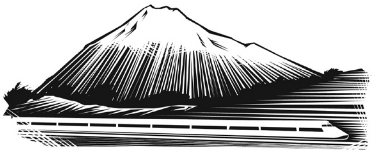

Solving Japan's Economic Puzzle

by Kazuo Ueda

THE CURRENT FINANCIAL crisis has affected virtually all corners of the world. Japan has, of course, been unable to escape from it. There is, however, a serious puzzle here. As widely documented, Japanese financial institutions' exposure to the credit market binge has been relatively limited. Yet, the data to date suggest that Japan's recession has been the worst among industrialized countries. Its GDP dropped by double digits in the fourth quarter of 2008. Data for first quarter 2009 to be released soon is expected to be equally weak. Japan's manufacturing production has fallen about 40% from its recent peak. In contrast, the corresponding figure is about 20% for the United States and 30% for Germany and South Korea. (See chart.)

Why has Japan been one of the most serious victims of a crisis originated in the U.S.? Let us first check if financial conditions are an explanation. The central banks of The Group of Three leading industrial nations (comprising the U.S., Japan and Germany) publish bank loan officers' survey detailing banks' lending attitude to nonfinancial businesses. In the most recent survey 64% of U.S. banks replied that they have tightened lending attitude to large firms. None of the banks said they have eased lending attitude. Similarly, 64% of European banks have tightened their lending attitude. Both areas are clearly in the midst of a credit crunch. In contrast, in the Bank of Japan's survey, only 8% of the banks have tightened, while 6% eased their lending attitude to large firms. Thus, credit conditions do not seem to be a major cause of the differential impact of the world financial crisis on individual economies.

Japan is perceived to rely heavily on foreign trade. In 2007 exports to GDP ratio was 16%. This is much higher than the U.S., where the number was 8.4%. Many countries, however, depend at least as much as Japan on foreign trade. The ratio was 15.5% for the United Kingdom, 40% for Germany and 38.3% for South Korea.

According to a different metric, however, Japan has depended much more on ex-

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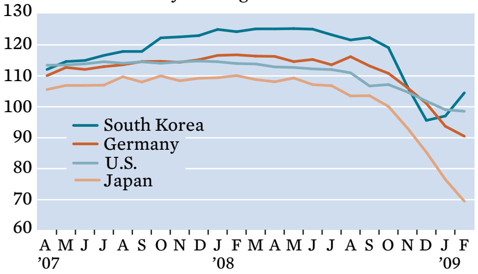
ON THE DECLINE

Manufacturing Production



ports recently. During the economic upturn of 2003-07 the contribution of exports to growth was stunningly high at 67%. In previous upturns the ratio was usually less than 50%. In the late 1980s, Japan's "bubble" years, it was less than 10%. More formally, the correlation between export growth and real GDP growth was surprisingly absent before 1990; the correlation coefficient between the two was minus 0.03 during 1970-90. It rose to 0.61 during 1991-2008. It is higher at 0.73 during the last 10 years. In other words, in the postbubble period Japan has failed to deliver a domestic demand-led growth and become increasingly exposed to economic fluctuations in the rest of the world.

The Bank of Japan, in its February monthly report, analyzed the structure of this vulnerability more carefully. Japan's manufacturing sector is dominated by industries such as electronics, autos and general machinery who have been hit hard by the crisis, while in the U.S. the shares of more stable industries such as food, beverage and tobacco are higher. In addition, Japan's manufacturing firms' domestic procurement rate for parts and materials is fairly high, while American firms rely more on imports for parts and materials supply. Thus, a given demand shock, say, a decrease in exports, generates larger spillover effects in Japan.

Changes in Japan's trading structure have also increased its susceptibility to fluctuations in the rest of the world. Japan used to be an exporter of final goods. Now, it exports intermediate goods to, say, China, which then are rerouted to the U.S. When Chinese exports to the U.S. fall, this will in turn affect Japanese exports, but by more than one for one. This is because Chinese manufacturers try to decrease intermediate goods inventories, in addition to passing on to Japanese producers the decline in final goods demand. One comfort of all this analysis is when strength returns to the global machinery industry, Japan will sure to experience a V-shaped recovery.

Can Japan deliver a domestic demand-led recovery this time? Some point to a progress in inventory adjustment as a result of the sharp cuts in production during the last few months. The situation, however, is not that rosy. It is true that the absolute level of inventories declined, on a seasonally adjusted basis, for two months in a row. Inventories would be at healthy levels if sales were as high as in the middle of last year. In reality, sales are down by 40%. Thus, the ratio of inventories to sales is at record highs.

It appears that producers are counting on a near-term rise of sales by 20% to 30%, if not 40%. Should this fail to materialize, inventories are clearly grossly too high and the manufacturing sector will need to go into a painful period of production cuts again. How soon should such a rise in sales come? Common sense suggests it should come within six to nine months. Otherwise expectation of sales and production plans would surely be affected. Worse still, corporate fixed investment and employment would also be seriously affected.

Thus, we will need a solid recovery in final demand in order to go into a sustained period of economic upturn. There is some hope. Above all, the Japanese government has recently submitted a supplementary budget proposal to the Diet. This has come on the heels of the last year's supplementary budget which was just passed in March. The fiscal 2008 package includes a 5 trillion yen (around $51.5 billion), and the fiscal 2009 package, 15.4 trillion yen of government-outlay components. Between the two, government's fiscal outlays total 4% of GDP. In addition, large amounts of lending and equity injection by semipublic financial institutions are planned.

Economists, however, have a sober view of the effects of the stimulus measures and expect that they will add to aggregate demand for good and services by about 1.5% to 2.5%. The effects are smaller than the outlays because some are tax cuts and subsidies which do not raise spending one for one. Bank lending by public financial institutions may just be substitutes for private-bank lending. Also, given that the next general election is very close, a significant part of public works included in the stimulus measures seem to be old-fashioned pork-barrel type spending and have only a small chance of generating large multiplier effects on the economy.

Ultimately, it seems the fate of Japan's economy will be determined by events in the rest of the world.

What would be the course of the Japanese economy once the effects of such stimulus packages are taken into account? The programs should already be starting to exert effects on the economy. For example, transfer payments of 12,000 yen per person included in the fiscal 2008 supplementary budget are now being distributed to the public. Most of the stimulative effects of the packages should manifest themselves within the next two years. In that sense, the packages have come when they are most needed.

Private demand for goods and services, however, is expected to stay weak. For example, the Bank of Japan's April *tankan* survey showed that companies are planning to reduce investment spending by 11% in fiscal 2009. Given that investment is 16% of GDP, this will reduce GDP by 1.8%. With some multiplier effects, the deflationary effects of such a decline in investment seem to more or less offset the positive effects of the stimulus packages.

There is also a lingering worry about the Japanese financial system. The decline in stock prices since last September has eroded the capital base of Japanese banks. The Bank of Japan's financial stability report indicates that in terms of economic usage of capital large Japanese banks allocate more than 50% of tier 1 capital to their holdings of equities. According to the report's simulation results, if the economy were to follow the economists' consensus path as of February and stock prices stayed as low as in early March, the TIER I ratio of Japanese banks would decline by 1.4 percentage points. In such a case a serious credit crunch could develop in Japan as well. However, there is a plan by the government to establish an entity to buy equities from the market to avoid a major collapse in stock prices.

Such an analysis of domestic sources of demand seems to indicate that the economy will stop declining soon, probably grow at positive rates for a while, but have hard time delivering a sustained recovery. The government's stimulus packages should have been directed more at measures to generate sustained growth in domestic demand. Once again, it is very likely that the fate of the Japanese economy will be determined by what will happen in the rest of the world.