



## Deflation - a tale of two economies



“No-one would accuse the Japanese people of indulging in their own version of *schadenfreude*, as they watch the rest of the world struggle to cope with their own financial crisis. Instead, Japan has been monitoring events with a great deal of personal interest, and no little concern.”

Japan's own persistent and prolonged downturn still weighs heavily on the nation's consciousness. Furthermore, the West holds the key to any potential upturn, for themselves, and also for most of Asia.

### Lessons from history

Analysts and economists have been looking to draw parallels between the global events of this year and the boom and bust that Japan suffered in the 1990s, and is still suffering from. Indeed, the West has been extremely conspicuous in its attempts to learn from the mistakes made by the Bank of Japan, when trying to revive their own economy.

Back in 2002 Ben Bernanke published a US Federal Reserve paper titled: *Preventing Deflation: lessons from Japan's experience in the 1990s*. Within it Bernanke pointed the finger fairly and squarely at the Bank of Japan, for failing to react swiftly enough to deal with the deflationary problems that presented themselves.

Hindsight is usually unforgiving. At the time Japan's monetary policy makers had to feel their way and respond to a crisis that no country had experienced in recent history. The measured approach, making incremental changes and pausing while attempting to gauge their effect, was the natural response. Gordon Brown and Bernanke have simply fast-forwarded the Bank of Japan's measures (massive capital injections into banks, slashing interest rates) in an effort to speed up the recovery process.

What happened to Japan demonstrates the dangers of not reacting quickly enough to prevent recession leading to deflation. Like a prize boxer suffering a humiliating knockdown, if you don't get back on your feet immediately, the likelihood is that you won't recover in time to beat the count. The result has been a decade or more in the doldrums, slipping down the rankings and fighting on the undercard. With this in mind you can sense the urgency in Brown and Bernanke's actions.

### A crisis for the new millennium?

The current crisis is a shade more complex, because the threat of deflation carries far more serious implications for the West's economic model.

Even in a decade-long downturn, because of Japan's strong export sector and expanding economies overseas, the impact of a deflationary environment has not been nearly as dramatic as it could have been. In Western economies, where growth thrived off a once rampant but now defunct credit cycle, corporate and personal bankruptcy could affect vast numbers of the population.

Such an outcome would be negative for Japan as the country still depends heavily on exports for growth. Despite managing to side-step most of the carnage that has taken place elsewhere over the last few months, the knock-on effects of the global recession are starting to have an effect on the economy which is unlikely to be offset by an uplift in domestic demand.

# The view from Japan



## Corporate confidence is returning

Despite a weakening economy, it has been encouraging to see Japanese companies willing to indulge in corporate activity overseas. Such activity has not been high on the corporate agenda until now and should be construed as a sign of confidence amongst management.

Japan's largest drug manufacturer, Takeda Pharmaceutical made an \$8.8bn purchase of US drug company Millennium earlier this year, funded through cash that had been sitting on the balance sheet. In July, insurance giant Tokio Marine Holdings purchased Philadelphia Consolidated Holding Corp. for \$4.7bn. More recently, TDK agreed to purchase German firm Epcos for \$2bn and Mitsubishi UFJ Financial bought a 21% stake in Morgan Stanley.

Foreign investors in Japanese equities have cut and run over the last few months and the export market remains an area of concern. But overall the country is not too badly positioned. If the US can drag itself up and off the canvas, and persuade its nation of consumers to keep consuming, then Japan's exports would spring back into life and the economy would be handily placed for a recovery. The stockmarket would respond very favourably to such an outcome.

Of course, it remains to be seen whether the West's response will be any more successful in combating deflation than the Japanese response has been. In the meantime, the economy of Japan is what it is: stable, well-capitalised and rather dull.

If Bernanke and Brown have learned the lessons from Japan's deflation story, which they appear to, they know not to expect a nation of savers to be able to kickstart their own economy, or anyone else's. Spenders in the West will be expected to lead us out of this crisis.

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