THE ORIENTAL ECONOMIST
REPORT
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A look back on our hits and misses

Twenty years of *TOE*

The very first issue of *TOE* came out 20 years ago, in March 1997 (see a reprint of the lead from our first issue on pg. 5-6). And this is our last issue for at least 18 months. It's been a labor of love to analyze day-to-day developments, but we're taking a sabbatical to write a book on the potential role of start-up companies in catalyzing Japanese revival. This makes it the perfect time to step back and look over the past 20 years: what we got right; what we got wrong. And, more importantly: what Japan got right; and what it got wrong.

Our mantra

TOE's coverage of Japan has been guided by a consistent outlook, nuch of which, we like to think, has passed the test of time. It can be summed up in the following mantra: No political stability without economic revival; no economic revival without structural reform; no structural reform without political leadership dedicated to reform; no reformist leadership without institutional rejuvenation in politics and business, including a transition from one-party democracy to truly contestable elections among parties that alternate in power.

PERSPECTIVE

We think we have been on target regarding the economic side of things, but our track record on the politics has been mixed. On the economic side, Japan has clearly been unable to revive itself without structural reform. Assorted fiscal and monetary fixes have proved necessary, but woefully insufficient.

On the other hand, even though some people characterized us as pessimistic—a perception we hate—we proved too optimistic on the political response to the "lost decades." In our 1998 book, *Japan: the System That Soured*, we wrote: "While nothing dictates that reform will succeed, it's hard to imagine that a nation as intelligent and resourceful as Japan could let itself fail…In all likelihood, Japan will not reform within five years; within twenty, it almost certainly will." We felt that the Liberal Democratic Party (LDP) was organized as a catch-all coalition to distribute the fruits of growth and would fall from power in an era of stagnation. Back in 2009, when the LDP was, for the first time, tossed out by the voters, we thought that Japan was on the road to the contested elections that we anticipated, and so we might meet the twenty-year timeframe. Cleary, we were wrong.

"Lost decade" turns into "lost quarter century"

The "lost decade" has turned into a "lost quarter century" and there is no quick end in sight. We have long argued that Japan's economic malaise was not caused by mere policy mistakes, but by deep-seated structural and institutional defects that fettered growth on both the supply side and the demand side. Without wholesale structural reform, economic rejuvenation is impossible. The notion in Abenomics that Japan's malaise could be cured by reviving inflation is just the latest is a series of chimeras fed by the desire to avoid taking politically difficult steps. Let us be clear: we have never argued that Japan should do structural reform instead of macroeconomic stimulus; rather, we insisted that neither could work without the other.

The supply side of the issue is this: how fast can Japan grow over the medium term with full employment of its workforce and full use of its physical capacity (factories, offices, roads, etc.)? This is hard to estimate with precision. The Cabinet Office puts medium-term potential growth at just 0.8%, down from 4-5% in the 1980s and 1% by the late 1990s. The OECD puts potential growth at half that pace: just 0.4% (see top chart on pg. 2).

The only path to reviving better growth rates is a productivity revolution. In any country, long-term growth is the sum of three factors: 1) how fast work-hours are growing; 2) how fast capital stock (e.g., factories, stores, offices, infrastructure, etc.) is growing; and 3) the productivity of that labor and capital, which is called Total Factor Productivity (TFP). If capital and labor are both growing 1% each year and TFP is growing 1.5% per year, total growth will be 2.5%. In Japan's case, the decline in the working age population and negligible growth in investment means that virtually all of its GDP growth has to come from growth in TFP (see bottom figure on pg. 2).

The good news is that there is a lot of low-hanging fruit. At present, Japan's output per work-hour is about a third below the OECD average. Just bringing Japan up to OECD standards over the next two decades would propel a lot of growth and a big improvement in living standards.

Throwing good money after bad

Instead of making the institutional changes in politics and business necessary to raise TFP (more on this below), Japan has repeatedly tried to offset this demographic slowdown by pouring on more and more capital investment. But this is a path with diminishing returns and therefore has proven ultimately unsustainable. Giving each worker a PC will enable them to produce more. But giving each worker two PCs won't do as much. On the other hand, giving each worker a more capable PC—which raises TFP—will do a lot.

Companies decide how much new investment to undertake based on how much profit they can make on that investment. One measure of this is Return-on-Assets (ROA). The latter has fallen in Japan from 5% in the 1980s—a low level by rich country standards—

to just 3.5-4.0% these days. Couple that with the declining number of workers and slow sales growth within Japan and it's no wonder that firms are hesitant to invest. Ultra-low interest rates cannot get Toyota to build new factories in Japan if it cannot sell more cars and if Toyota finds it more effective to reach overseas markets via overseas plants.

Consequently, says the Cabinet Office, the trend growth rate of capital stock is a negligible 0.1% a year (see again bottom figure on this page). For most of the postwar era, capital stock has grown faster than GDP; now, it will grow more slowly. We would not be surprised to see this figure become negative at some point.

Improving TFP growth

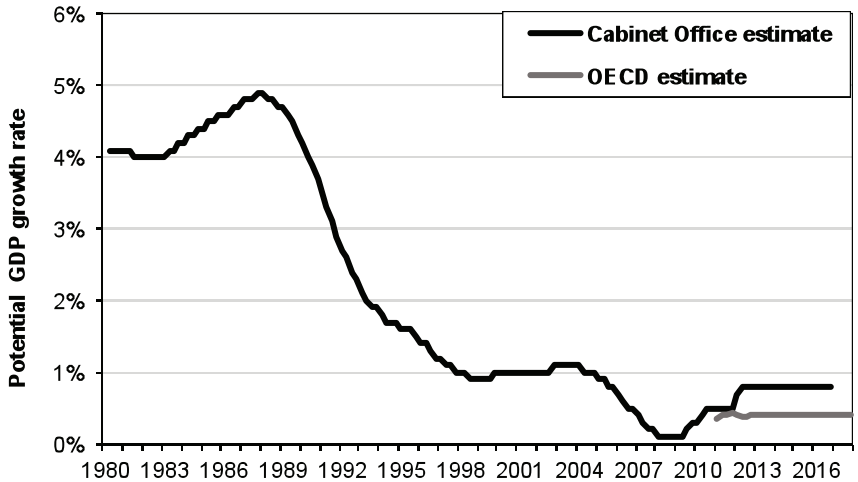
How can Japan improve TFP growth? This is where institutional reform comes in.

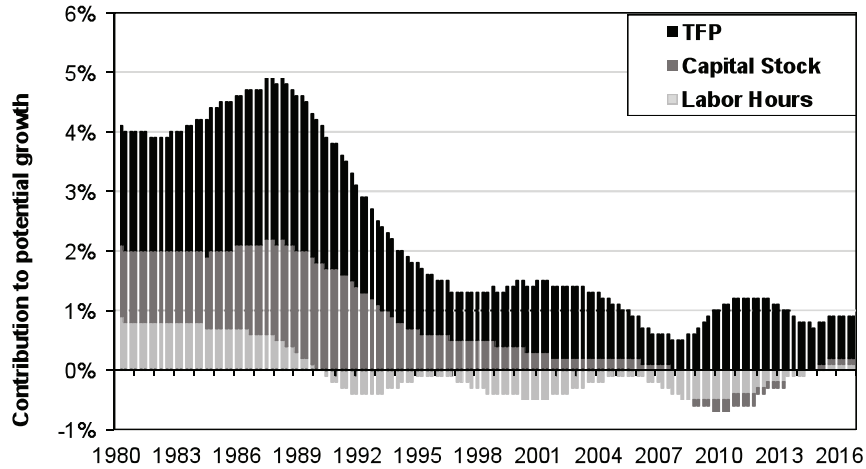
One way is improving "human capital," i.e., giving workers more years of education, and better-designed education, but also more training at the firm. The mechanics at your local auto repair shop need a lot more training in sophisticated electronics than their counterparts 30 years ago. Unfortunately, as firms rely more and more on non-regular workers, they give those workers far less training than they give to regular workers.

There is also the productivity of workers that comes from an education that instills initiative as well as human resource policies at firms that do the same. This issue falls outside our area of expertise but specialists whom we trust say Japan falls down on these two issues. The authoritative PISA test on 15-year-olds' educational achievement across dozens of countries shows that, in 2015, Japan came in second in scientific literacy and fifth in mathematical literacy, and yet, Japanese students score below the OECD mean on two indicators that predict how creatively students will apply their knowledge: first, their enjoyment of science and secondly, their "epistemic beliefs" that go more deeply into the "why" behind the scientfic facts. Moreover, only 18% of Japan's 15-year-olds said they want a science-related job by the time they are 30 years old. The OECD average was 24.5%.

All in all, growth in human capital is stagnating, and perhaps even going into reverse. Given that the human mind is Japan's greatest resource, the waste of this resource is a harbinger of trouble.

A second method is to embrace more modern technology. However, study after study has shown that Japanese firms get a lot less benefit than their counterparts in the US, and parts of Europe, from investing in either the new technology that they buy, or the innovations they make themselves. Sony spends a lot on R&D but it has lost the ability to generate new world-class products. All too often, these firms used modern technologies as mere labor-saving devices to cut costs, rather than "reengineering the firm" to take full advantage of the technology's potential. For example, modern retailers use electronic cash registers, not just for getting people though check-out lines faster, but also for a better record of what customers like and don't like, so that they can adjust what's on the shelves. As we reported in our March lead, among 14 OECD countries, Japan comes in fifth in its spending on "knowledge-





Source: Cabinet Office **Note:** For definition of potential growth in top chart and TFP (Total Factor Productivity) in bottom chart, see text

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based capital" (KBC)—R&D, software, and assorted "economic competencies" of firms—at 8.1% of GDP. But it comes in 11th in the contribution of KBC to annual productivity growth at just 0.3%. It comes in dead last in terms of the productivity growth per percentage of GDP spent on KBC.

Business reform

The third, and for Japan the most important, way to boost TFP growth is institutional reform that increases the force of competition in the business sector. Instead, Japan is going in the opposite direction. We don't have exact statistics, but we get the sense that, in sector after sector, the same four or five firms that dominated decades ago still dominate today. For example, according to the OECD, only a fifth of Japan's largest companies (measured by market capitalization) have been created since the 1960s, compared with three-quarters in the US. Few start-up firms scale upwards even ten years after their market entry.

Moreover, in part due to mergers, some of them promoted by the government—and even financed by it—the share of the market dominated by the top three or four firms has grown in sector after sector: from steel and petroleum refining to semiconductors and liquid crystal displays.

Trade holds a mirror up to Japan

Japan's trade performance holds up a mirror to the decline in Japan's prowess.

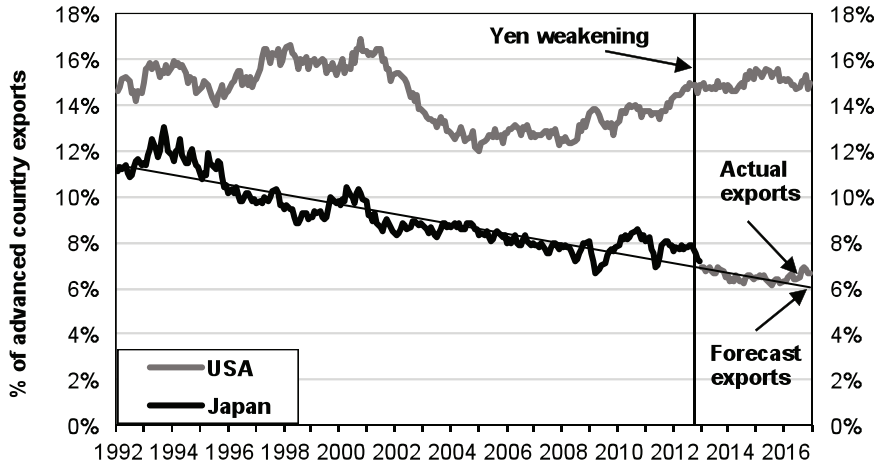
One indicator is Japan's declining market share in global exports. In some sectors, like electronics, this is because Japan's leading firms no longer set the global product trends. In others, like autos, Japanese firms are still leaders, but Japan is no longer the best base for their global production.

As a result, Japan's share of global exports by rich countries has nearly halved from 11% in 1992 to 6% in 2016. By contrast, the US share, which was 15% in 1992, is still 15%. As the trend line in the top chart on pg. 3 shows, neither the rise nor the fall of the yen have made much difference in this fundamental indicator. This is not an artifact of the rise of China, because it includes only exports by rich countries.

The hope that a weaker yen would solve Japan's export problems has proved yet another chimera in Tokyo's endless search for the easy solution.

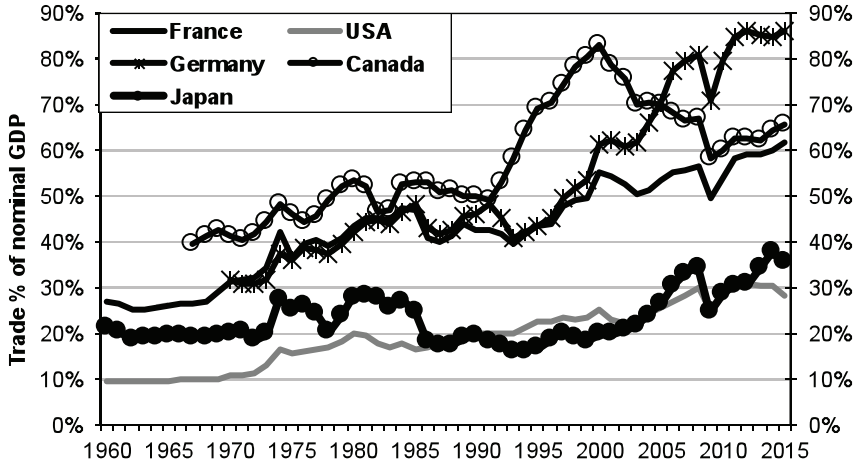
A second indicator is the size of total trade (exports plus imports) as a share of GDP. Historically, countries that trade more have higher growth, mainly because that exposes a country's firms to fiercer competition. In Japan's case, its sectors with greater exposure to the international market, through exports or competing imports, have higher

Weak yen can't cure exports' falling market share

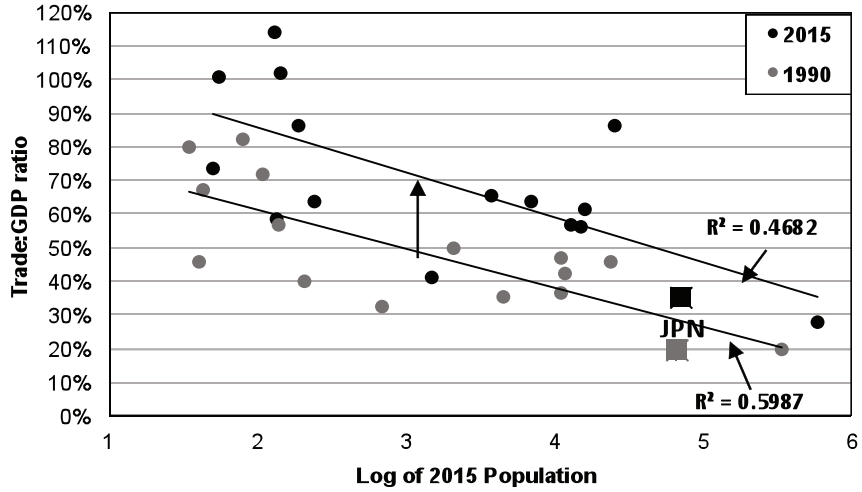


Source: IMF **Note:** For explanation of actual vs. forecast exports in 2013-16, see text

Japan trade:GDP ratio almost doubles . . .



. . . But still lags far behind rich country trend



Source: World Bank **Note:** The trade:GDP is partly a function of a country's population; see text for further explanation of bottom chart

levels of productivity, relative to global benchmarks. In addition, few countries have successfully undertaken economic reform without embracing globalization.

The good news is that Japan's trade:GDP ratio, after stagnating for years at around 20%, has now almost doubled to 35-37% (middle chart on pg. 3). The bad news is that Japan's improvement still leaves it behind the global curve (bottom chart on pg. 3). Rich OECD countries have all increased their trade:GDP ratios during 2000-15. If Japan had kept up with these trends, its trade would amount to about 47% of GDP.

Economic anorexia

Back in the mid-1990s, we coined the term "economic anorexia" to describe Japan's chronic shortfall in private demand. In other words, Japan has been chronically unable to consume all that it produces.

The Japanese establishment blames this shortfall in demand on "penny-pinching" Japanese households that allegedly hold back on spending. If this were true, then we would have seen an increase in the household savings rate. After all, not to spend is to save. But, as we can see in the top chart on pg. 4, household annual savings have steadily dropped from 8-10% of GDP in the early 1980s to a negligible amount these days. The biggest constraint on consumer spending is stagnant consumer income. If people had more money, they'd spend more money.

The real source of "penny-pinching" lies in company boardrooms. In a healthy economy, households save and corporations borrow from them to finance their new investments. In the 1980s-through-early 1990s, firms did borrow but, except for the bubble era, not enough to absorb household savings. Worse yet, since the mid-1990s, corporations stopped borrowing altogether. Instead, they became huge savers to the tune of 6-8% of GDP (see again top chart).

The reason is that firms do not have enough profitable opportunities to invest all of their cash flow, and yet dysfunctional capital and labor markets do not compel these firms either to return the excess cash flow to household investors and savers, or to raise wages. Had they done so, that would have improved consumer spending. If companies are not plowing back into the economy the cash flow that they draw from it, then there is not enough demand in Japan to buy all the products that these firms produce.

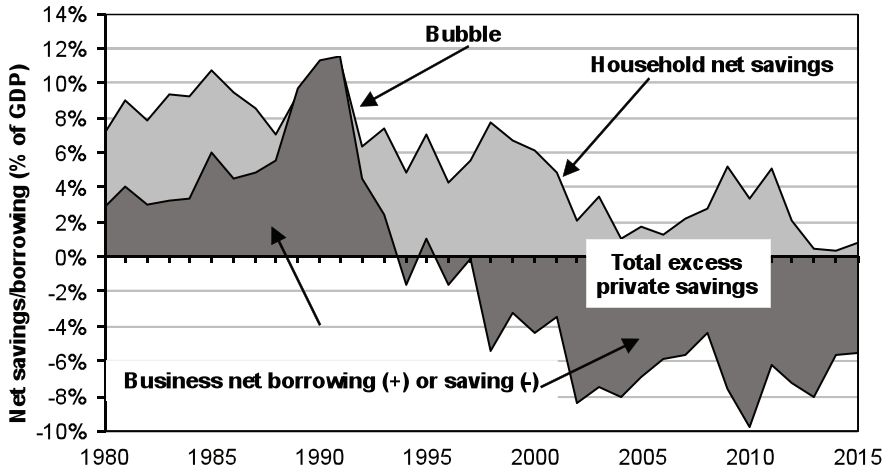
Because of all the money lying fallow in corporate accounts, the total shortfall in private demand—households and companies combined—now regularly totals 6-10% of GDP even in non-recession years (see the thick black line in the bottom chart).

If firms do not spend their money on new investments, and households do not have enough money to spend, then the only way to avoid chronic recession is to find another source of demand. Japan has used two sources: 1) trade surpluses—in which foreigners buy more from Japan than Japan buys from them; and 2) budget deficits, in which the government borrows from households and firms in order to spend more on goods and services than it takes in via taxes. As we can see in the bottom figure, year after year, the budget deficit and trade surplus combine to offset the shortfall in private demand. In years when the trade surplus is smaller, the budget deficit has to be larger. In short, contrary to the statements of Japan's leaders, its chronic budget deficits are not the cause of its economic problems, but a symptom of them. They are a direct reflection of economic anorexia.

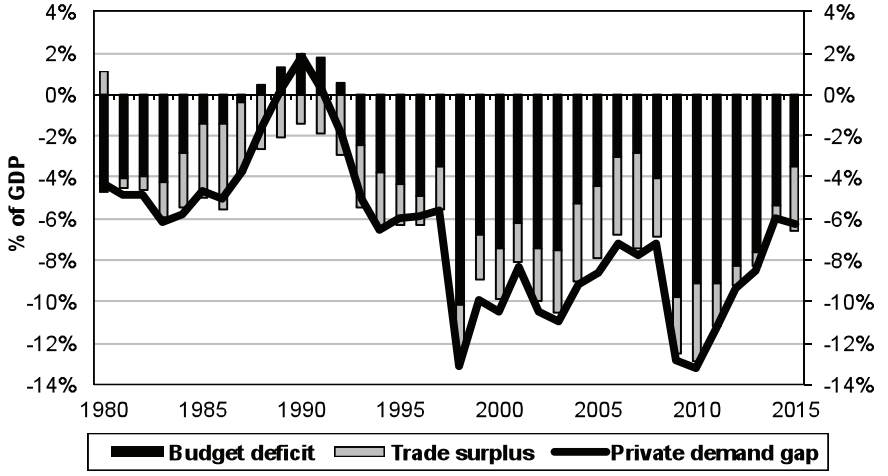
Why no solution?

Ever since Junichiro Koizumi in 2001, Japanese leaders have claimed to believe: "No growth without reform." Nonetheless, none have acted sufficiently to implement real reform (partly for the reasons we outlined back in 1997; see pg. 5-6). Abe's "third arrow" is nonexistent. We believe it will take a political transformation, the rise of multiparty democracy with parties alternating in power, for the needed reforms to come. Unfortunately, the Democratic Party of Japan (DPJ) utterly failed to perform as a viable alternative during its 2009-12 tenure, and no new alternative has yet arisen. (RK)

Excess savings by business, not households . . .



Has to be offset by budget deficits & trade surpluses



Source: Cabinet Office **Note:** See text for explanation

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No Easy Reform Options for Japan

After dropping from sight for months, Japan has made it back to America's fickle radar screen. Reports of stock market crashes and impending banking crises have a way of doing that.

This time, however, there's a new twist to the attention being focused on Tokyo. A host of newspaper and magazine accounts tell us that Japan's economic health is now so poor that deep reforms can no longer be avoided. Prime Minister Ryutaro Hashimoto will lead the charge to change Japan.

Could this be true? Anything's possible, but it's unlikely any time soon.

Japan's problems are indeed severe. The country is now entering its seventh straight year of economic malaise. A recent Economic Planning Agency report stated that "structural reform is a race against time, and Japan is clearly falling behind in this race." No less an authority than the Ministry of International Trade and Industry (MITI) says that without sweeping reforms, growth will steadily decline to 1.8% per year over the next decade, and a dismal 0.8% thereafter.

PERSPECTIVE

In a country whose institutions are so dependent on high growth, stagnation is a recipe for political and social instability.

But Japan is not about to drop into the Pacific Ocean. The country can probably limp along for quite a while and put off serious reform. Japan may very well be stuck with the worst of both worlds: growth so low as to preclude vitality, but not so low as to compel reform.

Let's put the problem in perspective. Japan's vitality is being slowly sapped by a bad marriage of obsolete economics and a political system based on a convoy ideology.

Think of Japan's banks. With one exception, no bank, no matter how mismanaged and loaded with bad debts, has been allowed to fail. Instead, strong banks were compelled to dilute their own resources by absorbing their weaker cousins. As a result, the whole banking system is wobbling under the weight of bad debts.

Convoy crisis

Now, project that convoy ideology on to the whole economy. Japan's growth is lagging because its vibrant industries like autos and electronics are forced to subsidize woefully inefficient industries like construction and retail.

Here's how it works. When Japan was in its economic catch-up phase in the 1950s and '60s, its industrial and trade policies created a genuine miracle. Export industries that met the test of global competition led the way, fueling growth and absorbing workers from declining industries. This is the Japan that created the illusion of an economic juggernaut with a superior economic system.

But there has always been another Japan, where the majority of Japanese still live and work. This is the Japan of very backward domestic industries that are shielded from both domestic and foreign competition. Many of these industries — construction, cement, paper, glass — are rife with cartels, many of them illegal, that collude to fix prices and block competition. The result is a deformed economy, a dysfunctional hybrid of super-strong export and super-weak domestic industries.

In the beginning, the large export firms exploited the cheap labor of domestic industries. But as Japan grew richer, wages went up in the domestic industries while productivity lagged, thereby raising costs for exporters. Every Toyota factory operating in Japan must pay prices far beyond global standards for the cement in the building, for the steel, rubber, plastic and glass that go into the cars, and even for the electricity to run the plant. The export sectors, in convoy fashion, increasingly subsidized the weak.

Now, for Japan's export industries, the weight of low productivity in most of the economy is too much to bear. The export sector can no longer generate sufficient momentum to cover up for the deficiencies of the low-productivity sectors. Export industries have found themselves caught between the 'rock' of high domestic prices and the 'hard place' of repeated bouts of upward pressure on the yen. Many have fled Japan, leaving behind weaker industries to predominate. The economy has stagnated, and unemployment has grown.

A convoy can go no faster than its slowest boat. With the slowest boats getting even slower, the Japanese convoy is crawling.

The reform dilemma

Why has reform been so difficult to achieve? Part of the problem is Japan's infamous 'iron-triangle' — the powerful coalition of politicians, bureaucrats, and small busi-

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ness interests whose existence depends on continuation of the status quo.

Small retail shops, auto inspection shops, trucking firms, construction companies, farmers — all lean heavily on the existing regulatory system to survive. The bureaucrats who promulgate these regulations would not exist if not for their power to regulate. Scores of politicians depend on kickbacks from the protected industries to finance their election campaigns, and they do not want to bite the hand that feeds them. That is the main reason why Prime Minister Ryutaro Hashimoto has straddled the reform issue, offering grand visions but doing little.

And Hashimoto is not alone. The whole conservative camp in Japan, which includes elements of the LDP and the New Frontier Party (Shinshinto), is a mixture of reformist and non-reformist forces. The same goes for the liberal camp, which includes sections of the LDP, the Pioneer Party (Sakigake), and the Democratic Party (Minshuto).

Neither the conservative nor liberal camp is categorically in favor of reform. The minds of both camps say reform. But the bodies hesitate.

The reason is simple. Opening up an economy that has long been protected would not be a pain-free process. The lives of many people in Japan would be dramatically changed. Many existing firms would go bankrupt. New firms would form. People would have to change jobs. Listen to the forecast of reform economist Iwao Nakatani: "According to my calculations, deregulation would wipe out 10 million jobs, but generate 11 million new ones."

Change on this scale would be disruptive for any society, but particularly in Japan, where stability and predictability are so highly valued. Eventually Japan as a whole would benefit from reform through increased productivity and rising national income. But such lofty goals provide little comfort to those who stand to lose their jobs, even temporarily.

Indeed, such insecurity runs right against the grain of Japan's convoy ideology. Up to now, Japan's political system has managed to hide the most ugly aspect of market economies: that they produce losers as well as winners. "Japan is organized so that society's losers don't feel like losers," says Takashi Kiuchi, chief economist of Long-Term Credit Bank.

Like the European social democracies, Japan has redistributed income. But Japan's 'socialist conservatives' did not depend on taxes and government programs. Instead, they utilized high prices, which ensured that resources would flow to the private sector, and the private sector in turn has been able to maintain high employment levels. High prices made low unemployment possible. Redistribution of income did not look like redistribution. Society's losers did not feel like losers. In effect, Japan was run like a giant commune.

The system worked well during Japan's high growth era. The interests of export and domestic industries were compatible. But now those interests have diverged, and the system has sided with the latter. "Many people think the objective of the Japanese government is the promotion of large corporations in strategic industries," says Professor Yukio Noguchi of Tokyo University. "But I see it as protection for low-productivity sectors." A formerly flexible system is now inhibiting the transition from declining to rising industries, eroding the productivity gains needed for high growth.

Ironically, the effort to preserve employment is precisely what is causing rising unemployment. In 1996, Japan suffered its third consecutive annual rise in unemployment. The 3.4% mark was the highest in 45 years. (The figure remains deceptively low, due to the government's conservative methods of counting the unemployed.)

Fear of losing

There are clear signs of reform in Japan — from promise of a Big Bang in the financial sector to shakeups in the highly-protected taxi industry.

But the prospect of being a loser in this 'new Japan' has millions of Japanese very scared. The problem goes beyond the 10 million who would temporarily lose their job. Millions more fear they might be one of those 10 million. The net result is an ambivalence about reform all over Japan — a recognition that it is necessary, but a fear of what it will bring.

"We need a general shift in consciousness," says Taroichi Yoshida, the former president of the Asian Development Bank. "What concerns me is that if we really allow free competition there may be a very strong negative reaction from parts of society. I worry that not many Japanese have the guts to rely only on themselves. Yet without that kind of independence I doubt if we'll do too well with the market economy."

Where is the vision?

In the end, much will depend on whether Japan's political leaders can provide a clear vision of the future. Thus far, they have signally failed to do so.

The view from Tokyo reveals no good model to follow. US-style capitalism concentrates so much on speeding up the train of economic progress that it ignores the people who are run over by the train. European-style capitalism has a generous social safety net, but progress lags, national budgets are severely taxed, and unemployment hovers at double-digit levels.

In short, Japan is stuck between an economic system that no longer works, and alternative models that are not appealing.

There is something attractive about a society that doesn't let people fall through the cracks just because they aren't as efficient as others. It is not surprising that many people in Japan want to hold on to it. To many, a frayed security blanket is better than no blanket at all.

It will take time to see whether Japan can manage to combine economic efficiency with its existing values. Until a clear vision of a 'new Japan' emerges, reform is likely to proceed very slowly. *(Richard Katz)*

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