



**BRIEFING PAPER**

Number 7895, 8 February 2017

# Japan: February 2017 update

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1. Domestic politics
2. International relations
3. Economy



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## Summary

Prime Minister Shinzo Abe is dominant at home but faces continued challenges in boosting economic growth, which has more or less flat-lined for two decades now.

Some analysts have suggested that Abe's approval ratings could go down over the course of 2017 if he mishandles the proposed referendum to change Japan's Constitution or if the economy loses the fragile momentum it currently has. A fraying of the US-Japan alliance could also affect his popularity. But the likelihood must be that he will end the year in as strong a position as he began it.

Abe favours amending Article 9 of the Constitution, under which Japan renounces the right to wage war to settle international disputes. He and his supporters want Japan to be able to exercise a right to 'collective self-defence', thereby playing a greater supporting role in military operations around the world being conducted by its allies.

To do this he requires legislation approving the new wording to be passed in both the lower and upper houses by a two-thirds majority, and a majority vote in favour of the new wording in a national referendum. Following the 2016 upper house elections, there is now potentially a two-thirds majority in both chambers for such an amendment, but a referendum vote in favour is far from guaranteed. So Abe is yet to take the plunge.

The most important foreign relationships for Japan continue to be with China and the US. In the case of China, the main source of tension between them remains their territorial dispute in the East China Sea. As far as Japan is concerned, China has been carrying out serial acts of provocation, sending a steady stream of naval vessels and airplanes into or close to Japanese territorial waters. Talks to establish a 'hotline' between the two countries to help prevent conflict have so far been unsuccessful. The two are also at loggerheads over issues like the South China Sea and visits by Japanese politicians to the Yasukuni Shrine in Tokyo, which honours (amongst others) 14 Class A Japanese war criminals from World War II.

The new US Administration has confirmed that the Senkaku Islands are covered by the 1960 *US-Japan Security Treaty*, under which the US has pledged to come to Japan's defence if its security is attacked. This is notwithstanding the fact that the US does not take a position on the sovereignty of the islands (this is also the UK position). The US supports the efforts of the Japanese Government to amend the country's Constitution so that its military can play a more active role in the world.

Nonetheless, there remains an underlying anxiety in Japan that the US might one day begin to loosen these ties. These were intensified by the statements made by Donald Trump during the US election campaign, when he suggested that the US might withdraw its troops from Japan unless it bore more of the costs of stationing US forces and that Japan might need to develop its own nuclear weapons capability in future.

The new US administration has already withdrawn from the Trans-Pacific Partnership (TPP), to which Japan was highly committed (see also below). On the plus side, the new Secretary of Defence, James Mattis, has already indicated that the US has no immediate plans to ask Japan to pay more towards the costs of the US military presence.

Japan will welcome the new administration's less enthusiastic view of relations with China – but does not want to see the kind of confrontation between the two countries that

could destabilise the international order, let alone the Asia-Pacific region.<sup>1</sup> Unlike President Trump, Japan is not interested in challenging the 'One China' policy.

The UK's vote to leave the EU has left Japan less confident about future relations. The UK Government has sought to reassure Japan. In recent years, the two countries have had an increasingly close defence and security relationship.

As already mentioned, Shinzo Abe's domestic political fortunes depend heavily on the country's economic performance. Abe has been the architect of what is known as 'Abenomics', which is comprised of three strands, or arrows – an aggressive monetary policy, fiscal stimulus and structural reforms. These policies are intended to address the main shortcomings of the Japanese economy as described above: weak growth, entrenched deflation and high debt, as well as the country's declining – and ageing – population.

GDP growth accelerated somewhat in 2016, and the outlook for 2017 remains relatively positive. In January 2017, the IMF estimated 2016 growth at 0.9% and forecast growth of 0.8% in 2017; higher than most estimates of the economy's trend growth rate of around 0.5% (given Japan's falling population among other things).

Nevertheless, for growth to be more sustainable, consumer spending will need to be a bigger contributor to growth. However, for that to happen wages will need increase at a faster rate than at present, particularly if consumer price inflation does eventually pick up (which would eat into real, inflation-adjusted, wage growth).

The final arrow of Abenomics – structural reform – is probably the most important (and difficult to implement) over the longer-term. It is made up of reforms to the labour market and deregulating some sectors of the economy. This is particularly important given the demographic challenges of an ageing population and the expected decline in the population over the coming decades.

Overall, most commentators think that the reform measures announced to date have not met the lofty expectations that the Abe Government set in 2013. Writing in mid-2016, *The Economist* said: "Progress has been incremental, at best, prizing breadth over depth".

Another element of Japan's growth strategy was the decision to join discussions on setting up the TPP, a free-trade area for 12 countries (including the US but not China) bordering the Pacific Ocean. The Japanese Cabinet Office estimated in 2013 that joining the TPP could boost Japanese GDP by 0.7% in a decade. In February 2016, a deal was formally agreed between the 12 nations accounting for around 40% of the world economy.

However, now that the US has pulled out, what happens next to the TPP is up in the air. It is possible that the TPP in a new guise without the US may be adopted, although there may be limited appetite for that, particularly in Japan given Prime Minister Abe's description of the TPP without the US as "meaningless".

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<sup>1</sup> "Obama's departure puts Japan's alliance with the US at a crossroads", *New York Times*, 28 December 2016

# 1. Domestic politics

## 1.1 State of the political parties

Prime Minister Shinzo Abe is the leader of the Liberal Democratic Party (LDP), which is in a coalition with the smaller centrist Komeito Party, whose main platform is 'clean government'. The LDP-led coalition currently holds 329 (35 Komeito) of the 475 seats in the lower house and 151 (25 Komeito) of the 242 seats in the upper house. The main opposition is the Democratic Party which has 96 seats in the lower house and 50 in the upper house.

Abe is dominant at home but faces continued challenges in boosting economic growth, which has more or less flat-lined for two decades now. He first came into office after the general election in December 2012 and renewed his mandate in a snap general election in December 2014. This second election was widely viewed as a referendum on his economic policies known as 'Abenomics' (see section 3 of this briefing).

Some analysts have suggested that Abe's approval ratings could go down over the course of 2017 if he mishandles the proposed referendum to change Japan's Constitution and/or the economy loses the fragile momentum it currently has. A fraying of the US-Japan alliance could also affect his popularity.<sup>2</sup> But the likelihood must be that he will end the year in as strong a political position as he began it.

## 1.2 Referendum to change the Constitution

During his first term in office (2012-14), Abe sought to build impetus for reform of Japan's 'peace Constitution'. He favours amending Article 9 of the Constitution, under which Japan renounces the right to wage war to settle international disputes. He and his supporters want Japan to be able to exercise a right to 'collective self-defence', thereby playing a greater supporting role in military operations around the world being conducted by its allies. Abe has also called for the Constitution to be amended to include a right to protect the lives and assets of Japanese citizens abroad, which would in theory have permitted a 'rescue mission' to save two hostages that were killed by Islamic State in January 2015.<sup>3</sup>

In practice, Abe has gone some way towards achieving these goals by re-interpreting the Constitution as it stands. In September 2015 Parliament approved legislation that allows the use of the Self Defence Forces in combat abroad and Japan currently has a small number of peacekeepers with the UN mission in South Sudan.

But he would still like the legitimacy that would come from amending the Constitution itself. To do this he requires:

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<sup>2</sup> [Outlook 2017 East Asia: Japanese PM could be tripped up by Trump, economy, Straits Times, 27 December 2016.](#)

<sup>3</sup> "Abe begins effort to revise Pacifist charter", *Straits Times*, 14 February 2015.

- Legislation approving the new wording to be passed in both the lower and upper houses by a two-thirds majority.
- A majority vote in favour of the new wording in a national referendum

Following the 2016 upper house elections, there is now potentially a two-thirds majority in both chambers for such an amendment, providing Komeito can be kept on board – the leadership has endorsed the changes being proposed, but there are reservations within its ranks. There is also no certainty of a majority vote in favour in a national referendum. There remains considerable public concern that such an amendment could mean Japan getting dragged into wars. Others question whether changing the Constitution should be a priority in economically challenging times.<sup>4</sup> The upshot is that Abe is yet to take the plunge.

### 1.3 Next elections

The next elections for the lower house must be held by December 2018. There is a chance that Abe may call a snap election earlier than this to take advantage of the opposition's weakness and his continued high ratings. Either way, the LDP are well placed to secure another term in office and retain its majority in the lower house.

The next upper house election, when half the seats in the chamber go up for re-election, is due in 2019.<sup>5</sup>

### 1.4 Other developments

Emperor Akihito, who is 83, has announced his desire to abdicate. Public opinion supports him being allowed to do so and the government is planning to pass a special law that permits it, without setting any future precedent. His heir is his son, Haruhito, who is 56. There is debate about whether female members of the royal family might in future be allowed to ascend to the throne.<sup>6</sup>

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<sup>4</sup> Japan Country Risk Report, *BMI Research*, 1 January 2017

<sup>5</sup> Japan: Country outlook, *EU ViewsWire*, 1 February 2017

<sup>6</sup> "Time to consider resuming debate on creating female Imperial branches", *Japan News*, 29 January 2017

## 2. International relations

### 2.1 China

#### The East China Sea

Who has sovereignty over a collection of islands in the East China Sea has become the biggest single bone of contention between two countries whose relationship has long been complex and difficult. The area is seen by both as potentially rich in oil and gas – but little has yet been proven.

China calls the islands Diaoyu, Japan calls them Senkaku. Taiwan also claims the islands. Japan, which administers the islands, does not accept that there is a dispute to be resolved. China insists that there is.<sup>7</sup>

Tensions have risen over the last five years or so since the Japanese Government bought three of the islands from a Japanese private owner. China subsequently asserted its claim in 2013 by announcing the creation of an 'Air Defence Identification Zone' in the East China Sea under which all non-commercial air traffic was expected to submit flight plans before entering the zone. Neither Japan nor any Western country has either acknowledged the zone or complied with it.

In June 2016 a Chinese spy warship entered what Japan considers to be its 'territorial waters' in the East China Sea for the first time since 2004. While a foreign vessel passing through the territorial waters of another state is permitted under international law provided it does so quickly and without engaging in intelligence-gathering, few believed that this was a case of 'innocent passage'.

In early August 2016, seven Chinese coastguard ships and 230 fishing vessels were said to have entered the 12 nautical mile territorial sea (also known as the 'contiguous zone') around the islands. This is immediately adjacent to what Japan claims as its territorial waters. There are concerns about the fact that the size (or tonnage) of the Chinese ships being deployed in such incursions is increasing. Chinese ships have regularly done the same since then, albeit usually on a smaller scale.<sup>8</sup>

Such incidents often lead to Japanese diplomatic protests and the scrambling of its own fighter planes and ships.<sup>9</sup> The number of times it scrambled fighters in 2014 was the reportedly the highest for 30 years.<sup>10</sup> Japan is increasing its military capabilities in the area; for example, it has opened a radar station that can track movements in the area and give earlier warning of Chinese movements. It is also

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<sup>7</sup> The background to the 'dispute' is described in this Library briefing: [The Senkaku/Diaoyu Islands: tension between Japan and China in the East China Sea](#) (April 2013).

<sup>8</sup> "Japan says China ships enter waters around disputed islets", *BBC Monitoring Asia*, 22 January 2017

<sup>9</sup> "Japan and South Korea also deploy jets after Chinese military operations in area", *Irish Times*, 12 January 2017

<sup>10</sup> "Japan: 7 Chinese coast guard ships, 230 fishing boats in disputed East China Sea waters", *The Diplomat*, 8 August 2016

developing an amphibious military response plan to any threat to its continued administration of the Senkaku Islands.<sup>11</sup>

China has accused Japan of escalating tensions, including in July 2016 authorising two Japanese fighter jets to 'lock on' to Chinese aircraft, which can be a precursor to actually firing at them. It made a similar accusation in December. Commentators say that Japan has decided to deploy a new 'home-made' surface-to-ship missile with a range of 300 km on the Senkaku Islands by 2023.<sup>12</sup> In the nearer-term, Japan may buy surface-to-air missiles from US company Raytheon.<sup>13</sup> In January 2017, Japan launched its first military communications satellite to increase the broadband capacity of its defence forces.<sup>14</sup> There are also plans to increase its submarine defence capability. Japan's defence spending began to increase in 2015 after years of decline and is set to continue at record levels (\$44 billion Yen) in 2017.<sup>15</sup>

For some in China, such moves are of a piece with Japan's alleged 're-militarisation', which will be facilitated in future by planned changes to the country's 'pacifist constitution'.

Western commentators attribute China's "pushing the envelope" to its growing sense of diplomatic isolation over its claims in the South and East China Seas. China has been displeased by Japan's stance on the South China Sea (it has called on China to abide by the 2016 ruling by the Permanent Court of Arbitration under the UN Convention on the Law of the Sea) and may be seeking to warn it off from joining in US-led 'freedom of navigation' operations in the area in future. It has been reported that China has hinted that it will take military action should Japan (which has not ruled it out) take this step.<sup>16</sup> Others argue that China is seeking to provoke a Japanese 'over-reaction' in the East China Sea that would justify further escalatory action on its part.<sup>17</sup>

One US think-tank has warned that tensions in the East China Sea could be "approaching a slow boil".<sup>18</sup> Talks to establish a 'hotline' between the two countries have so far been unsuccessful.<sup>19</sup> However, some argue that the two parties will be able to avoid matters spiralling out of

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<sup>11</sup> "East China Sea: approaching a slow boil", CSIS Asia Maritime Transparency Initiative (n/d)

<sup>12</sup> "Japan plans island missiles to ward off Chinese naval aggression", *Financial Times*, 18 August 2016

<sup>13</sup> "Japan plans missile deployment in East China Sea", *globalresearch.ca*, 22 August 2016

<sup>14</sup> "Japan launches first military communications satellite", *Channel NewsAsia*, 24 January 2017

<sup>15</sup> "Japan sets record defense budget with eyes on China, N Korea", *CNN Wire*, 22 December 2016

<sup>16</sup> "Beijing 'hinted at military action' against Japan over South China Sea dispute", *International Business Times*, 21 August 2016

<sup>17</sup> "China: pushing the envelope in the East China Sea?", *The Diplomat*, 10 June 2016

<sup>18</sup> "East China Sea: approaching a slow boil", CSIS Asia Maritime Transparency Initiative (n/d)

<sup>19</sup> "Japan, China fail to make breakthrough in talks on maritime hotline", *Japan Economic Newswire*, 9 December 2016

control and that 'back-channel' communications continue to this end. Both insist that they remain open to dialogue on the issue.<sup>20</sup>

## Other issues

The issue of the Yasukuni Shrine, which honours 14 Class A Japanese war criminals, continues to act as an irritant to bilateral relations. Prime Minister Abe visited the shrine in person in late December 2016, his first visit in person since December 2013.<sup>21</sup> Then, a few days afterwards, Japan's defence minister Tomomi Inada, who Beijing views as someone with 'historical revisionist' tendencies, also visited.<sup>22</sup>

For Japan, one of the geo-political virtues of the Trans Pacific Partnership (TPP), an ambitious regional free trade agreement, was that it excluded China. Following its death at the hand of Donald Trump (see also below), Japan will likely remain more cautious than most about including China, which was not a party, in future initiatives.<sup>23</sup>

## 2.2 US

The US has long been Japan's most important ally. The US continues to stress its commitment to this alliance.

It has confirmed on several occasions in recent years that the Senkaku Islands are covered by the 1960 *US-Japan Security Treaty*, under which the US has pledged to come to Japan's defence if its security is attacked. The new Trump administration has already reiterated this position.<sup>24</sup> This is notwithstanding the fact that the US does not take a position on the sovereignty of the islands (this is also the UK position). The US supports the efforts of the Japanese Government to amend the country's Constitution so that its military can play a more active role in the world.

Nonetheless, there remains an underlying anxiety in Japan that the US might one day begin to loosen these ties. These were intensified by the statements made by Donald Trump during the election campaign, where he suggested that the US might withdraw its troops from Japan unless it bore more of the costs of stationing US forces and that Japan might need to develop its own nuclear weapons capability in future. 50,000 US soldiers plus their dependants and support staff are currently based in Japan. The US paid about \$5.5bn for its Japanese bases in 2016, with Japan paying \$4bn.<sup>25</sup>

The new US administration has already withdrawn from the TPP. Japan has indicated that it now considers the TPP to be 'dead in the water' and is looking at alternative ways of promoting free trade across the

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<sup>20</sup> "Prime Minister avoids controversial shrine as Japan marks WWII's end", *Boston Globe*, 16 August 2016

<sup>21</sup> "Remarks by Yang Jiechi on Abe's visit to the Yasukuni shrine", *Tendersinfo*, 2 January 2017

<sup>22</sup> "China, S Korea blast Japanese official's visit to war shrine",

<sup>23</sup> "Japan could trump the US on TPP with revised Asia-Pacific trade accord", *Business Times*, 23 January 2017

<sup>24</sup> "Flexign their muscles", *South China Morning Post*, 20 January 2017

<sup>25</sup> "Donald Trump open to Japan and South Korea having nuclear weapons", *FT.com*, 27 March 2016

Asia-Pacific region.<sup>26</sup> On the plus side, the new Secretary of Defence, James Mattis, has already indicated that it has no immediate plans to ask Japan to pay more of the costs of the US military presence.

While the Japanese political class is nervous about a maverick Trump presidency, it is likely to be pragmatic in its approach – and hope that new administration turns out to be similarly inclined. Prime Minister Abe was the first head of government to meet with Mr Trump after his election victory and a further meeting has been scheduled for 10 February.<sup>27</sup> Japan will welcome the new administration's less enthusiastic view of relations with China – but will certainly not want to see the kind of confrontation between the two countries that could destabilise the international order, let alone the Asia-Pacific region.<sup>28</sup> Unlike President Trump, Japan is not interested in challenging the 'One China' policy.

There continues to be controversy over long-standing official plans to relocate the US Marine Corps Air Station Futenma in Okinawa to a less urbanised part of the island. Many Okinawans want the facility to be removed from the island altogether – not moved to a different part of it. The Supreme Court has backed the government. In December 2016, the US returned 10,000 acres of land under its control to Japan.<sup>29</sup> Former US Ambassador to the UN John Bolton recently suggested that some US troops on Okinawa could be redeployed to Taiwan.<sup>30</sup>

The Japanese Government declined to join in the international condemnation of President Trump's announcement of a temporary tightening of its immigration policy towards seven predominantly Muslim countries.

In the past, the US has put pressure on Shinzo Abe and the Japanese Government not to visit the Yasukuni shrine – the memorial to Japan's war dead, which includes leadership figures accused of war crimes during World War II. Whether the Trump Administration will do so remains to be seen.

## 2.3 The Korean peninsula

Relations between Japan and **South Korea** remain tricky, despite recent efforts to 're-set' them. In December 2015 Japan and South Korea reached an agreement on the issue of former South Korean 'Comfort Women', whereby Prime Minister Shinzo Abe made a formal apology and announced that 1 billion Yen would be provided to a foundation to support those still alive. In August, Shinzo Abe authorised the release of the funds. But many South Koreans, including surviving former Comfort

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<sup>26</sup> "Japan could trump the US on TPP with revised Asia-Pacific trade accord", *Business Times*, 23 January 2017

<sup>27</sup> "US affirms 'ironclad' support for Japan", *Straits Times*, 30 January 2017

<sup>28</sup> "Obama's departure puts Japan's alliance with the US at a crossroads", *New York Times*, 28 December 2016

<sup>29</sup> "US returns 10,000 acres of Okinawa to Japan", *UPI*, 21 December 2016

<sup>30</sup> "Could US troops move from Okinawa to Taiwan?", *China Post*, 25 January 2017

Women, view the deal as insufficient.<sup>31</sup> To Japan's visible frustration, there have been protests against the deal in South Korea.<sup>32</sup>

South Korea and Japan also have an unresolved territorial dispute over the islets of Dokdo (as Koreans know them)/Takeshima (Japan). In 2016, a group of South Korean parliamentarians made a symbolic landing on the island, leading to strong Japanese protests. South Korea was no more impressed than China by Prime Minister Abe's visit in late December 2016 to the Yasukuni shrine (see above).

The two countries see much more eye-to-eye on the issue of **North Korea**. Japan protested forcefully in 2016 after a North Korean test ballistic missile flew over its airspace and landed in the Sea of Japan. North Korean threats to hold a long-range missile test on the day of President Trump's inauguration was condemned by Japan.<sup>33</sup> In January 2017, Japan joined with South Korea and Japan in conducting naval exercises to counter North Korea's missile capabilities.<sup>34</sup>

## 2.4 UK

The UK's vote to leave the EU has left Japan less confident about future relations. The UK Government has sought to reassure Japan (and in particular, Japanese companies based in the UK). Secretary of State for Business, Energy and Industrial Strategy, Greg Clark visited Japan in July 2016 to reassure business and investors that the UK remains open for business in aftermath of the Brexit vote. Chancellor Philip Hammond was in Tokyo in December with the same message.<sup>35</sup>

In recent years, the two countries have had an increasingly close defence and security relationship. Under a 2012 Defence Cooperation Agreement they agreed to jointly develop new weapons.<sup>36</sup> The security relationship includes cybersecurity, which has been called Japan's "Achilles heel".<sup>37</sup> In 2016, the UK and Japan conducted their first ever joint military exercise in Japan. In January 2017, the two countries signed a Defence Logistics Treaty which is intended "to make it easier for our armed forces to work together on a range of activities, including UN peacekeeping operations and joint humanitarian aid and disaster relief missions."<sup>38</sup>

The UK position on the East China Sea and other issues such as the Yasukuni shrine mirrors that taken by the US. But the scaling up of UK-Japan defence relations has raised questions in some minds about what

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<sup>31</sup> "How to save the Comfort Women agreement", *The Diplomat*, 14 April 2016

<sup>32</sup> "Can Japan lay its 'comfort women' ghost to rest?", *Korea Times*, 19 January 2017

<sup>33</sup> "North Korea threatens nuclear missile test fire on Trump's inauguration day", *Japan Herald*, 21 January 2017

<sup>34</sup> "S Korea, US, Japan kick off maritime drill to counter NK missiles", *Korea Herald*, 20 January 2017

<sup>35</sup> "Philip Hammond: Japanese banks are concerned about Brexit", *Guardian*, 15 December 2016

<sup>36</sup> "[A New Dimension of UK-Japan Security Co-operation](#)", RUSI conference report, May 2016

<sup>37</sup> "Japan's Achilles heel: cybersecurity", *The Diplomat*, 13 April 2016

<sup>38</sup> "[UK and Japan strengthen defence ties](#)", FCO press release, 26 January 2017

role it may play in the event of a military clash between Japan and China.<sup>39</sup>

## 2.5 Other relationships

Japan has been seeking to improve relations with **Russia** over the last year. Plans have been announced on both sides to boost economic ties. On the Japanese side, these moves may in part be intended to encourage Russia to compromise over the territorial dispute between the two countries, but also to dissuade it from moving too close to China. The first appears optimistic, the latter more achievable.

The territorial dispute centres on four islands which Japan calls the Northern Territories and what Russia calls the Southern Kurils. Russia currently occupies the islands. The dispute has been the main obstacle to good relations over the past 70 years and has meant that the two countries have yet to sign a peace treaty post-World War II.<sup>40</sup>

Russia is neutral on which country has sovereignty over the Senkaku Islands.<sup>41</sup>

The **EU** and Japan have been trying to agree an Economic Partnership Agreement but it eluded them in 2016. Both will return to negotiations this year and are hoping to reach agreement by the end of the year.

Japan has been pursuing a deeper security partnership with **Australia**, including better interoperability between the two defence forces. There has been discussion in both Australia and New Zealand about whether their ANZUS alliance obligations with the US could draw both into a conflict over the East China Sea. One think-piece has [argued](#) that if the US insists on their involvement, "it will be very difficult to remain on the sidelines".

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<sup>39</sup> "Britain's Dangerous Post Imperial Fantasies". *Morning Star*, 7 November 2016

<sup>40</sup> "Japan to continue talks with Russia on joint economic activity on Kuril islands – Abe", *ITAR-TASS*, 23 January 2017

<sup>41</sup> "Japan's 'new approach' to Russia", *The Diplomat*, 18 June 2016

## 3. Economy

Upon taking office in December 2012 Prime Minister Abe undertook a series of economic reforms that were collectively called 'Abenomics'. This section provides a short background to the economic situation prior to 'Abenomics', what the reforms were and why they were deemed necessary, and an update on the country's recent economic performance.

### 3.1 Background<sup>42</sup>

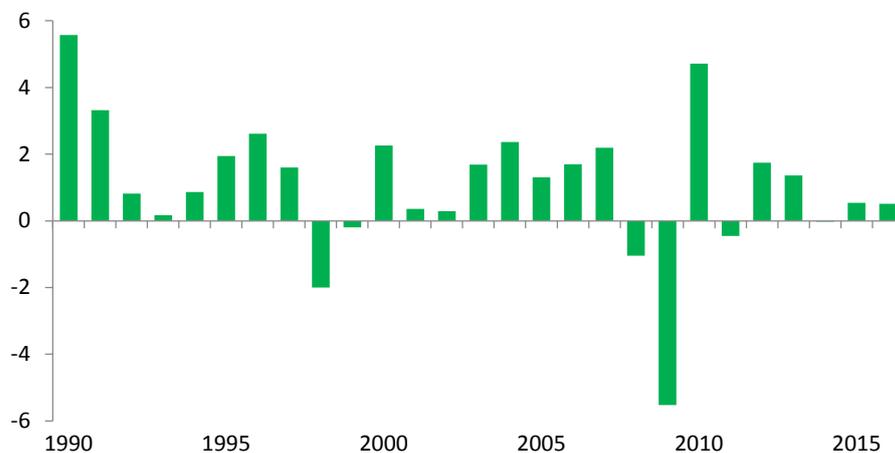
In the post-war period Japan's economy grew rapidly, averaging annual growth of 10% during 1955-1970, and around 5% in the 1970s and 1980s.<sup>43</sup> Large bubbles developed in the property and stock markets in the late 1980s, the collapse of which led to sluggish growth in the 1990s, known as the "lost decade". Lingering effects of this were still felt in the 2000s, as a modest economic recovery in the mid-2000s gave way, as in much of the world, to a deep recession in 2008-2009. Recovery was set back by the March 2011 earthquake and tsunami.

The Japanese economy, the world's third economy, faced (and still faces) three main problems when Mr Abe took office in 2012:

- **weak growth** over the past two decades, caused, in part, to structural problems including in the labour market;

#### GDP growth

% change (in real terms) on previous year



Source: IMF, World Economic Outlook Oct 2016 database

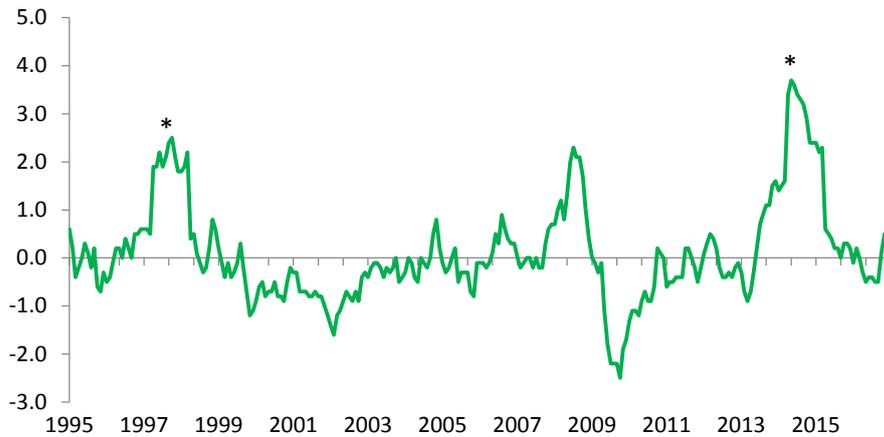
- **deflation** (falling prices) which has become entrenched since the late 1990s and has had a harmful effect on the economy;

<sup>42</sup> For more information on Japan's economic problems and its post-war performance (including the "lost decade" of the 1990s), as well information on Abenomics, see the Library's October 2013 briefing [Japan's economy: from the "lost decade" to Abenomics](#).

<sup>43</sup> Statistics Bureau of Japan, [Historical Statistics of Japan: National Accounts](#), table 3.1 and IMF, [World Economic Outlook \(WEO\) database](#)

### Consumer prices

% change over same month in previous year

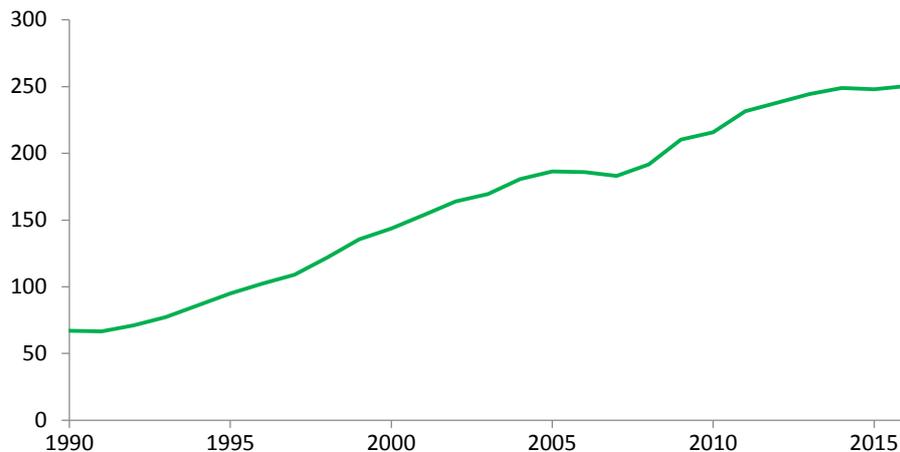


Source: National statistics agency, Japan \* Increases in consumption tax rate

- the **high level of public sector debt**. A weak economy and repeated government stimulus plans have led to debt levels currently unparalleled among major economies. Gross debt stood at 238% in 2012 (compared to 90% for the UK).

### General government gross debt

% of GDP



Source: IMF World Economic Outlook Oct 2016 database

## 3.2 Abenomics and recent economic performance

Abenomics is comprised of three strands, or arrows (named after a [Japanese folk tale](#)<sup>44</sup>). These policies are intended to address the main shortcomings of the Japanese economy as described above: weak growth, entrenched deflation and high debt, as well as the country's declining – and ageing – population. The three arrows – monetary

<sup>44</sup> A prominent feudal lord from the 16<sup>th</sup> century is said to have shown his three sons the benefits of working together by getting them to try and snap one arrow (easily done) and then to try and snap three arrows held together (not possible) thereby teaching them the significance of teamwork.

policy, fiscal policy and structural reforms – are described below, along with recent economic developments.

## Monetary policy

The Bank of Japan, the central bank, has dramatically expanded its quantitative easing (QE) programme, to be more aggressive in its attempts to end persistent deflation (falling price levels). Deflation can be harmful to economic growth as consumers may put off spending on goods and services as they will become cheaper in future and businesses are discouraged from investing.

The Bank of Japan (BoJ) had for most of the period since the late 1990s tried to end deflation and stimulate growth in the economy. Policies such as cutting the official interest rate to “virtually zero” and quantitative easing<sup>45</sup> (pumping newly-created money into the economy via banks) had by the end of 2012 failed to end deflation.

Mr Abe had vigorously pushed for the BoJ to be more aggressive in trying to end deflation. Upon taking office, he forced the BoJ to take a new more aggressive stance by implementing a 2% target rate for consumer inflation and appointing a new like-minded Governor, Haruhiko Koruda.

In April 2013, the BoJ announced a significant expansion of its quantitative easing policy – the BoJ would create a lot more money to buy financial assets (mostly government bonds) from the private sector. It was hoped that this additional money would filter through to the rest of the economy, pushing up inflation to its new 2% target.

Part of this policy was psychological: to get people thinking that prices would start to rise, breaking the cycle of deflation. Another element (not explicitly stated) was to weaken the value of the yen and make Japanese exports cheaper to foreign markets. The yen did fall sharply at the end of 2012 and in 2013 (by about 25% against the US dollar).

Initially this new policy appeared to be working, with inflation rising from below 0% in early 2013 to about 1.5% in early 2014. A rise in the consumption tax in April 2014 (more below) led to headline inflation rising sharply for a year, but looking through this temporary increase, a slowing economy - and falling energy prices - resulted in inflation easing again.

On 31 October 2014, amidst signs of slowing inflation, the BoJ [ramped up its QE programme](#) again from 50 trillion yen per year to 80 trillion (about £450 billion) – proportionately the largest QE programme among major economies.

However, inflation remained close to 0% during 2015, leading the BoJ in January 2016 to cut interest rates to -0.1% on some cash reserves commercial banks held at the BoJ.<sup>46</sup> The intention was to get banks to stop holding onto cash and to increase lending to the real economy

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<sup>45</sup> Japan was the first major economy to introduce QE in 2001.

<sup>46</sup> [“BOJ stuns markets with surprise move to negative interest rates”](#), *Reuters*, 29 January 2016

instead. The policy is generally viewed as not having achieved its goals, at least to date.<sup>47</sup>

A stronger yen over much of 2016 – it rose from 120 yen per \$1 at the beginning of the year to around 100 yen in September – added to the deflationary pressure as imports became cheaper. Deflation returned, with prices falling by 0.5% compared with a year earlier in mid-2016. Further stimulus measures were undertaken by the BoJ in September 2016. It announced it would not allow 10-year government bond yields to rise above 0%, essentially promising to buy any bonds above that level.<sup>48</sup> This promise aims to keep borrowing rates low across the economy. At the same meeting, the BoJ also announced it would deliberately try and overshoot its 2% inflation target in an effort to boost inflation expectations. Some analysts are sceptical as to how effective this will be given that inflation is still well below the 2% target in the first place.<sup>49</sup>

Following the election of Donald Trump to the US presidency, the dollar began to strengthen resulting in the yen falling against the dollar. This may help to boost inflation in 2017.

## Fiscal policy

Initially, this arrow of Abenomics called for a short-term stimulus designed to boost economic activity followed by a medium-term plan to reduce the large deficit and stabilise the level of public debt. However, further stimulus attempts have been implemented given the weak growth performance of the economy.

In January 2013, shortly after taking office, the Abe government announced a fiscal stimulus of over 10 trillion yen (about £75 billion or 2.2% of GDP). This was comprised of reconstruction funds for areas affected by the 2011 earthquake; money to help business investment; and, money to “revitalise the regions”.

Critics pointed to the large number of previous similar efforts to stimulate the economy via public funds (usually involving large-scale public-works projects) – the OECD estimates there were 15 such plans from 1990 to 2008. Critics also note that these stimuli only provide a short-term boost to the economy and add to an already extremely high level of public debt.

In order to address the large debt burden and build confidence in the nation’s fiscal sustainability, the government implemented a previously-agreed increase in the consumption tax rate (a value-added tax) from 5% to 8% in April 2014. The move was controversial given the last time the consumption tax was increased in 1997 the economy fell into recession. In order to mitigate against a repeat performance, Prime Minister Abe announced an economic stimulus package worth around 5

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<sup>47</sup> See for example, [“Negative Interest Rates Forcing Japanese to Stuff Cash Under Mattresses”](#), *Fortune*, 1 June 2016

<sup>48</sup> [“BOJ overhauls policy focus, sets target for government bond yields”](#), *Reuters*, 21 September 2016

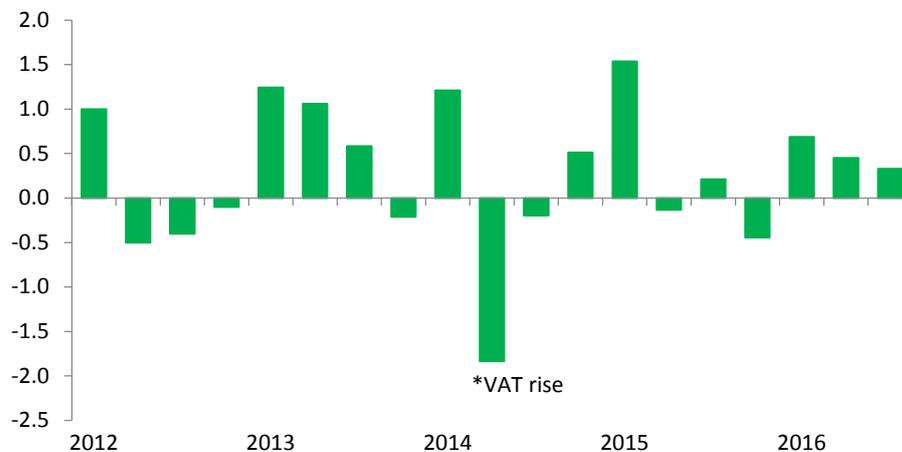
<sup>49</sup> [“BoJ launches new form of policy easing”](#) *Financial Times*, 21 September 2016

trillion yen (approximately £30 billion). A further stimulus of 3.5 trillion yen was announced in December 2014.

The rise in the consumption tax tipped the economy into recession in Q2 and Q3 2014 as consumers cut back on their spending. A rebound in growth around the turn of the year gave way to stagnation over most of 2015, as weakness in emerging markets led to falling industrial production and exports. A further planned increase in the consumption tax rate was temporarily shelved (delayed until 2019) by the government given the negative impact of the April 2014 increase.<sup>50</sup> Additional government stimulus was announced in December 2014 and July 2016 in an attempt to boost growth.<sup>51</sup>

### Quarterly GDP growth

% change (in real terms) on previous quarter



Source: OECDstat

GDP growth accelerated somewhat in 2016, and the outlook for 2017 remains relatively positive. In January 2017, the IMF estimated 2016 growth at 0.9% and forecast growth of 0.8% in 2017; higher than most estimates of the economy's trend growth rate of around 0.5% (given Japan's falling population among other things).<sup>52</sup>

Nevertheless, for growth to be more sustainable, consumer spending will need to be a bigger contributor to growth. However, for that to happen wages will need to increase at a faster rate than at present, particularly if consumer price inflation does eventually pick up (which would eat into real, inflation-adjusted, wage growth).

## Structural reforms

The final arrow of Abenomics is probably the most important (and difficult to implement) over the longer-term, made up of reforms to the labour market and deregulating some sectors of the economy. This is particularly important given the demographic challenges of an ageing population and the expected decline in the population over the coming decades.

<sup>50</sup> "[Abe Postpones Japan's Sales-Tax Hike Until Late in 2019](#)", *Bloomberg*, 1 June 2016

<sup>51</sup> For more on the stimulus measures see "[Japan Fiscal Plan Gives \\$45 Billion Spending Boost This Year](#)", *Bloomberg*, 1 August 2016

<sup>52</sup> IMF, [World Economic Outlook January 2017](#) and IMF, [Japan: 2016 Article IV consultation staff report](#), 2 August 2016, p8

Aggressive monetary policy and fiscal stimulus measures may provide a temporary boost to the economy, but, given past experiences, many believe only by tackling structural problems will Japan's economy be able to reverse two decades of underperformance.

The government announced some steps it intends to take as part of its "ambitious growth strategy" following reports in mid-2013 from committees looking into possible reforms. In June 2013 Prime Minister Abe made a speech presenting an overview of the strategy, which included:

- increasing the number of female workers (particularly mothers by improving availability of childcare) and younger people in work; and
- deregulating certain sectors, such as energy and health care, that are viewed as protected and uncompetitive. For example, plans have been announced to legalise the sale of non-prescription drugs.

The speech and subsequent announcements were viewed by some as underwhelming and lacking in detail.<sup>53</sup>

Subsequent reform measures, such as reforms to the corporate sector, have been introduced and received a mixed reception from analysts. For example, the IMF in 2015 stated that more needs to be done on reforms:

Abenomics needs to be reloaded so that policy shortcomings do not become a drag on growth and inflation. In addition to swift implementation of already announced reforms, further high impact structural reforms are urgently needed to lift growth, facilitate fiscal consolidation, and unburden monetary policy. The next round of reforms should lift labor supply, reduce labor market duality, continue agricultural and services sector deregulation and turn the financial sector into a driver of reforms.<sup>54</sup>

However, some give the government credit for attempting to tackle these fundamental problems and taking on vested interests that have long resisted such reforms. One area cited for its success has been the rise in the participation rate of women in the labour market – Japan now has a higher employment rate of working age women in work than the US.<sup>55</sup>

Overall though, most commentators think that the policy measures announced to date have not met the lofty expectations the Abe government had set back in 2013. *The Economist* is typical in its assessment of the progress of structural reforms, "Progress has been incremental, at best, prizing breadth over depth".<sup>56</sup> The IMF in a July 2016 assessment of the Japanese economy called for further structural reforms:

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<sup>53</sup> For example, see "[The third arrow of Abenomics: misfire](#)", *The Economist*, 15 June 2013

<sup>54</sup> IMF, [Article IV consultation on Japan](#), July 2015

<sup>55</sup> Source: OECDstat

<sup>56</sup> "[Japan's economy: Three-piece dream suit](#)", *The Economist*, 30 July 2016

**More structural reforms especially in the labor market are the only viable option to significantly raise growth prospects.** A stronger push on structural fronts would increase the chances of success of income policies by improving the effectiveness of fiscal and monetary policy and raising growth expectations. In particular, reforms should aim to:

- *Expand the labor force.* Boosting the labor supply of women and older workers and allowing for more foreign labor would be crucial to address a shrinking working-age population and protect the tax base.
- *Increase productivity.* Significant benefits can be reaped from: (i) promoting trade, FDI, and technology sharing by supporting the full implementation and possible expansion of TPP as well as proceeding with other trade and bilateral investment agreements; (ii) reducing barriers to entry to retail trade, professional services, and certain segments of network industries; and (iii) expediting deregulation in Special Economic Zones (SEZs) and subsequent rolling out nation-wide reforms to improve productivity and provide investment opportunities.
- *Enable capital deepening.* The financial sector's role in promoting innovation and new growth areas could be enhanced by encouraging securitization and private-equity funds; reducing government guarantees to SME lending to promote restructuring of viable firms and exit of nonviable ones; and fostering business succession.<sup>57</sup>

Another element of this growth strategy was the government's decision to join discussions on setting up a free-trade area for 12 countries (including the US but not China) bordering the Pacific Ocean. The Japanese Cabinet Office has estimated that joining the Trans-Pacific Partnership (TPP) could boost Japanese GDP by 0.7% in a decade.<sup>58</sup>

In February 2016, a deal was formally agreed between the 12 nations accounting for around 40% of the world economy. However, the US Congress did not ratify the deal during President Obama's final year in office despite his wishes and new President Trump has said the US will pull out of the deal.<sup>59</sup> What happens next to the TPP is up in the air. It is possible that the TPP in a new guise without the US may be adopted, although there may be limited appetite for that, particularly in Japan given Prime Minister Abe's description of the TPP without the US as "meaningless".<sup>60</sup>

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<sup>57</sup> IMF, [Japan: 2016 Article IV consultation staff report](#), 2 August 2016, p14

<sup>58</sup> Cabinet Office [estimate of the economic effect of joining the TPP](#) [in Japanese], Mar 2013

<sup>59</sup> [TPP: What is it and why does it matter?](#), *BBC News*, 23 January 2017

<sup>60</sup> ["Japan PM says TPP trade pact meaningless without U.S."](#), *Reuters*, 22 November 2016

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