Challenges of Abe-nomics

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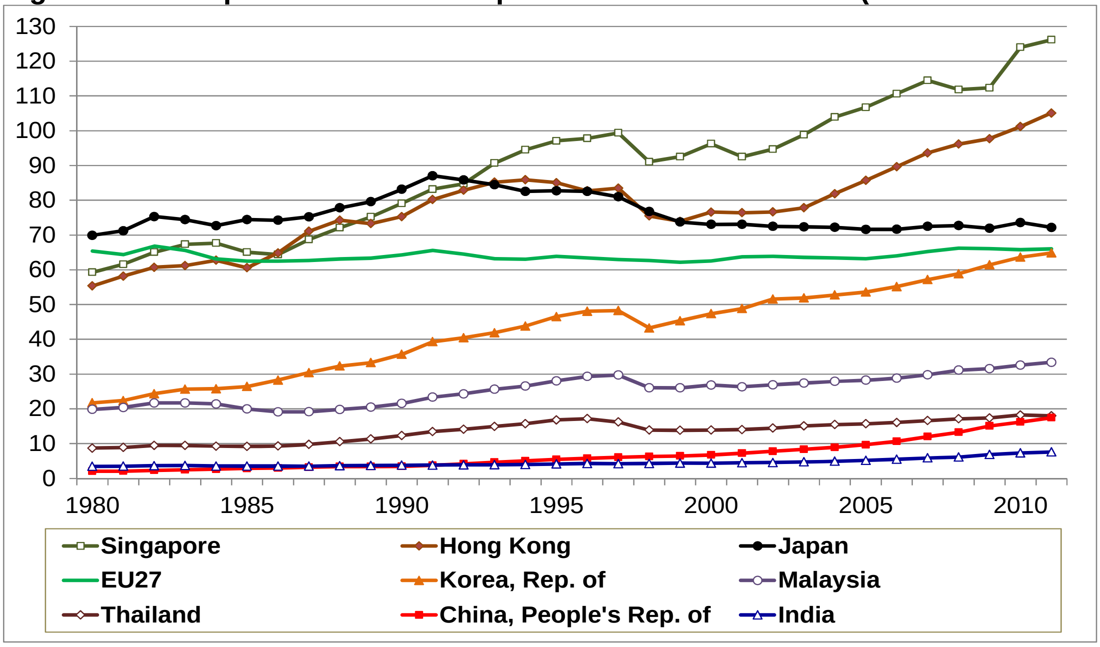
1. Need for Economic Growth

Japan's real GDP growth rate has been low in the post-bubble period, averaging 0.8% from 1992 to 2012. As a result, its per capita real GDP has not grown much particularly in comparison to many other economies in the world. For example, Japan' per capita real GDP (measured at 2005 PPP international dollars) as a percentage of the US level peaked at 87% in 1991, but then gradually declined over time to 72% in 2011 (see Figure 1). The figure shows that in contrast to Japan, most Asian economies have shown much higher per capita real GDP growth and that the EU27 has maintained a relatively constant share of the US level.

Figure 1: Per capita real GDP for Japan and other economies (% of the US level)



Note: Per capita real GDP is measured at 2005 purchasing power parity (PPP) international dollars.
Source: World Bank, *World Development Indicators* database.

Moreover, Japan's nominal GDP has been stagnant over the last 20 years: having reached a peak of ¥520 trillion in 1997, it began to gradually decline, falling to ¥480 trillion in 2012, about the same level as in 1991 (see Figure 2). In contrast to the remarkable two-decades long lack of nominal GDP growth, Japanese government debt has kept rising due to chronic fiscal deficits, and the government's gross and net debt as a ratio of GDP are expected to register 220% and 140%, respectively. It is clear that the level of government debt is unsustainable and that without nominal GDP growth and strong fiscal consolidation efforts,

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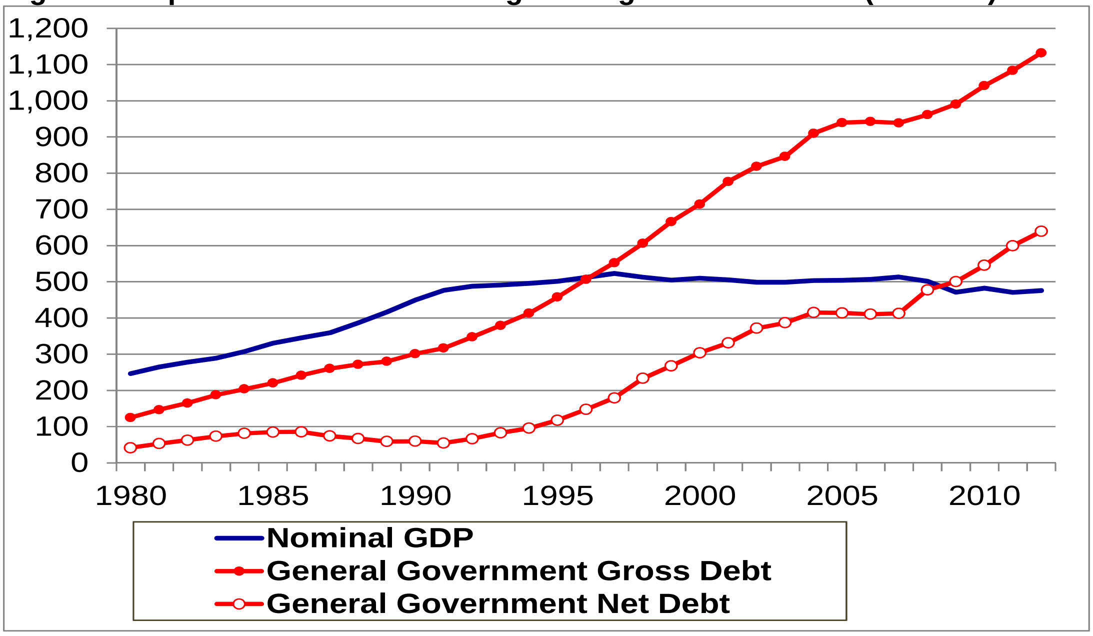
Japan would be heading toward a sovereign debt crisis. Once a sovereign debt crisis occurs, economic growth would be further disrupted and the current pace of social security spending and public service provision could not be maintained particularly in light of the pressures arising from a rapidly aging population.

Figure 2: Japan's nominal GDP and general government debt (¥ trillion)



Source: IMF, WEO database, April 2013.

Thus, Japan faces the enormous challenge of revitalizing its economy within a super-aged, and still aging, society and a significantly large government debt. The most important objectives of Abe-nomics are to end the long-term stagnation, revitalize the economy, and avoid a future debt crisis. Its success would provide a very useful lesson for other economies about how a mature, developed economy can resume long-term growth, tackle the aging problem, and restore fiscal and debt sustainability.

2. Challenges of Abe-nomics

As is well-known, the aim of Abe-nomics is to revive the sluggish Japanese economy with "three arrows"—more aggressive monetary policy easing by the Bank of Japan (BOJ), a massive fiscal stimulus, and structural reforms to boost Japan's productivity. What are the challenges facing three-pronged plan to lift Japan out of long-term stagnation?

Monetary policy easing

If aggressive monetary easing by the BOJ is successful, it will lead to any of the following outcomes. One outcome is that abundant domestic liquidity could generate an asset price boom, which would stimulate household consumption (through wealth effects) and corporate investment, but could also create asset price bubbles (if the underlying fundamentals do not improve) and financial sector vulnerabilities. A second outcome is that the long-term interest rate could eventually rise, creating risks for the Japanese financial system which is one of the most heavily exposed to domestic sovereign debt in the world. A third outcome is that the government's interest payment on its outstanding debt could rise, thereby making it difficult to pursue fiscal consolidation and raising the risk of a sovereign debt crisis.

These outcomes would require the BOJ and the Financial Services Agency (FSA) to intensify market surveillance—so that the risks in the fiscal side and in asset markets do not jeopardize the health of the financial system—and to design a macroprudential policy framework to maintain financial system stability. To avoid the second outcome, fiscal consolidation on the part of the government will be necessary.

Flexible fiscal policy

Flexible fiscal policy means a policy of supporting aggregate demand through temporary fiscal stimulus. Fiscal stimulus is also useful in supporting anti-deflationary monetary policy, and can provide a breathing space to implement structural reforms. The potential problem is that fiscal spending appears to be directed for traditional public works, but this should not be the case. Spending had better be directed for structural reform-supporting programs in line with the growth strategy.

If economic growth prospects continue to be favorable, the government will likely implement its planned consumption tax hikes in April 2014 and in Oct 2015.[1] But these could have contractionary macroeconomic consequences and might derail economic recovery and expectations of inflation. In light of this some have argued that consumption tax hikes should be avoided or postponed in order to support sustained economic growth. Although it is important to maintain economic growth, the planned consumption tax hikes are of critical importance to fiscal consolidation. If the planned consumption tax hikes were avoided or postponed, it would be very difficult politically to reinstate the decision to raise consumption tax rates at a later stage. A better policy option would be to increase the consumption tax rate as scheduled while considering to mobilize government spending for reform-supporting purposes—such as encouraging R&D investment, and supporting green growth, working mothers and agricultural reform—to offset the possible negative impact of tax hikes.

Growth strategy

The most important arrow of Abe-nomics is to carry out structural reforms in major economic sectors as part of a comprehensive growth strategy to ensure that Japan's productivity level will continue to rise.

Steady long-term economic growth requires constant increases in the quantity and improvement in the quality of labor and the capital stock as well as the level of technology. Encouraging women—particularly working mothers—and the healthy aged to return to, or stay in, the labor market is critical to increasing the labor supply. Investment in human capital, education and skills training is essential to improve the quality of labor. Given that net investment has been declining over the past 20 years (due to low levels of gross investment and rapid rises in capital depreciation), it is important to raise the capital stock through more aggressive gross investment and to improve its quality. Providing the right environment for active R&D and innovations by the private sector is critical to improving technology and productivity.

A series of deregulation measures—in such areas as labor markets, the health sector, energy and agriculture—would be needed to reduce impediments to private sector vitality. Professor Richard Cooper correctly pointed out that business-stifling regulations lead an economy to produce at a point below the production possibility frontier and that deregulation can shift the level of economy activity toward its production possibility frontier. In this sense deregulation can raise the level of real GDP. Thus continuous regulatory reforms over time can enhance total factor productivity (TFP). Moreover, the removal of business-unfriendly regulations would have the added value of fostering private-sector entrepreneurship.

[1] One may interpret flexible fiscal policy not only to refer to short-run fiscal stimulus but also to include fiscal consolidation as a medium- and long-term objective.

The government is focusing on industrial revitalization, strategic market creation (health, agriculture), and international partnership. I believe this approach is sound. Perhaps pushing energy security and electricity market reform should also be considered with greater urgency. International partnership—particularly through the Trans-Pacific Partnerships (TPP), the Japan-EU Economic Partnership Agreement (EPA) and the Regional Comprehensive Economic Partnership (RCEP)—could be extremely valuable as they would address various types of behind-the-border regulatory reforms. There would be significant synergies among the efforts to conclude these agreements. Given the closed nature of the Japanese economy—as shown by the global ranking of No. 194 (out of 198 countries) in the stock of inward FDI and No. 167 (out of 172 countries) in imports, both as a ratio of GDP (see Table 1)[2]—these trade agreements have the potential to further open up the Japanese economy to the rest of the world. To pursue the TPP, agricultural sector reform is vital as Japan will have to further expose the agricultural product market to international competition.

Table 1: Japan's economic openness, 2011

Openness indicators	Values	Global ranking	Advanced economy ranking
Export/GDP	13.9%	No. 137 out of 173	No. 31 out of 34
Import/GDP	14.5%	No. 167 of 172	No. 34 of 34
Stock of outward FDI/GDP	16.5%	No. 46 out of 155	No. 28 out of 34
Stock of inward FDI/GDP	3.9%	No. 194 out of 198	No. 34 out of 34

Note: Advanced economies include 35 countries as defined by the IMF, but no data are available for San Marino.
Source: IMF, *International Financial Statistics*; UNCTAD.

Fourth arrow: Fiscal consolidation

Professor Kazumasa Iwata suggested that fiscal consolidation should become the fourth arrow of Abe-nomics, and the government indeed has adopted this approach.[3] I believe this is the right approach. Fiscal consolidation would require cuts to the main spending items such as social security and grants for local governments—which together account for almost half of central government spending—as well as increases in tax revenues such as through hikes in consumption tax rates. To contain social security-related spending, this new arrow would have to address the issues of what sort of social security system would be desirable for Japan and how such a system can be made sustainable in a rapidly aging society. To cut grants for local governments, more fiscal decentralization is necessary so that local governments can collect more taxes to finance the provision of local services and local public goods.

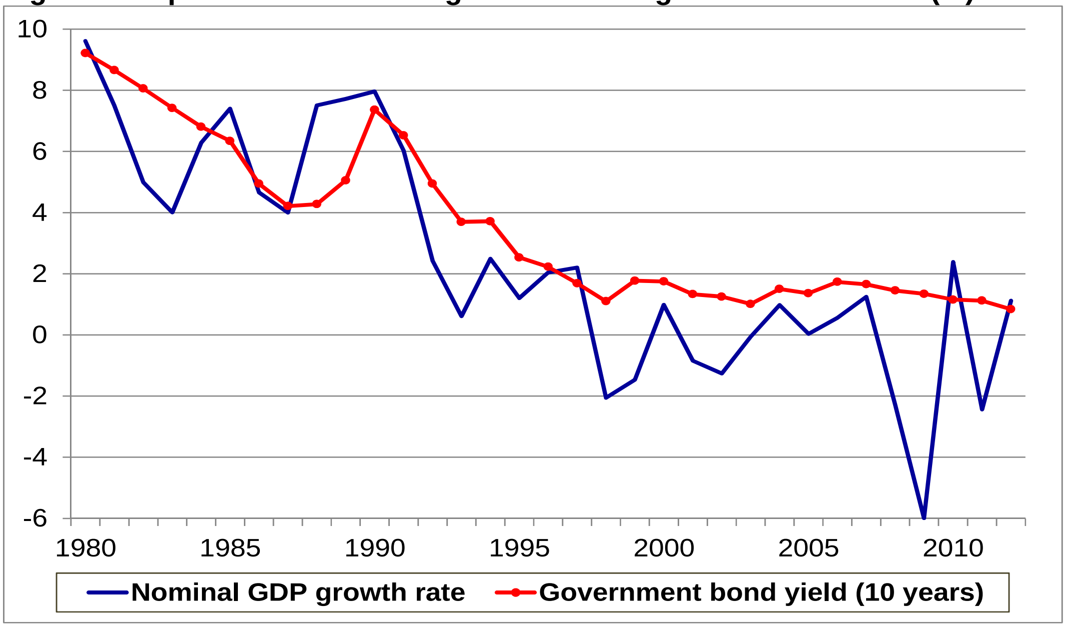
The government's existing medium-term fiscal consolidation program has become unrealistic in terms of schedule and thus will have to be revised in a credible way. Under the program, government is committed to halving the primary deficit/GDP ratio of FY2010 (which amounted to 6.6%) by FY2015, turning the primary balance into a surplus by FY2020, and beginning to reduce the government debt/GDP ratio from FY2021. This schedule is highly optimistic even if the consumption tax rates rise from 5% to 8% in April 2014 and then to 10% in October 2015. The reason is that the primary deficit in FY2013 is likely to rise to 6.9% due to the large supplementary budget. Cutting the primary deficit by 3.7% of GDP over the next two years—so that the primary deficit is reduced to 3.2% of GDP by FY2015—could turn out to provide a significantly negative impact on the economy. The fiscal consolidation program at least for FY2015 would have to be pushed forward at least for a few years, even though the target for FY2020 may be maintained.

[2] Japan has been a virtually closed economy in terms of the stock of inward FDI and imports, both as a ratio of GDP. Countries behind Japan in terms of inward FDI include Burundi, Cuba, Nepal, and Burkina Faso. Japan's level is even lower than that for North Korea. Countries behind Japan in terms of imports include Brazil, Venezuela, Sudan, Iran and Libya.
[3] This means that the second arrow of Abe-nomics, i.e, flexible fiscal policy, focuses on fiscal stimulus and does not include fiscal consolidation.

As mentioned earlier, however, the planned consumption tax hikes will have to be implemented as scheduled rather than being postponed. If they are judged to have negative impact on the economy, government may support economic activity through reform-supporting spending. Over the medium term, the consumption tax rates will have to go up further, probably towards the 20% level, as in the case of most other developed countries.

In addition, nominal GDP growth is necessary to facilitate fiscal consolidation. Over the last 20 years, nominal GDP growth rates have been lower than the long-term interest rates (Figure 3). Under such a circumstance, the primary surpluses that would be needed for fiscal consolidation would have to be unrealistically large, or fiscal consolidation would have to take a much longer time than desired. A sufficiently high nominal GDP growth rate, higher than the nominal long-term interest rate, would clearly help the fiscal consolidation efforts.[4]

Figure 3: Japan's nominal GDP growth and long-term interest rate (%)



Source: IMF, *International Financial Statistics*.

3. Quality of Growth

Although growth is important for the Japanese economy, the quality of growth is even more important. Professor Joseph Stiglitz has focused on the importance of quality of life. It seems that he has essentially talked about the importance of socially inclusive growth as well as environmentally sustainable growth.

Inclusive growth

In Japan, both the rate of unemployment and the level of income inequality are relatively low from an international perspective. But both have risen over the last two decades in Japan, which is a cause for concern.

[4] Under the usual circumstance, the rise in nominal GDP growth (resulting from rises in inflation rates and real GDP growth) would exceed the rise in the nominal long-term interest rate (which would correspond to the rise in inflation expectations) by the real GDP growth rate. A rise in risk premia can of course push up the nominal long-term interest rate, but this can be eliminated by the BOJ policy of purchasing long-term JGBs.

Inclusive growth means that the benefits of economic growth are to be shared by all segments of society, whether young or aged, males or females, skilled or unskilled, rich or poor, and so forth. Government policy must ensure that the young have jobs in promising sectors, women are engaged in the labor market, and the healthy aged can continue to work. Social sector protection policy must ensure that the unemployed can return to the labor market with adequate training, the aged are protected through sustainable pension and health systems, and the poor and socially vulnerable can enjoy a socially acceptable minimum level of living standards.

The implication is that inclusive growth may be embedded in the fourth arrow (fiscal consolidation and social security reform) or may become part of another new arrow that focuses on the quality of life.

Environmentally sustainable growth

Japan has made significant improvements in terms of environmental protection over the last 30 years. Since the first oil price shock in the early 1970s, Japan has developed energy saving production technologies. Its cities have become more energy efficient and environmentally sound than they used to be and compared with many other cities in the world.

However, since the Great East Japan Earthquake, which damaged the TEPCO Fukushima nuclear power plants, a big challenge for Japan has been how to achieve a good balance between energy and electricity security and global environmental sustainability. As the nuclear-based electricity supply has been disrupted, Japan has been relying more on imported fossil-based fuels—such as coal, oil and natural gas—and as a result its emission of CO_2 has increased, even though Japan is highly energy-efficient in coal and oil burning for power generation. In addition, import bills have soared and the trade balance turned into deficits because of the high cost of importing such fuels. Japan needs to use less-CO_2 intensive liquefied natural gas (LNG) and shale gas and develop more renewable sources of energy, such as geothermal, hydro, solar, and wind.

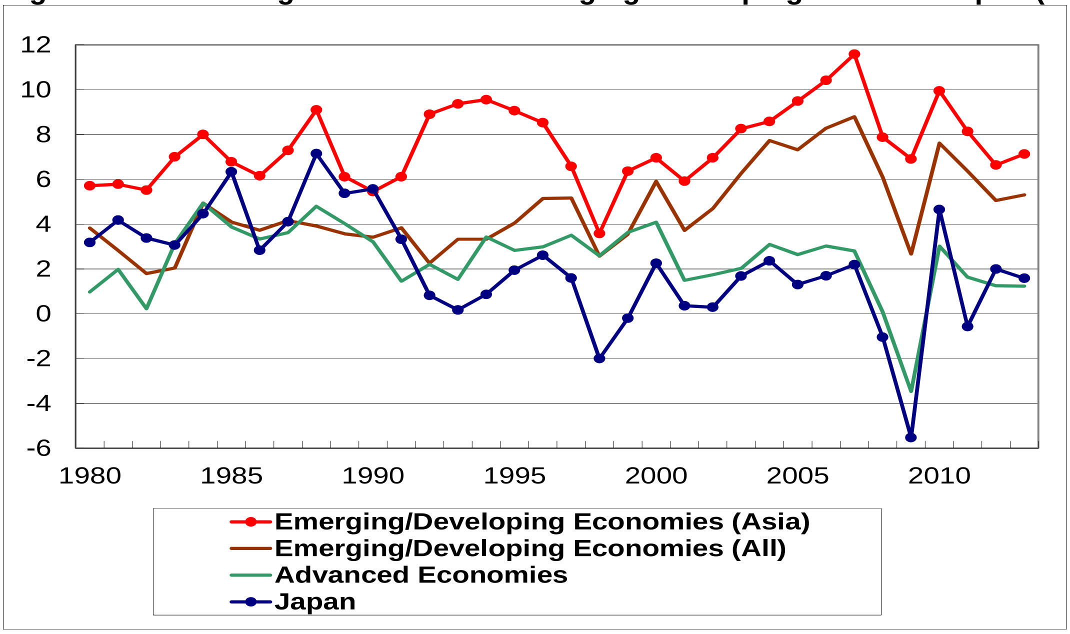
What this means is that Japan should pursue a green growth strategy. First, electricity sector reform—to separate electric power generation and distribution/transmission as part of the third arrow of Abe-nomics—is highly necessary to rationalize the sector and reduce CO_2 emissions. The reform can ensure stable supply of electricity at a competitive price by encouraging new power generators who develop renewable sources (such as geothermal, solar, and wind) to supply greater quantities of electricity. Second, Japan's environmental and energy-saving technologies—such as those for energy-efficient coal and oil burning, smart cities, high-speed trains, and clean water and sanitation services—would be useful for emerging and developing economies which face the problem of maintaining environmental sustainability. Thus, green growth for environmental sustainability could be part of the growth strategy.

4. Emerging Asia and Japan

Emerging Asia as a business opportunity

Emerging and developing Asia has been the fastest growing region in the world economy over the last few decades. Its growth rate has been higher than that of the world's average for all emerging and developing economies (Figure 4). Developed countries have been growing at a slower pace than emerging and developing economies, and Japan has been growing at rates even lower than the world's developed countries. This means that Japan can greatly benefit from working more closely with Asia's emerging and developing economies.

Figure 4: Real GDP growth rates for emerging/developing Asia and Japan (%)



Note: Data for 2013 are IMF projections.
Source: IMF, *World Economic Outlook* database, April 2013.

One important characteristic of emerging Asia is that following the PRC, India, and the major ASEAN countries, a series of low-income developing countries—like Bangladesh and Myanmar—are also coming to the world scene. The rise of the middle class and growing numbers of affluent people are creating a huge market for a wide variety of goods (both durables and non-durables) and services, particularly in the expanding urban centers of these economies.

Demand for infrastructure investment has also been expanding fast. ADB and ADBI projected that emerging and developing Asia has a total infrastructure investment need of $8.3 trillion during 2010–2020, or $750 billion per year. If the needed environmental investment were to be added, the investment needs would be much greater. Japanese firms can benefit from such huge market opportunities by helping emerging Asia to build their transport, information and communication technology (ICT), and energy infrastructure systems, particularly for smart cities, clean transport services, and energy-efficient water and sanitation services.

Economic partnership with emerging Asia

Open access to the entire Asian region would significantly expand the opportunities for Japanese firms to produce and export more and for Japanese households to consume and import more. For this purpose Japanese government need to take policy action to allow Japanese firms to consider emerging Asia as if it were a part of their own business area. Forging a Regional Comprehensive Economic Partnership (RCEP) among the ASEAN +6 countries (the ten ASEAN countries plus Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand) is a key step for the Japanese policymakers. An important step for successful RCEP negotiations is the completion of a trilateral agreement with the PRC and the Republic of Korea as a CJK agreement is an important missing link among the ASEAN+6 countries.

In addition to the RCEP, Japan needs to complete negotiations for the Trans-Pacific Partnership (TPP) as well as the Japan-EU Economic Partnership Agreement (EPA). These agreements can further open up and help revitalize the Japanese economy. To do so, Japan must achieve a high level of external liberalization through domestic structural reforms—particularly in agriculture—and various types of behind-the-border deregulation including changes in standards, rules and in some cases laws.

Managing the impact of developed country QE policies on emerging Asia

Emerging economies in Asia have already been impacted by the US quantitative easing (QE) policies in the form of capital inflows and exchange rate appreciation pressure. The BOJ's recent aggressive monetary easing— though beneficial to Asian economies once Japan has managed to end chronic deflation and restore sustained growth—can further aggravate the situation for these economies, at least in the short run.

As Professor Koichi Hamada has said, if these economies were to adopt much more flexible exchange rates, the negative impact could be significantly mitigated. These economies could also adopt monetary policy easing to offset exchange rate appreciation pressure if necessary. However, small open economies in Asia cannot afford to have very volatile exchange rates under flexible exchange rate regimes. These economies have underdeveloped financial markets and lack well-diversified industrial structures. Rather than solely relying on exchange-rate flexibility, they need policies to manage capital inflows that use a combination of macroeconomic, macroprudential and structural measures to be able to maintain macroeconomic and financial stability.

In addition, Japan and emerging Asian economies must start thinking about the possible consequences of the US's unwinding of QE policies. Once the US Federal Reserve System starts tightening monetary policy, massive capital outflows could occur in Asia, putting the region's emerging economies in vulnerable situations. Appropriate policy reactions will be needed in the future to cope with this challenge.

Peace and security

Finally, it is essential to maintain peace and stability in the region. Japan's diplomacy must support the government's growth strategy particularly in relation to emerging Asia. The recent visits by Prime Minister Shinzo Abe to several emerging Asian economies—such as Indonesia, Mongolia, Myanmar, Thailand and Viet Nam—are positive signs indicating the government's seriousness about strengthening economic relations with these countries.

However, some of the recent discussions on contentious non-economic priorities—such as those relating to constitutional changes and certain history issues—are aggravating political relationships with the PRC and the Republic of Korea. In addition, the North Korean nuclear issue is casting a dark shadow over the region's peace and security. It is vital for Japan to restore good political relations with the PRC and the Republic of Korea and cooperate with them to ensure that the region can enjoy peace and security. In this way, Japan can maximize the benefits of the rise of emerging Asia. It is to be hoped that the government will put the highest priority on the implementation of Abe-nomics for economic revitalization, setting aside the contentious non-economic issues, at least for the next several years. In this way, Prime Minister Abe can most effectively mobilize his political capital to achieve much needed economic reform and revitalization.

5. Concluding Remarks

The Japanese economy has been mired with long-term economic stagnation—often referred to as the "lost two decades"—since the bursting of the asset price bubble in the early 1990s. Japan has not been contributing to global economic growth for the past 20 years. Restoration of sustainable economic growth in Japan will benefit not only Japan but also the rest of Asia and the world economy. Abe-nomics, as a package of macroeconomic and structural policies, can provide a solution for Japan's long-term economic growth problem.

Without economic growth, it is not possible to maintain the current levels of social security spending or other public services as the fiscal situation is no longer sustainable. Ending price deflation and resuming nominal GDP growth through monetary and fiscal policy support would be the first step. The next step would be to raise productivity and (per capita) real GDP through structural reforms—including various types of regulatory reforms and growth-supporting structural reform measures. One important component of the government's growth strategy must be a clear Asia strategy, so that Japanese firms and consumers can gain from the dynamism of emerging Asian economies. This would require the supporting "diplomacy" that can strengthen Japan's political relationships with its neighbors.

Japan also needs to ensure that economic growth is both socially inclusive and environmentally sustainable. The benefits of growth need to be shared by the majority of Japanese people and by the global community on the climate change agenda. Fiscal consolidation must be pursued without jeopardizing social fabric. Energy sector reform must aim to achieve low-carbon energy security.