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Title:

The Reasons of Slowing Japanese Economic Growth

Today's Japan is no more the participant of headlines and leading articles of newspapers because of its economic miracle, but because the country faces now such problems that no-one in the world expected to occur.

In this assignment thus I would like to write about the reasons for this miracle to end, that is the slowing economic growth in Japan.

Before the crisis

After the II World War the Japanese economy needed to be rebuilt, ad it was totally devastated. The country was occupied by American Troops, which later contributed to the fact that democracy and market economy was established in the country. In years 1952-59 (Pre-rapid growth)[1] the economy returned to normal conditions after the demand-driven inflation, and the economic growth began to increase.

Years 1960-69 were the most successful for the Japanese. Economic growth averaged around 10%, industry expanded and balance of trade went into surplus. By the end of the 60's, Japan's economy was regarded as of equal with the other developed economies. Japanese growth since the 1960s was built on high rates of savings and capital accumulation, encouraged by institutions created to funnel savings into industrial investment. The goal of the Japanese at this time was to create an internationally highly competitive industry, and in the meantime save and subsidise the less productive industries in the countries.

The period 1970-74 was the period of transition. The demand for investment wasn't that high anymore, therefore the saving of the population was growing. Though the capital deepening absorbed this extra saving. This period ended with the first oil shock, to which the government of the country was able to adjust; though the real growth of the gross domestic product GDP was minus 0.6%.

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[1] Economic Development and Financial Deepening *Sato K.*; The Japanese Economy, vol 25, January-February 1997, pp 3-35

1975-1990 was the period of slow growth. (This may seem a bit ironic, as many of the developed countries would have been happy to achieve such a growth as Japan 5%). According to an OECD review[2] the reason for slower growth in the economy was that there weren't new potential buyers for the exports of the country.

In the mid-1980's Japan saw another boom, the stock and asset prices began to rise rapidly. This was because Japan became the first country in per capita income in the world, and one of the main creditors of the world.

The second reason was that in 1985 in the so-called Plaza agreement the dollar was devaluated to the yen, therefore the yen could buy more.

The other cause for growing stock and asset prices was the country made investments in other countries. There was a big balance of payment surplus Japan invested first in the first grade tiger countries, then in second grade tigers, Europe and the USA. But after a few years these investments became another sources of income, and as the government and the banks were afraid that if the balance of payment surplus would get into the country it would generate inflation, they have invested in the financial market instead of the good market. That is why the price of stocks and estates went up so high, because there was increased demand for these. This fact contributed to the establishment of a so–called bubble economy, in which the price of stocks and estates was highly overvalued. People brought their income to the financial markets as they could reach higher profits and banks took up credits from foreign banks whose funds were these overvalued estates. But as Kazao Sato has said: "In each bubble, stock prices start to rise rapidly, reach a peak and collapse with a bang."[3]; the same happened to the Japanese economy in 1989. Partly because the balance of payment surplus decreased from 100 billion US dollars to 40 billion US dollars, which wasn't able to keep the balloon high; partly because the central bank had to rise interest rate five times, as only those were

[2] Regulatory Reform in Japan, *head of programme: Jacobs S.H.;* OECD, Paris, 1999 p 22

able to buy any assets who had speculative purposes, but the people ordinary not. So the stock and asset prices began to fall rapidly and didn't stop until they have reached the level before the bubble.

Unfortunately as the authorities haven't detected the problem early enough, the bursting of the bubble lead to a deflationary crisis.

Adjusting to the crisis

The overall result of the before mentioned price-falls was that the stock-index fell by 40%, and the fall of the asset prices was even steeper than that. The cumulative loss until 1996 was 7000 milliard USD, which is equal to two -years' GDP in Japan.[4]

The economy stagnated as a result of this asset-price shock in the period 1992-1994 (see Table 1 in the Appendix.). Because a lot of people and banks lost their money, and therefore the number of bad and doubtful debts has increased. Quite many of the banks were at the edge of bankruptcy and the people lost their faith in the monetary system of the country.

There weren't too big corrections made at this time as the authorities though that this crisis is just the normal trend of the business cycle in which a peak is followed by a slowdown. This view was also backed by the fact, that there was still a budget surplus, which was 2.9% of the GDP, and slight government spending could have absorbed the fall in the domestic demand. There were 7 such demand–stimulating packages put into force until 1995, but unfortunately they haven't brought any success. Neither the private nor the industrial sector consumption has grown, which can be explained by the mentality of the Japanese people to save wherever they can, and by the fact that there was quite big unemployment, which shocked the people,

[3] Economic Development and Financial Deepening *Sato K.*; The Japanese Economy, vol 25, January-February 1997, pp 3-35

[4] Defláció és modellerózió (Deflation and Modelldegradation) ***Oszvald Éva,*** Külgazdaság, 1999. Október pp 34.

and they have lost their faith in the future. The budget deficit was 4.3% of the GDP[5], and a trend for drawing out investments from under-performing processing-industries came into being.

There were slightly any imports to the country and only the exports brought any force to the growth of the economy, which caused that the balance of payment surplus was high again. This lead to a newer appreciation of the yen, which indicated that the fast recovery from the crisis couldn't be carried out with such a strong currency.

By 1996 it seemed that the country has stepped into the upturn stage of the business cycle, as the economic growth began to increase again. This view declared by the government was accepted by the rest of the world as well, though they regarded the financial system as very unstable. In 1997 the growth has even accelerated which, as it later turned out was the consequence of the pre-consumption-tax-rise purchases.

Standstill and recession

In October 1997 the South-Asian financial crisis swept all over the world.

As quite a big amount of Japanese investors, banks have lost their money in this crisis, the consumption has decreased, and the number of bad and doubtful debts has increased by the bank.

The government didn't know what to do exactly. To accelerate consumption by increased governmental spending, or to cut on governmental spending, in order to decrease the budget deficit. The government did both.

This didn't seem to help the situation and the demand fall so much back as never before.

Japan fell into recession, and for the pressure of the G7 and the USA, the government decided to use an economic policy of budget expansion.

[5] Defláció és modellerózió (Deflation and Modelldegradation) *Oszvald Éva,* Külgazdaság, 1999. Október pp 35.

The crisis of the financial system

It turned out already in 1989, that the banks were major causes for the "bubble economy" as they have taken too many risks.

In 1997 the banks had enormous amounts of bad and doubtful debts. For us the most obvious solution would have been to write off these, but then too many banks would have bankrupted.

The accounting principles of the country and many foreign institutions have made it possible to hide it for a long time, how bad the situation of these banks is. Though when the first big bank (Hokkaido Takushoku)[6] bankrupted a panic broke out, and all depositors wanted to get their money back.

The government decided to introduce a programme for the liberalisation of the financial system was introduced, the so-called "Big-Bang". The aim of this programme is to achieve a free, fair and global financial market in the country. "The problem is that global finance runs on legal accountability, on the free flow of information and on transparency"[7] So this needed to be achieved.

As a result to the introduction of the Big Bang the Bank of Tokyo for example wrote off a 1.1 trillion in bad debt to clear its debts. Even optimists claim though, that for the real effect of the Big Bang the country has to wait.

This factor of slowing growth, that is the crisis of the financial system affected the small- and medium-size enterprises as well.

The banks after having suffered badly from the Asian crisis became very careful regarding the credits. Therefore those small-and medium size enterprises, which were still viable and competitive in such times, when many of the big went into bankruptcy, suffered from the very careful credit-policy of the banks, and they couldn't get access to money.

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[6] Defláció és modellerózió (Deflation and Modelldegradation) *Oszvald Éva,* Külgazdaság, 1999. Október pp 37.
[7] The Big Bang Blues *Hirsch M., Takayama H.,* Newsweek, 1997, September 22, pp 36

Liquidity trap

One of the most serious determinants of slow economic growth is the liquidity trap. According to Sloman: “Liquidity trap is the absorption of any additional money supply into idle balances at very low rates of interest, leaving aggregate demand unchanged.”[8]Usually such instances occur, when the capacity is higher, that aggregate demand.

By the end of 1998 the government has used the monetary policy in order to simulate the stagnating economy. There was a serious amount of money put into circulation, and the problem was, that the awaited effect didn’t come.

Partly, because the money leaks out to abroad, and partly because the people were still taking out their money from banks. Therefore the country faces liquidity trap.

According to Paul Krugman, that kind of monetary policy mentioned before would never work in Japan, as the population’s willingness to save is too high. He also says that the best solution to solve the deflationary problem of the country is that the central bank should generate inflation, which would convince people to spend more money, which would bring enough funds for growth again.[9]

But probably this method wouldn’t work in the case of Japan, because of the mentality of the Japanese (when the prices are getting lower, they would try to save more), so there would be no money surplus to convince them, that they should spend more.

The other problem with this theory is that the Bank of Japan (Japanese Central Bank) would never act this way as it has gained its independence only a few years ago, and such a behaviour would be beneath the accepted central bank activities.

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[8] Economics (3rd edition) *Sloman J.* 3rd edition, Prentice Hall Europe, 1997 pp 601

[9] Defláció és modellerózió (Deflation and Modelldegradation) ***Oszvald Éva,*** Külgazdaság, 1999. Október pp 39.

According to Vojnits[10] not only the over-capacity, but also the inflexible labour market, the inefficient banking system and the barriers to credits are also driving factors of the liquidity trap.

So the absorption of liquidity needs to be solved by financing deficits. But the question is: How long can it go that way? Maybe the central bank should try to act beneath itself

Labour

High rates of capital cumulation and labour force growth are the factors, -mentioned in the beginning- that have driven growth in 1960-1990. But unfortunately they aren't sustainable anymore in the Japanese economy.

The first reason why the labour force growth has fallen behind, is the fact that the Japanese society is ageing.[11] The number of older workers (above 65) is continuously rising and by the year 2005 it is expected to be one fifth of the population. Among that less and less people will be working, the population faces another problem, that of inefficient retirement system. By this I mean that less and less people will earn for the retired, which would cause that both sides would get less money, which again would cut on consumer spending, and capital cumulation.

There was a system of so-called lifetime employment, which was totally shaken up because of the high unemployment rates. More women, part-time workers and contractual workers are employed by companies, which clearly reflect, that the era of lifetime employment, that is reward systems based on seniority and egalitarianism, is over.

People feel thus very unsafe. The unemployment rate is now about 4.3% in the country, which is from a Japanese point of view very high. Job losses occur in those sectors especially, which

[10] Keleti kelepce (Eastern Trap) *Vojnits T.,* Figyelő, 1998. Július 16. pp 27.
[11] Defláció és modellerózió (Deflation and Modelldegradation) *Oszvald Éva,* Külgazdaság, 1999. Október pp 40.

are to be restructured that is those sectors with low productivity. Though, as after the restructuring the hopefully the increased demand would generate new jobs.

In many workplaces instead of the dismissal of the workforce the organisations improve the job training of their workers, or decrease wages incentives and overtime payments. Again in some other industries, the workers of the less productive section are placed to such sections, which are productive, this way the costs become lower.

All the above mentioned facts cause that the Japanese as they are very uncertain of what might occur in the future, tend even more to save, therefore their money wouldn't get into circulation, therefore the demand, which could stimulate the country would remain very low as long as the government introduces a more efficient retirement system, and as long as the people feel safe.

Structural problems and restructuring

The fact that the crisis of the Japanese economy couldn't be solved by simple monetary and fiscal regulations lets us assume that there are serious structural problems in the Japanese economy, which slow down the recovery from the crisis.

The main roots of the problems is the Japanese model itself, in which the industry, the banking system, the financial markets and the employment theories etc have already been out of date after the Japanese economy reached its peak and became one of the leading economies of the world.

The first problem is the two-tier character of the economy. In Japan we can distinguish two types of industries. The first one is the so-called 'dynamic Japan', which includes all the multinationals with sales and operations expanding globally. (E.g. Toyota, NEC, Toshiba, Sony etc). These companies benefit from a weak yen, and their cost-efficiency is extremely good, as they have established low-cost plan plants in USA, Europe, Latin-America and East

Asia. They have the leading stocks of the Japanese stock exchange, which are not overvalued, and their finances are healthy. These industries are highly competitive all over the world.[12]

The other 'face' of Japan are industries rooted in the domestic economy, especially banks, property, construction, retailing and local manufacturing. The costs of these industries are too high, because of the overregulation and because these are protected industries. This also means that these are weakly competitive industries, which are only protected by such trade barriers, which will sooner or later drop. The finances and the stock prices show inefficiency as well.[13]

The result of such protected result is the extremely high domestic price level. In the years of growth the population was tolerant toward these high price level, but not when the economic growth has slowed down, they are not willing to pay more for worse products. The second result is that the in the Japanese economy is among the lowest in the G7 (both in manufacturing and services), which reflect the high price levels, low levels of labour and total factor productivity.[14]

These all reflect that there is urging need for restructuring the whole economy, and new regulations should be made.

Conclusion

It can be stated that the Japanese-model of full employment, protecting the uncompetitive industries, the overregulated financial system, which have lead to the inefficiency of the economy in the last decade needs to reformed.

How and when is just a question of time. The people of the country are ready for the change, they are awaiting the free and liberalised market but they don't want to renounce the full-employment. How would the Japanese government solve this problem no-one knows.

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[12] Two Japans *Bremner B., Glasgall W., Galuszka P.,* Business Week, 1997, January 27 pp 30

[13] Two Japans *Bremner B., Glasgall W., Galuszka P.,* Business Week, 1997, January 27 pp 31.

Thus there would be urgent need for radical steps from the government's side (hopefully the new Prime Minister Mori Josiro, will do his best) as at the end of 1999 Japan got into another deflationary recession.

Before writing off Japan totally we should never forget that it is still member of the G7, and except for 1974 it has never experienced any negative growth in the economy.

And Japan has once made it… so it is hopefully just a matter of time to recover.

[14]Regulatory Reform in Japan, *head of programme: Jacobs S.H.;* OECD, Paris, 1999 pp 35.