BY ROBERT DEKLE

The Japanese economy (and, by extension, Japanese society), we are often told, has lost its way. On first look, the numbers seem to bear this out. From 1974 to 1990, the period in which Westerners waxed shrill about Japan Inc., real GDP growth averaged 3.8 percent. But from 1991 to 2000 – what the Japanese themselves label the "lost decade" – growth averaged a mere 1.3 percent. And in the years since, the rate has sagged still lower. Moreover, there's not a hint that the economy will soon snap back: mainstream projections of growth over the next decade or so center on one percent.

Yet, by most reports, the Japanese seem prosperous and reasonably content with their economic circumstances. Repeat visitors to Japan will notice that, compared with 20 years ago, the Japanese drive better cars, live in homes that are bigger and better furnished, and eat food that is even more exceptional. No longer a gritty, bustling Asian capital, today's Tokyo seems more like Paris – tranquil, beautiful, a pleasure to the senses.

What has happened is that aggregate growth has stagnated because Japan's labor force is declining, owing to a rapidly aging population. Living standards are still rising, however, because output is spread among a smaller group of people. Indeed, the Japanese seem disinclined to press for growth-boosting reforms, despite the fact that their nation is becoming increasingly marginalized in economic and geopolitical terms in the face of the rise of China and Korea.

In my view, their sangfroid is somewhat myopic. Japan could greatly benefit from productivity-enhancing deregulation and more immigration; both are needed to spur the integration of the Japanese economy with the rest of Asia – and, in the process, soften the likely future dislocation driven by a combination of demography and convergence with emerging-market economies. Japanese policymakers realize this and are fighting the inertia sustained by cultural contentment and interest-group gridlock.

WHY JAPAN LAGS

At the outset, note that it makes little sense to use the growth rate of China (or, until the past decade, Korea) as the standard by which Japan is judged. Emerging-market and middle-income countries can grow fast because they have yet to make the investment in capital – and modern social welfare institutions – that

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allow them to reach real affluence. By investing in education, abandoning low-productivity agriculture for high-productivity industry, and importing technology and management models from advanced countries, these economies can expand at astonishing rates.

Japan was an emerging market after 1868, when it opened its economy to the world with the Meiji Restoration. And it reverted to the status again after World War II, which had shattered its capital stock, infrastructure and feudal style of governance. In the mid-1950s to the late 1960s, GDP growth of 10 to 14 percent was commonplace in Japan.

Thanks to a persistently low birth rate – on average, each woman now bears just 1.3 children – Japan has one of the fastest aging populations in the world.

By the mid-1970s, though, Japan's catch-up phase was almost over – and it was certainly finished by the mid-1980s. From then on, Japan could not hope to grow much faster than the other advanced industrialized countries, like the United States and Germany. Even by that lesser standard, however, Japan has underperformed in terms of GDP growth in the past two decades. From 1990 to 2010, the United States and Germany grew at annual rates of 2.9 percent and 1.4 percent, respectively, while Japan's growth averaged only 0.9 percent.

However, the explanation for the too-deliberate pace of growth that has dogged the Japanese economy ever since the collapse of its real estate and stock market bubbles in 1991-92 has more to do with unfavorable demographics than with bad management. Thanks to a persistently low birth rate – on average, each woman now bears just 1.3 children – Japan has one of the fastest aging populations in the world. In 2011, 23 percent of the Japanese were above the age of 65, compared with 13 percent of U.S. residents. And by 2020, fully 30 percent of the population will be older than 65. Since the elderly are retired (or work fewer hours), the total supply of labor is rapidly falling: from 1995 to 2010, the total numbers working declined by 3 percent while hours worked fell by 12 percent.

Over time, growth in GDP is equal to the sum of the growth in labor productivity and the growth (or fall) in hours worked. So the fall in labor input is responsible for reducing GDP growth by an average of 0.8 percent annually since 1995. Put another way: had Japanese labor grown at one percent annually (roughly the rate in the United States), instead of declining in those years, annual GDP growth would have averaged over 2.5 percent – a very respectable rate for a mature industrialized economy.

It's true that for the past 20 years, Japan's GDP per person has grown at 0.8 percent per year, much lower than the 1.4 percent averaged by the United States. For the past decade, though, average Japanese growth in GDP per capita has been virtually identical to that of the United States. The difference in the two countries' aggregate growth rates, then, was a consequence of the United States' higher birth rate and relatively liberal immigration policy. Accordingly, the obvious fix (if you think something is broken here) is to increase the labor supply in Japan by increasing labor force participation by women and the elderly, and to raise the pace of immigration from its exceptionally low base.

There's not much more labor to be had

from the old: 60 percent of the males above the age of 65 are already working – almost triple the rate in the United States. Women's participation is up sharply over the past two decades – from 50 to 70 percent for those aged 25 to 40. However, since participation rates for Japanese males at those ages are above 95 percent, there is further potential for growth from this quarter.

One reason that female participation has lagged is the lack of child care outside the home, which could (and, in my view, should) be remedied with financial incentives that increase supply and/or demand. Note, too, that greater availability of high-quality affordable care might also raise Japan's rock-bottom fertility rate.

As for immigration, the United Nations estimates that to keep the Japanese population constant (without a change in the fertility rate), Japan would need to allow about 400,000 foreigners to become residents each year from now until 2050. Since the current flow is below 100,000, Japan would need to quadruple its intake of immigrants to meet that target. But that is plainly a disturbing prospect for a culture that has long prized its homogeneity. If annual immigration were 400,000, immigrants and their offspring would constitute about 20 percent of the total population of Japan by 2050.

On the other hand, to raise the Japanese labor force by, say, by one percent annually, Japan would need 700,000 to 800,000 immigrants per year. And while such flows might be realistic for the far larger U.S. economy – where legal immigrants alone now exceed one million annually – it's hard to imagine a circumstance in which Japan would ever voluntarily accept more than 200,000.

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RAISING JAPANESE PRODUCTIVITY

The other arithmetic component of growth is labor productivity, and the slow pace of increase in output per hour is often cited as a problem. This view is a bit misleading, though.

Japanese productivity growth may look bad compared with that of the United States, but it exceeds that of affluent European countries. From 1995 to 2010, Japanese productivity per hour grew at an average annual rate of 1.8 percent, compared with 2.1 percent for the United States and 1.3 percent for both Germany and France. Still, with limited prospects for increased immigration or increased labor force participation, raising productivity is about the only way Japan's aggregate GDP can grow. In 2010, GDP per labor hour in Japan was only 70 percent of that in the United States, so there is certainly potential for catch-up.

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Much research has been done on why Japanese productivity has lagged that of the United States. The conventional wisdom is that the Japanese economy – especially the sectors that are shielded from international markets – are insufficiently competitive. Certainly, there is some evidence that Japan tolerates inefficiency. During the 1990s, when the Japanese economy was truly in the doldrums, banks kept insolvent firms alive by continuing to provide them with loans, often at below-market interest rates.

These so-called "zombie" firms usually suffered from low productivity and lagging technology, but were kept moving because the banks were loath to show loan defaults on their balance sheets. Most of these technically insolvent firms were insulated from foreign competition and many were small. And – no surprise here – they were often better at lobbying local politicians for forbearance than producing what consumers wanted at competitive cost.

Excessive regulation has also blunted market forces. Even today, the government requires producers in some sectors to obtain explicit approval to enter a market, or otherwise compels them to prove that they satisfy very high standards for their products. This, of course, protects incumbents from competition and reduces the returns to innovation. For example, in the old-age assisted-living industry – a true Japanese growth industry – regulations on the training of nurses, the size of facilities and the like have all dampened the response to rising demand.

Labor productivity in Japanese manufacturing is world class (especially in export-oriented markets), growing at an average annual rate of 2.1 percent between 1995 and

2009. But the service sector lags: productivity rose at an annual rate of only 0.8 percent during this period. And since 70 percent of all workers in Japan are employed in service industries, raising service productivity is crucial to raising overall Japanese productivity.

But the service sector exposes the weakest aspects of the Japanese economy. Production scale is often too small to minimize costs; exit as well as entry responds sluggishly to market conditions; investment is low. Identifying the problems, though, is easier than solving them. Japan's business culture has magnificently evolved to resist change that is not in the interest of established companies.

KOIZUMI ADMINISTRATION REFORMS

Of all recent Japanese governments, the administration of Prime Minister Junichiro Koizumi, which ran from 2001 to 2006, went furthest in both financial sector reform and deregulation. It forced banks to disclose their problem loans and to lower their problem-loan ratios within a 30-month span. That meant many borrowers were no longer allowed to roll over their loans and went bankrupt. Public agencies that made loans for political and social reasons were scheduled to be privatized. This, too, helped to force many zombie firms to close their doors for good.

The Koizumi administration created "special economic zones" in localities, waiving some of the regulations that generally hobble the service sector, especially in medical care, old-age facilities and education. The intent was to test whether a lighter government

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touch would increase productivity; if it did, the hope was that other regions would adopt the deregulations.

The administration also made an effort to increase labor market flexibility, expanding the sorts of firms that could employ workers without providing them with legal job protection. These workers were hired by temp agencies and contracted out to companies. Benefits provided to these workers were inferior to those provided to permanent workers, and they could be let go at will at the end of their contracts.

The 2005-8 period, which overlapped the last half of the Koizumi administration, was probably the most dynamic for the Japanese economy since the onset of the recession in 1990. GDP growth was relatively high, and many entrepreneurial ventures popped up. Whatever growth-enhancing effects the Koizumi reforms may have had, however, the Japanese public's assessment of their impact was quite mixed.

The new treatment of contract workers, arguably a bellwether initiative, was severely criticized by the Japanese media for creating employment instability: of the 610,000 newly unemployed during the 2008-9 global financial crisis, more than half were contract workers. And the subsequent scale-back of the contract worker law no doubt tarnished the legacy of the Koizumi administration' reform policies and undermined prospects for similarly bold initiatives.

The privatization of public sector financial institutions has also been slowed, and the privatization of the gigantic postal savings system has been put off indefinitely. Bailouts of failing, well-connected firms by government agencies continue to this day.

WHITHER REFORMS?

At the moment, there is little appetite or urgency for large-scale market-oriented reforms because most Japanese live pretty well. Since the Second World War, when living standards were reduced to subsistence, the Japanese economy has managed to reach a per capita GDP of well over $40,000 (measured in current dollars). That's the highest in Asia and is in the same ballpark as France, Spain and Italy. Note, moreover, that while income inequality has increased in Japan over the past few decades, the nation has escaped some of the highly visible excesses associated with greed-is-good capitalism in America and Europe. Indeed, it is one of very few affluent countries in which the wages of the bottom 10 percent of earners have outpaced growth for the top 10 percent.

Perhaps it should be no surprise, then, that the Japanese public generally seems satisfied with the status quo – or, at least, resists change that involves any economic dislocation. Thus, market-oriented reforms promising to raise annual GDP growth by, say, half a percentage point in return for less employment stability and the demise of small unproductive businesses would almost certainly get a cool reception.

It is not clear, though, that Japan can stay in place without running faster. Facing stagnant domestic markets, Japanese corporations are seeking every opportunity to move sales (and operations) abroad. After all, in most businesses, profits (and equity market returns) depend on the scale of production. Big export-oriented Japanese corporations, which have been outsourcing labor, building plants abroad and creating designs to suit foreign markets for many years, are likely to put most of their resources into foreign (especially Chinese) operations. Thus, there is a real danger that the Japanese economy in general and manufacturing in particular will be "hollowed out." By the same token, a stagnant Japanese market will become less attractive to foreign producers, undermining competition and incentives for joint ventures. Indeed, the dynamic economy so recently seen as *the* power to be reckoned with, may slip to the periphery.

There's another scale factor to be considered here. The economic risks associated with sustaining a large government debt depend in part on the size of the debt relative to GDP. Japan's debt-to-GDP ratio is over 200 percent, the highest in the world. Until now, Japan has been spared even the hint of a debt crisis in which it becomes difficult to find buyers for the bonds. That's largely because about 95 percent of the debt is owned by the Japanese, and most of that 95 percent is owned by the domestic banks. So far, the banks have been willing to buy and hang onto the government bonds despite their minimal yields, but this won't last indefinitely if GDP growth doesn't keep pace with debt growth.

EXPORTING TO ASIA

One way of speeding growth without incurring heavy employment adjustment costs would be to go back to the tried and true formula of the postwar era: export more. This would expand markets for growth-hungry corporations, provide more employment opportunities, and, of course, raise living standards. Happily, exporting need not be a zero-sum, beggar-thy-neighbor game. If growth in China continues unabated, in a decade or two its economy will be two to three times as large

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as that of Japan, and its appetite for imports should be voracious.

That leaves the question of whether Japan has the will and the way to become more competitive in global export markets. Japan is no longer a very competitive exporter of consumer electronics, but it is competitive in precision machinery and sophisticated components needed to make these products in the rest of Asia. And the current government, which is controlled by the Democratic Party of Japan, wants to use government subsidies to accelerate this trend. Tokyo also intends to promote infrastructure projects in the rest of Asia, where Japanese management and technology can complement local low-cost labor. Then, too, the government is proposing tax incentives for foreign direct investment in Japan, along with policies to internationalize the Japanese university curriculum so that more Asian students will come to Japan to study.

All these initiatives hint of old-style Japanese industrial policies that have proved to be problematic. For one thing, giving bureaucrats more influence over production decisions opens the door to corruption and revolving-door crony capitalism. For another, bypassing market discipline can lead to some very expensive mistakes. One high-profile example: the Japanese government wasted the equivalent of tens of billions of dollars on a national system for broadcasting HDTV in the 1970s and 1980s, before the technology was ready for prime time. But given the current Japanese economic and political realities – and the potential downside of business-as-usual – these policies are worth trying, as long as their costs are modest.

The government is also pursuing the expansion of its bilateral and multilateral free-trade pacts, an initiative set in motion by the Koizumi administration. Currently, Japan has such agreements with Singapore, Mexico, Malaysia, the Philippines and Thailand. But there's one very large obstacle to moving forward: no Japanese government has been prepared to challenge its small but fierce agricultural lobby. Since Japanese farms (in particular, rice farms) are, for the most part, almost laughably inefficient, rural areas have a huge stake in preventing agricultural import liberalization. The Koizumi administration tried

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to finesse the political problem by providing subsidies to raise the scale of farm operations, believing that more efficient farms could withstand greater import competition. This might make a difference but wouldn't change the politics of trade for the foreseeable future.

EARTHQUAKE RECONSTRUCTION AS OPPORTUNITY

Last year's huge earthquake and tsunami caused damage of between 12 trillion and 21 trillion yen – equivalent to 4 to 6 percent of GDP – to property and infrastructure in northern Japan, including parts of Tokyo. And it stymied Japan's already-weak recovery from the financial crisis of 2008, sending the economy into a recession. Overall production in Japan was still below pre-earthquake levels six months after the disaster.

The government passed emergency budget measures for the reconstruction effort; among other things, it provided aid to some 740,000 firms across the length and breadth of Japan. Some of this money may have reflected the politics of patronage. But there's no doubt that it also reflected the magnitude of the disaster: the earthquake broke vital links in the supply chains of the economy that invented ultralean "just-in-time" inventory management. Indeed, the ripples significantly affected Japanese firms abroad – for example, depriving Toyota and Honda of key components for production plants in Asia and North America.

Still, despite the enormous costs (financial and human), there may be a silver lining to the tragedy of Tohoku. The earthquake cleared vast tracts of land, and left both households and firms in the most devastated areas with little left to lose – and potentially much to gain – from experimentation with new ways of doing things economic. Outside-the-box ideas have proliferated; some of these are closely related in spirit to the special economic zones introduced by Koizumi a decade ago. But this time, along with suspending government regulations in the zones, the government will be plowing huge sums into the zones for infrastructure, venture capital and the like. For example, there is talk of a media zone in Tohoku, involving infrastructure investment and start-up funds for companies and artists, where the usual government pro-

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cess to obtain permits would be fast-tracked. There is also talk of nursing and "old-age" care in deregulated new facilities built with government funds. Among the benefits: Filipino nurses needed to fill demand would be exempted from passing onerous Japanese language exams.

In essence, these "special zones" look like a hybrid of new deregulation and traditional industrial policies. It is a strategy that may work in contemporary Japan, with a population that opposes socially destabilizing change but does yearn to be seen again as relevant to the global economy – and wouldn't reject the fruits of growth. If successful, the experiment could act as a catalyst, easing the way for broader efforts to liberalize the economy.

Not on the table, but certainly in the same spirit, one could imagine the creation of another sort of special zone in Tohoku – a free immigration zone where foreigners would be allowed to come and work without running the gauntlet of Japan's hostile immigration regulations. The only requirement would be that foreigners live and work within the earthquake-affected areas for, say, a decade; thereafter, they would gain all the rights of Japanese residents.

It would be interesting to see how many people would come, what kind of contribution to the reconstruction effort they would make, and whether a positive experience would open doors to immigrants in other parts of Japan. For, at the rate the native work force is aging, Japan's need for labor to sustain economic growth and meet the needs of the elderly population will soon be quite pressing.

Readers may detect a degree of unwarranted optimism here. After all, the Japanese are adept at what the economist Herbert Simon called "satisficing" behavior – doing what's needed to get by, rather than reaching for better. But today's "satisficing" strategy may not work for long. Japan is growing uneasy in the shadow of the Chinese political and economic behemoth, not to mention a dazzlingly successful Korea. And pessimists may be underrating another aspect of Japanese culture – the facility for adaptation reflected in the country's ability to remake itself after World War II. Don't count out the Land of the Rising Sun just yet.