

Who is afraid of a Japanese decade?

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For the second time in a decade, central banks around the world have responded to the collapse of an asset bubble by moving aggressively to ease monetary policy, a tactic explicitly justified by the need to avoid a Japanese-style 'lost decade'. The problem, however, is that Japan never lost a decade...

The first decade of this century started with the so-called 'dot-com bubble'. When it burst, central banks moved aggressively to ease monetary policy in order to prevent a prolonged period of Japanese-style slow growth. But the prolonged period of low interest rates that followed the 2001 recession instead contributed to the emergence of another bubble, this time in real estate and credit.

With the collapse of the second bubble in a decade, central banks again acted quickly, lowering rates to zero (or close to it) almost everywhere. Recently, the United States Federal Reserve has even engaged in an unprecedented round of "quantitative easing" in an effort to accelerate the recovery. Again, the key argument was the need to avoid a repeat of Japan's "lost decade."

Policy-making is often dominated by simple 'lessons learned' from economic history. But the lesson learned from the case of Japan is largely a myth. The basis for the scare story about Japan is that its GDP has grown over the last decade at an average annual rate of only 0.6% compared to 1.7% for the US. The difference is actually much smaller than often assumed, but at first sight a growth rate of 0.6% qualifies as a lost decade.

According to that standard, one could argue that a good part of Europe also 'lost' the last decade, since Germany achieved about the same growth rates as Japan (0.6%), and Italy did even worse (0.2%); only France and Spain performed somewhat better.

But this picture of stagnation in many countries is misleading, because it leaves out an important factor, namely demography.

Measuring growth

How should one compare growth records among a group of similar, developed countries? The best measure is not overall GDP growth, but the growth of income per head of the working-age population (WAP) (not *per capita*). This last element is important because only the working-age

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population represents an economy's productive potential. If two countries achieve the same growth in average WAP income, one should conclude that both have been equally efficient in using their potential, even if their overall GDP growth rates differ.

When one looks at GDP/WAP (defined as population aged 20-60), one gets a surprising result: Japan has actually done better than the US or most European countries over the last decade. The reason is simple: Japan's overall growth rates have been quite low, but growth was achieved despite a rapidly shrinking working-age population.

The difference between Japan and the US is instructive here: in terms of overall GDP growth, it was about one percentage point, but larger in terms of the annual WAP growth rates – more than 1.5 percentage points, given that the US working-age population grew by 0.8%, whereas Japan's has been shrinking at about the same rate.

Another indication that Japan has fully used its potential is that the unemployment rate has been constant over the last decade. By contrast, the US unemployment rate has almost doubled, now approaching 10%. One might thus conclude that the US should take Japan as an example not of stagnation, but of how to squeeze maximum growth from limited potential.

Long-term prospects

Demographic differences are relevant not just in comparing Japan and the US, but also in explaining most of the differences in longer-term growth rates across developed economies. A good rule of thumb for the average growth rates of the G7 countries would be to attribute about one percentage point in productivity gains to the growth rate of the working-age population. The US has done slightly worse than suggested by this rough measure; Japan has done a bit better; and most other rich countries come pretty close.

Looking to the decade ahead, this analysis suggests that one can predict the rich countries' relative growth rates based on the growth pattern of their working-age populations, which one already knows today, given that anybody starting to work over the next two decades has already been born.

On this basis, Japan's relative decline as a major economic power will continue, as its working-age population will continue to shrink by about 1% per year. Germany and Italy increasingly show Japanese patterns of decline in their working-age populations, and are thus likely to grow very little as well.

In the case of Germany, one observes an interesting kink in its demography: from 2005-15, the working-age population is temporarily stabilised. But this will be followed by accelerating decline, as the working age population declines even faster than in Japan.

The current strength of the German economy is also partly due to this temporary demographic stabilisation. But a Japanese-style scenario seems inevitable after 2015. By contrast, the US, the United Kingdom and France are likely to grow faster for the simple reason that their working-age populations are continuing to grow, even if at a relatively slow pace.

Two lessons emerge from this consideration of the influence of demographic factors on economic growth. First, the idea of a Japanese-style 'lost decade' is misleading – even when applied to Japan. Slow growth in Japan over the last decade was due not to insufficiently aggressive macroeconomic policies, but to an unfavourable demographic trend.

Second, a further slowdown in rich countries' growth rates appears inevitable, given that even in the more dynamic countries the growth rates of the working-age population are declining. In the less dynamic ones, like Japan, Germany and Italy, near-stagnation seems inevitable.