

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## What the Japanese Government Can Do To Prod Consumption

by Hiromichi Mutoh, Japan Center for Economic Research

“Why is the Japanese savings rate so high?” an economist at the Federal Reserve Bank of San Francisco asked me 15 years ago. At that time I advanced a number of theories, and finally concluded, “Japanese do not trust the government. That’s why they try to save on their own.” Then I asked him, “Why is America’s savings rate so low?” He responded, “Americans don’t trust the government either. That’s why they want to spend it quickly.”

Not much has changed since then: Japan’s savings rate is still high and that of the US not gone up.

### Explanatory factors prior to the 1980s

Professor Charles Horioka,  
Professor of Economics in Osaka

University’s Institute of Social and Economic Research, studied Japanese savings rates in the 1960s and 1980s and concluded that six factors played a determining role:

- A. *Cultural Factors*; A tradition of savings, a high degree of risk-avoidance; and possibly a desire to leave heirs an inheritance
- B. *Demographic and Socioeconomic Factors*; Long life expectancies contribute to higher savings rates as does Japan’s high percentage of self-employed people (who save more than all other occupational groups, a surge in college enrollment since World War II has meant higher education-related savings, rapid urbanization boosts savings because migrants to cities wish to buy homes
- C. *Institutional Factors*; Twice-yearly, lump-sum bonuses tend to be saved, rather than spent, a large number of banks and other savings institutions that facilitate deposits, long work hours and less leisure time tend to depress consumption and boost savings
- D. *Governmental Policy*; Japan’s tax system rewards savings and provides no deductibility for interest paid on housing and consumer loans, as is the case in the US. Moreover, agricultural subsidies extended by the government boost overall savings because farmers save more than urban dwellers
- E. *Economic Factors*; Japan’s high economic growth rate between 1950 and the early 1970s had a two-way causality on savings, the positive correlation between higher inflation (caused in part by the twin oil shocks) and savings, high rates of profit from stocks and land (before the bubble economy popped) were channeled into savings
- F. *Miscellaneous Factors*; Oddly, Japanese seem to fear the outbreak of a nuclear war less than the citizens of other countries. Horioka points to empirical evidence that suggests savings are accordingly higher in Japan because have more confidence in their long-term future

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## What the Japanese Government Can Do To Prod Consumption

### Old Explanations No Longer Relevant

But some factors identified by Professor Horioka in his well-received 1986 article no longer apply to Japan today. The sluggish economy post-1990 applied brakes to rising household incomes. A corresponding drop in asset and stock values brought about a reverse wealth effect. And, due to a demographic bulge, the ratio of those aged 65 or older suddenly expanded.

While the old explanations are no longer relevant, it is not yet clear how changing socioeconomic conditions in Japan have affected its national savings rate.

### 1997 Tax Increases And General Anxiety Push Up Savings

As shown in the accompanying table, the propensity of Japanese households to save remained stable in 1996 and 1997, but rose in 1998 by 0.7 percent. Interestingly, real household income fell from in 1997 and 1998 from the level achieved in 1996. This trend seemingly contradicts the standard income hypo-

thesis: that consumers don't react to short-term income variations.

There are two possible explanations for the spike in savings. The first is that additional taxes imposed in 1997 depressed consumption. As shown in the table, the ratio of taxes and social security for 1997 increased by 0.8 percent. But consumption dropped by only 0.6 percent, thereby enabling saving to remain the same (0.2 percent). Tellingly, in 1998, when the Japanese government shifted gears and began to cut taxes, net savings expanded.

The second explanation is related to generalized anxiety. Triggered by management failures at major financial institutions including Yamaichi Securities and the Hokkaido Takushoku Bank in November 1997, consumer confidence fell sharply. Indeed, consumption, which had declined when taxes were raised in April but just had recovered during July-

October to the 1996 level, fell sharply again in November, when corporate failures were announced. Judging from the timing, the management failures at major financial institutions heightened consumers' anxieties about the future – and contributed to the rise in the consumers' propensity to save.

Anxiety about the future was not a temporary phenomenon – savings levels in Japan remain around 28

“...the management failures at major financial institutions heightened consumers' anxieties about the future – and contributed to the rise in the consumers' propensity to save.

percent. This tendency can be explained in part culturally: Japanese are famously risk-averse. But a parallel, economic explanation is that the bankruptcies of major financial institutions shook public trust in the system of lifetime employment, thereby altering future planning for lifetime income and resulting in lower consumption and higher savings.

### Is There a Policy of Consumption Expansion?

What can the government do to boost the consumption of Japanese households? Since the bubble economy popped in 1998, households

“While the old explanations are no longer relevant, it is not yet clear how changing socioeconomic conditions in Japan have affected its national savings rate.”

have spent an increasing percentage of their income on repaying debt. Clearly, debt repayments cannot be reduced easily, even if income declines.

One way to reduction the propensity to save is to expand government spending in individual services sectors that are linked to future employment expansion, and to remove barriers to new business entrants.

Health care for senior citizens is one promising sector. Though some 2.8 million elderly Japanese required care during 2000, there were only 800,000 such spaces and only 170,000 home care assistants. Cities are particularly hard-hit –shortages can mean that elders can wait more than one year to be admitted to a public care facility. Private facilities are clearly needed and should be permitted to compete.

Another promising lies in child-care facilities – more than 35,000 children are on waiting lists for government-approved child-care facilities at present. But there are a number of barriers to private institutions seeking to fill the gap. If the competitive conditions in the child-care field were made more equal, a good many needs would be simultaneously met – private institutions would offer new child-care services,

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families would be better served, government resources would be better allocated, and private sector jobs – mostly for women – would be created. This job creation would not only boost household income but might help to allay employment anxiety.

Changing the tax code would also help. To encourage senior citizens to spend more and save less, the government should consider two reforms: (1) waiving the consumption tax for senior citizens and, (2) giving corporations that provide merchandise or services for senior citizens, including both existing and new services (health maintenance, care, senior citizen package tours, classes in computer use) a tax credit on a certain portion of their revenues.

Conservative thinking runs deep, though. According to a survey conducted by the Ministry of Public Management, Home Affairs, Post and Telecommunications, throughout the 1990s, on average, the households of unemployed senior citizens consumed 10-16 percent (about ¥280,000–¥440,000)

more than their annual disposable incomes.

Given the average financial assets of households headed by persons 65 and older is ¥25 million, it would take 56-89 years before those assets could be spent down – far surpassing even Japan's fabled longevity. Clearly, recent consumption behavior by senior citizens is too conservative.

Why do Japanese seniors continue to save so much? The most important reason historically low interest rates on savings have substantially reduced their anticipated asset income. And secondly, the goods and services that are desired by senior citizens are simply not offered.

According to a survey, “The Central Council for Saving Information, Public Opinion Survey on Household Savings and Consumption, 2000,” the primary reason that senior citizens feel “they cannot live comfortably in their old age on their pensions alone” is because “the burden on the individual for the cost

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### ALLOCATION OF HOUSEHOLD INCOME OF THE JAPANESE WORKERS' HOUSEHOLD (%)

| YEAR | RATE OF CHANGE       |                            | RATIO TO HOUSEHOLD INCOME            |                         |                |         |                         | PROPENSITY TO SAVE |
|------|----------------------|----------------------------|--------------------------------------|-------------------------|----------------|---------|-------------------------|--------------------|
|      | CONSUMER PRICE INDEX | HOUSEHOLD INCOME (NOMINAL) | TAX AND SOCIAL SECURITY CONTRIBUTION | CONSUMPTION EXPENDITURE |                | SAVINGS | (NET DECREASE IN DEBTS) |                    |
|      |                      |                            |                                      | TOTAL                   | (NECESSITIES)* | TOTAL   |                         |                    |
| 1985 | 2.0                  | 4.9                        | 16.0                                 | 65.1                    | (26.4)         | 18.9    | (4.2)                   | 22.5               |
| 1990 | 3.1                  | 5.2                        | 15.6                                 | 63.6                    | (24.5)         | 20.9    | (4.5)                   | 24.7               |
| 1995 | -0.1                 | 0.6                        | 15.5                                 | 61.3                    | (24.2)         | 23.2    | (4.0)                   | 27.5               |
| 1996 | 0.1                  | 1.5                        | 15.7                                 | 60.7                    | (24.2)         | 23.6    | (3.7)                   | 28.0               |
| 1997 | 1.8                  | 2.7                        | 16.5                                 | 60.1                    | (24.2)         | 23.4    | (5.1)                   | 28.0               |
| 1998 | 0.6                  | -1.1                       | 15.8                                 | 60.0                    | (24.2)         | 24.2    | (5.8)                   | 28.7               |
| 1999 | -0.3                 | -2.4                       | 15.8                                 | 60.2                    | (24.7)         | 24.0    | (5.3)                   | 28.5               |
| 2000 | -0.7                 | -2.4                       | 15.7                                 | 60.8                    | (24.8)         | 23.5    | (5.6)                   | 27.9               |
| 2001 | -0.9                 | -1.7                       | 15.7                                 | 60.6                    | (25.2)         | 23.5    | (4.7)                   | 27.9               |

Note: \*Expenditure for necessities includes: food; housing; fuel; light and water charges; medical care; communication.

Source: Calculation based on Ministry of Public Management, Home Affairs, Post and Telecommunications, *Annual Report on the Family Income and Expenditure Survey*

of medical treatment and care will be increased." A second reason is their belief that "costs due to inflation and other factors will rise."

#### Policy Proposals

The promotion of new goods and services for senior citizens would contribute to the reduction of the medical treatment/care burden. Additionally, a waiver of the consumption tax for senior citizens will help lower their future living expenses. Although it is difficult to predict how much policies would increase

actual consumption, the goal would be to return the unemployed senior citizen household to the average level (=125.0 percent) that prevailed between 1986 and 1988. To realize this goal, consumption expenditures would have to increase to a level approximately 10 percent above current disposable income (¥265 thousand per household per year).

In 2000, some 6.15 million Japanese households depended on pensions and annuities for their sole incomes. Therefore, the expected consumption increment will be

¥1.63 trillion (0.57 percent of the nation's household consumption expenditures and 0.32 percent of the GNP). This may not reverse the business climate altogether, but it would go far in reversing the present negative trend. ■

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# Preferential Trade Arrangements, Asia, and the World Trading System

by Claude Barfield, American Enterprise Institute

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Three years ago, Japan and South Korea embarked on an historic course of action by advancing the possibility of negotiating a series of bilateral, subregional, and regional trade agreements with other nations, particularly with each other and with other nations in Asia. Previously, both nations had limited their trade objectives to membership in the multilateral system of the GATT and WTO, though trade experts in each nation had at times called for special bilateral relations with the United States.

This shift in trade policy has produced a wave of proposals over the past several years for various bilateral and subregional combinations, including Free Trade Agreements (FTAs) between Japan and Singapore, Mexico, Chile and Canada; and between South Korea and Chile, Mexico and Canada. China has further stirred the pot with proposals for new agreements with the ASEAN countries and with Japan and Korea. And finally, the United States has continued on a path, beginning with its agreements with Canada and then NAFTA, most recently Jordan, Chile and Singapore—as well as pushing ahead with the ambitious Free

Trade of the Americas Agreement (FTAA).

The renewed impetus for Asian-American FTAs, combined with equally strong movements centered around the European Union, has raised again the economic and political debate over the virtues and dangers of bilateral and regional preferential trade agreements and whether they are “building blocks” or “stumbling blocks” in achieving global free trade. There is no clear answer to this puzzle.

So-called “free trade agreements” short of full multilateral concessions do result in discrimination between members and nonmembers and, as economists have frequently pointed out, produce both trade creation and trade diversion. Trade creation results from a lowering of barriers between the members of bilateral, subregional and regional agreements. Trade diversion occurs when exports from the more efficient sectors of a country outside the agreement are “diverted” merely because of lower tariff rates. This distorts international competition and may reduce world economic welfare. Judging such agreements from the multilateral perspective of the WTO depends in part on whether the trade creation effects outweigh the trade diversion effects.

There are also other considerations and factors to assess. For instance, one danger comes from the possibility that nonmembers of FTAs may be provoked to take retaliatory measures by raising tariff barriers or creating trade diverting agreements with other nonmembers. The key question is whether incentives to consolidate smaller FTAs into larger FTAs and ultimately move to a global FTA is greater than counter-incentives to block new entrants or the amalgamation of FTAs by interest groups that oppose the increased competition. Recent studies have suggested that incentives blocking the expansion of FTAs, such as NAFTA and EU-centered bilaterals, are likely to outweigh a movement toward global free trade for the foreseeable future—without some changes in WTO rules and new guidelines.

A stalemate that produced a proliferation of small FTAs with little movement toward consolidation has other downsides. In the first place, it would result in an enormously fragmented and complicated trading system—just imagine a world of dozens of FTAs, each with its own interim timetables, tariff levels and nontariff barrier liberalization rules—and the huge costs to multinationals such as IBM, Siemens or

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Toyoda of sorting out trade rules for each trade grouping. The distinguished international trade economist, Jagdish Bhagwati, has labeled this unfortunate phenomenon, the “spaghetti bowl” effect.

Another problem is how to accommodate so-called Rules of Origin (ROOs), negotiated domestic content requirements with FTAs. In NAFTA, for example, there are over 200 pages devoted to ROOs, and this will be multiplied many times in a world of numerous overlapping FTAs.

Finally, some critics of FTAs have predicted—and recent history has proven them correct—that members of FTAs would discriminate against nonmembers when imposing trade remedies such as antidumping and safeguards rules. Indeed, in imposing the recent Section 201 steel safeguards action, the US loudly stated that it had excluded Canada and Mexico from high steel tariffs on the basis of their membership in NAFTA—a policy that is contrary to the WTO founding principle of non-discrimination. And as a part of the upcoming FTAA negotiations, a number of South American countries have already made it clear that exclusion from U.S. antidumping laws is a central goal.

### **Bilateral, Subregional and Regional Trade Agreements and the Doha Round**

Because of the very real dangers presented by a world of static and numerous preferential trade agreements, the newly launched Doha Round of WTO negotiations should be utilized as a vehicle for major reform of the rules governing bilateral, subregional and regional agreements.

From its foundation, the General Agreement on Trade and Tariffs (GATT) not only accommodated bilateral and plurilateral agreements, but provided rules by which they should be governed (Article XXIV). Unfortunately, during the Cold War in the 1950s, these rules were violated so that Europe could build a new economy based upon bilateral and regional discrimination against outside nations. The time has come, however, to rethink and reformulate rules for FTAs—and to enforce the sensible rules on the books that have been ignored for four decades.

Currently, WTO provide for two restrictions on FTAs: one, that they operate across-the-board and not exclude major sectors of the economy; and two, that on the whole, tariffs with other nations outside the proposed FTA not be higher than they were prior to the conclusion of the agreement. Because of the huge

measurement and definitional problems, the second rule will always be difficult to enforce—particularly now that nontariff barriers in services and intellectual property would have to be somehow incorporated in the trade restriction formula. The first rule, however, mandating that no major sectors be excluded from FTAs is much more clearcut and will be essential to enforce given the contemplated structure of a number of Asian bilateral and subregional agreements.

Specifically, both Japan and South Korea plan largely to exclude agriculture from the FTAs they are proposing. Neither wants to expose its weak and uncompetitive agriculture sector to international competition. While the United States and other nations should not oppose Asian FTAs as a general rule, they should move vigorously to force Japan and South Korea—and other WTO members—to include all sectors in any proposed bilateral or plurilateral agreements. Such action could be taken first in conjunction with the WTO Dispute Settlement System and followed up by more detailed negotiations on FTAs during the course of the Doha Round.

In addition, several new restrictions should be considered in order to tie FTAs more closely with the global free trade goals of the WTO.

First, the WTO should prescribe that for future FTAs, the member nations agree that they will adopt the lowest tariff and the most liberal trade and investment rule as the baseline for the agreement. This would mean that in no instance would other WTO members face increased trade barriers as a result of bilateral, sub-regional or regional agreements.

Second, there should be a new rule that dictates that, after a certain period (somewhere between five and ten years), the terms of the FTAs would be opened up on an MFN basis to all members of the WTO.

Third, nations entering into FTAs should be obligated to submit to full surveillance by the new WTO Trade Policy Review Mechanism. The WTO should have the authority to monitor and trace evolving trade patterns by sector and by industry before and after the agreement is signed. In this manner, it could assess the amount of trade diversion and issue rulings dictating changes in the framework of the FTA in question or compensation for injured parties.

Fourth, Article XXIV should be amended to include a mandate that all FTAs be open to any other members of the WTO should they apply. This principle of “open regionalism” would become an indispensable tool in thwarting the creation of prefer-

ential trade blocs and in encouraging what trade economist Richard Baldwin has called the “domino theory” of regionalism—that is, increasing the pressure for countries outside of FTAs to take steps to secure membership in one—or more!—regional arrangements and thus providing momentum for a future global free trade arrangement. “If these reforms to Article XXIV are put in place, they will go far to ensure that FTAs become “building blocks” rather than “stumbling blocks” on the road to global free trade and competition.”

**TABLE** Asian and Pacific Bilateral and Subregional Trade Arrangements

**1. Transpacific cross-regional free trade arrangements**

**a. NAFTA-Related**

- Singapore-United States
- Japan-Mexico
- South Korea-Mexico
- Singapore-Mexico
- Japan-Canada
- Singapore-Canada
- Pacific Five (Australia, Chile, New Zealand, Singapore and the United States)

**b. Chile-Focused**

- South Korea-Chile
- Singapore-Chile
- Japan-Chile
- New Zealand-Chile

**2. Western Pacific Integration**

**a. Northeast Asia**

- Japan-South Korea
- Japan-Korea-China

**b. Southeast Asia**

- China-ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam)
- ASEAN-New Zealand
- Australia

**c. Western Pacific Bilateral Arrangements**

- Singapore-Japan
- Singapore-New Zealand
- Singapore-Australia
- South Korea-Australia
- South Korea-New Zealand
- Hong Kong-New Zealand

**Source:** Modified version, Table: Robert Scollay and John P. Gilbert, *New Trading Arrangement in the Asia Pacific*, Washington, D.C., Institute for International Economics, 2001, p. 20). ■

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### **"President Bush's Visit to Japan"**

Brian Mohler, U.S. Department of State, February 28, 2002

President Bush's state trip to Japan in February further cemented the "great and enduring" bilateral alliance which is based on "common interests, common responsibilities, and common values," said Brian Mohler, the State Department's Director of the Office for Japanese Affairs. During his two day visit in Tokyo, the President met with Prime Minister Koizumi and other Japanese officials and was the third U.S. Chief Executive to address the Japanese Diet. President and Mrs. Bush also had an audience with the Emperor and the Empress.

"The bonds of friendship and trust" were never more evident than right after the terrible events of September 11th. Prime Minister Koizumi was one of the first leaders to extend condolences after the attacks, which Japan quickly followed with a seven-point Action Plan against terrorism.

Japan has made "vital contributions" in the global war on terrorism, Mohler explained, by working with the US to find and disrupt terrorist cells, shutting down the financial networks that channel money to global terrorists, and providing logistical military support.

Japan has also extended generous support to the refugees of

Afghanistan, Pakistan and elsewhere, and is helping to rebuild a liberated Afghanistan, Mohler said. The Tokyo conference yielded \$4.5 billion for Afghan reconstruction work over the next 2 and 1/2 years—of this, Tokyo pledged \$500 million.

Washington and Tokyo share a vision for the future of the Asia-Pacific region. Both are committed to seeking a peaceful region, which is free of missile proliferation and weapons of mass destruction, in which no power, or coalition of powers, can endanger security or the freedom of other nations. And the US and Japan support a stable and prosperous China which is at peace with its neighbors.

During his February trip to Japan, Mohler said that Bush expressed "confidence that Japan's greatest era lies ahead." Having had four face-to-face meetings with Koizumi, Bush believes the Prime Minister is putting Japan on the path to reform—that Koizumi is a leader of "energy and determination" and is "confident in his economic leadership and confident in his strategy."

Indeed, Bush reassured Koizumi, the US also had its share of economic challenges in the late 1970s and early 1980s—weak US competitiveness, faltering banks, high taxes and needless regulation discouraged risk-taking and strangled innovation.

But during periods of crisis and stagnation, Mohler said, the US has learned that it is better to move forward boldly with reform and restructuring than it is to wait, hoping old practices will work again.

Japan's proud history of moving forward—not through revolutions, but through restorations—will help greatly in its work ahead to defend freedom, advance development, produce reform, and enhance its alliance and friendship with the United States. ■

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