COUNCIL on FOREIGN RELATIONS

Backgrounders

Abenomics and the Japanese Economy

Author: **Beina Xu**, Online Writer/Editor
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Introduction

Just weeks after taking office in December 2012, Japanese prime minister Shinzo Abe announced plans to implement new economic policies geared at jolting the recession-riddled country out of its deflationary malaise. Abe, who previously served as prime minister from 2006 to 2007, has focused the early days of his second term in office on turning around his country's moribund economy. Following its spectacular economic boom in the 1980s, Japan became mired in deflation for two-plus decades, with weak consumer spending and low growth despite repeated attempts by the government between 1992 and 2008 to spur the economy out of stagnation.

Abe's Keynesian-inspired plan, dubbed "Abenomics," takes a three-pronged approach to reflate the economy through monetary, fiscal, and structural policies. It includes a hefty stimulus package worth 20.2 trillion yen ($210 billion), of which 10.3 trillion ($116 billion) would come in government spending with a focus on infrastructure. The Bank of Japan (BOJ) also doubled its inflation target to 2 percent and the government is aiming to create six hundred thousand jobs in a matter of two years. But as the yen began to depreciate in the early months of 2013, foreign governments worried that some of the more ambitious ideas being floated in the package—including the BOJ buying foreign government bonds to help weaken the currency and boost exports—would catalyze a "**currency war**." Concerns about hyperinflation and ballooning debt also abound among critics. As Japan welcomes its seventh prime minister in six years, observers question whether the policies of Abenomics will be enough to propel Japan out of its lost decades.

What is Abenomics?


A broadcast of Japanese prime minister Shinzo Abe in Tokyo. (Photo: Toru Hanai/Courtesy Reuters)

The economic policies that Abe supports include an aggressive set of monetary, fiscal, and structural reforms geared toward spurring inflation and pulling Japan out of its decades-long deflationary slump. The broad goal is to boost annual GDP growth, which currently stands at **2 percent**, and raise inflation to 2 percent via short-term stimulus spending, monetary easing, and reforms that will boost domestic labor markets and increase trade partnerships.

"What's important is that, in some sense, it's a gigantic experiment in monetary policy," said Greg Ip, U.S. editor of the *Economist*. "Those who have been frustrated by the performance of the Japanese economy have argued that the problem is not the failure of unconventional monetary policies, but the failure of the Bank of Japan to properly or more enthusiastically embrace those policies. Now that the Bank of Japan is embracing them about as enthusiastically as possible, we're going to see whether they really work."

Following the departure of former central bank governor Masaaki Shirakawa, Japan's central bank set an inflation target of 2 percent in January 2013, which it pledged to achieve through quantitative easing that would buy up mostly short-term government debt in an asset purchase plan due to start in 2014. Haruhiko Kuroda, a proponent of aggressive easing policies, was installed in February 2013 as the new head of the central bank **in a move** that Abe roundly touted as a "regime change" at the BOJ.

> *While monetary and fiscal policies will do most of the heavy lifting in the short term, structural reforms, which the BOJ has argued are long overdue, will be the long-term linchpin of Abe's plans.*

Abe also ordered a hefty 10.3 trillion yen **short-term stimulus package**, approved by the cabinet in January 2013, which will go toward infrastructure projects with a focus on building bridges, tunnels, and earthquake-resistant roads. Around a third of the package, which is Japan's second-largest ever, is earmarked to stimulate private investment, including steps to promote clean energy. Abe announced in October 2013 that he would raise the consumption tax in April 2014 from 5 percent to 8 percent; this is projected to increase to 10 percent in 2015. Some fear that the rise could halt recovery, as higher prices haven't yet been matched by higher wages. The International Monetary Fund warned that Japanese economic **growth would slow** from 2 percent to 1.2 percent in 2014 due to the hike.

While monetary and fiscal policies will do most of the heavy lifting in the short term, structural reforms, which the BOJ has argued are long overdue, will be the long-term linchpin of Abe's plans. Japan's troubling demographic landscape—the population of Japanese workers between ages fifteen and sixty-four has contracted by **6 percent** in the past decade—has been one of the largest culprits in hampering growth. Initiatives to counteract this trend include encouraging **greater female participation** in the workforce by adopting more comprehensive child-care support policies. Abe's government has also laid out specific initiatives to overhaul regulations in key sectors like energy, environment, and health care. In October 2013, Japan's parliament began debating the "third arrow" of its economic plan, although some topics, including Japan's labor laws and medical insurance, will likely be **left off the table**.

But one of the most high-profile elements of Abe's structural reform plans includes his decision to join the **Trans-Pacific Partnership (TPP)** [PDF], a proposed regional free trade agreement being negotiated between the United States and eleven other countries in Asia and the Americas. On March 15, 2013, Abe announced that Japan—which accounted for 14 percent, or $146 billion, of U.S. goods trade with TPP partners in 2012—would seek to participate in the **TPP negotiations**.

"What makes me more hopeful is that I see a positive convergence between the domestic efforts, the economic strategy, and what's been going on in the trade front," said **Mireya Solís**, a senior fellow at the Brookings Center for East Asia Policy Studies. "But this is just the tip of the iceberg. Three more TPP countries have to say yes to the plan, including the United States. There are many different hurdles, and we will have to see how it turns out in the future."

The partnership remains controversial, however, as some industries with significant political clout have vehemently protested against Japan's participation. The agriculture industry, for instance, has argued that the sector would take a hit from foreign competition due to the removal of high tariffs and other protective measures on imports. Some health-care providers have also complained that Japan's national health insurance system would be adversely affected as the TPP would force Japanese citizens to buy foreign-produced pharmaceuticals and medical devices. Despite these domestic sensitivities, Abe nonetheless insisted that Japan needed to take advantage of the "**last chance**" it had to remain an economic power in Asia.

How will it reinvigorate Japan's economy?

Abe hopes the easing of monetary policy will drive down exchange rates, which would give exports a major boost. The yen has fallen **7.8 percent** against the dollar since the end of 2012, dipping to a twenty-seven–month low last December and prompting Japanese manufacturers to predict a rebound **in production**. The hope is that a rise in corporate earnings will result in higher wages, thus increasing private consumption and boosting stock prices. So far, markets have rallied: the Nikkei index is up almost 40 percent and consumer prices are rising, albeit on the back of higher imported energy costs. These forces should cumulatively create a wealth effect, which Abe's government hopes will translate to higher growth as consumers are driven to spend more. In September 2013, the government revised Japan's GDP growth rate for the April–June quarter to 3.8 percent from 2.6 percent. A survey in October showed that **business sentiment** since Abenomics was launched was its most robust in six years.

> *"For some time now, many Japanese have been pessimistic about their future, and this lack of optimism and energy has been a significant factor in the economic and political doldrums there." —Sheila Smith, Council on Foreign Relations*

The fiscal push is aimed at reviving growth in the short term through a boost in government consumption and public works investment. The government has said that the extra spending will increase gross domestic product by about two percentage points and create about six hundred thousand jobs by revitalizing local economies. Analysts say that if the money is spent well on projects like energy-saving technologies, the rewards could be huge and bolster efficiency and tax revenues.

In the first week of April, Kuroda chaired his first policy meeting and announced that the central bank would be expanding its purchases of government bonds and buying riskier assets, entering "a **new phase** of monetary easing in terms of quantity and quality," Kuroda said. Markets surged upon the news, with the Nikkei 225 stock average leaping as much as **4.7 percent** to its highest level since August 2008, while the yen hit a new three-year low. Yields also fell on long-dated Japanese government debt.

What are the risks?

Critics point to major risks in the execution of the policies, including **hyperinflation** and the possible collapse of the yen, as well as the possibility that Abe's plan may do **too little** to reverse the deeply entrenched deflation. Japan's enormous debt load has been at the forefront of many criticisms, with some saying that Japan's national debt, which at **$10.46 trillion** is more than twice its GDP, is simply too large to afford an adequate rise in interest rates. Ip says that one circulating worry is that investors, anticipating inflation, could put a scare in the bond market by selling from fear that their investments will lose value in real terms. "Because Japan's debt is so large, [some people think that] rising interest rates would have a negative impact on the deficit and fiscal position of the government," says Ip, who thinks that these fears are overblown. "People don't realize that the whole point of the policy is to get inflation to go up by more than interest rates go up. You buy the bonds in order to cause inflation and in hopes of creating a real negative interest rate. That causes nominal GDP to go up faster than the debt, reducing the debt/GDP ratio."

Until now, the vast majority of Japan's debt has been **held domestically**—unlike Greece or other troubled eurozone member states—but the country's aging demographics have some analysts worrying that without drastic reforms, Japan may need to look abroad for financing, where demand for yields will be even higher. Those who remember the unfinished **public projects** that littered Japan's "lost decade" in the late 1980s also worry about fiscal discipline and the allocation of Abe's debt-financed stimulus. Critics worry that if the cash from the spending spree is wasted on politically beneficial pork barrel expenditures, the stimulus will only add to an egregious debt load without boosting output. "In a country where pork barrel projects have been rampant, infrastructure projects that seek to cater to the needs of construction companies have been a very common fact of political life," said Solís. "That it's in an electoral year gives me plenty of reasons to worry that when you are putting together a very hefty stimulus package, you are indeed using it in a wise manner and not just for the sake of spending to generate political support."

There is also worry that the fiscal and monetary efforts could give the government **an excuse** to postpone crucial structural reforms like deregulation and the opening up of trade to international competition. In October, the IMF warned that Japan could sustain substantial risk to its financial stability if Abe's government does not implement its planned **structural reforms**. "Failure to enact these reforms could lead to a return of deflation and increased bank holdings of government debt," it said.

What is different about Abenomics?

Japan's chronic deflation has resulted in weak demand, despite interest rates floating at 0 percent for years. Over the past two decades, the Japanese government has spent trillions of dollars in various bids to lift its economy out of a severe downturn catalyzed by the bursting of a real estate bubble in the late 1980s. During those years Japan accumulated the largest public debt in the developed world—around 180 percent of its $5.5 trillion economy—yet failed to generate an effective recovery. "For some time now, many Japanese have been pessimistic about their future, and this lack of optimism and energy has been a significant factor in the economic and political doldrums there," said **Sheila Smith**, CFR's senior fellow for Japan studies.

Analysts say that while there isn't much that's technically new about Abenomics, the sheer breadth and comprehensiveness of its mandates make it somewhat remarkable. "I think the combination of those elements and the force of will together are unprecedented," says Ip. "There is a vociferous and full-throated commitment of the central bank's leadership to achieving these goals, as opposed to constantly making excuses about why they couldn't."

So far, Abenomics has received **tepid praise**. In April 2014, the International Monetary Fund cut its growth forecast for Japan and emphasized the need to follow through on promised reforms, particularly structural ones, to ensure a turnaround. Although a hike in consumption tax marked a step toward curbing public debt, the **languishing of TPP negotiations** has elicited much criticism.

What does this mean for the global economy?

The effects of Abe's policies will have a long-standing impact in the international arena, especially as the world's export-led economies like Germany and China begin sounding off warnings about a **currency war**, otherwise known as competitive devaluation, where countries vie for low exchange rates to boost demand for domestic industry. Recent sovereignty disputes with Beijing over the **Diaoyu/Senkaku** islands in the East China Sea have spilled over into the economic relationship, and the yen's drop has only escalated the discord between the world's second- and third-largest economies. Abe has a reputation of being **hawkish** and fiercely nationalistic, which some observers worry will translate to increased defense spending that could derail some fundamentals of his economic plan. Yet Solís, objecting to views that the TPP is a way of containing Beijing, says that she expects the pragmatic side of Abe to prevail. "There's been this desire to not add fuel to the fire, and to have stable relations with China," she said. "I think everybody understands what tragic consequences could arise from using a very nationalist rhetoric that would be quite self-defeating."

> *"Almost the entire rich world is stuck in a zero interest rate liquidity trap situation, and I think everybody is haunted by the possibility that there's no way out of it. If Japan shows a way out of that, it will be very encouraging."—Greg Ip, Economist*

Others note that the TPP, in particular, has been a positive development for U.S.-Japan relations, which is one of the biggest platforms on which Abe **campaigned**. And in the context of Washington's Asia pivot, trade engagement and transparency via the TPP could forge an effective partnership with the new government of Japan and ensure that the United States can benefit from renewed engagement with Asia. "Obama and Abe successfully shifted the focus of the U.S.-Japan agenda to our mutual economic interests," said Smith. "The U.S. needs deeper economic ties with Asia, and cooperation in TPP is a part of that. Neither Tokyo nor Washington wants each other's economies to be weak, so there is much anticipation—and trepidation—about Abe's approach."

Japan faces myriad risks in the adoption and execution of Abe's grand plan, and critics have voiced plenty of concern over the audacity of the strategy. "The government might be tempted to rely on rapid inflation to try to reduce the real value of its debt," **Martin Feldstein** wrote for Project Syndicate.

"Fear of that strategy could cause investors to demand even higher real interest rates. The combination of exploding debt and rising interest rates is a recipe for economic disaster."

A hike in inflation within the year would signal a good beginning for Abe's radical overhaul, although, as Ip says, "it's still early days."

"It provides hope, by the way, for other countries," Ip said. "Almost the entire rich world is stuck in a zero interest rate liquidity trap situation, and I think everybody is haunted by the possibility that there's no way out of it. If Japan shows a way out of that, it will be very encouraging."

Additional Resources

This **Economist Intelligence Unit report** outlines some of Abe's policies and evaluates their potential efficacy.

This August 2013 **IMF country report** [PDF] discusses Japan's hopes for economic recovery.

The **Congressional Research Service** [PDF] discusses the major elements of the Trans-Pacific Partnership.

The Daiwa Institute of Research Group presents a multifaceted examination of the economic policies of the Abe administration in **this report** [PDF].

BOJ governor Haruhiko Kuroda discusses the challenges of overcoming deflation and Japan's economic policy in this **CFR meeting**.

Martin Feldstein argues against Abenomics in this January 2013 **Project Syndicate op-ed**.

This April 2013 ***Economist* article** appraises Abenomics.

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