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# ABENOMICS AND ITS IMPACT ON THE ASIAN ECONOMY

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P R O C E E D I N G S

MS. SOLIS: Good morning, everyone. I'm Mireya Solis, senior fellow and holder of the Knight Chair in Japan Studies here at Brookings, and I want to welcome you here this morning to this event on "Abenomics and Its impact on the Asian Economy." And I would like to say that this is a very timely event. The government of Japan released a new version of the growth strategy just last week, and I think there is a clear understanding that is a growth strategy, the third arrow, the structural reform, which is really the critical component that will actually determine whether this economic revitalization strategy succeeds or not.

And I think it's also fair to say that last year when the Japanese government released the first version, just exactly one year ago in June, there was a lot of skepticism as to whether the government could really undertake this broad range of structural reforms and really confront so many vested interests.

So I think the question that we have upon us today is to really examine what has been put on the table in the second version -- can the government of Japan now offer an attractive program for undertaking this economic revitalization reforms? And I think it's also a unique event in the sense that we're going to be hearing today about something that usually does not come up in the discussion, and that is how will Abenomics affect the Asian economy given that Japan plays such a central role in this region through the global supply chains, through investment, through economic assistance, through financial flows, clearly how Japan performs economically will also affect these Asian economies.

And I think we have a wonderful speaker to address these two issues. We have Dr. Naoyuki Yoshino. He actually has been a very influential advisor to the

Japanese government. He contributed to these revisions to the second growth strategy, and because he is now the dean of the Asian Development Bank Institute, he's also clearly aware of how Japan plays a very important role in the Asian economy and he will share his insights with us on those issues.

I should also mention that Professor Yoshino is also professor emeritus at Keio University and he has had a very distinguished academic career with appointments both in Japanese and American universities, and he has played a key role in influential government committees. For example, he served as chairperson of the Ministry of Finance's Council on Foreign Exchange and Fiscal System Council.

Now, I also want to introduce our discussant for this morning, a very distinguished economist, Dr. Eswar Prasad, who now holds the New Century Chair in International Economics at Brookings, and he is also the Tolani senior professor of Trade Policy at Cornell University. And just to give you a sense of the range and impact of Dr. Prasad's career, I should mention that in the past he was also head of the IMF's China Division.

So we have really an excellent lineup this morning for you, a very timely and unique topic, Abenomics and its impact on the Asian economy. And I would like to ask Dr. Yoshino to please come to the podium and start his presentation. Thank you.

MR. YOSHINO: Good morning. I was just introduced. I arrived this morning to Washington Dulles Airport and I hope I can wake up.

Today, I would like to talk about Abenomics and what is going on and what are the remaining factors we have to solve in Japan, and whether the economic recovery will continue or not. Those are the main issues I would like to discuss today.

Many people know there are three arrows of Abenomics. The first one is aggressive monetary policy, and this set up the target of 2 percent of inflation, and that is very different from previous monetary policy. And I know former Governor Mr. Shirakawa very well, and I know Mr. Kuroda, too. The two governors are very different in their character. Former Governor Shirakawa is just like an academic economic, so in the press conference when he's asked about questions, he always talks about the good scenario and bad scenario, but Mr. Kuroda only talks about the good scenario. So that influences a lot for media people, and Mr. Kuroda does not follow any bad scenarios.

And the first one is monetary policy and setting up the 2 percent of inflation, this is the first time. However, the inflation targeting sometimes creates problems in the Japanese economy. It happened in the late 1980s. The rate of inflation of Japan was almost zero percent in the late 1980s because our Japanese yen had appreciated a lot since 1985. And Central Bank of Japan was also looking at CPI or inflation rate and they thought Japanese monetary policy is all right because inflation was very stable in the late 1980s. However, stock price and land price climbed up. So, personally speaking, inflation targeting is one of the variables the Central Bank should watch. However, the Japanese exchange rate fluctuation significantly affected inflation of Japan. That has to be taken into account.

The second arrow is fiscal consolidation. Many people know Japan has the highest debt to GDP ratio in the world, and we have to consolidate this fiscal budget deficits.

The third one is growth strategy. Many people think the first arrow is very easy to stop. However, the second, and especially the third arrow takes time. So many criticism comes to the third arrow is very slow. Yes, of course, because the third arrow includes structural changes of the Japanese economy.

And since Prime Minister Abe came into power, this is the business conditions index captured by a survey of major companies. You'll see the trend is recovering very quickly. In one sense, Prime Minister Abe was very lucky when he came into the office. The Japanese yen started to be depreciated when he came into power. That was not necessarily by his policy but he was very lucky. The reason for Japanese depreciation since last year came from Europe and the United States. Up until last year, Europe had some uncertainty about their fiscal policy, especially Greece, Italy and Spain. Then last fall, the E.U. stepped in to consolidate the fiscal turmoil. And the U.S. economy was also uncertain until last year, and many countries, the E.U. and U.S., introduced quantitative easing policy, QE policy.

So lots of liquidities are floating around in the world. And they are looking for the place to invest and there are only four international currencies -- the U.S. dollar, euro, British pound, and Japanese yen. (Inaudible) looking for the place to invest. The European economy was uncertain, the U.S. economy was a little bit uncertain, and the British economy was the same, so the yen was the only currency those quantitative easing were looking for.

If China would open their exchange rate and capital, then much more money would have going to renminbi Chinese currency. Then the Chinese exchange rate would have appreciated. But China is still controlling its capital, so all the money came into Japan up until last year. And when Prime Minister Abe came into power, the first arrow was announced. That means the Japanese Central Bank will keep low interest rate policy until the 2 percent inflation target will be achieved. So that has shifted the interest of Japan from overseas, and European uncertainty has been settled down and the U.S. economy started to graduate to recover. So all the money which came into

Japan started to go back to their own territory, and that has depreciated the Japanese yen.

Inflation targeting of 2 percent was the first time the Central Bank set it up and announced. This has created a huge forward-looking policy; so many companies are looking for the monetary policy will continue to be eased until 2 percent will be achieved. So they are very much confident quantitative easing, QE policy, will last for a while. And expectations of the general public had been drastically changed. The yen started to depreciate, and that has created a good impact for export-oriented industries.

However, we have another difficulty for yen depreciation. After the tsunami and Fukushima nuclear accident, Japan has to rely on a huge amount of energy on oil and natural gas. The price of those natural gas and oil started to go up because Japan's yen had been depreciated. So that is pushing up the costs for the manufacturing industries and also households. So depreciation of yen looks good for export-oriented sectors. However, the oil prices are rising steady. And when the Japanese yen has started to depreciate, many overseas investors started to invest into Japan, especially for the stock market. The engine of the growth of stock price came from overseas investors first, and that has created a very good recovery of stock prices.

And at the same time, the Japanese government introduced number six, Nippon Individual Savings Account, which deducts the interest and dividends for individual investors up to a million yen for five years. That also has encouraged Japanese individuals to come into the stock market.

And in the past 20 years, Japan suffered an economic recession. And one of the causes I think came from international rule, especially Basel capital requirement. Basel I, which was established in 1988, was set up 8 percent of the capital for all the financial institutions who are internationally operating, and there is no discretion for country by country because in those days, international rule was set up identical to all the countries. However, my estimates show that is wrong. Basel capital requirement should be different from country to country; that is one. Secondly, whether a country is facing a recession or (inaudible), the capital requirement rule should be different. And this is my estimates for Japan. Optimal capital requirement rule should have been 8 percent minus 2.2 percent. So in Japanese case, 5.8 percent should have been the optimal Basel capital requirement ratio rather than 8 percent. And this high capital requirement ratio discouraged Japanese banks to lend money. That is called credit crunch in Japan.

A similar thing can be seen for the U.S. When the U.S. economy was in the boom and peak, the capital requirement ratio should have been 8 plus 4.42 percent. So when the economy is boom, the capital requirement should be increased, and in recession it should be lowered. Canadian banks are very much oligopolized so their capital requirement ratio is almost okay, all right, about 8 percent. But international rules should have been much more rigorous and in this Basel III, adopted part of my recommendation for countercyclical buffer for their new rule.

Next, I'd like to talk about monetary policy. Many American economists and overseas economists, including Paul Krugman, were talking about Japan as in a liquidity trap. And many people are focusing on monetary policy. However, Japanese's biggest problem comes from the aging population, and monetary policy cannot do anything about the aging population. So in the past 20 years, many economists are focusing on monetary policy as if it can deal with the aging population. But we now realize it was not, so we need structural reform.

And another weak point of Japan is we lack global managers. Many financial institutions have an asset management section. However, close to 90 percent of them are focusing on the Japanese market, Japanese financial market, stocks and bonds, and probably less than 10 percent of Japanese financial institutions are focusing on overseas asset allocation.

In order to do good overseas investment, probably there are six or seven points asset managers have to focus on. The first one is political situation of each region and monetary policy of various countries and liquidity of bank loans and so on. And asset managers have to see the entire world from the top rather than looking at it from Japan. Many asset managers of Japanese are looking at other countries from Japan rather than looking at from the top of the globe. Then their way of thinking is very different.

And this one is number five. First, asset management should focus on which region they should invest, then which country and which sector and which company. Those are the process how good asset management should be performed. But many Japanese asset managers starting from the company, and rather than looking at it from the global aspect. And also, many good asset managers overseas visit those countries by themselves to see the fluctuations of the economy. And they have to know the people of whom they should ask questions.

And this is a little technical, but monetary policy comes from this LM curve. And Professor Paul Krugman and many famous American economists are talking about Japanese monetary policy -- the Japanese economy was a liquidity trap, and they are talking about horizontal LM curve. But my observation of the Japanese economy is not coming from the money market LM curve; it comes from IS curve. I'm talking about a vertical IS curve. Vertical IS curve means even if the interest rate becomes low, companies do not invest. That was a Japanese symptom in the past 20 years. Japanese companies kept on investing overseas, not in Japan, but in other Asian countries. So even if interest rates were lowered, those companies do not invest within Japan. So the IS curve became vertical, and investment has shifted from Japan to other Asian countries, so this IS curve shifted to the left. And monetary policy has been eased, so LM curve shifts to the right. So the result is from point A to point B. Lower interest rate and lower real GDP. So I think the Japanese problem was coming from investment and IS curve, rather than monetary policy and liquidity trap.

This question was asked at the final examination of Macroeconomics at the University of Hong Kong about six years ago. All of a sudden, I received many emails from Hong Kong. I wondered why I was asked so many questions. Then, one professor read my paper and they put the questions whether the IS curve vertical or LM curve or liquidity trap is a Japanese problem. So many students asked me, so I said I'm correct and the other professors are wrong. That was my answer.

Then Prime Minister Abe, again, there are three arrows, monetary policy, targeting inflation for 2 percent, and the exchange rate has been very much affected by external factors, the U.S. economy, and the euro. That's why Japan's yen has been appreciating and started to depreciate again. And fiscal consolidation, currently Prime Minister Abe is talking about increase of tax rate -- consumption tax rate, T. But he should talk about government spending and tax revenue all together simultaneously. That is missing presently by Prime Minister Abe. The Japanese social welfare and pension system is close to Europe. Sweden RET, 28 percent. I think Germany, 19 percent. Japanese RET is 5 percent, which was just raised to 8 percent. So even if

Japan prefers lower RET, then government spending should have been lowered. And if we prefer the European style social welfare, then tax has to be increased. So Prime Minister Abe should talk to the general public. The Japanese have to think about government spending and tax revenue as a simultaneous equation, rather than either G or either T.

And growth strategy, there are four growth strategies so far. One is deduction of covered tax rate. If my explanation of vertical IS curve is correct, the deduction of a corporate tax rate will not encourage investment in Japan because even if the cost of capital becomes lower, Japanese companies do not invest. However, the reduction of corporate tax will encourage 40 companies to come into Japan, and that will accelerate competition within the Japanese market. So I think the reduction of corporate tax rate will not encourage Japanese investment. However, the overseas investors become very easy to come into Japan and that can enhance competition within Japan.

We are faced with an aging population, so female participation in the labor force is very important; especially child care will be a very important issue.

And number four is how to utilize old people. And I was joking to Prime Minster Abe that there are robots -- so many robots produced, so that could substitute the masters of old people. And he also talked about number four last week. So development in robots can compensate for their own participation into the labor market.

Next, I'd like to talk about asset allocation of households. There are three charts here. The left-hand side is the United States, the middle is Japan, right-hand side is Germany. The red portion is a share of deposits, and pink portion is insurance and pensions. And the black one is the bond market. And on the left-hand side is the stock market. So the U.S. is very well balanced -- deposits, insurance pensions, and bonds and stocks.  This picture made the U.S. recovery is much quicker compared to Japan.  Japan and the U.S. accumulated nonperforming loans by banks.  You can see in the middle Japan's banking share is 60 percent.  So they have carried so much nonperforming loans for so long.  But on the left-hand side, the share of the U.S. banking sector is very small.

Furthermore, U.S. banks sold those loan assets by securitization to overseas, so their share of the nonperforming loans became much smaller compared to the Japanese case.  And that made the U.S. economy much, much quicker to recover and Japan stayed very long by keeping those nonperforming loans at the bank.  And Japan now is trying to shift these deposit-oriented asset allocations into at least to Germany.  Germany is in-between Japan and the United States.

Financial assets in Japan are mainly accumulated by old-aged people. Deposits, insurance, securities, and other assets.  Those who are over 70 years or 60 years have a huge amount of deposits, insurance, and securities, and they are mainly interested in (inaudible) guarantee, and whether it is very easy to make deposits to withdraw money. So those are the main reasons many people choose financial institutions.  If you look at the bottom rate of return, it's very small.  Probably many westerners are interested in the rate of return, but Japanese people are interested in principal guarantee.  So that means they want to just keep on making their banking deposits.

Because of this bad asset management, Japan's dividend interest received divided by income is the lowest among OECD countries.  One is it is mainly focused on deposits.  Second, the asset management to overseas are not doing very well by Japanese asset managers.  So our rate of return is the lowest.  So that is affecting negatively to Asian society because people in old age have accumulated their financial assets. However, the rate of return is very small so they cannot consume so much. So we have to increase the rate of return in order to face with the aging population because aged people have less income. They have to use it as their accumulated assets.

And these are the population aging of Japan. The top part is the age over 65. The middle part is the working population. The bottom is number of children. You can see on the top over 65 is increasing drastically, currently about one-third are over 65. And the working population is becoming smaller and smaller. So GDP divided by per capita in Japan has diminished drastically. However, GDP divided by working population was not so bad.

So the last part of Japan is the retired people who are over 65 years of age, and that contributed a very low per capita GDP of Japan in these 20 years. So we have to make all these old people work much longer, and the wage rate has to be based on productivity rather than seniority wage system. And probably that can solve some of the problems Japan is facing now.

The next topic is Japan's debt-to-GDP ratio and government debt. Japan has accumulated the highest debt-to-GDP ratio. Japan is at the top, and the second one is Greece. Greece went into bankruptcy. So the other one is Italy. I hope there are no Italians, but Italy may be close to somewhere shaky, and Portuguese and (inaudible). And why has Japan sustained so well despite these very high debt-to-GDP ratios?

Japan's debts are mainly headed by domestic investors, only 8 percent ahead of overseas investors. On the other hand, Greece -- domestic investors, only 23 percent, and about 80 percent of their -- 78 percent are headed by overseas investors. So that creates a big difference between Japan and other countries. Most of the debt are held by domestic investors.

If I use a diagram again, the vertical axis is the issuance of government bonds.  The upward sloping curve is demand for government bonds.  And in Japanese case, demand for government bonds are kept on increase, so that means vertical axis is the interest rate.  The interest rate kept on falling down.  And this is the interstate of the Japanese economy.  So it is falling down.

On the other hand, Greece, 77 percent of their owners of government debt are overseas investors.  So overseas investors, if they're faced with crisis, then risk premium would be asked, and many of them start to fly away from Greece market, so the demand curve shifts to the left.  Then you can see the interest rate will climb up, and this is the Greece, Portuguese, and European countries.  So the Japanese (inaudible) comes from -- the demand is coming from domestic investors, and domestic investors prefer to buy government bonds.

And I think that many Japanese financial institutions, including pension funds, hold government bonds.  That has stabilized the Japanese government bond market.  And one of the reasons is lack of long-term asset management, number one, in Japan.  Many pension managers, asset managers, rotate once every two to three years, and lack of corporate bond market, many investors are investing into the government bonds market.  And our pension funds are not the 401(k) type, so all the money has been let the government asset management companies decide rather than individual decision. Once Japan introduces identification numbers for individuals, it will be possible to introduce a 401(k)-style pension system because the government can ask all the individuals their preference of safe assets and risky assets.  That will make asset managers much easier to invest into a risky financial market.  So I think the shift from the current pension system to a 401(k) system, introducing identification numbers for individuals is really important. Then that will create self-responsibility of asset management by individuals.

The Japanese compensation and bonus system also contribute to hold lots of government bonds. If some asset managers did very well, but their bonuses are very small. But if some asset manager made a big mistake compared to others, then he will be criticized strongly, so there is a symmetry between good (inaudible) and bad (inaudible).

Many people want to avoid risks, number three, and they are looking for a benchmark. And they are only looking for -- always looking for what other asset managers are doing. On the other hand, the U.S. is a (inaudible), so I think Japan should introduce somewhat (inaudible) based. That could create a better incentive for asset managers to diversify their assets. And because of these reasons, Japanese demand for government bonds kept on increasing, and that stabilized the Japanese bond market.

Lastly, I would like to talk about two issues. One is how to provide risk capital, risk money to many new sectors. I call it hometown investment trust funds. In Japanese, it is called (speaking in Japanese). And it was introduced about 10 years ago, and they started to invest in solar power, wind power, and many other small businesses and start-up companies. The method has especially grown after Fukushima and tsunami accident. After the tsunami, many fishermen lost their boat left on site. They already borrowed money from bans, so banks could not lend money to repair their boat. And these fishermen started to collect money by hometown investment trust funds, so they have repaired their boat and started to catch fish and returning that money to their investors. And similar hometown investment funds are wind power and solar power, and many individuals want to change their nuclear power into environment-friendly energy, and lots of (inaudible) money is coming into wind power and solar power.

Another interest is the agricultural sector looks very traditional. However, last year, the Minister of Agriculture introduced leasing system of agriculture land. Many Japanese farmers are close to retirement, 60-65, but they want to own their land, piece of land, as their own. But the leasing system allows them to lend that land to the young generation. It started last year and many (inaudible) started to cultivate their agriculture land, and some of them started beans. Some of the others started Japanese wine. And in order to create these new agricultural products, they needed some amount of money, and banks are very reluctant to lend money to them because it's very risky. So hometown investment trust funds are contributing their new cultivation. And this is another small business borrowing. Left-hand side, fish shark fin; right-hand side is a seaweed company. They also raised this money through hometown investment trust funds.

And the last one is SME, small- and medium-sized enterprises. In Asia, it is dominated by SME, and there is information that symmetry between large companies and SMEs. The top figure is large company. The bottom one is SME. If this line is above zero, they are relatively easy to borrow money. If they are below zero, they are difficult to borrow money. So you can see small businesses are almost always very difficult to raise their money from banks or capital markets, but large companies are not. Large companies are only accepting this period of Asian financial crisis and (inaudible) crisis. But other times they are relatively easy, but small businesses are always difficult to borrow money. The reason comes from information asymmetry between SMEs and lenders of financial institutions.

So Japan has studied to correct the SME database through credit guarantee cooperation, and we have accumulated 14.4 million data, and every day it is increasing. Then it is a surprise, we can start to look at economic models, and it is possible to predict the default risks of various sectors in SME. So correcting a database of SME will make them to reduce their information asymmetry. And I'm now trying to do a similar method to Thailand. I have a seminar next week, Thailand, and then Indonesia in August and we want to create this kind of SME database in order to make them much easier to borrow money. And this method will also encourage SMEs to do new businesses, and that will hopefully contribute to the growth of the Japanese economy.

Because time is up, I would like to stop here. Thank you very much.

(Applause)

MS. SOLIS: Thank you very much, Dean Yoshino, for a really interesting and comprehensive presentation.

So now we'd like to ask Dr. Prasad to please share with us his reactions and responses to Dr. Yoshino's presentation.

MR. PRASAD: Thank you, Mireya. Good morning.

That was a very enlightening presentation, so I would like to structure my remarks in three or four dimensions. One, is trying to think about the combination of policies under Abenomics, what was promised and what has been delivered so far and what has been intended by the Abe government to deliver. Second is the timing. Is it too late? As we know, the Japanese Lost Decade some have argued was the result of monetary policy that was constantly behind the curve, so where do things stand this time? And third, trying to think a little bit about whether it is too little or, as some have argued, too much trying to do too many things on the structural front at the same time.

And then fourth, I'll talk a little bit about the implications for the world economy and particularly the Asian region where, of course, the Japanese economy, although having been overtaken in size by the Chinese economy, still remains very crucial to the region in terms of capital flows, in terms of trade flows, and so forth.

So let's start with the combination of policies. Now, what was promised by Abenomics, of course, was a very ambitious set of policies, and I think there was a clear recognition that Japan had reached a stage in its growth where you could not work with just one set of policies. No, the reality is that macro policies, such as monetary policy and fiscal policy are a lot easier to put into train than structural policies which invariably require a lot of political capital. But in Japan's case, of course, even fiscal policy is somewhat hamstrung by the very high levels of debt that Professor Yoshino talked about. So ultimately, it came down to monetary policy.

Now, this is where things get interesting because, of course, it's not just Japan but a very large group of economies, both advanced economies, including the U.S., the Eurozone, and so forth, and a lot of emerging market economies, including my own India, where central banks have basically taken on the entire burden of supporting growth, maintaining inflation, either getting back up to a target range or bringing it back down to a target range, and trying to maintain financial stability.

Now, a central banker, as we have learned, can credibly say, "I will do whatever it takes," and the market seems to believe it. It's much more difficult for a politician to say I will do whatever it takes because there is a very large political price to be paid. But what Mr. Abe was trying to convince us was that if Mr. Kuroda could go in front of the public and say, "I will do whatever it takes conditional on everything else being done the right way," then perhaps Mr. Abe's statement would have much more validity and credibility.

The problem here, of course, was the sequencing got a little out of whack because we had monetary policy I think relatively forcefully early on, fiscal policy being somewhat hamstrung, again, for the reasons Professor Yoshino already mentioned, and then structural policies lagging.

So this comes to the entire issue of timing, whether in fact there is enough ammunition that Mr. Abe has in his cannons or in his quivers to be able to make structural policies effective at this stage. And the second issue, which this ties into, of course, is whether Mr. Abe is trying to do too much at the same time. Now, what I think Mr. Abe may have been using as a strategy is essentially to push things to a point where it was obvious that monetary policy had reached its limits. Despite all of the BOJ has done and has promised to do, Japan is only halfway towards its inflation target of 2 percent with inflation running at about 1 percent at an annualized rate right now.

Now, one might argue that this has already had particular effects, because if you look at the growth of the Japanese economy relative to many other advanced economies, Japan hasn't been doing too badly. In fact, there were a couple of quarters that Japan, among the major advanced economies, had by far the greatest rate of growth at an annualized rate. But I think there is a clear recognition that this is not the sort of stable balanced growth that will be enough to put Japan back on a trajectory towards sustained growth?

So in that sense, the structural policies, I think the time has come, and what Mr. Abe seems to have promised is exactly the right sort of things that need to be done -- dealing with the labor market, dealing with financial markets, dealing with corporate governance issues. And of course, the laundry list is very well known.

Now, I think the big question that remains on the floor is whether Mr. Abe will really do whatever it takes, because clearly when it comes to issues like labor market reform, in terms of changing labor force participation by females, in terms of freeing up some of the (inaudible) in the labor market, it's going to extract a pretty large political toll domestically. And one might argue that Mr. Abe early on in his term might have had more of a clear mandate to push forward, but perhaps a different strategy is to say that the Japanese economy is really not going to get going and there is a much broader understanding now of what needs to be done. So perhaps it made sense to wait. I am a little concerned that in a sense, although a lot has been promised, it is coming a little late, but we'll have to wait and see whether, in fact, Mr. Abe puts his political muscle behind this.

Now, one reality that Japan faces, of course, is that if this entire package doesn't have credibility, it's going to be very difficult to deal with the problems and aggregate demand that Mr. Yoshino referred to with this IS curve, because arguably, if firms don't have the confidence to invest, if consumers don't have the confidence to go out and consume, it's going to be very difficult to have a demand-led recovery in Japan. And again, the reality is with the yen sticking around at about 101 or 102 to the dollar, it's going to be very difficult to generate an export-led recovery, and Japan still is an economy that very much likes exports.

And this is where the external environment becomes very complicated, because Japan still needs sports as a viable engine of growth because it's hard to imagine, especially given all the constraints of a supply side which are going to take a while to get over, and also the constraints of the demand side, the lack of confidence that this economy can really get going without a somewhat weaker yen. And the question is whether the Japanese yen has reached a point where despite more actions by the BOJ, it isn't going to move much further.

And this is where regional dynamics become very important, and I think going around the Asian region, what I've heard increasingly is the sense that in many Asian economies there is a big concern right now that the global governance mechanisms are not working very well. What we've learned from the global financial crisis and the volatility in capital flows as a result of the U.S. announcement of its QE tapering and then the flows that went back into Asia after the pullback of flows after the taper announcement, it's led to a large increase in capital flow volatility. And emerging markets in the region feel that they need a lot more protection. They don't feel that they can trust the IMF still because, again, the IMF governance forms a block and what they face is a very complicated situation where despite the QE tapering and the U.S. money is beginning to flow back in from the U.S., and this has been the case for the last four or five months, even to formally vulnerable economies, like India and Indonesia, the European Central Bank has indicated that it is going to move forward with quantitative easing and many ECB members have made it abundantly clear that they want a weaker euro. China has made it very clear that it is not going to allow very large currency appreciation. Japan wants a weaker yen. So what does all of this mean? You're going to have a lot more capital flowing into Asian emerging market economies which in turn are going to recycle that capital because they don't want their currencies appreciating and they want more safety, so there is going to be a search for safe havens. And despite all the problems in Japan, Japan is still regarded as a safe haven, especially by economies that don't want to entirely rely on the U.S. dollar as a safe haven currency. And the problem in Japan, of course, is that despite the very large amount of debt, you have relatively thin liquidity in the JGB market because as Professor Yoshino pointed out, much of the JGBs that are outstanding are held by institutional investors, by domestic investors who actually don't trade a lot, and to a very limited extent, by foreign investors.

So relatively small amounts of money flowing into Japan can have fairly large effects at the margin in terms of what happens in the JGB market and in terms of the currency. So what I suspect is going to happen is that if the BOJ moves very aggressively with further monetary easing, that is going to push more capital out into the Asian region, which in turn is going to recycle back into Japan, thereby offsetting some of the attempts of the BOJ.

And I think this is why structural reform has become really important, because I think both for the reason that Japan may be in something of a liquidity trap; second, ultimately, monetary policy cannot deal with supply side constraints; and third, there is going to be a recycling of capital from the Asian emerging market economies back in Japan that I don't see a way out of forceful structural policies. So this is a very interesting juncture for Japan at one level. There was a realization that unless Japan put in place forceful structural policies, the economy wasn't going to get moving. And finally, we seem to be seeing the third quiver, the third arrow from the quiver being released, but how much force it is going to be unleased with, how much there is going to be pressure behind the arrow if there is pushback from the other side, remains to be seen. So as with much else, I'm cautiously optimistic but still somewhat worried.

MS. SOLIS: Thank you so much, Eswar. That was terrific.

And before I ask Dean Yoshino to briefly reply to these comments, I wanted to add just a few observations on three points. One is, of course, what ails the Japanese economy and what's the best approach to solve these problems? Second, what should be the best approach, the underlying philosophy, if you will, to economic reform? And third, Japan's role in the Asian economy.

And my comments very much echo what Eswar was saying. I think I really found it fascinating that you offered here a very novel interpretation about what is a root problem of Japan's economy and that you offered, you know, these vertical IS as the central issue to be addressed. And if that is the case, I think it very interesting that in the latest growth strategy that was just released last month, most attention really focused on the reduction on the corporate tax rate, and I think, Dean Yoshino, you told us that today, you told us that that is not going to address the issue of Japanese companies investing more in Japan. It will attract foreign direct investment but it will not get Japanese companies to invest more.

So I would like to ask if you see other elements of the growth strategy that could help entice Japanese companies to invest more, and if it's not there, what do you suggest we put on the table in the short or medium term to encourage this positive cycle of investment by Japanese corporations?

My second point has to do with what should be the overriding philosophy or approach to economic reform? I think it's clear that there is no appetite whatsoever in Japan for shock therapy, but actually it's gradualism. And of course, it's very ambitious because as you mentioned, the Japanese government is trying to really tackle so many areas. If you look at the areas of reform, it's really mind-blowing. It's healthcare, it's agriculture, it's the labor market, it's integration in the world economy, and so forth. But the idea is that you have to move gradually because these are structural reforms that also require legislative action, and therefore, they cannot be changed overnight.

And to me, these, Dean Yoshino, offers a question I, myself, have no answers to, but I would like to pose it to you and see what you make of this in the sense that many people, when they look at this gradualist approach, they only see policy capture and they tend to make the argument that vested interests have captured the process and it's not going to go far enough. Other people tell us, no, actually, this is just one step out of many and there is a real end goal in mind and we just have to be patient because we'll get there.

And so to me this brings a question as to what is really the tipping point? When will be reach this cumulative effect that will really trigger this positive cycle of productivity enhancing forceful structural reforms to be implemented? I, quite frankly, don't have an idea when I get asked this question as to what will be the turning point, the tipping point when we can say Japan has crossed that milestone and we're really now in the path to productivity-enhancing growth sustaining economic reforms. I wonder if you have any thoughts on that, knowing that, of course, it's a very difficult question to answer.

And the last one, I think that Eswar did a terrific job highlighting the regional dynamics and all these questions about excess capital looking for safe havens and perhaps how this actually then could put pressure on the Japanese yen to appreciate. I had a much more mundane, if you will, question about regional dynamics and it has to do with when you wear your cap as dean of Asian Development Bank Institute and you travel the region frequently and very broadly, what are Asian perspectives about Abenomics? Are they more optimistic perhaps than what we hear in the United States? Do they focus on different aspects than perhaps what the discussion is here in the United States or in Europe? What is the perception about where Japan is heading and how can Japan contribute to Asia's development?

So five minutes to all of that, please.

MR. YOSHINO: Yes. I wish I had 50 minutes.

As far as Abenomics are concerned by Asian people, there are two views. If it grows gradually, then many people are hoping the Japanese economy will recover by shifting (inaudible) band upward. So you know that to do so, corporations have to start to invest more within Japan. And mainly that may be forecasting on old people, elderly people, because their generation is changing from younger to older. And many corporations in Japan were forecasting on young people in the past, but if old people keep on working and they have their own income together with their pension payments, then they will start definitely for concern, and that will become a huge market for Japan.

As far as GDP, aggregate supply and growth strategy is concerned, there are three components for GDP. One is R&D TFP part and labor and capital. And labor, if old people start to participate in the labor market, and if the female participation comes much more, than the labor market will become much more active. And technological progress, as I mentioned about hometown investment trust funds (inaudible) will come into the market, and there is a potential for boost to R&D.

About female participation in the labor market, I would like to give two interesting examples. (Inaudible) economics, they made job openings, and it says this position is available only for women, no men. So that is a surprise for my graduate student. He is a boy. He was very angry. Why is it just for females? And financial services agents (FSA), which is a government financial regulation, this year 50 percent of their new hires were female. So I think in many companies they are stressing female participation into the labor market.

The next step is childcare, would be very important for females. And if those systems will be introduced, currently childcare costs a lot, but if we can introduce a much easier way then probably that will help, because there are many old, good ladies who also take care of their grandchildren. But currently there are so many restrictions for those people to open their private nurse care. So I think that should be open much more.

And structural reform, I think the labor market will become much more competitive once old people start to work and females come into (inaudible). And how about export-oriented growth? I think I'm hoping the older generation can contribute some part of the consumption, and the new investment will also come to take care of old people because Japan is facing an aging population. China will become an aging population. Europe will follow. So if Japan can develop very good technological progress in those areas, I think Japan can regain exports to those countries.

As far as Asian countries are concerned, I think China's exchange rate should be much more flexible and capital control should be gradually (inaudible). As you said, the Japanese yen is a safe haven. If the Chinese capital markets will open, the Chinese renminbi will be a much bigger safe haven for other countries. In my dynamic economic model for China, it's currently the Chinese exchange rate to U.S. dollar is about 0.85 rate. It used to be 1.00. The optimal value for Chinese renminbi to U.S. dollar is 0.58. That is the optimal basket rate. And they should take three to four years to achieve those optimal basket. Then the Asian capital market and the exchange rate market will drastically be changed and capital inflow and outflow for various countries will become enhanced.

I'm very much concerned about the QE policy, quantitative easing. In 1997-1998, Asia was hit by the financial crisis. That came from quantitative easing of advanced nations. So I think quantitative easing is mainly forecast on their own countries by advanced countries, but there are lots of side effects. So if quantitative easing lasts a little bit longer, then that will change the oil prices, the commodity prices, and also the capital inflow into the Asian region.

And my student, Farhad and I did empirical work about oil prices and commodity prices. They are definitely affected by quantitative easing policy of advanced nations.

I think -- I hope I answered almost all of them. MS. SOLIS: Thank you. Thank you so much. That was wonderful.

Now, I want to open it for questions from the audience, so if you can please wait for the microphone, and identify yourself, and ask a concise question.

I have a gentleman here. Can you reach him?

MR. BILLINGTON: Thank you. I'm Mike Billington. I'm with Executive Intelligence Review.

Your underlying -- one of your underlying themes is that Japan needs to be more like the U.S. and Europe in encouraging higher risk and less of the guaranteed stability. And you seem to be looking at a recovery in the U.S. and stability in Europe, but even the BIS this last week released figures showing that the bubble in the West is now increasing at a greater rate than at any time in history. Derivatives are now increasing at some 20 percent per annum, approaching $2 quadrillion in outstanding derivative debt in the Western Banks. So this is heading for a crash of unprecedented proportions, and I think increasingly people recognize that.

So Japan, you say, recovers more slowly than the West, but it also is more immune to such a crash because it maintains a commitment to long-term stable growth rather than risk. So I would ask you to respond to that, and perhaps also to the fact that the Eurasian countries -- Russia, China, India -- are going fully with infrastructure, big infrastructure, which is completely lacking in the West, and Japan, of course, could be a huge contributor to that, which is an avenue for, I think, the best kind of long-term real growth.

MR. YOSHINO: Thank you very much. Very good question.

I have looked at the bubble and crisis in many countries, especially focusing on Japan, China, and the United States. I created five indicators to watch carefully. The first one is loans to housing and real estate divided by total bank loans. And whenever we are faced with crises, that is drastically increasing in U.S. and Japan. That is one indicator.

The second one is growth rate of bank loans in comparison to growth rate of GDP. If bank loans -- the growth rate of bank loans exceeds GDP growth rate in very high trend, that will cause a crisis.

The third one is housing price divided by income. U.S. and Japan, we observe housing price compared to income suddenly increased, and it came back to the original level. That is the third indicator.

And the fourth indicator is the turnover ratio of stocks. And the turnover ratio of the stock market becomes very high in crisis period.

And the last one is many individuals and sophisticated individuals start to invest in the stock market. That is the end of the crash that was happening in the U.S. and Japan. So I'm looking at all those five indicators. And looking at some indicators are still not in a critical point. So far, quantitative easing is not so much based on these five criteria. But if quantitative easing lasts a little bit longer, it may create -- all these five indicators become very critical territory. And Russia, China, India, the exchange rate, I think I'm very much -- on the infrastructure. The infrastructure is quite required in Asian regions. However, there aren't any good assessment mechanisms whether some kind of growth will be needed or another may not be needed. So I think big research will be required to look at the performers of infrastructure investment.

And the final thing, there are lots of private sectors that started to invest into infrastructure investment in Asia and public-private partnership (PPP) is growing. So I think that can partly contribute to (inaudible) infrastructure and construction. However, we have to look at the efficiency of infrastructure investment.

QUESTIONER: What do you think of China's Asia Investment Banks that they are forming now?

MR. YOSHINO: China's Investment Bank is related to their exchange rate. China has a fixed exchange rate to the U.S. dollar and Europe. So the Central Bank of China keeps on accumulating U.S. dollar, euro, and Japanese yen. So they want to use those accumulated currencies for their development of their investment. So they invest a euro into European countries and Central Asia, and the U.S. dollar to Africa and Asia and so on. So the creation of those infrastructure investment banks comes from their fixed exchange rate, their accumulation of foreign currencies, and they want to use that foreign currency for those investments.

MS. SOLIS: So any more questions from the audience? Yes, Ira Wolf.

MR. WOLF: Ira Wolfe with PhRMA in Tokyo.

I don't understand what -- I mean, I agree with your comment about speed. I don't understand why everyone seems so hung up on the need for fast action in Japan. During the good days of Japan, we saw incredible growth, tremendous growth, miracle after the war, but it was also slow and incremental. Today, I look at the pharmaceutical sector, which is the only thing I know about any more about in Japan, and I see the beginning of significant structural change over the last 18 months. I don't know when the date is. I have the same question you have. I don't know whether we'll see the fruits in three years, five years, seven years, but it's very clear the direction it's going. Friends in the energy sector, about which I know nothing, say the exact same thing, and I'm trying to find others in other sectors who observe that. So what's wrong? So what? As long as that structural change occurs and it occurs in a stable way, which seems to be happening now, and this previous comment about does that also insulate you from the insanity of the rest of the world's macro and micro economic policies. Any comment?

MR. PRASAD: My view about reforms is indeed that trying to undertake too many drastic reforms at the same time, especially in an economy, including one like Japan's, which is very complex and where there are many inefficiencies and rigidities in the system already could lead to unanticipated, possibly not so positive effects. But history is important here, and I think in the case of Japan one does worry a little bit about whether there will be enough political will to carry through these reforms, and that ultimately is what it comes down to because when you speak about things like monetary policy, those are actions you can take fairly quickly and without much political resistance in countries where central banks are independent. But with big structural reforms, there are very powerful (inaudible) as is the case in Japan and in most other countries. And the problem is these reforms do tend to get watered down over time, and my concern is that given that there isn't that much credibility yet that these reforms are going to be put in place, it's important perhaps at least to lay out a long-term plan, which Mr. Abe has done and to provide some good down payments in the short term. So what we've seen over the last week from Prime Minister Abe is certainly what one would want -- a framework, a clear sense of direction in terms of where one wants to go, and a down payment on reforms. Because, again, one doesn't expect change overnight.

But again, going back to the issue of history, in the case of Japanese monetary policy, there seems to be a gentle agreement that more forceful actions by the BOJ might have, if not prevented, at least alleviated Japan from having to go through the last decade. So there was a sense that the financial system problems were not acknowledge sufficiently early. Action wasn't taken sufficiently early. So it is in the context of that history that I make those comments. But I do certainly think the point that a raft of reforms being unveiled overnight is certainly not what one would want or desire.

MR. YOSHINO: I think Japan was always facing problems the first time as a frontrunner. The banking crisis came to Japan first compared to Europe and the United States. In Japan, the Japanese government in the early 1990s tried to inject capital into the banking sector. However, many corporations opposed it. Why do we have to save bankers? And when some company goes into bankruptcy, the government will never support, then why should the government support the banking industry? That was a huge criticism against injection of capital into the banking sector. That delayed the Japanese economy to recover, and also Basel capital requirement of 8 percent identical to all the countries also delayed our Japanese recovery because of the credit crunch. So Japan was in a sense a frontrunner for the (inaudible) crisis.

And at the same time, the Japanese recovery and also the shocks are always mitigated by gradualism. So I think growth strategy will take time, but if Prime Minister Abe's policy could be fully implemented, I think gradually the Japanese economy will come back to the normal rate.

MS. SOLIS: Thank you very much.

Other questions from the audience?

QUESTIONER: Thank you very much. My name is (inaudible). I'm with SAIS at Johns Hopkins. These questions are for Dr. Yoshino.

I was wondering on the subject of collecting data on SME and Southeast Asian countries, are you traveling to Thailand and other countries as a representative of Japan? Is Japan leading the collection of those economic data? And also, will that be done on a country-by-country basis or in the larger ASEAN community which is expecting economic integration by 2015?

MR. YOSHINO: Thank you very much.

Small- and medium-size enterprises are dominating in all of Asia and (inaudible) how to finance SMEs. And as I mentioned, informational symmetry between SME and banks. So I think I'm doing it together with the Japanese government and also ASEAN secretariat and ADB all together. SME is a very big focus of attention in many countries and there are many loan sharks and many finance companies are charging very high interest rates for those SMEs because of lack of information. First, I did it for Japan, and then and Thailand I visited last year and Indonesia, and I'm going to the Philippines and Malaysia and entirely into all Asian nations I would like to try the same and exchange information. Thank you.

MS. SOLIS: I think we have time for one more question. No?

Okay. So I think that's what we have for today. We had a terrific discussion. Thank you, everybody, and please join me in thanking the panelists.

(Applause)

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