Japan is in recession — a downward revision of gross domestic product (GDP) data on December 8 determined that — and the world's third biggest economy is performing well below the expectations laid out when Prime Minister Shinzo Abe took office nearly two years ago. Moody's Investor Service highlighted growing skepticism over Abe's policies when it cut Japan's sovereign debt rating one notch down to A1 from Aa3 on December 1. This put Japan's national debt one notch below China's.

The decision by Moody's reflected concern over Japan's ability to reduce its fiscal deficits after Abe decided to postpone an increase in the sales tax, from 8% to 10%, judging that the blow to the economy from an April 1 hike in the tax from 5% to 8% left the recovery too shaky for another increase. Abe promised to come up with a new fiscal consolidation plan by next summer, promising there will be no further delays, with a sales tax hike to 10% to come in April 2017.

Seeking a fresh public mandate for his tax decision, among other policies, Abe dissolved parliament and called an election for December 14 that polls suggest is virtually certain to give the ruling Liberal Democrats an even stronger majority, despite misgivings over the "Abenomics" economic agenda of fiscal stimulus, aggressive monetary easing — better known these days as "quantitative easing" —and structural reforms. Both economic data and public opinion suggest that so far, those policies — aimed at ending years of deflation — have done little to encourage consumers to spend more.

Instead, economists generally agree that Abe's chief achievements so far have been a weakening of the Japanese yen, which has both positive and negative implications for the domestic economy, and higher stock prices, which have benefited wealthy Japanese and big corporations. The yen, inflated by massive injections of money into the economy through central bank asset purchases, has fallen 47% against the dollar since January 2013. The Nikkei 225 stock index has climbed 69% in the same time period.

"Quantitative easing is a very risky strategy, and fiscal stimulus hasn't worked in the last 20 years. All it has done is it has taken Japan from [being] the least indebted major country to the most indebted major country," says Wharton finance Professor Franklin Allen. So far, he notes, Abe has not done much to push through the "drastic" reforms needed to shore up Japan's waning competitiveness. "The country is getting to the point now where it is going to need a major crisis to solve the problem. That is very unfortunate, but that is where it is headed," Allen adds.

Most Japan watchers and economists, and even Abe himself, say that to restore sustainable growth, Japan needs sweeping deregulation and structural reforms to cope with its growing public debt and its declining and aging population. But pushing through such changes is proving daunting, despite Abe's pledges to "drill deep into the bedrock" of Japan's vested interests.

Far From Passing

"The only good thing that has happened is the mood in Japan became more positive than in the last two decades," says Seki Obata, an associate professor at Keio University's Graduate School of Business Administration. Obata, author of the book *Reflation is Dangerous*, suggests that Abenomics-style policies — which, like "Reaganomics" three decades ago, are based on the anticipated "trickle down" effects from public spending and the enrichment of the wealthy — will not bring long-term stable economic growth in Japan. He gives Abe an overall score of 33 out of 100, far from a passing mark.

Japan needs at least nominal 3-4% GDP growth in the next ten years to put its economy back on track, but Abe has accomplished little with his “third arrow” of reforms, meant to complement the first two arrows of fiscal and monetary stimulus, says Masamichi Adachi, an economist at JP Morgan Japan Securities Co., Ltd. “Is Japan on track to have stable nominal 3% growth in the next ten years? That would be extremely difficult,” he says.

Abe decided to postpone the planned 2015 sales tax increase because real GDP unexpectedly contracted 1.6% in the second quarter of the fiscal year, which ends in March 2015, after a 7.3% decline in the first quarter following April’s sales tax hike. The real GDP growth in the second quarter of this fiscal year was revised down to minus 1.9% on December 8 from minus 1.6%. Even after Abe put off the tax hike, some economists revised their forecasts downward for the year. Japan Chief Economist Junko Nishioka at RBS Securities Japan Ltd. dropped her forecast for the full fiscal year to minus 0.6% from her earlier forecast of plus 0.1%, but revised the outlook for the next fiscal year to 1.6% growth from an earlier forecast of 1.4% growth. London-based Capital Economics also lowered its GDP growth forecast for the 2014 calendar year, to 0.3% from its earlier forecast of 0.9%. Its forecast for calendar 2015 is for 0.1% growth, down from 0.5%.

Indulging his prerogative as incumbent, Abe is expected to splash out more than $25 billion, or three trillion yen, in fiscal stimulus after the election. Unlike much of the earlier stimulus, Japanese media reports say at least some of the new spending will be targeted at low-income families and others whose spending power is falling as incomes fail to keep pace with inflation. Whether it will make a significant difference remains open to question.

“As for the stimulus package, they have spent enormous amounts of money over the last 20 years and it has never helped much before,” Allen notes. “I do not think it is going to help this time. Twenty-five billion dollars is not big enough.

It won't have much effect in a $5 trillion economy [Japan's GDP in 2013]. It's a very small dollop." Obata agrees with Allen. "I do not see the package as meaningful because it will make Japan's fiscal condition worse. The government decided to postpone the sale tax increase, which is in a way the biggest possible stimulus," Obata points out.

Japan is in recession — a downward revision of gross domestic product (GDP) data on December 8 determined that — and the world's third biggest economy is performing well below the expectations laid out when Prime Minister Shinzo Abe took office…

Bank of Japan (BOJ) Governor Haruhiko Kuroda surprised markets and investors with an October 31 announcement that the central bank was increasing its annual asset purchases to around 80 trillion yen, from the 60 trillion to 70 trillion yen announced in April 2013 when he took up his post and pledged to do whatever is required to attain an inflation target of 2%. The BOJ at the same time released a revised three-year forecast for growth and prices that halved the agency's growth estimate for the current fiscal year, which ends March 31, 2015, to 0.5% from the 1% it had predicted in July. It also lowered its median inflation forecast for the coming fiscal year to 1.7% from 1.9%. The BOJ forecasted 2.1% inflation in the fiscal year to end March 31, 2017, unchanged from its earlier estimation. Some economists expect Kuroda may end up increasing BOJ asset purchases further next July to help raise inflation expectations.

Post-Election Predictions

What is the likely scenario after the election? Most economists expect Abe to keep his majority in the Lower House. “I’d be very surprised if Abe didn’t win the elections. The main reason is there is no effective opposition in Japan right now. There is no alternative, and he knows that,” Allen says. While most Japanese say they have not yet felt a positive impact from Abenomics, many still view Abe and the LDP as the most realistic choice. The opposition Democratic Party of Japan, which lost to the LDP in December 2012, has public support ratings of only 10% at best, a third or a quarter of the LDP’s, depending on the survey.

The most recent poll by the Japanese financial newspaper *Nihon Keizai Shimbun*, on December 4, found the LDP is likely to win more than 300 out of the 475 seats in the Lower House, and may even take a two-thirds majority of 317 seats. Before the election, the LDP held 295 seats and its coalition partner, the New Komei Party, had 31 seats.

“There is a less than 5% chance that the LDP and Komei Party will lose their combined two-thirds majority,” JP Morgan’s Adachi says. “But the question is whether the LDP will have less than 300 seats or not, which is tricky because it means Abe will have less support within the LDP.” Abe says he will resign if the coalition cannot keep its majority and he is not able to push forward with his Abenomics strategy.

Long-Term Prospects

Although Abe postponed the two percentage point tax increase until April 2017, in the long-run, Japan has little choice about raising the consumption tax given surging costs for social welfare as its population ages, and its growing national debt, which at nearly 250% of GDP is the biggest among wealthy industrial nations. Financial markets were counting on Abe to deliver on promises for “fiscal consolidation.” A failure to push ahead with the tax hike could have severely shaken investor confidence, though so far the markets have instead reacted favorably to the pragmatic choice not to weaken the recovery further.

Allen says there is an issue of long-term fiscal sustainability for Japan and this is part of the risk. “At some point, there will be a significant problem in the form of capital flight from Japan. Whether postponing [the sales tax hike] two years will trigger that or not — I don’t know. There’s some chance of it, but probably it won’t make too much difference,” Allen notes. Eventually, though, Japan must tackle its debt situation. “The problem is they can’t keep on borrowing,” he points out. “It’s a question of what one thinks the short-term versus the long-term effects are. The long-term effects at some point will catch up with them — but it could take a long time. This is why it’s such a tricky issue.”

From Adachi’s point of view, the delay is not such a critical problem. “The loss of 2% of tax revenues for 18 months amounts to 8.1 trillion yen or 1.7% of GDP,” he says. “Relative to the general government current debt, which stands at 243% of GDP on the IMF estimate from 2013, the potential loss is fairly small.”

Hisakazu Kato, economics professor at Meiji University, is among many Japanese experts who say the government will have to drastically reduce pension payments, raise the age at which pensions begin from 65 years old and increase the national sales tax to at least 20%. The most recent estimate by the National Institute of Population and Social Security Research is that the Japanese population will fall to 97 million by 2050 from 127.5 million in 2012, based on the 2010 birthrate of 1.39 children per couple. By 2100, the population could fall below 50 million, according to Ryuichi Kaneko, a population expert and deputy director of the institute. Those over 65 now account for about a quarter of the population. By 2050, those over age 65 will account for 38.8% of the population, rising to 41.1% by 2100, according to the National Institute of Population and Social Security Research.

"Japan's population is declining by 0.2% a year and the over-65s are increasing rapidly," Adachi notes. "In order for Japan to have 3% nominal economic growth for the long-term, Japan needs a great deal of economic structural reform and social changes. I think what Abe is doing is not enough. Whatever the BOJ does, it is worse than buying time. People may realize later that it was a big mistake for the Japanese government to make people think that BOJ action is changing Japan."

Hiroshi Shiraishi, senior economist at BNP Paribas Securities (Japan) Ltd., who is a co-author of the report "Why Abenomics Did Not Work: The Miscalculation of the Japanese Government and Bank of Japan," says Japan's fiscal stimulus and monetary easing have reached their limits, and structural reforms will take a long time to have any appreciable impact on the economy. "They are supposed to implement the 'third arrow,' which [includes] painful reforms, but they are giving pain killing medicine by stimulus and monetary easing," Shiraishi says. BNP Paribas views the most likely scenario as one in which Japan will have full employment, and inflation will begin to rise in earnest, along with wages, from late 2015 and into 2016. At that point, "the BOJ will start outright financial repression."

The BNP also cites a potential sharp depreciation of the yen as a significant risk. As domestic depositors flee negative interest rates, the yen could fall to as low as 150 yen against the dollar and beyond, the firm says. That could eventually push inflation as high as 10%. The BNP raised its assessment of this probability to 25% on November 17 from 20%. "This scenario is that Japan will not be able to control yen deprecation and inflation. This would be disastrous because there would be spiraling effects from yen deprecation and inflation," Shiraishi says.

A Need for Structural Reform

Not all economists agree with this assessment. Nishioka at RBS doubts the weakening yen will trigger high inflation. In the past, the main cause for such a problem was a shortage of goods, she contends. "For example, Zimbabwe suffers from hyperinflation not because of a weakening currency, but because of shortages of goods. I do not think this will happen in Japan, because Japan has ample supplies of goods and services despite its population decline," Nishioka says.

What does Japan need to be able to attain sustainable growth? Some economists, including Julian Jessop, chief global economist at Capital Economics in London, view higher inflation as the only plausible answer to Japan's fiscal problem, but say that achieving the current inflation target of 2% would not suffice. Japan needs a nominal 4% GDP growth rate for at least a decade to reduce its net debt to GDP ratio to 100% from the current level of about 140%.

The public debt problem, so far, has not boiled over into a full-blown crisis, but the demographic changes could soon cause Japanese finances to get out of control. A sustainable real growth rate of only 1% would require an inflation rate of 3% or more, and further expansion of monetary easing is needed to achieve this. But that will not be enough, Jessop says. "In order to achieve a 1% real growth rate in the long-term, Japan has to implement structural reforms. The remaining 3% has to come from inflation, which is where I think that the Bank of Japan has to do a lot more work," Jessop notes. "The Bank of Japan has to keep inflation at 3% and keep it there for at least ten years. It seems very high for Japan, but most major economies have been running inflation rates of 2% or higher in the last ten years or so." The International Monetary Fund is projecting the net debt of Japan will climb to 148% in 2018 from an estimated 140% in 2013, below Greece's 170% but still well above the 80% level of the US.

Given the slow pace at which Japan has been tackling reforms needed to catalyze new industries, promote innovation and increase productivity, Japan may end up facing a fiscal crisis before any drastic action is taken, says Allen. Abenomics is no panacea, he adds. "The issue with long-term fiscal sustainability is Japan is potentially heading for some massive crisis. Maybe that will solve everything for it, but it is also likely to be extremely disruptive and politically dangerous."