The world must watch Japan closely

Agenda

Interest rates are rising in the world's biggest saver, with global consequences

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Japanese interest rates are heading higher, with global consequences. Japan is the world's largest saver. In recent years, economic and financial problems led the Bank of Japan to cut interest rates to a record low level of only 0.5%.

There were two effects. Low interest rates at home encouraged more Japanese to shift money overseas in search of higher returns. And international investors borrowed heavily in yen, at low interest rates, to invest elsewhere. This boosted global liquidity, contributing to the surge in world financial markets, particularly in America.

In April the threat of a rate increase led some of these flows to be reversed. Japanese rates didn't go up, but the yen appreciated. Now, the threat of a Japanese rate increase has returned, following the release last week of the Bank of Japan's quarterly economic survey, the Tankan. This showed the economy is finally recovering, despite tax increases in the spring. Yet the recovery is not broad-based enough to trigger an imminent rate increase. Instead, the signal for the Japanese to raise interest rates has shifted from red to amber. It hasn't reached green, but it should before the end of the year.

The Tankan confirmed healthy exports are helping large manufacturing firms lead the recovery. It seemed like old times. The weaker yen in the last two years has boosted competitiveness. But it is not old times.

In recent years Japan has suffered under the burden of debt, deflation and deindustrialisation. Now deregulation is the main influence. At the Denver summit the Japanese agreed to deregulate their economy, opening it up to increased competition. This should have benefits, as deregulation removes economic barriers, boosting efficiency and productivity. Yet these benefits may take time to materialise, and the immediate impact could be negative, as firms in sectors to be deregulated like retailing, wholesaling and banking restructure and cut costs.

The impact is likely to be greatest among smaller firms. This was reflected in the Tankan, which showed that while business confidence for large manufacturing firms is rising it is weak for small businesses not involved in manufacturing.

Such weakness highlights the different characteristic of Japan's recovery. Data on Friday showed Japanese unemployment creeping up to a record high of 3.5%. Yet summer bonuses, which form a significant proportion of the annual take-home pay, are rising strongly. So if consumers want to go out and spend, they have sufficient money to do so. But just like the recovery in America and here, it will take time for the feelgood factor to return.

The biggest threat to a rebound in Japan is policy. The deregulation measures being pushed through are already denting sentiment. Fiscal policy is being tightened as the Government attempts to bring its finances back into shape. This is a tall order, because of excessive government spending in recent years to keep the economy afloat and the rapidly ageing population. We must hope the Japanese have learned from Continental Europe that excessively tight fiscal policies can be economically damaging. That leaves interest rates. If rates rise prematurely, with the yen appreciating as a result, the recovery could be knocked off track.

In view of this, the Bank of Japan will wait for more signals, including evidence that the economy has rebounded after the April tax increases. This should be visible in coming months. The low rates of 0.5% were appropriate for the economy when it was flat on its back, facing downside risks. Now, with growth heading for 2.5% this year, higher rates are inevitable. And once the Bank of Japan is confident about raising rates it will be keen to return them to a normal level, around 2% or so. This will be similar to pressures the US Federal Reserve faced in 1994, when after keeping rates abnormally low at 3% it doubled them in the space of a year. Then, higher US interest rates sparked a sell-off in world financial markets.

One should not underestimate the global impact when Japanese interest rates start rising later this year. International investors should be prepared for it, so the fallout may not be huge. Such rate increases pose more of a concern to world markets than the threat of Prime Minister Hashimoto last week that Japan would sell their vast holdings of Treasury bonds. US markets panicked until it became evident it was a hollow threat. There are few places apart from the dollar the Japanese want to put their money, and the last thing they want to do is bring it back home, making the yen stronger and derailing the recovery. But his comments reflect growing US-Japanese trade tensions. This, and the prospect of an eventual Japanese rate increase, should keep world markets on their toes.

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