On a Roll—Downhill

By Kenji Mizutani

The Japanese economy is in excellent condition. Although the past four years have been marked by turbulent currency fluctuation as the yen soared and the dollar plummeted, the upshot of all this turmoil is that the economy is doing very well today.

Judging from external appearances alone, it might seem that the yen's appreciation and the dollar's depreciation have sparked this boom. However, such is not at all the case. The currency changes were actually deflationary factors. Not so long ago, the yen was trading at ¥250/$. At the peak of its recent roller-coaster ride, it was ¥121/$. This doubling in the yen's value had to have a profound impact on exports and export-oriented industries. Making the same product in the same way and exporting it for the same dollar price earned exporting companies only half as much as before.

This was clearly an untenable position, and many of these companies were forced to create leaner operations by cutting back on production and laying off workers. These unemployed people, their incomes drastically slashed, adapted their lifestyles to these altered circumstances by tightening their belts and cutting back on spending. The next step in this vicious circle is further depression of domestic consumption and another body blow to the economy.

Yet when the *endaka** recession started, the leading Japanese companies moved into action to avoid this fate. Rather than sitting back and watching with dismay as the economy went into a tailspin, they embarked on a determined effort, not to cut production, but to cut production costs by rationalizing operations.

This effort was not limited to the exporting companies. All of the subcontracting and other supporting companies also pitched in. This had a trickle-down effect as the big companies pressed their subcontractors for improved efficiencies and the subcontractors similarly pressed

*As explained in numerous other articles on the Japanese economy, *endaka* is made up of the characters for "yen" and "high" and is used to refer to a situation in which the yen is sharply higher on exchange markets.

the sub-subcontractors. As a result, there was a frenzy of rationalization throughout Japanese industry, and it was this rationalization that enabled the economy to turn the *endaka* recession on its head.

Still, these industrial efforts alone did not roll back the *endaka* recession. There were also a couple of very fortunate circumstances that worked to Japan's advantage. For one, the United States continued to be a major importing nation. Even though a drastic devaluation was needed to cut American imports and trim the U.S. trade deficit—and in fact the whole purpose of the Plaza Accord was to engineer a sharp drop in U.S. imports and a correspondingly vigorous increase in American exports—the United States was still relatively laid-back about its trade deficit and did not make the effort needed to curtail its imports.

Obvious beneficiary

As a result, the United States continued to import greedily from all over the world. In theory, the dollar's devaluation should have meant a decline in American imports and a slowing of global economic activity. Yet that was only the theory, and the practice was quite different. Continued American consumption buoyed the global economy and powered worldwide growth. Japan was one obvious beneficiary.

When the *endaka* recession started, the Japanese government moved quickly with activist intervention to head it off. Most of this effort was concentrated in fiscal policy, and a number of stimulative packages were introduced that coupled tax cuts with sharply increased public works investment. As a result, the bottom did not fall out of the economy and it was possible to tide things over until the start of the next growth phase. There is little doubt but that Japan would have had a prolonged *endaka* recession had these policies not been implemented.

Such is not, however, to imply that there is no concern for the future of the Japanese economy. After a long growth period, the leading economic indicators are gradually peaking out, and there is considerable anxiety that they may get worse, portending a major slowdown in the economy.

Although the present boom is sustained by consumption, many observers have noted that consumption growth is not really that vigorous. Sustained for over seven years, American prosperity has buoyed world economic growth for a long time. If American growth were to turn down, this would pull down the entire world economy—including the Japanese economy.

Given the presence of these negative factors, it is most unlikely that the Japanese economy will soar to new heights and overheat. This means that it is improbable that there will be any extreme tightening such as would push the economy off the cliff. Rather, it is much more likely that the pace of economic growth will be reined in and the economy will remain on its current plateau for some time to come.

The upset in the July 1989 Upper House election has meant that the opposition is now in the majority—putting an end to decades of political stability dominated by the ruling Liberal Democratic Party (LDP) and raising concern about the possible economic consequences. While it is generally granted that Japan's becoming a socialist economy would spell the end for Japanese prosperity, this is not a high-probability scenario.

In fact, it was precisely because the Japan Socialist Party (JSP) was in perennial opposition that it was able to parade unrealistic policies appealing only to fringe elements and protest voters, and the JSP is very much aware of the need to effect major changes in its policy platform if it is ever to be taken seriously and to have a chance of forming a government. The JSP has already done radical about-faces on a number of issues, and it is now much closer to the LDP than it used to be. Thus it is unlikely that election results will poison the economy.

Yet the more political instability there is, the more sensitive politicians have to be to their constituents' wishes. And constituents tend to be primarily interested in short-term local gain. In effect, voters are constantly asking, "What have you done for me *today*?" Tax cuts, government subsidies, public works investment and many more policies are all geared toward placating local voter interests. Because they are vying for the same votes, both the LDP and the opposition parties can be expected to favor such measures.

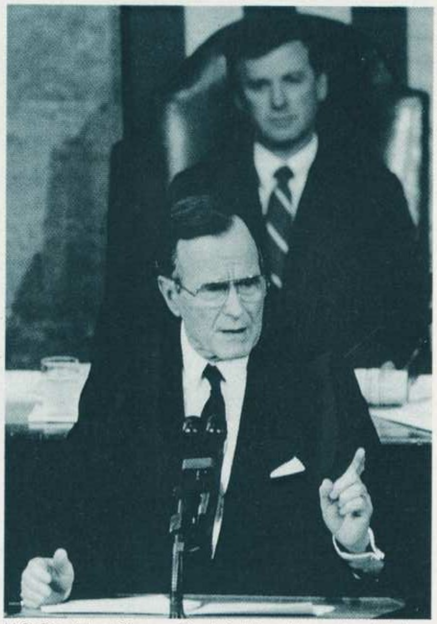


Photo: Reuter-Sun

U.S. President George Bush in his address to a joint session of Congress last February in which he presented his $1.16 trillion budget for fiscal 1990.

This will have a beneficial impact on the Japanese standard of living, at least in the short term. If the people feel better off and loosen their purse strings, there will be a new round of heavy consumption that will push the economy to new heights. Far from being a cause for concern, this opacity in the political situation will therefore work to the economy's short-term benefit. Yet there is the very real danger that people may ignore the long-term implications in their blind quest for short-term gratification.

Problems for the future

The most serious problem in the long term is the U.S. trade deficit. The United States has been running an aberrantly large trade deficit for the past few years. Yet because it has continued for a number of years now, the world has grown used to this situation and come to believe that it is acceptable.

Japanese Finance Minister Ryutaro Hashimoto (right) greets Barber Conable, president of the World Bank, at the annual meeting of the bank and the International Monetary Fund in Washington in September.

There is a feeling that this massive deficit has not had any adverse consequences for either America or the world economy at large. Indeed, some people even contend that the deficit has been a key factor in generating the current prosperity, in that America has been able to maintain a high standard of living by importing the things it needs and the other countries of the world have been able to base their economic development on strong exports to the United States.

In any country, it is natural to want to buy the best the world has to offer. Yet most countries have to settle for less, since they know that they will soon run out of money if they import more than they export. The United States, though, has been able to run massive multiyear deficits with no apparent harm—something that is possible only because the U.S. is a very, very rich country. There comes a point, however, when even the deepest pockets run dry. And when the money runs out, the consumption normally stops. Yet here too, the United States has been an exception—borrowing from abroad to finance its continued consumption binge. As a result, the world's once-richest nation became the world's largest debtor at the end of 1985.

The speed of this slippage is all the more striking when it is realized that America was the richest nation in the world as recently as the end of 1983—only two years before it took top-debtor honors. And in a truly frightening trend, the speed of the descent that began then has accelerated ever since.

America's massive trade deficit is intolerable. The underlying problems must obviously be solved, and soon.

The most rational procedure when a problem arises is for the person having the problem to identify the causes and to try to rectify them. It is very easy to blame things on other people, but that does very little to solve the underlying problem—especially since it is almost impossible to change the external circumstances.

Shifting the blame

If all your energies are devoted to the Sisyphean task of changing the rest of the world, you will have very little time or energy left for the much more important task of critically examining your own problems and trying to do better. Emotionally satisfying though it may be in the short term, shifting the blame to others is self-defeating and futile in the long run.

This is fundamental to all sorts of social behavior, and national economic policy is no exception. Concentrating on wrong-minded approaches is not going to yield right-minded answers. I do not see any progress being made so long as the United States relies on the crowbars of trade disputes and economic friction. Far from making things better, the process is more likly to turn long-time friends against the United States.

For the immediate future, I expect that the United States will continue its indulgent importing and that the world economy will continue to grow. But I do not see this as a process that is sustainable in the long term. Instead, it is a prescription for disaster.

What is needed is for the United States to recognize and admit its own shortcomings and to do what is needed to solve them. Having prospered so long with America's support, the world economy stands today at an important crossroads, and which way we go depends primarily on what America does.

There are also, of course, problems in Japan. The Japanese economy has had several rude jolts since the early 1970s (most noticeably the two oil crises and the exchange rate fluctuation). Every time, the government has gone deeply into debt to bail the economy out.

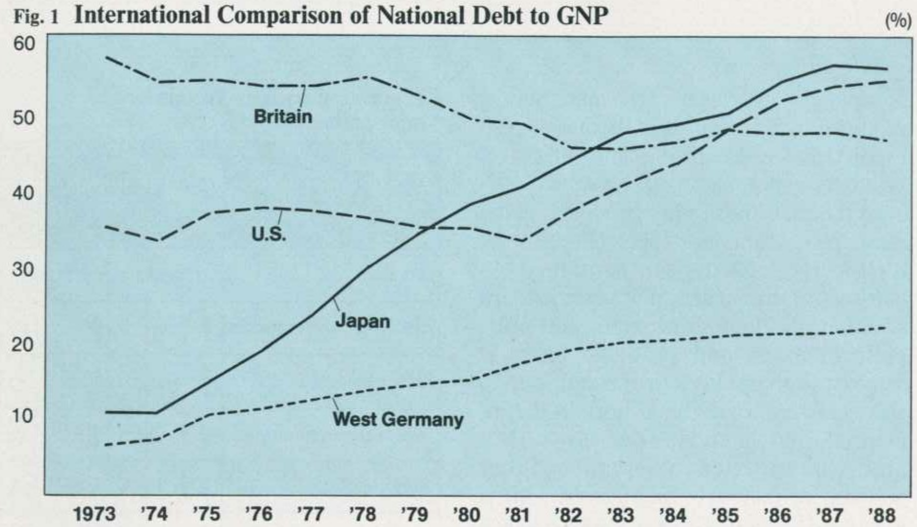
Theoretically, these debts were to be repaid and government finances put back on a sound footing once the economy recovered. This has not been done, however, mainly because of fears that the required fiscal austerity would plunge the economy back into recession. As a result, Japanese government finances have been deep in debt for the last decade-and-a-half. And every year of deficit spending has added to the total national debt.

Although the world's attention is today focused on the U.S. national debt, Japanese debt presents a much uglier picture. The Japanese national debt is today well in excess of America's, as is the annual debt service burden.

There was a time when Japanese finances were on a sound footing. Yet in fiscal 1975 (ended March 1976), the Japanese government budget went sharply into the red and the national debt started to balloon. Of the four leading industrial countries, it is Japan that has the highest ratio of national debt to GNP (Fig. 1). The government's debt service burden has jumped steeply, and things are very nearly at the point where the government will not be able to provide all of the services the people need.

During this same period, the people have grown conspicuously richer. Japanese life has been much improved, with both deep tax cuts and much-improved

Fig. 1 **International Comparison of National Debt to GNP**



Note: As of the end of each year
Source: Comparative Economic and Financial Statistics in Japan and Other Major Countries, Bank of Japan

welfare provisions. Following the classic pattern, the increase in disposable income has led to an increase in consumption, in turn leading to increased sales and strong economic performance.

The upshot has been to vastly strengthen and modernize the Japanese economy. Indeed, it may safely be argued that the Japanese economy would not be what it is today, and that the people would have to endure lower standards of living, had there not been this deficit spending.

However, while a little debt can be a good thing, it is possible to overdose on even the best of drugs. That is the situation now, as the economy is addicted to debt and as serious efforts must be made to dry it out. The withdrawal pains–specifically the deterioration of Japanese living standards–will be painful, but they must be endured if the patient is to regain his long-term health.

The Japanese economy is today characterized by a supply glut. Japanese industry is able to produce all manner of products in prodigious amounts, but there is less domestic demand than there is supply. While it would be possible to strike a balance by trimming output, the economy would be much better off if this balance could be achieved by expanding demand.

Worldwide, there are few countries that have sufficient supply to satisfy demand. Because everyone everywhere wants more and better consumer goods, the global demand is virtually infinite. Thus countries–and the United States is the prime example here–seek to enhance their standards of living by importing what they are unable to supply from domestic sources.

The United States imports heavily from Japan and a few other supply-surplus countries to sustain its proud standard of living and to carry the world economy on its coattails. As mentioned earlier, this is an option that is only open to the rich–including countries that were once rich and are now living on their credit.

Within Japan too, the supply glut is carried by fiscal indebtedness. Were the market to rely entirely on private-sector demand, demand would be inadequate and the economy could well be crushed under the weight of this supply glut. Thus the government's deficit spending was also an important way of sopping up this excess supply.

Yet the fact of excess supply anywhere opens up the possibility that other people elsewhere can draw on this supply. This is what finance is all about–providing the capital mediation so that customers without adequate supply can have access to the goods and services they want.

Indeed, this process has been responsible for economic development in a number of countries. Most of the developing countries have borrowed funds from the industrial countries and used this money to develop their economies. Unfortunately, many of these same countries have borrowed more than they could reasonably hope to repay and have been caught in the quagmire of international debt. Debt, of course, carries an interest burden, and countries that are having to borrow new principal just to keep up their interest payments are never going to get out of this debt trap on their own. These countries are a vivid illustration of the limits to living on debt.

Indulgent creditors

Things are somewhat different for the rich because creditors are more indulgent, but that often means that they are slower to recognize their predicament, get deeper in debt, and find it all the more difficult to get out. As is said of alcoholics, they may have to hit rock bottom before they can start back up.

It is certain that this debt party will come to an end and they will hit rock bottom sometime. When the party does end, it will leave the debtors with terrible hangovers. As soon as they stop their deficit spending, the economy will go into a tailspin. And this recession will be exacerbated as they try to repay their debts. How long will the people put up with this? How long can our societies tolerate deteriorating standards of living? There is a very real danger that what started as economic recession may well develop into social and political unrest and even upheaval.

As the heavily indebted countries wake up to their predicament, there may be a new anti-growth race to see who can get out of debt first. It is the country that wins this race that will be in a position to lead the new explosion of growth in the 21st century.

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