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U.S. THINK TANK SYMPOSIUM

# Economic woes of Japan, U.S. 'homegrown'

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Japan and the United States both face a common challenge of showing that their economic models remain relevant even as China increasingly drives global growth, said Gary Hufbauer, a senior fellow at the Peterson Institute for International Economics in Washington.

"Obviously, both of our countries benefit tremendously from economic interaction with China — great market, inexpensive goods, good place to invest," Hufbauer said at the Jan. 28 symposium.

The slow growth of the Japanese and American economies has "nothing to do with China's success," he said, adding that China's successes "are not the explanation for our failures. Our problems are homegrown."

Japan and the U.S. need to replace, over the next two decades, the huge amount of government debt "with private capital that is productive and is not relying on tax payments to service the income growth," he noted.

"Both of us face a fiscal train wreck. Japan is 10 years closer to the clear path of crash than the United States," and the recent downgrade of Japanese government bonds by U.S. rating agencies "is a useful wakeup call," he said.

The only answer for this train wreck, he said, is a combination of spending cuts, especially to entitlements, and using broad-based consumption taxes to provide revenue.

Hufbauer also argued that the two countries need to work together to "reinvigorate the liberalization agenda, which has driven world growth for the last 50 years" but is now lagging on the global and bilateral levels to some extent.

Since Japan started discussing its possible participation in the Trans-Pacific Partnership, a U.S.-backed free trade arrangement among Pacific

Rim economies, domestic opposition has focused on anticipated losses from liberalizing the politically sensitive agricultural sector.

However, Hufbauer stressed that Japan should be focusing on the services trade, where the potential for growth will be the largest. "Trade growth on an economic dynamism of the next 20 years will be in services — that's the big growth frontier. Both our economies have about 70 percent of our activity in services, but services trade is not more than a quarter of our total trade," he said.

He regards the TPP as a "central ingredient of the broad economic and security alliance between the U.S. and Japan." It is "more than a free trade agreement. It is a broad alliance agreement," he added.

Meanwhile, Mark Calabria, director of financial regulation studies at the Cato Institute in Washington, observed that Japan and the U.S. appear to be copying each other's policy mistakes — rather than learning from each other's errors.

"Foremost among the policy errors is a single-minded and narrow obsession with deflation," he said. "Japan has experienced almost a decade of deflation, although until about 2009 deflation never got beyond a negative 1 percent decline annually. Fears of a deflationary spiral turned out to be misplaced — deflation instead was slow and steady until 2009."

Like many other industrialized economies, Japan suffered a dramatic fall in consumption and production following the September 2008 collapse of Lehman Brothers, he pointed out.

"As is almost always the case in such a dramatic decline in consumption, consumer prices dramatically fell. So it should come as no surprise, as a decline in consumption in the face of stable supply will result in the decline of prices, and I believe this is quite distinct from the deflation trend, which has characterized the last decade or so," he said.

Calabria said the the primary problem facing Japan's economy is not a lack of aggregate demand. "The primary issues," he said, "are the absolute declines in both population and the size of labor force, along with the substantial slowing in the rate of increase in labor productivity."

But the fear of deflation — the belief that insufficient aggregate demand is holding back the economy — has provided the rationale for the Bank of Japan's long-running policy of quantitative easing, he said.

The problem, Calabria said, is that most of the liquidity has not made its way into the business sector. "In fact, it appears that much - if not all - of the last several years' corporate investments has been funded by internal cash flow that has been retained earlier, rather than bank lending," he observed.

He said the Japanese banking sector has to a large extent "shifted from its traditional role as provider of industrial credit to the role of primarily a provider of credit to the government."

And one of the factors behind the shift, Calabria said, is that in an environment of deflation, even the relatively low government bonds yields look more attractive on a risk-adjusted basis than triple-A rated corporate bonds.

Banks are also trying to reserve capital in the aftermath of the 1990s banking crisis and recent disruptions in international capital markets, he pointed out. "One cannot blame the banks for this behavior, while the behavior does have a significant negative impact on the overall economic activity," he said.

Given the declining population and labor force, "increasing labor productivity is likely the most important issue facing the Japanese economy and perhaps the only way to increase the size of the economy," Calabria said.

And as one avenue for shifting bank lending away from the government toward private sectors — particularly long-term capital investment — the BOJ, rather than maintaining interest rates at essentially zero, "should begin a slow but steady increase in rates so that the rates should rise in the medium term to around 1 percent," he said.

"This would discourage banks from investing predominantly in government securities and push them to riskier, higher-yield lending in the private sector. As there is little evidence that massive government stimulus activities are increasing capital deepening and enhancing labor productivity, shifting away from government lending toward the private sector should improve economic performance," Calabria said.

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