

# Medium-term Outlook for the Japanese Economy (FY2006 to FY2015): Towards Stable Growth with a Mature Society

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## *1. Overview of the postwar Japanese economy*

The current recovery that began in January 2002 is entering its fifth year. The length of the current recovery has already surpassed the bubble period, the postwar period's second longest recovery, and will likely exceed the longest one ---- the "Izanagi."

**Postwar recoveries**

	Trough	Peak	Length of recovery	Average growth rate
A recovery period called "Izanagi"	Oct. 1965	July 1970	57 months	11.6%
Current recovery	Jan. 2002	?	?	2.4%
Bubble economy	Nov. 1986	Feb. 1991	51 months	5.4%
A recovery after the burst of the bubble	Oct. 1993	May 1997	43 months	2.4%
A recovery period called "Iwato "	June 1958	Dec. 1961	42 months	11.3%

Note 1: The length of the current recovery counts to 56 months assuming that the recovery continues through September 2006.

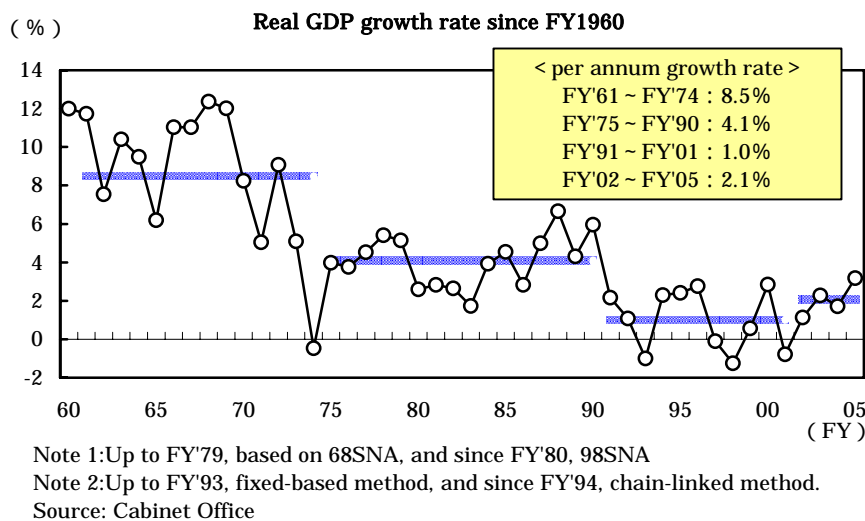
Note 2: The average growth rate for the current recovery is calculated for the period up to the second quarter of 2006.

Source: Cabinet Office, and own calculations

Since the end of World War II, the Japanese economy has experienced high-growth lasting until the early 1970s, followed by two oil shocks and stable growth until 1990. The last several years of the stable-growth period were considered the bubble-boom period. The

burst of the bubble depressed economic growth, becoming the so-called lost decade.

A prolonged recovery since 2002 indicates that the Japanese economy may enter a new growth period, but it will not be another high-growth period since the economic environment differs from those days. During the bubble period, people mistakenly believed that another such high-growth period was possible, and they learned a hard lesson. It may be also difficult to achieve growth rates comparable with the stable-growth period, but historical perspectives suggest that the Japanese economy has escaped its worst period, entering a new growth phase.



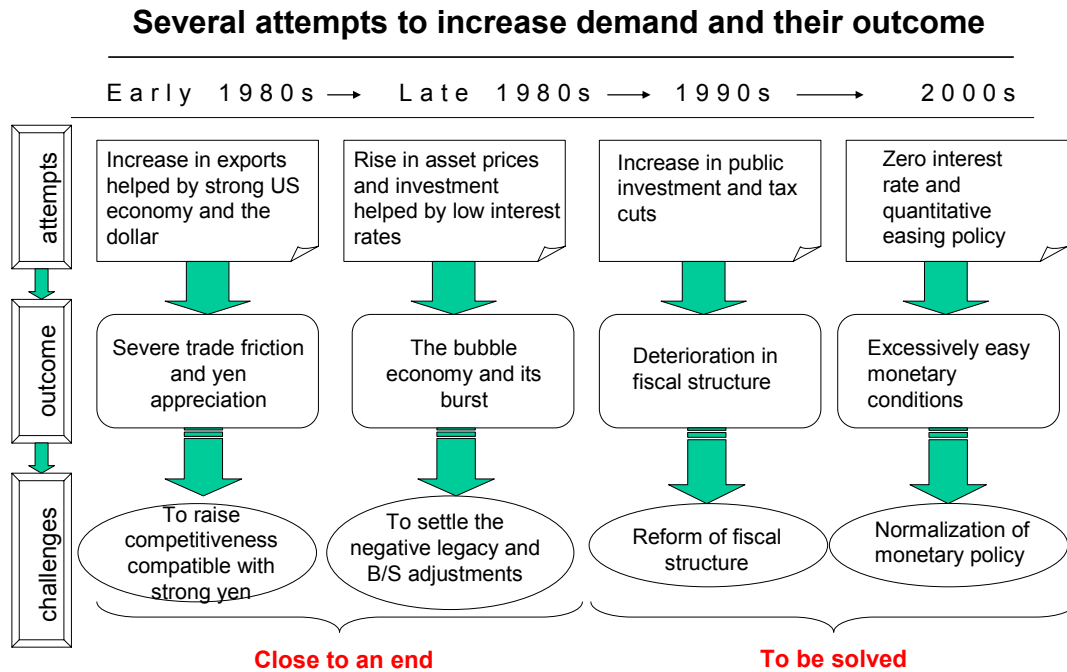
## 2. Three important trends influencing the Japanese economy

### (1) Declining birthrate and an aging population in a mature society

The population growth rate, birthrate, and the growth rate of households began to decline in the early 1970s. A declining birthrate with an aging population is the result of demographic changes during the last 30 years and more. The high-growth period ended simultaneously with the demographic changes, and economic growth rates fell, as the Japanese society matured.

There is no explicit definition of the mature society, but in such a society, high growth in demand is unlikely. A decline in population growth, an aging population, and diffusion of durable goods depress the surge of private consumption. In addition, as capital stocks have accumulated, public, housing, and business investment are less urgent. In a growth society, an increase in supply results in an economic growth, but in a mature society, the economy will grow only when demand increases.

Since the end of the high-growth period, several attempts have been made to increase demand, but all have failed, as indicated in the chart below.



## (2) The burst of the bubble and the recovery

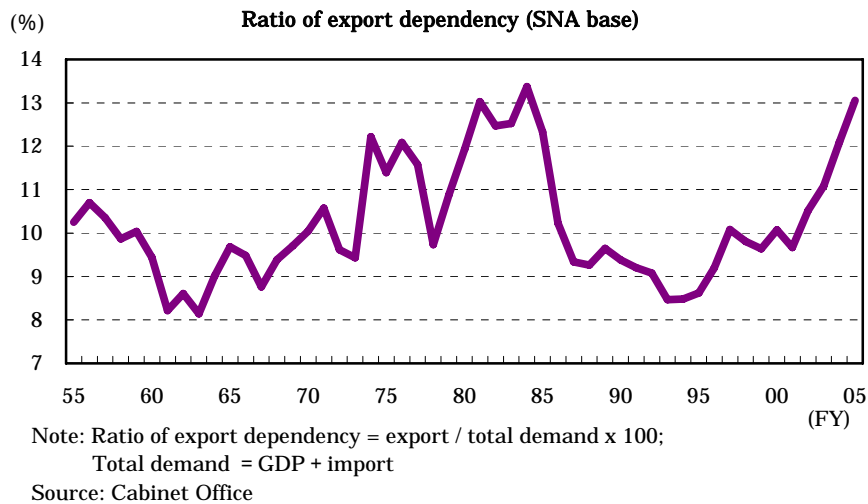
After the burst of the bubble, a decrease in business investment, as well as balance-sheet adjustments in order to settle the negative legacy of the bubble economy, had long suppressed the Japanese economy. But ten years have passed since the bubble burst, and excess capacity, employment, and debts have been resolved. And bad-loan problems are also close to an end. With improved financial conditions and profitability, companies are resuming investment.

Yet, lessons learned from the bubble period influence corporate behavior. Companies no longer make financial or business plans based on the assumptions that stock and property prices will continue to rise, and demand increase quickly. If businesses remain cautious, it is not likely that the growth rate will surge as during the bubble economy; rather the sustainability of the recovery intensifies, and overheating will be avoided.

## (3) The strong dollar policy and growth of the global economy

The third trend is the least watched one, but the strong dollar policy and its resulting, mounting current account deficit have brought growth to the world economy and a

rise in exports from Japan. Some argue that a recovery should be driven by domestic demand and question an export-led recovery, but there cannot be a prolonged recovery without an increase in exports. The strong dollar policy is not a mere exchange rate tool, but an important trend influencing the future of the Japanese economy.



### ***3. The Japanese economy in the next ten years***

#### **(1) Three important factors for the Japanese economy**

The declining birthrate, an aging population, and a mature society will increasingly suppress the growth momentum. In rebounding from the burst of the bubble, economic growth will accelerate for some time, along with improved financial conditions and profitability in the corporate sector. It will lose momentum, however, as the business environment toughens. A strong dollar policy and the resulting growth of the global economy will continue to support the growth of the Japanese economy, but as the U.S. and China grow less vigorously in the future, the environment for Japan's exports will no longer be as favorable.

#### **(2) Medium-term projections**

The average growth rate per annum will be 2.1% in real terms between FY2006 and FY2010, surpassing 1.5% per annum between FY2001 and FY2005 and the potential growth rate. Growth will accelerate, led by the corporate sector, as the negative legacy of the bubble economy will dissipate and the global economy expands.

During the following five years (between FY2011 and FY2015), the Japanese

economy will slow to some extent, but still maintain moderate growth of 1.8% per annum. The global economy will grow less robustly and the business environment will turn more rigorous. In addition, a declining birthrate and an aging population will drag the economy.

In the next ten years, the economic environment will be most difficult during the last five years. Thus, the first five years are important for facing long-term challenges to the Japanese economy, the goal to achieve mild but stable economic growth and build a solid economic system, financial structure, and social security system suitable for the mature society.

### Medium-term projections

	FY2001 to FY2005 (actual)	FY2006 to FY2010 (forecast)	FY2011 to FY2015 (forecast)
Real GDP growth rate per annum	1.5%	2.1%	1.8%
Nominal GDP growth rate per annum	0.1%	2.6%	2.5%
GDP deflator growth rate per annum	-1.4%	0.4%	0.8%

Source: Own estimates.

\* This is an English summary of a report originally published on September 28, 2006. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

\* The information and the views contained herein are subject to change without notice.

Translation and editing: Mariko Noda

Summary of Projections (1)

(FY)	Actual				Forecast											per annum		
	2003	04	05	06	07	08	09	10	11	12	13	14	15	01~05	06~10	11~15		
Nominal GDP		yoy, %																
Domestic demand contribution rate	1.0	0.5	1.8	1.9	2.5	2.9	2.9	2.8	2.7	2.6	2.8	2.3	2.4	0.1	2.6	2.5		
Private consumption	0.4	0.6	2.3	2.2	2.2	3.1	2.4	2.8	2.2	2.6	2.5	2.1	2.2	0.1	2.6	2.3		
Housing investment	0.0	1.0	1.7	1.8	2.1	2.6	3.0	3.0	2.5	2.6	3.1	2.2	1.8	0.5	2.5	2.4		
Business investment	0.0	2.3	0.7	2.3	1.5	-0.3	-0.2	0.0	1.4	1.7	1.9	1.9	0.9	-1.9	0.7	1.6		
Inventory (contribution rate)	4.4	4.6	6.8	8.0	4.3	9.7	1.9	4.3	2.4	4.4	1.0	2.3	4.3	1.0	5.6	2.9		
Government consumption	0.2	-0.3	0.2	0.1	0.2	-0.3	0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0		
Public investment	1.0	0.9	1.3	0.7	1.5	2.0	2.1	1.8	2.3	2.2	2.5	1.8	2.1	1.1	1.6	2.2		
External demand contribution rate	-9.3	-11.4	-0.1	-6.0	-3.5	-1.2	-2.0	-2.0	-2.0	-1.0	0.5	1.0	1.0	-6.9	-2.9	-0.1		
Exports	0.6	-0.1	-0.5	-0.3	0.2	-0.2	0.5	0.0	0.4	0.0	0.3	0.2	0.2	0.0	0.0	0.2		
Imports	6.5	11.0	11.7	9.4	7.6	8.3	4.9	8.4	4.3	5.4	5.2	5.2	5.0	6.1	7.7	5.0		
Private demand (contribution rate)	1.4	13.5	17.7	12.5	6.7	10.3	2.2	9.3	2.1	6.0	4.0	4.5	4.4	6.7	8.1	4.2		
Public demand (contribution rate)	0.8	1.0	2.1	2.4	2.2	2.8	2.2	2.6	1.9	2.3	2.0	1.7	1.8	0.3	2.4	2.0		
Real GDP	-0.4	-0.4	0.2	-0.2	0.1	0.3	0.3	0.2	0.3	0.3	0.4	0.3	0.4	-0.2	0.2	0.4		
Domestic demand contribution rate	2.3	1.7	3.2	2.1	2.0	2.5	1.9	2.1	1.7	2.1	1.4	1.7	1.9	1.5	2.1	1.8		
Private consumption	1.5	1.2	2.7	2.0	1.9	2.9	1.6	2.3	1.7	2.1	1.4	1.8	2.0	1.1	2.0	1.7		
Housing investment	0.8	1.6	2.3	1.7	1.6	2.0	1.7	2.3	2.1	2.2	1.7	1.9	1.7	1.5	1.9	1.9		
Business investment	0.0	1.7	-0.2	0.9	0.9	-0.8	-0.6	-1.3	0.2	0.7	0.3	0.6	-0.1	-1.7	-0.2	0.3		
Inventory (contribution rate)	7.0	5.6	7.5	8.1	4.3	9.3	2.0	4.0	2.0	4.0	1.0	2.0	4.0	2.9	5.5	2.6		
Government consumption	0.2	-0.3	0.2	0.0	0.2	0.0	0.1	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	0.0		
Public investment	2.5	1.8	1.5	0.5	1.5	1.5	1.5	1.5	1.5	1.5	1.6	1.7	1.8	2.1	1.3	1.6		
External demand contribution rate	-9.5	-12.4	-1.4	-7.6	-4.3	-2.0	-3.1	-3.5	-3.4	-2.1	-0.7	0.3	0.3	-6.8	-4.1	-1.1		
Exports	0.8	0.5	0.5	0.2	0.1	-0.3	0.3	-0.1	0.0	0.0	0.0	-0.1	-0.1	0.4	0.2	0.1		
Imports	9.7	11.4	9.1	6.5	6.3	5.1	5.3	5.3	5.1	5.1	4.9	4.9	4.7	6.5	5.7	4.9		
Private demand (contribution rate)	3.2	8.7	6.5	6.0	5.8	7.7	3.7	6.2	5.7	5.7	5.2	5.7	5.7	3.9	5.9	5.6		
Public demand (contribution rate)	1.6	1.6	2.5	2.3	1.8	2.7	1.4	2.1	1.5	1.9	1.2	1.5	1.7	1.1	1.9	1.5		
GDP deflator	-0.1	-0.3	0.2	-0.3	0.0	0.2	0.1	0.1	0.2	0.2	0.3	0.3	0.3	0.0	0.0	0.2		
	-1.3	-1.2	-1.3	-0.2	0.5	0.4	1.0	0.6	1.0	0.5	1.3	0.6	0.5	-1.4	0.4	0.8		

Source: Cabinet Office, own calculations, etc.

Summary of Projections (2)

	Actual				Forecast											per annum		
	2003	04	05	06	07	08	09	10	11	12	13	14	15	01~05	06~10	11~15		
(FY)																		
Current account	trillion yen	17.3	18.2	19.1	16.7	18.4	15.4	15.7	18.0	19.2	19.9	20.9	21.4	21.3	16.0	16.8	20.5	
Trade balance	trillion yen	13.0	13.2	9.6	7.7	8.4	5.4	5.2	6.6	7.4	7.8	8.6	8.9	9.0	11.2	6.6	8.4	
Current account surplus as of GDP	%	3.5	3.7	3.8	3.2	3.5	2.8	2.8	3.1	3.3	3.3	3.4	3.4	3.3	3.2	3.1	3.3	
Industrial production	yoy. %	3.5	4.0	1.6	4.8	2.5	4.2	0.9	1.7	1.3	1.9	1.0	1.5	1.4	0.4	2.8	1.4	
Consumer prices		-0.2	0.0	-0.3	0.3	0.8	1.3	2.3	1.3	1.1	1.1	2.4	1.0	1.0	-0.4	1.2	1.3	
excluding fresh food	yoy. %	-0.2	-0.1	-0.1	0.2	0.8	1.4	2.2	1.3	1.1	1.0	2.3	1.0	1.0	-0.4	1.2	1.3	
Domestic corporate goods prices		-0.5	1.5	2.1	2.8	1.1	1.7	2.3	1.2	0.7	0.6	2.5	0.4	0.4	-0.2	1.8	0.9	
Disposable income	yoy. %	-0.4	-0.3	1.7	1.8	1.6	2.2	3.5	2.7	2.3	1.9	3.0	2.2	1.8	-0.4	2.3	2.2	
Propensity to consume	%	95.9	97.3	97.2	97.1	97.7	98.1	97.6	97.8	98.1	98.7	98.9	98.9	98.9	96.2	97.6	98.7	
Wages per employee	yoy. %	-0.9	-0.4	0.7	0.6	0.7	1.9	2.7	1.9	1.7	1.6	3.3	2.1	2.2	-1.0	1.6	2.2	
Unemployment rate	%	5.1	4.6	4.3	4.0	3.9	3.8	3.9	3.7	3.6	3.4	3.5	3.4	3.4	4.9	3.9	3.5	
Labor distribution rate	%	51.9	51.5	51.4	51.4	50.9	50.4	50.6	50.5	50.3	49.9	50.0	50.0	49.9	52.5	50.8	50.0	
New housing starts	10 thousands units	117.4	119.3	124.9	126.5	125.2	124.5	123.3	122.4	121.9	121.4	120.8	120.3	119.8	118.7	124.4	120.8	
Owned		37.3	36.7	35.3	35.6	35.3	35.7	35.5	35.7	36.0	36.4	36.7	36.3	36.7	36.7	35.5	36.4	
Rented		45.9	46.7	51.8	52.4	51.6	51.0	50.5	50.0	49.5	49.0	48.5	48.8	48.3	46.8	51.1	48.8	
Built for sale		33.4	34.9	37.0	37.6	37.4	36.9	36.4	35.8	35.4	35.1	34.7	34.3	34.0	34.3	36.8	34.7	
Issued		0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	
Sales	yoy. %	2.5	5.6	4.6	5.8	2.5	3.6	0.6	3.7	3.1	2.4	0.8	2.0	2.3	0.7	3.2	2.1	
Current profits	yoy. %	16.9	24.6	8.4	2.7	1.1	4.3	-4.5	9.3	11.2	7.6	-4.0	4.0	4.9	6.4	2.5	4.6	
Ratio of current profit to sales	%	3.2	3.7	3.9	3.8	3.7	3.7	3.5	3.7	4.0	4.2	4.0	4.1	4.2	3.2	3.7	4.1	
Corporate bankruptcies	yoy. %	-16.8	-14.7	-1.0	2.1	0.7	-2.4	0.8	-3.0	-2.3	-2.4	1.6	-2.4	-2.5	-7.0	-0.4	-1.6	
Land price	yoy. %	-8.2	-7.5	-5.5	-3.0	-1.0	-0.5	0.0	0.0	0.5	0.5	1.0	1.0	1.0	-7.0	-0.9	0.8	
Discount rate	end of period, %	0.10	0.10	0.10	0.70	1.25	1.75	1.75	2.50	2.50	2.50	2.50	2.25	2.00	1.75	2.50	2.00	
Short-term interest rate	period average, %	0.001	0.001	0.001	0.500	1.000	1.500	1.500	2.250	2.250	2.250	2.250	2.000	1.750	1.500	2.250	1.750	
Long-term interest rate	period average, %	1.12	1.52	1.43	1.95	2.40	2.50	2.50	3.00	3.00	3.00	3.00	2.80	2.80	1.31	2.47	2.92	
Nikkei average	period average, yen	9,945	11,318	13,572	16,000	17,500	18,500	17,500	19,000	21,000	22,000	21,000	22,000	24,000	11,171	17,700	22,000	
TOPIX	period average, point	981	1,140	1,393	1,630	1,780	1,900	1,780	1,950	2,150	2,250	2,150	2,250	2,450	1,116	1,808	2,250	
Yen rate	period average, yen/\$	113.0	107.5	113.3	114.8	116.3	117.1	111.8	114.8	110.5	110.0	109.5	109.0	108.5	116.2	114.9	109.5	
Oil price (WTI near delivery)	period average, \$/barrel	31.4	45.1	60.0	69.7	73.5	77.5	82.0	83.0	80.0	78.0	76.0	74.0	72.0	37.9	77.1	76.0	

Note 1: Forecasts for discount rate and short-term interest rate are as of end of fiscal year.

Note 2: Short-term interest rate = uncollateralized overnight call rates; Long-term interest rate = newly issued 10-year government bond yield

Source: Cabinet Office, own calculations, etc.