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Japan's Economy in the Post-Koizumi Era

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Japan's economy has continued to recover steadily due to a combination of structural reform led by Prime Minister Koizumi and extremely loose monetary policy by the Bank of Japan. Business has trended upward since January 2002, already the second longest streak in the postwar period. Further, employment-related indicators reveal the resumption of the "virtuous cycle"¹ after a decade-long economic slump. The Bank of Japan announced in March 2006, however, that it would terminate its quantitative easing policy, thereby causing an increase in medium- and long-term interest rates and market volatility. Prime Minister Koizumi is expected to step down this September and the question in Japan is whether the recent economic growth trend will endure beyond his tenure. A definitive answer proves elusive and will depend on several factors, some political and some economic. One thing is certain: the first leader of the "post-Koizumi era" has some serious decisions to make.

Japanese firms have maintained stringent corporate downsizing efforts for more than a decade and accelerated such initiatives during the Koizumi era. They strived to concentrate on strategic areas of business to improve their ability to generate high-value-added products and services. As a result, the "three excesses"—excess debt, excess employment, and excess capacity—have for the most part been overcome² and profitability has improved substantially.³ This is because global investors have enjoyed purchasing stocks of slimmed-down, well-managed Japanese corporations. In addition, there has been a gradual increase in the number of "full time" employees and wages have begun to trend upward.⁴ Private consumption has been quite solid as a result of improved income conditions and a significant rise in Japanese equity prices.

At the same time, the exchange rate terms for Japan, especially with respect to China and the United States, improved after 1998, when the Consumer Price Index (CPI) continued its downward spiral. The yen appreciated more than 60 percent against the dollar after the Plaza Accord was signed in September 1985. When we take the trade-weighted average and the price change in all countries into account, however, (in other words, the real, effective exchange rate), the current level of the yen is similar to the levels recorded in January 1986.⁵ Thanks to eight years of deflation in Japan and concurrent steady inflation in other countries,⁶ the Japanese yen has depreciated 37 percent in comparison with the peak in 1995. Therefore, Japanese firms have enjoyed favorable terms of trade to export goods to the United States, China, and other countries in recent years, fueling an export-led rebound of the Japanese economy.

Although these positive signals bode well for the future, we should understand that Japan's recovery is still incipient; its gross domestic product has remained lower than what it was in 1997, while U.S. GDP has grown 46 percent in the last seven years. Japan needs to take more time to raise productivity, and success will depend on three primary elements: the policy choices of Koizumi's successor; the relationship with China; and domestic interest rates.

The first is the economic philosophy of the Japanese prime minister himself. Many corporate executives, government bureaucrats, and economists point out that the current economic recovery is due in large part to the structural reform efforts of

¹ Increased income in the corporate sector spreads to the household sector, which in turn feeds back to the corporate sector.

² For example, the ratio of interest-bearing debt to sales is currently as low as that seen in the mid-1980s, just before the bubble era. Secondly, the ratio of job offers to applicants has exceeded 1.00, which, according to the Health, Labor, and Welfare Ministry, indicates a tightening of the labor market. Finally, according to the Bank of Japan (*Short-Term Economic Survey of Enterprises*), the number of firms perceiving their production capacity as excessive is almost equal to the number perceiving capacity as insufficient for the first time since the early 1990s.

³ Corporate profits have increased for four consecutive years since fiscal year 2002. Firms' ratio of current profits to sales has already exceeded the historical peak.

⁴ Regular payments increase after the growth of overtime payments and bonus payments when firms feel confident about their operations in terms of profitability and sustainable growth.

⁵ *International Financial Statistics* (Washington, D.C.: International Monetary Fund, 2006).

⁶ *World Economic Outlook* (Washington, D.C.: International Monetary Fund, 2006). Indeed, the CPI in Japan decreased from 1998 through 2005 at a total rate of 3.2%. During the same period, the CPI in all industrialized countries, including Japan, increased by a total of 15 percent, and the CPI in all other countries increased by a total of 33 percent. Roughly summarized, the CPI of all countries except Japan has increased 23 percent in the last seven years. Then, the CPI in Japan coupled with the CPI of all other countries depreciated the yen by around 25 percent over eight years.

Prime Minister Koizumi.⁷ Koizumi's structural reform plan consisted of three key phases: (1) introducing globally standardized capitalism; (2) privatizing government agencies and creating efficient, lean government; and (3) introducing market mechanisms into both national and local governments and enhancing fiscal discipline. This coincided with his final goal to shun corporate traditions such as sweetheart deals and transform Japan economically into a "normal country" like the United States. During his five years in office, Prime Minister Koizumi forced big Japanese banks to write off enormous bad debts and initiated the privatization of Japan's postal system and the country's public highway corporation. He started to break down the old-fashioned and well-entrenched system of administrative guidance that was a pillar of traditional Japan. The reform effort remains at a formative stage, but because of Koizumi's moves, Japanese firms were forced to downsize drastically in order to survive. Equally important was his pledge not to raise taxes during his term, which prevented any negative sentiments from affecting capital investments and consumption. Some of his potential successors, however, have already suggested that they intend to consider raising taxes soon after Koizumi's term ends.

The second important element is China. Since Koizumi became prime minister, China has gained more significant attention both as an economic partner and as a threat to Japanese foreign policy. China's gross domestic product of \$2,224 billion in 2005 was almost half of Japan's gross domestic product. Exports to China accounted for 13 percent of Japan's total exports that year, an increase of 128 percent compared to the previous year. Japan's trade volume with other Asian countries accounted for 35 percent of Japan's total exports, and they linked their exports mostly to China and the United States. At the same time, imports from China accounted for 20 percent of Japan's total imports, an increase of 124 percent compared to the previous year, thereby contributing to a decrease in Japan's CPI. This situation indicates that China has become a trade partner too important to ignore as Japan takes a chance to regain its previous economic status in the world. Therefore, Japan needs to carefully consider what kind of relationship should be developed with China in the future.

A third factor is that domestic interest rates may rise quickly. Japanese commercial banks could dispose of bad loans and improve their profitability remarkably. Their lending attitude has become more active since last year⁸ and helped all borrowers. Interest rates, however, have risen since the termination of the quantitative easing policy, which will affect the interest burden of individuals and corporations, especially the small and medium-sized firms that compose 99 percent of all Japanese companies, even if they have already reduced their overall volumes of debt.⁹ But the more serious issue is how the Bank of Japan will control any future increases in the CPI. The downward trend of the CPI greatly benefited Japan's economy, and the effect on the real effective exchange rate was critical. In the future, the Bank of Japan will end its unorthodox maneuvers, terminating the zero interest rate policy and returning to more customary monetary policy tools. Japanese corporations will therefore likely experience a reduction in their competitive edge in terms of trade and production.

In sum, the Japanese economy is on the rebound thanks mostly to the economic reform measures of Prime Minister Koizumi and favorable terms of trade. It was not surprising to see articles like "Japan Is Flying Again" in the *Economist*,¹⁰ because Japanese firms that were once very highly competitive before the late 1990s have regained strength due to strenuous therapy. Japanese firms made painful yet productive decisions in response to Koizumi's push for reform; it is unclear whether this trend will continue after his departure. There is no question that economic policy will become a central theme of the Liberal Democratic Party (LDP) presidential election this fall given the infancy of the recovery and lingering questions about the sustainability of the Koizumi reforms. Let us hope for "post-Koizumi magic."

The Japan Chair invites other essays for the Platform. Please contact Eri Hirano at (202) 775-3144 or by e-mail at ehirano@csis.org.

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⁷ We must remember the phrase "Koizumi Magic" that refers to bold actions he took and the subsequent results. Specifically, his decision to call a snap election on August 8, 2005, after his postal privatization bill was voted down by opponents of reform, sparked an increase in business confidence as evidenced by a sharp increase in the Nikkei stock index.

⁸ According to the Ministry of Finance, the amount of outstanding loans by private banks finally increased on a year-to-year basis in August 2005 after a decade-long downward trend with an adjustment for loan write-offs.

⁹ In 2000, premature removal of the zero interest rate policy caused a drop in growth, and a nascent recovery turned into a fresh recession because the virtuous cycle had not yet started at the time.

¹⁰ "Japan Is Flying Again," *Economist*, February 14, 2004.