Economic stagnation in Japan is uniquely compatible with generally prevalent comfort, which is a major reason why stagnation is likely to endure. Underlying this endurance is the fact that zero economic growth or very slow growth in Japan still implies rising per capita income because Japan’s population will soon begin to decline.

In the 1970s and 1980s, Japan was the economic wonder of the industrial world, recording the highest annual growth rate among all developed economies throughout this period. Its annual growth averaged above 4 percent, transforming Japan into the world’s second largest economy. This remarkable record provoked a heated debate in policy and academic circles about explanations for the economic “miracle,” as well as prognoses that Japan would either surpass the U.S. economy, or at least buy substantial parts of it!

During the 1990s and the first years of the 21st century, Japan’s rapid growth was replaced by protracted economic stagnation, evoking hardly less wonder, and a corresponding debate about explanations for this economic deterioration, and its implications for Japan’s future performance. This debate is tinged with irony because many commentators—in both policy and academic circles—who had previously offered convincing explanations for Japan’s success, subsequently offered equally firm pronouncements about its more recent economic failures, having forgotten their categorical assertions about Japan’s enduring success in the prior decades.

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The Japanese “miracle” of the 1970s and 1980s was the result of several mutually reinforcing factors: high rates of savings and of private (if “guided”) capital formation; a skilled, vigorous, and growing labor force; a positive rate of productivity growth for both capital and labor; and accommodating monetary policy which provided credit on favorable terms to aggressive, export-oriented industries and firms, especially in the automotive and electronic fields.

In combination, these factors overshadowed the accumulating inefficiencies resulting from a protected domestic market and an industrial policy in which government and the bureaucracy (notably, the Ministry of Finance and the Ministry of International Trade and Industry), rather than competitive markets, determined how and to what purposes resources were allocated.

Japan’s stagnation in the 1990s and the first years of the 21st century has been driven by an equally potent set of forces, in large measure derived from the same factors contributing to the economic miracle of the 1970s and 1980s. These factors include:

- An industrial system principally driven by considerations of economies of scale, increasing market share, and export growth, with profitability viewed as less important in determining resource allocations and the development of particular industries and firms.

- A banking system pervaded by huge non-performing loans and weak balance sheets resulting from Japan’s distorted industrial base and the credit misallocations associated with it.

- A regulatory system marked by the heavy hand of government and protectionism, limiting free entry and market access both within Japan and from potentially competitive firms outside, in the process stifling entrepreneurship and innovation. (Recent RAND work on economic “openness” found that Japan ranked far below the economies of both the U.S. and Germany, and about on a par with China and Korea, in its profusion of non-tariff restrictions permeating the economy and impeding market access by foreign businesses.)

Reflecting as well as contributing to these negative drivers, the ratio of Japanese government investment to private investment nearly
doubled between the 1980s and 1990s, and the absolute level of private investment declined by more than 12 percent in the same period. Correspondingly, the amount of new capital formation required per unit of added output more than doubled, while the annual rise in productivity of both capital and labor plummeted from just over 0.5 percent in the 1980s, to a negative figure of 2.1 percent in the 1990s.

To mitigate these circumstances, Japan’s reforms have been somewhere between bland and modest. These efforts have included loosened monetary policies with near zero interest rates and government bailout funding for the major banks to strengthen their fragile balance sheets and encourage new lending; increased levels of public spending, thereby expanding Japan’s already large public debt, currently estimated between two and four times its GDP (the corresponding U.S. debt figure is less than half of GDP); and a modest degree of deregulation allowing foreign investors to acquire Japanese assets in some fields.

Most observers, myself included, think these efforts are inadequate. Without more drastic deregulation, Japan’s near stagnation is likely to continue. RAND forecasts envisage Japan’s annual growth in the first decade of the 21st century as likely to hover between zero and slightly above one percent annually.

Despite these trends, Japan is hardly in a “crisis” condition. It remains wealthy, with per capita GDP among the highest in the world. Sales in Japan of luxury consumer goods carrying the prestige labels of Vuiton, Gucci, Hermes, and Courvoisier continue to be strong, the standard of living of Japan’s 127 million people is among the highest in the industrial world, its current account surplus ($117 billion in 2000), is the world’s largest, as is its nearly $400 billion in foreign exchange reserves, almost twice those of second-place China. Its pledge of assistance for rebuilding Afghanistan ($500 million) is larger than that of the United States or the European Union.

Moreover, Japan’s cities are generally among the world’s cleanest and safest. Public services are reliable and efficient by comparison with those elsewhere in the developed world. (When one steps beyond the gate of an arriving flight in the Tokyo or Osaka airports, within five seconds a noiseless and speedy shuttle arrives to move one to another terminal for a connecting flight, a sharp contrast to
what one found in U.S. airports before September 11 and, more un-
derstandably, since then). And, even with low growth or zero growth in GDP, Japan’s per capita income will continue to rise because Japan’s population will begin to decline in the first decade of the 21st century; declining population will, by 2010, raise per capita income by nearly 1 percent in each subsequent five-year period, even assuming that Japan’s GDP remains unchanged!

Thus, stagnation in Japan is compatible with a high level of consumer well-being and comfort, as it would not be in, say, the United States or the European Union. This comfort level reduces pressures for real structural reform to reinvigorate the Japanese economy by pervasive deregulation, weeding out or consolidation of unprofitable firms and precarious banks through bankruptcies and acquisitions, and creating a new business environment to encourage rather than discourage Japanese entrepreneurs, as well as foreign investors. Whether internal political pressure will be able to alter this “stagnation with comfort” scenario is doubtful. A more likely stimulus, if indeed any ensues, may be provided by China. If China’s economic and/or military power provide strong evidence that China will eclipse Japan in the Asian regional context, the resulting shock in Japan may have consequences equivalent to those which occurred following the Meiji restoration in the late 19th century.

**Postaudit**

Whether Japan is more likely to respond to internal pressures (as many putative experts believe), or to an external shock (as I suggest), or to continue its comfortable stagnation more or less indefinitely, remains in contention.