

# Strategy for Restoring Japan's Economic Prosperity

Tokuo Iwaisako, Ph.D.  
Principal Economist  
Research Department  
Policy Research Institute, Ministry Finance  
[tokuo.iwaisako@mof.go.jp](mailto:tokuo.iwaisako@mof.go.jp)

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## 1. Japan's Long-run Economic Problems

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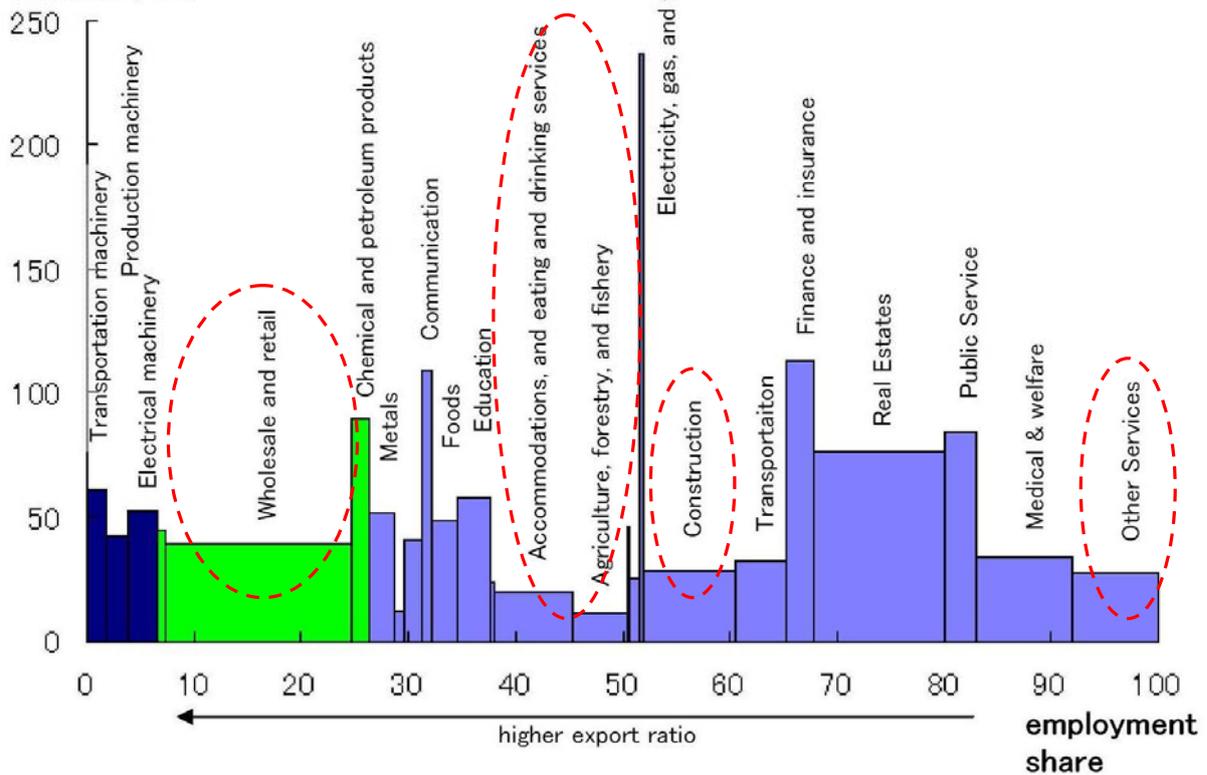
# Japan's long-run economic policy goals

- 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

labor productivity  
(100 million yen)



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## Aging economy

- The problem Japan started to face in 21<sup>st</sup> 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.

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## 2. Political economy of the delayed economic reform

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### Recent Japanese administrations

- Obuchi (July 1998 – April 2000)
  - Mori (April 2000 – April 2001)
  - Koizumi (April 2001 – Sep 2006)
  - Abe (Sep 2006 – Aug 2007)
  - Fukuda (Sep 2007 – Aug 2008)
  - Aso (Sep 2008 – Sep 2009)
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- Hatoyama (Sep 2009 – Jun 2010)
  - Kan (June 2010 – present)
- Liberal Democratic Party (LDP)**
- Democratic Party Japan (DPJ)**

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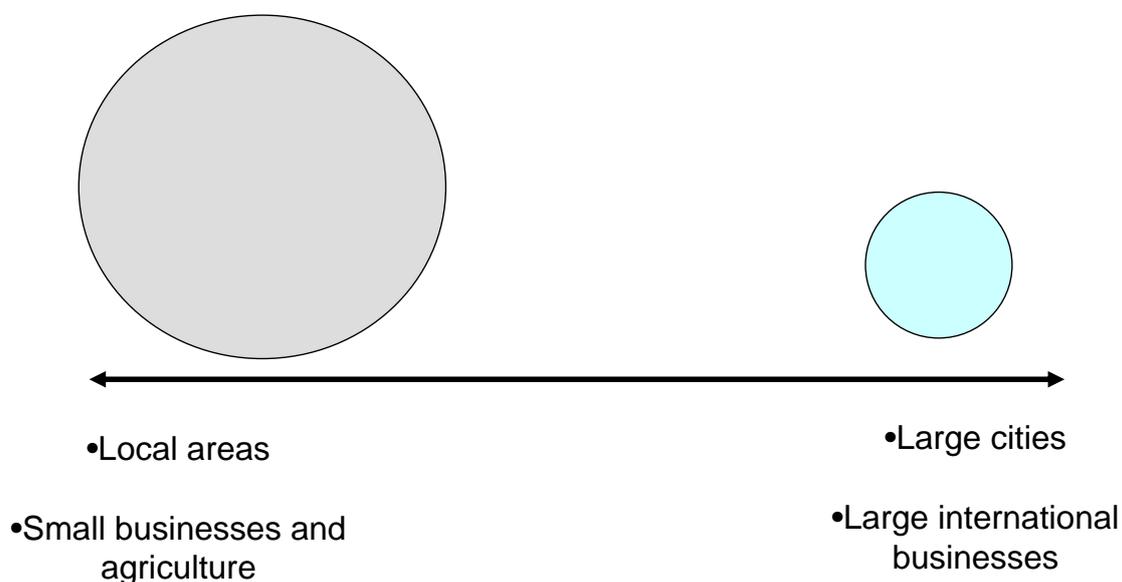
## Old LDP administrations (~2001)

- 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.

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## Short-run population and voting power



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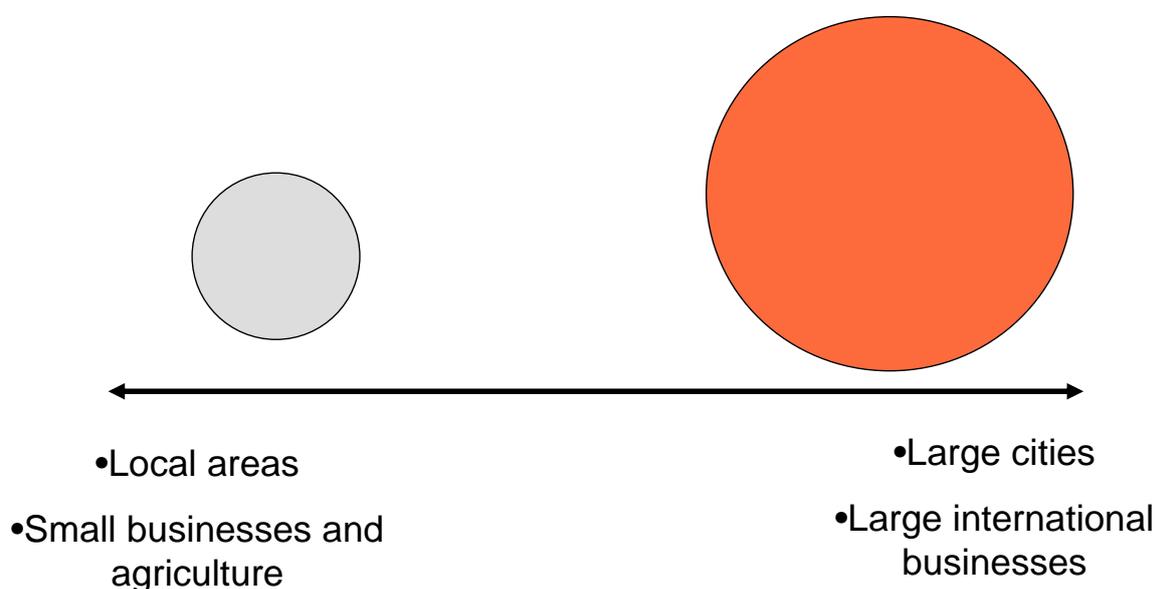
# In the long-run, population and economic power will shift

- 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

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## Economic Performance and long-run population



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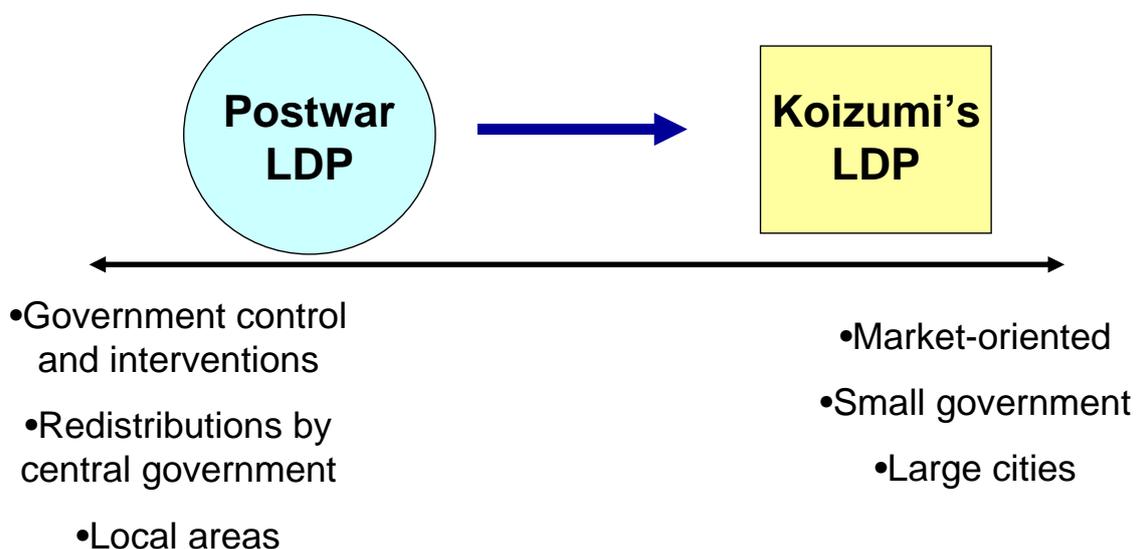
# Delayed structural reforms

- 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.

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## Koizumi Revolution



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# Economic side of Koizumi's structural reform

- Japanese neoliberalism revolution:
  - Followed *Thatcherism* in UK and *Reaganomics* in US in 1980s.
- 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.

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	Gross National debt/GDP (2010, OECD)	Net External Position /GDP (2008/9, BOJ)
Japan	<b>199.2 (%)</b>	56.1 (%)
US	89.6	△ 24.0
UK	82.3	△ 13.1
Germany	80.9	37.3
France	93.8	△ 19.1
Italy	<b>132.0</b>	△ 19.2
Greece	<b>129.1</b>	<b>△ 86.0</b>
Ireland	82.9	<b>△274.1</b>
Spain	72.8	<b>△ 93.6</b>
Portugal	95.0	<b>△112.0</b>

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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

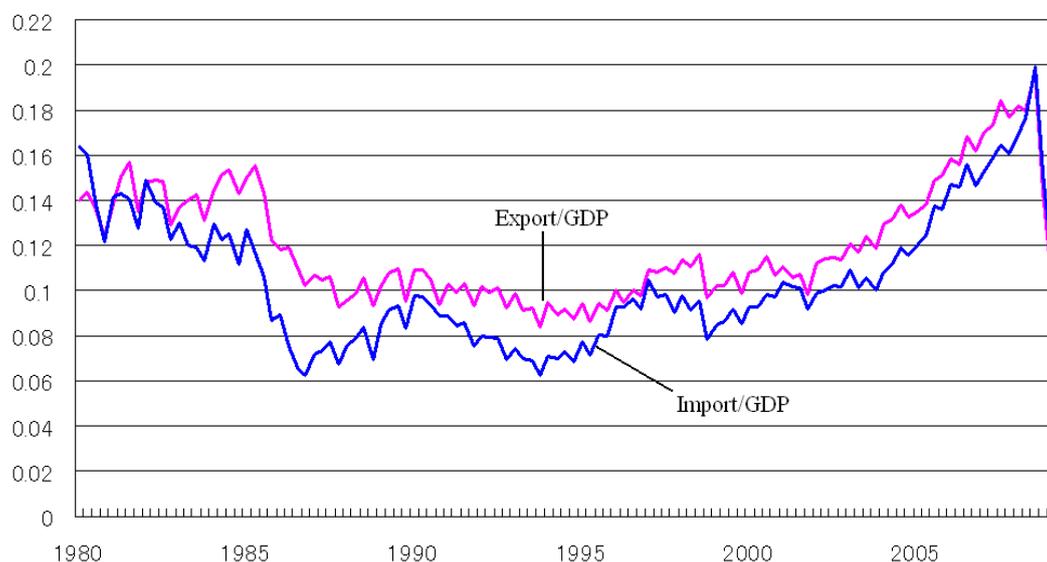
# Trade collapse and the recession after the global financial crisis

- 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.

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**Background:**  
Japan's dependence to international trade had been increasing through 2000s



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# Great Trade Collapse

Rates of contraction from peak to trough, 2008-2009

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

from Baldwin and Taglioni "The great trade collapse and trade imbalances," in Richard Baldwin ed., *The Great Trade Collapse: Causes, Consequences and Prospects*, A VoxEU.org Publication, 2010.

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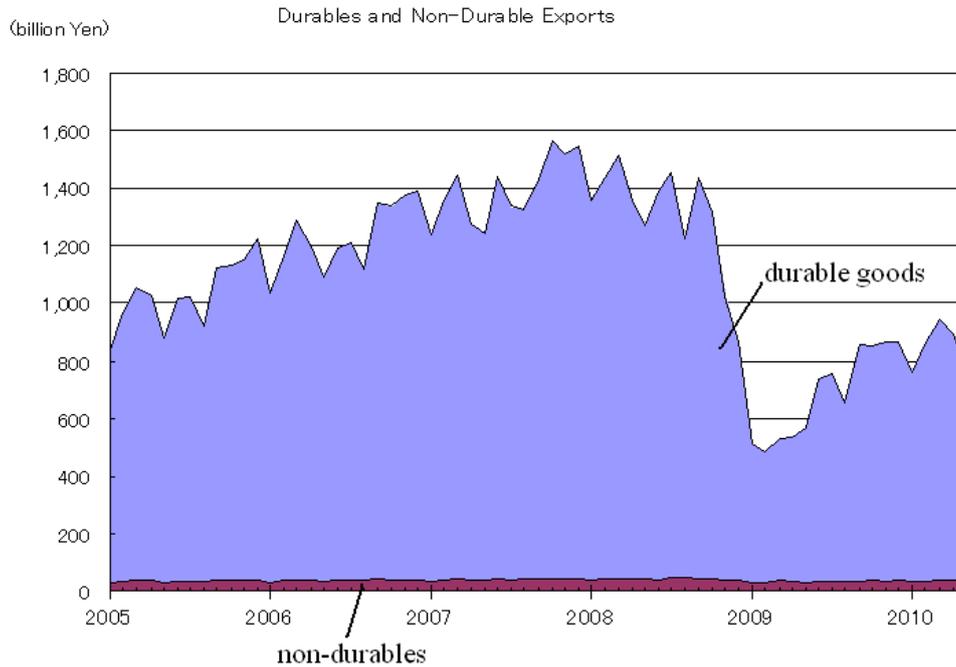
## Japan's trade collapse

- **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.

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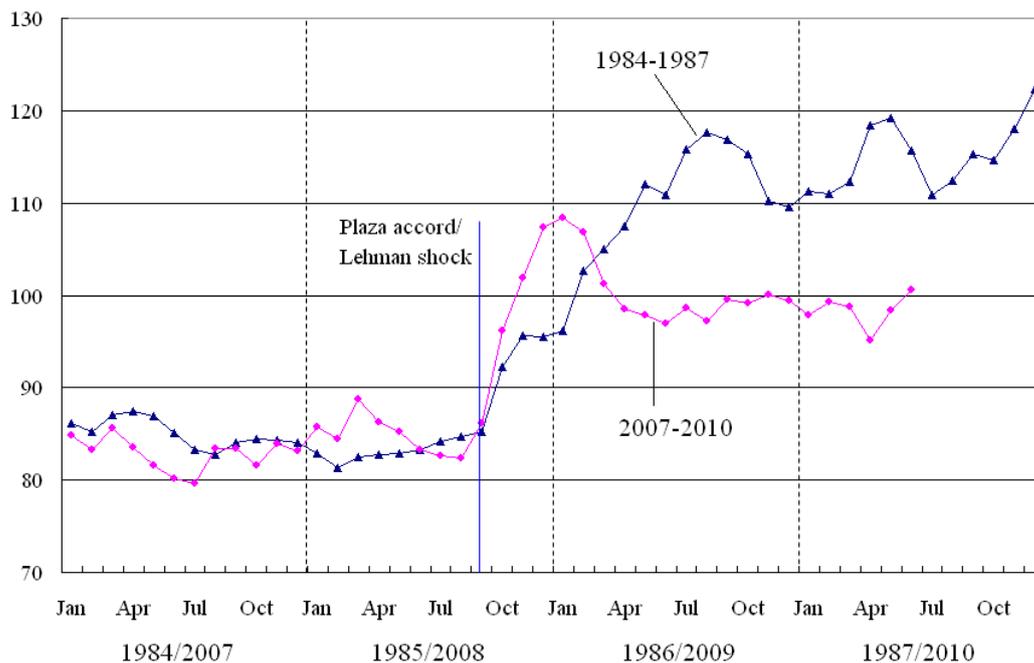
# Sharp decline in Japanese durable good exports



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# Real Effective Exchange Rate



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# Japan's export decline in 2008-2009

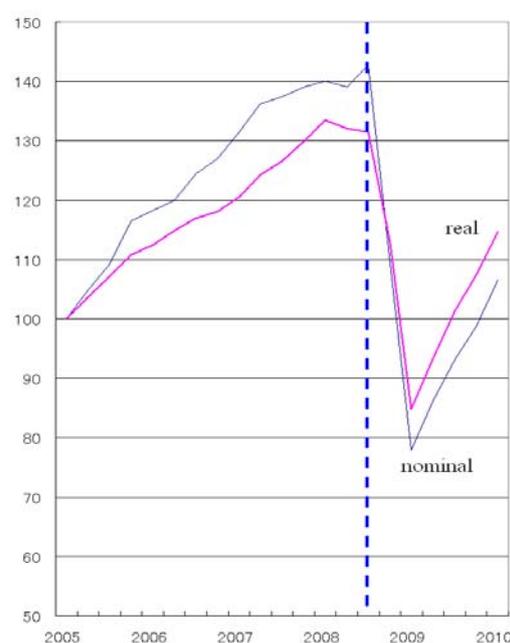
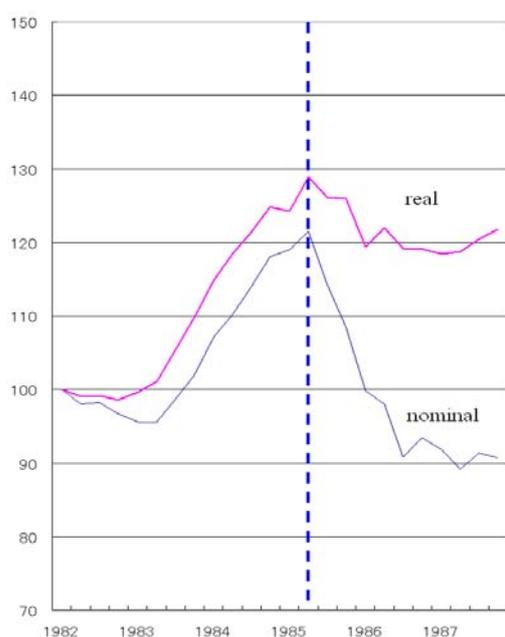
- Obviously, there was a FX rate shock too.
- But, it was mostly a demand (quantity) shock.
- When the foreign demand rebounded, Japanese export sharply recovered too.
  - Perhaps, large negative demand shock was the result of consumers' increased uncertainty.
  - However, it is difficult to imagine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

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## Nominal vs. Real Export

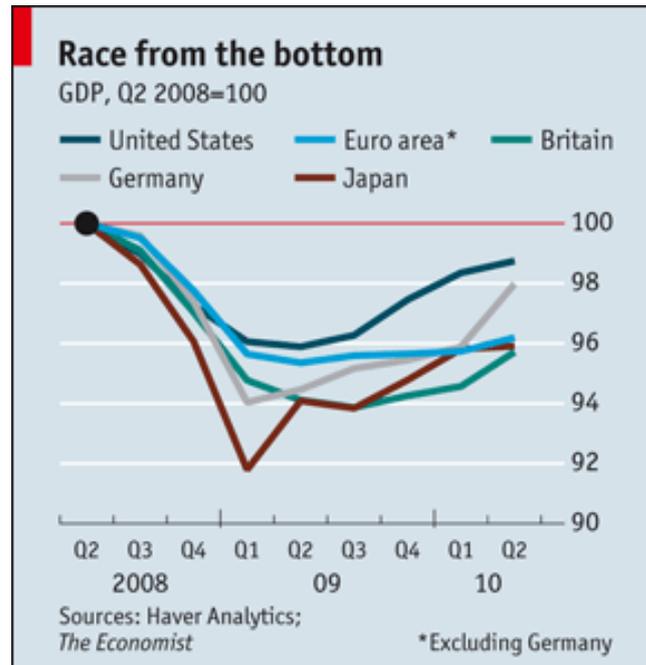
Plaza accord vs. Lehman shock



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# Dynamics of major OECD countries' GDP



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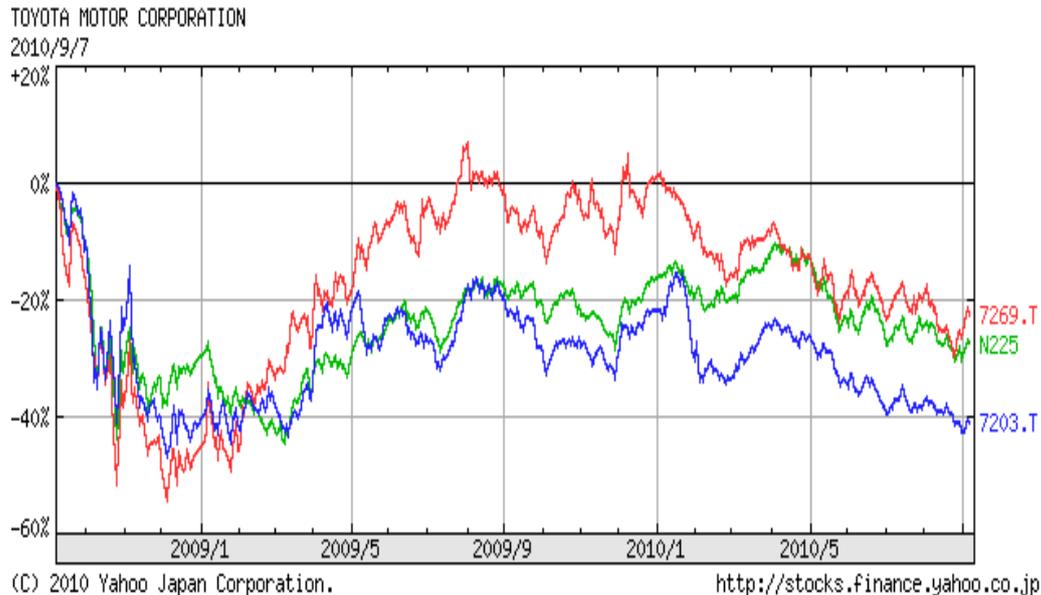
Japan has been benefitted from its closeness to Asian economies

- 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.

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## Stock prices of Toyota (blue), Suzuki (red), and Nikkei 225 (green)



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## 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.

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