

SPUTTER, COUGH, CHOKE

Japan Misfires as the
Engine of Asia

By Robert Alan Feldman

Hopes in Asia Pacific that Japan will help solve the region's financial crisis are all but certain to be dashed. Japan does not have the fiscal power and maneuverability to act as the engine of Asia. More important, it may not have the political will.

Since the equity and real estate bubble burst in 1990, Japan has abdicated the intellectual leadership of the region. By tinkering with and expanding—rather than junking—the state-capitalist economic model of the postwar period, Japan is offering a “wagons in a circle” example to Asian countries. Even if that strategy were right for Japan (which is doubtful), it is almost certainly not economically optimal for other Asian nations.

But economic optimality may not be driving either Japanese or Asian policy. If “Asian values,” rather than the conservatism of wealth, have been the determining factors behind Japan's torpid reform efforts of the 1990s, then the policy choices made by the Asian countries may not accord with Western logic. To the extent that Asian countries imitate the Japanese reform model, economic prospects for the region—and for the firms that operate there—could improve more slowly than now expected.

JAPAN'S ECONOMY: DOWN AGAIN IN 1998

The Japanese economy is now facing gale-force headwinds from private domestic demand. Fight as it may, the government's demand-support policies are unlikely to generate positive growth in 1998.

Business investment has already entered a downturn. Typically, such downturns last

Robert Alan Feldman is chief economist for Japan at Morgan Stanley Dean Witter. The views expressed in this article are the author's and not necessarily those of Morgan Stanley Dean Witter.

two to three years, and so far no sign of revival is visible. In addition to negative profit momentum, tighter credit standards imposed by banks are causing a credit crunch among small and medium-sized businesses. *Housing investment* is in just as serious shape. The effects of low interest rates and government housing programs have worn off, and the outlook for income growth is poor. Moreover, latest indications suggest that residential land prices are headed for another dive—hardly the time that households will rush to buy. *Inventories* relative to sales are at the highest level since 1975. The March decline of nearly 14 percent in overtime hours in manufacturing is a harbinger of a continued decline of production, income, and demand. Finally, the *export* outlook is cloudy. The drop of shipments to Asian economies, which make up about 40 percent of Japan's exports, will likely cut about 1 percent from Japanese GDP growth. Even the weakening of the yen against the dollar and European currencies and continued upswings in the United States and Europe will barely offset the losses to Asian destinations. (Net export contribution growth may be positive—only because Japanese imports are collapsing.)

Both fiscal and monetary are fighting against the decline. Although the initial 1998 package announced at the end of the year should generate a modest gain in growth, it works spending during fiscal 1998. Moreover, the package's replacement of the 2 trillion yen of income tax cuts, which had been withdrawn in February 1997, should replace much of income lost to lower overtime and the squeeze on wages. In addition, the Bank of Japan is maintaining its low interest rate policy, and is providing huge quantities of credit through nonstandard routes as a means to offset the credit crunch.

These measures put a floor under the economy for 1998, but are not likely to spark sustainable growth.

PRICE AND NONPRICE COMPETITION

The yen, already weak against the dollar, is unlikely to strengthen and may weaken fur-

ther, putting more downward pressure on the currencies of Asia against the dollar. That would exacerbate foreign debt problems in Asia, destabilize financial systems and corporate balance sheets further, and worsen and lengthen the Asian crisis. Certainly in the recent past, weakness in the yen against the dollar has been followed by Asian currency weakness. The yen's fall—to 132 yen to the dollar—in early 1998 coincided with the weakest point for many Asian currencies, and its subsequent rebound coincided with rebounds of some of the Asian currencies as well. At current exchange rates, many Japanese industries remain highly competitive.

Japan also remains strong relative to Asian countries in nonprice competitiveness. Product quality and innovation are high. Labor is expensive but high in quality and reliability. Distribution channels are well developed. Technology levels are high. And infrastructure in most areas is far above the levels of Asian competitors—although not necessarily competitors from industrial countries.

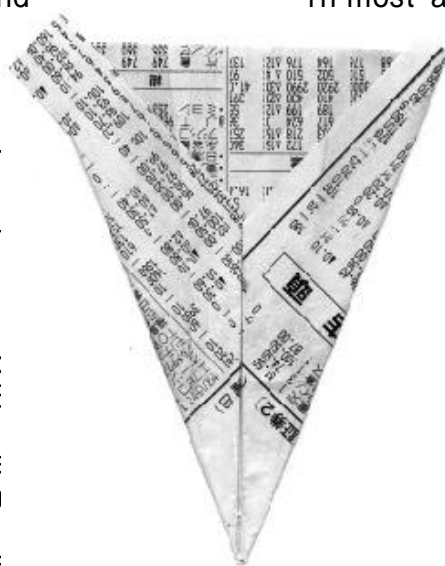
In short, in both price (exchange rate) and nonprice factors, Japan remains highly competitive against Asian competitors.

INTELLECTUAL LEADERSHIP: JAPAN HAS ABDICATED

The most important way for Japan to influence the course of the Asian crisis is to provide a model. Just as Japan's postwar success—such as an export-based, state-capitalist model—prompted developing Asian countries to follow that same model, Japan's current problems—such as the equity and land price collapses and banking problems of the 1990s—promise to shape Asia's reaction to similar problems. Asian leaders feel more comfortable with Japanese than with Western social philosophy. Japanese economic policies are presumed more consistent with "Asian values" and thus more likely to work than Western solutions.

DEMAND MANAGEMENT POLICIES

Japan reacted to the problems of the 1990s in several stages. First, it tried aggressive demand-support policies by raising public spending and cutting taxes and interest rates. General government fiscal balance shifted



from a surplus of 3 percent of GDP in 1991 to a deficit of more than 4 percent in 1996. The lesson was “when faced with a market crash and a banking crisis, the first thing to do is loosen fiscal and monetary policies.”

Japan could try that approach because its initial fiscal position was strong and real interest rates were high. It also had a huge excess of private savings over domestic investment and virtually no net debt denominated in foreign currencies. But conditions in other Asian countries (possibly excepting Taiwan) at the onset of the Asian financial crisis were totally different.

Now that Japan has run out of room for maneuver with both fiscal and monetary policy, what it does next will be the example it provides to Asia. If it tries to inflate its way out of a structurally weak economy, that would suggest to Asia that it try to do the same. In this sense, the fiscal package recently adopted in Japan would be a double-edged sword for Asia. It could support Japanese growth in the short run and hence the market for Asian exports, but it would be a disastrous example to countries already heavily indebted (in foreign currency debt to boot). The short-term gains to Asia from a year or two of Japanese growth could even be offset by long-term losses if Asia receives the wrong policy message.

PUBLIC-SECTOR REFORM

Japan also responded to the crises of the 1990s through public-sector reform to try to counter the tendency toward growth in government, in public-sector financial intermediation, and in special corporations. While helpful in earlier phases of growth, these institutions have led to inefficiencies that have been an important drag on growth in both Japan and Asia.

There have been two attempts at public-sector reform—under Prime Minister Murayama in 1994–95 and under Prime Minister Hashimoto in 1997—but both fell far short of hopes. Major privatizations and increases of accountability are yet to be implemented. A Hashimoto-led commission also proposed “administrative reform” to cut the number of ministries from 22 to 12 and shift jurisdictions among ministries. But the wings of that reform were clipped by vested interests in industry, bureaucracy, and politics well before the proposals were drafted

into legislation.

Despite private-sector complaints that the public financial system interferes with the private economy, steals business, and operates with unfair advantages, the public system continues to grow. The ratio of total assets of the Trust Fund Bureau (a Ministry of Finance bureau that invests funds of the Postal Savings Bank and Postal Life Insurance, public pension funds, and some other funds) to nominal GDP rose from 57 percent in 1990 to 81 percent in 1997. And recent proposals from the ruling LDP herald even larger lending by public institutions.

In short, Japan has not succeeded in reform of the public sector, despite a broad understanding of the problem, increasingly glaring inefficiencies, and a long series of scandals in a broad range of public-sector functions—hardly a good example for the rest of Asia.

FINANCIAL-SECTOR REFORM

The financial sector has also been a key focus of reform since 1991, when investors were shocked by even the first estimates of the extent of bad loans—20 trillion yen (about 4 percent of nominal GDP). Japan first tried a strategy of forbearance (not strictly forcing recognition and writeoff of bad loans) combined with demand stimulus in the hope that financial institutions would earn their way out of trouble. But the strategy failed, both because early estimates of bad assets were wildly low (recent estimates are many-fold greater than the initial estimates) and because growth was too weak to generate profits to write off the ballooning bad debts.

The focus of financial-sector support then shifted to tax relief. At a high cost in lost tax revenue, financial institutions were allowed to write off bad loans. Indeed, financial institutions were responsible for much of the plunge of corporate tax revenue from 19 trillion yen in fiscal 1989 to about 13 trillion yen in 1994–96. As estimates of bad debts continued to mount, depositors began shifting deposits out of the private system into the postal savings system.

Reform during 1994–96 also involved a quiet but clear improvement in the rules of financial oversight coupled with creation of a better safety net for depositors. The definition of nonperforming assets was tightened, and requirements for their disclosure were strengthened. The Deposit Insurance

Corporation was mobilized to liquidate financial institutions; its resources were augmented by increased premiums on banks, and its scope for borrowing was enhanced. In addition, work was begun on better capital requirements for banks, and life insurance companies were subjected to "solvency ratios," the equivalent of capital standards. But here too there has been backsliding, such as easing the accounting treatment of market assets to allow institutions to avoid declaring trading losses on bonds at book closing. Moreover, by mid-1996, it was clear that a true solution to the financial-sector problem was not in sight.

The third stage of financial-sector reform, announced with great fanfare in autumn 1996, was the Big Bang, a set of legal reforms encompassing a new central bank law, a new foreign exchange law, a new financial oversight agency law, a new holding company law, tightened accounting standards, increased cross-entry of financial firms into each others' traditional business areas, and many other reforms. But the commitment to Big Bang reforms was sorely tested in 1997, when several major financial institutions underwent stress, including bankruptcies.

In the wake of these disruptions, the authorities have embarked on actions that have shaken investor confidence in their willingness to enforce efficiency in the financial sector. For example, they have declared their intent not to allow the exit of any more large banks. And the weak conditionality on the injection of public capital into institutions raised questions about how sharp the authorities' teeth really are. Moreover these injections of public capital are more likely to prolong excess capacity, continue pressure on margins, and extend the caution of banks toward borrowers than to solve any of these problems.

In short, Japan's signals to Asia regarding financial reform have been mixed. While pursuing a clear agenda of improving rules on competition, oversight, and accounting, policymakers seem to be trying to maintain the status quo within the new set of rules. Because the authorities are not willing to take the consequences of recognizing losses, potentially productive resources are being withheld from the economy. The eruption of new scandals, including multiple murders and

suicides, has resulted in all-time low confidence in the financial system.

POLITICAL REFORM

The recession of 1991–93 knocked the LDP out of power for the first time since it was formed in 1957. In the year following the June 1993 general election, a motley coalition of old-line opposition parties and reformist LDP splinter groups managed to pass important political reforms. They eliminated multi-member election districts (2 to 6 members per district) in the Lower House of the Diet and replaced them with a combination of single-member districts and super-regional districts (with many seats allocated on the basis of party votes in the region). They reapportioned all districts to correct inequalities in the weight of votes between different parts of the country. And they strengthened campaign financing laws.

But the reforms have had little effect on economic policy. The LDP regained power in 1994 by forming a coalition with its former arch-rival, the Socialist Party, and in the run-up to the October 1996 general election, the LDP-led government favored such old economic chestnuts as public works spending and bigger subsidies for farmers. The usual coalitions of vested interests have also returned to blocking important deregulation items.

Voters, on balance, have validated the status quo. The fall in voter turnout in recent elections indicates a generalized antipathy toward the state of politics, but it does not alter the incentives felt by national political parties. For example, the 1996 general election virtually wiped out the Socialists and gave the LDP a near majority in the Lower House. And renegades from opposition parties have since joined the LDP, returning it to its past status.

Japanese voters seem to prefer familiar stagnation to the uncertainties of economic reform. Optimistic Western observers hope that the voters' preference grows out of the relative wealth of the Japanese people and that it will not flourish in the poorer Asia-Pacific soil. But the Japanese election results may also stem from the part of Asian social philosophy that values social stability over growth. The Upper House election in July will be the next test of Japanese voter attitudes. Should voters again signal their preference for stability over growth, the lesson is not

likely to be lost on leaders of Asia-Pacific nations. If Asian leaders act on that lesson, rather than in line with more aggressive reform models, hopes for rapid economic reform in the region would be clouded by the prospect of a more prolonged period of economic adjustment. ■