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The Irrelevance of the Restructuring Debate

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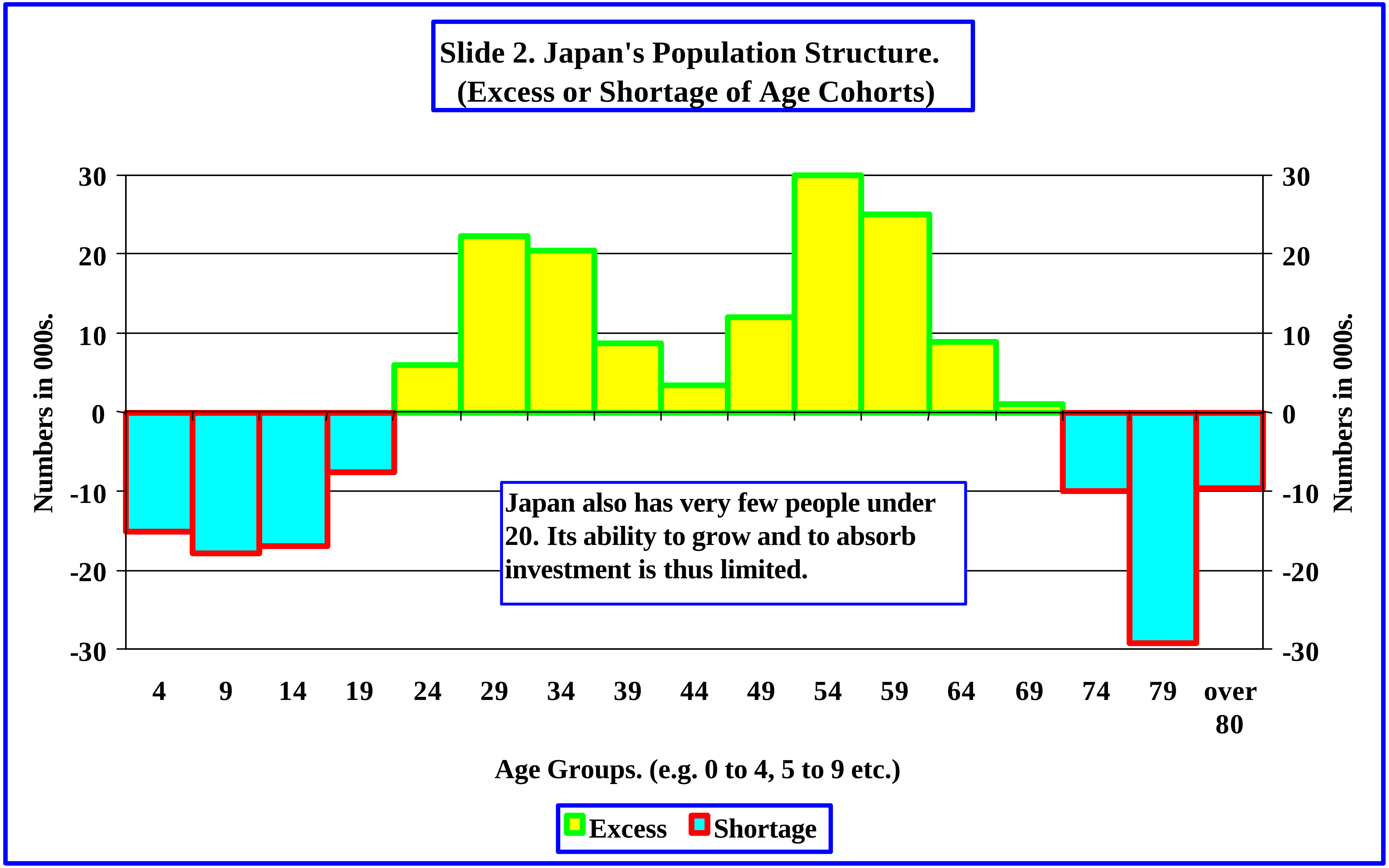
Slide 1. Japan’s Economic Problems.

- It has a structural savings surplus.
- The corporate and public sectors have excessive debt.
- The solution to both is inflation and a lower yen.

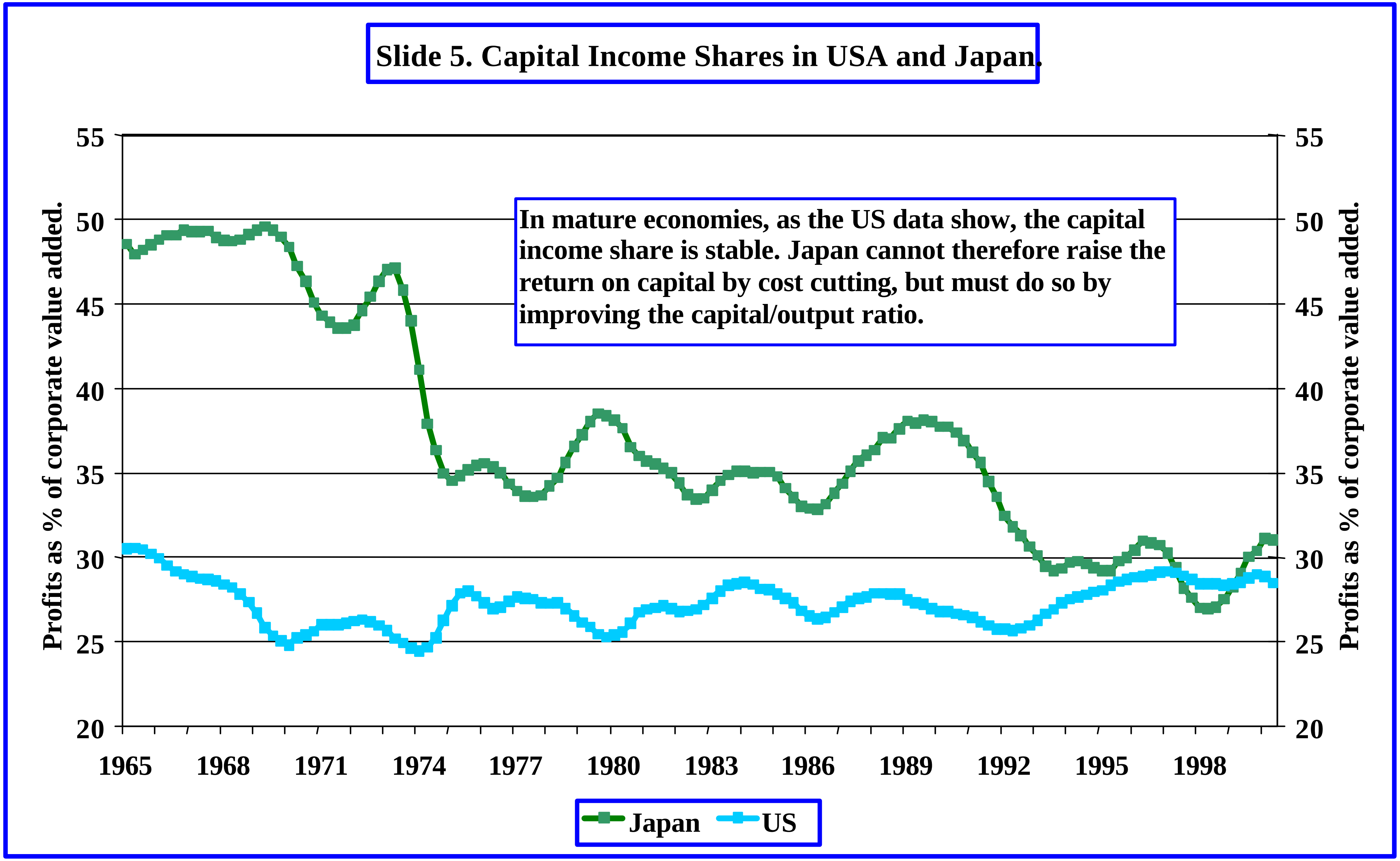

Slide 2. Japan's Population Structure.
(Excess or Shortage of Age Cohorts)
30
20
10
0
-10
-20
-30
Numbers in 000s.
Japan also has very few people under 20. Its ability to grow and to absorb investment is thus limited.
4
9
14
19
24
29
34
39
44
49
54
59
64
69
74
79
over 80
Age Groups. (e.g. 0 to 4, 5 to 9 etc.)
Excess
Shortage

Slide 3. The Consequences of Japan’s Age Structure.

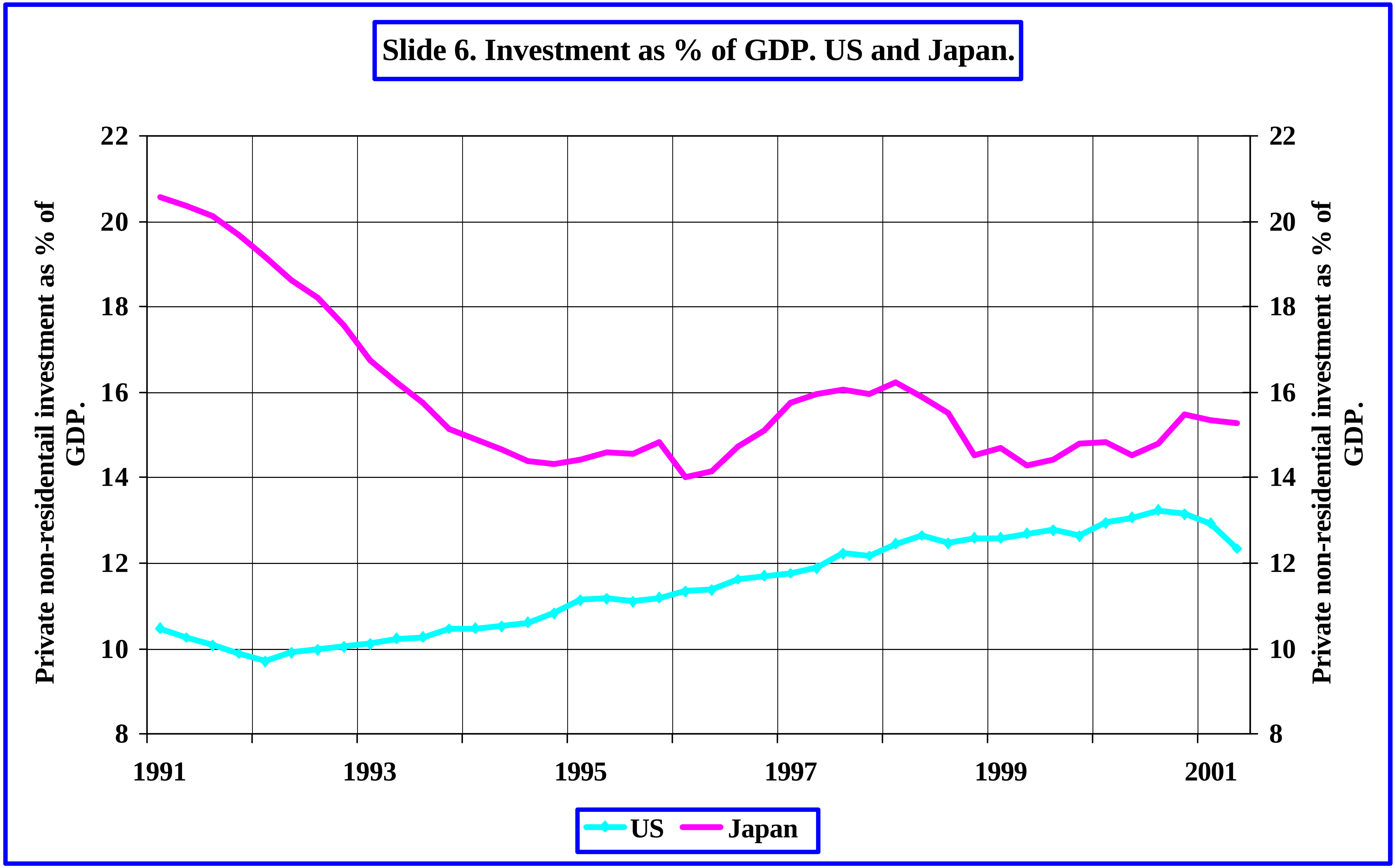
- The age structure causes the equilibrium national savings rate to be 4% of GDP above a steady state equilibrium.
- It also causes the equilibrium investment rate to be 3.5% below the steady state equilibrium.
- Thus for a sustained recovery, Japan needs a current account surplus of some 7.5% of GDP.

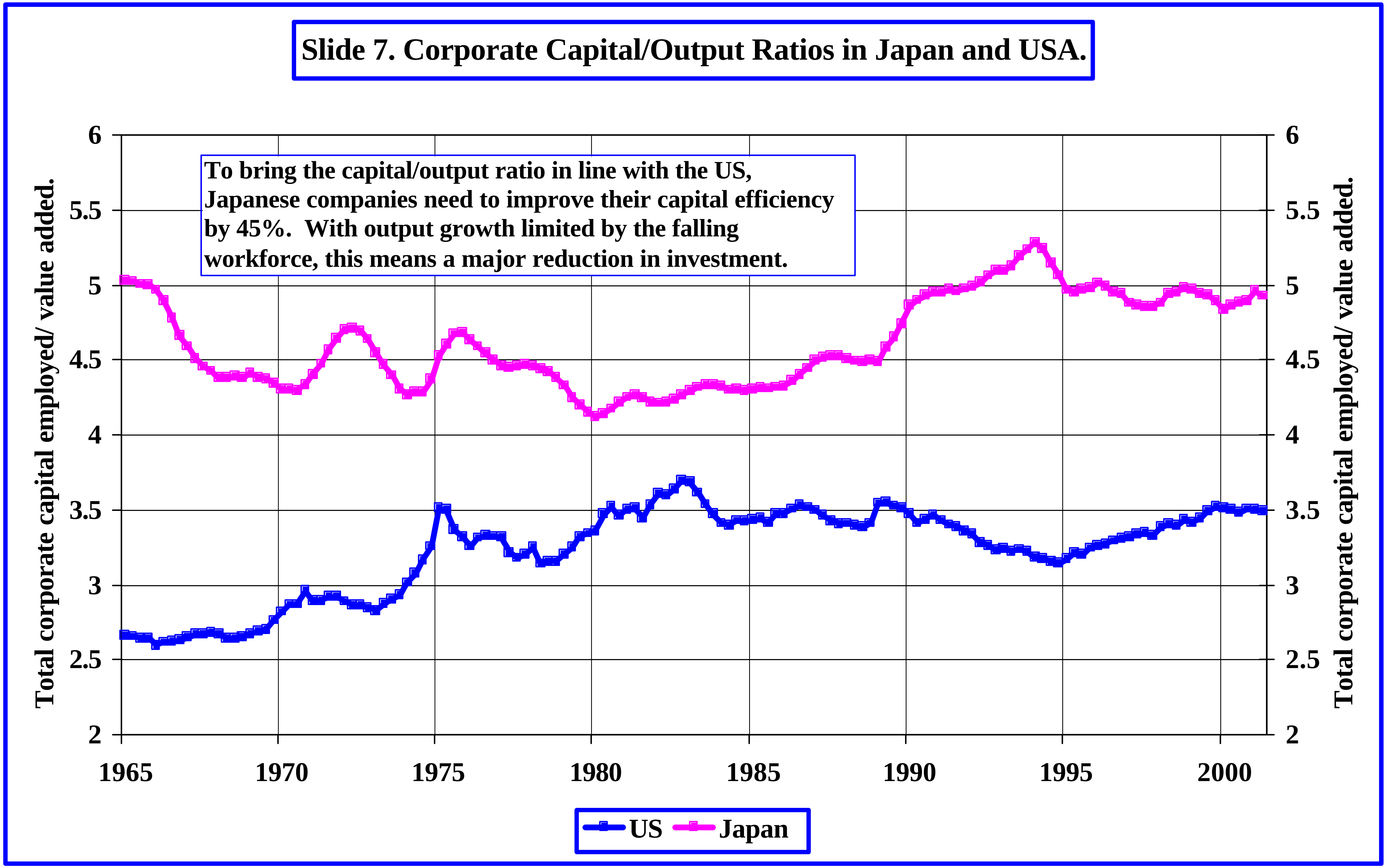
Slide 4. The Need for Lower Investment.

- 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.



Slide 5. Capital Income Shares in USA and Japan.
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.
Profits as % of corporate value added.
55
50
45
40
35
30
25
20
1965
1968
1971
1974
1977
1980
1983
1986
1989
1992
1995
1998
Japan
US


Slide 6. Investment as % of GDP. US and Japan.
Private non-residentail investment as % of GDP.
Private non-residential investment as % of GDP.
22
20
18
16
14
12
10
8
1991
1993
1995
1997
1999
2001
US
Japan


Slide 7. Corporate Capital/Output Ratios in Japan and USA.
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.
Total corporate capital employed/ value added.
6
5.5
5
4.5
4
3.5
3
2.5
2
1965
1970
1975
1980
1985
1990
1995
2000
US
Japan

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.

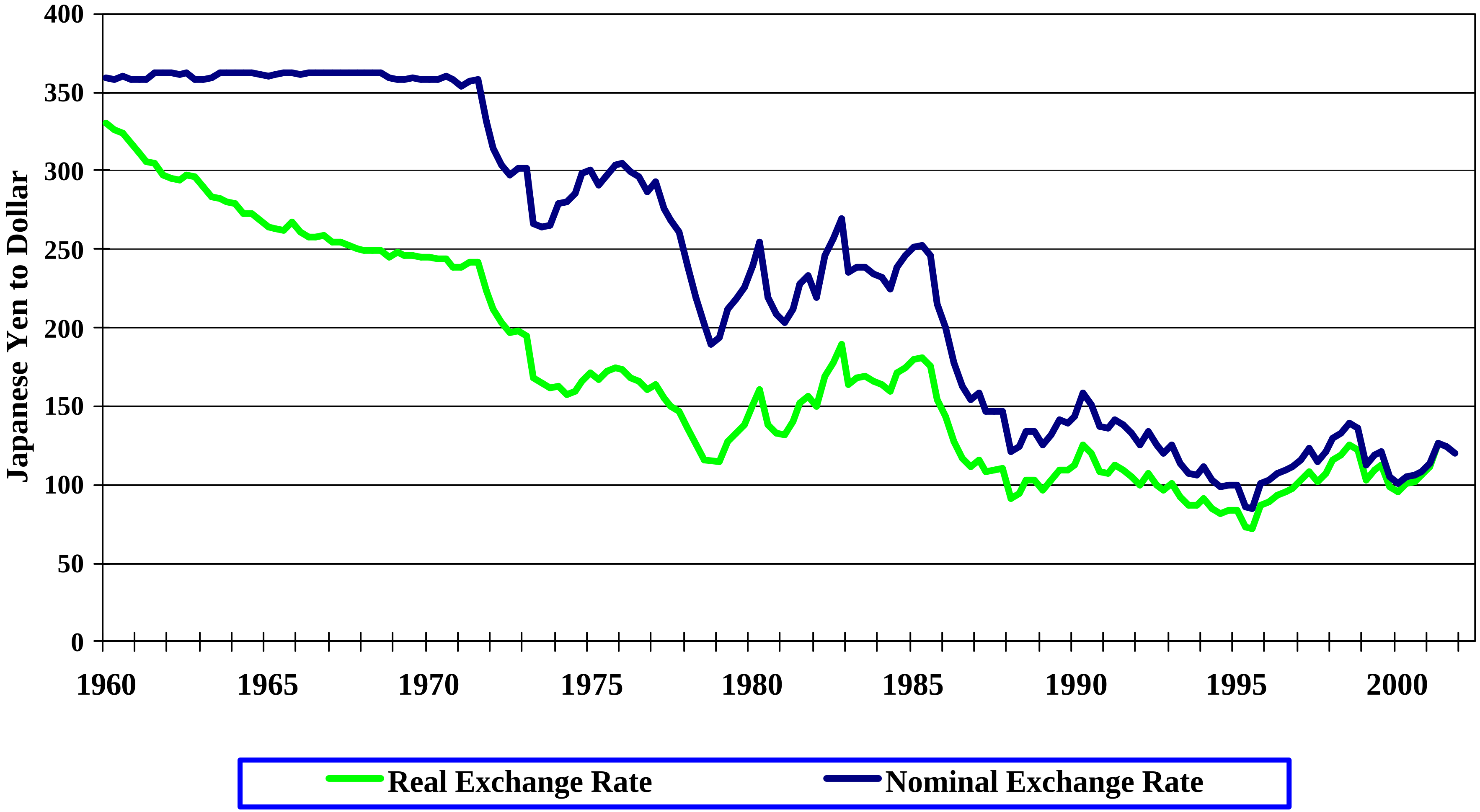
Slide 9. Existing Capital Must be Written Down.

- 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



Slide 12. Rising Real Exchange Rate Means a Low Return on Capital.

- 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.

Slide 14. Conclusions.

- 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.