfering in the ministry and attempting to impose their own stamp on foreign policy. Hence Tanaka was constantly upended by the bureaucrats. Offhand comments were leaked to the press, causing an embarrassment on more than one occasion. The media, with its allies in the LDP, was more than happy to comply in seeking to bring down the foreign minister. Finally, on January 29, 2002, Koizumi forced Tanaka to resign over the trivial issue of two NGOs not being allowed to attend a summit held in Tokyo on the reconstruction of Afghanistan.

Tanaka's ouster at the hands of LDP conservatives was immediately reflected in a downward shift in Koizumi's popularity in opinion polls from 85.6 percent in December 2001 to 55.6 percent in early February 2002. Opinion polls taken shortly after Tanaka's sacking also showed that 62 percent disagreed with the action. For Koizumi, the fall in public opinion indicated a loss of leverage over LDP conservatives. As Minoru Morita, a political analyst noted in the February 4, 2002 *Nikkei Weekly*, "Koizumi won't be able to control the Liberal Democratic Party's Old Guard, who oppose his reform plans, if his popularity continues to slide. The extremely high public approval ratings have been his strongest weapon to support his fragile power base with the LDP."

Prime Minister Koizumi remains committed to his reform agenda, despite the formidable opposition he faces. The nosedive in his approval ratings does not derive from public dissatisfaction with the reform agenda, but is the popular reaction to the firing of the foreign minister. (Tanaka has, however, expressed her continued support for Koizumi since her resignation.)

Koizumi will likely be sustained in office through 2002 and possibly beyond because the economy has not yet collapsed. Although public-sector debt is expected to climb to 140 percent of GDP by the end of the 2002 fiscal year (March 31), the economy will continue to contract and unemployment will climb further upward. Undoubtedly, the government will resort to tinkering to stop a stock market and bank meltdown. The government's stock market buying fund may buy stocks dumped into the Nikkei by the banks as they seek to raise cash. The government also is likely to inject capital into major banks that are threatening to collapse. And major corporations are likely to receive some form of government-guided assistance to postpone bankruptcies. This is geared in particular to help fend off further collapses in the retail and construction sectors, in sharp contrast to the United States, which recently let major retailer Kmart file for Chapter 11 bankruptcy.

Koizumi thus will continue in office for the foreseeable future. This is especially the case since no major rival appears to be on the political landscape, with the possible exception of former Prime Minister Ryutaro Hashimoto. Hashimoto, however, lacks popular support, which has become increasingly important to hold office. The public hardly puts much more trust in LDP conservatives or the opposition Liberal Party, which may be on the verge of falling apart due to internal conflicts. The bottom line to understanding the economic crisis facing Japan is the lack of urgency on the part of the Japanese political elite to deal with it. It requires too much work and reordering of the political economy.

Koizumi does have one additional card to play to prolong his tenure as prime minister—nationalism. Although both the reform and the conservative factions of the LDP have different views of economic policy, they share a growing sense of Japanese nationalism. Moreover, many around Koizumi espouse a "new nationalism," which can be broadly defined as economically progressive with regard to the required structural reforms, a need for a more entrepreneurial business culture and a more open economy, and a desire to see Japan take steps to convert its economic strengths into political and military power. This does not imply the creation of a militaristic culture similar to that of the 1930s, but it does mean a more assertive Japan in regional and international affairs, complete with a real modern army as opposed to the Self Defense Forces. This group also would like to see an end to the American military presence on Japanese soil and a stronger policy line toward China and North Korea. Without any other glue to keep a government together, the LDP may opt for a stronger form of nationalism, which would probably play well at home, but complicate relations with China, the Koreas, and the United States.

HOPE FROM THE PRIVATE SECTOR

Despite the gloom and doom hanging over the Japanese landscape, the private sector offers a glimmer of hope. The wrenching economic downturn is gradually leading to three developments: consolidation, a shifting of operations overseas, and greater domestic pressure for deregulation. All three developments are largely positive, although there is some angst over the "hollowing out" of Japanese industry to China and other parts of Asia.

The consolidation of various sectors of the economy is a painful yet necessary process. While the agricultural, construction, and retail sectors continue to maintain some clout with the government, other parts of the economy are carrying out structural adjustments. In the auto, electronics, and high-tech sectors, capital expenditures and workforces are being reduced. In the brewing, chemical, insurance, and steel sectors, mergers are occurring more rapidly. In many cases, companies have decided that mergers are preferable to bankruptcy. Even in the banking sector, the number of banks is shrinking, especially in areas outside the major cities.

The consolidation process does offer some hope but it must be allowed to run its course, which should include the downsizing of bloated workforces, the reduction of government assistance, and the introduction of more measures to deregulate the business environment. In this area, legislation has been passed to improve transparency and the disclosure of corporate information, and to provide a better corporate governance and a more clearly defined and market-friendly path to bankruptcy. Yet considerably more must be done in these areas, especially since a gap continues to divide what is passed as law and how it is put into practice.

Japan must also do more to encourage the creation of a vibrant sector of small and medium-sized enterprises that can compete globally. This has been a major factor in the long economic boom in the United States during the 1990s and a source of considerable technological innovation, which continues to positively impact productivity trends. Currently the small and medium-sized business sector in Japan is being hit hard by the recession, the lack of cost-efficiencies due to longstanding protectionism, and a lack of credit needed to augment productivity. Without further development of this sector, a Japanese recovery will take that much longer.

THE SLOW-MOVING AVALANCHE

Japan has been defined in the postwar era by its economic development—development that overcame the trauma of defeat and resulted in one of the world's most affluent societies. It also made Japan the leading economic power in Asia, dominating regional trade and finance. The danger for Japan is that when the unprecedented economic crisis that has gripped the country for nearly a decade really hits home sometime in the near future, all claims to past success will ring hollow. Much can be said for policies that promote coordination and stability, but not if they result in economic collapse. Japan remains prosperous. But when Japan's sense of economic security is truly threatened, the Japanese people will demand concerted action. This may halt the slow-moving avalanche. If not, the world will feel Japan's collapse. ■