Foreword

巻頭言

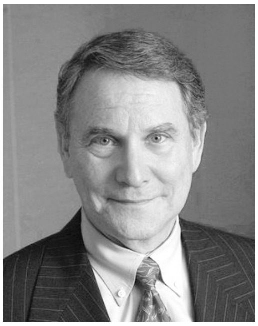
Japan in the Global Economy:

Utsubyo kara no Dassyutsu

Tudor Investment Corporation

Managing Director
Robert Dugger

Director of Global Economics
Angel Ubide



Japan has successfully exited the emergency situation of the last decade and is enjoying steady growth. It is beyond recovery. It is on a stable growth path that will be sustainable if Japan can continue to focus on what is best for long-term success in a global economy.

Japan's growth challenges are structural and have been the focus of several past governments. The challenges are (1) restructuring the private sector to enable Japan to do well in a globalized economy; (2) rebalancing the public sector's spending priorities to attain long-term sustainability; and (3) assuring a strong productive future workforce. In our 2004 paper, "Structural Traps, Politics, and Monetary Policy", we explained how Japan in the 1990s was caught in a trap of old-Japan political priorities and how structural reforms were the key to escaping.[1]

Japan is enjoying one of its longest expansions on record – lasting about 5 years, just shy of the record long expansion in 1965-1970. Labor markets are the tightest in the past fifteen years, and inflation has gone from negative to positive, from about -1.5 percent in mid 2002 to close to 1 percent in late 2006. Land prices are increasing again. However, some commentators argue that Japan is still in danger of deflation. These commentators, though technically correct – current headline inflation rate is flat year on

1） Robert Dugger and Angel Ubide, "Structural Traps, Politics, and Monetary Policy", *International Finance*, 2004.

year – are missing an important point. The deflationary years 1995 – 2005 were the result of a clear insufficiency of demand and probably entrenched deflationary expectations. That was a dangerous situation, and an extraordinary monetary expansion was warranted.

The economic landscape now, however, is different. With growth at around potential, a closed output gap, and unemployment very close to the NAIRU, the Japanese inflation rate is very low because Japanese citizens are enjoying a positive supply shock. Note the word "enjoying" – it is a good thing. The Japanese economy has transitioned from suffering a negative demand shock to enjoying a positive supply shock. The recent telecom industry price war is just one example of how Japanese citizens are benefiting.

Japan's current growth is taking place in a global environment characterized by flat or inverted yield curves and a large US current account deficit. This low-rate environment is the result of a combination of shocks occurring one after another that have led to a rise in the international supply of savings from emerging market countries. The 1997/98 emerging market meltdown responses, the post-2001 investment declines in OECD countries, the deflation scare following stock market bubble burst, the corporate scandals, the geopolitical events, and China and India's entry into the world trading system, all led to policy responses that then led to nominal interest rates declining sharply in line with real rates. An initial savings upturn has become a worldwide liquidity glut. While the fall in real interest rates was common to most OECD countries (especially in the US and the eurozone) the impact on domestic demand was asymmetric. Japan and Europe lagged behind, and consequently, current account imbalances rose. When persistent oil price increases added to the saving-investment imbalance, current account imbalances reached historic highs.

It is wrong to blame any individual country for the imbalances – not Chinese foreign exchange policies, US fiscal profligacy or Japanese monetary policy. Though complex, there were two consequences. A long period of lower inflation and interest rates is boosting asset prices. And, a widening of the disparity between labor and profit shares of GDP is increasing income differentials. These are structural shifts that will be long lasting and therefore should be accommodated rather than opposed.

The key conclusion for Japan is this: an emergency stance of monetary policy is no longer warranted. Japan escaped a structural trap when it abandoned politically directed fiscal expansion and instead embraced structural reform. The supportive stance of monetary policy was important for success, but the key to success, and a precondition for growth, was serious and credible structural reform.

Foreword

Is the work done? No. Much remains, mainly in the area of fiscal imbalances. Over the past seven years the priority was clearly: "Reform first, growth second". Now it seems "Growth first, reform second" is more accurate. The Abe government's ageshioseisaku policy seems to make strong nominal growth the main priority. In targeting nominal GDP growth in 2011 to be at 3.9 percent, with CPI inflation at 1.9 percent, the government seems to be leaning on the Bank of Japan to deliver inflation at the upper end of its definition of price stability (zero to two percent), rather than at the mid point. It looks like the government is trying to exert fiscal dominance over monetary policy and maximize the use of inflation as a tax and as an alternative to fiscal discipline.[2]

A priority shift would be understandable given how Japan's income distribution is widening and how its aging population is making further fiscal reform difficult. The ageshioseisaku policy seems to be directed at addressing both problems in the least politically painful way. Pressure on the Bank of Japan, however, risks diminishing Bank of Japan statutory independence. One test of whether this policy is acceptable is whether it generates undesirable distortions in the economy. Two distortions are possible. The first is accelerating yen weakening. The second is relaxation of structural reform incentives.

Some slow yen weakening should be expected as a result of households steadily diversifying savings from low-yield ultra-safe yen assets into higher yielding non-yen assets. This is a structural trend that will likely last for a long while and is unrelated to monetary policy. This natural portfolio shift is amplified by very low central bank interest rates and perceptions that interest rates will remain very low for a long time, amplified to the point that companies and people around the world finance their activities in low-cost yen and a natural reduction of home bias becomes global bubble-like behavior – the so called yen carry trade.

A second distortion involves the relaxation of incentives for much needed public sector structural reforms. As two billion workers from developing markets joined the global labor force, developed countries struggled to adapt by allowing wage growth to slow. This preserved competitiveness somewhat and increased productivity growth that moved them up the value-added ladder. The resulting decline in the wage share of GDP in

2) The example of Switzerland is perhaps illuminating. A few years of sluggish growth and very low and even negative inflation were accommodated with very low interest rates, reaching a low of 0.25 in 2003. Since then, the Swiss economy is growing strongly and interest rates are now 2.25 percent. However, as a result of a similar positive supply shock, inflation in Switzerland has remained subdued and the latest data indicates inflation at 0 percent yoy. Nevertheless, the SNB is expected to continue tightening policy in the foreseeable future.

developed economies amplified secular pressures toward increasing income and wealth inequality.

Japanese leaders are fully aware of why they should not try to solve Japan's inequality problem via active yen weakening policies. They know that these policies are short-term in nature, generate international political tensions and ultimately fail. Such policies, for example, interfere with efforts to help China move to more flexible exchange rates, and with US efforts to prevent protectionist policies from taking hold in the US Congress.

The solution is for Japan to do what it does well – focus on what is best long-term. By focusing on the long-term, Japanese leaders over the past decade did more than any other developed country in the world to restructure and modernize private business and financial sector practices and policies. They also did more than any other country to scale back unsustainable government pension and health care commitments. This is not enough, however. Because of Japan's demographic profile, deficits are still above 5% of GDP; government debt is still over 150% of GDP; and the Bank of Japan still has to buy over 25% of net new government debt.

To escape fully, Japan needs to turn political priorities upside down. Instead of focusing on the burdens of government debt, which arise mainly from its aging population, Japanese leaders need to focus on what is best for the next generation and the one after that. Youth human capital is where the highest economic returns are. They need to think long-term and put the life success of Japanese kids first in every policy decision, public and private. If they can do this, resource allocation will shift to generate faster GDP growth, more jobs, less crime, and a more competitive workforce.

Japan has successfully left the economic emergency room and it is now growing in line with standard business cycle dynamics. Interest rate normalization must be allowed to continue and policies that involve bending monetary policy to achieve artificial yen weakening, inflation increases and nominal growth targets must be avoided. Such "fiscal dominance" policies are short-term in their vision and put Japan in conflict with other nations.

Policies to maximize the lifetime wellbeing of the next generation of Japanese citizens will keep Japan on a sound growth path and solve Japan's fiscal sustainability challenges. Such policies will also lock in the hard won credibility of the Bank of Japan as a world class, independent central bank. Together these policies will enable Japanese companies to be able to continue improving efficiency and not become entangled in a downward spiral of low interest rate, weak currency policies. Japan cannot afford to fall again into a structural trap.