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Escape 'Japanization' with green investment

INSIGHTS *into the* WORLD

By Motoshige Itoh

Vast economic structural changes are said to be underway due to the coronavirus crisis. But there seem to be many cases in which the COVID-19 pandemic is actually just a trigger that is making evident underlying economic conditions that have been in place for some time. In this article, I want to focus on the "triple-low" macro conditions of low interest rates, low growth and low inflation.

Long before the outbreak of the coronavirus, Japan ran into the "triple-low" situation because of its deflationary predicament. The government and the Bank of Japan repeatedly resorted to bold fiscal and monetary countermeasures to keep the Japanese economy from suffering full-fledged deflation. Those remedies only resulted in continuously bloating both the public debt of the government and the balance sheet of the central bank.

The "triple-low" phenomenon is referred to abroad as "Japanization." The COVID-19 crisis is exacerbating Japanization, spreading it to European countries and the United States. To try to determine where we are headed, we need to understand why Japanization has become inevitable.

Long-lasting economic stagnation, which has become contagious among advanced countries, is behind the "triple-low" situation. In the past three decades, long-term interest rates in advanced countries have been on the downtrend because of declining potential growth rates on top of weak funding demand from the private sector.

Those negative trends have been especially conspicuous in Japan, which continues to see its population rapidly gray and its industries lag behind other countries in terms of technological innovations that would lead to economic growth.

Since the early 1990s, Japan has experienced deflationary pressures so serious that fiscal and monetary stimulants have had to be continually injected. Abenomics-driven stimulants can be said to have been critically effective in preventing Japan from plunging into a grave deflationary crisis.

Little effect on supply side

Nevertheless, Abenomics stopped short of enabling Japan to have a bright economic outlook, as its potential growth rate remained low. As a result, corporate demand for funding is still low even now, keeping the country from escaping the "triple-low" situation.

The COVID-19 crisis is aggravating the already worsened economic situation, raising the risk of the Japanese economy falling into a deflationary spiral. Against this background, there are growing calls for a new government fiscal stimulus package and bold action by the Bank of Japan for further monetary easing. However, successive fiscal and monetary shots in the arm alone are not expected to put the Japanese economy on a sustainable growth path.

This gloomy outlook is clearly inevitable when the prevailing macroeconomic circumstances are examined from both the demand and supply sides. On the demand side, the drawn-out period of stagnation has led to a chronic shortfall in demand, a situation that tends to end up setting off full-fledged deflation. In response, Abenomics came up with a series of bold measures to spur demand in the economy. That approach itself was meaningful, but it turned out to be ineffective to tackle another lingering weakness of the Japanese economy.

Abenomics programs were weak in terms of generating sustainable growth on the supply side of the economy. Even if there are repeated injections of stimulus on the demand side, no economy's vitality can be retained without ensuring growth on the supply side at the same time. So even while inheriting the Abenomics strategy that prioritized measures to stimulate demand, the "Suganomics" that Prime Minister Yoshihide Suga is apparently pursuing as his version of economic revival is likely to be tasked with strengthening the supply side of the economy.

Of course, Abenomics also placed importance on supply-side policies. The "third arrow" of Abenomics — the growth strategy — had many policies targeting supply. But government and central bank policies related to the supply side can only be indirectly effective in stimulating the economy, whereas those related to demand can immediately affect the marketplace.

Leverage digital transformation

As the old saying goes: You can lead a horse to water but you can't make him drink.

Aiming to help the Japanese economy improve its potential growth rate, the former administration implemented one set of measures after another to ease the regulatory environment and thereby encourage businesses to increase investment. However, businesses remained slow in converting to highly productive business models.

To raise the potential growth rate by increasing productivity, digital transformation is the key to reshaping the way both corporations and society are run, by utilizing fast-evolving digital technology. The digital transformation initiative had been emphasized well before the coronavirus pandemic broke out. Nonetheless, many of Japan's corporations chose not to take on digital transformation challenges, positioning themselves far behind their U.S. and Chinese counterparts.

Ironically, the COVID-19 crisis is pressing these slow-moving corporations in Japan to proceed with massive reforms to their business models.

For instance, the coronavirus crisis is prompting many Japanese businesses to more seriously advance work style reforms, a major Abenomics policy.

It is natural for the new administration to attach importance to digital transformation while pressing ahead with Suganomics. Progress in digitization within the government alone can hardly be effective in accelerating economic reforms. But it is still important to let digitization play a key role in causing the supply side to change.

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In theory, there are three factors for the supply side to facilitate economic growth: labor force growth, capital stock accumulation and improvement in total factor productivity (TFP). The first two factors cause quantitative growth, while the TFP factor is related to qualitative improvement bolstered by technological advances, among other elements.

Bloated corporate coffers

As mentioned earlier, digital transformation is the key to stimulating productivity growth. We cannot expect much quantitative growth from the labor force, given the aging of the population coupled with the low birth rate. So, let me touch on how capital stock expansion affects the potential growth rate of the Japanese economy.

It is widely known that the corporate sector of Japan has continued to amass an immense amount of surplus savings for more than 20 years, since the financial crisis of 1998. Now, the outstanding total of surplus corporate savings accounts for the equivalent of about 5% of the country's gross domestic product.

These excess corporate savings, stemming from businesses' preference to keep investment in plants and equipment on hold, have been used to purchase big chunks of government bonds, helping absorb fiscal deficits in the government sector. This shows how capital has actually been flowing behind the "triple-low" phenomenon combining low interest rates, low growth and low inflation.

The government's fiscal deficits have nothing to do with future-oriented investment, as they arise largely from fiscal expenditures for social welfare, such as medial service costs and pension benefit payments. In other words, both the public and private sectors of Japan have failed to continue investment for capital stock growth. Who could expect Japan's potential growth rate to improve against such a background?

When asked why Japanese corporations are so reluctant to actively invest in plants and equipment, the answer is that there are "no promising investment destinations."

In this connection, I want to point out the significance of green investment, primarily in the field of environment preservation. In Europe, for instance, the European Green Deal is being promoted as a key driving force for rehabilitating its economy from COVID-19 damage. European countries see such efforts not as the cost resulting from climate change remedies but as a newfound opportunity to improve potential economic growth. In the United States, too, when U.S. President-elect Joe Biden actually comes to power, his administration is expected to prioritize climate change countermeasures.

In China, its leadership is prioritizing an increase in the use of renewable energy and the acceleration of electric vehicle production as national projects. For its part, Japan seems to have finally begun acting to strengthen measures for reducing greenhouse gas emissions. Japan, too, will be required sooner or later to invest enormous amounts in ways to reduce such emissions. It is desirable to make such investments as early as possible. If that is the case, Japan should give serious consideration to green investment as a breakthrough that will contribute to post-pandemic economic revitalization. Though the government is expected to become a significant green investor, the private sector should play the truly key role first and foremost in facilitating Japan's green commitments.

It is true that Japan has been tackling the COVID-19 pandemic largely as a crisis management endeavor. Needless to say, it is important to keep implementing sufficient crisis management measures as the pandemic continues to rage. Even so, we need to shift our focus to economic revival because it is increasingly apparent that the coronavirus crisis is likely to continue for a prolonged period. To effectively cope with the situation, a supply-side approach is essential. Digital transformation and green activities are both vital to realizing this achievement.

(Special to The Yomiuri Shimbun)

Itoh is a professor of the Faculty of International Social Sciences at Gakushuin University. He was a professor of economics at the University of Tokyo through March 2016.

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