

Japan's economy

Down but not out

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Japan could yet outperform the other big rich economies over the next year

THE surprise resignation of Japan's prime minister, Yasuo Fukuda, has once again left the world's second-largest economy rudderless—just as it seems to be drifting dangerously towards the rocks. Although America is the centre of the world's financial troubles, Japan's economy appears to have been hit harder: its GDP fell sharply in the second quarter, whereas America's continued to expand. Indeed, many economists expect Japan's economy to shrink again in the three months to September, which on the rule of thumb of two consecutive quarters of decline, would imply a recession. You might conclude that without radical reform Japan will continue to underperform. However, a more thorough health check suggests that Japan's economy is actually in better shape than it looks, and its downturn may be shorter and shallower than those in America and most European economies could be.

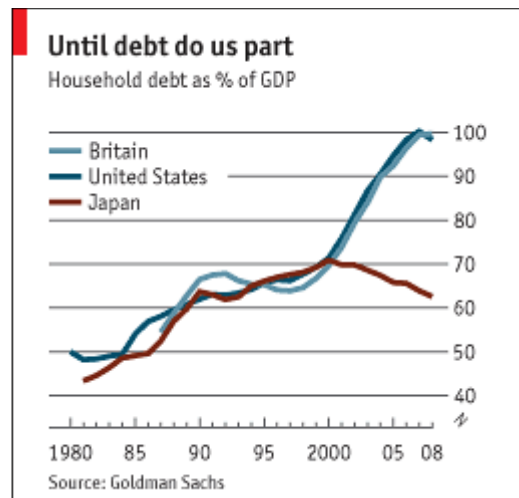
Three days before Mr Fukuda quit, fears that the economy was sinking into another deep recession panicked the government into announcing a modest stimulus package of tax cuts and financial assistance for transport and construction industries, and for smaller firms. Even if these measures are carried out, most economists do not think it would do much to revive the economy. Some politicians would like a big increase in public spending, but the government has promised to eliminate its primary budget deficit (ie, before interest payments) by 2011-12 in order to reduce public-sector debt of 170% of GDP—the largest among the big rich economies.

The government's balance sheet may seem dire, but the private sector's looks healthier than for many years, because Japan has avoided the economic and financial imbalances that threaten many economies in the West. Unlike America and parts of Europe, notably Britain, Japan is not experiencing a credit crunch and house prices are not collapsing. Consumer and corporate finances are also generally in better shape.

Japanese financial institutions' losses on securities linked to American subprime mortgages so far amount to just \$17 billion, out of worldwide losses of \$500 billion. As a result, most banks can still lend, except to property developers, some of which rely heavily on funding from abroad and from small regional banks. Several of them have gone bust in the past few months. More generally, however, Japanese house prices are unlikely to crumble. After its housing bubble burst in the 1990s, the market has not inflated again.

The biggest contrast with America and Britain is that Japanese households have reduced their debt from 71% of GDP in 2000 to 63% this year, according to Goldman Sachs. This is much lower than debt ratios of around 100% in both America and Britain, where borrowing has exploded over the past decade (see chart). The only other G7 economy where consumer debt has declined is Germany, which has also avoided a housing bubble.

Japanese companies have trimmed their debts even more dramatically, to 78% of GDP from 130% in 1991. The level is now well below where it was before the 1980s bubble, though higher than corporate America's debt of less than 50% of GDP. (American firms have traditionally relied more on equity financing.) On the other hand, corporate debt has expanded rapidly in the European Union.



Heavy debts, falling property prices and a shortage of new credit are a lethal cocktail, which could depress economic growth in America and parts of Europe for several years—as Japan itself found out in the 1990s. Today Japan's economy is much less burdened by debt and so likely to recover more quickly.

Another reason why the downturn in Japan could be fairly mild is that almost half of Japan's exports go to other buoyant Asian economies. Exports had been the main force behind Japan's recovery before they slowed this year. Shipments to America and to Europe have fallen, but demand from the rest of Asia remains strong. In July, for the first time, Japan exported more to China than to America.

Japan's long-term growth rate has undoubtedly been strangled by the lack of reform. Yet its economy is now in better shape than for many years. Japan's GDP is likely to grow faster than both America's and the euro area's over the next year. If so, 2009 will be the fourth year running that Japan's GDP per head shows the biggest increase of the three. And that is not only because its population is shrinking.