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Getting the Fiscal Arrow on Target
Abenomics' biggest challenge

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Getting All of the Arrows on Target

Abenomics is right to seek three pronged strategy

- Lack of monetary arrow limited Koizumi/Takenaka success
- Getting out of a deflationary equilibrium is a regime shift

Structural Policy – Right priorities but one is missing

- Skilled female labor is Japan's greatest unexploited asset
  - -Even if mobilized 2 million women, huge offset to demographics
  - -Positive supply shock to productivity and competition
  - -Requires multi-faceted policy approach but doable
- TPP is a great step towards reform as well as foreign policy

Monetary Policy – BOJ is doing exactly what it should be doing

- This is mainstream macro buying non-cash assets
- Government right to hold accountable for inflation target

Why Fiscal Policy is Tricky Now

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True, interest rates are low and fiscal multipliers are high

- I have long been documenting the short-run impact of fiscal policy and disproving the exaggerated claims about dangers of high debt
- There is no imminent crisis for Japan on public debt, especially given an active BOJ and very little foreign held savings

BUT there are costs to having very high levels of public debt

- Algebra of interest payments crowding out productive public investment
- Financial repression increasingly hurts investment allocation
- Risk of big decline in yen (not good given energy imports)

And even NET public debt in Japan is 85% of GDP higher now

Also, the multiplier depends a lot on *what* you spend/tax

- There are no shovel-ready projects of high return left
- Temporary spending is lower impact than tax cuts

The Fiscal Policy Challenge 2013-2015

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Consumption tax increases of 2014 and 2015 must proceed

- A true credibility issue for the government with markets and public
- Tax collection and incidence in Japan must be improved
- The costs of rising debt service have to be limited/offset

Yet, such tax increases will be highly contractionary

- Repeating 1997 is a very bad mistake and induces volatility
- The multiplier on such a tax increase will be quite high
- If the big monetary push leads to inflation but no real growth, this is the worst scenario for confidence in both public and bond markets

Needed: something temporary to smooth the course of GDP

- Very feasible to distinguish from permanent VAT increases

How to Smooth Out the Fiscal Adjustment

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A temporary investment tax credit and/or accelerated depreciation

- Long record of such policy measures having high impact
- Zero implementation lag or concern about cost
- Responds to corporate cash sitting on sidelines
- Can supplement with corporate governance reforms

Other policies can help with smoothing of fiscal policy

- Monetary policy can if needed move into corporate bond purchases, but anti-deflation target must be pursued without currency crash
- Higher wage settlements/bonuses – including in the public sector – is a smart thing to get done in the 2014 wage round *before* VAT hike

The fiscal shock will be so large in the short-term, and the need to distinguish temporary from permanent fiscal is so pressing, it is best to address this directly with fiscal policy smoothing itself