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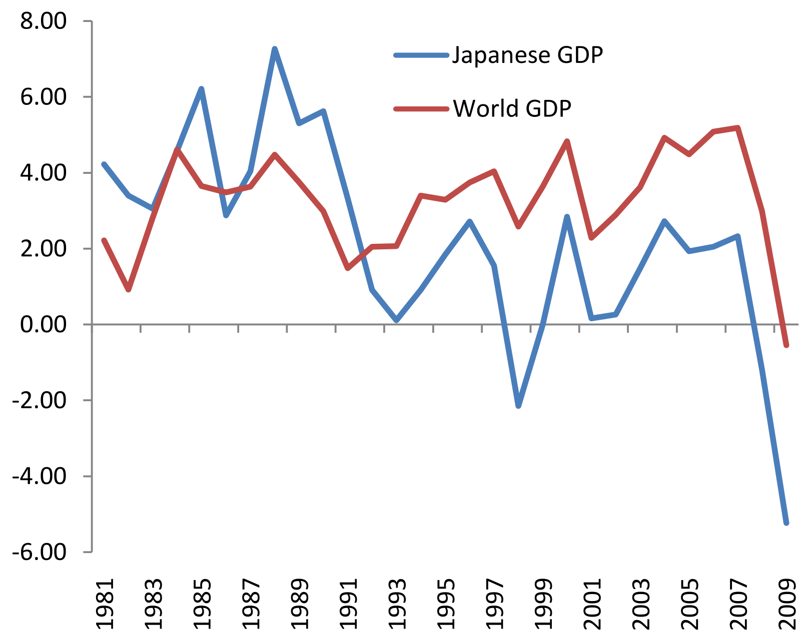
Time running out for Japan

By Kunal Kumar Kundu

Although it has taken until the past few months for Japan to yield the status of being world's second-largest economy to China, the Japanese economic outlook has a strong sense of deja vu.

Among the hardest hit economies during the recent global financial crisis, Japan staged a strong rebound during the first quarter this year, surprising many on the upside. However, it is natural for an export-led economy like Japan to react to global growth, albeit slowly.

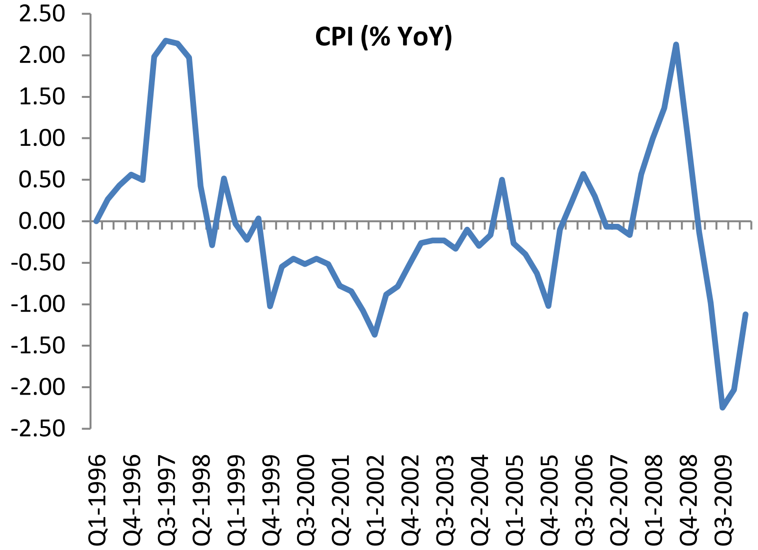


Initially, the world responded to the recession by furious destocking. When it gave way to restocking as inventories dipped to historic lows, Japanese exporters inevitably benefited. During the past nine months, Japanese exports increased at a pace of little more than 2% month-on-month.

However, as question marks arose over global growth prospects, Japan blinked and China overtook it. The Japanese economy grew at an annualized, seasonally adjusted pace of 0.4% during the second quarter, much lower than the revised 4.4% growth rate recorded for the preceding three months.

The latest quarterly growth rate gives us a sense of deja vu and brings to the fore the basic problem that the Japanese economy faces - anaemic growth, deflation and aging population, problems that are exacerbated by the high level of debt.

Japanese nominal gross domestic product (GDP) as of 2009 stood at 474.25 trillion yen, the lowest since 1991. Over the past two decades (post the bursting of the stock-cum-real-estate bubble), Japanese GDP grew at a mere 0.73% per annum. Not surprisingly, Japan has been caught in a deflationary spiral. Its GDP deflator has been generally falling since the mid-1990s while its Consumer Price Index (CPI) has been falling by nearly 0.3% per annum over the past decade.



The policy reaction has been to slash short-term interest rates to near zero, and they have remained there for more than a decade now. Meanwhile, a plethora of stimulus programs has been thrown at the economy, be it infrastructure development in rural areas, payments to poor families, or whatever.

While these achieved precious little in terms of pushing the economy forward, the debt burden continued to rise and at present it is about 200% of GDP. Add to that, high levels of fiscal deficit and none too strong financial institutions and it is clear why Japan faces a debilitating fiscal problem.

While most other economies would have faced disastrous consequences, Japan has managed to carry on because of the combined effects of high domestic savings, a current account surplus, low interest rates, deflation and yen appreciation. While the current account surplus and deflation lead to a stronger yen, this in turn aids deflation.

Deflation helps in keeping interest rates low. Anaemic economic growth also adds to deflationary tendencies. With monetary policy becoming virtually ineffective (especially because of weak domestic demand given the well-entrenched deflationary expectations) in spurring economic growth, the government is forced to take fiscal measures (quite often politically motivated) which, while adding to the deficit, do precious little in boosting the economy.

However, the high savings and low interest rates allow the government to finance its deficit quite easily. As a result, the government is not incentivized enough to tackle its fiscal problems. Public debt has reached unsustainable levels and only some fortuitous circumstances (as described earlier) have prevented the economy from exploding.

Not surprisingly, the International Monetary Fund has warned Japan of its rising fiscal problems, saying the country needs to set up a credible plan to cut its public debt. They feel that Japan must implement consolidation plans as the pace of deterioration of its fiscal problems is high.

Japan is not in immediate danger, unlike the PIIGS economies (Portugal, Italy, Ireland, Greece and Spain), despite its high debt levels. Mainly, that is because it can print its own currency and is not dependent on external funding to manage its huge debt levels.
But the luxury of ample domestic funding will not be afforded to Japan for much longer, especially with its aging population and immigration-unfriendly policies. As the aging population starts drawing down savings to meet up with old-age needs, financing the debt through domestic means will not be an option a few years down the line.

It is, therefore, high time that the Japanese government start taking concrete steps to increase revenue, reduce expenditure and address problems of the rapidly graying society.

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His other articles are available at http://kunalsthoughts.weebly.com