Japan's Economic Recovery: Policy Implications for Korea*

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Today's topic is Japan's economic recovery and some policy implications for Korea. I'm not a Japanese economy expert, but what I will be able to contribute is a comparison between Japanese and Korean economies to withdraw some implications from the Japanese recovery in the recent years. But of course we Japanese all know that there are many tasks still remaining on our side. However, you don't have to learn from the failure of Japan, you can learn more from some of the success in the Japanese economic recovery.

As Dr. SaKong mentioned, if you are interested in the Japan-Korean FTA, I will try to answer any questions with utmost efforts. Also, my colleague who is of course a specialist on Japan-Korean FTA here from the Japanese embassy will collaborate with me to answer any questions you may have.

So the Japanese economy has gotten back on the right track. In the process, what is most significant is that the core structure has totally changed. In the past decade, it has been mostly the public sector that has been contributing positively towards the business cycles, but in recent years, the private sector has been totally leading the economy.

Secondly, when the domestic demand used to be shrinking Japan, in contrast it was the external sector that has contributed something positive, although the trade dependant ratios is quite lower, it's almost the same as the United States, and quite smaller than Korea's.

Third, most of the public demand came from the construction services because the government was spending a huge amount of their budget to support all of the construction projects. But in the private sector, it is the investment by leading firms that has come back to meet with the growing consumption in domestic demand.

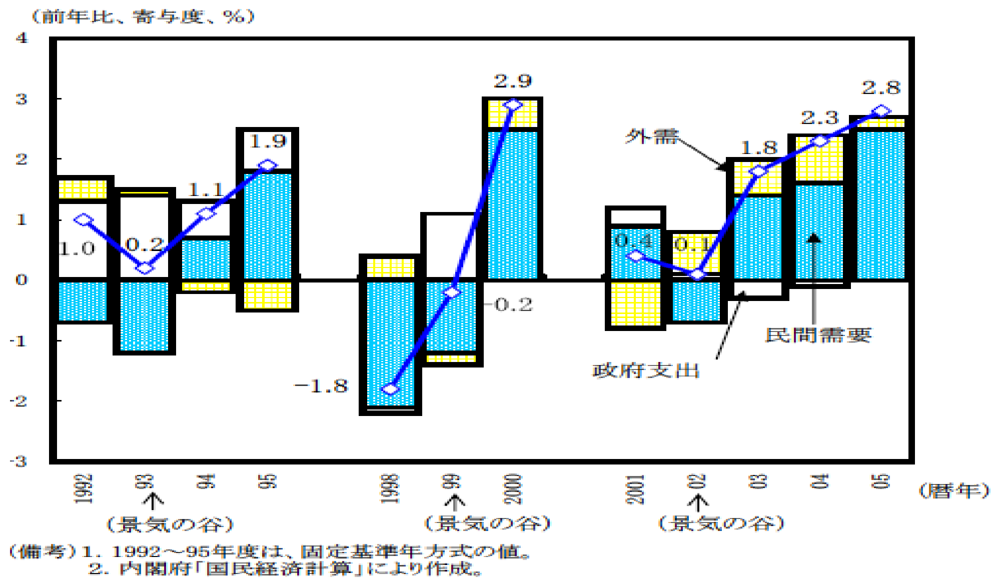
In terms of macro environment, more big news about the Japanese economy is that we are almost finally out of the long period of deflation, which we suffered for a decade. Indeed, Japan has been a very unique economy in which no textbook of economics can explain thus far to have such deflationary pressure consistently.

As I will explain later, the starting point was widening gap between demand and supply after the bubble economy crashed in 1992. The gap had widened in the shrinking cycle of the economy, but finally it has started to narrow, thanks to the picking up consumption and external demand. Structure adjustment in the financial sector has made drastic progress. Of course the adjustment was very much sustained by the upturn in property

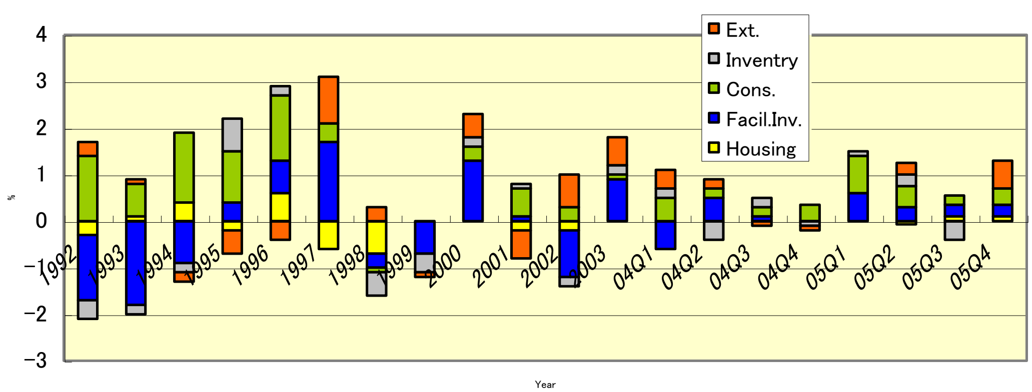
* Transcription of a speech given at the Distinguished Lecture Forum on Tuesday, March 28, 2006.

and stock market, because Japan's main bank system used to have a huge financial asset in stocks of business firms.

<Figure 1>
Contribution by public/private sector



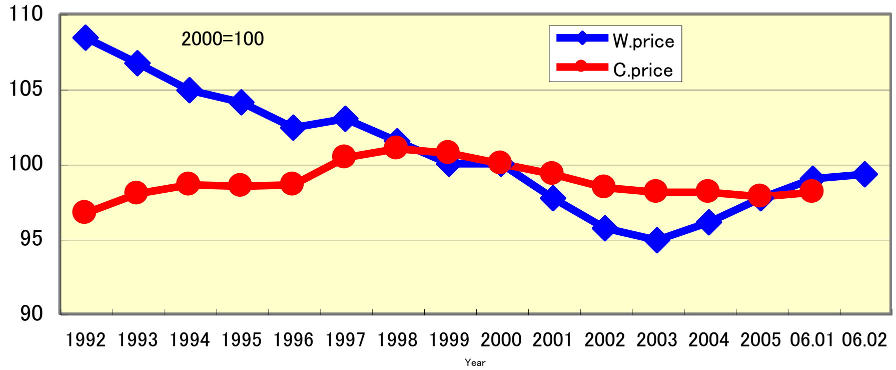
<Figure 2>
Contribution by demands



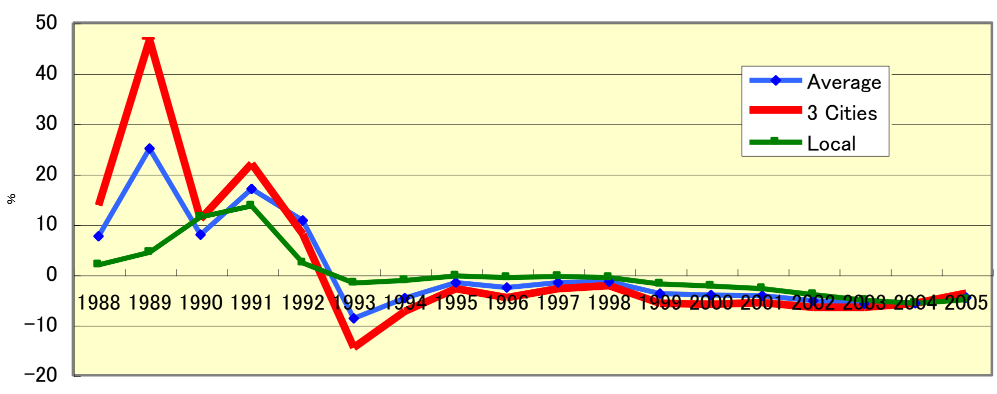
So the growth rate has picked up recently, but even in the last decade we did experience several positive signs, like in 1995 and 2000 (<Figure 1>). 2000 differed from 1995 in that, like in Korea, we saw the peak of the IT bubble in the U.S. so the private sector or IT-related investment in gray color in the <Figure 1> picked up. But for the rest of the decades, actually, the government made almost all contribution, which had not been sustainable. Then after 2001, the gray has consistently contributed to change the structure.

At the beginning of the 1990s, construction was the main reason for the close (<Figure 2>). But after 2001, facility investment started to contribute positively. Around 2001, the exports to both U.S. and China started to grow very rapidly so the external sector has also been contributing, but its portion has not so much.

<Figure 3>
Getting out of deflation: Prices



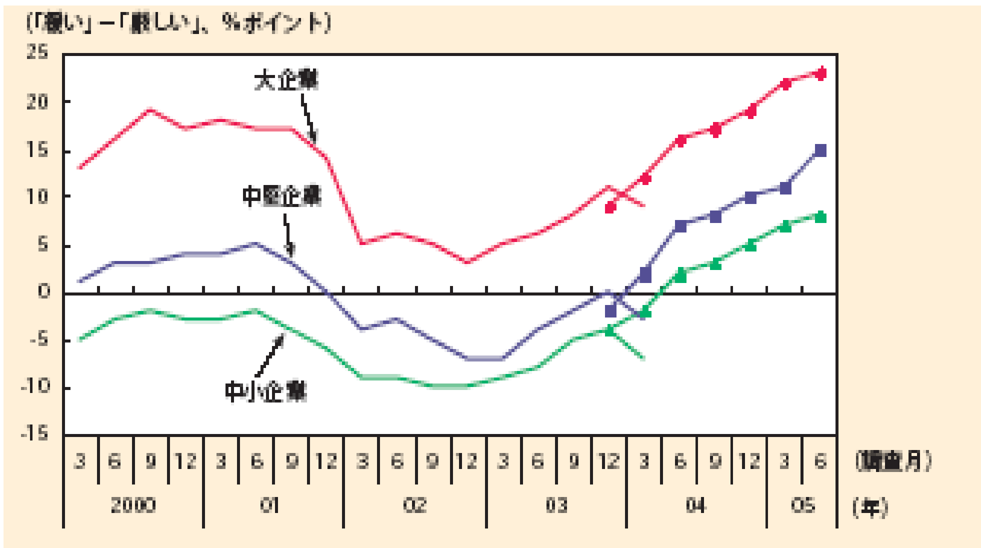
<그림 5>
Getting out of deflation: NPL



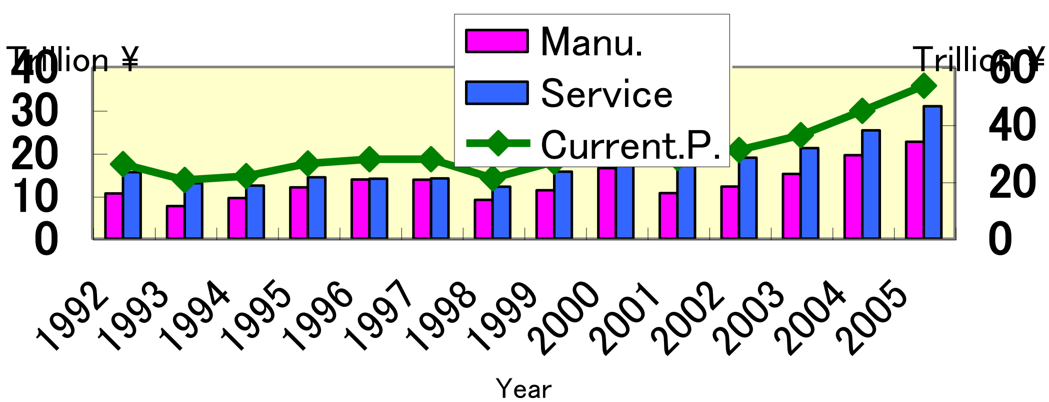
For another issue of deflation, the first indication appeared like in black line to show wholesale price, and Japan has been seeing consistent decline since 2000 (<Figure 3>). Then it started to pick up in 2003, and even the consumer price, though the fluctuation was smaller than the wholesale price, has started to pick up finally in 2006. This was why the Central Bank of Japan has decided to give up the quantitative easing policies recently.

Now turning to the property market, of course everybody knows that the crash of the Japanese economy was triggered by the collapse of the property market bubble. Finally again, the property price especially in Tokyo, Osaka, and Nagoya areas have started to pickup just a little bit in 2005, and we've recorded a plus close in 2006 and the deflationary pressures are getting very small now (Figure 4>). The <Figure 5> shows the ratios of non-performing loans in bank spending, and it is getting smaller and is now less than 3%, so it's not such a problem anymore.

<그림 6>
Getting out of deflation: Financial environment



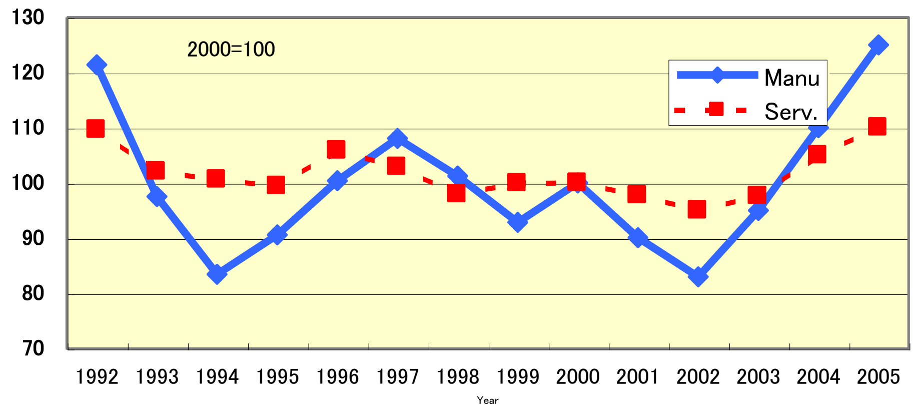
<그림 7>
Getting out of deflation: Company profit



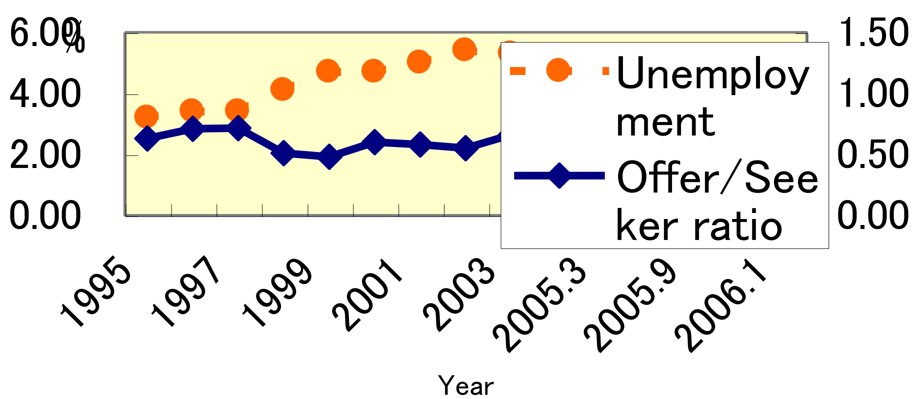
<Figure 6> says that thanks to the structural adjustment of the financial sector, the financial environment for business firms has been getting better than before. So after hitting the bottom in 2003, if you ask managers whether they feel that borrowing is difficult or easy to compile the index, the percentage that answered easy minus difficult

has turned to plus, first by big firms, but soon followed by small firms. Since 2001, company profit has been drastically recovered too. The line in the <Figure 7> shows the current profit of the private sector, which has got much better than before. It's not only being led by the manufacturing sectors, but also by the service sector, which is less productive in Japan, but has been picking up as well.

<그림 8>
Getting out of deflation: Investment



<그림 9>
Getting out of deflation: Employment



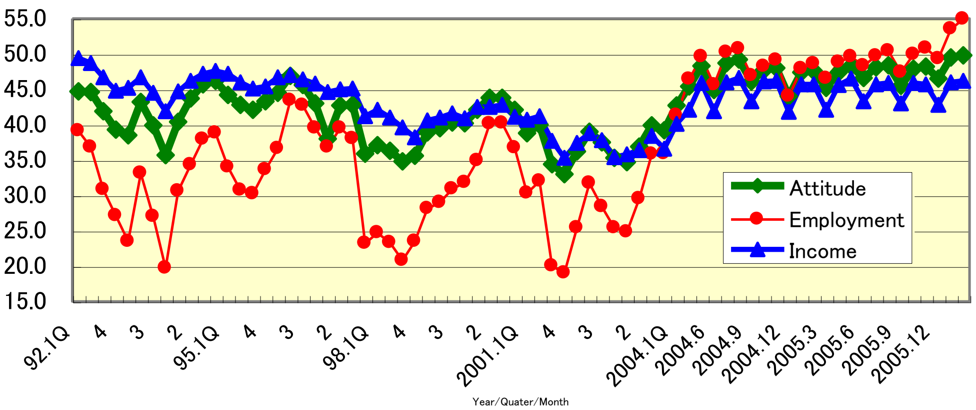
Another investment index, which shows 2000 as 100, shows that the manufacturing sectors, which recorded plus in 1997 has started to decline to hit the bottom in 2002 (<Figure 8>). However, it has bounced back very rapidly so that the level of investment has recovered the same level as the bubble times. The service sector has followed the manufacturing sector.

Thirdly, employment has always been a big issue in Japan. The <Figure 9> shows the unemployment rate and the offer/seeker ratio for jobs in Japan. Unemployment rate for total population reached its peak in 2002, at around 6% in historical record. However, the offer/seeker ratios have picked up to exceed 1 in 2006, indicating more jobs are offered for job seekers. This was also a big step, and this shows the real income for the laborers and has been steadily increasing since 2004.

So, income is increasing while unemployment rates are dropping. In response to better job security, consumption has also started to pickup gradually (<Figure 10>). The attitude of consumers usually tends to be influenced by the income prospect. But in Japan's case, employment itself is almost synchronized with the attitude of the consumers. Since Japan had been accustomed to a long-term or lifetime employment system, when the structure adjustment started, people were at a loss as to how to design their futures while they had huge mortgages or loans etc. So that has had a big negative impact on the consumer. But this can give way to the prospect of ending the employment adjustment. So the employment prospect and attitudes of consumers are each getting better.

<그림 10>

Getting out of deflation: Consumption



At present, our economy is in a comfortable situation where the deflationary pressures are almost gone, and the so-called triple pressures of over investment, over employment, and over borrowing has diminished somewhat, and there is an optimistic prospect of external demand from the U.S. and China. So if this situation continues, modest recovery, around 2%, is quite probable for several years from in the minds of major Japanese economists. The positive link between firm profits, investment, property, equity markets, employment income, and consumption sustains the optimism.

Even the OECD who used to project the Japanese potential growth rate very negatively like around 1.3% has already corrected their projections to 2% which is a comfortable range for Japan's economy as it tries to get out of the budgetary pressures. Huge public debts requires higher growth rate for its sustainability, as well as intensive government reform. Since public sector debts embrace the serious potential in inflation and interest rate hikes, privatization of many services is inevitable, which were dominated either by the government or quasi-government sector.

Typical sector is medicare and healthcare services. Japan is now a super-aging society, and one out of 5 is 0ver 60, so these services are big concern for them and thus a potentially huge market in Japan, once series of deregulations and rationalization programs work. Also, many Japanese are outspoken on the fact that Japan needs big reform of the education system, as education is now exposed to globalization's competitive pressures. So this sector needs some energy for reform.

In fact, there is much discussion on how to prospect the potential problem in Japan while the aging speed is being accelerated. Aging means less supply of young laborers, and this has potential to influence Japan's economy through declining saving rate. In response, Japan's balance of payment structure has already changed. Now many people, especially Koreans and Chinese still think Japan is making a huge surplus in trade, but more surplus has started to come from the capital balance rather than the trade balance since last year. This means Japan's economy is much like an old man relying on the pension fund or interest rate coming from abroad.

Not only is the number of younger generations getting smaller, but also many people are complaining that the quality of young labor is deteriorating because they are not trained or educated, and unemployed. Even if you work in a small firm or organization, you learn some skills to be trained socially, but those who are in a part-time job and trained in a manual way, their quality has started to be quite disappointing. So the human capital issues are there.

Energy and resource prospects are also constraints but are potential as well. Japan is a notoriously poorly endowed country for both energy and resources. So as the international price of energy and resources continues, the macro economy has to face with a downward pressure continuously. However, on the other hand, the constraints can be business opportunities for energy-saving technologies or alternative energy development. And the opportunities have made business environment better in Japan than some foreign countries, encouraging investment insides.

For some reason, Japan's attitude towards investment is very different from Korea now. Until around 2003, Japan was full of so-called "hollowing-out" arguments when many firms increased FDI into China intensively while being negative about Japan. However, since then, many companies that went through the structure adjustment tried to come back to the home market seeking country-specific advantages for their survival. The new demands in services as well as better environment as I mentioned before has been pushed by the private sector trying to find demand.

In addition, privatizations of government services may boost further investment in Japan. What is probably most important for the Japanese private sector is the inter-industrial, namely business-to-business network. If you see the Japanese IT market, it didn't come so drastically from the consumer side like it did in Korea, but it came more from the business sector. For example, Toyota is trying to have very good information sharing system with most of their business counterparts, and they try to sustain the small companies through this information network.

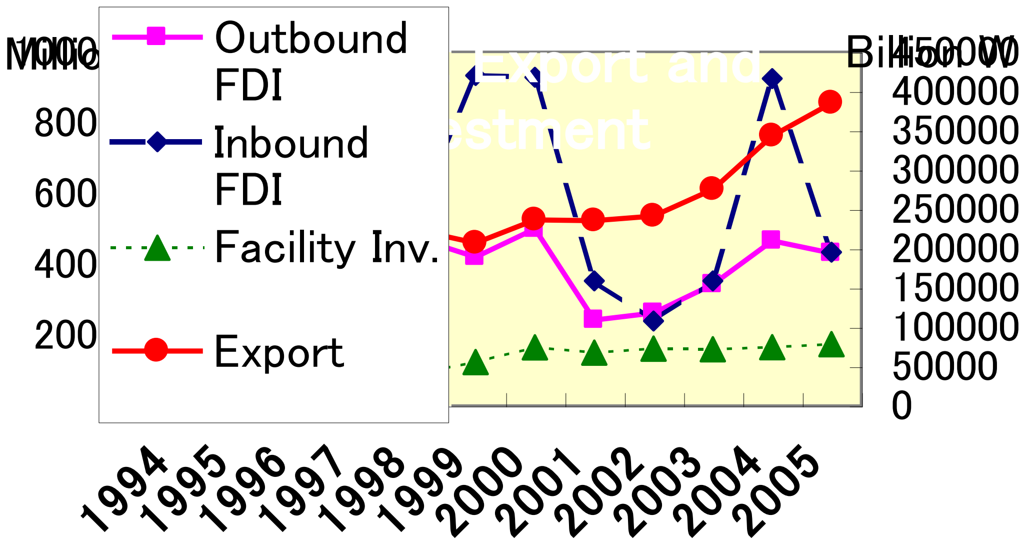
Toyota is also a good example in positive response in changing resource constraints into business opportunities. Oil-poor environment has constantly pressured Toyota for manufacturing super gasoline-conserving cars. The technology frontiers in Japanese firms may be going more for the sectors trying to overcome the constraints step by steps, rather than total innovation of new technology. This seems to be quite a stable direction because first, if your market is under such constraints like aging, oil-hikes, and public sector debts, that automatically means that the Japanese market is the most prominent market for you. So even though the technology risk is there, some may continuously to tackle the issues and that has formed the recent trend of investment coming back home.

In contrast, Korean firms have opted to go along with globalization intensively and to maintain the comparative advantage amidst the cutthroat competition. But this is partly because the IMF Crisis of 1997 has triggered Korean reform. So while Japanese companies could still rely on the home market even though the consumption is getting worse, Korean domestic demand was ignorable, and the most of the established companies like Samsung and LG have tried to depend more on international market. But, then a question may follow asking "how are you going to make your own country attractive for further investment and innovation?"

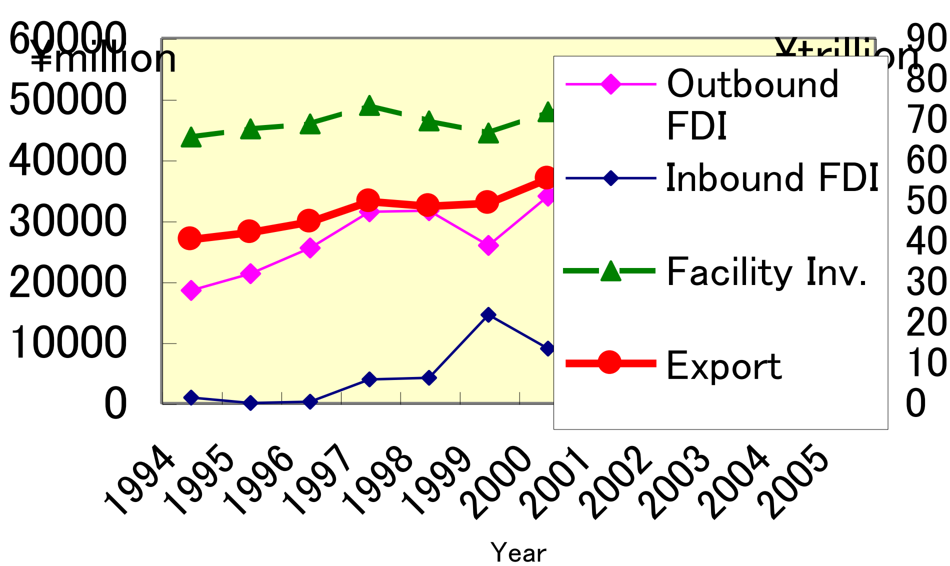
Korea does not seem to find this answer yet. For example, there is a missing link between international and domestic business. In the <Figure 11>, everyone knows, the export is the most robust sector for growth in the Korean economy and it has been growing very fast with much success. However, the line at the bottom is facility investment. In ancient times, if exports pickup, this usually stimulates the facility investment in Korea. But since the financial crisis, linkage has disappeared not really responding for the external demand. On the other hand, inbound FDI, which is stressed by the Korean government, reached the peak right after the financial crisis because of the structure adjustment. It reached another peak in 2004, but it has not been so robust at all since then. On the other hand, outbound FDI is following the export boom, which means Korean firms are much more interested in investing abroad than home. So Korean marketing policies are geared more towards globalization including export-substituting FDI, rather than further investment or innovation at home so that the linkage among investment, employment, income and consumption have been somewhat ignored.

Japan's case is very different. In Japan, the facility investment at home, especially after 2003, started to synchronize more with export (<Figure 12>). Outward FDI reached the peak in 2001 because many companies rushed into China and other East Asian countries after the financial crisis. But it has been stabilized after the peak, being taken over by more facility investment.

<그림 11>
Export and Investment (Korea)



<그림 12>
Export and Investment (Japan)



The motives for Japanese investment to come home may relate to the change in business strategies to make the best use of the market and technological resources for their challenges. However, there may be another reason of flexible labor market, which has made home attractive enough for firms.

At the time of restructuring, Japan introduced some sequence to mitigate unemployment. Many firms started adjustment with cutting wages. Thanks to the cooperating culture, major Japanese firms accepted wage cuts, sharing information with labor unions in turn for maintaining jobs. The following option is to transfer of the laborers into some more positive sectors, while hiring part-time jobs with less-paid and less protected status than full-time workers. These processes added almost unexpected flexibility in the labor market.

Now many economists say if you take out the flexibility in employment, wages for changing jobs, and the potential for new business, after all, the U.S. is the most flexible labor market, and Germany employment isn't that flexible enough. It is far less flexible regarding wages because their weak unions and institutional environment, but since they're based on industrial based unions, changing jobs is relatively easier than in Japan. But both Japan and Germany have struggled in creating new business during the structural adjustment period. On the other hand, Japan contrasts from Germany and the U.S. by the wages so far has been far more flexible.

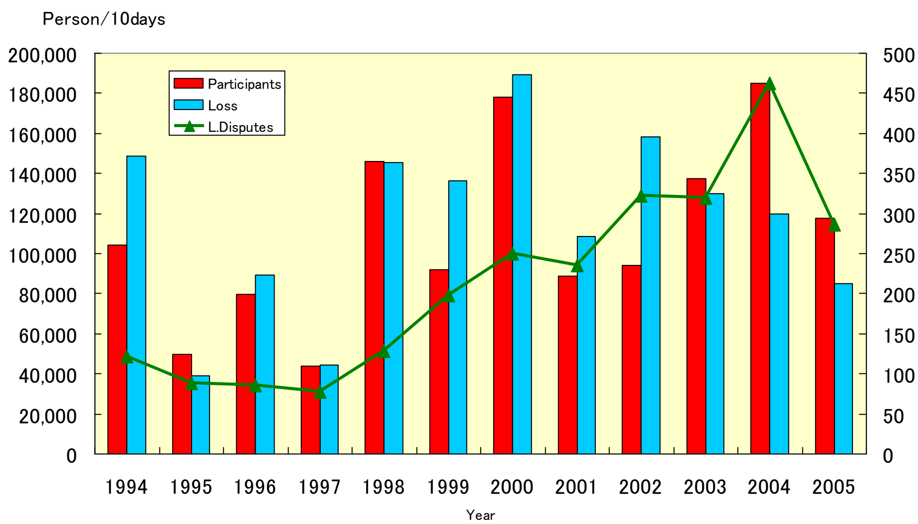
Comparing these three, from our observations, Korea seems to be the least flexible in employment and wages because you have such super-aggressive labor unions. In addition, changing jobs, unless you create a new business, may not be easy too in suffering low level of investment. So discussion is probably centered on how to approach the U.S. levels of flexibility. Th3 <Figure 13> shows the labor disputes in Korea, and after the financial crisis, the cases of labor disputes has picked up and continues to increase. But in Japan, even though the peak of the structure adjustment was 2001-2003, the cases of labor disputes have been declining consistently (<Figure 14>).

Regarding labor mobility, the recent trend is that the chances of getting a job are smaller than the chances of leaving a job. Japan used to experience the same thing, though I haven't had the chance to study Korea's labor mobility rate, but unlike the expectations in Korea, Japanese labor mobility is high enough, with something like 30% of people trying to get a new job. The recent good news is that the chances of getting a job are better. Since business has picked up, people have been trying to find better jobs, which is why the rate of people leaving their jobs has picked up, and entering rate is just following the trend.

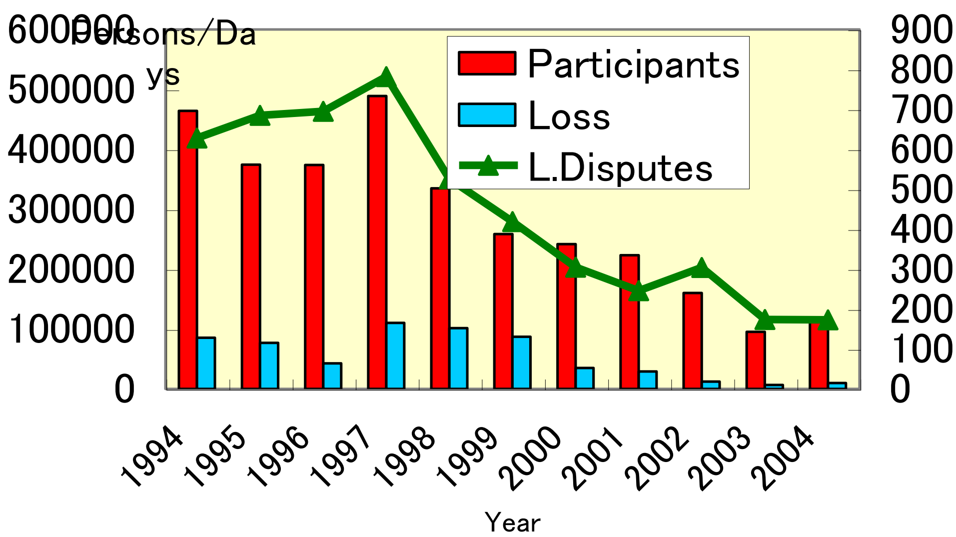
Japanese know that manufacturing is still crucial for their economy, but it was more the service sector than manufacturing that has created more jobs for the Japanese. If we classify the different types of businesses, most of the sectors that have created jobs are first Medicare, second other service industries including the IT sector.

The Japanese experience showed that there had been a dialogue between management and labor. In contrast, since the financial crisis, Korean firms have been pressured constantly by the financial organization and investors. In that sense, there is no incentive for the corporate managers to try to have discussions with labor unions when the company has more concerns and provides better promotions for financial managers. In Japan labor and human capital management has been mostly the top criteria, especially in manufacturing sector. Even now still human resource management is regarded crucial in relation to skill accumulation and technology aspects. So how to motivate labor management may be an issue in Korea.

<Figure 13>
Labor Disputes (Korea)



<Figure 14>
Labor Disputes (Japan)



Finally, what's most impressive about the Japanese labor market is the sophistication of placement services. At one time Japanese placement services was totally dominated by the government, but thanks to all the market demands, the service for people who are trying to move and get a new job has become very sophisticated especially in the past five years. Placement services have developed with outplacement services.

Another implication for Korea is the issue of creating jobs for the younger generation. Japan also suffered by a high unemployment rate around 10% for people of those who are in their twenties. Finally, the employment rate has started to drop, and more than 97% of college graduates are expected to find a new job in 2006. The biggest reason is that Japan has an intensive retirement by baby-boomers in the coming five years, and younger labor force has turned to be very precious to complement them. However, not only in quantitative change but quality issue has also given incentives for the private sector to train younger generation.

Many firms have found the quality of labor in baby-boomer generation is superior to younger ones without good training and experiences, and they are now trying to promote skill and technology transfer across the generations. So they try to keep the older employees on for extra five or so years to train the younger workers to maintain the skill levels of their workers. At the same time, the younger generation of workers is trying to educate the older generation on developments in the IT applications for sharpening their skills. So this seems to be a good combination of the two generations, which strengthens the labor market. Probably the most important message is that the efforts are motivated by private sector's own needs for better competitiveness, rather than government enforcement by political incentives.

The change in the labor market is also sustained by the different values and ethics about jobs in younger generation, which are very different even from my generation. In the early 1980s when our generation was trying to get a job and we were asked why we wanted the job, we answered that we wanted to challenge our ability or train ourselves. This kind of attitude has decreased in Japanese society, and most people are now answering that they want a job to make their life easier so they can spend money to make their life more enjoyable. Upon this different value, labor market has to be flexible, for you cannot expect strong commitment towards the long-term contract for younger generation anymore.

Finally another issue about job creation in Korea may relate to FTA negotiation with the U.S., which is to make a very broad range of economic negotiations. I would suggest the significance of Mutual Recognition Agreement (MRA) negotiations with the FTA for Korea. When it comes to the prospect of human capital, especially the service, MRA with an agreement on movement of persons may work in creating new business and jobs in Korea. We had a common qualifications standard for IT technologies between Japan and Korea, but these kinds of negotiations will indirectly help the labor market flexibility in the end.

My conclusion is that Japan's experience proved that after all, consistent reform is the only resource for the sustainable growth, and investment is the most crucial issue for the Korean economy because investment can only upgrade your growth potential without inflation. So for that purpose, service sector integrations with a bigger market is crucial because the Korean domestic market is limited. And labor market reform also needs reform, but cooperation and dialogue among the private sectors are much more crucial than the government pressures. Without collaboration, the realistic labor market flexibility is difficult only by politically motivated rules and rule enforcement. Finally, the human recourse management program is so crucial for us with aging society, and in that field, probably Japan and Korea have a lot of room to cooperate each other.

QUESTIONS & ANSWERS:

[Q] What implications do you think the rise of China, as an economic locomotive region will have for Japan and Korea for economic policy in short and long-term?

[Q] How about the recent trend of money supply?

[Q] I think if you look at the regional context, this is an area which is going through another spurt of rapid economic growth. In my opinion very largely due to the fact that the U.S. is running a huge balance of payment deficit and I am just wondering how long that is sustainable. If the U.S. reduces its balance of payments deficit and reduces economic activity, I think it will have a major impact on china and indirectly on all the countries that send the parts to china to be assembled. Based on the experience in Europe, when you start hitting a rough spot like this, that's when the real weaknesses and dangers of a rigid labor market start showing. If you hit a period of low growth, and stagnation, then you'll see that the countries that have serious labor market issues stop suffering and those with a very flexible labor market tend to go through these rough spots much more easily. In other words, a downturn tends to accentuate the differences between the flexible and inflexible labor markets. I'd like to hear you comment on that.

[A] In terms of your first question on the rise of China, that is related to the third question of how to deal with the potential shock that may come from the crash of the dollar. Of course Japan is very dependant on the U.S. market especially when we look into the structure of Japanese profit which is becoming bigger on the overseas market. So the crash of the U.S. economy might be a shock and since China is even more dependent on the U.S. economy than Japan, the crash of the U.S. economy may in turn crash the Chinese economy. So far, China's rise has been a big chance for Japan to sustain the reform, and we are very appreciating Chinese sustainable growth in the latter 1990s and we are, now. Considering the possible macro adjustment in the global economy, we should absolutely promote further regional integration and cooperation to mitigate the potential shock. However, as everybody knows, the political disputes between Japan and China prevent an FTA between the two countries, and may set further higher walls even in economic exchange.

Financial cooperation is generally better going on than FTAs, for no one wants to repeat the financial crisis. Everyone is now interested in a common Asian currency starting from the basket system and Asian Bond market, so the effort is still there despite the political disputes. However, the integration efforts should be integrated between the real sector and financial sector. In fact, East Asia has still a lot of challenges for the real economy integration, including labor market flexibilities. I am not so negative about the prospect of the labor market in Japan because Japanese don't believe in a government program and they have been trying to survive with their own efforts and it has been somewhat successful so far. So labor market flexibility won't bother the rising competition from china and India etc. However, I am less confident whether Korean labor market is flexible enough to mitigate integrating shocks including the competition from China. Labor market flexibility was keys issue in European integration, and probably Korea and other East Asian economies needs more serious reform in labor market while paying enough attention to the human rights.

Regarding the financial issues in the second question, the historical measure quantitative easy money policies by the bank of Japan have finally ended. The purpose has been to supply as much money as people need in the market to prevent financial shrinkage. One thing that has changed is that now we have established the comprehensive system to deal with massive non-performing loans, so that panicky shrinkage coming from uncertainties in the market will not be likely any more. This may be an important reason for the BOJ to abandon the easy money policy, in addition to the smaller deflationary pressures on the macro economy.

[Q] What would be an adequate growth rate of the Korean economy to achieve recovery, and what would be the best industrial policy to achieve increased facility investments by the private sector of Korea in your view?

[A] Regarding your first question, I think you should ask Dr. SaKong rather than myself, but I would say Korea still has high potential to mature, around 5-6%. If you consider the U.S., which is a matured economy, they can still grow at the rate of 3-4%, so I think the Korean economy, especially in the last three years has been under performing. And what's important about the potential growth rate is the investment as you pointed out. If we see stagnant Korean facility investment, even the potential growth rate will be withdrawn continuously. In short term, as long as the export sector is not bothered by the won appreciation against the dollar, I think 4-5% is a quite comfortable range for the Korean economy.

But my point is that even Japanese potential growth rate came back to 2% with all that facility investment in those three years, you may have lots of chances to go up to 6% of gross which isn't so unrealistic for Korea. Then the issue is how to stimulate the private investment. I think one of the most realistic policy measures is to promote further integration with the bigger market while making the best efforts to accelerate reform in the labor market. Chinese and Japanese markets should be very important for Korea's growth because manufacturing is competing in the global market but the service sector which Korean policy makers seem to be so interested in, has smaller potential because of the population size. Korea is in a good position geographically and the potential of human capital in Korea is very high because people are very highly educated and there are many who speak English well, and people can be very productive once they're provided right competition incentives. Market integration with neighboring economies will stimulate service and investment in Korea while promoting innovation.

[Q] Would you give us your comments on starting an FTA negotiation with the Korea-U.S.? What kind of values is possible that an FTA with the U.S. will bring? I would like to hear about the benefits of a possible future Japan-Korea FTA?

[A] I think these are the kind of decisions that take political courage to handle the U.S. for the Korean side. If you stick to the potential benefit, I would say the U.S. would be the best partner for Korea because the people educated in the U.S. and the information and deepness and size of the market. Whether this is politically effective or not is not certain, but I hope the achievement of the Korea-U.S. FTA will force Japan to open their market further. Probably by principle, Korea should be more strategic and prepared enough in FTA negotiation, having a consistent strategy on how to link the external shock for further reform and increasing growth potential. The major effects of Japan-Korea FTA will be somewhat similar to Korea-U.S. FTA in that better chances for sophisticating industrial structure especially in services and SMEs will be promoted by more competitive environment and more free movement of economic factors.