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Militant complacency

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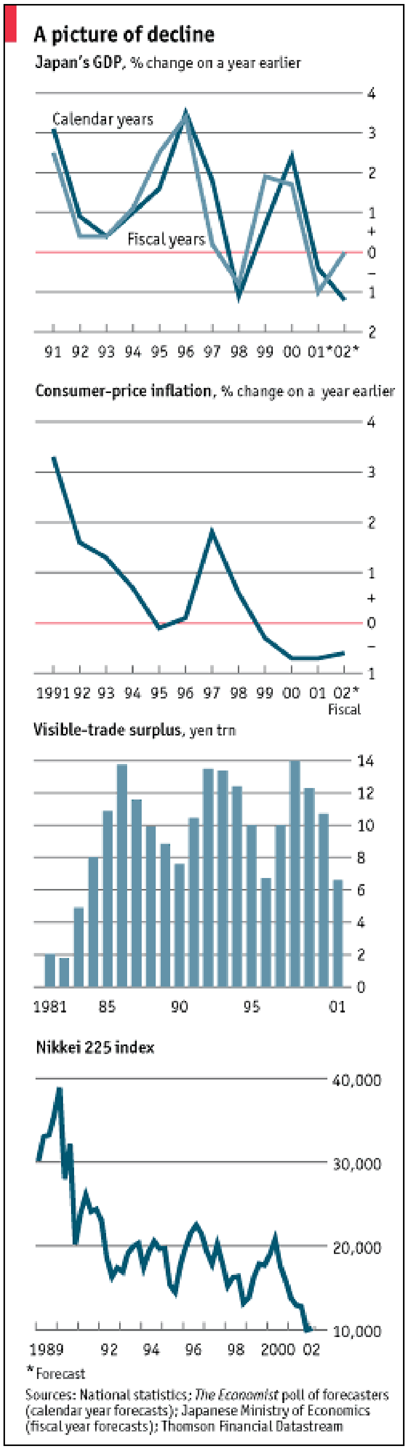
Japan remains mired in recession. Prices have fallen for the third year in a row and even the most optimistic forecasts predict no economic growth in the coming months. Yet the Japanese government, despite prodding from the United States and others to make painful changes, claims that it is doing enough. Is Tokyo too complacent?



THE gloomy statistics continue to accumulate. On January 25th new figures showed that prices in Japan fell for the third year in a row—unprecedented for a major industrial economy in modern times. Official data released on January 24th showed a 38.3% fall in the Japanese trade surplus for 2001, the largest fall since 1970 and the third successive year of decline. The Japanese government's own forecasts show that the economy will not grow at all in the fiscal year starting in April, with unemployment continuing to rise, to 5.6%. (Forecasters polled by *The Economist* are even gloomier, predicting, on average, a further fall in GDP of 1.2% in the current calendar year.) It would be hard to exaggerate the extent of Japan's economic problems.

Yet worries persist about the readiness of the government to tackle effectively the economic challenges the country faces. The current recession is the third in a decade and the scale of Japan's economic decline since the heady days of the 1980s—when the world marvelled at the Japanese "miracle" and, largely because of it, looked forward to something called the "Pacific Century"—continues to amaze and puzzle economists. Instead of the world's second-biggest economy acting as an engine of growth, it continues to stagnate, dependent for any upturn on an American economic recovery, as Heizo Takenaka, the Japanese economy minister, admitted on January 25th.

Japan's problems are not principally cyclical, though, and placing too much faith in recovery elsewhere could once more encourage the country's political leaders to shy away from the difficult structural reforms needed to transform the moribund economy. Last month, the Organisation for Economic Co-operation and Development (OECD) explicitly blamed the country's difficulties on past failures to address the need for reform. When Junichiro Koizumi was elected prime minister in April last year, his political success owed much to his commitment to tackle these shortcomings. Initially, at least, he did appear to understand the need for quick and effective action. But now there are signs that some of the momentum is fading.

That is not how the government sees it. A report approved by the Japanese cabinet on January 25th noted that, of 450 measures promised for the current fiscal year which ends in March, about 70% were already being carried out, with the remainder being discussed or prepared for legislation. "We came to the conclusion that most of the issues are being dealt with appropriately," said Mr Takenaka.

To many this attitude smacks of breath-taking complacency. It is widely agreed that one of Japan's biggest problems lies with its banking system, which has been crippled by huge number of bad loans left over from the asset bubble of more than a decade ago. Banks have propped up many companies which are effectively bankrupt and which have then cut prices to stay in business while potentially more productive sectors of the economy are deprived of credit. This makes deflation worse. As prices fall the real debt burden of the banks' customers rises; this, coupled with the rising cost of credit resulting from the record rise in bankruptcies brought on by the recession, simply increases the number of bad loans.

There are signs that the banking crisis may be coming to a head, with several of the largest banks promising to write down large amounts of bad loans in the current financial year. Mr Koizumi said on December 27th that he may inject public funds to boost banks' capital bases and so prevent a run on the banks. But it is still too soon to be sure that the government will once again duck the challenge and prop up rather than clean up the banks.

Meanwhile, much attention has been focused on the sharp depreciation of the yen in recent months. The Japanese government has persistently denied that it is deliberately pushing down the currency, although a weaker yen undoubtedly helps the economy by boosting exports. Japan's Asian neighbours are naturally suspicious. The South Korean finance minister has warned about the risk of triggering competitive devaluations across Asia.

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Koizumi must deliver

Now the American administration has come out firmly against any manipulation of the yen's exchange rate. During a visit to Tokyo, Paul O'Neill, the American treasury secretary, called artificial depreciation of the currency protectionist. He went on to say that "the weight of historical evidence shows that those who have tried to fix underlying economic problems with protectionist measures actually weaken their economy".

In public, Mr O'Neill just about stayed within the bounds of diplomatic niceties, saying that he had seen no evidence that Mr Koizumi himself believed in using exchange-rate policy as part of his reform programme. But his remarks were interpreted as a clear warning from the Bush administration, which is already hearing complaints from American manufacturers objecting to what they see as unfair competition from a weaker yen.

The ultimate source of Japan's economic problems is political, and the Bush administration will not want to undermine Mr Koizumi's efforts to push through reforms. If he is to succeed, the Japanese prime minister must confront and overcome the reluctance of Japan's political class to acknowledge the need for widespread change, not only among the banks, but in the political world as well—especially the traditionally close links between big business and the ruling Liberal Democratic Party.

At the same time, neither the Americans, nor any of Japan's other economic partners, want to see reforms postponed yet again. Anne Krueger, first deputy managing director of the International Monetary Fund said during a visit to Tokyo on January 25th that she did not see a crisis looming in Japan. But perhaps this is not really good news. Given Japan's longstanding inability to respond effectively to chronic stagnation, it may take a crisis to get Japan's politicians to take the painful and inevitably unpopular steps needed to pull Japan out of the mire.