

# **Japanese Economy: Genesis of the Malaise and Abenomics**

## **Perna Gandhi**

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#### **Japanese Economy**

Once called an economic miracle for its record period of high economic growth, Japanese economy today has also become the country suffering the longest economic recession in the world. Though the economy does recover intermittently, but each time, the recovery has been short-lived. The prevalent economic environment is a stark contrast to the High Growth Era when Japanese economy doubled every seven years from 1950-1973. The success of Japanese ‘Administrative Guidance’ or informal government intervention in economy became a vindication of the inefficiencies in the western market-dominated system. The Japanese Management System with its emphasis on stakeholders rather than shareholders was credited with Japan’s high productivity levels. The high degree of cartelization spurred a high focus on quality controls and cost management instead of dissuading competition. Financial linkages through Main Bank system and Cross-shareholding while stringently regulating financial markets drove massive new investments. So what exactly went wrong with Japan is a question that has become a dilemma for economists.

After trade friction with the US in 1970s and 80s owing to large Japanese trade surpluses, Japan embarked on a course of economic and financial liberalization. Following ‘Endaka’ (higher price of yen under the Plaza Accord in 1985), Bank of Japan (BOJ) rapidly expanded credit to help companies deal with rising costs. We also see the phenomenon of ‘hollowing out of industry’ wherein Japanese companies began setting large production facilities in Southeast Asia and China to rescale profits. On the other hand in the domestic market, the Japanese banks lent heavily to irresponsible projects using real estate as collateral which sharply inflated asset prices. BOJ to

curtail the excessive liquidity raised inter-bank lending rates in late 1989. This sudden monetary tightening led to the bursting of the bubble that had been building up in asset prices and crashed the Japanese stock market. Equity and asset prices fell, leaving Japanese banks and companies with large non-performing assets.

Rather than dealing with the problem head on, Japanese government sought to deny the crisis and kept imprudent firms from going down under. Constant government stimulus brought down not only productivity, but also creativity and competitiveness that had been characteristic of the Japanese economy. Japan's problems were further aggravated by the 1995 Kobe Earthquake whose destruction wiped out about 2.3% of Japan's GDP<sup>i</sup>. However, with the resilient Japanese spirit and reinvestment in Kobe's modernization, Japan saw a recovery the very next year in 1996. Yet, premature 'Big Bang' reforms that sought to reduce government deficit and raise consumption tax from 3% to 5% had a devastating effect and led to an environment of economic defeatism. While banks became averse to lending, especially to small and medium enterprises (SMEs) that could have been the real drivers of the economy, even consumers drastically cut consumption. This set in strong deflationary trends that saw overcapacity, unemployment and bankruptcies. The situation was exacerbated by the 1997 Asian Financial crisis that brought in many high-profile bankruptcies in Japan such as Yamaichi Securities, Hokkaido Takushoku Bank and, little later the Long-Term Credit Bank.

Japan at the time, became mired in a "trap of success" where it was unable to press ahead with reforms to business practices that had brought it miracle growth. Inability to lay off workers and lax corporate governance muted competition and led to serious misallocation of resources. Japanese government to deal with deflation and panic instituted a policy of quantitative easing under BOJ that effectively brought interest rates down to zero. Yet, a cultural aversion to debt, led

Japanese companies to focus on paying off their debts than borrowing to invest further. While private sector withheld investment, government escalated its spending to boost the economy. Growth of Asian tigers (Hong Kong, South Korea, Singapore and Taiwan) and later rise of China and other ASEAN economies had changed the market segmentation in East Asia with their technological catch-up. Japanese economy hindered by its slowing innovation, sought a fundamental readjustment by focussing on markets abroad and shifting domestic economy from manufacturing to services.

In efforts to end the long persistent deflation of two decades, Japanese government has made numerous interventions in the hope of revitalizing Japanese economy. Most have however fallen short, either due to external economic crises or government pre-empting recovery and reducing credit in a bid for structural reforms. To add to all that, Japan has also very quickly transitioned post-World War II from second stage of demographic transition or Baby Boom period, to fourth stage where population growth rate is minimal or even negative as both the birth rate and death rate reach their minimum. The labour population in Japan expanded to its maximum of 87 million in 1995 and has been shrinking thereafter. The elderly population over 65 years of age reached 23% of Japan's total population in 2010 and according to the Government of Japan statistics, it is expected that the elderly population will reach over 40% by 2050. This has rapidly declined both demand and supply in the Japanese economy. As lesser number of people are taking care of more numbers of elderly, both consumption and taxes for the government have become limited while social security costs have risen.

### **'Abenomics'**

In this scenario, the most enthusiastic government intervention has been made under Shinzo Abe, who in his second term as prime minister from December 2012, proposed Abenomics - three

“arrows” of monetary easing, fiscal expansion and structural reform to jolt the Japanese economy out of its economic malaise. Abenomics’ immediate goal is to boost domestic demand and GDP growth while raising inflation to 2%. Encouraging fiscal flexibility, Abe has expanded government budget to near-record levels of deficit spending. Japanese government debt is expected to soon reach 250% of its GDP. The next highest, Greece is at 183% of its GDP<sup>ii</sup>. However, under quantitative easing, the value of assets held by the BOJ has exceeded 70% of GDP. The US Federal Reserve's and European Central Bank's assets, by contrast stand below 25% of their respective GDPs. Japan’s net interest payments, as a share of GDP, are still the lowest in the G7<sup>iii</sup>. In January 2016, BOJ made the decision of introducing negative interest rates in a fresh bid to spur lending and investment. Yet, with private investment not picking up, the expansive credit and larger balance sheet of BOJ, has only served to make Japanese government debt more manageable.

Abe’s third arrow of structural policies aims to improve the country’s prospects by increasing competition, reforming labour markets, and expanding trade partnerships. Abe has sought to slash business regulations and cut corporate taxes in aim to revive Japan's competitiveness. While Japan remains hesitant of increasing immigration in fear of low political and social support, the Abe government has sought to incentivize hiring of women. With the trainee system in Japan having its own shortcomings, the focus has been on tackling issues such as maternity harassment and expand day care facilities to increase support for women in the workplace. Gender equality or ‘womanomics’ has been a key plank of Abenomics. Companies in Japan still have a huge preference against hiring women. Women are seen as the unstable parts of an efficient machine with their ‘short working lives’ and are not given important tasks or job training and thus no promotions. The current increased employment rate of Japanese women can be attributed to factors

such as continued employment due to a growing tendency to stay unmarried, and an increase in non-regular employment among married women.

Abe has also sought to deregulate the tight Japanese labour market by amending the 1986 Worker Dispatch Act in September 2015 that further loosened existing restrictions on employing dispatch workers. So far, however, his labour policy has focused on reducing the culture of overwork or Karoshi that has led to a rise in depression and suicides. In a bid to make Japanese exports competitive, Abe has also focussed on maintaining a weak yen policy. Despite an upsurge in yen value in first half of 2016, the yen has in fact fallen more than 10% against the US dollar since the November 2016 US presidential election. US Treasury yields have been rising with speculation that the administration of President Trump may expand government spending, causing higher inflation in the United States. However, a weaker yen is a double-edged sword, while it drives up the price of imports, it can dampen consumer demand and lead to reduced spending.

This may hinder Abe's efforts which has been on increasing spending. Abe has constantly pushed for companies to increase wages to increase demand. Wage hike has to precede price increase for Japan to witness inflation. Japanese Finance Ministry data also show that the combined net profits of Japanese firms in fiscal 2015 hit a record ¥41.8 trillion (around US\$ 368 billion), a 49% increase compared with fiscal 2006 (before 2008 Global Financial Crisis). However, the total wages paid to their employees including bonuses gained a mere 0.9% over the same period to ¥150.6 trillion. Various factors explain the negligible rise in the total wage cost, including the mass retirement of post-war baby boomers, an increase in the ranks of low-paying irregular workers and businesses' tendency in recent years to reflect changes in their earnings in bonus payments instead of monthly salaries<sup>iv</sup>.

Japanese economy is on a moderate recovery path, given the fact that labour market demand recovered to the level before the burst of the asset price bubble in 1990's<sup>v</sup>. Yet, Japan has a long way to go to before it can pick up its business investment. Though the FDI inward stock has risen substantially since the 1990s, Japan still has the lowest ratio of FDI as a proportion of GDP of any OECD member<sup>vi</sup>. The Abe administration has also committed to making Japan one of the top three destinations in ease of doing business. Japan currently ranks 27th out of the 31 OECD economies (2015 World Bank ranking) on the ease of starting a business indicator<sup>vii</sup>. Trade partnerships such as the Trans Pacific Partnership (TPP) were seen as a key plank for reviving Japan's economy to push ahead with unpopular deregulations in agriculture, industry and services and open new markets. Japan's agricultural industry heavily lobbied against the TPP, objecting to the removal of high tariffs and other protective measures. However, with President Donald Trump's vehement opposition to the TPP, it has fallen through despite Japan having passed it in its Diet.

While Abe has raised hopes, it will take more than the rhetoric of Abenomics to deal with Japanese Economy. Hopes that Abe's "virtuous cycle" will kick in — encouraging businesses to spend, thus increasing wages and leading to a wave of new consumer demand — remains a questionable bet at best. However, Abenomics has shown that central banks and governments can work out a sustainable fiscal expansion. Yet, monetary and fiscal policy is now reaching the end of the Japanese policy rope as fears of hyperinflation have risen. Further, a constant delay in the consumption tax hike from 8% to 10%, leaves doubt on how Japan will offset its rising social security costs. The tax hike was set to take effect in April 2017 but has now been pushed to October 2019. Without a serious effort at structural reforms, Japan will be unable to arrest deflation and restart the economy. Being a mature economy, Japan has to also look to reinvigorate its R&D culture and technological edge, an edge which it seems to be losing to China. With a stable political

government under Abe and the hosting of Tokyo Olympics 2020, Japanese economy is still in some luck.

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