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ABENOMICS: AN END TO JAPAN'S LOST DECADES?

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"Japan is back." This was the short yet extremely powerful title of the policy speech held by Japan's Prime Minister Shinzo Abe during a visit to the United States in February 2013. "My task is to look toward the future," said Abe, "and make Japan the second biggest emerging market in the world, and the ever more trusted partner for the region and the world."

Japan is indeed striving to return to its glory days of economic boom and prosperity that had lasted until the end of the 1980s, and were followed by the so called "lost decades" when the economy became bogged down in a vicious cycle of low growth and deflation. After taking the office in December 2012, Shinzo Abe launched a package of economic measures to kickstart the economy, which came to be known as "Abenomics". In order to determine, however, whether Abe's claim that "Japan is back" can hold true in the long term and whether Japan is truly leaving its lost decades behind, one needs to have a closer look at Abe's plan, its implementation, its early results and the challenges it is facing.

Abenomics is a three-pronged approach involving: i) monetary stimulus in the form of quantitative easing; ii) fiscal stimulus through increased government spending; and, iii) institutional and structural reforms in the long run. The idea behind this triple package is to use the monetary and fiscal stimulus to invigorate Japan's economy by increasing the money supply to create mild inflation, reduce the value of the currency and boost exports, while at the same time increasing government spending on large-scale projects to facilitate economic activity and create jobs. These measures are expected to spark economic growth and create a favorable environment for the implementation of institutional and structural reforms that will help to place the Japanese economy on a track of sustainable growth. An investigation into the performance of Abenomics so far reveals that the economy has responded positively to monetary and financial stimulus measures and Japan

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now finds itself at the stage where it can, and should, embark on structural reform.

The monetary aspect of Abenomics involves quantitative easing, in other words an increase in the money supply, that aims to reverse the long-running deflationary trend. Increasing economic activity within Japan requires increased investment and a shift towards greater consumption among the Japanese people, both of which have been extremely difficult to achieve under the deflationary environment. The Bank of Japan targets an annual inflation rate of 2 per cent, and aims to achieve this target by increasing liquidity in the market and purchasing government bonds. An inflationary trend also helps to reduce the value of the Japanese yen, the value of which had increased by 27 percent between 2007 and 2012, and is also crucial for increasing the competitiveness of Japanese exports. The value of the yen, together with the shrinking demand in external markets in the aftermath of the global crisis, has been undermining Japan's exports, and in 2011 Japan—traditionally a surplus country—has recorded a trade deficit for the first time in its history, the amount of which was 3.5 billion dollars. The trade deficit widened further to 87.1 billion dollars in 2012 and to 112.0 billion dollars in 2013, mainly due to increasing energy imports in the aftermath of the Fukushima nuclear disaster. A weaker yen is expected to improve the competitiveness of Japanese exports, thus helping to close the trade deficit.

The monetary easing is accompanied by fiscal stimulus, which takes the form of increased government spending, mainly in large-scale infrastructure and energy projects. A total expenditure of 260 billion dollars projected over a five-year period aims to stimulate private investment, create jobs and revitalize economic activity, thus eventually leading to higher growth.

The implementation of monetary and fiscal stimuli has already led to the indication of a number of positive signs. The Japanese yen is weakening as planned, which brings about the desired inflationary effect. Having ended 2012 at 86.3 yen per dollar, the Japanese currency fell in value by 22.1 percent throughout the year, closing 2013 at 105.4 yen per dollar. The inflation rate began to gain momentum during the second half of 2013, finishing the year with an increase in the consumer price index by 0.4 percent on an annual basis. The inflation rate can be expected to converge towards the Bank of Japan's target of 2 percent, as 2014 saw even higher price increases. The monthly inflation rate surged to 3.4 percent in April 2014—the highest rate since 1991—as a result of the sales tax increase at the beginning of the month.

Nearing of the inflation target is by all means a positive sign, and the fiscal stimulus that accompanies the monetary expansion can be expected to contribute to the efforts of achieving economic growth as well. Markets have also been receptive to these developments, as the Nikkei index registered a significant 56.7 percent increase in 2013, confirming the optimism of the business circles in Japan and elsewhere. However, despite this optimism, growth prospects have so far remained bleak. For the fiscal year of 2014, the Bank of Japan has revised its growth forecast from 1.4 percent down to 1.1 percent, and declining industrial production rates over the first months of 2014 add to the concerns that Japan's recovery will be more complicated than expected.

At the heart of this problem lies the fact that Japan requires a recovery in exports in order to achieve higher growth, and that a weaker currency is not sufficient on its own to achieve this goal. In fact, Japan's export volume contracted by 1.5 percent during 2013, although the yen had lost almost a quarter of its value over the same period. A weaker yen increases export prices, but not the export volumes. This is because under conditions of weak external demand—mainly due to the ongoing effects of the global economic crisis in the United States and Europe, and the slowdown in China's growth—Japan's exporters lack the competitive edge that is needed in combination with the weak currency to increase market shares in global markets.

This situation points to the importance of the third component of Abenomics, the need for structural reforms. Monetary and fiscal stimuli have been useful for breaking the deflationary spiral and they have provided maneuvering room for the government in the short term. However, for growth to be sustained in the long term, Japan needs to regain its competitiveness, which requires structural transformation, because a weaker yen and/or government induced investment and job creation can only provide a temporary solution for Japan's economic problems.

Japan's problem is that its economy is seriously lacking competitiveness. Under years of deflation and an appreciating currency, Japanese companies have found it difficult to invest in capacity enhancing measures such as research and development, while Japan's demographics and cultural idiosyncrasies have worsened the problem by negatively impacting both the quantity and quality of Japan's workforce. As a result, Japan has gradually lost its competitive edge. The monetary and fiscal components of Abenomics cannot solve this problem; they can only set the ground in macroeconomic terms, on which structural reforms can be implemented. It is the transformation that can be attained through these reforms that will ensure that "Japan is back" for real.

Structural reforms in Japan need to bring back competiveness and productivity to Japan's economy, and the starting point lies in addressing the vulnerabilities caused by the country's demographics. Japan has an ageing population and the working age portion thereof is diminishing rapidly. This is a serious burden on the economy, and Japan needs to make its workforce more flexible by increasing women's participation in economic life and opening its doors to skilled immigration, among other measures. Furthermore, increased efforts are needed to enhance the skills and capabilities of the workforce in order to increase its efficiency and productivity. Corporate governance is also a crucial area for reform. Japan's companies need to catch up with the competition in the global economy; they need to be more flexible, more efficient and able to make use of all available resources and technologies.

These structural reforms—if carried out in an effective manner—can make Japan's economy more competitive and more productive, in turn bringing Japan's export volumes back to an upward trajectory. The government's efforts for greater trade integration with the global economy, such as the decision to join the negotiations for the Trans-Pacific Partnership (TPP), are also a reinforcing factor in this process. The only question which has yet to be answered, is how far the Abe government can go with the structural reforms and how effective they can be implemented. Structural reform is the toughest of the three components of Abenomics, requiring not only macroeconomic maneuvering but also a strong political will to push ahead with changes at the societal level.

During its first one and half years, Abenomics has achieved positive results and brought renewed dynamism to Japan's economy. However, it is too early to claim that Japan's lost decades are now behind it. In order to jump back on a sustainable growth trajectory, the third component of Abe's plan—structural reforms—need to be carried out, and this means that Japan will have to navigate through challenging terrain. What the Japanese economy needs is a structural transformation, and only then will it be possible to claim that "Japan is back".