More *Sizzle* Than Steak

Why the Abe economy will fail.

BY RICHARD KATZ

Abenomics, the popular term for the economic policies of new Japanese Prime Minister Shinzo Abe, is likely to fall far short of its goals of reviving long-term vitality in Japan, although it could succeed in providing a temporary and illusory lift to both the economy and Abe's Liberal Democratic Party. To provide a lasting revival, Japan needs a three-pronged approach of monetary stimulus, the right kind of fiscal stimulus, and structural reform. None of the three work without the other two. Abe, however, is focused only on the first two. With his party just back in power, he doesn't want any reforms that step on toes. As a result, Japan is more likely to do what it has repeatedly done after previous bouts of stimulus: fall back into lethargy as soon as the stimulus is withdrawn. Beyond that, political obstacles from the Ministry of Finance, the Bank of Japan, and some parts of the business community are already preventing Abe from even implementing many of his ideas on fiscal and monetary stimulus.

Japan could certainly use a strong pro-growth program of stimulus and reform. Its GDP is still 3 percent below the pre-recession peak of five years ago. In the fifteen years since 1997, per capita GDP has grown a dismal 0.46 percent per year, far below its potential. But going forward, even after the economy gets back to full capacity, many economists and policymakers estimate its medium-term potential growth rate as low as 0.5 percent per year.

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The Three Amigos

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In looking at the pros and cons of Abenomics, it would be helpful to start with the varying reactions from three prominent economists: Martin Feldstein, Adam Posen, and Paul Krugman.

THE FELDSTEIN FEAR, A FEAR SHARED BY SOME AT THE BOJ

In a January 18 op-ed in the *Guardian,* Martin Feldstein, formerly Ronald Reagan's chief economist, warned that Abe's emphasis on restoring inflation could actually make things worse. His concerns are shared by some within the Bank of Japan and the investment community.

"Seeking to boost economic growth, the authorities may soon destroy their one great advantage: the low rate of interest on government debt and private borrowing. … [If Abe succeeds in achieving 2 percent inflation], investors will be willing to hold Japanese government bonds (JGBs) only if their nominal yield is significantly higher than it has been in the past. … With a debt/GDP ratio of 230 percent, a four-percentage-point rise in borrowing costs would cause the annual deficit to double, to 20 percent of GDP."

Does that mean leaving Japan in its present deflationary situation is the lesser of the evils?

What Feldstein is claiming is that, if bond investors expect a 2 percent rise in inflation, then they will refuse to buy bonds unless they get a more or less equal 2 percent rise in interest rates. His critical assumption is that the Bank of Japan has no way to counter the investors' desire, and therefore no way to lower "real" (inflation-adjusted) rates.

Fortunately, real world data show this fear is unwarranted. During 2000–2012, for every 1 percentage point increase in inflation (or decrease in deflation), nominal rates on ten-year Japan government bonds went up, not 1 percentage point, but only 0.3 percentage points. The remaining 0.7 percentage points comprised a fall in the real interest rate (see Figure 1). In the past couple of months, despite higher inflation expectations, the Bank of Japan has successfully reduced the nominal rates on bonds in the one-year to ten-year range to record or near-record lows.

Japan had turned itself into a "Blanche DuBois" economy, one dependent on the kindness of strangers.

Once Japan has positive inflation, it should be able to emulate the U.S. Federal Reserve in pushing real interest rates into negative territory. As measured by inflation-indexed bonds known as TIPS (Treasury Inflation-Protected Securities), the Fed has engineered negative real rates on ten-year bonds since early 2012, and on five-year rates since early 2011.

A temporary period of negative real interest rates helps spur company and household purchases of interest-sensitive items, such as equipment, cars, and housing. And that would be the major benefit of reviving inflation in Japan. Since nominal rates cannot go below zero, a nation cannot have negative real rates unless there is positive inflation.

As for the impact on the high ratio of government debt to GDP, a critical factor in lowering that ratio is to make sure that nominal interest rates are kept substantially below the rate of nominal GDP growth. So restoring moderate inflation while keeping nominal rates down would ease, not worsen, the debt problem.

The major danger would come if inflation were not accompanied by a return to real wage growth. In that case, consumer demand would take a big hit.

Continued on page 66

Continued from page 33

THE POSEN LIMIT: FISCAL COMPONENT WOULD HURT

Adam Posen, president of the Peterson Institute for International Economics, applauds Abe's efforts on monetary stimulus but condemns his attempt to couple this with fiscal stimulus. This is a remarkable turnaround since Posen came to fame back in 1998 by saying Japan needed sufficient, consistent fiscal stimulus. In a January 15 *Financial Times* op-ed, Posen wrote:

> The case for continued deficit spending in Japan ended by mid-2003. … From 2003 to 2007, per capita real income growth was the same in Japan as in the United States (averaging 1.8 percent annually)… Additional [fiscal] stimulus in Japan is counterproductive because it adds to the long-term costs [of higher government debt] without addressing Japan's real problem: a return to deflation and an overvalued exchange rate. The BoJ pursuing a higher inflation target through large-scale purchases of a wide range of assets, as Mr. Abe and his economic adviser Koichi Hamada rightly advocate, would be sufficient and appropriate.

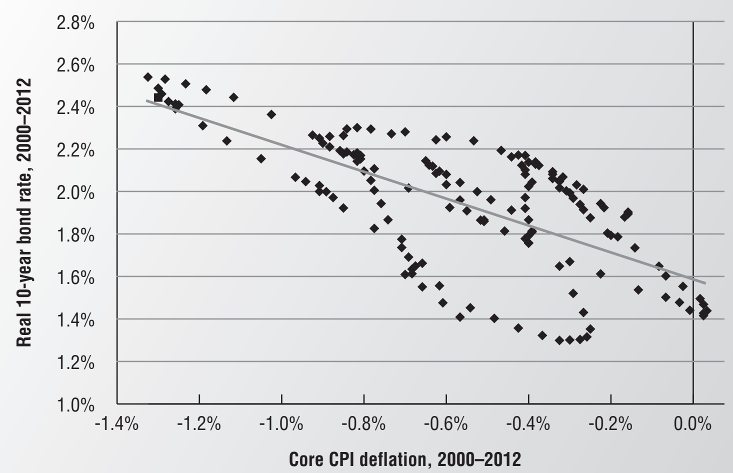
All of Posen's premises are inaccurate: that Japan enjoyed a vigorous recovery in 2003–2007, that Japan's major obstacles to growth are deflation and a weak yen, and that monetary stimulus alone is a panacea.

During 2003–2007, Japan was simply recovering from the previous five years (1998–2002) when per capita GDP had shrunk by 0.4 percent. Typically, countries coming out of a deep slump temporarily grow much faster than their long-term average; that's all that Japan did. By contrast, during 1998–2002, U.S. per capita GDP had grown nearly 11 percent and so could not be expected to enjoy above-par growth in 2003–2007. The bottom line? In 2011, U.S. per capita GDP was 17 percent higher than in 1997; Japan's was only 5 percent higher.

Equally important is the unsustainable nature of Japan's 2002-2007 recovery. With real wages dropping and interest income for seniors shrinking to virtually nothing, Japan could not depend on vigorous consumer demand. Instead, it obtained 40 percent of its entire growth in GDP just from an increase in the trade surplus. Another 30 percent came from growth in business investment, much of which was linked, directly or indirectly, to exports.

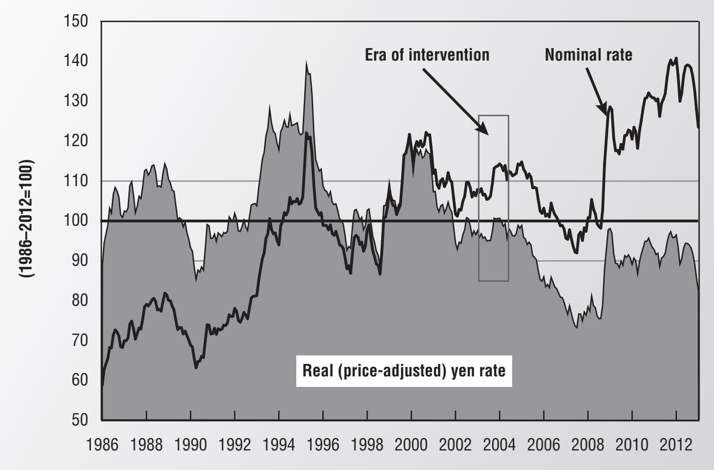
Japan had turned itself into a "Blanche DuBois" economy, one dependent on the kindness of strangers. Hence, when the global slump came in 2008, its GDP plunged a stunning 9 percent, a drop usually seen only in developing countries.

Figure 1 Japan's Real Bond Rates Go Down as Deflation Eases



Source: Ministry of Finance, Ministry of Communications.
Note: Core CPI is measured U.S. style, that is, CPI except for food and energy.

Figure 2 Real Yen 15 Percent Weaker Than Quarter-Century Average



Source: Bank of Japan.
Note: Nominal rate measures the yen against all of Japan's major trading partners. The real yen adjusts the nominal yen for price changes between Japan and its major trading partners.

Despite all the talk of a high yen, when we adjust for Japan's deflation compared to other countries' inflation, during 2002–2007, the real price-adjusted yen was driven to a level 30 percent cheaper than its average for the quarter century since 1986. Even at its highest nominal level in 2012, the real yen was still below its long-term average. At ¥90 per dollar it is 15 percent below its quarter-century average (see Figure 2). The faults of Sony and Panasonic lie not in an allegedly strong yen, but in their weak product line—for example, televisions instead of smartphones.

Core consumer deflation these days is just -0.6 percent, hardly enough to be responsible for Japan's ills.

Abe advisor Koichi Hamada claims that, if the Bank of Japan continues its alleged new policies, clear results will show up within six months to a year. In reality, years of effort have shown that monetary ease is insufficient to either revive growth or end deflation. As we have detailed previously (*TIE*, Spring 2010, "Saving Japan"), deflation is not the cause of weak demand, but just its symptom. No matter how much money Japan prints, it cannot cure deflation without first curing weak demand. Believing that adding a 2 percent target makes a difference is akin to believing that one can cure a patient's fever by telling the thermometer you have a target of 98.6 degrees Fahrenheit.

Nor, contrary to the claims of Hamada, can Tokyo depreciate the yen just by printing lots of money. Hamada contends that, if Japan doubled its money supply compared to that of the United States, then the ratio of yen to dollars in the foreign exchange markets would also double (halving the value of the yen). The data shows no such linkage. Over the past twenty-five years, money supply was even more inaccurate in forecasting the yen than a simplistic straight line predicting a steady 0.14 monthly decline in the number of yen per dollar (see Figure 3). The money supply measure was worse at capturing the big gyrations of the yen, often predicted a yen much weaker than actually occurred, and for stretches as long as fourteen years, that is, 1993 to 2007, mostly moved in the wrong direction. The yen rate is determined in global markets, not in the offices of the Bank of Japan.

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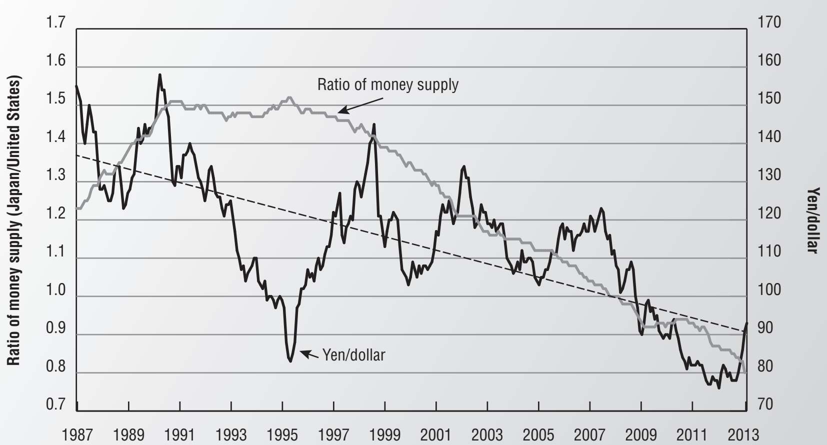
During the campaign, Abe talked of spending ¥50–¥100 trillion to buy foreign bonds in order to weaken the yen—talk that has disappeared down the "memory hole" since the election. When Japan spent a massive ¥35 trillion ($320 billion) on intervention from January 2003 through March 2004, the yen actually strengthened by 5 percent (see era of intervention in Figure 2).

Undeniably, Abe's rhetoric triggered a reversal of the herd instinct among currency traders. But these days, the main fundamental pushing the yen downward is the seemingly intractable series of trade deficits.

Figure 3 Yen/Dollar Does Not Echo Money Supply



Source: U.S. Federal Reserve, Bank of Japan
Note: The ratio of money supplies often moved in the opposite direction to the yen/dollar.

KRUGMAN'S FISCAL-MONETARY COMBO

Responding to Posen, Paul Krugman wrote a blog post insisting on the necessity of combining fiscal stimulus with the monetary easing.

> Posen is going with the notion that unconventional monetary policy, by working both on asset demand and on expectations, can do the job. Maybe, but most of us have taken the limited payoff to quantitative easing as a cautionary tale. There's a lot to say for the notion of using temporary fiscal stimulus to push the output gap down [the gap between actual GDP and what GDP

> would be at full capacity]…to jump-start the transition to an inflationary regime.

This is a remarkable, but welcome, turnaround by Krugman. For years, beginning with his famous 1998 paper on Japan, Krugman had downplayed the need for fiscal stimulus while claiming Japan's deflation could be cured mainly by creating expectations of future inflation (the "thermometer" argument).

If Japan were a healthy economy, a fiscal-monetary combo would be sufficient to restore growth as well as defeat deflation. A temporary dose of fiscal policy helps transform the vicious cycle of recession into the virtuous cycle of recovery. It does this by reducing the output gap, raising the operating rate at firms, and lowering unemployment. This causes firms to be more willing to hire and invest and consumers to be more willing to spend. Combining this with monetary ease prevents interest rates from rising in response, which would make the fiscal stimulus self-defeating. Then, the fiscal stimulus can be safety withdrawn in favor of self-sustaining private demand (*TIE*, Fall 2011, "On Government Activism").

Unfortunately, Japan is not a healthy economy and so is unable to respond to fiscal-monetary stimulus in the normal way. The household share of real national income has fallen. People are spending as much as they can, with the savings rate now down to around 2 percent from 13 percent back in 1997. If households had more money, they'd spend more. Instead, the scheduled consumption tax hike will leave them with even less income. This chronic shortfall in consumer demand is why Japan had to depend so unhealthily on a growing trade surplus in 2002–2007, a tactic that Abe wants to repeat by driving the yen as low as ¥100 per dollar, according to some of his aides.

In the absence of an improvement in household income, once the stimulus is withdrawn, Japan will fall back to stagnation. A preview came last year, when Tokyo removed subsidies to buy cars and energy-saving appliances, and sales immediately slumped. Fiscal-monetary stimulus is necessary, but not sufficient.

Abe's notion of a "growth strategy" is mainly a trickle-down approach of increasing corporate profits via a cheaper yen and tax cuts.

Worse yet, Abe's fiscal proposals are the same old "bridges to nowhere" that his Liberal Democratic Party tried in a stop-and-go manner in the 1990s–2000s. Besides some stimulus this year, Abe campaigned on a decade-long ¥20 trillion (4 percent of GDP) per year program of public works. This was aimed at garnering votes in key rural districts where part-time farmers do construction jobs. Meanwhile, a lot of worthwhile projects are being ignored. Just one example would be linking up suburban homes now using propane gas tanks and cesspools to the sewage and gas lines. That would not only stimulate demand today, but lower pollution and gasoline usage over the long term. In addition, Japan should postpone the hike in the consumption tax—the first stage is scheduled for April 2014—until self-sustaining private domestic growth is restored.

THE MISSING ELEMENT: STRUCTURAL REFORM

Abe's notion of a "growth strategy" is mainly a trickle-down approach of increasing corporate profits via a cheaper yen and tax cuts in the false hope that this would lead to more investment, hiring, and wage hikes. Real structural reform has to tackle Japan's deep-seated defects.

The first task is to raise household income as a share of GDP. While household savings rates are in the cellar, mountains of cash lie fallow in corporate treasuries. Tax and other measures should be used to transfer some of these returns to capital back to the original providers of the capital: household savers and investors. Abe says it will take years for his administration to figure out an energy strategy to deal with the shut-down nuclear plants. Meanwhile, Japan imports high-priced oil and natural gas, thereby shifting money from the wallets of Japanese consumers to the bank accounts of oil sheiks.

At the same time, Japan has to raise its pitiful rate of potential growth. With the working-age population shrinking, the only source of growth is for each worker to produce more GDP. Since Japanese productivity levels lag so badly behind the world's leaders, for example, 30 percent behind the United States in manufacturing, the country could grow by leaps and bounds just by catching up to world benchmarks. But that would require a huge amount of corporate reform, especially more competition and greater willingness to let inefficient firms die so that they could be replaced by better firms. That can only happen if Japan creates a strong social safety net and a more fluid labor market to protect the people put at risk by these reforms.

Macroeconomic stimulus should be used as anesthesia to ease the pain of structural reform. Instead, Abe is using it as a narcotic to dull the pain so as to evade the needed reforms.

He and his party continue to protect weak domestic firms from competition either at home or from imports. One hundred sixty-three of the 294 successful LDP candidates in the recent lower house election got the endorsement of the farm lobby by promising to oppose participation in the Trans-Pacific Partnership. Talk of deregulation is just that: talk. There are no plans to improve the social safety net to make Japan economically and politically safe for "creative destruction." Abe's party has opposed concrete steps to raise the household share of real national income; indeed, the so-called "labor reforms" that raised temporary and part-time workers to one-third of the labor force were just a device for cutting wages.

Saying Japan needs fiscal-monetary stimulus is like saying a car needs gasoline. You can fill the tank to overflowing, but if the engine remains broken, no one is going anywhere.

CAN ABE EVEN IMPLEMENT ABENOMICS?

There are serious questions as to what Abe will even be able to implement.

Despite near-universal expectations of a complete surrender by the Bank of Japan, so far it has merely given Abe a symbolic victory. On January 22, the Bank of Japan changed its meaningless "goal" of 1 percent inflation into an equally meaningless "target" of 2 percent inflation. It is meaningless because the Bank of Japan lacks the means to turn that goal into reality by itself. In fact, the new target made zero impact on the Bank of Japan's forecast of inflation over the next couple years (it projects 0.9 percent by 2014).

The Bank of Japan's "open-ended" program of asset-buying doesn't even begin until next January after it reaches its existing end-of-2013 target of ¥101 trillion ($1.2 trillion). Because most purchases will simply roll over short-term assets, the net increase during 2014 will amount to just ¥10 trillion, less than the previously planned net increase of ¥36 trillion in 2013.

Compare this to Abe's demand of just a couple months ago that the Bank of Japan print unlimited amounts of new money to buy up all the government's new deficit bonds. That would have meant tens of trillions of yen of net purchases per year. Abe dropped this when the demand created outrage in newspaper editorials and among many business leaders.

Rather than lose his "aura of power" in the eyes of the voters, Abe pretended he had created a "regime change" in monetary policy. The financial markets were not fooled by the rhetoric, and now believe that Abe's next chance to change monetary policy may not come until March, when he appoints a new Bank of Japan governor and two new deputy governors.

First of all, it is unclear how much real stimulus his fiscal stimulus budget will provide.

On the fiscal side, Abe already seems to have caved into demands, presumably from the Ministry of Finance, to drop much of the stimulus he promised during the campaign.

First of all, it is unclear how much real stimulus his fiscal stimulus budget will provide. The headline number is ¥10.3 trillion ($114 billion), or about 2.2 percent of GDP. But, as in past budgets, the so-called "real water" of demand is likely to be much less. The consensus among economists is that this could add about 1 percent to GDP growth in the coming year. What happens, however, once this shot in the arm is finished? In a late January forecast, Daiwa Institute of Research raised its forecast for fiscal 2013 (beginning April 1) to 2.2 percent as a result of the Abe stimulus. However, Daiwa then says growth will drop back to a tiny 0.4 percent in fiscal 2014 as the stimulus runs out and the consumption tax is hiked from 5 percent to 8 percent.

In another reversal, Abe has agreed to limit deficit bonds to ¥44 trillion in the fiscal 2013 budget, the same as in initial budgets of the past few years. Neither he nor any of his ministers have repeated the campaign talk of a ten-year ¥20 trillion per year program of public works. While Abe campaigned on possibly postponing the hike in the consumption tax, the Ministry of Finance is pressuring him to raise it on schedule.

In short, there is a lot more sizzle than steak to Abenomics. But Abe's top priority is to win the upper house elections this July. The last time Abe was prime minister, he ignored economic issues, lost the crucial July 2007 upper house election, and had to resign a few months later. Abenomics is all about convincing the voters that he is not repeating that mistake. A 71 percent approval rating in early February shows that, on that front so far, Abenomics is serving its purpose. ◆