Where is the Japanese Economy going?

Its rebirth lies in the revitalization of the corporate sector.

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1. Globalization and the Japanese Economy

Japanese economy stagnated for a decade in the 1990's, accompanied by persistent deflation after the bursting of the bubble. The recovery is under way since early 2002, as restructuring efforts by the private sector are bearing some fruits. The decade long stagnation of the economy and the subsequent recovery should be viewed in the context of globalization of the world economy during this period.

According to a publication by Oxford University Press for the World Bank entitled "Globalization, Growth and Poverty" [1], globalization provides opportunities for the poor but creates winners and losers: "Whereas many poor countries with 2 billion people have been left out from the process of globalization and are becoming marginal to the world economy, countries that strongly increased their participation in global trade and investment, with 3 billion people, grew at 5 percent per capita during the 1990's and reduced poverty ratio dramatically." The winners and losers can be the people, firms and financial institutions, as well as countries.

Globalization is also characterized by rapid progress in technology and massive movements of capital. "Globalization of knowledge has brought improved health, with life spans increasing at a rapid pace." "The most adverse effects have arisen from the liberalization of financial and capital markets—which has posed risks to developing countries without commensurable rewards." "The problem is thus not with globalization but with how it has been managed." (Joseph E. Stiglitz, Globalism's Discontents [2])

Apparently, among US, China and Japan, US and China have been winners in the 1990s and Japan, as well as Japanese firms and financial institutions have been, in general, losers during the decade. The recent economic crisis in East Asia has certainly affected the economic performance of Japan in 1998, and cheep imported products from emerging economies, at a time deflationary pressure was strong, has aggravated the economy, more conspicuously than other industrial countries. We need to look at the reasons why this was the case for Japan and to examine if the situation has been changing for first decade of the 21st Century.

The perspective of the Japanese economy in the next decade and thereafter should also be reviewed against the backdrop of aging population in a global context. The chapter three of the World Economic Outlook of IMF published in October 2004 [3] is entitled "How will demographic change affect the global economy?" It is stated that:

- Global population growth will continue to slow. By 2050, global population growth is projected to be only ¼% a year, compared with 11/4% at present.
- The world's population will continue to age. (by over 10 years to 37 years by 2050)
- The elderly dependency ratio (65 or older/ 15-64) is projected to rise dramatically in Japan and Europe, with lesser increase in the US .
- Aging will also begin to accelerate in Asia and Latin America around 2015, with China experiencing particularly rapid aging.

Following the general global trend of aging of population, Japan is ahead of others, in terms of its timing and its acuteness; Japan's population is expected to peak at 127million in 2006, as a female will give birth to only 1.29 baby on average in her entire life.(2003 Survey) As this result, Japan's aging ratio (the ratio of people aged 65 or above to the population) which was 19.5% in 2003, is expected to increase to 26% in 2015 and 35% in 2050. This will have an important bearing upon the pension program, medicare and social security program and hence upon the fiscal consolidation of the budget. More fundamentally, the aging of population and uncertainties arising from this issue are the heart of the matter related to the confidence of the people toward the future and growth potentials of Japan.

2. **Overview of the Recent Japanese Economy**

1) Are the policy efforts finally paying off?

Throughout a decade long stagnation and the recovery phase since 2002, Japanese government has made every effort to overcome prolonged deflation and to revitalize the economy and those efforts, accompanied with steady restructuring of the corporate sector, are gradually paying off.

Some of the key elements of those policy efforts are ;

-prompt resolution of major banks' nonperforming loans problems (being accomplished)
-fiscal measures to sustain demand in the 1990s (not effective in the long run)
-expansionary monetary policy by Bank of Japan, leading to zero interest rate policy (with some effect)
-fiscal consolidation to achieve a primary surplus in the early 2010s
(under way but still a daunting task)
-comprehensive review of the social security system (under way)
-reform of the fiscal relationship between central and local governments (under way)
-privatization of Japan Post (hot issue at the current diet session)

There have been clear indications that Japan' long standing economic problems have eased as shown below:

-Growth rate (real GDP) is rebounding ;

FY 01:-1.1%; FY02:0.8%; FY03:2.0%;(Estimate of GOJ) FY04:2.1%;FY05:1.6%;

-Unemployment rate is improving:

5.5% Jan 03→4.5%Jan05

-Deflation is diminishing as measured by Consumer Price Index（Estimate of GOJ):

－0.1%FY04→＋0.1%FY 05;

-Nonperforming loans of major banks is declining:

8.4%Mar02→4.7％Sep4→(Estimate)4%Mar05

-Corporate restructuring is improving profit situation

Profit before tax increased by 37.8% year on year in the third quarter of 2004

However, the fragility of economy and downside risks persist, above all, on issues related to:

-Overcoming the deflation

-Achieving the fiscal consolidation

-Increasing the consumer confidence,

With different nuance, IMF and OECD expressed similar views.

2) The View of the IMF at the time of Article 4 Consultation in Aug 2004

In the recent consultation paper of IMF [4], a question is raised; " Is the recovery for Real?"

The answer is that the recovery is more durable than the previous recoveries during 1990s for three reasons:

- The current expansion is more broadly based than previous expansions with a firmer basis in private domestic demand
- Corporate restructuring has fostered structural gains in profitability, which should support investment going forward
- The corporate and financial sectors have become more resilient to shocks

The paper also noted that weakness remains that could restrain growth over the medium term:

- Deflation, though mild, persists
- Public debt is high and rising
- Accelerated deregulation and other structural reform efforts are needed

3) The View of OECD in the Economic Survey in Jan 2005

In the most recent OECD Economic Surveys, Japan, Jan 2005[5], the present situation of the Japan's economy is described as follow;

- The strengthening of the economy has raised hopes that Japan is emerging from a decade of stagnation.
- However, Japan still faces a number of serious headwinds to sustained growth,

  -Notably entrenched deflation and continued declines in bank lending and land prices

-Meanwhile, the government' financial position continues to deteriorate,raising concern about fiscal sustainability at the same time that population ageing is increasing demands for public spending.

3. **Experience during the Lost Decade**

1) Economic performance has been sluggish due to deflation

The performance of the Japanese economy has been disappointing during the lost decade, with the annual growth of GDP increasing only by 1% since 1992. As a result of this development, per capita income of Japan, relative to US seems to have fallen from a peak of 85 % in 1991 to 75% in 2003. This has been caused by the sharp fall of asset prices during this period. For instance, the real estate price has plunged down 86% in urban commercial areas between Sep 1990 and Mar 2003. Nikkei Average Stock Index which was 34,043 yen on average in 1989 has declined by 79% between Dec 1989 and April 2003. (the index is a little below 12,000 yen in early March 2005.) Between 1990 and 2001, an estimated 1211 trillion yen was lost due to the fall in real estate price and stock price, which is equivalent to about 240 per cent of nominal GDP.

The deflationary pressure has become evident in price indexes to measure inflation of flows: The Consumer Price Index has shown consistent decline since 1999, as indicated below, while the GDP deflator had been declining since 1995, much earlier and deeper than CPI.

・Evolution of Consumer Price Index since FY 1998:

FY98	99	00	01	02	03
+0.6%	-0.3%	-0.7%	-0.7%	-0.9%	-0.3%

The 100 YEN SHOP (100 yen is roughly one US dollar) which sells all kind of goods at 100 yen, and UNIQLO Shop, which sells inexpensive garments, have become a symbol for "price destruction".

Bursting of stock and real estate price has aggravated balance sheet of firms and financial institutions.

- Particularly, persistent deflation has increased non-performing loans of commercial banks. Non-performing loans of major 11 banks has been around 20 trillion yen from FY1998 to FY 2000, increased to 26.8 trillion yen in FY 2001
  (NPL ratio of 8.4%) and subsequently declined to 20.2 Trillion yen (NPL ratio of 7.2%) Since the bursting of the bubble the injection of the public money into the financial sector reached 35 trillion yen. (of which the loss has been registered for 10 trillion yen.)

Overall, the corporate sector has suffered from three excesses (excess production capacity, excess labor force, excess debt)---While Paper of Japan's Economy in FY1999

2) Recovery is not sustainable.

During this period, the economy recovered from time to time. However, those recoveries have not been sustainable as was shown below. Particularly, recoveries in 1996-1997 and 2000 were short-lived and fiscal monetary policies were forced to be reversed to more accommodating ones during the process.

・ Evolution of real GDP since FY1996:

FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03
2.5%	3.6%	0.5%	-0.9%	0.6%	2.5%	-1.1%	0.8%	2.0%

-1997 Recovery:

After the gains from the correction of sharp appreciation of the yen in 1995(79 yen to the dollar), supported by investment in plant and equipment as well as the boost of consumption in anticipation of higher consumption tax, the economy recovered in 1996 and 1997. Consumption tax was increased from 3% to 5% in April 1997. However, this move was followed by a deflationary spiral, accompanied by financial crisis of Japanese bank and security companies, (Hotsukaido Takushoku Bank and Yamaichi Security Company) , as well as unfavorable external development resulted from the Asian Crisis. Due to this adverse development, the Fiscal Restructuring Law of 1997, which set numerical targets for the fiscal consolidation was frozen in 1998, leading to a further increase in fiscal deficit. The Bank of Japan (BOJ) adopted zero interest rate policy in Feb 1999.

-2000 Recovery:

Export-led recovery has been resulted from the recovery of Asia and IT sector. Investment in plant and equipment showed a steady increase while consumption became solid. BOJ lifted the zero interest rate policy in Aug 2000, which was modified in Mar 2001 due to the reemergence of deflationary spiral triggered by weak external developments arising from the bursting of IT bubble, uncertainty after the terrorism attack on September 11 and concerns over a number of emerging economies such as Brazil, Turkey, not to mention Argentina.

3) Public debt is increasing.

After the surplus year of FY 1992, because of the stimulating fiscal measures in the 1990s and the freeze of fiscal consolidation in 1998, Japan's fiscal deficit deteriorated to peak at nearly 8% of GDP in FY 2002 and FY 2003. This is due to a rise in spending (5% of GDP) and a decline in revenues (3% of GDP). Gross public debt for central and local governments seems to have reached 160% of GDP, which is by far the largest among OECD countries. This development has called into question, the sustainability of fiscal deficit of the Japan' budget. For instance, in 2002, Moody's Investors Services, Standard & Poor's and Fitch Ratings lowered the credit ratings of Japanese government bonds, respectively to A2, AA-,and AA for domestic currency issue. (Then the Vice-Minister of Finance for International Affairs, Mr. Kuroda sent a note to them to seek clarification of their reasoning.)

4. **Recovery since 2002**

In the 1880s, the strength of the Japanese economy became from time to time a thread to other industrial countries and occasionally Japan's behavior or policy stance was a target for criticism. "Japan as No 1"or

“Japan bashing” were often used in the press. In the 1990s when the economy stagnated for a decade those words were replaced by “Japan nothing” or “Japan passing”. If the recovery under way recently is the revitalization of Japanese economy, new expression might be necessary.

1) Overall recovery is continuing.

The recovery of the economy has been under way since early 2002. What is characteristic of the current recovery is the lack of fiscal stimulus, while the qualitative easing of the Bank of Japan continues. The recovery has been led by domestic demand, supported by strong earning position of corporate sector resulted from restructuring, repayment of past debt and positive global strategy. Of 2.6% growth in CY 2004, 1.9% is attributable to domestic demand and 0.8% to external sector (net exports of goods and services) Without doubt, while the current recovery is a private sector led upturn, with a major role played by firms, the economy has also benefited from favorable external development, such as good economic performance of the US ,the emergence of BRICs, particularly continuously high economic growth in China. Positive economic cycle of digital devices and strong commodity price development, backed by demand from high growth countries like China, have also been contributing factors behind the current economic upturn. Those developments seemed to have slowed the deflation, as measured by CPI, to a stable rate closer to zero.

2) Corporate Sector has become robust.

If one looks more closely at the corporate sector, a remarkable improvement has been achieved. After a decade long struggle to modify a traditional employment practice, such as life time employment or seniority system, a progress was made in restructuring through cuts in wage and employment. Until 1980’s the unemployment rate of Japan had been exceptionally low among OECD countries, at around 1-2 %. However, the unemployment rate increased to over 5% in 2003, as firms have tried to cut labor force: For instance, among major leading 12 companies, the total labor force has been cut by one third from 565,000 in 1990 to 3770,000 in 2003. Following those moves, the labor’ share of the net profits declined from 65.2% in 1995 to 61.5% in 2003. This has boosted profitability and increased the capacity utilization of Japanese firms.

-Profit sales ratio before tax has recovered to a level of late 1980’s for manufacturing sector as well as non-manufacturing sector.

-The break-even point is being lowered to the level of early 1990s.

-Stock market has risen by some 40-50% from April 2003.

Increased earnings and advance in IT technology (digital camera, DVD recorder and TV) have fueled a rebound in business investment at an annual rate of 6%. In addition to favorable export performance, the global strategy of Japanese firms has begun to bear fruits. The earnings of overseas operations registered a large increase, showing a 40% increase over the previous year, occupying 30% of the total operating income for the mid-year report ending Sep 2004.

“-----this development is a result of lower break-even point through a cut in human resources cost and other

administrative cost, new business model to revitalize firms、 and proactive stance to promote globalization of its operations,"according to a publication by Mizuho Research Institute. [6]
The fear for the hollowing of industry in the 1990's has been replaced by a renewed confidence in core competence as high technology production lines are restored in Japan. It is noted that the ratio of overseas production increased from 7.4% in FY 1993 to an estimate of 18% in FY2003. This compares with 27.7% for Germany and 32,1% for the US in the late 1990s.

"Rebirth of Japan, which becomes evident was actually the rebirth of Japanese firms, particularly large ones." "Efficiency of employment and equipment has been achieved gradually over the 14 years since the bursting of the bubble." " This is the invisible structural reforms, carried forward by turtles. (if US firms are by analogy rabbits)" [7] (Japanese Economy-Invisible Structural Reform, Kiyohiko Nishimura, Nikkei Press)

Thus, the employment and management practice of Japanese firms and financial institutions until the 1990s may not have been best fit for a rapid pace of globalization. However, a steady progress seems to have been made during the lost decade and thereafter to adjust those practices to global markets.

3) Banking Sector is improving.
During the current recovery phase, non-performing loans ratio of major banks is declining, on track to achieve the government goal of reducing the ratio to about the half (Financial Sector Revitalization Program, Oct 2002):

8.4%Mar02→4.7％Sep04→(Estimate)4%Mar05

Operating profits were recorded in FY 2003 for the first time in a decade.
However, bank profits are low and their capital base is weak. And bank lending is still declining at an annual rate of more than 1%. It is noted in this respect, that the bank's holding of government bonds have reached 169 trillion yen (34% of GDP), which might lead to a large capital loss when the long term interest start to increase. Furthermore, it is recognized that less progress has been achieved in restructuring the regional banks.

4) Labor market situation is improving but creating new issues.
The pace of growth has been sufficient to boost employment and reduce unemployment rate, as shown below.

The unemployment rate: 5.5% Jan 2003
4.5% Jan 2005

However, the gains in employment are due to an increase of non-regular workers, while the number of regular workers has been declining since 1998. The share of non-regular workers has risen, over the decade from 19% to 29%.Still the unemployment rate for the young age group 15-24 is as high as 10%.One fourth of the university graduates is becoming a part-time job seeker "free arbeiter" or "free-ter", which is becoming a new social issue.

5) The recent slow down of economy has not eroded the overall confidence.

To be noted, there has been slowing down of economy since the second quarter of 2004 as shown below. However, despite the fact that three consecutive decline of quarterly GDP is considered technically as " a recession", importantly, the slow down has not weaken confidence in the economy.

・Quarterly Real GDP during 2004: (compared with the previous one)

Q1+1.4%; Q2-0.2%; Q3-0.3%; Q4-0.1%

The annual real GDP growth for the calendar year 2004 was a solid increase of 2.6%.

・Annual Real GDP (Calendar Year)

CY02-0.9%; CY03+1.4%; CY04+2.6%

As for the estimate for real GDP in FY 2005 beginning April 2005, whereas the Government of Japan (GOJ) projected an increase of 1.6%, the private forecasters (13) envisages a range between 0.4% and 2.1 %, averaging at 1.2%. After the recent release of the 4th quarter GDP, it is noted that a number of economists still predict an upturn from the middle of 2005. The recently released JETRO(New York)'s newsletter dated Feb 28, even stated that " ----- there is no reason to worry about Japan's underlying fundamentals." [8] Overall, business and household confidence have rebounded and have stayed at a high level. For instance, consumers have become less pessimistic, as the confidence among households with 2 or more people increased to 47.4% in December 2004 from 44 % in the previous month. (A reading below 50 indicates pessimists outnumbered optimists.) Profit margins have recovered to the highest levels since early 1990s and still increasing for March 2005, to an estimated increase of 19.2 %, according to the Nikkei Press.

5. **Current Policy Stance**

Given the present situation of the Japanese economy, described above, the question is whether the current policies are in the right direction and sufficient to cope with the remaining issues.

1) Monetary policy is geared to overcome deflation

While the risk of a deflationary spiral may have receded, price declines, while moderate, continues. Overcoming deflation remains the top priority for the monetary authorities. In this respect, BOJ promised in 2003 to continue the quantitative easing policy at least until the core consumer price index which excludes fresh food is zero or above.

- By this measure, the core CPI fell slightly by 0.1% in 2004, while the overall GDP deflator dropped by 1.2%. It is noted that corporate good price index has been increasing since the beginning of 2004.

2) Fiscal consolidation efforts are continuing.

The revised Medium-Term Economic and Fiscal Perspective (Revised early 2004) limits public outlays through FY 2006 to the FY 2002 level of 38% of GDP by double –digit cuts in public investment spending. The Perspective, importantly, sets the objective of achieving a surplus in the primary budget by early 2010s

Note: Why the primary balance is important?

The primary budget compares the revenue which excludes borrowing and proceeds from the issuance of bonds on the one hand, with the expenditure excluding the payment of principal of bonds and the payment of interest rate of bonds. Hence the primary budget is composed of 1) taxes and revenues other than bond issuance on the revenue side, and of 2) general expenditure on the expenditure side. If the primary budget is balanced, it would mean that the revenue from the bond issuance is equal to the repayment of the principal and the payment of interest rate of bonds. And hence, the public debt or the outstanding bonds will increase in the amount which is equal to the payment of interest rate of bonds. Therefore, the balance of the primary budget is needed if the outstanding government bonds (public debt) needs to increase only at a pace proportionate to the growth of nominal GDP. However, this relation holds only if the growth of nominal GDP is equal to (or larger than) nominal long term interest rate= government bond yield.

- In FY 2004, the primary deficit is estimated to have fallen to 5% of GDP.
- The Perspective includes a decline of 1/2% of GDP in the primary budget deficit in each year from FY 2004 to FY 2008-a full decade to reach a primary balance.
- FY 2005 budget envisages 1)total expenditure increase of only 0.1%; 2) the bond dependency ratio reduced to 41.8% from 44.6% in the previous year, for the first time in the past 4years; 3)general expenditure cut by 0.7%, with ODA being cut by 3.8% while science and technology being increased by 2.6%.

In the context of achieving the fiscal consolidation, the reform effort to address the local government is also critical, as the local government debt has risen from 15% of GDP in the early 1990s to 40% of GDP in 2003.

- Thus, fiscal consolidation requires redefining the respective powers and responsibilities of central and local governments.
- The Trinity Reform, which aims at cutting earmarked grants (subsidies), reforming grants by the central government and increasing local tax revenue is vital.

3) Reform efforts are under way.

Government policy principle is: “No growth without reforms”; “Leave to the private sector the matters done by them” And “Decentralize the matters to be done by local governments”

- The top priority of the Koizumi Cabinet is the privatization of Japan Post, which is the world largest financial institution with the asset amounting to 80% of GDP, into 4 entities by 2007.

  The key issues are:

  -Postal saving and life insurance provide the JOG with financing to support public corporations and investment programs

  -Japan Post might undermine the operation of private financial institutions: the share deposit taking of Japan Post has increased from 11% to 20 % over the decade.

- The Three Year Plan for Promoting Regulatory Reform is updated every year
- The creation of Special Zones for Structural Reform in 2002, uses local government to advance nation-wide regulatory reforms.
- Market Test determines what is best done in the private sector.
- Achieving the government goal of doubling the stock of foreign direct investment has resulted in the stock of DFIs amounting to 2 % of GDP、which is still low among OECD countries, where the ratio is often 10%.
- Strategy for Creation of New Industry was published by METI in May 2004.

4) Banking supervision is making progress.

Much progress has been made in the banking supervision. Particularly, the reduction of non-performing loans (NPLs) of major banks by half by March 2005 to 4% is being accomplished, following the target specified in the Financial Sector Revitalization Program of 2002. The Program aimed for the establishing of the target to reduce NFLs, the strengthening of the assessment of bank's assets and the monitoring of the banks.

Also the final lifting of full guarantee of bank demand deposits up to a ceiling of Y 10 million is likely to be achieved without a difficulty for most banks. However, the reduction of NPL for local banks is much slower. And major banks need to strengthen their capital as well as earning power.

In December 2004, the Financial Services Agency issued the Program for Further Financial Reform-----Japan's challenge, Moving toward a Financial Services Nation.

The emphasis of the program has shifted from financial system stability to financial system vitality, as the phase surrounding the financial environment changes from the emergency reaction phase to a desirable financial situation. As concrete measures, the program put forward 1) Creation of a vibrant financial system, 2) Contribution to regional economies,3)Establishment of a reliable financial administration. In the context of globalization, the program calls for "Further development of a financial system which is internationally open and the financial administration with an international perspective."

5) External policy is producing a mixed result.

The external policy could mean a lot but here the focus is the policy framework related to trade, direct investment and foreign exchange rate.

- Pursuing FTA (free trade agreement) has made a limited progress, as the agreement has been reached only with Mexico and Singapore.
- During the process of recovery, the foreign exchange rate is a matter of a serious concern of the authorities that has expected a source of growth in the external sector. Particularly, the authorities stepped up vigorously in the foreign exchange market in 2003 and the first quarter of 2004, to avoid the appreciation of the yen above 100 yen/US dollar and subsequently above 105 yen/dollar, at the time the deflationary bias was still more evident than now. The amount of intervention reached 34

trillion yen and the foreign exchange reserve increased to US$ 824 billion by March 2004. Since then no intervention has been reported. The yen appreciated closer to 100 yen/dollar in early 2005, as the US dollar lost ground due to an increasing concern of market participants over the US twin deficits of the current account and the budget. The US dollar has recovered since then, as solid growth of the US economy around 3.5% and steady increase of the Federal Fund rate toward a range from 3 to 3.5% have been observed. (The yen is around 104-105 yen /US dollar in early March 2005.)

-Recent peaks and bottoms of yen/US dollar are:

Apr 19, 1995: 79.75 yen
Aug 11, 1998: 147.64 yen
Jan 17, 2005: 101.67 yen

6. **Uncertainty and Policy Requirement**

Whereas the past efforts of the government and private sector are paying off as is evident in the recent performance of the economy, a great deal of uncertainty remains and down side risks persist in the economy as well as in the framework of policy making and its implementation. As Japan is passing through a crossroads towards its rebirth, a number of risk scenarios have appeared in journals and books. For instance, “The Risk Scenario of the Japanese Economy”, Atsushi Nakajima [9],based on bold assumptions, depicted a risk scenario in 2015 and 2020, in which the collapse of the budget poses many serious problems, in case the public debt issue and other challenges are not properly addressed. In this sense, it may be very true that “The danger lies in the attitude of those policy makers who now feel nothing needs to be done.”Prof Hugh Patrick, Center on Japanese Economy and Business, Columbia Business School [10]

1) Eliminating Deflation

While the deflationary spiral seems to have eased, the recent price index appears to be precarious, (the core CPI showed a decrease of 0.2-0.3% compared with a year ago in the recent three months,) reflecting the recent deceleration of the economy, and an extreme care is called for in the implementation of fiscal and monetary policy:

- Premature change in monetary policy and fiscal policy (tax increase) might bring back the deflationary bias in the economy. It will lower the economic growth and consequently retard the achievement of a primary fiscal balance.
- If the zero interest rate policy is lifted earlier than needed,

-it might increase the long term interest rates earlier than warranted before the economy becomes robust and might worsen the fiscal consolidation. (Lower nominal economic growth and higher nominal long term interest rate will make the fiscal consolidation task more difficult.)

-it might affect negatively the balance sheets of banks, as bond holders’ capital losses will not be offset by gains in their equity holdings and improved quality of loan portfolio.

2) Achieving Primary Balance of the Budget

Achieving a surplus in the primary budget by early 2010 is the most daunting task of the government. Gross public debt ratio to GDP will not increase as long as the primary budget is balanced, provided that nominal GDP growth rate is equal to or more than long term interest rate. However, if the nominal GDP growth is less than the nominal interest rate, a (sizable) surplus in the primary budget is required to simply maintain the gross public debt ratio to GDP.

The path to achieve a surplus in the primary budget by early 2010s is not clear enough at this moment other than the below..

- In FY 2004, the primary deficit, is estimated to have fallen to 5% of GDP
- The Medium-Term Economic and Fiscal Perspective includes a decline of 1/2% of GDP in the primary budget deficit in each year from FY 2004 to FY 2008-a full decade to reach a primary balance.

The uncertainties are related to lack of concrete plan for the following:

- the scope for a cut in discretionary budget
- progress in the reform of social security system, including pension reform, medical care reform.
- the timing and scope for tax increase, including the consumption tax.(the Prime Minister Koizumi stated from time to time that his cabinet would not increase the consumption tax during his term until the fall of 2006.)

The uncertainty exists for the success of The Trinity Reform, which aims at cutting earmarked grants (subsidies), reforming grants by the central government and increasing local tax revenue and for the scope for the reduction of debt by local governments (40% in 2003)

3) Recovery of Financial Strength of Financial Institutions

As the health of the banking sector is closely linked with the sustained and broad base recovery, overall strengthening of the banking sector along the path shown in the Program for Further Financial Reform (December 2005) is vital for the economy.

- While the NPLs ratios is being reduced by half to 4% for major banks, the banking sector remains weak, with low capital base, low operating profits, weak loan demand.
- Huge government bond holdings might expose those banks to capital loss, once long term interest rates increase.

  For local banks the reduction of NPLs is much slower. Those banks may be more vulnerable to capital loss of government bonds.

4) Regain Confidence in the Household Consumption

In order to ensure the sustained recovery of the Japanese economy, it is imperative to maintain the level of household consumption, which occupies 55.3% of GDP. The past pattern of maintaining the consumption and living standard by reducing the saving rates may have come to an end.

-Decline in the household saving rate in relation to GDP:

16.5% in 1986
12.0% in 1995,
9.8% in 2000,
5.9% in 2002

Consumption increase would require income growth, age increase and employment.

In this respect, it would not be desirable to keep the share of labor in the profits artificially low to the present level of 61 %, if the wage increase is warranted in the light of demand and supply situation of the labor market and its productivity increase.

Consumption also depends on a better employment outlook and the certainty of future social security system, particularly the pension. A nonpartisan consensus on the key questions of pension and social security program is highly desirable in the long run, to eliminate uncertainty about the viability of the program.

5) Reestablishing Fair and Efficient Labor Market and Steps to Cope with Aging Population

Since 1997, full time regular employment has continually decreased, while part-time and temporary employment has risen steadily to 29% of the total labor force. This practice has strengthened the financial position and competitive position of firms during a decade of stagnation, while addressing particular needs and life style of those workers.

However, the increase in non-regular workers has created equity, efficiency and macroeconomic issues:

-Those workers are paid only half of what their counterparts in regular employment are earning.

-Non-regular workers are not getting the on the job training, an opportunity to enhance their skills.

-If the compensation package to this group continues to be lower than warranted, this practice may retard recovery of consumption.

Therefore, an overall review of this practice is needed.

While Japan has enjoyed the longevity with the average life expectancy for both men and women being among the highest in the world in 2003, (women 83.33 years and men 78.35 years), aging population and diminishing trend of young people is calling for bold steps to address this social and labor issue..

-On average, for the entire life a female will give birth to 1.29 babies the 2003 survey.

-Japan's aging ratio (the ratio of people aged 65 or above to the population) was 19.5% in 2003, 26% in 2015 and 35% in 2050.

Encouraging a higher employment rate, particularly for women, youth and senior workers is needed, in the light of rapid aging of population.

Immigration policy may also need to be reviewed, as the ratio of foreigners in the population in Japan is at this moment only 1.5%, including permanent residents. This compares with 10.43% in the US, 8.3% in Germany, 5.6% in France and 4% in the UK.

6) External Factors

External factors have always been the sources of the downward risks for Japan as well as for major economies. Most serious development is a major disruption of the global economy, while a cyclical issue may not have a significantly adverse effect on Japan.

For instance,

- Oil price increase, if not directly, might affect the economy through weaker external demand. Japan is an efficient energy user and may absorb the direct impact of the rise in the price of oil to $50/barrel, with only a limited negative effect on growth.
- Slowdown of US economic growth and Chinese economic growth might affect the growth potentials of Japan. While Japan may not be affected seriously by a cyclical movement of those countries, the loss of confidence of the US dollar due to the twin deficits or a major disruption of Chinese economy, such as the collapse of the bubble could be a critical factor for the Japanese economy.
- Unfavorable geopolitical development and another major attack of terrorism may affect global economic prospect, and hence Japan.
- Weaker dollar and sharp appreciation of the yen might have a deflationary impact on the economy unless the Japanese economy is back on the strong recovery path.

At this moment, external factors are relatively favorable for Japan, as growth prospects are good for the US, China and other emerging economies. Policy coordination among G7, G8 as well as G20 is needed to maintain and enhance global economic performance.

7. **Policies to Revitalize Japan**

Given the above, the policies to revitalize Japan are summarized in the below:

- Appropriate and timely change in monetary policy
- Clear, determined but flexible plan to achieve a primary budget surplus by the early 2010s.
- A comprehensive reform of social security system, including pension and medical reform.
- A comprehensive labor market policy to make it more efficient and competitive, and addressing the population aging problem.
- A more vigorous implementation and initiation of privatization and structural reforms
- Technology driven policy to increase competitiveness of corporate sector and financial sector
- Progress in WTO discussion and FTAs including initiatives to improve investment climate of Asian countries

8. **Lessons to be Drawn**

While the story to revitalize Japan is not yet complete, it is important for counties in the transition to try to draw some lessons from Japan, to the extent the episode is a fight in the context of globalization.

- Avoid deflation and the bursting of the bubble

-The bigger the bubble grows, the more damaging its bursting and deflation become. While eliminating the bubble is an impossible task for a policy maker, the bursting of the bubble and the subsequent deflation will become very costly for the economy.

(The emergence of a big bubble in Japan in the late 1980s had very much to do with the expansionary monetary policy to deal with the sharp appreciation of the yen after the Plaza Accord in 1885, as well as with high expectation toward the future of Japan, typically shown in "Japan As No1 Lesson for America" , Ezra F. Vogel. Harvard University Press 1979.) Therefore, every effort should be made to minimize the size of the bubble in the economy, should it arise. Monetary policy should be adjusted flexibly to a new development in the fight against deflation.

Note: A View of Dr. Tietmayer on Deflation:

The Governor of the Bundesbank (Central Bank of Germany) Dr. Hans Tietmyer stated in January 1998 that " a policy to deal with the real estate was a key to success to get out of the financial crisis in the US and UK and without those measures it would be difficult for Japan, to solve the banking crisis and to eliminate the sluggish lending of banks." The Governor went on to say that "nothing can be accomplished as long as the land price continues to decline."

(My visit to Germany in January 1998 was made following the request by Finance Minister Mitsuzuka, to explain the Emergency Policy Package to Stabilize the Financial System in 1998 as well as macro policies of Japan.)

- Do not depend too much on government expenditures

-Too much reliance on government expenditures to restore confidence in the economy or to sustain demand, is not effective in the medium and long term.

- Foster a strong private sector in the context of globalization

-The government policy should be geared to create an environment to foster a robust private sector. As a matter of fact, the fostering of viable private sector is a key to high economic growth needed to reduce poverty by half by 2015 in the developing countries in the context of the Millennium Development Goals.

-The key to the rebirth of Japan is the creation of internationally competitive firms, which are successful in a global market. (In a micro economic sense, a Japanese firm should be able to grow in the rapidly growing emerging economies as the growth potential of Japanese market is limited. From macroeconomic view point, the fiscal consolidation hinges upon continuous increase in corporate earnings which, in turn, depends upon profits in overseas operations.)

- In the same manner, for an economy in transition, the long term success for economic development depends upon the improvement of the investment climate in the home market, as well as upon the creation of global companies of the country and overseas investment of those companies. It is noted that a number of emerging economies/ countries have tried to establish an investment insurance program to increase the outward looking direct investments from their countries.

- Benefit from and contribute to the development of global market

  -More efforts need to be made to enlarge a global market by FTAs and other policy measures. Probably more attention should be paid to the role played by FTAs in improving the investment climate for the Asian region and in increasing the regional flow of foreign direct investments.

- Fiscal consolidation should revitalize the firms and individuals

  -Fiscal consolidation should be vigorously pursued, facilitated by stronger financial positions of firms, but it should not suffocate those firms and consumers.

  In this respect, the fiscal consolidation should be pursued, hand in hand with the revitalization of the economy.

- Remove uncertainty about aging population

  -Eliminating uncertainty surrounding issues relating to aging population (pension, medicare, social security program and labor market policy) is critical to restore confidence of consumers. Because of the lead time required to grapple with the issues, a viable long term plan to address demographic problem is vital for all the countries.

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