

# AN AMERICAN'S ASSESSMENT OF ABENOMICS AT MID-TERM

ADAM S. POSEN

Japan has been the subject of unrealistic growth expectations for more than two decades. When I was first writing about Japan 17 years ago, for example, the expectations were unrealistically pessimistic. At that time many experts feared that Japan would be doomed to unending stagnation, that it would never grow again. Yet when Prime Minister Junichiro Koizumi and Heizo Takenaka, his economic policy czar, cleaned up the banking system in 2002–03, and then the Bank of Japan (BOJ) stopped promoting deflation, Japan had its longest postwar expansion.

Today, the expectations have flipped. A number of people in markets and in Japanese politics set unreasonably high expectations for Japan in 2014 following Prime Minister Shinzo Abe's election in December 2012. These overly optimistic promises are distorting the current policy choices and now have dampened a number of forecasts for GDP and inflation for 2015 because everyone is overreacting to the surprisingly bad data of 2014Q3 (the second quarter contraction was no surprise). A more realistic approach is needed, one that is more positive about the successes of Abenomics to date, than the views underlying some recent exaggerated markdowns for 2015 and 2016. Yet, I would emphasize that Prime Minister Abe's government must still confront some important policy challenges to get growth up sustainably and meaningfully.

## ACHIEVEMENTS ON ONE-AND-A-HALF OF THREE ARROWS

In essence, the Japanese recovery is going right even if it is not going well. Prime Minister Abe's government was trying to combine a long-term fiscal consolidation with monetary expansion and real structural reform. Pursuing these three goals simultaneously is not easy. The most important structural reform for Japan is actually well under way. Many economists around the world have repeatedly emphasized the paramount importance of mobilizing the educated underemployed women of Japan to expand labor supply. The Abe government has made meaningful progress on that front. There is also some progress on other labor market issues. Also, the monetary regime change has been effective. The BOJ has not only driven down the currency for a few months at a time; there has been a fundamental shift in the price-setting regime and we are now seeing that throughout the economy. If Southern Europe were half as successful at pursuing this combination as Japan has been in the last two years, including its adoption of a sound fiscal-monetary policy mix and its implementation of significant labor market reforms, people would be impressed.

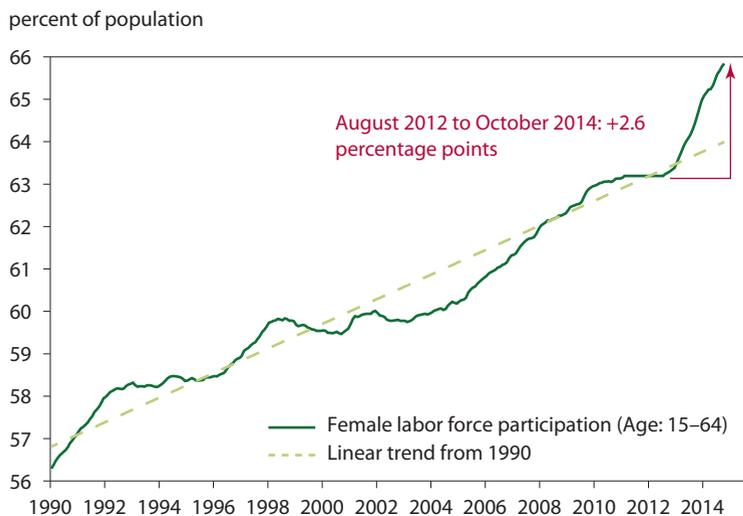
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But because Abenomics as initially proposed represents genuine change, required actual reform, and harmed certain interest groups, as well as representing implicit recanting of mistaken past policies, its future is not certain. Japan's form of democracy may not be entirely comprehensible to outsiders, but it is clear enough for me to say that the outcome is up in the air. Reforms are far from guaranteed to continue, even with the Liberal Democratic Party's renewed mandate.

Two major policy choices are at the center of the situation. In both, the Abe government is failing to carry through of late after initially proposing the right policy measures. First, Japan is not doing enough to avert a potential breakdown of the Trans-Pacific Partnership (TPP) talks. Frankly this failure hinges on whether Japan is willing to reduce its agricultural protectionism in its own self-interest. The other policy failure is fiscal. Prime Minister Abe, responding to political pressures and misplaced fears of lasting damage to the economy, has postponed the previously announced (and needed) consumption tax hike from 2015 to 2017. These two choices will have very significant implications for the outlook for Japan, both short- and long-term, and thus the world.

**Figure 1 Female labor force participation in Japan, 1990–2014 (12-month moving average)**



Source: Statistics Japan (Ministry of Internal Affairs and Communications).

Let us start with the most important and best news. Japanese female labor force participation has been rising for years, but its growth has accelerated enormously since Abenomics began. Female prime-age participation is now 2.6 percentage points above its long-term trend since January 2013 (figure 1). To give a sense of the magnitude of that achievement, the United States is now actively debating about whether an additional 1 percent of those who left the workforce between 2008 and the present could return to work. For Japan, the rise in female labor force participation constitutes a positive structural shift on the order of 1.5 percent of the total workforce. This matters and gives the lie to claims that there has been no reform so far.

The depth and size of this structural labor reform, bringing women in greater numbers into the workforce in Japan, however, is producing a deflationary effect. Such downward pressure on wages is only to be expected. Serious labor market reform, as Germany undertook in the early 2000s, for example, or as Spain and Italy are attempting right now with varying degrees of success, puts downward pressure on wages during the transitional period of expanding labor supply and deregulating labor markets. But these developments constitute a positive trend for the Japanese economy. (An equally positive development with more room to expand would come from allowing immigration, but leave that aside for the moment.) Of course, in the short run, it is a positive supply shock, which reduces inflation.

A large share of that participation increase has taken the form of part-time work, which produces mixed benefits and costs for the economy as a whole. As we know from the Nordic experience, an important way to bring women into the workforce on a sustained basis is to adopt flexible and part-time work arrangements. Of

course full-time work would bring an even bigger benefit to the economy. But establishing a more flexible labor market system, enabling part-time work for women, brings real benefits. I doubt labor supply will continue to grow at this pace. Straightforward policies to further encourage female participation—family care tax credits, reforming the tax penalty for couples' second income, adding more child care facilities—all at least considered by the Abe government would continue to increase female participation. Another 2 percent of well-educated or skilled Japanese female workers could be added to the labor force in the next few years. But the progress so far is genuinely large.

Second, it is important to remember that Japan is experiencing a tight labor market. The average unemployment rate has dropped to a multiyear low of about 3 percent, and this situation has persisted even during recent slowdowns. The ratio of job openings to applicants keeps going up. We are seeing a better functioning and heating up labor market in Japan, which must eventually help transmit inflation. This is not just the result of exchange rate depreciation. The economy is actually approaching full employment.

For the last several months of Abenomics, however, inflation has outpaced nominal wage growth. That is not good news. But the transmission of new inflation expectations and growth into the broader macro economy, and into the labor market, is a healthy trend. Inflation should start rising. Again, the headline inflation rate has been temporarily lowered by energy price declines and liberalizing labor supply. The underlying upward trend should reemerge, and inflation expectations remain well above zero, i.e., far higher than what they were before the monetary regime shift.

Underlying these developments is the impact of the monetary regime change at the BOJ, which has resulted in a rise in medium-term inflation expectations. According to the BOJ survey of inflation expectations, these expectations have not changed very much, but frankly, that survey is not entirely reliable. Another survey, by the Cabinet Office, is much more reliable, as are indicators extracted from the prices in the Japanese Treasury Inflation-Protected Securities (TIPS) market. The Japanese TIPS market is thin, and it cannot be read directly. But there has been a significant upward trend in inflation expectations on those two measures since the announcement of the 2 percent inflation target in April 2013.

Some forecasters will object to this line of argument, contending that inflation and inflation expectations are lower, and the BOJ will fail to get Japan to 2 percent inflation by April 2015. I think the promise of delivering 2 percent inflation by April 2015 was the one mistaken part of the new monetary policy. It should have been stated as the medium-term goal, as the aspiration. Governor Haruhiko Kuroda and the BOJ board have now adjusted their goal, saying that if it is not achieved, they will do what is necessary to achieve it shortly thereafter. They should have phrased it that way in the first place. Setting unrealistic goals may have resulted from the politics of Japan at that time, the sense of excitement associated with the regime change at the BOJ, or the more general arrogance of central bankers, which I have criticized, in pretending that they can control the economy closely. The belief that such trends can be fine-tuned arose in the late 1990s and early 2000s. As Milton Friedman said many years ago, fine-tuning is not a realistic expectation for a complex economy.

That the BOJ has more to do to reach sustained inflation and anchor inflation expectations at 2 percent cannot be denied. But, by the standards of Japan's recent past and the record of comparative central banking over the last ten years, fluctuations of inflation of plus or minus 0.5 percent over a few months are hardly unusual. Achieving an inflation rate that has moved from below zero to more than 1 percent on average, while various other measures of inflation expectations have moved in a positive direction, is more important than whether or not Japan gets to 2 percent inflation by April 2015. The BOJ regime shift, moreover, is actually a success when measured by the right standard. The shift is a necessary condition for Japan to move forward. It is not a sufficient condition by any means, but only by the standard of unreasonable expectations would one label the BOJ's policy anything other than a success. Price shocks are being transmitted differently because there is a different monetary regime. In the past, when there was growth or exchange rate depreciation, it was

clear that the old BOJ would lean against these trends, limiting transmission to the rest of the economy. We are now seeing actual transmission of the price shocks to the rest of the economy.

One other structural reform effort deserves mention, but because it has gone wrong. In the spring of 2014 a very interesting proposal was introduced for setting up special economic zones in many of the major urban areas including Osaka and Tokyo. It was convincingly explained to me, among others, that the major impact of the special economic zones would be felt through freeing up the labor market. These changes were described as improving small business competitiveness and the start-up culture, potentially breaking ground for changing the tax code for entrepreneurs. Most promisingly, the special economic zones were meant to promote more competition in the healthcare field through changes in hiring rules and zoning laws. Those are quite worthwhile objectives that could have furthered the reform agenda—if the Abe Cabinet had kept to the proposal.

But over the last few months sudden concern is being expressed over what are now being called regional issues. A famous think tank report declared that there are too many rural communities in Japan and that hundreds of “regional cities will disappear by 2040.”<sup>1</sup> As a result, many Japanese politicians—perhaps using the report as an excuse—are now contending that money should be spent on regions where there may still be some employment and residents but no real demographic or economic future. Of course, such redistribution measures not only look like but also actually are the old fashioned fiscal politics of Japan: Diet members putting money into backward places to buy votes to maintain support. This practice is pernicious—a waste of public money and a bad signal that the Abe government cannot maintain its reform priorities.

Good economists should all be criticizing this backsliding in the form of letting the special zones fall prey to regional capture. There is a genuine issue of how to deal with the persistent decline of some regions in large economies—whether to invest in them, empty them out, or ignore them. A universal political calculus governs the resources spent on the *Mezzogiorno* in Italy, Alabama and West Virginia in the United States, Okinawa and Northern Hokkaido in Japan, and so on. Whether these regions can develop is an open question. But my understanding of the literature is that, for the most part, the best policy is to increase rather than decrease mobility, to invest in making it easy rather than difficult for people to leave. For compassion and equity, benefits should be tied to individual citizens and not to regions. That is obviously a public interest and an economic argument, not an electoral logic, but it should be acknowledged.

## TWO CRITICAL POLICY CHOICES

The other critical choices facing the Abe government start with fiscal policy, especially given Prime Minister Abe’s postponement of the planned 2015 value-added tax (VAT) hike. No doubt tax increases are contractionary in the short run. The fantasy that fiscal consolidation is expansionary works only under very specific circumstances, which do not apply to Japan. Yes, a downturn in growth and consumption has followed the April 2014 tax hike. But the political establishment has overreacted because people underestimated the impact of the tax hike beforehand. Many officials and colleagues from Japan told me earlier this year that the tax hike was not going to have a big effect averaged over the year or even immediately, as occurred in 1997. Of course, there was a big short-term effect, but that does not mean that impact is meaningful for fiscal decisions about sustainability.

One definition of fiscal sustainability is that as long as the government bond market does not crash, the situation is fiscally sustainable. Forward-looking agents acting in markets could in theory sell Japanese government bonds (JGBs), so if they do not, there still is fiscal space. A more nuanced view is that fiscal sustainability is about foreign debt. Japan can run about another 12 years of current account deficits at reasonable rates before it runs out of net foreign assets. At that point, Japan is going to have to start paying off foreign rather than domestic creditors. Foreign creditors can get a country into trouble, so, on that criterion, Japanese fiscal policy

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1. Masuda Hiroya, “Regional Cities Will Disappear by 2040: A Polarized Society Will Emerge,” *Discuss Japan*, Japan Foreign Policy Forum 18, January 20, 2014.

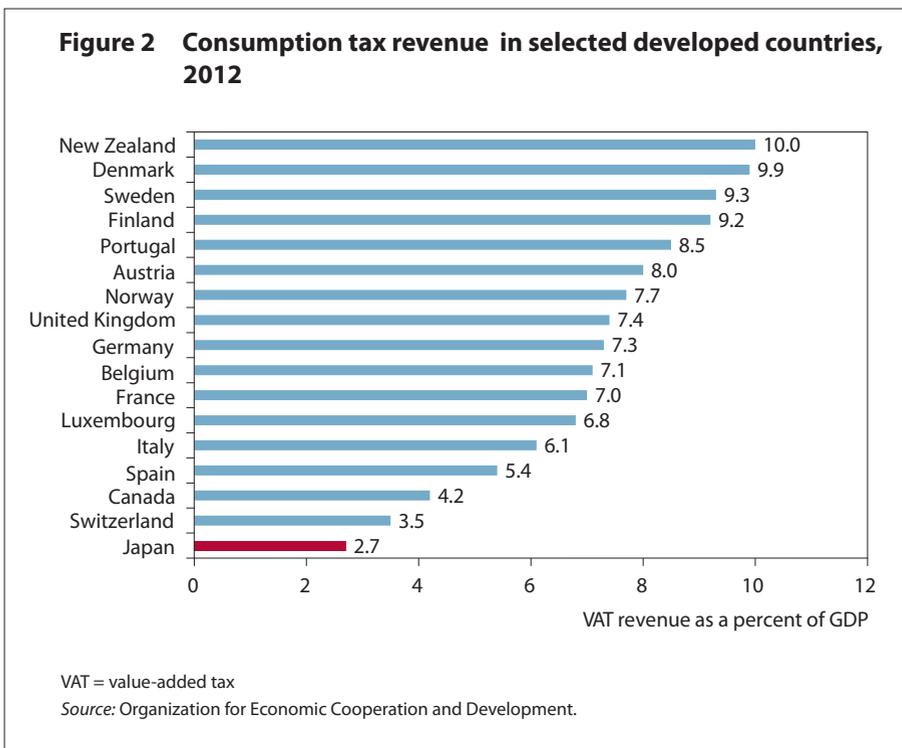
is sustainable for a decade or more. Another view is to do the simple math and project an extremely alarmist view: “This is what Japan has promised on healthcare, and this is how many 70-year, 80-year, and 90-year olds will be living—Japan must already be bankrupt.”

I would suggest a relatively boring middle ground for assessing Japanese fiscal sustainability. First, we should calculate whether Japan can stabilize its net public debt level at what would be a plausible future interest rate. This can be algebraically projected. Of course, for Japan, some stronger assumptions are necessary than they would be for other countries, because the Japanese debt level is so high and because the interest rates are unusually low. But without getting into too many details, a case can be made for Japan getting on to a sustainable debt path if real GDP growth rate is in excess of 1.25 percent on average; the inflation rate is well in excess of 1 percent on average, preferably 2 percent; and—here is the key—the VAT rate is raised to something over 20 percent.

The taxation share of the economy in Japan is extremely low by advanced-country standards (see figure 2). Japan has room to raise taxes significantly as a share of GDP without becoming like Portugal or France, where the marginal tax rates are already so high that they distort the economy. In most other advanced economies, or even many middle-income economies, VAT rates of 20 to 25 percent are common and sustainable. Arguably, the existence of this room to raise taxes when needed is a major contributor to markets maintaining the low interest rates in Japan to date.

I do not claim that if Japan gets fiscal policy to live up to these numbers for the coming years, everything works out perfectly. But if Japan were to get to these numbers, the amount that the Japanese government would have to cut from benefits and transfers, in order not to have to renege on huge amounts of debt payments, is manageably small over a reasonable range of interest rates. In other words, the debt level would become sustainable without extreme further austerity. I am thus more optimistic than many people because I am saying there is a possible path. It is not feasible absent major tax increases, however, which brings us back to the consumption tax decision.

When in October 2014 I endorsed the idea of proceeding with the planned October 2015 tax increase, I was on the opposite side of the argument from many people I admire and whose worldview I usually largely share, like Koichi Hamada or Paul Krugman. To be clear, I am not in favor of a rapid consumption tax hike on the grounds that there will be an imminent crisis of confidence in the JGB market, let alone anything like the crises afflicting Greece or Argentina. I agree with Krugman, Hamada, and others on that point. Given the ability of Japan to print its own currency, and given the overwhelming share of public debt that is domestically held, I do



not see that danger as pressing. Nor do I believe that raising the consumption tax would be costless in terms of growth and of tax revenues in the short term. It would be contractionary, not expansionary. So I have not recanted my basic economics from 1997, and I think Japan continues to demonstrate the relevance of basic economics.

I would argue instead that Japan, like some (not all) parts of Southern Europe, and like many other countries in history, does have to undertake a multiyear fiscal consolidation—but not because Japan is in danger of imminently becoming Greece or Argentina. Rather, as I argued in January 2013, after Abe's election, exceedingly high public debt imposes costs on even large economies with their own currencies.<sup>2</sup> These costs include displacement of investment, particularly of public investment, distortions in saving behavior, and other vulnerabilities—for example, in the case of national emergencies, when funding may not be as easy to obtain. Financial repression results from having to cram down as many JGBs as possible into the financial system and into savers' accounts. And over time, the longer the consolidation is put off, the harder it gets, or rather the less time there is left in which to make the necessary adjustment.

In short, 2014 is not 1997 in Japan. Japan has twice as much net public debt as a share of GDP today as then, so the costs and risks are bigger. Japan's economy has been growing since 2002, with the longest recovery in decades, except during the worst of the US-led financial crisis. Japan has a sound banking system, which it did not have in 1993 or 1997 or 2001. Japan has monetary policy that will stay as accommodative as it is ever going to be. Japan can also take other temporary steps to offset the contractionary effects of such tax increases. Finally, I note that Japan has a prime minister with a large mandate and as long a time-horizon as any recent Japanese prime minister has enjoyed. If Prime Minister Abe were pursuing the best possible economic policies for Japan, he would be adopting a succession of small VAT hikes over several years.

In politics, the bottom line is voters and their beliefs about the future. Prime Minister Abe is, however, focusing too much on the short term in the classical sense in which we economists criticize politicians. It made sense to postpone fiscal tightening in 1997, when the world was falling apart inside Japan, and then in 1998, when the Asian region was falling apart around Japan. During this period, the banking system was fragile, and the BOJ was causing even more danger. In 1997, the net debt-to-GDP ratio was still well below 100 percent of GDP. So it was perfectly reasonable then, as I argued at the time, not to raise taxes. The view was at the time: stabilize the economy, fix the banking system, and get the monetary policy in order first. The fiscal consolidation can wait. Seventeen years later, however, when everything else is much better in the Japanese economy, except that the total public debt level is much worse, consolidation perhaps can literally still wait—but it is no longer a good idea to wait. That is why I advocated that the consumption tax should be hiked as part of a series of ongoing, gradual rises.

Are there alternatives to increasing the VAT substantially? It is far from clear that raising taxes and cutting spending have considerably different economic effects. You have to go to a much more granular level of analysis to tell. What specific spending is being cut? Which particular taxes are being raised? One could come up with a reasonable proposal entailing major cuts in certain kinds of social welfare spending, while raising taxes by a smaller amount. The most persuasive argument for this alternative is that a higher consumption tax can be regressive—depending on how it is structured—and it punishes at a minimum all ages equally. We know that, if anything, old people in Japan have been getting a great deal versus young because of deflation, government transfers and the way that the politics works. Cutting spending could actually be more fair intergenerationally than raising taxes depending on what spending is cut. I choose not to advocate that alternative, however. The plan for raising the consumption taxes is already in place, putting money in the bank with easier and simpler implementation than other policies.

The second poor policy choice by Prime Minister Abe concerns trade. The TPP bilateral US-Japan talks are in danger of breaking down because Japan is not offering enough on agriculture. Granted, the United States

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2. Adam S. Posen, "Japan Should Rethink Its Stimulus," op-ed in the *Financial Times*, January 15, 2013.

is hypocritical on this policy to a large degree. The US government protects sugar and subsidizes corn, among other crops. But Japan stands to gain more on a sustained basis from a comprehensive TPP deal than any other country, including the United States. The reason is that it would constitute structural reform for Japan, as competition trickles down from agriculture through the retail and distribution sector. Japanese GDP would rise 2 percent a year with a full TPP deal, according to forecasts of Peter Petri et al., using a computable general equilibrium (CGE) model.<sup>3</sup>

Such reform would also cut the cost of food to average Japanese people. If, as a result of such a deal, Japanese households were to spend only 8 percent of their income on food, like their foreign counterparts who have access to food at world prices, they would save roughly \$1,500 a year per household. That saving is 1.25 percent of GDP, or more than half of Japan's projected gains from TPP. If politicians are worried about inflation outpacing Japanese workers' real income, then they should be in favor of a comprehensive TPP deal, based on domestic agricultural liberalization.

To summarize my bottom line on Abenomics: Womenomics is under way, though sexism is still rife in Japan, and the labor force has already seen substantial gains in flexibility and supply. Other labor market reforms are ongoing. The BOJ's monetary policy approach was not just a gambit to get the yen down (even if that was part of the motivation for some). The monetary regime shift has been genuine and is affecting how prices are transmitted throughout the economy. Thus, my forecast is that Japan is going to bounce back, not very strongly, but solidly from the 2014 VAT hike. It will grow reasonably solidly by its own standards, around 1.5 percent real year-over-year in 2015 and 2016, and inflation will resume rising. The BOJ's political commitment to 2 percent by April 2015 was a little too strong, but inflation will be closer to that than to zero percent.

The good news on Abenomics seems to end there, though, at least for now. There are two other major choices for Japanese economic policy and Prime Minister Abe is getting both wrong. The first regards TPP. It really is in Japanese negotiators' hands whether they are going to reduce pork and beef protection and gain 2 percent annually in Japanese national income for their own people or whether they are going to continue to be cowards in the face of an overprotected but still dying farming sector. If election manifestos and comments are to be believed, Prime Minister Abe will not use his renewed mandate to make TPP happen by closing the deal with the United States. Second, the prime minister's postponement of the VAT rise was a bad judgment, despite its short-term buoyant economic impact. At some point Japan is going to have to start paying down its accumulated debt. Starting now and continuing down the path of steady tax increases is the best way to do so.

## ABENOMICS IN THE GLOBAL CONTEXT

Finally, what does Abenomics mean for us in the United States and the rest of the world? Japan is not on a cliff. If anything, the 20 years of start-and-stop growth in Japan should have convinced the world that even very bad policies do not cause Japan to tumble over a cliff. Japan is afflicted by disappointing policies in some areas; less disappointing policies in some other areas; and positive motion in a few but important select areas. So Japan is going to be alright on growth and inflation for the next few years, barring a major external shock. If anything, Japan will experience positive growth surprises over the next year because of the delay in fiscal contraction while the BOJ has increased its rate of monetary expansion, and the yen falling further. (The extent to which the yen stimulates the Japanese economy is less now than it used to be, especially given energy imports, but the decline will also feed short-term recovery.) In short, Japan may get some additional short-term growth that is unsustainable on top of the lasting benefits of true reform on labor and monetary regime.

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3. Peter Petri, Michael Plummer, and Fan Zhai, *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment*, Policy Analyses in International Economics 98, Washington: Peterson Institute for International Economics, 2012.

Does this kind of partial improvement short of transformational reform in Japan change the game in Asia? No. I have always believed the real motivation of Abenomics was to permit Japan to have a strong, independent role in determining arrangements in Asia and strengthen its attractiveness as alliance partner with the United States and other Japanese neighbors. Both mean greater capability to stand up to China, though ideally not in an overly confrontational way. Yet, given Abe's failure to deliver on taxes, agriculture, and trade to date—and his lack of promises to do so during the end-2014 election campaign—it is increasingly doubtful that Abenomics is going to deliver that capacity.

It would be worrisome if reform were to end there. Some Japanese are doubtful of the benefits of Abenomics because they did not benefit directly or obviously in the last couple years. That disappointment is unavoidable when a currency depreciates at a time of energy shock and structural labor market reform: real incomes do temporarily decline. I do not deny that reality. It is not easy to sell such adjustment, even in a snap election with weak opposition. But given that some adjustment was in a sense inevitable, this was a good form and a good timing in which to take that adjustment. So, more Abenomics as originally scripted would be better, and stopping here is harmful.

Finally, regarding the rest of the world, the most important lessons of Abenomics are for Europe, not for the United States or China. The main lesson relates to the importance of coordinating fiscal and monetary policies. Another lesson is to recognize that fundamental labor market reform is deflationary and countries have to ride that out and offset it with other macroeconomic policies. Still another lesson relates to deciding realistically which economies need aggressive fiscal tightening and which do not, and how to do so given the existing tax share of GDP.<sup>4</sup> And frankly, Greece and Portugal do need that tightening, whereas Spain does not, just as Japan did not in 1997 but does now. As I said when I first wrote about Japan 17 years ago, textbook macroeconomics actually do apply in Japan. They still apply to Abenomics. They probably do not apply to the election debates. But, we have to hope that the Abe government will get back to textbook economics now that the elections have been won.

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4. Adam S. Posen et al., *Rebuilding Europe's Common Future: Combining Growth and Reform in the Euro Area*. Washington: Peterson Institute for International Economics, 2014.