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The Threat to Japan's Economy is Japan, Not China
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Over the past week, people have argued in the same breath that China is an economic threat to Japan and that China's currency should be revalued. This recalls a similar debate between the U.S. and Japan, which led up to, but did not end with, the Plaza Accords in 1985. American newspapers liked to portray Japan as a giant sumo wrestler or a Godzilla invading the U.S. economy and squashing American industry. Now, with China, journalists have equally sensational imagery to draw from - the dragon is swallowing the sumo wrestler. But those who say that China is a threat are wrong and have merely shifted attention from the biggest problem. The real threat to Japan's economy resides within Japan itself.

One reason that China is an economic threat, according to the worriers, is that Chinese imports are exacerbating the overall drop in prices, or deflation, in Japan. But this view misses the fact that there is good deflation and bad deflation. Good deflation, which comes from cheap, unrestricted imports, will benefit Japanese consumers directly by, for example, bringing an end to the era of paying $10 for a pear or $100 for a melon. Furthermore, a fall in the price in imports will benefit companies that buy inputs from abroad and it will boost Japan's terms of trade.

This is not to be confused with bad deflation, which has appeared in the price of land and other assets, where non-performing investments were made, or in the prices of goods and capital that face falling demand. Japanese consumers hold their money for several reasons. One reason is that prices will be lower tomorrow, so why spend today? Also since interest rates are so low in Japan, people must save even more for their retirement. Economics 101 would tell you that a higher rate of return would encourage people to save more. But in Japan, economics is turned on its head: the returns on investments are so low that people need to save even more (called "precautionary savings"). The effect of this low demand is that the non-performing assets, from the beginning of this story, are worth even less and are more numerous. Households and firms are therefore left with diminished net assets (more on this later).

The China-as-menace crowd also says that China is threatening Japan's production base, especially the labor-intensive sectors like textiles and computer manufacturing. Yet Japan is going through a demographic shift in which the available labor pool will shrink and more people will retire. Japan's aging society - the phenomenon of people living longer and having fewer babies - will require companies to find workers outside Japan. So the fact that Japanese companies are setting up plants in China is good news. As Japan becomes relatively more endowed in capital, it will find that it can make products that are capital-intensive more efficiently and those that are labor-intensive less so. Japan should, therefore, become a global supplier of capital, services, and high technology.

But the area of high technology is where China may be the biggest threat to Japan, they say. There are graphs that show Japan's exports of desktop computers to the U.S. are falling, while China's are rising. These numbers are deceptive. They reflect the value of computers that are merely assembled in China. Meanwhile, nearly all of the value-added technology comes from Japan and elsewhere.

The number of products in which Japan and China compete has been overstated; by some calculations, it is as little as one-fifth. The two economies are more complementary than competitive. Cooperation never makes a good news story, so it is not surprising that journalists have emphasized the competition. But China is not a giant Japan and the level of healthy competition between the two has pushed Japanese companies to be more conscious of profit margins and to focus on the areas where Japan excels.

How about China itself? Certainly, over the past decade, the Chinese economy has been booming, while the Japanese economy has been swooning. Yet after all that growth, annual per capita income in China is less than $1,000, while that number is almost 40 times higher in Japan. Moreover, Japan's $4 trillion economy overshadows China's $980 billion economy. If, in a strategic sense, economic weight equals power, then China still has a way to go to become any kind of threat.

But two big events will change China - its accession to the World Trade Organization and the 2001 Olympic Games in Beijing. Are these reasons to be more optimistic about the Chinese economy? The problem with forecasting investment flows, economic growth, and exchange rates based on these two events, however, is that their effect on the Chinese economy is still unclear. It is impossible to predict the net flow of capital in and out of China after it joins the WTO.

Similarly, hosting the Olympics will draw resources away from the interior of China, where capital is needed most. Not only will the relative marginal returns on investment be lower in Beijing, but the reallocation of resources could increase the level of disparity and resentment between the capital and the countryside.

After the Asian financial crisis in 1997, any debate about China's currency was whether China would devalue to compete with other weakened currencies in the region. The world was relieved that China decided against weakening its currency. Suddenly, the debate is now whether China should be obliged to revalue. Yet there has been no change in Chinese economy to support a stronger yuan. In fact, it could be argued that growth is slowing and the economy's mid-term prospects are cloudy.

China is no threat to the Japanese economy. If anything, China will complement Japanese industries. What might be more important, however, is that China provides pressure, from the outside, for economic reform in Japan because if Japan has anything to fear it is itself. Junichiro Koizumi, the exceptionally popular Prime Minister of Japan, has the foreboding task of fixing the economy. Now that he has convinced the country that reform will be painful, he must pull the economic levers in the right order or risk a severe recession.

In my neighborhood in Tokyo, there hangs a poster, left over from the elections, that depicts Mr. Koizumi with his shirtsleeves rolled up as if he had a rather large job to tackle. He does indeed. To address the difficulties of competing in a global economy, he must find ways for Japan to retrain and employ those who have lost their jobs. In early August, Economy Minister Heizo Takenaka suggested that the Japanese government directly provide jobs for the unemployed. One idea is to hire 50,000 temporary assistant teachers. This concern for the level of employment reflects a Keynesian bent within the Japanese government. A specter of the Great Depression haunts the economic authorities and they will not let market mechanisms go unchecked. They understand that a sharp decline in aggregate demand can lead to a vicious cycle, from which the economy would not quickly recover.

Fiscal austerity can therefore wait. The government should begin fiscal reform, but this does not mean reducing spending or increasing taxes. Rather it is a question of reallocating resources. Japan should follow the U.S. example from the mid-1990s of shifting investment away from roads and increasing investment in telecommunications infrastructure - from the highway to the information superhighway. Currently, e-commerce in Japan lags behind the U.S., Australia, Sweden, Norway, and Ireland.

But what is most urgent is restructuring the banking system. The government must force banks to write off non-performing loans (NPLs). Simply hoping or encouraging the banks to do so is insufficient. The NPLs - the exact amount of which is unclear - are most pressing for three reasons. First, for every bad loan, there is a bad lender and a bad borrower. And for every additional bad lender and bad borrower, the total amount of lending, and therefore economic activity, goes down. Second, bad investments have been and will continue to crowd out potential good investments.

Finally, the banking mess is hurting overall demand - consumer demand as well as business investment. Nobody is spending because no one knows exactly how bad the financial problems are. This is why the Japanese government must ask for full disclosure and force banks to write off bad loans before taking another step. Meanwhile Mr. Koizumi should stop wasting his political capital on shrines with war criminals and cheap Chinese imports and get to work immediately.

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