In the fourth quarter of 2004, Japan’s real GDP fell at an annualized rate of 0.5%. Following the downward revisions to second- and third-quarter growth rates, 2004:IVQ was the third straight quarter in which real GDP contracted. Nevertheless, the real GDP growth rate of 2.6% for 2004 was the highest since 1996, mainly because of large quarterly growth rates in 2003:IVQ and 2004:IQ.

Net exports have been among the major contributors to Japan’s real growth in recent years, and the overall trade increase has contributed to the economy’s expansion. China’s share of Japan’s total trade is now nearly equal to that of the U.S. In recent years, the former has been growing and the latter shrinking. Japan’s increased exposure to China has made some analysts fear that a slowdown in China’s growth could adversely affect Japan’s economy.

Unlike the U.S., Japan’s consumer spending has not been a key source of economic growth in the past decade, mainly because real compensation per worker has been decreasing. That is, nominal compensation has been falling faster than prices. Employers have been able to reduce their real labor costs by shifting from regular to nonregular workers (part-time employees, workers on short-term contracts, and workers employed by temp agencies). Although the total number of workers has not changed much since 1997, total hours worked have been trending downward.

Japan has experienced persistent deflation over the past decade. As a countermeasure, the Bank of Japan switched in March 2001 from targeting

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an overnight unsecured call rate to a program of “quantitative easing,” in which current account balances held at the central bank are targeted. The Bank of Japan supplies these balances, currently targeted at 30Y–35Y trillion, primarily by purchasing government bonds. In 2003, the Bank announced that it would continue its program of quantitative easing at least until core inflation (measured by the 12-month change in consumer prices excluding fresh food) rises to 0% or higher and its Policy Board forecasts a positive inflation rate for the year ahead. The rate of price inflation has now reached nearly 0%, and survey measures of consumer inflation expectations have been increasing as well.

The monetary base grew significantly as the Bank ratcheted up current account balances. However, no similar increase occurred in one of the major monetary aggregates (M2 plus certificates of deposit). Moreover, loan growth has remained negative since the program’s inception, although it recently has been moving closer to 0%. The problems within Japan’s banking sector have been well documented. A positive development for banking is that the goal of halving the nonperforming loan ratio at major banks from 8.4% in March 2002 to 4.2% in March 2005 seems achievable. Japan hopes to improve the efficiency of its economy further by a phased-in privatization (2007–17) of Japanese Post, the largest financial institution in the world with assets totaling 80% of Japan’s GDP.