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Economic Research:

The Bull's-Eye Of The Third Arrow Of Abenomics

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Japanese Prime Minister Shinzo Abe has marketed his economic policies to revitalize the Japanese economy, popularly known as "Abenomics," as comprising "three arrows:" bold monetary policy to end deflation and secure stable 2% inflation; flexible fiscal policy for two to three years to support a strong recovery and mitigate external risks; and a growth strategy based on supply-side reforms, deregulation, and government support to boost corporate competitiveness, promote innovation, and develop new growth industries(1).

Overview

- In contrast to the "first arrow" of Abenomics--bold monetary policy to end deflation--the "third arrow," the growth strategy, has underwhelmed most observers.
- There is no lack of content and ideas in the growth strategy, but it seems to be largely a product of the bureaucracy, showing little imprint of the prime minister's vision and direction.
- The growth strategy should be based on growth accounting: growth can come only from increasing labor inputs, capital accumulation, and productivity.
- Given Japan's shrinking population and workforce, unless radical action is taken to raise the fertility rate and embrace immigration, the target to lift real GDP growth looks pie in the sky.
- One atmospheric game-changer would be for Japan to embrace joint bank accounts, joint mortgages, and joint title to property for married couples and to treat a married couple as a single unit for tax purposes.

Taking Stock

Most observers would likely agree that, relative to the policy rhetoric, Mr. Abe has exceeded expectations when it comes to the first arrow: new Bank of Japan (BOJ) governor Haruhiko Kuroda has engineered a 180-degree shift in both communication--"yes, we can (end deflation); yes, we will (end it)"--and action. On April 4, the BOJ launched an open-ended expansion of the monetary base (essentially, the central bank's balance sheet) by ¥60 trillion-¥70 trillion a year, committing to continue the policy until deflation is ended and 2% stable inflation is secured.

Mr. Abe would probably also get relatively high marks for the second arrow, although this arrow gets less attention and what "flexible fiscal policy" means is sufficiently vague to be somewhat in the eye of the beholder. The clear intent was to signal a dialing back on the longstanding policy bias toward consolidating Japan's fiscal finances and at least a temporary shift to providing a boost to growth with expansionary fiscal policy. However, the prime minister showed flexibility in the other direction by announcing on Oct. 1, after a lengthy period of consultation with experts and interested parties and internal deliberation, that the government would proceed, as scheduled, to hike the consumption tax from 5% to 8% next April (and to 10% in October 2015). This tightening is to be offset by a simultaneously timed package of temporary fiscal stimulus measures.

However, when it comes to the third arrow--the growth strategy--so far most observers seem underwhelmed. This is not for want of policy proposals coming from the government or because the growth strategy lacks specific content. On June 14 this year, the government unveiled its growth strategy in the form of a 94-page report titled "Japan is Back" ("A strategy for Japan's revival" in Japanese) setting out a range of policy goals and measures to be pursued, accompanied by a 48-page detailed roadmap and timetable for implementing these, replete with numerical targets and KPI (key performance indicators). The growth strategy contains three "action plans": a plan to revitalize Japanese industry; a plan to create strategic markets; and an internationalization strategy. The industry revitalization plan covers six areas (in turn, subdivided into 37 subcomponents): industry revitalization; employment and manpower; science and innovation; information technology; bolstering locational competitiveness; and small and medium-sized enterprises. The plan to create strategic markets encompasses four themes (in turn, comprising nine elements): longevity; clean energy; next generation infrastructure; and regionalization. The machinery of the Kasumigaseki bureaucracy clearly went into planning overdrive mode to produce this impressive panoply of growth-enhancing ideas. No policy stone appears to have been left unturned.

More Is Less

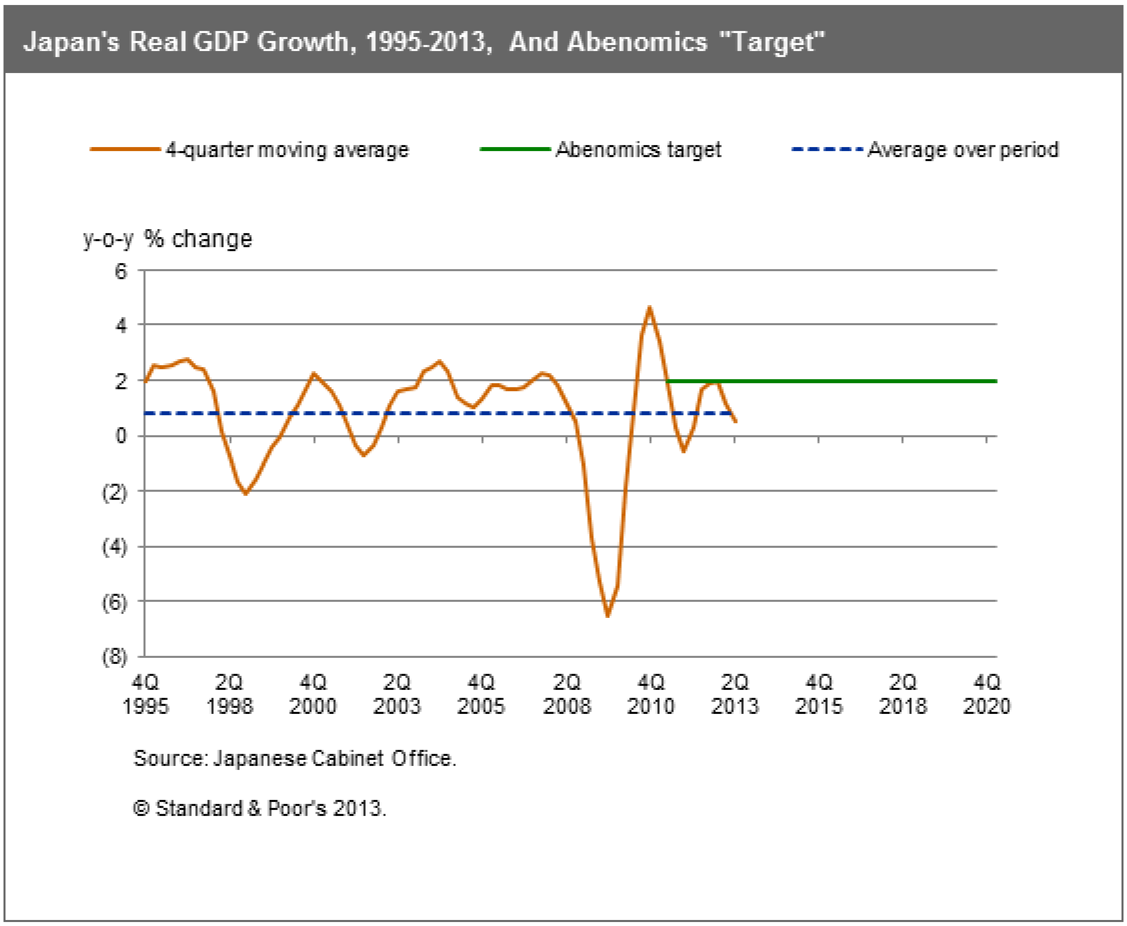
Why the disappointment then? Probably for three related reasons, all of which reinforce the sense that, when it comes to the growth strategy, it is more a case of "business as usual" than that something truly game-changing is afoot.

First, the growth strategy plan is in the grand tradition of such plans in Japan, dating back at least three decades and probably more. While some elicit more excitement and hope than others, virtually every new administration in Japan launches a new set of reform and deregulation initiatives, backed up by weighty reports produced by standing advisory panels, special commissions, and/or key parts of the bureaucracy. The Nakasone administration of the 1980s produced the Maekawa report, with its focus on stoking domestic demand. The Hosokawa administration of the early 1990s produced the Hiraiwa report, which argued that regulation should be "social" not "economic." The Hashimoto administration of the mid- to late-1990s produced the financial "big bang" and major administrative reforms. The Mori administration of the early 2000s hitched its wagon to the information technology revolution. The Koizumi administration of the first half of the 2000s trail-blazed under the slogan of "no recovery without structural reform," with privatization of the postal delivery, savings, and insurance system being the centerpiece (the privatization bit is still yet to happen). And the first Abe administration touted Japan as becoming the "Gateway to Asia."

Much was accomplished under these and similar plans of other administrations, and the economic, regulatory and institutional landscape of Japan today is much changed as a result. But, by the same token, much of what was heralded did not ensue, and, while the counterfactual cannot be observed, the reform and deregulation plans of the past two decades do not appear to have yielded much in the way of growth. Real GDP growth has averaged 0.8% year-on-year in the past 20 years and nominal growth has averaged negative 0.2%. Why should this time be different?

Second, the growth strategy plans, as detailed as they are, lack coherence and credibility, judged against the huge demographic headwinds that Japan faces and appears to be doing little directly to counter. There is a huge gap between the stated aims of the growth strategy and the reality of Japan's starting point and associated growth trend, and the growth plans don't seem to address this. The target of Abenomics is to have the economy grow at an annual average rate of 2% in real terms and 3% in nominal terms over the decade from fiscal year 2011 to fiscal year 2020, in overall, not per capita, terms (see chart 1). In the prior 10 years, quarterly real growth had averaged 0.8% year-on-year and nominal growth negative 0.4%. The implied stated goal therefore, notwithstanding stiffening demographic headwinds, is to lift the year-on-year rate of real growth by an average of 1.2 percentage points. This is a huge ask and something that has never been done in recent Japanese history.

Chart 1



Third, and perhaps most ominously, whereas Prime Minister Abe "owned" the "end deflation" or "reflation" issue, sending a clear and strong message and backing it up with decisive action, he has come across as a much more traditional political leader when it comes to the growth strategy, spouting vague and well-trodden policy rhetoric and giving the impression of subcontracting out the whole exercise to the ever-willing and, when it comes to devising detailed reform plans, capable bureaucrats of Kasumigaseki.

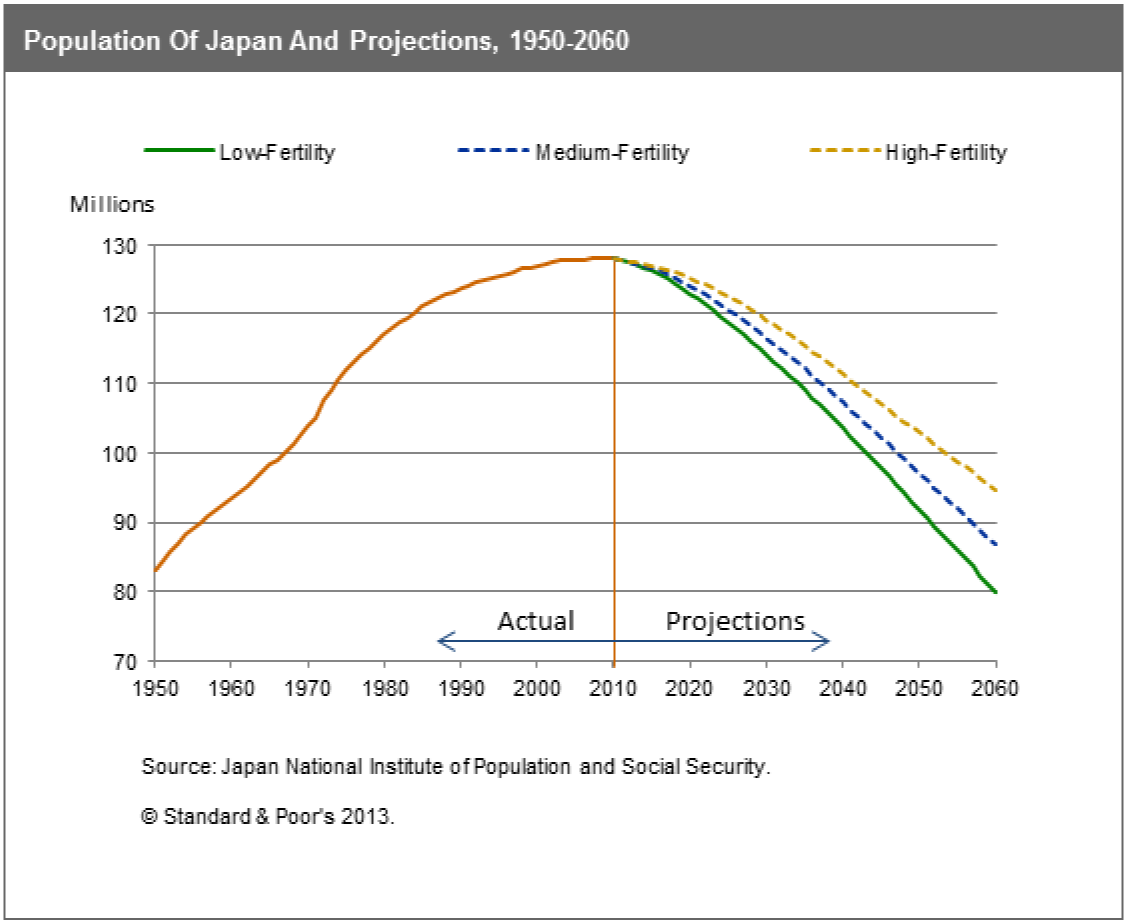
In short, the growth strategy part of Abenomics, as currently articulated, does not appear credible, relative to what it is ostensibly trying to achieve.

Conceptualizing A Growth Strategy

Economists use a "growth accounting" framework to think about real potential (or maximum sustainable) economic growth. Growth of real output can come from three sources: more labor inputs; more capital inputs; and smarter use of those inputs, or innovation (economists, not altogether helpfully, call this "total factor productivity"). To raise its potential real growth rate, Japan needs to address one or more--preferably all--of these three. It will need to expand the amount of labor going into the production of goods and services (GDP), it will have to accumulate and use more capital in that process, and it will have to raise the productivity of the labor and capital it uses, squeezing more output from a given level of inputs. That's it: there is nowhere else that growth can come from.

The Bank of Japan estimates Japan's potential annual growth rate currently to be 0.5%. But, given the demographic outlook, and assuming there is not a miraculous burst of growth-enhancing innovation, Japan's potential growth is set to decline steadily over the foreseeable and distant future (see chart 2). According to detailed population projections published by Japan's National Institute of Population and Social Security in January 2012, "Japan is expected to enter a long period of population decline." Specifically, under what the Institute sees as a "medium-fertility" projection, Japan's population, which was 128.957 million in 2010 (including non-Japanese residents), is set to fall below the 100 million mark in 2048 and to fall to 86.14 million by 2060. Under a low-fertility projection, the population is set to fall below the 100 million mark in 2044 and to fall to 79.97 million by 2060. Over the nearer term (the Abenomics horizon), the so-called "working age population" (those in the 15-64 age group) is set to fall from 81.735 million in 2010 to 73.408 million in 2020.

Chart 2



If Japan is serious about producing 2% real growth, starting yesterday, it is clear that the decline in the labor force will need to be arrested and this will be no easy task. There are three ways to do this: increase the labor force participation rate, particularly of women and of the "aged"; increase the fertility rate; and increase immigration. There is some focus in the growth strategy plans on the first one, although it is hardly given headline prominence, but mention of either of the latter two is conspicuous by its absence.

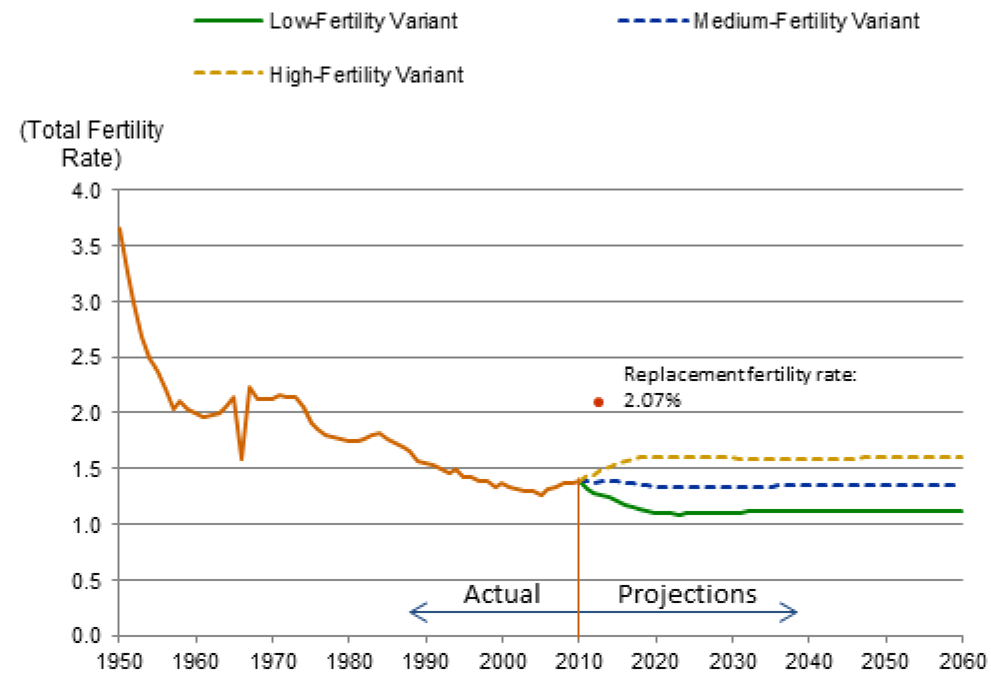
Moreover, a falling population and workforce not only hits growth potential via its effect on labor inputs, it is also likely to mean less capital accumulation. That puts an even greater onus on technological innovation and higher productivity to raise, and keep raising, potential growth.

Given that Japanese are living longer but the population is aging rapidly, a relatively "easy" way to reverse the decline in the workforce is for society to collectively agree to extend the working life of the average citizen. One way to do this would be to start to index the retirement age to life expectancy. Extending the retirement age has a doubly positive effect on productivity and fiscal burdens, because not only does it increase the productive capacity of society, it decreases the period of "dependency" of the aged on the rest of society (or on their own savings).

The biggest driver of the adverse demographics in Japan, however, is the very low fertility rate. The replacement fertility rate in Japan--that is, the birth rate that should keep the population stable, neither falling nor rising--is estimated to be 2.07 (births per woman). Japan's fertility rate, after falling sharply in the 1950s, fell steadily from the late 1970s, hitting a low of 1.26 in 2005 (see chart 3). In 2010 (the base year for the National Institute of Population and Social Security's projections), it was 1.39 and by 2012 it had ticked up to 1.41. The long-term projections of the Institute assume that the fertility rate is 1.35 by 2060 under the medium-fertility projection and 1.60 and 1.12 under the high- and low-fertility projections, respectively.

Chart 3

Japanese Total Fertility Rate And Assumptions Used In Population Projections, 1950-2060



Source: Japan National Institute of Population and Social Security.

Increasing the female participation rate also has merit, but, if the aim is to promote growth by reversing the decline in labor inputs to the economy, increasing the female participation rate could be counterproductive if it were associated with a decline in the fertility rate or the low fertility rate (that is, one well below the replacement rate) remaining so.

It would seem that Japan needs a concerted effort to bring about a society in which families of women and men can both participate in the workforce and have (more) children. The focus in the Abenomics growth strategy on providing more child-care facilities for working women is a step in the right direction. But much more, including serious tax incentives and other socioeconomic changes, will likely need to be done to turn around entrenched demographic trends.

Immigration is the best cure for a declining population. Immigrants not only add directly to the population but they tend to be younger and have higher fertility rates. A smart immigration policy would also loosen the labor constraints on child-care and aged care, helping to make it easier for working women to pursue a career while raising a family. In other words, raising female labor participation, increasing the fertility rate, and modifying immigration policy all directly (and over varying time frames) increase the labor force, thus being key potential drivers of a growth strategy--and there are also positive synergies between them. Yet the topic of immigration hardly rates a mention in the growth strategy plans of Abenomics. For Abenomics to constitute a serious growth strategy, a smart immigration policy, crafted strategically to suit Japan's own national interests, should be front and center along with raising the fertility rate. It is not, and there is no sign that it will be any time soon.

Abenomics Becomes Womenomics

Although promoting the role of women does not feature explicitly in a prominent way in the lengthy growth strategy blueprints released in June, recently Prime Minister Abe has been embracing and promoting the idea of "womenomics," a concept coined and long promoted by Japan-based Goldman Sachs strategist Kathy Matsui. For instance, in his address to the Sixty-Eighth Session of the General Assembly of the United Nations on Sept. 26, 2013, in New York, Mr. Abe said:

"Everything will begin with refortifying Japan's true abilities and its economy once more. The growth of Japan will benefit the world. Japan's decline would be a loss for people everywhere. So how, then, does Japan aim to realize this growth? What will serve as both a factor for and outcome of growth will be to mobilize the power of women, a point almost self-evident at this gathering. There is a theory called 'womenomics,' which asserts that the more the advance of women in society is promoted, the higher the growth rate becomes. Creating an environment in which women find it comfortable to work and enhancing opportunities for women to work and to be active in society is no longer a matter of choice for Japan. It is instead a matter of the greatest urgency. Declaring my intention to create 'a society in which women shine,' I have been working to change Japan's domestic structures."

On the previous day, in an address at the New York Stock Exchange, Mr. Abe argued that "active participation by women" is one of the keys to unlocking Japan's potential:

"In any event, there is another great source of potential lying dormant in Japan, and that is the power of women. The first woman ever to have a seat here on the New York Stock Exchange was a woman named Muriel Siebert, known by all around her as 'Mickie.' She achieved her seat on the Exchange 46 years ago. I am reminded of something she said. 'American business will find that women executives can be a strong competitive weapon against Japan and Germany and other countries that still limit their executive talent pool to the male 50% of their population.' As someone who demonstrated the validity of those words personally, Mickie served as a leader for women succeeding in the United States. I understand that she passed away just last month. I would like to express my deep respect for her activities as a pioneer until now and offer my prayers that she rest in peace. I will dramatically transform the Japan that is grappling with the feeling of being caught in an impasse because it 'still limits its executive talent pool to the male, 50% of its population.' In Japan, a great many women quit their jobs when they get married or have children, even though they are still very highly skilled and capable. I am convinced that if such women rise to action, Japan will be able to enjoy dynamic growth. To make this a reality, we need to eradicate the words 'children on the waiting list for child-care.' We will prepare, as one massive effort, child-care arrangements for 200,000 children over this year and next, and arrangements for 400,000 children over a five-year period. As of this summer, we already succeeded in achieving our goal of preparing places for 120,000 children. To repeat, the hallmark of Abenomics is action."

Some Out-Of-The-Box Ideas

Here are some other actions Mr. Abe could take that would help further:

- Introduce and promote joint bank accounts for married couples;
- Promote joint mortgages and ownership of primary residences for married couples; and
- Reform the tax system so as to treat married couples as a single unit for tax purposes.

Such changes would be atmospheric game-changers, galvanizing the rhetoric of the growth strategy, and would go a long way toward putting women on an equal economic and social footing in Japan, consistent with Article 14 of the Japanese Constitution(2).

Unlike the practice in most Western developed societies, Japanese banks do not offer married couples bank accounts in joint names. Married women may maintain their own bank account, but particularly for married women who are not engaged in paid work, the main family bank account is usually in the breadwinner's name--that is, the husband's--even if the wife often physically has possession of the passbook and family seal (registered in the husband's name). That may sound innocuous enough, but it is also the case that when a married couple takes out a mortgage it almost always does so in the breadwinner's--usually the husband's--name and the legal title to the property is almost always in the husband's name.

In the United States, the United Kingdom, Australia, and most other developed economies, married couples, regardless of whether the wife is engaged in paid employment or not, usually have a joint bank account, take out a mortgage in joint names, and have joint title to their residential property. Society treats the married couple as a single cooperating unit for economic purposes, regardless of what form of division of labor the couple has decided to maintain between work within the family unit (including child-raising) and work in the income-generating employment market.

Moreover, unlike in many other developed economies, the tax system in Japan does not treat a husband and wife as a single economic unit for tax purposes. When property and assets pass from one deceased spouse to a surviving spouse, while there are significant exemption limits, in principle, the assets are subject to taxation.

Making joint bank accounts, mortgages in joint names, and joint title to residential (and other) property standard practice in Japanese society and treating a married couple as a single unit for tax purposes would remove the implicit economic discrimination against the "non-working" spouses (overwhelmingly women) that is currently embedded in Japanese social and economic practices.

How might this help? Think about this from the perspective of a young working woman, perhaps a highly educated one, who is contemplating getting married, leaving the paid workforce, and raising children. In the traditional Japanese system, and still largely today, a woman who does this is treated, in some sense, as a "second class" citizen: income and property legally will accrue mainly to the breadwinner, the husband. The husband and wife will not be on a totally equal economic and legal footing, but rather the wife will be economically dependent, to a large extent, on her husband. Now consider if the wife decides to remain single, to pursue a career and to accumulate property in her name. She is likely to attain a high degree of economic independence. It is plausible that, because it offers an increasingly unattractive tradeoff, young women in Japan have been quietly opting out of the traditional social contract--marrying late or not at all and having fewer children if they do--and that this is one factor behind the large and steady decline in the fertility rate in recent decades.

Modernizing the social contract and making it more attractive to women by altering some of the basic economic, social, and institutional fabric of Japanese society would by no means be a silver bullet, but it may be a necessary starting point for tangibly raising the fertility rate.

A Sobering Assessment

Because of its low fertility rate and highly restrictive immigration policy, Japan's real potential growth is set to continue to steadily decline. Abenomics touts a commitment to dramatically raise both Japan's real and nominal growth, starting yesterday(3). As for raising real growth, the standard growth accounting framework in economics says that increments to output can come only from three sources: by using more labor, by using more capital, or by being more productive. Supply-side reforms to make the economy more productive are important, but it is hard to see Japan achieving anything like the stated growth targets without drastic measures to raise labor inputs, which would be most readily achieved by raising the labor-force participation of women and the aged, by attracting foreign workers to Japan and embracing immigration, and by making a sustained and concerted effort to raise the fertility rate. Other than the first of these, and then hardly in a headline way, such a policy thrust is almost entirely absent from the Abe administration's growth strategy. Such omissions do not augur well for its success.

Related Criteria And Research

- Reflecting On A Week In Japan, June 25, 2013
- All You Need To Know About "Abenomics", June 12, 2013
- Change Of The Guard--And The Deflation Storyline--At The Bank of Japan, March 28, 2013
- What To Look For From The Bank of Japan's New Leadership, Feb. 12, 2013
- Japanese Reflation Is In Play, But Hurdles Galore Stand In The Way, Jan. 3, 2013

Notes

(1) Rather than three "arrows," I would describe Abenomics as comprising two policy pillars: one using macroeconomic or demand-side policies (monetary and fiscal policy) to end deflation and secure (operational) price stability, and the second using microeconomic or supply-side policies to raise real potential growth.

(2) This states: "All of the people are equal under the law and there shall be no discrimination in political, economic or social relations because of race, creed, sex, social status or family origin."

(3) "Abenomics," and the condition written into the legislation passed in August 2012 to double the consumption tax rate by October 2015, calls for average annual nominal growth of 3% over the fiscal 2011 to fiscal 2020 decade, comprising real growth of 2% and a positive GDP deflator of 1%. The averages in the prior decade were: negative 0.6%, 0.8%, and negative 1.3%, respectively, implying lifts of 3.6 percentage points (pp), 1.2pp, and 2.3pp, respectively.