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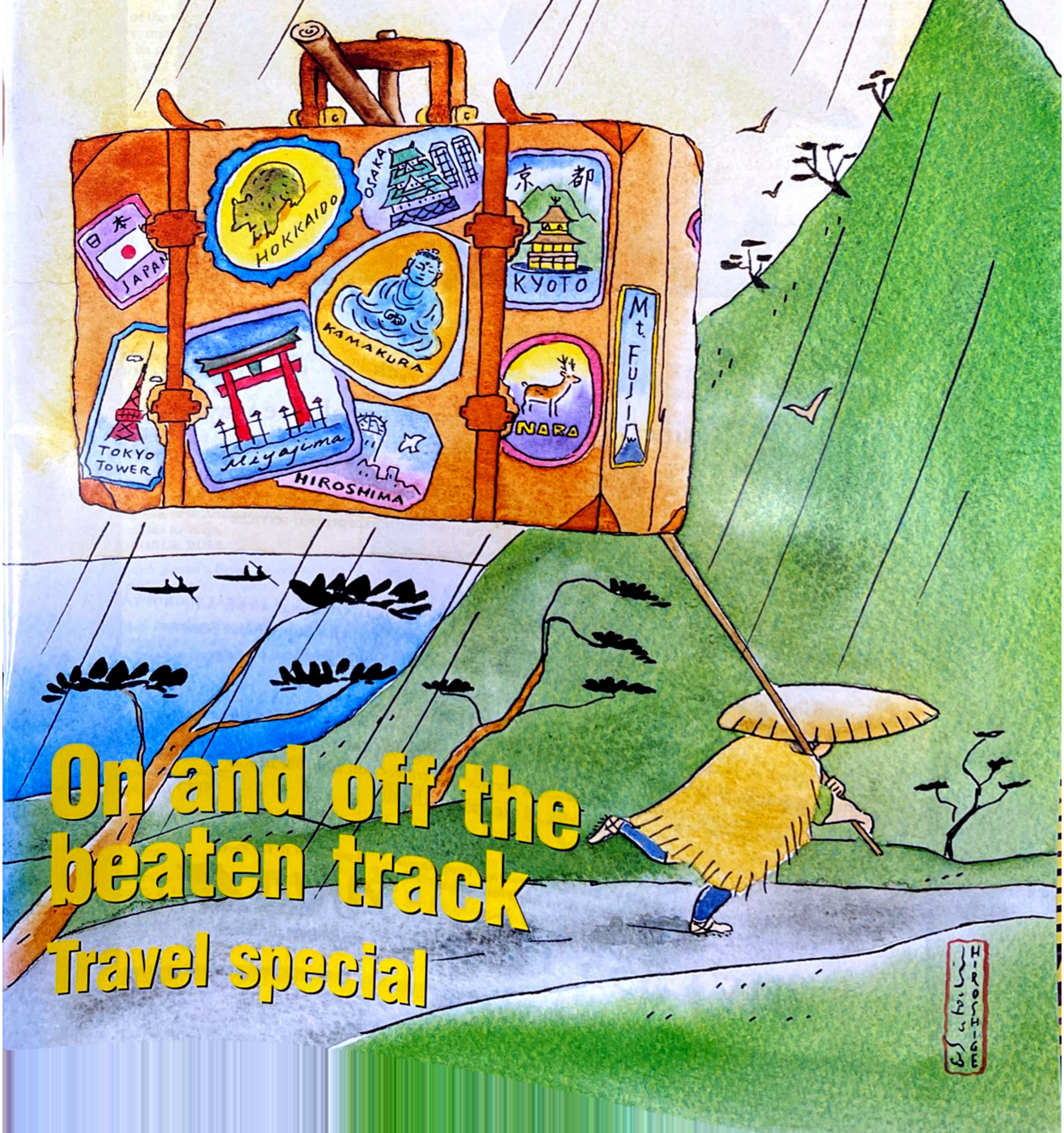
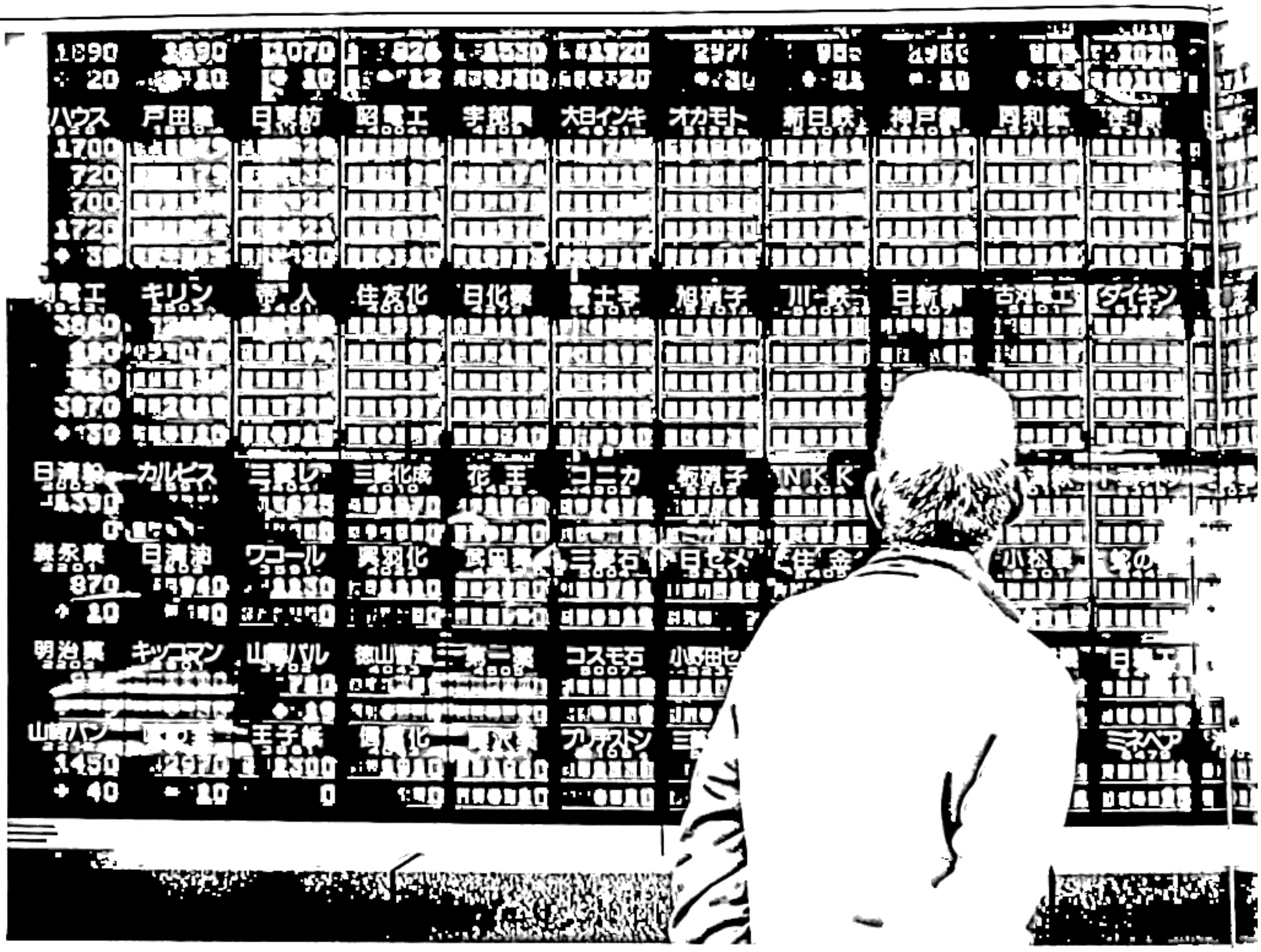


On and off the beaten track

Travel special



A time to invest in Japa

Is Japan a good place to invest these days? In the 1980s, investing in the Japanese stock market was a money spinner, particularly for British based investors. The booming Japanese economy sent the stock market (the Nikkei) higher, while the rising trade surplus pushed the yen stronger. The combination of a rising equity market and appreciating yen resulted in healthy returns to UK investors.

Then, the Japanese economic bubble burst in 1990 and the Nikkei slumped. After reaching a peak of 38,915.9 in December 1989 at one stage it had fallen to 14,485.4 by July 1995. Through the 1990s Japan's economic performance has been disappointing, yet there have been occasions when the economy has looked set to bounce back. In 1996, strong consumer spending resulted in Japan being the fastest growing economy in the Group of Seven (G7) major industrialised countries. Such strength proved short-lived, though, and the economy soon floundered.

Against this disappointing background the 1990s have not been good for Japanese equities. Misplaced expectations of a sustained rebound in the economy have resulted in many false dawns for the Japanese stock market.

By contrast, Japanese bonds have had a spectacular performance. Prices have soared, allowing yields to decline to record low levels. The combination of a disappointing economic performance, no inflation and low official interest rates (in September 1995 Japanese official interest rates were cut to 0.5 per cent) has created the best environment for bonds. Individuals in the main do not buy bonds: institutional investors do. In recent years, both Japanese and non-Japanese fund managers have bought Japanese bonds aggressively, as they have proved a better investment than equities.

PROSPECTS FOR JAPANESE FINANCIAL MARKETS hinge on many factors, the most important being the outlook for the economy. By the end of 1997 Japanese bond yields were low and the Nikkei looked tired and vulnerable, as economic problems persisted. The collapse in November of securities giant Yamaichi was not only the biggest post-war failure but highlighted the problems facing the financial sector.

The economy is not in good shape. Since taxes were raised in April 1997 economic activity has slumped. Consumer spending has been weak. If this was not bad

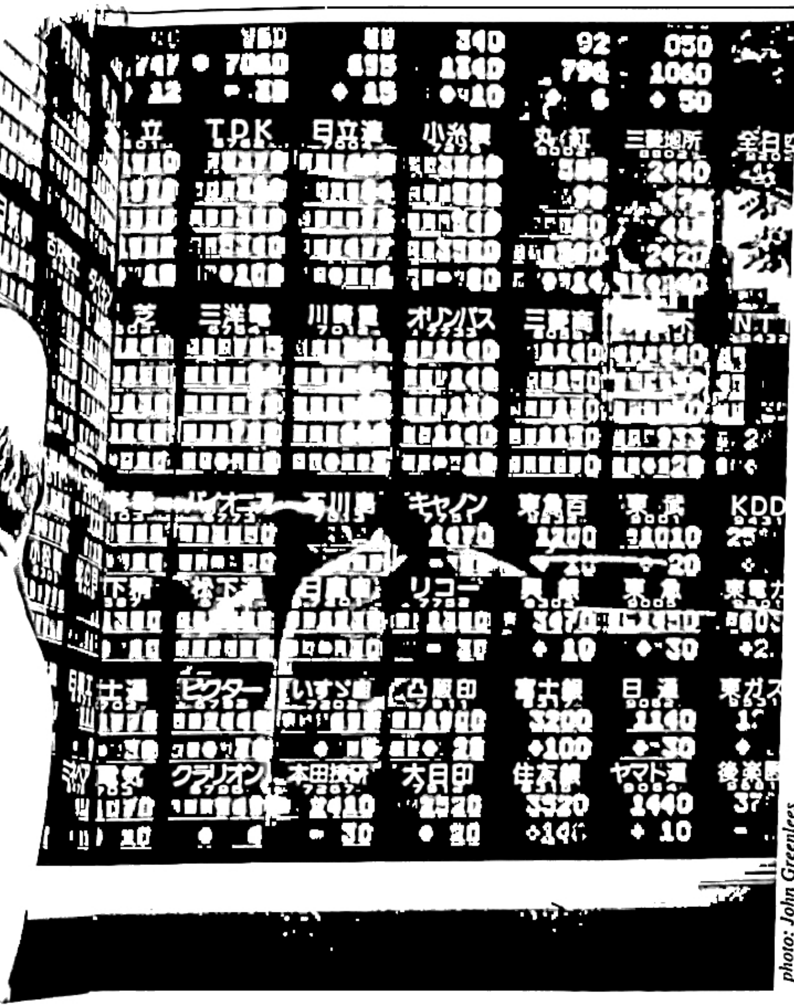


photo: John Greenlees

Japan?

GERARD LYONS

enough, the Asian crisis has made matters worse. Some 42 per cent of Japan's exports go to Asia, and Japanese banks have lent heavily to the region. Of total global bank lending to Asia of $822.9 billion, Japanese banks lent $276.2 billion.

This year is already proving a difficult one for the Japanese economy. A slowdown in domestic demand and Asian worries have compounded problems for the Japanese economy. Japan faces recession and deflation, as a tight fiscal stance, a credit crunch, Asian problems and a loss in confidence all combine to keep the economy weak.

The weakness of domestic demand since spring 1997 has already prompted aggressive US criticism of Japanese economic policy. These criticisms have intensified with the release, month after month, of healthy Japanese trade figures. In 1997, the current account surplus surged 60 per cent to ¥11.44 trillion, as exporters benefited from the yen's weakness and sluggish demand in Japan depressed imports.

Japan is the world's largest saver and it has a huge current account surplus, but domestic demand is weak. Japan should rely not on export-led growth, but on boosting demand and encouraging people to spend their savings. This is easier said than done, particularly when in recent years policy-makers' attention has focused on the rapidly ageing population and the need to reduce the budget deficit. Hence last year's badly timed and sizeable tax increases.

However, following the collapse of Yamichi there has been a sea-change in thinking in Japan. The focus switched away from reducing the budget deficit in order to address the future ageing problem, to boosting spending now to alleviate current problems in the financial sector.

AN IMPRESSIVE ¥30 TRILLION ($240 billion) boost has been provided to the financial sector, but even this may not prove enough. The major banks have recently revised their bad loan figures upward to ¥76.7trillion ($614 billion) and many banks are reducing lending, selling assets and some are even raising funds through share and bond issuance to raise capital ratios. In the process, the economy is suffering a credit crunch, as firms find it difficult to borrow and access funds.

As a result, a further fiscal stimulus is imminent, aimed at increasing public spending and reversing some of last year's tax increases. The scale of the stimulus needed is huge, not only to boost spending but to trigger a recovery in confidence among consumers and companies. The likelihood is that the Japanese Government will not do enough. Even if they did, a rebound in confidence may take some time, particularly as deregulation in many areas of the economy creates an additional feeling of uncertainty. As the American and British economies have demonstrated in recent years, in a disinflationary environment it takes some time for a recovery in the economy to feed through into consumer confidence, and so it is likely to prove in Japan.

In such an outlook, investors in the Japanese stock market should not expect immediate gains. Shifts in government policy will trigger renewed confidence in economic prospects at times, allowing the stock market to rally, but it may take some time for this to fully feed through.

Furthermore, there could be a shake-out in the financial sector, ahead of Japan's Big Bang. One consequence of this may be a reduction in cross shareholdings, whereby Japanese banks and insurance companies reduce their holdings of equities held in affiliated companies. This is a hurdle for the stock market to overcome.

Yet, for longer-term investors, the Japanese stock market may now be a good prospect. Globalisation and rationalisation have been two of the international trends during the 1990s, helping major firms worldwide. Japan is not immune to this: big is becoming best in Japan. Many of Japan's large firms should be well equipped to cope with any down-turn in Asia and should also be well positioned to take advantage of deregulation in the domestic Japanese economy. The biggest Japanese manufacturing companies can break-even at an exchange rate around ¥105-110 to the dollar; a weaker yen than this cushions them against problems elsewhere.

A big issue for Japanese assets is what Japanese savers do with their money. Although Japanese consumers are cautious at the moment, they have ample funds to spend. Japanese savers have ¥1,200 trillion ($9,600 billion) in financial assets. Against a background of low interest rates and yields at home, there is a strong argument for the Japanese to invest overseas, in higher yielding assets. If so, this would contribute towards a weaker yen. While the Japanese may be looking to diversify overseas, longer-term international investors may well wish to invest in Japan.

Dr Gerard Lyons is Chief Economist of Dai-Ichi Kangyo Bank (DKB) International.