Thunder clouds over Tokyo

Japan is in recession, the Nikkei has slumped and a financial crisis is looming. DKB International chief economist Gerard Lyons suggests how it could be averted

JAPAN is in trouble and its problems look set to mount. The world's second largest economy only just pulled itself out of recession at the end of 1993 and already it is back in another one. This recession could last a long time and will exacerbate financial problems.

A host of factors account for Japan's difficulties. They include:

● **Debt.** Just as Britain went on a credit binge in the late 1980s so did Japan, only on a grander scale. The banks are nursing huge bad loans, which have been made worse by subsequent events. The stockmarket has halved from its December 1989 peak. Big city land prices are 47 per cent below their highs and falling.

● **Deregulation.** Japan's economy is still heavily regulated. This has been at the root of the current trade dispute with the United States. Now deregulation is occurring, albeit at a slow pace, and is opening Japan to foreign competition.

● **Deflation.** Competition is forcing companies to cut prices and costs to survive. The casualty will be jobs. In recent years companies have hoarded labour but this cannot continue. Unemployment is at a record, albeit of only 3·2 per cent, but it will reach 4 per cent early next year.

● **Deindustrialisation.** Greater competition in Japan and the yen's strength are forcing manufacturers to move offshore, particularly to low cost areas in South East Asia. This is good news for companies but not for Japan's economy. But many small companies do not have the resources to move offshore and thus cannot cushion themselves from Japan's problems.

These four factors mean the economy is weak. The government needs to restore confidence and boost demand. If not, conditions will worsen, with the stockmarket being the first casualty.

The fear for outsiders is that Japanese investors may repatriate their capital as a result of their domestic problems. Japan is the world's top capital exporter. At the end of 1994, its net overseas assets stood at £430bn, with £300bn of that held by the private sector. The Japanese have invested heavily in many markets. Between 1972 and 1994 they brought a net £61bn of US Treasury bonds.

But last summer they changed their behaviour. Fed up with losing money abroad, they have kept their funds at home, buying bonds or staying in cash, despite an official discount rate at just 1 per cent. They have not bought shares and they are still reluctant to do so because of the poor economic outlook and the looming financial crisis.

The two main buyers of shares have been the government, through its "price keeping operation", and foreign investors. Foreigners bought £29bn of Japanese stocks in the first half of last year but even they have kept out of the market recently.

If no one is prepared to buy shares it is bad news for Japan. The Nikkei index plunge from almost 39,000 in December 1989 to just over 14,300 in August 1992 contributed to Japan's economic slowdown. It reduced consumers' wealth, limited companies' ability to borrow and invest and reduced banks' profits and thus their willingness to lend.

A further fall in the Nikkei could even threaten the viability of some financial sector companies. The table gives a rough guide to the exposure of banks and large insurers to the Nikkei. It shows the stockmarket is not far from levels below which profits on their equity holdings disappear.

This matters for two reasons. Firstly, insurers have relied on hidden stockmarket profits to help meet client obligations. This is a particular concern because some insurers have guaranteed clients' returns of more than 4 per cent. This is more than insurers can earn on cash or bonds, which now yield less than 3 per cent. In the past they would have realised profits on shares to meet any such shortfall but now they cannot do so.

Secondly, banks have used unrealised gains on shares to boost their "tier two" capital and meet international capital ratios.

These same ratios limit the ability of banks to write off bad loans at a more rapid pace. Last year Sumitomo became the first Japanese bank since 1945 to announce a pre-tax loss as it announced a £5bn bad debt provision. But losses need to be covered by "tier one" capital, effectively shareholders' equity. This must must also exceed 4 per cent of a bank's total assets.

This constraint means many banks do not have the capital resources to write off bad loans at a more rapid pace.

Thus most banks have planned to write off their bad loans over a number of years. But the weaker the economic outlook the longer this problem will take to resolve and the greater is the risk that fresh bad loans will emerge.

When the stockmarket was last at about the current level in August 1992 it caused severe concern and prompted the government to unveil two fiscal boosts totalling £140bn within seven months. The crisis was averted and the market recovered. But we are back near stockmarket lows and, if anything, the outlook is worse because of the economy.

Fortunately, there are solutions to Japan's problems, although they are not without difficulties. They are:

● **Large-scale fiscal reflation.** This will be aimed at boosting domestic demand and preventing a deepening recession. The trouble is that Japan's public finances are in a terrible state, with the underlying budget deficit far worse than America's.

● **Prolonged low interest rates.** Soon the discount rate will be cut to 0·5 per cent. This will help banks overcome their bad loans.

● **A weaker yen.** The currency's strength is squeezing the economy.

The danger is that the weak coalition government will not act decisively. But I think the scale of the problem will force it to boost the economy and provide direct assistance to the financial sector, particularly the banks.

The key to the yen will be portfolio flows. If the government does act then this will prevent the capital repatriation outsiders fear.

In fact it may well force a change in Japanese investor behaviour this summer. If interest rates fall there could be a shift out of cash into stocks, helping the Nikkei. Japanese investors may then invest in higher yielding overseas markets, particularly if they believe the yen has peaked.

Above all, the government needs to deregulate faster. This would reduce the trade surplus, weaken the yen and in the long-term improve the dynamism of the economy, particularly for small- and medium-sized companies. The trouble is that it would reinforce short-term problems. There is no easy way out for Japan, but in the past the economy has overcome shocks. Observers are asking if it can do the same again.

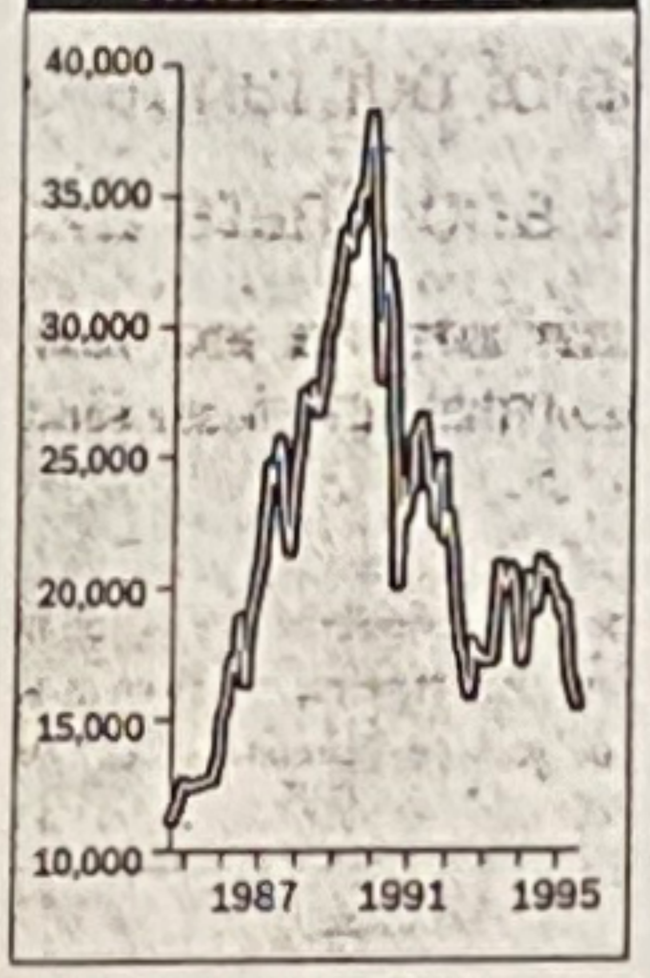
NIKKEI THREAT TO HIDDEN RESERVES

The level of the stock market below which hidden reserves disappear

Nikkei level	City banks	Long term credit trust banks	Insurers
16,000–15,000		Chuo Trust and Banking	Chiyoda, Mitsui, Yasuda
15,000–14,000	Hokkaido Takushoku		Asahi
14,000–13,000	Daiwa, Bank of Tokyo	Yasuda Trust	Dai-Ichi
13,000–12,000	Tokai, Fuji, Sumitomo, DKB, Sakura	Toyo, Mitsubishi Trust	Meiji, Nippon
12,000–11,000	Sanwa, Mitsubishi	Sumitomo Trust, Mitsui Trust, Nippon Credit	
11,000–10,000	Asahi	Long-trem Credit Bank, Industrial Bank of Japan	

Source: DKB Research Institute, Tokyo

NIKKEI INDEX



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