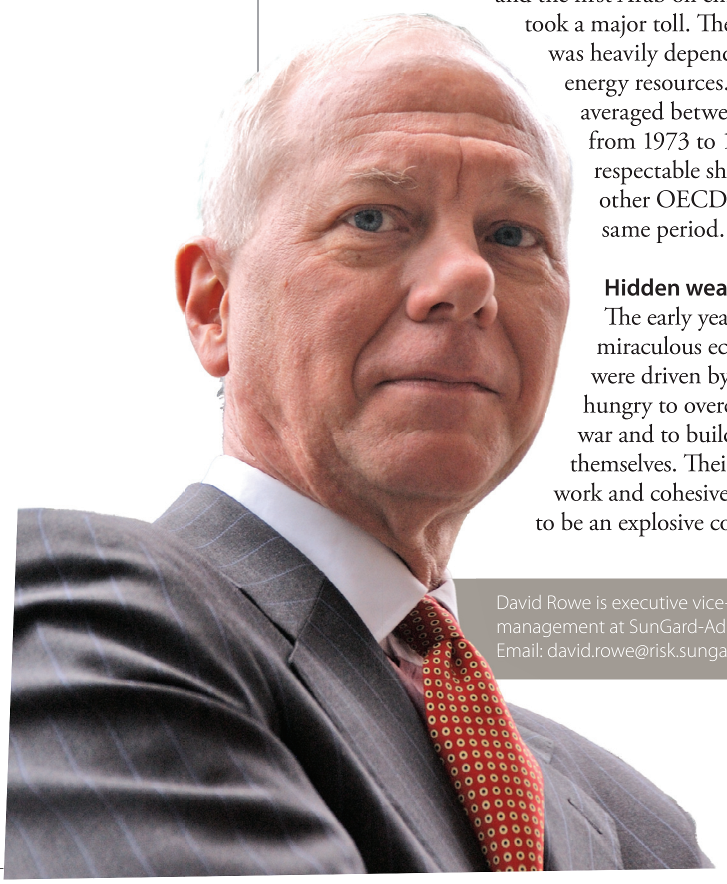
Awakening **giant?**

Some circumstances endure long enough to become embedded in the unexamined assumptions of a generation. In the case of the Japanese economy, these assumptions could prove costly, argues ***David Rowe***

Sluggish performance in Japan has been part of the global economic landscape for over 15 years. Those under 35 years old have known nothing else during their adult lives. Fear of outright deflation has been the central obsession of Japanese economic policy. Even quantitative easing, essentially Milton Friedman's classic prescription for countering a deflationary contraction by force-feeding growth in the monetary base, has had little effect.

Japan's protracted struggle just to avoid an outright depression must seem like a law of nature to most market participants under 40. This makes it difficult to recall that Japan was the original Asian miracle. From 1960 to 1973, the economy grew by 9.6% a year in real terms – rates now routinely associated with China. Obviously, such rates could not continue indefinitely, and the first Arab oil embargo in late 1973 took a major toll. Then, as now, Japan was heavily dependent on imported energy resources. Even so, growth averaged between 3.5% and 4.0% from 1973 to 1989 – a very respectable showing relative to other OECD countries over the same period.



Hidden weakness

The early years of Japan's miraculous economic recovery were driven by a population hungry to overcome the ravages of war and to build a better life for themselves. Their drive, appetite for work and cohesive discipline proved to be an explosive combination. By adopting quality control techniques long before these became standard practice in the West, Japanese exports took the world by storm. In 1955, 'Made in Japan' was synonymous with cheap merchandise and shoddy workmanship. By 1970, it was well on its way to becoming a mark of excellence.

Behind this remarkable post-war performance, however, was a hidden weakness. In many ways, Japan had an administered economy rather than a market economy. This was far from the detailed command-and-control approach that so effectively impoverished the Soviet Union and its allies. Nevertheless, strong central guidance was exerted by the Ministry of International Trade and Industry.

This was combined with the *keiretsu* system. Each *keiretsu* was a diverse family of companies with a bank playing a prominent role at its core. Employees would be encouraged to keep their savings in the affiliated bank, and these would be recycled to fund investments by *keiretsu* member companies. While there would be competition for funds within the *keiretsu*, such loans were not truly arms-length transactions. There was a sense of obligation to support struggling companies within the family.

Given the limited role of genuinely independent credit analysis, it is not a great surprise that many *keiretsu* banks accumulated disturbing levels of non-performing loans. By the early 1990s, the level of such loans became critical. Financial failures began to require injection of public money to contain potential systemic risk. Sadly, the crisis was not faced as squarely as similar situations had been in the West. Halfway measures allowed the burden of non-performing loans to drag the economy down for another decade and more.

A reawakening?

Recently, there are signs that Japan may be emerging from its protracted economic struggle.[1] The big question is whether it may also be emerging from its tradition of rewarding conformity over innovation. This tradition is very deeply embedded in its Confucian heritage, and not subject to rapid change. On the other hand, the cultural and economic challenge from the Chinese mainland is a new shock that has emerged during Japan's prolonged economic agony. There's also generational change. Those in their mid-40s grew up in Japan's period of rapid growth, only to find their early adult years blighted by the great slump. They may well have different ideas about how things should be done in the future.

Has the sleeping giant – the Japanese economy – awakened? We have only seen the first stirrings of change. If Japan can introduce genuine market discipline and accord greater esteem to innovation, it has the potential to recapture its role as a leading economic power. Success is far from certain – but don't dismiss the possibility either. ■

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[1] *See, for example,* Return of a heavyweight, Risk *June 2006, pages 20–23, and* Time to arise from the great slump, The Economist, *July 22–28, 2006, pages 75–77*