

## COMMENTINSIGHT & OPINION

# Politics undermining Japan's economic rejuvenation

Dan Steinbock says Abe's reform plan, now in its critical phase, will be derailed if tensions persist

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*Shinzo Abe is president of the Liberal Democratic Party and was elected prime minister of Japan in December 2012. He also served as prime minister in 2006 after being elected by a special session of Japan's National Diet, but resigned after less than a year*

After two "lost decades", Japan began its bold but risky reforms a year ago. The new governor of the Bank of Japan, Haruhiko Kuroda, pledged to do "whatever it takes" to achieve the 2 per cent inflation target, seeking to double the monetary base by the end of this year.

That was the first tenet of Prime Minister Shinzo Abe's economic reform agenda. It was followed by a major fiscal stimulus focused mainly on infrastructure spending.

The combined fiscal and monetary policies created joy in the markets. Abe made the point last September, when he rang the closing bell at the New York Stock Exchange and declared that "Japan is back".

But after these initial triumphs, the reform agenda faced its third and toughest challenge - a slate of efficiency-enhancing structural reforms.

What made the situation even trickier was timing. Abe had hoped to start fiscal consolidation after barely a year of expansion. Then politics got in the way.

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In Tokyo, the final 2013 parliamentary session was supposed to focus on reforms that would boost Japan's recovery. Instead, it was swept by a messy debacle over a controversial secrecy bill.

Further, Abe appointed assertive conservatives to Japan's public broadcaster NHK, including novelist Naoki Hyakuta, who announced that the Nanking massacre had never happened; and director general Katsuto Momii, who sparked another high-profile debacle by downplaying the tragedy of the "comfort women" who were forced to serve in brothels for Japanese soldiers during the second world war.

Last December, Abe himself visited the controversial Yasukuni shrine, which includes the graves of 14 Class-A war criminals. That escalated tensions further in the region.

Since then, Abe's strong 60 per cent approval ratings have dropped by some 10-15 percentage points.

The economic outlook has been similarly dim. During the last quarter of 2013, analysts expected Japan's growth to climb to 3 per cent. In reality, the economy grew at the tepid rate of 1 per cent.

Meanwhile, the US-led Trans-Pacific Partnership, which Abe needed to push structural reforms in domestic industries, is having to contend with increasing divisions, secrecy and popular concern for consumer protection.

In January, Japan's trade deficit widened to a record as surging import costs weigh heavily on Abe's efforts to foster growth.

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The first defining moment of Tokyo's reform agenda will follow early next month, when the administration plans to implement its consumption tax hike. Much also depends on the spring wage talks, which should support nominal pay rises to achieve sustained inflation and faster growth.

The BOJ is likely to wait a quarter or two to evaluate the full impact of the tax hike. If the impact is marginal, Kuroda will continue to sit tight. If, however, it affects lingering growth, he may well increase the BOJ's quantitative and qualitative easing programme.

To Kuroda, BOJ's 2 per cent inflation target is a vital goal.

Whether he succeeds will depend in part on the political environment.

Political and military risks have escalated in the East China Sea among Japan, China and South Korea over the extent of their respective exclusive economic zones.

Since late autumn, tension has increased around the disputed Senkaku/Diaoyu Islands, which were purchased by the Japanese government.

If tensions translate into major incidents, this is all just a prelude to something more serious, which would cause damage to sovereign creditworthiness in the region. That, as Standard & Poor's has warned, could result in action on ratings. While the agency does not see imminent threats, it expects tensions to prevail.

In the absence of change, East Asia could witness new, adverse scenarios - "black swans" with low perceived probability but a high potential impact in the region.

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It is amid these rising domestic and regional tensions that Japan is about to raise the consumption tax. An adverse scenario could penalise household spending more than anticipated, especially if the spring wage talks fail to achieve sufficient wage increases.

Japanese debt continues to worry. Today, almost 28 per cent of all long-term borrowing globally can be attributed to Japan - even though the economy represents only 8 per cent of the world total. Yet, its debt will continue to rise even as its economic role in the world continues to decline. That's an unsustainable equation.

A rejuvenated Japanese economy is in the interests of the region. Domestically, it requires accelerated reforms, which cannot be implemented without political support. Regionally, it needs reconciliation. Otherwise, Japan cannot achieve its economic goals.

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