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Abe-nomics

WILL THE THREE ARROWS HIT HOME?

The Japanese economy is a major source of capital, demand and technology transfer for Australia and the rest of the Asian region. Japan's immense scale – it is the world's third- or fourth-largest national economy depending on the weighting system used, Australia's second-largest trading partner, and China's largest – and its formidable corporate diaspora, have enabled it to retain a high degree of relevance despite its poor track record with economic growth over the last two decades. Quite simply, Japan matters, stagnation caveat or no. And if the stagnation caveat could be rendered obsolete, Australia would be in an enviable position to leverage the multitude of opportunities that would arise.

A bold new Japanese administration is acting to overturn the lazy assumption that, with a declining working-age population and a deeply embedded deflationary mindset, Japan is condemned to genteel decline.This essay outlines the basic contours of the "Abe-nomics" agenda, considers its early successes, and notes what is yet to be done.

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The ramifications of success

What is good for Japanese potential growth will also be of benefit to the global economy, its Asian neighbours and, of course, Australia. The direct impact of Japan achieving its 2% growth target between now and 2020, relative to a pre-existing baseline forecast, would be an extra $US360 billion in economic activity. That could translate into an additional $US4 billion in Australian export revenues under existing market share and compositional parameters. However, with the Japanese economy opening up to greater international competition, consuming more energy, tourism, foreign education and the like, no doubt that number could go even higher.

Japanese investment in Australia is currently significantly greater than by any other Asian country, and strong Japanese growth would likely be felt across a range of sectors due to the broad trade relationship with Australia. This would likely include finance, agribusiness, fisheries, resources, the hi-tech industry, food and beverages, tourism and advanced manufacturing. Certain high-level professional services would be among those likely to benefit: for example, there are strong links between Australia and Japan in the legal sector and in architecture. Japanese growth could also be expected to create opportunities in education, with Japan planning to send more students abroad as part of its reforms.

Japan's bold plan to defeat deflation

The economic policy platform of Japan's latest Liberal Democratic Party Government, led by Shinzo Abe, is unique in the post-bubble era. The plan dubbed "Abe-nomics" is a calculated, bold, high-risk-high-reward strategy, the basic premises of which have been very effectively communicated to the public by the Prime Minister and his experienced Finance Minister, Taro Aso. Furthermore, the initial aspect of the program has been executed very skilfully by the Bank of Japan Governor, Haruhiko Kuroda.

Never before in Japan's post-bubble history have policymakers brought such promising plans to the table while augmenting them with quality communication skills and adept execution.

The basics

Abe-nomics is a tripartite platform, with monetary, fiscal and structural reform components. The Prime Minister has borrowed from folklore to build a compelling public narrative around the three major aspects of his policy, dubbing them arrows. This imagery pays homage to the traditional tale of a legendary samurai, who teaches his three sons the value of teamwork. His method is to illustrate that while individual arrows can be easily broken, three arrows held together are much more formidable.

Abe's three arrows are: 1) an aggressive easing of monetary policy aimed at defeating deflation, 2) an expansionary fiscal policy centred on public works and reconstruction, and 3) structural reforms that aim to boost long-run potential growth.

Monetary policy and prices

A little history and a little theory are required to comprehend this challenge. First, the history. The overall Japanese price level has declined at a compound annual rate of 1.1% since 1994. Land prices have declined by 63% from their peak and are presently back around the level seen in the early 1970s. House price-to-rent ratios have almost halved since 1995. In short, goods and services and asset price deflation have been an enduring characteristic of the Japanese economic experience of recent decades.

As for the theory, future inflation is generally thought to rely on the level of resource utilisation (whether the economy is operating at, above or below its potential) and the public's expectations of where inflation might go (which is heavily influenced by current inflation), which will inform individual and collective economic decision-making.

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The present level of resource utilisation is low. Before this year, the economy had contracted in a little over one half of the completed quarters since September 2007. Excess capacity remains considerable. The capital stock of firms has increased by 80% since the peak in land prices, while their total sales have increased by just 6%. That implies downward pressure on future prices from this perspective for some time to come. That puts a large burden on expectations: but as they are not independent of revealed inflation, the argument can become circular quite quickly.

So what is one to do? The last time Japan achieved an inflation rate above its recently installed 2% target was for three months in mid 2008, when the oil price temporarily rose above $US150 per barrel and USD/JPY had averaged ¥113 in the previous 18 months (it averaged ¥79 in the year to October 2012 and ¥94 between November 2012 and August 2013). This experience highlights that perhaps the most promising channels for jolting inflation higher, thereby potentially breaking the vicious dynamics between current deflation and future expectations, are a lower yen and sustained rise in global energy prices.

The foreign exchange market has obliged by bringing about an approximate 25% depreciation in the USD exchange rate (and something similar in real trade-weighted terms). A lower exchange rate not only boosts imported inflation directly. Its ability to increase the profitability of the corporate sector is a valuable contribution to raising confidence, and ultimately spurring growth. Further, Governor Kuroda's bold execution has succeeded in raising inflation expectations, with consumer surveys and implied rates in the bond market both showing a material increase. There is little evidence yet that this increase in expectations is influencing corporate pricing and wage strategies, but the government ought to be satisfied with the results at this early stage.

Fiscal expansion

The second arrow comprises a sustained, large-scale program of expansionary public expenditure, centred on public works and reconstruction. This is a high-risk endeavour because the Japanese government's debt position is already extremely stretched, and any sustained rise in bond yields would be catastrophic for its fiscal sustainability. That is why Abe and Aso have repeatedly indicated that the central bank and the Finance Ministry should "cooperate" on debt management. That is code for the fact that yields must remain low if an expansionary fiscal policy is to be feasible. That is also why the government seems to be willing to countenance a long-overdue increase in the consumption tax on the schedule proposed by their predecessors (from 5% to 8% in April 2014, and from 8% to 10% in October 2015), despite the deep electoral scars left by the ill-starred attempt to do so in the late 1990s.

Structural reform

The third arrow will ultimately determine the success or failure of Abe-nomics. Deep-seated reform is a necessary component of any genuine effort to raise long-run growth potential, thereby aiding the deflation exit and the sovereign's ultimate financial viability. Most of what is described below is yet to be enacted, as Abe held back much of the detail until the lower house elections of July 21 had passed.

The major policy document relating to the third arrow is entitled "Japan revitalisation strategy: Japan is Back". This is not the first voluminous document produced by the Japanese bureaucracy with a similar theme. But this effort, alongside the aspirational rhetoric and fashionable jargon, sets concrete targets with transparent timelines for their achievement.

The targets are broad-ranging, as they should be. At the top level, the initial targets are 2% growth in labour productivity, 2% growth in real GDP and 3% growth in nominal GDP, with higher rates anticipated

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by late in this decade. On a sectoral basis, there are plans for energy deregulation, an education overhaul, agricultural concentration, 'ICT-ification', health technology and services, infrastructure exports, cultural exports, more liberal migration, and greater inward investment and tourism. Private entry to industries dominated by public entities, competition policy and industrial restructuring and upgrading are prominent. There are targets for female labour force participation, labour market flexibility, the rate of business churn, global university rankings, SME exports, the corporatisation of agricultural landholdings and improvements in various survey-based indicators of international competitiveness at the country, city and regional levels. There is also an intriguing idea to create experimental special economic zones to attract investment (from local firms, from genuinely foreign firms, and from Japanese firms that have gone abroad) through a tailored pro-business environment.

There is also a move towards greater participation in trade liberalisation efforts, through both bilateral and regional agreements. Most prominently, Japan has indicated that it will join the Trans-Pacific Partnership (the TPP), a grouping that presently includes the US, Australia, New Zealand, Thailand, Vietnam, Malaysia, Singapore, Canada, Brunei, Chile and Mexico. TPP is ideal for Abe's purposes, as it is focused on 'advanced-country problems' like intellectual property, financial services, access for foreign investment and government procurement.

Some preliminary judgements

The first arrow has gone straight to the mark. Aggressive monetary easing has purchased the government invaluable breathing space to unfurl an ambitious and far-reaching reform agenda.

Trends already under way in public spending have helped to boost growth in the first half of 2013, and most private-sector forecasters have revised their medium forecasts higher as a result.

Despite this extremely promising beginning, habits of scepticism die hard, especially in relationship to Japan. Once the current reconstruction effort concludes, it is unclear exactly what a sharply increased public works budget will be spent on in the second half of this decade. Similarly, it is unclear why foreign and Japanese firms will seek to physically invest more in Japan rather than elsewhere, even in new pro-business zones. Japan's private capital stock is more than ample already, and labour costs will remain uncompetitive in all but the most advanced pursuits. Furthermore, if inflation expectations stay where they are, wage earners will be less willing to accept stable nominal pay, which will discourage home investment, rather than sponsoring it.

Additionally, there is the matter of fiscal sustainability and how it may influence corporate decision-making. Japan's public debt is immense. The government needs to increase the taxation share of national income in the long run, not reduce it. Those companies considering the best location for long-lived, immovable capital will no doubt perceive that any tax 'discount' they receive at inception should not be counted on for the life of the investment.

What can be viewed with more certainty is that Japan should now approach international trade negotiations from a third perspective: domestic reform. That will be added to the traditional motivations for engagement on this front of 1) resource security and 2) foreign market access. That should lead to more productive conversations between Japanese negotiators and their various counterparts, including in Australia, where FTA talks have been tortuous to date.

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