Japan: Mounting economic contradictions confront Koizumi

Joe Lopez, Nick Beams
29 May 2001

The first monthly economic data to greet the government of newly-installed Japanese prime minister Junichiro Koizumi have again underscored the depth of the crisis facing the world's second largest economy.

Corporate bankruptcies rose 4.4 percent last month to hit the second highest levels since the end of World War II. Liabilities rose by 10.8 percent to 1.05 trillion yen, the third month in a row they have gone over the 1 trillion yen mark.

It was not the only bad news. The so-called index of coincident economic indicators, which is compiled by the Cabinet Office to assess the health of the economy, registered just 14.3 percent in March, following February's level of 10 percent. A reading of 50 percent and above is considered to indicate economic growth, while a reading below 50 percent points to economic contraction.

The Japanese government has downgraded its outlook for economic growth for the fourth straight month stating that the economy is “further weakening,” citing falling production, bloated inventories and weakening employment trends as reasons for the downgrade.

Machinery orders dropped 7 percent from the previous January-March quarter recording a decrease for the first time in seven quarters. Total exports declined 1.1 percent, the first drop in 18 months and exports to Asia have fallen for the first time in almost two years.

Koizumi came to power promising to “restructure” the Japanese economy by cutting government debt and eliminating the bad loans crippling the banking and financial system.

For the past 10 years successive Japanese governments have implemented a series of economic stimulus measures aimed at trying to kick-start the economy. But the largest program of fiscal expansion undertaken by any government in peacetime has failed to produce sustained economic growth.

The legacy of the failed program is a public sector debt of 666 trillion yen, amounting to 130 percent of gross domestic product, and debt service payments, amounting to about 70 percent of government tax revenue.

Since coming to office, Koizumi has made moves to cut public works spending by announcing that the government may reallocate road-related tax revenues. It has also declared that it will limit the issuing of government bonds to 30 trillion for the 2002 fiscal year and that no new borrowings will be undertaken except to pay back debt or fund interest payments.

Statistics on the relationship between the government debt and revenue make clear the depth of the fiscal crisis. According to American economist David Asher, the ratio of long-term debt to retained tax revenue, after mandatory transfers from Tokyo to prefectural government, hit 1,548 percent in 2000. This is twice as large as the peak level attained by Britain in 1947, following the massive debts incurred during World War II. On present trends, it is calculated that the gross debt will rise to more than 200 percent by end of 2005 and 300 percent by 2011.

In addition to cutting public spending and public debt, the Koizumi government aims to press ahead with clearing the bad debts of the crisis stricken Japanese finance sector and privatising the nation's postal and savings services along with other publicly funded institutions.

The level of bad loans held by Japanese banks is estimated to be as high as 110 trillion yen ($916 billion). The reasoning behind the restructuring is that with the removal of bad debts, the banks will cease propping up bankrupt enterprises and start lending to healthy businesses, sparking a general economic recovery.

There are two problems with this scenario. The first is that the continuing stagnation of the economy is giving rise to more bad debts. Last week, for example, Mitsubishi Tokyo Financial, one of Japan's four largest banking groups, reported that while it had allocated 800 billion yen to deal with bad debts, its level of bad and potentially troubled loans increased by 55 percent for the year. Sumitomo Mitsui, also one of the big four, reported that, despite allocating 819 billion yen in debt write-off, its level of bad debts and troubled loans remained the same.

The second problem is that the process of debt restructuring could wipe out many businesses, particularly in the employment-generating construction, manufacturing and retail sectors of the economy, which are only surviving with bank support.

Critics of restructuring point out that far from providing the stimulus to the economy claimed by its advocates, it will not bring increased spending, but the reverse as families, already worried by rising unemployment, falling asset prices, and under-funded pension and insurance schemes hold on to their savings.

A recent article in the *Japan Times* gave a glimpse of the contradiction between the popularity of Koizumi at the present moment and the “painful” reforms he is planning to carry out. Because his economic agenda has been rather vague and short on specifics Koizumi is seen as a new face that will bring about “change” and is still enjoying a honeymoon period.

Declaring that “Koizumi must deliver before the hoopla fades,” the article warned that the “entrancing effect” of the prime minister's repeated vows not to flinch at the pain of structural reform was starting to wear off and “market watchers now want something more to help them gauge where the economy is headed.”

“One major concern,” it continued, “is that crucial details remain elusive in the government's emergency economic package, submitted to [Yoshiro] Mori (the previous Prime Minister) in April. Central to the package is the final disposal of banks' problem loans and the unburdening by banks of their massive stock holdings. Plans call for erasing delinquent loans from banks' balance sheets within two to three years and for a system to absorb bank shareholdings. But even though a real economic recovery won't occur until the banking house is put back in order, the nuts and bolts of the problem loan disposal remain a mystery because the Financial Services Agency, banks and corporations have yet to agree on how to carry through with the so-called final disposal.

“Private research institutes estimated that if banks were to nudge borrowers whose financial positions are less than healthy into bankruptcy, as many as 1.5 million jobs would be lost. The pain of such a situation would also be exacerbated by government efforts to reduce the snowballing public debt."

Naoki Iizuka, senior economist at Fuji Research Institute, posed the following questions: "Where is the economy going? Where are the new industries that will absorb the ensuing unemployment? What assurance do we have that something new will spring up after we go on a destruction spree?"

Iizuka said he doubted Koizumi's high popularity rate would continue once people actually start feeling the pain of widespread restructuring.

The restructuring program has also drawn international criticism, amid fears that it could have a major impact on the global economy.

An article in the *Australian Financial Review* earlier this month voiced warnings about where it could lead:

"A dramatic weakening of the yen with disastrous results for non-Japan Asia, massive withdrawal of Japanese capital from the United States sparking a credit crunch or a severe depression in Japan, the world's second biggest economy."

These were "some of the possible consequences" of an assault by Koizumi on the problems faced by the corporate and banking sector with "enormous dangers" for the world economy if he faltered or if "in his fervour to administer serious pain for economic gain, he goes too far with his tough medicine."

Some of the potential international ramifications of restructuring were pointed out by Japanese management specialist Kenichi Ohmae. While US president Bush has said he wants restructuring, if "Koizumi succeeds in fixing Japan, he may break the US economy in the process."

According to Ohmae, with the size of the restructuring problem equivalent to a fifth of Japanese GDP, there will be a repatriation of the more than $1 trillion of Japanese funds presently invested in the US.

"Inevitably there will have to be a huge capital exodus, a homecoming of the Japanese money that has been tied up for 10 years plus, financing the US budget deficit. The US economy will experience a liquidity crunch."

US economist Paul Krugman, writing in the *New York Times* last month, warned that Koizumi's policies were reminiscent of the advice given by Andrew Mellon, the Treasury Secretary in the Hoover administration which ushered in the 1930s depression. Mellon called for the liquidation of stocks and real estate to "purge the rottenness out of the system."

According to Krugman, the plan to privatise postal savings and force banks to liquidate bad loans would be "right on target" if Japan faced a problem of insufficient capacity.

"But Japan isn't limited by its capacity. It is plagued by chronic insufficiency of demand—that is, consumers and business are unwilling to buy as much as the economy is already capable of producing. And in such an economy attempts to increase efficiency often do more harm than good."

While the country cannot go on as it has because "swelling public debt will eventually threaten the government's solvency", Krugman maintains the actions Koizumi has proposed "could tip Japan into a full-blown depression."

Economic analysts agree that the status quo cannot hold and that "something" must be done. But their prescriptions spell disaster at every turn.

According to Andrew Smithers of the British funds management firm Smithers & Co: "Action is needed to reverse the decline (in Japan). The new Prime Minister sees this and promises reform. The Tokyo stock market has picked up in response but the rise has been limited for fears his actions may not match his words. The stock market has got the stick firmly by the wrong end. It should be praying that Koizumi is all talk and no action. Bad as it is, inaction is better than promised follies."

A recent paper prepared by the firm "Japan: Why Restructuring is the Wrong Medicine" points out that the return on Japanese capital has fallen to below international levels and action is needed to restore it.

"In practice this can only be achieved by writing off capital. To achieve a competitive return on capital through cost reduction would require a 40 percent fall in income from employment. Such a fall is neither possible nor desirable. If it were possible, the ensuing collapse in domestic demand would be catastrophic."

According to this analysis, the write down in capital values necessary for a restoration of the rate of return and a revival of the economy can take place either through bankruptcy or inflation. But, with widespread bank collapses proving ruinous for an economy "as America proved in the 1930s," the only alternative is to run down the debt through a change in monetary policy and consequent inflation.

"Monetary policy must not simply be eased; it must be radically changed. A major fall in the yen, to achieve both rising exports and inflation, should be the new aim."

The significance of this analysis is that, having followed through the disastrous logic of all the alternatives it nevertheless arrives at a scenario which, if implemented, could provide the trigger for a major global financial and currency crisis.

The inflation and yen devaluation necessary to prevent a financial implosion in Japan would have an immediate effect on currencies in the rest of East Asia. In the crisis of 1997-98, Chinese authorities held back on a devaluation of the yuan for fear of deepening the world financial turmoil. But if the Japanese yen falls to any significant degree, the Chinese currency is certain to be cut as well, leading to further currency falls throughout the region and even more serious turbulence than that which hit global financial markets three years ago.

The failure of all attempts to devise a "solution" to the stagnation of the Japanese economy arises, in the final analysis, from the fact that its acute problems are not national phenomena. Rather, they are one of the most acute expressions of the developing crisis of the world capitalist economy, further signs of which are making their appearance in the bursting of the hi-tech bubble in the US and the emerging slowdown in Europe.