THE UNIVERSITY OF TEXAS AT AUSTIN

Title: **Is there light at the end of the tunnel for Japan?**

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Date: July 21, 1999

Abstract:

Explores Japan's economic predicament and prospects for eventual recovery. Describes the origins of Japan's economic issues and draws contrasts between Japan and America/Europe in terms of human resources, finance and politics. Offers three schools of thought on what will happen to Japan's economic predicament in the coming years. Provides five factors justifying optimism: increases in foreign investment, deregulation of financial markets, business restructuring, bureaucratic self-awareness and the rise of the Internet. Describes additional reforms necessary for recovery, including tax reform, modernization of land use policy, acceleration of risk-taking, prevention of unwise government spending and deregulation. Offers implications for a Japanese recovery for the U.S.

Keywords: policy; economic growth; Japan

IC² Institute Working Paper WP-1999-07-21

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IC² Institute – JIMT Series Working Paper
July 21, 1999

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Working paper # 99-07-21

Is there light at the end of the tunnel for Japan?

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Japan is a country of uncommon ambiguity, not at least in the fields of economics and finance.

It has world-class companies that have achieved dominance in several powerful industries, notably automobiles, manufacturing automation, and consumer electronics. But it has companies in fields such as retailing, distribution, pharmaceuticals, and business services that lag badly behind best-practice American or European firms. And even formally sound corporations have fallen onto hard times. The most striking example perhaps is that of the car maker, Nissan, which was facing imminent bankruptcy when it was able to orchestrate a rescue by France's Renault.

Japan also has enormously talented human resources. It has a highly educated and hard-working labor force that has enjoyed unimaginable increases in living standards over the past 50 years through impressive increases in productivity. Yet Japan almost entirely lacks a functioning labor market, one that people can count on to find new jobs and improve their personal career opportunities. The phenomenon of lifetime employment neatly summarizes the contradictions. As a system, it instills worker loyalty, but it breeds inflexibility and resistance to industrial reorganization. Japan is far from alone from having people who seek to preserve lifetime employment. The US has big pockets of it, too, e.g. school teachers. But what is distinctive is we rarely give lifetime employment to managers in private industry. Japan has promised to and this cultural trait has helped to stifle the capacity to change.

Japanese companies have sought to get around the straight-jacket of lifetime employment for managers in two ways. One is by adopting the American approach of giving sizable bonuses to encourage, if not force, early retirement at relatively young ages (ordinarily at 55 years old, but increasingly even at 50). Second, they route many of the less productive younger executives into various subsidiaries, often less important businesses that pay less well than the parent. But by now everyone sees through this ruse. There is a growing awareness, and hints even of some acceptance of the fact, that it is just a matter of time before more fundamental industrial restructuring, including wholesale layoffs will be common.

Another ambiguity resides in the area of finance. Japan gets considerable benefits from the huge personal savings rate of the Japanese household sector. Those funds have allowed Japan not only to finance its domestic capital spending needs and governmental budgetary deficits, but also to support an expansion of Japanese industry onto every continent. Yet, despite the considerable financial resources that are available, Japan is handicapped in numerous ways by the absence of significant risk-taking by Japanese households and firms.

Consider these data: US households hold barely 15% of their financial assets in what might be called 'super-safe' form: deposits, certificates of deposit (CDs), and money market funds. These are financial assets that offer certainty of capital value, but limited upside potential. Conversely, Americans hold well over half of their assets in the form of open market instruments (stocks and bonds) and mutual funds, all of which are exposed to market risk (but provide the opportunity for commensurably higher returns over time).

By contrast, Japanese households hold 60% of their assets in super-safe assets but well under a quarter of their financial assets in open market instruments. They own only modest amounts of mutual funds (although this has begun to change as both Japanese and American mutual fund companies are energetically seeking to develop an extensive marketing presence in Japan under liberalized regulatory guidelines). The anxieties of the ordinary Japanese citizen are further underscored by the weakness in housing starts over the past several years -- in a country with the lowest mortgage interest rates in modern history. Encouraging risk-taking has never been a priority for the Japanese Government. Instead, it has a vested interest in Japanese households putting large amounts of funds in the postal savings system at negligible interest rates, since that money is directly recycled into Japanese Government securities. The government of no other major industrial country depends on such a captive system for financing itself.

One final ambiguity is the following. Japan enjoys the political benefits of a relatively a flat distribution of income, certainly in comparison to that of the United States. Moreover, while it has been stung by the terrorist activities of a handful of extremist groups, the Japanese culture is generally devoid of the intractable social pathologies -- high crime rates, narcotics, illiteracy, extreme poverty or language barriers -- that confound the United States and some other industrial nations.

Yet, every opinion poll indicates that the Japanese Government and bureaucracy have lost considerable confidence with the Japanese people. There is a great deal of disillusionment with the Japanese Establishment more generally, but not much enthusiasm for any of the alternatives. The voters know that things have gone wrong, are worried about the future, but have not heard any new ideas from opposition political parties -- either about specific policy initiatives or broad philosophical alternatives -- that excite them. Thus, successive Japanese Governments have not had a powerful mandate to take bold measures to combat the country's economic and financial problems.

The upshot is that American and European views of Japan have changed dramatically during the past decade. Japan's admitted strengths were so widely admired and feared that by the late 1980s commentators and large segments of the public in the United States and Europe were convinced that Japan represented a genuine threat to their continued economic and financial prosperity. Hardly anyone noticed the contradictions in the Japanese system that almost overnight fell into stagnation and financial disarray. Now that these economic and financial problems have dragged on for ten years and show only tentative signs of being corrected, Western opinion has largely swung over to exaggerated pessimism.

Let's try to put the Japanese predicament and prospects for eventual turnaround in somewhat better perspective. To begin with, consider some of the origins of Japan's problems.

1. *Too much leverage in the 1980s created a bubble in asset prices.*

Leverage means borrowing to make capital investments, buy a house, or finance the purchase of financial assets. Thus, it can be deployed by business corporations, households, and investors. During most of the post-war reconstruction period, the Japanese authorities employed an essentially successful non-market credit rationing scheme -- it was called "window guidance" and helped direct credit to promising or otherwise favored industries. Then in the mid-1980s, in the midst of tremendous pressure from the US and other major Governments to open up the Japanese economy and financial system, they suddenly scrapped this system. But they didn't construct a competent system of financial supervision to replace it. The result was a splurge of financing -- of business capital expansion, of grandiose real estate developments, and of stock market speculation, sometimes by members of organized crime. Eventually, the bubble burst, when a tightening in monetary policy greatly limited credit availability. As the prices of land, office buildings, and stocks plunged, loans against that collateral couldn't be repaid. The financial sector of Japan reeled from the impact, which even the banks' considerable reserves could not protect them from.

In the same decade of the 1980s, the US also deregulated banking without improving supervision and ended up with the crisis of the savings and loan industry. But because of bipartisan guilt, we acted to put that sorry episode behind us. Japan misread the lessons of that approach and decided to put off realizing significant losses. They figured if they could buy time the financial positions of the banks would heal on their own. That turned out to be a big mistake and losses simply continued to accumulate. Only in the past year have the necessary remedial measures been taken.

2. *Too many politicians exploited the period of Japanese economic and financial strength without much regard for the longer-term consequences.*

The Liberal Democratic Party in Japan ruled from the 1950s onward as a relatively centrist, non-ideological party. Factionalism was at the core, but factions were based on personality and family connections, rather than policy or philosophical differences. By the 1980s, what had started out as a reasonably effect governing force was becoming increasingly corrupt. The LDP lost its way and its reputation. It even briefly split up and briefly a government was formed by a coalition under Prime Minister Hosokawa that did not include the LDP. But after the schism in the LDP was patched up, the Japanese political reform movement lost momentum, and politics still is handicapped by the absence of skilled, competent opposition.

3. *After the asset bubble burst, the Japanese establishment did almost everything wrong.*

The bureaucrats denied there would be much fallout on the real economy, an historic miscalculation. They have always had a tendency to push the line that "We Japanese are different" and in a number of respects that is true, as it is for every sizable nation. But even though there are plenty of admitted differences between Japan and the US or Europe, the line is dangerous is pursued too far. When asset prices fall, there are many complex wealth effects that take place. They take place through circuitous routes and are not easily captured in standard econometric models. Thus it is not surprising that the magnitude and duration of negative wealth effects were not appreciated by Japanese policy-makers. [They are not well understood here, either. The positive impact of higher stock market wealth on consumption does not come about directly. Mainly it happens indirectly, through more boisterous business formation, which leads to more jobs, higher income, and from there onto higher consumption.]

The Japanese business community figured they could simply export their way of the problem, which they had in the past. Japanese politicians agreed. That created immense trade frictions which in its first term the Clinton Administration was all too eager to exploit. Japan fought back instinctively, which was self-destructive. They wasted a lot of time digging in on subordinate issues and missed numerous opportunities to deregulate with determination. The history books will record that both Governments made big miscalculations that hobbled economic reform and delayed financial recovery. It was not the finest hour of either side.

Meanwhile, Japanese bankers tried to downplay the severity of their problems, while their regulators aided and abetted that conspiracy of silence. So useful things were not done.

Japanese officials, bankers, and businessmen all resented the advice they were getting from the US and Europe, even when it was right.

Through it all, Japanese politicians and bureaucrats had a profound blind spot about the need for a shift away from investment, which is obviously important for achieving sustained economic growth but can be overdone, toward consumption. Fixated by the need to raise more revenue to balance a bloated government budget deficit and frustrated by their inability to reform the existing income tax system, which was full of inequities and loopholes, they forced through the Diet a hugely unpopular consumption tax right in the middle of a fragile economic recovery. While their motivations were understandable -- the tremendous unfairness in the scope of the income tax was indeed scandalous -- they were tone deaf on timing and broader psychological consequences of the hated consumption tax. Consumption seized up and the Japanese economy was slipping into renewed recession just as the United States was on the verge of one of the most explosive periods of economic growth -- and stock market jubilation -- in American history.

4. *Technically macro-economic policies were conventional, but badly implemented.*

Every economics textbook teaches, even in Japan, that countries that are in recession have to provide stimulus either through monetary accommodation or fiscal policy actions or both. How much monetary ease and how fiscal expansion is the right mix is more a matter of art than economic science. And how much of the fiscal expansion should come through tax cuts and how much through expanded budgetary programs is primarily a matter of politics. But governments know what they should do and when they are not constrained by financing pressures or a foreign currency crisis, they usually do it. Japan was no different, only they moved too slowly and too timidly. Here the carping from the US Government for Japan to take such had its price -- too many delays, too many phony fiscal packages that promised more than they delivered.

5. *A certain amount of bad luck was involved.*

The Asian financial crisis of 1997-98 destroyed regional demand, worsened the Japanese banking problem, and created new US-Japan frictions, especially over new approaches to providing financial assistance to debt-troubled Asian governments. Japan didn't cause the Asian implosion and Japanese businesses and banks were among the most severe casualties. Fortunately, it has taken less time for the Asians to get back on their feet than most of us predicted at the time.

II. **Looking ahead.**

There are essentially three schools of thought on what will happen to Japan's economic and financial predicament in the coming years.

1. The *"nothing has changed"* school.

Those who subscribe to this view judge talk of restructuring Japanese industry as mostly talk. They fear the Japan is in a liquidity trap. Companies have too much excess capital, won't invest much, and what investment they will do will be to cut costs (worsening the unemployment problem). Plus bank recapitalization is still too slow for Japanese financial institutions to be dynamic lenders. Society will not permit wholesale layoffs, so cost-cutting will be a drawn out process, keeping consumers anxious about their own futures. An export rebound is limited by Japan's already huge current-account surplus and by financial constraints on the revival of the rest of Asia. Japanese politicians lack the ability to inspire and reassure. Any recovery beyond what has already been achieved will be hesitant and unsatisfactory to Japan's trading partners. So before long, we will be back in an endless sequence of trade complaints, recriminations, and unsuccessful negotiations.

2. The "*short-term lift, long-term malaise*" school.

Determined application of stimulative fiscal and monetary policy will provide a textbook result. But structural reform is a pipe dream. Japan is different, doesn't want to imitate Anglo-Saxon methods, and will look for ways to put off difficult decisions. Many in Congress and in the executive branch share this admittedly pessimistic view.

3. The "*they've done it before and can do it again*" school:

Times are changing, but the payoff will come later rather than sooner. Adverse cyclical forces are too strong to permit much of an immediate recovery, notwithstanding the bizarre spike in 1999 Q1 output, which reflected a spurt of (unsustainable) government spending. But much is happening that died-in-the-wool critics of Japan are missing. It is in these early and by no means irreversible positive signs of change that we can begin to recognize the makings of a more modern, more high tech, and more consumer-friendly Japan.

III. Why the optimism?

Four factors justify the optimism of this third school of thought.

1. *Foreign companies are coming in.*

Japan needs foreign inward investment, not so much because it needs the money but because it needs the management changes that come with it. This has been the preeminent benefit of foreign direct investment in every country, including our own. Naturally, the Japan Establishment resents and fears it, as many Americans did in the 1980s when we were on the receiving end of large-scale Japanese and other foreign purchases of real estate and construction of manufacturing facilities. But Japanese officials are stepping aside after a generation or more of blockages. As a result, there have been some extraordinarily important investments in the past years. Some examples include GE Capital's acquisition of Japan Leasing and Lake Finance and its expression of interest in expanding its activities in Japan further; the Cable and Wireless bid for IDT, the telecommunications company, despite opposition from NTT and most of the Japanese press; the merger of Sumitomo Rubber with Goodyear that left Goodyear as the surviving entity; the aforementioned Nissan - Renault affiliation; the Ripplewood Capital acquisition of the defunct Long Term Credit Bank; and a host of smaller investments in divested subsidiaries of large Japanese corporations intent on focusing on their core businesses and getting rid of units that don't have much chance of success in Japanese hands.

2. *Banking reform.*

Deregulation of financial markets is happening. Disposition of insolvent banks is in progress. The full results won't come overnight, but the facts on the ground are changing. There is more transparency in recognizing losses, a sensible program for recapitalizing viable institutions, and huge mergers designed to create entities that can be competitive both in Japan and internationally. Within the financial industry, there mainly needs to be redeployment of people, not net cuts. Japan has far fewer people engaged in financial services than US, despite the whopping savings rate. Under new liberalized regulations, there is ample scope for the development of a pension industry, a mutual funds industry, and a venture capital industry. Soon, the Japanese Government will begin to give some thought to denationalizing public institutions like the postal savings system and the Japan Development Bank, vestiges of a bygone era when Government allocated credit rather than the markets. That must and will change.

3. *Business restructuring is becoming a new creed.*

So far, progress has been spotty, but there are some success stories. Keiretsus are less disciplined, cohesive, and supportive of laggards. Cross shareholdings are being phased down. As mentioned, large corporations are slimming by selling off unprofitable subsidiaries. Perhaps most symbolically, top university graduates seek to work for foreign firms, a sea change from just a decade ago when you would be ostracized for doing that.

4. *Bureaucratic self-awareness.*

There is a generational change about to take place in government and the civil service. Deregulation is no longer under debate. It is a foregone conclusion. But anxiety over job creation is genuine, as it is in the United States even after a record-long economic expansion. Not all of the bureaucracy is on board. Those ministries like Agriculture, Construction, and Telecommunications who see their mandate as protecting existing jobs rather than putting in place a system in which new jobs in the modern sector can be created are digging in their heels. But now they know that what they are doing is anachronistic. The patriots are the deregulators these days.

5. *The Internet revolution.*

Japan makes high tech but doesn't use it very well. That is changing, and the figures prove it. Japan is number two in the percentage of the population with access to the Internet. E-commerce is on its way. New ventures are being formed, often with foreign partners. Even a new stock exchange has sprouted to provide a means for these start ups to go public. Soon, great wealth will be generated, and the old Japanese virtue of everybody of a certain age making the same money, with progressively higher salaries the older you get, will be gone forever because it is the younger generation that has the skills, the energy, and the desire to create new businesses. Japan Inc. was built around a set of industries that have reached and in several cases surpassed middle age. It cannot and will not be reincarnated in the modern industries for which we use the short-hand ".com".

IV. What's left to do?

1. *Help the poor consumer*, literally, through sweeping tax reform, including deep cuts.

Japan is burdened by an Establishment, including not only Government officials and bureaucrats but also scholars and journalists, who feel that the standard of living in Japan is high enough already, so there is no urgency or even merit in achieving greater economic growth. This is preposterous to almost everyone from the United States and Europe who has visited Japan and knows anything about Japanese economic data. There are huge unmet needs. And living standards are hardly comparable to those for people of similar age and profession in the United States. Lower income Japanese need a tax cut badly, and so do most middle and upper middle income people.

2. *Decompress Tokyo.*

Land use policy generally is a huge obstacle to the whole restructuring effort. For one thing, and the legal code must be modernized to allow distressed property to get back on the market and be put to its best use. Younger officials are determined to change outdated mechanisms in this area and they deserve US Government support.

3. *Push risk-taking.*

One key to jump starting risk-taking by the household sector is to accelerate the development of 401k-type self-directed pension plans s key. Equally important is to unlock all that money now deposited in the postal savings system. A trusted, clean mutual funds industry is also a prerequisite, but it can be taken for granted that the presence of American powerhouses like Merrill Lynch and Fidelity will speed that modernization.

4. *Stop the unwise government spending.*

Construction workers can't be coddled indefinitely. Fiscal stimulus has to come from tax cuts, not unwise spending programs. Even Japanese laugh about the idiocy of many of the public works projects that yield no conceivable economic benefit beyond paying off politically connected developers.

5. *Deregulate something every month.*

Build a contagion of positive change. Most of all, make it easier to set up new businesses. When it is as easy to set up a new business in Tokyo or Osaka as it is in New York or San Francisco, then the field will be prepared for extensive, deep reform.

V. What does rehabilitation in Japan mean for the United States?

For over two decades, successive US Administrations have been hectoring the Japanese to reform. And we have been right to do it, even when our rhetoric, tactics, and timing have been infelicitous. But now that the Japanese Government has done just about everything we have demanded we have the prospect of their being successful. And at just the wrong time. The US economy is supercharged. The dependence on foreign capital inflows to finance excess demand has never been higher. The Fed is gradually moving away from the easy money policy of the past few years, although genuine restraint is still in the future. The commodity markets have turned up, notably oil. The rest of Asia is rebounding.

When to this mixture you add a dose of recovery in Japan, even a moderate, halting one, you have the recipe for a sharp increase in US interest rates that could challenge the stock market, so far impervious to the meaningful increases in longer term interest rates that have occurred in 1999.

Let's admit the truth. The US has been benefiting from the misfortunes of others for a long time. That will end, and probably sooner than many now expect.