NBR ANALYSIS BRIEF

JUNE 25, 2013

Will Abenomics Restore Japanese Growth?

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Since the early 1990s, Japan has faced a daunting series of economic challenges, including slow growth, rising public debt, deflation, weak asset prices, and declining international competitiveness. Japanese policymakers have deployed a wide array of measures to combat these challenges, but have failed to end deflation, stanch deficit spending, or reignite growth.

"Abenomics" is the latest attempt to change Japan's fortunes. Named for current Prime Minister Shinzo Abe, it is a comprehensive strategy that is meant to reverse deflation and rekindle growth through the combined use of monetary, fiscal, and structural policies. In an era of slow global economic growth, the success or failure of Abenomics will have profound implications not only for Japan but for regional and global economies, including the United States.

TWO DECADES OF AMBIVALENT POLICIES

At first glance, Japan's policy responses to deflation and stagnation appear to have been very aggressive, including fourteen years of near-zero short-term interest rates and massive fiscal deficits that have created government debt more than twice the size of Japan's GDP. However, in reality, efforts to revive growth have been inconsistent and often poorly coordinated.

Japan's monetary policy has been the most forward-leaning, with both short- and long-term interest rates dropping to historically low levels over the last two decades. Yet despite the appearance of aggressive monetary loosening, the policies of the Bank of Japan (BOJ) have been quite timid in some respects. Deflation has meant that real interest rates were not particularly stimulative, while quantitative easing was implemented half-heartedly. Until 2013, BOJ governors further undermined quantitative easing by publicly expressing skepticism about its potential efficacy.

If monetary policy was "too little, too late," then fiscal policy was "stop and go." Tax cuts and spending increases in the 1990s contributed to a rebound of growth in 1996. But an increase in the consumption tax and a cut in public works spending in 1997 led to recession and pushed the banking system into crisis. While the government responded with a massive stimulus in 1998, a few years later Prime Minister Koizumi worked to reassert fiscal discipline. Then in 2008 the global financial crisis forced yet another reversal of policy.

Finally, several administrations have recognized the need to improve the productivity of the Japanese economy through structural policies. Unfortunately, however, deep discomfort with the growing national debt, combined with frustration that stimulus plans did not revive growth to 1980s levels, has often led policymakers to advocate such supply-side measures as a substitute for demand stimulus rather than in combination with it.

THE "THREE ARROWS"

Abenomics seeks to overcome two perceived weaknesses of previous policies: lack of coordination and timidity. First, the strategy recognizes that supply-side reforms to promote greater competition and innovation will be essential for long-term prosperity, but that such policies can be painful in the short term. Demand stimulus is thus seen as essential to allow for supply-side changes to have a positive effect. Second, Abenomics is meant to be much bolder than its predecessors.

The most formidable arrow is monetary policy. The BOJ responded to Abe's victory by announcing a new consumer price inflation target of 2%. Abe later appointed Haruhiko Kuroda, who has long advocated more assertive monetary easing, as BOJ governor. So far, these policies have contributed to a significant depreciation of the yen and a rapid run-up in stock prices, although the euphoria appeared to be ebbing by June.

Fiscal policy is likely to be a much less impressive arrow. Although Abe's stimulus plan is substantial (13 trillion yen, or $140 billion), it appears to combine stimulus and non-stimulus spending to reach a higher headline number. More importantly, it will offer only a temporary stimulus, as the Japanese government prepares to implement a fiscal consolidation agreement that features consumption tax hikes.

The third arrow of structural policy has the most question marks surrounding it. Abe has pledged to join negotiations for the Trans-Pacific Partnership (TPP), along with passing other structural measures meant to increase labor flexibility, encourage employment of women, promote innovation in healthcare, strengthen Japan's agricultural system, and separate electrical-power generation from transmission. While there is significant uncertainty about the likely effectiveness of these policies, Tokyo's ability to implement them is perhaps even more in question.

ABE'S GAMBLES AND IMPLICATIONS FOR THE UNITED STATES

While Abenomics is probably the best hope for the Japanese economy, it takes two major gambles. One concerns the sustainability of stimulative fiscal and monetary policy in the face of government debt. Creating inflationary expectations could lead to higher long-term interest rates, despite the BOJ's efforts to keep them low. Even relatively small increases in rates would mean big increases in debt service payments. If markets begin to question whether the debt is sustainable, the options for both fiscal and monetary policy will be much more limited.

The second gamble is political. Structural policies will cause pain to a variety of constituencies, and it may be difficult for Abe to hold the Liberal Democratic Party (LDP) together, not to mention the coalition with Komeito. With the LDP expected to win the Upper House election in July, Abe looks to be in good shape politically. But a major misstep could still weaken his base and endanger the success of Abenomics.

The United States has every reason to hope that Abenomics will succeed. A weak Japanese economy reduces market opportunities for U.S. firms, while also limiting Japan's ability to meet the needs of the U.S.-Japan alliance, which is the linchpin of U.S. strategy in the Asia-Pacific. Abe's commitment to the TPP will likewise be important to the success of that key trade agreement.

While there is little that the United States can do directly to ensure the political sustainability of Abenomics, it can help around the periphery by avoiding its own protectionist urges, by accepting that a weak yen is the inevitable result of stimulative monetary policies, and by working constructively toward the conclusion of the TPP. ◈

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