# How Should the World View Japan's New Economic Policy Strategy?

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After two 'lost' decades, Japan's economy is again attracting the attention of the rest of the world. The introduction of the package of policies known as 'Abenomics' has so far drastically affected financial markets, with stock prices increasing massively, exchange rates depreciating considerably and bond yields rising abruptly. The ultimate domestic and international effects of Japan's new expansionary monetary policy are ambiguous. However, fixing Japan's long-term problems will ultimately require more daring structural reforms than Abenomics has so far promised. Such a reform agenda could complement and find support in much of the emerging G-20 agenda.

## The Elements of Abenomics

The 'three arrows' of Abenomics are expansionary monetary policy, expansionary fiscal policy and structural reform. The first two arrows form part of a standard stabilization policy over the business cycle and are based on the Keynesian view that government intervention should aim to increase aggregate demand when the economy is operating under potential. There is nothing theoretically new in these two prescriptions.

The third arrow (like Thatcherism or Reaganomics in the past) focuses on the supply side, making deregulation of the economy the key to increasing economic efficiency. This is, like the first two arrows, not a new idea. The need for structural reform has been advocated in Japan and internationally for a long time. The famous Mayekawa Report published in the 1980s identified a number of issues relating to structural reform that are at the heart of Abenomics.

So far, no significant steps have been taken on the structural reform agenda. The global excitement and commentary generated by Abenomics are instead largely due to the impact of Japan's expansionary monetary policy on financial markets. In particular, the BoJ's new policy of 'qualitative and quantitative easing' released in April shocked the global financial market. Its announcement of the policy shift stated:

> "The Bank will achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years. In order to do so, it will enter a new phase of monetary easing both in terms of quantity and quality. It will double the monetary base and the amounts outstanding of Japanese government bonds as well as exchange-traded funds in two years, and more than double the average remaining maturity of Japanese Government Bond purchases."

What the term 'qualitative easing' means is not exactly clear. Regardless, the scale of accommodative monetary policy is huge. Indeed, the BoJ's aggressive quantitative easing seems to have been perceived as a commitment to an accommodative monetary policy stance far into the future. Given that the nominal exchange rate is determined by expectations about the monetary policy stance (not the amount of the base money itself), qualitative and quantitative easing have therefore brought with them a significant depreciation of the yen. The sharp depreciation of the yen will lift Japanese competitiveness and boost GDP, in line with the stated goals of Abenomics.

## Exchange Rate Effects of Expansionary Monetary Policy

There are many questions about the expansionary policies of the first two arrows. Domestically, these questions relate largely to the risks expansionary policy creates for Japan's huge public debt, risks that were illustrated in the recent volatile behavior of the Japanese bond market. Internationally, the more immediate focus is on how the depreciation of the yen will affect economic activity in the region and internationally, and on whether or not the new expansionary policies amount to a competitive devaluation, with deleterious effects on global imbalances.

Exchange rate depreciation boosts domestic output, and there is already some evidence of this happening in Japan. Japan is also the country with the world's largest net foreign asset position. Many of these assets are held in U.S. dollars, so exchange rate depreciation increases the value of foreign assets in terms of yen. This so-called 'valuation channel' effect of exchange rate depreciation[1] increases the income from net foreign asset holdings. Both the output and valuation effects appear to be visible in the data since exchange rate depreciation kicked in, and policy authorities in Japan's partner economies have overwhelmingly welcomed Japanese expansionary policies for the explicit reason that they benefit from lifting Japanese output.

However, increased output from a falling exchange rate won't automatically improve social welfare. For one thing, exchange rate changes lower export prices and increase import prices, adversely affecting the terms of trade. As it is, Japan's terms of trade are on a downward trend with energy import prices on the rise following the Fukushima nuclear disaster. Whether the output gains translate into increased income and social welfare therefore depends on the size of the terms of trade effect relative to the output and valuation effects.

The other important variable that determines whether depreciation leads to an improvement in social welfare is the size of the output gap. If there is a significant output gap, then exchange rate depreciation can lift social welfare. This then begs the question, how large is the output gap in Japan? The answer to this question is a matter of controversy.

In the past decade, Japan's GDP growth rate dropped to just 0.8 percent per year, from around 9.5 percent between 1955 and 1970, and 3.8 percent between 1971 and 1990. Between 1991 and 2010, the growth rate was 1.0 percent. Yet, if the output growth rate per working age person is compared with that of other industrial nations, Japan appears to have the highest growth rate among advanced economies in the 2000s. Is the current low level of output compared to the past due to very low aggregate demand, in which case there is an output gap, or is it due to very low potential output? If the former is the main reason, exchange rate depreciation will be the right prescription, but if the latter is true, structural reform is what is needed to increase output.

## Aging and the Terms of Trade

The fact that Japan is a rapidly aging society plays into the balance of costs and benefits from exchange rate depreciation. On one hand, Japan's total population fell this year to around 127.5 million people, and the labor force has been shrinking since 1995. Current projections suggest that Japan's population will fall to 84 million over the next 50 years, when the workforce will be around 42 million and over 40 percent of the population will be over 65 years old[2] . With a shrinking population and a rising dependency ratio, improvements in productivity and terms of trade become more important to maintaining and improving social welfare.

On the other hand, consumption now seems to have become the driver of economic expansion in Japan. Recently, consumption has been resilient even when net exports have been negative. This is in contrast to the past, when net exports and investment were the main drivers of expansion. In an aging society, consumption is underpinned more by savings than current earnings. Therefore, Japan's aging population reinforces rather than reconciles the divergence between the benefits from a higher return from net foreign assets and the cost of deteriorating terms of trade.

The recent increase in Japanese consumption, especially in durable goods, may, of course, simply reflect inter-temporal substitution in consumption, in response to an anticipated increase in consumption tax (as we saw during 1996 and 1997 before the consumption tax was first put in place). If this is true, the scope for further depreciation would be greater, as it could take up the slack from the decrease in aggregate demand as consumption recedes.

Export-led economic expansion, combined with net accumulation of foreign assets, a model that distinguished East Asian growth, is no longer a viable growth strategy in the face of aging populations. Regional policymakers will therefore be watching closely to gauge Japan's success in striking a balance between the competing terms of trade effect, which lowers incomes, and the valuation effect, which increases wealth measured in yen. In the short-term, however, Japan's expansionary monetary policy will likely also have implications for regional and global imbalances, and it is this aspect that has perhaps received more attention from regional policymakers.

## Implications for Regional Trade

It is significant that policymakers in the region appear to value restoration of growth in the Japanese economy over worries about the damage that yen depreciation might inflict on the trade prospects of their economies. This is partly due to implicit judgments they are making about the nature of Japan's problems and the existence of a significant output gap in the Japanese economy. However, it is also due to a view of the direct trade effects of the depreciation of the yen on their economies that is shaped by the complex nature of regional integration.

Asian economies remain competitors with Japan in a range of product lines, such as in the automobile and electronics industries, for example. However, the dense web of production networks in Asia[3] and the close integration among Japan and the other Asian economies, including China, means that the depreciation of the yen is not unambiguously bad for Asia's trade prospects, especially those of China.

Between 40 and 50 percent of Japanese manufacturing output is now produced outside Japan, with much of it in Asia. In those sectors where Japan is largely a competitor with its neighbours, depreciation will likely substitute net export growth or trade surpluses in Japan for net exports in the rest of the region. However, in those areas where Japanese and regional producers are complementary, depreciation would tend to lift Asian net exports (surpluses) more broadly and reverse the trend of reduced Asian imbalances vis-a-vis the rest of the world. It is these effects, and the expectation of some positive spillovers for Japan's regional trading partners, that are also behind the reactions of regional policymakers.

Whether or not Japanese quantitative easing reignites the East Asian imbalances issue will depend on how Japanese consumption responds to the stimulus and the relative price effects analysed above. G-20 central bankers appear to have coordinated monetary policy reasonably successfully through the crisis, led by the U.S. Federal Reserve Board's policy of quantitative easing and its contribution to the reduction in global imbalances. If the Japanese authorities have got it right and there is no tension between domestic objectives and external balances, all will be well, but Japan will certainly be a more active object of interest in the global dialogue on international policy coordination in the immediate future.

## The `Third Arrow' and the G-20

Ultimately, expansionary monetary and fiscal policy can only go so far, especially if the output gap in Japan turns out to be relatively small. Addressing the problems created by an aging and shrinking workforce and population will only be done by increasing potential output and improving efficiency and productivity. These in turn will not be won without the important structural reforms that are supposed to make up the 'third arrow' of Abenomics. Sadly, there has so far been little detail on a commitment to reform, apart from signing up to the negotiation of the Trans-Pacific Partnership, the uncertain outcome of which is, with the exception of its symbolism, peripheral to Japan's main economic reform agenda.

Many of the reforms that would deliver higher economic potential in Japan are purely domestic. These have to do with fixing the public and service sectors that relate to managing an aging society through social benefits, the health sector, the pension system, the tax system and immigration policy. With Japan's upper house election out of the way this month, the Japanese government can start to outline how it proposes to tackle these challenges and push ahead with the legislated consumption tax hike that at least addresses the long-term fiscal problem.

There is also, however, an important international dimension to the structural reforms that Japan needs. This dimension relates to how Japanese firms, especially those in the service sector, become more integrated into the global economy, which would represent an important structural change. Currently, the ratio of Japan's trade (exports plus imports) to GDP is only a third of Germany's[4].

The international structural reforms that Japan needs to undertake are rather germane to the G-20's emerging agenda. The G-20's efforts to rehabilitate the WTO by resuscitating the most-favored nation principle and non-discriminatory liberalization, and refocusing the WTO on issues related to structural reform could, if successful, help the Japanese economy in making this transition. Though there a few signs of it yet, hopefully the Japanese government might recognize this and help push this agenda through the G-20.

Japan could also stand to benefit from the G-20's infrastructure investment agenda. Greater investment in infrastructure projects in emerging countries would provide opportunities for Japanese firms with expertise in building infrastructure, raising demand for Japanese exports. Japan's aging infrastructure also presents opportunities for targeted investment, as the collapse of a forty year old tunnel last December made clear.

In the absence of deep and effective reform program for promoting private sector investment-led growth in Japan, the downside risks from expansionary monetary and fiscal policies, including a bond market collapse and a fiscal mess, will increase dramatically[5]. Japan must therefore support and make the most of international initiatives, including the G-20's agenda on trade liberalization and infrastructure investment and APEC's emerging focus on infrastructure investment, that will further the structural reform agenda that Japan so desperately needs.

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## Endnotes

[1] Gourinchas and Rey(2005)
[2] Nakatani (2013)
[3] Yi (2003)
[4] Itoh (2010)
[5] Drysdale (2013)