

Q4 Japan has repeatedly pursued government interventions in the hope of revitalizing its economy weakened by deflation, debt and ageing demographics. Japanese Prime Minister Shinzo Abe's three-pronged approach, combines fiscal expansion, quantitative easing, and structural reform to boost economic growth while raising inflation to 2 percent.

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- a) Explain the reasons why governments want to achieve sustained economic growth, a healthy balance of payments and a low rate of inflation. [10]**
- b) Discuss whether conflict in macroeconomic objectives is the most important reason that underlies Japan's three-pronged approach to achieve her macroeconomic objectives. [15]**

Suggested Answer for (a)

Reasons why governments want to achieve sustained economic growth

Economic growth can be defined as:

- an increase in the real output of a country (actual economic growth)
- an increase in an economy's capacity to produce goods and services (potential economic growth).

There must be a combination of actual growth (led by increase in AD) and potential growth (increase in productive capacity marked by an increase in LRAS) for economic growth to be sustained in the long run.

- "Positive" → indicates increase in amount of g/s produced for an economy → more g/s available for consumption → improve material standard of living (mSOL)
- "Positive" → also means rising household incomes → greater purchasing power to satisfy material needs → improve mSOL
- "Positive" → non-material standard of living (nmSOL) also increase in the presence of economic growth due to improvement in lifestyle. For example, there will be greater demand for cars and holidays to foreign lands. People become more conscious of the quality of living.
- "Sustained" → actual and potential growth in tandem → continued consumption levels over time
- May have some impact on nmSOL too → if greater tax revenue collected and channelled towards sectors like education and healthcare. + lower amount of social problems such as crime.

Positive impact on other macroeconomic indicators

- Reduces demand-deficient unemployment with actual growth: "positive" → increase in the derived demand for labour since there is greater income and hence output in the economy → falling unemployment due to increase number of jobs in the economy.
- Reduces demand-pull inflation with potential growth
- Sustained economic growth may lead to a rise in investor confidence as future prospects improve, leading to an increase in investment activities within the country, further enhancing actual and potential growth in the economy.

Reasons why governments want to achieve a healthy BOP

The Balance of Payment is a statement of all transactions between one country and the rest of the world. It is usually reported on an annual basis. The transactions included are merchandise trade, exchange of services and transfers of capital in both directions.

- “Healthy” → indication of external stability (long-term goal) + avoid the problems of large and persistent BOP deficit (example)
- “Healthy” → large and persistent BOP deficits may be financed by drawing on reserves → less resources for other sectors such as education and healthcare → affect nmSOL OR financed by borrowing → burden on the society in terms of debt servicing → future generations may suffer from a lower SOL

Positive impact on other macroeconomic indicators

- Improves investor confidence → further stimulate actual and potential growth (through FDI, I, AD) and unemployment

Reasons why governments want to achieve low rate of inflation

Price stability is reflected by the inflation rate which measures the change in the country's general price level. It is important to keep the inflation rate low in order to maintain confidence and stability in the country.

Related to SOL

- “Low” → income more likely to rise faster than price levels → increase in real GDP (per capita) → value of money is maintained → able to enjoy more g/s

Positive impact on other macroeconomic indicators

- “Low” → reduces uncertainty in decision making → firms can make investment plans more accurately → investor confidence → further stimulate actual and potential growth (through FDI, I, AD) and unemployment
- When the rate of inflation is low in the country, the country's exports become more price-competitive, leading to a rise in export earnings and improvement in the current account of the BOP. FDIs will also be attracted as confidence in the economy improves the rate of returns and profits for the investors, leading to an improvement in the capital account of the BOP.

Countries like Japan also wants to avoid deflation and attain a low rate of inflation because of the following problems:

- Deflation can lead to a vicious cycle of decreased spending and increased unemployment. People wait as prices fall, for goods to get cheaper before buying. Prices therefore fall further, leading to more job losses and an economic recession.
- Deflation also causes a reduction in investment spending because businesses lose confidence in the economy and invest less as prices of their goods and services fall, and profit margins are reduced.
- Deflation is harder to tackle than inflation. Unlike inflation, which can be combated with a rise in interest rates, there is a limit to how far interest rates can be cut when tackling deflation. Moreover, due to deflation, the real interest rate remains high no matter how low interest rates are cut. High real interest rates discourage capital expenditure and investment by companies.

L3	Well-developed and detailed explanation of the meaning and advantages of achieving the key policy objectives of sustained economic growth, healthy balance of payments and low rate of inflation.	8-10
L2	Under-developed explanation of the meaning and advantages of achieving the key policy objectives of sustained economic growth, healthy balance of payments and low rate of inflation.	5-7
L1	An answer that merely stated or defined the key policy objectives without or with little explanation of the reasons for the objectives	1-4

Suggested Answer for (b)

Introduction:

Governments have to make decisions about which economic policy to use, such as fiscal, monetary, or supply-side policies, in order to achieve sustained economic growth, a healthy balance of payments and a low rate of inflation. It is unlikely that these aims can all be achieved by any one policy concurrently, as the use of one policy may result in trade-offs between macroeconomic objectives. Therefore, Japanese Prime Minister Shinzo Abe would have to consider the trade-offs involved in his decision to employ the three-pronged approach. There may also be other factors that determine his policy decisions, and these include: current economic conditions and the nature of the economy/current problems faced by Japan.

Thesis: Conflict in macroeconomic objectives is a factor that underlies Japanese Prime Minister Shinzo Abe's three-pronged approach

Thesis 1:

In June 2014, Abe announced a broad structural reform package, including corporate tax cuts, agriculture liberalization, labor market reform, and initiatives to overhaul regulation of the energy, environment, and health-care sectors.

- ⇒ For example, labor market reform → providing training and education for workers e.g. support relearning of individuals, such as by enabling women, who once take child-rearing leave, to receive recurrent education for skill improvement and re-employment + attract foreign high skilled labour to boost labour productivity → increase LRAS → LRAS shifts to the right → NY increases, GPL falls. Hence the need to complement with fiscal expansionary and monetary easing policies to boost AD to increase GPL to bring Japan out of deflation to achieve low inflation.

[Additional infor: Fiscal stimulus began in 2013 with economic recovery measures totalling 20.2 trillion yen (\$210 billion), of which 10.3 trillion (\$116 billion) was direct government spending. It was focused on building critical-infrastructure projects, such as bridges, tunnels, and earthquake-resistant roads.]

Thesis 2:

The BOJ has simultaneously implemented quantitative easing and injected liquidity into the economy and pushed interest rates into negative territory to spur lending and investment.

- ⇒ With the increase in government expenditure + increase in I due to monetary easing → increase in AD → AD shifts to the right → increase in real NY. As more and more

resources are employed, the Japan economy will get out of deflation and face demand pull inflation without a corresponding increase in LRAS.

- ⇒ A high inflation may worsen the balance of trade. When inflation in Japan is relatively high, Japan produced goods will become more expensive and less competitive internationally. Exports will be relatively more expensive, thus foreigners will reduce the quantity demanded of exports. If $PED_x > 1$, the rise in price of exports will lead to a more than proportionate fall in quantity demanded. Total export revenue (X) will fall. When Japan goods become more expensive, Japan residents will buy more imports assuming imports and Japan produced goods are close substitutes. Demand for imports increases and import expenditure increases → fall in net exports → worsen BOT and hence current account for Japan.
- ⇒ Hence, the need to complement quantitative easing with structural reforms (e.g. policies to improve country's productivity and export competitiveness) to increase LRAS and improve current account to achieve sustained economic growth at low inflationary pressure and a healthy BOP.

Thesis 3:

- ⇒ If fiscal expansion and quantitative easing are successful and lead to economic growth in Japan, this may increase demand for foreign imports which have a positive income elasticity of demand resulting in an increase in import expenditure and hence worsening of current account. Furthermore, with monetary easing and lower interest rates (assuming interest rates in other countries remain constant), financial assets of the country becomes less attractive to financial speculators and this results in an outflow of hot money. Hence, demand for the country's currency fall and this causes Yen to depreciate. A depreciation of Yen, assuming Marshall Lerner condition holds can increase net exports and hence improve current account. However, a weaker Yen also drives up the price of imports. Hence, while the weak yen is helping export-oriented companies (e.g. Toyota Motor), it is adversely affecting companies that have to import a large amount of raw materials (e.g. steel makers who imported iron ore and coal and major power companies who rely on imported fuel). This will negatively impact employment in some sectors, thus causing economic stagnations.
- ⇒ Hence, the need for structural reforms to increase government spending on R&D to support Japanese companies → lower cost of production → reduce price and improve quality of exports and domestic goods → increase export revenue and help companies that have to import a large amount of raw materials to reduce cost of production.
- ⇒ A weaker yen also leads to higher cost of living with higher imported prices of gasoline, wheat flour and edible oil. → Hence, the need for structural reforms → labor market reforms to put pressure on companies to increase wages + cut corporate taxes to increase worker wages and pay increases → improve consumers' confidence → increase C → increase AD → to boost growth and achieve its inflation target.

Thesis 4:

Japan has spent trillions of dollars for the fiscal stimulus to lift the economy.

- ⇒ In the process it has accumulated a large public debt.
[Additional infor: There is also worry about Japan's national debt, which, at over one quadrillion yen (\$11 trillion), has surpassed 245 percent of its GDP. The International Monetary Fund (IMF) has repeatedly warned [PDF] that these debt levels are unsustainable. That's why Abe has attempted to reduce the deficit by raising tax. A 2014 increase in the national consumption tax from 5 to 8 percent further depressed consumer's confidence and hence spending and is likely to cause recession.]

- ⇒ While good for immediate growth, this decision arguably undermines the goal of fiscal sustainability → Japan government may need to rein in social security spending through cut on spending on wasteful infrastructure projects, labor market reforms like increasing retirement age and boosting growth through structural reforms to reduce public debt in the long run.

Thesis 5:

The Japanese economy is going to receive money supply injections through a stimulus package, which the Japanese Government wants to finance with an increase in tax receipts, instead of issuing Government denominated bonds. It is against this background that the sales tax hike came.

- ⇒ With households already impacted by rising costs of living, the net effect of the sales tax hike has been a contraction in the economy. It is clear that the government wants corporations to start increasing investment by giving them access to cheap capital. However, this assumes that the new capital will be able to find profitable opportunities to invest in. If the economy contracts as a result of consumers becoming more cautious in spending as a result of prohibitive taxes, corporations might shy away from investing in the economy, thereby reinforcing the same cycle.
- ⇒ Hence, the need for fiscal expansion to combat the contractionary effects on the economy by the increase in sales tax hike.
- ⇒ Hence, the need for structural reforms → labor market reforms to put pressure on companies to increase wages + cut corporate taxes to increase worker wages and pay increases / increase minimum wage to improve consumers' confidence level → boost consumption to increase AD.
- ⇒ Hence, the need for structural reforms → make Japan for attractive for investment → boost investment to increase AD.

Anti-thesis 1: The constraints faced by the Japan government is another factor that underlies Japanese Prime Minister Shinzo Abe's three-pronged approach.

- ⇒ Japanese Prime Minister's three-pronged approach are designed to overcome the constraints faced by the Japan Government.
- ⇒ As Japan has low interest rates for decades, it is caught in a liquidity trap. Hence, Prime Minister Shinzo Abe adopted the non-conventional monetary policy approach of quantitative easing where BoJ print money to buy bonds. This money increases the size of bank reserves in the economy/increases the overall amount of useable funds in the financial system and helps stimulate the economy by encouraging banks to make more loans to businesses and individuals. Furthermore, if BoJ convinces markets that they are serious about fighting deflation, then it can also boost economic activity by raising confidence.
- ⇒ Japan is a rapidly aging society → Japan's total population is falling and the labor force has been shrinking. In an aging society, consumption is underpinned more by savings than current earnings → fall in C → fall in AD
- ⇒ Fall in labour force → fall in LRAS
- ⇒ Hence, the need for labour structural reforms such as increasing labour-force participation – especially among women + lower barriers to entry for migrants + increase investment in capital-intensive technologies and machinery in order to boost productivity → allow the workforce to maintain or even increase levels of production even as the labour force shrinks
- ⇒ Currently, in terms of trade openness – sum of exports and imports of goods and services compared to GDP – Japan ranks relatively low to other countries. *[Additional*

infor: Japan is relatively low in terms of inward investment, R&D by foreign MNC in Japan accounts for only 5% and foreigners only comprise 1% of the total population.]

- ⇒ Fiscal stimulus focused on building critical-infrastructure projects/public works investment, such as bridges, tunnels, and earthquake-resistant roads → increase connectivity + improve productivity/ Fiscal stimulus to improve the investment environment and create a structure for investment support + improve the living environment → attract more inward FDI/increase public investment to compensate for the low inward investment (*public infrastructure projects have been suggested to increase public investment by 100 to 200 trillion yen over the next 10 years*) + structural reforms to open its economy, attract more inward FDI (e.g. tax incentives or subsidies for foreign companies with regional or global headquarters in Japan), improving regulations and administrative procedures concerning investment, internalisation of innovation, and improve openness to labor, particularly high skilled foreign workers.
- Evaluation:** With structural reforms, it could lead to economic restructuring and structural unemployment, hence the need to ensure sound labor market and training policies at an early stage to prepare the economy for the transition and minimise structural unemployment.

Anti-thesis 2: Japan's current economic condition/economic problem is another factor that underlies Japanese Prime Minister Shinzo Abe's three-pronged approach.

- ⇒ Japanese economy has been stagnant and facing deflation for more than two decades. Hence, Japanese Prime Minister Shinzo Abe launched the three-pronged approach to jolt Japan's stagnating economy out of its deflation. Its immediate goal was to boost GDP growth while rising inflation to 2 percent. It was determined that the long period of the stagnant economy and deflation justifies a massive fiscal stimulus despite Japan's public debt. While the expansionary fiscal policy may result in conflicts in objectives as mentioned earlier, it is likely that in this case, the immediate economic concern of Japan's Prime Minister was to boost GDP growth while rising inflation. Japan's Prime Minister's decision to unleash a massive programme of quantitative easing aims to double the country's money supply in a drastic bid to restore the economy to health and combat the deflation that has dogged the country for more than a decade. The aim is to rekindle demand to push up prices and wages. Persistent deflation tends to encourage households to hoard their cash, as they wait for prices to fall further. Monetary expansion will also lead depreciation of the yen, boosting exports and increasing investment and employment which will fuel consumption. As a result, AD will grow, while expectations of inflation will prompt further investment and consumption. Hence, the need for fiscal expansion and quantitative easing to combat deflation, improve confidence in the economy to create a virtuous cycle to boost GDP growth while rising inflation to 2 percent. Structural reforms are necessary to boost long-run growth to achieve sustainable growth with low inflation as well as achieve healthy BOP as explained above.

Conclusion:

- The criteria used to judge which factor is the most important in determining policy decisions would be how relevant the factor is to the Prime Minister Shinzo Abe in deciding on the three-pronged approach.
- In this context, it seems that Japan's current economic condition of stagnating economy and deflation is the most important factor in determining the three-pronged approach. This is because the main objective of Abenomics is to boost Japan's economic growth while rising inflation to 2%. Of course, the conflicts of macroeconomic

objectives will be the next factor to consider to ensure that the three policies complement one another to achieve sustained economic growth with low inflation and a healthy BOP.

- In reality, very little progress has been made in the area of Abenomics third arrow on structural reforms. This could mean that the current nature of Japan's problems is not the main factor of consideration in Japan Prime Minister's formulation of the three-pronged approach. There is a need for the Japanese government to advance full-fledged structural reforms, lest another valuable opportunity for economic revival be wasted. With limited capacity for more fiscal and monetary stimulus, it is increasingly apparent that maximum attention and effort needs to be directed to structural economic reforms. To achieve all macroeconomic goals concurrently, Japan's Prime Minister must address the problems created by an aging and shrinking workforce and population, lack of inward FDI, low openness to trade and the growing public debt. On fiscal stability, Japan's Prime Minister needs to take drastic measures to cut the budget deficit as tax base shrinks due to Japan's aging population.

Level (Marks)	Descriptors
L3 (8 – 10)	Well-balanced discussion that explain how conflict in macroeconomic objectives and how other factors affect Japanese Government's decision-making process to undertake a three-pronged approach to achieve her macroeconomic objective. Strong application to the context of Japan economy with reference to the preamble.
L2 (5 – 7)	Detailed explanation of how conflict in macroeconomic objectives affect Japanese Government's decision-making process to undertake a three-pronged approach to achieve her macroeconomic objective. OR Detailed explanation of a few factors that affect Japanese Government's decision-making process to undertake a three-pronged approach to achieve her macroeconomic objective. Some application to the context of Japan economy with some reference to the preamble.
L1 (1 – 4)	Weak and incomplete explanation. Poor application to the context of Japan economy. Mere listing of points without explanation.
Evaluation	
E3 (4-5)	For a rational conclusion and an evaluative assessment that is based on economic analysis (that is, a well-explained evaluation).
E2 (2-3)	For an undeveloped rational conclusion that is based on economic analysis.
E1 (1)	Judgment without elaboration (State a stand without justification).