The Japanese Recovery: How Will It Affect the Global Economy?

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• Growth in Japanese real GDP slowed from 2.7% during the first quarter to 0.8% in the second. Although growth slowed, private domestic demand remained solid compared to the recent past.

• In the second quarter, exports rose 3.5% and imports rose 7.3% (annualized rates).

• The recently passed federal budget for fiscal year 2006 reduces spending by 3 percent. The growth of government consumption has slowed over the past several years.

• Growth in Japanese domestic demand has increased over the past 10 years—but remains low compared to other G-7 economies.
Productivity Growth

Japanese productivity growth has slowed, while U.S. productivity growth has accelerated.

Productivity Growth Has Accelerated in the United States Since the Early 1990's

Source: OECD Productivity Database - GDP per hour.

- Japanese productivity growth has slowed since the early 1990s. This slowdown has been concentrated in services, with good manufacturing productivity performance continuing.

- The U.S. experience has been quite different. Overall productivity growth has accelerated, with many service sectors (retail trade, FIRE) playing an important role in this acceleration.
Inflation and Export Prices

Consumer price inflation is now marginally positive, but import prices are booming.

- Consumer prices have increased 0.3% over the past twelve months, but it may be too early to predict an end to deflation.
- Deflation continues for the broader GDP deflator. This deflator fell 0.8% over the four quarters ending in Q2 of 2006, only slightly slower than the rates of deflation experienced for the last two years.
- Japanese import prices are booming.
  - The current 12-month change has been over 15%.
  - Export prices increased only 4.6% during that time.
  - These increases are broad-based (e.g., not just petroleum).
  - Japanese import-price inflation is double that in the US.
- Import-price inflation may help boost CPI inflation, but pass-through from import prices to consumer prices remains low.
- Continued strong rises in imports may limit the extent to which imports expand with the recovery.
Japan has run a persistent current-account surplus since at least the mid-1980s.

- The current-account surplus has been rising the past 10 years and is now near record highs.

- The trade surplus, although smaller than the current-account surplus, has also been positive for over 20 years.

- Key open question: If Japan enters a sustained recovery, what will happen to its trade and current-account surpluses?
The Japanese fall has been at least as large as that in the United States.

By 2004, household savings rates were similar in both countries.

The plan to privatize and separate Japan's $3 trillion postal-savings system (the world's largest depository savings institution) into three entities, set to take place in 2017, will help better allocate household savings to investment opportunities.
Gross national savings in Japan has also been falling.

- Gross national savings has been falling, but still remains much higher in Japan than in the United States.
- The Japanese central government deficit was 5.4% of GDP in 2004. The government has run large deficits for many years, a force that reduces overall national savings.
- What has kept the national savings rate from falling even further? Rising corporate savings.
Investment

Investment in Japan has also been falling.

![Graph showing investment as a percent of GDP has fallen for many years.][1]

- Although investment has picked up some over the past two years, investment as a share of GDP has fallen considerably since its peak in the early 1990s.

- One potential source of domestic demand growth would be a resurgence of domestic investment. Is this likely?
While domestic investment has languished, Japan has increased its foreign direct investment into many countries.

- FDI into Asia, especially into China, has also been growing rapidly in recent years (market-seeking and cost-reducing).

This rising FDI is reflected in Japan’s expanding income surplus, which made up over 70% of the current-account surplus in the second quarter this year.

Inward FDI: Receptiveness to inward capital flows has been variable – in particular to private equity (e.g., Shinsei Bank).

- Will this change?
- Inward FDI could support capital investment.
- Inward FDI could also support productivity growth.
Demographics

- Population growth turned negative in 2006 (labor force earlier).

- The population is also rapidly aging.

- These demographics have not yet had a large effect on the current account, but at some point Japan is likely to start dissaving.

- Since household savings has already dropped, the big question is whether demographics will alter corporate savings: will high profits be saved, or paid out as dividends, or invested?

- And what about immigration?
  - Immigration inflows have historically been extremely low.
  - In 2004 just 2,400 people immigrated to Japan (0.0018%).
  - Potential source of economic—and productivity—growth.
Conclusions

• The current recovery in Japan is a very promising development for the world economy.

• But this recovery is unlikely to have a large impact on Japan’s overall external position.

• The recovery has been associated with increased FDI outside Japan. These capital flows are likely to boost growth in the recipient countries.

• Japan’s ongoing demographic transition is likely to play a larger role in determining its economic future.

• Three open questions: What about inward FDI? And immigration? And (thus) productivity growth?