

## Economy Watch

### Anorexia at 9% of GDP

Despite the economic recovery, Japan still suffers from its chronic problem of “economic anorexia,” i.e. a serious shortfall in domestic private demand. In 2005, the latest year available, this shortfall amounted to a hefty 9% of GDP. Until Japan conquers this syndrome, there will be constant pressure on the government to run deficits to make up for the demand shortfall.

The malady has plagued Japan ever since the high-growth era ended in the mid 1970s. What we call “economic anorexia”—the inability of the domestic private sector to consume as much as it produces—is what economists call “excess savings” or an “investment-savings gap.” To save is not to spend. If one sector of the economy is saving, say, \$100 billion, someone else has to borrow and spend the same \$100 billion to avoid recession.

Usually, the household sector is a net saver, and that “someone else” is companies, who borrow to build new factories, offices, stores and the like. But, in Japan, that system has broken down. So, for the past three decades, that “someone else” has predominantly been the government—by spending more than it takes in via taxes, i.e. running a deficit. The other “someone else” is foreigners who buy more from Japan than they sell, i.e. who enable Japan to run a trade surplus. During the 1980s “bubble,” monetary steroids fed enough private company investment to make it appear as if anorexia had been overcome. The popping of the bubble showed that this apparent solution was illusory.

The problem is not, as so many say, that anxious consumers are salting away too much money out of fear that the social security system will fail. On the contrary, consumer savings rates have plunged from 10% of household income in 1996 to 3% in 2005. As a portion of GDP, household savings dipped to a meager 1.7% in 2005.

The real problem is that corporations are saving too much, that the household share of national income is dropping, and, as a result, the personal consumption share of GDP is also dropping.

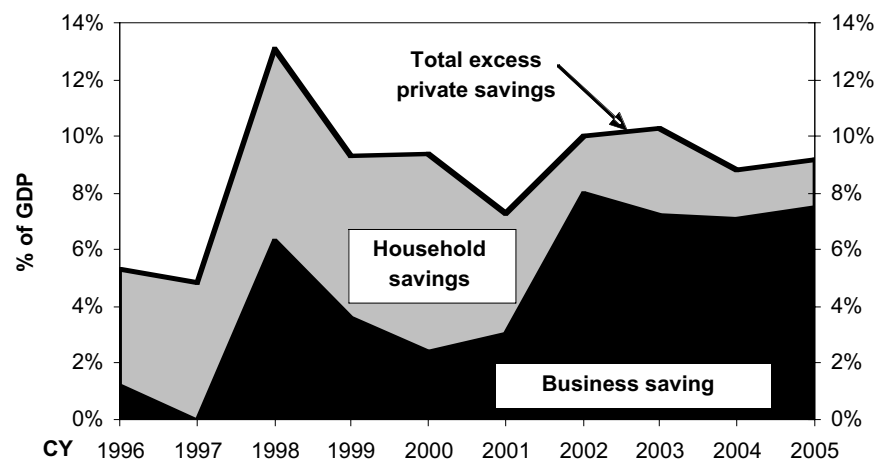
The problem has gotten worse in the past decade as corporations flush with profits became huge net savers. To avoid being

caught in another debt crisis, corporations have paid back loans, limited their investments to less than their cash flow, and hoarded the excess cash. Japanese firms have not been subject to strong labor and capital market pressures that would force them to return the cash to the household sector via higher wages, healthy interest rates and dividends. As a result, saving by financial and non-financial corporations has soared from 1.2% of GDP in 1996 to 7.5% in 2005.

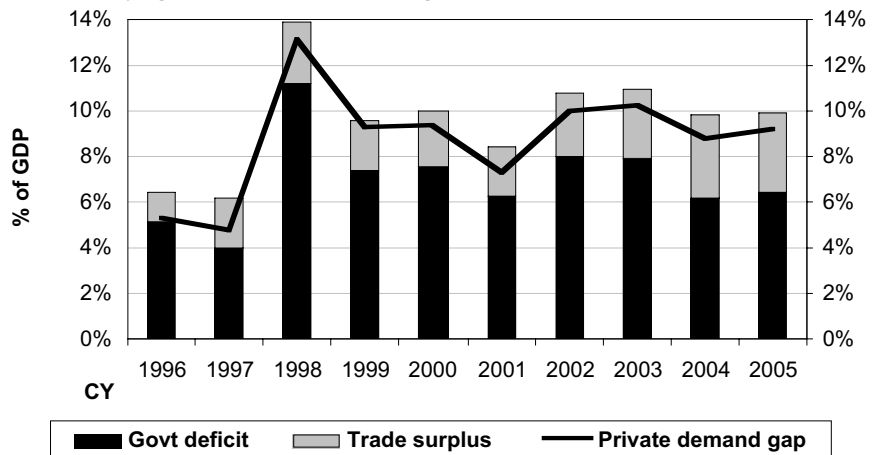
Put it all together and the excess savings in Japan’s private economy has risen from 5.3% of GDP in 1996 to 9.2% in 2005 (see top figure). This is substantially less than the 13% of the crisis year of 1998, but it’s still quite high. To put it another way, the demand shortfall in the private economy amounted to 9% of GDP in 2005.

If private sector is showing such a huge

### “Economic Anorexia” equals excess savings



### Offset by government budget deficit and trade surplus



Source: Cabinet Office

Note: The top chart shows net household and business savings (i.e. savings minus borrowings) as a % of GDP. The total, about 9% of GDP, represents “excess savings” or a deficiency of demand. In the bottom chart, where the black line equals the total from the top chart, the excess spending represented by the government budget deficit and the trade surplus offsets the deficiency of demand. The bar height doesn’t exactly meet the black line due to errors and omissions. See text for further explanation.

demand gap, how come the economy is not in deep recession? The answer is a chronically oversized government budget deficit and a rising trade surplus.

We can see this in the bottom chart on pg. 13, where the black line equals the total of business and household net savings in the top chart. The sum of the budget deficits and trade surpluses more or less equal that demand gap (they'd meet it exactly except for some errors and omissions).

In 1998, the combined deficit of national and local governments as well as state-owned entities soared to 11% of GDP. Since then, the deficit has come down, but in 2005, it was still a very substantial 6.4% of GDP. One reason the government has been able to lower the budget deficit despite ongoing anorexia is because the trade surplus has steadily risen, from 1.3% of GDP in 1996 to a record 3.6% of GDP in 2004 and 2005.

Raising household income is a macro-economic necessity, so that private consumption can replace budget deficits in spurring demand. Like most of its predecessors, the Abe administration shows little sign of understanding the problem.

## Amakudari alive and well

Despite all the efforts of the Koizumi administration to end the incestuous, and often corrupt, relationship between government bureaucrats and state enterprises, the ties remain quite active.

One key link is the system of amakudari (literally, descent from heaven), under which officials who retire from a ministry then take jobs at the very firms and state enterprises that they were supposed to supervise as bureaucrats. Those who coddle firms when they're in office can expect to be well taken care of by them in their post-retirement sinecures.

Amakudari continues to grow, according to a survey conducted by the Lower House at the insistence of the opposition Minshuto party. In 2006, the number of retired officials in amakudari positions at state and quasi-state enterprises increased by 5,789 to 27,882. The number of enterprises at which they worked increased by 589 to 4,576.

During April-September 2006, the government spent ¥1.83 trillion (\$15.6 billion) on state projects, of which ¥1.80 trillion (98%) was allocated to the amakudari enterprises. Often, there is no competitive bid-

ding. Bear in mind that this is only about 15% of the total public works spending during that period.

Prime Minister Shinzo Abe has pledged to reform the system by setting up a "human resources bank" to arrange jobs for retired bureaucrats. Officials there would be prohibited from arranging post-retirement jobs for others who had worked at the same ministries or agencies. However, under heavy pressure from members of the Liberal Democratic Party (LDP) and bureaucrats, the Abe administration has agreed to allow the human resources bank to cooperate with the personnel affairs department of each ministry or agency.

## Farm Ministry alarmism

There's nothing like a good scare story to help a lobbying effort. That appears to be the Agriculture Ministry's tactic as Japan enters more Free Trade Agreement (FTA) talks where liberalization of agriculture will be necessary to secure agreement.

At a February meeting of a government task force discussing ways to reform the inefficient farm sector, the ministry predicted that complete elimination of farm tariffs would reduce Japan's farm output by 42%. The reason is that production costs are so much higher in Japan. According to the ministry, the production cost of 60 kilograms of rice is slightly under ¥20,000 (\$170) in Japan, but only ¥2,200 (\$18) in the US. Japan applies a 780% tariff on all rice beyond "minimum access" quotas. Overall, according to the World Trade Organization (WTO), Japan's farm tariffs have actually risen a bit in recent years: from 17.7% in 2004 to 18.8% in 2006.

We have no idea whether the 42% drop estimated by the ministry is accurate or not, but we can say that the consequences that the ministry suggests for the economy as a whole make no sense. The ministry argued that, when ancillary industries to farming are also taken into account, liberalizing agriculture would lower Japanese GDP by almost 2%, while reducing jobs by 5%. In fact, the opposite would be the case. A big drop in food prices would liberate consumers to spend their money on other items, propelling a new spurt of growth.

What is required is transitional aid for the affected farmers, whose age now averages about 60. They are not about to move to the cities and get new jobs, although their children do. Consequently, some reformers

have suggested that Japan substitute direct income support for import protection and production subsidies.

Japan already subsidizes farmers to the tune of 1.3% of GDP, according to the WTO. The ministry says complete removal of tariffs would require another ¥2.5 trillion (\$21 billion) per year—or 0.5% of GDP—in income support. However, that figure is dwarfed by the ¥40 trillion that households spend on food, an amount equal 14% of their entire household budget. Replacing the huge covert subsidy from consumers via high prices with a smaller overt government income support program might make sense. If freeing up imports lowered food prices by more than 6%, consumers would gain more than the government needed to spend. Nonetheless, in an era when the government is desperate to cut spending, the farm ministry's warning may give some policymakers pause.

In any case, given the rapid aging of Japan's farm community, the amount of income support would gradually drop. Moreover, changing the law so that farmers could more easily sell their land for non farming purposes would give farmers a capital gains windfall.

## Happy days for landlords

A scarcity of up-to-date office space in large buildings in central Tokyo is sending rental prices there to the highest levels since the 1980s bubble. At the Shin-Marunouchi Building, scheduled to open this April, rents average ¥50,000 for every 3.3 square meters, a rate last seen during the bubble. That's about \$40 per square foot—a rental price comparable to office space in mid-Manhattan.

According to a survey by Mori Building, one of Japan's leading real estate developers, the trend is being driven by a dearth of available space to build large office buildings. The vacancy rate in central Tokyo was only 2.3% by the end of the year, a level that makes it a sellers' market. Yet, construction of new space is projected to fall 23% in 2007 to 1.19 million square meters, and then another 46% to 640,000 square meters in 2008 before rebounding a bit in 2009.

It's not just companies that are expanding in Tokyo. In 2006, the net migration of people into Tokyo from the rest of the country exceeded 90,000 for the first time since 1963. The three prefectures surrounding Tokyo also saw net inflows. This, too, feeds demand for residential and commercial property.