Breakthrough or Dead End? What Can we Learn from Abenomics?

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*The "Japanese miracle" after World War II was the one of the most magnificent periods of modern Japanese history. The rapid economic growth brought rising living standards, social harmony and satisfaction. By the 1980s Japan became one of the most developed countries in the world. However, as the 90s progressed the relative position of the country gradually deteriorated. On the surface Japan had seemed to manage the global crisis of the 1970s much better than other developed countries. At that time they implemented the same measures that had proved to be so successful before, and which although dampened the negative external effects prevented the country from adapting to the new situation thoroughly. It took leading countries two decades to get over this by adopting drastic measures and procedures and usher in the era of Great Moderation bringing an economic boom in the 90s and early 2000s. But not in Japan. The country that had been considered a success story for a long time faced a period of economic hardships, which is by no means a passing phase in the history of the country. The reasons for this were very deep and unique structural problems going back several decades. The quarter-of-a-century-long agony of Japan could be rightly called the era of Great Stagnation. The objective of Abenomics is to break out of this hard situation. (The ambitious prime minister of Japan Shinzo Abe announced his comprehensive economic programme in 2012, which is now known as Abenomics.) In this paper we examine what new elements the Abe Shinzo administration has introduced to manage the crisis, what he has achieved so far and what are the prospects for the third largest economy of the world (Walatabe, 2015; Muraközy, 2016).**

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The exhaustion of the Japanese developmental state

In the decades following World War II Japan underwent unrivalled development and caught up with the most developed countries of the world. This is of historic significance as it was the first non-European country that achieved this, and it served as an example to other countries in Asia, that were to follow suit. The Japanese model was a unique combination of formal and informal institutions. Japanese culture having ancient Chinese roots was the perfect basis for development controlled by a remarkably strong and efficient state, and this manifested itself even in the behavioural patterns of economic players. On the one hand it is true that it laid the foundations of rapid economic growth, but on the other two of the most important institutions of developed economies – namely the market and political democracy – remained underdeveloped. With regard to the latter, the scheme that developed in the mid-fifties has remained unchanged. A sort of one-party system with formal democratic institutions is in existence, which is tightly intertwined with the extremely rigid and strong state administration[1]. Effective democracy, as historical evidence strongly suggest, is not only a value in itself but also an important condition for the development of various competing strategies, and to make it possible for the political elite most suitable to implement the best strategy to take the helm. This can be especially crucial in such crisis-ridden and critical situations that Japan has got into over the past few decades.

The effect of market processes in the Japanese model was lessened by the fact that the economy was dominated by gigantic *keiretsus*, which replaced the previous *zaibatsus* after World War II. These types of corporate groups centred on a well-capitalized core bank. The key role of these great banks, cross-shareholding, interlocking directorates and interdependence significantly reduced the responsibility as well as the risk of corporations. The profit orientation of member companies was quite weak. The banks in the centre of *keiretsus* provided financial assistance or bailout facilities to member companies that were failing or making a loss. As a result the soft budget constraint formulated by *János Kornai* manifested itself in the Japanese private sector in a special way with all its negative effects. This – due to the unique nature of *keiretsus* – had to do with the strong state control over industries and monetary policy. The Japanese administration traditionally considered banking

[1] The fact that the seats of representatives in parliament are even today handed down from father to son – often publicly and ceremonially – lending an air of feudalism to the system is very indicative of the state of democracy in Japan.

as a means of achieving various economic policy objectives. This would lead to providing loans that were not profitable investments. As a result a gigantic amount of bad loans accumulated in the banking industry over the decades, which had by the 1980s fundamentally weakened the Japanese financial system. This contributed significantly to the crisis unfolding in the 1990s, and even has a ripple-on effect today.

A lot of retired state bureaucrats got key positions on the boards of corporations, further strengthening the intensive relationship between them and the state. The state interfered with both economic and financial processes through both formal and informal means. In Japan the unique situation of interlocking of state administration and businesses was an integral part of the organic network, as many state administrators – having attained high state positions – retired and then got top jobs with corporations, banks or other associations. This is the so-called *amakudari*, which can be translated as "descent from heaven". As *amakudari* became an integral part of the system, it became the breeding ground for corruption and favouritism. Over long decades the social network between state administration, businesses and banks became so dense that it was virtually impossible to untangle (*Muraközy,* 2016, *Abe–Fitzgerald,* 1995).

By the last decades of the 20th century we were faced with the paradoxical situation, that the key elements of the Japanese model that originally led to the spectacular economic success, were not only insufficient to secure the country a top position, but were actually the biggest hindrance to further development. With the spread of globalization this situation became increasingly more dramatic. By the nineties the economic growth of Japan became sluggish, the network of interlocking formal and informal institutions became a drag, and the deep structural problems and tensions became more and more visible. This led not only to the worsening relative position of Japan as a global economic power, but to grave crisis and a quarter-of-a-century-long agony.

In the Suffocating Grip of External and Internal Challenges

Issues that had been simmering under the surface burst out in the early nineties in the form of a financial crisis. In the eighties real estate and stock prices skyrocketed, and the situation was becoming more and more threatening. The inflated bubble reached its peak in the second half of 1989, and the majority of investors still did not perceive that stocks and real estates were overvalued. When the overpriced real estate and stock market collapsed in 1990, the previous enviable dynamism of Japan gave way to decades of stagnation in the country. Such types of bubbles tend to develop as a result of loose monetary policy, distortions in the tax system and financial liberalisation. And Japan was no exception to the rule, but in addition there was a much more serious issue culminating, the Japanese model that was so successful previously came to a dead end. This also contributed to the fact that the bubble grew so huge, and the effect of the collapse so dramatic and long lasting.

Table 1

Annual changes in Inflation/Deflation 1982–2001
(Per cent)

	1982–1991	1992–2001	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
United States of America	3.7	2.0	2.4	2.4	2.1	2.2	1.9	1.9	1.2	1.4	2.1	2.4
United Kingdom	5.9	2.7	4.0	2.7	1.4	2.6	3.3	2.9	2.9	2.5	2.2	2.0
France	5.3	1.3	2.0	2.3	1.8	1.7	1.4	1.3	0.9	0.5	0.5	1.4
Japan	*1.8*	*–0.1*	*1.7*	*0.6*	*0.2*	*–0.5*	*–0.8*	*0.3*	*–0.1*	*–1.4*	*–2.0*	*–1.2*
Canada	4.2	1.5	1.3	1.5	1.1	2.3	1.6	1.2	–0.4	1.7	3.9	1.0
Germany	2.8	1.9	5.0	3.7	2.5	2.0	1.0	0.7	1.1	0.5	–0.3	1.4
Italy	9.5	3.2	4.5	3.9	3.5	5.0	5.3	2.4	2.7	1.7	2.1	2.6
Developed countries	4.9	2.0	3.2	2.7	2.2	2.3	1.9	1.7	1.3	0.9	1.3	1.8

Source: IMF [2000], p. 209, IMF [2002], p. 187.

Actually, the latter is the key issue here. Why was Japan not able to get over the financial crisis in a couple of years, like other countries and regions hit by such crises have been able to? What led to the decades-long agony characterizing the country even today, to sluggish growth and deflation returning to the country from time to time? We have not seen many cases of a financial crisis paralyzing the economy of a country for long decades, and in spite of the repeated attempts to break free of the deflation and recession, the country has not been able to do so for a quarter of a century. This shows well that what we have at hand is much more than "simple" financial crisis. Due to external and even greater internal challenges, Japan had to face increasingly more serious problems. The structural problems, institutional weaknesses, the explosion of tensions that had been simmering under the surface – which are mentioned in the introduction – came to light when the bubble burst. This was but a spectacular and painful outcome of a quite complex and unique course of events, signalling that the Japanese developmental state was coming to an end (*Fukao,* 2003, p. 366, *Gibney,* 1998, *Garside,* 2012, p. 70, *Barsky,* 2011, p. 17).

Table 1 shows the peculiarity and ominousness of the situation after the collapse of the bubble. The very low rate of growth was accompanied by deflation. Already in the 1980 the annual rate of inflation in Japan was less than two per cent, while the average value in other developed countries was around five per cent. But the period between 1992 and 2001 saw a moderate annual decrease in prices, i.e. deflation in Japan. This was a unique moment in the history of the modern world economy, and posed an unprecedented challenge to Japanese monetary and fiscal policy.

Reform attempts in the two decades before Abenomics

By the seventies and eighties under the radically different external and internal conditions an economic development which focused only on short-term objectives and which was still controlled by state bureaucracy led to the weakening of fundamentals in Japan. This was a slow sinking process, the severity of which remained hidden, so the players did not notice it for a long time. The crisis of the early nineties, and the prolonged period of depression could have warned them of how grave the situation was, but people came to the realization very slowly. The once successful developmental model, the unmodified economic policy practice, and the continued existence of former institutions and structures were but a hindrance to growth. In spite of the dangerously deteriorating situation it proved to be difficult to change deep-seated attitudes and habits, which have pervaded all strata of Japanese business and society and have soaked into the minds of players over long decades and generations.

The sluggishness of the economic and political system, the inefficiency of instruments that were once so effective isolated Japan and caused the country to lag behind, while the majority of developed countries – through processes that were sometimes painful and brought conflicts – adapted much better to the spread of globalization, and could enjoy the upswing brought by the Great Moderation. Another curious paradox about the Japanese situation is that it was the administration itself that was in charge of curtailing its own formal and informal power, which – needless to say – posed formidable challenges. Bureaucrats protected their positions in state administration, but what was even more detrimental was that its all-pervasive influence over the private sector was decreasing quite slowly. Although there were some attempts in the 80s and 90s at structural change, they were quite fragmented and had little impact (*Callen–Ostry,* 2003, *Alexander,* 2003, *Bailey–Coffey–Tomlinson,* 2007, *Beason–Patterson,* 2004).

The stagnation and deflation period following the crisis of the 1990s forced out the first reform concepts and measures that promised to be comprehensive and radical at least as far as its objectives went. All this occurred during the short term of *Ryutaro Hashimoto,* who was the prime minister of the country from 1996 to 1998. His objectives included loosening the harmful ties between the state and the private sector, strengthening the banking industry shaken by the financial crisis, introducing more transparent rules and statements, and opening the extremely closed Japanese economy. In fact businesses had adapted but little to previous involuntary global economy opening processes. *Ryutaro Hashimoto* believed that the harmonization of Japanese and international accounting standards in the corporate sector was crucial. He realized that the interlocking of government, corporate management and the financial sector was detrimental to competition, weakened the working of the market, making Japan less competitive. Administrative reform, the streamlining of the government, and reducing the power of bureaucracy were all key elements of *Ryutaro Hashimoto's* programme.

The financial crisis, the bursting of the bubble highlighted the weaknesses of the banking system. This fragility had developed much earlier, but could remain hidden for a long time due to the successes achieved. However, under the premiership of *Ryutaro Hashimo*to the initiative to reform the financial system, which appeared to be a very a pressing need indeed, produced quite unimpressive results. The proportion of bad debts accumulated over the previous decade within the banking system was so high that in the end even the government backtracked on its original concept, and did not dare to face the imminent danger of the collapse of the banking system. So it was the government itself that softened the planned measures. Although there was no breakthrough, but the transformation and stabilisation of the financial system was started, even if in a lopsided way (*Rosenbluth–Thies,* 2010, pp. 95–154, *Ihori–Nakazato–Kawade,* 2003, *Ito–Patrick–Weinstein,* 2005, pp. 107–147).

Ryutaro Hashimoto was followed by *Keizo Obuchi* and then by *Joshiro Mori* as head of government, who in some areas tried to follow in the footsteps of their predecessor, even if half-heartedly. Having said that their tenure can be described as a period when no significant concepts were put forward and no decisive actions were taken. In 2001 *Junichiro Koizumi* took over as prime minister and remained in office until 2006. His was not in an enviable situation. In spite of the varying attempts at reform the interlocking, interdependence and network of relationships – verging on corruption – between state bureaucracy actors, politicians as well as corporate and bank managers was still strong. This minimized the impact of market forces very much. This greatly hampered recovery. *Junichiro Koizumi* – meeting the demands of the majority of the population – promised to bring radical changes. The main rallying cry was the effective implementation of structural reforms. This was an important turning point, because it indicated the realization that it was not merely a passing situation caused simply by some issues facing the financial system or bad economic policy, but the effect of deep-rooted, fundamental structural and institutional problems.

From an economic aspect structural reforms tend to increase the importance of the market and help create a smaller, more efficient and less intervening state. Another objective might be deregulation, trade liberalisation, increasing the role of competition and strengthening the financial sector. The part of the reform that most concerns the state is privatisation, fiscal and tax reform as well as the rationalisation of the welfare and pension system. The structural changes stated by *Junichiro Koizumi* – at least what the prime minister actually announced publicly – were to cover this whole spectrum. His premiership launched more powerful and comprehensive reform efforts, which have been trying to reverse the downward trend and get Japan out of the ditch with varying strength and intensity. These repeated efforts tried to get the country out of the deflation-recession spiral. The comprehensive efforts of *Junichiro Koizumi* were aimed at reforming the whole economic, social and political system of Japan, as he realized how tightly intertwined and interrelated these areas were. The multi-party system – only multi-party in name –, the cemented interlocking network has been able to block radical changes. In order to implement the economic reforms effectively *Junichiro Koizumi* tried to strengthen the role of prime minister as leader as well within the government structure (*Vietor,* 2007, pp. 221–244, *Mulgan,* 2013).

Junichiro Koizumi meant to intensify the market by assigning a central role to consolidating and transforming banks. What made it easier for the prime minister to make his plans about the strengthening of the bank system come true was that some significant changes had already been made in the regulatory and control institutions of the financial sector over the last few years. The most important of them being that the central bank law of 1998 made the Bank independent.[2] Another key measure was the consolidation of financial supervision (*Cargill–Hutchinson–Ito,* 2000, pp. 83–112, *Hutchinson–Westernman,* 2006, pp. 12–14, 33–156).

The legally independent central bank faced quite difficult challenges in the early years of the third millennium. The biggest challenge to monetary policy in Japan was not inflation but deflation. Which meant that the orthodox instruments of national banks could be used with either low efficiency or were completely ineffective. The interest rate, which was 8.2 per cent in March 1991, was lowered to virtually zero in eight years by March 1999, minimizing its role to influence the economy. In this situation decision makers had to find novel monetary assets. However, the central bank was slow to react, assessed the actual threats of deflation with considerable delay, and took a long time to identify the appropriate means. To the Bank of Japan's credit, it was a pioneer, taking a path never trodden before, or at least not in the period of modern finances since the end of World War II.[3] It only introduced the policy of quantitative easing after long years in March 2001. In this scheme the Bank of Japan increased the money supply significantly. Although the central bank declared that it was resolute to continue this policy as long as prices start increasing, even prolonged quantitative easing could not put an end to stagnation (*Hutchinson–Westerman,* 2006, pp. 10–11).

One of the main ambitions of *Junichiro Koizumi* was to stop or at least reduce state subsidies, aid, as this was the hotbed of political corruption and pulling strings[4]. State debt, which was increasing at a dangerous speed, made reforms in

[2] It is very telling of the continuity of the history of Japan that the Act on the National Bank of 1998 replaced a law enacted in 1942. For more than half a century the operations of the Bank of Japan were based on a law that was drafted to suit the then prevailing conditions of a war economy (*Cargill–Hutchison–Ito,* 2000, pp. 83–112).

[3] However, after a couple of years the instruments and practice of the up-till-then unique Japanese monetary policy began to be appreciated and received international attention. After the crisis of 2007/2009 other countries relied on the experience of Japan, of course adopting the monetary policy to be followed to their own situation (*Botman,* 2015; *Hoshi–Kashyap,* 2015).

[4] Even in 2006, at the end of the Koizumi era – in spite of rationalisation – state-owned financial institutions received 455 million yen (USD 4.5 billion) support from the budget. But the actual amount was much larger as state-owned banks did not have to pay corporate tax, and they got interest-free loans from the budget. According to some estimates if we calculated all these, state-owned financial

the public sector as well as stopping the practice of heavily subsidizing those rural constituencies that were the strongholds of the Liberal Party more and more urgent. Although these efforts were very popular with the majority of the population, they were strongly opposed by the representatives of the party (*Park,* 2011, p. 236–237; *Shinoda,* 2013, pp. 76–117).

The fundamental, wide-ranging reforms announced at the beginning of *Junichiro Koizumi*'s term were only partly carried through. What made implementation more difficult was that previous governments had introduced fiscal stimulus packages, which made the budgetary situation even worse and increased the indebtedness of the government. However, the necessary fiscal stringency measures understandably dented the popularity of the government. Partly as a result of the reforms carried out by *Junichiro Koizumi* and partly as a result of the global, and more specifically the Asian economic boom, the macroeconomic situation of Japan improved somewhat. Growth prospects, stock market indices and the position of the banking system became more favourable as well. *Junichiro Koizumi's* work was greatly appreciated abroad, but domestically opposition was growing, and the reform lost momentum. In 2006 *Junichiro Koizumi* announced that he would step down from office. *Shinzo Abe,* who was a close associate of his as head of the Prime Minister's Office, succeeded him as both the president of the party and as prime minister, albeit briefly, for only one year this time.

Shinzo Abe, at the beginning of his first premiership, took the helm at a time when the situation was relatively good. Although he announced the radical transformation of the post-war Japanese system – which suggested that he would continue what his predecessor started –, although not much of it was realized this time around. In the 2007 upper-house elections the Liberal Democratic Party suffered a historic defeat. This was mainly due to the party's own flaws and great corruption scandals. *Shinzo Abe* could still remain in office for a short time, but instead of implementing real reforms he was just fighting for his political survival. In the end he resigned after one year in office. The two prime ministers *Yasuo Fukuda* and then *Taro Aso* succeeding *Shinzo Abe,* and both serving a brief term, could not stop the declining popularity of the Liberal Democratic Party, and in the lower-house elections of 2009 the Democratic Party of Japan – formed when smaller opposition parties merged a year earlier – led by *Yukio Hatoyama* pulled off a landslide victory. What contributed

institutions cost the state nearly 1 billion yen a year around the turn of the millennium. This is one of the symptoms of soft budget constraint uniquely present the mixed economy of Japan (*Park,* 2011, pp. 236–237).

to the defeat was that the growth that began in the middle of the first decade of the twenty first century – which was partly due to the reform measures implemented by *Junichiro Koizumi* – was broken by the economic crisis of 2007–2009. The decades-long dominance of the Liberal Democratic Party seemed to be coming to an end (*Kiglics,* 2011, pp. 115–136).

The government led by the Democratic Party of Japan started reviewing budgetary expenditure with great vigour, trying to find opportunities for rationalisation and saving. However, it soon turned out that it was quite difficult to change things in a budget that developed over long decades and was quite complicated. And this meant there were no funds to fulfil election promises from. Although *Yukio Hatoyama* governed in the name of a new party, in many ways it was just continuing in the direction set by the Liberal Democratic Party administration. Like his reform-minded predecessors he also tried to reduce the power of bureaucracy and improve the efficiency of state control. The Democratic Party of Japan could only fulfil a small portion of the election promises it had made, and even *Hatoyama Yukio* came under suspicion in relation to a finance scandal, and was forced to hand over the reins to *Naoto Kan.* The governing party was defeated in the early upper-house elections, not least because contrary to what they promised in their campaign programme they were planning to raise the consumption tax to 10 per cent. This contributed to the defeat of the party in spite of the fact that the tax hike seemed undoubtedly necessary (*Koellner,* 2011).

Abenomics

In the 2012 elections – after a short detour – Japanese political system was back to normal, as had been since the mid 1950s, without any real challengers, to a one-party rule. The Liberal Democratic Party led by *Shinzo Abe*[5] returned to power. The new cabinet had to tackle the following interconnected challenges: deflation, moderate potential growth, massive deficit, increasing government debt, aging population, declining work force and acute social problems. The weight of the problems is clearly indicated by the fact that the nominal GDP of Japan decreased by more than seven

[5] *Shinzo Abe* is a member of one of the most prominent Japanese political dynasties. His father filled ministerial positions, his maternal grandfather was *Nobusuke Kishi,* who served as prime minister of the country between 1957 and 1960 – and played a key role in shaping the developmental state. *Eisaku Sato,* the second longest-running prime minister of Japan, was also a relative of *Shinzo Abe.*

per cent in the 16 years between 1997 and 2013, while government debt was around 230 per cent of the GDP in 2015 (OECD, 2015*a,* pp. 10–18, *Schiff,* 2015).

The economic policy dubbed Abenomics of the newly elected government of *Shinzo Abe* seemed rather novel, and received global attention, although if we look at what it consisted of, it was merely rehashing some of the Japanese recipes that had been used in earlier decades, and which had not achieved the necessary deep structural changes. Therefore it is crucial to look at the period of Abenomics in the context of the country's past quarter-of-a-century long history characterized by the struggle to fight deflation and stagnation and also look at its prospects this way and make clear that Japan would finally have to find a solution to problems that accumulated over the past 50 years. To understand *Shinzo Abe's* concepts, determination and programme it is absolutely crucial to see that he was one of the closest colleagues and then successor of *Junichiro Koizumi,* the most charismatic pro-reform prime minister of the previous two decades. If we look at the programme of Abenomics carefully, we can see that it is in many ways the continuation and further development of *Junichiro Koizumi's* ideas, drawing on the lessons of failures and with weaknesses corrected.

With all these things considered Abenomics was more radical, more comprehensive and more coordinated than the programmes that came before it. It identified more accurately the critical mass required to make a breakthrough and achieve real results, and assessed the main areas and their interactions much better. From the experience of *Junichiro Koizumi* as Prime Minister, *Shinzo Abe* learnt that he needed to secure a very powerful political majority to support him. He also realized that it was not only parliamentary power that was crucial to success, but credibility, persuasive communication that can help him get the support of the corporate world as well as the support of the population. This latter, excellent political marketing is one of the main strengths of his premiership. He took the helm armed with fierce determination and powerful nationalist rhetoric.

The great international interest in Abenomics was aroused not only by the decades-long agony of Japan and the charismatic personality of the prime minister or his strong statements. The 2007–2009 crisis forced the governments of developed countries all over the world to face the problem of what economic policy instruments can be used to break out of stagnation when state debt is high, growth is slow, inflation is low or there is deflation even, and all conventional instruments have failed. In the period of reflection and experimentation to find the way out, which characterized the past years divided members of the profession as well as politicians about what the best way to success is. The crisis and slow growth would clearly require a fiscal and monetary economic policy to stimulate the economy.

However, conventional fiscal stimuli lead to greater and greater deficits, reaching budget limits and leading to further indebtedness. If equilibrium considerations are in serious danger, state expenditures need to be cut and/or taxes have to be increased, which may wreck growth that is fragile to begin with. Massive government debt means a great repayment burden, which makes the fiscal policy situation even more difficult. The crisis and the period following it led to low inflation or even near-deflation at many places. In such a climate near zero interest rate and monetary policy can no longer rely on orthodox instruments and channels. Novel, innovative, unorthodox measures have to be taken, as remarkably the Fed in America has done in recent years.

On the one hand increasing the quantity of the money may help start lending, and boost business activities. However, there are other factors that are also needed to do so, e.g. increasingly stronger positive expectations, growing demand, profitable investment opportunities and the like. However, enormous liquidity surplus has developed on national financial markets as well as globally as a result of monetary policies, increasing the chance of risks, bubbles and financial crises developing in the future. The situation is quite tense in Europe, the European Union and in the Eurozone in particular. The above may indicate that the decades-long problems in Japan have by now appeared, or are becoming visible, in developed countries worldwide. The problem of deflation, which seemed to be but a unique Japanese phenomenon, identifying the opportunities and limitations of monetary and fiscal recovery in a depressed economy with no inflation has by now appeared as a problem to be solved in other parts of the global economy. This is why Japanese economic policy experiments have become so valuable in global economic and economic policy thought shaken by the crisis of 2007–2009. Of course, we have to be very cautious about what seem to be parallels on the surface as well as examples and advice that seem to be apt and applicable to the situation at hand. This is especially true with the very unique Japanese economy. The causes as well as the social, political and economic background are very different in Japan, Europe and the United States, so we have to be very careful when we draw parallels between them (*Botban,* 2015, *Hutchinson–Westerman,* 2006).

The similarity of symptoms – with regard to the adoption and application of specific economic policy methods – may not mean that the outcome and the treatment of the problems should also be the same in countries that are in very different situations. We also have to be careful with the undesired side effects of therapies, which often have a lot to do with the differences between the countries. Although the symptoms often appear to be the same, the nature of the underlying illness may be quite different. The challenge of overcoming a financial crisis in a country that has had a democratic market economy for centuries, like in the United States of America, is quite different from that facing Japan whose stagnation and deflation-related problems are the result of structures that were left unchanged for many decades. It is no accident that fiscal stimulus and monetary quantitative expansion seemed to be much more effective in the USA than in Japan, where repeated attempts were made with no apparent effects. All this may call for caution about our findings; what conclusions can be drawn and when we make an evaluation. However, comparing countries and regions with different locations and traditions adds to our knowledge about the opportunities of fiscal and monetary policy and how they work, and this can help us make a better use of them in the future (*Korniyenko–Loukoinova,* 2015, *Ueda,* 2012).

The enormous challenges facing the Shinzo Abe administration

When *Shinzo Abe* became prime minister of Japan for the second time, the position he found himself in was not better than it had been a couple years before, when he succeeded *Junichiro Koizumi* as premier of Japan. By then we could talk not about just a lost decade but about almost quarter of a century, in which the country could not break out of the circle of deflation, slow growth and losing its relative position on the global market. *Tables 2* and *3* show this quite well.

Table 2

Annual real GDP growth rate between 1991 and 2017

	1991–2001	2002	2003	2004	2005	2006	2007	2008
United States of America	3.5	1.8	2.8	3.8	3.3	2.7	1.8	–0.3
United Kingdom	2.8	2.5	3.3	2.5	3.0	2.7	2.6	–0.5
Finland	3.2	1.7	2.0	3.9	2.8	4.1	5.2	0.7
France	2.2	1.1	0.8	2.6	1.6	2.6	2.3	0.1
Ireland	7.8	5.9	3.9	4.4	6.4	6.3	5.5	–2.2
Japan	*0.8*	*0.3*	*1.7*	*2.4*	*1.3*	*1.7*	*2.2*	*–1.0*

	1991–2001	2002	2003	2004	2005	2006	2007	2008
Korea	6.4	7.4	2.9	4.9	3.9	5.2	5.5	2.8
Germany	1.6	0.0	–0.7	0.7	0.9	3.9	3.4	0.8
Italy	1.6	0.3	0.2	1.4	1.1	2.1	1.4	–1.1
Switzerland	1.4	0.1	0.0	2.8	3.0	4.0	4.1	2.3
Sweden	2.4	2.1	2.5	3.8	2.8	4.9	3.5	–0.7
OECD average	2.8	1.7	2.1	3.2	2.8	3.2	2.7	0.2

	2009	2010	2011	2012	2013	2014	2015	2016	2017
United States of America	–2.8	2.5	1.6	2.2	1.5	2.4	2.4	2.5	2.4
United Kingdom	–4.2	1.5	2.0	1.2	2.2	2.9	2.4	2.4	2.3
Finland	–8.3	3.0	2.6	–1.4	–1.1	–0.4	–0.1	1.1	1.6
France	–2.9	1.9	2.1	0.2	0.7	0.2	1.1	1.3	1.6
Ireland	–5.7	0.4	2.6	0.1	1.4	5.2	5.6	4.1	3.5
Japan	*–5.5*	*4.7*	*–0.5*	*1.7*	*1.6*	*–0.1*	*0.6*	*1.0*	*0.5*
Korea	0.7	6.5	3.7	2.3	2.9	3.3	2.7	3.1	3.6
Germany	–5.6	3.9	3.7	0.6	0.4	1.6	1.5	1.8	2.0
Italy	–5.5	1.7	0.7	–2.9	–1.8	–0.4	0.8	1.4	1.4
Switzerland	–2.1	3.0	1.8	1.1	1.8	1.9	0.7	1.1	1.6
Sweden	–5.1	5.7	2.7	0.0	1.2	2.4	2.9	3.1	3.0
OECD average	–3.4	3.0	1.9	1.3	1.2	1.9	2.0	2.2	2.3

Source: OECD [2015d], p. 245 (2015–2017 forecast).

By 2012-2013 the temporary improvement that had occurred in the mid 2000s in the growth performance of Japan, which confirmed *Junichiro Koizumi's* reform efforts, and served as proof that the country was headed in the right direction, was long forgotten. The positive tendencies were curbed by the 2007–2009 global economic crisis and the involuntary resignation of *Junichiro Koizumi.* We have seen quite poor growth performance and even some downturn in 2011 and 2014. The real GDP growth was around no more than half a per cent in 2015, and the 2016 and 2017 prospects are not very promising either. Slow growth goes hand in hand with the gradually worsening position of Japan in the global economy over the past quarter of a century. After decades of the economic miracle when Japan caught up with other developed countries, the country is now slowly but definitely lagging behind. The *Shinzo Abe* government was faced with slow growth and a near-deflation situation, improved temporarily only by the VAT increase in 2008 and 2014, but then low inflation returned. Although this does not make the problems of the current Japanese government any less serious, unlike in the years before and after the turn of the millennium – see *table 3* – low inflation, which was previously considered a unique Japanese phenomenon, is much less unique in the developed world, as today a lot of European countries and the Eurozone as well are in a near-deflation situation.

Table 3

Annual growth rate of the consumer price index between 1991 and 2017

	1992–2002	2002	2003	2004	2005	2006	2007	2008
United States of America	2.7	1.6	2.3	2.7	3.4	3.2	2.9	3.8
United Kingdom	2.1	1.3	1.4	1.3	2.0	2.3	2.3	3.6
Finland	1.9	2.0	1.3	0.1	0.8	1.3	1.6	3.9
France	1.6	1.9	2.2	2.3	1.9	1.9	1.6	3.2
Ireland		4.7	4.0	2.3	2.2	2.7	2.9	3.1
Japan	*0.4*	*–0.9*	*–0.3*	*0.0*	*–0.6*	*0.2*	*0.1*	*1.4*
Korea	4.6	2.8	3.5	3.6	2.8	2.2	2.5	4.7
Germany		1.4	1.0	1.8	1.9	1.8	2.3	2.8
Italy	3.3	2.6	2.8	2.3	2.2	2.2	2.0	3.5
Switzerland	1.5	0.6	0.6	0.8	1.2	1.1	0.7	2.4
Sweden	1.6	2.2	1.9	0.4	0.5	1.4	2.2	3.4
Eurozone		2.3	2.1	2.2	2.2	2.2	2.1	3.3

	2009	2010	2011	2012	2013	2014	2015	2016	2017
United States of America	–0.3	1.6	3.1	2.1	1.5	1.6	0.0	1.0	1.8
United Kingdom	2.2	3.3	4.5	2.8	2.6	1.5	0.1	1.5	2.0
Finland	1.6	1.7	3.3	3.2	2.2	1.2	–0.2	0.4	0.8
France	0.1	1.7	2.3	2.2	1.0	0.6	0.1	1.0	1.2
Ireland	–1.7	–1.6	1.2	1.9	0.5	0.3	0.1	1.6	2.0

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Japan	*–1.4*	*–0.7*	*–0.3*	*0.0*	*0.4*	*2.7*	*0.8*	*0.7*	*2.3*
Korea	2.8	2.9	4.0	2.2	1.3	1.3	0.7	1.6	2.0
Germany	0.2	1.2	2.5	2.1	1.6	0.8	0.1	1.0	1.6
Italy	0.8	1.6	2.9	3.3	1.3	0.2	0.2	0.8	1.1
Switzerland	–0.5	0.7	0.2	–0.7	–0.2	0.0	–1.2	–0.5	0.1
Sweden	–0.5	1.2	3.0	0.9	0.0	–0.2	0.1	1.4	2.2
Eurozone	0.3	1.6	2.7	2.5	1.3	0.4	0.1	0.9	1.3

Source: OECD [2015*d*], p. 262 (2015–2017 forecast).

A brief review of the symptoms indicates that two decades after the bursting of the Japanese financial bubble, in spite of the numerous reform attempts the Japanese economy has not been able to overcome the crisis it is in, and has not been able to solve its basic structural problems. All this is coupled with current issues, a great government budget deficit, enormous government debt as well as complex demographic and social problems, and to make things worse, all this in a global environment where it is increasingly more difficult to keep up with others in a cut-throat competition. What made the twenty-year-long agony of Japan even more striking is that meanwhile the part of Asia nearest to Japan has become one of the most dynamically growing regions of the world. Former followers have become the fiercest and at the same time closest competitors in the global economic competition.

The "three arrows" programme of Abenomics

In the difficult economic-demographic situation – having learnt a lot from earlier failures – Shinzo Abe launched his "three arrows" programme aimed at the recovery of the country with great determination. The three arrows are (1) aggressive monetary policy, (2) flexible/expansionary fiscal policy and (3) structural reforms. The continuity between Abenomics and earlier reform efforts is obvious. It is enough to call to mind the plans and actions of *Ryutaro Hashimoto* but especially *Junichiro Koizumi.* The objective and purpose of this as well as previous reform efforts was to get Japan out of the deflation spiral and set the country on a sustained growth path. The most difficult issue and at the same time the cornerstone of "three arrows" programme was (and still is) the structural reforms that were aimed at solving and resolving inherited historical problems. Based on earlier Japanese as well as international experience it is clear that only structural and institutional transformation can create a basis for greater and sustainable growth. And this is the central issue of the economic policy of every country. Without this expansionary fiscal policy and monetary expansion, important as they may be, are only scratching the surface, and cannot achieve the desired effect. In the first decade of the 21st century we registered only 0.8 per cent annual growth, much lower than what the majority of developed countries had.

The situation of *Shinzo Abe's* government was and still is made even more difficult by the fact, that what we are facing is not a cyclical slump, but the rate of potential growth is also quite low. In the 90s after the bubble burst the decline of investment and the decrease in total factor productivity caused the level of potential output to drop significantly as well. As of the turn of the millennium total factor productivity began to grow, but investments still remained at a very low level. Another blow for long-term growth was connected to demographic problems: workforce was declining in Japan's rapidly aging society. Sustained deflation also hindered economic growth and limited the scope of monetary policy.

It became clear to *Shinzo Abe* – based on the experience gained, and the failed attempts of the past decades – that sustained results can be obtained only through a comprehensive, extensive, coordinated and concerted reform process. Only this can lay the foundations for sustained, dynamic growth, without which – as international experience shows – not even the much needed fiscal consolidation measures can be implemented. The action programme launched in 2013 is based on the assessment of synergies of the simultaneous implementation of the building blocks of the "three arrows" programme. It is assumed that monetary expansion and expansionary fiscal policy can help break out of the deflation spiral, which in combination with low real interest rates can create a favourable climate for investment, consumption, and with the depreciation of the yen, exports as well. The above may give a short-term boost. If comprehensive structural reforms are launched simultaneously, this may bolster confidence and heighten expectations about the future. All this can induce more rapid growth on the long run as well, which may facilitate fiscal consolidation, decrease government deficit and slow down the dynamic increase of government debt. The idea is that through the growth triggered the considerable cost of aggressive monetary and fiscal expansion and its equilibrium risk can be reimbursed (*Botman–Danninger–Schiff,* 2015, *Hamada–Kashyap–Weinstein,* 2011).

Monetary policy

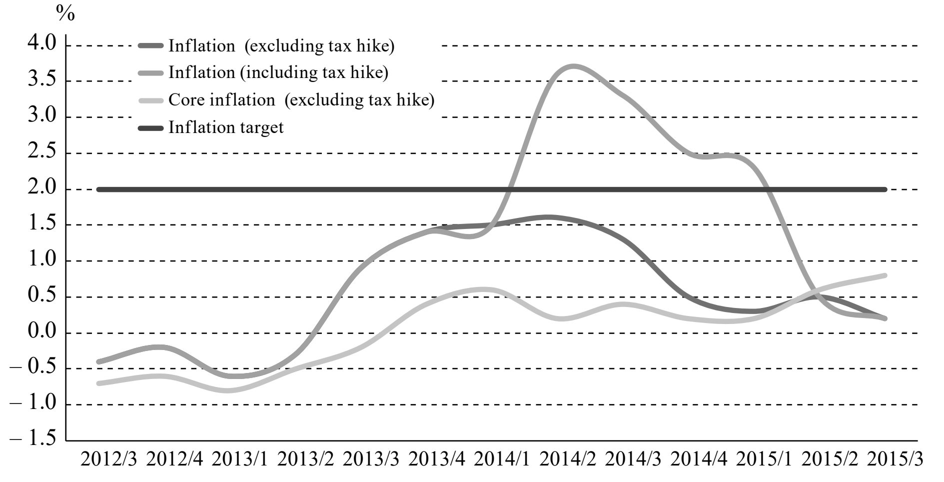
In March 2013 prime minister *Shinzo Abe* – without even pretending to respect the independence of the Bank of Japan – very aggressively nominated his own confidant *Haruhiko Kuroda,* former president of the Asian Development Bank as the governor of the central bank. The two-year target was to raise inflation to 2 per cent sustainably by 2015.[6] The Bank of Japan used various instruments to achieve this cognizant of the fact that all this will be insufficient without fiscal policy being adjusted to this target and without carrying out structural reforms. The instruments used were one called quantitative easing, which was used by the Fed in America after the 2007–2009 crisis and which received a lot of attention worldwide. Quantitative expansion, the first arrow of Abenomics to be implemented, set the target of doubling the monetary base in the period between 2013 and 2015. In the spring of 2013 the balance sheet of the Bank of Japan was around 34 per cent of the country's GDP, which was already higher than that of the USA (19 per cent), the United Kingdom (27 per cent) or the European Central Bank (28 per cent).

In two year's time, in the spring of 2015, as the result of aggressive monetary expansion the balance sheet total of the Bank of Japan was as high as 65 per cent of the GDP. In early 2015 in the United States it was 25 per cent of the GDP while in the Eurozone it was 21 per cent. However, the continuous expansion poses serious future risks. If the economic recovery really starts, this may run up interest rates in the future. But the failure of Abenomics, the loss of investors' confidence or external financial factors can have similar effects. If this happens the gigantic debt burden can skyrocket, which may rock the foundations of the whole financial system of Japan (OECD, 2015*a,* p. 33, *Hausman–Wieland,* 2014, pp. 23–25, *Rickards,* 2014, *Arslanalp–Lam,* 2013).

[6] Deflation is indeed a very unique problem of the Japanese economy. The GDP deflator decreased by 13 per cent between 2001 and 2013, and monthly consumer price index increased only in 12 months in this period. If there had been at least one per cent inflation in this period since 2001, the nominal GDP growth would have been 1.75 percentage points higher and public debt would be around 160 per cent of the GDP instead of the current 230 per cent. The Bank of Japan already tried really aggressive monetary policy to stop deflation between 2001 and 2006, but failed (*Koo,* 2015, pp. 153–198).

Figure 1

Consumer price changes between 2012 and Q3 2015



Source: OECD [2015*d*], p. 167.

Despite all its efforts the Bank of Japan did not hit the 2 percent inflation target by 2015 at all. As *figure 1* shows only the April 2014 consumption tax hike resulted in a volatile price increase, but its impact wore off soon, while it reduced domestic demand significantly. By the end of 2015 inflation rate was back at 0.5 per cent. Which is very telling, as core inflation is around that level. On the other hand, the gigantic quantitative expansion programme, while its impact is limited and only short term, involves major future risks. Japanese monetary easing was therefore exceptionally bulky compared to others using similar instruments like the Fed, the United Kingdom and the Eurozone which has partly started to follow suit. However, the scene in Japan, a country facing a prolonged and grave crisis was very different from that in the United States or Europe for that matter, so the oversupply of liquidity produced but unimpressive results (*Hausman–Wieland,* 2014, *Fujiwara–Nakazono–Ueda,* 2015).

Fiscal policy

The experience of Abenomics show that even the most powerful monetary policy may only produce limited results. The fiscal policy harmonised with it and especially comprehensive structural reforms may bring about considerable changes in the economy as well as in the society, they may boost corporate borrowing and investment. As government debt is enormous and therefore very significant in the operation of Japanese financial markets, in many respects fiscal policy has had a greater impact on this sector as well, than monetary policy would be capable of. This again is a very important peculiar Japanese trait to consider. It is because of this as well as other factors that the role of monetary policy – in spite of its aggressiveness and extensiveness – is still quite limited. It is because of this – and the lessons learned from earlier failed attempts – that the Bank of Japan emphasises that monetary and fiscal policy and structural reforms need to implemented simultaneously (IMF, 2015*a*).

The other important pivot of the "three arrows" programme in addition to monetary expansion is expansionary fiscal policy. This has been used quite often before as well, but due to the enormous government debt and deficit the consideration of fiscal consolidation proved to be more important. The conflict between the two considerations has caused certain cyclicity in the financial affairs of Japan. As part of the Abenomics programme they implemented a stimulus package equal to 1.5 per cent of the GDP. As a result public investment grew by 8 per cent in 2013, in contrast to 2.7 per cent the year before, and especially to the 8 per cent decrease seen in 2011. However, public investment grew only by 3.8 per cent in 2014, while a significant drop in public investment is expected in 2015–2016.

This is a clear indication that with such high deficit and government debt fiscal stimulus and fiscal consolidation will come into conflict even in a short term. As the first measure of consolidation – as had been planned originally – consumption tax was raised from 5 to 8 per cent in April 2014. However, this stunted growth, which was quite modest to begin with. According to the original plans the consumption tax was to be raised a second time to 10 per cent in October 2015. However this second hike was delayed by 18 months to April 2017. This way however the fiscal balance will deteriorate further, which means that fiscal consolidation will be an even more painful process, with greater and greater sacrifice ratio. By 2015 it became clear that the scenario to solve fiscal disequilibria painted in 2012 by the Shinzo Abe government was overly optimistic (*Lech Valier,* 2014, pp. 51–54, IMF, 2015*b,* p. 32).

In spite of recent failures the importance of fiscal consolidation cannot be stressed enough in the ominous shadow of growing government debt. In 1990 the gross public debt of Japan was only 65.3 per cent of GDP, while in 2000 it was 136.1 per cent of GDP, and today the gross national debt of the country is the highest among developed countries, at around a whopping 230 per cent of the GDP: Although funding the public debt has not been a problem so far, as Japanese investors and especially households prefer to invest in government securities. Domestic funding in the Japanese deflationary environment – due to low interest rates – even with such enormous government debt puts relatively little strain on the national budget. The net interest payment of the government is quite low in international comparison. However, if Japan is unable to make a sharp turn, and implement the "three arrows" programme, as a result of increasing government debt the country may need external funds, which would impose a heavy burden on the country and increase the risk. The situation is quite serious, according to OECD calculations if the trend continues the gross government debt of Japan may exceed 410 per cent of the GDP by 2040 (OECD, 2015*a,* p. 15, p. 32, pp. 109–115, *Arslanalp–Lam,* 2013, *Shigeki,* 2005).

Table 4

General government financial balances as a percent of nominal GDP, 1998–2017

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
United States of America	–0.4	0.0	0.8	–1.4	–4.8	–6.0	–5.5	–4.2	–3.1	–3.7
United Kingdom	–0.2	0.7	1.1	0.4	–2.1	–3.4	–3.6	–3.5	–2.9	–3.0
Finland	1.6	1.7	6.9	5.0	4.1	2.4	2.2	2.6	3.9	5.1
France	–2.4	–1.6	–1.3	–1.4	–3.1	–3.9	–3.5	–3.2	–2.3	–2.5
Ireland	2.0	2.4	4.9	1.0	–0.3	0.7	1.4	1.3	2.8	0.3
Japan	*–10.3*	*–7.1*	*–7.5*	*–6.0*	*–7.7*	*–7.7*	*–5.9*	*–4.8*	*–1.3*	*–2.1*
Korea	0.6	1.6	4.4	3.0	3.5	–2.0	0.2	1.6	2.3	4.2
Germany	–2.5	–1.7	0.9	–3.1	–3.9	–4.2	–3.8	–3.4	–1.7	0.2
Italy	–3.0	–1.8	–1.3	–3.4	–3.1	–3.4	–3.6	–4.2	–3.6	–1.5
Switzerland	–1.9	–0.9	–0.4	–0.8	–2.7	–2.4	–2.2	–1.2	0.3	0.9
Sweden	0.9	0.8	3.2	1.4	–1.5	–1.3	0.3	1.8	2.2	3.3
OECD average	–2.3	–1.2	–0.4	–1.8	–3.6	–4.3	–3.6	–2.8	–1.6	–1.5

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
United States of America	–7.2	–12.8	–12.2	–10.8	–9.0	–5.5	–5.1	–4.5	–4.2	–3.7
United Kingdom	–5.1	–10.8	–9.7	–7.7	–8.3	–5.7	–5.7	–3.9	–2.6	–1.5
Finland	4.2	–2.5	–2.6	–1.0	–2.1	–2.5	–3.3	–3.3	–2.7	–1.6
France	–3.2	–7.2	–6.8	–5.1	–4.8	–4.1	–3.9	–3.8	–3.4	–2.8
Ireland	–7.0	–13.8	–32.3	–12.5	–8.0	–5.7	–3.9	–2.1	–1.1	–0.3
Japan	*–1.9*	*–8.8*	*–8.3*	*–8.8*	*–8.7*	*–8.5*	*–7.7*	*–6.7*	*–5.7*	*–5.0*
Korea	2.3	–1.3	1.0	1.0	1.0	1.3	0.9	0.0	0.5	0.8
Germany	–0.2	–3.2	–4.2	–1.0	–0.1	–0.1	0.3	0.9	0.6	0.9
Italy	–2.7	–5.3	–4.2	–3.5	–3.0	–2.9	–3.0	–2.6	–2.2	–1.6
Switzerland	2.0	0.8	0.3	0.8	0.2	–0.3	–0.2	–0.2	–0.3	–0.2
Sweden	2.0	–0.7	0.0	–0.1	–0.9	–1.4	–1.7	–1.1	–0.6	–0.3
OECD average	–3.6	–8.4	–7.9	–6.6	–5.8	–4.1	–3.8	–3.3	–2.8	–2.3

Source: OECD [2015*d*], p. 271 (2015–2017 forecast).

The high government debt has run up as a result of the combination of deficits incurred over decades of repeated but unsuccessful fiscal stimulus measures and the frequent decrease in nominal GDP due to deflation. *Table 4* shows that in the years around the turn of the millennium in Japan – unlike in other developed countries with relatively balanced budgets – the deficit was substantial, amounting to 8-10 per cent of the GDP. By 2006–2008 the country managed to reduce the deficit, but then the positive tendencies were broken by the unfolding global financial crisis. After this massive deficits of up to 7–9 per cent of the GDP returned in Japan. All this warns us that Japanese economic policy can only follow a quite narrow path, as if the government achieves one of its main targets, namely price increase, interest rates will also run up, making it more difficult to fund the enormous government debt, and at one point can even hamper the recovery of private investment as well (OECD, 2015*d,* p 271).

The complexity of the situation is illustrated by the estimate made by the OECD in 2015 modelling the paths for Japan in the 25 years between 2014 and 2040 (OECD, 2015*a*). The authors examined three possible scenarios, with differences – at first glance quite small differences – in the growth and inflation figures used in the calculations. However, because of the length of the period under scrutiny these little differences resulted in very different paths for the country, and after a quarter of a century they produced very different results with regard to the position of Japan. The two key variables used in the calculations were real GDP growth and inflation rate. These two already determine how the third variable, nominal GDP will change. These three input values varied in the calculations, while the four output variables were long-term interest rate, current account and primary budget balance and gross government debt.

The first one is the baseline, which is the projection of the current growth path into the future, paints a rather gloomy picture. Here the one per cent real growth is accompanied by 1.75 per cent inflation. This combination would result in a growing current account deficit, which would be nearly one quarter of the GDP by 2040, while the gross government debt would reach 413 per cent of the GDP. The baseline indicates the danger noted earlier, i.e. that higher inflation – accompanied by moderate growth – due to the rise in interest rates may result in intolerable debt service burdens for the budget. Of course it is impossible to make accurate long-term predictions. And it was not even meant to be accurate. However, the baseline shows the rather dangerous outcome of what can happen if the current negative growth tendencies are not curbed, as this way Japan would rather sooner than later get into an economic situation that cannot be kept under control.

OECD experts looked at two other scenarios in addition to the baseline one. In Scenario 1 the real growth was 1 per cent, just like in the baseline scenario, but inflation was only 0.5 per cent, which is in fact a near-deflation situation. This is pretty close to the real situation, as the current period is also characterised by similar values. In this case, the relatively low interest rates would result in small current account deficit and even two per cent primary surplus after 2025. The gross government debt would take a sustained downward path, and by 2040 it could be 211.5 per cent of the GDP. This is a much more positive scenario; however, the achieving a primary balance surplus would require tax hikes and cutting expenditures drastically. And this is a quite difficult task as an ageing society and increasingly wider and deeper social problems may force the government to increase such expenditures.[7]

[7] The needs of the ageing population put increasingly greater pressure on the government to increase expenditures, including first and foremost pensions, social care, and health care. In addition – in spite of the fact that the average income of Japanese households is quite high – because of the significant differences in income, low-income families have difficulty making ends meet, while in 1985 12 per cent of the population lived in relative poverty, in 2009 16 per cent of the population. Even around the turn of the millenium it was one of the highest rate among OECD countries. Of the developed economies – with the exception of the United States – it is Japan that has the biggest difference between the top and bottom 10 per cent of the population with regard to income. At the end of the first decade of the new millennium the top 10 per cent earned only three or four times more than the bottom 10 per cent in the majority of European countries.

The most promising is Scenario 2, whose values are the furthest from current Japanese reality. A two per cent real growth is accompanied by a two per cent inflation here, meaning that the annual nominal GDP growth is four per cent. According to this optimistic scenario, the budget would improve gradually, and both the current account and primary balance would turn into large surplus. In the 15 years between 2026 and 2040 the current account balance would have an average surplus of 4.5 per cent of the GDP while the primary balance would have a surplus equal to 6.8 per cent of the GDP. If all these came true, government debt would decrease steadily, and by 2040 it would only slightly exceed the GDP. Currently this scenario does not seem to be very realistic, but it highlights the key importance of sustained economic growth.

The critical mass of structural reforms

Undoubtedly structural reforms are the most crucial of the three arrows, as it is only the reforms that can lay the foundations of long-term, sustained economic growth. As we have repeatedly stressed in this paper, the reasons behind Japan's prolonged stagnation are the fundamental structural and institutional problems, which developed over the previous decades. The third arrow of Abenomics is actually aimed at transforming these structures. In the course of this the economic policy has run into insurmountable obstacles and difficulties. However, if encouraging progress is made, the globally competitive private sector can have significant role instead of short-term state expansion and state intervention. Structural reforms are primarily aimed at boosting Japan's long-term growth potential. This in itself is of supreme importance, but it is also imperative for decreasing the extremely high public debt of Japan as well (IMF, 2012).

However, the current state and tendencies of Japanese economic growth are anything but encouraging. As *Table 5* shows that following the economic miracle, by the 90s potential growth was just 1.9 per cent, and in the first decade of the new millennium it was only 0.6 percent. And it continued to slump in the present decade. Currently the potential growth rate of Japan's economy is estimated to be around 0.4 per cent, which is the lowest in the developed world. The reason why real growth is so low is not the cyclical factors but rather fundamental institutional and structural ones. In its current position the economy of Japan will not be able to achieve higher level of growth sustainably (OECD, 2015*d,* p. 265, *Hausman–Wieland,* 2014, pp. 9–13).

Table 5

Annual growth rate of potential output between 1991 and 2017

	1991–2000	2001–2010	2011	2012	2013	2014	2015	2016	2017
United Kingdom	2.6	2.0	1.1	1.3	1.4	1.8	2.0	2.0	1.8
Finland	2.8	2.2	0.5	0.5	0.5	0.5	0.6	0.7	0.7
France	2.1	1.6	0.9	0.9	0.9	1.0	1.0	1.2	1.2
Ireland	7.2	4.6	1.5	1.7	1.4	1.7	2.1	2.4	2.6
Japan	*1.9*	*0.6*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*
Germany	2.1	1.2	1.3	1.2	1.1	1.1	1.3	1.3	1.3
Italy	1.6	0.7	–0.1	–0.3	–0.4	–0.3	–0.1	0.1	0.2
Switzerland	1.5	2.0	1.9	1.8	1.7	1.6	1.5	1.5	1.4
Sweden	2.3	2.4	1.9	1.8	1.7	1.7	1.7	1.8	1.8
United States of America	3.1	2.3	1.7	1.7	1.6	1.6	1.6	1.6	1.7
Eurozone	2.2	1.6	0.8	0.7	0.6	0.7	0.9	1.0	1.0
OECD average	2.8	2.1	1.5	1.6	1.5	1.5	1.6	1.6	1.6

Source: OECD [2015*d*], p. 265 (2015–2017 forecast).

Drawing on experience and learning from failures, the most essential areas, measures and achievements of the third arrow of Abenomics, namely structural reforms can be organized into ten groups. Reviewing them can give us a good picture about the problems that underlie the quarter-of-a-century-long stagnation (OECD, 2015*a,* pp. 19–20, OECD, 2015*b,* pp. 231–234, IMF, 2015*a,* IMF, 2015*b,* pp. 9–11, p. 28).

1. *Developing corporate management culture and knowledge and promoting this through the financial system.* In order to achieve this the JPX-Nikkei 400 index was launched on January 6, 2014, setting stricter rules, greater transparency and controllability for major corporations.

2. *The reform of governmental and quasi-governmental funds management.* Starting from 2014 they have been encouraging them to increase the proportion of securities in their portfolios as well as the transformation of the management system.

3. *Developing entrepreneurship and the corporate environment promoting it.* As of 2014 the taxation and the regulatory environment has been much more favourable to business angels than before. In 2014 the creation of six special economic zones with more flexible regulation was announced. These deregulation zones are to help double the import of foreign capital by 2020.

5. *Improving the scientific and technical conditions for innovation and making Japan the leading country in the robot revolution.* Government resources for science and technology, which were dispersed before, have now been centralized.

6. *Tackling employment problems by helping women get a job and help them get promoted.* The government increased kindergarten places by 400 thousand and school day care facilities by 300 thousand to make waiting lists shorter. The government believes that it was because of this measure that the employment rate of women grew by 3.9 per cent.

7. *Facilitating flexible working hours and promoting talents.* The government prefers to provide support for job maintenance where there is flexible job mobility. The government is determined to check and limit overtime. The government also wants to establish a system in which employees are paid according to performance rather than hours worked.

8. *Attracting foreign talents to Japan, and provide them with facilities to use their talents.* Foreign advisors and teachers who were given a three-year work permit can stay and work for another two years in Japan.

9. *Powerful agricultural policy.* The government would like to double the income of people working in agriculture, in a bid to promote economic growth. As of the fiscal year of 2013 the government decided to end its policy of limiting rice production for a five-year period.

10. *Improving the quality of health care.* The government would like to provide people eligible to state health care services with quick access to the latest approved medical treatments. They have set up a new institution to manage medical research and development.

As can be seen from the list, these are very general objectives and they cover the complete spectrum. All of them are aimed at promoting growth, eliminating bottlenecks and ironing out snags partly by increasing market competition and transparency and partly by overcoming labour problems. Promoting technical and technological development is also a key part of the reforms. However, when we look at the three years since *Shinzo Abe* has become prime minister, we see that the progress made has been slower than expected and planned originally. The key may be reforming the labour market and fully implementing measures offsetting the labour shortage caused by demographic processes. In 2014 80 per cent of Japanese businesses reported that it was getting increasingly more difficult for them to fill vacancies. In 2006 it was only 60 per cent of them who had such problems. In 2010 Japan had a 66.3 million-strong workforce, which is to go down to 56.8 million by

2030. The working-age population of Japan who are between 15 and 64 years old is decreasing by one million every year, and it is predicted to go down by 40 percent by 2050. The dependency ratio in Japan, which was 2.5 in 2013 will go down to 1.3 by 2050, which is giving the biggest cause for concern among OECD countries (IMF, 2015*c;* OECD, 2015*a,* pp. 21–23).

Women's employment in Japan is quite low, only 38 percent of women stay on the labour market after giving birth. The labour market participation rate of men is 85 percent, but that of women is nearly 20 percent point lower. If this latter were increased it would slow down the decline of working age population but not stop it altogether. The fact that the birth rate in Japan today is merely 1.4 percent, which implies further population decline as well as long-term demographic problems, is indicative of the gravity of the situation. By increasing the availability of nursery school, kindergarten and school day care facilities, and reducing or eliminating waiting lists the government would like to increase the number of women in the workforce as well as the number of births. In addition women's wages, which are far below the wages of men, should be raised, and make it easier for women to get promoted at their workplace. However, the social conditions underlying the phenomenon cannot be changed easily, traditionally Japanese women have a much more subordinate role than women in countries rooted in European culture. So it does not seem easy to integrate them more into the labour force.

Another – although much less substantial – internal resource could be the employment of the elderly. Compared to other developed countries the labour market participation of the elderly in Japan is already relatively high. The employment rate of people between 65 and 69 is 39 percent. However, if we look at the high life expectancy of Japanese people and how fit the elderly are, they could be reintegrated into the labour market by implementing an appropriate incentive scheme. The situation is further complicated by the fact that in Japan, just like in other countries, there are very considerable regional differences, and there are great differences in the demography of the urban and the agricultural population in rural areas.

Given the labour market and demographic situation the question arises naturally: should Japan increase immigration. In international comparison, because of its unique history and national characteristics immigration to Japan is quite low, they make up only 2 percent of the total labour force. It is extremely difficult to bring about change in this area as well, especially since the tendency between 2009 and 2013 was just the opposite. The net labour influx in this period decreased from 76 thousand to less than its half, 35 thousand people. The 35 thousand foreign labourers make up for less than 0.03 percent of the population. Mind you, the majority of them were highly qualified professionals and consultants. In recent decades there have been a much larger number of foreign business people, often fluent in Japanese and with extensive knowledge of the country, who chose to settle down here. The national strategic special zones are designed to facilitate the influx of skilled foreign labour in the future. For the time being we can say only that the immigration issue which was a taboo earlier is now something that is open for debate (IMF, 2015*c,* OECD, 2015*a,* pp. 21–23).

When the areas of reform were listed, the widespread use of cutting edge techniques and technology, developing innovation facilities, improving the quality of corporate management and competitiveness were mentioned as important factors that could contribute to economic growth. Numerous measures have been taken in the past decade in this direction, but the transformation of behavioural patterns, and the internalization of knowledge take a long time. One of the highest priority structural reforms of Abenomics is aimed at accelerating this process, understanding the dynamism and innovativeness of the business sector. In order to do this businesses have been encouraged to adopt more professional corporate management styles and drawing on international experience. Making it easier for foreign professionals to stay serves this end. In addition, as of January 2014 they made it possible for corporations to receive corporate tax credit in return for investment, which is expected to increase corporate investment. The above mentioned special economic zones also serve this purpose; these zones are places where they experiment with flexible regulation, the optimal type of stronger deregulation, which can later be used in the whole economy. In order to strengthen the corporate sector it is absolutely essential to stabilise the financial sector further. Major transformation is imperative in this sector as well, in order for the sector to become the driver of growth. Currently trading with government securities is still predominant, but for accelerated growth corporate lending needs to take over.

The reform of the agriculture of Japan, which is still heavily subsidized, is of less significance, but can be a dynamizing factor. As is the case with agriculture the competitiveness of those sectors of Japan's dual economy that satisfy domestic demands is quite low. All this puts a heavy burden on the economy at the moment, using resources that would be needed in key export sectors. The Abe government plans to deregulate the agricultural, the energy, the environmental and the health care sectors, opening these markets to a wide range of private investors.

Throughout its unique development the Japanese economy has always been insular, not letting the effects of global economy penetrate into the country. While export-oriented development supported by the state by all means played a crucial role in the exceptional dynamics of the country, numerous obstacles were placed by the governments to stop the influx of products and capital into the country. The inevitable opening of the global economy in the seventies and the eighties pointed out the internal structural and institutional weaknesses, but could not bring real change, so it contributed to the Great Stagnation. First and foremost because there was no real internal adaptation. If we look at the facts and figures we can see that Japanese economy is still insular. This is why the impact and outcome of joining the Trans-Pacific Partnership (TPP) for Japan is double edged. Increased competition, the greater number of foreign investors may on the one hand force the country to implement much needed structural and institutional changes , but on the other hand, if these reforms are not progressing as they should, they may make the bad situation even worse. Not joining the TPP may have catastrophic consequences, so Japan along with 10 other countries[8] from the region signed the treaty with the United States in February 2016, but the parliament still needs to ratify it. The fact that Japan was the last country to sign the treaty is very telling, Japan is aware of the double-edged situation it creates for the country. If Japan did not join, it would just isolate the country even more, but its effect cannot be predicted at the moment (OECD, 2015*a,* pp. 23–24, IMF, 2015*c,* pp. 78–80).

Quo vadis Japan?

The diverse measures taken by the *Shinzo Abe* government still have not coagulated into a solid reform programme. Although the Abenomics measures are very spectacular, their political communication is very powerful, but they may not achieve the set targets: halting the deflation spiral and set the country on a sustained growth path. It is a very important sign regarding the future that the instruments used now are not without precedent, and when they were put to use earlier they did not produce sustained results either. Chances are a breakthrough can be achieved only if all the elements of the programme are fully implemented. If the targets are only partly achieved – and the structural and institutional reforms are especially critical in this respect – the second half of the decade will see stagnation or even

[8] Australia, Brunei, Chile, Canada, Malaysia, Mexico, Peru, New Zealand, Singapore and Vietnam.

worse, a decrease in real GDP instead of the growth planned (*Hausman–Wieland,* 2014).

The task facing the Japanese government is quite difficult after a crisis-ridden quarter of a century and – in spite of apparent similarities to other countries and regions – in many respects quite unique. What we have at hand is not simple financial or cyclical crisis management. If this was the case, the actions required would be managing recession and issues caused by it, recovery and overcoming weaknesses, correcting errors after which the specific economy can get back on the dynamic growth path it had been on before. However, in Japan the majority of structural reforms have wanted to transform areas that developed and solidified over many decades as well as formal and informal institutions, and their success is dubious. What we see here is the system crisis of a unique capitalist planned economy that has been operating for long decades.[9]

Expansive monetary and fiscal policy – at their best – can accelerate growth only temporarily. Long-term price changes, the rate of inflation/deflation are the results of deeper processes of the economy. However, both of these economic policy measures increased future risks significantly. The quantitative expansion program implemented by the Bank of Japan, the near-zero inflation rate, the sudden increase of the monetary base – in addition to the development of gigantic financial bubbles – which may put a heavy burden on the balance of the central bank, which in turn will affect government balance. Government policies stimulating growth increased government debt even more, creating harsher and harsher conditions for the implementation of fiscal consolidation (*Aoyagi–Ganelli–Murayama,* 2015).

If we do not look deeper the instruments used in Japan can be compared to the crisis management measures taken in the United States after 2007–2009. However, the results are radically different in the two economies. The United Sates is on an encouraging, upward path, while Japan's agony continues. It serves as just another clear example that the success or failure of economic policies depends essentially on their interaction with the real economy, but also on the patterns of behaviour of the players of the national economy and the nature of informal institutions. When the main targets of monetary policy and the instruments used to achieve these targets in different countries and regions are set and identified a lot of considerations, interests,

[9] In this regard, in spite of the basic differences, in some sense we can compare the situation of Europe to that of serious task facing Japan. On our continent the welfare state, the so-called "European model", which developed over long decades, is facing multiple challenges. And there are a lot of obstacles to the much-needed radical transformation, just like over there, but since the nature of problems is very different we have to find the way that suits us best separately (*Muraközy,* 2012).

particularities are taken into account. All this goes far beyond making simplified analogies based on similar features that appear in financial techniques. After 2007–2009 the overriding consideration was to keep the banking system shaken by the crisis alive and consolidate it, while in Japan it was breaking out of the spiral. Deflation and stagnation are actually the visible symptoms of the crisis of the Japanese developmental state model. Whereas in the United States the latest financial crisis was just another recession, after which growth can be continued. Japan has been mired in deep structural problems, writhing in the spider web of interacting formal and informal institutions for a quarter of a century, and it is still very uncertain whether the country knows how to get out of it. The model that helped the country catch up earlier, has by now become the hindrance to further development. In the case of Japan path dependence is extremely strong (*Muraközy,* 2016).

The European Central Bank has in recent years followed the practice of the United States of America, the United Kingdom and Japan in quantitative expansion, but the results are quite different from those of these countries. The Eurozone is in a fundamentally different situation than Japan or the United States. The one-size-fits-all policy of the European Central Bank has very different effects on countries that are independent from each other and are at different levels of economic and social development. This example illustrates that we need to look beyond the instruments used in the measures taken by governments and central banks, and do more than simply identify the apparent similarities in fiscal policy. What determines the final outcome tends to stay quite hidden. The nature of the economy and society, the underlying characteristics and traditions of countries and regions determine whether the measures taken will bring success or failure. Economic policy in itself has relatively little effect on them. Politicians often do not even assess – or do not care – how powerful the instruments in their hands are, instruments that can be used to improve the situation only a little even on the long term, but can make it a lot worse as well. It is true that, provided the instruments fit, the timing is right, there is synergy and harmony, they can help to boost growth opportunities, and find the right development path. However, it is also very easy to blunder in the complex network of economic, political and social relationships and make an inadequate assessment of the long-term consequences and effects (*Korniyenko–Loukoinova,* 2015).

There has been constant crisis management in Japan since the early nineties, while the rest of the world was enjoying the prosperity of the Great Moderation. In this respect Japan, with its deflation, economic stagnation and crisis management measures was ahead of its time, as it was before the years of recession in 2007–2009.

The attempts Japan made before and after the turn of the millennium were valuable lessons to economic policy makers in the United States as well as in Europe. But *Shinzo Abe* also drew on this experience when he formulated his “three arrows” policy. However, today Japan is not the only struggling country of global economy, the developed world and great developing economies display symptoms of crisis from Europe to the United States, China and Brazil. This, however, does not make the situation of Japan any easier, even if it has accumulated a wealth of experience. Japan has always taken its own course, and still is (*Hoshi–Kashyap,* 2015).

After the financial crisis of the nineties, bursting the real estate bubble, numerous attempts were made in Japan to get the country off the deflation-stagnation course. The reform measures taken after the turn of the millennium yielded little results. Since the middle of the decade, during the second term of *Shinzo Abe,* the country has made an attempt based on bolder and more ambitious concepts than before. The “three arrows” policy – expansive monetary policy, fiscal stimulus and structural reforms – has not met the expectations so far. Monetary and fiscal policy in itself is not enough to change the underlying processes of the economy and society. For in Japan the problems are deeply rooted in these. Comprehensive structural reforms, the third arrow of Abenomics, may take us one step closer to an effective solution.

The appropriate transformation of formal institutions and structural reforms are of course necessary and can facilitate the operation of the market, since if the old conditions prevailed, they would prevent that. However, these only provide the boundary conditions. It is much more intensive market mechanisms that can get the country out of the ditch, but this takes market players who have the mentality, values and skills that match these market mechanisms. And this is necessary at all levels, at the level of employees, businesses, managers, finance and insurance professionals and consumers as well. For it is of primary importance how flexible the economy and its players are, whether they are able to react to economic policy measures and market changes. What we also need to keep in mind is that a financial crisis is very different from a prolonged system crisis.

However, even if we assume that things will turn out best, and the comprehensive reform of the formal financial system is fully carried out, we still cannot be sure of success. For – and the long-term development of Japan provides us with plenty of evidence – all this is insufficient to change and transform habits, customs, behavioural patterns, traditions, in other words, informal institutions. Even if this transformation is started after the reforms of formal institutions have been carried out, and using these as a framework, it will still take years to bring about fundamental changes.

Or – and this is just as likely – informal institutions will modify the operations of formal ones in a way that is undesirable. Currently we cannot tell whether Japan will continue to writhe in the dead-end street of sustained stagnation and lag behind, or – as we hope – will undergo radical transformation.

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