Japan's successful economic model

By Adair Turner

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Japan's GDP growth lags most other developed economies, and will likely continue to do so as the population slowly declines. But what matters for human welfare is GDP per capita, and on this front, the country excels.

Nearly everyone says that Japan's economic model has imploded. Since 1991, growth has averaged just 0.9% versus 4.5% over the previous two decades. Slow growth, combined with large fiscal deficits and near zero inflation, has driven government debt from 50% of GDP to 236% of GDP.

Abenomics, the cluster of reforms initiated by Prime Minister Shinzo Abe when he came to power six years ago, promised to get inflation up to 2%. But five years of zero interest rates and massive quantitative easing have failed to achieve this. A fertility rate of 1.4 and near-zero immigration mean that Japan's workforce could shrink by 28% over the next 50 years, making health care for the elderly unaffordable and dramatically increasing the fiscal deficit, which is already running at 4% of GDP.

Tax increases and public expenditure cuts to reduce the deficit are essential if a debt crisis is to be avoided. Structural reform is needed to raise the anemic growth rate.

Despite all this, the prevailing wisdom about the supposed failure of the Japanese model might be wrong. While Japan's demographic decline poses challenges, it may also imply some advantages: and Japan's debts are far more sustainable than they appear.

True, Japan's GDP growth lags most other developed economies, and will likely continue to do so as the population slowly declines. But what matters for human welfare is GDP *per capita*, and on this front Japan's 0.65% annual growth in the decade since 2007 equals the US and is better than the UK's 0.39% and France's 0.34% – not bad for a country starting with one of the world's highest living standards.

True, over the last 25 years, US *per capita* growth has been faster; but Japan's economy is not disfigured by the massive increase in inequality that has left many American workers facing stagnant real wages throughout that period. Unemployment is below 3%.

As a machine for delivering prosperity to a wide range of citizens, Japan's economy therefore compares well today with almost any other. With crime rates among the lowest in the world, the Japanese social model must be doing some things right. And tourism is booming, with the number of foreign visitors up from six million to almost 20 million in the last 15 years.

Of course, what's true today could be demographically unsustainable tomorrow; and if Japan's birth rate remains permanently at 1.4, rapid population decline could pose severe problems. But warnings that the ratio of workers to retirees will fall from 2.1 to 1.3 overstate the case, because they arbitrarily define working age as ending at 65, and ignore the potential to increase retirement ages, as the Abe government is now doing. If the average age at which people stopped working rose to 70, the ratio of workers to retirees would still fall, but only from 2.1 today to 1.8 in 2050.

Moreover, Japan leads the world in the technologies that can enable older people to remain economically active longer, and in the robotics that allow goods and services to be produced by ever fewer workers. Fears that robots will destroy jobs are notably absent in Japan's national debate. A recent book extolling the benefits as well as challenges of *The 100-Year Life* has been a bestseller.

In a world of radical automation possibilities, high and rising life expectancy and a declining population are better problems to face than the rapid population growth that threatens to overwhelm job creation in some emerging-market economies.

As for government debt and unsustainable fiscal deficits, doom-mongers who warn of an inevitable crisis if belt tightening is not soon imposed are likely to be disappointed. Japan's gross government debt may be 236% of GDP, but after netting out government-owned financial assets, the International Monetary Fund estimates net debt at a much lower 152%.

Moreover, the Bank of Japan owns government bonds worth 90% of GDP, and ultimately returns to the government as dividends all the money it receives from the government as interest on the bonds it holds. Deducting both public financial assets and all the debts the Japanese government and people effectively owe to themselves, the debt level is only about 60% percent of GDP and not rising. This level of debt could be sustainable even if fiscal deficits remain high for many years.

To see why, suppose a country had gross government debt of 250% of GDP, net debt of 150%, and central bank bond holdings of 100% of GDP, leaving net debt of 50%. Then suppose that inflation and real growth were steady at 1% each, so that nominal GDP grows at 2%. With bond yields at 2% (versus 0.1% in Japan today), those debt ratios would remain stable even if the government ran a primary deficit of 4% of GDP, and a total deficit of 5%, year after year.

That is roughly what Japan is doing now. Far from reacting in horror at this clearly unsustainable behavior, bond buyers around the world still line up to buy government bonds in return for yields that are little more than zero.

None of this is to deny important challenges. Health-care costs could drive fiscal deficits up further. And economic theory suggests that at some point, bond yields should be higher than nominal GDP growth. For both reasons, a medium-term plan for some fiscal consolidation is desirable. And, in the absence of an increase in the birth rate or at least some immigration, the technological progress that Japan seeks will be essential to cope with an aging society.

But the commonplace gloom about Japan's prospects is grossly overdone. Many countries would be lucky to have Japan's problems.

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