

## **The Japan's Economy in the New Century : A New Vision for Growth**

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### <Summary>

- (1) In order for Japan to liberate itself from these recurring crises, we need not only a short-term policy, but a medium to long-term vision of economic growth.
- (2) If Japan can undergo a structural reform that will make efficient use of its accumulated stock of R&D and social capital, under a continuous environment of a depreciating yen, then Japan will grow at an average rate of 1.6% per year by the year 2025.
- (3) A surplus will be attained in the primary balance in 2011, due to the reduction in public investment and a drastic reform in the social security sector on the fiscal side.

The current state of the Japanese economy is quite similar to that just before the financial crisis of 1997. Although public funds were injected into the financial system after the crisis last time, we now find ourselves facing the same kind of critical situation. Trying to avert a financial crisis by injecting public funds into the financial system is like temporarily stopping the bleeding of someone in ill health. The patient is not cured and he is not yet able to leave the hospital a healthy person. From 1999 to the present, Japan has been like this patient. The bleeding was temporarily stopped, but because the country has neglected to actually improve its health, it now has begun bleeding once again. Even if Japan can muddle through this impending financial crisis a second time, if the essential problem of the economy is not dealt with now, then we will have a third and fourth crisis.

To overcome this imminent crisis, it would be inadequate to merely implement reinforcing monetary measures. Besides these measures, we would need to be shown a clear perspective of a long-term growth model that would take the temporary stability in the financial system and tie it into a medium to long-term recovery in the economy as a whole. From this viewpoint, we put forward some forecast scenarios, coherent with short, medium and long-term economic conditions.

The forecast period for this long-term forecast extends to the year 2025. Although the forecast is centered on the supply side, there is a demand and supply gap – where the demand and supply sides diverge – until about 2010. However, we believe that due to the effects of

the structural reforms that will take place between now and then, a new path of stable growth will be realized from the year 2010.

The key to the improvement in the Japan's economy in the next ten years will be the continued depreciation of the yen. As for the current value of the yen, we do not think that the rate is lower than the yen's "appropriate" value. Rather, we think that the yen has been overvalued until now. There are two reasons that we are of this belief. One is that there exists a demand-supply gap in the economy at the moment, and the prices of goods in Japan must fall to international levels. This will encourage the real exchange rate to fall. The other reason is that throughout the 1990s, the economic fundamentals in the US have been stronger than Japan's, and so it is not normal for the yen dollar exchange rate to have maintained the levels from about the late 1980s. Thus, we forecast the yen rate to fall to about 170 yen to the dollar, bringing domestic prices in line with international prices.

The depreciating yen will lead to a more realistic assessment of Japan. First, real wages in dollar terms will fall. In the late 1990s, wage increases in Japan were greater than increases in productivity – becoming a major cause for the economic stagnation in Japan – but this will be corrected. Second, higher import prices will lead to an increase in general prices and thus alleviate the deflationary situation. This will lessen the excess debt load, and will work as incentive to revive investment activities. Finally, it will be easier for foreign investors to acquire Japanese companies, and more foreign investment will be realized in Japan. With more direct investment into Japan, the productivity of non-manufacturers (that has been low) should be improved. Although some are hopeful that further de-industrialization can be avoided with a low yen value, we do not expect any kind of revitalization in the manufacturing industry. During the yen appreciation and dollar depreciation of the latter half of the 1980s, what we saw was a rapid increase in direct investment from Japan into the US and not a robust revival of the US manufacturing industry. We expect to see a similar change in Japan's industrial structure with a further yen depreciation.

However, a lower yen is not without its negative effects. There are concerns that Japanese made goods will increase their market share in the US markets. In regard to this, as the US has diversified its supplier base for goods since entering the 1990s, we do not expect this to become a major issue. Yet, there is the possibility that the lower yen will lead to a flight from Japanese financial assets. On this point, the country's vision for the medium and long-term of the Japan's economy becomes critically important. That is, unless a structural reform is undertaken with economic and fiscal reforms that will maintain a long-term

confidence in the Japanese economy, a steady yen depreciation will not be realized.

According to the Future Population Projections (pessimistic scenario) from the National Institute of Population and Social Security Research, Japan's population will peak in 2004 and begin to decline from then on. Most of our forecast period, therefore, falls under an economy of population decline. In this situation, the driving force of economic growth becomes capital accumulation and the enhanced efficiency of the economy as a whole. As for economic structural reform, Japan should use wisely its assets that have accumulated, and use this accumulated capital to improve the efficiency of the economy overall.

In our forecast, we have the following specific economic structural reforms in mind. the promotion of investment into IT through the simplification in depreciation of innovative equipment, through the further reduction of communication costs and a further promotion of IT in government activities the accumulation of research and development stock through the strategic investment into developing fields reform in the distribution of social capital through tax incentives that favor urban development or the encouragement of PFI (private finance initiative).

As a result of these measures, on the capital accumulation side, IT capital will rise by 8-9% per year for the 15 years from the year 2005. Regarding other capital, there will be less excess debt from about 2005 and so investment is expected to expand and capital should grow by a rate of over 2% from the year 2010. As a result of this activity, the share of IT-related capital stock as a share of total capital stock will grow from 7% in 1999 to 19% by 2025.

The enhanced efficiency of the economy as a whole will be determined by the increase in the R&D stock that has occurred as a result of research and development, and by the distribution of social overhead capital between urban and rural areas. Expenditure in R&D will expand steadily as distribution becomes more strategic and will grow from a 3.1% share of GDP in 1999 to 3.8% in 2025 years. At the same time, the rate of distribution of social overhead capital to urban areas has been on a declining trend since 1970, and by 1998 has fallen to 36%. We assume that there will be policies implemented to increase distribution to urban areas to about 40-50% (the level from around 1970) while keeping total public investment as a whole at a low level. From the above, the increase in total factor productivity – an indicator of the efficiency of society as a whole – will be low from 2000 to 2005, but from 2005-2010 it will grow on average by 0.6% a year, and after 2010 by 0.8-0.9%.

As a result of all these factors, economic growth from a supply side perspective will be held back at an average 1.0% per year until about 2010 due to the low levels up to 2005. From 2010-2020 we expect it to be about 2.3%, and 1.5% in the first half of the 2020s. The average growth rate for the 25 years over the forecast period will be about 1.6%. Although this would not appear to be rapid growth, it works out to an annualized economic growth rate of 1.9% per capita. When we consider that the growth rate of labor productivity in the US over the last 30 years has been 1.3% per year, Japan should have the same potential for growth if our resources are used fully.

As for the demand side, the economic standstill should continue until about 2005, and the demand-supply gap will grow until 2003. However, after this, the excess debt will be reduced, investment will expand, exports will grow with a lower yen and the average growth rate between 2005 and 2010 should outperform the potential growth rate to be about 2%, eliminating the demand-supply gap by 2010.

In order for this scenario to be realized, it is imperative that there is also a structural reform in the fiscal side. It is not easy to improve the health of the fiscal sector under a low birth rate and an aging population. Our forecast makes the assumption that by the year 2006, public investment will continue to fall to about 90% of the total amount it was in 2001, and then be steady for the remainder of the forecast period. However, if this sector is not to show any improvements, then the primary balance will never be balanced because the social insurance sector will mark an increased deficit.

For the above reasons, a reform in the social security sector is absolutely necessary. For our model case, we reform the pension plan as follows ; (1)by the year 2010, the employee pension plan payments will increase every five years, and by 2004, half of the basic pension will be covered by national coffers, (2)In 2010, when the economy is expected to have been revived, the following major reform will be carried out: all of the basic pension will be covered by the government and to finance this, the consumption tax will be raised by 4 percentage points to 9% , (3)At the same time, for the next generation the second tier portion of the employees' pension scheme will be shifted to the funded system and will be privatized, (4) The second tier portion of the current generation will continue to follow the pay-as-you-go system, and the accumulated funds will be eaten into as is necessary. At the same time, pension benefits will be reduced by 16.3%.

Regarding healthcare, (1)from 2003 the amount of premiums to be collected will be on a

system based on total compensation, and the share to be paid by the subscriber will be raised to 30%. (2)As for elderly person, the share they pay will be gradually raised every five years from the year 2008.

Although this is not a conventional reform plan, we see a reform of this magnitude as a necessary condition for Japan to show its true potential for growth. Under this scenario, the primary balance will mark a surplus in 2011.

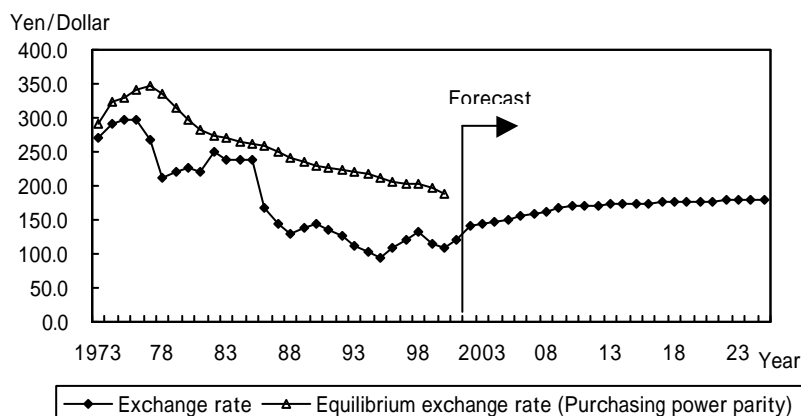
Recovering completely from an economic stagnation of ten years will take a long time. Having said this, Japan has much accumulated from its record breaking economic growth of the past. What needs to be done now is not to be overly pessimistic or to be easily affected by the ups and downs of each short-term measure implemented. We need to stand firmly between being complacent and emotional, hold a medium to long-term vision, and through the effective use of our current accumulations, to head towards a steady improvement in our economic health

Contributions to the GDP Growth Rate

	1990/80	2000/90	Forecast 2010/00	2020/10	2025/20	2025/00 (%)
Average annual growth rate of GDP at 1995 prices	4.1	1.4	1.0	2.3	1.4	1.6
(Contributions )						
Labor input	0.5	-0.4	-0.3	-0.2	-0.3	-0.3
Non-IT capital input	1.1	0.5	0.3	0.7	0.6	0.5
IT capital input	2.4	0.8	0.7	0.8	0.4	0.7
Total factor productivity	0.2	0.5	0.4	0.9	0.8	0.7

(Sources) Cabinet office, "Annual Report on National Accounts".  
 Ministry of Public Management, Home Affairs, Posts and Telecommunications, Labor Force Survey, Input-Output Table.

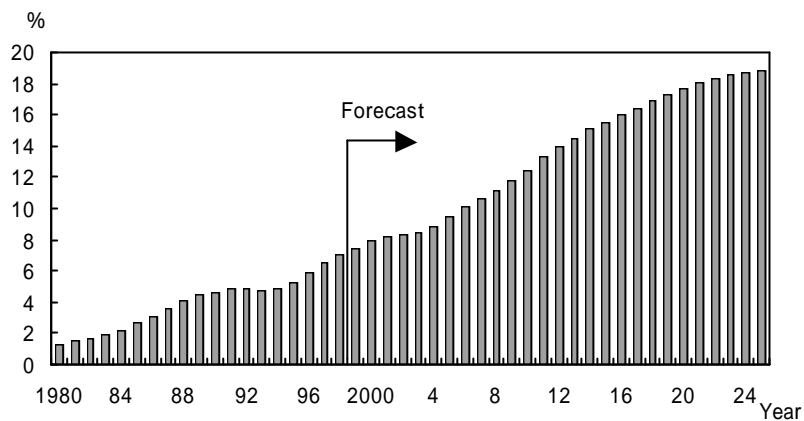
Figure1 Exchange Rate



(Sources) Bank of Japan, Economic Statistics Monthly.

Ministry of Public Management, Home Affairs, Posts and Telecommunications,  
Price Statistics Monthly.

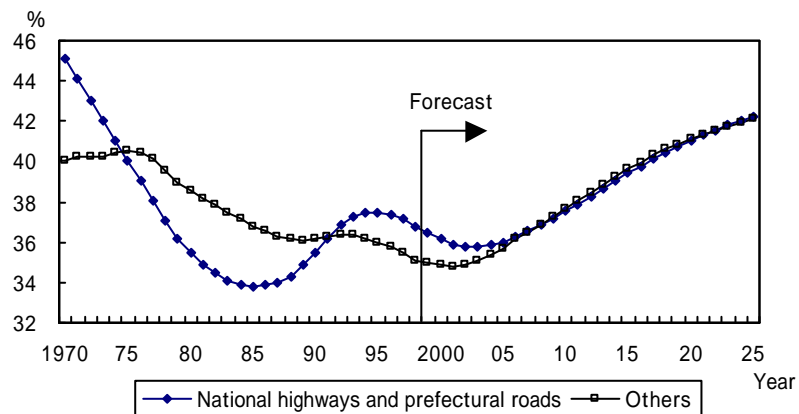
Figure2 IT-related Capital Stock as a Share of Total Capital Stock



(Note) IT-related capital includes computers, communications equipment, office machinery, and software.

(Sources) Cabinet office, *Annual Report on National Accounts*.  
Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Input-Output Table*. etc.

Figure3 Urban Share of Social Capital Stock at 1995 prices



(Sources) Economic Planning Agency, *Social Capital Stock in Japan*.  
Cabinet office, *Annual Report on Prefectural Accounts*.  
The Group Study of Local Policy, *Report on Administrative Investments*.