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Is Japan Lost Again?

EDWARD J. LINCOLN

In the fall of 2008 Japan was hit with stunning ferocity by the global recession. In the final quarter of the year (comparing it to the third quarter), the economy contracted at an annualized rate of 13.5 percent—and in the first quarter of 2009, at a rate of 14.2 percent. By the end of the first quarter of 2009, Japan's gross domestic product was 8.8 percent lower than it had been a year before. This compares to a drop of only 2.5 percent in the United States. The Japanese contraction was the worst among major economies, and the worst among East Asian nations. For the 2009 calendar year as a whole, predictions for contraction cluster around 6 percent, also considerably worse than what is expected for the United States.

From 2002 to 2007, a lengthy recovery in Japanese economic growth—albeit at a very modest annual rate of 2 percent—had led observers to conclude that the country's "lost decade" was finally over. Japan had suffered, between 1992 and 2001, through a period when average annual economic growth was only 1 percent, and the country experienced three separate recessions during that time. Now, given widespread optimism about renewed economic robustness, the deep recession of 2008–2009 has been especially shocking.

As recently as the summer of 2008, many in Japan had anticipated that their country would be only marginally affected by the economic problems in the United States, since Japanese financial institutions (unlike their European counterparts) had not bulked up on American toxic assets. However, Japan was affected severely by the steep drop in international trade that has accompanied the global recession. By early 2009, Japan's exports were running 50 percent below year-earlier levels, truly a startling drop.

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What does the current, sharp downturn portend? Is Japan going to face yet another lost decade? The answer is: probably not. Economic predictions are inherently unreliable, and another decade of economic stagnation cannot be entirely ruled out. Nevertheless, some of the specific features of the Japanese economy that prolonged the problems of the 1990s are not a factor this time.

Recovery from the current recession should be under way by 2010, but the strength of the recovery and of Japan's economic performance over the next 5 to 10 years is difficult to predict. Overall economic growth will certainly be low (for demographic reasons explored later), but GDP per capita should expand, meaning that Japanese people over time will continue to become more affluent. How rapidly per capita GDP will rise, however, is uncertain. As Japan recovers from the current recession, its economy boasts some areas of strength that suggest we will see a relatively good performance over the next decade. But those strengths come with important caveats that inject considerable uncertainty into the situation.

OMENS OF RECOVERY

The correct starting point for thinking about Japan's future economic performance is to remember the simple fact of its remarkable success since the nineteenth century. Starting its ascent somewhat late, in the 1870s, and despite the disastrous physical and human destruction of the Second World War, Japan rose from being a pre-industrial society to join the highest ranks of the world's advanced economies by the 1970s. Affluence, measured by GDP per capita, has remained since that time at the level of the leading, large European economies.

This was a truly astonishing achievement made possible by many factors, including political stability and a practical approach to social and economic policy. While the country's politics often appears arcane and corrupt, Japan is a peaceful, democratic society. Although reaction to the economic problems of the 1990s was slow, policy eventually moved in the right direction. These positive social and political attributes are unlikely to deteriorate—despite the usual grousing in Japan about politics or problems in the education system—and they should enable continued economic growth.

A second reason for optimism stems from the first. Over the past decade, Japan has undergone a slow but continuous process of changing the rules of the economic game, which should help it perform better going into the future. This assessment does not mean that Japan is converging with American economic rules and behavior, but it does mean that the economy is more market-based than in the past.

These changes were long overdue. Japan's very rapid economic growth from the end of the Second World War through the 1970s occurred in a setting of strong government intervention, muted price competition, heavily regulated financial markets, and corporations that were generally more interested in market share than profits.

Will the models that explain economic growth still hold in an economy with a shrinking population?

Economists and political scientists have argued for decades about the importance of this set of institutions and behavior patterns for producing successful growth. A burst of high growth in the late 1980s (averaging 5 percent annually from 1987 through 1991, a period known as the "bubble") caused many in Japan to claim that their version of capitalism was actually superior to the variants practiced in the United States and Europe. In reality, the bubble years were the result of very low interest rates and a huge, unsustainable, speculative bubble in the real estate and stock markets. (Sound familiar?) Urban real estate prices and the Nikkei average for the Tokyo Stock Market tripled in value from 1985 to 1990.

In retrospect, even if the Japanese system had enabled high growth in the earlier postwar period, it presented a poor structure for a mature economy. Consider the corporate sector's lack of emphasis on profits. A manufacturing firm in a rapidly growing economy can afford to retain poorly performing products in its portfolio when the growth and profits of its main products overwhelm losses elsewhere. Such a firm can also easily make a commitment not to lay off workers, since its need for workers is almost always constantly increasing (and recessions in such economies tend to be short and mild). A firm in a mature, slowly growing economy is in a very different situation. Peripheral products doing poorly can drag down a company if the sales of its main products are growing slowly and not generating high profits. In such an economy, recessions also imply a real need to reduce employment. By the mid-1990s, Japanese firms and the government recognized the need to alter the system.

The ensuing debate over change and deregulation got off to a slow and uncertain start—the country had so recently believed in the superiority of its economic model. The trigger for the debate was the onset of the lost decade, as the speculative bubbles in the real estate and stock markets collapsed. From their peaks at the beginning of the 1990s, indices for both real estate and the stock market dropped 70 percent—and they remain at this reduced level today.

As a consequence, the financial system was awash in bad loans when the bubble burst, and the government conspired with the banking sector for several years to paper over the problems. By 1998, however, the banking system was near collapse, and the government finally began the painful process of cleaning up the mess through temporary nationalization of some banks, recapitalization of others, and pressure on banks to write off their bad loans.

THE REFORM LEGACY

In addition, the continued economic stagnation during the 90s led many to realize that reform of other aspects of the economy was necessary as well. The result was a process of revision or complete alteration of a number of key laws affecting economic behavior. A partial list of these changes includes: better accounting practices (and a quarterly rather than a semi-annual reporting cycle), changes in the structure and legal responsibilities of corporate boards of directors, greater ease in spinning off individual divisions of a company, greater flexibility in labor practices, and better bankruptcy procedures. In this new environment shareholders, for example, have been able to put more pressure on firms to restructure and to increase their attention to profits.

These are important changes for Japan. In a mature market-based economy, financial markets play a crucial role in allocating resources, expanding the financing of firms and industries believed to be future leaders, and withdrawing funds from firms and industries that perform poorly. To be sure, the market process is imperfect, as has been demonstrated with stunning impact in the United States over the past year. But the important long-term issue is continuous reallocation of productive resources. Japan's economic system had been geared toward stability (with stable market shares and limited entry or exit of firms) and government guidance—attributes antithetical to the process of continuous, flexible reallocation.

Some of the changes in the rules have been sufficiently recent that it is difficult to determine how much impact they are having on corporate behavior. But we see evidence that shareholders are becoming more activist, firms are restructuring by jettisoning weak divisions, mergers and acquisitions are increasing, and even start-ups in fields such as biotechnology are becoming more common. To the extent that the rigidities of the old system were still operative during the lost decade of the 1990s, these changes suggest that Japan will emerge from the current recession more quickly this time around, so a new lost decade is not likely.

Another strength in Japan's current economic situation is that the specific problems that caused the collapse of real estate and stock market prices at the beginning of the 1990s, and that engendered a lost decade of economic stagnation, are largely gone. Reaction to problems in the banking sector was very slow, but the effort to clean up the mess was eventually successful. Bad loans were reduced to a low level and capital adequacy was restored by around 2004. Oversight of banks was shifted from the Ministry of Finance to a new Financial Services Agency (FSA), created in 1998. After a slow start, the FSA gained credibility as a tough regulator. Japanese banks will certainly face a new wave of bad loans this year as some manufacturers suffer because of the recession and the drop in exports. But the activist FSA will not stand for any prolonged pretense, such as existed in the 1990s, that problems do not exist. Therefore, the financial sector is unlikely to be the catalyst for a new lost decade.

Finally, Japan continues to exhibit considerable strength in manufacturing, driven by competent engineering. As in the United States, the percentage of young Japanese who choose to major in engineering has declined, but it remains relatively high. In 2005 (the latest year of available data), engineering majors made up 17 percent of all Japanese undergraduates, down only modestly from a 1970s peak of 21 percent. In the United States, less than 5 percent of undergraduate degrees are in engineering. While producing lots of engineers does not assure success in manufacturing, Japan's large supply of engineers does suggest one reason that the nation's manufacturing firms have succeeded in international competition over the past half century. With a sustained and sizable supply of young engineers coming out of the education system, Japanese manufacturing firms should be able to do well in global markets.

THE DEMOGRAPHIC DRAG

Offsetting Japan's current strengths are a number of caveats and negative factors. These include adverse demographic change, adverse macroeconomic developments, and the uncertain direction of change in reforming the economic system. These factors inject some doubt into the economic forecast.

The most obvious negative development is demographics. Japan has had a birth rate below two (that is, a birth rate of less than two children over the childbearing years of each woman) since the 1970s. Even with a population that is living longer, the low birth rates imply that Japan is now entering a prolonged period during which total population will shrink (a decline that may have begun in 2008). With this overall decline comes an equally important shift in the age structure of the population, as the number and share of children decline while the number and share of adults over the age of 65 expand rapidly. These developments have several implications for the economy.

Keep in mind that economists simply do not know much about the dynamics of economies with shrinking populations. In the roughly two centuries since the beginning of the industrial revolution, population has been expanding in all industrializing countries. Will the models that explain economic growth still hold in an economy with a shrinking population? We simply do not know. Assuming, however, that our understanding of economic dynamics is not completely invalidated by a shrinking population, these demographic changes hold several important consequences for Japan.

First, the obvious consequence of a falling population (and a falling working-age population) is that economic growth will be slower. Looking at the supply side of the economy, growth comes from three inputs: labor, capital, and productivity. Unless capital and/or productivity grow fast enough to offset it, falling labor input implies slower or negative growth. Of course, a smaller working-age population does not necessarily imply less labor input, since more women, more elderly people, or more foreigners could enter the workforce. While all three of these offsets are possible, are they likely?

Fifty percent of adult women in Japan do work, and moving that proportion higher will require both expanded day care facilities and further change in social attitudes (especially about women as corporate managers). People may keep working to an older age, but the trend in Japan over the past decades has been in the opposite direction as retirement benefits have become more generous. It is conceivable that more foreigners will begin working in Japan, but even with some expansion of foreigners living in the country over the past quarter-century, they still account for just 1 percent of the total population—by far the lowest among advanced industrial countries. Social attitudes about large numbers of immigrants or guest workers are slow to change in Japan—one of a relatively small number of countries where people regard themselves as belonging to both a nation-state and to a single distinctive ethnic group.

> *If Japan does not accept a substantial rise in immigration, economic growth will certainly be slow.*

What about capital and productivity change as offsets to a falling population? An acceleration of capital inputs alone is unlikely. The ratio of non-residential fixed investment to GDP remains higher in Japan than in the United States, suggesting that the economy is already building excess capital stock (despite corporations' presumably increased emphasis on increasing profits).

THE QUESTION OF PRODUCTIVITY

The real question mark is productivity. With a shrinking number of workers and limits on the impact of expanded capital, positive economic growth occurs only if output per worker rises faster than the number of workers declines. The desire in Japan to accelerate productivity growth has led, for example, to increased spending on research and development. Over the past two decades, R&D spending in Japan has risen as a share of GDP, and that ratio is now higher than in the United States or Germany. But despite the increased spending on R&D, productivity growth stagnated in the 1990s. That poor performance was affected by the inability of corporations to shed workers as the economy stagnated. (If output falls but the number of workers does not, then output per worker falls.)

Taking all this into account, it is difficult to predict a future acceleration of productivity growth coming from the more successful application of new technologies to the production of goods and services. Therefore, the most likely outcome in Japan is that GDP growth will slow over the next decade (and perhaps will average only 1 to 1.5 percent), while GDP per capita will rise a bit faster as the population falls.

A second major potential impact of demographics on the Japanese economy is that productivity could be adversely affected by the decline in the number of young people entering the workforce. While the high percentage of undergraduate students majoring in engineering may be good for the manufacturing sector, the absolute number of these students is falling. Consider the cohort of Japanese aged 20 to 24 years of age, who roughly represent the cohort of new entrants to the labor force. As of 2007, the number of Japanese aged zero to 4 years old was 25 percent smaller than the cohort aged 20 to 24. This means that, over the next 20 years, Japanese firms will see the annual number of young adults graduating from school and entering the labor force shrink by 25 percent. If these young people are the ones with the latest engineering education, and are a source of new ideas about innovative products and services, then Japanese firms will be weakened by the falling numbers, and the rate of productivity growth could decelerate.

Third, the rising share of Japanese who are over the age of 65 presents problems for the economy. The elderly tend to consume services (nursing care, for example) that involve relatively low levels of productivity and a low rate of productivity growth. As the elderly expand as a share of total population, therefore, a shift in the structure of the economy (relatively less manufacturing and relatively more services for the elderly) might lower overall economic growth and productivity improvement. As in the United States, moreover, financial problems are emerging with regard to both the social security system and the national health care system. These problems can be solved only through a combination of tax or fee increases and reductions in benefits—potentially a further drag on economic growth.

SEARCHING FOR GROWTH

Shifting the focus from the supply side of Japan's economy to the demand side, one important adverse macroeconomic development is the country's slow growth in household consumption spending. The largest component of any economy is household consumption (consumer spending exclusive of housing investment). In the United States, household consumption accounts for about 70 percent of GDP, and in Japan 56 percent. Because this segment of GDP is so large, weak consumer spending drags down overall growth. Performance of consumer spending was a problem for Japan in the recovery that began in 2002 and will continue to be a problem for the next five to ten years.

During the five years from 2002 to 2007, the main drivers of Japan's economic growth were exports and corporate investment (mainly by export-oriented manufacturing firms). In that five-year period, inflation-adjusted GDP rose a total of 11 percent, with exports rising 58 percent and non-residential fixed investment 30 percent. But consumer spending rose only 5 percent. During this time, optimists kept waiting for the rebound in economic growth to spill over into rising household incomes and to lead in turn to an acceleration in consumer spending. But this did not happen, largely because of Japan's necessary shift toward a more flexible labor force.

Japanese firms, faced with great difficulty in laying off "regular full-time workers," increased hiring of temporary and part-time employees who receive less pay per hour worked than do regular employees. As important as this shift may have been for corporations as a means of providing greater flexibility in employment over the business cycle, the impact on household income was negative. The only way households managed to produce even a modest increase in consumption was by spending a larger share of their after-tax income.

Indeed, although Japanese households were once known for their high savings rates, they are no longer big savers. As the proportion of elderly people (who have a lower savings rate in all societies) has increased in Japan, and as consumers have tried to sustain consumption levels even as incomes stagnated or fell, Japan's savings rate has declined sharply. The ratio of annual savings to after-tax income has fallen from a peak of almost 25 percent in the mid-1970s to only 4 percent today.

Going forward, consumer spending is likely to remain weak for a different reason. As in the United States, Japan has a "baby boom" generation (born 1947–1953) that is now approaching retirement age. Japan still has an age-related upward curve in wages and salaries that is more pronounced than in the United States. Therefore, as Japan's boomers retire and are replaced by young entrants into the workforce, income levels fall as each highly paid retiree is replaced by a cheaper young person. This trend is good for firms, which have been top-heavy with expensive older workers for some time, but it is not good for total household income. Thus, weak growth in household income is likely to remain a feature of Japan's economy as it struggles to recover from the current recession.

Some of the specific features of the Japanese economy that prolonged the problems of the 1990s are not a factor this time.

Weak growth in household income and spending implies that economic growth will have to come from other parts of the economy, and the logical source is exports. Growth of exports, in turn, will depend on economic recovery in Japan's principal export markets (China and the United States), as well as on the course of the exchange rate of the Japanese yen. As was the case in the 2002–2007 period, exports could lead the economy back to a sustained, moderate level of economic growth. But this prospect remains uncertain. The yen is stronger against other currencies than it was in the early part of this decade (thereby reducing the price competitiveness of Japanese exports in global markets), and Japanese firms in many leading export industries face ever-stronger competition abroad.

An additional adverse macroeconomic development would be a return of deflation (an economics term referring to a general decline in prices, including wages and salaries, in an economy). Japan experienced modest deflation from 1993 until 2007, an unusual development, since Japan was the only industrialized country since the Great Depression of the 1930s to experience any sustained deflation.

Economists do not like deflation because it makes debts harder to repay (as firms try to repay fixed-amount loans with a reduced revenue stream) and it complicates monetary policy (since nominal interest rates cannot be pushed below zero, that leaves real interest rates in positive territory). Japan had finally emerged from deflation by 2008, but the cause was not accelerating economic growth putting upward pressure on wages and prices—it was simply the pass-through of higher oil prices. With a sharp recession and a decline in oil prices, deflation could return to Japan, and once it returns it becomes difficult to reverse.

Lost in translation?

The final potential negative element in Japan's economic future lies in the nature of systemic economic change. Changes in laws and regulations have been extensive over the past decade. But the extent to which these legal changes will translate into better economic performance remains somewhat unknown. As noted above, important changes that may help corporate performance, such as a more flexible labor market, have in some cases been carried out in a way that hurts household income.

Also, consider the changes that have spurred an increase in high-tech startup companies financed by a rising venture capital industry. Compared to the 1980s, the growth seems substantial, since venture capital and high-tech startups were virtually unknown back then. But in comparison to the United States, the numbers seem rather small. Perhaps the venture capital market will continue to grow in Japan (once the current recession is over), aided by the regulatory changes of the past decade, but no one really knows.

Some in Japan are worried about the durability and impact of the legal changes that have taken place. Reform began in an atmosphere of anxiety during the lost decade and continued under Prime Minister Junichiro Koizumi (2001–2006). He was widely regarded as a reformist maverick who aggressively challenged the traditionalists in his party. Since he stepped down, Japan has not had a prime minister showing the same degree of activism on economic reform, leading to worries about whether some reforms will be scaled back or undermined by weak enforcement.

Equally uncertain is the extent of change in corporate behavior. One of the purposes of hiring temporary and part-time employees to reduce the number of workers with a high level of job security was to enable greater flexibility in downsizing during a time of recession. The first test of this greater flexibility has come with the current deep recession. However, as of May 2009, employment in Japan had dropped by only 2 percent from its peak a year earlier, compared to over 4 percent in the United States, despite the fact that the Japanese economy had shrunk much more than the US economy. When firms in Japan began firing part-time and temporary workers, the result was negative commentary in the press and talk of new regulations to grant these workers greater job security. The numbers suggest strongly that, faced with criticism, firms blinked when the time came to exercise their new flexibility in adjusting employment.

Too much has changed in Japan over the past 10 to 15 years to completely put the genie back in the bottle. Nevertheless, the extent to which the new, more market-oriented rules and regulations will be implemented, or the extent to which they will have a real impact on economic performance, remains to be seen. Analysts of Japan remain rather divided in their expectations. Only time will tell whether these changes will produce a more vibrant economy.

LOOKING INWARD

Japan has been one of the great success stories of the past century. It has become the first and so far the only large non-Western nation to join the ranks of the leading advanced economies in the world. That record alone should lead one to think that Japanese society will manage relatively well in responding to current economic challenges. The lost decade of the 1990s might undermine that optimism, but even in that case Japan eventually came to grips with the pressing issues of the day, prevented collapse of the financial system, and revamped many of the rules that shape the economic system.

As a result, Japan encountered the current global recession in much better condition than when it faced the homegrown asset-bubble collapse at the beginning of the 1990s. At that time, the economic system was long overdue for revamping, and the old system exacerbated the problems stemming from the collapse of the bubble and seriously delayed the recovery. This time the economy should be more resilient.

However, both the strength of recovery from the current recession and Japan's longer-term economic outlook are still clouded—above all, by demography. Since birth rates change only slowly, Japan will face a natural population decline for at least several decades. The native-born population could decline by as much as 16 percent in just the next 30 years, and 25 percent by 2050, according to Japanese government estimates. This might be enough to bring about a pro-immigration policy, but reluctance to accept foreigners into Japanese society has been so deeply ingrained that it is difficult to imagine any major change.

If Japan does not accept a substantial rise in immigration, economic growth will certainly be slow, even though productivity increases may continue to lift the level of affluence at a relatively healthy rate. What happens to productivity will depend on the continuing story of reform and deregulation. If that process continues, it is possible that Japan will experience a stronger boost in productivity as firms face more pressure from shareholders to behave efficiently.

The likeliest outcome—very slow growth—has broad economic and political implications. For starters, Japan will not be a driver of global economic growth. Equally important is the impact on Japan's role in global affairs. If the country faces slow growth along with financial problems in social security and national health insurance, it is unlikely that Japan will increase its foreign aid or defense spending. Indeed, spending on both of these elements of Japan's engagement in global affairs has been flat or falling for the past dozen years, and that trend is likely to continue.

More broadly, Japanese society may become more inward-looking—absorbed in problems ranging from reforming the economy to coping with a shrinking population. Such an outcome is by no means certain, but these are possibilities that are important for Americans to keep in mind when tugging on the Japanese government to play a role in global affairs more in line with its economic weight. ■