

# Japan could trigger global crisis

## Markets unimpressed by Obuchi's speech

**Nick Beames**  
**11 August 1998**

On the eve of last Friday's address to parliament by the newly-installed Japanese Prime Minister Keizo Obuchi, the president of the Toyota motor group, Hiroshi Okuda, made clear the issues, which he considered had to be confronted.

Speaking to the Japan Employers Federation, of which he is vice-chairman, Okuda warned that the crisis in the Japanese banking system could set off a global stock market crash.

"There is a possibility," he said, "of Japan triggering a worldwide financial crisis, such as a steep stock market plunge involving Europe and the US. To avoid that, [solving] the bad loan problem is an urgent task."

In his speech the following day, Obuchi acknowledged the widespread concern in international circles, declaring that the "greatest contribution Japan can make to the world is to revitalize our economy." But the world of international financial and capital markets, it seems, was singularly unimpressed with the measures he unveiled.

The Nikkei stock market index fell and the yen dropped to around 146 to the US dollar--close to the levels at which the Bank of Japan and the US Federal Reserve organised a \$6 billion market intervention in mid-June.

The decline came amid growing signs of a "second wave" currency crisis as the Asian slump deepens. Economic data released in Hong Kong last week show that the economy is contracting at an annualised rate of 2.8 percent, compared to the government's official forecast of 2 percent, placing the Hong Kong dollar, which is pegged to the US dollar, under great pressure. If the peg breaks, this will set off further devaluations throughout the Asian region.

China is reporting that deflation is now starting to affect growth projections, leading to pressure for a devaluation of the yuan. The currency hit a five-year low on the Shanghai black market last week.

South Korean statistics showed that exports fell 13.7 percent in July from the level of a year ago, despite a 28 percent drop in the value of the won against the US dollar.

Nothing in Obuchi's speech allayed concerns in the rest of Asia that the yen will continue to slide, adding to pressures

for further currency devaluations throughout the region.

Obuchi outlined plans to cut taxes by more than \$41 billion, lowering the top personal rate from 65 percent to 50 percent and cutting the corporate rate from 47 to 40 percent and promised "swift and decisive" action to tackle the "biggest problem" of "economic stagnation and declining trust in the financial system." But the measures he announced were criticised on both counts. In the first place the tax cuts will not come into effect until next year and secondly the speech contained no new initiatives to deal with the ever-deepening banking crisis.

As the London-based *Financial Times* commented, Obuchi "did not produce what international investors most wanted to hear: clear pledges to close weak banks and impose rapid restructuring on the banking sector."

The government plan for restructuring of the banking system and the liquidation of bad loans will go to the Japanese parliament this week. Under the proposed legislation, prepared under former prime minister Ryutaro Hashimoto, the government will establish a "bridge bank" which will have the task of liquidating insolvent banks without creating a financial panic and precipitating a credit crunch. The insolvent bank will be placed under the control of a government body, which will try to find a buyer for it while maintaining lines of credit to its customers. If, after two years a buyer is not found, the government will take over the bank's assets and wind it down.

But the plan has come under fire both in Japan and internationally because it deals only with insolvent banks and does not contain measures to deal with the bad loans held by the major banks.

According to the latest estimates by US Treasury officials and international financial analysts, the bad debt problem amounts to \$1 trillion, almost twice the official figure of \$550 billion and equivalent to 20 percent of gross domestic product.

The Financial Supervisory Agency, the bank regulator, is in the process of conducting a two-month review of 13 large banks to decide whether they should be closed. But the

inspection is not expected to lift international investor confidence, as the FSA is not allowed to release the results.

With criticism mounting in Japan, the "bridge bank" legislation is by no means assured of a smooth passage through the parliament and could form the centre of a major political crisis as the main opposition party, the Democratic Party of Japan, tries to force the Obuchi government to a new election.

The chairman of the banking committee of the DPJ has said the plan is "not sufficient to deal with the current financial crisis gripping the nation's largest banks."

The opposition of the DPJ to the legislation is only one aspect of growing divisions with Japanese ruling circles over how to confront the economic crisis. The series of reflation packages organised by the ruling Liberal Democratic Party have been widely criticised as merely providing handouts for the party's business backers in rural areas and in the construction industry while having a limited effect in stimulating the economy.

The platform of one section of the anti-LDP forces was set out in an article by Susumu Saito, the director of Trilateral Institute, a private economic think tank in Tokyo, published in the August 7 issue of the *Financial Times*.

It denounced the LDP for being "obsessed by the need to reduce the fiscal deficit over the past two years" declaring that this misguided austerity policy had now led to a collapse in asset values whose magnitude is "comparable only to that of American equity prices at the outset of the Great Depression of the 1930s."

The article declared that while there was a consensus in Japan over the necessity to reflate, the key question was how to carry this out. Expansion of the money supply was not an answer, as this would lead to a weakening of the yen, and further devaluations of Asian currencies.

"The result would be a further shrinkage of trade within and beyond Asia. ... At this point, a further reliance on the realignment of exchange rates will only risk the repetition of the mistake of the sharp shrinkage of international trade that the world saw in the early years of the Great Depression in the 1930s."

According to the article, fiscal expansion was necessary, but could not be carried out under the present LDP regime.

"The answer must be to re-examine the political mandate. The most effective way of doing that is to change the composition of the lower house, which has the final say on Japan's fiscal policy. Otherwise, the consequence is a continuation of sporadic and insufficient reflation which will lead, as history has shown, to another Great Depression which will probably engulf not just Japan but also the rest of the global economy."

But not all opponents of the LDP want an immediate

election. An alternative perspective was set out in an editorial published in the *Japan Times* of August 7. It said the decision of the upper house not to back Obuchi as prime minister but to instead endorse DPJ leader Naoto Kan was "another warning for the Liberal Democratic Party". But it cautioned against the push by the DPJ and the Japanese Communist Party for an immediate general election.

"At the moment," it declared, "... priority should be given to economic recovery. The opposition groups should first make specific proposals for economic rehabilitation through Diet debate and use their combined majority in the upper house as leverage. That way, the opposition parties should demonstrate to the public their ability to formulate better policies than the LDP ... Only then should they challenge a general election in their quest for power."

The more cautious tone adopted in this editorial seems to reflect concerns that the eruption of a major political conflict over the government's program would deepen the economic crisis.

Those concerns were also articulated in an article by the *Australian* foreign editor, Greg Sheridan, published on August 7 warning that the coming period, during which the Obuchi government would attempt to steer its legislation through parliament, was one of "high systemic risk".

"Obuchi probably has six weeks, perhaps two months at the most, to convince the world that he has got the bad debt problem licked. The markets might withhold judgement on a new government for a little while, but if he doesn't get his six reform bills through parliament, and display the will needed to make the reforms stick, the consequences could be extreme.

"The markets would then continue to sell down the value of the yen. That would feed, negatively, into the value of the Japanese stock market, exacerbating bank insolubility and general economic stagnation in Japan. That would feed through into the US and Europe. The threat of a global recession would increase very significantly."

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