

The Japanese Economy as I See It

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Photo: Kyodo News Service

From the Bubble Economy to the Heisei recession

First of all, with reference to the main economic indices, I would like to look back on the experience of the Japanese economy over the past decade, when it passed from the speculative bubble economy to the Heisei recession (figures 1 and 2). During the period of the bubble economy, which continued from November 1986 to April 1991, the main

economic indices, such as gross domestic product, Index of Industrial Production (IIP), land prices, and stock prices, generally showed a dramatic increase. The principal characteristic of this period was that asset prices, such as land and stock prices, increased rapidly, while the consumer price index and the wholesale price index remained almost stable.

However, stock prices suddenly plummeted after the Nikkei average peaked at 38,915 in December 1989. Land prices also set off on a downward trend after

peaking in September 1991, and the IIP subsequently reached a peak and began falling, too. As the indices continued to fall, the Japanese economy was visited by a major recession. This recession, dubbed the Heisei recession, lasted from April 1991 to October 1993. The principal characteristic of this period was that, although the GDP remained level, statistically speaking, the recession was fueled by the falling IIP. Land and stock prices also continued to decline, so that eventually, as a result of the Heisei recession, asset prices, which had risen so astronomically, returned to their pre-bubble level.

Background to the Heisei recession

How should this Heisei recession be understood then? Well, there is a complex web of factors in the background of this recession. Broadly speaking, there are three problems: (a) cyclical factors, (b) structural factors, and (c) Japan's growth pattern and macro resource distribution.

(1) Cyclical factors

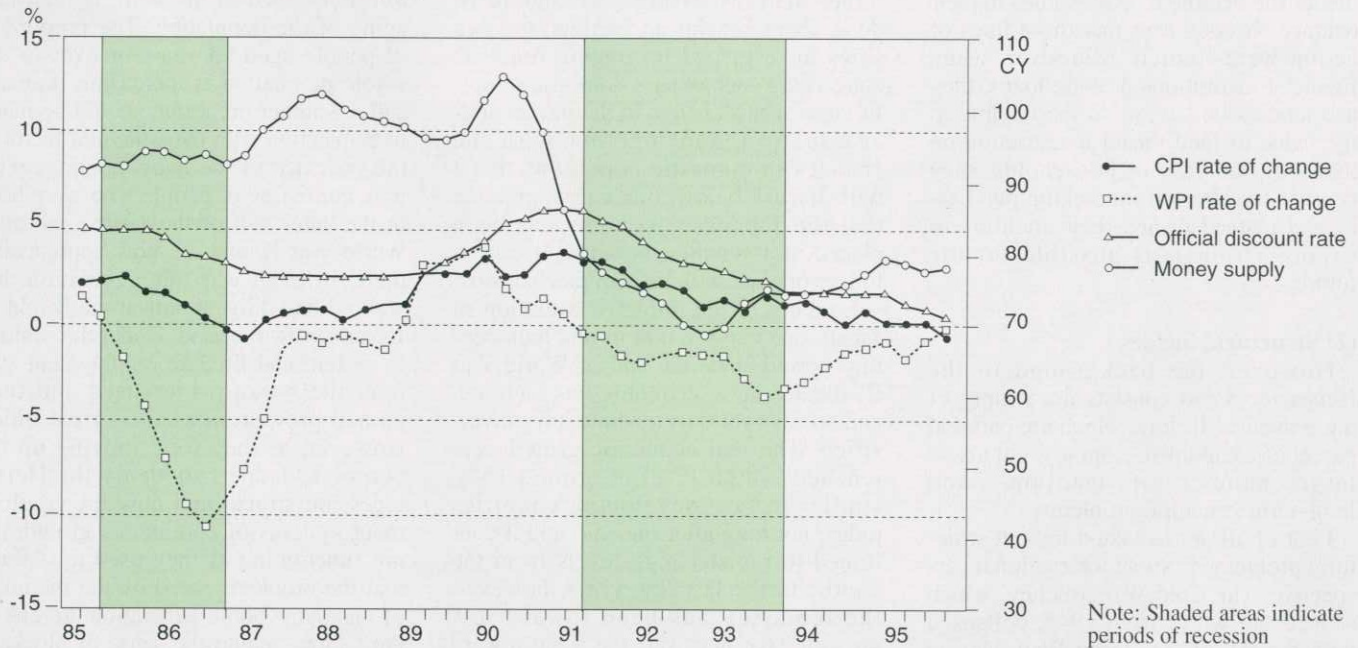
Regarding the first problem of cyclical factors, we can cite the usual stock

Figure 1 Trends in Economic Activity (1)



Note: Shaded areas indicate periods of recession

Figure 2 Trends in Economic Activity (2)



Note: Shaded areas indicate periods of recession

adjustment. From fiscal 1985 to 1990, private-sector capital investment increased at an annual rate of 10.7% in real terms, which was more than double the GDP annual growth rate of 4.6% in that period (also in real terms). Accordingly, the ratio of private-sector capital investment to GDP increased from 16.4% in fiscal 1985 to 21.8% in fiscal 1990. As a result, a glut occurred, and a gap emerged between the rapidly expanded production capacity and demand.

The cyclical factor can be cited with regard to consumption, too. The diffusion of durable consumer goods, such as automobiles and household electric appliances, advanced so that demand became saturated. In addition to this saturation, a reaction probably occurred to the "go-go" consumption of the bubble period.

Furthermore, in the wake of asset inflation, the inflated balloon suddenly withered, and asset deflation occurred. Asset deflation means a large decrease in the assets of corporations and households. In the case of corporations, they naturally keep an eye on such factors as asset values (latent) when deciding on lines of action, such as capital investment. The decline in asset values in their balance sheets meant that these lines of action were limited. Moreover, when financial institutions provide loans, they use land as collateral, so the decline in the value of land meant a restriction on loans. In the case of households, they decided to refrain from making purchases and instead turned their attention to saving as much as possible for the future.

(2) Structural factors

However, the background to the Heisei recession consists not simply of these cyclical factors, which are part and parcel of a capitalist economy, but also a large number of medium- and long-term structural problems.

First of all, let us take a look at structural problems from an international perspective. The Cold War structure, which shaped the world from 1945, collapsed with the fall of the Berlin Wall. During the Cold War period, the world became

smaller and smaller following the rapid progress in means of transport and communication, and the borderlessness and globalization of economies began. These changes can be easily understood from the agenda of the Uruguay Round of multilateral trade negotiations, which took place in the late 1980s and early 1990s. Previously, the main objective of negotiations under the General Agreement on Tariffs and Trade had been to promote free trade by doing away with so-called beachhead trade barriers, such as import restrictions and tariffs. Certainly this was also one theme in the Uruguay Round, but an even bigger theme involved the move to unify the domestic mechanisms and systems of participating countries. The question of how to coordinate the various domestic systems of participating countries became a foremost issue—for example, what should be done with intellectual property rights or regulations concerning services, and how should domestic subsidy systems be harmonized? I myself have taken part in various trade negotiations between Japan and the United States, and indeed the recent Structural Impediments Initiative talks and the Framework Talks are proof that now, rather than discussing what should be done about beachhead barriers, the two sides have turned to making requests concerning each other's domestic setups. In view of this change in the international situation, and together with the changes in domestic conditions that I will discuss below, one can appreciate that the Japanese economy has been placed in a situation in which it can no longer operate with its own mechanisms.

Looking at the domestic situation in Japan, one can see that in this half-century period since the end of World War II, the Japanese economy has matured, and social values as a whole have diversified. The real economic growth rate reached a high level of around 15%, similar to fast-developing countries today, not long after the war, and it continued to register high levels from the 1960s. In the last few years, however, the tendency has been toward low growth. That is to say, the trend toward continuous growth in Japan has slowed

down.

Japan's mechanisms and systems so far have been premised on the existence of continuous growth. In other words, the assumption has been that the economy will always continue to grow, to increase, and to expand. A typical example of this way of thinking is the land myth. Because of changes in domestic conditions during the last five decades, however, these mechanisms and systems have begun to show fatigue, and the time has come for their thorough review.

To take the financial system as an example, the setup was put together after World War II on the premise of a fund shortage. Around 15 years ago, however, there was a switch to a fund surplus, bringing into question the fundamental idea behind the system. The same is true for the labor problem. The seniority-based wage system, the lifetime employment system, and enterprise-based unions are often referred to as the three main features of Japan's labor market. These three systems are fine in a society that assumes continuous growth, but now their functions have begun to slow down.

Changes in the population structure should not be ignored as a structural factor either. First of all, there is the rapid aging of the population. The proportion of people aged 65 years or over in the whole population is increasing dramatically. Another point that should be made in connection with the structural factor is the presence of the baby-boom generation, consisting of people who were born in the latter half of the 1940s, just after World War II, and are now approaching their fifties. It was this generation that worked like diligent ants at the height of Japan's growth period. Under the seniority system and lifetime employment system, their wages increased and they gained promotion as they grew older. However, as they were moving up the corporate ladder, suddenly the Heisei recession struck, and now the employment systems of continuous growth are not functioning as they used to. I think that the problems faced by the members of this baby-boom generation are one of the factors behind the sense of blockage pervading the Japanese economy.

(3) Growth pattern

The final factor behind the Heisei recession that I would like to cite concerns Japan's growth pattern to date. This involves the problems of macro resource distribution and the investment-savings balance (figure 3). Gross national product refers to the total value of our work over a year. The results of this labor are either used for consumption or put away as savings. And then these savings are used for domestic and foreign investment. If the ratio of domestic investment to savings is small, then foreign investment and the current account surplus swell accordingly.

Now, what have been the actual ratios of savings and investment to GNP over the medium and long terms (figure 4)? Well, over the past 30 years the average ratio of savings to GNP has been very high. The ratio of the value of savings minus investment to GNP has been 1.6%. Looking at the overall trend, one can note that there has been a savings surplus in the economy since the latter half of the 1960s, but the figure has especially snowballed since the middle of 1980. Hence the current account surplus.

In summary, it can be said that the development of the Japanese economy has followed a process of high savings rates, active private-sector capital investment backed by high savings and high growth. Active capital investment raises production capacity and leads to

Figure 3 Investment-Savings Balance (Fiscal 1994 estimate)

GNP = consumption + savings			
¥482 trillion			
¥332 trillion		¥150 trillion	
Consumption		Savings	
Domestic investment			Overseas investment
Public works investment	Private-sector capital investment	Housing investment	
¥41 trillion (5-10%)	¥70 trillion (14-20%)	¥26 trillion (5-6%)	¥13 trillion (current account surplus)

increased export capacity. Accordingly, the current account chalks up a surplus. Another characteristic is that, in comparison with the high rate of savings, there is little domestic investment. Although, as explained above, private-sector capital investment has increased rapidly since the latter half of the 1980s, the share of public works investment has shrunk considerably, bringing down the general level.

Prospects and issues

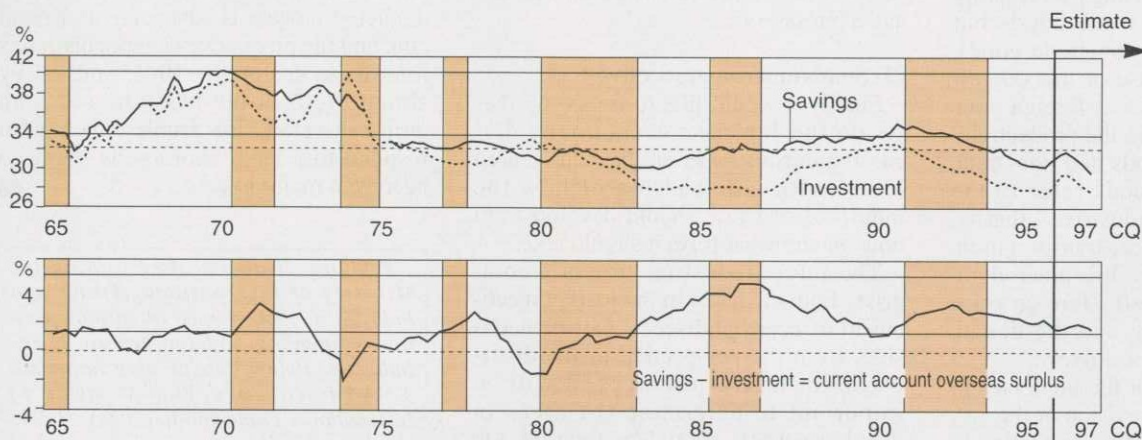
When discussing future prospects and the policy response that Japan should make from now on, it is extremely important to think about the situation systematically from three perspectives: micro, macro, and semi-macro.

Also, the economy has two sides, sup-

ply and demand. Since both sides exist symbiotically, we cannot have a proper discussion by focusing only on one side.

Furthermore, it is important to coordinate domestic policies and responses to the international community. That is to say, the world is becoming a single entity, so when considering domestic policies, we must make sure that they suit the international community. To put it another way, we must be open to the international community, and we must think about our contributions to the international community and economy. These contributions mean our contributions to the establishment of international frameworks, such as the Uruguay Round and the World Trade Organization, and our efforts to tackle the problems of the Asia-Pacific

Figure 4 Composition of Nominal GNP



- Notes: 1. Shares are nominal, quarterly, and seasonally adjusted.
 2. Savings = GNP - consumption (= private consumption + government consumption)
 3. Investment = private-sector capital investment + private-sector inventory investment + private-sector housing investment + public works investment + government inventory investment
 4. Figures are nominal average figures for the past 30 years (1965-94).
 5. Shaded areas indicate periods of recession.

Economic Cooperation (APEC) forum and also global issues, such as the environment, energy, resources, food, science and technology, information, and medical treatment.

(1) Micro perspective

The micro-level response refers to the structural problems that I described above. It is necessary to carry out a thorough revision of the systems, mechanisms and practices that have grown fatigued over this half century. "Deregulation" has recently become a buzz word in Japan, but what I would say is that rules and regulations should be not simply eliminated but thoroughly reviewed.

A related issue here is the domestic-foreign price gap. A typical example of this domestic-foreign differential is the price of land, which is still at a ridiculously high level in Japan compared with other countries, despite having fallen to a noticeable extent recently. The domestic-foreign price gap is also the difference between purchasing power parity and the exchange rate. In 1960, when I joined the Ministry of International Trade and Industry, the exchange rate was $\$1=\text{¥}360$, and purchasing power parity was $\$1=\text{¥}180-200$. Today, although the exchange rate has changed to $\$1=\text{¥}105-107$, purchasing power parity stands almost unmoved at $\$1=\text{¥}150-180$. In other words, exchange rate fluctuations lead directly to changes in the domestic-foreign price gap. The exchange rate is made up basically of trade goods, but purchasing power parity consists of not only trade goods but everything, including non-trade goods. That is to say, the cause of this domestic-foreign price gap can be seen to lie in the productivity gap between trade goods and non-trade goods. Non-trade goods refer to the non-manufacturing industries—that is, such services as finance, transportation, distribution, and energy. It is precisely in these areas that domestic-foreign price differentials are large and the debate about deregulation is most lively.

The first principle for the implementation of a fundamental revision of the various systems should be the permeation as

far as possible of the market mechanism—or, the thorough permeation of the principle of self-responsibility. The second principle should be international harmonization. Since the world is becoming a single market, systems and mechanisms must be unified to an extent. Bearing this in mind, Japan must harmonize its systems and mechanisms, for example, taxation and corporate law, as much as possible.

(2) Macro perspective

On the macro level, we must respond, as explained, through the investment-savings balance. Japan's high rate of savings should be directed to the domestic market and should be invested in areas that are relatively lagging by international standards. This will result in a reduction of the current account surplus, and a smaller surplus will avoid any sharp appreciation of the yen and alleviate trade friction.

As a result of the rapid aging of the population, it can be expected that Japan's savings rate will gradually fall from now on. Accordingly, we should direct investment to the improvement of lagging social capital now, before it is too late. It is important for us to invest, from the perspective of increasing social affluence, in housing and other areas related to urban development and living conditions (medical care and welfare in preparation for the coming aged society, environmental issues), and, from the perspective of building the foundations for future economic development, in information, education, research and development, and such infrastructure as airports, harbors and expressways.

(3) Semi-macro perspective

Finally, I would like to finish my thesis on the Japanese economy by discussing our response on the semi-macro level, with a discussion of how the industrial structure should develop from now on and what form it should take.

The future industrial structure comprises both elements in the market mechanism of needs and seeds. On the needs side, from the perspective of the distribution of macro resources, it will be important to determine the areas in which resources should be focused. On

the seeds side, technological innovations will have an important role to play, while the revision of systems and deregulation themselves will lead to the birth of new businesses. Interest in venture businesses is increasing among the nation as a whole, and the Japanese government is striving to establish an appropriate environment for the creation of new businesses. For this purpose, lively discussions are taking place concerning such issues as the establishment of a stock-option system, the expansion of the over-the-counter registration system, and the supply of venture capital.

Furthermore, since the industrial structure involves production, the question of changing the industrial structure also involves the question of how to change the labor market. In the traditional Japanese labor market, the general thing to do was to respond to changes in the framework of the internal labor market, which rested on the seniority-based wage system, lifetime employment, and enterprise-based unions. From now on, however, we will have to make use of the external labor market. For example, in order to start a venture business, it will be necessary to mobilize talented human resources. This will require not only the conventional employment system but also the double-tracking and diversification of employment. In order to make full use of the external labor market, we will have to change various mechanisms, for example, to ensure the portability of pensions. Currently, the unemployment rate stands at 3.3%, which is an extremely high level for Japan. As described above, however, the aging process is advancing at a rapid clip, and the productive-age population is forecast to decline by 10-15 million by about 2020. In the medium and long terms, therefore, the problem of how to respond to a labor shortage is going to become a major issue. ■

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