Abenomics: Japan’s New Economic Policy Package

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Abstract

This paper addresses Japan’s economy, its new economic policy package, and the new term – Abenomics – that is used to describe the three pillars, or “arrows,” of the Abe government’s focus on the Japanese economy and on economic policy. The term Abenomics is an example of brilliant branding. At the same time it is risky, since it implies Prime Minister Abe’s success or failure will depend on the success or failure of Abenomics. This paper makes three major points. First, it is far too early to tell whether Abenomics will be successful – in ending deflation, bringing about price stability and getting the economy onto a stable, full employment growth path. Second, perhaps the most important change is the shift in people’s feelings about Japan’s future, from resignation to optimistic hope. However it is not at all clear that this new mindset will become deeply engrained and sustained. Third, we should distinguish between Abe as Prime Minister and Abenomics.

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1 This paper is based on the keynote speech presented at the STAJE Conference, Stanford University, June 6-9, 2013.
This paper addresses Japan’s economy, its new economic policy package, and the new term – Abenomics – that is used to describe the three pillars, or “arrows,” of the Abe government’s focus on the Japanese economy and on economic policy. The term Abenomics is an example of brilliant branding. At the same time it is risky, since it implies Prime Minister Abe’s success or failure will depend on the success or failure of Abenomics. Before going into more detail, this paper makes three major points.

First, it is far too early to tell whether Abenomics will be successful – in ending deflation, bringing about price stability and getting the economy onto a stable, full employment growth path. The initial evidence is certainly positive, but there is a long way to go.

Second, perhaps the most important change is the shift in people’s feelings about Japan’s future, from resignation – sho ga nai – to optimistic hope. Revitalization is a somewhat strange term, especially regarding the economy, but that is one catch word that is being used. Economists use the term expectations, but what is going on is deeper than that. This optimism is propelled in large part because many Japanese are sick and tired of the malaise of the past two decades, and have been eager to buy into Abenomics, probably a lot more than buying into Abe himself as an outstanding leader. However it is not at all clear that this new mindset will become deeply engrained and sustained.

Third, we should distinguish between Abe and Abenomics. It is possible that both will succeed. Or it is possible that Abe will fail as Prime Minister but that his successor will embrace the Abenomics economic policy program, and forward momentum will continue. Or, the three arrow package will not be implemented sufficiently well, and Abenomics and Abe will fail. But that does not mean the end of Japan. Japan will muddle through once again; it is quite experienced and good at that.
It is easy to label Japan as having suffered from its so-called two lost decades. In a broad sense that is true – modest but pernicious deflation, inadequate domestic demand, mediocre growth below potential, weak labor markets and a widespread sense of malaise. Over the period growth has been volatile—recessions, recoveries, growth, the sharp decline in 2009 as the global Great Recession hit all high income countries, Japan’s partial recovery and then slide back to modest recession again in 2012, and now rapid recovery—at least this year.

But that is too simple a statement of what has been going on in Japan over the past two decades.

First, there has been a great deal of change in institutions, organizations, corporate and personal behavior, generational values, and various other changes below the radar screen. Japan is quite different today from 20 years ago.

Second, the demographic realities of a declining labor force since 1995 and now declining population have already had a big effect and will continue to have a big effect; and they provide lessons for Korea and China as well as Europe.

Nevertheless, Japan has not done so badly in a comparative context. We have to stop focusing simply on GDP growth rates, given the new demographic context, and emphasize the growth of GDP per capita, GDP growth per worker, and especially labor productivity, Japan has done better than Europe, and almost as well as the US in the past decade, with even higher growth rates of these variables in the 1990s. Japan’s performance should not be so surprising, since its labor productivity and GDP/capita are still below that of France, Germany, and the UK, and especially the US where the gap has actually been widening. However, Japan’s good productivity performance has been hidden in aggregate terms by the decline in the Japanese labor force. Nonetheless, even with that decline, Japanese labor is still misallocated and underutilized, due to poor growth relative to potential and the employment system rigidity for regular workers.
Japan will grow well this year – maybe 2.5% or so – but that alone will not be enough to end deflation and provide sustained growth in the longer run. That’s why Prime Minister Abe’s top priority of economic policy is so important.

Abenomics has three interrelated components – or arrows. The first is a dramatically expansive monetary policy initiated April 4 and anticipated well before the appointment of Governor Kuroda and Deputy Governors Iwata and Nakaso, who took office March 20.

The second arrow is fiscal stimulus, embodied in the very large supplementary budget (10.3 trillion yen) passed in March, in the fiscal year ending March 30. The third arrow, the most important and the most difficult, is the long-run growth strategy, based on a range of structural reforms.

Like most observers, I certainly had expected the Bank of Japan to take a new and bold monetary easing policy when its Monetary Policy Board met on April 4. However, the new policy package is dramatically stronger than I, and apparently most others, expected, and unprecedentedly so. “Shock and awe” was an appropriate phrase some commentators have used. The Japanese stock market immediately rose sharply, and the yen weakened further.

In addition to the measures now being implemented, if necessary, the Bank of Japan could even purchase more exchange traded funds, taking on more credit risk and signaling that it is prepared to do anything and everything to end deflation.

The Bank of Japan is pursuing two seemingly contradictory policies at once. Most important, its goal is to end deflation and achieve an increase in prices on the order of two percent of the consumer price index, which translates into about one percent annual increase is the GDP deflator. That means that a nominal interest rate of one percent would be equivalent to a real interest rate of zero. On the other hand, the BOJ wants to keep nominal interest rates, not only short term but especially long term, very low in order to encourage investment and consumer
durables spending. The yield on ten-year Japanese government bonds is a market benchmark. In the near term, the BOJ apparently aims to keep the JGB yield below one percent. In other words, it wants real interest rates to be negative or zero during the present transition recovery period.

Since the government debt and amount of JGBs outstanding is huge, increases in interest rates reduce JGB prices and bring about substantial capital losses to government debt holders. Moreover, monetary policy implementation has led to significant increases in the volatility of JGB prices, with increased uncertainty leading to a higher risk premium. The riskiness of JGBs so far has not been credit risk – risk of default – but capital loss risks. However default risk – a JGB market crisis – is eventually in the making since continued large government budget deficits and JGB issue are unsustainable in the long run, as Professor Takeo Hoshi and others have well analyzed.

The current volatility has certainly shaken up the JGB market, and the JGB yield has recently gone from its bottom point of 0.4 percent to almost one percent – and deflation has yet to end, so positive real yields persist. The monetary policy challenge is to reduce real interest rates during this transition period, by keeping the rises in the JGB yields below the improvements in the CPI.

We should not be surprised by the increased volatility in the JGB market or the stock market. Those are probably inevitable big hiccups in the adjustment process.

The second arrow – fiscal policy – has a clear direction and target in the near term, but its longer run strategy is not yet set. This is in part because of the uncertainties as to how quickly and how strongly monetary policy will be effective in ending deflation and stimulating demand.

The current fiscal stimulus is essential. Fiscal and monetary policies are necessary complements for an effective macroeconomic policy. In general terms
these new government expenditures follow traditional LDP public works programs, many of which were not very productive. However, this time in addition to the ongoing rehabilitation of Fukushima, some public works involve much-needed repair of bridges, tunnels, and other parts of much earlier infrastructure investments. But perhaps I am being too optimistic; political pork barrels have not disappeared.

Japan faces four fiscal policy issues. First, when should fiscal stimulus be ended, and replaced by fiscal consolidation? Fiscal consolidation should not be done prematurely. Deflation has to be brought to an end first and a stable full employment growth path established.

Second, should the currently enacted consumption tax increase from 5 percent to 8 percent in April 2014 and to 10 percent in October 2015 be allowed to go into effect, or should they be delayed? I hope they will stay in place, but I don’t know. It depends on how the economy is doing this coming fall, when a decision has to be made in October.

Third, once fiscal consolidation becomes the proper policy over the longer term, what further taxes, not only the consumption tax, should be raised, by how much and over what long-term time frame? Japan’s tax system needs to be revised and restructured. In principle national taxes should not be increased further on consumption, which needs to be encouraged, but on assets… but as of now, that seems politically impossible.

Fourth, to what degree should government current pension, medical care and other welfare programs be cut in order to restrain government expenditure growth as the population ages? The trade-off between social welfare expenditures and taxes is a major issue in all societies.

In terms of the first two arrows – macroeconomic monetary and fiscal policies - Japan is on the right path. But it is far too early to see other than short-
run results. To repeat, one key is expectations – both about ending of deflation and about restoring full employment growth. Even before Abe was elected, Japanese expectations shifted positively. A year ago in Japan the attitude was one of resignation, of *sho ga nai*; now it is one of hope, as earlier noted.

It is difficult to manage expectations. Sustaining positive expectations needs more than hope, it needs action which so far we are seeing – and it needs results, which takes time to achieve.

The third arrow – structural reforms to achieve better economic growth in the longer term – is both the most necessary and important, and the most difficult to achieve. It is not a single arrow, but rather a package of arrows. One danger is that too many reforms will be defined as elements of the third arrow, and the target will be a big blob, with lots of darts rather than big arrows. A few priorities have to be defined and given high policy focus.

Fiscal and monetary policy alone cannot provide good, stable, long-run growth, but they do provide the underlying policy environment. Market liberalization and structural reforms are needed in Japan to create new opportunities for companies to invest – both in services and in agriculture. It is not simply a matter of blanket deregulation – it is the right kind of regulation which is supportive both of competitive markets and of consumer safety and security.

The growth strategy report was announced by the Prime Minister on June 14. It was essentially based on the Industrial Competitiveness Council report of May 29. There, the Council outlined three broad strategies for growth, each with topics or goals. The first is industrial revival, including industry restructuring, labor market reform, IT, innovation and help for SMEs. The second strategy is to create new growth markets, centering on health care, energy, infrastructure and agriculture and fishing industries. The third strategy emphasizes globalization; promoting strategic trade relationships such as TPP, trade and foreign investment.
inflows and outflows, and globalizing Japanese human resources, which I assume means learning English or other foreign languages.

Since the long-run growth strategy was announced only five weeks before the upcoming Lower House election, it is not surprising that the specification of priorities and implementation procedures was somewhat vague. Presumably those are to be clarified in the late summer and early fall, following the election, according to the June 14 report. It is essential that Abe define a few policy priorities and push them hard. Japan’s decision to join the TPP negotiations is a major step forward, but that alone will not be enough. The problem is that established vested interests, not only in agriculture, are strong and will resist changes.

The government has already addressed the major sector of electric power generation and distribution. The cabinet approved a sweeping electricity power reform on April 2. It involves a drastic restructuring of the electric power system by forcing the major electric power regional monopolies to separate their electricity production from its transmission and distribution, to make it possible for new entrants to produce electricity and sell it to the grid, and enter and develop electricity transmission networks. As always, the devil lies in the details, which will be spelled out over the course of the next two years. There will be significant political fights, since the public utility companies were very powerful and probably still are despite their pre-Fukushima scandalous assertions that all their nuclear power plants were completely safe.

Council members are significantly divided in their fundamental approach to reform. One group wants to deregulate and free up markets, thereby creating opportunities for private companies to enter previously protected markets and niches. The other group’s view is that the government should give priority to new industrial policy initiatives, and provide new funding in support. Both views are
incorporated into the Council’s growth strategy outline, but it seems that the
industrial policy group was more powerful. I worry about government funding for
smaller so-called “winner” firms that are not able to borrow from banks but that
are presumed to have dormant patents and technologies which could profitably be
developed commercially. In practice such funding could simply mean continuing
to support some 40,000 or so SME zombie companies as well as some larger
zombie firms.

It is really important that the emphasis on freeing up markets become the
fundamental basis for deregulation and structural reform – relying more on markets
than on government-based funding to bring about structural reform and growth in
the long run.

I assume the LDP will win the July Upper House election and stay in power for
another 3 years, and Abe will be Prime Minister for a further 3 years or longer
unless he makes some terrible mistake or his health becomes bad, or for some
reason a Lower House election is held sooner. Right now Abe seems a new man –
energetic, self-confident, well briefed and demonstrating considerable leadership. I
assume he wants to win the next election in 2016, and stay in power for an even
longer period. If so, he has to focus primarily on the economy, not on his
ideological predilections.

Will he do that, or will he use his political chips to push for comprehensive
constitutional reforms and other domestic, and foreign, policies which represent his
fundamentally nationalist thinking? Will he continue to be a pragmatist, or will
his right-wing nationalist objectives prevail?

In terms of the third arrow, if Abe is willing to bear the political costs, he will
have a one-year or so window of opportunity after the July election to push
structural reform measures though. Vested interests will be angry and his public
popularity will go down. But no elections will be held for three years. Over time
people will calm down, particularly if Abenomics achieves its goals and the feeling is that Japan has become revitalized. The danger of course is that if Abe does not carry out structural reform, and reduces emphasis to economic policy, that Abenomics will not succeed. Then Abe and the LDP will have a tough time in the 2016 Upper House election, when a simultaneous Lower House election might well be scheduled.

Japan’s economy will do well for the next 12 to 15 months, but after that I am much less sure. I continue to worry about inadequate domestic demand, a major structural problem for two decades. Will structural reform and improvements in expectations lead companies to invest more at home? Will the economy grow well enough that labor becomes tight, and companies have to raise wages? Now that household saving rates are so low, sustained increases in consumption spending require household incomes to rise, and for most families that depends fundamentally upon wage increases.

When will the Abe government succeed in ending deflation? How long will that process take? I am concerned less about the specific 2 percent inflation target than I am about the maintenance of optimistic expectations. Even if the CPI rises less than a 2 percent annual rate within the next two years, if people think that deflation has ended and growth performance will be better, that will be good enough.

In conclusion, obviously the first big challenge for monetary policy – and indeed for macroeconomic policy – is to end deflation definitively. With monetary reforms and good growth achieved, then that will be the time to tackle the long-run problem of fiscal consolidation, which will require eventually raising taxes even further, as well as constraining pension expenditures. But fiscal consolidation should not happen prematurely. There is no contradiction between fiscal stimulus
and fiscal stabilization. It is essentially a matter of timing. It is really costly to pursue austerity before full employment growth is sustained.

So I am optimistic about Abenomics for the next year or so, but beyond that I feel quite uncertain because I don’t know how the third arrow package will be defined and implemented. The comings months following the election will be important for many issues – the third arrow implementation policies, Diet legislation proposals, the October deadline on whether to implement the consumption tax increase from 5% to 8% on April 1, 2014, and the government budget formulation in November for the next fiscal year. At worst, Japan will somehow muddle through.