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Introduction

While Japan's economy performed reasonably well in 2007 and through the first quarter of 2008, as of mid-2008 it had, dismayingly, slowed so much and so rapidly that it very likely is now in a recession. The extended recovery and expansion since 2002 has come to an end, and recovery may well not resume until late 2009. Given Japan's increased interdependence with the global economy, as well as domestic factors, uncertainty is greater than usual. At issue are the severity of the downturn and its length before satisfactory growth resumes. Inadequate domestic demand is the major constraint on growth.

Due to sharply rising costs of oil and other commodity imports, Japan's decade-long mild deflation has come to an end, at least temporarily. The core consumer price index (CPI), which in Japan excludes fresh food but not oil, rose throughout the second quarter of 2008 to a 1.9 percent annual rate in June, and assuredly will increase further before slowing in late 2008. However, the GDP deflator has not become positive, and land prices have stopped rising in urban districts and are continuing to decline in most prefectures.

Domestic politics have become interestingly unclear and uncertain now that the Democratic Party of Japan (DPJ) unprecedentedly controls the Upper House of the Diet, while the Liberal Democratic Party (LDP) and allies have an important two-thirds majority in the more powerful Lower House. The DPJ has been trying to force an early Lower House election—the deadline is September 2009—and is opposing Prime Minister Yasuo Fukuda and the LDP however it can. The consequence has been political gridlock. It is premature to evaluate the effects of the Cabinet reshuffle on August 2, but key appointees have given priority to fiscal austerity.

In the near term, government administration proceeds on autopilot, the economy moves along on its own, and the likelihood of successfully addressing significant economic policy issues is low. Substantively, this political situation has not harmed Japan's international economics relations, although the dark comedy of the Diet process to approve appointment of the new Bank of Japan (BOJ) governor has been internationally embarrassing. One of the two deputy governor positions has yet to be filled.

Japan's cyclical economic process is embedded in a long-run major transformation of its economy, polity, society, and population. My colleague Gerry Curtis argues that the past fifteen and next ten years are comparable to the transformative periods following the Meiji Restoration of 1868 and the loss of World War II. Underway are generational changes in values and behavior, the possible emergence of a real two-party political system, a population aging and beginning to decline in numbers, and restructuring of many economic and other institutions.

Having "caught up with the West" in the 1980s, Japan now has a high-income, high-productivity, mature economy with a long-run per capita potential growth rate comparable to other advanced economies. Japan is one of the first major economies to begin to experience a secular decline in its population and labor force. Japan's economic problems as this transformation proceeds are not unique, but that does not make them any less difficult.

Having discussed labor, financial markets, and corporate governance at some length in last year's essay, here I address several longer-run economic issues. But first, as always, I review Japan's current economic situation.

The Current Economy in Perspective

Any evaluation of where Japan's economy is today, and where it is going, must be in the context of several factors. The first is Japan's overall economic stagnation following the bursting of the 1980s stock and real estate bubbles. From 1992 to 2002, Japan had three recessions and its GDP grew at only 0.9 percent annually (0.6 percent per capita), significantly below its potential. One major cost of this was the potential growth foregone: GDP today could be 20 percent higher than it is. A second cost was the sharp decrease in job opportunities for those leaving school. This created what has been called the "lost generation" (some term it the "ice-age generation"), comprised of those now between their mid-twenties and mid-thirties who do not have full-time regular jobs. They are a significant portion of the sharp rise in the number and share of part-time, contract, and temporary workers that are now one-third of total employment.

Coming out of the early 2002 trough, the economy did reasonably well. Between 2002 and 2007, GDP growth averaged 2.1 percent in both total and per capita terms. This was slightly better per capita than the OECD average of 2.0 percent, and 1.9 percent in the United States. While the growth has been erratic, it was the longest expansion in Japan's postwar history.

The central government was able to reduce its huge budget deficit by better than 0.5 percent of GDP annually to 3.0 percent in fiscal 2007 (which ended in March), from 6.7 percent in fiscal 2002. The bank nonperforming loan problem was resolved, the banking system was restructured, and capital market reform and development proceeded, albeit slowly. Most large corporations succeeded in restructuring, including reducing excess debt, workers, and capacity. The stock market rebounded from its April 2003 trough. By the second quarter of 2005 urban land prices had finally stopped declining and begun to rise, though land prices have continued to decrease nationwide.

Unemployment declined from a peak of 5.5 percent to 4 percent. While Japanese between the ages of fifteen and sixty-four have continued to decrease gradually since the 1995 peak, total employment actually rose between its 2003 trough through 2007 by 960,000 (1.2 percent); those fifteen to sixty-four slightly increased their participation rates and 29 percent of the men and 13 percent of the women over sixty-five continued to work. Self-employed and family workers, some 8.6 million including virtually all farmers, continue their slow reduction but still constitute 13.4 percent of all workers. While full-time regular workers rose slightly, the share of non-regular employees also increased to 33.5 percent in 2007; they earn 31 percent less than regular employees.

During the 2002–2007 period, both corporate governance and capital markets improved considerably, but still have a long way to go. Financial markets do not yet allocate capital well. The shares of half the listed companies sell below book value, a startling indicator of the institutional constraints placed upon activist institutional investors. Almost all companies are under management control, including founder-family managers. Boards of directors are filled by insiders from management; the relatively few outside directors in practice have limited power. Since there is no labor market for senior executives, the top priority of managers is to keep their positions even in adversity; very high salaries are accordingly less important. To assure corporate success management uses profits for new investment; including R&D, while keeping dividend payouts low; for survival some firms hoard profits in liquid assets or land. Management has come to place greater emphasis on longer-run value maximization, though its commitment to regular employees is still more important.

Most listed companies have created corporate executive officer systems while reducing board size, in significant part to speed up decision making, strengthen internal controls, and assign greater individual executive responsibility. External monitoring, with the capital market replacing the earlier role of the main banks, is probably the greatest weakness of Japanese corporate governance. As transformation proceeds, the Japanese model of corporate governance will continue to be significantly different from the American model.

However, growth has not been sufficiently rapid to bring about a full recovery: Japan has not yet returned to economic normalcy. Extraordinarily low interest rates persist; wages have been flat; many part-time workers want full-time, regular jobs; consumption has grown slowly; and mild deflation, measured both by core CPI and the GDP deflator, has not yet been overcome. With the rise in import prices of oil, food grains, and other commodities, Japan's terms of trade have worsened, reducing the growth of real income (GNI, gross national income, a measure of domestic purchasing power) by about half since mid-2007. Also, despite GDP growth, household incomes did not rise much, and consumption increased at only about a 1.4 percent annual rate.

Japan's biggest macroeconomic problem since the early 1990s has been inadequate growth of aggregate demand, particularly domestic demand, despite massive budget stimulus in the 1990s and continuing extremely easy monetary policies and high liquidity. Between 2002 and 2007, some 40 percent of demand growth was due to business domestic fixed investment, and its share of GDP rose from 13.6 percent to 15.7 percent. This extraordinarily high investment rate relative to GDP growth suggests inefficient investment allocation. So, too, does continued low returns on corporate investment.

The role of foreign trade has become especially important, particularly with China and other Asian economies. Indeed, one-third of the growth in demand in 2002–2007 was the result of the rapid growth of exports—an annual rate of 9.7 percent. Exports and the current account surplus provided three-fourths of the growth in demand in fiscal 2007, and Japan's current account surplus rose to 4.8 percent of GDP in current prices, an all-time high. Such demand growth is unbalanced and unsustainable in the longer run, as discussed later.

Exports have risen to 15.4 percent of GDP in current prices, imports to 13.4 percent. China has surpassed the United States as Japan's largest direct export market, and Asia buys about half of Japan's exports. Some 45 percent of large manufacturing firm sales are foreign, inclusive of their overseas subsidiaries. While Japan is the world's most efficient energy user, it has to import all its oil, now about one-third of total imports.

Despite good growth, with GDP reportedly having increased at an annual rate of 2.9 percent in the fourth quarter of 2007 and 3.2 percent in the first quarter of 2008, mild deflation has persisted for more than a decade. Thus, the GDP deflator has continued to be modestly negative since fiscal 1998, which means current-price GDP growth (the source of taxes) has continued to be below real GDP growth. The fiscal 2007 GDP deflator decreased by 1.0 percent, slightly worse than the 0.8 percent decline in fiscal 2006.

In November 2007 Japan's core CPI finally rose above 0.5 percent, which is my break point between deflation and price stability because of inherent overstatement in CPI numbers, as my colleague David Weinstein has well documented. The increase was due almost entirely to the rise in the prices of oil and food, notably imported wheat. (Wheat prices are controlled by the government and were increased 30 percent in April.) As do many others, I consider annual increases in core CPI of between 1 and 2 percent to constitute price stability.

Price increases can come from either demand pull or cost push. Demand pull is better because it is a consequence of buoyant growth, which makes markets sufficiently tight that producers can raise prices. Alas, that is not what has transpired. Rather, Japan is in the throes of modest cost-push (supply) price rises due to skyrocketing commodity import prices, particularly iron ore and coking coal in addition to energy. The major effects of cost-push inflation on the economy are negative. It reduces consumer purchasing power and domestic demand, in addition to the adverse terms of trade hit.

The positive CPI has generated negative real interest rates, but that is only temporary. Moreover, interest rates have been so low for so long that any further incentive for business investment is small. Nonetheless, they may accelerate the flow of household bank deposits into other financial assets, domestic and foreign.

The Near-Term Future

Not only has the economic recovery stalled, but Japan may be entering a recession, which I simplistically define as two successive quarters of negative GDP growth. The government's first estimate, on August 13, of April – June GDP growth was a negative 2.4 percent (seasonally adjusted annual rate). July-end data for June suggest ongoing softening, with the unemployment rate rising slightly to 4.1 percent, industrial production continuing its downturn, consumption slowing, and summer bonuses low. Negative growth for the July-September quarter now appears a possibility. While any recession will be mild, subpar growth probably will persist well into 2009, in keeping with the slowing in world economic growth. The stalling of Japan's recovery is even more serious than recession.

One noteworthy pattern has been the recent ongoing reductions in growth forecasts by both government and private-sector participants. In July the Cabinet Office and the BOJ reduced their fiscal 2008 growth projections to 1.2-1.3 percent, clearly subpar. For fiscal 2009 their estimates of 1.5–1.6 percent barely reach conservative estimates of potential growth. At least 2 percent growth is needed to reignite recovery. Government and private forecasts will probably be further reduced in coming months. In a Nikkei survey at the end of July, all ten economists stated Japan already is in a recession.

Uncertainties about conditions not just in Japan, but especially in the world economic environment, make short-term projections more hazardous than usual. While the U.S. financial crisis appears to have crested, financial turmoil persists, with adverse effects globally. Japan has had only limited exposure to the subprime mortgage market and foreclosure difficulties. Indirect effects have been more substantial, and more complex to disentangle. These include reduction of foreign institutional investment in Japanese equities, ongoing Japanese investment in foreign financial assets, and the relatively weak yen following its interim surge to 95.7-yen-to-U.S.-dollar peak on March 18, 2008, a modest rise in terms of economic fundamentals.

Japanese policymakers place major emphasis both on the slowdown of U.S. growth and the timing of a U.S. recovery, and on world economic performance. The IMF estimates that world output increased at 5.1 percent in 2007, but is projected to slow to 4.1 percent (3.0 percent on a fourth quarter-to-quarter basis) in 2008 and 3.9 percent (but 4.3 percent growth fourth quarter-to-quarter) in 2009. While this is a substantial cyclical downtown, world growth in the past fifty years has been more rapid than ever before in history, and has accelerated over the past decade. This global improvement has been significantly driven by rapid catch-up growth of Asian developing economies—first Japan, then the newly industrializing economies of South Korea, Taiwan, Hong Kong, and Singapore, and now dramatically China and India. A cyclical global growth slowdown seems necessary to dampen global inflationary pressures.

Like everyone, the Japanese also are anxious about the future of commodity prices, signaled and symbolized by crude oil. As the IMF and Asia Development Bank (ADB) have cautioned, inflationary pressures are once again a serious concern, particularly in Asia. While part is cost push, demand-pull inflationary pressures from rapidly growing emerging countries are more important.

Fortunately, the Japanese labor market for new entrants has been relatively tight for the past several years, and this will continue. Those under twenty-four or so are the post-ice-age generation. Their cohorts are smaller, the retirement of postwar baby boomers proceeds, and large firms seek to offset earlier under-hiring. However, a stalled recovery—even more, a recession—means that the overhang of existing part-time, temporary, and contract workers seeking full-time regular employment will persist. Moreover, wages are not rising significantly, and the national average continues to be dragged down by the still rising share of nonregular workers and the replacement of high-earning retirees with new, young entrants, as well as by the shift of "retirees" from full-time to part-time employment. (With retirement at sixty still the norm for most workers at large firms, follow-on jobs are common—inevitably at lower pay.)

Significant increases in consumption growth, long anticipated (or at least wished for) by the government, have yet to materialize, and with only modest wage income increases, is unlikely to occur soon. Business investment is slowing, indeed hardly growing at all, as corporate profits are squeezed by rising input costs. The contribution of foreign trade (net exports) has been decreasing sharply since March 2008, and seems likely to continue. Export growth is slowing, and was negative year-on-year in June 2008 in both volume and value measures, while imports continue to increase.

Given the rapid slowing of world trade, Japan almost certainly cannot continue to rely on exports as a major source of demand growth. Substantial drops in oil and other commodity prices, should they occur, will mitigate the slowdown in external demand, while reducing pressures on producer profit margins and, to some extent, on the CPI.

Unlike the rest of the world, inflation is very unlikely to be a serious problem for Japan. The world commodity price boom will level off, possibly even decline, and Japanese demand growth unfortunately is unlikely to grow strongly enough to generate demand-pull inflation any time soon.

Many market participants expect core CPI to rise temporarily above 2 percent during the remainder of 2008, but to begin to subside in early 2009. In July the BOJ significantly raised its core CPI forecast for fiscal 2008 to 1.8 percent from its 1.1 percent forecast in April, but essentially maintained its earlier estimate for fiscal 2009, raising it from 1.0 percent to 1.1 percent, both within its policy target range of 0-2.0 percent. The government also raised its fiscal

2008 CPI forecast to a 1.7 percent increase, much higher than its forecast in January of 0.3 percent.

Japanese expectations data are a mixed bag. Consumer inflationary expectations tend to be higher than what actually occurs, perhaps because consumers are unduly influenced by rises in prices of daily necessities, while major cost-reducing productivity improvements take place in goods purchased much less frequently. On the other hand, capital markets continue to signal very low inflationary expectations. On August 15 the yield on 10-year Japanese government bonds (JGBs) was 1.7 percent; on 20-year, 2.3 percent; and on 30-year, 2.5 percent. Japan has inflation-indexed 10-year bonds, but the market is too thin to be a good expectations indicator.

A key issue is the extent to which price rises spread beyond imported commodities. How much will producers be able to offset the rising input costs that have narrowed margins? Like Bank of Japan governor Masaaki Shirakawa, I do not think second-round price increases will become significant because domestic demand remains weak: this remains the case even if the economy is not in recession. Rather, as prices of imported oil and other commodities decline from peaks, and as labor productivity increases, firms will restore margins by not reducing prices. This suggests any slowdown in the CPI increase may happen less rapidly in 2009 than is currently expected.

Economic Policy

The economic reform agenda of Prime Minister Junichiro Koizumi was attenuated during Prime Minister Shinzo Abe's year in office, which ended in September 2007. It has been further watered down under Prime Minister Fukuda, in part a casualty of the LDP-DPJ power struggle. Structural reform—deregulation of industries, liberalization of markets, and institutional pro-market regulatory reform—is fundamentally different in purpose and economic effect than fiscal consolidation (government budget deficit reduction), but the two have become deeply intertwined politically. The economic reforms proposed by the government's Regulatory Reform Council, the most recent in July, have not been implemented and, without strong leadership from the prime minister, are unlikely to be. Nonetheless, modest, specific reforms continue at the Ministry level, such as in residential construction and slow, erratic financial market liberalization.

The current slowdown exacerbates Japan's persistent macroeconomic problem of inadequate domestic demand. Under Governor Shirakawa's able leadership, BOJ policy of low interest rates and great monetary liquidity will continue and monetary policymaking is becoming even more transparent, appropriately, until sustained good growth is achieved, which probably is two to three years away. Fiscal contraction will ease, and may even temporarily end, as tax revenue growth slows and politicians press to increase government expenditures. Such fiscal stimulus would help Japan out of recession and back into recovery.

The stage for LDP-DPJ political theater will again be active in fall 2008 as the Diet addresses key economic issues. The setting is hugely important: the timing and specific policy issues for the next Lower House election. The ongoing macroeconomic policy conflict between fiscal consolidation and economic growth through demand stimulus will be center stage. Important themes include pension reform and funding; how to respond to the current economic slowdown; how to achieve good growth in current prices, as well as by real GDP measures; and, especially, how much to reduce budget expenditures or raise taxes in the fiscal 2009 budget. Whatever else happens, the government target to achieve budget primary balance in 2011 will not—and should not—be achieved. Rather, it should be put off, flexibly, to 2015 or even 2020. For fiscal 2009, and beyond if necessary, the government should temporarily suspend fiscal consolidation.

The combination of looming recession and higher oil and food prices has forced the government in August 2008 to pledge fuel and other subsidies to fisherman, livestock farmers, transport companies, and small businesses in a stimulus package that may be enacted in a modest supplementary budget this fiscal year even prior to setting the 2009 budget. The dilemma for politicians is that, since Japan can achieve at best the moderate growth rate of advanced high income countries, ample tax revenue increases are no longer available to transfer additional income to inefficient producers. Yet their political clout remains strong. How this tension is resolved is important, not only in the short run, but is a major political element in Japan's long-run political transformation.

One important backdrop in the economy policy debate is the huge gross government debt relative to GDP, now 188 percent. That will continue to rise, albeit slowly, until budget primary balance is achieved. The way to reduce the government debt as a share of GDP in the long run is to grow well in current prices as well as in real terms.

In retrospect, Japanese fiscal policy in the 1990s was a classic case of how not to implement expansive fiscal policy: it was too little, too late, too ad hoc, and too uncertain—not to mention quite wasteful in ways that now strain the economy. The debt overhang is even more a psychological concern than an economic problem. On a consolidated basis the government owns much of its debt—net debt is 88 percent of GDP—so the level, though still high, is manageable. Accordingly, the fundamental problem of fiscal sustainability over the long run is timing fiscal consolidation so as to not reduce aggregate demand at a debilitating rate.

The principal LDP policy for some years has been to resolve the budget deficit by steady annual expenditure reductions, especially in government spending on public projects, which have been mainly in rural areas. This was a sharp break from the LDP's previous, long-running use of central government funds to pay for projects for rural constituents. This fiscal consolidation has successfully reduced the general (both central and local) government budget deficit from 8.0 percent of GDP in fiscal 2002 to 2.4 percent in fiscal 2007. It now seems, certainly politically and probably economically, that substantial further expenditure reductions are not desirable.

The alternative policy approach, proposed by LDP leader Hidenao Nakagawa and Koizumi's economic czar Heizo Takenaka, has been to increase nominal GDP growth to 4 percent through a combination of higher real growth through government reforms plus a positive GDP deflator increasing at more than 1 percent annually. However, to achieve that requires dramatic monetary stimulus, probably including BOJ purchases of real assets (such as stock market indices and real estate investment trusts), and that is not going to happen.

The government is committed to increasing its share of national pension funding from one-third to one-half from fiscal 2009; and the numbers of elderly will increase steadily. The government would eventually have to raise taxes in order to finance present commitments for pension, health care, and other welfare expenditure programs. One option is to reduce those commitments.

Economically the simplest way is to raise the consumption (sales) tax; each one percentage point increase above the current 5 percent will augment government revenues by about ½ percent of GDP, assuming everything else is equal. (Of course it is not: there will be a reduction in aggregate demand.) However, raising the consumption tax is politically disastrous. Accordingly, a consumption tax increase evidently has been put off to fiscal 2010 or later. While the consumption tax will be part of the Diet tax reform deliberation this fall, my expectation is that serious consideration of the consumption tax will be postponed. The DPJ has announced it will campaign against a consumption tax increase in the next election.

The key instrument for macroeconomic policy change for the next year or two (or longer) will almost certainly be fiscal policy. Unless global commodity prices surge further, the BOJ's extraordinarily easy monetary policy will (and should) persist. An interest rate increase will not occur until Japan is once again on—indeed, well along—a sustained growth path.

The LDP has proposed reductions in public work projects and social security, and education expenditures for the fiscal 2009 budget, to be decided by year-end. It is unclear whether it will succeed in implementing its proposed expenditure cuts, or even whether it really wants to. The DPJ is proposing social expenditure increases, though how it proposes financing them is not clear. A major dilemma is that any budget easing, particularly in an election year, is likely to include substantial pork barrel spending rather than economically sensible expenditures.

With the consumption tax off the table, and the need to overcome slow-growth revenue shortfalls, other taxes may be increased. A likely candidate is cigarette taxes, which are low relative to Europe. Some 43 percent of Japanese adult males smoke, far greater than the OECD average of about 20 percent. Of course, raising the tax would accelerate the decline in smoking, but that is desirable for health reasons; smoking is estimated to reduce the life expectancy of Japanese men aged forty by 3.5 years. The tobacco tax now generates about ¥2.2 trillion, which is approximately equal to the revenue from one percentage point of the consumption tax. Thus, assuming price inelasticity of demand, a doubling of the tobacco tax is equivalent to about one-percentage-point increase in the consumption tax, and would be a good revenue expedient.

Japan in Comparative Context

Japan is deeply engaged in the 21st century's multicentric but highly interdependent economic world, in which East Asia, India, and, notably, China are of increasing importance. Globalization is not new for Japan, as attested by its trade, foreign direct investment outflows, technology transfers, and foreign aid activities over the past quarter century. While its economic interactions with the United States continue to grow, they have become relatively less important for both countries. China has replaced the United States as Japan's largest trading partner; Mexico has replaced Japan as America's second largest trading partner. Still, for good reasons

Japan’s foreign policy continues to be founded on its alliance with the United States, embedded in the U.S.-Japan security treaty.

Like virtually all economies, Japan is participating in the global cyclical slowdown in economic growth. How long Japan’s recovery stalls, and how deep its recession is, will be significantly affected by external factors. Japan’s financial system, now basically healthy, has been less adversely affected than Europe’s by the turmoil that originated in U.S. credit markets. Unlike other countries, inflationary pressures are not a problem; medium-term core CPI increases will be within the 2 percent bound of BOJ monetary policy.

While importing essentially all if its oil, natural gas, and coal, Japan has been in the forefront of cutting the amount of energy per unit of GDP. This process began with the 1970s oil shocks, and in Japan, unlike in most countries, it continued, if less urgently, in the 1980s and ’90s when energy prices dropped. As a result, Japan is the most energy-efficient nation in the world.

From an international perspective, the quality of Japanese life is very high. I sometimes think many Japanese do not fully realize how fortunate they are. Japan is probably the safest country in the world. Crime is very low, and so too are threats from other countries and terrorists. Japan is the first non-Western country to have developed a high-income, high-tech, advanced industrial economy and, accordingly, advanced nation status. Japan has a peace-loving democracy with strong civil and human rights, good rule of law, and relatively low corruption. A now-mature economy, it enjoys a standard of living roughly comparable to Western Europe and the United States, and the Japanese have the highest life expectancy in the world.

Longer-Run Issues

Of course, Japan has many important economic problems and difficulties; so do all major economies. Some have been alluded to above: inadequate domestic demand, labor and financial market weaknesses, incomplete deregulation and liberalization, providing for the elderly. Many other problems could be considered, such as increasing urban-rural disparities; poor productivity, wages, and profitability of small enterprises; structural imbalances in both GDP production and expenditures; and especially the demographic realities of aging, population decline, and labor force decline. Here I focus on population decline, potential economic growth, financing elder care, and varying Japanese perceptions of Japan’s position in the world.

Japan is among the first major countries in which the demographic transition has proceeded so far; its population peaked at 127.7 million in 2006. This has been inevitable: the fertility rate has been below the break-even level of 2.1 since 1974, and had fallen to 1.34 in 2007. I do not expect it to rise significantly in the foreseeable future. Population decline will be slow. The medium projection is a population of 126.3 million in 2020 and 108.2 million in 2050, about the level it was in 1973. This is not the “demographic suicide” anxiety that some have expressed for Europe. But the 2020s age distribution will be significantly different from that of 50 and more years earlier. Not only will the dependency ratio be higher, but the dependents will be primarily the old rather than the young.

These projections assume no significant immigration. Once economic conditions improve and the Japanese are fully employed, demand for low-wage, less-skilled labor will become intense, and for certain occupations such as nurses and elder-care providers. As part of its recent bilateral Economic Partnership Agreements, the Japanese government has established work-visa programs for qualified Indonesian and Filipino nurses and elder-care providers. However, the numbers are miniscule—in the hundreds. While the terms and conditions for foreigners to work in Japan will be a topic of policy debate, I do not expect immigration or importation of contract workers to have a significant macroeconomic impact in the foreseeable future.

To achieve long-run potential economic growth requires that both demand and supply (productivity) growth be sustained at full-employment, price-stability rates. The composition of Japan’s aggregate demand will have to change: a lower share of exports and current account surplus, and a rising share of domestic demand; plus an increase in the share of consumption and a decrease in the share of business fixed investment. Much Japanese business fixed investment is inefficient; returns on investment have been, and still are, too low. A major corporate governance problem continues to be how to alter the goals of, and incentives for, managers who control large corporations to enhance efficient investment allocation. The contrast between the efficiency with which Japanese manufacturers use physical resources and the inefficiency with which the economy allocates capital is striking.

For the consumption share to increase, household income must rise, because saving rates are very low. This means wages will have to increase across the board. But that will happen only when the economy grows relatively rapidly for a sustained period and labor markets really tighten. This is a familiar dilemma: better growth requires higher consumption, but higher consumption requires better growth. Exports have propelled recent growth, but this is not sustainable.

In the short run, the transformations needed are likely to slow growth. Although I have long been a critic of the glacial speed of reforms in Japan, changes should take place only gradually in the composition of GDP expenditures.

Long-run growth depends fundamentally on the supply side: changes in labor and capital inputs, innovation, technical progress, education, and all the other sources of increases in labor productivity. Even though women and older persons participate more, Japan's labor force will continue to become smaller for demographic reasons. Accordingly, Japanese growth will depend even more than earlier on increases in labor productivity.

All advanced economies—Japan, the United States, Western Europe—apparently have a long-run economic growth potential of about 2 percent per capita at best. To achieve 2 percent growth per capita is very good. It means that Japan's standard of living would double every 36 years, and quadruple in the lifetime of an average Japanese.

For a sustained intermediate period, Japanese labor productivity has the potential to increase significantly. Full recovery to a normal economy has yet to be achieved. Labor—with so many part-timers desiring full-time jobs, and others having withdrawn from the labor force, in addition to those listed as unemployed—is still underutilized.

Moreover, Japanese economy-wide productivity is only about 70 percent of that in the United States, despite more capital per worker. Closing that gap will accelerate growth. While manufacturing technology and productivity are high, the Japanese service sector, almost 70 percent of GDP, is notably inefficient, with very low levels of productivity (though measurement of the high quality of Japanese personal services is difficult and underestimated). Agriculture is particularly uncompetitive because at average farm size is 1.7 hectares; Japanese farmers have miniscule amounts of land, despite high technology and ample capital (equipment). However, agriculture comprises only 1.5 percent of real GDP and 3.8 percent of the labor force; and 57 percent are more than sixty years old (and 32 percent are over seventy). Nonetheless, together with the retirees and local government employees, they still have considerable clout in rural districts. Agricultural protection will continue to constrain Japan's leadership in multilateral, regional, and bilateral trade and other economic negotiations for some time.

Some policymakers have targeted Japan's internationalization of financial services as a new growth industry; salaries are high and the financial services share of GDP is low. Given its economic size and high level of development it is not surprising that Japan's domestic financial sector is the largest in Asia. However that makes it more difficult to internationalize since domestic tax, legal, and institutional arrangements, and particularly mind-sets, are deeply imbedded; and they are not fully compatible with established best global practices. Japan has two further difficulties: the language of international finance is English, that of domestic finance Japanese; and the numbers of skilled Japanese professionals are in short supply and the asset management industry nascent.

Japan will not anytime soon set up a sovereign wealth fund (SWF) using its foreign exchange reserves, which were $1,002 billion as of June 2008. However, the Government Pension Investment Fund, with $1,500 billion in assets, is a SWF, in that it is government-controlled. Government policy regarding foreign SWF investments in Japan is not well-defined but in practice it has been encouraged. As in other countries, it will probably depend on the source and type of investment.

The most recent OECD estimate of Japanese potential growth for 2009–2013 is for GDP to increase 1.5 percent annually, and GDP per worker (labor productivity) 2.2 percent. While the working-age population will decline by 0.9 percent, a 0.2 percent labor participation increase means labor input will decrease by 0.7 percent. Population is projected to decline more slowly, at a 0.3 percent rate, so GDP per capita will grow at 1.8 percent. Those are reasonable but conservative estimates. For example, the ADB and the Japan Center for Economic Research estimate growth will be about 1.7–1.8 percent until 2020. With appropriate government deregulation and liberalization policies, and more efficient private sector and capital market allocation of resources, labor productivity could increase significantly more rapidly than 2.2 percent for a sustained period, and thereby so would GDP.

To achieve potential growth, Japan, like other advanced industrial economies, will have to rely essentially upon technical progress and growth of labor and total factor productivity. One of Japan's greatest challenges is to develop further a culture of innovation: high education and skills, basic and applied research and development, support for needed institutional and organizational change, and especially risk-taking. The economy and society will have to reduce its currently very severe penalties for failure, as well as excessive pressures for conformity. The Japanese should be rewarded, not penalized, for thinking outside the box.

When we address aging as a problem, we are really considering how to cope with all the economic, health care, societal, and personal family adjustments needed to take care of the elderly adequately. In particular, providing and funding public pensions and health care services is one of Japan’s most important long-run social and economic challenges. Because policymakers, the media, and the voting public are deeply aware of these problems, I feel rather confident that solutions will ultimately be found. Further, I expect Japan will be a global leader in this area.

Financing can be achieved in two ways: increasing government expenditures as a share of GDP funded by increasing taxes (the consumption tax); or reducing the increase in pension and other benefits the elderly are now scheduled to receive.

The basic policy issue is how much of the growth in GDP per capita should be spent on the elderly over the long run. Put differently: to what extent should retirees share in the increase in GDP through pension and medical benefit increases? If the policy were only to maintain the same pension level (adjusted for inflation) that a retiree initially receives, without their sharing in future increases in GDP per capita, financing should be relatively easy. One premise of the laudable 2004 social security reforms was that pensions would rise, but less rapidly than GDP per capita growth. However, implementation has been severely undermined because the fundamental assumptions on CPI increases and nominal GDP growth have not been achieved.

It is stimulating but difficult to sort out the varying attitudes and world views of the Japanese. Some are inward-looking, domestically oriented, and seem rather comfortable, even complacent. Others, with a global orientation, are pessimistic about Japan’s future, visualizing Japan declining as a major international player and “great power.” Those accustomed to assume that Japan is the major power in Asia have been subject to the shock of the rise of China. I sense that attitudinal differences are not simply generational.

I am dismayed by comments that Japan has become a second-tier economy. That simply is not true. What is true is that Japan’s growth rates, like those of the U.S. and Europe, are modest compared to the current generation of catch-up developing economies. But Japan has caught up and is even a leader in many areas. For others also to achieve economic progress and improvement in their well-being is desirable, and indeed is to the economic benefit of the already well-off.

Japan today is the world's third largest economy in purchasing power parity terms, and continues to be second by foreign exchange rate measures. Unless Japan really messes up, it will be one of the world's five largest national economies for the next twenty to thirty years. While there will be fewer Japanese, they will have a significantly higher standard of living than today, and certainly, for decades to come, will live far better and longer than the vast majority of Chinese and Indians. The Asia Development Bank estimates that in purchasing-power parity terms Japan's GDP per capita, $35,604 in 2005, will be $47,088 in 2020, still more than ten times that projected for China.

The Japanese should be realistic, not pessimistic. Of course everyone wants normal, full-employment economic growth restored, with a renewed sense of vigor and vitality. That will take time, probably longer than the next two years. In addition, the Japanese have to live with two fundamental realities. First, since it is a high-income, advanced country, Japanese economic growth per capita in the long run will not be significantly greater than 2 percent, and slower in total GDP terms as population declines. Like the United States, Japan's share in global GDP will gradually decrease. The second fundamental reality is that China now is the largest East Asian economic and military power, despite its very low per capita income. This is the case because its population is more than ten times Japan's, and its economy will continue to grow much more rapidly for many years.

China's rise does not mean Japan's fall. Indeed this is obvious from the benefits Japan has been reaping trading with and investing in China. Japan will continue to be Asia's technological giant, with a high standard of living that will continue to rise. The challenge for Japan and China is to learn how to work together politically. Through trade and foreign direct investment (FDI) they can continue to interact economically extraordinarily well and harmoniously. For both, the challenge will be how to integrate China as a player and stakeholder into the global political economy system. At the same time, as the Doha Round tribulations signal, powerful new global players (China, India, Brazil) will require new approaches and new rules.

Conclusion

Japan's third major transformation in the past 150 years proceeds erratically, somewhat haphazardly, but inexorably. While the demographic transition is the most predictable and the growth implications of economic maturity are reasonably straightforward, political and social change are much more difficult to forecast. Others can learn from Japan's demographic experience of a declining population with more elderly and fewer children. Japan can learn from Scandinavian social welfare, female employment, and fertility-friendly policies.

An ongoing challenge for Japan, as for all countries, is to live up to its economic potential. Japan's economic recovery has stalled and apparently is in mild recession; political gridlock is a real concern. I remain fundamentally fairly optimistic about Japan in the long run; the Japanese are smart, well educated, hardworking, ambitious, and pragmatic. They live in a good democracy, and have a stable society. My greatest concerns are not economic. Can Japan develop a more effective political system and policymaking processes as the transformation proceeds? In the long run I am hopeful that Japan will overcome the many problems, difficulties, and failings it confronts like all mature, successful societies.