Japan’s Incipient Transformation

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Outline

1) The Fundamental Problem of Excess Savings
2) The Consequent Structural Distortions
3) Scenarios for Japan’s Future Economic Evolution
4) Reasons for Cautious Optimism
5) Remaining Risks

Conclusion
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Conclusion
The Demographic Wave

Population Distribution, 2000

Source: National Institute of Population and Social Security Research
A Paucity of Profitable Investments

- **Poor Historical Returns**
  - The average real rate of return on bank deposits was negative from 1960 to 1989.
  - Except in the bubble period, the yields generated by household portfolios of stocks and bonds were paltry—often below zero.
  - Only land appreciated dependably from the 1950s through the early 1990s.

- **Deflation of the 1990s**
  - Since the bubble’s collapse the value of residential real estate has fallen by 60%.
  - According to the Official National Accounts, households lost some Y500 trillion in wealth, or roughly a year’s GDP, over the course of the 1990s.

- **Insufficiency of Retirement Savings**
  - Government, corporate pensions are under-funded by well over one year’s GDP.
  - Assuming the current level of household wealth and a life expectancy of 80 years, a typical retiree will have to live on only 24-32% of his pre-retirement income.
An Over-Abundance of Capital

Gross Savings Rates

Source: International Monetary Fund
Summary

- The poor rates of return available on household investments aggravated the tendency of middle-aged people to save a high proportion of their income.

- The consequent, elevated savings rate represented a chronic insufficiency of aggregate demand.

- This created a deflationary bias that might have driven the country into a deep and prolonged recession — or even a depression.

- The question, therefore, is not why Japan grew so slowly during the 1990s and early 2000s but rather how it managed to grow as rapidly as it did . . .
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Expedient One: Excessive Corporate Investment

Source: Goldman Sachs

Corporate Investment

Percentage of GDP

Japan’s Bubble
US Technology Bubble

Japan
US
Efficient Level

Source: Goldman Sachs
Expedient Two: Fiscal Stimulus

Government Budget Balance

Percentage of GDP

Source: Economist Intelligence Unit
Combined Contribution to Aggregate Demand

Sources: Goldman Sachs, Economist Intelligence Unit

Excess Savings Absorbed

Percentage of GDP

Government Deficit

Corporate Investment

“Excess” Demand

“Sustainable” Demand

Sources: Goldman Sachs, Economist Intelligence Unit
Summary

- From the middle 1980s through the early 2000s Japan resorted to various expedients to compensate for the weakness of adequate demand, including:
  - A large current account surplus
  - Excessive corporate investment in plant and equipment
  - Huge government budget deficits

- Unfortunately, these expedients damaged the economy by depressing efficiency and profitability and by driving up the national debt.

- Since the corporate and government sectors could not expand much further relative to GDP, Japan must sooner or later find new sources of growth . . .
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Conclusion
Overview of Three Scenarios

- Scenario One: Lowering the Savings Rate
- Scenario Two: Exporting Excess Savings
- Scenario Three: Continuation of the Status Quo
Scenario One: Lowering the Savings Rate

Return to Typical Balance

This could occur through aggressive structural reforms, which would transfer more wealth to households and enable them to curtail their savings; or it could happen spontaneously, through an exogenous change in household financial behavior.

Source: Goldman Sachs, Economist Intelligence Unit, National Accounts
Scenario Two: Exporting Excess Savings

New "Sustainable" Demand

Source: Goldman Sachs, Economist Intelligence Unit, National Accounts
Scenario Three: Continuation of the Status Quo

Further Structural Damage

- Government Deficit
- Greater Corporate Inefficiency
- Corporate Investment

Percentage of GDP

Sources: Goldman Sachs, Economist Intelligence Unit
Summary

- Japan could continue as it has, relying on inordinate corporate investment and government deficits to absorb its surplus capital, but doing so would eventually depress profitability while also causing the national debt to expand indefinitely.

- A long-term solution must therefore include curtailing savings, dramatically increasing net exports, or some combination of both.

- If there are economic or diplomatic reasons why the current account surplus cannot double or triple in size, then the only way forward is through a sharp contraction in private-sector savings.
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The Ideal Trajectory

Greater Consumption and Net Trade

Source: Goldman Sachs, Economist Intelligence Unit, National Accounts
The Nature of the Present Recovery

Contributions to Economic Growth

Note that the deflators for investment and perhaps consumption overstate growth.

Source: Cabinet Office
The Promise of Less Supply, More Demand

Household Surplus

Percentage of GDP

Source: BOJ
Private-Sector Surpluses

Source: BOJ
The Continuing Financial Imbalance

Countervailing Government Demand

Household Savings
Corporate Savings
Government Deficit

Source: BOJ
The Probable Trajectory

Reluctant Adjustment

Percentage of GDP

Sources: Goldman Sachs, Economist Intelligence Unit
Japan Transformed

Real GDP Growth

Percentage


Inadequate Demand

Inadequate Supply

Return of Inflation?

Current Account Deficits?

Official Figures  Adjusted Deflators

Source: Economist Intelligence Unit
Summary

- The present recovery began as a typical Japanese upturn, stemming from overseas—and particularly Chinese—demand.
  - One quarter of the growth derived from improved net exports.
  - One half of the growth comprised greater corporate investment, much designed to serve overseas markets.

- The recent, sharp decline in household savings, however, gives reason to hope that aggregate supply and demand may soon come back into balance.

- Paradoxically, the likely failure of the government to implement aggressive structural reforms enhances the probability of this desirable outcome; with domestic demand stronger, and GDP rising faster, than would otherwise be the case.

- The output gap could close as early as the end of 2006, transforming Japan from a country with chronically inadequate aggregate demand into a more typical economy whose growth potential is limited by supply-side constraints.
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Short-term Risk: Stalled Recovery

**Domestic Factors**
- Investment falls too sharply
- Consumption stagnates

**International Factors**
- China experiences “hard landing”
- US growth rate falls precipitously
- Oil price surges

**Potential Impact**
- Several points of GDP
- One or two points of GDP
- 0.5-0.9% of GDP directly, 1.0-2.0% indirectly
- Less than China
- 0.3-0.4% of GDP for every sustained $10 per barrel increase

**Consequences**
Some combination of adverse developments could conceivably kill the recovery and cause a reversion to Japan’s recent pattern of inadequate aggregate demand and deflation.
## Long-Term Risk: National Debt

### Net Debt

<table>
<thead>
<tr>
<th>Size</th>
<th>70-90% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis</td>
<td>Gross debt minus assets</td>
</tr>
<tr>
<td></td>
<td>Loans between central, local govts.</td>
</tr>
<tr>
<td></td>
<td>Pension assets</td>
</tr>
<tr>
<td></td>
<td>BOJ holdings of JGBs</td>
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<tr>
<td>Implications</td>
<td>Debt is low</td>
</tr>
<tr>
<td></td>
<td>Interest rates will remain low</td>
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<tr>
<td></td>
<td>No danger of crisis</td>
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### Gross Debt

<table>
<thead>
<tr>
<th>Size</th>
<th>165% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis</td>
<td>Asset values overstated</td>
</tr>
<tr>
<td></td>
<td>Book values sometimes deceptive</td>
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<td>Many assets illiquid</td>
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<td>Political constraints on local loans, BOJ holdings</td>
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<td>Liabilities understated</td>
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<td>FILP generally ignored</td>
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<td>Other accounts ignored</td>
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<td>Implications</td>
<td>Contingencies critically important</td>
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<td>Bank, insurance costs are public</td>
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<td>Pensions must be paid in part</td>
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<tr>
<th>Analysis</th>
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<tbody>
<tr>
<td></td>
<td>Rates could rise gradually or sharply</td>
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<tr>
<td></td>
<td>Danger of crisis in 2010s or later</td>
</tr>
</tbody>
</table>

### Implications

- Asset values overstated
- Book values sometimes deceptive
- Many assets illiquid
- Political constraints on local loans, BOJ holdings
- Liabilities understated
- FILP generally ignored
- Other accounts ignored
- Contingencies critically important
- Bank, insurance costs are public
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Fiscal Consolidation (I)

Budget Deficit Trajectory

Source: Economist Intelligence Unit
Fiscal Consolidation (II)

National Debt Trajectory

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of GDP</th>
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<tbody>
<tr>
<td>1998</td>
<td>100</td>
</tr>
<tr>
<td>1999</td>
<td>125</td>
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<tr>
<td>2000</td>
<td>150</td>
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<tr>
<td>2001</td>
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<td>2006</td>
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<tr>
<td>2007</td>
<td></td>
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<tr>
<td>2008</td>
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</table>

Source: Economist Intelligence Unit

Basic Scenario
Reform Scenario

Projections
Summary

- Japan could still stumble back into deflationary circumstances.
  - A combination of adverse international developments
  - Sudden, sharp decrease in corporate investment
  - Premature fiscal tightening like that of 1997

- Regression is also possible in the medium term if corporate investment continues at such a high level that it creates vast overcapacity like that of the 1990s while also depressing the returns available to workers and investors.

- If those short- and medium-term obstacles are safely overcome, the biggest long-term challenge is redressing the government’s finances before they become vulnerable to possible spikes in interest rates.

- Ultimately this is a political question: will the government avoid premature tax increases for a few years but then brave voters’ wrath by hiking them sharply enough to eliminate the budget deficit relatively rapidly?
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Japan’s slump may well be over.
- External demand brings positive impetus in the short term.
- Higher consumption and lower savings, though, are far more important.

The country may soon look very different than in the recent past.
- Inflation ameliorates many of the stresses in the banking system, lightens the burden of household and corporate debt.
- The current account very slowly moves from surplus towards deficit.
- By the early 2010s foreigners are providing more of the capital necessary to fund the debt.

The challenge would no longer be bolstering demand but rather overcoming the more usual supply-side constraints.
- After the output gap closes the country’s trend growth rate will fall to 1.0-1.5% per annum.
- Elevating the sustainable rate above that level will require big cuts in capital investment and probably more immigration.

The focus of political debate will ultimately shift to the national debt.
- Due to the confidence problem, fiscal retrenchment makes no sense until at least 2007.
- Greater healthcare and pension costs then render spending cuts impractical, so the key is big tax increases—perhaps raising annual government revenues by 6-9% of GDP by 2012 or 2015.

Ultimately both of the big tasks—moderately faster growth and fiscal retrenchment—depend critically on the quality of Japan’s elected leadership.