Longer-term Prospects for Japanese Economy

Conditions for Another Leap

By Masahiro KURODA

Japan's Present Economic Situation

IN the early 1980s, the Japanese economy's performance was excellent enough to prompt some people to predict Japan would lead the 21st century. After the 1985 Plaza Agreement, however, prices of land and other assets in Japan skyrocketed in the wake of a surge in the yen's value against other major currencies induced by industrial nations' concerted foreign exchange market interventions based on the accord and the Bank of Japan's easing of credit controls for expansion of domestic demand. Entering the early 1990s, the Japanese economy followed a downward path due to the burst of land and other asset bubbles, prolonged disposal of nonperforming loans and a long-lasting deflationary trend.

Who could have predicted in the early 1980s such economic stagnation that is described as "the lost 10 to 15 years"? Saddled with a monetary environment of ultra-low interest rates and a huge budget deficit, the Japanese economy has yet to be confident of reversing deflation. Rather, the US subprime mortgage crisis has raised concern over further deterioration of Japan's economic environment.

In December 2007, the government released revised data on gross domestic product (GDP) in and before 2006. *Table 1* shows the GDP growth trend in and after 1996. Real GDP growth was at 0.2% in 2001, 0.3% in 2002; 1.4% in 2003; 2.7% in 2004; 1.9% in 2005 and 2.4% in 2006, indicating a sign of slow recovery. But nominal GDP shrank 1.0% in 2001; 1.3% in 2002 and 0.2% in 2003 before growing 1.6% in 2004; 0.7% in 2005 and 1.4% in 2006. During the period, nominal growth rates remained below real ones, meaning that prices were falling in the deflationary economy.

In the meantime, the global rank of Japan's dollar-denominated per capita GDP fell from third ($36,790) in 2000 to 18th ($34,252) in 2006. The decline is attributable not only to the economic slump, but also to the yen's depreciation and the euro's rise. But the yen's drop can be taken as indicating Japan's economic decline. None can deny that the Japanese economy's global position has fallen relatively.

On March 12, 2008, the Cabinet Office released revised GDP data for the October-December quarter of 2007. Real GDP growth in the quarter accelerated from 1.3% in the previous quarter to 3.5% on an annualized basis. Nominal GDP growth remained below the real growth at an annualized 0.8% and the GDP deflator posted a 1.3% drop from a year earlier, keeping alive the reversal picture of slower nominal growth than real growth in a deflationary environment. For the whole of 2007, real growth was 2.1% against 1.3% in nominal growth. The October-December growth beat market forecasts as corporate capital investment and exports firmed despite slack household consumption in the presence of overseas causes of concern, including fast-rising oil prices and the US subprime crisis. The causes of concern may remain strong over a short term. Depending on European and US economic developments, the Japanese economy could plunge into a slump again.

Table 1 Trends of annual growth rate of GDP

Calender Year	Nominal GDP (%)	Real GDP (%)
1996	2.2	2.7
1997	2.2	1.6
1998	-2.0	-2.0
1999	-1.4	-0.1
2000	1.1	2.9
2001	-1.0	0.2
2002	-1.3	0.3
2003	-0.2	1.4
2004	1.6	2.7
2005	0.7	1.9
2006	1.4	2.4

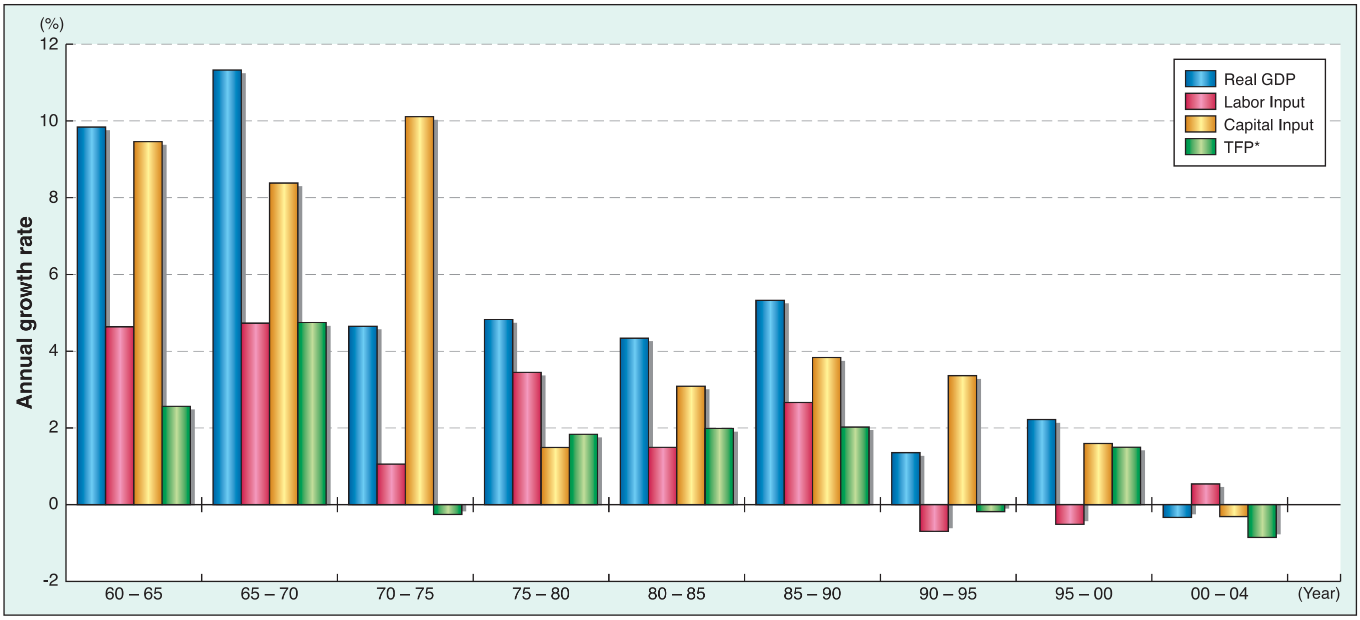
Source : *Annual report on national account statistics (December 2007), Cabinet Office*

What Happened to Japanese Economy?

In the "lost 10 to 15 years," surroundings of the Japanese economy turned around rapidly and structurally. The first is acceleration of a decline in the birthrate and aging of the population. This has not only worked to change the endowment of labor as a production factor in the labor market but also brought about major employment system reforms, including revisions to the lifetime employment system and expansion of part-time and non-regular employees. Second, the household savings ratio has declined because of the increased labor market liquidity and the slowing growth of employee income coupled with the aging of household members. On a macroeconomic basis, Japan's household savings ratio dropped from 11.4% in 1997 to 3.2% in 2006.

Third, the slack growth in employee income is reflected in a fall in labor's relative share from 74.3% in 1998 to 70.5% in 2006. Fourth, income gaps between generations and between regions have expanded in the wake of structural labor market changes and subsequent economic growth gaps between regions. Fifth, budget deficits have been expanding, increasing the possibility that bills for such deficits produced in the present generation could be passed on to future generations. Sixth, Japan's income balance surplus has exceeded its trade surplus as economic globalization has encouraged Japanese companies to step up overseas operations, boosting the inflow of profit and investment returns from abroad. Seventh, introduction of information and communications technology (ICT)

Chart 1 Factors of Japan's economic growth broken down for each 5-year period since 1960



Note : * *TFP stands for total factor productivity. Author estimated the decomposition of sources ofeconomic growth originally. Basic data depends upon the Japanese basic input-output tables.*

Source : *Annual report on national account statistics (December 2007), Cabinet Office*

has not necessarily improved productivity. With a phenomenon similar to the so-called productivity paradox continuing, the services industry's productivity remains low despite its positive ICT investment, impeding productivity improvement in the manufacturing sector and restricting betterment of Japan's international competitiveness.

Scenario for Japan's Economic Revival

In a society plagued with a labor shortage amid a shrinking and aging population, a sagging household savings ratio, swelling budget deficits and continued ultra-low interest rates, growth potential cannot be expanded without structural reforms that will increase the value added and boost productivity. *Chart 1* shows factors of Japan's economic growth broken down for each five-year period since 1960. In the 1960s, robust capital investment, a growing labor supply and rising total factor productivity (TFP) were driving economic growth. In the early 1970s, Japan experienced its first postwar stagflation caused by labor shortage-induced wage hikes and steep rises in crude oil prices stemming from the first oil crisis. This resulted in a TFP decline. The Japanese economy owed its revival in the 1980s to improved efficiency caused by a TFP rise and to expansion of overseas demand helped by the yen's depreciation.

In the second half of the 1980s and the first half of the 1990s, overseas economies proceeded with structural reforms for improved productivity and market-opening efforts amid globalization in a move to socialize ICT benefits. In the meantime, the Japanese economy was preoccupied with the pursuit of economic bubbles and exposed to a wave of economic globalization in the course of the burst of the bubbles while maintaining old uncompetitive practices, including the lifetime employment and main bank systems. These were the greatest factors behind the bubbles and their burst that led to the stagnation. The Japanese economy cannot overcome such stagnation without building an efficient industrial structure. As shown in *Chart 1,* the growth of macro-level TFP slowed in the early 1990s but recovered in the second half of the 1990s. In the 2000s, however, TFP began to decline again.

The rate of macroeconomic productivity growth is the combined total of productivity growth in all goods provided as final demand. For example, productive efficiency in the supply of automobiles to consumers covers not only the efficiency of their production but also a combination of related factors – the efficiency of production of intermediate goods (including steel sheets, semiconductors, tires and glass) in their production processes and the efficiency of services (including marketing, transportation and finance). Macro-level productivity deterioration can be considerably affected by a fall in the efficiency of various services as well as in the production of goods.

The Japanese economy is relatively good at improving the efficiency of production through manufacturing innovation. The problem is improvement of productivity in the services industry. Japan cannot improve it without increasing the efficiency of the social system or innovating social technology. Japan is now required to promote social system reforms, including financial market deregulation and liberalization, construction and transportation market deregulation, and systematization of healthcare services. JS

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