

Session 4

Comment on the Sapir and Ito papers¹

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It is a pleasure and privilege to comment on these essays written by two of the economists I respect most. Both essays provide level-headed assessments of Abenomics, André from the European perspective and Ito-san focusing on the monetary aspects.

A common theme that underlies both essays is that Abenomics has both costs and benefits. Our new policy is acceptable or at least comprehensible to our economic partners, the Brazilian Finance Minister Mantega's criticism notwithstanding. This is in fact refreshing. For almost two decades, Japan has been viewed as an anomaly, a country that just could not seem to get its act together. The BRICS were booming their way up the global economic rankings, the US enjoyed irrational exuberance, and the Euro was becoming a world class currency. In contrast, in Japan, Prime Ministers were coming and going, the economy was in the doldrums while our national debt kept piling up. The government and central bank seemed unable (or unwilling) to do anything about this. We were criticised, and we felt isolated.

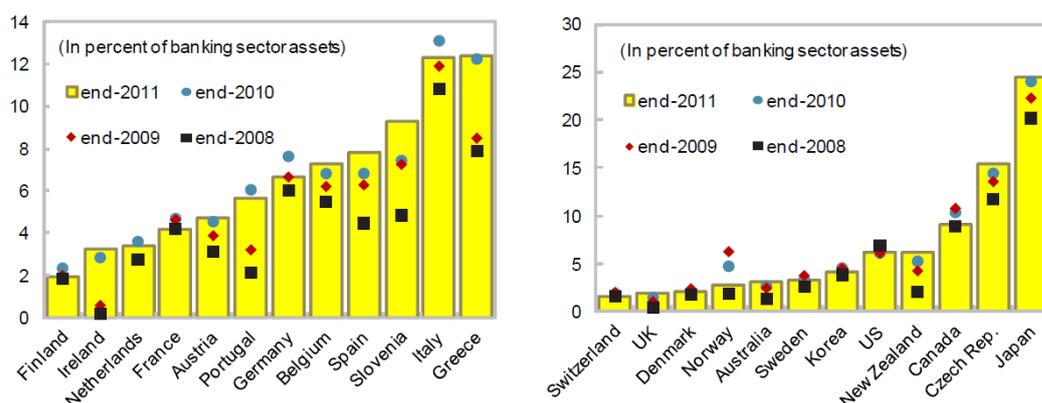
Now, this is no longer the case. There are two reasons. One is Abenomics, the topic of this conference. As Ito-san writes, the new administration created an "expectation driven depreciation, but if it had not been followed up by action, it would not have been sustained", and "inflation targeting with commitment to future expansion of the BoJ monetary base seems to have succeeded through raising exporters' profit via yen depreciation and increasing consumption via the wealth effect". The Nikkei 225 rose more than 50% in less than half a year. Although lately there have been some volatility, obviously, now we ARE doing something.

The other reason is the crises that happened on both sides of the Atlantic. We are no longer alone in our difficulties. Japan is the new normal. In terms of the perils of debt, population ageing and need for reform, the US and

¹ Ryuichiro Izumi, a 4th year student at the faculty of economics at Keio University, provided able assistance in locating and arranging data.

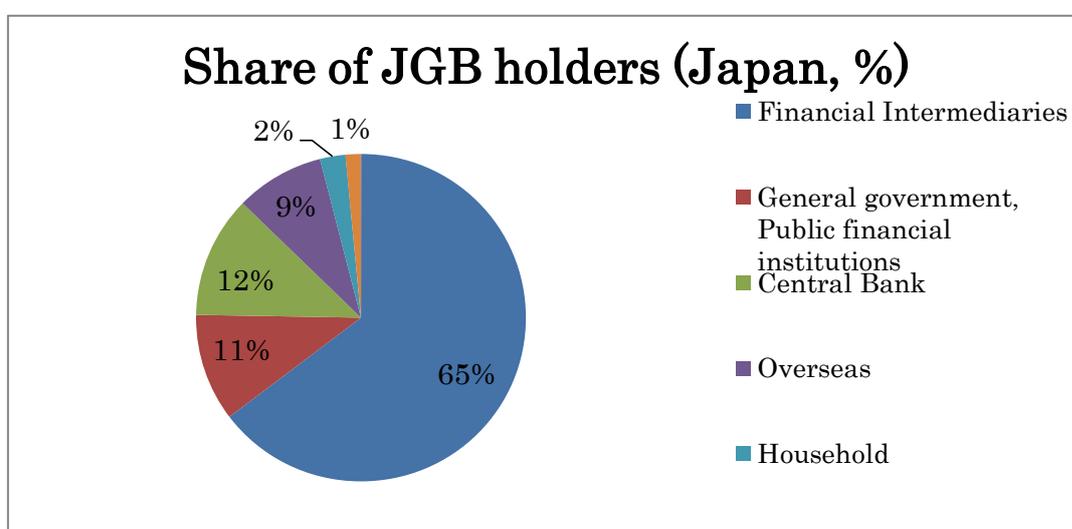
Europe have essentially the same problems as Japan. Events have proven that there was nothing unique about the Japanese economy; all economies came under the same fundamental economic logic. If the costs of borrowing (interest rates and opportunity costs) are too cheap, a bubble develops. After the bubble bursts, financial intermediation falters, government spending increases to sustain economic activity and shaky banks (capital injection). The result is the mutual dependence between governments and banks, which the European Banking Union is aiming to get rid of.

Figure 15. Euro and Non-Euro Area: Bank Holdings of Own Government Debt, 2008–11

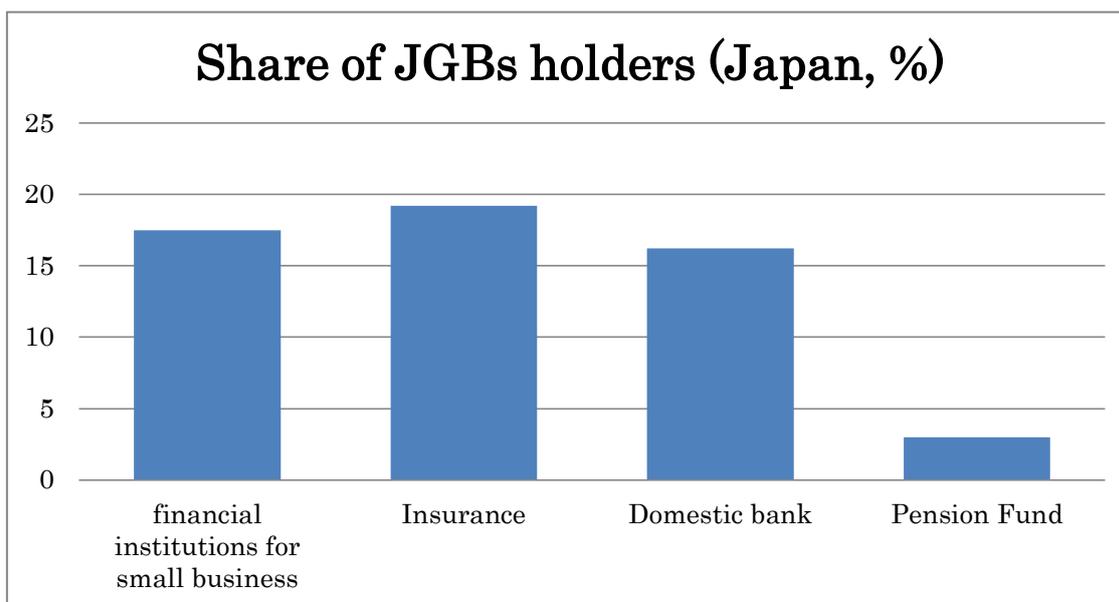


Sources: IMF International Financial Statistics, IMF Monetary and Financial Statistics, and authors' calculations.
 Note: The 2011 figure for Canada is as of end-2011Q3.

Serkan Arslanalp and Takahiro Tsuda (2012) "Tracking Global Demand for Advanced Economy Sovereign Debt", IMF Working Paper 12/284



Source: Bank of Japan, Fund Flow statistics (<http://www.boj.or.jp/statistics/sj/sjexp.pdf>)



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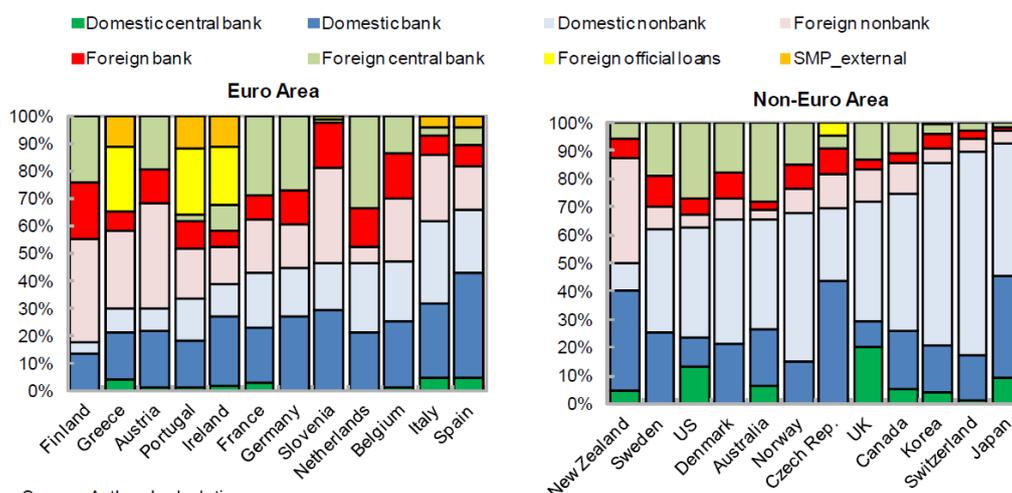
André's essay seems to suggest that essentially, trade and financial linkages between Japan and Europe are not strong enough to significantly affect the EU economy. To the EU, the euro crisis and the series of governance reforms including EBU are much more important. Having said that, Europeans watch Abenomics with "hope and apprehension", for reasons André explains well.

In fact when it comes to "watching with hope and apprehension", so are the Japanese. Because things could go both ways. If we can achieve and maintain some kind of equilibrium it will be a knife-edge, in three ways.

One, with economic recovery and expectation of inflation, the rate of interest rises and attractive investment opportunities (other than JGBs) will emerge. If the supply of JGBs does not decline sufficiently quickly, more JGBs will have to be sold to foreign buyers. If foreign buyers do not make up for the decline in domestic JGB demand, or if they do but one day decide to dump JGBs, JGB prices could tumble. Obviously, this could have huge consequences. Two, with (the expectation of) inflation, households will begin to increase consumption. If the resulting decline in savings diminishes the financial institutions' appetite for JGBs, and if the supply of JGBs does not decline sufficiently quickly, again, JGB prices could tumble. Three, it will be a knife-edge also in the sense that recovery and debt/deficit stabilisation can diminish the momentum for painful reforms. Reform is the third arrow in

Abenomics, but the need for reforms applies also to the USA and Europe. Finding and staying on the equilibrium path is not going to be easy.

Figure 2. Advanced Economies: Holders of Government Debt, end-2011
 (percent of total)



Source: Authors' calculations.
 Note: Government debt indicates general government gross debt on a consolidated basis, which excludes intergovernmental holdings. Domestic banks are depository corporations residing in the country (IFS definition). Foreign banks are BIS reporting banks residing outside the country. Foreign central bank indicates government debt holdings as foreign exchange reserves. SMP_external indicates SMP holdings of foreign central banks. Foreign nonbanks and domestic nonbanks are imputed from external and total debt.

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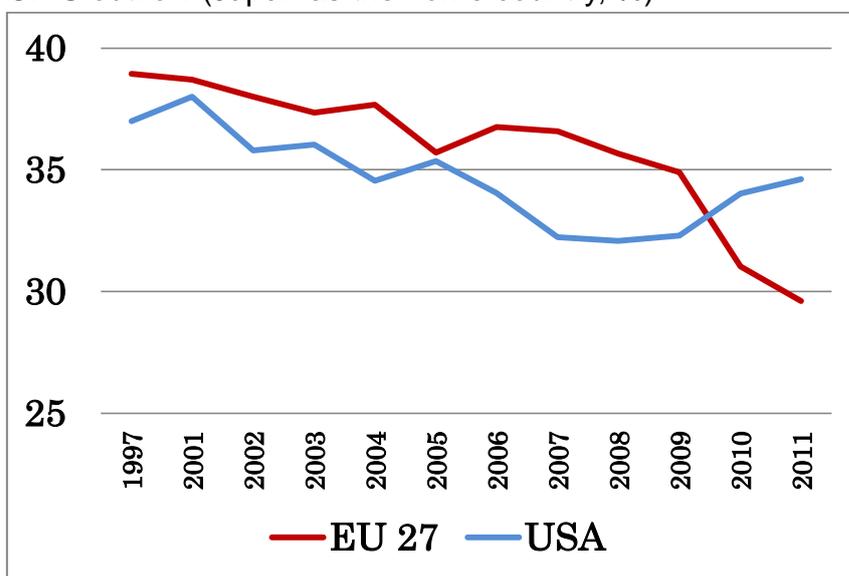
So the question is where we go from here, and what we should expect of one another and ourselves. We do have the same problem but commiserating is not helpful. How do we get out of this, without engaging in harmful acts such as "currency wars"? Where is the growth going to come from? The answer seems to be "from the third arrow"². So then, how can we encourage ourselves to carry out the necessary reforms? The Europeans have each other but would Japan get no help on that front?

André writes that "(i)f, as one hopes, Abenomics succeeds, the real implication for Europe will be that reviving the economy requires a combination of bold macroeconomic and structural policies, with the right sequencing between the two". Actually, this will also be the real implication even if

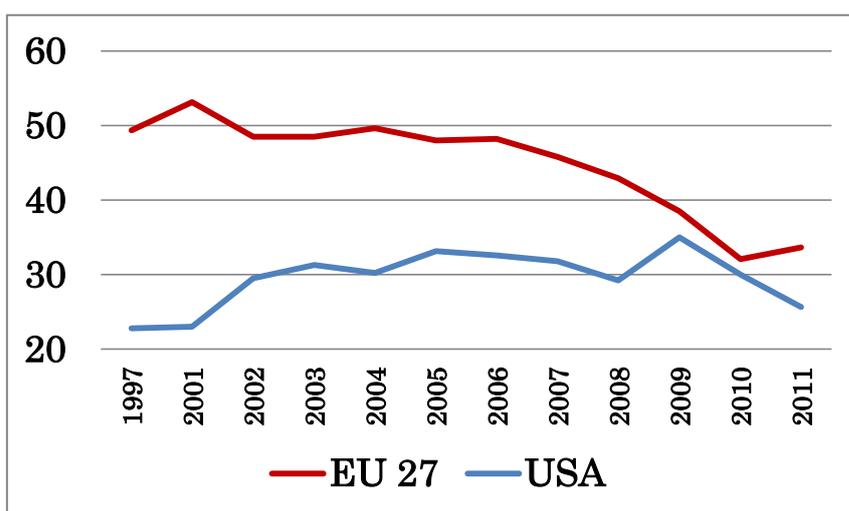
² In an earlier session, Jeff Sachs asked what was the economic crisis in Japan, by pointing out among other things that Japan's output gap was only 2% (in contrast to the US's 4.3%). Japan's crisis is about finding a new structure that increases employment and investment. Output gap is measured with the current industrial structure as a given. But we need a new structure where childcare, care for the elderly and smart electricity etc. will be our major industries. This will solve at the same time the deflation and debt problems. Prices are falling because demand is not effective; the market does not even exist for some of the things we Japanese actually want to buy. This is why reform is important.

Abenomics fails. If Japan ends up on the wrong side of this knife-edge equilibrium, Europeans are not going to be shielded from the resulting global turmoil. In fact, when we look at the IMF's Cooperated Portfolio Investment Survey (CPIS), as far as Japan is concerned, EU27 has been more important

CPIS outflow (Japan as the home country, %)



CPIS inflow (Japan as the home country, %)



Source: International Monetary Fund, Cooperated Portfolio Investment Survey (<http://cpis.imf.org/>)

than the USA in terms of CPIS inflow and until recently CPIS outflow also. So even if Japan's percentage is low for total portfolio flows for Europe, volumes (US\$ 681,340 million for CPIS inflow from Europe into Japan, US\$ 999,414 million for CPIS outflows into Europe from Japan for 2011 estimated) may be

large enough to affect European economies³. This suggests that encouraging the Japanese to carry out the necessary changes is in the interest of Europeans. This provides an added importance to a successful EU-Japan EPA.

I conclude by listing some specific questions to both speakers:

André

1. What are the prospects of successfully concluding the EU-Japan EPA? What are the “musts” for Europeans?
2. “Last year Japan only accounted for 3.6% of EU merchandise imports and 3.3% of EU exports (compared to, respectively, 9.3% and 5.4% in 2000)”. Why has trade between Europe and Japan shrunk, as a proportion of total EU trade?
3. “As far as Europe is concerned, the main spill-over channel is likely to be trade.” In terms of the share of CPIS outflow from European countries, Japan has been small (0.2%, 4.2% and 1.0% for Belgium, France and Germany respectively for 2011 estimated). Why has Japan not been attractive for Europe in terms of portfolio investment? Is it the strong yen, low interest rates and poor market performance or are there other factors? Do you expect this to change with Abenomics in 2012 and 2013?

Ito-san:

1. If this is not a “currency war”, where do we go from here? What should Japan do while the yen is weaker and the stock market is up?
2. What should we be careful about when we exit from QE? Is there a danger specific to Japan?
3. In your view, what is the state of the Japanese economy that we need to arrive at, in order to say that Abenomics was a success?

³ For 2010, Japan's share of CPIS inflow into Belgium was only 4.3% of total inflows, but still the volume was US\$18,046 million, the share for inflow into France was only 5.5% but still US\$151,982 million, the share for inflow into Germany was only 6.9% but the volume was US\$ 202,285 million. If these are suddenly pulled out, similar to something that actually happened in 2011, the effects will not be negligible.