What Next for Japan?

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Although a surge of government spending has given the Japanese economy a temporary boost, the outlook for later this year and beyond remains grim. The lack of consumer and business confidence and the admitted weakness of the banking system mean that growth will fade and unemployment will continue to rise. To revive growth and lower unemployment, Japan may eventually seek to raise exports by engineering a major decline of the yen or to increase domestic spending by a major military buildup. Either strategy, or both together, would pose an important challenge for American policy.

The current lack of confidence in Japan is easy to understand. After decades of strong growth and near zero unemployment, Japan has suffered stagnant output and rising joblessness throughout the 1990s. The unemployment rate in Japan now exceeds that of the U.S. and is expected to rise further as companies are forced to restructure and to abandon lifetime employment. In a country where mid-career hiring of white-collar workers is virtually unknown, the rise of layoffs causes already cautious households to cut spending and save even more.

Lack of demand and the low level of profits discourages business spending on new plant and equipment. Even companies that want to expand are often hampered by banks’ reluctance to lend. After years of disguising their bad loans and poor investments, Japanese banks have begun to admit the seriousness of their condition and to recognize that their capital positions do not meet international standards. Less tolerant government policies now mean that banks are allowed to fail and bankers to be fired. Relatively healthy banks are therefore reluctant to take on further risks by new lending because they fear that continued economic decline would impair their capital.

Many Sources

Japan’s current economic troubles have many sources. An excessively easy monetary policy in the mid-1980s caused an unsustainable explosion in the prices of real estate and stocks. The Japanese boasted that the value of Tokyo real estate exceeded the value of all the land in the U.S., and Japanese banks took that overvalued real estate as collateral on high-risk loans. The keiretsu system of corporate
affiliates with their lead banks encouraged the making of bad loans on the theory of collective responsibility. And the banks compounded their problem by investing large parts of their capital in stocks. When the Nikkei index fell from more than 40000 to less than 15000, bank capital and lending ability collapsed. Weak banking supervision allowed the banks* capital to erode until the problems could no longer be hidden.

The Japanese economy was weakened further when the government introduced and stubbornly retained a new value-added tax that cut household spending power and discouraged consumption. The collapse of imports in Southeast Asia after the 1997 currency crisis hurt key Japanese exporters with spillover effects throughout the Japanese economy. And the official acknowledgment that the Social Security pension system cannot meet its future obligations has caused nervous workers to cut spending in order to build retirement assets.

The economic remedies Tokyo has adopted in an attempt to rekindle growth have failed. The Bank of Japan has driven short-term interest rates to less than 1%, but nervous consumers still don’t want to borrow, and capital-short banks don’t want to lend. Under pressure from the U.S., the Japanese government abandoned its traditional reluctance to run budget deficits and began a program of massive deficit-financed infrastructure spending. These spending programs have had only very limited success, because much of the money is used to purchase land rather than to finance construction employment. Corruption may further hinder the effectiveness the of these programs.

The combination of these spending programs and the recession-induced decline in tax revenues will drive this year’s budget deficit to more than 10% of gross domestic product, an unprecedented peacetime level for any major industrial country since the Great Depression. The enormous deficits of recent years have caused Japan’s national debt to explode to more than 100% of GDP. After decades of government warnings about the dangers of debt, the public is frightened by what it sees, causing an even further retrenchment of consumer spending.

With interest rates close to zero and the scope for greater fiscal deficits exhausted, the government must seek other ways to stimulate the economy. The latest proposals emphasize reducing unemployment through training programs and temporary-employment agencies and strengthening corporate incentives by reducing keiretsu stock cross-holding. Such policies may have some positive effects but will do little to spur demand.

One easy way to stimulate economic activity would be for the Japanese government to relax the zoning rules that keep landowners from replacing houses with larger homes or apartment buildings. There is a substantial pent-up demand for better housing in Japan, and the extra building that would follow a relaxation of zoning would also expand demand for appliances and furniture.

In addition, the government could stimulate consumer spending by resolving the uncertainty about Social Security benefits. The most convincing way to do so would be to establish individual annuity accounts and deposit government bonds equal to the present value of the benefits that the government can afford. Such a system of “recognition bonds,” used in Social Security reforms throughout Latin
America, would reassure citizens, allowing them to resume spending. Although the implied benefits would be less than the amounts promised under current law, their size would no longer be uncertain and their payment would be guaranteed.

Unfortunately, domestic political considerations in Japan are likely to block both the revision of building rules and the fundamental reform of Social Security. What is more likely is an attempt to stimulate the economy through export growth by driving down the value of the yen. While traditional “sterilized” currency intervention (in which the Japanese government simultaneously sells yen for dollars and then takes back yen in exchange for government bonds) has little effect on the exchange rate, a massive “unsterilized” intervention in which the Japanese money supply is expanded and used to buy up dollars could take the yen down sharply.

This could start a spiral of devaluation. Driving the yen from its current level of around 120 yen per dollar to 150 or even 180 could cause the currencies of Korea, Thailand and other Asian countries to float lower in order to reduce their loss of competitiveness. China might respond by devaluing the yuan as it has warned repeatedly could follow a weaker yen. Those shifts would reduce the effect of the yen-dollar decline on Japan’s overall exports, pushing Japan to seek an even lower yen.

The weak yen would hurt American firms and cause the U.S. trade deficit to become even larger. This would inevitably cause conflict between Washington and Tokyo in a U.S. election year, especially if America’s economy is beginning to slow and its unemployment rate is beginning to rise.

An alternative Japanese strategy for economic recovery -- a major increase in military spending -- might be more favorably viewed in Washington but would potentially be much more troubling for the Asian region and eventually for the global balance of power. Japan could set aside its long-standing reluctance to spend more than 1% of GDP on defense and begin major military buildup. Such spending could be more effective in boosting demand than traditional infrastructure projects (because funds would not be spent on land) and would permit Japanese manufacturing industry to share in the fiscal package in a way that is not possible with construction programs.

As the generation that lived through World War II becomes politically less significant, there is growing support for what one major Japanese politician has called making Japan a “normal nation” with the same kind of defense capacity as other industrial powers. Many Japanese officials also fear that the end of the Cold War has made Japan vulnerable because the U.S. no longer needs it as part of its anti-Soviet presence in the Pacific.

**Nuclear Weapons**

Military events in Asia during the past two years are likely to increase Japanese voter support for greater military spending. North Korea’s demonstrated ability to send a rocket that could reach Japan was a shock to the Japanese public. One Japanese politician worried aloud that Japan must have its own retaliatory capacity because the U.S. might not attack North Korea if it launched a missile that hit a sparsely populated region of Japan. The nuclear weapons tested by both India and Pakistan make
Japan look feeble even though, with its nuclear energy program, it could quickly develop its own nuclear weapons.

The recent revelations that China has long-range missiles with the most sophisticated nuclear warheads can only add to Japan’s sense of defenselessness. Japanese military and political leaders may well argue that Japan can deter attacks on its territory only if it has substantial land-based and submarine-based nuclear retaliatory capacity.

The latest U.S. Japan military agreement welcomes Japan’s initiative to engage in military operations in support of U.S. activities beyond Japanese territory. In doing so, it provides a rationale for a Japanese capability to project force that can cause serious concern throughout Asia and as far away as Moscow. If that comes to pass, the world would no longer be the same.

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