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Setting Sun

BY DAVID M. SMICK

IMAGINE YOU WERE GEORGE SOROS'S chief currency and bond trader. Throughout the late 1980s, you bet that an almighty Japanese juggernaut—the new capitalist model for the 21st century—was taking over the world, Rockefeller Center and all. Today, had you followed that line, you would not be George Soros's chief trader. Or imagine you were CEO in the late 1980s of an American computer chip manufacturer. At the time, you were convinced Japanese chip makers were so advanced you directed your company into other, less technologically competitive niches. Today, Japanese chip makers have fallen far behind their U.S. competitors. You would no longer be CEO.

The Japanese economic juggernaut that was to have owned us all has entered a period of crisis. Japan now finds itself wound in a series of frustratingly tight policy knots. Most Tokyo policymakers know in their gut they have one, messy solution left: bold liberalization and deregulation of the economic and financial systems. But it won't be easy, given Japan's rigid political environment. The best bet is that Japan is doomed to years of economic drift marked by slow growth and a lackluster stock market.

Not that Japan is a basket case. The country continues to have a high savings rate with some extraordinarily competitive, world-class companies. So Japan can never be entirely counted out. The system confounded conventional wisdom twice during the oil shocks of the 1970s, adjusting to new price levels with amazing speed.

But the situation is different this time. The tried and true policy tools are not working. Monetary stimulus, for instance, has been surprisingly ineffective. The Bank of Japan for years now has left short-term interest rates at the unusually low nominal level of 0.5 percent. Yet both the supply of and demand for credit have continued to decline. Meanwhile, the Japanese government, the last Keynesian stronghold in the world, enacted a multi-year series of massive supplemental budgets to pump up public-works spending. The exercise failed to spark much additional economic activity. Indeed, without the additional spending, real gross domestic product would have slightly declined over the last four years. Japan is now left with a deficit-to-GDP ratio of 7 percent (or perhaps higher, depending on how it's measured). In other words, Japan's deficit ratio is nearly twice that of Italy.

The lingering economic crisis has eroded the confidence of the Japanese people in their national leaders. Five years ago, a president of a large financial institution in private conversation would have been highly respectful of officials in the Ministry of Finance. Today, individuals at this level are sneeringly dismissive of finance bureaucrats. And they've lost faith in Japan's economic potential, too. Since 1994, domestic investors as a whole have been net sellers on the Tokyo stock market, the Nikkei. Only buying by government pension funds (the so-called price keeping operation or PKO) combined with sporadic buying by foreign hedge funds and mutual funds has stabilized the market—at less than half its value at the beginning of the decade. Now on some days, transactions on the stock market are roughly the same as the daily transactions in the United States of one stock, Intel. True, it has been relatively easy to prop up the market artificially, giving the illusion of stability. But it is an illusion.

Until several months ago, Japan seemed headed toward the bold deflationary approach, coupled with deregulation of financial and economic systems. It would be messy, but at least it dealt with a fundamental cause of the private sector's dwindling confidence: today's still artificially ballooned asset prices. Under this approach, Japan's horrendous bank balance sheet problem would be tackled quickly through a bank restructuring not unlike the process that saved struggling U.S. banks five years ago. Indeed, many large Japanese banks today look enviously at institutions such as Citibank, which were mired in an ugly restructuring effort as the savings and loan crisis unfolded in the early 1990s. Citibank's stock price dropped to single digits. Yet once the restructuring was over, Citibank stock, propelled by a much healthier balance sheet, became one of Wall Street's biggest winners. Japanese reformers would like to emulate this success, but it won't happen until the all-important asset price floor is established, giving investors confidence in the system again.

Prime Minister Hashimoto appeared to be on board, as did the Diet. With soaring rhetoric, Hashimoto offered to deliver the so-called big bang financial reforms. The lower house of the Diet approved foreign-exchange liberalization legislation, which would ease cross-border transactions.

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Beginning April 1, Japanese pension funds were ordered to change their reporting practices to reflect the true market value of holdings. Hashimoto and his coalition, led by his Liberal Democratic party, were responding to, among other things, pressure from the pro-reform opposition.

But suddenly, the reform drive stopped. The big bang reforms look vague and weak as bureaucrats fill in the details. Government strategists insist the reform effort remains alive, but those in the private sector believe the pendulum has swung the other direction toward the old, go-slow, status quo approach. One example: the failure to forge a solution to the troubles of the life-insurance industry. During the financial bubble of the 1980s, investors were guaranteed a 5 percent annual return for 30 years. Now, government bond yields have dropped to a fraction of that rate, which means the "5 percent promise" threatens to bankrupt the entire industry.

But continuing with the old inflationary approach will stretch out rather than solve Japan's acute problems. Going slow was always the approach favored by many in the ruling LDP, whose political and financial base consists largely of Japan's mid-sized and smaller corporations and financial institutions. Under an abrupt liberalization and deregulation, they would be most at risk. The status-quo option means continuing government jawboning to stabilize the yen-dollar rate. And it involves continued buying by government pension funds on the Japanese stock market along with the injection of quick amounts of stop-gap cash from the Bank of Japan in the event of an occasional bank failure. This is pure Keynesianism, and it's a policy that Japan's leaders, despite rhetoric to the contrary, seem unwilling (or unable) to abandon, absent a powerful external shock.

Watching this drama for signs of the future are Japan's largest corporations—the Toyotas and the Sonys. Notice that the top 25 or 30 industrial giants account for roughly 75 percent of Japanese exports. Most are in manufacturing, which represents 25 percent of the economy but 68 percent of the Nikkei 225 (Japan's Dow Jones Industrial Average), a fact that creates considerable confusion for policymakers. These 25–30 large firms are the core of the industrial base. Their position today is similar to that of many large U.S. corporations at the beginning of the 1970s: Having concluded that the U.S. political and economic situation involved too much uncertainty, these companies moved offshore and transformed themselves into broadly diversified global conglomerates. Today, many of Japan's industrialized giants are also moving offshore, regardless of exchange rate considerations and other promised policy changes. It is a process that threatens to hollow out further the beleaguered domestic industrial sector.

Japanese individual investors are thinking along the same lines. The dollar has until recently appreciated against the yen in part because Japanese individual investors are moving offshore in search of greater yield. This will accelerate with the pending regulatory changes forcing the huge pension funds to disclose their poor return on investment. Indeed, the yen today would be far weaker if Japanese tax authorities had not been deliberately vague and slow at communicating to the public the tax advantages of individually owned offshore accounts. Again, the go-slow, holding-pattern approach at work.

Somehow, Japan will likely muddle through and avoid catastrophe. Yet one cannot help but reflect on the old U.S. "revisionist" crowd that throughout the 1980s thought Japan would run the world. American-style capitalism, the revisionists firmly believed, was becoming obsolete. Today, many of these folks are completely befuddled by the U.S. stock market's robust performance. Most failed to predict the massive U.S. corporate restructuring that has taken place since the mid-1980s.

The truth is that developments in the U.S. market, in Japan, and elsewhere are probably more interrelated than we think. The great global financial market is like a beauty pageant, says an official from the New York Federal Reserve. Out on the runway walks Miss Japan. Though she has potential, she hardly looks very beautiful these days. Out walks Miss Germany. Plagued by huge uncertainties over monetary union as well as the public and private sector's reluctance to initiate painful restructuring, Miss Germany looks even worse. The same with Miss France, who now sees currency devaluation—a new, but weak euro—as her only hope.

Suddenly, the beautiful Miss America saunters out, with all her computerized curves and technological prowess. True, she may be overvalued. She may be problem-ridden, too. But she sure ain't Miss Japan. ◆