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COMPLETING THE VIRTUOUS CIRCLE: HOW JAPAN CAN OVERCOME ITS LOST DECADES ONCE AND FOR ALL

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- For the “virtuous circle” of reflation to remain intact, Japan must look beyond immediate wage-price developments and invest in the future until households, too, participate in market investments to maintain their purchasing power over time.
- Firms’ investment in productivity-enhancing technology is pivotal and, by the same token, investment in energy efficiency and decarbonization is part and parcel of long-term productivity growth in resource-scarce Japan.
- Labor participation among women has risen substantially but strategic investment in child-care and services designed to support double-income families can eventually bear a demographic dividend, perpetuating Japan’s “virtuous circle.”

Japan at an economic crossroads: emergence from deflation

After thirty years of intermittent deflation and stagnant growth, numerous factors have finally aligned to allow Asia's second-largest economy to emerge from its decades-long malaise. Japanese core consumer prices, pushed up initially by supply-driven factors such as imported raw materials, continue to rise at annual rates above the Bank of Japan's inflation target of 2%, which in turn has allowed nominal growth to shift from negative (in deflationary times) to strongly positive, thereby allowing companies to regain pricing power and therefore boost corporate revenues and profitability growth.

Meanwhile, Japan's aging and shrinking demographics, long maligned as the root source of the demand shortages that gave rise to deflationary lost decades, now provide workers negotiating power to demand ongoing wage increases. Against the backdrop of many quarters of structural labor shortages, real wage growth has finally turned positive. Households are now afforded the possibility of increasing the volume of consumption, even despite the higher price tags on their consumption baskets. Rational households also have the choice to allocate their surpluses to savings for consumption tomorrow, provided the returns on these savings outpace future price rises.

This confluence of factors forms the backbone of what the Bank of Japan describes as the "virtuous circle" of wages, prices and economic growth – where households can afford to absorb price rises from companies, who can then afford to raise wages and absorb other input price increases that ensue from reflationary conditions.

Combating deflationary norms: the "circle" has begun to turn for households

In response to the concert of factors described above, the Bank of Japan has started to withdraw monetary accommodation. Policy remains historically accommodative, with real interest rates well below real rates of economic growth. That said, both the Bank of Japan and the Japanese government have stopped short of declaring conclusive victory in the fight against deflation. There are several phenomena that justify such caution. Among these are the stickiness of deflationary norms – growth in both nominal and real income is fairly new among households long accustomed to shoring up cash to consume at ever-cheaper prices. Households must now adapt to an environment where they must plan for future consumption that is likely to cost more tomorrow than it does today. Household balance sheets meanwhile do not yet fully reflect such expectations.

Where the “circle” has yet to be completed: the “wealth effect”

According to Bank of Japan flow of funds data, the household balance sheet has started to diversify away from cash (which still accounts for around half of financial assets) and into equities and other market assets. Some of this move, as in the United States, may be attributed to a rise in the value of equity markets rather than physical reallocation; cash balances among households continue to rise, albeit at a slower pace than the balance of market investments. Nonetheless, some of the shift does reflect behavioral change. After the new Nippon Individual Savings Account (NISA) framework of tax-advantaged financial market investment took effect at the beginning of 2024, both the formation of new accounts and investment balances have seen strong increases.

Still, even though reallocation from cash to financial assets appears to have begun, participation in capital markets and related investment returns is not yet widespread enough to have an impact on aggregate consumption (the “wealth effect”). This contrasts with recent developments in the United States, amid similar increases in equity valuations. Meanwhile, recent issuance of NISA-compliant investment trusts for *Tsumitate* (long-term cumulative investment) NISA has been focused on foreign assets, particularly US stock funds. It is not in itself a negative phenomenon that households are investing overseas; at this stage, that they are participating at all is a positive signal.

Domestic financial participation, a buffer against imported volatility

For Japan to establish an effective buffer against swings in overseas demand, consumption (which comprises over half of Japan’s GDP) needs to shoulder a larger share of domestic growth to the extent that it may offset any unexpected decline in demand for exports (especially because net exports comprise an extremely small share of Japan’s GDP). Similarly, diversification of household balance sheets into both domestic and foreign assets may help to control interim portfolio volatility and cement stable growth in household consumption over time. Households especially stand to benefit if they can maintain their market investments long enough to benefit from the mechanics of compounding, wherein market assets’ rate of return increases proportional to time, yet market risk (measured in terms of volatility) increases at a lower rate, i.e., at the square root of time.

It is comforting that some domestic investors (particularly those seasoned investors who participate in the more self-directed “growth” NISAs) are developing greater appreciation for improving corporate governance among domestic firms. It would behoove Japan if this trend were to become broader-based among households.

To complete the "virtuous circle": technology, energy, career and family

For an economy whose population is aging and declining, it is tougher, though not impossible, to continue to grow. To offset the future decline in its labor supply, Japan must grow per capita output and, to do this, it must increase total factor productivity. Fortunately, corporate Japan's balance sheets are now replete with cash (one legacy of deflation), and the time has come to put the cash to use in investments in software and other technologies likely to boost future productivity. A recent analysis from the Bank of Japan shows that firms in the labor-intensive services sector are doing just this, which is a helpful signal for such firms but this trend must continue over time in a broad-based manner to boost productivity. Thankfully, it no longer requires a suspension of disbelief to foresee growth in profit margins and return on equity among listed Japanese firms; both have been trending higher for the broader market index in Japan since 2010. However, investment in future productivity must continue to keep the "virtuous circle" in play.

Secondly, although many blame Japan's weak yen for eroding the country's terms of trade, there is a much more obvious culprit. Indeed, we may point to a single event that dealt net export surpluses a mortal blow: this was the 2011 Tohoku earthquake, tsunami and nuclear accident. As nuclear reactors were shut down, resource-scarce Japan was compelled to import greater volumes of fossil fuels to meet its energy needs. Although initially Japan's energy intensity was forecast to decline alongside its population, officials have recently been compelled to revise and reverse their forecasts in favor of an increase, mostly thanks to investments surrounding new technologies such as artificial intelligence data centers and related production (such as semiconductors). Japan is reliant on such technologies to increase productivity amid a declining population and, by the same token, GDP growth benefits twofold from investing in reducing reliance on imported fossil fuels. Insofar as Japan wishes eventually to reduce its reliance on both fossil fuels and nuclear power, interim reliance on nuclear energy, investment in decarbonization plus in innovative technologies related to renewable energy are central priorities, for Japan's long-term economic prospects as well.

Lastly, although Japan's population has been contracting for quite some time, its labor force has actually been on the rise. This owes to increasing participation among traditionally under-represented cohorts, such as workers past traditional retirement age (who are becoming increasingly numerous as Japan ages) and female workers. Women have joined Japan's labor force at a faster pace than the overall population, and this has until now moderated the inflationary impact of demographics on wages. Currently, women's participation in the labor force sits around the OECD average (in the mid-70% level). For it to increase any further, Japan will have to invest in child-care, flexible working arrangements and other facilities that allow both women and men to participate equally in the workforce and family life, as described in the work of Nobel Prize-winning economist Claudia Goldin. There is another "virtuous circle" inherent in such investment: owing to significant investments in child-care and policies designed to support double-income families, Sweden's 80%+ female participation rate also comes alongside a fertility rate of 1.8 live births per female, substantially higher than Japan's 1.4 over the last 20 years.

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[1] rev23j13.pdf (boj.or.jp).

[2] https://www.jcer.or.jp/english/has-the-female-labour-force-participation-rate-in-japan-reached-its-maximum (see figure 8).

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