Comments on the Third Session: Economic Policy of Abenomics

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It is an exciting and wonderful time for someone like myself, who happens to be both a Japanese and economist. Also, as a person who has been advocating reflationary policies for more than a decade, I am grateful that the Prime Minister Shinzo Abe has finally took this policy package, and am deeply honored to be here. Due to time and space constraints, I will comment on the underlying themes of three papers presented, and concentrate on risks in the future.

1. Regime Shift from Deflationary to Reflationary

There is now a wide consensus that the "first arrow," monetary policy, is really the main pillar of Abenomics, and has worked so well so far, as all the papers presented here attest. In essence, what Mr. Abe has initiated was a "regime shift" of economic policy making, as endorsed by Christina Romer (Romer 2013). It is truly a "regime shift" of monetary policy making by the Bank of Japan that makes a great deal of difference. Several evidence including the paper by Umetani, Ueno, and Tada shows that the expected inflation rate has increased, and the real interest rate has declined when Mr. Abe's election as the Prime Minister seemed certain.

2. Risks about New Reflationary Regime

This leads to several issues regarding the future prospect of the New Regime. As Professor Ito touches upon, the old BOJ, supporter of the deflationary regime, resisted a reflationary policy, and we are lucky to have Prime Minister Abe just on time to appoint Haruhiko Kuroda as the new governor of the BOJ.

There still remains an institutional uncertainty regarding the outlook of the future BOJ, however. This time we are lucky, but what happens next time? Clearly we do not want to have a repetition of the same BOJ-induced recession and stagnation any more. In this respect, the BOJ act of 1998 which gives a considerable amount of independence to the BOJ must be revised to cement the foundation of the new BOJ. This is in accordance with the recent discussion about the central bank independence. It used to be useful in the high inflationary environment but it may be harmful in the low inflationary or deflationary environment. Striking the correct balance is a matter of judgment, but that judgment should be informed by the fact that the central bank independence is a product of circumstances and not a goal itself: it is a tool to achieve the goal of macroeconomic growth and stability. Also the future goal could, and needs to be improved. As other central banks experienced, the future goal could be nominal GDP level targeting or anything which takes unemployment rate and other real variables into account.

I would like to make a brief remark about the relationship between nominal wage and inflation. This is now one of the major discussion themes in Japan as Professor Ito suggests. It is a common knowledge that there is a close correlation between changes in nominal wage and changes in price level. But there are also close correlations between changes in money stock two years before and changes in price level, and between changes in money stock two years before and changes in nominal wage. It is more plausible to suppose the causation runs from money to inflation and wage growth rather than vice versa.

Let me turn to the issue of fiscal consolidation. No one denies the necessity of fiscal consolidation and one of the reasons why I support reflationary policy is precisely we do need it eventually, but measures and timing matter as well (small quibble: the 200% debt-GDP ratio is in gross term. In net term, the figure should go down to a smaller number of 143%). Let me point out several facts and estimates. First, unlike the fiscal tightening in 1997 in which a tax reduction preceded a tax increase, this one involves only tax increase. Second, after 1997, Japan started to experience a full-fledged deflation. Third, according to the short-term macroeconomic model of the Japanese economy by Economic and Social Research Institute of the Cabinet Office, the Japanese economy will experience a reduction of around 0.45 real growth rate by a planned three percent increase in consumption tax.

So what to do? The issue should be analyzed in the context of the policy regime. If one believes that a regime shift to a reflationary one in Japan is accomplished, there is less danger of Japan plunging back to deflation once again. But if one believes, as I do, that a regime shift is not yet complete and there is a danger of sending a wrong signal to the public about the policy stance of the government and the BOJ, there is a considerable risk of Japan going back to a deflationary regime, and it is better to think twice about the fiscal consolidation.

One historical episode worth mentioning is contractionary measures taken by the second Roosevelt administration after the Great Depression, the “Mistake of 1937”. Both the government and the FRB turned to contractionary stance and the American economy plunged back to deflation and recession. Now there is a debate about which one to blame for this debacle, monetary or fiscal, but the point is that a regime shift to a reflationary one could be precarious (Eggertsson and Pugsley 2006). Therefore, I am inclined to propose a postponement of tax hikes with several proviso: the government should reemphasize the economic conditions under which tax hike would take place. Right now one of these conditions are as three percent growth in nominal GDP and two percent growth in real GDP, as specified in Supplementary Provision 18 of the fiscal consolidation law, but they should be considered long-lasting rather than temporary. Even if the postponement is not accepted for some reasons, several countermeasures to cushion the fiscal shock should be implemented as Dr. Posen points out: they would include reductions in corporate, investment, and R&D investment taxes.

3. After Reflation, What?

A Reflationary regime is temporary and transitory by definition. Reflationary policies are only need until the Japanese economy gets back to an inflationary, and normally growing environment. So, what does the New Regime look like?

Here, the “third arrow,” growth strategy, matters greatly. The exact details have not yet been known since the whole plan would be released on June 14, but as far as I gather from press conferences and reporting, there are broadly two sets of policy ideas competing with each other. One is a government-led growth policy including industrial policy-like target policy and the set-up of government-sponsored funds, and the other emphasizes facilitating initiatives of the private sector including deregulation, private finance initiative, and trade liberalization.

From an economic point of view, one thing is certain about growth policy: there is no silver bullet or panacea to economic growth. In particular, contrary to the popular view, industrial policy has rarely worked in Japan or in other countries (Okita 2010). The track record of government initiatives are not particularly stellar. So I am inclined to support the latter view, but I also need to take political economy into consideration. In any case, this eventually would influence the outlook of the Japanese economy.

References

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