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Japan's New Economic Policy

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I support the three economic arrows of the Abe administration: get the inflation rate into positive territory through greater monetary stimulus, stimulate the economy through fiscal policy, and introduce many changes in Japan's economic structure. But the first two arrows will be of little value over the longer term unless the third arrow is pursued earnestly and seriously.

Many observers believe the Japanese economy has unrealized potential, but to convert this potential into higher output requires significant changes in the structure of Japan's economy. Some of these changes in structure require changes in policy to permit greater competition in sectors that are now protected or coddled. Others require changes in public attitudes and behavior that may have served Japan well in the past but serve Japan badly in the present and future. A notable example is the attitude that women can have careers or children, but not both.

Reduction or elimination of protective policies and changes in traditional attitudes are always discomfiting and are sometimes painful. And often there will be real losers even when society as a whole gains. Such changes are made less painful in an economically buoyant environment – a period of growth rather than one of stagnation. Thus the main function of the first and second arrows, in my judgment, is to facilitate the structural changes of the third arrow. It is of course difficult to evaluate the third arrow without knowing in detail what the planned changes in policy are.

Expansionary monetary and fiscal policies cannot by themselves move Japan onto a trajectory of higher long-term growth. But they can create a temporary economic environment in which making the necessary structural policies is both easier and less painful. Europe is at present attempting to make necessary structural changes in an environment of economic austerity, aimed at reducing budget deficits with a view to reducing outstanding government debt. The turmoil in bond markets got the attention of the political class, and of the public. But public resistance to change is fierce when the public, and many politicians, see the need for painful adjustment with little prospect of economic gain in the near future.

"Growth" is unfortunately a somewhat ambiguous word. One should in principle distinguish between a once-for-all rise in output from a long-term trajectory involving a higher rate of growth. Once-for-all changes may however be spread over several years, resulting in a higher observed rate of growth in those years, not to be denigrated. But higher long-term growth from Japan's starting point of high income and high capital stock relative to the labor force can only be achieved by raising permanently the pace of technological innovation or by raising permanently the rate of growth of the labor force, which would require a significant rise in natality or in immigration, or both – and both are

problematic for Japan. Japan's long-term rate of growth is thus likely to be lower than that of many other countries, and of Japan's own past experience.

Japan leads the world in aging, with a median age (half below, half above) of 44.6 in 2010, expected to rise to over 54 by 2040, with a substantial increase in persons over 80. It is the first modern society to experience a long-term, secular decline in its labor force. We have no experience in managing such an economy, but the phenomenon will be much more common in 20 to 30 years unless there are substantial increases in birth rates in many countries, especially in Europe and in East Asia. Japan is leading the way, and all will learn from Japan's successes in managing such an economy – and from its mistakes.

There has been much public discussion, in Japan and elsewhere, of aging, and of the growing strain on public finances created by national pensions and by public commitments to health care. Higher taxes on the work force (or on wealth) are likely to be required to sustain those commitments as society ages.

Less attention has been paid to the implications for growth of a declining number of new entrants to the labor force – both on the supply side and on the demand side. Young adults these days are the most highly educated members of society, and they are the most flexible in terms of geographical location and in terms of occupational choice. Their choices permit a reallocation of resources within an economy from sector to sector without (up to a point) requiring re-adjustments by older members of the labor force. But the combination of a dynamic, possibly increasing pace of change and a declining number of flexible new entrants to the labor force inhibits change and strains those who have to adjust. In Japan, the number of young adults is expected to decline by a third over the next three decades. This reduction will reduce Japan's long-term growth rate, not only directly with the declining new entrants to the labor force, but also indirectly by reducing the adaptability of Japan's economy to the changes in the world that will inevitably take place.

What can be done? First, the decline in the labor force can be reduced through later and more flexible arrangements for retirement. People are not only living longer; they are healthier into old age. There is no reason why many cannot continue to work, particularly as the physically demanding employment declines. Retirement can also be made more flexible, so that older people (why not younger people too?) can work fewer and more flexible hours in each week, or fewer weeks in a year.

Second, greater work-time flexibility along with greater institutional support can permit women both to pursue a career and to have children. They must be enabled to return to employment after the desirable pause around child-bearing. And they can be provided with better day care facilities, and shorter and more flexible work weeks, once their children leave infancy. Japan is rich enough to do both, but it requires some supportive action and some change in attitudes.

On the side of demand, fewer young adults imply fewer new families, thus less new housing. Demand for new housing will not go away: old houses deteriorate and have to be replaced; tastes change, particularly as incomes rise; people want to move to new locations. But growth in number of families has been a major source of demand for housing in the past, and for all the items associated with

housing: new appliances, furniture, dishes, etc. Fine dishes and furniture will be passed down to younger generations, also some housing. Demand for these items will decline. Demand for working space and equipment will also decline with a declining number of new entrants to the labor force.

What will replace this demand? Recall that output will also decline (relative to what it would be otherwise) because of a declining labor force. So a decline in demand will not necessarily result in a slack economy, although it will result in lower growth. But as demand by young adults declines, demand by older adults will grow, or at least change in composition. As the population ages, demand for medical care and old-age hospice care will increase of course. But even healthy people will have new activities associated with their leisure in retirement: travel, entertainment, camps with both brainy activity such as lectures and training in traditional crafts, and so on. There will be a premium on adaptability, more for the economy than for individuals. The third arrow should be directed at producing that adaptability, even with a lower overall rate of growth.