

Keynote Address by Mr. Masatsugu Asakawa
Coping with Macroeconomic Vulnerabilities and Spillovers
Monday, November 7, 2016

I. Introduction

Good morning, ladies and gentlemen. It is my great honor to deliver a keynote address at this seminar, co-hosted for the first time by the University of Tokyo and IMF Regional Office for Asia and the Pacific.

I understand that participants of the seminar will discuss important issues such as global risks, macroeconomic vulnerabilities in major economies, and spillover effects of these economies on other countries.

Talking of global risks, we are facing several economic and non-economic risks, including the US monetary policy normalization, Brexit, Chinese economic slowing down, European Banking sector, and crude oil price. Among these, let me first draw your attention to the Chinese economy, because people may not have paid sufficient attention about its impact, spillover effect on global economy. As you may know, over the past 2 and a half years, the renminbi has depreciated against the U.S. dollar, to almost the same level as that in June 2010, when the authorities resumed a more flexible exchange rate regime. This reflects the fact that capital is flowing out of Chinese capital market in various modalities. Under this circumstances, in order to control the speed of depreciation of renminbi, the Chinese authorities have intervened in the FX market, which has resulted in rapid reduction of their foreign reserve.

The reason why capital is flowing out is China's deep rooted structural issues. They include, among others, the huge excess production capacity, which surely have a large spillover effects, as it is creating global deflationary pressures. They also include the NPL issue in both banking and shadow banking sector, which need to be addressed in the near future. Addressing these issues would require a series of structural reforms aimed at achieving sustainable growth in the medium term. We should be vigilant on the development in the Chinese economy, which surely has a huge implication on the global economic performance.

Now, let me turn to the current global economic developments and challenges more in general, and then I will talk about the recent progress in implementing Abenomics here in Japan.

II. Global economy and policy measures

The global economy faces uncertainty stemming from complex factors. They include:

- weak growth prospects of 3.1 percent in 2016 and 3.4 percent in 2017 according to the IMF;
- vulnerabilities in emerging economies; and
- uncertain political environment in some major economies.
(This week, we are going to observe the US presidential election, which has got more and more exciting.)

Nevertheless, excessive pessimism will increase the risk of provoking a vicious economic circle. Therefore, it is essential that policymakers pay close attention to their communications and take appropriate policy measures.

I would like to give you one example. I sometimes encounter pessimistic views on global trade, as its real growth is projected by the IMF to slow down to 2.3 percent in 2016, below the real global growth rate at 3.1 percent. However, we should bear in mind that the trade slowdown is a reflection of several underlying global economic changes. What we really need to do is to look at the causes behind the phenomenon and take appropriate policy responses.

Here, I would like to point out that there are broadly two kinds of the causes why global trade has been slowing. One is “causes which are inevitable.” The other is “causes which we should be concerned.”

One example of “inevitable causes” is China’s economic rebalancing. Chinese economy should shift to consumption-led growth model from the current investment-led growth model, which has resulted in huge excess production capacity as I mentioned before. But if and once Chinese economy becomes more consumption based one, China’s export will slow down, but it should be inevitable. Another example is an expansion of overseas production base, as has been observed here in Japan. I will elaborate Japan’s BOP later. Such an expansion of overseas production may constrain trade growth at least temporarily, though it may stimulate local economic activities and employment in the medium to long- run.

On the other hand, the creeping protectionism is indeed a “cause for grave concern,” which we should fight by all means. In this respect, Japan is determined to play a leading role in promoting free trade and advance the Trans-Pacific Trade Partnership (TPP), which is currently being discussed at the Diet.

The bottom line is that it is critical to create a business-friendly environment where corporate can make economically reasonable management decisions, in terms of both trade and capital transaction. For instance, upon the UK’s exit from the EU, the UK and the EU should maintain and strengthen an open business environment, allowing free trade and investments. It is important to ensure predictability of the UK’s exit process in this regard.

I also hear pessimistic views that going forward, secular stagnation is unavoidable due to the demographic trends and a slowdown in productivity. However, we should not succumb to stagnation from these pessimistic standpoints. We should rather redouble our efforts to take necessary measures to raise productivity and potential growth with an appropriate mix of fiscal, monetary, and structural policies.

III. Abenomics

Now, let me now turn to Abenomics, under which the government has been taking bold measures to tackle Japan’s challenges. At the outset, I would like to highlight the point that Abenomics has positive spillover effects on the rest of the world as the IMF points out, “stronger economic recovery in Japan would have positive spillovers for its trading partners.”

As you know, Abenomics started in December 2012 and consists of three sets of policy measures, “Three Arrows,” namely (1) aggressive monetary policy, (2) flexible fiscal policy, and (3) growth strategy.

As for the first arrow, the Bank of Japan adopted an aggressive monetary policy, “quantitative and qualitative monetary easing” or QQE in April 2013. It initially involved doubling the monetary base over two years, and has been strengthened further as I will explain later.

Next, the second arrow is a combination of fiscal stimulus and medium-term fiscal consolidation. As part of the second arrow, the government formulated a large-scale supplementary budget in January 2013 to address the economic downturn soon after the inauguration of Prime Minister Abe’s second term. At the same time, we have made efforts towards fiscal consolidation with an aim of achieving a primary surplus by FY2020.

Lastly, the third arrow aims to raise potential growth through a set of structural reforms under “Japan Revitalization Strategy.”

As Abenomics has made various achievements, Japan’s economic fundamentals are solid. The Japanese economy is now gradually entering into a virtuous circle as we see corporate earnings in FY2015 hit the highest level in history, and the unemployment rate declined to 3.0%, the lowest level in almost 21 years. Real GDP growth in the first and second quarters of this year was 2.1 percent and 0.7 percent at an annualized rate, respectively, both of which are above potential. I have heard about many anecdotes of a labor shortage. For instance, hotel business is now finding it extremely hard to sufficiently secure working staff in response to increased foreign tourists.

Despite all these achievements, Abenomics still requires further efforts, as highlighted by the fact that private consumption remains subdued, and private investment has not fully recovered yet.

Accelerating Abenomics

So, we need to accelerate Abenomics. One example of such acceleration efforts is the introduction by the BOJ of the new monetary policy framework this September. Thanks to the BOJ’s QQE, which was introduced in April 2013, Japan’s economy is no longer in deflation, which is commonly defined as continuous decline in prices. However, it is also true that the BOJ’s price stability target of 2 percent has yet to be achieved. Against this background, BOJ conducted a comprehensive assessment of the developments in economic activity and prices under its QQE at its Policy Board Meeting of this September. The BOJ pointed out factors that have hampered achieving their 2 percent inflation target. One of them is that, amid the decline in the observed inflation rate, inflation expectations have actually weakened, reflecting the fact that expectations formation in Japan is largely adaptive, or backward-looking. This deep-rooted deflationary mindset itself would be a part of reasons why inflation expectations are formed in a backward-looking rather than forward-looking way in Japan. You know, the young generation has hardly experienced inflation in their life, nor “*base-up*”, which is a pay-scale raise, except for the recent couple of years.

Based on the comprehensive assessment, the BOJ decided to introduce a new framework with yield curve control and overshooting commitment. Some argue that the BOJ failed because they modified the QQE framework. But I beg to differ. I would support the BOJ’s assessment of their monetary policy and its appropriate adjustment to their QQE framework. We must not forget the fact that an unconventional monetary policy tool is experimental because of its unconventional nature. Therefore, it should be reviewed on an ongoing basis and modified if appropriate.

In this context, I would like to draw your attention to one thing. Initially, right after this comprehensive assessment was announced, some market participants may have thought that the new framework was de facto tapering. That was wrong. Now the target has been set on the level of the nominal interest rates, so the amount of assets to be purchased by BOJ could be either smaller or larger than before, depending on the market conditions. I have a feeling that quite recently many market participants have got to realize this point.

However, at the same time, if I am asked whether the BOJ alone is sufficiently able to overcome the long-lasting deflationary mindset, I would say no. Of course, the BOJ's monetary easing has effectively supported Japan's economic recovery and will continue to be a necessary support. In fact, corporate earnings in FY2015 hit the highest level in history, which was also supported by the improvement in terms of trade due to crude oil price declines.

But, in spite of the improved corporate earnings and labor market situation, private consumption remains subdued, and private investment has not fully recovered yet. It is therefore essential to realize a virtuous circle in the economy, in which favorable corporate earnings and a tight labor market will lead to continued wage hike, which would encourage people to spend more, which would further encourage investment by the corporate sector, which in turn would bring additional profit to them, and on and on. To kick off this circle, what is crucial is sustained wage hike. That would ensure a final exit from deflation, and achieve sustained economic growth.

But why do companies hesitate to sufficiently increase wages? Why are they reluctant to invest in Japan? You may be even more mystified when you know that the Japanese companies have been very active to invest abroad including through M&A, despite of the current yen depreciation. As a result of this active investment abroad, in 2015, net income receipt from Foreign Direct Investment was 690 billion dollars [or 8.3 trillion yen], the largest number in history. Also, we are now enjoying surplus in our balance of royalty. In a sense, we are now exporting capital and knowledge, instead of goods. Consequently Japanese current account surplus largely comes from the return from overseas investment and loyalty, not from trade.

The income from overseas investment, or income balance on the Balance of Payment statistics, does not increase GDP by accounting definition, but it does improve GNI, Gross National Income. Real GNI is equal to real GDP plus income from abroad and improvement in terms of trade. GNI is more relevant than GDP in terms of measuring people's purchasing power and their decision about consumption. In Japan, its GNI has been recently performing better than GDP, and in fact higher than GDP since the fourth quarter of 2014. Here's a natural question to ask: where has the increased income coming from abroad gone or been distributed?

The answer is; they are again kept as retained earnings on the corporate balance sheets. So, we have to come back to a question why companies don't raise wages, why they don't invest domestically?

The answer to the question is related to a long-term declining trend in potential growth and expectations for even lower growth in the future. If companies expect only lower growth, it is quite natural that they would be reluctant to hike wages, and make investments here in Japan. Such prevailing pessimism and resulting slower income growth expectation may also encourage individuals to save more and consume less. Lower potential growth would mean lower natural interest rate, since they will be matched in the long run. So, the decline of potential growth would also complicate the operation of monetary policy with the zero lower bound.

To this end, the third arrow of *Abenomics*, or structural reform, should play a crucial role to boost potential growth by enhancing labor force, capital investment and productivity. Let me go through government's efforts for these three aspects.

First, in order to increase labor force, the government has been taking several measures for promoting female participation in the labor force. Those measures include an increase of the child-care capacity and introduction of the 30 percent women's share target of leading positions by 2020. In addition, we have just started to discuss modification of a tax rule that currently favors stay-at-home wives over working women.

Japan is also making proactive efforts to increase more foreign labor in Japan, including through relaxing regulations and giving incentives for foreign workers. You can easily find many non-Japanese working at convenience stores in Tokyo. Prime Minister Abe is eager to reform the rule of permanent residency and create Japanese *Green Card*. Under some conditions, we are aiming that the speed for foreign workers to obtain their green card will be among the fastest in the world. The government is now working on the details.

Second, on the **capital investment**, the government has formulated an economic stimulus package with its fiscal component at 2.7 percent of GDP. This comprehensive package aims to accelerate structural reforms and "investment for the future". The related budget bill was approved in the Diet this month.

Regarding "investment for the future", we have focused public investment on infrastructure that would lead to increased productivity. The package includes projects such as accelerating the construction of magnetic levitation trains and improving international strategic ports so that they can accommodate larger-sized ships. This is a beautiful collaboration between fiscal and monetary policies, as taking advantage of an ultra-low interest rate environment created by our monetary policy for financing the long-term infrastructure project.

Another key component of the package is "**work style reform**". This reform aims to enhance **productivity**, which is the third element of the potential real GDP growth, as well as promote labor participation of women and the elderly. Labor market reform can be a game changer for those purposes.

The reform includes the following:

- Reducing labor market duality between regular and non-regular workers, including through an introduction of "equal pay for equal work", which will contribute to raising productivity of non-regular workers as well as inclusive growth.
- Rectifying the practice of working long hours is an over-due agenda in Japan, which is expected to promote labor participation of women and the elderly.
- Improving labor condition for child-care workers.
The government has already taken a holistic approach such as securing additional childcare capacities for 500 thousand children, and raising their wage by 2 percent.
- In addition, 3 percent of minimum wage increase across all the sectors has been already effective from this month.

In 1958 (the year I was born), *James Abegglen* wrote about Japanese employment practice and published a best-seller book “the Japanese Factory”. He pointed out the lifetime employment, seniority-based wages, and enterprise union as notable features of Japanese employment practice. Probably, those practice worked very well at that time, when Japan was the factory of the world. Ever since, economic structure and circumstances has significantly changed. Manufacturing sector now accounts for only 20 percent in terms of production. The economy has been getting softer and more global. The share of non-regular workers has been increasing to 37.5 percent in 2015.

The Japanese labor market system clearly warrants an overhaul. The current base of the employment system has been established during 1940s during the war time. Before the War, Japan actually had a very flexible labor market. It is high time for us to reconsider an option of more flexible labor market, which will be able to allocate labor resources in a more efficient manner by enhancing labor’s mobility.

In addition to labor market reform, we should press forward other regulatory reforms notably in service sectors and maximize a synergy effect. For example, the medical sector is growing rapidly, reflecting the demographic aging, and still has large room for liberalization. By liberalization, new service and market will be created, and pent-up demand for investment will be unleashed, which would surely contribute to the productivity improvement.

Ladies and gentlemen, today I mainly talked about productivity and the supply side. Nonetheless, the demand side is also important. If people work more productively, they should be better paid. If people earn more, they will surely buy and consume more. This is a virtuous circle we want to make, as I mentioned before. To this end, we have been trying to coordinate the wage formation process, and encouraging profitable companies to raise wages. I hope that we will see a good pay raise at next “*Shunto*”, the annual wage negotiation between companies and labor unions, in the spring next year.

IV. Conclusion

In conclusion, we need to realize higher growth. This is a serious challenge that almost all advanced economies have been facing since the global financial crisis. The prolonged low growth in combination with income disparity could culminate in deep dissatisfaction of ordinary people with the establishment. Our economic growth will not be able to depend solely on the engine of Chinese and emerging economies. We also need to search a source of growth in our own economy. As a means, not only monetary policy but also fiscal and structural policies should be wisely used. In case of Japan, the increased political attention toward structural reforms including labor market reforms is a step in the right direction.

I hope this speech give some food for thought for your active discussion at today’s seminar which will provide helpful policy advice.

Please enjoy the rest of your stay in Japan.

Thank you for your kind attention.