

## **The Industrial Structure and the Revitalization of the Japanese Economy From Cyclical Expansion to a Sustained Growth**

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### **-Summary-**

The Japanese economy has had to endure a prolonged economic stagnation due to the rigidity of the industrial structure, and the relative decline in international competitiveness resulting from the emergence of the Asian countries. However, after some painful restructuring, and thanks to the appearance of some new digital products, Japan has finally grasped an opportunity to revitalize. Some economic support from the government sector will be needed in order for the recovery to be on solid ground.

### **-Main Text-**

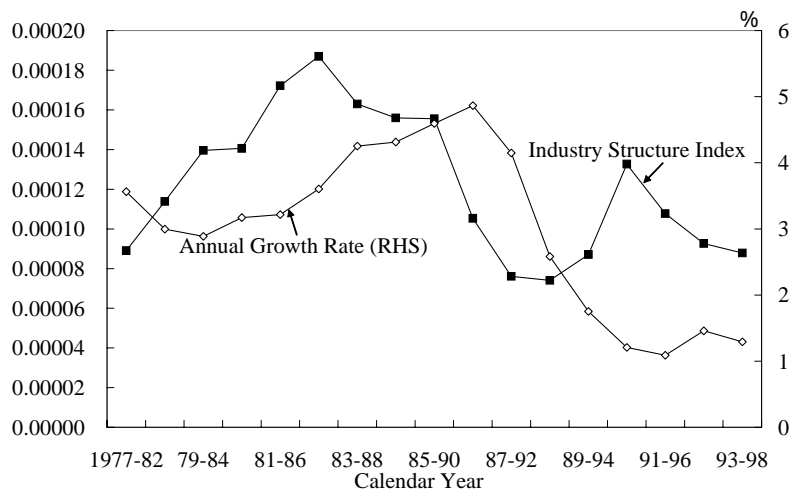
#### **Changes in Industry Structure Led to Economic Growth**

Japan has endured a prolonged economic stagnation for the ten plus years after the burst of the economic bubble. However, since last year, we have finally begun to see the light at the end of the tunnel. There has been much debate regarding how Japan could grasp the chance to recover. As far as we can see now, the recovery of the Japanese economy has depended in large part on the progress made in the structural adjustment in industry. In this report, we show the path from the past stagnant Japanese economy to the current recovery, focusing on the changes in industrial structure and the international competitiveness of industry.

There are two major views to the causes of the prolonged sluggishness in the Japanese economy. One was that the fiscal and monetary policies implemented were not sufficient to induce demand creation. The other is that the industrial structure had become too rigid, and there were no new industries being created to increase productivity.

We take for the moment the latter perspective to examine the relationship between economic growth and the structure of the industry. We created an industry structure index – one whose value becomes higher when the industrial structure is undergoing active change – and we see that a few periods after this index shows a change, the economic growth rate shows a change in the same direction. As we see in Figure 1, in the first half of the 1980s, as the semiconductor industry and the processing and assembling industries – such as the automotive industry – were expanding, the economic growth rates also continued to grow robustly in the 1980s. Then, as we entered the 1990s the industrial structure became rigid, and the prolonged economic slump began.

Figure 1. Industry Structure Index and Economic Growth Rate



(Source) Cabinet Office “ Annual Report of National Accounts”, JIP Database

The factors behind the rigidity in industry and the stagnation in productivity that accompanied it can be divided into internal and external factors. Large factors in the domestic side are in the inflexibility in the markets for factors of production, particularly the rigidity in the labor markets.

In other words, for a prolonged period, many workers remained in industries where productivity was not rising, and they did not migrate to those industries with increasing productivities. Moreover, the rigidity in the labor market offsets some of the productivity increases that resulted from advances in IT and deregulation in the market. In addition to this, since wages were increasing at a faster rate than productivity, this resulted in a stagnant profit rate. This results in a vicious circle whereby there is a sense of excess capital, that leads to lower capital investment and delayed replacement investment, and this leads to the overall decline in the competitiveness of the industry.

As for external factors, an example of this would be the decline in the international competitiveness of Japan relative to other Asian countries such as the more rapidly developing Korea and China. This is reflected in the fact that Japan’s main trading partner shifted from the US to Asia in the 1990s. Not only did Japan lose market share in such products as semiconductors and general electrical machinery, but it also took a long time to begin to create new industries due to the delay in adopting information technology. These factors have led to the long-term sluggishness in industry.

Japanese industry reacted by taking measures such as the large-scale restructuring from the end of the 1990s and the utilization of state-of-the-art technology led on by IT in Japanese-style production methods. This strategy has helped transform the corporate sector to be able to earn profits and at the same time has led to them taking on a leading position in the production of new products such as DVD players, liquid crystal display televisions, digital cameras, and the production of their parts.

In addition to these efforts on the part of the companies, the growths in the US and Chinese economies have helped the businesses of the raw materials industries such as

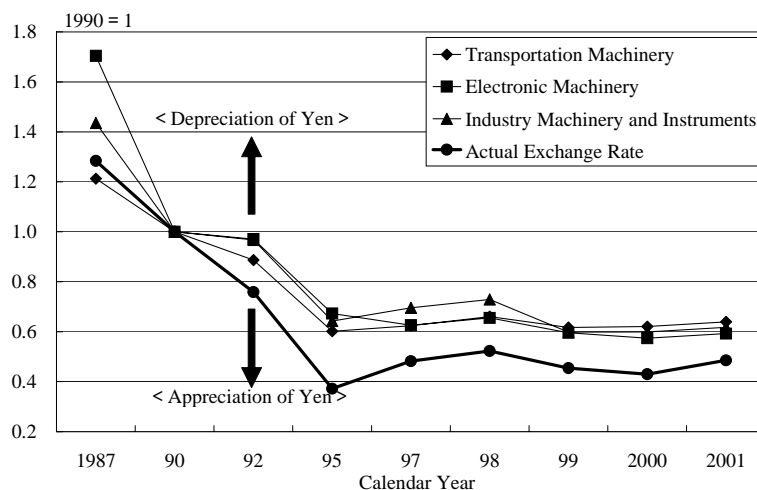
steel and iron, and these have been the main factors contributing to the current recovery in the Japanese economy. However, it is too early to conclude from this that the Japanese economy has indeed been revitalized. Although we do see a more wide-spread recovery this time in the industries than during the IT recovery last time, in order for the economy to return to a path of balanced growth, we need to see more activity in the non-manufacturing industries and the local economies.

**Current RMB is Undervalued**

Here, we suggest three strategies that the government should implement to make this current recovery a sustainable one. First, we need a mechanism whereby the exchange rate between the Japanese yen and Chinese RMB is adjusted appropriately. We have shown in Figure 2 that according to our calculations, the appropriate value of the yen given the actual economy is judged to be 26% higher than the actual exchange rate against the RMB in 2001. As the yen has appreciated since then, the yen may be even more overvalued now.

If the day-to-day exchange rate continues to deviate from the appropriate rate given the state of the actual economy, like the accumulation of magma resulting in a volcanic eruption, some extreme exchange rate adjustments – such as the rapid yen appreciation of the mid 80s or the Asian currency crisis -- will occur. Japan needs to press upon China that a flexible exchange rate system will need to be adopted because the Chinese economy is becoming a larger and larger presence in the world and because it will want to avoid any severe economic consequences due to drastic exchange rate adjustments as Japan had experienced in the past.

Figure 2. Appropriate Exchange Rate of RMB/Yen



(Sources) JETRO, National Bureau of Statistics of China “ China Statistical Yearbook ”

Second, we need policies to promote foreign direct investment into Japan. One of the issues with the hollowing out of industry is that production bases have been moving only in one direction -- from Japan to overseas. If we can vitalize foreign direct investment into Japan, that is in effect a movement in the opposite direction, then we

can retain the employment opportunities lost to the hollowing out of industry. This is a point particularly important to the revitalization of local economies.

Also, we see benefits to foreign direct investment in the way of an international transfer of management methods. As we have seen in the case of Nissan, once a good management method is introduced and the efficiency of Japanese companies can be enhanced, then this will contribute greatly to the revitalization of the economy.

Although it is not necessarily the case that all foreign capital companies that enter the market will be successful, it is important that Japan keep the barriers to entry as low as possible for foreign companies to be active in Japan. In order for this to happen, the central government and the local government units will need to work together.

For example Shizuoka prefecture, Kita-kyushu city and Fukuoka-city use their statuses as special zones for structural reform (for their harbors and business) to promote foreign direct investment into Japan. The central government should actively support these initiatives of the local governments to revitalize the local areas.

### **Public Sector Should Learn Project Management from the Private Sector**

Finally, the third strategy is to re-examine the business activities of the public sector. Letting the public sector become too big becomes a disincentive to the productivity of the various sectors. Moreover, even from an investment and savings balance, the recent excess savings of the corporate sector has become remarkable, and in this sense, the government needs to provide new markets and businesses that will make full use of private savings. From this perspective, they are headed in the right direction with the privatization of highway and airport businesses.

However, if they are only thinking of utilizing private funds, then they will make the same mistake they made before with the joint public/private ventures of the past. It is important that they utilize not only the funds of the private sector, but that they learn from them how to reduce their business risk. A good example of this would be the Chubu International Airport project where a private firm is in charge of the business and this resulted in a reduction of expenses by 120 billion yen. The government should look upon this reduction of costs and set it as a new standard, and it also needs to be more creative in linking these cost reductions to lower user costs for the consumers.

It can be said that the painful restructuring efforts of the private sector have brought Japan to the threshold of escape from the prolonged economic stagnation. It is the responsibility of the government to be able to shift these efforts so that they lead to a revitalization of the Japanese economy as a whole. Although the hands of the government may be tied due to the massive debt of the government to implement some kinds of policies, we are hopeful that through some qualitative and effective support policies, the industry-led efforts will lead to a coordinated public and private-led economic revitalization.