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Japan's bet on reforms: Growth first – fiscal sustainability to follow

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ABSTRACT

Given the underwhelming results of the large-scale fiscal and monetary stimulus implemented by the administration of Japanese Prime Minister Shinzo Abe, the country is now focusing on structural reforms. The government's new economic and fiscal plan – released in late June 2015 – is clear in its message: to reduce Japan's gigantic debt, now estimated at over 246 % of GDP, and achieve fiscal sustainability, the country needs robust economic growth. The government is betting that structural reforms will trigger a 'productivity revolution' and boost income, investment, consumption and profits. Fiscal sustainability will then follow, as a revitalised economy will broaden the tax base and bring in higher revenues. Despite Abe's good intentions, however, his economic policy agenda has been criticised on several fronts. The international community is calling for greater fiscal discipline, while the business community is dissatisfied with proposed measures to simplify doing business in Japan. The plan has also failed to convince many of Abe's genuine commitment to advance economic reforms at a time when the Prime Minister seems more interested in upgrading Japan's defence capabilities. If Japan is serious about restoring its glorious economic past, far-reaching economic reforms will need to move at a faster pace.

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Introduction

Abenomics is a 'three-arrow' (or three-pronged) plan of monetary, fiscal and structural reforms designed to drag Japan out of economic stagnation.

For over two decades now, Japan has been trapped in economic stagnation characterised by little or no real growth, chronic deflation, lagging productivity and a dysfunctional labour market. Over these two 'lost decades', no government has managed to restore the glory of the Japanese economy, or return it to its once-prominent position at global level.

While monetary and fiscal stimuli have had few long-lasting effects on the economy, structural reforms could in principle have a greater impact. Progress is, however, slow.

Since Shinzō Abe took office as Prime Minister at the end of 2012, the situation has shown potential for change. The revitalisation of the Japanese economy has become a government priority and Abe's set of monetary, fiscal, and structural reforms – known as 'the three arrows of Abenomics' – has made progress in tackling the adverse conditions impeding economic growth in Japan. While monetary and fiscal reforms have had some immediate positive economic effects, structural reforms have progressed slowly with the result that the Japanese economy is experiencing a modest recovery, although the growth prospects for the future remain uncertain.

The latest economic and fiscal plan released in June 2015 was intended to demonstrate the government's commitment to fiscal sustainability. Japan's public debt now amounts to about 246 % of GDP[1], and concerns about its sustainability have been expressed by several parties (the IMF, the OECD, business investors, the credit-rating agency Fitch). The plan, however, announced only vague intentions to cap spending targets, and pointed to structural reform as the means of achieving a primary budget surplus by 2020. These measures are intended to trigger a 'productivity revolution' in both the public and private sectors of the Japanese economy, thus boosting income, consumption and investment, and ultimately translating into higher tax revenues.

Both the business community and the general public want more from Abe's plan.

Once again, Abe's administration has given priority to growth over fiscal consolidation. The bottom line is that securing economic growth is necessary to achieve fiscal consolidation, and the future of the Japanese economy is largely dependent on if – and how – structural reforms will manage to remove labour market rigidities, address demographic challenges, and engage firms in higher productivity and innovative activities. Both public opinion and the business community have shown signs of dissatisfaction with the achievements of the reforms so far. More needs to be done to unlock the potential of the Japanese economy if Abe wants to meet the dual goals of sustained growth and fiscal sustainability.

1 Background

When Shinzō Abe took office as prime minister at the end of 2012, the Japanese economy had been trapped in stagnation and economic

[1] IMF article IV Consultation with Japan, June 2015.

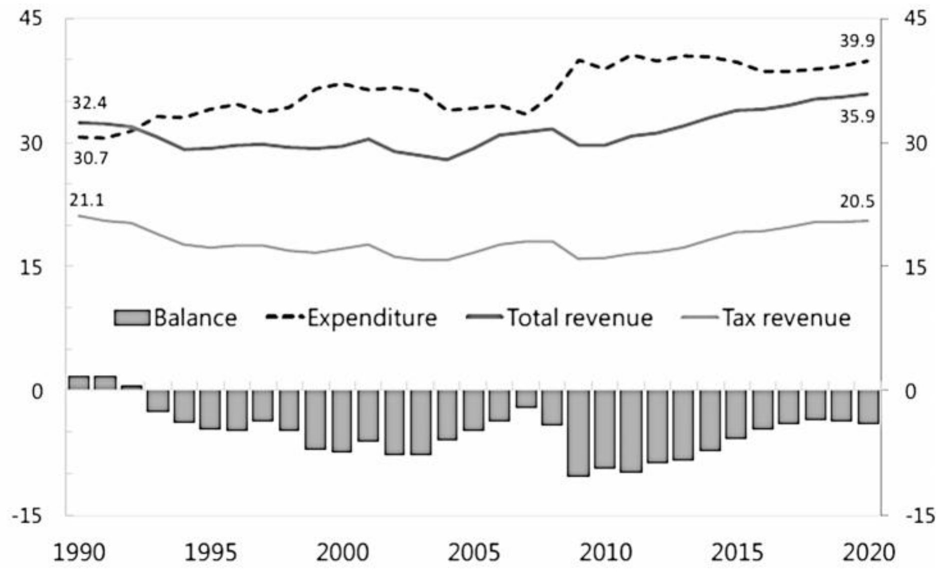
The 'Japanese malaise' developed some 20 years ago, but worsened after the 2007/2008 financial crisis and with the triple Fukushima disaster in 2011.

uncertainty for over two decades. The collapse of the asset price bubble in the early 1990s and the ensuing banking crisis led to prolonged asset deflation and a liquidity trap – a situation in which private demand is so weak that spending keeps falling even with zero short-term interest rates. The Japanese malaise developed as a consequence of pressing socio-economic challenges (an aging population, strong reliance on exports, yen appreciation, and symbiotic ties between government, the banking system and big corporations) and the inability of the leading party – the Liberal Democratic Party (LDP) – to implement far-reaching reforms[2]. Japan's economic situation further worsened after the 2007-2008 global financial crises and the 2011 triple disaster: the earthquake, the tsunami and nuclear catastrophe. Fiscal stimulus packages combined with the estimated GDP loss caused by the 2011 events (estimated at about 3.5 % of GDP) translated into a heavy burden on Japan's already stressed public finances.

Japan's economy was already on a recovery path in 2012 when Abe took office, but was facing deep socio-economic challenges and a gigantic public debt.

When 'Abenomics' was launched, the Japanese economy was on a timid recovery path. After the sharp GDP growth contraction of 0.5 % registered in 2011, when the country also recorded its first annual trade deficit in three decades (USD 32.3 billion), economic growth reached 1.8 % in 2012. The concatenated social and economic issues responsible for Japan's sluggish economic performance over the 'two lost decades' were still present and their depressing effects on the economy persisted. Public debt had already piled up to over 200 % of GDP in 2012, while the population kept aging and the birth rate kept falling, resulting in a progressively shrinking labour force. Under these circumstances, social spending steadily increased and Japan systematically recorded fiscal deficits.

Figure 1:
Government fiscal balance (as % of GDP)



Source: OECD 2015 on IMF WEO database and IMF staff estimates

Political views differ on

The LDP party – back in power with Abe in 2012 – has been internally

[2] Okimoto 2015.

whether to favour economic growth or to promote fiscal consolidation.

divided into two opposite factions: the 'Growth-first' group – also known as 'the Rising Tide' (*Ageshio ha*) since the mid-2000s – and the 'Fiscal Hawks' (*Zaisei taka ha*). The former group was chaired by Junichiro Koizumi (the 2001-2006 prime minister) and included powerful politicians such as Heizi Takenaka (former minister of internal affairs and communications) and Hidenao Nakagawa (LDP secretary-general in 2006). Among the ranks of the Fiscal Hawks were Kaoru Yosano, an LDP politician appointed minister of state for economic and fiscal policy during the 2009 Taro Aso administration, Sadakazu Tanigaki, and the late Nobutaka Machimura, twice Minister for Foreign Affairs (under Koizumi and then Abe). The two factions held opposing views on how Japan could exit the protracted stagnation. While the first group advocated a growth strategy to promote innovation, aggressive monetary easing, and few or no cuts in public spending, the Fiscal Hawks were instead prone to more aggressive fiscal policy measures aimed at reforming the social security system and/or raising tax revenues by imposing a higher consumption tax rate. This historical dispute has been a feature of the alternating governments over the last ten years and is still present in current discussions inside the Japanese government.

So far Abe has sided with the pro-growth theory, although its first attempt in 2006 failed to deliver sound results. Abenomics now builds on previous experience.

Since his first term in office as prime minister in 2006 Abe has sided with the 'growth-first' philosophy, although with some caution. In his first policy strategy he set an ambitious high-growth target of 4 % (nominal growth) to be reached through expansionary policies, while, at the same time, he provided for some expenditure caps in order to achieve a primary budget surplus by 2011. This embryonic attempt to implement Abenomics in 2006 was aborted at an early stage for a number of reasons – first and foremost because Abe lost political support in the upper house in the 2007 elections and resigned. The Bank of Japan was also not very supportive of Abe's plan and raised the interest rate, thus putting an end to the monetary stimulus. To add further difficulties, the global financial crisis broke out in 2007-2008. Since returning to power in 2012, Abe has relaunched the 'growth-first' policy strategy, proposing a reinvigorated version of what was planned during the previous mandate. This plan is now widely known under the name of 'Abenomics'.

2 Abenomics: its progression and achievements

2.1 'The three arrows of Abenomics'

The fiscal and monetary policy of Abenomics entailed unprecedented monetary easing and fiscal stimuli.

'Abenomics' is Prime Minister Shinzō Abe's new plan for revitalising the Japanese economy. It encompasses three sets of reforms – monetary, fiscal, and structural – labelled 'the three arrows'. The logic of Abe's plan was to have a coordinated approach on multiple fronts in order to cure Japan's deflationary hangover and restore the country's fiscal sustainability, in compliance with Japan's 2010 G20 commitment to halve its primary deficit in the 2015 fiscal year and to achieve a primary balance by 2020.

The first of the three arrows has been an unprecedented programme of

Monetary reforms involve an open-ended programme of quantitative and qualitative easing aimed at pushing inflation up to 2% or above.

massive quantitative and qualitative monetary easing (QQE) that expands Japan's monetary base by JPY 80 trillion, about 16 % of GDP. Led by Haruhiko Kuroda, the Bank of Japan (BOJ) has enacted the monetary measures primarily by buying Japanese Government bonds (JGBs) in order to encourage inflation. In an initial round the BOJ doubled its balance sheet in order to send inflation towards the 2 % target. As inflation remained low, however, the BOJ switched to a second open-ended phase in which it committed to buying up government debt until the 2 % target is achieved[3]. While effects on inflation so far have been modest, notable success was achieved through the depreciation of the yen, which declined by more than 30 % in 30 months[4].

Fiscal reforms include public works intended to boost private investment.

The second arrow of Abenomics aimed to stimulate private investment and deliver a flexible fiscal policy. Reforms were initiated with a fiscal stimulus package worth USD 150 billion (corresponding to EUR 113 billion) devoted to the reconstruction of areas affected by the March 2011 disaster. These funds were allocated to public works such as railway lines and tunnels in the areas affected by the disaster. On 27 December 2014, Abe announced a further JPY 3.5 trillion (EUR 27.5 billion) economic stimulus package aimed at supporting low-income citizens by reducing energy and service costs, revitalising local communities and bolstering the resilience of waterworks and other social infrastructures in the face of natural disasters such as earthquakes and typhoons. This fiscal stimulus, however, resulted in a further deterioration in state finances without producing any long-lasting effects on the economy in return.

To partly offset swelling social security costs, Japan approved a consumer tax hike, which in turn depressed the economy.

In addition to these measures, the Japanese government increased the consumption tax rate from 5 % to 8 % in April 2014. This measure was aimed at partly offsetting the enhanced fiscal pressure on Japan's national accounts. Abe sold the consumer price hike as his commitment to fiscal consolidation, thus responding to pressure from the 'Fiscal Hawks'. The consumption tax hike, however, was not entirely a product of Abenomics and dates back to the administration of DPJ Prime Minister Yoshihiko Noda in 2009. Amidst the deepening financial crisis, the Democratic Party of Japan (DPJ) – historically in opposition – had won the elections in 2009 and, concerned by Japan's progressive accumulation of a gigantic public debt, the new government pushed for fiscal consolidation. As a result, the Diet passed a bill in August 2012 that approved a consumer tax hike. While this was achieved thanks to cooperation between the DPJ and LDP, the planned hike from 5 % to 8 % implemented in April 2014 cannot be seen as a product of Abenomics[5]. The extra consumption tax revenue was meant to raise a further USD 140 billion that would help to halve the primary budget deficit by 2015[6]. Instead, the negative reaction of the markets to the April

[3] CFR Backgrounders, 10 March 2015.
[4] The Economist, 4 June 2015.
[5] The Economist, 13 May 2015.
[6] The Economist, 13 May 2015.

2014 increase prompted Abe's administration to push back the second consumption tax hike (up to 10 %) that was initially planned for October 2015 to a later date (April 2017).

Monetary and fiscal policies have delivered underwhelming results so far. The focus now is on structural reform.

As monetary and fiscal expansion had failed to deliver the expected results for a long-lasting economic recovery, the 'third arrow of Abenomics' has gradually taken shape and acquired importance over time. Structural reforms were nothing more than an announcement at the time of the launch of 'Abenomics'. Each year since then they have deepened, to the point of acquiring a central role in the new economic policy agenda as revised in June 2015.

Structural reforms are an essential part of Abe's growth strategy and are meant to engender a 'productivity revolution' that will counteract the adverse conditions that have dragged Japan down for over two decades. In June 2014 the government announced a broad package of reforms focused on enhancing corporate governance, promoting the liberalisation of agriculture, addressing labour market shortcomings (e.g. women's participation, the treatment of temporary workers, shrinkage of the labour force, etc.) and tackling demographic challenges.

An aging population, labour market rigidities and gender gaps are major socio-economic challenges facing Japan.

Demographic challenges and gender issues have significant implications for the Japanese economy. The Japanese population is expected to decline by about a third to 87 million by 2060 and it is estimated that Japan's workforce will decrease by 41 % (i.e. 38 million fewer people) from current levels. The ratio of dependents (people younger than 15 or older than 64) to the working-age population has gradually increased to reach 62 % in 2013, and it is expected to be over 95 % in 2050. Population aging imposes an increasingly heavy burden on the Japanese economy with a negative impact on public spending, productivity growth and consumption.

A crucial part of the reform is 'Womenomics', which aims to boost the role of women in the Japanese economy.

Alongside the rapidly aging population, gender gaps are also large in Japan and are holding back the economy. As reported by the OECD, gender inequality affects the Japanese labour market in various forms. The male participation rate is 84 %, while the female participation rate is only 63 %; the gender pay gap for median earnings is 27 %; 70 % of relatively low-paid non-regular workers are female; and women account for fewer than 5 % of listed company board members. By increasing female participation in the workforce and closing the gender gap, Japan could boost its GDP by 13 %[7].

To counteract the aging and decline of its workforce, a key component of the third arrow is 'Womenomics' – the increased participation and advancement of the position of women in the workforce. To that end, the government has made plans to adopt a number of social policies ranging from expansion of the availability of day care to increasing parental leave benefits and allowing foreign housekeepers in special economic zones, etc.

[7] Congressional Research Services, Japan-U.S. - Issues for the Congress, January 2015.

Some of those measures have been already implemented.

Corporate governance reforms aim for higher productivity and greater accountability in the sector.

A collateral goal of structural reforms is to make the country more attractive to investors and business and to create a better business environment that will foster productivity growth and innovation. To achieve this, Abenomics acts on corporate governance. It attempts to encourage the corporate sector to switch to more productive practices, for instance by introducing more accountability within boards of directors. These are the intentions of the new Corporate Governance Code that entered into force on 1 June 2015. The government has also reduced the effective corporate tax rate from 35 % to 33 %, and is planning further reductions down to 20 % over the coming years.

Some other important reforms are currently under discussion in the Japanese Diet: (i) labour reform, addressing current restrictions on companies as regards hiring temporary and contract-based workers (i.e. 'irregular workers', as opposed to 'regular workers' entitled to extensive benefits and protected by the post-war lifelong employment legislation); (ii) a power sector reform that will dismantle the monopoly in the sector in Japan ; (iii) a reform of agricultural cooperatives that will dismantle some rigidities in this sector in order to promote greater consolidation and enhance productivity.

2.2 Achievements

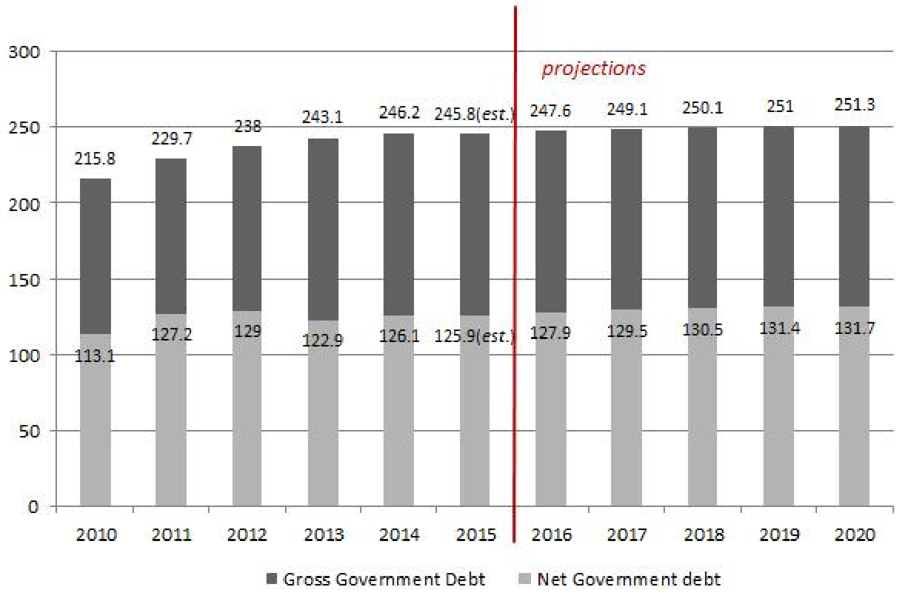
Modest economic achievements so far: Japan's commitment to reach fiscal sustainability by 2020 remains distant.

The achievements of Abenomics have been rather 'unconvincing' so far. Regarding fiscal sustainability, public debt has kept piling up to reach 246 %, according to the latest IMF estimates[8]. The commitment made at the G20 summit in 2010 to restore the country's fiscal position by 2020 is now more necessary than ever, but remains very difficult to achieve.

In February 2015 the Cabinet Office projected that its primary budget deficit would fall short of the target by JPY 9.4 trillion in the fiscal year 2020[9]. This figure was, however, promptly reduced in the government's later projections. On 22 July, the Cabinet Office released its medium- and long-term economic and fiscal projections in which the 2020 projections are JPY 3.2 trillion narrower than previously estimated. This is the result of a JPY1.4 trillion increase in revenue and a JPY1.8 trillion decrease in spending. While the Cabinet Office's projections still show a primary budget deficit for 2020, these mysterious upward adjustments also have little credibility. They are based on the assumption of a 1 % inflation rate and a 2 % growth rate. Even this conservative scenario does not correspond to the current economic reality of Japan or the underwhelming results of Abenomics in most areas.

[8] IMF article IV Consultation with Japan, June 2015.
[9] Asian Review, 10 August 2015.

Figure 2:
Japan's government-debt-to-GDP (%)

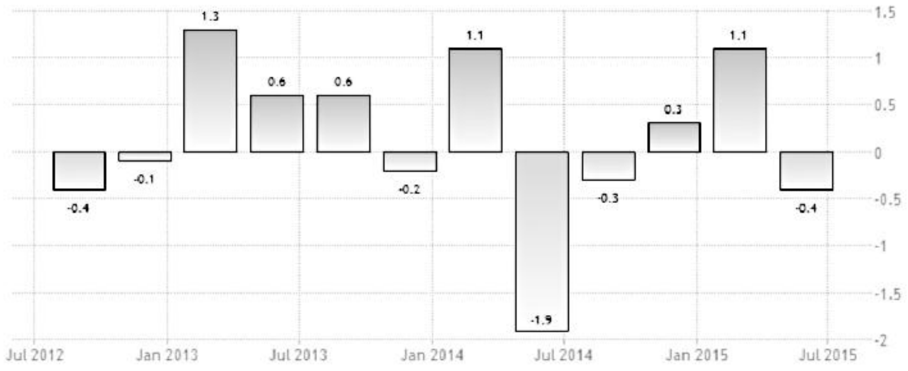


Source: IMF article IV Consultation with Japan, June 2015.

In the second quarter of 2015 Japan's economy unexpectedly slowed down by 0.4 %, with consumption down by 0.8 % and inflation up by a sluggish 0.2 %.

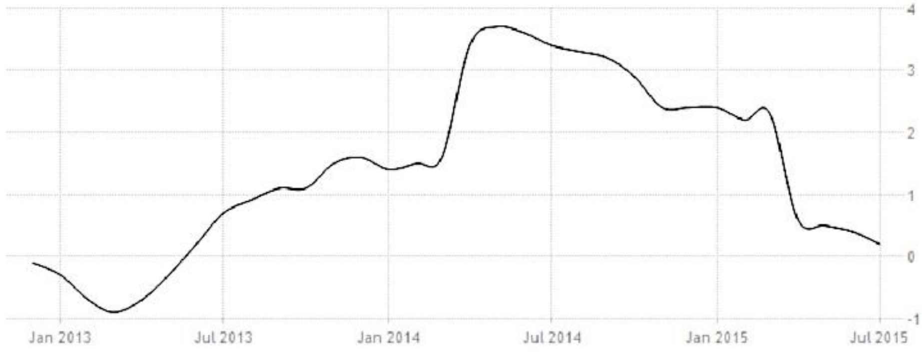
The recently released (17 August 2015) GDP estimates show that Japan's real GDP fell in the second quarter of 2015 by 0.4 % (on the quarter), or 1.6 % (in annualised terms). This negative growth rate was rather unexpected as projections were forecasting a timid, but positive, annualised growth of 0.7 %. While the slowdown in exports to China has inhibited industrial production, the negative outlook for the Japanese economy is also due to anaemic household consumption. The reversal from the timid recovery of the first quarter of 2015 to negative growth in the following quarter is mainly due to a slump in private consumption (- 0.8 %) accompanied by a well-below-target inflation rate of 0.2 %. The IMF argues that consumers' reluctance to spend is a sign of their concerns regarding Japan's fiscal sustainability.

Figure 3:
Japan's GDP growth rate



Source: www.Tradingeconomics.com; Cabinet Office, Japan

Figure 4:
Inflation rate

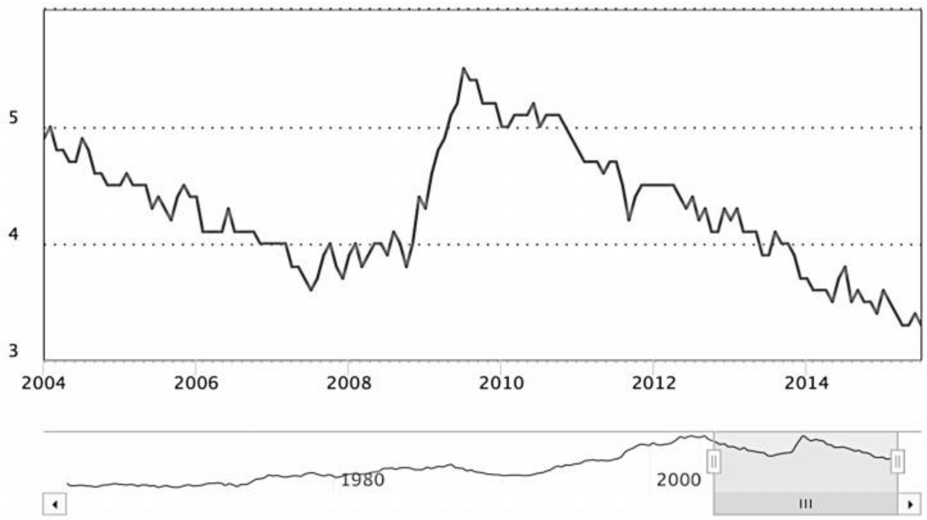


Source: www.Tradingeconomics.com;
Ministry of Internal Affairs & Communications, Japan.

Modest success has been recorded in the labour market: unemployment has fallen, wages are rising slowly and female participation has increased, albeit from a very low base.

Against this backdrop, however, the Japanese economy has also recorded some positive signals in the labour market. The steady reduction in unemployment, down to 3.3 % in July, was accompanied by a relative increase in wages. As the Japanese economy is now operating at quasi 'full employment', the further expected tightening in the labour market arising from a continuous increase in the number of job offers compared to applicants (see the rising job offers-to-applicants ratio) should ignite more robust wage inflation. At the same time, Abe's reforms have managed to increase labour force participation rates, including the historically low participation rate for women.

Figure 5:
Unemployment rate - seasonally adjusted (%)

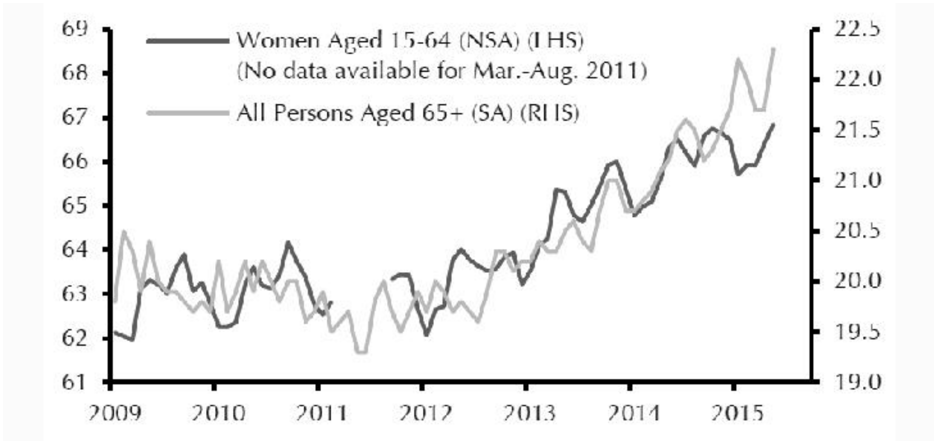


Source: [Japan Macro Advisors](); MHLW, JMA.

Figure 6:
Job offers-to-applicants ratio - seasonally adjusted (%)

Source: [Japan Macro Advisors](); MHLW, JMA.

Figure 7:
Labour force participation rates (%)



Source: Thomson DataStream.

The steadily decreasing exchange rate favours Japanese exports and inflows of tourists, but at the same time increases the cost of imports.

Following the huge monetary stimulus, the yen has depreciated by about 30 % against the dollar since the programme was announced, enhancing the international competitiveness of Japanese exporters such as car manufacturers. At the same time, however, a weaker yen has driven up the price of imports and contributed to dampening consumer demand.

Taking the current situation as a baseline, it is unlikely that Japan will fulfil its G20 commitments of halving its primary balance by 2015 or of reaching a surplus by 2020, unless the new structural reforms trigger a rapid, positive cycle, engendering high growth, high consumption, constant inflation of over 2 % and immediate fiscal revenues.

3 Economic and fiscal blueprint

The economic and fiscal blueprint puts the emphasis on structural reforms, which aim to enhance productivity in all sectors of the Japanese economy.

The new economic policy agenda of Abe's administration was released in June 2015. The cabinet issued a revised version of the 'Basic Policy for Economic and Fiscal Management and Structural Reform' for the 2015 fiscal year, together with a revised version of the Revitalisation Strategy. These two Abenomics updates make a further push for implementation of the 'third arrow', making it clear that structural measures are instrumental to boosting income, investment, consumption and profits. More investment in infrastructure technology and human capital will trigger a 'productivity revolution' that will ultimately lead to fiscal consolidation in the form of a primary budget surplus by 2020.

The fiscal plan includes a ca. JPY 1.5 trillion cut in in social security expenditure by 2018.

The economic policy objective of this 'productivity revolution' shall engender robust economic growth with higher tax revenues in return, thus covering the swelling social spending driven by Japan's fast-aging population. The plan also foresees limits on public social spending, i.e. a bland 'expenditure reform' that introduces a 'soft' target to cap "*unnecessary*" social security expenditure. The target set at JPY 500 billion per annum until 2018 will secure a total reduction of about JPY 1.5 trillion in social security expenditure for the three-year period. Measures under this reform seek to encourage, rather than compel, the more efficient use of public resources at local level also. Among these measures, the government has announced, for instance, the promotion of public-private partnerships (PPPs) to deliver healthcare services and care for the elderly.

Japan has one foot on the accelerator and one foot on the brake, with its political class divided into those supporting growth measures and those calling for fiscal consolidation.

The content of the economic and fiscal plan is the latest episode in the historical dispute between 'growth-first' supporters and 'fiscal hawks'. As the plan postpones the second consumer tax hike to April 2017 and proposes only a soft spending cap, it seems to lean towards the growth-first philosophy. There is no doubt that public debt is at critical levels (over 246 % of GDP), and no-one questions the need for fiscal sustainability, but different views emerge regarding the urgency of budgetary tightening.

Supporters of the 'growth-first' philosophy favour expansionary measures that boost demand, and see austerity measures at this stage as an unnecessary threat to consumption and to the whole process of recovery. According to this line of arguments, Japan holds numerous assets, making its net debt position less critical as it would drop to 126 % of GDP[10]. Much of its debt is, moreover, held domestically either by the central bank, the Bank of Japan, or by Japanese trust and investment funds. As a percentage of GDP, the share of the debt held by the BOJ is about 70 % and, according to this logic, the outstanding debt position that should be of concern to Japan would only be about 80 % of its GDP as of June 2014[11].

Public debt is an issue, but might not be as urgent as it seems.

On the other hand, fiscal hawks and international organisations – such as the IMF, the OECD and the credit-rating agency Fitch – have expressed concerns about the long-term sustainability of the Japanese debt and the growing risks to which Japan will be exposed if does not act promptly to restore sound public finances. Their argument is based on the fact that social security expenditure is swelling on account of a rapidly aging population and a shrinking labour force. According to their calculations, it is unrealistic to count solely on economic growth to achieve fiscal sustainability, especially in the light of the currently underperforming GDP

[10] IMF article IV Consultation with Japan, June 2015.
[11] See commentary by Professor Masazumi Wakatabe of Waseda University.

and inflation growth rates recorded so far by Japan. Their view is that it would take much more than a 10 % increase in consumer tax to restore Japan's public finances and meet the government's commitment to a primary budget surplus by 2020.

4 Challenges ahead

Real progress in structural reform is a matter of urgency if Japan wants to restart growth and achieve fiscal sustainability in the future.

The bottom line of the debate between those urging measures to reduce Japan's public debt and those pushing for more growth-oriented measures is whether or not Japan will be able to unlock its growth potential, and where the country currently stands in its reform process. At present, the country has many regulatory barriers in all fields of the economy, and far-reaching structural reforms could – if properly implemented – relaunch growth.

Abe's growth strategy, which combines industrial revitalisation, strategic market creation and a strategy of global outreach, is not so ambitious, and the actual reform process has yet to loosen most of the rigidities in the Japanese labour market, business environment and social culture. More work is needed in those fields.

Labour market reforms and improvements in the business climate are key aspects for relaunching Japan's economic growth.

Some of the growth measures approved are proceeding at high speed (e.g. IT and innovation, the revitalisation of SMEs, deregulation in the 'National Strategic Special Zones'). By contrast, the labour market reform included in the new strategy is vaguely worded ('holding discussions, planning, considering reviewing, etc.'). These reforms are intended to remove many of the rigidities in the labour market, but it remains to be seen how far their actual implementation will go. Also, as pointed out by the IMF, Japan could do more to encourage labour market participation (e.g. removing the disincentives for women to work after marriage, relaxing immigration restrictions in some sectors and delaying the retirement age)[12]. Finally, business sentiment has improved, reaching its highest point since October 2013 - mainly thanks to the yen's depreciation - in numerous sectors (manufacturing, as well as the retail, hotel and restaurant industries). Nevertheless, reforms are still needed in the area of simplifying tax payment procedures, and the business community is calling for further reductions in corporate tax rates[13].

[12] IMF article IV Consultation with Japan, June 2015.
[13] Business Insider, August 2015.