

## The Viagra economy

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**Japan is getting older but its economy is looking perkier. Will that mean fewer savings to send abroad?**

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FOR much of the past two decades, Japan has been cast as the villain of the global economy because of its large saving surplus. In the mid-1980s, when America was last running large external deficits, the Reagan administration berated the Japanese for their trade barriers and their unwillingness to consume American goods. In the 1990s, the Clinton administration lectured them for relying on exports instead of sorting out their moribund domestic economy.

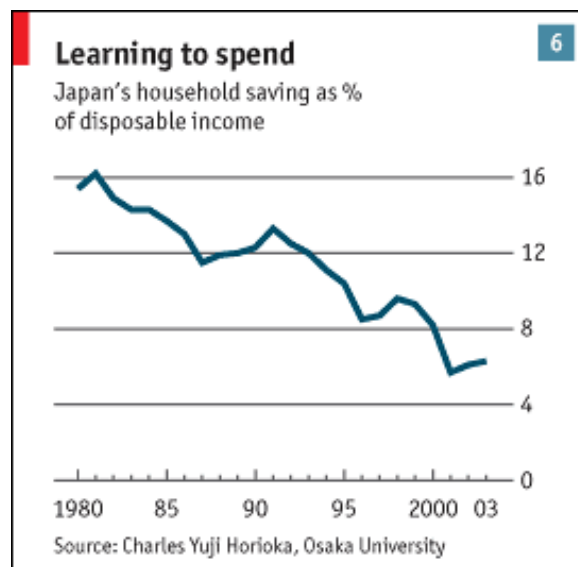
Today, in contrast, there is little Japan-bashing, even though as a share of Japan's total economy the country's current-account surplus is now even bigger than it was in the 1990s (see chart 5). Instead, America's attention has shifted to China, with its soaring foreign-exchange reserves and (until recently) fixed currency. But Japan remains an important factor in the global imbalances. Its central bank still holds the largest stash of dollar reserves. A big drop in Japan's capital exports could quickly end the global saving glut. But is that likely?

With only a handful of exceptions, Japan has run a saving surplus every year since the late 1960s, but its underlying saving and investment patterns have varied a great deal. Back in the 1960s, Japan was a young, fast-growing economy, with high investment rates and even higher saving rates. Today Japan is an old, low-saving country. The trouble is that investment is even lower.

In the 1960s and 1970s, the household saving rate soared, giving rise to the idea that the Japanese were peculiarly frugal people. In fact, their behaviour was unexceptional. Charles Yuji Horioka, an economist at Osaka University, argues that the Japanese household saving rate rose sharply in the 1960s and 1970s because the country was growing rapidly; there was little consumer credit; the population was young; and there was little pension provision (Japan had only a modest state pension scheme until 1973).

None of this applies any more. Consumer credit is widely available (Japanese households' debt was 136% of their income in 2000, more than in America). The economy has been stagnant for a decade. And the Japanese have grown old. The share of pensioners in the population is surpassed only by Italy and Sweden. Not surprisingly, household saving has plummeted, from its peak of 23% of disposable income in 1976 to 15% in the 1980s, 10% in the 1990s and around 6% today (see chart 6). Twenty years ago, Japan's household saving rate was almost twice as high as the OECD average; today it is merely average.





Given this drop in household saving rates, why has Japan's current-account remained in surplus? Again, the reasons have changed over time. In the early 1980s, firms were investing more slowly and the government's fiscal position improved. By the late 1980s, private investment was soaring, swept along by the stock and property bubble. The current-account surplus shrank, but remained positive.

Then the bubble burst. Stock prices and then property prices plunged. Investment collapsed and corporate saving rocketed. With Japan's government unable, or unwilling, to clean up the banks' loan portfolios or force restructuring of the weakest firms, Japanese firms have spent the past decade painfully working off their earlier excesses. All profits have gone into improving firms' balance sheets. In the late 1980s, firms were borrowing from households at the rate of almost 10% of GDP a year. For the past decade they have been paying down debt or building up cash balances at a similar rate.

Japan's government, in contrast, has been dis-saving for a decade. Japanese politicians like to blame failed Keynesian stimulus packages; in fact, the country's budget deficits were caused mainly by economic stagnation. With growth weak and prices falling, tax revenues plunged. For the past ten years the budget deficit has been running at an average of 6% of GDP, and Japan's levels of government debt are now by far the highest of any rich country. But even record budget deficits and falling household saving could not counteract the scale of corporate thrift. Japan's current-account surplus has been rising.

Will that change? The answer hinges mainly on whether Japanese firms start investing again. Optimists have been repeatedly disappointed over the past ten years. There were a few mini-recoveries, but they relied on export growth rather than domestic investment, and none lasted long.

## Land of rising investment?

But now the mood in Tokyo is more upbeat, and for good reason. The economy has been growing at a respectable rate for two years. After ten years of painful adjustment, corporate balance sheets are looking healthy. The banking system has been cleaned up. Firms are beginning to hire again and wages are picking up. The jobless rate is at its lowest level for seven years. Even land prices in Tokyo are beginning to rise. All this suggests that domestic investment could recover. Given Japan's demographics and its firms' memory of the past decade, no one expects an investment binge, but a gradual rise is likely.

What about Japanese households? In the long term, demographic pressure will push the saving rate down further as more people retire. But in the short term, household saving could rebound, particularly if people were drawing down savings while the economy was weak. Mr Horioka thinks that demographics will prove the stronger factor, and expects the household saving rate to turn to zero or even negative by 2010. The IMF is more circumspect. In its latest analysis of Japan, it forecasts that household saving will fall to around 3.5% of GDP by 2010, a drop of about 2.5 percentage points from its current level.

Given the improved investment outlook and the secular decline in household thrift, it seems clear that Japan's current-account surplus ought to fall. But Japan's new government is adding a new factor to the equation. With public debt already so high and the population ageing so quickly, Japanese politicians are nervous about their fiscal deficits.

There has already been some fiscal tightening. Spending on public infrastructure, for instance, has fallen sharply in the past couple of years. Moderate tax hikes are slated for 2006 and 2007. Japan's prime minister, Junichiro Koizumi, has promised not to raise the consumption tax under his watch, but no one is ruling out other measures. Much depends on how strong the recovery proves to be. Paul Sheard of Lehman Brothers, an investment bank, reckons that stronger growth in Japan will trigger more fiscal tightening.

Mr Koizumi's landslide election victory on September 11th strengthens that impulse. The prime minister had called the election because the old guard of his party, the Liberal Democrats, opposed the privatisation of Japan's postal savings system, a big financier of poorly allocated public spending. This issue was code for an even larger one: reducing the size of the state, and its borrowing. Now Mr Koizumi has a strong mandate to do more of that.

A tighter fiscal policy will counteract lower household saving and higher investment, so the overall effect on the current-account surplus is hard to gauge. Most official forecasts suggest that Japan's current-account surplus will decline gradually. But Japanese technocrats seem to see things differently. When the Council on Economic and Fiscal Policy, Japan's cabinet-level steering group for the economy, released a set of long-term fiscal and economic projections in January, it actually forecast a bigger current-account surplus in 2012 than today.

The council expects a marked improvement in the government's finances, with the deficit falling from 7% of GDP to around 4%. It sees only a modest drop in Japan's private-sector saving surplus, from 11% of GDP in 2004 to 9% in 2012. If this comes to pass, the current-account surplus could rise to 5% of GDP in 2012. This is only a forecast, but it tempers hopes for a rapid turnaround in Japan's saving surplus.