

Will Japan's Deflation be Prolonged?

By Sakamoto Sakae

Japan's economic woes are deepening as financial institutions continue to delay settlement of their bad debts. Although the United States, in an official intervention, sold the dollar to help stop the yen's free fall, on condition that Japan resolve the debt issue, market pressure against the Japanese currency persists. The Tokyo Stock Exchange Stock Price Average, a gauge of the Japanese economy, remains on a weak tone depressed by reports concerning fragile financial institutions. Analysts are increasingly pessimistic about the future. Some economists even warn that the Japanese economy has passed the stages of depression and deflation, and has taken a plunge into panic.

The first panic since early Showa

An influential independent economist says that the panic was triggered by the collapse of Yamaichi Securities, Sanyo Securities and Hokkaido Takushoku Bank in autumn last year.

"The panic began when Yamaichi and Hokkaido Takushoku went broke. A total of between five and six million customers of those firms, including 2.86 million Yamaichi clients, incurred direct damage. The tragedy of the bankruptcies was embedded in the minds of the general public, too, after they repeatedly saw Yamaichi President Nozawa cry during his press conference on television. This prompted a panic, the first since the early years of the Showa Period. As a result, I believe most Japanese will refrain from buying durable consumer goods for the next year or two," he said.

While the panic was triggered by the collapse of major securities firms and a bank, the underlying cause is, needless to say, the bursting of the bubble in asset prices.

"The value of Japan's land assets, which totaled ¥2,400 trillion in 1990,



Photo: Kyodo News

Can he revitalize the Japanese economy? Obuchi Keizo was elected president of the LDP on July 24, and as prime minister on July 30

had shrunk to ¥1,400 trillion by 1998. This means that ¥1,000 trillion, roughly double the Japanese annual gross domestic product (GDP) of ¥500 trillion, evaporated in the last eight

years. The contraction is tantamount to the impact of World War II, when the economy is said to have lost double its then GDP. Also considering the drop in securities prices, which amounts to

¥300 trillion, the Japanese economy is certain to have a tough time trying to recover."

How long, then, judging from the nation's strength, should the panic continue in Japan? "Experience in Japan and abroad shows that the impact of the collapse of a bubble economy is most severely felt 10-12 years after its peak," says the economist. "This is the ninth year from 1990, when the Japanese economic bubble is assumed to have reached its peak. Next year will be worse. No wonder the ruling Liberal Democratic Party has begun serious attempts to restructure banks. I suspect that there will be another wave of bankruptcies of both financial and ordinary corporations after the Upper House elections in mid-July. The economy will see the real bottom next year."

The Asian crisis to strike Japan

The Asian economic crisis adds deflationary pressure to Japan and compounds its problems. The economist is aware of the fact that the resignation of President Suharto did not end the crisis in Indonesia, but left many problems yet to be resolved.

Due to the fall of the rupiah, Indonesian GDP has contracted drastically, from the equivalent of U.S. \$229 billion to \$60 billion. However, the interest payment on its \$140 billion foreign debt exceeds \$10 billion a year. Jakarta apparently has no choice but to abandon debt repayment. Because half of Indonesia's debt comes from Japanese banks and corporations, it is only a matter of time before Japan's bad debt balloons.

The Asian impact will not be limited to finance, but will be felt among Japanese manufacturers as well. "Japanese chemical makers will face a nightmare, because Asian petrochemical imports will enter Japan at prices 40-50% cheaper than before. China and Hong Kong will devalue the yuan and the Hong Kong dollar respectively, when they are no longer able to withstand the fall in exports competitiveness. Japan will see an influx of cheap Asian goods from the end of this

year to next year. This deflationary pressure will remain for the next four to five years."

Another economist working with a major think tank expects the Japanese and Asian crisis to take a toll on the U.S. "Japan is definitely in the midst of deflation. The most important goal for the government and the financial authorities this year is to prevent deflation from developing into a deflationary spiral. The question is whether the problem can be contained within Japan. If the Asian crisis spills over to the U.S., it will be a serious situation. And the probability of Washington getting trapped in a deflationary cycle is 50%," he said.

Japan's real GDP for fiscal 1997, which ended in March, slipped 0.7% from the previous year, the first drop since 1974 and the second fall since World War II. The fall was sharpest in the previous January-March quarter, when it plunged 5.3% in annual terms, underlining the independent economist's view that the collapse of financial institutions late last year dampened individual consumption.

Recent economic indicators point to mixed outcomes. Wholesale prices for April and May fell by about 2% from a year earlier, while consumer prices inched up 0.4% in April from a year earlier. However, major think tanks forecast a 4 to 5% drop in wholesale prices and a 2 to 3% fall in consumer prices for the whole year, clouded by the domestic economic slump and an increase in cheap imports.

Calls surface to suspend "Big Bang"

A former Ministry of Finance official with long experience in administering banks says it is impossible to solve financial institutions' problems simultaneously with "Big Bang" reforms to deregulate, internationalize and securitize the financial system based on the rules of being free, fair and global. He notes that the problems, namely settling bad debts the banks incurred following the collapse of the bubble economy and the reduction in their numbers, including major banks, cannot be carried out alongside the

reforms while deflation looks likely to persist.

"Ministry officials were well aware of the need to reform the financial system drastically, but failed in its enforcement because they were obsessed with the idea of making it 'non-violent,' meaning lukewarm changes that cause no victims," the former official said, referring to the ministry policies of the 1980s. Specifically, he regrets the ministry's failure to forcibly reorganize the banking industry and system (indirect financing) to shift weight to securitization (direct financing) to reflect the diminishing role of banks in the developed Japanese economy. Another source of regret is that despite the buildup of personal assets which pushed the nation's per-capita GDP to the world's highest, the ministry failed to promote individual direct investments in securities as a means of spreading return risks. The final mistake, according to the former official, is the delay in globalization of banking activities following the introduction of the floating exchange rate system, which exposed other firms to international competition.

Knowing the changes surrounding Japanese financial institutions, why did the ministry waver in carrying out the reforms? The official explains that "the ministry thought that it was possible to 'live together' in positive terms, or to 'go on as escorted group of ships in a convoy' in negative terms." Recalling that such a concept was shared by the media, it may be crude to place the entire blame over the absence of reforms on the Ministry of Finance. The former official calls for a suspension or postponement of the "Big Bang," saying that "resolving the financial crisis and going ahead with the 'Big Bang' while the economy is in deflation, frankly speaking, poses a dilemma."

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