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C O L U M B I A U N I V E R S I T Y I N T H E C I T Y O F N E W Y O R K

Thoughts on Japanese Economic Performance¹

Hugh Patrick

Abstract

The purpose of this paper is to provide a broad overview of the strengths of the Japanese economy and to consider some of its major problems. First, however, the paper begins with two fundamental economic policy proposals. It ends with a discussion of some effects of the March 11 earthquake triple disaster.

First, Japan should implement a major macroeconomic stimulus package of more aggressive monetary policy, taking on a lot more credit risk and further fiscal stimulus, and then implement comprehensive tax increases and reforms. Second, it should institute a major program of comprehensive deregulation of the economy.

Predictions about Japan's economic decline are off-base. Japan is a major, high income, technologically advanced, sophisticated economy and society, and will be among the top five economies for at least the next two to three decades. Some tend to believe that China's rise means Japan's decline, but though this may be true in relative terms, economic power is a positive-sum game; it is better to do business with rich, growing economies than poor, stagnant ones.

Japan has three important strengths: its people and cohesive society; its high level of technology; and its very large stock of real capital. Of course Japan has problems as well. One is Japan's mediocre economic performance for the past two decades. It has been very difficult for Japan to shift from a model of investment-led growth to consumption-led growth; this has had a number of interrelated adverse effects, including a sustained deflation of prices of goods and services and a depressed job market (though the unemployment rate is far lower than in the U.S. and Europe). A second problem is the very low productivity and lack of international competitiveness of agriculture, and in forestry and fishing, due to small amounts of arable land, in a high wage, high labor cost economy. Agricultural interests are very well organized and effective in protecting their entitlements; this is why Japan has not been able to negotiate any serious free trade agreements, and why TPP poses such a difficult political problem. Third, Japan's corporate governance system is weak, principally because of the dearth of independent directors. The management continues to give higher priority to the interests of its regular employees than its shareholders, often cannot effectively manage their foreign operations, and perpetuates their management system for its own self-preservation.

Finally, I consider the effects of the March 11, 2011 triple disaster in Tohoku. This was a regional, not nationwide, disaster. It showed the impressive response of the Japanese people, as well as the strength of Japanese supply chain systems. The outpouring of support from America and around the world has demonstrated how much goodwill – soft power – Japan has built up over the years. However, it brings into serious question Japan's pre-earthquake energy policy of heavy reliance on nuclear energy. At this point, it is politically difficult to reopen these plants soon, but if they're not, there will be electricity shortages this winter, and again next

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summer. So either short- or long-term, Japan will probably have to either revert to more coal energy, which will increase greenhouse gas emissions as well as health-related diseases, or more sources of still expensive renewable energy.

I begin by proposing two structural economic policies I would implement if I were economic czar of Japan. First, I would implement a major macroeconomic package of more stimulative monetary policy, taking on a lot more credit risk, and fiscal stimulus, spending more money, and announce clearly and firmly that I would continue this stimulus until deflation and deflationary expectations had been overcome and the economy restored to its full employment, potential real growth path. Only then would I begin the process of significantly raising taxes – and not just the consumption tax.

Second, I would embark on a major program of comprehensive deregulation of the economy. This would focus not only on agriculture and TPP, and TEPCO and the electric power industry, but also on the many small, niggling restrictions on domestic economic activities, as the Tohoku tragedy has somewhat exposed. This would create a wide range and large number of new domestic investment opportunities, especially for nimble, smaller firms. That would revitalize the Japanese economy.

I certainly have no impact on the thinking of Japanese policymakers, so let me continue more prosaically. I start by reminding you that the U.S.-Japan business and economic relationships are strong, well-established, mutually beneficial, and durable. They are one of the key foundations of the U.S.-Japan relationship and will continue to be.

Japan is a major, high income, technologically advanced, sophisticated economy and society, with a high standard of living, and is a very safe, comfortable place to live. It is in the process of major demographic transition, and has some major political economy difficulties, which in fact are not so different from those in the other advanced industrial economies of the U.S. and Europe.

Some of the perceptions floating around in some quarters – though I'm sure not here – about Japan's future are misguided, and deeply incorrect. There is a tendency among the

American public to take Japan for granted, and to more or less ignore it, in particular because of the exciting rise of the Chinese economy. But ignoring Japan means ignoring a country that will be among the top five economies for the next two to three decades at least. More importantly, its GDP/capita is high and will continue to rise, though slowly like the other developed, industrialized economies.

Some people talk of Japan's decline without making clear what they mean. The major economic variable that is and will be declining absolutely in Japan is the working age population, and now the total population, though gradually. Demography of course is profoundly important; but 20-30 years from now Japan's population of 90 million or so will still be larger than that of any present European country. And who knows what Europe will look like in the coming decades.

Political scientists think in terms of political and military power. One country's gain is another's loss. It is a zero sum game. However, economic power is a positive sum game. A growing Chinese economy is good for the Japanese economy and for the world economy, as well as for the Chinese themselves. It is better to do business with rich, growing economies than poor stagnant ones. Japan benefits significantly from the economic rise of China – in its exports, imports and FDI. Of course there are problems. Japanese companies face the loss of their technology to Chinese competitors. More importantly, the international system has to figure out how to accommodate and integrate effectively China as a major new rising economic player, just as the U.S. and Europe had to deal with the rise of Japan in the 1970s and 1980s. China's integration into the global system obviously is much more difficult and complex than Japan's was, and that wasn't easy then.

Let me say a few words about the fundamental strengths of the Japanese economy before turning to some of the challenges it faces.

First, Japan's most important strength is the Japanese people themselves and the very coherent, cohesive society within which they live and operate. Many Japanese see the heterogeneity in their country, while foreigners tend to stress its homogeneity. Both perceptions are correct. Of course Japan's group-oriented cohesiveness has weaknesses as well as strengths. Many Japanese institutions find it difficult to think outside of the box, and it can

be difficult to mobilize the innate creativity that Japanese people certainly have. Nonetheless, Japan has an incredible human capital stock: well educated, hardworking, high standards of performance, strong will, ambition, perseverance, endurance. These human qualities were certainly manifested in the response to the March 11 earthquake triple disaster.

Second, Japan's technological level is very high. Many of Japan's companies have state-of-the-art technology, and are global innovators. Others are laggards, of course. And certainly there are some gaps – mainly in military technology. But Japan will continue to be a major technological leader, since Japanese understand that their future growth depends upon labor productivity growth, and that depends essentially upon ongoing innovations, technology improvements, and other productivity enhancing changes.

Third, Japan has a very large stock of real capital – factories, buildings, infrastructure, and housing. An important macroeconomic strength is that Japan's saving rate is significantly greater than its investment rate, which also is high. Japanese saving is able to finance both a large government budget deficit – needed to maintain domestic demand – and a current account surplus in the balance of payments of about 3% of GDP. More of this saving now is done by the corporate sector than by households. The savings rate is a key variable in Japan's future performance – and for the maintenance of low interest rates on JGBs.

What are some of Japan's problems?

The first is Japan's mediocre economic performance for the past two decades, with slightly positive but subpar growth. That has been due fundamentally to deficient domestic demand. Once Japan caught up with the other advanced industrial economies by the 1980s, having fully utilized the earlier global productivity/technology gap, inevitably as a mature economy its growth rate slowed down. However it has been very difficult for Japan to shift from a model of investment-led growth to consumption-led growth over the past two decades. Incidentally, that suggests China in due course also will have major difficulties as it tries to increase domestic consumption in its share of GDP in order to sustain its own growth.

Sustained mediocre growth, below potential growth, has had a number of interrelated adverse effects. One is the modest but sustained pernicious deflation of prices of goods and services (and many assets), for more than a decade. That has been hard on companies, and on

government tax revenues. A second negative effect has been on the job market, especially for young new entrants into the labor force. Companies replace retiring regular workers, who have high wages and a long-term employment commitment, with young workers with lower wages and less certain long-term job prospects.

What I see among Japanese business leaders today is a mixture of complacency about the economy today – profits are doing very well, thank you – and a lack of optimism, even pessimism, about the future. A sense of malaise is embedded in phrases as “revitalizing Japan” or “rebuilding Japan.” Government economic policy is a mess too because of the ongoing political gridlock.

I might note that while Japan has not had really full employment for some years, the unemployment rate – even at its worst – has been and is far lower than in the U.S. and Europe. Companies do not quickly lay off workers. That means that labor productivity and profits go down sharply in a downturn, but rise sharply in an upturn – in addition to the ongoing reduction in labor costs that ongoing technological progress contributes.

So Japan, a market-based economy so much like the West in the context of other macroeconomic variables, is an outlier in two important respects: it has persistent deflation, yet lower unemployment rates than in the West.

A second major problem for Japan is the very low productivity and lack of international competitiveness of agriculture, and in forestry and fishing as well. These are relatively labor-intensive, low tech sectors in what is now a high wage, high labor cost economy. The basic problem of agriculture is not technology or capital, but Japan’s very small amount of good, flat farmland, combined with still far too many farm families. The average farm size in Japan is about 2 hectares – or about 5 acres – only one-hundredth or so the size of American family farms. Agriculture has been a declining, and highly protected, industry for a long time. The average farmer’s age is 65. Almost none of their kids have stayed in farming. The good jobs have long been elsewhere. Indeed farm families obtain most of their income from non-farm jobs in nearby towns. Japanese farm families are not poor; they live well since they are so protected – and they do produce high quality, if high priced, products.

The farm role – and more broadly the rural, small community role – is very important politically as well as socially. Agricultural interests are very well organized, and effective in protecting their entitlements. This is why Japan has not been able to negotiate any serious free trade agreements, and why TPP poses such a difficult political problem. Prime Minister Noda's commitment at the recent APEC leaders meeting to participate in the TPP negotiations is an important step forward, because it implies that Japan must tackle agricultural reform and liberalization. But that will take time, which fortunately the TPP process recognizes and incorporates into its negotiations. After all, 15 years from now most of Japan's farmers will be 80 years old, and the problems of their inefficient production will gradually disappear as part of the overall demographic transition. But today farmers are a symbol of the decline of rural prefectures in an increasingly urbanized country, with all the political difficulties that implies. TPP is by far the most difficult issue in otherwise very good Japan – U.S. economic relations, as I am sure you all know much better than I.

A third problem area lies in the way public (listed) companies are managed and controlled, namely the nature of Japan's corporate governance system. The Governance Metrics International corporate governance index ranks Japan fourth from the bottom of 38 countries, significantly below Italy, India and Greece among other countries. This is not because Japanese companies are bad; it is probably because they are not required to have many truly independent, outside directors or to announce the individual compensation packages – salaries and bonuses of the CEO, other top officials, and Board members, unless they are 100 million yen or more. However, Japanese companies are more controlled by their own management than in any other country I know. That has both strengths and weaknesses. Two key features are: first, essentially all managers are promoted from within, including the President and Chairman, in a well-defined hierarchy system combining merit (capability) and seniority; and second, almost all of the Board of Directors have been selected from within the company's management by the CEO and his advisors. The few outside directors only play a limited role. Corporate governance certainly has been improving over the past decade or two – but on a scale of 1 to 10, most Japanese companies have gone from 1 to about 4. Even the most global of Japan's global companies do not have any non-Japanese on their Boards, with only a few

exceptions. On the other hand, managers do know much more about the company – its strengths and its problems – than do the outsiders, even Board members.

This corporate governance system has several consequences. First, for historical reasons the resolution of conflicts between management and unions in the 1950s, management continues to give higher priority to the interests of its regular employees than its shareholders, though shareholders have become more important than earlier, when they were barely considered at all.

Second, for Japanese companies that want to engage in direct investment abroad, the Board often does not have the expertise or the mind-set to delegate authority to their foreign operations, does not really understand the local national conditions in which their company operates, and does not know well how to handle foreign employees, especially those in management positions. It is essential, but very difficult, to develop a global mind-set in a Japanese Board of Directors. On the other hand, companies have been learning and striving to improve, though I think most Japanese companies are still behind the curve.

Third, as in the U.S. and elsewhere, the basic motivation of Japanese managers is to protect themselves, and by extension to protect their company's management system – and the younger members of the management track – in order to provide them job security, especially in the Japanese world of a very imperfect external labor market for senior managers. If the company does not grow and technological progress proceeds, the company needs fewer workers – and fewer managers. Japanese top management has been extraordinarily self-disciplined, and wise, in not giving themselves exorbitant wages and bonuses, unlike their American counterparts. In Japan you are more likely to see an Occupy Kasumigaseki than an Occupy Otemachi – though probably we won't see either. Top Japanese management does receive very good expense accounts and other perquisites, but it is all handled very quietly: Japanese top managers are loyal, not greedy for money. Some companies are willing to build new factories or take on new projects in Japan even though the expected returns on investment are low, simply in order to sustain company jobs. In the past, some companies have been very protective of the privacy of the personal lives and reputations of their CEO, in effect being willing to make special payments to avoid scandals. The current Olympus and Daio Paper

Company scandals are, I believe, really extreme cases of management's misuse of its power, certainly not typical. Think of Enron or similar cases in the U.S.

Let me end with some brief remarks about the March 11 Tohoku triple disaster of earthquake, tsunami and – qualitatively different – the Fukushima Daiichi nuclear power plant meltdown, explosions, and radiation releases.

First, the earthquake and particularly the tsunami, while certainly significant human tragedies, were localized, regional – not nationwide – disasters. Only small shares of GDP and of the population were directly affected... less than 4 percent of each.

Second, the responses have been very impressive – of the people afflicted by these disasters, by the outpouring of volunteer efforts to go up and help – from throughout Japan, and certainly by companies. The supply interruptions were a surprise, but the quickness and effectiveness with which they have been handled indicate how basically strong Japanese supply chain systems are, despite an extreme shock. Toyota and other companies sent 2000 or more engineers to Tohoku to restore production in related suppliers, not just their own facilities. The government's immediate response of rescue and evacuation was really good, but recovery has lagged badly since then. The outpouring of support from America and indeed around the world has demonstrated how much goodwill – soft power – Japan has built up over the years. And the U.S. government Operation Tomodachi and related official actions were the right thing to do, as Ambassador Roos has repeatedly stated. All this has generated an increasing feeling of good relationships between our two peoples.

Government special spending for Tohoku will not only fund recovery, it should provide more stimulus for economic growth over the next 15 months or so. However, I am worried about domestic demand in 2013 and beyond.

Third, one major long-run effect of Fukushima Daiichi is to bring into serious question Japan's energy policy before the earthquake to increase reliance on nuclear energy for electricity generation from 30% to 50% over the next decade or so. Instead Japan's 54 nuclear power plants are not being re-opened as they go through their 13 month routine maintenance closed-down cycle; there are only about 10 in operation today. There is a lot of emotion about nuclear energy, and it is politically difficult to reopen these plants soon. However, if they are

not re-opened, there will be electricity shortages this winter, and again next summer. This is a serious immediate policy issue. The longer-run issue is whether Japan will go to zero reliance on nuclear energy as present nuclear facilities become obsolete and are not replaced. That will have its own severe costs not only in terms of the costs of importing fossil fuels but in terms of air pollution – causing significantly more deaths than from radiation – as well as climate change. It is estimated that Japan’s shifting from nuclear to fossil fuels will cause 300 deaths directly, while the Fukushima Daiichi radiation plume in the first few days will cause 5 cancer deaths. However, the shift to natural gas, which is the future for a long time to come, will be less polluting than oil or coal.

Finally, I had hoped that this Tohoku triple disaster would be seen in Japan as a national crisis, a wakeup call to address the issues of inadequate growth below potential, deflation, and huge and ever increasing government debt and budget deficits. If Europe does not generate a crisis for Japan – and probably it won’t directly – then the coming crisis will probably be in the JGB market.

Let me end where I began. To prevent a JGB crisis, Japan has to do the following:

1. End deflation and deflationary expectations, and define price stability as 1 to 2 percent annual increase in the GDP deflator,
2. Achieve full employment growth at the potential rate,
3. Raise the tax share of GDP significantly, and
4. Probably modestly reduce government pension and health care benefits.