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Japan's Abenomics: So Far So Good, But Will It Prevail?

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Abstract

The 2012 election gave Japan's LDP control of both houses of the Diet, with Shinzo Abe as the new leader promising to provide decisive and energetic leadership out of the malaise of the past two decades. The vision incorporated in his economic policy program, Abenomics, is to end the two decades of economic stagnation and resignation, revitalize Japanese enterprise, and halt population decline; these go hand-in-hand with his political/security desires to restore Japanese self-confidence and national pride, and make Japan an internationally-respected country.

The three arrows of Abenomics—fiscal policy (the government's purview), monetary policy (Bank of Japan), and structural reform (private sector and government)—have had some initial success, but implementation will take years. Monetary policy has successfully halted deflation, but achieving and then sustaining an annual 2 percent increase in consumer prices will be a major challenge. Fiscal policy's major challenge persists: achieving sufficient private consumption and investment demand growth so that fiscal consolidation can be implemented. Structural reform to achieve growth requires a wide range of policies, so it is a thousand darts, not a single arrow.

Abe's immediate challenge is how rapidly and how well the economy rebounds from the consumption tax increase, as he faces major policy decisions by year-end or early next year. Perhaps the most important are whether to pursue the 2 percentage point consumption tax increase scheduled for October 2015, the planned cut in the corporate income tax rate, and whether an agreement can be reached in the Trans-Pacific Partnership (TPP) free trade agreement negotiations.

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Introduction

Three themes have dominated Japan's economic performance over the year to late September 2014. First is the ongoing implementation of Abenomics. Second is the steady if unspectacular recovery from the 2008–9 global recession. Third is the consumption tax increase from 5 percent to 8 percent on April 1, which is the most gripping because of its dramatic short-term impact on GDP growth.

The December 2012 election gave the Liberal Democratic Party control of both houses of the Diet as the electorate sought positive, decisive, energetic leadership out of the malaise of the past two decades. Shinzo Abe offered himself as that leader, with Abenomics as the means. Elections are next scheduled for mid-2016. If things go well for Japan and Abenomics, then Abe likely will continue as prime minister until those elections, and probably until late 2018, when his final LDP presidency term ends. This provides an Abe administration the opportunity not only to address immediate economic policy issues, but also to vigorously pursue solutions to Japan's long-standing, fundamental economic problems.

Coming into the 2012 election and since, the Japanese mind-set has been shifting from resignation to a more positive, if skeptical, mix of attitudes, expectations, and hopes. Abe is building on that by stressing Japan's revitalization. His first Cabinet shuffle, on September 3, reaffirmed his commitment to tackle major structural economic reforms. One major risk is that the political and security policies he has pursued to demonstrate that "Japan is back" will undermine him, especially as they play out with China and Korea.

The vision incorporated in Abenomics is to restore Japanese self-confidence and national pride, and to make Japan an internationally respected country. A range of economic policy objectives have been articulated, and reiterated, in the June 24 Cabinet revitalization and growth policy statements. The aim is to raise Japan's profile in international affairs as a constructive contributor to peace in Asia and in the world. The major demographic goal is to stabilize the population at 100 million within 50 years or so. In other words, end two decades of economic stagnation and resignation, end Japan's inward-looking "passive pacifism," and halt population decline.

This essay is on Japan's economy and Abenomics, not on national security or foreign policy. However, Abe has stated that they are fundamentally intertwined: economic pragmatism and ideological commitment. To generate a sense of Japanese pride, Abe has articulated views of Japanese colonialism, World War II, and "comfort women" that are inconsistent with the evidence. Consequently, many Chinese and Koreans, as well as Japanese, are suspicious of Abe's ultimate intentions and national goals. Abe will have to maintain a careful balancing act to keep broad public support and good relations with its neighbors. So far, he has been somewhat inept.

Abenomics was introduced as a multifaceted approach to a multitude of problems. The three arrows of Abenomics are straightforward: fiscal policy (the government's purview), monetary policy (Bank of Japan), and structural reform (private sector and government).

The objectives are also straightforward: price stability, meaning replacing deflation, with an indefinitely sustained 2 percent annual increase in the consumer price index (CPI); flexible fiscal stability, implementing a difficult balancing act both to maintain adequate domestic demand and to reduce the high government budget deficit and government debt/GDP ratio; and a comprehensive growth strategy to achieve 2 percent real GDP growth. The government's role in structural reform is to reduce regulations and other obstacles, encourage innovation, provide other incentives to increase private business investment and the supply of labor, and support private consumption.

Abenomics has achieved some success in its early stages. Initial exuberant optimism has waned, but those who say it is a failure are judging prematurely. Abenomics is not a quick fix; implementation will take years. Monetary policy has successfully halted deflation, but achieving and then sustaining an annual 2 percent increase in the CPI will be a major challenge. The major challenge of fiscal policy persists: achieving sufficient private consumption and investment demand growth so that fiscal consolidation can be implemented. Structural reform to achieve growth requires a wide range of policies, so it is a thousand darts, not a single arrow.

A fundamental objective of Abe's growth strategy is to revitalize the Japanese, to awaken their Keynesian animal spirits to move ahead constructively, and take more risks. The government's June 24 revitalization and growth report—representing Abenomics' third arrow—is an important long-run policy statement. The report lays out major economic and social goals in the context of the coming several decades, not just the next few years. It is thus clearer and more credible than the 2013 report.

Abe's immediate challenge is how rapidly and how well the economy rebounds from the consumption tax increase, as he faces major policy decisions by year end or early next year. The April–June contraction was severe. Recent forecasts were for 4.1 percent growth over the summer quarter, but the most recent data suggest the rebound is disappointing. Hope seems to be shifting to good final quarter performance.

Over the next six months, the Abe government faces some major decisions. Perhaps the most important is whether to pursue the 2 percentage point consumption tax increase scheduled for October 2015. Abe has indicated he will make that decision by year end. If third quarter GDP growth data, to be announced November 17, are disappointing, then he may delay his decision until early next year. I think the consumption tax increase will take place. The Trans-Pacific Partnership (TPP) free trade agreement negotiations are important to Japan for both domestic and international-relations reasons. Another major immediate issue is that the planned cut in the corporate income tax rate must be revenue neutral, which means policy changes to increase other tax revenues.

The next section reviews the past year. I then consider the major themes of Abenomics, particularly the growth strategy, and the international context.

The Year in Review

Japan had good economic performance in 2013. GDP grew at 1.5 percent, considered the high end of its potential growth rate range, and the slack in the economy (output gap) was substantially reduced. Core CPI (which excludes fresh food) turned positive in the second quarter, and by year end was increasing at a 1.3 percent annual rate. The unemployment rate continued to improve to 3.7 percent by year end, close to the full employment rate of about 3.3 to 3.5 percent. However, total cash earnings were flat, and as the CPI increased, wages declined slightly in real terms. Japan's recovery from the 2008–9 collapse was steady, but not very fast.

In contrast, 2014 has been a tumultuous year due to the April 1 increase in the consumption tax from 5 to 8 percent (equivalent to an annual demand reduction of GDP of about 1.5 percent). Not surprisingly, GDP sharply increased at a 6.0 percent annual rate in the first quarter as Japanese accelerated purchases of durable goods and stocked up on everything they could. GDP then plummeted in the second quarter, at a 7.1 percent rate according to the September 8 preliminary estimate.

Accordingly, data for calendar and fiscal years (which end March 31) tell different stories. Calendar GDP growth in 2013 was 1.5 percent and in 2014 will be about 0.8 percent. However, fiscal 2013 growth was 2.3 per cent, and fiscal 2014 growth will be close to 0.

Economic output has been basically flat for the past year. Export volumes have been stagnant due to slowing Asian and global demand, despite the sharp decline in the yen/dollar exchange rate from 80 to about 102, and in mid-September to 108. Corporate profits have been very good, especially for export manufacturers, and exporters are not yet reducing dollar prices significantly. On the other hand, yen prices for oil, LNG, food, and other imports have risen.

The labor situation is fundamentally positive but, as always, complex. The unemployment rate is 3.7 percent, but many part-time workers want full-time jobs. Employment increased slightly for regular full-time workers and more for nonregular (part-time and contract) workers who are paid significantly less. Keidanren reported wages increased by 2.24 percent in the 2014 spring offensive, above their annual estimates of about 1.8 percent for previous years; this was due mainly to regular increases based on length of employment, rather than significant increases in entry-level wage rates. Cash earnings jumped in July with a large 7.1 percent summer bonus. Japan's total wage bill did not increase because of the rising share of part-time and contract workers. Excluding the consumption tax rise, wages increased about as much as the CPI, so real wages would have been flat. However, the consumption tax means that real wages are decreasing at a 1.4 percent annual rate. That decline is transitory as the tax effects are absorbed.

Abenomics: Macroeconomic Management

Ending deflation and maintaining sufficiently strong private aggregate demand to make possible a reduction in the government budget deficit continue to be the two major objectives of macroeconomic policy.

The Bank of Japan (BOJ) has been successful in ending deflation. The inflation rate, measured by core CPI (which excludes fresh food), turned positive in late spring 2013, and improved to a 1.3 percent rate through March 2014. The higher consumption tax has added about 2 percentage points to the CPI; excluding the tax, core CPI increased at a 1.1 percent rate in August. While inflation may subside temporarily, it will pick up again. Private-sector experts forecast the CPI will increase about 1.5 percent over the next year or beyond. The optimistic BOJ forecast is that the 2 percent target will be achieved by the end of 2015. In any case, BOJ governor Haruhiko Kuroda is determined the target eventually will be achieved, even if additional monetary stimulus is required.

The BOJ will continue to maintain extraordinarily low interest rates, probably for at least another two years. I do not expect another round of major monetary stimulus soon unless inflation trends below 1 percent, third quarter or subsequent GDP results are surprisingly weak, or the yen strengthens significantly. By next spring it will become clearer whether achieving the 2 percent CPI increase target requires a further round of monetary easing.

Revenues for the fiscal 2014 budget cover only 57 percent (¥54.6 trillion) of the government’s ¥95.9 trillion general account budget; bond issue funds the rest. Japan’s fiscal deficit in 2013 was 8.4 percent of GDP, and it will not be much lower this year. With the February 2014 ¥5.5 trillion supplementary stimulus package, government spending this year will be about ¥101 trillion. The Ministry of Finance (MOF) July request for the fiscal 2015 budget is ¥101.7 trillion.

The immediate fiscal issue is how quickly and how well the economy absorbs the April 1 consumption tax increase from 5 to 8 percent. This will shape Abe's decisions about implementing a 2 percentage point increase in October 2015 and the expansionary or contractionary nature of the fiscal 2015 budget. Gross government debt at the end of fiscal 2014 will be about 230 percent of GDP; net debt, 143 percent. These will continue to rise.

While ensuring that private demand is sufficient for growth, the government's goal is to achieve a budget primary balance (net of interest paid) by 2020 and then to reduce the debt ratios. This will be difficult. It requires both increases in the consumption tax, eventually to more than 20 percent, and some modest reduction of retirement benefits. Both are major political challenges.

The yield on 10-year government bonds (JGBs) remains below 0.75 percent and touched 0.5 percent in late August. With the CPI increase likely to be at least 1 percent, the negative real yield will continue. In the longer run that is unsustainable. Yields will rise, and prices will decline. How to manage this adjustment so as to prevent a bond market crisis is a major challenge.

Abenomics: Structural Reform and Growth

Abenomics' fundamental objective is to put Japan on a long-run, stable, full employment growth path, which includes raising potential GDP growth from its current rate on the order of 0.5–1 percent. The immediate target of 2 percent annual GDP growth between 2013 and 2022 is extremely optimistic. With the labor force decreasing by about 0.5 percent a year, output per worker will have to increase at a very ambitious 2.5 percent.

The growth strategy is straightforward and standard: to energize and stimulate innovation and technological change, mobilize labor and capital effectively, and maintain strong aggregate demand. Ultimately, growth depends on the private sector—businesses, individuals, and households.

A general concern, which I share, is the degree to which reforms will be implemented. Abe is trying hard to energize everyone. He is establishing many committees to develop bold policy proposals. And, he has made strong public commitments to drill through the obstacles, push through deregulation, and enact and implement the reforms. But each proposed reform has its critics, which has led to often heated debate in the media and in the Diet. Most government incentives are tax based; with the budget deficit overhang, they will be deemed "loopholes" and be difficult to legislate.

Some reforms have already been initiated; others are to start by the end of this year or next year. The initiatives will take years to have a discernible effect on the economy, so it is easy to denigrate Abe's efforts and difficult to show anytime soon that they are having good results.

The growth strategy and the revised revitalization strategy announced June 24 listed 249 policy items of widely varying importance and quality for long-run structural reform in 10 broad areas. These proposals are packaged into three themes.

First, and most comprehensive, is to ensure the earning power (return on investment) of businesses through corporate tax cuts, better corporate governance, restructuring and promotion of innovation, and increasing the return on public pension and other government funds. Second is to expand human resources by increasing women's participation in the labor force, changing company work styles, and increasing the limited number of foreign workers modestly. Third is to reform and restructure major industries, notably agriculture and health care, and help small and medium enterprises and local and regional economies.

With a shrinking labor force, innovation and productivity growth are essential. The government seeks measures to improve the weak institutional linkages between academic scientific research and businesses, but it is not clear that government funding of basic R&D will increase substantially. The government is establishing a council to plan the "robotics revolution," but basically companies will decide the costs and benefits of replacing people by robots—that is, substituting ample capital for relatively expensive labor.

For advanced countries, every 1 percentage point increase in R&D expenditures as a share of GDP can be associated with about a 0.4 percent increase in labor productivity

(GDP/worker). If this indeed is a causal relationship, in order to increase labor productivity growth to 2.5 percent, Japan must increase the share of R&D in GDP from 3.3 percent now to about 6.5 percent. Almost all of this will have to be done by the private sector. Current government R&D spending is only about 0.5 percent of total government spending.

Japan has one of the best educated, most skilled, and highly dedicated labor forces in the world, but its numbers are declining. Japanese unemployment rates have been lower than those in the West, even in recessions. The current rate is close to the optimal full employment rate of 3.3 to 3.5 percent. Demand for workers is strong. The overall ratio of job offers to applicants has been about 1.1, the highest since 1992, but it is only about 0.7 for regular workers. For nonregular workers, the ratio is 1.8. Nonregular (contract, part-time, and day labor) workers receive lower wages, fewer fringe benefits, and lack long-term job security.

The labor markets have significant imperfections, and labor is not allocated efficiently. Almost two-thirds of Japanese employees have regular full-time, secure jobs, but some 36 percent do not, and that ratio has been rising over the years. However, according to Abe's recent statement, 1 million workers moved from irregular to regular employment in the last three years.

The shortage of construction workers is the most serious mismatch; the ratio of vacancies to workers was 3.4 in June 2014. The markets for nonregular, low-wage workers in convenience stores and fast food restaurants are also tight, which desirably puts upward pressure on wages.

Abenomics has made labor markets one of its three priority areas for reform. This includes increasing female participation, encouraging corporate working styles to become more flexible, and a slight increase in the small number of foreign workers. Other than "womenomics," labor market reform so far has been modest, and I am not persuaded that Abe will push through major reforms.

Increasing the participation of women in the labor force is important. Much has already taken place; since Abe entered office, the number of women working has increased by 820,000. Japan's female labor force participation rate of 62.4 percent is about the OECD average. However, Japanese women age 30 through 44 participate at a significantly lower rate than American women.

Abenomics aims to increase the percentage of married women in the labor force by providing more nursery and child care facilities, shifting to tax neutrality for second wage earners, and various other measures. The goals are to increase the percentage of women returning to work after their first child from 38 percent in 2010 to 73 percent in 2020, and raising female labor force participation rates for those aged 25–44 from 68 percent to 73 percent. However, success would only modestly reduce the demographic decline in the overall size of the labor force.

By policy, not many foreigners work in Japan, and that is not likely to change significantly. Immigration is restrictive. The number of permanent foreign residents in 2012 was 2.0 million. Excluding Korean permanent residents (most born in Japan), some 714,000 foreigners are working in Japan legally, making up 1.1 percent of the labor force. Some 320,000 are permanent residents descended from Japanese emigrants, mostly from Latin America. About 150,000 are relatively unskilled workers in training programs, mostly from China. Another 200,000 are foreign students working part time. There are up to 50,000 illegal workers, mainly students or guest workers who have overstayed their visas. When media report on immigrants, they usually are referring to worker trainees and related programs, not permanent immigrants.

Japan tries to attract highly skilled foreign managers, engineers, and other professionals, as do other countries. The Japanese language is a major barrier. To meet the demand for low wage, relatively unskilled workers, the government plans to increase trainee and intern programs from three to five years, and to increase somewhat their annual flow from the 85,872 who participated in 2012, but I do not expect it to total more than 200,000. The government also has to improve oversight of these programs significantly; 79 percent of the companies were in violation of the Labor Standards Law ensuring trainees' rights in 2012, with some instances of egregious exploitation. Almost all trainees will return home after their contracts end.

Abe's extremely ambitious, very long-run demographic goal is to stabilize Japan's population at 100 million by 2100 without substantial immigration. This requires profound changes in government family benefit programs, family values and objectives, and a very supportive socioeconomic environment. Family benefit programs in France, Finland, and Sweden have increased fertility rates somewhat, though not to a break-even level. A major fertility rate increase in Japan will be a major challenge.

Assuming Japanese do choose to have more children, timing is key. A Japan Center for Economic Research projection is that, if the fertility rate rises gradually to 2.07 by 2050, then the population would stabilize at 90 million by 2100. Other assumptions about timing stabilize the population at 80 million, close to the population in 1950.

Key Sectors

In June, the government regulatory reform panel proposed 230 deregulation measures. They focused particularly on three key sectors: electric power, health care, and agriculture.

The 10 regional electric power companies will unbundle electricity production, transmission, and distribution beginning in 2016. Already, new entrants are creating more competitive markets. While reducing feed-in tariff rates somewhat, the government continues to subsidize renewable sources heavily, especially solar and wind, but they will only replace coal and gas modestly. With all nuclear power plants closed, 90 percent of electricity is generated thermally. High-cost LNG imports have soared and will continue as a major energy source.

The Cabinet's April 2014 Basic Energy Plan pledges to "lower dependency on nuclear power as much as possible" while supporting early reopening of existing nuclear plants once the government's now-stringent safety standards are met. The Fukushima incident has made most Japanese anxious about nuclear power plant safety, more so than air pollution deaths or other health risks, without assessment of the economic costs.

The Nuclear Regulation Authority in early September certified the reopening of two reactors in Kyushu, but local government consent has to be obtained. Media reports indicate that Abe will make the final decision by year end, presumably positive since he has strongly promoted reopening safe plants. Companies have applied to reopen 20 plants; that will take several more years. Reopening most of the other 28 operable nuclear plants is not viable for cost or locational reasons.

Even though in macroeconomic terms agriculture is no longer a major sector, producing less than 1.2 percent of GDP and utilizing 3.8 percent of the labor force, agriculture reform is always a major political issue. Agriculture encapsulates in extreme form Japan's major socioeconomic issues: demography (many old farmers, few young farmers); inefficient production; a powerful, monopolistic producers' association in the nationwide Central Union of Agricultural Cooperatives (JA); and decades of rural depopulation.

Abenomics aims to double the income of farm, and farming communities, but without specifying how or when this will occur. The government has already announced that in 2018 the traditional rice production quota system will be ended, making production more responsive to market forces. The Abe government's deregulatory agricultural policies promote land consolidation, vegetable and fruit production, and a wider range of services to be provided by more decentralized JA and other local cooperatives.

Japan has 1.6 million commercial farm households, with 4.5 million members. The average farm size is 4.8 acres. The average age of farmers is 65. The 886,000 households with farmland less than 12.3 acres earn more from side jobs than from farming. Only farms larger than 35 acres earn farm incomes of more than ¥11 million ($110,000). Japanese farmers are technologically sophisticated, have ample equipment, and productivity per unit of land is high, but not per farmer. A significant organizational transformation is the increasing number of corporations, with half their shares owned by local farmers who contribute their land and the other half by outside investors. This provides mechanisms to land consolidation.

Transformation of agriculture will continue to be a gradual, long-run process. The government will nudge this along without fundamentally undermining the well-being of existing farm families, for good political and social reasons. The issue ultimately will be resolved through a combination of demographics and market forces. For decades, most children of farmers have migrated to urban areas. In another decade or two, 80 percent of current Japanese farmers will have retired. Japan will then have some 250,000 younger core farmers producing high-valued perishables for domestic markets.

The health care system is in good shape and coverage is universal. Most services are provided privately through hospitals, doctor clinics, long-term care, and other facilities; most costs are covered by national, corporate, or other insurance. Health care costs are about 8.5 percent of GDP, less than in most other advanced countries. But no system is perfect. Japanese health care experts have proposed many specific improvements in the organization of medical services, the insurance systems, and other measures.

Most health care costs are paid through the public sector. Some Japanese also pay for increased or new services not provided through the national system. Public health spending in 2010 was funded 48 percent by premium contributors, 13 percent by patient copayments, and 39 percent by government transfers to the programs.

Japanese have the longest life expectancy in the world, 82.8 years. Health care spending rises sharply for the elderly. For a Japanese 85 or older, costs are seven times as much as for someone aged 40–44. Long-term health care expenditures are more dramatic; those 85 or older cost 30 times as much as those aged 65–69, due to custodial care.

Health care spending increased from 4.4 percent of GDP in 1990 to 9.8 percent in 2011. Two-thirds of this was due to the increased number of those 65 or over, the remainder to costs of technological advances, the high income elasticity of health care demand, and wage rates. Increased government spending paid for 4.75 percentage points of the increase, contributing significantly to the government budget deficit.

Conservative assumptions generate projections that aging costs will increase health care's share of GDP in 2030 to 12.8 percent of GDP. If costs rise 1 percent more rapidly than GDP/capita growth, then health care's share of GDP in 2030 will be 15.6 percent. Most presumably will be paid for by the government. Government transfers are projected to increase from 3.6 percent of GDP in 2010 to 7.8 percent in 2030. Funding this is roughly equivalent to raising the consumption tax by 7 percentage points.

The Abenomics program proposes to improve the quality of health care services and incentives for preventive health care measures but does not provide a comprehensive analysis and strategy. Nor does it address how to pay for the increasing costs.

For good political as well as economic reasons, Abenomics stresses the importance of developing local regions, though what is to be done is not clear. The government has designated six regions as National Strategic Special Zones to test bold structural reform proposals. Two are in the primary metropolitan areas. The potentially most important are to make the Tokyo area an international business hub and to make the Kansai (Osaka-Kobe) area a hub for medical and health care innovation. A third is to make Fukuoka City (on Kyushu) a center for start-ups, in effect encouraging younger people to move to this mid-size urban area rather than to already-crowded Tokyo or Kansai. I am not persuaded that this zone approach will become important. The concept of testing new policies in these zones is good, but I will wait to see whether effective reform policies will actually be strongly implemented.

In the long run, Japan's potential growth remains good, since it still has to catch up with the U.S. in per capita terms. Japan has done less well than the U.S. since the mid-1990s. In 1995, Japan's GDP per capita was 80 percent of the U.S.; in 2012, just 69 percent. Labor productivity in Japanese manufacturing is high. Japan's challenge is to increase labor productivity dramatically in services.

Corporate Opportunities and Challenges

Revitalization and growth depend on mobilizing the private sector. The government is promoting a better business environment through deregulation, regulatory reform, and other business-friendly measures. The June 2014 basic policy statement includes corporate tax reduction, corporate governance measures, participation of women in the labor force, and other measures to increase innovation and total factor productivity.

Business investment is a key driver of growth. The most recent data indicate that, after a long hiatus, businesses are beginning to invest. Large firms plan to increase capital spending by 7.4 percent in fiscal 2014, above economic expert forecasts. Since 2002 companies have saved considerably more than they invested and have replaced households as the major source of net saving. In 45 of the 48 quarters from 2002 to 2013, companies paid down debt and, over time, accumulated now-large cash reserves. In large part this has been a survival-mode response to the severe balance sheet shocks of the bursting of the real estate and stock market bubbles, then the credit crunches in 1997–99 and 2002, and most recently, the 2008–9 recession. In January 2014, the government provided new tax incentives in the form of accelerated depreciation allowances and investment tax credits for new investments.

The government plans to legislate corporate income tax cuts next spring. Passage will have a useful symbolic effect, demonstrating that Abe is pursuing reform. The plan is to reduce the present 35 percent rate to slightly less than 30 percent in annual increments starting in fiscal 2015. Eventually, the rate is to fall to 25 percent. MOF, of course, wants to fully offset the revenue loss, so the government has rather vaguely stated that enough current tax incentives (loopholes) will be ended to make the cuts revenue neutral. This will be a major issue.

As it is, only 28 percent of Japanese companies pay corporate income taxes, less than in most countries. Of Japan's 2.45 million firms, some 24,000 large firms (with paid-in capital of ¥100 million, about $1 million) pay two-thirds of corporate income taxes. Small and medium enterprises pay out most profits to their owner-managers as wages and expense accounts. Given the difficulty in identifying personal income and taxing it, the consumption tax is considered more administratively feasible and fairer, even though it is regressive.

The main focus of Abenomics is on the 3,414 companies listed on the stock exchanges, primarily the 1,814 major companies listed on the first section of the Tokyo Stock Exchange (TSE), the predominant market by market value and trading volume. These companies are the locus of a mixture of government guidance, TSE rules, and market and public pressures. Foreign institutions now hold about 31 percent of market capitalization, and some foreign hedge funds are active participants. The Abe administration places considerable emphasis on stock market prices as an indicator of its success. However, prices are influenced by foreign as well as domestic conditions, and by short-term speculative flows.

Most Japanese listed companies are controlled by entrenched management that replicates itself over time through entry-level hiring and cohort-based evaluation and promotion.

Management cozily takes care of other stakeholders, particularly regular employees. Firms generally pay stable (though not large) dividends to shareholders, mainly Japanese pension funds, trust banks, life insurance companies, and other institutional investors.

Firms within the same industry vary widely in performance. However, so long as management performs reasonably well, it has great autonomy. There have been egregious cases of companies holding huge amounts of cash and not being very profitable, seemingly ideal targets for restructuring and increase dividends. Foreign hedge funds sensed an opportunity. Between 2001 and 2008 there were some 47 hostile interventions. However, domestic institutional shareholders, and the courts, generally backed incumbent managements, even at great cost to domestic shareholders.

Japanese companies have low returns on investment and on equity, only about half that of Western firms. To succeed, Abenomics needs firms to invest in good projects rather than holding so much cash. Friendly mergers and acquisitions are increasing as firms consolidate to remain competitive; hostile takeovers remain quite rare. However, with an aging client base, Japanese pension funds, life insurance companies, and others are now more willing to press Japanese companies to be more profitable and pay higher dividends.

The Abe administration has made corporate governance a top priority. The basic objectives are to increase transparency, to assure compliance with regulations, and to enhance corporate performance. The TSE, together with the Financial Service Agency (FSA), is drafting a corporate governance code that will require several outside directors and provide formal protection for whistle-blowers, among other provisions. The code will be presented to shareholders at company annual meetings in 2015. Other government proposals are to reduce the cozy, mutual cross-shareholding arrangements that firms have with each other, and to increase the power of independent shareholders. The FSA has introduced guidelines to provide more information so that shareholders can better monitor companies.

With government backing, in January 2014 the TSE launched the JPX-Nikkei 400 Index, selecting outstanding companies based mainly on their superior operating profits and ROE (return on equity). Inclusion signals a company's quality, which provides an incentive to improve profitability. The index is reconstituted every six months.

More than 85 percent of the boards of directors of listed companies are internal, selected from top managers. The Abe administration has amended corporate law to require companies, beginning in 2015, to explain why they have no outside directors if they choose not to. As of June 2014, 74 percent of the TSE first section companies had at least one outside director, up from 62 percent in August 2013. While there are few cases of outside directors constituting a majority, 622 companies (34 percent) have two or more.

Increasing the role of women in the economy has two major goals: to increase the total labor force and to increase the number of women in managerial and other decision-making positions. In appointing 5 women to the 18 positions in his September 3 Cabinet reshuffle, Abe stated he wanted women to provide a fresh set of perspectives. Abe's very ambitious goal is for large corporations, as well as the public sector, to promote women to 30 percent of management positions by 2030. In 2011, women held 10.6 percent of management positions (*kachö* or higher) and were 1 percent of board members.

The United States over the past 50 years has achieved a major increase in the gender and ethnic diversity of highly skilled occupations. Increasing the talent pool by including women should increase productivity and growth rates, as qualified women are promoted to senior management and other skilled positions previously allotted to less-qualified men. Many companies today are actively hiring female college graduates for their management track, but there are very few females in the career-track cohorts hired a decade or more ago.

Japanese managerial corporate culture is based on spending long hours at work, not necessarily very effectively, leaving the office late at night. This has been taken as a signal of commitment to the company and to one's career. It takes about 13 years of continuous employment before management-track cohorts are promoted to section-chief level *(kachö)*. This conflicts with family life.

The objective is for women to pursue full-time management-track careers and to marry and have several children, but it is not make clear how these competing objectives will be achieved. Will families be prepared to have their children in day care or with grandparents from a few months old in order for the wife to pursue her career? Will the supply of nurseries and other child-care centers be adequate and at a reasonable cost? Are Japanese companies prepared to incorporate a supportive female dimension to their corporate work culture? Will other indicators of commitment, such as good performance, replace long hours? Having a significant proportion of women in senior management positions implies that Japanese managers of both genders will, as in the West, leave the office by 6:00 or 7:00 p.m. and even return home for dinner and time with their families. It is my sense that many young men are not eager to replicate the traditional model. They are more willing to work with women as equals, even as bosses, and enjoy the pleasures of fatherhood.

International Context

The world economy continues to recover from the 2008–9 Great Recession, but at a modest pace. The U.S. and Japanese economies are doing moderately well. Eurozone economic difficulties persist, exacerbated by Germany's relatively good performance in contrast to the southern European economies; austerity has been costly, and deflation and renewed recession are real dangers. Asia continues to be the world's most dynamic region, led particularly by developing China, India, and Indonesia, and developed Japan and Korea. Economic interactions in East Asia are extensive, deep, and mutually beneficial. However, it is not a harmonious political or security region; political trust among countries is low, and nationalist sentiments are often strongly voiced. Abe's pronouncements and policies have exacerbated political tensions.

Substantively and symbolically, China and the 12-nation Trans-Pacific Partnership (TPP) free trade agreement are especially important for Japan. China became Japan's largest trading partner two years ago; in 2013, 18.1 percent of Japan's exports went to China, and 21.7 percent of its imports came from China. Japanese direct investment in China increased rapidly until 2011, then leveled off, declined slightly in 2013, and dropped precipitously by 49 percent in the first half of 2014. This suggests China's labor costs and geographical diversification for Japanese are less important than concerns about the political relationship. Nonetheless, China's ongoing, relatively rapid development means that China economically will become more and more important to Japan.

Japan’s participation in the TPP depends on the success of the intense U.S.-Japanese bilateral negotiations still under way. This is the most contentious issue in the bilateral relationship; moreover, it sets the context for broader Japanese and U.S. trade policy.

Japan’s big TPP challenge is to end its high protection of agriculture. That makes TPP an important policy instrument in agricultural reform. But it is not clear that Abe and the LDP are prepared to eliminate or significantly reduce tariffs on enough key items to satisfy the U.S. There are 566 tariff line items in the five “sacred” agricultural categories of rice (778 percent tariff), dairy products such as butter (360 percent), sugar (328 percent), wheat (252 percent), and pork and beef (38.5 percent). Even in the best case scenario, agricultural trade will only gradually be liberalized over at least 10 years.

Whether Congress will pass a TPP agreement also is a major hurdle. Experts suggest that the U.S. and Japan must agree on TPP within the next six months, or it will go into limbo.

The good news is that the yen is not likely to strengthen significantly. It would be even better if the yen continues to weaken modestly in the coming months.

Tourism has become an important industry. Some 4.4 million tourists visited Japan in 2005, 8.0 million in 2013, and probably more than 10 million this year. Japan has significantly eased visa requirements and made it easy for Chinese budget airlines to fly to a number of Japanese cities. The weaker yen has contributed. Most tourists come from Taiwan (26.0 percent in 2013), Korea (24.8 percent), and China (8.9 percent). A positive indicator is that in the first seven months of 2014 some 1,290,300 tourists from China visited Japan, a 91 percent increase from the comparable period in 2013.

The Abe Cabinet significantly revised the government’s interpretation of the Constitution by deciding on July 1 to exercise the right to collective self-defense. This has generated strong critical reactions, especially in China and Korea. It is seen as the first step onto a path to a much more nationalistic and militaristic Japan. Collective self-defense is a major political issue in Japan, and Abe has decided to delay presenting enabling legislation to the Diet until next year.

Conclusion

Japan will be doing quite well if, in the coming decade, it achieves GDP growth of 1 percent and GDP per capita growth of about 1.5 percent. However, that requires labor productivity to increase at slightly more than 1.5 percent, which in historical and comparative terms would be impressive.

It is always important to keep Japan in perspective. It is a highly successful, high-tech, high-income, globally competitive, democratic, peace-loving, comfortable, safe country, based on a strong, homogeneous, cohesive society and its own, distinctive language. As one of the world's five largest economies, Japan will continue to a major player. It will continue to be transformed by economic success and the demographics of population and labor force decreases. Urbanization will continue; rural areas will continue to lose population despite government efforts. Japan is a forerunner in many of these trends, but it is not unique.

Abe and Abenomics have benefited from and contributed to the more positive mind-set in Japan. Japan may not "be back," but it is basically on its way. If not immediately, Japan will move onto a path of good economic growth, price stability, and better use of labor and other resources. At worst, Japan will continue to muddle through. More likely, given Japan's fundamental strengths as an economy and as a society, as in the past, Japan will prevail.