

Abe's Three Arrows*

Revised: November 10, 2014

Shinzo Abe was elected Prime Minister of Japan in December 2012 after two decades of slow growth and falling prices. He pledged dramatic policy changes to revive the Japanese economy, dubbed the “three arrows” of “Abenomics.” We consult the Economist Intelligence Unit and press reports for specifics:

- Arrow #1: Fiscal stimulus. A sizeable economic stimulus package was passed by parliament in February of 2013, and a smaller one in October. The IMF reports that this resulted in a 2013 fiscal deficit of 7.6% of GDP and net government debt over 130% of GDP.
- Arrow #2: Monetary stimulus. After nearly two decades of deflation, the Bank of Japan (BOJ) announced in April 2013 an aggressive plan to expand the money supply to achieve an inflation target of 2%. Falling short of their target, the BOJ announced on October 31, 2014, a further massive increase in its balance sheet. Total assets of the BOJ are now projected to exceed 70% of GDP in 2015, more than double comparable figures from the Fed, the European Central Bank, and the Bank of England.
- Arrow #3: Structural reform. The government has proposed a broad array of micro-based reforms, including looser product-market regulations, a more flexible labor market, and smaller subsidies to an inefficient agricultural sector. However, the government has been reluctant to reduce Japan's high level of agricultural protectionism, which keeps out a range of agricultural products, including rice, from other countries. Many observers remain skeptical that the government will promote these structural reforms aggressively.

Your mission is to explore the impact of the three arrows using the aggregate supply and demand framework summarized by Figure 1.

- Explain, for each “arrow,” whether it affects supply or demand. Which way does each one shift the appropriate curve(s)?
- Compare the short- and long-term impact on output of the three policies. Which are likely to have the greatest impact in the short term? In the long term?
- The fiscal stimulus was enacted despite fears that Japan's public debt was reaching dangerous levels. To allay these fears, parliament raised the consumption tax from 5% to 8% in April 2014. At the government's discretion, a further hike to 10% is scheduled for October 2015. If the second tax hike is implemented, the IMF

*This was written with Kim Schoenholtz, Japan expert extraordinaire.

projects Japan's fiscal deficit to decline to 6.7% of GDP in 2014, 5.5% in 2015, and 4.7% in 2016.

What are the likely effects of these tax increases?

- Overall, which arrow do you think is most important to Japan's future?

Figure 1. Aggregate supply and demand diagram

