

The Invisible Arrow of Abenomics: Structural Reform and Innovation

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The Center on Japanese Economy and Business (CJEB) hosted a lecture by Takatoshi Ito, professor at Columbia's School of International and Public Affairs and CJEB's associate director of research, on the state of Abenomics, and particularly the uncertainty surrounding its "third arrow." David E. Weinstein, CJEB's director of research and Carl S. Shoup Professor of the Japanese Economy at Columbia, opened and moderated the event.

Professor Ito began by noting that, of the three arrows – monetary easing, fiscal stimulus, and structural reforms – many people are skeptical of the third: that it may never be fired at all. He also noted that the third arrow is not the only one with troubles: the first arrow has not raised the inflation rate to 2 percent yet, and the first and second arrows have resulted in a labor shortage.



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mandatory retirement age and encouraging the elderly to work; and moderately increasing the number of foreign workers in Japan. Professor Ito demonstrated a simulation where he tested these strategies and their effects on GDP growth. It concluded that encouraging women who are constrained by childcare to stay at work would add 4 percent to GDP over 10 years; postponing retirement would add 4 percent over 10 years; and doubling the level of foreign workers would add 1.4 percent over 10 years. In total, if all of these steps were taken, GDP would increase by 9 percent over the next 10 years.

Before going into the progress of the third arrow, Professor Ito reviewed the statuses of the first and second arrows. There have been many ups and down when it comes to the first arrow over the past four years. For the first two years, inflation, stock prices, and growth rates all went up. However, this was followed by a slowdown in growth and a decrease in the inflation rate, along with a depreciation of the yen. In January 2016, the Bank of Japan (BoJ) made the bold and surprising move of introducing a negative interest rate, which is widely viewed as the limit of quantitative easing in influencing the inflation rate.

A key explanation to the “stagflation” phenomenon is that inflation will not grow if wages do not grow as well. Wages cannot increase without an increase in inflation. Abenomics failed to cut this cycle. This is because it is not the correct use of monetary policy to change real wages; they only go up when productivity goes up. The third arrow – structural reforms – must do the job of influencing real wages. If successful, it can be expected that the inflation rate will rebound as interest rates go up.





The second arrow is largely seen as the implementation of a flexible fiscal policy. However, the consumption tax increase was forecasted incorrectly and, as a result, consumption has remained low. For now, fiscal policies are on hold because the debt level is high and getting higher. As a result, many worry that the debt-to-GDP ratio is problematic and that this level of debt is not sustainable in the long run.

Professor Ito then returned to the third arrow, noting that the growth rate is currently fluctuating around 0 percent. Compared to other OECD countries, this is low. Many economists are comfortable with a potential growth rate of 0.5 percent, which is within the range of the current rate. As a result, these economists, which include Professor Ito, do not suggest a continuation of massive fiscal stimulus. Instead, this low, but steady, growth rate could be the new normal for the Japanese economy unless labor input – employment and hours – increases dramatically. Labor market conditions have been improving, and are as tight as the bubble years of the mid-1990s. Labor market conditions are telling us that the economy is near full employment and entering a stage of labor shortage. A labor shortage would constrain the economy from growing faster and thus must be addressed.

Professor Ito described the statistics surrounding the labor shortage. The working age population (20-64) is declining. This results in an annual decrease of about 1 million workers, amounting to a 1.57 percent loss in GDP, which is a tremendous drag on



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economic growth. While some of these workers can be replaced with technology improvements, there are limits to that. This problem cannot be reversed, but the effect can be mitigated by encouraging those who are not working to work; in short, to increase the participation rate. The candidates include women and the elderly (the male participation rate is already over 90 percent). In Japan, women traditionally participate much less. The elderly refers to ages 65 and over, but the population to focus in on is between the ages of 65 and 69. Many of these baby boomers are healthy and willing to work. As for foreign workers, there is tremendous political controversy over immigration. As such, increasing the level of foreign workers, as of now, is a third solution. There is an additional possibility of labor mobility: moving workers from



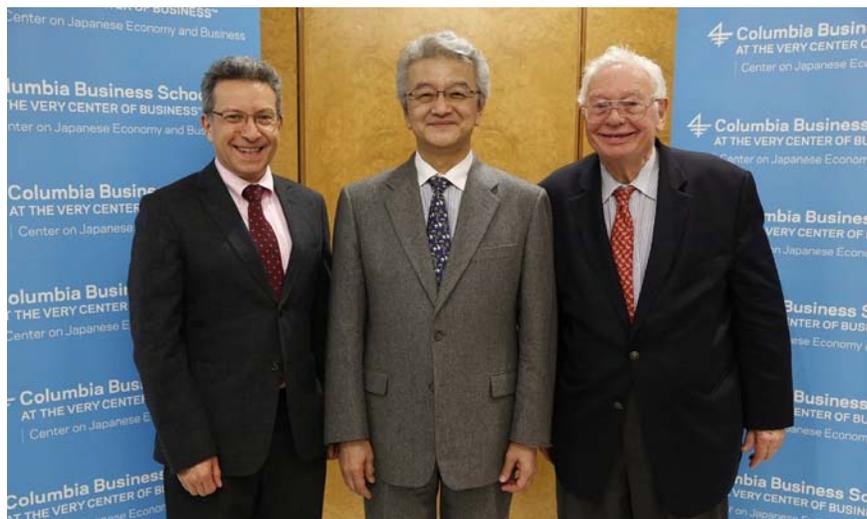
unproductive to productive sectors to increase total productivity of the economy. Because the labor participation rate has been steadily increasing as the level of workers decline, the impact on GDP has not been stark.

Many economists refer to the “M shaped” graph for women’s participation in the labor force, in which women leave the work force for a few years after giving birth. Japan and Korea are the only OECD countries that still have this M-shape. In Japan, the M-shape is getting shallower and the “dent” is getting filled: fewer women are leaving the work force around ages 25-39, and women in all age groups are participating more. It can be expected that Abe will take credit for this.

There are a variety of ways to encourage women to stay in the workforce: encouraging companies to shorten working hours and allow working from home; allowing foreigners to work as household help, nannies, and long term care; extending hours for nursery school and kindergarten so women don’t have to leave work early to pick them up; discouraging long workdays for men (and women) so men will be able to help with childcare; doubling the overtime premium charged to companies; and punishing corporations who take advantage of unpaid overtime work.

As of 2015, there are 907,896 foreign workers in Japan. This number only includes foreign workers who are in Japan legally. If this number is doubled, it would add 1.4 percent to GDP. This may be an overestimate because foreigners typically do lower-wage jobs. However, it could also be an underestimate because this addition of foreign workers will free up women from domestic duties that constrain them from being in the workforce.

Professor Ito concluded by expressing the hope that women, the elderly, and foreign workers will rescue Japan from labor shortage and slow growth.



David E. Weinstein, Takatoshi Ito, CJEB Director Hugh Patrick