

**Conclusion**

(Fragile Nature of Current Economic Recovery in Japan)

The Japanese economy bottomed out in the January-March term of 2001, supported by an export growth. Its impact is gradually spreading throughout the economy, and momentum for recovery is enhancing. However, as discussed in Section 4 of Chapter I, there is no guarantee that this trend will continue without interruption. It will be heavily dependent on the developments of the global economy, especially the U.S. economy.

Since the 1990s, Japan's business cycles have all been considerably affected by global economic trends. The recent recession that began in October 2000 was also caused by the business slowdown of the U.S. IT industry, leading to a drop in exports from Japan. The susceptibility of Japanese business to the ups and downs of the global economy is an evidence of the weakness of the Japanese economy. Since private demand and other driving forces for achieving an autonomous turnaround and self-sustaining recovery are weak, external demand is having a relatively large impact on the Japanese economy. When the respective averages for the 1980s for the contributions of private demand, public demand, and net export to the real economic growth rate are compared with those for the 1990s, while the contributions of public demand and net export for the 1990s saw no change from those for the 1980s, the contribution of private demand has declined dramatically in the latter period. Of particular note is the fact that the contribution of plant and equipment investment has turned negative in the 1990s.

Such weakness in the economy's capacity for self-sustaining recovery is mainly due to the still-ongoing adjustment of the balance sheet that commenced with the collapse of the bubble economy (see Section 2 of Chapter I). Companies still suffer from excessive debts and banks remain beset with a build-up of non-performing loans. As a result, resources stay with less-productive companies and business categories, and positive resource spending, such as plant and equipment investment, has been withheld so as to allocate resources mainly for disposing of excessive debts and/or non-performing loans. Another factor behind the weak capacity for self-sustaining recovery is that labor costs have been stuck at high levels. Companies' efforts to adjust employment and wages have continued from the 1990s to lower personnel costs to adequate levels. When such adjustments are underway, an increase in production would not result in higher profit, employment and wages, nor in increased private demand such as plant and equipment investment and personal consumption. A virtuous cycle that would bring about a recovery in the economic conditions cannot be set in motion because the propagation channels are presently cut off in various places.

#### (Fragile Economy and Deflation: A Vicious Circle)

Deflation is one of the major causes of the fragility of the economy. There are two aspects to the current deflation in Japan: asset price deflation, which has been observed since the burst of bubble; and general price deflation, which has been observed since the mid 1990s (see Section 1 of Chapter 1). The asset price deflation has been a cause for the aforementioned balance sheet adjustment, which is mainly conducted by companies. On the other hand, the aggravation of the general price deflation, which has increased the real debt burden and raised the real interest rate and real wages, has been serving as a downward pressure on the economy.

At the same time, however, the weakness in the capacity for economic recovery had the effect of aggravating the general price deflation by widening the gap between supply and demand. In addition, the fact that the economy's capacity for sustainable recovery was weak and the economic prospects did not become any brighter contributed to lower asset prices that are susceptible to expected rates of returns. As a result, non-performing loans have not decreased, but in fact increased recently. Serving as a burden on the real economy on one hand, non-performing loans weakened banks' financial intermediary function and made it difficult for deflation to be overcome on the other.

This interaction between the real economy and the deflation makes it difficult for the economy to emerge from the deflation.

#### (Lack of Vitality in the Japanese Economy)

Behind the aforementioned fragility of the economy lies the medium- and long-term issue of the lack of vitality in the Japanese economy.

The lack of vitality in the economy also caused people to be concerned about the "hollowing out of industry." One of the "hollowing out" concerns is that the industrial base, centering on the manufacturing industry, which has supported Japan's growth up to now, may lose its edge due to export thrusts from countries such as China.

As discussed in Section 1 of Chapter 3, detailed analysis of the trade structure reveals that exports from China have mainly been goods in which Japan has already lost its comparative advantage, such as labor-intensive goods. The situation is thus not at all different from the catching up of developing countries that Japan has experienced until now. Just as before, Japan should be capable of overcoming the situation by improving its industrial structure and trade structure. Nonetheless, people still hold concerns about the "hollowing out of industry", because China has achieved an unprecedented rate of economic growth and the people at home have felt a sense of crisis that Japan may lack the capacity to adapt to such quick changes in the international division of labor.

In fact, the manufacturing industry is recording a high rate of productivity growth, and its importance in the overall economy has not changed. However, as comparative advantages are changing dynamically, enhancing the competitiveness of not only the manufacturing industry but also the services industry is an urgent task.

The decline in vitality is clearly indicated by the drop in the productivity growth rate since the 1990s. The growth rate of labor productivity in Japan has decreased since the beginning of the 1990s as mentioned in Section 2 of Chapter 3. This is in contrast to the situation in the United States where the growth rate of labor productivity was raised with the leverage of the IT revolution. The cause for the decline in Japan was that the loss of efficiency in corporate management, labor/capital allocation, and research and development gradually became obvious with the paralysis of the Japanese style management system and the non-performing loan issue in the 1990s. The pressing task is to raise labor productivity by eliminating inefficiency and improving knowledge and skills through rectifying the distortion in the allocation of resources.

#### (Tasks of Structural Reform)

In order for the Japanese economy to emerge from its current state of stagnation, it is essential to rid the economy of its fragile nature and carry out structural reform to build an economic structure that contains high growth potential. However, the action for structural reform delayed. The “lost decade” of the Japanese economy was not merely a decade of no economic growth, but also one in which the chance to take action was missed in terms of structural reform. Full-fledged actions only started with the adoption of the “Basic Policies for Macroeconomic Management and Structural Reform of the Japanese Economy” in June of last year.

The policies for structural reform cover extensive areas. They need to be comprehensive policies that include (1) the disposal of non-performing loans, (2) reform of public finance and the social security system, and (3) economic vitalization. Among these policies, the policy for “economic vitalization,” which has been taken up in this year’s Annual Report, aims at building an economic system where resources can be speedily and smoothly shifted from fields of low productivity growth potential to those of high, while raising the productivity of the economy on the whole. This kind of system used to exist in Japan. It is clear from the fact that Japan experienced “the high growth period” and recovered from two crises—the oil crisis and the strong-yen shock. However, in the course of the development of the bubble economy, and its subsequent collapse, the conventional system ceased to function properly, and instead grew to be a constraint.

The specific directions for economic vitalization were reviewed in detail in Section 2

of Chapter 3. As discussed, economic revitalization must be promoted in each of the following areas: (1) improvement of efficiency in corporate management, (2) improvement of efficiency in labor allocation, (3) improvement of efficiency in fund allocation, and (4) improvement of efficiency in research and development. (1), (2), and (3) are tasks for reaching the frontier of production possibilities by eliminating inefficiency so as to optimize the utility of given technology and human resources. On the other hand, (4) is a task for upgrading the technology and human resources in order to actually shift the frontier outward.

Of the above, structural adjustments are already underway with regard to the improvement of efficiency in labor/fund allocation by the force of the market mechanism. Such movements were observed in extensive fields particularly in the latter half of the 1990s. Nevertheless, the established systems are serving as impediments even in some of those fields, and without reforming these systems, no major steps forward will be seen in structural adjustments. Structural reform does not only mean supporting the proceeding structural adjustments, but also building new frameworks for those structural adjustments.

#### (Tax Reform Measures)

One of the actions required as part of the structural reform for bringing about a recovery in the vitality of the economy is fundamental and comprehensive tax reform.

While tax is an indispensable means of procuring funds for government activities, it inevitably has an impact on resource allocation through the distribution of tax burden. An inadequate tax system could make resource allocation inefficient and diminish the vitality of the economy. The “Basic Policies 2002” also aims to prevent distortions in the choices available for companies and to maximize the vitality of the economy and society in the course of structural changes thereto. From this perspective, there is the demand to reform the tax system to one suitable for the 21st century by construing “equity, neutrality, and simplicity,” which are often cited as the three principles for a desirable tax system, as “fairness, vitality, and simplicity,” in order to keep up with the times.

When examining tax reform, it is important to give considerations to such impacts of taxation on the vitality of the economy. The influence on the economy, and hence adjustment costs for structural reform, will vary depending on what specific tax reform measures are implemented.

#### (Mutual Relations and Concrete Procedures)

The individual policies that make up the structural reform thus have impact on other fields and, at the same time, are influenced by other fields. Therefore, when thinking about structural reform, it is important to consider not only the individual policies, but also the

interrelations between those policies. For example, the following can be said about the fiscal policy and monetary policy discussed in Section 3 of Chapter 1.

Fiscal structural reform is promoted as part of fiscal policy. Although its impact on the macroeconomy has been limited so far, macroeconomic impacts should be taken into account in promoting fiscal structural reform in the future, as indicated in the “Structural Reform and Medium-term Economic and Fiscal Perspectives.” Meanwhile, the macroeconomic effects of fiscal policy will change with the progress of structural reform in other fields. Thus, the concrete procedures for fiscal structural reform need to be decided with due consideration given to all of these matters.

With regard to monetary policy, Japan has continued to pursue a policy of quantitative easing. The effects of this policy are not actually being seen through the initially expected route of bank loans. As analyzed in Chapter 1, the effect of the quantitative easing seems to be emerging in the form of changes in exchange rates via the route of portfolio rebalancing. Nevertheless, this does not mean that the initially spotlighted route was completely ineffective. As structural reform advances and the balance sheet adjustment that had been blocking the routes makes progress, a route for spreading the effects of the monetary policy to the real economy will open up, and effects will arise through that route. This is the reason why the government and the Bank of Japan must make concerted efforts to overcome the deflation.

With respect to procedures, the introduction of the “special structural reform areas” is noteworthy. By conducting structural reform in specific areas, the reform can be commenced in areas where possible, and if it succeeds, it will add momentum to the overall structural reform.

(Economy after the Structural Reform)

The economic system that would be realized through this structural reform was discussed in Section 3 of Chapter 3. It is difficult to indicate the concrete future form of the economic structure in advance. However, the conventional economic system that was dependent on internal markets and negotiated transactions would undoubtedly convert into an economic system based on market-oriented transactions. This brings into light the importance of “information,” “transparency,” “risk,” “the principle of self-responsibility,” and “a safety net.”

The Japanese-style corporate management system will also transform dramatically. This does not mean, however, that the Japanese-style system will be replaced by the U.S.-style system. The recent disorder over business accounting in the United States shows that the U.S.-style system is not infallible. Important is to recognize that an optimum system differs

considerably by era, economic environment, and the type of business, and it is difficult to specify one in advance. It is important to secure flexibility where diverse systems are available, with each company being able to choose an optimum system for itself. At the same time, as corporate management systems become more and more diverse, the working patterns of individuals will also become diversified, and this will lead to demand for a system in which one can work and also enjoy one's private life (self-fulfillment and family life).

By shaking up the old economic system and building a new economic system through the structural reform, a path will open for the Japanese economy to achieve dynamic growth while dealing with such issues as the declining birthrate, aging population, and environmental problems. The lost vitality of the economy cannot be restored either by maintaining the status quo or by regressing to the past. Instead, revitalization is only possible through a complete rebirth of the Japanese economy.