The Opportunity and Risk of "Abenomics" That Has Begun to Push the Japanese Economy Out of Stagnation and Deflation

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The Japanese cabinet headed by Abe Shinzo is attracting worldwide attention for its anti-deflationary and economic revitalization package, which is known as "Abenomics." Behind this attention, there is concern that failure of the package, which includes an unprecedented level of monetary easing, would not only send the Japanese economy into a crisis situation but also affect the growth and stability of the entire global economy. For the time being, it has given people hope through the rise of share prices and the reversal of the excessive appreciation of the yen. An increase in capital investment in the corporate sector suggests a resurgence of entrepreneurship.

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However, continuation of economic growth beyond this short-term economic recovery will depend on whether or not the government manages to carry out the painful structural reform needed for economic reconstruction. Structural reform for continued economic development is referred to as a growth strategy, but inadequate implementation of the reform will mean that the economic stagnation continues and that there will no longer be a chance of eliminating the government deficit, which is now more than double the country's gross domestic product (GDP). In that case, confidence in Japanese Government Bonds would be lost, the long-term interest rate would skyrocket and a financial crisis would result.

The International Monetary Fund (IMF) expressed its hopes for Japan's audacious economic reform in its Global Risk Analysis Report in August 2013. At the same time, it warned that failure of the reform is one of the greatest risks facing the world economy. This report presented a possible scenario, in which if the Japanese Government Bond yield suddenly jumps 200 basis points the Japanese government will be under pressure to cut fiscal spending and adopt a massive tax increase, which would throw the Japanese economy into a deep slump and slow the global economic growth rate down by two percentage points. As of October 22, 2013, the ten-year Japanese Government Bond yield stood at 0.6%.

The second Abe government was inaugurated on December 26, 2012. Earlier, Abe formed his first government in September 2006 and resigned as head of government less than a year later for his own health reasons.

The prime minister declared the launch of Abenomics, saying: "I failed once, I learned from the failure and I am now back. I will revive the long-ailing Japanese economy." Abenomics comprises, first, a bold monetary relaxation policy; second, a flexible fiscal policy; and third, a growth strategy aimed at stimulating investments in the private sector. Thus, the package is dubbed the three arrows.

This policy direction was already seen in the general elections for the House of Representatives of the Japanese National Diet at the end of 2012. The Liberal Democratic Party (LDP) achieved a landslide victory, securing 294 seats out of 480 in total in the House, to regain power from the Democratic Party of Japan (DPJ), which was considered unfriendly to business. The event sharply heightened public expectations, and particularly market expectations.

For monetary policy, a historical collaboration between the Abe cabinet and the Bank of Japan was declared in the form of a joint statement between the government and the country's central bank in January 2013. In the joint statement, the Bank of Japan officially announced a consumer prices inflation target of 2% per year in a bid to exit from deflation and declared that it would meet the target as early as possible.

In March 2013, Kuroda Haruhiko, who had championed Abenomics, became governor of the Bank of Japan. He introduced a qualitative and quantitative easing (QQE) policy and sought to massively increase money supply while maintaining the zero interest rate policy. That added momentum to the stock market, which has been booming since the general elections. As the stock market expectations swelled, for a while some said that Abenomics would be Asset Bubble Economics.

Indeed, the atmosphere of the stock market has totally changed under Abenomics and the public mood is now positive. Business is buoyant. The U.S. Pew Research Center provided an analysis titled *Japanese Public's Mood Rebounding, Abe Highly Popular* in July 2013. Japan has experienced twenty years of economic slowdown since the bubble burst in 1991 and saw its nominal GDP tumble around 10% from its peak level. Japan was long left outside of global geopolitical interest, and Abenomics suddenly drew worldwide attention to Japan. *The Economist* had made pessimistic comments on the Japanese economy for twenty years before it carried a cover story with an illustration of Abe flying in Superman costume in May 2013.

On his visit to Japan at the end of April 2013 to deliver a presentation on the Japanese economy analysis, Angel Gurria, Secretary-General of the Organisation for Economic Co-operation and Development (OECD), hailed Abenomics by saying: "I am pleased to confirm a feeling of optimism and dynamism in Japan. Prime Minister Abe deserves much credit for the new spirit of optimism in Japan, based on the "three arrows" that he is launching to revitalize Japan and exit deflation. (...) the Bank of Japan's new commitment to a 2% inflation target and "quantitative and qualitative monetary easing," is welcome."

Formerly sour on Japan, Paul Krugman, a Nobel laureate in economics, also began to make positive remarks about the new Japanese economic package: "Whatever his motives, Mr. Abe is breaking with a bad orthodoxy. And if he succeeds, something remarkable may be about to happen: Japan, which pioneered the economics of stagnation, may also end up showing the rest of us the way out. (...) Indeed, our policy response has been so inadequate that I've suggested that American economists who used to be very harsh in their condemnations of Japanese policy, a group that includes Ben Bernanke and, well, me, visit Tokyo to apologize to the emperor. We have, after all, done even worse."

According to the IMF World Economic Outlook published in October 2013, Japan's real economic growth rate is estimated at 2.0% in 2013 and at 1.2% in 2014. These figures are lower than those of emerging economics but relatively robust among developed economies, including the eurozone, which is estimated to grow at minus 0.4% in 2013 and at 1.0% in 2014. The U.S. economy is forecast to expand at the rate of just 1.6% in 2013. Abenomics has thus made a good start.
However, what matters is the long-term trend of the Japanese economy. Monetary easing and increased public spending will merely have a temporary economic effect. They alone cannot ensure lasting economic growth. Economic expansion cannot be sustained without a structural reform. Monetary and fiscal measures for economic stimulation merely buy time until the structural reform produces its effect.

The growth strategy based on structural reform, the third of the three arrows, has yet to be put into action. So, the IMF and the OECD – while basically favorable towards Abenomics and placing their hopes in it – urge Japan to boldly and swiftly release this arrow.

The Staff Report for the 2013 Article IV Consultation published by the IMF in August 2013 says: "The Japanese authorities have embarked on an ambitious agenda to raise growth and exit deflation. The new policy framework—"three-arrows" of Abenomics comprising aggressive monetary easing, flexible fiscal policy, and structural reforms—provides a unique opportunity to end decades-long deflation and sluggish growth, and reverse the rise of public debt." On the other hand, it stresses that although Japan's short-term economic outlook improved it is essential to carry out the structural reform and the growth strategy, dubbed the third arrow, together with the two other arrows, and added that Abenomics still has some risk in this sense. With respect to the structural reform, the IMF states that it is necessary to implement comprehensive reform, specifically including deregulation in the agricultural and service sectors, remediation of the polarization (or the gap) in the labor market, encouragement of women's participation in the workforce, stabilization of the financial sector by remedying the state in which banks hold excessive portions of Japanese Government Bonds, and fiscal reform. After that, it warns: "Failure to follow through on fiscal and structural reforms could lead to an overreliance on monetary policy with negative consequences for Japan and the global economy."

Here, there arises a question about the details of the growth strategy. The key to its success lies in structural reform in the sectors of agriculture, urban development, and medical and nursing care among others.

The structural reform involves a readjustment of vested interests. Any reform will confront opposition. No reform can be done without political leadership. In this respect, the Abe cabinet has both opportunity and risk. Opportunity means that the cabinet is capable of making the necessary laws if it decides to do so given that the LDP, headed by Abe, now holds an overwhelming majority in both houses of the National Diet. After the landslide victory in the lower house elections in December 2012, the LDP, together with its coalition partner the party New Komeito, massively increased the combined number of seats they hold in the House of Councilors to 135 and secured a majority of the total of the 242 seats in the house. That put an end to the twisted parliament, which created difficulty in making laws and induced a long period of indecisive politics.

The Abe government has another advantage. There will be no national-level election for the next three years. This will help Abe remain in power for a significant period. Before his current cabinet, each government lasted just about a year. A combination of short governments with a twisted parliament generated a policy vacuum. All these cabinets pledged to carry out a structural reform but they ended before putting it into action. While the policies that were actually implemented were short-sighted, the necessary structural reform has so far not been done. That ultimately prolonged the Japanese economic stagnation.

Outside Japan, some see Abe Shinzo as a rightist and nationalist. *The Economist*, which as we have seen depicted him as a Superman, and other media speculate that his government's economic package may stumble on his nationalism, which could bring about a diplomatic deadlock. However, Abe's priority for the time being is the economy, economy, and economy, followed by a long term in office. He seems convinced that economic rehabilitation is the way to ensure Japan's diplomatic power.

Economic reconstruction does not mean just boosting the economy for the short term. Rather, it means ensuring continued economic growth and reversing the downward trend in the potential growth rate that lasted for more than twenty years after the bubble burst; in order words, pushing the growth rate upwards.

The economist Robert A. Feldman likened the post-bubble developments of the Japanese economic policies and trends to the CRIC cycle. According to his argument, in the event of a Crisis, a stopgap Response action was taken to Improve the economic situation to some extent. That led to Complacency and to a resulting postponement or omission of any painful reform. As a result, the economic structure remained unchanged and caused another Crisis. After that, a similar policy action was repeated. For this reason, the government failed to stop the decline in potential growth rate and government debt, which are the price to be paid as a result of the stopgap economic stimulus package, have incessantly swollen.

Actually, more than ten economic measures adopted since the 1990s had such adjectives as "emergency" and "comprehensive" in their names. In reality, Japan continually took non-painful monetary easing measures and pork-barrel spending for economic stimulation.

The Japanese economy faces a number of structural issues. They include, first, a shift to a growth model in recognition that the era of a latecomer economy catching up with advanced ones is over; second, construction of programs and economic and industrial structures geared to the world's fastest aging population; third, responding to the globalization of the world economy; and fourth, redeveloping an energy policy including reforms to the system of power supply in the wake of the Fukushima nuclear accident. There have been other issues, too, such as addressing the aftereffects of the Japanese bubble, such as settlement of bad loans, but these have mostly been resolved.

In the catch-up phase, Japan was able to introduce key technologies from developed Western countries and develop industries it sought to foster at low risk, as they had already been tested in developed countries. Japan regarded it as more important to refine the technologies it introduced than to create new technologies and provided equalized and uniform education to meet demand for a massive homogeneous workforce with high average quality rather than to produce unique and talented human resources.

With the catch-up period now offer, Japan needs to develop technologies on its own and open new technological and industrial frontiers for the purpose of continued development. The system, human resources and corporate management required at this stage are totally different from those required during the catch-up phase.

It is estimated that Japan completed its catch-up process around 1980. However, the country retained the systems and practices of its catch-up period. They helped inflate the economic bubble of the late 1980s. After the bubble burst, Japan was busy disposing of bad loans and excessive production capacity. Even today, the systems and practices in the catch-up period remain intact and impede fresh growth.

Japan also delayed taking action in response to globalization of the world economy. Coincidently, globalization accelerated tremendously when the Japanese economic bubble burst in 1991 after the Cold War ended with the collapse of the Soviet Union.

Many countries carried out reforms and opened their markets in pursuit of opportunities for higher growth. They were in a large-scale global race in institutional reforms. As they competed for foreign direct investment, national barriers to direct investment became lower and lower. Direct investment thus increased at a tremendous pace worldwide. This triggered a major division of labor and growth in world trade. Interdependence among different national economies increased dramatically. A global economy was formed.

Amid a worldwide trend towards globalization in the 1990s, the Japanese economy was experiencing a persistent recession. Meanwhile, the country suffered a number of serious domestic events, such as the Great Hanshin-Awaji Earthquake, the sarin nerve gas attack by a regional cult, the end of thirty-eight years of the LDP's monopoly on power, which is often referred to in Japan as the 1955 System, and a subsequent sequence of short-term governments. Japan became inward-looking and deviated from the general trend of the global economy. Meanwhile, the Japanese population steadily aged.

With a sense of socioeconomic stagnation, the Japanese general public plunged into excessive pessimism. The entrepreneurial spirit was weak. Deflation commenced in 1998 and persisted for as long as fifteen years. Businesses took a conservative stance to overly depend on labor cost cuts. That created a vicious circle, in which job cuts led to a decline in household income, consumption slowdown, contraction of corporate earnings and further job cuts.

The third arrow of Abenomics, which is the growth strategy based on structural reform, is definitely significant in the sense that it is necessary to go beyond the temporary expansion of the Japanese economy and terminate the vicious spiral into shrinkage. The IMF, the OECD and investors around the world all pay attention to the details of the third arrow of Abenomics and their implementation.

The prime minister dubbed the extraordinary Diet session that commenced on October 15, 2013 as "the Diet (session) to execute the growth strategy." At the beginning of the session, he asserted in his policy speech: "Their [Japanese] confidence withered away during Japan's prolonged deflation. We will free Japan from this spell and once again restore a nation brimming with the spirit of entrepreneurship. We will create a society in which young people are dynamically engaged and women shine. These are the very essence of my Growth Strategy. Finally, we will open the curtain on Japan's *new growth*."

The Japanese government is working to draw up specific measures for its growth strategy in a bid to finish the process at the end of 2013. Its underlying concept is reflected in the government report published in June 2013 titled "Japan is Back." In the report, we find the word "innovation" used in more than thirty places and the word of *shinchintaisha*, literally "metabolism," in more than ten places. That suggests Abe's stance of emphasizing structural reform in a bid to bring the country out of the CRIC cycle.

The "Japan is Back" report specifies many challenges. They include acceleration of the reform driven by the program for National Strategic Special Zones, promotion of innovation based on information technologies, maximizing the use of women's power, enhancing technical capabilities, and introducing corporate income tax cuts and deregulation aimed at encouraging investment.

The point lies in how thoroughly the structural reform can be implemented to increase the potential growth rate and to revitalize the economy. Japan's participation in the Trans-Pacific Partnership (TPP) is another key issue and a benchmark for reform. Japan recently began negotiations with the other participating countries.

After the period of twenty years or so during which Japan continually adopted an inward-looking attitude, its image as a trading nation is now different from the reality of the country. Japan's dependence on foreign trade, which is the ratio of total imports and exports to GDP, stood at 28.58% for 2011, which puts Japan in 175th place among the 180 countries and regions. Amid this trend towards interdependence, the global economy as a whole has an ever-rising dependency on international trade, which stood at 52% for the same year. Germany's figure stood at 76% and the Republic of Korea's at 97%. Japan's ratio of exports to GDP was 14%, which is far below the worldwide average of 26%. On that measure, Japan ranked 148th among the 185 countries. These data do not project an image of Japan as a trading nation.

Japan's ratio of foreign trade under free trade agreements (FTAs) and economic partnership agreements (EPAs) stood at 19%, which is much lower than the figures of the United States and the Republic of Korea, specifically 38% and 35% respectively.

In the past, the Japanese economy was urged to shift from its conventional model of dependency on foreign demand to a model of dependency on domestic demand. In reality, it is now overly dependent on domestic demand. However, Japan's domestic demand is in decline given population shrinkage. In the future, it will face downward pressure for demographic reasons. It is necessary to expand domestic demand by means of structural reform but Japan's low export dependency rate of 14% was a result of the shrinkage of domestic demand in addition to a decline in GDP as denominator. Japan's share of total worldwide foreign trade has nearly halved in the past two decades whereas Germany's share has remained almost flat.

It appears to be the agricultural sector that is an impediment to the FTAs and EPAs that will help expand Japan's foreign trade. This sector not only opposes deregulation of trade but deregulation of anything.

As reform faces many challenges, the leadership of the Abe cabinet is being tested. In the days of the divided parliament, the cabinet had to deal with objections from other parties. Now, the LDP has a stable majority in the National Diet. The forces of resistance to reform are no longer opposition parties but certain LDP insiders working to defend traditional vested interests after the party gained a majority. The degree of implementation of the necessary reform will depend on Abe's own leadership, and his leadership depends on approval ratings for himself and his government. So far, his cabinet enjoys a high popularity rating of 60% to 70%. It suggests that a certain degree of structural reform is expected.

Abenomics has created the first opportunity for Japan's revival in many years. However, its failure would mean a loss of domestic and foreign trust in the Japanese government and the national treasury facing debt that is double GDP. The country would sink into a serious crisis. In this sense, Abenomics may well be the first and last chance for Japan's revitalization.

Translated from an original article in Japanese written for Discuss Japan. [November 2013]

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