Japan’s Economy and Policy in a Global Context:
Postwar Experience and Prospects for the 21st Century

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1. Introduction

The revival of the Japanese economy after World War II has often been referred to as an “economic miracle.” Having started from the ashes of destroyed factories and infrastructure as well as dwellings, the Japanese economy managed to develop to become one of the leading advanced economies in the world in less than a quarter of a century.

However, the economic miracle could not have been achieved by Japan alone. Interactions with the global economy were indispensable. If it were not for the exchanges of goods and services, capital, human resources, and technology with the rest of the world, the miracle would not have taken place. Participating in the global framework and helping to further develop the arrangement was vital for Japan, and the United States was always at the focal point in Japan’s relationship with the rest of the world.

In fact, the close ties established between Japan and the United States after the war could likewise be called a “political miracle.” In contrast to the regrettable relationship seen before and during the war, in the postwar period the economic relationship between the two countries has been close and strong. It has become the single most important bilateral relationship for both countries.

The aim of this paper is to review Japan’s economic developments and policies in the 70 years after the war, shedding light particularly on the impact that Japan’s economic relationship with the United States had on its path. Toward that end, focus will be given to the special features of the respective periods instead of going into the details of the historical events. It should bring out the basic momentum that operated behind the developments, which, in turn, would be useful in discussing the possible future scenario for the Japanese economy and its relationship with the Asia-Pacific and the rest of the world. Suggestions on areas of possible contribution to the Asia-Pacific region and other parts of the global economy will be discussed before the concluding remarks, which will make some proposals.

2. Economic developments and policies in the postwar Japan

Figure 1 shows how Japan’s annual real GDP growth rate has evolved since 1956 (the first year for which Japan keeps data in its national account figures system). It shows that, during the past

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60 years after World War II, there are a number of distinct periods that have different average growth rates, which, in turn, reflect the economic development and policy implementation specific to those periods.

Figure 1: Real GDP growth rates

![Real GDP growth rates chart]

Data source: Cabinet Office, Government of Japan.

The distinct periods that we focus on in this paper are the reconstruction period (1945-54); the high-growth period (1954-70); the unstable external environment period (1970-86); the bubble economy period (1986-91); the burst of the bubble and the lost decade (1991-2002); the longest expansionary phase of the 2000s (2002-08); the global financial and economic crisis and its aftermath (2008-12); and the Abenomics period (2012-). The features of each period will be discussed in turn below.

2.1. Reconstruction period (1945-1954)

The most important task that had to be tackled immediately after the war was to restore the daily lives of Japanese citizens: Demand for food and other necessities exploded as people returned to their homeland from overseas: The supply of these goods, however, was far from enough because the destruction of factories and the suspension of imports had reduced production levels to one-tenth of the prewar level (averaged across the 1934-1936 period). Accommodated by the

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2 The beginning and the ending years for each of the periods are determined by taking account of the dates of the peaks and troughs of business cycles. The dates are formally identified by an academic committee set up in the Economic and Social Research Institute of the Cabinet Office.
ample liquidity that circulated as a result of deferred payments for the war, the wide gap between demand and supply resulted in hyperinflation.

During the early years, however, the focus of the policies directed by U.S. General Douglas MacArthur and his General Headquarters, Supreme Commander for the Allied Powers (denoted as GHQ hereafter) was in the de-militarization and democratization of the Japanese economy. The goal was to completely transform the Japanese system so that it would no longer be able to challenge the new economic and political order put in place by the United States and its allies.

Rapid transformation of the legal and economic framework took place within about a year of the end of war. The new initiatives that were introduced include the (a) establishment of trade unions (December 1945) and labor standards (April 1947); (b) dissolution of the zaibatsu (March 1946) as well as the introduction of an Anti-Monopoly Law (April 1947), and (c) creation of small agricultural land ownership (April and October 1946). These postwar reform measures, some of which had to be revised later, shaped the economic development of the following years. One of the important outcomes of the reforms was increased competition and market pressure. This proved to be essential in accomplishing reconstruction and preparing for the high-growth period that followed.

Meanwhile, the Japanese government tried to address the economic crisis by employing demand-side and supply-side measures, as well as price controls. Efforts to contain excess demand were made by freezing bank deposits and replacing old yen notes with new yen notes (February 1946). Supply was stimulated by funneling available resources into strategically important industries that had become bottlenecks for production in a wide range of other industries (December 1946). Prices of important goods and services were also directly controlled by the government (March 1946).

Real progress was not made, however, until the priorities of the GHQ shifted to restoring Japan as an ally. It was a response to the changes in the international political situation: the Cold War that broke out between the United States and the Soviet Union. Faced with the tense confrontation, the United States began to see Japan as a strategically important frontline state for the Western bloc to prevent penetration by the Eastern bloc into the Asia-Pacific. While the United States provided military protection, Japan was encouraged to concentrate on restoring production and containing inflation and to become an independent partner.

The final stage of reconstruction was set by Joseph Dodge, chairman of the Detroit Bank, who was invited to make a set of recommendations to put an end to inflation and restore the economy. The most effective measure in his recommendations, called the “Dodge Line,” was the immediate balancing of the budget, which had been running huge deficits (December 1949). While it exerted a severe deflationary pressure on the economy, its implementation made a dramatic contribution in calming down inflation.

Price stability and recovery of production paved the way for a more normal framework for economic activities. After fixing the exchange rate to 360 yen per U.S. dollar (April 1949), international trade managed by the government was liberalized to allow the private sector to engage in exports and imports once again (December 1949 and January 1950, respectively), and
the authority for foreign exchange control was handed back to the Japanese government (January 1950).

The level of production at the beginning of 1950 was still below the prewar level. It was not until the surge in demand due to the outbreak of the Korean War in June 1950 that the economy finally took off. The Korean War was undoubtedly a surprise for the Japanese economy. Therefore, the recovery of the Japanese economy may look like an accident. Yet it should be noted that the Japanese economy would not have been able to take the opportunity if the economy was not prepared to respond to the surge in demand.

The production level surpassed the prewar level in the October 1950 and continued to increase. The White Paper on the Japanese Economy by the Economic Planning Agency (EPA) in 1956 reported that “the Japanese economy can no longer be considered to be in a postwar reconstruction period.”

On the basis of these achievements, San Francisco Peace Treaty was signed (albeit only by Western bloc countries) in September 1951, and Japan was restored to independence in April 1952. Furthermore, Japan joined the International Monetary Fund (IMF) and the World Bank in August 1952 and the General Agreement on Tariffs and Trade (GATT) in September 1955. Japan’s return to the international community was completed when it became a member of the United Nations (UN) in December 1956. The process of the return to the international community was not always a smooth one. In the case of GATT, for instance, Japanese membership faced strong opposition from the European countries. It was only because of the strong support provided by the United States that the accession made its way through.

2.2. High-growth period (1954-1970)

From late 1954, the Japanese economy entered a decade-and-a-half long period of high growth; real GDP growth recorded an average of about 10 percent during this period. The high-growth period, as it is now called, consisted of two distinctive phases.

The first half of the high-growth period that extended from 1954 to 1964 was characterized by domestic demand-driven growth. In particular, a rapid increase in private investment was the main factor of growth during the period. The 1960 White Paper on the Japanese Economy characterized the growth in this period as being driven by “investment which induced further investment.” It contributed to modernizing plant and equipment with new technology while expanding the production capacity of the economy.

Even though the momentum was still strong, booms during the period often had to be slowed down by a deliberate tightening of monetary policy. That was because the accompanying increase in trade account deficit led to the reduction of foreign reserves under the fixed exchange rate regime that was in place at that time. Since Japan’s foreign reserves was very limited, its depletion had to be prevented by policy action.

The situation changed in the second half of the high-growth period that lasted from 1965 to 1970. The rise in the household savings rate gradually changed the macro-balance. The undelaying balance of the current account shifted from deficit to surplus. The accumulation of
foreign reserves that followed alleviated the constraint on the economic expansion. Since there was no need to deliberately cool down the boom, the expansionary phase lasted from 1965 to 1970, making it the longest expansionary phase in the postwar period until more recent times (it was overtaken by the sustained expansion of the 2000s).

The preparation for an export-driven growth pattern had been made during the first half of the high-growth period when efforts to liberalize trade were initiated. An important initiative was the “General Direction for Trade Liberalization” announced in June 1960. The initial target of the initiative was to liberalize 80 percent of trade by April 1963. The efforts were accelerated (partly in response to a request by the United States) so that, by the target date, 89 percent liberalization was achieved.3

As a result of these efforts, Japan was able to accede to Article XI of GATT in February 1963. Further efforts were made under the GATT framework to reduce tariffs as well. Japan, whose economic growth relied heavily on increasing exports, is considered to be one of the nations that benefitted the most from the tariff reductions of the Kennedy Round, which took place between 1964 and 1967.

Similar efforts were also made in the area of exchange controls, which included an arrangement called the foreign exchange budget system. It was an arrangement in which the government purchased all of the foreign exchange received by the exporters and allocated them to the importers that met government policy objectives. It was in place until it was abolished in March 1964.

In fact, the year 1964 was an epoch making year: Japan accepted Article VIII of the IMF Agreement in April and celebrated the occasion by hosting the annual IMF-World Bank Meetings in Tokyo in September. Japan also became a member of the OECD in April and hosted the Olympic Games in Tokyo in October.4 1964 can be considered to be the year in which Japan formally became a member of the group of advanced industrial economies.

During the high-growth period, real GNP quadrupled, and nominal GNP became more than nine times larger. As a result, in 1968, Japan surpassed West Germany to become the second largest economy in the world (excluding the Eastern bloc), next only to the United States. It opened opportunities for Japan to participate in wider range of areas as one of the major economic powers.

However, the period was one that witnessed a widening of the trade imbalance. The U.S. trade account balance against Japan turned into a deficit in 1965, and the deficit continued to

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3 It is interesting to note that the recession between October 1964 and October 1965, which separates the two phases of the high-growth period, is often called “the structural recession.” Indeed, it was a structural watershed between domestic demand-driven growth and a period of export-driven growth. In addition, it also opened the floodgates to some structural changes that were unprecedented up until that time. The recession saw the collapse of a number of large firms, accompanied by a financial crisis that led to an emergency liquidity provision by the Bank of Japan. In view of the economic difficulties, government bonds were issued for the first time under the new Fiscal Law of 1947. In FY 1966, construction bonds, which are for financing set-creating expenditures, started to be issued (and continue to be issued to date).

4 European countries were not supportive of Japan’s membership bid to the OECD, which was, until 1961, called the Organization for European Economic Cooperation (OEEC). Japanese membership was again made possible by the support of the United States.
widen afterwards. It led to strong pressure from the United States and some tough negotiation, often involving the leaders of the two countries. In sectors such as textiles (wool and man-made), the issue was raised in late 1960s, and Japanese firms finally agreed to engage in a volunteer export restraint (VER) in 1970-1971.5

Meanwhile, the economic relationship between Japan and other Asian countries deepened. In response to a request made by the United States, which had to bear a heavy burden because of the war in Vietnam and the widening of trade deficit, Japan became increasingly involved in the stability and the prosperity of the region. Japan started to provide official development assistance (ODA) in 1954, and increased its amount to the region after normalizing its relationship with South Korea in 1965. The Asian Development Bank (ADB) was also established in 1966 with Japan subscribing the most capital.

On the other hand, there were differences between the two countries in their attitude toward China. During the period, Japan was eager to strengthen ties with China through trade; the United States, however, expressed strong concern over such action in view of the military threat of China to the region.

2.3. Unstable external environment period (1971-1986)6

Obviously, the high-growth period could not have continued forever. As the catch-up had been made in late 1960s, a slowdown of growth rate should have taken place. In the case of Japan, however, the completion of the catch-up coincided with an outbreak of a number of external shocks. The combined effect of the two overlapping events was to lower the average real GDP growth rate during the period to about 4 percent.

The first of these shocks was U.S. president Richard Nixon’s surprise announcement in August 1971 that brought an end to the global fixed exchange rate system—the so-called “Nixon Shock.”

President Nixon’s announcement included the suspension of the convertibility of the U.S. dollar to gold and the introduction of import surcharge of 10 percent, among others. It meant that the IMF system of global fixed exchange rates had collapsed. Efforts to reinstate the fixed exchange regime were made and led to a temporary agreement at the Smithsonian Institute in December 1971. The Japanese yen, which was one of the major currencies subject to realignment, was revalued to 308 yen from 360 yen per U.S. dollar.

However, the agreement proved to be short-lived, and the Japanese yen was finally floated in February 1973. Since the start of the floating, yen has been subject to occasional rapid appreciation, which became the utmost concern for the government as well as the exporting sector. In that sense, the floating set the background for the economic policy implementation in the following forty years.

5 It should be noted that textiles in early the 1970s were not the first VERs to be implemented. In fact, VER has a long history, going back to a VER on Japanese tuna exports to the United States in 1952.
6 The period is generally called “the stable growth period.” The terminology is not adopted here because of the fact that the real GDP growth rate, as well as the environment for growth, was far from stable.
The second shock was the steep rise in oil prices that followed the outbreak of the 1973 Arab-Israeli War.

The “first oil shock,” as it was later named, sent the Japanese economy into chaos. Oil prices shot up, and fear of shortages of oil-related goods led consumers into a panic. In response, direct price control was introduced. Macroeconomic policies were tightened to contain inflation.

However, as inflation peaked out, the concern of the government turned to the recession that followed. Real GDP in 1974 showed its first negative growth rate in the postwar period. In order to counter the recession, the government’s stance on macroeconomic policies was overturned. Fiscal stimulus measures were introduced, and in order to finance these measures, deficit-financing government bonds were issued for the first time since 1965 (and have continued to be issued to date except for a brief period in early 1990s).

The trilemma (recession, inflation, and current account deficit) that followed the first oil shock was the main theme of the first Economic Summit between the leaders of the six advanced industrial countries (including the Japanese prime minister) held at Rambouillet, France in November 1975. The economic influence that Japan had acquired by then was reflected in the agreements made in the following Summit Meetings, which called on Japan, together with the United States and West Germany, to expand its domestic demand in order to play the role of a locomotive pulling the rest of the world out of recession.

Compared to the first, the second oil shock in 1978 was dealt with more successfully, at least in Japan. With preventive monetary tightening in place, inflationary expectations were kept under control. The actual inflation rate turned out to be moderate, and the recession shallow.

Third was the trade friction with the United States, which intensified particularly in early 1980s. 7

Having overcome the changes in the international monetary system and the two oil shocks successfully, Japan was able to sustain moderate growth with relatively low inflation. In such an environment, it was also able to improve productivity and international competitiveness. This was in stark contrast with the United States, which continued to suffer from stalled productivity growth and a high inflation rate. In order to improve the situation, expansionary fiscal policy and tight monetary policy were taken under President Ronald Reagan and Federal Reserve Board (FRB) Chairman Paul Volker. The consequences of the policy mix were a high interest rate, strong dollar, and a large U.S. current account deficit.

Frustrated with the sustained and expanding current account deficit, the United States demanded Japan to improve market access and increase its imports. The two countries engaged in a series of difficult negotiations and agreements and reached agreements such as Japanese firms’ voluntary export restraints on automobiles (1981-1994) and Japanese firms’ import targets for semiconductors (1986-1992). Talks also took place on issues regarding the financial sector, where the report by the Yen-Dollar Committee in 1984 led to the liberalization and internationalization of the Japanese financial market. The discussions were expanded to include other sectors in the Market Oriented Sector-Specific (MOSS) talks (1985-1986), which covered

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7 Trade frictions in the 1970s included those over steel and color TVs, for which VERs were introduced.
telecommunications, medical equipment and pharmaceuticals, electronics, forestry products, and transportation machinery.

The fourth shock that characterized the period was the Plaza Accord in September 1985, which ignited a steep and significant appreciation of the yen.

Seeing that its current account imbalance had not improved despite the trade agreements, United States gradually leaned towards exchange rate realignment. At the meeting in Plaza Hotel, New York, the finance ministers and central bank governors of the G5 announced that the Japanese yen needed to be revalued. The exchange rate of the yen per U.S. dollar, which was 240 yen just before the Plaza Accord, appreciated to under 160 yen within ten months.

The steep appreciation led the Japanese economy into a recession. The need to engage in structural reforms to transform the Japanese economy to a more domestic demand oriented model was emphasized by the government sponsored Maekawa Report published in April 1986. Meanwhile, the government introduced a series of economic stimulus packages to counter the decline in economic activities. The official discount rate, which was used by the Bank of Japan as the policy rate at the time, was successively cut; in response to the Louver Accord in February 1987, which aimed to stabilize the exchange rate, it was cut to a record low (at that time) of 2.5 percent.

Throughout the period, Japan sought closer relationships with its Asian neighbors. Building on the efforts made in the previous periods, and supported by the change in the environment as a result of the end of the war in Vietnam and the President Nixon’s new approach to China (the other “Nixon Shock” for Japan), Japan agreed to open formal diplomatic relations with China in September 1972 and with North Vietnam in September 1973.

Efforts to further deepen the relationship with other Asian countries continued until a tour by Prime Minister Kakuei Tanaka was met by protestors in Thailand and Indonesia in January 1974. It did not, however, stop the commitment of Japan to the region. The overall approach of Japan to Asia was expressed in a speech made by Prime Minister Takeo Fukuda in August 1977. The speech, which is now known as the “Fukuda Doctrine,” declared that Japan would never become a military power again, would establish a heart-to-heart relationship with the Southeast Asian economies, and would make a contribution to peace and prosperity in the region as an equal partner.

The idea was further developed to include Australia and New Zealand as well as the United States and Canada when Prime Minister Masayoshi Ohira proposed a Pacific Basin Cooperation initiative in 1979. The idea materialized in the form of the Pacific Economic Cooperation Council (PECC), which had its first meeting in September 1980.


Improvement in the terms of trade brought about by the appreciation of the yen, and the impact of economic stimulus packages and monetary easing that were implemented in order to address the negative impact of the appreciation were successful in pulling the economy out of the recession. The real GDP growth rate rose to an average of about 5 percent between 1986 and
1991. In view of the favorable environment, a consumption tax was introduced for the first time in April 1989. The budgets in early 1990s were also formulated without relying on deficit-financing bonds for the first time in nearly 15 years. However, it turned out that the achievements were based on unsustainable economic performance.

The problem with the economic expansion during the period was the fact that it was based on bubbles that were created in asset markets. The rapid increases in stock and land prices were founded, at first, on an expectation of a surge in real activity, i.e. the expectation that Tokyo would become a global financial center. Ample liquidity provided by monetary easing, however, continued to pour into asset markets, accommodating the speculation of a further rise in prices. Monetary policy was left unchecked because of stable prices, due to the fall in import prices accompanying exchange rate appreciation. Prices in the stock and land markets—supported by self-fulfilling expectations—grew to be far in excess of the prices that could be justified by the fundamentals.

Discussions of the problem with the bubble during the period focused mainly on the widening inequality between asset holders and non-holders. In reality, a more serious problem was imbedded in the banking sector, i.e. the damage that could be done by the non-performing loans, but was not acknowledged during the period. Its seriousness was not realized until it became apparent that the burst of the bubble had seriously affected banks’ balance sheets.

Meanwhile, as the yen strengthened, the presence of Japan overseas increased. Japanese tourists became increasingly visible. In addition, increasing purchasing power supported firms and individuals to purchase expensive real estate and valuable properties abroad, most notably in the United States.

Firms in the manufacturing sector, on the other hand, were distressed by a loss in competitiveness. In order to adapt to the new environment, their choice was to shift their production sites abroad, in particular to Asia, in order to benefit from the low labor cost. Foreign direct investment surged, raising anxiety over the possibility of a hollowing out of the Japanese industrial base. However, while assembling plants for final products shifted overseas, the production base for intermediate goods remained in Japan, and their exports increased in the medium term. It is during this period that a complex network of global supply chain across the region began to be established.  

Trade discussions between the two nations entered a new stage when macroeconomic issues such as the savings/investment balance—not only that of Japan but also the United States—were taken up in the Structural Impediments Initiative (SII) (1989-1990). It provided an opportunity for Japan to express views about the U.S. macroeconomic balance, as well as to review its own regulations that prevented competitive pressure to play its full role. However, the talks were not enough to prevent Japan from being listed as an unfair trader under the 1988

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8 Prior to this period, there were foreign direct investments to purchase rights in the energy sector of energy producing economies. Foreign direct investment was also made in the United States and Europe to establish production sites within their borders to overcome barriers to trade. The changes in the nature of Japanese foreign direct investment over the years were discussed in Jun Saito, “Deepening of Economic Interdependence in the Asia-Pacific Region: Its Structure and Driving Forces” (paper presented at Economic Planning Agency conference on “Macroeconomic Interdependence in the Asia Pacific Region” held in Tokyo, Japan, October 1996).
Omnibus Foreign Trade and Competitiveness Act. Trade frictions during the period led to some tense moments between the two governments.

2.5. Burst of the bubble and the lost decade (1991-2001)

The policy setting was finally reversed at the end of 1980s. The official discount rate was raised, legislation to limit the use of land was introduced, and bank lending to the real estate sector was restrained in 1989-1990. As a result, stock prices started to fall in the beginning of January 1990, and land prices started to decline after reaching a peak in September 1990.

The burst of the bubble economy had its consequences. Households were left with large debts backed by nominally valued financial and real assets, and firms suffered from excess capacity, excess employment, and excess debt. The most serious problem was the rapid increase of banks’ non-performing loans. Having to meet the capital adequacy ratio requirement which was introduced in FY1992, banks engaged in a couple of apparently contradictory behavior. On the one hand, it restrained lending to firms that had better balance sheets (credit crunch) in order to contain the growth of risk-weighted assets. On the other hand, banks continued forbearance lending to firms, which were on the verge of collapsing, in order to contain damage to their capital. The former led to a fall in business investment, while the latter had an effect of preventing inefficient firms from exiting the market, and keeping the average productivity of the economy low. In order to address the weakening of the economy, a series of fiscal stimulus packages was introduced. The Bank of Japan assisted government actions by reducing the official discount rate to 0.5 percent by September 1995.

Mainly because of these policy efforts, the economy managed to enter an expansionary phase in 1996-1997, reaching a real GDP growth rate of almost 3 percent. This favorable performance led the government to go on with the planned consumption tax rate hike to 5 percent from 3 percent in April 1997. However, since the recovery at that time was policy driven, the economy was not strong enough to resist the deflationary effect of the consumption tax rate hike. Combined with the negative impact of the Asian Financial Crisis that broke out in July 1997, the economy quickly returned back into recession. The recession further worsened the balance sheet of banks and other financial institutions. The economy faced a financial crisis when a number of large financial institutions collapsed in late 1997 and in 1998. Japanese banks as a whole, which were perceived to be risky at that time, had to pay premiums to the foreign banks (the “Japan Premium”) for their borrowings.

The critical situation that erupted in the financial system was enough to wash out any optimism that the problem of non-performing loans would be solved by the future economic recovery. Firms finally started to engage in severe restructuring. In addition to dismissals, early retirements were encouraged while new intake was virtually stopped. In the late 1990s the total number of employees started to fall. In order to put a stop to further deterioration of economic conditions, the government finally injected capital into the banks in 1998 and again in 1999. It also tried to support the economy by introducing more economic stimulus packages. The Bank of
Japan responded by reducing the target for the collateralized overnight call rate to zero in February 1999-August 2000.9

Because of the economic weakness that became apparent during this period, the 1990s is often called “the lost decade” for the Japanese economy. The average real GDP growth rate for the period actually fell to only 1 percent. Because of low growth in aggregate demand, the negative output gap with the potential GDP widened. Since the mid-1990s, price decline became chronic, and deflation started to torment the Japanese economy.10

While Japan was struggling with domestic economic difficulties, the global economy was facing one of the most significant turning points in the postwar period: the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991. Former centrally planned economies started their transformation toward market-oriented economies. In addition, China increased its presence in the global market with the reform and opening up policy initiated by Deng Xiaoping in 1979, to which China’s commitment was renewed when Deng made his 1992 “Southern Tour.”

During this period, trade disputes between Japan and the United States continued. The two countries made efforts within the Japan-United States Framework for a New Economic Partnership (1993-1996). There were sharp disagreements as to the use of objective criteria, but the allies managed to reach agreements in areas such as automobiles and auto parts in 1995.

Meanwhile, Japan further increased foreign direct investment to the region, except for a short period in the late 1990s when a financial crisis broke out, in order to strengthen the global supply chain. Interdependence in the region was enhanced during this period. Japan took initiatives to establish a forum for the Asia-Pacific economies to discuss issues of mutual interest. In addition to the establishment of PECC mentioned earlier, Japan led the establishment of the Asia-Pacific Economic Cooperation (APEC) forum in November 1989.11 APEC, for instance, agreed to achieve free trade and investment by 2010 for the developed economics, and by 2020 for developing economies (the Bogor Goals). In order to achieve this target, an action agenda was agreed upon in October 1995 when Japan hosted APEC meetings in Osaka.

When the Asian Financial Crisis broke out in July 1997, those economies facing difficulties asked for the IMF’s support, which in turn collaborated with the World Bank, ADB, and other countries including Japan. In view of the need to have a regional arrangement to assist countries in need, Japan proposed the establishment of an Asian Monetary Fund (AMF)—an Asian version of the IMF—in 1997. However, due to the strong opposition from the United States, the proposal did not materialize as intended. The opposition seemed to come from the concern that the proposal overlapped with the functions of the IMF in the Asian region, and that it would provide less pressure on the borrower economies toward implementing reforms the

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9 The policy rate of the Bank of Japan was changed from an official discount rate to a collateralized overnight call rate in 1995. The name “official discount rate” itself was formally abolished in 2006.


11 The author was responsible for planning and drafting the first APEC Economic Outlook in 1995 for the Economic Committee of APEC. The main theme of the Outlook was the deepening of economic interdependence within the region.
United States considered essential. A looser arrangement called the Chiang Mai Initiative (CMI) was established later in 2000.


As the global economy recovered from the aftermath of the burst of the IT bubble in 2001, by 2002 the Japanese economy also started to recover. The expansionary phase eventually lasted for more than six years, making it the longest expansionary phase since the business cycle started to be recorded in early 1950s.

With the help of favorable economic conditions, the new administration led by Prime Minister Junichiro Koizumi embarked on implementing bold structural reform measures that were considered essential to the improvement of long-term growth prospects. In line with his principles, no economic stimulus packages were introduced during the period.

On the other hand, the Bank of Japan was pressured to do more after the policy rate reached zero. The Bank became the first central bank to introduce an unconventional monetary policy called the Quantitative Easing Policy (QEP). This switched the operational target from the policy rate to the current account balance of the financial institutions at the Bank of Japan, and gradually raised the target outstanding balance from 5 trillion yen in March 2001 to 30-35 trillion in January 2004. QEP was maintained until 2006, when the Bank of Japan judged that price levels had stabilized.

Among structural reform measures, Japan’s highest priority was given to resolving the non-performing loans problem. With a numerical target set by the government, banks were pressured to make considerable efforts to halve the volume of non-performing loans that existed in FY2001 (8.4 percent of total assets) by the end of FY2004, a target that they managed to achieve (2.9 percent).

Other items on the reform agenda, including the privatization of the postal service and fiscal consolidation, were pursued with varying degrees of success. The privatization of the postal service faced strong political resistance, but it was overcome when the Liberal Democratic Party (LDP) gained a large majority in a snap election. Japan Post, a private company whose stocks were initially 100 percent held by the government, was established in October 2007.

Fiscal consolidation also faced strong headwinds due to its emphasis on spending cuts. In order to meet the target of achieving a primary surplus by FY2011, the government decided to cut government expenditures by 11.4 to 14.3 trillion yen. A ceiling was set for each of the spending categories, including social security expenditures, and was observed in the annual budget formulation. The target probably would have been achieved if not for the drastic change in Japan’s economic environment brought about by the global financial and economic crisis in late 2000s.

The United States was also very negative about the prospect of Asian countries setting up institutions in the region that did not include itself. The proposal in 1990 by Malaysian Prime Minister Mahathir to create an East Asia Economic Group (EAEG) also faced U.S. opposition.
During the period, foreign direct investment to Asia continued, but a new trend emerged. A majority was still aimed at establishing or strengthening the global value chain across the region, but a greater portion of investments to large economies, like China and India, were aimed at capturing their fast growing domestic markets. Also, because of rising labor costs, investments were diversified to new host economies like Vietnam.

In the area of international trade policy, Japan had been giving highest priority to achieving a multilateral agreement under a GATT/WTO framework. However, difficulty in achieving agreement between developed and developing economies became increasingly evident and led many countries to engage in bilateral FTA/EPA agreements. Japan belatedly changed its stance in the 2000s and signed its first EPA agreement with Singapore in 2002.


Growth momentum of the Japanese economy gradually lost steam and entered a recessionary phase after a financial crisis broke out in the United States in the summer of 2007. The financial crisis almost brought financial activities in the United States to a standstill, and speculative money moved into government bonds (flight to quality) and to commodity markets (flight to simplicity).

The recession that Japan faced beginning in February 2008 was initially a mild one because Japanese financial institutions were not very exposed to subprime mortgage related securities. The negative influence mainly came from the loss in terms of trade due to a steep rise in the price of oil and other primary goods. The situation suddenly worsened when Lehman Brothers collapsed in September 2008. A sharp drop in global demand for Japanese exports, automobiles in particular, resulted in large negative GDP growth, much bigger than that experienced by the country where the crisis originated, the United States.

In order to deal with the situation, the G20 held a meeting in London in April 2009. The G20 became the main forum for international policy coordination. It agreed to take concerted action to bring the global economies out of the crisis by introducing expansionary macroeconomic policies. The action helped Japan as well as other countries in recovering from the crisis. Economic growth in Japan resumed after March 2009.

However, Japan’s pace of recovery was more modest than that of the United States. Improvements in corporate profits were slow in benefiting the household sector, expansion of employment was mainly in non-regular workers, and the increase in wages was limited. Weak household consumption kept private demand fragile. Since the recovery was not full-fledged, it was susceptible to the shocks that periodically occurred in the early 2010s—namely, the European sovereign debt crisis that broke out in Spring 2010, the Great East Japan Earthquake that took place in March 2011; and the great flood in Thailand, which affected economic activity in the summer of 2011. As a result, deflation, which was temporarily alleviated during the period between 2006 and 2008, returned to the Japanese economy in 2009.
Low growth and a fall in prices limited the nominal growth of Japanese GDP relative to other countries. In 2010, Japan surrendered the seat for the second largest economy in the world to China.\(^\text{13}\)

### 2.8. Abenomics (2012–)

Prime Minister Shinzo Abe, who came to office in December 2012, introduced Abenomics as his economic policy package. Abenomics gives highest priority to strengthening the growth potential of the Japanese economy and overcoming deflation. To achieve its objective, three arrows of economic policy were introduced: bold monetary policy, flexible fiscal policy, and a growth strategy to promote private investment.

Monetary policy took a major step forward when the Bank of Japan introduced Quantitative and Qualitative Monetary Easing (QQE) in April 2013, which included a commitment to achieve an inflation rate of 2 percent within two years by doubling the monetary base. Fiscal policy reversed the past trend of government expenditure cuts in order to provide short-term stimulus until monetary policy could start to show its impact. At the same time, the government maintained its commitment toward fiscal consolidation. The medium-term fiscal consolidation program of achieving primary surplus by FY202 and the plan to raise the consumption tax rate twice was reconfirmed. Finally, concrete measures for the growth strategy were listed in the “Japan Revitalization Program,” published in June 2013 and revised every year.\(^\text{14}\)

In response to the announcement of new policy initiatives, stock prices soared, and private consumption strengthened in anticipation of the improvement in employment and wages. Depreciation of the yen also took place, relieving exporting firms that had been suffering from the appreciation that had continued since 2008. The economy showed recovery and reduced the negative output gap. The inflation rate started to rise toward the 2 percent target by early 2014.

Improvement in corporate profits led to an increase in employment. However, the tightening of the labor market led to only a very limited rise in wages. Improvement in household income proved to be insufficient to absorb the impact of the consumption rate hike that took place in April 2014. Private consumption dropped after the consumption tax rate hike, and the economy weakened. Judging that the economy was too weak to absorb the second consumption tax rate hike scheduled to take place in October 2015, government postponed it to

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\(^{13}\) The timing of Japan receding to third place globally in terms of GDP as mentioned above (and cited often) is based on a comparison of nominal GDPs converted to a common currency by using market exchange rates. If the comparison is made by using purchasing power parity (PPP), the timing would be brought forward to as early as the late 1990s. It reflects the undervaluation of the renminbi in the market relative to its PPP.

\(^{14}\) Structural policy has been slow in showing progress. However, more concrete results have started to show up in recent years. One of the most significant is the successful conclusion of the Trans-Pacific Partnership negotiations (October 2015). Other achievements include the designation of nine areas as National Strategic Zones, where experiments in deregulation will be tested for future extension to other regions (May 2014 and December 2015) and the introduction of a Stewardship Code and Corporate Governance Code (February 2014 and June 2015, respectively). A reduction of the effective corporate tax rate to below 30 percent and the liberalization of the retail electricity industry have also become effective as of April 2016.
April 2017. The Bank of Japan also expanded QQE by raising the pace of increase in the monetary base.

Even though the fall in oil prices improved the terms of trade, the slowdown of the global economy, most significantly in China, also delivered a negative influence on growth. As a result, real growth remained weak, and the inflation rate fell back to almost zero by early 2016. In order to address the increase in uncertainty, the Bank of Japan further reinforced QQE by introducing a negative interest rate for part of the current account balance held at the Bank by financial institutions in January 2016.

In September 2015, Prime Minister Abe declared that Abenomics had entered the second stage. As an agenda for Abenomics II, he proposed a new set of three arrows: creating a strong economy to open up a new future, providing child care support to foster family dreams, and establishing a social security system that leads to a strong sense of reassurance. More than the details of the new three arrows, what should be noted is the fact that the government for the first time committed itself in setting a target for the size of the population; it aims to maintain a population of 100 million in 50 years’ time. This reflects the problems that a shrinking population is expected to cause for the Japanese economy, an issue to be touched upon later.

3. Japan-U.S. economic relations in the postwar period

3.1. Basis of the relationship

As the brief economic history indicates Japan’s relationship with the United States has been the most important and successful bilateral economic relationship that Japan has had in the postwar period.

The basis of the close ties between the two countries is their shared values. Both Japan and the United States believe in the importance of respecting the will of the individual and securing their free choice. The political system is thus based on democracy, and the economic system on the market. The two countries not only base their systems on these values individually, but also cooperate in protecting and expanding these values. The cooperation of the two countries has been very important particularly in view of the challenges they faced from opposing powers who have had different set of values—most notably, the Soviet Union and the Eastern bloc during the Cold War, and China in the most recent period.

As a matter of reality, there was no other choice for Japan but to adopt and to absorb these values after the war, since, after all, the purpose of the occupation of Japan was to introduce such values into Japan. In this sense, they were “given” to the nation. However, Japan quickly learned and became aware that these values were indispensably important for the well-being and prosperity of its people. There is no doubt that these values are now deeply imbedded in Japan’s economy and society.
3.2. Form of the relationship

Because of their shared values, the economic relationship between the two countries has generally been close and intimate. Needless to say, across the different postwar periods there were some differences in nuance. Between 1945 and 1970, United States was like a guardian: providing protection to Japan, while teaching Japan the way to reconstruct and develop at the same time. While the United States wanted Japan to take more responsibility in the realm of national security to match the economic power it was achieving, it avoided pressing Japan too hard out of a fear of causing instability in the country. It was a close and strong relationship but was, in a sense, one-way. In contrast, after late 1990 the relationship became more balanced. The United States still provides protection, but Japan also shares the burden of the protection. In many areas the two have become more equal partners.

The period between the late 1960s and mid-1990s was different. Starting from textiles and expanding to automobiles and semiconductors, trade frictions brought tension and hostility to the relationship between the two nations.

It is difficult to understand in hindsight why such events took place at a time of the Cold War. Even though the Soviet Union did ultimately collapse later on, the period saw some serious confrontations with the United States over the deployment of intermediate-range ballistic missiles and the invasion of Afghanistan, among others. Obviously, the United States and Japan should have wanted to avoid confrontation amongst themselves at such a time as this.

The clue may lie in the different trend the two countries were experiencing in terms of macroeconomic performance. On one hand, the United States was gradually losing ground as the largest economy in the world after suffering from chronic low productivity growth and the twin deficit that emerged after its involvement in the Vietnam War. On the other hand, Japan had achieved successive years of high growth and had become the second largest economy in the world with a large current account surplus. The difference heightened frustration in the United States. For a nation that provides protection to Japan, it was intolerable to see the difference in the macroeconomic state.

Such tension gradually receded in the 1990s. To explain the changes in the political attitude, a number of factors can be mentioned. First, a new opposing player in the international power balance game—China—emerged. As has already been mentioned, China made an important shift in policy stance when it decided to reform and open up its economy in 1979. After a brief interruption starting in late 1989, it resumed its efforts in 1992 and succeeded in expanding trade and achieving remarkable growth. It became a member of WTO in 2001 and soon overtook Japan to become the second largest economy in the world. China’s economic power became prominent in economic development assistance, international policy coordination, and international organizations.

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15 This period was concluded by the extension of the Japan-United States Security Treaty in June 1970 and the reversion of Okinawa to Japan in May 1972.

16 Fading of tension did not mean a direct return to intimacy. To use common terminology, after “Japan bashing” came “Japan passing,” followed by “Japan nothing”.

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However, despite these achievements, there were concerns over such areas as government intervention (e.g. state owned enterprises), law enforcement (e.g. intellectual property rights), and market norms (e.g. food safety). Trade imbalance is also always a great concern for the United States. The emergence of China became a common challenge for Japan and the United States.

Second, the United States regained its dynamism by realizing the IT revolution. Capital deepening and the increase in total factor productivity in both IT-producing industries as well as IT-using industries raised the labor productivity growth rate above the historical trend. The pick-up in growth rate enabled the fiscal balance to record a surplus in the period between FY1998 and FY2001. It should not be forgotten, of course, that in the 2000s the subprime mortgage problem and its impact on the financial system led to a global crisis. However, even this event proved that the U.S. economy was flexible and dynamic when it showed a much quicker recovery than Japan.

Third, Japan in contrast began to suffer from long-term stagnation. The average growth rate since the 1990s has been significantly lower than in the past. The output gap has stayed negative, and deflation has become chronic. There are a number of reasons behind this stagnation. Since the 1990s, the current economic system that provides the institutional framework for economic activities (such as the lifetime employment system and the seniority-based wage system) has become inconsistent with recent changes in underlying structural conditions (such as the aging of the population). As a result, limited resources have not been fully mobilized to achieve growth.\(^{17}\) In addition, in the 1990s and early 2000s severe downward pressures on the economy came from the burst of the bubble. After the mid-2000s, significant downward pressure has been exerted by the aging and declining population.\(^{18}\)

Fourth, the strength of Japanese exports became a less salient issue in the United States. It is partly due to the loss of its market to Chinese exports, but it is also due to the increase in foreign direct investment by Japanese firms to increase production in the United States so as to replace exports from Japan. Foreign direct investment also created jobs in the United States, which made the U.S. society more receptive to Japanese firms and products.\(^{19}\)

### 3.3. Relationship in the Asia-Pacific

These changes worked to reduce tensions between the two countries after the 1990s, and the economic relationship has become more close and intimate in the recent years. One of the main fields in which economic cooperation between the two countries has been successful is the region of the Asia-Pacific.

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\(^{18}\) It is often mentioned that Japan has “lost two decades,” namely 1990s and 2000s. However, as is indicated, the reasons for the stagnation in each period are quite different. In this sense, the two decades should be decoupled.

\(^{19}\) The establishment of the WTO dispute settlement system in 1995 also contributed to avoiding direct confrontation over specific trade issues.
The increase in interdependency across wider Asia has continued to take place. As the region grew (fueled strongly by the establishment of global supply chains), labor costs gradually increased. This provided motivation for investment in a wider range of economies in the region. In order to invite investment and reap its benefits, the free flow of goods, services, and capital was essential. These developments naturally led regional economies to prefer the reduction of barriers to trade, investment, and harmonization of institutional arrangements.

APEC is an organization in which Asian economies, which had become the growth center, are members alongside Japan and the United States. It has committed itself to achieving free and open trade and investment in the region. However, since APEC operates on the basis of non-binding, voluntary principles, this ambitious program has been difficult to realize.

As a consequence, interest in the Asia-Pacific region gradually shifted to FTAs/EPAs. The APEC economies themselves already had such arrangements as the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), North American Free Trade Agreement (NAFTA), and ASEAN Free Trade Area (AFTA), but the number of FTAs/EPAs is increasing at a fast pace. Regional integration continues to expand and deepen.

Japan was slow at first to engage in bilateral free trade agreements because of its focus on a multilateral agreement under GATT/WTO. However, it became evident that the negotiations in WTO faced a stalemate. It led Japan to become more positive toward bilateral negotiations. Japan signed its first EPA with Singapore in January 2002. Japan’s share of trade between countries with FTAs/EPAs remains low (22 percent in 2014), far behind competitors like South Korea (63 percent in 2014). In this respect, the recent successful conclusion of the Trans-Pacific Partnership (TPP) negotiations in October 2015 should significantly make up for the delay. With the United States and Japan as members, it commands about 40 percent of world GDP and about a quarter of world trade.

In the international finance area, the long awaited regional monetary organization was finally established when the ASEAN+3 Macroeconomic Research Office (AMRO) started its operation in February 2016. It will conduct regional economic surveillance and supports the implementation of the multilateral version of the CMI, the Chiang Mai Initiative Multilateralization (CMIM). This time, the United States did not oppose its establishment probably because AMRO has emphasized its closer cooperation with the IMF, and because there was growing acknowledgement of a need for regional arrangements after the experience of the Asian financial and European sovereign debt crises.

4. Prospects for Japan in the world in the 21st century

Looking ahead into the middle of the 21st century and thereafter, some significant changes are expected to take place both globally and domestically. They should affect Japan’s relationship with other countries and its contribution to the world.
4.1. Global changes expected in the 21st century

One of the significant changes that are going to take place globally is related to China and India, which continue to grow faster than the developed economies. China, which has already become the second largest economy in the world, is in general expected to continue to grow at a relatively high rate. By extrapolating the past trend of real GDP growth, some even expect that China will eventually overtake United States and become the largest economy in the world.

However, China will not be able to continue to grow as it has in the past. It is expected to slow down in the long term because of the multiple transitions it will have to make simultaneously. First, a structural transformation from an economy that is dependent on investment to one that is more dependent on private consumption has to be made. It is essential in resolving the overcapacity that has become apparent in its heavy industries. Second, the negative impact of the burst of the bubble in the real estate and stock markets has to be overcome. If the non-performing assets are left unresolved, they will continue to exert negative influence on the economic activities of households, firms, banks, and the government. Third, adaptation to the aging and the declining population that have resulted from the one-child policy has to be made. China’s working age population (those aged between 15 and 59) is already declining as of 2012, and the total population is expected to start declining in the 2030s. The decline in population is sure to constrain China’s long-term potential growth rate.

Taking into account the difficulties the country faces, the average real growth rate could fall to less than one percent in the 2040s. However, even if the growth rate is subject to slowing over the long term, China will still be able to maintain its second place ranking in real GDP, admittedly a great achievement.

What is more spectacular is the fact that India is expected to achieve even higher growth. That is because of its ample room to catch up, India’s potential to shift to a more market-oriented economic policy, and its young and growing population. After achieving an average real growth rate of 7.5 percent in the 2000s, India is still expected to grow by more than 4 percent in the 2020s and 2030s and above 3 percent in 2040s. It is expected to overtake Japan by 2050 to become the third largest economy in the world.

4.2. Domestic changes expected in the 21st century

The changes that are going to take place domestically relate to the aging and declining population, which has already become a heavy burden on the Japanese economy. Not only will

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20 In a sense, China is about to go through a number of transitions simultaneously that Japan experienced in a sequence. Japan experienced the slowing down from the high growth period in the 1970s, the resolution of the non-performing loans in 1990s and 2000s, and tackling the downward pressure coming from its aging and declining population in and after 2010s. Even if China is able to draw lessons from Japan’s experience, this will still be an overwhelming task.

21 For the details of these projections, see Vision 2050: Long-Term Forecast and Policy Proposal (Tokyo: Japan Center for Economic Research, December 2013), updated in April 2014. Real GDP in the projections takes 2005 as the base year.
Japan’s growth potential continue to be subject to downward pressure, but significant changes are also expected to take place in its external relationships.

According to the official projection shown in Figure 2, Japan’s total population, which was 128.1 million in 2020, is expected to shrink to 86.7 million people by 2060, or to about two-thirds of the 2010 level. In the following fifty years (by 2110), the total population is projected to shrink to 42.9 million people, or to about one-third of the population in 2010.22

![Figure 2: Demographic projections](image)


At the same time, the aging of the population is going to advance further. As Figure 3 shows, the old-aged dependency ratio—the ratio of the number of people aged over 65 to those between 15 and 64—will rise from 36.1 percent in 2010 to 78.4 percent in 2060, and further to 83.3 percent in 2110.

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Figure 3: Old-aged dependency ratio


The rapid decline in population, at an average rate of minus 1.1 percent per annum, will lower the contribution of labor input to the potential growth rate.\(^\text{23}\) The current potential growth rate of about 1/2 percent, which already incorporates some of the negative impact of the demographic change, may fall further in the long term. According to one projection, Japan’s average real GDP growth rate is expected to fall to minus 0.1 percent in the 2030s and minus 0.4 percent in the 2040s.\(^\text{24}\)

If the Japanese economy is to grow, it will be necessary to offset the negative effect in some way. To that end, efforts need to be made by the government as well as by the private sector.\(^\text{25}\) It is in this sense that Abenomics II announced in September 2015 is important.

\(^{23}\) Applying a simple growth accounting framework, it implies that, even taking into account only its impact on labor input, the potential growth rate would be subject to a downward pressure of 0.7 percent per annum. Similarly, if the calculation is based on the rate of decline in the working age population, which is minus 1.3 percent, the downward pressure would be 0.9 percent. While acknowledging that the actual magnitude of the downward pressure depends on how the participation and structural unemployment rates behave, it does show that the impact of declining population on the potential growth rate is significant.

\(^{24}\) Vision 2050: Long-Term Forecast and Policy Proposal (Tokyo: Japan Center for Economic Research, December 2013), updated in April 2014. It is based on a projection assuming no policy change in Japan.

4.3. Japan’s contribution to the 21st century

In view of these changes, there are reasons to expect that the nature of Japan’s contribution to world will also change in the long term.

4.3.1. Receiving goods, services, and capital

One of the most significant changes to occur in the global context is the fact that Japan will no longer be a net supplier of goods and capital, but will instead become a net receiver of them. Immediately after the war, Japan was a young country with an ample young labor force and a high household savings rate. This enabled it to achieve a high growth with a large current account surplus. Its main contribution to the world during the period was through supplying high value added goods to other countries. Japan also contributed by providing foreign direct investment and portfolio investment abroad. It contributed in establishing a global supply chain in the Asian region. The external activities of the Japanese economy provided one of the main drivers of growth and development in the region.

Because of the aging and declining population, however, the situation is doomed to change quite rapidly. It means that the household savings rate will eventually turn negative and the current account to a deficit. As Figures 4 and 5 show, early signs of this are already observable in the data. It means that Japan will have to import more goods and services and also to receive more capital inflows in order to finance domestic investment.

Figure 4: Household savings rates

![Graph showing household savings rates](image)

Data source: Cabinet Office, Government of Japan.
Japan has been good at opening up in terms of “going out” but will now have to change to be good at opening up in terms of “receiving in.” In this regard, it will be in the interest of Japan to remove any barriers against transactions of goods and capital if the country is to survive.

4.3.2. Accepting foreign workers

At the same time, Japan will have to change its policy toward foreign workers. Instead of the very restrictive policy that has been in place, it needs to invite more workers from abroad if the negative impact of changing demographics is to be cancelled out in order to secure positive growth.

As has already been mentioned, the impact of the aging of and decline in its population is expected to exert a negative impact on potential growth in the long term. In order to prevent the potential growth rate from turning negative and to raise it to a comfortable positive rate, which is necessary to sustain fiscal and social security systems, significant efforts are needed. There are a number of options that to which Japan could resort. Yet even if they were all implemented, it

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26 Other important but difficult options include raising the participation rate of women and the aged, raising total factor productivity, and raising fertility rate. Their pros and cons are discussed in Chapter 1 (by Jun Saito) in Yoshio Higuchi, Kohei Komamura, and Jun Saito, eds., Innovation in a Super Aging and Population Declining Society (Tokyo: Keio University Press, 2016). A summary of the discussion can be found in Jun Saito, “Agenda for the Second Stage of Abenomics”, JCER English column Japanese Economy Update, October 2015.
would still be essential to increase foreign workers in the medium term. This would offset the negative impact on labor input that the aging and declining population may have, and contribute in generating more value added in the Japanese economy.

Accepting more foreign workers would require a significant change in people’s mindsets as well as the social system. It may require some time in order to make it happen. When it does, it should help in maintaining the population in the medium to long term in Japan. At the same time, it should also contribute to equalizing wages across the economies in the region (higher wages for the foreign workers), and also in transferring human capital abroad, probably most significantly to neighboring economies in Asia.27

4.3.3. Integrating FTAs/EPAs

Even though these changes are expected to occur, they would not change the fundamental value that Japan places in democracy and a free and open market. As has been mentioned already, Japan has benefitted greatly from the international framework for free and open trade and investment as well as the international arrangement for stable foreign exchange. It enabled Japan to grow at a pace unprecedented in economic history and to become one of the largest economies in the world. In turn, Japan gradually exerted its influence for the well-being of the international community. In particular, Japan focused on the Asia-Pacific region in establishing a stable environment for development. Japan should continue to promote free and open trade and investment as well as to harmonize institutional arrangements, particularly in the region.

In this respect, close cooperation with the United States, which has the largest influence in international policy setting, will be essential. Japan needs to cooperate in such international institutions as the IMF, World Bank, and WTO. In a more regional sense, APEC is still the main forum for promoting free and open trade and investment and exchanging information and ideas in the region. As two of the main members in the forum, it is important that the United States and Japan cooperate in making it more effective and conducive to growth and prosperity of the region.28

As a way of cooperating in the Asia-Pacific, Japan and the United States do not need to form a group on all occasions. If the two have deep understanding and trust between them, there could be a division of labor in terms of the area or organization. That attitude did not seem to have been in place when the AMF was proposed in the late 1990s but has since been gradually formed to allow AMRO to be established. In an area as dynamic as the Asia-Pacific, it is difficult

27 Issues related to accepting more foreign workers to Japan are discussed in Jun Saito, “Immigration: A Solution for Plummeting Population?” East Asia Forum Quarterly 6, no. 3 (July-September 2014).
28 While emphasis has been given mainly to the Asia-Pacific region, it should also be given to the relationship between Asia and Europe. Compared to the relationship between Asia and the United States as well as between Europe and the United States, the relationship between Asia and Europe has been limited. The recognition that this missing link needs to be strengthened led to the creation of the Asia Europe Meeting (ASEM) in 1994 at the governmental level and forums like the Asia Economic Forum (AEEF) in 2006 at a more individual level. Japan can also play a significant role in strengthening this relationship.
for either country to be fully visible in all activities in the region. Fostering understanding and trust and engaging in a division of labor deserve serious consideration.29

One of the region’s more recent features is the proliferation of FTAs/EPAs. The most recent developments include the successful conclusion of the Trans-Pacific Partnership (TPP) negotiations in October 2015, and the creation of the ASEAN Economic Community (AEC) in January 2016. There are negotiations taking place among the ASEAN countries and six countries in the region—Australia, China, India, Korea, and New Zealand as well as Japan—to create a Regional Comprehensive Economic Partnership (RCEP). The realization of a Free Trade Area of the Asia-Pacific (FTAAP), which has been proposed by the United States, is also being studied within the framework of APEC. These arrangements could further expand economic interdependency to a wider range of countries.

While pursuing an increase in the number of FTAs/EPAs, the pros and cons of these partial arrangements needs to be acknowledged. Regional agreements inevitably involve a trade diversion effect as well as a trade creation effect. They are clearly less efficient relative to multilateral agreements. If the regional agreements are to be justified, it is only when they are considered to be temporary arrangements that would eventually move toward the final goal of a global arrangement. It is important that countries do not lose track of the importance of reaping the dynamic gains of regional arrangements; the integration of the existing FTAs/EPAs needs to be pursued. Japan and the United States, which are both committed to achieving a global arrangement under the auspices of the WTO, should be ready to play a more significant role in this respect.

4.3.4. Extending high-quality markets and societies

Japan may be at a stage where a new approach toward international society should be taken. This comes from the acknowledgement that Japan should no longer emphasize the size of the economy in contributing to the international community. The size of the economy, being the third largest economy in the world, is not yet that small. However, the decline in the potential growth rate reduces the relative importance of emphasizing its size. Instead, Japan should emphasize the importance of achieving a high-quality economy that would lead to greater well-being for its people. This involves both high-quality markets and high-quality living standards.

The necessary condition for a high-quality market is the freedom to compete and trade with others. However, there are other sufficient conditions for it to be a high-quality market. The sufficient conditions include such attributes as the transparency and reliability of trade, as well as the quality, safety, and punctuality of goods and services. Japan can be considered to be one of the markets that could be seen as successfully achieving such attributes.30

The quality of development in Japan can be seen in the longevity of its people. Average life expectancy at birth was 86.8 years for Japanese women and 80.5 for men in 2014. They are

29 The suggestion shares the vision similar to the notion of “virtual unipolarity.” See Patrick Cronin and Michael Green, eds., The U.S.-Japan Alliance: Past, Present, and Future (New York: Council on Foreign Relations, 1999).
30 The author calls this as the PQRST (punctuality, quality, reliability, safety, and transparence) of the quality of a market.
both among the longest in the world. While such ageing is often seen as a problem, in particular from the point of view of the social security system, it is still a blessed achievement. Other indications of the high quality of development can be seen in the low infant mortality rate, low homicide rate, low assault rate, and high literacy and numeracy rate, among others. They can be considered to be among the qualitative targets that should be achieved by economic growth and development. Transferring Japan’s know-how and institutional arrangements in achieving such a high-quality economy should benefit the development of other economies.

4. Concluding remarks

Japan is currently struggling to overcome the problems that it currently faces in realizing a higher growth potential. On the one hand, the current economic system, the origin of which was established in the high-growth period where an ample young labor force was available, has become outdated and inconsistent with demographic changes, and is now preventing the limited resources available to make a maximum contribution to growth. On the other hand, Japan needs to tackle the negative influence coming from the aging and declining population. Its impact on capital input and total factor productivity as well as on labor input will inevitably lower Japan’s growth potential further.

The problems in the domestic economy have implications for Japan’s position in the global economy. Japan has been overtaken by China in terms of the size of its GDP. Japan has lost confidence in its economic power, which was once the source of its influence in the international community.

From a different angle, however, the picture looks different. In terms of the quality of the market and of society, Japan can be regarded as one of the leaders in the world. There are many aspect of the economy of which Japan can be proud. In that respect, by transferring the lessons it has learned during the process of its own development to other countries, Japan would be able to make a significant contribution to other economies that would like to follow its path.

In turn, Japan would benefit from the dynamic expansion of Asian and other economies, which would stimulate Japanese economic activity through global supply chain activities. It would also benefit from the capital and labor that would be supplied to Japan in order to compensate for the negative impact of the change in demographics. In this context, the paper suggested areas that Japan may be able to contribute to the world and the Asia-Pacific region in particular. They include such areas as integrating the achievements of FTAs/EPAs, facilitating international mobility of labor, and transferring experience and lessons for achieving a high-quality economy.

Most of the areas, however, lack fora for analyzing and discussing the related issues in the Asia-Pacific context. APEC’s Economic Committee has the potential to be one, but it currently focuses on promoting structural policy to remove obstacles to trade and investment and to doing business. PECC used to have a Pacific Economic Outlook (PEO) project, which

31 See, for instance, the OECD Better Life Index for Japan and How’s Life in Japan (Washington, DC: Organization for Economic Co-operation and Development, October 2015). They also suggest areas where Japan should make more improvement.
discussed economic forecasts and structural issues in an analytical manner, but has ceased its activity as of 2014. At this moment, there is no existing forum that could analyze and discuss these issues.

Creation of such fora in the Asia-Pacific context would be an important first step in securing the prosperity of the region. Japan, in cooperation with the United States, should take initiative in making such a move. After all, Japan will only be able to develop further by developing along with the Asian and the global economies. Japan’s contribution to international society will benefit not only the global economy but also its own economy.