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**Spend
spend
spend**

The way forward?

Americans and the Japanese need to swap places. Not physically but in behaviour. The Americans spend too much and save too little. By contrast, the Japanese are spending too little and saving too much. This is already causing problems for the world economy.

A continuation of current trends could drag Japan from recession into depression and pull the rest of Asia down with it, whilst a continued US boom would soon be followed by a US bust, with a collapse in the stock market and the dollar.

The US is acting as the locomotive for global growth, but if America runs into trouble this will be bad news for the world economy. To stop this happening the US needs to spend less and save more, allowing its economy to slow to a more sustainable pace.

In view of the problems that could affect the US, it is doubly important for Japan, the world's second largest economy, to bounce back soon. For this to happen Japan needs to save less and spend more. What then are the prospects for Japan?

The Japanese economy is in trouble. After a bad year in 1998 the economic situation is deteriorating in 1999. Confidence is low, demand is weak, investment plans are being cut and unemployment is heading higher. Despite this doom and gloom, the Government is forecasting a rebound in growth over the next year; in this, they appear to be in a minority of one. It seems that everyone else not only expects Japan to contract this year but many predict the outcome to be worse than in 1998.

Despite this dismal scenario, all is not lost. Positive changes are taking place in Japan. The financial and banking sector is undergoing a major upheaval, the final outcome of which will have a positive impact on the economy. A shakeout is taking place in many companies across the economy. Merger mania has characterised other economies and it could become a feature in Japan. The aim of the supply side changes that have already begun in Japan is for firms to become leaner and fitter. The worry is that without a recovery in domestic demand these firms could become skinnier and weaker.

To understand fully Japan's present predicament it is best to recall the start of the nineties when the economic bubble burst. It soon became evident the economy faced both a demand and a supply side problem. The demand side problem was the weakness of spending, as people and firms repaid debts accumulated during the bubble years. The supply side problem was the need to deregulate what was a heavily regulated economy.

The policy response to the economy's predicament was good, but not good enough. As spending by firms and people declined the Government sought to offset this weakness of private sector demand through a series of fiscal packages. Roads and bridges were built. This kept the construction sector happy. By contrast, few serious attempts were made to address the supply side problem and deregulate the economy.

Last year the Government announced more huge fiscal boosts but the financial markets were not impressed. Previous government spending had failed to turn the economy around

and so the financial markets doubted if another spending package would make much difference.

Yet the lesson from the nineties is not that fiscal policy does not work but that it cannot solve all of Japan's problems by itself. Demand and supply side problems need demand and supply side solutions. The demand side solution is higher Government spending alongside measures such as tax and interest rate cuts to encourage a rebound in consumer spending. The supply side solution is deregulation, aimed at encouraging greater competition across the economy. Now, some nine years after the bubble burst, demand and supply side problems are being addressed. Thus, there are reasons to be optimistic about Japan's longer-term prospects.

A high price to pay

Yet the price to be paid to turn the Japanese economy around is high. The price for the demand side solution will be increased government spending and high debt levels. A dramatic deterioration in the Government's finances has already begun.

The price of supply side change is a shakeout in the labour market, with wages and bonuses being squeezed and a large increase in unemployment.

The fear of unemployment plus the ageing of the population has led the Japanese to save. For instance, the poorest one-fifth

Memo to Japan: spend, spend, spend

of the Japanese population have savings five times their annual income. This cushions them against future problems. This may be good for their own finances but it is not good for the economy, starving it of the recovery in private sector spending that it needs. Japanese consumers have the ability to go out and spend if they want to but in current conditions they are unwilling.

There could yet be further shocks to hit the consumer if land prices fall. Residential land prices are still high and are yet to reach a level that could be sustained. By contrast, the stock market has recently performed well and if this improvement was sustained it could have a self-sustaining impact, helping to boost sentiment.

A recovery in spending is vital for an improvement in sales and in corporate profits. In recent years firms have learnt it is sometimes possible to have too much of a good thing, particularly when it comes to investment. Whereas some economies do not invest enough, others like Japan have probably invested too much. Because of excessive past investment the ratio of investment to GDP is still high. With immediate growth prospects poor this will reinforce the pressure on Japanese companies to reduce their capital stock. Moreover there is still a need to improve the rate of return on capital. In view of this, capital investment is set to fall in coming years. Because of the problems facing Japanese manufacturers



*Needed:
a little more
conspicuous
consumption*

Photo: Jeremy Hoare

there are often calls for the yen to weaken. Although there may be a case for the yen to fall eventually, it is not necessary now. A weaker yen would trigger further problems in Asia and divert attention in Japan from the supply side changes that are needed.

The US and the yen

In recent months the yen has firmed, benefiting from a large current account surplus. The yen's rally against the dollar has also been helped by doubts about the sustainability of the present US economic boom.

One reason why financial markets overlooked Asia's problems in 1997 is that too much attention was paid to low inflation and healthy government surpluses across the region. Trade deficits and deteriorating private sector balance sheets were ignored. There are a number of similarities between the US now and the Asian economies that got into trouble two years ago. The US is enjoying low inflation and healthy public finances, but the US trade deficit is becoming sizeable. At the heart of the US's problems is that Americans are now saving less than at any time since 1936.

If the US continues to run large trade deficits this leaves the dollar exposed to any shift in international sentiment towards it. Once foreigners stop wanting to accumulate dollars, it will run into trouble and fall. The large trade deficit not only poses problems for the dollar, it has already led to trade tensions at the start of the year, with the US worried about cheap steel imports. The trade situation needs to be watched closely.

If the dollar gets into trouble, the yen will strengthen and there will be a pressing need for Japan to turn its economy around soon.

This year began with huge euphoria towards the Euro. The economics underpinning the Euro are bad and point to troubles ahead. Despite this, the euphoria that greeted its introduction could be sustained this year.

The introduction of the Euro led Japanese Prime Minister Obuchi to visit France, Italy and Germany in January. Obuchi stressed the case for a tripolar currency system of Euro, yen and dollar and not just a bipolar system based on the Euro and dollar. His fear was that the yen could be relegated to a small, regional currency. The Prime Minister's comments, supported by policies at home, have led to a stable and firm yen. Obuchi highlighted the importance the Japanese attach to a leading international role for the yen. For the yen to play such a role requires a recovery in Japan, its financial markets to become more open and the yen to be more widely used internationally.

If this is to happen then one area where Japan and the yen can play a leading role is Asia. It was already evident towards the end of last year that the Japanese have this in mind. A number of initiatives were announced late last year by the Japanese, including the Miyazawa Plan, which aimed to provide \$30 billion to help crisis-hit Asian economies. Half of this money was to be made available in long-term aid and the other half in short-term growth boosting funds. Such initiatives are welcome, but the best news for Asia would be a recovery in Japan, as it is the biggest economy in the region. If this is to happen, the Japanese need to start spending - and soon.

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