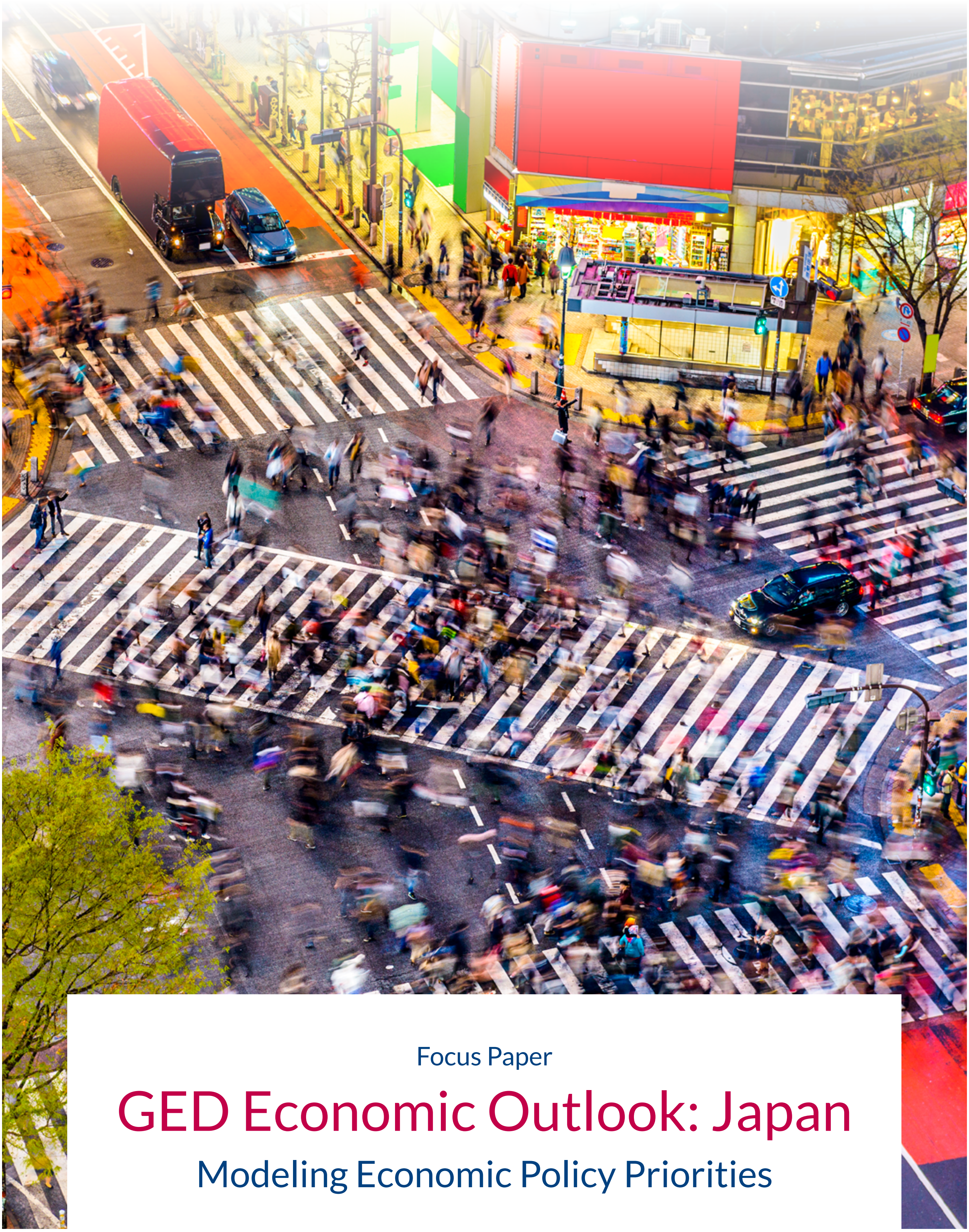

Focus Paper

GED Economic Outlook: Japan

Modeling Economic Policy Priorities

Bertelsmann**Stiftung**

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GED Economic Outlook: Japan

Modeling Economic Policy Priorities

Author: Dr Christian Bluth

Content

Present Economic Situation

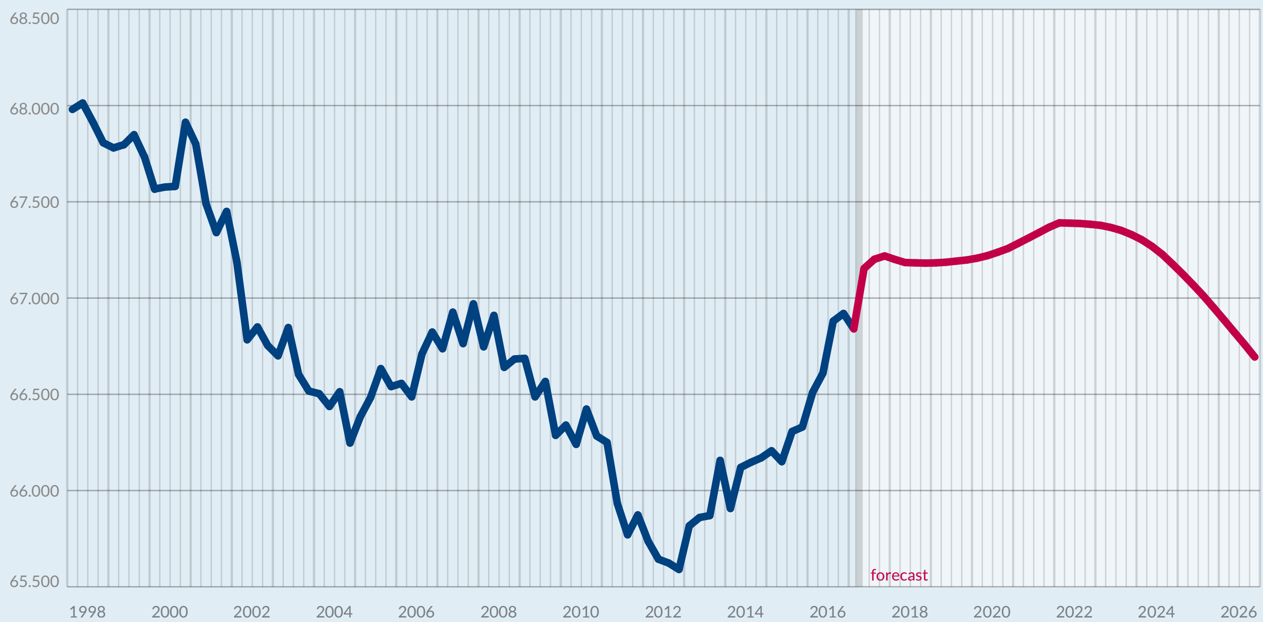
After a long period of stagnation and deflation, Abenomics aimed at reviving the Japanese economy. After his election in 2012, Prime Minister Shinzo Abe gradually implemented this economic strategy characterised by its "three arrows": reflation, increased government spending and structural reforms. This note aims at providing a brief overview over Japan's present economic situation and forecast the medium-term macroeconomic effect of some proposed policies on the Japanese economy.

Generally, the results of Abenomics have been mixed. On the positive side, the negative trend in employment is reversed (cf. Figure 1) and recently there has been a positive development on wages and salaries, giving rise to the hope that inflation rates will rise in the foreseeable future. On the other hand, there is no sign of inflation picking up yet. After an initial rise, inflation rates have collapsed again, showing no structural improvement (cf. Figure 2). Also it is too early to herald a change in trend growth as becomes clear from Figure 3.

Monetary Policy

Monetary policy is the strongest arm of Abenomics. One of the first steps of Shinzo Abe was to nominate Haruhiko Kuroda as head of the Bank of Japan with a clear mandate to bring inflation up to a two percent target. Subsequently, the Bank of Japan lowered its interest rates below the zero lower bound (-.1 percent) and in 2013 conducted a decided

FIGURE 1: **Japan – Labour supply, in 1,000 workers**



Source: Oxford Global Economic Model

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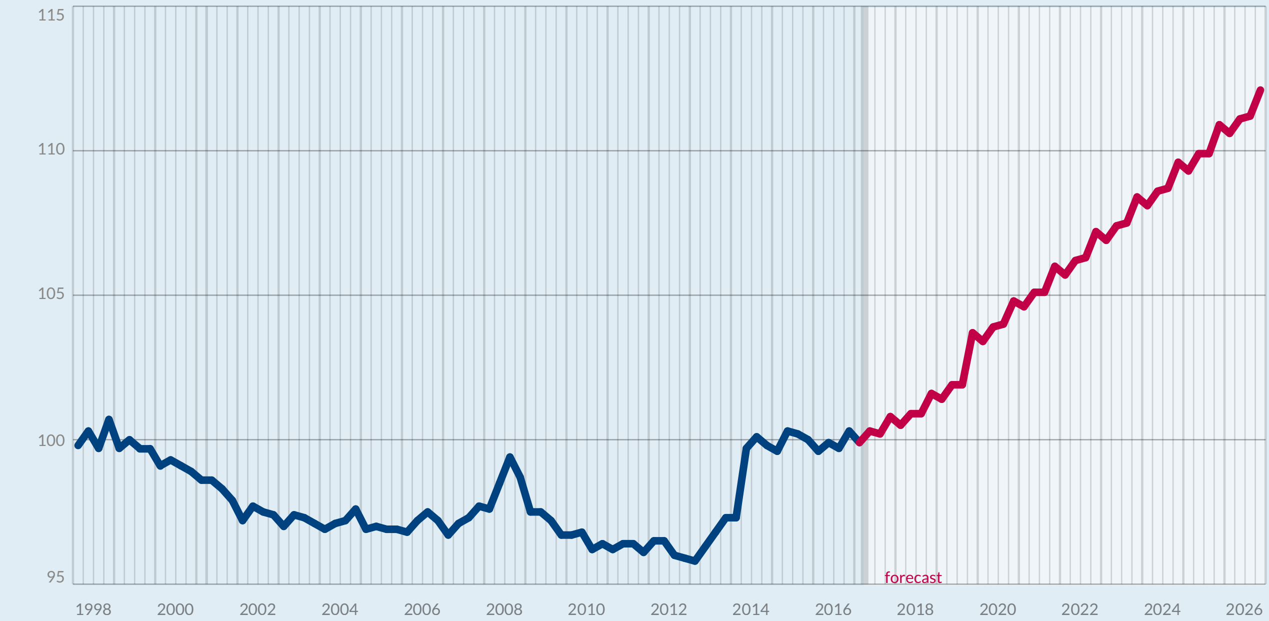
FIGURE 2: **Japan – Consumer price index, in percent change**



Source: Oxford Global Economic Model

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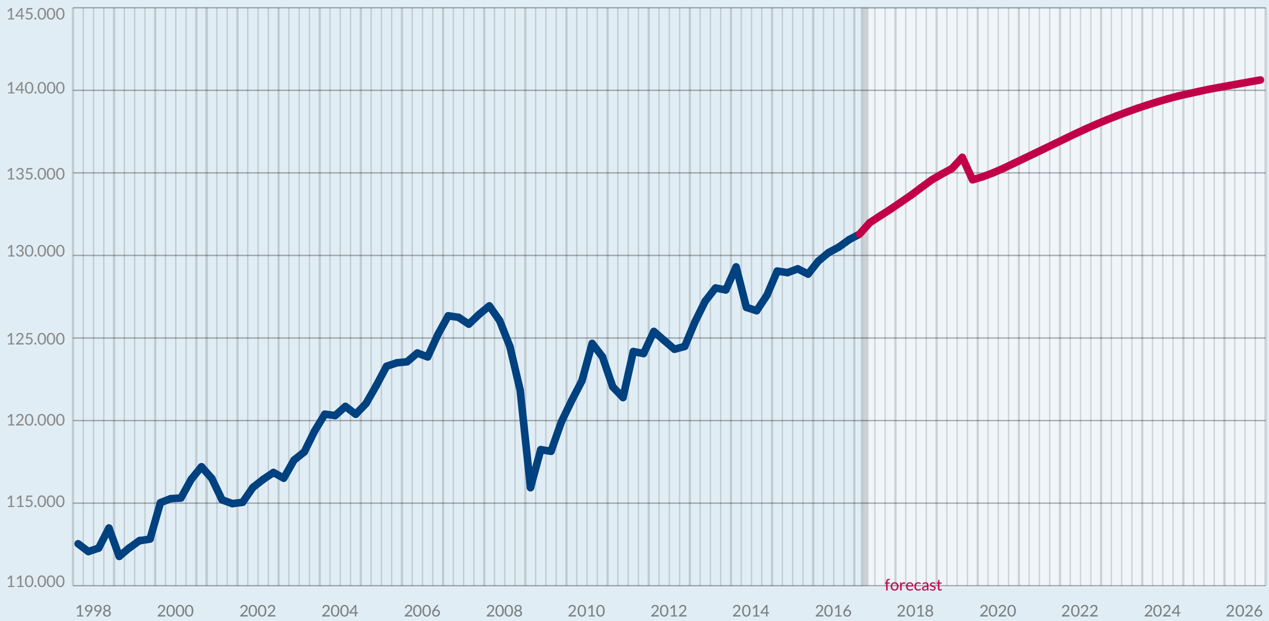
FIGURE 3: **Japan – GDP, real, LCU, in Yen Billions**



Source: Oxford Global Economic Model

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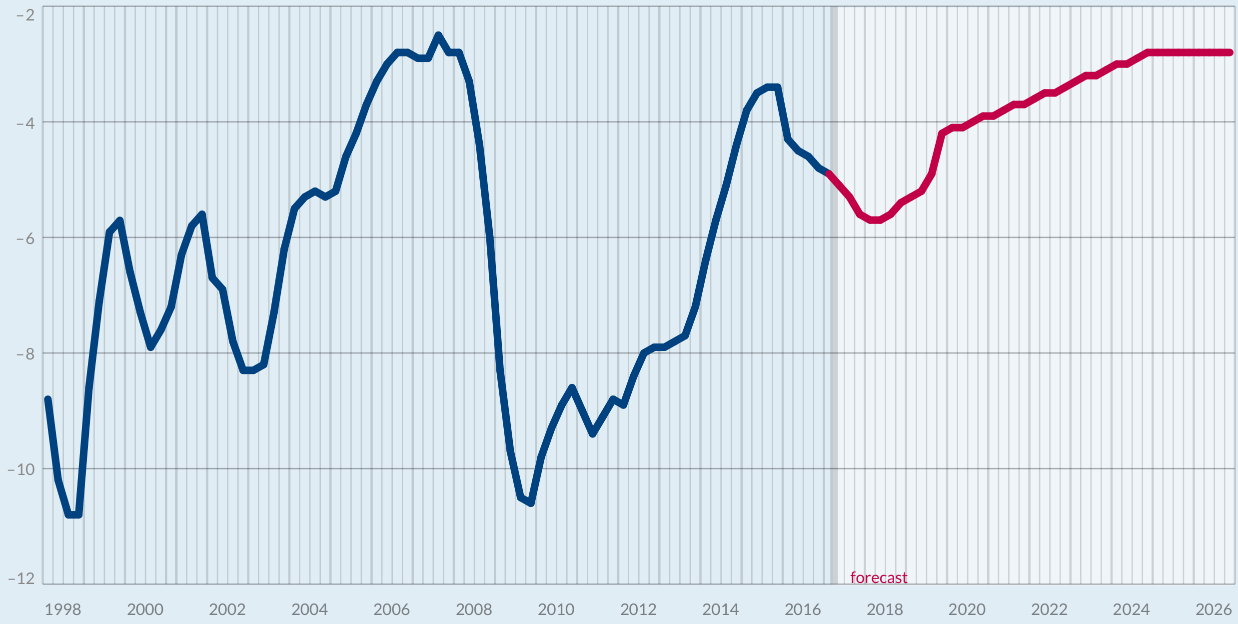
FIGURE 4: **Japan – Government balance, share of GDP, in percent**



Source: Oxford Global Economic Model

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quantitative easing programme, buying Yen 60–70 trillion of assets annually, a sum that was increased to Yen 80 trillion in October 2014. As a consequence, the Bank of Japan balance sheet has increased from Yen 160 trillion in 2012 to Yen 476 trillion in 2016.

Fiscal Policy

In theory, Abenomics relies on a significant fiscal stimulus. In practice, however, the contrary was the case. Abe's government reduced the size of the government balance (cf. Figure 4). This is driven by keeping spending mostly stable and raising consumption taxes in 2014. Another VAT rise is expected in late 2019, leading to a slowing of consumption and GDP growth in the underlying forecasts. The government balance however remains well in the negative territory, implying a further rise in Japan's already large burden of debt. As of 2016, gross government debt figured at 216 percent of GDP.

Structural Reform

Several important structural reforms have been undertaken by Shinzo Abe. While some call for a further effort, some strategic sectors of the Japanese economy have been mobilised by Abe's reforms. The most important are:

- The liberalisation of the energy market, leading to an already sizeable reduction of the world's highest consumer energy prices.
- Agricultural cooperative reform: This will lead to increased productivity in the agricultural sector. It also breaks entrenched interests and constitutes a politically courageous move.
- Japan has one of the highest corporate tax rates in world, Abe's reforms have lowered it from 34.62 to 32.11 percent. This is less aggressive than suggested by many analysts, but it is in line with the cautious overall fiscal policy of Abe's government.
- The sharp dichotomy of the labour market between permanent and temporary employment has not sufficiently been tackled by Abe's government. Both the IMF and the OECD agree that this reform would be important to raise productivity levels.

Proposed Economic Policies

The IMF and the OECD mostly agree on their analysis of the Japanese economy. In their latest country reports, both call for more structural reforms in order to enhance productivity, increase confidence in Japan's growth strategy and to counter demographic headwinds. More precisely, the key recommendations are:

- Labour Market: Break down the stark job market dualism between regular and non-regular workers. Increase the labour market participation rate by fostering the share of women in employment.
- Fiscal Policy: The IMF calls for a credible consolidation plan to reduce Japan's burden of debt in order to improve confidence in the Japanese government.
- Structural Reform: Relax product market regulation in order to improve productivity, especially in service sector. Improve the contestability of markets and facilitate company creation as well as the exit of non-viable firms. This includes an improvement of the mergers and acquisitions market and the availability of venture capital. The government should also provide incentives for the private sector to engage in larger investment, particular in research and development.

Scenarios

Using the Oxford Global Economic Model, this paper develops economic scenarios based on the implementation of some of these policy implications.[1] The simulation is based on the following changes to the baseline projection:

Scenario 1: Structural Reforms

- Increase of the labour force participation rate: We assume reforms which cause an immediate and linear rise in labour supply from now 67m workers to 69m in Q4 2022
- Higher service sector productivity: Immediate exogenous shock increases productivity by 5 percent
- Higher private R&D expenditures: R&D expenditures are assumed to increase constantly by .005 of GDP.

Scenario 2: Structural Reform + Consolidation

- Cautious consolidation plan

Scenario 3: Structural Reform + Investment

- Increase in public investment

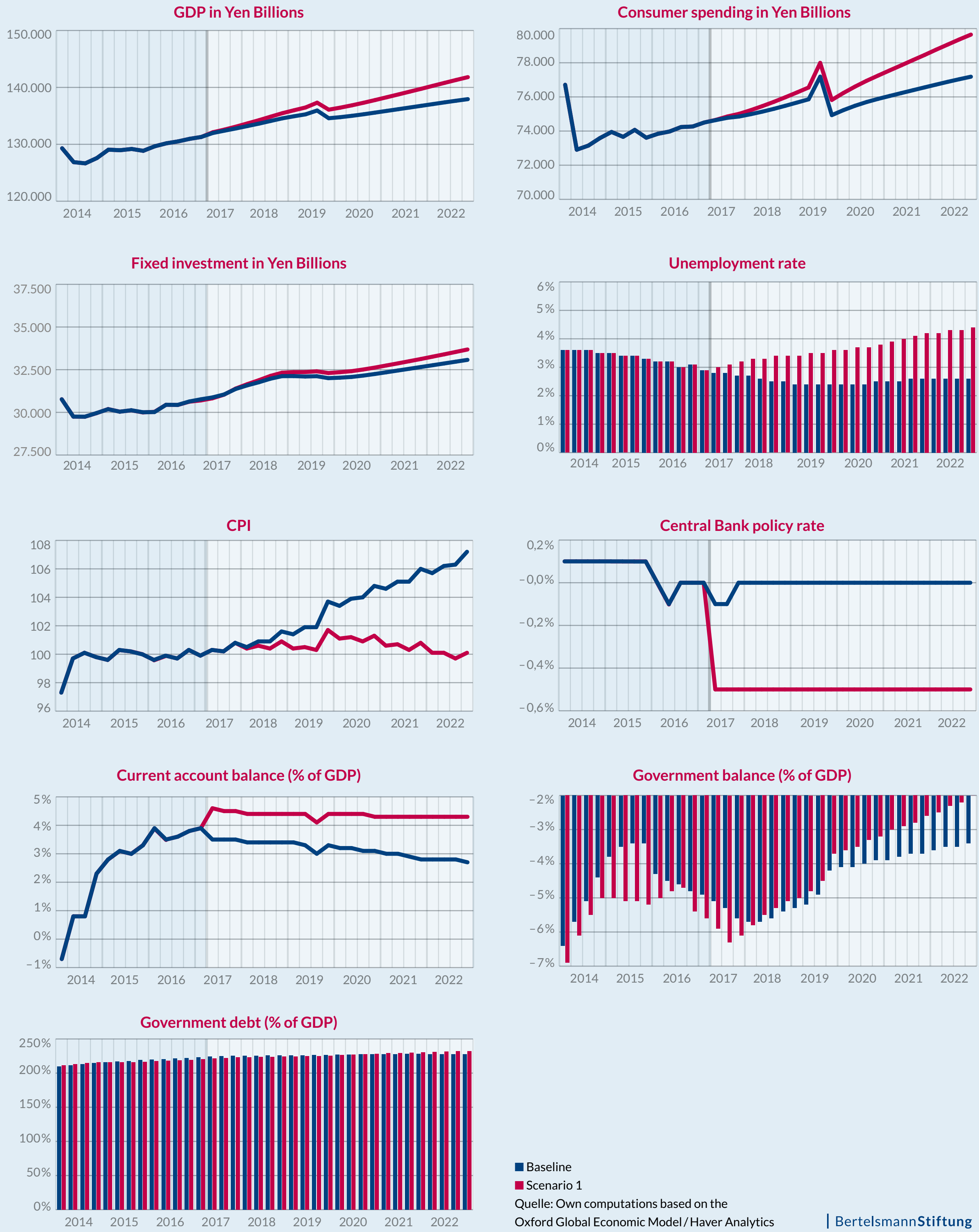
The Structural Reform Scenario (Scenario 1) leads to interesting results: GDP and consumer spending pick up quickly and the economy proves more resilient against the upcoming VAT tax rise shock that the government has already announced. Also investment takes a more positive path. Unemployment rises as the labour market would be unlikely to absorb tthe entire newly generated workforce. The increased labour supply takes the pressure from wages, thus leading to lower headline inflation which would in fact turn into negative territory again. The central bank would be required to step in by further lowering interest rates or expand its QE programme. As a result, also bond yields would move into negative territory while equity prices develop favourably. Competitiveness improves (a smaller index value implies a more competitive economy). The government balance improves as well.

In a subsequent step, we further develop the above described scenario by modeling different fiscal policy scenarios on top. First, we look at a careful consolidation plan. This is implemented by adopting a lower path for real government consumption. Instead of rising to almost Yen 28,000 bn by Q4 2022, we assume a rise to slightly above Yen 27,000 bn (2011 prices). As one would expect, the most important effects are a lower growth and inflation rate but also a faster improvement of the government balance.

Scenario 3 studies the opposite case. We now assume a strong increase in real government investment. Since the baseline scenario already assumes a sharp increase in nominal government investment until Q3 2018 (by Yen 1bn over the current level), we assume a continuation of this course increasing it until Q4 2022 by Yen 2.5bn over the current level (all 2011 prices). In the baseline scenario, investment would fall back to almost current level after its peak in late 2018. As a result, GDP growth is substantially higher and overall fixed investment in the economy smoother. The unemployment rate would remain below 4 percent and inflation would mostly remain near zero, not drop into negative territory. Such an investment path would be consistent with a continued closing of the government balance, albeit at a slower pace.

1 These scenarios are based on assumptions motivated by illustrating the effects of a certain policy path. While efforts have been made to make these assumptions realistic, the aim is to show direction of the effects rather than develop precise policy recommendations or projections.

FIGURE 5: **Scenario 1** – **Global Economic Model Dashboard – Forecast / scenario overview, Location: Japan**



Quelle: Own computations based on the
Oxford Global Economic Model / Haver Analytics

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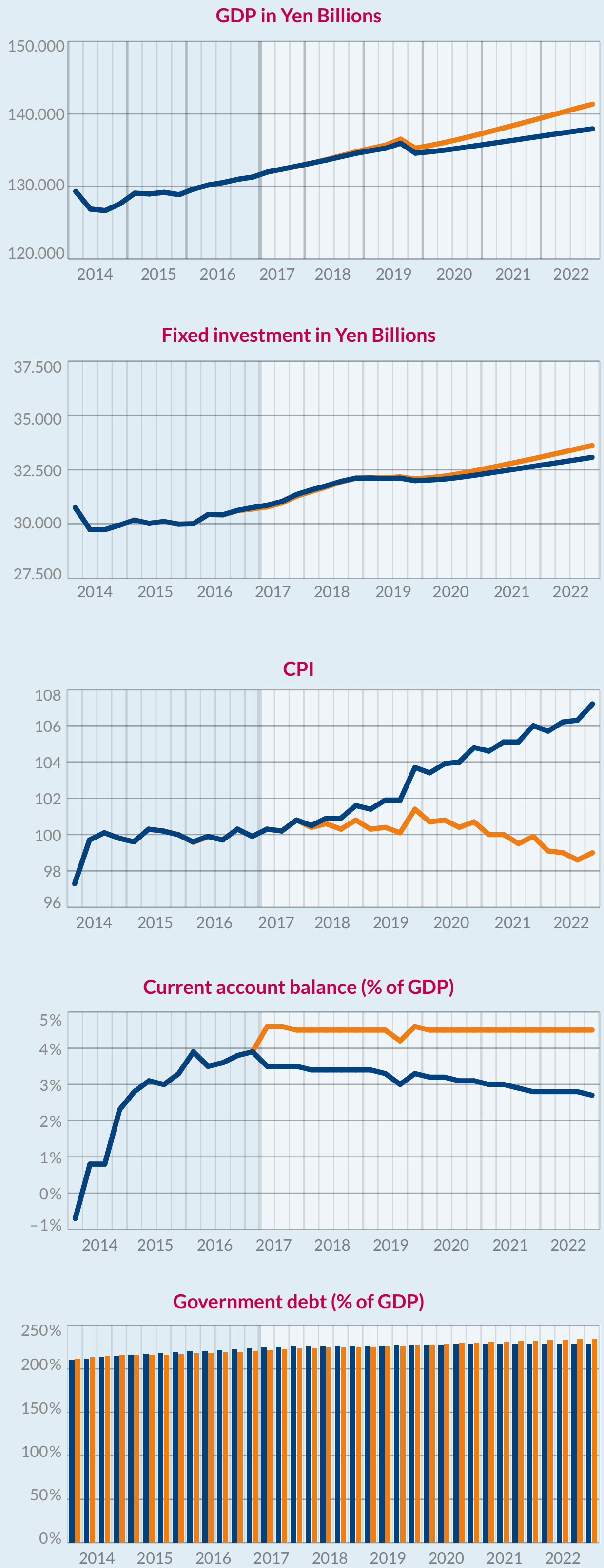
FIGURE 6: **Scenario 2 – Global Economic Model Dashboard – Forecast / scenario overview, Location: Japan**



Baseline
Scenario 2
Quelle: Own computations based on the
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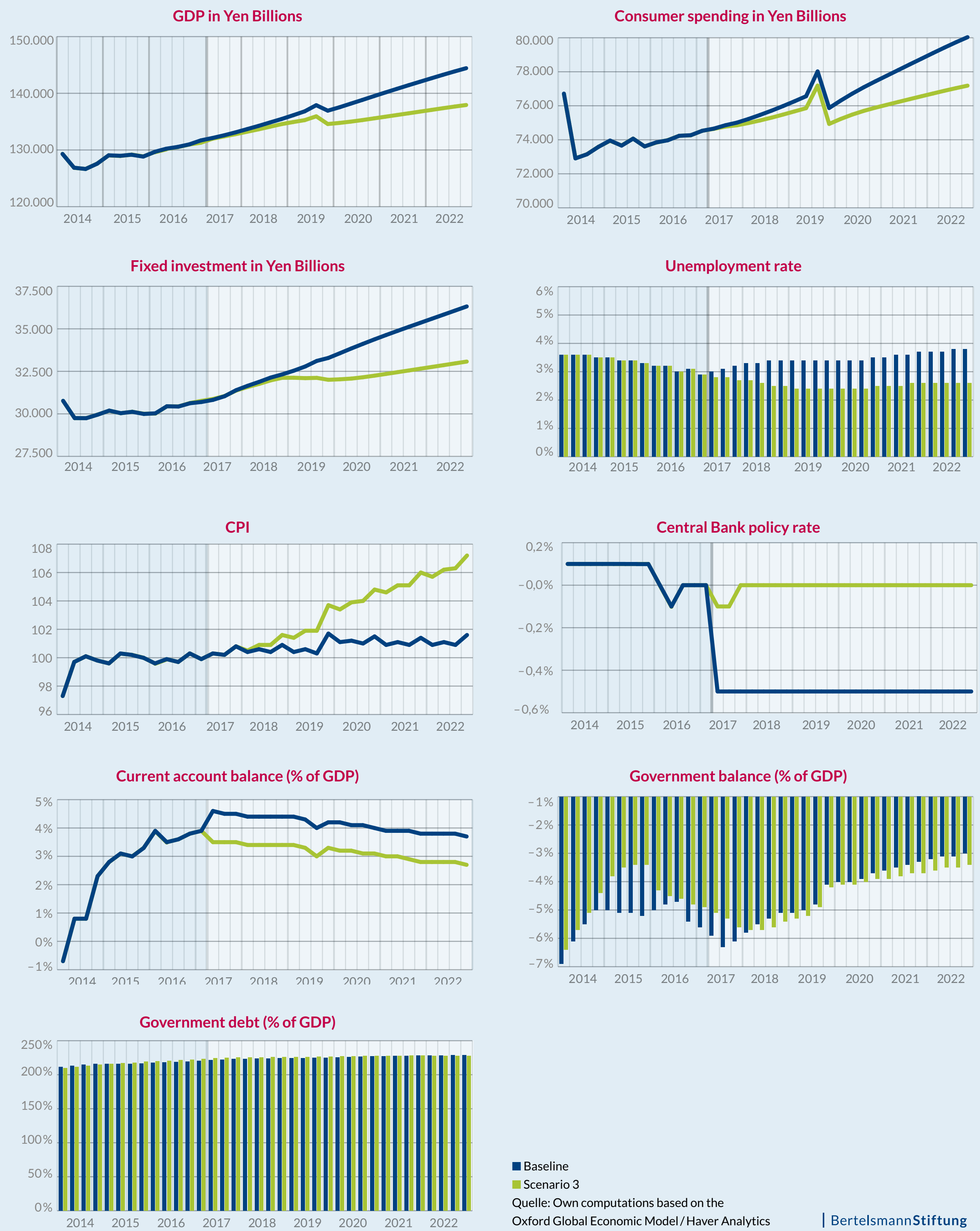
FIGURE 7: **Scenario 3** – **Global Economic Model Dashboard – Forecast / scenario overview, Location: Japan**



Quelle: Own computations based on the
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Conclusion

The simulations presented in this paper show that Japan can gain from conducting structural reforms aiming at increasing productivity, activating the potential labour force and creating a more favourable environment for private investment. The activation of labour force – an indispensable reform, given Japan's imminent rapid demographic decline – does however also come with some potentially problematic side effects. Most importantly, the decline in wages counters the efforts of Japanese policymakers to raise the inflation rate.

This could be offset by a stronger investment activity of the Japanese government. Apart from lifting the growth rate, smoothing the VAT rise-induced growth shock, it would also prevent headline inflation from dropping in the negative territory. While not inconsistent with an improving overall government balance, it would come at the price of a slower consolidation path.

The simulations in this paper assumed a quite strong and sudden rise in the labour force. Even if important policies activating the labour supply were implemented immediately, the induced increase would probably be lower and less linear. An investment strategy designed to counter the effects of an increased labour supply should thus be commensurate to actual labour force increases in size and timing.

Generally, our simulations show that Abenomics is a good strategy to revive the Japanese economy. The structural reforms and monetary "arrow" should be continued and may be complemented with a more targeted fiscal "arrow" aiming at investment.

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Imprint

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Design
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