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Japan's Economic Disaster: Addressing Some Misperceptions

Japan is currently facing the worst economic downturn since 1945. This statement is factually correct, but somewhat misleading. In the fourth quarter of 2008, the economy shrank at a stunning 12.1 percent quarter-on-quarter annualized rate (i.e. the amount by which the economy would shrink if the drop in GDP from the third quarter to the fourth quarter were to continue at the same pace for three more quarters). The economy will certainly not continue to shrink at that rate, but economic forecasts for calendar year 2009 are in the range of a decline in real GDP between 5 and 7 percent. In terms of economic growth, this would clearly be the worst performance since 1945, and is larger than the expected decline in the United States. Previous downturns in 1974, 1993, 1998, and 2001 involved a fall of real GDP for the calendar year of 2 percent or less (and some of these recessions actually involved no decline at all for the year as a whole). So this recession, like that in the United States, is outside the parameters of the experience of the past half-century, and appears rather serious. Nevertheless, there are several misleading aspects to the 'worst since 1945' designation. This 'Lincoln Log' explores these misleading aspects. I do not mean to downplay the seriousness of the current recession, but there is a danger of exaggerating the situation.

Misleading Point of Comparison

The Japanese economy was fortunate to have experienced over a half-century without any period in which economic output fell very much. But stating that it is necessary to go back to 1945 to find a time that was worse provides a false point of comparison.

The Japanese economy declined with the onset of the Pacific War in 1941, due to the difficulties of maintaining production given material supply restrictions and military production priorities, and then collapsed under a hail of bombs and shells in the closing months of the war in 1945. Economic statistics do not exist for 1945. However, one careful estimate of real GDP (the Hitotsubashi University's *Estimates of Long-Term Economic Statistics of Japan since 1868*) indicates that the economy shrank 48% from a peak in 1941 (when the Pacific War began) to 1946.¹ The situation was so dire that in the winter of 1945-46, the United States initiated food aid to stave off the potential for widespread starvation and malnutrition. On the eve of the war, Japan had been a moderately successful developing country, with a level of GDP per capita that was about 40 percent the level of that of the United States (somewhat similar to Hungary today). By 1946, that ratio was down to 12 percent. So, statements about 'worst since 1945' are misleading in the same way that 'worst since the Great Depression' conjures up an inaccurate comparison for the United States. Even though the current economic downturn is serious, it is not even close to what happened in the past.

¹ Ohkawa, Takamatsu, and Yamamoto, *Estimates of Long-Term Economic Statistics of Japan Since 1868, Volume 1: National Income* (Tokyo: Toyo Keizai Shinposha, 1974), p. 214.

The only reason the current recession appears bad is that periods of actual economic contraction from 1945 to 2008 were remarkably minor. From 1945 to the 1970s, the record of growth was enhanced by Japan's success at 'catching up' with the developed economies. Since that time, Japan has been evolving toward being a more 'normal' slow-growing advanced industrial nation. Such economies experience a normal business cycle that periodically involves a decline in GDP. Japan now appears to have achieved that normality.

The Decline Viewed in Contemporary Perspective: Not a Disaster

Today, Japan is one of the leading industrial economies of the world. Even when adjusted for differences in price levels, Japan has a level of GDP per capita that is about 74 percent the level of that in the United States, and similar to that of Germany, France, and the United Kingdom. In fact, one could argue that these kinds of cross-country comparisons are inherently imprecise, so that the Japanese population could be considered to be at roughly the same level of affluence as the United States.

What would a 7 percent decline in GDP imply for such an affluent society? As large as this drop appears to be, the answer is 'not much.' On average, the Japanese will have 93 percent the level of output and consumption as in 2008. If one thinks '93 percent' instead of 'down by a record 7 percent' the outcome does not seem so dire. This mild reality is the reason why all through the 'lost decade' of the 1990s foreigners visiting Japan were usually struck by the absence of many signs of economic distress. Only those familiar with Tokyo's past noticed that restaurants were less full, more empty taxis cruised the streets as corporations cut back on expense accounts, and household real income stagnated. Big deal.

To be sure, in the 1990s households experienced a catastrophic decline in real estate prices (with real estate prices in the six largest urban areas of Japan falling 70 percent from the peak in 1991, and remaining at that depressed level even today). However, turnover in real estate is sufficiently low that relatively few households actually suffered from trying to sell a house that had a mortgage much larger than the market value of the property. Many real estate developers went bankrupt in the crash, but not many households. Consider, for example data on home ownership (table 1). A survey conducted once every five years, shows that the percentage of households owning their own dwelling fell slightly (1.5 percentage points) from 1988 to 1993, due to the impact of rising real estate prices making home ownership less affordable.² From 1993 to 2003, a period of sustained, large real estate price declines, home ownership actually rose back to 61.2 percent, the same level as 1988. Lower real estate prices enabled other real estate firms to finally amass large (and lower priced) plots of land in Tokyo on which they constructed many economically viable new luxury apartment complexes. Visitors from abroad often noticed the high density of construction cranes, a puzzle in an economy experiencing an extended period of stagnation and periodic recession. The lost decade

² Real estate prices peaked in 1991, so by 1993 they were in sharp decline. However, the level was still higher in 1993 than it had been in 1988. Thus, the decline in ownership appears to be more likely due to higher prices than defaults resulting from falling prices.

left at least parts of the Japanese population much better housed at a more reasonable price than in the 1980s.

	Total	Owned	Share
	(million)	(million)	(percent)
1983	34,705	21,650	62.4
1988	37,413	22,948	61.3
1993	40,773	24,376	59.8
1998	43,922	26,468	60.3
2003	46,863	28,666	61.2

The downturn in 2009 will be worse than the long stagnation of the 1990s in terms of the extent of the drop in GDP. Household income will be unambiguously lower. But in a society as affluent as Japan is today, the impact involves—on average—a relatively minor amount of ‘belt tightening’ that will be hardly visible.

Unemployment and Employment: Unexpectedly Mild Shock

Of course, in any economy, the term ‘on average’ does not fully capture the impact of recession on the society. Some households will be entirely unaffected (if their jobs remain intact and pay levels are not reduced). Others will experience major losses through unemployment. This unevenness can be especially noticeable in Japan. In an economy where ‘lifetime employment’ remains for a core of employees, there is no market for mid-career job changing for those in this category. Therefore, workers who had secure lifetime employment jobs, and who actually lost their jobs in the 1990s (when their firms went bankrupt) faced a very difficult job market, in which they were highly likely to end up with a new job that paid far less. Anecdotes of bank managers who ended up as taxi drivers abounded. This problem will certainly emerge once again – lifetime employment may cover a smaller share of the labor force than it did a decade ago, but it is far from gone. This same problem affects those graduating from school and entering the labor market. Firms cut back on lifetime employment hires in a recession, and when they eventually hire more people, they will turn to the current crop of new school graduates. Young people graduating in a bad year, therefore, find themselves permanently excluded from the possibility of a job with that great company they had hoped to work for. As in the 1990s, however, these people will suffer in silence.

Equally important, Japan has been evolving a more highly bifurcated labor market in the past decade. Whether a firm is committed to lifetime employment or not, labor laws and the court interpretation of these laws has meant that workers with the designation full-time ‘regular employee’ are very difficult to lay off. Recognizing this difficulty, firms expanded their use of part-time and temporary workers. Workers without the ‘regular full-time’ designation are not protected from layoffs, so expanded use of such workers

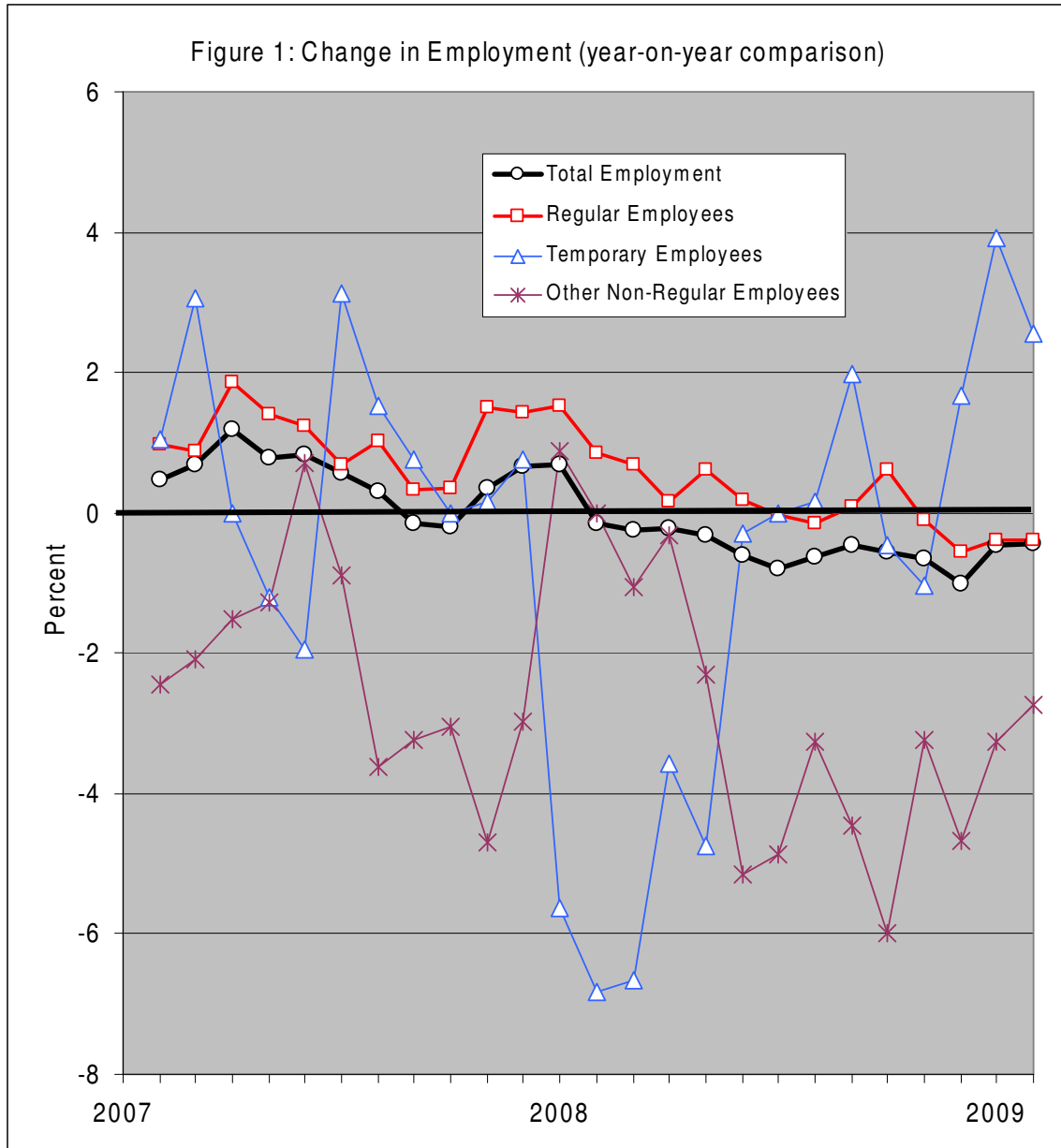
provided firms with the potential for greater flexibility in responding to labor costs over the course of the business cycle. This structural shift was accelerated by a change in labor law in the late 1990s that made it much easier for firms to hire temporary workers. Part-time and non-regular employees now account for one-third of all employment in Japan. In addition to having no employment guarantee, these workers typically are paid considerably less for the same work, and are often not covered by unemployment benefits. Therefore, Japan now has a labor market with a sharp contrast between some workers who are well paid and relatively secure in their jobs (unless the firm goes bankrupt), and those who are less well paid and insecure in their jobs.

Having undergone this structural change in the past decade, the expectation is that unemployment will rise faster and farther than it did in the 1990s making this recession more painful for workers. Not only is the downturn worse than the three recessions during the 'lost decade,' but firms should have more flexibility in shedding workers by firing their temporary and part-time workers.

As is often the case with simple concepts, the reality in the Japanese labor market is much more complicated. First, an extensive discouraged worker effect (in which laid-off workers despair of finding a new job and stop looking for one) implies that official unemployment data are not an accurate measure of what is happening to workers. However, getting at the impact of structural change in the labor market using employment data has problems as well. Employment data categories in Japan include regular employees, temporary employees, day laborers, self employed, and family employees. Of these, only full-time regular employees are the ones who are difficult to lay off. However, calculating how many regular employees are full-time and how many are part-time is very difficult. Corporations have designations of full-time and part-time regular employees, but these are not reported in monthly labor data (and show up only in a once-in-five-years survey). On a monthly basis, data are available on employees by hours worked per week, with part-time workers usually defined as those working less than 35 hours per week. However, employees with a part-time designation in their corporations may work more than 35 hours (and may even work as long a week as full-time employees), and full-time employees may be reduced to less than 35 hours a week in slack times.³ Therefore, the data on part-time workers defined by hours worked per week fluctuate a great deal from month to month. Finally, Japanese employment data are highly cyclical over the course of the year, so it makes more sense to look at year-on-year change rather than from one month to the next.

With these data problems in mind, what has been happening to Japanese employment in the current economic downturn? Figure 1 shows year-on-year changes in employment. Total employment has been falling since early 2008, at about one half a percent (varying from 0.2 percent to 1.0 percent). As might be expected, regular employees have fared

³ For further detail on the part-time and temporary worker data and conditions of employment, see Susan Helpman and Machiko Osawa, 'Part-Time and Temporary Employment in Japan,' *Monthly Labor Review*, October 1995, pp. 10-18.



somewhat better, with the employment trend remaining positive until November, when it, too, turned slightly negative at about 0.4 percent. Due to the volatility in the data for regular workers by hours worked, I have not attempted to separate the trend for regular employees into full time and part time. Temporary employees, however, follow a very strange pattern. Early in 2008, temporary employment was shrinking at a rapid rate (almost a 7 percent year-on-year drop in each of the first three months of the year), but later in the year and into 2009, temporary employment was actually rising! Meanwhile, the major decline in employment occurred among those workers in other forms of non-regular employment (day laborers, self employed, and family workers), with employment in those categories shrinking since mid-2007, and falling at a 2-to-6 percent rate by late 2008.

What do these trends mean? There are two important conclusions from these confusing data. First, overall employment is shrinking, but very slowly. This is consistent with past economic downturns. There is little evidence yet that this recession is going to have a substantially different impact on employment than previous ones, despite the structural change in labor markets. For the 12 months from February 2008 to February 2009, total employment was down only 0.43 percent, or a decline of 270,000 workers. This mild decline has occurred despite three consecutive quarters of negative GDP performance, including the very large 12 percent annualized contraction in the fourth quarter. By way of comparison, employment in the United States (where the contraction in GDP over the past year has been milder) declined 3 percent, or by 4.2 million in the 12 months from March 2008 to March 2009.⁴ The year 2009 will certainly bring further job losses in Japan, but the evidence so far strongly suggests that the job impact of the recession will continue to be far milder in Japan than the United States.

Second, temporary workers do not appear to be bearing the bulk of the downward adjustment in the economy, given the very erratic employment pattern for these workers. Rather, the adjustment has fallen on the even more vulnerable categories in society (day laborers, the self-employed, and family workers). These other groups are relatively small, with all three categories accounting for only 14 percent of total employment, but they account for the majority of the loss in jobs.

I fully expected to see that the employment impact of the current recession is worse than in previous ones, and somewhat closer to the patterns of the United States. The media attention in Japan on the layoffs of temporary workers, the sprouting of camps of homeless people in Tokyo and other major cities, and the effort of the Diet to help temporary and part-time workers, certainly leads to the conclusion that job losses must be large. The data simply do not bear this out.

Political Exaggeration

I believe that, as is the case in the United States, fiscal stimulus is an appropriate government response to the current downturn in Japan. Having lessened the government deficit over the past seven years, the government can afford to have the deficit widen once again on a temporary basis. Low interest rates indicate that the government should have no problem floating extra government bonds (and the Bank of Japan appears to stand ready to buy those bonds if necessary to keep interest rates low and money supply expanding). However, the approach of the government to this policy has been heavily affected by the messy state of politics, the result of which may well be an exaggeration of both the problems facing Japan and the advertised policy responses.

The ruling party in Japan, the Liberal Democratic Party (LDP), is in trouble. After the very popular Prime Minister Junichiro Koizumi (in office 2001-2006), the party has had three successive weak and unpopular leaders (Shinzo Abe, Yasuo Fukuda, and now Taro Aso). Under Japan's constitution (a parliamentary system), there must be an election for

⁴ Bureau of Labor Statistics, U.S. Department of Labor, <http://www.bls.gov/news.release/empsit.t01.htm> (April 9, 2009)

the lower house of the Diet by the end of September 2009, though the Prime Minister could call the election earlier. When Mr. Aso assumed office in September 2008, it was anticipated that he might call the election quickly (to take advantage of a bounce in popularity). But his popularity sank very quickly, to abysmal lows. Unlike his two immediate predecessors, however, he did not succumb to pressure to resign. Instead he seized the opportunity of economic recession to make himself appear to be a leader. He proposed and pushed through the Diet two supplemental budgets, one late in 2008 and one in early 2009 to provide stimulus to the economy. Then the Diet focused on passage of the regular budget (which went into effect at the beginning of the fiscal year in April). Now he is proposing a new supplemental budget to add as much as \$150 billion (or 3 percent of GDP) in stimulus to the economy, citing the dire state of the recession.

What Prime Minister Aso has been doing is twofold. First, he has created a series of successive policy initiatives, with each of them acting as an excuse to postpone the election. Of course, the election must occur by the end of September, but many things could happen prior to that time that might push the outcome in the favor of the LDP. For example, the suspiciously timed exposure of a bribery scandal involving the leader of the main opposition party (Ichiro Ozawa) in March has already caused a shift in opinion polls. Therefore, stringing out a series of fiscal stimulus packages works to the potential benefit of Prime Minister Aso and the LDP by giving them more time before facing the reality of the election.

Second, he has created the image of an activist prime minister responding to the needs of the public. The media in Japan did not like him, and he had all the potential of being an abject failure like his two predecessors. All three men are the children or grandchildren of prime ministers and senior politicians. They literally inherited their Diet seats (by inheriting the district political machines that elected their relatives in an earlier time). And Aso certainly has a penchant for appearing foolish and ignorant. He reads comic books (and boasts about it) and has trouble pronouncing printed Japanese correctly. For a Prime Minister with such personal liabilities with the media and the public, the recession has been a godsend. He has used this opportunity to do several important things:

- a) He attended the G-20 meeting, at which he sided with the United States and its dynamic new president (rather than with the cautious Europeans) on the subject of fiscal stimulus. Although his former Finance Minister appeared foolish at an earlier G-7 meeting in January (and was immediately fired), the Prime Minister can at least attempt to portray himself as a responsible international leader trying to combat the global recession. If the United States government appreciates his gesture and manages to say favorable things about his policy stance, so much the better for him.
- b) He has kept the recession and the need for stimulus firmly in front of the public, especially by proposing the unexpectedly large stimulus package in April. Since supplemental budgets are usually not introduced until the fall, proposing one within a few days of enacting the regular budget carried a clear message of urgency and activism on the part of the Prime Minister. The effect was enhanced

- by calling for a stimulus package that was one-third larger than what was rumored in the press only a few days earlier than the announcement (a disparity that had to be planned).
- c) He has used his policy activism to battle the opposition, daring them to oppose his package. The opposition cannot prevent the current package from being passed (even though they control the upper house of the Diet), but it can delay the legislative process (a common opposition tactic in Japan). Delay would enable Prime Minister Aso to portray the opposition as hurting the economic interests of the public by postponing needed stimulus.

If Prime Minister Aso is actually successful in using the recession to keep his party in power in the upcoming elections, it would be very interesting. For many years, observers of Japanese politics have been expecting an eventual loss by the LDP, followed by a possible splintering of both the LDP and the main opposition party (the Democratic Party of Japan), with a grand reconfiguration of new parties into a center-left party and a center-right party that would then provide real policy choices for the voters. Prime Minister Aso might be able to postpone that day of reckoning once again.

These political machinations do not imply that the current recession is not serious or that the government should not respond with fiscal stimulus. If the Japanese public is lucky, Prime Minister Aso will end up doing the right thing even if for the wrong reason. Nevertheless, any observer of Japan needs to be aware that the political maneuvering implies a strong incentive to exaggerate both the nature of the problem facing Japan and the scope of the proposed remedies. In reality, Japan probably could use a fiscal stimulus package larger than the current proposal (especially since true fiscal stimulus will be smaller than advertised), but Prime Minister Aso will do only what is necessary for his political purposes. Furthermore, a prime minister who was truly serious about addressing the economic problem should have moved much more aggressively with a single large stimulus package in late 2008 rather than stringing the process out with multiple packages.

Conclusion

As recessions go, Japan is experiencing a serious downturn. Some workers are losing jobs, and total household income and consumption will fall. Since in all successful economies, people expect each year to be better than one before, an actual drop in income comes as a rude and unpleasant shock. In addition, a possible drop in real GDP of 5-to-7 percent looks large relative to what Japan and other advanced industrial economies have experienced over the past half century. And Japan's performance will be worse than that of the United States in 2009. But the point of this paper has been to suggest that we should not exaggerate, for several reasons:

1. As bad as this situation is, it bears absolutely no comparison to what happened back in 1945.

2. Even a 7-percent decline implies that output per person in Japan this year would be 93 percent the level of the year before—hardly a disastrous drop in an affluent society.
3. The expected flexible labor response, with a larger and more rapid drop in employment than in the past, is not happening. Workers in this recession in Japan are still better protected from the downturn than is the case in the United States. Jobs will be lost, but not all that many.
4. We should not be sucked in by the political rhetoric. That has been driven by Prime Minister Aso's desire to keep himself and his party in power, which leads to a tendency to exaggerate the urgency of the situation.

Those who lose jobs (or fail to obtain good jobs when graduating from school) will bear much of the economic pain this year. Nonetheless, they are not out marching in the streets (unlike some Europeans who are angry about their economic downturn). The government should care about their plight, and adopt policies to moderate the economic downturn and bring the timing of the eventual recovery closer to the present. But we should not hyperventilate.