



## NEWSLETTER

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**Analysis****Can Japan Survive and Overcome Global Recession?**

Takatoshi Ito\*

Just a couple of years ago, very few people expected that the US-based problem in housing and finance would grow to a full-scale financial crisis and global recession which seems almost certain today. There are four, mutually reinforcing channels through which the economic crisis can be transmitted from the US to the world economy: (1) the global linkage of stock prices, (2) fluctuations in foreign exchanges, (3) increases in risk sensitivity, and (4) the effects on the real economy (consumption, investment, exports and imports).

First, on stock (asset) prices, many commercial banks, investment banks, insurance companies, hedge funds, and other financial institutions in the US are now facing severe capital deficiencies, and being questioned about their survival, making their depositors and creditors withdraw their money or assets from their accounts. In anticipating such behaviour by their depositors and creditors, financial institutions try to sell their own assets to raise cash outside as well as inside the US. As a result, those assets held by US financial institutions are sold all around the world, and cash is sent back to the US, leading to sharp drops in stock prices in Europe, Japan and emerging economies and relative increases in the value of the US dollar against all currencies. Japan is an exception to the extent that it has a stronger banking system than other countries including the US and also because of the closure of 'carry trade' positions (borrowing the yen and investing elsewhere).

Yet Tokyo has so far been among the most adversely affected markets in terms of stock

prices. This is because about 60 per cent of daily stock trading in the Tokyo market is done by foreign investors, who are frantically trying to sell their stocks simply for their liquidity needs regardless of the valuation of corporate earnings these days. If there are persistent decreases in stock prices, financial institutions whose asset holdings decline in value, will suffer from capital deficiencies, causing their own stocks to decline further, and setting the vicious circle in motion. A prolonged slump in the stock market tends to affect consumption and investment negatively, undermining the foundations of the real economy.

Since the bankruptcy of Lehman Brothers in the US, many of the emerging economies have been severely affected by western financial institutions' rush to sell their assets in those countries, reversing the trend of capital flow, depreciating their currencies, destabilizing their financial systems and causing a shortage of liquid foreign reserves. The liquidity problem, similar to the Asian financial crisis in the late 1990s, is now pushing such small and open economies as Iceland, Hungary and Ukraine close to bankruptcy, and forcing them to ask the IMF for emergency financial assistance.

On exchange rates, it seems increasingly clear that the yen is emerging as strongest in value, followed by the US dollar, and dollar-pegged currencies, and the Euro is a little weaker, leaving the currencies of smaller countries in the weakest position. It is a kind of irony that the value of the US dollar has increased relative to other currencies (except the yen) despite the fact that the financial crisis originated in the US. This is due to the nature of the US dollar as the key international currency widely used in financial contracts, so the US dollar is being sought by financial institutions for liquidity purposes.

Another problem is the fact that the valuation of 'risks' all over the world has drastically changed since Lehman Brothers' bankruptcy. Various kinds of spreads have widened in the world markets, and those institutions and individuals who used to take risks are now suffering from large capital losses and no longer offering any new credit. For

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now, no institution is following the business model that seeks high returns by investing in high-risk products in a highly leveraged position. In fact, virtually no credit or loans are readily available on the global scale, causing business investment to decline sharply, and possibly giving a devastating blow to the real economy.

As far as large financial institutions in the US and Western Europe are concerned, there appears likely to be no big surprise any further, owing to capital injections by the governments and/or M&As in the financial markets. But the risk of rapidly deteriorating real economies is becoming a major problem throughout the world. Consumption and investment in the US are continuously declining along with its import demand, contributing to the slowdown of the Japanese and European economies, all anticipating negative real growth for 2009, as shown in the recent IMF forecast. In particular, many of the Asian economies such as China, South Korea as well as Japan, have been relying so heavily on their exports to the US that they are severely affected by the slowdown of US import demand. As a result, it seems almost inevitable to have a world-wide recession in 2009, as even oil-rich economies like Middle Eastern countries and resource-rich economies like Australia and Brazil are slowing down significantly due to sharp drops in the prices of oil and other commodities in the world markets in recent months.

As far as Japan is concerned, the high value of the yen does not necessarily have all negative impacts on the economy. Particularly, those companies that are interested in taking over their foreign counterparts tend to benefit from a higher value of the yen, as the purchase price in terms of the yen goes down. Also currency fluctuations are no longer significantly affecting the business performance of Japan's excellent 'global' companies, which have by now diversified their production locations in various countries around the world. However, the country in which they choose to produce does depend on currency values, production costs, taxes, etc. Hence, as the yen rises, production tends to move away from Japan to other parts of the world, depressing employment and investment within Japan. Without political and economic decisions to lower production costs at home, Japan as a country

(or at least its public finance) might not survive, although Japan's global companies might.

What is the chance of recovering from the global recession anytime soon? One possible scenario is the bottoming out of the US housing market within a year or two. It is reported that currently unsold housing stocks in the US could be digested in the market in six months to one year, as housing starts on the supply side are now so depressed that the optimal inventory level may be restored and the housing market may become gradually normalized within the next couple of years.

Another scenario is that financial stabilization policies may work effectively, resulting in sharp drops in risk premiums and leading to the normalization of the financial and capital markets in the world economy. For this to happen, the health of financial institutions must be fully restored and widely acknowledged in the global markets. Needless to say, the recovery of the US housing market is a prerequisite for this scenario.

Yet another scenario may be a reversal of the vicious circle in the stock markets by involving more active and 'contrarian' individuals and institutions including investment funds and pension funds. There should be a large number of potential investors who would think of the current low stock valuations as 'best buying opportunities.' Once the momentum changes, the stock markets in various countries might well bottom out.

All fiscal and monetary policy measures must be mobilized to halt a further deterioration of the real economy and push recovery from the current global recession as soon as possible. Although Japan does not seem to have many policy options, given its extremely low interest rates and highly indebted public finance, it is possible to adopt careful fiscal measures with large multiplier effects as well as tax reform to stimulate the economy.

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