

# *AJISS-Commentary*

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## **TACKLING STRUCTURAL PROBLEMS: THE JAPANESE ECONOMY**

*Motoshige Itoh*

The Japanese economy is struggling with structural reform. The turning point for structural change dates back to 1990 when the country's asset-price bubble began to burst. For nearly two decades since 1992, the Japanese economy has been in a deflationary gap, that is, demand has remained far below potential supply capacity. The gap was somewhat narrowed for a few years before and after 2005, but this was due to the overheated global economy at the time – a special factor beyond the scope of Japanese domestic

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reform. If the Japanese economy is to recover, the most pressing issues that Japan needs to address are the structural problems that underlie this deep-seated deflationary gap.

Behind the deflationary gap is a rapidly aging society. The population of productive age (15 – 64 years old) is projected to shrink roughly 25% by 2035. Longstanding domestic industries will have to be scaled down accordingly, but the pace is very slow. Supply capability and workforces are in excessive supply in many industries, from construction to retail distribution and subcontract manufacturing. This imbalance is the chief reason for the deflationary gap.

The direction that Japan should take with regard to structural reform is fairly clear. Firstly, there is a need to drastically adjust the excess supply in traditional domestic industries. Many industries have already begun working on this issue, considered a key contributing factor in today's stagnant economy. Nonetheless, this adjustment is unavoidable for drastic economic reform in Japan.


Secondly, Japan needs to cultivate overseas markets, Asian markets in particular, to compensate for its shrinking domestic industries. Measured in terms of ratio to gross domestic product (GDP), Japan's exports and imports are very small. Japan's trade dependency ratio stands at just a third of that of Germany, which has been actively engaged in both import and export trade with its neighbours. The situation may improve as the economies and markets of Asian countries expand rapidly. What Japan needs to do as soon as possible is to transform its industry and trade structure so that the country can be more reliant on trade (both exports and imports). In addition to traditional export industries, such as the automobile and electronics industries, an increasing number of firms that have so far been domestically-oriented have recently begun setting up operations in Asia. They include manufacturers of sundries, cosmetics and foods, and companies engaged in retail and financial services as well as infrastructure businesses. This is a welcome trend that should be accelerated further. The government should consider encouraging it with state policy.

Thirdly, Japan should foster new domestic growth industries. Given the aging society, demand for medical and elderly care services is expected to grow.

The government should initiate institutional reform so that these sectors can generate employment and innovation. Another potential area is the environmental technology. By applying advanced technologies to the solution of environmental problems, Japan will be able to generate new domestic demand. Furthermore, Japan will need to open itself up to foreigners and accept a greater number of tourists and students from abroad.

Many Japanese, including those in business, seem to understand the necessity of the above-mentioned direction. What is at issue is whether they are prepared to accelerate the pace of reform even if it entails pain, for the sense of stagnation surrounding the Japanese economy today can be attributed to the slow pace of reform.

More to the point, rebuilding sound public finances is a key to carrying out structural reform. The alarming level of government debt is a major source of stagnation felt by the Japanese people. Propelled by concerns about social security, the Japanese people have built up a far larger store of savings than people in other countries, contributing to subdued domestic demand. Public funds will also be indispensable to generating demand and employment in potential growth industries. The Japanese government's worsening fiscal condition is discouraging it from taking action in this endeavour.

It would be difficult for the government to take drastic steps toward fiscal reform when there is a widespread belief among the public that the easy step of increasing taxes would only exacerbate the economic slump. The Japanese people would not allow a tax increase unless they are convinced that the government has sufficiently cut down on waste. However, it is crucial for the government to draw up a plan for fiscal reconstruction and carry it out as swiftly as possible if it is to ensure the long-term sustainability of the Japanese economy and put the economy on a stable path to recovery. 

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