

Why is japan's economy shrinking?



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WHY IS JAPAN'S ECONOMY SHRINKING SINCE 2011

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1. 1 AN OVERVIEW OF JAPAN'S ECONOMY

After the devastation of the Second World War, Japan's economy saw rapid progress propelled by the highly successful car and consumer electronics industries. Its economy is the world's third largest one and it is a major aid donor and a source of global capital and credit. This success story, however, started losing steam in the 1990s and was further precipitated by the 1997 Asian financial crisis and bouts of recession (BBC Website 2014). This was primarily due to mounting debt burden that successive governments could not address effectively. The public debt ratio has risen steadily for two decades, to over 200% of GDP (Jones & Kim 2013). After two severe shocks – the 2008 global financial crisis and the 2011 Great East Japan Earthquake – Japan fell into recession for the third time in five years. One of the biggest challenges also facing the economy is meeting the huge social security costs

engendered by an ageing society. In this light, the new government's resolve to revitalize the economy through a three-pronged strategy combining bold monetary policy, flexible fiscal policy and a growth strategy, is most encouraging (Milton 2014).

1. THE 2011 CRISIS

On March 11, 2011, a magnitude 9.0 earthquake struck off the east coast of Japan. The earthquake sent tsunami waves rushing into the coast of Japan and rippling out across the entire Pacific basin. An estimated 28,000 were dead or missing, and at least 500,000 were displaced (NASA 2011). To make things worse, radiation contamination was added to their concerns. The earthquake and resultant tsunami were bad enough; it also caused a radioactive leak at the Fukushima nuclear power plant. Japan's nuclear industry supplied a third of the country's electricity. In total, 11 of Japan's 50 nuclear reactors were closed immediately following the earthquake. The capacity to produce electricity was reduced by as much as 40%, and has remained at less than 80% of pre-quake levels. The World Bank estimated that Japan's disaster would cost between \$100 billion – \$235 billion, and take five years to rebuild (ABC NEWS 2011). The quake-hit Japan's north-east section is responsible for 6-8% of the world's third largest economy. Many wondered if Japan would need to sell U.S. Treasury to pay for rebuilding. However, Japan didn't need to because it was able to finance the rebuilding program from its people's savings. Although the Bank of Japan provided market liquidity to ensure the stability of financial markets, the long-term impact has been negative to the country's struggling economy (Nanto et al. 2011).

1. 3STRATEGIES ADOPTED BY THE GOVERNMENT

In July 2010, the government of Japan released the New Growth Strategy in order to propel the sagging Japanese economy into a higher growth trajectory. This was, however, followed unexpectedly by the crisis caused by the Great East Japan Earthquake and the nuclear power plant accident in March 2011. Hence, the Cabinet adopted the Comprehensive Strategy for Rebirth of Japan on 31 July 2012 in which four key policy areas were identified - green; life; agriculture, forestry and fisheries; and small and medium sized enterprises. The Strategy is to be implemented through 11 growth strategies, one initiative and 38 sets of priority policy actions in order to realize inclusive growth and “ Country of Co-creation.” Among the growth strategies was the revival of a strong middle class through creation of decent work for all; promotion of women’s active participation in workforce; and livelihood support (Boesler 2013). After being elected for the second term in Dec 2012, the Prime Minister of Japan Shinzo Abe revealed a policy mix of “ three arrows” consisting of (i) aggressive monetary policy to bring the economy out of deflation; (ii) flexible fiscal policy to ignite the dampened economy; and (iii) new growth strategy to restore the confidence of business and people. On 14 June 2013, the third arrow, “ Japan Revitalization Strategy” was approved by the Cabinet which details concrete initiatives for the realization of the growth through three action plans: (i) revitalizing the Japanese industry through employment system reform and reinforcement of human resources development; (ii) strategic market creation plan; and (iii) strategy for global outreach (AFP 2013).

1. 4IMPACT OF THESE STRATEGIES

Since Abenomics was launched, the “ deflation gap” (the difference between actual and potential output) has dropped from roughly three percentage points to below 1. 5. In fact, since Abe’s first arrow took flight, Japan’s stock market has soared with it, recording an unprecedented 40% annual gain, while the yen has depreciated against the dollar by 20%, boosting Japanese firms’ export competitiveness. Moreover, credit growth has accelerated and asset prices have risen. Monetary expansion is also having a positive impact on the labor market: the unemployment rate has fallen to 4%, and the job-to-applicant ratio is nearing parity (Hamada 2013). However, in April 2014, the International Monetary Fund cut its growth forecast for Japan and emphasized the need to follow through on promised reforms, particularly structural ones, to ensure a turnaround (Xu 2014). The core inflation rate, stripped of fresh food prices, fell slightly to 1. 3 per cent in June. That is better than the deflation in which Japan was trapped for 15 years. But it is not enough to ensure the central bank reaches its target of 2 per cent inflation by next spring. Employment data are strong, but wages are not picking up much. Many of the jobs being created are low paid. Growth, which had a promising start when Abenomics was launched in December 2012, has tailed off. The economy raced upwards as consumers front-loaded spending before this April’s increase in consumption tax, but then headed down to earth just as fast in the subsequent quarter. Even with the benefit of massive monetary stimulus, Japan’s economy has barely grown at all in the past 12 months (Editorial, ft. com 2014).

1.5 CONCLUSION

Shinzo Abe's three pronged strategy, also called "Abenomics," is one of the biggest economics experiments the world has ever seen. Japan faces myriad risks in the adoption and execution of Abe's grand plan, and critics have voiced plenty of concern over the audacity of the strategy. If the government relies too much on inflation to reduce the real value of its debt, investors might demand even higher real interest rates. An economic disaster could result from exploding debt and rising interest rates. However, most of the developed economies of the world are trapped in a zero interest liquidity trap situation and believe that there is no way out of it. If Japan shows a way out of that, it will be very encouraging.

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