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## THE LONG GOODBYE: JAPAN'S UNSOLVABLE PROBLEM

The gloomy conclusion reached in 2002 when we wrote "The Death of Birth" suffered from over optimism. In that article we concluded that Japan's unsolvable problem is demographic not economic. Its disastrously low fertility rate of 1.3 meant that Japan would run out of workers just as more than a third of its population exceeded 65 years of age. This spelled trouble for Japanese national debt and its unfunded retirement system. Both require a growing work force not a shrinking one, and Japan's zero immigration policy means that it cannot import younger foreign workers. Now returning from our first trip to Japan and fourth to Asia, we realize that our original economic and demographic analyses were too academic to grasp the truly human dimension of Japan's tragedy.

The statistics remain gloomy, but our visit caused them to show up in a very real way. For example, Japanese hotel maids are old where in the rest of Asia these are jobs for younger workers. Shop clerks, waiters and hotel staff are unfriendly and unhelpful, compared to elsewhere in Asia where they are gracious and eager to please. The tour guide in Tokyo is most proud of the Japanese copy of the Eiffel tower, built in 1958. This is less than impressive considering it came 80 years after Gustave Eiffel awed the world with his marvel of engineering. Japan's most recent engineering feat, the bullet train, was built way back in 1964 by a German company. We found no pride in any current accom-

plishments. The country remains unfriendly to children. For example, in Tokyo there are more dogs than children under the age of 15. The Japanese are obsessed by germs, wearing surgical masks in the street and using tissues to push elevator buttons and open doors. There is lots of bowing, but one had the impression this is only to avoid handshaking.

This bad mood, a sort of Parisian arrogance, is understandable. The population is old, the oldest in the world with a median age of 40. In the next twenty years this will increase to 50, meaning every year the median age will increase by six months. In just twenty years one third of the population will be 65 or older. Japan's suicide rate, at 24.1 per every 100,000 people, is the highest in the world and doubles both the U.S. and Canadian rates. Additionally, there are over a million "homeboys" living in Japan. These are men in their twenties and thirties who, after having given up looking for work, opt to stay home in their parents houses playing video games and surfing the internet. One might view Japan's highest longevity rate in the world as a bright spot. However, this coupled with its far below replacement rate birth rate, produces a population pyramid balanced on its point. It is obviously unsustainable.

Retirement systems work because they are intergenerational transfers – a sort of legalized "chain letter." Retirees trade assets to current workers for a fraction of their output or taxes transfer a fraction of current workers output to retirees. This chain letter only works as

long as there are substantially more workers than retirees. The chain has broken in Japan. The Japanese retirement age is 65. In the 1950s, when their defined benefit retirement system was put in place, the life expectancy was 64. This meant that only half the people would live to retirement. Currently the life expectancy is 82, the highest in the world, and expected to rise to 88.

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### SPECIAL POINTS OF INTEREST:

- *The Japanese birth rate remains alarmingly low.*
- *Japan's population is old, the oldest in the world with a median age of 40.*
- *Japan's high longevity rate coupled with its low birth rate produces an unsustainable population pyramid.*
- *In just twenty years one third of Japan's population will be 65 or older.*
- *Japan's "chain letter" retirement system has broken.*
- *Japan's persistent trade surplus is not a virtue but the flip side of a capital account surplus.*
- *Japan is exporting capital because it can not import workers.*
- *Better economic policies will be too late to close Japan's birth deficit.*
- *The U.S. birth rate exceeds its replacement rate, and it imports both capital and labor.*

Japan runs a persistent and large trade surplus. Warren Buffet argues this is evidence of a strong and healthy economy. This is wrong. For any country to run a trade balance surplus is must run a capital account deficit. This means that Japan is a net exporter of capital. Japan Inc. is in fact dis-investing and exporting capital to the rest of the world. This is the same as a steel company that does not reinvest in its aging steel mills. It in effect is selling its assets off through the income statement. For Japan, this is a rational economic response given that it can not import labor. It must export capital to countries where the after-tax, ex-ante returns on capital are higher. A persistent trade balance surplus is not a virtue; it is a verdict on Japan's

bleak future.

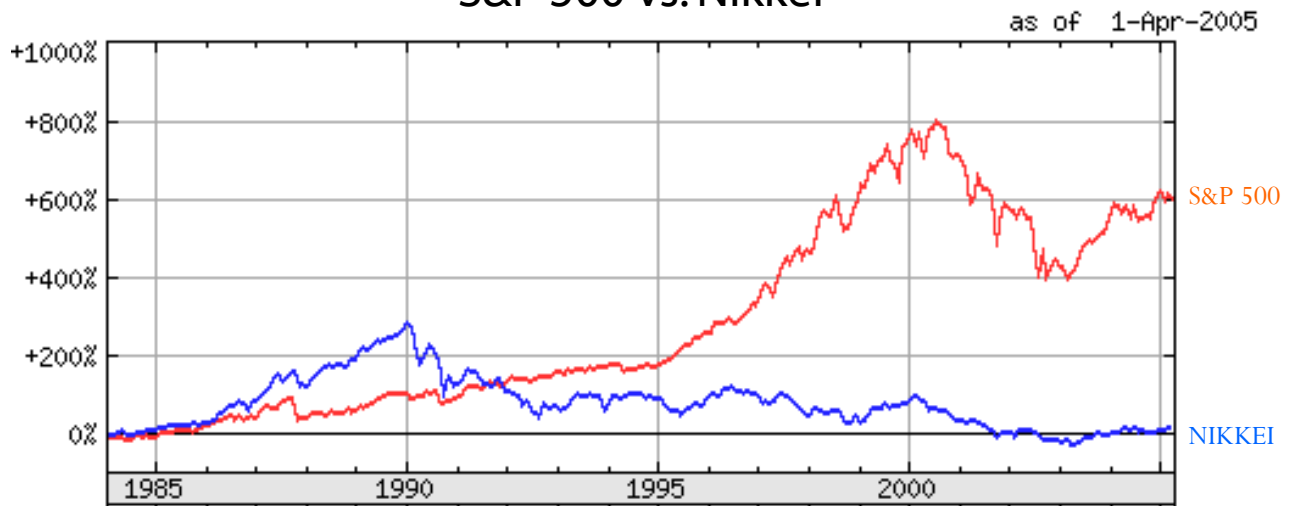
One solution to Japan's problem could be to change its economics. Japan has suffered from poor economic policies since the very late 1980s. Clearly it is possible to reverse these policies by lowering marginal tax rates, adopting a non-deflationary monetary policy, changing the national retirement system to a defined-contribution type, and substantially raising the retirement age. However, it is too late. The Japanese birth rate has been below the replacement rate for more than thirty years, and the birth deficit can not be closed. If Japanese families suddenly started having children, it would take eighteen years to increase the work force, while worsening the de-

pendency ratio in the mean time.

The U.S., by contrast, has a birth rate exceeding its replacement rate, is importing capital through its trade balance deficit/capital account surplus, and is importing foreign workers. The U.S. is the destination of choice for both foreign capital and immigrants. Its economic policies are good and getting better, and it is more than likely to transform its Social Security system into an asset-based, defined-contribution type.

The real competition between countries is over capital inflows not product exports. The U.S. is the place to invest, not in spite of our trade balance deficit/capital account surplus, but because of it.

### S&P 500 vs. Nikkei



**Japans stock market signals a bleak future. We are convinced the blame is not merely on Japan's poor economic policies, but on its unsolvable demographics. The Nikkei index is down two thirds from its 1990 peak, while the S&P 500 is up 500% from that same time.**