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Japan is in the early stages of a demographic transformation that will ultimately reinvigorate its economy. Most of its structural imbalances over the past 20 years stemmed from the fact that a disproportionately large number of its population was middle-aged and high-saving, and those people are now retiring. It is difficult to overestimate the importance of this change.

Japan is casting off the burden of excess saving

By Robert Madsen

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The usual pattern for developing nations is that, as they approach industrial maturity, the range of profitable investment opportunities diminishes, rates of return fall and households react by saving less and spending more. Consumption thus replaces capital expenditures as the primary source of new aggregate demand. Yet, although Japan achieved maturity in the late 1970s or early 1980s, its private-sector savings rate remained as high as that of a frugal developing country until quite recently.

There were two reasons for this. First, the institutions of corporate governance were weak and did not compel companies to disgorge their earnings to shareholders. Instead, many companies hoarded so much cash that the net effect was that the corporate sector had little need to borrow from the household sector. Second, during the 1980s a very large number of Japanese entered the high-saving 40-64 age bracket.

Japan's gross national savings rate therefore stayed well above 30 percent of gross domestic product through the late 1990s, as opposed to 20-22 per cent for the European Union and even less for the admittedly improvident US. Textbook theory suggests that this surplus capital should have flowed overseas so that foreigners could procure more of Japan's output, thereby maintaining full employment in Japan while also lowering global interest rates. But Japan was so big that the rest of the world could absorb only about a third of the necessary exports. It was left with a surfeit of capital that threatened to depress prices, multiply bankruptcies and shrink GDP.

Japan's most conspicuous structural flaws stem from attempts to employ these superfluous funds. During the late 1980s and early 1990s low interest rates and reckless banking practices encouraged companies to use this money to acquire vast expanses of

productive capacity, causing GDP to surge in the short term. In the longer term, however, such enormous investment produced severe industrial distortions.

When companies started to reduce their investment spending towards profitable levels in 1992, the government compensated by increasing its budget deficit in order to forestall prolonged recession. This extra stimulus ensured that GDP continued to grow modestly, yet it also inflated the national debt to vast proportions. At the turn of the decade the first wave of Japan's previously middle-aged workers started retiring. Their income decreased relative to their spending and they simultaneously began transferring more wealth to relatively profligate children and grandchildren. Hence the household savings rate plummeted. On a flow-of-funds basis this had ranged between 6 and 9 per cent of GDP until 1998, but then declined to 1.7 per cent in 2002 and turned negative last year. The macroeconomic effect of this change has so far been muted by parsimonious corporations that are saving more in order to reduce their leverage, but sooner or later the swelling ranks of the retired people will drag down the overall private sector savings rate.

The implications are immense. If consumption increases while investment and government expenditures remain stable, aggregate demand will strengthen, which means the pace of economic growth over the next decade should pick up considerably. Moreover, once this expansion has closed the output gap and the pace of real GDP growth slowed to the sustainable rate of perhaps 1.5 per cent a year, greater demand will bring persistent price inflation. That will improve the health of the banking system and lighten the load for indebted companies.

A decline in the savings rate relative to investment will also translate into fewer net exports. Japan's chronic current account surplus could thus turn into an equally enduring deficit by the mid-2010s. Western protectionists may applaud this development, but the fall in Japanese capital exports will push up global interest rates and may even eventually compel the US to curtail its current account and budget deficits.

Regardless, the Japan of 2014 will scarcely resemble that of today. That country will have a very low savings rate, significant inflation and either a small current account surplus or an outright deficit. Its reputation for frugality will be but a quaint memory.

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