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People use the term "Japanization" in different ways. Depending on what the person has in mind, it could refer to a chronic situation of: low growth or economic "stagnation;" a shrinking population and/or workforce; too low inflation or outright deflation; low or even negative interest rates; or large budget deficits and mounting government debt. While these attributes tend to go together, some being causes and others effects, it is important to be precise as to what one means by Japanization; otherwise we risk talking past one another.

For many years, I equated "Japanization" with a situation of chronic mild deflation, because this was the phenomenon that characterized Japan's macroeconomy and set it apart from other major economies. Policymakers are not supposed to tolerate a declining price level, so the fact that deflation was the norm in Japan, to me, warranted using the term. In looking at Japan's deflation, I have always started with the GDP deflator, the measure of prices that links real to nominal GDP. Japan's GDP deflator peaked in the second quarter of 1994 and *declined* for the best part of 20 years (falling a cumulative 16.4%), and it is still about 12% below that peak. In the same period, the US deflator has *increased* by a cumulative 60%. A declining GDP deflator means that the growth rate of nominal GDP was consistently below that of real GDP, whereas it is normally above it.

Viewed through this lens, the rest of the world has not become Japanized. While disinflationary forces have been at work and consumer price inflation, which is what most central banks target (typically to be around 2%), has generally been running a little below target, GDP deflators remain on a rising trend.

A broader and perhaps more useful way to define Japanization is as a situation of chronically low interest rates, and that of the monetary and fiscal policy settings

that attend them. Looking at (nominal) interest rates, both policy rates and longer-term market rates, the rest of the advanced world *has* become Japanized. Most developed world central banks have cut their policy rates (typically an overnight rate) to zero, or close to it (some on the negative side of it) and many are implementing some form of "quantitative easing" (proactive balance sheet expansion). The Fed's target range for the federal funds rate is zero to 0.25% and the ECB's deposit rate is minus 0.5% and its main refinancing rate is 0%. Long-term rates are low too. Ten-year bunds are trading at around minus 50 basis points (bp) and 10-year treasuries are yielding around 80bp, while the Bank of Japan is targeting 10-year JGB yields to be around zero percent. "We are all Japanese now."

It important to distinguish real (or inflation-adjusted) interest rates from nominal interest rates. There is a growing consensus among economists and monetary policymakers that the "natural rate of interest" or the real equilibrium interest rate, known as "R-star," has become very low (perhaps even negative) and is set to stay low for a long time. The real equilibrium interest rate, an unobserved analytical category, is the interest rate associated with savings equaling investment at full employment with price stability. At a macro level, in a decentralized market economy, there is no reason to expect desired savings to be equal to desired investment; it is movements in the real interest rate that helps realized savings equal realized investment, which must happen, because investing is the mechanism by which society saves. If society wants to save more than it wants to invest, the real interest rate will be pushed down.

The simplest way to understand this, and its economic and policy implications, is to look at things at the level of the world as a whole. From the national accounting identity,[1] it turns out that private net savings (savings in excess of investment) must equal government net dis-saving or the budget deficit. The private sector can save more than it invests only by having the government (in aggregate) run a budget deficit of the same amount.

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[1] Real GDP for the world can be broken down into what happens to the output (consumption, investment, and government spending) or what happens to the income received from it (consumption, savings, and net taxes), and by equating the two, cancelling consumption on both sides, and rearranging it follows that net private savings (savings minus investment) and net government savings (net taxes minus government spending) must equal zero.

There are two broad explanations for private sector (desired) savings far exceeding (desired) investment and thereby putting downward pressure on real (and nominal) interest rates. This can happen when the economy is hit by a big negative shock and is pushed into recession, such as happened after the bursting of the 1980s asset price bubble in Japan, in the Global Financial Crisis of 2008-09, and with the Covid-19 pandemic this year. But, depending on how effective policy responses are, the real equilibrium interest rate being pushed lower should be a temporary not permanent condition of the economy.

A second set of explanations for (desired) savings far exceeding investment, and for R-star being low, focuses on structural factors. Three in particular seem indicated: increasing inequality (every extra dollar of income that goes to the rich is saved not spent); aging of the population (an aging workforce wants to save for its retirement but a mature economy has an abundant capital stock); and the economy becoming increasingly digital and virtual (investment becomes less commodity- and capital-intensive as more of it takes the form of software engineers writing computer code or, with the advent of machine learning and artificial intelligence, "machines" themselves doing so). I put most weight on the last factor: the unleashing of Moore's Law is most responsible for lowering R-star.

This widespread "Japanization" has deep implications: we need to rethink both the intellectual foundations and the institutional design of the existing macroeconomic policy framework. This framework, which assigns the primary responsibility for macroeconomic stabilization (keeping the economy at full employment with price and financial stability) to an independent, technocratic central bank, reflects the considerable social learnings of the twentieth century. This was generally a period of high potential and actual economic growth, a high natural rate of interest (R-star), and high inflation; a key imperative was to craft institutions that served to constrain the ability of government to print too much money by running large budget deficits.

But the challenges of a "Japanized" (low R-star) world are different, and macroeconomic policy thinking and the associated optimal policy framework need to be tailored appropriately. There are two clear implications. First, as is becoming increasingly recognized, in such a world, central banks are likely to find

themselves operating close to or at the "effective lower bound"[2] of policy interest rates and monetary policy loses much of its potency. Second, fiscal policy likely will need to be called upon more often and more actively, and it is not necessary for governments and society to be as concerned as they were in the past about large budget deficits and high and mounting levels of government debt.

What does this line of thinking mean for Japan? I would highlight three points.

First, widespread "Japanization" means that Japan, rather than facing its own idiosyncratic problems, is dealing with a common set of challenges. This is good news for Japan. Japan is not alone; it just got there first and has accumulated some valuable experience along the way.

Second, when it comes to reforming the way we think about, structure, and operate the macroeconomic policy framework, Japan has already got a pretty good framework that is amenable to evolution in the desired direction: that of closer coordination and joint activation of monetary and fiscal policy. I am referring to a revised (in 1998) Bank of Japan Act that is more about governing the place of monetary policy in the overall policy framework than central bank "independence" per se; the Council on Economic and Fiscal Policy, on which the BOJ governor sits; and the monthly meeting of the Economic Cabinet, to which the BOJ governor reports.

Third, Japan can jettison its pessimistic obsession with fiscal sustainability and its mooted looming debt crisis – spoiler alert: it is not coming – and focus on the real game: what it needs to do to ensure that it has the necessary productive capacity in the future, in terms of physical, human, technological, and social capital, to secure an adequate standard of living for an older population. Japan meets that challenge with formidable assets in hand: a big stock of financial claims on the rest of the world; a highly skilled workforce; strong technological capabilities; a very high level of social capital and demonstrated capacity to sustain it; and abundant scope to tap an attractive pool of young Asian immigrants, among them.

[2] This used to be called the "zero lower bound," but several central banks have pushed their policy rates into modest negative territory, something they can do because, at any point in time, they can determine the aggregate amount of reserves that banks have to hold.