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Thinking ahead for Europe

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Demographic Lessons from Japan for Europe

Daniel Gros

Japan's record of achieving growth without inflation should persuade the ECB that its preoccupation with maintaining "close to 2%" inflation might not be so important after all.

Demography is not destiny, at least not entirely. Over centuries, policy can affect fertility decisions and migration can transform a country, as the experience of the United States shows. Over shorter time horizons, however, demographic trends must be taken as a given, and they still can have a profound impact on growth. Yet demographic factors are often neglected in economic analysis, leading to significant distortions in assessments of countries' performance. Nowhere is this more apparent than in Japan.

With real output – the key measure of economic performance – having risen by only about 15% since 2000, or less than 1% per year, Japan easily seems the least dynamic of the world's major economies. But given Japan's demographics – the country's working-age population has been shrinking by almost 1% per annum since the start of this century – this result is remarkable.

In fact, Japan's growth rate per working-age person was close to 2% – much higher than in the US or in Europe. Although the US economy has grown by more than 35% since 2000, its working-age population has also grown markedly, leaving the annual growth rate per working-age person at only about 1%.

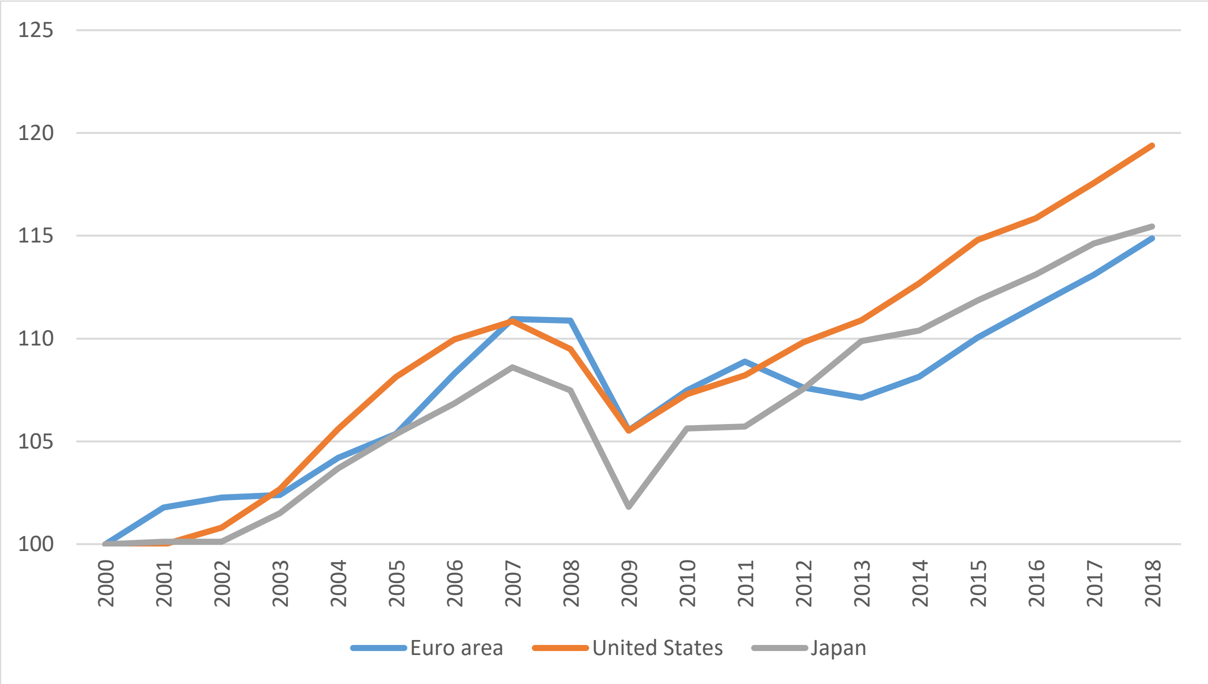
That indicator – growth rate per working-age person – is not widely used by economists, who instead focus on GDP *per capita*. By that measure, Japan is doing about as well as Europe and a little worse than the US (see Figure 1). But, while *per capita* indicators are useful for assessing a country's consumption potential, they do not provide an adequate picture of growth potential, because they include the elderly and the young, who do not contribute to production. Even in Japan, with its long life expectancy, those over the age of 70 do not contribute much to output. Figure 2 thus shows that Japan is clearly ahead if one looks at (real) GDP per working age person.

So, given its rapidly declining potential, Japan has been extraordinarily successful. A key reason is that it has put a growing proportion of its working-age population to work: unemployment is

Daniel Gros is Director of CEPS. This Commentary was originally published on the website of [Project Syndicate](), 8 November 2017, and is republished on the CEPS website with its kind permission.

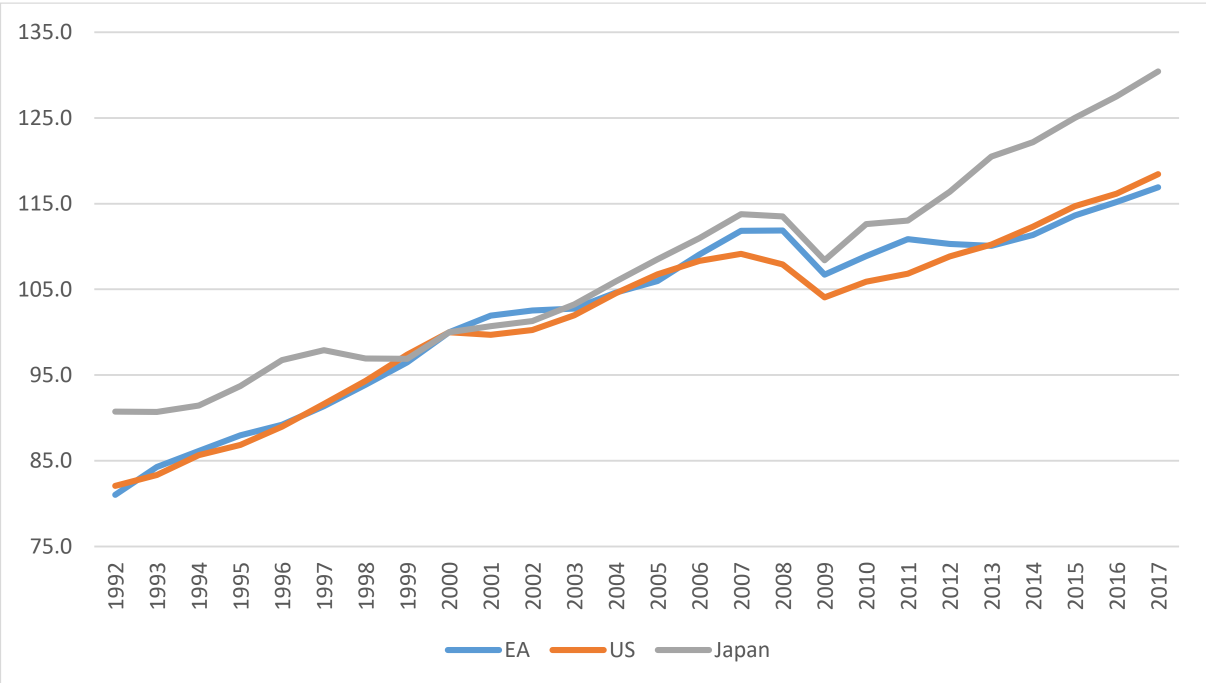
today at a record low of less than 3%, and almost 80% of those who are able and want to work have a job, compared to about 70% for Europe and the US.

Figure 1. Growth in real GDP per capita in the euro area, the United States and Japan (2000-2018)



Data source: European Commission, AMECO database.

Figure 2. Growth in GDP per capita per working age population, 1992-2017



Data source: European Commission, AMECO database.

Japan's achievement of full employment and high job growth over the last two decades is all the more noteworthy in view of near-permanent deflation during this same period (most prices are still lower today than they were 15 to 20 years ago). This should give food for thought to those who maintain that deflation imposes unbearable economic costs.

The Japanese experience holds important lessons for Europe, where the demographic future looks a lot like Japan's past. The eurozone's working-age population has not grown at all in recent years, and will soon start to decline at a rate similar to Japan's over the last generation. It seems unlikely that immigration will alter the trend. In recent years, Europeans, like Japanese, have proven to be highly resistant to large-scale immigration, which is what would be required to offset demographic decline.

Moreover, the eurozone has now settled on a current-account surplus of around 3% of GDP. That level is similar to the one long seen in Japan (except for the short period in the aftermath of the 2011 Fukushima Daiichi nuclear meltdown).

A first lesson to draw from Japan's experience is that, despite the eurozone's difficulty in generating inflation in an aging society characterised by excess savings, growth is not necessarily out of reach. Rather, given Japan's record of growth without inflation, the European Central Bank should recognise that its target of maintaining "close to 2%" inflation might not be so important after all. In any case, the particularities of the eurozone's structure mean that the ECB will have no choice but to halt its bond-buying operations in a year or so. This means that the ECB will not be able to follow in the footsteps of the Bank of Japan, which continues to purchase large volumes of government bonds, without any visible pick-up in inflation.

Another lesson from Japan is that a country with a large savings surplus can handle a large public debt, because it can be financed internally. That does not necessarily mean that it is desirable to run up the debt. Japan's debt-to-GDP ratio now exceeds 150% of GDP (taking into account the large financial assets of the government-owned savings institutions) and continues to rise, owing to large fiscal deficits.

This brings us to a final key lesson from Japan: in a low-growth economy, the debt-to-GDP ratio can quickly spin out of control. Fortunately, it seems that this lesson has already been learned, with the average deficit in the eurozone now amounting to only around 2% of GDP. The deficit cap imposed by the Stability and Growth Pact (3% of GDP) seems to have had at least some impact in terms of stabilising the debt ratio.

The structure of the eurozone imposes limits on the use of both fiscal and monetary policy. This should prevent the excessive build-up of debt, ultimately making it easier for the eurozone to manage a future in which the only way to sustain growth is to capitalise fully on the economy's declining demographic potential.