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Is the Japanese Crisis Over?

The good performance of the Japanese economy during the first half of 1999 was better than expected. But, it may only be temporary. The present rebound is being led by an acceleration of household spending which appears to be very fragile. Furthermore, it has rapidly led to a rise in the yen that risks undermining continued growth. The room for manoeuvre of fiscal policy has been largely used up. At the same time, the Bank of Japan eschews any further relaxation of monetary policy. Yet the obstacles to growth are more fundamental. The Japanese model has not yet completed the transformation that would allow it to return to higher growth. The crisis and subsequent reforms of the banking system illustrate well Japan's present weakness, its problems of adaptation and the nature of the costs the transformation entails.

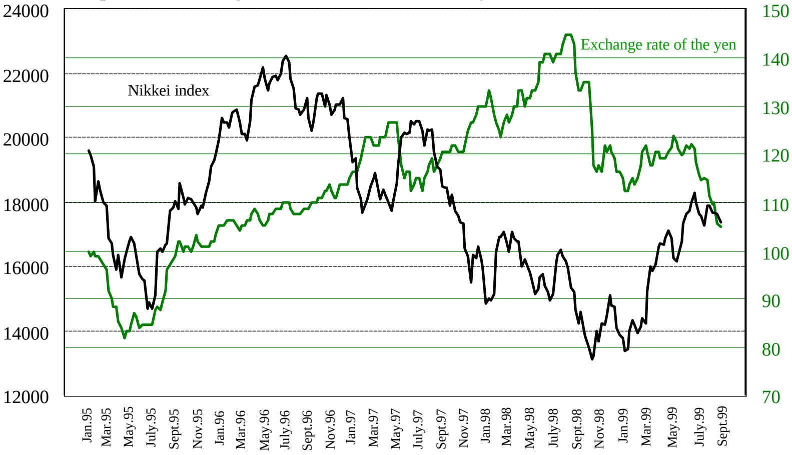
The Paradoxes of the Business Cycle

The situation in Japan has changed radically since a year ago. In October 1998, the Japanese economy was sliding further into recession. The umpteenth plan for financial stabilisation, which had been agreed after months of interminable debate, was being greeted with much scepticism. The stock exchange and the yen were at record lows, both victims of a major crisis of confidence[1]. This led to fears of a collapse of the banking system and a renewed spiral of devaluation in Asia.

Today, the outlook is markedly different. The financial stabilisation plan triggered a real change in the management of the banking crisis, which has led to the nationalisation of two big banks, the closing of several insolvent regional banks and an acceleration in the restructuring of the sector. The crisis of confidence has been soothed, and capital is once again flowing into Japan. The yen is rising and the stock exchange has begun moving upwards (Graph 1). The Japanese premium, the surcharge which Japanese banks must pay in international markets to obtain finance, has practically disappeared. Given this favourable financial climate, growth is clearly picking up, thus supporting the renewed optimism. The first quarter of 1999 was indeed very good, with growth reaching an annualised rate of 8%, while the second quarter was not as bad as was forecast (1.6% growth compared to the fall expected by most institutes).

Yet, the return to growth has had a paradoxical, negative effect. It has led to a rise in the yen, which has become strong enough to weaken growth. To begin with, the

Graph 1 - Exchange rate movements of the yen and stock market trends

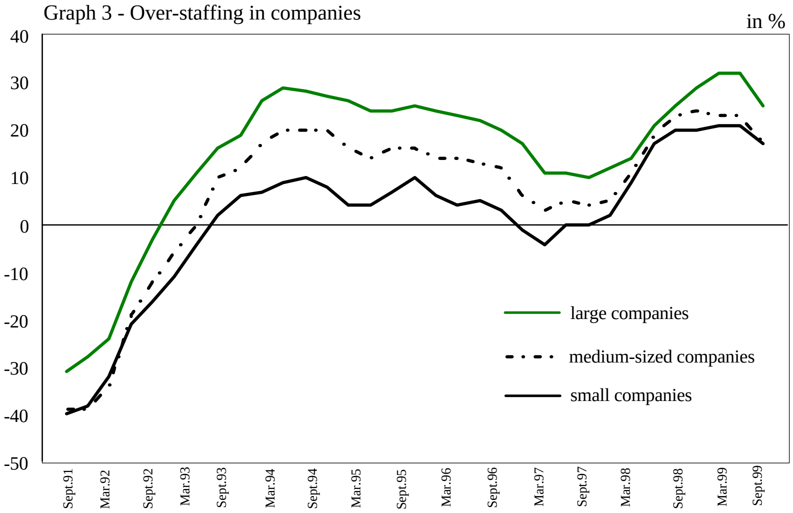


Source: WEFA.

1. C. Lacu, "La crise bancaire japonaise et l'instabilité financière mondiale", *La Lettre du* CEPII, N°175, 1998.

rise in the yen is weighing down on Japanese trade: on average it is estimated that a 10% appreciation of the yen leads at least to a half-point fall in growth, after two years[2]. Subsequently, the appreciation of the yen, by reducing the price of imports, risks fuelling deflation and squeezing household spending. Lastly, expectations of such unfavourable developments may lead to a downturn in the stock market, which in turn would weaken banks, given the importance of capital gains in banks' solvency ratios. Such a negative chain of events already took place in 1995, and reveals the persistent fragility of Japan.

Graph 3 - Over-staffing in companies

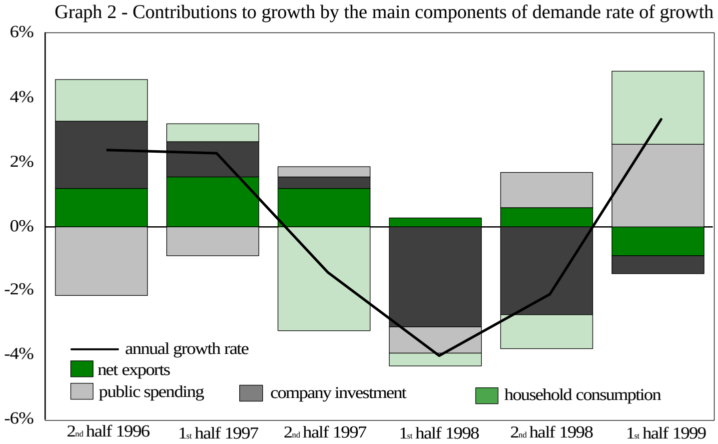


Diffusion index: (number of companies considering their staff to be excessive minus the number of companies considering their staff to be insufficient) / total number of companies.
Source: Bank of Japan - Tankan Survey .

Upturn or Flash in the Pan?

What are the facts underlying the good results of the first half-year? The latter are essentially due to public spending and to the dynamism displayed by household consumption (Graph 2). In contrast, exports fell on average during the semester, even if a slight rise may be observed as of April. Above all, companies with substantial, accumulated over-capacity during the bubble economy have continued to adjust their investment downwards[3] . This trend is likely to continue[4]. Companies in the manufacturing sector have been pursuing restructuring for a long time, but non-manufacturing companies have hardly started[5]. Furthermore, while many companies are seeking to reduce their indebtedness, others still have to put up with relatively unfavourable conditions of access to credit.

Graph 2 - Contributions to growth by the main components of demande rate of growth



Source: EPA.

Companies are also going ahead with labour market adjustments: the rate of unemployment has gone up to 4.7%, and wages are now subject to cuts, which have already affected overtime and bonuses. Redundancy programmes planned by major companies rule out any improvement in this area. On the contrary, according to a study by the Bank of Japan, companies are still burdened by substantial over-staffing (Graph 3). Economists at Nomura estimate that excessive staffing is running at between 6.5 and 10 million (or about 10% to 15% of the working population[6]).

The rebound in household consumption and residential investment, which was pulling growth during the first half-year, was not therefore based on an acceleration of incomes. It was made possible by tax measures, whose impact may wear off quickly, along with a fall in the savings rate. This fall was unexpected, given the rise in unemployment and concerns about retirement. But it may be explained by reassuring consequences of financial stabilisation, after many years of great uncertainty.

Given this fragile context, the economic situation could change rapidly for the worse, which would have major repercussions for the financial system. The resolution of the banking crisis is on the right track, but should still take at least two years to complete[7]. If growth slows down too much, then new bad debts may emerge, adjustment will be delayed and credit access conditions will become even more

2. S. Guichard, “Japon : les limites d'une gestion macro-économique de la crise financière”, *La Lettre du* CEPII, No163, 1997.
3. The adjustment of capital hides the growth of investment in new technologies, which nevertheless remains insufficient (see NRI, Economic Research Department, "Medium-term outlook for Japan: options for regaining dynamism through structural change", *NRI Quarterly*, summer 1999.
4. The evolution of private sector orders for machinery, traditionally a leading indicator of investment spending, confirms this trend.
5. See Bank of Japan, "Stagnation and structural adjustments of non-manufacturing industries during the 1990s", *Research and Statistics Department Working Paper*, 1999.
6. NRI, Economic Research Department, *op. cit.*
7. S. Guichard, *La défaite financière du Japon*, Economica, 1999.

restrictive. Another cause for concern follows from the firing, in October, of the person responsible for financial reform, who was nevertheless at the centre of improvements underway. It is to be hoped that this move will not threaten the consolidation the banking system.

These real and financial risks explain the nervousness brought on by the rise of the yen, which may trigger a reversal in the economic outlook. Such nervousness is all the sharper given that the credibility of macroeconomic policy has been seriously undermined.

The Relevance of Economic Policies

The active Keynesian-style macroeconomic policy, which was pursued between 1992 and 1996, and since 1998, has merely permitted Japan not to slide further into recession, but it has been incapable of spurring growth durably[8]. Hence, the room for manoeuvre is now exhausted.

Since 1992, cumulative fiscal support for economic activity has amounted to 22 percentage points of GDP; but less than half these sums have actually been injected into the economy, without generating further activity[9]. Public investment programmes have above all favoured construction, which has thus been able to put off adjustments that are needed, given the sector's over-capacity of nearly 40%. Set up in 1998, support for small and medium size firms has provided them with credit without any borrower-quality requirements. This has helped them avoid bankruptcy, temporarily. Furthermore, the tightening of fiscal policy in 1997 was a major error, as it reinforced the recession Japan was only just beginning to pull out of.

The debate over monetary policy is fiercer still. The loosening of monetary policy was very limited, at the start of the crisis (1992-1994). Subsequently, interest rates were progressively brought down to practically zero. Since the beginning of the year, numerous economists have called for further relaxation of policy to support growth, though without success. As the overnight interest rate is at its lower limit, such a policy would require changes in monetary regulation. The aim would be to target longer lending periods, possibly by buying public bonds. Another solution would be for the Bank of Japan to fix an inflation objective or a money base growth target, which would encourage expectations of rising medium term prices, which in turn would make real interest rates fall[10]. Concerned about asserting its recent independence (April 1997), the Bank of Japan has not however ceded to such pressures, claiming that such action would have no impact on activity, but would be dangerous in the medium term.

In the autumn of 1999, the rise in the yen again stoked up this debate. At the behest of the Ministry of Finance, the Bank of Japan intervened in the markets to stem the rise of the yen. However, it has systematically sterilised its interventions[11]. As a result, the Bank of Japan has refused to use an important channel for transmitting monetary policy: the exchange rate, which otherwise stands out as one of the last options it has for staving off a renewed fall in growth. Such inaction reflects a deep disagreement between the two institutions over support for activity. The conflict goes back to the more fundamental question of the pertinence of going beyond cyclical policy; the answer lies in the nature of the crisis.

The Nature of the Crisis

There are two major explanations for the Japanese crisis, which to some extent mirror present analyses of America's continued expansion. For some, the crisis is due mainly to a succession of unfavourable shocks (the bursting of the speculative bubbles, the rise in the yen until 1995, the Kobe earthquake, and the Asian crisis), as well as errors of economic policy (the tightening of fiscal policy in 1997). Exiting the crisis therefore requires a Keynesian expansion, even if this leads to a further worsening of public finances[12] and risks causing the public debt to be monetised at some point in the future. The new fiscal programme announced in October takes this line of reasoning. However, the inability of counter-cyclical policies to stimulate demand has also led to another diagnosis. It suggests that the Japanese economy is suffering from fundamental organisational flaws, which rule out a return to sustained growth (in other words a sort of negative, opposing manifestation of the "New American Economy")[13].

The rapid expansion of Japan until the 1980s was based on successful catch-up: it is thus only normal that the pace of growth has slowed down since. Yet the weakness of growth over the last eight years would appear to reveal something else: an inability of the "Japanese model" -

8. See *La Lettre du* CEPII No163, *op. cit.*
9. A. Posen, *"Restoring Japan's economic growth"*, Institute for International Economics, Washington DC, 1998.
10. Such policy was supported notably by Paul Krugman (his comments are available on the web site: http://web.mit.edu/krugman/www/jpage.html).
11. For information on central bank intervention, see in particular A. Bénassy-Quéré, "La BCE et l'euro" *La Lettre du* CEPII, No 182, 1999.
12. Japan's gross public debt is already greater than 100% of GDP (in 1999), and the deficit equivalent to 8.6% of GDP, of which 6.7% is the structural deficit, according to the OECD. For the moment, and in the face of successive attempts at expansion, long term interest rates on government bonds are still very low. This can be explained by the flight to quality investments, which has led banks to buy stocks massively, to the detriment of bank credit, and by massive purchases on behalf of public financial institutions. However, there is nothing to rule out a rise in interest rates in the long term. Indeed, uncertainty surrounding the ability of the Japanese Savings Bank to continue buying up such stocks already led to some tensions in bond markets at the beginning of 1999.
13. This diagnosis can be found increasingly in reports on Japan by international organisations (OECD, *Economic Surveys Japan*, the IMF etc.) See also E. Dourille-Feer, *L'économie du Japon*, La Découverte, collection Repères, 1998.

which permitted such catch-up - to adapt to the workings of a mature economy integrated in the world economy.

The banking crisis is symptomatic of such present structural weaknesses[14]. It results from the attempt to super-impose a deregulated financial system on traditional bank behaviour and the statutory regulatory authorities set up after the war. Reforming the financial system thus challenges fundamentally the "Japanese model".

The financing and governance system of companies by banks, the so-called main bank system, has been blown apart. Solidarity between banks or between banks and companies is weakening. Since 1995, cross-shareholdings are being eroded as banks are selling off their shares in the other companies of the *keiretsu*, in order to realise capital gains and expand profits. Up until the end of the 1990s, a main bank would aid companies to overcome financial difficulties when these arose, by providing financial support for restructuring. The deterioration of bank balance sheets has henceforth made it impossible for main banks to continue providing such support. But, if banks intervene less in the management of companies, market forces have yet to take on this role. Cross-shareholdings remain sufficiently strong to limit the threats of take-over bids: regulatory instruments and legislation, such as the law of bankruptcy, are insufficient and slowdown company restructuring.

Companies still face excess, unprofitable capacity as well as heavy indebtedness, and are adapting slowly, which stems partly from this incomplete transition between banks' and market governance. However, economic policy has taken this constraint on board by putting forward measures aimed at facilitating liquidation, accelerating the depreciation of capital and helping investment in new technologies.

The erosion of the main bank system is also weighing down on the labour market. Before, when a company faced financial difficulties, shareholders (other companies in the same group, including the banks) would carry the fall in profits, while jobs were largely saved. Adjustments in pay rolls occurred primarily through cuts in bonuses and overtime. This explains the over-staffing in Japanese companies. If the weakening of financial solidarity in groups has led to more volatile and demanding shareholders, then the privileged situation employees used to enjoy may be challenged, and excess labour shed drastically. Japan could then face severe unemployment problems, with all the attendant social consequences.

Overall, these mutations are vital for the long-term growth of Japan, and they are likely to continue to bear down on Japanese economic activity over the next two years. Counter-cyclical policies will essentially be limited to lightening the costs of such adjustment. It is to be hoped above all that such policies will not be pursued at the expense of reforms, as has often been the case over the last ten years.

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14. S. Guichard, 1999, *op. cit.*

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