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Conventional wisdom suggests that after a spectacular economic performance during the 1970s and 1980s, Japan has endured two "lost decades" that have seen it slip from its status as a premier economy to be overtaken by China in 2010 as the world's second largest national economy. It is useful to put such assertions into context to understand better both Japan's economic performance and its prospects.

This essay argues that Japan's economic performance over the past two decades has, in many ways, been better than is generally recognized. At the same time, Japan will face a number of economic challenges during the coming decades. To address these challenges successfully will require a comprehensive series of policy changes.

Japan's Economic Performance

Japan's annual growth in total output has slowed during the past two decades while China and other emerging economies are currently experiencing much higher rates of growth. This pattern is not unusual. There are certain conditions that facilitate rapid periods of growth such as Japan achieved during the Meiji Restoration in the late nineteenth century, when it opened its economy to the world, and during the years following World War II, when Japan experienced a major rebuilding of infrastructure and embraced more market oriented economic arrangements.

Both periods of rapid economic growth in Japan were times of substantial economic transformations.

Likewise, China and other emerging economies have produced impressive growth rates as they move from rural agrarian to modern industrial economies. Many emerging economies, including China, have also benefited from large inflows of foreign investment and technological know-how. Economically, it is much easier to catch up than to lead.

Economic growth is only one measure of the health of an economy and not necessarily the most important. The well being of individual citizens rests more heavily on how that growth is achieved. Assume two similar-sized economies that experience five percent real growth. One of them achieves it by employing five percent more workers and the other does so without any additional workers or hours worked but through productivity growth. The size of the economy in each is identical. What is different is that in the first instance the real standard of living for individual workers is unchanged. In the second instance, there is five percent more output to be divided. In terms of a nation's standard of living, the second economy is clearly superior to the first.

In the two most recent decades, Japan's economic performance is most appropriately compared with other advanced economies such as the United States and Germany. From1990 to 2010, annual GDP growth in the United States averaged 2.9 percent, while growth in Germany averaged 1.4 percent and Japan's growth averaged 0.9 percent. What accounts for these differences? As is usually the case, several factors contributed. Perhaps the single most important element involved demographic factors. Japan's population over these decades aged rapidly while its birth rate declined and immigration was negligible.

This combination of factors had a powerful effect on Japan's labor force. By 2011, the share of the Japanese population over age 65 was 23 percent, compared with 13 percent in the U.S. The aging of the population contributed to a 3 percent decline in the size of the Japanese workforce from 1995 to 2010. The average number of hours worked fell by 12 percent. Had Japan's workforce instead grown at one percent annually, similar to that of the United States, annual GDP growth in Japan would have averaged over 2.5 percent.[i]

Aggregate economic growth in Japan has slowed, but this is in large part because of a declining labor force and an aging population. At the same time, the standard of living continues to rise. A balanced assessment shows that the Japanese economy has in many respects performed better than is commonly believed. The comparison with the United States and Europe is in many ways the most appropriate, and in that light, Japan's economic performance compares favorably with Europe and slightly below that of the United States.

Current Strengths of the Japanese Economy

Few countries have sustained tragedies from natural disasters of the magnitude that struck Japan in March 2011. The Tohoku earthquake, the most powerful in Japan's history, triggered massive tsunami waves, which engulfed the coast and caused a series of nuclear accidents. The devastation killed nearly 16,000 people and collapsed or damaged more than a million buildings, along with roads, railways, and a dam. The World Bank estimated the economic cost at $235 billion, making it the most expensive natural disaster in world history.

In its wake, and with assistance from allies like the U.S., Japan has demonstrated remarkable resilience and adaptability in recovering from the shock. In the near term, Japan's economy should benefit from reconstruction spending with low inflation.

Japan is not a country blessed with abundant natural resources. It must import the overwhelming share of the oil, natural gas, and coal it consumes. Only a small portion of its land is arable and a large amount of its food comes from abroad.

Japan has built an outstanding economy based on a harmonious, diligent and highly competent workforce, an outstanding elementary and secondary school system that leaves few children behind, and a remarkable level of technological innovation that rests on an admirable research and development effort.

One should not take any of these three great assets for granted. The nation's commitment to hard work and sacrifice, so evident now and in the aftermath of World War II could easily drift into a contented complacency once the urgent task of rebuilding is behind it.

Likewise, the admirable intensity of the Japanese education system and the commitment of students, teachers and parents to its success require renewal and sustained effort. A culture that prizes education and appropriately rewards the development of great skills is essential. Each generation must recommit its members to excellence in education and lifelong learning.

Finally, Japan's research and development effort as a share of gross domestic product ranks among the highest in the world at 3.5% of GDP. Japan's effort compares favorably with that of the United States at 2.8%, with Europe spending 2.0% of its GDP on research and development.[ii] The technological prowess of Japan continues to benefit greatly its manufacturing enterprises, but this will require sustained investment if it is to persist.

The Principal Challenges for the Japanese Economy

The global economy is full of both promise and peril. The transportation and communications revolutions as well as advances in agriculture and the spread of other technological innovations are rapidly transforming many emerging economies.

In advanced economies there are two major challenges that Japan must address if its future is to remain bright. The first is the huge demographic challenge of a rapidly aging population and a low birth rate. Productivity increases alone will be insufficient to offset the graying of the workforce.

The second challenge is the level of public debt and how it will be financed. The debt burden being left to future generations is unlike that in any previous period of time and raises difficult questions regarding generational equity.

Demography

As Peter Drucker once observed, demography is the future that has already happened. For Japan, the future is a smaller and substantially older population with a rapidly shrinking portion of the population serving as the nation's workforce. Three crucial factors are playing a potentially major role in Japan's economic future.

Longevity. The domestic tranquility and healthy diet that most Japanese enjoy has contributed to one of the world's longest living people, with an average life expectancy of 83 (86 for women). This encouraging phenomenon brings with it a set of understandable demands associated with those who are older – for long-term care, medical services, and pension income. At the same time, the personal savings rate is likely to fall with a smaller portion of the population in their earning years.

Family Size. Not only are Japanese living longer, they are having smaller families. The statistics are stark. The number of children born per woman in Japan is now less than 1.4 -- only two-thirds the replacement fertility rate of 2.1 children. And this phenomenon has now persisted for decades. The Japanese birth rate has been below the replacement rate in every year since

1974. Barely 40 percent as many Japanese babies were born in 2007 as were born in 1947, sixty years before.[iii]

Immigration. A third element affecting the size of Japan's workforce is immigration. In 2010, there were an estimated 2.2 million foreigners living in Japan, less than 2 percent of the population. According to the OECD, Japan naturalized fewer than 15,000 new citizens in 2007. Indeed, Japan is the only wealthy nation with net out-migration over the past four decades.[iv]

The combined effect of these long-term trends is striking. Nicholas Eberstadt has estimated that "Thirty years from now there will likely be fewer Japanese under the age of 65 than there are today, and many fewer under the age of 50 – but many more over the age of 75. This Japan could have more people in their 80s and 90s than it has children under 15."[v]

Accelerating these trends is a flight from marriage by Japanese women. The Asia Research Institute reports than between 1970 and 2005, the proportion of never-married Japanese women in their late 30s more than tripled from 5.8 percent to 18.5 percent. Unless these trends are reversed, Japan's population is estimated to decline from over 127 million today to roughly 104 million in 2040. Significantly, the working age population – those aged 15 to 64 – is expected to fall by 30 percent from 81 million to 57 million.[vi]

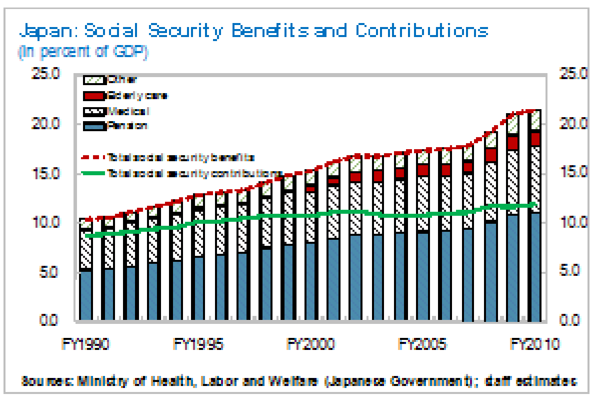
These trends will have several powerful economic effects. A shrinking workforce will make achieving Japan's economic growth goals more difficult. Even with solid productivity growth, increasing total output will prove challenging. With family arrangements becoming a less powerful force, the need for institutional settings to take care of a growing elderly population will rise, requiring more resources and personnel.

These trends will also occasion a number of other adjustments with respect to crucial parts of the economy such as real estate and housing. Japanese researchers project a 20 percent decline in the number of households by 2040, from 47 million to 38 million.[vii]

Debt

Japan has the highest ratio of gross public debt to GDP (over 200 percent) of any OECD country. Recent projections by the Bank for International Settlements suggest that if Japan remains on its current budgetary path, this ratio could rise to 600 percent by 2040.[viii]

Net public debt has increased nearly ten-fold over the last two decades to more than 125 percent of GDP. As a result of population aging, social security spending has risen rapidly (see chart), while persistently weak growth and deflation have depressed tax revenues.



(Source: International Monetary Fund, “Concluding Statement of the IMF Mission,” 2012 Article IV Consultation with Japan, June 12, 2012)

Japan’s net public debt is higher than almost all other advanced countries and is expected to rise further in the absence of a substantial change in fiscal policy. Even a relatively small increase in interest rates and the sovereign risk premium would make Japan’s fiscal situation even more precarious. In this respect, the recent experience of several countries in Europe is instructive. Once market confidence is lost, regaining it becomes extremely difficult. It is also the case that growth is essential to bring down the high public debt to more sustainable levels.

Fiscal Policy

Addressing the long-term fiscal imbalance will likely require a combination of spending restraint and revenue enhancement measures. The Japanese government is currently considering a plan to double the consumption tax rate to 10 percent in stages by 2015 as well as enacting restraints on some non-social security spending. The IMF has estimated that this plan would achieve a 5 percent of GDP improvement in the structural primary balance by 2020.

Small steps, however, are unlikely to prove sufficient. Many economists, including the IMF staff, believe additional measures are needed in order to achieve a primary surplus of about 3 percent of GDP by the early 2020s and put the public-debt-to-GDP ratio on a clear downward path. That would require additional spending restraint.

If Japan were to embrace such a goal, the means used to achieve it would make a large difference. In general, most economists prefer measures that are more likely to produce stable results and to improve incentives to work and invest. Such measures include revenue changes that are easy to administer and do not distort investment decisions. The way to address the regressive nature of consumption taxes would be through targeted transfers to low-income households. Likewise, further reductions in Japan's high corporate tax rate would enhance the incentives to invest. Other possible measures might include eliminating the tax deduction for dependent spouses and reducing the exemption for pension income.

In terms of budget outlays, raising the social security eligibility age, as other advanced economies have done or are contemplating, and introducing a form of means-testing for wealthy beneficiaries, are among the set of measures worth considering.

There are a number of powerful reasons for undertaking major fiscal reforms. An increase in net public debt as a share of GDP imposes a larger and larger burden on future generations. Likewise, it reduces the resources available for productive investments in physical, intellectual and human capital. Not least, if the trajectory of rising debt as a share of GDP is not addressed, Japan risks losing the confidence of investors in financial markets who will allocate their investments elsewhere, as Greece and other countries have experienced.

The most recent IMF report on Japan shares the view that such changes are essential to achieving sustained economic growth.

Fiscal adjustments are invariably difficult and are enhanced by rules that provide genuine and needed discipline, such as the budget caps (spending limits) and pay-go rules adopted by the United States during the 1990s. Such spending limits can be imposed ministry by ministry or in broader categories. Other measures that involve discipline include restricting the use of supplementary budgets and tax expenditures. Successfully implementing such measures heavily depends on public support, which is more likely if political leaders persuasively explain the need for reform.

Deploying Resources Efficiently

Japan has serious labor problems as a result of a declining population. There are several avenues Japan could pursue to address this challenge: (1) encourage workers to remain in the labor force longer; (2) attract more women into the labor force; and (3) increase immigration. Among the measures it can take to address this are to:

- Raise the eligibility age for social security and retirement programs; one way of doing this would be to gradually increase the age by three months each year for the next twenty years or for a total of five years.

- Expand childcare facilities, which are currently highly regulated, thus encouraging greater female labor participation.
- Eliminate the tax deduction for dependent spouses.
- Increase immigration and the recently introduced "points-based" system that gives preferential treatment to highly-skilled professionals. This could be expanded to help meet shortages in long-term nursing care and other sectors.

In comparison with many economies Japan has relatively limited availability of risk capital. This is especially true for startup companies and many dynamic small and medium-sized enterprises. Specifically, Japan could reduce the role of the government in allocating credit through government-backed guarantees for small and medium enterprise loans. This would ensure a level playing field and could improve the availability of risk capital. Public pension funds could also become an additional source of investment capital as in some other countries.

Enhancing Healthy Competition

Another area worthy of consideration is the benefit of healthy competition, as reflected domestically in antitrust policies and internationally in trade policies. The economic benefits of international trade are well known and represent one of the main drivers of global prosperity in recent decades. These benefits also bring with them adjustments for some economic sectors, workers and companies. Reducing Japan's barriers to trade, both tariff and non-tariff, requires the political commitment and will to overcome domestic interests fearful of more open trade, notably in agriculture and services. Concrete steps to do so include joining and actively participating in the Trans Pacific Partnership (TPP) as well as pursuing free trade agreements with Japan's European trading partners.

The clock is running. The 12th TPP round of talks began in early May 2012 in Dallas, Texas. Canada and Mexico, the first and third largest U.S. trading partners, have now been invited to join the talks. Japan cannot afford to be left out. Should Japan and South Korea join, the free trade area would include more than 700 million people with a combined GDP of $26 trillion. Current estimates are that by 2025 this integration in the Asia-Pacific would generate almost $2 trillion in additional trade.[ix]

Dealing with Deflation

Japan has now experienced mild deflation for more than a decade. This has raised the real level of debt and contributed to lower private investment because of high real interest rates.

Prudent monetary policy can help. The Bank of Japan's recent adoption of a price stability goal of 1 percent has helped to clarify the objective of monetary policy. Monetary easing on several occasions over the past year, through sizeable asset purchases, has supported the recovery. More, as the IMF advises, may be necessary.[x] Goals are useful but they should serve as one's servant and not master. Given the past two decades, should Japan reach the 1 percent inflation goal, raising it modestly further could prove wise.

The sustained deflationary period of the past two decades suggests the wisdom of pursuing fiscal policy that shows a determined commitment to reducing public debt, as well as further quantitative easing through monetary policy to enhance the outlook for growth.

Conclusion

Japan has proven itself resourceful and agile in the past and will need both qualities to successfully deal with the demographic and debt challenges it faces. At the same time, it needs to sustain the quality of its labor force, continue its commitment to research and development, address its fiscal imbalances, and further reduce barriers to trade. Unless its birth-rate rises and immigration increases, its shrinking population will make meeting its economic goals even more difficult.

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[i] Robert Dekle, "Remember Japan?" The Milken Institute Review (Second Quarter 2012), p. 8.
[ii] Eurostat, "Gross Domestic Expenditure on R&D, 2000-2010 (% share of GDP)," January 2012.
[iii] Nicholas Eberstadt, "Demography and Japan's Future," American Enterprise Institute Policy Studies, July 4, 2011, p. 1.
[iv] *Ibid.*
[v] *Ibid.*
[vi] *Ibid.*, p. 2.
[vii] *Ibid*., p. 4.
[viii] Nicholas Eberstadt, "Japan Shrinks," The Wilson Quarterly, Spring, 2012, p. 35.
[ix] Claude Barfield, "A Big Deal: Canada and Mexico Join the Pacific Trade Pact," The American, June 26, 2012.
[x] International Monetary Fund, "Concluding Statement of the IMF Mission," 2012 Article IV Consultation with Japan, June 12, 2012.