Japanese *Optical Illusion*

The "lost decades" theory is a myth.

By William R. Cline

The stylized fact that almost no one seems to dispute is that Japan has "lost" two decades of growth, and that the icy grip of deflation on the economy is responsible. Abenomics now seeks to restore growth by ending deflation, employing massive quantitative easing to ensure that inflation reaches 2 percent.

But the underlying premise—that there has been a failure in growth over the past two decades—is at best questionable and at worst dangerously misleading. The lost decades are an optical illusion caused by demographics and a stagnant labor force. As the figure on the next page shows, from 1991 to 2012 Japan's real GDP per unit of labor force approximately kept pace with that of the United States and Germany. For the full period, output relative to the total labor force (including unemployed) rose at an annual rate of 1.66 percent in the United States, 0.91 percent in Japan, and 0.87 percent in Germany. Japan did even better in the 2000s, when growth of output per labor force was equal to that in the United States.

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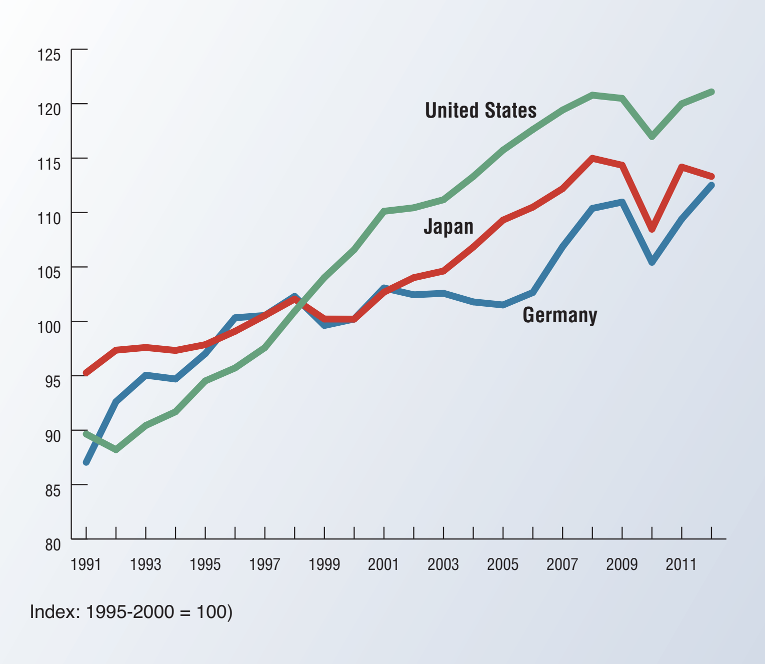

Real GDP per Labor Force: Germany, Japan, and United States

The key difference is that whereas the U.S. labor force expanded by 23 percent from 1991 to 2012, Japan's labor force rose by only 0.6 percent, causing the optical illusion of economic failure in Japan in contrast to economic success in the United States. Nor was discouragement of potential job seekers as a consequence of poor growth the reason for a stagnant labor force in Japan. An aging population and limited immigration have instead been responsible. Thus, the ratio of the total labor force to the population cohort of 20–64 years of age was 85.5 percent in 1990 and 90.3 percent in 2010 in Japan, compared to 86.2 percent in 1990 and 82.0 percent in 2010 in the United States.

It is true that there has been deflation in Japan in recent years. The GDP deflator rose at an average of only 0.15 percent annually between 1991 and 2000 and fell at an annual average of 1.3 percent from 2001 to 2012. In the United States, by contrast, the annual increase in the GDP deflator was 2.1 percent in the first period and 2.2 percent in the second. A problem for the stylized Japan story, however, is immediately evident in this comparison. Japan's growth performance was better in the second period than in the first (output per labor force rose at 0.63 percent annually from 1991–2001 and at 0.87 percent from 2002–2012), yet it was the second period that was characterized by deflation.

Our perception of the damages of deflation is primarily informed by the Great Depression in the United States, when from 1929 to 1933 there was a cumulative decline of 26.6 percent in real GDP accompanied by a cumulative decline of 25.3 percent in the GDP deflator. But Japan's far more gentle deflation in recent years would not necessarily have been expected to yield a decline in output at all, if the negative effects of deflation are nonlinear as would be expected.

If there was not a lost decade or two in Japan, and if growth was better during deflation than before it, then there would seem to be reason to suspect that achieving 2 percent inflation would not prove particularly powerful in boosting growth. Yet there is one area where it could hurt: boosting the nominal interest rate on Japan's already-high public debt. Over the past three decades, the implicit net interest rate on Japan's total public debt averaged 1.5 percent, in comparison to average consumer price inflation of 0.8 percent and average GDP deflator inflation of 0.1 percent. Boosting consumer price inflation to 2 percent might thus be expected to boost the interest rate to 2.7 percent but raise the GDP deflator inflation rate to only 1.3 percent. The International Monetary Fund's baseline forecast instead has a far more favorable differential between the implicit net interest rate (an average of only 0.5 percent in 2013–18) and the GDP deflator rate (an average of 1 percent, making the real net interest rate negative). So the main consequence of achieving the 2 percent inflation target could be to cause an escalation in Japan's debt ratio (already at 238 percent of GDP for gross debt) thanks to higher interest rates, while achieving relatively little acceleration in growth. ◆

Achieving the 2 percent inflation target could cause an escalation in Japan's debt ratio.