ECONOMIC STAGNATION IN JAPAN is uniquely compatible with generally prevalent comfort, which is a major reason stagnation is likely to endure. Underlying this endurance is the fact that zero or very slow economic 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, which transformed it 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 would buy substantial parts of it!

During the 1990s and the first years of the twenty-first century, Japan’s rapid growth was replaced by protracted economic stagnation, evoking hardly less wonderment, as well as a corre-
sponding debate about explanations for this economic deterioration and its implications for Japan’s future performance. This debate is tinged by 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.

The Japanese miracle of the 1970s and 1980s was the result of several mutually reinforcing factors: high rates of savings and private (if “guided”) capital formation; a skilled, vigorous, and growing labor force; a positive rate of productivity growth for both capital and labor; and an accommodating monetary policy that 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, largely determined how and to what purposes resources were allocated.

Japan’s stagnation in the 1990s and the first years of the twenty-first 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.
Japan’s Comfortable Stagnation

- A banking system pervaded by huge nonperforming 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 United States and Germany, and about on a par with China and Korea, in its profusion of nontariff 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 during the period, whereas the annual rise in productivity of both capital and labor plummeted, from just over 0.5 percent in the 1980s to a negative 2.1 percent in the 1990s.

To mitigate these circumstances, Japan’s reforms have been somewhere between bland and modest. Those reforms have included loosened monetary policies with near-zero interest rates and government bailouts to 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 twenty-first century as likely to hover between 0 and slightly above 1 percent annually.

Despite these trends, Japan is hardly in a crisis. It remains wealthy, with per capita GDP among the highest in the world. Sales 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; and 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. 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 understandably, 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 twenty-first century; declining population will, by 2010, have the effect of raising 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 consolidating unprofitable firms and precarious banks through bankruptcies and acquisitions, and creating a new business environment to en-
courage 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 power or military power or both provide unequivocal evidence that China will eclipse Japan in the Asian regional context, the resulting shock in Japan may have consequences equivalent to those that occurred following the Meiji restoration in the late nineteenth century.

**POSTAUDIT**

The diagnosis of Japan’s “miracle” growth of the 1970s and 1980s and its stagnation of the 1990s seems robust. That the economy now shows signs of improvement is plausibly and partly attributable to the wake-up call transmitted by China’s resurgent growth. Other factors, too, have contributed to a brighter outlook, notably former prime minister Koizumi’s taxation and other liberalizing reforms; MITI’s (now renamed the Ministry of Economy, Trade and Industry) somewhat diminished influence; and the trimming of non-performing loans on banks’ balance sheets.