How much growth is enough for Japan? The question of Japan’s potential growth rate is one that has been hotly debated in recent years and is also one of enormous importance to economic policy. For example, the Bank of Japan’s (BOJ) justification for raising interest rates in August 2000 rested in large part on a belief that Japan’s (annual real) potential growth rate is about 1 percent, so forecast faster growth would be inflationary. Most other observers put Japanese potential growth in the range of 1.25 percent to 1.75 percent a year.

All participants in Japan’s economic policy debate are right to focus on this issue. A country’s potential growth rate—defined as the highest long-term trend rate of expansion that can be sustained without causing inflationary pressures—is a critical benchmark for economic performance. A country below its potential growth rate could conceivably be brought to a faster rate of growth through expansionary macroeconomic policies, such as tax cuts or open market purchases of government bonds by the central bank. The same macroeconomic policy efforts could be wasted, if not counterproductive, in a country already at or above its potential. Meanwhile, the comparison between a country’s potential growth rate and that of its recent past, or those of other countries at a similar stage of development, gives information on how well the country’s structures are faring in the international division of labor. This can point toward how much structural reform should reasonably be undertaken and with what urgency.

The current discussions of Japanese economic potential, however, are mistakenly pessimistic in their assessments. Japan’s potential growth rate has risen since mid-1998 from a starting point higher than many estimates made at that time. These assessments are misguided because they do not take into account the positive structural changes that have taken place in the Japanese economy in recent years. The policy implications of this underestimation of Japanese potential growth are profound. This essay concludes by suggesting which policy efforts and structural reforms should be prioritized in light of a more realistic assessment of Japanese potential.

**The Difficulties of Assessing Potential Growth**

This failure to recognize Japan’s rising potential is a forgivable error, given the
inherent difficulties of assessing a country’s sustainable growth rate. Assessing the performance of a national economy is always in some sense a statistical fiction. No one “Japan” or “United States” is making economic decisions; they are being made by literally millions of individuals and companies pursuing their own goals, allocating their own labor and savings, and reaping their own gains and losses. Nevertheless, because these decisions by individuals and companies depend on their expectations of the environment around them, including, notably, government policy, economies defined by national borders do constitute legitimate units of analysis.

When an economy is said to “be growing,” this is shorthand for the amount of wealth available to all the economy’s citizens is expanding, with it accumulating to some specific subset of those citizens. When an economy “suffers from inflation,” that is shorthand for individuals and companies bidding up the prices and wages they face because fewer desired goods are available than they can purchase with available funds. Thus it is useful to speak of an economy growing and incurring a certain rate of rise (or fall) in the general price level.

Growth has to come from somewhere, though. It can come through the accumulation of greater labor inputs (by people working longer or by population growing through births or immigration), of more capital in the form of machines and structures used to produce other goods, or of how productively labor and capital are used. An economy putting all its productive resources to their best currently available uses is said to be growing at its potential growth rate. If it grows faster (slower) than potential, and no (much) additional input of productive factors is available for use, demand will exceed (fall short of) supply, and the prices of those factors will rise (fall), resulting in inflation (deflation). This is why the potential growth rate is also referred to as the “sustainable” rate of growth for an economy, because it can be sustained without causing monetary or financial feedback in the opposite direction. This is also why economies can be said to have an output gap, positive or negative, in a given year, defined as the amount that actual growth is above or below potential.

The potential growth rate of an economy is something that cannot be directly observed. Unlike actual growth, potential growth must be estimated rather than measured. The standard conception of potential growth just described leads to two general types of techniques for estimating it. One is to look for statistical relationships, mostly long-term trends, in the aggregate time-series data on an economy’s growth and inflation, because inflation should be steady in an economy growing at potential, everything else being equal. The other technique builds estimates up from projections of the accumulation of factors of production (i.e., labor and capital). Both methods have led many observers to discern a decline in potential since the early 1990s (though few are as low as the BOJ’s announced 1 percent estimate). Neither technique, however, has got the sign of the change in Japanese potential correct, mistakenly seeing a decline where an improvement has taken place.

The time-series statistical techniques have the benefit of making few assumptions about the economy (“imposing little structure” in the econometrician’s jargon) to make their estimates of potential. They simply use different statistical methods to pull out the economy’s underlying growth trend based on

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the assumption that inflation responds to growth above or below potential. In Japan in the late 1990s, however, these methods missed the positive developments in making their estimates for three reasons: First, they inherently treat any lengthy string of actual sub-potential years as a downward shift in potential because the techniques assume that deviations from trend cannot persist. Second, they inherently place excessive weight on the most recent observations when making their estimates because of their smoothing techniques—and in Japan the worst years were 1997-99. Third, these techniques are also confused by the persistent stickiness of prices and wages in a time of deflationary pressure, as is the case in Japan of late. In other words, the estimated statistical relationship between inflation and growth used to identify the trend in these models breaks down when price movements do not correspond as closely to movements in growth as they do when inflation is above zero.

The bottom-up estimation methods have also missed many of the positive developments in Japan of late. Unlike the purely statistical methods, these estimates require strong assumptions about what the accumulation of and return to labor and capital will be in the future. Analysts using these methods have tended to make projections of declining labor in Japan (instead of allowing for rising retirement ages or increased use of women in the workforce) and have assumed an excess of capital in Japan (rather than noting that the new capital investment, in information and telecommunications technologies (ICT) for example, is both better than and different from what occurred earlier). They have also generally assumed that the returns to capital and labor will largely remain the same as a function of the size of their respective stocks, their marginal products rising only in line with reductions in these stocks. When economic developments, however, improve the efficiency of allocation of factors of production and the level of total factor productivity (also known as technological progress) rather than adding to stocks of labor or capital, the rise in potential tends to be outside the variables looked at in bottom-up analyses.

**Why Japanese Potential Has Risen in the Past Few Years**

In Japan, the efficiency in the allocation of labor and especially of capital has gone up of late, and technological progress from the “New Economy” has begun to be felt. The primary motivating factor supporting this change has been the financial sector reforms undertaken since the Obuchi government’s financial reform legislation of October 1998. As can be seen in the aggregate evidence of a credit crunch, as well as in the increasing frequency of specific instances where major Japanese banks refuse to roll over loans to bankrupt borrowers—such as in the cases of Sogo Corp. and Chiyoda Mutual Life Insurance Co.—lending standards have risen since the major banks were recapitalized by 1 April 1999. Of course, this rise in standards has not been imposed on all borrowers, especially in the all-too-often protected construction industry, but that it holds even for some is an improvement over the near-universal loan rollover practice of the mid-1990s. Coupled with improved supervision from the Financial Supervision Agency and tighter, more transparent accounting practices, this means that about 50 percent of all corporate finance in Japan is being allocated more efficiently than in the past. Returns on capital in Japan are rising as a result.

Not only are companies that have failed or that have simply overinvested in unproductive activities being limited in their ability to waste further assets, new companies and activities are being supported by Japanese banks. This can be seen in the development of the OTC stock markets (like MOTHERS and JASDAQ), the increasing role of venture capital and inward foreign direct investment, and the rising investment of Japanese business in ICT (including software). So taken as a whole, the average quality of Japanese investment is improving by a substitution of higher-return projects for wasteful efforts. Furthermore, with 45 percent of the 160 trillion yen ($1.5 trillion) in Postal Savings Time Deposits coming due in
2000-01 being moved into private-sector investments, there is a beneficial reallocation of capital into more productive sectors. It is true that the other half of Japanese corporate finance and the bulk of Japanese savings continue to be squandered by either smaller Japanese banks allowed to continue rolling over bad loans, making the total grow, or by the Fiscal Investment and Loan Program (FILP) on wasteful rural public works projects. Nevertheless, for much of Japan’s financial system, the change has clearly been for the better in the efficiency of capital allocation.

Other reforms have taken place in recent years. The Japanese retail sector, which remains less than 60 percent as productive as the American system, has had some increasing competition introduced. After an unjustifiably long struggle, the Japanese Ministry of Posts and Telecommunications has reduced some of NTT’s access charges, and despite its ongoing protection of NTT, some alternative carriers (particularly wireless ones) have emerged. Gasoline prices, a cash cow long protected by the Ministry of International Trade and Industry (MITI), have also been significantly deregulated of late, as seen in the limited net price rises at the Japanese consumers’ pumps, despite the rise in world oil prices. It is undeniable that vast sectors of the Japanese economy, notably in services and non-tradables, are beset by inefficiency as a result of domestic protection and lack of competition. Yet it is equally undeniable that some important sectors of the economy have begun to offer more competitive pricing—as seen in the BOJ’s ability to legitimately point to some instances of “good” deflation.

Meanwhile, the Japanese economy is proving slightly more adaptable than some observers have wanted to give it credit for. Investment in information and communications technology has been growing ever faster in Japan in the past six years. Although this is not comparable to the ICT investment boom in the United States, there has unquestionably been a rise in the share of investment that is productive, and it may have spillover benefits, as opposed to the overhang of depreciating old-fashioned capital. The former replaces the latter without replicating it, so the returns are higher even if the total undifferentiated capital stock rises. On the labor side, despite a temporary rise in mismatch between the unemployed and available vacancies—which is itself an indication that the newer industries requiring different skills are rising while employment in the older industries is contracting, an efficiency gain—labor supply has begun to increase. The retirement age has risen in practice, and it will rise again as old age pension reform proceeds. Young Japanese women’s willingness to stay in the labor force has increased a small but noticeable amount, along with their job tenure and availability, meaning an underused resource is finally being tapped. As on the economy’s financial side, the changes in the efficiency with which labor and goods are used, and in technology, are all in a positive direction, no matter how vast the areas for further potential reform and improvement remain.

THE POLICY IMPLICATIONS OF RAISING ASSESSMENTS OF JAPANESE POTENTIAL GROWTH

Putting a precise number on the increase in Japanese potential growth in recent years is difficult. As discussed, the two standard techniques for making such an estimate have generated results that are biased downward (for understandable reasons). The value of the additional capital moving from public sector...
and old firms to private sector and new technologies, the increase in labor supply from changing patterns of female and older workers, and the rises in productivity of capital and labor that will result from better allocation with greater discipline (and less protection) will be able to be ascertained only in retrospect a few years from now. It is fortunate that we can be certain at present that all the major changes in Japanese potential have been in a positive direction, meaning that they have been increasing at a sustainable growth rate.

In short, most estimates agree that Japanese potential growth was about 1.75 percent to 2.00 percent, annual rate, in 1996. This is a useful starting point, being before both multiyear deflation and financial fragility biased the purely econometric estimates downward, and before the important structural reforms, especially in the finance sector, which raised the returns on capital and the share of ICT investment, took place. Then it would seem logical that potential growth has now risen at least to somewhere from 2.50 percent to 2.75 percent—the financial sector reforms that improved the allocation of (and returns to) 50 percent of Japanese corporate finance being worth a few tenths of a percent of GDP a year, the productivity-enhancing effects of capital deepening through ICT investment being worth another few tenths, and the limited but real deregulation in energy, telecoms and retail being worth at least a tenth each.¹

Yet important policymakers have got the sign of the change in Japanese potential wrong. The BOJ justified raising interest rates in August 2000 in large part through the belief that Japan’s potential growth rate is about 1 percent, so the forecast of 2 percent growth would be inflationary (despite unused capacity and unemployed workers). The Economic Planning Agency (EPA) has steadily given gloomier and gloomier assessments of Japanese economic potential, perhaps to spur reform policies. Japanese politicians and bureaucrats have taken low assessments of their country’s sustainable rate of growth as justification for foretelling doomsday scenarios about Japan—especially with regard to the fiscal situation and the long-term sustainability of old-age pensions.

This underestimate of Japanese potential has had profoundly negative implications. It has brought on a too-tight monetary policy that has resulted in a more than three-year unopposed deflationary drag on consumption and on the financial system. It has depressed expectations in financial markets and increased precautionary savings by households—both of which raise the risks of a panic or a run on yen-denominated assets such as Japanese government bonds. It has given too little credit to the financial reforms already undertaken in the major city and regional banks and has therefore undercut support for their rapid and needed implementation in the rest of Japan’s financial system. It has focused the structural reform debate in Japan on drastic, often “all-or-nothing” scenarios rather than on the very doable, incremental yet meaningful, reforms that can pay off in the short term, and have already begun to do so.

If the true rise in Japanese potential output were recognized, a very different set of policy priorities would be in order. First, the output gap would clearly be recognized as still increasing (though more slowly) and therefore still amenable to expansionary macroeconomic policy. Given the public debt situation and, more important, the demonstrated inability of the Japanese Diet in fiscal expansions to pursue structurally sound tax cuts instead of colossally wasteful public construction

¹ These rough estimates of productivity gains rest on the estimates in various OECD publications and EPA and MITI white papers of what the benefits from complete deregulation in these sectors would be, halving them for the financial sector and taking less than a quarter in the other three sectors. The benefits from ICT accumulation are taken from comparison with standard estimates of U.S. benefits in the 1990s from its ICT investment, scaled down proportionately for the smaller share in Japan. Doing this assumes that returns to deregulation and ICT investment exhibit constant returns to scale. If the benefits were to exhibit diminishing returns to scale, as is usually assumed, the benefits from the deregulation, ICT investment, and capital allocation undertaken to date should be even higher.
projects, aggressive loosening of monetary policy should be used. Given the BOJ’s commendable transparency in finally making its estimate of 1 percent potential output public, this would be a total reversal of policy—but one that will inevitably come when the BOJ’s pursuit of a tight monetary stance at below potential growth rates will merely lead to more and more quarters of deflation. It would cost the Japanese people less if the BOJ were to reverse policy based on the logic of the situation instead of waiting until their mistake was demonstrated by the absence of inflationary demand pressures.

The second most important priority would be the extension to the rest of the Japanese banking system of the standards, supervision, and conditional recapitalization/nationalization/closure for banks that were implemented for the major banks in the first quarter of 1999. Allowing vast numbers of small banks to remain open and rolling over distressed loans only increase the accumulation of bad debt and keep a large share of Japanese capital from getting higher returns. This could be abetted by a continued encouragement of consolidation in the Japanese banking system, including mergers and foreign direct investment. Since the banking system reforms so far undertaken have had large and partially ongoing benefits in terms of stemming losses and encouraging reallocation of investment, whatever credit crunch results should be accepted as the limited one-time costs that they are.

The third priority would be the realization that structural reform and expansive macroeconomic policy not only coexisted in 1998-99, but also abetted each other. The contractionary effects of the BOJ’s passive-aggressive “nothing more than ZIRP” (zero interest rate policy) policy and the rollbacks of public investment and tax cuts since spring 1999 have only served to hide the rise in Japanese potential from easy recognition. A direct implication of this realization would be an acceptance that structural reform need not be all or nothing—more limited reforms, especially in key sectors such as finance and telecoms, have meaningful benefits. The great must not be the enemy of the good, neither by pushing for outrageously ambitious structural reform programs (which may be needed, but will never be implemented all at once), nor—even worse—by trying to provoke an air of crisis to achieve change when positive change is already taking place.

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