

Rebalancing the world economy: Japan

Stuck in neutral

Aug 13th 2009 | TOKYO

From *The Economist* print edition

Japan's long-standing inability to rebalance its economy is bad for the world and even worse for its own people. The last in our series

NO CITIZENS in the rich world take as few holidays as the Japanese. No wonder. This week, as millions left the cities for an annual pilgrimage to villages where they venerate the souls of their ancestors, many were likely to be stuck in 40-mile traffic jams on oven-like expressways, cursing the midsummer heat.

Such misery is common during the Buddhist festival of Obon, but it is worse this year. One of the government's aggressive measures to alleviate the economic crisis is to encourage people to spend money on hotels, transport cafés and other forms of leisure. To do that, it has slashed the cost of toll roads to almost one-tenth of their normal level, attracting yet more people on to fume-choked roads. This is not the first time Japan's leaders have tried to emphasise the fun side of life to strengthen Japan's domestic economy and leave it less vulnerable to the vagaries of world trade. In 1986, when Japan's bulging current-account surplus was a huge source of tension with America, the Maekawa report, written by a panel of Japanese experts, preached the virtues of more time off as a means for workaholics to let their hair down and spend, spend, spend.

It never happened. Instead, what Japan gave the world in the late 1980s was a lesson in how tricky it is to rebalance economies. The country first mollified America and evened out its trade books by raising the value of the yen. But as the dollar slid, it reversed course and cut interest rates, which boosted spending on everything from golf-club memberships at home to splashy buildings in Manhattan. Cheaper credit had the effect of stoking the vast stockmarket and land bubble that popped with disastrous consequences in the 1990s and beyond.



Fast forward to this decade and Japan's current-account surplus was higher than ever, reaching a record 4.8% of GDP in 2007 (see chart 1). That is because the impact of foreign trade on the growth

of the economy is still much larger than in many other, more open economies. Export growth increased from 4% a year in the decade beginning in 1992 to nearly 10% annually from 2002-07. OECD figures show that the contribution of foreign trade to GDP growth during those years was as high in Japan as in Germany. Some of the bumper profits of large exporters selling Lexus cars, video-game consoles and flat-screen TVs to Westerners during the cheap-credit era were also pumped back into building factories and investing in new technology at home, which further boosted growth. According to OECD estimates, export industries generated about a third of annual output during the pre-crisis years.

A current-account surplus that has persisted for almost all of the past three decades, whether the yen was strong or weak, suggests a structural issue rather than a cyclical one. A recent report on Asian imbalances by Morgan Stanley shows that throughout the boom-and-bust periods since the early 1980s, investment has consistently fallen short of savings (see chart 2). Households, which used to be Japan's greatest hoarders, put less aside in the years before the financial crisis as a combination of low wage-growth and an ageing population took its toll: the household-saving rate fell from above 10% in the 1990s to about 2.2% in 2007. But the country continued to spend less than it earned because exporters squirrelled a chunk of their profits away.

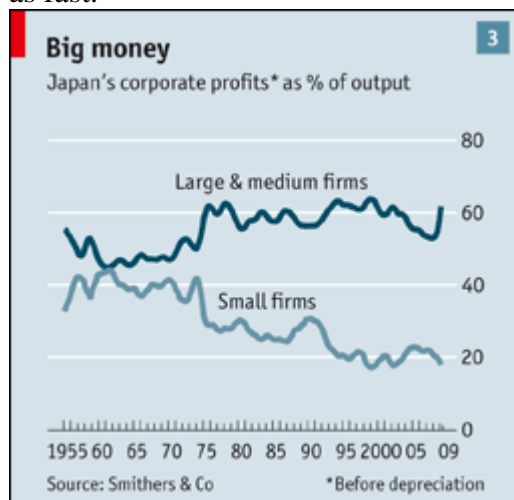


A combination of factors kept domestic demand below par. Japanese workers benefited less from the recent export boom than they had previously: the OECD says their share of GDP fell from a peak of 73% in 1999 to 65% in 2007. Japan's ugly demography, with a shrinking working-age population and a growing grey-haired one, helped the downward pressure on wages. More high-paid workers were retiring and being replaced by lower-paid youngsters, which dragged down overall wages. The retirees did not spend as freely as they might because of uncertainty over the government's commitment to state pensions.

Two other features in the economy also held down pay, and hence consumer spending. First, Japan suffers from a glaring gap between large firms, which are highly profitable, and small ones. According to the IMF the latter continue to struggle with the legacy of Japan's 1990s debt crisis. Although they provide about 70% of jobs in Japan, they have meagre profits from which to fund wage increases (see chart 3).

Second, within the manufacturing industry, there is a big disparity between unionised workers, who enjoy high pay, bonuses and job security, and "non-regular" workers. In the years before the crisis the latter grew to account for about one-third of the workforce, as firms sought to increase flexibility in the face of competition from low-wage rivals in Asia. That shift led wages to fall in 2007, even though the economy was near full employment. These wage pressures meant that the country's five-year growth spurt before the crisis—the longest in Japan's post-war history—had very little impact on the average household. Over the five years to 2007 real private consumption grew by 1.1% a year, about the same level as during the "lost decade" of the 1990s. That was higher

than in Germany, but far lower than in America, where consumer spending grew almost three times as fast.



Skew etiquette

Why is Japan such a lopsided economy? Explanations for why the Japanese are serial exporters include government support of trade and industry (the links between big business, the ruling party and civil servants are known as the “iron triangle”), a strong sense of shared mission among firms’ employees, and an obsession with detail that enables Japan to manufacture high-quality goods.

The aversion to spending is also deep-rooted. Richard Koo, chief economist at the Nomura Research Institute, believes that domestic demand is stunted by a respect for hard work, which chains people to their desks rather than unleashing them to enjoy themselves in shops or on holiday. A further structural problem is the way the Japanese save in order to rebuild their homes every 15 years or so. This is a legacy of centuries of earthquakes and fires in Japan, but it prevents an American-style culture of lavish home improvements.

There is also a reluctance to borrow. Consumers rarely shift credit-card debts from one card to another. Small businesses are still paying off loans from the previous crisis; banks are shy of lending because of the current one. Katsuyuki Hasegawa, chief market economist at Mizuho Research Institute, says the anti-debt culture is deeply entrenched. “People don’t like borrowing. They just like paying back.”

The crisis that has hit Japan since 2008, and which is expected to generate a decline of at least 5% of GDP this year, is only likely to make people more cautious. The export collapse that first hit Toyota and other big carmakers quickly spread down the supply chain to the domestic economy. As profits dived, so did business investment. Unemployment jumped from 3.8% in October to 5.4% in June—not as high as in America and Europe, admittedly, but accompanied nonetheless by yet another onslaught on wages. In this context the sharp narrowing of the current-account surplus to 1.4% of GDP in the first quarter is nothing to celebrate.

In the short term Japan’s path out of the crisis is familiar. The government has stepped in with one of the most aggressive fiscal-stimulus packages in the rich world. Hopes are pinned on a pick-up in exports to China as it rebounds. On August 17th Japan is expected to report its first increase in quarterly GDP in five quarters.

But in the long term, rebalancing the economy is the best way to ensure higher growth. This is particularly important to Japan because it is saddled with the highest public-debt-to-GDP ratio in the rich world, at about 180%, the legacy of years of propping up a moribund economy.

The debt will rise even higher as spending on the elderly increases, raising the possibility of a fiscal crisis if ever the Japanese grow tired of funding their government’s borrowing habit. (So far Japanese bond yields have risen less than in other crisis-hit countries such as America and Britain,

partly because most of the debt is held at home, but the IMF warns that Japan would be very vulnerable if there were a loss of confidence in the sustainability of public debt.)

Eventually taxes will have to rise to reduce these debts. But the best way to ensure that does not throw the economy into another slump is to foster a more even-keeled recovery, with services playing a bigger part. Such businesses—retailers, builders, hairdressers and the like—are so inefficient that, according to the OECD, they have dragged down labour-productivity growth in the country as a whole from 4% in the boom years of 1976-89 to just 2% between 1999 and 2004. Only brothels appear to be doing well. A recent report from the Bank of Japan showed their numbers have mushroomed in the otherwise depressed northern city of Sapporo. Nearby eateries, by contrast, have shut down in droves.

The OECD last year set out to explain why service industries were so poor in Japan. Research and development (R&D) in services was minuscule—one-quarter the level of America, as a share of total R&D. Competition among firms is stifled, with very high levels of concentration and high barriers to new entrants. Information technology in services is poor, an extraordinary weakness in such a tech-savvy country. Multinationals, meanwhile, find it unusually difficult to set up Japanese affiliates in fields such as telecoms and travel because of investment restrictions and regulatory barriers. But the outsiders' record, by and large, should encourage Japan to deregulate further: the OECD found that productivity growth among those foreign firms that did enter the market was 1.8 times the national average.

With the working-age population likely to shrink by 9% during the next decade, according to government estimates, the quest for higher productivity will become pressing. That search has costs of its own: restructuring would require job losses in some enterprises. But an unshackled service industry would eventually generate wage gains. Without one, overall living standards will suffer.

One of the most sensible ways to achieve higher productivity would be to slash the forest of regulations that surround service industries, protecting them from competition in the name of quality control. Farming could be liberalised, as could heavily protected bits of the economy such as energy, transport, health care and education. Policies to encourage investment, both foreign and domestic, would help.

Vote sinners

But in the run-up to general elections on August 30th, a poll that may mark the end of 54 years of almost unbroken rule by the Liberal Democratic Party, there is little talk of rebalancing the economy. Instead, politicians still seem fixated by exports, this time geared towards fast-expanding but lower-margin regions such as China rather than America. There is also talk of re-regulating wages by restricting the hiring of non-regular workers in manufacturing.

None of the election rhetoric sounds enough to jump-start the juggernaut that Japan, still the world's second-largest economy, could be. Nor does it offer Japanese people much cause for optimism that the daily grind of hard work and modest pay will get any better. Despite the traffic jams, spending a few of their seven days' annual holiday venerating the past is more fun than contemplating the future.