

Speech

Abenomics: An American View

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Americans see Abenomics in a few ways. Japanese economic and political developments are still largely ignored or taken for granted in the United States, in contrast to 15 or 20 years ago when Americans viewed the Japanese economy with a combination of fear and admiration and followed it very actively.

There have been three reactions to the Abenomics policy by Washington insiders and the New York markets. The first is a generally positive view of a Japan with a strong prime minister and a strong government. The post-Koizumi era with the rapid turnover in prime ministers was very unhelpful.

The second set of responses tends to differ depending on whether people work on the foreign policy/national security side or the purely economics/market side. Those in the former are very positive. There is occasionally concern about some of the symbolic aspects, including the Yasukuni shrine discussion (a misstep in my opinion), but broadly, the very positive feelings in defense and diplomacy circles is that Japan is lining up with the United States and will more than share the burden on security, and there is much sympathy among Americans for potential constitutional change or a change in attitude. It's not 100 percent, but people are much happier with that than with the Democratic Party of Japan (DPJ) governments of recent years, which were viewed frankly as somewhat anti-American, and previous LDP [Liberal Democratic Party] governments were seen as irresolute and unable to commit to or make decisions.

On the economics side, it's somewhat different. As those at the Research Institute of Economy, Trade and Industry (RIETI) know, there was a generation of people who specialized in Japan and US-Japan economic relations and US-Japan trade. Many of them were only responding to incentives and have been left high and dry as the perceived importance of Japan has declined over the past 10 years. Many of these people have a vested interest in being cynical and are very publicly dismissive of Abenomics. Meanwhile, a number of the best Japan specialists have moved on to other issues—people with transferrable skills transferred and those without them remained. The unfortunate impact of this is that much of the press coverage is dominated by this group of leftover people who are very cynical about Abenomics and Japan.

It's a little different in my community: economists who have worked on Japan in the past. Among this group, which includes central bankers from around the world, there is huge excitement and admiration for what the Bank of Japan (BOJ) is doing. An overwhelming majority of central bankers are very strongly supportive of what the BOJ is doing and very impressed with how they are doing it. Broadly speaking, Abenomics has strong support from the central banking community.

This can be seen on the exchange rate issue, where the US Federal Reserve and the BOJ have cooperated de facto by not viewing domestic quantitative easing, in the United States and in Japan, as an attack on exchange rates or manipulation. Former Federal Reserve Chairman Ben Bernanke explicitly stated this on a number of occasions. This wasn't altruism. The BOJ, the Bank of England, the Federal Reserve, and, in some ways, the People's Bank of China, are basically on the same line. This part of Abenomics enjoys very great support.

Views are much more mixed among market circles. I have received a very mixed picture from the major hedge fund and fixed income investors and others with whom I've spoken. They don't seem to view the Nikkei as overvalued yet and were bullish through the start of this year. They also believe in the BOJ but are increasingly worried about debt sustainability in Japan. That's a technical issue. It would be wrong not to worry at all about Japanese government debt, but there is a tendency to overestimate massively the risks. Hedge funds have tried repeatedly to short the Japanese government bond (JGB) market by taking positions to profit from rising interest rates and have lost very large amounts in the process. I have advised hedge funds repeatedly not to bet against JGBs.

However, I would welcome your assistance in communicating to Japanese politicians the fact that while private foreign investors cannot greatly affect the JGB market given the purchases

by the BOJ and other institutional factors, they can have a very large effect on equity prices in Japan and on the yen. Given the mindset of many investors, if the Diet were to postpone or fail to pass the second increase in the consumption tax this fall, international investors would react very negatively. Investors sometimes react in stupid and unjustifiable ways, but in this case I'm sympathetic with their views. If the government continues on the path of slow but steady tax increases, it will be seen as increasing the danger and a bad commentary that the government cannot deliver. The view of many foreign investors is that if Japan cannot deliver the consumption tax increases now with the easy monetary policy and the mandate that the Abe government has, then it never will. There is a risk of a negative shock in the stock market and in the yen later this year if the Diet wavers on this point.

Moving on to the trade issue, which is one of the most controversial and complicated pieces of Abenomics and of great interest to RIETI. This is a very difficult issue for the United States, but the world has changed fundamentally since the mid-1990s, when people in the United States were scared of Japan, because of the subsequent creation of the World Trade Organization (WTO) and changes in the US economy. While trade is a very difficult issue for the United States, almost none of our current trade concerns and bad behavior are directed at Japan. There is very little of the direct anti-Japanese trade sentiment that was so strong in the United States through the mid-1990s, though some geographical areas remain concerned. Because the states of Ohio and Michigan saw the largest declines in auto production, they retain a permanent narrative that this was due to unfair competition by the Japanese. The United Automobile Workers (UAW) labor union is very active in supporting particular Congresspeople from those states, and their senators and most of their Congresspeople are still very auto-centric and anti-Japan, but this is a very small segment of the overall US political picture and a very small portion of the trade picture.

In bilateral Trans-Pacific Partnership (TPP) discussions between the United States and Japan over the last year or so, despite ongoing tensions in the auto and insurance sectors, we are close to reaching a deal. At present, the remaining issue to discuss in any depth is agriculture, not autos, insurance, or something else. This should be solvable since there are people in Tokyo, including the Abe government, who would be happy to push some agricultural reforms. In that narrow sense, US-Japan trade relations are potentially on a good path. There's a big national security group in the United States that views the TPP as extremely important. Another issue is the hope that the United States could export natural gas to Japan, thereby strengthening the alliance while boosting US exports and helping Japan's energy stability.

However, the broader trade picture in the United States with respect to the TPP is not great. US President Barack Obama chose not to make a very strong push on trade in his State of the Union address this year. This contrasts with a year ago when he specifically mentioned the trans-Atlantic negotiations and made a general push on trade. This was followed by Senator Harry Reid and House Minority Leader Nancy Pelosi stating that there would not be a vote on trade promotion authority this year and certainly not before the November mid-term election. Vice President Joseph Biden then immediately said that the Trade Promotion Authority (TPA) would not be pushed in Congress before the election. I view this as a very bad decision by the White House. If the TPA were brought properly before Congress, it would likely pass with mostly Republican Party votes. The president and his senior political advisors obviously have made a purely political decision not to support a bill that would win with Republican votes or to avoid jeopardizing certain House and Senate races with a trade push.

What does this mean for the TPP going forward? The TPP obviously is very important for Japan and Abenomics as well as for the United States and our friends in Asia. The first thing to remember is that the United States is largely motivated by a desire to update the North America Free Trade Agreement (NAFTA) and some of our Latin American deals without admitting to doing so. This emphasizes how important Japan is to the United States: Cooperation between both countries was an important way of setting high standards for the TPP negotiations and ensuring that the agreement would contain strong intellectual property rights and environment rights protections, and that it would strongly challenge state-owned enterprises.

I will conclude now on the TPP and discuss Abenomics in the question-and-answer session. There are very experienced people including my colleague Jeff Schott who will argue that there is no need to worry too much, that Ambassador Froman will continue negotiating from the Office of the United States Trade Representative (USTR), that it is inevitable that Reid and Pelosi would talk negatively about trade, and that shortly after the election, Congress will pass the TPA and quickly pass the TPP. The TPP can also be sold as a response to China's rise. This is a plausible scenario, a reasonable forecast, and I hope it's right because it's the best we can hope for, that roughly a year from now we will have a deal.

What I personally worry about is two-fold. The first worry is that this president will not make it a priority to get the TPP through, even after the election, causing the process to drag out. The greater worry is that the US negotiation partners in the TPP, including Japan, but more worrisome concerning Malaysia, Vietnam, and Singapore, will be discouraged by the US negotiators not being able to deliver Congress. The United States is unpopular in Korea right

now for similar reasons, and this is also one of the factors behind the fact that Korea is not in the TPP. Some Asian partners in the TPP have doubts in the background of their thinking as to why they should put so much at risk, believing that maybe they should hold out longer on agriculture or state-owned enterprises and see what happens in the US Congress. The Obama Administration has done great harm to itself on the TPP, so the worry is that the negotiations may start to unravel from the other end. That won't be directed at Japan, but it would be a very big loss for Japan as well.

Finally, circling back to Abenomics: I would like to give my personal view, which appears in a memo I wrote and that RIETI will distribute on its website. A different version of that also appeared in [today's *Financial Times*](#).

Put simply, by the standards of economic reform packages, I think Abenomics is quite good. It is doing many of the things that other mainstream economists and I have been advocating for a long time. It's also more risky and less easy now than if it had been done 10 or 12 years ago. It includes the right components: monetary stimulus, slow but ongoing permanent fiscal consolidation, and structural reform, starting with the labor market and female labor participation and other key things including health care and agriculture.

Many governments have purported to do reform, including Japan in the past, but they get the economic analysis wrong or do too many things at once. Instances of that include Indonesia in 1998 or Greece recently. This leads to distraction and insignificant progress. The people advising the prime minister have avoided many of those mistakes. The priorities are not innumerable, and they are, broadly speaking, the right ones and not wasting time on politics.

My complaint is that simply not enough is being done; it needs to be more ambitious. Raising the consumption tax to 10 percent and dangerously suggesting that it might be postponed is not sufficient. There needs to be a multi-year commitment to raising the consumption tax to the neighborhood of 20 percent, which might take five or more years. Increasing female participation in the workforce is good for the economy, but instead of providing 150,000 nursery places, there is demand easily for 300,000–400,000 spots. Instead of quotas for middle management in government alone, the same should be in place for the private sector.

To conclude, I saw the prime minister's excellent and well-received speech in Davos this year at the World Economic Forum. There is a great image that he is going to be the diamond drill bit that goes through the hardened special interests. They've set up the huge expensive drill bit, moved it to the rock face, and they're drilling two inches. If you're going through all of this trouble, you might as well drill a little deeper than that.

Transcript
Question and Answer Session

Q1: I was very encouraged by your speech. The top Japanese leaders seem frustrated by American reactions. Why do you think American officials do not deliver their appreciation to the Japanese government?

Adam S. POSEN

Much of it comes down to this president. There are many insider stories and reporting that President Obama is very standoffish, doesn't interact with people very well, and acts very entitled. Another factor is his lack of interest in foreign affairs. There also is still a fundamental feeling in the United States, including in much of the national security community, that it's not a credible threat that Japan would suddenly say, "We don't need the United States, and we're going to be nice to China." The Japanese government has to realize at some point that it doesn't have a strong bargaining position.

Q2. You are the most well-known and authoritative person on monetary policy. Could you talk about the cost of quantitative easing (QE)? Do you have any other advice for the Bank of Japan?

Adam S. POSEN

I am amazed by the amount of discussion about the costs of QE. There's actually no good evidence that there's a cost to QE, and it's not even clear that there's a good theoretical case for it. Taking Japan's history over the last 15 years or so as an example, it's a counterargument: There were various forms of quantitative easing, but we didn't see inflation, there was no bubble, and there was no breakdown in market functioning—the three biggest costs that people talk about.

The BOJ policy board at the moment is actually in a good place. Looking at it carefully and econometrically, Ben Bernanke made this clear: On the data, QE basically looks every bit as effective as normal monetary policy, or at least close to it, in terms of its monetary impact.

The vast accumulation of academic research on monetary policy as well as applied work on monetary policy over the last 30 years reveals that people don't believe cheap talk by central banks. The whole point of QE is actually to buy something, to have something at stake—actions speak louder than words. When people talk about forward guidance, to me, it's at best no different than when a central bank governor gives a speech.

As for the BOJ, most people, even on the policy board, don't think that the 2 percent will happen in the two-year promise. I think there will be significant progress towards that goal, and we are already seeing that. But whether you are going to get there, and in a sustained way with expectations going forward, bond prices going forward, etc., is still in question. So, the issue for the BOJ policy board for the next year will not concern forward guidance but rather whether to add more stimulus or keep going on the current path.

Q3. You're proposing that we raise the consumption tax to a level of approximately 20 percent, somehow avoiding a collapse caused by that. In the past, on the industrial side of things, Japan managed things in a very special way that separated itself somewhat from the rest of the international economy. The reason we haven't seen more negative impact over the last 10 years from some of the changes is that in fact over that period of time, Japan truly has integrated itself into the international economy and no longer has different input costs and different rules for the game. Perhaps you are suggesting that if we just keep on with QE more and more, that somehow that will moderate the impact, but if the rules have changed and money that used to stay in Japan starts moving out very quickly, couldn't we have a very difficult situation?

Adam S. POSEN

The first point is that there is no costless way to do this. At this stage, abrupt changes to the tax system are required, and there will be accumulated debt. That this wasn't done 10 or 12 years ago is one of the big losses of the lost decade. Whether the consumption tax is the fairest tax to go with in Japan can be argued. There are issues with raising the consumption tax. Usually, most people would say that you also want to have either direct subsidies on food and basic clothing or exemptions or direct subsidies to poor people or similar measures in order to curtail negative distributive effects. I don't know whether the Diet will do that.

Looking at the economic math, I believe that Japan can get to a sustainable state. It should be possible on a 20 percent consumption tax, which frankly is not that unusual—looking at Europe, a VAT in the 17 to 27 percent range is not unusual, a cutback on benefits for the elderly, and a growth rate that ideally stays above 1.5 percent on average. People like my colleague Mitsuhiro Fukao of Keio University would say that even a 25 percent consumption tax would not be enough and that other things would be required.

As far as structural reform, if you actually look at the data, the multiplier on fiscal policy is not that different from the past four decades; it doesn't change that much over time. It might change greatly if Japan became radically more open so that fiscal spending programs would

see a lot of the money go outside the country. But it is wishful interpretation of the data to suggest that Japan has become radically more open. I think that Japanese industry quite rightly and sensibly has moved production abroad and integrated its supply chains and so on. That required change in Japan and foresight on the part of Japanese industry. In past work from a dozen years ago, I pushed for “Made by Japan” rather than “Made in Japan” strategy. That change has happened. It will not have a great effect on fiscal policy.

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