Overhyped, underappreciated

What Japan's economic experiment can teach the rest of the world

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In the 1980s Japan was a closely studied example of economic dynamism. In the decades since, it has commanded attention largely for its economic stagnation. After years of falling prices and fitful growth, Japan's nominal GDP was roughly the same in 2015 as it was 20 years earlier. America's grew by 134% in the same time period; even Italy's went up by two-thirds. Now Japan is in the spotlight for a different reason: its attempts at economic resuscitation.

To reflate Japan and reform it, Shinzo Abe, prime minister since December 2012, proposed the three "arrows" of what has become known as Abenomics: monetary stimulus, fiscal "flexibility" and structural reform. The first arrow would mobilise Japan's productive powers and the third would expand them, allowing the second arrow to hit an ambitious fiscal target. The prevailing view is that none has hit home. Headline inflation was negative in the year to May. Japan's public debt looks as bad as ever. In areas such as labour-market reform, nowhere near enough has been done.

Compared with its own grand promises, Abenomics has indeed been a disappointment. But compared with what preceded it, it deserves a sympathetic hearing. And as a guide to what other countries, particularly in Europe, should do to cope with a greying population, stagnant demand and stubborn debts, Japan again repays close attention.

Take monetary policy. The lesson many are quick to draw from Abenomics is that the weapons deployed by the Bank of Japan (BoJ)—and, by extension, other central banks—since the financial crisis do not work. The BoJ has more than doubled the size of its balance-sheet since April 2013 and imposed a sub-zero interest rate in February; still more easing may be on the way (the BoJ was meeting as *The Economist* went to press). Yet its 2% inflation target remains a distant dream.

The naysayers have it wrong. Unlike other countries, Japan includes energy prices in its core inflation figure. Excluding them, core consumer prices have risen, albeit modestly, for 32 months in a row. Before Abenomics, Japan's prices had fallen with few interruptions for over ten years; they are now about 5% higher than they would have been had that trend continued. Japan has increased inflation while it has fallen in Australia, Britain, France, Germany, Italy and Spain.

If central banks have more sway than some pundits allow, Abenomics also shows the limits of their power. The BoJ has buoyed financial assets, but it has failed to drum up a similar eagerness on the part of consumers or companies to buy real assets or consumer goods. Household deposits are high. And despite bumper corporate profits, firms doubt such plenty will persist. They have been happy to raise prices but less eager to lift investment or base pay (which are harder to reverse). Japan's non-financial firms now hold more than ¥1 quadrillion ($9.5 trillion) of financial assets, including cash.

Herein lies another lesson of Abenomics: monetary policy is less powerful when corporate governance is lax and competition muted. Mr Abe has handed shareholders greater power. In 2012 only 40% of leading companies had any independent directors; now nearly all of them do. But if Japan's equity culture were more assertive still, shareholders might demand more of the corporate cash hoard back—to spend or invest elsewhere. And if barriers to entry were lower, rival firms might expand into newly profitable industries and compete away these riches. They might also pay more. In theory, reflating an economy should be relatively popular, because wage rises should precede price increases. In reality, the price rises came first and pay has lagged behind. That is why the IMF has pushed for Japan to adopt an incomes policy that spurs firms to raise wages.

Someone must spend

If companies are determined to spend far less than they earn, some other part of the economy will be forced to do the opposite. In Japan that role has fallen to the government, which has run budget deficits for over 20 years. Mr Abe set out intending to rein in the public finances. But after a rise in a consumption tax in 2014 tipped Japan into recession, he has backed away from raising the tax again. This week he signalled a large new fiscal-stimulus package worth ¥28 trillion, or 6% of GDP (although it was unclear how much of that money will be new).

Abenomics has not only demonstrated how self-defeating fiscal austerity can be, particularly when it comes in the form of a tax on all consumers. It has also shown that, in Japanese conditions, sustained fiscal expansion is affordable. Without any private borrowers to crowd out, even a government as indebted as Japan's will find it cheap to borrow. Japan's net interest payments, as a share of GDP, are still the lowest in the G7. Politicians in Europe make fiscal rectitude a priority. Abenomics shows that public thrift and private austerity do not mix.

Many people argue that Mr Abe's monetary and fiscal stimulus has served only as an analgesic, masking the need for radical structural reform. To be sure, greater boldness is needed—to encourage more foreign workers into the country, for example, and to enable firms to hire and fire more easily. But a revival in demand has encouraged supply-side improvement, not simply substituted for it. Stronger demand for labour has drawn more people into the workforce, despite the decline in Japan's working-age population. The increased presence of women in the labour force has prompted the government to create 200,000 extra places in nurseries, and to make life harder for employers who discriminate against pregnant employees. In recognising that reflation and reform go hand in hand, Abenomics is an unusually coherent economic strategy.

Abenomics has fallen short of its targets and its overblown rhetoric. That makes it easy to dismiss as a failure. In fact, it has shown that central banks and governments do have the capacity to stir a torpid economy. And in some senses, the hype was needed. Japan's stagnation had become a self-fulfilling prophecy; Abenomics could succeed only if enough people believed it would. This is a final lesson that Japan's economic experiment can impart to the rest of the world. Aim high.