Japan's Growth Strategy, with an Emphasis on Distribution


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Introduction

The global economy is facing the risk of inflation. With active fiscal policies aimed at minimizing the economic damage caused by the pandemic until some years ago, macro policies were inflationary and the Russia-Ukraine war that began in 2022 triggered more expensive fuel raw material costs, as well as food. This cost-push inflationary pressure accelerated concerns about global inflation.

In 2025, another concern emerged, namely that the US tariffs policy would increase the prices of imported US goods and thus affect global prices. Such layered inflationary pressure could lead to continuous inflation worldwide that could result in a serious recession.

In the case of the Japanese economy, it now faces a fiscal debt that is 2.4 times as large as Japanese GDP. This is another challenge to be considered in thinking about how to cope with inflationary pressure in Japan. The Bank of Japan (BOJ) still continues to maintain low interest rates even after the Japanese economy pulled out of deflation, as it remains concerned about the possible negative impact of interest rate hikes on the economy over the long term. Another concern, however, is about the impact of such hikes on the government fiscal situation, as an increase in interest payments due to rate hikes would further fuel the fiscal debt, which could make Japan's fiscal situation unsustainable.

It can be said that Japanese monetary authorities are always under pressure to avoid high interest rates because of this fiscal concern. Even with excessive debts in its public finances, the Japanese government will still need to meet rising demand for public expenditure, such as for social welfare in an aging society or for defense to cope with geopolitical tensions. It will need to rationalize expenditure as well as enhance tax revenues to be fully prepared for the future.

The challenges we are facing are not limited to these. Another is the continuing weak yen. This could work as a driving force for inflation. Assuming that the BOJ is always under pressure to refrain from high interest rate hikes, the yen could continue to be weak over the long term and thus inflationary pressure could be permanent. Inflation weakens a currency, and this is how the Japanese economy could fall into a vicious cycle of weak yen and inflation.

Escaping from a Vicious Cycle

One way of escaping from this vicious cycle would be to raise the Japanese economy's growth potential. The Japanese economy's growth potential is currently very low, around 0.5% or even almost zero. This is very low, compared with US economic growth potential of 2.0-2.5% and the average growth potential of European nations of 1.0-1.5%.

Growth potential is the long-term trend of growth without fiscal or monetary stimulus. To achieve this, Japan would need to change its economic structure to support growth. Raising productivity by technological innovation is certainly one way to achieve it, and with it, tax revenues could be increased and the fiscal debt thus reduced. It would also help in lowering the pressure on the BOJ over raising interest rates. The central bank would have room for rate hikes to cope with inflation. With interest rate differentials between Japan and the rest of the world then shrinking, the weakening of the yen would slow down, which could reduce inflation.

Raising growth potential is therefore a key to achieving a sustainable economy and public finances simultaneously.

Raising Growth Potential

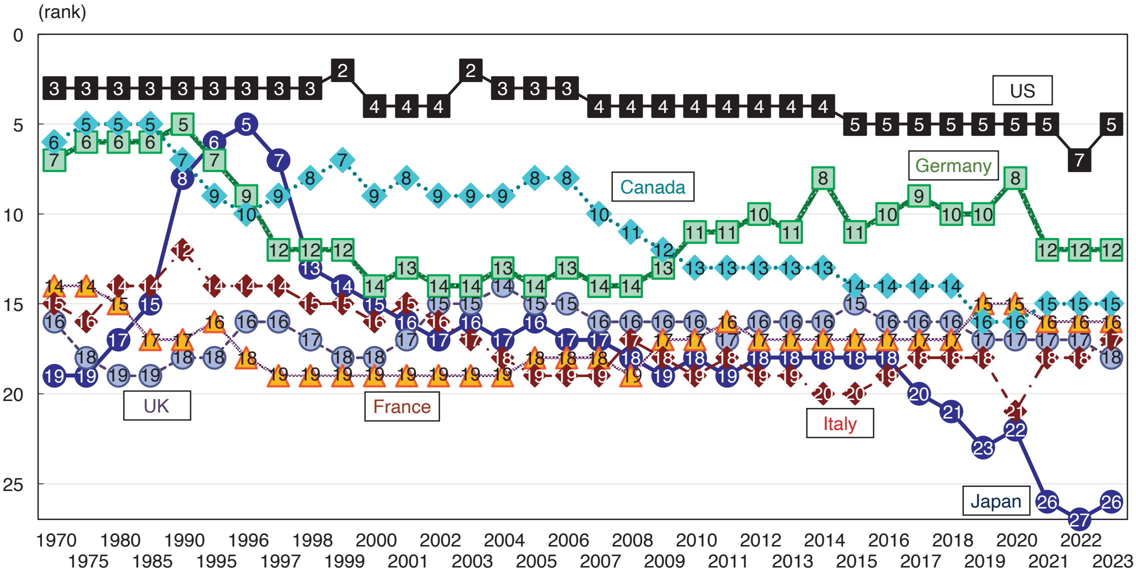
There are several ways to raise the economic growth potential of Japan. Encouraging technological innovation is certainly an obvious solution. Innovation is labor saving and thus can raise labor productivity. But it can also deprive workers of their jobs. For example, while generative AI would raise labor productivity overall, many non-skilled workers could be unemployed. Skilled workers or intellectual workers benefit from AI, as they can rationalize their work with it and raise their productivity, and accordingly their salary. Income inequality between skilled and non-skilled labor would expand. Strictly speaking, whether innovation brings us high economic growth would dependent upon which impact is bigger in the end.

Conventional economics holds that a pro-competition economic structure always favors a positive economic performance and in the end growth potential. But on this point as well, unless the government takes care of the losers in this competition through relevant policies, it is not certain that free competition will always encourage economic growth.

Creating new industries would certainly add growth potential to the economy. There will be new industries emerging in the future from new technologies with big potential such as biotechnology, nanotechnology, and big data, and new energies like hydrogen and renewal energy sources, and from AI. However, these industries

CHART

Changes of rank in labor productivity per hour among G7 countries



Source: Japan Productivity Center

born from new technologies would require several decades to fully develop. In the case of Japan, in the short term, the most promising sector with growth potential would be the service sector. Others that have not yet fully matured but have enormous potential include IT software, tourism, entertainment, and medical services and equipment. They need to meet high potential demand worldwide, but with appropriate policies could become large industrial sectors.

Another factor in raising growth potential is on the labor side. Technological innovation is obviously an important force in encouraging growth potential through improved efficiency and increases in capital and facility equipment. As mentioned, some labor-saving innovations would bring higher unemployment, putting a drag on growth potential, but structural reforms on the labor side would contribute to enhancing growth potential without such concerns. I would like to focus on two possible elements on the labor side that could contribute to growth potential.

Wage Hikes Equal to Labor Productivity Growth

According to “International Data of Labor Productivity 2024” by the Japan Productivity Center, published on Dec. 20, 2024, Japan’s labor productivity per hour was US$56.8 (5,379 yen) and this is 29th among the 38 OECD member nations. In 2022, it was 31st and so the decline in rank of the labor productivity of Japan was halted in 2024. In real terms of labor productivity growth, Japan’s was 1.2% and 9th among the OECD nations, following US labor productivity growth at 3.1%.

Meanwhile, according to the Monthly Labor Supply published by the Japanese Ministry of Health, Labor and Welfare (MHLW) in July 2025, although total salary amounts paid in cash per person corresponding to nominal wages increased by 4.1%, a rather robust increase, real wages excluding the impact of inflation decreased by 0.2%, a decline for the seventh consecutive month. The same statistical report by the MHLW in August 2025 showed that this real wage decrease expanded to 1.4%, indicating that wage increases do not catch up with rises in labor productivity. Under current inflation, nominal wage increases cannot make real wage increases positive. Nominal wage increases must be large enough to offset the inflation rate. Assuming that nominal wage hike rates do not push inflation rates further, they should be kept within labor productivity rises.

However, the Japanese nominal wage hike rate is 4.1%, whereas the labor productivity increase rate is 1.2%, according to the data above. Therefore, the nominal wage hike is contributing to an increase in the inflation rate. However, the inflation rate in Japan is now 4-5% and the real wage increase rate has turned negative. This means wages in Japan still have some room to be raised to make workers feel a little wealthier and spend more on consumption.

Meanwhile, looking at Japanese business firms’ retained profits, according to the Financial Statements Statistics of Corporations by Industry published by the Japanese Ministry of Finance in September 2025, Japanese corporations’ internal reserves totaled more than 637 trillion yen in FY 2024, the highest ever since 1948 when statistical research on corporations’ financial statements began. In spite of this good business performance, the percentage of corporate profits allocated for the wages of labor was 53.9% in FY 2024, the lowest ever since 1973. Thus, Japanese business firms in general can afford to allocate more reserves for wage increases. Incidentally, according to international data, while Japanese companies’ internal reserves are rather high, the share of labor in corporate profits is low.

Redistribution of corporate profits in favor of labor would be a good way to achieve robust economic growth. Sufficient wage hikes would encourage personal consumption, occupying the largest share of GDP, and eventually lead to economic growth.

Raising Labor Mobility to Strengthen Incentives to Work

Another factor in encouraging Japan's growth potential is labor mobility. It is generally believed that the Japanese management system of lifetime employment and seniority-based salaries and promotion is still dominant, but this is not actually the case anymore. According to the MHLW, the proportion of firms offering lifetime employment to college graduates was around 50% and those with seniority-based salaries and promotion were less than 30% in 2018. However, for permanent workers in large enterprises, both remain largely true. Until the 1980s when the young population was growing steadily, the merits of these two labor practices were enormous, since employers could incentivize workers with confirmed job security and firm prospects of salary rises and promotion. Thus, low labor mobility became a fixture in the Japanese economy, and this management system was the driving force behind high economic growth from the 1960s to the 1980s.

However, with the demographic change in Japan's aging society since the 1990s where the proportion of elderly workers has been drastically increasing, the rationale behind this management system has not been working so well, as it would no longer be beneficial for the companies, given that their labor costs could rise enormously. So most Japanese companies have been saving labor costs since the 1990s by employing large numbers of non-permanent workers at lower wages. The proportion of non-permanent workers to the total labor force is now more than 50%. But there are still many companies that maintain lifetime employment and seniority-based salary systems among their permanent workers. In an aging society and with depopulation that the Japanese economy is now facing, it is more rational for companies to adopt performance-based pay systems without lifetime employment.

At first glance, this looks good for companies and bad for workers, as lifetime employment and seniority-based salary systems can eliminate uncertainty in their professional life and job security would always be assured. But I think AI and new information technologies would pressure businesses to save more money on labor costs, in particular with less-skilled workers being replaced by AI. Non-permanent workers on low wages would be largely displaced by AI, since most of them are non-skilled. Companies would then try to keep only the skilled and intelligent workers among their permanent ones who could be in charge of the jobs not to be replaced by AI and who have deeper insights into organizational management or human resources development. Under this situation, it would be even more difficult to maintain the traditional Japanese management system. Labor would benefit as well from a performance-based pay system without lifetime employment if there were equal opportunities for retraining and capacity-building of skills in the new tech-dominated world. Labor mobility would increase and people could look for their preferred jobs with high wages. We must underline in this context that workers would need equal self-learning opportunities to improve their skills. Such a system, if successful, would raise the whole wage level and thus work in favor of increasing consumption and encouraging economic growth.

New Growth Strategy in Favor of Labor Force

So wage increases and improved labor could be a new growth strategy in Japan. Both would contribute to enhanced labor welfare. If left in its vicious cycle, as mentioned above, the Japanese economy will see a further weakening of the yen and further inflation, which would result in a continuous slowdown in economic growth and an increase of fiscal debt.

At this moment, the Japanese economy is enjoying a current account surplus mainly due to the expanded surplus in its capital balance. Japanese companies today are more involved in overseas business activities by setting up subsidiaries and factories overseas rather than in the domestic market, which is shrinking due to depopulation. Their earned profits overseas are returned to their headquarter offices, creating a surplus in the capital balance and eventually in the current balance. Even with snowballing fiscal debt, such as cumulated capital surplus or current surplus saves the nation from bankruptcy by its increasing current deficit. With twin deficits – the current deficit and the fiscal deficit – national bonds would be partly owned by foreigners and the risk of them selling their bonds if the Japanese economy worsened or fell into recession would increase, and thus the price of government bonds would fall, the long-term interest rate would skyrocket, and the national economy would plunge into a critical situation.

Japan must be prudent in preparing for future economic possibilities, and should have a long-term vision and strategy to avoid such a crisis.

Long-Term Vision & Strategy

Japan is facing uncertainty over the economy, public finances, and debt. Mitigating such uncertainty would be another way to achieve economic growth. To do this, the government must show the public how it plans to avoid an economic and fiscal catastrophe and achieve the path of sustainable growth over the long term. It must prepare some scenarios, such as structural reforms to achieve wage hikes and greater labor mobility. The Japanese public can then compare the likely outcomes of each scenario on economic growth, inflation and public debt so that they can support whichever they believe is best for the future. I think at this moment, the government needs to pay attention to the distribution aspect of the economy to achieve growth and welfare. JS

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