ESRI International Conference
"Toward Revitalization of the Japanese Economy: The Role of Policy in the Global Economy"

30-31 May 2013

30 May 2013

Keynote Address

Mr. Akira Amari, Minister in charge of Economic Revitalization, Minister of State for Economic and Fiscal Policy:

First off, I extend my sincere gratitude to the many scholars and researchers from abroad who have made the time and effort to travel here from afar and attend this conference.

Abenomics has attracted worldwide attention. At the Davos Conference back in January this year, Martin Wolf, the Financial Times Associate Editor that chaired one of the sessions I attended, likened Abenomics to a policy revolution. More recently, Japan's Prime Minister Shinzo Abe was depicted in a Superman outfit on the cover of the British news weekly *The Economist*. As someone from the generation that grew up watching Superman episodes on TV, for me, that classic "It's a bird. It's a plane. No, it's Superman!" is a nostalgic phrase. The *Economist* cover had "Is it a bird? Is it a plane? No, it's Japan!"

Lately, the foreign cabinet-level government officials and parliament officials that I meet on their visits to Japan always say that they are interested in Abenomics and then ask for briefing in detail. Thatcherism and Reaganomics were renowned economic policies in their day. It may be that Abenomics also will carve out its own place in economic history, provided it succeeds in rescuing Japan from over a decade of deflation and puts our economy on the comeback trail as an engine of global economic growth.

As you know, Abenomics comprises three policy arrows: bold monetary policy, flexible fiscal policy, and a growth strategy that encourages private sector investment. Today, I would like to utilize this opportunity to present an outline of Abenomics and its key features.

At its core, Abenomics aims to change the deflationary sentiment of Japanese consumer and market which has been kept for more than a decade—and accordingly spur the nation's leading economic agents into following a new course of action. To bring about a change in hard-set deflationary sentiment, the strategy is to intensively apply every resource at once rather than in gradual increments. Another point underlying Abenomics is the determination to go all-out with these concerted policies until they deliver results. This is because it is backed by the view that persistence is the key to success.

Although market and consumer expectations remained unchanged for more than a decade now, they have already begun to show signs of improvement. Benefits are also beginning to appear and work their way through the real economy.

In the first quarter of 2013, real GDP expanded at an annualized 3.5 percent compared to the previous quarter. Since the inauguration of the new Abe Cabinet, stock prices have been rising. The resulting asset effect has improved household sentiment and stoked a turnaround in consumer spending, particularly on car purchases and meals at restaurants. Another background factor that may be cited is the renewed expansion in exports that has been aided by firming business conditions in the U.S. and other economies abroad. In my view the Abe government's a new phase of economic policy has begun reaping benefits led by an increase in consumer spending. In the period ahead, the economic recovery should gather more convincing momentum as steps are taken to leverage private investments that have stopped declining.

Prices have also begun displaying signs of change in certain areas. Under the previous administration, about 60 percent of surveyed Japanese households expected prices to be higher a year later. By April this year, the share of households that felt that way rose to 82.8 percent.

First, in relation to the bold monetary easing that counts as the first arrow of Abenomics, in January this year the Abe government and the Bank of Japan issued a joint statement and BoJ adopted a price stability target for the first time. At that point in time, the BoJ committed itself to achieving a target rate of 2 percent at the earliest possible time. At its Monetary Policy Meeting in April, the BoJ decided monetary easing that is of an entirely new dimension both in terms of quantity and quality. It will double the monetary base and the remaining maturity of long-term JGBs that it purchases. In addition, it sets a two-year time line for achievement of its price stability target of 2 percent. This is indeed a bold policy platform that deserves being described as a new phase of monetary easing, and I applaud the BoJ for putting it into motion.

The second arrow is flexible fiscal policy. Under the previous government administration, the Japanese economy approached an abyss that threatened to sink it to new depths. In fact, the GDP growth rate for the July-September quarter of 2012 registered a negative 3.5 percent at an annualized rate compared to the previous quarter. To rescue the ailing economy, the Abe Cabinet put together a 10 trillion yen supplementary budget proposal equivalent in scale to 2 percent of GDP and had this budget measure enacted in February. Immediately after its enactment, the Abe government launched efforts to have this supplementary budget implemented at full speed. The goal is to create more jobs, thus generating increased income and spreading the ripple effects of the economic recovery to all corners of the nation without delay, and quickly provide the Japanese public with the realization and sense of relief that an economic recovery is at last under way. The consequent improvement in consumer sentiment will in turn lead to an expansion in both consumption and investment. This is the scenario of the virtuous cycle that we hope to achieve at an early date.

In any event, speedy implementation is the common denominator that the Abe government has applied to the first and the second arrows. That stance reflects Prime Minister Abe's observation that we cannot have growth without action.

From the earliest days of its coinage, the term "Abenomics" has been attacked for entailing prohibit implications by the political opposition and the news media. This new phase of monetary easing has also been heavily criticized.

Most of the currently popular criticisms of Abenomics have to do mainly with its presumed side-effects. As such, they can be divided roughly into two categories, as follows.

The first category of criticism stresses that the policies of Abenomics will deal a blow to the lives of average citizens and certain business sectors through price inflation. The argument is that inflation in the absence of rising wages will actually have a detrimental economic impact on peoples' lives, or that rising import prices due to the weakened yen will be painful for consumers or cause distress for businesses.

The second category emphasizes that rising long-term interest rates will have a negative impact on the economy and public finances. One argument along these lines is that if this new phase of monetary easing undermines market confidence in JGBs and drives long-term interest rates sharply higher, the economic growth rate will be forced downward and the fiscal and monetary systems will suffer dysfunction.

My current positions on these criticisms of Abenomics are as follows.

The key claims representing the first category of criticism are that the lives of citizens will be seriously impacted by price inflation in the absence of wage hikes or by rising import prices due to the weakened yen. However, our solution to that scenario will be to rescue the economy from further deflation and achieve growth in employment and income through the synchronized implementation of the three arrows forming our unprecedented package of policy measures. Of course, in that process, it is especially important that improved earnings in the corporate sector be fairly distributed. To that end, Prime Minister Abe has called on those members of the business community with available reserves to consider boosting wages to workers, even if it is like a bonus. Some companies have already announced plans to boost employee compensation in sympathy with this policy. Our hope is that as improved business performance buoys corporate confidence, wage hikes will spread through the economy. It is also important, however, that government, the business community, and the labor community engage in candid discussions regarding the domestic employment-related issues they respectively face, strive for deeper mutual understanding, and together work toward solutions. We are currently studying the idea of setting up an appropriate forum that facilitates this process.

Although yen depreciation can be expected to have the effect of increasing price levels for imported goods, it will also lead to improved earnings in certain sectors of the economy. In my view, recycling such benefits back through the economy as a whole will also be important.

As I indicated earlier, the claims forming the second category of criticism of Abenomics focus on the risk that long-term interest rates will enter a sharp uptrend. First of all, as I see it, the BoJ will be able to handle this scenario because it has announced plans to establish a forum for closer coordination and exchanges of views by market participants than has been the case to date. The government, for its part, will watch bond market trends primarily in the interest of assuring that the market is able to effectively absorb new government bond issues. A sharp climb in long-term interest rates would pose serious risks to the economy, public finances, and the lives of all citizens. Accordingly, in line with the Joint Statement by the government and the BoJ in January this year, the government will move forward with steady steps to establish a sustainable fiscal structure while demonstrating its intentions and plans for the achievement of sustainable fiscal structure.

“Basic reform program of economic and fiscal management” that is expected to be laid out by the Council on Economic and Fiscal Policy in mid-June will provide an outline and direction for the strategies aimed at balancing Japan’s economic revival with the need for sustainable fiscal structure. The actual policy measures will be laid out in the medium-term fiscal plan that the government puts together this summer. Medium- and long-term perspectives toward both Japan’s economic revitalization and sustainable fiscal structure will also be prepared this summer.

Benefits have already begun to accrue from earnest implementation of the first two arrows of the Abenomics. However, thus far, those benefits cannot yet be described as sufficient.

Japan has become a 500 trillion yen economy with its private sector playing a primary role. To put this economy to work and have it start new growth, the Abe administration will, as its third policy arrow, develop a growth strategy that expands private investment and consumption. That growth strategy will be the central pillar of Abenomics.

The biggest difference between this growth strategy and others of years past is that this time, strategy is followed by action. The Abe cabinet pledges that the new growth strategy it soon unveils will be implemented with speed in an entirely new dimension. This is the prime feature distinguishes Abenomics that departed from political gridlock where decision are rarely forthcoming.

Specifically, we plan to set key performance indicators (KPIs) for each of the sectors addressed by the new growth strategy and assess progress in each sector at least once a year. If progress proves to be below expectations, our approach will be to identify the underlying causes and devise serious supplementary measures aimed at meeting initial sector targets rather than lowering the bar or delaying the schedules for achievement of those targets. In effect, this will be a growth strategy that continues to evolve.

The foundation of this new growth strategy will be built on three pillars.

The first pillar will consist of measures to remove six serious burdens on the business environment and reinforce the nation's industrial base. This will involve efforts to strengthen the industrial base in multiple areas, including human resources, science and technology, the utilization of information technology, and energy. The goal is to equip Japanese industry with fundamental strengths that enable it to maintain its competitiveness at the global level.

The second pillar involves the creation of new growth markets. We often hear the saying that crisis breeds opportunity. Japan currently faces several pinches, including a declining birthrate with the demographic aging of its population along with the aging of key infrastructure. If it can find solutions to these challenges, it will have opportunities to export those solutions to other countries that face similar challenges in the years ahead. Our goal is to be able to realize, "Japan is back!" and once again experience the prestige of "Made in Japan" in the global marketplace. That possibility and its opportunities are now knocking at our door. We must not allow ourselves to be distracted and intimidated by the crisis conditions we face. We must instead gaze squarely at the opportunities and dare to accept the challenges ahead.

The third pillar of the new growth strategy will be a drive to create structures that enable Japan to fully exploit its geographic position of the midpoint of the world's growth center— the Asia - Pacific region —and achieve growth hand-in-hand with this region. Its participation in negotiations for a Trans-Pacific Partnership count as our first step in that direction but additional initiatives also will be implemented to shape an environment that allows Japan to promote its economic role at the international level.

The final touches to this three-pillar growth strategy should be complete by mid-June. Prime Minister Abe plans to outline this strategy at the next G8 summit.

Before closing, I would like to talk briefly about the shape of the market economy that Abenomics aspires to build. Prime Minister Abe frequently uses the expression "*mizuho no kuni* style capitalism" Implementation details for "*mizuho no kuni* style capitalism" are to be hammered out by a special committee to the Council on Economic and Fiscal Policy. Abenomics is different from the speculative financial capitalism that brought us to the crisis triggered by the collapse of Lehman Brothers. Abenomics strives to return the market to its paper form, to establish a system that places more importance on medium- and long-term investments, and on the basis to create an economy marked by continuous innovation.

Known as a champion of innovation, the economist Joseph A. Schumpeter once stated, "The difference between a speculator and an investor can be defined by the presence or absence of the intention to 'short-term trade'". On that note, I feel that one of the most important themes in economic policymaking today has to do with how economic systems integrate mechanisms that encourage investments in fixed assets, research and development, and human resources. It would be interesting to me if this question is also discussed during this conference.

To borrow a phrase from John M. Keynes, "The difficulty lies, not in the new ideas, but in escaping from the old ones." May this conference provide us an opportunity to abandon outdated concepts and generate new ideas.

Thank you.

Session 1
Intensive Discussion on Economic Policy Designing: World Economy and Environment

Keynote speech : Jeffrey Sachs (Columbia University)

Discussants : Richard Cooper (Harvard University)
Koichi Hamada (Special Advisor to the Cabinet)

Dr. Jeffrey Sachs, Director, The Earth Institute, Columbia University: Thank you very much and let me thank you Prof. Hamada and the other conference organizers for including me in this conference. I know all of us coming from Europe and the United States are extremely excited to be here and to learn more about Abenomics and its direction. I will speak for myself but I assume that I speak for others to say that we are very excited by the recent developments. I am going to talk not so much about a one- or two-year time horizon, even though that is important, but a little bit longer time horizon. Because I believe that we should put even the short-term macroeconomics into a more structural environment and more structural understanding.

But before I get to that, let me say one point very clearly about the short term. In my view the actions of the BOJ in recent months had been enormously helpful and long overdue. So, I believe the most important facts that we have seen are a monetary expansion leading first and foremost to a depreciation of the yen, which had become seriously overvalued in recent years, and in my view had been chronically overvalued for many years before 2008. So I believe that the most important single event of Abenomics so far has been an aggressive BOJ policy that has successfully weakened the yen and that this is a desirable phenomenon for Japan, which should help to revive the Japanese exports and growth and will, on the whole, be beneficial to the entire world. That I believe is the core of the short term. But as I would say, I do not think it will lead to miracles because I think that the structural challenges facing not only Japan but all of the high-income world are very real and I think we should put the Japanese challenges in the same context as Europe and the United States. All regions of the high-income world are growing relatively slowly, and I think for reasons that are persistent.

The first graph shows the growth rates of the developed countries and the developing countries with the developed countries in blue and the developing countries in red. And clearly the basic phenomenon of the past 15 years is the process of convergence of the emerging economies. These are the developed economies. The United States, Europe and Japan, though growing at different growth rates and having different cyclical amplitudes and timing have all been growing less rapidly than in the past and the emerging economies have been growing more rapidly than in the past and the gap that has opened up has been a three to four percentage points gap in favor of the developing countries for a decade.

I believe that is a deeper process of long-term global convergence that is likely to continue and that it on the whole is both understandable and salutary because it signals the catching up much of the developing world, of course led by China but by no means involving just China, involving as it does quite a wide range of developing countries, even the African countries now. And I believe that the slowdown of the high-income countries, which started with Japan's slowdown in the 1990s, is to some extent the counterpart of the speeding up the emerging economies.

In other words, there really are aspects of globalization at play, which have led to more investment in the emerging economies and somewhat hollowing out of the high-income countries, especially in the open sectors and especially in manufacturing. All of our high-income economies have experienced a significant drop of manufacturing sector employment since 1990. Part of that is definitely technological: the improvements in process technology and robotics; and part of it is offshoring. We do not know exactly the proportions; maybe 60/40 is technology to internationalization, but I think both are at play. And both have led to a slow down of growth in the high-income countries.

Japan was the first to experience this in a significant way because the process started in the 1990s. My interpretation is that Japan had two attributes that made it more vulnerable to hollowing out than Europe and the United States. First is its proximity to China and to other countries of developing Asia, and the hollowing out was more intensive and faster. Second, the aging of the population was a lot faster in Japan. This was a second part of the maturation of the Japanese economy, in this case the literal maturation by age in Japan. But I think that all parts of the high-income world are part of this process. The United States is feeling it in the same way but at a lag. I think it is important to not attribute all of Japan's problems to macro-economic management or to bad debt in the banking sector or to failures of macro-economic policy. The process is too similar to what is going in many other places that have very different short-term experiences.

The next slide shows three representative countries, Japan, Germany and the United States—three major economies. Japan is in red, the United States in green, and Germany in blue. You can see the sharp fall of Japan from its 5% growth rate to 1% growth rate, starting in the early 1990s. The other economies did not experience quite the same step down. But I think that it is reasonably the case, especially if one were also to adjust for different population growth rates, that all major regions have experience a longer-term decline of growth. And Japan went first, and I think again, for structural reasons and also because of financial and related reasons following the collapse of the bubble in the early 1990s.

Part of the maturation process is the declining net national saving rate in all regions. Again, this is partly the effect of a slowdown of growth and is partly the cause of the slowdown of growth. It partly reflects demographic trends; it partly reflects the rising weight of depreciation in the national accounts, thereby subtracting from gross saving rate. But it is part of the process of all the high-income countries achieving what would be normal slowdown in a normal solo-style growth process, capital deepening leading gradually to a slowdown of long-term growth. But I think it is compounded by internationalization, which has also caused the acceleration of the loss of employment in the open sectors of the three economies.

I think it is notable that while all economies have slowed down, the unemployment consequences of the slowdown are really quite different. That is because our labor market institutions work quite differently. Germany had quite a sharp decline of gross national product (GNP) growth, for example, after 2008, but you can see that its unemployment rate actually continued a decline of unemployment. Germany has the lowest youth unemployment rate of any major economy in the world. This partly the result of job sharing and flexible job hours; it is partly the result of Germany's special apprenticeship institutions. But I just want to emphasize that unemployment consequences are quite different from growth dynamics. In the United States we often linked it to through Okun's law and say that the unemployment rate closely follows the growth dynamics. That is relatively the case for the United States but that is not the case in general. Labor market institutions play a big role in mediating the consequences of changes of growth to changes in both employment and unemployment rates. And Japan also has maintained a relatively low unemployment rate, although one that has gradually risen over time despite a very long period of low growth.

One thing that I did want to point out is how different also the government revenues are. The United States and Japan are chronic low tax collecting countries. Europe has a much higher rate of tax collection. I believe as I will mention in a moment that Japan's tax collection as a share of GNP will absolutely need to rise over time, hopefully done in a way which does not cripple an economic recovery. But I do not think that Japan can continue with the government revenues on the order of 30% of gross domestic products, considering all levels of governments. This seems like an insufficient level of taxation in my view given the various responsibilities of government, especially for an aging society.

So I believe that basically we have been experiencing a "mature economy syndrome," I call it on this graph. I listed nine attributes, but this is basically standard neoclassical growth economics for high capital intensity economies. First is high capital-labor ratio; second, an aging population; third, a falling saving rate; fourth, the hollowing out of industry; fifth, technological unemployment;

The sixth point is increasingly high-cost infrastructure—it costs our economies a fortune to build any infrastructure compared to the cost in emerging economies. It is about US$1 billion a mile now to extend the New York subway system; it is almost unaffordable to do anything. This is pretty much par for the course for all high-income countries.

The seventh point is of course strong vested interests of mature economies.

I think an eighth point is that probably we are all underestimating true economic growth in our countries because I am quite convinced that we are not adequately capturing a lot of the real benefits of our information technologies. So I do not think that we are actually measuring the full growth that is being achieved; I think it is faster than we are measuring it. I just want to add that. It does not change relative dynamics necessarily but we are probably underestimating economic progress by the way that we measure a lot of the outputs in the national accounts.

The ninth point is that all of our economies on the transition to lower growth have experienced financial bubbles, but I would consider the financial bubbles in a way to be an outcome of the transition to lower growth rather than a cause. It is usually said that Japan's financial bubble caused the subsequent low growth, but I think the low growth in a way caused the financial bubble as well. And by that I mean that as growth forecasts in Japan diminished in the 1990s, the high-growth period having come to an end, this led to a massive reassessment of assets prices, both land and equity prices, and that created a collapse of financial assets and banking sector distress. The United States, I think, in a way has had a similar experience. I do not want to oversimplify a much more detailed story, but I do not think that the bubbles that we have experienced are simply the primary causes of subsequent events; I think they also reflect the slowdowns of mature economies.

What are some of the macroeconomics policy implications of this view? First, I think that low growth is mostly structural not cyclical. But let me caution, I want to say what I said in the beginning, Japan was punishing itself even more than necessary, so there is still room for macro policy in all of this. Monetary policy should have been more expansionary, but it cannot solve some of the more fundamental issues. Low growth is a trend factor if we compare growth between, say the 1950s to the 1980s and the growth afterwards. It will not come back to earlier trends, except maybe if we change the way we measure things significantly.

Second, new sources of growth need to be sought, especially in advanced skills and in information technology, and export of high-technology services. As the minister was saying few minutes ago, Japan knows how to do a lot of things, building highly sophisticated cities and highly sophisticated infrastructure better than almost anybody in the world. That is a service sector export needed throughout the world, and that I think is a growth sector for Japan. Not the traditional export of manufactured goods, which will come out of the emerging economies, but rather the design of them and the design of systems. Nobody knows how to make cities more efficient in my view than Japan, and lower ecological impact. Those are very much needed in the world, but those are exports of high-skilled services and high-tech services, not exports of manufactured products.

Third, new markets should be sought in emerging economies, especially in Africa and Asia, rather than in the United States and Europe. Japan is still looking for the United States and Europe through TPP for example as its growth engine. But the real growth will be in the emerging economies for the next 30 years, and that is where the new export markets will be. For some reason, China is the only one that has figured out so far how to make exports in Africa. Of course, they are financing them so they still have to prove that they can get repaid for their exports, but they are the only ones exporting on a large scale to Africa right now. I think they will get repaid and I think exporting infrastructure to Africa is a very good bet for the future and for Japan it is exporting infrastructure services, design, urban planning, transport networks, power grids and so forth that could be a very significant activity.

Fourth, technological advances should aim for environmental sustainability. We have entered an era of profound ecological instability caused at the human hand. Climate change is not only real, it is already occurring to a significant extent. It will intensify markedly in the next 40 years. We need a massive shift to energy efficiency and low-carbon energy sources. Japan also plausibly could be world leader in this, because Japan with its front-runner technology policies has really pioneered energy efficiency more than any other major economy. But right now, Japan's energy policy is deeply unsettled and that is also deeply unsettling, because Fukushima has really derailed Japan's vision of energy policy, and the question is what will come next. I hope that Japan continues to lead in low carbon energy, including nuclear power if properly managed, and does not try to turn back to natural gas or other fossil fuel based energy systems.

The fifth point that I would make on macroeconomic policy is that we need to improve the national accounting considerably in the information age, because we are simply not capturing a lot of the quality improvements in services, in retail and wholesale trade, in design, in entertainment, in many areas that are relevant.

Finally, some structural policies implication that I would mention. First, I think it is obvious but for high-income countries like Japan, the European Union and the United States, skill training is absolutely the main investment that society needs to make, generation by generation. I find it a tragedy that half of the kids in the United States are not properly trained now for the 21st century; they cannot get jobs, they cannot stay out of poverty, they cannot get out of poverty—they do not have the skills. So this is really a fundamental challenge for all our economies.

Second, this means investing heavily in higher education, research and development and information and communications technologies, which is the greatest technology revolution of our time. And of course many technologists believe that the information technology revolution will now be followed by a manufacturing technology revolution with what is called atomically-precise manufacturing, in other words nanotechnologies. Japan of course is in a good position to be a leader in that revolution as well. But it takes a major continued massive investment in higher education, in university-based research and development (R&D) and in overall national R&D policies.

Third, just reflecting on Northern Europe's experience, our economies need to deploy better school-to-work transition programs, more sophisticated ways to help young people get a foothold in the new 21st century economy. Similarly, deploying flexible employment models is very important.

Finally, I would say sixth, my own view is that Japan will need to raise tax rates—or tax collections, I should say, not tax rates, but taxes as a share of GNP. There are many ways to do that; there are many options for taxation. The United States faces the same problem. Unfortunately, if anything we are moving in the opposite direction. We have an ongoing tax revolt going on, and perhaps a global race to the bottom in tax collections as countries compete with each other in cutting their tax rates in order to attract internationally mobile capital. This actually brings me to the favorite issue of the two gentlemen and my teachers both on my right and my left, and that is international policy coordination, because they are both the leaders of the study of international policy coordination. One place where we need it I believe is in tax policy, to make sure that we do not have a race to the bottom in tax collections. Because an aging society that needs to invest heavily in technology and in R&D and in social welfare does not have the luxury either of running 10% of GNP budget deficits forever, nor of avoiding the social responsibilities. Therefore higher tax collections in my view are needed.

Thank you very much.

Dr. Koichi Hamada, Special Advisor to the Cabinet of: Thank you. This format is conversations between three of us, plus the audience participation later. Prof. Richard Cooper will be the next speaker, but I would like to say a few things. First of all, I really thank Economics Minister Akira Amari and vice minister Takashi Matsumoto and the president of ESRI Kenji Umetani, this research institute. In addition, I would like to thank Minister Amari because I was wondering how I should explain to foreign participants what the objectives and the present state of this Abenomics is, but the minister very clearly and concisely and in substance explained the content as well as its future problems.

Of course, I should have said first of all, that I would like to welcome and thank all foreign participants for this meeting, and also Japanese participants as well. I feel like I am celebrating my academic birthday today because Prof. Cooper was my thesis advisor, and the topic Jeff Sachs just mentioned—the competition or the harmonization of tax policy and so forth, was my first I should say, virgin article in international professional journals. Prof. Cooper was leading research in that field and he helped me a great deal to make it an article.

Then my work on policy coordination in international finance, very few people paid attention to my work as again the theory was probably too difficult for general trade theories, but Jeffrey Sachs wrote an influential article to show that the idea is important. But, there is a tilt. Since the world changed to flexible exchange rate from the fixed rate, the need and benefit of policy coordination is now minimized. Policy coordination or system coordination in real matters like immigration, tax competition and so forth, are still very seriously important.

So I am very happy to be surrounded by my teacher as well as the stockholder of my intellectual capital today. I think Minister Amari laid out the present issue very systematically and very well, so I think we can start discussing what we assess or we expect from this Abenomics. I am very glad to introduce my advisor, Prof. Richard Cooper of Harvard University.

Dr. Richard Cooper, Harvard University: Thank you very much. I was asked six or seven weeks ago to comment on the presentation by Prof. Sachs at this conference, and during the last weeks I have been waiting patiently to get his comments to discover what I should say on them, and I finally got them starting about 20 minutes ago which is the same time that you got them. I have known Jeff for many years and it is not an entire surprise; the question is what to do under such circumstances. One strategy is to play it by ear and respond to what he said spontaneously, the other is to prepare some remarks ahead of time, which may or may not have any bearing on what he has actually said. I adopt a straddle strategy, a little bit of both. Let me start with some things that he said.

First I want to say that I very largely agree with the main thrust of his presentation, but he said a few things which stimulated some qualifications. Before I do that though, I noticed that in all of your packets there is a paper by me and Prof. Hamada, and it has no date on it. I need to tell you that it was published well over a year ago. It was a critique of the then prevailing Japanese policy and it has been overtaken by events, so you need to put a date of spring of 2012 or something on it. It is still relevant, but the thrust of it has been taken on.

Two things I want to say in particular in response to what Jeff Sachs said. He talked about the decline in manufacturing employment and used the phrase several times of 'hollowing out' of the manufacturing sector, and identified it with offshoring. I spent some of my youth as a farmer and my own view is that manufacturing is going the way that agriculture went. That is to say, output goes up and up and up; there are some bumps but it generally goes up; and employment goes down and down and down. The difference of course is productivity. We have had over the decades a tremendous increase in productivity growth in agriculture, and the result is it now accounts for only a small part of employment, less than 2% in the United States, but output has continued to grow. Manufacturing employment in the United States reached its peak in 1979, not the 1990s, so that was already over 30 years ago, and it has been going down ever since then.

We have heard a lot about the hollowing out of manufacturing in the United States and it comes from people who are focused on employment. But if you look at the level of output and correct for recessions—because we do have recessions from time to time and a big one just recently—but if you look at trends rather than recessions, manufacturing output has gone up and up and up. I have not looked at the figures in detail for Japan but my guess is that one could make the same statement about Japan, about Germany, about most of the European countries, and again the difference is productivity.

Prof. Sachs mentioned one source of productivity, which was robotics, which was really pioneered on the manufacturing floor in Japan. I have worked as a farmer, and the best thing that happened to me was getting off the farm. I have never worked on a factory floor, but my observation of work on the factory floor is that it is a little bit like farm work. It is repetitive, boring, sometimes actually dangerous. From a human point of view the faster we eliminate manufacturing jobs, the better. It should not be a matter for regret. Of course it is a matter for regret for any particular person who works in manufacturing and loses his job, and that raises the questions of how society is organized to deal with the constant change and the transformations that are taking place. But I do not think that we should regret the loss of manufacturing jobs. Substituting machines for people on the factory floor is a highly desirable development. I guess a general way of putting it is that hollowing out really refers to manufacturing employment, and not to manufacturing output. It is important to keep that distinction in mind.

The second observation stimulated by what Jeff said has to do with savings rates and the decline in savings rates, but I note with high approval that he also mentioned the mis-measurement of GDP these days. One of the components that are badly mis-measured in my judgment is savings rates and investment rates. We understate in all modern economies the true rate of savings and the true rate of investment. Keep in mind that the national accounts were laid down in the 1930s and '40s at the height of the industrial age, and they are preoccupied with things that you can touch and move around. Services fit in to the national accounts very uncomfortably, particularly when one is trying to measure real output and the related price changes.

Just take healthcare, which is a large and growing segment of the national accounts. Our mis-measurement in the healthcare area is incredible. We have had fantastic improvements in healthcare and medical science over the last four or five decades. I could give you several stories but we do not have time for that. We measure productivity increases in this area terribly—that is the only way to describe it, which means we also measure price increases terribly. In human terms, prices have gone up much less rapidly than we record, and productivity has gone up more rapidly than we record.

So I think that we need to treat all of the hard figures, usually published to six significant digits, with a degree of increasing skepticism. They are rough orders of magnitude, and they may even lead us to misjudge the trends. In this respect I strongly agree with what Jeff said, but I would give it even more emphasis.

Something he did not mention at all but one of the novel and in my view potentially extremely important developments in recent years is the development of shale gas. We have known about shale gas for about a hundred years, but it was considered an inaccessible resource economically and technically. It is just a concrete example of what Jeff was talking about, the application of knowledge to actual problems. What was once a known but considered totally inaccessible resource has now become an abundant resource thanks largely to technological developments, the applications of brain power, and also to the fact that oil prices are quite high these days and it makes it economically more attractive to extract the shale gas.

This is not the place to develop the theme at length. I think shale gas is going to revolutionize the energy sector worldwide and not just in the United States. I think it will probably along with Fukushima push nuclear power off more in to the future because cheap gas is a perfect energy for generating electricity. I think it will also push some renewables off; I think wind power is here to stay, but other renewable will be pushed into the future. Those are both bad developments from the point of view of climate change, which is the theme I want to end on, but gas also pushes out coal that is a really good development from the point of view of climate change.

So my guess is that as our total demands for energy rises, the share of gas is going to rise very rapidly in the next two or three decades. Not next year or the year after, but in the next few decades. If the price differential between gas and oil continues to be as large as it is today, in that timeframe even transportation or at least land transportation will be shifted to gas-based transportation, including gas to liquids.

Macroeconomic issues have become the dominant international concern these days, and for a good reason: the financial crisis that started in the United States became a world recession. While the United States is struggling out of that recession at a moderate pace, Japan has not, and Europe has managed to go into a double-dip recession, something that was greatly feared five years ago for the United States but it has actually appeared in Europe. There is inadequate aggregate demand in the world. That is all there is to it, and Abenomics I think is a step in the right direction; it is a partial antidote to that development. We need more in Europe and in my judgment, we need more in the United States but we are not going to get it for political reasons.

Macroeconomics has crowded climate change off the global agenda, but that does not mean that the problem of climate change has gone away. My own view, and again this is not the place to develop it, is that the international discussions on climate change are on a dead-end path. (I am talking about climate change by the way, because the title of this session said that Jeff was going to talk about the environment. He did actually get it in there a little bit, but that provides my excuse for talking about climate change.) The path that we are on internationally I think is a dead-end, first procedurally—a UN body with 193 members cannot in my view negotiate a complicated operational agreement by consensus, so we need to find an alternative procedure. The G20 is one possible route. The group of important economies or large economies is one possible group.

Secondly, I think the target-based scheme, which was introduced formally in the Kyoto Protocol, is also a dead-end scheme. We need to shift the conceptual framework from targets to instruments, and of course as an economist I have my favorite instrument, which is a tax on GHG emissions. I think it needs to be a worldwide tax, the same tax rate negotiated and applied worldwide, revenues to be kept by each country collecting the tax, and not big cross-country distributions that complicate solving this problem greatly in my judgment. But I end up on the same note reinforcing Jeff Sachs' last point, that if you want an ideal source of revenue—and we all need revenues as there is hardly a country that does not need additional revenue at the present time—here is a potential source of revenue which will actually do a lot of social good.

Thank you.

Dr. Hamada: Thank you, Prof. Cooper. Today when I planned this conference I wanted to name it as "The Abenomics and the Miss of Currency War," but staff members are not very happy. Mr. Amari went to Davos and very quietly and benignly asked foreign countries that after the Lehman Shock when other countries such as the United States, the United Kingdom, Europe and Korea all expanded drastically, they drastically depreciated their currency at least against the yen, but we Japanese were civilized and very quiet at that time. So why do you not blame us? That was the way to ask other countries for an understanding of monetary policy that is anyway needed now. But other logic I would like to show to the audience, that under the fixed exchange rate monetary coordination or somewhat joint action is sometimes needed, but under a flexible exchange rate basically Laissez-Faire monetary policies will achieve some kind of desirable situation.

So I distributed these two pages that is an extract from our Nikkei article, without permission of my co-author, and I added some adjustments but probably it is outdated. There was a very important section in that Nikkei article that we should rely on a wider range of taxes in order to implement our fiscal needs. Any tax except poll taxes—that Koichi Hamada should pay and certain things because you are Koichi Hamada, that is a poll tax—but without that, any tax has an incentive effect and consumption tax is a rather reasonable form of raising revenue, and corporate tax cannot be raised because of the tax competition without hurting the welfare of the raising tax country. So I think relying too hastily on consumption tax is a problem, but today I would like to show a couple of slides about the currency war under the flexible exchange rate.

Prof. Takatoshi Ito will talk about the Japanese exchange rate policy later in more detail and in better scientific way, but I will give some rough understanding on why the concept of the currency war is in itself meaningless. I thought recently that I proved nice results that if we make each country under a very classic world like quantity, theory of money type of simplification, then monetary approach to balance of payments or approach to exchange rates will prevail. In that case, the currency war is an obsolete idea. Prof. Wakatabe sitting there told me that Prof. Sachs and Barry Eichengreen, and also Richard Cooper already pointed it out a long time ago. That is, the currency war is not a genuine concept as long as the world is under the flexible exchange rate. I do not have time to explain in detail. There are some naive ideas of the currency war if Japan would like to expand the economy. So 110 yen to a dollar is the norm for Japan, and the United States thought 100 is the norm, then there is no room for reconciliation such as 100 dollar. If we are unsatisfied Japan will expand, so Japanese monetary policy will go up from some point and then the US dollar is too expensive for them. So yes, monetary policy will expand. According to Harry Johnson's monetary approach, exchange rate is related to the ratio of currencies. It is not exactly true in the real world but the basic most important determinants are the quantities of currencies, which most journalists did not understand at all until very recently. But what we are doing as Minister Amari said is not to name any exchange rates, but we are trying to get the proper combination of price increase and unemployment rate.

In the phase diagram—young mathematically orientated economists do not like these kind of informal graphic solutions—but making sure that if the Japanese monetary policy works stronger for the Japanese economy and the monetary policy works stronger relatively to the US economy, then the reactions curve looks like this. If you start from any point, Japanese will try to go to Japanese reaction curve and the US economy will reach to the United States. So monetary policy will expand if you start from the middle, but it will converge. From the other side, some deflation is competitive deflation but it will converge to an equivalent. You can write up multi-country models for this.

I enjoy the nostalgia of the 1960s that Prof. Solo and others showed that rows some conditions or columns some conditions of the Leontief input-output model. So as long as the effect of one country's monetary policy does not affect more in to the world, then the world is stable. This is sort of proof that currency war does not occur under the flexible exchange rates. Under more simplified conditions, it may be even Pareto optimal. It depends on the model.

But you can of course create the meltdown of the currency system. Say if Brazil takes care of Japanese price conditions, and Japan will take care of Brazilian monetary conditions, then you go to the other way round because the reaction curve of Japan is different. So instead of going from this, because Brazil's reaction curve is usually steeper that Japan's one, in order to converge to that one, in this perverse case John Robinson would relate that beggar-thy-neighbor monetary policy will lead the world into complete deflation or complete inflation. This is sort of a preamble to Takatoshi Ito's more realistic approach.

Thank you.

I think the quality of this kind of conference is measured not by the quality of the speech made, but because of the volume or the quality of the floor participation. I do not think that on the Japanese stage that always actually takes through. We have really distinguished economist around, so we need to listen to them carefully and understand them carefully, and not react by their own ideas. So I think after one round of comments of each other by two professors, I would like to open the discussion to the floor. But at the same time, participation does not mean making a long speech, and you have to prepare the questions or your opinions in a very succinct or very concise form to make the interaction more active.

With these comments, I would like Prof. Sachs and Prof. Cooper coming back to the discussion, each in less than a few minutes. Prof. Sachs. You do not have anything to add to each other? Okay, then, Prof. Iwata.

Prof. Kazumasa Iwata, President of the Japan Center for Economic Research: Thank you very much. In short, I want to make one question to Prof. Sachs; that is the malaise of advanced economies. One of them I find is the financial sector and excessive financing, not only public debt but also private debt. Sum of this debt is divided by GDP. In the case of the United States, more than 360. How do you find it now in the process deleveraging on the side of the private sector? But this problem is also commonly observed in the case of China. Even though in developing economies financial deepening is sought to be a desirable thing, but I find that now it is a little bit more excessive because of the existence of so-called shadow banking. A great moderation and accumulation of financial assets, and behind this there has been a shadow banking system in advanced economies; also in China. How do you assess this problem?

Dr. Sachs: I think clearly the US financial sector was very poorly managed and very poorly regulated, and I would put two different aspects to it that are related. One is that the very strong monetary expansion in the early 2000s definitely contributed to the housing bubble, and this is something that we do have to watch out for of expansionary monetary policy in general, that we still do not properly know how to manage. We want the macroeconomic consequences but we do not want the financial disasters.

I do not think we have a very good accounting of this, but clearly the housing bubble was observed by the Fed for several years and several senior managers in the Fed warned that the easy monetary policy of the Fed and the lax regulation was going to lead to a bad conclusion, but Greenspan continued to press ahead saying that there was no danger of a financial crisis coming from real estate. It was a very peculiar view and we never really assessed that I would say in a very clear way after the crisis hit. of why all of the risks that were noted—many economists pointing out how housing prices had gone far above historical norms, many people who had noted how the quality of the mortgage process had deteriorated badly—were ignored by the regulators and by the monetary authorities in general. So that is one issue.

Second, I think on a more general level even aside from the macroeconomics, the progressive deregulation of the financial system that took place starting in the 1980s in the United States, which started with the savings and loans institutions and then continued with the end of Glass-Steagall in 1999, then also left the derivatives system unregulated as well as the hedge fund market unregulated, clearly has been an invitation to a tremendous amount of unsavory practices and, I think, macroeconomic-scale instability. In that a tremendous amount of the trading that is taking place is clearly not directed even at a remove from real investment, but is a lot of churning by money managers that have incentives to gamble either through the nature of their contracts or through the very high leverage of their institutions. So we have created a system of extreme leverage with very little regulation in a moral hazard context where bailouts were either expected or even were unnecessary in that the leverage was so extreme that nobody had any money at stake, they only had one-side bets.

I think that this problem largely continues in the US system because the post-2008 regulatory attempts have been severely watered down. The derivatives markets, which in nominal terms are hundreds of trillions of dollars of derivative securities, are still unregulated. The hedge fund industry is a walking time bomb in my view. It is not as macro-economically large, but it is a reckless industry where the managers have gambling as their only incentive as I understand it. It should be called the “non-hedge fund industry” because it is the opposite of hedging. It is pure gambling because the contract that they apply is only an upside opportunity contract, the two and 20 rule where managers are able to secure 20% of profits but pay 0% of losses. This just means that they have the maximum incentive to create volatility.

So I think that the US financial model is extremely dangerous. When you combine it with loose monetary policy, the risks are exacerbated, and we have not really changed very much that I can see since 2008. Maybe Prof. Cooper or Prof. Stiglitz would add to that or give me some comfort that something better has happened, but it does seem to me that we are in as much danger as we were the last time around, and that no real regulatory reform has taken place.

Dr. Hamada: I admire that really distinguished economists are faithful to principles and not to nationalities. Last time when Prof. Stiglitz came to this country, he gave a mild precaution that in the TPP negotiations there are many interests of American lawyers that are hidden. Today Jeffrey was very honest that there are problems in America's Wall Street's interest.

Dr. Cooper: I do not want to touch on the American situation, but I do want to put in a positive word for shadow banking in China. I think the name is a little misleading. As I understand it, the shadow banking system is a regulated system in China. From the point of view of the Chinese household, the menu of possibilities for placing their savings is very limited, and that is one reason why there is some speculation in housing and so forth. So I see the so-called shadow banking system, which is basically wealth management arrangements of various kinds, as a positive development in the Chinese financial system by increasing the array of possibilities for household investment in China.

The risk is that these institutions are new. Any new institutions create first on the purveyor side the possibility of fraud, and on the buyer side ignorance, which of course feeds the possibility of fraud. So I expect we will see some bad stories coming out of the shadow banking system. But I see this as an exercise in getting through the period of infancy in which the regulations will tighten and become more serious, and the customers will become more knowledgeable about what they are actually buying. So I would not want to leave a negative cast on these developments in China.

Dr. Hamada: Another question? You may speak in Japanese, as there is simultaneous interpretation.

Prof. Shimizu, Professor, Hitotsubashi University: I am Shimizu. I have a question for Prof. Sachs for the last recommendation on tax increase. You recommended the increased tax to fund social security net. This is exactly what Japan is suffering for. There are huge amounts of social security costs. This is a global problem, and aging as you mentioned, this problem is one of nine characteristics of developed countries. Also in the EU, so many countries are suffering from the issue of how to reduce the cost of the social security net. But if you talk about just to increase to prepare the social security net there are no limits. If it is the way to the large government and to the welfare state, what is the limit then? If just increasing the tax could reduce the growth rate? I do not think that this is simply a final answer. There should be a balance, and Japan is suffering so much. Even though Japan increased the tax to 20% or 25%, it is still very difficult.

Dr. Hamada: I was warned by the administration that time is coming up, but I think that it is an important role of a political advisor to sometimes resist the bureaucratic demands. I will continue with one or two questions because the minister took 10 minutes or so already. But also, I would ask you to be short.

Dr. Sachs: First let me just recite the facts as they are. Japan and the United States collect about 30% of national income in government revenues. This is general government, national state prefectural or national state local in the United States. A number of Countries, Canada and the United Kingdom and other collect about 36% or 37% of national income. Then, the Western European countries, the middle-tier: Belgium, France, Italy are at about 42%, and the Northern European countries at about 45% to 50%. Only the Northern European countries are covering their budgets, by the way. They have no budget deficits to speak of, or budget surpluses in the case of Norway. The United States has been running fairly large budget deficits, Japan also running very large budget deficits.

The United States right now is ending its budget deficits largely by cutting government programs to a very significant extent, especially programs for the poor, so that our social safety net is really extraordinarily small as is our research budget, our infrastructure budget, and our other investments in public goods. So when I have added it up trying from the bottom up to ask what needs to be paid for and how, I have reached a level of taxation in the United States that should be closer to 35 to 40% rather than 30% of GNP. I just do not believe we can do it at such a low level and still meet healthcare, poverty, infrastructure, science and technology, education levels and so forth.

I do not mean to give a simple number, but I would say that judging across countries, where Japan and the United States are at right now is a very low end. I see lots of successful countries at a considerably higher end though there are also many that are also messed up at a higher level as well. Collecting more revenues and using them badly is probably worse than collecting low revenues and not collecting them. So of course, one has to invest them wisely.

It is a calculation that I think should be made from the ground up. What is needed to run the basic public services, transfer payments and public investments that are necessary? I know that in the United States' case it cannot be done at the current level of spending. Though one could look for economies of reducing certain costs; especially our healthcare costs, but even so I do not believe that Japan or the United States can really meet the needs at 30% of GDP. That would be my guess.

Dr. Hamada: I said something, but just one question if any. Prof. Stiglitz?

Dr. Stiglitz: It is not a question; it is really an elaboration on the answer. When you look across different societies, economies, what goes in to the public sector differs. So that in the United States, a much smaller fraction of healthcare goes to the public sector than goes to the private sector. But people have to spend money on healthcare. It is just that when you do it privately, it is done extraordinarily inefficiently so you wind up paying a lot more. So France for instance has a public healthcare system. All told they spend about 11.6% of GDP on healthcare. It is part of their tax base, but they get better healthcare outcomes than the United States, which is mostly private, and we spend 17.6%.

The same thing goes for social security like old age pensions. The United States has a mixed of private and public, and —the private part is very inefficient. Wall Street makes its money out of transaction costs and does not provide the kind of insurance that the public sector provides, such as indexing pensions to inflation. So the government social security system is much more efficient when it comes to in transaction costs. There are good reasons for that: it does not have to try to do cream —skimming —, adverse selection—, and it can deal with a lot of the problems that the private sector cannot.

So I think when you look at what is the appropriate scale of the public versus the private sector and make these comparisons across countries, you have to ask for any particular country which sector can perform that function be done better? In many countries the public sector can do the function better, and you ought not to just do it as a tax. It is a service that is provided in this particular mechanism with relatively low transaction costs.

Dr. Hamada: Thank you very much.

Dr. Sachs: Can I just put an underscore and an exclamation point to this? Because so often we talk about the public sector inefficient and the private sector efficient, but the experience in the United States in healthcare for example, is radically the other way, or in finance.

Dr. Cooper: Well if we are going to get in to this, I would like to disagree with Joe Stiglitz on the retirement issue, not healthcare. I think it is very hard to beat the scheme that you and I are in, TIAA-CREF. I do not think the government could do that as efficiently as TIAA-CREF does. There are some activities in the private sector that are much too costly, but there are also some very efficient ones, and that happens to be one. So beware grand generalizations, I would say as a generalization.

Dr. Hamada: I should not say opposite to my teacher, but it is very efficient. When my wife wanted to shift some funds of TIAA to some private firm, then the resistance of the TIAA is formidable. So they have a very bureaucratic nature in TIAA itself, but that is my single observation.

Thank you very much for this first meeting, the first session. When should we gather next?

Session 2
Intensive Discussion on Economic Policy Designing: Economic Growth and Inequality

Keynote speech : Joseph Stiglitz (Columbia University)

Discussants : Kazumasa Iwata (Japan Center for Economic Research)
Masahiro Kawai (Asian Development Bank Institute)

Dr. Joseph Stiglitz, Professor, Columbia University: Well thank you, and thank you for this opportunity to discuss what I think is a really fascinating set of economic policies.

This is clearly a very difficult time for the global economy. There is slow growth; the ability of conventional monetary policy to stimulate the economies in the United States and in Europe is very limited. Deficits have constrained the ability of fiscal policy. And in fact both Europe and the United States have in one way or another engaged in austerity. Europe talks about growth, but the austerity policies that they have imposed have actually brought recession. And in some of the countries—Spain, Greece and others—they have actually brought depression. The magnitude of the depression should be well understood: youth unemployment is around 60% in Greece and around 55% in Spain. Austerity is destroying their future.

In the European context there is a lot of discussion of structural reform. But most of the structural adjustments have long-run supply-side effects. The problem in Europe is one of demand. And for some of those structural reforms, even if they were effective in the long run, the more immediate effect is to reduce demand in the short run. And so they are in fact exaggerating the economic downturn in Europe. That is why I think many economists around the world have welcomed the actions of Prime Minister Abe here in his concerted policy to bring together monetary policy, fiscal policy and a growth or structural policy to try to break out of the kind of downward spiral in which Europe has been engaged, and the malaise in which Japan had been engaged for over two decades.

What I believe very strongly is that policies matter. And I will come to talk about some of the ways in which that is the case. We have already seen one example. We have seen that even though Japan has zero growth, its unemployment rate is much lower than that of the United States. We have also seen, for instance, that Germany, which had a sharper economic downturn in 2009—, partly because of its stronger industrial sector— actually has had a much better performance in the area of unemployment.

We could have also looked at—and I will comment a little bit more on this —measures of inequality. The economic forces affecting the different advanced industrial countries are similar, and yet the way they play out in the extent of unemployment is markedly different, with the United States having the highest level of inequality and the least equality of opportunity of the advanced industrial countries.

So what I want to do this afternoon is first begin with a set of observations about where the Japanese economy is today. And then a broader set of remarks about the objectives of economic policy. And I will follow that with a set of prescriptions.

I want to begin with an observation that I think is very important: that Japan's economy actually has already been performing much better than many people both in Japan and outside of Japan have thought. One of the reasons that this is important to point out is that confidence is important—. Confidence is important for businesses, for investment, and for households. And if they have a view that things are not very well then that will undermine their willingness to invest, their willingness to consume. Well, Japan has actually performed relatively well once one takes into account its demography. The numbers that Prof. Sachs put up there were numbers on economic growth. But they did not take into account the major difference between Japan and other countries in the rate of growth of the labor force. Obviously if your labor force is growing more rapidly, you ought to get more economic growth. There is a full percentage point difference in the population growth. Japan grew at an average annual rate of 0.08% from 2002 to 2011, as compared to 0.647% for the OECD, 0.94% for the United States and 1.21% for the world as a whole.

What this means is that when you look at what really matters, productivity, productivity increases have been strong. Average annual rate of labor productivity growth for Japan from 1999 to 2011 was 1.8%, much stronger than the Euro area's 1.0% , and comparable to 1.8% for the United States. And one of the distinctions, though, is that in the United States while productivity was going up, none of the fruits of that increase in productivity went to the workers. Essentially all the benefits went to that 1% at the top. So today in the United States, the median income of a full time, male worker is lower than it was 40 years ago.

Another dimension in which Japan's performance has been slower is in unemployment. It has remained low, far lower than in Europe and America. Japan's unemployment rate has averaged 4.5% from 2007 to 2012, a period in which t was 7.7% in the United States and 9.4% in Europe. And as I mentioned before, while US workers over the past two to three decades have not shared increases of prosperity, In fact median income, household income, is the same as it was as 15 years ago. The Gini coefficient in Japan has increased far less than it has in the United States over the past 30 years or so.

On the other hand, there are some reasons for concern. I do not have time to talk about all of them here, but there are worrying trends in terms of inequality, both in terms of what has been happening to median income and to particular groups such as the elderly inside Japan.

There are other indicators showing that Japan is doing well; life expectancy at 83.6 years at birth is the highest in the world in 2012. Similarly, in education, the percentage of the population that has obtained tertiary education is second only to Korea; it now surpasses that of the United States. It is eighth in the world in reading scores, ninth in mathematics, well ahead of the OECD average and ahead of the United States. Female education has been doing especially well, where the gender gap in science and math is much smaller than in other countries.

I recite these numbers just to highlight the fact that, even before Prime Minister Abe began on this particular set of policies, there are actually many ways in which the Japanese economy was performing quite reasonably. And this provides the basis, I think, for optimism that what these policies are directed at is a nudge to move it up to a somewhat higher level, from a level that was actually not that bad.

The fact that there is a widespread perception that Japan is not doing well—, a perception that many Japanese share—means that I should dwell a little bit more on the objectives of economic policies. It is not increases in GDP or the rate of growth of GDP that really matters. As Prof. Cooper pointed out, GDP is not a good measure of economic output and it is an even worse measure of wellbeing. That was the main message of the International Commission of the Measurement of the Economic Performance and Social Progress that I chaired.

The objective of economic policy should be to improve the wellbeing of all citizens of the country in a sustainable way to promote shared prosperity rightly understood. This means value in not just the consumption of material goods, but also of all those things that make life meaningful. It means treasuring, for instance, the environment.

There are policies that could increase growth as measured by GDP that would not increase living standards; policies that would increase insecurity, increase inequality, and degrade the environment. I believe such policies would be a mistake. Some of the policies that I shall mention later that increase growth will simultaneously improve equality and standards of living. But there are others that I will mention, where there is a need for national debate and an awareness of the tradeoffs that they might entail.

But before turning to these I want to mention a couple of worrying trends: significant increases in inequality, although not as bad as in the United States; increases in poverty, especially among the aged—the poverty level among the elderly was 21% in 2000, as compared to 13% in the OECD on average. Japan is also distinctive among the advanced industrial countries in having a relatively low labor force participation rate of women— 49%, according to the World Bank, as compared to 58% for the United States and 60% for Denmark. There is also even more striking lower participation of women in senior positions in management—just 7%, one of the lowest in the world, according to one estimate. It is particularly unusual given the high level of female education and the low fertility rate that I refer to earlier. To the extent that this reflects that the talents of a large fraction of the labor force are not being utilized, and the aspirations of large numbers are not being realized, this is and should be a cause for concern.

I should add however a note reinforcing the observation made earlier: what matters is not measuring GDP, but the quality of life. Seventy-five years ago, Keynes asked how we would spend what might be called the "productivity dividend." For thousands of years, people had to struggle just to survive; most people had to work in agriculture, produce food, work full time to get clothing and shelter. Now, because of the increases in productivity, we can in a few hours of work meet all of our basic needs. The question is, how will we spend that productivity dividend? In the United States, hours worked in many households have gone up—in poor families out of necessity, in the struggle to stay ahead with stagnant wages; in upper income families, in a rat race that often leaves families' lives destroyed.

Europe and the United States took different courses. Europe has taken more the productivity dividend leisure, with longer vacations. While economic theory cannot say which one of these alternative courses is better, from the perspective of the planet we will not survive if others follow the US route, unless we succeed in restructuring our economy in ways that impose fewer demands on the environment.

This brings me to the prescriptions and some responses in some sense to the Abenomics agenda. It begins with the observation already made, that I believe that the three arrows, the fact that one has monetary fiscal policies and growth policies, structural policies is absolutely essential. There is weak global demand caused by a number of factors: European structural problems, austerity, financial sector problems in many countries, the legacy of the bubble, and inequality.

In a globalized economy, it is global demand that matters, and Japan cannot by itself solve the problem of weak global demand. It can make sure that it gets an appropriate share of the global demand through competitive exchange rates. And though policymakers are not allowed to say that, one of the objectives of monetary policy inevitably has an effect on exchange rates. I know that it is not the objective, but it is the consequence. Just as it was not the objective of QE2 or QE3 to lower the US exchange rate, it just happened to be the effect that was predicted, and the only effect that many of us saw that had any real consequence.

I do want to express my view that there has been a lot of attention on increasing the inflation rate to say 2%. A lot of people think of that as bringing down the real interest rate. The real interest rate in my mind is not the major problem. In the United States the real interest rate right now is -2% and this has had very little effect on investment. I do not believe that if the real interest rate went from -2% to -3% or -4%, it would solve the United States' problems. What the deflation in Japan is symptomatic of though is that there is a lack of aggregate demand, and we should focus on that issue. And so the real objective of monetary policy, fiscal policy and growth policy is to get demand up, and to get it up in a way that is sustainable so that living standards going forward will be improved.

Let me focus then most of my remarks on this third arrow, the growth or structural policies. One of the points is that there should be a synergy between these various elements of the arrows. Government spending should be directed at helping restructure the economy. Let me emphasize that all economies always need restructuring. But this is a particular problem I think for Japan: the aging society; moving from manufacturing to a service sector economy; changing comparative advantage. These are all examples of the kinds of restructuring that have to go on in all economies all the time. But in addition, in Japan there are further problems. Japanese manufacturing has traditionally been at the top of the world, the most efficient, but its service sector has not been taking advantage of all the knowledge base that has been produced in the manufacturing sector. So there is a great deal of learning that can be done in improving efficiency in the service sector.

So let me talk about five or six agenda items that seem to me particularly important in terms of these structural policies. The first I have just referred to, that it has long been recognized that there is a major gap between the productivity in manufacturing and other sectors. There is some subtlety in how these policies need to be pursued. Improving sectoral efficiency, but moving low-productivity workers into unemployment does not improve overall efficiency. Productivity of workers who are unemployed is even lower than productivity of workers who are in low-productivity jobs. That means that jobs have to be created as old jobs get destroyed, and that is the importance of the monetary and fiscal side, and the reason that those have to be very carefully attuned with the structural side, the growth side. Japan's government played a key role in its restructuring after the Meiji Restoration and again after the war. It will now have to play a similar role in restructuring into the service sector economy. I should point out that the US government played a major role in helping the US economy restructure from agriculture into manufacturing at the end of World War II. We did it through the GI Bill that provided an education to everybody coming back from the war, which was essentially everybody. But unfortunately, the US government is now really backing off, and we are making it more difficult for young people to get an education. Education, health, and culture are sectors in which governments are inevitably going to play a big role, and there are good reasons for that, but with the government of the United States withdrawing, there will not be the demand to help people move into these new sectors.

Secondly, R&D in universities is absolutely critical. That has been the basis of the US success in the high tech sector and Japan has shown strong technological capacities. What Japan needs to do is more active engagement of creating what I call a "learning society." This is essential in the 21st century knowledge economy. One has to remain on the knowledge economy, and one has to push that frontier out.

Thirdly, one has to exploit the synergies between the proven manufacturing capacities and its service sector, for instance in the healthcare sector. There are very innovative people doing work in the healthcare sector. You have an aging population that puts heavy demands on the healthcare sector, but in that process there will be a development of lots of diagnostic equipment. Those can be marketed, developed, manufactured and sold around the world. A little bit earlier this discussion mentioned another example, ideas that can be exported around the world. But that in turn means that Japan has to become further immersed in globalization. That includes through better command of English, sending young students abroad for a year or more of education, having them return better equipped to compete in a globalized economy. The example that was mentioned earlier is exporting services that create livable cities, good cities—public transportation, etc. But as one thinks about being more immersed in the globalized economy, one should not do this willy-nilly; one has to be thoughtful. For instance, there are some discussions associated with the TPP, and in my talk here last March I expressed some hesitancy about the TPP, a whole variety of problems that I saw and increasingly those in the United States with the TPP: lack of transparency, a trade agreement that is being designed by special interests, the possibility of intellectual property provisions that will undermine innovation and make access to medicine more difficult, investment agreements that are not up to the standards of 21st century justice systems. I could go on and I do not want to distract from the main messages, but one should be aware that these are not free trade agreements. Rather these are managed trade agreements, and they are managed for the special interests of the United States. And even at that, they are not managed even for the interests of the United States as a whole. You will be asked to get rid of rice subsidies, but the United States will not be offering to get rid of sugar subsidies, or cotton subsidies. You will be offered an asymmetric agreement and your arms will be twisted.

Most controversially, I want to talk about a number of measures to increase labor supply. One of the reasons why there is a lot of discussion of increasing labor supply is because as I said before the demographics in Japan have meant that your labor force has been growing 1% lower than in say the United States, and so some people have suggested that one way of responding is increasing the labor supply. But that raises some really deep questions. Would Japan benefit from a higher growth rate per se, not just from higher productivity? In the United States, measures have sometimes had an ambiguous impact on wellbeing. More hours worked per household, some would argue, lead to adeterioration in the quality of family life. Large immigration, overall increases in labor hours of unskilled and semi-skilled may have contributed to adverse changes in the distribution of income. So as one thinks about this general agenda of increasing growth through increasing labor supply one has to weigh the benefits and assess what those benefits are versus the cost. Growth itself should not be the objective.

There are two areas that I think are more likely to be positive. One is the increased effective inclusion of women. This would improve equity, tap into an under-utilized resource and allow more people to realize their ambitions.

Second, a later retirement age, at least for those not engaged in difficult manual labor— reflecting greater health, the ability to contribute later in life—might help in addressing concerns over poverty among the aged, improve the government's fiscal position, and it might even improve the quality of life of the aged.

So in conclusion, let me return to the basic theme. One should not be pursuing growth for its own sake, but for the impact on the quality of life and wellbeing. One has to be sensitive to the distribution: who benefits? In terms of growth, adjusted for demographics, Japan has actually been doing far better than is generally realized. In terms of inequality, compared to other countries it has not been doing badly. But compared to Japan of the past, there are causes for concern. The government's three-pronged attack is, I believe, the right approach, and compares favorably with approaches taken by so many governments around the world that have relied on a single arrow, or in some cases no arrows. All three are essential, especially in this era of weak global demand, in which traditional monetary instruments have reached their limit.

Thank you.

Prof. Kazumasa Iwata, President of the Japan Center for Economic Research: Thank you. The next speaker is myself, then followed by Dr. Kawai.

I would like to talk about the future growth path of the Japanese economy through to the year 2050. That is, from the very long-term perspective I would like to talk about growth strategy. In my view, the government currently discussed and announced a new growth policy strategy in mid-June. But I find what Japan faces are quite long-term issues such as population decline, or the appropriate energy-path choice, and also the tax and social security system reform. They take a long time. Not five or 10 years, but more than 20 years or even 30 years. Therefore, I think it is appropriate to talk about this issue in terms of very long-term.

What is the determinant of this long-term growth? I would like to put the emphasis on the role of institutions. Institutions can play an important role in establishing incentive-reward mechanism. We are living in a global competition of institutional evolution. Reforms of political, social, and economic institutions can affect the difference of total factor productivity levels, not the rate of change. Usually we economists talk about this total factor productivity in terms of growth, or the rate of change, but the level itself is important over the very long-term. For the role of the institution, it is better to focus on the level difference of total factor productivity among different countries.

The differences in institutions lead to the difference of long-term performance, growth, and distribution as well. Our center is now embarking on this focus to 2050 in Japan, and we compile the data and various indicators, which shows the degree of quality of various institutions. We broadly classified it into five categories. They are political system stability, openness of the economy, gender gap, easiness to start up business, and flexible labor market. Five categories. I will show you later using the so-called “T-scores” deviations from the average.

I think it is sensible to improve the various Japanese institutions aiming at achieving the best practice in the world. Notably in the area of women's participation as mentioned already by Prof. Stiglitz, and the new entry of domestic and foreign firms into regulated markets, the smooth exit of unprofitable firms, as well as in the area of education. I put emphasis on these barriers of investment in Japan, the degree of barriers, various legal and business practices. The indicators are compiled the indicator by OECD. The Japanese degree of openness to investment from abroad is almost equivalent to India, very closed. And the actual outcome of the ratio of foreign direct investment from abroad to Japan is very low.

From this perspective it is essential for Japan to participate in the TPP negotiations process. This makes a difference from Prof. Stiglitz's position. I think this will trigger other bilateral and regional Free Trade Agreement and EPA. For instance RCEP, this is ASEAN plus six. Finally, I hope FTAAP, this APEC Free Trade Agreement, should play the role of the WTO in the Pacific area. Although I admit that there remain business-vested interest problems as mentioned by Prof. Stiglitz, such as the pharmaceutical industry, automobile industry, agriculture industry both in Japan and the United States and the insurance services. They are the sensitive items now on the negotiating table.

What I want to emphasize is that it is desirable to set long-term national goals in talking about growth strategy, to establish and maintain the status of Japan as a "first-tier nation." The word was used by the Armitage-Nye Report last fall. They asked Japan whether it wants to maintain its status as a "first-tier nation" into the future. I find this question sensible. It is a good thing for Japan. At least in the economic area, we should maintain the "first-tier nation" status. For instance, the first national goal from this perspective is to stop the diminishing trend of population and maintain the population size in the year 2050. At about that time, our population size would be 100 million. Today it is about 130 million.

The second goal is to double the per-capita gross national income (GNI), from about US$ 40,000 to US$88,000. This is the level of current per-capita GNI in Norway. In that case Japanese per capita GNI would become within the number three status. The second point I want to make is on the flexible fiscal policy management. The three arrows of Abenomics make sense if we understand them as integrated package policy measures. Achievement of 2% inflation target by BOJ is throughout possible if the government achieves 2% real GDP growth rate over the medium term. I find that with respect to the 2% growth over the medium term, the government should have the responsibility. For instance if five years took on average for 2% growth to be achieved, then it would be possible for BOJ to achieve 2% inflation target . However, I find though at the same time it is very difficult to achieve a 2% inflation target in two years.

Also on this fiscal management, we can implement the "growth-friendly fiscal consolidation" from the longer-run perspective. The first thing to do is, we need a fourth arrow; that is the medium-term or longer-term fiscal consolidation targets. Strong commitments on credible fiscal targets from the longer-run perspective allow flexible management with fiscal policy in the short-run. The second point I want to make is fundamental reform of the tax and social security system, which serves to mitigate the trade-off between growth and fiscal consolidation. I will show you by using the macroeconometric simulation results.

Now Japan faces the agenda to increase the infrastructure investment massively. Now the LDP are arguing that there is a need of 200 trillion yen in infrastructure investment in the coming 10 years. If we rely only on government money, given the very sizable deficit and a large size of debt, it is almost impossible to carry out. Instead of solely relying on public money—I find that it is absolutely necessary to utilize and mobilize private funds or money through the introduction of covered bonds, which are not existent in Japan, and the infrastructure investment fund that is also not existent in Japan, and the intensive use of Private Financing Initiatives (PFIs) and Public and Private Partnerships (PPPs).

This is the fiscal issue but I want to make a small comment on the last session where Prof. Hamada provided three very marvelously presented cases of the international coordination of monetary policy. I agree fully that if all the countries adopt the domestic currency pricing as in the case of the United States, in that case 100% pass through will take place. Unfortunately, the real world is different from this 100% domestic currency pricing. In the case of Japan, only 50% pass through is observed, so local currency pricing also exists. A mixed use of this pricing by export industries could have a different spillover effect, and this is more complicated than the case of domestic currency pricing. But I find that the nature of the problem is very similar to the international taxation of capital income, which is the issue of coordination originated and pioneered by Prof. Hamada.

I find at the same time there is not only the big possibility of a "beggar-thy-neighborhood" effect, but I find a “beggar-thyself effect” in the case of Japan notably; we are relying heavily on imported energy. Currently after 11 March, 30% of electricity sources disappeared and we are obliged to depend heavily on natural gas and oil imports. The total amount of fuel imports amount to 20 trillion yen. Under this condition, if the yen depreciates excessively, then the terms of trade will deteriorate and real income loss will take place and then we could have a recession. We already had stagflation. This already happened in early 2008. In March 2008, I left BOJ. At that time our economy was already in recession, but CPI inflation was above 1%, but nobody welcomed.

Next, I would like to illustrate the two simulation analyses. On the medium term forecast in February 2013, that was before the announcement of actual measures of BOJ. This is the "Aggressive Fiscal Monetary Policy" simulation case, and the second one is fundamental reform of tax and public pension scheme. I recommended already two years ago the partial privatization of public pension fund, that implies immediate cut of 16% of wage tax. The public insurance fee is 16% and this is equivalent to wage tax, and also a 10% cut in corporate tax rate, which is financed by a consumption tax rate increase by 15%.

Before showing the next page, I will show you the importance of institutional factors. I have set five broad categories. These are five groups of institutional factors s and this shows a "T-score." 50 is the average and more than 50 means a more excellent system. You see Japan, the United States, and China. The United States has a much better institutional framework than Japan. What is the difference to China? China is growing very rapidly but institutional progress is very much modest.

Using this "T-score" we made a forecast of growth scenarios. We have presented three scenarios on Japan. On the diagram, the growth scenario is the top one; the second one is the standard or stagnation. This is the scenario, if we continued the same pace of reform in the past. The final one is fiscal bankruptcy. If there is no action taken our debt is increasing and then leads to bankruptcy. Our economy if you look at the year 1990, the per capita GNI was second in the world. Then it declined very sharply in 20 years. Now, it is the 15th rank, which will drop furthermore afterwards if we do not make a serious effort. Then it would be a standard case of 17th, and we are becoming a second-tier nation. But there is a case of the first-tier nation, and this is 8.8 thousand per capita.

This level is comparable to Norway in 2010. How to achieve it? We need to attain the best practice of various institutional reforms. It is throughout possible to attain this status. What is important; another information is China. China's per capita GNI is $12 thousand. This implies that China still in our scenario remains in the middle-income trap. So the United States maintains economic hegemony until the year 2050.

Now on "aggressive fiscal and monetary policy." Our center regularly provides this medium-term forecast, and before the announcement of BOJ's rather strongly expansionary policy, we have assumed additional five trillion yen investment every year, not once but sustained expansion in public investment. In addition we assumed that our exchange rate remained at 95 yen per dollar. This is, according to our estimate, a kind of equilibrium rate of yen compared with the standard case. The standard case is the blue line, and the dotted line is expansionary monetary and fiscal policy. At the upper top left-hand side, you see the CPI. We can achieve 2%, the dotted line, but you see that this is the year 2025. It takes a long time and I find the actual policy measure adopted by BOJ maybe much more stronger than our assumption. Therefore, some early realization is possible, but I find it very difficult to establish 2% within two years because of the GDP gap development of the dotted line.

This is 4% excess demand. Prof. Stiglitz argued the importance of demand. Demand shortage is the problem, but we should have 4% excess demand situation in order to achieve our inflation target of 2%. Starting from the 3% deflationary GDP gap (currently the 2.3% deflationary gap), the change of the required gap is about 7% in two years. It seems to me almost impossible.

Moreover, I should put an emphasis on unemployment rate. In the year 2025 our unemployment rate will go down and be below 3%. Below 3%, then we can achieve 2% inflation target, but currently we have 4.1% unemployment rate. Can we achieve a lower than 3% unemployment rate in two years? I find it is very difficult.

What is important is the terms of trade deterioration. This is standard case simulation. You see that this is the terms of trade gain and loss registered in our national income statistics. If these terms of trade continue to depreciate, our loss of this income is very significant. This is amounting to 20 trillion yen and actually, that happened in 2007 and 2008, then we entered recession. I am afraid that if the depreciation proceeds further, these terms of trade deterioration will be further aggravated.

In March, the real effective exchange rate stands of 146, but last year it was the peak at 196. About 25% depreciation in the real effective exchange rate is already done. We have estimated the equilibrium exchange rate using the concept of “behavioral equilibrium exchange rate”. This estimated value is derived by using the fundamental value of variables such as the terms of trade, the Balassa–Samuelson effect, net foreign asset position, real interest rate differentials between Japan and abroad, and then we estimate the theoretical value. This shows the deviation from this theoretical value, about 15% deviation or we have 15% excessive appreciation in 2012. But already the yen have depreciated 25% at the end of March.

Another simulation result is the public pension reform combined with the tax reform. 10% corporate tax rate cut, and the partial privatization of our scheme. Our scheme is consisting of a two-tier system. One of them is the basic part of which half of them is now financed by consumption tax revenue, but it is a good thing to finance entirely 100% by consumption tax revenue. The remaining second-tier must be privatized, moving from unfunded to a funded system. What is the outcome of this? The consumption tax rate is assumed to be, every year 1% increase for 15 years, and there is every year 1% reduction in effective corporate tax rate.

What is the outcome on macro economy? We have a significant increase of private investment and business investment and consumption spending. As a result, we can achieve about 2% growth rate over the medium term and as a result, we have lower unemployment rate slightly below 3%. Then, we get the 2% consumption CPI inflation rate. So this is as I suggest, one of the ways to stimulate private demand over the medium-term.

That concludes my remarks.

So then, Dr. Kawai, please.

Dr. Masahiro Kawai, Dean, Asian Development Bank Institute: Thank you very much. I am very happy to be invited to make comments on Prof. Stiglitz's presentation. Just like Prof. Richard Cooper I got Prof. Stiglitz's memo only after I arrived at this venue, so I did not have any time to prepare my response to Prof. Stiglitz's presentation in advance. I would like to respond to Prof. Stiglitz in four ways. One is to talk about why growth is needed in Japan. To almost everybody in this room perhaps this is obvious, but I want to make sure that this is a key issue. Second, indirectly responding to points made by Prof. Stiglitz, I want to touch on the issue of what sort of growth is needed? Third, I want to talk about the importance of emerging Asia for Japan's economy and the value of a regional free trade agreement, as well as the value of TPP for Japan. I agreed with Prof. Stiglitz on everything he said, except on TPP, so I have some suggestions for Prof. Stiglitz on TPP. Fourth, I want to mention the implications of ultra-easy monetary policies adopted by the US Fed, BOJ, and other developed economy central banks for emerging economies in Asia.

First, Prof. Stiglitz made the point that Japan's labor productivity rate grew at 1.8% between 1999 and 2011. I agree that labor productivity growth has been quite robust in Japan, which is good news. But Japan's problem is more complicated. The population aging issue, which both Prof. Stiglitz talked about and our Chairman Mr. Iwata talked about, means that the share of the old age population in the total population is rising. Therefore, it is good that Japan has a-high-labor productivity growth, but we also want to see high per capita GDP growth. This represents the ability of the Japanese economy to support the entire population in a rapidly aging society.

I took a look at several long time series data on per capita real GDP across countries, and I made some interesting observations. The Conference Board's data (based on 1990 international dollars at Geary-Khamis PPPs) show that when US per capita real GDP is defined as 100, Japan's per capita real GDP reached its peak of 85; in 1991, and then started to decline, falling to as low as 70 in 2012. The World Bank’s per capita real GDP data (based on 2005 PPP international dollars) indicate that Japan’s per capita GDP reached a peak of 87 in 1991 and then declined to 72 in 2011 when the US level is defined as 100 for both years. Over a long period of 20 years or so, it is rare for an economy not in conflict or in political and social turmoil to experience such a persistent stagnation. Most Asian economies have grown in per capita real GDP terms at much higher rates than the US, and the EU has maintained a relatively constant share of the US level.

In addition, as most Japanese economists know, Japan's nominal GDP did not grow over the last 20 years. Japanese nominal GDP peaked in 1997 at 520 trillion yen, but it has since declined as a trend and reached 480 trillion yen in 2012. This level was almost the same as the level in 1991. So for more than 20 years Japanese nominal GDP did not grow. During this long period of stagnation, Japan continued to run large fiscal deficits Japanese sovereign debt skyrocketed. The public sector liabilities to GDP ratio will reach 220% on a gross basis and 140% on a net basis by the end of 2013 according to OECD data. Such a high, and still rising, debt level is not sustainable unless significant policy changes are made. Over the past 20 years, Japanese long-term interest rates have been consistently higher than the nominal GDP growth rate, which has also contributed to public debt accumulation. Without nominal GDP growth and needed policy efforts, Japan would be heading towards a sovereign debt crisis. Many experts and analysts talk about the benefits as well as the risks and costs of Abenomics. I believe the biggest benefit of Abenomics is that it can reverse these trends—stagnant per capita real GDP, lack of nominal GDP growth, and an unsustainable public debt level Critics of Abenomics must explain what alternative policy measures could end Japan’s persistent price deflation and lack of nominal GDP growth, and eliminate the high risk of a sovereign debt crisis.

Second, Prof. Stiglitz talked about the importance of quality of life, which everybody would agree with. He did not use the phrase “inclusive growth” but I think this concept is a key component of quality of life. Inclusive growth means that the benefits of growth are shared by everyone in a society —whether young or aged, male or female, uneducated or educated, unskilled or skilled, and rich or poor—in a fair way. Essentially, equal opportunities must be given to everyone. This is something policymakers in every country including Japan should try to achieve through various measures such as job creation, education, training, social sector protection, support systems for working mothers, and so forth. I think this can be a part of the fourth arrow, which Mr. Iwata recommended for fiscal consolidation and social security reform, as inclusive growth attempts to support all segments of society. Alternatively, another arrow may be launched for inclusive growth, in addition to the arrow of fiscal consolidation.

Another key component of quality of life is to maintain environmental sustainability. Japan has tackled much of the earlier pollution problems—in the air, water, and soil— and has been successful in preserving a good natural environment at home. However, Japan's responsibility should go beyond its national border. As Jeff Sachs discussed earlier today, in the post-Fukushima nuclear power plant accident era, Japan's energy policy is critical to addressing climate change. Given the difficulties of resuming the operation of nuclear power plants, Japan is now reversing its earlier international commitment to climate change mitigation by burning a lot of coal and oil and emitting a higher amount of CO2 than before, although Japanese coal-and oil-burning technology is of the highest international standard. Japan needs to achieve a good balance between national energy security and climate change effort. A shift to more carbon-efficient liquefied natural gas (LNG) and shale-gas as well as the development of renewable sources of energy—wind, solar, geothermal, and small hydros—would be quite useful Reform of the electricity power sector, to separate power generation and power distribution and introduce price mechanisms to affect supply and demand, is essential to achieving greater use of clean energy and rationalization of the power market. Third, let me talk briefly about the importance of free trade agreements (FTAs) for the Japanese economy. Japan needs to work with emerging Asia in various ways —including the transfer of Japan's technology of CO2-efficient coal burning and energy efficiency— so it can benefit greatly from dynamically growing emerging Asia. Jeff Sach's earlier diagram indicated that emerging economies in general are performing better than developed economies, and Asian emerging economies are doing much better. Emerging Asia's high economic growth has generated a large class of middle-income people as well as high-income affluent people. Not only China, India and major ASEAN countries, but also other low-income countries such as Myanmar and Bangladesh are joining the growth process. So emerging Asia provides huge market opportunities. Prof. Stiglitz did not discuss Asia's FTAs, but policymakers are now negotiating a Regional Comprehensive Economic Partnership (RCEP) among the ASEAN+6 countries (including the 10 ASEAN members, Australia, China, India, , Japan, the Republic of Korea, and New Zealand) to create a large Asia-wide market . I would like to hear what Prof. Stiglitz thinks about the value of such a large regional trade agreement. Through a large Asia-wide FTA, Asians can produce more and consume more by being more integrated with each other and this would also help rebalance the global economy.

Contrary to what Prof. Stiglitz said, I believe TPP would also be very useful for the Japanese economy. Of course there are some concerns on certain issues, such as the excessive protection of intellectual property rights in the pharmaceutical industry and the treatment of genetically engineered agricultural products. Prof. Stiglitz talked about the risk of TPP being asymmetric between the United States as a major power and other small countries which tend to be pressured by the United States. Such a risk may be high in bilateral trade negotiations but as TPP is a multilateral negotiating table the risk of asymmetric bargaining power will be limited. For example, Japan, Australia, New Zealand, and perhaps other countries can get together and negotiate as a group against the United States on certain issues.

As Mr. Iwata said, Japan is very closed in terms of trade and foreign direct investment (FDI), particularly inward FDI. In fact, Japan's inward FDI stock as a share of GDP is only 3.9% and ranked 194th out of 198 countries in 2011, and this ratio is lower than that for North Korea which is one of the most closed economies in the world. Even for trade, Japan has very low leels of exports and imports as share of GDP and we need to further open up the economy and society. We need more English speaking students, and more globally oriented talent. TPP is a very useful instrument to open up Japan. Perhaps my suggestion to Prof. Stiglitz would be to become an advisor to the Japanese government so that Japan can negotiate with the United States in an effective way to minimize the negative consequences of the possible asymmetry. Forth, I would like make a comment about the impact of advanced economy monetary policy easing, including BOJ's quantitative easing, on emerging Asian economies. Prof. Hamada's earlier point was that if every country adopted a fully flexible exchange rate regimes, the negative consequences of QE policies by the Fed and BOJ would be minimized and the problems would be resolved. In principle I agree but the reality for many emerging economies, particularly, small and open ones is that adopting a freely floating exchange rate regime would be difficult. I believe Dr. Chalongphob from Thailand would agree on this. The reason is that exchange rate movements can become volatile, and exchange rates volatility in a small, open economy has negative consequences and thus had better be avoided. What we need is to explore the best policy option for these emerging economies in managing capital inflows in order to avoiding excessive overheating, potential asset market bubbles, and financial sector vulnerabilities. An even more important issue is the impact of the future exit by the US Fed from its QE policies, as this change in policy could have serious implications for many emerging economies, including those in Asia, by generating capital outflows and, in the worst case, currency crises. This is a common issue for many countries, and we need to prepare for this together.

My very final point is that peace and security is very important in Asia. Japan's diplomacy has to support its emerging Asia policy. Getting along with China, the Republic of Korea and other emerging economies is vital for Japan in implementing its growth strategy and to be able to benefit from the economic dynamism of emerging Asia. Thank you very much for your attention.

Prof. Iwata: Thank you very much, Dr. Kawai.

I had planned to discuss amongst ourselves but time is coming, and now we only have 10 minutes remaining. We should adjourn this session at 18:00 so far as I am informed, so we have only 10 minutes. Therefore I find it is better to have the Q & A session. Anyone who wants to make questions or comments, please raise your hand and identify yourselves.

Dr. Masazumi Wakatabe, Professor, Waseda University: Thank you for your presentation. My name is Masazumi Wakatabe from Waseda University. I have a small quibble about Prof. Stiglitz's presentation. It is about the Japanese economy doing relatively better than the others in terms of the lower unemployment rate. I think it is kind of misleading official statistics because we have a system called the “subsidy for employment adjustment,” so we are paying the corporations and firms to keep their laborers inside their corporation.

I think if we count that and also if we count the discouraged workers who want to work but they are giving up on finding jobs, the unemployment rate in Japan could be higher than the official figure. The official figure is right now 4.1 but some say that it could easily be five, and some would even argue for more like seven or eight. So this is just a small quibble, but I think that in terms of even unemployment rate, you cannot give the Japanese economy a better mark than other economies. This is just one for Prof. Stiglitz.

Dr. Stiglitz: Yes, can I just respond very quickly? In every country there are these statistical problems and in the case of the United States if you included discouraged workers and workers who had to take part-time jobs because they could not get a full-time job, the unemployment rate actually gets much larger. So that at the peak our unemployment rate was not 10% but was more than 16%. That is to say, over one in six Americans who wanted a full-time job could not get one. So yes there have to be adjustments but even then, Japan looks better than the United States.

Prof. Iwata: Okay, Please.

Prof. Shimizu: I have a question regarding Prof. Stiglitz's definition of the wellbeing of the people. The quality of life is of course so important in the target of the policy. But what is the definition of this concept? Without a clear definition we cannot focus on any problems. Maybe based on your definition Japan may be doing pretty good, but if we include everything it obscures everything. So could you elaborate on your definition of the wellbeing of the people, which is a better measure than the GDP?

Dr. Stiglitz: That was the subject of the international Commission on the Measurement of Economic Performance and Social Progress, and there were four aspects of that which I will just talk about very briefly. The first is that GDP actually does a very bad job of measuring large parts of the economy.

Richard Cooper talked about that. The healthcare sector, the service sector more broadly, the government sector are all areas where there are systematic biases in the way we calculate. We can do the corrections, but most countries do not do those corrections. We do not include leisure, we do not include home production, and one of the problems is that if the structure of the economy did not change, there would not be any biases. We would be misreading it but the way we misread it would be the same year after year. As the structure of the economy changes we are increasingly misreading what is going on. Just to give you another example, an increasingly large fraction of GDP is based on imputations of one kind or another, quality adjustments that we use models for. Sometimes the models are good but sometimes they are very bad and these discrepancies can be quite large.

The second thing is sustainability. If you looked just at the GDP before the crisis it looked like the United States was doing reasonably well, but it was doing well based on a mountain of debt and it was not sustainable. But that is only one dimension of sustainability. There is also environmental sustainability. And again we have metrics that we can bring in, and we recommend a set of metrics having to do with comprehensive wealth measures. Typically, though, GDP does not do that.

Thirdly, it does not talk about distribution, and this is one of the issues I think that is really very important in what we have been talking about, and Masahiro, for inclusive growth. The real point is that if you have an economy where GDP per capita is growing but most citizens are worse off year after year, then that is not a well-performing economy. Regrettably that is exactly the case in many of our advanced countries; it is certainly the case in the United States. So an ambition of having GDP per capita going up—if it is not corresponding to a statement that you want most citizens' median income to go up—is, I think, a flawed objective. In one way or another, growth has to be inclusive. That is a very well defined objective and there are many ways of measuring it, and this is not ambiguous. We can discuss what the best ways of measuring it are, but it is clear what the concept is.

Finally, the one area that is most difficult and in which there is the slowest progress, are notions of wellbeing Material consumption may not be closely related to an individual's sense of wellbeing that is tied to notions of connectedness. A manifestation of this is that people who do not have a job are often unhappy. (Japan does well on this particular point.) Even if the job is partially subsidized by the government, they are willing to put that aside. They are happier than if they were unemployed. There are lots of statistical studies that really confirm this. So having an economic system that in one way or another provides gainful employment to larger numbers of people is a system that is performing better.

Prof. Iwata: Other questions? Okay, yes please.

Ms. Yuko Kinoshita, International Monetary Fund Regional Office, Tokyo: Thank you, I am from the international monetary fund regional office in Tokyo, Yuko Kinoshita. I think this session actually raised a very interesting point about the potential of the “fourth arrow” about inclusive growth. So I probably want to ask the speakers what would be the concrete policies. Maybe Japan could consider moving towards a more fair society and a sort of fair distribution of income in the sort of inclusive growth.

Dr. Stiglitz: Let me just suggest a couple, and they have been hinted at during our discussion. One of the aspects and ways in which Japan does not have inclusive growth are the gender disparities that we talked about before, particularly in the labor market. Partly that has to do with what you might call social norms that you cannot easily legislate, but part of it has to do with support systems. The Scandinavian countries and the Nordic countries have been very good about having a set of support systems that allow for more active participation of women in the labor force. The interesting thing about Norway for instance, is that it has a distinction of having one of the highest levels of education of women. But it also has one of the highest birthrates of the advanced countries, and a very high labor force participation. Now how do you bring all those together? Partly, it is because their society has really good support systems.

Another aspect of dealing with inclusive growth is going to be dealing with poverty amongst the aged, which is now becoming a serious problem in Japan, partly because people live longer. But the idea of privatization of old age pensions would almost surely make that worse unless you had really strong programs to offset that. In America there was a proposal pushed by President Bush to privatize social security, and I think most of us are really glad that he failed. If he had succeeded, in 2009 the amount of misery amongst the aged in the United States would have been enormous. Our social security system works such that when wages go up, the most elderly— who contributed when they were very young and incomes were lower—are also lifted. No private system has that kind of a provision in it, so it seems to me that part of inclusive growth is having a well-designed system for old age.

Also a very important part of inclusive growth is provisions for children. You might talk about people who are older at working age and have low income being lazy, but children do not get to choose their parents. I think in a civilized society it is unconscionable that the fortunes of a young kid should be so dependent on the income and education of his parents. In the United States 22% of children are now living in poverty. It is very important as part of inclusive growth to have programs that are targeted at young people, particularly those living in poor communities, and making sure that they have access to education, including university education.

Prof. Iwata: Thank you very much. Unfortunately the time has come and I would like to just to say one word about women’s role in Japan. In Norway the politicians or parliament member share of women is 45%, and Japan is 10%. There is really a political leadership needed. That adjourns our session.

31 May 2013

Report

Dr. Hiroshi Nakaso, Deputy Governor, Bank of Japan:

Thank you for giving me an opportunity today to speak at the international conference organized by the Economic and Social Research Institute, the Cabinet Office, the Government of Japan.

Japan's economy has been in a state of deflation for nearly 15 years. During the period, the economy has been trapped in a vicious cycle. Amid the continued decline in prices, corporate profits and wages were squeezed. Those induced business fixed investment, private consumption, and other economic activity to plunge. As a result, prices fell again. For Japan's economy to get out of the vicious cycle and recover sustainably, it is critical first to overcome deflation, thereby turning the behavior of economic entities, such as firms and households, positive. In that regard, the biggest challenge Japan's economy is faced with is to overcome deflation promptly. The Bank of Japan recognizes that its role is critical.

With such recognition, the Bank introduced quantitative and qualitative monetary easing at the Monetary Policy Meeting held at the beginning of April. It aims to achieve the price stability target of 2 percent in terms of the year-on-year rate of change in consumer price index at the earliest possible time, with a time horizon of about two years. With a view to pursuing quantitative monetary easing, the main operating target for money market operations was changed to the monetary base. On that basis, the monetary base and the Bank's outstanding amount of JGB and ETF holdings will be doubled in two years. The average remaining maturity of the Bank's JGB purchases has been extended more than twice as long. The policy clearly differentiates itself from the gradualism or incremental approach adopted in the past. Besides, the Bank is committed to continuing with quantitative and qualitative monetary easing, aiming to achieve the 2 percent price stability target, as long as it is necessary in maintaining that target in a stable manner.

As quantitative and qualitative monetary easing requires a massive purchase of JGBs, we need to conduct purchases while monitoring the effects in the bond market. After quantitative and qualitative monetary easing was introduced and in the process of the market digesting its contents, there have been rises in the volatility of government bond yields. The Bank has been having close dialogue more than ever with market participants and taking firm action, including an adjustment of the "parameters" of the JGB purchase operations. Yesterday, the Bank released the outline of the outright purchases of JGBs for the time being. Specifically, it decided to increase the frequency of JGB purchases. While the amount to be purchased was left at approximately 7+ trillion yen per month in principle, it also decided to conduct such purchases in a flexible manner by taking account of market conditions in order to ensure that the effects of monetary policy permeate the economy. The Bank expects that these measures will lead to the stable formation of long-term interest rates by suppressing excessive rise in interest rates and heightened volatility.

Let me next explain how the Bank considers economic activity and prices will develop under quantitative and qualitative monetary easing. I will explain in line with the baseline scenario of the "Outlook for Economic Activity and Prices" released by the Bank at end-April.

First, the real economy. Japan's economy has started picking up. As for the outlook, Japan's economy is expected to return to the moderate recovery path around the middle of the year. On the back of that, domestic demand is expected to remain resilient and growth rates of overseas economies will gradually pick up. Thereafter, the economy will be influenced by a last minute surge in demand and its reversal decline at two scheduled consumption tax hikes. Despite that, with a virtuous cycle of production, income, and spending expected to be maintained, the economy is likely to continue growing above the potential growth rate of around 0.5 percent as a trend. Let me quote specific figures from the median of the Policy Board members' forecasts. The growth rate is projected to be 2.9 percent for fiscal 2013, 1.4 percent for fiscal 2014, and 1.6 percent for fiscal 2015. On such growth rate projection, the output gap, which illustrates aggregate supply and demand balance, will gradually turn positive from the current level of about negative 2 percent. It will further widen to about 2 percent in the latter half of the projection period up to fiscal 2015.

As for prices, the year-on-year rate of change in the consumer price index (for all items excluding fresh food) has been negative. Based on the economic projection I have just mentioned, it is expected to be on an uptrend. Main factors behind that are an improvement in aggregate supply and demand balance and a rise in the expected rate of inflation. It is likely to reach the "price stability target" of about 2 percent through the latter half of the projection period up to fiscal 2015. Specifically, the median of Policy Board members' forecasts was 0.7 percent for fiscal 2013, 1.4 percent for fiscal 2014, and 1.9 percent for fiscal 2015.

The Bank's clear commitment to achieving the price stability target and quantitative and qualitative monetary easing that underpins the commitment are expected to lead to a rise in prices through three routes. First, an improvement in aggregate supply and demand balance. When growth beyond the potential growth rate is achieved, aggregate supply and demand balance will improve and the positive output gap will widen. Second, a rise in the medium- to long-term expected rate of inflation. The expected rate of inflation will be on an uptrend under quantitative and qualitative monetary easing and will gradually converge on the price stability target of about 2 percent. Third, an increase in import prices. Foreign exchange rate developments will put upward pressure on those prices for the time being.

And on the assumption that international commodity prices will be on a moderate uptrend in tandem with the growth of the global economy, import prices are likely to continue rising.

Of the three, the important key to achieving the price stability target under the current policy is the second route, namely, to raise the medium- to long-term expected rate of inflation. Let me explain the reason by using the so-called Phillips curve, which shows the relationship between aggregate supply and demand balance and the inflation rate. As mentioned, when growth beyond the potential growth rate is achieved, the positive output gap widens. As the gap widens, the inflation rate will rise along the positive slope of the Phillips curve. As deflation has continued for nearly 15 years, the Phillips curve itself has shifted downward. And its slope has become moderate, due partly to a decline in firms' pricing power amid globalization. Given such shape of the current Phillips curve, the 2 percent price stability target cannot be achieved only by achieving a 2 percent positive output gap. One reason for the difference in the outlook for prices between the Bank and private institutions might be that many private institutions have based their outlook on the Phillips curve during the period of deflation. Therefore, to achieve the 2 percent price stability target at the earliest possible time, the Phillips curve needs to be shifted upward by an increase in the expected rate of inflation. Namely, it is necessary not only to improve aggregate supply and demand balance but also to firmly raise the expected rate of inflation by significantly changing "deflationary expectations" of economic agents, such as firms and households. A combination of those two will lead to the achievement of the price stability target at the earliest possible time.

The Bank made a clear commitment to achieve the 2 percent price stability target at the earliest possible time, with a time horizon of about two years. As a means of underpinning the commitment, the Bank has embarked on a new monetary easing policy, that is, quantitative and qualitative monetary easing. We believe that the Bank's strong commitment and decisive actions will significantly change the expectations among firms and households. Looking at the financial markets, market expectations appear to have started changing. Looking also at indicators that show the expected rate of inflation of the market and economic entities, some have suggested an increase. Positive moves have started to take place, driven by the Bank's quantitative and qualitative monetary easing. In further pursuing the policy, we expect such moves to spread to firms and households, and deflationary expectations to be reversed. Those firms and households released from deflationary expectations are expected to make active investment and consumption by fully utilizing accommodative financial conditions. Such positive economic activity and a change in expectations will induce an improvement in the real economy and a rise in the expected rate of inflation, paving the way to the achievement of the 2 percent price stability target.

The government has set its economic policy with a combination of three-pronged strategy (three arrows). Namely, bold monetary easing, flexible fiscal policy, and a growth strategy to promote private investment. As for the first arrow of bold monetary easing, the Bank, aiming to achieve the price stability target, has introduced a new monetary easing policy of quantitative and qualitative monetary easing. Naturally, in meeting our price stability target, we do not want to see only consumer prices climbing to 2 percent. The price stability target we aim at should be achieved in a virtuous cycle in which the real economy improves in a balanced manner, accompanied by an increase in corporate profits, employment, and wages. If the government can effectively deliver two other arrows and create real demand, that would underpin the virtuous cycle. It would enable the Bank to achieve the price stability target more smoothly. The government has already started various initiatives, and I have high hopes for more to follow.

At the same time, to continue with quantitative and qualitative monetary easing, it needs to be recognized by the public that the Bank's purchase of JGBs is carried out solely to achieve the price stability target and not in any way to finance the fiscal deficit. To that end, it is critical to maintain fiscal credibility. The government and the Bank released a joint statement in January. The government clearly stated that it would steadily promote measures aimed at establishing a sustainable fiscal structure with a view to ensuring the credibility of fiscal management. We strongly expect the government to move on that front.

The Bank of Japan Act stipulates that the principle of monetary policy conduct should "be aimed at achieving price stability, thereby contributing to the sound development of the national economy." Overcoming the longstanding challenge of deflation and achieving sustainable growth with price stability conform with the principle. Japan's economy has started picking up, and now is a great opportunity to overcome the challenge. I believe seizing the opportunity is our manifest mission.

Thank you.

Session 3: Economic Policy under the Abe Administration, "Abenomics"

Moderator : Kazumasa Iwata (Japan Center for Economic Research)

Reporters : Motoshige Itoh (Council on Economic and Fiscal Policy)
Kenji Umetani et al. (ESRI)
Adam Posen (Peterson Institute for International Economics)

Commentators : Masazumi Wakatabe (Waseda University)
Hiroshi Yoshikawa (University of Tokyo)

Prof. Kazumasa Iwata, President of the Japan Center for Economic Research: Good morning, ladies and gentlemen. Yesterday we discussed economic policy issues, notably economic growth and inequality. Today, we start a discussion on economic policy under the Abe administration—that is, Abenomics. A couple of months ago, a director of PIIE organized a similar conference on Abenomics and both Prof. Hamada and Prof. Itoh participated in this meeting. There had been heated discussion. I myself also visited in mid-April and I had the occasion to have a luncheon workshop on Abenomics and talked about my view on Abenomics. I also met there global investors from the United States who had a big interest in this new move by the new administration and new policy under the new leadership of BOJ.

In this session we have three reporters: Prof. Itoh and President Umetani and also Dr. Posen, and the two commentators, Dr. Wakatabe and Dr. Yoshikawa. The time allocated for this session is 15 minute for each speaker. Let us start with Dr. Motoshige Itoh's presentation.

Dr. Motoshige Itoh, Member of the Council on Economic and Fiscal Policy: Thank you, Iwata-san. I do not have any slides so I would just like you to follow the material presented for the meeting. What I did is try to raise what I think are the most important points of Abenomics, and hopefully that provides material for further discussion in this meeting.

Prime Minister Abe often emphasizes recovery in 10 years. Ten years is a long period, so that basically implies how we can depart from the lost two decades. The first point I would like to emphasize is that although the recovery from the lost two decades is very important, also we have a recovery of the lost three years, or maybe I should say three-and-a-half years, and the two things actually combine.

The recovery from the lost two decades is easy to imagine. We had a lot of structural problems; we cannot catch up with globalization, and the very rapidly aging population provides a lot of problems. Also just the crash of the bubble; they had a lot of difficulties. So we have many, many very difficult structural problems, just like other industrialized nations. It is obvious that it takes some time to recover. But one good thing for Mr. Abe is fortunately or unfortunately we had 3.5 lost years, which means after the Lehman Crisis, the performance of the Japanese economy is very different from the performance of the other industrial nations. You know just how the exchange rate moved: yen is among the few currencies that appreciated very rapidly after the Lehman Crisis. Although I did not prepare the data, if you have an opportunity to compare the stock prices of the United States, Germany and Japan after the end of the 1990s, I had once looked at the data, and that person just set the price of stock of the three countries to 100 in 1998 for comparison. There is a very beautiful, very similar movement among the three stocks until 2007. Then of course there was the crash of stock because of the Lehman Crisis, but gradually the United States and Germany is recovering in the same way. Japan is the only one that has a very stagnant situation.

There are three hypotheses for this kind of very different performance of Japanese stocks after 2008. One is obviously the monetary policy: BOJ did not pursue very aggressive monetary policy, unlike the Federal Reserve or ECB. The second hypothesis is politics. As you know, the Democratic Party of Japan (DPJ) held the government during this period, and there was a lot of discussion of whether their policy was effective or not.

The third hypothesis is that maybe because of the lost two decades, Japan has become a very weak economy in many respects, so we had the hardest hit of the Lehman Crisis because of that kind of difficulty. Maybe each of these three hypotheses will explain some.

So what happened after Mr. Abe became Prime Minister? Two things changed. One is that monetary policy changed, as you know. The second is that politics changed from DPJ to the Liberal Democratic Party (LDP). The third one is the structural problems that we will discuss later. But the important thing is that first we have discuss how we can experience the departure from those lost two decades and the lost three years.

Now, in page two I make a very brief comment about monetary policies. Maybe I do not have to speak much about monetary policy. One thing I am particularly interested in is the difference between the previous BOJ and the present BOJ is very active purchase of long-term government bonds. I refer to the old saying of a Chinese story when your army is fighting, the strong army is coming to your side, and there is a river behind you. What he did is burn down the bridge, to show that there is no way he can escape, not only to his soldiers, but also to the opponent. The opponent says, “Oh, he is serious,” so they just stop. This is what economists call “commitment.” The reason why the previous BOJ only purchased short-term government bonds is so-called exit policy; it provided more flexibility for exit. It seemed to be very reasonable, because anyway exit is very important when monetary policy start effecting and there is overheating, there must be a way to find an exit. But that kind of position shows a very weak signal to the market: BOJ can only change the behavior once the something of the recovery. So what Mr. Kuroda did is burn down the bridge. He showed a seriousness to the market that this time is different.

Now, there is a lot of discussion about the second point about the price increase, and I just discuss briefly in page three. Obviously, stock prices, exchange rates and maybe even real estate prices respond very quickly, but when it comes to the general price and wages, we know it is very sticky, so we will have to wait and see. The question is whether prices will actually increase. So, Mr. Kuroda just proposed that BOJ will raise inflation rate to 2% in two years; it seems to be a very difficult task. We have to wait and see.

But the important thing is that the market seems to be reacting. Recently people have started talking about break-even inflation rate. This is the difference between the long-term government bond interest rate and the price-indexed government bond. We have some very small circulation of price-indexed government bonds. Price-indexed government bonds compensate for increasing general price level at the point of redemption. So basically, the interest rate on break-even inflation rate is something like market-expected real interest rate. You can see that it is now declining very rapidly, even before Mr. Abe became Prime Minister. Especially after Mr. Kuroda announced very drastic monetary measures, we had a very big minus interest rate on the price index among the bonds. So in spite of the fact that long-term interest rates are still around or below 1%, what happened is the market-expected real interest rate is a very large minus. So expected inflation rate, what people call break-even inflation rate, is something approaching 2%. This does not imply price is increasing, but the market at least shows their expectation about the coming mild inflation.

There is another discussion about inflation. If prices increase but not wages, that is not a very good thing for ordinary people. This is a very popular argument about the distributional influence of inflation/deflation. Retired people are very happy under deflation, because they are given a nominal amount of pension and nominal amount of savings, and price is declining very rapidly. So they do not have any reason to stop deflation, unfortunately, and they actually dominate the election. So I think this is a very difficult political issue for the government. The Abe government is very sensitive to this real wage issue.

I have to ask some professionals on macroeconomics like Prof. Yoshikawa or someone else, what is the relationship between price and wage? As far as I look at the previous data casually, there is no reason to believe that price changes before wage or wage changes before price. But I am not an expert on that issue. My guess is that when price increases, wage increases; when wage decreases, price decreases. One problem in Japan is that during the last 10 years, in most countries wages increase more than price. But unfortunately in Japan wages decrease more than prices decrease. But this is maybe based on a very simple thing—labor productivity was very low in Japan. Because the wage share is supposedly constant; basically the difference between wage increase and labour pricing rate should be equal to the labor productivity rate growth. So I think that labor productivity growth is very important to us to have a higher wage increase than price increase. Anyway, this is a very important issue. So politically, what happened is that the Abe cabinet gave a very strong emphasis to speeding up the process of wage increase. We are still talking about how we can promote the industry to expand employment and also to speed up the process of wage increase. This is a very important issue coming later, because we know that some countries like Holland were very successful to do some kind of consensus among industry, labor and government to have some coordinated policy to promote wage improvement.

The second thing that I would like say is in page four, about the asset market. You probably know that one of the very interesting features of Japan in the last 20 years is that people just save and save and save, and do not spend. If you look at the data, for example the average amount of household financial assets divided by their annual income, Japan is the highest. It jumped from 300% to 400% in the last 10 years, which means that consumers are very protective. They do not spend; they just save. Most of the savings are in the form of deposits. That is very rational for them under deflation, because prices are decreasing and stock prices and other asset prices do not have good performance. Similarly, the corporate sector, as you probably know by now saves more than the household sector. What they did in the last 20 years is not investment, just restructuring and squeezing down, not employing, and how to utilize so-called part-time workers rather than full-time workers. So they accumulated. Again, under deflation this may be rational for them individually.

Now, the important thing is that the expectation of inflation may change all these behaviors. This is what we have to watch very, very carefully. If people just expect mild inflation and some constant increase of stock price and various prices, I hope there is some change in the behavior of the financial market. The important thing is—and I will also discuss this later—we have finished balance sheet adjustment. European countries are still struggling to adjust the balance sheet after the crash of asset prices. In the United States, after the Lehman Crisis they had a lot of struggle, and maybe they have now hit the bottom; I do not know. But in the case of Japan, after the bubble crashed, the households had a huge amount of loans, but now they have a huge amount of savings. After the bubble crashed, the corporate sector had a huge amount of debt and a huge amount of non-working assets. But now, they just squeezed down and have a huge amount of savings money. Even financial institutions after the bubble crashed had a high level of leverage but now they have very low leverage. So theoretically they are ready to move, but unfortunately because of a deflation mindset, it is very slow. I am teaching at university, but my students, who are undergraduates are something like 22 years old, after they were born they have never experienced the economy other than deflation, so it is not easy to ask them to change their mindset. So there may be some kind of very drastic change, but anyway we have to watch very carefully about the changing deflation expectation.

Now, in page five I talked about the second arrow, fiscal policy. The important thing is that Japan is expecting very drastic change from now to 2015. BOJ have said that inflation rate will be increased from minus to 2%, a very big change. The consumption tax rate, which is now 5%, is expected to increase to 10% in two years. The government also promised to squeeze down the size of the primary balance deficit to half by 2015. Now, the question is whether everything can be achieved perfectly, or they need some kind of adjustment, but the point is that there is going to be very drastic change in fiscal policy. So the management of fiscal policy is very delicate, and we have to be very careful.

Because time is limited, I will just go to the other side. Fiscal consolidation has become a very big issue, because if there is something that the market believes Japan cannot achieve the fiscal consolidation, there may be some kind of influence on the government bond market. Now, there are several important things. The first thing is what I wrote in page six, does anti-deflation policy promote fiscal consolidation? And the answer is yes. It is obviously possible to just deal with the big debt problem under deflation, right? And increasingly expectation of inflation, hopefully if we have 2% inflation, that allows a lot of decrease of the real value of debt. And if you believe what we experienced before, what happened is that during the process of deflation, price decreased more than interest rates, which means real interest increased under the deflation process. So when we are moving back to mild inflation, hopefully real interest rates will decrease, and that means price increases more than interest rates. If that happens, that will help a lot the management of government bonds.

Thirdly, even in some mechanisms like the pension system, the government decided to introduce macro-economic slide mechanism, which is a very interesting creature. Usually, pension is price indexed—if price and wage increases by 2%, pension will increase by 2%. The government decided that the pension would increase by the amount of the inflation rate minus 0.9%. This minus 0.9% is a magic number that is actually calculated by considering the diminishing size of the working population and so forth. So when inflation is 2%, that means that automatically the nominal amount of expenditure on pension will be controlled. It cannot be implemented under deflation, politically. So inflation provides a lot of room for more flexible adjustment.

But the important thing is that you cannot tackle all of the problems, because of the aging community and the increasing expenditure on medical and so forth, so there must be at the same time important fiscal considerations.

Since time is limited, I will not discuss much about growth strategies, but I think that other people will discuss growth strategy. Thank you very much.

Prof. Iwata: Okay, thank you very much, Prof. Itoh.

The next speaker is President Umetani. So please, sir.

Mr. Kenji Umetani, President, Economic and Social Research Institute: Thank you very much. I will present our empirical paper entitled “Improving Household Expectations and Implications for Renewed Growth of the Japanese Economy.”

The paper examines the rising household expectations, which is one of the features brought about by Abenomics, and probable effects on household consumption. The outline of my presentation is as follows. First, I will check the reactions of the market and the changes in confidence by the end of April. Second, after clarifying the likely mechanism for consumption to grow, we will show the estimation results on the magnitude of a consumption increase induced by an improvement of consumer sentiment. Finally, some concluding remarks will follow.

This is the stock market development since summer of 2012. It is clear that stock market prices rose since mid-November, when the Lower House was dissolved. By the end of April, the Nikkei average rose by about 60%, and this has much larger gains than the Dow Jones in the United States, which rose by about 17%. During this period, there have been a series of significant events that could offer dealing factors in the stock market.

In order to examine the statistical significance, an event study was carried out. This is the result: the estimated equation is such that the day-to-day rate of changes in Nikkei is regressed on various dummy variables, representing events, with the carry-over effects of change in Dow Jones controlled. As you can see, the followings are statistically significant. The Dummy B is the news on regime change, including the general election. The Dummy D is news on the appointment of BOJ governors, and the Dummy E is other news on Abenomics, including the G20 summit. It may be surprising that the estimated parameters are close to 2%, which is substantial in magnitude. The point is that the events in this period helped market sentiment turn into positive, and trade in the market became bullish.

Now I will look into the sentiment. This is the comparison of business and household sentiment between present and early 2000s. The early 2000s mean the longest economic expansion period, spanning from January 2002 to February 2008, amounting to 73 months. Business sentiment indicates the BOJ’s Tankan survey. Consumer confidence is taken from the Cabinet Office survey. It consists of four components, that is: a sense of daily living, income increase, job environment, and purchase timing of durable goods.

The difference between now and then is very clear. First, in the previous expansion phase the business sentiment improved rapidly, while the recovery of consumer confidence lagged behind. As regards the wage, that is the monthly cash payment regularly paid without bonus, remained subdued. Second, in the current phase, the consumer confidence is rising in a dramatic way, although wage and employment data have not yet seen any improvement. Such a rise in consumer confidence may be partly explained by the wealth effect, because of stock price hikes. It should be noted that recovery of confidence in the business sector has been modest and slower this time.

Then, an interesting question is to what extent a pickup in consumer confidence will lead to arise in real consumption expenditure. This is a flow chart to show the mechanism from Abenomics to an increase in consumption expenditure. So far, Abenomics has been effective on consumer sentiment and financial market, entailing a wealth effect. From past experiences, we know that turnaround in confidence of future income growth has accompanied an actual wage increase with three to four months' lag. This wage increase is not automatically warranted, but needed to be realized in the labor market.

When income growth is realized as a consequence of larger corporate earnings, an increase in consumption expenditure is sure to result, in addition to the wealth effect. We estimate a single-consumption model that reflects the influence of consumer sentiment on income increase. Based on the framework proposed by Campbell and Mankiw, the model considers that a change in consumption depends on a change in disposable income and in the household net wealth, with the sentiment used as an instrument of future income growth. The estimation period is from the first quarter of 2001 to the first quarter of 2012.

We then calculate magnitude of the possible effects of improving consumer sentiment on consumption in 2013. We assume two cases. First, the sentiment stays at the same level throughout this year. This is case A. Second, it continues to improve by the end of this year, and this is case B. In both cases, the results indicate that the improved sentiment would increase household consumption by around 3% on an annual average. It should be noted that this increase will be realized only if the expectation of future income growth is actualized and strengthened without pause.

Then, finally concluding remarks. So far, Abenomics has been leading to a clear change in people's expectations. When an expectation is strengthened through its realization, it would have a sustainable pushing effect on the real economy. Professors Akerlof and Shiller called this the "Confidence multiplier effect". For example, if the expectation is supported by a constant increase in income, it is estimated to increase household consumption by around 3% in 2013. So the virtuous circle of economic growth from business to the household sector is necessary for economic revitalization, and Prof. Itoh and other speakers, including yesterday, already mentioned this.

Prof. Iwata: Thank you very much, President Umetani.

The next speaker is Dr. Adam Posen, please.

Dr. Adam Posen, President, Peterson Institute for International Economics: Yes, just-in-time delivery; I learned something from my years with the Toyota people. Thank you all very much for including me in this conference. Thank you particularly to Prof. Hamada and President Umetani.

As Prof. Iwata said, I had the privilege to organize a conference on Abenomics at PIIE a few months back, and we were excited to do it both because it is so intellectually interesting to finally see the reverse experiment of reflation versus the experiment of enforced deflation that Japan has suffered for so long, but also because it is important to the world that Japan get back.

I just want to take one minute to perhaps say the obvious, but we have come a long way politically in the last 20 years, even if in economics the decades get lost. We have come a long way from the world in which many American politicians were very scared of a strong Japan, of a Japanese economic recovery, and then from a world in which Japan was seen as lost. We are in a world where a lot of American and other Western people—and I try to help this—recognize that Japan is not lost permanently; it is within Japan's power to be back, and it is a good thing for the whole world is back. Again, in this audience, with these distinguished people, that is not a controversial statement, but let us at least appreciate that that is the world we are in now, and not the world of the 1980s and 1990s conflicts.

In terms of economics, I was asked to contribute on the fiscal policy in particular, and I am essentially expanding on something that Dr. Motoshige Itoh just said, which is that of the three arrows that Abenomics is shooting, I think actually the most difficult one to hit the target is fiscal policy, not monetary and certainly not structural policy. This is sort of odd, because fiscal policy is the thing most under control of the government, and arguably has the least political problem compared to some of the structural reform measures, but I think we have to recognize what is going on with fiscal policy and try to fix it.

I think it is very important to recognize that the "three arrows" is not just for convenience; it makes sense. Abenomics is right to have a three-pronged strategy. A decade ago, then-Prime Minister Koizumi and Economics Minister Takenaka made a huge effort to reflate the Japanese economy to instill confidence and it was largely successful. They importantly cleaned up the banks, they stopped bashing the Japanese economy over the head with premature fiscal tightening, and they did a certain amount of structural reform. The problem was that BOJ at the time was not being helpful. That to me was what limited in many ways the ultimate success of the Koizumi/Takenaka package. Others have cited the very good recent speech by Christina Romer, that you really want to do a regime shift. I think that this is an important lesson for not just Japan but for our friends in Western Europe as well and even to a lesser degree the United States. There is still a discussion in macro-economic policy often, as though right now the major economies are in this finely balanced situation, that if we do a little too much policy we have to cut back on the monetary policy. I think this is a gross misunderstanding of the situation. We are so far from equilibrium, so far from full employment, so far from where we potentially should be caught up to, that it is more important to get all the policies working in the same direction, and not worry in this mindset of fine-tuning that one policy must offset another.

In terms of the structural policies that Abenomics is pursuing, I feel duty bound to say, as so many people do but it has to be said, that the prioritization is missing. The single greatest asset Japan has that is underused is its skilled female labor force. The Prime Minister has spoken about this, many people have spoken about this, but if I believe the press reports—and I am happy to be wrong—this is not seen as a major priority for the announced structural reforms. My friend Iwata Kazumasa has also spoken about a gender gap in his remarks. Very simply put, there is a bundle of policies that should be undertaken to tackle this, and this is the single most important thing that could be done to offset the demographic issue. It would have some effects on wages. It would obviously be a positive supply shock, which would drive down certain wages. It would obviously be an investment in Japan's future. I am not going to belabor this, we can pick it up later, but as much as I am a huge supporter of Abenomics, I think it is a terrible loss if the structural reform agenda does not feature this.

On monetary policy, I am in agreement with so many people here and with Deputy Governor Nakaso that BOJ is doing the right. I come at it at a slightly different way than say Deputy Governor Nakaso or Prof. Itoh, in the sense that I am always a little less that of the Michael Woodford school that it is all about expectations and statements. I think the portfolio balancing effects matter. Therefore, it matters a lot that BOJ is now buying longer-duration JGBs instead of buying cash. That is a key part of transmitting their policy. It is very heartening that the leadership of BOJ is committed to this. That was one of the key messages that we tried to get across with our conference on Abenomics a few months ago. I think people are going to be surprised on the upside. There has been some mumbling of late even from BOJ that it may be very hard to reach 2% within two years. There are all these projections about pricing to market and therefore the large move in the yen will not change inflation. I think that this is a mistake. Luckily, it does not matter because they are doing the right thing anyway. I just think they will be pleasantly surprised by the inflation going up.

Regime change changes the pass-through on the exchange rate. I experienced this at the Bank of England, where in the 1990s and the early 2000s they were in a very different regime, but nominally the same one, and the pass-through from the exchange rate movements in and out of the ERM was very small. But in 2008 the pound underwent a 20%-plus deflation, and we got a 10 to one pass-through of close to 3% inflation over the next two years, which was totally out of line with the previous econometric evidence. I think something similar can happen to Japan.

The final remark that I would make on monetary policy, which I think has to be made, is that I and I think everyone responsible commends the Abe government for holding BOJ accountable for reaching its target. The great Stanley Fischer 20 years ago wrote a paper in which he distinguished between what central banks have goal independence and instrument independence. That it is up to the politicians to set the targets for monetary policy, and then the independence of the central bank should be to set month to month what needs to be done to achieve the target. When Bernanke, Mishkin, Laubach and I wrote a book on inflation targeting, we designed it with that in mind, that the governments would reset the inflation target, but also that the governments would hold central banks accountable for achieving the inflation target over a multi-year period. So again this is very mainstream, what the Abe government is doing with BOJ, and it is right.

If all that is going well except for the women, why is fiscal policy tricky now? Some of my colleagues in the west, in the United States, particularly those who remember me pushing for fiscal stimulus in Japan in the 1990s, are busy telling me, well, why do you not just let Japan borrow and spend? Interest rates are low and fiscal multipliers should be high; it is a closed economy. And obviously on the basic economics I do not disagree with this. Part of what Japan in 1997 demonstrated, which has been shown again in Western Europe when it should not have needed to be shown again, is that short-run policy multipliers on fiscal policy are quite high; they are greater than 1.0. And that particularly if you have a damaged banking system or a recessionary state, they are even higher. Now, Japan is luckily not where it was in 1997, and so the multipliers are likely to be lower than they were then, but they are still likely to be high.

Furthermore, as again we should have known before the recent kerfuffle—that is a technical term—about the Reinhart-Rogoff result is that they never made any sense; that there was never any cliff to be had at a certain level of public debt, especially if you are not a small economy and you are borrowing in your own currency. So the idea that with an active BOJ and very little foreign holdings of Japanese debt there would be a financial crisis never made any sense. So why am I not telling the government, just spend, spend, spend? Well, you can have cost to something without it being a huge crisis, and there are costs to having very high levels of public debt. There is a straight algebraic cost that if you have a lot of debt and you are making the payments on it, it eats up a lot more of your tax base and it is not productive. Jeff Sachs very articulately yesterday set out all of the reasons you would want public investment in Japan. If you are giving away a huge chunk of your public budget to interest payments, you are wasting money, as opposed to public investment.

We also know that part of the reason that Japan has been able to get away with its high public debt is because there is what is called "financial repression." There is the fact that banks buy a huge amount of government bonds and savers are—partly through incentives and partly through other means—encouraged to keep their money in low-yielding accounts. This is not the end of the world; it has financial stability benefits. As I have said several times, one person's financial repression is another person's prudential supervision; it is not an all-bad thing. But taken to an extreme, it diminishes returns in the economy; it diminishes what savers get; and it mostly erodes the allocation of investment. And Japan is now at a sufficiently advanced state of financial repression that that cost starts to mount up.

Third, ultimately BOJ can prevent a panic in bond markets whenever it wants, and that is why nobody should be so excited about the last couple of weeks' moves in interest rates. But it cannot prevent a sustained fall in the yen if enough people decide there is a problem. That is not all good. Again, as Iwata-sensei and others have spoken about, we know that Japan is now a net importer of energy in a way that it was not before; its terms of trade have reduced; and so if you go too far with yen depreciation, the cost to business and competitiveness and the cost to real incomes become very high.

I think it is also worth noting that even though Broda and Weinstein told us a dozen years ago rightly that net debt in Japan is much lower than gross public debt, it is still a lot higher now than it was 15 years ago. It is still some people say 140% of GDP and some people say 160% of GDP. We have to take that reality.

Finally, I think the traditional public works spending in Japan is reaching the limit. This is not just because of all the usual stereotypes of oh, there is concrete on every island and we do not need any more concrete. It is because in comparison to what literally happened in the US stimulus plan, there are no shovel-ready projects. As I understand it from speaking to officials and businesses in Japan, every useful construction person in Eastern Japan is already at work in the Fukushima region; they are already there; there is nothing else to be done. You are not going to have a supply of construction workers and material. In all of Western Japan, there is nothing to be done. So this is not a good use of money. So what should you do instead?

I think the key challenge is the next couple of years. I will argue—I will assert, and I can argue in more detail later—that the consumption tax increases of 2014 and 2015 must proceed. I think it would be a true credibility issue for this government in political terms with the markets, with the public, as well as an economic mistake not to make that shift in Japan's tax base. Japan's tax base is too narrow, its incidence is very unfair, and it is very inefficient. The tax collection in Japan should be improved through taxpayer ID for cracking on old people, for cracking down on small business, but that is not likely to happen. So let us go ahead with the VAT increase and really get a permanent tax increase. And again, I will echo Jeff Sachs that there needs to be more revenue. And as I said, the cost of rising debt service has to be offset.

But we should not kid ourselves; for the reasons I just said, such tax increases will be contractionary. I have friends in the audience with whom I used to debate what happened in 1997, and I know that there are people in the speakers today who will still claim that the 1997 tax increase was not a big deal, that it was not so harmful. I find it sort of incredible that anybody still says that. But the bottom line is that these multipliers, these effects that people are projecting of -0.9% of GDP in 2014 are probably slightly on the low side. So if you have a projected growth rate based on reflation of 2% to 2.5%, and you cut it down to something like 1% or less, it would matter quite a bit, as would the volatility.

The worst possible scenario is that BOJ succeeds in raising inflation and there is no real growth to go with it. That is the worst scenario for the bond market and it is the worst scenario for the Japanese people. So we need something to smooth the course of GDP adjustment, and it should be something that you can feasibly distinguish from the permanent VAT increase.

I am sorry if I am belaboring a simple point as opposed to my distinguished colleagues, but I just feel this is the key issue for the success of Abenomics in the next couple of years. What the government of Japan and the Abenomics team should be pursuing is a significant temporary tax credit for the next two to three years. You can make it in the form of accelerated depreciation; you can put on all kinds of bells and whistles. There is a long record across many countries of these kinds of temporary tax measures having a very large and rapid impact. This is something like the VAT rise, where there is no implementation lag or cost to doing it.

And most importantly picking up on something that Itoh-sensei said: we know that the major issue in Japan is the sitting of cash on the sidelines in corporate balance sheets. This is something that has to be mobilized. I agree that the change in deflation expectations will mobilize some of that cash, but one can do more. Moreover, to bring over a proposal I made in the United Kingdom where there are some significant parallels, perhaps surprisingly, you can put in corporate governance changes in which you tell companies that if they sit on too much cash they either have to put it to an annual general meeting vote and turn it over to shareholders in the form of dividends, or spend it, it is entirely legal and possible to force companies to disgorge their cash.

So just to conclude, you can think of other ways to smooth the economy: through additional monetary measures, through higher wage settlements, which would be critical to get done before the VAT hike in April 2014. But in the end I think these are riskier and less efficient; they would be supplements at best. So we do want all three arrows flying to target. The monetary arrow is well watched; the structural reform arrow is the right direction but it needs another feather; but most of all we need to get the fiscal arrow in the right place, and I think that requires this temporary investment tax to offset the needed consumption tax rise.

Prof. Iwata: Thank you very much, Dr. Posen.

Now we have two commentators. Let us start with remarks by Prof. Wakatabe please.

Dr. Masazumi Wakatabe, Professor, Waseda University: It is an exciting and wonderful time for someone like myself, both Japanese and an 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 taken 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.

I have just received Dr. Posen's presentation just on time, but I expected what he is going to say, and my expectation was quite rational and correct. So what I am going to say has already been covered by three presentations. What is happening right now is a kind of "regime shift" which Christina Romer said in her speech this April. It is a policy regime shift from a deflationary one to a reflationary one. So listening to what Deputy Governor Nakaso just said, I cannot help thinking how far BOJ moved its policy stance. He talked a lot about inflation expectations and he talked a lot about the crucial role of BOJ to tackle the inflation expectation. So I think this is certainly the emergence of a new regime. That is what Abenomics is currently achieving.

This is a diagram that shows what I understand of how Abenomics works. This is concentrated on the very concept of the changing real interest rate. As Mr. Umetani's paper shows, we must think about other routes to influence expectations, such as consumer sentiment and corporate sentiment. But I think this is a kind of standard understanding of how the whole package of Abenomics fits into economics. Raising the expected inflation rate is quite key to this whole enterprise. I believe that as Mr. Umetani's paper and other evidence suggests, the first arrow of Abenomics has succeeded in doing just that.

This is other evidence from New York Fed economists Mandel and Burns. They calculated the increased inflation expectation using other method. They relied on the foreign exchange rate and so on and so forth. So this is the rising inflation expectations calculated from the exchange rate movement. You can see that after Abenomics and after Abe Shinzo was considered as the shoe-in for the next Prime Minister, the expected inflation went up.

Now the risks. There are several risks to a nascent reflationary regime. If I paraphrase famous speech during the Battle of Britain that "Never was so much owed by so many to so few," this is actually what is happening: Shinzo Abe the Prime Minister and his advisors including of course Prof. Koichi Hamada and the new BOJ Governor Kuroda changed the regime from deflation to reflationary. But after Kuroda, what happens? There is some institutional instability about the new inflationary regime. Central bank independence is useful in an inflationary environment, but as recent experiences of the advanced countries and even developing countries, the central bank independence in low inflationary or deflationary environments could be harmful. So we have to rethink a little bit about the desirability of central bank independence. I am not saying that we have to discard the central bank independence altogether, but we have to strike the correct balance between the potential dangers of having central bank independence and discarding central bank independence. But I would say that central bank independence is not the goal or objective of the economy. The objective must be macro-economic stability, including employment and price stabilities.

So that is one part, but I think in light of the past 15 years or 20 years that Japan had, we have to revise the BOJ Act of 1998 to reach a new kind of consensus among the government and BOJ. Particularly, I think some kind of inflationary targeting or other goals should be specified in the revised act itself.

The second point is that we could improve on the inflation targeting. Perhaps we could think about adopting price level targeting or nominal GDP-level targeting and so on and so forth. That has something to do with how the central bank could influence the real economic variables such as unemployment rate and so on and so forth. But I think that is one part we should think about.

The third one is the point which has already been pointed out by Dr. Posen and also touched upon by Prof. Iwata, that of the danger of premature fiscal consolidation. I will begin with several facts. Actually, there was a typo or mistake in my previous version, so I asked to redistribute the new version. First, the 1997 tax hike was preceded by tax reduction of the same amount. So we can talk about the danger of the 1997 tax hike, but we have to remember that that tax hike was preceded by a tax reduction. Second, after 1997, Japan experienced a full-fledged deflation. So we could debate whether or not the 1997 tax hike was a cause for this deflation or not, but the coincidence was striking. Thirdly, the 3% consumption tax hike would translate into about I think a reduction of real GDP growth of 0.45%. I used the older estimate by ESRI and I came up with a number of 0.9%. Somehow the new version of the ESRI macro-economic model revised down the number, so the impact would be smaller now. We can also debate the numerical estimates, but clearly I think this tax hike would translate into real GDP growth rate reduction

Now, the issue is, will the nascent reflationary regime survive? We can talk about the impact of the fiscal consolidation in many ways, but what I am concerned with is the sustainability or the regime. Will this new Abenomics regime survive? There are several plans. Plan A is a postponement until Japan gets back to normal nominal growth rate of 3%, which has been specified by the provisional part of the law, of raising consumption tax. Plan B is for some reason the case in which Plan B is not desirable, as Dr.

Posen argues. The credibility is really at stake. Then we have to think about the countermeasures to cushion the increase in consumption tax. Plan C is one more measure. I would say that we could strengthen inflation expectations. Perhaps we could introduction nominal GDP level targeting or any other measures to strengthen inflation expectations by other measures.

One historical episode is worth remembering. I actually come from a historical background so I am drawn to historical examples. One is the so-called “mistake of 1937.” That happened when the second Roosevelt administration took office, and the government and the FRB took a sort of contractionary stance. The result was this disaster. That was called the Roosevelt Recession. So I am inclined to say that we should not repeat that kind of mistake. I am inclined to support Plan A or B or C to cushion the impact of the tax hike.

Now, sorry about the Japanese language here in the diagram because I did not have time to translate this, but I think you can get the numbers from FRED. Just a brief comment on stock price behavior these days. The figure shows what happened before and after the New Deal. During the Great Depression the stock price plunged, and when Roosevelt took office, the stock price rose. But then came a plateau. After the real economy recovered, however, the stock price again began rising. I am not saying that the Japanese stock price behavior is following the same pattern, but we could see that there are some time lapses for stock prices to react to the real economic developments.

Now just a comment on the relationship between inflation and wage growth. I comment on it because this is right now a kind of hot topic among the Japanese economists. We can see a correlation between wage growth and inflation. The question is how we could interpret the relationship in a causal manner. One interpretation is from the nominal wage growth to inflation. If we have nominal wage growth rate increase then we have inflation. Another causal mechanism would be to think about the third factor: money growth. Money growth would affect inflation and also wage growth. This is the relationship and the inflation and wage growth are highly correlated, but if we think about the money stock growth in the previous two years, then the correlation of the money stock growth of the previous period and the inflation and also wage growth are also highly correlated.

Now, how about the third arrow? I would say that the reflationary regime is transitory or temporary by its nature or its definition. Once the Japanese economy gets back to a sort of normal circumstances—normal in terms of inflation—I think that the reflationary regime is no longer needed. Actually, we do need the inflation targeting and other mechanisms to ensure that Japan would not go back to a deflationary regime, but I do not think that the reflationary regime is the permanent regime.

So what is the next regime? I would say that the third arrow would influence the direction of the next regime. But as far as I know, there is no silver bullet or panacea to economic growth. Growth policy is very complicated, as we know. As far as I know, there are now two policy philosophies or ideas competing with each other in the planning of the third arrow. One says that the government should lead the economy so that industrial policy-like target policy is on the table, and the government fund is also talked about. The second line is more like the market-enhancing view. It emphasizes the private sector initiatives, so we should concentrate more on competition and deregulation, perhaps some private finance initiatives.

We will see how the battle of ideas will play out. But as far as I know even, for Japan , the industrial policy rarely works, and also the government initiatives have less than stellar track records. So I am inclined to support the latter view, but even so, as Prof. Stiglitz and others have argued, we do need to take into consideration the political economy and we do need to take into consideration the complicated issue of designing institutions. So I think it will take a long time to have the third arrow and have the next regime.

Thank you very much.

Prof. Iwata: Thank you very much, Prof. Wakatabe.

Then the final commentator is Prof. Yoshikawa, please.

Dr. Hiroshi Yoshikawa, Professor, Graduate School of Economics and Faculty of Economics, University of Tokyo: Abenomics consists of three arrows, so I would like to make comments on the three arrows by showing some data figures.

The first arrow is the "Q-squared E," which I heard for the first time by the way this morning. A good expression. A very expansionary monetary policy.

In my view or in my mind, it is a big experiment. It is monetary easing, so what we would expect is a lower interest rate, but as you know the interest rate is actually rising after 4 April. Everybody talks about regime shift. But actually there was a regime shift in the Japanese economy in the year 2003. At that time, we had had a very serious banking problem, an unstable financial market, and the government finally succeeded in putting public money into the Resona Bank, which had suffered from significant capital shortage. That was May 2003. Before that, the stock price had been below 8,000 yen, but then after that the stock price started rising very sharply to 12,000 yen. So at that time there was really a regime shift, and after that the Japanese economy could enjoy a real 2% growth for about 4 years under the Koizumi administration. In the year 2003, the fundamental of this regime shift was the real end of the bad loan problem.

Now, everybody talks about the regime shift but, so I am sometimes wondering what would be the fundamental of this regime shift. The stance of BOJ changed, and everybody talks about the change in the expected rate of inflation. So I will make a remark on that shortly. But for the moment, now that the base money is increasing very sharply, and Prof. Wakatabe showed us that when money increases, very soon or after maybe two years, the price starts rising. I have a figure here that gives us a different impression. This is a record of base money, money and price. We have four periods here and the figure shows five-year cumulative change. HM is high-powered money, base money. M2+CD and CPI. My reading of this figure is that base money has little to do with the price.

Now the total assets of the central banks. This compares BOJ, ECB and Fed. We are putting much money into the economy, but still we face deflation.

My belief is that the cause of this stubborn deflation in Japan is a major change in wage setting that occurred in Japan during the 1990s.

As for wage formation, we know the Philips curve. In economics we have expectations of augmented Philips curve. But I remember that some people like Jim Tobin and Arthur Okun did not really like to call this term “expectations.” Expectations are by definition forward looking, but they said that at least some of the so-called “expected inflation term” contains backward-looking inertia. And I also believe that at least some of the so-called expected inflation is really a backward-looking inertia. I do not know how much this so-called expected inflation term contains real forward-looking expectations. Actually I am very skeptical that the real forward-looking expectations can easily change wage formation and prices.

Mr. Umetani and others showed us that consumer sentiment is picking up. That is good news. And in fact in the first quarter of this year, mainly from January to March this year, Japan’s real GDP grew at an annual rate of 3.5%. Fixed investment still kept declining. So the major contributor to the growth was private consumption, and behind it perhaps there is better consumer sentiment. Here I show you the increase of consumption by age during the period January to March this year. We have a mixed result. Interestingly, young peoples’ consumption did not increase much, or only marginally. Old-aged people’s consumption actually declined, but the consumption of the 50s to early 60s increased very sharply. So what did they buy? Basically cars. So while it is good news on the whole, the result is mixed, and I do not know how much so-called “expected inflation” contributed to this result. The expected inflation should discourage money hoarding. We must note that the young are the people who hold only money as their assets, and yet their consumption stagnates.

Exchange rate depreciates sharply, and the so-called regime shift and BOJ's action I agree contributed to this sharp depreciation of the yen. I think that this would help the Japanese economy in the short run. The Japanese economy depends very heavily on exports. Not always as this figure shows, recently Japan's economy depends very heavily on export, but during the rapid growth era, actually the growth was led by domestic demand.

This shows the time of the Lehman Brothers Shock, and as you can see, Japan's economy is very much affected by the fall of export exchange rate. As I said, recent sharp depreciation of the yen was, in part at least, caused by BOJ's action. But at the same time I would like to point out that the trade deficits after 11 March two years ago is also contributing to this depreciation of the yen. Certainly it is a fundamental.

Let me go on to fiscal deficits. Fiscal deficits are very serious, so I would like to take issue with what was said by Dr. Posen and Prof. Wakatabe on some points. First of all, they refer to the so-called "net debt." Well, yes the Government of Japan holds the JGBs, but they are earmarked for committed expenditures in the future, such as private pension payments. So I do not think that the distinction between net and gross argument makes much sense, in the case of Japan's public debt.

The second is on the experience of 1997. Concerning consumption tax, frankly I do not know what kind of economics or data support the proposition that repeating 1997 is a very bad mistake and induces volatility. The year 1997 was a very bad year for Japan, and we had a very serious financial crisis in the fall. If you remember, we had the Asian currency crisis, and Japan's exports fell. If we naively look at the data, fixed investment and exports declined very sharply. Consumption tax is of course directly related to consumption for obvious reasons. On the whole, the effects of a decline in consumption are much smaller than those of a fixed investment and exports. So my view is that we have to raise consumption tax unless we face a very unusual crisis or something. As far as normal cyclical ups and downs are concerned, we better ignore them and go ahead with raising consumption tax. That is my view.

Finally, let me show you one more figure concerning Japan's deficits. Some say that we have deficits but deficits are caused by decreased tax revenues, which are in turn caused by slow growth. This is sort of a decomposition of an increase in debt outstanding from 1990 to the year 2013. Broadly, the left-hand side is the contribution of expenditures and the right-hand side is the effect of revenues. Yes, tax revenues declined. By the way, that is not wholly due to recession, because during the period the government lowered the tax rates at various points, you can see that the increase in expenditures contributed to deficits. What kind of expenditures? For the last 10 or 15 years social security-related expenditures., Every year, this component increases by 1 trillion yen, because of aging. In short, the deficits are just structural and we lack tax revenues. So it is really necessary for Japan to raise VAT from 5% to 10%.

Finally, the third arrow, which is actually my favorite. In Japan, perhaps the most serious source of pessimism is demography; the population is declining. But I would like to point out that in an advanced economy, population and growth are different things. I certainly think that the declining population is not a good thing, and that we would like to have mild population growth. But that is one thing. Economic growth is another, because in an advanced economy the growth is chiefly brought about by an increase in per-capita income.

The problem of Japan is the behavior of corporate firms, which I think Prof. Itoh referred to and discussed. This is the net lending / net borrowing by sector. Normally, the household sector saves and the corporate sector borrows. But here in Japan, the corporations have been net savers, which is almost weird. This is the problem. I am expecting that the third arrow of Abenomics can change this state of affairs.

Thank you.

Prof. Iwata: Thank you very much, Prof. Yoshikawa.

Then we are going to discuss the points that were raised by this first presentation. But today, Prof. Motoshige Itoh should leave earlier, and maybe it is a good thing to start with this fiscal issue, that final point that you mentioned. So please start off.

Dr. Itoh: Thank you very much. I have to apologize that I have to leave earlier. I would just like to make a comment about the comparison of 1997 and the present, and that is very much related to the consumption tax increase. There is a considerable difference between 1997 and now. As you know, in 1997 we had a very significant problem in the banking sector, a huge amount of debt of the corporate sector and so on and so forth. The collapse of the Japanese economy may be partially due to the decline, but more importantly the financial crisis.

Now, what happened now? As I said before, we have a very good-shaped balance sheet of the financial institutions and the private sector. Unfortunately we have a very bad-shaped balance sheet of the government. So the largest risk from the expectation is not by the private sector, but more by the public sector. So I think that the credibility as Dr. Posen just mentioned is very important. And the Japanese government has promised to decrease the primary balance by 2015 for many years, and increasing consumption tax is necessary for that kind of process. So I think that some kind of adjustment has to be made as Dr. Posen mentioned for the smooth transition. But this is a very important issue.

The second thing that I would like to emphasize is that when we are talking about fiscal consolidation we have to be very sophisticated. We have to talk about fiscal consolidation in the next two years and we have to discuss about fiscal consolidation for an economy like Japan, that is continuing aging. These two issues are very different. The issue of consumption tax increases now and the issue of the shrinking budget deficit by 2015 are something like short-term or mid-term issues. But everybody knows that we are having a more and more difficult situation in the future because aging is just continuing. That is a more time-consuming process; we have to work very carefully about social security reform; we have to maybe rethink about additional tax increase in the future. That is what we should discuss now, but not to be implemented tomorrow.

But the important thing is that unless we lose the confidence of the market, Japan is not going to be in good shape in five or 10 years, then the market will attack.

I will just give one very interesting episode. One year ago I had a very interesting discussion with a politician in Italy. Italy was in a very difficult financial crisis at that time. So as a greeting, I said that I felt very sorry for your situation in government. And what he said was, “you are not the right person to say that.” He said that Japan should do their own business and Italy will do their own business. He said that the debt of the government of Italy over GDP is about 125%, while our debt is more than 200%. So he implicitly implied that Japan is in a worse situation. I did not respond to this point, but one thing I would like to say is that Italy had a problem of fiscal crisis even at 125%. We do not have any fiscal crisis even at 200%. So the size of the debt is not important. What is important is will the market believe that your country or their country will believe in consolidating fiscal policy?

So the immediate discussion and very good plan of the future fiscal consolidation is very important. But do not look only at the size of the debt.

Unfortunately, at this point I have to leave. Thank you very much.

Prof. Iwata: Yes, on this point, thank you very much.

Then, Dr. Posen.

Dr. Posen: Thank you, Prof. Itoh and thank you Prof. Iwata. I want to pick up very briefly on Prof. Yoshikawa’s last chart, the demographics chart. I just want to strongly back his statement that demographics is not destiny. There is a tendency in the Japanese debate and increasingly in the US debate, particularly from those who want to provoke a fiscal crisis, to say that once the demographic is hit there is nothing you can do about it. Similarly, when BOJ was trying to make reasons for why it was not doing anything, specific people at BOJ who are known well to you all would come up with arguments that the deflation was a demographic problem not a monetary problem, which was always absurd.

So I think it is one more piece of the confidence and sense puzzle with Abenomics to say that yes, we want a welfare state and public investment that supports our older people in Japan, but not to do the scaremongering about demographics. So I comment Prof. Yoshikawa for putting that in and I hope that is an additional message we take away from today.

Prof. Iwata: Okay, thank you very much.

Then, other issues I identified in this session, one of the issues is the fiscal consolidation problem. Dr. Posen proposed a kind of temporary shock-absorbing measures if the consumption tax rate proceeds as planned. On these shock-absorbing measures our center made a proposal last October. We argued that it is a good thing to provide compensatory measures like the corporate tax rate reduction, because after 11 March a special tax has been imposed on the corporate sector of 3% and also on the household secter these are additional reconstruction taxes imposed. Our center made the proposal that in order to mitigate the contraction effect that could arise from the consumption tax rate increase, it is a good thing to remove this special construction tax a little bit earlier, and implement it in fiscal 2014. Other measures we propose are the removal of the special automobile tax. The government announced some reduction of automobile tax but still it is a good thing to remove this entirely. The time of increase of consumption tax rate, therefore my position on this consumption tax rate hike issue: it is a good thing to go with this planned consumption tax rate hike but it is needed to compensate for the damping effect arising from the consumption tax rate.

On this issue, Prof. Yoshikawa may be closest to my position, or if you have any other suggestions, or Prof. Wakatabe, please.

Dr. Yoshikawa: May I make sure that when the VAT consumption tax rate is raised, always before that consumption increases and after that consumption declines, so that the short-term volatility of consumption necessarily increases. So are you suggesting that we should smooth out this short run volatility?

Prof. Iwata: Yes, this is my view, but I want to hear your view.

Dr. Yoshikawa: Well if possible, we should try. I understand that the major component is residential construction, so that the government is thinking of some sort of measure to smooth out this residential construction. That may make sense.

Prof. Iwata: Okay, I understand. Already such kinds of shock absorbing measures were adopted by the government.

So, Prof. Wakatabe next, please. Ah, okay, next.

Dr. Wakatabe: Just briefly, I think that Prof. Itoh who has just left talked about the European fiscal situation, but I think that is kind of misleading to apply that to Japan, precisely because we have monetary policy independence. European countries are having a fiscal crisis because they are in the Eurozone area, so they had no other choice but to deal with that crisis. But again, in Japan we are sort of in the recovery phase, so I am not quite sure that the consumption tax hike right now is a good move. So I strongly support some kind of countermeasures.

One more thing: as I said, I come from a history background so I do not really come up with a historical example in which the country is in a deflationary phase and tried to consolidate fiscally and succeeded. So I think that history will tell us that we should not pursue the precarious course of action. Thank you.

Prof. Iwata: Okay, thank you very much. And given the limited time, we have about 20 minutes and I find it a good thing to have the questions or comments from the floor. Now we will open the discussion to the floor. Please raise your hand.

So, Prof. Stiglitz.

Dr. Stiglitz: A couple of comments on several of the presentations. First, I think there has been a little bit too much emphasis on the role of expectations as a driver of the mechanism of monetary policy. To the extent that you think intertemporal prices are important, Adam's point about a temporary investment tax credit or something like that is really a much more effective instrument, because it changes the relative prices of investing today versus investing tomorrow, and it is likely to be a much more effective instrument.

I think the point is that the macro-economic effects of imposing most kinds of tax is it is going to be deflationary, so it is important to have some offsetting measures. But it is also important to think about how different taxes have different aggregate effects and other effects. The consumption tax is a regressive tax. I think it is basically a bad tax. There are better ways of raising revenue; we talked about them yesterday, for instance environmental taxes, and carbon taxes. The advantage of a carbon tax is that it simultaneously incentivizes investment, because it means that you need to have new kinds of capital goods reflecting the change in relative prices of energy-intensive and carbon-intensive goods. So it is actually an example of a tax that stimulates the economy, provided you have an adequate flow of tax.

The second point I wanted to make is a little bit of disagreement with Prof. Wakatabe. I think industrial policies have often worked. In fact, there is no successful country in which there has not been a good industrial policy and Japan is one example. In the United States the Internet, which is the major source of stimulation into the last century was a government-sponsored activity. Biotech is a government-sponsored sector. We had bad industrial policy—poorly designed bankruptcy law and a tax law to encourage the financial sector—that was a kind of industrial policy that was flawed. So I agree with you that one has to do it carefully, but there is no successful country large or small that has not used industrial policy. Norway is using it very effectively to diversify out of oil; it is the one successful resource-rich country that has not been afflicted by the resource curse.

In terms of your two approaches, market enhancing or government led, I do not think there is a choice; I think you want to do both, and I think your comment that one wants to be careful about deregulation is important.

My final comment very briefly is that as I said, I think it is understandable that one wants to have some degree of fiscal consolidation; how you offset the inflationary effects. A corporate tax cut is exasperating the distribution issues. The corporations are sitting on huge amounts of money. It is not a lack of money that is causing them not to invest, and a change by one or two percentage points is not going to induce them to do anything. An investment tax credit might.

But the broader framework is I think some of the additional revenue that you could get from an environmental tax ought to be spent, because there is a basic principle of a balanced budget multiplier, and a well-designed balanced budget multiplier can be very large. You need to stimulate the economy; Jeff pointed out yesterday that you have a very low tax-to-GDP ratio, so there are effective ways of increasing the taxes, accompanying them by some additional spending that would stimulate the economy, and spending with investment tax credit would not just be in the government sector; it would be in the private sector.

Prof. Iwata: Thank you very much. We will first accumulate the comments and questions from the floor. Please, Prof. Sachs and then Prof. Cooper.

Dr. Sachs: I would like the panel to clarify a little bit more what they think the economic crisis is here. And the reason I say this is this is not simply a standard macro-economic decline or depression by normal definitions. The unemployment rate is low; the employment ratio for men is quite high, much higher than the United States. The unemployment rate is lower than the United States. According to the IMF data that I was just looking at, the output gap is very small. So at least as estimated by the IMF there is no apparent output gap; it is 2%, whereas in the United States it is 4.3%. The current dollar GNP per capita is almost identical in the United States and Japan, although in purchasing power Japan is about three fourths of the US level. But I am not sure that I believe those numbers also because there are so many flaws and assumptions in the PPP adjustments.

On many indicators, life expectancy for example, Japan is number one in the world. On happiness Japan is way down in the world, so whether that is long-term culture or real crisis, Japan ranks quite low in life satisfaction.

But I am not sure that I really know about what you feel or what I should feel about the crisis. There are a couple of things that are clear, which is that the growth rate of the economy has been low for 20 years. I am not sure whether that is structural or really macro-economic; that was a point that I was asking yesterday. Are you sure that is a matter of macro-economic management versus more fundamental factors. Maybe fundamental factors that could be overcome by the third arrow, but it is not to my mind obvious that the 20 years of low growth is a reflection of what we would call short-term macroeconomic phenomena versus long-term issues that we have not really talked about. It is clear that the budget deficit is very large and the public debt is very large. Although it is not clear to me how large the net debt is, because net debt is obviously a contested measure here. I do not know whether it is 120% or 150% or 180%, it is large.

So I am quite sure of two things. One is that the growth rate is low and that that the debt ratio is high. It seems to me clear that this is not simply a standard downturn with large excess capacity, except if you talk about cultural factors of women's participation, but I would not call that a cyclical phenomenon. That is an important issue, but not of the normal macro-economic business cycle variety. On many, many indicators, Japan is a very advanced high-technology society where the consumption levels in real terms of technology, Internet, mobile, health and life expectancy are at the top of the chart.

So my question—and it is not meant to just be provocative, what is the crisis here that we are trying to solve right now? I am quite sure I like easy monetary policy here, but that is for a lot of reasons that I think are somewhat indisputable. But I do not really understand what the assumed macro-economic crisis is, other than what I regard as a too-casual assumption also made in the United States and elsewhere that we know how to make economic growth faster or slower, and that we really think we control a 20-year growth rate, which I do not believe we really do. I think these are deeper, more structural phenomena than simply levers that one pulls in one direction or another.

Prof. Iwata: Please go ahead, Prof. Cooper.

Dr. Cooper: I have actually shared Jeff Sachs' puzzle, but I am not going to pursue that. I am going to pick up a statement by Adam Posen that demography is not destiny, which I agree with strongly, but I also think that the economics profession—and here I am talking about American graduate students—pay much too little attention to demography, not too much.

So I would like to ask a very concrete question. As Jeff has said and we all know, life expectancy has grown not only in Japan, but almost everywhere. When US social security was introduced in 1936, life expectancy of a white male at birth was 65 years of age, the retirement age for social security. It was actuarially speaking, a widows' pension. Now, life expectancy is 78 years in the United States for a white male, even higher in Japan.

So my question concerns the retirement age. We enter the labor force later because of more education. We live longer, we live longer more healthily, and the retirement age is stuck on historical grounds. So my question is, is raising the retirement age under active consideration in Japan? If not, why not? If so, why has it not already been done, and what are the obstacles to it? And from the point of view of fiscal consolidation, how much difference would it make? If you look at the last 50 years in Japan, it would be warranted to raise the retirement age two years per decade. And if one did that, between now and 2050, how much of a budget difference would that make, both in terms of the earnings that would be paid in and the deferral of pensions? It is a very concrete, very operational question.

Prof. Iwata: Okay, thank you very much. Prof. Hamada has comments, please.

Dr. Hamada: Along with Governor Masaaki Shirakawa, Hiroshi Yoshikawa was one of my best students I taught at the University of Tokyo. I boldly assigned T. C. Koopmans' "Three essays on economic science." to freshmen or sophomore in the class he attended. I thought the article with hardly any mathematics was easy. It turned out to be an ordeal. Mr. Yoshikawa was among the very few of course, maybe the only one who survived. However, I also taught them independence of thinking. You can object to teachers as much as possible. So I have to debate seriously now with my former brilliant student.

Just one correction about a comment on Jim Tobin's expectation view; I have a completely different experience. When I was assigned a term paper in his monetary course, that I chose "expectations" as the topic. He let me write a letter to psychologist George Katona at University of Michigan, and Prof. Katona kindly sent me his hand-written data set to guide my research. So I think Prof. Tobin was also considering forward-looking things very important.

Another comment on the effectiveness of the first arrow. A few days ago, ESRI published local economic indicators, and I will probably be able to show you in the discussion session all districts have improvement in employment figures. So why Mr. Yoshikawa, do you bring monetary policy as something harmful or ineffective? If employment improves, why do you want to blame the first arrow?

Prof. Iwata: Thank you very much. Given limited time—we have only one minute remaining—there have been some concrete questions by Prof. Stiglitz on Prof. Wakatabe's remark and also several comments from the floor on the expectation of inflation and expected growth on real income activity. Actual policy recommendations made were for instance to utilize more carbon tax or the investment tax credit to raise the inflation rate, and not necessarily by monetary policy. So very interesting comments are coming.

Already, time has come, but maybe a few remarks by panelists, if you want to make on these three or four points, as you like. Please, President Umetani.

Mr. Umetani: Let me say some words on the opinions. As for the expectation, we studied in our paper, and showed an improvement in consumer confidence will have a positive effect on private consumption. This is just because their income growth expectation will be realized in the actual wage increase. So that is the necessary condition. As long as their actual wages will increase, that is preceded by the expectation of income growth. That is a good thing for the effect on the actual economy.

Prof. Cooper mentioned about the retirement age, and now in the Japanese system the retirement age is shifting from 60 to 65. But there must be many efforts to accommodate such a retirement age extension. So the Japanese companies and Japanese government are now carrying out your statement.

Prof. Iwata: Thank you. Then, Dr. Posen.

Dr. Posen: So much to talk about, so two things, one quick and one slightly less quick.

Joe is absolutely right about carbon taxes and I am shamefaced that I was not pushing that; it was just a failure of imagination on my part. That is where we should be going, and that is what I have advocated for the United States, but within the current policy options considered I went with investment.

Jeff's much more trouble question, although he is not the only one to ask it, is what is the crisis? I would make three points. The first is that I think we have all become shell-shocked too much with the word "crisis" and it is okay to say an economy and a society can improve itself even if there is not a crisis. But we are being somewhat disingenuous here, because if you walked around Japan over much of the last five to seven years—and I hope that my Japanese friends will forgive me for being arrogant enough to say this—you felt a real stagnation of the spirit. There was a malaise, to use the old Carter phrase. And it was very palpable in opinion data, in writing, in the availability of opportunities for younger people. And again we have got to get rid of the disingenuousness, a very real feeling of Japan being passed over and threatened by the US-China relationship, and Japan reasonably in its own enlightened self interest wanting to have a stronger role in that aspect of global affairs.

And so when you say, what is the crisis, it is not an overt economic crisis as was 1998; it is a different kind of crisis or a different kind of problem, and I think it is entirely legitimate for a democratic society. I know that you are not disagreeing with this, to say that we want to deal with that.

The second point. I hesitate to accuse anyone such as you of *post hoc ergo propter hoc* thinking, but this has been the recurrent problem of Japan analysis, particularly by the IMF, the OECD, and occasionally in the past although thankfully not now by the Cabinet Office, which is that if growth has been slow, whether by statistical method or by assumption, we must assume that that is the trend. And I defer to my colleague the historian here, but this so-called lost two decades is really four periods in Japan. You have the boom and the bust of the bubble, and there had to be some recession after that. Then you had five years in which they pursued very poor macro policies and ignored the banking system problems and threw the economy back into recession. Then you had five to seven years, depending on how you count it, of recovery, where Japan was growing at a per-capita growth rate that was, as you imply and point out, as good or comparable to everybody else in the G7 and everybody else in the rich countries. And clearly was productivity-driven, because it was certainly not workforce growth.

Then I do not want to get into DPJ versus LDP, but you do have a sense that now they blew it again in the last few years. So I completely agree with you, there are long-term institutional and technological factors that are not driven by macro policy. But these output gap estimates that IMF and others put out really do not capture what has happened here, and understate the potential of the Japanese economy in my opinion.

Prof. Iwata: Okay, then Prof. Yoshikawa.

Dr. Yoshikawa: Well, I would like to respond to Prof. Sachs' question. I do not think that we are in panic or crisis at all. And in fact, I do not think it is appropriate to use the term "the lost two decades." The first half and the second half were very different. The bubble burst in 1991 to 1992, and then we had a very serious problem, as you know, which was a banking problem, bad loan problem. That is one period. As I said, that was over in May 2003. That was a sort of regime shift, so to speak. Before and after May 2003 are completely different; that is my view.

After 2003, we had four or five very decent years. In real terms there was 2% growth. Then came the Lehman Brothers Shock, the World Financial Crisis. That was the exogenous shock on the part of Japan. You remember that we had March 2011. Many things happened. People take it for granted that the growth rate of Japan is very low. But when we look at 2000's and we take into account the effects of the World Financial Crisis and March 11, I would not say that is fine, but it is a reasonable record. That is what I want to say.

But still, as Dr. Posen said, there is a widespread sense of pessimism or stagnation. First, that is demography, and I made a comment on it myself before. The second is change in the labor market: wages and employment. Prof. Sachs rightly pointed out that the unemployment rate in Japan is very low compared to other advanced countries. And yet, in Japan the share of casual or part time workers was one sixth 30 years ago, but now it is more than one third. Some of them are voluntary I am sure, but many others are involuntary. And of course they are young people, naturally. And stagnation of wages.The problem is basically distributional. I show that corporations have ample cash while wages are declining.

So wages and quality of employment are deteriorating. So it is natural that among young people there is a widespread sense of stagnation and pessimism.

Prof. Iwata: Okay, thank you. Then finally, Prof. Wakatabe.

Dr. Wakatabe: Okay. Thank you for your comments, Prof. Stiglitz. Briefly, I emphasized lowering real interest rate because that would explain the current situation better than other explanations. Also, for other measures of taxes, I think you are quite right that we have to think about carbon tax and so on and so forth. But I did not cover that part.

In regard to industry policy, I said that industry policy rarely works; I did not say it never works. But as far as I know, the so-called Japanese experience has been examined by many scholars, and nowadays we have a kind of academic consensus that the Japanese case is no longer the typical success story. Even for the South Korean case there are some questions. Also, as for the American case, you might have picked up some effects from the R&D spending rather than the specific industrial policy. So that usually is heavily dependent on R&D spending. You put a lot of money on R&D spending and that has some spillover effects. That might be the case. We can discuss later.

About the definition of economic crisis, I think that is quite an important point. But I will point out just two things. One is that we might have some survivor bias, because with the rising unemployment rate, the suicide rate in Japan has increased. In a sense we are surviving the deflationary and low growth situation, so we tend to think that things are not that bad, but I think there are many so-called human casualties. This is one point.

The second point is the sustainability of this situation. We cannot go on forever, and I think the good institution we used to have and we are still kind of having is being eroded. So we see a rise in poverty among children and rising problems in the social sphere. I would say that this may not be the stark crisis but it is more like killing us slowly.

So I think that what Abenomics is trying to accomplish is to change the scenery completely. And we can get to a normally-functioning economy. I think we are going to face many structural issues down the road, no doubt, but at least we do not have a problem arising from deflation.

Prof Iwata: Let me make my final remarks. In response to the question posed by Prof. Cooper on the late retirement, our center made a proposal in January this year. The first one is to stop the declining tendency of the population. The other is higher participation rate of women. And the third is to facilitate the elderly to work until the age of 70. In addition, it may be desirable to have larger scale immigration. In the year 2050 it is a good thing to have maybe 20 million every year. That kind of change is needed. This is a smaller size than the Meiji Restoration; at that time we had more than 30 million. I think not only from the economic perspective, but to maintain the position as a first-tier nation in the world economy, I find that it is a good thing to have a national goal on population and also the maintenance of working-age population from the long-term perspective.

Having said this, I adjourn this session. Thank you very much for your active participation.

Session 4: Spillover Effects of Economic Policies

Moderator : Atsushi Seike (ESRI)

Reporters : Takatoshi Ito (University of Tokyo)
André Sapir (Bruegel/Free University of Brussels)

Commentators : Sahoko Kaji (Keio University)
Chalongphob Sussangkarn (Thailand DevelopmentResearch Institute)

Dr. Atsushi Seike, Honorary President, ESRI: Thank you very much for your kind introduction. I am the President of Keio University, which happens to be located just a few blocks away from here but, as mentioned in my introduction I am also serving as the Honorary President of ESRI of the Cabinet Office. In this capacity, it is my great honor and pleasure to be able to play a role as a moderator in this session.

So, good afternoon ladies and gentlemen. Yes, this is an afternoon session and I know that you had a pretty good lunchtime so I can see many of you feel a little bit sleepy. However, do not worry. We have very strong speakers and discussants in this session who will open your eyes. So without further ado, let me introduce our first speaker.

Our first speaker is Dr. Ito. The title of his presentation is "War and Peace among Currencies: Spillover of Monetary Policy in the age of Quantitative Easing." It is a stimulating title, is it not? So, Prof. Ito, please.

Dr. Takatoshi Ito, Professor, University of Tokyo: Good afternoon. Let me start with the currency wars, which was coined by Finance Minister Mantega of Brazil. It was in the context of the US QE2, and he was complaining that those QEs from advanced countries caused capital flows from those advanced countries to emerging market economies, appreciating the currency and making their industries suffer. So he was complaining to the US, the UK and Eurozone QE policies.

At that time, the Japanese yen was appreciating, so Japan was not part of the war in Mantega's words. Then when Mr. Abe became prime minister and the yen started to appreciate, there was some talk about whether this policy, so-called Abenomics, is an act of the currency war. So that is the main question that I am going to ask.

The first point is that in any macro-economic model, monetary easing would produce currency depreciation. Large countries tightening monetary policy means that interest rates go up and currency will appreciate. A large country adopting monetary easing, lowering the interest rate causes the currency to depreciate. That is the textbook classic macro-economic reaction. So why should that be a problem? If that is a problem then you cannot make any monetary policy at all. That is the first point.

The second point is, is there any difference between the interest rate change and the quantitative easing? Because this word came when the QE was being adopted. So maybe the interest rate change may be more natural, but QE is a more unnatural policy action. Also, QE by one country like the United States may prompt QE of the Bank of England (BOE), may produce others to counter by other QEs, like the beggar-thy-neighbor policy of the 1930s, and that is a bad thing.

This is the yen/dollar exchange rate, and Abenomics effects. The turning point was 16 November. That was the time that the Lower House was dissolved, so the market suddenly found out that there would be a change in the government and probably the LDP will win, and Mr. Abe, the leader of the LDP, would become prime minister. So this is the starting point of Abenomics. He was very forceful in arguing that BOJ had to change; BOJ should adopt 2% inflation targeting. Here, the expectation of regime change already moved the market and yen started to depreciate and go through the actual adoption of the inflation targeting in January. And as Mr. Abe said, he appointed the inflation targeter Gov. Kuroda on 20 March, and Gov. Kuroda came out with a strong “quantitative and qualitative easing,” or QQE, as Mr. Nakaso mentioned this morning, on 4 April. So a series of events, which started with expectations on 16 November, has driven the yen depreciation. So I would say that yen depreciation during this period is a combination of a correction of overvaluation, on which I will elaborate a little bit later, and expectation of further monetary easing.

Yen was overvalued up until 16 November last year and the International Monetary Fund (IMF) did say that the yen was slightly overvalued. The reason for this overvaluation was that after the Lehman Brothers shock the yen was a currency, which appreciated, and after that Europe prices further made the yen appreciate, and some say it is the safe haven effect. Then tsunami and nuclear accidents caused Japan to import a lot of fossil fuels, natural gas, and that resulted in a trade deficit. So even the fundamentals would say that the yen should depreciate. So it was not really surprising that the yen started to depreciate. The US economy showed strength in recovery, so they had talk of an exit and that also appreciated the US dollar, which means depreciation of the Japanese yen.

So I think that this correction of overvaluation is a big part of the Abenomics yen depreciation. But of course, the expectation of further monetary easing was also in play, and one by one those expectations were realized, and we are here at around 100 yen per dollar. From here on, I am not sure how much is the remaining expectation to be realized.

The movement of stock prices are very similar. On 16 November, the day that the market realized that there will be a general election, stock prices started to go up. There is a good reason that yen depreciation or correction of overvaluation has an effect on the exporters' stock prices, but also there was a strong reaction across the board in stock prices, exporters, housing, real estate, they all appreciated in their values. So this is also not so much surprising. But I think the speed was a little bit surprising—how fast the stock prices have been going up.

Now going back to the assertion that this is a correction of the overvaluation. These are the central bank balance sheet for four major banks. In the fall of 2008, when Lehman Brothers collapsed and the global financial system was on the brink of an abyss, the three major central banks that had systemic financial problems expanded the balance sheet, purchasing assets right and left. The result was that their balance sheets doubled and tripled within a few months. BOJ did nothing. So the balance sheet is, as you see, flat. This means that the euro, pound and dollar will depreciate vis-à-vis Japanese yen, no surprise. Come 2013 and the regime change, Mr. Kuroda and his team announced that the balance sheet will be doubled; the monetary base, to be precise, will be doubled in two years. That is what QQE means in terms of the balance sheet of BOJ. So it catches up at least to the European Central Bank (ECB) and maybe closer to the Federal Reserve (FRB). If the FRB, BOE and ECB are said to have acted like currency wars, then Japan did not go into the currency wars and lost. But four years later, here comes BOJ and tries to do the same thing as ECB, FRB and BOE,—four years too late, maybe. So that is the picture that I want you to see.

This is the ratio of the balance sheets of the BOJ and FRB. This is the ratio of the monetary base of the BOJ and FRB in correlation with the yen/dollar rate. Some people call it a Soros Chart. But I see the clear correlation most of the times, except the so-called QE0 of BOJ, which is 2003 to 2006. Japan purchased a lot of short-term government bonds and they targeted the current account balance at BOJ. Did it depreciate the yen? Not much. The previous regime of BOJ would say that this is proof that QE does not work. I would say that the mistake was communication. So they enacted QE but they said that they were reluctantly doing so and they would take it off as soon as the inflation rate became positive. That is not a good message. So this shows a correlation of the balance sheet and the yen dollar rate, but it also shows how important the communication is, how important a forward-looking message is, and this time BOJ is doing the right thing and committing to QE into the future. This is a scatter diagram to show the same thing, the correlation upward sloping.

I think so far the arguments which I presented have been understood clearly among G7 and maybe most but not all of the G20 countries. I think the debate has subsided already. No complaints in G7 for example, but there are some noises in Korea and China, I understand. So let me show a graph of the won/yen, euro/yen and dollar/yen exchange rates. This is the bilateral, nominal exchange rate of the yen versus those three individual currencies. After the Lehman Shock, yen was a strong currency, a safe haven and a favored country to park an international portfolio. The Korean won is an emerging market, risky currency, so that people pulled funds out of. So the won depreciated and the yen appreciated. The ratio moved remarkably; it is like 60% won depreciation against the yen. That is big. That favored, no wonder, the Korean manufacturing industries which were in competition with the Japanese industries, namely electronics. So I usually do not have sympathy to industries that complain about the currency fluctuations but this time I have some sympathy to the Japanese electronics industry from this 60% currency movement within a few weeks. Won/yen is the most dramatic example of yen appreciation, which is putting hardship on the Japanese exporting industry. After four years the won has recovered a little bit and came down to what we were after Abenomics. Abenomics is just recovering to the pre-Lehman level, even if you look vis-à-vis US dollar, vis-à-vis euro and vis-à-vis Korean won. So this is just recovering to the level we were at.

So may the controversy of the currency wars rest in peace. Thank you.

Dr. Atsushi Seike, Honorary President, ESRI: Thank you very much Dr. Ito for your stimulating presentation.

Now I would like to invite Dr. Sapir to give the next presentation. The title of his presentation is "Spillover Effects of Economic Policies." I think this is the same title as the session. I expect he is going to talk about the European view on Abenomics. Dr. Sapir, the floor is yours.

Dr. André Sapir, Senior Fellow, Bruegel / Free University of Brussels: Thank you. Let me first thank the organizers for the kind invitation. I must say that I came here with some trepidation. And I think it is quite clear why from this morning's session, when Jeff Sachs and others asked why Abenomics? Why there was a sense that something drastic needed to be done?

I think we heard that the economy has been facing two lost decades; that there has been a lot of pessimism. We heard about the banking crisis from the 1990s. And those are all terms that resonated to the ear of a European, because that is where we are today. We are still in a banking crisis. And when we typically discuss Japan in Europe, it is as a fear that we may be repeating or may be in the midst of repeating the lost-decade experience. So, the real reason why I accepted to come to this conference is to understand more about Abenomics and really to try to understand what the lessons for Europe are.

Now, let me say that I do welcome the policy that was launched a few months ago and I do welcome all three of the arrows. Let me also say that, although like everyone else, one can see by looking at the number of indicators like the stock exchange, like others, that the policy that has been implemented since January this year—or one can go back a few months before, in terms of expectations—the first two arrows of the policy, the macro side, both the fiscal and the monetary side, seem to have delivered so far, what they could have delivered in five months.

I personally do very much look forward to the next step of the policy, to the structural measures. I heard Adam Posen this morning say that he was attaching most importance in the discussion on the fiscal. I must say I attach more importance on the structural. What I personally regard is that this has been a very shrewd policy, very shrewd both in economics and in political terms. But the real goal, I hope, is going to be on the structural measures, on the longer-term issues, on the growth policies, on productivity and other factors.

What has happened so far in the successful first five months has given the space both in economic terms and in political terms for the government then to move to the third arrow, and to start implementing structural measures. We know that there is no magic button. For monetary policy we know where the button is; that is relatively simple. For fiscal policy also we know, although one can discuss a little bit about how the button is, but we know where to look for the button and what to do. When we talk about growth policies, that is a much more complicated issue. None of us has really a magic button in their pocket. So we are still waiting for the government to announce the measures in June, and then we know that once the measures will have been decided and announced, they will take time not only to be implemented, but they will take time to produce results.

So my guess is that to make the next step of the assessment, it is not in five months that we are going to meet. Now we are taking stock of the first five months, and we can say, yes, things are on track. But I think the next time we meet, it is probably in one or two years, to see whether the second step, the third arrow, is starting to deliver. But as I said, it will take some time. This is what in a sense interests me from a European perspective, hoping that Japan is turning the corner on the lost decades and is showing the way of how one can recover with a mixture of macro and structural measures.

Now, this is the introduction. I think that Prof. Ito has laid the ground for me extremely well. As we discussed before, I think all presentations are rather complementary, and I want to look at what he discussed, and with which I agree, with the eyes of a European, and what it means for us. You said, Prof. Ito, that in the G7 and also in the G20 there has been broad support, and that is clear. The declarations that were done again in the G20 from the finance ministers when they met in Washington in April declared that Japan's recent policy actions are intended to stop deflation and support domestic demand. There have not been any negative elements there. I think that everybody understands that it is not healthy not only for Japan but for the world economy to have the third largest economy in the problems of deflation and low domestic demand that it has been in, with the result that there has been so much accumulation of debt. It is clear that the path that has been followed up and down over the last 10 to 20 years is not sustainable, and that it was time to take bold measures. So I think that the international community understands that very well, and in Europe as well. The new policy has been generally welcomed.

That does not mean that there are not some concerns, and the concerns do indeed circle around the issue of the exchange rate. Also, obviously one has to see that in Europe the economic situation is rather poor. We are in the 6^{th} quarter now of negative growth. Not strongly negative growth but negative growth nonetheless. The latest forecast is that the Euro area for 2013 will have negative growth of -0.4%. The EU as a whole will have negative growth of 0.1%. So we are in a sort of negative territory; as I said, not strongly negative but certainly our economic situation is not brilliant. Therefore what happens on the exchange rate is a matter than one is certainly being aware of, but so far certainly there is no worry.

You may also know that in March of this year, negotiations for a free trade agreement between Europe and Japan started. Not only there is the TPP; we had a discussion about the TPP and where Japan has also moved to participate, and I think one can discuss the plus and the minus of that. We in Europe are likely to launch with the United States a transatlantic negotiation. I have not been personally a strong supporter to say the least of this; I have been a doubter of the virtue of this, but there we are probably. Now we have this bilateral discussion between EU and Japan. I would have much preferred we do all of this in a multilateral manner than this bilateral, but I think we have to take that into account.

Now, looking from the viewpoint of Europe, what is it we have noticed about Abenomics? We have certainly noticed that the mood has changed, and again the observers in general have welcomed the change of mood in Japan. They have also noticed that the euro has appreciated against the yen, by the same extent as the dollar and other currencies. There has not been anything special. But if you look let us say from September—again, it depends a bit on which date you look against—when Mr. Abe became the leader of the opposition, I think one can look at that also as the start of Abenomics, it does not really matter, the euro has appreciated like the dollar about 30% against the yen. The general view in the IMF and in Europe also is that this has been a correction against previous appreciation of the yen, and I think that this view that was put forward is I think generally recognized by the international community, by the international institutions in Europe, to the extent that there is a discussion of that; I think that view is there as well.

So I think that is what has happened so far. The question is, what is coming next? I think one generally also hears on the part of Japanese economists including Prof. Iwata that a yen at about 100 yen to the dollar is about the right ballpark. I generally see in Europe currency strategists in private banks are predicting that the yen will be at 110 yen to the dollar by the end of this year. That is still I think within a reasonable range, one would say. The question is how far this will continue.

I noted in my paper, in my short contribution, that there have been two signs of a bit of worry. One is the one that was already indicated by Prof. Ito, it is in Asia. Certainly in Korea and I think in Taiwan, and maybe even a bit in China. And I think that this is something of relevance to Europe. So not only what is happening to Japan, but what is the evolution of currencies in Asia in general? And I think that is something that people will be watching.

Certainly one has already seen on the part of the US Treasury some declaration that the Treasury is monitoring closely what is happening in Japan, and the semi-annual document published by the Treasury that monitors exchange rate has declared, and I quote, "Japan's economic policies to ensure that it refrains from competitive valuation and it is targeting its exchange rate for competitive purposes." I have not heard anything of that nature yet in Europe, nor do we have a mechanism that is following exchange rate in this manner with a report that is published every six months. But I am sure that what is being done in the United States is being read also in Europe by authorities and by others. Those are all elements that contribute.

Now, on the part of official declarations, there has been little declaration about Abenomics. Only ECB and Mario Draghi the President of ECB has made some statements, and those statements have been positive statements, to the effect that indeed the monetary policy of BOJ is justified by domestic consideration, by deflation, and that it does not constitute in any manner a currency war. One does not read in the press or one does not read from the part of different interests so far a great deal of worry.

Now, if you look at the period from September of last year until now, if you look at the euro, the euro has appreciated by about 5% on an effective basis. So as I said, it appreciated by about 30% against the yen, but it depreciated a bit against the dollar, against the Chinese yuan and even against the Korean won, so all together it appreciated by 5%. That is also the result of the fact that now trade between the European Union and Japan has become relatively low. It is only about 3% to 4% of EU trade on both the export and import sides with Japan, much down from what it was in 2000 when Japan accounted for 9% of EU imports. So it has been a real reduction. Everybody can see that there has been a correction here, so at the moment there is not much worry.

I should add a footnote here. There has been mention of Korea, and Korea probably among the Asian countries is the one that has the product composition closest to Japan, and therefore the discussion. If you look in Europe, the country that has the closest product composition to Japan is Germany. Now, for Germany the euro is not strong. The euro is strong for a number of countries inside the euro area. So this is certainly a difficulty that we have at the moment with the euro area being divided into two groups. There are the core countries: Germany, the Benelux countries and Austria, which are doing relatively well. And then the peripheral countries, which are suffering very much, both in terms of competitiveness and in other aspects. For those countries, the euro is very strong, and already a few years ago they suffered very much from a strong euro. So it depends a bit on which countries you are looking at. But Germany, which is the country with a production and export structure closest to Japan, there is a bit of room there, and I think one is fine.

Now, let me come to an end. If I look at trade spillovers, I think we can for the moment be optimistic in Europe that the growth factor dominates the exchange rate depreciation. And as I said, Japan is the third largest economy in the world, and one should welcome the impetus that is being brought to this part of the world, which I think is good for Japan, for the world, and for Europe as a part of that. And perhaps also this free trade agreement between Japan and the European Union would help a little bit.

Now, when I look from a European perspective on this, I think it may well turn out that the biggest effect is really not on this kind of spillover, the trade spillover and the growth spillover, again because of the trade relationship not being so important at the moment between those two countries. I think that the more important spillover potentially is in terms of the policy experiment, and hoping that this policy experiment will indeed be a success.

But I repeat, for me this policy experiment is about the three arrows; not just the two arrows, and in particular what is going to come next in terms of the structural measures. I think that Europe needs to have something like what I am hoping will be successful here. That is, to have both macro-economic space being created in order to be able to implement structural measures. I think some are hoping that we will do the reverse. That countries will be able to implement structural measures in a period of austerity, and I think that is going to be prove extremely difficult and self-defeating. So that is why I am so much hoping that this will work, not just for your own sake, but for our own sake, and that there will be a demonstration effect. And the demonstration effect will be also not just in the three elements but in the sequencing of the elements. And for that, we will have to get back again as I say in a year or two years and make an assessment of how well the total package of the three arrows have delivered what they are supposed to deliver.

Thank you very much.

Dr. Seike: Thank you very much Dr. Sapir for your really insightful presentation.

We have listened two excellent presentations. I would now like to invite two distinguished discussants to give their comments on the presentations. The first discussant is Dr. Sahoko Kaji from Keio University. So, may I ask Dr. Kaji to start?

Dr. Sahoko Kaji, Professor, Department of Economics Graduate School of Economics, Keio University: Thank you, Mr. Chairman. I would also like to thank ESRI for giving me this opportunity. It is a pleasure and privilege to comment on these essays written by two of the economists I respect most.

A common theme that underlies both essays is that Abenomics has both costs and benefits, and our new policy is acceptable or at least comprehensible for the moment 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 United States 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 in Japan seemed unable or unwilling to do anything about this, and we were criticized, and we felt isolated.

Now, this is no longer the case, and there are two reasons. One is Abenomics, the topic of this conference. The other reason is the crises that happened on both sides of the Atlantic. We are no longer alone in our difficulties. In fact, Japan is the new normal. In terms of the perils of debt, population ageing and need for reform, the United States and Europe have essentially the same problems as we do. Events have proven that there was nothing unique about the Japanese economy; all economies come under the same fundamental economic logic. If the costs of borrowing are low, a bubble develops. After the bubble bursts, financial intermediation falters, government spending increases to sustain economic activity and shaky banks because you have to have capital injection. The result is a mutual dependence between governments and banks, which the European Banking Union is aiming to get rid of just now.

This slide shows you the euro and non-euro area bank holdings of own government debt. All the way to the right side we have Japan here as well. The next slide shows you the share of JGB shareholders. Famously, overseas investors hold only 9%, but this is high. It used to be 5%, and now it is up to 9%. Then among the Japanese financial institutions, this is the share held by each of them. But overall, we need to remember that financial intermediaries have 65% of the JGBs issued.

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 European Union, 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 foreigners. If foreign buyers do not make up for the decline in domestic JGB demand, or if they do but one day suddenly decide to dump JGBs, JGB prices could tumble. Obviously, this could have huge consequences.

Two, with inflation, or 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 stabilization can diminish the momentum for painful reforms. Reform, as we all know, is the third arrow in Abenomics that André was also talking about, but the need for reforms applies also to the United States and Europe. So finding and staying on the equilibrium path is not going to be easy.

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 just not going to be 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." And here, I would like to add something in response to Jeff's question this morning: what crisis? What is the crisis that we are having? In my humble opinion, Japan's crisis is about finding a new economic structure that allows more employment and investment. If my understanding is correct, the output gap is measured with the current economic structure as a given. But we need a new structure, so that we could be providing a higher supply of health care, child care, care for the elderly, smart electricity, smarter use of resources, so that such industries would become our main industries. This will solve the deflation and debt problem at the same time. Prices are dropping because we are not making the kinds of things that we actually want to buy. There is no effective demand because there is not even a market there for some of the things that we Japanese actually want to buy. So that is why reform is important.

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? Are we alone again?

André writes that "if, 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 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 than the United States 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 may be large enough to affect European economies.

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

I hastily conclude by listing some specific questions to the two speakers. First, to André I have three. One, what are the prospects of successfully concluding the EU-Japan EPA? For the Europeans, what are the “musts” that you need to have? Two, why has trade between Europe and Japan shrunk, as a proportion of total EU trade? I understand that EU trade would have gone down, but why has the proportion for Japan gone down since 2000? Three, 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?

And then to Ito-san, one, 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? Two, what should we be careful about when we exit from QE? Is there a danger that is specific to Japan? Every central bank is going to face danger in exiting from QE, but ours being QQE especially, what is the specific danger to us? Three, in your view, what is the state of the Japanese economy that we need to arrive at, in order for us to say that Abenomics was a success?

Thank you very much.

Dr. Seike: Thank you very much, Dr. Kaji for your inspiring comments.

The next distinguished discussant is Dr. Chalongphob from Thailand. So, Dr. Chalongphob, please.

Dr. Chalongphob Sussangkarn, Distinguished Fellow, Thailand Development Research Institute: Let me first of all thank ESRI for allowing me to participate in this conference with many distinguished scholars, policymakers and participants, and of course the chance yesterday to meet with and listen to Prime Minister Abe and Minister Amari. I will stick to the comments that were distributed with the conference package.

So let me start by saying that I am very impressed by the resoluteness of Prime Minister Abe in pushing for a new direction of economic policies for Japan, so called “Abenomics,” particularly the adoption of very strong monetary easing with the aim of achieving 2% inflation target in the medium term, and bringing Japan out of an extended period of deflation and stagnation. Having been Finance Minister of Thailand in the past, I know that such a change in direction takes very strong political will and strong sense of responsibility, particularly when there are diverse opinions about the consequences for the Japanese economy of such a change in policy direction.

Market reactions to Abenomics have been substantial, with large depreciation of the yen against all major global and regional currencies, and Japanese stock prices have risen by 40% to 50% since Prime Minister Abe took office. There seems to be a renewed confidence within Japan about prospects for the Japanese economy and first quarter GDP growth at an annualized rate of about 3.5% provides some evidence that growth is picking up. However, volatilities particularly in the stock and bond markets in the past week or so may be signs that things will not be all smooth sailing for Abenomics and the Japanese economy, and delicate policy navigations will be needed to weather potential episodes of financial market shocks and volatilities and take Japan back to a sustainable growth path.

Professor Ito's paper focuses on the yen depreciation in relation to possible accusations that Japan is engaging in currency manipulation or a currency war. My interpretation of his message is that the yen has been recovering from a period of post-Lehman Brothers strong yen appreciation during which Japan mostly stuck to conventional monetary policies while unconventional monetary policies were being pursued vigorously elsewhere. Figure three in Prof. Ito's paper showed that the BOJ's balance sheet had hardly increased since the start of the global financial crisis while those of US Federal Reserve, the ECB and the BOE have increased two to five times. The increased liquidity of the other major currencies contributed to large appreciations of the yen.

It seems to me that the pursuit of rather conventional policy also extends to Japan's exchange rate policy, where here "conventional" refers to little or no foreign exchange market intervention. Japan has intervened relatively little in the foreign exchange market since 2004. In contrast, many East Asian economies have actively intervened in the foreign exchange markets, both to prevent their currencies from strengthening too much and also to increase self insurance against rapid capital outflows such as occurred after the closure of Lehman Brothers. This can be seen in figure one in my paper, which shows the foreign reserves accumulation of Japan vis-à-vis China and the rest of East Asia.

In the past, I have asked Japanese officials and academics many times, particularly after the onset of the global financial crisis, why Japan kept sticking to very conventional, almost textbook like, monetary policies when most major countries of the world were resorting to unconventional policies. The impression I got, whether rightly or wrongly, was that there was a sense of pride for Japan, as a major global economy, to pursue conventional policies and set a good example for other economies. This is very commendable, but in a world where most other economies are rewriting the rulebook to justify unconventional policies as the new normal, rigidly sticking to conventional policies may bear very high costs. So Japan is now catching up with some of the unconventional policies that others have pioneered, as well spelt out by Professor Ito.

While most countries are grudgingly accepting that Japan is catching up to unconventional policies that others have been using before, and there have been expressions of understanding of Japan's situation and no outright condemnation at meetings such as the G7 or G20, there are obviously concerns about where things might be heading. Professor Sapir's paper summarized some of the European perspectives. The sense I got from his paper is that European policymakers are carefully monitoring the outcomes of Abenomics. As trade between the European Union and Japan is a rather small proportion of GDP, the yen depreciation is unlikely to have a large impact via relative trade shifts. However, a continuing trend of increasing liquidity of the US dollar and the yen could shift the burden to the euro, and this would have a much larger effect on the Eurozone. If the euro ends up appreciating significantly against other currencies, and if yen liquidity injection can lead to Japan's economic recovery, the Eurozone may have no choice but to follow suit. Would this then be a genuine global currency war?

Professor Sapir also raised the issue of at what level the yen might reach. This is obviously very important, as other countries might be able to accept a yen level of about 100 to 110 yen per US dollar as going back to the pre-unconventional monetary policy era. But if the yen went to 120, 130 or even 150 yen per US dollar, would this still be regarded as acceptable? It would be highly unlikely. An important issue is whether the Bank of Japan and the Ministry of Finance have sufficiently policy instruments to target particular ranges for the yen. This is not easy to do in the case of a major currency with huge amounts of market trades. Much depend on market expectation and also speculation, and managing market expectation and speculation is one of the most challenging tasks of monetary policy.

The yen depreciation and resulting stock market boom has benefited Japan's real economy through exports including tourism, and increased domestic consumption. On tourism, I understand that the flights between Thailand and Japan are now almost full every day, every flight. So many Thai tourists are coming for the bargain shopping that you can do now in Japan. And on this trip my wife and I have a long shopping list, so we are hoping to help contribute to reviving the Japanese economy as well.

Managing inflation expectation to the 2% target may boost domestic expenditure further. However, I still cannot rid my mind of a phrase that was drummed into me when studying economics many years ago that "there is no free lunch." May be in the modern world, lunch is freer, but I think there are still considerable challenges for managing Japan's monetary policy that need to be faced. One is the relationship between inflation expectation and long-term interest rates. If investors really believe in the 2% inflation target, and market reactions to Abenomics suggest that market participants believe in the credibility of the policy, then long-term rates, say on 10 year JGBs, may tend to rise near to the expected inflation. This will be a big jump compared to current levels. The market values of outstanding long-term bonds will decline substantially. What will happen to the holders of these bonds, particularly financial institutions? To keep yields down, BOJ may need to continue to buy more and more JGBs. But then how to keep the yen exchange rate in check and also make sure that inflation remains around the 2% level and not get out of hand? I am not saying that these challenges cannot be managed, but these problems need to be anticipated and appropriate institutional mechanisms—particularly between the Bank of Japan and the Ministry of Finance—put in place to monitor and react quickly to potential problems with appropriate policies. What I mean is really that you need operational institutions, mechanisms, that would operate on a daily basis, because markets are very volatile.

Finally, I just want to mention that monetary easing by the major economies of the world also leads to a lot of spillovers and policy challenges for emerging market economies, particular ones like my own country, Thailand, with relatively open capital accounts. Excess liquidity of the major international currencies lead to large and volatile capital flows to emerging markets to seek higher returns. Because of the relatively small size of emerging markets, moderate flows can lead to large swings in exchange rates and asset prices. Thailand has faced many episodes of large capital inflows, going back to well before unconventional monetary policy became fashionable, leading to excessive exchange rate appreciation with negative impacts on exports, and the past six months or so is another one of such episodes. There are many constraints on the central bank in managing such episodes. Exchange rate intervention and sterilization can lead to large losses for the central bank and can have fiscal implications. There can be vastly different points of views on the appropriate direction for interest rates, with open conflicts between various agencies. Many countries are still struggling with the most appropriate policy combinations to deal with these capital flows. It seems likely that unconventional policy measures on capital flows, or some form of capital controls, need to be part of the policy toolkit, but these need to be thought out and designed carefully. The Thai experience with capital controls that were introduced in December 2006 was not a good one. But more targeted capital control measures, such as those introduced by Hong Kong and Singapore several months ago to cool down the real estate market seemed to have worked.

So, this appears to be an age where unconventional policy measures in many areas are the new normal. This should raise a lot of questions for the more conventional economists to think about.

Thank you.

Dr. Seike: Thank you very much, Dr. Chalongphob for your very constructive comments.

So now we have heard from two excellent commentators, and I think that the speakers would like to reply to these comments. So, Dr. Ito would you like to reply first?

Dr. Ito: Yes, thank you. And thank you for excellent comments by Sahoko and Dr. Chalongphob. The theme of this session was spillovers, but I think the questions spill over to other questions. So let me start with my understanding of Abenomics. In that way I can answer most of the questions posed by the two discussants.

Everybody knows that Abenomics has three arrows. Employing three arrows, what does Abenomics try to achieve? It is a jump. It is a jump from a deflationary trap to a normal economy. So in economics terms it is a multiple-equilibria story. Deflation causes investment to go down because the real interest has to be positive, even if the nominal interest rate is zero. And consumption will go down because price is expected to drop, so the GDP gap remains large, which causes prices to decline and confirms the deflationary trap. To break this equilibrium, you need many things simultaneously applied to lift this deflationary-trapped economy to a normal economy. The first arrow is working on the expectation. The second arrow works directly onto the GDP gap, and the third arrow is for long-term potential, which makes the whole economy achieve higher economic growth.

Sahoko asked what is the state of the economy that Abenomics wants to lead to. That is a normal economy. So a normal economy with 2% economic growth, 2% inflation, and a long-term interest rate of 3% to 4%. So that is where Abenomics want to lead the Japanese economy to in maybe two to three years. This is a concerted effort of the package of economic policies, to lift the deflationary-trapped economy to a normal economy. That I think is very clear. The monetary policy, the first arrow, has made the environment of other policies to work. So answering Sahoko's first question, yes, this made breathing space for some industries, and you can apply the short term stimulus so that the economy actually gets out of deflation and starts to grow. And the third arrow will work in one year or so; it takes time for the growth policies to work. So by the time fiscal stimulus is withdrawn and consumption tax increases in April next year, the third arrow growth strategy will work in that investment and consumption will start to rise. So these three arrows are lined up for the reason that those growth policies will come in time, to replace the short-term fiscal stimulus. This way, you can jump from the deflationary-trapped economy to a normal economy. That is my understanding of Abenomics.

Sahoko asked the second question, is there any danger, any side effects of this QE, especially when QE has to find an exit? Well, if this scenario of a jump works, I think you can withdraw the QE slowly, and there are ways to exit slowly without selling massive JGBs. So I think that there is an exit. And the same thing goes for the Federal Reserve. So I think Ben Bernanke and Kuroda-san will have a lot to talk about and share their mutual experiences. And this time I think Kuroda-san can learn from Ben Bernanke's exit, which is probably a year or two earlier than BOJ. So there are dangers, but yes there is a way to avoid it. Maybe it is a narrow path, but I have full confidence in Prime Minister Abe and Governor Kuroda in that they can walk on this narrow path.

Dr. Chalongphob asked about the intervention policy. I think intervention works, but has also strong political costs from other G7 countries, so if you can do it without intervention then why not? My understanding is that every time Japan intervenes, Japan has to get at least tacit approval from Washington and Europe, and every time they give tacit approval they say that monetary easing should accompany intervention. So this time, monetary easing comes and has the desired effect, and you do not need intervention. So this proves that monetary easing is most potent as the intervention, and this time it worked.

Dr. Chalongphob asked what if the yen/dollar goes out of range, and is there any danger that financial markets go one way or the other to the level that may not be acceptable. I think there is a way to stop too much depreciation quite easily, which is intervention on the other side. Japan has huge foreign reserves, and using a little bit of it as a signal I think would work to stop too much depreciation, so I do not worry too much about depreciation. So keeping the yen/dollar rate in the band of what many consider equilibrium, that may be 100, plus/minus 5 or 10, but you can imagine that is a comfortable range. So we have corrected overvaluation, and there may be some room—maybe 110 or something. But I do not see any reason that it should go to 150 for example. So I do not worry about yen/dollar so much. And hopefully, as I mentioned, those three arrows will work and will make a jump possible from the deflationary trap to normal.

Thank you.

Dr. Seike: Thank you very much, Dr. Ito. So, how about Dr. Sapir?

Dr. Sapir: Yes, before I answer Sahoko's questions I want to comment on what was just said. As I said in my remarks, I very much agree with the sequencing of Abenomics; I think it is the right approach to do the macroeconomics first, create the right environment, and then move to the second gear. That being said, I must say I would have liked to hear a little bit more about the third arrow. Everybody is talking about the third arrow, but we have not seen anything yet. And again, the sequencing is right, I am not saying that it should have been done five months ago, I am not going back to that. But I would still like to hear a little bit more of what the next phase will consist of in concrete terms. So that is moremy question. I would not say it is a concern, but I think that one needs to fill the envelope with the elements, so that one can judge in deed. You say that you are fully confident that it will work fine, but I cannot say I am fully confident. Rather, I am fully hopeful. I can only be confident after I see the details and I hear the plan. So broadly, there is a nice sequencing and I support the sequencing, but we will need to judge not only on its implementation but also on the actual details of the plan, and maybe in the last session we will get a chance to get to the details. I very much look forward to it. Again, from the perspective of my European eyes I know that we have a lot of tasks in front of us, and I am quite keen to hear how you are going to approach this.

Now, about the specific questions. The first question was about the EPA, the bilateral free trade agreement, and what the prospects are. It is very hard to tell. All I can say I that we have now implemented for a year already the free trade agreement between the EU and Korea, and it went fairly smoothly—surprisingly, I must admit. I did not expect that. After the agreement had been signed and before it was ratified, there was—at least on the European side, I do not know what happened in Korea—some attempt to slow down the agreement on the part of Italian automakers, so there was fear about that. But that was the only issue, and that was a hurdle that was passed fairly easily, I must say. So when I look at the agreement between the European Union and Japan, at least from the European side I do not expect too many problems, at least as far as the usual topics are concerned: trade in goods and trade in services.

Regarding the EU-US Transatlantic Trade and Investment Partnership (TTIP), those agreements, which are probably going to be launched in June with the United States, are not really meant to dismantle the very low barriers that exist in trade and goods, obviously apart from agriculture, which is the sticky point. But it is meant to have, with the United States at least, an important regulatory side. I must say that there I do not think that is very credible. When I look at all the studies, that is where the big benefits would be, but I do not believe that we would make much progress, even with the United States. So I am not expecting too much of that either in the discussion with Japan. So it will be a traditional agreement on trade in goods and trade in services. We do not have too many barriers; there are some areas but it should not be too much of a problem.

Now, why has trade between the European Union and Japan shrunk? Looking from the EU side, what has certainly not shrunk is trade between the European Union and East Asia. It is Japan within that which has shrunk. And I think that there are different factors. One is the developments in the Japanese economy. But I suppose part of the trade with Japan now goes via other Asian countries and probably China is playing an important role. I do not have all of the numbers to look into this, but it would not be too hard to look into. So one would have to do the proper accounting of what in the trade between the European Union and Asia in general comes directly—that is easy to see—but also indirectly from Japan via other Asian economies. It is the trade between Europe and factory-Asia, and we have those numbers now thanks to the new studies in terms of value-added trade, so one can really look into this.

I cannot answer your question about portfolio investment I am afraid. I just do not know; I have not looked into this.

Dr. Seike: Thank you very much. Do the discussants have any counter reply? Yes, Dr. Chalongphob, please go ahead.

Dr. Chalongphob: Just to stress the point that I already made, achieving the monetary policy is possible but not easy. In the case of Japan, I think you need operational mechanisms, because it is like a war room. You are fighting against huge financial speculators around the world. And in the case of Japan it is even more complicated, because the policy on foreign reserves is with the Ministry of Finance and not with BOJ. So you really need to set up a mechanism between the two that monitors daily what is happening, and reacts. For example when there was a spike in the bond rate, because they had some guideline on how much to trade each day, they did not react.

In Thailand we also had a situation where the central bank had some guidelines on the maximum amount that they would like you to intervene per month, per week or whatever. But when there was a huge inflow, they therefore did not react sufficiently, and the exchange rate became stronger, and this led to even more speculation, because they could gain on the exchange rate too. So really, the operational mechanism is they key tool contributing to the success of the policy.

Dr. Seike: Okay, now how about Dr. Kaji?

Dr. Kaji: Thank you very much for your responses. If I may, I still have some additional questions about what Ito-san has said.

Also, André said that the sequencing is good and I would tend to agree with that; it is the right sequencing, we are giving ourselves time. But what kind of timeframe does Ito-san have in mind, I wonder? Because if we wait for another three to five years then it is going to be another "lost whatever" before we know it. So how long do we have to wait? In the meantime, peoples' lives will be changed and we will actually be affected by all of this. So I was wondering what kind of timeframe you had in mind. I do not want to put you on the spot, but this is just what I am genuinely wondering about.

Certainly because you are much more important than I am, you cannot afford to say this, but I personally still think—and this is a comment rather than a question—that the Japanese may yet lose the momentum for change. Because I cannot think of a reason why we would be wiser than the Italians and the Spanish and the Greeks and the Portuguese. They did not start changing until the thing basically blew up in their face and there was absolutely no other choice but to make some changes. And changes are taking place that would have been completely unthinkable. The way that the European Commission is now interfering in domestic policymaking is something that would have been even a complete joke even one year ago, but now that is actually happening. So that sort of deep and broad change occurs once a crisis occurs. So I have to say that I do not see any reason why the Japanese do not have to go through a similar one.

And Ito-san is saying no, no, no, so I am turning my comment into a question: why do you think that the Japanese will be wiser than the rest of the global citizens in managing to accept these painful changes that have to take place if the third arrow is going to be a success?

Dr. Seike: So, Dr. Ito, would you mind making it short?

Dr. Ito: Yes, I can spend another hour explaining the third arrow, but I think that is outside the mandate of the session. Chalongphob's question or advice I will take and tell Mr. Kuroda about it, but I am sure that he is fully prepared, as he was in charge of the interventions before and he is now at BOJ, so he is fully aware of both sides of the monetary policy and the intervention.

By the way, I think that his policy is for domestic purposes and not to manage exchange rates; so this is monetary policy.

Sahoko asked about time frames. I would say about three years to make a jump from the deflation-trapped economy to the normal economy. But it is not waiting three years; it is a process to get there. We already saw the growth rate of this first quarter to be 3.5%; that is quarter-to-quarter annualized growth rate. And the second quarter will be good.

Dr. Kaji: I am sorry, I really do not know if I should put you on the spot like this. But you are saying that within three years, Japan will have 2% growth, 2% inflation, and 3% to 4% long-term interest rate?

Dr. Ito: Yes.

Already the first arrow is working and we have seen the growth rate going up. The content will change from government stimulus and asset wealth effect to genuine investment and growth-oriented policies. So the composition of GDP growth will change from the first to second quarter of this year to the latter half and will go to the next year and the third year. So that is what the first, second and third arrows will produce. But we already see the fruits of the first arrow, and we will see the package effect in full force in three years.

Now, fiscal policy, the biggest difference between Japan and Greece is that the consumption tax, which is a value added tax, is 5% in Japan. We can imagine that it will go up to 25% in probably 10 years. In Greece, when they got into trouble it was already 19%; they had only 6% fiscal space up to 25%. 25% seems to be a maximum for VAT. So if we could increase overnight to 25%, we erase the entire fiscal deficit for this year. We would produce surplus. So we have the fiscal space. If anything happens, we can raise consumption tax and we do not need IMF or EU commission.

That is the reason why the market is calm. The market knows that there is an economic solution; it is only political that will avoid the crisis. We now already have legislation to go to the first step in the right direction, next April and October 2015.

Dr. Seike: Dr. Kaji, you have 30 seconds.

Dr. Kaji: Okay, I buy all of that and I agree with you. Which makes me even more worried that the Japanese would have less of a reason to go through these painful structural changes, which is why I would like to emphasize to André that we are counting on the Europeans to keep an eye on us through the EPA, so that we will make the necessary changes.

Dr. Ito: Prof. Kaji admires Europe somehow. But I think that the premise of Abenomics is that having first and second arrows succeed, there will be no relaxing to shoot the third arrow.

Dr. Seike: How about Dr. Sapir? No? So it seems that the time is almost up, but if I may I would like to extend the session time by ten minutes. We have five minutes to open the floor to questions and comments, so if you have any please raise your hand. Please identify yourself and to whom you are asking your question.

Prof. Shimizu: This is just a comment to everybody. Everybody seems to be interested in what happens next, but I believe that the next step has already started. I believe that stopping deflation has a huge impact, a bigger and more profound effect already to the economy. What happens when people believe deflation will stop? The biggest impact is—wage will not change immediately, but what happens first is an increase in profit. This is what the market expects. So that is why the stock price is going up. The future is already expected, and the market already believes in the future, and the near-future profit of the company will increase. That has already happened.

Then, what happens when the stock prices increase? This increase in stock prices increases the asset value a lot, and a big wealth effect, which is now already going on. Then the profit increase increases tax, because of the progressive tax system. Tax will go up more than the GDP rate. So the fiscal restructuring is already started. This is what the market tells you what is going on in the future. So we have to think about what is going on now. That shows what is going on in the future.

Dr. Seike: Thank you, Prof. Shimizu.

Are there any questions or comments? Prof. Stiglitz.

Dr. Stiglitz: I just want to ask a question of Prof. Ito. Assuming that in three years you succeed in getting the interest rates up to 3%. I am confident that the central bank and the government can handle this, but how do you think they ought to handle the problem of what happens to the value of the bonds in the banks? Even in the central bank, this is a problem I know we are facing in the United States, it has bought all of these long-term bonds at very low prices; and when the interest rate rises the price will fall and it will experience a very large capital loss. Now, it is going to try to pretend that it is not making that capital loss by—even though it insists that everyone else use mark-to-market accounting, it will not use mark-to-market accounting, and it will pretend that it has not had a loss. But everybody should know that there is a loss. And then the question is, what are the effects of that loss,in suppose in the private banking system and in the central bank?

Dr. Ito: The central bank has seigniorage profits, which in normal years is transferred to the fiscal authority, and when you make capital losses on the JGB holding, they can just reduce that seigniorage to the government to have the reserves for those losses.

Dr. Stiglitz: Yes, exactly. But that will mean in effect that in terms of the improvement in the balance sheet of the government, there is less of an improvement than actually—

Dr. Ito: But the government will have the higher tax revenues because the economy is doing well, so they can endure that capital loss on the central bank. The Japanese economic health is more important than balance sheet health of the central bank.

For the commercial banks it is worrisome, but the three megabanks have already taken actions. Their average maturity is around 2.5 years, so they can hold to maturity no problem. Some regional banks still have long bonds, and *shinkin* banks and credit corporates have long bonds. That is their managerial skills and responsibility of how they manage it. But the authorities may force some of the regional banks to merge or the *shinkin* banks to merge, but that is long-term structural reform, which is good. There is no systemic risk from those any way.

Thank you.

Dr. Seike: Okay, thank you very much. I am sorry, it seems that time is really running up. So in closing, once again I would like to extend my deepest appreciation to our marvelous speakers and discussants for their excellent contributions to this session. Thank you all very much.

Session 5: Panel Discussion "Toward Revitalization of the Japanese Economy"

Coordinator : Koichi Hamada (Special Advisor to the Cabinet)

Panelists : Richard Cooper (Harvard University)
Adam Posen (Peterson Institute for International Economics)
Jeffrey Sachs (Columbia University)
Joseph Stiglitz (Columbia University)
Heizo Takenaka (Keio University)

Dr. Koichi Hamada, Special Advisor to the Cabinet: Thank you. This is the last session of the conference and we will have free discussions about the questions surrounding Abenomics—what is its exact contents and its worldwide implications. I feel very happy because I am surrounded by former teachers, former colleagues, former students and former mentors. This session is a bit of a problem because Mr. Takenaka used to be my superior in the government, to whom I have to keep Japanese loyalty, according to our morale but I may probably not completely. Prof. Takenaka will give short remarks first about the present situation of the Abenomics policies, particularly the third arrow. Prof. Takenaka, please.

Dr. Heizo Takenaka, Professor, Keio University: Well, thank you very much for the very nice introduction, Prof. Hamada. And good afternoon, ladies and gentlemen. It is my great pleasure and great honor to be here with such distinguished panelists. I heard that you have been discussing a lot about Abenomics and in this session we are going to focus on the third arrow maybe: the growth strategy. But before that, I would like to remind you what happened in the Japanese economy ten years ago. At that time, in the year 2003 in May, I was in charge of disposable non-performing loans as the Minister for Financial Services. And in May 2003, I injected capital to Resona Bank and right after the capital injection the Japanese stock price started increasing dramatically. And the stock price in Tokyo increased by 50% in a year—in a year.

At this time, since the resolution of the Diet six months ago, the stock price once increased by 70% for six months. Of course now it is in the process of some more adjustment, but still, at this moment, compared with that of six months ago, Japan's stock price is higher than five or six months ago by 50%. Anyway, this is indicating some effectiveness, some impact has already been seen because of Abenomics. Of course, we should consider various kinds of indicators besides the stock price, but anyway the effectiveness of Abenomics is symbolized in the recent movement of the stock price.

However, now we have to discuss very seriously the so-called third arrow: the growth strategy. This finalized growth strategy will be published in about two weeks, so we are in the final stage of the discussions on that. Of course, I personally have been expecting a lot of good results of the discussion, but at the same time there are a lot of constraints. That is also true. I was in the position of macroeconomic management in the Cabinet Office from 2001 to 2005 for 4.5 years. At that time, when I was in charge of macroeconomic policy, I did not make any growth strategy. After I stepped down, every year a growth strategy was announced from the government—seven strategies for seven years. And after these strategies were announced, the growth rate declined. So this indicates that there is no magic way for the growth strategy. The basic structure of the strategy is that governments should provide more freedom to the business sector, try to reduce—not to increase—the burden in the form of tax or insurance. As you know, Prime Minister Abe established a new policy council by the name Industrial Competitiveness Council, and I am a member of that.

But there are two kinds of ideas, basically. One is, as I mentioned, the reform type of idea, that governments should provide more freedom to the private sector. Another one is that governments should provide more help in the form of grants, etc., or support to the private sector. The former is very typical reform—the economic reform type of idea. And the second type of idea is also very typical—the old-fashioned industrial policy type of idea.

I am sorry, this is sponsored by Cabinet Office bureaucrats, but bureaucrats have a tendency to prefer the second one. Of course in the council, I and Mr. Mikitani and Mr. Ninami are insisting the former. Of course, both are needed. I am a realist. I was in a real government position, so I am a realist. Both are needed. Still, the priority should be put on the first one. Very interestingly, there is a very informative indicator or ranking issued by the World Bank. This is about regulatory quality or regulation quality. Japan was ranked in the 40s in the year of 2000. Then, after that, in the Koizumi government, we tried to have deregulation. Then recently, Japan's status improved to 28th in 2006. In 2006, the Koizumi government ended and the first term of the Abe government started. But after that, the momentum of the reform declined a lot. Then, Japan was ranked 47th. So it is quite clear that more deregulation, regulatory reform is needed. But still, there is a lot of resistance, political resistance.

As time is limited, I would like to hurry up with my presentation. Actually, in the discussion, there is some important debate in this council. One is deregulation. There is a Deregulation Council or Committee (*kisei kaikaku iinkai*). Honestly speaking, the activity or performance of this council is not very promising. That is a regret.

And also we insist on the importance of so-called metabolism. It is well known in the case of Japan or Japanese society that the ratio of new entries, of opening a company, this ratio is quite low—about half of that of the United States. But still, the ratio of closing businesses is also quite low—about half of that of the United States. This is mostly because of the so-called metabolism—the new entry and opening/closing mechanism—is not working. This indicates a very weak system of corporate governance. For example in the case of major American/European companies, about half of the board members are so-called independent, outside members; but in Japan, there is no explicit rule on that. So in Japan, very weak companies are existent and very unable presidents are surviving—there is no system to change these because of the weakness of the corporate governance. We insisted a lot to improve the system. However, in this case, it was not the bureaucrats but the business leaders who were strongly against that. This is actually what is happening in the council, so more political leadership is needed.

Under such circumstances, very finally, I would like to raise one piece of information about the growth strategy. That is the special economic zone system. I proposed to establish a completely new type of economic zone. This system started about ten years ago under the Koizumi administration, but nowadays again the momentum of reform has been declining. So this time, we are going to establish a completely different type of economic special zone. This is, for example, a special zone under the initiative of the Prime Minister himself. For example, Prime Minister Abe orders: Let us establish a financial center in Asia-Pacific in the central part of Tokyo. In order to realize that, such and such deregulation is needed. Let us establish or create farmland focusing on export of agriculture. In order to realize that, such and such deregulation is needed. Very fortunately, this was accepted by the Prime Minister and the Chief Cabinet Secretary and this is going to start. I really hope that this will become a very important kickoff for much bolder deregulatory reform from now on.

Also, finally, many politicians are insisting that there are some political constraints because in July this year, they are going to have the Upper House elections, and beyond July, the formal reform—the more full-time, full-scale reform—will start such and such. This is the very general story told among politicians. But I doubt it. I doubt it very much. Because the Upper House elections, there is another type—a tribe type—of Diet member who will get more power. So from now on, the most important point is how Prime Minister Abe will allocate his own political capital in the reform. He is going to focus on the amendment of the Constitution, he is going to focus on economic reform? Of course, I understand the importance of the amendment of the constitutional law. However, at this moment I really hope he allocates more political capital on the economic reform, even beyond the Upper House elections in July. Thank you.

Dr. Hamada: Thank you very much for your very short and concise presentation. The moral is that no policy is the best growth strategy. In terms of strategic game, there is a choice of orders of presentations—the first speaker's advantage or the last speaker's advantage—but by some negotiations Prof. Sachs starts first. No?

Prof. Jeffrey Sachs, Director, The Earth Institute, Columbia University: Now?

Dr. Hamada: Yes.

Dr. Sachs: Richard.

Dr. Hamada: That means, you would go?

Dr. Sachs: Yes, Dick will go next.

Dr. Hamada: Okay.

Dr. Sachs: And then, I will follow.

Dr. Richard Cooper, Professor, Harvard University: Either way, Mr. Chairman, is okay with me. Well, thank you very much. We have limited time, each of us panelists, so I have a written text that is before all of you. I will not go over all of it. Let me just say that my starting point is very much the same as you have heard from André Sapir, which is that I strongly support the first two arrows of the Abe program, but I see them as simply laying the groundwork, creating the favorable conditions for the third arrow, so I think that the success of the program cannot be measured until we see both what the content of the third arrow is and whether it is actually implemented and has some effect. That will take a few years. So that is my first point.

My second point is that the word economic growth is unfortunately somewhat ambiguous and I think in our conversation—in fact, in most conversations—two quite different issues get mixed up. One is a positive change in gross domestic product (GDP) from one level to another, which may take place over several years and so it shows up as an increase in the growth rate, but in fact analytically is simply a change in the level of GDP spread over several years. And that is the type of thing that one would expect from deregulation, for example, as Takenaka has suggested, of particular sectors moving from a less efficient to a more efficient level, which enhances the growth over a few years, but then it runs out of steam and does not contribute to long-term growth. The only way of generating long-term growth—sustainable long-term growth—is to increase and improve continuously the quality and the quantity of the labor force and to increase/improve technology, some of which will be embodied in new capital, but it is technology that is the real driver, not the formation of the capital—Japan is already intensively endowed with capital relative to other countries in the rest of the world.

So what can one do under these two headings for long-term growth? The labor force is in demographic decline at the present time. And the headings are the obvious ones—they were mentioned earlier today. (1) More immigration— Japanese know much better than I do as a foreigner about what the possibilities there are. I will say as an American, that immigration into the United States is a tremendous source of vitality for the American economy. And I think most Americans actually underestimate the importance of immigration to the United States. That is not to say that can be easily replicated elsewhere. (2) Increasing both the quantity and the effectiveness of female participation—underutilization of a tremendous resource in this economy; (3) lengthening the working period—extending retirement ages and so forth; and finally, (4) having more children, which gets back to the question of women and enabling Japanese women to have both a career and be a mother at the same time. Difficult in every society, but we know that some societies are much more successful than others at making the necessary compromises. So that is on the labor force side.

The other component is introduction of technology. That gets back to the question of human capital that Joe Stiglitz emphasized yesterday. Building human capital, but also creating the environment in which the human capital can actually introduce effectively new ideas into society. So the human skills are a necessary but not a sufficient condition for moving the country forward to the technological frontier, and moving the technological frontier forward.

I just want to close by suggesting that neither of these things, starting at today's Japan's starting point, neither of these things is very easy. You in your own minds will have in mind a number of practical obstacles to introducing these changes. The only final comment I want to make is that there are going to be tremendous changes in the composition of demand—both within Japan as the society ages and between Japan and the rest of the world, because the rest of the world is a very dynamic engine these days, and that puts a tremendous premium on adaptability even at a low rate of growth. So my parting advice is to focus not so much on the growth rate—I am talking long-term now—that involves leisure–work tradeoffs and lots of other complicated things. Focus on adaptability. If the Japanese public collectively decides that it wants to translate that into higher growth, that will take place; and if it does not, that is okay too.

Dr. Hamada: Thank you. Then, Jeff will start.

Dr. Sachs: Thank you very much. I also want to speak about the third arrow, because we did speak quite a bit about the monetary and the fiscal policy and I think that it is interesting that there is a general consensus that monetary and fiscal policy can be helpful but is not the main challenge. And I think that is a healthy view. I believe that is also true for the United States, that while there are limited things that can be accomplished through traditional macroeconomic policies, the bigger challenges right now are structural challenges. Our societies are changing, technologies are changing, and the challenges that the world is facing are also changing. And we should also think therefore not about growth as a statistic about the rate of change of some national account variable, but rather about progress in our societies that meet certain challenges and that improve the quality of life. And I think that this is not so easy to do because our indicators are not very good at directing us in the right ways often.

It seems to me that we face some very particular challenges. The first is environmental, which is one of the most serious—if not *the* most serious—global challenges, but one of the least discussed, because it is very slow-moving, it is extremely serious and it is an issue in the course of decades. It does not make anybody a hero month to month, quarter to quarter, year to year, and yet we continue to worsen the global environmental crisis, especially climate change, but also other related ills, such as the acidification of the oceans, the overfishing of the oceans—something of great concern for this country—the destruction of biodiversity and so forth. So it seems to me that it would be a mistake to have any growth strategy that was not a strategy of sustainable growth, using sustainable in its environmental sense. And Japan has a huge amount to offer in this way because Japan more than any other country in the world has managed the challenge of highly concentrated living with a lot of efficiency—and this is the challenge that a lot of the world is going to face. And Japan has managed energy efficiency farther than just about any other country in the world—and this is a challenge that everybody needs to face. But Japan has its own challenges also still: What kind of energy system to use? Will Japan continue to use nuclear energy? And if not, will it simply revert to liquefied natural gas and carbon emissions, or will it face up to the challenge of continuing to de-carbonize the energy system? These are enormously important issues, but they are very hard for governments to take on, because they are longer term and not so sexy for the population, not so easy to understand and not so immediate.

A second issue obviously is aging. Japan is the first society to age. So, with such a rapid demographic transition, it is leading the way, but everybody is facing this challenge, and we have talked a bit about retirement age, but also health care systems are obviously under a tremendous challenge in facing a great demographic change—and I want to come back to say a word about that in the context of industrial policy.

The third is another basic point for Japan and for all of our countries and that is that most of the economic growth in the world quantitatively will take place now in what are the developing countries today. So 6 billion out of the 7 billion people in the world live in developing countries. The growth rate is perhaps three times faster in those countries than it is in the high-income world. And our own success in the United States or in Japan or in Europe will depend to a considerable extent on the ability to export and contribute to the development of today's emerging economies. This requires a different kind of marketing and a different kind of skill, but again to my mind it is an area where Japan has tremendous strengths. Most of the world is grappling with the question of how to urbanize; Japan has a tremendous, tremendous extent of knowledge of architecture, urban design, urban transport systems, urban water and sanitation systems, and so forth. These are not obviously marketable; they are not simply marketable. They are often not even in private companies, they are in urban governments, they are in public entities, but they are enormously important. Consider that China will add 300 million people to its urban areas—your next-door neighbor—and they will have to have urban centers that have a lot of the qualities of Japanese cities with very efficient transport, very tightly, densely packed populations and so forth that Japan knows how to do. And this is not only in China obviously, this is a worldwide phenomenon.

So it seems to me the kinds of industries are changing a lot and the real opportunities for Japan are not to export to the US market or the European market, which has been the dominant way to think about the economy for the last 50 years. The real opportunities are in China or in Africa or in Vietnam or in India or elsewhere, but that is a very different kind of enterprise activity—not that Japan lacks the experience, but it does not necessarily show the intention right now. I travel all over Africa and I can go two years without meeting a single Japanese person in any of the places in Africa that I visit. That is why I am very happy that the Tokyo International Conference on African Development (TICAD) is taking place this weekend and more than 30 African presidents will come. But this is not about foreign aid and votes in the General Assembly. This is about the future of the planet, its development, markets, economic activity, building infrastructure, energy systems and so forth. And I do not think the mindset is there yet. It used to be in Japan the idea was very much Indonesia, Thailand, Malaysia, and Japan was the fundamental mover of the development of those countries, without question. They never would have made it without Japan's role from the 1950s through the 1980s, but then Japan lost interest in all of this, and foreign aid collapsed and it was not really taken to be much of an interesting role, it was just "We do not want to do that anymore." But your markets are there and the interesting challenges in the world in my view are there as well—not in the mature economies as much as in the 6 billion people living in much more dynamic circumstances in need of technological answers that often reside here or can require you to help figure out these answers. So this is I think the main point that I want to stress, which is that growth is for purposes; it is not just for recording a gross national product (GNP) number. And also, I think Prof. Cooper said it but I want to add on to it, you can always grow by more work hours or you could grow by more children and so forth. I do not find that a very compelling motivation for achieving or for racking up higher numbers on a chart. I actually believe that this world would be better if we followed Japan's model of stabilizing the population and even having it decline. Seven billion is a lot of people in the world. We are going to be at 8 billion or 9 billion soon because of sheer population momentum. I wish fertility rates would come down. I do not think we need to make major policies to boost population. The world is not a Ponzi scheme of population where you keep adding more in the next generation to help the older people have a better retirement age. I think we should learn to stabilize the world's population and to bring it down.

And I am also generally of the view that we have too little leisure time, not enough. Now I am a bad example of that also, but it does seem to me that when John Maynard Keynes wrote his famous essay about the economic possibilities of our grandchildren in 1930, the main thing he got wrong in that beautiful article was that he said we would solve the problem of poverty by the time of his grandchildren—and he was exactly right about that for Great Britain or Japan or the United States—but he said that the biggest problem we would face is what to do with our leisure time. And he definitely got that wrong, because with all of the robots that you showed the world how to build and all of this efficiency, we should be enjoying our lives a bit more and finding a higher quality of life, I think, than we perhaps are.

I wanted to just end with just a word about the United States situation because I think it is also relevant and a word of caution to the idea about deregulation per se. The United States deregulated—I am not sure my colleagues will agree with my interpretation exactly, but I am going to give it and they can disagree with it, especially after I leave. But we deregulated many sectors or gave the private sector leadership, but that did not result in a market for those sectors and often resulted in a corporate governance of those sectors that was also not market nor regulated, but rather run by powerful interest groups. And our health sector, for example, is more private than anybody else's health sector, but it is also the highest cost, least competitive—not least competitive—but the highest cost and most wasteful health sector of any high-income country in the world, because creating a private health economy did not create efficiencies, it created one of the most powerful lobbies that we have in the United States and it ended up with monstrously high drug prices, monstrously high hospitalization costs and so forth, so I would not deregulate. You have a much more efficient health sector. I would not deregulate it and certainly not move to the US model, which is not a model; it is a catastrophe.

We have a deregulated energy sector. In a way, it is productive. You could see it with the hydrofracking now, but it is so powerful that it is impossible to have an honest discussion of climate change in the United States, because we are run by the oil industry. That will never happen in Japan the same way as far as we know until you have a great discovery, but when you deregulate or privatize, you end up with lobbies; you do not just end up with markets. And so we have a very powerful energy lobby which has completely blinded us to environmental issues.

We deregulated the financial sector starting in the 1980s and had nothing but bubbles and busts since then in the savings and loan, in the derivatives markets, in the subprime mortgages. Wall Street is more of a game than it is a market in a lot of ways. It is a miserably incentivized system of gambling that comes from rules written by the financial industry itself.

And fourth, we privatized the military sector. And when you do that, you end up with a lot of wars and a lot of arms sales—and this is a very powerful lobby also.

So we have four very powerful lobbies in the United States: health, energy, finance and the military. And these are our biggest problems in the US economy. We deregulated all of them; we privatized partially all of them. We ended up with extraordinarily powerful interest groups making a lot of money on these sectors and not following the public interest, so you have to be extremely careful with deregulation. It can lead to interest groups that are so powerful that they absolutely eliminate any of the social gains that one might have. This is not to say that markets are always bad, but they are not always good. If the underlying reality is not really a competitive environment—and it is not when it comes to the military or to financial markets with fractional reserve banking or with energy and environment or with the health sector—we know that these are not truly free market sectors. Therefore, deregulating and privatizing is a very dangerous proposition. One should keep very clearly in mind the profound market failures that come with these sectors.

Dr. Hamada: Thank you. Whenever I come back to Tokyo, I am surprised how clean the air is here and also how calm the streets are. Sometimes a hybrid car does not make any noise and I neglect seeing the car behind me, but I think this cleanup of the air was not done by just a market-free mechanism, because there is essentially public goods or externality involved. But Prof. Stiglitz, please.

Prof. Joseph Stiglitz, Professor, Columbia University: Thank you very much. What you said is very much touches on the themes that I was going to stress. First though, I want to say that I do not think we should underemphasize the first two arrows, because it is still the case that there is an underutilization of resources. It is not as bad as in the United States and Europe—unemployment is relatively low— but there is still room for an increase in aggregate demand, and the first two arrows are designed to address that. It is important, as we discussed this morning, that it be done in ways that address some of the other problems—that one can have a tax structure that addresses the problem of environment that Jeff was talking about. I think a carbon tax is an important part of that. Tax structures like using investment tax credit can encourage investment, especially green investments. And that can be an important part of the strategy. But I think one should not dismiss the importance of restoring strength to the macroeconomy.

But I want to focus mostly on the third arrow—the growth. Actually, as one thinks about it, one really hold not think of there being a single arrow but multiple arrows. And as I have listed, I think of at least five. One, the direct increase in productivity. Second the increase in the effective supply of labor, which means improvement in education, gender, enabling people to participate longer in the labor force. Three, the issue of inclusion—in other words, equality—is absolutely critical because in too many countries around the world, you have growth as measured by conventional GDP, but most citizens do not benefit. Fourth, I think of the region's environment as one of the structural factors—growth factors have to be included. And finally, globalization and embedding Japan more in the global economy is another arrow.

So let me talk about these very quickly. Overall, in this area, the important thing is that there is an important role for government, and that there are market failures. Jeff articulated the large number of market failures that we in the United States have been experiencing. I could add to his list: when we deregulated electricity, we wound up with Enron destroying the California market and actually destroying productivity in California. When we deregulated the higher education sector, we wound up with for-profit universities exploiting the poorest Americans and being a lobby group with power sufficient to stop regulations that would have stopped this terrible, exploitation.

So our history has lot of strong evidence of the need for regulation. Markets by themselves do not work. One of the reasons is that you need to make markets act like markets—Adam Smith talked about the proclivity of markets to be non-competitive, so you really need a strong role of government to make markets be markets. It is also important to realize that markets do not exist in a vacuum. Government has to set the rules and regulations and those rules and regulations shape the entire economy. And that brings me to the important point: every economy has a kind of industrial policy because rules and regulations that are on the books—tax policies, education policies, infrastructure—shape the economy. The only question is whether you are conscious of where you are going or whether you are not. Will you let your industrial policy be shaped by the lobbyists or will it be shaped by society more generally?

Productivity is one of the most important areas where economics has recognized that market failures are endemic. There are large learning externalities/spillovers. Bruce Greenwald and I have just finished a book called “Creating a Learning Society” that emphasizes and identifies the nature of those spillovers and the appropriate government responses.

This morning we had a very brief discussion about the alternative ways and Prof. Takenaka talked about this a little bit, about the old approach versus the new approach. I think you need both of those. You need to make sure to get rid of old stifling regulations, but because of these strong learning externalities and innovation externalities, there is a role for government supporting universities. It is not an accident that Silicon Valley has become one of the big high-tech centers. Government basically supported Stanford University, the University, of California at Berkeley, and Lawrence Livermore National Laboratory. So there is a very important role in creating a productive innovative economy.

But going beyond that, I think there is a role for selective intervention. Take one of the more innovative companies, FedEx. It was started with a loan from the Small Business Administration (SBA). While there are failures, there are also very few cases of success where government has not played an important role.

The second arrow that I talked about was on the supply side. Prof. Cooper talked about that and I do not have much more to say.

But the third one I want to mention is inclusivity, growth, and equality. Japan, as I mentioned in my talk yesterday, while it certainly has a lower Gini coefficient than the United States or many many other countries, there have been increases of inequality, and increases in poverty. And unless government takes explicit policies to address this, those problems could get worse.

The final set of ideas I want to talk about have to do with globalization. In Ethiopia and in Myanmar, for example, I have seen the important role that the Japan International Cooperation Agency (JICA) has been playing. They are certainly more engaged in development-oriented growth strategies than the United States Agency for International Development (USAID) . While even more would be desirable, I think the point that Jeff was raising is that the future is going to be in the developing countries and emerging markets and there needs to be more of a focus toward that.

But I do not think the Trans-Pacific Partnership (TPP) is going to be the answer. Let me make just a few comments—and I know you are going to go ahead and do it, so these are really comments that as you negotiate with TPP, here are at least seven points that you should keep in mind. The first is that you should make sure that it does not undermine the multilateral framework. We have spent decades creating the multilateral framework; bilateral and regional agreements are at risk of undermining it.

Second, Japan has become part of an Asian supply chain, which is very important. And China is not part of TPP and the result of that is there is a real risk that through things like rules of origin it will really undermine/impede the Asian supply chain and one has to be at least very conscious of that. It will interfere with economic integration within the region, unless one is very careful.

Third, one should make sure that the agreement is symmetrical. One hears lots of demands for the evaluation of rice subsidies in Japan. I have not heard lots of offers on the part of the United States to get rid of its sugar subsidies, sugar quotas, cotton subsidies, water subsidies in California, electricity subsidies; there is a comprehensive set of subsides to agriculture in the United States. So, yes, it is a good thing for you to modernize and get rid of some of these subsidies, but it is important for the agreement to be symmetric. I am saying this partly as an American citizen. I think a lot of Japanese hope that TPP will help Japan move in this direction. I think our hope as Americans is that it will help America move in this direction as well. Third, or as part of that symmetry, most of these trade agreements are not free trade agreements. We have to be clear. They are managed trade agreements; they are usually managed for a special interest in the United States. And embedded in these so-called trade agreements are agreements about investment and intellectual property. The investment agreements typically give foreign investors more rights than domestic investors. They give rights without responsibilities. And as part of symmetry, that should not be allowed.

Fourth, we have been talking about regulation André pointed out that tariffs now are very low and a lot of these agreements are about stripping away our regulatory harmonization. It is very difficult. The business interests have a lot of interest in stripping away the regulations that are usually there for good reason. Some of those regulations are now hamstringing many of the countries as they try to impose good financial regulation. Chile wanted to manage its financial markets to stop the inflow of capital that was leading to an appreciation of the currency, but the bilateral agreement between Chile and the United States was and is an impediment in their efforts to manage their financial markets.

The fifth thing is that there should be no backtracking. The fifth thing has to do with intellectual property rights. There is a broad framework called the New Trade Policy, which involved access to medicine, intellectual property—a whole number of issues—that were put in part of the bilateral agreement that we had with Peru and a couple of other countries at the insistence of civil society fighting against pharmaceuticals and other special interests. The texts of the TPP that have leaked out so far—and I will come to that in a minute—show that the United States Trade Representative (USTR) is backtracking on agreements that it has already made with other countries, including some in the area. And that is, it seems to me, a great concern, and Japan should make sure that there is no backtracking on these new trade policies, that there is access to medicine, there is access to knowledge and so forth.

Sixth, one of the great concerns in TPP is the lack of transparency in the whole process. It has been a field day for the special interests and for the lobbyists, but the rest of society has been kept out. And that of course leads to suspicion that it is an agreement, for American business and by American business, and not even for American citizens, much less the citizens in Japan and the other countries.

And the final remark I want to make is to echo the point that one has to be careful about growth fetishism. One has to recognize that GDP does not really measure the quality of life. This is of course the point that I raised yesterday, the point of the Commission on the Measurement of Economic Performance and Social Progress that I chaired. It pointed out that there are strong and systematic biases in the way we measure GDP that do not reflect many of the things that we care about—issues in environment, issues of distribution, issues of the quality of life. In the rush to get the economy going again to end the Japanese malaise, one should not lose the plot, so to speak. The plot of all this is to increase the standard of living of the Japanese people. That should be the basis on which every program should be judged.

Dr. Hamada: Thank you, Joe. Yesterday, Prof. Kazumasa Iwata proposed the fourth arrow that is some fiscal long-term consolidation, but Prof. Stiglitz proposed that some human value or ethical value or happiness should be added to those three arrows. I would like to hear then from Dr. Posen.

Dr. Adam Posen, President, Peterson Institute for International Economics: Thank you, Hamada-sensei. I am in favor of happiness. Let me say that at the start. It is, as Koichi said at the start of the panel, it is a little uncomfortable for me. It was 30 years ago almost that I was studying international economics taught by Dick Cooper and Jeff Sachs.

Dr. Hamada: We thank you.

Dr. Posen: Thank you, Jeff. And it was ten years ago that I was running messages to Heizo Takenaka and Koichi Hamada between Washington and Tokyo. But I think—I hope—that certainly we and Japan has come a long way and let me try to pull that together.

One of the most important lessons that I think we all agreed on today, and which was very explicit at the start of Joe's remarks just now, is that strong macro policy, strong growth environment, positive actions by government are conducive to structural reform and conducive to the success of structural reform. And this is an important intellectual victory and an important policy victory, because we have now seen—we saw many years in Japan where officials and intellectuals would claim that we need to have a crisis in order to force structural reform. We need to keep policies tight in order to put pressure on people. And we are seeing that same mistake being repeated on an epic scale consciously in Europe right now. And the result as we saw in Japan in the 1990s and the result as we are seeing in Europe right now is backwards motion. Very little structural reform, erosion of the supply side, erosion of political support for markets and economics in a sensible way. So among the many other things to commend Abenomics to the Japanese people and to take out of this session that we had today is that we have gotten past that nonsense. We are now about a government threatening and risking crisis to get progress. We are about a government making progress. And I think that is an important step forward and it will be an important demonstration by Japan for Europe and for the rest of the world.

I think the second thing I want us to take away is picking up on the very good image that Heizo brought up of the metabolism of an economy—of the idea that we are living. Think of the economy as a living system and it is not a static quantity of stuff, which is also of course part of what everyone here has been saying. To me, the key attribute that the Japanese economy has had to get back and has had to instill and is on the way I hope to installing is a willingness to overturn incumbents. That was in a sense, if you pick what was the plate on the structural side of Japan for the last decades, it is that once a company was in place, once a worker was in place, once a practice was in place, it was very, very hard to dislodge them. And this is true of course in every country, you get it in every economy and every polity. But partly for demographics perhaps, for culture or for geography, I do not know, but this was in the economics sphere, particularly acute for Japan. When we talked a little bit ago about what was part of the reason why even if there is no overt crisis, Japan needed Abenomics, needs continued reform, needs improvement, it was this overwhelming sense that the young people of Japan were somehow being excluded from the wealth, from the opportunities, from the future in Japan, from the decision making. I will never forget being here in—I forget which year, but I remember the meeting—when Fuji Bank and Dai-Ichi Kangyo Bank were being merged into Mizuho. And I went to a presentation by the Chairman of Mizuho about what wonderful things were going to happen from the merger, and I said "Are you shedding any people? Are you closing any branches?" and he said "Well, 5% over the next 10 years." I said "Then, are you going to hire any new people?" and he was shocked. He said, "No, my job is to protect the workers we have. The new people have to fend for themselves." And so to me this is a key part of Abenomics.

This is a key part of what should be the reform arrow of Abenomics. And that is why I emphasize repeatedly in my remarks today and in my remarks in general that of all structural reforms Japan should pursue—and this again picks up on the Dick Cooper and Joe Stiglitz and everybody, but—is the additional empowerment and integration of women in the workforce. It is the biggest single structural improvement Japan can make. You have an enormously educated pool of women who you are not making good use of. Full stop. If you look at Japanese exceptionalism in the economics sphere—and I very much appreciate the remarks from the professor from Keio in the previous panel that the economics and the problems of the financial systems and regulations and all that are all very common from Japan to the United States to Europe. But if you look at Japan's exceptionalism among rich countries and among Asian countries now, it is the treatment of women in the workforce. That is in many ways the most exceptional aspect of Japan. If you go to your neighbor China now, in any professional area and you meet the people under 40, it is 50/50 female on male. And this is just an extraordinary waste of people and there are no cultural excuses that can justify it.

But so let me move on and say, picking up in the spirit of what my colleague said, let us imagine a world where the macro policies are right and André Sapir earlier said I was making too much out of fiscal policy. No, the reason I chose fiscal policy is partly because they asked me to, but partly because it seemed to me the most difficult to navigate for the next couple of years. But let us get beyond that. So let us assume that we have a world where we are out of deflation, where the debt ratio is stabilized or on a good path, where there is growth in Japan. And I want to spin the growth idea just a little differently than my colleagues. Growth is not an end to itself, as the colleagues have rightly said, but I think another way to think about it and this is what I have been arguing about Japan for 15+ years is that a healthy democratic society with good property right should naturally grow. It was a marker that something was fundamentally going wrong in Japan that a society with price stability, with property rights, with civil peace, with good education, with all the community capital was not growing. That was an indicator that something was wrong. So let us now imagine we get to the point four years, three years from now and Japan is back to growing. Then I think we do get—perhaps for the next major election—but we do get to the big questions that Dick and Jeff and Joe and Heizo raised, which is: What then do you do with it? What then is Japan about?

For me, the other sort of selfish—but I do not think selfish in a personal sense; I mean selfish as a citizen—reason that I have kept wanting Japan to come back in a sense of being a leading economy and a leading player in world affairs is because there was this brief window, sort of lagging the boom of the 1980s, so into the early 1990s, when Japan's role in world affairs, in Asia in particular, was incredibly constructive. That was the era of the Kyoto Protocol, which for all these reasons we know did not work, and the era of worrying about refugees and aid and an era of trying to integrate Asia before the Chinese situation became as clear and strong as it was. And that I think for the world's interests and for Japan's interest is what we can hope for from a Japan that has better growth, better strength, more equal treatment of young people and women and then is able to stand up and engage and provide—I hate the word "leadership" but—useful guidance, insight, courage to the world. I cannot add anything to what my colleagues have said about the environmental challenge and the inequality challenge, which I agree are the two common great global challenges for the rich world and the world as a whole. But I do want to go back to a world where I remember with some of the people in this room talking about a Japan that was building a better integrated Asia on a peaceful model.

Obviously, there are parts of Japan and parts of the Japanese government no matter what now anyway, but I think that is where you get the payoff from doing the right things on economics and the rest of the world will benefit as well. So thank you very much.

Dr. Hamada: Thank you, Adam. Prof. Sahoko Kaji's beautiful English. She has of course an international family background, but her beautiful English illustrates an aspect of the high skill of Japan's women power. Japanese firms are wasting female labor that has much better—I am afraid to say—communication skills addressing the world.

Before turning to mutual discussions, I would like to show the effect of the first arrow—monetary policy—by a handout.

The first chart, Japan's map for foreigners, shows from the north to the south, from Hokkaido to Kyushu and Okinawa. The job offers-applicants ratio shows that all data are turning upward in the past three quarters. Of course, monetary policy and other macroeconomic policies increased the asset wealth of people and naturally the real balance effect is working. We do not need to go to Tobin's Q or financial acceleration effects, but anyway, if people have more wealth, and if they expect that the price level is not falling, then you want to spend. That is human nature. The Japanese people still want improvement in quality of life. They just gathered money and accumulate it because of deflation. This is from ESRI, this institute's local economic reports, just reported three days ago. Next, we have a kind of spider diagram. In the last quarter, we had in all districts gradual improvements because the outer circle is a much better situation. Okinawa looks best here, it is the best change from the last period. But if you look at the picture of the level of ratio here, the level of Okinawa is the worst. From the local statistics, the economic effects that Abenomics is actually working throughout regions—the number of new jobs, as you look at, is increasing all over the country. From economics we know that we have a real balance effect and that will increase consumption, but we did not know how much or how fast. Here, I am very pleased to find from this diagram that Abenomics' monetary stimulus is working towards real terms.

When I arrived at Narita, I saw that the stock market was in turbulence, but I do not worry very much, because the real economy is growing steadily. This is the accomplishment of Prime Minister Abe who changed the paradigm, or who changed the political agenda of the election from other subjects to the issue of monetary policy. That was crucial for the economy suffering from deflation and excessive appreciation of the yen. That is a simple application of the general equilibrium picture of the economy with money that economists have elaborated 250 years after Adam Smith.

The Economy Watchers Survey at the bottom of the spider diagram in the hand out shows that the diffusion index—the solid one is simultaneous index, the thinner one is the forward-looking diffusion index from ESRI. That is also increasing steadily, just after the announcement of Prime Minister Abe in November that he set forth the aggressive monetary policy.

Having shown this sign of recovery, I would like to come back to the main discussions. We noticed with some differences in opinion among major speakers. For instance, Takenaka trusts in price mechanism and individual incentives or ingenuity to propel the real growth. So that government need not intervene too much in private activities.

Rather it should refrain from putting unnecessary constraints on private behaviors. Deregulation is the key word for the third arrow. If I look at the practice of Japanese bureaucrats, I see so many instances of their not helping growth but restraining people's behavior, sometimes for the sake of bureaucracy itself. So I am more or less inclined to agree with Heizo in this case. Speakers, particularly among others Joe and Jeffrey, think that there are so many instances of externalities in the world, and that we have to make rules and so forth, According to them, just laisser-faire does not make the world more productive or happier. Prof. Takenaka, do you have some thoughts?

Dr. Takenaka: Why thank you very much for your kind summary on our first-round discussion. Whenever we have this kind of discussion, I am a little bit embarrassed to hear some cautious voice from excellent American economists for the deregulation. I would like to understand the so-called imaged deregulation, imaged regulation. The level is very much different between Japan and the United States. We do not discuss the importance of laisser-faire. No, no, no, regulation, the regulatory framework is needed. I am quite often labeled as a market fundamentalist or something like that, but when I was in the government I made a lot of regulations. Otherwise, we could not have disposed the non-performing loans in the banking sector. So it is not constructive to discuss whether deregulation is good or bad. We have to go beyond that kind of discussion. For example, we are now discussing almost the same topic as we discussed 15 years ago. For example, in Japan, a new entrant to the agricultural sector, especially in the case of business, corporate business sector, cannot enter in the cultural sector at all. Can you imagine it? We have been discussing this for more than 15 years. So in the past 15 years you had a lot of deregulation in the United States, so the level of regulation, the level of deregulation is completely different. So for each case, we should discuss very carefully what kind of policy is needed. What kind of policy, what kind of problem is existing and what kind of prescription is needed? What will be the side effects of the new policy, etc.? Then, we have to realize what is exactly needed?

And also, I basically agree with all other points. Yes, sound macroeconomic management is the base for the sound economic growth. It is quite true and Prof. Hamada already relayed some—although it was very short-term, but—some evidence and the result of the better macroeconomic management. However, we should discuss very carefully the interaction or interdependence between the second arrow and the third arrow. As you know, the second arrow is flexible fiscal policy. Flexible fiscal policy has two meanings: one, in the short run, fiscal expansion is needed; but, two, in the mid-term, fiscal consolidation is needed. The Japanese government bond–GDP ratio is reaching 200%, this is much higher than that of Greece, so very steady fiscal consolidation is needed. But in order to realize this fiscal consolidation, some sound economic growth, especially nominal economic growth, is needed. In the past several years, the average nominal growth rate has been 1% or 1.5% or so. We do not propose a very high growth rate—2% or 2.2%—but that is a very realistic one. If deflation is conquered and nominal growth of 4% or 4.5% is realized, it will become quite easy to pursue fiscal rehabilitation/consolidation. Actually, between 2003 and 2007, only in four years, the Japanese primary deficit declined dramatically, from 5% of GDP to almost 1% of GDP. If the policy at that time had been continued, we may have already realized fiscal rehabilitation to restore the primary balance. It is very important to realize not very high but sound nominal economic growth so that we can retain the fiscal balance. That is another important topic to be discussed.

Dr. Cooper: Well, Koichi Hamada has already raised the issue I wanted to raise. I want to push back against what Jeff Sachs and Joe Stiglitz said on deregulation in the United States. Sachs mentioned four industries. He talked about health care, energy, the military sector, and finance, and said that deregulation was a mistake and there are market failures and so forth, and heavy lobbies. I agree on the second two points—there are heavy lobbies and there are some market failures—but these are not industries that were deregulated in the United States, except for finance. They have always been private; they have never been closely regulated, so I think it is very important to distinguish between an undesirable situation and the movement that led to that undesirable situation. In the case of finance, we did deregulate. I was one who opposed the repeal of Glass–Steagall, which took place during the Clinton administration, not the Bush administration, but I lost that battle and I thought then and I think still that it was a mistake. Joe mentioned higher education. As far as I am aware, we have never regulated higher education. So I think what Koichi Hamada said is very important for all economists to keep in mind in making judgments about policy. The initial conditions are extremely important and the initial conditions in Japan are very, very different from the initial conditions in the United States. We have a number of bad situations. A few of them can be blamed on deregulation, but most of them cannot be blamed on deregulation, so I will support Takenaka-san in his emphasis in his committee on deregulation in Japan, but of course it must be done thoughtfully and carefully.

Dr. Hamada: Joe, do you have anything?

Dr. Stiglitz: I think the way it was put a few minutes ago, the question is: What is the right regulatory framework? For example, in our higher education sector, we could not get the regulations that were needed to prevent the abuses that some for-profit schools were clearly engaging in, because of the presence of these strong lobby groups. We have had a hard time getting a well-functioning health care sector because of these special interests. I agree with Dick, it is not just a matter of regulation. But the important thing is that one needs to go through sector by sector to see what are the sources of problems and what are the appropriate ways of responding to them, and what are the minimal interventions that will lead to a well-functioning market economy. What I mentioned in my talk was that one of the key things is to make markets work like markets, and in many of these cases, the problem is that markets do not work like our textbook competitive markets—and for good reasons. Some of reasons are natural, having to do with imperfections of information, but some of them because of the existence of imperfect competition and a variety of other problems. The situation in Japan— does suggest that in many of the examples that they have talked about, probably there is a need for deregulation—deregulation relative to what there is—but it may be more deregulation relative in some of the areas where there has not been adequate regulation, so this is a constant struggle.

I could not help but respond a little bit to your siding. I think it was the Doing Business survey of the World Bank; I think that is the one you are referring to. That is a very bad study and I just want to make sure that no one else uses that study. The International Monetary Fund (IMF) has agreed not to use it because it is so flawed and some members of the US Congress actually have put a lot of pressure on the World Bank because it is so full of bad policy recommendations. It is again an example of trying to use a one-size-fits-all framework to all countries and unfortunately it is used too widely or more widely than it should be.

Dr. Hamada: I appreciate your honesty to criticize the institution you worked in and probably worked out the document frankly. Anyway, Adam, something to add?

Dr. Posen: Are there questions?

Dr. Hamada: Yes, but Heizo, last one, would you like? Okay. Then, we would like to collect questions, but I think that, as I said first, the quality of coherence is dependent on the active interaction between the speakers and the floor. We are not preaching to you, but you should mention your opinion frankly to us and as a directive we enhance our mutual knowledge. At the same time, some speakers are not trained to speak your ideas in a concise manner and since time is limited, please actively participate, but make your comments concise. Prof. Wakatabe, first.

Dr. Masazumi Wakatabe, Professor, Waseda University: Thank you to all panelists. That was an excellent discussion. I have just one question to Joe Stiglitz. You are really persuasive and convincing in your description of the political economy, how the politics works out in deregulation. But on the other hand, of course regulation serves the lobbies and the vested interests, so why can you end up against deregulation rather than for regulation? My question is briefly speaking, why can you trust the political system to support your kind of intervention? I mean, you are arguing for more government involvement in the economy, but on the other hand you are very convincing in saying that the political system actually fails or “sucks” so how can you end up with arguing for more government? Thank you.

Dr. Stiglitz: That is a very good question, and maybe the answer lies in what we call in the United States “Midwestern optimism,” referring to the region I am from. It is really a recognition of the continuing existence and importance of democratic processes. Yes, lobbyists have huge, untoward influence, but in spite of that , we did get a bill, Dodd–Frank, that put some restraints on the financial sector, even if it was far from perfect. Sometimes I put it that 350 million Americans had almost as much weight as 10 banks, so that is the democratic process working out.

But the point is that we need to have constant discussion. What we are very aware of, I think, is that,for one thing there are market failures—, both the negative and positive kind. The negative ones are exemplified by the banks. In the Clinton administration I was also opposed the repeal of Glass-Steagall, because I saw it as deregulation that was special interest legislation. And this goes back to the point I made before. Markets do not exist in a vacuum. You are going to have laws and regulations—the question is which laws and regulations. We will always have a debate about which are the best. What I have been arguing is that we know the nature of some of the market failures having to do with externalities, and imperfections of competition, and we have an intellectual framework to talk about them, so we know in a sense what has to be done. We know the limitations of the political process and all we can do is to keep fighting to make sure that we are trying to address some of these. Still your question is well taken.

Dr. Hamada: Thank you for waiting.

Dr. Chalongphob Sussangkarn, Distinguished Fellow, Thailand Development Research Institute: The Japan that we have been talking about over the last one and a half days has been the geographical Japan, but Japan extends way beyond that, for example corporate Japan—Toyota and Sony, the people who are producing and selling throughout the world. My general question is to what extent is the revitalization of Japan related to the revitalization of corporate Japan? And we know that in some sectors Japan is still the leader, producing world-class products—automobiles, cameras and so on—but corporate Japan has lost out in some key areas—in telephones, televisions—so you are being faced by competition from Samsung, Apple and so on. I mean if corporate Japan becomes innovative again, they will produce world-class products, new products that people want. I am sure a lot of them will have to be produced in Japan, although some might be produced in other countries in East Asia, but this will help to revitalize the Japanese economy and I wonder whether part of the policy to revitalize Japan has elements that will help to revitalize corporate Japan.

Dr. Hamada: Thank you. Anybody?

Dr. Takenaka: As you mentioned, Asian economy is deeply integrated and in the case of Japanese leading business like Toyota and automakers and electric appliance companies, they have a lot of integrated systems—whole Asia or Asia-Pacific. We are now discussing how to strengthen the power of growth. Some of them mentioned the labor input, labor quality, technological progress and capital input based upon the growth accounting. At the same time also, as I mentioned, we should focus the metabolism, how to replace the old one by the new one. In this regard, the corporate governance system issue is an important issue to strengthen the power of Japanese businesses. If this kind of new system to strengthen corporate governance is employed successfully, in this case, this will have a very positive impact on Japanese businesses—domestically and internationally. At the same time, we are also discussing the need for innovation. But still, some people are saying “Government should increase their R&D investment to support the business sector” or so, but in the past 20 years, government expenditures on R&D have tripled. But still, the effectiveness is not so clear. In that sense, sound competition and the corporate governance system, these kinds of strategy, should be included to some extent in the growth strategy. Then, this will have some positive impact on Japanese businesses.

But another change to influence our Asian neighboring countries will be that in the past three or four years, Japanese leading businesses have been increasing their foreign direct investment (FDI) to Asian countries, including Thailand itself. If Abenomics becomes successful, they will relatively increase domestic investment. This will be good for the domestic labor market, but this will on the contrary have a negative impact for the short term in the neighboring countries, but the impact will be not so substantial in my understanding.

Dr. Posen: Can I just say something quickly on that? At the Peterson Institute, we have people working obviously not so much with Japanese data, but on FDI issues and we find for the advanced countries there are huge complementarities that the more you invest abroad and deepen your supply chain, the more R&D and more profitable you become at home and sometimes even creating jobs. When you say about it—I am sure you meant it this way, but I think we have to make sure that the people in the audience hear it—that when you say the success of corporate Japan or Japanese corporations, we are talking about "Made by Japan" not "Made in Japan." It was a dozen years ago that I did some work with Keidanren and that was the declaration that they were going to make that shift and I think that is a key part of Japan's vision going forward.

Dr. Sahoko Kaji, Professor, Keio University: Thank you so much. I have a question for Dr. Posen. I am very glad that you are so optimistic about the success of our structural reforms and that Japan would become probably one of the first countries that succeeds in getting through the painful and politically unpalatable reforms without experiencing these ghastly crises. I do not know if you are also from the Midwest, but I wonder why you are so optimistic and, if possible, if you could give us one concrete example of a phenomenon that you have seen in Japan that makes you strongly believe that we would not lose the momentum for change. Because seeing you sitting next to Takenaka-sensei I am reminded of the fact that we did have some sort of momentum for change during the Koizumi administration but somewhere, somehow it fizzled away. And so, I am worried that it could happen again and I would like a strong encouraging word from you and a concrete example of a phenomenon that you have seen that makes you believe that this will not happen this time.

Dr. Posen: I will give you a few—and if you had listened to my talk this morning, you would have already heard one of them, specifically in response to Heizo Takenaka. In Japan in the 1990s, there were accumulating financial problems. There was Yamaichi Securities, there was Hokkaido Takushoku Bank, there was the failure of Resona—there were all these things that went wrong in the banking system. My colleague has written about this. We saw repeated efforts by the Bank of Japan and by the Ministry of Finance to try to use the crises to provoke reforms in the banking system and nothing happened. We saw the Bank of Japan tighten policy and refuse to do what was needed in the hopes that this would purge the banking system and force change. When Koizumi and Takenaka came to office and they stopped tightening fiscal policy, that created an environment in which Heizo was able to bravely recapitalize the banks. That is just one example.

If we look at the environment in Japan, there was a period where we did have deregulation of energy prices and deregulation of telecom prices. And again in the spirit of the discussion between Joe and Heizo, I am generally in the United States very much where Joe is, but in Japan deregulation of energy and telecom prices was very necessary and that took place in an environment when Japan was in one of its upticks and it was not when they were trying to beat down the economy. But it is not just Japan. If you look at Germany, their major labor market reform that has turned into a major success for them took place in 2003 in an environment—these were the Hartz III reforms and basically it was a reduction of the extremely generous unemployment benefits for older male workers who wanted to be on the glide path to retirement and that had messed up the labor supply in Germany. That reform had been discussed for, I do not know, 15 years or something and it turns out that it was after the worst of the reunification problems and after the Bundesbank had tried to keep the screws on and only when you started to get the pickup in growth following the initial bout of the euro and the recovery from the reunification boom that Germany was able to pass and implement these structural reforms.

It is not so much that I am optimistic. I apologize for coming across that way. I am from Boston, so I am not supposed to be optimistic. What I was trying to say was two things. First, I can imagine a world where if the Abenomics program goes as I hope it will, three to four years from now, Japan will be in the position I was speculating on and that to me was the exercise that I think should motivate us. And second, I was not so much saying that good macroeconomic times automatically lead to good reforms. What I was saying was that we have a number of episodes in recent Japanese history, recent European histories, across countries over time, where bad macroeconomic conditions lead to stoppages of reforms and reversal of reforms. That was more the point I was trying to make.

Dr. Hamada: Prof. Kawai?

Dr. Masahiro Kawai, Dean, Asian Development Bank Institute: Thank you. I have questions for Professors Richard Cooper and Heizo Takenaka. I thought Prof. Cooper said something interesting. He said deregulation itself may lift the level of GDP but may not have a lasting impact on GDP growth and what has a lasting impact would be the quality of labor and technological improvement, that is, investment in human capital in technology. Are you suggesting that Japan should be focusing on these two areas rather than on deregulation? That is my question for Prof. Cooper. And I have a related question for Prof. Heizo Takenaka. Deregulation may be needed, but perhaps rather than a series of small deregulation measures, I believe focusing on a few major deregulation and reform issues could be more effective, such as those in the energy or, the agricultural sector. The medical and health sector,and labor market and immigration policy. Some of the major reform as may be more rewarding for the economy.

Dr. Hamada: Probably it is better to collect some of the questions together. Prof. Sapir?

Dr. André Sapir, Senior Fellow, Bruegel and Professor, Free University of Brussels: Thank you. Just a short word, because everybody is talking about deregulation. Could I suggest that we use a different term? I think what most people on the panel were speaking in favor of deregulation and not really meaning regulation in the sense of what we are talking about like in the financial sector. My feeling is that most people here are talking about removing barriers to entry. And maybe one should say it in so many words, because deregulation has all kinds of connotations, and again I am also of the view that regulation in some cases, in some areas, it is extremely important, so I think when everyone is talking of deregulation, one brings along all kinds of baggage, which I think is not desirable. Again, if what is being implied here is that there are certain areas, certain sectors—I mean, you were talking about the agricultural issues, there you are really talking of removing barriers to entry.

Dr. Posen: No, in Japan you are removing barriers to consolidation. Nobody is entering agriculture in Japan. But anyways, sorry, go ahead, André.

Dr. Sapir: Entry or exit, whatever. But I think this is what one is talking about.

Prof. Kazumasa Iwata, President, Japan Center for Economic Research: Thank you very much. On the structural issues, I find one of the most important matters in Japanese business is the very low rate of start-up of businesses and also the exit from business. Both of them are very low, as Prof. Takenaka pointed out, and I find sometimes excellent Japanese companies exiting and unprofitable companies remain in Japan, then the total return of capital is declining. This implies the misallocation of resources and capital and also the human resources. I find this is one of the basic problems. For instance, if we take the example of new start-up of businesses based on universities or colleges, the number of new start-up of businesses in the United States. Last year that was 1,700. This is the number of new businesses that appeared. In the case of Japan, this is only 79. Economic size about one-third or so compared to the United States, so we should have at least one-third of this number of start-up of business based on colleges or universities.

This is one thing. Another one is that the exit ratio is also very low. I find this is related to the restructuring process of private companies. Sometimes the Japanese government is involved, from financial aid or local government engaged in helping this restructuring, but sometimes not really helping. One of the big differences from the United States is that in the United States it is business-based or private initiative-based restructuring process and there is a very well-developed market for restructuring business. I find this is a big difference between the United States and Japan. Finally, I find the education system reform, notably university or college, in order to stimulate more R&D, research and also this new start-up of business from the colleges and universities and I would like to hear from the US professors, do you have any recommendations or suggestions for the reform of universities in Japan.

Dr. Hamada: Any comments? Prof. Shimizu, please make your comments brief and concise.

Prof. Shimizu: I completely agree, 100% with Prof. Takenaka's opinion. Maybe the three arrows are important as a political gesture, but I think the first arrow does the most. Once it is successful, then people's expectations of the permanent income increase and they start to use the huge financial asset, which is 1,100 trillion yen. Then, it is the start of the growth already. And then, profit will grow and companies and corporations will invest. That is the start of growth already, so without any restrictions of regulations, this is just the main part of the growth strategy, so maybe it is the second and third arrow. Better than nothing, but the second one cannot continue forever. And the third one may be better, but deregulation is so important. So how do you have your idea on the importance of the three arrows? This is my question to Prof. Takenaka.

Dr. Hamada: Will you answer? If I may substitute. I think the third arrow is expansion of our production capacity itself, the potential growth path that can be increased, but we do not know the best way to increase our productivity, even though government gathers intelligent people to consider the ingredient of production enhancements. One important thing is to stop unnecessary regulation to make private incentives to work. But the first arrow that Prof. Shimizu mentioned is about the utilization of the production capacity. Because of the rigidity in wages and prices and other elements, we could not reach the potential growth rate for 15 years or 20 years and monetary policy can do some if not all, but wait for the growth path to reach the potential. I agree in essence that right now the most important thing is the first arrow and once we reach the capacity limit, then we have to work out more real things. Just printing money does not increase our productivity.

Any questions or comments, Prof. Takenaka?

Dr. Takenaka: Thank you very much, Kawai-san and Shimizu-san who raised a very direct question to me. I completely agree with you, Kawai-sensei. Yes, it is important to pick up maybe six major regulatory reforms for the time being. For example, but all of them it is very tough to tackle, so let us pick up two major topics a year and assume that the Abe administration will continue at least for three years or so. Then, we can conclude in total six regulatory reforms, we can finish. The typical one is new entry to the agricultural sector; another one is the so-called mixed medical care system, etc. and reform of the so-called job agency, Hello Work. Maybe five or six major ones are very important. Another one will be immigration, importing human talent from foreign countries. We have now exactly the proposal to the Deregulation Committee to pick up two major issues a year. This strategy will be very much important.

And also, Shimizu-sensei mentioned the importance of the continuation of this kind of discussion. We have been discussing this kind of growth strategy for five months or six months, but, it is very important to continue this kind of effort, so in about two weeks, as I mentioned, the first-round proposal will be revealed. But this is only the first step. It is impotent for the government to continue the discussion. How to continue this kind of discussion and in what policy board should we continue? This is very impotent.

Additionally, I would like to raise one comment. I worked under the Koizumi administration. At that time, there was a policy panel or policy control power in the name of Council on Economic and Fiscal Policy. And there was a commander, a very strong commander, Prime Minister Koizumi. Now we have a commander—Prime Minister Abe is there—but the control tower, the Council on Economic and Fiscal Policy and Industrial Competitiveness Council, etc., these are not well-functioning yet in my understanding. I am also responsible since I am one of the members, so it is very important to rebuild this control tower or policy board system beyond the Upper House election so that they can tackle another round of regulatory reform.

Dr. Stiglitz: I want to pick up what I thought was a very good question about the start-ups and part of the general question of the dynamic aspects of the Japanese economy. It was right to point out the pivotal role that universities play in the United States in terms of the generation of new businesses. I think it is partly because the major universities that you are talking about and that are associated with have all become both teaching institutions and research institutions with a lot of government support for their research. It is, you might say, part of our industrial policy. I think the money is very well spent and has generated lots of ideas that have led to lots of start-ups.

There are a couple of other aspects of what you might call creative strengths of American enterprises. One of them is our venture capital. It is a very small part of our financial sector, but it is a part of the financial sector that was working fairly well. There is some question about how well it is continuing to work, but it has been an important part of giving funds to new enterprises. But it is also the case that the SBA has also financed some important new businesses —as I pointed out earlier, Federal Express started with an SBA loan. So this is another area where at least in the context of the United States, the private sector and the banking sector have not done as much as we are sometimes told. And it is one area where we need to foster a regulatory framework that discourages speculative and trading activities, because those have really misdirected the resources of the financial sector away from creating new enterprises.

Finally, I want to return to is globalization, which again is important for Japan to consider in its strategy. Partial immersion in the global economy will contribute to Japan's success going forward. But part of that globalization is having universities that are more interconnected with the global academic context. An ingredient in this is improving English proficiency. It's something that I hate to point out, because as a native English speaker I fear it may seem as though I am trying to boost the language that I speak with little effort. But this conference, for example, like most international meetings, has been conducted in English, and that gives those of us who are born in the English-speaking countries an advantage. Simply because English has become the language of science and academia more generally —and not because it has any special merits as a language, in and of itself— it is important for young Japanese to become fluent. And that means they ought to be spending a year at school abroad, which could entail a large program. This could be a boon to Japan's internationalization, which would in fact help strengthen Japanese corporate life as well.

Dr. Cooper: I would like to first respond to Mr. Kawai's question about what I am recommending for Japan and then secondly say something about the question on higher education. On the first point, I am actually not recommending anything. I do not feel my knowledge of the Japanese situation is nearly good enough to recommend policy and I have spent enough time in a policy position to know that details are all important. So I am not really recommending anything. The distinction I was trying to draw—and one can think of it just in terms of the classroom production possibility frontier—is that by wide recognition Japan today is performing well below the production possibility frontier. For a variety of reasons—some are macroeconomic in nature, some are regulatory in nature and so forth—so there is a whole class of policies that would move Japan from where it now is closer to the frontier. That—and this is the distinction I was trying to make—that is actually not improving the long-term growth rate by itself. It is a plus; standards of living go up. But improving the long-term growth rate means pushing the frontier outward and that involves on the one hand technology and on the other hand the labor force—the quality and the quantity of the labor force and the various issues that have been discussed.

The issue of immigration, the issue of the role of women in society and so forth—these are very fundamental issues and I think they need to be thrashed out by the Japanese people and decided by the Japanese people. My only injunction is to keep in mind that there will be implications on the long-term growth rate of however that discussion comes out. But you ought to keep your eye on what is good for the Japanese and not on the growth rate. Several of us have made that point. Do not get fixated on the growth rate. Japan is never going to return to the growth rate of the 1970s and 1980s, so get growth per se out of your mind and focus on the content that is of real interest. Some of that will affect the growth rate in a positive or a negative way.

On higher education—and here I speak very hesitantly, because I do not feel I know the Japanese educational system well enough to comment—I do not think this is a question of higher education. I think this is a question of education—and it starts in the first grade and even before. My impression, which is much more up to date on China and Korea than it is on Japan, but I lump the three countries together in this regard—perhaps wrongly—but my impression of the education system in Japan is that it is a vehicle to pass the received wisdom from the older generation to the younger generation. It is a one-way flow, with a strong emphasis when kids become teenagers on the examination system in order to get in not to *a* university, but into one of the *top* universities. I am now speaking about China and you can decide whether it applies to Japan. The children lose their childhood in China. There is so much pressure on education, passing the exams, tutoring outside of the classroom, special lessons in English and mathematics—the children lose their childhood. A really important part of childhood is curiosity and being encouraged to develop and satisfy curiosity My impression is that curiosity is stamped out by the educational system. Curiosity is very closely related to creativity. So in stamping out curiosity, creativity is stamped out. A tremendous amount of diligence, tremendous amount of memorization of material topass the exams, but a loss of curiosity and a loss of creativity. That cannot be created at the university level; it has to be created but nurtured—not just created—at a much younger age. I am especially conscious of this. I am on my second family. I have two kids in elementary school. In the United States, children are encouraged to ask questions, not provide answers to questions that teachers have asked, but to ask questions from the first grade on. We Americans complain all the time about our educational system, but I think this is a very positive aspect of the American educational system and it shows up at the university level.

Dr. Hamada: I do not remember if Prof. Cooper invited me to a conference he organized. On the other hand, every other conference I go, Prof. Cooper is invited. The secret is, as we have seen, that he has a special talent to make comments and particularly the concluding remark that put everything into a proper order.

Now let me use a few minutes with some positive but fragmentary notes about the international aspect of Japan before conclusion. Whenever I see the yellow sun or a sandstorm in Beijing, I wish Japan, our country, is situated on the west instead of the east of China. Then we will have better external economies. However, in some sense, this may be considered to be a good profit chance. The Japanese are having a civilized life, relatively clean air and water, solid technology to live in good environment. Therefore, ideas and technology for civilized human life will be exported abroad. It is an opportunity to profit, but the opportunity for Japan to improve welfare of people in the world.

I know a lady from Indonesia who graduated from Nagasaki University in economics, and now an accountant expert at Yale. She tells me that Japanese people and their ways of life are very much liked by people in many parts of the world. When I visited African countries with the external evaluation team of IMF, Enhanced Structural Adjustment Facility (ESAF) as it was called. People said, Japanese Embassies and Japanese politicians or Japan External Trade Organization (JETRO) are friendly and helpful. They appreciate, however, the people working for JICA. They go into farms or factory and fixing technical problems and so forth. Japan developed after its long growth period substantial techniques that can be taught abroad to improve the welfare of the international society.

I would like to thank all the participants, particularly those who came after long trip, to discuss so lively the economics of the new Prime Minister Abe. Also I would like to thank ESRI, the research institute of the Cabinet Office. In spite of my remarks on Japanese bureaucrats, they demonstrated themselves to be very efficient today and we would like to applaud their great accomplishment.

Lastly, Mr. Kenji Umetani, President of the Economic and Social Research Institute, would like to give a closing remark by way of thanking the audience and panelists.

Mr. Kenji Umetani, President, Economic and Social Research Institute: In closing, I would like to make a brief comment. On behalf of the organizer, I would like to express my gratitude. Thank you for attending the two-day conference. Such active discussions were made not only from the short-term perspective, but also longer policy direction. I would like to sincerely express my gratitude for coming over to Japan to be a part of these active discussions and for the foreign travelers who came to share their insight with us. Abenomics has been recognized globally and we have been successful in changing expectations toward the Japanese economy. In order to grow out of the deflationary economy, we would like to reconstruct our economy. We sincerely hope that the fruits of this conference will serve that objective so as to contribute to the global economy, so we sincerely hope that we play a role to conduct a study on the policy with the kind participation of the audience and the panelists here. I would like to apologize if there has been any inconvenience regarding the way the conference has proceeded. Thank you for your kind attention to this conference.