Japan's unhappy dilemma

After a bittersweet 2000, Sally Wilkinson of Daiwa SBCM looks at the prospects for the year ahead in Japan's uncertain economy.

Last year was bittersweet for Japan. The year got off to a good start, with GDP surging by an annualised 10% in the first quarter and the stock market breaching the 20,000 mark for the first time in nearly three years. Company restructuring finally appeared to be under way, the financial sector looked considerably more sound than for some time and the consumer 'feel bad' factor appeared to be dissipating. Three years of fiscal pump priming, structural reform and improved transparency seemed to be finally paying off.

How quickly things turned. By late summer, the sustainability of the economic recovery was in doubt, bankruptcies had soared, the stock market had plunged 4,000 points and the crutch offered by the Bank of Japan's (BoJ) zero interest rate policy had been removed. Ratings agency Moody's downgraded Japan's sovereign rating to Aa2, despite the country's ample savings surplus, citing the lack of progress on fiscal reform. Japan's problems were compounded by the death of Prime Minister Obuchi and his replacement by the accident prone Mori.

It was almost as if the first part of the year had never happened. By the end of 2000, talk of recession had resurfaced, with most pundits blaming Japan's political impasse and shaky commitment to structural reform for the lack of economic progress.

Talk of recession moves back onto the agenda

There are undoubtedly reasons to be gloomy about Japan's economic prospects during 2001. Public investment looks set to slacken from excessively generous, prior levels, with the public works budget frozen in nominal terms and actual expenditure likely to be considerably lower than planned, due to fiscal constraints faced by local governments. In addition, the anticipated slowdown in global demand will weigh on Japan's export prospects. Meantime, sluggish growth in household income and a high level of precautionary saving will limit the scope for consumer spending growth.

The only bright light appears to be private investment. Private capital expenditure was strong throughout 2000 and this is likely to persist into 2001. Corporate profitability is strong, thanks to continuing cost-cutting initiatives, and this is providing the funds for investment. At the same time, a need to step-up investment in new technologies to boost long-term productivity is providing the incentive to invest despite still high levels of traditional spare capacity. That said, the slower outlook for final demand, both at home and abroad, will reduce the need to boost cyclical capacity, even for Japan's more vibrant industries.

Along with fears of financial sector crisis

Indeed, on a worst case reading, Japan's problems could spiral during the coming year. The equity market tumble and surge in bankruptcies have noticeably weakened the balance sheets of Japan's major banks, albeit from positions of strength following the 1998/99 public funds injections. Further severe stock market weakness, bad loan accumulation and falling business profitability could place banks' capital adequacy ratios back in jeopardy. The life insurance sector would be equally vulnerable in such an environment.

Sally Wilkinson

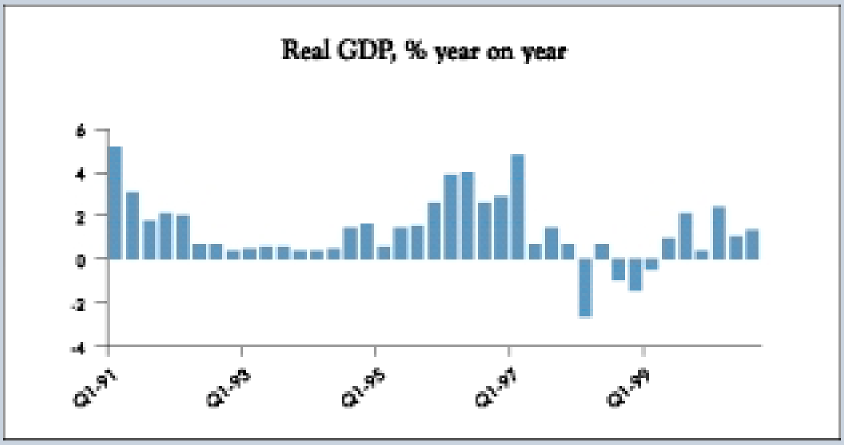
The government authorities and central bank would almost certainly be called upon to take action to deal with such a crisis. The BOJ would almost certainly readopt its zero interest rate policy. Indeed, the BOJ insists renewed financial system crisis is one of the only conditions under which it would consider easing policy. Also, the government might be forced to provide fresh injections of capital into the top tier of banks, courtesy of the Japanese taxpayer. Hopefully, the conditions attached to a further round of public funds injections would be more severe than in the past, with the Financial Supervisory Agency this time ensuring that banks adhere to their restructuring plans.

And a hard landing

Of course, backtracking on reform has become the stamp of the incumbent government, but Japanese taxpayers and JGB investors would likely be less forgiving than during the 1998/99 crisis. And with Upper House elections scheduled for July, the government would surely be more cognisant of popular sentiment than in the past. Indeed, a combination of renewed financial system crisis and rising JGB yields is probably just what is needed to prompt the government into more serious action to address Japan's structural problems.

FIGURE 1

FIGURE 2



But, in the process, the economy would suffer the hard landing the authorities have so desperately tried to avoid.

The negative spin is overdone

However, just as early 2000 saw overly ambitious expectations for Japan, the prevailing negative sentiment about the country's prospects appears overstated. The reality probably lies somewhere in between. Japan undoubtedly has severe and ongoing structural problems, and the government has been too slow to promote reform and too quick to shield special interest groups and spend taxpayers' money on superfluous public works projects. The country has also suffered a lot of bad luck, not least the slowdown in the global economy and the global stock market slide, which have sapped export demand and weakened the financial system in the process. The April 2000 re-weighting of the Nikkei 225 index, which weighed significantly on share prices, could not have come at a worse time.

Japan is also blessed – or cursed – with an incredibly cautious consumer sector, which refuses to view the government's current fiscal excess as anything other than its future tax burden. Therefore, despite falling real incomes, household saving ratios remain stubbornly high, weakening consumer demand and counteracting even the short term gains afforded by the government's fiscal injections.

Much positive news has been ignored

Indeed, the prevailing negative sentiment towards Japan has ensured that a host of positive developments has been overlooked. First, considering Japan's continuing structural inadequacies, the pace of economic growth has been respectable. It's just that the quarterly pattern of growth has been unfortunate. Smoothing the quarterly swings in activity, growth during January-September 2000 averaged a handsome 4% annualised (although admittedly, the figure is flattered by base effects). In addition, Japanese GDP statistics are notoriously unreliable and there is a strong tendency for GDP to eventually be revised higher. The wide discrepancy between initial expenditure-based estimates of GDP and our own supply-based estimates during 2000 certainly suggests that recent numbers understate the true pace of activity.

Reform is progressing, albeit in piecemeal form

Second, despite the government's reputation for wavering on reform, progress has been made, albeit in piecemeal form. Mark-to-market securities accounting, revised pension provisioning rules and bankruptcy reform all materialised during 2000. Indeed, the surge in bankruptcies during late 2000, particularly in the life sector, was at least partially related to the new bankruptcy rules allowing companies to file for court protection before they reach insolvency. Further progress is anticipated during 2001, with reform of the Fiscal Investment and Loan Programmme (Japan's shadow budget), a streamlining of government bureaucracy, the introduction of real-time gross settlement for money market and bond transactions and withholding tax reform all scheduled for the year ahead.

Companies are restructuring and slashing costs

Company restructuring is also quietly progressing. From the high profile success stories such as Nissan, to the traditional manufacturing companies, businesses are rethinking their strategies. Costs are being slashed, companies are investing in new technologies and cross shareholdings are being unwound. Admittedly, companies are finding it difficult to abandon traditional labour practices such as lifetime employment and promotion based on age rather than merit. Many businesses are opting to cut wages rather than shed excess staff, providing only a temporary remedy to the problem and prolonging uncertainty for employees. Eventually, they will have to bite the bullet. Even so, the benefits of company restructuring are beginning to show. Japanese exporters, in particular, have shown an amazing resilience to the appreciation of the Japanese yen, remaining fiercely competitive via cost and margin reductions. As a result, export volumes continued to grow strongly and export prices fell over the last year.

The financial sector is stable, for now

The woes of the financial sector may also have been overstated. A host of mergers have taken place over the last two years with resulting synergies, redirection of business and a renewed domestic focus. Costs have been cut (albeit with very limited labour shedding) and balance sheets have been cleaned up via the unwinding of cross shareholdings and aggressive bad loan provisioning. The slump in the equity market and resurgence in bankruptcies is undoubtedly unfortunate, but speculation about renewed financial system crisis may be premature.

As of September 2000, banks possessed sizeable cushions of capital, with the average capital adequacy ratio for the top 16 city and trust banks standing at 11.6%, with a Tier 1 ratio of 6.3%. Even taking into account additional losses on bad loans, we estimate that the Nikkei 225 would have to fall to 11,000-12,000 before the banking system would be at risk (and this estimate ignores possible equity price protection measures instituted by the banks on their remaining equity holdings). Of course, given current global equity market jitters, such a slide cannot be ruled out.

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Japan is still the world's largest net creditor

Finally, it is easy to forget that despite Japan's economic woes and the government's fiscal excess, the country remains the world's largest net creditor nation. It continues to export a steady 2%-3% of GDP in capital each year. And it is precisely this excess saving which is used to prop up countries with less prudent savings practices, most obviously the US. The Japanese authorities might dearly wish that Japanese households and businesses spend more, but it would be interesting to see how the global economy would cope with this potential capital drain.

Slowly, slowly approach to continue

So what does lie ahead for Japan in 2001? The risk scenario, and the one currently favoured by most pundits, sees renewed economic recession, stock market collapse, financial system crisis and reinstatement of the BOJ's zero interest rate policy.

However, we believe it is more likely that the government's 'slowly, slowly' approach persists. Under this scenario, the economy will limp ahead, reforms will be diluted and the government will hang onto power, if only for a lack of alternatives. Of course, it is not clear which of these two alternatives is the real disaster case for Japan. ■

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