When its stock and land price bubbles burst in the early 1990s, Japan entered a period of weak economic growth and disinflation (now deflation) from which it has not yet recovered. Falling asset prices have reduced investment’s share of GDP from 19% in the early 1990s to roughly 16% now and have discouraged lending by reducing the value of both banks’ capital and the collateral required to promote favorable lending terms.

Government spending stabilized in the second half of the 1990s, but the continued revenue declines caused by economic weakness and deflation have created a primary budget deficit of about 5% of GDP. Because of structural reforms designed to enhance growth prospects, government authorities have deferred moving the budget to surplus status until the early 2010s. Low inflation has helped keep long-term interest rates and debt financing costs low. If interest rates increase, it may become difficult to maintain fiscal stability over the medium term.

Inefficiencies in the banking sector, such as the evergreening of loans, have produced a large number of nonperforming loans. Low (and now negative) inflation levels have exacerbated the problem by discouraging spending and increasing the real value of debt payments. Nonperforming loans have significantly reduced bank profitability and discouraged the new lending needed to spur economic growth. In October 2002, the government announced its goal of halving the stock of such loans by March 2005, and it has made some progress toward this goal.

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To reduce deflationary expectations, the Bank of Japan committed itself to a program of quantitative easing in March 2001 by targeting current account balances that banks hold at the central bank. This has led to dramatic growth in the monetary base and has slowed disinflation, perhaps even reversing it. However, the program has not yet solved either the deflation problem or the problem of declining loans.

Economic activity has picked up recently, with real GDP growing 2.7% in 2003, and the International Monetary Fund has increased its forecast of 2004 real GDP growth from 0.8% last September to 3.4% this March. Unlike Japan’s two previous recoveries, this one has benefited significantly from net exports’ contribution to real GDP growth. To promote export growth, the Ministry of Finance has been selling yen through foreign exchange interventions. Although the yen has appreciated against the dollar over the past two years, it has done so less than the euro.

Japan’s recent growth is heartening. However, productivity growth has fallen from the levels reached in the late 1980s and early 1990s, and hours worked have generally been declining over the past 14 years. The Organisation for Economic Co-operation and Development now forecasts that hours worked in 2003–08, adjusted for cyclical factors, will fall 0.3% annually, and that during this period, Japan will have the lowest potential GDP growth of any country in the OECD. This underscores the importance of success with structural reforms and antideflation strategies to the nation’s growth prospects.