Asia Grows, and Japan Slows: Prospects for the World Economy and Markets*

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In the last couple of years, Korea has been a leader in Asia that dealt with problems frankly--from which Japan should take lessons. Last year, I predicted that the yen would rise to about 100; the world economy, global and regional markets, and the Korean economy will become strong; and Japan will continue to be in a very challenging situation. There were great problems to deal with, but there had been just enough momentum exerted into the world economy to help deal with those problems.

The world has seen many reversals in the conditions of regional economies. The Korean exports for January shows that its current account surplus was up 33%. Thailand's current account surplus runs about two-thirds larger than it was two years ago. Singapore will have about 11% surplus growth in the first quarter. Even in countries in such dramatic conditions as Indonesia, a base has been put under economy and things are moving broadly in a more positive direction. If we look at China, the government has cut interest rates, dramatically increased government spending and even taxed savings to increase consumer spending. It seems to be working: exports are increasing and consumer spending seems to be turning up for the time being. Even though there are downward pressures on prices, the deflationary cycle for the moment seems to have stabilized.

In the U.S., expansion is increasingly driven by the consumer, who is looking at full employment, higher wages and the wealth-effect as a result of the strong stock market. In 1993, total consumer spending was about 5 trillion dollars and stock market capitalization was 5 trillion dollars. In 1999, it was about 6 trillion dollars and 16 trillion dollars, respectively. Modigliani, an Italian Nobel-prize-winning economist analyzing the wealth effect, clearly illustrates how rising asset prices affect consumer spending. So, the question that Greenspan now faces is, how do you get the consumer to decrease spending and increase savings rate? The U.S. continues to look at a negative savings rate and a current account deficit of about 360 to 375 billion dollars. With the rest of the world growing, there are insufficient savings to finance growth at the current interest rate. So, unless the U.S. can slow its growth rate, there will be a continued rise in the interest rates.

We are at the beginning phase of a very powerful upward cycle of expanding growth of the world economy. Looking back, there had been one hundred and thirty-three Central Bank interest rate cuts in the OECD countries in the last eighteen months. In the last fifteen months, Japan spent 1.25 trillion dollars trying to stabilize its economy. There were vast interest rate cuts in emerging markets. In more advanced countries, such as Korea, governments have socialized large portion of the non-performing assets in the financial sector, which is in effect, fiscal expansion.

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In the last eighteen months, the total amount of stimulus put into the world economy has been over 2 trillion dollars. In addition, there was an unprecedented effort to stimulate the world economy through monetary policy, and it worked: the world economy has reflated. Everything we look at leads us to the conclusion that the world economy is well and that expansion is nowhere near its peak yet: the broadening of the cycle of growth in the world economy is continuing.

My view is that an Asian financial crisis did not occur. How can I say that given the problems that Korea went through? I believe that what we really went through was a global crisis in emerging markets, caused by massive build-up in investment and expansion in capacity in the traditional sectors of the industrial economy, largely financed with debt and in context where a number of assumptions were made that things would not change. The main reason for investment was the need to cut costs in the economy, largely based on the assumption that emerging markets will stay the same, strongly tied to the U.S. dollar. Developed countries were looking for low-production bases, reopening of the world market by the GATT and the WTO, and new technology. There was also a rush to invest in emerging markets for the last 15 years, on the assumption that the emerging markets would, more or less, stay largely tied to the falling U.S. dollar.

In 1993, Japan and the U.S. thought it was in both countries' strategic interests to have strong dollar and weak yen. So, in 1995, the two countries got together and mobilized the rest of the OECD, buying the dollar against the yen, driving up the dollar. That meant all the countries that had any ties with the dollar saw an increase in their currency, which undermined their cost structure in the world economy of excess capacity. Many companies had to make short-term loans that they could not repay, pushing major banks into financial difficulties, which could have led to a global credit crunch.

So, in fact, it wasn't an Asian crisis, but a broad global crisis of excess capacity, high debt load, and very slow global growth. All of that, mixed with local problems in each economy, were the driving forces behind the global crisis that we have been through; the Asian economies just happened to be the first part of the world to head into the crisis. In such a situation, theoretically, closing all excess capacities can solve the problems. Unfortunately, in real life, closing all excess capacities would have caused a global banking system crisis, much similar to that of the 1930s.

When looking at the Asian economies in detail, the pattern is that across the region, cost structure has been dramatically reduced through currency devaluations, wage reductions, lay-offs, reorganizing companies, reduction in rents and land prices, removal of some red tape, reduction in interest rates and some taxes. All in all, East Asian economies have never had better cost structures than today. We used to liken the East Asian economies to tigers, but they were mere kittens then, compared to the tigers they have become today. No one is as competitive in the world economy at producing mainline industrial products than East Asia.

Korea can produce and export a car for $7,000. It can produce, export and sell a desktop computer for $400 and a microwave oven for $40. All for profit. The world's third largest computer seller is E Computers, selling each Korea-made unit for $399. So, if you can make cars for $7,000 and computers for $400, then Korea does not have any problems; its competitions do.

The broad outlook for the Asian economies in the next twelve months depends fundamentally on the global economy. If there is a strong growth rate between 4 to 4.5%, then the Asian economies will continue to surprise the world with their performances, with Korea leading the way. Current accounts surplus will be larger, exports will be more dynamic, earnings will be stronger, and GNP will be higher than the expectation.

On the other hand, let's assume that there isn't a large growth rate, but a moderate one. Let's say that the U.S. stock market drops dramatically, scaring the consumer into slowing down the spending, ending up with only about 2% growth rate in the world economy, which I doubt will ever happen. The East Asian economies will continue to do well. However, countries like Brazil, Portugal, Greece, Poland, and low-to-mid level producers in other parts of the world that have not gone through restructuring will be in trouble. Do you realize that without coffee and sugar, 71% of Brazil's exports overlap that of Korea? However, Brazil did not go through the same difficult restructuring that Korea has and continues to go through.

If there was a more dramatic situation of 0% growth rate, then there is trouble. Besides the fact that in every Asian country, reforms are slowed, debts are also too high. In Korea, domestic and international debt runs about 200% of GNP, about 250% of Thailand's GNP; and about 340% of Malaysia's GNP. If there is a 10% long-term interest rate and the debt is about 340% of the GNP, then it is taking more than one-third of the GNP, just to service the debt. That is ridiculous. Yet, the world banking system, especially the Japanese system, is too weak to write-off the 80-85% of the Indonesian debt that will have to be written-off: the balance sheets are too weak in Japan to do that. So, if there is slow or zero global growth, then it will lead back to a global crunch, such as the one in 1998. If the global economy stays very strong, then there will be a continued strong performance.

In 1998, the current account surplus of East Asia, excluding that of Japan, was 156 billion dollars higher than it was in 1996. I think the current account will continue to perform strongly, which is critical to generate the cash needed to lower the debt load in the region. In the Southeast Asia, Thailand and Malaysia in particular, the real excess investment problem is in the real estate sector. Bangkok probably has enough apartments in reserve for the next 50 years. About 42% of commercial real-estate is vacant in Thailand and that doesn't include the building where the construction was stopped. The bad thing is, you can't export buildings. Also the Thais still refuse to allow foreign investments in real-estate. In fact, the new bankruptcy laws are worse than the last one because it allows 17 years for workouts. So, foreigners are still very cautious about investing in Thailand. In addition to its economic problems, Malaysia also has political struggles. Thailand and Malaysia have continued to under-perform, but their export sectors are performing very strongly, carrying the rest of their economies.

Indonesia's economy needs to be restructured and reformed completely: it is headed by an Iraqi-educated Muslim mystic, who is largely blind and had two strokes, and yet a dynamic politician; his vice president has failed even the lowest expectation; the courts, markets, the banking system, the legislature, the central bank all need to be restructured and the constitution has to be redrafted. And yet, because the world commodity has risen so strongly and the currency has been so weak, the export sector of the economy is doing relatively well. This has given a base to the economy: things are stabilizing and businessmen and entrepreneurs who fled to other countries are slowly creeping back to Indonesia. Some would argue that the situation is problematic, but I would argue that it's probably difficult to have seen a better transition so far in what could have been an extraordinary bloodbath.

Taiwan has managed its economy strategically throughout this crisis and continues to do well. Politics will continue to be problematic and will become more so after the elections because it is possible that none of the candidates will come anywhere close to a majority. Beijing does not yet have the military capacity to cross the water to attack Taiwan. I think China has painted itself into a corner and it saved face last year only because of the Taiwanese earthquake. Whatever happens, Taiwan's economy will not be destabilized by it.

The Chinese economy has made enough effort to lift itself back up. However, less than 1% all bank loans go to the private sector. So the savings are channeled largely to companies that destroy value: companies produce more and more goods that fewer and fewer people want to buy. This in turn causes the companies to produce more goods in an attempt to raise the revenue necessary to repay the bank, causing a constant downward deflationary pressure on the economy. The situation then drives the government to adopt increasingly strong measures to stimulate the economy to offset the pressure. China will have to undertake major reforms to allow private savings to be channeled toward the private sector of the economy, which is creating jobs, paying taxes and generating exports. If these companies can be systemic, get regular financing and are allowed to list on the stock market, then "the Great Chinese Job Machine" will be put into gear. There would be a vast increase in the private sector, dramatically increasing employment opportunities. The whole reform process would get into high gear again because using the capital market solution to move through the next step would drive the government to address the issues of rule of law, supervisory system, contracts, regulatory system and transparency.

It seems that the financial sector reform is the key to the next step in China's WTO membership process. China's successful entry into the WTO is something most are hoping for soon, but the negotiations with EC have not gone well. The U.S. Presidential election, complicated with the developments in Taiwan, makes it more difficult to get it through the U.S. Congress.

The momentum of the reforms in Korea will not and cannot be regenerated until after the elections, as the president forms a new working majority. But broadly, my view continues to stay positive about Korea.

The real problem in Asia is Japan. Japan has spent 1.25 trillion dollars in the past 15 months and in the last quarter, the economy contracted and it will contract probably again in the first quarter this year. That would mean Japan would have to get 2.4% quarter-on-quarter growth in the first quarter this year to hit the government's target of 0.6% growth for the fiscal year. Well, the numbers for January and the first two weeks of February are in, and it is impossible to get an expansion of 2.4% for the quarter.

The official line is that things are getting better and the economy is stabilizing. And already, politicians are talking about a new supplementary budget, even before the current annual budget for the next fiscal year is put into place. Looking at the Japanese public sector, I don't want to say it will never get better; it will, eventually.

It would be wrong to underestimate Japan and its enormous strengths in education, technology, savings rate, and its resiliency to fight back. Even if the current recapitalization of the current banking sector works, there continues to be huge problems. About 20 % of Japanese bank loans are made to what I would call "the bullet-proof companies, " or companies like Tokyo Electric Power, which are quasi government utilities. These loans are ok. Another 25% of Japanese bank loans are made to companies that currently have the money at less than the prime rates, which means the banks are not making any profits. The remainders of the loans are to companies that have debt-to-cash-flow of about 20-to-1. If you have a debt-to-cash flow of 20-to-1 and the economy starts to contract, then there will be an increase in bad debt. In fact, in my view, there was an increase in the bad debt in the banking system the last quarter. If we take total Japanese bank loans, it is about 146% of its GNP. Of those loans, about 20% are to mid-to-small size real-estate companies. These companies have a net worth of negative 20% of their balance sheet. The write-offs will be 6% of GNP, which is about 300 billion dollars.

We can make the same analysis for small and mid-size construction and real-estate companies. These three sectors together have a net and negative equity of about 15% of GNP, largely financed through bank debt. It is imperative to get growth in Japan's economy or the banks will somehow have to deal with this.

The Japanese insurance companies are locked into contracts whereby they pay their policyholders 4 to 5.5% return. Most of this money is invested in Japanese bond, yielding about 1.6% for 7 years. We calculate that the insurance companies are losing 26 billion dollars a year because of the interest mis-match. They have money reserve to last for about 22 months. The conditions for the workout of the Toho Insurance Company, the twelfth largest insurance company, depleted the entire government fund created to support life insurance companies in difficulties. The policyholders were told that instead of 4 to 4.5% returns, they will now get only 1.5% and the policy will not be converted into annuity when the people turn 65, but when they turn 68 years old. What it means is that the government now recognizes that it is running out of funds.

After the elections, it is very clear that there will be new financial problems and with solutions like this, this will have a depressing effect on consumption. As consumption declines, it will be rather difficult for growth to become stronger. At the same time, there will be further pressures on wages and employment.

In 1988, Japan was neck to neck with the U.S. and Europe in many industries, and in fact, ahead in some industries. In 1988, of Japan's total capital investment, 17.8% went into high-technology and for the U.S., 16.2% went into high-technology. So, in 1988, not only was Japan out-investing the U.S. in high-technology, but Japan also doubled the U.S. in the percentage of total investment, as a proportion of GNP. In 1998, Japan's investment, as a proportion of GNP, had shrunk somewhat and its commitment to technology had fallen to 15.9% of GNP. Meanwhile, the U.S.' investment in technology has climbed up to 39.1%. So, in a sense, Japan has largely missed the technology boom/revolution of the 1990s. It has a number of consequences. First, much of the excess capacity in Japan is based on old technology that is no longer competitive. The real problem is that companies' balance sheets are too weak to write-off that capacity, unless the yen falls dramatically, which is unlikely. Second, technology is a huge opportunity in Japan and with its underlying strength, it will probably move aggressively in this direction. Third, much of the new technologies allow dis-intermediating: it puts producers directly in contact with consumers. There is one country in the world that has an extremely inefficient distribution system: Japan. The total wholesale sales of Japan are 2.42 times larger than retail sales. So, if there is one part of the world that is right for the Internet, it is Japan. Of course, it will be very disruptive because there is such high level of employment. So, the technology equation for Japan is very complex. There is a huge opportunity and potential, but it's going to first go through a stabilizing process by restructuring. Fourth, in the U.S., there is talk about the crisis in the U.S. social security system in 2021 because the number of people retired will exceed the people working in the social security system. This crossover point actually occurred in Japan last year. This year's payout to the retired people in Japan exceeded the amount contributed by people working. Unless the money can somehow be invested to generate fantastic returns, there is a building pressure on the pension system, and therefore, on public finances. This is an issue that politicians can no longer hide from because increasing number of voters are retirees.

Finally, let's look at the U.S.' problematic debt situation, where improvements in the government sector have been more than offset by deterioration in the debt position of the household sector and the corporate sector. Some advocate the wealth effect of the rising stock market, but if everyone tries to realize the profit they made on the stock market, then there will be no wealth effect.

In 1991, Japan's government debt to GNP was 51%. By the end of 2001, public sector debt will be about 151% of GNP. So, Japan today makes Italy of yesterday look like a paragon of fiscal discipline. Let's assume that you are in charge of Japan's economy. If you raise taxes in this environment, the economy will die. Then, cut government spending. If you make upper echelon pay higher taxes, then you will not be re-elected. What would happen if the interest rates rise? Japan has no other choice but to monetize a large portion of the debt. Japan will have to sufficiently expand the money supply in order to accommodate a large portion of that increasing debt. These are dramatic measures, but Japan is in a dramatic situation. I believe this economy will suffocate and then rollover again towards where it was in 1998. It is not in anyone's interest in this region.

At the moment, Japan has a very easy fiscal policy and spending. It also has a very easy monetary policy because overnight interest rates are zero. That is questionable. The method of measuring the tightness of monetary policy is where real long-term interest rates are. What are real long-term interest rates in Japan? 10-year bond interest rates for mid-level corporations are running about 3.25-3.5%. Officially, the economy is deflating at about 1.5%, which does not include any discounting. I would argue that the economy is deflating by 3%, which may be wrong. If I'm wrong, real interest rates are at 4.75%, and if I'm right, then real interest rates are at over 6%. If real interest rates are between 5 and 6%, this type of bad debt situation escalating in the government sector will end up killing the entire economy. The conditions of a tight monetary policy and a very loose fiscal policy are the conditions in the U.S. in the early 1980s.

If this condition continues, the yen will go to 90. The numbers show that the economy and exports are slowing and profits of top companies are falling. It's only a matter of time before the Bank of Japan is forced to adopt measures that would make monetary policy easier. The Bank of Japan should move-up the yield curve by buying midterm and long-term assets and targeting a real long-term interest rate of closer to 0%, instead of between 5 to 6% it is now. The only way to achieve this is to increase the money supply substantially to accommodate the build-up of debt and drive-down real interest rates.

When this occurs over the next couple of years, we might get in a crisis because there is a lot of resistance. What will be the consequences? I think these consequences are very important for Korea. One, there will be huge amounts of money leaving Japan because real interest rates will be dropping. So there will be a lot of money going into other markets, entering into a period of yen weakness. I believe that during that period over the next two or three years, the yen will fall below 160.25, the lowest point since the Plaza Accord. Two, there still will be lots of liquidity left in the economy, which can be invested in the stock market. As the stock market rises, banks will be more willing to recapitalize and companies more willing to rebuild balance sheets, and there will be asset dis-investitures and management buyouts. It will also start to restore the wealth effect as asset values rise and people will reverse their views that there was asset wealth destruction over the last decade, which in turn will put a floor on spending. The only practical way for the Japanese government to get out of this debt situation is to privatize huge amounts of government assets, but in order to do that, there must first exist a very strong stock market. I see this happening in the next 5 years, as the stock market rise back up to 30,000 or 35,000 level.

What does it mean for Korea? You must first imagine living in a world with the yen at 160, 170, 180, or for a short period, even at 200. How dramatic would that be for Korea? Through the first phase of the Asian crisis, Korea's link with the dollar was broken. I don't know what the policy of the Central Bank is today, but it seems that broadly, the Korean won is shadowing the yen at a rate of about 10 to one: when the yen was at 140, the won was at 1400. The only countries still tied to the dollar in the region are China and Hong Kong.

The real problem then becomes, how do we deal with the reaction that we would have in America and Europe, if the yen drops so dramatically? The Americans have to make a decision: it cannot tell Japan to monetize its debt to reflate the economy and at the same time, not have weak currency. Both cannot coexist. In the broad scheme of thing, it would seem more important to the U.S. to see money flow out of Japan because it is more important to have a continued flow of money into the U.S., keeping the interest rates low and stock markets high. It would seem more important to get that money than to live with a less competitive Japan that has a weaker yen.

So, as I look to the next year ahead, I see a very optimistic future for Korea and the rest of Asia.

Question & Answer

Q: The idea of monetizing Japan's massive debt has been around for a while. However, many Japanese economists believe that it will be ineffective because of leakage effect, unlike the 1930s. What do you think about that?

A: I think it has already started. The last seven currency market interventions have not been sterilized. Every time there was a currency market intervention last year, the Bank of Japan intervened within the 24 hours to sterilize the effect on the domestic money supply of the intervention. It seems to have stopped since December. Its interventions on the overnight market continue, but the Bank of Japan is working on three-month money in their daily interventions. Last week, the Bank of Japan has accepted the delaying tactic of starting a study that will be reported later this year on setting the inflation target.

Yes, there are major leakages. Leakages are one of the reasons for the yen's sharp drop. In dropping, the yen will put back some competitiveness in some of Japan's exports companies.

Q: You alluded to some political problems in Japan. How do you see that working, if the scenario that you mentioned actually comes to pass?

A: In a country that is going under this type of extraordinary strain, obviously, everything will be expressed politically. Politicians will be influenced by people who believe were cheated by the government on lowered return on long-term insurance policies, reduced pensions, reduced job market, restructuring in big firms, etc. The governor of Tokyo has recently proposed a tax on banks and the strong public opinion support for the bankers to take responsibility for the crisis is a first glimmer into public discontent. I would suspect that conflict and crisis that have been endemic to Japanese politics in the 1990s will intensify over the next four to five years. I would be very surprised if it doesn't.

Japan's history seems to move in cycles of 60 years. These cycles are divided into four phases: the first phase in which the Japanese are trying to figure out how Japan relates to the rest of the world, who and what are the Japanese; the second phase of conflict; the third phase of huge restructuring, and the fourth phase of rapid growth.

The cold war was in fact, more like "the Golden Ages" for Japan. The post cold war was the end of that era. So, my sense is, before you get a new consensus, the crisis in Japan probably gets deeper. Japan is probably the biggest economic and political problem facing the world economy today.

Q: You gave a very optimistic view of the Korean economy, despite the fact that Korea is increasing trade balance deficit and current account deficit. What key macroeconomic indicators give you such optimistic view about the Korean economy?

A: It is true that Korea's January current account numbers were negative. Is that the beginning of a trend? I would rather think not. I think the companies finally have their working capital back in place. If anything, the interventions of the central bank to stop the currency from rising create vulnerabilities for the economy later, as though the effects of the interventions will have to be dealt with. Of course, you would need more money to do that. I just can't help but have positive view on any country that can go from 0 foreign exchange reserve to $75-76 billion in foreign exchange reserve in two years, as Korea has. I have three recommendations for Korea: one, more reform; two, more reform; and three, even more reform.

Q: Japan's complicated distribution system may be intentional as a trade barrier. What are your views on this?

A: Someone once said that the Narita Airport was placed where it was to make it terribly inconvenient for foreigners to come to Japan and that it was a trade barrier. I think the Japanese distribution system has been built up over centuries and of course made difficult to penetrate that market. However, I don't think trade barrier was part of the motivation for how it was built up. I think distribution systems largely reflect on the sociology of a country.

Q: Korea's Internet population is growing at a rapid rate, reaching 10 million users last year. Japan, which needs the Internet most, does not have as rapid a growth of Internet users as Korea. What are your views on Japan's turning into a digital economy?

A: Korea today is probably the hottest Internet market in Asia, probably also the most interesting. Korea is globally competitive in the traditional industrial sectors and has a very strong foothold in the new economy. You can also see an evidence of this in the telecommunications market.

The Internet and Japan's induction into the digital age will be part of the solution for the breakdown of old social system. The Internet will also bring years of confusion. However, Japan, with its determination and potential, should be able to take advantage of the Internet business and come out on top.