

EXCERPT

Can Abenomics Succeed?

Overcoming the Legacy of
Japan's Lost Decades

Dennis Botman
Stephan Danninger
Jerald Schiff



Note to Readers

This is an excerpt from *Can Abenomics Succeed? Overcoming the Legacy of Japan's Lost Decades*.

Since the bursting of the bubble in the early 1990s, Japan has been unable to sustain economic recoveries. At the heart of Japan's economic challenge lie four, closely related, issues: ending deflation, raising growth, securing fiscal sustainability, and maintaining financial stability. These objectives need to be achieved against the background of Japan's rapidly aging society, entrenched deflationary expectations, and a global economy that remains mired in subdued growth. With much at stake and multiple goals, Japan clearly needs a comprehensive, coordinated, and mutually reinforcing set of reforms. This recognition lies at the heart of Japan's revitalization plan dubbed the "three arrows of Abenomics." This book discusses mutually reinforcing reforms on several fronts, including aggressive monetary easing, growth-friendly fiscal consolidation, and structural and financial sector reforms to revive animal spirits and stimulate potential growth. The authors provide an assessment of Abenomics and its significance for the rest of the world, as well as suggestions in each of the policy areas.

The Table of Contents and Chapter 1 are included in this excerpt.

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Japan's Lost Decades

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Foreword

At the heart of Japan's economic challenge lie four, closely related, intertemporal problems: ending deflation, raising growth, securing fiscal sustainability, and maintaining financial stability. These objectives need to be achieved against the background of Japan's rapidly aging society, entrenched deflationary expectations, and a global economy that remains mired in subdued growth.

Most readers will be familiar with the following striking statistic: in 2013, Japan's level of nominal GDP was about 6 percent lower than it was in the mid-1990s. There can be little doubt that this in part is caused by persistent deflation. Nonetheless, it remains a challenge to quantify exactly how much of the slow growth was due to deflation rather than the typical post-bubble blues, population aging, and the waning effects of technological convergence. As a result, it is also difficult to measure how much living standards will improve from a successful reflationary effort and whether these potential gains are lower now than they would have been in the 1990s. Compared to other advanced countries, Japan has fared relatively well in terms of productivity growth, suggesting that the biggest bang for the buck will likely come from greater capital accumulation (domestic investment rather than outsourcing) and providing additional, high-quality, employment opportunities (rather than increasing part-time work with lower wages and less investment in human capital). The Bank of Japan's quantitative and qualitative easing measures should lead to greater portfolio rebalancing and financial risk taking, raise inflation expectations, and support aggregate demand, which, together with complementary fiscal and structural measures, should help greatly to revive Japan's economy and decisively end deflation.

Another striking statistic—unprecedented among advanced economies—is the debt-to-GDP ratio, which now tops 240 percent and has risen by 50 percentage points in the last five years. Restoring fiscal sustainability by putting the debt ratio on a firm downward path is a priority for Japan's future. Although bond yields in Japan have remained very low despite ever increasing government debt, this is partly due to special factors, including a marked home bias of Japanese investors. None of these special factors can be taken for granted in the future especially with the prospect of higher yields as the Bank of Japan exits from its quantitative easing policies after achieving its two percent inflation target. Indeed, managing the normalization of interest rates along all asset classes and maturities in a way that maintains economic and financial stability will depend, in no small part, on the credibility of the government's fiscal adjustment strategy.

Ambitious structural reforms are pivotal for lasting success of Abenomics. Ending deflation and eliminating the government debt overhang will be good for potential growth, but these efforts themselves depend a great deal on the economy's expected growth rate in the future. Specifically, ambitious labor market

reforms would strengthen the monetary policy transmission channel and accelerate the attainment of the Bank of Japan's inflation target by enhancing the pass through of rising inflation expectations into higher wages. Ambitious structural reforms will support demand in the near term as expectations of permanent income rise. As we have seen recently in Europe, fiscal consolidation without faster growth is unlikely to succeed. A more dynamic Japan is also key from a multilateral perspective, by preventing excessive reliance on monetary and fiscal easing and an undue weakening of the exchange rate.

With much at stake and multiple goals, Japan clearly needs a comprehensive and coordinated set of reforms. This recognition lies at the heart of Abenomics and the chapters in this book offer detailed recommendations in the areas of monetary policy, fiscal adjustment, and structural and financial sector reforms to make Abenomics a success for Japan and the rest of the world.

The various recommendations in this book are presented as a package and, ideally, one would like to make progress on all three arrows of Abenomics equally and simultaneously, not least because they create mutual synergies. However, there is a clear recognition that the amount of emphasis on each policy area needs to be state-dependent. This was evident, for example, around the time of the consumption tax increase to 8 percent in April 2014. Faced with weak demand and a possible reversal of actual and expected inflation, the Bank of Japan significantly further scaled up its asset-purchase program in October 2014. The authorities also decided to delay the second consumption tax increase to 10 percent and adopt further fiscal stimulus while placing greater emphasis on formulating a medium-term consolidation plan to maintain fiscal credibility. The key take away from this experience is that most, if not all, of the agenda for Abenomics laid out in this book will likely have to be implemented for Japan's efforts to be successful, but the reader should remain mindful that priorities need to be recalibrated at times depending on how economic conditions unfold.

This is not just a book about Japan. The main message that policymakers should use all policy levers at their disposal in a coordinated manner when faced with persistently weak demand and high public and private balance sheet vulnerabilities extends to other important parts of today's global economic landscape. As such, policymakers around the world have much to learn from Japan's experience and from the analyses presented in this volume.

David Lipton

First Deputy Managing Director
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Acronyms and Abbreviations

BoJ	Bank of Japan
CAO	Cabinet Office (Japan)
CPI	Consumer price index
DSA	Debt Sustainability Analysis (IMF)
ECG	Excess cost growth
FDI	Foreign direct investment
FLP	Female labor participation
FTA	Free trade agreement
FY	Fiscal year (in Japan: April 1–March 31)
G7	Group of Seven
G20	Group of Twenty
GDP	Gross domestic product
GIMF	Global Integrated Monetary and Fiscal model (IMF)
IMF	International Monetary Fund
JGBs	Japanese government bonds
OECD	Organisation for Economic Co-operation and Development
QQE	Quantitative and qualitative monetary easing
R&D	Research and development
REIT	Real estate investment trust
SMEs	Small and medium-sized enterprises
TFP	Total factor productivity
TOPIX	Tokyo Stock Price Index
TPP	Trans-Pacific Partnership
VAR	Vector autoregression
VIX	Volatility index
ZIRP	Zero interest rate policy

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Abenomics: From the Lost Decade to the Three Arrows

JERALD SCHIFF

EMERGING FROM THE LOST DECADE

The last 20 years have not been easy for Japan. The “Lost Decade”—actually a decade and a half of low growth and deflation—was followed by the global financial crisis in 2008–09 and, in 2011, the tragic Great East Japan Earthquake. Policy responses over this period—including sizable fiscal stimulus and large, if piecemeal, monetary expansion—proved only marginally effective in the face of strong headwinds, most notably from a declining population and rapid aging. To provide some perspective, between 1997 and 2013, nominal GDP in Japan has *declined* more than 7 percent.

What Went Wrong?

Several factors were at play, but the collapse of the Japanese asset bubble in the early 1990s played a key role. In its wake, balance sheet repair in the banking system, corporate deleveraging, and household attempts to rebuild net worth all combined to suppress demand. The external shock from the Asian financial crisis in 1997–98 contributed to a deficiency of demand, creating the environment for an extended period of moderate deflation and stagnant growth.

Once deflation took hold, it worked its way through the economy in textbook fashion. Businesses began to hold off on investment and households stepped back from buying big-ticket items, delaying purchases on expectations that prices would decline. Financial strategies adjusted to the deflationary environment, with portfolio allocations across households and financial institutions shifting toward “safe assets” which, despite low nominal yields, provided stable real returns such as currency, deposits, and government securities. And firms grew reluctant to hire workers on the lifetime contracts that previously characterized the Japanese workplace, increasingly opting for “nonregular workers” with lower basic wages, less job security, fewer benefits, and lower productivity.

Parts of the section on “What Went Wrong” are based on “From Deflation to Reflation: Japan’s New Monetary Policy Framework, Effectiveness, and Broad Lessons,” Speech by David Lipton, First Deputy Managing Director of the IMF, at the 2014 BOJ-IMES Conference on Monetary Policy in a Post-Financial Crisis Era, Tokyo, May 28.

As discussed in Chapter 2, demand management tools were deployed against this difficult backdrop in a variety of ways, but failed to decisively end deflation. In particular, the Bank of Japan (BoJ) provided monetary policy support through various means, cutting the policy rate to the zero lower bound and experimenting before other advanced economies did with quantitative easing and asset purchases. In hindsight, the experience points to the need for clear communication regarding the end objective and consistent implementation of policy easing toward that goal. But the failure of monetary policy also spotlights how difficult it is for a central bank to stimulate demand when confronted with powerful private sector imperatives to deleverage, repair balance sheets, and restore net worth.

As Chapter 3 highlights, a rapidly declining birthrate and high and rising life expectancies were aging and shrinking Japanese society at a nearly unprecedented rate throughout the Lost Decade, adding to the country's difficulties. This has contributed to falling potential growth, a tendency toward deflation, and sizable fiscal pressures (owing to large increases in social security spending).

Japan in Decline?

These developments left Japan, at the start of the second Abe administration at the end of 2012, mired in low growth, mild deflation, and nearly unprecedented public sector debt. More broadly, many had come to see Japan—at home and abroad—as a country in inevitable decline, with potential solutions difficult to imagine and even harder to pass through a fossilized political system.

But this view was always an exaggeration. Even as Japan's growth slowed and prices began their long gradual decline, its economy and society showed strengths.

- Per capita GDP and especially productivity continued to rise at rates that were broadly in line with other advanced economies.
- The rapid recovery from the earthquake and tsunami of March 2011 pointed to the admirable resilience of its people and the economy. Beyond the loss of life, the tragedy badly shook the economy: all nuclear power plants—accounting for a quarter of power—were shut down, and remain closed, while supply-chain disruptions brought production in parts of Japan to a virtual halt. Yet, growth had rebounded to above 4 percent by the first quarter of 2012.
- During the last 15 years, periods of reform were rewarded with renewed economic activity, most notably during the Koizumi period of 2001–06, suggesting that better results were possible.

Nevertheless, it was clear that Japan was facing enormous challenges. Persistent deflation had taken much of the air out of the economy. The combination of an aging population and decreasing work force, declining potential growth, and a rapidly rising public debt burden pointed clearly to the need for a new approach.

THE “THREE ARROWS”: A BREAK WITH THE PAST

It was in this challenging context that Prime Minister Shinzō Abe, in late 2012 and early 2013, rolled out a comprehensive approach to reviving the Japanese economy, summarized by three policy arrows: aggressive monetary easing, flexible fiscal policy, and structural reforms to raise potential growth.

The idea was this: An escape from deflation triggered by monetary easing and fiscal stimulus would lower real interest rates and stimulate investment, consumption, and—with the yen at least temporarily weaker—exports. Structural reforms would boost confidence in the near term and ensure that higher growth was sustained over the longer term. Lower real funding costs and higher growth would improve debt dynamics. And a credible medium-term fiscal plan would curtail risks of a government bond rate spike and allow for a measured pace of adjustment. Complementarities among policies would be the key—all three arrows would be required for success. But if all went according to plan—a big and highly uncertain if—a more dynamic Japan would emerge, with higher growth and lower risk of a fiscal crisis in its future. This would be an important plus for the regional and global economy as well.

Abenomics: Changing Minds

But would it all work? That was less than obvious. What was being attempted under Abenomics was unprecedented, and nothing less than a leap from a low-growth deflationary equilibrium to a new equilibrium characterized by positive inflation and higher sustained growth. This requires a parallel shift toward more risk taking, requiring changes in expectations and behavior by businesses, consumers, and financial institutions. Confidence would be key, in both Japan’s growth prospects as well as the government’s ability to carry out needed reforms. These changes would not be easy to engineer and would require the firing of all three arrows. Failure could mean a slide back into deflation or, even worse, a loss in confidence in Japan’s public finances with everything that might entail. But while risky, Abenomics is less so than the prior status quo, which seemed clearly headed for an unhappy ending.

Given the need to adjust long-held expectations, it is notable that the Abe administration had early and significant success in “changing the conversation” both in and about Japan. No student or observer of economics in 2012–13 could have missed the discussion of the “three arrows” of Abenomics. The prime minister himself appeared on the cover of *The Economist* as a super-hero in flight. Even J-pop groups recorded paeans to the economic policy named after the newly elected premier. It is clear that “Abenomics” was a remarkable branding success and, given the key role of expectations, this was not a trivial achievement. But high expectations are easily dashed and, in the end, just provide an opening for the right policies to do their job.

Monetary Policy: An End to Incrementalism

In April 2013, the Bank of Japan fired the first of the three arrows, announcing its new quantitative and qualitative monetary easing framework to achieve 2 percent inflation in a stable manner within about two years. The sheer size of the

asset purchases marked a clear departure from the incremental approach of the past, as did forward guidance aimed squarely at sending the message that this framework would continue for as long as necessary to achieve its goals. Another difference is a clearer articulation of the idea—seen most evidently in the pact signed between the government and the BoJ in the early days of Abenomics—that the effectiveness of monetary policy depends on complementary fiscal and structural reforms to lift growth expectations and support price momentum.

As described in detail in Chapter 3, monetary policy was expected to be transmitted to prices and the real economy in four interrelated ways. First, quantitative and qualitative easing would hold down long-term real interest rates, raising domestic demand and reducing the output gap. Second, BoJ purchases of large amounts of Japanese government bonds from the books of financial institutions would lead to portfolio rebalancing, including higher domestic and overseas lending. Third, enhanced communication and increases in actual inflation would raise inflation expectations. Finally, the at least temporary depreciation of the yen would help raise inflation and close the output gap.

These important changes in monetary policy coincided with a significant decline in concerns over Europe, improving the global outlook and reversing sizable safe-haven flows into Japan. This had the fortunate near-term effect of adding to the depreciation of the yen, which declined about 24 percent in real effective terms from September 2012 until May 2013, and contributed to early gains in inflation and inflation expectations. However, this source of support for inflation eventually petered out, leaving the other transmission mechanisms to carry the load. Progress toward the 2 percent goal has since been steady, but the BoJ remains roughly only halfway there.

Fiscal Policy: Spend Now, Save Later?

The new government faced the delicate balancing act of addressing serious fiscal challenges without unduly compressing growth, in particular during the hoped-for “takeoff” period of Abenomics.

As Chapter 4 argues, a clear and convincing plan to reverse the long-term trend of rising government debt was needed urgently. Net public debt had increased from 13 percent in 1990 to 134 percent in 2012, while gross debt had surged to close to 240 percent, the highest among advanced economies on both measures. This rise in debt had so far been financed without problems, given domestic investors’ large appetite for government bonds. But the contemporaneous experience in the European periphery had underlined that investor views can change quickly, and that confidence, once lost, was extremely costly to regain. Moreover, longer-term trends, including a shrinking population and declining household savings, were not working in government’s favor.

While adjustment was clearly necessary, the European experience playing out at the time also illustrated that adjustment without growth was unlikely to work. In this context, Abenomics proposed to use fiscal stimulus to help jump-start the economy in the near term while promising the needed adjustment over time. The

bridge would be provided by a medium-term fiscal plan that was sufficiently concrete and credible to maintain the confidence of investors and avoid a sharp spike in government bond yields that would threaten the entire operation. However, given the long period of large deficits and growing debt and the inevitably gradual nature of any adjustment plan, maintaining this confidence would require, beyond promises, at least some upfront action.

Chapter 5 highlights that the adjustment plan itself would need to be as growth friendly as possible, relying on a package of measures that could deliver deficit reduction while improving incentives to work and invest. This adjustment would also need to include measures to both raise revenue and control spending—most notably rapidly growing social welfare spending—and ensure that the overall burden of this deep adjustment would be broadly shared.

The first year of Abenomics was, largely as expected, more about stimulus than adjustment, but that tide may be turning. Following a series of stimulus measures totaling about 1.5 percent of GDP over 2013–14, the government raised the consumption tax from 5 to 8 percent in April 2014, the first major step toward dealing with the sovereign debt burden. The government had planned a second increase, to 10 percent, in October 2015, but decided to delay this hike until 2017 given the weaker than expected economic growth following the April tax increase. Japan still finds itself only a very modest way toward the ultimate goal of reducing public debt as a share of GDP and, with the delay of the second tax increase, the formulation of a concrete medium term plan has become particularly urgent. Such a plan is apparently in the works, to be articulated in 2015, and much will be riding on it.

The Third Arrow: Raising Potential Growth

As Chapter 6 makes clear, Abenomics will not ultimately succeed if it relies solely on fiscal and monetary policy stimulus. Rather, a hand-off to sustainable and private sector-led growth, together with a substantial rise in potential growth from its current low level of about $\frac{1}{2}$ percent per year—to something like $1\frac{1}{2}$ or even 2 percent—is urgently needed. The necessary transformation will be difficult but, as discussed in the chapter, not unprecedented. A permanent exit from moderate deflation would get Japan part of the way there—reversing the costs of deflation outlined above—but much of the heavy lifting will need to come from a comprehensive series of structural reforms, summarized in a new growth strategy.

Japan has not suffered from a lack of growth strategies over the past decade and a half, although one would be hard pressed to find any impact on economic performance. These strategies have tended to avoid the most fundamental roadblocks to growth, which have also typically been the most politically difficult to address. However, early on in the Abe administration there was real hope that “this time will be different.” First, by boldly launching the first two arrows, the prime minister emphasized his focus on growth. In addition, the political environment for reform had improved considerably, with the ruling Liberal Democratic Party capturing sizable majorities in both houses of parliament and with the prime minister’s popularity at impressive levels.

The government's growth strategy has proceeded more tentatively than many had hoped, but the broad contours can now be seen, notably in the revised growth strategy of June 2014. To offset the demographic decline in the workforce, the strategy aims to increase labor force participation among women, older workers, and—in a closely proscribed manner—foreign workers. Participation in the Trans Pacific Partnership and other trade agreements would help further integrate Japan with rapidly growing Asian markets, raise inward and outward foreign direct investment, and incentivize much-needed deregulation in agriculture and the services sector. Special economic zones could serve as “laboratories” for a variety of forms of deregulation. A lower corporate tax rate and improved corporate governance would help bring down high corporate savings. And a range of policies would transform the stable financial sector into a growth engine. Still, a more ambitious and better-defined program of structural reforms will likely be needed to ensure a significant, sustained rise in growth.

Chapter 7 looks in particular at the need for aggressive labor market reforms, which could enhance many aspects of economic performance. As noted above, efforts to bring more workers into the labor force are critical, but measures thus far go only a short way toward achieving this. But the dual nature of the Japanese labor market—with a sizable and growing segment of the labor force in “nonregular” positions alongside the traditional heavily protected and better-compensated regular workers—also raises important challenges. Notably, this duality appears to limit labor productivity by dulling incentives for training and contributes to low female labor force participation rate, as women face challenges of reentering the regular track after childbirth. A reduction in this duality—for example, through the use of a new labor contract that bridges the gap between regular and nonregular workers—would seem promising, but the government has not yet taken it up.

Financing Growth

While not officially an “arrow” of its own, the financial sector plays a crucial role in the new policy framework. Abenomics is all about encouraging risk taking, which will require a different sort of financial sector, more proactive in searching out lending opportunities and nurturing new enterprises. At the same time, increased risk taking will require a somewhat different focus for financial oversight.

As highlighted in Chapter 8, the Japanese financial system, while sound, could do more to support growth. Venture capital and other financing for start-ups lag badly behind those in other advanced economies, while less dynamic small and medium-sized enterprises (SMEs) are kept alive via loan guarantees.

The new monetary policy framework already provides a window for financial institutions to support growth. The BoJ's purchases already amounted to some 70 percent of newly issued Japanese government bonds when it launched its quantitative and qualitative easing in April 2013 and this has risen further with the expansion of the program in October 2014. With government bond exposures declining, banks can more assertively seek opportunities at home or abroad. In fact, domestic lending is picking up, rising some 3 percent on an annual basis, including to SMEs, after many years of decline. Some larger banks are increasingly focusing

on expansion to foreign markets, in particular in rapidly growing emerging Asia, with foreign profits accounting for as much as one-third of total profits. Nonetheless, some financial institutions—notably regional banks, insurance companies, and pension funds—have maintained strong demand for government bonds, continuing a wait-and-see approach, while banks hold large excess deposits with the BoJ.

Structural reforms can help eliminate bottlenecks to financial intermediation. In particular, the existing credit support system for SMEs tends to weaken both credit risk assessment by banks and incentives for restructuring or exit of nonviable SMEs. At the same time, risk capital is limited for start-ups. This significantly dampens the natural process of entry and exit critical to economic dynamism. It will be important to gradually phase out credit guarantees to restore credit discipline and replace them with more targeted support for businesses. More diverse sources of funding also need to be encouraged, including asset-based lending. And the reform of the governance and investment rules of the government pension fund has the potential to provide funding to venture capital funds and other innovative sources of financing.

The transition to a higher-risk/growth equilibrium could pose challenges, although these appear manageable. For example, with the flattening of the yield curve, banks—particularly regional banks—may be pressured to take excessive risks to raise profitability. As more and more financial institutions move abroad, they also face making risk assessments in new economic settings and bear some increase in funding risks in overseas activity. Financial regulators will need to be alert to such risks.

Investing for the Future

Of course, for productive lending to take off, strong demand from credit-worthy borrowers is needed. Indeed, amid ample liquidity, in the aggregate, the low growth of credit until now has been primarily caused by weak demand rather than an unwillingness of banks to lend.

As discussed in Chapter 9, investment in Japan has been on a declining trajectory since the onset of the Lost Decade, and the nation's capital stock has aged dramatically, even while corporate savings have continued to rise. Reversing these trends would go a long way toward ensuring the success of Abenomics. The chapter finds that investment responds most strongly to expectations about future economic performance and certainty about economic policies. This suggests that an ambitious reform program can have a positive economic impact even in the near term. Financing constraints are also an important limiting factor for SMEs, especially for new entrants and the services sector, pointing again to the need to for financial sector reforms.

IS IT WORKING?

So, the Abe administration, together with the Bank of Japan, has put some very significant policy changes in place, and a number of others are in the pipeline. What has this all meant to actual economic performance? Is Abenomics working?

Structural reforms can help eliminate bottlenecks to financial intermediation. The monetary policy “big bang” has raised actual and expected inflation far more effectively than many imagined possible. This has lowered real interest rates and raised asset prices, contributing to stronger consumption, credit demand and, more recently, investment. The government took the politically difficult decision to go ahead with raising the consumption tax in April 2014. Although this had a larger than expected adverse impact on growth and confidence, the economy now appears to be slowly getting back on its feet and the outlook still features above potential growth in the coming quarters. Compensation is rising at the strongest pace in many years, albeit with only modest increases in base wages. There are initial signs that export volumes will finally start to rise, which should bode well for investment growth going forward. Taken together, this would support the hand-off from stimulus to more sustainable sources of aggregate demand, which so far has been elusive.

Yet, it is clear that Japan is not fully back. While wages and exports have begun to pick up, the sustainability of those trends remains in doubt, with much resting on the government’s policies continuing to engender confidence.”

Specifically, all considered, exports and, by extension, investment growth, have remained surprisingly flat and net exports a drain on GDP, despite the large yen depreciation. In part, this likely reflects the so-called “J-curve,” that is, the observation that trade balances typically improve following depreciation, but only with a delay. But there also appear to be important underlying trends holding back exports, including the acceleration of Japanese firms’ production moving abroad and the loss of competitiveness in former bellwether industries, such as electronics. These trends highlight the continued headwinds facing the economy and point to the need for serious thinking about how to maintain high value-added and skill-intensive production within Japan.

And, while much progress has been made, much can still go wrong. A new bout of global financial volatility or a slowdown in global growth could act as a brake on domestic activity and cause the yen to appreciate just as the economy is taking off.

But the bigger risk is domestic: that through complacency or political obstacles, Japan gets only a partial version of Abenomics, missing important elements of fiscal or structural reform, and leading the country back to deflation or to a more generalized loss in confidence, including in its ability to address its public debt problem.

WHAT DOES ABENOMICS MEAN FOR THE WORLD?

The success or failure of Abenomics, and of Japan more generally, is of great significance to the rest of the world. Despite 15 years of low growth, Japan remains the third largest economy and among the largest net creditors and trading nations. It is also wrestling with an unprecedented public debt burden, for which failure could have major negative implications for the global economy.

As Chapter 10 explains, Abenomics can impact other countries in a variety of ways, with the net impact on any single country difficult to determine. The weakening of the yen would tend to impose costs on countries that are direct competitors,

such as Korea. At the same time, the important upstream role that Japan plays in the Asia supply chain means that lower prices for its inputs would benefit regional economies. Portfolio rebalancing by Japanese financial institutions and households would generate capital outflows, including to emerging Asia, the desirability of which would depend on the macroeconomic situation in each recipient country. Thus far, such spillovers have been subdued, with net outflows limited and Japanese exports yet to rise in a decisive manner. But if Abenomics is to succeed, it will likely generate larger spillovers along the lines laid out above.

While these individual channels are important, the overriding point is that a dynamic and growing Japan would undoubtedly be a boon for its neighbors, its region, and the global economy.

WHAT'S NEXT?

To deliver on this vision, Japan must overcome a series of daunting challenges. Fiscal adjustment on a large scale and over a decade or more will be needed. The population will continue to grow older and smaller. And the global economy will undoubtedly suffer from further episodes of volatility or even crisis. Even success will bring new challenges, such as an eventual Bank of Japan exit from large-scale asset purchases. Against these potential difficulties, the country will need to demonstrate steadfastness in implementing its reform agenda. This book offers suggestions in each policy area to complete this economic transformation.

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