

Is the World at Risk *of the* “Japan Disease”?

Scholars and experts are wrestling to define the nature of globalization in the twenty-first century. To what extent can the global picture of 2017 be described in one sentence: Significant parts of the world are at risk of becoming more like Japan. In other words, the world's public and private debt today is approaching 300 percent of GDP. Yet despite an extraordinary degree of monetary expansion and relatively tight labor markets, a number of central bankers are finding it tough to meet their inflation targets. Meanwhile, wage growth remains modest. Productivity growth gains are disappointing. As Japan has done in recent years, some central bank authorities, including those in China, are purchasing equities to stabilize stock markets. Has the world been afflicted with a kind of “Japan disease”? Or is the current global environment a temporary development? Or is Japan doing better economically than advertised? If a negative Japan-like scenario is a risk for significant parts of the world, what policy steps would potentially lead to the avoidance of such a scenario?

**Twenty international observers
offer their thoughts.**



Yes, there are significant risks of Japan-like outcomes—namely stagnant growth and deflation.

STEPHEN S. ROACH

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For the past seven years, I have taught a very popular seminar at Yale, “The Lessons of Japan.” The first half of the course is a deep dive into the rise and fall of the modern Japanese economy, with an aim toward distilling key lessons from a stunning collapse. The second half of the seminar uses the tools of forensic macro to ascertain the relevance of those lessons to other major economies in the world—especially Europe, China, and the United States.

The short answer to the question of whether the world is at risk of the “Japan disease” and the major conclusion of this seminar is that there are, indeed, significant risks of Japan-like outcomes—namely stagnant growth and deflation—in other major economies of the world.

The lessons of Japan are many—from a dysfunctional mercantilist growth model and the toxic *zaitech* of financial engineering to condoning asset bubbles and productivity-inhibiting zombie corporates. But the most salient lesson pertains to the insidious sequencing of policy gambits that stem from what can be called the political economy of false prosperity. Convinced that the (lifetime) employment guarantees of what Chalmers Johnson dubbed a “plan-rational development state” were all that ultimately mattered, Japan, in effect, succumbed to the alchemy of a failed growth experiment.

A similar temptation can certainly be detected elsewhere. The political economy of growth imperatives is a common thread that runs through the policy and regulatory blunders that have given rise to Europe’s dysfunctional currency union, China’s unbalanced state-directed producer model, and America’s property- and credit-distorted bubble economy that culminated in the Great Financial Crisis.

In all of these cases, there is strong insistence in policy circles that the lessons of Japan have been heeded and that, as a result, similar outcomes are unlikely. That’s especially the case in the United States, where Fed

Chairmen Alan Greenspan and Ben Bernanke argued that a quick policy response was all that was needed to forestall a Japan-like outcome.

It is also the case in China, where there continues to be active debate over the possibility of the Japan syndrome; the now famous “authoritative person” interview featured in China’s *People’s Daily* in May 2016 is a particularly prominent case in point, where a senior Chinese official warned of the Japan-like perils of debt-intensive, bubble-distorted economic growth. Having given several presentations in China on the lessons of Japan, I can personally attest to avid Chinese interest in this topic.

In the end, however, it’s not enough simply to recognize the risks. It is delusional to think that the interplay between real economies, asset markets, and financial systems can be pushed to excess without severe and lasting consequences.

Similarly, it is ludicrous to believe that the “big bazooka” of massive monetary and fiscal policy responses can successfully address post-bubble carnages. The persistence of sharp growth slowdowns and below-target inflation outcomes in most major economies in the world today is *prima facie* evidence of lessons unlearned.

That gets to the toughest lesson of all—the misplaced notion that a reactive policy function is a substitute for a proactive growth sacrifice. Bubble-induced prosperity is a recipe for systemic failure.

Yet political economy pressures have led to a succession of misplaced growth gambits and the related contagion of the Japanese disease. As Japan’s third lost decade underscores, the cure remains as elusive as ever. And at Yale there continues to be a long waiting list for my seminar on the lessons of Japan.



The symptoms of Japan disease do appear to be spreading around the world.

SCOTT BESSE

CIO and Founder, Key Square Capital Management

The question of whether the world is at risk of the “Japan disease” mirrors the difficulties that an infectious disease specialist would have in identifying

a pathosis that should have devastated any other patient years, if not decades, ago. Japan is what is known in medical jargon as Patient Zero, the first case of a condition or syndrome to be described in the medical literature. That patient usually has the most basic, least mutated form of the disease, which may either make them invaluable to medical efforts or completely useless.

Indeed, if we continue the medical analogy, the patient is extraordinarily healthy as measured by many metrics. Recent OECD Economic Survey data show the probability of becoming unemployed as a Japanese citizen is the lowest in the developed world. Net household wealth ranks among the world's highest. Japan's net external financial position is the largest of any country. Literacy and personal safety also score the highest, and World Health Organization statistics show Japanese citizens enjoying the longest life expectancy.

So what are the symptoms of the Japan disease and why do we care about this malady emanating from Tokyo? In a seminal 2016 paper, "Japanization: Is It Endemic or Epidemic?" Columbia University Professor Takatoshi Ito, an early critic of the Bank of Japan's policies and an advisor to the Abe government, defines "Japanization" as a combination of the following four economic conditions:

- The actual growth rate is lower than the potential growth rate for an extended period;
- The natural real interest rate is below zero and also below the actual real interest rate;
- The nominal policy rate is zero;
- The inflation rate is negative (that is, deflation).

Based on this rubric, some of the symptoms of the Japan disease do appear to be spreading around the world. The European Union and the United States have been struggling with weak inflation, below-trend GDP growth, and nominal policy rates that are only now starting to move away from zero.

However, two factors unique to Japan made the duration, depth, and durability of the Japan disease possible.

First, the structure of Japan's bond market and the country's persistent current account surplus during the deflationary decades has allowed the government to grow its gross debt-to-GDP ratio nearly four times since the early 1990s. Historically, less than 10 percent of Japanese government bonds are held by foreigners, giving the Ministry of Finance a committed domestic pool for its issuance.

Second, the tradition of social cohesion in Japan has not spurred the government to radical policies. Despite stagnant wages, there has been little widespread labor unrest or punitive policies aimed at Japanese corporates. Contrast this with the rise of populist parties and politicians in the United States and Europe.

Given these Japan-specific factors, what lessons can other advanced economies learn from Patient Zero? First and foremost, countries diagnosed with Japan disease should pursue monetary easing in an aggressive and timely manner. As Ito and Frederic Mishkin (2006) describe, Japan's inability to escape the most pernicious symptom, deflation, was ultimately "a failure of monetary policy."

As evidence of this failure, GDP growth in Japan had been consistently lower than nominal JGB yields from the bursting of the bubble in 1992 to the beginning of Abenomics in 2013. With risk-free interest rates higher than nominal growth, monetary policy had been incentivizing the private sector to deleverage for two decades. Naturally, this deleveraging led to weak inflation outcomes and embedded deflationary expectations among Japanese citizens.

Indeed, as *Financial Times Japan* noted in their "Deflated Generation" piece last year, the current cohort of Japanese twenty-year-olds is "the first to have lived its entire life with the economy in a broad state of deflation." As Tokyo University Professor Hiroshi Ishida explains, "economic factors have stripped away the incentives for young Japanese to leave home, buy cars, marry, have children, take risks, and generally grow up."

Thankfully, the European Union and the United States appear to have taken the lessons learned from Patient Zero to heart. Since the financial crisis, monetary authorities have been far more proactive than during Japan's two lost decades, with the European Central Bank and the U.S. Federal Reserve intervening in bond markets via aggressive quantitative easing.

Thus far, this has largely forestalled widespread deleveraging and prevented deflationary expectations from taking hold. This offers some hope that the United States and the European Union can avoid Japan's costly mistakes.

Finally, lost in the myriad of *ex post* working papers, academic articles, and monetary and fiscal policy advice is what economists, historians, and policymakers should properly define as the real "Japan disease"—the negligent asset bubble that was allowed to develop from 1986 to 1991.

Today as global central bankers continue to provide substantial monetary stimulus to achieve arbitrary inflation targets, they should be extremely wary of how the virus of asset inflation enters a host country's financial membrane. It is unlikely that any country other than Japan could have survived this type of financial excess with a chance of a recovery, albeit at the expense of a lost generation. Other potential host nations will likely find such a virulent disease devastating and perhaps fatal.

John Zhou and Lindsey Raymond contributed to this article. The views presented in this article are purely the opinions of the author and are not intended to constitute investment, tax, or legal advice of any nature and should not be relied on for any purpose.



No, the world is not becoming like Japan, but there are lessons to be learned.

EWALD NOWOTNY

Governor, Oesterreichische Nationalbank

Let me give you a clear answer: No. The world is not at risk of ending up in a situation akin to Japan's. However, both the world economy and the Japanese economy do face substantial structural challenges. Thus, the world can still learn from the Japanese experience.

Debt levels are elevated both around the world and in Japan. However, the similarities end here. For Japan, the problem of elevated debt is a domestic issue, which certainly is a boon. Yet demographics create a very pressing situation in Japan. The working-age population is shrinking, and this weighs on the overall economy. Japan therefore cannot hope that economic growth substantially helps reduce its debt burden. So for Japan, deleveraging needs are quite uncomfortably linked to demographic developments.

For the world, foreign debt is far more problematic than for Japan. Imbalances in debt and asset holdings persist, which is the challenge here. Then again—from a global perspective—demographic developments are much more positive. Unlike in Japan, it is thus easier at the global level to boost overall income just by putting more people into work; and rising income, in turn, makes it easier to pay back debt. This is not to say that deleveraging is not a necessity, but demographics actually make a bigger debt burden easier to cope with for the world than for Japan.

Labor markets, however, tell a somewhat different story. Numbers of nonstandard employees have doubled over the last two decades in Japan, with nonstandard employees now accounting for far more than one-third of the labor force. Not only do nonstandard employees have substantially lower incomes that grow at a slower pace, they also have only constrained access to on-the-job training and qualification measures. Firms simply do not invest in these people. This is not only a substantial drag on wage growth, which adds to the deflationary environment, but it also constrains productive capacity. The combination of restrained productivity growth and the aforementioned unfavorable demographics will be enormously demanding for Japan.

Looking at the world at large, skill-biased technological changes are likely to enhance the pool of nonstandard employees significantly in the future. As in Japan, this could not only affect wage growth but will also considerably impact the productivity of nonstandard employees. Growth potential will be lost. In the medium term, it will therefore be crucial to implement sensible reforms that help boost qualifications at the lower end of the labor market and counteract the dequalification of large sections of the workforce. This is a key lesson that we can draw from the Japanese experience.



The problem is that Japan's saving continues to exceed public and private investment by a good margin.

RICHARD N. COOPER

Maurits C. Boas Professor of International Economics, Harvard University

Analogies are usually fraught with misinterpretation, and are often deeply misleading. Japan has a number of distinctive characteristics, too many to be listed here, but starting with its aged and aging society and the declining number of young adults which, together with cultural hostility to immigration, conduces to a relatively stagnant economy in a world of rapid change. And despite its relatively high public debt, Japan has ample overseas assets to assure high consumption for years to come.

The entire world is aging, but at very different rates. Many countries—the United States and India among the major ones, mainly through immigration in the U.S. case—will experience a rising number of educated young adults in the coming years, which if well managed will invigorate their economies.

There is one respect in which Japan provides a warning: saving continues to exceed public and private investment by a good margin. If this phenomenon were to become general—and we see it strongly in other countries such as Germany, the Netherlands, Sweden, and Switzerland—it would lead to a period of secular stagnation in the world economy.

But while not robust, economic growth seems now to be adequate in the United States and Europe, not to

mention China and India, to avoid that possible outcome. And the Chinese initiative of One Belt and One Road, if carried out as promised, with mainly Chinese financing, should assure reasonable growth also in many Asian and African countries in the coming years.

I do not worry about large central bank liabilities. When economic circumstances permit, they can be reduced with relative ease, and in any case may well remain permanently higher than the world was accustomed to before 2008.



The world's problems are significant, but we're not becoming like Japan.

AUSTAN GOOLSBEE

Professor of Economics, University of Chicago Booth School of Business, and former Chairman, Council of Economic Advisers for President Obama

It's an important question, but let's not confuse what it means to "become like Japan." The lost-twenty-years era in Japan was about a popping asset bubble followed by an extended period of no growth. The other things that went along with that slowdown, such as large accumulations of public debt to pay for stimulus, infrastructure, and more, the deflationary environment, and the complete breakdown of inflation expectations, were the result of slow growth.

The troubling question about "becoming Japan" is not about the symptoms. It is about whether the world is in for twenty years of no growth.

As a statement about the world economy, though, it seems very unlikely to me. The global economy has major issues it will need to confront in the coming decades, but they aren't really the problem of Japan.

At a fundamental level, Japan's labor force grew less than 1 percent combined over more than a decade. That has undermined the raw growth rate in Japan quite seriously. As previously documented by authors in these very pages, on a per capita basis, Japan's growth was not actually that bad over the period—faster than Germany and, perhaps, even the United States. There were issues with zombie banks and corporations that needed to be shuttered sooner, but fundamentally it was a demographic story.

In the emerging markets, where they continue to have population growth and robust domestic and international investment, it's not a demographic problem. The economic issues they face such as accumulating debt, dealing with large commodity price fluctuations, or reducing corruption are more likely to end up as traditional emerging market crises if things go badly awry than to turn them into Japan.

Japan's problem wasn't primarily caused by excess dollar-denominated debt, by excessive government spending, or the like. Those were the symptoms of stagnation, not the cause of Japan's problems.

All of that said, many advanced economies will face that demographic squeeze of Japan. Some already have. For that part of the world economy, they may already be Japan.

But in the United States (so long as there is not a radical disruption to immigration), the Japanese experience of taking twelve years before level of GDP returned to the earlier peak just has not been repeated, and it seems quite unlikely to be repeated going forward.

Yes, the issue of slowing productivity growth is a major problem, as are the issues of stagnant median wages and growing income inequality. We will face some tough decisions regarding these in the coming years. But that's not really what it means to become Japan.



The world will be very lucky if it ends up as Japan is now.

BERNARD CONNOLLY
CEO, Connolly Insight, LP

Japan set the template for the world thirty years ago in the bubble economy, in which *ex ante* real rates of interest were held far below the rate of return anticipated, however unwisely, on investment. Despite that example, U.S. Federal Reserve Chairman Alan Greenspan followed a similar course in the second half of the 1990s. In both cases, asset bubbles were the inevitable consequence.

That malignant lunacy, the euro, and the constraints faced by the Chinese authorities in coping with the

globalization of a formerly Communist economy, further distorted intertemporal price signals, not least for emerging-market economies.

Whereas Bank of Japan Governor Yasushi Mieno deliberately burst the bubble in Japan, Greenspan and his successors reacted, when rate-of-return expectations crashed, by pushing *ex ante* real rates of interest down, far below any reasonable guess of the rate of household time preference.

There is no benign end to this process—or to “whatever it takes” in the euro area or to credit expansion in China. If *ex ante* real long rates are below the rate of time preference, the expected path of consumption relative to income must be downwards, unless there is a credit bubble—in which people ignore the No-Ponzi-Game constraint—or an asset-price bubble—which, by deluding people into thinking future consumption possibilities are higher than they actually are, offsets what would otherwise be a downward drag on current consumption.

But ignoring debt constraints and inflating asset values produces the risk—and eventually the materialization—of financial crisis. And, in conjunction with deteriorating growth in productivity and real wages in the Western world resulting from a combination of the distortion of capitalism produced by false intertemporal price signals, the distortion of society produced by replacing education with Cultural Marxist indoctrination, and mass immigration, they have effected a massive shift in both the functional and the personal distribution of wealth and have required “workers” to borrow more and more. In fact, they have led to outcomes which are represented, however inaccurately, as confirming Marxist predictions about capitalism.

Getting intertemporal prices right is crucial, combined with radical deregulation. But abandoning distortionary monetary policy now would produce a market crash—arguably a good thing from a sociopolitical perspective but likely to create a deep recession unless offset by a vast program of public-private infrastructure investment, possibly financed by wealth taxes. And deregulation might have to be accompanied, in advanced economies, by restrictions on immigration.

One cannot espy any political group with quite that combination of proposals. Perhaps U.S. President Donald Trump comes closest to it in some, but unfortunately not all, respects.

If Trump fails, which is far from unlikely, the risk of sociopolitical chaos in the United States will be substantial, and such chaos is inevitable in the euro area and is a major risk for China and emerging markets. Worse, the degradation of culture and society by political correctness in the “education” system in the West may be irreversible. The world will be very lucky if it ends up as Japan is now.



*Interesting question,
difficult to answer.*

JIM O'NEILL

Former Commercial Secretary to the Treasury, United Kingdom, and former Chairman, Asset Management, Goldman Sachs International

What an interesting question, which is so hard to give a simple answer to. But if pressed, the answer is no, for a few reasons. First, a large part of Japan’s problem is due to their extremely weak demographics, with a declining working population and growing dependency ratio. While other major countries have some signs of this demographic challenge, none are yet in the same state as Japan, with the possible exception of Italy within the G-7. I should add that unless birth rates improve and/or more immigration is encouraged, then others will have the same problem within the next twenty years, including Italy, possibly Germany and elsewhere, importantly, and maybe China and Russia. A lot of Japan’s weak GDP growth and rising debt is due to this, and not the lack of success of quantitative easing. Indeed, so far this decade, Japan has grown on average by 0.9 percent. This growth is in line with most sensible estimates of their potential growth, and positive-adjusted for the population, that is, GDP per capita has grown. Last, this growth has been faster—until recently—than growth in the euro area.

Second, a number of other places have grown in line with their potential, oddly including the very chaotic United Kingdom, and of course, the likes of China and India, the latter two which are by definition becoming a bigger share of global GDP. As a result of these two countries, world GDP growth has been around 3.4 percent since 2011, which is actually the same as the average in the 1980s and 1990s. So this casts doubt on the underlying premise of the question, although it is clear that the question has some validity to the United States, especially in the euro area, and maybe some other places. And of course, if we didn’t have such extraordinarily friendly monetary policy, would growth be as strong as it is in the few places where it is?

Third, and what makes the question especially intriguing, is that recently some of the key places where the

Japan comparison is so tempting have shown evidence that something is changing. In the euro area, economic growth is probably close to 2 percent if not possibly more, and this would of course would be very gratifying if it were permanent. I should quickly add that inflation does remain remarkably subdued. I would also add—and this is very important for your editor, and your readers—debt in the euro area has been improving, and deficits in general actually notably improved. Of course, within this, Germany is running fiscal surpluses and thus seeing its government debt fall sharply. And despite many comparisons to Japan, China has managed to pursue policies that brought their brief period of reported deflation to a close very quickly.

Still, many key places around the world continue to have remarkably generous monetary policies, and it remains a large unknown as to what would happen to growth if policy were tightened sharply. I suspect we are not about to run this risky experiment any time soon!



*Governments must
act as both borrower
and spender
of last resort.*

RICHARD C. KOO

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The Escape from Balance Sheet Recession and the QE Trap:
A Hazardous Road for the World Economy (2014)*

My contribution in the previous issue of *TIE* argued that the United States and Europe are suffering from the same balance sheet recession that has afflicted post-1990s Japan. With the private sectors in these countries saving massively in order to repair damaged post-bubble balance sheets, their governments must act as both borrower and spender of last resort so as to avoid the paradox of thrift resulting in depressing their economies.

Another challenge that the West and Japan are facing together is that their domestic manufacturers have found out that the returns on capital are much higher in emerging countries than at home. This is the result of improved educational standards, better infrastructure including information technology, as well as lower wages in the emerging economies.

As a result, businesses in developed countries have been investing massively in manufacturing capacities abroad. The entire east coast of China is now covered with factories while there was not a single businessman in 1979 when Deng Xiaoping opened China's economy. This shows the enormous amount of money that developed countries have poured into the country since then.

As manufacturing is where large productivity gains can be expected, its shift to emerging economies has left developed countries largely with service industries where productivity increases are typically slower. As a result, domestic wages and productivity growth will remain stagnant. Stagnant wages, in turn, will make consumers much more careful about the value for the money, making it difficult for businesses to raise prices.

With more businesses investing abroad, there is also reduced demand for borrowing at home, even at very low interest rates. This reduction in demand for funds diminishes the already depressed demand for borrowing from deleveraging households and businesses who are repairing balance sheets.

Weak or non-existent demand for funds means the money multiplier is very low or even negative at the margin, making monetary policy largely ineffective. As a result, central banks are unable to meet their inflation targets.

At the same time, fiscal policy becomes more effective with the reduced risk of the "crowding-out effect." Government bond yields have also fallen to unthinkable low levels as the private sector continues to save and the government is the sole borrower.

This means advanced countries are all facing an additional paradox of thrift problem in that households continue to save for an uncertain future but businesses are no longer borrowing and investing at home. In order to counter this problem, government must borrow those excess private savings and invest them in public works projects that can earn the social rate of return in excess of the low government bond yields.

The projects need to be self-financing because this is a long-term challenge and public debt is already very large in many countries. The sad state of social infrastructure in the United States and many developed countries means there should be many renewal projects that could be self-financing at the current low level of interest rates.

The United States and Western Europe started losing manufacturing when they faced competition from Japan in the 1970s. All three then faced competition from the Asian Tigers and China in the 1990s. It is time for advanced countries to face up to this reality and set their best and brightest to unearthing self-financing public works projects until domestic investment opportunities present themselves again.



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Many advanced economies will face a version of this disease.

If you ask most people, they would likely tell you that Japan is doing poorly. Policymakers have failed in their efforts to restore growth and to avoid deflation. This is largely wrong. Since 2000, output per hour worked in Japan has risen at an average annual rate of 1.36 percent—well above the G-7 average. And prices today are roughly what they were in 2000. On these key measures, Japan’s economy is performing well, not badly.

Yet things could be better. The government could be far more aggressive in implementing structural reforms (the first arrow of Prime Minister Abe’s three). And inflation could be closer to 2 percent, but we applaud the aggressive policy of the Bank of Japan, with its large balance sheet and long-term interest rate cap. While falling short of its inflation target, the Bank of Japan has kept the country from a severe deflation.

Japan does face big challenges. The “Japan disease,” if that’s what you want to call it, is the combination of high government debt and an aging population. At 240 percent of GDP, gross government debt tops the global rankings. And, at 84 years, so does Japan’s life expectancy at birth. Combined with one of the lowest fertility rates and very low immigration, this means that the Japan’s population is aging and its labor force is shrinking. Today, more than one-quarter of Japanese are over 65!

As the government financial demands grow, the overall size of the economy is likely to shrink. That is, there will be a shrinking pie, produced by fewer and fewer workers, to be divided up among more and more people. Something

will have to give. But what? Japan will have to find a way to increase taxes on those working and lower the real value of its promises to bondholders, to the elderly, or to both.

Many advanced economies, especially those in Western Europe, as well as China, will face a version of this disease in the next decade or so. They too have high government debt and aging populations.

These countries need to redesign pension and health-care systems to manage the wave of people that everyone knows is coming. This will involve lengthening working lives, increasing saving, encouraging female employment and immigration in places where it is low, and possibly reducing the generosity of planned benefits. Only then can we maintain standards of living. Hopefully Japan will show us the way.



The world is unlikely to drift into a Japan disease.

ANNE O. KRUEGER
Senior Research Professor of International Economics, SAIS-Johns Hopkins, and former First Deputy Managing Director, International Monetary Fund

Japan’s economic malaise began when its huge asset bubble burst. For years, the Japanese authorities believed that growth would resume and enable a reduction in the ratio of sovereign debt to GDP. In fact, as the Abe government has recognized, structural reforms were also needed both to offset the demographic downturn and to permit large gains in productivity through liberalization of much of the domestic economy. Until recently, however, structural changes were minimal, and among those that were made, some—especially the move toward a two-tier labor market with “temporary jobs”—made things worse. Japan’s large debt contributes to making the situation more difficult, but the debt leads to slow growth just as the slow growth leads to more debt.

The global financial crisis had its roots partly in the financial bubble and buildup of bad credit in the housing sector of the same type that had afflicted Japan. The situation was not so dire, however. The bubble was not as large; the initial debt burden was not as high; and although there

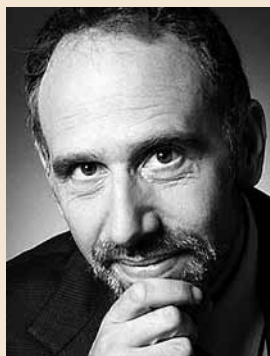
were structural issues in most other advanced economies, they were generally far less severe than those in Japan. Moreover, the response was much more rapid. The relatively prompt cleanup of the banks, imposition of stress tests, and fiscal stimulus greatly shortened the period before growth resumed relative to Japan's lost two decades.

There are some similarities, however. In the United States, it seems clear that there are a number of spheres—overkill with regulation, the swiss cheese nature and high rate of corporate profits taxes among them—which slow growth. In the face of problems such as these, plus the slowdown in population growth and political uncertainty, U.S. growth actually looks fairly healthy.

Some of the same forces have afflicted Europe. The slowdown in population growth has been even more abrupt; the crises in southern European countries were a significant headwind; the financial system needed further integration, and uncertainties associated with Brexit have all been drags on growth.

In these cases and in the rest of the world, there are identifiable problems that must be addressed to enable growth to accelerate. But the fact that countries such as Australia and Canada were far less vulnerable to the problems enumerated above and able to maintain growth in the face of the global slowdown is a strong piece of evidence that the world is not heading for “Japanese disease.”

There has been a conjunction of events: the inevitable Chinese growth slowdown, the demographic shift and population aging, the southern crises in the European Union, and the financial situations in the United States and Europe. That all of these occurred at about the same time is better thought of as a “perfect storm” than an inexorable drift into Japanese disease.



Japan's hardly a horror story.

DEAN BAKER

Co-Director, Center for Economic and Policy Research

It is amazing that Japan is being held up as a model of how things get really bad as public debt grows out of control. With a ratio of public debt-to-GDP of more

than 250 percent, Japan should be the poster child of everything bad that is supposed to happen with runaway debt. However, none of the textbook stories fit Japan at all. The problem is the deficit hawks just haven't bothered to notice.

For fans of logic and consistency, the debt story is supposed to be one of excess demand. The textbook story is that excessive government borrowing pushes the economy beyond its limits. This most immediately leads to higher interest rates. Higher interest rates crowd out new investment, thereby slowing productivity growth. They also lead to a rise in the value of the currency, which leads to a large trade deficit. This means higher foreign indebtedness.

Alternatively, the central bank can try to keep interest rates from rising by printing money. This leads to higher inflation, which if carried far enough leads to a Weimar-type situation with hyper-inflation leading to the collapse of the currency.

None of this is happening in Japan. In fact, it is pretty much the exact opposite of the textbook story. Interest rates are incredibly low, with the interest rate on ten-year government bonds hovering near zero. Inflation is also extremely low. The central bank has been desperately struggling to raise the inflation rate, which has occasionally slipped into negative territory, to its 2 percent target. It has largely failed to date, as the inflation rate remains near zero. Instead of a trade deficit, Japan has a surplus of more than 3 percent of GDP. And the country's debt service burden is nearly zero, which follows from its zero or negative interest rates.

Japan's unemployment rate is under 3 percent. Its employment rate for prime-age workers (ages 25 to 54) has risen rapidly in the last five years, especially for women.

We know that Japan has an incredibly high debt-to-GDP ratio, but what exactly about this situation are we supposed to look at with horror? It's true that its economy is not growing rapidly, but fans of intro econ know that it is per capita GDP that matters, not total GDP. In this category, Japan is not doing especially poorly. Furthermore, it is not clear how the debt is impeding growth.

For all practical purposes, Japan looks like an economy that could benefit from more spending. It still has excess supply, as indicated by weak wage growth and low or non-existent inflation. This would send its debt even higher, but why should anyone care? The debt is not posing any of the problems that economic theory predicts; in fact, in almost every case the story of Japan is the opposite.

In short, the story of Japan's economy is one that directly contradicts all the horror stories about large debts and deficits. Incredibly, economists are choosing to ignore the reality of Japan's economy today and instead act like the textbook story applies. It is economics that is in crisis, not Japan's economy.



The global policy response to the Great Financial Crisis broadly followed the Japanese model.

THOMAS MAYER

Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank

The “Japan disease”—low growth and low inflation—was caused by avoiding structural adjustment after the burst of the “bubble” economy in the early 1990s. Banks and companies in financial difficulties were propped up by loose monetary and fiscal policies, and private households were protected against adverse consequences. Hence, although land values plunged and the Nikkei Stock Index dropped by 55 percent between the end of 1989 and 1993, the Japanese economy did not fall into recession. At the same time, however, adjustment was impeded and resources locked into unproductive “zombie” companies and banks. Productivity growth fell from more than 3 percent per year on average in the 1980s to less than 1 percent in the 1990s. This induced a decline in wage growth as employers and employees wanted to minimize job losses. As a result, inflation fell. As adjustment was postponed to the indefinite future, low productivity growth and low inflation became entrenched. Easy monetary policy was not only a consequence of the conditions it helped to create, but also helped to perpetuate these conditions.

The global policy response to the Great Financial Crisis of 2007–2008 broadly followed the Japanese model and hence has created a similar environment on a global scale. Emergency liquidity assistance by central banks in the wake of the collapse of Lehman Brothers averted a collapse of the financial system. The operation was similar to defibrillation in case of cardiac arrest. But the persistent injection of liquidity after the immediate emergency with the intention of fortifying economic recovery and pushing inflation to central banks’ target rates has been counterproductive. It has prevented liquidation of unviable projects and locked the economies of the affected countries into a low-growth-cum-low-inflation state similar to that of Japan.

What is to be done? The answer seems to be clear: End a policy that has failed! But this is easier said than done. In Europe and Japan, a highly indebted public and private sector have become dependent on readily available funding at ultra-low interest rates. Should financing

conditions ever become tighter, bankruptcies on a large scale would be the result. Priming the liquidity pump therefore seems essential for survival. The supply of the world with massive amounts of liquidity by the European Central Bank and the Bank of Japan thwarts the efforts of the U.S. Federal Reserve to exit from its own policy of ultra-easy money. Money flows from Europe and Asia keep U.S. Treasury yields low even though the Fed raises its policy rate and is about to shrink its balance sheet.

How will it end? Central banks pursuing harmful policies will lose credibility in the event and confidence in our fiat money system will wane. Whether people will then embrace “old money,” such as gold, or “new money” in the form of privately issued crypto currencies such as Bitcoin, remains to be seen.



Not much can be done aside from intensifying pressure for labor market and welfare reform.

RICHARD JERRAM

Chief Economist, Bank of Singapore

A decade ago, explanations of Japan’s poor economic performance typically pointed to avoidable policy errors. Failure to fix distressed banks. Central bank tolerance of deflation. Half-hearted fiscal stimulus. Inadequate economic reform. We could debate the importance of different factors, but the implication was that economic stagnation was largely a self-inflicted wound. Back then, I remember a Fed official telling me that they had learned nothing from Japan’s lengthy stagnation, because it was simply a function of bad policy decisions.

How far do we need to reassess this critique, based on the experience of the past decade? Not very much, I would argue. To its credit, the United States largely avoided repeating Japan’s mistakes after the global financial crisis, although the policy response of the eurozone was more “Japanese” and it has paid the price. Policy failings were mainly due to political constraints, not disagreement over the appropriate course of action. This also raises the question of whether the recent rise in populism will lead to better or worse policy making. My guess would be the latter, but docile Japan has nothing to teach us on this front.

Of course, demographics were there in the background, but the sense was that this mattered in the longer term, but not as a factor in recovery from recession and financial crisis. The drag from demographics in Japan has steadily become more intense and the impact might have obscured an improvement in policy making in recent years. This is becoming a global problem and Japan could offer signals for other countries, but there is not too much that can be done, aside from intensifying pressure for labor market and welfare reform.



Yes, the same forces affecting Japan are spreading to the world.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

Some of the forces that began to affect Japan about twenty-five years ago are spreading to the rest of the world. The details differ across countries, but there are common elements from which to draw important lessons for policy.

Most advanced economies and many emerging-market economies are experiencing slower productivity growth, slower labor-force growth, and a regulatory push toward safer assets. These forces reduce business investment and increase desired saving. The net effect has been a shortfall of demand relative to supply, which has reduced inflation almost everywhere. (But downward wage and price rigidities have kept a floor under outright price declines.)

Economic theory implies, and empirical studies show, that these forces have lowered the equilibrium real interest rate. The challenge for central banks is to get ahead of the curve and to lower the policy rate far enough and fast enough to prevent inflation from undershooting its target. Japan failed to do this and it suffered twenty years of deflation and excess unemployment until the launch of Abenomics. Given the difficulty in pushing nominal interest rates much below zero, central banks should give serious consideration to raising their inflation targets over the longer run to create more room for countercyclical policy.

Japan tried to fight deflation with stop-and-start fiscal expansions that built up government debt without lasting

success on inflation. A better approach would be raising public worker salaries and jawboning private companies to follow suit to jumpstart inflation expectations. The Bank of Japan should fully accommodate higher inflation by holding bond yields near zero for at least several more years. Higher inflation would improve Japan's fiscal position and reduce the burden of its debt over time. Although Japan may have allowed debt to rise too high, it bears noting that borrowers can sustainably manage higher ratios of debt to income when interest rates are low.

By maintaining moderately low but positive inflation, central banks can ameliorate some of the harmful effects of the Japan disease. The only true cure, however, requires structural policies to first, raise labor force participation, including of women and the elderly; second, increase workforce education and training; third, open protected industries to competition, typically in the service sector; and last, build productivity-enhancing infrastructure.

Some governments have intervened excessively to hold down their currencies in order to boost exports, a classic beggar-thy-neighbor policy. Fred Bergsten and I show in our new book, *Currency Conflict and Trade Policy: A New Strategy for the United States* (Peterson Institute, 2017), that officials in twenty countries engaged in massive and excessive currency intervention from 2003 through 2013. This intervention worsened the Japan disease for the rest of the world, especially the United States and the euro area, the issuers of the main reserve currencies. Currency manipulation has receded since 2014 but it remains a tempting option for economies feeling the effects of the Japan disease. We need stronger global rules against harmful currency competition.



Risks of a Japan-style debt-deflation spiral are real.

JÖRG ASMUSSEN
Managing Director, Lazard, and former Member of the Executive Board, European Central Bank

Risks of a Japan-style debt-deflation spiral for most advanced economies—and notably in the eurozone—are real, even though reflationary forces are at play.

The gradual global recovery will not prove sufficient to grow advanced economies out of the current debt overhang. Over the past decades, our growth model has been extensively credit-intensive, exacerbating the risks of prolonged balance sheet recessions. According to Bank for International Settlements data, total debt (public and private combined) has kept rising since 2007, reaching 266 percent of GDP in advanced economies and 232 percent of GDP globally. There are no signs that global deleveraging is happening. The most vulnerable countries, beyond Japan (364 percent), are all located within the eurozone: Ireland (411 percent), Portugal (337 percent), Belgium (337 percent), Netherlands (309 percent), and Greece (300 percent).

High levels of total debt and bad demographics (including negative migration flows and low female labor participation) are some of the key factors underlying the debt-deflation spiral that Japan has experienced since the 1990s. Many eurozone countries—Germany, Italy, Portugal, Greece, Spain, and Netherlands—have low fertility rates, along with Japan (eight to ten births per thousand inhabitants). They are at the frontline of other potential cases of “Japan disease,” though Germany is in a slightly different situation with a relatively low level of total debt (184 percent).

Limiting the risks of a debt-deflation spiral requires accelerating the deleveraging trend in most advanced economies and notably in the eurozone. To reach this goal, it is necessary to deal with the main factors at the root of low growth (the so-called “secular stagnation”) but also high credit intensity: an overleveraged financial sector, fueled by the predominance of real estate in banks’ credit allocation (a phenomenon that started in the 1970s) and rising inequality, as lower and middle classes are tempted to go into debt to maintain adequate standards on living.

Solutions are not simple and require a well-balanced policy reaction. In the short term, we need to rebalance monetary and fiscal policies back to less expansionary modes in order to gain freedom to act in forthcoming cyclical downturns. This is important to avoid fiscal dominance over monetary policy. However, that will not be enough. We need to reallocate public spending toward investment in the longer run and implement structural reforms, notably labor market reforms, to generate productivity gains. We need to allow skilled migrations, integrate migrants, and support female labor force participation to fight demographic decline. We need to fight inequality in incomes and opportunities, especially for the lowest 20 percent of the population, with more targeted redistribution and effective minimum wage policies. We also need to reflect on how we could reform financial regulation to avoid excessive credit creation in the banking system.

Efforts to accelerate deleveraging are ahead of us. If we fail, probably debt restructuring will come back as an alternative policy more often.



*The key is whether
China follows in
Japan’s footsteps.*

CHI LO

**Senior Economist, BNP Paribas Asset Management,
and author, *Demystifying China’s Mega Trends:
The Driving Forces That Will Shake Up China and
the World* (Emerald Publishing, 2017)**

Given the size of the Chinese economy, its rapid rise in global influence, and the similarities that it shares with Japan’s economic development, a clue to assessing whether the world is at risk of the “Japanese disease” is to understand whether China is contracting the “disease.” My assessment at this point is no, because China does not necessarily have to follow the Japanese footsteps into prolonged stagnation as some analysts worry will happen.

Let’s not forget the big differences between the two economic giants. First and foremost, China’s current economic development stage is only equivalent to where Japan was in the early 1970s. Its potential growth is presumably higher than many observers expect. It is possible that a combination of structural reform, debt reduction, corporate balance-sheet repairing, and economic growth will still enable China to skirt the debt-deflation spiral that has plagued Japan since the early 1990s.

Furthermore, the proximate cause of China’s economic woes is, arguably, less damaging than Japan’s. By the late 1980s, Japan suffered an extremely large and prolonged asset bubble which valued the land under the Imperial Palace in Tokyo at more than the total land value of the state of California in the United States. The bursting of this giant property bubble set off prolonged asset price deflation with both land and equity prices falling by three-quarters in the following few years. And this drastic wealth destruction led to a balance sheet recession that forced Japan into a debt-deflation spiral.

China is not there yet. While Japan’s property bubble was systemic, China’s bubble risk is local, with bubbly conditions seen in the first-tier (large) cities only while the rest of the country’s property market is stuck with recessionary conditions. China’s main problem is capital misallocation leading to excess capacity being concentrated in a few state industries, notably steel, cement, glass, shipbuilding, and others, whose fortunes are tied closely

to the construction industry. But China has not suffered a balance-sheet recession, and structural reforms are meant to correct the capital misallocation and excess capacity problems and prevent the country from falling into a debt-deflation trap. China has so far shown a much stronger reform resolve than Japan.

Last but not least, China is a far bigger and more independent country than Japan, which relies heavily on the United States for military and strategic support. This means that China has in store more potential domestic demand and entrepreneurship than Japan for boosting growth if and when its structural reform program unfolds to deliver results. The Chinese leadership's strategic ambitions of rejuvenating China's international and economic influence suggest that it would be very unlikely to follow the Japanese path of sinking into a stagnant growth paradigm and relying on American military support. Its desire to wield more global influence may even become a force for sustaining economic reforms.

Without the destabilizing force from China, the risk of the world contracting the "Japan disease" is low in the medium term.



*What disease?
Japan's successes
are underreported.*

ANDREW DEWIT

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Rikkyo University*

Japan is more than a basket-case of negative lessons. The Japanese are doing more with less, through extensive and inclusive policy integration. They maintain an enviable sociopolitical stability, and a responsive democracy, even as their population shrinks and ages more rapidly than anywhere else.

The glass seems at least half-full on Abenomics. In June, the International Monetary Fund declared it "successful in easing financial conditions, increasing corporate profits, and boosting employment and female labor force participation."

Other indicators include a 9 percent growth in Japan's nominal GDP, between 2012 and 2016. Jobs increased by

1.85 million over the same period, with a striking reversal of eight years of declines in non-contractual, "regular" employment. These latter grew by 290,000 in 2015 and 500,000 in 2016. Japan also posted a 15 percent increase in capital investment, returning it to levels preceding the Lehman shock.

Japanese workers' incomes also finally appear to be rising, after a protracted fall of 12.5 percent between 1997 and 2012. In their July 7 analysis of Japan's May 2017 "Monthly Labor Survey," Japan Macro Advisors argue that the 0.9 percent increase in the basic wage is the highest in just under twenty years.

Lessons to learn from Japan include smart structural reform, which has generally been overlooked by the spotlight on tax cuts and deregulation. Decades of adversity, and the sobering reality of demographic, disaster, and energy vulnerabilities, have driven policy coordination and strategic planning. One important focus is bolstering the sociopolitical and infrastructural resilience of local communities.

For example, over one-third of Japan's 1,718 local governments have set up new citizen- and NPO-led organizations to help manage a range of local challenges. These organizations nearly doubled between 2014 and 2016, from 1,656 to 3,071, and will likely increase further as 89 percent of local governments deem these necessary. This expanded local democratization is one element of an unprecedented collaboration among central agencies, subnational governments, business, academia, and other stakeholders. Cooperation extends across all policy fronts, linking urban, demographic, industrial, and other planning. Extensive and inclusive vertical and horizontal collaboration not only keeps the streets clean and safe; it also facilitates finding and implementing a consensus on long-range goals.

Moreover, this broadly participatory approach helps concentrate productivity-enhancing information and communication technology investment on urgent priorities, particularly disaster resilience. We see this in Japan's "Dam Revival Vision," adopted June 27, 2017. Supported by a cross-party alliance, the Vision aims at more than doubling hydro output from existing dam assets, while diffusing artificial intelligence, drone, and other technologies to cope with climate and other risks as well as build international competitiveness in smart hydro systems.

Ironically, even as Abenomics began to bear real fruit, Japanese Prime Minister Shinzo Abe grew more interested in his controversial constitutional reform and historical revisionism. But recent electoral shocks and a stunning 13 percent drop in the opinion polls in early July suggest he either puts his nose back to the grindstone of economic policy or finds himself deposed. So while hardly hale, Japan is clearly robust enough to deliver a swift kick when and where it counts.



*Here's how to avoid
the "Japan disease."*

GEORGE R. HOGUET

Chief Executive Officer, Chesham Investments, LLC

The International Monetary Fund forecasts that world economic growth will accelerate over the next several years, but risks to global economic activity remain to the downside given the bad debts in the Chinese financial system and the enduring legacy of the global financial crisis, including a sharp increase in sovereign debt levels, the possibility of trade wars, and ongoing vulnerabilities in the global financial system. However, the pace of technological change is so rapid, and the impact of disruptive technologies so profound, that we should be cautious in asserting that the current global productivity slowdown is permanent and that the world economy is slipping into the "Japan disease."

Several factors have contributed to Japan's "Lost Decade(s)": monetary policy mistakes; failure to rapidly restructure failing enterprises; and a cumbersome business environment for small- and medium-scale enterprises, to name a few. Japan's demographic dynamic has also contributed to slow growth. Twenty-seven percent of Japan's population is over sixty-five (versus 15 percent in the United States). Japan's population has fallen by roughly one million over the last five years, and Japan has entered a period of slow but inexorable population decline.

According to the United Nation's latest "World Population Prospects," over the past ten years world population growth has fallen from 1.24 percent annually to 1.10 percent. While there are many imponderables, this declining trend is expected to continue, with a 27 percent chance that the world's population could stabilize or even begin to fall before 2100. The Pew Research Center projects that by 2050 Germany's population will fall by 13 percent; Russia's by 16 percent; and Japan's by 15 percent.

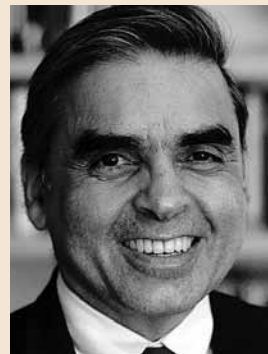
While the level of output per capita is the most relevant metric, rapidly aging societies, particularly in advanced economies, will limit potential growth and place large strains on public finances and private pension plans. Some promises will be broken.

To avoid the "Japan disease," carefully considered and prudently implemented structural, fiscal, and monetary policies are required. Structural policies to enhance

long-run potential growth are key. This means an ongoing commitment to pro-competition policies, flexible product, labor and capital markets, and the promotion of an open and expanding world trade and investment regime characterized by equitable burden sharing and market access. Policy should also focus intensively on family-friendly measures and human capital development, building effective and credible retraining efforts, and offering to individuals incentives to delay retirement and to firms to retain qualified older workers.

Prompt focus on longer-term fiscal imbalances should accompany structural measures. Part of the solution could entail a coordinated global crackdown on tax evasion. And the world can ill afford another major financial crisis. Accordingly, policymakers should continue to research carefully crafted, market-sensitive macro and micro prudential regulations, with a particular focus on the non-bank sector.

Finally, emerging markets' share of global output will continue to grow; the fate of the world economy is increasingly influenced by developments in China. Policy should continue to focus on constructively engaging with China, providing incentives for it to further integrate into international norms.



*No, watch instead
for an India fever
that envelopes
the world!*

KISHORE MAHBUBANI

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(PublicAffairs, 2013)*

No! The world is not in danger of contracting Japan disease. Instead, it will be infected by an India fever. It is a fundamental mistake to view the world through a Japanese lens. Japan has seen its heyday. The Japanese people will continue to enjoy a wonderful quality of life, the envy of many. But Japan represents the past.

India represents the future. At least three forces will continue to propel India forward. The first is the removal of obvious bureaucratic inefficiencies which blocked growth.

With a single electronic ID (the *Aadhaar*), a billion Indians can now access all kinds of services. The demonetization exercise slowed Indian growth in the short term, but also gave a massive boost to mobile payments. With a billion cell phones, India is leapfrogging over conventional banking systems. The massive introduction of harmonized GST rates will also cause short-term disruptions and promote long-term growth. Indian planners were known for caution, not boldness. Now their courage will become infectious.

Second, India is at an inflexion point in the growth of its middle classes, from 5.4 million in 1990 to 50 million in 2013. The number is expected to reach 475 million by 2030. This is part of a larger explosion of the Asian middle-class population, which will grow four-fold in a decade, from 500 million in 2010 to two billion in 2020. These new Asian consuming classes don't understand contemporary Western pessimism on globalization. They want more of it, not less.

Third, all this optimism is triggering a vital psychological change in Asian societies that has gone largely unnoticed in the West: a revival of the strong animal spirits of many Asian societies. While Japan may not be experiencing this, most of the rest of Asia is. There are risks. All these power shifts could lead to new geopolitical competition in Asia. But not all geopolitical competition is zero-sum. Some of it will be positive-sum. China could win the race to build new infrastructure in Southeast Asia, while Japan could win in India. This explosion of infrastructure spending will provide another positive boost to the virtuous circle of development which many Asian societies are already experiencing. Incomes will rise sharply. Between 1980 and 2014, India's per capita income in PPP terms jumped 10.3 times, while China's jumped an astonishing 42 times. What China accomplished yesterday, India will accomplish tomorrow. And an India fever will envelop the world. ♦

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