An assessment in the seventh year of Abenomics: Labor reforms should be implemented immediately, ahead of monetary and fiscal measures

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Key points

- **Set a permissible range of 1% over or under the 2% inflation rate target**
- **Take measures for banks when deepening the degree of negative interest rates**
- **It is necessary to improve labor mobility and raise wages for young workers**

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Six and a half years have now passed since the second Abe administration was established in December 2012. Continued economic expansion has led to a remarkable improvement in the employment situation. Although people reportedly do not have feel that their income has increased, the overall growth rate is above 1% despite the decreasing working-age population and the aging society. The effect of the radical quantitative and qualitative easing has kept the average inflation rate positive, at slightly under 1%.

Some are critical, however. To put it plainly, Abenomics, which entered its seventh year with continued strong market conditions, has led to a significant improvement in macro-economic conditions, but the government has yet to achieve its balanced budget goal and inflation rate target. The improving results of Abenomics could be felt noticeably from 2013 to 2014. Since then, however, the economic conditions have not shown a noted improvement, and may have even worsened. Stock prices have not risen continuously, though they are at the high end of their range.

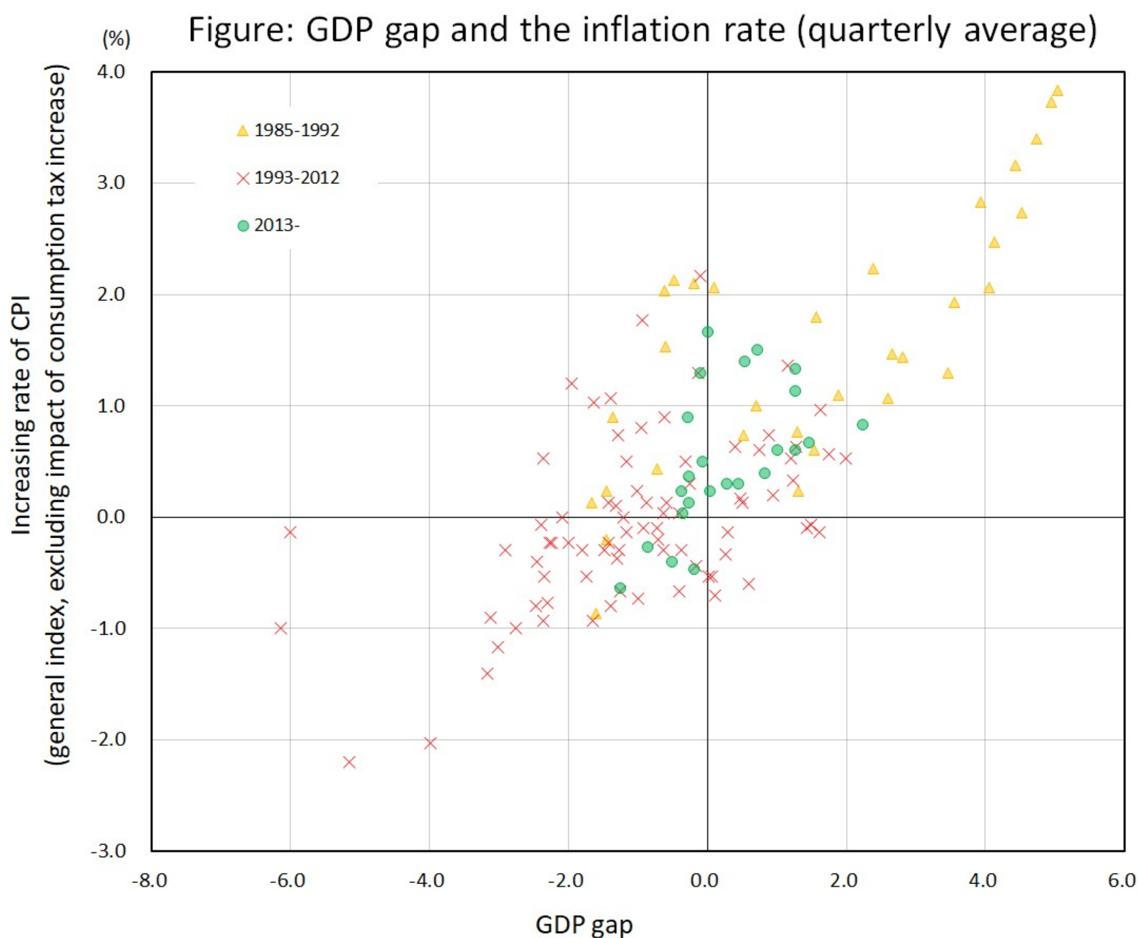
In terms of the growth rate as well, the improvement of per capita productivity by technological innovation that is necessary to break through the 1% range is lacking. The inflation rate has never reached the target of 2%. The budget deficit is gradually shrinking, but the government has yet to achieve a surplus in the primary balance.

On the other hand, some argue that the prolongation of the extraordinary monetary easing led to an increase in the side effects. Because of the flattened the yield curve, half of regional banks that depend on asset management using long- and short-term yield spread have deficits

in their main businesses. Because the labor shortages also prevent companies from securing the necessary workforce, they have been a hindrance to growth.

Monetary policy is on the verge of a difficult situation. The extraordinary monetary easing, which was launched in April 2013, pulled the Japanese economy out of deflation, but the inflation rate remains low. On the other hand, the GDP gap shows positive figures (total demand surpasses total supply), and the labor shortage is also serious. This situation makes it unnecessary to strengthen monetary easing.

Article 2 of the Bank of Japan Act stipulates, "Currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy." In this context, price stability can be interpreted as maintaining the inflation rate within the neighborhood of 2% and the sound development of the national economy as maintaining the GDP gap within the neighborhood of zero.



Source: Created from the data of BoJ and Statics Bureau of Japan by author

As illustrated in the chart, initially, if positive GDP gaps become higher, the inflation rate increases. But the inflation rate under the Abenomics recovery process is lower than it should be, considering the rise in the GDP gap.

To convey that Abenomics is a "flexible" inflation rate target-based policy, it is conceivable to express the inflation rate target as 2% accompanied with a permissible fluctuation range of 1% above and below the target number, as in the United Kingdom, instead of setting the target at 2%. This method is aimed at setting a mid-term average inflation rate target of 2% and at inflation expectations converging on this number, but the method can tacitly express the permission of an inflation rate of 3% if the real economy is bad and allow to be lower than 2% if the real economy is good, instead of aiming to achieve a rate of 2% disregarding the real economy.

The future trends of the global economy are uncertain. There is a possibility that the Federal Reserve Board (FRB) will move to lower policy interest rates because of the emergence of recession risk in the United States. In addition, the possibility of the US-China trade war intensifying even further cannot be ignored. The possible yen appreciation and the decrease in exports would also have a negative impact on the Japanese economy. If that happens, what tools of further monetary easing will the Bank of Japan be left with?

Conceivable tools of monetary easing include lowering policy interest rates (deepening the degree of negative interest rates) and increasing the sum of quantitative monetary easing (buying assets) or expanding types of assets to buy. A forward guidance is also a strong means. But it cannot be said that market participants' expectations have reacted significantly so far to the guidance of "permitting an overshooting (excessiveness) of an inflation target" (September 2016) or "continued monetary easing until the spring of 2020" (April 2019).

The deepening of the degree of negative interest rates is a strong means of monetary easing. It can be expected to lower lending rates and boost investments in housing and in plant and equipment. In addition, the deepening the degree of negative interest rates makes it possible to keep the interest gaps between Japan and the United States at a certain level when US policy interest rates are lowered.

The banking industry is expected to be fiercely opposed to such a measure, however, just as it was when the negative interest rate policy was introduced in January 2016. Banks, especially regional banks, will suffer from further worsening of profits in the face of lowered lending rates and bond yields. Because deposit interest rates cannot be slid into negative figures, the profit margins between lending and deposits will reduce. It is conceivable that when the Bank of Japan says, "considering the balance with side effects," it is thinking about the negative impact on the profitability of regional banks.

With half of regional banks running deficits in their main businesses, some argue that if this situation persists, it could result in failure of vulnerable regional banks and financial systemic risk. In fact, since there are structural problems, such as a decline in population and the closure

of the local companies to which regional banks extend loans, the blame cannot be placed solely on negative interest rates. The Financial Services Agency, which is a main supervisor of retional banks for stable operations, has recommended that regional banks carry out structural reforms, including the reduction of fixed expenses, by promoting mergers among regional banks. In addition, the government will enact an exceptional-case law of the Antimonopoly Act and promote the restructure of regional banks.

One of the methods of introducing negative interest rates and minimizing their side effects at the same time is to introduce negative interest rates to funds-supplying operation by loan support funds from the Bank of Japan to general banks or funds-supplying operation by the fixed-rate funds-supplying operation against pooled collateral. This operation means loans with negative interest rates from the Bank of Japan to banks that have extended loans, which provides significant advantages to banks that borrow funds from the Bank of Japan. If these additional measures are combined, it may be possible to expand the margin of negative interest rates.

The key to realizing the mid- and long-term recovery of the Japanese economy, however, is neither monetary policy nor fiscal policy. Monetary policy is almost powerless to raise the potential growth rate itself in the medium term. Meanwhile, labor market reforms that boost per capita production work on the supply side and boost the potential growth rate. The improvement of productivity will enable an increase in wages, which stimulates consumption. The expansion of consumption will prompt a healthy increase in inflation rates, which leads to the achievement of the Bank of Japan's long-held ambition of a 2% inflation target. In addition, the increase in income and consumption will make it possible to achieve an increase in tax revenues without raising tax rates.

To raise per capita productivity, workers need to be able to do jobs appropriate to their skills in companies that are the most suitable for them. To this end, it is important to boost labor liquidity and for companies to pay workers suitable wages for their productivity.

Based on the traditional lifetime employment and seniority promotion systems, Japanese companies pay wages that are lower than productivity when workers are young and wages that are higher than productivity when they are in their fifties. In addition, Japanese companies pay high lump-sum retirement (severance) pay when workers retire from their jobs. From the perspective of these workers' careers, deferred-payment wages cause a significant deterioration in labor mobility. With digitization and artificial intelligence (AI) progressing, however, industrial survivability is becoming more and more uncertain, not to mention the survivability of individual companies.

The Japan Business Federation (Keidanren) also says that lifetime employment cannot be protected. Since Keidanren says so, companies should abolish the seniority promotion system

and retirement benefits and significantly raise the wages of young workers. This means that as workers approach retirement age, the increase in wages will become unjustifiable. Companies should always pay workers wages that reflect their productivity at that point. It is desirable to significantly raise the incomes of young workers as an advance payment of traditional severance pay. This measure will stimulate consumption, which will make it easier to achieve both the inflation rate target and fiscal consolidation.

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