

## Challenges Facing the Japanese Economy

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In an economy as large and diverse as Japan's it is difficult to identify every important factor. There are non-economic problems, such as the state of the political system, which have bearing on the economy. There are other purely economic challenges. Before anything else I must touch on the political dimension to Japan's current problems.

Over the last ten years Japan has been unable to develop an appropriate policy response to the economic problems it has faced. This can be seen as a problem of political leadership; or it can be seen as a problem of the political structure. It is in fact probably a little of both. Now, however, the time for more serious choices has arrived. Public sector indebtedness has reached dangerously high levels, while distress in the banking system has caused the Bank of Japan to embark on a policy without precedent in major developed countries.

If Japan fails again to develop the political leadership required to overcome these challenges then the future would be not just a rerun of the past ten years, but probably much worse. Japanese know this. The last ten years is widely referred to as the "lost decade". The greatest challenge facing Japan is how to develop the political leadership necessary to overcome the economic, and social, challenges, we now face.

In particular the problem of public sector debt requires a political solution. How the population at large will react to large-scale tax changes is as yet unclear, but it is clear that serious choices need to be made in the areas of public spending and taxation. The political approach to these problems is likely to determine the economic outlook for Japan over the coming years. The need for new thinking is great.

Taking a more narrowly economic view, two major challenges are now to be confronted. The first challenge is macro-economic in nature – deflation. The second challenge is a mixture of micro and macro factors – it is the challenge of recovering the stability of the financial system.

Though these challenges are large, there are signs of progress in both areas.

### 1. Deflation

First, the question of deflation. After nearly 4 years of a falling CPI, deflation has a firm grip. It will be difficult to dislodge. But the Bank of Japan's policy is evolving in a positive direction. The Bank's policy may not be explicitly inflationary, but it is at least implicitly inflationary. And this is beginning to yield changes in inflation expectations. Both consumer sentiment surveys and future inflation gauges underline the possibility that deflationary pressures have passed their peak.

If we look at the sources of deflationary pressure in Japan we can see why this progress is being made. It is often asserted that there exists a "state of permanent over-capacity" in Japan

and that this is the cause of the country's deflation. Yet it is actually the case that in recent years total productive capacity has been shrinking.

Figure 1 shows that even as capex rose in 1998-2000 there was no increase in overall capacity

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The index of capacity stood at 101 in 1998 and is now 94.5. This 6% fall indicates that large amounts of capacity must have been scrapped at the same time as new capacity was being added.

As we all know, it is change at the margin is the determinant of pricing, and not the static balance of supply and demand. At the same time as the corporate sector has been reducing overall capacity, the central bank has allowed the creation of base money to accelerate sharply. The monetary base is growing 36% while M1 has reached a growth rate of 24%. The growing divergence between the growth rate of narrow money and the growth rate of capacity should put us on our guard against believing the open-ended continuation of deflation to be the only possible outcome. This is shown in Figure 2

Figure 3 shows the ECRI Future Inflation Gauge for Japan. While still low, it would appear to have bottomed. Furthermore, consumers appear to have reached the same conclusion. In recent surveys of consumer sentiment conducted by the Government, consumers have begun to indicate that the worst price declines seem to be in the past.

Perhaps this should not come as a surprise. In a growing number of areas, Japanese prices are either not out of line with global comparables. One form of deflationary pressure - the unusual gap between domestic and overseas prices – has now all but closed. Indeed, an English visitor to Tokyo recently observed that even golf course memberships are now cheaper in Japan than in London!

The image of Japan as “expensive” rests on the reality of ten years ago, and, I’m afraid to say, the twin facts that most foreign visitors do not leave a small area of central Tokyo and most Japanese do not have a passport. To use the prices charged in the center of Tokyo as a guide to actual prices is as unrealistic as supposing that the shopping in the Landmark represents all of Hong Kong, that Sloane Street represented Britain or that 5<sup>th</sup> Avenue represented the US.

Japan is not doomed to deflation. In fact it may be making its first steps towards an escape.

## **2. Financial system instability**

I will now turn to the greatest of Japan's challenges. We must restore stability to the financial sector. Recently the system has again experienced instability as deposit insurance caps were introduced in respect of time deposits. There is clear evidence that the public is losing confidence in traditional banking system, for instance, in the recent popularity of gold.

So how bad is the situation? First, it is important to note that progress in the fight against deflation would help reduce future bad debts. Here, as I noted, some rays of hope are visible,

Second, it is also necessary to review the state of the banks' borrowers. Without healthy borrowers, there can be no healthy banks. Here again, some slow change for the better can be seen.

Many observers remain concerned that Japanese companies are doing nothing. But the recent results season has shown that, whatever Japanese companies are doing, it is having some effect on profitability and asset returns.

In fact both ROE and ROIC have been rising for the last five years. This recovery is the counterpart of falling capacity and falling employment. Japan is moving towards a less inefficient corporate model, as Figure 4 shows

Clearly many challenges remain. An ROE of 4% is inadequate when set either against the rate at which Japan's pension liabilities compound, and against the levels necessary to survive in international competition. And in the area of international competitiveness, stern challenges remain. As Figure 5 shows, Japan's share of total OECD member exports has been falling for 15 years.

The corporate sector remains too heavily weighted to backward-looking companies and sectors. But even here market mechanisms are increasingly making themselves felt. As Figure 6 shows, older companies are being cleared away, while bankruptcies amongst newer companies continue to fall.

Very gradually the number of Japanese companies in declining sectors is shrinking. Meanwhile new companies – and Japan's better companies – continue to grow. The corporate sector is in transition. The leaders are improving dramatically, while the laggards remain problematic. Weeding out bad borrowers does represent progress – even if it is painful.

When we examine the problem of bad debt, we can see that it has two sides. First, there is the backwards looking question of bad debt left over from the bubble era. Then there is the separate question of bad debts induced by deflation. The first is a problem of accounting; the second a question of deflation. For as long as deflation continues, average credit quality will deteriorate, leading to a rise in bad debts. As I have noted, some progress is being made in the area of deflation. This should help cap the increase in bad debts in the future.

So the real problem is the backward looking question of bubble era bad debt. While not perfect, changes in the regulatory environment have forced better disclosure. In December the bank of Japan surveyed 21,300 borrowers, and asked the banks to downgrade some 1,900. A total of 29 trillion Yen was downgraded. The role of the RCC has been expanded to allow it to buy bad debt at market prices. While not perfect, oversight of the banking system is much improved compared with the past.

Constraints on the speed of progress, in the form of the poor quality of bank capital and the low level of bank's earnings are real. But some progress is evident. This year, a further Y10 trillion will be written off bringing the total written off to nearly Y70 trillion in the past 10 years.

Major problems remain, but with a more efficient corporate sector, and some progress towards ending deflation, even our financial sector problems can be managed. There are some hopeful signs, but much greater effort will be needed to see things through to a successful conclusion.