The “Three Arrows” policy-mix adopted by the current Abe administration remains a combination of monetary, fiscal and microeconomic policies.

While the monetary policy executed by the Bank of Japan achieved some of the goals, the outcome of fiscal and growth strategy policies remain uncertain.

The success or failure of Abe’s policy ultimately depends on the “Third Arrow” that contains the element of industrial competition policy, although its instruments critically differ from conventional activist approaches that Japan adopted before the 1980s.

It is still too early to make the final judgement on Abenomics, especially its policies on competitiveness.
Business-Government Relations in Japan: The 1950s to the 1990s

**Zaikai**

- Japan Business Federation
- Japan Federation of Employers’ Associations
- Japan Association of Corporate Executives
- Japan Chamber of Commerce and Industry

**Government**

- Administration
- Ministries
- Bank of Japan

The diagram illustrates the relationship between Zaikai (business associations) and the Government, highlighting the Bank of Japan as a key institution.
Schumpeterian Innovation Coordinated by Activist Industrial Policy

Supply

International

Domestic

Entrepreneurship

Demand

Technological know-how

Financial Resources (Banks)

Large industrial enterprises

Growing domestic markets

Growing international markets

Industrial Policy

Government agencies

MITI

MOF

Zaikai Corporate Community
The End of Classic Industrial Policy

- Activist policy for industrial competitiveness became dysfunctional in the 1980s as:
  - Governmental dynamics shifted as ministries lost the instrumental mechanism to control and influence corporate behavior.
  - Firm behavior changed as corporations became self-sufficient in terms of technology acquisition and growth financing.
  - International environmental settings became competitive as the East Asian Tigers such as South Korea, Taiwan and especially China established themselves as the major player of global industries.
Basic Troubles in the 1980s: Potentials That Would Create Chaos

- Japanese enterprises enjoyed high profitability and international reputation
- Huge free cash flow on its own!
- Bank loan was thus not needed anymore
- Shareholders, institutional as well as individual, remained weak
- No more government interventions and regulations especially by MITI

⇒ Agency problems: Quick and Dirty growth-oriented profitability-harming behavior committed by the management: Speculation in real estate and corporate shares?
Sales Growth and Performance Decline of Japanese Listed Corporations

![Graph showing sales growth and ROS over time.](image)

- **Rapid Growth**
- **Bubble**
- **Recession**

**ROS**

**Sales growth**
Basic Troubles in the 1990s: Nagging Concerns That Didn’t Go Away

- (Grossly) underestimated problems
  - Industrial enterprises
    - Three major excesses:
      - Huge debt (Non-performing debt)
      - Excess capacity
      - Surplus employees
  - Banks and financial institutions
    - Non-performing loans
- Government lost the grip of the economy
  - Wasting the entire decade (The Lost Decade) by not acknowledging, coping with or fixing all the macroeconomic troubles.
High Savings, High Investments, High Growth? Those Day Are Gone!

- Good old days of high savings and high investment:
  - Young households’ savings remained high
  - ⇒ deposits in commercial banks
  - ⇒ long-term loans to industrial companies
  - ⇒ large-scale productivity-oriented investment
  - ⇒ international competitiveness

- Bad new reality of low investment:
  - Ageing and shrinking households don’t save
  - ⇒ companies do not invest!
  - ⇒ companies do not need bank loans
  - ⇒ banks commit to unsecured loans
  - ⇒ they get flooded with bad loans
Prosperity Is Just Around the Corner?

- The administrations of the **Liberal Democratic Party** that lasted to 1993 and came back to power in 1996 could not resolve nagging troubles of the Japanese economy.
- Yen continued to appreciate in spite of the weak economy.
- The commercial banking sector saddled with non-performing loans and suffered from low equity ratio.
- The industrial sector gradually lost international competitiveness.
- Government started relying on bond issuance, as fiscal revenue secularly declined.
- Economic growth visibly slowed down.
Strong Yen Continues, No Matter What!

Fig. 7.2. Yen Exchange Rates (end-of-month rates)


Source: Bank of Japan
Fiscal Deficits Increased

Lost Decades

Expenditure
Revenue
Bond Issue

(兆円)
120
100
80
60
40
20
0

1990  2000  2010
Long-term Growth Rate of Japanese Economy

Notice the frequency of recessions in slow growth economy.

Lost Decades
Here Came the Koizumi Reform

- The Koizumi administration of the LDP (2001-2006) ultimately put the Japanese economy on the (slow) growth path by:
  - Forcing banks to write-off non-performing loans to restore the credibility of financial system
  - Establishing Financial Supervision Agency
  - Privatizing government-owned businesses such as highways and postal system
  - Refusing to rely on fiscal stimuli to revive economy, as they worried about 1) fiscal discipline and 2) crowd-out effects.
Why Not Industrial Policy?
Success Created Failure!

- The apparent success of those microeconomic policy mechanisms to lead Japan to economic maturity created the adversarial conditions:
  - The industry targeting lost its focus, as Japan now stands at the world frontier.
  - Industrial companies are self-sufficient in terms of technology and financial resources.
  - East Asian nations applied the similar learning paradigms to the success of their economies.
  - WTO ruled out industrial policies (except for technology policy).
Toward New Forms of Industrial Policy?

- Learning from other East Asian nations
- Toward the industrial future!
  - High-tech industrial policy!
  - Technology policy! WTO rules tolerate.
  - Policies for SMEs? Entrepreneurship!
  - Tradable goods only? Services!
  - Human resources? Business schools!
- MITI (and its successor, METI) misplaced its policy focus and lost bureaucratic credibility.
Trends in R&D Expenditure in the Major Countries

Source: Japan Ministry of Education

出典: 文部科学省「科学技術要覧（平成24年度版）」
Can Japan Compete in Technology?

- Japanese government has been heavily pressing companies to invest in R&D in terms of both human capital and financial resources.
- Competition has got much tougher:
  - The U.S. reinvented itself as an economy committed to technology.
  - Europe is holding on to its past glory.
  - Emerging nations such as China and Korea have investing heavily in R&D.
- Who wins in the end? How Japan fares?
Relative Decline of Bureaucracy-led Industrial Policies

- MITI’s bureaucrats, especially in-house economists (官庁エコノミスト or bureaucrat economists), have eventually lost the prestige, power and capacity to formulate basic policies for industrial competitiveness.

- In their place the executive blanch (beginning with the Koizumi administration, 2001-2006) started exercising the formulating basic policy agendas with the assistance of academic economists and bureaucrats.

- Bureaucrat economists are practical and goal-oriented, while academic economists exhibit different philosophy especially about microeconomic interventions in market mechanism.
Business-Government Relations in Japan: The 2000s and On

Zaikai

- Japan Business Federation
- Japan Federation of Employers’ Associations
- Japan Association of Corporate Executives
- Japan Chamber of Commerce and Industry

Government

- Administration
- Ministries
- Bank of Japan
Shifting Policy Brains: From Bureaucrat Economists

- **Osamu Shimomura (Ikeda Administration)**
  - Graduated from the Economics Department, University of Tokyo
  - Entered Ministry of Finance
  - Published *Growth of Japanese Economy* in 1962 by which became brains of the Ikeda administration that generated rapid economic growth in the 1960s.

- **Heizo Takenaka (Koizumi Administration)**
  - Graduated from the Economics Department, Hitotsubashi University
  - Entered Japan Development Bank
  - Published *Economics of R&D* in 1984
  - Became the brains of the Koizumi administration that resolved the nagging troubles of financial systems since the early 1960s.
Shifting Policy Brains: To Academic Economists

- **Kikuo Iwata (Abe Administration)**
  - Graduated from the Economics Graduate School, University of Tokyo
  - Entered Jochi University teaching macroeconomics and finance
  - Entered the Bank of Japan as a vice-president after bitterly criticizing it for a long time

- **Koichi Hamada (Abe Administration)**
  - Graduated from the Economics Graduate School, Yale University
  - Entered University of Tokyo teaching finance
  - Entered Yale University teaching finance
  - Became the major brains of Abe
From Government Activism to Growth Strategy with Structural Reforms

- **Government activism:** MITI (and, to a lesser extent, MOF) did not hesitate to commit to microeconomic interventions into market prices and to introduce price regulations.
- **Intellectual climate shifted to avoid distorting market prices or holding on to price regulations.**
- **Structural reform policy:** The administration remains as the organizer of institutional infrastructure to allow private businesses to operate most effectively (without government-owned enterprises or price regulations).
Here Comes “Abenomics”!

- After he took office in late 2012, Shinzo Abe claimed his policies as a magic pill to cure all the illnesses of Japanese economy.

  - Economic growth by two macroeconomic and one microeconomic policies
    - First arrow: Monetary policy
    - Second arrow: Fiscal policy
    - Third arrow: Growth strategy with Structural reform
  
  - Fiscal discipline by sales tax hike
    - Sale tax to 8% in 2014 and to 10% in 2016?
Abe’s Policy Mix of “Three Arrows”

- The “Three Arrows” policy-mix adopted by the current Abe administration remains an incoherent combination of monetary, fiscal and microeconomic policies.
- While the first two macroeconomic policies attracted much attention, the last element, microeconomic competitiveness policy should play the key role.
- Abe formed Industrial Competitiveness Council in 2013 to which he invited business leaders.

Source: Prime Minister of Japan and His Cabinet, *Prime Minister in Action*
Abenomics' Three Steps!

"Freedom to Businesses through Deregulation!!!"

Source: Abe Administration homepage
Contents of Monetary Policies

- Inflation targeting (2% in 2 years!)
  - The Bank of Japan makes call rate (short-term prime rate) negative.
  - “Unlimited” quantitative easing to increase money supply.
- Loosing conventional conservative policies to purchase short-term government bond.
- Correcting overvalued yen to help out struggling domestic industries.
- Revision of the legislation regarding the Bank of Japan.
Contents of Fiscal Policies

- Short-term stimulus packages
  - Public infrastructure projects on the large-scale such as roads, tunnels and bridges.
  - Promoting projects for clean energy and earthquake-resistant infrastructure.
  - Issuing government “construction bonds” that the Bank of Japan bought.
Outcomes of Monetary and Fiscal Policies

- Kuroda’s new monetary policy should result in moderate inflation (No).
- Expected inflation should works as a stimulus for consumers to start spending (No).
- Expected consumer demand should encourage firms to invest more and hire more with higher salaries (Yes/No).
- Expected inflation as well as increased money supply should lower the value of yen (Yes).
- Expected higher international demand and domestic disposable income should further encourage more active economic activities by Japanese firms (Yes/No).
- Expected higher international demand and domestic disposable income should invigorate stock markets (Yes).
Inflation Target of 2% Achieved in Two Years?

Source: Financial Sense
Functions and Outcomes of Fiscal Policies

- Abe’s fiscal spending on public infrastructure projects and energy-saving and earthquake resistant buildings should function as a classic Keynesian “prime the pump” instrument to “crowed in” private investment that will generate economic growth momentum.
Problems of Monetary and Fiscal Policies

- Economists: No theoretical coherence, monetarist or Keynesian? Mixed bag!
- The whole policies of monetary and fiscal policies go against the principle of fiscal discipline!
  - Aggressive policies to purchase government debt by bank notes issued by the central bank may ultimately result in hyperinflation.
  - Adding more fiscal burden to the already astronomical government debt (unless Abe’s policy recrates economic miracle that will generate huge tax revenue!).
The Third Arrow as the Key Factor

- The policy instruments of the “Third Arrow” critically differ from conventional approaches that Japan adopted before the 1980s.
  - The role of the government remains passive. The corporate sector plays the major and active role.
- Growth Strategy by structural reform to create a firm-friendly market environment
  - Deregulation in energy, health care and agricultural sectors
  - Regulatory reforms in labor markets
  - Corporate governance reforms of U.S. style
The Third Arrow: Growth Strategy Crowsed-In Private Investment

- Lowering corporate income tax
- Deregulation, microeconomic, for creating business-friendly environment
- Opening strategic industries as agriculture, energy, health care to international firms
- Corporate governance reform in introducing global standards to entice foreign investors to buy into Japanese corporations
- Deregulation and reform, social and labor market, to utilize hidden resources: “Japan with Shining Women!” by allowing the employment of foreign domestic workers
Getting Out of Deflation, Japan’s Economy Reborn!

- Virtuous cycle perpetuates:
  - Corporate performance improves
  - Corporate investment expands
  - Compensation goes up
  - Consumption grows

- Everybody, households as well as corporations, will be happy thereafter!

- Where METI plays a role?

Source: METI homepage
Abenomics After Two Years: “Flowers Are Consecutively Blooming!”

Share Prices
- **実質GDP**
  - 年率 +1.5%成長 (2014年10-12月期)
  - 累計 +1.5%成長 (2014年10-12月期/2012年10-12月期)

- **株価**
  - 政権発足後+90% (2015年3月26日 日経平均)

- **有効求人倍率**
  - 引き続き高水準 (2015年2月 1.15倍)

- **賃金引上げ**
  - 平均月額：過去15年で最高水準
  - 夏季賞与：過去23年で最高水準

Corporate Profits
- **企業の経常利益**
  - 過去最高水準 (2014年10－12月期 17.6兆円)

- **女性就業数**
  - 政権発足後、94万人増加 (2015年2月 2,747万人)

- **企業倒産件数**
  - 24年ぶりに年間1万件を下回る (2014年 9,731件)

- **外国人訪日客数**
  - 2014年 1,341万人
    - (前年比29.4%増・過去最高)

**Source: Abe Administration homepage**
Why Large Corporation Became Profitable?

- Facing rapidly appreciating yen since the mid-1980s:
  - Japanese corporations relatively shifted their production to overseas locations.
  - This overseas investment now generates much profit.
  - Depreciating yen further inflate the profit in yen terms.
- Corporate profits became sensitive to exchange rate
Has Abenomics Revived the International Competitiveness of Japan’s Industries?

Source: IMD Global Competitiveness Report

2014/2015
Japan (#21/27)
U.S. (#1/1)
Singapore (#3/3)
Germany (#6/10)
U.K. (#16/19)
China (#23/22)
Korea (#26/25)
France (#27/32)

Source: IMD Global Competitiveness Report
Recent Trends in Current Account and Trade Balances

Source: Asahi Newspaper, May 14, 2015
Export Struggles, While Import Soars!

Abenomics
Changing Compositions of Current Account Balance

Figure 1: Changes in Japan’s Current Account Balance

Note: Yearly averages and quarterly numbers are annualized; unit in 1 billion yen; % used for comparison vs GDP.

Source: Balance of International Payments statistics from the Ministry of Finance Japan, National Accounts statistics from the Cabinet Office

Source: Japan Foreign Policy Forum
Why Domestic Industries Still Struggle?

- As production moved away, corporations lowered incremental investment in domestic facilities. ⇒ “Hollowing” of Japanese economy
- Export competitiveness of Japanese products relatively declined.
- Export became insensitive to exchange rate, while import remains insensitive to it.
- Japan’s productive investment further lost momentum since the 1990s because market growth struggled thanks to: 1) lasting recession and 2) ageing and shrinking population.
Success or failure of Abenomics depends on the investment by companies as well as the consumption by households.

- Companies are not quite investing in Japanese operations because of the expected limitations of domestic markets. They rather commit to strategic activities, including M&As, in growing international markets.

- Households are not quite spending enough because of lowering earnings, consumption tax hike and uneasiness about economic future.

Can Abe break the vicious cycle?
Changing Population Structure

Source: Population Census
Trends in Share Prices and Real Wages

Real Wages

Share Prices

Abenomics

[Graph showing trends in share prices and real wages, with a notable event marked as Abenomics.]
Long-Term Trends in Unemployment

Source: Japan Statistics Bureau
Trends in Household Savings

Disposable Income (A)
Household Savings (B)
Savings Ratios (B/A)
Has Abenomics Rescued Corporations and Reinvigorated Economy?

- A calculated gamble! Still too early to predict the success or failure of the whole policies.

- Given the overseas shifts of production committed by Japanese businesses since the 1980s, yen’s depreciation that Abenomics targeted may function in dissimilar ways:
  - For the profitability of Japan’s large corporations and the earning power of the financial sector, Abenomics may be positively working.
  - For the competitiveness of Japan’s domestic industries and the welfare of average households, Abenomics may not be positively working.

- Will there be positive spillovers from the corporate sector to the domestic industrial sector?