

Abenomics: Skepticism and Hope
Columbia Business School on November 10, 2015

It is a pleasure to be invited to speak at “Zadankai” seminar this afternoon. I often come to New York. Actually this is my fifth visit to New York this year. Because I usually stay here for only a few days before I go home, I cannot afford to talk with my best friends in town like Hugh Patrick as often as I like. Thanks to Hugh’s invitation today, I am very happy to be able to spend an hour and a half with you, during which time I hope we will all stay awake even though my tedious remarks may invite you to a pleasant slumber after lunch.

Abenomics is now almost three years old, counting from the day Mr. Abe became prime minister, and two and a half years since Mr. Kuroda became Bank of Japan governor. I know that a number of people came here to speak about Abenomics: some were in favor and others critical of it. It seems to me that there has been deep skepticism about Abenomics in the Japanese academics since its inception whereas strong hope in the business circles. Before I discuss these, however, let us examine briefly the recent economic conditions in Japan by looking at the first two charts on the screen.

The left-hand side shows two labor market indicators from a long-term perspective. The unemployment rate of Japan recently stands at 3.4%, the lowest since 1997; the ratio of job openings to applications at 1.24, the highest since 1992, or comparable to the record of 1989. The labor market is very tight at present by historical comparison. On the right-hand side are shown two indicators of corporate profitability. The ordinary profit, or earnings before tax, is now higher by a wide margin than in any other year in three decades. On the inflation front, about which I have prepared no chart, the CPI inflation rate reached 1½% in mid-2014 but later came down to zero on account of sharp declines in oil prices while inflation rate excluding energy has moved up to 1%. No inflation indicator has reached 2% target of the BOJ yet. If I went on examining economic indicators like these, I am afraid I would exhaust my time as well as your patience. Here I

would just like to point out the fact that the Japanese economy is in an excellent shape in these regards. Abenomics has apparently worked well albeit not to the extent that it achieves 2% inflation, and in that regard it is still half way through.

I have prepared another page of charts because I know there is a popular view in Japan as well as the U.S. that the rise in consumption tax rate from 5 to 8% in April 2014 derailed economic growth in Japan. Before the event I had not expected that it would, and now I don't think it did, either. I have already discussed the Japanese economic conditions in terms of the labor market and corporate profits. In terms of real GDP, it is true that economic growth appears to have been lackluster during the past one year, but in my opinion real GDP understates the strength of growth momentum. Even leaving this aspect aside, I consider that the effects of consumption tax increase have been transitory. On the screen you see two charts I reproduced from Professor Oguro's publication. The chart on the left shows that there had been a temporary boom before the tax increase, and that was followed by a steep decline. The broken line is a trend growth in line with the estimate of the Cabinet Office. Real GDP growth returned to the trend after three quarters. Professor Oguro did the same examination over 1989 and 1997 episodes, when the consumption tax was introduced and raised, respectively. Each line on the right chart displays the difference between actual GDP and its trend. The green line of 2014 moves back to zero, meaning that the actual GDP returned to its trend. The 1997 line on the right chart illustrates that the economy went into recession after the tax increase whereas the 1989 line shows a continued growth. 1989 was the year of equity and property bubbles whereas 1997 was the year of financial crisis, which involved a few large bank failures like Yamaichi Securities in addition to the Asian currency crisis. The lesson drawn from these charts is that the consumption tax increase has temporary effects on real GDP, which lasts for a few quarters, but the growth performance after that depends on more fundamental elements. Now it seems all right as far as the aftershock of 2014 tax increase is concerned. So much for factual analysis!

Let us segue to the main topic of Abenomics, beginning with skepticism about monetary policy. Those who are critical of aggressive monetary policy in Japan, or BOJ QQE, argue the following: monetary policy cannot raise trend growth

but it only buys time before structural policy takes effect; Japan's slow economic growth cum deflation is, in large part, attributable to its declining and aging population; Japan's deflation was persistent but mild, which hasn't caused such serious problems as the deflation spiral of the 1930s.

In addition to these points, some of the skeptics point out risks of QQE by saying that: by QQE financial asset prices have been bloated, which distorts resource allocation and paves the way for bursting of the bubble; the extra liquidity cannot be withdrawn easily under political pressure, and it might end up with hyper-inflation. Finally, these risks have global implications as BOJ QQE and Fed QE fuel credit bubbles in emerging market economies, which might entail nasty bursts here and there.

I have sympathy for these risk analyses, but I disagree with the main arguments of monetary policy/economic growth nexus, or non-nexus, to be precise. The risk sensitive critique is correct in that monetary policy influences financial asset prices. Indeed, we have seen such influences in Japan during the past few years: QQE has put upward pressure on both equity and bond prices in Japanese yen while putting a damper on the yen on exchange markets. These changes in financial asset prices have in turn influenced allocations and prices in a wider spectrum of assets like commodities, property, goods and services. In other words, by the change in liquidity in the system, the general equilibrium moves to a new one.

Before Abenomics was launched, the general equilibrium was reached under a relatively tight monetary policy, which allowed deflation to persist, real interest rates to stay high, and deflationary mindset firmly established. Under these circumstances, investments in cash, bank deposits, JGBs were encouraged as deflation enhanced their purchasing power, while equity investment, goods investment, and borrowing were penalized. In other words, from individuals' viewpoint it made sense to minimize risk taking and sit on cash in those years. From a macro-economic perspective, however, the lesser the risk taking, the lower the prospect for economic growth because economic growth stems from technological innovation and resource reallocation from Zombie companies/sectors to more

productive ones, both of which are a function of risk taking. By restraining risk taking, tight monetary policy had limited trend growth before Abenomics began.

In Japan many pundits believe that declining population is the main cause for slow growth, which results in deflation. I disagree. Population growth in Japan was 1% per year in the 1960s, went up to a little over 1% in the early 1970s and gradually declined over time. Before the bubble burst in the early 1990s, Japan's economy grew at an annual rate of 4 or 5%, and even after that, before deflation set in around the turn of the century, it grew 2%. In other words, the declines in economic growth rate over the years are accounted for by mainly drops in productivity gain. Another reference of growth arithmetic! Population in Germany hardly increased in the 2000s and actually decreased in the latter half, even including immigrants, but the German economy grew without deflation. Likewise, Italy, with no population growth in the late 1980s and 1990s, did not fall into deflation.

Let me emphasize once again that economic growth stems from risk taking, or John Maynard Keynes' famous animal spirits, which is a function of liquidity conditions. On the flipside of animal spirits there are risks of unsustainable bubbles inherent in QE and QQE in theory. In fact, lax monetary policy fueled bubbles in Japan in the mid-1980s and also in the U.S. 20 years later. At the moment, however, there is no large buildup of leverage in the Japanese private sector. From a micro-economic viewpoint, too, there is no rush in bank lending despite excess liquidity in the money market. Under these circumstances I think it is premature to worry about risks of unsustainable bubbles in the economy. In other words, positive effects of BOJ QQE on asset prices are part of the transmission mechanism of monetary policy and haven't become excessive so far.

A risk of hyper-inflation is even more remote than a risk of bubbles. However, this risk may materialize in a subtle way. Whenever exit from QQE approaches, the market will anticipate action by the central bank and interest rates may jump abruptly, which may trigger a panic in fixed-income markets, accompanying disruptions in the financial system, and in turn, a premature economic downturn. The risk of this scenario increases in proportion to the size of

fiscal imbalance and public debt accumulation. Therefore, central bankers have reasons to emphasize the importance of fiscal consolidation when they engage themselves in extra-easy monetary policy while the government may put pressure on the central bank to exit from QE later than sooner. The central bank's procrastination in this regard may entail much higher inflation than desirable while its precipitation may kill dynamics of the economy prematurely.

This brings us to fiscal policy aspects of Abenomics. Abenomics began with stepped-up fiscal spending to kick start the economy in 2013. In late 2014 Mr. Abe's cabinet decided to postpone the rise of consumption tax from October 2015 to April 2017. Nevertheless, the tax revenue has gone up and the budget deficit decreased because of both economic growth underway and consumption tax increase of April 2014. Abenomics seems to be successful in this regard, too. However, a lot more must be done to keep the budget house in order. The official target of the Japanese government is to close the gap on the primary balance in 2020. It is a high hurdle to clear, but can be done. Even after the achievement is in scope, the budget balance of the general government will remain in deficit because of debt service cost. Suffice it to say, the deficit would widen if interest rates move up, making the debt consolidation a pipe dream. Therefore, fiscal spending must be cut down, but like in many other countries this is a matter of politics. Mr. Lee Kuan Yew, the late great leader of Singapore, once said, "Charity became entitlement, and the stigma of living on charity disappeared and welfare cost grew faster than the government ability to raise tax for it." He said this, referring to the United States, but the same is true of Japan in an even worse fashion.

I am afraid I have consumed 15 minutes preassigned for my initial remarks by discussing monetary policy and its tangential areas. Some of you may have expected my discussion of Abenomics 2.0, which incorporates three new arrows: GDP of ¥600 trillion; fertility rate of 1.8 as against 1.42 of 2014; no job leave for seniors care. I think these are more of targets than arrows, and it remains to be seen what policy programs will be prepared by the end of this year, when the draft budget is proposed.

I haven't discussed the third arrow of the original Abenomics, either, which is growth-oriented structural reform. A number of legislations have actually been passed by the Japanese parliament with respect to agriculture, health care, labor market, and special zones. In addition, non-legislative reforms have also been underway over GPIF investment scheme, corporate governance of listed companies and stewardship of institutional investors. Last but not least, TPP, or the Trans-Pacific Partnership agreement, has been reached by the executive branches of Japan, the U.S. and other 10 countries around the Pacific Ocean. These will have lasting, positive effects on economic performance of Japan although the degree of which is uncertain and it will take time until they take effect. For those who hoped for more ambitious reform, Abenomics may appear small. I heard a cynical remark that Abenomics' third arrow is something like a thousand needles. In comparison with economic policies of all the governments in Japan after Mr. Nakasone's of the 1980s, however, Abenomics has tried a lot and is working well in my opinion. With this optimistic note, let me stop here to go for a dialogue with Hugh Patrick.