Lessons to be learnt in Europe from Japan

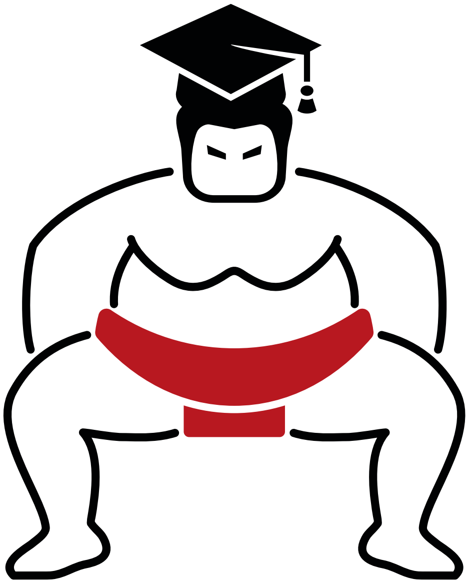
With debt running ragged and growth virtually at zero, improvement seems a remote prospect for the Japanese economy

When prime minister Shinzō Abe began his second term in December 2012, he introduced a policy strategy with 'three arrows' to kick-start Japan's stalled economic engine. The first two arrows, aggressive monetary policy and fiscal injections, began immediately. Early signs were promising as the boost to demand temporarily lifted growth and inflation. But the third arrow, supply-side reform, has been woefully lacking. As a result, the Japanese economy is stalling again. European economies have much to learn from the Japanese policy experiment. Without proper economic reform, costly stimulus programmes will not lead to faster growth in the long term.

In Japan, interest-rate cuts and large-scale purchases of government bonds by the central bank combined with government spending following the infrastructure that was damaged in the 2011 earthquake lifted growth and inflation during 2013. But in an attempt to address the piling debt and the enormous public deficit, Abe raised the rate of VAT to 8% from 5% in April 2014. This had an immediate negative effect, prompting two subsequent quarters of negative growth.

To offset an appreciating yen and in a further attempt to boost growth, the central bank then eased again by widening its purchases to further asset classes. More recently, the Bank of Japan joined the European Central Bank (ECB) and set a negative policy rate. But despite ultra-easy monetary policy, the economy has slipped back into deflation and total real GDP remains about the same size as it was in 2008. Why? The problems of the Japanese economy are not monetary in nature. Further easing will not lift growth.

One of Japan's key problems lies in its demographics: a shrinking labour



force caused by an ageing and declining population. But demographic problems are hard to address in Japan. Even in Europe, which has a long history of cultural and ethnic variation, fears about the impact of migration are at the top of the public debate. For a country like Japan, whose history has been less shaped by migrants, the challenges are greater.

Japan faces a tough dilemma. While trend growth for real GDP is virtually zero, GDP per capita is rising as the population shrinks. Japanese citizens enjoy one of the highest standards of living in the world. But the level of public debt is unsustainable without a stronger trend rate of economic growth. Allowing more foreign workers to enter the Japanese labour force could provide the antidote. But as is often the case, the fixed-pie fallacy presents a big-policy obstacle.

The perception that total wealth is limited and must be shared out better is the false reasoning behind most attempts to prevent migration or redistribute incomes from the rich to the poor. There is no good reason why a properly managed economy cannot continue to grow and provide an improving standard of living for all its existing and new citizens. But for an economy like Japan, where the pie hasn't grown in almost a decade, overcoming this misconception is easier said than done.

Europe's major economies can indeed learn from Japan's economic quandary. Rising right-wing populism in core Europe reflects a frustration by its citizens that is rooted in the sluggish improvement in general living standards since the financial crisis. And while the ultra-aggressive policies of the Bank of England in the UK and the ECB policy in the eurozone have helped to lift Europe from the depths of recession, growth cannot accelerate further without proper economic reform. Inflexible labour markets in Italy and France, land and planning policies not fit for purpose in the UK and the reversal of some of the 2004 labour market reforms in Germany pose the major threats to long-term economic prosperity in these economies. The Japanese economy is where it is because the country has shied away from essential reforms for many years. There is no easy road out for Japan. For the UK and other European countries, Japan serves as an example of the problems ahead if they do not implement the necessary reforms to raise trend growth soon.

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