

Japan's *Golden Age*

BY CHI LO

What to make of the age demographic.

Contrary to conventional wisdom, the effect of Japan's aging population on the economy and the asset market could be positive in the short- to medium-term. In the short-term (three to five years), Japan's shrinking population (expected to start falling by 2007) will shrink the labor force, tighten labor market conditions, and lower the jobless rate. On the back of a structural economic turnaround, a tighter labor market will push up wages, boost inflation and, hence, nominal GDP growth, which is essential for the asset market growth.

In the medium-term (ten to twenty years), the declining birth rate will lower the dependency ratio (thus lessening the burden on the workforce), and the rising female labor participation rate will offset some of the decline in the labor force. These forces will boost household savings and consumption, giving Japan a new window of growth opportunity. But Tokyo needs to embark on new and drastic policy initiatives soon to tackle the aging population's dire long-term effects.

SHORT-TERM BOOST TO NOMINAL GDP

Japan's jobless rate has fallen to 4.2 percent now from a peak of 5.8 percent in March 2003. The number of unemployed peaked in December 2001 at 3.67 mil-

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lion. It has since fallen steadily to 2.83 million in the third quarter of 2005.

The improvement in the job market came first from the decline in the labor force, which fell by 1.3 million persons between the end of 2001 and the end of 2004. Employment fell by 40,000 in the same period. Then job growth picked up, with the number of employed rising by almost one million in the first three quarters of 2005.

While job market improvement due to a shrinking labor force may be cold comfort under normal circumstances, it is different for Japan. Japan has to live with a falling population, but the resultant natural decline in the labor force will tighten the labor market as the economy recovers under structural improvement.

The upcoming retirement of the baby boomers will create a bottle-neck condition in the labor market. The jobless rate will thus continue to fall in the next few years, unless there is a negative demand shock. There are now 6.8 million people in the 56–58 age range, including five million workers (7.5 percent of the labor force). These baby-boomers will reach Japan's typical retirement age of sixty years old starting in two years. With employment growth expected to remain steady under the secular economic rebound, this will put downward pressure on the jobless rate and upward pressure on wage growth.

Indeed, after falling for more than six years, wage growth has returned since this April. The improved structural backdrop behind the job market suggests that the wage recovery this time would not be a false alarm as in 2000 and 2003.

Empirical research shows that the so-called Phillips Curve phenomenon applies to Japan—as the jobless rate falls, core CPI inflation rises. In particular, the inflation rate will start rising as the jobless rate falls below 4 percent for a sustained period (over six months).

Wage hikes on the back of a tightening job market should create inflationary pressures via increased private spending. When wage growth rises faster than inflation, real purchasing power rises. This will boost demand-pull inflation. Current trends suggest that Japan's jobless rate could fall below 4 percent by early 2006, so that inflation is expected to pick up after mid-2006. This is consistent with the Bank of Japan's recent assessment that the core inflation rate will start rising in late 2006 and early 2007. The resultant rise in nominal GDP, which is on a multi-year recovery path, is positive for asset price growth in the next few years.

**MEDIUM-TERM BOOST
TO SAVINGS AND SPENDING POWER**

Japan's shrinking and aging population does not need to result in declining income and savings in the medium-term. Interestingly, labor discretionary earnings and savings could even rise because of the fall in the dependency ratio, which is the non-working population (those under 14 and over 65 years old) divided by the working population (ages 15–64). Since the working population has to support both the youngs and the olds, this ratio measures the burden imposed by the dependent groups on the workers.

Japan's declining birth rate will lower her dependency ratio. The current population dynamics suggests that the drop in the number of children will more than offset the rise in the number of retirees. The birth rate's decline will also exceed the fall in the labor force in the next thirty-five years. All this will result in a fall in the dependency ratio.

With a smaller burden to support the dependent population, discretionary labor income and personal savings will rise. Of course, the problem of supporting an aging population still remains in the long-term, when the smaller pool of children reaches working age.

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Further, although Japan's labor force will shrink over the long-term, the rise in female participation in the labor force is a bright spot for income and demand growth in the medium-term. The rise in the female labor force has been evident since the 1970s, coinciding with a drop in the marriage rate.

The increase in the female labor participation rate (the ratio of female labor force to total population) is most notable in the 25–34 year old groups, which has risen by 16 percentage points to 56 percent of the labor force since 1975. This compares with the overall female participation rate, which has risen by less than 5 percentage points in the same period. This rise in the female labor participation rate helps explain both the fall in the marriage and birth rates.

Higher female participation in the labor force will increase the labor pool (by mobilizing the unutilized female labor), and offset some of the decline in the labor force. This should boost income and demand growth. Meanwhile, with an increasing number of females working in the coming years, their spending power will rise, adding to the consumption recovery.

RISKS

A big assumption behind the benign scenario of a tightening labor market boosting nominal GDP in the short-term is that there is no negative demand shock to upset Japan's labor market. But there are potential risks. A sharp fall in exports, due to weaker external demand, is one. Domestic fiscal consolidation—involving public spending cuts, tax hikes, and restructuring of public corporations—to pare

the fiscal deficit along with premature monetary tightening are others.

Further, the baby boomers may want to remain in the job market longer, due to concerns about their public pensions. In this case, the expected decline in the labor force will be smaller and, hence, the upward pressure on wage growth, demand and nominal GDP will also be smaller.

POLICY IMPLICATIONS

Japan still has to face a declining population, which adds to the burden of the working population and aggravates the government's fiscal deficit, cutting into the country's growth and living standards over time. To address these problems, Tokyo should relax its immigration laws to take in more foreign labor. It has always resisted such an idea due to a strong preference for homogeneity to build an integrated society. But as the negative impact of an aging population bites, it will not have many effective choices. Immigration can expand Japan's labor force quickly, boosting GDP growth, raising the ability of the workforce to sustain the aging population, and increasing tax intake, thus helping to cut the budget deficit.

The government should also break the cultural logjam of discriminating against female labor. Japan's support for working mothers has been extremely unfavorable. Childcare facilities are in extreme shortage. Less than 15 percent of Japanese children under the age of three go to daycare centers, compared with 54 percent in the United States. Meanwhile, households are taxed without sufficient child benefits. Legal support for pregnant and working mothers is inadequate. The corporate culture of long working hours and discouragement of long holidays, including maternity leave, are deterrents to working mothers. All this will need to change in order to boost the birth rate and female labor participation.

The authorities must enact laws to help working mothers, build more childcare centers, raise tax incentives for having babies, and provide friendlier working practices for working mothers. The recent measures to raise taxes and pension contributions to address the fiscal deficit and pension liability problems, ironically, act to discourage people from having babies. The long time lag for changing the legal and institutional frameworks to raise the birth rate suggests that Tokyo will have to resort to immigration as a stop-gap measure to halt the deteriorating population trend. ◆