A SYMPOSIUM OF VIEWS

Japan Rising

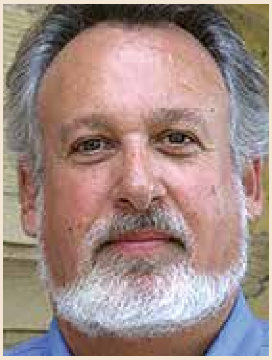
Is the Land of the Rising Sun finally on the rise?

Writing in the *Financial Times,* noted investor and bestselling author Ruchir Sharma is highly bullish on the Japanese economy:

> *In periods of gloom like this one, when commentators see nothing but faults in most countries, it is worth highlighting the few that defy the prevailing pessimism. … The most surprising country on my list is Japan, where growth is actually picking up. After being dogged by deflation for years, Japan is also the rare country that gains from a return of inflation—now running just over 2 percent. Its supposedly weak corporate culture has been raising profit margins. Labour costs are now lower in Japan than in China. The cheap yen is boosting exports and could revive animal spirits in the market as a late reopening from Covid restrictions draws back visitors.*

Other commentators (but not all) are equally optimistic. Could Japan economically could be in the midst of a positive "perfect storm"? Or was it a slow news day and the positive performance of the Japanese economy is being exaggerated?

Nearly twenty noted observers offer their views.



Japan has become, again, a global leader.

DANIEL SNEIDER
Lecturer in East Asian Studies and International Policy, Stanford University

Japan has been struggling since the collapse of the bubble economy in the early 1990s to counter the perception that it has a hopelessly stagnant economy, burdened by public debt, living off the fruits of past innovation and technological leadership, its efforts at reform stymied by a sclerotic political system, with a society heading over a demographic cliff, and, not least, replaced by a relentless and growing China.

Some of those perceptions have shifted in the last decade. Japan has not only managed its debt well, but its central bank pioneered the use of monetary easing, now a global standard. Economic growth is not spectacular but per capita growth is at par with others. Unemployment was minimal, even during the worst of the pandemic, and income inequality in Japan is among the least in the advanced world.

But beyond these measures, Japan has become, again, a global leader. And it has done so by turning three things that appeared to be sour lemons into a sweet lemonade—an aging society, political stagnation, and a rising China.

Demographics is turning into a source of strength for Japan. It has been in the front lines of coping with an aging society—it leads the world with more than 28 percent of its population over the age of sixty-five, compounded by a shrinking population due to falling birth rates. But as a result, Japanese policymakers, at a local and national level, are coming up with new approaches to keep older Japanese engaged in the work force and innovative preventative care that keeps them healthy, both physically and mentally. Japanese specialists talk of creating "workplaces for a second life."

Japan has also become the world's leading power in robotics, supplying almost half the world's industrial robots. The need to replace labor with technology, including growing use of artificial intelligence in areas such as health care, is driving Japanese growth in many arenas.

As for politics, the almost uninterrupted monopoly on power of the conservative Liberal Democratic Party used to be seen as a negative, blocking crucial reforms like labor flexibility and protecting entrenched special interests such as agriculture. Now, looking out at a world struggling to contain extremist movements, fueled by nationalism and racialism, Japan's megastable system, one where the ruling party effectively blocks the emergence of such extremist threats, is a clear plus.

Last but not least, there is China, once seen as having left Japan in the dust. But China is struggling with the pandemic, retreating to a state-run economy as it suppresses the most dynamic elements of its market economy, and locked into an alliance with a Russia embarked on a dangerous war. Japan, in marked contrast, has re-emerged as a leader in Asia, an attractive partner in the region and globally, a source of investment, technology, leadership on trade policy, and even security. A renewed, global Japan offers a safe shelter from China's growing turbulence.

Japan may well be the only G7 economy to avoid recession in 2023.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

Japan may well be the only G7 economy to avoid recession in 2023 and there is a good chance it will continue to grow at or above trend even as the rest of the world slows down.

The seeds of this good performance were sown in 2016 when the Bank of Japan adopted yield curve control targeting a ten-year bond yield of zero. This was always a second-best strategy in that it did little to speed the pace of achieving the Bank of Japan's inflation target of 2 percent. (The best strategy would have required monetary-fiscal coordination and jawboning to raise both public and private salaries and wages, as advocated by my colleagues Olivier Blanchard and Adam Posen in the *Financial Times,* December 2, 2015.)

Yield curve control was designed to leverage any future positive shock to demand or inflation into a sustained rise in growth and inflation through an automatic decline in the long-term real rate of interest. The post-Covid global inflation shock may be providing the necessary kick-start.

The massive widening of long-term yield spreads between Japan and other economies has pushed the yen to its lowest level in decades. That supports inflation both directly through higher import prices and indirectly through greater demand for Japanese exports, including tourism into Japan now that Covid restrictions are eased. It should help to insulate Japan from any harmful effects of the looming recession in other countries.

To preempt any slowdown, the government is adopting yet another massive fiscal package. It is also critical that Prime Minister Fumio Kishida appoint a new Bank of Japan governor in April who will stick to current governor Haruhiko Kuroda's resolute stance of maintaining yield curve control until inflation reaches the 2 percent target on a clearly sustainable basis.

Markets don't yet believe that Japan will achieve 2 percent inflation beyond the next year or two. But markets are notoriously bad at predicting changes in economic trends—they failed utterly to predict Japan's long decline into deflation. With both monetary and fiscal policies in strong support of growth and reflation, Japan is poised to outperform its peers in 2023 and beyond.

The only fly in the ointment is that the government of Japan has muted the price effects of the global energy crisis on Japanese consumers, which discourages energy conservation and thus forces more of the needed adjustment onto the rest of the world. The government should allow domestic energy prices to rise to world levels over the next year or two, both to reinforce inflation expectations and help reduce the burden of adjustment in poorer countries.

Japan's current spurt is unlikely to presage a shift back to the glory days. But the period of stagnation and declining real GDP may be over.

ANNE O. KRUEGER

Senior Research Professor of International Economics, Johns Hopkins School of Advanced International Studies, and former First Deputy Managing Director, International Monetary Fund

A quarter-century after the end of the Second World War, analysts began recognizing that the Japanese were sustaining a high and even accelerating rate of economic growth even after the post-war reconstruction phase had ended. As Japan succeeded in sustaining a rapid pace over the next decade, American businesses and lobbyists became almost hysterical in their concerns about "unfair" Japanese competition. Protectionist pressures mounted, and the Japanese were, among other things, even persuaded to place "voluntary restraints" on auto exports. Those restraints enabled Japanese producers to raise prices in the American market and did little to help the U.S. auto industry.

The U.S. auto industry eventually learned to improve quality and compete, and restraints were removed.

As the near-hysteria about Japanese competitive and innovative abilities was peaking, the Japanese economy began running into major difficulties, and years of stagnation followed. Asset prices had risen sharply during the upswing and had to depreciate. That in itself put deflationary pressure on the economy. In addition, the rate of population growth was falling, and the population is now declining. The percentage over age sixty-five in the population has risen and will continue to rise. The deflation, which accompanied the asset price decline, itself contributed to perpetuating the stagnation.

The downward pressure on demand and the economy from the asset price bubble appears to have been spent, and prices have risen to the target rate of 2 percent. Japanese economic growth has picked up somewhat. But there are other headwinds. The slowdown in the Chinese economy and rising fuel prices are both negatives. Uncertainty about the entire geopolitical situation surely contributes further.

Absent significant improvement in the geopolitical situation and a reduction in uncertainty and pessimism about the global economy, it is difficult to foresee a remarkable economic future for Japan with economic performance much better than that of other oil-dependent economies. More likely, real per capita GDP will increase slowly but perhaps enough so that real GDP per capita rises. But the weight of population and labor force decline, the energy outlook, and the global economic/geopolitical situation weigh heavily.

Japanese economic growth has depended heavily on export performance. There is scope for significant improvements in productivity in nontraded goods including services, wholesale and retail trade, and construction. Were significant reforms undertaken, the outlook might improve markedly, but there is little sign that these measures are being seriously contemplated.

In the period before 1990, there was overoptimism about Japanese economic performance. Then there were two decades where pessimism has prevailed. The current spurt is unlikely to presage a shift back to the glory days. But the period of stagnation and declining real GDP may be over.

With the slumping yen, negative economic growth, the working-age population in decline, and productivity at the bottom of the G7 barrel, Japan doesn't seem to be experiencing a "positive perfect storm."

MARINA V. N. WHITMAN
Professor of Business Administration and Public Policy Emerita, University of Michigan, and former member, President's Council of Economic Advisors

No, Japan is not in the midst of a "positive perfect storm." Despite the positive developments just described, not everything is coming up roses for the Japanese economy. A yen at a twenty-four-year low against the dollar and down 28 percent over the past twelve months may indeed be encouraging exports, but the government's intervention to support it indicates that the decline has been too great for comfort. Currency gyration tends to increase uncertainty, which generally makes people indecisive about what to expect and, therefore, how to behave to reduce their personal risk.

Japan's economic growth rate remains negative, and its economy has not yet returned to its pre-pandemic level. And the country's import bill rose by 50 percent over the most recent twelve months. Despite the fact that Japan's central bank, almost alone among wealthy countries, continues to hold its interest rates down, that doesn't seem to have had a positive effect so far. Some type of fiscal stimulus, in the form of tax cuts or incentives for business investment, might be needed to reflate the economy.

The population is declining, and the ratio between the working-age population and the elderly is going down even faster. A fertility rate of 1.4 children per woman, well below replacement, has been declining more quickly than predicted. And given a long-standing cultural opposition to immigration, an increase in the working-age population from that quarter is unlikely.

Finally, Japan's productivity is the lowest among the G7 nations. It is 60 percent of that of the United States, which is ranked at the top of the same group.

With the yen in a deep slump, the country's economic growth rate in negative territory, the proportion of working-age people available to support the elderly in decline, and productivity at the bottom of the G7 barrel, Japan doesn't seem to be experiencing a "positive perfect storm." Maybe its situation is not as unfavorable as the term "perfect storm" would suggest, but certainly the adjective "positive" doesn't seem warranted.

Japan is walking along the cliff edge on the verge of a crisis.

MAKOTO UTSUMI
Former Vice Minister of Finance for International Affairs, Japan

Japan is walking along the cliff edge on the verge of a crisis. The seeds of this imminent crisis are the following:

The first seed is the budget deficit and accumulation of national debt, which has reached 260 percent of the GDP (compared to 155 percent in Italy, 138 percent in the United States). This is the consequence of policy mistakes over the past three decades. Japan's population started to decrease in the 1990s, particularly among the 15–60 age group. Consequently, the country's potential growth rate had been declining. Policymakers did not recognize this creeping change in the economic fundamentals and continued to insist on aiming to attain an unrealistic economic growth by continuously implementing a stimulative fiscal policy. In particular, Prime Minister Shinzo Abe (2012–2020) emphasized and accelerated this trend—the so-called "Abenomics."

The second seed is Japan's monetary policy. The Bank of Japan has continued its unconventional monetary policy for almost a quarter of a century, engaging to buy out national bonds. Because of these operations, fiscal policy self-restraint through the financial markets did not function, and as of now the central bank holds 40 percent of the national bonds, amounting to ¥500 trillion. In particular, this operation by the Bank of Japan was drastically strengthened under the Abenomics. While the U.S. Federal Reserve and the European Central Bank are rapidly tightening in order to fight the surging inflation, the Bank of Japan maintains an extremely easy monetary policy, regardless of a price surge of nearly 3 percent, already much higher than its initial target.

The third, this monetary policy is a main factor in the drastic depreciation of the yen. Japan is heavily dependent on its imports of raw materials, food, and energy. The weak yen will exacerbate the acceleration of the inflation, which will then inevitably further the yen depreciation, causing a vicious circle.

The fourth seed is Japan's international competitiveness. There was a time when Japan held a leadership position in essential products on which the rest of the world relied. The lack of innovation in the corporate sector has resulted in the deterioration of its competitiveness, and hence, of its productivity as well.

The fifth is the national security environment. Japan is on the front line *vis-à-vis* China, Russia, and North Korea. In view of what is happening recently, Japan needs to rapidly strengthen its defense forces. The lack in the sense of crisis of the Japanese people, together with the serious budget constraint, is a course of concern.

Finally, the deterioration of Japanese politics is the sixth seed. In the past, the country was faced with several crisis heights, such as its defeat in the Pacific War, with the quasi-total destruction of its economic structure, the 1973 oil crisis followed by hyper-inflation, and more. The country allowed strong political leadership to emerge, which in turn could persuade its people of the need for extremely strict fiscal and monetary policies and the need for endurance, while showing a positive perspective at the end of the tunnel. This kind of political leadership is nowhere to be found anymore—not just in Japan, it seems, but in most of the developed world.

Japan is likely to continue muddling through. The risk is that the cream of the younger generation will leave Japan.

TAKATOSHI KATO

Senior Adviser to the President, Japan Center for International Finance, and former Deputy Managing Director, International Monetary Fund

While I appreciate Mr. Sharma's interest in Japan, it seems to me that the picture is not that clear-cut. Let me start by reviewing some of negative elements in the current Japanese economic fundamentals.

The first is unfavorable demographics. The Japanese population dwindled by 0.6 million out of a total of 123 million in 2022 and is expected to shrink somewhat faster in the coming years. Shrinking labor inputs are reflected in the very meager Japanese potential rate of growth. The Bank of Japan's estimate of Japan's potential rate of growth stood at 0.2 percent in the second quarter of 2022.

Faced with an acute labor shortage, the Japanese populace grudgingly accepts the need to import foreign workers from neighboring Asian countries. Yet they remain adamantly against a large-scale inflow of foreign immigrants.

The second is the dramatically shrunken purchasing power of the yen. At its peak, namely April 1995 (incidentally, I was then in charge of dollar-buying intervention at the Japanese Finance Ministry), the real effective exchange rate index of the Bank for International Settlements stood at 150.84. The 57.95 September 2022 BIS index was roughly a 60 percent decline from its peak and a 15 percent decline even from the December 2021 index due to the starkly different monetary policy stance between the United States and Japan as well as the sharp rise in energy and commodity prices.

During the peak "bubble" years, Japanese investors purchased U.S. crown jewels such as the Rockefeller Center in Manhattan and the Pebble Beach golf course. Now the Japanese media reports that various Japanese real estate items were purchased by bargain-hunting Asian investors.

The third unfavorable element of Japanese fundamentals is the shortage of dynamism in the area of DX, or digital transformation.

Excessive addiction to manufacturing excellence in Japan prevented Japan from producing a Japanese version of GAFA or Tencent/Alibaba. In fact, the digital competitiveness ranking for 2020 by the International Institute for Management Development puts Japan in twenty-seventh place, far behind the United States at number one or Singapore at number two.

Turning to the favorable elements of Japan's fundamentals, Japan today can be characterized as the most stable matured democracy among the G7 countries. There does not exist political tension to speak of between the far right and the far left.

Second, Japan is known for its clear air and abundant water supply, as well as its maintenance of safety in the streets. The sharply depreciated yen has turned Japan into an attractive destination for foreign investors or tourists.

Following TSMC's plant construction in Kumamoto, Kyushu, the *Nikkei* newspaper reported that Google intends to invest ¥1 billion to build its data center and other investments in Japan.

Third, Japan's neighboring countries are above-average growth economies. Japan's number-one trading partner is obviously China. Korea, Taiwan, and the ASEAN 5 (Indonesia, Thailand, Malaysia, Philippines, and Vietnam) are all high-growth performers and their aggregate economic size now surpasses that of Japan. These economies provide economic opportunities for Japanese businesses to cultivate.

The above review indicates, it seems to me, that no clear-cut way forward can be drawn. Rather, Japan is likely to continue muddling through various challenges. The risk associated with the muddling-through approach is, as in the cases of central and eastern European countries, that the cream of the younger generation will leave Japan, seeking more attractive opportunities elsewhere.

Japan has the best opportunity in a generation to launch an authentic economic revival. Still, progress remains an uphill climb.

RICHARD KATZ
Senior Fellow, Carnegie Council for Ethics in International Affairs, and author of a forthcoming book on how to nurture new, high-growth companies in Japan

Even if Japanese wages really were lower than those in China, which is not the case, how could anyone think it's a sign of economic health for Japanese wages to drop below those in a country with just one-fourth of Japan's per capita GDP? Yes, there is wage austerity in Japan, but nowhere close to that bad. Still, it's bad enough to suppress consumer spending and thus overall recovery. That is why the government is trying to get companies to hike wages, albeit in a rather feckless manner. The rising profit margins lauded by Mr. Sharma are not the result of a genuine increase in efficiency, but of this wage suppression. As for the cheap yen, most economists in Japan recognize that its costs outweigh the benefits. On the one hand, such a weak yen further depresses real wages by raising the prices of import-intensive food and energy. On the other hand, a weak yen does not boost exports as much as in the past.

That's the bad news. The good news is that Japan has the best opportunity in a generation to launch an authentic economic revival. It could do so by restoring the entrepreneurial effervescence that marked the postwar high-growth era. This opportunity arises due to several new societal megatrends. Generational changes in attitudes about work and gender relations are leading more and more talented people to tens of thousands of new companies. Many of them are ambitious women regularly denied promotions and equal at traditional companies.

The rise of e-commerce is enabling tens of thousands of small and medium-sized firms to bypass the traditional distribution system and sell their products to millions of customers. For decades, the distribution system, which is dominated by the incumbent companies, has made it hard for newcomers even to get their products on store shelves. Most importantly, three decades of low growth have convinced many within both the elites and the public of the need for change.

Still, progress remains an uphill climb because of resistance by powerful forces. Bank financing for new firms remains quite difficult. While parts of the government try to promote more startups, other parts oppose the needed changes in regulations, taxes, and budgets. While Prime Minister Fumio Kishida has stressed the need for more entrepreneurship as part of his "new capitalism" agenda, he has yet to offer specific measures to turn his lofty goals into practical reality.

Japan has a pattern of missing opportunities. It would be a shame if it missed this one.

Japan has a bright future. Unfortunately, the bright future will be preceded by a crash of the currency.

TAKESHI FUJIMAKI
Former Member, House of Councillors, Japan, and former Tokyo Branch Manager, Morgan Guaranty Trust Company of New York

Yes, Japan has a bright future because its people are honest, faithful, highly educated, and hard workers. Unfortunately, the bright future will be preceded by a crash of the currency.

Over the past three decades, Japan's GDP growth has been by far the lowest in the developed world. Japan's economy grew only 60 percent, while the U.S. economy grew 250 percent and China's grew 5,300 percent (1990–2020).

The ratio of cumulative government debt to GDP is by far the highest in the world: Japan's ratio is 257 percent, Greece's is 207 percent, and Italy's is 155 percent.

The central bank's balance sheet versus GDP is by far the biggest, and is the most fragile among the G20 countries. The Bank of Japan increased the monetary base substantially in the last thirty years. A disproportionate amount of money was supplied to the economy in comparison to the size of the economy.

(The Bank of Japan increased the monetary base by 13.9 times from 1990 to 2020 despite slow economic growth, that is, GDP increased only 1.13 times for the same period. By comparison, the Federal Reserve increased the U.S. monetary base by nine times, but the GDP grew 3.5 times.)

Despite these facts, the Japanese market has not suffered much, unlike the recent situation in the United Kingdom. This has been possible only because the market is totally controlled by the central bank and government so far. The Japanese market is functioning like the market of a planned economy.

The Bank of Japan is the biggest holder of stocks in Japan. No other central bank among the G20 holds stocks as part of their monetary policy.

The Bank of Japan also holds more than half of government bonds outstanding. By comparison, the Fed held 18.1 percent as of September 2020. The central bank is financing the fiscal deficit of the government, which is prohibited in many countries. The Bank of Japan is the whale in the Japanese government bond market, and totally controls the market and artificially keeps long-term rates at extremely low levels.

The Bank of Japan intervened in the dollar/yen market—the biggest amount in a day—on October 21 to prevent the yen's depreciation.

However, I do not think that the government nor the central bank can control the markets forever, especially when the intervention is against economic fundamentals.

Once the Bank of Japan can no longer control the dollar/yen level, the yen will depreciate substantially and the consumer price index will rise sharply.

The Bank of Japan cannot do anything to slow down inflation, because if it starts quantitative tightening or raises the policy rate, it will have huge negative net worth and will have negative seigniorage for a long time.

Once the Bank of Japan cannot hold down long-term rates through its huge bond-buying operations, those rates will rise substantially, and eventually, the Bank of Japan will have huge negative net worth.

In order to control the markets, the Bank of Japan purchases assets, stocks, and long-term bonds whose prices can have significant price fluctuations. Central banks were prohibited from holding such assets to prevent a possible negative net worth which would lead to the destruction of the central bank's credibility as well as the credibility of the currency.

A planned economy cannot control the markets in the long term, and the side effects of trying to control the markets are severe. As a result, I think Japan will experience hyper-inflation, and the Bank of Japan will be replaced with a new central bank as happened to the Reichsbank, the old German central bank which was replaced with the new central bank, the Bundesbank.

Japan drastically changed its system twice in the modern period, during the Meiji Restoration and after World War II. We will see the third drastic change after the chaos that is about to unfold.

The reason Japan's GDP did not grow for the last thirty years is that Japan is a typical socialist country, although the Japanese believe Japan is a capitalist country. History has shown that a capitalist system is superior to that of a socialist system. Japan will once again prove that theory correct.

Japan's laws and tax system are aimed at creating equality of outcome instead of equality of opportunity.

There are too many stakeholders in Japanese companies. In many cases, management and labor unions may have stronger rights than its shareholders.

So the main purpose of a company is not making profits, but maintaining the employment of its workers. As a result, lifetime employment and the seniority system still persist. The pay gap between new graduates and the CEO is among the smallest in the major economies.

Taxation in Japan is very progressive and minimum taxable income is very high. The majority pays less than 10 percent income tax, and people who earn more than $61,000 (taxable income) pay rates of 33 percent to 45 percent.

The inheritance tax is very high and progressive as well. When a parent dies leaving a spouse and two children, the exemption is only ¥48 million ($330,000). The rate on the taxable portion then rises quickly from 10 percent to 55 percent. Naturally, rich people spend a huge amount of time and energy on avoiding the inheritance tax instead of thinking where to invest to maximize profits. Japan is one of the few countries with a high inheritance tax.

As for the universal insurance system, the premium depends on the level of income. Therefore it is not an insurance but a tax.

The most important thing for Japanese politicians is the equality of result.

If and when Japan can drastically change from being a socialist country to a capitalist one, the future of Japan will be very bright.

Until corporate management fully understands the need to change and to take the necessary risks, the weaknesses of the Japanese economy may continue.

SHIGEO KASHIWAGI

Former Executive Director for Japan, International Monetary Fund, and Senior Adviser, Evolution Japan Securities Co., Ltd.

The Japanese economy seems to have recovered from the negative impact of Covid-19 but has not restored its growth after a decades-long period of deflation. The Bank of Japan continues to keep its policy rates at an ultra-low level, despite the global trend of increasing interest rates in the face of inflationary pressures, reflecting the view that the economy remains weak.

Why does the Japanese economy continue to be weak, convincing the Bank of Japan to keep its interest rates low, even though the inflation rate has already reached its target of 2 percent? It is because wages have not increased and thus consumer demand remains stagnant, despite the high profit levels being enjoyed by the corporate sector. Then why is corporate management not willing to give higher wage increases for its workers?

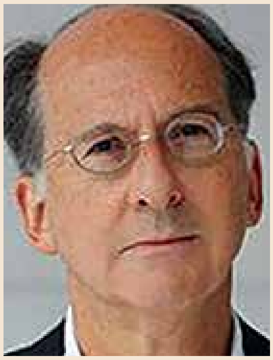
Part of the reason is Japanese labor law and practice, which makes it almost impossible for management to sack workers in difficult times. Both management and workers are willing to keep jobs at the price of lower wages.

But there seems to be an additional reason for being cautious about wage increases. With its population declining and domestic market shrinking, business leaders in Japan need to look for new sources of growth, probably by employing new innovative ideas and by exploring foreign markets. Until they become confident about their new strategies, they will be content with piling up reserves, rather than using their profits for higher wages or for investment to expand their capacity.

As a result, despite the rapid changes in the global economy, business transformation in Japan has been slow, the number of start-ups has remained very small, and zombie companies have been kept alive, making the economy stagnant overall.

Even though society is not entirely happy with the status quo, they too prefer not to go through big changes. For example, it is obvious that long-standing labor practices in Japan, such as lifetime employment, a seniority-based wage structure, mandatory retirement at around age sixty, and the so-called simultaneous recruitment for new employees, no longer fit the globalized world. Nevertheless, making changes in these areas is taking far too much time, especially for big corporations.

Until corporate management, especially in big corporations, fully understands the need to change and to take the necessary risks, the weaknesses of the Japanese economy may continue. The recent depreciation of the yen should be a good wake-up call for the Japanese to react to the new realities and rise to the challenges.



Japan is having a comparatively strong and robust moment. Don't count on it lasting.

MARK SOBEL

U.S. Chair, Official Monetary and Financial Institutions Forum, and former Deputy Assistant Secretary for International Monetary and Financial Policy, U.S. Treasury

Japan's post-pandemic performance looks positively and relatively bright!

The International Monetary Fund's latest *World Economic Outlook* predicts Japanese annual average growth in 2022 and 2023 of 1.7 percent and 1.6 percent respectively. For 2023, that easily beats the Fund's forecast for the United States (1.0 percent) and euro area (0.5 percent) hands down.

Japan's inflation has now reached an unimaginably lofty 3 percent, after years of deflation and undershooting the Bank of Japan's 2 percent target. With U.S. and European inflation having reached 9–10 percent recently, Japan's inflation looks by comparison well-behaved. The authorities can arguably contend inflation is finally more or less on target. The U.S. Federal Reserve and the European Central Bank are furiously hiking rates, while the Bank of Japan sticks with heavy monetary accommodation and yield curve control.

Yet whatever the "new normal" might be, mean reversion will set in.

Longer-term potential growth is anemic—0.5 percent per year. Japan faces ongoing demographic issues. Inflation is expected to return over the medium term to well under 1 percent per year. Fiscal policy must shift to restraint given Japan's humongous government debt. Plans for digitalization and tackling climate change, although highly welcome, won't materially boost productivity.

U.S./Japanese monetary policy divergences are driving the yen down. But when the U.S. rate cycle peaks and downshifts, the yen could snap back. Governor Kuroda leaves the Bank of Japan in the spring of 2023, heightening the potential that exists for a new governor to pursue "normalization" and narrow the divergences. In the meantime, Japanese intervention is tantamount to spitting in the wind.

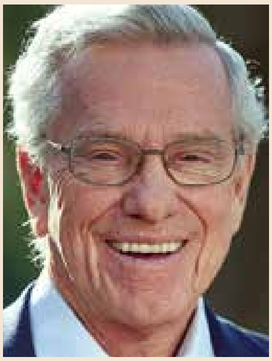
Nor will yen weakness spark a Japanese revival—given widespread Japanese manufacturing offshoring, a weak yen is no longer such a major boost to trade. Plus, with global growth slowing, external demand cannot bolster a relatively anemic domestic economy.

Geopolitically, Japan will face heightened challenges going forward. Chinese sustainable growth is falling, which will create its own economic spillovers in the region. This is taking place while some degree of deglobalization is setting in and America and Europe are spurring reshoring and/or near-shoring.

China's increasingly authoritarian and truculent behavior in Asia also poses geopolitical challenges for Japan, as does Russian conduct and Putin's global gas and oil threats.

Altogether, this picture poses major uncertainties ahead for Japanese policymakers. But that doesn't mean that Japan won't continue to see per capita income growth and remain overall a prosperous society.

Japan is having a comparatively strong and robust moment. Don't count on it lasting.



Japan has an advanced case of the disease stalking all of east and southeast Asia—an aging and shrinking population. Japan cannot be a long-term bet.

CLYDE V. PRESTOWITZ
President, Economic Strategy Institute

After literally decades of trying, Japan is at last experiencing a bit of inflation. Nothing spectacular or worrying, mind you, but at least a bit of much desired inflation. Better yet, with the number of Covid cases declining, the Japanese economy is actually growing.

The growth is being powered by two main factors that will probably be sustained for some time. First is the dramatic decline in the value of the yen *vis-à-vis* the U.S. dollar. At 145 yen to the dollar, Japan has not had its currency this weak since 1998, nearly a quarter-century ago. Although this will raise the cost of oil and other raw materials, it will strongly reduce the dollar cost of Japan's exports which are likely to keep rising and keep pouring strength into the Japanese economy.

The second factor is the increasingly significant reshoring of production by Japanese companies from China back to Japan. The Japanese government has twice increased its budget for subsidies to facilitate the transfer of production from China back to Japan.

That is the good news and it is very welcome after long years of stagnation. However, we must not become overly optimistic. Japan has an advanced case of the disease that is stalking all of east and southeast Asia—an aging and shrinking population.

The number of people in Japan is falling at a relatively rapid rate. People talk about China losing half its population by the end of this century, but Japan is in pretty much the same boat.

The obvious solution—immigration—does not seem to be in the cards. Ergo, Japan cannot be a long-term bet.

Japan was never as bad as it was often portrayed by uninformed commentators abroad.

RICHARD C. KOO
Chief Economist, Nomura Research Institute

It is understandable that many non-Japanese investors are suddenly in need of a good reason or excuse to invest in Japan now that its assets can be bought very cheaply due to the falling yen. For those of us in Japan, however, it was never as bad as it was often portrayed by uninformed commentators abroad.

For example, the so-called bad demographics, which have been the favorite reason for many foreign investors to steer clear of Japan, have completely ignored the fact that the number of people working in Japan is at an all-time high, even though the total population started shrinking in 2009. Others referred to closed immigration as a reason for not investing in Japan, but that was only true until about thirty years ago. Now the country is full of non–native-born workers. And those workers are far better assimilated to the host society than immigrants in most other countries as they speak very good Japanese and are as polite, courteous, and hard-working as the native population.

Even deflation, the favorite topic of foreign economists who bash Japan, was largely a result of the opening of the Japanese market to imports that started around 1995. Since then, fierce competition among Japanese businesses has made Japan one of the cheapest places to live among the developed countries. This is a huge change from the time when the country was repeatedly voted the most expensive place to live in the 1980s and 1990s.

In this new Japan, a weak yen is not as beneficial to the economy as in the past when the economy was largely closed to imports, because so many of its businesses and households today are dependent on imported components and products. With higher input prices and a falling currency, some companies have stopped taking long-dated orders because they can never tell what their cost will be at that future date. Most consumers are also feeling the pinch because imported inflation is basically an increase in taxes that never comes back to the country's income stream.

What Japan really needs is a more efficient use of land and supply-side reforms such as lower taxes and deregulation to increase the return on capital at home. These measures are needed so that more businesses will invest at home instead of in emerging economies. An education system that is more attuned to independent thinking and challenging the status quo is also needed so that the country can remain at the forefront of science and technology.

It seems reasonable to believe that the sun also rises.

JAMES E. GLASSMAN
Head Economist, JPMorgan Chase & Co., Commercial Bank

Japan's economy has fared better in recent decades than is often recognized, thanks to Asia's rising economic tide and to the Japanese business community's business prowess. That's because popular impressions of Japan's performance have been obscured by striking demographic trends, a population that has been slowing since the early 1980s, and that has been declining outright in the new millennium. Demographic forces, a result of well-known dislocations caused by World War II, have been slowing the growth of other developed economies as well. But they have been more intense in Japan's economy, which is more insular to immigration inflows.

Unflattering perceptions of Japan's economic performance have been shaped by the trauma caused by asset "bubbles" in the late 1980s and early 1990s. Residential property values doubled in the 1980s and then retraced those gains over the next two decades before stabilizing. And the Nikkei stock market index of 225 companies quadrupled in the late 1980s and into the early 1990s and then by 1993 lost 50 percent of its value. Japan's policy response to the economic damage caused by collapsing asset values was blunted by several factors. A decline in the natural level of interest rates, which limits the effectiveness of traditional monetary tools (short-term interest rate pegs) when interest rates near the lower zero bound on interest rates, forced the Bank of Japan to pursue unconventional monetary policies (asset purchases, including equities) long before other key central banks. Others faced similar challenges in the wake of the global financial crisis. The secular decline in equilibrium real interest rates reflects slowing potential growth and low inflation that eventually others have seen as well. At the same time, external resistance in the past to a weaker yen blocked an important channel for the transmission of the Bank of Japan's monetary policy.

The Asian financial crisis, triggered by Thailand's currency shock in July 1997 that spread across Asia, represented yet another challenge for Japan even though it left other developed economies relatively untouched.

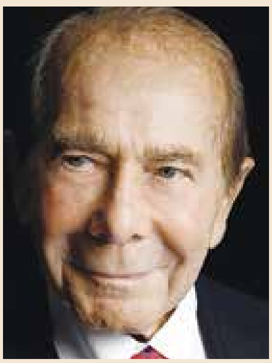
Nonetheless, two stylized economic facts indicate that Japan has had more in common with other developed economies than is widely recognized. First, Japan's cyclical economic performance in this millennium actually mirrors that of the United States, according to the evolution of the output gap. Japan experienced a mild downturn around the turn of the new millennium, like the United States and Europe, following the September 11, 2001, terrorist attacks and volatility in the technology sector associated with the Y2K concerns. Later, Japan, like most others around the world, suffered from the global financial crisis of 2008–2009. And Japan too contracted sharply in response to the Covid-19 pandemic, although Japan's real GDP is still about a full percentage point below potential whereas U.S. real GDP has fully recovered. Otherwise, the evolution of Japan's output gap in this millennium parallels that of the other developed economies.

Second, despite Japan's slow economic growth since the collapse of her asset bubbles, Japan's living standard, approximated by real GDP per capita, aligns with that of the other developed economies. For example, in the twelve years between the 2007 U.S. business cycle peak and 2019, just before the pandemic hit, real GDP in Japan, the euro area, and the United States grew 2.6 percent, 9.5 percent, and 21.9 percent respectively, according to the OECD. However, over that same twelve-year span, real GDP per capita in Japan, the euro area, and the United States rose 4.0 percent, 6.1 percent, and 11.4 percent, respectively.

Japan's demographic headwinds are likely to remain stiff for a while. The population that is fifteen years of age or younger has been decelerating. This population declined 1 percent annually over the past decade and currently is shrinking by 2 percent. But the price pressures associated with the global pandemic recovery may be more of a help than a hindrance for the Bank of Japan, which has been dealing with a deflationary pressures. The rise in long-term interest rates ought to strengthen the effectiveness of the central bank's policy tools.

Despite all the challenges associated with the global pandemic and the Ukraine war, Japan's economic prospects appear even more promising than they have in a while largely because the country's terms of trade have turned even more favorable than they were before the pandemic. That's because the real trade-weighted value of the yen has declined 25 percent since 2019 versus a broad group of countries that Japan trades with. A swing of this magnitude would be expected to provide substantial support for Japan's exporters.

Peering through Japan's demographic haze, and taking account of the country's improving terms of trade, it seems reasonable to believe that the sun also rises.



I am encouraged by the positive developments we are seeing in Japan today.

MAURICE R. GREENBERG

Chairman and CEO, Starr Insurance Companies, and Chairman, Starr Foundation

Japan has the third largest economy in the world and is one of the most important trading partners for the United States. Like all large economies, Japan has experienced cycles of expansions and contractions. Recently, it has seen promising growth through new reforms and a more formalized strategic alliance with the United States in key areas, such as digital technology, cybersecurity, infrastructure, and supply chain resilience. Japan's economic success is immensely beneficial to U.S. national interests, and I am encouraged by the positive developments we are seeing in Japan today.

I have a hard time believing Japan's labor costs are lower than China's.

CHEN ZHAO

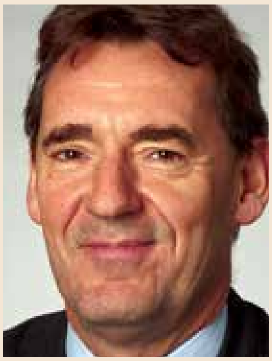
Founding Partner and Chief Global Strategist, Alpine Macro

There could be a cyclical case for Japan's economy and its stock market. There are three bullish arguments for Japanese equities. First, the Japanese yen is the cheapest currency in all high-income economies and a much cheapened yen could stimulate Japanese exports, attract capital flows into Japanese assets, and fatten corporate profit margins for Japanese multinationals. Second, Japan's inflation, running at about 2 percent, is very low and the Bank of Japan will not tighten policy for a long while. This is in a stark contrast to all other G7 countries, where central banks are battling high and rising inflation via aggressive monetary tightening. Finally, the Japanese stock market is cheap, with forward price-to-earnings at about twelve times. This compares with sixteen times for the U.S. equity market. All these factors could lead to a period of outperformance in Japanese shares, particularly if the zero-Covid policy is lifted in China and Asia begins to recover.

From a secular viewpoint, however, I don't believe that Japan's economy will head for any meaningful long-term revival. For any economy, the steady state economic growth is determined by two factors only—labor productivity and labor force growth. Japan's long-term productivity growth has averaged about 0.5 percent per year since 1990, while its labor force has only grown by about three million, or at 0.01 percent annual rate, for the same period. The Japanese labor force would have contracted had female workers not re-entered the labor force. Regardless, combining labor force growth and productivity suggests that Japan's long-term economic growth is unlikely to exceed 0.5 percent on a sustainable basis.

Moreover, Japan's overall population is contracting at -0.3 percent a year since 2010. Therefore, it is safe to say that the natural demand growth in Japan is very low, if not negative. This, together with technological advances and positive productivity growth, means that Japan's aggregate supply growth will continue to exceed aggregate demand growth. In other words, it is too early to declare an end of deflation for the Japanese economy.

Finally, I have a hard time believing Japan's labor costs are lower than China's. Japan is a high-income country, with per capita GDP four times higher than China's. China's average pay for a manufacturing worker is CNY 55,304 a year, or around $8,000. A Japanese manufacturing worker is paid ¥2,792,148 a year ($19,525). How is it possible labor costs in Japan are lower than in China?



The sun sadly is probably not rising.

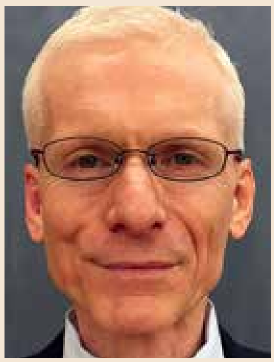
JIM O'NEILL
Former Commercial Secretary to the Treasury, United Kingdom, and former Chairman, Asset Management, Goldman Sachs International

I am in the skeptical camp that Japan is finally turning the corner. I hope I am wrong, because it would be a wonderful development to have another important economic engine among the G7 other than the United States and the erratic contributions of the European countries.

But let's look at the basics. Long-term growth is driven by two basic forces: the number of people working and their productivity. Japan, as is well known, has the worst demographics of the G7 countries, although Italy isn't too far behind.

Without a sizeable pickup in productivity, Japan's growth potential is barely positive, optimistically 0.75 percent. So where is the evidence of a structural improvement in Japan's productivity? Because of a push many moons ago by my former Goldman Sachs colleague Kathy Matsui, there are more women entering the workforce, and there looks to be a policy focus on tourism, but neither of these appear to be yet big enough to really cause a belief in structural improvement in productivity. And Japan barely turning positive in terms of its nominal GDP performance, and with it, inflation finally getting close to what the Bank of Japan has been trying to do for almost a generation in circumstances of a massive decline in the yen and a huge rise in commodity prices, seems a premature thing to celebrate.

Indeed, this really is premature for three reasons. First, if global commodity prices turn and if the yen were to recover, then the imported influences might bring inflation right back down again, flirting with negative territory. Second, unless Japan is going to finally have the bond market crisis that many international financial participants have eagerly awaited for nearly thirty years, then the yen will probably recover, perhaps significantly when the Fed has finished tightening. And third, if the inflation pickup were indeed more permanent, then the Bank of Japan is going to have to abandon its yield curve control approach within its current quantitative easing framework, and all hell could break loose in the bond market. So no, the sun sadly is probably not rising, but I hope I am wrong.



Prospects for a rising sun depend very much on accelerating the restart of Japan's long-idled nuclear capacity.

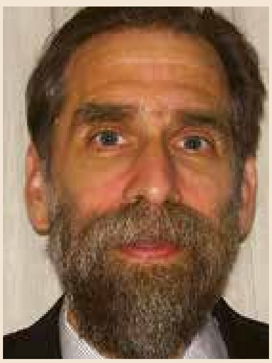
ANDREW DEWIT
Professor, School of Economic Policy Studies, Rikkyo University

In decades past, a cheap yen was key to "export drives" by Japan's manufacturing powerhouse, and an appreciating yen worried business and policymakers. But along with subsequent offshoring of much of the manufacturing base, the legacy of Japan's 2011 Fukushima catastrophe coupled with strikingly expensive and insecure energy make the yen's current depreciation very different from two decades ago.

Fukushima idled the nuclear plant that once supplied a third of Japan's power needs at very low cost. The eleven years since have seen restarts—overseen by overzealous regulators—proceed at a needlessly slow pace. As of November 2022, just six of thirty-three viable reactors are operating, providing about 6 percent of overall electricity. Expensive natural gas, coal, and fickle solar fill the gap, and consequently power prices have climbed nearly 30 percent in October, with a further 20–30 percent in the pipeline for 2023. The Japanese government is now deploying a whopping ¥6 trillion to subsidize power, gasoline, and other energy costs. The government is also keen to accelerate restarts, as each reactor restart cuts costly LNG demand by one million tonnes per year. But observers caution that only a couple more may restart before year's end, with at best fifteen or so in operation over the next few years.

Numbers don't lie. Japan relies on imports for roughly 90 percent of its primary energy supply, and each trillion yen of its dramatically depreciated currency buys far fewer tonnes of fuels in the midst of the world's first truly global energy crisis. Thus, during the first half of fiscal 2022, imports climbed by 47.1 percent, largely due to energy costs, versus a 21.3 percent increase in exports.

Of course, were this energy crisis merely transitory, the cheap yen might soon begin to deliver more benefits than costs. But the outlook is for a protracted crisis of at least a few years. This fact threatens the recent uptick in growth through eroded consumer purchasing power and the business sector's inability to keep sucking up the pain of the highest-ever rise in the producer price index. Adding to the gloom, Japan is also gravely exposed to the so-called "greenflation" of lithium, copper, rare earths, and other imported critical minerals required for its ambitious industrial policy of growth through clean energy and digital transformation. So prospects for a rising sun depend very much on accelerating the restart of its long-idled nuclear capacity.



The "rising sun" aspect may be most noticeable as the public and private sector work together on debt resolution.

GARY KLEIMAN
Senior Partner, Kleiman International Consultants

Japan may be ending decades of deflation, but perverse financial markets have yet to reflect the prospect of real saver returns for the outsize elderly cohort or younger generation.

After ten years of monetary easing with the hallmark of setting the government bond ten-year yield not above 0.25 percent, the central bank owns half the market as well as 40 percent of equities through ETF buying, also designed to micromanage liquidity at the cost of blocking normal asset class return signals and rotation. All the world's stockpile of negative-yielding bonds is lodged in the country, as the United States, Europe, and emerging market authorities have ratcheted benchmark rates to manage much higher single- and double-digit inflation.

This disconnect unsurprisingly has pummeled the yen, heading to the ¥150-per-dollar range, before minimal interventions from the $1 trillion foreign exchange reserve stockpile stunted momentum. Deploying this pool at all dented the external backstop story, always one of Japan's strengths, with a top net international creditor position to offset the 300 percent debt-to-GDP stretch at home. The Finance Ministry routinely dismisses jitters over the latter by pointing out that 90 percent is domestically held by long-term buyers, but foreign investor views advocating short positions to smash the yield curve ceiling have permeated the bubble.

Japanese stocks are only down single digits to relatively outperform global markets, but local investors after years of repression are now accustomed to looking abroad for healthy returns and corporate governance treatment. Activist funds face uphill battles removing management even for outright fraud, with the tangled web of bank-industrial cross-shareholdings still in force.

Asia as a whole lags other regions on this front, and in Indonesia's case, for example, minority rights are also a deterrent for traditional emerging market forays that have faded. A decade ago, Japan had a yen-denominated Samurai bond market that lured Turkey, South Africa, and other sovereign/corporate borrowers, and retail funds offered exposure to regional developing currencies. That appetite has shifted to safer, higher-result United States and Europe instead, with banks virtually alone in maintaining a distinct emerging market franchise commitment with trade finance.

However, the "rising sun" aspect may be most noticeable as the public and private sector work together on debt resolution in places like Sri Lanka, where the country accounts for one-third of the $10 billion bilateral total. A successful outcome there can revive optimism about Japan's overlooked contribution to balance sheet and capacity building in emerging markets.

It's a worrying situation when Japan is looking relatively attractive without having enacted significant domestic economic reforms.

RICHARD JERRAM
Chief Economist, Top Down Macro

Japan is a great example of the question of whether we should focus on overall growth or per capita growth. Japan's working-age population has been shrinking since the mid-1990s, so it is hardly a surprise that headline GDP growth numbers are poor.

From some perspectives, per capita growth is what matters. From that viewpoint, Japan has been doing fine. Pre-Covid, Japan was broadly in line with other advanced economies, and readings since then are unreliable and open to massive revision.

Policymakers must ask if their citizens are becoming more prosperous as the years pass, and by that measure Japan is no laggard. You might think headline GDP growth is important for the stock market, but there is a notoriously loose correlation between the two. And in Japan's case, whatever firms might be losing from weak domestic sales growth is being offset by a steady improvement in corporate governance thanks, in part, to Shinzo Abe's reforms.

Up to a point, these things are also relative. Japan is looking increasingly attractive compared to Europe and even has more stable policy settings than the United States, having avoided the worst of the inflationary surge.

Unfortunately for Japan, total GDP also matters. Two areas stand out. First, the debt accumulated over the past thirty years is a gross, nominal amount and is backed by the future productive potential of the economy, and the taxes this might generate. The relative burden rises if the overall economy shrinks with the population.

Then there is the question of national security. It is harder for a smaller country to protect its borders and project international power than a large one. As China's foreign minister told his Asian neighbors in 2010, "China is a big country and other countries are small countries, and that's just a fact." Considering the potential instability of the region, Japan must consider its overall capacity for self-defense, which is undermined by a shrinking economy.

Overall, it's a worrying situation when Japan is looking relatively attractive without having enacted significant domestic economic reforms. It's a sign of how badly some other major economies have gone off track. ◆

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com