Columbia Business School

CENTER ON JAPANESE ECONOMY AND BUSINESS

日本経済経営研究所

Working Paper Series

November 2009, No. 286

Japan’s Deep Recession and Protracted Recovery

Hugh Patrick

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK

Japan’s Deep Recession and Protracted Recovery

Hugh Patrick

Center on Japanese Economy and Business

Columbia Business School

November 2009

Abstract

This paper discusses Japan’s deep recession from summer 2008 to spring 2009 and the recovery as of fall 2009, considers near-term and longer-term prospects, and briefly addresses Japan’s international economic relations. The August 2009 Diet Lower House election victory by the opposition Democratic Party of Japan (DPJ) heralds a major change in Japanese politics, ending long-term control by the Liberal Democratic Party. While the DPJ proposed significant changes in economic policy in its election campaign, it remains too early to determine just what its economic policies will be in Japan. Japan has a major problem, not just cyclically but structurally: a combination of inadequate domestic demand and its unbalanced composition – notably a high share of business investment in only slowly growing GDP and a low share of consumption yet little household saving. A further major concern is the persistence of mild deflation for the foreseeable future. Both suggest the need for significant further macroeconomic stimulus to jump-start economic recovery in order to generate full employment sustained growth.

This is an update of the September 15, 2009 essay “Japan’s Deep Recession and Prolonged Recovery” which will appear in English and Japanese in the 2008-2009 Annual Report of the Center on Japanese Economy and Business.

Japan’s Deep Recession and Protracted Recovery

Hugh Patrick

Center on Japanese Economy and Business

Columbia Business School

What a year! Since my 2008 essay, the world has been engulfed in financial crises, and Japan, the United States, and the world economy went into their worst recessions in the postwar period. Furthermore, the Democratic Party of Japan’s election victory signals a new era in Japanese politics.

While Japan escaped severe direct effects of the global financial crisis, it was hard hit by global declines in demand as its exports suddenly collapsed in fall 2008. What began as mild declines in Japanese GDP in the second and third quarters of 2008 turned into a debacle in the fourth quarter and continued into the first quarter of 2009, with GDP falling at an annual rate of about 12 percent during those six months. Japan’s decline has been more severe than those of the United States and Europe. However, Japan bottomed sooner, in spring 2009. The economy turned around in April-June 2009 with positive growth from the previous quarter at a 2.7 percent annual rate. The government on November 16 announced surprisingly strong third quarter GDP growth of 4.8 percent, substantially greater than the consensus forecast of 2.9 percent. However, it is likely this rebound will quickly lead to full recovery, namely achieving sustained full employment growth. Discouragingly, after achieving price stability in 2008, essentially as a consequence of the global oil and commodity price boom, Japan has now returned to mild but persistent deflation.

As Japan proceeds in its ongoing fundamental transformation from the earlier postwar system era, economic policy thinking has to deal with three fundamental realities.

First, Japan is a high income, high tech, sophisticated, and mature economy. This means that, like other advanced industrial economies, long-run potential GDP growth per capita is on the order of 2 percent a year, once cyclical recovery is achieved.

Second, Japan, sooner than other countries, is in the advanced stage of demographic transition. An increasingly large share of the population is over 65, those of workforce age have been decreasing for more than a decade, and the total population is beginning a slow decline.

Third, Japan's most important macroeconomic problem for the past 15 years, and certainly for the next several, is lack of domestic demand growth, particularly consumption. Inadequate domestic demand is more than a cyclical problem; it is structural. Japan is not short of labor. For almost two decades labor has been in surplus because Japan has been unable to achieve sustained, full employment growth.

What the current recession vividly demonstrates is that Japan's overwhelming macroeconomic problem is the combination of lack of aggregate demand and its unbalanced structure. There was great reliance on growth of exports and domestic business investment. Related to this, mild but persistent deflation is a significant concern. The big question continues to be: Where will sufficient aggregate demand come from to bring about a real recovery and sustained growth?

Japanese public discourse on the economy is replete with false facts and misleading clichés. Rapid growth in the 1980s was not miraculous; it is explained by standard economic factors. The 1990s were not a "lost decade"; economic growth was mediocre, but a host of institutional, political, and social changes took place. The main source of increases in income inequality is not Prime Minister Junichiro Koizumi's economic structural reforms; failure to achieve full employment is. Fiscal policy in the 1990s was not a failure; it was a success when it was allowed to work. Its inadequacies existed because the fiscal stimulus was too little, too late, too ad hoc, and too uncertain; and when successful, it was prematurely terminated in 1997.

I am less optimistic than in previous years about the near and medium term. In the sections that follow, the focus is on Japan's macroeconomic challenges and policy choices. I consider the August elections, the incomplete 2002–2007 recovery, recent economic performance, the economy's near-term future, the aggregate demand conundrum, Japan's international economic relations, and growth in the longer run.

The New Political Ball Game

The Democratic Party of Japan (DPJ) won an overwhelming victory in the House of Representatives election held August 30, and DPJ president Yukio Hatoyama became prime minister on September 16. Aside from an 11-month period in 1993, this is the first time since 1955 that the Liberal Democratic Party (LDP) has been out of power. But the election reflected less a commitment to the DPJ than a great dissatisfaction with poor LDP performance and a strong desire for change. The DPJ's victory gives the party both a surge of energy and a sense of urgency. But it is a new government, inexperienced and untested. Not only is this the DPJ's first government—almost half its lower-house members (143 of 308) are serving first terms.

Policy change is in the air—economic, political, government administration, foreign relations. But specifically what will change, how much, and to what degree, are far from certain. The DPJ is characterized as slightly left of center, and the LDP slightly right of center, but both parties encompass a broad political spectrum. DPJ Diet members range from moderately conservative to socialist, and some were once LDP members. Still, despite a great deal of rhetoric, significant change is unlikely to come quickly.

In addressing both immediate and longer-run issues, the debates in the coming months will be shaped by preparations for the House of Councillors election in July 2010. The DPJ currently controls the upper house in coalition with two very small parties that cause disproportionate difficulties in achieving policy consensus. Depending on how its performance during its first 10 months is perceived, the DPJ could gain complete control then. But it could also face a backlash that weakens DPJ control of the government, or even gives the LDP an upper house majority, although that seems unlikely. In any case, the DPJ is here to stay—lower house elections do not need to be held until 2013.

The DPJ's economic philosophy is not oriented toward efficiency-enhancing structural economic reform. Rather, it is to reject what it considers market-liberalization excesses, especially in labor markets, although it is not antimarket. While it has yet to think through and articulate a comprehensive economic growth strategy, the DPJ has stated that it will pursue three major economic policy objectives.

The first is switching government expenditures from public infrastructure to household consumption. The centerpieces of this is providing annual payments for each child of ¥312,000 ($3,284 at 95 yen per dollar) through middle school (age 15), educational payments to reduce senior high school education fees and costs, and income transfers to farmers. These new expenditures are projected to rise to about 3 percent of GDP, to be financed by cutting other expenditures.

The second is fiscal moderation. The DPJ will not depend upon deficit financing more than the LDP did in its 2009 government budget; it will not engage in further deficit financing (government bond issue) to finance the new social welfare expenditure programs. While in the 2010 budget the DPJ will utilize government special account reserves as well as cutting out some infrastructure projects, in the longer run other expenditures will be cut and revenue adjustments made, such as eliminating family deductions for income taxes. The DPJ has promised not to raise the consumption tax in the next four years.

The third objective is to create a new, powerful, politician-dominated policymaking apparatus, in order to reduce significantly the power of the central government bureaucracy and its long-standing, cozy relationships with the LDP. The new National Strategy Bureau reports directly to the prime minister; presumably it is to consist of 30 or so knowledgeable policy advisors drawn from the private sector, Diet members, and some bureaucrats. It is led by Naoto Kan, a former head of the DPJ, who concurrently serves as deputy prime minister. The DPJ is determined to impose stronger political control over the bureaucracy, and to the extent it succeeds it will bring about basic change in the way Japan is governed. But the DPJ cannot rule without the cooperation of the bureaucracy, so pragmatism will lead it to some kind of accommodation with the bureaucracy.

The immediate policy battleground has been in the full Diet session beginning in late October. As the deliberations indicated, the rhetoric has been substantial but the process of DPJ policy-making has only begun. One major test will continue to be the Diet decisions on the fiscal 2010 budget, in final draft form at the end of 2009. The transfers for children will probably begin next June, but for the first year at half the amount planned for subsequent years.

One key political issue is whether the DPJ can increase social welfare expenditures without having to increase total expenditures and thus further increase the deficit. It can find the revenues for fiscal 2010, but for fiscal 2011 and beyond that will be difficult. A second issue is whether the current recovery will slow down so much in the first half of 2010 that it puts pressure on the DPJ to initiate a special supplementary budget stimulus package early in the year or immediately after the 2010 budget is passed. A third issue is whether the National Strategy Bureau will become well established and effective. A fundamental reality is that the DPJ has inherited important macroeconomic, microeconomic, and structural economic problems; it is far from clear how, and how effectively, the DPJ will address these challenges.

The Incomplete 2002–2007 Recovery

It is important to place Japan's current economic condition in the context of the 2002-07 incomplete recovery from the difficulties of the 1990s. From 2002 to 2007 Japanese GDP increased 11 percent, about 2 percent annually, in both total and per capita terms since population growth was flat. In per capita terms Japan grew slightly faster than the United States, though from a greater initial output gap.

Companies were able to eliminate their three excesses: too much debt, too much capacity, and too much labor. The main drivers of growth during 2002–2007 were exports and business fixed investment. Exports increased a remarkable 58 percent and rose impressively as a share of GDP from 10.9 percent in real terms (11.3% in current prices) in 2002 to 17.4 percent (17.6%) in 2007. Business fixed investment, already high at 13.7 percent of real GDP in 2002 (13.5% in current prices), rose by 30 percent to a 16.0 percent share (also 16.0% in current prices) in 2007. Consumption spending was of little help, increasing only 5 percent. Already a low 57.5 percent (56.5%) of GDP in 2002, the consumption share fell to 54.8 percent (56.3%) in 2007. Public investment continued its decline, from 6.3 percent to 3.4 percent (6.3% to 4.0% in current prices).

Japan benefited from surging Chinese development, combined with good growth in the United States and the rest of Asia. Exports also benefited from the weak yen, due to low Japanese interest rates, the carry trade, and other Japanese capital outflows. Japan's comparative advantage was and is in automobiles, electronic goods, and machinery, all of which respond strongly to rises in foreign demand and, as the last year has demonstrated, also to declines. Most of the increase in manufacturing capacity and industrial production during the period was to provide exports.

Growth from the 2002 trough to the 2007 peak was good, but not good enough. Recovery was incomplete: full employment was not achieved and domestic deflationary pressures were not brought to an end. Equally important, the structure of aggregate demand was unbalanced; growth depended primarily on extraordinarily high rates of growth of exports and business investment. Aggregate demand imbalances were not overcome by consumption growth because household income increases were low; and government policies of fiscal consolidation (reduced deficit spending) held back faster growth.

The core Consumer Price Index (CPI) fell slightly or was flat during 2002–2007. Only in late 2007 did prices begin to rise, and then only due to the global oil and commodity price boom. CPI inflation increased to a peak monthly rate of 2.4 percent in July 2008 before rapidly declining to zero by the beginning of 2009. The Bank of Japan was not able to raise its basic interest beyond 0.5 percent (from zero), which meant a more normal level of market interest rates could not be achieved.

Unemployment declined from a monthly peak of 5.5 percent in early 2003 to 3.8 percent by the end of 2007. Labor markets became more efficient; but without strong GDP growth and demand for labor, many workers were adversely affected. Nonregular workers continued their dramatic rise as a share of the labor force—from a fifth in 1990 to a third in 2009. The part-time, contract, subcontract, and temporary workers who make up this group receive weak employment commitments, lower wages, and fewer benefits. For some, nonregular status reflects a lifestyle choice, but large numbers, especially young people, have unsuccessfully sought regular, full-time employment.

Firms have benefited doubly; they can replace retiring regular workers with low-cost nonregular workers, and in times of economic downturn the nonregulars can be laid off easily. Thus, even as unemployment was reduced, the economy’s wage bill fell over the period, and disposable household income as a share of GDP declined.

Labor market developments in a micro sense increased efficiency and benefited companies but retarded total demand. This has contributed to the public view that income inequality has become a significant social problem, a dramatic change from the 1980s when more than 90 percent of the Japanese considered themselves to be middle class (or middle mass, the Japanese phrase used to avoid the concept of class). Income inequality in fact has increased somewhat from the 1980s. The distribution is slightly less equal than the OECD median, but still considerably more equal than in the United States. The incomplete recovery, with its failure to achieve full employment, has been a main source of the increased inequality.

Recent Economic Performance

In late summer 2008 the emerging recession was seen as halting the recovery but otherwise was not expected to be severe. Instead, Japan has gone through its longest and deepest postwar decline in GDP. The economy turned around in the second quarter of 2009, but GDP in summer 2009 was still 6.4 percent below its peak.

However, in aggregate, the adverse economic effects of recession have been relatively modest. GDP per capita in 2009 in purchasing power parity terms is estimated to be about $32,300, a decline to just above the 2006 level. Consumption has fallen only slightly. Unemployment has rather sharply increased, from a monthly low of 3.8 percent in October 2008 to an unprecedented 5.7 percent in July 2009, but remains far below Western levels. Housing ownership has remained stable, and foreclosures are not a problem. Unlike the 1973-74 oil crisis, there is no inflation or widespread sense of panic, no fears of import embargoes or shortages. However, the recession has hurt the already vulnerable, including part-time and temporary workers and those soon entering the labor force. Japan's unemployment insurance programs are not well developed.

GDP plunged 3.2 percent in fiscal 2008 (ending March 31, 2009). This was triggered by a 10.2 percent decline in exports and a 9.6 percent decline in business fixed investment; together they accounted for more than the total drop in GDP. The annual data smooth out what were stunning quarterly slumps. Compared to a year earlier, exports fell 12.6 percent in the 2008 fourth quarter and by 36.4 percent in 2009 first quarter; business fixed investment dropped

11.8 percent and 20.5 percent, respectively. Consumption held up fairly well over the year, declining only 1.5 percent.

The good news is that in the second quarter of 2009 GDP stopped declining and began to rise at a 2.7 percent annual rate (according to the latest revision), and the growth rate even increased to 4.8 percent in the third quarter according to the government's first estimate, announced on November 16. While second quarter growth was completely due to the increase in net exports since domestic demand continued to decline, third quarter growth was more balanced. Of the 4.8 percent growth, 1.4 percentage points were contributed by net exports, 1.7 percentage points by renewed consumption growth, and 1.6 percentage points by inventory increases (a suspect estimate which may be revised downwards). And, after declining for five quarters, business fixed investment made a positive contribution of 0.9 percentage points.

Japan's financial system has so far weathered the crises and recession reasonably well, in large part because in the late 1990s it went through its own crisis, consolidation, and reform. The regulatory system was overhauled and the Financial Services Agency (FSA) was established. The FSA's problem is not lack of regulatory authority or basic quality but lack of staff, budget, and better market oversight information technology. In fall 2008 the Bank of Japan (BoJ) effectively stepped in to prevent the freezing of domestic financial markets by actively purchasing commercial paper and corporate bonds and taking other temporary measures to avoid a credit crunch. These policies were successfully implemented without necessitating a major expansion of the BoJ balance sheet. As the need for these special measures waned, the BoJ announced plans to let them end as scheduled by 2009 year end.

The Tokyo stock market dropped to 7,055 (Nikkei index) on March 10, 2009, its lowest level since the market bubble burst in 1990. Foreign holders reduced their share of the market by 4.0 percentage points to 23.6 percent as of March 30, 2009.

Japan's major banks have large corporate shareholding positions for client relationship purposes. Banks took substantial book losses on the decreased mark-to-market value of their holdings of stock and other securities in fiscal 2008 and have hustled to raise new capital. However, given limited exposure to U.S. subprime loans and related derivatives, the banks were not otherwise directly hit hard by the global financial crisis and recession. The ratio of nonperforming loans did not increase. At the end of March 2009, it was only 1.9 percent for major banks and 3.0 percent for the entire banking system, though some small local institutions continue to be in real trouble.

By late summer the stock market rebounded, but has been erratically flat since then; on September 11 the Nikkei was 10,444, and on November 16 it was 9,791. Stock market volatility is a source of banking vulnerability, but for competitive reasons, no individual bank can reduce specific-company holdings. A government policy to restrict bank equity holdings by half, or more, from the current 100 percent limit relative to bank Tier 2 capital, makes sense.

While the pace of mergers and acquisitions has slowed somewhat in Japan as elsewhere, it has continued with greater participation by Japanese firms, both domestically and internationally. Some parent companies such as Hitachi are buying listed profitable subsidiaries at below book value. The number of management buy-outs of small companies continues to rise, albeit from very low levels. The strategic decisions of major Japanese to acquire foreign companies are an important trend.

With population declining, companies in markets where economies of scale are important face saturated domestic markets. Managements do not want to reduce firm size and distribute proceeds to shareholders and employees. Domestic merger with a competitor is increasingly taking place but is not easy. Successful diversification into new fields or industries is not easy either, as the 1980s and 1990s demonstrated. The current surge of Japanese company expansion abroad, usually by acquisition, will persist. This will pose difficult human resource management and institutional challenges for these firms, especially for nonmanufactures, as they enter unfamiliar foreign environments.

Small and medium enterprises (SMEs) have been particularly hard hit by the recession. SMEs comprise a large share of output and, more importantly, employment. The LDP government took a range of steps to ensure that SMEs do not suffer a credit crunch. Regulations for lending institutions were eased, such as not counting rescheduled loans as nonperforming or special attention loans if the SME borrower had a viable restructuring plan. Importantly, the government in October 2008 provided ¥20 trillion ($211 billion) to back 100 percent loan-loss guarantees through local credit guarantee corporations, rather than requiring lending banks to bear a portion of the losses. By February 2009, some ¥8.8 trillion in loan guarantees had been utilized. Given ongoing SME difficulties, the DPJ is beginning to grapple with policies and channels for providing further financial support.

Bank of Japan (BoJ) policy has been good, but its ability to combat the recession by standard policy instruments has been severely constrained. During the 2002–2007 recovery it was not able to raise its basic overnight call rate above 0.5 percent (reached in 2006). The BoJ lowered its rate to 0.3 percent on October 31, 2008, and to 0.1 percent on December 19, but, not surprisingly, the effects were small.

The main failure of monetary policy has been its inability to halt deflation, even to the BoJ's own conservative implicit range of an annual core CPI increase of 0 to 1 percent. (I think the range, explicit or implicit, should be 1 percent to 2 percent, similar to the European Central Bank and the U.S. Federal Reserve System.) As a consequence of booming world and Japanese import commodity prices, core CPI rose to a peak of 2.4 percent in summer 2008, but as commodity prices plummeted, the CPI dropped to 0 in January 2009 and to a peak of minus 2.4 percent in August. In the semiannual October 30, 2009 forecast of the BoJ's Policy Board members, the median forecast of core CPI change was -1.5 percent for fiscal 2009, -0.8 percent for fiscal 2010, and -0.4 percent for fiscal 2011, similar to market forecasts. The BoJ argues that since the pace of price decline is becoming less bad, "it is unlikely that the decline in prices will induce downward pressure on economic activity." I am astounded by this policy stance.

Deflation has a wide range of bad effects. It discourages investment, borrowing, and current purchase of durable goods. It makes traditional monetary policy ineffective. And, also important for Japan, it has an adverse fiscal policy effect. Deflation reduces government tax revenues, in addition to the revenue declines from slowed real GDP growth. Japan's GDP price deflator has been negative consistently, if modestly, since 1998, so GDP changes in current prices are lower than in real terms. The GDP deflator declined by 0.3 percent in fiscal 2008.

As the economy suddenly declined precipitously, in spring 2009 the LDP government dramatically abandoned its fiscal consolidation policy of the previous several years. While it kept the conservative 2009 budget intact, once it was enacted the government immediately announced a huge supplementary budget stimulus package, passed May 29, of ¥13.9 trillion ($146.3 billion), about 3 percent of current price GDP. About half is direct expenditure. This one-shot boost is now having an impact on consumption and public investment, which will continue, albeit diminishing, through the early part of 2010. However, through its newly formed and probably increasingly important Administrative Reform Council, the DPJ has frozen almost 3 trillion yen in expenditures, presumably to generate funds for its children's support program in the fiscal 2010 budget.

Unemployment is a lagging measure of an economy's performance. Japan's rate rose from a low of 3.8 percent in October 2008 to 5.7 percent in July 2009, surpassing the former peak of 5.4 percent in April 2003. Despite the current recovery of output and temporary improvement in the employment rate in September, unemployment is projected to continue to rise to about 6.0 percent before beginning to decline later in the first half of 2010.

Japanese increases in unemployment have been less severe than elsewhere, in part because companies shortened work hours and shared reduced workloads, thereby retaining regular workers. Importantly and perhaps not widely recognized, the government now pays two-thirds or more of the wages of some 2.4 million regular workers deemed surplus in more than 83 thousand firms whose sales have decreased significantly; they comprise 3.6 percent of the total labor force. Accordingly, quarterly measures of output and productivity per worker have temporarily plummeted. Japan continues to rely on a company-based employment welfare system rather than direct unemployment compensation for unemployed workers.

Bifurcation in labor markets has become more important as nonregular workers have increased. Full-time regular employees are protected both by company permanent employment commitments and by laws that make it difficult to lay them off. Those losing jobs are usually temporary workers, subcontractors, and those whose contracts have expired.

The Japanese system of wage payments has significantly greater downward flexibility than in the United States or Europe. It is not only a matter of replacing retiring regular workers with nonregular workers, though that has been important. A major source of downward wage cuts is reduction of the semiannual bonuses that virtually all employees receive. The norm is for winter plus summer bonuses to be about four months of regular monthly wages, depending on the industry and firm size. Profitability is an important factor, so bonuses can vary significantly from year to year and firm to firm. Surveys estimate the summer 2009 bonuses of large firms were lower by about 17 percent from a year ago, the first absolute decrease since 2002. Export-oriented manufacturing firms cut bonuses even more. The decline for nonmanufacturing firms was a modest 2 percent, the first time in five years that their bonus payments were larger on average than that of manufacturers. Disquietigly, newspaper reports suggest the winter bonuses of large firms will decrease by 15.9 percent from a year earlier.

The combination of these forces—increases in nonregular workers, reduced overtime, and lower bonuses—meant that total cash earnings of all employees in Japan decreased from the previous year by 0.7 percent in fiscal 2007, 1.1 percent in fiscal 2008, an unprecedented 4.7 percent in the second quarter of 2009, and apparently a further 3.3 percent in the third quarter. It is not surprising that household income as a share of GDP has stagnated, that the household saving rate is now a low 3 percent to 4 percent, and that the consumption share of GDP has continued to be low, 57.8 percent of GDP in current prices (55.5% in real terms) in fiscal 2008.

Labor market flexibility makes for greater efficiencies in a full employment economy, but the widening inequalities of income distribution, unemployment, and underemployment have generated a political backlash. Thus, dissatisfaction with changes in the labor market is deemed one factor in the DPJ's election victory, and a challenge for DPJ labor market policies.

The Near-Term Outlook

I am not optimistic about Japan's near- to medium-term economic performance. Japan will not achieve full recovery until GDP grows at 2 percent or better for long enough to eliminate the output gap and full employment is achieved. I do not foresee that happening soon. The economy is recovering nicely in fall 2009, but is still below the previous peak and may well slow significantly in the first half of 2010, as the LDP fiscal stimulus package ends. The rate of recovery will depend , importantly on DPJ policy initiatives and continued increases in exports.

I expect the DPJ fiscal 2010 budget to signal fiscal caution. New welfare expenditures will be financed by other expenditure cuts and use of reserve funds. Export success depends both on how rapidly China, the other Asian economies, and the United States recover and grow, and the extent to which they shift demand more to domestic consumption and investment and less to foreign trade.

Growth in the final quarter of 2009 will probably be somewhat less strong than surprisingly robust third quarter estimates. Exports will increase, but at a less dramatic rate as foreign inventory adjustments are completed. Consumption and public investment will continue to do reasonably well due to the 2009 supplementary budget, and Japanese inventory restocking will continue. Overall, year-on-year GDP growth forecasts see a downturn for calendar 2009 of 5.2 percent or more, and a negative 2.5 percent or so for fiscal 2009—the fiscal year does not include the terrible January–March 2009 quarter.

The prospects for 2010 do not look very good: a still huge output gap, relatively high unemployment, and a consensus GDP growth rate of about 1.2 percent. Although negative CPI growth has bottomed, deflation will not end for several more years unless a new global oil and commodity boom develops, or the BoJ implements a new, dramatically bold policy. The CPI change will be on the order of minus 0.8 percent in fiscal 2010, the BoJ October forecast.

I think the economy will continue modest recovery into 2011, at perhaps a 1.5 percent rate. This is significantly below the BoJ's median forecast of 2.1 percent GDP growth for fiscal 2011, which apparently is based on spill-over domestic demand effects of substantial export increases. Interestingly, the BoJ reduced its estimate of the potential growth rate from a conservative 1 percent to an even more conservative 0.5 percent, which implies the output gap will be reduced more quickly. Nonetheless, full employment seems at least several years away. Mild deflation will persist with small negative values of core CPI changes through 2011 and beyond.

It is more difficult to forecast Japanese economic performance for the three- to five- year period, and I may be too cautious. Some analysts I respect are more positive. The IMF optimistically forecast in spring 2009 that Japan's growth will accelerate to a peak of 3.2 percent in 2012 and will still be a very good 2.5 percent in 2014, mainly as a consequence of renewed world GDP and trade growth. It will be wonderful if this proves correct. It could mean that, after more than two decades, Japan will finally be achieving full employment growth.

A modest rebound in the rest of 2009 and growth of 1.2 percent or so in 2010 are not very good news for the DPJ, but not terrible news either. The economy could perform even better if the world economy and trade recover rapidly and Japanese investors and consumers become more optimistic. It would be bad news if Japan were to appear to stop growing, even if avoiding a double-dip recession, in early 2010. If so, and if recovery prospects looked dim, I would not be surprised if the DPJ were to pass a major stimulus supplementary budget in spring 2010, as the LDP did in spring 2009. Indeed Naoto Kan and others have recently suggested this may take place. The July 2010 election looms large.

Japan's Aggregate Demand Conundrum

In the long run, Japan's growth of GDP per capita depends fundamentally on improvements in labor productivity through innovation, technological change, education, institutional and organizational improvements—all the factors that make the economy more efficient and increase aggregate supply capacity. However, in the near to intermediate period, Japan's major macroeconomic problem will continue to be the persistence of inadequate aggregate demand. The huge economic policy challenge for the DPJ is how to stimulate demand and shift expectations away from the persistent deflation and mediocre growth, while dealing with the huge and increasing amount of government debt.

The composition of domestic demand is a structural, not just a cyclical, problem. Business fixed investment is too high a share of GDP, and household consumption is too low a share. Japan's business fixed investment share of 15 percent is greater than the U.S. share, but the U.S. economy grows more rapidly. Japan's business incremental capital/output ratio, an inverse measure of capital efficiency, is triple that of the United States. Given Japan's demographic reality of a declining labor force, in equilibrium the economy requires business investment of, at most, 11 percent to 12 percent of GDP, a reduction of 3 to 4 percentage points.

The average returns on business investment and on assets in Japan are significantly below Western companies and industries and have been for two decades. It is not just that interest rates have been extraordinarily low, or that exports have boomed. Most listed companies are controlled by their management, and smaller firms by their owners. Their basic objective is to ensure the company survives, and, if possible, thrives. Management retains cash flow and profits in order to invest; dividend payout ratios are low. New investment increases productivity, expands capacity, and maintains jobs, including those of managers. (Japan has no labor market for senior corporate executives, unlike the United States.) Over time the share of domestic investment to GDP will probably decrease as market pressures strengthen and population declines. Instead, firms will invest abroad as they seek markets.

A good domestic demand structure implies that, rather than 55 percent of GDP, consumption should be somewhere between 60 percent and 65 percent. How to achieve this is a conundrum. Consumption depends mainly on household income, and to a lesser degree on household assets. In aggregate the household savings rate is now low, and dissaving by the elderly as they spend assets is constrained by the skewed wealth distribution. Pensions are lower than wages when workers retire. Household income depends on employment and wage payments; both are determined by demand for labor, which is dependent on GDP growth. For consumption to rise significantly, wages have to increase significantly. But that will occur only in a growing economy already having achieved full employment.

The third major domestic demand component is the government sector. The 1990s were a period of great fiscal expansion, significantly due to tax shortfalls and mandated welfare transfer payments. Consequently, the gross government debt to GDP ratio rose sharply and is now 172 percent. From 2002 until early 2009, the government pursued fiscal consolidation in what turned out to be an unrealistic effort to achieve primary balance by 2011. In the face of recession, in June 2009 the LDP government's goal to achieve primary balance was postponed for a decade or so, and on the condition that the consumption tax, currently 5 percent, be gradually increased to 10 percent or 12 percent. A further condition is that prices rise sufficiently that a 3 percent GDP growth in current prices, and hence government tax revenues, be achieved. Not surprisingly, the DPJ has yet to address longer-run fiscal adjustment, but that will be a key component in any fundamental macroeconomic policy strategy.

Effective macroeconomic policy, which is sorely needed not just for economic recovery but sustained full employment growth, requires complementary monetary and fiscal stimulus policies, given Japan's circumstances. Since interest rates continue to be so low, the BoJ could boldly purchase significant amounts of assets (stock indexes) as well as government bonds (JGBs) in order to stimulate demand and shift expectations. However, I doubt that the BoJ is prepared to take such dramatic action. I have argued for several years that Japan needs a strong, temporary fiscal stimulus to jump-start the economy, rather than a misguided policy of fiscal consolidation when labor and other resources are underemployed. However, the political reality is that sufficient fiscal stimulus is unlikely to be adopted beyond an effort to be sure the current recovery does not halt.

Many Japanese policymakers, media, and the general public apparently do not sufficiently understand basic macroeconomic principles and analyses. Certainly the ratio of government debt to GDP is very high and should be reduced, but only once the output gap is eliminated and the economy is back on a sustainable full-employment GDP growth path.

The risks of the high gross debt to GDP ratio are exaggerated and overly feared; they are not catastrophic. About half the debt is owned by various government units and the Bank of Japan. Government net debt is about 90 percent of GDP, high but sustainable. Almost all the debt is owned domestically; foreign holdings are too small to create exchange rate or balance of payment difficulties, and Japan's foreign exchange reserves are an excessive $1.057 trillion as of October 31.

Interest rates are extraordinarily low, and government interest payments on its debt are only 2 percent of GDP. Market long-term interest rates indicate that inflationary expectations are very low for the foreseeable future. The government debt problem in the near to medium term is not as important as the problem of lack of domestic demand essential for economic recovery and growth. Japan's fiscal experience of the 1990s showed that stimulative fiscal policy works if managed correctly.

Unfortunately, most Japanese do not think this way. There is strong public concern that the government debt is too large and should not be increased significantly, even temporarily. There is insufficient appreciation of the high costs of inadequate aggregate demand, hence the apparent fiscal conservatism of the DPJ as well as the LDP. Fiscal policy will be a key indicator of DPJ economic thinking.

Because increases in business investment, consumption, and government net spending will probably not be sufficient to propel the Japanese economy, export growth and a strong current account surplus in the balance of payments will be the remaining possible major sources of demand growth. To recover and grow, more than before Japan will depend on the growth of

China, the rest of Asia, and the United States. Japanese manufacturers will have to become even more competitive and export oriented, and service-sector companies must develop effective operations in foreign markets.

Given the likely slow recovery to full employment as well as persistent deflation, the Bank of Japan will have to continue its very low interest rate policy indefinitely. That suggests Japanese capital outflows will increase as interest rates rise in the United States and elsewhere, and as Japanese corporate strategies of foreign direct investment develop further. Temporary movements aside, this implies the yen will not strengthen significantly despite continuing lower inflation rates than in the United States and EU. While a weaker yen would encourage exports, government intervention by purchasing dollars (and providing further stimulus) is internationally unacceptable.

The appropriate exit strategy from macroeconomic stimulus is certainly a key issue for Japan but in a somewhat different context than the United States and Europe. Japan is unlikely to face an inflationary surge in the foreseeable future. The Bank of Japan will be able to exit soon from its temporary measures to prevent a credit crunch but will sensibly maintain its low interest rate, easy monetary policy as long as necessary. My fear is that the Japanese fiscal stimulus will end prematurely. However, perhaps the DPJ will enact an annual series of ad hoc supplementary budget stimulus measures. If so, I hope that, rather than muddling along, they will manage fiscal stimulus more efficiently and effectively than in the 1990s.

International Economic Relations

Japan has long been a major player in world trade and capital flows, actively involved in Europe, the United States, and Asia—indeed everywhere. It is the fourth largest exporter, after Germany, China, and the United States. China is now Japan’s largest trading partner, and that share will probably increase. Japan’s trade with other Asian economies is becoming increasingly important. East Asia has been, and will continue to be, the world’s most dynamic, rapidly growing region. In technology, economic achievement, standard of living, and quality of the labor force, Japan is the East Asian leader, but China is a dominant force in terms of total GDP and growth.

East Asian economies have developed a high degree of trade integration, enhanced by regional supply-chain production systems. However East Asia has not developed a significant regional architecture for trading and financial relations, and it will not anytime soon. This is not surprising, given the major differences in size, levels of development, political systems, language, and histories.

Prime Minister Hatoyama has proposed an East Asian Community (EAC) as the central pillar in his Asia policy. In his speech at the Asia-Pacific Economic Cooperation (APEC) summit in Singapore on November 15, he indicated Japan would play an active role in considering a range of possible free trade agreements or economic partnership agreements, potentially involving not only East Asia but the United States. He did not address Japan's trade policy thorn of its protectionist agricultural policy.

Certainly we can expect increased rhetoric on regional trade nad financial cooperation, and probably some further modest actions. However, effective participation in global and regional economic institutions and policymaking will continue to be based more on the power of individual countries than on any regionwide consensus and supporting mechanisms. Keys to the future lie in the ambitions and prospective roles of Japan and China in dealing with each other and with the other East Asian economies.

China's development has benefited Japan economically, but it poses challenges for Japan's regional and global roles. China has responded positively to the global financial crisis and trade deterioration by pursuing strong domestic stimulative policies and quickly restoring rapid growth. China is an important global actor but has yet to take the role of a global leader.

For the first time in history Japan and China are simultaneously regional powers. China is the largest economic and military power in East Asia, despite its very low per capita income. China's population is 10.5 times that of Japan, and its economy should be able to pursue rapid catch-up growth for many years.

The evolving strategy of many Japanese companies, given declining domestic population and slow market growth, is to actively expand abroad, particularly in Asia and Australia, through acquisition and other direct foreign investment. However, the Japanese government has rarely exercised a global or regional leadership role commensurate with its economic power.

It will be interesting to see whether Prime Minister Hatoyama's East Asian Community proposal will engender a new, more active role for Japan.

Many in the United States and the EU see China, not Japan, as the most appropriate focus: perceptions of dynamism and growth trump stability and maturity. But this is too narrow and short sighted a perspective. Even with subpar growth, Japan will be the fifth largest economy in the world 20 years from now, following the United States, EU, China, and India; its GDP will continue to be substantially larger than other populous countries such as Brazil, Indonesia, and Russia.

In terms of economic well-being, Japan's already high standard of living will double every 48 years if GDP per capita growth is 1.5 percent. If the advanced-economy long-run growth standard prospect of 2 percent per capita growth is achieved, the standard of living will double in 36 years, and more than quadruple in the lifetime of a typical Japanese.

National economic power is often measured by total GDP, reflecting the combination of population size and labor productivity. Economic welfare is proxied by GDP per capita. In a listing of the top 20 economic entities ranked by GDP per capita in purchasing power terms, all but two, the United States and the Netherlands, have populations smaller than New York City's 8.4 million.

Growth in the Longer Run

In the years after World War II to about 1990, Japan's growth challenge was on the supply side: to expand productivity capacity, production, and productivity as rapidly as possible. Exports were necessary to pay for required imports, not as a major source of demand. However, for the past two decades, Japan's major macroeconomic problem has been how to achieve sufficient aggregate demand. This problem will continue for at least several years. Nonetheless, in the longer run the supply side will determine Japan's potential growth rate.

Growth depends on changes in employment and in labor productivity. Long-run productivity growth per hour is determined by innovation, technological change, and education, as well as new investment. As with the United States and Europe, Japan's potential labor productivity growth per worker per hour is on the order of 2 percent to 2.5 percent. Japan's may be slightly higher than the United States since its average productivity for the economy as a whole is only about three-quarters of the U.S. level. Japanese manufacturing productivity is high, but service sector productivity remains extraordinarily low, even though it is probably somewhat underestimated.

Over the next 20 years the Japanese labor force will inevitably become smaller. As of February 2009, 82.0 million Japanese (64.3%) of the total population of 127.6 million were from ages 15 through 64 (that is, of working age), 28.5 million (22.3%) were 65 or older, and 17.1 million (13.4%) were under 15. Assuming no net immigration, Japan's population in 2030 is projected to be 117.6 million, of whom 69.6 million (59.2%) will be in the working age group, 34.8 million (29.6%) 65 or older, and 13.2 million (11.2%) under 15. This is a reduction of 12.4 million in the working age group, an annual average rate of decrease of 0.8 percent. Offsetting this, there is likely to be some rise in the female labor participation rate and continuing work by some of those 65 or older, so labor input may decline about 0.7 percent annually on average.

These projections of a rise in labor productivity but a decline in the labor force suggest that Japan's GDP potential growth rate will be on the order of 1.3 percent to 1.8 percent. That is based on many heroic assumptions. One is that, while Japan may import workers on a contract basis, net immigration will be negligible. Whether to encourage significant immigration, and by how much, will be one of the most important, and difficult, decisions Japan will eventually face. A further assumption is that labor productivity will increase as rapidly in an economy with a declining population and an aging workforce as when there are growing populations and relatively young labor forces. We simply do not know.

Conclusion

Over its modern history, Japan has gone through a series of long-run major transformations in virtually every dimension—economically, politically, socially, and demographically. It is yet again in the midst of a new era. Since the early 1990s, the operative constraint on good economic performance has been lack of aggregate demand. A new dynamic of sustained full employment growth has yet to be achieved. The election of the DPJ government is a major step in the political transformation process. However, how long the DPJ will retain power and, indeed, what the political landscape will become are substantial uncertainties. There are significant generational changes in values, or at least behavior. Fewer young people are getting married, and do so at a later age on average, though married couples have about as many children as couples did two decades ago.

While I am cautious, indeed concerned, about Japan's near-term economic performance and am anticipating only slow recovery to full employment sustained growth, I am more optimistic about Japan's longer-run future. Japan has strong human and social resources. It is a stable society, peaceful and quite crime free, and has an operating democracy as effective as most others. Japanese are intelligent, educated, pragmatic, hard working, and ambitious. Over time Japan has demonstrated great flexibility and adaptability. Japan does eventually solve its problems. What I have been unable to discern is what kinds of future Japanese want for themselves and their nation.

November 18, 2009