Richard Katz on the Japanese Economy

Richard Katz is Editor-in-Chief of *The Oriental Economist Report (TOE)* and also a special correspondent for the *Weekly Toyo Keizai*, a leading Japanese weekly business magazine. Katz holds a BA in history from Columbia University and an MA in economics from New York University. A veteran journalist, Katz has been writing about Japan and US-Japan relations for three decades. For several years, Katz was a Visiting Lecturer in Economics at the State University of New York (SUNY) at Stony Brook and then Adjunct Professor of Economics at the New York University Stern School of Business.

Katz is author of two books on Japan: *Japan: The System That Soured—The Rise and Fall of the Japanese Economic Miracle* (M.E. Sharpe 1998), and *Japanese Phoenix: The Long Road to Economic Revival* (M.E. Sharpe, 2003) both of which received favorable reviews from a variety of publications. Katz has testified before Congressional committees on US-Japan and US-Asian relations as well as on lessons for the US from Japan's banking crisis.

His comments on Japan are frequently quoted in major publications such as *The Washington Post*, *TheWall Street Journal*, *The New York Times*, *Los Angeles Times*, *London Economist*, *Chicago Tribune* and the *San Jose Mercury News*, and he has been interviewed on "Newshour with Jim Lehrer," CNN, Bloomberg TV, and BBC's "The World" and "Marketplace." His op-eds have appeared in *The New York Times*, *London Financial Times*, *Asian Wall Street Journal*, *Asahi Evening News*, *Japan Times*, *Christian Science Monitor*, and *Investors Business Daily*. Longer essays have been published by *Foreign Affairs*, *The Washington Quarterly*, *The International Economy* magazine, *Challenge*, and *The American Prospect*.

In what follows, Richard Katz lucidly describes Japan's recent economic history, the nation's current economic and political climate, and its future economic prospects.

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Lucien: *Richard, please provide our readers with some background information about your early life and about how you became interested in Japan.*

Richard Katz: I grew up in a small town (17,000 people) in western Massachusetts. Although the people were wonderful, it was boring. By age ten, I knew I wanted to move to a big city and see the world. Attending Columbia University in New York City helped fulfill that goal. My involvement with Japan was an accident. Like Columbus, I got lost on my way to a different destination. At Columbia, I was involved with the anti-Việt Nam War movement and desired to take a course on Việt Nam, even though I expected to major in Western history. There were no courses on Việt Nam, so I took a seminar—the first semester covered China, and the second semester covered Japan. At the time, I knew almost nothing about Japan except that, when my parents bought me a toy and it broke three days later, it was sure to have been made in Japan. As someone interested in both history and economics, I found the post-Meiji history of Japan to be absolutely engrossing. With the debates over industrial policy just breaking out in the US, Meiji Japan's ability to avoid colonialism by a forced march to industrialization fascinated me. And with the US-Japan trade friction escalating, that, too, became a subject of interest. After college, I launched a freelance career in journalism, including writing articles in Japanese publications about US-Japan relations. I've always been self-employed and now publish my own newsletter on Japan, called *The Oriental Economist Report*.

Lucien: *As EAA readers are aware, Japan suffered from an extended economic malaise that encompassed all of the 1990s and the first few years of this century. Can you briefly summarize the major reasons for the so-called "lost decade?"*

Richard Katz: Some of the very features that led to the Japanese economic miracle in the 1950s–60s led to the lost decade. That's because the same policies that were so helpful during the catch-up era that had turned a poor, rural economy into an industrial powerhouse in the

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twinkling of an eye became harmful once Japan had caught up. The caterpillar, not realizing it had turned into a butterfly, refused to leave the cocoon. In the mid-1970s, industrial policy changed from promoting future winners like autos, electronics, and steel to protecting losers or has-beens like textiles, material goods industries, chemicals, retail, and farming. As a result, productivity growth and long-run GDP grew slowly. Today, even at full employment and full capacity-utilization, Japan cannot grow faster than 1.5 percent a year over the long haul.

Japan has a dual economy—good efficiency in sectors exposed to international competition and poor efficiency in domestic sectors where there is also little domestic competition. In food processing (not farming, but once the food leaves the farm and heads to the grocery shelf), Japan's productivity is forty percent of US levels. In addition, the same structural defects that hurt productivity growth also kept household income too low as a share of GDP. As a result, Japan suffered from "economic anorexia," i.e., a consumption disorder. Consumer spending was weak, not because people did not want to buy, but because their income as a share of GDP was too low. With private domestic demand too low to absorb Japan's output, Japan needed artificial sources of demand from big trade surpluses, to big budget deficits, to excess private investment stimulated by monetary steroids. The 1980s bubble was a symptom of these structural defects, as was the nonperforming loan (NPL) crisis in banking. The lost decade was the ultimate outcome.

Lucien: *What structural problems that helped to cause the "lost decade" have been addressed? Which problems remain unresolved and contribute to current woes?*

Richard Katz: The biggest positive achievement of the last decade was the Koizumi administration's resolution of the non-performing loan (NPL) problem; bank losses on bad debt. That was the *sine qua non* of doing anything else. But, many of the deeper structural defects that led to the NPL problem and lost decade have only begun to be addressed. Very little has been done to raise household income as a share of GDP. On the contrary, real wages have fallen every year since 2001 except for 2005. The new Democratic Party of Japan (DPJ) government has pledged to remedy this situation and, in its campaign manifesto proposed some very helpful steps, such as a child allowance of ¥312,000 ($3,250) per child per year and free high school education in the public schools. This is the first time Tokyo has even recognized low disposable income as a major impediment to growth. However, due to excessive fears about the budget deficit, the Hatoyama administration had only partly fulfilled its promises. It did pass the free tuition law and passed the child allowance at half the promised amount. Whether it will go to the full amount next year or later remains unclear. On the core issue of raising potential economic growth by raising productivity growth, the DPJ's "growth strategy" document issued in January offered little growth and even less strategy. The DPJ's goal is a terribly lame one percent average real growth from the pre-recession peak in 2007 through 2020. Although some in the party have more progressive ideas, the current leadership seems to acquiesce in Japan's low growth.

Japan needs to raise real growth to take care of the elderly, provide opportunities for the young, and so forth. The main way to get that growth is to increase competition among firms so that they have to improve efficiency to survive. You can't have competitiveness without more competition. There are too many product areas where a few firms dominate the market, and there is little change in market ranking or market share or entrance of new competitors. Mergers have often taken a few leading firms in sick industries and made oligopolies even more concentrated. Using irregular workers to push down wages is not flexibility; it is wage austerity. Yes, there has been some corporate reform, but not enough to spur a productivity revolution in Japan's backward industries, where it is most needed. Most of the reform has occurred in the same sectors most exposed to international competition where there has always been continuous reform. So, while we can easily point to many positive actions, they have not been sufficiently widespread or deep enough yet.

Lucien: *I've heard conflicting reports about Japan's current economic situation—more bad than good. As of this interview (February 2010), what is your prognosis as to which economy—Japan or the US—is facing the most serious economic situation and will likely have the most difficult time recovering?*

Richard Katz: Japan has greater difficulties. Their 1990s recession was the most severe among rich countries, and it is taking a long time to get back to its pre-recession peak. In Japan, the primary problem was pervasive dysfunction in the economy, which was reflected in, among other things, a banking crisis. In the United States, the primary problem was pervasive dysfunction in the financial sector, which spilled over into the real economy, causing a deep and unnecessary recession. America's financial dysfunction is not the result of structural flaws, as in Japan, but of grave policy mistakes, compounded by widespread investor panic. The current US crisis is also far smaller than Japan's crisis in the 90s, and the response of its policymakers has been much quicker.

Japan's malaise was woven into the very fabric of its political economy. The country has a thin social safety net, and so in order to protect jobs, weak domestic firms and industries were sheltered from competition by a host of regulations and collusion among companies. Ultimately, that system limited productivity and potential growth. The problem was compounded by the anorexia I mentioned earlier. To make up for the shortfall in demand, the government used low interest rates as a steroid to pump up business investment. The result was a mountain of money-losing capital stock and bad debt.

Japan's crisis pervaded virtually its entire corporate world. In sector after sector, white-elephant projects—from office buildings to auto plants—were built on borrowed money under the assumption that if times got tough, the government and banks would bail out the debtors. But the banks were too poorly capitalized to write off bad loans. And for every bad loan, there was a bad borrower whose products were not worth the cost to make them. The cumulative total of bank losses on bad debt between 1993 and 2005 added up to nearly twenty percent of GDP. Policy mistakes—from Japan's mismanaged fiscal and monetary

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policy to the government's failure to address the loan crisis—made a bad situation even worse. Even if policymakers had done everything right, Japan's economy still would have stagnated until Tokyo addressed its more fundamental flaws

The financial crash and recession in the US was primarily the result of discrete, avoidable, and correctable mistakes brought on by ideological excess and the power of financial-industry lobbyists. The balance sheets of most US non-financial corporations, outside of autos and housing, are sound, unlike Japan. The first mistake was the US government's refusal to regulate subprime mortgages. The second policy blunder was the US government's failure to regulate the compensation of chief executive officers (CEOs)—a system that in its current form gives executives incentives to take outrageous risks with other people's money. The third error was the virtual non-regulation of the derivatives market. I am worried that the prospects for serious financial reform in the US seem rather dismal at present.

Lucien: *Recently, the DPJ gained control of Japan's House of Representatives for the first time in history. Do you see this political change as good, bad, or mixed for Japan's economy, and why?*

Richard Katz: I see this as potentially very good. The Liberal Democratic Party (LDP) was inherently incapable of solving Japan's economic reforms because of its very nature. Part of the LDP base would benefit from reform; part would be hurt. So the party was paralyzed. Even Junichiro Koizumi could not make lasting changes in the LDP.

The DPJ suffers from many of the same divisions, but it is not closely tied to the vested interests that hamstrung the LDP. However, it is tied to the labor movement, which often prefers job security even at the cost of wages and efficiency. The DPJ needs to find a way, like Sweden has, to combine market/labor flexibility with high wages and income security. Rather than trying to protect a worker's job at a given firm and therefore protect zombie firms, Japanese policymakers have to make it possible for workers to move from firm to firm, even in mid-career, and help with the transition. Irregular workers are not the problem per se, but the fact that they get lower wages and few benefits is a problem.

A second positive factor is the changing nature of elections. In the past, voters mostly chose based on their local Diet candidate. Now, they are choosing based on which party will run the national government. They will switch from party to party. The role of support organizations, the bedrock of LDP rule, is much weaker. Twice in a row, people have voted massively for change, differing only on whom they thought could deliver that change. If the DPJ does not perform, its 2009 victory could just as easily be lost in the years to come.

Most importantly, the era of one-party dominance is over. Just as economic health requires competition, so does political health. One-party states are not very good at major course corrections. None of this makes reform inevitable, but for the first time, it makes it genuinely possible.

My fear is that the DPJ might blow its opportunity. Prime Minister Yukio Hatoyama is weak and indecisive. DPJ Secretary-General Ichiro Ozawa exercises far too much power even though he has no government post. And those within the DPJ who have good ideas, particularly some of the younger Diet members, are too weak. With every passing opinion poll, approval of the DPJ sinks lower and lower—it probably has blown its chance to win a single-seat majority in this July's Upper House elections, and could do very poorly. Meanwhile, defectors keep leaving the LDP. We could eventually see another round of party realignment.

Lucien: *Japan has been experiencing the demographic trend of fewer children and a steadily expanding senior citizen population for over two decades. How does this trend affect Japan's economy right now, and what are the long-term effects?*

Richard Katz: Aging increases economic, financial, and political strains. How can Japan support its aged when there are fewer workers per retiree? That creates pressure to either cut benefits for the elderly, raise taxes, or run huge deficits. All have negative economic and political consequences. The only solution is to raise output per worker, higher returns to capital, and to increase the tax base. All of that requires more structural reform. This demographic squeeze will only get worse over the coming two decades. So, while aging creates big political/economic tensions, it also created pressure to address these tensions by adopting more reform.

Lucien: *Thanks for sharing your insights about Japan's economy with our readers, Richard.* ■