The Abenomics Difference: Three Arrows of Roosevelt Resolve in Japan

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Abstract

This study investigates Japanese Prime Minister Shinzo Abe's economic policy package, known as "Abenomics." Abenomics is intended to end two decades of deflation in Japan, based on a Three Arrow approach (monetary policy, fiscal stimulus, and structural reform). This study examines how it is different from past policies and actions, its initial results, and the outlook concerning future results.

In 1990, Japan's asset bubble burst and the country became mired in two decades of deflation and low GDP growth. This study examines existing analysis and compare past policies to the present. It concludes that although the First Arrow (monetary policy) and Second Arrow (fiscal stimulus) have been able to achieve initial success, Abenomics may struggle to succeed without a firmly executed Third Arrow (structural reform). All three arrows are needed. However, many difficult barriers pose an obstacle for reform. American President Roosevelt also pursued aggressive measures in the 1930's to take the United States out of the Great Depression. Roosevelt's resolve was instrumental in his succeed. Japan will need seamless and simultaneous execution of the Three Arrows, along with aggressive Roosevelt Resolve to ensure success in its domain.

Dedication

This thesis is dedicated to my loving wife, who has been a constant source of encouragement and support for me in every aspect of my life.

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Chapter I

Introduction to Abenomics

In December 2012, Shinzo Abe won Japan's general election and re-entered office as the new Prime Minister (having previously served from 2006 to 2007). This victory came as a landslide win for Abe's Liberal Democratic Party (LDP) over Yoshihiko Noda of the Democratic Party of Japan (DPJ). It was also a resounding win for Abe's proposed economic policy, "Abenomics." Abenomics is based on three core principles that are often referred to as the "Three Arrows," referring to (1) unconventional monetary policy, (2) strong fiscal stimulus, and (3) structural reforms for longer term growth.[1] Significant about Abenomics is that the three arrows are not conceived as independent efforts standing on their own, but rather as one comprehensively planned and synchronized package. Nearly all of the Abenomics policies have been attempted in the past individually. However, Abenomics is different in both the sheer boldness of the measures and an unprecedented level of coordination of policies – this induced something that other promises and plans over the prior two decades could not provide. Hope. Abenomics injected hope not only into Japanese

[1] Hugh Patrick, *Abenomics: Japan's New Economic Policy Package* (New York: Columbia University Center on Japanese Economy and Business, Occasional Paper Series, No. 62, 2013).

markets, but also expectations abroad that Japan was setting the right stage for a turn-around.[2]

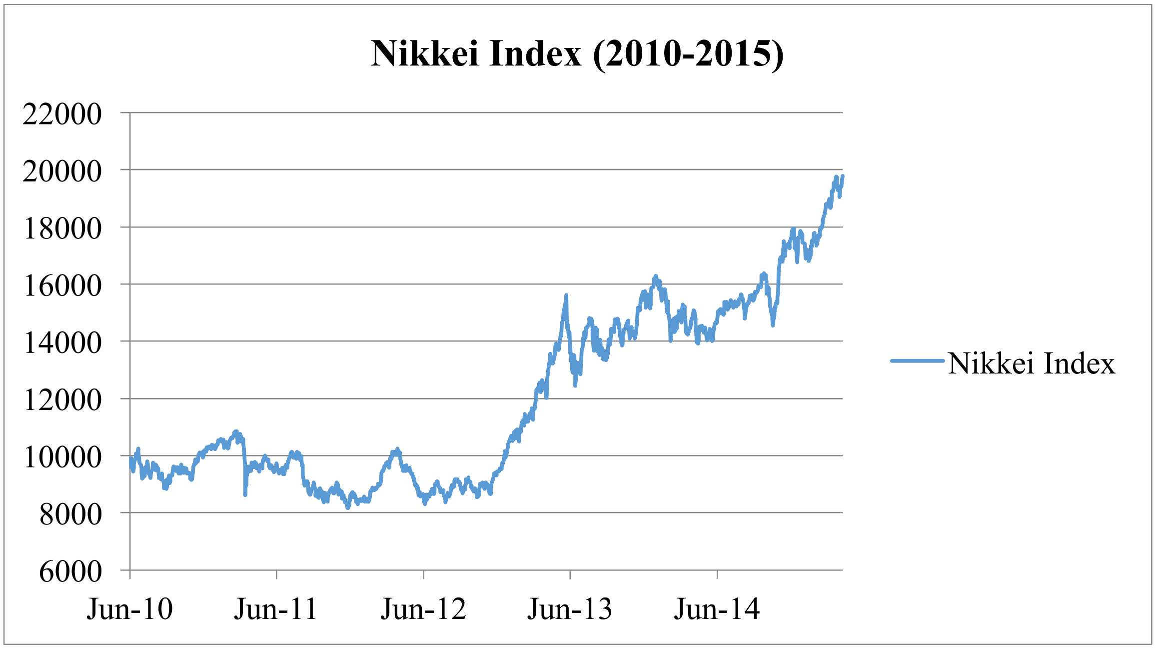

Figure 1.1. Nikkei Index (2010-2015), from Bloomberg website.

This injection of hope can be illustrated through the performance of the Nikkei, the principal index of share prices in the Japanese market,[3] in Figure 1.1 above. We can observe a range-bound period leading up to 2012, where the Nikkei stayed mostly between 8,000 to 10,000. However, with market expectations for Abenomics beginning in mid-2012 and Abe taking office in early 2013, we can see the Nikkei climb higher.

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[2] Shinichi Fukuda, *Abenomics: Why Was it so Successful in Changing Market Expectations?* (Tokyo: Tokyo University, 2014).

[3] John Black and Nigar Hashimzade, *Oxford Dictionary of Economics,* 4th ed. (Oxford: Oxford University Press, 2012), 282.

This figure also shows that Abe has, at least up to now, been able to sustain growth and maintain positive market expectations as the Nikkei has continued to go higher.

The First Arrow – Monetary Policy

Aggressive monetary policy was not something Abe intended to implement himself as Prime Minister, but rather through engaging appropriately with the Bank of Japan (BOJ), the independent central bank of Japan. A central bank is a bank that "controls a country's money supply and monetary policy."[4] Monetary policy generally refers to the "use of interest rates or controls on the money supply to influence the economy,"[5] typically by a government or central bank.

On January 22, 2013, the government and BOJ delivered a joint statement on their strategy for overcoming deflation and reviving economic growth. The BOJ set a price stability target at 2 percent, based on the year-on-year rate of change in the consumer price index (CPI). CPI is a globally recognized price index covering the prices of consumer goods. It is a measure of inflation that is used for macroeconomic purposes and forms the basis for inflation targeting.[6] The setting of a target for CPI was very significant as prior to this, the BOJ had historically used the USD/JPY currency exchange rate as a measure of inflation.

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[4] Ibid., 56.

[5] Ibid., 266-267.

[6] Ibid., 78.

Abenomics obtained a significant boost from Haruhiko Kuroda, who was appointed as the 31st Governor of the BOJ on February 28, 2013.[7] Kuroda aligned more with the culture of Abenomics and favored strong action, unlike the outgoing incumbent governor, Masaaki Shirakawa. Kuroda wasted no time in making his mark on BOJ policy. In his first BOJ meeting on April 4, 2013, Kuroda unveiled a massive program of quantitative easing. Quantitative easing is an "extreme form of monetary policy whereby the central bank creates money and uses these funds to engage in open market operations."[8] It involves buying government bonds using this created money. The purpose of these purchases is to increase "the stock of money held by financial institutions,"[9] thus enhancing liquidity. The ultimate goal of a monetary easing policy is to stimulate the economy, typically applied at a time when interest rates are near or equal to zero and cannot be reduced further. Kuroda's first quantitative easing measure was unconventional even amongst past easing done by central bankers, by virtue of its sheer size. Even Kuroda himself described the action as "monetary easing in an entirely new dimension."[10] The BOJ planned to increase Japan's monetary base by two-fold, from 135 trillion yen to 270 trillion yen by December 2014, primary through further easing (purchasing more long-term government bonds).[11] Quantitative easing was not new in

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[7] Toru Fujioka and Masahiro Hidaki, "Abe Nominates Haruhiko Kuroda as Next Bank of Japan Governor," *Bloomberg News,* accessed March 3, 2015, http://www.bloomberg.com/news/articles /2013-02-28/abe-nominates-haruhiko-kuroda-as-next-bank-of-japan-governor.

[8] Black and Hashimzade, *Oxford Dictionary*, 334.

[9] Ibid.

[10] Ben McLannahan, "Bank of Japan Unveils Aggressive Easing," *Financial Times,* accessed Feb 14, 2015, http://www.ft.com/cms/s/0/81fbc13c-9cd6-11e2-9a4b-00144feabdc0.html#axzz3 Vdx5oMWJ.

[11] Ibid.

Japan, and such easing measures were expected of Kuroda. However, the unprecedented size of his program shocked the Japanese markets. The Nikkei responded positively, immediately welcoming the news by jumping 2.2 percent.[12] Sentiment in the financial markets had changed.

Kuroda's record easing meant the BOJ would purchase approximately ¥7.5 trillion JPY of long-term government bonds per month, an extremely high 70 percent of all government bonds existing in the market as a whole. For a frame of reference, this was a considerably greater amount than previous Governor Masaru Hayami's program. Hayami's program in October 2002 peaked at ¥1.2 trillion JPY of bond purchases. Certainly, this puts U.S. Federal Reserve staff economist David Bowman's argument into the spotlight, in which he claims that easing in Japan's past was not sufficiently large enough to slow down deflation.[13] Alongside the shock factor stemming from the large size of easing, equally surprising was the BOJ's extra focus on purchasing longer-maturity bonds to increase the monetary base. This "contrasted with previous attempts at an expansionary monetary policy that mainly focused on short-term government bonds."[14]

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[12] Heather Stewart, "Japan Aims to Jump-start Economy with $1.4tn of Quantitative Easing," *The Guardian,* Apr 4, 2013.

[13] David Bowman, Fang Cai, and Sally Davies, "Quantitative Easing and Bank Lending: Evidence from Japan," (Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 1018, 2011).

[14] Naoyuki Yoshino and Farhad Taghizadeh-Hesary, "Three Arrows of' 'Abenomics' and the Structural Reform of Japan: Inflation Targeting Policy of the Central Bank, Fiscal Consolidation, and Growth Strategy," (ADB Institute, ADBI Working Paper Series, No. 492, 2014).

According to one economic analyst, the result was "nothing short of a regime change," [15] clearly noting that this was a departure from the Shirakawa era and that a new era had begun. Contrasting Kuroda, Shirakawa publically and regularly noted his priority was to maintain market stability. Kuroda is also different from Hayami, who was the last Governor to attempt significant quantitative easing in Japan. Hayami was known to be controversial due to his insistence that politicians make structural changes to the economy before he would continue to execute additional easing. However, Kuroda in his first public statement as Governor noted that his first priority was to "do whatever is necessary to overcome deflation."[16] He also noted that in the past, the BOJ had tried similar zero-interest rate policies and easing, but to minimal result.[17] He felt strongly that the BOJ "should make all-out efforts to utilize every possible resource"[18] available to the bank, rather than adopting a slower-paced or multi-layered approach. In addition, he indicated he did not intend to neglect the duties of price stability, noting that stability is clearly one of the Bank's defined responsibilities, but at the time a point of secondary importance.

Kuroda was different from his predecessors because he not only created a stir in the markets with a drastic change in monetary policy, but was also able to change public sentiment as well. Toward this end, Kuroda sought to display the BOJ's policy stance

[15] Leika Kihara, "BOJ to Pump $1.4 trillion into Economy in Unprecedented Stimulus," *Reuters,* Apr 4, 2013, accessed Dec 1, 2014, http://www.reuters.com/article/2013/04/04/us-japan-economy-boj-idUSBRE93216U20130404.

[16] Haruhiko Kuroda, "Quantitative and Qualitative Monetary Easing," (speech before a meeting held by the Yomiuri International Economic Society in Tokyo, April 12, 2013).

[17] Ibid.

[18] Ibid.

with “clarity and intelligibility,”[19] to dramatically change the expectations of not only market participants, but that of individual citizens as well.

The result of past quantitative easing is historically observable. The three most significant measures in Japan took place in the fourth quarter of 1999, third quarter of 2003, and Kuroda’s second quarter of 2013. A recent study found that between the quantitative easing measures in 1999, 2003, and 2013, only 2013 showed a significant effect on Gross Domestic Product (GDP).[20] GDP is one of the most commonly used measures of economic activity. It is defined as “the total market value of all final goods and services produced in a given period of time (usually a calendar year).”[21] This study also concludes that, regarding CPI, there is always a visible response following a quantitative easing measure. However, it was only in 2013 that the response had permanent significance and did not have effects that reverted in the shortterm.[22]

In October 2014, Kuroda and the BOJ again surprised the market by increasing quantitative easing measures to even higher levels. The BOJ also extended the average maturity of government bonds purchased. The increased easing would raise the annual target for enlarging the monetary base to ¥80 trillion JPY, from the previous ¥60 to ¥70 trillion JPY.[23] This would equate roughly to an additional ¥2.5 trillion JPY of easing per month.

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[19] Ibid.

[20] Henrike Michaelis and Sebastian Watzka, “Are There Differences in the Effectiveness of Quantitative Easing in Japan over Time?” (University of Munich, Munich Discussion Paper No. 2014-35, June 2014).

[21] Black and Hashimzade, *Oxford Dictionary,* 179

[22] Michaelis and Watzka, “Are There Differences?”

The Second Arrow – Fiscal Policy

Abe's Second Arrow is based on fiscal policy. Fiscal policy refers to a government's use of policy to influence the economy, primarily through decisions on spending and taxation.[24] Abe's Second Arrow initially took form in the area of spending. On January 11, 2013, less than a month into office, Abe announced a ¥10.3 trillion JPY stimulus package as part of the supplementary budget.[25] Japan's supplementary budgets exist for the purpose of being used in times of absolute necessity, mainly to deal with major unexpected events (for example, the Tohoku Earthquake in 2011 or Lehman Shock in 2008). However, in recent years, usage of the supplementary budget for spending has become beyond emergency usage, and routine.[26] Abe's package included ¥3.8 trillion JPY devoted for disaster prevention and reconstruction, ¥3.1 trillion JPY for stimulating private investment and other measures, and ¥3.4 trillion for various social and regional expenditures (for example, medical care, revitalizing struggling regions, and etc).[27] At the time, the total ¥10.3 trillion JPY stimulus amounted to roughly two percent of Japan's

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[23] Leika Kihara and Tetsushi Kajimoto, "Japan's Central Bank Shocks Markets with More Easing as Inflation Slows," *Reuters*, Oct 31, 2014, accessed Dec 14, 2014, http://www.reuters.com/article/2014/10/31/us-japan-economy-boj-idUSKBN0IK0B120141031.

[24] Black and Hashimzade, 157.

[25] Keiko Ujikane and Mayumi Otsuma, "Japan's Abe Unveils 10.3 Trillion Yen Fiscal Stimulus," *Bloomberg News*, Jan 11, 2013, accessed Nov 13, 2014, http://www.bloomberg.com/news/2013-01-11/japan-s-abe-unveils-10-3-trillion-yen-fiscal-boost-to-growth.html. Jan 11, 2013.

[26] Mitsuru Obe, "Japan Reins in Spending in Extra Budget." *Wall Street Journal*, Jan 9, 2015, accessed April 1, 2015, http://www.wsj.com/articles/japan-reins-in-spending-in-extra-budget-1420795646.

[27] Daniel Harari, "Japan's Economy: From the 'Lost Decade' to Abenomics," (House of Commons Library, Standard Note SN06629, London, Oct 24, 2013).

entire GDP. Thus, it was expected for GDP to increase by 2 percentage points and, in addition, to create about 600,000 jobs.[28]

In conjunction with such broad economic stimulus, Abe realized that the budget and country's deficit needed to be controlled. In August 2012, under Prime Minister Noda, the Diet passed a bill that would see consumption tax increase from 5 percent to 8 percent in April 2014, and from 8 percent to 10 percent in 2015.[29] Prior to the first hike, scholar Joshua Hausman notes that the consumption tax hikes would dwarf the increase in government spending.[30] Indeed, the International Monetary Fund (IMF) projected that the budget deficit would fall from 8.5 percent in 2013, to 6.0 percent in 2014 and to 4.8 percent in 2015 (of expected GDP). The hikes would be able to offset Abe's fiscal stimulus plan, helping keep the government's debt from over-expanding.

In April 2014, Abe allowed the first tax hike to occur as originally planned by Noda's bill. However, in November 2014 he chose to delay the second of Noda's proposed tax hikes, keeping the consumption tax at 8 percent in April 2015 and onwards, which favored the promotion of growth and consumer spending.[31]

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[28] Keiko Ujikane and Mayumi Otsuma, "Japan's Abe Unveils 10.3 Trillion Yen Fiscal Stimulus," *Bloomberg News*, Jan 11, 2013, accessed Nov 13, 2014, http://www.bloomberg.com/news/2013-01-11/japan-s-abe-unveils-10-3-trillion-yen-fiscal-boost-to-growth.html. Jan 11, 2013.

[29] Isabel Reynolds and Takashi Hirokawa. "Japan Ratifies First Sales-Tax Increase Since 1997 in Noda Win," *Bloomberg News*, Aug 10, 2012, accessed Sep 15, 2014, http://www.bloomberg.com /news/articles/2012-08-10/japan-passes-first-sales-tax-rise-since-1997-in-win-for-noda-1-

[30] Joshua K. Hausman and Johannes F. Wieland, "Abenomics: Preliminary Analysis and Outlook," *Brookings Papers on Economic Activity 2014*, no. 1 (2014): 1-63.

[31] Leika Kihara and Tetsushi Kajimoto. "Japan PM to Seek Fresh Mandate for 'Abenomics' with Snap Poll," *Reuters*, Nov 14, 2014, accessed Jan 15, 2015, http://www.reuters.com/article /2014/11/18/us-japan-election-idUSKCN0J20A120141118.

While the Second Arrow's stimulus package is clearly defined, scholar Hugh Patrick notes there are still fiscal policy issues that remain to be addressed by the Second Arrow. Issues include when is the end date or the event to trigger reducing or stopping the fiscal stimulus package, at what time fiscal consolidation would take place, if or when consumption taxes (or other taxes) may be raised further, and to what degree government welfare programs (such as medical and pensions) will be cut back in order to reign in government spending.[32] These questions have yet to be answered by Abe.

The Third Arrow – Reform

Unlike the First and Second Arrow, which have numerically measurable actions, Abe's Third Arrow is more ambiguous in nature. Also unlike the first two arrows, it was not tangibly implemented right at the start of his tenure. Specific information was not given on how reform would be conducted, whereas the first two arrows were very specific and numerically observable. Evaluating the effectiveness of reform becomes tricky as it cannot be measured or calculated, nor implemented instantaneously. Results are often not seen or expected for long periods of time. However, many different reforms were broadly outlined by Abe. These included reforms on taxation, trade, labor, agriculture, finance and banking, and energy, amongst other sectors. Concerning tax reform, we have yet to see whether Abe will allow the consumption tax to increase from 8 to 10 percent in the future. However, tax reform extends beyond consumption tax.

[32] Hugh Patrick, "Abenomics: Japan's New Economic Policy Package."

Against increasing consumption tax, Abe is set to lower corporate taxes from the current 35.6 percent to somewhere between 20 and 29 percent.[33]

Another more pressing topic of reform is Japan's participation in trade agreements. In the past, Japan has been relatively shy from entering bilateral or regional Free Trade Agreements (FTAs), and also Economic Partnership Agreements (EPAs), which are weaker than FTAs. In recent years, Japan has been confronted with two models of regional trade liberalization—an Asian agreement with ASEAN (Association of Southeast Asian Nations)[34] nations, and, more notably, the comprehensive Trans-Pacific Partnership (TPP) with eleven other nations led by the United States. The countries engaged in TPP negotiations aim to create a comprehensive, strong FTA.

Japan faces a difficult labor problem due to its aging and shrinking population. Boosting employment of young and old workers is one of Abe's major challenges. Another aspect of the labor problem Abe plans to tackle is gender inequality. Japan has historically had low gender equality in positions of power, especially in politics and positions of responsibility. As of early 2014, "women made up only 10 percent of Parliament and just 3.9 percent of the board members of publically listed Japanese companies."[35] Women in Japan have long complained about numerous obstacles they face in advancing their careers. Abe continually emphasizes that a key part of his Abenomics growth strategy was to increase gender diversity and promote qualified

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[33] Ira Kalish, "Japan: The Third Arrow of Abenomics," *Global Economic Outlook 3* (2014): 20-22

[34] Association of Southeast Asian Nations, "ASEAN Member States," accessed Feb 1, 2015, http://www.asean.org/asean/asean-member-states.

[35] Yuri Kageyama, "Japan's PM Shinzo Abe Embraces 'Womenomics' by Putting Five Women in His Cabinet," *The Independent*, Sept 3, 2014.

women to leadership posts. His self-proclaimed goal is for women to "occupy 30 percent of leadership positions in both private and public sectors by 2020." [36] In September 2014, Abe selected five women for his newly formed cabinet, out of 18 cabinet members.[37] This female representation was the greatest in Japan's history, sending a strong message on his determination for change.

In approaching the long-standing need for agricultural reform, Abe plans to consolidate systems of food production and distribution to boost efficiency.[38] The Central Union of Agricultural Cooperatives ("JA-Zenchu") is Japan's main agricultural lobby and largest opponent of opening agricultural trade with other nations such as the United States.[39] It has approximately 10 million members, and provides services for members including banking and insurance.[40] Abe wanted to weaken this group's influence, as its power was built on older entrenched farm policies that Abe sought to reform. Following a number of small steps, on February 9, 2015 Abe won a major victory. JA-Zenchu accepted significant farm cooperative reforms. These reforms would reduce their organization's role in "overseeing local cooperatives and representing the agricultural sector in its deliberations with Tokyo."[41] JA-Zenchu would be transformed. It

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[36] Ibid.

[37] Ibid.

[38] Hugh Patrick, "Abenomics."

[39] Takada, Aya, "Japan Farm-Lobby Chairman Resigns after Losing Battle with Abe." *Bloomberg*, Apr 9, 2015, accessed on Apr 25, 2015, http://www.bloomberg.com/news/articles/2015-04-09/japan-farm-lobby-chairman-resigns-after-losing-battle-with-abe.

[40] Ibid.

[41]Tobias Harris, "Abe's Third Arrow Finds Its Mark," *Wall Street Journal*, Feb 11, 2015, accessed Mar 26, 2015, http://www.wsj.com/articles/tobias-harris-abes-third-arrow-finds-its-mark-1423675406.

would no longer have its special taxation exemptions under the law, and be subject it to ordinary taxation instead. Amongst other changes, it would lose its regularly functions and parts of it would be converted into publically held companies, such as its wholesale division.[42] Although the actual legislation may take additional time to pass and implement, this was a major accomplishment in one of the sectors most urgently requiring reform,[43] as agriculture has been long considered as a stronghold of Japan's heavily protected, inefficient sectors.[44] This led to the resignation of JA-Zenchu's Chairman Akira Banzai, who expressed that a new era had arrived and felt "reform of our organization [should] be done under the leadership of a new chairman."[45]

Reform is also expected for the financial landscape. Traditionally, domestic insurance and pension funds have held government bonds as the majority of their investments. Abe hopes to change this by encouraging portfolio allocation of the public pension funds to gear towards less investment in government bonds and more investment in equities and other riskier assets. No legislation was required to allow the change of asset allocations, and asset allocation changes can already be seen happening. In November 2014, the Government Pension Investment Fund (GPIF), the public pension fund of Japan, announced it would re-allocate funds from government bonds into domestic and foreign equities. GPIF would have to make significant purchases of both

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[42] Ibid.

[43] Ibid.

[44] Reiji Yoshida, "JA-Zenchu Accepts Drastic Farm Cooperative Reforms," *Japan Times*, Feb 15, 2015, accessed Mar 1, 2015, http://www.japantimes.co.jp/news/2015/02/09/business /ja-zenchu-may-support-most-proposed-farm-cooperative-reforms/#.VPS59EK4mu4.

[45] Aya Takada, "Japan Farm-Lobby Chairman Resigns after Losing Battle with Abe."

domestic and foreign stocks (¥9.8 trillion JPY domestic, ¥11.5 trillion JPY foreign) in order to meet its new allocation targets.[46] This would mean their equity weight would increase from 12 percent to 25 percent, and their domestic bond holdings weight would decrease from 60 percent to 35 percent, a significant change.[47] The TOPIX index, an index based on all the domestic common stocks listed on the Tokyo Stock Exchange first section, soared 4.3 percent in anticipation of this allocation change. It was also motivated by the BOJ's unexpected October 2014 stimulus boost mentioned above, which included a three-fold increase in buying exchange-traded funds (the increase of easing was not limited to government bonds only). Given GPIF's status as the second largest fund in the world and the largest in Asia, its move toward a riskier asset allocation of its portfolio is a highly significant development. It is significant notably in its "domino" effect of putting pressure on other pension funds and insurance funds domestically to consider adopting less conservative asset allocation models.

Finally, in regards to energy, Abe came into office at a critical time in which energy had become a stressful topic in Japan following the Fukushima nuclear disaster in 2011. Well known and somewhat controversial in Abe's agenda was his desire to reform and restart Japan's nuclear power industry.[48] However, his plan to reform energy went beyond this. On April 2, 2014, energy reform was approved by Abe's cabinet. This included a forceful attempt to reduce major regional power monopolies by separating the

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[46] Yoshiaki Nohara and Toshiro Hasegawa, "GPIF's Strategy Shift Means Adding $187 Billion to Stocks," *Bloomberg News*, Nov 4, 2014, accessed Jan 28, 2015, http://www.bloomberg.com /news/articles/2014-11-04/japan-pension-s-new-strategy-means-adding-187-billion-to-stocks.

[47] Government Pension Investment Fund, "Adoption of New Policy Asset Mix," GPIF, accessed on Apr 15, 2015, http://www.gpif.go.jp/en/fund/pdf/adoption_of_new_policy_asset_mix.pdf.

[48] Kalish, "Japan: The Third Arrow of Abenomics," 20-22.

ability to transmit and distribute. This would allow new players both to produce and distribute electricity, and also develop their own networks to transmit the electricity.[49] Essentially, the barrier was removed for new entrants to be able to produce and sell electricity alongside the traditional monopolies.

Other reforms on Abe's agenda include boosting private sector participation in public infrastructure projects, liberalizing governance on foreign direct investments (FDI), creation of special economic zones, and improving corporate governance to become more compliant with international standards.

From the start of Abenomics, it was planned that while the Third Arrow was announced together with the first two, the reform component would take more time to implement. In addition, a certain momentum is starting to develop and much of the practical impact of reform will be seen in the future. In February 2015, Abe declared the 2015 spring session of the Diet that it would be a "banner year for reform"[50] and he promised to deliver the most sweeping reforms Japan would experience since the American Occupation following the war.[51] But what is so different now under Abe and Abenomics, as opposed to past efforts that included many of the same ideas and policies? And what does Abe still lack?

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[49] Hugh Patrick.

[50] Staff of the Nikkei Asian Review, "Japan's Prime Minister Declares Banner Year for Reform." *Nikkei Asian Review*, February 13, 2015, accessed on April 1, 2015, http://asia.nikkei.com/Politics-Economy/Policy-Politics/Japan-s-prime-minister-declares-banner-year-for-reform.

[51] Staff of Japan Today, "Abe Pledges to Carry Out Sweeping Reforms," *Japan Today*, Feb 13, 2015, accessed Feb 27, 2015, http://www.japantoday.com/category/politics/view/abe-pledges-to-carry-out-sweeping-reforms.

Roosevelt Resolve

In 1999 Ben Bernanke, then-Chairman of the US Federal Reserve Bank, concluded that Japan needed "Roosevelt Resolve."[52] By using this term, Bernanke was referring to the aggressive mentality observed in U.S. President Franklin D. Roosevelt after his inauguration in March 1933, when he attempted to pull the United States out of the Great Depression. Bernanke notes that Roosevelt's most effective actions were rehabilitating the banking sector and devaluating the currency,[53] actions that are similar to what Japan is currently doing under Abenomics. However, Bernanke also notes that Roosevelt's policy actions in themselves were less important than his strong personality and will-power. Roosevelt was aggressive, not afraid to experiment, and, in short, was prepared to do whatever was necessary to achieve his goal of economic recovery for his nation. Many of Roosevelt's policies actually did not work as he had intended. However, Bernanke credits Roosevelt for "having the courage to explore and abandon failed paradigms and do what needed to be done"[54] to pursue solutions to the social and economic challenges brought on by the Great Depression. In essence, his resolve was just as important, if not more, than his actions.

It is still too early to determine the success or effectiveness of Abenomics.[55] However, the initial results of the three arrows are very encouraging. Abenomics may

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[52] Ben S. Bernanke, "Japanese Monetary Policy: A Case Of Self-Induced Paralysis?," in *Japan's Financial Crisis and its Parallels to US Experience,* eds. Adam S. Posen and Rioichi Mikitani [Special Report] (Washington, DC: Institute for International Economics, 2000), 149-166.

[53] Ibid.

[54] Ibid.

[55] Henrike Michaelis and Sebastian Watzka, "Are There Differences in the Effectiveness of Quantitative Easing in Japan over Time?" (Munich: University of Munich, Munich Discussion Paper No. 2014-35, June 2014).

very well be the “Roosevelt Resolve” in Japan today. Kuroda and Abe share the Roosevelt mentality and spirit—a willingness to experiment and take radical steps to solve Japan’s economic problems. Their policies and political activism have broken the trends of the last two decades, and they are attempting to implement monetary policy, fiscal policy, and reforms in a cohesive, mutually planned execution. This resolve will be needed to pull Japan out of its Lost Decades in the same way the United States resolve over World War II pulled that country out of its Great Depression.

In this study, I pursue four goals. My first goal is to observe the historical backdrop of Japan’s economic landscape leading up to the start of Abenomics. In Chapter II, I share the results of my historical study, and find that ultimately it is the “Iron Triangle,” amongst other reasons, that has made deflation so difficult to defeat in Japan. My second goal is to review unsuccessful attempts to stop deflation in Japan. In Chapter III, I describe and analyze multiple different policy attempts made in the past by monetary and fiscal leaders to try to stop deflation, and their resulting failures. My third goal is to examine scholarly arguments on why these attempts could not succeed. In Chapter IV, I explore the research and conclusions of scholars on the insufficiencies, poor timing, and other difficulties that hampered Japan. My fourth and final goal is to offer a fundamental comparative analysis of how Abenomics differs from prior attempts to stop deflation and bring back economic growth to Japan. In Chapter V, I will explore the initial results of Abenomics, explain why they have been positive, and see what hurdles may remain going forward.

Chapter II

Brief History of Deflation in Japan

In order to have a proper context against which to understand the importance of Abenomics, a review of history is necessary. In this chapter, I will examine the beginnings of the Japanese currency and current political system, the post-war era following defeat in World War II, and the Bubble Era. I will also examine the formation of the "iron triangle" and its survival over time, which has made reform so difficult to implement in Japan.

Historical Overview

The Japanese Yen was born as part of the Meiji Restoration around 1871. It replaced an existing monetary system from the Edo period, based on the "mon." The Meiji Restoration brought about an overhaul in Japan's political and social structure, and showed Japan as a modernized nation to the rest of the world. [56] The Bank of Japan was created in 1882 as an independent entity, neither a government agency nor a private company. As gold was the standard during the era for major economies such as the United States, Japan adopted the gold standard—"a system for fixing exchange rates by

[56] Richard Sims, *Japanese Political History Since the Meiji Restoration, 1868-2000* (London: C. Hurst, 2001).

the central banks by making their currencies freely convertible into gold at a fixed price."[57]

In 1942, the BOJ was reorganized through the Bank of Japan Act. This reorganization strongly reflected the wartime situation, to act as a control on economic volatility during a time of turmoil. Article 1 stated the Bank's objectives as "the regulation of the currency, control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to national policy, in order that the general economic activities of the nation might adequately be enhanced."[58] The BOJ operated under its "window guidance" credit controls where it imposed quotas for credit growth for commercial banks.

In July 1944, Japan and other major nations gathered at the Bretton Woods Conference, during which it was agreed by the participants to form the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD), both of which are now part of the World Bank. The IMF agreement states: "The nations should consult and agree on international monetary changes which affect each other. They should outlaw practices which are agreed to be harmful to world prosperity and they should assist each other to overcome short-term exchange difficulties."[59] The IBRD was created to aid nations struggling with post-war reconstruction and political instability. Attending countries agreed to fix or "peg" currencies by means of fixed rates of exchange within small margins of fluctuation and with adjustments to exchange rates

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[57] Black and Hashimzade, *Oxford Dictionary*, 175-6.

[58] See Bank of Japan website at https://www.boj.or.jp/en/about/outline/history/index.htm/.

[59] International Monetary Fund, *Articles of Agreement of the International Monetary Fund*, accessed on May 18, 2015, https://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf.

as they became necessary. Following Bretton Woods, the Japanese Yen was pegged to the US Dollar at the rate of ¥360 JPY = $1 USD.

Following the end of World War II and Bretton Woods, Japan saw unprecedented growth and prosperity. Japan's defeat in World War II enabled its people to start a new economy afresh. With Japan's acceptance of the Potsdam Declaration on August 15, 1945, Japan became a subordinate of the United States. Soon thereafter in 1946, Japan's Constitution was written by MacArthur's military staff. In September 1951, Japan again became a sovereign nation through signing of the San Francisco Treaty. The period lasting from the end of the war until the signing of the San Francisco Treaty would become known as the "American Occupation" era.

The American Occupation brought about a series of reform policies designed to reconstruct the devastated nation and ultimately to create the opportunity for Japan to grow economically on its own will. The Americans drafted the Constitution for Japan, and it was passed with only a few changes in September 1946. It was accepted by the Emperor in November 1946 and became officially effective in May 1947.[60] Significant reforms did indeed take place during this era. The Constitution itself brought considerable reform. Through it, the bicameral Diet was born. The "Lower House" (House of Representatives) comprised of representatives who were elected for four-year terms, and would elect the prime minister. The Lower House would get "dissolved" when the prime minister called for a new election.[61] The "Upper House" (House of Councilors) consisted of fewer members who served six-year terms. By law, "three fifths

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[60] David Flath, *The Japanese Economy,* 3rd ed. (Oxford: Oxford University Press, 2014), 76.

[61] Ibid., 76-77.

of the Upper House are elected by various prefectures and the remainder are elected by national vote, while all the members of the lower house represent local districts."[62] This is a significant change applicable today because this bicameral Diet system continues onwards today. The Constitution also allowed women to vote for the first time in Japan, and reduced the voting age from 25 to 20.[63]

Another reform laid out during the American Occupation was regarding land. This reform was actually led by the Japanese government, and not an American initiation. It sought "to institutionalize the changes in agricultural land rental wrought by wartime controls" as "land rentals and sales had become subject to sweeping price controls"[64] that were instituted in the late 1930s, and continued to stay in effect after the war. Also, prices for agricultural commodities such as rice (the most prominent) became subject to price ceilings. However, the presence of price ceilings caused concern. The government was worried that the agricultural industry would lose its incentive to continue production, and so wanted to protect the domestic industry. The government began to purchase these agricultural goods (i.e., rice) from local producers at inflated prices, only to eventually sell them back to consumers at lower prices.[65] This system, which over the years was upheld by strong interests from the powerful agricultural lobbyists, has remained unchanged to this day. Bureaucrats played a key role in drafting policies during this time, and hence their interests made way into the policy, a dangerous predicament given the

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[62] Ibid., 76-77.

[63] Ibid., 77.

[64] Ibid.

[65] Ibid., 77-78.

incentives different bureaucrats could have to influence policy. Many of the bureaucrats simply "parachuted into the ruling party where they quickly assumed leading roles."[66]

Another American Occupation reform was breaking up the "zaibatsu". "Zaibatsu" is a Japanese term referring to the extremely large and influential business conglomerates that, during Japan's Empire era, enjoyed considerable political power. They were able to influence and control significant parts of the Japanese economy from the Meiji era to the end of World War II. The major stakeholders of Japan's zaibatsu drew special attention from the American authorities because many of these authorities were suspicious of monopolies, corruption, and restrictive business practices that they felt to be anti-democratic.[67] Also during the American Occupation, labor reform took place in the form of encouragement to create unions. Following the implementation of the Labor Union Law in December 1945, unionization of Japanese workers grew rapidly. By the end of 1949, 55.8 percent of the nation's non-farm labor force unionized.[68]

The reforms set by the American Occupation spurred spectacular growth by Japan. Japan grew from being a start-up industrializer into one of the world's largest economies – in fact, Japan was second only to the United States.[69] In 1971, the Bretton Woods system collapsed when the United States abandoned the gold standard. This forced a realignment of world currencies. Soon thereafter, under the Smithsonian

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[66] Gregory Noble, "The Evolution of the Japanese Policymaking System," in *Routledge Handbook of Japanese Politics*, edited by Alisa Gaunder (New York: Taylor & Francis, 2011), 249-260.

[67] Flath, *The Japanese Economy*, 79.

[68] Ibid., 83.

[69] Kenji Kushida, *Syncretism: The Politics of Economic Restructuring and System Reform in Japan* (Palo Alto, CA: Walter H. Shorestein Asia-Pacific Research Center, 2013).

Agreement, the dollar/yen exchange rate was quickly pegged again, this time at ¥308 JPY = $1 USD. This ratio would be short-lived, as two years later in 1973 Japan decided to let the yen float freely against the US dollar. A floating exchange rate occurs when a currency's value is allowed to "fluctuate in accordance to the market forces of supply and demand" [70]—with intervention from the government or central bank. The implementation of this decision by Japan marked the beginning of a period of yen appreciation and a condition of economic deflation. In economics, deflation is a decrease in the price level of goods and services. It is also a term used more broadly to depict a decrease in economic activity due to the lack of demand.[71] Deflation is indicated when the inflation rate falls below 0 percent (i.e., a negative inflation rate).

Since the time of Bretton Woods' collapse, the United States began to grow concerned of Japan's ascension on the world stage, with growing competitiveness in various sectors internationally and also sizeable trade surplus. Being Japan's biggest trade partner, the United States took advantage using pressure in the form of threatening trade sanctions in sensitive industries to encourage the appreciation of the yen.[72] In the coming years, Japan would succumb to some of this pressure.

However, the US dollar would continue to appreciate, and this began to cause international imbalances. [73] These imbalances led to the G5 (including Japan) to sign the

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[70] Black and Hashimzade. *Oxford Dictionary*, 160.

[71] Ibid., 102.

[72] Ronald McKinnon, "Japan's Deflationary Hangover: Wage Stagnation and the Syndrome of the Ever-Weaker Yen," (Palo Alto, CA: Stanford University Working Paper, July 2007), 2.

[73] Christopher J. Neely, "A Foreign Exchange Intervention in an Era of Restraint," *Federal Reserve Bank of St. Louis Review* 93, (September/October 2011): 309.

Plaza Accord in September 1985. The Accord was established with special focus on depreciating the value of US dollars against the Japanese yen and German Deutsche mark. Execution was set to be handled jointly by the respective central banks through currency intervention. The very strong dollar and the resultant international trade imbalances eventually prompted this accord. The yen would rise by roughly 20 percent within just a few months. This adjustment in the yen-dollar ratio was seen to have been sufficient by the G6. Thus in 1987, the G6 (including Japan) signed the Louvre Accord. The Louvre Accord sought to end the dollar's weakening as the result of the Plaza Accord. However, the effect of the Louvre Accord on USD/JPY was minimal and the US dollar kept appreciating against the yen. By 1988, USD/JPY would fall to a post-war low of 120.45, and this trend would continue. This continued lowering of USD/JPY was partly due to the BOJ succumbing to political pressure from within Japan, but also from the United States to grow the money supply in Japan (weaken the yen). This growth of plentiful supply of cash would only increase the propensity for the Japanese to continue their spending, and maintain its very lenient lending system.[74]

Japan was spurred by this spending that continued to be funded by easily obtainable lending. At the end of the 1980s, Japan experienced an extreme asset price growth. As seen in Figure 2.1 below, the Nikkei stock index surged in only five years only from 7,000 to over 39,000, a very drastic move.

[74] Flath, 140.

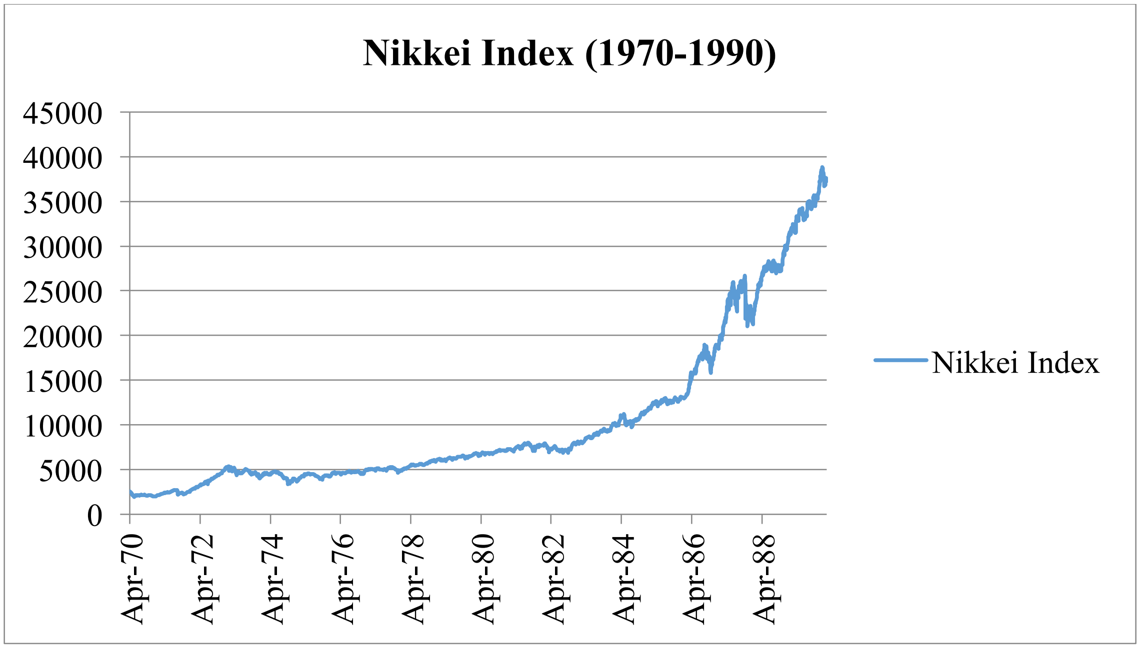

Figure 2.1. Nikkei Index (1970-1990), from Bloomberg website.

Japan’s GDP growth during this time, in Figure 2.2, became a topic of study and considered an economic miracle. The figure shows Japan’s GDP rising from being nearly zero to $1 trillion USD by the end of 1978, already an astonishing growth. However, it would more than triple by the end of 1990 to over $3 trillion USD, growth indeed worth the nickname of “the miracle.”

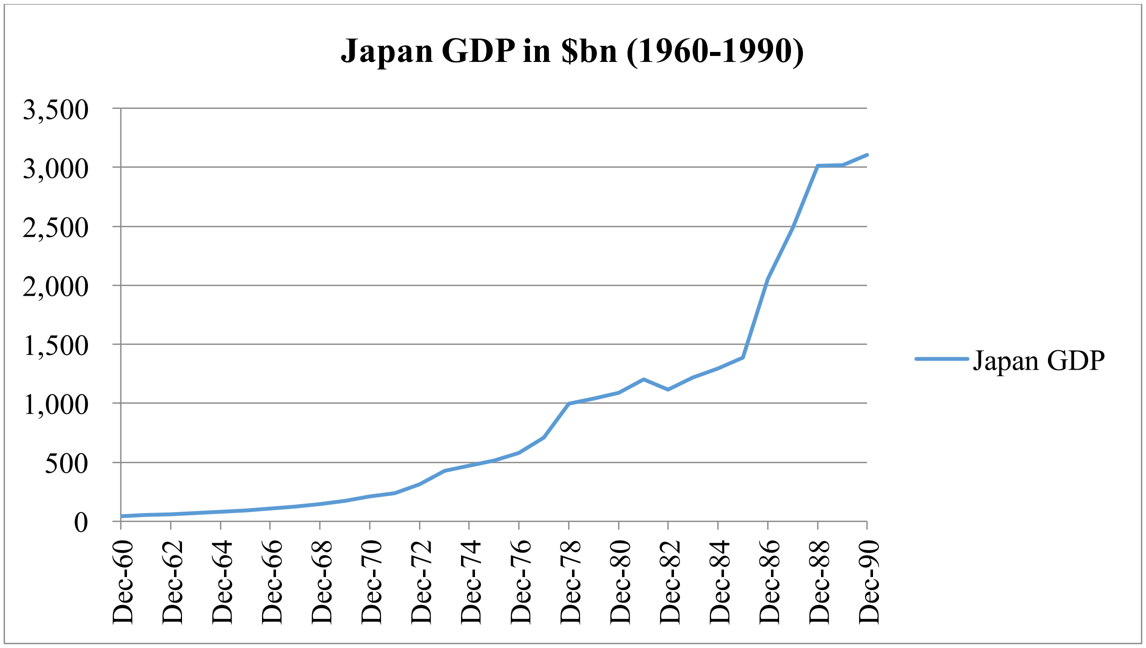

Figure 2.2. Japan Gross Domestic Product (1960-1990), from The World Bank website.

Meanwhile asset prices, especially in real estate, increased by large multiples. Despite this, the BOJ continued to maintain extremely loose policies that held interest rates low, perpetuating the availability of low-cost borrowing. Consequently, domestic banks made loans freely and frequently, helping fuel the surge in prices. The lending extended beyond home mortgages or loans for large purchases like cars for individuals. Loans were also freely made for investment, building industrial capacity, and for spurring business growth to an alarming scale. The size and frequency of lending would only be practical and sustainable if the already "miraculous" growth trends continued indefinitely.[75]

[75] Jennifer Amyx, *Japan's Financial Crisis – Institutional Rigidity and Reluctant Change* (Princeton: Princeton University Press, 2006).

This propensity to continue borrowing and lending without pragmatism led to the beginning of the bubble burst in the late 1980s. The performance of the Japanese economy since the turn of that decade has been less than stellar. Growth fueled by cheap and easy credit, and driven by speculation, would begin to fall. According to Christopher Wood, this is an apt description, as the "Bubble Economy" would spawn banking scandals that would have shocking consequences for the real economy.[76] The Nikkei plunged first, and land prices quickly followed suit. This caused a severe chain reaction. Borrowers, ranging from individuals to large corporations, struggled to repay their lenders on their loans. This would become commonly known as Japan's non-performing loan problem.[77] The inability to collect on mortgage and loan payments left banks throughout Japan in severe financial distress. This fall impacted both larger and smaller banks. The massive amount of distressed debt only continued to grow. In December 1992, the Finance Ministry estimated that the twenty-one largest banks together were holding approximately ¥4 trillion JPY in non-performing loans.[78] However, scholars and analysts estimated the amount to be closer to $250 billion USD, a far larger amount, even considering the exchange rates at the time.[79] The burden of looming bank defaults finally curtailed the banks' excessive lending. However, this also meant curtailing credit to new and qualified borrowers. Without new sources for accruing interest on new, reliable loans

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[76] Christopher Wood, *The Bubble Economy* (Jakarta: Solstice Publishing, 2006).

[77] Eisuke Sakakibara, *Structural Reform in Japan – Breaking the Iron Triangle* (Washington, DC: Brookings Institute Press, 2003).

[78] Editorial Staff, "Japan's Banks Standing on Shaky Ground," *Daily Yomiuri*, Dec 7, 1992.

[79] Jongsoo Lee, "The 'Crisis' of Non-Performing Loans: A Crisis for the Japanese Financial System?" *Pacific Review* 10, no. 1 (1997): 57-83.

and facing difficulties monetizing existing ones, the likelihood of the banks' collapsing continued to rise sharply.[80] This period, from roughly from 1990 to 2000 would become known infamously as Japan's "Lost Decade."

The start of the twenty-first century would not bring about an end of the Lost Decade, as the grip of economic stagnation persisted into a second Lost Decade.[81] The persistency of economic doldrums was partially attributable to the government delaying action. Throughout history, many nations and regions have faced financial crises.[82] However, Japan has proven to be unique because of its hesitant government delaying aggressive action to address the non-performing loan problem. The country would pay a considerable cost for this delayed response.[83] According to Jennifer Amyx, resolving banking crises should call for the use of public funds to recapitalize banks and establish a temporary agency to take control of failed banks and their assets.[84] The World Bank also echoes this, adding also that fast action is an essential ingredient for success, as is public support for the re-structuring strategy.[85] However, the use of public funds for such purposes is understandably unpopular. This can be seen recently in the United States, in

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[80] Amyx, *Japan's Financial Crisis*.

[81] Jeff Kingston, *Contemporary Japan: history, politics, and social change since the 1980s,* Vol. 1 (New York: John Wiley & Sons, 2010).

[82] Charles P. Kindelberger and Robert Z. Aliber. *Manias, Panics and Crashes: A History of Financial Crisis* (London: Palgrave Macmillan, 2005); Cihan Bilginsoy, *A History of Financial Crises: Dreams and Follies of Expectations* (London: Routledge, 2014).

[83] Amyx, *Japan's Financial Crisis.*

[84] Ibid., 1-2.

[85] Stijn Claessens, "Experiences of Resolution of Banking Crises," Joint PBOC/BIS Seminar, February 28-Mar 2, 1990, The World Bank.

light of the negative public reaction to the government-assisted bailout of Bear Stearns, and ongoing bailout of U.S. banks using taxpayer money. Thus, government leaders often are unwilling or avoid allocating taxpayer money in this way.[86]

According to the IMF, historically, countries which were most successful when faced with financial crises tend to spend an average 10 months before embarking on systemic financial restructuring. Even the slowest of the success stories begin restructuring within approximately 4 years.[87] Japan's gap was eight years. By the time Japan finally started restructuring, the amount of non-performing debt outstanding in Japanese banks estimated to be approbatively $1 trillion USD. [88] This was a stunning 30 percent of Japan's GDP. By the end of the 1990s, the GDP growth rate dropped to 0.5 percent.[89] From the late 1990s to 2010, the trend would only continue, with GDP still stagnating while other major nations saw exuberant growth. [90] During this period, the United States' GDP more than doubled, as seen in Figure 2.3.

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[86] Amyx, *Japan's Financial Crisis.*

[87] Paul Hilbers, "The IMF/World Bank Financial Sector Assessment Program," *Economic Perspectives* 6, (2001).

[88] Editorial Staff, "Japanese Banking: Loud and Clear," *The Economist* 350, no. 8103, accessed on Mar 12, 2015, http://www.economist.com/node/183485.

[89] Fumio Hayashi and Edward C. Prescott, "The 1990s in Japan: A Lost Decade," *Review of Economic Dynamics* 5, no. 1 (2002): 206-235.

[90] Derek Scissors and Kumi Yokoe, "Japan's National Budget: Time to Give Up on Keynesianism," *The Heritage Foundation* 103, (2012).

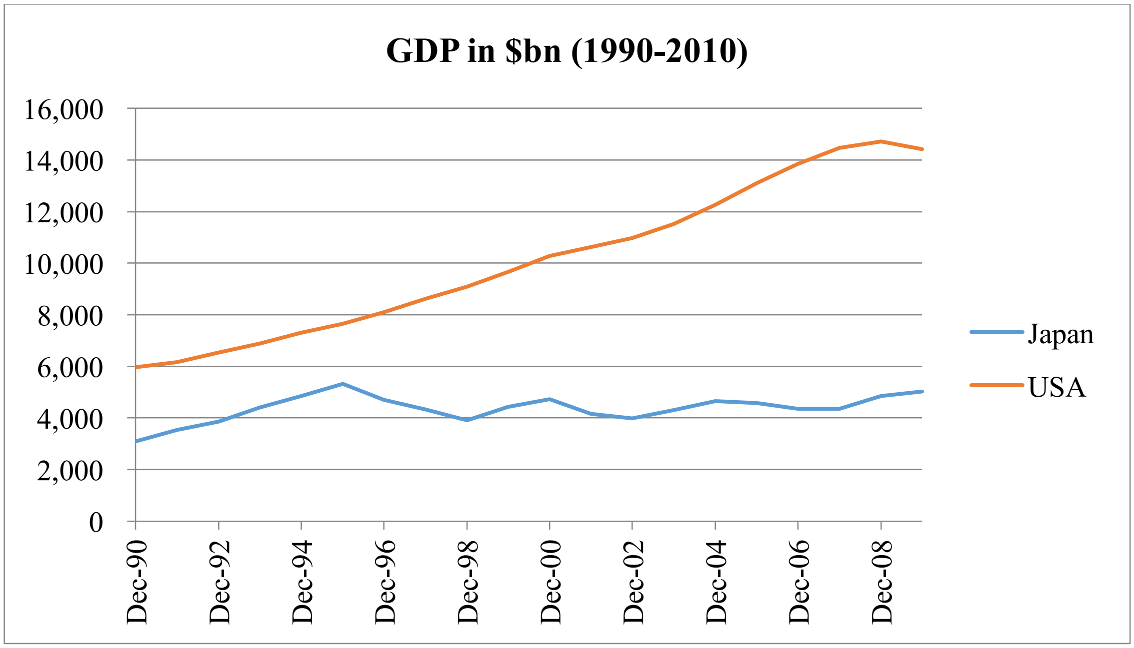

Figure 2.3. Japan and United States GDP (1990-2010), from the website of The World Bank.

Also during this time, Germany's GDP rose by 50 percent, while the GDP of Japan's neighbor South Korea more than quadrupled.

The Organization for Economic Cooperation and Development (OECD) maintains growth figures for countries. Japan's performance in this regard during its Lost Decades placed it last amongst OECD countries.[91] Adam Posen concludes that even if Japan had only half of the non-performing loans outstanding in 2001, the government would still have to cover costs considerably greater than other non-performing loans historically. Comparing the percentage of GDP of debt accumulated, Japan needed to

[91] Scissors and Yokoe, "Japan's National Budget."

cover four times that of the United States, when the United States was cleaning up its own loan crisis in the 1980s.[92]

Some fifteen years since the first Lost Decade in the early 1990's, the collapse of Lehman Brothers in September 2008 and the ensuing global financial crisis threatened the entire world economy. This was not helpful to Japan as it was already enduring a difficult financial situation. Japan's budget deficit-to-GDP ratio rose to over 200 percent in 2010. [93] This was caused mainly by the aging population forcing the government to maintain a high percentage of government spending in pension funds, which put the efficiency of public investment into question.[94] To make things worse, in March 2011 a catastrophic earthquake and tsunami struck Japan.

The Iron Triangle

Thus arrives the deep question of why is difficult to implement reform in Japan? Steven Vogel summarizes a response to this question with three points, two of which state: (1) "Japanese political systems impeded reform"[95], (2) "the Japanese political system favors the concentrated interests of the few, who oppose reform, over the diffuse

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[92] Adam Posen, "A Strategy To Prevent Future Crises: Safely Shrink The Banking Sector," in *Financial Crises in Japan and Latin America* (Washington, DC: Inter-American Development Bank, 2003), 259-72; Adam Posen, "Is Germany Turning Japanese?" (Peterson Institute for International Economics, working paper 03-2, Washington, D.C., 2003).

[93] Naoyuki Yoshino and Farhad Taghizadeh Hesary, "Three Arrows of Abenomics."

[94] Ibid.

[95] Vogel, Steven K. *Japan Remodeled: How Government and Industry are Reforming Japanese Capitalism*. (Ithaca: Cornell University Press, 2006), 40.

interests of the many, who support it."[96] Essentially, Vogel is referring to the Iron Triangle, a unique feature of Japan.

Japan's Iron Triangle is a relationship stronghold between the governing party (the LDP to be specific), the bureaucracy, and vested interested groups. The first political party to take power in the post-war era was the LDP, and public policy following the war disproportionately favored members of the LDP. According to Gregory Noble, this was particularly beneficial for small and rural farmers, construction businesses, and independent professionals such as doctors and dentists.[97] Elite bureaucrats, particularly from the agriculture sectors and large industries such as construction, would become powerful figures in Japan's policymaking process despite a lack of political upbringing, education, or experience. Koh notes bureaucrats drafted almost all bills and regulations, most of which were intentionally vague to leave room for discretion on how they would be implemented.[98] Noble notes bureaucrats would often "parachute" into the LDP and assume leading roles, including Prime Ministers, the Finance Minister, the Minister of Trade and Industry, amongst many others.[99] For example, Shigeru Yoshida (Foreign Ministry, Prime Minister, 1946-47 and 1948-54), Nobusuke Kishi (Ministry of Commerce and Industry, 1957-60) and Eisaku Sato (Railways and Transport, 1964-1972), all ex-bureaucrats, nearly "monopolized the prime ministership."[100]

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[96] Ibid., 44.

[97] Gregory Noble, "The Evolution of the Japanese Policymaking System."

[98] Byung Chul Koh, *Japan's Administrative Elite* (Berkeley, CA: University of California Press, 1989).

[99] Yoshino and Hesary, "Three Arrows of Abenomics."

[100] Gregory Noble, "The Evolution of the Japanese Policymaking System."

The LDP's survival was funded through donations from modern or competitive sectors of the economy. The LDP would then feed the funding to individual candidates' political efforts to obtain the votes from less competitive and traditional sectors, in particular the farmers.[101] These donations generally would come from the vested interest groups, which include large corporations and influential power brokers. They would lobby, finance, and support elected officials, which in turn would make it difficult for elected officials to implement structural reform against their own financial backers. [102]

Policy-wise, it was a similar structure of vested interest groups finding clout through their ability to wield power through financing. Frances Rosenbluth outlines that in the case of policy, a transfer of resources gained from taxation to fund subsidy programs for farmers and inefficient small businesses that would struggle against international competition otherwise.[103] While the money would come from the more powerful businesses, the votes the LDP needed to earn were those from the farmers. This made large corporations and the agricultural lobby strong vested interest groups the LDP needed to appease in order to stay in power.[104]

To really see why the LDP candidates needed so much funding, we would have to examine the Single Nontransferable Vote (SNTV), or in other words, the Lower House's electoral system. Rosenbaum notes that under the SNTV, each voter could cast only one

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[101] Frances McCall Rosenbluth and Michael F. Thies, *Japan Transformed: Political Change and Economic Restructuring* (Princeton: Princeton University Press, 2010), 53-55.

[102] Elliss Kraus and Robert Pekkanen, *The Rise and Fall of Japan's LDP* (Ithaca: Cornell University Press, 2011).

[103] Rosenbluth and Thies, *Japan Transformed, 53-55.*

[104] Ibid.

vote, for one candidate only.[105] However, it would still be a single vote to cast even in districts that sent multiple representatives. Thus under the SNTV, "any party seeking to win two or more seats in a district would have to nominate as many or more candidates, but then, crucially, the party's supporters could not simply vote for the party but would be forced to choose among"[106] competing candidates from the same party. Thus, the competition even within the LDP was very fierce for politicians to win voters, and each had the incentive to maintain (at great cost) their political territory of voters. It also made it more difficult for competitors of the LDP to compete against such a well-oiled, well-funded, and well-connected Lower House machine.

The LDP would maintain majority power in both Diet chambers (Upper and Lower) from its founding until 1989. However, this seemingly unbreakable power would lead to many side effects including scandals and economic downfalls, which would ultimately paralyze the potential of policy makers. I will discuss economic downfalls in further detail later in Chapter IV, where I examine the observations on why Japan struggled to stop its decline.

[105] Ibid.

[106] Ibid.

Chapter III

Japan's Attempts to Stop Deflation

Over the course of the two Lost Decades, many different attempts were made to stop the downward spiral of the economy. They have ranged from many different monetary policy measures to fiscal stimulus. In this chapter, I discuss the different actions that have been taken and their results.

Interest Rate Policy

One of the main functions of the Bank of Japan is to maintain monetary policy, through the management of interest rates. Controlling interest rates is widely recognized as one of the preeminent policies available to central banks to maintain inflation stability, and to a lesser extent currency rate stability.[107] The idea of controlling "interest rates" could mean many things, but the most salient rate a central bank has command over is the discount rate. The discount rate is defined as an interest rate charged by a central bank when it makes loans to private financial institutions.[108] In an effort to counteract the appreciation of the yen following the Plaza Accord in 1985, the BOJ repeatedly cut the

[107] Joaquim Pinto de Andrade and Jose Angelo Divino, "Monetary Policy of The Bank Of Japan – Inflation Target Versus Exchange Rate Target," *Japan and the World Economy*, no. 17 (2005): 189.

[108] Bank of Japan, *Brief Explanation of Words,* accessed on Nov 1, 2014, https://www.boj.or.jp/en/about /outline/word.htm.

discount rate.[109] While Japan had a discount rate as high as 9.0 percent at the start of the 1980s, it was around 5 percent by 1990, and was dropped below 2.0 percent for the first time in September 1993. In 1996, the BOJ under Governor Yasuo Matsushita reduced the discount rate to just 0.5 percent.[110] This would begin a prolonged era of low interest rates in Japan. In 1999, incoming Governor Masaru Hayami started reducing interest rates again, and it would reach a new low of 0.02 percent in February 1999. In April 1999, he would reduce it to zero "until deflation concerns were dispelled."[111] This was the birth of the zero-interest rate policy era.

The theory behind low interest rates is that with lower rates borrowing becomes more attractive since there is less interest to repay to the lender. Then theoretically, investment money would come out of government bonds (since they would have lower yields), and pour into assets and stocks – a creation of demand and price growth. However, this strategy proved unsuccessful as a means to re-inflate the Japanese economy. Kunio Okina and Shigenori Shiratsuka note that monetary policy by itself would have difficulty inflating an economy, especially when the situation is coinciding with low economic growth.[112] By 2001, despite zero-interest rate policies the banking sector was still reeling. At the same time, consumer prices were still dropping lower, and

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[109] Gregory W. Noble, "Front Door, Back Door: The Reform of Postal Savings and Loans in Japan," *Japanese Economy* 33, no. 1 (2005): 107-123.

[110] Kunio Okina and Shigenori Shiratsuka, "Policy Commitment and Expectation Formations: Japan's Experience Under Zero Interest Rates," (Institute for Monetary and Economic Studies, Discussion Paper No. 2003-E-5, July 2003).

[111] Ibid., 3.

[112] Ibid.

not much hope existed to escape continued recession.[113] Becuase the BOJ had already reduced the discount rate to zero, it eliminated one of the primary monetary tools for the BOJ, forcing the Bank to consider other options.[114]

Beyond losing leverage from not being able to lower interest rates any further, there was also a fall-off in bank lending. One of the benefits of lowering interest rates is to create a demand for borrowing money and investing. However, even with interest rates near zero percent, commercial bank lending continued to be stagnant in Japan after its experience with the non-performing loan problem that was a factor in causing the bubble to burst. Thus, the BOJ was not only entering an environment where it could no longer cut interest rates, but the demand for borrowing had dropped off as well, despite the near-zero interest rates (near-zero cost of borrowing). This phenomenon is referred to as a "liquidity trap."[115]

Okada and Shiratsuka conclude that the BOJ's efforts on interest rate policy and quantitative easing did help stabilize Japan's economy to an extent, but it failed to make an impact beyond the financial sector. [116] Thus, they concluded, monetary policy alone

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[113] David Bowman, Fang Cai, and Sally Davies, "Quantitative Easing and Bank Lending: Evidence from Japan" (Board of Governors of the Federal Reserve System, International Finance, Discussion Paper No. 1018,Washington, D.C., 2011).

[114] Ronald McKinnon and Kenichi Ohno. "The Foreign Exchange Origins of Japan's Economic Slump and Low Interest Liquidity Trap." (Institute for Monetary and Economic Studies, Discussion Paper No. 2000-E-19, Tokyo, 2000).

[115] Mitsuru Iwamura, Takeshi Kudo, and Tsutomu Watanabe. "Monetary and Fiscal Policy in a Liquidity Trap: The Japanese Experience 1999-2004," in *Monetary Policy with Very Low Inflation in the Pacific Rim, NBER-EASE, Volume 15* (Chicago: University of Chicago Press, 2006): 233-78.

[116] Kunio Okina and Shigenori Shiratsuka, "Policy Commitment and Expectation Formations: Japan's Experience Under Zero Interest Rates," (Institute for Monetary and Economic Studies, Discussion Paper No. 2003-E-5, Tokyo, 2003).

could not resolve deflation.[117] Despite the high price and low yields of government bonds, financial institutions (particularly domestic institutions) continued to be inclined to continue purchase government bonds at these heightened prices. There was little belief that inflation would return to the economy. Hence there was no fear that rates would go higher, which would lead to potential capital losses on buying bonds. While the BOJ had done similar policies as Kuroda has done recently, it was neither as potent nor complemented with well-timed fiscal stimulus or structural reform. Also, a dosage of Roosevelt Resolve was missing, to convince investors away from bond purchases and into the greater economy. The BOJ was back peddling and investors remained unconvinced.

Currency Intervention

Another measure Japan attempted was intervening in the foreign exchange currency markets. Foreign exchange intervention by definition is "the practice by monetary authorities or finance ministries of buying and selling foreign currency to influence exchange rates."[118] Since the bubble burst, both Japan's government and the BOJ continued to target the USD/JPY exchange rate as a measure of inflation. Although since 1973 the yen was theoretically a "free-floating" currency, the BOJ intervened multiple times in the foreign exchange market. In its attempts, it bought US dollars and sold the yen, in an attempt to weaken the yen. Thus, Japan's foreign exchange reserve continually increased. These increases are most evident during the periods of heavy

[117] Ibid.

[118] Neely, "A Foreign Exchange Intervention," 306.

intervention—in the mid-1970s, the late 1980s, the mid-1990s, and the mid-2000s.[119] The reserve would grow from $4.3 million USD (1970) to $892.8 million USD (June 2007).[120] By the mid-1990s, scholars and governments had grown skeptical about the effectiveness of currency interventions.[121] However, Japan continued to intervene directly in the currency market. The BOJ set a new historical record for central bank intervention in 2011 with a ¥700 billion JPY selling operation.

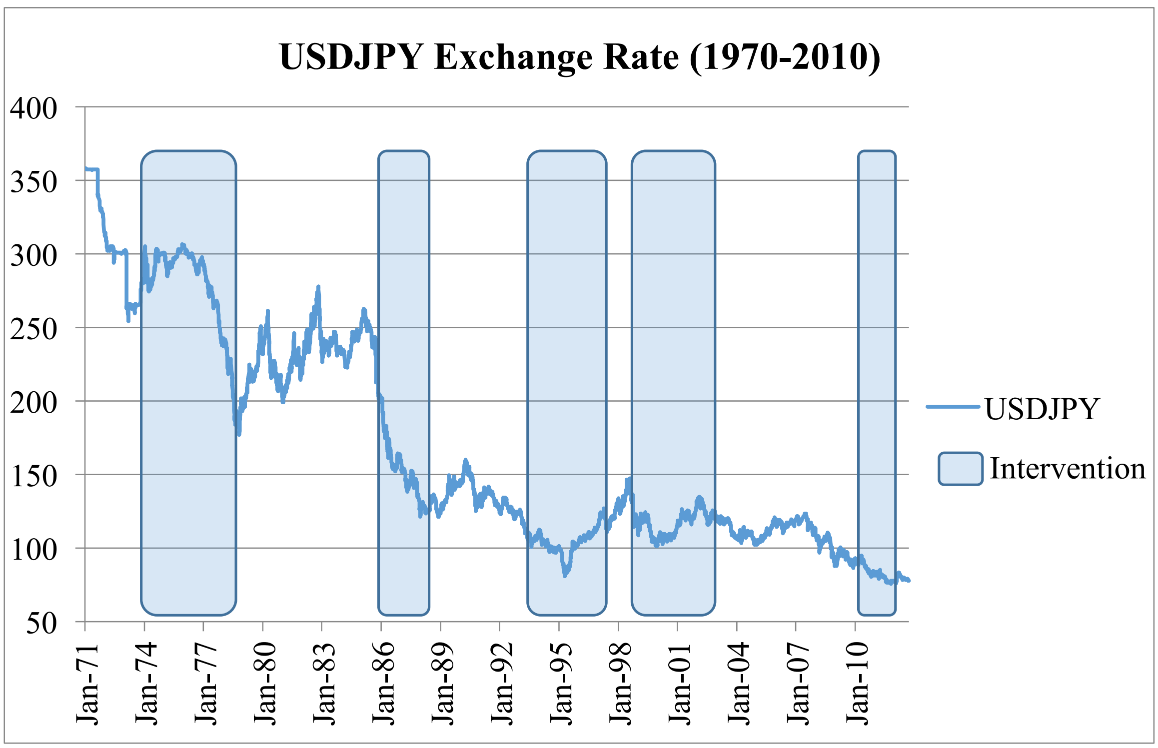

Figure 3.1. Periods of Intervention in USD/JPY (1971-2012), from Dick K. Nanto, "Japan's Currency Intervention: Policy Issues," [CRS Report for Congress] (Washington, DC: Congressional Research Service, 2007) and Bloomberg Website, accessed on April 15, 2015, http://www.bloomberg.com

[119] Dick K. Nanto, "Japan's Currency Intervention: Policy Issues," [CRS Report for Congress] (Washington, DC: Congressional Research Service, 2007).

[120] Ibid.

[121] Neely, "A Foreign Exchange Intervention," 309.

Figure 3.1 above shows that intervention was not able to fulfill any of the goals to depreciate the currency on a sustainable basis, inflate the economy, or stabilize market volatility. Even during the highlighted times of intervention, the exchange rate usually tended to go lower, as opposed to higher as intended.

Mark Spiegel, a senior research advisor for the United States Federal Reserve, notes in a study that for Japan, exchange rate movements do suggest that temporary results (of higher USD/JPY) were achievable from intervention. [122] For example, in 2003 following intervention the yen weakened for eight consecutive months as the BOJ intervened. However, Spiegel concludes ultimately that the effects (if any) appear to be temporary, and even in this 2003 example, the yen appreciated strongly as soon as intervening activity completed.[123]

Open Market Operations

Another way the BOJ can manage interest rates is through open market operations. There are two areas in which this is done. The first is through the interbank money market, where financial institutions borrow and lend funds among themselves, through the supply or withdrawal of funds. The second is in the open markets, where commercial companies can also participate in transactions, through the buying and selling of bills and bonds.

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[122] Mark M. Spiegel, "Japanese Foreign Exchange Intervention," *FRBSF Economic Letter,* 36 (2003).

[123] Ibid.

Effectively, open market operations are a monetary policy tool in which a central bank would purchase or sell securities, usually government bonds, as a means of altering interest rates and the money supply.[124] In the case of open market operations, expansionary monetary policy would typically mean quantitative easing through purchase of shorter-maturity bonds. However, when short-term interest rates are at or close to zero, normal monetary policy can no longer lower interest rates. Quantitative easing would then have to be extended by purchasing assets of longer maturities, and seeking to lower long-term interest rates. Quantitative easing aims to lower the yields of the assets purchased, or in other words, raises the prices. While quantitative easing policies by central banks have become a commonplace today, the BOJ was a pioneer in the policy. However, the BOJ's quantitative easing would ultimately fail in its objective to eliminate deflation. David Bowman notes that the effect of the BOJ's easing boost was usually small or insignificant.[125]

In March 2001 when the zero-interest rate policy was finally accepted as insufficient, and quantitative easing was born under BOJ Governor Masaru Hayami. The BOJ increased the outstanding current account by ¥1 trillion JPY, to around ¥5 trillion JPY, by purchasing of government bonds.[126] From March 2001 to March 2003, easing measures were increased from ¥400 billion JPY to ¥600 billion JPY per month, indicating the target for the current account increased to ¥6 trillion.[127] In December 2001

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[124] Black and Hashimzade. *Oxford Dictionary*, 292.

[125] Bowman, "Quantitative Easing."

[126] Yutaka Kurihara, "The Relationship between Exchange Rate and Stock Prices during Quantitative Easing Policy in Japan," *International Journal of Business* 11, no. 4 (2006): 382-383.

[127] Bowman, "Quantitative Easing."

easing was increased yet again, to ¥800 billion JPY per month (current account target of ¥10-15 trillion JPY). [128] The BOJ would continue this trend of gradual increases – in February 2002 it increased monthly purchases to ¥1 trillion JPY per month, and in October 2002 to ¥1.2 trillion JPY per month.[129]

In March 2003, a new BOJ governor and team were appointed. Unlike his predecessor, newly appointed Toshihiko Fukui gave the market a sense of calm by publicly stating that he would sustain the zero-interest rate policy in the future. This was also in line with the hopes of the national government. Fukui would also continue to increase easing. By January 2004, the current account target had grown to ¥30-35 trillion JPY. The Bank stated two conditions under which the zero-interest rate policy would end: (1) CPI (excluding fresh food) rate is positive for at least a few months, and (2) prospective CPI is not negative (in reference to the regular forecasts of BOJ Policy Board Members).[130]

Although the BOJ made clear references to CPI at this time, it should be clearly distinguished from inflation targeting. Although the BOJ was leaning away from using USD/JPY as its sole indicator for policy making direction, it was not necessarily setting an inflation target to achieve. It was only observing CPI as a reference rate and potential trigger against the application of zero-interest rate policy. The turning point for which a CPI rate (inflation) would actually be targeted would not come until current Kuroda era.

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[128] Takatoshi Ito, "Inflation Targeting and Japan: Why Has the Bank of Japan Not Adopted Inflation Targeting?" (National Bureau of Economic Research, Working Paper 10818, Cambridge, MA, 2004).

[129] Ibid.

[130] Ibid.

Bank of Japan Independence

In 1996, Japan's newly elected Prime Minister, the LDP's Ryutaro Hashimoto, revised central banking law. He believed a firm demonstration through concrete measures was necessary to show his commitment to reforming Japan's troubled economy.[131] A full revision was made to the Bank of Japan Act in 1997. A new Bank of Japan would emerge. It would be a central bank with much greater independence from the bureaucracy (in particular, the Ministry of Finance, or "MOF") and the national government. The Bank of Japan Act remains today, defining the Bank's objectives to be "to issue banknotes and to carry out currency and monetary control" and "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system." [132] The Act also reinforces the Bank's principle of currency and monetary control, stating "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," and "in recognition of the fact that currency and monetary control is a component of overall economic policy, the Bank of Japan shall always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the

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[131] Jennifer Holt Dwyer, "Explaining Central Bank Reform in Japan," *Social Science Japan Journal* 7, no. 2 (2004): 245-262.

[132] Bank of Japan, *Outline of the Bank,* accessed Nov 1, 2014, http://www.boj.or.jp/en/about /outline/index.htm, 2014.

government's economic policy shall be mutually harmonious."[133] Here we can see that the ground was set for independent entities to mutually cooperate. Similarly to inflation targeting, this would not truly be seen until the Abenomics era, more than 15 years removed since these words of cooperation were written in the 1997 Bank of Japan Act.

Government Spending and Taxation

One of the major economic tools used by the government was increasing spending. When in the 1990s and 2000s GDP growth grinded nearly to a halt, the Japanese government responded with a large fiscal stimulus plan. By directly injecting funds into the economy, it sought to increase demand, particularly in private investment and consumption by companies and individuals. However, as famous as these fiscal stimulus packages were, they were not actually as large as seemed. According to John Makin, the stimulus amounts were often inflated due to some programs already planned from before being re-counted.[134] More concerning, he notes that they were poorly directed, "largely towards unproductive public works projects and credits to small businesses that were no longer economically viable."[135] He suggests that it would have been better to simply reduce taxes to allow households to use their increased disposable incomes as they pleased.[136]

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[133] Bank of Japan, *Bank of Japan Act,* accessed Nov 1, 2014 http://www.boj.or.jp/en/about /boj_law /index.htm, 2014.

[134] John Makin, "Japan's Lost Decade: Lessons for the United States in 2008," *Economic Outlook* (2008).

[135] Ibid.

[136] Ibid.

However, in April 1997, the opposite was on Prime Minister Ryutaro Hashimoto's mind. He believed that government spending was working as intended. Indeed, with the help of sharp interest rate reduction, the real growth rate reached nearly 4 percent by this time. The long period of deflation and stagnating GDP growth was largely ignored by Japan's policymakers including Hashimoto.[137]

Thus, Hashimoto thought the economy was improving. Moving on to concern with the government debt buildup, he seized the opportunity to *increase* the consumption sales tax from 3 to 5 percent. He also repealed an income tax cut, further adding to what would end up being a significant mistake. This repeal sent the economy into an even deeper bottom.[138] The tax increase in particular was seen as rather ill timed, and is argued to have been Japan's biggest policy mistake of the Lost Decade.[139]

Table 3.1. Japan GDP tThrough Hashimoto's Tax Hike (1992-2000)

Year	GDP ($bn USD)
1992	$3,853
1993	$4,414
1994	$4,850
1995	$5,334
1996	$4,706
1997	$4,324
1998	$3,915
1999	$4,433
2000	$4,731

Source: The World Bank, accessed on April 15, 2015, http://data.worldbank.com

[137] Ibid.

[138] Ronald McKinnon and Kenichi Ohno. "The Foreign Exchange Origins of Japan's Economic Slump and Low Interest Liquidity Trap," (Institute for Monetary and Economic Studies, Discussion Paper No. 2000-E-19, Tokyo, 2000).

[139] Makin, "Japan's Lost Decade."

As can be seen in Table 3.1, Japan's GDP was on an upward trend until Hashimoto implemented the tax hike in 1996. Consequently, Japan saw GDP decrease the following two years as well. In 1999 (after Hashimoto failed to be re-elected in 1998), the GDP would rebound.

One scholar notes that it was the responsible thing to do, but perhaps not at the right time.[140] In the "Black November" of 1997, the collapse of several major banks and securities firms overwhelmed the efforts of the MOF to execute traditional "convoy" approach to regulations: stronger financial firms were no longer willing or able to take over failing firms. To make amends for this, in March 1998, large capital injections were made into domestic banks by the government, but this was not sufficient to prevent the failure of two large banks that year.

Some parallels can be seen between Hashimoto's policy directions to Abenomics. Similar to the Second Arrow, he executed fiscal stimulus through government spending and also taxation to control the budget. He made attempts at structural change as well (Third Arrow), such as granting the Bank of Japan more autonomy and removing responsibility for financial regulation away from the bureaucratic Ministry of Finance and into the independent Financial Supervisory Agency (FSA). However, the differences between Hashimoto and Abe's stimulus plans are significant. While Abe also introduced a fiscal stimulus package and allowed a tax cut, these happened in a coordinated fashion, as part of a well-publicized plan that had already set the public's expectations. These actions were also coordinated with monetary policy, as opposed to independent actions

[140] Gregory W. Noble, "Front door, Back Door."

taken by Hashimoto. Hashimoto's policies were more reactive to other elements than those for which he cohesively planned. For example, his tax hike was only founded after assuming economic improvement, which in turn was on the back of lowered interest rates by an independent BOJ decision.

After Prime Minister Hashimoto resigned in 1998, the government continued to introduce new public spending programs, dominated by infrastructure investments – still too resounding with Makin's concern regarding not only size, but application, of stimulus. By this time, Japan was in full swing facing its liquidity trap issue. The textbook response solution for overcoming this trap is government expenditure, but given its debt problems, continued government spending would not be sustainable – it was too late for spending to solve Japan's problems. In 2002, the United States Board of Governors of the Federal Reserve System studied Japan's experience with preventing deflation, and the lessons that could be drawn from it. It concluded that in the early 1990s, Japanese fiscal policy was indeed relatively stimulative by conventional standards, but it should have been even more aggressive to prevent deflation.[141]

In recent years, government spending has grown faster than tax revenues – the national debt is still growing. The aging population has forced the government to continue to spend more on welfare, pensions, and health services. Meanwhile, deflated prices and recession have crumbled the nation's revenue from taxation. Adjusting the balance between tax revenues and government spending is now necessary.[142]

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[141] Alan Ahearne and Joseph Gagnon. "Preventing Deflation: Lessons from Japan's Experience in the 1990s," (Board of Governors of the Federal Reserve System, International Finance Discussion Paper, No. 729, Washington, D. C., 2002).

[142] David Flath, *The Japanese Economy,* 3rd ed. (Oxford: Oxford University Press, 2014), 259.

Pre-Abenomics Monetary Policy under Shirakawa

While the Bank of Japan Act of 1997 increased the independence of the Bank, the Act was also a fundamental shift in the Bank's purpose. The old law mandated the Bank to help maximize the potential growth of the economy, but the new mandate brought greater focus on the Bank to maintain price stability.[143] After being appointed as Governor in April 2008, Masaaki Shirakawa would perform his duties with a priority on sustaining price stability. Shirakawa was originally appointed as a deputy governor, the first temporary governor of the BOJ in over eighty years. The previous two government nominees were vetoed by the Upper House. This partly stemmed from the fact that the Upper House had been controlled by the opposing party DPJ since 1997. After successive failures to appoint a governor, the government, under LDP Prime Minister Yasuo Fukuda, turned to Shirakawa as a compromise candidate who would likely (and finally) win approval in the Upper House.

Although Shirakawa was willing to work closely with politicians and was seemingly on a public relations campaign not just with the government but also with the public, he did not necessarily fully adhere to all governmental requests. His ultimate concern remained the independence of the Bank, and he stubbornly stuck with his mandate to maintain market stability, at which he certainly succeeded. In helping Japan return to growth and inflation, however, he failed as did his predecessors. In Figure 3.2 below we can see that since the mid-1990s, Japan has been unable to sustain positive inflation.

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[143] Ito, "Inflation Targeting and Japan."

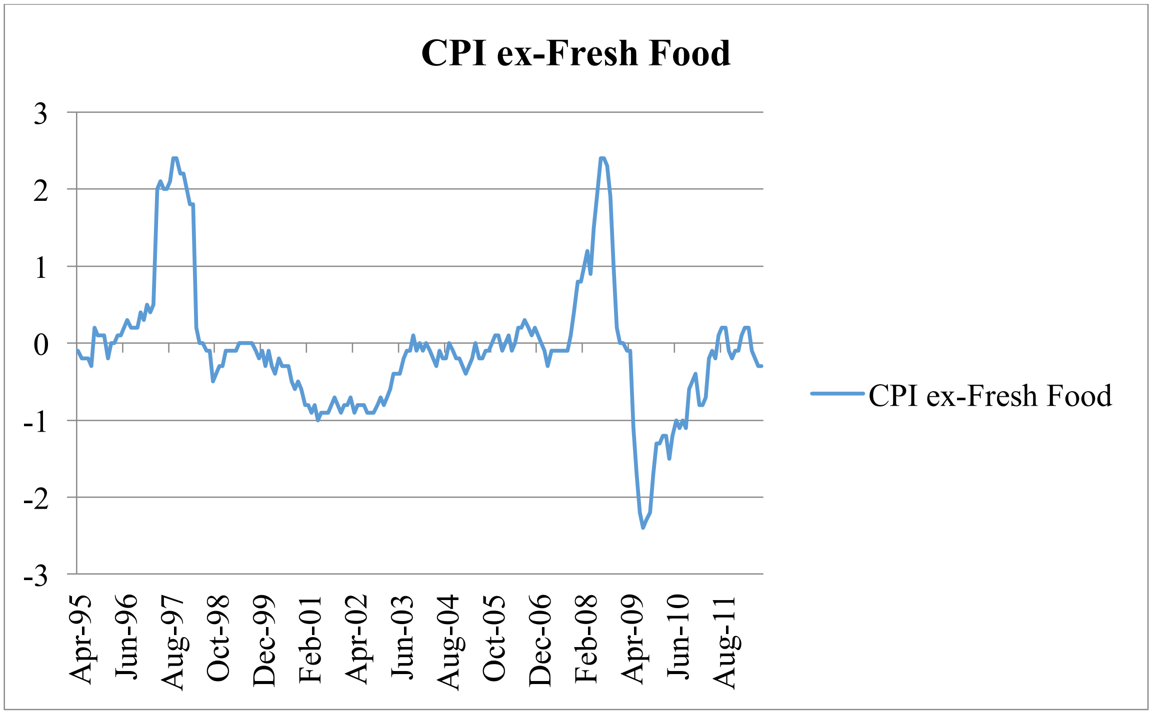

Figure 3.2. Japan CPI ex-Fresh Food (1995-2012), from Source: Bloomberg Website, accessed on April 15, 2015, http://www.bloomberg.com.

By the end of the Shirakawa era, the BOJ had not yet created a record of accomplishment, nor a track record of strong attempts. Thus, it was not able to build credibility in the markets[144] – and it had no Roosevelt Resolve.

The Bank was often criticized for both its lack of action and lack of quality of the actions it did undertake throughout the Lost Decades. Ben Bernanke notes that the BOJ made "exceptionally poor" [145] monetary policy-making decisions. He notes that among monetary-policy mistakes were 1) the failure to tighten policy during 1987-89 despite

[144] Adam Posen, "Declarations Are Not Enough – Financial Sector Sources of Central Bank Independence," *National Bureau of Economic Research Macroeconomic Annual* 10 (1995): 253-74.

[145] Bernanke, "Japanese monetary policy: A case of self-induced paralysis?"

evidence of growing deflationary pressures, which really led the way to the bubble burst; 2) the apparent attempt to "prick" the stock market bubble in 1989-91, which helped to induce an asset-price crash; and 3) the failure to ease "sufficiently" during the 1991-94 period, as asset prices, the banking system, and the economy were in a free-fall.[146]

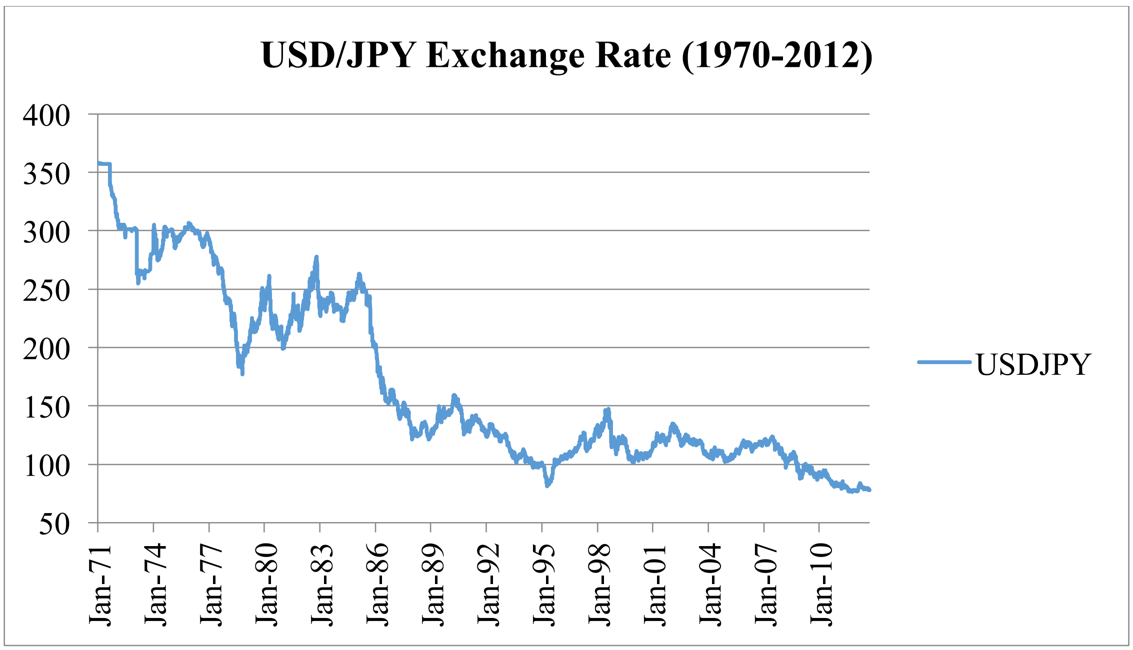

Figure 3.3. USD/JPY Before Abenomics (1970-2012), from Bloomberg Website, accessed on April 15, 2015, http://www.bloomberg.com.

Over these five years of Shirakawa's tenure, he would not only be able to re-inflate the economy, but Figure 3.3 shows he was also not able to stop the Yen from strengthening to historical record high's, hurting major corporations/exporters and consequently the Nikkei.

[146] Ibid.

Governor Shirakawa understood his mandate to be first and foremost to "achieve a stable financial environment" that would "contribute to the sustainable economic growth."[147] He interpreted this to mean that his utmost priority was to ensure a non-volatile environment in Japan and its financial system, through achieving price stability.[148] Seen neither as a dove nor a hawk ("dove" referring to those who primarily focus on employment and jobs, while; "hawk" referring to those who focus primarily on inflation),[149] he would ultimately become known for his preference for inaction. He did indeed achieve stability – interest rates, foreign exchange rate, consumer price index (CPI) indicators all exhibited limited volatility during his tenure. However, they also exhibited a downward trend, both shown in the Fig. 3.3 above.

Pre-Abenomics Political Situation – Multiple Prime Ministers

Compounding the struggles of the BOJ to spur the economy during the Shirakawa era was a political landscape that had struggles of its own. At the time of Shirakawa's appointment, Japan was reeling from having had three different Prime Ministers lead the nation over the previous eighteen months, and Shirakawa would go on to work alongside five different prime ministers during his five-year term as Governor. The longest tenured Prime Minister would be Naoto Kan, whose term was only fifteen months long (June 8,

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[147] Masaaki Shirakawa, "Future of Central Banks and Central Banking," (speech given at 2010 International Conference hosted by the Institute of Monetary and Economic Studies, Tokyo, May 26, 2010).

[148] Ibid.

[149] Simon Constable, "In Translation: Fed Doves and Hawks," *Wall Street Journal*, May 5, 2013, accessed on Jan 20, 2015, http://www.wsj.com/articles/SB100014241278873233096045784292817 79707410.

2010 to September 2, 2011). During this time, he would also see two different political parties in power, with the DPJ taking control of the government in 2009. This ended a long reign by the LDP, who had not been displaced since the end of the World War II. However, the LDP would return to power in December 2012.

Table 3.2. Prime Ministers of Japan

Name	From	To	Party
Eisaku Sato	9-Nov-64	7-Jul-72	LDP
Kakuei Tanaka	7-Jul-72	9-Dec-74	LDP
Takeo Miki	9-Dec-74	24-Dec-76	LDP
Takeo Fukuda	24-Dec-76	7-Dec-78	LDP
Masayoshi Ohira	7-Dec-78	12-Jun-80	LDP
Zenko Suzuki	17-Jul-80	27-Nov-82	LDP
Yasuhiro Nakasone	27-Nov-82	6-Nov-87	LDP
Noboru Takeshita	6-Nov-87	3-Jun-89	LDP
Sosuke Uno	3-Jun-89	10-Aug-89	LDP
Toshiki Kaifu	10-Aug-89	5-Nov-91	LDP
Kiichi Miyazawa	5-Nov-91	9-Aug-93	LDP
Morihiro Hosokawa	9-Aug-93	28-Apr-94	JNP
Tsutomu Hata	28-Apr-94	30-Jun-94	JRP
Tomiichi Murayama	30-Jun-94	11-Jan-96	JSP
Ryutaro Hashimoto	11-Jan-96	30-Jul-98	LDP
Keizo Obuchi	30-Jul-98	5-Apr-00	LDP
Yoshiro Mori	5-Apr-00	26-Apr-01	LDP
Junichiro Koizumi	26-Apr-01	26-Sep-06	LDP
Shinzo Abe	26-Sep-06	26-Sep-07	LDP
Yasuo Fukuda	26-Sep-07	24-Sep-08	LDP
Taro Aso	24-Sep-08	16-Sep-09	LDP
Yukio Hatoyama	16-Sep-09	8-Jun-10	DJP
Naoto Kan	8-Jun-10	2-Sep-11	DJP
Yoshihiko Noda	2-Sep-11	26-Dec-12	DJP
Shinzo Abe	26-Dec-12	Incumbent	LDP

Source: Prime Minister of Japan and his Cabinet, accessed on April 15, 2015, http://japan.kantei.go.jp/archives_e.html

Visible in Table 3.2 is the frequent changing of the guard in national leadership during the years of Shirakawa's tenure (highlighted in maroon color). After Junichiro Koizumi, no prime minister was able to hold onto the position for much longer than a year from 2006 to 2012, a period that would see eight different leaders. Also important to note is that during this period, the LDP first lost power, and Japan saw three successive DPJ representatives assume the prime minister position. However, this lack of continuity in political leadership would cause instability and make reform very difficult.

From 2008 to 2011, the DPJ was in power, led by three successive prime ministers – Yukio Hatoyama (September 2009 – June 2010), Naoto Kan (June 2010 – September 2011), and Yoshihiko Noda (September 2011 – December 2012). The DPJ during this period raised considerable hope for economic and social change, given that its rise to power was already a change in itself. Its core promises included revamping fiscal and economic policy and moving forward in Japan's relationships with its neighbors. However, DPJ was not able to prove itself quickly enough for the voters, who voted the unreformed LDP and a tarnished former prime minister back into power. According to Yves Tiberghien, the DPJ proved to be a "hodgepodge of politicians covering too wide a policy spectrum to act together on a coherent economic strategy at home or abroad." [150] All three of the DPJ administrations would end up being "fraught with internal divisions, incoherence, and policy U-turns."[151] The DPJ leaders failed to instill confidence by being unprepared to lead and seeming disorganized in the higher ranks. Further, unfortunately

[150] Yves Tiberghien, Robert Pekkenan, and Steven Reed, eds., *Japan Decides 2012 – The Japanese General Election* (New York: Palgrave Macmillan, 2003), chapter 16.

[151] Ibid.

for the DPJ, there were also external factors that made their time of power difficult, especially for economic recovery. During the DPJ tenure there was the Great Tohuku Earthquake and the Fukushima nuclear disaster, as well as the European credit crisis.

The iron triangle, although it was built upon the LDP foundation, was still visible in the DPJ as well, as the DPJ was heavily influenced by the MOF and global events. Prime Minister Noda in particular worried primarily about the potential of a Greek-style crisis hitting Japan.[152] He pushed forward efforts to raise the consumption tax from 5 to 10 percent, conjuring memories of the disastrous consumption tax hike from the prior decade. However, the road was not easy for the DPJ. The previous consumption tax hike in Japan by Hashimoto to five percent proved to be extremely unpopular and essentially ended his chances at re-election. Gregory Noble notes that political leaders associated with consumption tax hikes struggled to earn votes for re-election.[153] It was a bold move for Noda to take, and in a sense also somewhat surprising that the bill was passed. However, as difficult as it may have been, "analysts of all stripes agreed that a five percentage point increase was only a start – albeit a crucial one – to bringing Japan's massive deficits and accumulated debt under control.[154]

Part of the reason for the DPJ's ascent to power was its empowered politicians who were willing to stand up against the bureaucracy. In a sense they were willing to contend against the iron triangle that featured the LDP as one of its cornerstones.

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[152] Gregory W. Noble, "Too Little, Too Late? Raising the Consumption Tax to Shore Up Japanese Finances," *Japanese Political Economy* 40, no. 2 (2014): 48-75.

[153] Ibid.

[154] Ibid., 67.

However, Kushida and Lipscy write that “ironically, this acted as a constraint on the DPJ’s ability to implement its reform agenda.”[155] One of the major ways the DPJ tried to loosen the power of the bureaucracy was by trying to reduce their influence over politicians in decision-making processes. Kushida and Lipscy note that the “role of political appointees was expanded, with the top three levels of bureaucratic leadership occupied by politicians.”[156] The DPJ also distanced bureaucratic leaders from positions of power and information, and attempted to centralize power over the budget and personnel management to within the prime minister’s office.[157] However, internal disagreements and lack of an internally accepted strategy caused confusion. This would naturally lead to a weak political image and set the stage for the LDP to regroup and resurge.

With the DPJ reeling from internal divisions, Japan was a place of transition yet again at the end of Noda’s tenure—the end of the DPJ in power. In the 2012 election, a record number of candidates ran for positions, and nearly half were doing so for the first time.[158] In this election the LDP would assume power again after a three-year hiatus. However, the LDP did not exhibit much change or a new image after having three years to reform itself. Daniel Smith notes that in the LDP, women remained underrepresented as before, and the powerful family dynasties remained unbroken, resuming undeterred to

[155] Kenji Kushida and Phillip Lipscy, “The Rise and Fall of the Democratic Party of Japan,” in *Japan Under the DPJ,* ed. Kenji Kushida and Phillip Lipscy (Palo Alto, CA: Walter H. Shorestein Asia-Pacific Research Center Books, 2013), 32.

[156] Ibid., 32.

[157] Ibid.

[158] Daniel Smith, “Candidate Recruitment for the 2012 Election: New Parties, New Methods...Same Old Pool of Candidates,” in *Japan Decides 2012-The Japanese General Election*, ed. Robert Pekkanen, Steven Reed, and Ethan Scheiner (New York: Palgrave Macmillan, 2013), 101-122.

the next generation.[159] It appeared that the LDP was picking up right where it left off. However, at this point would enter a rejuvenated Shinzo Abe, which we will examine in Chapter IV.

Part of the reason for the frequent changes in administration stemmed from public sentiment. Public opinion polls of the Prime Minister reveal the flickering status of public opinion—a repetitive pattern of expectation at the start of each new prime minister followed by disappointment.[160] Kenji Kushida concludes that a pattern appears of approval ratings for each prime ministers' administration falling below the disapproval ratings, followed by a new prime minister.[161] He also finds a pattern in a link between political leadership and reform. During bursts of reform, especially during the tenures of Prime Ministers Ryutaro Hashimoto and Junichiro Koizumi, there were high public approval ratings.[162] This is well illustrated in their book *Syncretism: The Politics of Economic Restructuring and System Reform in Japan*.[163]

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[159] Ibid., 120.

[160] Kenji Kushida and Kay Shimizu. "Overview: Japan's Political and Economic Transformations since the 1990s," in *Syncretism: The Politics of Economic Restructuring and System Reform in Japan*, ed. Kenji Kushida, Kay Shimizu, and Jean Oi (Palo Alto, CA: Walter H. Shorenstein Asia-Pacific Research Center Books, 2013), 11-35.

[161] Kenji E. Kushida and Kay Shimizu. "Syncretism: The Politics of Japan's Financial Reforms," *Socio-Economic Review*, no. 313 (Mar 2013).

[162] Kushida and Shimizu, "Overview."

[163] Ibid., 16-17.

Chapter IV

Scholarly Arguments and Recommendations

Japan has figured prominently in academic studies due to the different eras of phenomenal economic growth it has seen. In the aftermath of World War II, eastern Asia was the only region globally that "experienced continual economic growth and no other East Asian country enjoyed more economic success than Japan."[164] Like its successes, its economic problems have similarly been noticed and studied. Scholars and observers, both inside and outside of Japan have pointed to a laundry list of various issues Japan faces. The problems range from being structural, political, and financial in nature, and extensive scholarship has been devoted to understanding the difficulty of economic recovery along with difficulty of reform in Japan. In this chapter, I will review scholars' arguments on why Japan's attempts have not been sufficient, and the suggestions they make.

Currency Intervention and Inflation Targeting

In the early 1990s, there was growing belief amongst both politicians and economists that an important long-term goal of monetary policy should be maintaining a stable and low (but positive) inflation rate. [165] To achieve this, monetary policy in many countries was long conducted by "relying on intermediate targets such as monetary

[164] Lucien Ellington, "Learning from the Japanese Economy," *National Clearinghouse for United States-Japan Studies, Japan Digest*, no. 15 (2004).

[165] Pierre-Richard Agénor, *Monetary Policy Under Flexible Exchange Rates: An Introduction to Inflation Targeting* (Washington, DC: World Bank Publications, 2000).

aggregates or exchange rates."[166] However later in the decade some nations began to target inflation itself instead of stability or other targets such as currency exchange. Japan was not one of these nations yet.

Currency intervention actions stem from an assumption that there is strong correlation between deflation and the foreign exchange rate.[167] The aforementioned periods of intervention in Japan (Figure 3.1), including Shirakawa's record-setting action in 2011, have led scholars both domestic and international to conclude that the BOJ was emphasizing exchange rate targeting to monitor inflation[168] (for example, Hutchinson,[169] Okabe,[170] and McKinnon and Ohno[171]). McKinnon and Ohno agree that trade imbalances and other factors, particularly between the United States (Japan's largest trading partner) and Japan, should bring about changes and fluctuation in the exchange rate as natural supply/demand behavior.[172] They also argue that unnatural adjustment of the exchange rate is both ineffective and costly,[173] something Japan would find out only after repeated failed attempts.

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[166] Ibid.

[167] Clarida R. Gertler, "How the Bundesbank Conducts Monetary Policy," (National Bureau of Economic Research, Working Paper No. 5581, Cambridge, MA, 1996).

[168] Joaquim Pinto de Andrade and Jose Angelo Divino, "Monetary Policy of the Bank of Japan – Inflation Target Versus Exchange Rate Target," *Japan and the World Economy*, no. 17 (2005): 189.

[169] M. M. Hutchison, "Monetary Control with an Exchange Rate Objective: The Bank Of Japan 1973–1986," *Journal of International Money and Finance* 7 (1988): 261–271.

[170] M. Okabe, ed., *The Structure of the Japanese Economy* (London: Macmillan, 1995).

[171] R. McKinnon and K. Ohno, *Dollar and Yen, Resolving Economic Conflict between the United States and Japan* (Cambridge, MA: MIT Press, 1997).

[172] Ibid.

[173] Ibid.

In a study on central bank intervention, Richard Baillie and William Osterberg note that intervention has been relied on by central banks for the theoretical purpose of either influencing exchange rates, or reducing their volatility. [174] However, through statistical analysis using the Martingale-GARCH model, they find "little support for the hypothesis that intervention can consistently influence the level of an exchange rate."[175] Additionally, they find evidence that "intervention tends to increase volatility rather than 'calm disorderly markets'."[176] Given these findings, they conclude that excessive doubt exists on the viability of using intervention, and caution "against the conventional acceptance of intervention as an important policy instrument."[177]

In another study, Galati, Melick and Micu argue that sterilized intervention *can* potentially be effective if it is "announced publically, coordinated across central banks, and most importantly, consistent with underlying fiscal and monetary policies." [178] However, that did not happen with Japan. Interventions were un-announced and not openly planned. Also, American monetary authorities intervened only when there was cooperation with Japan. The Japanese, however, intervened impulsively on their own, haphazardly reacting to deviations in the market or general uncertainty in the marketplace.[179] Finally, Japan did not coordinate its intervention with other fiscal and

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[174] Richard Baillie and William Osterberg. "Why Do Central Banks Intervene?" *Journal of International Money and Finance* 16, no. 6 (1997): 909-919.

[175] Ibid.

[176] Ibid.

[177] Ibid.

[178] Gabriele Galati, William Melick, and Marian Micu, "Foreign Exchange Market Intervention and Expectations: The Yen/Dollar Exchange Rate," *Journal of International Money and Finance*, no. 24 (2005): 982-1011.

[179] Ibid.

monetary policies. Thus, given the BOJ's lack of transparency, global cooperation, and policy unification, it could not increase its credibility or generate positive expectation in the markets. Considering this lesson on intervention in relevance to Abenomics, although intervention is not part of it, the coordination of monetary and fiscal policy is part of the core foundation on which Abenomics is built.

Okina and Shiratsuka, proponents against the intervention, do note that intervention indeed could have been successful if the Ministry of Finance were able to generate more credibility amongst market participants. [180] They comment that even without actually intervening, authorities could naturally influence the market to weaken the yen on its own through managing market expectations.[181] However, authorities at the time did not have a cooperative vision to share to the public, nor the Roosevelt Resolve we have seen in Kuroda and Abe. Thus, it could not build public belief into a recovering Japan.

This debate has continued in Japan for many years – how effective is depreciating the yen on creating inflation? News media continued to report that eminent economists and policy makers in Japan have endorsed so-called "yen yasu-yudo," meaning active inducement of the yen's depreciation. Calls for depreciating the currency came also from international economists, such as Svensson,[182] as part of policy recommendations on how to extract the economy from its liquidity trap.

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[180] Kunio Okina and Shigenori Shiratsuka, "The Illusion of Unsterilized Intervention." *Shukan Toyo Keizai*, Jan 15, 2000.

[181] Ibid.

[182] Lars EO Svensson, *Inflation Targeting* (Cambridge, MA: National Bureau of Economic Research, 2010); Lars EO Svensson, *Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others* (Cambridge, MA: National Bureau of Economic Research, 2003)

However, studies such as Baillie and Osteberg's and others discussed above countering intervention's effectiveness have continued to arise. Examples include Eiji Fuji, who concludes through empirical analysis that although initially the yen's depreciation may have had marginal success, it was no longer effective like earlier periods in creating an inflationary pressure.[183] Taylor suggests that effectiveness has declined in many countries, making depreciation of domestic currencies less inflationary. He also notes it is very subjective and difficult to convene on what level of exchange rates should be targeted.[184]

In regards to the BOJ's currency intervention, the question arose as to whether USD/JPY is an appropriate indicator for inflation, or if inflation itself should be targeted as opposed to an exchange rate. Like the zero-interest rate policy implemented in 1999, currency intervention also failed to inflate the economy. This spurred calls for additional action from policy makers and academics.[185] The list of potential methods varied greatly. One of the key ideas was inflation targeting, and beyond this thoughts included quantitative easing, switching from shorter to longer duration of asset purchases, purchasing riskier assets, and even purchasing foreign bonds. While all of the latter would be attempted at some point, inflation targeting would never be until Abenomics made 2 percent a target.

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[183] Eiji Fujii, "Exchange Rate Pass-Through in the Deflationary Japan: How effective is the Yen's Depreciation for Fighting Deflation?" (CESifo working paper No. 1134, Munich, 2004).

[184] Mark P. Taylor, "Is Official Exchange Rate Intervention Effective?" *Economica* 71, no. 281 (2004): 1-11.

[185] Ito, "Inflation Targeting and Japan."

Pierre-Richard Agenor concludes that inflation targeting is a "flexible"[186] policy framework that allows the central bank to "exercise discretion as necessary."[187] Agenor believes that inflation targeting would help central banks refrain exchange rate targeting and intervention, thus allowing the potential to utilize monetary policy better than alternative procedures.[188] He also concludes that inflation targeting is particularly effective for relatively well-off, developed economies that have existing low inflation but liquid financial markets.[189] Japan certainly fits this description. Also, inflation has an advantage over currency exchange rates in that it is a non-tradable entity – it cannot be manipulated by external players. Regardless, the BOJ continued to use currency intervention as its primary tool to try to fight deflation.

Even as recently as Kuroda's predecessor, intervention was still executed on a grand scale. Shirakawa undertook historical levels of intervention in 2011 without coordinating supportive monetary or fiscal policy alongside it. Results continued to show futility; scholars as well as the U.S. Federal Reserve continued to proclaim that intervention results were at best only temporary, and deteriorate when intervention was reduced or ceased.[190]

After Shirkawa's intervention failure, sentiment grew that action action was becoming imperative. Inflation targeting became "symbolic" as the next progressive step

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[186] Agénor, "Monetary Policy."

[187] Ibid.

[188] Ibid.

[189] Ibid.

[190] Mark M. Spiegel, "Japanese Foreign Exchange Intervention," *FRBSF Economic Letter,* no. 36 (2003).

the BOJ should undertake.[191] However, according to Ito most of the Bank's board members and economists continue to overlook inflation targeting as a viable policy, and gave several reasons following the Bank's policy meeting on February 10, 2000.[192] To paraphrase the BOJ's own statement, first, they stated inflation targeting was a simple-minded reflation policy, or in other words that it was naïve to create an inflation price level target as it would decrease transparency to monetary policy.[193] Secondly, the BOJ stated that no country had adopted inflation targeting to move from deflation to inflation.[194] This was true: historically inflation targeting had be used to reign in hyperinflation, the opposite problem Japan had, in predominantly developing economies such as in Brazil. Thirdly, the BOJ claimed there were no available policy measures to lift the inflation rate, given such low interest rates at the time thus damaging the Bank's credibility.[195] An interesting observation for the BOJ to state given its credibility was already in question. Fourthly, the BOJ believed that mere announcement of an inflation target would not actually change expectations. Lastly, the BOJ noted even if the public were convinced a targeted inflation level could be achieved, then long-term interest rates would increase, having a counterproductive effect on the economy.[196]

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[191] Ito, "Inflation Targeting and Japan."

[192] Ibid.

[193] Ibid.

[194] Ibid.

[195] Ibid.

[196] Ibid.

However, Ito recommends inflation targeting, contradicting the Bank's official statement. Ito argues that since the Bank was an independent entity, it should be held accountable for its actions and effectiveness but there was no numerical measure to compare against given the lack of an inflation target.[197] Secondly, he notes that even if the BOJ committed to a specific inflation target, it would still have the discretion in deciding for itself how to achieve the result – thus making less susceptible to criticism and less concerned with defending its actions.[198] This is starkly in contrast with historical observation, where the BOJ would have to respond to the public for failed attempts of policies that had been repeatedly attempted in the past, such as interest rate decisions or currency intervention. Ben Bernanke notes that if BOJ had focused on stabilizing inflation rather than being distracted by exchange rates and asset prices, monetary policy's results would have been better.[199] Lastly, Ito suggests that effective monetary policy requires an optimistic outlook on deflation coupled with positive expectations from the public.[200] The BOJ needed to build a comprehensive, transparent strategy, and convince the rest of the nation on its potential and the resolve to see it through.

Over-zealous Keynesian Belief

Derek Scissors and Kumi Yokoe of the Heritage Foundation have argued that amongst the man causes of deflation, the most significant has been a naive faith by

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[197] Ibid.

[198] Ibid.

[199] Bernanke, "Japanese Monetary Policy: A Case of Self-Induced Paralysis?"

[200] Ito, "Inflation Targeting and Japan."

policymakers in Keynesian economics.[201] In particular, there was an over-belief in Keynesian stimulus. Keynesian economics is a theory that is based on the works of economist John Maynard Keynes (1884-1946) published in the 1930s. This theory focuses focuses around the ability of prices (and wages) to adjust to free markets, and the effect of demand on an economy's output and employment.[202] It asserts that demand is the driving force of an economy – and most importantly, that in a recession a government could boost demand (in the form of consumption and investment) by increasing spending.[203] Japan took this model to heart, continually increasing government spending in hopes of increasing demand to drive the economy upwards again. However, this trend would not be brief and continue for over two decades.[204]

The theory behind Keynesian stimulus in particular is quite simple. In a stagnating economy, the total demand is not sufficient enough to grease an economy to operate at full employment. The proposed solution laid out by Keynesian stimulus is simply to raise the level of demand that would achieve the possible output level of the economy. However, according to J. D. Foster the problem is that fiscal policy is not necessarily effective at raising output and lowering unemployment. [205] In addition, Foster notes that Keynesian stimulus theory conveniently ignores the fact that deficit spending must still be financed somehow, thus has consequences in the country's budget though

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[201] Scissors and Yokoe, "Japan's National Budget."

[202] Black and Hashimzade, Oxford Dictionary, 228-229.

[203] Ibid.

[204] Scissors and Yokoe, "Japan's National Budget."

[205] J. D. Foster, "Keynesian Fiscal Stimulus Policies Stimulate Debt–Not the Economy," (Heritage Foundation, Backgrounder Report No. 2302, Washington, DC, 2009).

perhaps not initially.[206] The need to borrow money to finance spending can be counter-productive, especially over a long period of time. When borrowing is over-extended, savings may actually dwindle from interest payments, leaving less remaining for investment. It could also cause an import of savings from abroad – thus, in this case any change to demand would be nullified.[207] The result of over-extended Keynesian stimulus in Japan is plainly visible—"despite racking up the largest peacetime debt in modern economic history, while entirely failing to grow, the government continues to respond to every downturn with more stimulus."[208]

A Need for Reform and the Iron Triangle

Japan's government has been called to implement structural reforms throughout the years. Scissors and Yokoe note that they are "indispensable" to Japan's future.[209] However, change is an intimidating idea because of the burgeoning budget government combined with facing challenging issues such as aging and labor problems. Little reform has been implemented in response to such challenging issues. By 2011, Japan's government debt far exceeded its GDP. However, with government bonds yields very low, the return on capital was very poor, exacerbated by the fact that the majority of the government bonds are owned domestically.[210] This domestic overshift hampered domestic growth. Scissor and Yokoe go on to note that with a shrinking labor force and a

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[206] Ibid.

[207] Ibid.

[208] Scissors and Yokoe, "Japan's National Budget."

[209] Ibid.

[210] Ibid.

limited land endowment, Japan cannot grow while return on capital is low and innovation is weak.[211] Yet they note this is exactly the outcome one might expect from an "excessive state role in the economy" and "mass government borrowing at near-zero interest rates."[212]

While the reason for this could be blamed on poor fiscal, monetary, or financial supervisory policies, Eisuke Sakakibara argues that failure of macroeconomic or supervisory policies does not provide sufficient explanation. He argues that the focus needs to shift from macroeconomic to microeconomic—from GDP analysis to structural analysis, and from that shift a different picture emerges.[213] The necessary structural reform applies from the national government down to the corporate level—and at its core necessitates a breaking of the Iron Triangle between the LDP, the bureaucracy, and vested interest groups.

Iron Triangle and Non-Performing Loans

As discussed earlier, when the asset bubble burst in 1991-92, Japanese banks took large losses from their non-performing loans. These losses were compounded due to interest rates being marginally higher than zero, making any new lending to low credit risk borrowers unprofitable.[214] Thus, recapitalizing balance sheets against non-

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[211] Ibid., 1.

[212] Ibid.

[213] Eisuke Sakakibara. *Structural Reform in Japan: Breaking the Iron Triangle* (Washington D.C.: The Brookings Institution, 2003), 70.

[214] Ronald McKinnon and Kenichi Ohno. "The Foreign Exchange Origins of Japan's Economic Slump and Low Interest Liquidity Trap," (Institute for Monetary and Economic Studies, Discussion Paper

performing loans became very difficult for banks. On the one hand, bad loans were progressively worsening. On the other, banks were unable to generate new profits to offset this ongoing bleeding. The proportion of non-performing loans to total loans was incredibly high in Japan, reaching an astronomical 93 percent in 2000.[215] For comparison, the United States had a non-performing asset ratio of 5.0 percent in 2008 (the year of the Lehman crisis), and its historical high was only 5.4 percent, in 1991.[216] Furthermore, in Japan, excessive debt and nonperforming assets were more commonly a burden for small and medium-sized businesses as opposed to large corporations and institutions. This made solutions targeting large institutions inefficient. Thus, Sakakibara concludes that behind this issue is a structural problem, regardless of whether deflation is a structural issue or a monetary phenomenon."[217]

Through history, there have been multiple examples of non-performing asset problems causing recession. However, in these examples, nations were able to respond and recover in the matter of a few years, while in Japan this problem has lingered for nearly two decades. Here we can observe Japan's unique iron triangle that other nations did not have to face, making change difficult. For reform to happen on an institutional level Sakakibara notes it must first happen on a structural level through public policy.[218]

No. 2000-E-19, Tokyo, 2000), 17.

[215] The World Bank, "Bank Non-Performing Loans to Total Gross Loans (%)," The World Bank, accessed on May 1, 2015, http://data.worldbank.org/indicator/FB.AST.NPER.ZS/countries?page=1.

[216] Ibid.

[217] Eisuke Sakakibara, *Structural Reform in Japan: Breaking the Iron Triangle* (Washington DC: The Brookings Institution, 2003) xiv-xv.

[218] Ibid.

He suggests this could be done via economic reform by increasing (or decreasing) regulation as necessary.[219] He also suggests that there could be political and administrative reform, through changes in laws, regulations, and administrative guidance especially for the budget and tax policy.[220]

These suggestions may help alleviate pain from non-performing loans, but would not necessarily address a issue with generating profits from *new* lending. The reluctance of Japanese banks to lend at low interest rates makes it even more difficult to raise demand. [221] Sakakibara states that this causes a desperate government to buy much of its own debt to inject money into the economy, worsens the problem of trust funds relying on a government-run postal savings system, and forces the central bank to become a necessary lender.[222] Another distinction that should be made is that banking or financial reform (and restructuring) would not necessarily resolve profitability issues with *new* lending – another issue Japan will need to face separately.

Iron Triangle and Japan Post

Looking in Japan's past few decades, major reforms occurred in thrusts, when political leaders were able to overwhelm vested interest groups momentarily and appear to break into iron triangles. However, when the power of the leaders advocating reform waned, particularly due to the discontinuity and lack of tenure, the vested interest groups

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[219] Ibid.

[220] Ibid., 40.

[221] Ibid.

[222] Ibid.

substantially slowed or hampered overhauling reform. In a sense, Japan was stuck in "syncretism," where new ideas, organizations, and practices combine with existing ones to co-exist[223] as opposed to replacing or updating them. The postal system discussed earlier is a prime example of syncretism. The Japan Post Bank and Japan Post Insurance are wholly owned by Japan Post, whose majority owner is the national government. Reversals of the attempts to privatize reform have kept the government's stranglehold of Japan Post ongoing. The quasi-government firms would compete with private firms both domestically and internationally, while having the advantage of being tied to the governing powers of Japan. This feature is unique to Japan relative to other nations such as the United States or United Kingdom.[224]

The official provider of postal services in Japan is Japan Post (Nihon Yusei Kosha), a public corporation established under the Japan Post Law of 2002. While a postal service in most nations may not be a major factor in economics or public policy, for Japan it is quite important due to its complex connection to the public from going beyond postal service into providing savings and insurance services. Since launching a national post office in 1871, Meiji era reformers established the postal savings scheme in 1875. In 1916, it was followed by the creation of a postal life insurance scheme. Japan Post historically has always exempt from banking regulation. It does not pay deposit insurance premiums and certain taxes, and interest rates paid on insurance accounts were historically set higher than bank interest rates. As of 2012, it was the world's largest bank

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[223] Kenji E. Kushida and Kay Shimizu, "Syncretism: The Politics of Japan's Financial Reforms," *Socio-Economic Review*, no. 313 (2013).

[224] Ibid.

(as it had been for many years), holding ¥176 trillion JPY in deposits, more than any other financial institution in the world.[225] This accounted for 22.3 percent of all bank deposits in Japan.[226] As of 2013, it ranked 13th in the Fortune Global 500 list of the world's largest companies,[227] unusual for a company that is majority-owned by a government.

Given the importance and size of Japan Post, then Prime Minister Junichiro Koizumi made it a priority to pass a privatization law, and succeeded in 2005. The postal privatization law passed in 2005 stipulated that the shares of banking and insurance units of Japan Post be entirely sold by the end of September 2017 to complete the privatization of these units. The scheme was proposed to move the huge financial assets now tied up postal savings into investments to create jobs and growth in the economy.[228] However, this notion was a point of major contention between the LDP and opposition DPJ. When the DPJ took control of the government in 2009, it passed legislation suspending the privatization process until the older law was revised. In 2012, in a rare occasion, the opposition parties agreed to roll back some parts of the landmark 2005 Koizumi legislation in an effort to aid recovery efforts following the 2011 earthquake and tsunami.

However, the terms would be changed. In an effort to ease the private sector's concerns about possible unfair advantages for state-owned Japan Post Bank and Japan

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[225] Toko Sekiguchi, "Japan Nears Deal on Postal Privatization," *Wall Street Journal,* accessed on Feb 2, 2015, http://www.wsj.com/articles/SB10001424052702303404704577303353507499354.

[226] Ibid.

[227] Staff of Fortune, "Japan Post Holdings Co., Ltd.," *Fortune 500 2013*, accessed Feb 10, 2015, http://fortune.com/global500/2013/japan-post-holdings-co-ltd-13/.

[228] Amelia Porges and Joy M. Leong, "The Privatization of Japan Post," in *Progress toward Liberalization of the Postal and Delivery Sector* (New York: Springer, 2006), 385-400.

Post Insurance, the LDP-Komeito bill said the ceiling on bank deposits eligible for insurance protection would not be raised "for the foreseeable future." Private-sector banks claimed a higher limit would encourage Japan's conservative investors to put more money into the state-backed bank. Foreign firms in Japan have been especially vociferous in complaining about Japan Post's market dominance. The American Chamber of Commerce in Japan’s President, Michael Alfant, issued a statement in March 2012 calling for full privatization to "establish a level playing field between Japan Post entities and private-sector banks, insurance and delivery companies." Still, room for more separation and independence from the government exists.[229]

The breaking and privatization of Japan Post would be a rare victory at breaking one of the strongest Iron Triangles. Patricia Maclachlan explains that the postmasters had evolved into an electoral ally of the LDP and their relationships with national bureaucrats complemented that relationship. This relationship has been a very durable triangle as well, the ongoing economic recession and foreign pressure having substantially weakened the iron triangles by exposing them to foreign competition, or weakening domestic demand, but has had minimal impact on the postal services sector.[230] Thus, postal reform seemed imminently necessary.

The primary obstacle to privatizing Japan Post is where the Iron Triangle is most evident. Japan Post’s massive savings and insurance deposits are used to provide politicians with funds necessary for public investment. In addition to this, its network of

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[229] Toko Sekiguchi. “Japan Nears Deal on Postal Privatization,” *Wall Street Journal*, Mar 25, 2012. Accessed on Feb 2, 2015, http://www.wsj.com/articles/SB10001424052702303404704577303353507499354.

[230] Patricia L. Maclachlan, “Post Office Politics in Modern Japan: The Postmasters, Iron Triangles, and the Limits of Reform,” *Journal of Japanese Studies* 30, no. 2 (2004): 281-313.

post offices provides organization support for politicians – this stems from the fact that Japan's "postmasters," unlike other countries, are commissioned by bureaucrats.[231] In many cases they were approved by local LDP Diet members.[232] So again, we have here an intricate network system between the triangle stakeholders making change difficult and encouraging a continuation of the status quo.

At the time of Koizumi's process of getting approval, Amelia Porges concluded that although the electorate had overwhelmingly endorsed Koizumi's vision of postal privatization, many details remained to be decided. She concluded:

> Will Japan's policymakers create a strong post with so much preferential treatment and so many subsidies that it will overpower its competitors and threaten competition in the industry, or a weak post that will struggle to meet its universal service obligations and its deferred liabilities and ultimately need a government bail-out? Koizumi's team and the Diet have a challenging, but hopefully not impossible, task before them: to create a postal privatization scheme that walks a line between these two extremes and results in both a viable post and a flourishing competitive market.[233]

These questions remain valid today, with a different Prime Minister and administration, as we head into the preparation stage for Japan Post's IPO.

Iron Triangle and the Bank of Japan

This relationship among the three parts of the iron triangle is evident also in the history of the Bank of Japan. In the pre-war period, former MOF officials regularly occupied the post of BOJ governor—a clear reflection of the MOF's dominance over the

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231 Amelia Porges and Joy M. Leong, "The Privatization of Japan Post," in *Progress toward Liberalization of the Postal and Delivery Sector* (New York: Springer, 2006), 385-400.

232 Ibid.

233 Porges and Leong, "The Privatization of Japan Post."

central bank at the time. However, even over most of the postwar period, the post of governor alternated between a career central banker and the MOF's former top civil servant, meaning that approximately every five years, a former MOF official held the reins of power at the BOJ. Hence, we can see a strong correlation between the BOJ and the bureaucracy. In addition to frequently occupying the top post, MOF officials often took up other top positions in the BOJ.

Table 4.1. Bank of Japan Governors

Name	From	To
Yoshihara Shigetoshi	6-Oct-1882	19-Dec-1887
Tomita Tetsunosuke	21-Feb-1888	3-Sep-1889
Kawada Koichiro	3-Sep-1889	7-Nov-1896
Iwasaki Yanosuke	11-Nov-1896	20-Oct-1898
Tatsuo Yamamoto	20-Oct-1898	19-Oct-1903
Shigeyoshi Matsuo	20-Oct-1903	1-Jun-1911
Korekiyo Takahashi	1-Jun-1911	20-Feb-1913
Yatarō Mishima	28-Feb-1913	7-Mar-1919
Junnosuke Inoue	13-Mar-1919	2-Sep-1923
Otohiko Ichiki	5-Sep-1923	10-May-1927
Junnosuke Inoue (2nd)	10-May-1927	1-Jun-1928
Hisaakira Hijikata	12-Jun-1928	4-Jun-1935
Eigo Fukai	4-Jun-1935	9-Feb-1937
Seihin Ikeda	9-Feb-1937	27-Jul-1937
Toyotaro Yuki	27-Jul-1937	18-Mar-1944
Keizo Shibusawa	18-Mar-1944	9-Oct-1945
Eikichi Araki	9-Oct-1945	1-Jun-1946
Hisato Ichimada	1-Jun-1946	10-Dec-1954
Eikichi Araki (2nd)	11-Dec-1954	30-Nov-1956
Masamichi Yamagiwa	30-Nov-1956	17-Dec-1964
Makoto Usami	17-Dec-1964	16-Dec-1969
Tadashi Sasaki	17-Dec-1969	16-Dec-1974
Teiichiro Morinaga	17-Dec-1974	16-Dec-1979
Haruo Maekawa	17-Dec-1979	16-Dec-1984
Satoshi Sumita	17-Dec-1984	16-Dec-1989
Yasushi Mieno	17-Dec-1989	16-Dec-1994
Yasuo Matsushita	17-Dec-1994	20-Mar-1998
Masaru Hayami	20-Mar-1998	19-Mar-2003
Toshihiko Fukui	20-Mar-2003	19-Mar-2008
Masaaki Shirakawa	9-Apr-2008	19-Mar-2013
Haruhiko Kuroda	20-Mar-2013	Incumbent

Source: The Bank of Japan, accessed on April 15, 2015, http://www.boj.or.jp/en/a bout/outline/history/pre_gov/

Unlike the Prime Ministers (Table 3.2), BOJ's governors have had a consistent history of serving five-year terms, as seen in Table 4.1 above. From 1973 to 2011, there were nine BOJ governors, as opposed to twenty-five Prime Ministers. However, the appointment of BOJ governors has been questionable. The MOF has historically had a strong influence over the BOJ. In the pre-war period, it was typical for top MOF officials to be appointed into the BOJ as governors and into executive posts, and this continued into the post-war era.[234] Even the controls for the BOJ, such as auditors and comptrollers, were appointed by the MOF. Yet, this issue of staffing of top posts by MOF officials was only "one of the many ways in which the BOJ's independence in decision making was compromised."[235] Financially, the BOJ budget required MOF approval.

Staffing of important posts was only one of the ways in which the BOJ's independence was compromised, particularly by the MOF. Beyond this, nearly all aspects of the Bank's activities were legally under government control, and the MOF was authorized to issue general directives and act as a supervisor of operations. The BOJ even lacked its own ability to independently decide its budget—this required approval from the finance minister. The Bank's board of advisors was also in a similar situation as the Bank's leadership, with MOF or former MOF officials taking many of these seats. The BOJ's auditors and comptrollers were appointed by the MOF, and the MOF had the power to dismiss bank officials including the governor. Jennifer Amyx concludes that as a result of these ties between the BOJ and MOF, monetary policy preferences of the BOJ did not visibly differ from those of the MOF in most cases.[236]

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[234] Amyx, p. 103.

[235] Ibid.

[236] Ibid.

Until re-invented by the Bank of Japan Act in 1997, the BOJ ranked as one of the least independent central banks globally.[237] Following the 1997 Act, however, the BOJ would still struggle to maintain true independence. While the influence of the MOF diminished, politicians continued to apply influence on the bank. Jennifer Holt Dwyer notes that while monetary policy had been delegated to an independent central bank, opportunities for politicians to exert influence were still available. [238] However, she notes this influence was rather limited, allowed lesser powers such as the ability to appoint and question, adopt laws to limit or eliminate independence and transfer authority back to the government, or in some cases, resort to threats which would compromise independence.[239] Dwyer concludes that politicians in Japan have used all three channels.[240]

Earlier, I noted that Governor Hayami tried to protect the BOJ's independence by refusing to consider any policy that even slightly hinted at political interference to BOJ's views. Dwyer points out that Hayami did not succumb to pressure to increase the money supply in 1998, criticized the government's consideration to purchase government bonds in 1999, abandoned the zero-interest-rate policy in 2000 against the government's desire for delay, and refused to embrace inflation targeting.[241] However, his successor Fukui

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[237] Alex Cukierman, Steven B. Web, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes," *World Bank Economic Review* 6, no. 3 (1992): 353-398.

[238] Jennifer Holt Dwyer, "Explaining the Politicization of Monetary Policy in Japan," S*ocial Science Japan Journal* 15, no. 2 (2012): 187.

[239] Ibid.

[240] Ibid.

[241] Ibid., 259.

was far more attentive to political leaders. As a result, both Fukui and the BOJ were well portrayed in the press and by politicians. Having seen this, Shirakawa largely mimicked Fukui's efforts to maintain communication with political leaders and meet regularly with the prime minister. Dwyer notes that Shirakawa acknowledged that the BOJ needed public trust in order to effectively conduct monetary policy, and so embarked on a public relations campaign.[242]

Iron Triangle and Agriculture

Perhaps one of the most visible sectors lacking and needing reform is the agricultural sector. Agricultural reform would touch around 2.6 million farmers, which accounts for approximately 4 percent of the labor force yet producing only 1.5 percent of the GDP.[243] This ratio shows it is not particularly an efficient producer for the economy. However, the National Federation of Agricultural Co-operatives (JA Zenshu) is one of the most politically and economically powerful organizations in Japan, and a highly effective lobbyist. However, the average age of the Japanese farmer is increasing. Patrick Hugh argues implementation of trade agreements are on graduated schedules that can spread over ten to fifteen years, something that may be suitable to complement Japan's labor force problems.[244] This is a sensible suggestion given the natural trajectory the agricultural labor force will face over a similar time period given the aging issue and decreasing entrants of younger labor.

[242] Ibid., 195.

[243] Hugh Patrick, "Japan's Sputtering Economic."

[244] Ibid.

Even reform-minded Koizumi compromised with the farmers. For example, in the case of the Japan-Mexico Free Trade Agreement, Koizumi agreed to remove tariffs on 86 percent of imports from Mexico rather than the targeted 90 percent, the 4 percent difference was accounted for by pressures from the agricultural lobby that succeeded in achieving special protections on agricultural commodities such as pork, beef, chicken, and oranges.[245] Despite the recent victory by Abe over J.A. Zenshu, the agricultural lobby still exists and thrives, and representatives continue to press for concessions as before.

Multiple Sectors Needing Reform

Japan's labor situation is well known—it has an aging and shrinking population that limits the contribution of labor to growth. The National Institute of Population and Social Security Research, a governmental think-tank that provides 50-year demographic trend data every five years, estimates that the proportion of seniors (people aged 65 or older) will jump from 23 percent in 2010 to 39.9 percent in 2060.[246] Japan at 23 percent is already the highest in the world currently. During this same time period, the workforce population (15-64 years old) is expected to shrink to half of the total population. For a point of reference, sociologists consider nations whose populations have 21 percent or higher to be a "hyper-aged society."[247]

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[245] Aurelia George Mulgan, "Where Tradition Meets Change: Japan's Agricultural Politics in Transition," *Journal of Japanese Studies* 31, no. 2 (2005): 261-298.

[246] National Institute of Population and Social Security Research, *Nihon no shorai suikei jinkko hokoku-sho*, 2012, accessed on Feb 10, 2015, www.ipss.go.jp/syoushika/tohkei/newest04/hh2401.asp.

[247] Floria Coulmas, *Population Decline and Ageing in Japan: The Social Consequences* (Routledge, London, 2007).

While labor productivity is reasonable, it is not very flexible. Hirata and Warschauer argue that employment amongst the elderly and women could be enhanced by improving conditions for part-time employment and non-traditional employment tracks.[248] Additionally, given the unlikeliness that Japan will restore its birth rate to the replacement level of 2.07 children per family, they suggest that the only way to keep the population from diminishing is through increasing immigration.[249] However, for this to happen there would need to be not only a social perception change but structural reform to allow it to begin with. Structural reforms relevant to labor and product markets have proven to have a clearly positive impact for growth.[250] Thus, immigration reform would likely have a positive impact for Japan.

Some advocates for opening immigration do exist. Hidenori Sakanaka, a former head of the Tokyo Immigration Bureau with a 35-year career in the Justice Ministry, says Japan must accept ten million immigrants by 2050, as the country "is on the brink of collapse."[251] In his view, it needs a "social revolution equal to that of the Meiji Restoration," and that "there is no way for Japan to survive but to build a society of living with immigrants and hoisting a new flag: "Immigrants Welcome."[252]

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[248] Keiko Hirata and Mark Warschauer, *Japan: The Paradox of Harmony* (New Haven: Yale University Press, 2014), 106.

[249] Ibid.

[250] Juhana Hukkinen, "Economic Policy Options in Conditions of Weak Growth and Low Inflation," *Bank of Finland Bulletin 1*, 88 (2014).

[251] Michael Hoffman, "Only Immigrants Can Save Japan," *Japan Times*, October 21, 2012.

[252] Ibid.

Some politicians are also beginning to agree. In 2008, a group of 80 conservative LDP party members headed by Hidenao Nakagawa submitted a report to then-Prime Minister Yasuo Fukuda, proposing an increase in the number of immigrants to ten percent in fifty years (thus adding ten million more foreigners). [253] They proposed not only increasing immigration, but also providing assistance with language and vocational training, and encouraging naturalization.[254] This position is mirrored by Japan's Keidanren, the Federation of Business Organizations. It has suggested that Japan should quickly expand its immigrant labor to offset the shrinking domestic workforce, especially in labor-intensive sectors such as manufacturing and construction. [255] Like Nakagawa, the Keidanren also urged Japan to encourage immigrants to become long-term residents.[256] In spite of these calls, the government has resisted opening up the country to foreign workers. However, unless Japan can miraculously improve through other means—such as dramatically raising the birth rate or incorporating many more women and older workers into the labor force—it may end up reaching a critical decision one day between either increasing immigration or facing social and economic collapse.[257]

Another way to address the labor issues without immigration is increasing the employment of women. According the Kathy Matsui of Goldman Sachs, "Japan has

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[253] Minoru Matsutani, "Radical Immigration Plan under Discussion," *Japan Times*, June 19, 2008, accessed on Feb 10, 2015, http://www.japantimes.co.jp/news/2008/06/19/national/radical-immigration-plan-under-discussion/#.VPYS_0K4mu4.

[254] Ibid.

[255] Minoru Matsutani, "Keidanren: Immigrant Worker Influx Vital to Half Labor Shortage," *The Japan Times*, October 15, 2008, accessed on Feb 10, 2015, http://www.japantimes.co.jp/news/2008/10/15 /national/keidanren-immigrant-worker-influx-vital-to-halt-labor-shortage/#.VPYUCkK4mu4.

[256] Ibid.

[257] Hirata and Warschauer. *Japan: The Paradox of Harmony,* 125.

much to gain by boosting female employment."[258] As mentioned earlier, increasing the employment rate of women could boost Japan's GDP significantly. While some progress has been made, there is still significant potential for more to be done. Matsui recommends a three-pronged approach. First, she focuses on policy measures the government could pursue, such as "deregulate daycare/nursing care sectors, reform immigration laws, neutralize the tax and social security codes, mandate gender-related corporate disclosures, equalize part-time and full-time work, and boost female representation in the government."[259] Secondly, she provides recommendations for the private sector to "stress the business case for diversity, create more flexible work environments, adopt objective evaluation schemes, set diversity targets, introduce a more flexible employment contract, and engage male champions of diversity."[260] Thirdly, she notes that society at large "needs to dispel various myths about Womenomics and encourage greater gender equality at home."[261] While her latter two recommendations are not specifically addressed to the government, with charismatic and capable leadership Abe should be able to influence the private sector, and Japan's society as a whole.

The situation for land is similar to that for labor. The potential for land to be a large contributor to growth is capped, as Japan it lacks the natural resources of larger and more endowed nations. Scissors and Yokoe contest that Japan's limitation of land could be compensated for if government spending was not wasted on unnecessary infrastructure

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[258] Kathy Matsui, Hiromi Suzuki, Kazunori Tatabe, and Tsumugi Akiba, "Womenomics 4:0 Time to Walk the Talk," Goldman Sachs Report, May 30, 2014.

[259] Ibid.

[260] Ibid.

[261] Ibid.

projects or agricultural production that could be achieved more efficiently overseas. [262] However, beyond labor and land, they conclude that the largest problem is capital. They note capital must play a critical role given the limited natural resources and shrinking labor force. However, fiscal policy has made it difficult to mobilize capital to encourage innovation and investment. According to the 2012 Index of Economic Freedom, Japan ranks as the 22nd most "free" economy in the world, and ranks 17th in corruption (lack thereof).[263] However, Japan ranks a very contrasting 145th for fiscal freedom, out of 179 countries evaluated.[264] Government spending into inefficient sectors still dominates domestic Japanese capital allocation.

Another sector needing reform is trade. Trade liberalization is supported by some members of the DPJ and LDP, but there are powerful vested groups (in particular, the agricultural group and health group) that strongly oppose it. According to Hugh Patrick, joining TPP would push Japan to carry out structural and institutional liberalization.[265] Abe is not the first Prime Minister to acknowledge the upside of TPP, as his two predecessors, Naoto Kan and Yoshihiko Noda, also attempted to sign a TPP agreement. However, their efforts were not successful, mainly due to opposition from the agricultural

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[262] Scissors and Yokoe, "Japan's National Budget."

[263] Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2012 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow Jones, 2012), accessed on Feb 10, 2015, http://www.heritage.org/index.

[264] Ibid.

[265] Patrick, "Abenomics."

lobby that feared cheaply imported agricultural goods would hurt the profitability and sustainability of domestic goods.[266]

The national budget itself is also in need of reform. There are three primary types of budgets are prepared annually for the Diet to approve – the general budget, special accounts budget, and a third budget for government-related organizations.[267] The general budget includes the basic expenditures for government operations. Next is the special accounts budget, or "special budget," which is designed for special ad-hoc programs. The third is the budget for government-related agencies, which include public service companies and financial institutions.

Spending cuts on the budget are (or will be) necessary in Japan, especially given that by late September 2014 Japanese government debt was 134 percent of GDP.[268] From 1985 to 2011, the general account increased by 75 percent, a reasonable amount for a long period. What is alarming though is that in 1985, the special account was already "twice the size of the general account,"[269] and by 2011 the special account would grow exponentially to more than four times the size of the general account.[270] The separation of general and special accounts is ambiguous as they overlap, thus removing transparency.

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[266] Theresa Robles, "Abe's TPP Strategy: Overcoming Domestic Division through Reform," *RSIS Commentaries*, no. 58 (2013).

[267] Mieko Nakabayashi, "Japan's Budget Process," Research Institute of Economy, Trade & Industry, accessed on May 20, 2015, http://www.rieti.go.jp/en/papers/contribution/nakabayashi/01.html.

[268] Noah Smith, "Japan's Debt Trap," *Bloomberg*, Sept 24, 2014, accessed on April 15, 2015, http://www.bloombergview.com/articles/2014-09-24/japan-s-debt-trap

[269] Ministry of Finance, "Expenditure of General Accounts and Special Accounts of Central Government, Government-Affiliated Agencies, and of Ordinary Accounts of Local Governments, and Fiscal Investments and Loans (F.Y. 1980–2011)," (Feb 10, 2012), accessed on Feb 1, 2015, http://www.stat.go.jp/data /nenkan/zuhyou/y0501000.xls.

[270] Ibid.

Thus, budget analysis and reform based on the general account are already irrelevant and insufficient. This is why many recent prime ministers have shied away from addressing the special accounts directly. In 2011, more than 50 percent of the special account allocation went into debt payments—a situation that is both politically embarrassing and challenging.

Table 4.2. Distribution of Major Items in Japan's Special Accounts (2011).

Item	Share of Account (in %)
Debt payments	50.5
Pensions of all types	17.7
Transfers to local governments	13.8
Corporate subsidies	10.1

Source: Japanese Ministry of Internal Affairs and Communications, Statistics Bureau, Japan Statistical Year Book 2012.

Table 4.2 shows that even excluding the large payments to recover debt (over 50 precent of the special account budget), the next three categories still account for more than 40 percent of spending. There is only 7.9 percent remaining for other expenditures. Scissors and Yokoe note that this shows that significant progress can be made simply by addressing only a few of these items, given their significant portion of the special budget.[271] This would resonate in line with Hugh's call for Japan to define a few

[271] Scissors and Yokoe, "Japan's National Budget."

priorities and give them considerable focus for policy.[272] The special budget indeed seems primed to be a place this approach can succeed.

Unhelpful to the budget and debt issues was the fact that the effects of policies that could be effective, such as quantitative easing by the BOJ, were diminished by the Iron Triangle. Okina and Shiratsuka conclude that easing effects "failed to be transmitted outside the financial system in Japan, since the transmission channel linking the financial and non-financial sectors remained blocked."[273] The benefits of monetary policy were being absorbed by inefficiency, and instead of banks increasing lending, they continued to be inclined to purchase bonds despite low rates. Other scholars note that monetary policy is "not a cure-all nor a substitute for policy measures directed at latent structural problems."[274]

Ultimately, Japan has lacked reform since the American Occupation during World War II, despite considerable economic, social, and demographic changes since then. Its constitution is one of the oldest constitutions in the world, and "has never been revised in any particular."[275] Also neglected have been the labor laws enacted in 1946-1947, which legitimized unions and detailed standard terms of employment. Also this list of unchanged, aging legislation includes anti-monopoly laws, land use controls, and regulations of producing and distributing agricultural products, to name just a few.[276]

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[272] Patrick, "Abenomics."

[273] Okina and Shiratsuka, "Policy Commitment and Expectation Formations: Japan's Experience hnder Zero Interest Rates."

[274] Hiroshi Fujiki, Kunio Okina, and Shigenori Shiratsuka, "Monetary Policy under Zero Interest Rate: Viewpoints of Central Bank Economists," *Monetary and Economic Studies*, (February 2001): 89-130.

[275] J. A. A. Stockwin, *Governing Japan*, 4th ed. (New York: Blackwell Publishing, 2008).

[276] David Flath, *The Japanese Economy,* 3rd ed. (Oxford: Oxford University Press, 2014).

The economic growth strategy based on industry protection that helped Japan rise after the war would end up containing the seeds of failure. Industry grew quickly in the post-war era due to the business-growth centric environment, but the Iron Triangle proceeded to leave its mark. Policies that conveniently protected the interests of vested interest groups who were financing politicians continued to bog down progress.[277] LDP politicians, forced to compete against each other in multi-member districts due to the rules of the electoral competition, were unable to campaign on the basis of a party platform, and had to "sell" protective regulation in exchange for campaign contributions.[278]

Before long, a pattern would emerge. Large businesses and corporations continued providing politicians with capital for their campaign ambitions. Meanwhile, farmers and small businesses were providing politicians with votes. Thus, this varied group of interested stakeholders were vying (often against each other) for the favors from politicians, as well as influence over them. Given this nature of tug-and-war, there was less pressure on Japan's producers to innovate due to immunity from foreign competition, the domestic producers from small to large were well protected by policies from the LDP machine.[279] However, this would force the LDP to continue spending more of its resources and time to keep its very diverse range of supporters appeased. It would also

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[277] Frances McCall Rosenbluth and Michael F. Thies, *Japan Transformed: Political Change and Economic Restructuring* (Princeton: Princeton University Press, 2010).

[278] Ibid.

[279] Ibid.

encourage LDP candidates to continue focusing on their own individual beliefs and agendas, instead of grouping together as one unified party.[280]

In 1994, electoral reform swept through Japan, intending to change these aspects. The reform would change political landscape profoundly. Most importantly, it set out to eliminate intraparty competition in order to weaken factions and centralization of authority. Theoretically, the changed rules would motivate politicians to aim towards the interests of the voters, creating a more responsive electoral environment. Politicians would become less tied down to spending large amounts to maintain their support networks.[281] However, all would not be perfect. Becker notes that still, organized groups retained a political advantage over the unorganized, regardless of electoral rules.[282] The new electoral system was not a simple solution, as it did not eliminate the shortcomings of the previous system, and posed problems of its own.

[280] Ko Maeda, "Has the Electoral System Reform Made Japanese Elections Party-Centered?" Stanford Conference on Electoral and Legislative Politics in Japan, June 2007, accessed on April 10, 2015, http://fsi-media.stanford.edu/evnts/4905/Maeda.Paper.pdf.

[281] Rosenbluth and Thies, *Japan Transformed.*

[282] Gary S, Becker, "Public Policies, Pressure Groups, and Dead Weight Costs," *Journal of Public Economics* 28, no. 3 (1985): 329-347.

Chapter V

Why Abenomics is Different

The individual components of Abenomics have all separately been tried before. Low interest rate policies, quantitative easing, government spending, and various reforms have been attempted by Japan throughout its history, and are not new or ground-breaking policies. These components have also been achieved by foreign governments during times of economic difficulty for their own economies. However, Abenomics is different in that monetary policy, fiscal policy, and reform require execution together within a single grander plan, and there are signs of increasing cooperation between stakeholders to Japan's success. At the minimum, there is certainly a level of mutual policy agreement between the Prime Minister and the Bank of Japan.

A technical study conducted by the Bank of Finland concluded that in an environment of already low-interest rates and low inflation, policy options do not allow for pursuit of conventional policies.[283] Japan was in this situation when Abe and Kuroda came into the scene in 2013. Based on the study's calculations, any individual economic policy is insufficient to speed up economic activity in this environment.[284] Thus, in order to accelerate recovery from a financial crisis, "all segments of economic policy are

[283] Hukkinen, "Economic Policy Options."

[284] Ibid.

needed to boost growth."[285] The results are visible from the face thatAbe and Kuroda are working together on all segments of policy.

The popular notion of having three arrows stems from Japanese folklore and is commonly known across Japan's population. Although just a fictional story, it is not a coincidence that the principal of the story resonates strongly with Abenomics. One arrow can easily be snapped alone, but three together cannot be snapped.[286]

Early Reactions to Abenomics

The initial results to Abenomics, as seen in the financial markets, have been very positive. In fact, Abenomics began to have an effect even before Abe took office. In the months ahead of his actual election into office, there was growing expectation that Abe and his LDP would win. Simply on this expectation, investors began to invest in Japanese stocks and bet on USD/JPY going higher.[287] We can see the USD/JPY move in Figure 5.1 below, alongside major points in the Abenomics timeline. Appointment of Abe and Kuroda into their respective offices, as well as increased easing by Kuroda in 2014, all had an impact in weakening the yen. The tax hike did not increase USD/JPY; however, it is notable that it did not cause it to go lower either, which indicates that there was existing market expectation for a period of slowdown around the time of the hike.

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[285] Ibid., 50.

[286] Economist Staff, "Japan and Abenomics: Once More With Feeling," *The Economist*, May 18, 2013.

[287] Takatoshi Ito, "'Abenomics': Early Success and Prospects," *Japan Spotlight* (2013): 4-7.

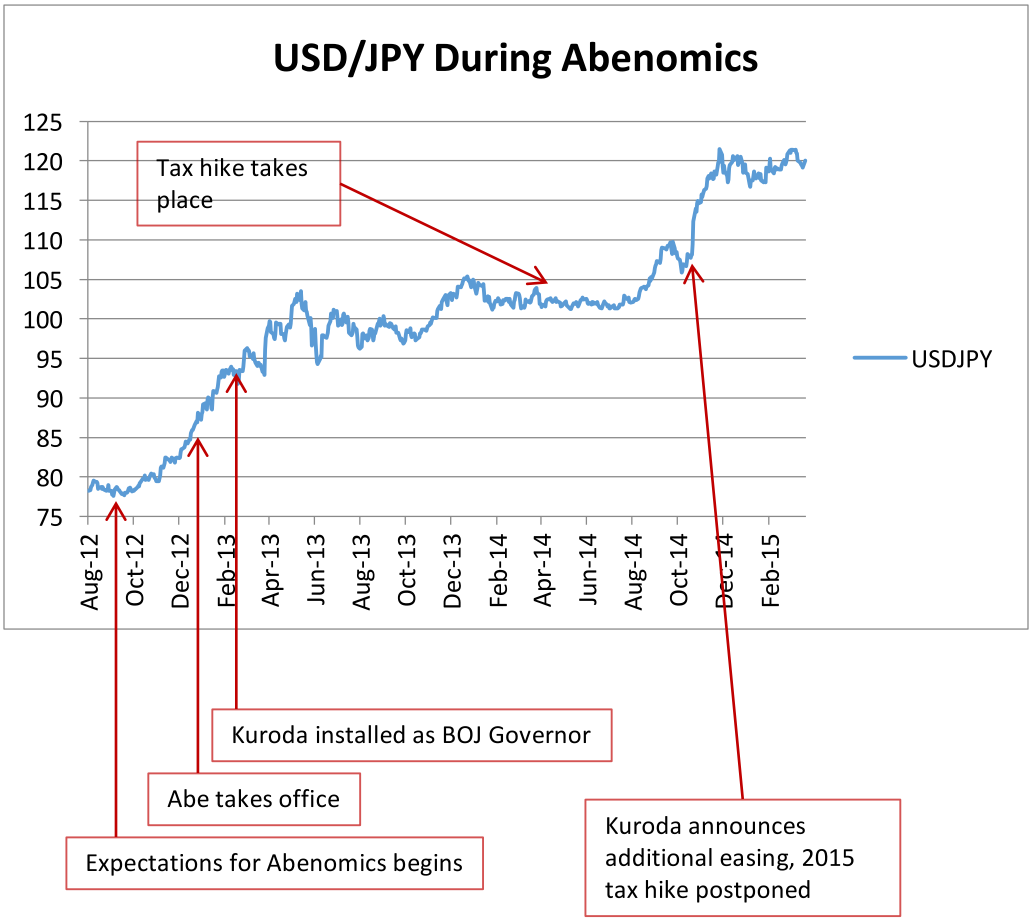

Figure 5.1. USD/JPY during Abenomics, from Bloomberg website, accessed on April 15, 2015, http://www.bloomberg.com.

Abe's Second Arrow of fiscal stimulus has been seen as being an initial success. Theoretically, the stimulus has helped ensure a shrinkage of the GDP gap to hasten an exit from deflation. Also, continued signs of success helps the government build public support to gain more seats in the House of Councilors (Upper House). This was particularly critical, as the previous election in 2010 saw the DPJ remain the majority leader in the Upper House. However, the LDP was able to regain control of the House in the July 2013 election, and with this win once again controlled the majority of both

Houses. This control can be seen as vote of confidence in Abe, and an endorsement of his economic strategy.[288] Regarding the effect of Womenomics on this election, 22 of the 105 women who ran in the election won seats, an increase of five women who won seats in 2010.[289]

Lastly, if stimulus succeeded in growing the economy, the growth rate would be used as a decision for the planned consumption tax hike.[290] Given the economy's recovery since the beginning of Abenomics, the tax hike was implemented in April 2014 despite the expected negative effects on economic growth and inflation data. The risk going forward would be moving from fiscal spending to fiscal consolidation. Skeptics point out that fiscal stimulus that is not followed by fiscal consolidation could lead to a disaster in the nation's financial balance.[291] The Second Arrow, though promising thus far, will only be a true success after fiscal consolidation is on track. Whether this consolidation will materialize remains to be seen.

The recent global conditions have not been ideal for a struggling country. Oil prices have dropped considerably, which makes it difficult for prices (inflation) to go higher. However, many outside observers think the policies are still working. Despite the difficult global environment, Japan at the end of 2014 had a 3.6 percent unemployment

[288] BBC News, "Japan Election: Abe Wins Key Upper House Vote," BBC News, July 21, 2013, accessed on April 3, 2015, http://www.bbc.com/news/world-asia-23396234.

[289] Kyodo, "22 of 105 Female Hopefuls Win Seats," Japan Times, July 22, 2013, accessed on March 28, 2015, http://www.japantimes.co.jp/news/2013/07/22/national/politics-diplomacy/22-of-105-female-hopefuls-win-seats/#.VU9MAJNggjU.

[290] Ibid.

[291] Ito, "'Abenomics.'"

rate, and companies were struggling to find workers.[292] This need for workers is a bright spot when compared to the unemployment in United States at six percent, the United Kingdom at six percent, and most of Europe above ten percent.[293] Abenomics is on track to deliver inflation the "old fashioned way"—by increasing demand. Though the process is slow, the conditions are ripe for wages to pick up, which would create a virtuous circle of further inflation.

However, it has not all come without setbacks in the midst. Widely seen as caused by the consumption tax hike, financial markets were stunned in November 2014 when Japan's GDP was found to have contracted at 1.9 percent.[294] This was much worse than the 1.6 percent contraction reported the prior month. However, the extra unexpected easing measure announced by the BOJ just prior to this (at the end of October), and Abe's postponement of the second tax hike planned for April 2015 (from 8 to 10 percent) was able to counter this and restore faith in Abenomics and growth in the Nikkei. Nevertheless, it was a stern reminder than the road to recovery would not come easily. December 2014's change in GDP growth rate was -0.6 percent, an improvement from the November shock. In January 2015, GDP returned to positive growth of 0.4 percent.

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[292] Robin Harding, "World Watches Japan and Waits for Outcome of Abenomics Experiment," *Financial Times*, Mar 29, 2015, accessed on April 2, 2015, http://www.ft.com/intl/cms/s/2/b3dc68d8-b376-11e4-9449-00144feab7de.html#axzz3WPhqfrBn.

[293] Mike Bird, "The West Can Only Dream of Japan's Level of 'Failure,'" *Business Insider*, Nov. 18, 2014, accessed on Dec 5, 2014, http://www.businessinsider.com/shinzo-abe-is-right-abenomics-has-not-failed-and-he-deserves-credit-2014-11.

[294] Jessica Menton, "Japan Recession 2014: Why Abenomics Isn't Working," *International Business Times,* December 8, 2014, accessed on Apr 27, 2015, http://www.ibtimes.com/japan-recession-2014-why-abenomics-isnt-working-1743270.

Government data released in April 2015 show that Japanese workers' wages rose for the third consecutive month, and winter bonuses increased for the first time in 6 years.[295] "Shunto," the "spring offensive" negotiation by Japan's trade unions with corporations, has been promising this year. In March 2015, shares in Toyota, the world's largest carmaker by sales, hit an all-time record high on the back of expectations of wage increases.[296] In April 2015, Toyota did indeed increase wages, giving workers an average of 3.2 percent increase, a significant number not just because of its magnitude itself but because it was greater than the 3 percent consumption tax increase the year prior. As the negative effects of the consumption tax hike wear off, companies have begun to ramp up production again. Similarly, consumer spending is showing signs of recovery.[297] The Nikkei reached a fifteen-year high on March 2015.

This leaves us with the Third Arrow. There is a mix of waiting and some disappointment thus far, such as a proposal for special economic zones. However, there is change slowly occurring. On October 17, 2014, Abe's cabinet approved a bill requiring large companies (301 or more employees) to announce publicly plans on increasing the proportion of women in management positions.[298] Corporate governance is beginning to

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[295] Tetsushi Kajimoto, "Japan Bonuses Up, Real Wage Decline Slows in Positive Sign for Abenomics," *Reuters*, April 3, 2015, accessed on April 4, 2015, http://www.reuters.com/article/2015/04/03/us-japan-economy-wages-idUSKBN0MU0DM20150403.

[296] Financial Times Staff, "Toyota Shares Hit Record-High," *Financial Times*, March 2015, accessed on Apr 4, 2015, http://www.ft.com/intl/fastft/292233/toyota-shares-hit-record-high.

[297] Jacob M. Schlesinger, "Abenomics Gets Boost, But for How Long?" *Wall Street Journal*, Feb 2, 2015. Accessed on Jan 14, 2015, http://www.wsj.com/articles/abenomics-gets-boost-from-rebound-signs-1422912782.

[298] Eleanor Warnock, "Japan Cabinet Approves Bill on Women in the Workplace," *Wall Street Journal,* Oct 17, 2014, accessed on May 3, 2015, http://blogs.wsj.com/japanrealtime/2014/10/17/japan-cabinet-approves-bill-on-women-in-the-workplace/.

apply pressures on companies to distribute cash. The TPP deal is becoming more plausible than ever before.[299]

In corporations, the beginnings of reform are visible as well. A governance code has been created to reinvent corporate Japan. This includes a range of changes, from "demanding explanations of keiretsu-style cross holding of shares in related public firms"[300] to introducing more sophisticated codes of conduct, and protection for those who report violations.[301] Essentially, the new rules seek to reinvent the sense that domestic firms are not inefficiently structured, instruction-driven work force, but dynamic firms working for and held accountable by shareholders.[302]

However, critics argue Abe's package for structural change lacks focus on how it will affect the most inefficient sectors.[303] The development of inflation expectations, record amounts of quantitative easing, and extreme fiscal stimulus packages have succeeded in cutting the deflationary spiral in Japan. It is, however, too soon to say whether the measures have been sufficient, or lasting.[304] The First Arrow has been on target thus far, and the Second Arrow has also been successful thus far. However, the remaining work in Japan is structural – the Third Arrow.

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[299] Robin Harding, "World Watches Japan and Waits for Outcome of Abenomics Experiment," *Financial Times*, Mar 29, 2015, accessed on Apr 2, 2015, http://www.ft.com/intl/cms/s/2/b3dc68d8-b376-11e4-9449-00144feab7de.html#axzz3WPhqfrBn.

[300] Iain Marlow, "Abenomics: Japan's Dramatic Push to Save its Economy," *Globe and Mail*, Friday Mar 27, 2015.

[301] Ibid.

[302] Ibid.

[303] Jacob M. Schlesinger, "Abenomics."

[304] Niko Herrala, "Japan's Inflation Expectations as a Measure of the Success of Abenomics," *Bank of Finland Bulletin 1,* 88 (2014).

The critical question today is the execution and effectiveness of the Third Arrow. It is having all three arrows together that Abenomics will have the greatest chance at lifting the economy out of the deflationary trap.[305] Still today, the Third Arrow continues being slowly launched, but is still hampered by the LDP's base of support that continues to expect protection on the back of its investment into the political party. The LDP still appears to be in the process of switching support groups from the vested interest groups and businesses, to pairing efficient businesses with taxpayers and consumers, instead of dragging bogged down sectors along and over-concerning itself with rural voters as in the past.

The opportunity to influence Japan with resolve is in place. To quote Kuroda again, he intends to "make all-out efforts to utilize every possible resource" available to the BOJ.[306] Abe is embarking on "the greatest reform effort since the end of the war."[307] However, as Abe says himself, "a rocky road lies ahead of all these goals."[308] Abenomics will certainly need Roosevelt Resolve and flawless execution in order to break through obstacles, and continue onwards from its short-term gains the past few years to realize longer-term potential.

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[305] Ito, "'Abenomics.'"

[306] Haruhiko Kuroda, "Quantitative and Qualitative Monetary Easing."

[307] Peter Symonds, "Japanese PM calls for Constitutional Change in Keynote Speech," World Socialist Web Site, Feb 14, 2015, accessed on April 22, 2015, http://www.wsws.org/en/articles/2015/02/14/japa-f14.html.

[308] Ibid.

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