



BANK OF ENGLAND

Speech

Japan can – and will – be a normal economy again

Speech given by

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For several decades, business and economic pundits have exoticized Japan's economy. The supposed lost decades since 1990 have only heightened perceptions of a country whose economic system operates in unique ways, not subject to standard economic analysis. As I have argued tonight, this view of Japan as atypical and mysterious is, however, unfounded for macroeconomic policy purposes. With the enormous challenges that Japanese citizens face today, it is important to keep in mind this fundamental commonality – returning to the belief that Japan has its own path economically, not just culturally, could lead to deeply mistaken conclusions about the country's longer-term economic prospects.

It is my belief that the human tragedy of the March 2011 earthquake and tsunami will do nothing to dislodge the Japanese economy from the long-term development path common to all advanced economies. If, as I have argued, the story of Japan's economy in the 1990s is that of *Seven Samurai*: in which a terrible, negative shock disrupts the normal farming village cycles of Japanese economic life, eroding communal prosperity until strong leadership requiring significant sacrifice is exerted to restore normality. Seen that way, the future for Japan's economy is continued normality in the absence of new, self-destructive social or policy paths – and even a horrendous natural disaster can be overcome.¹

Absent the current crisis, Japan's prospects over coming decades should be fine for a normal country at the global technology frontier, with ample savings, and secure property rights. This means the economy should grow over time at approximately the rate of productivity growth—around two percent annually—adjusted for changes in prices and population size. The country should have normal business cycles, and be vulnerable to external or further natural shocks, but should not display any unusual patterns. The rebuilding from the tsunami will only accelerate the growth rate in the short-term with a surge in capital investment, just as occurred following the devastation of World War II or the Kobe earthquake.² This is of course what a Solow-type growth model would tell you would happen when an economy in the steady state suffers a sudden loss of capital (and history bears this theory out in practice beyond Japan).

Yes, the Japanese population is aging rapidly, but what matters for human welfare and for sustainable performance is *per capita* income growth, and history shows that slow demographic changes do not prevent sustained growth by that relevant measure. The meaning of the terrible loss of life in the Japan's 2011 earthquake and tsunami cannot be captured in economics. But from the narrow view of longer-term economic prospects, the loss is insufficient to alter the country's current or future workforce on a national scale. If the devastation encourages many older Japanese to leave the more exposed rural regions to be closer to safety and health infrastructure, that would be an efficiency enhancement going forward – all the more if it erodes some of the persistent lobbying support in Japan for redistribution towards agricultural and provincial interests.

¹ Obviously, I am assuming – nay, praying – that the nuclear situation at Fukushima is resolved without further widespread harm for this to be the case.

² In this sense, the relative remoteness and low economic value-added of (not all) most economic activities in the worst hit region is an advantage. For a prescient and generally applicable analysis of economic geography and rebuilding, see Donald R. Davis and David E. Weinstein, "Bones, Bombs, and Break Points: The Geography of Economic Activity," *American Economic Review*, December 2002, pp. 1269-1289 and "Does Tokyo Matter? Increasing Returns and Regional Productivity," NBER Working Paper 8518, October 2001.

Yes, the outstanding public debt level is very high, though there remains a roughly 100% of GDP difference between net and gross public debt.³ The national savings available to fund government borrowing remains far larger still, public indebtedness to foreigners remains insignificant, and Japan has \$3 trillion (around two-thirds of GDP) in foreign assets to draw down if needed. Re-building the devastated parts of Japan's northeast regions, and even of the country's electrical power grid and nuclear power systems more generally, should cost on the order up to 10 per cent of GDP spread over three to five years, and thus be readily financed.⁴ While something someday will limit Japanese public debt capacity, there is no particular reason to think this is it. I would go further, and suggest that there is an optimistic scenario in which the Japanese government could substitute the one time spending on reconstruction for ongoing wasteful public spending and transfer programs ("We have to live within our means to pay for rebuilding, so every expenditure needs to be met with a cut elsewhere..."). If implemented even in part, that would shrink the structural deficit in Japan going forward.

Yes, Japan has suffered from persistent deflation, with its attendant drag on the economy, but even that is surmountable in the years to come. Just as the long recovery of 2002-2008 finally brought inflation back above zero before the crisis hit, the current recovery will bring Japan back to price stability. An inevitable depreciation of the yen against the euro and the Chinese currency will in coming years help overcome deflationary trends, as will mounting global upwards pressures on energy import prices. The coordinated G7 intervention last month to prevent an undeserved and unsupportable appreciation of the yen is to be commended as part of the international cooperation in support of Japan's recovery.

I am not so obtuse or Panglossian to suggest that the horrible devastation that hit Japan and its people is an economic benefit, or even that every negative aspect could perhaps be turned into an opportunity.⁵ I am, however, joining most macroeconomists in reminding everyone that both the historical experience and the economic logic of recovery from such natural disasters (and even their mismanagement-made multipliers) is compelling, even absent the specifically Japanese social strengths and the solidarity and courage that millions of Japanese citizens are displaying today. It is of course possible to list those areas long begging for structural reform in Japan, most notably the under-utilization of female and younger workers and the inefficient services sector. While intolerance is the major cause of these deficiencies, and that is distasteful to many Japanese as well as to most Western observers (including myself), their purely economic significance as a constraint should be kept in perspective.

To date, the Bank of Japan and Ministry of Finance have reacted to their nation's natural disaster with speed, creativity, and constructive commitment. Beyond their justified immediate desire to help, I would like to think that Japanese economic policymakers have learnt from their predecessors' macroeconomic mistakes of the

³ See the pathbreaking study by Christian Broda and David E. Weinstein, "Happy News from the Dismal Science: Reassessing the Japanese Fiscal Policy and Sustainability," NBER Working Papers 10988, June 2004.

⁴ I am grateful to Joseph Gagnon and Marcus Noland for discussion of what would be a reasonable upper bound.

⁵ For a broader historical and political perspective on this possibility of crisis bringing reform, see Marcus Noland, "Will the crisis create a new Japan?," *Washington Post*, March 16, 2011.

1990s, as well as from the benefits of American and European rapid macroeconomic response to the financial crisis of 2008-10. Underestimating the potential growth rate of Japan again, and returning to monetary or fiscal policy tightness too soon could become a self-fulfilling prophecy.⁶ That danger is the primary reason for stating clearly the facts of Japan's strong recovery in the 2000s when mistaken policies were reversed, and grasping the positive implications of that recovery for Japan's long-run growth potential even after the earthquake and tsunami of 2011.

The response of the Japanese private sector, both of individual investors and business leaders, will be at least as important as that of macroeconomic policy, barring such policy mistakes. In particular, if Japanese business can continue to overcome mutual distrust with Japan's Asian neighbours to enable further outward investment from Japan into the region, Japan would become a still greater managerial, financial, and technological hub for the developing economies of the world's fastest growing region. Given the fundamental strengths of Japan's normal economy, there is an excellent basis for an ongoing upwards trajectory. If the physical and demographic vulnerabilities of home production and supply lines revealed by Japan's quake and tsunami give more impetus at the margin for Japanese companies to move physical capital and production abroad, so much the better. A decade ago, the Japanese business federation Keidanren articulated a vision for a commercial strategy based more on "Made by Japan," instead of "Made in Japan," and tightening integration with their East Asian neighbors – the coming rebuilding and reorganization of the Japanese economy should reinforce the worth of that vision as a practical guide.⁷

My argument that Japan can and, I believe, will be a normal economy again, even after the current crisis, may not be too exciting, or may seem too sanguine. But it is a reasonable aspiration that Japan will have a productive economic garden of one's own to tend – a goal that Japanese concepts of normal life rightly value highly. As Kurosawa shows in *Seven Samurai*, and as the world has seen in the response of the Japanese people to the quake and tsunami disaster of March 2011, a return to normal hard work and rewards in conditions of social peace is something to be grateful for.

⁶ A general discussion of this risk, learning from Japan, is given in Adam S. Posen, "The Central Banker's Case for Doing More," *PIIE Policy Brief* 10-24, October 2010.

⁷ Japan 2025: Envisioning a Vibrant, Attractive Nation in the 21st Century, Nippon Keidanren, 2003.
<http://www.keidanren.or.jp/english/policy/vision2025.pdf>