Papering over cracks in the economy

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Japan's economy is improving after government help, but the need for further change means recovery will be slow, argues Gerard Lyons

The two economic success stories of the post-war period have been Germany and Japan. We know cracks are appearing in the German economy, but what about Japan?

The Japanese economy has performed poorly throughout the 1990s; annual growth has averaged only 0.6% in the past four years. This is substantially weaker than the boom days of the late 1980s, when growth averaged 5.1%, and it is also much weaker than all other major industrialised countries. Since 1992 growth in Britain has averaged 2.1% and in Germany 1.4%.

Just as the UK had to recover from the excesses of the Lawson boom, Japan had to overcome the huge debts it incurred during its "economic bubble", when it borrowed on a much grander scale.

Problems in the financial sector have caused the most worries, notably the failure of some small banks and credit institutions. But even if the Japanese economy had performed well there would have been a need for a shake-out in the financial sector. Since the war the financial sector has been heavily regulated: barriers were erected between types of banks and interest rates were controlled. Regulations have been relaxed recently, increasing competition, squeezing margins and pointing to a shake-out.

However, the weakness of the economy has made the shake-out more severe than it might have been. Banks have had to cope not only with increased competition but also huge bad loans after corporate bankruptcies and poor economic performance. A halving of land prices, used widely as collateral, compounded this.

Fortunately the problems appear to be receding. The big banks have enjoyed record profits during the last fiscal year, helped by low interest rates, a steep yield curve and an improving economy. Most big banks will write off their bad loans in the next few years but some smaller financial institutions may still fail.

Just as the financial sector appears to be past the worst, so too does the economy. This is largely due to a switch in government policy. At the start of 1995 things looked bad. The strong yen was squeezing industry and consumer confidence was rock bottom because of the Hyogo earthquake, terrorist attacks and rising unemployment.

The government stepped in. Interest rates were cut to a historic low of 0.5%, the Bank of Japan intervened to weaken the yen and a £90 billion increase in public spending was unveiled in September. Such spending has been a hallmark of recent years and has pushed government debt to astronomically high levels. This will pose problems, but at least it has helped the economy recover during the past year. There has been a sharp rally in the stock market, consumer demand has picked up, corporate profits and private investment plans are improving.

Yet there are genuine worries about what will happen later this year, when the impact of last year's policy easing fades away and next spring's planned tax increases kick in. Consumption tax, Japan's version of VAT, is to rise from 3% to 5% and a "temporary" income tax cut announced a few years ago to give spending a boost is to be phased out.

The Bank of Japan is hoping to push interest rates higher. Although Japan's vast number of savers will benefit, higher interest rates could be counter-productive: the yen could rise still higher, squeezing industry; and long-term bond yields could grow, undermining investment plans.

Even if the Bank of Japan does opt to tighten interest rates they will not need to rise far because inflation will remain low for some time. Prices have actually fallen of late. This has reduced margins, forcing firms to cut labour costs by squeezing wages and, in some cases, laying people off. Even though Japan's unemployment rate has fallen in the last two months to 3.1%, low by European standards, job insecurity is now a reality in Japan.

At the root of concerns about the future are the structural changes Japan is undergoing. The pace of deregulation is slow, because of opposition from vested interest groups – in its latest three-year deregulation plan the government plans to remove 1,797 of the more than 10,000 regulations that cover industry – but change is occurring.

The clearest evidence is the movement of manufacturing production out of Japan. Many firms are establishing lower-cost centres elsewhere, such as South-East Asia and Wales, where the number of Japanese firms is set to reach 50 this summer. Previously the hope in Japan was that only low-cost, low-quality jobs would move offshore, but quality production and even research work is being lost abroad.

There have been large-scale job losses in manufacturing, amid gains in the retail and service sector. Traditionally such a shift implies slow growth. But the government's Economic Planning Agency doesn't think so. As long as deregulation measures are implemented, it believes the economy can grow at 3.5%. Therein lies the problem. If deregulation remains slow, then even the government admits growth may average only 1.75%, rates more typical of western Europe. Further change is inevitable. After initial problems, the outcome could be a leaner, fitter economy.

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