Japan’s rigid labor laws make it nearly impossible to lay off permanent employees in downtimes, companies now tend to fill open slots with part-time or temporary workers, and they typically pay them a third less. Prime Minister Shinzo Abe promised to revive Japan when he took office in December 2012. Abe’s economic program -- known as “Abenomics” -- is, at its core, a confidence game. To restore confidence, Abe has undertaken a program of what he calls "three arrows": monetary easing to reverse deflation, fiscal stimulus to boost immediate spending, and structural reforms to revive long-term growth. But two of the arrows have already flown wide. That leaves just one real arrow: monetary easing. But none of the three arrows can work without the other two. Confidence must rest on something more substantive than inflation: meaningful structural reforms to reverse Japanese companies’ lagging competitiveness. Otherwise, any temporary economic boost will soon give way to disillusion.

Imagine the predicament currently facing a growing number of Japanese men in their early 30s. Despite having spent years cramming in high school and attending good colleges, many can’t find a full-time job at a good company. Since Japan’s rigid labor laws make it nearly impossible to lay off permanent employees in downtimes, companies now tend to fill open slots with part-time or temporary workers, and they typically pay them a third less. Today, 17 percent of Japanese men aged 25 to 34 hold such second-class jobs, up from four percent in 1988. Low-paid temps and part-timers now make up 38 percent of Japanese employees of all ages and both sexes—a stunning figure for a society that once prided itself on equality.

Prime Minister Shinzo Abe promised to revive Japan when he took office in December 2012, and he often boasts of all the gains he has added since. But all the gains have been for irregular work; regular jobs have fallen by 3.1 percent. Consequently, the average wage per worker in real terms has fallen by two percent under Abe. No wonder consumer spending is anemic. Imagine as well the frustration of these irregular workers when a low salary thwarts their natural desire to start a family. Whereas 70 percent of Japanese men in their 30s with regular jobs are married, among irregular workers in their 30s, that percentage plunges to just 25 percent.

What counts as a personal tragedy for each worker translates into an economic disaster for Japan as a whole. The
country's reliance on irregular workers eats away at its main resource: its human capital, meaning the skills that enable workers to use the most up-to-date technology and methods. Because irregular workers don't acquire the skills employers seek, the longer they stay stuck in their dead-end jobs, the harder it becomes to ever get a regular one-and the more human capital erodes. The low marriage rate among irregular workers accelerates Japan's demographic decline. That, in turn, amplifies economic strains, such as the shrinking number of workers to support the growing ranks of retirees.

Given how much these interconnected syndromes lie at the core of Japan's economic malaise, one would think they would also lie at the core of Abe's revival strategy. Yet they merit not a mention. Abe has not even proposed minimal steps to tackle these problems, such as a law requiring companies to offer irregular workers equal pay for equal work. Until Japan reforms its labor practices more thoroughly, the use of so many irregular workers will continue to lend firms the flexibility they need to adjust payrolls as sales rise and fall. At the same time, equal pay for equal work would end the incentive for firms to replace regular jobs with irregular ones simply as a way of cutting wages.

Instead, Abe's economic program-known as "Abenomics"-is, at its core, a confidence game. Abe and his advisers argue that the root cause of Japan's malaise is insecurity. If only Japanese had more faith in their country's prospects, the theory goes, then consumers would spend more and companies would do more investing and hiring. In this view, deflation represents the primary cause of Japan's woes. "For 20 long years of deflation, Japan suffered a deep loss of confidence," Abe said in a speech last year.

To restore confidence, Abe has undertaken a program of what he calls "three arrows": monetary easing to reverse deflation, fiscal stimulus to boost immediate spending, and structural reforms to revive long-term growth. If all three arrows were hitting their targets, there would be reason for bullishness. But two of the arrows have already flown wide: any stimulus from temporary spending has been more than offset by premature tax hikes made to cut government debt. Meanwhile, the prospects for structural reform have not progressed beyond vague sloganeering.

That leaves just one real arrow: monetary easing. But none of the three arrows can work without the other two. Confidence must rest on something more substantive than inflation: meaningful structural reforms to reverse Japanese companies' lagging competitiveness. Otherwise, any temporary economic boost will soon give way to disillusion.

Disenchantment is already appearing in Japan's stock market, which rose by 65 percent from Abe's ascension until the end of 2013-almost entirely on buying by foreign investors-but, as of early May, had lost a third of those gains as foreign investors sold. These investors rightly fear that Abe is not spending his political clout on reform. Since many Japanese voters view the stock market as the smart money's verdict on revival, if jitters on the exchange continue, that could reduce Abe's approval ratings and his political clout. If Abe is unwilling to take on vested interests to advance reform now, it is hard to see how he will be able to do so after his clout diminishes.

THE INFLATION BOGEYMAN

When Abe named him the new governor of Japan's central bank in February 2013, Haruhiko Kuroda promised to deliver two percent inflation in just two years, and to create all the money needed to meet that goal. Abe and Kuroda claim to be well on their way. After all, in March, consumer prices were up by 1.3 percent from the year before.

Unfortunately, most of that increase stems from a 25 percent drop in the value of the Japanese yen, which raised prices on imports of everything from electronic gadgets to food to raw materials such as oil, as well as on products made from those imports. The devaluation effectively transfers income from Japanese consumers and firms to foreign oil sheiks, farmers, and manufacturers. Besides, since the yen has more or less stabilized, the inflationary effect of the depreciation is likely to ebb.

Suppose Kuroda were to achieve two percent inflation in two years-which 34 of 36 economists polled by Bloomberg
in April said will not happen. By itself, this would do little to boost growth. Kuroda contends that if consumers see prices rising, they will rush out to buy things so as to avoid paying more in the future, and their spending will lead firms to increase their investment and hiring. Yet data over the past decade show that when Japanese consumers expected prices to rise, they spent less, not more. The reason is simple: if prices rise faster than incomes, people can't afford to buy as much. But Kuroda, devoted to abstract economic theories as he is, dismisses such evidence. Abe, in turn, likes the theory because it says that he can rejuvenate Japan via the easy route of printing money rather than the hard route of structural reform.

Since 1997, wages in Japan have fallen by nine percent in real terms. They are expected to continue falling, despite highly advertised wage hikes by a few hundred giant firms whose profits from overseas sales have been artificially boosted by the weaker yen. Abe claims that wages will rise once workers and firms come to expect inflation. In reality, deflation is not the cause of Japan's problems but a symptom. Trying to cure Japan's malaise by generating inflation is like trying to cure a fever by putting ice on the thermometer.

Abe and his team boast that they have pushed down the yen's value vis-à-vis the dollar by 25 percent. But here, too, their optimism is misguided. Currency depreciation can cheapen the price of exports in overseas markets, helping a country export more. But the flip side is that imports become more costly, and in Japan's case, the harm suffered by consumers and companies has vastly outweighed the benefits enjoyed by exporters. The real volume of exports-tons of steel, number of cars, and so on-has barely risen since the start of Abe's term. Sony's problem is not that the yen is overvalued but that the company is no longer creating the innovative products that people want (such as smartphones and tablets). Likewise, auto exports are flat because automakers continue to shift production offshore rather than exporting from Japan. The fact that Japan now runs a trade deficit despite a currency exchange rate that, in price-adjusted terms, is the cheapest since the 1970s, suggests that it has suffered a deep loss in underlying competitiveness. This requires a real cure, not a chimerical quick fix.

The second arrow, fiscal stimulus, was supposed to give people the money they needed to spend more. Either tax cuts or the right kind of spending could do the trick. Yet while Abe has put one foot on the gas pedal, he has put a heavier foot on the brake. His new spending measures, mostly of the pork-barrel variety, have been more than offset by his raising of the consumption tax from five percent to eight percent this past April. Another hike, to ten percent, is scheduled for October 2015. How can people spend more when Abe leaves them with less money to spend?

Abe's team claims that fiscal austerity is necessary to prevent Japan from becoming the next Greek tragedy. But that is nothing but a scare story spread by officials such as Kuroda, who ought to know better. Once again, ideology is overriding evidence, due to the long-standing devotion to fiscal austerity on the part of the Ministry of Finance (where Kuroda spent virtually his entire career). In reality, foreign debt matters just as much as domestic debt in turning a manageable problem into a crisis. In Europe, the financial crisis hit only those countries saddled not just with lots of government debt but also with huge foreign debts caused by years of big trade deficits. These countries saw foreign lenders pull out their money, interest rates spike as a result, and their economies tank. Meanwhile, countries with equally big government debt but little or no foreign debt, such as Belgium, France, and Germany, suffered no crisis.

Japan's long run of trade surpluses makes the country a huge net lender. Even if it runs a small trade deficit, its massive foreign exchange reserves are large enough to prevent capital from fleeing. Precisely because Japan finances its own government debt, the Bank of Japan has proved its ability to keep interest rates down, a fact Kuroda ignores when he counsels Abe that rates will skyrocket without austerity.

Most economists believe that Abe's tax hike will hamper growth for a couple of years. And if Abe also cuts spending to meet the Finance Ministry's goal of halving the budget deficit in two years, growth will suffer even more. Why go this route when Japan has time to fix its fiscal problems? Success requires not just doing the right things but also doing them at the right time and in the right order. Japan should first restore growth and then work on the deficit.

OUT WITH THE OLD
In the end, it is Abe's third arrow-structural reform-that will determine whether Japan can raise its long-term real growth rate from the 0.8 percent average prevailing since 1992 to the two percent the prime minister has promised. Even Japanese government economists admit that without reform, the country's long-term growth rate will never exceed around 0.5 to 1.0 percent. With the working-age population shrinking, the only way to generate more growth is to gain more productivity from each worker. Japan's gdp per hour worked lags behind the average for rich countries by 25 percent. Yet the erosion of human capital caused by the rise of irregular workers makes raising productivity even harder.

To lift productivity, Japan needs serious structural changes to promote creative destruction, the process of replacing decaying firms with vibrant ones. The sectors of Japan's economy that face international competition, such as the auto industry, enjoy high productivity. But the lion's share of the economy is domestically oriented, and much of it is shielded from both international and domestic competition by domestic regulations and cartel-like business practices. In these sectors, Japan lags far behind its peers. To take one tiny but characteristic example, regulations currently restrict online sales of non-prescription drugs because if unrestricted, such sales would hurt brick-and-mortar pharmacies; one corporate member of an Abe advisory panel on reform quit when bureaucrats emasculated his proposal to lift this regulation.

Or look at Japan's inefficient dairy industry, which the government has refused to open up to foreign competition-holding up negotiations for the Trans-Pacific Partnership, a proposed free-trade deal among 12 countries, in the process. Japan's milk market isn't even open to domestic competition. The powerful farm cooperative known as Japan Agriculture uses its stranglehold on distribution to protect inefficient farmers in the main part of Japan by hindering shipments of milk from the larger, more efficient farms in the northern island of Hokkaido. Tokyo turns a blind eye because Japan Agriculture is a powerful electoral ally of Abe's political party and because rural voters are disproportionately represented in the Diet. A real reformer would scrap Japan Agriculture's exemption from the Antimonopoly Act, a law passed in 1947 designed to encourage competition, and use the act to crack down on such practices.

Japan needs an economy in which newcomers can edge out moribund firms, in which workers can move easily from job to job, and in which a solid safety net helps the unemployed through that transition. If reforms to create such an environment were put in place, now-lagging sectors would be propelled to world benchmark levels of efficiency, and productivity-led growth would soar—just as occurred in retail, rust-belt manufacturing, and other traditional sectors in the United States during the productivity revolution that began in the mid-1990s. The United States does so well in information technology today because it boasts a fertile ecosystem for nurturing start-ups. When IBM flagged, Microsoft and Intel were ready to take its place, and when Microsoft started to coast, Google and Apple quickly stepped in. In Japan, however, there aren't any successors to floundering Sony and Panasonic. The country's list of the top 20 electronics hardware firms has not included a new company since 1946.

Rigidities in Japan's labor market, as well as incestuous ties among Japan's entrenched firms, all too often hinder would-be entrepreneurs from gaining the financing, staff, and distribution channels needed to compete. Yet firm turnover—the exit or downsizing of inferior firms and the rise of better ones—is as vital to economies as Darwinian natural selection is to evolution.

Abe could promote innovation by enforcing laws against anticompetitive practices, promoting genuine labor flexibility (rather than the use of irregular workers), and financing a solid safety net. Instead, he, like his predecessors, has moved in the opposite direction, promoting ill-fated mergers among troubled firms. Countries such as Sweden spend up to 1.5 percent of GDP on programs for ongoing adult education, job matching, and the like to help workers shift from job to job, but Abe's fiscal austerity rules out similar steps. This is penny-wise and pound-foolish.

THE POLITICS OF PRODUCTIVITY

If reform were easy, it would have been accomplished long ago. The problem is that reforms aimed at promoting competition would hurt many entrenched firms and their workers. Since a Japanese worker's current job at his
current firm is his main social safety net, a desire to avoid social dislocation is the main reason Japan protects moribund firms. To ease the pain of reform, Tokyo should use fiscal and monetary stimulus as an anesthesia.

In the past, Japan has enacted reforms that worked, such as deregulating the financial market, forcing resistant banks to clean up the massive nonperforming loans that were hamstringing economic growth, ending laws that allowed small stores to block the entry of larger ones into their neighborhoods, and giving new entrants in the cell-phone business equal access to the mobile infrastructure of a previously dominant monopoly. These reforms ushered in huge productivity gains in retail and telecommunications (and for users of telecom), while partially unlocking distribution channels for newcomers.

Nothing in Abe's program, however, remotely resembles those advances. His proposed agricultural reform, for example, would merely replace a subsidy focused on production levels with one focused on income, while giving no incentives for tiny inefficient farms to consolidate or for agribusiness to expand sufficiently. His talk of increasing career opportunities for women omits any mention of the main obstacle: that most of them get taken off the promotion track once they become pregnant. And while Abe has raised taxes on consumers, he is talking about cutting taxes on corporations. His claim that this would promote investment is false, as even the Ministry of Finance acknowl-edges. Japan's corporate giants already have far more cash than they choose to invest at home. But a corporate tax cut might raise stock prices and gain Abe more corporate support.

His plans for the electricity sector, meanwhile, would ostensibly allow room for newcomers by separating generation from transmission. In reality, the existing regional electric monopolies will be allowed to form a holding company that controls both parts. He has done nothing to force rectification in the nuclear utilities, some of which falsified their safety records with the connivance of the regulators in the lead-up to the 2011 Fukushima nuclear accident. As a result, a justifiably distrustful population has so far blocked a restart of the reactors that previously supplied a third of the country's electricity. The resulting electricity shortfall and higher energy costs are propelling automakers and other efficient exporters to shift even more of their capacity overseas. All told, the third arrow has turned out to be nothing more than a bunch of nice-sounding goals for growth, job creation, and investment-without a plan for achieving any of them.

The most obvious litmus test of the third arrow is Abe's handling of the negotiations for the Trans-Pacific Partnership. In recent months, these talks have stalled largely because Abe's team has insisted on keeping tariffs and other barriers high in a few agricultural sectors (such as beef, dairy, and pork) that employ less than 100,000 households but where high prices boost Japan Agriculture's income. As of mid-May, an agreement had not been reached. Even if a deal is eventually signed, Abe's capitulation to small interest groups means that it won't be used as a catalyst for domestic reform, unlike the way South Korea used its trade agreements with the United States and Europe, and as reformist officials in the Ministry of Economy, Trade, and Industry have urged Japan to do as well.

Abe certainly has the clout to take on these vested interests: he still enjoys an approval rating around 60 percent, and his party holds an over-whelming majority in parliament. Yet it seems impossible to find a single case in which the prime minister has truly challenged a powerful do-mestic constituency. Instead, he is wasting his political capital on deny-ing seven-decade-old war crimes and refusing even to admit that Japan committed aggression, claiming Japanese ownership of islets long con-trolled by South Korea, and trying to change school textbooks to reflect these retrograde views. Even when Abe's ideas on security are sensi-ble such as his proposals for Japan to exercise a right to collective self-defense-the need to overcome resistance in pacifistic Japan diverts Abe's energy. Inevitably, this puts the third arrow on the back burner.

The sad fact is that Abe's heart does not beat to the rhythm of reform and revival. Instead, Abenomics is a means to an end: to gain enough popular support to pursue the goals that really move him- security and history issues. But Abe can stay insulated from the political consequences of his economic mismanagement for only so long. Eighty percent of Japanese polled say that his policies have failed to improve their lives at all. Abe remains popular because people still expect Abenomics to start working. Sooner or later, however, its failures will become impossible to ignore, and Abe will lose the political power to make necessary reforms-even if he somehow gained
the stomach for them.

Japan will eventually reform and revive. Its tragedy is that it is filled with smart, ambitious, creative individuals who are trapped in once vibrant but now ossified political and economic institutions. The whole is so much less than the sum of its parts. The country will revive when it finally undertakes the necessary institutional overhaul. But that takes a visionary leader; Abe is not that leader. ∂

 Sidebar
Abe's economic program is, at its core, a confidence game.

Sooner or later, Abe will lose the political power to make necessary reforms.

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