Strategy for Restoring Japan’s Economic Prosperity

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*The views expressed in this presentation material are the author’s own and do not represent those of the Ministry of Finance.

1. Japan’s Long-run Economic Problems
Japan’s long-run economic policy goals

• Restoring “normal” economic growth

• Adjustments to the aging process of Japanese society.

Restoring economic growth

• Problem Japan has been suffering since early 90s ---“lost two decades.”

• Structural reform to enhance productivity growth
  – More efficient industrial structure and resource allocation.
  – Better corporate governance
  – Enhancing R&D activities

• Improving Human capital
  – Reform of educational system
    • International competitiveness of higher education.
    • Language education.
  – Global managers vs. Galápagos managers
Aging economy

• The problem Japan started to face in 21\textsuperscript{st} century.

• Sustainability problems
  – Fiscal sustainability (high debt/GDP)
  – Social security and pension reform

• Microeconomic reforms
  – Medical system reform
  – Decrease of population and rapid aging in local areas
    • Geographical allocation of hospitals, schools, transportations, housing, and etc.
2. Political economy of the delayed economic reform

Recent Japanese administrations

- Obuchi (July 1998 – April 2000)
- Mori (April 2000 – April 2001)
- Abe (Sep 2006 – Aug 2007)
- Fukuda (Sep 2007 – Aug 2008)
- Aso (Sep 2008 – Sep 2009)
- Hatoyama (Sep 2009 – Jun 2010)
- Kan (June 2010 – present)

Liberal Democratic Party (LDP)
Democratic Party Japan (DPJ)
Old LDP administrations (~2001)

- Rapid fiscal expansion (perhaps unavoidable) in response to the severe recession in late 1990s caused by Asian currency crisis and especially by domestic banking crisis.

- Old LDP type government expenditures
  - E.g. Large construction projects (dams and highways) in local areas.

Short-run population and voting power

- Local areas
- Large cities
- Small businesses and agriculture
- Large international businesses
In the long-run, population and economic power will shift

- From local areas to large cities.
- From domestic small businesses to large international businesses.
- So in the long-run, productivity growth will be restored.
- But, can we wait for such a natural transition process?
  - Deteriorating fiscal situation
  - Serious damages to human capital
    - Unemployed young workers

Economic Performance and long-run population

- Local areas
- Small businesses and agriculture
- Large cities
- Large international businesses
Delayed structural reforms

• Inequality in electoral system
  – Number of per capita representatives is larger in local areas.
  – Max/Min ratios are 2.3 in lower house; 4.9 in upper house
  – Retired old voters have more time and incentives to go to election than young working voters.

• Old business model of government spending has lost its effectiveness recently.
  – The government spending multiplier has dropped significantly since mid to late 1990s.

Koizumi Revolution

- Market-oriented
- Small government
- Large cities

- Government control and interventions
- Redistributions by central government
- Local areas
Economic side of Koizumi’s structural reform

• Japanese neoliberalism revolution:
• Structural reform toward more market-based economy and small government.
  – Privatization of postal services
  – The reform of medical service, pension system, and public health insurance system
  – Fiscal reconstruction
  – Consolidations and downsizing of public financial institutions (including JBIC)

3. Medium Run I: Fiscal Problem
Fiscal Problem

• Japanese debt/GDP ratio is the worst among developed economies.
• Still, the possibility of fiscal crisis in next several years seems to be remote, since 95% of JGB are held by domestic investors.
• But, Japan’s economy is still weak.
  – Foreign demand for Japanese exports have not fully recovered after the Lehman shock.

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Japan</td>
<td>199.2 (%)</td>
<td>56.1 (%)</td>
</tr>
<tr>
<td>US</td>
<td>89.6</td>
<td>∆ 24.0</td>
</tr>
<tr>
<td>UK</td>
<td>82.3</td>
<td>∆ 13.1</td>
</tr>
<tr>
<td>Germany</td>
<td>80.9</td>
<td>37.3</td>
</tr>
<tr>
<td>France</td>
<td>93.8</td>
<td>∆ 19.1</td>
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<tr>
<td>Italy</td>
<td>132.0</td>
<td>∆ 19.2</td>
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<tr>
<td>Greece</td>
<td>129.1</td>
<td>∆ 86.0</td>
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<tr>
<td>Ireland</td>
<td>82.9</td>
<td>∆274.1</td>
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<tr>
<td>Spain</td>
<td>72.8</td>
<td>∆ 93.6</td>
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<tr>
<td>Portugal</td>
<td>95.0</td>
<td>∆112.0</td>
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Fiscal Problem (cont’d)

• Have to balance between short-run economic stimulus and long-run sustainability.
  – Obvious, but very difficult task.
• Have to avoid creating unnecessary distortions by fiscal stimulus.
  – Recent research on US Great Depression (eg. Cole and Ohanian 1999, 2002) suggest that “New Deal policies toward monopoly and the distribution of income created distortions and prolonged the Great Depression.”
• Intergenerational inequality is also important.

3. Medium Run II:
   International Trade
Trade collapse and the recession after the global financial crisis

- Japan was relatively unharmed from the initial shock of global financial crisis.

- A significant decline of export demand hit the country so hard from the last quarter of 2008.

Background:
Japan’s dependence to international trade had been increasing through 2000s
Great Trade Collapse
Rates of contraction from peak to trough, 2008-2009

<table>
<thead>
<tr>
<th></th>
<th>Trough month</th>
<th>Goods exports (cumulative change)</th>
<th>Industrial production (cumulative change)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>May 09</td>
<td>△ 25%</td>
<td>△ 13%</td>
</tr>
<tr>
<td>Industrialized</td>
<td>May 09</td>
<td>△ 24%</td>
<td>△ 17%</td>
</tr>
<tr>
<td>US</td>
<td>May 09</td>
<td>△ 23%</td>
<td>△ 14%</td>
</tr>
<tr>
<td>Japan</td>
<td>June 09</td>
<td>△ 22%</td>
<td>△ 36%</td>
</tr>
<tr>
<td>Emerging</td>
<td>Jan 09</td>
<td>△ 28%</td>
<td>△ 9%</td>
</tr>
</tbody>
</table>


Japan’s trade collapse

- The size of the trade collapse was almost same as in other developed economies.
- But, Japanese output dropped more dramatically. Why?
- Compositional effect:
  - The demand shock was very large, but also focused on a narrow range of value-added activities. The production of “postponeable” goods, such as consumer durables and investment goods.
  - This demand dropped immediately, reducing demand for all related intermediate inputs (parts and components, chemicals, steel, etc).
  - They were main Japanese exports.
- Japanese yen appreciated
  - Against almost any other currencies.
  - In contrast, Korean won sharply depreciated.
Sharp decline in Japanese durable good exports

Real Effective Exchange Rate
Japan’s export decline in 2008-2009

- Obviously, there was a FX rate shock too.
- But, it was mostly a demand (quantity) shock.
- When the foreign demand rebounded, Japanese export sharply recovered too.
  - Perhaps, large negative demand shock was the result of consumers’ increased uncertainty.
  - However, it is difficult to imagine that US and European demand for Japanese exports will bounce back to the pre-crisis level in near future.

Nominal vs. Real Export
Plaza accord vs. Lehman shock
Dynamics of major OECD countries’ GDP

Japan has been benefitted from its closeness to Asian economies

- E.g. Stock prices of TOYOTA and Suzuki
- For the medium-run, the export demand of Asian countries will be an important factor for Japan’s recovery.
  - Has to compete with other Asian countries in the low-to-medium end product markets.
Japan’s foreign trade in the medium-run

- Japanese corporations have to revise their strategies.
  - Sticking to the high-end manufacturing good exports to developed economies will be difficult.
  - Trade with Asian countries will be more important.
  - The importance of non-manufacturing exports will and should increase.

- Government should support such a structural transformation in the private sector.