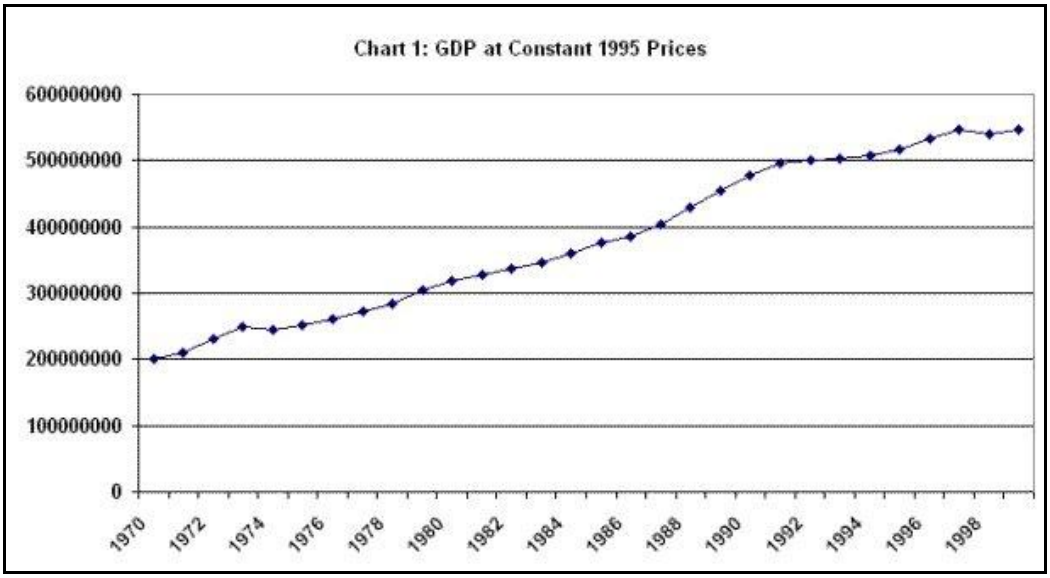
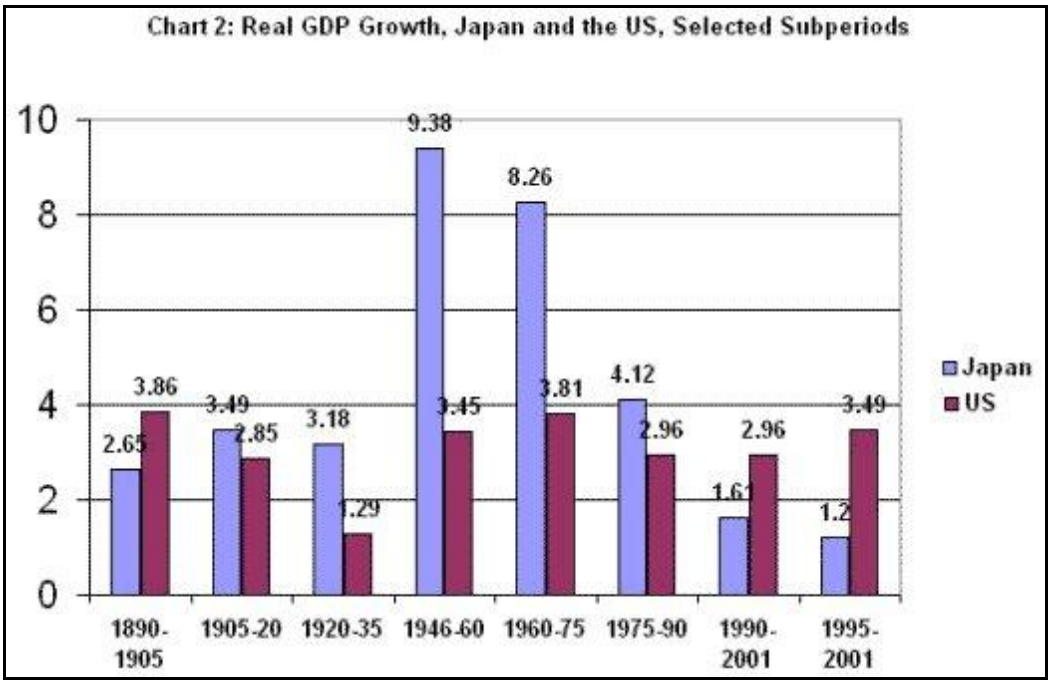
Explaining Japan's Decline

C.P. Chandrasekhar & Jayati Ghosh

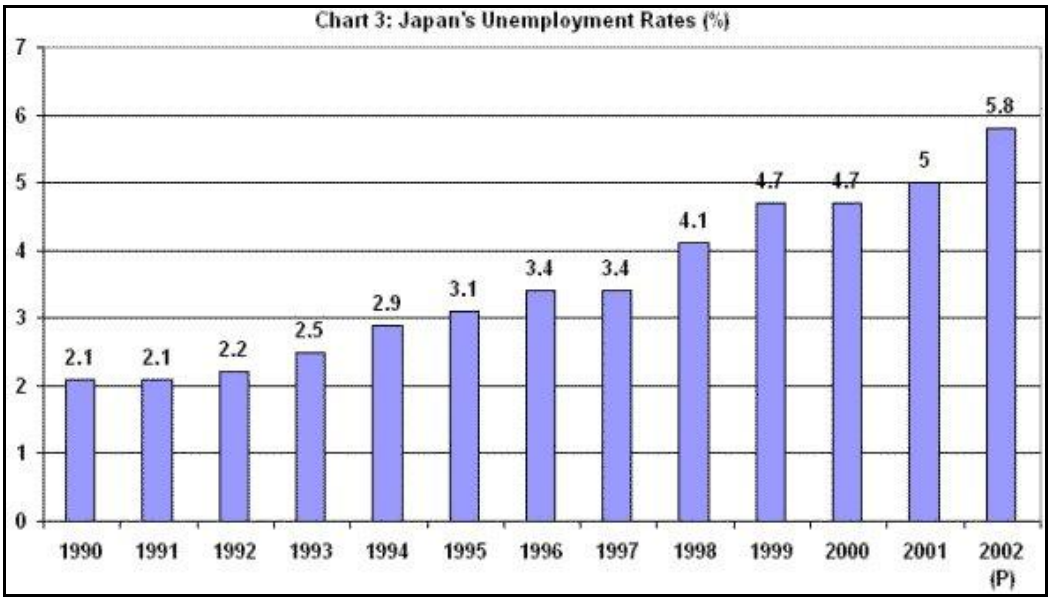
Ever since the asset bubble of the second half of the 1980s burst in 1990, the Japanese economy has undergone a phase of slow growth during which it has experienced four recessions. A slight reversal of this trend is visible in the provisional GDP figures released in June 2002, which suggest that the Japanese economy grew by 2 per cent during the first three months of this year. Coming as it does after three consecutive quarters of contraction the previous year, this evidence has rekindled hope among some observers. They see the country as being on the verge of a recovery from the fourth recession that has afflicted it over the last twelve years. Others are still pessimistic, however, for recent experience has shown that similar cause for hope has been quickly sunk by real developments.

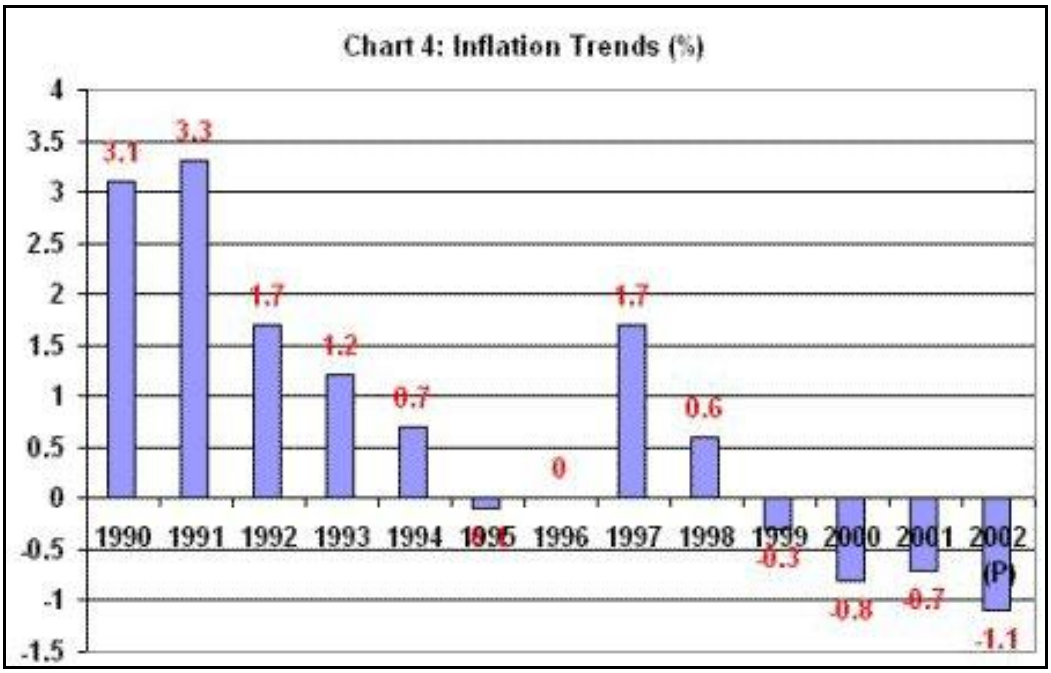
If the trend rate of growth of GDP in Japan during the period 1970-90 had been maintained, the country's GDP would have been close to 50 per cent higher by the turn of the century (Chart 1). This is significant to note, for Japan's expansion at a breakneck pace since the Second World War had in fact slowed after the oil shock of 1973. As Chart 2 shows, as compared with annual rates of growth of 9.4 and 8.3 per cent recorded during 1946-60 and 1960-75, the growth rate during 1970-90 was much slower, at 4.1 per cent. It was from this slower rate, which was creditable in itself when compared with that in the US for example, that Japanese growth slumped to 1.6 per cent during 1990-2001 and 1.2 per cent during 1995-2001.



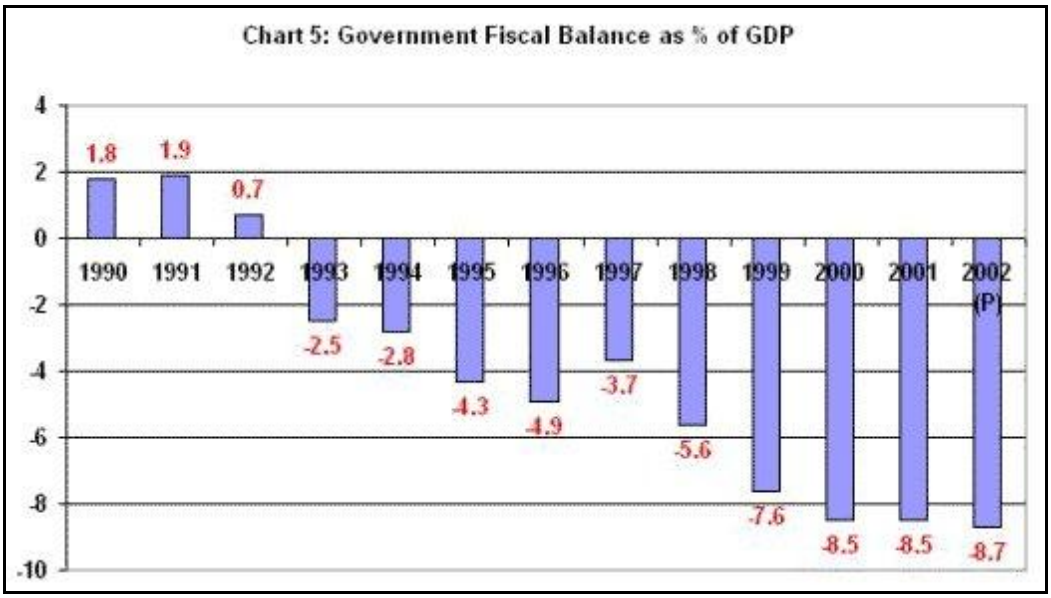


For a population that had almost forgotten the suffering brought about by war,, thanks to the country's rapid and prolonged post-war growth, the more than decade-long collapse of the economy has indeed been painful. Long accustomed to guaranteed and lifelong employment, the Japanese have had to contend with a rising unemployment rate which has nearly tripled during this period, from just above 2 per cent in 1990 to close to 6 per cent at present(Chart 3). Anecdotes about increasingly insecure Japanese households cutting back on consumption are now legion. Combined with a reduction in investment, which triggered the downturn in the first place, this has meant chronic deflation. Inflation rates that fell from 3 to 0 per cent over the first half of the 1990s, have been negative in most years since 1996(Chart 4).





The principal puzzle that emerges from the prolonged period of near-stagnation coupled with periodic recessions is the failure of conventional counter-cyclical policies to deliver a recovery. Over these twelve years, the Japanese government has launched almost as many reflationary initiatives, by increasing deficit spending and prodding the central bank to cut interest rates and maintain an easy money policy. The general government fiscal balance, which showed a surplus of close to 2 per cent of GDP in the early 1990s, has been in deficit since 1993. And the level of that fiscal deficit has risen from just 2.5 per cent of GDP in 1993 to 5 per cent in 1996 and 8.5 per cent in 2001(Chart 5). Yet the Japanese economy has not been able to extricate itself from the recessionary bias that has characterized it through the 1990s.



Mainstream explanations for this predicament, now internalized by sections of Japan's government as well, revolve around the country's failure to reform what is considered to be a badly designed and unviable financial system propped up by the state. However, as has been noted by some observers, there are two problems with such explanations. First, they leave unanswered the question as to why, during the years of rapid post-war growth, the same Japanese financial system was considered to have been the engine that triggered and sustained that growth, and therefore a 'model' that was worth emulating. Second, they do not take into account the fact that the asset price bubble and its collapse, which preceded the period of deflationary bias, followed and in all probability was triggered, inter alia, by a process of financial liberalization.

The financial system that underlay Japan's post-war growth was one in which government regulation and control were the key. Interest rates on deposits and loans were controlled, with the government using differential interest rates as a mechanism to target the growth of specific industries. Similarly, the design and pricing of insurance products were state-guided, keeping larger objectives in mind. The net result of such control was: either (i) the government had to guarantee financial agents a portfolio of activity that ensured that they earned returns adequate for self-sufficiency and growth, or (ii) the government had to channelize resources garnered through taxation or other means to the financial system to ensure the viability of individual financial agents. The government's implicit or explicit guarantee of such viability implied that it guaranteed depositors' savings as well, making bank deposits and insurance products rather than stock market investments the preferred form in which household savings were held.

This system was permissive on some fronts and restrictive on others. It required firms to approach banks that were flush with funds drawn from household savings for finance. In turn, banks were in a position to use the resulting leverage to ensure that their funds were profitably employed and properly managed. Inasmuch as the government 'permitted' the banks to play this role, Japan saw the emergence of a main bank system where "a bank not only provides loans to a firm, but also holds its stock. Typically, a firm develops a relationship with a particular bank and relies on its steady support in funding over the long term. In return, the firm uses the bank for major transactions from which the banks earns fees and profits." Thus, unlike in the US, where the performance of individual stocks and the threat of takeover when stock prices fell or "the market for corporate control" were the means to

ensure effective deployment and efficient utilization of capital, in Japan it was the link between direct and indirect ownership and management that formed the means to realizing these goals. And the state was expected to monitor the monitors, who were the main banks.

The restrictive role of the system was that it limited the ability of banks to undertake investments in areas that were not in keeping with development goals. Thus investment in stocks or real estate purely with the intention of making capital gains was foreclosed by regulation. Banks, insurance firms and non-bank financial institutions had their areas of operations defined for them. Regulatory walls which prevented conflicts of interests and speculative forays that could result in financial crises and hamper the growth of the real economy clearly demarcated these areas.

During the years of high growth this system served the Japanese economy well. It allowed banks and firms to take a long-term perspective in determining their borrowing and lending strategies; it offered entrepreneurs the advantage of deep pockets to compete with much larger and more established firms in world markets; and it allowed the government to 'intervene' in firm-level decision-making without having to establish a plethora of generalized controls, which are more difficult to both design and implement. Above all, when the rate of expansion of world markets slowed after the first oil shock of 1993, and when Japan, which was highly dependent on exports for its growth, was affected adversely both by this and by the loss of competitiveness entailed by an appreciating currency, the system allowed firms to restructure their operations and enter new areas so that profits in emerging areas could neutralize losses in sunset industries.

Not surprisingly, Japan's economic system was bank debt-dependent for financing investment and highly overgeared. Bank debt accounted for 95 per cent of Japanese corporate borrowing in the mid-1970s, as compared with a much lower 67 per cent in the US. And while outstanding bank loans amounted to 50 per cent of GDP in the US in the 1970s, from which level it gradually declined, the debt: GDP ratio in Japan had touched 143 per cent in 1980 and risen to 206 per cent by 1995. This was not a problem, however, because the government worked to stabilize the system. As one observer put it: "A combination of international capital controls, willingness to use monetary policy swiftly to defend the currency, and the absence of other countries simultaneously following the same development strategy shielded Japan from serious problems."

In the event, Japan's economic success between 1950 and 1970 resulted in its system of regulation, which was 'unusual' from an Anglo-Saxon point of view, and was looked upon with awe and respect. Even now, but for the fact that Japan is faring so poorly, the overwhelming evidence of accounting fraud, conflicts of interests and strategies to ensure stock price inflation emanating from leading US firms such as Enron, Andersen, Merrill Lynch, WorldComm and Xerox, makes the Japanese system appear far more robust.

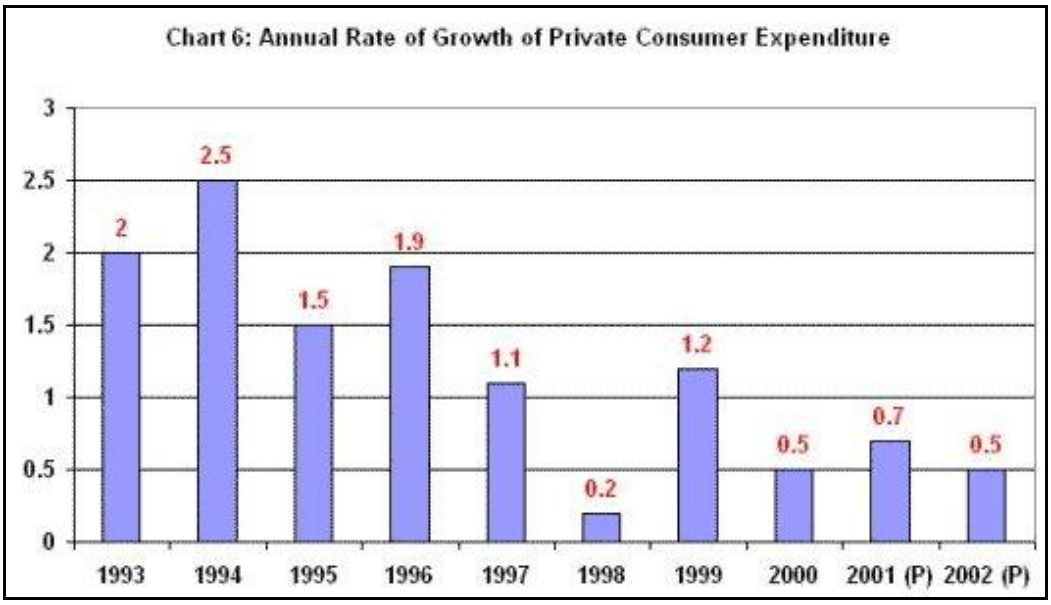
The question remains, however: why did the system fail to serve Japan as well during the 1990s? The answer lies in the fact that the system was changed and considerably diluted as a result of American pressure during the 1980s. The pressure was applied in three stages. First, international banks and financial institutions wanted Japan to open up its financial sector and provide them space in its financial system. Second, once these external agents were permitted to enter the system, they wanted a dilution of the special relationship that existed between the government, the financial system and the corporate world in Japan, since that implied the existence of an internal barrier to their entry and expansion. Third, these agents, along with some Japanese financial institutions adversely affected by the deceleration of growth in the system, wanted greater flexibility in operations and the

freedom to 'innovate' both in terms of choice of investments and instruments of transaction.

The principal reason behind Japan succumbing to this pressure was its dependence on world, especially US, markets to sustain growth. When faced with US opposition to protectionism against Japanese imports, Japanese investors sought to Americanize themselves by acquiring or establishing new production capacity in the US in areas like automobiles. In return for the 'freedom' to export to and invest in the US, Japan had to make some concessions. But the demands made by the US proved to be quite damaging. It began by requiring Japan to reverse the depreciation of its currency. Following the celebrated Plaza Accord, arrived at in New York in September 1985, the Japanese yen, which had started to appreciate against the US dollar in February 1985 from a 260 yen-to-the-dollar level, maintained its upward trend to touch 123 yen-to-the-dollar in November 1988. Though the following year saw movements that signalled a strengthening of the dollar relative to the yen, the downturn soon began, resulting in a collapse of the dollar once again from an end-1989 value of 143.45 yen to its April1995 level of below 80. Any economy faced with such a huge appreciation of its currency was bound to stall, more so an export-dependent one like the Japanese one.

This trend, which resulted in the hollowing out of Japanese industry, undermined the principal area of business of the banks as well, which were faced with the prospect that some of their past lending could turn non-performing. It was in response to this that the Japanese banks joined the chorus against financial controls, demanding that they be permitted to diversify away from their traditional areas. The government responded by effecting regulatory changes in the form of a revision of the Foreign Exchange Control Law in 1980 and granting permission to commercial banks to create non-bank subsidiaries (jusen) to lend against real estate investments. Besides expanding overseas operations, the main areas into which the banks diversified were lending against real estate and stock market investments. The rate of growth of real estate lending rose from 7 per cent in the second half of the 1970s to 18 per cent in the first half and 20 per cent in the second half of the 1980s.

The result was a speculative boom triggered by a mad rush into the new areas. Even as GDP growth was slower in the 1980s as compared to the 1950s and 1960s, the six-largest-cities-index of real estate prices tripled between end-March 1985 and end-March 1990, from 33.6 to 100 (Chart 6). Similarly as Chart 7 shows, there was a massive speculative boom in stock markets, with the yearly high of the Nikkei stock market index rising from 12,500 in 1985 to 38,916 in 1989. By 1989 it was clear that the asset bubble was bound to burst, and in a belated effort to halt the frenzy and respond to householder complaints that acquiring housing was virtually impossible, the Japanese government stepped in by controlling credit and raising interest rates. The net result was a collapse in both real estate and stock markets. The real estate index fell to half its peak level by 1995 and to a third by 2001. And the Nikkei, which registered a high of 38,713 on 4 January 1990, fell soon after to an intra-year low of just above 20,000, continuing its downward slide thereafter right up to 1998. A slight recovery in 1999 was followed by a further fall in 2000.



As a consequence of this collapse and prolonged decline there was a huge build-up of bad debt with the banking system. At the beginning of 2002, the official estimate of non-performing loans of Japanese banks stood at Yen43 trillion, or 8 per cent of GDP. This, despite the fact that over nine years ending March 2001, Japanese banks had written off Yen 72 trillion in bad loans. There is still a lot of scepticism about official estimates of the extent of bad debts. In September 1997 the Ministry of Finance announced that the banking sector held Yen 28 trillion in non-performing loans, but soon after that, using a 'broader definition', it arrived at a figure of Yen 77 trillion, which amounted to 11 per cent of outstanding private bank loans in Japan and 16 per cent of its GDP. And in 1998 the Financial Supervisory Agency placed problem debt at Yen 87.5 trillion and debt already declared bad at Yen 35.2 trillion, which added up to a total of Yen 123 million. Whatever the figure, in the past this would not have been a problem, as it would have been met by an infusion of government funds in various ways into the banking system. But under the new liberalized, market-based

discipline, banks (i) are not getting additional money to finance new NPAs; (ii) are being required to pay back past loans provided by the government; and (iii) are faced with the prospect of a reduction in depositor guarantees, which could see the withdrawal of deposits from them.

Accumulation of such bad debt inevitably leads to a credit crunch, as banks are strapped for cash and turn wary in their lending practices. Overgeared corporations with outstanding loans in their books were no longer favoured customers, resulting in a collapse of investment and a fall in utilization for lack of long and short-term capital. In addition, insecure Japanese consumers have chosen to hold back on consumption. The rate of growth of private consumption expenditure had fallen by 2000 to a fourth/third of its 1993/1994 values (Chart 5). In the event, growth decelerated sharply, and periodic recessions became the norm.

The point to note in all this is that, with growth having slowed and with the increasing difficulty in showing a profit before interest and tax, firms were unable to meet their past commitments. As a result, the bad loans problem has only aggravated. This explains why huge provisioning against past bad loans by the banking system has not adequately reduced the ratio of non-performing loans. The government has sought to resolve the problem and spur growth, over the last decade, by increasing its own expenditures. With growth, it argued, the performance of firms would improve, making it possible for them to clear at least a part of their debts. Unfortunately, the depth of the slump was such that the government's effort to increase deficit spending, on a budget, which has always been small relative to the size of the Japanese economy, has not worked. Deceleration has persisted despite the fact, noted earlier, of a rising fiscal deficit on the government's budget.

It is not only the higher deficit spending formula that has not worked. With the credit crunch created by the bad loans problem seeming to be the proximate explanation for Japan's decline, the argument that a badly designed and managed financial system was responsible for the crisis has gained currency. This amounts to saying that, rather than return to the regime that prevailed before the liberalization of the 1980s, Japan must liberalize its financial sector further, allowing some banks and financial institutions to down their shutters in the process, if necessary. This strategy would only worsen the crisis in the short run, with depositors turning more nervous and intensification of the credit crunch. Yet, Japan is once again surrendering to external pressure and adopting precisely such a strategy. In fact, Prime Minister Koizumi rose to power in 2001 on the slogan that he would reform the Japanese system along these lines. However, the immediate results of whatever he tried were such that he has been unable to proceed any further. Extended reform, to the extent that it has occurred, has not worked either. With the crisis persisting and evidence accumulating that he is not pushing ahead with his reform agenda, even Koizumi's personal political ratings have taken a beating.

In practice, the real beneficiaries of further reform in Japan will be the international financial institutions who will be there to pick up the pieces as the system goes bust, so that they can finally play the dominant role in an economy into which they were unable to enter during its miracle growth years. This is likely to be the denouement of this decade-long drama, unless, of course, policies change substantially in Japan. But to expect that of a country which based its earlier miracle growth primarily on an expansion into world markets is perhaps to expect too much.