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Critical Developments in Japan

Japan's economy is in a grave crisis. The financial and economic crisis in several East Asian NICs, which began a year ago and has still not been overcome, has certainly contributed, but Japan is by no means their "victim", even if its trade and financial ties with these countries are much closer than those of the USA or Western Europe. Rather, growth had already flattened out a lot since the beginning of this decade, especially due to "home-made" problems; national output has hardly risen at all, and unemployment has been increasing considerably for some time now.

The virtual stagnation in the nineties is a reflection of basic, mainly structural, problems in the world's second largest economy. This is also evident from the low efficiency of economic policy. Monetary policy already shifted to a very expansive course some years ago. The discount rate has been at 0.5% since as long ago as autumn 1995 and on the capital market the government has been able to obtain long-term loans "cheaply", since last autumn even for considerably less than 2%. In real terms, too, capital market interest rates are very low. The demand for money, however, has not risen any faster.

This low-interest policy failed to stimulate the economy for two main reasons: firstly, low interest rates only made themselves felt to a limited extent in the private sector because the banking sector is very reserved with regard to the granting of loans due to the great need for consolidation it has faced over a period of years. Secondly, the sales and earnings expectations of businesses have remained gloomy and the propensity to invest and consume has been restrained for a long while. The weakness of Japan's economy is thus a combination of a "credit crunch" and a liquidity trap.

Monetary policy, however, is also unable to stimulate the economy because fiscal policy is unpredictable. In April the government unveiled an exceptionally extensive programme to boost the economy - amounting to nearly 372% of gross domestic product. About three-quarters of the total are earmarked for public spending and a quarter for tax relief limited to a two-year period. Much of this, however, is a "corrective" to the restrictive course which was adopted only a year previously, and which had completely misappreciated short-term economic trends. The April package did not stabilize the expectations of the private sector. On the contrary, opinion poll results for June indicate that pessimism is continuing to spread, particularly amongst small and medium-sized firms producing for the domestic market.

The fact that this kind of massive fiscal programme did not stabilize expectations is also a consequence of the loss of confidence in the government, whose persistent fiscal policy vacillation in recent years has caused uncertainty among economic players. Added to this zig-zag course are the intransparent and "doctored" stimulus packages of previous years.

All this impairs the effect of fiscal measures all the more as it now appears almost impossible to detect a clear strategy in fiscal policy for all the hectic initiatives.

In a phase such as the current one, which is unstable both in cyclical and psychological terms, it is therefore unlikely that the temporary tax relief provided for in the April programme will succeed in igniting the economy. This is evidently why the government is also considering a far-reaching reform of income and corporation tax. No announcements have, however, been made so far on the size of long-term relief, the details of the tax rates and the date the reform is due to enter force (most likely next spring at the earliest). The defeat of the ruling party in the elections to the upper house and the resignation of Prime Minister Hashimoto have no doubt exacerbated uncertainty about the tax reform, which is also being urged by other countries. This will continue to cause businesses and private households alike to exercise restraint with regard to spending. ^

Apart from the insufficient predictability of fiscal policy, the effectiveness of monetary policy is currently also so slight because of the persistence of large consolidation problems in the financial sector. The financial structure of many banks had already deteriorated seriously at the beginning of this decade, when highly inflated real estate and share prices in Japan started to drop sharply. A fundamental overhaul of the banking sector was, however, postponed. Only under the pressure of a dramatic escalation, an ineffective economic policy and exhortations from abroad has the government now resolved to allow the necessary value adjustments on lending, even at the price of bankruptcies, to set up bridging banks and underwrite private deposits with government guarantees. This kind of therapy cured the banking crisis in the USA and in Sweden in the early nineties within about three years - although those crises were not as far-reaching of course.

A return to a path of economic growth and increasing employment could also be supported by a further reduction in regulation in a number of other sectors. Prospective growth gains which could be "activated" in the medium to long term by deregulating the electricity industry, trade, air and road transport and telecommunications are rated at 6%. Deregulation and structural reform are all the more important as Japan is among the economies with the world's highest per capita incomes. In order to promote growth, the wealthy economies are particularly dependent on innovation. The most fruitful method in the search for innovation has proved to be competition. An adequate institutional environment would be likely to advance growth in Japan all the more effectively as the necessary human capital undoubtedly already exists.

In general, fundamental structural adjustments and reforms put a brake on the economy as a whole in the short term, but only a credible approach to remedying the basic problems can regain the confidence of the economic players. Until this is done, the effects of economic policy will remain limited. Experience shows that returning to a new balanced growth takes some time. Not least because of the considerable risk of a sustained economic slump, monetary policy in Japan needs to be more expansive than in the case of a "normal" transmission process. Considering the precarious economic situation this may even have to be at the price of medium-term inflationary risks.

This is all the more so as Japan's return to a growth path is also important for East Asia and ultimately even the world economy. The crisis of the real economy has hardly yet reached its peak in the newly industrialised countries of East Asia. They will find it particularly difficult to recover without the locomotive of Japan. If the centre of gravity in the region cannot perform this role for a prolonged period there is the danger of a steeper downward spiral, especially with the in this case likely continuing weakness of the yen. It would then be virtually impossible to stop the Chinese currency from falling as well. Competitive devaluation in Asia would, however, have substantial adverse impacts on the rest of the world.

Gunter Weinert