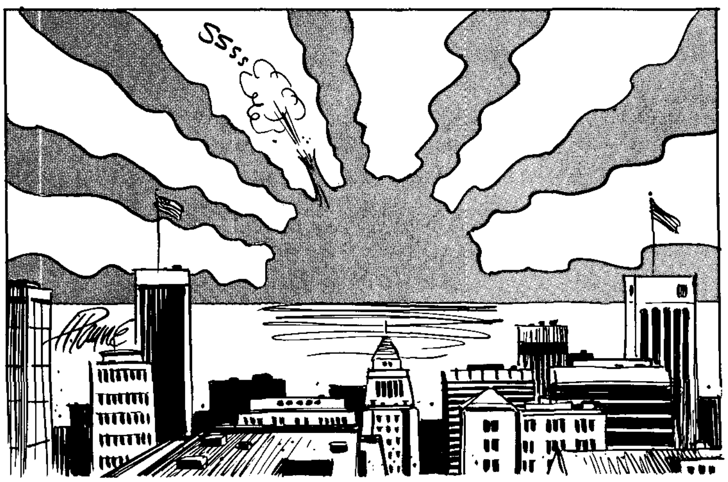
Pop!

BY BRINK LINDSEY

The Bubble Economy, by Christopher Wood, New York: Atlantic Monthly Press, 210 pages, $21.00

Say it ain't so. After all those record-breaking, gold medal–winning performances in the late 1980s, it turns out the Japanese economy tested positive for steroids. Take away the medal for perpetual dirt-cheap capital, take away the medal for a gravity-free stock market, take away the medal for *zaiteku* financial wizardry, and take away the medal for buying up America. Our favorite bogeyman shrivels before our eyes as the drugs wear off.



THE RECESSIONING SUN

I'm referring, of course, to the bursting of Japan's "bubble economy." The rollicking growth that Japan enjoyed during the late '80s—over 5 percent a year—was fueled in large part by an upward spiral of land and stock values that some thought would never end. It ended. The Nikkei fell more than 60 percent from its 1989 high, and real-estate values in the Tokyo and Osaka markets dropped 30 percent or more. As boom turned to bust, it was hoped that the bubble's extravagances would not affect the underlying "real economy"—most prominently, the formidable manufacturing sector. Hopes were dashed.

Hence all the dolorous economic news coming out of Japan over the past year. For the first time since the 1973 oil embargo, Japanese GNP declined for two straight quarters; total growth for 1992 was an anemic 0.5 percent. The money supply has been shrinking. Corporate profits are down for the third straight year. Capital spending dropped an estimated 4 percent last fiscal year. Monthly statistics for business failures have been rising for more than two years. Unemployment, still low by Western standards at 2.4 percent, has been edging upward, and overtime payments, a big part of total employee compensation, are down sharply. Consumer confidence is at its lowest mark in a decade.

Even Japan's best-known and strongest corporate giants are being squeezed. Fujitsu, NEC, and Sony have all reported losses. Nissan, also in the red, is shutting down a major plant in Zama—the first such plant closing in Japanese auto-industry history. Nippon Telegraph & Telephone has announced plans to shrink its payroll by more than 10 percent—that's 30,000-plus people—over the next three years.

With rough times at home, the supposed takeover of the U.S. economy has been put on hold. Direct investment (i.e., establishing new companies in the United States or buying up existing ones) plummeted from $19.9 billion in 1990 to $800 million in 1992; purchases of U.S. real estate dropped from a high of $16 billion in 1988 to $5 billion in 1991. The Japanese were net purchasers of $2 billion worth of U.S. Treasury securities in 1989; in 1990 and 1991, they were net sellers of $15 billion and $8 billion worth, respectively.

In key industries where Japanese domination was thought inevitable, things are now looking rather different. The Japanese share of the U.S. auto market has slipped from 30 percent to 27 percent. For the first time since 1986, American semiconductor manufacturers in 1992 edged out their Japanese competitors for the largest chunk of aggregate world market share. Japanese computer makers remain far behind the U.S. industry; even in the laptop segment, where they have been competitive, Japanese companies' U.S. market share has dropped from almost 40 percent in 1988 to under 25 percent in 1992.

No one is suggesting that Japan is about to fall apart. Its fundamentals are still very strong—an excellent, innovative manufacturing sector; a well-trained, hard-working labor force; and continuing high levels of saving and investment. Still, the Japanese are looking distinctly mortal right now; where once only their strengths were noticed, now their weaknesses are getting some attention. Which gives us in this country a good opportunity to reassess Japan, its place in the world, and its relationship to the United States, with—finally—a dose of realism.

A good place to begin is by reading Christopher Wood's *The Bubble Economy*, a vigorous and intelligent account of the spectacular excesses and

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rampant corruption of the late-'80s boom years, and the painful retrenchments of the current bust. Wood, an editor at *The Economist*, describes a Japan Inc. that has virtually nothing in common with the country depicted in such Japanophobic screeds as *Rising Sun* and *Zaibatsu America*. (See "Samurai and Sexual Deviants," December.) In fact, it's hard to believe that Wood's book and those books were copyrighted in the same year.

According to Wood, Japan in the late '80s was far from the conspiracy-theory image of a disciplined, masterfully orchestrated industrial/financial army, moving inexorably toward world economic domination. It was, rather, an economy gone off the deep end. In Wood's words: "It was the twentieth century's best example of the dictum of Charles Mackay, the celebrated nineteenth-century historian of speculative manias, who observed that men think in herds, go mad in herds, but recover their senses one by one."

The craziness started with the Plaza Accord of 1985, which drove down the dollar versus the yen in a vain effort to "cure" the U.S. trade deficit. The yen doubled in value by early 1988, and consequently Japanese wealth doubled in value in international markets. The rise of the strong yen, known in Japan as *endaka*, pinched the profits of Japanese exporters and led to an economic slump in 1986. The Bank of Japan reacted by cutting the discount rate from 5 percent to 2.5 percent and allowing money-supply growth to exceed 10 percent a year. Japan was now both rich and flush with cash. What resulted was a speculative boom in stock and real-estate values—in Wood's estimation, "the biggest financial mania of this century."

The stock market tripled in value between 1986 and 1989. At its height, it accounted for 42 percent of the total capitalization of world stock markets (compared to 15 percent in 1980). Stock prices became unhinged from reality; average price-earnings ratios exceeded 60 (in the United States P:E ratios of 20 are considered high). Nippon Telegraph & Telephone, privatized in 1987, was trading at an astronomical P:E ratio of 300.

Real estate was more absurd yet. Land values in Japan's six largest cities doubled in less than two years. Prices were rising at 50 percent a year in Tokyo, even faster in certain areas. By 1990 the total stock of property in Japan—a country the size of California—was estimated to be worth four times the total stock of property in the United States. The Imperial Palace grounds in Tokyo had a higher value than all of Canada.

Expanding with the stock and real-estate bubble was the Japanese financial sector. Banks poured money into the stock market and real estate, thereby driving up values and, in effect, creating new capital reserves and collateral to lend against. The main "city banks" increased their assets by 80 percent between 1985 and 1989. The 10 largest banks in the world were now all Japanese. Meanwhile, life-insurance companies, the biggest investors in Japan, with 13 percent of the Tokyo stock market, rode that market's rise to new heights of size and power. And the "Big Four" securities companies—Nomura, Daiwa, Nikko, and Yamaichi—made a killing on fixed brokering commissions. Nomura, the biggest (indeed, the biggest stockbroking firm in the world), saw a fourfold rise in profits between 1983 and 1987, earning nearly $4 billion in 1987.

Swimming in money, the Japanese flooded the world with it; capital exports, after all, are the flip side of trade surpluses, and we all know about those. In 1981 Japan had less than $11 billion in overseas assets; by 1988 the figure exceeded $200 billion. In the United States, Japanese life-insurance companies and other investors bought an estimated 10 percent of U.S. Treasury bonds. Industrial corporations established new factories and bought up existing companies, including blockbuster deals like Matsushita's purchase of MCA and Sony's acquisitions of CBS Records and Columbia Pictures. Japanese real-estate firms poured billions into the U.S. market, buying up huge chunks of Hawaii, much of the Los Angeles skyline, and such high-profile "trophy" properties as Rockefeller Center, Tiffany's, and Pebble Beach.

The inflow of Japanese money gave rise to predictable paranoia mongering about American economic decline, typified by books like Martin and Susan Tolchin's *Buying Up America* and Robert Kearns's aforementioned *Zaibatsu America* (with its charmingly subtle subtitle: "How Japanese Firms Are Colonizing Vital U.S. Industries"). As it turns out, the people who should have been paranoid were the Japanese, many of whom were flushing money down the toilet so fast they were clogging the sewers.

In Wood's telling of the story, Japanese financial institutions were simply out of their league when they ventured overseas. "Japan may have a first-rate economy that is the envy of the world, but it has a second-rate financial system," he writes. "Leading Japanese financial institutions border on the feudal compared with their Western counterparts." According to Wood, in throwing their money at the U.S. market the Japanese "were entering an investment world about which they had scant knowledge and in which they had almost zero experience." The results bear Wood out.

Japanese life-insurance companies, for example, began their heavy investments in U.S. Treasury bonds just as the dollar was free-falling against the yen. From 1985 to 1988, the life-insurance industry's combined losses on those investments totaled some $30 billion. In real estate, Japanese developers bought at the height of markets that have since collapsed, most spectacularly in Hawaii and California. Among the more impressive wastes of money was the construction of the Grand Hyatt Wailea on Maui, with a price tag of $600 million. It's been estimated that the hotel will have to charge $700 per room per night at 75-percent occupancy rates just to break even. Nothing, though, can top the fiasco of Minoru Isutani's purchase of Pebble Beach. He bought it in September 1990 for $841 million and sold it in February 1992 for $500 million—a loss of $341 million in just 17 months.

Cushioning even the clumsiest business moves, though, was the unceasing rise of stock and land prices back home. Until, of course, it ceased. As inflation approached 4 percent—low enough by our standards, but abnormally high in Japan—the Bank of Japan finally decided enough was enough, pulled out its needle, and pricked. Late in 1989, the central bank started raising the discount rate, which eventually reached 6 percent. Money-supply growth descended rapidly. The bubble burst.

The predictable chain reaction ensued. Bankruptcies have shot up: $63 billion in 1991, an estimated $100 billion in 1992. Banks have been staggered by an ever-increasing portfolio of nonperforming loans. On top of that, banks must scramble to meet the so-called Basle Accord international capital-adequacy standards. The 1987 Basle Accord required all international banks to meet an 8-percent capital-to-assets ratio by March 1993; Japanese banks arranged for 45 percent of their (at the time massive) unrealized stock gains to be recognized as capital. Many of those unrealized gains they were counting on have subsequently disappeared, forcing banks either to add capital (hard to do in a bear market) or shrink assets. Can you say credit crunch?

For Japanese companies generally, the era of free money is over. During the bubble, companies were able to go to London's Euromarket and issue warrant bonds (giving investors the chance to buy rapidly appreciating stock at a set price) at rates as low as 1 percent. Those bonds are beginning to come due, and companies must now refinance at dramatically higher rates. For example, Toyota recently sold a $1.5-billion bond issue with a 5.2-percent interest rate. The Japanese advantage over Americans in the cost of capital, so frequently cited in the competitiveness debates of the '80s, has been eliminated.

Meanwhile, the end of the bubble is having a direct effect on many companies' bottom lines. Japanese firms actively played the stock market during the boom; the game was called *zaiteku*, or financial engineering. In 1989, *zaiteku* profits made up an astounding 15 percent of reported earnings of companies listed on the Tokyo Stock Exchange. For many companies, these bubble gains made the difference between good times and bad. In the 1988 fiscal year, for example, securities profits accounted for over 58 percent of pretax profits at Matsushita Electric, 65 percent at Nissan, 73 percent at Sharp, 134 percent at Sanyo, and 1,962 percent at Isuzu.

Ending a speculative boom is like kicking over a rotten log—all kinds of creepy crawlers are brought out into the unwelcome light of day. So it was in Japan, with falling stock and real-estate values exposing a nest of scandals. Wood describes these various affairs in engaging detail: securities firms reimbursing favored clients' losses, banks issuing phony certificates of deposit as collateral to lend against, shady dealings with *yakuza* gangsters, and so forth.

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Especially amusing is Wood's account of the mini-bubble in golf-club memberships. Memberships are traded like securities in Japan and run into the millions of dollars; there is even a Nikkei Golf Club Membership Index. At the height of the bubble Japan's 1,700 golf clubs boasted a total membership market value of $200 billion. New courses were developed by preselling memberships; the temptation to oversell was in many cases irresistible. The ill-fated Ibaraki Country Club sold 49,000 memberships instead of the 2,800 figure promised to investors. And the Gatsby Golf Club promised a membership of 1,800—to 30,000 buyers.

The mood in Japan today is one of self-flagellation. A book called *The Philosophy of Honest Poverty* is currently a best seller. And it is possible that the worst is yet to come. The Bank of Japan has once again slashed the discount rate; the Diet last fall passed an $86-billion "stimulus" spending package and is considering another $120 billion or so of Keynesian sugar high. More ominously, the Ministry of Finance has been actively propping up the stock market, pouring public-pension funds into the market and discouraging big private investors from selling. These short-term fixes may only be postponing necessary corrections and restructuring, thereby prolonging and deepening the pain. As Wood argues, taking the pessimistic viewpoint, "Japan's managed economy may delay the impact of market forces, but it can never repeal them."

Whether or not the economy has yet hit bottom, it will eventually bounce back. Binges may end in hangovers, but hangovers end too. Beneath the cyclical ups and downs, there remain the well-known fundamental strengths of the Japanese economy—and also some less well-known fundamental weaknesses. Over the longer term, the strengths will provide the motive power for continued economic growth, but the weaknesses will contort that growth and undermine its benefits for the Japanese people.

If there is one basic flaw in the Japanese economic miracle, it is the combination of government policies whose concerted effect is to stifle personal consumption. In the real-estate market, tax policies (very low landholding taxes, combined with high taxes upon sale), zoning restrictions (about one-seventh of the Tokyo metropolitan land base is zoned for agriculture), and rent controls make housing artificially scarce and expensive, even without a speculative boom. Agricultural protectionism inflates the cost of food. Restrictions on large retailers (now being relaxed) have helped to perpetuate an archaic and inefficient distribution system, increasing the cost of consumer goods generally. Many of the major consumer-service industries—air travel, telecommunications, financial services—have traditionally been shielded from competition by government protection and are only now seeing that protection decline. And high personal income-tax rates—with no deductions for consumer or mortgage interest expenses—channel income out of consumption.

With consumer demand stunted, investment to meet that demand is likewise stunted. The result is a country with the highest per-capita economic output in the world but decidedly less impressive living standards; a country with a world-beating manufacturing sector but a backward, uncompetitive service sector; a country with chronic trade surpluses (or, put another way, chronic domestic investment deficits).

In short, the result is a country that accumulates more savings than it knows what to do with. Some are poured into ruinous manufacturing overcapacity, some are poured into speculation (à la the bubble), and some are poured into overseas investments, not all of which are well-advised. The foreigner's perception of Japan, usually viewed through a mercantilist squint, is of a "predatory" competitor conquering the world with its goods and money. The reality, though, is a nation that is structurally hindered from investing enough in its own future and its own well-being, and so cannot hold on to its capital.

The United States, on the other hand, has precisely the opposite problem. Its tax policies actively discourage savings while promoting consumption. And its regulatory environment, while dreadful enough, is by world standards relatively open to competition (and thus to investments in promoting consumer welfare). In the mirror image of Japan, then, the American economy has an attractive domestic market but not enough capital to feed it. Fortunately for us, the capital can be imported—hence our trade deficit.

The United States and Japan thus compensate for each other's primary economic weaknesses. To Japan, the United States provides an outlet for abundant capital. To the United States, Japan provides a source of scarce capital. This is the reality of the U.S.-Japan economic relationship: not one swallowing the other but two economies leaning on each other. And there are only two ways out of this mutual imbalance: righting ourselves, or falling on our faces.

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Robbing the Poor

BY CAROLYN LOCHHEAD

The Dream and the Nightmare: The Sixties' Legacy to the Underclass
By Myron Magnet, New York: William Morrow & Co., $23.00

Jersey City, a sprawling and largely poor place across the Hudson River from Manhattan, was my home for eight years. Slum living provides daily exercises in incivility, but I will never forget one particular night when the annual church festival on my street turned into a quasi-riot. Teenagers rampaged through an acquiescent crowd, demolishing cars with baseball bats, hurling rocks and bottles at people and homes, lighting fires in trash cans, knifing bystanders, and taunting the police, who stood by either afraid or apathetic, yielding both moral authority and physical control. You could see in the eyes of these children a gleeful, terrifying savagery, and I could not help thinking of the British schoolboys in William Golding's famous novel, *Lord of the Flies*, who, stranded on a desert island, descended so swiftly into an unthinkable barbarism.

It doesn't take much more than living in a major city, or even reading a city's newspaper or watching its nightly television news, to know that something has gone terribly wrong among a group we now call the underclass, and that in tandem with the rise of this underclass, urban life has become uglier and more dangerous than was conceivable 30 years ago. From an otherwise routine litany of violence, only a few especially egregious horrors make headlines: the Central Park jogger raped and left to die by "wilding" teenagers; the Utah tourists whose son