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## Japan's economy

# Three-piece dream suit

**Abenomics may have failed to live up to the hype but it has not failed. And the hype was necessary to its success**

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JAPAN is not, by nature, a boastful country. Its opportunities for bombast have shrunk along with its population. And its economic pride has suffered many years of deflation, a form of macroeconomic self-deprecation, in which firms and workers continuously discount what they do. In some fields, however, Japan still allows itself some swagger. It is, for example, happy to describe itself as a “robotics superpower”. In a speech early this year Shinzo Abe, the prime minister, praised a “dream robot suit” made by Cyberdyne as a prime example of the country’s technological advances. The robotic exoskeleton can add strength and stamina to healthy limbs and restore movement to enfeebled ones. As a symbol of Japanese ingenuity in overcoming debility, the suit’s appeal to Mr Abe is easy to understand.



Since returning to office in 2012 Mr Abe has strapped Japan into an economic exoskeleton of his own. Dubbed “Abenomics”, his three-piece dream suit includes monetary easing, fiscal pragmatism and structural reform. He claimed it would repel deflation, repair the public finances and revive productivity. Over time, he later boasted, the combination of stronger growth and higher prices would lift Japan’s nominal GDP (which includes the effects of inflation) to ¥600 trillion (\$5.7 trillion). Economic resurgence was also meant to bolster Japan’s national security and global standing.

His bold vision has not been fulfilled. Inflation remains well below target. The economy is too weak to sustain a further increase in a controversial consumption tax. This week Mr Abe promised another fiscal jolt, of ¥28 trillion, although the true dimensions of fresh spending may be smaller. It may be combined with more quantitative easing from the Bank of Japan (BoJ), which was meeting as *The Economist* went to press. Structural reforms have advanced haltingly. In the run-up to an election for

the upper house of the Diet, on July 10th, in which Mr Abe scored a sweeping victory, his party dropped mention of the need for monetary easing.

Many observers, particularly foreign ones, say Abenomics is dead. As they see it, Mr Abe used his monetary and fiscal powers not to boost productivity, but to buy popularity, allowing him to advance his nationalist aim of revising Japan's American-written pacifist constitution, a legacy of military defeat over 70 years ago. In the autumn of 2015, Mr Abe pushed through laws allowing the army, known as the Self-Defence Force, to come to the aid of the country's allies if under attack, a freedom the constitution formerly denied it.

Impugning Mr Abe's motives is too cynical. His commitment to economic revival was no doubt sincere, even if he also saw it as a precondition for national greatness. Disdain for Abenomics is also forgetful, failing to recall the grimness of late 2012, when deflation seemed inescapable, the yen was export-sappingly strong and the Nikkei 225 stockmarket index, now above 16,000, languished below 10,000 (it peaked at nearly 39,000 in 1989).

Compared with past efforts to revive Japan, Abenomics has achieved a great deal. It has defeated core deflation (excluding energy prices); lifted companies' profits and dividends; expanded employment, especially among women and the old; and sprinkled Japan with a light dusting of gentle reforms that may hold the promise of more radical future ones. In early 2013, for instance, few believed that Japan would sign the Trans-Pacific Partnership, an ambitious free-trade agreement among 12 countries: it did (though the TPP's fate now rests on American politics). Against the will of the country's powerful business lobby Mr Abe introduced a corporate-governance code and guidelines to oblige shareholders to be more active.

### Potent potion

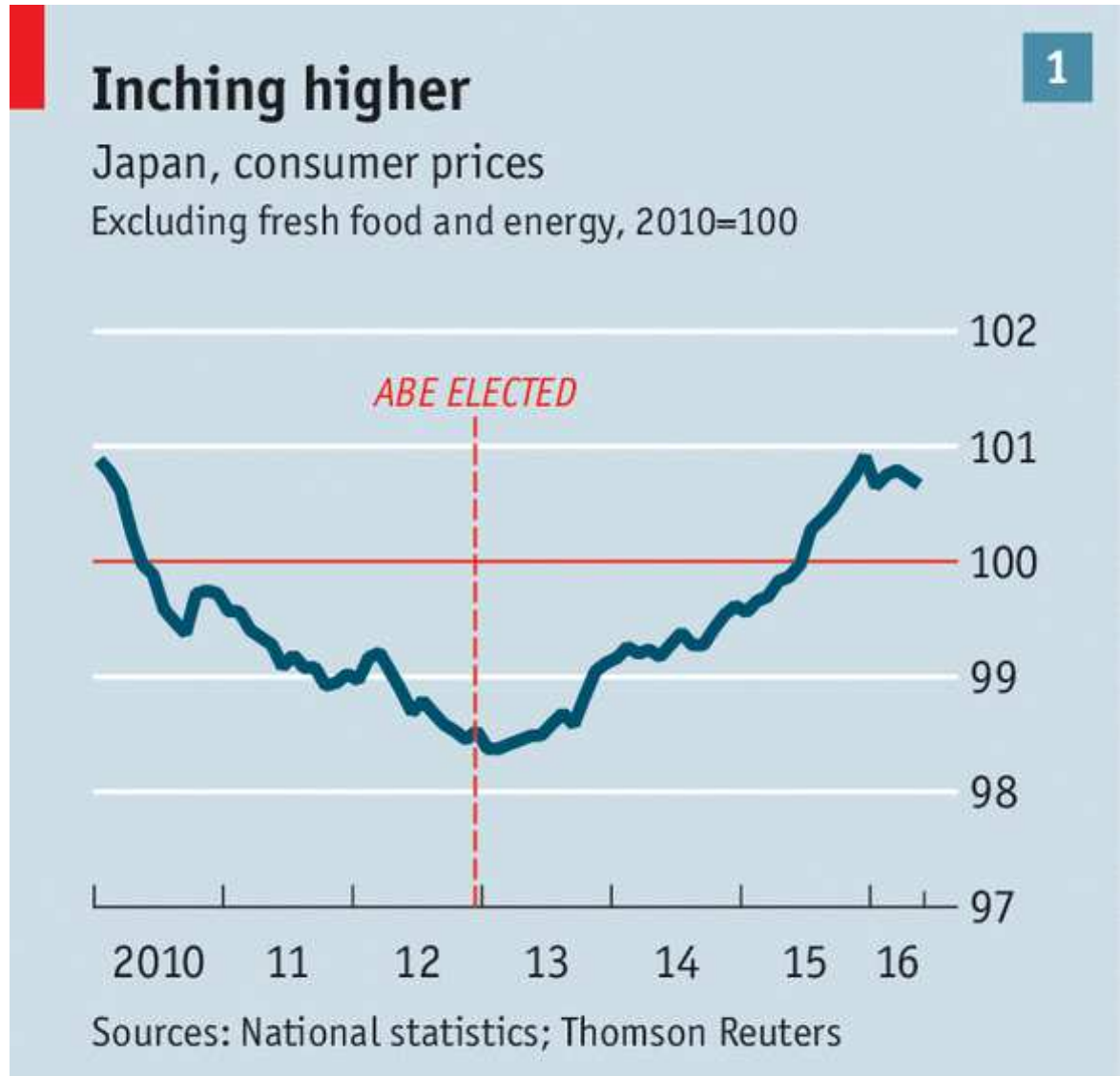
Abenomics may have fallen short of the hype that accompanied it. But to break Japan's deflationary mindset, some bombast was required. When Mr Abe and his Liberal Democratic Party (LDP) returned to power in December 2012, he had already signalled his intention to ease monetary policy and thereby to weaken the yen. In April 2013 his pick as governor of the BoJ, Haruhiko Kuroda, broke decisively with the central bank's defeatist past. He set an inflation target of 2%, backed up by asset purchases of impressive scale and scope.

Financial markets at first responded strongly to these signals. The currency fell and the stockmarket leapt. It did not take long for tourists to flock to cheaper Japan, taking advantage too of newly loosened visa rules. Last year around 20m came, mostly high-spending Chinese visitors.

Companies felt emboldened to charge a little extra for their wares. By September 2015, two-thirds of the items in Japan's inflation index were increasing in price. It was around then that Kagome, the country's biggest condiment firm, raised the price of its ketchup for the first time in 25 years. After falling for two decades, Japan's consumer prices (excluding energy and fresh food) have risen gently

for 32 months in a row (see chart 1). Under Abenomics Japan's nominal GDP has grown at its fastest for 18 years.

Compared with its deflationary past, Japan's mild inflation is a remarkable achievement. Compared with the central bank's promise, it is a failure. The BoJ now says it will not reach its 2% inflation target (which includes energy prices) until the 2017-18 fiscal year, or around three



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years late. The BoJ anticipated that its easing would spur borrowing and spending, including capital expenditure. Business expansion would add to employment. Strong hiring would drive up wages, in turn pushing up prices. Reality has not matched up to the textbook. The economy's two most significant limbs—consumption and investment—have proved less bionic than hoped.

Rather than inflation rising to the BoJ's target, many economists now fear it will fall. The bank already owns over a third of government bonds and is projected to own around 55% by December 2018, according to Marcel Thieliand of Capital Economics. Having created vast sums of money to buy assets, this year it imposed a negative interest rate on some of the money that banks deposited with it. This decision has backfired, many believe, damaging consumer confidence, bank profitability and money-market turnover. And, they point out, the yen is extremely unlikely to fall by 30% again. Indeed, in the wake of European bank scares and Brexit, it has strengthened, hurting share prices.

Other trends will, however, work in the central bank's favour. The number of workers has increased by more than 1.5m under Abenomics, despite a decline of 3.5m in the working-age population (see chart 2). Many people have taken on part-time work for modest wages, dragging down average pay, but increasing collective spending power. Total wage income (earnings multiplied by the number of employees) in March-May was over 2% higher than a year earlier, in nominal terms.

Japan's workers tend to base their wage claims on today's cost of living rather than on the central bank's promises of future inflation. Now that energy prices have stopped falling and core prices are creeping up, unions should in theory strengthen wage demands.

Future

inflation may thus turn on the outcome of a race between the falling expectations of financial markets and the rising expectations of workers.

The BoJ can still influence this race. There are plenty of assets left to buy. Pension funds and life-insurance companies may be reluctant to sell their government bonds, but at some price they will do so. And the bank may get more bang for its buck by buying larger quantities of riskier assets, including corporate bonds and equities, via exchange-traded funds.



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But the bank's hasty imposition of a negative interest rate on some bank reserves was not a success. Market participants initially struggled to transact at negative rates and banks have been reluctant to pass them on to depositors, despite the harm to their margins. The policy is beginning to bed down, however. Banks are competing fiercely for mortgage borrowers, which should eventually increase housing demand and put more money in the pockets of borrowers. And even if banks stop short of inflicting negative rates on retail savers, they may impose them on corporate deposits.

If Mr Kuroda's monetary-regime shift was not as decisive as hoped, fiscal policy has proved unexpectedly powerful—albeit unhappily so. An increase in the consumption tax in April 2014 caused large and lasting damage to household spending and housing investment. The BoJ's monetary easing could not offset it, as many economists had hoped it would. A second tax rise has been twice postponed.

Instead Mr Abe has opted for more fiscal stimulus. Can the country afford it? Its public debt is 250% of GDP. But the government also holds voluminous financial assets, reducing its net debt to about 130% of GDP. Thanks to rock-bottom interest rates, its net interest payments, as a percentage of GDP, are the lowest in the G7.

How is this possible? When governments borrow too much, they crowd out private borrowing. The result is high interest rates or inflation. Japan has neither. In Japan, public borrowing is not crowding out private investment. On the contrary, Japan's government borrows so much only because the private sector refuses to borrow or spend enough, preferring to hoard financial assets instead. If the government were to cut back, Japan would suffer from a disastrous shortage of demand.

Until private spending picks up, fiscal stimulus will be both necessary and cheap: the government will find willing takers for any additional debt. And the central bank could always purchase and hold the government's additional bonds, replacing debt (which must be repaid) with money (which need not be). That combination could be unusually powerful, resembling a "helicopter drop" of newly printed money. Mr Kuroda recently ruled the option out, but might again change his mind.

### Not-so-golden hoarders

Further stimulus would not be necessary if corporate Japan did its bit. Its caution is a source of barely concealed frustration at the Kantei, Mr Abe's office. His government is among the most pro-business in the world, yet firms have not responded with large increases in either wages or investment.

Companies could not hoard money if investors demanded it back. Mr Abe has tried to make owners more assertive, introducing codes on corporate governance and for Japanese institutional investors. In 2012 only two-fifths of leading companies had independent directors; now nearly all of them do. These moves have made a difference. Firms' return on equity rose from 5.8% in 2012 to 8.2% in 2014, according to Kathy Matsui of Goldman Sachs. The government may go further, perhaps imposing a tax on retained earnings.

Mr Abe's irritation with Japan Inc is reciprocated by the country's firms. His government promised rapid and sweeping reforms of the economy and society, covering the labour market, immigration, education, electricity, agriculture, the role of women, medicine and welfare spending. Japanese bosses welcome all or most of this. But Mr Abe's team raised expectations to the highest pitch in private meetings with foreign investors. In one encounter with hedge-fund chiefs, Yasuhisa Shiozaki, the labour minister, is said to have promised stringent standards of corporate governance and bank lending—so stringent that even household names like Japan Airlines, the national flag carrier, would be shut down.

These expectations have not been met. Progress has been incremental, at best, prizing breadth over depth. Mr Abe has chosen not to follow the model of a former prime minister, Junichiro Koizumi, who chose one cause—post-office reform—and pursued it doggedly. Instead, his method has been to make partial progress on multiple fronts, says a government official.

Voters seem to share his instincts, handing Mr Abe repeated election victories. Thanks to high employment and a cohesive society, Japan feels little sense of urgency. The growing ranks of the underprivileged—single mothers, young irregular workers, the elderly and children living in poverty—are not yet large or vocal enough to demand change. Japanese seem to prefer *kaizen*, or continuous improvement, to *kaikaku*, a pejorative word for reform.

One casualty of his caution is labour reform. Two years ago officials planned to allow large companies to fire staff provided they offered sufficient severance pay. For Japan it would have been an abrupt departure from the traditional norm of lifetime employment. The media said it would “chop off the heads of people”. In the run-up to an election in December 2014, Mr Abe stopped discussion of the bill.

The reform's supporters now doubt it will ever come. However, senior officials signal in private that Mr Abe plans to press ahead, starting with two bills early next year. Firing with severance pay would be the first, followed by a delayed bill allowing well-paid, white-collar workers to be paid by performance rather than the number of hours they clock up.

In tackling the lowly status of women in the workplace, Mr Abe has shown more mettle. “Womonomics” was not a natural policy for Mr Abe, who surrounds himself with ultraconservatives, points out Yuriko Koike, an LDP lawmaker who is now the favourite to become the governor of Tokyo. Traditional housewives are the backbone of LDP election campaigns, preparing coffee and rice balls. No one wants to upset them, she says.

Like a highly qualified female graduate obliged to bring the tea, Mr Abe's womonomics policy has suffered numerous humiliations. As soon as he spoke of allowing women to “shine”, the frequency of public sexist comments by LDP politicians shot up. A scheme offering ¥300,000 to small companies that promoted women to supervisory roles attracted no takers.

Lower down the ranks, women face a financial disincentive to rise. Married people earning less than ¥1.3m a year are eligible for health care and a pension through their spouse. Those earning less than ¥1m are exempt from income taxes and social-security taxes. In some workplaces, new hires can tick a box indicating they do not wish to earn more than these sums. They can then limit their hours accordingly. There is little sign that the LDP has gathered the will to change the rules.

To help working parents, the government has created 200,000 extra places in nurseries and set a target of 500,000 by the end of next year. Reports of “maternity harassment” (in which employers bully, demote or fire pregnant employees) have increased dramatically, because people are newly aware of its illegality.

### Foreigners needed

Allowing unskilled foreign workers to settle permanently remains taboo for Japanese politicians, who fear the public’s xenophobia. But the public may be more open-minded than they think. In January, Mr Abe lauded the country’s unlikely victory over South Africa in the 2015 rugby world cup. Japan’s heroes included players called Broadhurst, Hesketh and Wing.

Foreigners are filling other jobs too. Thanks to the strength of labour demand, there were almost 908,000 foreign workers last year, up by over 15% from the year before. Japan needs hardworking housekeepers and homebuilders. It also needs high-flying tech leaders, says Takeshi Niinami, who sits on the council for economic and fiscal policy. In this year’s growth strategy, the government proposes to give skilled foreigners permanent residency, with a waiting period of as little as three years, compared with five before 2012.

Mr Abe once also promised to make Japan a far easier place to do business. He aimed at moving it to third (among rich countries) in the World Bank’s rankings on this score. Instead it has slipped from 21st in 2015 to 24th. Even Cyberdyne was once a victim of bureaucratic inertia. The company’s bionic leg brace was not certified as a medical device until February this year, about eight years after regulators were first approached. Back then, the same certificate covered both medical devices and drugs. The firm was thus obliged to describe the side-effects of drinking its exoskeleton (to appease regulators, it said what would happen if you licked it). But the Abe government has tried to streamline regulations and improve co-ordination among ministries, the company says. Cyberdyne is now struggling to keep up with demand for its products.

The force of demand will also govern Japan’s immediate future. A healthy appetite for labour has already increased the number of foreign workers by a third since Mr Abe came to power, even though he could go much further in reforming rules on immigration. The same economic force has created jobs for an extra 1.2m women, despite the limitations of the womenomics campaign. And if demand is strong enough, market forces will begin to improve conditions for irregular workers.

It used to be said that Abenomics had reflatated Japan but not reformed it. Now, thanks to the yen’s recent strength, even the reflation is in doubt. But as long as monetary and fiscal policy work in

tandem, demand should be resilient. Mr Abe's bold macroeconomic efforts may then achieve some of what his structural reforms have so far fallen short of achieving. Abenomics has underperformed its targets but outperformed the past. And its next, surely more humble, three years could then improve on its first boastful ones.

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