Japan must reinvent itself once more

A threat to international financial stability

by William White in Basel

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The package of economic measures being pursued in Japan has been wrongheaded in both conception and execution. The 'three arrows' of Abenomics – the economic policies of Prime Minister Shinzo Abe – were to consist of monetary expansion, fiscal expansion followed by restraint, and significant structural reforms. The short term objectives were to jump start the economy, replace deflation with low inflation and increase corporate productivity. The ultimate goal was higher nominal growth to ensure the continued capacity of the Japanese government to service its debts.

The conceptual problem is that Abenomics assumes a degree of understanding and control of the economy that is simply unrealistic, and the way in which these policies have been implemented means they will not achieve the objective sought. Monetary policy has failed to work as intended, implying that it has not been possible to ensure the degree of fiscal restraint needed to put the debt on a sustainable path. Structural reforms have been too timid. The unintended consequence of these shortcomings could be the need for an eventual restructuring of Japanese sovereign debt or its rapid reduction in real terms through very high inflation. Either would pose a threat to international financial stability.

Abenomics has not adequately stimulated aggregate demand. Expansionary monetary policies, even when supported by corporate tax cuts, failed to increase corporate investment and exports as significantly as hoped. In any event, the capital stock in Japan and the country's external assets are both remarkably high by international standards. As for consumption, there is reason to believe that easy monetary policies and an associated decline in the yen played some part in the almost three percentage point increase in the household saving rate between 2014-16. Low interest rates increase the need to save on the part of those still working, while depressing the income and consumption of pensioners.

Further, a weaker yen reduces real incomes by increasing the costs of imported goods and services. The suggestion that stronger corporate balance sheets would 'trickle down' in the form of higher wages and spending has proved disappointing. Accordingly, faced with a still weak economy threatening government revenues, the promised process of debt stabilisation began with an increase in the value added tax in 2014. This affected consumer demand so negatively that a second VAT increase was postponed and further packages of fiscal stimulus introduced. These policies could have unintended consequences. Not least, easy monetary conditions have supported 'zombie' companies that lower productivity growth overall. These same conditions threaten the business models of many financial institutions. Moreover, Japanese general government debt has been allowed to rise to almost 240% of GNP, while the deficit remains over 5% of GDP. By any metric these numbers are unsustainable over the longer term. Should interest rates rise only proportionally with any increase in the growth rate of nominal GNP, there will be an explosive increase in debt service given that debt stands at well above 100% of GNP. Should interest rates rise for any other reason, the dynamics are even worse.

In those circumstances, the Bank of Japan would be seen increasingly as the lender of last resort to the government. Indeed, consistent with the monetary arrow of Abenomics, the BoJ is already purchasing bonds at a rate sufficient to finance around 40% of total government expenditures. The dangers inherent in continuing, much less expanding, such financing are evident from both theory and history. Eventually, a lack of confidence would see both inflationary pressures and interest rates rise suddenly and sharply. On the other hand, should the BoJ withhold such financing, rates might rise sharply in the near term and trigger the crisis everyone wishes to avoid.

The focus should shift from spurring corporate investment to encouraging consumer spending. Higher corporate taxes, particularly on undistributed profits, would be helpful. So too would smaller depreciation allowances for corporate investments. This would raise measured profits, encouraging both higher dividend payments and higher wages. Decreased reliance on monetary easing might increase real household disposable income by reversing the contractionary forces described above. A detailed and concrete plan for fiscal consolidation would help maintain confidence until consumer spending strengthens. Finally, the third arrow of structural reform must become the first arrow. There is no other suitable method by which

Japan can achieve 2% real growth over time, given that current estimates of potential growth are essentially zero.

These suggestions might seem revolutionary, but Japan reinvented itself successfully after the Meiji Restoration and again at the end of the second world war. It needs to do so again. The stakes are high, and not just for Japan.

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