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Economic implications of the Prime Minister's European trip, June 2013

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Abstract

As the second-tallest Japanese prime minister in the modern era, Prime Minister Shinzo Abe stood tall among other world leaders in the "family photo" at the recent 2013 G8 Summit, held at Lough Erne in Northern Ireland. The image seemed somehow symbolic of the fact that Japan has enjoyed an increased prominence in the global economy this year, as the effects of the new LDP administration's bold economic stimulus programme have started to take hold. The summit trip was part of a tour of European capitals which gave Mr. Abe the chance to make the case for Abenomics in person, and to seek to boost Japan's trade and investment relations with the EU in a number of areas. This discussion paper looks at how Abenomics is raising Japan's profile in Europe, and considers the economic goals of this trip - in particular, the goal of doubling Japan-bound FDI - and the likely effects of the "three arrows" in achieving these goals.

1 The European Tour

Mr. Abe has been active in pursuing a number of Europe-related initiatives in recent months. Following the EU-Japan summit in Tokyo in March, the two sides started negotiations in May for the proposed EU-Japan FTA. Also in May, Mr. Abe visited Moscow to discuss the Northern Territories/Kuril Islands dispute with Vladimir Putin, and hosted French president Francois Hollande in Tokyo in early June. En route to Lough Erne, Mr. Abe stopped off in Warsaw for a first-ever summit with the leaders of the "Visegrad Group", or "V4" (Poland, Hungary, the Czech Republic, and Slovakia), to make the case for Japan's nuclear power technology exports - one of his favourite themes on recent overseas trips (indeed, one could almost imagine the ghost of Charles de Gaulle dismissing Mr. Abe as "that reactor salesman").

At the G8 Summit, Mr. Abe raised North Korea-related security concerns with the other heads of government, but his main efforts went into explaining and seeking support for his "three arrows" - expansionary monetary policy, fiscal stimulus, and structural reforms - particularly in light of concerns in Germany and elsewhere about the weakening yen, which was down almost a third against both the dollar and the euro since its peak last year. After a visit to Belfast (discussed below), Mr. Abe gave a keynote economic policy speech in London, discussed in detail below. Finally, with Ireland currently holding the rotating EU presidency, he visited the Irish Taoiseach (prime minister) Enda Kelly in Dublin, to discuss the ongoing FTA talks, as well as negotiations for a separate Strategic Partnership Agreement.

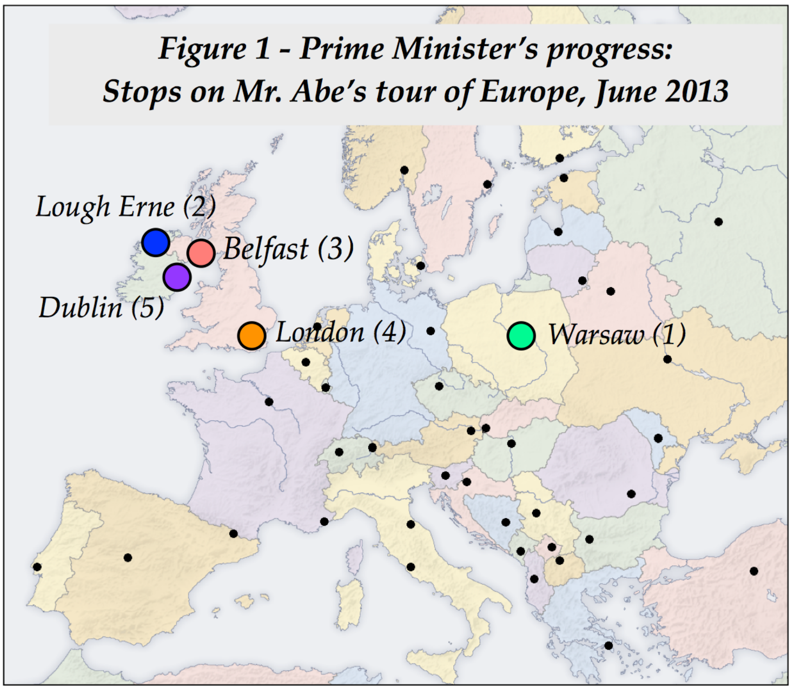


Figure 1 - Prime Minister's progress: Stops on Mr. Abe's tour of Europe, June 2013

2 Northern Ireland pays attention

In the short-run at least, Abenomics seems to be boosting Japan's image abroad. One example of this came when Mr. Abe visited Belfast, and was given red-carpet treatment by Northern Ireland's two political leaders, known under a power-sharing agreement as the First and Deputy-First Ministers. Mr. Abe was the only head of government apart from President Obama to visit the Northern Irish capital, and the interest he generated among politicians and in the media there gave an indication of the growing interest overseas in the potential of the Japanese economy.

In recent years, the Northern Ireland government - a devolved regional administration within the United Kingdom - has been pursuing a trade and development strategy focused largely on China, with its leaders undertaking a number of trade missions to Hong Kong and Beijing, and more recently to the US, Brazil, the UAE, and India. Japan, the world's third-largest economy, was notable by its absence from that list. Japan's relatively low profile there has changed since the visit, which coincided with the announcement of a large investment by a Japanese medical technology firm in Larne, near Belfast. The First and Deputy-First Ministers also accepted an invitation to travel to Tokyo in the near future to discuss trade relations. Thus, from east to west, there is evidence that Abenomics seems to be raising the profile of Japan and its economic policies in Europe in a way that we haven't seen for some time.

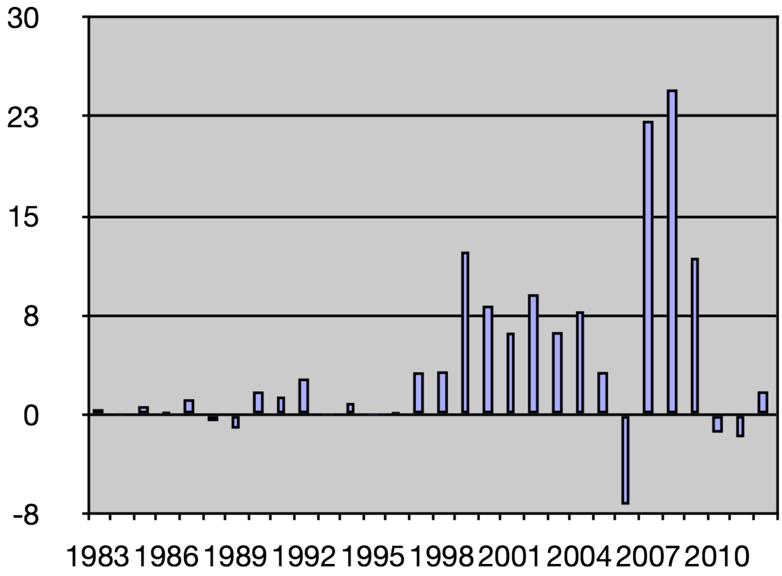
3 London keynote speech: Japan seeks FDI (again)

In the keynote economic policy address of the European trip, made in the Guildhall in the City of London, Mr. Abe acknowledged some of Japan's structural problems - deflation, low labour productivity, fiscal discipline - and emphasized his desire to implement meaningful structural reform, in what was a clear pitch to attract investors from the City and beyond. The prime minister outlined a goal to double the balance (i.e. stock) of direct investment in Japan by foreign companies by 2020. Of the three arrows, Mr. Abe said that the third arrow, structural reform, was the most important, and was underpinned by three key concepts:

- greater "openness" to investment and foreign skills, including through deregulation of the electricity market and a "wide spectrum" of other sectors;
- actively taking on "challenges", such as encouraging start-up enterprises and investment through tax incentives, and creating "National Strategic Special Zones"; and
- "innovation", to improve female workforce participation, increase childcare provision, internationalise Japan's universities, and grow and improve the healthcare market

Mr. Abe also used interesting some statistics to underline Japan's economic size and importance: in nominal GDP terms, he said, Japan is bigger than Germany and the UK combined; and were Japan to annualise the 4.1% quarterly growth rate it achieved in 2013 Q1, it would be the equivalent of a country the size of Israel emerging into the world economy.

Figure 2: Japan-bound-FDI, 1983-2012



Unit: USD, billion. Source: JETRO 2013.

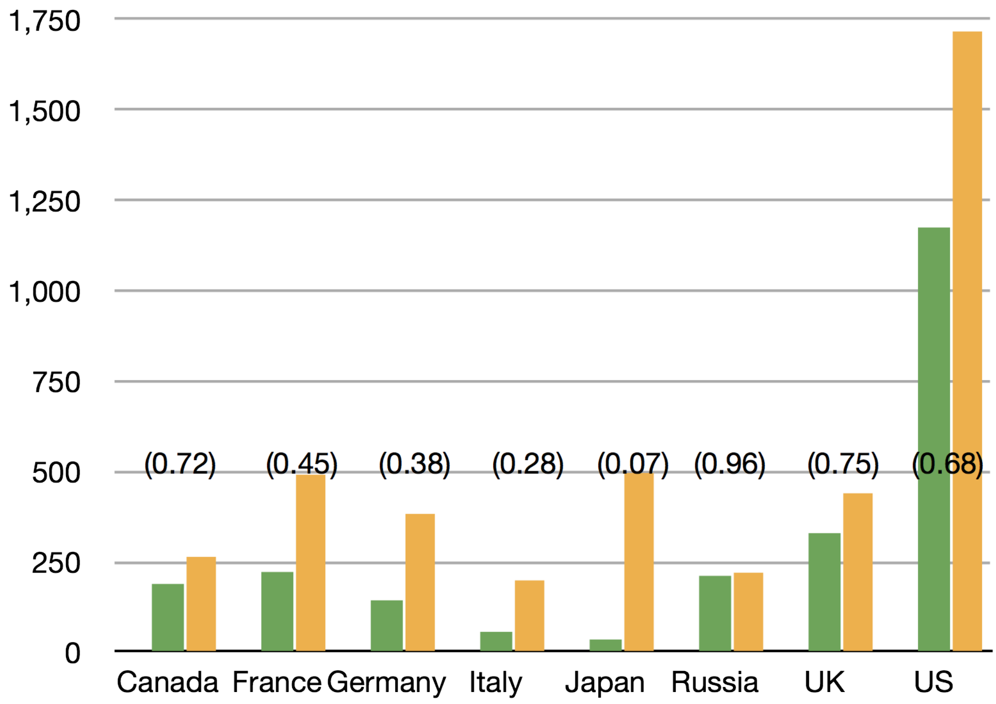
If a Japanese prime minister vowing to double Japan's inward FDI in a short period sounds somehow familiar, that's because it is: in 2003, Junichiro Koizumi set the same goal with a five-year timeframe - and the Japanese economy more than achieved it, only to see those gains reversed after the global crash (the Naoto Kan-led DPJ government also articulated a similar aspiration in its 2010 New Growth Strategy, though to little effect).

As Figure 2 illustrates, Japan's inward FDI grew rapidly around the turn of the millennium, reaching $12 billion in 1999, and after a dip, it surged again from 2006, peaking at $24 billion in 2008. The decline since then has been equally dramatic, and Japan again lags significantly behind other major economies in attracting FDI. Figure 3 shows that in the post-crisis period 2008-2012, Japan attracted the smallest cumulative FDI inflows (shown in green) of all G8 economies, receiving US$35 billion; the UK attracted $330 bn in the same period, Germany $144 bn, and the United States $1175 bn. By comparison, China, whose nominal GDP most closely matches Japan's (albeit with very different economic structural features), attracted $956 bn.

The situation is quite different with regard to FDI outflows (shown in yellow). In the same period, Japanese companies invested US$496 billion overseas, second only to the

United States ($1717 bn), and ahead of France ($491 bn), the UK ($440 bn) and Germany ($383 bn). The figure for China was $263 billion.

Figure 3: G8 FDI, Total Inflows and Outflows, 2008-2012



Unit: USD, billion. Source: OECD 2013.

Absolute FDI figures make for an imperfect comparison, since they fail to take account of relative economic size, among other factors. The figures in parentheses in Figure 3 provide the inward-outward FDI ratio for each country, an alternative measure for comparison, again shows Japan as an outlier among G8 nations. Other FDI measures, such as the UNCTAD FDI performance index, also show Japan under-performs relative to its potential.

The reason for this discrepancy has been the subject of much interest to both the academic and business communities. Studies suggest that the most important factors discouraging inward investment include strict and complex government regulation, high rent and labour costs, and culturally specific business practices which create a “closed market”. Underlying structural problems that negatively influence the Japanese market’s long-term economic growth prospects - such as population decline and ageing, and entrenched deflationary expectations - are also major reasons why so much domestic capital goes overseas and so little foreign capital has arrived from abroad.

As Ralph Paprzycki and Kyoji Fukao note in their insightful study *Foreign Direct Investment in Japan* (2008), inward FDI brings “management skills, business models, and the knowledge and technology embodied in products”, which would boost total factor productivity (TFP) though direct channels and indirect effects, like technical spillovers and increased competition. Moreover, one of the likely major recipients of increased Japan-bound investment would be the services sector, which is both a vital sector for Japan's future growth and one in which TFP has been lagging. The logic for encouraging more inward FDI is clear.

And yet, Prime Minister Abe seems to face a circular dilemma regarding his FDI goal and his broader aim of revitalizing the economy as a whole: foreign capital will only flow in if investors feel confident that the Abe administration will make good on its promises to finally tackle these regulatory and structural weaknesses; but at the same time, without the competition and innovation brought by foreign investment, it will be difficult for the Japanese economy finally to break out of certain rigid and inefficient practices that have held it back in recent years. In these circumstances, it is essential that Mr. Abe's commitment to structural reform is seen as credible by overseas investors.

4 The three arrows and the FDI target

Are the three arrows of Abenomics consistent with this target of doubling FDI? The first - monetary expansion - has left the yen significantly weaker against both the dollar and the euro than when the Abe administration took office at the end of December 2012. This makes investment in Japan a more attractive prospect for foreign companies, while also making overseas investment more expensive for Japanese firms. The second arrow - fiscal policy - also seems to be pointing in the right direction, if the policies in the keynote speech are implemented. Investment-related tax incentives should help attract FDI, since corporate tax rates in Japan are currently at 38% - one of the highest rates among OECD countries.[1] The possibility of a sales tax rise from 5 to 8% looms in the autumn, although the recent experiences of Germany and the UK suggest that the impact of a rise on domestic demand may not be much more than a short-term bump.

But the most important arrow, as Mr. Abe himself noted, is indeed structural reform. It is in this area that the government can do most, since many of these issues that hinder foreign businesses in Japan relate directly to government policy. According to METI's annual foreign business activity survey, these include product standards, complicated administrative procedures, and strict regulations. The government can also act to address more general problems, like developing human resources capable of interacting easily in English in global business environments, improving the research environment, and tackling the "exclusivity and distinctiveness of the Japanese market" (METI 2011). These issues have been around for some time; what may be different this time is that Japan has entered negotiations for the

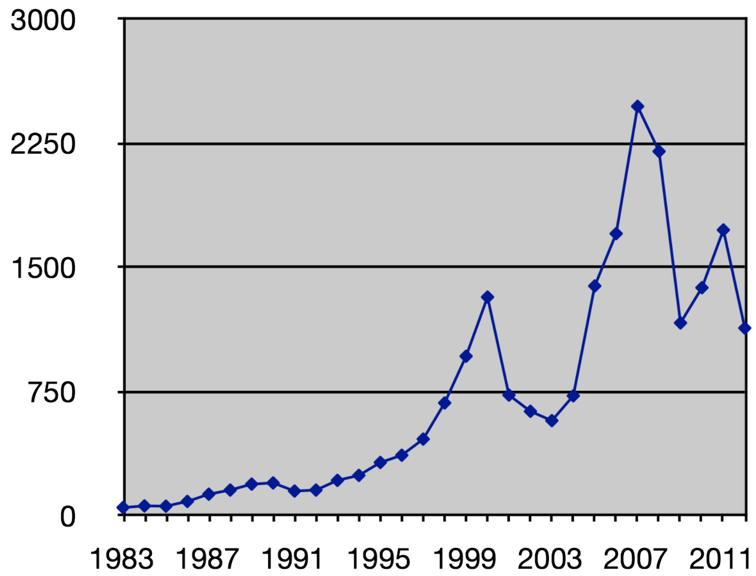
[1] It is worth noting, however, that many companies have paid a lower rate than this in recent years. For example, many megabanks paid no corporate tax at all for a decade or more until 2011, while in the process of disposing of post-bubble bad loans.

Trans Pacific Partnership (TPP), which could offer Mr. Abe the political cover he needs to implement meaningful reforms.

5 Government policy is not the only factor

There is another view worth considering: that the surges of Japan-bound FDI in 1999 and 2006-07 were caused, not by government policy, but as a consequence of increased global FDI activity generally in those years. In this interpretation, the fact that Mr. Koizumi's FDI goal was met was mainly due to good timing. Support for this interpretation is found in Figure 4, showing global FDI inflows between 1980 and 2012, which indicates a close correlation between global FDI inflow levels and inflows to Japan (shown in Figure 2, above).

Figure 4: Global FDI inflows, 1983-2012



Unit: USD, billion. Source: World Bank 2013.

The lesson from this is not that government policy doesn't matter, but rather that governments that wish to maximize inward FDI must first create the optimal conditions to attract it, and then wait for a favourable global investment climate to arise. And on this score, there is cause for optimism: although flows dipped in 2011-12, UNCTAD cautiously predicts that global FDI levels will stabilise in the coming year, and return to pre-crisis levels by 2015 (UNCTAD 2013: xii). If Mr. Abe can set Japan's economic sails in a more investment-friendly direction, the global winds should be at his back.

5 Conclusion: on tip-toes?

The early indications are that Prime Minister Abe's Europe visit seems to have generated a number of positive effects. Other G8 leaders gave a largely sympathetic hearing to his economic programme despite the yen-weakening that quantitative easing is causing; he gave a solid speech underlining his commitment to reform and calling for foreign firms to invest more in Japan; and he made efforts in a number of capitals to boost Japan's trade and investment links with a range of European countries.

And yet, when it comes to judging the medium- and long-term prospects for Abe's economic programme at both the national and international level, the devil remains very much in the detail. The LDP-New Komeito coalition's victory in July's Upper House elections would appear to suggest that Japanese voters are largely supportive of Abenomics and wish to see it continue (that said, the victory was achieved on a mere 52% turnout, with the LDP receiving the same number of total votes as at the last election, which they lost by a substantial margin). But whether monetary easing-induced inflation will truly feed through to stimulate an upturn in the real economy remains a matter of debate among economists - and one recent study here at APIR suggests that there is no noticeable effect of the current policies, once the impact of post-disaster reconstruction spending is controlled for.

Moreover, monetary and fiscal adjustments are essentially exercises in pulling policy-levers to implement desired policies, whereas structural reforms are better considered as acts of political virtuosity, as a reform-minded prime minister must employ all his political talents and wiles to overcome entrenched policy pathways and recalcitrant bureaucratic and sectoral interests. There is some scepticism in Japan about whether Mr. Abe has the attention to detail that will be necessary to see through his ambitious reform plans; the policies implemented so far are simply to a greater magnitude of the failed programmes of the past two decades, as yet with none of the "innovation" that Mr. Abe himself thinks will be so central in Japan's economic recovery.

Structural reform, then, is the key. Without it, the short-term buoyancy from loose monetary policy will not translate into demand-driven growth in the real economy, and Japan will be left with a debt-to-GDP ratio heading towards 300%. Without it, overseas investors will not find Japan any more attractive than they have done in the recent past, and the potential impacts of the EU-Japan FTA and the TPP will be much reduced. LDP governments are traditionally better at spending money than taking tough policy decisions, and Mr. Abe's ambiguous positions on raising the consumption tax and participating fully in the TPP remain causes for concern. At this point, there is no clear way of knowing whether Japan's economy is truly about to start standing tall again in the world economy, or whether it is currently standing on tip-toes. Europe, and the world, awaits Mr. Abe's next steps.

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*Your comments are most welcome. The author may be reached at: contact@apir.or.jp *

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