Japan's Indian Summer

By RICARDO CABALLERO and ANIL K KASHYAP

Good news from Japan at last. Gross domestic product growth in the first quarter of the year was positive for the first time in a year -- actually coming in at a ripping annualized rate of 5.7%. Other, less noisy indicators, such as overtime hours and business-confidence surveys, also point in an optimistic direction. The third Japanese recession in a decade is over.

But will it last? Mostly, this is a decision that is up to Japan's politicians. Let inertia and complacency take over, and this recovery will be no more than an Indian summer; the worst of the winter is yet to come.

Few will fail to realize that much of the current recovery in Japan is owed to foreigners -- mostly the United States' recovery. Japan is far from being an independent engine of growth -- certainly not to the world, but not even for itself. And few will fail to be concerned that an externally driven recovery is tenuous, for it relies on the U.S. continuing to run the largest current-account deficit ever seen. A hopefully gradual depreciation of the dollar will erode the export-driven recovery channel for Japan. Of course, it is the disillusioned Japanese themselves who are partly financing the U.S. current-account deficit, which in turn finances Japan's growth, but this "arrangement" is fragile and it would be imprudent at best to count on it for long.

The question therefore is what steps Japan can take to seize this window of opportunity. The answer depends on a proper diagnosis of the underlying structural problems that strangled the economy for the last decade. Japan's growth is shackled by a complex financial bottleneck that has turned into a vicious circle.

Japanese banks see no worthy projects to finance. Concerned with the aesthetics of their balance-sheets, insolvent banks provide life support for the zombie-firms that got them into trouble in the first place. But providing life support to the money-losing firms stops new firms from entering the market and successful firms from gaining market share. This in turn guarantees that there are no good lending opportunities, and so the cycle repeats.

Thus, not only do new firms see no borrowing opportunity from insolvent banks, but solvent banks and financial markets see no lending opportunities as the potential borrowers face "unfair" competition in goods, labor and financial markets from subsidized zombie-firms and their black-mailed domestic banks. According to the central bank, the Bank of Japan, during 2001 (solvent) foreign banks cut their lending by 5% while their deposits grew by 20%.

A frozen creative-destruction process is extremely costly for growth. In the U.S., for example, more than 50% of productivity growth in manufacturing comes from the reallocation of resources from shrinking establishments to expanding ones. In Japan, the flow is going the wrong way.

The macroeconomic side of the financial bottleneck compounds the problem. Scared individual Japanese, foreseeing a mounting (implicit) tax liability to pay for the bank losses, run for cover with their savings, depressing aggregate demand and profitability further. Worse, there is not even the normal silver lining of increased savings, as the receiving banks either channel the resources back to unproductive domestic investments or to overseas investment.

How can the system be unstuck? There are three obvious steps.
First, banks must be prevented from perpetuating bad lending. This cannot happen without a significant recapitalization of a great number of domestic banks. Public funds will have to be used for this purpose, perhaps in exchange for a large equity position to be distributed to future tax payers through pension funds or alternative means.

Unlike potentially profitable banks, zombie firms are outdated. Pulling the plug on them rather than recapitalization is the answer -- reconstructed banks shall do just that. Closing zombie firms will generate a massive release of workers. While some will undoubtedly be reabsorbed by the surge in new projects and firms that unshackling the creative-destruction process will bring about, it won't be enough. The government must be willing to commit significant resources to facilitate worker reallocation and retraining. Whenever possible, active labor-market policies are to be favored over passive ones during this transition. The idea is, after all, to boost restructuring, not to park resources in protected unemployment.

The government's fiscal investment loan program last year had earmarked over 40 trillion yen -- 8% of GDP -- for the building of roads. This money can be much more productively used in absorbing the short-term costs of reallocating workers.

Finally, the government must rein in its own financial institutions. The postal system has deposits roughly equivalent to 50% of GDP or one-third of all deposits. The government overpays on its deposits and often lends funds to unworthy borrowers. More generally, many of the government financial institutions are losing money and in the process are killing the banks' and other private financial institutions' ability to compete.

All this is going to be costly. Part of the resources will come from the privatization of the government's financial services and from shutting down inefficient unemployment programs (disguised as demand policies). But the most important message is one of timing: Paying during a period of growth, mild as it is, is a lot easier than doing so once this Indian summer is over.

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