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Japan's Future Economic Competitiveness

Barry P. Bosworth
Senior Fellow, Economic Studies Program
The Brookings Institution, Washington D.C.

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To the visitor from abroad, it sometimes seems that Japan is beset by an overwhelming number of economic problems. Japan's economic problems have also aroused concerns—both governmental and popular—in the United States. Whereas the US took an optimistic view of Japan during the 1990s, it recently seems to be adopting a slightly too pessimistic view.

The problems confronting Japan, such as its aging population, are undoubtedly serious. It is predicted that Japan's workforce will shrink by approximately 18 percent by the year 2030. An additional problem is the cost of pensions and health care. It is also forecast that the dependency rate among the elderly will have increased by around 50 percent by 2030. In addition, Japan's budget deficit, which stands at 8 percent of its GDP, is the worst among the nations of the OECD. The US budget deficit is also a topic of some debate; compared to Japan's budget deficit, however, it probably constitutes less of a problem. With respect to the balance of payments, Japan's outstanding sovereign debt has ballooned to 150 percent of GDP.

It must be pointed out, however, that the Japanese economy is coping effectively with these problems. In particular, the author is extremely impressed with Japan's responses in the field in which he is engaged in collaborative research with Japanese research organizations—for example, with the way in which Japan is dealing with the problem of pensions for the elderly. Ten years ago the pension system appeared completely unsustainable. Over the intervening ten years, Japan has modified it in various ways and, within a five-yearly review framework, has converted it into a system that has a chance of survival. Now that Japan has slashed pension payments, the ratio of outlay on pensions to GDP is no longer so high in comparison with other countries. It can probably be said that the pension problem has been virtually resolved.

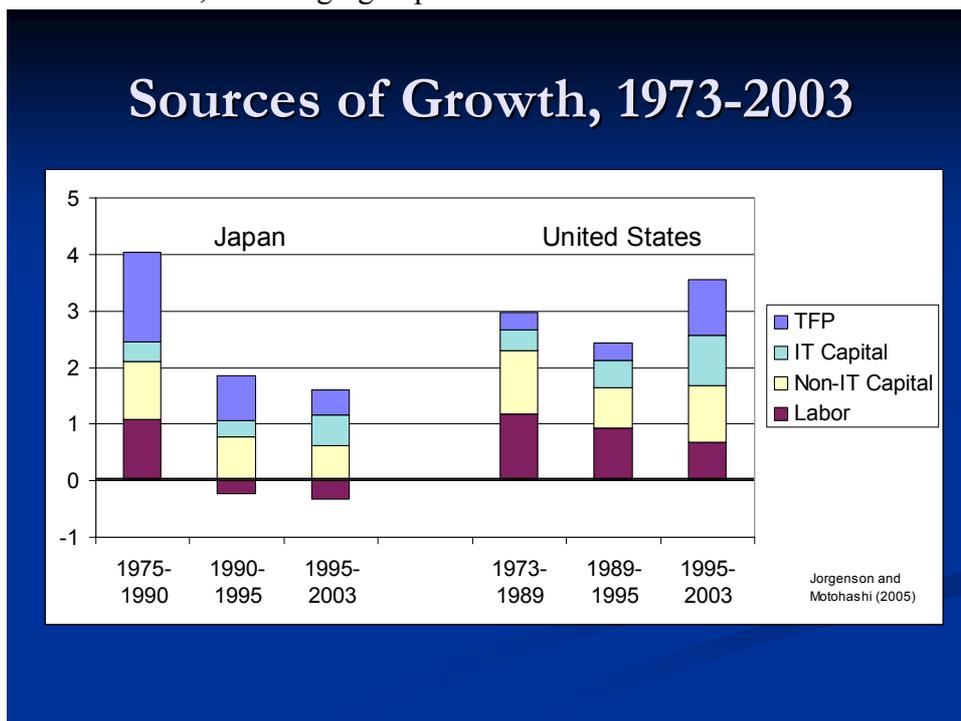
Japan is also exemplary for the share of its elderly population that continue to work past retirement age. In the United States the question of the extent to which old people will have to continue working is the focus of considerable attention in relation to the question of health care costs. Japan currently manages to restrict health care costs to around 8 percent of its GDP—astonishingly low compared to the United States figure of 15 percent. This is because less frequent surgical operations, costs are closely regulated, and moderate wage levels can be maintained in the health care industry.

Although the budget deficit problem is serious, there is light at the end of the tunnel. Japan is reining in government spending, but tax revenues are low in comparison with other countries. Essentially, taxes will have to be raised in order for the issue of the budget deficit to be resolved.

Thus, despite the fact that Japan faces significant problems, it appears to have the resources to overcome them. Certainly, Japan's ample human resources position it well to respond flexibly to these challenges. In the end the problem is simply whether or not the economy will continue to grow. Economic growth will mitigate or resolve

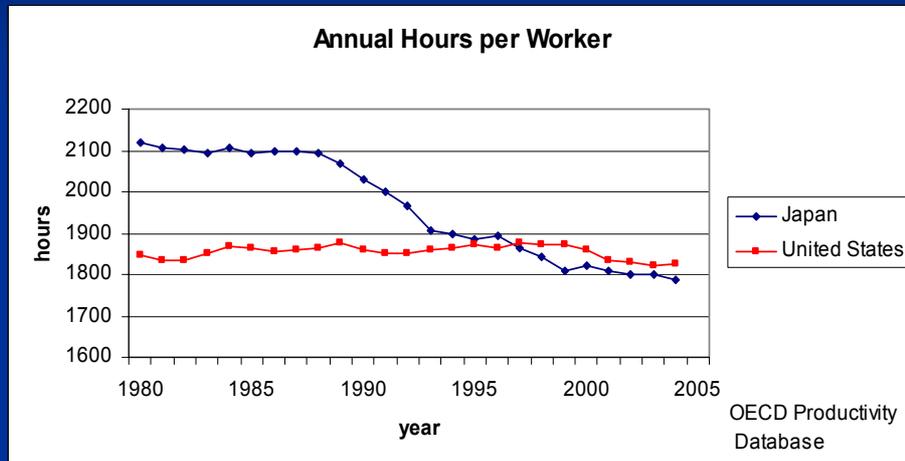
all of the problems outlined above. However, if the economy cannot grow, the aging of society will have far-reaching effects. In light of these circumstances, the following questions might be posed: why has the rate of growth of the Japanese economy been so low over the past ten years, and how will it fare in the future?

Even among economists arguments are raging over these questions. Historically it was difficult to find the relevant statistics (unlike in the United States); however, this has changed considerably in recent years. Outstanding analysis of productivity in the Japanese economy has been carried out in the course of joint research by Hayashi and Prescott (2002), and more recently in joint research by Jorgensen and Motohashi (2005) and Fukao and others (2004). This research has shed light on why growth in the Japanese economy has slowed down so much. After outstripping the US economy in growth in the 1970s and 1980s, the Japanese economy rapidly went into a slowdown in the 1990s. According to the research carried out by Jorgensen and Motohashi, this was attributable to a reduction in the labor input. A combination of two factors—a slower increase in the workforce population and declining working hours—contributed greatly to the slowdown in overall growth. Furthermore, the IT industry has made a substantial contribution. Although growth in the accumulation of IT capital is not as rapid as in the United States, it would probably be fair to say that things are going reasonably well. In addition, total factor productivity growth, the contribution of so-called technological progress to the growth rate, has also continued at a reasonable rate, encouraging hope for the future.



The primary cause of the slowdown is evidently the labor input volume, as exemplified by the number of hours worked. When the author first came to Japan in the 1990s, the Japanese worker was the most industrious in the world. The United States and Sweden approached Japan's level in this regard, but other countries had a much shorter workweek. In the 1990s, however, the basic number of hours worked has declined substantially. Now the average Japanese worker does no more work than the average American worker—an astounding turnaround. This phenomenon is particularly striking in the manufacturing industry.

Hours of Work, Japan and the United States



Why has the workweek declined? It may well be because of an increase in the number of companies and workers open to the idea of work-sharing in the face of the decline in overall demand. Their willingness to share work probably motivated them to use work-sharing as a means to cope with the slowdown in economic growth. However, this seems unlikely to continue in the future, and this phase seems already to be coming to an end. The number of hours worked annually is leveling off, and the situation may become akin to that in the United States. While the working population in the United States is growing at an annual rate of approximately 1 percent, however, in Japan it is contracting by approximately 1 percent per annum. Thus, the overall growth in the labor input will be much less than in the United States

Other research has reached similar conclusions to those of Jorgensen and Motohashi, and these results indicate that in the future overall labor productivity will increase by 2 percent annually. Combined with a decline in the workforce, the overall growth in GDP over the next ten years should average about 1.5 percent annually.

Competitiveness

There is a large gap in the productivity or efficiency between Japan's global and domestic enterprises. While Japanese companies that are engaged in activities in global markets demonstrate extremely high levels of productivity, industries that provide goods and services to the Japanese domestic market are weak in comparison with their counterparts in other advanced nations.

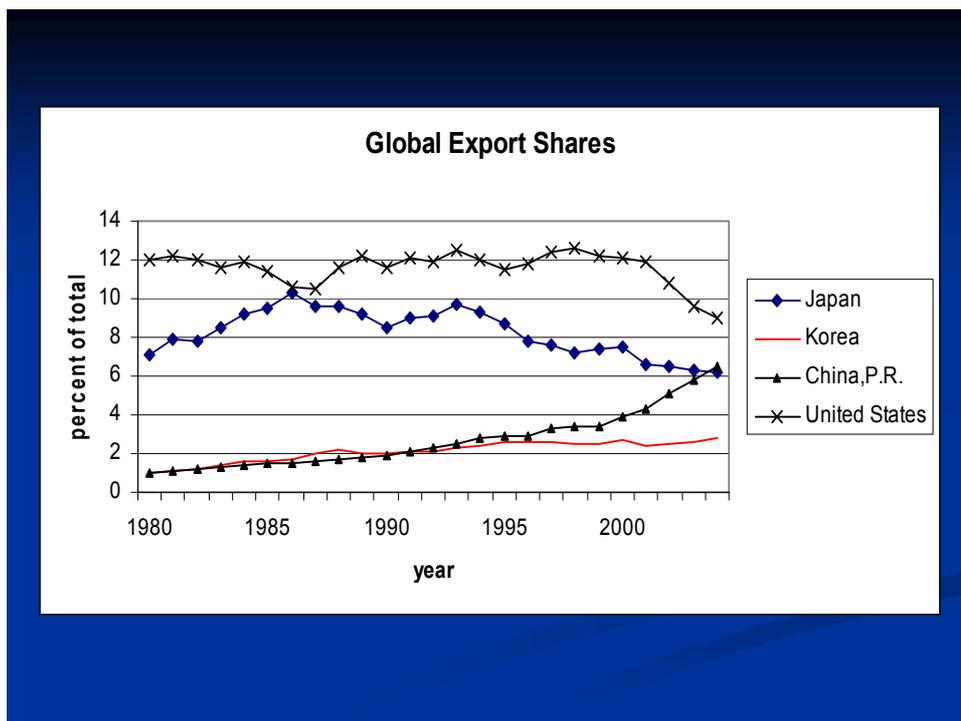
This is a major difference between Japan and the United States, and seems to stem from Japan's predilection for protecting inefficient companies. As global markets do not permit Japan this luxury, it is forced to adapt accordingly. Since domestic markets are protected, there has been no need to raise productivity in domestic-oriented firms. In areas such as the service sector, however, conditions are slowly changing and competitiveness is improving. This can probably be attributed to

deregulation. Also, in the past exports by the highly competitive manufacturing industry were the major strength of the Japanese economy. Now domestic non-manufacturing firms are beginning to improve their competitiveness as they become exposed to various types of competition.

The Japanese manufacturing industry will be exposed to even fiercer international competition in the future. Chinese and Korean companies are fighting to close the gap with Japan, and as advances in communications technology facilitate overseas production via outsourcing, Japanese companies are being forced to engage in relentless cost-cutting.

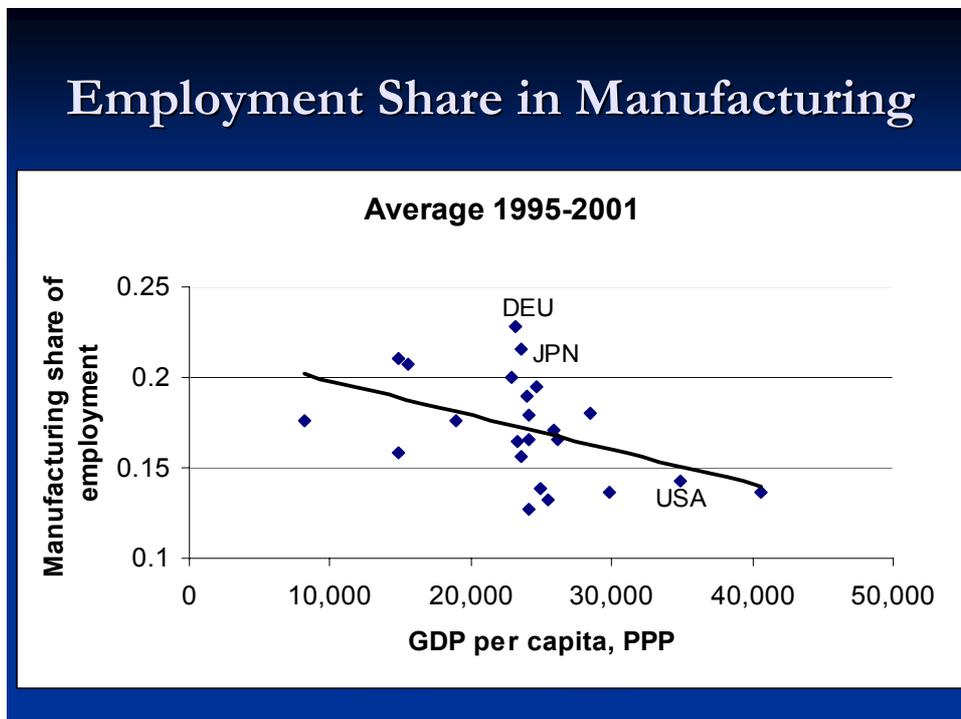
There does not seem to be any need to increase immigration, since the export of capital and technology for overseas corporate activities will obviate the need to import manpower. Instead of bringing manpower to Japan, Japanese companies should make inroads into places where manpower is already congregated. In short, it is likely that the trend towards overseas production will mushroom.

It is useful to compare Japan's export shares and industrial structure to those of other countries. In terms of exports, the United States still leads the world in market share. With its colossal economy, the United States retains an enormous share of the market; however, this has rapidly declined over the past four or five years. Japan's export share, which had seen a long unbroken upward trend, reached an overall peak in the 1990s and has been declining ever since. Of late, China's rise has been particularly noticeable.



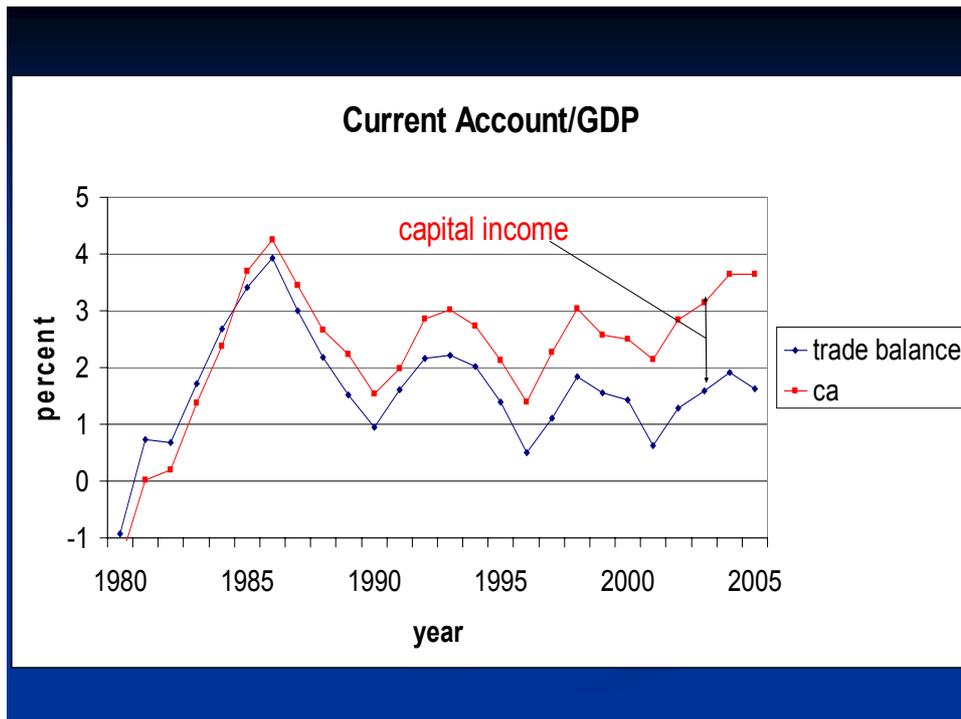
At the same time, the extent of Japan's reliance on the manufacturing industry is evident when the Japanese manufacturing industry's share of the overall workforce and per-capita GDP are compared with those of other nations. Japan's manufacturing industry is enormous compared to those of other advanced nations. Since the service-producing industries weight is known to increase as incomes rise, it can be predicted that the Japanese manufacturing industry's share of the workforce will probably decline in the future. Considering which sectors of the domestic market are

set to grow in the future, trends such as the manufacturing industry's forays overseas, especially in light of increased international competition, will naturally occur. In terms of the overall structure of Japan's industry, the extent of its dependence on industries targeting domestic markets will probably rise.



Japan's ratio of investment in R&D to GDP is the third best in the world after Sweden and Finland. Japan invests approximately 3 percent of its GDP in R&D. Incidentally, the United States invests approximately 2.5 percent, and this percentage is declining. By contrast, the ratio for Japan is rising, and Japan also has high educational standards in international terms.

Japan's net international investment position is 1.8 trillion dollars, whereas the United States is burdened with 2.5 trillion dollars of debt. No other nations come close in terms of debt or credit. With regard to the ratio of current account balance to GDP, approximately half of the current account balance is comprised of investment earnings or so-called capital gains. As a creditor nation Japan also receives extraordinary amounts of capital from abroad. This will undoubtedly continue to increase in the future. The ratio of current account balance to GDP stands at around 4 percent but is likely to increase.



Summary

The relative predominance of the manufacturing industry will undoubtedly fade. Due to severe workforce problems in Japan, the globally active manufacturing industry is likely to raise its competitiveness by increasing its presence overseas. Meanwhile, industries that remain focused on Japan and target domestic markets will have to raise their levels of production efficiency. It is likely that the entire industrial structure will shift markedly towards the service industry and that greater emphasis will be placed on product development through advanced R&D. Japan is currently strong in R&D in fields such as ICT (information and communications technology), environmental science, and energy efficiency, and future investment will probably be focused in these fields. Japan's capacity for future growth resides in its ability to confront and overcome the increased competition. So far, Japanese companies are responding extremely well. Deregulation and stimulation of participation by foreign companies are likely to be crucial in maintaining this response.