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Japan's Sputtering Economic Recovery Amid Heightened Political Turmoil

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Abstract

The purpose of this paper is to provide an overview of the current state of the Japanese economy, and to consider some of the major challenges it faces during these tumultuous political times. It begins with an economic policy proposal focused on Japan's muddling recovery amidst the difficult political climate presently inhibiting growth. I then discuss several domestic and global issues likely to impact recovery of the Japanese economy.

Regarding macroeconomic policy, Japan should pursue growth—focusing on unemployment, overcoming a sluggish recovery, and generating revenues—until stable full employment is achieved, and then implement effective fiscal consolidation with a high priority on tax and other reforms, deregulation, and liberalization. This policy should be implemented by a strong but temporary macroeconomic package of further monetary easing and additional fiscal stimulus until deflation has ended and good growth achieved, then followed by gradual but significant tax increases as a share of GDP and an end to monetary easing.

Japan currently faces several challenges to economic growth. Although government infrastructure investments in Tohoku and the quick repair of supply chain ruptures led to impressive 5.5 percent growth in the first quarter of 2012, that growth slowed sharply in the second quarter to an estimated 0.7 percent rate. Furthermore, within the Japanese government, petty political gamesmanship is peaking, economic policymaking is gridlocked, and the government faces numerous structural issues including inadequate domestic demand, fiscal consolidation, deflation, and weak labor markets.

The DPJ will surely lose the upcoming election and control of the government after three years in office. In addition to Japan's still-unresolved long-run structural issues, the new government will also have to address energy policy, the role of nuclear power, trade liberalization, and financial market reforms, along with growth and the ongoing recovery effort in Tohoku. The Fukushima Daiichi plant disaster has had significant economic, political, and societal effects. Energizing an increasingly large antinuclear movement, the disaster has forced the government to examine the fate of existing nuclear plants, decide how far and how quickly nuclear power downsizing should proceed, and aggressively promote conservation and the development of renewable resources.

Japan must also now confront two models for Asia-Pacific trade liberalization: the comprehensive Trans-Pacific Partnership (TPP) of 11 nations, led by the United States; and an "Asian track," exemplified by Japan's trilateral trade negotiations with China and Korea. Though it is in Japan's best interest to proceed vigorously on the TPP track, the Japanese government

will not join negotiations until next spring at the earliest, and its inability to engage in major agricultural reform soon could risk its ability to shape the rules of the TPP. Finally, the Japanese government must also pursue financial reforms after high-profile scandals revealing widespread insider trading, and after several attempts by foreign banks to manipulate the Tokyo interbank offer rate (Tibor).

I am not particularly optimistic about the Japanese economy for the next several years; I am concerned about continuing economic policy gridlock and inaction. Despite my best hopes, I anticipate that the new government will only muddle along. Regardless, because of its unique position in the global economy, I still believe that ignoring Japan is a big mistake. It will continue as one of the world's five largest economies for the foreseeable future, a technological leader, and a major global economic partner and competitor. We can also learn from how Japan deals with a range of problems common to most advanced economies. In the long run, I continue to be optimistic about Japan. As its history demonstrates, it has a record of being a strong, highly motivated, effective society, demonstrably capable of responding well to and overcoming adversity.

Japan’s Sputtering Economic Recovery Amid Heightened Political Turmoil

The March 11, 2011, triple disaster of a major earthquake, tsunami, and Fukushima Daiichi nuclear power plant damage delayed even further what was already a sputtering recovery from Japan’s deep 2008–2009 recession. GDP contracted by 0.7 percent in 2011. Growth was negative in the earthquake-hit first half of the year. Then, a strong third quarter (at a 7.7 percent annual rate) was followed by a flat fourth quarter.

Impressively, supply chain ruptures were relatively quickly repaired. Supported by government infrastructure investments in Tohoku, impressive 5.5 percent growth in the first quarter of 2012 accelerated further recovery, but then growth slowed sharply in the second quarter to an initially estimated 1.4 percent rate, substantially below the consensus forecast of 2.3 percent, and on September 10 to a revised even lower 0.7 percent. The government’s August 17 mid-year forecasts optimistically indicated that, based on robust private demand, not only would growth in fiscal 2013 be 1.7 percent, but deflation could be coming to an end. The GDP deflator, negative since 1997, would turn from a minus 0.3 percent this fiscal year to a positive 0.2 percent next year. However, summer data indicate a further slackening, with no clear signals that deflation is ending. The September consensus forecast is 2.3 percent growth for 2012, slowing to 1.2 percent in 2013 and 1.1 percent in 2014. Both the output gap and underemployment persist. GDP and GDP per capita are still below their 2007 peak.

These are tumultuous political times in Japan. Complex, petty political gamesmanship has been at an extraordinary height, making political turmoil even more intense. Economic policymaking has been gridlocked because the Democratic Party of Japan (DPJ) controls the Diet Lower House but not the Upper House. Prime Minister Yoshihiko Noda succeeded in obtaining opposition support for consumption tax increase legislation, but at substantial DPJ and personal cost. On August 8 he agreed to a Lower House election “soon” although elections are not due until August 2013. Otherwise the Liberal Democratic Party (LDP) threatened to join minor opposition parties in an Upper House vote of censure against Noda, a nonbinding but severe blow.

The DPJ will surely lose the election and control of the government after three years in office. In order to force Noda to set an early election date, on August 29, the LDP and the minor opposition parties did vote a motion of censure, and boycotted further consideration of legislation until the Diet session ended on September 8. An integral element of the situation is that the annual elections for the heads of the parties were held in September. Noda was easily reelected president of the DPJ on September 21. LDP incumbent Sadakazu Tanigaki, realizing he had little support, decided not to run. In a vigorous competition, Shinzo Abe won over Shigeru Ishiba on September 26. Abe, prime minister in 2006-2007 for one year, will probably become the prime minister following the Lower House election.

The Fukushima Daiichi power plant disaster has significant national, as well as local, effects. It has forcefully raised issues of safety, energy policy, public utility company behavior, and government regulation and policymaking. The July 2012 independent committee report was scathing, as were earlier reports. Electricity shortages have been a major concern for summer 2012, given the government's decision to delay reopening the other 50 nuclear plants closed for routine maintenance. With impressive conservation efforts, the reopening of old thermal plants, and the restarting of two nuclear plants supplying electricity in Kansai, Japan was able to avoid rolling blackouts.

Japanese structural issues have not been resolved, including inadequate domestic demand, huge government budget deficits, immense government debt as a share of GDP, small but persistent deflation, unemployment and underemployment of young Japanese, and an uncompetitive agriculture sector.

Two important macroeconomic policy decisions may ultimately break the policy gridlock. First, on February 14, 2012, the Bank of Japan (BOJ) announced it was setting a goal (if not an explicit target) of a 1 percent annual increase in the CPI, which would bring deflation to an end. Second, Prime Minister Noda made fiscal consolidation his top priority. In June, the Diet Lower House passed legislation increasing the consumption tax, currently 5 percent, to 8 percent in October 2014 and to 10 percent in April 2015; on August 10 the Upper House passed the bill. However, it has an escape clause: if economic conditions are adverse, the Cabinet can decide not to implement the consumption tax increase.

The forthcoming election dominates headlines, but financial institution scandals and the strong yen are also major concerns. The unfolding local investigations of insider trading involving corporate new stock issues and the London-centered manipulation of Libor (London interbank offer rate), the key global interest rate benchmark, and possible manipulation in Tokyo (Tibor) are major concerns.

The yen is strong in part because, despite a trade deficit, Japan continues to run a balance of payments current account surplus since net foreign interest earnings, repatriated profits, and management fees have become 3 percent of GDP. The current account surplus will persist. And so long as interest rates are low globally, incentives for Japanese capital outflows are limited. The yen is somewhat overvalued because Japan has become a parking lot, if not a long-term safe haven, for those fleeing the euro.

Global economic growth is slowing because of deficient demand, weak banking systems, and the prospect of fiscal consolidation in the United States and Europe. With monetary policy already easy and interest rates near the zero lower bound, fiscal policy is particularly important to sustain demand and prevent a looming return to recession. Moreover, dynamic growth in

China, Japan's largest trading partner since 2007, has slowed as its economy engages both in cyclical adjustment and domestic restructuring.

Japan faces major foreign economic uncertainties. Who will be elected president of the United States? Who will control Congress? Will the "fiscal cliff"—the automatic termination on December 31, 2012, of Bush-era income tax cuts and mandated cuts in defense and welfare expenditures—be averted? If not, the reduction in government demand would be so large, 4 percent of GDP, that a recession would result. This will not be resolved before the November elections, and perhaps not by year-end. These uncertainties create anxieties worldwide.

I am particularly concerned about the Eurozone crisis. European countries and the European Central Bank have repeatedly and expensively bought time, but without reaching clear-cut solutions. The deep differences in productivity levels and growth not offset by wage or price increases between the southern and northern European countries are a huge challenge. I doubt the members will agree soon enough on sufficient political union to achieve fiscal as well as monetary policy centralization. The economic policy adjustment demands on Germany at one extreme and Greece at the other are huge. And what about Spain and Italy? Will the Franco-German relationship continue to be strong enough to overcome these challenges? The euro crisis will probably come to a head when Greece or some other country exits, which is likely.

The macroeconomic policy debate in Japan, the United States, and Europe is often framed as austerity versus growth. Austerity: to reduce the government budget deficit, restore fiscal discipline, overcome possible inflationary pressures (nonexistent in Japan), and carry out structural reforms. Growth: to reduce unemployment, overcome sluggish recovery, generate government and private-sector revenues, and achieve potential growth.

To view austerity and growth as alternatives is misplaced. It is a matter of the sequencing and timing of macroeconomic policies. Growth should first be pursued until stable full employment is achieved, and then effective fiscal consolidation should be implemented. Tax and other reforms, deregulation, and liberalization should be given high priority under either policy regime as an integral part of any policy package.

The social and personal costs of unemployment and underemployment are substantially greater than those of large budget deficits and high government debt, especially in a noninflationary, much less deflationary, environment. I have proposed for some years that Japan should implement a strong but temporary macroeconomic package of further monetary easing and additional fiscal stimulus and announce that these policies will persist until deflation is ended and good growth achieved. Then, taxes should gradually be increased as a share of GDP and monetary easing brought to an end.

In the following sections I briefly discuss Japan in domestic and global context, recovery and growth, energy policy, the Trans-Pacific Partnership and related international trade institutional arrangements, and the financial scandals.

Japan in Context

Dynamic catch-up growth was completed more than two decades ago, and Japan's political economy has muddled along since. I note a tendency in the West to not pay much attention to Japan—taking it for granted—even while recognizing it as an advanced industrial economy, albeit with many problems. And Japan is not skilled in communicating about itself.

Ignoring Japan is a big mistake. It will continue as one of the world's five largest economies for the foreseeable future, a technological leader, and a major global economic partner and competitor. And we can learn from how Japan deals with a range of problems common to most advanced economies, including an aging and declining population.

Japan has had difficulty making the transition from a catch-up, investment-led growth model to an advanced, mature-economy consumption-led growth model. Japan's economic performance since 1990 has been erratic, subject to huge shocks, below potential growth, but nonetheless modestly positive. Decline has been relative, not absolute. Over the 20-year period from still-good growth in 1991 to cyclically negative growth in 2011, GDP increased 15.8 percent and GDP per capita rose 10.6 percent. Japan's GDP per capita in purchasing power parity terms relative to the U.S. peaked at 85.6 percent in 1991 but had receded to 71.8 percent by 2011, due to good U.S. economic performance. GDP per capita in most European countries grew a bit faster than Japan's over the past two decades, mainly in the 1990s.

Japan has been engaged in major changes in its markets, in economic, political, and social institutions, and in generational values and behavior. Japan in 2012 is significantly different from and in many respects better than Japan in 1990.

The level and growth of real GDP per capita is the best single measure of a country's economic performance, but it is only a crude indicator of human and societal well-being. In most indicators of well-being, Japan ranks well relative to other OECD members, better on some measures (educational skills, household financial wealth, life expectancy), and worse on others (income distribution, gender equality, air quality, working hours). Nonetheless, Japan's income distribution is less unequal than in the US.

Japan differs from the United States and Europe in three major respects. While Japan has not achieved full employment, overt unemployment is far lower than in the U.S. or Europe. Japan's labor problems are weak markets, poor job prospects for those newly entering the labor force, and a significant increase in the share of part-time employees to a third of its labor force.

Second, Japan is unique among the advanced countries in suffering mild but persistent deflation and this has been so for the past 15 years.

Third, Japan's government gross debt as of March 2012 was 230 percent of GDP; only Italy (at 121 percent) and the United States (at 103 percent) are also in triple digits. Only Japan has a net government debt to GDP ratio in the triple digits, 123 percent; the U.S. ratio is 80 percent. However, unlike the heavily indebted European governments, more than 90 percent of Japanese government bonds (JGBs) are held domestically by banks, insurance companies, the post office system, and other financial institutions that are less likely to dump them.

Relative poverty remains a significant problem in Japan, as in most advanced economies. Some 11 percent of Japanese are in households whose income is less than half of the Japanese median. As of March 2012, 2.1 million Japanese in 1.5 million households received welfare assistance. Some 40 percent of the households were elderly, in another 20 percent the family head was injured or ill, and 7.5 percent were single mothers (typically divorced or deserted) with children.

Recovery and Growth

The devastation from the tsunami and Fukushima Daiichi nuclear disaster forced the evacuation of several hundred thousand people along Tohoku's east coast. Recovery has been slow; many evacuees remain in temporary housing and face stark life choices. But this has been a regional, not a national, disaster.

Japan's macroeconomic difficulties persist. The government's operational forecast is that the economy will grow at a 1.1 percent annual rate over the 2010–2019 decade, and 0.8 percent in the following decade through 2029. In making its social welfare expenditures forecasts, the Ministry of Health, Labor and Welfare assumes growth will continue at 1.1 percent until 2030. Given projected declines in population and labor force, even a 1 percent long-run growth forecast implies fairly strong but not unreasonable growth in labor productivity.

While deflation benefits consumers, particularly the elderly on pensions, it has been at the cost of their very low income from savings deposit interest and other assets. Small but persistent deflation has retarded both growth and fiscal stability, costly for young Japanese. The Bank of Japan (BOJ) has yet to take vigorous proactive measures to end deflation.

The BOJ reasonably forecasts 0.2 percent CPI increase in 2012. However, its predicted 0.7 percent rise in fiscal 2013 and achievement of its 1 percent goal in 2014 are widely regarded as too optimistic. The August market consensus forecast is that the CPI increase in 2013 will be 0.1 percent, and in 2014 0.2 percent. The government's August 17, 2012, forecast update also is too optimistic. It expects the CPI to rise by 0.5 percent in 2013 and the GDP deflator, a more comprehensive measure, to become a positive 0.2 percent. However, the GDP deflator has been slightly more negative than the CPI thus far in 2012, as in previous years. The market consensus forecast is that it will be a negative 0.5 percent in 2013. I do not expect price stability, defined as a 1 to 2 percent annual increase in the CPI, to be achieved soon. Deflation will probably continue to be a major macroeconomic policy challenge.

Passage of the landmark consumption tax bill is the first time in years that the government and political parties have addressed the major challenge of ongoing huge government budget deficits, high government debt, and a potential Japanese government bond (JGB) market crisis. The consumption tax legislation reduces the risk of a major crisis soon but does not end it.

Policymakers face two challenges. One is to ensure that good, stable growth be achieved within the coming 18 months before the consumption tax increase goes into effect, quite aside from temporary spending on big-ticket items. The more enduring challenge is that this is only a modest first step toward achieving fiscal equilibrium. Tax revenues as a share of GDP will have to be increased gradually in the coming decade, given the pension, welfare, and health care needs of an aging population. Increasing the consumption tax is not the optimal tax policy but has been politically feasible.

On July 31, 2012, the DPJ government announced its new growth strategy, updating its June 2010 plan of 21 major programs. While the prime objectives—energy, environment, healthcare, tourism, and international trade agreements—are laudable, how the government would implement them is unclear. They require a combination of new government funding, deregulation, and liberalization.

In the longer run, to achieve adequate domestic demand, Japan's personal consumption has to rise from its current 59 percent of GDP. That requires household income to increase from its present 64 percent share of GDP. That means wages have to increase, not just absolutely but as a share of GDP. But in an economy growing below its potential and with weak labor markets, that is virtually impossible. Given the constraints on stimulative macroeconomic policy, revitalization and accelerated growth could be achieved by comprehensive liberalization and deregulation, notably in agriculture and many services. This approach offers both an opportunity and a challenge for the new government.

Once Noda agreed to hold the Lower House election, the consumption tax was quickly passed. However, because of the late August vote of censure and Diet boycott, two essential bills were not passed: the approval of the government bonds to fund the huge 2012–2013 government budget deficit; and legislation providing modest electoral reforms constitutionally required by the Supreme Court. But when the election will be held is really unclear. One possibility is that the bills will be passed in the special Diet session scheduled for early October, before dissolution and the elections. The election might be held November 4 and December 9 Sundays, since they are propitious days; or possibly early next year.

The DPJ will suffer substantial losses in the election. The LDP expects to increase its seats but is unlikely to achieve a majority. So, which party or parties will Abe and the LDP work with to form a coalition government? One key question is how Toru Hashimoto's new political party, *Nihon Ishin no Kai* (Japan Restoration Association), established September 28, will do. Hashimoto, the regionally popular, young Osaka mayor (and former Osaka prefecture governor), is rather conservative and nationalistic. He is a proponent of decentralization and deregulation, has assembled a brain trust of well-known, capable reformers, has been developing a policy platform, and reportedly plans to have his party run some 350 candidates for the 480 Lower House positions.

The new government, whenever it takes office, may well face a stagnant economy, as exports are hit by slow foreign demand and with anemic domestic demand. It would be a nice surprise if the election brings about improved expectations about Japan's economic future. While the immediate policy challenge may well be sputtering economic performance, the new government will have to deal with Japan's persistent fundamental economic problems.

Electric Power

The Fukushima Daiichi plant disaster has had significant economic, political, and societal effects. The government and TEPCO (Tokyo Electric Power Company) nontransparently mishandled information and communications following the disaster, increasing public mistrust of regulators in general and nuclear power in particular. Several commissions have reported on the disaster and its mishandling. The Fukushima Nuclear Accident Independent Commission report in early July 2012 is a scathing indictment of a "profoundly man-made disaster that could and should have been foreseen and prevented."

The government has had to focus both on near-term electricity shortages and Japan's long-run energy policy, particularly the role of nuclear power. The government's immediate decision not to reopen the remaining 50 nuclear power plants as they closed for routine maintenance meant that by May 2012 the share of nuclear power in electricity generation went from 26 percent in 2010 to zero. Japan has had to deal with substantial electricity shortages this summer.

The summer 2012 electricity potential shortfall of 10-15 percent in afternoon peak demand has been managed successfully without rolling blackouts. This was achieved by a range of approaches: reopening inefficient thermal plants; government administrative guidance to curtail demand, especially by large users; and massive voluntary conservation efforts by households and companies alike. The Kansai area was a major challenge, since 28 percent of KEPCO's (Kansai Electric Power Company) capacity is nuclear. In July, two nuclear plants in Oi were restarted to alleviate Kansai's projected severe shortages. They managed to get through the summer without blackouts.

Government administrative guidance set targets to decrease electricity consumption by 3 to 10 percent in the region served by each of the 10 public utility companies. Power companies adjusted their contracts with most of their large institutional customers, particularly for peak hour usage. KEPCO scrambled to develop additional capacity and provided a detailed plan for outages to alert users to which two-hour period on what day they would be subject to a blackout, if necessary.

Japan is the world leader in energy conservation. Households and businesses have reduced electricity consumption with a myriad of small-scale adjustments, adaptations, and small innovations—and a willingness to suffer the discomforts of warm offices and homes. Companies and the central and local governments were asked to set office air conditioning at 28°C (82° F), and some set them even higher. This personal sense of patriotically participating in a national need is an indicator of Japan's cohesive societal strength.

Japan's long-run energy strategy will depend on a combination of ongoing technological change and government policy. Technological innovation is a major driver of energy supplies and costs in a world of rising energy demand from rapidly growing emerging economies. Globally, the most important innovation in the last decade has been to obtain huge amounts of natural gas from shale relatively inexpensively. Natural gas prices will be low globally in the foreseeable future, though the cost of liquid natural gas (LNG) for Japan is high because it is linked to the price of oil under long-term contracts. In the long-run, solar, wind, and other renewable resources will continue to decrease in price, and eventually are expected to be truly competitive with fossil fuel and nuclear power.

The government is aggressively promoting development of renewable resources. Higher costs, initially about $1.10 a month for the average household, are generally being used rather than direct government subsidies. In order to have adequate electricity supplies in Hokkaido for peak winter demands, without reopening nuclear power plants there, the government will subsidize local companies to install their own power generation facilities. From July 1, 2012, public utilities are required to buy electricity produced by renewable resources at very high prices (feed-in tariffs) under long-term contracts. The feed-in tariff for solar power is about triple, and wind power double, the cost of fossil fuel electricity. Because the above-market prices make such investments profitable, Japanese and foreign companies are building major solar and wind projects. They will be able to utilize the large amount (150 million square meters) of still unused land in some 900 industrial parks throughout Japan. The tariffs will be reduced gradually as technology and large-scale operations reduce costs.

Renewable resources are now only 1 percent of total electricity supply, excluding hydro (which is about 9 percent of total electricity capacity). Renewables are projected to increase to more than 20 percent in 2030, regardless of nuclear power policy.

On June 29, 2012, the Cabinet-level Energy and Environment Council issued a comprehensive report as the basis for public policy discussion on the government's new long-run energy policy. The report addresses the future role of nuclear power by providing three scenarios. In all of them, the shares of fossil fuels decline and renewable resources increase. The crucial options are whether nuclear power in 2030 will comprise 20–25 percent (somewhat below its pre-Fukushima level), 15 percent, or 0 percent of total electricity capacity. The economic cost evidence in the report, in terms both of GDP growth and household costs of electricity, are supportive of the middle (15 percent) option. This report was considered at public forums held in late July and early August.

Fukushima has energized an antinuclear movement, and increasingly large demonstrations have been held from early August. On September 14 the government announced a goal to end nuclear power plants by 2040, but did not address potential loopholes. On September 19, it backtracked on setting a terminal date, as the Cabinet issued a vague statement of continuing review. The LDP has supported the electric power companies, all of which have nuclear power plants except in Okinawa. Japan's energy strategy will be determined only after the forthcoming election.

Two interrelated nuclear power issues have to be dealt with soon. First, what additional existing nuclear plants should be reopened to overcome potential power shortfalls and to reduce costs? Second, how far and how quickly should nuclear power downsizing proceed? Will power companies eventually be allowed to reopen and operate most nuclear plants until their normal 40-year lifetime is reached? If so, 18 existing plants would be in operation in 2030. If not, they will have huge balance sheet problems as they write off the value of their nuclear power plant assets. If their nuclear power plants are not re-opened, four public utilities in addition to TEPCO will become insolvent. Further, will the three nuclear plants currently under construction be allowed to be completed and opened, and run for their 40-year lifetime?

Shifting from nuclear power and engaging in conservation have both benefits and direct and indirect costs—economic, international commitments on CO_2 emissions, and health. Thermal fuels are more costly and renewable sources even more so. Under any option, electricity costs and prices will rise, and Japan already has some of the highest rates globally. Fuel imports will increase; supply security is an ongoing concern. Inadequate or unreliable electricity supplies are incentives for manufacturers to relocate abroad. In some instances, conservation has been seriously overdone. More elderly people die of summer heat or winter cold, and very warm work places reduce productivity. More than 21,000 people were hospitalized for heatstroke in July, a 17 percent increase over disaster-stricken July 2011.

Different methods of producing electricity have different health consequences. The Fukushima Daiichi disaster naturally is a deep emotional and political issue for the Japanese public. Deep fear of radiation as a consequence of the disaster will certainly constrain the use of nuclear power, even though the health consequences of radiation exposure following Fukushima Daiichi are limited, according to radiation specialists. The initial intense radiation plumes from the nuclear accident were followed by low levels of radiation until total cold shutdown of the four reactors was achieved in December 2011. Hiroshima, Nagasaki, and Chernobyl provide data on the effects of high emissions of radioactive materials. But only Chernobyl and Fukushima Daiichi provide data on persistent low levels of radioactive emissions. Thus, estimates of the deaths and illnesses attributable to Fukushima Daiichi have a wide range. A recent study by Professors John E. Ten Hoeve and Mark Z. Jacobson of Stanford University estimates that 125 people globally, 94 in Japan, will eventually die from exposure to the Fukushima radiation.

Replacing nuclear power with fossil fuels will cause many direct deaths in Japan from air pollution, but that has not entered the public policy debate. My colleague David Weinstein, using data based on tables in the reputable medical journal *Lancet*, estimates that ending nuclear power electricity production completely in Japan and replacing it with natural gas will result in 747 Japanese deaths *every year* from air pollution, replacing with oil 4,891 deaths, and with coal 15,240 deaths. Renewable sources are much safer for people, but they will become significant only in the long run. Reducing coal's present 28 percent share of electric power and replacing it first with natural gas and eventually with renewables would have significant health benefits. The problem is that imported coal is abundant and cheap.

Trans-Pacific Partnership and Trade Liberalization

With the multilateral Doha Round of trade liberalization moribund, Japan has rather slowly pursued bilateral and regional FTAs (free trade agreements) or the weaker EPAs (economic partnership agreements). Japan now confronts two models for Asia-Pacific liberalization: the comprehensive Trans-Pacific Partnership (TPP) of 11 nations, led by the United States; and an "Asian track," exemplified by Japan's trilateral trade negotiations with China and Korea, presumably with eventual inclusion of the 10 ASEAN nations.

The countries engaged in TPP negotiations aim to create an extremely comprehensive, strong FTA. The U.S. proposes a "platinum standard," not just of complete free trade in goods and services including agriculture, but the setting of high standards for intellectual property rights, government procurement, state-owned enterprises, labor and environmental standards, and other measures less directly trade related. The trade components alone would significantly benefit trade and economic growth for all its members.

The U.S. policy position is controversial. TPP members have rebuffed certain U.S. proposals. The negotiations have been more secretive than usual, enhancing anxieties. My colleague Jagdish Bhagwati argues that TPP should be limited to direct trade matters in order to make it possible for China and India to join in due course; intellectual property and other matters should be in a separate agreement. China opposes TPP. One danger is that TPP be perceived as anti-China rather than pro-trade liberalization. Given its size, Japan's participation in TPP would be important for the current members; together they would comprise 40 percent of global GDP.

TPP is a hot topic in Japan, and for good reason, since trade liberalization is supported by some members of the DPJ and LDP, but opposed by agricultural and other powerful vested interests. Prime Minister Noda indicated earlier that Japan would join the TPP negotiations, but with the election looming, he has not moved forward. If the government decides to join the TPP negotiations, it would be next spring at the earliest. The risk is that if Japan does not join the negotiation process, it will not be able to shape the rules before they become final.

Joining TPP will force Japan to carry out much-needed structural and institutional deregulation and liberalization. Agriculture's political resistance has been the stumbling block for years, preventing Japan from embarking on any significant trade liberalization agreements. Health care, other professions and those constraining Japan Post's full privatization also oppose joining TPP.

Agricultural reform will directly affect rural villages and towns far beyond the direct effects on the 2.6 million farmers, who comprise only 4 percent of the labor force and produce only 1.5 percent of GDP. The National Federation of Agricultural Co-operatives (the JA group) is politically and economically powerful, and an effective lobbyist. It has 9.5 million members, of whom 4.8 million are associate members. JA is a huge trading and financial services conglomerate serving rural and small-town Japan. It handles almost half of the sales of rice, an important, heavily protected crop that provides a quarter of agriculture output. JA owns a large bank, Norinchukin, and provides a wide range of insurance products.

Agriculture reform is necessary. The average age of Japanese farmers is 65, and there are few new young entrants. Farm households derive most of their income from nonfarm activities; only 15 percent are full-time farmers. Implementation of trade agreements is on gradual schedules that can spread over 10 to 15 years. That is sufficient time for Japanese agriculture, which is already adjusting to its demographic realities.

In May 2012, Noda joined the leaders of Korea and China in agreeing to enter trilateral trade talks, which will be less comprehensive than TPP. While Japan brings considerable historical baggage and currently politically explosive territorial disputes to the negotiations, each of the three countries has political, as well as economic, interests in pursuing negotiations, scheduled to start in fall 2012; however they probably will be delayed. In addition, the European Union has decided to begin trade agreement negotiations proposed by Japan.

Japan is in a political bind. It does not want to be left out of trade liberalizations, but it has not yet committed to enter TPP. Because of its political inability to engage in major agricultural reform soon, even though such reform has to be an integral component of its revitalization, Japan may gradually proceed with weaker agreements with China and Korea and with the European Union. It is also in Japan's interests to proceed vigorously on the TPP track.

Financial Scandals

With management in autonomous control of most of the 3,481 Japanese companies listed in the soon-to-be-merged Tokyo and Osaka stock exchanges, corporate governance in Japan is weak. Japan is ranked 96 of 135 countries in a global corporate governance index. With permanent employment persisting, few mid-level hires, and few outside directors, each company has its own deep corporate culture, a source of management strength. Managers typically consider themselves stewards of the company's survival and well-being. In many respects corporate social responsibility is real, if somewhat narrow. Companies look after their employees and their families; they try to keep customers satisfied; they usually have good, if tough, long-term relationships with suppliers and subcontractors; they are good members of local communities; and they provide stable dividends to their shareholders. However, corporate profitability on average has been very low over the past two decades. Many firms have invested in unneeded new facilities domestically, and have yet to figure out how to invest abroad successfully.

The high-profile scandals at Olympus, Daio Paper, TEPCO, and AIJ Investment Advisors have been superseded by insider trading, Libor manipulation, and other financial institution scandals.

Insider trading is evidently widespread in Japan, and some Japanese financial institutions are deeply involved. Leaks apparently have been regarded in many financial institutions simply as a service to major clients in opaquely-defined systems of information flows. Japanese laws regarding insider trading are weak and full of loopholes, and the financial and other penalties are laughably minor. This year, cases have involved short selling of company shares. Short selling as such is legal; it helps make financial markets more efficient. But selling based on advanced knowledge of a company's announcement that it plans to issue new shares is illegal; such news typically results in an immediate drop in the company's share price.

Japanese regulatory authorities have asked five major Japanese banks and seven foreign banks in Japan to submit compliance reports. The investigators thus far have identified three major Japanese brokerage firms and three asset management companies as being involved in insider trading, and several Japanese firms and some foreign firms have already been penalized.

The key global benchmark interest rate is Libor, the London interbank offer rate. There are about 150 Libor rates for 15 maturities, from overnight to 12 months and for 10 currencies, including the dollar, euro, and yen. Libor is essential; it is used in setting interest rates on many loans, mortgages, and derivatives throughout the world.

The various Libor rates are based on reports of some 18 global reference banks, including Japan's three megabanks and Norinchukin. Since these reports represent offers, not actual market transactions, as a benchmark, Libor is inherently flawed; but nothing else has wide general acceptance. Appalling behavior by major U.S. and European banks has once again been exposed; thus far 10 have been implicated in manipulating Libor. In early August one Japanese bank was implicated. The regulatory authorities in the U.S., U.K., and Japan have investigations under way for all global financial institutions. At least half of the banks, though none Japanese, are being sued for manipulating Libor yen, used in the Euroyen market and for yen overseas derivatives.

Supplementing Libor, financial institutions use the Tokyo interbank offer rate (Tibor) in Japan for domestic yen and Euroyen benchmarks. In December 2011 the FSA penalized the Japan units of two foreign banks for an employee working at first one, and then the other, attempting to manipulate Tibor; neither bank is currently a member of the Tibor reference system. Of the 16 banks setting the yen Tibor, 15 are Japanese, as are 12 of the 15 for Euroyen Tibor. Participants are selected by the Japan Bankers Association, which makes the Tibor estimates. This interest rate benchmark scandal is still in its early stages. Thus far it is a global, but not a major Japanese, scandal.

Conclusion

Japan, the United States, and Europe are in the throes of major economic and political uncertainties. Each suffers from a lack of domestic demand, and misaligned exchange rates that reinforce balance of payments imbalances. For Japan deflation is also a problem. Public investment is needed to improve education, R&D, and, in some countries, major infrastructure overhauls. Without renewed fiscal stimulus, developed country return to recession is a real concern. Japanese consider the revitalization of their economy to be a major challenge.

Summer has been a period of intense and increasing political turmoil, with continued policy gridlock and major uncertainties. When will the Lower House election be held? What will be the role of the New Komeito party? Toru Hashimoto's Japan Restoration Party is attracting great attention and considerable political support. How will it do in the election? What will the policy platforms at all the parties be? It is clear the DPJ will suffer major losses and lose control of the government. The LDP will gain seats and probably will lead the government, but its chances of winning a majority are slim. How well the LDP does in the election will determine which coalition partners it will need in order to control both the Lower and Upper Houses.

The new government will have to address energy policy, the role of nuclear power, and trade liberalization, as well as Japan's still-unresolved long-run structural issues, including growth, fiscal consolidation, deflation, weak labor markets, insider trading, and other financial market reforms.

Japan's recovery, interrupted by the 2011 earthquake triple disaster, proceeded well in the first quarter of 2012 but slowed really significantly in the second quarter. Summer evidence and market forecasts suggest a weak performance for at least the second half of 2012. My concern is that the new government will be confronted with a sputtering economy, with inadequate domestic and foreign demand, and continued political infighting. How revitalization occurs will depend on the policies of the new government, and its ability to carry them out. With a mature economy and a declining population, the key to Japan's economic performance is growth in GDP per capita and per worker, since growth of the economy will be low. Increasing labor productivity is the key to achieving good, sustained growth.

After two "lost decades," it has become easy to underestimate Japan's strengths and overstate its problems. However, Japan will continue to be not only an Asian but a global technology leader. It has a strong, vigorous private sector. Its standard of living is high and will continue to rise, though probably only slowly. Its people share a strong society, which responds well to sudden, adverse shocks. Japan's economy will continue to be one of the world's five largest for at least the next two decades.

Japan is at the forefront of an ongoing global demographic transition. Its population is rapidly aging and slowly declining; its labor force peaked 17 years ago. This transition is a fundamental reality. To increase fertility to stable population levels requires Scandinavian-type familial, social, and economic adjustments that Japan may accomplish, but only in the very long run. With an abundance of underutilized female and older workers, labor will not be in short supply in the foreseeable future. However, who will do the 3-D jobs (dirty, dangerous, dull) is always an issue in Japan as in other high-income economies. Substantial immigration is unlikely; Japan will adjust in other ways.

Economic revitalization and creation of domestic demand requires comprehensive and deep economic deregulation and liberalization. Japanese policymakers, even in a new government, are unlikely to have the political will to carry out a major fiscal and monetary macroeconomic policy package such as I have long proposed, unless a government bond market crisis occurs. Deregulation will create new business opportunities, stimulate new business investment, help smaller firms, and create jobs. The political dilemma is that vested interests are so strong, not only in agriculture but in some service sectors as well.

Internationally, Japan's staunch alliance with the United States will continue, and bilateral business relationships will be stronger than ever. China, Japan's largest trading partner, provides both ever-increasing economic opportunities and political challenges. Japan needs to liberalize trade further. It should join TPP and negotiate trilateral agreements with Korea and China, as well as the EU. But policy initiatives continue to be severely constrained by domestic protectionist interests.

I do not see a well-defined vision in Japan of the country's longer-run goals. Many Japanese are inward-looking. It is such a comfortable, easy, enjoyable environment, and the domestic market is large. Japanese do not really want isolation, but many see benefits in being an insular nation with a distinctive language and culture. Others are outward looking, as shown by Japan's being a major supporter of, and player in, world economic and financial markets. Fewer young Japanese are studying abroad, but that is because there are fewer young Japanese; the proportion of the cohort going abroad remains stable, slightly above 5 percent. However, those studying in the United States have declined from 3.1 percent in 2000 to 2.1 percent in 2009. Japan's greatest international weakness is the general limited capabilities in English and other foreign languages. Japanese scores on TOEFL (the test of English as a foreign language) are lower not only of those students in Korea and China, but of 24 other Asian countries.

I am not particularly optimistic about the Japanese economy for the next several years; I am concerned about continuing economic policy gridlock and inaction. Despite my best hopes, I anticipate that the new government will only muddle along. The slow recovery in the U.S. and the ongoing difficulties in Europe are dampers.

In the longer run, nonetheless, I continue to be optimistic about Japan. As its history demonstrates, it has a record of being a strong, highly motivated, effective society, demonstrably capable of responding well to and overcoming adversity.

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