

# Agenda for 2020: Can Japan Win Gold for its Economic Performance?

Thursday, October 4, 2018

Room 1501, International Affairs Building, Columbia University

*Presented by the Center on Japanese Economy and Business (CJEB), Columbia Business School*



## **Takatoshi Ito**

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On Thursday, October 4, 2018, the Center on Japanese Economy and Business (CJEB) hosted a special lecture delivered by Takatoshi Ito, Professor at the School of International Affairs and Director of CJEB's Program on Public Pension and Sovereign Funds, on the current conditions of the Japanese economy, as well as risks that weigh on the outlook for the economy over the next two years. David Weinstein, Carl S. Shoup Professor of the Japanese Economy,

Columbia University, and Director of Research at CJEB, moderated the event. He began by welcoming everyone and introducing Professor Ito.

Professor Ito opened his lecture by highlighting several key events that are expected to take place between 2018 and



*David E. Weinstein*

2020 which will be crucial to the future trajectory of the Japanese economy and Japanese politics. In July 2019, the world will be paying close attention to how the Liberal Democratic Party (LDP) of Japan fares in the elections for the House of Councillors, which is the Upper House of Japan's bicameral legislature. The results of the House of Councillors election is expected to reflect the level of public approval for Prime Minister Shinzo Abe's policies and the strength of the LDP. (In September 2018, Prime Minister Abe was re-elected for a third term as the head of the LDP. The LDP also won a landslide victory in the House of Representatives, or Lower House, election in October 2018.) In May 2019, there will be a dynastic change as a new



Emperor of Japan ascends the throne. Japan will also be the site of many events of cultural and political significance to the international community, such as the 2019 Rugby World Cup, the 2019 G-20 Summit, and the 2020 Summer Olympics. In

terms of changes to fiscal policy, the Abe administration has scheduled a consumption tax increase from 8 to 10 percent, effective October 1, 2019. The result of this confluence of events for the Japanese economy depends greatly on how the Abe administration prioritizes different policy agendas over the next two years.

Professor Ito then reviewed the current state of the Japanese economy, examining the present conditions as well as the challenges that the Abe administration will need to navigate in order to achieve the



goals set out by the Abenomics program of economic reforms. Overall, Professor Ito noted that real GDP indicators for Japan have been very strong and, arguably, are equally as strong as those of the U.S. economy. As with the United States, Japan is currently experiencing its longest period of economic expansion, defined as the period from trough to peak in an economic cycle. Real indicators include production, consumption, and the labor market. Nominal GDP, however, has not been rising and this is reflected in flat prices and wages. Regarding evidence for the assessment of the real GDP performance of Japan, Professor Ito observed that the GDP gap, which is the difference between aggregate supply and aggregate demand, has been steadily recovering since the 2008 global financial crisis such that aggregate demand is now greater than aggregate supply. Unemployment has decreased from over 5% in crisis years to above 2% currently, indicating a tight labor market. Opportunities for recent university graduates have



been increasing and the stock market currently has a 27-year high in price levels, although the level of prices has not surpassed the Japanese stock exchange's all-time high, observed in 1989. Although such indicators may create

concerns that the economy is overheated, Professor Ito noted that corporate earnings are still rising, indicating that increasing stock prices are natural. However, risks related to spillovers from a trade war between the U.S. and China, as well as the potential direct application of tariffs by the U.S. on the Japanese automotive industry, would certainly weigh on the outlook for Japan's real GDP over the next few years.

Regarding nominal GDP, Professor Ito noted that there has clearly been improvement in inflation under the Abe administration in the sense that Japan finally exited fourteen years of deflation, the last three of which were very painful for the Japanese economy. However, the economy has still fallen short of the Bank of Japan's target inflation rate of 2%. Although wages for part-time employees have increased significantly, wages for full-time employees have largely remained flat and have even decreased slightly. This



has provided a conundrum for economists as the Phillips Curve indicates that unemployment and inflation are inversely related. Thus, inflation should increase as unemployment decreases, and yet this has not been the case in Japan.



Professor Ito remarked that it is possible to interpret the current conditions as the Japanese economy still approaching the cusp in the Phillips Curve, at which point inflation in Japan will increase.

Professor Ito then reviewed the policy responses of the Japanese government to the economic challenges that Japan has been facing in recent years. With regard to monetary policy, the Bank of Japan adopted a quantitative easing (QE) program in 2006 to combat deflation. This QE program was expanded in 2014 and followed by the introduction of a negative interest rate in early 2016. In late 2016, the Bank of Japan transitioned from QE to



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“QQE” (quantitative *and* qualitative easing), which meant incorporating a yield curve control (YCC) policy. Prior to QQE, the yield curve in Japan had a negative slope, which had an extremely adverse impact on bank profits in Japan. Thus, fixing the

overnight rate to -0.1% and the 10-year government bond interest rate to 0.1% created a positive slope for the yield curve and generated profits for regional banks. Thus, QE or YCC was hailed by Japanese regional banks as a lifesaver for the banking sector and, by extension, the economy. However, Professor Ito also observed that critics of the Bank of Japan's yield curve control policy have

interpreted the policy as a way for Japan to “stealth taper” its QE program before the Japanese economy reaches the 2% inflation target. Professor Ito interprets this action by the Bank



of Japan not as stealth tapering, but rather a means of flexible inflation targeting, which is consistent with the Bank of Japan Act of 1998. The BOJ Act of 1998 describes a mandate similar to the dual-mandate (sometimes interpreted as a triple-mandate) for the Federal Reserve, which can be encapsulated in the following priorities: maximum employment, stable prices, and moderate long-term interest rates. Professor Ito underscored that the BOJ's forward guidance on reducing ETF purchases still supports its QE program.

On the topic of fiscal policy, the most discussed subject has been the scheduled consumption tax rate increase from 8% to 10% beginning October 2019. Critics of the tax rate increase have pointed again to the fact that these Japanese economy does not yet have 2% inflation and expressed concerns that monetary and fiscal policies are not being coordinated. Professor Ito drew attention to the fact that Japan currently has a 240% debt-to-GDP ratio,

which is actually higher than the debt-to-GDP ratios of even Greece and Italy. Thus, he believes that some form of increasing tax revenues is necessary to increase the fiscal space that the Japanese government has to manage fluctuations and downturns moving forward. This consumption tax increase is smaller than the previous increase in 2014 from 5% to 8%. The Abe administration plans to use two-thirds of the tax revenues to finance public programs and one-third to reduce the deficit.

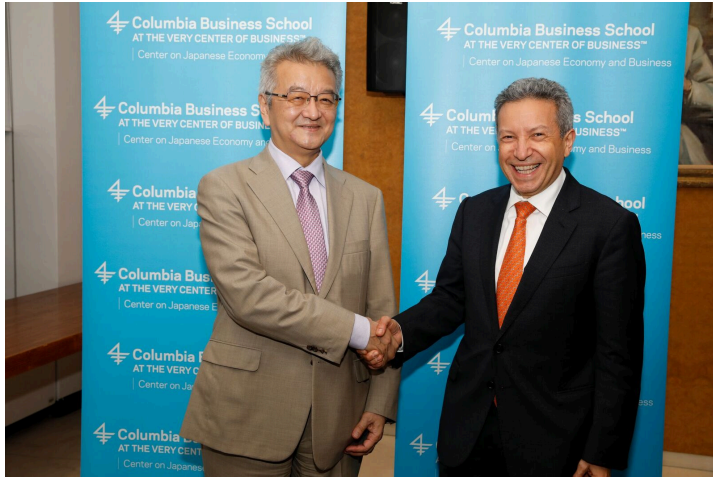
In addition to the policies already implemented, however, many obstacles remain to economic growth that the Japanese government must continue to address. One of the largest challenges, as Professor Ito highlighted, will be continued prioritization of the economic reform agenda in Japan. Observers of Japanese politics have speculated that Prime Minister Abe may want to make his mark in Japanese history in his last



term by amending Article 9 of the 1946 Constitution of Japan, which has not been amended since it came into effect. Article 9 of the Constitution of Japan states the following:

Aspiring sincerely to an international peace based on justice and order, the Japanese people forever renounce war as a sovereign right of the nation and the threat or use of force as means of settling international disputes. In order to accomplish the aim of the preceding paragraph, land, sea, and air forces, as well as other war potential, will never be maintained. The right of belligerency of the state will not be recognized.

As Professor Ito explained, the article is contentious because certain legal interpretations of the text conclude that self-defense is currently unconstitutional in Japan.



Prime Minister Abe wishes to amend the constitution to explicitly state that self-defense is constitutional, which aligns with the prevailing legal interpretation that self-defense is the right of every sovereign state. The amendment would require a two-thirds

majority vote in both houses of the Japanese legislature, the National Diet, as well as a two-thirds approval by the public in a referendum. Although Prime Minister Abe's previous attempts to make reforms in the area of national security have caused his approval rating to decrease, Professor Ito also noted that an alternative political scenario would consist of Prime Minister Abe concurrently advancing the widely popular Abenomics program along with the national security agenda to mitigate the effect on approval and increase support for both agendas.

Other near-term risks include the possibility of tariffs, which Prime Minister Abe and President Trump discussed during trade negotiations on September 29. Although Japan has agreed to reduce agricultural tariffs on U.S. products to the levels in the TPP agreement, which the U.S. withdrew from, Japan will not voluntarily restrict its automotive exports or apply quantity restrictions as South



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Korea, Mexico, and Canada have conceded to. Thus, a measure that would be satisfactory to both Japan and President Trump in order to avoid tariffs on Japanese automotive exports remains unresolved.

Lastly, Professor Ito discussed the demographic risks and the challenges they pose to sustained growth of the Japanese economy. There is a declining ratio of young-to-old persons in Japan, which is reducing the size of the labor force. Although the labor force participation of women and elderly have increased, the labor needs of the Japanese economy require not only overseas workers to supplement the labor force, but also labor-saving technologies that can raise the overall productivity of workers. Professor Ito concluded his talk by opening the discussion for Q&A.

Professor Weinstein closed the event by thanking Professor Ito for his lecture and the audience for their participation.