JAPAN’S ECONOMIC CHALLENGE AND THE IMPLICATIONS FOR AUSTRALIA

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Japan is currently experiencing its deepest economic downturn of the post-war era. The economy has contracted by at least 4¼% since the most recent peak in the January-March quarter of last year (Chart 1a), compared with a decline of 2.7% in what was, until now, Japan's worst post-war recession, the one which followed the first oil shock of 1973.

Unlike that earlier episode, however, the current downturn has been accompanied by price *deflation* - that is, by an outright fall in the general level of prices, after allowing for the impact of last year's sales tax increase. As a result, *nominal* GDP (the level of economic activity measured in today's yen) has also fallen over the past year (Chart 1b).

Contractions in nominal GDP have been extremely rare in the post-war era, when recessions have usually resulted from belated attempts by governments and central banks to reverse accelerations in inflation (Chart 1c). There have been only three such episodes in the United States since the war, and none since 1958. In Germany there has been only one (and it brought to an end the political career of the author of Germany's *wirtshaftwunder*, Ludwig Erhard); in Britain none at all. In Australia it has happened twice, in the recession of the early 1960s and in 'the recession we had to have' in the early 1990s. In Japan, it has not happened since the 1930s.

Contractions in nominal GDP are particularly painful for economies with high levels of debt. In a typical post-war recession, when real GDP is declining but inflation, though usually falling, is still positive, debt will normally decline as a proportion of GDP if the rate of growth of new borrowing slows sufficiently (which it typically does). But if nominal GDP is falling, then debt burdens will tend to rise as a proportion of GDP even if new borrowing ceases altogether. And if enough debtors get into enough trouble, then - as we will recall from Australia's experience earlier this decade - then creditors can get into trouble as well.

The risks posed to the stability of the entire financial system are thus much greater than in an 'ordinary' recession. And the traditional antidote to recession of cutting interest rates is much less likely to work.

For Japan, where the ratio of debt to GDP is considerably higher than for any other advanced economy, the fact that *nominal* GDP is falling makes the financial pain of the current recession especially acute..

The unusual nature of the current slump in Japan will be further dramatically highlighted when, sometime before the end of this year, Japan's unemployment rate - already the highest since Japan began compiling such statistics in 1953 - exceeds that of the United States for the first time (Chart 1d).

This is likely to be a cathartic moment for Japan. Maintenance of full employment, almost irrespective of the ebbs and flows of the business cycle, was supposed to be one of the crowning achievements of the Japanese economic system: it was meant to be

one of the main rewards for the many sacrifices made by ordinary Japanese, both as workers and as consumers, in the interests of the system as a whole.

So the time when Japan's unemployment rate passes America's may serve forcefully to illustrate what many Japanese suspect already: that Japan's so-called '1940s system' has passed its use-by date. The key principles of this system - elements of which date back to the Meiji era, when they were consciously copied from Bismarck's Prussia - can be summarized as follows:

- the primary purpose of economic activity is production, not consumption, so that the economic system is run for the benefit of producers, not consumers;
- flowing from this, the nationality of producers is important - production should be controlled by Japanese, not by foreigners;
- the financial system should be controlled to serve the interests of producers of 'things', not savers or shareholders;
- producers are expected to 'compete out' - that is, to prove themselves in export markets through attention to efficiency and product quality - but are 'protected in' from foreign competition: in effect, exporters provide the means by which cross-subsidies are provided to uncompetitive and inefficient - but labour-intensive - agricultural, distribution and services sectors;
- producers accept a wide range of social obligations - including in relation to employment (maintain it), investment (undertake lots of it), profits (don't pursue them too aggressively) and income distribution (don't widen it) - in exchange for the protections offered by the system; and
- real authority rests with bureaucrats, rather than elected politicians, lest consumers ever seek through the democratic process to overturn the system.

It has to be said that this system has served Japan extremely well for most of the post-war period. Under it, Japan has progressed from the ruins of the aftermath of World War II to become the world's second largest economy, and its largest creditor. That is why the essentials of this system have been so widely emulated elsewhere in Asia. Indeed, I suspect that, were One Nation (and those in the Queensland National Party who seem to see it as their mission to have the Coalition emulate One Nation's stance on every issue) ever to get around to formulating their own vision of what the Australian economy ought to look like - instead of complaining about other people's - they would probably come up with something like Japan's 1940s system.

A major part of the problem facing Japan is that, over the past decade or so, progressively fewer and fewer of the requirements for this system to work properly have been met.

Since the 1940s system requires high levels of business investment whilst restricting opportunities for that investment to be undertaken by foreigners, high rates of personal saving are essential (Chart 1e). Typically these have been achieved through a

combination of carrot (tax breaks for saving) and stick (repressing consumption through high prices for housing and consumer goods and restricted access to consumer credit). Japan's saving rates remain high by OECD standards, although at around 13½% of disposable income in recent years they are nevertheless some 4 pc points below the average for the 25 years up to the mid-1980s.

While the Japanese system has suppressed consumption, it has encouraged investment. Not investment by foreigners, of course: foreign investment accounts for a smaller share of GDP in Japan that of any other Western economy (and of most non-Western economies) (Chart 1f) .

Japan has consistently devoted a much higher proportion of GDP to business investment than either the US or Europe (Chart 2a). Since the early 1970s, however, the rate of return on business investment has been consistently lower in Japan than in the United States: moreover, whereas the rate of return on investment has tended to decline in the former, it has risen substantially in the latter. Debt finance has been essential to sustaining high levels of business investment in Japan: had it been more reliant on equity capital, profitability might have been a more important consideration. As a result, by the end of the 1980s, the Japan's ratio of debt to GDP was roughly twice that of the US (Chart 2b).

One of the effects of the on-going bank crisis is of course that cheap credit is no longer readily available to an increasing proportion of Japanese businesses.

As a corollary of the importance of cheap credit, the Japanese system has also relied on on-going inflation of land prices, in order to provide the required collateral, and of stock prices, in order to underpin the capital base of the banking system (thanks to the special deal obtained by Japanese banks in 1988 under which they were allowed to count 45% of the unrealized capital gains on their stock holdings as 'Tier 2' capital).

The 'bubble economy' of the late 1980s contributed mightily to these requirements: its subsequent collapse has been equivalently devastating (Chart 2c). The decline in land prices has eroded the collateral of borrowers, while the fall in the stock market has reduced the capital of the banking system, forcing it to constrain lending growth - and more recently to reduce the actual volume of loans outstanding, by calling in loans - in order to maintain compliance with internationally agreed capital adequacy standards. The decline in the yen since 1995 - which raises the yen value of Japanese banks' overseas loans - has compounded the problem. Over the last six months, Japanese banks have reduced their loan books by the equivalent of nearly 4% of GDP - actions which have in turn propelled the sharp rise in bankruptcies and the unprecedented rise in unemployment.

Japan's capacity to 'prop up' its sheltered workshops in agriculture, distribution and services has been seriously damaged by the rise in the yen over the twenty years to 1995, something which, despite the yen's 45% decline since April 1995, has been only

partly undone. The yen exchange rate was set quite arbitrarily at ¥360 to the US$ during the post-war American occupation[1], and left there until 1971; it remained 'undervalued' until 1973 (Chart 2d).

At the same time, America's vision of Japan as a bulwark against the expansion of Communism in Asia led it to turn a blind eye to Japan's plethora of protectionist devices.

In this benign environment, Japan had captured over 8% of world exports. Over the following two decades, Japan's exporters preserved their aggregate share of world markets - in the face of an increasingly over-valued currency - by shifting their focus to up-market consumer goods and capital goods, by reducing their costs through investment in labour-saving technology at home and (later on) through transplantation of labour-intensive activities to other parts of Asia. But, apart from some ephemeral gains resulting from the mid-1980s surge in the US dollar, Japan's share of world exports has remained essentially unchanged at around 8%.

Finally, Japan's 1940s system has rested on the willingness of the Japanese people to accept all of its trade-offs. For most of the past 50 years this has been readily forthcoming: and given Japan's record of economic success over this period it would perhaps have been surprising were this not to be so. In the current decade, however, it appears that, as Japan's economic performance has faltered, so too has popular support for the Japanese economic model. Last month's Upper House election, in which the ruling LDP failed to win a single seat in any of Japan's four largest cities, highlights the revolt of Japan's long-suffering city-dwellers against decades of extravagant subsidization of over-represented rural electorates.

Japan has spent most of the last eight years avoiding the need to confront its festering banking crisis (Chart 2e). There is a 'standard menu' for dealing with systemic bad debt problems which all countries who have found themselves in this situation have had to follow. This menu basically entails:

- requiring full disclosure of the extent of 'bad' and 'doubtful loans';
- insisting on full write-off and adequate provisioning for bad and doubtful loans;
- where, as a result, banks no longer meet acceptable capital adequacy standards, requiring the closure, merger or public takeover of the banks concerned;
- using public funds, if necessary, to protect depositors in failed banks and to prevent destabilizing 'runs' on the banking system;

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[1] The selection of 360 as the yen-dollar exchange rate has been attributed in a number of different ways to the fact that there are 360 degrees in a circle. The word 'yen' is rendered in Japanese as 'en' (as in 'endaka' or 'high yen') which also means 'circle'; the symbol ° is often used for yen in Japanese script. Another variant of the story holds that Douglas McArthur, when asked at what rate the exchange rate should be fixed, responded 'pick a round number'.

- reducing real interest rates to zero, so that banks can re-capitalize by making profitable loans or raising fresh equity; and
- allow the exchange rate to fall, so that foreigners can participate in the markets for assets backing 'bad loans' (which is usually required because domestic market participants are so lacking in confidence) without excessive risk of exchange rate losses.

Japan has spent most of the past eight years avoiding or delaying such decisions, partly because as a creditor country it has not until recently been subject to the same extent of pressure from financial markets as other countries which have faced similar problems; and partly out of a belief that its long-cherished 'convoy system' (in which change proceeds only at a pace which can be absorbed by the weakest participant) was capable of dealing with these problems.

What has happened, of course, is that by sweeping these problems under the carpet rather than dealing with them promptly, they have become much worse. Banks' loan loss reserves are currently equivalent to just over 4% of their total assets (until earlier this year they were barely equivalent to 3% of total assets). Yet estimates by the newly-created Financial Supervisory Agency put the total of bad and doubtful loans at over ¥87 trillion, or around 11% of total loans (Chart 2f).

To put these figures in some sort of perspective, ¥87 trillion represents about 17% of GDP. This compares with estimates of between 5 and 7% of GDP for total bad loans at the height of the US savings and loans crisis in the late 1980s and early 1990s.

Moreover, if the history of recent bank failures in Japan is any guide (Chart 3a), these official estimates are almost certainly underestimates.

Instead of tackling the bad debt problem at its source, successive Japanese governments have instead sought to offset the 'credit crunch' by repeated doses of fiscal stimulus totalling (if the ¥16 trillion of measures enacted by the Hashimoto Government just before its electoral defeat are included) some ¥72 trillion - equivalent to about eighteen months of Australia's entire GDP (Chart 3b).

Without these successive fiscal stimuli, Japan's growth record during the 1990s would undoubtedly have been even weaker than it actually was. But fiscal stimulus failed to generate a self-sustaining recovery. Instead they left Japan with budget deficits approaching 8% of GDP - higher than ever attained (on the same measurement) by America during the Reagan era. The primary beneficiary appears to have been Japan's bloated construction sector, already considerably larger by most measures than its counterparts in other Western countries. As *The Economist* put it earlier this year, 'money was poured into building ... tunnels through mountains that lead to nowhere of importance and new harbours for dying fishing villages. Even the beds of some rivers were concreted, supposedly to improve their flow' (21 March 1998).

And when fiscal policy was thrown into reverse in April last year, in the (mistaken, as it turned out) belief that the economy had turned the corner, private domestic spending fell in a heap (Chart 3c).

The financial crisis elsewhere in Asia has added to Japan's home-grown problems. Exports to the rest of Asia, which grew at an average annual rate of almost 8% over the five years to 1997, and which in 1997 accounted for 44% of Japan's total exports, fell by 15% in the first half of 1998 compared with the corresponding period of 1997 (Chart 3d).

Japan's rising current account surplus reflects the fact that imports are falling even more rapidly than exports and should be seen as a symptom of Japan's weakness - not, as in earlier years, as a sign of its strength.

Indeed, although Japan has been generous in its provision of official financial assistance to Asian economies stricken by the crisis, its economic and banking problems represent an added threat to the rest of Asia (Chart 3e). For each of the crisis-ridden Asian economies, Japan is either the largest or second-largest export market outside of the region itself: yet Japan's imports from each of these countries are declining (by an average of 14½%, in yen terms, from year-earlier levels in the first half of 1998). And Japan's banks have been much more aggressive in withdrawing lending from the region than banks from other parts of the world (including European banks whose aggregate exposures are larger than Japanese banks').

The on-going decline in the yen represents a third channel of 'negative feedback' from Japan to the rest of Asia. Indeed some have argued that the decline in the yen beginning in April 1995 helped to precipitate the Asian crisis by eroding the competitiveness of other Asian exporters and thus puncturing the Asian export boom, and by reducing the rationale for Japanese direct investment in Asia which had helped to fund Asia's current account deficits - although my own view is that this was at most a relatively minor factor and that, with the admitted benefit of hindsight, the Asian crisis would have happened at some point irrespective of movements in the yen.

What is unarguable, however, is that the failure to deal effectively with the banking crisis has added to downward pressure on the yen. The loss of public confidence in the Japanese banking system after last November's bank failures - reflected in the renewed spurt in deposits with the postal saving system - has forced the Bank of Japan to engage in massive liquidity support for the banks (Chart 3f). This has required a dramatic expansion of the BoJ's balance sheet, in effect adding substantially to the 'supply' of yen and, in the absence of equivalent additional demand, putting downward pressure on its 'price'.

Increasing pessimism about Japan's economic prospects and growing recognition of the deflationary environment has been reflected in falling share prices and declining bond yields. Both have reduced the attractiveness of investment in Japanese financial assets.

And with April's 'Big Bang' reducing the restrictions on overseas investment by Japanese institutions, capital has flowed out of Japan at an accelerating rate, more than offsetting the rise in Japan's current account surplus. This too has directly put downward pressure on the yen.

In its last weeks in office the Hashimoto administration finally came up with a plan for dealing with the banking crisis which, at least in outline form, appears to be credible (Chart 4a) and, arguably, deserves greater credence than markets have to date given it. Former Prime Minister Kiichi Miyazawa was one of the principal authors of this 'bridge bank plan', and as Finance Minister in Keizo Obuchi's new government he will have the primary responsibility for implementing it.

However there are several serious questions surrounding the 'bridge bank' plan:

- first, will the necessary legislation be passed by the Upper House, in which the LDP and its allies no longer have a majority, or will the newly resurgent Opposition see political advantage in seeking to force the LDP to a Lower House election not otherwise due until the year 2000;
- second, will the Financial Supervisory Agency - which only has 160 inspectors at its disposal - be any more realistic in gauging the true extent of bad loans than the discredited Finance Ministry officials whom they have replaced?
- third, is the government willing to accept wide-ranging rationalization of Japan's financial sector, which comprises 4,911 different institutions, with all which that inevitably entails for employment in that sector?
- fourth, will the ¥30 trillion provided for the plan, including ¥13 trillion to capitalize the 'bridge banks', be sufficient?
- and finally, will it all happen quickly enough - or does the horizon of up to five years envisaged for bridge banks simply provide a means to allow failed institutions and borrowers to remain 'on the drip' for a longer period?

These questions will continue to weigh on market confidence until they are answered.

In the short term, the ¥16 trn of fiscal stimulus announced in April will show up as a temporary boost to growth from about September onwards. This will be bolstered by the ¥10 trn of additional public spending promised by Mr Obuchi in his election campaign: although if this is to proceed, existing legislation requiring the elimination of deficit-financing bonds by the middle of the next decade will need to be repealed. The tax cuts foreshadowed by Mr Obuchi last Friday will in, the current gloomy climate, largely be saved and hence will have only a marginally positive impact on growth.

Sustainable recovery requires speedy implementation of something along the lines of the 'bridge bank' plan. However, implementation of the plan will initially dampen growth.

In all likelihood, therefore, the yen will weaken further no matter what happens. If all goes well, and the 'bridge bank' plan is implemented, the yen's decline will probably end somewhere around ¥150 to the US$, and may be partially reversed during 1999. If, however, the Obuchi government is unable or unwilling to begin dealing with the bad debts crisis in a credible way, the yen could embark on a much more disorderly and destabilizing decline, in turn threatening a 'third wave' of downward pressure on other Asian currencies. In those circumstances, the Chinese Government may well decide to renege on its oft-repeated pledge not to devalue the yuan.

Over the longer term, Japan's potential growth rate is constrained by its shrinking labour force, by the exhaustion of the potential for 'catch-up' with other Western economies, and by the other constraints imposed by the '1940s system'.

Although Japan's population is not set to peak until the year 2007, its labour force has already begun to shrink (Chart 4b). On current official projections, Japan's working-age population is set to decline at an average rate of 0.3% per annum over the decade to 2005, and by the year 2030 will have shrunk by some 20% from its current level. Japan's 'reverse population time-bomb' reflects Japan's very low fertility rate of 1.4 per female of reproductive age - itself a tangible indication of the way in which the ordering of Japan's working and social arrangements inhibit family formation - and its long-standing hostility towards immigration.

Most estimates of long-run potential economic growth are derived by adding an estimate of long-run growth in labour productivity to growth in the labour force. That being so, even if Japan were to be able to maintain the productivity growth trend of the past decade of around 1¾% per annum - which would require some improvement on the performance of the past five years - it would be unable to sustain real economic growth of above 2% per annum (Chart 4c).

Japan could generate substantially greater growth in productivity if it were willing to embark upon more far-reaching structural reform. Many parts of Japan's manufacturing sector lead the world in productivity. But in other areas of its economy - and especially in those sectors long sheltered from domestic, let alone international, competition - productivity is less than half that of the corresponding sector in the United States (Chart 4d).

Such structural reforms - including measures to promote consumer spending, reform working arrangements - including to make them more 'family friendly', greater accountability of corporate managers to their shareholders, and greater access for foreign investors to hitherto closed sectors - would of course be tantamount to an abandonment of the 1940s system. Murray Sayle, an Australian who has lived in Japan for many years, summed it up rather well in an article published in the June issue of *Atlantic Monthly*, in which he wrote:

> 'In short, Japan needs a social revolution inspired, for the first time ever in its history, by ordinary people in their own interest'[2] .

To those who may feel that all of this sounds altogether too gloomy, I draw attention to a survey published in *The Economist* at the beginning of this month (Chart 4e), which shows that a smaller proportion of Japanese than of any of 29 other peoples were optimistic about the future of their country. Even Australians, with all the anguish to which we seem to be giving vent at the moment, are more hopeful of the future of this country than Japanese people are of theirs.

Japan is easily Australia's largest trading partner, so a gloomy outlook for Japan cannot be good news for the Australian economy, and I do not wish to pretend otherwise.

Despite that, Australia's exports to Japan have held up rather well over the past year (Chart 4f). While exports to the rest of East Asia have plummeted in the first half of 1998, exports to Japan have risen at nearly four times the average growth rate of the previous five years. Indeed based on Japanese data, Australia's share of Japanese imports is now rising for the first time in a decade.

This partly reflects the fact that, as a crude generalization, Australia exports to Japan's exporters rather than to Japan itself (Chart 5a). Although growth in Japan's exports have slowed, as noted above, they haven't slowed as much as the Japanese economy in total. And the decline in the yen, both to date and prospectively into the future, implies that exports are likely to increase as a share of Japanese GDP.

The fall in the Australian dollar against the currencies of many of our competitors in the Japanese market (Chart 5b) will also assist Australian exporters in improving their market share, not only of 'intermediate goods' used by Japanese exporters but also of final products destined for consumption within Japan: hence the growth in exports of items such as beef, dairy products and wine over the past year.

Of course the decline in the A$ has also assisted Australian exporters in diversifying away from Asia altogether, not only to previously 'traditional' markets in the United States and Western Europe but also to less familiar territory such as Latin America, India, Eastern Europe, South Africa and Turkey (Chart 5c).

The same is true of tourism, which despite the sharp fall in arrivals from most Asian countries, including Japan, has nonetheless begun to experience a recovery in total visitor numbers thanks to an upturn from North America, Europe and other areas (Chart 5d).

One other 'silver lining' for Australia from the Asian crisis may be a further boost to Australia's appeal as a location for regional headquarters for multi-national firms.

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[2] 'The Social Contradictions of Japanese Capitalism', *Atlantic Monthly*, June 1998, p. 94.

Almost 400 of these regional HQs have been established in Australia over the past five years, including 40 since the onset of the Asian crisis.

These operations, the majority of them in information technology or finance, have involved inward investment of some $US800 million and created around 3,000 new jobs. They have been enticed here by Australia's advantages in terms of property and services costs, and by the skills of the local workforce - including its cultural diversity and linguistic skills. These are advantages which we ought not lightly cast aside.

On the other side of the trade equation, Australia's imports from Japan have also accelerated over the past year (Chart 5e). That partly reflects the strength in domestic demand in the second half of last year and, to the extent that imports from Japan are invoiced in US$ rather than yen, may also have been boosted in A$ terms by the decline in the A$ against the US$. Nonetheless, Japan's share of Australia's total imports has also risen over this period.

As Asia's economies recover from the financial crisis - something which will not, in my view, be accomplished quickly, though the period of sharp contractions in economic activity in Asia may largely be passed - there may well be some displacement of Japanese imports by cheaper substitutes from elsewhere in Asia.

Even so, it may well be the case that, as a by-product of the Asian crisis, the decade-long decline in Australia and Japan's importance to each other - as each paid greater attention to the territory in between - is at least partly reversed.

Certainly that has been the case with our respective currencies over the past year (Chart 5f). The Australian dollar's movements against its US counterpart have very closely mirrored those of the yen. And although the A$ has not been dragged down by the latest bout of yen weakness quite as markedly as it was during June - it took the yen going through ¥146 to the US$ to drag the A$ through US60¢, as opposed to ¥140 in June - the A$'s recent gains vis-a-vis the yen have not taken it out of the very narrow range in which it has traded over the past eighteen months.

So further yen weakness is likely to spell further declines in the Australian currency.

Will Japan's problems thus inevitably push Australia into recession?

Japan's problems are unambiguously negative for Australia, and we may not have seen the last of them. However, to date the net effects on Australia have not been as bad as might initially have been expected. Less than half the Australian economy is 'trade-exposed': that is, exports or competes with imports. And domestic economic policies should, on balance, support domestically led growth over the next two financial years. In particular, interest rates should remain at their current, historically low levels or perhaps even fall some more.

If the Reserve Bank were to be panicked by further falls in the A$ into raising interest rates, then the risk of an ensuing recession would be considerably higher. But there is not, and is unlikely to be even if the A$ were to fall to (say) US55¢, any justification for the Reserve Bank to raise interest rates - and I doubt that they will.

Another risk to the outlook for Australia lies in the possibility of a much sharper correction on Wall Street than we have seen to date, although I think that risk has been at least partly diminished by the downward movements of the past few weeks.

And of course, we could bring on a recession ourselves if we were to turn our backs entirely on the world economy, and pretend to ourselves that we can do without the equivalent of 4% or so of GDP in foreign savings with which we have been routinely supplementing our own paltry efforts over the past fifteen years.

In that respect, Japan's continuing challenge - of reforming a system which has served it extremely well in years gone by, and for which many are understandably nostalgic - holds out many important lessons for Australia.