

# **The Japanese Economy in the Age of Globalisation**

**Kumiharu Shigehara\***

**Remarks at the Third Asia Forum  
in Barcelona, Spain on December 12 2005**

---

\* President of the International Economic Policy Studies Association. Former Deputy Secretary-General and Chief Economist of the Organisation for Economic Co-operation and Development (OECD).

The author wishes to thank John Martin (Director, Directorate for Employment, Labour and Social Affairs, OECD) and Paul Atkinson (Visiting Fellow at Groupe d'Economie Mondiale de Sciences Po in Paris and former Deputy Director, Directorate for Science, Technology and Industry, OECD) for helpful comments on an earlier version.

I am pleased to be invited to the Third Asia Forum and to talk about economic trends in Japan and its challenges in the age of globalisation. In discussing this topic, it is useful to start with a brief review of Japan's economic records over the past decade.

## **1. The state of the economy in the last decade**

Japan's economic growth performance over the last decade is generally considered to have been dismal. Growth performance in the late 20th century was adversely affected by large swings in asset market prices not only in Japan but also in a number of other OECD countries. But, Japan's case proved to be the most difficult to deal with.

In the late 1980s when huge increases in stock and land prices occurred in Japan, there was no noticeable erosion of general price stability. Moreover, Japan's huge current account surpluses did not decline significantly in dollar terms, despite the doubling of the yen value from 235 yen per dollar to 120 yen within a year after the Plaza accord in September 1985. Against this background, there was a strong international and domestic political pressure on the Japanese authorities not to resort to monetary restraint to contain asset price inflation.

The asset market finally burst in 1990. Despite substantial monetary policy easing, business fixed investment and housing construction collapsed. However, there was no significant decline in consumer confidence and private consumption never contracted on an annual basis as it happened in other OECD countries such as the US, the UK and some Nordic countries that had suffered asset market bubbles somewhat earlier than Japan.

Another notable feature is a sustained rise in employment until 1997. Job increases, in particular in the construction sector, were maintained by huge expansion of public works expenditure through government debt finance. The unemployment rate did begin to pick up in 1993 from a low of 2.1 per cent in 1991 and rose to 3.4 per cent by 1997, but this was still only half of the OECD average of 6.9 per cent. Under the lifetime employment system, Japanese firms made considerable efforts not to shed surplus labour in the face of continued weak output, hoping for an early turnaround of the

business cycle. In this situation, there was no strong evidence of widening income distribution or signs of increased social instability. Such was the general economic and social situation that in its annual report on Japan for 1999, the OECD argued that it was only by the high standards that Japan set itself in previous decades that its economic situation could be seen as disappointing.<sup>i</sup>

However, a series of negative shocks, some foreseen and others unforeseen, aggravated the economic situation dramatically in 1998. A premature, sharp tightening of fiscal policy in 1997 coincided with the outbreak of the crisis in emerging Asian economies. Moreover, the sudden collapse of several Japanese financial institutions late that year triggered a panic among bank depositors and worsened consumer and business confidence. Subdued consumer spending and a sharp fall in business investment thereafter contributed to a 1.1 per cent decline in real GDP in 1998, the first negative growth since the 1974 recession in the aftermath of the first oil crisis. Activity remained sluggish in 1999 and economic growth for the 1990s as a whole declined to an annual average rate of 1.5 per cent, much lower than the US growth rate of 3.3 per cent and the Euro area growth rate of 2.4 per cent. As a result, there was a decline in Japan's position in international ranking for per capita income. True, based on the very high value of yen against the US dollar in the foreign exchange market, Japan's GDP per capita was some 11 per cent higher than that of the US and about 80 per cent above that of the Euro area. But, at purchasing power parities, it was 23 per cent lower than the US level, though still 7 per cent higher than the Euro area average and slightly above the French and German levels.<sup>ii</sup>

## **2. Recent economic trends and short-term forecasts**

Economic growth was again volatile in the first years of the 21<sup>st</sup> century. Business fixed investment, in particular, remained erratic largely as a result of swings in both domestic and foreign demand for information and communication technology goods. But, a new upswing in output started in early 2002, with more balanced growth of domestic demand and exports. There were two short periods of pause in output in the second halves of 2002 and 2004. But the uptrend in domestic demand has been sustained by the recovery of business investment and firmer private consumption in the face of declines

in public works expenditure. Accelerated restructuring in the corporate sector since the economic downturn in 1998 has paid off, and higher profitability has revived business confidence. The capacity utilization ratio has been rising steadily and the labour market situation has improved somewhat. The unemployment rate declined from the peak level of 5.4 per cent in 2002 to 4.2 per cent by September 2005. The downward trend in consumer prices is almost at an end and they are likely to edge up in coming months even after excluding the effects of steep oil price increases.

Looking ahead, the major downside risks to economic activity are the direct negative effects of oil price increases on the world economy and slower export market growth. In particular, if market confidence in the US economy with substantial external debt is weakened and the US dollar value declines sharply, the consequence on the Japanese economy could be very serious. This is partly because the use of expansionary fiscal policy measures is constrained by the very large size of budget deficits amounting to about 6 per cent of GDP and the huge stock of government debt equivalent to 160 per cent of GDP. It is also because monetary policy is constrained by the zero bound on interest rates. In fact, the Bank of Japan's policy interest rate has been kept virtually zero since 1999 except for a brief period from the summer of 2000. And, since spring 2001, to provide further monetary stimulus, the Bank of Japan has been resorting to an unorthodox policy framework of "quantitative ease", namely expansion of financial institutions' current deposits at the central bank far above the levels required under the reserve requirement system.

Turning to the downside risks on the domestic side of the Japanese economy, they are less serious now than at any time in the past decade or so. Business and consumer confidence remains solid and the most recent consensus forecasts of 10 leading private research institutes for real GDP growth rates are 2.6 per cent in fiscal year 2005 ending next March and 2.5 per cent in fiscal 2006, higher than the government forecasts published last August of 1.6 per cent in fiscal 2005 and slightly less than 2 per cent in fiscal 2006.<sup>iii</sup> With the potential GDP growth rate for this year and next estimated to be around 1 per cent by both the Bank of Japan and the OECD, these growth forecasts imply that the existing GDP gap will be narrowed steadily.

### **3. Demographic trends and growth prospects in the long run**

Forecasts of economic growth potential over the present and coming decades have important implications for designing a wide range of public policies as well as the future of the average living standards of private individuals. One view is that the decline in Japan's future economic growth is inevitable as labour supply is projected to fall significantly as a consequence of rapid population ageing and continued low birth rates. Indeed, Japan's population is set to decline in 2005 for the first time since records began more than a century ago.

Already in the 1990s, the decline in labour supply was an important factor reducing Japan's potential growth rate. During that decade, the mandatory ceiling on working hours was reduced from 48 to 40 hours per week. As a result of this and a rise in part-time jobs, annual average working hours per worker in Japan declined by about 10 per cent and is now nearly at the same level as in the US, Canada, Australia, New Zealand and some European countries such as Spain and Finland, though still longer than in France and Germany.<sup>iv</sup> Reduced labour input, together with a collapse in business capital formation, contributed importantly to the estimated fall in Japan's potential growth rate from 3.9 per cent in the 1980s to 1.5 per cent in the 1990s.

Demographic factors did not have a major influence on labour supply in the 1990s, but the projected fall in the working-age population should become an important determinant of labour supply in the course of the present and coming decades, unless major labour market reform measures are implemented in Japan. In this context, it is important to note that labour market participation of prime-age males (25-54 years old) in Japan is above 96 per cent, the highest together with Iceland among OECD countries, and there is little scope for increasing labour supply from males in this age group. Participation of males in the age group of 55 to 64 is also high in Japan, well above 80 per cent, compared with 55 per cent in the EU-15 and 65 per cent for the OECD average. The participation rate for those in the age group of 60 to 64 is presently close to 70 per cent, still high by international standards, but significantly lower than in the earlier decades. Indeed it was as high as some 80 per cent in 1970. Over the same period, the rate for those in the age group of 65 and above also declined from some 50 per cent to

30 per cent. A reversal of declines in the participation of males in these age groups would help ease labour supply shortages in the future. Japanese males as well as females continue to enjoy the longest life expectancy in the world, and at a time when baby-boomers will soon reach the age of 60, it would be particularly important to encourage them to remain in the labour market by increasing their work incentives through pension reforms and tax measures.

In contrast to the high participation of Japanese males, the participation of prime-age females in Japan is relatively low. In 2004, it stood at 68 per cent, compared with 75 per cent in the US and 76 per cent in the EU. A wide range of public support measures as well as changes in business practices would be required to encourage prime-age females, in particular those raising children, to remain in the labour market. With Japan's fertility rate as low as 1.3, one important issue is whether greater participation of prime-age females will inevitably reduce the fertility rate and aggravate the labour supply problem at a later stage. But in Nordic countries, most typically in Denmark, high participation of prime-age females is associated with relatively high fertility rates, and the policy experience of these countries should be assessed carefully in Japan's attempt to increase women's participation in the labour market and to reverse the declining trend in the fertility rate at the same time.<sup>v</sup>

#### **4. Labour productivity performance**

Greater supply of labour is certainly important for increasing the capacity to grow. But it is not sufficient. One may even say that it is not necessary. The economy with a declining working population can still grow if the rise in labour productivity is greater than the decline in labour supply.

Labour productivity varies widely across industries in Japan. Productivity levels are particularly high in most manufacturing industries, and above the US levels in automobiles, electronic and several other high-tech industries. In contrast, labour productivity in most of Japanese non-manufacturing industries is low. International comparison of labour productivity is difficult particularly for the services sectors, but some statistical data suggest that Japan's labour productivity is below 60 per cent of the

US level in the transport sector and about 40 per cent of the US level in both wholesale and retail industries, while there is not much difference in medical services productivity.

What is striking is the fact that labour productivity gaps between Japan and the US, the overall productivity leader in the world, further widened rather than narrowed in many non-manufacturing industries over the past decade. Indeed, productivity in total manufacturing in Japan grew between 1990 and 2003 at an annual average rate of 3.6 per cent, not much different from 4.0 per cent in the US and substantially higher than 1.8 per cent in the EU.<sup>vi</sup>

Productivity growth in Japanese wholesale and retail sectors over the same period was 1.8 per cent, again higher than the growth rate of 1.0 per cent in the EU, but substantially lower than that in the US which was as high as 4.5 per cent. Over the same period, labour productivity was virtually nil in agriculture and forestry and it declined at an annual rate of 2.6 per cent in construction.

Such poor labour productivity performance over the past decade or so at least in part reflected Japanese business firms' strenuous effort to maintain employment in the face of the protracted economic downturn while restraining total labour costs essentially by cutting overtime and bonus payments as well as the government policy of securing jobs by public work in depressed local areas. In economic upswings, labour productivity can pick up rapidly as business firms start to make fuller use of hoarded labour force before hiring workers from outside. This is indeed happening now. However, to sustain the upturn in income per capita, Japan's productivity performance must improve beyond the business cycle and across sectors.

Multilateral trade liberalization and exposure to international competition in export markets as well as intense internal market competition among domestic rival industries have been important driving forces for rapid productivity growth in the Japanese manufacturing sector. On the other hand, shielding of Japanese agriculture from international competition by maintaining high trade barriers against foreign producers has weakened incentives for its modernization and productivity increase. In the services sector, protection of existing firms and stores through restraints on new entrants both

domestic and foreign has been relaxed extensively by regulatory reforms in recent years. Nevertheless, more needs to be done to accelerate productivity growth and use labour more efficiently in this sector as well.

## **5. International competition and trade integration**

The substantial yen appreciation after the Plaza accord of September 1985 and its further rises up to the mid-1990s raised Japanese labour costs as well as prices well above the US and European levels. This has been reflected in large gaps between Japan's purchasing power parity and market exchange rates for the yen. According to the OECD estimate, Japan's purchasing power parity was 175 yen per dollar in 1995 whereas the yen's average exchange rate was as high as 94 yen per dollar. And, according to a joint study by three economists at the University of Groningen<sup>vii</sup>, unit labour cost in Japanese manufacturing was 62 per cent above the U.S. level in 1995.

The changes in relative wage and other cost advantages as well as rising protectionist tension against Japanese merchandise export induced a shift of Japanese production bases to North America and Europe during this period, while higher wage and other costs as well as cumbersome administrative procedures in Japan dissuaded foreign direct investment into Japan.

The wage and other cost gaps between Japan on the one hand and North America and advanced European countries on the other have tended to narrow as a result of protracted price and nominal wage declines in Japan and further exchange rate developments. Still, in 2000 unit labour cost in Japanese manufacturing was 27 per cent above the US level, according to the above-mentioned study. In that year, the OECD estimate of Japan's purchasing power parity was 155 yen per dollar whereas the yen's average exchange rate was 108 yen to the dollar.

At current market exchange rates, wage and price gaps between Japan and other advanced countries are narrower than they were over the 1990s.<sup>viii</sup> But, huge differences remain between Japan and emerging Asian economies. For example, at the current exchange rate, labour costs in Japan are estimated to be on average 20 times as high as

in China.

Faced with such huge cost gaps and the challenge of global competition, Japanese manufacturing firms have been trying to secure international price competitiveness by cutting costs through outsourcing and to increase non-price competitiveness through specialization of domestic production in areas where the labour content is low and the value-added component based on advanced, difficult-to-copy technology is high. Consequently, the share of intra-industry trade in Japan's total trade with East Asia is estimated to have risen from 25.6 per cent in 1990 to 45.7 per cent by 2002.

Among emerging economies in East Asia, China has become the largest exporter to Japan and the third most important destination of Japanese exports after the US and the EU.<sup>ix</sup> Japan had no import quotas on Chinese manufactured goods even before China's joining the World Trade Organization, and, unlike the US and the EU, it has no serious trade disputes with China on such items as textiles and similar products. On the whole, trade integration between Japan and emerging Asian economies has been proceeding steadily as a natural consequence of the evolution of relative wages and other production as well as transportation costs and comparative skill advantages, rather than through large-scale governmental initiatives like the North American Free Trade Agreement (NAFTA) and the European Single Market.

The recent decision by the Chinese authorities to move to a more flexible exchange rate regime is welcome. More significant currency adjustment than what has happened so far should help correct global external imbalances. But, they cannot be reduced on a sustainable basis unless domestic savings and investment imbalances are corrected in all major trade partner countries. Care must be taken for China's currency adjustment not to damage its domestic economic growth performance and undermine social stability. China is advised not to repeat Japan's experience with very volatile currency movements and subsequent disruptive domestic economic developments which in the end proved to be unhelpful also to countries competing with Japan in the global market.

## **6. Technological progress**

Technological progress is a key to economic prosperity especially in the age of globalization. To provide an internationally comparable measure of the output of a country's research and development (R&D), the OECD has recently developed a patents indicator called "triadic patent families". This is a set of patents registered at all of the three largest patent offices, namely the European Patent Office (EPO), the Japanese Patent Office (JPO), and the US Patent and Trademark Office (USPTO). The number of triadic patent families according to the residence of inventors was about 15 thousands in the US, some 12 thousands in Japan, and slightly under 6 thousands in Germany, about 2 thousands in France, slightly under 2 thousands in the UK and less than 8 hundreds in Italy in 2000.<sup>x</sup>

It is natural for a country with a larger population to have a greater absolute number of triadic patents than a country with a smaller population. However, even after adjustment is made for the size of population, Japan stands out as one of the three top performers together with Switzerland and Sweden for innovation activity. According to the OECD data, the numbers of triadic patents in millions of working-age population in these three countries were more than 120 in 1998, while the corresponding figure for the US was less than 80. Japan is a top performer, together with Sweden and Finland, also in the league tables for R&D intensity, measured in terms of R&D expenditure as a share of GDP, and in terms of the percentage share of researchers in total employment, according to the OECD data for 2001.

It is also interesting to look at the percentage share of patenting activity with foreign co-inventors. Japan's applications with foreign co-inventors account for less than 3 per cent of its total applications to the EPO. For all the other countries surveyed, the percentage shares of patent applications with foreign co-inventors were in double-digit figures. These data suggest that there is much scope for enhancing the international co-operative work of Japanese inventors.

## **7. The patterns of foreign investment flows**

Inflows of foreign capital coupled with advanced technology and management skills can be another important source of productivity growth in Japan. The stock of foreign direct

investment (FDI) in Japan is currently extremely low by international standards; it was 1.2 per cent of GDP in 2000, compared with 28.1 per cent in the US, 34.1 per cent in the UK, 12.0 per cent in Germany and 16.7 per cent in France. The Japanese government's aim announced in January 2003 is to double the stock of FDI in Japan by 2008.

Excessive regulations, restricted capital markets, unfriendly legal regimes and an uncertain tax environment were often cited as impediments to foreign direct investment in Japan. But, these arguments and Japanese manufacturers' persistent concern about trade protectionism against exports from Japan to the US and the EU alone cannot explain one-sided flows of FDI between Japan and other OECD countries over the past decades. The OECD product market regulation indicators suggest that regulatory impediments in Japan are no longer as high as in major continental European countries such as Germany, France and Italy, though still higher than in the US and the UK. One must add that Japan's relatively high domestic wages and non-wage costs at current and expected nominal exchange rates vis-à-vis the US dollar and euro have been a major macroeconomic factor impeding FDI into Japan.

Japan's direct investment abroad with the transfer of technology and management skills can be an important contributor to global economic development. While Japan's direct investment abroad is large in dollar terms, and far larger than foreign direct investment into Japan, it is still relatively small as a ratio to GDP, at 6.5 per cent in 2000, compared with 28.1 per cent for the US, 63.6 per cent for the UK, 20.0 per cent for Germany and 23.9 per cent for France. Regional integration under the North American Free Trade Agreement and the European Single Market initiative as well as the lack of similar large-scale regional arrangements involving Japan is an important reason why the ratio is so low in Japan. Its foreign direct investment as a ratio to total gross foreign assets was as low as 9 per cent, against the US ratio of 29 per cent, both at end-2003.

It is interesting to note that while Japan has been maintaining the highest level of net asset external position in the world with its net assets at end-2004 amounting to 1.8 trillion US dollars, net FDI amounts to only 15 per cent of total net foreign assets and the rest is divided almost evenly between net portfolio investment abroad and foreign

exchange reserves.

Asia accounted for mere 6 per cent of Japan's total FDI outstanding at end-2004; the US and the EU have remained the two most important destinations of Japanese FDI, the US share being 42 per cent and the EU 40 per cent at end-2004. This geographical pattern is likely to change as business investment opportunities increase in China, India and other emerging economies in Asia as well as those in other regions including Russia with rich natural resources.

## **8. Concluding remarks**

In concluding, let me just say that a multi-facet approach is required to increase overall economic growth potential and raise the living standards of citizens in all age groups in countries such as Japan where population is rapidly ageing. Domestic policy measures for growth enhancement I have just discussed briefly are certainly of primary importance. However, globalisation should also help Japan to meet the challenges of population ageing and to secure further economic prosperity. There is growing interest in Japan in the ideas of establishing and strengthening regional as well as bilateral trade and investment agreements in Asia. However, as the second largest industrial country in the world and the most advanced one in Asia, Japan should assume a more active role in furthering broader trade and investment liberalization in the multilateral framework of the World Trade Organization, overcoming resistance from domestic vested interest groups. This should be most beneficial to both Japan in need of sustained economy-wide productivity growth in the face of rapid population ageing and to the economic development of the rest of the world.

---

## Notes

<sup>i</sup> OECD Economic Survey: Japan 1999, page 29.

<sup>ii</sup> According to the OECD estimates of GDP per capita based on PPPs, Japan ranked 7<sup>th</sup> among OECD countries in 1999 whereas it was 17<sup>th</sup> in 1970. In 2000, based on the exchange rate of 108 yen to the US dollar, Japan's GDP per capita was 37,546 dollars, compared with 33,619 dollars for the US and 19,812 dollars for the Euro area. At purchasing power parities, it was 25,963 dollars in that year, while the Euro area average was 24,273 dollars.

<sup>iii</sup> The OECD forecasts published in late November 2005 are 2.4 per cent for CY 2005 and 2.0 per cent for CY 2006.

<sup>iv</sup> The annual average working hours in 2004 were 1,789 hours in Japan and 1,824 in the US. Note that the ratio of part-time workers to total workers is lower in the US than in Japan. The annual average working hours varied considerably among EU member countries, much longer in Spain (1,800) and Finland (1,736) than in France (1,441) and Germany (1,443), with the UK in between at 1,669 hours.

<sup>v</sup> See OECD report "Babies and Bosses – Reconciling Work and Family Life (Vol. 2): Austria, Ireland and Japan" (2004) which looked at the specific case of the reconciliation of work and family life in Japan.

<sup>vi</sup> Productivity growth figures for the EU are averages for 1995-2003.

<sup>vii</sup> In comparison, in 1980 Japanese unit labour cost stood at only 82 per cent of the U.S. level. See "*Losing ground*" *Japanese labour productivity and unit labour cost manufacturing in comparison to the U.S.*, Robert Inklaar, Harry Wu and Bart van Ark (University of Groningen Working Paper GD-64, July 2003).

<sup>viii</sup> The OECD estimate of Japan's purchasing power parity in 2004 is 133 yen per dollar whereas the yen's average exchange rate was 108 yen to the dollar.

<sup>ix</sup> In 2004, 21.7 per cent of Japan's imports came from China, 22.4 per cent from the rest of East Asia, 13.7 per cent from the US and 12.6 per cent from EU. In that year, 13.1 per cent of Japan's total exports went to China, 33.8 per cent to the rest of East Asia, 22.4 per cent to the US and 15.5 per cent to EU.

<sup>x</sup> In 2000, the number of Japanese applications to the European Patent Office (EPO) was 21 thousands, compared with about 30 thousands for the US, 22 thousands for Germany, 7 thousands for France, somewhat smaller than 6 thousands for the UK about 4 thousands for Italy.