Japan: Another Economic Recovery, New Political Terrain

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Abstract

This paper reviews Japan's recent economic performance through the first half of 2005, as well as the economic implications of Koizumi's snap election. After a disappointing final 3 quarters in 2004, first quarter growth in 2005 was a strong 5.8 percent annual rate, followed by a reassuring second quarter at 3.3 percent annual rate. Slow gradual improvements across the economy can be expected to continue, but achieving sustained full employment economic growth depends on whether growth rates over the next five years are closer to 3 percent or 1 percent. The most significant improvement over the past year has been in the labor market. Unemployment dropped to 4.4 percent in July, from its 5.5 percent January 2003 peak, while total employment and employee compensation figures are on the rise. The systemic problem of bank excessive nonperforming loans has been solved. Corporate restructuring proceeds, albeit in the light of new worries over hostile takeover bids.

Despite improvement in virtually all Japan's economic indicators, most of the major concerns fundamentally persist. Aggregate demand remains inadequate; both deflation and labor market slack continue; household income growth is modest; capital is misallocated; and business borrowing continues to decrease. Koizumi's potent political victory will ensure the necessary postal privatization, although the details of implementation remain unclear. He has yet to define how he will use his public mandate to make other economic reforms, but general optimism prevails. The most difficult fiscal challenge will be to successfully navigate tax increases without inhibiting economic growth. The Bank of Japan faces two challenges: reducing the quantitative target, and proceeding to exit the current ZIRP monetary policy. Internationally, Japan must forge productive political relationships with its regional economic partners, specifically China, and continue to work towards greater East Asian economic corporation.

In summer 2004, many Japanese expressed exuberant optimism that the economy was finally well on the road to recovery and to a self-sustained, full-employment economic growth path. By late fall, that optimism had been dashed. The economy had abruptly stalled, with three quarters of no growth. The 2.6 percent GDP growth for 2004 only reflected an excellent first quarter and the momentum to higher levels begun in 2003 (the base-year effect).

Optimism once again prevails. The economy has rebounded well in the first half of 2005 from last year's soft patch. Exuberance has been ignited by Prime Minister Junichiro Koizumi's overwhelming election victory on September 11 and the bullish upward revision of the slightly disappointing second quarter GDP growth initial estimates. The key question is, how strong and sustained will this growth be during the rest of 2005, in 2006, and beyond? Will Japan finally break out of its mediocre cyclical pattern and achieve its feasible growth path by eliminating excess capacity, or will it simply repeat its poor performance of the previous fifteen years? In last year's essay I was cautious, awaiting more evidence before being willing to judge whether the growth momentum was sufficient to restore the economy to a self-sustained, full employment growth path. I am somewhat more optimistic than a year ago, but I remain cautious and want more evidence that the current momentum will be sustained and enhanced.

With two or three years of robust growth—3 percent or so annually—Japan could absorb its labor and industrial slack and return to normalcy. I do not think that is likely just yet. Alternatively, sustained growth at 2 percent over the next five years would probably also achieve this, and that seems most likely. However, slower growth, at less than a 2 percent annual rate, remains a danger; that would mean the Japanese economy would continue in its mediocre growth cyclical pattern.

Virtually all of Japan’s economic indicators are improving, albeit mildly. The Japanese economy is in the best shape it has been since 1990. It is even possible that this widespread, gradual process at some point will create a sudden, optimistic shift in expectations that generates a virtuous circle of significantly increased business investment, employment, wages, consumption, and price stability instead of mild deflation. However, serious obstacles could prevent this happy event: exogenous factors such as slower world economic growth and sustained high oil prices; slow private sector and government structural reforms; the huge budget deficit and abnormally low nominal interest rates; and, potentially most dangerous, premature tightening of fiscal or monetary policy.

My somewhat cautious stance persists because despite broad-based improvements, most of Japan’s major economic problems persist. Aggregate demand remains inadequate, and deflation has not yet ended. Considerable labor market slack continues, and household income growth is modest. Capital is misallocated. Business borrowing continues to decrease. On the other hand, the systemic problem of bank excessive nonperforming loans has been solved, and corporate restructuring proceeds. Even so, these continue to be abnormal times.

The results of the Lower House election and their implications and increasingly optimistic expectations about Japan’s economic performance dominate Japanese news headlines in mid-September. Other issues have also received great media attention this year. One is the contrast between the worsening political relationship with China and a continuing strong economic relationship. Another is merger and acquisitions, highlighted by the Livedoor–Nippon Broadcasting hostile takeover bid melodrama. These and other topics are considered below.

Recent Economic Performance

Japan's recovery in the first half of 2005 from 2004's final three quarters of stagnation has proceeded reasonably well. The strong first quarter rebounded at a 5.8 percent annual rate and was followed by a very good second quarter at a 3.3 percent annual rate. The evidence indicates broad-based improvements across the economy.

First quarter growth was driven entirely by private domestic demand; net exports were slightly negative, and a modest increase in government consumption was mostly offset by continuing decreases in government public works. Consumption—growing at a 4.9 percent annual rate—was strong, providing half of quarterly growth. Business fixed investment, a volatile major component of aggregate demand, grew rapidly, at 12.8 percent, contributing a third. Inventory accumulation, the most volatile aggregate demand component, increased excessively, comprising a quarter of the growth. Corporate profits increases slowed but remained strong. However, deflation did not significantly improve. The GDP deflator, year on year, was -1.0 percent, and the CPI worsened slightly to -0.4 percent.

The initial government report on second quarter growth, at only a 1.1 percent annual rate, was disappointing. The September 12 significant upward revision to 3.3 percent lifted expectations and forecasts for 2005 and 2006. The good news is that the upward revision was due mainly to a surge in business fixed interest, rising 15.4percent, almost all of the net increase in domestic demand. Inventory investment were negative, -0.9 percent, but substantially less than initially estimated. However, consumption was slightly less though than initially estimated and had slowed significantly, but even so increased a good 2.4 percent. Exports grew faster than imports, contributing to about a fourth of the quarter's growth in real terms. That said, in current prices net exports were a significant negative factor, due to high oil and commodity import prices, slowing nominal GDP growth by a quarter in the first half of the year. The CPI improved to a -0.1 percent rate, and the GDP deflater to -0.9 percent, but both remained negative.

The most significant improvement this past year has been in the labor market. Demand for labor, both employment and wages, drives household income; that drives consumption. Consumption is the largest component of domestic demand and always is a major factor in aggregate demand growth.

As I have stressed in previous essays, substantial labor slack due to inadequate aggregate demand—unemployment, lower participation rates, the increased share of part-time and contract workers, and labor misallocation—has been one of the most serious costs of sustained mediocre performance. Between 1995 and 2004, the labor force participation rate dropped 3.5 percentage points for all males and more for those 20 to 24 and those 65 and over. Female participation rates have decreased more slowly, by 1.4 percentage points, and rates actually increased slightly for women 25 to 64. I presume Japanese simply withdrew from the labor force as job opportunities dried up; they represent disguised unemployment.

Young Japanese have disproportionately borne the costs of poor employment opportunities. The unemployment rate of those 15 to 24 is 9.1 percent as of May 2005; too many of those employed worked in part-time jobs, since survey data suggest some 70 percent want full-time jobs. Japan has an estimated 640,000 NEETs (people 15 to 34 not in full-time education, employment, or training). Most live at home and are supported by their parents, a by-product of a rich country. About half the NEETs, presumably mostly women helping their parents at home, do not intend to enter the labor force. NEETS and “freeters” (some 2.1 million living an independent, usually part-time, work lifestyle) are an interesting and perhaps important new social phenomena, but in macro perspective they do not alter the realities of a slack labor market.

Over the past year, and particularly in the past few months, the employment situation has improved significantly. The unemployment rate declined to 4.4 percent in July from 4.8 percent a year earlier, and 5.5 percent at its January 2003 peak. The bellwether ratio of job offers to applicants did rise to 0.97 from 0.85 a year ago, its highest level since October 1992.

Total employment began to increase from January 2004, but this was entirely in the form of contract and part-time workers; full-time regular employment continued to decrease. Now there is some improvement in the quality of employment: full-time employment has been increasing, while part-time, contract, and other nonstandard employment growth slowed, and perhaps has even begun to decline. It still remains some 30 percent of the labor force, however. Part-time workers continue to be one-fifth of the total; contract and subcontractor workers are 5 percent; and dispatched workers (employees sent to a subsidiary or affiliate) are 2 percent.

The improvement is more modest than it appears: increases are due basically to shifting part-time and dispatched workers to full-time, "regular" status, but not to "permanent employment" regular status with full bonuses. Permanent workers continue to decrease as retired employees are replaced by workers with more limited benefits. More than a cyclical adjustment, this is a structural increase in flexibility.

Household income depends both on employment and on wage and bonus increases. The second piece of good news in mid-2005 was that regular scheduled wages and total cash earnings, combining regular wages, overtime, and bonuses, have been increasing since April 2005, after having decreased slightly but continuously in both nominal and real terms for several years. Employee compensation in real terms, at 54.5 percent of GDP, is at its lowest share in more than 25 years. The peak, slightly below 56 percent, came in the mid-1990s. As a consequence, real consumption decreased from about 57.5 percent of real GDP in the mid- 1990s to 55.7 percent in the second quarter of 2005.

Relative to output increases, and especially to the dramatic profit increases, wages are growing slowly. Labor markets, though strengthening, are still quite slack. A plus is that winter bonuses for all firms with five or more employees rose 2.7 percent, the first increase since 1996; and preliminary survey data suggest that summer 2005 bonuses rose about 2 percent. Wages will need to increase at a substantially greater rate if consumer spending is to become a leading force to sustain good growth over the longer run.

As a huge economy, Japan in the past decade has depended too much on export and current account surplus growth to bolster aggregate demand. Domestic demand picked up in the first half of 2005. Export volumes increased modestly in the second quarter of 2005 after three quarters of decline. Exports to China, which surged in 2003 and early 2004, have dramatically decelerated to virtually zero growth, despite China's continued extremely rapid GDP increases. Imports in current prices have continued to grow at a double-digit rate, in substantial part due to the major rises of oil and other raw material prices.

Even though large listed companies have relatively small shares of total output, value added, and employment, much of the analysis of Japanese corporate performance is based on data about them. One reason is that they are perceived to lead the economy. After all, a significant portion of small-firm production of goods (parts, components) and business services is sold to larger firms and, in due course, to the largest firms. Another reason is that the quality of data for large firms is substantially better than for small and medium-sized enterprises.

Japanese data coverage is comprehensive and extensive. However, the quality of much monthly and quarterly data, as reflected in their considerable volatility and significant revisions, is mediocre, often because survey samples are too small or not well constructed. The government has committed additional resources to improving data quality, so perhaps short-term forecasting will improve.

Small and medium-sized enterprises (SMEs) employ 76 percent of employed workers. When self-employed and family workers are included, large firms (those with 500 or more employees) comprise only 20 percent of total employment. Despite the opaqueness of their balance sheets, the available evidence suggests that the performance of most SMEs is improving substantially, especially in profitability. SME operating profits for fiscal 2004 (ending March 2005) rose 30.3 percent in manufacturing and 18.4 percent in services, more than for large firms.

SMEs have paid off debt. While still substantial, net debt to equity ratios are at their lowest since 1974. SME ability to service debt is at its highest since 1992; for large firms, this ability is the highest since 1985. However, loan interest rates are extraordinarily low, so the corporate sector is not yet out of the debt woods.

Winners and losers, both across and within sectors, have become more apparent and more significant. Large urban areas are more productive than rural regions and small towns. Despite widespread Japanese self-identification as being middle class, differentials in household income by age, gender, and occupation have widened. The OECD estimates that Japan’s income distribution is among the five least equal of its 30 advanced country members.

Koizumi’s Economic Reform Mandate

Prime Minister Koizumi’s decision to call a snap Lower House election on September 11, when his dominant economic and political priority, the postal privatization legislation, was rejected by the Upper House of the Diet on August 8, was a huge political gamble. It was compounded by his decisive rejection of the 37 Liberal Democratic Party Lower House incumbent renegades who had voted against the postal privatization as LDP candidates, instead selecting attractive candidates to run against them. And Koizumi won. It was a stunning victory, far beyond the most optimistic projections. The LDP achieved an absolute majority and, with its Komeito coalition partner, secured the two-thirds majority sufficient to pass the postal privatization bill and indeed any legislation regardless of the Upper House.

Koizumi brilliantly cast the election as a contest between those favoring and those opposing postal privatization and, by extension, between reformers and those wanting to maintain the status quo system of support for a range of vested interests. It was also a contest between those supporting small versus large government, those favoring markets versus government invention, and ultimately those for or against Koizumi as a leader of change, albeit vaguely specified. It was a victory for a charismatic, media-savvy, idiosyncratic leader; the LDP rode in on his coattails.

Koizumi's fundamental objective has always been reform of the LDP itself. To that end he has significantly strengthened top-down party discipline, reduced the power of traditional party leaders and factions, and moved the party from maintenance of the status quo towards reform. The election victory is the culmination of a longer run process in which pork-barrel public works spending has been reduced, and authority over income and resource redistribution has been more centralized in the Prime Minister's office, in a Cabinet supporting the Prime Minister's policy preferences rather than representing factions, in a vigorous Cabinet Office, and in a proreform Council on Economic and Fiscal Policy.

Postal privatization, the sole concrete issue of Koizumi's campaign, now is certain. The same, substantively somewhat weak legislation earlier rejected will pass the Diet this fall and become law. Privatization of Japan Post is important. It is by far Japan's largest deposit-taking and life insurance institution, and inefficiencies abound. As of March–end 2005, postal savings deposits were ¥214 trillion ($1.9 trillion), four-fifths of the deposits of the four major banking groups combined. Postal savings assets are invested overwhelmingly (85.6 percent) in central government bonds, bills and deposits in the fiscal loan fund. Postal life insurance assets of ¥120.2 trillion ($1.1 trillion) are almost equal to Japan's four largest private life insurance companies combined and equivalent to 43 percent of the assets of all private life insurance companies.

In principle, privatization will make greater efficiencies possible in postal fund asset allocation and operations. While the postal legislation is flawed in some respects and the specifics of implementation are far from clear, it is both a fundamental economic reform in itself and a signaler of further economic reform. Privatization begins in 2007 and is scheduled to take ten years. However, the devil lies in the details—to what degree and in what concrete, specific ways implementation proceeds will involve an ongoing political economy process. The strife is not over.

Koizumi now has a public mandate for other economic reforms as well. How far and how well Koizumi will use this mandate is far from clear. He has yet to define his economic reform agenda, much less their priorities. In his victory press conference, he mentioned the need for reform of health care, public pensions, central and local government financial relationships, government finances, and civil service. Probably an early reform will be the consolidation of government financial institutions, since a major report is due out in October. Relatedly, the government may sell off financial assets and reduce gross government debt. Health reform will probably be another reform objective. The focus will be more micro—how to improve the efficiency of health care services while lowering costs—than the macro issue of how to cover the budget costs of the universal health care system.

While the longer-run implications of the election on Japan's political and economic systems are probably profound, they are not at all obvious. The election was a one-off event involving a unique leader, not a political party victory. To what extent will the LDP become an urban party of reform? How will the Democratic Party of Japan reform itself? Half of the newly-elected LDP members still represent rural districts. While the urban LDP victories smashed many DPJ candidates, the margins of victory were not great, and the impact of nonaffiliated, floating voters was substantial. The LDP old guard has been weakened but they have not disappeared. While the LDP won 61 percent of the Lower House seats, it garnered only 48 percent of the popular vote for single-member districts and only 36 percent of the proportional representation votes, though that was better than the DPJ's 31 percent.

Further economic reform will depend fundamentally on Koizumi's exercise of leadership, including ongoing oversight of the implementation specifics as in postal privatization and unlike the earlier, less successful highway corporation privatization reform. In the coming months, Koizumi will probably define his economic reform agenda and will make its acceptance and support a requirement for whomever the LDP elects as his successor. To accomplish this, Koizumi may have to extend his term another year. He has repeatedly stated that he will retire as prime minister when his term as LDP president expires in September 2006. It is possible that by next spring Koizumi will change his mind. Regardless, the key issue will be who his successor is.

Post-election euphoria has generated further positive expectations about Japan's future, fueling what already is a good recovery. Nonetheless, the development of government economic reform policies and especially their implementation is a long-run process, not a quick fix.

Successful reforms will raise productivity, especially in the public sector. They will also enhance private sector expectations about Japan’s economic future. Even so, businesses and households now rely far less on government leadership than before. The basic sources of efficient resource allocation and economic growth lie more than ever before in the autonomous actions of the private sector.

Economic Growth Prospects

Will current moderate momentum in domestic demand and production continue for the rest of the year and throughout 2006? Will growth be sufficiently strong and rapid by the end of 2006 to break out of the recurrent cyclical pattern and restore Japan’s economy to a self-sustained full employment growth path? Yes to the first, but probably no to the second, are the simple answers. But the world is never so simple, even assuming, as I do, that the election will not fundamentally alter government economic policy or overall economic performance in the near term.

While improvement is widespread, Japan’s basic problems persist: inadequate aggregate demand; mild deflation; labor slack; business investment demand not sufficient to reverse the long-run decline in business borrowing from banks or financial markets; and the ongoing need for corporate and public sector restructuring, particularly government enterprises and institutions. Nationwide land prices are reported to be declining, but more slowly. In reality, both given time lags and inadequate weighting of differently valued land, coupled with such evidence as the expanding market for real estate investment trusts (J-REITs), land prices may have already stabilized. If so, that will be a significantly positive factor. I expect broad-based, incremental, slow, improvements in all these dimensions will continue. One negative is the increases in tax rates already legislated. I consider these issues here and in following sections.

Consensus forecasts in early September, prior to the election, were that Japan will grow about 2.0 percent in fiscal 2005 and 1.8 percent in fiscal 2006. The election results have generated further optimism about government economic reform policy and Japan's economic performance. Several respected forecasters in mid-September projected growth to be close to 2.5 percent in 2005. However, views diverge significantly for 2006, from an optimistic 2.8 percent growth to a pessimistic 1 percent. The Bank of Japan's Monetary Policy Board April 2005 forecast will almost certainly increase in its October announcement. I take these expert projections to mean that recovery will proceed, but how rapidly and how long remain questionable.

Forecasts of when deflation will come to an end are important indicators of changing expectations, both of price movements and the ending of the very easy monetary policy. Japan's core CPI is expected to continue to decrease slightly in 2005 or to reach 0 or even become slightly positive by year-end. For 2006 a slight increase on the order of 0.2 percent is expected. The BoJ Monetary Policy Board April CPI forecasts for fiscal 2005 were -0.1 percent with a range of -0.1 percent to +0.1 percent, and for fiscal 2006 +0.3 percent with a range of 0.1 percent to 0.5 percent. While sustained CPI increases just above 0 are inadequate because the CPI measure overstates price increases (or understates price decreases), nonetheless it seemingly has become a significant indicator that deflation will end soon.

A number of official surveys provide information of business confidence, business sentiment, and consumer confidence. The Bank of Japan *Tankan* quarterly survey of business conditions and outlook three months hence is watched closely. The June-end *Tankan* was quite positive, though with some cautions. The July *Shoko Chukin* survey, while still slightly negative, showed small improvement in SME business sentiment. However, the Cabinet Office quarterly consumer confidence index in late June decreased slightly, ending its steady improvement since the first quarter of 2003. The monthly economic data and various surveys during the summer indicate some slowdown in consumption and production, but expectations are that the economy will continue to do reasonably well. Presumably, upward momentum will be reinforced by the election results, but hard evidence is not yet in. The September-end *Tankan* was only moderately positive, a disappointment to optimists.

Good growth in coming months and years depends predominantly on expansion of domestic demand. While the yen's relative weakness is a happy surprise for Japanese exporters, it seems unlikely that exports will continue to increase rapidly, even if U.S. and Chinese growth continue strong. And should the high price of oil persist, it could reduce Japanese growth on the order of 0.5 percent annually, as world growth slows and the economy bears further domestic adjustment costs.

The most important growth driver will be Japanese household expenditures. This means employment has to rise, its quality improve, and the labor market tighten. Only then will wages increase sufficiently to underpin strong consumption. Based on the incremental, gradual improvements of the past two years, this is not likely to occur soon. The other important growth driver is rapid business investment, as the June *Tankan* suggests is possible.

Suppose somehow the economy does achieve 3 percent growth this year and next. Such an optimistic scenario is not probable, but it is not impossible. Continuing incremental improvements in major variables might generate a sudden positive shift in market expectations from deflation to reflation, from moderate to more robust growth, from flat or slowly declining to rising land prices, from a stagnant to an even more buoyant stock market. First quarter rapid growth means that the base year effect for fiscal 2005 will be about 1.1 percent year-on-year growth, even if each quarter has zero growth, since the economy's level is higher than fiscal 2004. Sustained 3 percent growth would dramatically change Japan's economic and policy environment, with a virtuous circle of positive reinforcing interactions among the major variables.

However, Japan's fiscal policy throws cold water on this optimistic scenario. Tax increases have already been legislated. From October 2004, as part of pension reform, social security contributions will increase by a cumulative 5 percentage points of wages until 2017, 0.354 percentage points per year (0.18 percent of GDP). Income and residence tax increases, restoring one-half of the 1995 tax cuts, and amounting to 0.33 percent of GDP, will go into effect in January 2006. This, combined with restrictive fiscal expenditures and tax revenue increases that are already better than expected, suggests that increased fiscal drag will be an even greater negative factor for GDP growth than it has been over the past several years.

2007 and Beyond

The year 2007 will be important symbolically and substantively. Japan's population will have peaked and, each year for five years, over two million baby boomers will reach the traditional retirement age of 60. While certainly some will seek continued employment, the labor force decline will accelerate the process of ending labor force slack. By the end of the decade, Japan could well move to a labor shortage. Consumption will rise as retirees begin to enjoy life more. In 2007, postal privatization will begin. By 2007, the Bank of Japan will have reduced excess liquidity sufficiently to begin to raise interest rates, assuming all goes reasonably well. However, the government may increase consumption taxes in 2007, which probably would be a major mistake. A two-percentage point rise (from 5 percent to 7 percent) would have a significant negative growth effect of 1 percentage point of GDP.

In the medium term, Japan's growth prospects depend both on its long-term potential growth rate and the gradual elimination of the current slack in the economy (the output gap). The key intermediate growth issues are the actual degree of slack today; the degree to which aggregate demand will increase sufficiently to pull underutilized resources into the economy; and the degree of restructuring and other productivity improvements. The Japanese government and the OECD estimate quite small output gaps, so their intermediate possible growth rate estimates are not substantially greater than the longer term potential growth rate.

My intuition is that the slack is substantially larger. Industrial output capacity analysis focuses on manufacturing, only a quarter of the economy. Services—retail stores, restaurants, finance—could expand sales and transactions substantially with only limited increases in physical capacity. At least equally important, labor is still substantially underutilized, as already stressed. Given some 15 years of inadequate demand for labor, until Japan has a sustained period of strong demand, we do not know what the full employment equilibrium will be.

Japan's long-run potential growth rate depends on changes in the labor force (the demographic factor and the participation rate) and increases in output per worker. Labor productivity in turn depends on increases in capital per worker, improvement in labor skills, and technological change (total factor productivity). In the longer run, labor productivity will probably rise on the order of 1.5 percent, the cautious OECD estimate, to 2 percent annually. Japan's working-age population will decrease some 0.7 percent annually. This implies that, assuming full employment of resources by 2007, Japan's longer-run growth rate will be between 0.8 percent, the OECD estimate for 2007–2010, and 1.3 percent. The IMF estimate is 1.6

percent. Growth per capita will be slightly higher as Japan's population decreases on the order of 0.2 percent annually for some years.

I think the OECD growth estimate for 2007–2010 is too low. The Japanese Cabinet Office in January 2005 forecast an average growth rate between 2005 and 2112 of 1.6 percent, assuming that economic reforms proceed. Labor productivity could grow more rapidly as labor and capital are allocated more efficiently through deregulation, restructuring, better capital, labor, and land markets, and also rising rates of Japanese and global technological improvement.. The supply of labor could be increased by importing contract workers or, indeed, outright immigration. By the end of this decade, this is likely to be one of Japan's most important economic and social issues.

Fiscal Policy

Japan's macroeconomic policy over the past fifteen years has succeeded in preventing systemic crises but not in achieving full employment growth and price stability. Four combined effects—the burst land and stock price bubbles in 1990 and 1991, the slow responses by both business and government, the institutional and structural changes required as Japan undergoes transformation from rapid growth to economic maturity, and demographic change—have resulted in sustained mediocre economic performance. This is despite massive macroeconomic stimulus—huge, sustained government budget deficits and a Bank of Japan policy of a zero interest rate and extraordinary liquidity. In this section, I consider fiscal policy and, in the next, monetary policy.

Why hasn't the government tackled the aggregate demand issue more vigorously and proactively? The key has been that Japan came close to, but has not actually suffered, a systemic financial or economic crisis. Incomes on average have risen slightly, not declined. Unlike other Asian economies, Japan has not had an external crisis. Indeed, Japan has continued to pile up current account surpluses and thereby increase its position as the world's largest creditor. One lesson is that rich countries can afford to temporize and delay taking difficult, painful short-term policies necessary to overcome powerful interests benefiting from the status quo. Without a sense of crisis, major reform takes strong political leadership in democratic societies.

Japanese policymakers—government officials and politicians alike—do not understand macroeconomic policy well. Each time recovery has appeared, a degree of complacency regarding needed reforms has set in, bolstering unrealized expectations that, this time, the economy will break out of its mediocre performance trap. Maybe 2005–2006 will be different.

While large deficits persist, fiscal policy has been slightly contractionary rather than stimulative for several years, as government expenditures have been restrained and a variety of small tax increases—for pensions, health care, and other specific purposes—have been put in place. While the rate of the consolidated (central plus local) government deficit has declined slightly, it was still 7.3 percent of GDP in 2004; the deficits have politically constrained even short-term fiscal stimulus measures.

Gross government debt has burgeoned over the last fifteen years, to more than 160 percent of GDP. That has raised, quite incorrectly, fears of a future fiscal crisis. In fact, the government is an immense financial intermediary, and its debt is partly offset by huge holdings of financial assets, including government debt itself. Foreign exchange reserves alone, at $840 billion, are 18 percent of GDP. The net government debt, the appropriate measure, is about half the gross debt.

In the long run the government will have to raise taxes, but the timing and size of tax increases are crucial. It is premature to raise taxes when aggregate demand is insufficient, growth is mediocre, underemployment exists, and deflation continues. The annual increases in social security contributions of 0.18 percent of GDP probably make sense because it well addresses long-term pension funding concerns.

The most important fiscal policy decision the new Koizumi government will face is the type, amount, and timing of further tax increases. One proposal, not yet enacted, is to raise income taxes by another 0.33 percent of GDP from 2007. However, the main policy impetus seems instead to raise the consumption tax significantly as soon as possible. While Koizumi earlier rejected increasing the consumption tax, he did not object to its being considered in 2006 for enactment from 2007. It appears that a drastic tax reform will be proposed by 2007. Whether any consumption tax increase goes into effect in 2007 or 2008, for reasons of administrative feasibility, may well be significant. It all depends on how well the economy has progressed and is doing.

The danger is that further tax increases will be premature. Nevertheless, the Ministry of Finance, always the basic force pushing tax increases, apparently believes it can marshal political support only if there is a sense of crisis. The gross government debt, ongoing huge fiscal deficit, and aging population provide such an opportunity to create a crisis mentality, especially if economic growth is seen as proceeding reasonably well. I fear that “reasonably” means a 2 percent rate, which is not sufficient to reduce slack quickly.

Achieving fiscal sustainability, with a stable government debt-to-GDP ratio, is a long-term goal, since it requires significant tax increases in order to reduce the budget deficit. The problem is how to achieve private sector plus foreign aggregate demand sufficient both to maintain full employment growth and to offset the negative effects of tax increases.

The government earlier this year, based on quite optimistic assumptions, projected that budget equilibrium can be achieved by 2012 or so. That not only is probably unrealistic but actually undesirable if the required tax increases choke off growth once again, as in 1997. The transition process, for both the budget deficit and rising government pension expenditures, should be spread over considerably more years, thereby sharing generational costs more equitably.

Japan's significant public pension reform, effective October 2004, in reality goes a substantial way toward reducing the expected budget difficulties of financing future old age benefits. Just as important as the increased employer and employee contributions, benefits will not rise as rapidly as nominal GDP. The ratio of initial benefits to wages at retirement is projected to decline gradually, from 59 percent now to 50.2 percent by 2023, and ultimately to 50 percent.

Moreover, after the initial year of retirement, benefits are indexed to price inflation (CPI) rather than to the presumably larger nominal wage or income growth rates. Future retirees will not share in the economy's productivity increases directly. As with all such projections, particularly as long term as this, the demographic, income, discount rate, and other assumptions will not be completely accurate and will require subsequent policy adjustments. Japan's decision whether to have a big welfare state as in Europe or a small welfare state as in the United States is fundamentally a political, not economic, matter.

Monetary Policy

The central goal of the Bank of Japan (BoJ) is to maintain price stability. Like all central banks, other key goals are to prevent systemic financial crises and to maintain the monetary conditions for good growth.

The BoJ has engaged in massive monetary stimulus since the late 1990s. The benchmark short-term rate, the overnight call rate, was reduced to zero in 1999; this has been termed the "zero interest rate policy" (ZIRP). Following the mistaken termination of ZIRP in summer 2000, the Bank in effect returned to it in spring 2001 by adopting a policy of extreme monetary quantitative easing. This was done by providing so much liquidity that financial institutions held official reserves as current account balances at the BoJ far in excess of their legal requirements. The BoJ increased this total reserve target in a series of steps to the current level of ¥30–35 trillion, far above required reserves of about ¥5 trillion.

In these abnormal monetary circumstances, a major policy objective has been to generate positive market expectations both to prevent a financial crisis and to bring deflation to an end. Crisis management has indeed been successful. Bank nonperforming loans have been reduced from dangerously high to more normal levels; and the government's unlimited guarantee of all deposits (except settlement accounts) was smoothly terminated this year when demand deposit guarantees reverted to a ¥10 million limit on March 31. However, the Bank's quantitative easing policy has not yet succeeded in ending mild but enduring deflation; market expectations have not improved as quickly or to the degree the authorities had hoped.

The BoJ has made it clear that it will not exit quantitative easing and ZIRP until year-on-year core CPI is positive for several consecutive months, until a strong majority of its Monetary Policy Board members forecast that the CPI will continue above zero, and until good economic performance is achieved. None of these conditions have been met yet but probably will be in spring 2006. A barely positive CPI is too low a barrier. Given upward bias due to technological change, I am among those who think price stability should be defined as an annual CPI increase of about 1 percent, and that should be BoJ policy, at least implicitly.

One current policy debate focuses on the timing and process whereby the quantitative target is reduced from the ¥30–35 trillion range first to a more normal interim level of ¥10 trillion and then to only holding the required amount of reserves. The essence of the argument lies in how market expectations will be affected as the target and actual amount are reduced.

Another debate is on how the monetary policy exit process should proceed. One scenario is in three stages: first, reduction of the quantitative easing targets; then their termination, explicitly targeting interest rates instead, with ZIRP continuing; and, finally and most importantly, ending ZIRP by raising the overnight interest rate, thereby returning to interest rate changes as the main monetary policy instrument. One could argue that since quantitative easing did not seem to affect price expectations positively as the target was increased, a decrease in these excess reserves to a more normal level should not affect expectations negatively. However, any reduction is uncharted, potentially risky, territory; no other major country since the 1930s has experienced Japan's miasma of persistent deflation.

The BoJ has correctly signaled it will err on the side of caution; it will not end its easy monetary policy prematurely. After all, the CPI could readily move around from a slight minus to a slight plus without meaning deflation has ended. Undesirable supply effects, such as oil price increases, could even dominate demand affects. (It will be interesting to see how the BoJ reacts to the expected approximately 0.2 percent decrease in the CPI index from August 2006 when it shifts from 2000 to 2005 prices.) It now seems likely that the current account surplus will be reduced from spring 2006. The real issue will be when to end ZIRP. The ultimate goal should be not just to end deflation, but also to achieve sustainable real recovery.

A related policy debate is whether the BoJ should adopt, explicitly, or at least implicitly, an inflation target, say, of a CPI annual increase on the order of 2 percent. A few Monetary Policy

Board members presently propose this. A more sophisticated monetary policy is initially to set a price level target (for instance, a return to the 1995 price level) that, once achieved, is followed by an inflation target. Since quantitative easing apparently did not affect inflation expectations significantly, the BoJ seems unwilling to use inflation targeting to overcome persisting deflation expectations. The question thus will be whether the BoJ will adopt an inflation target once a post-deflation environment is achieved.

Banks

Japan’s most successful economic reform during Prime Minister Koizumi’s tenure has been in banking, particularly the major banks. The specter of a systemic banking crisis has been eliminated. The Financial Services Agency (FSA) required banks to reduce their nonperforming loans (NPLs) to one-half their dangerously high peak levels of 2002 with a March 2005 deadline. Major banks have achieved this by actively writing off bad loans and restructuring their worst large borrowers, financed by raising additional capital and retaining all operating profits.

Bank NPLs had declined to ¥17.9 trillion ($163 billion), equal to 4.0 percent of loans, by March 2005. The eleven major banks continued to be the most aggressive, reducing NPLs to ¥7.4 trillion, equal to 2.9 percent of credit, down from 9.6 percent in March 2002. Given balance sheet weakness, banks could only deal incrementally with their large, very weak, inefficient major borrowers (the so-called “zombies”). Of 35 such firms, 30, including two in the IRCJ restructuring process, have significantly improved their financial conditions through debt workouts and restructuring. Almost all the most extreme major cases of corporate distress have finally been reasonably well resolved.

The 113 regional and secondary regional banks have lagged. As of March 2005, their NPLs were ¥10.4 trillion ($94.5 billion), equal to 5.5 percent of their loans. They reported a combined net profit of about ¥800 billion ($7.3 billion), the first in years. However, the gap is widening between winners and losers. While 90 percent of the 87 listed regional banks reduced their NPL ratios, the ratio for the ten weakest remained between 7.9 percent and 13.3 percent. Similarly, reported capital adequacy ratios diverge widely. The best regional banks are stronger than the megabanks. Consolidation among weak banks continues, but slowly. Their best news is the improved performance of their SME clients.

While a systemic threat has been taken care of, bank NPL difficulties are not yet fully resolved; some remain hidden. Banks persist in rolling over loans at low interest rates to weak borrowers, while charging higher rates to more creditworthy clients. This retards the development of loan and bond markets for below-investment-grade, mid-level credit risks. Banks are just beginning to enter these markets.

A year ago a big banking story was the unprecedented contest between Mitsubishi Tokyo Financial Group (MTFG) and Sumitomo Mitsui Banking to take over UFJ Holdings. MTFG won, but the merger of the banking units, scheduled for October 1, has sensibly been delayed until January 2006 to ensure adequate systems integration. Japan will then have three megabanks, culminating an amazing decade-long consolidation and restructuring process.

While strong domestically, none of these megabanks is globally competitive, and none is likely to become so any time soon. First, their capital base remains weak. Deferred tax assets are still a quarter of total capital. The banks are committed to repaying the capital earlier injected by the government to overcome the NPL crisis. The government has been willing to share with the banks about one-half the gains on those holdings as they are realized, rather than selling its shares in the market, but the FSA may be changing that implicit policy. It will take some years of excellent retained profits to build bank capital to an adequate level. Second, banks still do not have state-of-the-art financial technology in either IT hardware or human capital, and both are expensive. Third, while the mind-set of senior management is changing, caution and safety still seem to dominate credit risk-taking.

Like life insurance companies and other financial institutions, banks are subject to potential government bond interest rate risk. Megabanks do have two assets supporting their international business: access to cheap Japanese savings and Japanese multinational clients with which they have close relationships.

Corporate Reform

Japanese corporations are in their best shape in years. Debt-to-equity ratios are at a normal, acceptable level. Firms are borrowing more money than they are repaying, for the first time in nine years. However, on balance they remain savers, by some 3 percent of GDP; their borrowings are being used to invest in financial assets rather than in expansion of plant and equipment. Good performance has produced a major increase in recurring profits, up 28.2 percent in fiscal 2004 and projected to rise another 8 percent or so this year. However, profit growth has been at the expense of workers; while labor productivity continues to rise, wages have decreased until very recently and are only rising modestly now.

Corporate restructuring continues, though more needs to be done. Firms are focusing increasingly on core competencies, preparing to shed less profitable activities through spin-offs and management buy-outs, often with private equity fund participation. Mergers and acquisitions

(M&A) activity is rising from its historically low base. Almost every M&A deal in Japan, as elsewhere, is friendly.

Hostile takeover bids (TOBs) are exceptional, but understandably they attract immense media attention and negative management reactions. Business leaders used anxiety about foreign takeovers, friendly or not, to delay until 2007 provisions in the major new corporate law, which otherwise goes into effect in 2006, which will enable foreign firms in friendly, triangular, cross-border transactions to use shares to acquire Japanese firms.

Livedoor's hostile attempt to take over the established Nippon Broadcasting System (NBS) and, thereby, potentially, its parent, Fuji Television Network, during February–April 2005 generated huge media and public excitement. Livedoor is an upstart Internet service provider; NBS and Fuji TV are core companies in Japan's largest media group, Fuji-Sankei. Iconoclastic, young, brash outsider Livedoor president Takafumi Horie was cast as a populist symbol of much needed change. He was pitted against the traditional business establishment, personified by much older Fuji TV chairman Hisashi Hieda, a symbol of incumbent management control and stakeholder capitalism.

Which was the good guy, and which the bad, depended on one's point of view; there was plenty of grey on both sides. Both made strategic misjudgments and mistakes as the contest progressed. The ultimate result was a standoff involving a somewhat strange alliance among the contestants. Although Livedoor's hostile bid failed, it made some money in the process.

The Livedoor brouhaha has had several significant effects. It made clear that listed companies that own a substantial share of a larger affiliate's stock are vulnerable to TOBs. The most immediate consequence was to strengthen management opposition to hostile takeover bids by making development of defensive measures a high priority. These include higher dividends, stock buy-backs, and poison pills, those sophisticated instruments of legal technology designed to force takeover bidders to negotiate with management or suffer massive share dilution. Another effect has been to accelerate reshaping of the Japanese public and legal environment so as to make future hostile TOBs more feasible. It also accentuated stockholder activism in response to the poison pill defenses that company managements have begun to propose.

Hostile takeover bids are an extreme instrument of corporate governance, generally occurring only when a company's stock price is far below its potential value or the firm is liquid asset rich. TOBs generate a market for control of corporations, usually to the benefit of shareholders. However, some TOBs are harmful to existing shareholder interests of firms potentially being acquired. A market rationale for using poison pills is to halt or slow the process until the bid sufficiently reflects value.

The Ministry of Economy, Trade and Industry (METI) and the Ministry of Justice in May announced guidelines for proper and fair defenses against hostile TOBs. These guidelines essentially adopt Delaware state law principles and endorse poison pills, although they will have to be adapted for use in Japan. As the legal home of many major U.S. corporations, corporate law in Delaware has been refined over time through many court cases. Regarding TOBs, the result has been to increase shareholder value by slowing the TOB process. However, the legal system is flexible, and implementation depends significantly on the corporate governance context within which it operates. In the United States, the system of poison pill defenses is founded on a combination of legally responsible, powerful, independent directors, knowledgeable and capable courts, and effective capital market pressures.

Japanese corporate governance is in a process of substantial change, with major improvements in transparency and disclosure. Nonetheless, in most companies management remains in tight control. Boards of directors consist overwhelmingly of internal directors, and it is not clear what proportion of the relatively few outside directors is truly independent. However, stockholder activism gathered substantial momentum this past spring, and at June 2005 annual meetings, stockholders in three major companies rejected management proposals to increase authorized shares because the boards could have preferentially allocated shares to friendly stockholders. Stockholder activism now includes Japanese pension funds as well as foreign institutional investors.

Poison pills in Japan can benefit shareholders or they can protect incumbent management. They will become increasingly important as stable and cross-shareholding continues to decline. How the poison pill develops in Japan remains to be seen. TOBs are a new phenomenon, and the normative and institutional framework assigning predominance to shareholders rather than stakeholders is still weak. Indeed, how the overall market for corporate control will develop is still far from clear, involving as it does actors reflecting the interests of incumbent management, the government ministries, political parties, finance, and the legal profession in a new, evolving, economic environment. How the courts rule will be important. In the recent Livedoor and Nireco cases, the courts have indicated that shareholders will have to approve management use of poison pills and other defensive share issuances in order to ensure that they are legal.

Japan in the Global Economy

Japan, the world's second largest economy measured by market exchange rates, continues to be a major, though somewhat stalled, global economic engine. Its economic performance is affected by world GDP growth, trade, foreign direct investment, exchange rates, and other elements in the globalization process. Japan's economy is especially linked to the economic performance and policies of the United States, EU, and now China, the other major engines of the global economy.

Alliance with the United States economically, politically, and in security terms continues to be Japan's pre-eminent foreign policy objective. Three big problems in the Japan-U.S. economic relationship persist: Japan's mediocre economic growth; the huge, ongoing U.S. trade and current account deficits; and, relatedly, low national savings rate.

I have been surprised by the dollar's rebound and concurrent yen and euro weakness, in the first three quarters of 2005. That has been affected by other surprises: better than expected world economic growth despite high oil and commodity prices; and U.S. long-term interest rates lower than expected as the U.S. central bank maintained its steady rise in short-term rates. Long-run economic fundamentals—a U.S. current account deficit of more than 6 percent of GDP and a Japanese surplus of 3.5 percent—indicate that the dollar should weaken. Cyclical forces, such as the widening of interest rate differentials, attracting financial flows to the United States from Japan and better growth in the United States, combined with less good growth in Japan, have sustained yen weakness without any need for the Japanese foreign exchange authorities to intervene.

In real terms, after adjusting for inflation differentials, the yen is now as weak as it was in 1998 when the rate was 140 to the U.S. dollar. A rate of 110 today is equivalent to 145 in 1995. Even aside from global forces weakening the dollar, once the Japanese economy restores normal growth, the yen should rise.

One factor supporting the dollar has been the reliance by the rest of the world on running a trade surplus with the United States as a means of sustaining domestic demand and their willingness to invest saving and foreign exchange surpluses in U.S. financial and other assets.

Once U.S. trade deficits no longer become sustainable, Japan and other trading partners will have to replace slowing U.S. import demand with domestic demand, pursuing more simulative macroeconomic policies to maintain their growth. These structural adjustments, in the United States, Japan, and the rest of the world will not be easily achieved.

China's recent announcement that it would end its yuan peg to the dollar, revalue the yuan by about 2 percent, and shift to a Singapore-style "currency basket, band, and crawl" exchange rate regime is welcome, especially since it has substantially reduced anti-Chinese political pressures in the United States. In the longer run, this desirably enhances the potential flexibility of all Asian exchange rates, including the yen. Nonetheless, the short-term economic effects will be minimal, so long as the yuan does not appreciate significantly.

China's burgeoning global trade and current surplus, 4.2 percent in 2004 and probably still rising, imply that the yuan will appreciate substantially in the longer term. One problem for Chinese monetary authorities is how to limit speculative capital inflows or sterilize them without generating domestic inflation. On the other hand, liberalization of currently restricted capital outflows by Chinese institutions and households would significantly depreciate the yuan. My expectation is that the yuan will appreciate only very gradually, and the net impact on the Japanese economy will be modest.

In long-run perspective, the world continues to participate in, and benefit from, the continuing spread of the industrial revolution to Asia. This is the economic development story of Japan from the first half of the twentieth century; Korea, Taiwan, Hong Kong, and Singapore from the second half; and, more recently, China, India, and most Southeast Asian countries. As labor productivity rises rapidly, a nation's power becomes much more a function of its total population. China and India will become the largest economies in the twenty-first century, although their standards of living (GDP per capita) will remain substantially below those of advanced, mature countries such as Japan. Just as Japanese production systems have become world class and are emulated globally, China and India will increasingly shape the process of globalization in their own ways; it will not be the simple Americanization of the global economic system.

China and East Asian Economic Cooperation

China looms large in Japan's consciousness, both in the complex, multidimensional nature of the Japan-China relationship and in Japan's ambitions to lead the development of mechanisms for government-led East Asian economic cooperation. China's sustained, very rapid growth for a quarter of a century has made it a strong nation. Both Japan and China are strong at the same time, a first in history. This poses immense challenges and opportunities.

The contrast between Japanese and Chinese very good economic relations and very poor political relations is remarkable. China has now passed the United States as Japan's largest bilateral trading partner, with one-fifth of total trade. While Japanese exports to China have slowed significantly over this past year despite China's continued rapid growth, they remain larger than Japan's imports from China. Earlier Japanese fears of cheap imports have been replaced by the delight of exports: electronic and other components to be assembled in Japanese-owned factories, as well as construction equipment, steel, and machinery in support of China's domestic investment boom.

Japanese foreign direct investment (FDI) in fiscal 2004 in China, ¥491 billion ($4.5 billion), was almost as great as in the United States (¥502.7 billion, or $4.6 billion). It appears that Japanese FDI flows into China will not decline, even though the risks of worsened political relations and the possibility of supply interruptions due to another SARS-type outbreak provide impetus to second-sourcing through investment in low-wage Asian countries.

Their poor political relationship is harmful. The legacies of World War II bedevil it. The current flashpoints are: Prime Minister Koizumi's refusal to renounce visits to the war memorial Yasukuni Shrine, which became a particularly charged nationalistic symbol after the spirits of fourteen convicted Class A war criminals were enshrined in 1978; Japan's treatment of its war with China in school textbooks; and territorial disputes over East China Sea gas reserves and maritime boundaries.

Chinese policies and behavior are not without fault; they have exacerbated these tensions. While significant in themselves, these disputes are even more important as indicators of a fundamental structural change in the bilateral relationship as a consequence of China's growth. Japan and China both compete and cooperate for leadership in East Asia; their mutual efforts are essential for any region-wide economic cooperation process.

Japan's relations with South Korea have been soured by the same issues, though with somewhat different nuances. The territorial issue is a small island between them that Japan calls "Takeshima" and Korea calls "Dokdo." It was taken by Japan in 1905 as part of the Russo-Japanese war treaty and for Koreans is a potent symbol of Japanese oppression. The textbook issue has to do mainly with Korea's history as a Japanese colony.

Every country has to come to terms with its own history through a process of self-reflection. Horrible things happen in wars and conquests. Unlike Germany, Japan has not come to terms with its colonial and wartime history. Ardent nationalists proclaim that Japan was not at fault. These are contentious issues, not just domestically, but also in Japan's relations with China, South Korea, and North Korea. These grievances are very difficult to resolve. This is one of the most onerous challenges Japan faces. While segmented so far, poor political relations may well spill over to less-good Japanese foreign economic relations, especially with China.

Even so, the Chinese and Japanese governments are actively participating in an East Asian economic cooperation process through the ASEAN+3 (China, Japan, South Korea) dialogue for regional financial cooperation. Thus far, substantive regional financial cooperation has been small, limited, and non-threatening, and complementary to, rather than competitive with, the international financial system based on the IMF and global financial markets. This dialogue, while heavy on rhetoric relative to economic substance, is an important initial phase in what inevitably will be a very long-run process. The first, current, stage is focused on increasing mutual knowledge, understanding, and trust; the next will involve significant, incremental, substantive commitments; and if they reach a final stage, it will include major commitments.

Japan and other participants are pursuing East Asian economic cooperation on two tracks, trade and finance. Market-driven, deeper intraregional trade and FDI integration have been significant components of East Asia’s sustained rapid growth. Further market integration will benefit from government cooperation in developing trade facilitation measures, capacity enhancement, and other institution building.

Since 2000, Japan has shifted its trade policy by adding bilateral (and potentially regional) preferential trade agreements, popularly termed FTAs (free trade agreements). Bilateral agreements have been ratified with Singapore and Mexico and negotiations virtually completed with Malaysia, the Philippines, and Thailand. However, negotiations with South Korea have stalled, and the prospects are not bright.

Japan’s FTA strategy has a serious obstacle and a major flaw. The obstacle is the persisting power of Japanese agricultural and, now, health care–vested interests to prevent significant liberalization of agricultural imports and inflows of foreign health care workers. Until Japan overcomes such protectionist forces, it will be difficult to commit to significant FTAs with other Asian partners. That may not be so bad.

The flaw is that, while FTAs provide short-term gains for their members, they are likely to create overwhelming longer-run, systemic costs because they embed specific, incompatible, bilateral rules and agreements. Most FTAs are so complex, with so many intertwined elements, that they are difficult to make sufficiently general for other countries to join. Rules of origin are a particularly serious problem. It will be very different to create a single East Asia-wide FTA from existing and proposed bilateral FTAs.

Because bilateral and regional FTAs are less efficient than WTO multilateralism, Japan and other East Asian countries should be pushing the Doha Round vigorously. East Asian economic cooperation is a nice phrase, but it is difficult to implement in practice. Membership is one issue, mutual trust another, and incompatible national interests yet another. A crucial issue, not effectively addressed, is where the United States and India will fit in the Japanese and other Asian visions of economic cooperation.

Indeed, APEC (the Asian Pacific Economic Community forum) is the only governmental organization that encompasses members representing the major East Asia, South Pacific, and U.S. and other Western Hemisphere economies. It may be that its mid-term review and its annual meeting in Korea in November 2005 will re-invigorate and restore APEC momentum and its multilateral commitments, in contradistinction to incipient East Asian preferential regionalism.

In Conclusion

Will the Japanese economy grow rapidly enough this year and next to break out of its cyclical mediocre growth trap and return to a full employment, sustainable growth path? Probably not, though for the first time in many years that is a real possibility. The post-election positive mood, an optimistic sense that Japan is finally changing and moving ahead, might provide a sufficient additional impetus to a decisive, positive shift in business and market expectations. That could generate a virtuous growth circle of a 1–2 percent CPI rise, real estate price increases, buoyant business investment, output and employment growth, increases in household income, and rising tax revenues that reduce the budget deficit.

I think a more likely scenario is slow gradual improvements across the economy which will eventually achieve a full employment equilibrium. That could take as much as five more years. It will be based significantly on the future reduction in the labor force through baby boomer retirements, and continued modest declines in private sector saving rates to bring aggregate saving and investment into better balance, particularly if companies raise dividends rather than hoarding cash flow.

I need further evidence that the current momentum will be sustained and enhanced before I judge that the economy is finally achieving self-sustaining, full employment growth. Both these scenarios are based on the assumption that a significant cyclical slowdown will not occur in 2006 or beyond. The greatest risk to achieving sustained growth is that the government will prematurely adopt an excessively restrictive fiscal policy by raising consumption taxes significantly. That could once again choke off sustained recovery, as occurred in 1997. A further concern is that wages, employment, and household incomes will not soon increase rapidly enough to sustain sufficiently strong consumption growth.

Good sustained economic growth, utilizing its labor, capital, and land resources fully and well, is Japan’s fundamental macroeconomic challenge. As I have stressed, the economy faces, and on the whole is dealing increasingly well with, a wide range of structural and microeconomic challenges, including corporate and public sector restructuring, more efficient markets, and corporate governance. Internationally, Japan’s greatest challenge is how to develop constructive, effective relations with its neighbors, especially China.

We should always remember that Japan’s economy has a great deal of capital, excellent labor skills, and sophisticated technology, which combine to generate a now high standard of living and wealth. Most Japanese are capable, well motivated, and ambitious. As its long-run transformation proceeds, the economy will become more market-based, competitive, and efficient. Japan has many problems, but I have every reason to believe that GDP growth per capita will continue to rise, leading to ever-greater economic well-being.