

# Focus on Economics

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## Japan's demographic millstone

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Japan's economic growth continues on its bumpy ride. Following a slight decline in economic output in 2014, the growth performance was also uninspiring in the first half of 2015. After strong growth at the beginning of the year, GDP fell back in the second quarter. Against this backdrop, there is a lot of discussion on the monetary and fiscal policy prospects. The demographic trends are not in the spotlight. However, it is precisely these trends that represent a major challenge for Japan. In order to mitigate the associated growth-dampening effects, a number of adjustments will have to be made (some, in fact, are being made already). There is simply no getting round the fact that Japan's long-term growth prospects are poor because of the demographic trends it faces.

### Current situation

The Japanese economy continues to paint an ambivalent picture. As far as the country's monetary policy is concerned, it's still full steam ahead – and this appears to be having the desired effect with regard to the Japanese currency and the equity markets. So far, however, there is only limited evidence that this policy has a major positive impact on the real economy. The Japanese economy has struggled to recover from its temporary relapse into technical recession caused by the VAT increase in spring 2014. Real GDP growth performed well in Q1 2015 (up 1.1% on the previous quarter) due to a major extent to a strong build-up in inventories.

However in Q2, real GDP fell by 0.3% on the previous quarter. That said, we expect the Japanese economy to grow by

around ¾% in 2015 as a whole, following its rather disappointing performance in 2014 (real GDP down 0.1% on 2013). One of the most significant obstacles to greater momentum, however, remains the moderate dynamic of the most important GDP component: private consumption. Despite the fact that unemployment has fallen to historically low levels and despite increasing strains in the labour market, it has so far not proven possible to generate higher wage dynamics. In this year's annual pay rounds, higher basic salaries were agreed but this came at the cost of lower bonus payments. Against this backdrop, the inflation target of 2% still seems a long way away – a point that even the Bank of Japan has conceded.

Although further monetary stimulus measures have not been agreed so far, they remain on the cards.

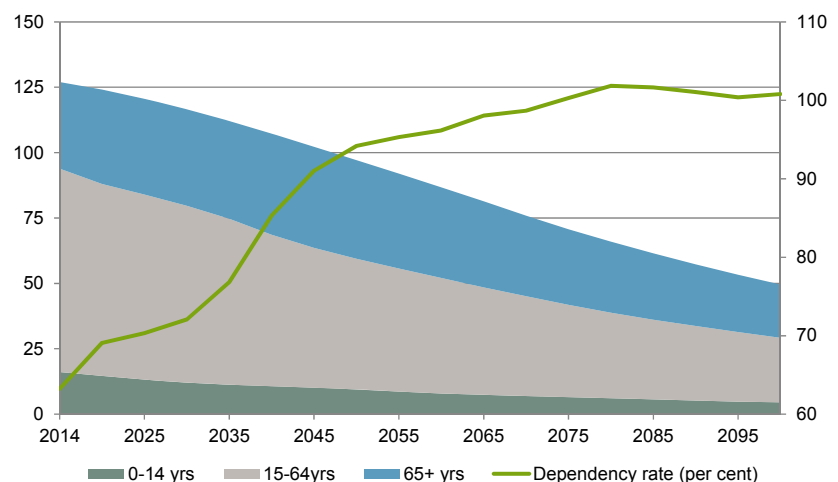
There are already signs of a change in the further course of fiscal policy. With

the exception of the planned hike in the VAT rate in 2017, no further restrictive measures are expected until 2020. Instead, Prime Minister Abe recently flagged up the possibility of new tax reductions for companies. The Japanese government is committed, above all, to achieving higher growth rates in order to get its deficit problems under better control by 2020. However, this is easier said than done. As even if the much praised but thus far rather half-heartedly implemented structural reforms<sup>1</sup> were to be pursued with greater vigour, they are unlikely to produce miracles. They would not be able to boost growth potential to any significant extent, managing merely to cushion the effects of Japan's greatest shortcoming: its unfavourable demographic situation.

### Major population decline and significant deterioration in age structure

According to figures issued by the Japanese "National Institute of Population and Social Security Research", if birth and mortality trends continue as they have done in recent years, the Japanese population will shrink from a level of around 127 million in 2014 to less than 100 million by 2050 and as little

**Figure 1: Projected population growth in Japan up to 2100: Age structure (in millions, left scale) and dependency rate (in per cent, right scale)**



Source: National Institute of Population and Social Security Research

as 50 million by 2100.<sup>2</sup> This will coincide with a significant deterioration in the country's age structure. The proportion of people aged 65 and above in the total population will rise from its current level of around a quarter to nearly 40% by 2050. During the same period, the proportion of working-age (15 to 64 years) Japanese will fall from around 61% to approximately 50% of the overall population.

The so-called "dependency rate", which measures the cumulative percentage of young (less than 15 years) and old (65+) people relative to the working-age population (15-64 years), will keep on rising significantly in the years ahead from its current level of 63% towards 100%, reaching a peak in 2075 before stabilising at that new level. Japanese society therefore faces a massive "demographic malus" and has to find answers to deal with these trends and to minimise their adverse effects.

**Impact of demographic changes ...**

**... on public finances and growth potential**

Demographic change has already left a clear mark on public finances. Whereas less than 20% of Japanese public expenditure was accounted for by social security outlays in the late 1990s, the proportion has now climbed to somewhere around a third, easily beating debt servicing (25%) as the largest item of expenditure in the Japanese central

budget. The proportion of overall expenditure attributed to the future-orientated fields of education and research has been trending downwards for quite some time, relegated to the status of virtual "also rans" in 2014 at less than 6%. This is just the beginning. Unfavourable demographic prospects will dramatically increase the pressure on public finances in the years ahead.

Japan is already failing to generate enough revenue to cover its expenditure. According to the most recent IMF figures<sup>3</sup>, Japan's budget deficit in 2014 stood at 7.3% – the highest level among the G7 countries. The figures also highlighted Japan's unenviable position at the top of the international debt league with gross national debt of 250% of nominal GDP and a net figure of around 130%. Although, according to IMF forecasts, the current budget deficit in relation to nominal GDP is likely to fall in 2015 (-5.9%) and 2016 (-4.7%), it will remain significantly higher than in most other industrialised countries. And yet the Abe government does not plan any fiscal austerity measures beyond the second phase of the VAT increase (from the current level of 8% to a new level of 10%) due to be introduced in 2017. With one eye on demographic trends, however, it is doubtful whether enough growth can be generated to boost inflation and gain better control over the budget deficit.

Admittedly, the structural reforms that are underway can provide some assis-

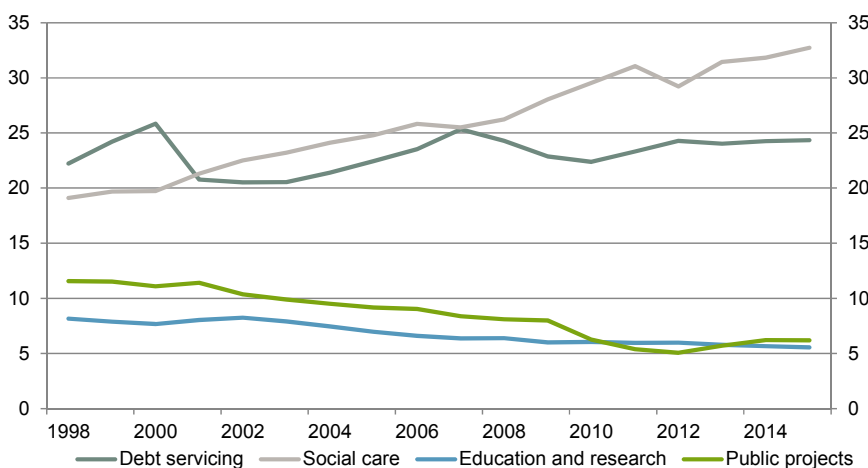
tance in this context but they will not be enough to achieve the Government's medium-term growth target of around 2%. The IMF estimates current Japanese growth potential at around ½% (OECD assumptions are somewhat higher at ¾%) and considers that, even after implementing the structural reforms, this potential will grow only by around 0.5 percentage points.

**... on the labour market**

It is all the more important, therefore, that Japan should make the best possible use of its available workforce and raise its productivity potential. The results in this area are mixed. At first glance, Japan's labour market figures look impressive. The unemployment rate currently stands at 3.3%, the lowest level since 1997. And Japan scores highly on labour market participation. In the main employment group comprising men aged between 25 and 64, Japan's figure of nearly 95% is considerably better than that of Germany (just under 93%) and the United States (88%), for example.<sup>4</sup> And the proportion of women aged 25 to 64 in employment is a very impressive 74.5%, marginally beating the United States' 2014 figure of 73.9%.

But these impressive numbers also conceal some rather less comfortable truths. Japan's labour market is characterised by a large proportion of temporary and part-time workers, who now make up 40% of the total labour force (the figure was 16% thirty years ago). These employees are substantially worse off than their full-time counterparts when it comes to wages and training opportunities. This segment of the labour market also contains a disproportionately high number of women (more than two thirds of the total). This is also reflected in wages paid. These gender-specific differences in remuneration (the so-called "gender gap") are the third highest in the OECD, while the proportion of female academics in the Japanese labour market is the third lowest in the OECD.<sup>5</sup> One of the factors that causes many female employees to stop work completely or to move to lower-paid part-time work once they get married is tax considerations. The government is keen to see further increases in the number of women in employment. In order to achieve this, it plans to over-

**Figure 2: Most important expenditure categories in Japanese budget: Share of overall expenditure (in per cent)**



Source: Ministry of Finance Japan

haul the tax system in a way that makes it more attractive for women to work and to expand childcare opportunities for working mothers. However, that won't be the end of the story. Harder questions have to be asked regarding the quality of jobs undertaken by women. Furthermore, in order to establish a more family-friendly working environment, the Japanese working habits will need to undergo a fundamental change. The need for adjustments in this area is underlined by OECD findings. These put Japan in the bottom third of OECD countries with regard to work/life balance. The only way for Japan to achieve greater female employment without causing a counter-productive downturn in what is already a very low birth rate (at 1.4 children per woman, the rate is as low as Germany's), is for a fundamental reappraisal and change of the gender roles in Japanese society. A cultural change of this magnitude cannot be achieved overnight.

In addition to increasing the proportion of women in employment, Japan, which has the best life expectancy figures in the world, should seek to increase the number of older people in work. It is certainly true that Japan already has a better employment ratio (21%) than other major industrialised nations for people aged 65 and above but there is still room for improvement.

Another way of alleviating Japan's demographic problem would be to have greater recourse to economic migrants. The proportion of foreign workers within the economically active population as a whole is currently less than 2% – significantly lower than the European (10%) or American average (16%). However, in order to achieve this, the Japanese government would have to do a great deal

more to overcome prejudices amongst its own population.

### ... on the corporate sector

As well as making better use of its labour resources, Japan needs to increase its productivity. In recent years Japan has been able to achieve respectable growth rates in the field of "Multi-Factor Productivity". According to OECD figures, the increase in Japan averaged 0.6% between 1995 and 2013 and was therefore not far away from Germany's growth rate of 0.8% over the same period. However, there are areas in which Japan can do better. Japan's flagship corporations, the big companies of the automobile and electronics sectors, already have a very strong international presence. The small and medium-sized enterprises, however, which, like their German equivalents, make up 99% of the corporate sector and employ over three quarters of the Japanese workforce, face major challenges. Given poor long-term growth prospects in the Japanese domestic market, they will need to internationalise their business activities. Simultaneously, they will be confronted with intensifying competition for skilled labour. In order to succeed on international markets, they need to come up with attractive products – and this applies to both large and small enterprises in Japan. A look at international patent statistics shows that Japan has constantly been one of the top performers with regard to "high-tech" patents in recent years. Japan is well ahead of both Germany and the United States in the patents league table.<sup>6</sup> However, Japanese companies appear to have problems in transforming this technological edge into marketable products. The country's risk-averse corporate culture acts as a brake on product innovation. One indication of this is the

difficult environment facing Japanese start-up businesses, as evidenced by the World Bank's "Doing Business" rankings. The 2014 business start-up rankings had Japan in 120<sup>th</sup> place out of the 189 countries surveyed.<sup>7</sup> In line with these figures, older firms tend to dominate the small enterprise segment in Japan. Three quarters of the small and medium sized companies in Japan are more than ten years old (this compares to an OECD average of less than half). It appears, therefore, that the creation of a better environment for business start-ups, to stand alongside previously-introduced initiatives aimed at improving corporate governance, would be another worthwhile starting point to boost efficiency potential in the Japanese economy.

### Conclusion

There is no magic bullet that Japan can employ to escape the consequences of the country's unfavourable demographic trends. All that can be done is to limit the adverse economic effects by turning the right screws at the right time. This includes making better use of a declining labour supply. Greater innovation is also required – not the easiest task in an ageing society that is becoming increasingly risk-averse. Even if Japan were to take a more determined approach to structural reform in the future, there is still no possibility that it could achieve the Abe government's declared GDP target of an average of 2% per year. This will lead to a conflict situation as Japan will no longer be able to solve its deficit problem – which its bleak demographic perspectives will make more acute – by relying on growth alone. Japan will be unable to avoid painful cuts in public expenditure in the years ahead if it is to retain control over its government debt ratio. ■

<sup>1</sup> Structural reforms constitute an important element of "Abenomics". They are targeted at a number of areas, seeking, amongst other things, to provide some stimulus to the labour market (e.g. by increasing the number of women in work), using deregulation to improve efficiency in previously isolated business areas, improving capital efficiency and promoting the internationalisation of the Japanese economy (including by means of the Trans-Pacific Partnership Free Trade Agreement).

<sup>2</sup> National Institute of Population and Social Security Research, Population Projections for Japan, January 2012.

<sup>3</sup> IMF, Japan, IMF Country Report 15/197, July 2015.

<sup>4</sup> Barclays Capital, Global Insights, Ageing and the global workforce: Demography is not (quite) destiny, 30 June 2015.

<sup>5</sup> OECD, Economic Surveys, Japan, April 2015.

<sup>6</sup> Fraunhofer Institute for Systems and Innovation Research ISI, Patent Applications – Structures, Trends and Recent Developments 2014, February 2015, page 9, Table 1.

<sup>7</sup> World Bank, Doing Business 2014, Understanding Regulations for Small and Medium-Size Enterprises, page 200.