"Abenomics - What follows the money?"

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Introduction

Perhaps, a prevalent opinion about Abenomics can be summarized as follows:

The new monetary policy direction, namely the scaling up of bond buying by the BOJ is the easiest part of the 3 fleches, or the 3 pillars of the Prime Minister Abe's economic reform program.

However now that all positive results of the easiest part are realized, the Japanese government needs to tackle the hardest part, namely the structural reform.

Otherwise the Tokyo Stock market will lose the steam soon…

Reflecting this general sentiment a wide variety of structural reform measures are debated in the media in and out of the country.

The situation reminds me of 1997, when severe financial crisis hit Asia.

At that time a wide variety of structural measures are proposed for the problem countries, Thailand, Indonesia, and Korea by the IMF and the US government as indispensable cures to the Asian structural diseases.

But historical verdict of the validity of the IMF promoted structural reforms would be not so positive. Apart from few exceptions, like the consolidation of Korean Chaebols' activities, these reforms were not crucial for the subsequent economic progress in the region and totally meaningless as the measure to end the financial crisis.

I do not place a high expectation on the idea of the Abe administration to organize a comity of experts to find out what will be needed as the structural reforms.

It would be a miracle if from such witches' soup of the comity's recommendations come out a very effective remedy to cure the Japanese low growth syndrome once and for all.

Take for instance the proposal to liberalize the sales of cold formula (aspirin) through internet. (See the attached document)

It is certainly more convenient for us to buy aspirin through internet.

But aspirin won't cure the disease, cold, and personally, I could not see why the liberalization of aspirin sales through internet can be such an important step in promoting the Japanese economic growth.

So in my presentation today I avoid discussing the reform proposals coming out from the witches' soup altogether.

From my perspective more important questions are the following:

(1) What is wrong about our system?

In particular, what is (are) the main problem(s) of our political/bureaucratic system which obstruct economic growth?

(2) Did Mr. Abe have a coherent plan of growth strategy when he announced Abenomics?

Or what he had in mind concretely at that time was just a monetary policy boosting pure and simple although he has sensed vaguely that mention on an additional factor X, a structural reform to be defined later, will be needed to make him credible as a responsible leader in front of the Japanese voting public?

To be more specific, what Mr. Abe conceived as a reform plan then and now has a potential to cure the main problems of our system?

In what follows I will discuss (1) and (2) in order and then I will pick up the criticism of Martin Wolf (Financial Times) on Abenomics.

1. What is wrong about the Japanese system?

In my view the biggest problem in our administrative (Political/Bureaucratic) system resides in the skewed electoral system: One vote in densely populated areas has, at worst, between one fourth and one third of weight compared to one vote in depopulated and depopulating areas.

This skewed political representation creates, at least, 2 major economic problems.

(A) Due to the skewed political influence, public investment, in general, serves as a distributional policy, the transfer of wealth from densely populated areas, like Tokyo, Yokohama, and Nagoya, to depopulated or depopulating areas, like the Northern Japan (Tohoku).

There is a consensus of experts that currently the productivity of Japanese public investment is low because the government has been overspending on public investment for past 20 years

As a matter of fact, there are still plenty of productive public investment projects left in the city area, like the (unrealized) investment project to ease the traffic congestion in the Tokyo metropolitan area.

The fact that the actual productivity of public investment is low is no surprise: If you invest money in the area in which few people live then the investment won't be very productive!!

Thus the skewedness in our electoral representation results in a diversion of the precious governmental resources for public investment; from productive uses to totally unproductive uses.

We can highlight this problem further by comparing our situation with that of China.

In fact the Chinese government has been promoting the urbanization as a key to promote domestically oriented growth strategy.

In other words, their idea is that in order to promote domestic consumption you have to promote growth of big cities like Peking and Shanghai because city people have more opportunity and tendency to consume.

With this strategy in place the Chinese economy withered the storm of the global economic crisis since 2008.

(B) Despite its small scale in population, the agricultural lobby is still quite strong. This creates a huge obstacle for our country to conclude Free Trade Agreement with other countries.

2. Is there a coherent plan in Abenomics?

In order to answer this question, let me start by picking up once again the structural problem that I have enunciated in the last section, namely (A) the diversion of public investment funds.

Does Abenomics provide some cure to this problem?

Yes, to some extent.

Take the invitation of the 2020 Olympic Game to Tokyo, for example.

I have been quite skeptical on the economic benefits of the Olympic game for some time because I find the claim that this Olympic will bring us economic benefits comparable to the first one in 1964 downright silly.

Recently, I begin to see some positive sides of the second Tokyo Olympic Game.

The Japanese government can use the 2020 Olympic Game as a pretext to claim back precious financial resources for public investments in order to promote the development in the Tokyo metropolitan area.

Due to our precarious fiscal condition most spending items in the governmental budgets must be frozen in due time.

(Defense?)

But public investments in the Tokyo metropolitan area alone can be kept on growing because the government can claim that managing a successful Olympic Game is our national priority.

Take the low interest rate policy of BOJ next.

The low policy interest rate will naturally translate into a low mortgage interest rates which, in turn, will encourage residential constructions

Residential constructions, however, will be more intense in densely populated areas than in depopulated or depopulating areas.

We can perhaps consider that residential constructions supported by artificially produced low mortgage interest rates as a type of public investment.

This means that the ultra-easy monetary policy by the BOJ amounts to another way to redirect the Japanese public investment, from low productive uses to high productive uses.

3. The export-driven growth Strategy

In general when faced with a difficult situation people reverts back to the same strategy which led them to a success last time around.

Mr. Abe may not be an exception in this regard.

Remember that he has served as the chief of staff of P.M. Koizumi whose mandate as the prime minister went over 5 years, the maximum tenure under the LDP code of conduct and the longest record in past 20 years.

Clearly, the longevity of the Koizumi government owes no small part to a good economic record.

So what was Koizuminomics?

In short it was an export-driven growth strategy.

Under his guidance, the export dependency of our country doubled (see the next diagram).

Fig. 1　**The Japanese Export Dependency (Export/GDP)**

The main factor behind our amazing export growth in that period was the boost in the US consumption triggered by the ultra-loose Fed monetary policy under the Chairman Alan Greenspan.

But it was also supported by a currency intervention, dollar buying and yen selling, of an epic scale totaling 35 trillion yen conducted by the Japanese Ministry of Finance.

And guess what…

The person who took the initiative to start this was no other than Mr. Haruhiko Kuroda, then the Vice Minister of Finance.

You can now see why Mr. Abe has picked Mr. Kuroda as the governor of the BOJ and you can see also what Mr. Abe is aiming at by this choice.

The fact that Mr. Abe has embarked on the TPP negotiation is a further proof of the fact that promoting an export-driven growth is his strategy.

(Unlike other structural reforms, the TPP negotiation is truly crucial to the success of Abenomics. So we should watch its outcome carefully)

It is not uncommon for a country which was hit by an economic crisis to recover through growth of its export.

The puzzle in this case is why it took so long in the Japanese case for this to happen.

In contrast, the Korean Economy recovered from the economic crisis in 1997 quite precipitously thanks to a boost in its export.

In fact, after 1997 the Korean economy transformed itself into a formidable Export Machine!!

(See the next diagram)

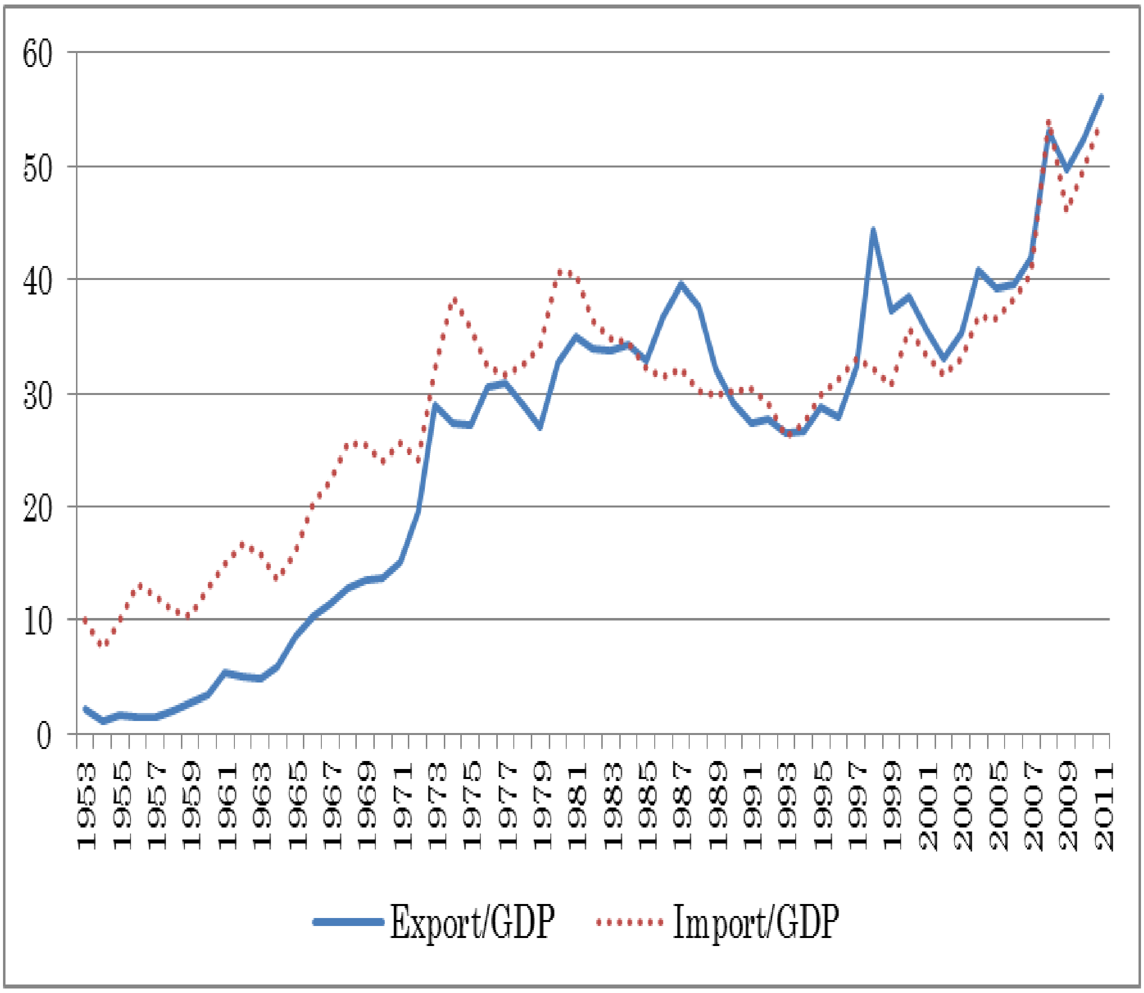

Fig. 2. Korean Export and Import with respect to its GDP

What retarded in the Japanese case the Korean type export driven recovery was a curious movement of the Yen-Dollar exchange rates.

Whereas Korea experienced right after the crisis Won depreciation amounting at one point 50 %, Yen kept on rising throughout the 1990's despite the fact that a major financial crisis erupted in 1992 and again in 1998.

In fact, every time our country experienced a crisis Yen appreciated;

In particular, right after the Earthquake-Tsunami-Nuclear Accident disaster hit our country; Yen reached a historical record high level.

This is because unlike Korea Japan is a major capital exporting country.

So when a crisis hit our country instead of capital flight, Yen selling and Dollar buying, capital repatriation, Yen buying and Dollar selling, will take place.

To this day, I think that the Koizuimi/Kuroda strategy focusing on export-driven recovery and growth was wise and right in the context of that time.

Unfortunately, the experience ended up in tears due to the eruption of the US subprime crisis in 2007.

But this is not a fault of the Koizumi-Kuroda team.

This time around the Abe/Kuroda strategy may put our economy into a higher growth trajectory based on export growth as long as the US economy realizes a steady recovery.

So in short I consider a steady US economic recovery, rather than structural reform proposals coming from the witches' soup, as the more genuine third fleche of Abenomics.

Nevertheless, if Mr. Abe just mentions and promotes one particular reform, I will buy Japanese stocks right away myself.

Namely, the reform in our electoral system.

He should make efforts to realize that one vote has an equal weight everywhere in our country.

But probably he won't be able to do this fearful of an escalation of fighting inside the LDP.

So my verdict on Abenomics is that the Mr. Abe has basically a right idea.

But he does not have courage and political clout to solve the main problem of our system in a straightforward manner

Instead he is trying to simulate the solution by other politically less demanding measures.

4. The Criticisms of Mr. Wolf

Much as I admire Mr. Wolf, and he was a classmate of Mr. Kuroda at Oxford so that he should understand the thrust of Kurodamonics, I have some reservations about his criticism or pessimism on Abenomics.

Basically, his points are two:

(1) Just like he abhors the economic management of the German government, which has achieved a massive trade surplus at the expense of others, he abhors the idea that Japan promotes its growth at the expense of others by realizing a huge trade surplus.

(2) He does not think that the Japanese firms have a much scope for increasing investments, even in the presence of the current low interest rate environment, because their profitability by any standard accounting measure is low.

Let me answer (1) and (2) in order.

For (1) I would respond that an export-driven growth or recovery can be achieved without the country running a trade surplus because it is the growth in the country's export, rather than the growth in the difference between export and import, which is the key for economic growth.

Suppose a country's import consists mainly of raw materials and energy while its export mainly of manufacturing goods.

Then an increase in its import will be a driver of growth.

Even if import increase at the same magnitude as export the scale of this economy will increase so that the country will enjoy the benefits of economy of scale.

The Scandinavian recovery episode after the 1991 financial crisis is a case in point.

(See the next table)

Table **Economic Recovery Process of Finland and Sweden (1993-1998)**

The period growth rates of the GDP components (%)

	Finland	Sweden
Private Consumption	21,4	9,8
Public Consumption	12,1	0,6
Private Investment	47,6	36,9
Export	61,6	68,8
Import	51,1	62,0
GDP	25,7	15,5

In the recovery process the Swedish and Finish exports realized amazing over 60 % growth rates but alongside export import also sprung up so that if you take the difference between the two contributions to the growth may seem of a small order.

These economies, nevertheless, recorded high growth rates in this period.

In fact gauging economy of scale originating from enlarged foreign markets, Nokia and Erikson sprung up.

Currently despite depreciation of Yen the Japanese trade balance is still recording deficit so that Mr. Wolf’s criticism is not warranted.

Let me now turn to his criticism (2), the low profitability.

Let me take his argument upside down.

We can argue that from the standpoint of Japanese firms equity financing is not a low cost financing method because international investors will require Japanese firms to reward shareholders more handsomely.

The true puzzle for me is not so much low profitability of the Japanese firms but rather the fact that these firms are relying more and more on equity financing rather than debt financing despite the fact that the financing costs of the latter are getting lower and lower thanks to the monetary easing by the BOJ.

In fact, I think that the key to the success of Abenomics is that the Japanese firms realize the cost advantage of debt financing and start to use it.

My idea is not necessary contrary to the interests of shareholders because if the Japanese firms use more debt financing their profits will be boosted, enabling them to reward shareholders more handsomely.

I predict that in due course such a shift to more debt oriented financing will take place.

A simplest way to trigger this shift is a spark in the LBO.

In fact, an environment in which (a) Yen is weak, (b) interest rates are low, and (c) stock prices are on the rise, is an ideal condition for LBO activities.

Needless to say there is no better way to boost stock prices than a LBO boom.

Big Japanese companies should be aware that if they keep doing what they are doing, namely stockpiling cash rather than investing them in intangible assets they will be targeted for LBO.

So if Japanese managers want to avoid being thrown away from companies they should use spare cash for investment or for rewarding insiders, like employees, by raising wages.

The Japanese government should make clear that it will take a completely neutral or even favorable stance in the events of LBO boom.

I urge British investors to start considering LBO of Japanese firms, partly for patriotic reason, because I consider a surge in LBO as a key to the success of Abenomics.

On the other hand there are Japanese firms which can enjoy the benefits of the low cost debt financing right away.

These are technologically competitive medium and small scale manufacturing companies which have to rely on borrowing.

In our correspondence Mr. Goto stated that his company intends to promote the market for these companies.

I support his Idea 100%.

Thank you.