



Overcome a Number of Traps and Gaps Embedded in the Japanese Economy and Society

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The world is now facing an historic and major change in trends and structural transitions. In this context, I would like to reexamine the position of Japan and discuss the direction, potential, and issues related to Japan in the future.

What becomes apparent through this attempt is the variety of gaps and traps that are embedded in Japan. There is a gap between Japan and other countries that is caused by a major change in global trends and Japan's consistent failure to respond to the shifting currents. There is also a gap in awareness about issues and policy opinions between the younger generation and the elderly generation in Japan, which has led to the advent of an aging society in which Japan has become a typical silver democracy. Moreover, as I mentioned in the Editors' Blog, there is a gap between the image of Japan held by Japanese people and the reality of Japan. Turning to traps, although heated discussions about the trap of middle-income countries have been taking place, the trap of mature countries that Japan is facing is even more serious. Japan must carry out fundamental policies and structural reforms, yet it is incapable of adopting bold transitions. The timidity trap, as explained by Paul Krugman, is evident. There is also the case of the trap of success, a term referenced by Peter Drucker, in which people are unable to discard systems, practices, and management ideas that no longer effectively respond to the needs of the times because they are preoccupied with the nostalgia of the good old days.



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"Abenomics has failed," the evaluation made by the IMF

First, I will examine the gap between the domestic and overseas evaluation of Abenomics. The International Monetary Fund (IMF) announced the results of its evaluation of the Japanese economy in August 2016, stating, "Abenomics achieved certain results in the early stages, but, in its third year, the growth rate of Japan has slowed and the inflation targets have been repeatedly delayed. The current policies are incapable of achieving the government targets. Significant policy upgrading is now required."

In the first one or one and a half years after Abenomics was introduced, foreign investors who probably thought that Japan would change bought up to 10 trillion yen's worth of Japanese shares. However, they have recently become net sellers. Abenomics has three arrows. However, the only

arrow that was actually released was an arrow of substantial monetary easing, which was only outstanding compared to the other arrows. In fact, the impact of the second arrow, flexible fiscal policies and fiscal reconstruction, was only felt mainly in the fiscal stimulus policies; almost nothing has been done to achieve fiscal reconstruction. As for the third arrow, a number of measures to realize growth strategies have also been discussed and certain measures have actually been introduced, but the arrow still appears to be caught in the timidity trap. It also lacks speed. Effectively, only one and half arrows have been released. Even during this period, the aging of the population has progressed steadily.

The unorthodox monetary policies even now include negative interest rates. However, these policies are regarded as bridging policies, time-buying policies or aggressive policies designed to last only for a short period to support growth strategies centered on structural reform, because it will take time for growth strategies to start to show their effects. Despite this, the bridging monetary policies are now used as long-term measures while failing to release the third arrow. Moreover, because the introduction of the negative interest rate policy effectively contains interest payments for the government, it appears that a moral hazard has been created, that politicians are losing their sense of crisis over this fiscal issue, namely the high level of public debts against GDP, a level that is astonishing even by global standards.

The CRIC cycle still continues

Robert Feldman, the economist and commentator, for some time has been saying that policies in Japan follow the CRIC cycle, and that cycle appears to be still in place even now. The CRIC cycle theorizes that when people face an economic crisis (C), they respond (R) with measures, and, with the measures having some effect, when the economic situation somehow improves (I), people become complacent (C) and they leave the issues unattended without adopting any policies that cause real pain that must be endured. Under this cycle, the countermeasures that are taken after facing a crisis are temporary prescriptions. Because no fundamental economic structural reform is carried out, the next crisis will take place soon or later. Because responses to that new crisis are also temporary measures, avoiding pain, the cycle repeats itself. Unfortunately, since the collapse of the bubble economy, Japanese policies have continued to postpone the timing of real pain, duly falling into Feldman's cycle.

In fact, since the collapse of the bubble economy in 1991, more than ten economic policies with the prefaces of "general" or "comprehensive" have been introduced. However, most of the policies remained in the category of economic stimulus packages; as a result, the economic structure in Japan has never changed. There were discussions about structural reform, but, because Japanese governments were typically short-lived, by the time the experts had compiled policy recommendations, the government in question had been replaced. Although the new government established workshops in a similar manner, the policy recommendations were put on a shelf. After this repetition, even though structural reform and growth strategies ended only with discussions, without realizing it, people started to feel that they had actually carried out the necessary reforms and strategies.

As a result, Japan failed to strengthen its economic foundation and its potential growth rate continued to fall. Even after the government introduced fiscal expansion policies as part of its

stimulus packages, tax revenue did not increase because the fundamental economic strength had never recovered. Consequently, while public debt continued to rise, the situation has remained unchanged.

The government of Abe Shinzo has been the longest since World War II. As a result, it has had the time to not just discuss structural reform but to actually implement it. This was a chance for the government to use its so-called political capital. Indeed, when Abenomics was introduced, I too hoped for a great outcome. The goals of the three arrow policy targets are convincing. However, as I described above, the reality is that Abenomics is a one-and-half-arrow policy, and the third arrow has become stuck in the timidity trap. Partly for these reasons, the IMF has now evaluated Abenomics severely.

Falling out of global trends

Since the collapse of the bubble economy in 1991, the Japanese economy has stagnated for a prolonged period, and it has continued to remain sluggish with the additional negative effects of its sustained deflation since 1998. In hindsight, 1991 was a watershed year in world and Japanese history and it was also a year when the direction of the progress of the world and Japan became more clearly divided.

In that same year as the collapse of the bubble economy, 1991, the Soviet Union disintegrated in a self-destructive manner and the Cold War between the East and the West that had dominated most of the world's postwar history ended.

Also in 1991, witnessing the collapse of the Soviet-style economic model, India, which had pursued a Soviet-style economic model since its establishment, also experienced a serious economic crisis. As a result, it radically redirected its policy, moving from a controlled economy to a free and open economy. This awoke India and direct overseas investment began to increase.

In the following year, in 1992, under the leadership of General Secretary Deng Xiaoping, China boldly accelerated reforms and the open-door policy that had already been adopted ahead of India. China did so with an eye on joining the World Trade Organization (WTO) in the future. This goal was welcomed by the world, prompting a rapid increase in direct investment in China. This direct investment became the drive to transform China into the factory of the world and to realize its high growth potential.

After the end of the Cold War, the global economy moved into the age of globalization and high growth. The engine of globalization was literally the explosive expansion of direct investment across borders. As a result of the dramatic expansion of globalization, the number of countries that were capable of producing and exporting low priced products with low labor or other costs increased rapidly, and while creating emerging economies, the global economy saw the advent of the age of the great division of labor.

Japan has diverged from these great trends. Countries competed with each other to attract direct investment, often in the form of regulatory reform. However, Japan focused on making investments overseas instead of adopting a policy of attracting direct investment to Japan. Abenomics places a weight on policies that expand direct inward investment and, to achieve this, the creation of an environment in which businesses are able to operate efficiently. The direction of these policies is correct. Unfortunately, however, there is a gap on this subject once again between

the speed of reform in overseas countries and those in Japan. Although the direction of the policies is appropriate, the gap in the speed is problematic.

Contrary to the government's intentions, the ranking of Japan in the "Ease of doing business index," prepared each year by the World Bank, has been declining.

The fact that Donald Trump won the US presidential election might indicate that a reaction against globalization has begun. However, since the 1990s, Japan has tended to look inward and it is possible it is considered to have been in a non-globalization mode, relatively speaking. The world is moving faster than Japan.

The gap between the stock market and the real economy

Higher stock prices have the effect of making people happier and revitalizing companies. At least, when stock prices are higher, people feel better than when stocks are underperforming. However, politics is a different story. Stock price fundamentalism, which is the assumption that the economy is well-managed only because stock prices increase, is problematic. There are certain quarters in Japan that hope for the wealth effects from higher stock prices. However, the rate of individuals holding stocks in Japan is much lower than that in the United States, and indeed is lower than it is in Europe.

Moreover, the higher stock prices in Japan since the end of 2012 have been overwhelmingly inspired by purchases by foreign investors, and both individuals and companies in Japan have remained net sellers. The rate of foreigners holding Japanese stocks has risen, and capital gains have been flowing overseas. In fact, the disposable income of Japanese individuals has been decreasing due to the effects of companies striving to contain labor costs, and consumer spending has also been restricted, reflecting people's concerns over the future outlook.

When the yen is weaker, stock prices tend to increase. But this is not reliable. When the yen is weaker, the market reacts enthusiastically to an increase in earnings of exporting companies attributable to the weaker yen. However, the problem is that companies internally accumulate increased income, rather than investing in growth. In the past, there was anticipation for the so-called J-curve effects, in which exports eventually increase after the depreciation of the yen. In recent years, however, the J-curve has vanished as volumes of exports do not increase even if the yen remains weak for the long term.

The weaker yen pushes up the prices of goods imported by domestic companies, and, if the companies are unable to transfer higher import costs to their products, the weak yen will become a factor that oppresses company earnings. The Bank of Japan may welcome the weaker yen to achieve its target of a 2% rise in consumer prices. A hike in the prices of imported goods is an inflationary factor, but it is a deflationary factor in the real economy.

When then-Prime Minister Sato Eisaku reported to Emperor Showa about the decision on the revaluation of the yen based on the Smithsonian Agreement in 1971, the Emperor reportedly said, "I think that Japanese people worked hard and developed a sound economy and, as a result, the Japanese currency has become strong. Is the revaluation of the yen a bad thing?" The Emperor indeed had a sound understanding. I believe that the problem of Japan is that the policy creation power and companies' management determination to establish an economy and industry that are capable of responding to the appreciation of the yen and maintaining a competitive edge are weak.

Is Japanese management herbivorous?

In an effort to regain the ability to generate earnings, companies have been taking steps in corporate governance. Corporate governance is indeed the core policy of the growth strategies of Abenomics. Certain companies are actively strengthening corporate governance by increasing the number of outside directors and taking other measures. However, despite a growth strategy to stimulate private investment set out by the government, the corporate stance on capital investment is still cautious. The IMF looked into the fact that Japanese companies maintain an extremely high rate of cash against market capitalization compared with other G7 countries, and has recommended that companies should allocate funds for investments instead of retaining profits.

By adopting a negative interest rate policy, the Bank of Japan is working to push out banks' surpluses deposited in the current accounts of the BOJ and encourage banks to use the funds to increase loans. However, bank lending remains rather anemic. This is because companies already have excess funds and have no intention of increasing their investments with bank lending. As a result, bank loans have grown significantly only in the construction industry.

Corporate earnings now stand at a record level. In most cases, however, strong earnings have mainly resulted from the reduction of labor costs and foreign exchange gains as a result of the weak yen and the disposal of assets. Contributions from the development of new markets or the expansion of new products and new services appeared to have been limited. There are also a number of companies that have increased share buybacks using cash reserves. Although the preferential treatment of shareholders is part of corporate governance reform, a rise in stock prices through buybacks only has temporary effects, and this will not strengthen companies' ability to generate sustainable profits.

Challenges in new fields are accompanied by risk. However, corporate management today appears to avoid all kinds of risk. I understand that the word "risk" originated from the Italian word, *risicare*, which means to dare and try to do something courageously. The important thing is not to avoid every risk, but to evaluate and manage the risks.

In fact, about twenty years ago, Edward Albert Feigenbaum, an expert in artificial intelligence and other fields said, "Japanese entrepreneurs value stability and safety more than growth. Risk aversion or minimization helps to prevent failure but it also takes away opportunities for experiments and innovations. Risk aversion means the withdrawal from the cutting-edge sectors." I am afraid that corporate management today is heading toward further risk aversion.

In addition, arguments about the six management difficulties or other multiple management difficulties that often took place until recently suggest the deterioration of the entrepreneurial spirit. When Japan faced the oil crisis in the 1970s, and, going back further, the pollution crisis in the 1960s, companies took on challenges to overcome the difficulties with the sense of crisis and acquired sophisticated energy-efficient or eco-friendly technologies. These technologies led new developments in the Japanese economy and industry. Today's arguments about multiple management difficulties are pessimistic, and they appear to have been used as an excuse for not doing what is supposed to be done. Needless to say, certain companies are taking on new challenges with the entrepreneurial spirit, but the situation is not as encouraging as in the 1960s and 70s.

Japan's most effective security is the redevelopment of its economic power and technological capabilities

Arguments about the threat of China have been increasing. Only a few years ago Japan was overtaken by China in terms of GDP. China's GDP is now more than double that of Japan and the gap is widening rapidly. The number of countries whose largest trading partner is China is also steadily rising. It is not realistic to call for the cooperation of countries for which economic relationships with China have been growing steadily to create a net around the fast growing China. Asian countries are hoping that Japan will become a model in terms of the economy and technologies for the Asian countries to follow. The issue of the aging society is an issue that all Asian countries will face sooner or later, and they are already facing environmental issues. I think that Japan's task is to lead the creation of new sustainable economic and social models as a country that has already been facing and dealing with these issues.

To achieve this, it is essential for Japanese governmental policies, corporate management, and the higher education sectors to include long-term and global viewpoints. The strength of both Japanese policies and corporate management was once its long-term view. However, I feel that Japan has recently been only focused on short-term ideas, in an even more exaggerated manner than other countries.

I think that it was around the time of the Lehman Brothers collapse in September 2008, when people started to talk about a new English term, "short-termism," in the United States and it gradually spread to Europe. Short-termism means a principle based on short-sighted or short-term views, and I believe that this new word was created as a criticism or reflection against such a principle.

We have already heard enough about the arguments of the lost twenty or twenty-five years. I think that those were twenty years that we did not need to lose. The key point is to examine why we lost those twenty years and to learn those lessons and we should simply stop complaining about it. The issues are clear. One of the critical issues is the continued existence of systems and customs as almost vested rights that were established in a period when Japan was working to catch up with developed economies in the context of the history of Japanese modernization. We need to move out of this situation as soon as possible. Another issue is the financial system centered on banks that continued and amplified the bubble economy in the late 1980s. Even after the collapse of the bubble economy, the system still remains. There is a shortage of risk money that supports risk-takers. A sufficient amount of risk money is never created through a financial system centered on banks.

As a result, people pretend to be weak under the principle of equality, while there are real cases of truly weak people who are not able to be rescued.

Since the emergence of Donald Trump, many critics point out that the world is facing a reactionary period against globalization. However, I think that it is necessary to squarely address the fact that Japan has not embraced globalization, because of its inward, downward, and backward looking attitudes since the 1990s, when globalization trends were taking off in the world. I would like to evaluate Japan's position in the world and have it become a little bit more outward, upward, and forward looking to reform Japan. With a sense of crisis as a driving factor, Japan has

overcome great crises to date. Japan went through numerous crises, including the arrival of the black ships a century and half ago, defeat in World War II, pollution, oil, and the appreciated yen. In such situations, the sense of crisis pushed the Japanese economy, industry, politics, society, and people not only to overcome it, but also to establish a new and resilient economy and society. Japan is persevering under the pressure of the issues of the aging society, the environment, and energy, which are larger than those of other countries. For this very reason, if Japan is able to directly address the issues and challenges and squarely deal with them, it will be able to be a leader in tackling these issues. Almost all of the countries will face these issues after Japan, even though it will be at a different time and to a different degree. Because Japan has already been placed in the front position in sectors related to the issues, methods, and solutions, Japan will be able to become a role model in the world.

Fortunately, Japanese politics are now more stable than we have ever seen, leaving behind the period of frequent changes in government. Amid growing political and social instability in many countries around in the world, with its political stability, Japan is in a sound environment and can address long-term issues. If the general public and the leadership are able to share this awareness of issues, they will even be able to provide Japan's new models of development to the world. I believe that Japan has a greater chance of accomplishing this than other countries.

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