Japan's Economy:
Finally Finding Its Way to Full Employment
and Sustained Growth

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Abstract

With 2005 recording the best economic performance in the past decade, continued growth in 2006, and only a moderate slowdown likely in 2007, Japan finally is escaping its mediocre performance trap. The economy is moving reasonably well from recovery to full employment and sustained growth. GDP grew 3.2 percent in fiscal 2005, ending March 2006. The consensus is that growth will probably be at least 2.5 percent in fiscal 2006, and then slow to a slightly better than 2 percent rate in fiscal 2007. I am more optimistic about the Japanese economy than I have been for fifteen years, though that is not saying much. However, concerns persist: the economy has not yet returned to full employment growth, deflation has not quite ended, considerable employment slack remains, and the surprisingly low annualized growth rate of 1.0 percent for the April–June 2006 quarter is a splash of cold water, though it is less bad than it seems. I think domestic demand-side challenges will continue to dominate well into 2007, and perhaps beyond.

Near-term uncertainties are greater than usual. One major near-term uncertainty in early autumn 2006 is political. In succeeding sections I address Japan's recent economic performance; near-term prospects; government economic policy, with special focus on the monetary and fiscal policy components of macroeconomic policy; increasing income inequality; the financial sector; corporate management and governance; Japan in the global economy; and implications of economic maturity and declining population in the long run. I end with brief concluding comments.

Major international concerns include the future price of oil; slowing growth of the United States economy; incipient global inflationary pressures; the global trade imbalances centering on the huge and increasing U.S. trade and current account deficits and Chinese surpluses; and the implications for the yen-dollar rate. A different type of concern is that Japan's current economic success will generate complacency among public and private decision-makers such that still-needed public and private sector reforms are not fully carried out. Despite these concerns, I anticipate that Japan will indeed achieve sustained growth with full employment over the course of the next two to three years.

With 2005 recording the best economic performance in the past decade, continued growth in 2006, and only a moderate slowdown likely in 2007, Japan finally is escaping its mediocre performance trap. The economy is moving reasonably well from recovery to full employment and sustained growth. GDP grew 3.2 percent in fiscal 2005, ending March 2006. The consensus is that growth will probably be at least 2.5 percent in fiscal 2006, and then slow to a slightly better than 2 percent rate in fiscal 2007.

The highly regarded Bank of Japan (BoJ) *Tankan* quarterly survey at June end indicates business expectations support the widespread optimism permeating Japan. In response to these better economic conditions, the BoJ terminated its five-year zero interest rate policy on July 14, a major shift in monetary policy.

I am more optimistic about the Japanese economy than I have been for fifteen years, though that is not saying much. But concerns persist: the economy has not yet returned to full employment growth, deflation has not quite ended, considerable employment slack remains, and the surprisingly low annualized growth rate of 1.0 percent for the April–June 2006 quarter is a splash of cold water, though it is less bad than it seems. I think domestic demand-side challenges will continue to dominate well into 2007, and perhaps beyond.

Near-term uncertainties are greater than usual. One major near-term uncertainty in early autumn 2006 is political. As expected, Shinzo Abe was elected President of the Liberal Democratic Party (LDP) on September 20 and Prime Minister on September 26, replacing Junichiro Koizumi. The Abe administration rhetoric on economic policy has been good but it remains to be seen how fully and well policy proposals, still rather general, will be implemented. A further concern is that the recently released monthly economic performance indicators for summer 2006 are mixed, and not great.

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Despite these concerns, I anticipate that Japan will indeed achieve sustained growth with full employment over the course of the next two to three years.

Subsequent sections address Japan's recent economic performance; near-term prospects; government economic policy, with special focus on the monetary and fiscal policy components of macroeconomic policy; increasing income inequality; the financial sector; corporate management and governance; Japan in the global economy; and implications of economic maturity and declining population in the long run. I end with brief concluding comments.

1 Recent Economic Performance

For three decades, Japan has had a structural problem of deficient domestic private aggregate demand. In macroeconomic terms, Japan's high private saving rate was significantly greater than its high private business investment rate, and the gap was too large to be absorbed by an export and current account surplus. This was exacerbated over the past fifteen years, necessitating huge government deficit spending to prevent a serious recession. However, the private sector saving-investment gap has decreased significantly, and so will be much less of a problem. The household gross saving rate, some 15 percent of GDP in 1991 and 11.6 percent in 1998, declined to 6.0 percent in 2004 and even lower in 2005. This was due in large part to the increase in the elderly population and to a widespread desire to maintain consumption levels. While corporate saving rates have risen, now that balance sheet health has been restored, companies are prepared to invest more rather than paying down debt.

Excellent growth in fiscal 2005 was driven by consumption expenditures, business investment, and exports. Consumption increased 2.4 percent, substantially better than any year since 1996, and provided half of domestic demand growth. Business fixed investment rose 7.5 percent, providing another two-fifths of growth. Exports rose 9.2 percent; however, imports rose 6.8 percent in real terms, and even more in current prices, so net external demand was only one-sixth of real GDP growth. After several negative years, government demand in fiscal 2005 temporarily rose slightly, comprising 0.2

percentage points of the 3.2 percent GDP growth; this was mainly due to the substantial slowing of the decrease in government public works investment of previous years.

Despite the erratic and somewhat unreliable monthly movements of many economic indicators, on a quarterly basis they demonstrate that the recovery has been strong and broad-based, and is continuing to move into expansion mode. The economy started 2006 with a continuation of good growth, at a 2.7 percent clip (seasonally adjusted annual rate). While more mixed indicators led the consensus of experts to expect some slowdown to a 1.8 percent rate in the April–June quarter, the government's first preliminary estimate on August 11 was only a disappointing 0.8 percent. The second preliminary estimate, released on September 11, inched the annual GDP growth rate estimate up to 1.0 percent, but the substance was basically unchanged. The good news was that domestic private demand—consumption and business investment—continued to grow well, at a 2.9 percent rate. Moreover, the slowdown was due predominantly to a decline in inventories and in government spending, which in fact is not bad news.

Importantly, national average land prices rose by 0.9 percent in 2005, the first increase since 1992. While in some prefectures land prices are still falling, though more slowly, they are rising in major cities, notably Tokyo. Bank lending has turned positive, and increased notably in July. Industrial production and exports continue to rise, and services are growing reasonably well. The sharp decline in July in core machinery orders is worrisome, only partially offset by an increase in August. Hopefully this is only a temporary aberration.

The private sector is an ever-more important driver of the economy. The corporate sector has resurged. Successful restructuring has reduced costs, worker productivity has continued to increase and unit labor costs to decrease; even without price increases, profits rose by an impressive 12.5 percent in 2005 for larger firms, and 10.4 percent for small and medium enterprises (SMEs).

While not yet satisfactory, labor markets are improving. Unemployment, 4.1 percent in August, continues its slow decrease. The quality of employment has turned around. The number of full-time workers has begun to rise, and the still-too-high share of part-time workers and contract workers has leveled off at about a third of employees. However, persisting labor slack is evidenced in the reality that compensation of employees, based on rises in regular employees of 0.5 percent and in earnings of 0.7 percent, increased only 1.3 percent in 2005 and is not yet rising significantly. The summer 2006 wage bonus for some 800 large firms rose 1.79 percent, only 239 yen (0.08 percentage points) more than summer 2005.

2 Near Term Prospects

The data now available, and the various private forecasts, suggest that the July-September quarter performance will be somewhat better than the weak previous quarter, but not strong enough to fully alleviate concerns about slowdown. Nonetheless, the September – end Tankan of business sentiments and expectations was once again strong, more than expected, which suggests recovery and growth will be sustained. The first preliminary estimates of July – September GDP growth will be announced on November 14; that will provide a better sense of how the economy is doing.

The Economist consensus of foreign financial institutions as of early October is that real GDP will grow 2.8 percent in 2006, with a 2.6 – 3.0 range and 2.1 percent in 2007, with a 1.6 – 3.1 range. Consumer prices are forecast to increase 0.3 percent in 2006 and 0.5 percent in 2007. Since estimates of the longer-run potential growth are 1.5–2 percent, this is good news. The government, Bank of Japan, IMF and OECD forecasts tend to be more cautious but are nonetheless good. Growth depends on the demand side on how rapidly consumption increases, as well as business fixed investment and exports; and on the supply side the degree of slack in the economy, especially labor slack, and relatedly, the size of the output gap.

2.1 Labor Slack

Japan’s labor force as of spring 2006 totaled 67.25 million, of whom 64.84 million have jobs. Labor slack is still substantial. Of the 50.0 million employees (excluding corporate executives), 16.6 million (33.2 percent) are not regular employees. This includes 7.8

million part-time workers (of whom 7 million are women), 3.4 million temporary workers, and 5.4 million contract or dispatched workers. Full-time employees have decreased by 5 percent since 2000, while part-time and others have risen by 25 percent.

The labor slack includes unemployed seeking jobs, those who have reluctantly withdrawn from the labor force, the many part-timers who desire regular full-time jobs, and many of those who reluctantly accepted early retirement, as well as the elderly who would like at least part-time employment. It is important to distinguish between those who work part time by choice, predominantly married women, and those, especially temporary workers, who cannot obtain satisfactory full-time employment.

Some of the greatest costs of Japan’s mediocre economic performance over the past fifteen years have been inflicted on young Japanese. They have disproportionately been unemployed or underemployed in part-time work. They are not receiving adequate on-the-job training. Many have stopped actively seeking work, or have dropped out of the labor market. Although some have deliberately chosen alternative life styles, most seek full-time work in a suitable occupation. New terms have entered the language: freeters (part-time and temporary workers), NEETs (those not in education, employment, or training). As of 2005, of those aged 15 to 34, 2,132,000 were unemployed (including about 640,000 NEETs), and another 2,010,000 were freeters, including many high school dropouts. Most NEETs come from poor families and have low educational attainment.

Sustained economic growth, creating demand for workers, is the solution. While we do not know just how young people will respond to better job opportunities, I consider this potential labor supply to be the major resource to sustain rapid growth for another two years at least. However, some 60 percent of the freeters and NEETs are 25 or older; rigid recruiting age norms are an obstacle to their obtaining regular fulltime jobs. They probably will not be absorbed until labor markets become quite tight.

Some 19.4 percent of Japanese 65 or over are employed. This is higher than in other countries, though the rate has decreased over the past 15 years. Many baby boomers retiring from full-time, regular jobs will seek continued employment. How large a labor reservoir older people are is unclear.

Japan’s traditional large-firm permanent employment system has not disappeared, but it has become more narrowly defined. Many companies impose a hierarchy of job categories: permanent regular full-time employees (the core), essentially permanent part-time workers (mostly women), contract employees (one year or so), workers temporarily dispatched from another firm, ordinary part-time workers, temporary part-time workers (often on specific projects), and casual day laborers. Most of these categories are mainly for blue collar or clerical work. Management-track employees are key members of the core. The weak labor market of the past fifteen years has enabled firms to shift more flexibly to lower-wage categories.

There are grounds for optimism that full-time employment will increase and that unemployment and part-time employment will decline significantly. This is because GDP will grow faster than 2 percent for the next two years and because the surge of early postwar baby boomers will begin to retire from 2007. With labor markets tightening as labor slack evaporates, wages eventually will have to rise. Better employment and higher wages will accordingly generate higher household consumption, an essential ingredient to sustain growth. The key is how quickly and strongly this process will take place.

2.2 The Output Gap

Two major objectives of economic policy are simultaneously to achieve and maintain both full-employment potential growth and price stability. In any forecasts, the size of the output gap—the amount of slack in the economy—is a key factor in estimating growth. The gap between actual output (GDP) and potential output under conditions of full employment of resources and price stability may be conceptually clear, but empirically it is difficult to measure, especially in an advanced economy where services rather than goods comprise most of the output. As Japan demonstrates, this empirical difficulty is exacerbated when an economy undergoes a long period of below-potential growth combined with modest deflation. The size of the output gap depends on the amount of slack in the economy, as well as future employment, capacity utilization, and labor productivity growth.

I share the view that the estimates of the output gap made by the government and the BoJ have been too small, and that slack in the economy is still substantial. Part has to do with the estimates of long-run potential growth, which are too cautious. Part has to do with the difficulties in measuring capacity (and, indeed, output) in services, now more than three-quarters of GDP. Even with good growth, slack will exist so long as prices are not increasing, wage rises are small, and unemployment and underemployment persist. Improvements in these indicators, rather than direct estimates of the presumed output gap, will tell us when the economy is back to normal.

An additional uncertainty is the degree to which labor productivity will grow, due not only to public and private sector reforms and restructuring but, more fundamentally, to the rate of technological progress. Japan has the potential to increase its rate of productivity growth from technological change and its diffusion as well as from increased efficiency in the allocation and utilization of labor and capital. Total factor productivity (TFP) growth slowed to 0.45 percent between 1995 and 2003, far below the 1980–1990 rate of 1.25 percent. This occurred despite the rise in capital investment in, output of, and TFP in information technology (IT) industries. The spread of IT to non-IT sectors has lagged. This provides Japan with an opportunity to increase labor productivity and total factor productivity.

2.3 Deflation

While real economic performance will probably continue to do reasonably well, still being debated in Japan is whether deflation has finally come to an end. Obviously, much depends on how deflation is defined. The core CPI based on 2000 prices maintained very small positive monthly increases from November 2005, and in June continued at a 0.6 percent annual rate after the 0.5 percent rate for the first four months of the year. That was sufficient to persuade the BoJ that ending its zero interest rate policy (ZIRP) was appropriate and desirable.

The August 25 revision of the CPI index to a 2005 price benchmark is another splash of cold water. The downward revision of the new core CPI was 0.4 percent for

July and 0.5 percent for the January–July period, substantially larger than expected. Accordingly, the July core CPI increased only 0.2 percent, and basically only became positive in June 2006, unlike the 2000 measure, which had become positive in November 2005. This will certainly reduce forecasts for the core CPI for this year and 2007.

I am concerned both that deflation has not yet completely ended and that price stability will be fragile. The dangers of deflation outweigh inflation, and their costs are disproportionately large. Financial markets evidently have a similar view, as indicated by the still-low yields on Japanese government bonds (JGBs). As of October 11, the yield on ten-year JGBs was 1.74 percent. The yield was 2.23 percent on twenty-year JGBs, and 2.51 percent on thirty-year. These suggest an expectation that price stability will continue with the CPI near the Bank of Japan's zero lower bound.

3 Government Economic Policy

Prime Minister Abe, his economic policy team, and the LDP face a host of economic policy issues. Abe's initial statements regarding his economic policy intentions are straightforward and good. They represent basically a continuation of Koizumi's policies but with somewhat different emphases and nuances. The focus is on growth of 3 percent in nominal GDP, combined with continued government expenditure tightness. Increased tax revenues thus will be the means of government budget deficit reduction, rather than an early increase in the consumption tax. In principle, Abe will preserve and implement the reform agenda of regulation and privatization. He has outlined a longer-term economic growth strategy focusing on innovation, technology, and productivity; educational reform; and a more flexible economic system to provide losers a second chance (whatever that means). How rapid nominal growth will be achieved in the near term is not at all clear.

The key will be the nature and degree of policy implementation. It is unclear how strongly Abe will exercise leadership in carrying out economic policies and how effective the results will be. He apparently is concentrating economic policy power in the Prime Minister's office. Will the reconstituted Council on Economic and Fiscal Policy, even with its strong private sector members, once again become a powerful economic policy-making institution? In what ways will there be political support in the Diet for still-needed reforms? How about the still-powerful central government bureaucracy, which opposes reforms reducing its power? In what ways will the policy agenda be shaped by the summer 2007 Upper House elections, in which LDP control is at risk? Agricultural sector reform is essential to implement any foreign trade initiative. How likely is that?

Together with reduction of protectionist regulation, the government appropriately has enacted prudential, pro-market regulation to enhance market transparency, efficiency, and competitiveness. However, Japan still has a long way to go on deregulation and liberalization, even apart from agriculture.

Prime Minister Abe, his Cabinet, and his economic advisors will need to make their own strong commitment to sustain and enhance economic reform measures in order to provide the government policy foundation for sustained growth. While the coming year will be good economically, it will be unsettled politically. Given the current political and government bureaucrat backlash against Koizumi’s free market agenda, there is a real danger the government’s economic reform program will slow substantially.

Prime Minister Abe’s most dramatic and indeed welcome action has been to quickly begin the process of repairing political relations with China and South Korea by his weekend trip to Beijing on October 7 to meet with President Hu Jintao, and then to Seoul on October 8 to meet with President Roh Moo-Hyun. Those meetings, desired by all three leaders, were constructive, and presumably will put Japan on a better path in its relations with them. Of course, the situation has been made considerably more complicated by North Korea’s announcement of its nuclear bomb test on October 9.

3.1 Fiscal Policy

Reducing the still-huge budget deficit and restoring fiscal balance continues to be a top priority under the Abe administration. Key issues are how rapidly to reduce the deficit, the relative contribution of expenditure cuts and tax revenue increases, what kinds of taxes to raise, and by how much. Koizumi’s final package of economic and fiscal-policy guidelines for fiscal 2007- 2011 was finalized in July and approved by the Cabinet, and apparently has been accepted by Abe, not surprising since he was directly involved.

Although fiscal stimulus was essential in the 1990s in order to maintain aggregate demand sufficient to prevent a crisis or serious recession, the government budget deficit became enormous, and government debt ballooned. With recovery beginning in 2002, the government has been able to pursue an appropriately moderate fiscal tightening policy, on the order of 0.5 percent of GDP a year. The combined budget deficit for both central and local governments, 8.0 percent of GDP in 2002, has declined to 6.0 percent in 2005 and a projected 5.2 percent in 2006. With the economy now well along its recovery path, the fiscal 2006 budget deficit may actually be somewhat smaller as revenues increase beyond official cautious projections.

An ongoing debate in the LDP has been whether to give priority to expenditure cuts or to consumption tax increases. That has been resolved in favor of the former by the Abe administration, coupled with the new goal of substantial nominal growth. Koizumi’s fiscal priority was first to restrain and then to reduce expenditures, as the fiscal 2006 budget proposals demonstrate. Flat expenditures combined with revenue growth since 2004 have reduced the deficit absolutely as well as a share of GDP. With good growth performance, government revenues have been rising significantly. The government terminated its 1999 income tax cuts, instituted small annual (but cumulatively important) increases in social security taxes on wages, and is increasing private co-payments for the government national health care program.

On July 21, guidelines were announced for the fiscal 2007 budget. Central government general-account expenditures are to be ¥46.8 trillion, below ¥47 trillion for the first time in nine years. Expenditure cuts are not across the board as before, but instead range from 1 percent to 3 percent. Public works and official development assistance (foreign aid) are cut 3 percent, defense by 1 percent.

The government’s five-year target is to return to budget primary balance by 2011, meaning that the budget deficit excluding government interest payments on its net debt will be zero. By the end of fiscal 2006 the primary deficit, 5.7 percent of GDP in 2002, is projected to be 2.8 percent. The long-run goal is to run a primary surplus by 2015 sufficient to achieve a balanced or even surplus government budget. These projections are founded on important assumptions, particularly that private aggregate demand will be sufficient to sustain the potential growth rate, both nominal and real.

To achieve primary balance by 2011, the government will have to overcome a projected five-year budget shortfall of ¥16.5 trillion. In July the Cabinet adopted guidelines that require most (between 69 percent and 86 percent) to be covered by reductions in expenditures, and the remainder by tax increases. These projections are based on the assumptions that current-price GDP growth will average 3 percent, and real growth 2.2 percent. Implicit is the expectation that economic reforms and total factor productivity increases, plus absorption of remaining slack, will generate this growth.

The projected expenditure cut targets are unlikely to be fully achieved. The summer 2007 Upper House election puts great pressure on the LDP to halt the large declines in government local public works projects, and to increase transfers to local governments. In the longer run, public pension payments will increase as the population ages. Importantly, Japan's defense share of the costs of the planned relocation of U.S. military forces in Okinawa is ¥1.9 trillion spread over eight years, and is not in the proposed budgets. The longer-run fiscal wild card is national security: will the North Korean nuclear and missile threat and other security concerns lead to significantly increased defense expenditures?

Cuts in government expenditures and rises in revenues have significantly altered the nature of the ongoing tax policy debate. The main issue is the consumption tax, currently 5 percent. A rise of 1 percentage point in the consumption tax increases government revenues (and reduces aggregate demand) about 0.5 percent of GDP. In 2005 the debate was whether to raise the tax 5 or 10 percentage points and whether to start in fiscal 2007. Now the starting date is no sooner than 2008, more likely 2009, and possibly not until 2010. And the question is whether the long-term increase should be 1 to 2 percentage points or 5 percentage points. The risk of premature fiscal tightening is currently considerably lower than before. I expect that the government will need to raise the consumption tax at some point. When and by how much depends on real and current price economic performance, social welfare programs, and national security expenditures.

3.2 Monetary Policy

The Bank of Japan dramatically altered macroeconomic policy, beginning in March, by shifting from a policy of extraordinary monetary ease to one of still considerable ease. The BoJ thereby began the process of implementing the three sequential policy steps essential to restore a normal monetary policy. These are: (1) reversing its quantitative easing policy by withdrawing excess liquidity in the system; (2) terminating the zero interest rate policy (ZIRP); and (3) gradually raising interest rates to a neutral level once sustained, full-employment growth consistent with price stability is achieved. The first two steps have been taken. The key policy issue now is how frequently and how far the BoJ will raise interest rates over the next year or two.

The BoJ also adopted a new monetary policy framework, which embodies transparent and flexible perspectives. It provides the Monetary Policy Board's "understanding" of price stability in the medium to longer term as being a CPI range of 0 percent to 2 percent. This provides an anchor for price expectations.

The new framework also is more forward looking. That is, policy will depend more on expected CPI and economic performance movements than on actual data, which in practice are backward looking. A potential danger of a forward-looking approach is that it may ignore the legacy effects of past poor economic growth and modest deflation. Effective BoJ communication, which Governor Toshihiko Fukui has done extremely well, will be even more important in implementing the new framework.

The BoJ successfully removed from the system most of the ¥24 trillion in excess reserves generated by the quantitative easing policy. That was necessary before it could restore its main policy instrument, namely changes in short-term interest rates. On the whole, the termination of quantitative easing has been accomplished quite smoothly, simply by letting BoJ holdings of short-term government debt run off. Excess reserve reduction alone was not sufficient to end ZIRP. For that, economic conditions and the CPI both had to be improving sufficiently and be expected to continue to improve.

On July 14 the BoJ ended ZIRP, as was widely expected. It raised the overnight call rate from 0 to 0.25 percent, and the basic lending rate at which banks can readily borrow from the BoJ (the "Lombard rate") from 0.1 percent to 0.4 percent. Further, it stated that an “accommodating monetary environment ensuing from very low interest rates will probably be maintained for some time.” The ending of ZIRP and restoring of interest rate policy flexibility was an important signal affecting expectations. Of course, the direct interest rate effect on borrowers, lenders, and depositors has been small.

For optimal macroeconomic results, fiscal and monetary policies have to operate in tandem. For the next decade or so, fiscal policy will continue to focus on budget consolidation. This means a moderate fiscal drag on aggregate demand will persist. Fiscal policy is implemented through budget policy. That is inherently a political process involving Diet decisions on the mix of government expenditure reductions and tax increases. The BoJ has to accept this contractionary fiscal policy as a given, and adjust monetary policy so as to achieve adequate levels of aggregate demand consistent with price stability. The future will be a mix of relatively tight fiscal policy and relatively easy monetary policy.

The key policy objective of the Bank of Japan, as with all central banks, is price stability. The definition of price stability is just as important as its measurement. Price stability is not a single point on a price index (or weighted average of different price indices), but a range. Given imperfect data, imperfect knowledge of the future, and inevitable random economic shocks, this is appropriate. As in other advanced countries, the BoJ essentially measures price stability by consumer prices. The BoJ has been using as its primary measure of price stability the core Consumer Price Index (CPI), which excludes fresh foods. Unlike the United States and many other countries, Japan’s core CPI does not exclude energy.

The BoJ Monetary Policy Board now defines price stability as a range of 0–2 percent increase in the overall CPI, referred to as “headline CPI,” lower than the U.S. Fed and European Central Bank, which both have an implicit range of 1–3 percent. The differences apparently lie in different perceptions of the degree of upward bias in the CPI measurement and of the safety buffer needed for the lower bound. It is generally accepted that the CPI inadequately handles technology-driven quality improvements, business price discounting practices, and lags in data, despite the improvement of using a hedonic price index to adjust quality for some items. In addition, there are technical debates on the best price index formula, as well as inevitable measurement errors. The general view is that in the United States the CPI has an annual upward bias of up to 1 percent. The Federal Reserve Board's implicit lower bound for price stability is a 1 percent rise in the core personal consumption expenditures (PCE) measure it uses. My guess is that Japan's core CPI has an upward bias of at least 0.5 percent, even following the August 25 revision.

All this makes the BoJ March statement that the Japanese consumer price index has no significant bias astounding. So too is its assertion that, in light of BoJ flexibility and macroeconomic policy effectiveness, it does not need a safety margin for its lower bound to act as a buffer against the risk of declining prices. Given measurement uncertainties and random shocks, it is risky for the BoJ to accept 0 percent as a lower bound for policy guidance. I would like the BoJ to adopt a 1–3 percent CPI increase as its measure of price stability, more like other central banks.

The BoJ monetary policy framework is in transition. I expect it to evolve as relevant conceptual issues are further analyzed and new empirical evidence becomes available. The BoJ has stated it will review its understanding of price stability every year in light of the structural changes in the economy. I do not expect the BoJ to adopt explicit inflation targeting any time soon, but I expect that at some point it will move its "understanding" of price stability to a 1–3 percent range, with 2 percent as the desired midpoint.

Other price measures are also relevant. The most important is the GDP deflator, which measures whether prices for total output are rising or falling. It is now 10 percent below the 1997 level, having declined every year; accordingly, current-price (nominal) GDP has been below real GDP. Many forecast the GDP deflator will flatten out and turn positive next year. To achieve the government's 3 percent nominal growth target, it will have to.

The most important monetary policy issue now is the course of further interest rate increases. The BoJ has stressed that it will pragmatically and flexibly respond to economic conditions, including price movements, as they develop. It also depends on the course of government fiscal and other economic policies. The Monetary Policy Board's semi-annual forecasts of GDP growth and CPI movements will be announced on October 31; that will provide some insight into the policy thinking of the members.

An intense debate is going on between hawkish and dovish commentators on how soon, how rapidly, and how steadily the BoJ will raise interest rates. It rests on different interpretations of BoJ statements, as well as its past behavior. Obviously a great deal depends on how the economy performs and whether deflation has indeed been brought to an end. The BoJ evidently does not expect a significant resurgence of deflation, presumably defined as several months of negative changes in the core CPI.

I consider the ongoing implementation of these three steps of monetary restraint more a lessening of the previous extraordinarily easy monetary policy than a tightening. Future BoJ policy should continue on this path, without premature tightening, until sustained, full employment growth and a comfortable degree of price stability are achieved. The recently revised CPI index suggests that the BoJ should not raise interest rates very soon.

4 Increasing Income Inequality

By the 1980s, prosperity and homogeneity had created the widespread perception that virtually every Japanese was middle class. However, subsequent fundamental economic and social transformations, combined with the unemployment and other adverse effects of poor economic performance, have led to a focus on the widening inequality of income distribution, an awareness of differences in lifestyles, and a newly articulated sense of unfairness between the wealthy and the poor. Opponents of free-market reforms are vigorously blaming Koizumi’s policies. This is surely too simplistic, and almost impossible to demonstrate. But it is true that, thus far, government policy has not done much to counter the increasing inequality.

The government’s summer 2006 economic white paper addresses the income distribution issue. The Gini coefficient, the standard measure of income inequality, has been slightly rising in Japan ever since it was first officially estimated by the Ministry of Health, Labor, and Welfare in 1987. After adjusting for declining household size, the coefficient increased modestly, by 0.012, between 1989 and 2004. Between 1992 and 2002, inequality in labor income increased in every age bracket. In Japan, as in all countries, it is very difficult to estimate the income of the wealthy, there are other data difficulties, and there are substantial lags in data availability.

An OECD study both documents Japan’s increasing income inequality and places it in comparative perspective with other advanced industrial countries based on data for 2000, the latest available. The simple average of the Gini coefficients of OECD countries is 0.306. Japan, at 0.314, and five other countries are close to the average. The United States, at 0.357, has the highest observed inequalities; Denmark, with 0.225, has the most equal income distribution.

According to the OECD study, Japan’s Gini coefficient increased by 0.017 between the mid-1980s and mid-1990s, and a further 0.019 in the five years to 2000. Japan’s top fifth of the working-age population received 37.5 percent of disposable income, up 1.3 percentage points since 1995; the bottom fifth received 6.7 percent, down 0.7 percentage points.

Two major causes of increasing income inequality have been labor market weaknesses and demographic changes. Wages of part-time and contract workers are significantly below those of regular full-time workers, and their share in employment has risen substantially. In Japan, unlike other countries, the unemployed are only about 10 percent of the poor.

The OECD study estimates that the disposable income of Japanese elderly households was 89.9 percent of the average in 2000, but the Gini coefficient is considerably higher for such households, and their share of the population is rising. Japanese 66 and older were 21.1 percent of the population in 2000, an increase of 5.1 percentage points in five years. About 70 percent of Japan’s social welfare expenditures are for the elderly, about 4 percent for baby births and child rearing. The elderly hold their financial assets overwhelmingly in the form of deposits, which means for many years their interest income has been virtually zero.

Solving the financing of retired workers’ pensions and expanding health care, while restoring budget equilibrium, is a major challenge. However, these problems are widely understood by political leaders and government bureaucrats, as well as the Japanese public, so they will be resolved more readily than some of the other challenges Japan faces. The fundamental issue will be to determine what kind of welfare system

Japan wants, how large social welfare expenditure should be, and, accordingly, how much taxes will have to be raised as a share of GDP.

5 Finance

Banks continue to be the core of Japan's financial system for both borrowers and savers, so bank performance is important both in its own right and as an indicator of the economy more broadly. The net profits of the six major bank groups soared to a record ¥3.1 trillion ($27.0 billion) in the year to March 2006. That, however, exaggerates their fundamental strength. The banks did not pay any income taxes because they have large deferred tax credits (loss carry-forwards). Moreover, about a tenth of reported profits are from reducing loan loss reserves.

This was possible because the nonperforming loan (NPL) problems of almost all banks were resolved by last year. NPL were only 1.8 percent of total loans for the major banks. While the NPL average for regional banks is 4.5 percent, the range is wide, and dangerously high for perhaps a dozen or so smaller banks. The major banks are now using profits to pay back the government capital received during the banking crisis.

However, large-bank profitability is still low; the pre-tax return on assets in 2005 was 0.84 percent, far below the 2.06 percent of major U.S. banks, though comparable to major banks in a number of continental European countries. A prime reason is that interest rate spreads on lending are still too narrow; they do not incorporate credit risk adequately. The spread for fifteen large Japanese banks was 1.07 percent, compared to 2.65 percent for twelve U.S. banks. With relatively low core capital ratios, Japanese banks are not internationally competitive. Most foreign loans are to finance the activities of their Japanese multinational corporation clients. Moreover, the IT and financial technologies of most banks are not yet state of the art.

Following its outstanding performance through 2005 from its April 2003 trough, the stock market retreated 19 percent in the spring and summer of 2006 from its Nikkei index high of 17,563 on April 7 to its June 13 low before beginning to meander upward. With 2005's run up, price-earnings ratios were high by international comparison, and corporate profit growth is projected to slow somewhat this year. The shift to quality on international financial markets, in response to increasingly uncertain economic prospects, has been a negative factor. Foreign institutional purchases (and sales) continue to be important. By March's end 2006 foreigners owned 26.7 percent of the Japanese stock market, up 3 percentage points from a year earlier and from 18.6 percent in 2000, a profound change from the 4.9 percent share in 1990. Japanese households, with huge savings in deposit form, have thus far been slow to purchase Japanese shares directly or through investment trusts (mutual funds).

The bond market provides important indicators of expectations about the economy's future performance, particularly inflationary expectations. With short-term interest rates expected to rise, the yields on benchmark ten-year JGBs and other government securities have begun to rise but not very much, notable given the increased uncertainty. Since many financial institution holders of JGBs also hold Japanese equities, capital losses due to interest rate rises will be offset, in many cases more than fully, by good economic performance (and stock price increases) that justifies and indeed requires appropriate interest rate increases.

Hedge fund and private equity fund activity, though still modest, continues to develop. It involves Japanese financial institutions investing mainly in foreign alternative investment instruments, but gradually increasing in Japan as well. A relatively small number of dedicated foreign funds invest predominantly in Japan; that too is rising.

Significant capital market imperfections persist despite real improvements over the past several years. The market for the junk bonds and higher-yield bank loans of less-creditworthy large and medium firms remains underdeveloped. Capable credit-risk evaluation of SMEs is weak. For small firms and consumer finance, a key issue is whether the government will reduce the interest rate ceiling from 29.2 percent to 20.0 percent, in legislation scheduled for this fall. While that is likely, also likely are exceptions for smaller loans, possibly with a ceiling higher than the level of most current loans, and a significant delay before the new regulations are implemented.

A pro-market, prudential regulatory system, essential for financial market efficiency, continues to be put into place, though loopholes remain. Equally important is effective implementation of existing rules and regulations.

With the NPL problem behind it, the Financial Services Agency (FSA) has been able to turn to proactive reform of the financial system. The FSA has vigorously opened investigations, and has imposed business suspension, improvement orders, or other significant sanctions and penalties on leading firms throughout the sector. This includes both domestic and foreign firms and auditors (the Kanebo case), as well as fraudulent behavior scandals at specific companies such as the Livedoor and Murakami melodramas. The FSA is working to establish a rules-based system with accountability and transparency. One danger is that those supplying risk capital, Japanese and foreign, will be targeted, particularly in the media, as part of the backlash against still needed reforms.

In addition to ongoing FSA activities, further reform of Japan's financial institutions is both needed and, by and large, moving ahead.

The Tokyo Stock Exchange, plagued by a series of embarrassing incidents revealing its technological inadequacies and inefficiencies, is committed to major investment in infrastructure so as to become world class. The Securities and Exchange Surveillance Commission (SESC), under the FSA, has been increasing staff to investigate securities violations, though it still needs considerably more professionals with requisite technical skills. It probably should become an independent government agency.

Reform of government financial institutions (GFI) is moving ahead. Consolidation is underway, and two of the eight GFI will be privatized. Importantly, government (and Japan Post) provision of funding for these lending institutions will continue to decrease significantly. The great question marks for GFI reform are the specifics as to how Japan Post is privatized.

6 Corporate Japan

The corporate sector has changed dramatically in the past two decades. The traditional pillars of the postwar economic system are evolving: the permanent employment commitment is being narrowed to a smaller core of full-time regular employees; while still bank based, corporate finance relies more on capital markets and is more responsive to their signals; and entrenched corporate management autonomy is weakened by new rules on transparency, disclosure, and modifications in corporate governance.

Most firms have engaged in restructuring, consolidation, and reduction of their work force by attrition and early retirement. With continued improvements in labor productivity and reduction in costs, firms have become quite profitable without significant increases in sales. Considerable consolidation and restructuring through friendly mergers negotiated directly between managements have taken place in major industries, notably steel, vehicles, paper and pulp, chemicals, pharmaceuticals, banks, and insurance companies.

Japan's business system is even more rooted in long-term relationships than most other countries. While the economist's abstract ideal may be spot markets, the important reality is that most business transactions are regularly repeated over extended periods of time. This is typically the case with the suppliers of inputs: workers, component parts makers, service providers, creditors. Sustained relationships require and engender trust, and under most circumstances are economically beneficial. When economic conditions significantly change however, so that resources need to be transferred to more efficient uses, binding relationships can become liabilities. Moreover, some relationships become too cozy, self serving, and even collusive.

Japan's economy is in the long-run process of becoming more competitive and market oriented. Inefficient relationships are being eroded, even ended. The past fifteen years have seen many such cases of changing relationships: Nissan and its excess number of parts suppliers, banks continuing to lend to weak companies with nonperforming loans, the Ministry of Finance convoy system of financial institution regulation, government officials retiring into cushy corporate positions *(amakudari)*, bank-client cross-shareholding, and the permanent employment system. Efficient and effective relationships will persist, but they will be more conditional, which means less strong and probably less long term.

6.1 Corporate Governance

Japan's corporate governance system continues to evolve. Global convergence proceeds in terms of the overarching principles of transparency, disclosure, honesty, accountability, and responsibility. However, important specific differences in how these principles are interpreted and implemented persist in each country. Japan is considering legislation based on the U.S. Sarbanes-Oxley law, referred to as J-Sox. The results of the debate will further shape the legal basis for corporate governance behavior.

Japan will not wholeheartedly adopt an Anglo-Saxon model of corporate governance. The overwhelming majority of Japanese listed companies will continue to be controlled by entrenched management as members of the board of directors, even with the legal changes that mandate that a majority of the separate board of auditors must be outsiders. Relatively few companies will choose to use an American-type committee board system. For most listed companies, one or a few members of the board of directors will be from the outside, but they will not control the board.

A major lesson of the past fifteen years is that good profits, if not actual profit maximization, are essential to all stakeholders – not just shareholders, but also management, employees, creditors, and suppliers. While management has certainly become much more responsive to company share prices and other shareholder interests, companies will continue to weigh heavily the interests of their regular, long-term employees, especially those on the management track. After all, these employees embody the technology and know-how essential to produce goods and services efficiently and competitively, and to sustain the management system over the longer run.

The infamous thirty or so distressed large companies termed "zombies" have been resuscitated or otherwise dealt with. Nonetheless, many weak companies, both large and small, persist. They are still kept afloat by banks at interest rates completely unrelated to credit risk. Until July the prime rate was 1.375 percent. At the end of May 2006 loans and discounts with an interest rate less than 1.0 percent amounted to 27.7 percent of total bank loans, an increase from 20.0 percent in May 2002 when the economic recovery was beginning. Loans at less than 0.5 percent interest were 13.0 percent of the total, up from 8.2 percent in 2002. The bank prime lending rate will surely continue to increase over the next two years. Will these weak borrowers improve their businesses sufficiently to pay increasing loan charges? If not, will they go under, or will they continue to be kept alive by their banks, at increasing cost to bank profitability?

Perhaps a more serious potential problem is how successful firms will behave. While managements have identified their company's core competencies, they have not yet completed the process of divesting divisions or activities that are no longer central. Mergers and acquisitions involving outside players, though actually always friendly, are still relatively few; they will increase only gradually.

Japan has yet to fully develop a hostile takeover bid (TOB) market. Though unsuccessful, Oji Paper's hostile bid for Hokuetsu Paper this summer, also involving Nippon Paper Group and Mitsubishi Corporation, represents a significant qualitative change. Unlike the attempt by upstart Livedoor to take over Nippon Broadcasting in 2005, this pitted large, long-established, traditional Japanese companies against each other. Many such companies now have ample cash; the TOB market may finally emerge in Japan.

A real danger now is that managements will squander cash on new but unprofitable domestic investment projects. They should distribute substantially more profits to shareholders through dividend increases and share buybacks. However, managers want their empires to be larger. Such behavior in these good times would set back the still-incomplete process of allocating resources more efficiently.

7 External Economic Relations

Large current-account surpluses, achieved by significant increases in exports, have long played an important role in maintaining Japan's aggregate demand, despite trade's relatively small share in GDP. This reflects Japan's manufacturing competitiveness, as well as surplus savings being lent abroad. In fiscal 2005, Japan's current account surplus was a hefty 3.7 percent of GDP. The surplus is expected to persist for 2006 and narrow in 2007 as export growth is projected to slow.

Japan's balance of payments position is being significantly influenced by two relatively new factors: its role as a creditor and the likely continued high level of oil prices.

In 2005, Japan's net surplus of ¥12.5 trillion ($109 billion) on its income account—interest and dividends—surpassed its trade surplus. Japan is a mature creditor country, the largest in the world. As a result of annual current account surpluses since 1980, Japan is a global net creditor on the order of ¥184 trillion ($1.6 trillion). About half is in the form of government foreign exchange reserves. About 9 percent are the assets (undervalued in fact) of Japanese multinational foreign direct investments (FDI). Japanese FDI outflow in 2005 amounted to $46 billion, the highest since 1990; most was in the form of reinvested profits. In contrast, Japan continues to be a low recipient of FDI; the inflow of $2.8 billion in 2005 was below the $7.8 billion in 2004.

Japan has to import essentially all its oil and natural gas. The world price went from $45 a barrel in fiscal 2004 to $60 in 2005, and may average $70 in fiscal 2006, despite the recent sharp decline of more than 20 percent to about $60. These movements have not yet seriously affected Japan's CPI.

The actual global supply-demand situation for oil is not clear, and the price has been subject to considerable volatility. In the short run, oil shocks significantly interrupting supply are accidents waiting to happen. And, given the course of human history, they probably will. Sustained oil price spikes are probably the single greatest economic threat to Japan and the world economy. Japan would be harmed mainly by the slowing of world growth, global inflationary pressures, and export slowdown if oil prices rise further. It can absorb the direct effects of its increased oil costs reasonably well.

I have been surprised by the yen's weakness over the past year, given the economic fundamentals. However, the large and widening interest rate gap between yen and dollar financial assets has had a significant impact, generating huge net financial outflows from Japan. As the economy continues to improve and as Japanese interest rates rise while they level off in the United States, I expect the yen to appreciate somewhat against the dollar, but I am not sure how soon this will occur. That is quite aside from whether the dollar will decline significantly versus other currencies because of the huge U.S. current account deficit.

Japan's two fundamental realities are that its population has peaked and will decline, and now that it has become a mature economy the long-run potential growth rate is not likely to be much more than 2 percent per capita at best. Consequently, Japan's economic structure will profoundly change over the long run.

Projections of Japan's demographic transition indicate the population will decline slightly over the next five years or so (-0.1 percent annual rate), then more rapidly (-0.3 percent) until 2020, and at a further -0.5 percent rate during the following 30 years. The population is projected to decrease to 121.1 million in 2025 from 127.7 million today, and to about 100 million in 2050. As context, the population was 94.8 million in 1960, including Okinawa. The share of the population 65 and older, now 20.6 percent, will rise to about 27.8 percent by 2020. Those 15 to 65, termed the working age population, will continue to decline annually about 0.7 percent until 2010, and then 1.1 percent until 2015.

With decreasing supplies of workers, labor markets will be tight. Wages will be bid up, especially for 3D jobs (dirty, dangerous, difficult). Government pension and health care costs will rise as a share of GDP, and so, too, will revenues (taxes). Large-scale immigration sufficient to maintain the labor force and the population is unlikely. At most, foreign contract guest workers will be tolerated in order to ameliorate labor shortages in 3D jobs and health care. It is possible that at some point in the distant future Japan's total fertility rate, now only 1.25, will rise to the 2.1 sufficient to maintain a level population. For that, profound changes in values and behavior, as well as in institutions, will have to take place.

As an advanced, high income, wealthy, mature economy with a sophisticated technological base, Japan's potential GDP growth rate may be about 2 percent per capita. That has been the experience of other economies more or less at the global technology and productivity frontier. However since labor input will decrease, many argue the potential total GDP growth rate will be only about 1.5 percent. The key to Japan's sustained growth will be continually improving labor productivity. That depends fundamentally on technological innovations and their diffusion, enhanced education and training, and better capital (machinery, buildings, software) per worker.

Japan's standard of living will double every thirty-six years if GDP per capita grows at 2 percent annually. Even if it only grows at 1 percent—slightly worse than its performance over the past fifteen years—the average standard of living will double in Japanese lifetimes.

Achieving Japan's potential growth rate in the long run will not be automatic or easy. Probably the most important structural transformation the economy requires is to shift the growth engine from high saving, high investment, and high exports to domestic consumption-led growth. Japan's saving and investment rates are wastefully high for an economy growing at 2 percent. Japan needs to invest less but more efficiently.

The key to generating sufficient aggregate demand is consumption growth. The Japanese economy is too large to rely significantly on net export growth to be a major source of aggregate demand. Consumption will have to become a significantly larger share of GDP. To achieve that, wages and household incomes must rise, which they will because labor markets will be tight and the yields on financial assets will improve.

9 Conclusion

To recapitulate, Japan is on a sustained growth path and, if growth continues well, will probably fully absorb remaining slack and achieve full employment growth within two years or so. As that takes place, financial markets will gradually return to normal. However, economic expansion may falter on its current path to sustained growth, though that is not very likely. Downside risks are greater than upside risks.

I worry both about demand disappointments and supply shocks. My greatest near-term concern is that Japan's domestic demand effect of U.S. economic slowdown, which will reduce Japanese exports, will not be offset by a sufficient increase in domestic consumption. Inadequate aggregate demand has been Japan's long-term problem which has not yet been fully resolved. I also worry that the policy definition of price stability will be too low, and that deflation will not really end soon. I suspect that the Abe administration will not persist strongly in implementing economic reforms. And I continue to be wary of the global, and hence domestic, effects of oil price volatility and especially of continued high price levels.

A major challenge for Japanese will be how to alter their mindsets. The postwar economic mindset, and the institutions supporting that mindset, has been buffeted by the economic failures of the past fifteen years as well as by Japan's longer-run economic, political, and social transformations. To compete globally, Japan has to allocate resources more efficiently and effectively, and that requires major mindset changes. Established practices, modes of behavior, and rules of the game (social norms) will have to continue to adjust to today's new realities.

Many issues are yet to be resolved. How far should competitive forces and free market forces go? How, and to what degree, should the weak be protected and sustained? How can such goals be achieved more efficiently? Japan is neither an American Darwinian-type society nor a European welfare-state society. I think its middle-of-the-road, rather egalitarian, commitments will persist.

Japan is certainly not alone in the challenges it faces. It has many strengths that will enable it to do well. Japanese have attained a high educational level; workers are skilled, strongly motivated, and very productive. Its high capital/labor ratio will increase further. Japan's technological level is outstanding and will continue to improve. Japan is a democracy, with strong rule of law. Compared to most other countries, the degree of corruption is low. It is a stable society; status differentiation is important, but a considerable egalitarian sense constrains inequalities. Japan will continue to be a major world player in the global economy, and certainly at least as successful in dealing with its problems as most other major advanced countries.