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Japan After Two Years of "Abenomics"

Monetary Illusions, Timid Reforms: So Far, Prime Minister Abe's Economic Policy Has Missed Its Mark

Hanns Günther Hilpert

When Shinzo Abe became Prime Minister of Japan in December 2012, he raised great economic expectations. He promised a radical turnaround in monetary policy, long-term fiscal consolidation, and structural reforms to revive the economy. Two years on, the interim results of "Abenomics" are sobering. Despite unprecedented monetary expansion and vigorous fiscal stimulation, Japan has been unable to overcome deflation and weak growth. And although the consumption tax has been increased, the country is far from achieving sustainable budget consolidation. Abe has also failed to deliver on his promise to introduce groundbreaking structural reforms aimed at stimulating growth. Why have these goals not been achieved? In light of Japan's large – and growing – national debt and its ageing population, what other economic policy options can be pursued?

Japan's economy has never really recovered from the bubble shock of the early 1990s, when an unparalleled real estate and stock market bubble burst. The results included high household and corporate debt, a crippling banking crisis, and a steady decrease in Japan's potential growth from its previous level of 4 percent to 1 percent. Only by filling the demand gap through fiscal spending largely on construction projects – some of them absurd – did Japan manage to avoid sliding into a depression. As a result, the International Monetary Fund calculates that Japan's national debt rose to 245 percent of GDP. On the other hand, the Bank of Japan, the country's central bank, was unable to avoid mild deflation, even with a vigorously expansive monetary policy. At the same time, more and more Japanese found themselves in precarious employment; income and wealth disparity steadily grew.

As the political-social consensus that had shaped Japan's traditional "growth coalition" of LDP policymakers, bureaucrats and business leaders disintegrated, established interest groups turned to defending their own vested rights. The process of creative destruction necessary to initiate reforms and change – for example breaking up cartels and oligopolistic structures or changing the corporate governance of Japanese companies – has still failed to materialize. The temporary change of leadership in 2009,

Dr. Hanns Günther Hilpert is Head of SWP's Asia Division

which put the Democratic Party (DPJ) in office for three years, was unable to produce the game-changing reforms, structural transformation and economic upswing many had hoped for.

"Three Arrows" for Japan's Economic Reform

With his promises of professional governance and sustainable economic improvement, Shinzo Abe, who had already served as Prime Minister in 2006/2007, won a landslide victory in the Lower House Elections of December 2012. As a result of his victory the Liberal Democrats (LDP), who had ruled the country almost without interruption from 1955 to 2009, returned to power. Abe announced that he would fight deflation with aggressive monetary policy, stimulate the economy by means of expansive fiscal policy, and overcome investment blockades through structural reforms. By using the popular "three arrow metaphor to explain his economic and business cycle policies, he delivered a clear message: the penetrating power of coordinated monetary, fiscal and structural policy would restore the country economically and make it strong again. Japan, the world's third-largest economy, fifth in the world in exports, the seventh-largest recipient of foreign investment and second in the world in patent registrations, was to regain its status as a "first-tier nation".

But it was obvious from the start that the Three Arrows differed substantially in terms of importance and size. Structural policy reforms initially consisted of nothing more than announcements, and fiscal expansion, in classic manner, benefitted primarily domestic construction firms. The shift in monetary policy, by contrast, was tantamount to an institutional and monetary revolution. Although the independence of the Bank of Japan, which oversees monetary policy, is enshrined in law, Abe quickly managed to overcome resistance to the change in monetary policy – by means of political pressure and the rotational appointment of a new governor and two members of the central bank's Monetary Policy Board.

The reshuffled Policy Board, under the new leadership of Governor Haruhiko Kuroda, announced in April 2013 that it would achieve an inflation rate of 2 percent within two years through quantitative and qualitative monetary expansion (QQME). The new monetary base target was to be doubled from ¥138 trillion (end of 2012) to ¥270 trillion (end of 2014) – regardless of how interest rates developed. Thus the monetary base to GDP ratio, which was already at an unprecedented level, was to be doubled to nearly 60 percent. Internationally, up until 2007 monetary base to GDP ratios of 5-10 percent were common. This shows how the Japanese central bank was breaking new ground. The quantitative monetary expansion was implemented (and continues to be implemented) by purchasing Japanese government bonds, including long-term ones maturing in six to eight years, in order to qualitatively influence the long-term capital market interest rate.

With this new policy, the Bank of Japan aims to drive down long-term interest rates, support the development of tangible assets, and suppress the external value of the yen. In this way, the Bank intends to bolster overall economic demand and defy deflationary expectations among economic actors. The chain of effects is intended to lead to higher good prices, stronger wages, greater investment, and increased durable goods purchases. The macroeconomic demand gap would be filled.

Mixed Interim Results

Macroeconomic development: After two years of economic policy under Abenomics, there is no sustainable recovery in sight for Japan's economy, despite the fact that monetary and fiscal policy got off to a brilliant start initially. Central bank governor Haruhiko Kuroda's announcement of a monetary turnaround was effective, particularly as the government and parliament passed two supplementary budgets. Shortly thereafter, share prices rose, business confidence improved, bond yields fell – and the yen continually reached new lows. Thanks to strong consumption growth rates, residential construction and public investments, real GDP growth increased by 1.6 percent in 2013. The positive development in business activity reached its climax in the first quarter of 2014. At the time, consumers preferred to purchase durable goods ahead of the impending consumption tax raise from 5 percent to 8 percent. As a consequence, the economy grew by 2.4 percent in real terms over the previous quarter. But following the tax increase that took effect on 1 April 2014, private consumption and business activity went into a downright tailspin. In the following two quarters, the economy slid into negative territory. Once again Japan found itself temporarily in recession. According to preliminary Cabinet Office statistics, for 2014 as a whole, GDP just barely maintained the level of the previous year (+0.0 percent).

Price development and monetary policy: It still remains to be seen whether the deflationary price trend can be halted. In the course of the monetary expansion, the inflation rate as measured by the consumer price index (CPI) has indeed returned to positive figures; in April 2014 it peaked at 2.1 percent. But subsequently the inflation rate fell again, and with it fell the credibility of the Bank of Japan, prompting Governor Kuroda to further intensify the expansive money growth. On 31 October 2014 he announced plans to increase the monetary base to GDP ratio to 70-75 percent. To this end, the central bank promised to raise the annual purchasing volume of long-term Japanese government bonds from ¥50 to ¥80 trillion and to directly or indirectly bolster the real estate and stock markets. As it did in 2013, the expansive monetary policy had a direct impact on the financial markets: returns dropped to nearly 0 percent, stocks rose again, and the yen continued to lose value. Due to sinking oil prices, however, the inflation rate slid back into the negative range, reaching −0.4 percent in December 2014. This time the real economy showed no response, since there were no fiscal stimuli at first. Private households simply lacked the purchasing power necessary to boost consumption. In 2014 real wages sank once again. Due to rising inflation, nominal wages stagnated or grew only insignificantly for 2014 as a whole. Add to this the devaluation of the yen and plummeting interest rates on savings and it becomes clear that under these conditions, consumption is unlikely to pick up anytime soon.

Employment and the labor market: Japan's absolute number of workers reached a new high in 2014. Unemployment fell to 3.4 percent in December. The downside of this positive trend in the labor market is that regular employment has been declining for more than twenty years. At the moment 21 percent of men and 55 percent of women are in more or less precarious employment. They earn considerably less than regularly employed workers, are not protected against dismissal, and have limited access to social benefits. The rise in irregular employment is partly responsible for the fall in real wages and for Japan's slow productivity growth. Without a guarantee of long-term employment, companies are reluctant to invest in training and education. When companies have difficulty covering costs or maintaining their competitive edge, they replace regular employees with irregular workers instead of investing in measures designed to increase productivity.

National budget and fiscal policy: In contrast to 2013, when additional spending financed by supplementary budgets stimulated the limping economy, in 2014 fiscal policy was focused on consolidation. The above-mentioned increase in the consumption tax led to an economic crash. Due to the shortfall in tax revenue, the national budget deficit, at 7.1 percent – as a share of GDP – was still comparable to that of 2013 (8.3 percent). Gross national debt grew to a record 245 percent of GDP (138 percent net). In the meantime fiscal policy is once again expanding.

Foreign trade: Japan's trade balance was already deep in the red in 2014, with a deficit of $108 billion. Its current account, however, posted an esstimated $45 billion surplus due to substantial asset gains from abroad. Japan's hitherto legendary structural trade surplus has become a structural trade deficit. Three factors are responsible for this development. First, Japanese companies have transferred twenty percent of their production overseas out of cost and marketing considerations. Second, the nuclear power plants that were shut down after the Fukushima catastrophe have been replaced by imported fossil fuels. And third, many export articles have run into unexpected sales problems. For these reasons, a devaluation of the yen now has a much weaker impact on Japan's exports than it did in the past. A 36-percent devaluation of the yen against the dollar (from the beginning of 2013 to the end of 2014) led to a substantial export plus, but imports also increased. There was no net gain derived from exports.

Structural reforms: The Abe administration has initiated a series of reforms, but so far there has been no spectacular breakthrough that could spur economic growth or sustainably stimulate potential growth. Rather, the reform process follows in the footsteps of yesteryear – haltingly and gradually, the Japanese government and the private sector continue to adapt to the changes and competitive challenges of globalization. On a positive note, Abe's structural policy pursues laudable objectives, such as promoting the professional advancement of women, strengthening shareholder rights vis-à-vis corporations and institutional investors, and promoting investment through liberalization and deregulation, for instance in the agricultural and energy sectors. The measures introduced thus far include the liberalization of land acquisition, which is intended to facilitate the creation of larger, more profitable agricultural areas; the expansion of daycare and after-school programs; the establishment of six special economic zones governed by liberal labor and zoning laws; the promotion of exports and foreign investment; the drafting of a corporate governance codex; and – following the British model – the introduction of individual savings accounts as a new pillar of pension insurance.

Economic Reform as a Catalyst for Conservative-national Policies

However mediocre the current economic balance of Abenomics may be – politically it is a success. At the very start of his term of office, Abe sparked euphoria by making use of the "three arrow" metaphor and demonstrating economic resolve. It seemed reasonable to hope for an end to the stagnation. Proponents of Abenomics continue to dominate economic discourse. In Japanese media as well as in public opinion, the Abe administration is seen as competent, which – like in Germany – is the decisive parameter for general political support. To the present day, Prime Minister Abe has managed to pull off the feat of garnering approval rates of over 40 percent. After he had surprisingly called snap Lower House Elections for 18 December 2014, the opposition was unable to counter Abe's dictum that there is "no alternative" to his economic policy. The governing coalition of LDP and Komeito was thus able to maintain its two-thirds majority in parliament. But if one takes a closer look at the initiatives and actions in which Abe invests political capital, it becomes clear that his primary objective is not the recovery of the Japanese economy and certainly not the pushing through of structural reforms. Instead, the Prime Minister's economic policy seems to be the means to an end. Abe's main objective is to gain a free hand in security matters in order to pursue his "proactive pacifism" policy; establish a nationalist view of history; and instill patriotism in education policy. Economic policy serves as a sort of catalyst for these processes. As was the case under the premiership of Junichiro Koizumi (2001–2006), Abe, too, is exploiting the reform narrative primarily as a means of pursuing his conservative-national agenda.

However, Abe was not re-elected due to popular support for his political goals. Rather, Japan's voters have given the Prime Minister a mandate to continue pursuing his economic policy and above all to introduce growth-enhancing reforms. To make the country fit for the future, the government would naturally have to broaden its agenda. Among the most urgent tasks are: halting the gradual erosion of Japan's economic competitiveness and its attractiveness as an investment and business location; meeting the challenge of demographic change; and staving off national bankruptcy. Against this background, it is prudent to weigh the prospects and risks entailed in Abe's monetary, fiscal and structural policy – the Three Arrows of the Abenomics strategy.

Monetary Policy: Halting Transmission, Growing Risks

One can already say with certainty that central bank head Haruhiko Kuroda cannot keep his promise to achieve 2 percent inflation in 2015. Furthermore, the theoretically forecasted chain of effects designed to eventually lead to greater spending by both firms and households has so far failed to materialize. But the failure of Abenomics surely does not derive from hasty consumer tax increases. Rather, it is rooted in a much more fundamental failure at the level of monetary transmission.

First, companies in Japan are not financed through stocks, as they are in the Anglo-Saxon world, but rather by bank loans, as is the case in the Eurozone. Despite ultra-low interest rates, however, there has been very little growth in bank loans. Second, as mentioned above, real incomes and purchasing power have declined, above all due to wage stagnation. And third, Japanese exports have not grown nearly as fast as would have been expected following the devaluation of the yen. Moreover, it is important to question whether the mild deflation is even the decisive cause of Japan's long-standing growth weakness and persistent stagnation – or rather a symptom thereof. The monistic monetary view can be countered by the argument that investors lack trust in Japan's economic development for structural reasons and that Japanese consumer reluctance can be attributed largely to the fact that Japanese society is ageing. But monetary policy is ill suited to overcoming structural deficits or solving demographic problems.

On the other hand, both theory and empirical studies show that the effects of expansive monetary policy can be unpredictable and slow to materialize. So the last word on Abenomics has not yet been spoken; it remains to be seen how prices and macroeconomic expenditures develop. But even if it is still unclear for the moment how effective monetary expansion will turn out to be, one must not lose sight of the risks involved.

First, rising prices and nominal interest could quickly lead to a vicious circle in which returns on government loans and public debt charges drive one another up – Japan would suffer a sovereign debt crisis. Second, the extremely bloated monetary base could make it difficult to keep inflation down. It is well known that the velocity of money is a factor that is difficult to control. One cannot rule out the possibility that galloping inflation and an internationally falling yen could lead to a hard landing.

Third, expansive monetary policy has a negative impact on the global economy. The devaluation of the yen harms the price competitiveness of Japan's trade partners and – together with the euro, which is also flagging – threatens to spark an international devaluation race. The yen-carry trade, i.e. financing investments abroad with cheap Japanese money, threatens to contribute to speculative bubbles around the world. And fourth, the reputation of the Bank of Japan could suffer long-term damage if it becomes a source of financial instability in itself. There is a real danger that Abe's monetary policy – in addition to creating monetary illusions – is also generating new, uncontrollable risks.

Fiscal Policy: Stop-and-go under the Threat of Sovereign Default

For decades Japan's fiscal policy has been defined by a dilemma. On the one hand there is a need for continuous Keynesian demand stimulus; at the same time, however, the situation calls for fiscal retrenchment. This dilemma has now come to a head. In macroeconomic terms, Japan has not yet overcome its weak demand. Fiscal stimulus measures are continually required in order to stabilize the economy. The ¥3.5 trillion stimulus package passed at the very end of 2014 is merely the latest episode in a series of stop-and-go policies applied in recent years. In the current legislative period, the governing coalition is expected to lower the maximum corporate tax rate (currently 35.6 to 39.5 percent) to strengthen the competitiveness and investment capacity of domestic enterprises.

At the same time, the extremely high national debt has forced the government to pursue fiscal consolidation. Japan's finances threaten to spiral out of control. Since fiscal year 2010 the budget deficit has hovered between 7 and 10 percent of GDP. Gross national debt has risen to 245 percent – nearly the sum of the net financial assets of the private household sector in the country today. Amortizing the debts would require at least eight years' worth of tax revenue, according to current estimates. So far domestic investors have financed the government's deficit spending. Over ninety percent of Japan's national debt is denominated in yen and is held domestically. But this is likely to change. In 2013 private households already stopped accumulating savings; their savings ratio has turned negative. What is more, the once high structural current account surplus is melting. Soon the state is likely to become dependent on foreign investors to finance both its budget deficits and its interest and amortization expenditures.

In response to Japan's fiscal dilemma, Abenomics promises stronger economic growth. The message is that a more favorable economic environment would not only generate greater tax revenue but also make it easier politically to push through higher tax rates and cut spending. This promise is tantamount to a wager on the future. Japan's economy and public finances must be stabilized before risk surcharges on Japanese government bonds rise to unsustainable heights.

In this configuration, monetary policy, with its massive purchases of Japanese securities, has become a willing handmaiden of fiscal policy. The bond market has become the principal means of financing skyrocketing government expenditures, while the share financed by tax receipts has fallen to less than 50 percent. In effect, the Bank of Japan is financing debt by printing money. Its monthly purchases of government bonds on the open market total ¥8 to ¥12 trillion (approx. €60 to €80 billion). According to media reports, the central bank absorbs approximately 70 percent of primary emissions. Japanese pension funds are currently reducing their bond exposure, redirecting investments to the stock market and investing abroad. Market analysts estimate that at current rates, the Bank of Japan will hold approximately 50 percent of Japan's government bonds between 2017 and 2020. It is entirely possible that the central bank will at some point write off its government bond assets with the stroke of a pen, thereby drastically reducing the national debt.

The Bank of Japan's involvement in the country's bond markets entails dramatic side effects and risks. The overwhelming demand of the central bank has repeatedly driven returns to new lows – most recently to 0.01 percent for two-year government bonds, 0.08 percent for five-year bonds, and 0.33 percent for ten-year bonds. Bond capital can be raised practically for nothing in Japan, which suspends the allocative function of interest on capital. Virtually unlimited liquidity fuels speculative bubbles in Japan and around the world.

Little has been said about the exit strategy. Will the Bank of Japan manage to end its expansionary open market policy in an orderly fashion? Or will it be a disorderly exit? The latter can happen if, for example, international hedge funds begin speculating on rising bond yields by trading uncovered options – on foreign stock exchanges that cannot be controlled by the Japanese ministry of finance.

At the same time, the massive purchases of Japanese government bonds do not exonerate the government from its duty to make use of the remaining window of opportunity and effect real economic consolidation. One thing is certain: the goal of achieving a balanced primary budget (i.e. excluding expenditures for interest and amortization) by fiscal year 2020 cannot be achieved.

Not only must the current shortfall in revenues resulting from the weak economy be overcome – additionally, the second phase of the consumption tax raise has been postponed until April 2017. In the near future the Japanese government will have to tap into supplemental tax revenue – if only to offset the planned decrease in corporate tax.

Furthermore, in the middle to long term the Japanese tax system will definitely have to be restructured. The national budget will have to absorb not only rising expenditures but also the increasing cost of maintaining the public health system in order to provide sufficient care for the country's ageing population. Today, 25 percent of the population is over the age of 65. By 2035 this number will rise to 33 percent. In order to manage this burden in future, it will be necessary to raise the consumption tax to the European average and to expand the income tax assessment basis. From a present-day perspective, neither of these measures stands much of a chance of being implemented given the current political situation.

Fainthearted Structural Policy

Structural policy is the decisive component of any plan to revitalize Japan's economy. While monetary and fiscal policy may be able to compensate for weak demand, greater potential growth can be achieved only by implementing supply-side measures. In order to attain strong sustainable economic growth with substantial productivity advances, corresponding structural reforms are required. Prime Minister Abe has promised to implement the legislative and administrative proposals elaborated by the newly constituted Industrial Competitiveness Council. The proposals are aimed primarily at gradually improving professional opportunities for women; opening up the Japanese market to agricultural imports in the framework of trade agreements with the USA and the EU; facilitating the hiring of skilled workers from abroad; and liberalizing the energy market. Also planned are selective measures in the agricultural and healthcare sectors and policies aimed at promoting innovation, tourism and SMEs.

These reforms point in the right direction, but it would take much more to achieve substantial productivity growth. In order to regenerate its economy, Japan would need uniform labor laws capable of overcoming the duality between regular and irregular employment; shareholder-friendly corporate laws that allow more restructuring and startups; and a breakup of insider structures in the country's domestic industries. The latter requires effectively safeguarding against unfair competition, opening the market to foreign competitors, and ensuring that antitrust authorities are endowed with executive powers – and the will to use them. In the agricultural and healthcare sectors, not only selective but fundamental reforms are necessary. And in order to meet the challenges of an ageing society, the promotion of women and families would have to be expanded considerably, following the example set by Northern Europe. Furthermore, immigration laws would have to be relaxed and skilled workers actively recruited.

In order to push through all these measures, the Abe administration would have to break societal taboos and overcome resistance from bureaucrats as well as political and economic interest groups. Given Abe's conservative stance and the fact that his priorities lie elsewhere, such a pro-active strategy seems unlikely. Although the government has a mandate to carry out substantial reforms and disposes of the necessary majorities in parliament, there is a danger that it will fail to act in time – and there is still time – to avert a financial and political crisis.

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

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