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Economic challenges ahead

Back in June 1997, Paul Samuelson, a Nobel Prize laureate in economics, wrote an article in which he noted:

“The 1990s have brought gloom to Japan … I have been critical of the passive acceptance by Japan of its continuing slump. A program of deregulation and privatization is a good thing for long-run efficiency and growth. But no nation ever cured a short-run recession or depression with such a program. What will be needed is vigorous use of fiscal expansionism.”

In July 1997, just a month after Samuelson’s article was published, the Asian financial crisis broke out. The ensuing contraction of domestic demand in East Asia and appreciation of the yen weakened Japanese exports. A series of expansionary fiscal measures were introduced in Japan in vain to reflate the domestic economy and turned its fiscal position into the worst among advanced countries.

Rather than following Samuelson, I as OECD chief economist stressed the importance of aggressive monetary policy and exchange rate management at confidential meetings of high-ranking officials from finance ministries and central banks in the Group of 10 rich countries at the OECD.

After leaving the OECD in 1999, I started to argue openly for a global solution to deal with the “Japan problem,” no longer shackled by institutional constraints that had been imposed on me during my tenure as an international civil servant.

For example, in the spring of 2003 I wrote an article in the Financial Times newspaper proposing a 10-point program. It included a call for aggressive monetary policy easing by the Bank of Japan and for the Japanese government to take action in the foreign exchange market as well as creation of a new regional mechanism for currency stabilization in East Asia.

Immediately after the outbreak of the global financial crisis in 2008, I once again argued openly, in a series of articles both in Japanese and foreign publications such as the Financial Times, that the BOJ must act more aggressively.

This policy advice on monetary activism did not find favor with the authorities at the time. Yet it is essentially the monetary policy component of "Abenomics" unveiled by Shinzo Abe, leader of the then-opposition Liberal Democratic Party just before the December 2012 general election.

Japan's continued sluggish growth performance since the burst of the bubble in the early 1990s resulted in its decline in global rankings for standard of living. In fact, Japan's per capita income measured by purchasing power parity declined to about 70 percent of the U.S. level in 2013, while in 1990 it had been about 80 percent of the U.S. level. Japan's per capita income was higher than that of Britain and France in 1990, but by 2013 it stood at about the same level.

What is striking is the economic performance of Germany in recent years. Unlike Japan, it was not hit by a collapse of asset market prices. But between the late 1990s and the early 2000s, Germany was often called "the sick man of Europe." Both in 1990 and in 2000, Germany's per capita income stood at virtually the same level as Japan's. However, by 2013, it was some 20 percent above the level of Japan, Britain and France and rising to 84 percent of the U.S. level.

In my view, Germany's better performance essentially reflects more solid economic growth driven by strong exports that have been supported by the common currency mechanism.

Indeed, one lesson for Japan I would draw from the German experience is the importance of a regional mechanism for exchange rate stability in a well-integrated trade area. And in fact, it was one component of the 10-point package deal I proposed in my Financial Times article in early 2003.

But even now such a mechanism does not exist in Asia. Nor is it considered a goal to be aimed for under the aegis of Abenomics.

The three "arrows" of Abenomics are aggressive monetary easing, fiscal stimulus and structural reforms. I have already touched on the first. On the whole, this arrow appears to be drawing close to its target.

For the second arrow of flexible fiscal policy, I would argue that further government stimulus can't be used as a policy tool to revive overall economic growth in a sustainable manner. In 2014, Japan's general government gross debt amounted to 226 percent of GDP, the highest ever recorded among OECD economies.

In the OECD analysis of fiscal requirements, Japan's general government gross debt is projected to amount to 252 percent of GDP in 2030. This projection is based on the assumption that potential real GDP will grow at an average annual rate of around 1 percent and that the target for inflation at 2 percent will be achieved throughout the projected period. Its simulation shows that Japan's public debt ratio would decline to nearly 100 percent by 2040 if potential real GDP growth is raised to 2 percent at an average annual rate while inflation is kept at the 2 percent target rate.

This highlights the crucial importance of the third arrow of Abenomics: structural reform to enhance economic growth potential.

In my view, measures so far taken or announced are inadequate and the government should be more ambitious.

First, we must cope with the labor supply problem associated with population aging by boosting the participation of women and older people. These two sources of labor are particularly important as Japan has linguistic and other disadvantages in expanding inflows of foreign workers.

Second, we must accelerate Japan's integration in the world economy through trade agreements, notably the Trans-Pacific Partnership (TPP) and a Japan-European Union economic partnership agreement.

Third, we must improve the business climate by upgrading corporate governance, promoting venture capital investment and redesigning policies for small and medium-sized enterprises, known as SMEs.

How can the Japanese government embark on such an undertaking?

In a number of Asian countries that were hit by the financial crisis, labor market and other structural reforms were included as important components of conditions for receiving financial assistance from the IMF. On the other hand, Japan did not resort to external assistance to deal with the shocks associated with the burst of asset market prices.

The situation in Germany was the same in this respect. No forceful outside guidance was exercised for structural reform. However, faced with severe stress in the labor market situation with high unemployment, Germany has undertaken structural reforms that are far more significant than in France, where unemployment has been even higher.

This reflects differences between the two countries' systems for industrial relations. Faced with the economic stress, the German system, intrinsically more flexible than the highly centralized French system, allowed the decentralization of wage determination from the level of industries to the levels of single firms or single workers.

This review raises an important political economy issue regarding structural reform in Japan. Can the Japanese government, businesses and labor market institutions spontaneously engage in fundamental reforms before experiencing such a critical labor market situation as in Germany?

Another important policy issue is the societal consequences of greater labor market flexibility. Labor market dualism is a major cause of the rise in income inequality and relative poverty in Japan. The precarious situation of nonregular workers with low income discourages marriage and hence reduces the fertility rate with negative social and economic consequences.

The government should make efforts to break down dualism by reducing the factors that encourage firms to hire nonregular workers. It should increase social insurance coverage and upgrade training programs for nonregular workers. At the same time, effective protection for regular workers at the sacrifice of nonregular workers should be reduced. And clear rules should be set for the dismissal of workers.

The Japanese government should address the issue of growing anomalies in income distribution and increasing relative poverty as a matter of top policy priority.

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