NEW HAVEN – Japan is the petri dish for the struggle against the secular stagnation that is now gripping most major developed economies. And, notwithstanding all of the fanfare surrounding “Abenomics,” Japan’s economy remains moribund. In the six quarters of Shinzo Abe’s latest stint as prime minister, annualized real GDP growth has averaged just 1.4% – up only slightly from the anemic post-1992 average of 1%.

Abenomics, with its potentially powerful combination of monetary and fiscal stimulus, coupled with a wide array of structural reforms, was supposed to end Japan’s “lost decades.” All three “arrows” of the strategy were to be aimed at freeing the economy from a 15-year deflationary quagmire.

Unfortunately, not all of the arrows have been soaring in flight. The Bank of Japan seems well on its way to delivering on the first one – embracing what it calls quantitative and qualitative easing (QQE). Relative to GDP, the BOJ’s monetary-policy gambit could actually far outstrip the efforts of America’s Federal Reserve.

But the flight of the other two arrows is shaky, at best. In recent days, Abe has raised serious questions about proceeding with the second phase of a previously legislated consumer-tax hike that has long been viewed as the linchpin of Japan’s debt-consolidation strategy. Abe has flinched because the economy remains weak, posing renewed risks of a deflationary relapse. Meanwhile, the third arrow of structural reforms – especially tax,
education, and immigration reforms – is nowhere near its target.

Abenomics, one might conclude, is basically a Japanese version of the failed policy combination deployed in the United States and Europe: massive unconventional liquidity injections by central banks (with the European Central Bank apparently now poised to follow the Fed), but little in the way of fundamental fiscal and structural reforms. The political expedience of the short-term monetary fix has triumphed once again.

Such a gamble is especially problematic for Japan. With an aging – and now declining – working-age population, it has limited scope for reviving growth. Japan must either squeeze more out of its existing workforce by boosting productivity, or uncover new sources of demand at home or abroad.

At home, that could mean adding workers, either by boosting female participation in the workforce, which, at 63%, is among the lowest in the developed world, or relaxing immigration restrictions. Unfortunately, there has been little progress on either front. Moreover, even if the political will to launch third-arrow structural reforms were suddenly to strengthen – a dubious proposition – any productivity payback would most likely take a long time to materialize.

That leaves external demand, which underscores what is perhaps Abenomics’ most serious strategic flaw: It does not take into consideration some of the biggest changes that are likely to occur in the global economy. That is a great pity, because Japan is well positioned to take advantage of one of the most powerful global trends – the coming rebalancing of the Chinese and US economies.

China appears to be more committed to restructuring than the US – at least for the foreseeable future. Its Third Plenum reforms provide a cohesive framework for a pro-consumption transformation. Though America currently remains intent on resurrecting a tired growth model, there is good reason to hope that it, too, will eventually rebalance.

Japan cannot afford to squander these opportunities. As the main driver of Chinese growth shifts from external to domestic demand, who could benefit more than Japanese exporters? China is already Japan’s largest export market, leaving it ideally situated to capture additional market share in the coming surge of Chinese demand for consumer products and services.
Likewise, Japan stands to benefit from its technological prowess in environmental remediation – an urgent priority for China in the years ahead. Japan already has great expertise in many of the solutions to some of China’s toughest problems.

Japan is also likely to gain from a long-overdue rebalancing of the US economy. A shift in the US – from excessive consumption of goods largely sourced in low-wage developing countries to the capital equipment that an increasingly investment-led economy will require – would play to Japan’s greatest strengths. As a global leader in sophisticated machinery and the earth-moving equipment needed for infrastructure investment, Japan should be able to seize these opportunities.

In looking to external demand, Japan should not lose sight of its earlier achievements. In the 1970s and 1980s, Japan was the envy of the world, owing to an all-powerful export machine that tapped the demand of a rapidly growing global economy. “Japan, Inc.” still has a good institutional memory of what it takes to draw support from external demand.

It is time to recapture that memory. Failure to do so would leave Japan, the world’s third largest economy, at risk of being further marginalized by transformations in the world’s two largest, the US and China.

There is one obvious and important caveat: Poor Sino-Japanese relations, owing to unresolved historical grievances, could prevent Japan from realizing the economic benefits implied by China’s economic rebalancing.

The interplay between economics and politics lies at the heart of the rise and fall of great powers. In a rapidly changing world, underscored by likely shifts in the economic structure of China and the US, Japan cannot afford to lose sight of that fact. Just as the US and China have much to gain by transforming their economies, Japan is running out of time. In the grip of two lost decades and counting, this could be Japan’s last chance.


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