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The Irrelevance of the Restructuring Debate

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Tokyo, 12th February 2002

- It has a structural savings surplus.
- The corporate and public sectors have excessive debt.
- The solution to both is inflation and a lower yen.
Japan also has very few people under 20. Its ability to grow and to absorb investment is thus limited.
Slide 3. The Consequences of Japan’s Age Structure.

- The age structure causes the equilibrium national savings rate to be 4% of GDP above a steady state equilibrium.

- It also causes the equilibrium investment rate to be 3.5% below the steady state equilibrium.

- Thus for a sustained recovery, Japan needs a current account surplus of some 7.5% of GDP.
Slide 4. The Need for Lower Investment.

- The return on capital needs to be competitive in Japan with that available in other mature economies.
- Labour productivity in Japan is unlikely to improve faster than that in other mature economies.
- The capital income share in mature economies is stable.
- Therefore Japan must sharply reduce the level of its domestic investment.
In mature economies, as the US data show, the capital income share is stable. Japan cannot therefore raise the return on capital by cost cutting, but must do so by improving the capital/output ratio.
Private non-residential investment as % of GDP.

US
Japan

1991 1993 1995 1997 1999 2001
To bring the capital/output ratio in line with the US, Japanese companies need to improve their capital efficiency by 45%. With output growth limited by the falling workforce, this means a major reduction in investment.
Slide 8. The Need for Net Export Growth.

• The budget deficit is around 7% of GDP and must fall to near zero.
• Investment in plant and equipment needs to fall by around 7% of GDP.
• The household savings rate should fall as the budget deficit improves (Ricardian equivalence and an end to deflation).
• But the demand gap requires a massive rise in net exports.
Reduced investment can raise the return on new spending.

But it cannot increase the return on existing capital.

This means that the current stock of capital must be written down.
Slide 10. Write Downs Mean Excess Debt.

- Writing down capital would be easy if it was equity financed.
- 75% of corporate capital comes from debt and most of this is from banks.
- Write downs require massive write-offs of bank debt.
Slide 11. Japan's Appreciating Real Exchange Rate

Japanese Yen to Dollar

Real Exchange Rate
Nominal Exchange Rate
A 7% return in the US has been equal to a 4% return in Japan.

Japan’s low historic returns are just the natural result of high growth.

Investment returns must now be the same.

To do this, we estimate that ¥ 120 trn. of debt now needs to be written off.
Slide 13. Ways to Write off Debt.

- Banks default on their deposits.
- Tax payers pay.
- Inflation.

• Japan has a structural demand problem.
• Since it is structural, budget deficits are no answer.
• Since it is a demand problem, supply-side solutions, i.e. reconstruction, are irrelevant.
• Devaluation is the solution.
• Intervention or non-funding provide the route.