

The Japanese Economy in the Next Decade

By Yoshikawa Hiroshi

In the buoyant 1980's when some even suggested the idea of "Japan as Number One," who would have imagined that the 90's would be so gloomy? As it turned out Japan suffered from the decade-long stagnation during the 90's, which will surely be remembered as a historical event.

By any measure, the performance of the Japanese economy in the past 10 years was poor. The average growth rate during the period was a mere 1% as against 4% during 1975-90. In the well-cited international competitiveness ranking (World Competitiveness Yearbook) compiled by the International Institute for Management Development (IMD, Lausanne, Switzerland), Japan had kept the place of number one in the world during 1989-93, but her ranking went down to 26th in 2000. In the same year, the unemployment rate in Japan was higher than in the United States. Nobody dreamed that this would ever happen.

Both at home and abroad, observers of the Japanese economy now all seem to be pessimists, perhaps understandably. I would like to argue otherwise, however. Although the Japanese economy does indeed face serious problems, its future is not as dark as some people might think. Before we discuss the next decade of the Japanese economy, we must begin with the causes and origins of the long stagnation in the past.

The past 15 years saw an extreme surge and then a subsequent fall in stock and land prices in Japan. Thus it is natural and understandable that many economists have turned to the problem of non-performing loans (NPLs) one way or another to understand the Japanese economy during this period. However, it is actually not so clear whether a fall in asset prices and NPLs were the only causes of the decade-long stagnation. A credit crunch certainly occurred during 1997-98, and it was the major cause of

the -1.1% growth of real gross domestic product (GDP) that year, the worst record in postwar Japan. (Table 1) There is no denying that a fall in asset prices and NPLs are still the major problem in Japan. However, they are far from the whole story. What is most important is that they are not really the fundamental cause of the decade-long stagnation. When considering Japan's future, we must approach the problem from a different angle.

The Lost Decade

The long stagnation cannot really be explained by a single factor. NPLs, mistakes in fiscal policy, particularly in 1997 and changes in the labor market, all contributed to this historical event. Unprecedentedly depressed consumption is also the major problem since by sharing 60% of GDP, it is by far the most important factor determining economic growth. Consumption is depressed because of the heightened risk and uncertainty facing consumers.

It is well known that the unemployment rate in Japan had been very low by international standards. Even during the 1980's when the unemployment rate reached 10% in many European Union (EU) countries, the figure in Japan was only 2%. The low unemployment rate traditionally contributed to the stability of Japanese society. The deep recession during the 1990's, however, has thoroughly changed the structure of the Japanese labor market. Most important, with the slogan of "restructuring," firms are now ready to discharge workers. In the autumn of

Table 1 Real GDP Growth Rates in Major Countries

| | Japan | U.S.A. | Germany | U.K. | France |
|------|-------|--------|---------|------|--------|
| 1997 | 1.8 | 4.4 | 1.4 | 3.4 | 1.9 |
| 1998 | ▲1.1 | 4.3 | 2.0 | 3.0 | 3.5 |
| 1999 | 0.8 | 4.1 | 1.8 | 2.1 | 3.0 |
| 2000 | 1.5 | 4.1 | 3.0 | 2.9 | 3.4 |

Sources: Materials from the Cabinet Office including "'Flash' Estimates of Quarterly GDP: Time Series Table" and "Overseas Economic Data"

Notes: 1) Seasonally adjusted annual rate from previous quarter (%)
2) The real growth of GDP in Japan is based on the level of 1995 (calendar year)

1997, huge financial institutions such as Hokkaido Takushoku Bank and Yamaichi Securities went bankrupt. These events made an unmistakable announcement that the celebrated lifetime employment in Japan was over. It is understandable that job insecurity depressed consumption. Unfortunately, labor market conditions kept worsening through 2001, and the unemployment rate reached 5.5% by the end of last year. Currently, to secure employment, the idea of "work sharing" is being seriously discussed.

The uncertainty surrounding the public pension and medical insurance programs also depresses consumption, particularly among the elderly. People aged 65 and older in Japan, on average, hold ¥20 million worth of financial assets as against the ¥7 million held by their counterparts in the United States. Still, uncertainty motivates the old to keep making precautionary savings for the future!

In the face of a deep recession, what can and should the Japanese government do? The traditional answer is monetary and fiscal policies. Throughout the 1990's, the Bank of

Japan has indeed pursued an easy monetary policy to its limit, namely the zero interest rate. However, corporate investment which has great effects on the economy has only feebly revived. The problem of NPLs is one reason. The "structural" problem facing the Japanese economy is another. Here I will not go into the problems surrounding the efficacy of monetary policy. Rather, I would like to discuss fiscal policy in detail since it is more directly related to the problem of Japan's future.

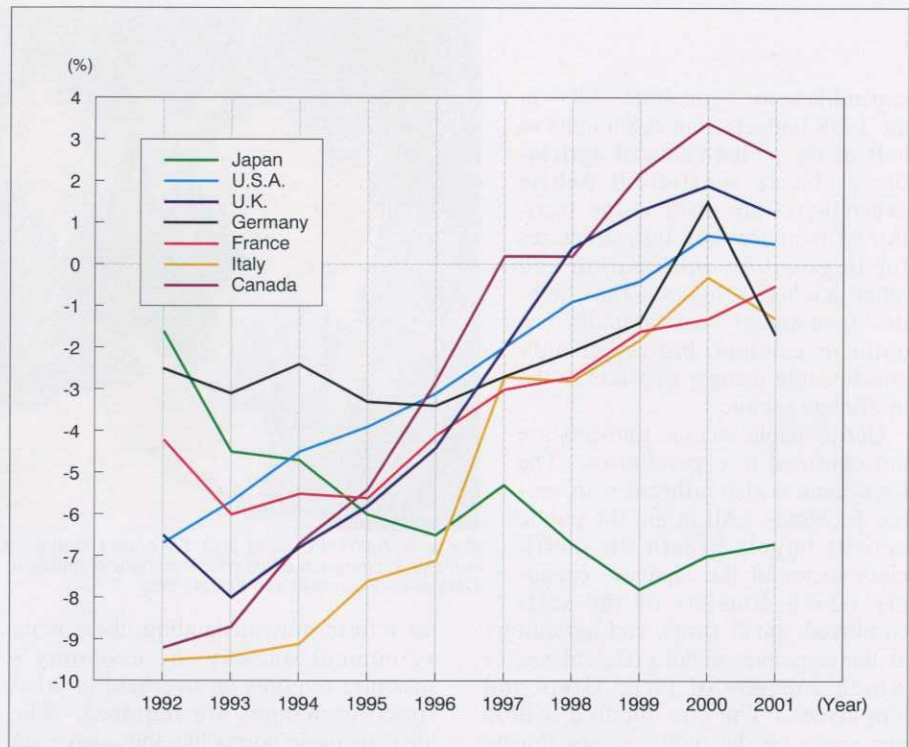
The Problem of Fiscal Policy

Fiscal policy symbolizes the problem of today's Japan. Fiscal policy in the 1990's was very different from the 1980's. Throughout the 1980's, the single objective of the Ministry of Finance (MOF) was to balance the budget. Thanks to an increase in tax revenues during the economic bubble, the MOF's goal had been basically achieved by 1990. As of 1990, the deficit/GDP ratio of Japan was the lowest among the member countries of the Organization for Economic Cooperation and Development (OECD). Given today's figures, it is actually hard to believe the picture only 10 years ago.

As the recession deepened from 1992, an expansionary fiscal policy was called for, and with it deficits mushroomed. The amount of public debt is now expected to reach ¥700 trillion, which is 140% of GDP, and the deficit/GDP ratio exceeds 8% of GDP. The monotonous worsening of Japan's budgetary position during the 1990's is indeed in sharp contrast to the trend observed for other OECD countries. If Japan were in Europe, she would not be able to meet the Maastricht requirements, and could not join the EU! (Figure 1)

With such high costs, how do we assess fiscal policy during the 1990's? Some say that it was a simple failure because it did not produce any sustained growth. Although one can reasonably argue that fiscal expansion saved Japan from a great depression, it

Figure 1 National and Local Fiscal Balances (on the basis of the System of National Accounts)



Source: OECD, *Economic Outlook* (No. 69, August 2001)

Note: Value excluding the social security fund, which may become a future real debt in Japan and the United States, where the pension system is based on the revised accumulation method

is also true that it did not produce sustained economic growth.

Naturally, the pessimism prevailed about fiscal policy. The pessimism does not only stem from the current size of debts and deficits, but it also stems from mounting doubt about the efficiency and justice behind these deficits. In every economy, the public finance involves transfers of income among households and firms. Transfers of income are, in fact, one of the major purposes of public finance and, therefore, in itself, there is nothing wrong with this. There is a broad consensus among the Japanese, however, that aside from the size of debts and deficits, there is a serious problem about the current situation of public finance in Japan. As I pointed out earlier, risk and uncertainty concerning the future of public finance are now depressing consumption.

To understand the problems which Japan faces, and also to consider Japan's future, one can usefully visualize the Japanese economy as a two-sector economy: one consisting of a highly

efficient manufacturing sector, and the other consisting of inefficient small firms and the self-employed, particularly in the non-manufacturing sector, including agriculture. The political system in Japan allows significant income transfers from the former to the latter through both public expenditures and taxes and other social security contributions.

Some of the public expenditures are believed to be so inefficient as to be almost equivalent to "digging holes." Their only purpose appears to be sustaining inefficient firms. The construction industry is a symbolic case. Orders of public investment, which exceeds ¥30 trillion or 6% of GDP, are required by legislation to be made to small firms on quota. Many small firms which receive orders pass them on to larger firms. In 1985, for example, there were 520 thousand construction firms, 99.9% of which were very small. Out of 520 thousand, only 250 thousand firms were actually engaged in any construction at all! Another example is agriculture. The public

Photo: The Mainichi Newspapers



Koizumi Jun'ichiro (left) and Takenaka Heizo, state minister in charge of economic and financial policy, at the Council on Economic and Fiscal Policy

expenditure for agriculture (4.2% in the 1999 budget) almost amounts to half of the added-value of agriculture. These inefficient public expenditures are made at the sacrifice of the necessary infrastructures for large cities, information and other new technologies. Thus, public "investment" was actually not quite investment, but rather only questionable income transfers to the inefficient sector.

Questionable income transfers are not confined to expenditures. The tax system is also inflicted with serious problems. All in all, the public deficits largely benefit the inefficient sector of the Japanese economy which consists of the self-employed, small firms, and agriculture at the expense of the efficient sector which consists of large firms and employees. The one hundred trillion yen spent by the public sector during the 1990s hardly contributed to the necessary infrastructures, and therefore contributed very little to raising profitability in the private sector. Japan needs fundamental reform.

The Future

Amid the pessimism, the administration of Prime Minister Koizumi Jun'ichiro, which has raised a reform banner aloft, was inaugurated with overwhelming support from the public last April. The motto of the new administration might be stated as "No economic recovery without structural reform."

Actually almost everybody with an interest in the Japanese economy today shares the view that structural reform is necessary. The opposition parties are no less vehement than the ruling parties in their calls for the economy's restructuring. At the Bank of Japan as well, where the effective zero-interest-rate policy was reinstated last March, the need for structural reform is keenly appreciated. The term structural reform crops up repeatedly in commentaries in newspapers and in analyses by economists.

This national consensus on the need

for reform notwithstanding, there is no agreement on why the economy's structure requires an overhaul or what specific changes are required. The ideas on basic points like these have yet to be sufficiently thrashed out. There are those who say that achieving structural reform means eradicating the mountain of NPLs, which will translate into more bankruptcies and unemployment, but this line of reasoning misses the mark.

To understand why the economy and the broader social framework are in need of restructuring, it may be helpful to compare the situation Japan faces today to the time when railroads were introduced to a society that had been using the horse and carriage as its principal means of transport. It might be expected that disorientation would become widespread, but on viewing the big picture, should people have seen it as a bright one or become alarmed by its dark aspects? Surely readers will agree that brightness is what people ought to have basically perceived in the situation.

This is not to say that there were no problems. When trains came into use, livery stables were driven out of business, and related industries such as carriage manufacturing went into decline. But trains provided a far more efficient means of transport than carriages, and they brought with them virtually unlimited business opportunities, which

reformed the economy and society. The pains involved were all on the microeconomic level; there were only gains macroeconomically. In his Nobel Prize address on the origins of economic growth, Sir John R. Hicks attributed the economic development of the 19th century, which at the time was unprecedented in human history, to the invention of the railroad.

When economies and societies were reformed by the advent of the railroad, the horse and carriage had to give way to the train as a matter of historical necessity. It was structural reform that enabled the shift from the carriage to the train to proceed smoothly and, in the process, unearthed ample new growth potential. The displacement of the livery stable was a negative aspect of the change, but fundamentally this structural reform was a forward-looking concept — one that had the goal of exploiting the growth potential that the railroad brought into being. It was akin to the "creative destruction" that Joseph A. Schumpeter has spoken of, since it involved a redistribution of the factors of production from low-productivity and low-growth sectors to high-productivity and high-growth ones.

As I explained it in detail, Japan's fiscal policy has long propped up unproductive, slow-growth industries. By writing off NPLs and carrying our structural reforms of government spending, we must get the Japanese economy off the horse-drawn carriage and onto a train. The key to the process is to set a clear course not just toward destruction but also toward creation. The essence of today's structural reform lies in connecting new technologies to the true needs of Japanese society in the 21st century.

Before we proceed to consider where the true needs lie, we need to discuss the pessimistic view of Japan's future. One very influential view focuses on a demographic trend. Japanese society is rapidly aging. The population is expected to peak in 2004 and decline by 6.8% in the next 25 years. The share of people aged 65 and older in the

total population will become one-third which is almost double the current level.

The labor force, on the other hand, is expected to decline by 0.6% per year from 2000-2025. As the labor force declines, the growth rate of the economy is bound to decline also, and anticipating this trend, Japanese companies have begun adjusting their capital stock by curbing investment. According to this view, with a declining labor force, the potential growth rate of the Japanese economy declined from 4% to 2 or 1.5%. This is the basic reason why the growth rate remained at 1% despite such expansionary fiscal and monetary policies. The 1998 *Economic Survey of Japan* of the Japanese government endorsed this view.

By facing a rapid aging and declining labor force, is the Japanese economy bound to concede a growth rate as low as 1%? We must look at the past record. What economists call "growth accounting" allows us to separate the growth rate of GDP into (1) the contribution of capital, (2) the contribution of labor and (3) technical progress or total factor productivity (TFP). When we apply this process to the Japanese economy, the result clearly shows that to account for the growth of the Japanese economy, labor is a relatively minor factor. One cannot explain the high growth during the 1960's nor the fall in the growth rate in the 70's by labor. Growth must be basically explained by capital and TFP. Beyond that, economists find that more than half of salaries/wages is a remuneration for human capital rather than "raw labor." A declining labor force means a declining number of heads, but does not necessarily mean a parallel decline in human capital. Therefore, an apparently persuasive thesis that a declining labor force necessarily lowers economic growth is, in fact, too simple.

If a declining labor force and an accompanying deceleration of the potential growth is not an answer to the question why the growth rate of the Japanese economy was so low for such a long period, then what is it? Here, we must go back to the basic theory of

growth. Standard theories all attribute economic growth to supply factors. Whether the focus is on the labor force, the savings rate or production factors used in research and development activities, the existing literature on growth all focuses on supply factors.

Although the supply factors are important for economic growth, they are not the whole story. I suggest here that "saturation of demand" is another important factor to restrain growth. In the causal discussions, the idea of "demand saturation" has been very popular. In fact, if a time series of production of any representative product such as steel and automobiles, or production in any industry is plotted against the year, one obtains a S-shaped curve. The experiences of diffusion of consumer durables such as refrigerators, television sets, cars and personal computers tell us that deceleration of growth comes mainly from saturation of demand rather than diminishing returns in technology. Growth of an individual good or an individual industry is bound to slow down because demand grows fast in the early stages but eventually its growth slows down. The celebrated Engel's law based on saturation of demand for food is merely an example.

An obvious implication of the S-shaped growth of an individual product/industry is that the economy enjoys high growth if it successfully keeps introducing new products or industries for which demand grows fast, and allocates capital to growing sectors. As I explained earlier, during the late 80's and 90's, Japan failed to allocate capital to the sectors that would command high growth of demand and high profitability. The failure to take advantage of the "IT revolution" to generate new growing sectors and services is particularly noteworthy. Policy mistakes such as a fiscal tightening in 1997 and a postponed action for solving the NPL problem certainly played an important role in causing the very poor performance of the Japanese economy of the 90's. However, the failure to turn potentially high demand for housing, infrastructure in large cities and IT-

related services in particular to effective demand is, in my view, the fundamental cause for the 1% growth during the 90's.

Thus, by way of structural reform, we must connect new technologies to the true needs of Japanese society. What will be the true demand in the future? I refer to the 2001 report of the Industrial Structure Council held at the Ministry of Economy, Trade and Industry (METI) in which I participated. It identifies the growth sectors as follows: Demand for health and care of aged people, for example, is expected to increase from ¥11.1 trillion in 2000 to ¥23.7 trillion in 2010. Likewise, demand for barrier-free housing is to increase from ¥0.2 trillion to ¥1.6 trillion in an aging society, and given the IT revolution, demand for communications will grow from ¥7.4 trillion to ¥26 trillion. Demand for a better environment is also rising. On the assumptions that these potential demands for new products and services are met, and that the risk and uncertainly facing consumers are reduced to a normal level, METI's report predicts the growth rate of the Japanese economy during 2006-10 will return to 3%.

Some economists argue that the emergence of China as an economic power will be a threat to Japan's future. Many Japanese firms have already started shifting their factories to China, and some worry about a "hollowing out" of the Japanese economy. It is true that the rise of China is a challenge, and the undervaluation of the yuan is currently a problem. China's challenge is not confined to Japan, but is common to all the industrialized countries. In spite of all the difficulties and challenges, Japan is still well endowed with good human capital which enables her to advance frontier technologies. My conclusion is that 3% growth is possible. JTI

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