COMBATING THE GLOBAL ECONOMIC CRISIS: JAPAN'S POLICIES AND POLITICS

LIM Tai Wei

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Executive Summary

1. Exports have always been the main engine of growth for Japan, accounting for over half of the Japanese economy's growth in the last quarter of 2007. But even this leg of growth is tenuous, given the effects of the global crisis on Japan’s export economy.

2. Japan’s problem is not the financial crisis but its slow growth in the real economy where it is really hurting. Japan fell into its first recession in 7 years when gross domestic product shrank 0.1 per cent in the third quarter of 2008 from the previous quarter; this followed a quarterly decline of 0.9 per cent in the second quarter after businesses cut spending and slashed inventories in anticipation of a prolonged recession.

3. Demand for Japanese cars had fallen overseas, forcing the Japanese carmaker giant Toyota to slash its forecast earnings in 2008 to less than 1/3 of the previous year and cutting 18 shifts over 11 days, or the equivalent to nine days’ worth of production at all 12 of its domestic facilities.

4. The global financial crisis has precipitated a U.S. slowdown to such an extent that it cannot be offset by demands from Asia and Europe, both of which are also experiencing downturns. The October 2009 dip in Japanese exports overseas is also due to the sudden sharp rise of yen in October 2008.

5. By 5 January 2009, then Finance Minister Shoichi Nakagawa indicated that Japan was ready to intervene in the foreign-exchange market for the first time in four years. This was due to the tremendous pressure of a surging yen on exporters against the backdrop of a recessionary economy and the slump in the U.S. and Europe.

6. Encouraging Japanese to spend more may be a futile exercise due to the saving propensity of its elderly population in the face of perceived uncertainties and its youngsters holding non-regular job with low disposable

income. In addition, the populace in general has experienced stagnancy in income for a decade or more.

7. In Northeast Asia, leaders of South Korea, China and Japan held a summit in Fukuoka in December 2008 to discuss the global financial crisis. This Northeast Asian summit is one positive spinoff from the annual South Korea, China and Japan meeting on the sidelines of the Association of Southeast Asian Nations (ASEAN) Plus Three summit.

8. The basis of all these regional initiatives lies in the fact that Japan needs to stimulate regional recovery in order to increase its exports which is its main engine of economic growth. Northeast Asian cooperation is essential for the regional economies to be consumers of Japanese goods.

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Japan's slow growth and mature economy

1.1 Japan's economic story has been mainly based on rapid export expansion, especially after Ikeda's income-doubling years in the 1960s. After 1989-90, however, when the "bubble economy" of high land prices and high stock market prices collapsed, Japan suffered from a combination of decade-old prolonged recession, slow growth amidst a mature economy.

1.2 By 2004, Japan began a gradual climb out of its prolonged recession after Koizumi's economic reforms (See Chart 1), bolstered mainly by increased exports to the United States and other countries like China before it was hit by the US sub-prime crisis in 2008.

1.3 Japan started off with relative insulation from the US sub-prime crisis and the early stages of the global financial crisis. Initial Japanese media coverage even isolated the US financial woes as the "Lehman Shock" and gave it less coverage than domestic news on typhoon and a tainted rice scandal.[1]

1.4 According to the International Monetary Fund, subprime-related losses of Japanese financial companies totaled just US$8 billion, out of global subprime-related losses that some say could total US$1 trillion or more.[2] Moreover, Japanese have an accumulated US$14 trillion pile of household

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* Dr LIM Tai Wei is a Research Fellow at the East Asian Institute. He wishes to thank Professor Zheng Yongnian and Professor John Wong for their useful critiques over several drafts of this paper.

[1] Fackler, Martin, "In Japan, Financial Crisis Is Just a Ripple" dated 19 September 2008 in the New York Times website [downloaded on 19 September 2008], available at http://www.nytimes.com/2008/09/20/business/worldbusiness/20yen.html

[2] *Ibid.*

savings from trade surpluses and frugal lifestyles to finance its immense $8.1 trillion fiscal deficit and still have enough money left over to be the world's largest creditor nation for the last 17 years. In other words, Japan is really not facing any financial meltdown like the US.

1.5 But Japan's splendid isolation did not last long. Japan's problem is not the financial crisis but its slowdown in the real economy where it is really hurting. Demand for Japanese cars had fallen overseas, forcing the Japanese carmaker giant Toyota to slash its forecast earnings in 2008 to less than 1/3 of the previous year.

1.6 Toyota is also reducing production at several factories in North America as the global slowdown continues to cut into the automaker's sales abroad; it is also cutting 18 shifts over 11 days, or the equivalent of nine days' worth of production at all 12 of its domestic facilities.[3] Japan's carmakers based in the US even had to offer interest-free loans to up its sagging car sales. The continuing credit crisis has also increased the value of the yen over the dollar and other major currencies, eroding the carmakers' profits earned overseas.

1.7 Local governments are also feeling the effects. The Toyota city government in Aichi forecasts tax revenue for the next fiscal year to drop by more than 20 billion yen--almost 20 percent of the 123.4 billion yen forecast for this fiscal year with the impact of cutbacks stemming from this shrinking income trickling down and affecting local residents.[4]

1.8 In Tahara City of Aichi, which also hosts a Toyota plant, the city has ordered an across-the-board 10 percent cut on all items in next fiscal year's budget. The city is reviewing plans for projects including road and river maintenance,

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[3] AP, "Toyota to further cut production in N. America" dated 10 December 2008 in the MSN website [downloaded on 8 Jan 2009], available at http://news.moneycentral.msn.com/provider/providerarticle. aspx?feed=AP&date=20081210&id=9439408 and Irish Times, "Toyota to cut production in Japan" dated 7 January 2009 in the Irish Times website [downloaded on 8 Jan 2009], available at http://www.irishtimes.com/newspaper/finance/2009/0107/1230936732506.html

[4] Yomiuri Shimbun, "TROUBLE AT TOYOTA--Spreading shock waves/Impact of cutbacks hits local government coffers" dated 20 December 2008 in The Yomiuri Shimbun [downloaded on 20 December 2008], available at http://www.yomiuri.co.jp/dy/business/20081220TDY01301.htm

park improvements and work to improve the earthquake resistance of buildings at primary and middle schools. As a whole Aichi prefecture's tax revenues for next fiscal year will be down by a real 270 billion yen, making up 20 percent of the prefecture's 1.36 trillion yen.[5]

1.9 Japan fell into its first recession (See Chart 1) in 7 years when gross domestic product shrank 0.1 per cent in the three months to September 30 from the previous quarter, following a quarterly decline of 0.9 per cent in the second quarter after businesses cut spending and slashed inventories in anticipation of a prolonged recession.[6] Japan's gross domestic product is projected to shrink in the October-December quarter by 12.1 per cent on an annualised basis, in what would be its sharpest contraction in 34 years.[7]

1.10 In other sectors like electronics, an effort to compensate for declining unit prices have seen electronics and computer manufacturers introducing new products, with new models of flat-screen TVs that come with extra features and specialized digital cameras coming out one after another.[8]

1.11 Despite all these measures, October 2008 turned out to be a black month for the Japanese economy (See Chart 2 which indicates the monthly percentage change year on year from Jan 2007 to October 2008) as its exports declined at the fastest pace in almost seven years as sales of cars and electronics slumped, causing exports to fall by 7.7 percent from a year earlier, the biggest drop

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[5] Yomiuri Shimbun, "TROUBLE AT TOYOTA--Spreading shock waves/Impact of cutbacks hits local government coffers" dated 20 December 2008 in The Yomiuri Shimbun [downloaded on 20 December 2008], available at http://www.yomiuri.co.jp/dy/business/20081220TDY01301.htm

[6] Nakamoto, Michiyo, "Japan enters first recession in 7 years" dated 17 November 2008 in the Financial Times website [downloaded on 1 Jan 2009], available at http://www.ft.com/cms/s/0/c55a0bcc-b45b-11dd-8e35-0000779fd18c.html

[7] Reuters, "Japan Q4 GDP to post worst fall since 1974" dated 30 December 2008 in the Business Spectator website [downloaded on 12 Jan 2009], available at http://www.businessspectator.com.au/bs.nsf/Article/Japan-Q4-GDP-to-post-worst-fall-since-1974--BarCap-MTFHY?opendocument&src=rss

[8] Yamamoto, Takanori and Kensuke Nakazawa "IN THE MARKETPLACE / Electronics firms battle to lift sales" dated 22 December 2008 in The Yomiuri Shimbun [downloaded on 22 December 2008], available at http://www.yomiuri.co.jp/dy/business/20081222TDY07305.htm

since December 2001.[9] A month later, exports fell 26.7 percent compared with a year earlier, the sharpest drop since comparable data were made available in 1980 and exports to the United States, an extremely important market for Japanese goods, tumbled a record 34 percent.[10]

1.12 Neither can Japan turn towards other export markets. The global financial crisis has precipitated a U.S. slowdown to such an extent that it cannot be offset by demands from Asia and Europe, both of which are also experiencing downturns. Europe, for example, is in recession - shipments there plunged an annual 17.2 percent in October 2008, the largest drop since December 2001 while exports to Asia were down (by an annual 4 percent) in October 2008 while shipments to China fell for the first time in three years.[11] The October dip was due to the sudden sharp rise of yen in October 2008.

Japanese domestic policies to combat the crisis

2.1 Would prime-pumping be a possible panacea as seen by some economists and policy-makers? Analysts in Nomura for example have urged the government to boost government spending on research and development (e.g. in fossil fuel alternatives), medical healthcare and education on top of the classic infrastructure building to boost domestic consumption.

2.2 To combat the crisis, Japanese Prime Minister Taro Aso unveiled a 26.9 trillion yen (US$402 billion) package on 30 October 2008 to jump-start Asia's largest economy which includes tax cuts mainly targeted at households and small businesses. This is the second package after Yasuo Fukuda's first

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9 Hugh, Edward, "Exports Drop Sharply As Japan Officially Enters Recession" dated 22 November 2008 [downloaded on 8 Jan 2009], available at http://4.bp.blogspot.com/_ngczZkrw340/SSfwIbwl2FI/AAAAAAAALhU/oYfq7_6rujE/s1600-h/japan+investment.png

10 Bloomberg News, "Exports From Japan Fall at a Record Pace" dated 21 December 2008 in the *New York Times* [downloaded on 8 Jan 2009], available at http://www.nytimes.com/2008/12/22/business/worldbusiness/22trade.html

11 Hugh, Edward, "Exports Drop Sharply As Japan Officially Enters Recession" dated 22 November 2008 [downloaded on 8 Jan 2009], available at http://4.bp.blogspot.com/_ngczZkrw340/SSfwIbwl2FI/AAAAAAAALhU/oYfq7_6rujE/s1600-h/japan+investment.png. (Japan had increasingly depended on China for export growth since 1990 but it dipped in October 2008 for the first time since 2005. See Chart 3 which indicates the value of Japanese exports to China)

stimulus initiatives instituted in late August 2008 aimed at easing the hardship caused by rising commodity prices. Japan is spending 5 trillion yen or 2% of its GDP in direct cash payouts to families, tax breaks on mortgages, bank rescue scheme in public fund injections and tax relief for small firms.

2.3 Other measures include larger tax deductions on home mortgages and an extension of current tax reductions on capital gains and dividends and, to boost the use of highways outside the metropolitan urban areas, traffic tolls will be reduced to a maximum of 1000 yen for car owners on vacation.[12] Crisis response also extends to the corporate sector where increased loan guarantees for small and medium sized firms are the largest component of the stimulus package; the goal is to ease the credit crunch that small companies may experience as banks reduce lending.[13]

2.4 Critics have countered that the October 2008 stimulation package is not enough because the main components of that supplementary budget are cash handouts and lower expressway tolls while job creation programs, clearly needed during difficult economic times, were not the main pillar of that package.[14]

2.5 Others consider this initiative as a gimmicky populist policy by the ruling party LDP (Liberal Democratic Party) for the upcoming lower house elections. While popular, they counter, the stimulus package may result in bloated expenditures and debt, focusing for the time being on economic stimulation while neglecting improvement in the fiscal condition. The central government will be forced to issue 33.3 trillion yen in new central government bonds, the

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12 Kwan, Weng Kin, "Japan's big helping hand for families" dated 31 October 2008 in the Straits Times, p. A11.

13 *Ibid.*

14 Goromaru, Kenichi, "Budget misses mark during economic crisis" dated 22 December 2008 in the Asahi Shimbun website [downloaded on 22 December 2008], available at http://www.asahi.com/english/Herald-asahi/TKY200812220061.html

first time in four years that an initial budget proposal has had new bond issuance in excess of 30 trillion yen.[15]

The Rising Japanese Yen

3.1 In the currency and interest rate aspects, the Bank of Japan (BOJ) lowered its interest rate from 0.3 percent to 0.1 percent on 19 December 2008. This move was forced by the steep fall of the dollar to a 13-year low against the yen on the third week of December after the U.S. rate cut propelled many investors to dump the dollar for yen and other currencies (See Chart 4).

3.2 An appreciating yen hurts Japan's export-oriented economy as it limits companies' profits when converted to yen. On the other hand, pushing interest rates even closer toward zero would discourage banks from lending. This central bank concern expressed through BOJ Governor Masaaki Shirakawa probably explains why it reduced the rate to 0.1 percent instead of down to zero.

3.3 To alleviate the fear of further liquidity crunch, BOJ supports the credit markets where companies raise funds by launching a new, temporary program to buy commercial paper, a critical short-term debt instrument for businesses as a countermeasure. Besides the unwanted effect of tightening up the credit markets, others have criticized the move towards lower BOJ interest rate as compromising the independence of the central banks as the lowered interest rates are perceived as a consequence of undue pressure from cabinet members for political reasons.[16]

3.4 By 5 January 2009, then Finance Minister Shoichi Nakagawa indicated that Japan was ready to intervene in the foreign-exchange market for the first time in four years due to the tremendous pressure of a surging yen on exporters

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[15] Goromaru, Kenichi, "Fiscal 2009 budget largest ever" dated 22 December 2008 in the Asahi Shimbun website [downloaded on 22 December 2008], available at http://www.asahi.com/english/Herald-asahi/TKY200812220062.html

[16] Asahi, "EDITORIAL: BOJ rate cut reasonable" dated 22 December 2008 [downloaded on 20 December 2008], available at http://www.asahi.com/english/Herald-asahi/TKY200812220054.html

against the backdrop of a recessionary economy and the slump in the U.S. and Europe.

The Japanese private sector

4.1 While Japan's government is battling the crisis at home, its private sector is making long-term investment decisions. In the weekend between 15 and 16 November 2008, Japan released up to US$100 billion to the IMF as financial aid to emerging economies and invested US$2 billion in a new World Bank fund to recapitalize banks in smaller emerging markets.

4.2 Mitsubishi UFJ Financial Group MUFG) purchased 20% of Morgan Stanley while Nomura Holdings bought Lehman operations in Asia, Europe and the Middle East, giving them access to new markets and growth potential in the long run. Morgan Stanley also benefits from this when it gains access to MUFG's US$1.1 trillion in bank deposits in exchange for MUFG's representation on Morgan's board and business tie-ups. Morgan will also have access to US$15 trillion personal financial assets of MUFG's Japanese clients database, about US$8 trillion of which are in bank deposits.

4.3 Sumitomo Mitsui also injected several hundred billion yen in Goldman. MUFG also laid out US$3.5 billion to buy the remaining 35% stake in UnionBanCal, giving it full ownership of the bank. Up till 25 September 2008, overseas acquisitions by Japanese banks and other financial institutions made up a total of US$12.5 billion.

Japan's New Regional Initiatives

5.1 In Northeast Asia, leaders of South Korea, China and Japan held a summit in Fukuoka in December 2008 to discuss the global financial crisis. This Northeast Asian summit is one positive spinoff from the annual South Korea, China and Japan meeting on the sidelines of the Association of Southeast Asian Nations (ASEAN) Plus Three summit.

5.2 Related to this summit, the People's Bank of China announced the establishment of a bilateral currency swap arrangement with the Bank of Korea on 12 December 2008, supporting amounts of up to 180 billion yuan or US$39 billion. The arrangement helps to improve short term liquidity and promote bilateral trade.

5.3 This comes on the back of South Korea's own bilateral currency swap arrangements with Japan, increasing an existing won-yen arrangement to US$20 billion from US$3 billion that had been in place since May 2005. This upgrading of swap arrangements took place on the same day. South Korea also already has an agreement that gives it access to US$10 billion from the Bank of Japan in a crisis while the agreement with China would give them access to 38 trillion yuan at any time for the next three years.

5.4 Japan is also doing its part to insulate Southeast Asia as much as possible from the global financial crisis. It has reaffirmed since 13 October 2008 that it would continue to invest in ASEAN countries to make up for the slowdown in the US and the EU as much as possible. Hiroyuki Ishige, Vice Minister for Economy, Trade and Industry, continued to see ASEAN as a strong production base for the world. Japan also initiated a cooperative venture known as the "East Asia Industrial Corridor" for ASEAN and China, South Korea, India, Australian, New Zealand as well as Japan to invest in their logistics systems and create new shipment links. This will include the New Delhi-Mumbai and the East-West Economic Corridor for ASEAN countries slated to be completed by 2025.

5.5 The basis of all these regional initiatives lies in the fact that Japan needs to stimulate regional recovery in order to increase its exports which are its main engine of economic growth. Northeast Asian cooperation is essential for the regional economies to be consumers of Japanese goods.

The Politics of recovery

6.1 The greatest urgency within Japan in combating the effects of the global financial crisis not surprisingly comes from the center-right pro-business groups, including their media like Yomiuri Shimbun.

6.2 The business daily urged Japanese politicians not to repeat the same mistake made in 1998, when lawmakers wasted three months on meaningless debates before mapping out a bailout plan for the Long-Term Credit Bank of Japan.[17]

6.3 In essence, Japan's challenge in managing the financial crisis is as political as it is economic. Alongside the challenges posed by the global economic downturn, Japan is also facing political uncertainty domestically. With the support rate for PM Aso and his Cabinet plunging to 25.5 percent in early December 2008, Aso's three-month old administration is struggling before the general election deadline in September 2009.

6.4 Aso's biggest problem is internal dissent. Heavyweights like former LDP Vice President Taku Yamasaki, former Secretaries General Koichi Kato and Hidenao Nakagawa, and former Chief Cabinet Secretary Yasuhisa Shiozaki are already distancing themselves from Aso. But the biggest political setback for Aso was by ex-administrative reform minister Yoshimi Watanabe who sided with the opposition DPJ in a recent bill submitted to the Diet on Christmas Eve urging Aso to dissolve the Lower House.

6.5 It is going to be a tough year for Aso with all these political problems. In the next few months, he must obtain the Japanese parliament Diet's approval for the second supplementary budget for fiscal 2008, the fiscal 2009 budget, and legislations containing the economic measures to fight rising unemployment and economic downturn.

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[17] Takemori, Shumpei, "Japan must waste no time in crisis control" dated 23 November 2008 in The Yomiuri Shimbun website [downloaded on 23 November 2008], available at http://www.yomiuri.co.jp/dy/business/20081123TDY08001.htm.

Appendix

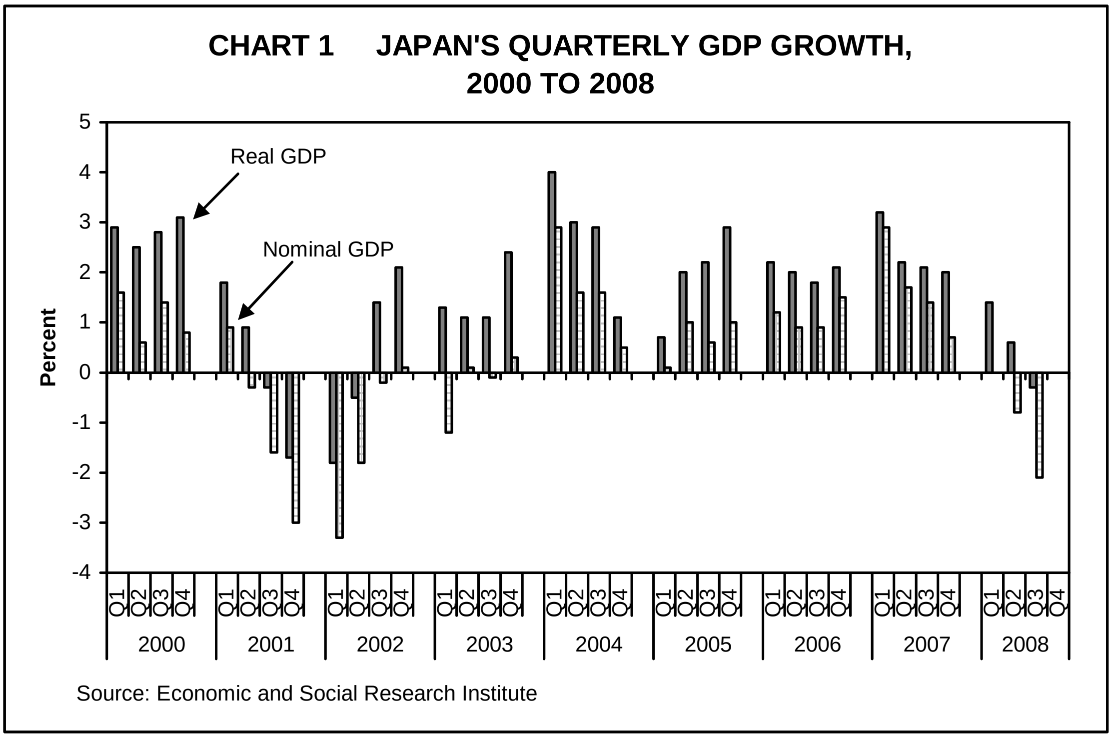


CHART 1 JAPAN'S QUARTERLY GDP GROWTH, 2000 TO 2008
Real GDP
Nominal GDP
Percent
5
4
3
2
1
0
-1
-2
-3
-4
Q1
Q2
Q3
Q4
2000
2001
2002
2003
2004
2005
2006
2007
2008
Source: Economic and Social Research Institute

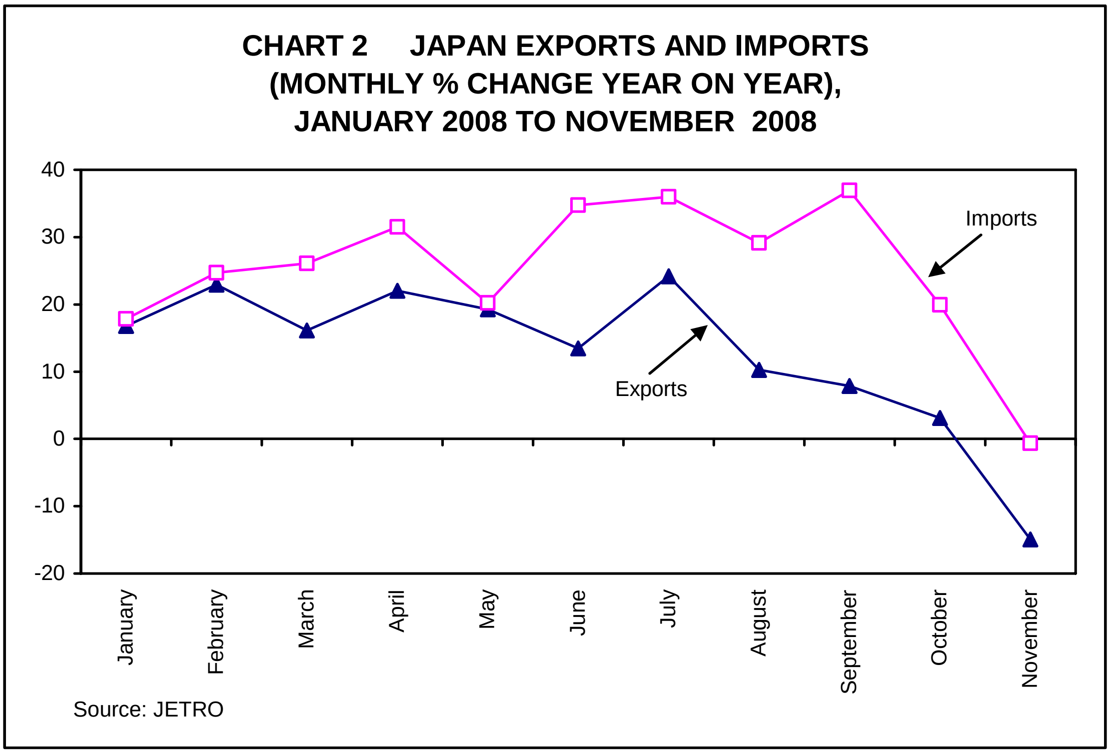
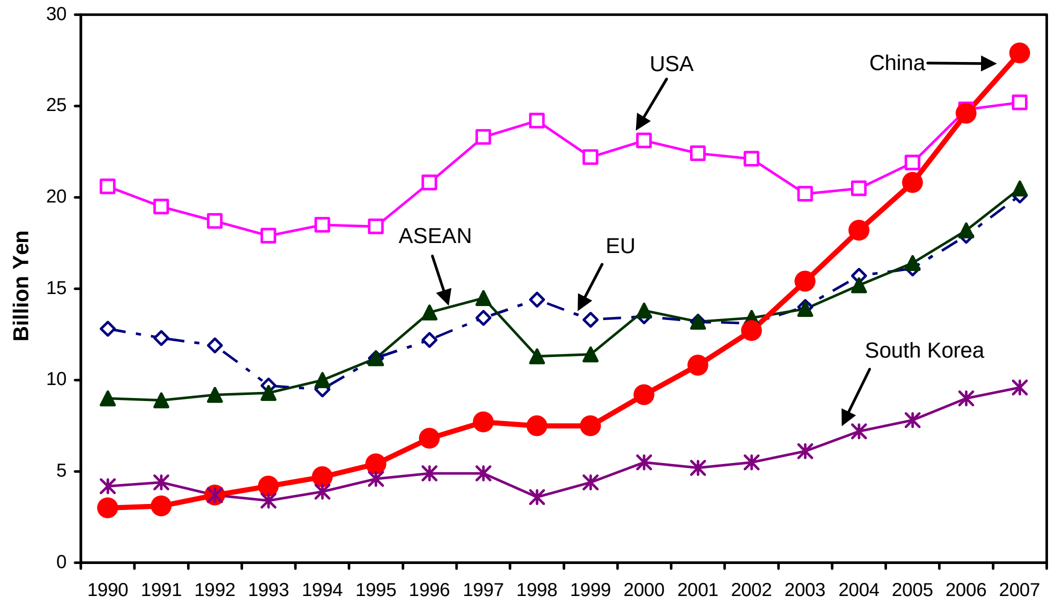


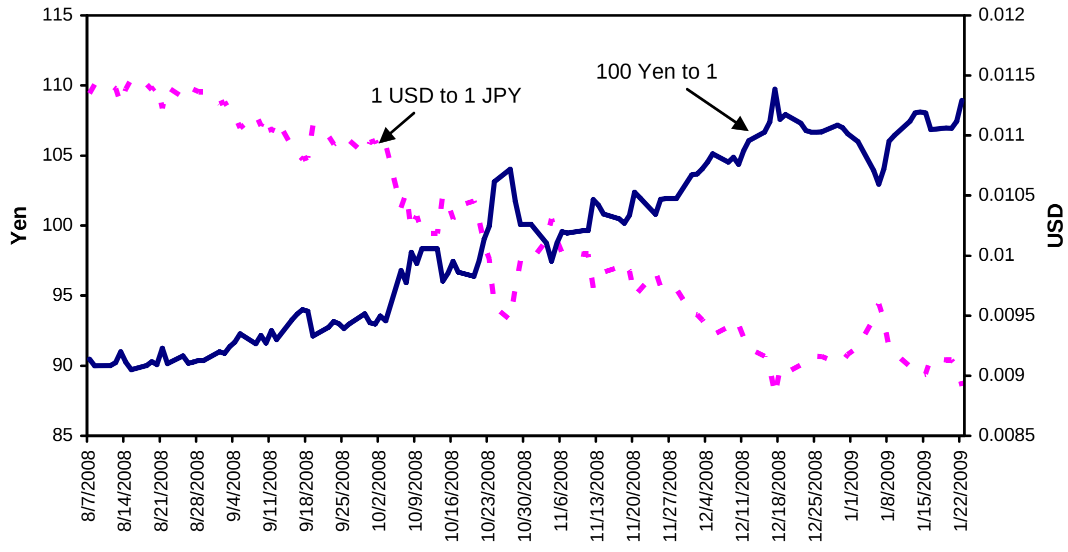
CHART 2 JAPAN EXPORTS AND IMPORTS (MONTHLY % CHANGE YEAR ON YEAR), JANUARY 2008 TO NOVEMBER 2008
40
30
20
10
0
-10
-20
Imports
Exports
January
February
March
April
May
June
July
August
September
October
November
Source: JETRO

CHART 3 JAPAN'S TRADE WITH MAJOR PARTNERS, 1990 TO 2007



Source: Trade Statistics of Japan

CHART 4 CURRENCY EXCHANGE RATE BETWEEN USD AND JPY



Source: X-rates.com