

Japan's Revival. Can Economic Momentum Be Sustained?

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Right now, Japan is enjoying something of an economic resurgence.

- After a long battle with deflation, the Bank of Japan's latest quarterly outlook says it expects inflation to remain at around 2% over the next three years.
- Interest rates are now in positive territory for the first time in 17 years after a rise to a range of 0%–0.1% in March.
- The Nikkei share index has increased by more than 30% in the year ending 30 April.

The So What

The key question is whether this positive momentum can be sustained in the long term.

“The Japanese economy is on a good trajectory and there are many positive signs. But there are also significant headwinds. And there will need to be stronger economic fundamentals before declaring a recovery,” says Sam Karita, who leads the BCG Henderson Institute in Japan.

Some of the reasons for Japan’s current attractiveness to foreign investors include:

- Geopolitical stability as both a business location and a trading partner.
- Recent changes to corporate governance regulations providing greater transparency around company performance.
- The current strength of the dollar against the yen, which makes Japanese goods and services cheaper for dollar holders.

The Backdrop

Japan has been struggling with deflation and an ageing population for many years. Although it has enjoyed some growth, this has lagged well behind other large Asian economies including China and India.

Some of the underlying weaknesses in the economy include:

- Productivity rates remain stubbornly low. Japan ranked 30 out of 38 OECD countries for labor productivity in 2022.
- Japan has scarce natural resources and is a net importer. Exports will need to rise further to boost growth.
- The ageing population means that consumer demand will stay low and hinder meaningful GDP growth.

Now What

To sustain economic momentum, Japan needs to fundamentally improve supply. But there needs to be even greater effort still to increase demand given the declining population.

These are some levers to help strengthen the underlying economy:

Harness the power of AI. Automation and robotics have huge potential to increase productivity. This holds for both new areas such as semiconductors and traditional manufacturing hubs such as chemicals or engineering. There is also significant investment in GenAI already underway, and large language models are being trained on the Japanese language. This positions Japan well to take advantage of AI's potential to create new efficiencies as part of the end-to-end transformations that will follow.

Maximize the potential of the workforce. To increase overall productivity, the labor force that is freed up from automation efforts will need to be re-skilled and re-directed toward new value-adding workstreams. Individual companies should consider shifting internal resources to new roles which require empathy, agility, or other human abilities that can't easily be replicated with AI. At the industry level, there may need to be a shifting of resources toward the highest growth areas.

Target employee engagement. This is another important lever to improve productivity. Japan's workers report significantly lower levels of satisfaction than elsewhere, even taking into account a cultural bias toward muted survey responses, Karita says. Being willing to act swiftly to increase wages, when able, is vital to maintain satisfied workers. Many companies are also taking steps to actively improve employee well-being and provide a greater sense of purpose. Helping employees feel motivated and empowered to reach their full potential is also key.

Broaden the workforce. Policymakers have already seen significant success in encouraging more women in the workplace. There are also a number of schemes to encourage older workers to stay, or return to, the workplace. And in order to attract and retain more foreign talent, companies will need to ensure their workplaces are attractive, for example by offering training programs and competitive benefits.

Increase net exports. One of the biggest opportunities for future growth is within the technology sector. "Japan wants to make up for lost time and is investing heavily to reestablish itself as a leading player in the semiconductor industry, for example," Karita says. Many large Japanese firms are already market leaders in specialized technologies such as manufacturing image sensors or carbon fibers. And there are also many more relatively small companies that dominate the market in niche categories, thanks to strong craftsmanship and precision in design and manufacturing.

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