EconoFact Chats: The Japanese Economy - Robust to Anemic, but Now Recovering?
Paul Sheard
Published on November 10, 2024

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I'm Michael Klein, executive editor of EconoFact, a nonpartisan, web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
In the early 1990s, the MIT economist Lester Thurow published the book *Head to Head: The Coming Economic Battle Among Japan, Europe, and America*. This book reflected the widely held view at that time that the Japanese economic model was ascendant, with its focus on production as compared to the consumption-based focus of the American economy. But on the heels of the collapse of the stock market and real estate bubbles in the late 1980s, Japan began a period of relative stagnation and deflation, which it is only now, three decades later, emerging from. What were the sources of the rapid post-war growth of Japan, and why did this stall and reverse? And are there lessons from the Japanese experience that we should consider for the United States? To discuss these issues, I'm happy to welcome to EconoFact Chats Paul Sheard. Paul was a professor at Osaka University and a visiting scholar at the Bank of Japan and Stanford University. He was Japan's strategist for Baring Asset Management and has held chief economist positions at Lehman Brothers, Nomura Securities, Standard & Poor's Rating Services, and S&P Global. He is an expert on the Japanese economy. Paul, welcome to EconoFact Chats.

Paul Sheard
Thanks very much, Michael. Pleasure to be here.

Michael Klein
What was the performance of the Japanese economy in the post-World War II period up until the 1980s, and why was it seen as a juggernaut?

Paul Sheard
Well, I think the post-war period up until the pinnacle of the asset price bubble in the 1980s can be broken down into three periods. The first period, after the initial reconstruction from the devastation of World War II, in the 1950s and 60s, was the so-called high-growth period, where Japan really got on its feet again, and was able to grow at about 10% per year for that period. And then in the 1970s, if you remember, we had the famous oil price shocks, particularly the first oil price shock, and that dealt a pretty heavy blow to Japan's heavy industries—steel industry, aluminum industry, shipbuilding industry—but Japan came out of the 1970s and into the 1980s with a fairly good scorecard or reputation in terms of its ability to restructure these uncompetitive industries, and emerge in pretty good shape into the 1980s. And then the third period—the icing on the cake, so to speak—was the bubble economy, which really took off in the second half of the 1980s where land prices went through the roof, and the equity market went through the roof. And that was the period where people also looked at Japan's manufacturing capability, the Toyota auto production system, just-in-time…and you had a lot of books about,

you know, Japan was this juggernaut that was going to take over the world. And that was about to—the wheels were about to come off the story when we get to the end of the 1980s.

Michael Klein
What were the economic reasons behind these high rates of growth?

Paul Sheard
Well, I think in the initial period, there were a number of factors at play, Michael. One was, of course, the Second World War—if you go way back—had interrupted a period of rapid economic development and modernization in Japan. And then, in a sense, after the World War, the United States came in and helped to restructure a lot of the institutions and the society, and that set the base or the foundation for Japan to resume its very rapid industrialization and economic development. But one factor in that mix was, of course, the technological catch-up. Japan had fallen behind the technological frontier, and there was a rapid process of catch-up. Japan was also, in the post-war period as a U.S. ally, newly formed U.S. ally, able to benefit from the Pax Americana, if you like, the U.S. opening up its markets, providing a very important export destination for Japanese exports. And Japan had a very high investment rate as savings supported very capital-intensive investments in steel, petrochemicals, machinery, automobiles, and electronics. There are also some other factors that you might throw in, which perhaps are a little bit more controversial or maybe proved later on to be not so helpful to the Japanese economy. Two I would focus on would be the role of industrial policy. The Ministry of International Trade and Industry, famously, was very important in coordinating the whole investment and industrial development process in that high-growth period. And then on the corporate side, Japan developed or evolved a number of interesting corporate organization forms. The so-called Zaibatsu had been dissolved, and these evolved into enterprise groups. There were sort of six of these main enterprise groups which developed their own full set of industries and competed with one another. So you had this unique mixture of coordination through the government, including financing and competition within the corporate sector.

Michael Klein
So, I looked this up, Paul, and in the late 1980s, real estate in Tokyo, measured by price per square foot, was selling for more than 350 times that in Manhattan. The land under the Imperial Palace was worth more than the real estate in the entire state of California. The Nikkei reached a high of almost 39,000 at the end of 1989, after 40% gains in 1988 and 29% gains in 1989. Economists refer to asset market bubbles, and this seems to have qualified as one. Would you agree with that?

Paul Sheard
I would definitely agree, Michael, that in the second half of the 1980s, really from around 1985, Japan experienced, you know, one of the biggest, and ultimately one of the most devastating, for the economy, asset price bubbles. And this was a land price bubble, a real estate bubble, and an equity price bubble. I don't think I've ever encountered any economist or observer of Japan that makes the contrarian case that this was not a bubble. And the essence of a bubble, as you well know, is that the asset price valuations, or asset prices, get untethered or detached from the underlying foundations, and they just keep going up. And what happens there, of course, is that

the expectation of further rises in asset prices actually becomes a self-fulfilling prophecy. That happened in Japan.

Michael Klein
So, bubbles are called bubbles because they pop. When and how did the Japanese stock market and real estate bubbles pop?

Paul Sheard
So, I think there are a confluence of factors. One is simply, eventually, as we've just noted, bubbles do burst. So there reaches a point of almost saturation, where people start to say, 'well, it can't go much higher; I think I'll take some profits.' A second set of factors were policy tightening. Both the Bank of Japan—the central bank—and the banking authorities—the Ministry of Finance—were trying to rein in and sort of deflate the bubble, raising interest rates and doing other measures aimed at limiting bank lending. And a third factor I would point to, it's kind of a little bit technical, is the idea of a focal point, that the equity market in Japan actually peaked on the last trading day of 1989, which means the last trading day of the whole decade. And, you know, sometimes these focal points can be important. That is, they don't have any—the last day of the decade doesn't have any intrinsic meaning. But everybody knows about it, and everybody kind of coordinates the behavior on that. That's my own little theory of why the bubble, the equity market bubble, popped exactly when it did—that everybody looked at the clock and said 'hmm, this is a good time to check out.'

Michael Klein
Yeah, that seems reasonable to me because if everybody kind of knew that things were overvalued, you don't want to be the last one out the door. And so, when you see a time that is, in fact, potentially a trigger moment, everybody agrees, and you know, immediately, you have this collapse. So what were the consequences of the popping of the bubble for the balance sheets of banks, corporations, and individuals? And then, how did this affect the broader economy?

Paul Sheard
Well, they were really devastating, Michael, particularly for the banking industry and for corporates. The households were a little bit more insulated because of the nature of the Japanese economy; they weren't directly exposed as much to the equity market, and their deposits—that is, the gains that they'd made from selling their real estate to corporate developers—were essentially protected by the government. But for the banking system—and you have to bear in mind here that Japan had, and still, to a large extent, has, a very bank-centered financial system. So the bubble was fueled largely by a rapid increase in bank lending to the corporate sector, who then developed real estate projects. Now, when asset prices started to fall, if you think in balance sheet terms for the banking system, on the left-hand side, the asset side, you had a rapidly depreciating asset, and on the other side of the balance sheet that showed up as essentially a rapid eating away of the bank's equity, which was not particularly big to begin with. So essentially, it meant that pretty soon the whole banking sector in Japan was technically insolvent. It was technically insolvent. But, of course, that fact was not really well known and was not marked to market.

Michael Klein
In fact, in one of your papers, you argue that forbearance contributed importantly to the persistent weakness of the Japanese economy after the bursting of the bubble. Can you explain what you meant by forbearance and why it had such a bad effect on the economy?

Paul Sheard
Yes, certainly, Michael. I think this was probably the most important policy decision that was taken by the government in the 1990s. And essentially, what it means is that when the bubble unwound and the banking system was essentially insolvent, and corporate Japan was in trouble, the government had two possible choices, two choices about how they could proceed. One is a more U.S.-style approach of saying, we'd better admit the problem, we'd better fix these balance sheets..and that really would have required a massive infusion of capital, and probably that would have had to come from the government—tackle the problem head-on and move on. But the Japanese did something else. They essentially played for time, and they used a process of forbearance. What forbearance means is, instead of recognizing the true state of the balance sheets, you sort of cover that up. You give the banks sufficient time to work through their problems and rebuild their equity base slowly. And Japan did this circa 1995 by putting in place a blanket guarantee of all deposits in the banking system. And that was good for quelling any runs in the banking system and sort of financial turmoil, but it kind of let the banks off the hook, and corporates off the hook in terms of having to recognize the problems they had on their balance sheets and work through them slowly. But that proved to be, I think, counterproductive for the overall economy.

Michael Klein
So, along with this kind of forbearance, were there other reasons why there was a persistent weakness in the Japanese economy? I remember people like Ben Bernanke would advise them to try to be 'responsibly irresponsible' by having inflation be very high, but they were never able to get inflation to rise, and as a consequence, the real cost of borrowing remained quite high. What's your view on that?

Paul Sheard
Well, I think a couple of things. One is that, what happened because of these policy errors—so I mentioned the banking system policy of forbearance—then you had the Bank of Japan using monetary policy. And they did ease monetary policy, but I think they did it in a way that, you know, after the event, you could certainly say was too timid and perhaps, in some cases, counterproductive. And then on the fiscal side, the government was—because you had this bursting of the bubble, budget deficits blew out, and the fiscal authorities got very worried about budget deficits and debt in Japan. So, every opportunity they had, they would try to rein in fiscal spending. And that proved to be a deflationary force in an already deflationary economy. And to add to that story, what happened, Michael—big picture—through the 1990s and into the 2000s was that Japan fell into this deflationary mindset. Now, we're only talking here about maybe 1% deflation per year, but that's not 2% positive inflation. So, you had this mild chronic deflation that got embedded in the economy, got embedded in economic behavior and the way people thought, and proved very, very difficult to get out of.

Michael Klein
Paul, I'd like to shift gears a little bit now and talk about demography. Japan's median age at almost 50 years is the second highest in the world, and more than one quarter of its population is over 65, and this is expected to reach 40% by 2060. This reflects very slow population growth. In fact, Japan's population has been declining since 2008 due to both low birth rates and a lack of immigration. How does this contribute to the country's economic problems?

Paul Sheard
Well, in some sense, Michael, this is really at the heart of the economic problems that Japan faces. What we were talking about before, with deflation, was more of a kind of nominal phenomenon. We're talking now about, if you like, the real economy. What is the actual sort of capacity of the Japanese economy to produce goods and services? And the demographic headwinds are very, very steep in Japan. And essentially this means that real growth, or potential growth, in the economy is structurally very very low and getting lower. And it can only be reversed, in a sense, if there are dramatic steps taken to stem the reduction in the population, or if there are dramatic steps taken to raise productivity, so that even with fewer people, you can still produce a lot more. The numbers on the population are quite striking: in the 50 years to 2070, so pretty much the next 45 years or so, the population is projected to shrink by about 31%, from about 127 million to 87 million. I mean, this is a dramatic headwind for the economy, and so, you know, needs to be addressed in some shape or form.

Michael Klein
Another striking feature, something you alluded to before, is that the Japanese government has huge debt. Relative to its GDP, the debt is estimated to be over 260%. And to put this in context, there's great concern now about the U.S. government's debt-to-GDP ratio, and that's about 100%. How can Japan sustain such a high debt-to-GDP ratio, and what are the broader economic implications of this?

Paul Sheard
Yeah, this is a big topic, Michael, and a somewhat controversial topic. And if you just look at those figures, they look very, very worrying. A few footnotes, if you like. One is that that’s a gross debt number, and some of the debt is held within the government, and essentially cancels out. So, you really want to look at a net debt number, and that’s probably more like 160% of GDP, still a big number. But I actually—you know, in my recent book, *The Power of Money*, I have some analysis of this. And there is a school of thought which would agree with me that we really shouldn't be thinking of this government debt in the way that we think of normal debt for households or corporates—that it’s something that has to be repaid. It’s government-created money. Where that debt comes from is it’s stock and flow. It’s the stock which is related to this flow over many, many years, if not decades, of governments running budget deficits. And the budget deficit means the government injects money net into the economy. So, the problem is: is there too much sort of purchasing power building up in Japan relative to its capacity to produce goods and services? And you would think that would have to be the case, because we just talked about the population shrinking, and fewer people working, and yet, there’s this huge stock of debt, which bear in mind, are assets for the Japanese people who mainly hold them—this is purchasing power. So, the concern, I think, would be more not so much that Japan becomes insolvent with a fiscal crisis, but that at some point that purchasing power is released into the

economy, overwhelms its ability to produce goods and services. What do you have? Then you have inflation. Well, that's a slightly ironic story because we've been talking about Japan trying to get out of deflation for 30 years. But I would look at it more through that prism. Another element, just to bear in mind, is that while Japan runs these big government deficits, it doesn't have a twin deficit. In other words, it also runs a fairly substantial current account surplus. That means, essentially, that Japan continues to be a net lender to the rest of the world. It is accumulating claims on the rest of the world, roughly about 3% of GDP over the last 40 or 45 years, maybe 50 years. What that means is that you might say the Japanese government looks like it has a debt problem, but Japan itself doesn't have a debt problem.

Michael Klein
In fact, the people in Japan are acquiring claims, not only on their own government, but on the rest of the world. So there's this huge amount of potential. And as you say, it is kind of a puzzle why that doesn't lead to inflation given that, and I guess it has to do with low consumption demand. Would that be right?

Paul Sheard
Yes, and I think the mindset of the Japanese consumer, or Japanese household, it has been very, very negative. And Japanese are very pessimistic about the future. So you might say, well, why not spend today and forget about the future? But it works more in the reverse way, that the Japanese household sector tends to sit on its savings, which are mainly bank deposits, which themselves are largely claims on government debt, and really just sits on them rather than turning them into consumption.

Michael Klein
So recently, Paul, some people have said that Japan has turned a corner. And also, there have been other changes, like in the most recent election, the Prime Minister was forced to step down. What do you make of the events over the last six to nine months?

Paul Sheard
Yeah, very interesting. I think you can separate them, as you did, Michael, into two categories. One is what is happening on the macroeconomic front—so deflation, inflation, that kind of thing. And here, there have been some very positive developments, because Japan, and the Bank of Japan were the only central bank or country in the world that essentially welcomed the inflationary shock from COVID. Inflation is now running around about 3% in Japan, so this has allowed both nominal GDP to pick up in a way it hasn't done before. So, we're starting to see prices and nominal variables rising, which could shift the mindset, and it's allowed the Bank of Japan to finally exit from its extraordinary sort of regime of what's called quantitative easing, or quantitative and qualitative easing, with yield curve control. They've had this strange framework where they essentially pegged long-term interest rates at 0%, they've now exited from that and are starting to raise interest rates, while other central banks are now looking at lowering them. So that's an interesting macroeconomic development. On the political side, it feels a little bit less optimistic in the sense that there's political turmoil in Japan, a little bit reminiscent of what happened in the 1990s. The government—well, we just had an election, they lost their majority, and so there's a lot of haggling going on in the political realm. Now, you might say, isn't that a good thing? I mean, it potentially is a good thing if you get a more contestable political system in

Japan. But in the short term, it seems that Japanese politics is reverting to type, and I would worry just a little bit that that's not a great environment in which to get the political and policy-driven changes around immigration, around perhaps corporate restructuring, labor market reform that would help to lift Japan's growth prospects.

Michael Klein
So finally, Paul, I'd like to ask you about any broader lessons you see from the Japanese experience, especially for the United States. So you've touched on a number of issues—things like demographics and the lack of immigration, government debt, policy towards banks and financial institutions, industrial policy, efforts to steer the economy towards particular industries. If somebody were to ask you, as I'm now doing, what would you say that this teaches us about American economic policy? How would you answer that?

Paul Sheard
Yeah, that's a great question. Well, partly, a lot of the sort of obvious lessons from Japan around, what do you do in a banking crisis, what do you do with a shrinking population—I'm not sure if the U.S. has learnt those lessons. It's more the case that the U.S. knows those lessons but has never had to learn them. So, you know, the U.S., obviously, is very much an immigration-led country. In the global financial crisis or the COVID crisis, shows the ability to take very dramatic, forceful policy action. But that, I think, is a big differentiator. So, where are the lessons for the U.S.? I mean, one thing that we haven't talked about, Michael, is that Japan, for all this dismal economic picture, in relative terms, has what you would call a very high level of social capital or social cohesion. What that means is the society works very well. Everything works in Japan; it's a great place to visit, to live. And so, you know, perhaps the mirror image of that is the sort of social division, political division that you have in the U.S. So, you know, directionally, it would be nice if the U.S. could move a little bit more in the Japan direction, having a better sort of civic culture, civic square. That's one point I'd emphasize. The other thing is that two or three things have happened. You mentioned industrial policy. It's been a big shift in the last few years in the U.S. to recognize that perhaps the U.S. does need a strategic industrial policy, particularly related to national security. Well, Japan kind of invented industrial policy, so perhaps there are some lessons from how Japan's done that. Another one is there's been a shift in the way we look at corporations. Remember the Business Roundtable statement in August 2019, which declared that the U.S. corporate world would now be one of stakeholder capitalism more than shareholder value capitalism. You know, that may have been a little bit overstated or overdone, but Japan, again, essentially invented stakeholder capitalism. It's had that kind of system—might be worth looking at some of those factors. And the last one is, recently, with COVID, lot of emphasis on supply chain problems—near-shoring, friend-shoring, on-shoring. And again, Japan has got a history, a long history, of being very adept and skilled around supply chain management—obviously in the automobile industry, but also the general trading companies that operate these global supply chain networks. So again, perhaps some interesting lessons to learn from Japan around supply chain management.

Michael Klein
I think it's interesting that you point out that the U.S. didn't have to learn the lessons about immigration or taking dramatic action at the time of a crisis. But in fact, now those things are really being called into question. So maybe it should reinforce that immigration in the United

States has been a net positive, and taking dramatic action at a time of a huge crisis like COVID actually is an important thing to do. So, these are things that the United States kind of knows but are called into question. Maybe the experience of Japan is something that can help reinforce those lessons.

Paul Sheard
I think so. And one of the positive things is a lot of people, tourists in particular, are going to Japan now, and so I think they're seeing with their own eyes, “wow, this is a society that works and functions very well,” and perhaps some of those attributes could be brought back into the U.S. system.

Michael Klein
That would be nice. So, Paul, this has been really interesting for me, and I really very much appreciate the insights that you bring to this given your vast experience in the Japanese economy. Thanks for joining me today on EconoFact Chats.

Paul Sheard
Thank you, Michael. It's been a great pleasure.

Michael Klein
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