Still Wallowing in The Shallows

The ongoing failure of Abenomics.

By Milton Ezrati

Japanese Prime Minister Shinzo Abe has politicked exquisitely. He has done public relations even better. It is with economic policy that he has fallen short. His Abenomics, as he calls his program, has simply failed to lift Japan's economy from the shallows in which it has wallowed for more than twenty years now. That is hardly surprising. Despite all the fanfare, little that he has implemented is new, while he has neglected the one novel and promising aspect of his agenda: structural reform. Until he (or someone else) takes this fundamental aspect of policy seriously enough to actually do something, Japan's economic prospects will remain mediocre.

ABE'S INITIAL SPLASH

Since Abe first took office in 2013, he has touted his supposedly novel plan to revitalize the economy. His agenda consists of three initiatives, or "arrows" as he calls them. One is a massive government stimulus program, mostly on new infrastructure amounting to as much as 3.5 percent of Japan's GDP. The second "arrow" consists of extremely easy monetary policies, including an increase in the Bank of Japan's inflation target from 1.0 percent to 2.0 percent and a large injection of liquidity into the system through a quantitative easing that would, the government claims, expand the central bank's balance sheet by 1.0 percent of GDP in the first year. The third "arrow" would aim at structural reforms to make Japan's economy more dynamic

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and growth-oriented, including efforts to streamline energy, environmental, and healthcare regulation and take steps to cope with the rising average age of the population and the resulting overhang of dependent retirees.

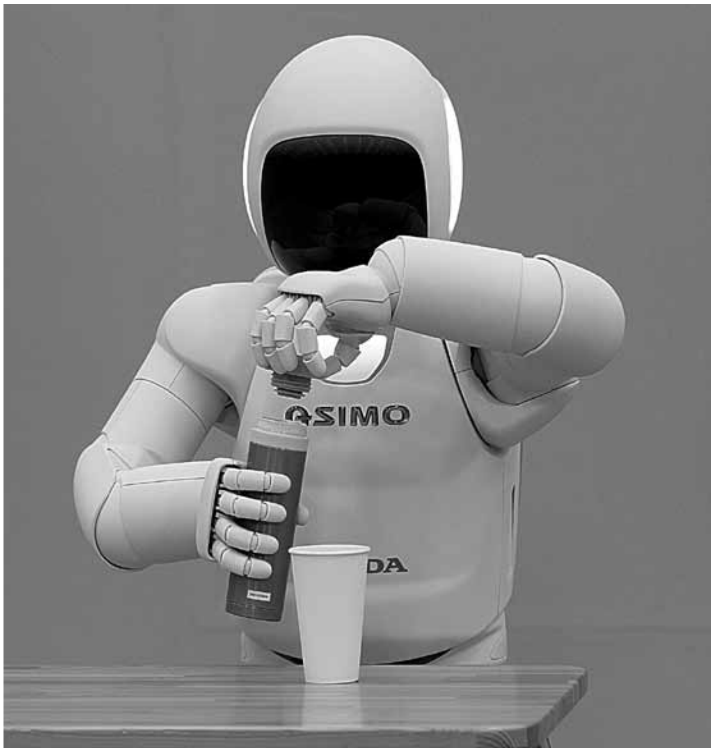
Abe has only ever loosed his first two arrows. For a while, these seemed to be sufficient. Japan's financial markets responded well, as did its economy. The country's real GDP expanded at a 3.7 percent annual rate during 2013's first three quarters, a major turnabout from the half percent decline recorded in 2012. It fell modestly in 2013's fourth quarter but jumped again at an impressive 6.6 percent annualized rate in 2014's first quarter. By that time, it appeared as though Abenomics was working, even with its third arrow still in the prime minister's quiver. But then the skein of good news began to unravel. The economy fell a hard 7.4 percent at an annualized rate in the spring quarter of last year, and continued to decline at a less precipitous but still severe 2.0 percent annualized rate during the summer quarter. Preliminary data for the fourth quarter points to a rise but only barely, at a 0.2 percent annualized rate.

WHY THINGS HAVE FALLEN APART

At base, the recovery faltered because what Abe has done is essentially a reprise of past failed polices. Floods of infrastructure spending certainly are an old story for Japan. Tokyo has turned to this "solution" frequently throughout the country's long period of stagnation, so much so, in fact, that the government now carries an outstanding debt burden in excess of 260 percent of the country's GDP, by far the highest in the developed world. To be sure, all this past spending has also created a world-class infrastructure in Japan, with rail, roads, and ports of all kinds, and that, no doubt, has contributed to the country's still-great wealth. But the world's shiniest and newest infrastructure offers less return from additional spending than a less impressive structure would. It clearly has with Abe's recent effort.

Abenomics has failed to lift Japan's economy from the shallows.

There is an ominous side to the infrastructure spending that also speaks to why it has had a limited effect. Prime Minister Abe's Liberal Democratic Party, since it became the leading party of Japan in the mid-1950s, has notoriously rewarded its supporters, both regions and firms, with infrastructure contracts. The current policy would seem only to extend that old and, incidentally, economically inefficient pattern. As if to underscore continuities with these less than optimal past practices, the LDP not too long ago promised to offset the ill effects of scheduled consumer tax increases by spending more on infrastructure, in other words, use tax monies to reward its favorites in areas where there may be no real need.



Honda's ASIMO robot opens a water bottle. Japan is a leader in robotic technology.

Abe's second arrow, easy monetary policy, including quantitative easing, may avoid the corruptions of the past, but it, too, is hardly new. The Bank of Japan resorted to it in the mid-1990s, when Japan tried to recover from its earlier real estate collapse. The policy failed again later in the 1990s, when the Bank of Japan tried to use it to offset the effects of the general Asian financial collapse referred to commonly as the Asian contagion. The program is reminiscent of still-earlier Bank of Japan policies that aimed to promote exports by using easy money to depress the foreign exchange value of the yen. This time, though the yen did decline in response to the bank's policy, it did so in a very different economy than Japan once had. The country's wealth, high average wage rate, and more recently huge overhang of dependent retirees have

Continued on page 94

Continued from page 63

rendered it much more consumer-driven and much less export-driven than it once was. Today, exports constitute a mere 15 percent of the economy, less than half what they once were. It's little wonder the old yen-depressing approach has had little lasting effect.

ABE'S UNUSED THIRD ARROW

Meanwhile, Abe has done little or nothing about structural reform. Here Japan has a great need and consequently a great potential response to effective policies. Its structural problems run wide and deep. A high wage structure makes it increasingly difficult to compete against the rest of emerging Asia, most particularly China, while an aging population, in which already one person in five is of retirement age, makes it impossible for the country to recapture its old position as the world's workshop. To remedy such economic impediments, Japan needs to uncover new sources of labor and economic efficiency as well as re-orient its economic focus away from broad-level exports, where it competes directly with China, toward higher-value products where it has comparative advantages that can support its relatively high wage structure. Yet however much promise here is in policy initiatives to serve these critical needs, Abe has failed even to define his fundamental structural reforms, much less implement them.

To be fair, he has taken two tentative steps. To supplement Japan's shrinking workforce, he has pledged to increase child care facilities to bring more women into the paid workforce. The potential here is huge. Japan has the lowest women's labor participation rate in the developed world, less than 50 percent. But his effort so far is small indeed next to the need, so much so it looks more like a pilot program than a policy initiative. He has also made arrangements to allow a few more foreign workers into Japan under very strict conditions. This, too, is only a minor adjustment in the face of pressing needs, though questions remain about the effectiveness of any immigration in Japan's still xenophobic culture.

While playing small ball in those instances where he has acted, Abe has otherwise ignored other critical aspects of the economy's structural failings. One involves Japan's notoriously inefficient distribution network. Instead of the large national warehouse, shipping, and retail outlets in evidence elsewhere in the developed world, it still has a vast numbers of small, largely family-owned arrangements, many of which fall short of even regional scope. The approach protects much small business, which has its virtues, but it is also notably inefficient and expensive, and it uses more labor than otherwise, an especially unfortunate quality in a nation with a large overhang of retirees and a shrinking working-age population. Yet Abe's supposedly reformist program has done nothing to alter the licensing and zoning practices that perpetuate this system, something it could otherwise easily do in Japan's highly centralized system of government.

The country would also benefit from reforms in its overarching industrial structure. It has an extremely top-down approach to economic organization. A close association of politicians, bureaucrats, and big business, referred to popularly as the "iron triangle," has long set the economy's priorities and direction. In the more distant past, when Japan trailed Western development, the approach worked well. The iron triangle could use trends in the United States to identify developmental directions and set the country's economic agenda accordingly. But after Japan caught up to the West some twenty-five years ago, it has needed more innovation and new development of its own to meet the demands of a developed, high-wage economy. Those requirements are best met by new firms, experimenting with new technologies, as well as novel business strategies. To be sure, even the iron triangle has managed innovations. Japan leads in robotics, for instance. But an economy of Japan's size and scope needs more than a single line of development. Only newer firms can bring such a broad-based effort, and the big business leg of the triangle naturally has resisted. Yet Abe's supposedly reformist team has not even considered policies that might improve this situation.

The economy fell a hard 7.4 percent at an annualized rate in the spring quarter of last year.

PROSPECTS

Were Abe to loose his third arrow and actually begin these and other structural reforms, Japan's economic prospects would almost surely pick up, greatly and durably. Its investment climate would become that much more attractive in tandem with such an improvement. While, however, he continues to rely on the backward-looking and less and less effective policies that constitute his first two arrows, those economic and investment prospects will remain limited, as they have for more than twenty years now. ◆