Transcript of Interview with Tadashi Nakamae

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Interviewed by
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Note: This is a verbatim transcript but with minor editing for clarification.

Garten: I want to thank you very much for doing this interview. Obviously, Japan is a very significant part of the global financial system, and I'm delighted to have the chance to talk to you about that and broader issues.

I thought maybe we would start with "Abenomics," and I would love to get your view about what it is, and how you think it is working, and whether you think it is the right medicine for Japan.

Nakamae: Abenomics has not worked, and I do not think it will work in the future. That's because for all the commotion over Abenomics, its core concepts are riddled with problems. I'll touch upon some of these problems first.

The biggest problem with Abenomics is its reliance on extremely aggressive monetary easing. It has three objectives. One is to weaken the yen. The thinking is that this will increase exports, stimulate production and economic activity, and trigger capex growth. Instead, exports have been stagnant – at least in terms of export volume. Even if we consider export value, in dollar terms, Japanese export performance has been grim compared with American or European exports.

A weaker yen has been unable to boost Japanese exports because Japanese companies have too many factories overseas. With so many factories based in other countries supplying what is needed, Japanese exports are these days unaffected by global economic conditions. However, a weaker yen does affect import prices - and as these go up, Japan's trade deficit increases (substantially). All this is bad for the economy. Last autumn, Japan's current account fell into deficit for the first time since 1980, an ominous development.

Easy monetary policy also aims to stimulate the stock market. True, Japan's stock market rallied (in 2013) - this was entirely due to rising foreign (speculative) investment into Japanese equities, and not because the economy or domestic sentiment had improved. Nor did rising stock prices create a wealth effect (advocates of Abenomics had hoped this might stimulate consumption). This would never have worked since only 15 percent of Japanese households own equities; 85 percent do not.

The third objective of easy money is to try to accelerate CPI inflation to 2 percent by altering consumers' perception. According to Abenomics, people believe deflation has depressed Japanese consumer and business sentiment. Abenomics seeks to create positive inflation. And inflation did pick up in 2013: a weaker yen which caused import prices to go up. Unfortunately however nominal wage growth did not keep up with consumer price increases leading to an acceleration in the decline in real wages . The latest figures for June 2014 show real wages falling 3.5% YOY (year over year), an unlikely environment for a rise in consumption.

These are the three big negatives that have emerged from Japan's aggressive pursuit of easy money.

As far as fiscal policy is concerned, aggressive government spending, particularly on public works, has not stimulated the economy because government investment as a proportion of GDP is too small.

The so-called third arrow of Abenomics (after the quantitative easing and fiscal consolidation arrows) is a supposed growth strategy. But this simply recycles proposals presented by numerous governments since 1986. These proposals mostly involve economic reforms and restructuring, which despite decades of debate have never materialised, and are just as unlikely to materialise under the present government.

This leads me to the biggest challenge facing Japan right now - how to revive the economy by creating a structure that is more service- and domestic-oriented.

The first condition is to normalize interest rates. Zero interest rates prevent businesses, bankers and consumers from taking risks and making new investments. This is a crucial issue. In the past two decades, Japan has maintained very low interest rates which have destroyed the market's ability to reallocate resources and function efficiently.

Second, and most important for Japan – as is probably the case in other economies – productivity has to rise. Japanese productivity has been steadily decreasing over the last two to three decades. My view is that this has been caused by monetary easing. But how does Japan raise productivity?

These days productivity is growing by 0.5 percent at best – or not at all. The issue of how to raise productivity is best considered by splitting the economy in two. The first part of the economy consists of industries such as manufacturing, where there is huge over-supply capacity. We need to eliminate excess supply capacity by raising interest rates. In other words, since the bubble burst in 1990, Japan has tried very hard to support so-called zombie companies for fear that a collapse would set off a financial crisis.

But propping up these companies has made things worse. Consider the following scenario. An industry has only room (given the level of demand) for seven companies, but instead there are ten (with several surviving only because interest rates are so low.) If three companies surrender to market forces and fold, then productivity and profitability at the surviving seven companies will increase by roughly 40 percent. So eliminating excess supply capacity, say, by 30 percent would increase productivity in many industries in Japan

Unfortunately this also leads to a 30 percent reduction in the workforce. The laid-off workers should be - and can be - retrained. This is crucial. Japan also needs to expand and develop fresh industries. I believe there are many industries in Japan which have been unable to take advantage of enormous potential demand. These include nursing (caring for the elderly), health care and agriculture. But it is not enough to simply boost these industries. They need to be cultivated as high-wage and high-productivity industries, rather than giant low-wage industries.

These industries will need substantial investment to become highly productive. For example, investing in equipment such as robotics will improve efficiency in these service-oriented industries. Also, as I mentioned earlier, since these are the growth industries of the future (partly because of Japan's grim demographics, and partly because they are being stifled by archaic laws) they are in a great position to reabsorb laid-off workers. Thus Japan needs to prepare to invest in massive retraining. This will also help Japan reduce its exposure to global risk – and this will become increasingly significant given that I believe the global political-economic situation is likely become very risky and dangerous.

Garten: Would I be right that what you're saying about Abenomics, and what you're saying about the challenges facing Japan, what you're saying really is that Abenomics is the wrong medicine for the problems.

Nakamae: Yes, completely.

Garten: And, also, that it's not having any positive effects.

Nakamae: No.

Garten: I think I would conclude so far that you're saying that the ship is moving in the wrong direction.

Nakamae: Yes.

Garten: In this setting you're talking about investments in human resources and in different kinds of industry. Here is another issue: How should we think about Japan's large debt? How much of a constraint is this, and how concerned are you that if Abenomics doesn't work, Japan will not be able to grow its way out of this debt, and we would have a different kind of financial crisis? Is that a concern of yours, or am I wrong in thinking in this way?

Nakamae: No, you are completely right. And I think this is a very important issue in the near term. My basic view is that without an actual crisis or crisis-like situation, a resetting of its economy if you will, Japan's economy will not revive, because, as I mentioned earlier, near-zero interest rates will prolong the status quo. Japan has to raise interest rates, even though this will probably trigger a crisis in the Japanese government bond (JGB) market.

This is because Japan's enormous deficit is not sustainable. As you described in your letter to me, JGBs are a time bomb. I think that is 100-percent correct.

Garten: I just want to be sure I understand what you're saying. Are you saying that a debt crisis is both inevitable and also over time, part of the solution?

Nakamae: Yes.

Garten: When you think about a debt crisis, you are thinking about some very large-scale restructuring and write-offs, right?

Nakamae: Yes.

Garten: You're saying a crisis is the only way to bring the debt down to a size where the economy can function normally?

Nakamae: That's right. I think the reason why JGBs have been so stable over the past15 years, despite huge annual budget deficits and an accumulating debt burden, is because Japan has been able to maintain a current account surplus. That means private-sector savings were bigger than the government deficit. These household and corporate savings enabled the government to finance its deficits in the past. Now, however, Japan's current account is in deficit – a fact that has been mostly overlooked in discussions about Japan's debt crisis so far. I think this is very serious. This is no short-term dilemma, it is a structural problem. A country's current account falls into deficit when private sector savings cannot fully finance the government deficit. Short of turning the current account into surplus, Japan will need more foreign investors to purchase its debt - which would probably cause its government bond yields to rise to U.S. or European levels (government bonds would become cheaper than they are now).

Garten: Let me ask you if there were a debt crisis in Japan, what could be the global ramifications? I realize that an overwhelming amount of the debt is held by Japanese entities, but even so, a lot of those entities are linked to the rest of the world economy. Can you describe a little bit how a debt crisis in Japan would have spillover into the global financial system?

Nakamae: Well, first of all, even though the debt problem is huge for Japan, I don't think that this will be a very big issue for the rest of the world. This will not be anything like the Southern European crisis of 2012. This is because unlike other developed countries Japanese institutions, households and the Bank of Japan hold the bulk of JGBs. Foreign exposure is negligible - therefore a JGB crisis would have practically no direct effect on international markets. But, as you rightly point out, there will probably be some significant side effects. For one thing, a poorer Japan is likely to stop investing overseas. If a crisis occurs and the current account remains in deficit, Japan might stop buying foreign securities such as US Treasuries and mortgage-backed securities.

Japan is also one of the biggest financiers of Asian development, including China. Japan would have to stop financing the region. Thus, this poses a risk for the rest of the world in the sense that Japan will stop being a global financier for a while.

Garten: So you are envisioning a Japan that is in a financial sense, deglobalizing, correct?

Nakamae: Yes, that's right.

Garten: And would that be a permanent condition or are you saying this is an intermediate step?

Nakamae: I would say this is an intermediate stage that lasts, say, about ten years. This is because Japan would not be the only country with big problems within the global economy at this point. Indeed, the rest of the world is facing much bigger problems, and the global economy is trending towards more deglobalizaton.

Garten: Let me ask you then about another aspect of the economy which everyone is conscious of, but I don't think they have made any linkages to finance in the way that you have linked the debt. I'm talking about the aging society.

If we stipulate that over the next couple of decades the Japanese population will get much older and also smaller, what kind of impact will that have on Japan's economy and Japan's financial system?

Nakamae: Before talking about this, I want to point out that the problem of demographics is the same or worse for the rest of Asia. Today, Japan appears to be ageing more rapidly than other countries, but China will soon catch up thanks to its one child policy launched in 1979.   South Korea’s ageing problem is also more serious than Japan's for different reasons – and the same can be said for most of Asia.

It is important to remember that Japan's demographic issues are part of a trend taking place across many parts of the world. That being the case, countries, including Japan, need to adapt to this difficult trend. I believe Japan may adapt better than most. In ten years, Japan should not have very serious issues in terms of its labor supply. After all its labor participation rate is currently lower than the United States', and can be raised by creating new jobs in the largely-untapped services industries. Also, ageing workers, supported by robotics, will be able to work more equally with younger folks. This is one supply-side issue that can be solved.

As for demand side issues, I know this is particularly important to those who believe that an economy's well-being greatly depends on GDP expansion. I believe that shifting the focus from GDP growth to per-capita GDP growth will solve this problem. But all this will only happen after Japan's economy is "reset". Japan will need to figure out how to solve a potential financial crisis and subsequent economic upheaval, sparked by a rout of the JGB market. Much depends on whether the costs of restructuring the economy are borne by savers in the form of higher taxes, capital losses and perhaps even wiped-out savings, or by corporations and financial institutions through capital losses and possible bankruptcy. Perhaps rampant inflation will wipe out savings and capital for both individuals and corporations. Japan should be able to determine, at least to a certain extent, what path it takes. How it chooses to deal with a crisis will determine its economic future.

Garten: How do you see in this picture the impact of what seems to be significantly more geopolitical tensions in Asia? Do these have any impact on Japan's economic and financial situation, or are they independent?

Nakamae: My answer is towards more independence. Whatever happens, I think Japan needs to focus more on domestic development rather than globalization. I believe the potential for regional conflicts has increased, especially in emerging markets, because these markets (including China) have seen their growth potential has practically disappear.

Emerging markets enjoyed significant growth over the past 10-15 years, thanks in most part to industrialization. But industrialization has reached its limit. Take China, which has many industries with huge over-supply capacity. China’s steel industry accounts for half of total world production capacity and they are unable to fully utilise this. That means they will not be making new investments for maybe 10-20 years. That is why I think they also need to shift to a more service-oriented economy. But this will be very difficult.

Though we debate this endlessly, it is almost impossible to make this shift because in order to do so countries have to completely change their political, social, and economic structure. As I mentioned earlier, Japan has been trying, but failing, to do this since 1986.

Emerging-market economies are deteriorating rapidly. The ensuing unrest leads to coup d'états, revolutions and regional conflicts. This is not good for the global economy, but I think that it was inevitable - given the rapid expansion of emerging markets as easy money policies in developed countries sent money abroad. Japan is able to be more independent from those issues because although exports are important, Japanese export dependency is at best 15 percent of GDP, far smaller than most other countries (except the United States). So, Japan will avoid the worst of the economic repercussions - at least as long as Japan is not directly involved in military fight or upheavals, which I think is very unlikely.

Garten: Let me ask you the final question. This has to do with the global financial system that Japan needs to prosper in the future. The question is if we supposed that in ten years from now there was a major global conference on reform of the monetary system and the financial system, and you were the delegate from Japan, what would want to see in the global system that would be of cardinal importance to Japan? In other words, when you think about the global financial system, what matters most to the Japanese future?

Nakamae: I think maintaining a stable global financial system is important. The US dollar has been the world's reserve currency since the end of the Second World War – and this has worked very well. Recently the US dollar has been challenged by the renminbi, the euro, and so on. But I do not believe they are strong enough to replace the US dollar as the world's reserve currency.

The reason the US dollar is facing these challenges is because its economic fundamentals are too weak for a reserve currency. While I believe the US dollar should continue to be the reserve currency, I think the policies underpinning the dollar, particularly its monetary policy, needs to be more disciplined.

Garten: Well, Nakamae-san, this was very, very interesting. I think you gave a very clear, and in many respects, contrarian view of Japan's interests. And I think people will be very interested in your views.

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