

CENTER ON JAPANESE ECONOMY AND BUSINESS

日本経済経営研究所

Occasional Paper Series

June 2016, No. 76

Interview with Hugh Patrick

Anna Balderston

This paper is available online at www.gsb.columbia.edu/cjeb/research

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

Interview with Hugh Patrick¹

Anna Balderston²

Abstract

This is an interview with Professor Hugh Patrick conducted by Anna Balderston on March 31, 2016. Their discussion covered a range of issues concerning the Japanese economy: the present macroeconomic situation; the state of “Abenomics”; international interrelationships, particularly with China; the recent policy of negative interest rates; and long-term demographic challenges, particularly Japan’s aging population.

¹ R. D. Calkins Professor of International Business Emeritus; Director, Center on Japanese Economy and Business, Columbia Business School

² Student, Claremont McKenna College ‘18

1. Could you please briefly explain to our readers the current macroeconomic situation in Japan in terms of growth, deflation, other macroeconomic indicators?

Let me start with some simple basics. Japan is a high income, technologically advanced democracy of 127 million people. It is a safe, peaceful, comfortable place to live and has a quite stable society and social structure. The current prime minister, Prime Minister Abe, has allowed for considerably more political stability than in the past. Before Abe, Japan had 5 prime ministers in 5 years.

A very important point to note is that Japan is furthest along in the demographic transition, meaning that now it has an absolutely declining population and increasing share of those who are 65 or older. This is basically because Japan has had very low fertility rates for the last 40 years or so.

When I look at the macro side to determine how the Japanese economy is doing, I look at employment, growth and price stability. One of the remarkable things about Japan is it has very low unemployment, about 3.2-3.3%, which means that almost everybody who wants a job has a job. However, a number of those jobs are part-time, and some of those people want full-time jobs.

Because the labor force, which is key, is declining and will continue to decline, I think economists like myself have spent too much time in the past focusing on the growth of GDP, the total output, instead of output per person. We have to change our ways of thinking about output as a measure of economic performance.

Japan, with its declining labor force, expects to grow at a rate of about 1.5 percent per capita. This would be a good growth rate, particularly with a declining population. The Japanese economy has been relatively flat for the last couple of years — slightly positive and then slightly negative — and not quite at its full potential.

The main characteristic of the Japanese economy that is attractive for policymakers and others is that Japan is the only country I know that is going through a long period of deflation. It has been very mild deflation, but it has been pernicious. Trying to break the back of deflation is a major policy target, and the government has set a target of two percent

rise of the CPI, or Consumer Price Index. The government has been working on combatting deflation for a couple of years now, but it certainly is not near the 2 percent goal. Japanese leaders say they will achieve this target next year, but I think it will take longer.

2. What is Abenomics? What are the three “arrows” and how effective have they been in reviving the Japanese economy? Do you think Japan will add the "fourth arrow" to Abenomics (tax incentives for companies to provide wage increases) that the IMF recommended?

Abenomics is basically summarized as three arrows of policy. Abenomics is a very clever brand term because it works so well. The policy itself is a combination of really quite standard economic policy issues that are common to most advanced countries. What the Japanese are emphasizing first is to end deflation. This is done primarily through monetary policy.

The second target is to have a good enough private aggregate demand, consumption, investment and exports, such that the government doesn't need to provide a budget stimulus or expansive fiscal policy. Up until now — and now as well — the government has provided a certain amount of stimulus to make sure the country has enough demand.

With that comes the third target, which is sustainable economic growth and full employment growth. To do that, Japan not only has to have good macro, fiscal, and monetary policy, but it also has to think about how to allocate resources more efficiently. This is done by implementing structural reforms in the economy, increasing competition, aiming to increase the potential growth rate and then actually achieving it.

This brings us to where we are now with Abenomics. As I've suggested, monetary policy is moving ahead. But part of the reason people are saying Abenomics is hitting a wall is that it has been much tougher to break the deflationary set of expectations and actually get prices to rise. Many are still disappointed that Abenomics has not done better. The policies are the right policies, and Japanese policymakers have been very aggressive. Therefore, it is very difficult to understand why Abenomics has not done better.

On the growth side, there is the immediate short-run problem. But there is also the longer-run problem of trying to increase productivity. Productivity is the output per hour per worker, and this has slowed down in Japan. It has also slowed down in Europe and the United States, which has created somewhat of a global puzzle: why hasn't productivity continued to be strong? Japan is full of puzzles, actually. Another puzzle is how Japan can have such a low unemployment rate and still not have the pressure to increase wages. Wages have been rising a little bit in Japan, but the unions and management were much less assertive in their demands this spring than I would have thought. They have a spring wage offensive called *Shuntō*. This year it was defensive, not offensive, because the unions asked for less of a wage increase for their base wages than last year. Even though Prime Minister Abe asked companies and management to raise wages, they have not done so by much. I am not surprised. If I were an American businessman and my President asked me to raise wages, I would say that wages depend on how my company is doing and what the labor market is, and not on what the President suggests. Thus, I am somewhat skeptical about that. But clearly, the fact that the unions did not press hard this year, and even set a lower target than last year, implies something about their anxieties about the future. They don't seem to worry so much about employment as about whether wages can increase.

One of the interesting things about wages in Japan is that when companies are very profitable, they are likely to give big bonuses instead of giving a big increase in the basic wages, which continue indefinitely. Bonuses are a one year, one shot method of increasing compensation. We may see pretty big bonuses this summer, but with the expectation that they will not continue in the future.

3. What are your thoughts on the fact that the IMF is pushing for tax incentives for companies to provide wage increases?

In a sense, the IMF has the same view as Prime Minister Abe. The IMF says it would be good for the economy to generate more demand, which means households need to spend more. One way to have households spend more is to have higher wages. Raising wages is common sense and very reasonable, but it is really a decision each company has to make.

Someone running a company, and who is cutting costs to increase profits, is not really having trouble hiring workers. Because of high worker productivity, these companies need fewer workers. Thus, there is very little pressure on management to actually raise wages. That lack of pressure is the primary challenge in the push for increased wages. This spring has been a disappointment for the IMF and Prime Minister Abe, as well as for me and many economists who would like to see wages going up. But the Prime Minister cannot make this happen easily given the reality of how wages are set in a market economy.

4. So you don't necessarily think Abenomics has hit a wall because of the policies themselves, but because these businesses have no incentive to raise wages?

Abenomics has sort of hit a wall, in part because of external conditions, such as China's slowdown and the lackluster global economy. This is a time when Japan needs fiscal stimulus. The problem has been that the Abe government was trying very hard to reduce the budget deficit, which has been quite high. In fact, tax revenues have gone up more than they expected, and because interest rates are so low, interest payments on government debt have gone down. This means that Japan now has a reserve of funds, and that there is a policy fight within the government over how to use that reserve. The position of the Ministry of Finance is to use the reserve to reduce debt. Others say there should be a supplementary budget, and that the government should take other stimulative measures and spend that money. The government will probably have a fairly large supplementary budget announced very soon.

5. As you alluded to earlier, do you think the slowdown in China in particular has had an effect on the success of Abenomics and/or affected the Japanese economy as a whole?

It is convenient to say that the Chinese slowdown has affected both Abenomics and the Japanese economy because Japan is an exporting country, and its export sector has been declining. Obviously, export growth is slowing down and stalling, at least while the Chinese go through an adjustment process. However, China's economy is not the dominant reason for Japan's difficulties. The cause is on the domestic side.

For reasons I do not quite understand, households have been quite conservative about spending their money. Domestic consumption has been actually going down, not up, and people are saving more since the beginning of this policy. That suggests, too, that people are worried about the future. This means Japan has to create a new set of incentives that makes it attractive for people to think more positively about the economy — to have more money, and to be able to spend more of it as well. I think it's very tempting to blame a lot on China, but although it is a factor, I don't think it's as important as domestic forces.

Many people also blame the fact that the world economy is slowing down. While Europe has slowed down, the U.S. is doing quite well, and the U.S. is more important for Japan in terms of exports and trade relationships and in terms of political alliances. This challenges the notion that the global economy has had a major influence on the difficulties facing Japan's domestic economy. Although the deterioration of the external environment is, in fact, a partial explanation, more important is what is happening domestically in Japan, where consumption is slowing, people are cautious, and expectations are low. Abe is working very hard to change those expectations, but it is not an easy thing to do.

6. Why has the Bank of Japan adopted negative interest rates? What will be the likely consequences for the economy?

If you take a straight economic textbook view, moving from almost zero interest rates to negative interest rates is just part of a continuum of trying to use interest rates, or the cost of borrowing money, as an incentive to encourage people to invest or consume. Therefore, negative interest rates make sense in a straightforward, economic analytical way.

For Japan, however, this is brand new territory — they have never had negative interest rates before. However, we should be very careful when saying Japan has negative interest rates. In fact, interest rates are not negative for depositors, or ordinary households that have deposits in banks. Banks that lend to companies also do not face negative interest rates. Negative interest rates actually impact another aspect of the economy. Banks that have too much money which they simply put in their central bank account, meaning they have excess

reserves that they are not lending out. These banks are not lending because they cannot find customers, or they are being cautious, or for other reasons. The negative interest rate is a penalty for them if they increase the reserves they hold at the central bank. Therefore, negative interest rates are really an incentive to banks. Instead of having to pay a penalty for building their reserves, they are incentivized to go out and spend more of this money, to lend it, to find new customers and to take a bit more risk to expand their customer lending base. That said, banks can also buy government bonds or other kinds of bonds; and because the interest rates have gone down on those bonds, that is another alternative. The basic idea is just trying to get banks to be more aggressive in looking for customers.

Because the implementation of negative interest rates in Japan is unprecedented, it was quite reasonable and brave of the Bank of Japan to take a small negative interest rate policy adjustment, even though the policy has been implemented in several countries in Europe. The problem with this policy is it has affected people's expectations in the wrong way. People did not understand negative interest rates and were confused. Because they were nervous and they didn't know what it meant for them, they became more cautious in spending their money. Hopefully this is a learning process such that in coming months, people will better understand the intention of the policy. I think the sentiment is probably is changing a bit for the better. We will see how it works itself out in the coming months.

7. Are there other policy options available to Japan in better combating deflation and slow growth?

Monetary policy will continue to fight deflation, but clearly more demand is needed for the economy to grow. Monetary policy does not seem to be generating enough investment demand or consumption to create that growth alone, so the government should now be very active in pursuing a stimulative fiscal policy. That would mean not only spending the new unexpected money that came in, but actually taking the more vigorous step of issuing more debt. Certainly the Japanese government bond market is a very liquid market, and a relatively easy place to sell. That is what the government should be doing.

8. Are there valuable lessons other countries, in particular, the U.S., can learn from Abenomics?

The one lesson learned was that deflation is bad and should be avoided. Some years ago when other countries were looking at Japan, they realized they did not want to be in Japan's situation. I think that every country has its own political conflicts. The question is, "What should the government do?" One conflict is big government versus small government, and the other is whether the government should run deficits to stimulate the economy. A small economy can still run deficits if it cuts taxes and maintains expenditures. Now, in the longer run, Japan has a further complication because the so-called baby boomers are starting to retire. They are going to get retirement benefits and will probably need more healthcare. Government welfare expenditures are going to rise steadily simply for this demographic reason. One big issue is whether to let that happen and run deficits, or to impose new taxes. Japan is trying to figure out what to do in this regard. Under the current legislation, Japan is supposed to raise its consumption tax, its value-added tax, from eight percent to 10 percent next year. Prime Minister Abe will have to decide whether to postpone that once again. We keep getting conflicting signals out of Japan as to whether Prime Minister Abe is going to announce a delay in that tax increase legislation or not, and it is likely that we won't know for a while yet.

9. So there is a tension between Japan's aging population, the taxation that is necessary to support them, and the slow economy?

Yes. Let's look at it from the other side. Why are people opposed to having Japan spend more and issue more government debt? After all, the yield on Japanese government debt is very low, and this means it is very safe and is highly rated. So why not just issue more when the interest rate is so low? The answer to that question is that the government's outstanding debt now relative to the size of the economy is larger than that of Greece. So, people worry about the future, and say Japan cannot continue to issue debt indefinitely. There is this group of very good economists who say Japan should focus on how to prevent a bond market crisis in the future, because people will lose confidence in the ability of the government to take

care of its debt. On the other hand, there are others who say that Japan has to stimulate its economy now, and that it has to start and keep growing. That is the fundamental tension in Japan's economy today.

Returning to the question of which lessons Japan could teach the United States, I think the United States, Europe and Japan are facing similar kinds of problems. The United States has had a remarkable decrease in the unemployment rate, and its economy is growing at a reasonable rate of two percent. This is a little slower than I would like, but is sufficient for now. We can watch what is happening in Japan from the U.S. perspective and make sure that we have enough stimulus in our economy, and keep watching our budget deficit, which is also a big issue.

Europe, on the other hand, is a kind of a mess, so I am not sure the Europeans are watching Japan as closely. There are European experts who know and study Japan very well, but I think Europe's problems are more internal to Europe. They face different obstacles because there are different countries trying to deal with issues such as what to do about the Eurozone, employment, and refugees. They have their own set of problems that neither the United States nor Japan has, because both the U.S. and Japan are single countries. Additionally, neither of us has huge inflows of refugees.

10. Do you have anything else you'd like to add?

When you think about Japan's expenditures policies over the longer run, you have to think about how there will be more and more elderly people. The question is, should Japan continue giving them generous medical care at a very low price, and how will it pay for this? The price of that medical care is only going to increase. Japan has to think about how to support the elderly, particularly the elderly poor.

Japan also has to continue to put emphasis on education and improving the educational system. I think Japan has a very good K-12 system, but the universities are quite cautious and conservative, and need a good deal of reform.

Lastly, although this problem is not as bad as in the U.S., Japan also needs to maintain its bridges and roads. There is a lot of infrastructure maintenance needed in Japan. The question is, how should Japan fund this infrastructure maintenance? These are the challenges that Japan is facing now.