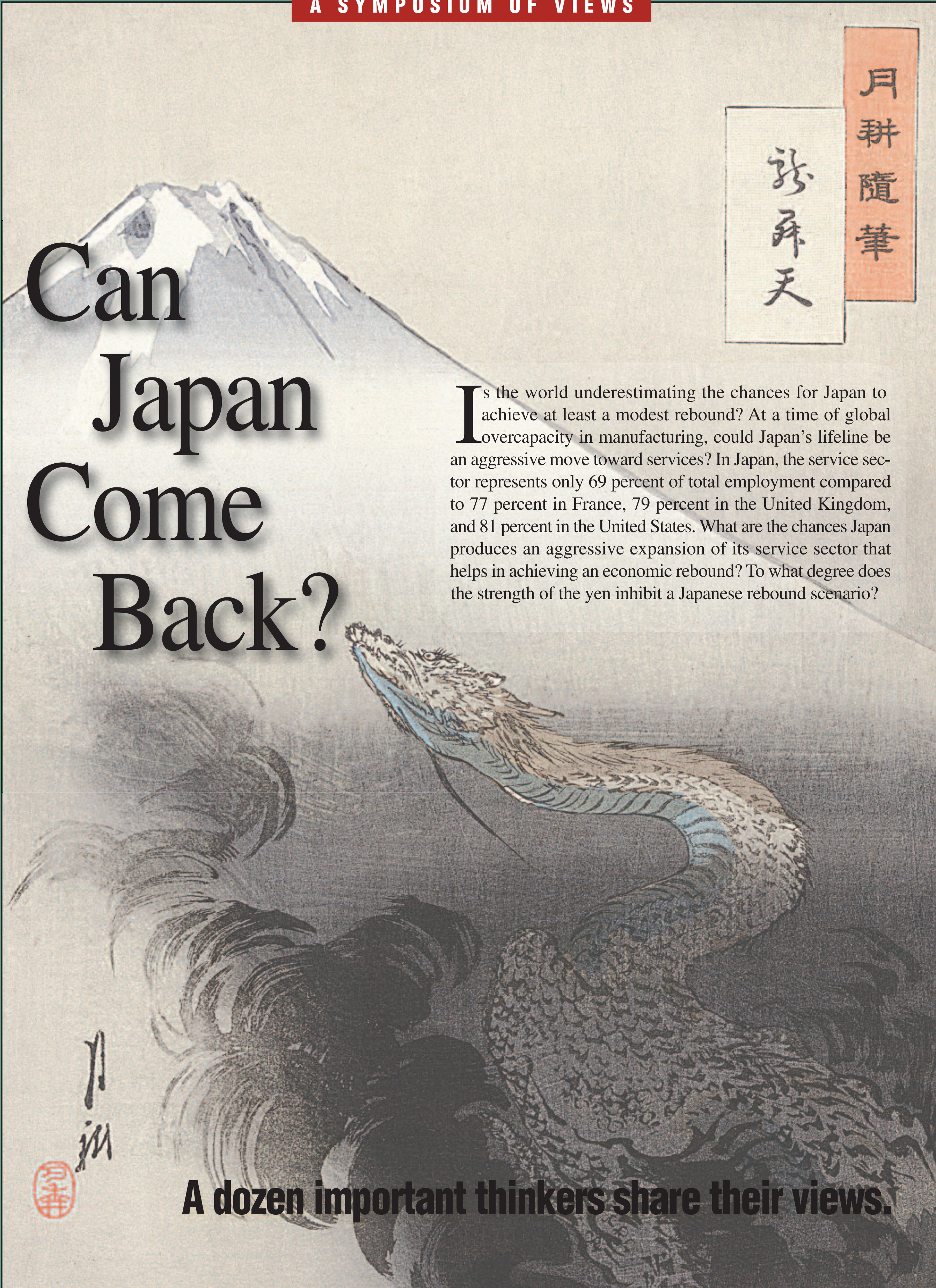
A SYMPOSIUM OF VIEWS

Can Japan Come Back?



Is the world underestimating the chances for Japan to achieve at least a modest rebound? At a time of global overcapacity in manufacturing, could Japan's lifeline be an aggressive move toward services? In Japan, the service sector represents only 69 percent of total employment compared to 77 percent in France, 79 percent in the United Kingdom, and 81 percent in the United States. What are the chances Japan produces an aggressive expansion of its service sector that helps in achieving an economic rebound? To what degree does the strength of the yen inhibit a Japanese rebound scenario?

A dozen important thinkers share their views.

DRAGON RISING TO THE HEAVENS BY OGATA GEKKO, RESTORED BY ADAM CUERDEN

Few signs of structural changes.

JIM O'NEILL
Chairman, Asset Management, Goldman Sachs International

I am torn between not wanting to write Japan off, and wanting us all to write them off so they will finally shake themselves into undertaking policy change. Even after their colossal tragedy this year, Japanese policymakers still struggle to introduce major policy changes to raise the country's productive potential.

I visited Japan in early July and heard anecdotes that on one level, Japan cannot be simply written off. They have proved, through unfortunate stories, that they are a key part of the global economy, supplying lots of important technology and intricate items. Whether through high-tech inputs for the world auto industry or the most delicate pottery or fashion designs, Japan has a place in the world. It is clear that their supply disruptions negatively impacted the world economy in a way that some of us might not have expected in advance, certainly not me.

It also seems clear that Japan is bouncing back from its tragedy, and might positively surprise markets which seem eager to be disappointed about almost anything. That being said, I detect few signs of important structural changes to boost the services industry, which is surely where Japan does need ultimately to make a lot of progress. Without this and given their very poor demographics, all one can look for is a better-than-expected near-term cyclical bounce.

I find myself more and more in the camp of those who have believed for years that the yen's strength is very unjustified. It is fashionable—and successful—to trade the yen based on the two-year note differential between the U.S. and Japanese bond markets, but I cannot see how the yen can stay so strong given Japan's huge challenges going forward.

I haven't even mentioned Japan's continued debt burden, but of course it makes the European picture seem modest. If we ever reach the stage where domestic investors stop buying Japanese government bonds in the manner they do, then the yen will start to fall sharply, irrelevant of the short-term differentials with the United States.

Japan could be the winner in the Green Revolution.

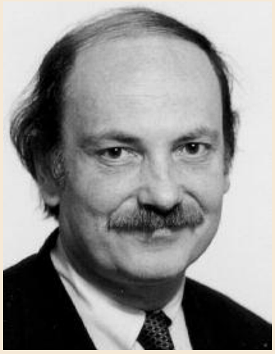
TATSUYA TERAZAWA
Director-General, Multilateral Trade System Department, Ministry of Economy, Trade, and Industry, Japan

The Great East Japan Earthquake has brought an energy crisis in Japan. With dozens of nuclear power plants temporarily put out of service to ensure safety, Japan is facing the possibility of a power supply shortage and almost certain increases in energy costs as a result of turning to fossil fuels for power generation. Japan is now scrambling to conserve energy, expand renewable energy, enhance nuclear safety, and expand efficient thermal power generation while trying to contain carbon dioxide emissions and limit cost increases.

These are indeed great challenges. But these are exactly the challenges that the world will face for the next fifty years. The world will need to find efficient ways to avoid global warming, as well as cope with ever-increasing fossil fuel prices and the possible shortage of fossil fuel. Energy conservation, efficient thermal power generation, renewable energy, and nuclear safety are all necessary. These challenges will force the world to pursue the "Green Revolution."

The earthquake has put Japan in the forefront of the Green Revolution. If Japan can succeed in meeting these challenges, it will lead the revolution equipped with the necessary technology. This will translate into strong industries which can capture the huge potential demand for green technologies, products, and services.

The word "crisis" in Japanese is composed of two letters. One stands for "danger," but the other stands for "opportunity." The oil embargo in the 1970s brought a serious crisis to Japan which until then had been heavily dependent on imported oil. But that crisis transformed the Japanese auto industry into a truly global industry capable of supplying gas-efficient cars. The same can happen this time. Japan is already the most energy-efficient country among the developed economies, with advanced technology related to renewable energy. The current crisis brought by the earthquake can make Japan the winner in the Green Revolution, revitalizing its industries and economy. It would be a mistake to write off Japan.



Japan holds key cards of future relevance.

KENT CALDER
Director, Johns Hopkins University/SAIS Reischauer Center for East Asian Studies

Japan's March 11 9.0-magnitude earthquake, and the tsunami that followed, killed over 15,000 people, rendered more than 320,000 homeless, and wreaked well over $200 billion in damage, making them collectively the most expensive natural calamity in history. This disaster struck amidst a surge of growth and rising competitiveness in surrounding nations that compounded Japan's competitive challenges. Nevertheless, important overlooked competitive strengths remain, while the country's massive economic scale and strategic role remain unchallenged. On many issues of emerging global importance, Japan holds key cards of future relevance.

The first points to consider are Japan's economic scale and strategic location. Its GDP totals over $5 trillion annually—third in the world, and significantly larger than Britain and France combined. Situated off the northeast coast of Asia, it lies near the heart of the most rapidly growing region on earth, helps to balance China's increasing geopolitical weight, and is Asia's most technologically advanced and arguably most well-organized nation.

Japan remains one of the world's most important capital exporters—indeed, the largest creditor, when the positions of both the public and private sectors are considered. It also has critical expertise across a variety of sectors in addressing global problems. Its energy efficiency, for example, is the highest of the major nations, and it is a pace-setter in new materials, as well as microelectronics and construction techniques, while it has earned a reputation for both performance and safety in high-speed rail. It also has an excellent record in both fusion technology development and intellectual property protection.

Although slowed by power shortages and supply-chain disruption, the Japanese economy is coming back more rapidly than expected and should record positive growth for 2011, despite the March disasters. It has traditional inefficiencies in some service sectors, such as retailing and distribution, whose gradual restructuring will help propel future domestic growth. And it has service-related strengths—systems engineering and expertise at transforming diverse technologies into saleable products, as it did in robotics—as well as its versatile general trading companies. These enduring strengths should help support future competitiveness, even in the face of a firm yen. As Asia becomes increasingly important in the global political economy, Japan will be a core element, and cannot be dismissed, in either the global economic or strategic equations.

Japan cannot be written off, because the world economy cannot do without it.

RICHARD C. KOO
Chief Economist, Nomura Research Institute

There may be overcapacity in manufacturing globally, but the March 11 earthquake and tsunami demonstrated how much of that global capacity is dependent on products coming from Japan. In fact, until March 11, Japan was running trade surpluses with all three export powerhouses in Asia: Taiwan, South Korea, and China. And that is with a very strong yen. What this means is that the Japanese have been producing products that are not easily replaced by manufacturers in other countries. Highly profitable business models for Asian countries other than Japan to a large extent are dependent on the availability of quality components arriving from Japan. Japan is one of those few countries that cannot be written off, because the world economy cannot do without it. And this is all made possible by the diligence and penchant for perfection that are so strong in the Japanese society.

As for the services industry, there is a horrendous misunderstanding abroad that Japan's services sector is not very productive. But if that is the case, Japan should be flooded with foreign suppliers by now. The fact that repeated tries by both American and European companies failed miserably is because, given the differences in relative factor prices, the Japanese were actually doing the right things. In particular, energy and land prices are high compared to labor costs in Japan, while the opposite is true in Europe and the United States. Given these initial conditions, it is correct for the Japanese to use relatively more labor and less energy and land, while Americans and Europeans would use relatively more energy and land and less labor to maximize profits. Foreigners who ignored this and tried to set up U.S.- or European-style operations in Japan invariably failed because they ended up maximizing labor productivity to the detriment of total factor productivity.

Even though there was some protectionism before 1995 which resulted in higher prices in Japan compared to elsewhere, Japan today is one of the lowest-cost places except for energy and land. Products available in so-called ¥100 shops all around Japan would put Walmart and Target to shame. Eateries such as Sukiya or Matsuya offer quality meals for far less than $10 even at the current exchange rate. Foreigners who only know Japan through expensive hotels and restaurants used by Japanese businesses to entertain them should venture out and see what the real Japan looks like.

Normalization of interest rates is crucial and a strong yen may actually be positive.

TADASHI NAKAMAE

President, Nakamae International Economic Research

Japan's lost two decades have at least served to erase the huge over-investments made since the country industrialized in the 1950s and 1960s, when total investment growth reached 16 percent. This figure has slowly declined—even during the rambunctious 1980s—eventually falling to negative growth during the past two decades (-0.6 percent in the 1990s and -1.9 percent in the 2000s). Total investment (capex, housing, and government investment) as a ratio to GDP was 21 percent in 2010 (down from a peak of 36 percent in 1973)—a level not seen since 1955 when it was just below 20 percent.

Japan can finally start investing again. But will it do so wisely? The return on investment needs to be high. This will not be achieved with interest rates at zero. For Japan to grow, banks need to start lending again, rather than collecting deposits at zero rates and then buying risk-free government bonds. Thus, short-term rates must go up. Long-term rates need to go up even more, enabling banks to take risks and lend to innovative businesses.

Potential investments will be in domestic services and agricultural industries. The essential ones will be robotics for medicare, nursing care, agriculture, and other labor-saving devices. These will also include home renovation for Japan's rapidly aging population, energy-saving and fresh energy-supply technologies, retraining (adult education), and other areas. These will become more attractive with Japan's traditional manufacturing companies facing sluggish exports as the yen continues to strengthen. This is why the normalization of interest rates is crucial: bank lending supports mostly small businesses which make up a large proportion of these sorts of innovative domestic growth industries. These industries have huge potential demand: nursing care, medicare, hospitals, home renovation, and agriculture are tied to Japan's rapidly aging population, and new energy technologies as alternatives or supplements to nuclear power. Thus, it is these small businesses that will create the huge opportunities that will in turn help large manufacturers, which will become suppliers to these industries. Instead of increasing jobs for low-wage immigration workers, Japan can create opportunities for high-productivity workers in a high-quality services industry.

Despite the howls of protest from exporters, a strong yen may actually be positive for Japan in the long run as it acts as a force for change. One of the biggest barriers to change is an archaic and unwieldy bureaucracy, which acts as a gatekeeper to the fledgling industries that need to be deregulated and allowed to grow. Elected officials come and go. They can and do make a difference, and should be spearheading legislation that would make domestic industries with growth potential thrive. But the real obstacles are the bureaucrats, with territory to guard and vested interests (the more myopic dinosaurs of the corporate world) to support.

Yet should some of Japan's global corporate giants turn their attention to the domestic market, things might change. Instead of making energy-efficient batteries for cars, these companies could be making Japan's next power company based on preserved energy. Or they could be making robots for hospitals and nursing care instead of cars and trucks. As the strong yen eats into their profits, they have more incentive to do so. Their lobbying efforts will do more to change bureaucratic traditions than any political heft.

A worsening economy adds pressure. Bureaucratic clout came from the ability to hand out public subsidies. With a looming budget deficit, that has all but disappeared. Small but critical changes are taking place. The health ministry, which controls medical services, recently found itself forced to lower costs of medicine and raise fees for doctors' services, allowing Japan's hospitals to hire much-needed administrators. Now the system (and business) is more efficient—since doctors need not laboriously type up their own charts, they can spend more time operating or seeing patients.

As the global economy sinks, and Japan's economic outlook gets bleaker, it will be forced to make bigger changes. Slightly more efficient hospitals is a small step, but one that Japan's mighty mandarins would not have countenanced a few years ago. There is hope yet for Japan's dream of a deregulated, profitable domestic growth sector.

There will be no real reform without a bloody battle.

HARUYUKI OSHIMA
News Commentator, NHK-TV

Theoretically, Japan has a great opportunity to develop a new service industry sector, particularly on the social service front in areas such as medicine and medical care. Until now, these fields have been well protected by strong regulation, with a lot of visible and invisible barriers. These regulations came about through the efforts of three sectors—the so-called golden triangle—the vested interest groups composed of businesses, lobbyist politicians, and the unions of government officials. And as long as this system keeps working, the productivity of these sectors will never rise. So the question is, "Can Japan break through this triangle system?"

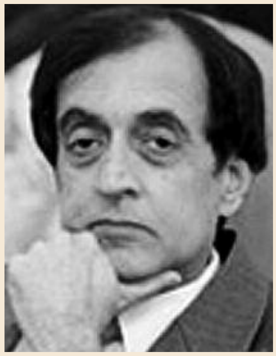
Japan has recognized the necessity of reform since the mid-1990s, but no administration has attempted any improvements to this system because of the huge political risk.

Even the Koizumi administration's only reform enacted during its five years in office was the privatization of the postal system, even though nobody felt the necessity for immediate postal reform.

The situation hasn't changed since the DPJ took over, because the DPJ basically represents the interests of the unions while the LDP represents the interest of enterprises and lobbyist politicians, and the whole point is that neither wants to change the *status quo.*

There seems to be only one possibility for change in Japan: through the rebuilding of the business model for Tokyo Electric Power Company, which has incurred a huge debt from the Fukushima nuclear disaster.

In fact, the Japanese electric power industry is the true blue king of the golden triangle system. A surprising number of chairman's seats of local economic organizations are occupied by the electric power industry. Why? Numerous companies depend on TEPCO's procurement. And this is exactly what Japanese capitalism has brought forth for more than sixty years. There will be no real reform without a bloody battle. And we may find out within several months if there will be such a battle.



It will require broad political consensus on a bold reform strategy.

ANOOP SINGH
Director, Asia and Pacific Department, International Monetary Fund

Japan's economy has withstood a number of severe shocks during the last few years. The global financial crisis led to the deepest contraction in post-war history. On top of this, the Great East Japan Earthquake has inflicted significant damage and will take several years of restoration efforts.

The underlying challenges for Japan, however, go even deeper. Growth has been stagnant and deflation pressures have persisted since the asset bubble burst in the early 1990s. A shrinking labor force due to population aging further dims growth prospects. Consumers are cautious in spending and businesses have held back investments despite strong profits. And more worrying, the policy space to counter these challenges is diminishing. Gross public debt outstanding as a share of GDP is higher than in any other advanced country, and policy interest rates are at near record lows.

But writing off Japan based solely on these challenges would be a mistake. Japan continues to benefit from Asia's booming economy—trade between Japan and the rest of Asia has doubled over the past decade. Manufacturers across the globe rely on Japan's leading-edge technologies and production processes as an integral part of the global supply chain. History tells us that countries can rebound after long periods of lackluster performance. Not long ago Germany, which shares a similar economic structure to Japan, was derided as the "sick man of Europe," with high unemployment and a sluggish economy. But over time, with appropriate policies, Germany has turned around and achieved strong and resilient growth.

So what needs to be done to restore growth to Japan? Japan needs a comprehensive package of fiscal and structural reforms to revive growth and contain debt to sustainable levels. Comprehensive tax reforms centered on a gradual increase in the consumption tax along with entitlement reforms, especially to social security, will be critical in putting public debt on a sound footing and addressing pressures from an aging society.

Structural reforms are essential in order to support fiscal adjustment and enhance growth. Labor reforms are needed to boost the employment of women, youth, and the elderly. Further trade liberalization, such as participation in the Trans-Pacific Partnership, would not only aid exporters but also open up protected sectors, and potentially be a catalyst to productivity improvements. Finally, promoting start-ups and restructuring small- to medium-sized companies would create jobs and foster innovation and new investment.

A *genki*—vibrant and dynamic—Japan is just what the global recovery needs. We know from experience in many parts of the world that growth can be revived and public debt contained to sustainable levels. But it will require a more determined policy effort and broad political consensus on a bold reform strategy.

There's a good chance the country will have its second Meiji awakening.

GARY CLYDE HUFBAUER
Reginald Jones Senior Fellow, Peterson Institute for International Economics

After twenty years in the doldrums, Japan is past due for a rebound, economically and politically. The economic answers are straightforward: stop taxing large corporations at punitive rates, start liberalizing services on a grand scale, figure out what will replace nuclear power, and keep the yen from getting overvalued. Together these steps can deliver 3 percent growth and add 5 percentage points to the employment rolls. The political answers are more difficult. Japan needs to reconfigure the Diet so that rural districts are not hugely overrepresented, and it needs to take more responsibility for its own defense. Will these reforms happen? Possibly not, but it would be a great mistake to write off Japan when there's a good chance the country will have its second Meiji awakening.

Look at the rapid expansion of the green economy.

ANDREW DEWIT
Professor of the Political Economy of Public Finance, Department of Economics, School of Policy Studies, Rikkyo University

Japan's service sector has ample incentives and scope for expansion. The country's demographics, of course, make it a fertile ground for innovation in products and services for the elderly. And in the wake of the Fukushima disasters, Japanese firms confront power shortages and other challenges that are compelling them to revise their business models and employment practices.

One very significant area of service innovation is seen in the rapid expansion of the green economy. The Ministry of Economy, Trade, and Industry's research group on the green economy brought out an interim assessment on September 16. The report determined that, globally, industries related to renewable energy will likely triple in scale during this decade, from ¥30.3 trillion in 2010 to ¥86 trillion by 2020. Even Fuji-Keizai Group's rather conservative September 14 analysis argues that the domestic "smart community"-related market—encompassing transportation as well as energy production, storage, and transmission—is slated to grow 370 percent over the next decade to about ¥3.3 trillion by 2020. Both reports suggest considerable opportunities in infrastructure design, installation, operation, maintenance, and related fields.

Also, it is increasingly understood in Japan that the financial sector will have to innovate new products and services to finance and otherwise foster renewable energy facilities, the smart grid, smart cities, and other infrastructures that blend green with information technology. For example, insuring these facilities is a sector at present in its infancy, offering Japan another opportunity to innovate as it rebuilds its devastated northeast according to a smart template. Allied with that is the fact that there is much room for collaborative innovation in all these business areas. The telecommunication giant Softbank's new Japan Renewable Energy Foundation is one example of Japan pulling in overseas talent to bolster its own. The country starts from a very low level of knowledge-economy interaction with the outside world, particularly in the expanding and diversifying sustainability sector. Japan therefore has a great opportunity to build on its expertise in green manufacturing by growing and internationalizing its finance, consultancy, information technology, energy conservation, and other fields and making them central to global development.

Japan will remain important.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Japan is in severe demographic decline. It is one of the few countries where total population is falling, despite increased longevity. More serious from the perspective of economic vitality, the number of persons entering young adulthood—the best educated and most mobile component of the population—is declining even more rapidly, by nearly 1 percent per year between 2010 and 2020. Hostility toward immigration remains high. Aging and the decline in numbers of new workers make Japan a testbed for treatment of older workers and retirees. For the same demographic reasons, Japan will inevitably become more of a service economy.

The question is how rapidly Japan is able to make the necessary adjustments, and how deliberately. The world has an interest in how well, or badly, Japan handles this widespread challenge. Yet Japan remains a rich and productive society, with a very large market. It is the world's largest creditor nation, with extensive investments around the world, some of which will be liquidated as Japanese citizens age. It has led the world in energy conservation. For all these reasons, Japan will remain important to the world economy for many years, and certainly should not be "written off."

There is no such magic sector that will stoke dynamism.

RICHARD KATZ
***Editor,* The Oriental Economist Alert**

The shift to a services economy is already occurring, whether Japan wants it or not, because that shift always occurs in mature economies. Across the rich countries, even in those with big trade surpluses, factory jobs have shrunk. Between 1990 and 2008, they fell 27 percent in Germany, 26 percent in Japan, 24 percent in France, and 24 percent in the United States.

Japan's effort to forestall this shift via a large manufacturing trade surplus has proved not only futile but harmful. That's because, in the effort to preserve factory jobs, Japan has shored up some of its most inefficient sectors, a policy of comparative disadvantage. Contrary to widespread myth, Japan is only efficient in a narrow sliver of manufacturing: the big exporting sectors like autos, electronics, and machinery. For manufacturing as a whole, Japanese labor productivity at its pre-recession peak in 2007 was 36 percent below U.S. levels. Ten years earlier it was only 20 percent below U.S. levels.

Many in Japan keep trying to find the "magic" sector that will lead an overall rebound in the economy. Nanotechnology is often mentioned, as is renewable energy. The fact is that there is no such magic sector, whether in manufacturing or services. Japan's problem is not choosing the "wrong" sectors, but horrible inefficiency across the board. Japanese real GDP per work hour is 35 percent below U.S. levels. By contrast, in

France, it's 3 percent above U.S. levels, and in Germany just 2 percent below U.S. levels.

If Japan is to restore its dynamism, it will have to do so in the same manner as the United States did in its post-1995 productivity revolution: by reforming its backward sectors. The key to the U.S. productivity revolution was not the rise of the so-called "New Economy" sectors, but massive reform in the "Old Economy." Under the pressure of fierce international and domestic competition, "old economy" sectors from retail to rust-belt manufacturing adopted not only the new information technologies, but also older technologies—from numerically controlled machine tools to optical scanners—that they had ignored for years. New, superior firms replaced older firms that couldn't or wouldn't change. Japan, by contrast, has the lowest rate of firm turnover among rich countries.

The underlying root of Japan's lethargy is a dearth of competition in much of the domestic economy. Competition, including the ability of new players to displace entrenched incumbents, is the key to the much-needed leap in productivity. Japan should adopt as its mantra, "There is no competitiveness without competition."

The key is the will and willingness of the Japanese people.

YASUO KANZAKI
Special Advisor, Macquarie Capital

It is not wise to write off Japan for two reasons. First, you cannot disregard Japanese corporations, such as Toyota and Panasonic. Back in 1979, when I left London after five years of depressing time there, my good friend Andrew Smithers, then at Warburg, advised me to buy British shares. I asked him why he recommended shares of a stagnant economy. He said that 60 percent of the companies listed on the London Stock Exchange generated revenue outside of the United Kingdom. This may apply to today's Japan.

The other reason is structural reforms, which have been talked about for so long. Healthcare, agriculture, and infrastructure are the industries most in need of reform. There should be enormous opportunities to improve productivity. But these industries are backed by powerful groups: physicians, farmers, and bureaucrats. Advanced medical technology could offer service to non-Japanese patients, high-quality agricultural products could attract the appetites of non-Japanese gourmets, and infrastructures mainly administered by ex-bureaucrats could provide better service, as did the railway system when it was privatized in the 1980s. The Japanese railway system now offers punctual service with efficiency, which has also helped related service sectors to prosper.

The key factor to the success of this reform is the will and willingness of the Japanese people; otherwise, Japan should be written off. ◆

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