Japan, Rising?

Shinzo Abe’s Excellent Adventure

By Barry Eichengreen
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Longfellow, the early-19th-century American poet, was obviously not referring to the current Japanese prime minister, Shinzo Abe, but he could have been. What Abe calls his “three-arrows” economic-regeneration plan is a shot in the dark in a country generally not inclined to risk-taking. The first arrow, aggressive monetary easing, is designed to slay the dragon of deflation. The second, a one-time dose of fiscal stimulus, is intended to jump-start economic growth after more than two decades of stagnation. The third, a mix of structural reforms, is designed to boost productive efficiency, attract investment and render faster growth sustainable.

It remains to be seen whether Abe’s arrows will follow the trajectory he anticipates. On the first, the chattering classes seem evenly divided between those who doubt the Bank of Japan will succeed in ending deflation and those who fear that the inflation produced by monetary easing will spiral out of control. On the second, some wonder whether fiscal stimulus is, in fact, gilding the lily, warning that additional deficit spending by an already heavily indebted Japanese government could provoke a crisis of confidence.

Views are less divided when it comes to the third arrow, comprehensive structural reform. Here observers are all but unanimous in their approval – but question whether the weapon will even get off the ground.

Why?

No one, not even Abe’s harshest critics, doubts that the Japanese economy needs shock therapy. Economic growth has been anemic since the real estate and stock market bubbles burst in 1991. Since then, GDP growth has averaged just 0.6 percent annually. By comparison, the U.S. economy grew more than four times as fast, even taking into account its sharp contraction during the Great Recession of 2008-09.

Adding to Japan’s woes, consumer prices have been falling since 1995, reflecting a combination of weak demand, the reluctance of banks to lend, and the failure of the Bank of Japan to take concerted action to prevent deflation. Having come to expect lower prices in the future, consumers have grown reluctant to spend; businesses, anticipating that their revenues (measured in yen) will fall, are reluctant to borrow and invest. And their collective hesitancy has created a vicious circle of sagging demand leading to more deflation leading to even less demand.

Then there’s the government’s staggering debt load to consider. Net public debt (gross debt, less government-owned financial assets) is equivalent to 145 percent of GDP and rising. By comparison, the U.S. government debt that has caused such alarm among bond market oracles equals just 90 percent of GDP – and seemingly holding fast at that level.

Japan could raise taxes in order to retire some of its debt, or at least slow the debt’s growth, but doing so would impose a further drag on an already anemic economy. Better to grow the denominator of the debt-to-GDP ratio. That, however, is easier said than done: nominal GDP has remained virtually unchanged since the early 1990s, thanks to the combined effects of slow growth and falling prices.
But the obstacles to faster growth extend well beyond the stance of monetary and fiscal policy. Start with Japan’s last-one-out-the-door demographics. Fertility is running far below the rate needed sustain the population, and the country does not welcome immigrants. If current trends continue, the total population will decline from 127 million now to just over 116 million in 2030 and 97 million in 2050.

No country has experienced a peacetime decline of this scale since the Irish potato famine (and mass emigration) in the mid-19th century. One consequence will be a shrinking labor force – and more important, fewer workers per retiree. This will make a problematic matter worse, for Japan already has the highest ratio of people aged 65 and over to working-age individuals in the world. Barring the unforeseen, in 2050 there will be more than two pensioners dependent on the productivity of each active worker.

As the population ages, moreover, the composition of spending will shift from manufactures to health care and other services, where productivity growth has historically been low. This will further aggravate Japan’s existing problem of disappointingly slow productivity growth, for which there is a long list of culprits – among them, rigid labor markets, including regulations that effectively prevent solvent companies from laying off workers.

These rules make companies reluctant to lock themselves into labor obligations in the first place. Instead, they hire young workers on temporary contracts, a practice that creates insecurity for employees and gives employers little incentive to provide on-the-job training (which had long been one of the economy’s strengths). Note, too, that rigid labor markets add to the risks faced by startups, which are an important source of innovation in other countries – but not in Japan.

By the same token, heavy regulation of product markets is blamed for raising costs and stifling competition. For example, Japan bans the sale of nonprescription drugs over
the Internet. Power companies enjoy local monopolies, allowing them to charge some of the highest energy prices in the world. Family farmers are barred from selling their land to agribusinesses, which could raise productivity by exploiting economies of scale. Imports of agricultural products are heavily taxed and controlled.

WHY NOW?
Japan plainly needs an economic-policy makeover. But it has needed one for years. And in the last decade, 10 governments have come and gone without imposing a policy that fits the magnitude of the problem. So, why now?

One factor, surely, is the rise of other Asian economies. China has just overtaken Japan as the world’s second largest economy. Korea has surpassed it as a shipbuilder and producer of consumer electronics. China’s and Korea’s economic gains are not necessarily Japan’s loss – indeed, much of modern economics rests on the opposite premise. But as these neighboring economies have grown, they have become more assertive in political terms.

Japan and China both claim sovereignty over the Senkaku, a chain of uninhabited islands in the East China Sea currently controlled by Japan, while South Korea and Japan have both claimed Dokdo Island (known as Takeshima in Japan). Japan’s capacity to defend its interests (symbolic or real) derives in part from its economic clout, adding to the sense of urgency that Abe exploited in his electoral campaign.

Then there was the shock of the global credit crisis and the lessons from the policy response. Japan actually suffered more than the United States from 2008 to 2012, even though its financial system was not directly implicated in the crisis. The U.S. Federal Reserve responded forcefully to events, not just
cutting interest rates to the bone but purchasing trillions of dollars in assorted securities from the open market. The Bank of Japan remained passive. Its excuse – that it was beyond the capabilities of a central bank to prevent deflation from emerging in the wake of a financial crisis – was thus blown out of the water.

Moreover, on the heels of the global credit crisis came the Fukushima nuclear reactor disaster, which was not only an economic calamity but a national embarrassment. The event led to widespread disenchantment with energy companies, government regulators – and to interest group gridlock-as-usual.

Finally, Abe proved to be not only an unusually decisive politician, but also that truly unusual political animal capable of learning from past errors. Having failed to take bold measures to rekindle the economy during his earlier term in office in 2006-7 and having paid a heavy political price for that failure, he was apparently committed to not repeating the mistake.

**RADICAL MONETARY THERAPY**

Recall that deflation wreaks its damage by discouraging spending – investment spending in particular. No one questions, therefore, that putting Japanese prices on a gradual upward trend is needed to encourage growth. But many Japan-watchers are skeptical about the traditionally conservative Bank of Japan’s commitment to the task. On the other side of the coin, some worry that if the bank does follow through, it will go too far, triggering more inflation than anybody bargained for.

Two weeks after Abe’s choice for central bank governor, Haruhiko Kuroda, took office together with two additional newly appointed members of the central bank board, the Bank of Japan made an impressive start. Kuroda proclaimed that the bank would aim for 2 percent inflation, double the previous target. And he announced a plan to purchase $68 billion worth of government bonds a month.

That was a big commitment, and then some. The $68 billion is equal to about two-thirds of the bonds the government issues to cover budget deficits and recycle expiring debt. And it is the same rate of purchase as the Fed’s third round of quantitative easing – in an economy roughly a third the size. Indeed, the Bank of Japan’s bazooka shot promises to double the monetary base (the most restrictive definition of the money supply) in little more than a year.

Even so, some market participants have questioned whether this policy would, indeed, transform chronic deflation into modest inflation. Exchanging government bonds paying an interest rate close to zero for cash paying an interest rate of exactly zero would have only a marginal impact, they warned: since Japan is already in a Keynesian “liquidity trap,” monetary easing would not affect spending.

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and, therefore, cannot exorcise deflation.

This pessimism is rooted in the very narrow view that central bank policy works only by changing interest rates. But a central bank can also influence the decisions of consumers and investors by changing their expectations about the bank’s own future actions. If it convinces them that it is sincerely committed to producing a bit of inflation, it can drive the prospective “real” interest rate – that is, the nominal rate (which can’t fall below zero) minus the expected rate of inflation – into negative territory. Or, to put it another way, it can convince prospective borrowers that they’ll be able to pay off their debts in the future with money that’s worth less and, along the way, it can convince prospective business investors that they will be able to sell their products for higher nominal prices.

By the same token, the Bank of Japan can “talk down” the exchange rate of the yen. A cheaper yen would stimulate demand for Japanese goods by making imports more expensive for the Japanese and exports more attractive to foreign buyers.

The early returns on the Bank of Japan’s new policy have been strongly positive. Stock prices have soared, bond yields have plummeted and the yen has dropped sharply since the policy was announced in early April. In fact, the Nikkei 225 stock index began rising in November 2012, when it first appeared likely that Abe’s party would win the election the following month on a platform of radical stimulus. GDP rose by an impressive 4 percent annualized rate in the first quarter of 2013 and, if early indicators prove accurate, grew only slightly less in the second. Remember, this output response began in advance of the implementation of the new policies, underscoring the power of the expectations channel.

Exports are also rising in response to a weaker yen. In August 2012, less than 80 yen bought a dollar; in August 2013 it took almost 100 yen to buy that same dollar. Bank lending finally started rising in May. In June, it showed its largest annual increase in nearly four years, rising 1.9 percent from a year earlier with most of the additional credit being directed toward construction and mortgage lending. Most important of all, consumer prices rose in June for the first time in more than a year.

**Collateral Damage?**

The Bank of Japan says it wants to push the nominal interest rate all the way to zero and ratchet the inflation rate up a bit further, to the 2 percent target. But critics warn that the two goals will prove incompatible. In particular, if bond markets come to expect future inflation (as the Bank of Japan fervently hopes), lenders will demand to be compensated with higher interest rates on government bonds, not lower ones.

That outcome would not be pretty. A rise in interest rates on government bonds by one percentage point would increase the government’s budget deficit by roughly 1 percent of GDP by adding to debt-servicing costs. That could trigger a collapse in confidence in Japan’s ability to honor its obligations, or it could require an untimely increase in taxes – either of which would crush hopes for growth. Higher interest rates (or rather, their flip side, lower bond prices) would also mean problems for Japanese banks, insurance companies and pension funds that are invested heavily in government securities.

But the scenario is not an especially worrying one because it is within the power of the Bank of Japan to contain interest rates on government debt at any level it chooses. Remember, the government’s debt is denominated in yen. And since the Bank of Japan can create any quantity of yen it chooses, it has the ability to buy whatever volume of bonds
is needed to keep interest rates from rising.

Market players understand this; the cost of buying credit-default swaps on five-year Japanese government bonds (which amount to private insurance against default) has actually fallen by more than a fifth since January. And there are plenty of precedents, notably the Fed’s policy of capping interest rates on U.S. Treasury bonds at 2.5 percent for nine years ending in 1951.

But there is a potential danger to creating whatever liquidity it takes to contain interest rates: undesirably high inflation. In the 12-month periods ending in June 1947 and June 1948, when the Fed was printing money and buying bonds to cap the interest rate on U.S. treasuries, prices rose by 17.6 percent and 9.5 percent, respectively. Economists have an unflattering name for this situation, referring to it as “fiscal dominance,” when a fiscal objective (here, an interest-rate ceiling on government debt) dominates monetary policy at the expense of the central bank’s ability to meet other objectives.

A misstep in the direction of substantially higher inflation in Japan would generate both winners and losers. On the one hand, it would inflate away some of the real burden of the government’s debt on future taxpayers. On the other, it would corrode the savings of the elderly, who are an exceptionally large and well-organized interest group. There would thus be considerable pressure on the Bank of Japan to back off at the slightest sign of overreach – which goes a long way toward explaining its lack of resolve in fighting deflation in recent decades.

In any event, the misstep would have to be large to trigger worrisome inflation; after a long period of slow growth and weak demand,
there remains considerable slack in the Japanese economy and no prospective pressure on productive capacity. Barely 58 percent of working-age Japanese are actually in the labor market, compared with more than 63 percent in the United States.

Bank of Japan officials are undoubtedly aware that the risk of inflation running out of control is remote, while the political risks of doing nothing are quite tangible. And while warnings of contemporary Japan morphing into hyperinflation-ridden Weimar sell newspapers and investment newsletters, neither market participants nor the voting public seems alarmed.

Japanese firms’ competitors in global markets have their own, somewhat more realistic, worries. The Bank of Japan’s policy, they assert, will work mainly by pushing down the exchange value of the yen, boosting Japan’s exports by beggaring its neighbors. These complaints are reminiscent of criticisms of countries that abandoned the gold standard in the 1930s in order to sell more into global markets. But (as in the 1930s), the impact on other countries is likely to be subtler than the critics suggest.

To be sure, depreciating the yen tends to slow growth in countries whose producers find it more difficult to compete with Japanese firms. But at the same time, negative real returns on Japanese government bonds will encourage investors to shift toward higher yielding investments abroad, lowering the cost of capital in recipient countries. The net effect of greater Japanese exports of both goods and capital could thus be either positive or negative, depending upon which effect dominates.

So far, there is not much sign of Japanese
investors stepping up their foreign purchases. But that could change.

Early in his administration, Abe inadvertently fed foreign fears of a currency war by emphasizing the desirability of a weaker yen and suggesting that the Bank of Japan might seek to achieve it by intervening aggressively in the foreign exchange market. But he never said that boosting exports was the only way (or even the main way) that the Bank of Japan could stimulate the Japanese economy. And for good reason: consensus estimates suggest that a 20 percent real depreciation of the yen — the magnitude seen over the past 12 months — will add at most half a percentage point to average GDP growth over the next five years.

So if Japan meets Abe’s goal of raising the growth rate by a few percentage points, the weaker yen will play only a modest role. And happily, Abe and the Bank of Japan have backed away from the weak-yen meme, emphasizing other channels through which central bank policy could encourage growth.

**FISCAL FOLLIES**

The second arrow in Abe’s quiver is a one-time $100 billion fiscal stimulus. At a little more than 2 percent of GDP, this might seem small by the standards of the 2009 Obama stimulus, which amounted to 6 percent of U.S. GDP. But any addition to the deficit is courageous (or, to some, a cause for alarm) in a country with a debt burden as heavy as Japan’s.

There’s more here than first meets the eye. The Abe government is also committed to halving the primary deficit (the deficit net of interest payments) by 2015, and plans to do so in part by raising the consumption tax — a levy similar to European value-added taxes — from 5 to 8 percent next April and then to 10 percent in 2015. There may be further tax increases down the road to enable the government to meet its longer-term target of running a primary surplus and paying down debt by 2020. Value-added tax rates in Europe are as high as 25 percent, suggesting that Japan has considerable scope for raising additional revenue in this way.

A one-time stimulus seems inconsistent with these debt and deficit goals. Moreover, in light of the Bank of Japan’s massive commitment to monetary growth, it is not obviously needed. Indeed, it might do more harm than good by raising fears about unchecked budget deficits.

Still, one can imagine the thinking behind the stimulus. It may be a way for Abe to make good on his campaign promises, since it includes money to accelerate earthquake reconstruction, to prevent and mitigate future disasters, to bolster inadequate medical and child care services and to revitalize depressed regions. Moreover, it may be yet another way to send the message that Japan is serious about ending deflation and committed to getting the economy moving again.

Most likely, though, the government simply sees the one-time fiscal stimulus as a way to temporarily offset the fiscal drag created by the scheduled consumption tax increase without appearing to postpone it. Better, the thinking goes, to allow the consumption tax
rate to begin moving upward as planned, while using a short-term stimulus to fine-tune the timing of the impact to counter the business cycle.

BENT ARROW
Structural reform is undoubtedly the hardest of the three arrows to launch. Abe could re-orient monetary policy simply by appointing his people to the Bank of Japan’s board. Likewise, he assembled support for a fiscal stimulus by distributing the benefits like a lord of the manor distributing Christmas turkeys. But with structural reform, the opposition is fierce because the potential losers are very well organized. Will older workers see their job protections weakened? Will retirees see their pensions cut? Will doctors and nurses agree to allow additional health care workers from abroad? Will rice farmers tolerate competition from Thai and Vietnamese growers?

Implementing changes that challenge established interests is difficult in any country. But it is especially difficult in Japan because the potential losers have influence across the spectrum of political parties and trade associations. Agreement turns on compromises, which are not quickly negotiated and are open to future challenge.

This explains why Abe relied on two advisory bodies, the Industrial Competitiveness Council and the Council for Regulatory Reform, made up of business leaders, academics and a secretariat comprised of government bureaucrats, to hammer out specifics. And why the results had “committee” written all over them.

• There was agreement on lifting the ban on the sale of nonprescription drugs on the Internet and on allowing patients to pay for extra treatment without forfeiting their public health insurance benefits – but not on importing the large numbers of foreign health professionals needed to treat an aging population.

• There was agreement on modest changes in the point system used in allocating a limited increase in visas for skilled foreign workers – but no far-reaching liberalization of the country’s highly restrictive immigration policy.

• There may be modest changes in labor contracts – but no big-bang labor-market overhaul of the sort opposed by the unions.

• There will be an expansion of the National Strategic Districts plan, where taxes and regulations will be relaxed in the effort to attract foreign companies – but no carte blanche to foreign competition in health care, education and other services.

All told, the Abe structural reform agenda is heavy on goals, but light on specifics. Thus, it “proposes” to raise household incomes by 40 percent over the next decade and to double inward foreign direct investment from its present, depressingly low level by 2020. Just how remains to be seen.

Some say that Abe will be able to move more decisively because his coalition recently won a majority in the upper house of the legislature to complement its existing majority in the lower house. The victory does suggest that Abe will have three years to rule without a challenge to his leadership. But there are plenty of opponents to the structural reforms within his party, who will force negotiation and compromise.

One bold (but plausible) strategy for untying the Gordian Knot would be to broaden the agenda for change still further – in effect, pushing for a grand bargain. The idea: ask for sacrifice from every major interest group, but in the process make it clear how, on balance, each would benefit more from the package than it lost.

The nature of those additional changes is no secret. Agribusinesses could be allowed to buy – not just rent – land from family farmers.
The retirement age could be raised to reflect the reality of improved health, greater longevity and mounting pension costs. Japanese companies could be required to appoint independent directors to challenge entrenched management – and hopefully enhance efficiency. The government could invest in day care and early childhood education to encourage childbearing and the quick reentry of new mothers into the labor force. Large-scale gambling resorts could be established to attract tourists to depressed regions, over the opposition of religious groups. And the country’s nuclear power plants could be restarted, over the objections of environmentalists.

Beyond this political argument for comprehensive change, there is also an economic argument. Masahiro Aoki, the leading Japanese theorist in organizational economics, has observed that in a complex interconnected system like the Japanese economy, changing one component without also changing the others can worsen overall performance, just as improving a car’s engine and transmission without changing its suspension can make for a rougher ride.

Success will require Abe to take hold of the reform agenda, rather than delegating it to the secretariats of his advisory panels. That would be a big break from precedent, since the bureaucracy has long played a critical role in coordinating Japan’s economic policy. But those bureaucrats are strongly inclined to ignore the big picture in focusing on the concerns of their own ministries and the interest groups that dominate them.

**KUROSAWA, NOT HAWTHORNE**

Abe’s reference to three arrows comes not from Western poetry, but from the last great epic of the Japanese film director Akira Kurosawa. In *Ran* (Japanese for “up-rising”), Kurosawa tells the story of the powerful Ichimonji clan in an era of tribal warfare. Hidetora, the patriarch, cedes control of his kingdom to his three sons, but stresses they must work together. One arrow is easily broken, he says, but, when bundled together, three arrows are not. The sons ignore the message, of course (otherwise there would be no drama), and tragedy ensues.

Like Hidetora, Abe is asserting that his three arrows will work where one would not. Measures to stimulate demand won’t do much without corresponding measures to free up supply. But, in the same spirit, difficult restructuring will be far easier to swallow when combined with fiscal and monetary measures to boost spending. And meaningful commitment to pro-growth policies alike will be needed to climb out of the crisis of confidence dogging Japan.

Will Abe’s wings melt because he is flying close to the sun? Maybe. But mixed metaphors aside, one can’t fault his vision of a Japan roused from its torpor or his determination to achieve what the last ten governments have only dreamed about.