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Economics Group

Special Commentary

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Japan and the Third Arrow of Abenomics

The Three Arrows Were Never Meant to Be Loosed

Commentators on the Japanese economy have had a field day coming up with headlines related to the three arrows of Abenomics. After a year's deliberation, the long-anticipated third arrow (structural reform) is coming into focus and has been met thus far with a lukewarm reception. References to "missing the target" or "arrow falls short" have been impossible to resist. We would be the last to criticize clever wordplay, but in this instance we feel that all the imagery of fired arrows misses the point of the original Japanese folktale upon which the three arrows are based.

Mōri Motonari was a prominent daimyo (territorial lord) in 16th century Japan. He was also the father of three boys. Legend has it the father gave his sons three arrows with the instruction to snap them all at once. Upon realizing it could not be done, Motonari explained to his boys that while one arrow could be easily snapped on its own, three arrows held together could not. It was an admonition that if they stuck together, they would be stronger than if divided.

In November of last year we wrote it "is critical that structural changes (the third arrow) be implemented as close to simultaneously as possible with the stimulative fiscal policy initiatives and the accommodative monetary policy measures (the first two arrows)."

In this special report, we revisit the most-needed structural reforms in Japan.

On June 16, Japanese Prime Minister Shinzo Abe hosted an annual industrial conference at which he laid out the highlights of his "Strategy for Reviving Japan."[1] After months of anticipation, what was supposed to be a bold new reform program instead feels a lot more like a litany of potential reforms to gauge the political winds and weigh public interest.

In this special report, we revisit the most-needed structural reforms in Japan and contrast that with what seems likely to be included in the official Strategy for Revitalizing Japan. Japan needs to (1) fix its shrinking labor force problem, (2) sort out its fiscal situation and (3) embrace growth strategies like trade reform and other measures. Time is running out for the implementation of structural reform. The IMF recently acknowledged the early success of Abenomics but cautioned that, "Without additional reforms Japan risks falling back into lower growth and deflation, a further deterioration in the fiscal situation, and an overreliance on monetary stimulus."[2]

The seeds of inflation were sown by the Bank of Japan by expanding the monetary base. For those seeds to take root, inflation expectations must remain intact. That could be at risk when second quarter growth turns negative as the Japanese economy absorbs the consumption tax hike. Growth is likely to pick back up in the second half of the year, but it would help inflation expectations and economic growth in general if structural reforms were implemented expeditiously. Three arrows together cannot be broken; one on its own could be snapped easily.

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[1] The 120 page "Strategy for Reviving Japan" from June 16 was available only to media. For this paper we will make use of a June 2014 publication from the Office of the Prime Minister, titled *"Abenomics" is Progressing! The Latest Progress and Achievements of the Abe Administration* which offers details of coming proposals for structural changes.

[2] *Regional Economic Outlook, Asia and Pacific, Sustaining the Momentum: Vigilance and Reforms*, International Monetary Fund, April 2014 Page 24.

1. Fix the Shrinking Labor Problem

Japan has passed an inflection point in terms of population growth. According to the Statistics Bureau of Japan, the official national population was 127.1 million as of April, down roughly 700,000 from the 127.8 million figure at the beginning of 2012 (**Figure 1**). The trajectory of population growth has shifted from slow growth to outright declines due to low fertility rates and the absence of immigration.

Figure 1

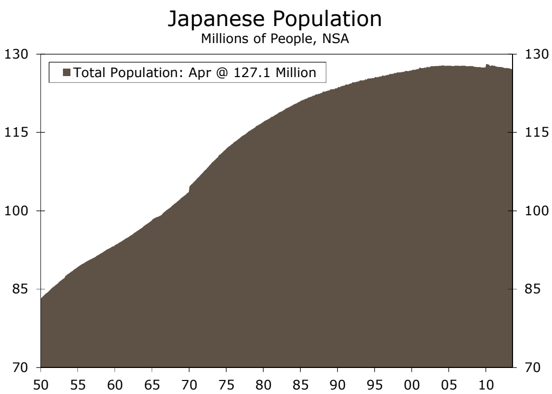
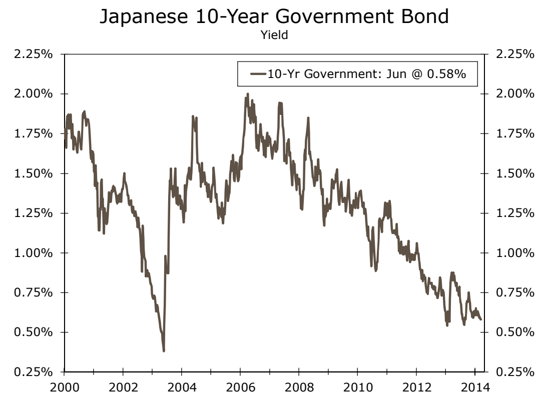


Figure 2



Source: Japanese Ministry of Internal Affairs and Communications, IHS Global Insight and Wells Fargo Securities, LLC

Compounding this problem is the fact that the average age of the population is getting higher as the nation grows older. While the overall population has only recently begun getting smaller, the labor force has been shrinking for more than a decade. This has serious implications for both the size of Japan's future workforce and for domestic demand. According to the IMF, the size of the working-age population is projected to fall from its peak of 87 million in 1995 to about 55 million in 2050. If realized, that would roughly equal the size of the Japanese workforce at the end of World War II.

In addition to reducing potential growth, the aging of the population in Japan is having a downward influence on interest rates.

In addition to reducing potential growth, the aging of the population in Japan is having a downward influence on interest rates (**Figure 2**).[3] While it is certainly true that official BoJ purchases of Japanese Government Bonds (JGBs) keep a lid on interest rates, it is not the only factor. According to the IMF, elderly households prefer to avoid risk and feel more comfortable with perceived safe assets such as JGBs which has exerted much of the downward effect on rates.

It is clear that something has to be done to offset the negative economic effects of a shrinking workforce. The IMF has formally recommended that structural reforms should embrace measures to raise female labor participation as well as a relaxation of immigration rules to address labor shortages.

Women in the Workforce

Abe's latest proposals include an unflinching commitment to strengthen female participation in the workforce. According to government estimates, at present there are roughly 24,000 day care centers and almost the same number (23,000) children on waiting lists to enter a daycare facility; a dynamic that many observers feel is keeping would-be female workers out of the labor force. So it is not surprising that one major thrust of the reforms is to improve the childcare centers throughout Japan (**Figure 3**).

[3] **Arslanalp, Serkan and W. Ralphael Lam, "*Outlook for Interest Rates and Japanese Banks' Risk Exposures under Abenomics*", IMF Working Paper, WP/13/213, October 2013, page 8.**

Figure 3

Promotion of the Advancement of Women's Roles in the Workforce

- Open more childcare centers by utilizing a rental system and Government-owned land
- Secure childcare workers to sustain the growing demand
- Advanced implementation of new schemes including subsidies for small scale childcare businesses
- Assistance for unregistered childcare centers that are seeking registration
- Support for on-site childcare centers on business premises

Source: Cabinet Public Relations Office and Wells Fargo Securities, LLC

Other measures include proposed corporate incentives for encouraging female workers to pursue both a career and a family through subsidies or other tax measures. This sort of program has double benefits by our reckoning. Not only does it help grow today's workforce through a higher female participation rate, it helps grow tomorrow's workforce as well through a higher fertility rate. Unfortunately, other measures seem less specific in how they would help fix the problem. One example of this is a call for the creation of a centralized website where businesses can post information about females in executive roles or management.

Immigration Reform

A quick fix for any nation struggling with a shrinking workforce is to dial back immigration restrictions. In Japan, there is a reticence to embrace an open-door immigration policy and any proposal dealing with this issue is hotly contested. So much is this the case, that the Abe administration has to walk on eggshells in approaching any changes in this area. Under a category diplomatically referred to as "Sourcing High-Skilled Human Resources from Overseas" the Japanese government lays out proposals for bringing in top talent from abroad including things like awarding merit points for post-graduate degrees, loosening income requirements to allow talented foreign workers to bring parents or housekeepers as well as shortening the waiting time for permanent residency to three years from the present 5-year waiting period. Still, the goal of this program is just 1,500 fulltime positions over the next three years, a decidedly underwhelming figure for a nation whose workforce could benefit from a pool of highly skilled immigrant labor.

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In recognition of the fact that there might be an even greater need for immigrant labor in other sectors, there are separate provisions for attracting other types of foreign workers. The needed infrastructure build-out associated with the 2020 Olympics provides a needed catalyst for pushing Japanese lawmakers to consensus on this controversial issue. The latest proposals suggest opening a window for "work-ready" foreign construction workers from 2015 until 2020 in designated economic zones. But the minutia surrounding the length of stay in Japan gives some clue as to how arduous the negotiating must be. Foreign construction workers can stick around for two years provided they have completed "Technical Intern Training" but their stay could be extended to three years provided the foreign workers have "stayed in their country for more than one year after finishing the training, on the visa-status of *designated activities."* Remarkably, this byzantine scheme becomes even more convoluted for the foreign worker who has the tenacity to apply for re-entry upon completion of their two or three year working period. The heading for this category of proposals, "Acceptance of Foreign Workers in the Construction Industry" reveals the institutionalized reluctance with which these proposals are considered.

2. Sort Out the Fiscal Situation

Corporate Tax Reform

Japanese Prime Minister Shinzo Abe has made clear his desire to cut the corporate tax rate in Japan, even if his administration has not yet provided specifics in terms of how a rate reduction would be facilitated or how the government would absorb the lost revenue.

Japan faces something of a conundrum in its approach to corporate taxes. As we described in a recent special report, Japan faces some daunting challenges if it is to stabilize its enormous debt-to-GDP ratio, making any loss of government revenue something to avoid, at least at face-value. However, at more than 38 percent last year, the corporate tax rate in Japan is second only to the United States among the G-7 nations (**Figure 4**), but when compared to other major economies in Asia, Japan's corporate tax rate is the highest (**Figure 5**). Not only does this put Japanese businesses at a disadvantage, it also deters foreign investment and acts as a headwind to economic growth. An exact reckoning of the negative economic impact of higher taxes may be difficult to quantify, but when considered from this perspective the case for a lower tax rate makes more sense.

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Figure 4

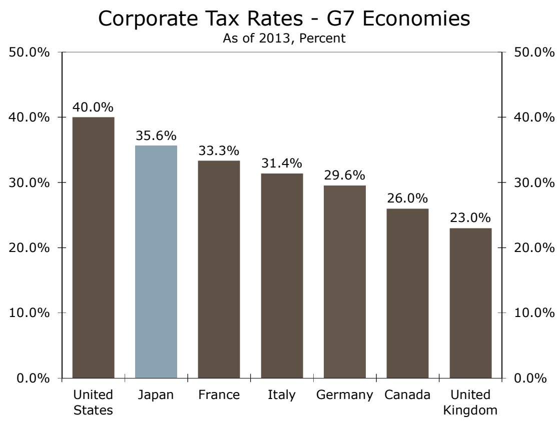
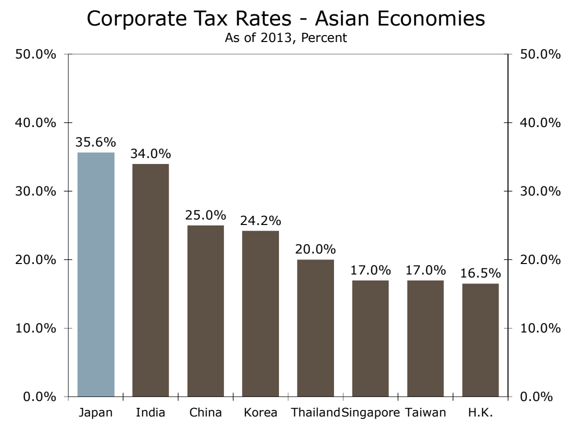


Figure 5



Source: KPMG[4] and Wells Fargo Securities, LLC

Still, if the corporate tax rate were lowered, how would the Japanese government absorb the lost revenue? According to an estimate from the Japanese Finance Ministry, a 1 percentage point reduction in the corporate tax rate would result in a loss of roughly ¥470 billion in revenue. The other variable to consider is the timing of the reduction. Prime Minister Abe has discussed targeting a corporate tax rate below 30 percent, perhaps getting there incrementally over the course of a few years; others have advocated an immediate cut.

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In some ways, the tax policy in Japan could be compared to driving with one foot on the gas and one foot on the brakes. At least in the near term, the lost tax revenue from a corporate tax cut offsets some of the benefit from increasing the consumption tax in April. That move, while unpopular, came amidst public calls from a number of private sector economists, the IMF and third party ratings agencies to go through with the tax hike to bring needed tax receipts to help stabilize Japan's debt. The Finance Ministry has been vocal about the need to find other revenue sources to offset the lost income in the wake of any corporate tax cut. Aside from a widening of the tax base through the elimination of loopholes and exceptions, there are no specifics being offered in the new proposals to find other sources of revenue.

In the absence of specific proposals we will concentrate on things that we know, and those include the following: the corporate tax rate in Japan is higher than in most other economies and that is a headwind to economic growth. At the same time the Japanese government, with its bloated debt, needs all the revenue it can get. Any transition to a lower tax environment must be managed carefully so as to not be too disruptive to government finances, which leads us to our next topic…

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[4] **We used the corporate tax rates as reported in KPMG's global corporate tax rate table. Cross country tax comparisons are never perfect. In the U.S., for example, "The marginal federal corporate income tax rate on the highest income bracket of corporations is 35%. State and local governments may also impose income taxes ranging from 0% to 12%, the top marginal rates averaging approximately 7.5%. A corporation may deduct its state and local income tax expense when computing its federal taxable income, generally resulting in a net effective rate of approximately 40%." The rest of the table can be found here: http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx**

Fiscal Consolidation

In addition to being an outlier in its corporate tax rate, Japan also stands out in terms of the size of its debt-to-GDP ratio.[5] At more than 200 percent, the Japanese debt-to-GDP ratio is the highest in the world – and not by a small margin. As recently as the mid-1990s, Japanese debt-to-GDP figures looked very similar to those of the United States. But slow economic growth and large fiscal deficits in Japan over the past 20 years have caused the Japanese debt-to-GDP ratio to balloon while the comparable ratio for the U.S. government has risen at a much slower pace (**Figure 7**).[6] This trajectory raises questions about the debt sustainability of the Japanese government and one of the structural changes being considered would start by trying to balance Japan's primary budget balance.[7]

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Figure 6

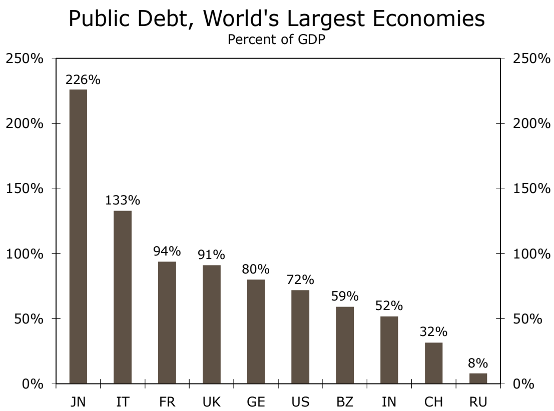
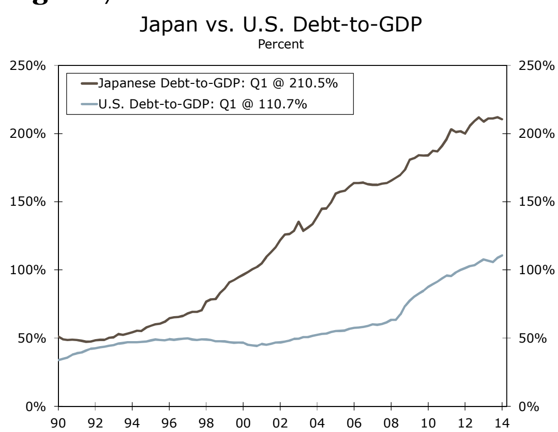


Figure 7



Source: CIA World Factbook, IHS Global Insight and Wells Fargo Securities, LLC

The ongoing primary budget (along with other factors like the size of the total debt, the interest rate paid on it and growth rate of the economy) is a key factor in examining a nation's debt sustainability. For that reason, improvement in reducing the primary budget deficit would help improve the probability of long term debt stabilization and reduce the default risk.

The latest round of proposals reiterates a commitment to halving the budget deficit by fiscal year 2015 and by achieving a balanced budget by fiscal year 2020. Unfortunately, there is not a lot to go on in terms of how the balanced budget will be achieved. An addition to its reservations about cutting the corporate tax, the Ministry of Finance has suggested that it is not likely the budget can be balanced by 2020. Seemingly at odds with the balanced budget target, there is no commitment in the proposals to implement the final stage of the consumption tax increase presently scheduled for October 2015. Rather, it says that the Prime Minister will make a decision on the 2015 consumption tax increase within this year. As we observed in our April paper referenced above, it is possible for Japan to stabilize its debt situation; though it would be much easier if the budget deficit could be eliminated without disrupting economic growth.

3. Embrace Growth Strategies; Trade Reform & Other Measures

Pursuit of Free Trade Agreements

Trade has been an inconsistent factor for Japanese GDP growth over the past two years. The trade balance has gone from a modest surplus at the end of 2010 to a record deficit in recent months

[5] Debt-to-GDP ratios in figure 6 represent debt held by the public (debt held by individuals, corporations, state or local governments, the central bank and foreigners). Figure 7 represents total debt which is debt held by the public plus intra-governmental holdings. For more info see: https://www.treasurydirect.gov/govt/resources/faq/faq_publicdebt.htm

[6] Between 1993 and 2013 real GDP in Japan grew 0.9 percent per annum while the annual fiscal deficit averaged more than 6 percent of GDP.

[7] For a detailed discussion of the sustainability of Japan's debt, see our recent special commentary, "Can Japan Stabilize Its Debt Dynamics?" by Jay Bryson and Tim Quinlan, April 8, 2014.

(**Figure 8**) but seems to be shrinking more recently. Import volume picked up with domestic demand in recent quarters and exports were weak in the second half of 2013, despite yen weakness. In terms of the trade movement in volumes, the picture is brightening modestly as export growth has been positive on a year-over-year basis for the past nine months (**Figure 9**). In terms of the impact on GDP, trade boosted growth in the first half of 2013 and was a drag in the second half of the year. In the first quarter of 2014, trade was a non-factor adding just 0.1 percentage point to the annualized growth rate for the period. In the context of these observations, it is critical that Japan find a way to increase exports.

Figure 8

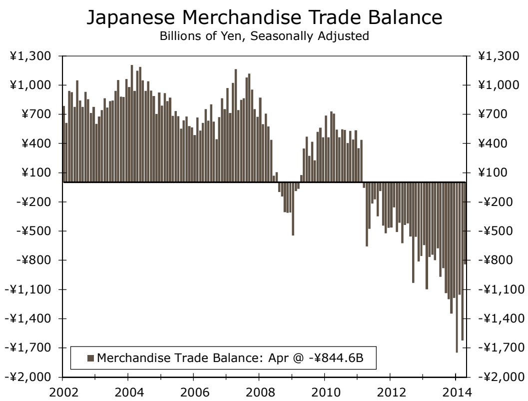
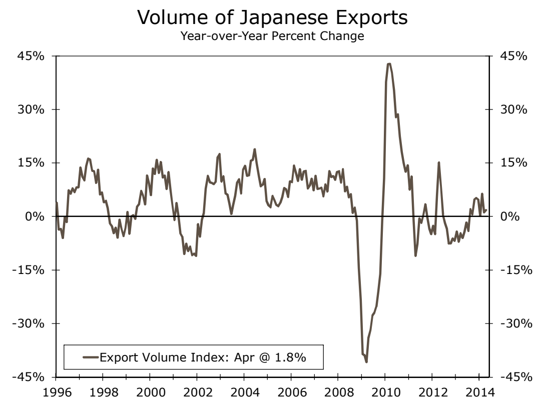


Figure 9



Source: IHS Global Insight and Wells Fargo Securities, LLC

In one positive development, Japan officially inked a trade agreement with Australia in April 2014, which will eliminate most tariffs on Japanese goods sold in Australia and secures a stable source for energy, raw materials and food products.

It is still not clear whether or not Japan will be a part of the Trans-Pacific Partnership.

While the trade deal with Australia is a step in the right direction, it is still not clear whether or not Japan will be a part of the Trans-Pacific Partnership (TPP); the proposed free trade agreement that has been in negotiation since 2010 and at present involves 12 countries in Asia and the western hemisphere. Japan was late to the negotiating table due to resistance from the domestic agricultural lobby which has held public protest demonstrations to voice their opposition. The agriculture lobby has an entrenched record of influencing favorable legislation. The Organization for Economic Cooperation and Development compiles data on producer support estimates (government subsidies) as a percentage of gross farm receipts including support. According to this data, Japan's farmers depend on government subsidy for a whopping 55.9 percent of their income. That is more than three times the 18.6 percent average across the OECD countries and it goes to show that the lobby has sway in terms of pushing legislation in a direction that is favorable to the entrenched interests of agriculture.

Prime Minister Abe backs the TPP and has extolled its economic benefits but he has to walk a fine line politically in his support. While hosting U.S. President Obama in Japan in April, the U.S. and Japanese leaders were not able to come to agreement on terms of the TPP despite negotiations that reportedly went well into the night. The lack of a U.S.- Japan deal took the wind out of the sails of a May meeting of negotiators for all 12 countries and it clouds the timeline of eventual implementation of the TPP. The latest wording in the proposals from the Abe administration carry little in the way of a compromising tone, stating flatly that the government will continue negotiations on the TPP with "a view toward maintaining Japan's national interests."

Japan has other prospects for bilateral trade deals, as the recent program with Australia illustrates, as well as opportunities for regional trade pacts including a potential three way free trade agreement between Japan, China and Korea. So it is not as though the TPP is the only option for Japan, but it is the best option in our view as it could significantly increase trade with the United States and 10 other foreign economies.

National Strategic Special Zones

Part of the growth strategy for Japan is a series of special economic zones. This includes a series of targeted regulatory reforms with varying objectives based on the city or region. For example, there are proposed regulatory exemptions for building codes and a streamlined approval process for commercial building permits in Tokyo with a stated goal of promoting that city's status as an international business hub. Another example would be relaxed visa requirements in Okinawa prefecture with the goal of promoting sightseeing.

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With goals as far flung as promoting mountain agriculture in one region and attracting the world's best medical doctors in another, it is difficult to summarily praise or dismiss these programs. All of the zone projects have laudable goals and the measures to get there sound reasonable, but rollout involves the cooperation and coordination between national and local governments and the "buy-in" of leaders at both levels of government which suggests to us a lack of immediate economic impact. In other words, the potential legislative and implementation lags that might be associated with these programs might mean years could pass without the desired effect of lifting economic growth. That is not to say that these are not worthwhile programs, they are just another example of something that is in the planning stage when what Japan really needs is something in the execution stage.

Government Pension Investment Fund (GPIF)

The Japanese Government Pension Investment Fund boasts more than ¥200 trillion in assets under management. The new growth strategy includes the recommendations of expert panel chaired by a graduate professor from the University of Tokyo. The over-arching theme of these recommendations is fundamental shift from conservative, bond-centric investment ideology to one that embraces risk and geared more toward equities and investment in real estate and venture capital. The implementation of this shift carries significant implication for financial markets and inflation expectations, all of which are dependent upon the timeline for the transition and that is the key piece of information missing from the current proposals.

Bottom Line

Despite the tepid reception that the proposed policy changes have received thus far, we applaud the Abe administration for dedicating time and energy trying to come up with the right solutions to solving Japan's economic problems…not just with this most recent batch of reforms but with Abenomics as a whole.

The first two arrows (bold monetary policy and flexible fiscal policy) have succeeded in their objectives to stimulate growth and create wanted inflation. But these are the easiest reforms to implement. The third arrow (structural reforms) is harder to implement, but that difficulty can be partially offset by the other two. In June 2013, Prime Minister Abe promised greater clarity on his proposals. It took 12 months and we are still in the proposal stage, and the effects of the first two arrows are beginning to wane. The Prime Minister's recommendations could certainly be more succinct, but they do address the greatest shortcomings in the Japanese economy at present. What is most needed is a sense of urgency. Three arrows together cannot be broken; one on its own could be snapped easily.

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