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The Abe Administration's Attempt to Escape from Deflation through Abenomics

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Abstract | Five years have passed since the implementation of the "three arrows" of Abenomics—bold monetary policy, agile fiscal policy, and growth strategies to stimulate private investment. Indeed, the Japanese economy has slowly started to recover and has shown signs of escaping from its long-term recession. Such signs include the weakening of the yen, rising stock prices, and improved conditions for employment. However, in addition to Abenomics, international affairs have also had an impact on the weakening of the yen and rising stock prices. Also, employment conditions improved largely due to changes in the population structure, rather than Abenomics. The decrease in the population lowers the potential growth rate. In Japan, the labor force is declining, wages are not rising, and private consumption is not increasing at all. As a result, people have not realized the boom Abenomics has brought. Knowing these problems, the Abe administration sought to change direction in 2016. The first stage of Abenomics, which focused on the problem of the lack of aggregate demand, tried to stimulate reflation with quantitative easing. However, it encountered some challenges and its limitations were revealed. The second stage of Abenomics focuses on labor reforms as a growth strategy in order to solve the constraint problem of aggregate supply. In the end, the success of Abenomics depends on labor reforms that aim to change Japan's ingrained labor practices.

Keywords | Abenomics, weak boom (*teion kōkyō*), monetary policy, quantitative easing, growth strategy

Introduction

There is a widespread perception that the Japanese economy, which had suffered following the global financial crisis triggered by Lehman shock in 2008, is recovering due to the economic policy package called Abenomics. After the implementation of Abenomics, the yen remained weak, share prices recovered,

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and the employment index hit a record high. The Composite Index released by the Cabinet Office indicates that the Japanese economy started its sixteenth cycle from the end of 2012. This economic boom has lasted for over sixty months (as of December 2017). It is the second longest boom, following the *Izanami* boom (*Izanami keiki*) during the Koizumi Jun'ichirō administration that lasted for seventy-three months. Does this mean Abenomics has rescued the Japanese economy? The change of direction for Abenomics in 2016 could possibly answer this question.

The initial policy goals of Abenomics projected a rise of two percent in consumer price inflation, three percent in nominal growth rate, and two percent in real growth rate. Taking office as the governor of the Bank of Japan in March 2013, Kuroda Haruhiko reconfirmed the goal of consumer price inflation at two percent. Moreover, the "Japan Rehabilitation Strategy" (*Nihon Saikō Senryaku*), which was announced in June 2013, restated the nominal growth rate of three percent and real growth rate of two percent as its goals (Taniguchi 2015, 1-2).[1] To achieve these goals, Abenomics proposed the three arrows of bold monetary policy, agile fiscal policy, and growth strategies to stimulate private investment. Evaluating the past five years, Abenomics is an economic policy package that has been partially revised in tandem with changes in the economic condition, rather than a consistent economic policy.

Indeed, Abenomics entered a new stage in 2016 with big changes to the policy. In September 2016, there was a major shift in monetary policy to implement quantitative and qualitative monetary easing with short-term and long-term interest rate adjustment. Prior to the change, Prime Minister Abe Shinzō had presented three new arrows of Abenomics in October 2015. In addition, there was the cabinet mandate entitled "All One Hundred Million Taking Active Parts Plan" (*Nippon Ichioku Sōkatsuyaku Puran*). Abenomics then officially entered its second stage, which focused on growth strategy. These changes in monetary policy and the shift of focus to growth policy arose from a common concern. In fact, the year of 2016 became an inflection point for Abenomics.

I will clarify the specific background in which the each of the three arrows of Abenomics was included in the economic policy package and evaluate the economic performance of Abenomics. Moreover, paying special attention to the change of direction for Abenomics in 2016, I will identify the key factors that

1. Unlike the previous government under the Democratic Party of Japan, which emphasized the independence of the central bank, the Abe administration tightened political pressure on the central bank. This eventually led the government and Bank of Japan to announce a joint statement about the inflation goal of two percent.

would lead to the policy's success.

The Background for the Emergence of Abenomics

1. The Causes of the Long-Term Recession[2]

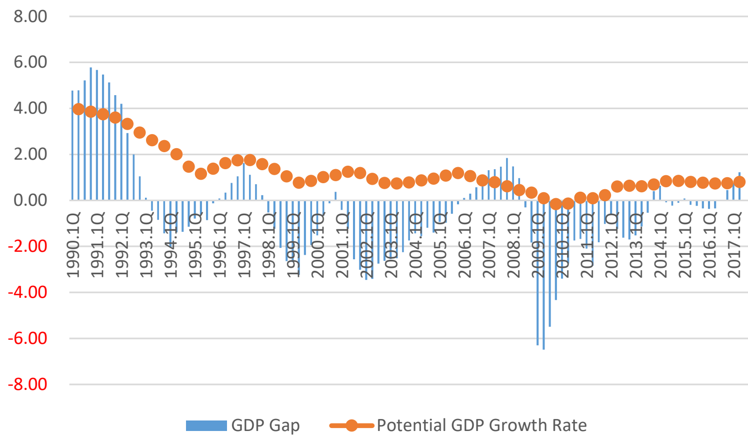
Prior to understanding the background for Abenomics, it is necessary to look at the long-term recession in Japan. The recession began in the early 1990s with the collapse of asset prices. The Plaza Accord in 1985 and the resulting overreaction due to a strong yen created a bubble that burst in 1990-91. As a result, the per capita GDP growth rate dropped to 0.3 percent in 1992. Following the oil shock in 1993, the growth rate fell to minus 0.2 percent for the first time. For the next twenty years, Japan went through a long-term recession, with per capita GDP growth rate remaining at 0.6 percent until December 2012, when Abenomics was enacted.[3]

There are two distinct characteristics of this recession. First, a decline in the potential GDP growth rate and a negative GDP gap took place simultaneously. Potential GDP growth represents the mid to long-term growth rate that a country's economy can reach. If the potential GDP growth rate decreases, the economic growth will also fall, even if a hundred percent of the available production factors are used. In addition, a GDP gap is the difference between potential GDP and actual GDP. A negative GDP gap means that the economy is not producing as much as its current potential. In other words, the long-term recession in Japan posed problems for both the supply side and the demand side. Second, there were long-term deflation and liquidity traps. The monthly average for the consumer price inflation rate was minus 0.1 percent from 1995 to 2012. Japan was the only major developed country to record a negative average inflation rate for such a long time, and this long deflation caused the liquidity trap.

The decline in potential growth rate indicates a problem with aggregate

2. See Pak Sang-jun (2016, 60-119) for more information.

3. In the same period, France grew by 1.0 percent, Germany by 1.1 percent, and the US by 1.6 percent. Comparing the growth rate to developed countries, Japan's growth rate was not particularly low at all. Their long-term recession drew attention not because of the low growth rate but because of the rapid change in growth rate. During the period from 1975 to 1991 when Japan recovered from the first oil shock, Japan grew by 3.6 percent, while France rose by 1.9 percent, Germany by 2.5 percent, and the US by 1.9 percent. Japan's growth rate sharply dropped compared to other developed countries.



Source: Processed by the author upon raw data from Nihon Ginkō (n.d.).

Figure 1. The Trend of GDP Gap and Potential GDP Growth Rate

supply. As shown in figure 1, the potential growth rate has been continuously decreasing since the collapse of the bubble. In order for potential GDP to grow, it is necessary to increase production factors, including labor force, human capital, and physical capital, or to improve total factor productivity. The changes in the population structure brought by low fertility and aging have resulted in a decrease in the labor force. Japan's working-age population started to shrink in 1999, while the peak of the population for people in their twenties to fifties was around 1995.

However, the labor shortage alone did not cause the aggregate supply slump during the recession. According to Hayashi and Prescott (2002), the slowdown in the growth of total factor productivity was the most fundamental cause of Japan's economic downturn in the 1990s. They show that the annual average for the growth rate of total factor productivity from 1983 to 1991 was 3.7 percent, and the economic growth rate was 3.6 percent during the same period. The annual average for the growth rate of total factor productivity from 1991 to 2000 was 0.3 percent and the economic growth rate was 0.5 percent during the same period. In other words, the growth rate of total factor productivity sharply declined, so the economic growth rate also fell. In the end, in order to solve the long-term recession, it is necessary to increase productivity through structural reforms that include eliminating zombie enterprises, reducing non-performing loans, and privatizing public enterprises with low productivity.

Japan's long-term recession is not just a problem of aggregate supply. In figure 1, the negative GDP gap indicates a deficit in aggregate demand. Considering the dates between the collapse of the bubble and Abenomics, those periods from the second quarter of 1993 to the fourth quarter of 1995, from the first quarter of 1998 to the fourth quarter of 2005, and from the third quarter of 2008 to the third quarter of 2013, have negative GDP gaps. During the recession in the 1990s, the GDP gap remained negative except for 1996-97. This illustrates that the lack of aggregate demand was the cause of the recession. The Japanese government had planned to increase the aggregate demand through financial and fiscal policies several times to solve these problems.

On the other hand, the second characteristic, long-term deflation and the liquidity trap, distinguish Japan's long-term recession from the low growth of the US and Europe. The liquidity trap is a situation in which economic agents are making pessimistic predictions so that even if the interest rate is low, there is no room for consumption or investment to be stimulated. It could also be a situation in which the interest rate is already so low that it cannot be lowered more. This paralyzes the central bank's interest rate policy. Krugman et al. (1998) assert that expected deflation had put the Japanese economy into a liquidity trap. In other words, if economic agents anticipate that deflation will become more intense in the future, they will delay current consumption, and the decline in consumption will lead to deteriorating sales performance of companies, resulting in job and wage cuts. This leads consumption to decrease even more. In addition, expected deflation has the effect of lowering investment by increasing real interest rates. Eventually, the decrease in consumption and investment leads to further deflation, and this vicious cycle creates a deflationary spiral, causing the economy to be stuck. Krugman's prescription for this is to defeat the expected deflation through quantitative easing. By shifting expected deflation to expected inflation through a policy of unrestricted monetary base expansion until the appropriate level of inflation is firmly established, the economy can escape from the vicious deflation cycle.

2. The Result of the Policy Debate: The Bold Monetary Policy

To place the three arrows of Abenomics with the policies explained above, the first and second arrows, monetary policy and fiscal policy, fall under the category of aggregate demand policy. The third arrow, growth strategy, fits with the aggregate supply policy. As a policy package, Abenomics includes both aggregate demand and aggregate supply. Nevertheless, a bold monetary policy of quantitative easing was the primary means for implementing Abenomics. In fact, Abenomics was not the first policy to introduce quantitative easing.

Table 1. Financial Policies of Bank of Japan

Period	Financial Policy	Goal and Tool
February 1999	Zero-interest-rate policy	Target call rate at zero
March 2001	Quantitative easing	Change of target from the uncollateralized call rate to the balance of current account Continue with the zero-interest-rate policy
March 2006	End of quantitative easing	Change of target from the balance of current account to the uncollateralized call rate Continue with the zero-interest-rate policy
October 2008	Non-traditional monetary policy	Purchase stocks of financial institution, CP, corporate bond
October 2010	Comprehensive easy money policy	Purchase national bond, corporate bond, ETF, J-REIT Real zero interest rate policy
January 2013	Set a goal for inflation rate	Stated the goal of inflation rate at two percent
April 2013	Quantitative and qualitative easing policy	Change of target from call rate to checking account balance Expand the amount of long-term national bond, Expand the purchase of ETF and J-REIT
October 2014	Expansion of quantitative and qualitative easing policy	Expand the increase range for monetary base, Expand the amount of long-term national bond Expand the purchase of ETF, J-REIT
February 2016	Quantitative and qualitative easing policy with negative interest rate	Apply interest rate of minus 0.1 percent for some financial institutions' checking accounts in Bank of Japan
September 2016	Quantitative and qualitative easing policy with short-term and long-term interest rate adjustment	Yield curve control Overshooting commitment

Note: The period of Abenomics is shaded in the table.
Source: Compiled by the author.

At the beginning of the Koizumi Administration, Japan became the first country to implement quantitative easing in March 2001. As shown in table 1, prior to Abenomics, quantitative easing policy took place from March 2001 to March 2006. Japan increased the monetary base from five to six trillion yen.

Then it expanded from thirty to thirty-five trillion yen from 2004. The economic team in the Koizumi Administration was aware of the lack of aggregate demand. Thus, it accepted Krugman's idea of quantitative easing on an experimental basis in 1998. The result turned out to be successful.[4] Under the Koizumi Administration, Japan enjoyed the *Izanami* Boom, which was the longest economic boom in the postwar period. The Bank of Japan declared the end of the quantitative easing policy in March 2006 when it was certain that Japan was in a boom cycle.

However, the reflationists' idea of solving the problem of the aggregate demand deficit by quantitative easing was not a core economic policy of the Koizumi administration. With structural reformers who sought to solve the problem of aggregate supply constraints, the Koizumi administration prioritized the improvement of the Japanese economic system (Yi Chŏng-hwan 2016, 244). For example, the administration focused on fiscal consolidation policies, non-performing loans disposal, and privatization of public enterprises. As a result, the ratio of non-performing bank loans, which grew to 8.7 percent in 2001, declined to 2.7 percent in 2006. In addition, the primary balance of GDP, an indicator of fiscal sustainability, was close to zero percent.

The second Abe administration thoroughly grasped the idea of the reflationists. Resigning from his first term as the prime minister in 2007, Abe had learned about the reflationists' theories through Yamamoto Kozō, a famous reflationist from the Liberal Democratic Party. After his return as prime minister, Abe appointed Hamada Kōichi and Honda Etsurō as special advisors to the cabinet (*naikaku kanpō sanyo*), and Iwata Kikuo as deputy governor of the Bank of Japan. With these famous reflationists in his government, Abe successfully implemented their ideas into Abenomics.[5] Moreover, the fact that the US and Europe applied quantitative easing after the Lehman shock convinced Abe to follow the same path.[6]

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4. There were some criticisms on Koizumi's achievements in quantitative easing policy. The critics said that the scale of quantitative easing was not large enough and it was over in a hurry, even before deflation had completely disappeared. However, there was some success. Koizumi's policy led economic recovery through the *Izanami* boom with the depreciation of the yen and strong exports.

5. For more information about implementation of reflationist's idea, see Yi Chŏng-hwan (2016, 243-45).

6. In the wake of the 2008 financial crisis caused by the Lehman shock, the US implemented QE 1 (Quantitative Easing 1: November 2008–June 2010) which was large-scale financial easing. Then it implemented QE 2 (November 2010–June 2011) and QE 3 (September 2012–October 2014) in a row. With the economic recovery, the six-year of quantitative easing period ended in October 2014. The European Central Bank also introduced quantitative easing immediately after the

As a result, the quantitative easing of Abenomics turned out to have different characteristics than that of Koizumi and his successors. The most significant trait of Abenomics is that "it used all the available means on a large scale." As shown in table 1, when the financial crisis began, the Bank of Japan had already purchased CP and corporate bonds. In 2010, when the Democratic Party of Japan (DPJ) was in power, the Bank of Japan expanded financial easing policy, purchasing ETF (exchange traded fund) and J-REIT (Japanese real estate investment trust). The quantitative easing by Abenomics did all of these on a much larger scale and conveyed its size to the market with clear numbers, such as two years, two times, and two percent. Finally, Abenomics was a time-based policy that encouraged market speculation by promising unlimited quantitative easing.[7] These are the three distinct characteristics of Abenomics. As a matter of fact, the first arrow of Abenomics, a bold monetary policy, has emphasis on the adjective "bold" rather than monetary policy itself.

3. Strategic Choice: Agile Fiscal Policy

After the policy debate, there was no dispute that quantitative easing should take place ahead of structural reform. However, fiscal policy was a strategic choice in which Prime Minister Abe's personal experience played a crucial role. When his first cabinet was established, Abe had no particular ideas regarding economic policy. In his speech at a press conference on September 26, 2006, Prime Minister Abe showed his willingness to promote a growth strategy to combat low fertility and an aging society. He promised to improve productivity through technological innovation. He also mentioned launching a reform of the social security system. His reform included pensions, medical care, and nursing. In addition, Abe stated that he would reduce expenditures and the amount of government bonds issued for financial reconstruction. Indeed, Abe meant to succeed Koizumi's structural reforms and hardly anything was new.[8] Abe's cabinet did not realize that they would need a new economic policy because they were quite confident about the economic recovery after March 2006 when quantitative easing ended.

Abe was interested in other areas, and he adopted a series of strong conservative policies. The Abe administration had turned rightist. It established

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Lehman shock and implemented it until August 2012.

7. For the difference between the financial policy of the DPJ and Abenomics, see Taniguchi (2015, 4-5).

8. For information about the economic policy of the First Abe Cabinet, see Fujita (2006).

the National Voting Act through the Constitutional Amendment Procedures, passed three laws related to education in the House of Representatives, and deliberated a bill to reform the public service system. In the meantime, his approval rating plummeted. When the Abe administration took the office, it had an approval rate of sixty-three percent. However, the approval rate fell after some Diet members who had opposed the postal privatization during Koizumi administration, returned to his party. They gave an impression of renegades who deviated from the Koizumi reform line. In addition, Yanagisawa Hakuo, minister of health, labor and welfare, used improper language, calling women "birth-giving machines" (*umu kikai*), and Abe's approval rate fell again due to the inadequate response to the statement. Moreover, about fifty-million pension records disappeared, leading the approval rate to drop to thirty percent. The Abe administration collapsed. To make matters worse, Abe's health had deteriorated, and so he left office one year after his inauguration.

The Japanese economy, which had overcome the lost decade and entered into a long-term boom, fell into recession again in 2008 due to the global financial crisis. After the first Abe administration, Japan underwent political turmoil, replacing five prime ministers in five years. The Japanese economy sank into a pit during this period. In August 2009, when the dissatisfaction and distrust toward the Liberal Democratic Party (LDP) peaked, the voters punished the LDP by voting for another party in the House of Representatives. With the landslide victory, the DPJ asserted income-led growth through income redistribution. However, there were overwhelming social welfare pledges that created difficulty in raising funds. The economy in the recession did not show any signs of recovery for a few years (Song Sŏk-wŏn and Kong Chŏng-sŭng 2013, 255-56).[9] At the same time, the Great East Japan Earthquake struck the Japanese economy, accelerating the collapse of the DPJ administration.

During the debates over the reconstruction bonds for the Great East Japan Earthquake, Abe seized an opportunity to rise again (Pak Sang-jun 2016, 143-46). On May 4, 2011, he gave a lecture entitled "How to Set Japan on the Right Track?" (*Ika ni Nihon o tatenaosu ka*) at Reitaku University. He argued that the government should issue reconstruction bonds to recover from the devastation caused by the earthquake. On June 16, 211 Diet members, including Abe, announced a statement that supported the issuance of reconstruction bonds. Abe, who had insisted on fiscal consolidation in his first cabinet, conversely insisted on active fiscal spending four years later. Because of the experience

9. To achieve every pledge of the DPJ's welfare commitments, the government needed about 16.8 trillion yen. However, only 3.9 trillion yen was allocated for the period.

from the Great East Japan Earthquake, it was possible to shift from fiscal consolidation to allowing aggressive fiscal spending. This helped Abe to build Abenomics' second arrow of agile fiscal policy.

Because of the decline in tax revenues due to the prolonged recession and the surge in social security costs due to aging, Japan's debt to GDP ratio has steadily increased since the 1990s. In the past, the government promoted fiscal consolidation by trying to reduce the size of government debt through increasing taxes and restricting expenditures. For example, Hashimoto Ryūtarō's cabinet, which came into office in January 1996, raised the consumption tax rate from three percent to five percent and implemented a strong fiscal consolidation policy. This had little success.[10]

However, the consumption tax weakened consumption and investment, slowing the economy rapidly. Then the Asian financial crisis emerged in 1997, making the situation even worse. The Hashimoto cabinet left office in July 1998. Even when Koizumi came into office in April 2001, fiscal consolidation was a hot topic. The cabinet declared that it would issue treasury bonds worth no more than thirty trillion yen per year. However, it gave up its pledge a year later when the economic deterioration caused a decrease in tax revenue. In the end, the fiscal consolidation plan achieved some improvement in 2006-07, when the economic recovery had become clear. The DPJ, when it took over the government, reduced fiscal spending that focused on public works with the slogan of "from concrete to people" (*konkirīto kara hito e*). This shows that, even when the government changed, the major direction of fiscal consolidation did not.

On the other hand, unlike the previous governments, which had put fiscal consolidation at the forefront, the Abe administration included an aggressive fiscal policy in Abenomics. Indeed, the Abe administration expanded the budget for large-scale public works. It even proposed a revised budget if it became necessary. But this did not mean that there were no alternative plans for fiscal consolidation. The Abe administration also planned to achieve a surplus in the primary balance of the GDP ratio by 2020, considering it as an extension of social security and tax reform (*shakai hoshō to zei no ittai kaikaku*). However, as the pace of economic recovery slowed down due to the increase in the consumption tax in April 2014, the Abe administration postponed further increases in the consumption tax, and it could not achieve its goals. The Abe administration had learned from the preceding government that it is risky to

10. In comparison with the previous year, annual expenditure decreased by 300 billion yen and revenues increased by two trillion yen in 1997.

implement fiscal consolidation policies when the economy did not fully recover. It is likely to fail and increase a political burden. Rather than pursuing fiscal consolidation, Abe chose an aggressive fiscal policy to stimulate aggregate demand that would lead to an increase in tax revenues as the economy recovered. However, the government could not pursue fiscal expenditure endlessly. Thus, it decided to use an agile fiscal policy when the need arose. Just like the bold monetary policy, the agile fiscal policy emphasized the adjective "agile."

The Evaluation of Abenomics

1. The Limitations of Quantitative Easing

When Abenomics first emerged, the most important policy was the first arrow, the quantitative easing policy, which can be divided into four major periods. The first period lasted less than two years. The quantitative easing policy had started with the inauguration of Kuroda as the governor of the Bank of Japan in March 2013. But the first period lasted from December 2012, when Second Abe Cabinet came into the office, to October 2014, before the quantitative easing policy was expanded. With the implementation of Abenomics in January 2013, the Abe cabinet and Bank of Japan decided to use the money supply rather than the interest rate as a method of regulation for monetary policy. The cabinet also stated a two percent interest rate as the goal for inflation. The Bank of Japan announced that it would purchase long-term government bonds to achieve the goal. In April 2013, Kuroda, the governor of the Bank of Japan, announced that it would implement financial easing that was highly distinctive in both quantitative and qualitative ways. For specific plans to achieve a consumer price inflation of two percent within two years, the administration announced that it would increase the monetary base by sixty to seventy trillion yen every year, doubling the base within two years. It also said that it would purchase twice as many long-term government bonds. Moreover, it would purchase risk assets such as ETF or J-REIT. The announcement of Abenomics had a remarkable effect early on because Governor Kuroda clearly and firmly showed commitment to the goal of "two percent consumer price inflation" within two years. Because the monetary policy's goals were beyond the expectation of the market, the value of the yen depreciated and share prices rose even before the specific policy was implemented.

The second period was from the announcement of quantitative and qualitative easing in October 2014 to the introduction of negative interest rates in February 2016. Although the rosy outlook was dominant over the first year or so, the increase in the consumption tax in April 2014 (from five percent to eight percent) undermined the past achievements. When the US ended its third quantitative easing (QE3) in October 2014, the Japanese government became anxious that the deflationary mindset might continue for long. Japan needed a firmer commitment to prepare for expected inflation. Indeed, the Bank of Japan declared additional quantitative easing. It stated that it would increase the monetary base from sixty to seventy trillion yen to eighty trillion yen and the amount of long-term government bonds from fifty trillion yen to eighty trillion yen. It also added that it would purchase three trillion yen of the ETF and ninety billion yen of J-REIT, which were three times the previous sizes.

The third period lasted from February to September 2016. It ranged from the introduction of quantitative and qualitative financial easing with negative interest rates to the introduction of quantitative and qualitative monetary easing accompanied by short and long-term interest rate adjustments. Quantitative easing, which had entered the third year of quantitative easing, gradually begun to show its limitations. First, it failed to achieve the inflation rate goal of two percent within two years. The increase in the monetary base failed to lead to an increase in money supply because commercial banks' checking deposits in the central bank failed to attract business loans.[11] This not only meant a failure to achieve the goal, but also created a problem of credibility. The Bank of Japan Governor Kuroda faced accusations that the credibility of his commitment had become the problem. Since Kuroda had emphasized the goal of "two percent within two years" in strong tones several times over the previous years, the impression that the Bank of Japan's pledge had failed remained strong. In addition, the surprise of policy announcements became less effective. In the first year of Abenomics, the announcement effect of the government and Bank of Japan was quite large, but as the players in the market adapted to the new economic environment, their announcements no longer surprised economic agents. In the end, the Bank of Japan was forced to revise its existing quantitative and qualitative financial easing.

11. The case of a corporation suffering from a recession in a balance sheet could be an example. If new borrowing is reduced in order to minimize debt, the amount of money supply will not increase, even if the monetary base increases. Moreover, a bank that has suffered bad debts in a long-term recession could be conservative when lending. If this happens, the money supply would not increase. For more information of the balance sheet recession theory, refer to Coo (2014, 16-111).

The introduction of the negative interest rate[12] was expected to have a positive effect that would lead to a decline in the overall market interest, causing inflation to rise. This would spur consumption and investment. The yen would then depreciate, so exporting businesses would be more competitive. This would result in strong exports and high growth rates (Chŏng Chin-yŏng 2016, 16). However, there was little room for further interest rate decrease when the rate was already zero. As a result, the impact of the decline in interest rates for investment during the recession was minimal (Coo 2014, 16-111). In fact, Japan has a serious issue with population aging, and because interest is the main income source for elderly people, this might have caused a decrease in consumption. The biggest problem of all was that the introduction of negative interest rates worsened the profitability of banks. The decline in long-term interest rates had led to a reduction in loan-deposit margins, which resulted in financial difficulties, especially for local banks (Chŏng Chin-yŏng 2016, 12).[13] As a result, the decrease in loan-deposit margins led to a reduction in the credit supply of banks. It also brought worries about the deterioration of corporate liquidity caused by the decrease in loans ("Ijigen kanwa," 2016, 54-57).

The fourth period is from September 2016 to the present. This period represents quantitative and qualitative easing accompanied by short and long-term interest rate adjustments. In September 2016, the Bank of Japan conducted a "comprehensive verification" (*sōkatsuteki kenshō*) on quantitative and qualitative financial easing. The comprehensive verification was necessary because the previous quantitative and qualitative financial easing failed to achieve the goal of two percent inflation within two years. In addition, the purchase of a large amount of government bonds had reached its limit, and the introduction of the negative interest rate did not produce a great effect. As a result, the government decided to buy government bonds to keep the long-term interest rate at zero percent (yield curve control) and continue to expand the supply of money to a level where the inflation rate was stable above two percent (overshooting commitment). Based on these two linchpins, the government started quantitative and qualitative financial easing with short and long-term interest rate adjustments.

12. The negative interest rate means a mechanism of taking a commission on checking accounts by applying minus 0.1 percent interest rate on some of the banks' checking accounts of financial institutions. Since 2012, central banks of four European countries (July 2012 for Denmark, July 2014 for Sweden, December 2014 for Switzerland, March 2016 for Hungary) and the ECB (June 2014) implemented the negative interest rate.

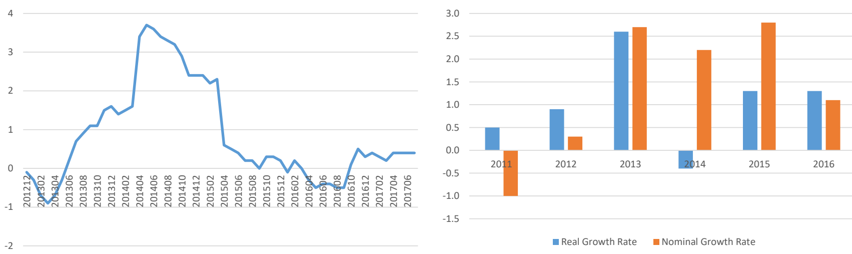
13. Because of the negative interest rate policy, the decline in local bank profits (minus fifteen percent) was twice as large as that of large banks (minus eight percent).

Will these adjustments be able to achieve policy goals? There are two limitations. The first limitation is whether yield curve control is a feasible policy. Traditional financial policy achieved policy goals by adjusting short-term interest rates. While financial policy also affected long-term interest rates, expectations of market players ultimately decided them. This illustrates that long-term interest rates are not easy to adjust, and it is not necessarily desirable to distort the market. The second limitation is that the two linchpins send inconsistent signals. Yield curve control means that the interest rate of the long-term government bonds will not fall to a negative level. In order to maintain this, the government may reduce the purchase of government bonds in certain cases. This implies that the Bank of Japan may pursue the opposite of financial easing. The Bank of Japan finally admitted that the bold monetary policy, the core of Abenomics, has reached its limit (Lee Chang-Min 2016, 39). The Bank of Japan was also aware of this and intended to raise expected inflation by declaring an overshooting commitment, which meant it would not stop financial easing, even if it achieved the policy goal. Due to the contradictory characteristics of the linchpins, the Bank of Japan sent out vague signals to economic agents. Thus, whether the Bank of Japan wanted an expansion of quantitative easing or an exit strategy became ambiguous.

2. The Emergence of the "Weak Boom" (*Teion Kōkyō*)

Let us evaluate the performance of Abenomics according to its policy goals (two-percent consumer price inflation rate, three-percent nominal growth rate, two-percent real growth rate).[14] As shown in figure 2, the performance of Abenomics can be assessed by dividing it into two periods on the basis of the inflation rate. The first period lasted from the announcement of Abenomics in December 2012 to the announcement of an increase in the consumption tax in April 2014. During this period, the consumer price inflation rate rose smoothly, from a negative rate to the stated two percent goal. However, in the second period, when the consumption tax was hiked, the inflation rate decreased again. In 2016, it returned to the negative level it was at before the start of Abenomics. The government had seemed to achieve the two percent goal in 2014. However, if one subtracts the effect from the increase in consumption tax, Abenomics

14. For a short-term goal, Abenomics aimed to escape from deflation. For a medium-to-long-term goal, it seeks sustainable economic growth. In order to elucidate its policy goals, Abenomics stated goals numerically. A consumer price inflation of two percent, nominal growth rate of three percent, and real growth rate of two percent highlight the goals of Abenomics.



Source: Compiled by the author with raw data from Sōmushō (n.d.) and Naikakufu (n.d. b).

Figure 2. Consumption Price Inflation Rate and Growth Rate (%)

never really succeeded.[15] As for economic growth, it has recovered under Abenomics. However, the government has not achieved the nominal growth rate of three percent and the real growth rate of two percent. After the increase in consumption tax, the real growth rate dropped sharply. As a result, the anticipated goals of Abenomics have failed because of the increase in the consumption tax in 2014. The Abe administration recognized this problem and postponed the second consumption tax hike (from eight percent to ten percent) from the scheduled October 2015 to April 2017. Then the government postponed the increase again to October 2019.

Although Abenomics has failed to meet its policy goals, the Japanese economy is experiencing its second longest post-war boom, as illustrated by the Composite Index. In March 2017, Abenomics surpassed the "bubble boom" (from December 1986 to February 1991, fifty-one months) which was the third longest boom in the post-war period. Then, in September 2017, it surpassed the *Izanagi* boom, which was the second longest (from December 1965 to July 1970, fifty-seven months). If Abenomics keeps pace, it will replace the record *Izanami* boom, the longest boom in the postwar period (seventy-three months), by 2019. Figure 3 shows the Composite Index since 2000. The economic recovery that started with the launch of the Abe administration continued to rise until April 2014, accompanied by inflation and economic growth. Then it moved up and down within a certain range. Therefore, despite the fact that the economy is in a boom, the condition of the economy has remained relatively neutral. Indeed, the Japanese economy has been in a state of "weak boom" since the increase in the consumption tax.

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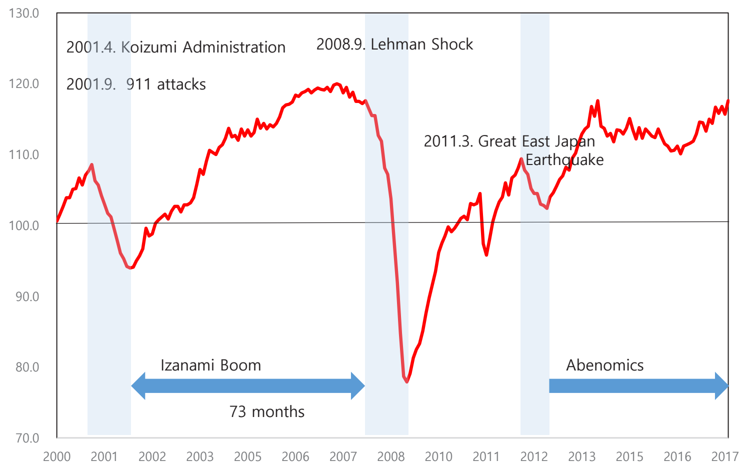
15. It is necessary to consider the drop in international oil prices since the second half of 2014. From June 2014 to January 2016, oil prices fell nearly seventy percent.



Source: Compiled by the author with raw data from Naikakufu (n.d. a).

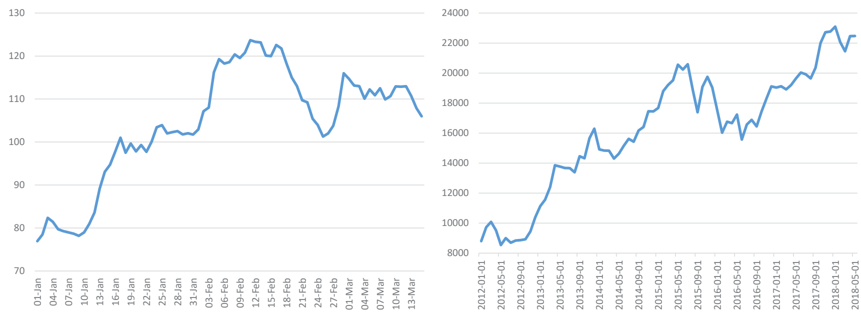
Figure 3. Composite Index

What has supported the "weak boom" since April 2014? Abenomics' major successes include the weakened yen, increase in stock prices, and improvement in employment. The yen/dollar exchange rate started at eighty yen at the end of 2012 and continued to fluctuate, but it has remained at 110 yen since 2017.[16] The average Nikkei stock price also began to fluctuate from 8,000 yen at the end of 2012 to 20,000 yen in 2017 (as shown in figure 4). It is clear that there has been a tendency towards a weak yen and increased stock prices for five years under Abenomics. Data also show improvements in the employment rate. The full unemployment rate had been steadily declining and stayed at three percent since 2013. It fell to two percent in 2017, achieving virtually full employment. Job-to-applicant ratio, which means the number of jobs per laborer, rose steadily to 1.01 in November 2013. It was 1.63 as of December 2017.

The question is whether the weak yen tendency and rise in stock price led to an increase in exports and an increase in consumption as a mechanism of financial easing.[17] As many critics of Abenomics pointed out, there was no clear correlation between the weak yen and exports. Regardless of the weak yen, exports hardly increased. In addition, there were discrepancies in profit gains between large corporations and small or medium-sized enterprises. Large

16. Accessed January 2018.

17. About the mechanism for financial easing, see Okabe (2014, 3-6).



Source: The exchange rate is from time-series statistic of Bank of Japan. The stock price data is compiled by the author with data from *Nihon keizai shinbun* (Japanese Economic Newspaper).

Figure 4. Exchange Rate (dollar/yen) and Stock Price (Nikkei Stock Average)

corporations operating on the global stage were expected to see earnings rise due to the decline in the value of the yen, even if exports themselves do not increase. However, SMEs operating domestically were at risk of worsening profitability due to rising raw material prices (Ryu Sang-yun and Yi Chi-p'yŏng 2014, 25-26). Slowing consumption is also one of the biggest weaknesses of Abenomics.

There was a slight rebound in 2013 and 2014 when there was last-minute surge in consumption (*kakekomi shōhi*). However, total consumption did not deviate from the long-term decline. The improvement in the consumption index and employment index was more a result of the change in population than the effect of Abenomics.

The full unemployment rate peaked at 5.5 percent in July 2009, decreasing to four percent in 2011. The job-to-applicant ratio also turned upward since 2009, inversely proportional to the unemployment rate. In fact, the labor force population started to decline in 1999. After ten years, the total population declined in 2008-09. As a result, the unemployment rate declined naturally and the job-to-applicant ratio has increased.

The value of the yen as a safe asset has declined due to the recovery of the world economy, and the Japanese economy has begun to recover as large public investment and capital investment by enterprises increase. However, it is hard to say that recovery and growth have reached a stable level, as Abenomics aimed to achieve autonomous growth led by domestic demand. Due to the decline in the workforce, employment indicators have improved. As a result, however, the potential growth rate has declined, and companies are hesitant to raise wages due to Japan's rigid employment system. The rise in income is uncertain and there is no confidence in the future, so consumption has not revived. It is true that the bold quantitative easing policy has somewhat resolved the prolonged period of helplessness in Japanese society, but it has not completely eliminated the prevailing deflation. In the end, the Japanese economy, which was already in a weakened condition, met with a positive external environment and created a special situation called a "weak boom."

The Change of Direction for Abenomics after 2016

1. The Unspecified Growth Strategy

Growth strategies and structural reforms go hand-in-hand. The long-term growth of the economy follows the increase in potential GDP. To increase the potential GDP, it is necessary to reform the country's economic structure. The reform of the economic structure should create an environment in which companies and workers can work efficiently and stably under fair rules. The third approach of Abenomics, the growth strategy for promoting private investment, aims to reform the economic structure in order to address the problem of aggregate supply constraints. In fact, there were voices pointing out the importance of structural reform since the late 1980s. The Maekawa Report, written in 1986 by the Nakasone Yasuhiro cabinet, claimed that Japan needed to improve the surplus trade structure with the US and reform the economic structure that had supported rapid growth. It was a bold policy proposal back then, but it became a milestone, as structural reforms appeared in each successive government.

In the 1990s, as the economic recession continued and structural problems such as low fertility and aging began to appear, interest in structural reform became more important (see table 2). In 1995, the Murayama cabinet announced structural reforms in ten areas to deal with the strong yen and problem of low productivity. In 1996, the Hashimoto cabinet issued six major reforms. Its fiscal reform aimed at consolidation, but it was largely ineffective due to the economic downturn. By contrast, the Obuchi cabinet, which succeeded Hashimoto, expanded its fiscal spending in order to recover the economy. Apart from the fiscal spending, the Obuchi cabinet announced various structural reforms for sustainable growth.[18] Koizumi's structural reforms have been discussed above.

18. For the summary of structural reforms from previous governments, see Nakanomyō (2003,

Table 2. Structural Reforms of Cabinets in the 1990s

Date of Announcement	Cabinet	The Name of Policy	Contents
April 1986	Nakasone	The Maekawa Report (The Report of the Advisory Group on Economic Restructuring)	Housing and urban development projects for the expansion of the domestic market Transformation of industrial structure Improvement for market access and promotion for imports Liberalization of financial market and globalization of yen
December 1995	Murayama	Economic and Social Plan for Structural Reform	High cost reduction and vitalization measures in ten fields (logistics, energy, distribution, telecommunication, finance, passenger transportation, agriculture, licensing, public works, housing construction)
December 1996	Hashimoto	Six Major Reforms	Administrative reform, financial reform, social security reform, economic reform, financial system reform, educational reform
December 1999	Obuchi	Strategy to Revitalize the Japanese Economy	Economic recovery and sustainable finance Building a healthy competitive society Building a financial system Industrial revitalization with international competitiveness Infrastructure investment and local revitalization

Source: Nakanomyō (2003, 4-7).

Thus, it is evident that Japanese governments have announced similar reforms on various structural problems of the Japanese economy, including low fertility, aging, deteriorating fiscal soundness, and rigid labor market since the 1990s.

Not only the LDP, but also the DPJ, which took over in September 2009, announced its structural reform plan under the name of "New Growth Strategy" (*Shin Seichō Senryaku*) in December 2009.[19] The six major focus areas included energy, health, Asian economy, tourism, regional vitalization, science and

4-7).

19. About the economic policy of the DPJ, see Masuda (2009, 10-20).

technology, and human resources. After the Koizumi cabinet, Japan experienced six years of political and economic turmoil. In December 2012, when the second Abe cabinet took office, the government suggested a growth strategy that promoted investment, as per the third arrow of Abenomics. In addition, the "Japan Rehabilitation Strategy" released in June 2013 announced a more concrete growth plan. The strategy stated the necessity of overcoming the existing systems, laws, and practices that hindered private investment. It also presented plans for promoting new entrants, rebuilding the economic infrastructure for globalization, and expanding government support for the development and practical use of advanced technologies.

There were many other contents in the "Japan Reconstruction Strategy." However, there were no major differences from the structural reforms or long-term growth strategies previously pursued by the LDP government. Even when compared to the DPJ's "New Growth Strategy," there were no significant differences except the plans for the national strategic zone, reactivation of nuclear power plants, and corporate tax cuts (Ch'oe Hŭi-sik 2013, 181). As a result, Abenomics' growth strategy has been criticized from the beginning as a mere slogan that lacks an authentic agenda. The reason that Abenomics' growth strategy has the same characteristics of all previous policies is as follows. First, as explained above, the structural problems of the Japanese economy are so obvious that all Japanese know them. Because the problems are obvious, the government cannot help to propose similar measures to deal with them. Second, the government can do only a limited range of things with the growth strategy. Unlike the aggregate demand policy, which is expected to have a direct and immediate effect, the growth strategy, which is an aggregate supply policy, is an indirect and medium-term strategy. In essence, the government needs to improve the investment environment to attract private investors. This will lead to gradual economic growth.

The Abe cabinet emphasized quantitative easing rather than structural reform. It was a policy decision indicating that aggregate demand shortage was a more serious problem than the aggregate supply constraint. Moreover, the Abe cabinet was under pressure to produce an economic recovery via their economic-focused policies as soon as possible. In fact, it was not easy to suggest structural reforms, which take time to see effects (Park Young-June 2014, 88).[20] When Prime Minister Koizumi came into office in April 2001, the approval rate of his cabinet exceeded eighty percent. Based upon this high approval rate, Koizumi

20. In an interview with *Foreign Affairs*, Prime Minister Abe said that the priority of the second Abe cabinet is to eliminate deflation and restore the Japanese economy.

sought thorough structural reform. Takenaka Heizō, who served as minister of state for eonomic and fiscal service and minister of state for financial services, took charge of these drastic reforms. Despite the effort, there was negative growth at the beginning of the Koizumi administration. It led his approval ratings to drop to forty percent in June 2002. However, the effect of the structural reforms emerged gradually. The ratio of non-performing loans was decreased and many zombie companies were eliminated. Japanese corporations made structural improvement in industries. The exports were strong as a result of the weak yen, leading the Japanese economy to recover. Koizumi maintained an approval rate of forty percent and retired in September 2006 during the longest post-war boom. Abe, who served as chief cabinet secretary, was second-in-command during the Koizumi administration. Serving in the Koizumi cabinet, Abe closely observed that the success of the economic policy led to the high approval rate.

2. Structural Limitations: The Importance of Labor Reform

The year 2016 was an inflection point for Abenomics. First, there were two great fluctuations in the quantitative easing policy, the introduction of negative interest rates in February and the introduction of short and long-term interest rate adjustments in September. In October 2015, Abe labeled the next three years as the "second stage of Abenomics," and announced a slogan that Japan aimed to become a society that would promote "All Hundred Million Taking Active Parts in Society" (*ichioku sōkatsuyaku shakai*). At the same time, Abe announced three new arrows for Abenomics. They included a strong and hopeful economy, supportive childcare, and reassuring social security. It merged the existing three arrows into a single, "strong economy" arrow and added two new social security measures. As a result, the first "Hundred Million Active National Congress" was held on October 29, 2015, and the "Japan Hundred Million Total Action Plan" was decided on June 9, 2016, at the 9th meeting. After 2016, Abenomics shifted its focus from quantitative easing to growth strategy (or structural reform).

There are two interpretations for this change of direction for Abenomics. One interpretation is that Abenomics' quantitative easing policy had reached its limit (Han'guk Kŭmyung Yŏn'guwŏn 2015, 20).[21] As mentioned above, the

21. Quantitative easing alone could not achieve the two percent inflation rate. Because of the increase in consumption tax, private consumption shrank. The decline in the fertility rate and aging caused a decrease in the labor force, and it resulted in the problem of productivity decline. It was clear that Abenomics could not deal with all these problems by itself.

introduction of negative interest rates and the adjustment of short and long-term interest rates were measures to boost the effects of quantitative easing or offset its side effects. The other interpretation is that Abenomics is working according to its original plan to "use quantitative easing first for economic recovery and when the economy starts to turn around, structural reform will take over" (Taniguchi 2015, 1).[22] Abenomics did not meet its goal because the increase in the consumption tax hindered the economic boom. However, looking at the Japanese economy in the long run, it did turn around in October 2015 when the second stage of Abenomics was in action. Recognizing the limitations of Abenomics and evaluating Abenomics as a half-success is essentially the same. Each approach admits that Abenomics needed a change of direction after three years. The change turned out to be dealing with supply constraint problems through a more concrete growth strategy, rather than demand shortage problems.

The slogan of "All Hundred Million Taking Active Parts in Society" represents the plan to sustain a population of one hundred million who can play roles at home, work, and the regional community even after fifty years. The concrete means to achieve such a society are the three new arrows described above—strong economy, child care support, and social security. The goal of a strong economy is to increase nominal GDP to 600 trillion yen by 2020. To achieve this goal, the government plans to promote a productivity revolution by fully expanding the employment of women, workers, and disabled people. In addition, it plans to revitalize the local economy. Regarding child care support, the government plans to raise the fertility rate, which is currently 1.4, to 1.8 by 2025. In order to reduce the economic burden related to child rearing, the government is willing to support free education for early childhood and infertility treatment care. The social security plan involves improving elderly care facilities to reduce the loss of employment caused by family nursing. In addition, the government intends to expand the social security system by supporting elderly households, including pensions. The new three arrows concentrate on the problem of supply, exemplified by the lack of labor force brought about by the low birth rate and aging society (Han'guk Kŭmyung Yŏn'guwŏn 2015. 21).

The success of the second stage of Abenomics depends on the success of labor reform. The third Abe cabinet, which was established in August 2016,

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22. The three arrows of Abenomics represent time order. An expansionary financial policy comes first to create a breakthrough for deflation. Then an expansionary fiscal policy accelerates the process to eliminate deflation. Finally, stabilize the economy and promote sustainability through deregulation.

appointed Katō Katsunobu as minister for working style reform (*hatarakikata kaikaku tantō daijin*). In September, the government launched the "Reform for Working Style Conference." The government also suggested equal pay for the same work, ending long working hours, and the promotion of employment for the elderly as specific action plans for working-style reform. The government emphasized labor reform because the labor shortage continues even though the unemployment rate has fallen to near full employment. Despite the unemployment rate falling below three percent in 2017, the job-to-applicant ratio exceeded 1.6, worsening the labor shortage. The labor shortage at near full employment means that the economy is close to its potential GDP, but the lack of labor force is constraining economic growth.

Usually, as the total and working-age populations decrease, the labor force also decreases. However, after the implementation of Abenomics, the total population and the working-age population decreased, but the labor force increased.[23] From 2013 to 2016, the total population decreased by 560,000, from 127.31 million to 126.75 million. On the other hand, the labor force population increased by 710,000, from 65.77 million to 66.48 million. This is because women, elderly people, and foreign workers who used to be categorized as a non-labor force in the working-age population entered the labor market. Full-time housewives who left the labor market due to pregnancy, childbirth, and child care entered the labor market again, and those over sixty-five years of age continued to remain in the labor market through the "continued employment system". In addition, Abenomics' positive employment policy for foreign workers attracted many foreigners to enter the labor market.

However, women, the elderly, and foreigners comprise a higher proportion of non-regular workers to regular workers, and non-regular workers have a relatively lower wage. Low wages lead to a decline in consumption, which results in a reduction in aggregate demand. Consequently, the reduction in aggregate demand does not create a virtuous cycle for economic recovery. Companies are also required to provide continuous employment for the elderly. This can cause problems of productivity deterioration, and productivity deterioration leads to aggregate supply constraint in the long run. The bigger problem is that the shift of the non-labor force population to the labor force population cannot be a solution in the long run. As the working-age population continues to decline,

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23. The working-age population in Japan has started to decline since 1999. The total population also started to decline in 2008. In the 1950s and 1970s, the increasing rate of the working-age population surpassed the increasing rate of the total population. However, in the 2000s, the decreasing rate of the working-age population surpassed the decreasing rate of the total population.

the process of pushing the non-labor force population into low-wage non-regular jobs will soon face limitations. Therefore, Abenomics' change of direction is based on the recognition that these existing growth strategies cannot help the Japanese economy escape from recession or promote long-term growth.

In the end, the key to labor reform depends on the reform of Japanese labor practices. Under Abenomics, the wage level is declining while employment indicators are improving. A possible reason for this contradiction is Japanese labor practices, which include long-term employment and the seniority wage system.[24] Managers are cautious about the base salary increase, which increases fixed costs, so even if the company's performance improves, it is not returned to the household as wages. As a result, private consumption does not improve. The Japanese labor practices place high risks on changing jobs and retirement. This increases the opportunity cost for childbirth or childcare, creating difficulties for women to reenter the market. Moreover, the wage gap between regular and non-regular workers is also related to the high risks of changing jobs and retirement, which are directly linked to the problem of lower productivity. These risks have led workers to be specialized for their companies only. Moreover, there are problems with working overtime and hospitality customs. Therefore, the reform of Japanese labor practices is a fundamental measure to solve the aggregate supply constraint, and the shift of Abenomics occurred as a result.

Conclusion

The three arrows of Abenomics prior to 2016 are as follows. The first arrow was bold financial easing that expanded the unlimited quantitative easing that had been implemented since the Koizumi administration. The second arrow was the agile fiscal policy designed to aggressively implement fiscal stimulus. The policy was chosen because the Abe administration could not increase the fiscal expenditure forever while not bound by fiscal consolidation like previous administrations. Finally, the third arrow was the growth strategy that consolidated all the long-term growth strategies of the previous administrations. The second Abe cabinet, inaugurated in December 2012, concentrated on bold financial easing as the prime mover to start Abenomics. First, Abe planned an expansionary monetary policy to escape from deflation. This was followed by an expansionary

24. There are various explanations for the irony of the decline of wages in the labor market. For more information, see Genda (2017).

fiscal policy to accelerate the escape. Finally, he planned to promote steady economic growth through various growth strategies.

The economy under Abenomics seems to be booming. However, it is a "weak boom," which is difficult to notice. It failed to achieve the policy goals of a two-percent inflation rate, a three-percent nominal growth rate, and a two-percent actual growth rate. On the other hand, there are a number of experts who consider the weak yen, the increase in stock prices, and the low unemployment rate as a success for Abenomics. However, Abenomics does not solely affect fluctuations in the value of the yen and fluctuations in the average Nikkei stock prices. There are other determinants. In addition to US political circumstances and the Federal Reserve Bank's interest rate policy, the economic condition of Europe and emerging economies affect the value of the yen in the international market. The Japanese stock market then reflects this. Thus, while Abenomics could be one of the reasons for the increase in stock prices, it is an overestimation to say that Abenomics has been solely responsible for the weak yen and stock market. In addition, employment has increased, in part due to the improvement in corporate earnings since the implementation of Abenomics. However, the fundamental cause for the fall in unemployment is the labor shortage, which constrains the labor supply.

In essence, it is clear that Japan must overcome the problem of aggregate supply constraints, not aggregate demand shortages, in order to escape from the long-term recession. The key to the problem of aggregate supply constraints is labor reform. Japan needs to reform its labor practices and working style in order to sustain a society that maintains a population of one hundred million people who play a role at home, work, and regional communities even after fifty years. The original prescription for Abenomics focused on converting the non-labor force population to the labor force population. But this cannot be the ultimate solution for the long-term shortage of labor. In the end, the success of the second stage of Abenomics and the recovery of the Japanese economy are all dependent on the success of the labor reforms.

• *Translated by JEON Hae Jeong*

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