Why Did Japan Stop Growing?

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January 21, 2011

* This report is prepared for the National Institute for Research Advancement (NIRA). We thank NIRA for financial support as well as the comments on an earlier draft by Jiro Ushio, Reiko Kanda, and Tetsuo Ota. Research assistance was provided by Jess Diamond, Daisuke Fujii, Eigo Kato, Satoshi Kimura, Norimasa Kudo, Kyohhei Matsuyama, Kazunari Nakajima, Yuki Nonomura, and Kunitaka Ueno. We benefited from conversations with Takero Doi, Robert Feldman, Kyoji Fukao, Yuji Genda, Yoshihisa Godo, Masako Ii, Takatoshi Ito, Kazumasa Iwata, Richard Jerram and Ulrike Schaede.

Executive Summary

The Japanese economy has been stagnating for almost two decades. The purpose of this report is to explain the causes of this stagnation and identify policy choices that might help restore growth. Our focus is intentionally on longer term issues, rather than the immediate challenges that are associated with the fallout from the global recession.

We start our analysis using the neoclassical growth model to describe the post war Japanese economy. The model conveniently describes the growth experience and shows how growth changed over time. Prior to the 1970s, the Japanese economy enjoyed a very rapid pace of economic growth. But, during the 1970s important factors that supported this rapid growth started to disappear. First, Japan was catching up with more advanced economies such as the U.S. Thus, Japan could no longer grow just by imitating or importing new technologies from the advanced economies. The practices and economic institutions that worked well during the catch-up phase were not so well-suited for a more mature economy.

Second, financial globalization and the collapse of the fixed exchange rate regime meant that by the end of the 1970s that Japan could not rely on an undervalued currency to boost its exports. Japan had to rearrange its production system and other economic institutions to cope with globalization to reduce its reliance on external demand.

Third, Japan's population structure was shifting and becoming increasingly elderly. The aging meant slower growth of the labor force. The aging and the declining fertility also eventually reduced the domestic saving that supported economic expansion during the rapid economic growth period.

The end of catch-up phase, globalization, and the rapid aging together created a major challenge to the Japanese economy. Japan has yet to successfully meet these challenges. But during the 1990s, additional problems emerged. Private investment slowed and productivity growth also fell. Within a single decade, Japan shifted from a high growth economy to a stagnating one.

One important observation is that some advanced countries such as the U.S., Canada, and the U.K. continued to grow at the rate higher than Japan even after they reached a similarly high level of GDP per capita. Figure 4 in the report, replicated below, shows the growth rate of the trend GDP per capita (calculated using the Hodrick-Prescott filter) along with the level of the trend for G7 countries. As per-capita GDP went above roughly $25,000, the U.S., the U.K., and Canada seem to have begun converging to a steady state growth rate of around 1.7%, while Japan seems to be converging to the growth rate of about 1.0% at best. Hence, Japan should ask what it needs to do to grow like the U.S., Canada and the U.K.

The report reviews three sets of policy choices that Japan made after the growth slowdown that contributed to economic stagnation. The first were the policies that served to protect incumbent firms and their regular workers against macroeconomic shocks in the 1990s. The government delayed dealing with the losses in the banking system that accompanied the land and stock market collapses at the beginning of the 1990s. Weak banks operated for too long by misallocating credit to obscure their problems. By rolling over loans to zombie firms, the banks distorted competition, keeping the zombies in business and reducing the rewards to strong firms from expanding their presence. Over time this stifled the competitive process of creative destruction that is essential for innovation and productivity growth in a mature economy. These problems were most pronounced in the non-manufacturing sector where the trouble could be more easily disguised. For most of the 1990s far too little money was allocated to address the banking problems and only during the Koizumi administration was real progress made in confronting the banking problems.

Regulatory policies, more precisely, the failure to deregulate many industries exacerbated the zombie problems. In the non-manufacturing sector, the industries that had the most deregulation grew fastest. But the deregulation happened very slowly for the non-manufacturing sector. On average, regulatory barriers in the non-manufacturing sector actually started to increase from the late 1990s.

Finally, monetary and fiscal policy performed poorly. The Bank of Japan consistently undershot its inflation objective. The government pursued massive fiscal stimulus during the 1990s and 2000s, so much so that Japan went from having the best debt position amongst advanced economies to the worst. Japan's current mix of spending and taxing if sustained will force the country to either renege on the future promised transfers (through the national pension system or the national healthcare system), or pursue very high inflation (that would reduce the real value of debt), or to engage in an outright default on its debt.

Worse still, much of the spending that took place was misguided. We calculate that almost 90% of public spending that took place between 1993 and 2002 was on the types of projects which already been shown to have relatively unproductive by the start of the 1990s. Hence the payoff from the spending binge will not be high.

The last section of the report reviews several of the major reforms undertaken by the Koizumi administration. The purpose of these case studies is two-fold. First, this government stood out from the others during the last twenty years in terms of its willingness to try different reforms. It is important to know which ones succeeded and to understand why they worked. But it is also useful to understand why some reforms failed and did not improve growth. A detailed appendix gives more information on the six reforms that are analyzed.

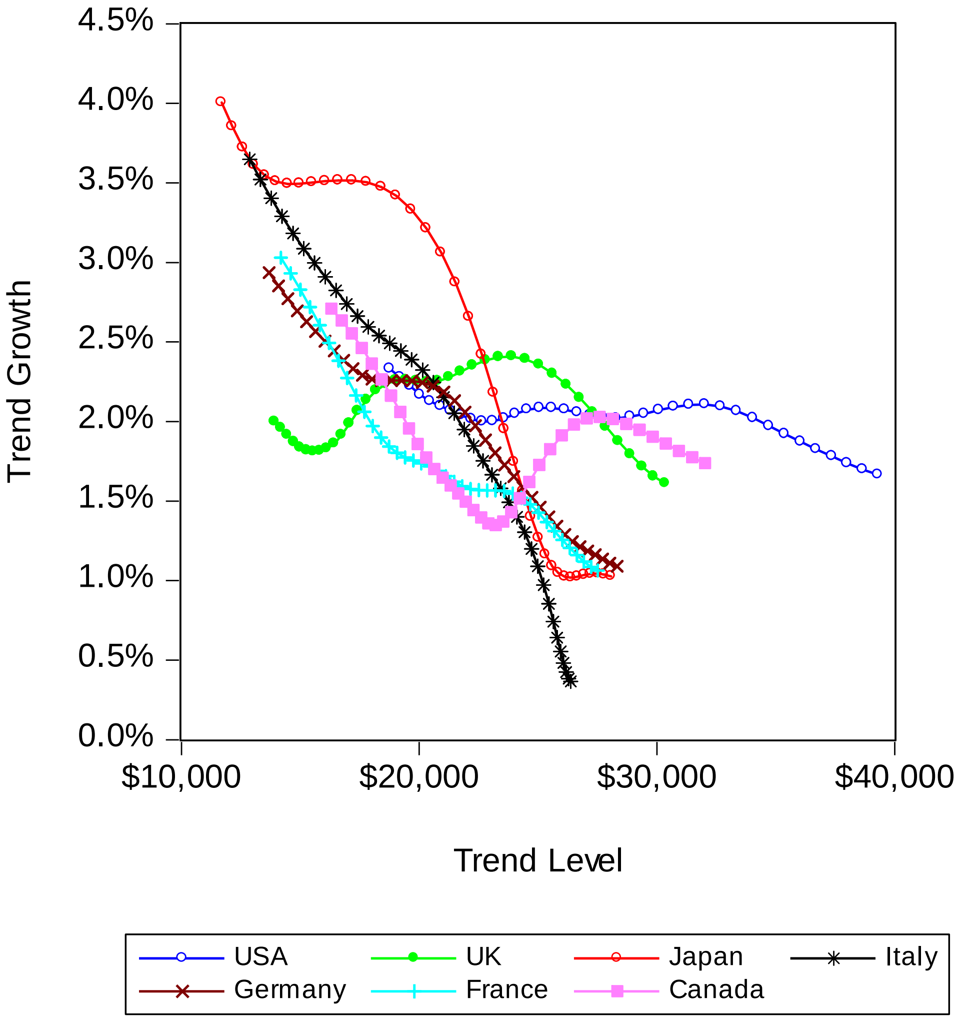
The analysis of the Koizumi reforms offers three clear lessons for what is needed for further deregulation to be successful. First, it is important to focus on sectors (or distortions) that are important for growth and target those. Second, this strategy improves the chances that the gains will be meaningful. It also makes it easier to explain the importance of the reform to the public and measure the progress towards the goal. Lastly it is also important to have clear targets (preferably numerical) that can be achieved in a few years, not in a few decades. Concretely this suggests that policies that remove regulation to protect inefficient incumbents in many areas of the economy are an appropriate place to start.

Our concluding section has a very brief comparison of our policy recommendations to the current government's "New Growth Strategy". Given the vast number of proposed projects, a full assessment is beyond the scope of this report. But, much of what is being proposed does not pass our proposed test for maximizing growth prospects. In particular, we argue against the use of old fashioned industrial policy, against strategies that rely primarily on external demand, and against special policies that aim to boost tourism in certain regions. We do identify and laud the specific proposals that aim to remove regulations that impede growth.

Japan needs to change direction if it wants to grow. The path that will work is well understood. The main question is whether the political courage to shift to the policies that could work exists and will be utilized.

Figure 4: Trend Growth In the G7 Countries: 1971-2009

(Measured for per capita PPP GDP expressed in year 2000 USD)



*NIRA Homepage:

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