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Japan's Changing Role

Japan's Changing Role: Economic Affairs

Economic Trends

Long-term view: Japan is a rich country that possesses the habits, institutions, and policies of a successful nation. The institutions that make countries rich do not vanish. Japan's economic future ranges from mediocre to good: 1%-2% real growth of gross domestic product (GDP) per person. The lower bound would be comparative failure; the upper, a considerable achievement.

All fast-expanding countries are poor, although not all poor countries achieve rapid growth (figure 1). Rich nations grow more slowly than the high-flying, poorer countries. Focusing on Japan, China, India, Korea, and the United States, the U.S. is at the high end of the rich-country range (figure 2). Japan approached 2% growth in the 1990s, and then fell below. China and Korea lie on the upper envelope of the 121-country experience plotted in figure 1. India started in the middle of the distribution and has shifted upward toward the high-fliers.

Many observers, including most Japanese, thought that the country's post-World War 2 experience indicated special or even unique national qualities. With the benefit now of more than a half century of experience and analysis, we can note that Japan's economic miracle followed extensive wartime destruction. However, its human capital and institutions remained largely intact. When investment recovered in the 1950s, returns to investment and overall growth were high. By the 1970s, the capital stock approached equilibrium levels, returns declined to values appropriate to the mix of human, physical, and institutional capacities, and growth decelerated. Japan was lucky enough to approach economic maturity.

Recent experience: From 2002 to 2008, Japan's exports were the main positive component of GDP as Japan experienced its longest postwar expansion, building on Chinese and other Asian demand. The share of exports in GDP rose from 10.5% in 2002 to more than 18%, the highest in Japan's entire postwar history. However, contrary to popular views, Japan's economy has not generally been driven by exports, either in the post-World War 2 period or earlier. An accumulating body of research demonstrates quite the reverse: imports rather than exports were associated with growth and productivity improvements.

High energy and materials prices, global financial turmoil, and collapsing exports plunged the economy into recession in 2008. Japanese financial institutions, however, were saved from the worst excesses of their overseas peers by their conservative stance, bred from the decade it took to dig themselves out of a nonperforming loan hole and over-leveraged balance sheets in the 1990s; that, plus weakness in the skills of complex derivatives trading made them wary of the dodgier assets.

The recession deepened in the first quarter of 2009 as real GDP fell 15.2% (annual rate) from the previous quarter—the steepest decline since the figures were first produced in 1955. Nearly every sector participated in the downturn. Perhaps the most positive sign was that private inventory accumulation slowed from the end of 2008 as producers began to bring output into line with demand.

Glimmers of hope: Although GDP has fallen 9% from year-ago levels, three fiscal stimulus packages are beginning to strengthen demand while exports, especially to Asia, resumed their expansion at the beginning of the year. Producers' inventories have fallen sharply; manufacturers' shipments and output started to rise in March, with faster growth projected for coming months.

Consumer confidence bottomed out last December. The Economy Watchers survey of people holding jobs that enable them to observe household and producer activity shows the same strong recovering trend. The survey asks for assessments of both current conditions and the direction of change. From January to May, expectations of future conditions has jumped two-thirds of the way back to its previous peak of early 2006. The sub-indices all shared in the overall strength. Household consumption, itself, turned positive in March from a month earlier, the first rise in more than a year.

As household demand solidifies, especially for durables such as automobiles, I expect GDP to steady in the second quarter and resume growth by mid-year. Absent further severe shocks to the global economic system, 2010 is expected to return to near normal

Japanese consumers' undeserved bad reputation: Japanese consumers have a bad reputation, allegedly being under-paid, under-consuming, and obstinately refusing to become the engine of economic growth. Cultural explanations based on the presumed qualities engendered by rice cultivation, or so-called rabbit hutch homes, have been offered as explanations. Such explanations, however, are not needed. Whereas Japanese households at one time saved almost one-quarter of disposable income, that ratio is now under 3%, less than the notoriously low current American savings rate (figure 3). This dramatic change is due primarily to the country's shifting demographic structure; predictably, as a nation like Japan becomes older, the relatively fewer families in the prime working ages contribute less to aggregate savings, while older, retired people draw down their holdings.

The notion that Japan's consumption is under-powered is belied by comparisons with other rich countries. Table 1 shows the ratio of household consumption to GDP; Japan is in the middle of the pack. It is the U.S. and U.K. that are the outliers.

Table 1: Ratio of Household Consumption to GDP, Selected Countries, 2003-2007 Average (%)

Canada	56.1
France	56.5
Germany	58.9
Japan	**57.3**
UK	65.3
U.S.	70.4

Source: World Bank

Another allegation is that workers' share of national income is exceptionally low in Japan, thereby starving the nation of consumption. Again, this charge is wrong, as shown in the estimated labor shares in Table 2. Japan is near the average of all countries. Moreover, there is no evidence of a long-term trend in employees' share of national income, although there is considerable cyclical variability, falling in good times as profits soar, and rising when companies protect workers' earnings in recessions.

The conclusion to draw from these data is that Japanese consumers are not a long-term drag on the economy. If confidence remains robust and output continues to expand, households could lead the way to the next expansion, especially considering their year of abstinence from buying items whose purchase could be postponed.

Transition from the 1935-45 system: Over the past two decades, Japan has moved away from the economic system constructed during the 1930s, organized to mobilize the economy for war.

The postwar occupying powers left in place many of the existing economic institutions and structures. Most important were bank-centered finance and the legal structure of corporate governance. In combination, they dethroned shareholders and profitability from their premier positions influencing corporate behavior.

Table 2: Employee Compensation Share of GDP (1994), Including Income of Self-Employed and Proprietors, Selected Countries

Australia	0.67
Belgium	0.74
Finland	0.73
France	0.72
Italy	0.72
Japan	**0.69**
Korea	0.70
Netherlands	0.68
Norway	0.64
Sweden	0.77
UK	0.78
U.S.	0.74

Source: Douglas Gollin, "Getting Income Shares Right," *Journal of Political Economy*, Vol. 110, No. 2 (Apr., 2002), p. 470.

Despite government's key economic role, any sense of an overall vision quickly lost coherence in the post-war period. As elsewhere, government planners and regulators often became the pawns of politicians and of the industries and companies they were supervising. Internal battles for dominance within the government further weakened any sense of coordinated strategy. Nevertheless, bureaucrats' inclinations to distrust markets influenced regulation and guidance.

Japan's postwar economic system started to change in the 1970s, proceeded over the next 30 years, and is still ongoing. The first moves occurred in the tightly bound financial system. When the government incurred large fiscal deficits in the 1970s, it was forced to relax its interest rate controls to make government debt attractive to financial institutions. As Japanese companies ventured abroad in the 1980s, they found that financial products in London were cheaper and more diverse than in Tokyo.

Tokyo lagged behind financial market innovations in the 1980s, largely because of still remaining regulations. Prime Minister Hashimoto announced a "big bang" scheme of financial market deregulation in 1996, phased in over several years. These changes helped end the system of bank-centered corporate finance, especially for large firms.

Company oversight and monitoring were strengthened in 1993 by reducing the costs to initiate shareholder suits and allowing collection of damages. From 1950 to 1990, shareholders in Japan filed fewer than 20 derivative suits against directors By 1999, there were 286 such suits before the courts, 95 filed in 1999 alone.

Other changes reduced the shareholding threshold to demand inspection of records, allowed stock options, simplified merger procedures, allowed stock swaps to underwrite mergers, eliminated the ban on holding companies, facilitated the ability to spin off companies, removed prohibitions on treasury stock, and authorized companies to adopt an American style board of directors.

A new corporation law in 2006 embraced a reversal of the regulatory philosophy, shifting from a stance that everything that is not allowed is prohibited to one where everything that is not prohibited is allowed.

Corporate officers now must consider seriously bids for mergers or acquisition; failure to accept profitable offers could be interpreted as acting against shareholder interests. The number of mergers and acquisitions subsequently increased to levels that would have been unthinkable in the mid-1990s. Moreover, significant foreign takeovers, counted in single digits in the 1980s, hit 100 in 2000 (figure 3). Although successful domestic hostile takeovers remain infrequent, they are increasing, from only a single case in 1995 to 53 in 2005.

Low returns to capital: A consequence of the wartime system was little regard to returns on investment. American output growth required little additional capital deepening whereas Japan's capital, after recovering from wartime destruction, continued to climb as a share of GDP (figure 4). Japan's private sector by 2007 required 60 per cent more capital per unit of output than did the American.

As Japan recovered from wartime losses, returns on investment were extraordinarily high (figure 5); they then declined steadily. The American trajectory also declined following catch-up from the depression and war, converging to a stable long-term level above Japan's.

The downward course of Japan's rates of return resulted from corporate governance that did not emphasize profitability, a banking system that did not adequately monitor borrowers, and government policy that protected insolvent firms from dissolution.

Corporate governance is now increasing the attention to profitability. Returns at the macroeconomic level have started to rise. Business data collected by the Ministry of Finance confirm that, prior to the current recession, the era of dismally low returns may be ending.

The vast private savings held by Japanese families would benefit enormously from higher rates of return. Higher return on investments automatically provide for their own redemptions in later years by generating the resources to pay back savers. If Japanese households were more confident of future returns, they could save less today or draw down their stock of savings at a higher rate. Consequently, higher returns could yield higher consumption, which would produce added aggregate demand, investment, and domestic growth, not to speak of higher incomes for retirees. Therefore, corporate governance policies that encourage a greater attention to the bottom line would, paradoxically, make the future more secure while creating new risks for current managers.

Scientific research: In recent decades, the linkages between basic science and economic output and productivity have intensified in the advanced economies. The practical orientation of much of Japan's R&D and the acknowledged weaknesses of its basic research and university science may retard productivity growth in the future. The business orientation of Japan's R&D was correctly identified in the past as the foundation of the country's technological strength. Now, that slant is a growing problem.

Japan's spending on research and development ranks second globally at 40% of the U.S. level. Its chief feature is neither its scale nor its considerable vigor, but its orientation toward business, especially manufacturing. Since more than three-quarters of Japanese research is funded and performed by industry compared to 60% in the U.S., its focus is on industrial products and processes, whereas American research tends more toward scientific output. The American share of basic research in all R&D spending, for example, is 50% greater than Japan's. (figure 7) Consequently, the scientific content of Japanese efforts is considerably less than the overall spending would suggest. Japanese scientists write only about one-quarter as many scientific articles as Americans. Moreover, each of these articles is cited by other scientists at less than half the U.S. rate.

Japan would not have to be overly concerned about its relatively weak science base if it could take better advantage of the leading science around the world. However, the diffusion of scientific results has a strong local affinity. It often is asserted that the results of basic research are available at little cost to anyone with access to the latest science journals. This allegation, however, is not consistent with the evidence, which demonstrates that science is transferred via people, not articles. What makes the problem more serious for Japan is that it seems to be more insular than many other countries in its ability to benefit from foreign science. Japanese scientists are weakly connected to global science compared to many other countries, including regional neighbors China, South Korea, and Taiwan.

The increasing role of basic research in advanced industrial technology, the contribution of this type of work to corporate and national productivity, and the links between academic science and high technology industry all speak to the importance of a healthy research base for economic welfare. Japanese companies recognize these issues and have tried to compensate by establishing laboratories abroad. However, these moves have been belated and insufficient, points recognized by industrial leaders.

The comparative weakness of basic research in Japan and the institutional impediments to its use supply a rationale for the government's policy of strengthening the performance and the institutional framework of the Japanese research system. Despite strong policy statements in this direction, implementation has been weak and disappointing. Japan's scientific base could be a future problem.

Alternative paths: The difference between mediocre 1% and energetic 2% growth lies in policies that continue to open and deregulate the economy. For example, when the share of trade doubled between 1994 and 2008, the increased exposure to foreign competition intensified the pressure felt by Japanese businesses, and had measurable effects on productivity and prices. If policies continue to encourage the focus on profitability, trade should increase as companies find it to their advantage to source their inputs globally.

Foreign direct investment is one of the greatest stimulants to productivity. Although it has increased by a factor of 10 since 1996, it remains a tiny fraction of other rich countries' inflows. Further gains will require reducing the barriers to mergers and acquisitions, such as by diminishing unprofitable cross-shareholding of companies and banks (which act as M&A defenses) and by strengthening corporate governance rules that give greater rights to shareholders who can protest refusals to negotiate advantageous transactions.

Entire industries have been thwarted by excessive regulations. An example is health care for older people. Licensing that protects incumbents constrains the development of new combinations of health and retirement services.

Immigration reform is part of the solution to caring for an aging population as well as more generally compensating for a declining work force. There have been tiny steps to open immigration of nurses, for example, but these and other moves have been reluctant and halting.

A disadvantage that can benefit Japan's future growth is that its productivity lags the global leaders. Various estimates put the country's manufacturing productivity at roughly 70-80% of the most efficient economies, varying across industry. Productivity in food products was only 30% of the American level, whereas Japan's metal products producers were 60% more productive and transportation equipment was better by 26%.

Lower productivity can be an advantage because better ways of doing things already have been demonstrated elsewhere. Japanese companies would not have to experiment with uncertain methods or technologies to achieve higher levels of efficiency, but have models on which to base their plans. Having such models, though, does not guarantee their speedy or successful adoption. It took a quarter century for American automobile companies to adopt the Toyota system of manufacturing, which was demonstrably more efficient than the way that Detroit made cars. And it required a similar length of time for Japanese airlines to reach American efficiency levels after deregulation and competition confronted the American industry. Nevertheless, once pressure to change impinges on firms, having others to follow can speed the adjustments.

In short, if Japanese political leaders, parliament, government bureaucrats, and businesses adopt such policies, growth can be at the high end of the projections. Otherwise, plodding growth can be expected.

Demographic Trends

The Japanese population is becoming older and smaller. Low fertility rates below the breakeven level plus the longest life expectancy in the world mean that fewer babies are being born and that older people are becoming a larger share of the population. (See figures 8 and 9.)

The population peaked around 2005 with 127.8 million people. Current mid-range projections put the 2030 and 2040 numbers at 117.6 and 109.3 million. That is, 30 years from now, Japan will have 15% fewer people than it does today, about the same number as in 1973.

It should be noted that Japan is not unique. European fertility rates are similar to Japan's. What makes Japan notable is that its life expectancy is driving the age structure faster than in Europe and forcing Japan to cope with the consequences first.

Many of the consequences of the changing demographics are obvious:

- Declining population
- Proportionately more older people
- Smaller share of working age population
- Slower aggregate economic growth
- Challenges to pension and social security systems
- Greater health care resources devoted to older people

I do not label the above items as negative consequences, but as changes that require adaptation. Indeed, another list of what might be labeled positive consequences demonstrates the ambiguity of assessing population decline:

- Reduced pollution
- Lower expenses for schooling and education
- Less crowding
- Smaller environmental impacts

Because these changes are occurring gradually and are clearly forecast, adaptation can be smoother than might be the reaction to sudden and unexpected events. For example, relatively modest changes to the social security system could make it sustainable over a long horizon. Some of these changes, such as delayed retirement, have already been implemented.

The population is projected to decline 0.5% annually over the next 30 years. However, because of the shifting age structure, the so-called working age population (16-64) will fall at twice that rate, or about 1% annually. Economic growth arises from the changes in the quantity and quality of the labor force and capital stock, as well as from productivity improvements separate from these inputs such as those that come from science or simply doing things more efficiently. Even though the quantity of labor inputs will decline, all the other contributors to economic growth will continue to increase.

There are two things that can ameliorate the effects of a falling labor force. First, older people need not stop working at the age of 65. Although the labor force participation of older people has declined steadily since the 1950s, there is a notable counter-cyclical effect in the other direction. The implication of long-term decline with upturns during expansions is that older people are responsive to two different incentives. As incomes rise in general, they tend to use some of that income to reduce their labor force contributions (an income effect). However, when demand conditions raise the wages that they can earn by remaining in or returning to work, they respond to these incentives (relative price effects). As recently as the expansion that ended last year, a half million people age 65-69 returned to employment. If labor shortages were to arise in the future, this cohort as well as others would face incentives to swell the job market.

The second thing that could drastically affect the quality as well as the number of workers is the better use of women. Women make up a smaller share of the labor force than in many other advanced economies. At 60% participation, it is more than 10 percentage points below countries such as Sweden, the U.S., and U.K. Moreover, women are used in inefficient ways; they are more likely than are men to be part-timers and they find it even more difficult than men to reenter the labor force if they temporarily withdraw, as they are likely to do when they have children.

The ratio of female to male wages in the late 1990s was 0.64, the lowest among 13 countries studied. Moreover, the proportion of females in private sector managerial positions rose from only 5 per cent in 1990 to 8.3 per cent in 2001; the entry of women into higher paying jobs compares poorly with other countries such as the United States, where women hold some 45% of managerial positions. Personal observation suggests that there may be more competent, intelligent, and hard-working Japanese women working at higher level jobs in New York or Washington than in Tokyo. It is no accident that such competent people leave their country to find opportunities elsewhere. When half the labor force is under-utilized, the potential for greater productivity gains is obvious.

Japan's Regional Role

Japan is the world's third largest economy, after the United States and China. When measured in purchasing power parity (PPP), the only adequate way to assess relative economic scale, China overtook Japan around 2000 and is now more than 50% larger. India is coming up fast, but remains about 30% smaller, according to the World Bank's PPP estimates. (Although PPP is more appropriate than exchange rates to measure size, enough uncertainties remain that fine distinctions are not warranted.)

As was seen in figure 2, Japan is a rich, developed economy while China and its Asian neighbors still are in their fast-growing, development stage. Korea could achieve maturity in 10 years; that goal remains a more distant dream for the others.

Japan will remain the third or fourth largest economies for the foreseeable future. Although not growing as fast as its neighbors, it will retain the scale and resources to engage fully in the regional and global areas. More resources will be devoted to its aging citizens in the future, and slower growth will require finer choices. However, Japan's role will be dependent more on its choices and preferences than on its absolute size or rate of increase. The size of an economy imposes only the roughest constraints on military or diplomatic efforts, Many countries punch well above their economic weight: think North Korea or Israel. Others are less involved internationally. Economics will not by itself constrain Japan's future role.

It has been argued that Japan is bound to decline relatively and perhaps even absolutely regionally and more widely. It will be even harder to justify defense spending to an older society that is possibly more conservative and risk averse. New and expensive weapons systems will compete with more immediate social needs. There could be greater reluctance to send an increasingly precious resource, younger, productive members of society, into military service. A military career has never been popular in postwar Japan; it will be harder to compete with the private sector in the future.

These arguments are valid, but they presume past values and political judgments continuing into an uncertain future. Changing international environments could easily shift Japan's perceptions and choices. Consider that a single North Korean missile test that flew over Japan altered domestic psychology in a way that hundreds of deployed Soviet nuclear warheads targeted on Japan failed to do. It is not possible to speak with confidence about potential scenarios that could include either a pacified North Korea or an increasingly belligerent and nuclear one, not to speak of other regional scenarios.

My main point is that economics is not determinant if situations change drastically. However, given the more likely alternative that events proceed in an incremental, gradual way, then the arguments given above of a Japan that is declining relatively in the region are more tenable.

China is an important part of Japan's future. It is an expanding customer, supply base, and investment target. Japan will remain a regional financial center even if China's currency is convertible because Japan possesses a large and liquid volume of tradable assets, a sophisticated financial market (even if behind London and New York), a stable economy, an effective criminal and civil justice system, and experience. The appearance of a rich neighbor can only be beneficial to Japan, although it could cause disruptions and reallocations as resources shift within the economy to meet new demands and depart no-longer competitive activities.

Economists dislike speaking about nations as economic competitors. However, China does compete with Japan in one sense. China's trade agreements with many Asian countries have spurred Japan to make internal changes so that it could compete better with the Chinese brand. The main impediment to trade deals has been Japan's protected agricultural sector. Government officials in non-agricultural ministries as well as political leaders such as former Prime Minister Junichiro Koizumi noted that domestic changes were necessary to allow agriculture's inclusion in future trade negotiations. Consequently, reforms to agriculture were started under the threat of a China competing for Asian hearts and minds.

United States-Japan Economic Relations

Twenty years ago, Congressional hearings on the "Japanese threat" were a common feature in Washington. Fifteen years ago, the U.S. trade representative, as one element of his president's reelection campaign, could proclaim, "We negotiate and negotiate and nothing happens." Those days are past.

Many officials in earlier administrations held mercantilist views of international trade. The same was even more true of members of Congress and the public. The allegation is that exports are good and imports are bad. Such ideas seem to be based on the very direct (but partial) observation that exports create jobs and higher profits while imports compete with domestic producers and raise unemployment. Such beliefs are deficient because they do not go far enough in completing the loop of cause and effect. An additional export will tend to crowd out some other export or lead to more imports (probably a combination of both). Unless the economy ends up with greater savings, any jobs gained in one company will be lost elsewhere in the economy. However, the power of direct personal experience often overwhelms the indirect arguments and evidence of economic analysis.

In addition to their mercantilist theories, several people in and out of the Clinton administration held a "Japan is different" view, asserting that Japan played by different rules of capitalism. According to this theory, Japanese markets are managed or guided by government bureaucrats and politicians working closely with business leaders. Under such conditions, it is fruitless to negotiate market opening measures; the intertwined groups will simply find new ways to keep outsiders from entering their protected realms.

Unfortunately for American trade negotiators, their demands to open Japanese markets by assigning import targets confronted a "never again" mentality among Japanese government officials that was born in the semiconductor agreements of the late 1980s when Japan had agreed to a specified foreign share goal of the Japanese semiconductor market. The result of these Clinton-era trade talks was severe tensions in American relations with Japan that spilled over into broader security and diplomatic affairs. It required the dedicated attention of skilled participants on both sides to overcome these frictions.

Over the past 15 years, significant changes have occurred in the trade and investment relations between the United States and Japan. Many of the industries that suffered directly from Japanese imports have adjusted to the intense competition by becoming much smaller or more competitive. Whether in steel, automobiles, machine tools, or many other products, the challenges have faded into the past, if not entirely disappeared. In addition, Japan is no longer the only, or even chief, protagonist. Korea, China, Russia, Brazil, and others have often taken over the role first played by Japan.

Japan is now the fourth largest source of American imports, behind Canada, China, and Mexico, accounting for less than half the flow from either Canada or China. Thus, the salience of Japan in the eyes of business and political leaders is considerably reduced from earlier decades.

Whereas the U.S. used to be Japan's largest single trade partner, that no longer is true. Japan now imports twice as much from China and from the rest of Asia as it does from the U.S. In the past 12 months, as the United States sank into recession, China became Japan's largest export market. In the most recent data, Asia loomed twice as large as the U.S. on both sides of the trade ledger.

Americans used to complain about the almost impossible task of investing in Japanese companies. As of 2007, the value of U.S. direct investment in Japan came to more than $100 billion, three times the 10-year ago value. Foreigners now own almost one-third of the value of the Tokyo Stock Exchange and accounted for half of all transactions last year.

Because of these substantial changes, the old emotions and animosities have been replaced by a more cooperative approach. According to John Taylor, the former Under Secretary of the Treasury for International Affairs, President Bush and his team developed a new approach to American economic relations with Japan. There would be no Japan bashing. The administration based its policies on respect and cooperation, not antagonism. Taylor thought that lectures from the U.S. government had proven ill-suited to advancing either Japan's prosperity or mutual relations. There was close cooperation with Japan when the Ministry of Finance informed the U.S. that it planned to intervene heavily in foreign exchange markets to hold down the price of the yen as part of its economic recovery efforts. After more than $300 billion was spent in the final 12-month splurge, the Japanese government ended its attempts to depreciate the currency when it appeared that the economy was on its way to a solid recovery. There have been no further interventions since the end of 2003.

That same cooperative approach appears to be continuing under the administration of President Obama.

Japan and the Global Financial Crisis

Japanese financial institutions have suffered only mild losses in the ongoing financial crisis. According to the most recent data from the Financial Services Agency, losses from subprime assets have amounted to approximately $10 billion, and total losses from derivatives trading add up to $25 billion. Because of their lack of exposure, the financial authorities have not had to bail out Japanese banks, which have buttressed their capital by raising funds in financial markets.

Many financial and nonfinancial firms have sufficient cash to acquire companies around the world, including many in the United States, especially because of the fall in stock market values. Recent examples include the $8.4 billion offer from Japan's biggest bank, Mitsubishi UFJ Financial Group, for up to 20% of Morgan Stanley and the $3.5 billion paid for the remaining 35% of UnionBanCal, a California bank, that it did not already own. Mitsubishi UFJ's security subsidiary entered merger negotiations with the Japanese subsidiary of Morgan Stanley. Nomura, Japan's biggest broker, bought the Asian, European, and Middle Eastern divisions of Lehman Brothers, for a reported $225 million. Meanwhile, the insurer Tokio Marine Holdings paid $4.7 billion for property and casualty insurance company, Philadelphia Consolidated, to gain access to the American market.

Domestically, the Japanese government was not expecting as sharp an economic decline as actually occurred. It had prepared two stimulus programs that turned out to be insufficient for the scale of the downturn. In early 2009, though, the government was shocked when it discovered that the growth rate had fallen an annualized pace of -12.1%. The government's third stimulus package amounted to about 3% of GDP and was larger than the new spending of the previous two packages. As this spending shows up in the economy, it seems to be having the desired effect.

At the international level, Japan has helped to provide funds for countries and institutions. In particular, it has loaned the International Monetary Fund an additional $100 billion from its foreign exchange reserves to be used to make loans to emerging market and other economies. In addition, the country invested $2 billion in the World Bank to help recapitalize banks in smaller, emerging market economies. In cooperation with other countries and central banks, it has provided currency swaps and other arrangements for countries that might face shortages of foreign exchange.

Until late 2008, Japan was the largest holder of American government assets, according to Treasury Department reports. China then took over the top position. In recent months, Japan has been acquiring American government bonds and other securities at a $25 billion annual rate, about half the flow from three years ago when it was heavy in the market for Fannie Mae and Freddie Mac assets.

The Political Capacity for Economic Reform

Political change is likely coming to Japan. Mandated parliamentary elections must be held no later than September 10. The opposition Democratic Party of Japan (DPJ) is favored to win according to recent surveys of its popularity compared to the ruling Liberal Democratic Party (LDP). A change in electoral fortunes, the first major one in 55 years except for a brief period in 1993, could have a major effect on economic policies.

First, a new party would enter with support from different constituencies than the current web of political relations built over a half century. Although the DPJ would feel bound to support its own backers, the important point is that they would be different from the old group. Among the LDP's constituencies that may be given less weight in a DPJ government are small shopkeepers, small firms, and small farmers, all of which have sharply dwindling numbers.

The second reason for expecting change is that the ties to personnel in the government bureaucracy would be broken. The LDP has ruled through an alliance between the politicians, their supporters, and the ministerial administrators, who have considerably more power than American government staff. Breaking these links would reduce the impact of bureaucrats' preferences.

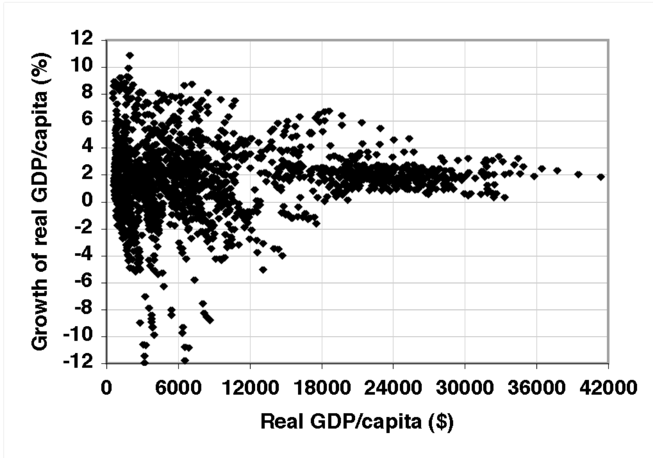
The DPJ's published policy proposals include tax cuts and transfer payments to individuals to stimulate consumer spending. Part of the financing of this stimulus would come from shifting expenditures on favored LDP projects involving large construction projects. In addition, the DPJ platform calls for cutting business taxes on smaller firms.

Nonregular employment has risen dramatically in the past decade, reaching almost one-third of all workers. This growth has been based on deregulating the temporary employment system at the same time that companies were searching for ways to increase workforce flexibility. However, the nonregular employees earn very low wages, have few fringe benefits, and remain outside the main unemployment compensation schemes, which were designed for the prevailing concept of so-called lifetime employment. The DPJ proposes reducing the disparities between types of workers as well as increasing the minimum wage in several installments. However, it has no plans for overhauling the social safety net. Moreover, many DPJ members had been in the old socialist parties and have strong commitments to unions and workers' rights. They would like to retain many of the current protections that create labor market rigidities.

Can the DPJ bring new leadership to Japan? It is unlikely in the first iteration of forming a new government. However, the appearance of a political leader like Prime Minister Koizumi as well as the rise of many innovative governors at the prefectural level show that true reformers are not absent in Japan. Mr. Koizumi's problem was that he was trying to break old norms from within the traditional governing party. He was like Mikhail Gorbachev who tried to transform the Soviet Union from within the Communist Party. It required the disestablishment of the Communists and transformation of political life to achieve lasting reform.

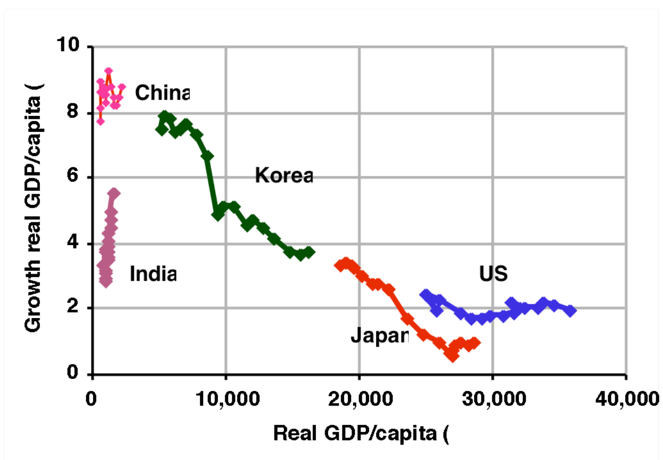
Nevertheless, enough change has occurred in political and economic institutions that bold leadership could emerge from the confusion of a new party, new people, and new institutions. However, no one has lost money by betting against the conservative nature of the Japanese people, at least not in the last 60 years.

Figure 1: Average Growth Rate, Real GDP/Capita Over Preceding 10 Years and GDP/Capita, 1980-2007



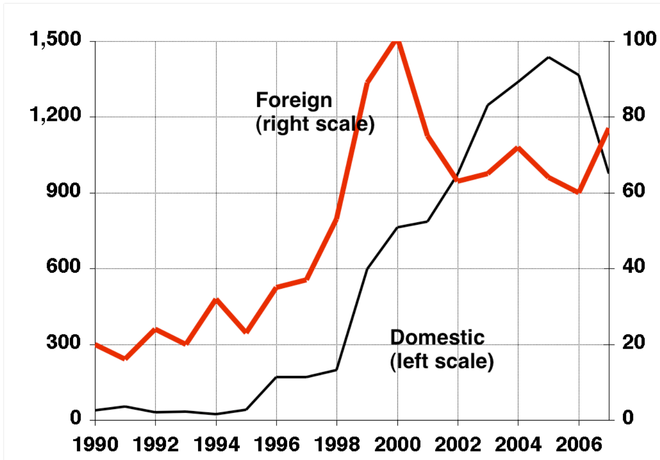
Note: National currencies converted into 2005 dollars at purchasing power parity. Excludes oil-dependent countries, those with fewer than 1 million population, and less than $1,000 GDP/capita.
Source: World Bank

Figure 2: Japan, China, Korea, India, and United States: 1980-2007; Average Annual Growth Rate of Real GDP/Capita Over Preceding 10 Years and GDP/Capita



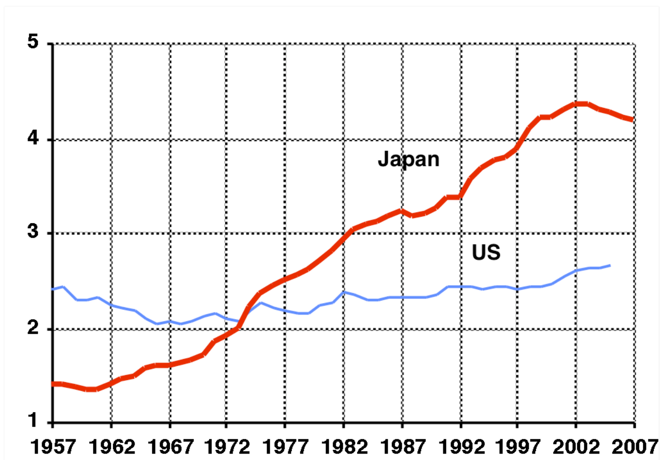
Note: National currencies converted into 2005 dollars at purchasing power parity.
Source: World Bank

Figure 3: Mergers and Acquisition in Japan, 1986-2007 (number of transactions)



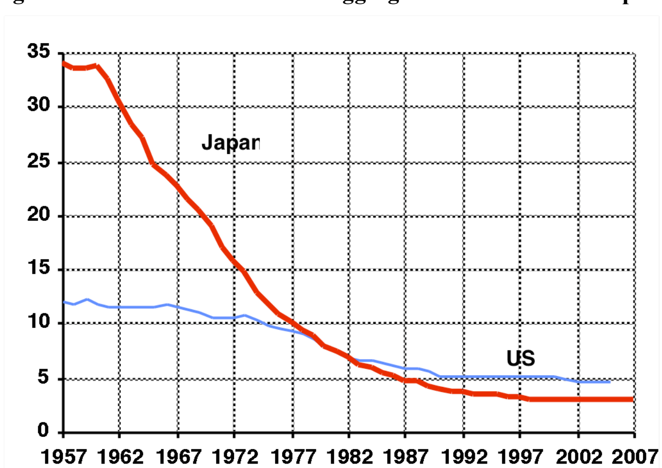
Source: Thomson Reuters

Figure 4: Ratio of Capital Stock to GDP



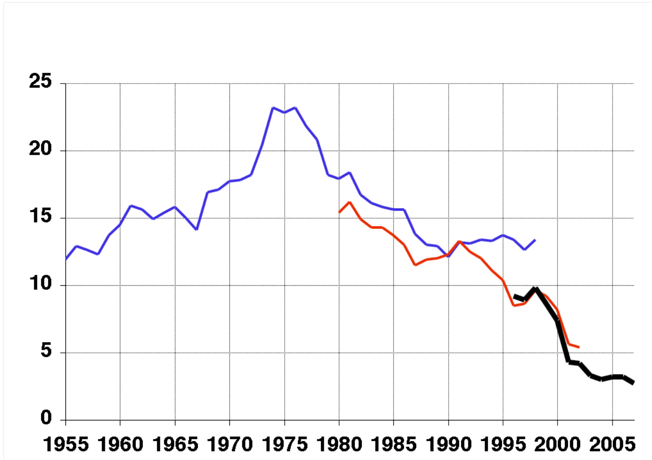
Source: Arthur Alexander, *The Arc of Japan's Economic Development*, Routledge, 2008, p. 107.

Figure 5: Real Returns on Total Aggregate Nonresidential Capital



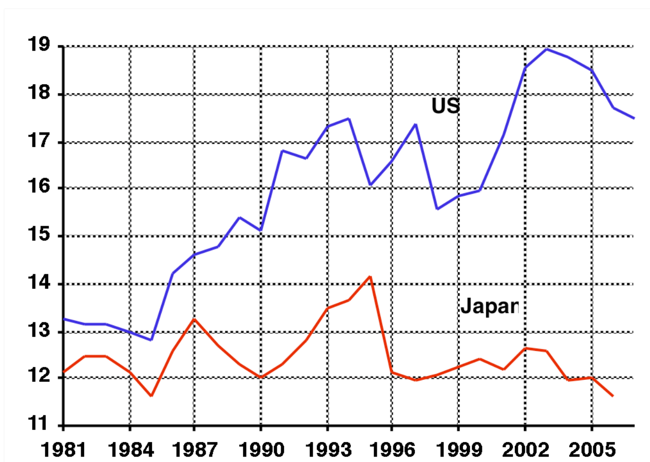
Source: Arthur Alexander, *The Arc of Japan's Economic Development*, Routledge, 2008, p. 108.

Figure 6: Ratio Household Savings to Disposable Income (%)



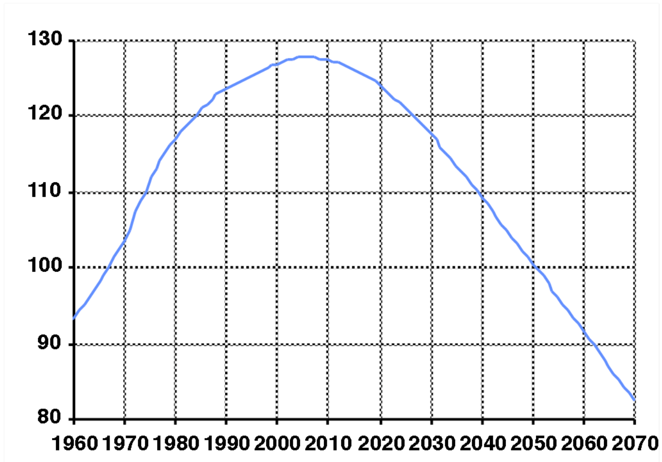
Note: Separate lines reflect changes in national account definitions.
Source: Cabinet Office, Economic and Social Research Institute

Figure 7: Basic Research Expenditures as Percentage of Total National R&D Spending



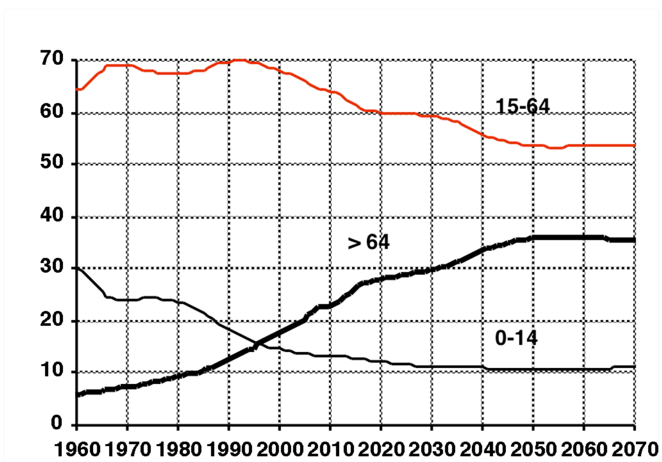
Source: OECD, Main Science and Technology Indicators

Figure 8: Japan's Actual and Projected Population (million)



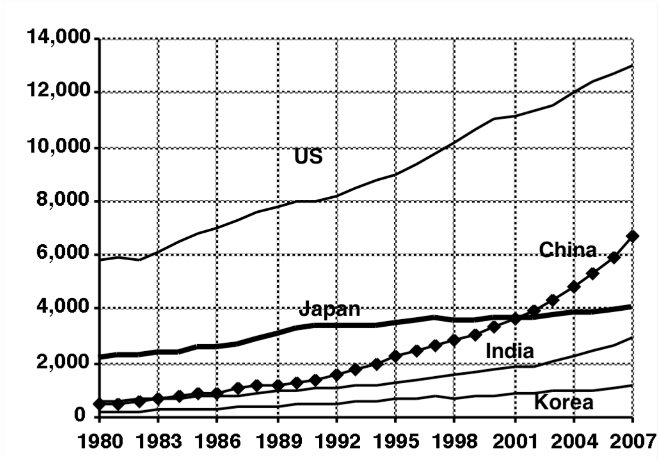
Source: Statistics Bureau, Ministry of Internal Affairs and Communications

Figure 9: Japan's Population Share by Age Group (%)



Source: Statistics Bureau, Ministry of Internal Affairs and Communications

Figure 10: Real GDP (billion 2005 constant purchasing power parity dollars)



Source: World Bank

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Dr. ARTHUR J. ALEXANDER

Biography

Dr. Arthur Alexander's experience includes ten years as president of the Japan Economic Institute specializing in Japanese economics, staff member at the Rand Corp, advisor and consultant to a wide range of industry and government clients, teaching at major universities, and publications in academic journals, magazines, and newspapers. His most recent books on the Japanese economy include: *In the Shadow of the Miracle*, Lexington Books (2002); and *The Arc of Japan's Economic Development*, Routledge (London) (2007).

Dr. Alexander joined the Japan Economic Institute in Washington, D.C. as its president in 1990. At JEI he conducted research on the Japanese economy, industry, technology, and innovation. JEI, a nonprofit research organization supported in part by Japan's Ministry of Foreign Affairs, ceased active operations at the end of 2000. In 2001, Dr. Alexander received an award from the Japanese Foreign Ministry for "distinguished service" promoting understanding of Japan.

He has conducted research directly for the American and Japanese governments, the World Bank, and private companies. He has testified before the U.S. congress on Japanese and other economic issues. focused on Japan studies, Dr. Alexander also has published research on the Korean economy. He is the Mitsui adjunct professor on Japan at Georgetown University and a professorial lecturer at the Johns Hopkins University School of Advanced International Studies.

Dr. Alexander grew up in Carbondale, Pennsylvania. He graduated from the Massachusetts Institute of Technology in 1958 with a BS degree in engineering and industrial management. Following service in the U.S. Army, he worked for the IBM Corp. as a systems analyst in Poughkeepsie, New York. He then received a M.Sc. degree in economics from the London School of Economics in 1966 and a Ph.D. in economics from the Johns Hopkins University in 1968.

From 1968 to 1990, Dr. Alexander was a member of the research staff of the Rand Corp. in Santa Monica, California and was the associate head of its economics department from 1977 to 1985. At Rand, he specialized in a wide range of subjects, including Soviet affairs, research and development, weapons acquisition policies, and defense decisionmaking. Dr. Alexander turned to Japanese issues in the 1980s, including studies on trade in services, legal markets, innovation, and defense industry.

In 1976-1977, Dr. Alexander was a research associate at the International Institute for Strategic Studies in London. He was a member of the U.S. Army Science Board for five years, chairing studies on policy analysis, weapons acquisition, and labor requirements. Dr. Alexander was also a member of the faculty and advisory board of the Rand Graduate School and a visiting professor at UCLA.