FT.com
FINANCIAL TIMES

How Japan could lead return to durable growth

By Tadashi Nakamae
Published: March 30 2010 16:14 | Last updated: March 30 2010 16:14

Twenty years of recession – or near-recession – and a potent dash of deflation may not seem like a recipe for economic success. The struggle to emerge from a global recession looks as if it could drag on for several more years. The US and Europe are wasting time exploring the same muddled policies that cost Japan its two "lost decades". Having already wasted time testing these theories, Japan could jump out in front of the crowd and become the first economy to return to growth.

The root of the current economic downturn is excess capacity, and the country that solves the dilemma of excess supply capacity will be the first to return to durable growth. During economic bubbles, people spend based on illusions of rapidly increasing wealth. As a result, companies invest in anticipation of continued strong growth in revenue from consumption. When bubbles burst they leave a huge gap between supply capacity and spending demand that crashes to earth. The logical solution to this problem is to cut supply capacity down to the new level of demand, but scrapping capacity cannot be accomplished without making cuts in the workforce – not popular in any country.

Rather than accepting the painful step of cuts in capacity and the workforce, Japan's government, like many others, has been using fiscal and monetary policy measures to stimulate demand without having a clear vision of how to permanently reduce the supply-demand gap. As it turned out, the gap was so large that its measures were inadequate. And the existence of the gap exacerbated the problem. Capital expenditure declined and companies capped wage increases, leading to further weakness of demand and consumption. Despite aggressive fiscal and monetary policies, the capacity-utilisation rate continued to decline and increased corporate inefficiencies.

This inefficiency is caused by excess capacity. Japan's manufacturing industry operates with at least 30 per cent of unused supply capacity. Using figures from the Statistics on Incorporated Enterprises, a 30 per cent reduction in capacity and employment would lead to a rise in profits from Y4,000bn to Y25,000bn (an increase of Y21,000bn or 4.5 per cent of GDP), partly through a big reduction in depreciation and wage costs.

The remaining workforce would share some of the benefits of the increased efficiency as wages would rise without hurting profits. It would also help the government trim its budget deficit as increased corporate profits would produce additional government revenue.

There would be drawbacks. The biggest would be the impact on unemployment. Japan's manufacturing sector employs 10.5m workers. A 30 per cent workforce reduction translates into a 3.2m rise in unemployment, or 5 per cent of the workforce. Excess capacity is also prevalent among large-scale retailers, and the construction

and transportation industries. These job losses need to be offset by expanding domestic non-manufacturing industries such as healthcare, old-age care, education and agriculture. Fortunately, a large amount of potential demand exists within each of these growth industries. Japan’s medical spending, for example, represents 8.0 per cent of GDP – much smaller than the 18 per cent in the US.

Japan needs structural reform, especially deregulation, in order to stimulate sustainable domestic economic growth. Eliminating excess supply strengthens competitiveness and increases efficiency. It is important to note that inefficiency is not caused by deflation. As I have shown, it is possible to achieve higher efficiency even under deflationary conditions.

Fiscal stimulus and monetary easing policies should not be used as they get in the way of real reform. In the last two decades demand-side fiscal and monetary policies have served only to delay the much-needed elimination of excess capacity while dragging the growth rate of the economy down to zero.

Fiscal spending needs to be scaled back and the private sector needs to be expanded, particularly the non-manufacturing industry. Excess money must also be removed from the economy so that interest rates can rise and function appropriately, say, by forcing zombie firms to file for bankruptcy and allowing healthy companies to grow. Higher interest rates also benefit households by increasing interest income and in turn consumers’ ability to spend more, leading to increases in employment and wages, even under deflation.

In the long term, given that Japan has exhausted almost all of its ill-planned fiscal and monetary policy options during the past twenty years, it should make it easier for it to look for new solutions. Japan’s appalling regulatory hold over non-manufacturing industries has also left it with numerous areas of untapped growth, should this grip be eased. Ironically all this could make it possible for Japan, despite its deep problems, to become the first of the rich-world countries to make it out of the global recession.

Tadashi Nakamae is President of Nakamae International Economic Research and a former Chief Economist of Daiwa Securities