

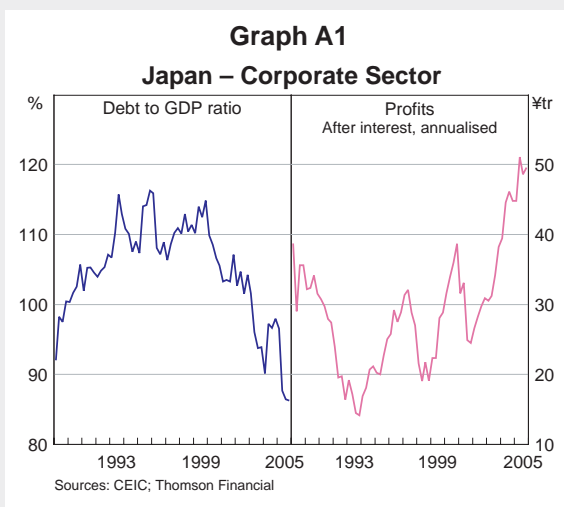
Box A: Recovery in Japan

Japan's economic expansion is now in its fourth year and is increasingly showing signs of durability. Unlike in the short-lived public-demand-driven episodes of the 1990s, growth is now broadly based across domestic private demand and exports, and thus more likely to be sustained. A feature of the current recovery has been the improvement of conditions in the corporate sector, which has now flowed through to households via labour market recovery. A further positive sign is that the deflation of the past decade also appears to have abated.

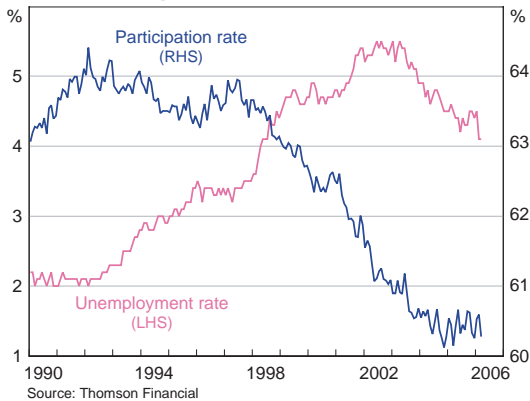
Structural adjustment by businesses has allowed them to reduce their excess debt, labour and capacity from the bubble years. Previously fragile corporate balance sheets have markedly improved, as strong profitability has permitted lower debt levels. Corporate profits after interest payments increased by almost 11 per cent in 2005 (Graph A1). The ratio of corporate debt to GDP has declined to 86 per cent, its lowest level in almost 20 years, and debt to equity ratios are at low levels by Japanese standards, though they are still higher than in

most other countries. Balance-sheet repair has also been evident in the banking sector. Official estimates show that non-performing loans have fallen from a peak of 8.4 per cent of bank lending in 2001, to 3.5 per cent in September 2005, as bad loans have been written off and, more recently, lending has begun to expand. In February, loans outstanding were higher than a year earlier, for the first time in over nine years. Within the total, lending to individuals has been increasing solidly since early 2005, while the pace of decline in lending to firms has moderated.

Central to the corporate restructuring process has been the active shedding of labour by firms. Over the 10 years to 2002, the unemployment rate had increased from 2 per cent to 5.5 per cent – the highest rate in more than 50 years. Full-time employment declined over the same period, as firms replaced full-time employees with part-time and casual employees, shifting away from the traditional Japanese system of lifetime employment. More recently, however, labour market conditions have begun to recover. The unemployment rate has fallen to its lowest level in over seven years and the participation rate has stabilised after a protracted period of decline (Graph A2). Total employment has been rising steadily since late 2003, and full-time employment has risen since the start of 2005. Surveys are now indicating that firms have insufficient labour to



Graph A2
Japan – Labour Market



meet demand. The improving labour market is encouraging consumer spending. Year-average consumption growth was 2.2 per cent in 2005, compared with an average of 1.1 per cent over the preceding 10 years.

Japan is also showing some early signs of emerging from deflation. Year-ended CPI inflation was running at around ½ per cent in the first three months of 2006, both in headline and underlying terms. Asset prices have also been rising. The health of the corporate sector has been reflected in strong growth of share prices; the Topix index has risen by

more than 50 per cent over the past year and is now around 15-year highs. There are also tentative signs of a turnaround in property prices. Over 2005, Tokyo property prices increased for the first time in 15 years, and the year-ended pace of decline in nationwide property prices continued to moderate. The developments in both consumer and asset prices have contributed to an improvement in balance sheets, which should assist prospects for a sustainable recovery. Given these signs of self-sustaining growth, the Bank of Japan has begun the transition to more normal policy settings, after an extended period of very expansionary monetary policy. ✕