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CAN THE DEMOCRATIC PARTY OF JAPAN IMPLEMENT A NEW ECONOMIC POLICY?

In August 2009, for the first time since 1955, an opposition party, the Democratic Party of Japan, won a clear mandate to form a new government, ousting the incumbent Liberal Democratic Party. Its initial economic reform programme of refocusing growth on domestic demand using large social transfers has come under severe political pressure, including within the current majority, with the supporters of Naoto Kan in favour of reining in budget spending and those of Ichiro Ozawa partisans of a vigorous economic stimulation policy. Naoto Kan's election as President of the Democratic Party keeps him in the post of Prime Minister and seems to confirm the shift in the DPJ's economic policy towards one of tighter control of public finances.

For a period of around thirty years, between 1955 and the end of the 1980s, the policies of the Liberal Democratic Party (LDP) in Japan were designed to meet the three aspirations of the country's electors, namely: to use the economy to restore Japan's status as a global power, to ensure full employment and to raise living standards across as evenly as possible. However, from the beginning of the 1990s, the slowdown in the annual growth of real GDP (1% during the crisis years of 1992-2002 and just 2% during the upturn period of 2002-2007) led to a decrease in Japan's contribution to global GDP from 14.3% in 1990 to 8.9% in 2008[1], an increase in poverty rate from 13.7% to 15.7% between 1995 and 2007[2] and a rise in unemployment.

Public dissatisfaction intensified because despite the improved economic conditions enjoyed between 2002 and 2007 and the upturn that got underway in the second quarter of 2009 following a year of crisis (April 2008 - March 2009), there were few tangible positive effects on individual salaries. A profound desire for change led electors to vote massively for the young Democratic Party of Japan (DPJ) in the legislative elections held in August 2009.

Not only did this event mark a major political turning point in post-war history, but and more importantly, it raised hopes of an innovative economic programme. Nevertheless, the sudden resignation of the increasingly unpopular Prime Minister Yukio Hatoyama in June, the growing concerns of the markets *vis-à-vis* the level of public debt and the DPJ's loss of a majority in the Upper House on July 11 forced the government to alter some of the original aspects of its economic policy.

The economy as the crisis draws to a close

When the Prime Minister Yukio Hatoyama, leader of the DPJ, took office on September 16 2009, real GDP for the second quarter of 2009 was just 94% of its 2007 level, one third of all employees had little job security, unemployment had risen to 5.7% and deflationary pressures were intensifying.

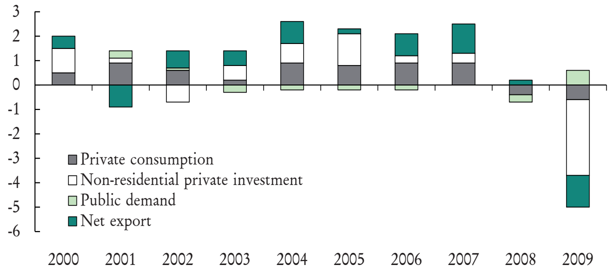
Weak consumption

The global economic slowdown – international trade in particular fell by 31% between August 2008 and March 2009[3] – plunged the Japanese economy into the deepest recession seen since the end of the World War II. The sudden contraction of real GDP (-1.2% in 2008 and -5.2% in 2009) can be explained by the bursting of the "export bubble"[4] formed between 2002 and 2007, when the share of exports in nominal GDP rose from 11.4% to 17.6%. Growth during this period was driven by investment-generating exports, while household demand was far too weak to act as an alternative engine of growth (graph 1).

Various factors explain this sluggish demand. First of all, between 2002 and 2007, despite the relatively rapid increase in company profits as well as falling unemployment resulting from the contraction in the labour force,[5] wages stagnated. As the crisis worsened, wages then fell, with consumption declining less significantly at the end of the period (graph 2).

1. FMI, World Economic Outlook Database.
2. OECD, *Social Indicators* and Ministry of Health Labour and Welfare. Poverty threshold: below 50% of median income.
3. Value of international trade. World Bank, http://www.worldbank.org/globaloutlook
4. V. Bojkova, D. Bruce & C. Dixon (2009), Japan after an 'Export Bubble', *Global Policy Institute*, *Policy paper* No. 1, April.
5. Between 2002 and 2007, the active population fell by 200,000 (-0.3%).

Graph 1 – Contribution to changes in Japanese real GDP between 2000 and 2009 (%)

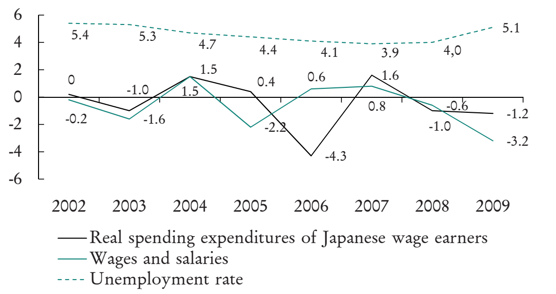


Note: GDP, base year 2000.
Source: ESRI, May 2010.

Between 1996 and 2006, real wages only rose by 1% while labour productivity increased by more than 20%. The low profitability levels of firms between 1996 and 2002 might have explained these figures. Yet, between 2002 and 2007, productivity grew much faster than real wages (20% difference between the two) whilst unemployment fell and companies were gradually seeing a return to profit.

Three principal factors are cited to explain sluggish wage levels[6]: foreign competition and relocations, labour market deregulation (increase in the number of working people with no job security) and the ageing population (older employees on high salaries replaced by younger people on lower salaries, older people then rehired on lower salaries). According to Martin Sommer's research, the demographic factor is the least relevant: sluggish salaries can be explained above all by Japan's statutory and sectorial market dualism. He has demonstrated that, on the one hand, the significant disparities in the levels of legislative and social protection afforded to full-time employees on permanent contracts compared with employees with little job security promote the employment of the latter (34% of employees in 2007 had this status), which in turn exerts downwards pressures on the wages of permanent workers; on the other hand, the productivity differential between the manufacturing sector and the services sector (70% of employment) – highly unfavourable to the latter – has a negative impact on wages. In addition to these factors, Japanese exporters became increasingly uncompetitive with the rising value of the yen against the dollar and the won between July 2008 and January 2009.

Graph 2 – Changes in the growth of real wages, real consumption spending and the rate of unemployment (%)



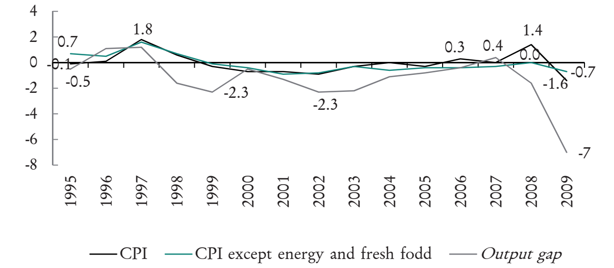
Note: 2005 prices.
Source: Statistics Bureau, Family Income and Expenditure Survey.

The return of deflation

In 2006 it seemed that the Japanese economy had finally emerged from the deflation inherited from the domestic financial crisis of 1997-1998[7], but the global crisis of 2007-2010 plunged it straight back into it (graph 3).

The return of deflation results from the significant difference that exists between the recorded levels and potential of economic activity, the output gap (graph 3). According to the IMF[8], deflationary pressures could well last until 2015, when the output gap should be close to zero (-0.2% of GDP).

Graph 3 – – Changes in the consumer price index (CPI) in Japan and output gap



Note: 1) Annual % change in CPI. 2) Output gap as % of GDP.
Source: CPI: MIC, Statistics Bureau, Output gap: IMF.

While consumers and savers may be seen as "winners" in a period of deflation, employees and tax payers are among the "losers" (downwards pressures of salaries and likely increase in taxation), and the State even more so.

An all-time high public debt

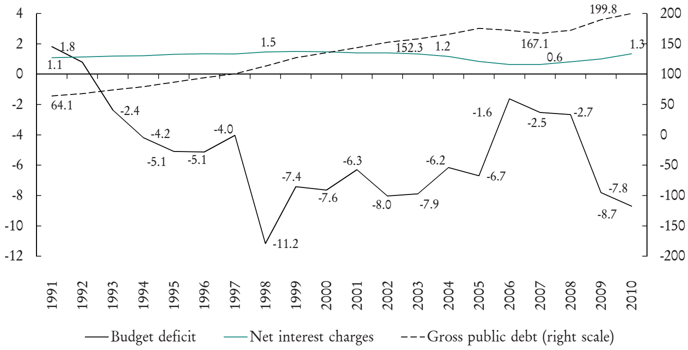
Between 1991 and 2002, gross public debt jumped from 64% to 152% of GDP, with the budget deficit rising to 11.2% of GDP at the height of the banking crisis in 1998. The upturn that followed enabled the deficit to be brought back to less than 3% of GDP in 2007, but the crisis of 2008-2009 sent it spiralling once again. In the face of falling tax receipts, gross public debt has risen once again, a situation exacerbated by increased public spending associated with the economic recovery programmes for the period 2009-2010 and the expansionary budget of 2010 (graph 4).

The share of GDP dedicated to servicing this debt did nevertheless decrease in the period 2008-2009 compared to the period 1992-2004 due to falling interest rates on 10-year government bonds, from 5.6% to 1.5% between January 1992 and January 2009.

Several factors explain the absence of speculative attacks against the yen and the stability of Japan's debt rating ("AA" since April 2007), although rating agencies are showing signs of growing nervous. Firstly, 94% of public debt is owned by Japanese residents[9]. In addition, Japan is the world's second largest holder of currencies (1 trillion dollars in April 2010 according to the IMF), the stock of net financial assets is worth more than double the GDP and new government bonds are snapped up quickly.

6. M. Sommer (2009), Why are Japanese wages so sluggish?, *IMF Working Paper*, WP/09/97, May.
7. É. Dourille-Feer, C. Lacu (2002), "La crise japonaise, ou comment un pays riche s'enlise dans la déflation", *L'économie mondiale 2003*, CEPII, Éditions La Découverte.
8. International Monetary Fund (2010), World Economic Outlook Database, April.
9. K. Tokuoka (2010), The Outlook for Financing Japan's Public Debt, *IMF Working Paper*, WP/10/19, January.

Graph 4 – Changes in the budget deficit, gross public debt and net debt interest charges, (% of GDP)



Note: OECD.
Source: 1) Budget deficit and net interest charges (%), left scale, 2) Gross public debt as % of GDP, right scale.

Nevertheless, a budget stabilisation policy must now be implemented before the decline in domestic savings[10], associated with ageing, leads to a significant reliance on foreign investors to finance the public debt.

The DPJ's "third way"

The DPJ conducted its electoral campaign in August 2009 against the backdrop of a Japanese economy that was emerging from its deepest post-war economic recession. The first two approaches adopted by the LDP to stimulate growth – via public works projects and via deregulation – appeared to have reached their limits because both growth and full employment remained stubbornly absent and, what's more, living standards were declining. To get out of the rut, the DPJ came up with a "third way" focusing on stimulating demand – especially household demand –, offering increased autonomy to regions and supporting SMEs, developing new sectors and reinforcing links with Asia.

A demand-focused policy

The economic programme presented by the DPJ at the legislative elections in 2009 reflected a determination to remove the growing inequalities in the economy and Japanese society as a whole, reducing job-related insecurity (increased minimum wages, money and training for the unemployed coming to the end of their entitlements, regulation of interim work labour), supporting the poorest families (lone-parent allowances, compensation programme for farmers, minimum pension and improved access to long-term care) and reviewing the privatisation of the postal services in order to reinforce social solidarity (re-opening of post offices, financing of social projects). In addition, a proactive demographic policy appeared at last to be taking shape (significant increase in the childbirth benefit and family allowance, extension of free education) (table 1).

Hence, unlike the LDP, who, other than in periods of crisis, systematically focused on supply measures, supporting in particular the major exporters, the DPJ has chosen to stimulate household demand using social transfers. The social benefits available to Japanese households have traditionally been somewhat less generous than those provided in Europe.[11] By increasing them, the aim is to boost domestic demand and reduce income inequalities that have drifted above the OECD[12] average.

Decentralisation is also one of the DPJ's key policy priorities. In addition to the greater fiscal autonomy granted to regions, specific stimulation programmes for local economies are planned (support for the agriculture, fisheries and forestry sectors through income compensation systems or direct aids, gradual abolition of motorway tolls to reduce distribution costs and prices, reorganisation and relocation of postal services).

These regional job-creating measures fall within the framework of a national policy making employment a priority and focusing on providing support to SMEs in particular – who account for 70% of all jobs – *via* a reduction in corporate tax rates from 18% to 11% as well as access to subsidised loans. To offset job losses resulting from the rapid relocation of manufacturing production (960,000 jobs lost in 2008[13]), there are plans to develop new sectors, particularly related to protecting the environment.

However, significant budget constraints, the European financial crisis and the change in Prime Minister in June have forced the new majority to put back some campaign promises and shift the emphasis *vis-à-vis* some of the reforms announced.

Table 1 – Democratic Party of Japan's (DPJ) economic programme 2009

Employment	Families	Seniors	Others
Minimum wage: Objective: 1,000 yen/hour (€8)	Childbirth payment: Objective: 550,000 yen/child (€4 400)	Minimum pension: Objective: 70,000 yen/month (€ 560)	Corporate Tax on SMEs: Reduce from 18% to 11%
Unemployment at end of entitlement and in training 100,000 yen/month (€800)	Family allowance 26,000 yen/month/child (€208) (13,000 yen in 2010)	Improved access to long-term care	Income compensation system for farmers
Part-time labour legislation	Re-introduction of lone parent allowance		Reduction in petrol taxes Abolition of motorway tolls
	Free high school education		Post office privatisation frozen

Source: From the "Manifesto" of the Democratic Party of Japan, July 2009 http://www.dpj.or.jp/english/manifesto/manifesto2009.pdf

A growth policy under constaint

The initial budget set for 2010 (April 2010-end of March 2011) was 4% higher than that of 2009 despite the very high level of public debt. This budget fits squarely with the two major aims underlying the campaign promises: "less concrete" (public works: -18.3%) and "more social" (social security: +9.8%). There is also an increased focus on education and research (+5%).

10. Gross savings in Japan fell from 33.2% to 27% of GDP between 1992 and 2007 (OECD).
11. In 2005: 18.6% of GDP in Japan, 26.7% in Germany and 29.2% in France (OECD).
12. OECD, Economic Survey of Japan, 2006.
13. Source: Yasuhito Watanabe, Japan Loses 35 trillion yen of Output Due to Manufacturer Exodus, *Nikkei.com*, 31 May 2010.

Although the monthly family allowance payments of 13,000 yen (€104) per child, free high school education as well as income support payments to some categories of farmers are now on the statute books, some laws remain on hold (post office and temporary workers), and a number of electoral promises have not been met (reduced corporate taxes for SMEs, lower petrol taxes, toll-free motorways, *etc.*) due to the limit placed on the amount of government bonds issued – 44.3 trillion yen (€353 billion).

The Prime Minister Yukio Hatoyama had also promised not to increase VAT before the next legislative elections at the end of 2013, the need to stimulate household demand taking precedence over the need to re-establish the fiscal balance. However, his replacement by Naoto Kan on the June 4 and the bursting of the Greek sovereign debt bring changes.

As soon as he was sworn in, the new Prime Minister emphasised the importance of restoring order to public finances, while continuing to strengthen the economy and the social security system. Later on, he raised the possibility of doubling VAT from its current level of 5% in order to reduce the public debt, although no date was set. This VAT targeting caused a degree of consternation amongst the electorate, fearing the imminent adoption of the measure. In addition, the DPJ's policy focus for the upper house parliamentary elections of July 11[14] marks a clear reorientation compared with that of August 2009 towards an increase in tax revenues and a cap on spending with a view to achieving a surplus in 2020. It is for this reason that the objective of injecting 16.8 trillion yen (€134.4 billion) into the economy by 2013 *via* the different measures set out in the economic programme in August 2009 has been abandoned. Similarly, the 26,000 yen promised to households in the form of family allowances are no longer on the table. Although the budget constraints mean that the planned social measures have had to be scaled back, the medium-term macro-economic objectives remain ambitious against the backdrop of a rapidly ageing population.

Hence, the government is aiming for an annual real GDP growth of at least 2% in the decade up to 2020, with the country exiting the period of deflation by March 2012 thanks to its New Growth Strategy[15] stimulating internal and external demand. Five strategic areas are to be developed: infrastructure systems, green energies and products, cultural industries (tourism, culinary arts, *etc.*), healthcare, cutting edge technologies (robots, space, *etc.*) that could generate 123 trillion yen worth of demand and 5 million jobs by 2020. The establishment of an Asia-Pacific free-trade zone should reinforce Japan's commercial integration into Asia, particularly though the export of infrastructures and cultural products. In addition, a renewed focus on innovation (increasing R&D spending to more than 4% of GDP in 2020) will be crucial in order to generate significant added value despite a declining active population.

In 2009, the DPJ had proposed a new economic policy focusing on boosting household demand via the increase in social transfers as well as the creation of jobs in buoyant sectors such as the environment, health and tourism. The objective was to weaken Japan's reliance on exports and establish stronger, more stable domestic demand. But budget constraints were already tight at the end of 2009 and the situation worsened following the Greek debt crisis. The result is that the policy of supporting households with a series of social transfers has been scaled back and large-scale recovery plans could only be considered if the global context were to deteriorate significantly. Moreover, the recovery plan published on the 31st of August 2010 designed to counter the negative impact on the economy of the rising value of the yen only amounts to 920 billion yen (€8.5 billion).

While households were central to Yukio Hatoyama's policy, Naoto Kan appears instead to focus more on companies, favouring corporate tax cuts and deregulation. The DPJ's economic policy, undermined by the significant political instability of the past twelve months, seems to be wavering between two potential avenues: the creation of a "European-style" protective welfare state which has a greater influence on the economy, or the creation of a liberal state that is more favourable to companies, in which case exports may continue to be the engine of the economy for a long time to come.

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14. Restoring vitality to Japan, 17 June 2010, http://www.dpj.or.jp/english/manifesto/manifesto2010.pdf
15. New Growth Strategy, METI, http://www.meti.go.jp/english/policy/economy/growth/report20100618.pdf

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