An OECD Assessment of "Abenomics"

Author Randall S. Jones

By Randall S. Jones

Japan faces difficult economic challenges. More than two decades after the collapse of the 1980s asset price bubble, Japan remains stuck in deflation, with land and consumer prices (as measured by the core consumer price index, excluding food and energy) continuing to decline. Sluggish output growth and rising public spending, due in part to population aging, have pushed gross public debt to nearly 230% of GDP, raising serious concerns about fiscal sustainability. Eliminating the budget deficit, which was close to 10% of GDP in 2012, implies large-scale fiscal consolidation that will hold back nominal GDP growth, making it difficult to stabilize the public debt ratio. Meanwhile, structural problems, including rapid population aging and weak integration in the world economy, reduce growth potential. To address these challenges, Prime Minister Shinzo Abe has launched a strategy of three arrows — a bold monetary policy, flexible fiscal policy and a growth strategy that encourages private-sector investment — to exit deflation and revitalize Japan.

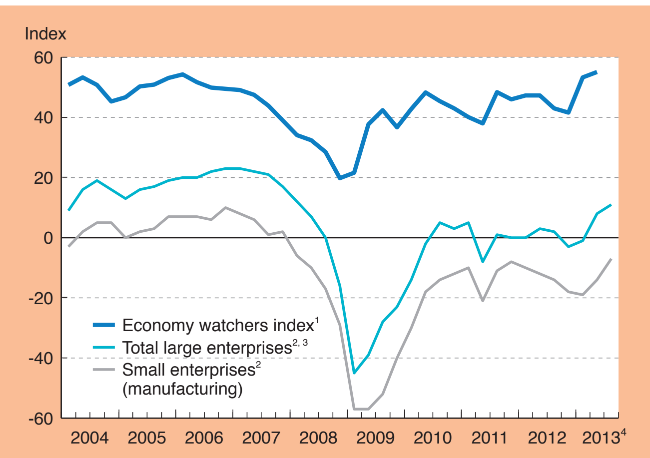
The first two arrows were launched in early 2013, with the fiscal stimulus package and the introduction of "quantitative and qualitative monetary easing" (QQM) to achieve the new 2% inflation target. The immediate impact was to boost confidence *(Chart 1)* and push the Nikkei stock price index up by as much as 80%. Despite some correction, the index in the second quarter of 2013 was up about 50% from its level in the third quarter of 2012 *(Chart 2)*. The renewed optimism was due in part to the weaker yen, which has depreciated by more than 20% over the same period in trade-weighted terms. Rising optimism and improved expectations for the future strengthened the economic upturn, which had begun in late 2012. Indeed, economic growth in the first quarter of 2013 accelerated to almost 4% at an annual pace and appears to have remained strong in the second quarter at around 2.5%.

While the initial results of the first two arrows have been impressive, the effect of monetary and fiscal stimulus will be only temporary. The long-term impact of Abenomics will instead depend primarily on the third arrow to promote Japan's growth potential, which requires addressing long-standing structural issues. In addition, the economic strategy will require a fourth arrow of fiscal consolidation to stop and eventually reduce the run-up in the public debt ratio.

First Arrow: Bold Monetary Policy

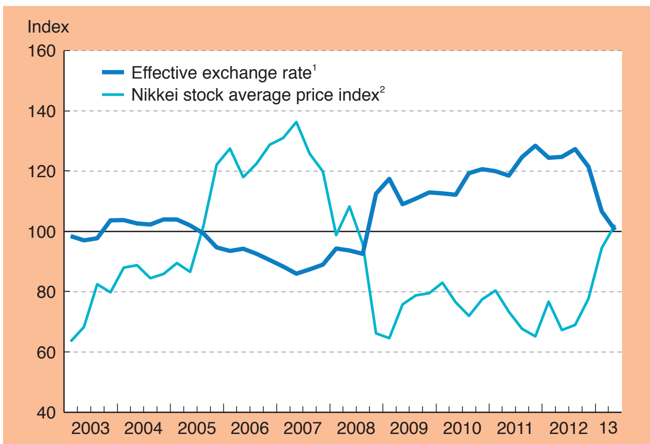
The GDP deflator has dropped by 17% since 1998, and core consumer price inflation remains in negative territory *(Chart 3)*. Deflation lowers nominal GDP, thereby boosting the debt ratio and threatening fiscal sustainability. In addition, deflation acts as a headwind that hinders economic growth. Given the deleterious effects of deflation, achieving price stability is a top priority. However, the Bank

CHART 1
Course of confidence index



Notes: 1. Survey of workers, such as taxi drivers and shop clerks, whose jobs are sensitive to economic conditions. The index ranges from 100 (better) to 0 (worse), with 50 indicating no change.
2. Diffusion index of "favorable" minus "unfavorable" conditions.
3. Large enterprises are capitalised at 1 billion yen or more and small enterprises at between 20 million yen and 100 million yen.
4. April and May for the Economy Watchers index. Figures for the third quarter of 2013 for other measures are projections made by companies in June 2013.
Sources: Ministry of Economy, Trade and Industry; BOJ; and Cabinet Office

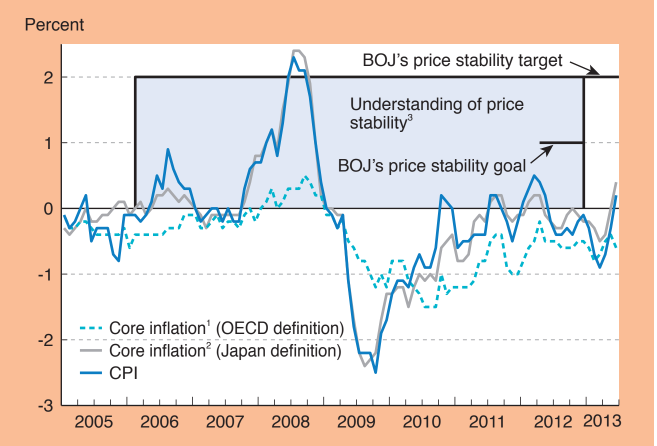
CHART 2
Rising equity prices & depreciating yen



Notes: 1. Trade-weighted, vis-à-vis 48 trading partners.
2. The Nikkei stock price index averages the price of 225 individual stocks listed on the Tokyo Stock Exchange.
Sources: OECD Economic Outlook Database and Nikkei Indexes

CHART 3

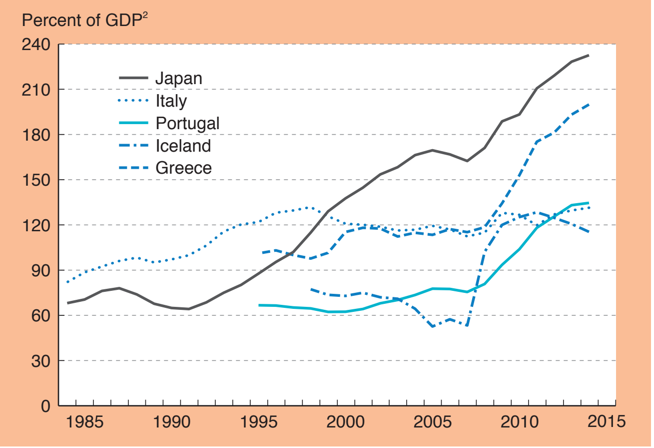
Entrenched deflation:
Year-on-year percentage change



Notes: 1. Excludes food and energy.
2. Excludes only fresh food.
3. Of BOJ Policy Board members.
Sources: BOJ and OECD Economic Outlook Database

CHART 4

Japan's soaring public debt[1]



Notes: 1. The five countries with the highest gross debt ratios (gross liabilities divided by GDP) in the OECD area in 2010.
2. OECD estimates for 2012 and projections for 2013-14.
Sources: OECD Economic Outlook, No. 92, and revised OECD estimates and projections for Japan for 2012-14

of Japan (BOJ) in the past blamed deflation on Japan's falling growth potential and argued that it could not achieve price stability without policies to boost potential.

The introduction of a 2% inflation target, the mid-point of most central banks in the OECD area that target inflation, was a welcome first step. The higher target, if achieved, would help reduce the towering public debt ratio and reduce the risk of falling back into deflation. In order to achieve the target, the BOJ announced a new framework that aims to double the size of the monetary base in two years. This goal requires nearly doubling purchases of government bonds to 7.5 trillion yen (1.5% of GDP) per month. In addition to expanding the scale of quantitative easing, the new framework aims at enhancing its effectiveness by lengthening the maturity of the BOJ's government bond holdings and increasing purchases of private assets.

The new monetary policy has been accompanied by increased volatility in financial markets, although this appears to be an inevitable side effect of policies to end entrenched deflation. Another side effect is the depreciation of the yen. The new policy already appears to have been successful in raising inflation expectations and positive headline inflation in June 2013. The BOJ expects to attain the 2% inflation target in about two years, an ambitious goal given that deflation has become entrenched during the past 15 years. While it is difficult to project when the inflation target will be achieved, the BOJ has accepted that it is responsible for achieving the target and has promised to maintain its very expansionary policy stance until 2% inflation is firmly achieved.

Second Arrow: Flexible Fiscal Policy

The arrow of flexible fiscal policy was launched with the announcement of a 10.3 trillion yen (2.2% of GDP) stimulus package in January 2013. Financing the package will require around 5 trillion yen (1% of GDP) of additional bond issuance.

While the fiscal package is supporting economic growth, it makes it more difficult to achieve the government's target of cutting the primary budget deficit (*i.e.* excluding net interest payments) of central and local governments to 3.3% of GDP in FY 2015. Indeed, this measure of the deficit was estimated at 7% of GDP in FY 2013. The FY 2015 objective is important as a first step towards the FY 2020 target of a primary budget surplus to stabilize the ratio of gross debt to GDP, which has risen to uncharted territory *(Chart 4)*, leaving Japan vulnerable to a loss of market confidence in the sustainability of its public finances.

Moreover, the fiscal package, with its emphasis on public works spending, is likely to provide only a temporary boost to growth. Between 1990 and 2008, Japan embarked on large-scale public works spending through 15 fiscal stimulus packages, without much positive impact on its growth potential. Boosting Japan's growth prospects depends instead on bold structural reforms.

Third Arrow: Growth Strategy

In June 2013, the cabinet adopted the "third arrow" of a new growth strategy aimed at revitalising the economy. The strategy maintains the key targets in the 2010 growth strategy: boosting Japan's real growth rate to a 2% annual pace over the next decade and nominal growth rate to 3% by overcoming deflation. In addition, it aims to raise *per capita* gross national income by more than 1.5 million yen to 5.3 million yen (around $53,000) by 2023. In addition, the strategy introduces a range of numerical targets in its three main action plans.

The industrial revitalisation plan

- Increasing the total amount of business investment by 10% during the next three years, thereby reaching the pre-2008 level of 14% of GDP.
- Creating a business environment that is ranked in the top three among developed countries by 2020.
- Reducing the number of long-term unemployed (more than six months) by 20% in five years.
- Raising the employment rate of women in the 25-44 age group

from 68% to 73% in 2020, in part by eliminating waiting lists for childcare centers by 2017.

The strategic-market creation plan

- Expanding demand and jobs in the areas of health and green innovation.
- Doubling agricultural earnings within 10 years through increased exports and promotion of intensive farming, while cutting the production cost for rice by 40%.

Globalization plan

- Boosting the share of Japan's trade with countries with which it has signed free trade agreements (FTAs) from 19% to 70% by 2018.
- Doubling the stock of inward foreign direct investment to 35 trillion yen (7% of GDP) by 2020 (the stock has been basically flat since 2008).

In addition to the numerical targets, the road map shows how Japan will boost growth in four areas through 2030: i) health and fitness services; ii) energy: iii) next-generation infrastructure; and iv) regional resources. The next three years are to be an "investment promotion period", driven by regulatory reform and tax measures, as well as by government support to growth industries.

OECD Perspective of Growth Strategy

The strategy is a step in the right direction, focusing on regulatory reform, in contrast to the previous government, which emphasised stimulating demand. Moreover, the new strategy includes some key reforms that were stressed in the 2013 *OECD Economic Survey of Japan*:

- Consolidating farmland and increasing competitiveness in agriculture.
- Reforming the electricity sector by liberalizing retail and separating power generation and transmission.
- Encouraging the use of generic medicines and reducing the drug lag.

However, it is not clear how Japan can achieve the many numerical targets in the plan. Moreover, some of the objectives are not internally consistent. For example, doubling agricultural income will be difficult to accomplish while dramatically expanding the scope of FTAs, which will tend to reduce agricultural output.

Announcing difficult reforms, particularly in the month prior to a national election, is never easy. Hopefully, as Prime Minister Abe stated in introducing the strategy on 5 June, the initial growth strategy is just the beginning:

"…this report is no more than a first step towards the realisation of the growth strategy. There is no end to the regulatory reforms of the Abe Cabinet. In the next cycle as well, with a view to revitalizing the Japanese economy, I would like to ask for your cooperation in taking dynamic steps to implement even more bold regulatory reforms that will promote the structural reform of the economy."

Prime Minister Abe's resounding victory in the July election should facilitate the introduction of bold regulatory reforms. In particular, the growth strategy should be expanded to include two major issues that were also analyzed in the 2013 *OECD Economic Survey of Japan*: comprehensive agricultural reform and labor market measures to reduce dualism.

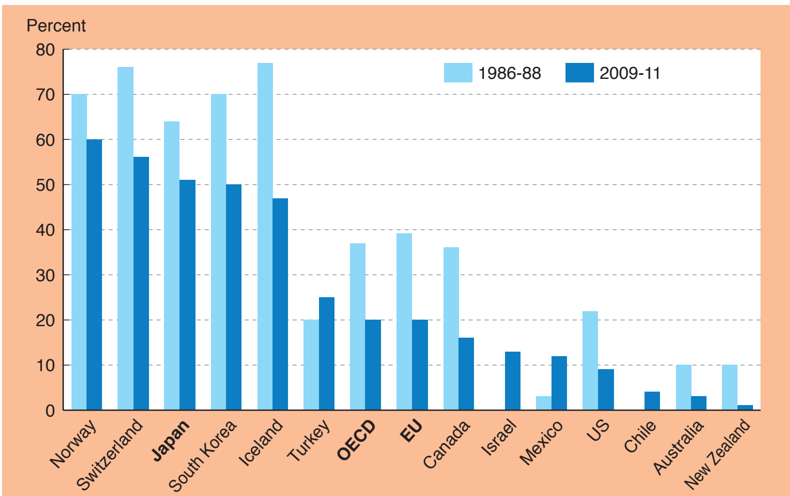
Comprehensive agricultural reform

Although Japan's agricultural sector is small, it is a major obstacle to Japan's participation in comprehensive international trade agreements. During the past half century, agriculture's share of GDP dropped from 9% to 1%, while its share of the labor force shrank from 28% to 4%. Meanwhile, the cultivated land area has fallen by a quarter, while part-time farming has become the norm. While some parts of agriculture are thriving, such as vegetables, the sector faces a number of challenges:

- Productivity in land-intensive agriculture is low, primarily reflecting the small average farm size of only two hectares, compared to the European Union (14 hectares) and the United States (170 hectares).
- High levels of commodity-specific support on certain products impose heavy burdens on consumers and taxpayers. The overall level of assistance, as measured by the Producer Support Estimate, was 51% in Japan in 2009-11, about double the OECD average *(Chart 5)*. Higher prices boosted consumer spending on agricultural products to 1.8 times above what it would have been in the absence of government policies.
- Border measures, including a tariff of 341 yen per kilo of rice, which amounted to a 780% tariff rate in 2012, isolate farmers from international competition and complicate Japan's

CHART 5

Agricultural support in OECD countries[1]



Note: 1. As measured by the producer support estimate, which is the annual monetary value of gross transfers from consumers and taxpayers arising from policies that support agriculture, regardless of their nature, as a percentage of the value of gross farm receipts. Countries are ranked according to their 2009-11 levels.

Source: OECD PSE/CSE Database 2012

- participation in comprehensive regional and bilateral trade agreements.

The government's 2010 *Basic Policy on Comprehensive Economic Partnerships* acknowledged that Japan is falling behind other countries in establishing high-level FTAs. In March 2013, the Abe government decided to take part in the negotiations for the Trans-Pacific Partnership (TPP) Agreement, while promising to make every effort to defend the interests of Japanese agriculture. A more open and competitive environment is essential to secure the growth and competitiveness of agriculture and promote Japan's integration in the world economy. Demographic factors create an opportunity for farm consolidation and other reforms to boost productivity. Indeed, in 2010, the average age of farmers was 66 and 56% of rice farmers were over 70, while another 36% were between 50 and 70. Only 8% were under age 50.

Bold agricultural reform to revitalize the agricultural sector should begin promptly:

- The production adjustment program, which allocates rice production to specific regions and farmers, should be phased out, thereby increasing the share of rice production by efficient farmers and reducing its production cost.
- Support for farmers should be decoupled from market price supports — the most distortive type of support — toward payments decoupled from production and based on environmental services, such as water-buffering to prevent flooding. The degree of decoupling of agricultural support remains far below the EU and the US. Moving away from market price supports would reduce the overall cost of agricultural support.
- Farm consolidation needs to make progress, in line with the government's goal of having a majority of farms with 20 to 30 hectares in flat regions of Japan. Indeed, land productivity on rice farms of 10 to 15 hectares is double that on farms of 0.5 to 1 hectare, the current average. Obstacles to transactions of farmland should be lifted to promote productivity.

Moving to a more market-based agricultural sector would facilitate a reduction in import protection and promote Japan's integration in the world economy. To achieve these goals, Japan should participate fully in the TPP and conclude FTA negotiations with Australia, launch negotiations with the EU and achieve regional economic partnerships such as a China-Japan-South Korea FTA. Further opening of the agricultural sector would tend to reduce food self-sufficiency, at least in the short run, in contrast with the government's goal of raising it from 41% in 2008 to 50% by 2020 in terms of calories consumed. Japan should focus instead on food security, which would best be achieved by a comprehensive strategy that includes a competitive, efficient farm sector, complemented by emergency reserves and agreements to promote stable trading arrangements.

Breaking down labor market dualism

A flexible labor market is essential for achieving Japan's goal of developing new growth areas. At present, Japan's labor market is segmented between regular and non-regular workers, primarily part-time, fixed-term and dispatched workers. The share of non-regular workers has nearly doubled since 1990 to 34% of total employment in 2012, as firms hire non-regular workers to achieve greater employment flexibility and to reduce labor costs. However, it creates a number of problems for growth and equity:

- *A significant wage gap*: Non-regular workers were paid only 60% as much per hour as regular workers (excluding bonus payments) in 2009. After adjusting for workers' type of job and educational attainment, the wage gap between full and part-time workers is 54.8% for men and 69.5% for women, making it a major cause of rising income inequality.
- *Less firm-based training*: The short tenure of non-regular workers reduces the incentive for firms to invest in training them, thus reducing their human capital accumulation and earning power, as well as Japan's growth potential. Only about a quarter of firms provide systematic on-the-job training to non-regular workers, less than half the proportion for regular workers.
- *Less coverage by the social safety net*: Around 35% of non-regular workers are not covered by employment insurance, even though they face precarious employment and consistently higher unemployment rates. Moreover, less than half of non-regular workers are covered by employee pension insurance.
- *Limited mobility between regular and non-regular employment*: Non-regular employment is not a pathway to regular employment, heightening concern about the equity impact of dualism. One study found that only about 10% of non-regular workers become regular workers.

Not surprisingly, the government's 2012 survey on well-being found that the happiness level reported by non-regular workers is below that of regular workers and the self-employed.

The 2012 revisions to the labor law tightened restrictions on the use of non-regular workers by limiting the length of employment of dispatched and fixed-term workers. However, restrictions on non-regular workers tend to increase the costs of employment flexibility and lower overall employment, without addressing the fundamental causes of dualism. Instead, a comprehensive strategy aimed at weakening the factors that encourage firms to hire non-regular workers is needed, including increasing social insurance coverage and reducing employment protection for regular workers, while upgrading training programs for non-regular workers.

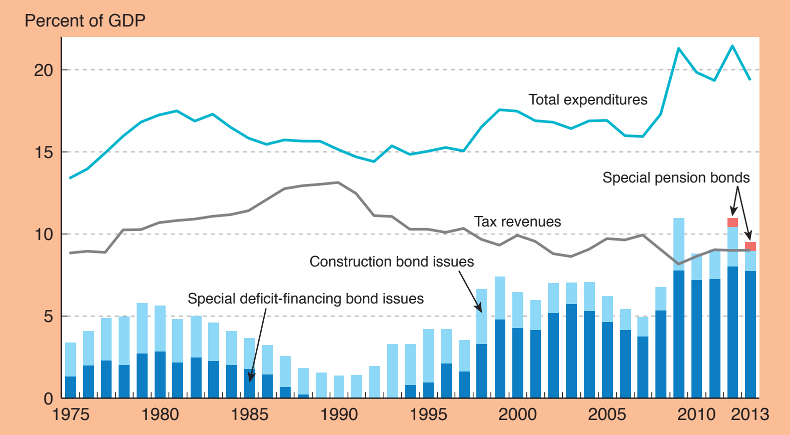
Need for Fourth Arrow: Fiscal Consolidation

The three-arrow strategy to achieve robust nominal income growth through inflation and reforms to boost real growth is essential to address Japan's fiscal predicament, which has reached a critical point after two decades of budget deficits. For the central government, borrowing exceeded tax revenue in FY 2009-10 and again in the FY 2012 initial budget *(Chart 6)*. However, the impact of big deficits and high public debt has been mitigated thus far by exceptionally low interest rates, currently at less than 1% for 10-year government bonds. A number of factors have kept interest rates low, including persistent deflation, the risk aversion of investors after a prolonged period of sluggish economic growth, the "home bias" that keeps savings in Japan, and ample household financial assets.

CHART 6

Gap between central government expenditure & tax revenue

Central government general account as percentage of GDP[1]

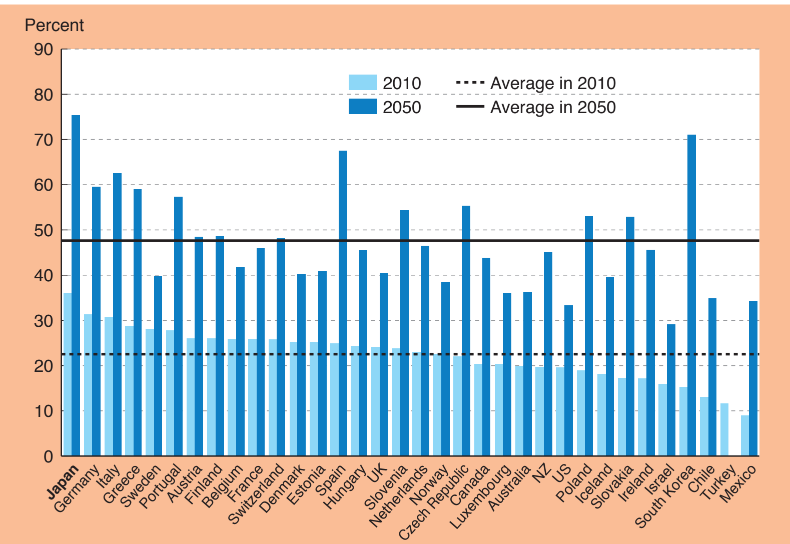


Note: 1. Final outcome for FY 1975-2011, revised budget for FY 2012 (including the government's contribution to the basic pension system and the special pension bonds to finance it), and initial FY 2013 budget. Reconstruction spending and bond issuance are excluded for FY 2011-13.
Source: Ministry of Finance and OECD calculations

CHART 7

Elderly dependency ratios in OECD countries

The elderly dependency ratio[1]



Note: 1. Over-65 population as a share of the working-age (15 to 64) population.
Source: OECD Demography and Population Database

However, the deflationary equilibrium — large government deficits financed at low rates by Japanese savers — will not last forever. The immediate priority is a detailed and credible medium-fiscal plan, including both tax hikes and measures to limit spending, to forestall, or at least limit, any rise in the long-term interest rate. The plan should include measures to achieve the FY 2015 target of a 3.3% of GDP primary deficit. This requires implementing the planned hike in the consumption tax rate from 5% to 10% in FY 2015. Past experience in OECD countries shows that even a short delay in consolidation increases the required fiscal tightening to reach prudent debt levels.

In the longer term, the debt-to-GDP ratio must be stabilized and then gradually reduced. According to OECD estimates, if the necessary fiscal improvement were achieved entirely through the consumption tax, this would require increasing the rate to around the European average of 22%.

The fiscal challenge is heightened by the continuing rise in social spending driven by population aging. Indeed, the working-age population is projected to fall by nearly 40% by 2050 and Japan's elderly dependency ratio will remain the highest in the OECD area through 2050 *(Chart 7)*. The ratio of working-age persons to the elderly will plummet from 2.8 in 2009 to 1.3 in 2050. Reforms to control public social spending, which doubled from 11% of GDP in 1990 to 22% in 2009, should focus on pension and health spending, which together accounted for 9 percentage points of the rise. The OECD has recommended a number of reforms to contain health spending, including promoting the shift of long-term care away from hospitals toward more appropriate institutions, improving the payment system and expanding the use of generic medicines. Pension reform is also urgent, as the share of the population contributing to the mandatory basic pension continues to decline. The best option would be to raise the pension eligibility age, which would reduce the fiscal burden while increasing the labor participation of older persons and improving intergenerational equity. The hike in the pension eligibility age to 65 should be accelerated, followed by further increases achieved by linking it to longevity.

Conclusion

Abenomics has had a positive impact, reflected in stronger confidence and optimism in Japan. The determination of the BOJ to achieve the 2% inflation target is certainly welcome. Much of the positive impact of Abenomics, though, is due to fiscal and monetary stimulus. However, the short-run effect could fade quickly unless accompanied by reforms to address structural issues. The long-run impact of Abenomics depends on an effective growth strategy that includes bold reforms to boost Japan's growth potential. Such a strategy should include reform of the agricultural sector, which would in turn facilitate Japan's integration in the global economy, and labor market reform. Finally, the three arrows should be accompanied by a fourth arrow of fiscal consolidation to stabilize, and eventually reduce, the high ratio of public debt to GDP. The first step is a detailed and credible medium-term fiscal plan, including tax hikes and measures to reduce spending growth, to achieve fiscal sustainability. JS

Dr. Randall S. Jones is head of the Japan/Korea Desk at the OECD, where he has written 12 OECD Economic Surveys of Japan, as well as 13 of South Korea.