Macroeconomic Report No. 2006-08

The Japanese Economy: Stagnation and Revitalization and a Strategy for Enhancing Growth Potential

—The Outlook for 2007-08 and a Strategy for Growth —

December 13, 2006

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Overview

Observers believe that the Japanese economy saw its current growth phase outrun the "Izanagi Boom" in November 2006 and since then has been extending the record for the duration of a growth phase in the postwar period.

In recent months, however, a number of causes for concern over the future of the economy have emerged, including the deceleration of the US economy, the growth of inventory of IT devices and the softening of consumption, and the key issue is now whether the economy can overcome these negative factors in 2007. Meanwhile, even if the possibility of an adjustment phase in the short term cannot be entirely discounted, it is thought that, in the medium term, the basic economic trend will continue to be upward. Given this prospect, the key issues are how long this upward trend will continue, and what is needed to set this upward trend on a firmer footing.

To put the current economic phase in a medium-to-long term perspective, let us reexamine the history of stagnation and revitalization that the Japanese economy has experienced since the bursting of the "bubble".

First, looking back on the changes that the framework of the global economy has undergone since the 1990s, the revolution in information and telecommunications, followed by the emergence of China and other "newly developing superpowers" and the rapid economic growth of the resource-exporting nations led to the establishment of a growth cycle mechanism in the global economy, based on interdependence between the United States, China and the oil-producing nations. These conditions brought about "rapid global growth under a climate of high resource and commodity prices and stable interest rates".

The process by which these changes in the framework of the global economy came about forced the Japanese economy into an extended period of stagnation in the 1990s, against a background of emerging high cost structures and declining capacity for innovation. From the beginning of the 2000s, as the growth cycle mechanism in the global economy based on interdependence between the United States, China and the oil-producing nations began to form, the growth of overseas demand also began to benefit the Japanese economy. Under these conditions, as reform of the corporate sector and economic systems progressed, the Japanese economy recovered its competitiveness on the strength of the globalization of new international industries and markets.

However, if the current economic upturn is to become established and grow stronger, Japanese enterprises will have to address new issues, including the onslaught of Asian enterprises, the dawning of an age of global mergers and acquisitions and a growing shortage of human resources.

So, how is the Japanese economy likely to fare in the future? Looking at the global environment, conditions in which must be the basis of any forecast, for the next few years, with the growth cycle mechanism based on based on interdependence between the United States, China and the oil-producing nations set to remain in operation, the global trend of economic growth is likely to continue.

Under these conditions, the outlook for the Japanese economy from the second half of fiscal 2006 and into fiscal 2008 is as follows.

The second half of fiscal 2006 will see a continued deceleration, owing to the deceleration of overseas economies beginning to make itself felt in earnest, an adjustment in production speed in the IT sector and a tailing-off of the surge in capital investment due to large-scale projects. However, in contrast to the situation at the time of the collapse of the IT bubble or during the "plateau" phase of 2004, the Japanese economy retains a considerable ability to absorb shocks, and is likely to avoid slipping into a recession phase.

In fiscal 2007, the positive effects of the recovery of the US economy and the boost to corporate profits provided by the mass retirement of *dankai* generation baby boomers (through increased consumer spending on the strength of a rise in the payment of lump sum retirement benefits and through a fall in personnel costs) will allow the growth rate to accelerate into the second half of the year.

In fiscal 2008, a deceleration of capital investment is likely to become apparent as the corporate sector begins to take steps to avoid excessive investment, but, owing to strong exports and the demand rush ahead of the rise in the consumption tax rate (probably by 2 points in April 2009), anticipating demand that would normally be expected in fiscal 2009, it is likely that the recovery trend will persist, somehow or other, until the end of the fiscal year.

Although the recovery is set to continue until fiscal 2008, is possible that global economic conditions will deteriorate thereafter, and at some point, it will have to be seen whether or not the Japanese economy is capable of autonomous growth even under adverse conditions. Moreover, Japanese enterprises will face increasing pressure to develop their businesses on the assumption of a global market, and, to survive against intensifying domestic and foreign competition, will have to make still greater efforts to create added value.

In this light, it is clear that, over the next two years or so, which are likely to see the favorable conditions of "global economic expansion against a background of disinflation" continue, Japan needs to bolster the growth potential that it has begun to regain and build up the economic strength that will allow it to survive the adjustments that may follow. For this reason, Japanese enterprises should make 2007 the first year of a drive to build up their growth potential and set about investing in "three key areas" with an eye to the future.

On the policy front, rather than boosting the growth rate in the short term, Japan should focus on building up its base for growth in the medium-to-long term using a two-pronged approach based on systemic reforms and taxation and fiscal measures designed to promote investment in the "three key areas" and fiscal and monetary measures designed to create a macro environment conducive to sustained, high-quality investment.

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