Is Abenomics Working?

TOKYO – Last April, Japan’s government implemented a long-planned consumption-tax hike, from 5% to 8%, the first in a two-step increase that is expected to bring the rate to 10% by 2015. The hike – a key feature of “Abenomics,” Prime Minister Shinzo Abe’s three-pronged strategy to revive Japan’s economy – signals the government’s long-term commitment to fiscal consolidation. But it has also dealt Japan a heavy macroeconomic blow.

Preliminary GDP data show a 6.8% contraction year-on-year in the second quarter of this year – the largest since the 2011 earthquake and tsunami that devastated the country. Moreover, consumer spending fell by a record amount, contributing to a total real (inflation-adjusted) decline of 5.9% from last July.

But it is not all bad news. Expansionary monetary policy – the second of three so-called “arrows” of Abenomics, after fiscal stimulus – has brought down the unemployment rate to just 3.8%. The ratio of job openings to applicants has exceeded parity, and the GDP deflator narrowed to close to zero.

Such data have given rise to two opposing views. Some economists worry that negative second-quarter data will dampen inflation expectations, thereby undermining Abe’s plan for boosting growth. Meanwhile, the Bank of Japan (BOJ) is emphasizing the positive outcomes of its monetary policy – and is hesitating to continue its expansionary...
measures.

If the first view proves correct, the BOJ will need to ease monetary policy further to counter falling inflation. If the BOJ is right, it should maintain its current approach, while the government should either postpone the next consumption-tax increase or implement it in two 1% increments, instead of a single 2% hike.

Of course, the second-quarter GDP data show the economy’s immediate response to the hike. But no decision should be made until the third-quarter results are released, providing a clearer picture of what will happen to Japan’s economy after it absorbs the first rate increase. Fortunately, that is precisely what Abe intends to do.

In any case, the success of monetary policy is difficult to deny. As the deflation gap narrows, however, the overall impact of monetary policy will weaken, as it increasingly influences prices more than output.

That is why it is time for Japan’s leaders to shift their focus from the demand-focused first and second arrows to the supply-oriented third arrow: a new growth strategy.

When there is sufficient excess supply in the economy, promoting supply-side productivity is practically useless without efforts to boost demand. That implies that it was not appropriate to focus on growth until the deflation gap narrowed considerably – that is, until now.

The third arrow is not a traditional industrial-policy-based approach. On the contrary, it emphasizes reform of the labor market, deregulation, and a reduction in the corporate-tax rate.

A key component of Abe’s growth strategy is to expand the workforce – a major challenge, given that Japanese society is aging rapidly. One logical solution would be to integrate more foreign labor into the Japanese economy. But efforts to promote immigration face considerable social and cultural barriers.

A simpler solution would be to mobilize working-age women who already – or plan to – stay at home. By removing the barriers to employment that women face – whether practical obstacles, like insufficient childcare services, or social constraints – Japan could substantially increase women’s workforce-participation rate, creating an invaluable buffer against the growing labor shortage.
The second imperative for boosting growth is the removal of excessively cumbersome government regulations. Under the current system, it took 34 years to approve the establishment of a new medical school – the result of collusion between government officials and doctors.

Abe’s plan calls for introducing a series of less strictly regulated special economic zones, each with a specific objective – for example, adopting new medical technologies or attracting foreign businesses. Such a move promises to help prevent damaging obstructionism by the authorities. At the same time, the government should work with the country’s trade unions to boost the flexibility and efficiency of the labor market.

Finally, Abe’s growth strategy demands a corporate-tax reduction – a powerful tool for increasing the tax base in a world in which countries are competing to attract multinational companies. Indeed, lower taxes are vital to increase foreign and domestic investment in Japan.

Some of these initiatives, particularly deregulation, will undoubtedly face resistance from bureaucrats concerned about losing their influence. But, as long as Abe, backed by Chief Cabinet Secretary Yoshihide Suga, remains committed to his stated objectives, Japan’s economic future will remain bright.


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