

Is Japan's Long Nightmare Finally Over?

After a decade of stagnation, the Japanese economy has finally commenced marked growth. In the fourth quarter of 2003, Japan delivered an astonishing 6.4 percent real annualized GDP growth, the fourth expansionary quarter in a row. The unemployment rate has dropped to 5 percent, and heavily battered private consumption is warming up. Reflecting overflowing optimism, particularly among large manufacturing corporations, the Nikkei index has surged more than 40 percent since bottoming out in April 2003.

The superficial explanation for this recovery is that fixed investment and exports have turned the economy around (*Chart 1*). The underlying reasons are somewhat more complex.

Factors Contributing to the Recovery

The Japanese government's monetary and fiscal policies appear not to have been the chief contributors to this economic jump start. Although the Bank

of Japan has been pursuing expansionary monetary policy to stimulate the economy, financial intermediaries have not responded with substantial increases in loans. Nervousness among these inter-

mediaries has held the nation's money multiplier at extremely low levels for years (*Chart 2*).

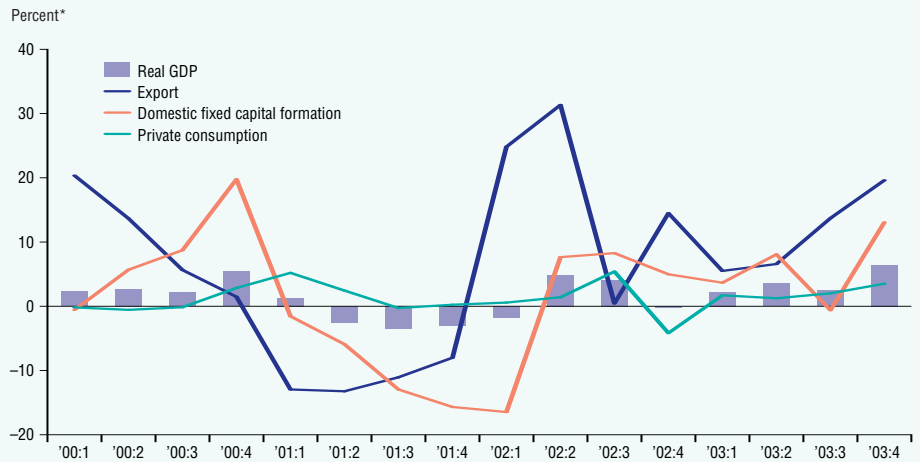
On the fiscal side, Japan's government is no longer drawing up grand spending packages. A record-high government debt-to-GDP ratio of more than 130 percent in 2003—and not much to show for it—has turned policymakers into fiscal conservatives.

Instead of government pump priming, the key to recovery has been the enhanced flexibility of the real economy. What is most encouraging is that after Japan's long period of stagnation, the labor market has finally become more flexible. As an example, the ratio of temporary to regular employees reached a record high of 26 percent in 2003 as the share of workers in lifetime jobs declined (*Chart 3*). Corporate profitability has also picked up as companies allocate resources more efficiently (*Chart 4*).

In spite of the Japanese yen's recent appreciation against the U.S. dollar and the Chinese yuan (which is pegged to the dollar), heavy exports have bolstered Japanese growth (*Chart 5*). Here, the

Chart 1

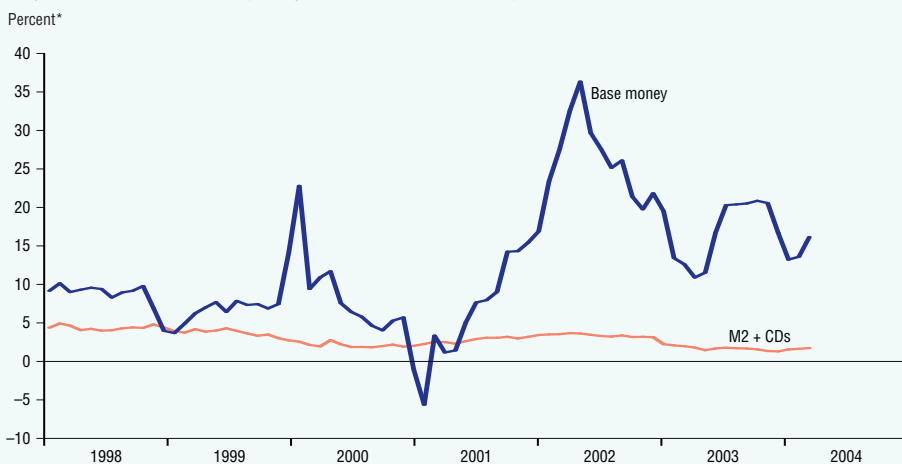
Japanese Recovery Is Propelled Mainly by Investment and Exports



* Quarter-over-quarter, annualized.
SOURCE: Japanese Cabinet Office.

Chart 2

Japanese Monetary Expansion Has Only Limited Effect



* Year-over-year.
SOURCE: Bank of Japan.

brightest spot is China. Data on Japan–China trade are somewhat confusing because Japan and China use different methods to calculate trade that flows through Hong Kong but is destined for each other. According to the Japanese Ministry of Finance, Japanese exports to China alone increased 24 percent year over year in 2003. Using Chinese customs statistics, the increase was even greater, at 39 percent.

The evolving business environment over the past decade has also forced Japanese companies to become more global through overseas investment. Again China stands out. Even though Japanese companies have only recently started making sizable investments in their neighbor to the west, Japan was China's third largest foreign investor for 2003.

Domestic labor market flexibility, coupled with globalization, has enabled Japanese companies to ride the wave of the positive technological shock in digital electronics, where these companies' comparative advantage lies.

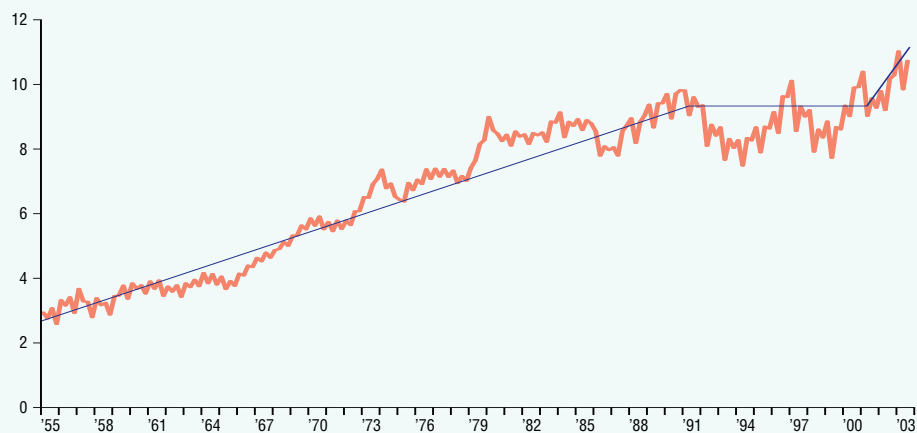
Deflation Remains an Obstacle

Although the real sector has bounced back and the deflationary pressure has abated, the perilous fight against deflation is not over yet. The latest Consumer Price Index inflation numbers were either above or very close to zero, but most other inflation measures remain negative. For example, the fourth quarter 2003 GDP deflator was down 2.7 percent compared with a year earlier.

Chart 4

Company Efficiency Is Up Again After a Long Stall

Quarterly sales per employee in manufacturing (millions of yen)*



* Sales are adjusted with GDP deflator.
SOURCE: Japanese Ministry of Finance.

The major concern is that the financial sector cannot function properly until deflation worries disappear. The Bank of Japan and the Japanese Ministry of Finance are determined to continue injecting money into the system to deal deflation a final blow. To achieve this, they have picked the foreign exchange market as the major channel, resulting in a fast buildup of foreign reserves. The foreign exchange market intervention also serves to maintain Japan's export competitiveness, which is still a crucial part of any sustainable recovery. In February 2004, Japanese foreign reserves

reached \$777 billion, up \$36 billion from the prior month.

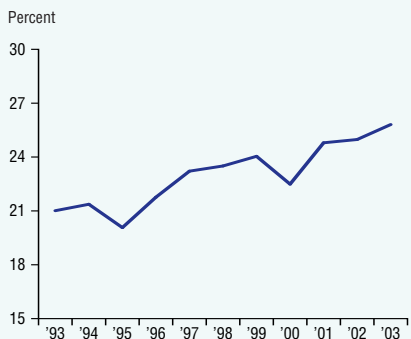
Conclusion

The Japanese economy's recent performance and, more important, the reasons behind it are giving the strongest signal in a decade of a solid rebound. Domestic flexibility, globalization and, particularly, the China factor all point to a sustainable economic recovery. The long nightmare may indeed be over.

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Chart 3

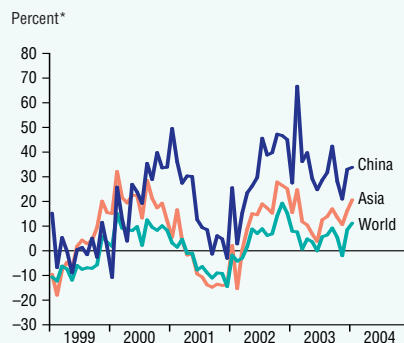
Ratio of Temporary to Regular Employees Is Up*



* Temporary employees are those who work less than 35 hours a week.
SOURCE: Japanese Ministry of Health, Labor and Welfare.

Chart 5

Japanese Export Growth to China Tops All Others



* Year-over-year.
SOURCE: Japanese Ministry of Finance.

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