

Financial Instability Clouds Business Climate

By Sakamoto Sakae

Although the Bank of Japan (BOJ) has lowered the official discount rate to its lowest-ever mark and the government has hammered out measures to boost the economy, the Japanese economy has yet to be stirred out of its current slump. To make matters worse, the surfacing of illegal trading in U.S. Treasury bonds at Daiwa Bank's New York branch in late September spells further trouble for the Japanese financial world, which is already troubled by the bad debt crisis. While Daiwa Bank's losses of \$110 billion through unauthorized bond transactions is an internal problem, it is also the reason Japanese banks must pay higher costs for making dollar transactions.

Bank of Japan Governor Matsushita Yasuo has expressed fears over this so-called "Japan premium," saying "if [this] continues over the long term, impacts on the profits of Japanese banks will be unavoidable." If a recovery of trust in Japanese banks—now wavering due to the dual problems of bad debt in financial institutions and the Daiwa Bank affair—is delayed, the economic recovery may also be delayed.

In their October monthly economic assessment report, the Economic Planning Agency (EPA) described the current Japanese economic climate as "moving on a weak note in this lengthy economic slump." Director-General of the EPA, Miyazaki Isamu, said in a late October speech, "At the present time, the unemployment rate is at a high 3.2%, but the unemployment rate will probably rise slightly above this level in the future." (Japanese companies tend to hold on to excess workers rather than carry out layoffs during bad economic times. If this so-called "in-company unemployment" is considered, actual unemployment rates are around 5.5%.)

The BOJ's view of the economy is basically the same as the EPA's, but the BOJ comes across as slightly more optimistic than the government. At a late October meeting of heads of BOJ branch offices, BOJ Governor

Matsushita said, "The BOJ implemented easy-money measures in July and September, with the intention of quickly knocking the economy out of its slump and pushing it back on to the road of recovery. Little time has passed since these measures were implemented, and we still cannot confirm any concrete indications that the economy is moving out of the slump. However, on top of the dropping of short- and long-term interest rates, large-scale supplements to government expenditures have been implemented and the exchange rate is also being corrected. I believe that these factors will have due effect in turning the economy towards a recovery. In fact, the recent pessimistic view of the economy's future is receding."

This slight discrepancy in diagnosis of the economy seems to originate in a difference in the political standpoint of the EPA and the BOJ. The BOJ feels that, with the inducement of low market interest rates in July and the lowering of the official discount rate in September (from 1.0% to 0.5%), all necessary financial policies have already been put in place. The EPA, on the other hand, put together an economic-stimulus package of ¥14.2 trillion under the title of "Economic Measures to Ensure Economic Recovery" in late September, but believes that now, with compilation of the 1996 fiscal budget on the horizon (at the end of December), it would not be prudent to sound too optimistic about the economic climate.

The winner of this game of hedging bets about the economy's future should become clear in the first half of 1996. The outstanding elements that can still influence the outcome are, as mentioned above, (1) the outcome of the management of the bad debt crisis in Japanese financial institutions, carried out mainly by the Ministry of Finance and (2) the Daiwa Bank scandal, which is the direct cause of the high cost for Japanese banks to procure dollars (the so-called "Japan rate"). At the present time (the

end of November 1995), it is probably more prudent to reserve judgment on which way the game will go.

Long-term standstill and deflation

After peaking in the spring of 1991, the Japanese economy officially hit bottom in the fall of 1993. However, the economy has stood at a standstill for the two years since then. Recently, with the added insult of a strong yen and weak dollar pushing the slumping economy and falling prices into a downward spiral, more and more economists are taking the extremely pessimistic view that the Japanese economy has entered a deflationary phase.

Certainly, conventional wisdom, based on Japan's experiences with economic downturns since the end of World War II, has it that gross domestic product (GDP) should rise by about 8% in the two years after a bottoming out of the economy. Now, however, two years into the economic standstill that followed the bursting of the bubble economy, GDP has only risen around 2% from rock bottom. Another key reason behind economists' current plunge into extreme pessimism is the psychological shock of twice seeing New Year's predictions of an end to the economic doldrums shot down by reality.

EPA Director-General Miyazaki takes a view directly opposite of those proclaiming the beginning of deflation. "The economic climate is clearly serious, but the current situation is not deflation," he says, comparing the current situation to the Great Depression of 1929-31. Wholesale prices in 1930 were 17% lower than in the previous year and 1931 prices were 15% lower. Consumer prices in 1930 were 14% lower than the year before and 12% lower in 1931. Gross national product (GNP) in both 1930 and 1931 was 9% lower than the previous year and unemployment during both years was 6.5%.

In the present economic downturn, however, the year-on-year change for wholesale prices, consumer prices and the growth rate are all hovering around zero.

Clearly, in comparison to the Great Depression between the two world wars, it would be an exaggeration to label the current economic standstill a period of deflation. It cannot be denied, however, that a vicious deflation-like circle is emerging. Falling prices lead to falling corporate profits which lead to corporate cost-cutting. Cost-cutting leads to pressure to hold personnel costs down which leads to falling consumer consumption. Lower consumption causes lower prices and the cycle continues.

According to Miyazaki, the causes of the long recession can be explained by the following four points. First of all, in a backlash following excessive plant and equipment investments during the bubble period, companies are now holding plant and equipment investments down. Secondly, since land and stock values plummeted when the bubble burst, investment by companies and consumption by individuals have been low. Thirdly, the plummeting of real estate values saddled financial institutions with huge amounts of bad debts. The banks, now burdened with writing off these debts, are conservative about extending loans. The fourth reason is that the future path of structural reform, necessitated by the high yen, is hard to foresee and companies are taking a conservative attitude in their business activities.

Investment of public monies also necessary

How are finance authorities attempting to respond to the problem of bad debt? In late October, BOJ Governor Matsushita gave the following three prescriptions for correcting the debt crisis in a speech entitled "The Plaza Accord and Lessons in Policy Management."

"The first [prescription] is for the restructuring of individual financial institutions carrying bad debts. This is the foundation—and the prerequisite—for all other measures. The impor-

tant point is recovery of appropriate net worth."

"Second is burden-sharing among all the component members of the financial system, including, for example, raising the premiums on insurance on deposits."

"Thirdly, at a time like this, when losses have arisen which cannot be completely recovered by members of the financial system alone, it unfortunately becomes necessary to ask for help from the people in the form of government expenditures in order to protect the stability of the overall system."

On the subject of the "Japan premium," Matsushita, attempting to erase financial unease, said, "It is unfortunate but true that 5% of the total capital of

Japanese financial institutions is in the form of non-performing loans. However, that is not the whole story. Another important fact is that the financial institutions that make up the core of the financial system, with their accumulation of net worth and strong current profits potential, have a good chance of writing off their debts mostly over the next two to three years."

It is not clear which banks he meant by the core financial institutions but it might be a mistake to assume that all Japanese banks are on unsure footing.

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Photo: Kyodo News Service

Daiwa Bank President Fujita speaking on foreign loan fiasco at a press conference.