

# A Long and Deep Trough

By *Josen Takahashi*

As far as the start of the latest recession is concerned, the exact date of this business cycle has not yet been established. During the initial stages of the recessionary phase, various macroeconomic indicators, including those pertaining to employment, remained at high levels. It is also widely acknowledged that both government and business, distracted by the possibility of exceeding the record "Izanagi boom," were extremely tardy in recognizing underlying changes.

Simply judging from movements in the indices of economic trends alone, microeconomic factors would seem to indicate that the downturn began during the October-December 1990 period. Trends in national income statistics also support this, with the underlying slowdown in private consumption and residential investment beginning during this period. Corporate investment in plant and facilities began to level off in the April-June 1991 period, but because a large portion of this was set forth in the fiscal year plan it was unavoidable that these underlying changes would take time to surface. Looking at business results according to recurring profits, there had already been a decrease in profits by the July-September 1990 period (*Quarterly Statistics of Financial Statements of Incorporated Enterprises*).

In short, from the latter half of 1990 the underlying business climate of the Japanese economy began to change and it is appropriate to assume that from the spring of 1991 the economy had clearly entered a recessionary phase. With this in mind, the duration of the 11th post-war economic upturn that began in December 1986 was from 46 to 49 months. While this doesn't match the 57 month "Izanagi boom," it does exceed the 42-month "Iwato boom," making it the second longest post-war upturn.

The problem is the continuing recession. Two years of recession will soon have elapsed and if autumn 1990 is counted as the starting point of this transition, it would add up to two and a half years, or

30 months. The present consensus is that the recovery will not come during the first half of fiscal 1993 so it is hard to avoid the conclusion that, at a minimum, the recession will have continued for two and a half years, or up to three years if one includes the transition period.

The slump that followed the second oil crisis was the longest post-war economic downturn, from March 1980 until February 1983, an extensive downturn that lasted exactly three years. It appears almost certain that this latest slump will be equivalent in length. Large-scale industrial and corporate restructuring and the deflation of assets are two major issues that have been grappled with during this latest slump and, considering that the usual anti-cyclical measures have not borne fruit in the slightest, there is great danger that this current economic standstill will be even more protracted.

## Package of comprehensive economic measures

Now, as far as Japan's economy in 1993 is concerned, problems of overall economic countermeasures should probably be identified first. The point is that this is literally a comprehensive package that must balance three important facets. Along with boosting demand, these countermeasures must deal with the uncertainty of credit and stock prices.

After the March 1993 closing period, financial institutions will move forward on financial disclosure. However, this does not include all financial institutions, just the 21 city, long-term credit and trust banks. Regional banks and other financial institutions will only have to disclose customer bankruptcies and other items that they have deemed to be unrecoverable. In other words the sector that is in the most difficulty will not provide enough disclosure.

Financial institutions that want to liquidate bad debts can advance purchasing funds to a newly-created company (the Cooperative Credit Purchasing Company, formed January 25, 1993) and have the

transactions made with those funds. In other words, they will make the purchases with their own money, but even so will be seen to have sold off the assets. The sales are thus seen as losses and the bad debts the banks were saddled with are handled as losses for tax-exempt depreciation. So financial institutions can buy their bad debts with their own money and obtain tax-exempt write-offs. Non-banks and small and medium-sized financial institutions in danger of bankruptcy, however, will not share in those benefits. In the final analysis this countermeasure does nothing more than augment the strength of companies that are not unstable.

As far as economic measures to boost demand are concerned, the focus on psychological aspects and the benefits of this announcement had dissipated by the autumn of 1992. From the standpoint of actual demand, the passage of the bill to stimulate the economy was stalled in the Diet and when it finally began to move it was almost the end of the year. Moreover, it is impossible to begin public works in colder regions during this time of year. In the case of public works, there is a pronounced lack of designers, on-site engineers and construction workers and the capacity for consumption has already hit a brick wall. There is an ongoing situation in which work is available, but construction does not commence. From the standpoint of boosting demand, it appears that no benefits can be expected from these comprehensive economic countermeasures during fiscal 1992.

## Reductions in the money supply

One indicator that has merited special attention of late is the slowdown in the growth of the money supply. The growth rate was at the 6% level in January 1992 but has declined rapidly since then. It was 0.2% in July 1992, 0.2% in August, declined 0.5% compared to last September, 0.6% in October and November, and 0.5% in December. In other words, the money supply fell below the levels of the





Trans-Tokyo Bay bridge construction—the largest public works project in fiscal 1992.

previous year for four consecutive months. For the money supply, growth is more or less normal if it is one or two percentage points above the nominal GNP growth rate. As such, the economy can be considered healthy if the growth rate would be 4% to 5% at present. If it is zero or even in the minus column it would, of course, be a post-war first and a very unusual situation.

As an indicator, the money supply is considered to precede real economic activity by a year or a year and a half, in which instance, these conditions will continue for at least another year or a year and a half. This is a condition of asset deflation in its truest form. Cash currency makes up a bit less than 10% of the overall money supply at 7% to 8%. The major portion consists of bank accounts such as current, ordinary, fixed-term deposits and CD (certificate of deposit) accounts, however, none of these are growing. Lack of growth in bank lending is the primary factor causing this stagnation in deposits. There are various arguments regarding the reasons for the lack of growth in bank lending, but most people think that it is because of banks' "reluctance to lend." On their part, banks say that it is "due to a chill in demand for funds on the part of ordinary companies." Both are correct.

Banks have become extremely cautious about lending risk and this is why lending has not increased. Ordinarily, banks

adhere to an iron rule that safety comes first in lending and deployment of investment funds. The inconsistent lending practices that banks engaged in during the "bubble" period was an anomaly that greatly diverged from this iron principle. Currently, banks have reverted to their normal posture, as opposed to being "reluctant to lend." It is also true that banks do not have the financial leeway to make indiscriminate loans. This can clearly be seen from banks' capital earnings and expenditures in the first half of 1992—Japanese banks have fallen deep into the red as far as the balance of their capital flow is concerned.

### Effects of the decline in land prices

There is also more than enough reason for the chill in demand for capital on the part of ordinary companies. In this type of climate, when the future is uncertain, it is natural that few business people want to procure new capital to try to expand business or develop new enterprises. Paradoxically, for many companies depreciation expenses on investments made up until now have ballooned and fixed expenses have increased drastically. The sudden jump in fixed costs has had a negative effect on earnings, making it a major factor in worsening business conditions. In this type of climate it is a matter of course that corporations are putting off

new investments.

Another factor is the reduction in corporate debt capacity. Take, for example, property that was appraised at ¥1 billion four or five years ago. If this was used for collateral at that time ¥1.2 billion could be borrowed from a bank. This was because at the time many people believed in the myth that property prices could never fall—they would continue to rise. Imagine if a company tried to do the same thing now. First of all, the price of the property has dropped to about ¥500 million. The collateral is now worth only 70% or 80% as well, so only ¥300 to ¥400 million could be borrowed. The potential for capital procurement has actually dropped by about one third. In addition, this would only hold true if the property was unencumbered. Under the bubble economy, it was normal for most property to be repeatedly mortgaged and because of this the property would have almost no collateral value.

This is the fundamental point when assets become deflated. When discussing the deflation of assets the common understanding is that "asset prices drop, losses are incurred, and the economy fails to improve," but some experts have commented that "there are both winners and losers so it comes out even overall." This is definitely the case when talking about profit and loss accounting. Even so, in capitalist economies the actual economy



has expanded through the expansion of credit. With the expansion of the actual economy the foundations for credit grew. This favorable interaction is what has upheld Japan's economy up until now. Those credit foundations are now shrinking for banks and ordinary businesses alike. In this type of climate it is not likely that the actual economy will continue to prosper on its own. The effects of asset deflation have more to do with this than profit and loss accounting.

### When will the economy hit bottom?

Macroeconomics and microeconomics differ considerably as far as the bottoming out of the economy is concerned. In addition, there has been a particularly broad-ranging divergence during the latest downturn. The microeconomy, that is, business on the company level, had already decreased in profitability by fiscal 1990.

On the other hand, there are still conflicting arguments as to when the recession began in the macroeconomy, but, at the latest, the Economic Planning Agency (EPA) concluded in its *Monthly Economic Report* that it was February 1992. In retrospect, though, the macro-indicators would seem to indicate that it might have been in the spring of 1991. As far as the onset of the slump is concerned, the microeconomic indicators preceded the macroeconomic indicators by nearly two years. If that is the case then it would seem that the microeconomic indicators should also precede macroeconomic indicators in the case of recovery, however, this is not the case—they are lagging behind. In other words, the recessionary phase is longer in the microeconomy.

Bearing this in mind, there is a strong possibility that corporate business profits will decrease in 1993 as well. At the very least, a large decrease in profitability at the mid-term closing will be unavoidable. At the earliest, corporate results will most likely bottom out in the fourth quarter of 1993 or at the beginning of 1994. As such, it is unlikely that the microeconomy will hit bottom during 1993, but there is a chance that the macroeconomy will start to rebound in the spring of 1993.

### Three proposals

Looking at the Japanese economy as a whole, companies are now desperately trying to cut fixed costs in order to boost earnings and, as a result, the economy is in a vicious circle—consumption is stagnating and unemployment is increasing. I have devised three methods to halt this vicious cycle.

First, assets must be reappraised. Currently, for financial institutions as well, assets are calculated at book value, that is, the current price of the property at the time of the purchase. These assets would be reappraised at 70% or 80% of the present posted prices so that they would approximate current market prices. Assets would then swell, making it easier for banks and so on to sell off inferior assets. There would also be more leeway for lending and this would be advantageous in dealing with the regulations pertaining to the ratio of capitalization to net worth. This would provide more depth in corporate assets as well, restoring capital procurement capabilities. However, implementation of this idea would lead to higher tax burdens. This is why up until now no one has gone so far as to actively attempt this, they were just left as latent assets. This is what led to the spread of a management style that depended upon latent assets. As far as this measure is concerned, high-fixed asset taxes should not be immediately levied in conjunction with these asset reappraisals. Instead, a grace period of five to seven years should be established and adjustments should be made over the medium to long term.

Second, as a countermeasure for stock prices, special steps for inheritance taxes on shares could be considered. There are very few individual investors in the Japanese stock market today and the market is at the mercy of institutional investors. The restoration of the stock market to a healthy condition will be a deciding factor if individual investors are to be lured back in future. With this in mind, inheritance taxes should be waived for the time being when stocks are inherited. Instead, a transfer tax should be levied when the shares are sold, deferring tax collection. Inheritance of stocks will confer benefits and through the levy of taxes

on sales transactions the number of owners who will continue to hold on to their shares will increase, bringing stability to the capital markets.

Third, in order to halt worsening business conditions, bonus write-offs or accelerated depreciation in the case of the depreciation of investment in plant and facilities should be considered. Looking at the present situation, in which many companies are troubled by the depreciation of investments made during the time of the bubble economy, it might be a good idea to allow larger write-offs for investments in energy conservation, labor reduction, or other investments that are in line with national policies.

Whatever the case, the Japanese economy is about to reach a crucial point. I offered repeated warnings about the advent of this type of downturn prior to this latest slump. During the heyday of the bubble economy people looked at me as if I did not know what I was talking about. Now I have written a book called *Nihon Keizai no Sokojikara (The Latent Energy of Japan's Economy)*, Tokuma Shoten, November 1992). It appears that people who were familiar with my previous opinions were surprised.

The initial responses from business people who read this book were interesting: A representative from Honda Motor Co., Ltd. stated, "We have begun to cut development and production costs. However, we are not reducing technology development. This is because, in any event, technological expertise is what makes us competitive and gives us potential." A Matsushita Electric Industrial Co., Ltd. spokesman echoed: "Ever since it was founded, our company has produced improved results during business downturns. I think that this is what you would call 'latent energy'." These are the kinds of responses that I expected.

With cost cutting and the implementation of other appropriate steps, I think it is safe to say that the day is not far off when the Japanese economy will fully demonstrate its latent energy to the world. ■

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