Japan crisis is a lesson to the world

Gerard Lyons

JAPAN is in recession. Badly timed tax increases in April last year and the Asian currency crisis have combined to hit Japan hard. So what? you may ask. After all, it is eight years since the country's economic bubble burst, when its equivalent of the Lawson boom came to an end. Since then the UK and US economies have done well, despite problems in Japan. And, for all the worry, Japan's unemployment rate after eight difficult years is still less than ours.

Now, things are different and there is a clear need for the rest of the world to sit up and take note. Problems in Japan could seriously affect the world economy. Japan is Asia's biggest and most powerful economy. If its economy falls from recession into a slump, it could pull economies in Asia down with it. There could be another round of currency devaluations. This time, China could buckle, despite its determination not to devalue. If China devalues, the Hong Kong peg will go and the Hang Seng will collapse.

To understand how this affects us, it is important to appreciate how different this economic cycle has been. Unlike the inflationary 1970s and 1980s, the 1990s has been the decade of low inflation.

There are three reasons for this. First, economic policies around the world have converged. Central banks have become more powerful and political parties have adopted similar anti-inflationary policies. Second, after the buoyant 1980s, new technologies and domestic cost constraints have forced prices down. Third, global competition has become a dominant force.

This latter effect has been exacerbated by Asia's currency crisis, which has made goods from that region very competitive. As more than one-quarter of world exports come from Asia, this competitive impact should not be under-estimated. The exposure of international banks to Asia reinforces the need to be concerned about problems there. By last summer, half of all international bank lending was to Asia – a huge $822bn.

Since Asia's crisis broke, prospects for the region are not good. There may be several years of weakness, or even worse. In view of Asia's global importance, the US has put huge pressure on Japan to play a lead role and be a solution to Asia's problems, not a symptom of them. For Japan to be a solution its economy needs to be buoyant, but it is far from that. Last week, the Bank of Japan released its quarterly economic survey, the Tankan. This is the most comprehensive survey of its type in the world. A total of 9,308 firms took part, including every top Japanese company.

The results shocked global markets. Business confidence fell sharply in the first three months of the year and is expected to remain weak, with firms reducing excess inventories and shedding labour. Last year's tax increases and fears about job losses have led to weak consumption, as people have increased their savings. Moreover, 42% of Japanese exports go to the rest of Asia, highlighting the significance of problems elsewhere in the region.

The Tankan confirmed Japan is in recession and fed negative sentiment about the economy. Despite this, it may also trigger policy measures to turn the economy around. As a result, it is premature to write off Japan just yet.

In spring 1995, Japan was on the brink of recession and financial meltdown. That precarious position spurred the government into a three-pronged policy response, as it weakened the yen, boosted fiscal policy and cut interest rates to a record low level of 0.5%.

The economy is again in difficulty, only this time the government's policy options are limited. Interest rates cannot fall, so it is up to fiscal policy or the yen. Hence the problem.

Last summer the Japanese government adopted its equivalent of the Maastricht treaty in the form of the fiscal structural reform law. Because of Japan's ageing population, this law aims to cut the budget deficit. But it has also prevented the government from being able to cut income taxes and relax policy as much as the economy needs. As a result, a weaker yen has acted as a safety valve for economic problems in Japan. Yet a weaker yen is not the most effective way to boost demand in Japan and it could feed currency problems elsewhere in Asia.

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Large income tax cuts and increased public spending are needed. This will require a revision to the fiscal stability law. Although this will mean a policy U-turn by the prime minister, Ryutaro Hashimoto, the weakness of the economy suggests it is inevitable. If so, it will be a sensible move. There is always the need for economic policy to be flexible in the event of economic shocks.

In recent months the Japanese government has unveiled an impressive series of packages. The emphasis has been on boosting the financial sector and promoting deregulation. However, as these fiscal boosts have not provided a direct stimulus to consumers, the financial markets have given them the thumbs-down. Although this response is too pessimistic, there is no doubt another stimulus is needed, and soon.

Gaiatsu, or foreign pressure, will have a big bearing on events in Japan. As the world's biggest saver, Japan has sufficient funds to sort out its own problems. At the Group of Seven (G7) meeting in London, Japan was put under pressure to do more. By the time of the May G7 summit in Birmingham, there is no doubt another big fiscal boost will have been announced. This will allow Hashimoto to attend, showing he has taken necessary action.

Ahead of this, beware the Japanese government's desire to stabilise the yen. Any attempt to help the yen will be credible only if policy measures at home improve the chance of a self-sustaining rebound in the Japanese economy. The world watches with bated breath.

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