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Japan: Will It Kick the High Savings Habit? [redacted]

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A Research Paper

Secret

EA 85-10098
May 1985

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Japan: Will It Kick the High Savings Habit? [redacted]

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A Research Paper

This paper was prepared by [redacted] 25X1
Office of East Asian Analysis. Comments and queries
are welcome and may be directed to the Chief, 25X1
Northeast Asia Division, OEA, on [redacted]
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Japan: Will It Kick the High Savings Habit?

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Summary

Information available as of 10 May 1985 was used in this report.

Recent calls by US officials for reduction or better domestic utilization of Japanese savings have struck a raw nerve in Tokyo. Even Japanese proponents of fiscal stimulus—which is one possible response to US concerns—insist publicly that decisions affecting savings rates are purely internal matters and not suitable topics for international debate. In private, many Japanese officials admit that about one-third of the country's current account surplus stems from surplus savings, which is savings not used for domestic investment, but they still consider saving a virtue not to be tampered with lightly.

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This paper explores the relationship between excess savings and current account surpluses. It assesses the demographic, institutional, and policy factors that will guide Japanese savings rates—and, indirectly, current account trends—in coming years. The large share of wages distributed in the form of bonuses, the underdeveloped social security and consumer credit systems, and the availability of tax-free savings options are among the institutional factors examined.

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Most economists believe the household savings rate in Japan may fall during the next two decades because of the aging of the population and probable institutional changes, including the expanded availability of consumer credit. Such a scenario—which implies declining current account surpluses—is plausible, but we believe several caveats are in order:

- The savings-investment imbalance model on which the assessment hinges has several shortcomings, including a high level of aggregation that blurs the distinction between cyclical movements in the savings rate and permanent levels.

- Policy options under consideration in Tokyo, including a near-certain reduction in social security benefits, have the potential to cause household savings rates to rise once again.

- Even if the personal savings ratio falls by 2 to 3 percentage points by the turn of the century, as is commonly expected, the government savings ratio may rise by nearly as much if Prime Minister Nakasone makes good on his pledge to eliminate new deficit-covering bond issues by 1990. Under this scenario, the prospects for a sharp drop in Japan's national savings rate seem to vanish and with them the likelihood of an end to perennial Japanese current account surpluses. In light of this, we believe Tokyo's fiscal policy moves merit close attention in coming years.

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Deciphering Savings Definitions and Data

Economists define savings as current income not consumed in the year it was received. Statisticians assume households consume durable goods such as automobiles and TVs during the year they were bought, whereas the consumption of a newly purchased house is spread over a number of years. Personal savings data thus reflect additions to financial holdings and fixed assets (mainly houses) less increases in financial liabilities.

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The Annual Report on Family Income and Expenditure Survey, which contains extensive data on Japanese savings, calculates savings in such a manner. Although this survey is sent to over 8,000 households, some economists allege the results are biased by the low response rate from low-income families. Fewer households are surveyed in the annual Public Opinion Poll on Savings *published by the Bank of Japan, but this survey is unique in asking individuals why they save.*

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The national income accounts put out by Japan's Economic Planning Agency (EPA) provide data on savings that cover all households as well as the corporate and government sectors (see figure 1). The EPA calculates the savings rate as a residual, what remains of income after consumption, and thus the figures are affected by any errors in the vast consumption category. Although the economic definition of savings is the same for corporations and the government as it is for households, there is no neat financial counterpart to the first two sectors' savings.

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The rate of household saving is calculated as the ratio of aggregate saving to aggregate disposable income (that is, income net of income taxes). In analyzing the national accounts, the economist employs a second ratio: the ratio of household savings to aggregate GNP.

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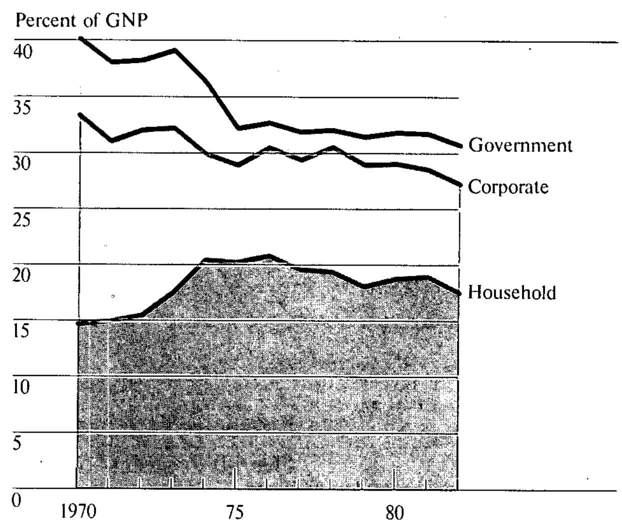
Figure 1
Japan: Savings Ratio, by Sector, 1970-82



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Japan: Will It Kick the High Savings Habit?

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High Japanese Savings: The Good News

In the high-growth era of the 1960s, Japan clearly benefited from the people's willingness to save—that is, to forgo consumption—at a much higher rate than in the United States, West Germany, and the other non-Communist industrial powers (see figure 2). High savings helped fund immense investment requirements and prevented the inflation and balance-of-payments problems normally associated with rapid economic expansion.

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When the first oil crisis struck Japan in 1973-74, GNP growth and investment outlays declined, but savings failed to drop commensurately (see figure 3).

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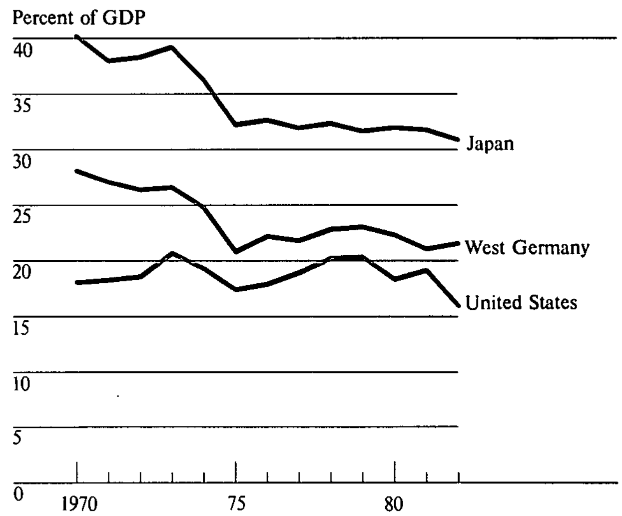
Figure 2
Selected Countries: Gross National Savings Rates, 1970-82



Excess Savings Fuel Trade Friction: The Bad News

Despite Tokyo's attempts to put surplus savings in a positive light, most economists have concluded that high Japanese savings are not the virtue they once were. Economic theory asserts that when savings exceed investment, domestic demand will fall short of its potential. Weak domestic demand, in turn, will depress import requirements and foster export drives by encouraging firms to focus on overseas markets. The push to export makes both an expansion of trade and current account surpluses far more likely. These economic relationships are expressed in terms of national income accounting as an equation that shows savings less investment as equal to the current account surplus. Japanese national income data in fact generally reflect this relationship, although the statistical discrepancies involved sometimes are quite large (see figure 4).

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This reasoning leads many economists to describe persistent Japanese current account surpluses as fundamentally a result of excess savings. In the United States, the Japan Economic Institute, Federal Reserve Bank officials, and numerous academics have come to this conclusion. In Japan, the Economic Planning Agency subscribes to the excess savings thesis. The more conservative Ministry of Finance has privately also called the link between Japan's excess

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Figure 3
Japan: National Savings and Investment Ratios, 1970-82

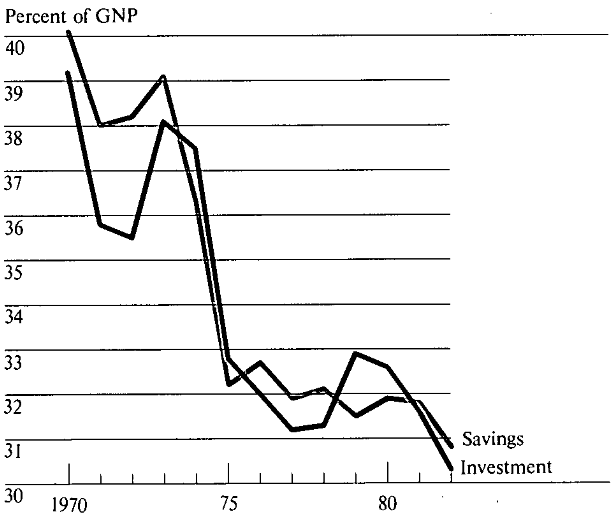

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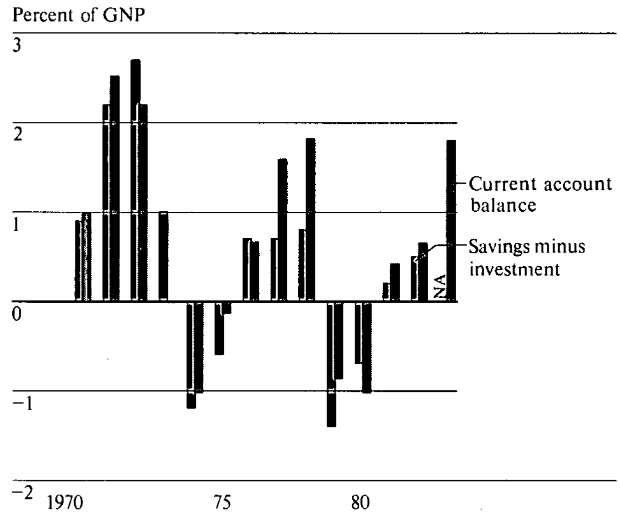
Figure 4
Japan: Excess Savings and Current Account Balances, 1970-84



[redacted]

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savings and its large current account surplus plausible, [redacted] Publicly, moreover, Finance officials quickly rebuffed recent suggestions by Secretary of State Shultz and Federal Reserve Board chairman Volcker that Japan alter policies affecting savings and investment. [redacted]

We also perceive some problems with drawing an oversimplified picture of the connection between the current account surplus and excess savings. In particular, the aggregation involved in savings statistics masks important distinctions between the savings generated by business or economic cycles and those generated by the structure of the economy. Cyclical, unlike structural, excess savings are not the cause of persistent current account surpluses. The weakness of the yen against the dollar, abnormally high interest rates, and depressed raw material prices during recent years have substantially inflated the cyclical segment of the savings-investment imbalance. The Economic Planning Agency (EPA) estimates these factors, along with differences in the business cycle in Japan and the United States, accounted for $11 billion of the country's current account surplus in fiscal year 1983 (April 1983–March 1984). The EPA believes that structural factors such as ingrained frugality were responsible for an almost permanent level of excess savings that accounted for the remaining $13 billion of the surplus. [redacted]

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The Savings Half of the Excess Savings Equation

Despite the risk of oversimplification, we believe the theoretical model that relates excess savings and the current account surplus is a valid analytical tool to assess long-term trends in Japan's current account. To use it in this manner, the equation must be broken

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Four-Sector Investment and Savings Model

In addition to breaking down the savings/investment equation into its two component parts, detailing the sectors in which each occurs improves analysis of the excess savings problem. Traditionally, the domestic economy is divided into corporate, household, and government sectors. Economic interaction with nonresidents, involving imports or exports of goods, services, or financial assets, is treated as occuring in the foreign sector. [redacted]

Savings and investment need not balance within any one sector but must balance across sectors. Given the diverse motives for investing and saving, such balance is by no means assured when discussions are confined to the domestic economy. Financial intermediaries—primarily banks—strive to lend all available savings to investors, changing interest rates if necessary to induce individuals and companies to deposit or borrow more. Even this may be insufficient to achieve the desired result of using all savings domestically. In this case, the foreign sector will come into the picture (see table 1). For example, if savings are in excess of domestic needs, the surplus will be shipped abroad in the form of capital outflows. A current account surplus will be the counterpart to these financial flows. [redacted]

down into its component parts, namely savings and investment. Examination of investment prospects is beyond the scope of this paper, but most experts foresee a slight decline in Japanese corporate investment as a percentage of GNP during the next decade as the economy shifts away from capital-intensive manufacturing and into service activities. We believe the ratio of government investment to GNP also will decline because fiscal policy probably will remain tight. Although these trends would raise the amount of excess savings, many economists expect significant declines in the savings rate over the decade and thus, a net reduction in trade surpluses. We believe, however, that this judgment puts too much emphasis on developments in the household sector while ignoring important trends in the corporate and government sectors: thus it may prove off the mark. [redacted]

Table 1 *(Billion US $)*
Japan: Sectoral Financial Flows, 1982

	Savings	Investment	Balance [a]
Household	187	76	111
Corporate	102	172	−70
Government	37	74	−37
Rest of world	167 [b]	177 [c]	−10

[a] Balance does not add to zero because of statistical discrepancies. 25X1
[b] Receipt of foreign funds and goods.
[c] Disbursement of funds and goods to foreigners.

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Japanese Households: Extraordinary Savers

[redacted] the savings rate of the household sector should drop from 19 percent of GDP in 1980 to 16 to 17 percent by 2000. Other reputable economists who have analyzed the Japanese savings scene anticipate a similar decline. [redacted] 25X1

This fairly wide consensus about future trends masks sharp disagreements among economists about the factors responsible for Japan's past savings record (see figure 5). In the following sections we will analyze these cultural, institutional, macroeconomic, and demographic factors and assess how they could change in the coming years. We will also examine how policy moves by Tokyo, especially in the social security program, could affect savings motives and the course of personal savings. [redacted] 25X1

Demographic Factors: Improving With Age?

The rapid aging of the Japanese population is the prime ingredient in all forecasts of a decline in the personal savings rate. The widely accepted life-cycle theory of savings contends that elderly people liquidate their nest eggs to make ends meet. The theory appears applicable, although only loosely, to Japan. In each of the last 10 years, Japanese over 65 as a group

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Figure 5
Japan: Explanations for High Personal Savings in Postwar Era

have not drawn down their savings, but they have saved much less of their income than any other adult age group except those under 25. As long as this pattern continues, the increase in the over-65 age group—projected to grow from 9.1 percent of the population in 1980 to an estimated 15 percent in 2000—should result in a reduction of the savings rate. [redacted] on average each household—of which there were 34 million in 1980—will be saving $20 less annually by 2000 than would have been the case if Japan's population kept the age distribution evident in 1965. [redacted] 25X1

Other probable demographic changes—such as increased life expectancy and decreased family size—have less significant implications for savings. Future shifts in these variables, moreover, probably will be minor compared with those that have already taken place: 25X1

- Life expectancy in postwar Japan has lengthened dramatically and by 1982 was the highest in the world. Past increases in longevity probably spurred savings of the working age population to meet the expanded need for retirement income.

- The average number of children per family has decreased for several decades. With fewer children, parents have put away less money for education and marriage expenses, depressing the personal savings ratio in the process. Smaller families also have contributed literally to more room for people—the floorspace per individual has doubled over the last 25 years. This has encouraged higher spending on furniture and other consumer durables, further reducing savings. [redacted] 25X1

By injecting new uncertainty and insecurity into the lives of the elderly, however, other recent demographic changes are pushing savings up somewhat. In particular, changes in living patterns probably are increasing the perceived need for precautionary savings. For example, three-generation households accounted for 58 percent of all households in 1967. Their share had dropped to 44 percent by 1982. [redacted] 25X1

Traditional Frugality: Can It Survive the Younger Generation?

Japanese social traditions and Buddhist religious teachings place a high value on frugality. In our view, many economists have framed their analyses of Japanese savings too narrowly and in the process have underestimated the importance of such cultural factors. Economists have generally hesitated to give much weight to cultural factors because prewar data on savings is not conclusive. Savings data first constructed for the late 1800s and early 1900s suggested that net private savings were generally below 10 percent of GNP and, on an annual basis, frequently negative. Although such results suggest high savings 25X1

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is a relatively recent phenomenon, not a traditional virtue, the original series on savings was derived indirectly from investment data and, according to many researchers, was flawed by estimation errors and methodological shortcomings. When the series was recomputed using different depreciation assumptions, calculations showed private savings were consistently above 10 percent of GNP after 1900. Moreover, statistics from this period of relative poverty could not accurately measure attitudes toward frugality, because there was little to save, however strong the desire. In short, we believe the link between cultural values and high savings has merit. [redacted]

Many observers believe that, like the effect of generational change in other societies, the younger Japanese generation is becoming less financially cautious and is abandoning such notions as postponement of present gratification and sacrifice for the good of the family. As young adults devote more time to leisure activities and develop their own values, these analysts foresee consumption rising as a percent of personal income. The Japanese, however, have thus far been able to raise both consumption and savings at a rapid rate because of the extraordinary growth of the economy. *The Economist* in 1983 pointed out that the Japanese already are "almost as rabid consumers as Americans"—while maintaining their impressive savings rate. [redacted]

In fact, annual savings surveys by the Bank of Japan provide some evidence that generational differences may not be as great as commonly assumed. For example, only 2.4 percent of those surveyed in 1983 said it was more important to enjoy life by boosting consumption than to save. In 1966 the comparable figure was 5.1 percent. Another survey, which asked young single women why they worked, also suggests high savings will not die with the younger generation. Nearly half of those surveyed indicated they worked largely to earn money to save. [redacted]

In general, Japanese seem to believe saving is still important, although perhaps not as much of an imperative as it once was. They continue to have a strong desire to save in order to pay for their children's education, to buy houses, and to provide for retirement (see table 2). Generational changes, we conclude, should have only a mildly depressive effect on the savings rate. [redacted]

Table 2
Japan: Motives Most Often Cited for Personal Savings

Percent

	1970	1975	1980	1984
Illness or accident	36.9	42.2	36.1	34.4
Children's education	16.9	16.4	18.3	18.3
House purchase	16.8	13.9	15.4	12.3
Retirement income	12.0	13.0	11.3	15.5
Peace of mind	8.9	7.7	5.9	6.5
Miscellaneous	8.5	6.8	13.0	13.0

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[redacted]

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Institutional Factors: Key to High Savings?
Although economists usually play down the cultural underpinnings of Japanese savings, they often highlight unique institutional arrangements that help explain why Japanese households save more than their counterparts in other industrialized countries:
- The large share of wages distributed in the form of bonuses, which gives people a large lump sum that they tend to bank rather than spend.
- The underdeveloped social security and consumer credit systems.
- The availability of tax-free savings options.

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Analysts differ on the relative importance, and sometimes the real effect, of these individual items. [redacted]

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We believe institutional factors create a favorable environment for savings. We do not, however, subscribe to any of the popular, one-factor, institutional explanations for high Japanese savings. In our judgment, such theories—which give all the credit for the country's high savings rate either to the social security system, the bonus system, or tax incentives—fail to explain adequately saving trends during the past 20 years. [redacted]

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Tax Incentives. After World War II, the Japanese Government adopted various tax incentives to encourage savings. These included a tax exemption on capital gains from sales of securities, low property taxes, and a zero-to-low tax on interest and dividend

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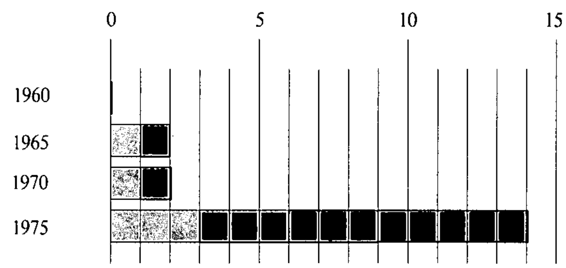
Figure 6
Japan: Tax-Free Savings Options for Individuals[a]

Million yen

Legend
- Postal savings account
- Small savings accounts in banks
- Government bond holdings
- Postal installment savings for housing
- Wage earner's property accumulation holdings



[a] Maximum permissable tax-free per individual.

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income. The amount each individual could place in tax-free postal savings accounts, for example, was boosted from its wartime level of 700,000 yen to 3 million yen in 1947, about $8,000 at the prevailing exchange rate. Since then, Tokyo has expanded the list of accounts qualifying for tax-free status and the limits on individual holdings (see figure 6). Every Japanese is now entitled to hold 14.5 million yen ($58,000) in tax-free accounts. Such accounts totaled $900 billion, or 60 percent of all private savings, in early 1984.

Observers usually praise Japan's tax incentives for meeting the key requirements of a rational savings promotion program. Tax policy specialists have argued that to increase the rewards for saving, a government must (1) avoid benefit caps that remove incentives for high-income groups to save and (2) discourage borrowing as well as encourage savings. By not permitting deductions for interest payment on consumer debt,[1] the Japanese tax system fulfills the second requirement. Moreover, although the amount of money that can go into tax-free accounts is capped, these limits are so high as to have affected only a small number of households and, in any event, are easy to evade.

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Many economists point out that incentives to increase savings sometimes can have perverse effects. In theory, a high yield on savings lowers the cost of future consumption compared with present consumption and thereby spurs higher savings. But an individual can meet lifetime savings goals with smaller annual increments when the interest paid on savings rises. A recent IMF study concluded that the relative strength of these two opposing forces depends on the age distribution of the population and the distribution of financial assets among age groups. The authors of the study ascribe the recent fall in the US personal savings rate—which coincided with introduction of such savings incentives as individual retirement accounts—to the large share of assets held by the elderly, who are apt to boost consumption when yields increase. We suspect Japanese assets are similarly concentrated among the elderly, but data limitations prevent a more definitive statement about parallels with the US experience.

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The handful of economists who have examined the relationship between Japan's tax laws and savings performance find little evidence to support the contention that the country's generous savings incentives work. They have concluded that tax laws do not seem to be important in shaping the average wage earner's saving behavior. Although their findings indicate that conventional wisdom overstates the importance of tax incentives, we do not think the incentives should be dismissed as totally ineffective.

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The debate about the efficacy of tax incentives is far from academic. Since the late 1970s, the Japanese Government has periodically discussed tightening restrictions on, and possibly eliminating, savings incentives. Tokyo has tried for years to end the widespread practice of holding multiple or anonymous postal savings accounts. Since January, individuals wishing

[1] Under special circumstances, however, individuals can deduct annually up to $120 of the interest paid on mortgages.

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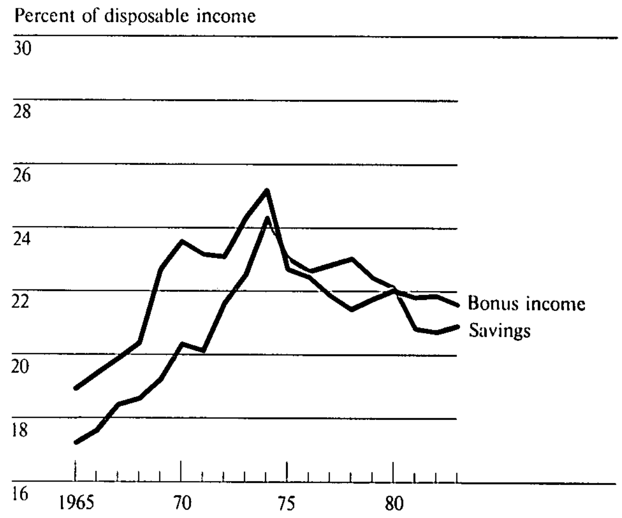
to open tax-free savings accounts have been required to present identification. In 1984 the Finance Ministry recommended more drastic measures, including imposition of a uniformly low tax rate on all savings accounts. This last option would have added $2 billion to government coffers if the tax rate were set at 5 percent, but Liberal Democratic Party officials killed the proposal. 25X1

Despite the failure of recent attempts to pare tax-free savings, we believe future movement on this front is likely. If incentives are cut back, savings in the upper income brackets probably will decline. But reduced yields may boost the savings rate among the elderly. Neither we nor the Japanese, however, are well positioned to assess such trends at this point because of the ongoing liberalization of Japan's financial system, which complicates analysis of interest rate movements. Since 1981, financial institutions have begun to offer individuals high-yielding instruments. As financial liberalization gains momentum through the 1980s, the rate of return on such instruments before taxes probably will climb and perhaps offset increases in the tax burden on interest income. 25X1

Figure 7
Japan: Savings and Temporary Income, 1965-83



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Bonuses. Japanese workers typically save half of their semiannual bonuses, which each year normally amount to two months' salary. Several economists have pointed to the large share of wages paid in the form of bonuses as a key element in high Japanese savings. Economic theory provides some support for this idea. It contends individuals base their consumption on income they believe is dependable and predictable (monthly salaries) rather than on transitory income (bonuses), which is therefore initially saved.

Many economists doubt that the Japanese really view bonuses as transitory and unpredictable income. Bonus income has been less volatile than wage income since 1975, adding credence to this skepticism. The share of disposable income received in the form of bonuses, moreover, has grown and shrunk independently of savings since 1976 (see figure 7). Efforts to test the savings/bonus linkage with econometric methods suggest an accurate description of this relationship lies somewhere between these extreme positions. Analysis of the linkage in 1984 found that at most 3 percentage points of Japan's savings rate can be attributed to the effect of bonuses.

Semiannual bargaining sessions between corporate treasurers and union officials determine the share of income dispensed via bonuses. After a sharp rise in the 1960s and early 1970s, the ratio of temporary income (bonuses) to disposable income has remained quite stable—staying between 21 percent and 23 percent—since 1975, and we suspect the ratio will not move up or down by more than 1 percentage point during the next decade. Using the econometric formula derived from the 1984 test of the savings-bonus linkage, a shift of this magnitude would imply a change in Japan's savings rate of only 0.1 percentage point. 25X1

Consumer Credit. Some observers have suggested that the Japanese save because of the difficulty of buying on credit, a legacy of the country's postwar preoccupation with industrial reconstruction. In the 1950s and 1960s, commercial banks were busy looking after the needs of corporate loan clients and had

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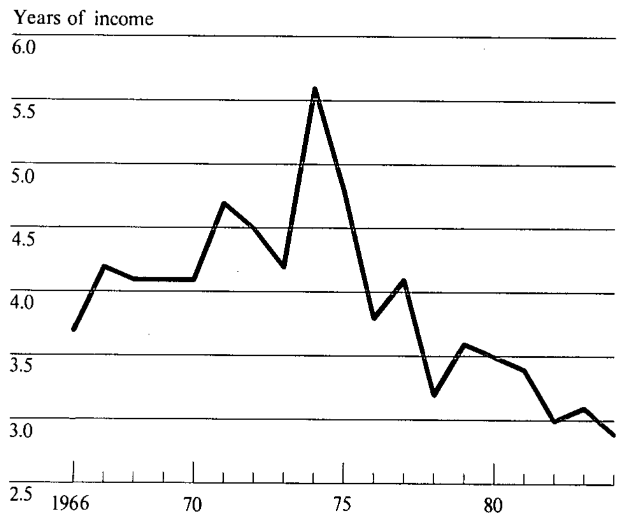
little desire to extend personal loans. The latter were—and still are—considered risky because concerns about privacy made it difficult to collect and exchange personal credit histories. As corporate financing needs diminished in the 1970s, banks took an interest in consumer business. Personal loans shot up from 0.3 percent of the loan portfolios of major commercial banks in 1965 to 9 percent in 1980. Housing loans account for almost all of the increase. 25X1

Banks continue to shy away from making general consumer loans. *Sarakin* firms—essentially legal loan sharks—have traditionally provided this service. Public and political sentiment against these firms has, however, intensified in recent years as hundreds of suicides have been blamed on their strongarm tactics. In an effort to rein in the *sarakin,* the Ministry of Finance in 1978 forbade Japanese banks from extending loans to these companies and in 1983 reduced the maximum lending rate charged by *sarakin* from 110 percent to 73 percent per annum. These changes have bankrupted many smaller *sarakin,* making consumer finance even scarcer. 25X1

Over the next decade consumer credit should be more available even if the *sarakin* continue to scale down their operations. The Finance Ministry last year gave small credit associations and labor cooperatives permission to undertake consumer lending and recommended that commercial banks become more active in this field. More important, government officials have said they may draft legislation to encourage greater competition in consumer finance and to improve protection for borrowers. 25X1

Better access to consumer finance should depress precautionary savings not associated with any particular future consumption. The number of Japanese who said they saved primarily to ensure "peace of mind" drifted down during the 1970s, perhaps in response to improved consumer credit options (see table 2). Survey results on questions about the savings/income ratio the Japanese believed they should maintain show a similar pattern of decline punctuated by temporary savings spurts whenever external economic shocks struck home (see figure 8). These trends suggest to us that precautionary savings in Japan are influenced by economic prospects as well as by the availability of credit. Similarly, other factors—including the lack of widespread legal precedent for individuals to seek redress for costly injuries resulting from negligence, and the perceived inevitability of natural disasters—are certain to lead the Japanese to continue to set aside money for peace of mind. Thus the reduction in the savings rate associated with an expansion of consumer credit may not be as large as is commonly assumed. 25X1

Figure 8
Japan: Personal Savings Targets, 1966-84



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Social Security. Nearly every economist who analyzes Japanese household savings examines the possible causal relationship between the country's high savings ratio and the small share of GNP devoted to social security. Those who see such a relationship consider the benefit levels in state-run pension schemes low and claim this forces young Japanese to amass huge amounts of savings to provide retirement income. These economists claim that the need to save

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for retirement while young will force up the national household savings ratio. Other economists, however, insist that benefit levels of the current system are not underdeveloped and therefore do not act, in effect, to boost the savings rate.

We believe both arguments contain some truth. Notwithstanding the growth in the number of senior citizens, Japan's population is comparatively young. This is the key reason, in our view, for the small share of social security in national income. In fact, on paper, benefit levels of Japan's old age pensions are more generous than those in the West. In 1983, for example, a Japanese retiring at the age of 60, after contributing to the government plan for 30 years, could receive benefits equal to 44.2 percent of his previous year's earnings. In West Germany, the United States, and the United Kingdom, men got an equivalent amount only after reaching age 65. *The Economist* points out, however, that such comparisons are somewhat misleading. The public employees' pension plan that covers almost half of all Japanese workers was not established until 1961, so no one in that plan yet qualifies for the high benefit levels mentioned.

Although some foreign observers continue to chastise the Japanese Government for its underdeveloped social security system, officials in Tokyo worry that the system could exhaust its reserves by the turn of the century if not reformed. The Health and Welfare Ministry has proposed boosting contributions and capping benefits. The Diet passed these measures in late April. Although such action may boost the savings rate of future generations, most adults appear to have anticipated such measures, and we doubt the changes will soon alter the savings rate much. Fears about possible changes explain the recent resurgence in the "saving for old age" motive. Annual polls reveal the percent of respondents who said they saved primarily for old age climbed from 12 percent in 1970 to 15.5 percent last year, even though social security benefits improved substantially during that period.

Retirement Age. We believe economists' standard emphasis on social security slights a feature of the Japanese employment system that has profound effects on the level of savings for old age income. This feature involves the traditional gap between the age at which large firms force employees to retire—55—and the age at which they are eligible for a state pension—60. Firms generally give employees a lump-sum payment to help tide them over this period, but individuals also are compelled to take low-paying jobs at smaller companies and to liquidate savings to make ends meet. For the Japanese, the need to fill this retirement "gap" has made target levels of lifetime savings relatively high.

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Some larger companies now allow employees to remain on the job until they are 60. If this practice spreads, it could lower target savings levels. Its effect may not be as great as first appears, however, because planned changes in social security annuities would delay the onset of full benefits until age 65. Even once these changes are implemented, partial payments will still begin at age 60, allowing savings targets to fall somewhat.

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Economic Variables: Of Declining Importance?
In the 1980s, Japan's economy appears to be on a steady course, making it unlikely that random economic shocks will affect savings rates much. Inflation and unemployment have stayed below 3 percent for several years, and GNP growth is running at 3 to 5 percent annually. The ease with which the economy digested the 1979-80 round of oil price hikes makes us somewhat optimistic that stable noninflationary economic growth can be maintained unless an extremely severe external economic shock strikes. The volatility of the yen may prove a major exception to the stability scenario. Even in this case, however, the impact would be greater on the corporate than on the household sector because imports of raw materials—used by businesses—exceed those of consumer products.

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Although not expected to be particularly important in guiding savings in the future, economic variables—particularly changes in inflation and disposable income—figure prominently in past saving rate trends. The sharp rise in personal savings in 1973 and the subsequent gradual decline can be partly explained by

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movements of these two specific factors as Japan adjusted to the 1973-74 oil price crisis and its aftermath.

The behavior of the Japanese in the 1970s demonstrates that their inclination to save can be directly affected by their ability—or failure—to anticipate inflationary spirals. Most analysts view the jump in inflation in the mid-1970s—from less than 5 percent in 1972 to nearly 25 percent two years later—as a prime contributor to an upswing in the savings rate. Because the inflation was unexpected, individuals had failed to shift their savings into assets, such as real estate, capable of retaining their value in the face of price increases. The spending power of their nest eggs dwindled, providing an impetus for a one-shot savings spurt to bring holdings back to the desired level. Tokyo's subsequent policies to check inflation have been successful, facilitating a return to lower savings rates.

Personal savings rates have ebbed and flowed in reaction to changes in disposable income as well. Healthy increases in real per capita income in the early 1970s allowed the Japanese to boost consumption and savings simultaneously. But growth in real disposable income slackened following the first oil crisis as employers moderated wage increases and the government abandoned indexation of income taxes. To maintain improved living standards in the face of income restraints, Japanese households reduced their savings rates. Income trends obviously were not the only factor behind the decadelong decline in the savings rate. Institutional changes—such as increased consumer credit and later retirement—also played a role. Moreover, we believe the growing self-confidence of the Japanese increasingly will bring them to see economic reverses as temporary and to behave more calmly in maintaining consumption levels.

Overall Prospects for Personal Savings

The "high saver" label for Japanese has remained appropriate throughout the postwar era, but the motives for household savings have changed apace with changes in the economic and institutional environment. Economic factors played a prominent role in forcing personal savings rates down during the latter half of the 1970s. We believe demographic factors will become more important in coming years, with the aging of the population pushing the savings rate down. Most anticipated institutional changes, including improved access to consumer credit and later retirement, 25X1
should further reduce savings rates. But other factors, particularly reform of the social security system, hold the potential for reversing this trend. A savings ratio decline of 2 to 3 percentage points between now and the turn of the century is quite likely, but it certainly is not the only possible outcome. And even if this projected decline occurs, Japanese households will remain high savers largely because of society's emphasis on personal and familial responsibility that is central to the social, cultural, and historical roots of the nation. 25X1

Government Savings: Growing for the Rest of the Century?

Following the first oil crisis the Japanese Government 25X1
switched from being a net lender of funds to being a net borrower. In other words, it began to run budget deficits. The central government deficit peaked at 6 percent of GNP in 1979. In the same year the deficit of the general government sector, which also includes local governments and the social security fund, reached 4.4 percent of GNP. The deficit in the more-inclusive general government sector usually is smaller than its central government counterpart because the social security system traditionally runs a substantial surplus. 25X1

Despite these deficits, the government managed to chalk up positive savings rates throughout the 1970s (see figure 9). The distinction between current and total expenditures is central to the apparent contradiction between budget deficits and positive savings. When calculating budget balances, total government spending is subtracted from total income. But when 25X1
calculating savings, only noninvestment expenditures are considered. Japanese public works spending, 15 percent of central government outlays, is thus not counted and the result is a positive government savings rate. 25X1

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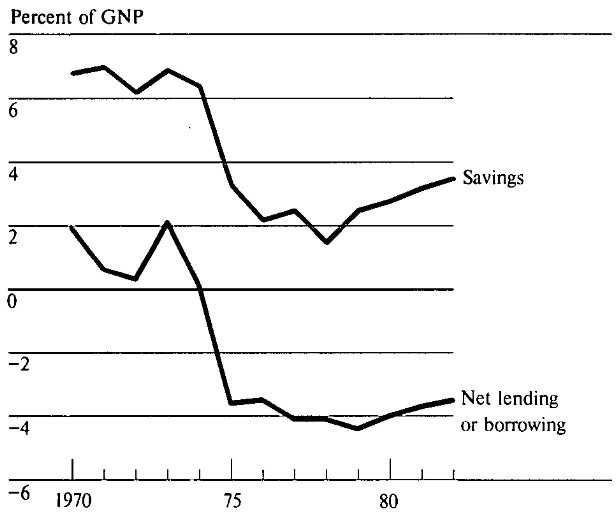
Figure 9
Japan: Government Savings and the Budget Deficit, 1970-82



[redacted]

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In recent years, Japanese policymakers have been intent on sticking to austere budgets to contain the deficits. Prime Minister Nakasone has pledged to eliminate new deficit-covering bond issues by 1990. Realization of this goal implies that government savings as a share of GNP will rise, perhaps by as much as 2 percentage points, through the end of this decade. Typical business cycle developments, such as a recession-induced fall in tax revenues or an increase in outlays for unemployment benefits, are unlikely to derail Tokyo's plan. Estimates [redacted] indicate that cyclical movements in Japan's budget in recent years have been only about one-tenth as severe as dislocations in other countries. [redacted]

The government's growing responsibilities for social security pose one threat to the decreasing deficit/increasing savings scenario. Officials in Tokyo have made dire predictions about the future of the social security system. Some economic observers blame "half-prudent" government policies for these poor prospects because Japan's fully funded system theoretically should be immune to demographic changes. Fully funded systems, unlike the pay-as-you-go programs of the United States and West Germany, earmark the contributions (and interest on those contributions) for retirement benefits for the generation making the payments. Tokyo, however, has invested accumulated reserves in infrastructure projects, which often yield negative real rates of return. Thus, the ability to fund future benefits has decreased while potential benefit levels have been increasing. [redacted] 25X1

As no change in social security investment practices appears imminent, Tokyo faces a dilemma: either the present system will have to be made less generous or the government will have to subsidize the system more heavily in the future. Legislation to trim benefits somewhat has already been passed. Implementation of the new measures will reduce the need for, but will not rule out, increased official subsidization of the system. A decrease in government savings attributable to social security responsibilities thus remains a possibility. [redacted] 25X1

The other threat to a rising savings scenario is the unhappiness of LDP leaders with tight fiscal policies. Party faction leader Toshio Komoto and prime-ministerial hopeful Kiichi Miyazawa have repeatedly called for increased public spending. They argue that stimulating domestic demand might help ease trade friction. This argument has grown in importance as US concern about the Japanese trade surplus has mounted. Stimulative action by Tokyo might also benefit construction firms, a key constituency of proponents of pump priming measures. [redacted] 25X1 25X1

Corporate Savings: Profit Driven 25X1

Japanese corporate savings performance depends largely on profitability (see figure 10). For example, the ratio of corporate savings to GNP tumbled in 1975 as raw material price hikes and large wage demands slashed profits. The corporate savings ratio has been relatively stable since then, as inflation has subsided. Successful efforts to reduce the raw material requirements per unit of output also played a part 25X1

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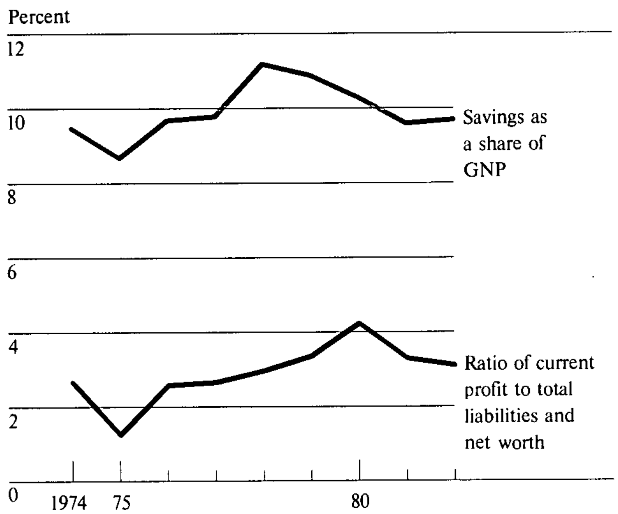
Figure 10
Japan: Corporate Savings and Profitability Ratios, 1974-82



[redacted]

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in the improved profits and increased savings during the late 1970s. Despite these efforts, dramatic changes in Japan's terms of trade still hold the potential for pushing around the corporate savings rate. Specifically, continued softness in world oil markets could brighten corporate profit and savings pictures. On the other hand, a sharp appreciation of the yen—although of benefit to some sectors, such as petrochemicals—could shave savings rates. [redacted]

Removal of Japanese barriers to imports is likely to impinge on profits and savings in the future, although probably only slightly. The protection afforded domestic industries by current barriers may have improved the industries' profitability, but we believe the fierce competition among domestic firms makes it unlikely such profits are very large. Thus, the removal of trade barriers through import liberalization probably will have a minimal impact on the savings rate compared with the potential fallout from sharp changes in the terms of trade and exchange rates. [redacted]

Putting the Pieces Together: The National Savings Rate

The contradictory trends in personal and government savings rates suggest that predictions of a falling national savings rate are premature. Moreover, projecting a national savings rate based on estimates of Japan's household, government, and corporate savings rates is more than a simple additive operation. Economists have long recognized that corporate and household savings affect each other and that there are trade-offs between these savings rates and government savings as well:

- A jump in the national wage scale frequently involves a trade-off between corporate and private savings. If wage increases exceed productivity gains, profits will suffer and corporate savings will fall. But personal savings may increase if the resulting income gain was unexpected.
- An increase in taxes, which by itself boosts government savings, may in its wake cut into personal or corporate savings rates. [redacted]

We believe it is too early to predict how these relationships will affect future Japanese savings rates. [redacted] We believe tax reform may prove a precursor of tax increases. If income taxes are raised, personal savings as a share of GNP probably will decline even further than the 2 to 3 percentage points mentioned above. In this case, despite the increase in government saving, the national savings rate probably will decrease. If it falls enough, the estimated 1 to 2 percent of GNP structural saving/investment imbalance may be erased. If such trade-offs do not occur or if consumption rather than income is taxed, however, the prospects for a sharp drop in Japanese savings rates seem to vanish and with them the likelihood of an end to perennial Japanese current account surpluses. In light of this, we believe Tokyo's fiscal policy moves merit close attention in coming years. [redacted]

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