

Making Real a Growth Agenda for Japan

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I am grateful to Dr. Masao Nishikawa for the invitation to speak here today. I'm a little intimidated coming here. It was just said that the history of ESRI is short. Perhaps so in count of years, but the Institute's impact is large. We all were inspired by what Koichi Hamada achieved during the early years of the Koizumi cabinet. We have had many subsequent distinguished leaders from ESRI, including Kazumasa Iwata and Kenji Umetani who went on to senior policy roles, and now we are fortunate to have Masao Nishikawa as ESRI's president. I am very honoured to be asked to participate in this conference. So many good friends and colleagues from the US and elsewhere as well as Japan are here for the NBER Japan Project meetings and are presenting in depth academic research on various aspects of the Japanese economy.

Therefore, I am not going to try to give you an entirely new take on the economy. What I would like to do is to give you some pointed suggestions on how to take what we already know about the Japanese political economy and implement them as an operational growth strategy. By my title, making real a growth agenda for Japan, I mean that in two senses. First, that as much as I and many others here admire the recent accomplishments of the Bank of Japan, I think we all agree that the emphasis now must be on the structural rather than monetary side of the economy and thus supply side reforms. Second, as a sense of making real, I mean how do you actually get

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reform done, that is implemented on a sufficient scale and sustained. On both counts, I will address the key policymakers – even though the colleagues assembled here are researchers, the mission of ESRI is to advise the policymakers leading Japan.

I think at the start that it has to be said is that all policy makers have and express the feeling that they do not get enough credit for the reforms they undertake. So when we discuss the economic situation in Europe right now, one always finds elected officials saying, ‘we know that we haven’t yet achieved financial union or given sufficient accountability to the European Parliament, but look how far we’ve come versus where we were,’ or ‘look, it took the US a hundred and fifty years to get from its constitution to an integrated stable economy, so look again at how far we’ve come.’ US elected officials are no exception to this habit. We have had a succession of presidents who have whined about not getting enough credit, from Clinton on the IT boom to Bush on education to Obama on health care. But, we have a particular issue in Japan over the last twenty years of seeing Cabinet members announce very long lists of specific policies that are meant to be implemented, and trying to impress people with the sheer number of announced measures. Yet, very little true change has been made, and the gap between announcement and impact has made people very sceptical of such lists.

Therefore, the Abe Administration has been quite wise to get out of the habit of listing fifty, or sixty or seventy, bullet points of things to fix. Having a clear set of priorities is not just important for internal effectiveness, but for external credibility and political support. I fear there’s been a little bit of backsliding of late on this, and there’s one particular area I’m worried about, which I will mention. But I think the way that Prime Minister Abe spoke at Davos in January 2014, and the way that the issues of healthcare reform, agriculture reform, female labour force participation, and GPIF reform have been clearly prioritized, is paying off. By concentrating on those plus fiscal consolidation and cooperation with monetary policy, we now have here in Japan largely the right priorities. That’s still a long list but it is far shorter than the lists that used to be announced.

We can even argue that two of the reforms items on the agenda are already on track to completion. In terms of both the substantive inflation target and the cooperation with the other macroeconomic policies, I think the Bank of Japan is on the right path, and I am quite certain that most of the distinguished participants in this conference agree with me about that. The taboos of having cooperation between the government and the Bank of Japan have been broken, and we have seen that the results are positive, not dangerous. So I think that one is settled. And the reform of the GPIF, which while not the biggest of the reforms, is still important, is also very visible to monitor, and is well underway.

We are now then looking at the four remaining reforms: agriculture, female labour force participation, healthcare, and raising the consumption tax and revising the tax code. So how should we think about moving those forward to completion? Do not start adding other things, even promising or easy reforms, to the agenda. If the Cabinet starts adding other policies to the list, the government will lose focus, will lose credibility and momentum - and others in the Japanese public, in the press, and in global financial markets will lose patience. That sounds very simple but let me be very clear about the danger here.

We had a very interesting initiative undertaken about special economic zones in Japan, being set up within many of the major urban areas including Osaka and Tokyo. And I think many people in the US, and I would expect even some people in Japan, do not fully understand how these are going to work or what they're going to do. It was convincingly explained to me that the major impacts of the special economic zones were to happen through freeing up the the labour market; this would improve small business competitiveness and the start-up culture, and potentially break ground for changing the tax code on high earners. Most promisingly, the special economic zones were meant thru changes to hiring rules and zoning laws to promote more competition in the healthcare field. Those are quite worthwhile objectives, using a liberalizing means, and basically fit with the remaining four agenda items – if they were kept to as the list.

But over the last few months in Japan there has been a sudden burst of concern over what are now being called regional issues. There was a famous think tank report that there are too many rural communities in Japan, and we are going to have to shut down five hundred of them over the next couple of decades. As a result, or maybe with this excuse, many Japanese politicians are now out there saying we need to put money into those regions where there is still some employment and residents but no local life. Of course, these kind of redistribution measures not only look like and smell like, but actually are the old fashioned fiscal politics of Japan: Diet members putting money into backwards places to buy votes to maintain support. This is highly pernicious, not just in direct waste of public money which Japan can no longer afford; it is of course bad as a signal about the inability of the government to maintain its priorities.

I would contend that, as good economists, we should all be standing up and calling this out and not letting this backsliding reappear in the form of taking over the special zones into so called regional policies. There is a genuine issue of how long-term declining regions in large economies should be dealt with, whether invested in, encouraged to empty out, or ignored. There is an obvious political calculus of why so much time and effort has been spent on the *Mezzogiorno* in Italy, Alabama and West Virginia of the US, Okinawa and Hokkaido in Japan, and so on. It is an open question whether you can ever get these regions to develop. But my understanding of the literature is that, for the most part, the best policy is to increase rather than decrease mobility, to invest in making it easy rather than difficult for people to leave. To make it so that benefits are tied to individual citizens and not to regions. That is obviously a public interest and an economic argument, not an electoral logic but we have to stick with it.

Let me turn now to agricultural reform. This is to me in many ways the ultimate area exemplifying what I said at the start, where the elected officials from the Prime Minister on down insist that we economists or outsiders have no idea how much blood they are spilling, how much political capital they are spending, how much time they are devoting to agricultural reform, and so on. The politicians have to recognize that even if sectoral competition in Japanese agriculture is better now than it ever has been, or more likely the prospects of eventual

reform are higher than they ever have been before, from the outside the lack of visible progress remains a problem.

At the end of July 2014, a group of a hundred and forty members of the US Congress from both parties suddenly signed a public letter saying to President Obama, we want TPP to go through but we cannot countenance Japan going through with an easy ride on agriculture. Now there are many reasons why we can make fun of Congress, all justified. There is also no doubt about the huge hypocrisy in American Congressmen with their agricultural supports for sugar complaining about Japanese protectionisms. But it does reflect a basic reality, which is that Prime Minister Abe has made clear that the average age of JA members is over eighty, so if we all were to wait five years most of them will be otherwise occupied, and therefore he feels he can take his time. Whereas the feeling from the outside is that the beneficiaries of Japan's protectionist agriculture policies are on their way out anyway, so why not get it done now, at least in terms of a commitment to trade liberalization. I think there is a problem in particular that in the context of TPP, as well as for the sake of agricultural productivity in Japan, there has to be a path to zero tariffs for essentially everything except rice. If Japan does not offer that, then the market opening efforts that both Japan and the US wish to get from the less developed members of TPP will not have credibility, and the deal will not pass Congress. So this is an example of a place where the pace of reform probably has to be faster than is comfortable.

These two areas of backwards motion, subverting the economic zones into regional handouts, and agricultural foot dragging, hide what I think is one of the greatest success stories of the sustainable growth strategy underway: increasing female labour force participation in Japan. The economic arguments about the number of skilled and work experienced women in Japan who are underutilized tell you that increasing their utilization would be found money. If you gain their increased participation, it would be a positive supply shock, especially in a context where Japan has a marked demographic decline. Again I don't need to resell this to anyone in this room, let alone the Abe Cabinet, and so I do want to give credit, that in the last twelve months roughly five hundred thousand additional women have entered the work force in Japan.

Many of them are working flex-time or part-time but in a sense that's good. We want to have the forms of employment available that make it feasible for women to come in. But even where there is progress, the government must face the question is that progress enough? Is it the fact that this is a big gain in Japanese female labor participation compared to where it was? Or is it enough to get to where Japan needs to go?

There are, as the IMF, as well as people within the Japanese Cabinet, have identified, several other steps that can easily be taken to increase female labour force participation. There are mostly in supply side, having to do with providing more available public childcare, with changing the rules on joint tax returns, with providing write-offs for women who need to find child healthcare or parental care in today's environment. We know these processes work, we have seen them work in Sweden, Germany, and elsewhere. Yet, the bill that I gather will be sent soon to the Diet on this issue, will be about affirmative action and monitoring of the share of women in management in the private sector. I am all for this. I would be very happy to see progress on that front - but that is not going to do the job as much as these other policy measures would do.

The fourth agenda item in the background of everything else is of course the big issue of fiscal sustainability. As someone who is known for having opposed the tax increase in 1997, to the degree I'm known for anything in Japan, I find myself in the interesting situation of repeatedly telling Japanese friends and politicians that this time you do not have a choice about raising taxes. Note that I am not denying there will be a slowdown in demand as a result of the tax increase, but the government has got to keep going with it nonetheless. Obviously what I'm referring to is not the just implemented consumption tax increase, but the question of when and how do you approve the further increase in consumption taxes to take place in Fall 2015 and beyond.

Now there is more art than science in determining what is fiscally sustainable for large economy with its own currency. We have the ground breaking paper by Christian Broda and David

Weinstein of 2005 which helped us put this in perspective for Japan specifically. There has been a lot of good recent work on fiscal sustainability in the US and the euro area that is applicable to Japan in terms of method. If you take all of that seriously, Japanese politicians have to just accept that unless the value added tax reaches a level somewhere north of 20% within a few years, Japan's government cannot make the numbers add up. I think Takatoshi Ito has argued, and I agree, that a major reason there has not been a breakdown in or market attack on JGB trading up till now is because everybody knows you could eventually raise taxes. There is this room to raise taxes, in terms of the limited share of tax revenue in national GDP for Japan. But we are reaching the point where it is no longer a question of the Japanese government *could* do that when needed, but that the government *should* do that starting now.

Now the challenge is of course politically a question of, can you continue to raise taxes when people are obviously unhappy right now and the recovery is slowing? But to make the reform real, it is also a question whether the government can substitute other fiscal measures for raising the consumption tax and maintain market credibility? So requiring taxpayer identification numbers for all Japanese individuals, such that smaller businesses will finally get taxed, broadening the base in other ways, or, as some people would have it, making major cuts to social entitlements and public spending, all have their virtues and their limitations. This is actually an area where economics has done a lot of good applied research in the last twenty years, and particularly in the last five. And we're seeing in real time the relative value of these means to fiscal consolidation as both revenue raisers and political commitments in southern Europe right now. And what do we know?

The first is it is extremely difficult to sustainably cut entitlement expenditures, extremely. We have already seen two major steps in Japan, one during the Koizumi period when there was some real but temporary caps on social spending; the other pension reform that took place roughly ten years ago, which is analogous to things the US could potentially do on social security. Both of these helped, in terms of buying time and space, but they did nothing to change the unsustainable upward trend of social welfare expenditure in Japan. It is a much

less credible, much less deliverable, and most of all a much less visible policy measure to go on a crusade against these expenditures than to stick to a announced tax regime that merely brings Japan back into line with most other countries in terms of tax rates. And I do not wish to be a doomsayer and I know that many, many people have continually lost money betting on crashes in Japan, but I do think that there is now a true market risk - not so much in the JGB market but in the Japanese equities market and in the yen exchange rate. Were the Abe government to hesitate too much or fail to commit this fall to raising the tax in 2015 as scheduled, much of the asset price gains seen in Japan since December 2012 would disappear, and credit would be disrupted.

Again some politically sophisticated Japanese leaders and their advisors will say, well, VAT rises are particularly unpopular. What happens if we do this instead, so we get revenue from here or there in a more efficient way? Of course, in the abstract what matters is the amount of permanent revenue and the temporary growth trade-off. A clever economist can come up with some policy that supposedly will deliver the same revenue for less immediate or acute pain. But in practice, given immediate effect on long term sustainability and the ability to monitor it, as well as the room to keep increasing it rather than assembling new one time measures every budget, I think there is very little that can substitute for a value added tax increase.

There are many things of course I have not touched on, so usually this is the point at which a speaker says, "well I only have twenty minutes, so forgive me" My point is entirely different. The whole laundry list of other things in the arena of Japanese economic reform that could be talked about truly are of secondary importance, and should be kept that way. The six agenda items I mentioned at the top, reflecting the Cabinet's initial priorities are still the things that the Abe government needs to concentrate on. We can talk a lot about things like corporate governance reform, something which many of us have been hoping for in Japan for years, and that would be nice. We could talk about energy policy, which is important for a variety of reasons. But neither of these issues is critical to making largely irreversible and visible progress in the short-term Japan's long term growth and fiscal sustainability. We could also

talk about new business start-up, as touched upon in the original discussion of special economic zones, but the real material impact has to be via health care competition and labor force participation. I think are areas of potential reform that have to be recognised as unlikely to make a material difference to growth in the near term, as having much more uncertain impact, and most of all as being rather opaque to the average voter or market participant.

Please let me conclude by just asserting a few guidelines for how you do reform. I need to support the claims I made that the Japanese government can speed up reform in these key areas, rather than reveal I just made a politically naïve wish. Most of all, I want to attack the notion that is often invoked, that elected officials have a limited amount of political capital. You hear this quite often. You hear of this in the Obama White House. You hear this being spoken about all the time now in the press here in Japan and outsiders commenting on Japan. The Prime Minister spent so much political capital on the security re-interpretation, it is said, so therefore he does not have political capital to go further with agriculture or labor force reform, or on fiscal consolidation.

I think this is a fundamentally misleading image for politicians. We have in the room Prof. R. Glenn Hubbard who demonstrated the opposite in action, when he served as a very influential CEA chair (ESRI President counterpart) in the US under President Bush; we saw it happen, with Heizo Takenaka working for then Prime Minister Koizumi, who was on the way out it seemed in mid-2002, but after winning on bank reform got to push through a bunch of other measures in his remaining time. Pushing through decisive victories multiplies your political capital – its accumulation is neither linear nor automatically eroding over time. And diversification does not necessarily give you benefits the way it does in financial capital. When you win a battle it is usually something that you concentrated upon, and can then build on and so should move immediately to the next battle. You have to go forward at times, whereas to timidity may only increase opposition.

Second and related, I think it's important to be very aggressive in, as the phrase would have it, the Nixon goes to China approach. That is the idea that a politician gains enormously by doing something that seems to be contrary to what they or their party has professed for a long time, exemplified by the staunch anti-communist Richard Nixon going to open relations with Maoist China, is the example. But I think there are other examples in the economics sphere. We look at Bill Clinton doing welfare reform in the mid '90's. We look at Gerard Schroeder doing reform of unemployment benefits in Germany, in the early 2000's. We look at Ronald Reagan mid-way through his first term raising some taxes. We look at the current Prime Minister of Greece, who comes from the conservative party, raising taxes on some oligarchs. The point is you sometimes have to sacrifice somebody on the politician's side, not just for sometimes substantial direct economic benefits of the policy, but for the demonstration effects and increase in political capital. This is why I talk about Japanese agriculture reform as something that, instead of waiting it out, should be pursued aggressively.

Third, a leader should not only hit her allies, it is always good to destroy an opponent or interest group served by the opposition as well, to put it crudely. Ronald Reagan gained greatly from breaking PATCO, the air traffic controllers union. Margaret Thatcher gained greatly from breaking the coal miners' strike. I think it is useful for the LDP to, and the Abe leadership, to be thinking about taking out some of the regional subsidies that are going to districts that are not theirs.

Finally, I would like to make explicit something I referred to throughout my talk, but that I feel ultimately is key. We have learned a lot in political economy over the last several years and one of the most important things is that it's very useful to have publically accountable targets. Now this is very simple in some ways in the monetary sphere. You announce an inflation target, and the central bank has a very clearly defined measure of policy success and a very clearly defined time-frame. In the fiscal arena, you can come up with perhaps not quite as neat and clean but arguably similar targets for multi-year budgets. Announce a commitment to make sure small

changes are revenue neutral. Set a public path for the structural budget deficit to be closed in 'X' years (where X is less than the number of years to the end of a prime minister's second term).

The tricky part arises, as I've tried to say in my talk, when you move to structural reform of the real economy; it's much more difficult to set out what is the visible verifiable target. In part this is inherent because structural reforms tend to take much longer time to pay off and their effects are much more subtle. There is no easy way around this, but that's why, going back to where I started, that I think the Abenomics agenda and announced priorities of its first year and a half in office, were largely right. It's a question of in a sense doubling down on them, and increasing their visibility and ambition. Having an explicit target for the number of women you want to get into the workforce over the next few years, for example. Having an explicit target of zero tariffs for everything but rice. Having an explicit target for reallocating the GPIF funds, which has already been launched.

I think there is something to be said for emphasising those broad sweep policies, even if it forgoes some of the other detailed policy priorities a government might pursue, because of the transparency and credibility of such targets. I hope this will be a useful contribution to the discussions here today, if not to the broader discussion in Japan. Once again, please let me express my gratitude to President Masao Nishikawa and to ESRI for inviting me to participate and to all of you for taking the time to listen. Thank you very much.