Back in Power, Abe Aims to Spend Japan Back to Economic Vitality

BY HIROKO TABUCHI

Kim Kyung-Hoon/Reuters Prime Minister Shinzo Abe has been back in power for less than a month.

TOKYO – Perhaps the pendulum was destined to swing back.

Japan, once lauded as an economic miracle, has spent much of the last two decades playing the world economy's poster child for policy gone wrong. But as austerity budgets bring no end to economic dormancy in Europe, the Japanese government's profligate ways are getting an unlikely second look.

Enter Shinzo Abe, Japan's intrepid new prime minister, who promises to blaze a trail even further away from deep cuts and lean economics.

He and his predecessors have been warned countless times by economists that Japan, saddled with a sky-high debt and rapidly graying population, must also focus on austerity to avoid financial ruin. But Mr. Abe, who has returned as prime minister after a short-lived stint in 2006-7, has decided to flout such advice.

Not yet a month back in office, he has essentially ordered the Bank of Japan to fire up its printing presses without limit and has promised to pump 12 trillion yen ($134 billion) into public works and other government projects. Mr. Abe has also assembled two panels of economists and executives to advise him on a path that might finally lead Japan out of its economic malaise.

"We are making a break with the shrinking economy of the past," Mr. Abe told the Japanese people as he announced the stimulus spending. "From now on, the government is spearheading the economics of growth."

With his newfound audacity, Mr. Abe has made Japan a living experiment in how long a country can defy the seemingly inevitable reckoning that accompanies living well beyond its means. And Mr. Abe has also implicitly demanded a whole new understanding of the causes of Japan's prolonged economic slump.

"Finally, we have a politician who understands what's been wrong with Japan's economy all along," said Koichi Hamada, an economist at Yale University who has long argued for an aggressive monetary solution to Japan's economic woes.

Like any country, Japan has its structural faults, but the main culprit behind its malaise has been the central bank, Mr. Hamada said.

The bank’s failure to do enough to fight deflation, the across-the-board fall in prices, profits and wages that has sapped the strength from Japan’s economy since the late 1990s, has trumped all other efforts by Japan to grow, he said.

Mr. Hamada, 77, an adviser to the prime minister, has been named in the local media as one of Mr. Abe’s preferred picks to take over as governor at the central bank. Mr. Hamada said it was unlikely he would accept, however, citing health reasons.

So far, markets have reacted positively to Mr. Abe’s economic push. Foreign investors have helped to push up the Nikkei 225 share average more than 20 percent since mid-November, when Mr. Abe, an opposition leader at the time, began promoting aggressive monetary and fiscal policies.

The yen fell last week to a two-year low against the dollar, a boon to Japanese exporters. Meanwhile, Mr. Abe’s talk of ramping up spending has not, for now, brought about the feared disruption in government bond markets; interest rates on the government’s long-term borrowing remain well under 1 percent.

Still, the enthusiastic market response has hardly silenced the debate between those who declare that Japan is now on the threshold of a welcome rise in prices, profits and tax revenue, and doomsayers who warn that officials are ignoring risks of fiscal insolvency, bond sell-offs and runaway inflation.

For Mr. Abe’s critics, his pump-priming could energize markets and buoy the economy in the short term, but would eventually push Japan even further toward the fiscal brink. Interest rates may be low now, they say, but will rise with inflation — or even spike — if investors start to question the effectiveness of Mr. Abe’s growth policies or grow too jittery about government debt, which is now more than twice as big as Japan’s entire economy.

Even a moderate rise in interest rates, critics warn, could weigh heavily on a debt-servicing burden that already makes up a quarter of Japan’s annual budget. The country’s widening trade deficit and a graying population that is eating into its savings are further worries.

“Investors are mainly worried about Europe right now, but that concern could easily jump to Japan,” said Toshihiro Nagahama, chief economist at the Daiichi Life Research Institute in Tokyo. “The Europeans at least have a plan to try to get back to fiscal health. The Japanese have no plan.”

Mr. Abe’s supporters, on the other hand, argue that Japan will better stoke investor confidence by finally beating deflation and generating growth, not by simply tinkering with budgets. Those advocates, referred to as the reflation school or “refle-ha” in Japanese, argue that aggressively aiming for a healthy level of inflation targeting — and the weaker yen the policy has already brought about — will galvanize exports, revive production, spur profit, expand employment, raise wages and drive up tax revenue in a virtuous cycle of growth, one that will more than make up for the higher debt-service costs.

Moreover, if there is moderate inflation with no large rise in borrowing costs, Japan could inflate away some of its debt, they say. Leading the charge on the economic growth front is a star-studded panel of eight chief executives and an academic who will join cabinet ministers as advisers on bolstering the country’s competitiveness.

“Ninety-nine percent of Japan’s economic stagnation can be put down to the abnormally tight monetary policies of the Bank of Japan,” said Takuro Morinaga, an influential econom ist who has led the refle-ha charge. “It’s written in every college freshman’s yearbook, that an increase in the money supply will lead to rising prices. It’s basic economics.”

The argument between the two camps is, as Mr. Morinaga points out, a debate over the fundamental causes of Japan’s decades of economic stagnation since the collapse of its bubble economy after 1990. And here, Mr. Abe, until now better known for his revisionist views of Japan’s wartime history, also pushes an alternative reading of Japanese economic past.

The now widely accepted take on Japan’s economic malaise has focused on the structural faults that hold back its economy, from an inflexible labor market to the heavy-handed role played by a largely uninspired and vested public sector. Many of Japan’s once-stellar exporters have done a terrible job at innovation, and have lost much of their dynamism, critics say, even as Japan has been unable to retool its economy to generate more domestic demand.

And public works spending in the 1990s fueled pork-barrel politics and built many “bridges to nowhere,” but did almost nothing to bring growth to the wider economy. All the while, the lavish spending was disastrous for Japan’s public debt.

Mr. Abe’s critics charge that flooding that broken system with more money, with no bold restructuring of the economy, is not effective. The money will go to all the wrong places, they predict, like keeping uncompetitive “zombie companies” afloat or helping to maintain excess capacity in industries ranging from autos to consumer electronics with little regard to international or domestic consumer demand.

And without a fundamental restructuring of the economy, these critics say, there are limits to what the central bank can do. And worse, they warn, a loose monetary policy could inflate another damaging bubble, memories of which still remain fresh in financial circles here.

“All that extra money becomes like morphine for the Japanese economy — we become dependent on it, and we keep on asking for more,” said Mana Nakazora, chief credit analyst for Japan at BNP Paribas. “In the meantime, fiscal restraint weakens. It’s a very risky strategy for Japan.”

The central bank, for its part, has printed money since 2001 in a bid to reverse the deflationary slump. But critics accuse the bank of pulling back prematurely in 2006 at the first signs of economic recovery. That dashed inflationary expectations, and the economy remained entrenched in deflation.

Japan needs to do much more to combat the persistently strong yen that has battered its exporters, the refle-ha say. They point especially to the punishing gap between the South Korean won, which weakened by 60 percent in the wake of the global financial crisis, and the yen, which strengthened 20 percent. That gave South Korean exporters the decisive upper hand as they crushed Japanese rivals in markets everywhere.

The refle-ha are somewhat more divided on public works spending, mainly for construction, which many argue did help soften the blow of Japan’s post-bubble recession. But the spending did not lead to a wider recovery, they acknowledge, either because the government pulled back too quickly or because the spending was aimed at the wrong targets and had only a weak ripple effect on the rest of the economy.

Mr. Abe has gone to pains to argue that his Liberal Democratic Party — which for many in Japan has become synonymous of the pork-barrel spending of an earlier era

— has changed, and that his stimulus will focus on more productive sectors. But a look at Mr. Abe’s recent stimulus plans, with up to 6 trillion yen earmarked for public works, suggests he will have a lot of convincing to do.

“We get the impression that the Liberal Democratic Party is going on a spending spree out of elation that it was able to take back the reins of the government,” the Asahi daily newspaper said in an editorial last week.

But perhaps the biggest question mark over Mr. Abe is how long he can keep blazing a trail without falling victim to Japan’s revolving door of leadership, which has brought the country seven prime ministers in almost as many years. In a country long-accustomed to falling prices, there is already grumbling from within Mr. Abe’s own party that if prices rise more quickly than wages, it could hurt people’s pocketbooks. And the public will have a chance to voice any displeasure it might have with Mr. Abe’s policies this summer, when Japan holds elections for Parliament’s upper house.

Last time around, public opinion turned so harshly against Mr. Abe that a stress-induced intestinal illness led him to resign. This time, he is armed with a new anti-inflammatory drug that he says will keep his health problem in check. What his other wonder drug, inflation, will do for the Japanese economy is another question altogether.