Japan moves into recession as credit rating cut again

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Japan has once again moved into recession—the third in the last decade and the second in the last three years. Figures released on Friday showed that the economy had contracted by 0.5 percent in the third quarter, following a contraction of 1.2 percent in the second quarter. The annualised growth rate is now a negative 2.2 percent.

Commenting on the results, BNP chief economist Ryutaro Kono told the Associated Press that all factors on the demand side had been "annihilated." "The world economy is in a downturn so exports are down. Corporate profits are faltering so investments are down. With the economy slowing, incomes are down so consumption is down."

The contraction came in the wake of the credit-rating downgrades of the Japanese government by three major international agencies—Moody's, Fitch, and Standard and Poors. Moody's, which cut its rating from Aa2 to Aa3, criticised the Koizumi government's economic reform, describing its efforts as "elusive." "Neither current macroeconomic policies nor new reform initiatives offer much tangible hope for an early turnaround in economic performance," it said.

Japan's public debt of $5.4 trillion, equivalent to 130 percent of gross domestic production, is the highest in the industrialised world and could rapidly escalate in the future, according to the credit rating agencies.

Standard and Poors said it expected debt levels to rise to as much as 175 percent of GDP by the middle of the decade, even after the proposed sale of government assets.

Fitch, which last month downgraded Japan's rating from AA+ to AA warned that economic problems would continue to worsen unless the government stopped "muddling through."

"In a largely vain attempt to kickstart the economy, the government has continued to borrow roughly 8 percent of gross domestic product per year. This has seen gross government debt rise above 140 percent of GDP and Fitch expects it to exceed 150 percent by end 2002," the agency said. It warned that if government policy remained broadly unchanged and recent growth levels continued "government debt would rapidly be approaching 200 percent of GDP by 2007."

The failure of government efforts to boost the economy through increased spending has led to calls for increased action on the monetary front. With interest rates already nominally close to zero, there is little room for further cuts. But even with nominal rates at or close to zero, the real rate is still positive because prices are falling.

Consequently, one policy being proposed is that the Bank of Japan (BoJ) should pursue an inflationary monetary policy and pump liquidity into the system. According to this scenario, real interest rates would then turn negative, providing a boost to investment. At the same time the increase in money supply would bring down the value of the yen, making Japanese goods more competitive on international markets and providing a boost to the economy from increased export demand.

A comment by Richard Katz, the senior editor of the *Oriental Economic Report*, published in the November 21 edition of the *Financial Times*, exposed some of the flaws in this argument. Katz posed the following question: Even if the BoJ did manage to create inflation who would increase their spending in response?

"Companies are plagued by excess capacity, some by 30 percent or more. Why would any business with so much useless equipment go even deeper into debt to buy still more of it just because the BoJ promises inflation or because real interest rates are a negative 2 percent?

"As for consumers, not only are their current wages depressed but so are future incomes as life assurers cut annuities and companies cut pensions. Meanwhile, zero interest rates have reduced yearly household income by almost 5 percent. To promise consumers negative interest rates is to promise them an erosion of the value of their

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savings, i.e. a negative wealth effect.

"How about depreciating the yen? Could Japan replace a budget deficit of 8 percent of GDP with a price-adjusted trade surplus of the same size—about $250 billion? In 1999, Japan's $70 billion trade surplus amounted to 15 percent of the combined trade surpluses of all the world's surplus countries. At $250 billion, Japan would eat up more than half the global surplus. For Japan's surplus to soar, the surpluses of China, South Korea, France, Germany and the rest would have to dwindle. That will not happen."

As the problems in trying to devise an economist boost become ever more intractable, official statistics record the continuing decline. Industrial production in October fell to its lowest level in 13 years, after a decline of 0.3 percent for the month, with analysts expecting further cuts in the coming months as domestic and overseas demand slows.

Consumer spending, which accounts for 55 percent of economic activity, is also falling, adding to deflationary pressures. Figures for October show that the consumer price index fell by 0.7 percent from a year earlier—the 25th consecutive monthly fall.

Falling consumer demand and prices are squeezing profits, leading to bankruptcies and job losses. Niigata Engineering, a heavy machinery maker, filed for bankruptcy late last month with liabilities totaling 227 billion yen (close to $2 billion).

The Niigata bankruptcy represented the 12th publicly-traded Japanese company to go under this year with job losses of around 2,300. More such bankruptcies are expected as banks write-off bad loans and send struggling corporations and small businesses to the wall.

Japan's jobless rate reached a new post-war record for the month of October, climbing to 5.4 percent with predictions that it will shortly go to 6 percent. The number out of work was 3.6 million, the highest level since records began in 1953. Unemployment among males increased sharply from 5.4 percent to 5.8 percent with significant job cuts by major corporations, once the centre of the so-called "life-time" employment system.

Isuzu, the Japanese truck maker controlled by the US giant, General Motors, announced plans last week to slash 12,700 jobs, almost one third of its workforce. NSK Ltd, an auto parts producer, will cut 2,500 jobs.

JR West, Japan's third biggest railway operator, announced it would axe 9,000 workers by April 2005, in a bid to cut costs as a result of stagnating sales. In total, manufacturing, transport, telecommunication and services industries have cut 400,000 jobs in the recent period.

And unemployment will worsen. Prime Minister Koizumi has said that "an increase in unemployment can't be helped as we're trying to carry out reforms". The senior economist at Nikko Salomon Smith Barney, Yukari Sato, is predicting that the unemployment rate will reach 6 percent by the middle of next year. The recent rise was "just the beginning," he said. "Spending is set to fall, pushing Japan to the edge of a deflationary spiral."

Increasing international pressure is bearing down on the Koizumi administration to push ahead with structural reforms, particularly in the banking sector, in order to deal with the bad loan crisis.

Criticising the lack of action, chief White House economic adviser Glenn Hubbard said: "Japan cannot look at counter cyclical macro policies alone as a saviour. Japanese banks have obscured non-performing loan problems through essentially lending to insolvent firms. Funding zombie firms on an ongoing basis is nothing more than a dissipation of capital."

But it has been estimated that if the government were to implement the type of policies demanded by Hubbard and others anywhere between 650,000 and four million jobs would be destroyed.

Such measures would not only rapidly erode support for the Koizumi government but would increase social and political tensions in a situation where million of working class families already face a bleak and uncertain future.

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