Lessons from Japan

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A Reversal Again

During the 1980s, Japan attracted considerable attention in the United States and elsewhere as a model for economic progress. At the same time, many suggested its policies should be emulated by American leaders. Then came the complete reversal of the 1990s: the US economy expanded strongly while the Japanese bubble burst. Its economy stagnated due to policy mistakes made in dealing with the bursting bubble. These errors set the Japanese economy on the path to "lost" decades of stagnation and deflation. During that time policy-makers in the US and Europe looked elsewhere for lessons on how to manage a market economy.

Now strikingly, it all seems to be changing again. Japan has a new leader, Shinzo Abe, who recently became Prime Minister for the second time. On taking office, he adopted a new economic policy which appears to be working. Japanese businesses and consumers are spending rather than hoarding, with promising results. We find then the fastest rebound of share values in the post-Lehman shock period, and also a rapid recovery of the real estate prices after a long period of stagnation. Economic activity is expanding and the economic future finally looks bright again. Abe's economic revival policies have mattered.

What is most striking about Abe's new economic policies is that they are not new at all. Instead, they largely follow well-established stimulus prescriptions, including deficit financing of enhanced government expenditures. To this extent, they represent Keynesian remedies. Keynes of course was the British economist whose principles are now practiced by a Japanese prime minister but not by his British counterpart whose policies instead reflect those pursued in Japan during its two decades of decline. As for the United States, its policies falls squarely in the middle, where the on-going political deadlock has prevented the adoption of consistent actions, whether for good or for ill.

In this brief column, we review the foundations of Japan's new economic policies, sometimes called "Abenomics," and contrast it with those pursued in the United States. We follow that with a suggestion of the lessons to be learned.

The Three Arrows of "Abenomics"

What is most remarkable about Prime Minister Abe's new policies is their sharp break from the austerity policies formerly in place in Japan. Most strikingly, those policies were in place during Mr. Abe's first tenure as Prime Minister in 2006 and 2007. Furthermore, pressures for austerity should be even greater now than they were before. Since the Japanese national debt has grown to approximately double the nation's nominal GDP, many "experts" have argued that the government should act first to reduce the government deficit. Otherwise, these "experts" believe, the country would go bankrupt. Strikingly, such recommendations point in just the opposite direction of the Prime Minister's new policies. It took great courage for Mr. Abe to reject the debt-focused measures of the past.

His approach consists of the "three arrows" of stimulus policy. The first arrow is enforcing an aggressive monetary policy which rests on an inflationary target of fully 2% per annum. While stable price levels may generally be considered a goal of monetary policy, Abe recognized this is not so in a deflationary context. Some inflation would be a minor price to pay to escape from the malaise of the past two decades. In this effort, he prodded the Bank of Japan to publically reject its former target of a 1% inflation rate.

At the start, there was skepticism about the inflation targeting policy. In fact, the former Bank of Japan Governor, Masaaki Shirakawa, was most skeptical about the effectiveness of inflation targeting, believing it would fail to raise inflationary expectations unless the government also adopted an appropriate set of fiscal and structural policies at the same time. In this respect, his argument may have some validity since inflation targeting may also require fiscal stimulus. This is why the second pillar of "Abenomics" is an aggressive fiscal policy,

In this second arrow of the new policy, there is expanded government spending together with a still larger government deficit. His proposed supplemental budget for fiscal year 2012 (ending March, 2013) called for increased government outlays of more than 13 trillion yen, which approaches 3% of nominal GDP. If this spending would lead to a still larger national debt, that result would again be a small price to pay for ending the malaise.

Finally, the third arrow of his policy refers to actions taken to promote private sector investment. These outlays can be stimulated by deregulation, infrastructure investment and tax incentives. Again, there could be some effect on greater government deficits but again this would be a small price to pay.

Lessons for the United States

While US economic policies under President Obama are not as austere as those pursued in Britain, they are also not as simulative as the new policies pursued in Japan. In the first place, taxes were raised at the start of 2013. These included an increase in income tax rates for incomes above $400,000, but even more important, a rise in the payroll tax rate on employees of 2 percentage points. Then, more recently, a budgetary “sequestration” of $85 billion occurred which led to reduced government spending. Both elements are indicative of the austerity policy that characterized Japanese policy-making in the last two decades, and still characterizes British policy today.

These polices directly threaten the recent improvements in both the housing and job markets which have materialized. To be sure, trends in those markets could be strong enough to withstand them. But whether this is or is not the case, the economy remains vulnerable and the net effect of both actions is negative.

Despite their appeal, there is increasing evidence that austerity policies don’t work, as is clearly evident in the Eurozone economy. They don’t bring market economies out of recession but instead frequently make conditions worse. That is the lesson to be learned from the recent Japanese experience.

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