Japan heads into deflationary spiral

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30 January 2002

With Japan moving into its third recession in 10 years there are growing fears that the world's second largest economy is being dragged into a deflationary spiral of falling prices and profits.

In a major address earlier this month, Bank of Japan governor Masaura Hayami said he expected that the Japanese economy would remain in a severe state as prices continued to fall. "This year, the economic and industrial structural reform will move into full swing. In that process, low growth and price falls will inevitably continue. But preventing it from leading to a deflationary spiral will pose a significant policy challenge," he told Bank of Japan managers in Tokyo.

Hayami's comments follow an earlier bleak assessment by the Japanese Cabinet Office. It said the economy would show no growth next fiscal year and would grow no more than 1.6 percent a year for the next four years. The Cabinet Office predicts a probable contraction of 0.9 percent for the fiscal year ending in March.

As the *Economist* magazine commented: "The gloomy statistics continue to accumulate. On January 25 new figures showed that prices in Japan [fell] for the third year in a row—unprecedented for a major industrial economy in modern times. Official data released on January 24 showed a 38.3 percent fall in the Japanese trade surplus for 2001, the largest fall since 1970 and the third successive year of decline. The Japanese government's own forecasts show that the economy will not grow at all in the fiscal year starting in April, with unemployment continuing to rise, to 5.6 percent. ... It would be hard to exaggerate the extent of Japan's economic problems."

Every economic statistic points in the same direction. Figures on corporate bankruptcies, published by the private research firm Teikoku Databank, show that 2001 was the second worst year in post-war Japan. A total of 19,441 companies went to the wall, an increase of 1.9 percent from the previous year and the largest number since 1984. Because Teikoku's figures only cover business failures with liabilities of 10 million-yen or more, the real situation is even worse as small business bankruptcies are not accounted for.

The release of the figures prompted an editorial comment in the *Financial Times* entitled "Bankrupt Japan". It noted that there were few worse combinations for Japanese companies than the falling prices and stagnant growth they have experienced over the past few years "as they have had to service their loans with ever-falling revenues."

"Deflation lies at the root of Japan's problem. It ensures high levels of bankruptcy and low consumer demand, which, in turn, put further downward pressure on prices. Unless luck intervenes or policies change radically, the prospect of Japan escaping its deflationary spiral is bleak."

The figure for bankruptcies would have been far higher, but for the proposed bailout of Japan's biggest retailer Daiei Inc. The $3.2 billion rescue of Daiei by its major lenders is conditional on the selling off of its hotels, restaurants and other non-core businesses.

In total 6,000 jobs will be destroyed as part of the plan. One thousand workers will be cut from its retail stores and 5,000 jobs will be axed through the selling of its subsidiaries. The bailout plan apparently has the blessing of Prime Minister Junichiro Koizumi because of government fears that the total collapse of the corporation, which employs 100,000 people, could cause "social damage and financial instability."

But Koizumi's support for the bailout has come under fire from financial interests fearful that the government's talk of the need to press ahead with structural reform and a resolution of the bad debt crisis is just that—talk.

A recent article in the *Daily Yomiuri* entitled "Koizumi needs fiscal shot to ring round the world"

noted that, after the September 11 terrorist attack in the US, Tokyo's stock index rose on a day when it might have been expected to plummet.

"Why did the Nikkei move up? What could explain the breath of life in an otherwise flat and dreadfully stale Japanese economy? Prime Minister Junichiro Koizumi and his colleagues of the Liberal Democratic Party should have called a Diet hearing to investigate. Or perhaps the Prime Minister's economic policy czar, Heiko Takenaka, should have attempted some explanation as to why Japan's stock index seemed to have power past the shock of the day's earlier traumatic events.

"What triggered this shiver of hope was the bankruptcy of Japan's third largest retailer, Mycal Corp. Rather than prolonging by sleight of hand its insolvency, Mycal forced a real and transparent reconciliation of its deteriorating assets and accumulating debts."

Contrasting the support given to Daiei by the government and the banks, the article said that Mycal's actions had earned the applause and support of the markets. "This is the shot that should ring loudly through the halls of Nagatacho and Kasumigaseki, and frankly, throughout Japan."

The article concluded that, despite his "slick veneer as a reformer and rhetoric that he would protect 'no sacred cows'," Koizumi had so far failed utterly to "make market forces his friend in changing the course of the nation's economy."

Pressure is also being applied by the United States. On his recent visit to Tokyo, US treasury secretary Paul O'Neill emphasised the necessity of pressing ahead with the economic reforms and not pursuing a policy of lowering the value of yen to try to boost exports and promote recovery.

"The straight fact is this: exchange rates cannot improve productivity or fix non-performing loans. The weight of historical evidence shows that those who have tried to fix underlying economic problems with protectionist measures—and I count artificially depreciating the currency as one of those—actually weaken their own economy," he said.

O'Neill was responding to criticisms from within the US that the Bush administration was silently acquiescing in moves to push down the value of the yen and improve Japan's export position. As Frank Vargo of the US National Association of Manufacturers put it prior to O'Neill's visit: "We want the Treasury not to be as silent as Japan intervenes to talk down the yen. The US has said nothing and the financial market has taken this as consent."

Japanese government spokesmen have responded by saying that "in principle" there is no government intervention and that "recent currency movements are occurring where we have no involvement."

Amid continuing warnings about the long-term outlook, attention in the short-term will be focused on the banks. Under measures introduced by Koizumi, they will have to disclose the real extent of bad loans in reports published for the end of the fiscal year on March 31.

This has prompted warnings that the disclosure of the real level of bad debt could set off a wave of corporate failures and banking collapses in the following year. However, such fears were discounted by IMF first deputy managing director, Anne Krueger, who said last week that she did not see a crisis looming in Japan.

According to the *Economist*, reflecting the views of large sections of the financial markets both in Japan and internationally, "perhaps this is not really good news. Given Japan's longstanding inability to respond effectively to chronic stagnation, it may take a crisis to get Japan's politicians to take the painful and inevitably unpopular steps needed to pull Japan out of the mire."

Such prescriptions are advocated on a virtual daily basis in the financial press. But the advocates of "shock therapy", whose policies wreaked havoc in the former Soviet Union and Eastern Europe, have never explained how their program of corporate bankruptcies, the destruction of millions of jobs and sweeping cuts to the living standards of the Japanese working class will bring a return to economic prosperity.