insight Japan

Quarterly journal of news & analysis
ISSN0966-8071 • APRIL 1993 • VOL.1 NO.4 • £2.50

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Cold comfort, or a warmer economic climate?

GERARD LYONS

"When America sneezes, the rest of the world catches a cold," goes the familiar saying, which highlights the importance of the US economy. When America is booming, it sucks in imports at a rapid pace, providing a strong locomotive to the world economy. But when the US hits problems, the rest of the world soon knows about it, as exports to the US slump. But what happens when things go wrong in Japan? Is there the same impact as a downturn in the US? .

It is no longer possible to think of the US as being the only dominant Western economy. As recent meetings of the Group of Seven industrialised countries (the G7) have shown, Germany and Japan are playing an increasingly important role. We should be paying as much attention to events in Tokyo as in Washington.

The post-war success of the Japanese economy needs no introduction. Less clear, and more surprising, are the problems that have befallen Japan in recent years. In the late 1980s, the economy grew at an unsustainable pace. There were similarities to events in Britain, as bank lending soared, particularly to the property sector, and inflationary pressures intensified, with land prices and the stock market rising sharply. The resulting "bubble economy", as it is now known, was clearly unsustainable. It was halted by a tighter monetary policy, but at the cost of a Japanese style recession – best explained by the oxymoron, "growth recession". The economy is still growing, but at a sluggish pace.

The consequences of the bubble economy have taken many people in Japan by surprise. Consumer confidence has slumped as labour market conditions have eased and failing land prices have hit personal wealth far more than the dramatic collapse in the stock market ever did. And, in the wake of recent scandals, people no longer have faith that politicians will deliver the buoyant growth that has been the hallmark of Japan in recent decades.

Consumer spending has slowed in recent years, albeit from a high level, prompting a rise in unsold stocks and subsequent retrenchment by the corporate sector. Output and investment have declined. Financial sector problems have mounted: the weakness in stock prices has hurt securities houses, whilst the decline in land prices has added to the banks' bad loan portfolio.

By Western standards, of course, nothing appears wrong in Japan: the economy is still growing, the trade surplus is rising, inflation is low, the unemployment rate is only 2.3 per cent and the Government's healthy fiscal position allows it ample room to respond to any prolonged downturn in the economy. Last August the Government unveiled a Yen10.7 trillion fiscal package and an even bigger boost is possible in coming months. But as healthy as the position appears from the West, the problems are acute in Japan and will definitely have global implications.

LESS TRADE

The most obvious way a downturn in Japan affects the rest of us is through trade. Japan's trade and current account surpluses have risen sharply over the last decade and are now at record levels. In 1981, Japan's trade surplus was "only" $19.97 billion. By last year, it had reached a record £132.6 billion, as sluggish Japanese growth led to a fall in imports.

Japan is heavily criticised for restrictive trade practices – and an inefficient retail distribution system. These combine to make the Japanese market very difficult to penetrate, although many Western companies have had more success in recent years. The ratio of imports to GNP is only 16.7 per cent in Japan, compared with 11.6 per cent in the US, 40.8 per cent in the UK and 41.9 per cent in Germany. This ratio is small. Indeed, last year, British imports of $207.3 billion exceeded Japanese imports of $198.2 billion. Despite this, the volume of imports to Japan still makes it an important export market for many countries, particularly those elsewhere in Asia.

Probably the most interesting effect is what happens to Japanese capital. Japan is a very big investor in overseas countries, and problems at home could have profound implications for the future direction of Japanese capital flows.

During the last two decades there has been a significant change in outflows from Japan. During the 1970s Japan invested primarily in the manufacturing sector and in Latin America and Asia. In the 1980s Japanese foreign direct investment diversified. In addition to heavy investment elsewhere in Asia, there was a rapid increase in investment in the US and in Europe. Furthermore, there was heavy investment in services, as well as manufacturing.

The 1980s saw rapid growth in foreign direct investment amongst developed countries. For Japan, the outflow was particularly dramatic in the second half of the decade, such that by 1989 Japan became the biggest source of direct investment outflows. But since 1989 Japanese direct investment overseas has fallen.

CORPORATE RESTRUCTURING

This trend is set to continue, as the Japanese corporate sector restructures. Whilst Japanese companies are likely to remain heavy investors in Europe, the Japanese recession has already led to a greater emphasis on the need to generate profits. This is likely to favour investment elsewhere in Asia, where advantage can be taken of low labour costs.

But it is not just Japanese companies who have become more cautious. In common with their international competitors, Japanese banks have adopted a cautious lending stance in recent years. Not only is bank lending growing at a historically low rate in Japan, but Japanese banks have reduced their international exposure. This process is unlikely to be reversed quickly, given the scale of bad loans that Japanese banks face.

Despite the "growth recession" Japan is still the best placed of all the G7 countries to offer international aid, particularly to Russia. In a difficult global economic climate, where the US has a huge budget deficit and Continental Europe is in recession, it is only Japan, with its record trade surplus and healthy fiscal position, that can play a key role. With this year's G7 summit taking place in Tokyo in July, there is added reason for expecting the Japanese to want G7 to succeed. But even this will not guarantee that Russia receives the capital it needs. The Japanese will remain wary of providing assistance in the absence of a sensible long-term economic strategy in Russia.

Arguably, the most interesting aspect of the Japanese downturn is the impact it will have on Japan itself. In recent years, there has been steady progress towards more openness in the Japanese economy. Regulations in the financial system have been eased. The retail distribution system has been relaxed. Recession may slow this momentum towards change.

Probably conscious of this possibility, and realising the need for Japan to continue to fulfil its international commitments, the US administration is putting pressure on Japan to play a more important role in boosting the world economy. For the US, central to this is the need to reduce Japan's trade imbalances.

When President Reagan tackled the US-Japanese trade imbalance he focused on macroeconomic adjustment. The US pressurised Japan to boost domestic demand, in order to suck in imports, and successfully sought an appreciation of the yen, through the Plaza and Louvre accords. By contrast, President Bush tried to tackle the problem by removing "invisible barriers" in Japan. These were either unfair practices or cultural barriers which the US Government felt limited US exports to Japan.

The key development in recent years was the Structural Impediments Initiative (SII). This sought to remove some of the so-called "invisible barriers", but the major element of SII was the fact that the Japanese agreed to boost public works spending through the 1990s.

It is not clear whether the Clinton Administration will focus on macroeconomic adjustment, or the removal of invisible barriers as a way to open the Japanese economy. The likelihood is that it will be a combination of the two. This would be good news for the world economy. It would reinforce the trend towards deregulation in Japan and it would force the Japanese Government to adopt more relaxed policies. Of course, the benefits from the opening-up of Japan would take time to be seen, but the gains to world growth and international trade from policy relaxation in Japan would be seen immediately.

OUTLOOK

If Japan's growth recession continued it would have serious consequences for the world: trade would weaken, overseas investment from Japan would fall and the Japanese Government might be less able to fulfil its international role. And the risk of a trade war could not be ruled out.

Fortunately, such a deterioration is unlikely. Previous sound economic policies should allow the Japanese Government to respond to the weakness of domestic demand and the rising trade surplus by unveiling a huge fiscal boost this spring or summer. Even though the financial hangover from the bubble economy may take time to clear, positive Government action should allow the Japanese economy to recover later this year. It may not be a cold that the world catches from Japan, but rays of sunshine from the east. □

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