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1

Overview

Daniel A. Citrin and Alessandro Zanello

Japan's transition out of the economic stagnation that followed the bursting of the land and equity price bubble in the early 1990s has been long and tortuous. Undermined by a cycle of deflation and financial instability, growth was intermittent and narrowly based for much of the decade. Dislocations in the banking and corporate sectors weighed on confidence and activity, while policy slippages and external shocks added to the headwinds. By 2000—about ten years after the stock market went into a freefall—GDP was some 40 percent lower than what it would have been if growth had continued at the 1990–91 rate. The price level, as measured by the GDP deflator, was not much higher than at the time the bubble collapsed, but on a downward trajectory that proved hard to reverse. As the new millennium dawned, Japan seemed bogged down in the deepest slump of its postwar history.

The corner was turned in 2002. Surging exports, particularly to China, primed activity. Rising corporate profits spurred investment; expanding employment revived household spending. Slowly but surely, a virtuous cycle set in: progress by corporates in redressing the imbalances of the bubble period—too much debt, too much capacity, and too much labor—strengthened the underpinning of the expansion and facilitated further restructuring. Banks' health improved, defensive postures began to unwind, and confidence started to return. As a result, internal sources of growth took over as the main engines of activity. With domestic demand contributing the bulk to growth in spite of a large negative contribution from a shrinking public sector, real GDP expanded at a rate close to potential through 2007 when Japan's expansion became the longest on record and entrenched deflation started to ebb.

Policies had laid the foundations for the up-cycle. Tighter supervisory frameworks and large injections of public money finally addressed the

most immediate financial sector problems. Under rising regulatory pressures, banks (especially the largest money-center groups) accelerated their balance-sheet clean-ups. Structural reforms to improve the functioning of labor and product markets and strengthen social safety nets were launched, thus easing somewhat the transitional costs of corporate restructuring. Financial stability was also supported by the Bank of Japan's (BoJ's) unprecedented injections of liquidity under its quantitative easing policy which shored up confidence in the banking system and arguably kept long-term interest rates—and the external value of the yen—low. On the fiscal front, steps were taken to restore fiscal sustainability *inter alia* by cutting spending (particularly public works of questionable value), and by reforming social entitlements and intergovernmental relations. Meanwhile, a new policy to shift resources from the public to the private sector led to ambitious plans to privatize Japan Post—the world's largest financial institution—and other government financial entities. Last but not least, new trade agreements and a commitment to increase inflows of foreign direct investment deepened Japan's linkages with the global system.

Sound policies and a supportive global environment have lifted Japan out of the post-bubble stagnation, but new challenges loom ahead. Looking beyond the near-term policy requirements (which will reflect for the most part conjectural developments and the global business cycle), all observers agree that the quickening pace of globalization and a rapidly graying society will shape the policy agenda for years to come. On the one hand, Japan's aging and shrinking population raises questions about the growth outlook over the long term, the viability of existing social programs, and the equity and efficiency of the current tax system. On the other hand, heightened global integration exposes Japan to shifts in comparative advantage, raising regional and sectoral inequalities, and two-way channels of transmissions for real and financial shocks.

This book is about the changes set in train by demographics and globalization in Japan and the related policy priorities. It is the fourth in a series of IMF volumes on Japan's recent economic history—*Structural Change in Japan* (1998), *Post-Bubble Blues* (2000), and *Japan's Lost Decade* (2003). Like these companion publications, it illustrates how research and policy analysis come together in the work of the IMF staff to refine views on policy issues—and inform policy advice. Seven parts define useful—if somewhat arbitrary—boundaries to organize 16 chapters. Taken together, the chapters offer a comprehensive overview of issues facing Japan's policymakers at present.

The first part, “Growth and Demographics” contains two studies on how the changing population structure is affecting Japan’s potential growth and saving behavior. In Chapter 2, “Japan’s Potential Output and Productivity Growth,” Papa N’Diaye looks into how an aging population complicates the pursuit of strong self-sustaining growth. With a declining labor force (such as Japan has experienced since 2000), per capita income growth will depend crucially on higher productivity. A better understanding of the fundamental determinants of productivity growth thus becomes a prerequisite for pro-growth policies. The econometric results point to significant potential gains from reforms to remove lingering labor and product market distortions. In Chapter 3, Hali Edison looks into another channel through which adverse demographics may dampen Japan’s growth outlook: the secular decline in household savings due to a growing share of the elderly in the population. Econometric analysis based on both aggregate and cohort data suggests a significant downtrend for the foreseeable future—raising questions about the pace of capital accumulation and the evolution of Japan’s external assets.

The second part, “Fiscal Policy Challenges,” bundles three chapters on the implications for policy and fiscal structures of the evolving domestic and external context. In Chapter 4, “Strategies for Fiscal Consolidation,” Dennis Botman, Hali Edison, and Papa N’Diaye explore policy tradeoffs to accommodate the rising cost of social programs as the population ages. The analysis, based on the IMF’s Global Fiscal Model, highlights the impact on growth of different fiscal designs and provides a platform for discussing the relative merits of alternative consolidation measures. Chapter 5 focuses on “Tax Policy Challenges from Globalization and Aging: Issues and Options.” Michael Keen draws on recent international experiences to identify some of the key issues that need to be addressed in reforming Japan’s tax system. While fiscal pressures from an aging population may arrive sooner in Japan than elsewhere, other countries too are graying. Similarly, globalization has put tax systems worldwide in a state of flux. Thus, there is a considerable scope for drawing broad lessons for Japan from a cross-country perspective. The core message of the chapter is that, although increasing revenues when many external pressures act to reduce it will not be easy, Japan is well-placed to tackle a comprehensive tax reform. Social security reform is another element in the strategy to secure sound public finances. In Chapter 6, “Pension Reform Issues,” Dora Iakova reviews what has been accomplished with the 2004 overhaul of the public pension system—and what still remains to be done. Options for further reforms are analyzed within a broader

discussion of fiscal sustainability, pointing to the need for ancillary initiatives to boost labor force participation and promote greater self-reliance for retirement income.

The role that monetary policy needs to play to foster price stability in a changing environment is the topic of the book's third part, "Monetary Policy After Deflation." Charles Kramer and Mark Stone in Chapter 7, "A Post-Deflation Monetary Framework," look at options for the monetary regime and its operations once entrenched deflation is beaten. Foreshadowing choices made by the BoJ a few months later, they argue in favor of a clearly communicated medium-term inflation objective to anchor market expectations and the re-adoption of a short-term interest rate as the operating target. The details of the monetary framework adopted by the BoJ in early 2006 upon exiting its policy of "quantitative easing" are explored by Christopher Faulkner-MacDonagh in Chapter 8, "Practical Issues Surrounding the New Understanding of Price Stability." The chapter offers new insights on two fronts: it assesses the BoJ Policy Board's definition of price stability from an historical perspective; and it evaluates the role that alternative measures of price pressures could play in the BoJ's communication strategy and analysis.

Part IV has two chapters on "The Rise in Cross-Border Capital Flows." Chris Walker in Chapter 9, "Home Bias in Japan," looks at the regulatory and structural changes (related in part to the evolving demographics) behind the apparent decline in investors' preference for foreign over domestic assets—and gauges the macroeconomic impact of this behavioral shift. In Chapter 10, Shinobu Nakagawa and Christopher Faulkner-MacDonagh broaden the analysis by reviewing "Recent Developments and Outlook for Japan's Capital Flows" including the yen carry trade. The upshot of their work is that Japanese households could increase their external holdings significantly over the medium term, with implications for the external value of the yen, the development of domestic financial markets, and the evolution of regulatory frameworks at home and abroad.

Financial sector themes take center stage in Part V. Alexander Wolfson asks in Chapter 11 "Why is Japanese Banking Sector Profitability so Low?" The issue is critical even in the much improved financial landscape of post-deflation Japan because low profitability makes banks more vulnerable to shocks—and leaves them at risk of capital shortfalls. The chapter explores a series of structural factors that may affect banking profitability, including the role of Japan Post and other government financial institutions, and outlines policy priorities. Chapter 12, "The Re-emergence of Japanese Banks in Asia," by Shinobu Nakagawa, documents the efforts of the largest and most dynamic banks to raise their bottom line by expanding oversea

operations. Re-engagement with the rest of Asia is a striking feature of Japanese banking in recent times. More broadly, the chapter illustrates how globalization is reshaping the business models of Japanese banks which largely withdrew from the region in the 1990s.

Fiercer international competition also provides a powerful motivation for a revamped structural reform agenda, the topic of the sixth part of this book. Only through steps that increase the flexibility of labor and product markets can beneficial productivity gains be unlocked, boosting Japan's longer-term growth prospects and safeguarding its international competitiveness. Yougesh Khatri's "Priorities for Structural Reform," Chapter 13, provides a comprehensive overview of reforms to strengthen competition and boost potential growth, with particular attention to the service sector. In Chapter 14, "Agricultural Policies in Japan: Domestic and International Repercussions," Bradley McDonald zeroes in on Japan's agricultural sector where extensive protection and regulations create far-reaching distortions. Difficult policy choices lie ahead in the search of a balance between the desire to cushion the impact of globalization and aging on rural populations and the goal to improve the intersectoral allocation of labor and capital.

The international repercussions of Japan's policies are taken up in the final part. In Chapter 15, Nicoletta Batini, Papa N'Diaye, and Alessandro Rebucci use model-based simulations to show that fiscal adjustment and productivity-enhancing reforms could reduce substantially Japan's fiscal imbalances with limited adverse spillovers to the rest of the world. With ambitious reforms that deliver broad-based productivity gains, Japan could make a further contribution to the global rebalancing of growth and current accounts through a decline in its external surplus. Chapter 16, "Capital Flows and the Yen–U.S. Dollar Exchange Rate," shifts the focus to the international impact of Japan's monetary policy and the declining home bias in portfolio preferences. Econometric analysis by Papa N'Diaye shows that shifts in capital flows have played an important part in the medium-term dynamics of the exchange rate and might delay further the adjustment of the yen–dollar exchange rate to its longer-term value.

Taken together, the chapters in this volume provide a comprehensive exploration of the main policy issues facing Japan as it enters a period of unprecedented internal and external changes. Unfavorable demographics weigh on growth prospects and the public finances; deeper trade and financial integration call for greater flexibility in policy frameworks, markets, and institutions. Japan's recent economic revival gives confidence that the country is better placed than it has been in a long time to meet successfully the challenges ahead.

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