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The State of the Japanese Economy

An Overview by Shijuro Ogata

Former Deputy Governor of the Bank of Japan

Executive Summary by Japan Chair Interns

Naoko Noro and Guyltone Sukawati

The Office of the Japan Chair hosted a seminar on the Japanese economy on October 5, 2004. The speaker, Shijuro Ogata, is a former Deputy Governor for International Relations of the Bank of Japan.

Mr. Ogata began by observing that Japan's economy is finally overcoming the decade-long stagnation. It boasted a 6% real growth over two quarters, with the second quarter showing a slight slowdown. Experts believe that Japan can expect 3.5% real growth for the 2004 fiscal year, though the IMF and OECD have revised this number to 4.4% for this calendar year. He points out that strong external demand and revived corporate activities after restructuring are two factors that contributed to the recovery.

However, the Japanese economy faces several ongoing problems that hinder its recovery: an uncertain level of domestic demand, the condition of major external markets, oil prices, the exchange rate, and bond prices.

Though the strength of domestic demand is growing due to increased personal consumption, the current jobless recovery is marked with a continually high unemployment rate. Since prospects for consumption depend on the employment situation, it is uncertain that personal consumption will rise constantly in the future.

The condition of external markets also has a great impact on Japanese economy. All forecasters expect a slowdown in the Japanese economy next year mainly because of a possible slowdown of the two major external markets, the U.S. and China. Furthermore, some analysts believe that China's bubble economy may eventually burst. Depending on a soft or hard landing of the economy, Japan may be adversely affected.

The third influential factor in the Japanese economic recovery is the price of oil. The current high price of oil has not inflicted serious damage on the Japanese market because of domestic deflation in Japan, high oil inventory, and Japan's efforts in reducing its dependence on foreign oil after two oil crises in the 1970s. However, other external markets, especially the U.S. economy, would be affected if the oil price continued to rise.

A Sept 29th article in the Financial Times stated that the current price of oil per barrel is fifteen dollars above market price and is due to several reasons. First, the US currency is relatively weak at the moment. Secondly, there is instability in Iraq, Saudi Arabia, Nigeria, and Venezuela. Thirdly, the state of affairs in Russia is having a marked affect on oil prices. Lastly, OPEC's diminishing oil capacity has made it unable to cope with inflating oil prices.

The fourth concern is the exchange rate of the Japanese Yen. The Japanese Yen has been stable without intervention this year due to the growing anticipation of high U.S. interest rates. However, a huge U.S. account deficit might devalue the U.S. dollar. Export-oriented manufacturers could compensate for this outcome by outsourcing, however this would speed up the hollowing out of Japanese industries.

The Japanese fiscal imbalance, which is by far the largest among developed countries, is another obstacle to the Japanese economic recovery. Despite bond prices presently staying high and long-term interest rates staying low, if the Japanese Government Bond's (JGB) credit rating is down-graded, the situation may change. Bond prices would decrease while long-term interest rates would simultaneously increase before Japan's economic recovery becomes sustainable, stifling its pace. This would be an increasing likelihood if the postal service, which holds a quarter of the JGBs until maturity, were to be fully privatized. In this scenario, the privatized postal service could not always be expected to invest in and hold this number of JGBs.

Aside from fiscal imbalances, Mr. Ogata states that longer-term problems to the Japanese economy loom on the horizon. Demographic change caused by a falling birth rate, the hollowing out of industries, and the egalitarian nature of the Japanese society are all challenges to recovery. He urges prompt action to counteract these problems.

As the birth rate is declining, Japan is rapidly moving towards an aging society without an adequate pension system. Japan needs to improve current systems such as nursery support, tax incentives for larger families, maternity leave, and consider liberalizing labor immigration laws.

In order to offset the hollowing out of industrial activities, steps need to be taken to promote inward direct investment of high value-added and/or high technology industries through drastic deregulation and some other incentives.

Mr. Ogata also points out the downside of Japan's egalitarian nature of the society. The Japanese educational system currently produces good workers, but not good leaders.

Japan's egalitarian society is conflicting with the market approach of Koizumi's new economic policies.

Q&A

Q. Mitsubishi-Tokyo Bank merger issue: Is it really desirable to have such a large bank in terms of assets?
A: This new bank has the potential to become one of the world's leading banks. However, care must be taken to ensure that Mitsubishi-Tokyo adopts the strategy of being a good bank over merely a large bank.

Q. What is the prospect of privatization of the postal services?
A: It can be discussed from several points of view: macroeconomic, competitors, consumers, and political and financial beneficiary.
1) Macroeconomic POV: The biggest problem of the existing mechanism of the postal service is the fact that it has been automatically channeled to the government without the scrutiny of Japanese parliament or without the scrutiny of financial markets.
2) Competitor's POV: Private banks and security companies are concerned that the postal service has enormous advantages in taxes and governmental guarantees, and a semi-privatized postal service might be given more authority to widen its activities.
3) Consumer's POV: The privatization of the postal service is not a big issue to the ordinary citizen.
4) Political beneficiary: governmental control by conservative politicians, postal workers and unions prefer the status quo

Q. What about foreign investment in the postal service area
A. Foreign investment is favored, but it is probably not possible for the foreign companies to establish new postal system.

Q. Inflation: Can the BOJ survive if deflation ends?
A. The dilemma of the BOJ is that it must self impose a limit on the purchase of JGBs. The BOJ will be forced to purchase JGB's if deflation ends.

Q. Why has payroll income not increased?
A. The current economic recovery is a jobless recovery. The amount of labor in Japan is too large, thus the companies began outsourcing. This is resulting in a lack of payroll income increase.

Q. What is the situation of current bad loans in Japan?
A. The strict regulatory control under Takenaka, the recovery of the stock market, and the economic recovery contributed to reduce a significant amount of bad loans. Moreover, demand for bank borrowing has still been moderately low, which also contributed to a reduction in bad loans.

Q. At what point does the fiscal imbalance reach point of no return where Japan's only alternative is to inflate or default?
A. Half of the government expenses are covered by tax revenue and half of it is covered by borrowing. The government is therefore trying to achieve an equilibrium of primary balance. The Japanese government does not have clear plan on this issue

Q. The government is borrowing everything that goes in to postal savings. How do you alleviate that?
A. Privatization process has to be gradual, rather than rapid. When privatized, the funds received by the postal savings services before privatization should continue to be invested in government bonds. Then, newly deposited funds should be invested to other various financial instruments.

Q. The consumer price index is showing moderate deflation in Japan. Where is the other deflation coming from?
A. The GNP deflator is exaggerating. Consumer price index is more reliable. Nominal growth is more important.