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Japan's Economic Performance and Challenges Ahead

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1. Economic policy mismanagement by passivism?

Back in June 1997, Paul Samuelson, a Nobel Prize laureate in economics, wrote an article titled "For Japan, a message of optimism".¹

He started the article by noting:

"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. ...

But it is not my present purpose to rehash these macroeconomic wisdoms. My present message is one of optimism, not one of despair. ... Japan workers still have the work ethic. Skills have not been rusting away. Class warfare and trade-union bad feelings have not been spawned by its long stagnating economy.

The odds favor a substantial Japanese recovery – if not in 1997, then in 1998. Once its wheels of commerce again spin at a normal rate, Japan will probably astound the world and itself by a catch-up and acceleration in Japanese production."

In July 1997, just a month after Samuelson sent out this message of optimism on Japan's future, a financial crisis broke out in Thailand. The crisis soon spread to Malaysia, Indonesia, the Philippines, Hong Kong and Korea. They

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saw their currencies depreciated substantially against the US dollar and the yen. The contraction of domestic demand in these Asian countries and the yen appreciation 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 who called for more aggressive fiscal expansion in Japan, I as OECD chief economist stressed the importance of aggressive monetary policy and exchange rate management at confidential meetings of high officials of finance ministries and central banks of Group of Ten rich countries at the OECD.

There, I argued that an effective way to jump start the economy after the burst of a bubble is aggressive easing of domestic monetary conditions to ward off a deflationary spiral; and once the zero bound to nominal interest rates is reached, it is essential for an open economy in a liquidity trap and recession to resort to exchange rate adjustment and realize export-led economic recovery.

Some prominent US and European economists including Profs. Jeffery Sachs, Joseph Stiglitz and Lars Svensson expressed similar opinions at some points in time.

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

In the spring of 2003, I wrote an article in the Financial Times to propose a ten-point program. It included a call for the Bank of Japan’s aggressive monetary policy easing and the Japanese government action in the foreign exchange market as well as a new regional mechanism for currency stabilization in East Asia.²

Immediately after the outbreak of the global financial crisis in 2008, I once again started to argue openly that the Bank of Japan must act more aggressively in a series of articles both in Japan and abroad.³

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

Its victory in the election enabled him to come back as prime minister of Japan for his second term.

Despite Samuelson's note of optimism, Japan's continued sluggish growth performance resulted in its decline in global league tables for citizens' living standard. In fact, Japan's per capita income measured by purchasing power parity declined to about 70 percent of the US level in 2013, while it was about 80 percent of the US level in 1990. Compared with Britain and France, Japan's per capita income was higher in 1990, but in 2013, it stood at about the same level.⁴

What is striking is the economic performance of Germany over recent years. Germany was not hit by the collapse of asset market prices as Japan was. 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 per cent above the levels of Japan, Britain and France, rising to 84 percent of the US 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 ten-point package deal I proposed in my Financial Times article of early 2003.

But, even now, such a mechanism does not exist in Asia. Nor is it considered as a goal to be aimed at in the so-called "Abenomics".

2. Policy activism, where is it required?

Let me now turn to the issue of where I think policy activism is required most urgently in Japan.

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

On the second “arrow” of flexible fiscal policy, I would argue that further fiscal stimulus cannot 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 in the OECD area.

In the OECD analysis on long-term growth prospects and fiscal requirements, Japan’s general government gross debt is projected to amount to 252 percent of GDP in 2030.⁵ This projection is based on the assumption that potential real GDP will grow at an average annual rate of around 1 percent⁶ and that the target for inflation at 2 percent⁷ will be achieved throughout the projected period.

An OECD model simulation exercise shows that Japan’s public debt ratio would decline to nearly 100 percent by 2040, if potential real GDP growth were raised to 2 percent at an average annual rate while inflation were kept at the 2 percent target rate.⁸ This highlights the crucial importance of the third “arrow” of Abenomics: structural reform to enhance economic growth potential.

The Japanese government announced Japan Revitalization Strategy in June 2013 and revised it a year later. It includes important measures to promote economic growth. But, 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 ageing by boosting the participation of women and older people.⁹ The two sources of labor forces 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 the Japan-EU Economic Partnership Agreement.

And, third, we must further improve the business climate by upgrading corporate governance, promoting venture capital investment and redesigning policies for small and medium-sized enterprises (SMEs).

How can the Japanese government embark on such undertaking?

In a number of Asian countries including Korea that were hit by the Asian 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 shocks associated with the burst of asset market prices in the early 1990s

and the loss of Japan's competitiveness resulting from the yen's sharp appreciation.

The situation in Germany was the same in this respect. No forceful outside guidance was exercised for structural reform.

The so-called "Hartz Reforms" to the German labor market, implemented under the Gerhard Schroder government in 2003, is often credited for the successful restructuring of the economy. But, the reforms were extremely controversial at the time. And, in fact, the process of wage decentralization and the improvement in competitiveness had begun in Germany nearly a decade before the Hartz reforms were implemented.

In his June 1997 article, Samuelson wrote, "Japan's continued stagnation has involved massive waste of potential production. But, ... Japan has not yet been hurt in the way that their countenancing of two-digit unemployment rates has hurt Germany and France".

Since Samuelson's article was published, Germany has undergone structural reforms which are far more significant than in France. This reflects differences between the two countries in the system of 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.¹⁰

This review raises an important political economy issue involved in structural reform in Japan. Can the Japanese government, business firms and labor market institutions spontaneously engage themselves 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. In Japan, there is growing concern about the rise in income inequality and relative poverty. Labor market dualism is its major cause. The precarious situation of non-regular workers with low income discourages marriage and hence reduces the fertility rate with negative social and economic consequences. The Japanese government should make efforts to break down dualism by reducing the factors that encourage firms to hire non-regular workers. It should increase social insurance coverage and upgrade training programs for non-regular workers. At the same time, effective protection for regular workers at the sacrifice of non-regular workers should be reduced. And, clear rules should be set for the dismissal of workers.

To be fair, I should hasten to add that, despite increases in inequality, Japan ranks at the top in personal security among OECD countries and performs well in many other dimensions of citizens' well-being.¹¹ And, the results of international tests on children's educational attainments and adult skills invariably show excellent marks for Japan.¹² But there are reasons to argue that the Japanese government should address the issue of growing anomalies in income distribution and increasing relative poverty as a matter of top policy priority.

3. Japan's roles in Asia and the world

The rise of China was a topic Samuelson picked up in his June 1997 article "For Japan, a message of optimism".

"Now that the Soviet Union has collapsed, it is mainland China that is occupying people's mind. We read headlines about more than 10 percent growth rates in mainland China. ... (However), China's level of per capita living is only about one-sixth that of Japan. It will be a long time until China's entire civilian population comes anywhere near its present military might. But then, with some luck, perhaps China will have evolved into a stable multiparty democracy."

According to the latest IMF statistics, China reached 16.3 percent of the world's purchasing-power-adjusted GDP last year, surpassing the US, which made slightly less, 16.1 percent.¹³

The IMF's estimates for 2020 are that China's share of world total GDP will rise to 18.9 percent and the US share will decline to 15.0 percent. For the same year, India's share is estimated to rise to 8.5 percent, compared with Japan's 3.7 percent and Germany's 3.0 percent.

Concomitant to China's growing economic power, its increasing military strength has given rise to concern not just in its neighboring countries and the US with her military presence in Asia. But, concern is expressed also in Europe.

In January last year, at "The War and Peace Seminar" held in Barcelona at the invitation of Javier Solana, former EU High Representative for the Common Foreign and Security Policy and former NATO secretary general, he stated that, as the world's economic center of gravity is moving to Asia, peace and prosperity in East Asia is without any doubt one of the most important issues the international community must face.

Solana then pointed out that “economic prosperity is assured in East Asia, but we can not say the same on the security field”. A number of European participants raised concern about growing political tensions in East Asia that were developing at the time of the Barcelona seminar despite ongoing regional economic integration.

As an invited speaker, I argued that economic integration in East Asia has been driven essentially by market forces that rely on long-term structural complementarities in key industrial sectors resulting in strengthened interdependence, trade flows and transfers in technology. Deepening of the understanding among East Asian political leaders and peoples about mutual benefits from economic interdependence should help reduce the risk of a building-up of tensions resulting in armed conflicts among East Asian countries.

That said, I also noted that, unlike the process of EU integration that was promoted and deepened by conscious efforts of European political leaders with the general support of electorates, institutional frameworks for regional economic, financial and monetary co-operation remain far less developed in East Asia.

This is matched by the lack of mechanisms to deal with any security crisis that might erupt as a result of territorial and other international conflicts. Indeed, a regional collective security system has historically been absent in East Asia and is currently still missing.

In this context, concern was expressed about the internal sources of instability in China. One China expert at the seminar noted that “the Communist Party of China might be facing the most serious legitimacy crisis since 1949”. According to him, “corruption, economic slowdown and a demographic crisis” are the three most serious issues China must face. He pointed out the danger that faced with such internal issues, the Chinese leadership might intend to divert the general public’s attention to external issues and try to foster extreme nationalism to secure national unity. In such a situation, the lack of international security crisis management mechanisms in East Asia may increase the likelihood of an accident leading to major military conflicts.

At the seminar, Australian Ambassador to Spain suggested the need to consider a wider region and explore the conceptualization of the Indo-Pacific basin instead of a narrower East Asian framework. I stressed the importance of including India in the general scheme of Asia’s economic integration and geopolitical stability.

This year marks the 70th anniversary of Japan's surrender to the allied forces to end the Asia-Pacific War. Just a month ago, the strong ties between Japan and the United States were demonstrated by Japan's prime minister Shizo Abe in his rather emotive speech at the US Congress. I personally hope that a statement he intends to make on the 70th anniversary of the war's end will include key messages for strengthening Japan's friendly ties not just with the US but also with China, Korea and other countries in Asia and Oceania as well as the rest of the world both in bilateral and multilateral frameworks.

Japan's enhanced international co-operation in particular with China can bring about benefits not just to the two countries. But, given the size of the two Asian economic powers, it can have significant beneficial impacts on the economic prosperity and peace of the world as a whole.¹⁴

It is in this context that Japan should positively consider her participation in the Asian Infrastructure Investment Bank which is proposed by China.

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1. Paul Samuelson, "For Japan, a message of optimism", The Daily Yomiuri, Tokyo, 2 June 1997.
 2. Kumiharu Shigehara, "A global solution needed to deal with the Japan problem", The Financial Times, London, April 3, 2003. The author's article written to the same effect in Japanese was published by the Nihon-Keizai Shimbun, Tokyo, 28 April 2003.
 3. Kumiharu Shigehara, "Japan's monetary authorities must act more aggressively", The Financial Times, London, November 25, 2008; "Swift BOJ action needed to check yen's sharp rise ... Central bank ought to take aggressive forex, other measures amid growing economic risk, threat of currency's strength crushing exports", The Nikkei Weekly, Tokyo, December 1, 2008; "Managing the international economic crisis", The Japan Times, Tokyo, December 10, 2008; "Japan needs more aggression in warding off deflation", The Financial Times, London, October 26, 2009, "Japan's demand management and yen rate in the global crisis", The Japan Times, Tokyo, November 2, 2009; "Central banks 'experimenting' to counter deflationary pressure", The Japan Times, Tokyo, November 3, 2009.

The same author's articles written to the same effect and published in Japanese newspapers and other economic journals are not listed here.

4. World Bank data on gross national income (GNI) converted to international dollars using purchasing power parity rates, May 2015.
5. OECD Economic Outlook, May 2013, Chapter 4.
6. More precisely, potential real GDP growth is assumed to rise from an average annual rate of 0.8 percent in 2012-2017 to 1.1 percent in 2018-2030.

7. At my first press conference as OECD chief economist at the OECD Headquarters in Paris in June 1992, in response to a question about the definition of “price stability” to be aimed at by central banks (that was raised by a journalist of the International Herald Tribune), I answered that I would call the annual rate of increase in the consumer price index (CPI) of about 2 percent as “price stability”, taking into account various measurement biases such as quality improvements in goods and services not fully reflected in the index measure. This was the first occasion for the OECD chief economist to publicly explain the numerical expression of price stability. See Kumiharu Shigehara “Price Stabilisation in the 1990s”, Macmillan Press, London, 1992.

The Bank of Japan led by Governor Masaaki Shirakawa formally adopted 2 percent CPI inflation as its target in late January 2013, reportedly under strong pressure from the new government soon after Shinzo Abe came back as Japan’s prime minister. See for example the Wall Street Journal of 22 January 2013.

8. OECD Economic Survey of Japan, April 2015, Overview p. 28.

9. Japan’s employment rate for women with a university education was the third lowest among OECD countries in 2013, even though Japan’s rate for all women in the 15-64 age group was above the OECD average (63 percent versus 58 percent). Most Japanese firms still impose mandatory retirement at age 60, reflecting steep seniority-based wage profiles and the cost of dismissing regular workers.

10. Christian Dustmann, B. Fitzenberger, U. Schönberg, and A. Spitz-Oener, “From Sick Man of Europe to Economic Superstar: Germany’s Resurgent Economy”, Journal of Economic Perspectives, Winter 2014.

11. OECD, “How’s Life in Japan?” 2014.

12. OECD Education at a glance, 2014, and OECD Skills Outlook: First Results from the Survey of Adult Skills, 2013.

13. IMF World Economic Outlook data, April 2015.

14. Environmental cooperation is one of the few areas that have not suffered a serious setback as Japan's political ties with China and South Korea remain strained over territorial and wartime issues. In 1996, as the environmental consequences of China's rapid economic growth had become far-reaching and cross-border in nature, two comprehensive basic frameworks of bilateral cooperation for environmental protection were established between Japan and China. Since then, cooperation has been conducted not only by the governments of the two countries but also by various implementation bodies, such as private enterprises, local governments, academics and NGOs. Moreover, late April this year, the environment ministers from Japan, China and Korea agreed to work closely in helping China reduce air pollution. The Chinese environment minister told that solving environment protection problems of a large developing country like China would make a contribution to the rest of the world.

One potentially important area for cooperation between Japan and China is economic and social policy management related to the process of population ageing. As Japan is the most rapidly ageing country with the longest life expectancy in the world and most advanced social security and health care systems, it can help China in dealing with the economic and social policy issues associated with population ageing. In fact, China is already starting to undergo the ageing process. Its success in maintaining social stability in the process should help secure peace within the country and thus reduce the risk of an internal conflict adding to tensions in the world.