economic *insight*

Mixed blessings in disguise

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'When America sneezes, the rest of the world catches cold'. This saying used to symbolise the importance of the US for the world economy. It illustrated that the US was often the locomotive for the world, pulling growth along or slowing it down sharply. Although America's dominance is less than it was, its economy is still extremely important. But what of the world's second-largest economy, Japan? How important is Japan for the rest of us?

Throughout the 1990s the Japanese economy has barely grown. Having just pulled itself out of recession at the end of 1993, Japan is now back in another one. Despite this dismal performance the rest of the world economy seems to have been largely unaffected. How can that be?

Although Japan is a large economy, it does not have such an impact on growth elsewhere. This is partly because countless regulations have limited the extent to which foreign exporters have been able to sell to Japan. Thus the weakness of demand in Japan has not been fully transmitted overseas. In fact there is some evidence that the rest of the world has benefited from Japan's current economic discomfort.

THERE ARE SEVERAL FACTORS accounting for Japan's present difficulties, not least the debt overhang from the days of the Bubble economy. But deregulation has compounded current problems for the Japanese economy by opening it up to foreign competition. This is excellent news for foreign companies which are now able to sell into the Japanese market. But it is not such good news for Japanese firms. Increased competition is forcing Japanese enterprises to cut prices. Thus their margins are being squeezed; this in turn is forcing them to cut costs, including their payrolls. These problems are set to continue as foreign companies will continue to make inroads into the Japanese market. In the first three months of this year, for instance, the volume of imports into Japan rose by a sizeable 15.1 per cent from a year earlier.

Another factor adding to Japan's problems is the strength of the yen. Whereas countries like America and Britain have reaped strong gains from depreciation of their currencies in recent years, Japan has suffered from currency moves. The yen's appreciation has ensured pain for Japanese businesses and gain for Japan's competitors.

A weaker yen would clearly provide one of the solutions to Japan's present difficulties. But for that to happen the Japanese would need to take a more pessimistic view of the yen. That could happen but not just yet. Ironically the Japanese have accounted for the yen's strength during the last year, despite the problems this has caused at home. Last summer, Japanese portfolio investors, such as pension funds and life insurers, changed their behaviour. Fed up with losing their money abroad, they have since kept their money at home, buying bonds or staying in cash. The fear for outsiders is that global stock and bond markets could suffer if Japanese funds decide to repatriate more capital back to Japan. But they would only do this if financial problems in Japan got worse.

SUCH A COURSE OF EVENTS would not be good news for international financial markets. Money makes the world go round, and the Japanese have a lot of it. At the end of last year, Japan's total net holding of overseas assets was $689 billion. The USA, by contrast, is a holder of large overseas debts. Thus the damage that could be caused by a repatriation of Japanese funds could be quite large. Fortunately this situation is unlikely to occur as it would only compound problems for the Japanese themselves. In fact, the Japanese authorities are likely to act to solve financial problems in Japan with lower interest rates, a fiscal boost and intervention to encourage a weaker yen. This would minimise the fear of capital repatriation.

Other developments on Japan's capital account have been good news for the rest of the world – and again this is because of problems in Japan. Japanese banks, for instance, have found it difficult to lend to good borrowers in Japan on account of the recession. Consequently many of them have increased their lending overseas, particularly in South East Asia and have stimulated economic growth in this region.

Domestic economic difficulties have encouraged increased foreign direct investment. This year, large Japanese companies are planning for one-quarter of their investment to be overseas. Again, this is good news for the countries who will receive such inward investment.

When the Japanese economy is truly open, Japan's problems will have a negative impact on the rest of the world. But for now, there is a strange situation where problems in Japan are having a positive impact elsewhere. The removal of barriers is allowing foreign exporters to sell into Japan, whilst increased overseas bank lending and foreign direct investment is improving economic prospects elsewhere.

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