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The Abenomics Growth Strategy Enters the Implementation Stage

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On June 24, 2014, the administration of Abe Shinzo endorsed the "third arrow" growth strategy for Abenomics (the economic policy of the Abe administration) by Cabinet decision. This is a revised version of the growth strategy of one year ago. In addition to incorporating the previously postponed reduction in corporate tax rates, it also gets to grips with regulatory reforms in the so-called "regulatory bedrock" of the agricultural, health and medical fields, which had been thought difficult due to strong resistance by existing groups with vested interests.

Markets have reacted favorably, unlike last year when the growth strategy was met with disappointment by investors worldwide and led to a sharp drop in share prices that coincided with the announcement. Immediately after the announcement of the second part of the current growth strategy, even the British magazine *The Economist*, known for being outspokenly critical, commented in a positive vein while using an image of Prime Minister Abe as a warrior facing down the enemy with his bow and arrows in their cover story. The magazine suggested that this time the third arrow of Prime Minister Abe would hit the target, drawing a simile with Japan's period of rapid modernization after the Meiji Revolution.

The policy borrows its name, the Three Arrows, from the tale of a warrior who showed his three sons how one arrow is easily broken, even two can be broken, but three arrows together cannot be broken. The brothers then joined forces as "the Three Arrows."

The Three Arrows are bold monetary easing (the first arrow), flexible fiscal policy (the second arrow) and growth strategy to secure continuous economic growth and stimulate private-sector capital investment (the third arrow). By setting out the first and second arrows of the policy at an early stage, Abenomics raised expectations by producing significant results in terms of economic recovery, correcting the extreme appreciation of the yen, and raising share prices. There are also indications that Japan is ridding itself of the unprecedented and persistent deflation that has been ongoing since 1998.

The Abe administration was inaugurated on December 26, 2012, but in actual fact, Abenomics had already started when the then-Prime Minister Noda Yoshihiko (DPJ) dissolved the Diet on November 14, 2012. During the election campaign, Abe positioned overcoming deflation as the key to rebuilding the economy in Japan, and made strong appeals for the Bank of Japan to adopt inflation targets and bold monetary easing policies.

Under the leadership of Abe, the Liberal Democratic Party (LDP) achieved a complete victory, capturing two thirds of parliamentary seats and forming the Abe administration. Since the Abe administration was pro-growth, focused on corporations, and indicated increased investment in public works where the Democratic Party of Japan (DPJ) had been against growth, corporations, public works and legislative initiatives from the civil service, the atmosphere in industrial circles brightened with the formation of the Abe administration. Anticipating such an atmosphere, share prices started to rise the instant that Prime Minister Noda dissolved the Lower House of parliament. Share prices continued the upward trend when the Abe administration was inaugurated, rising by 40% in four months.

As well as assuming the office of Prime Minister, Abe clarified his stance on making economic revival his top priority, and set about implementing the Three Arrows policy. In January 2013, he embarked on a bold policy of monetary easing, announced in an exceptional joint statement of the government and the Bank of Japan on overcoming deflation and achieving sustainable economic growth. Properly speaking, monetary policy is the exclusive jurisdiction of the Bank of Japan, but the Abe administration forced the addition of monetary easing as the first of the Three Arrows. In March 2013, Kuroda Haruhiko, a progressive on monetary easing hailing from the Ministry of Finance, was appointed governor of the Bank of Japan, and by the start of the following month, he was implementing a drastic monetary easing policy described as a 'different dimension.'

Prime Minister Abe at the press conference, 24 June 2014.
***Source*:** Website of the Prime Minister of Japan and his Cabinet

The second arrow came in the shape of a large-scale supplementary budget. But the third arrow, a decision on growth strategy only came about three months later. It was not given priority and seemed to consist of a number of measures designed to give something to everyone. It did not include the reduction in corporate tax rates expected by the markets and it also fell short on regulatory reform.

Therefore, Hamada Koichi, the University of Yale professor emeritus and influential advisor to Prime Minister Abe, patterned his assessment on student grades with the first arrow (monetary easing) receiving an A, the second arrow (fiscal policy) a B, and the third arrow (growth strategy) an E. Ironically, taken together, the grades spell out ABE.

In contrast, as indicated by the comments in *The Economist*, the current growth strategy is a strikingly improved version that embarks on concrete policies including specifics on lowering the corporate tax rates.

The revised version of the growth strategy announced by the government is a hefty volume extending to 120 pages. It incorporates all the measures that Prime Minister Abe announced at the Davos meeting in January 2014 in the form international commitments, as it were. They include lower corporate tax rates, reforms to the employment system, making society a place where women can shine, corporate governance reform and doubling inward direct investment (by 2020). All of these measures are specified in the revised growth strategy.

When the revised version of the growth strategy was announced, Amari Akira, the minister in charge of economic and fiscal policy and economic revitalization, said that the changes due to Abenomics will not be transient, but will set the economy back on a secure path to growth.

This is how the first chapter in the revised version of the growth strategy summarizes the results of Abenomics up to this point.

> “Japan's economy has experienced twenty years of stagnation due to low economic growth and protracted deflation. (…) Now, with a virtuous economic cycle being set in motion, the Japanese economy is beginning to regain confidence that had been lost in the prolonged recession and deflation. The government will accelerate this virtuous cycle, ensure the end deflation and revitalization of the economy and thus keep expectations for growth high. To these ends, the government will work to steadily increase demand. The closing gap between supply and demand is providing a valuable opportunity to take on new challenges. Seizing this opportunity, the government will strive for a growing economy where innovations are continually produced, and high value-added goods and services are produced.”

> “The “three arrows” strategy has been having a positive impact on the Japanese economy. Real GDP increased for the sixth consecutive quarter. During the same period, the diffusion index rose across the board, including in the SME sector. Capital investment has been on the rise as well. Economic conditions improved significantly in every region of Japan. Steady improvements are also seen in employment. The ratio of new job offers to new applicants has reached 1:1.6. The unemployment rate has dropped to the middle of the 3-4% range. (…) All these pieces of evidence show that the economy is making steady steps forward to break free from deflation.”

The strategy also points out four issues for the future.

(1) Flexible policy responses that consider the impact of the consumption tax hike (from 5% to 8%, implemented in April 2014)

(2) Improve productivity, revitalize innovation, and further expand the positive economic cycle. The decade from FY2013 to FY2022 will be the "decade of recovery" when Japan will aim for 2% growth in real GDP terms and 3% growth in nominal GDP terms. Investigate substantial "affluence" and grow the gross national income (GNI).

(3) Change the trend toward rapid depopulation and the super-aging society. Stabilize total population at the 100 million level in 50 years' time.

(4) Devise economic revival and compatible fiscal soundness. As well as delivering a strong economy and increased tax revenue through economic growth, aim for a

positive growth cycle where progress with fiscal soundness contributes to further progress with the economic recovery, and where the economic recovery stimulates fiscal soundness by means of cuts in expenditure where nothing is off limits.

In addition, the strategy lists ten challenges for reform.

I. Restoring Japan's Earning Power

(1) Enhance corporate governance (formulate a Corporate Governance Code)

(2) Review the management of public and quasi-public funds (public pensions = review the GPIF asset composition, encourage more investment in shares)

(3) Accelerate industrial regeneration and venture businesses, promote the provision of funds for growth

(4) Pro-growth corporate tax reform (aim to lower the corporate tax rate to the 20% level over several years)

(5) Promote innovation and the robot revolution (a national system that creates business from innovative technologies. A new industrial revolution that uses robots to resolve social issues.)

II. Cultivating Human Resources: Promoting Participation by Women and Reform Working Styles

(6) Promote social participation by women (expand childcare, introduce neutral tax and social security systems with regard to women's employment)

(7) Reform working styles (strengthen initiatives to prevent overwork, create systems for rewarding performance instead of length of time spent at work, expand systems for regular employees, build conflict resolution systems with a high level of predictability)

(8) Utilize foreign human resources (review systems for skill training for foreigners, accept employees of overseas subsidiaries in the manufacturing industry, foreign exchange students in the nursing field)

III. Nurture Industry to Support Local Communities and Become New Growth Engines

(9) Proactive development in agriculture, forestry and fisheries (reform agricultural committees, agricultural production corporations, and agricultural cooperatives, diversify distribution channels for dairy farms, link to the domestic and international value chain, promote exports)

(10) Stimulate the healthcare industry and provide high-quality healthcare services (greatly expand the system for healthcare expenditure not covered by insurance)

The issue for the growth strategy is whether the Japanese economy can secure sustainable economic growth, not only cyclical economic recovery, through these measures. The first and the second arrows lifted the economy and share prices and brightened the mood among people. The gloomy atmosphere that continued for a long time after the collapse of the bubble economy (1991) is receding into the past.

So far. Every time a new administration is formed, it hammers out a policy referred to as a growth strategy. However, most of them have not ventured outside the areas of economic measures and measures to shore up share prices. As a result, there is no sign of a sustainable long-term growth rate, or increases in the potential growth rates. The result has been rising fiscal expenditure and a ballooning government debt.

Immediately after the collapse of the bubble economy, the potential growth rate was about 5% in annual terms, but since then the trend has been moving downward. At present, it is thought to have dropped as far as 0.5%.

Innovation is vital for raising the potential growth rate. It is necessary to improve productivity across the whole economy.

Growth accounting for medium, long-term growth

The 'growth accounting' argument for economic growth in the medium to long term can be expressed with the following identical equation.

$$\triangle Y/Y = \triangle K/K + \triangle L/L + TFP$$

Y is GDP and △Y is the incremental increase. Consequently, △Y/ Y is the rate of economic growth. K is the capital input and L is the labor input. △K/K is growth in the capital input, △L/L is growth in the labor input, and TFP is the total factor productivity, which is overall productivity for TFP.

In short, the economic growth rate is shown as the sum total of the contribution of growth in capital input, the contribution of growth in labor input, and the contribution of productivity growth.

The growth strategy aims to increase the contribution ratio of the three elements on the right side of the equation.

The population of Japan, especially the 15 to 64 age group, is shrinking rapidly. The 2013 growth strategy used the term 'population decline,' but in the revised 2014 version, the term has been changed to 'rapid population decline.' This indicates the seriousness of the extent of the decline and the revised version gives an idea of a deeper sense of crisis than it did one year ago.

Unless labor input grows, the growth contribution due to increased labor input on the right side of the equation will be zero, and if the input decreases, the result will be to push down the growth rate.

In order for capital input to increase, corporations must increase their capital investment activities. Capital input requires savings that can be converted to capital, but as the population decreases, people aged above 75 are dipping into their savings, and the increase in new savings has slowed down due to the decline in the working-age population. As a result, there is a tendency to suppress capital investment.

To eliminate this shortfall, it is, first of all, particularly important to increase total factor productivity (TFP).

The word 'innovation' appears forty times in the 120 pages of the revised version of the growth strategy. The word 'productivity' appears 27 times.

Ensuring growth for capital input is also a strategically important issue. The fact is that both the revised version of the growth strategy and last year's version are seen as strategies for stimulating private-sector capital investment.

The present situation is one of continuing decline in the working-age population. Staying with conventional labor market policies, employment policies and customary practices will shrink labor input and can only act as a serious brake on economic growth. Consequently, labor market reform is one of the key points for the growth strategy. Prime Minister Abe has emphasized "a society where women shine" because the employment rate for women in Japan is low even for developing nations. In particular, the ratio of women leaving the workplace due to childbirth and childcare is higher than other major countries, and the so-called M-curve for women's employment rate, which has been eliminated in most advanced countries, still exists in Japan alone.

A rise in the employment rate for women would alleviate the rapid decrease in the overall working-age population. Another problem is that even women who are in employment find themselves in an environment where it is difficult for them to make full use of their skills.

In the World Economic Forum (WEF) ranking of the global gender gap, Japan is in the group of countries with the largest gap. The growth strategy insists that it is necessary to prepare an environment and system where raising children and working is compatible, and where safe childcare is available. The strategy aims to promote women to management professions and to deliver a society where women can maximize their potential strengths, i.e. a society where women shine.

Where growth accounting is concerned, it is important to improve the quality as well as the quantity of capital and labor including where to inject capital, and how to train the workforce to ensure improved quality. If the quality of capital and labor is high, productivity will increase, and the growth rate will also be lifted.

It is also essential to add the global perspective to growth accounting. In March 2013, Prime Minister Abe decided to participate in the Trans-Pacific Partnership (TPP) negotiations. Concluding the TPP or the Economic Partnership Agreements (EPA), which involve negotiations with many countries, would further globalize the Japanese economy and make it possible to go beyond national borders to have economies of scale over broad areas. It would also increase capital input for growth accounting by injecting overseas capital. Another outcome would be to stimulate the domestic industry due to competition with foreign capital. To deal with the labor shortage, there are measures to introduce foreign workers as well as immigration policy.

After all, the aim of the growth strategy is to improve each item on the right side of the equation for growth accounting.

Japan's relative level in the world

The revised version of the growth strategy also specifies many numerical targets. For example,

(1) To realize a situation where the rate of starting businesses exceeds the rate of discontinuing businesses, and to pull the rate up from the current 5% to the 10% level

of the United States and Britain.

(2) To be ranked among the top three advanced countries in the World Bank rankings for business environment (location conditions) by 2020 (ranked 15 in 2013).
(3) To double the balance of investment in Japan by foreign corporations to 35 trillion yen by 2020.
(4) To raise Japan's share of the global market in storage batteries to 50% from approximately 10%.
(5) To increase the ratio of next-generation automobiles in new car sales from 23% in 2013 to 50-70% by 2030.
(6) To aim to double exports of agricultural, forest and marine products and foods from the current 450 billion yen to one trillion yen.
(7) To increase the number of foreign tourists visiting Japan from 10.36 million in 2013 to more than 30 million.
(8) To double the number of Japanese foreign exchange students from 60,000 in 2010 to 120,000 in 2020.
(9) To have more than ten universities in the top 100 global rankings for universities (five at present)
(10) To rise from fifth place in 2012-13 to the top of global innovation rankings within five years.
(11) IT companies at the top international level
(12) To increase the ratio of overall trade covered by FTA from 18.9% in 2012 to 70% by 2018

However, the Japanese economy currently finds itself in an extremely difficult situation. The world rankings are falling in many fields and even doubling performance from the present would hardly improve Japan's relative level in the world.

This is true of, for example, direct inward investment.

In 1990, the balance of direct inward investment in Japan was 0.3% to GDP and it has been steadily increasing to 1.1% in 2000 and 3.9% in 2010. However, since 1990, the Cold War has ended and direct investment across national borders has seen explosive growth. Direct investment is not only capital, but also crosses borders with manufacturing technologies, manufacturing skills and business knowhow. As a result, global 'mega-industries' have arisen. There has been a sharp increase in countries with productivity and strong exports leading to mega-competition. Since countries that have accepted direct investment have increased their growth and exports, all countries are trying to attract quality direct investment, leading to mega-competition for incentives.

This is how the direct investment balance has risen quickly around the world. According to the World Investment Report, 2013 by UNCTAD, the ratio of global direct investment to global GDP has also increased from 9.7% in 1990 to 23.3% in 2000, and 32.2% in 2012, which is ten times that of Japan.

Some have argued that the policy of accepting direct investment is a policy for developing countries, but the ratio for developed countries was 8.8% in 1990, 22.8% in 2000, rising dramatically to 33.4% in 2012. There is definitely a sense that Japan is falling behind.

The recent resurgence of industry in the United States has attracted attention, but here as well, the ratio of the balance of direct inward investment to GDP has moved from 9.4% in 1990 to 28.1% in 2000 and 26.2% in 2012, with large-scale foreign capital in addition to domestic capital securing capital input growth for the abovementioned growth accounting. Currently, the ratio of direct inward investment to GDP in Germany is 21.2%, which is nowhere near the Japanese ratio.

Japan is lagging and even if the country doubles the balance of inward investment, it will fall far short of the world average and remain a minor country for inward investment.

The second classic example is the number of exchange students going overseas. The number of Japanese exchange students at overseas universities peaked at 82,945 in 2004 and has been decreasing since then, falling to 57,501 in 2011. The goal is to double the figure, but here is the global reality.

According to a UNESCO study, the number of foreign exchange students (overseas studies at higher education institutions above high school, not including short-term exchanges of less than one year) worldwide has doubled in the past twelve years, topping four million in 2012. By country, China was at the top after a rapid increase from 140,000 in 2000 to 694,000 in 2012. Korea was second with 123,000. This is also a major increase from 70,000 in 2000. Japan is in tenth place with numbers dropping to 33,000 from 59,000 in 2000. Japan is dropping out of the international trends and going against the current. It is likely that the number of exchange students will increase further and that it will be difficult for Japan to join the trend even if the numbers are doubled.

Japan is also at bottom in terms of receiving foreign tourists. When the number of foreign tourists visiting Japan reached ten million in 2013, the government was pleased by the record numbers, but with these numbers Japan ranks 27th in the world. Germany receives 31.45 million visitors and Britain 31.17 million. Our Korean neighbors with a population of half that of Japan surpassed Japan by receiving 12.17 million foreign tourists. People are clamoring to make Japan an international travel destination, but unless we cool down and come to grips with the current position of Japan, no strategic policies will be produced.

Japan is also deviating from international trend in terms of trade. Japan itself has long believed itself to be an exporting nation and a trading nation. However, this 'self-portrait' is quite far removed from the reality.

Japan's share of worldwide exports has halved from a little less than 10% in 1985, when Japan's export offensive intensified trade friction between Japan and the United States, to around 5% in 2010.

According to an international comparison of export reliance by the WEF (ratio of exports to GDP), Japan is ranked a lowly 140 among 148 countries. According to World Bank data, the ratio is 14.0%, which falls far short of the international average of 26%. Japan is ranked 148 among 185 countries.

Even with targets double or triple that of the current situation, it will be difficult to come up with valid policies unless they are perceived in the context of the international situation.

How far will the reform of the regulatory bedrock go?

Even though the revised version of the growth strategy in itself has been well received for reducing corporate tax rates, this point still presents issues.

At present, the effective rate for corporate tax in Japan is 35.6% (Tokyo, 2014), which far exceeds the average of 25.3% for the Organisation for Economic Co-operation and Development (OECD) and the 22.5 % average for the Asian countries.

According to a survey of foreign-affiliated firms carried out by the Ministry of Economy, Trade and Industry (METI) in 2011, firms launching in Japan regard the corporate tax levels too high a business cost, mentioning high personnel costs (73% of respondents) and the tax burden (61%) as obstacles to doing business in Japan.

The revised growth strategy will bring the corporate tax rate to the 20% level over a period of several years with the first step to be implemented from fiscal 2015 (starting in April 2015). But, although 20% level is mentioned, it is assumed that the rate will be 29%, which hardly is attractive enough to entice new foreign-affiliated firms. In addition, there are presently no resources for lowering corporate tax.

Proposals for Tax Reform to Attract Growth, a report published by the Japan Center for Economic Research on May 22, 2014, proposes lowering the rate to 25%, stating that there is competition to lower corporate tax rates around the world and if things stay as they are Japan will be left behind. The proposal emphasizes that lower corporate taxes are necessary as the spark to accelerate market opening and attracting capital and people from overseas.

The revised version of the growth strategy is looking in a positive direction. This is also recognized by investors inside and outside Japan, and differs from last year when the growth strategy was perceived as nothing but slogans, disappointing markets and causing a sharp drop in the share prices.

The required legislation for a policy of National Strategic Special Zones to set up strategic zones and relax regulations within those zones was passed in December 2013, and six special zones were designated in March 2014. The Council on National Strategic Special Zones chaired by Prime Minister Abe has been established and the policy for the special zones is underway.

The government has also strengthened its policy leadership on innovation promotion and set up a structure for comprehensively advancing policies that have been split across ministries in the past. Specifically, the Council for Science and Technology Policy positioned within the Cabinet has been reorganized as the Council for Science, Technology and Innovation (CSTI), and a Budget Strategy Council has also been established to prioritize the allocation of the science and technology budget for the government as a whole. Structures for strategically tackling innovation promotion across all ministries have also been completed.

But, critics also say that the government intervention in private-sector economic activity is too strong, and that the ideas in both the growth strategy of last year and the revised version are government-led, whereas it is actually the private sector that promotes innovation and drives growth and it is the role of the government to create an environment where the private sector is free to innovate.

On this point, it is indeed regulatory reform that is the most important growth strategy. Prime Minister Abe himself says that reform is the highest priority. In his speech at Davos, Prime Minister Abe said that he is willing to act as a drill strong enough to break through the regulatory bedrock and that nothing will be off-limits for the regulatory reform that is needed for the growth strategy.

Prime Minister Abe delivered a keynote speech at the Annual Meeting of the World Economic Forum (Davos Meeting), January 22, 2014
Source: Website of the Prime Minister of Japan and his Cabinet

But, there are many areas where resistance is strong, including agriculture and healthcare, and industry and bureaucrats will try to protect vested interests. To what degree it is possible to face down the opposition of groups with vested interests and to secure an environment where the private sector is free to innovate is an issue for the future.

Unlike the market (investor) disappointment and slumping share prices at last year's strategy announcement, this year has brought some appreciation and expectations, but share prices are still seesawing. This is because there is an atmosphere of wanting to ascertain how far the reform of the regulatory bedrock will actually go.

The private sector is not only reliant on the government, but needs to do its own reforms. Even if capital investment in the private sector increases, attitudes to investment are still pessimistic. This is symbolized by the increase in corporate cash reserves. At the end of March 2014, 53% of all listed companies were virtually debt-free with cash reserves exceeding interest-bearing debt. Corporations that continued conservative fiscal strategies during the long period of deflation still have not changed their pessimistic attitudes.

The direction of the growth strategy is known, and we are now approaching the important aspect of whether it will reverse and raise the growth potential for the Japanese economy, which has continued to decline since the 1990s.

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