"Abenomics": Early Success & Prospects

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Introduction

"Abenomics" is a policy package of three "arrows": aggressive monetary easing; flexible fiscal policy; and a growth strategy. The package is designed to bring the Japanese economy out of 20 years of stagnation and 15 years of deflation, and put it on a sustainable growth path.

Let us go back in time to when Abenomics was first contemplated, that is, mid-November last year. The yen/dollar exchange rate was around 80 yen, and the Nikkei 225 stock index was around 7,800 yen. The growth rate had been stagnant for two decades, but especially during the global financial crisis, triggered by the collapse of Lehman Brothers. Prices had been declining for 15 years. As a result, both nominal and real GDP in mid-2012 was below that of 2008. The nominal GDP in 2012 was about 8% below 2008 — an incredible shrinking economy. For the previous two quarters, the growth rate had been in negative territory. Shinzo Abe decided that overcoming deflation would be a prerequisite for putting the economy back on the track of potential economic growth.

So here was his plan:

The first arrow, aggressive monetary policy, would take the form of quantitative easing (QE), that is, massive purchase of long-term government bonds and other assets. QE theoretically encourages the private sector to invest more in riskier assets, i.e., a portfolio balancing effect. An increasing demand for riskier assets, such as equities and foreign assets, would most likely result in stock price increases and depreciation of the yen. As the yen was too overvalued, monetary easing, which tends to depreciate a currency, would be an appropriate policy from an external balance point of view. Yen depreciation would make the yen value of profits from foreign sales in dollars larger, and would encourage greater export volumes in the future. Exporting firms' stock prices would rise in response to favorable export conditions, and also due to the yen's depreciation. Higher stock prices, in turn, tend to stimulate consumption through the wealth effect.

The second arrow, a flexible fiscal policy, would be designed as a quick fix to boost the economy out of deflation. However, the level of debt-to-GDP ratio was already very high at 200%, and the level of fiscal deficits since 2009 had been alarmingly high at close to 45% of the budget. Considering the very bad and deteriorating sovereign debt situation, fiscal stimulus cannot be very large or sustained. It has to be applied only to get out of a deflationary trap, as temporary prime-pumping. A plan for medium-term fiscal consolidation, mainly relying on tax increases, would have to be implemented to ensure fiscal sustainability; otherwise, the bond rate may start going up, which would become an unbearable burden on the government budget. Thus, "flexible" would mean short-run stimulus, followed by medium-run consolidation.

The third arrow, a growth strategy, would aim at raising the potential growth rate through regulatory reform. For example, entry barriers to agriculture, medical care and energy sectors could be relaxed. Then new businesses and entrepreneurs would enter the market and invest. They would introduce more efficient forms of production by exploiting economies of scale and scope. In the medium term, these investment and management changes would raise productivity, so that the potential growth rate would become higher. This is important, as the Japanese economy is now entering a stage of decline in the working-age population and increase in the retired population. Regulatory reform would also aim at raising the female labor participation rate, especially during the child-bearing and caring years, through deregulation of childcare facilities.

Combining the three arrows, this policy package can be understood by components of the GDP definition and straightforward growth theory. The first arrow will raise consumption (C) and net exports (NEX) through the wealth effect and exchange rate effect. The second arrow will raise government expenditure (G). If the two arrows are sufficiently successful in bringing aggregate demand higher, then investment (I) will rise in anticipation of the narrowing GDP gap. The third arrow, which stimulates investment (I), accelerates the potential growth rate, raising capital (ΔK), labor (ΔL) and productivity growth (ΔA). Thus, Abenomics works on all components of aggregate demand and aggregate supply:

Aggregate demand is $Y=C+I+G+NEX$ and aggregate supply is $Y=A\,F(K, L)$. Or to put it another way, potential growth rate $g=\Delta A+\Delta K+\Delta L$.

Early Success of First Arrow

The first arrow started to work even before Abe became prime minister. The House of Representatives (the lower house) was dissolved on Nov. 16, and investors in the foreign exchange and stock markets immediately forecasted that the Liberal Democratic Party (LDP) would win in the upcoming general election. Thus, the yen/dollar rate and stock prices started to move on that very day. On the day before the dissolution, the yen/dollar rate was 81 yen and the Nikkei 225 stock index was at 8,830 yen. In the election campaign, Abe declared the need to reform the Bank of Japan (BOJ), which had allowed deflation to continue for 15 years, arguing that an inflation target of 2% should be adopted and that aggressive quantitative easing should be the instrument to achieve this. The market gradually believed the plausibility of such steps, especially after the general election on Dec. 16 which the Abe-led LDP won. As prime minister, Abe has continued his campaign for a 2% inflation target and associated aggressive monetary easing.

After some strong persuasion, the government and the BOJ agreed to sign a document to declare that the BOJ would take the 2% CPI inflation rate as a policy target on Jan. 25, 2013. By this time, the yen had depreciated by 11% to 91 yen and the Nikkei stock index had risen by 24% to 10,927 yen. It is remarkable that only talk and expectation had produced such changes. The yen depreciated without any foreign exchange intervention and ahead of a massive expansion of the balance sheet of the BOJ.

Then Abe started to call for the appointment of a person who would support his idea of inflation targeting and aggressive quantitative easing upon expiration of the then governor's term. Eventually, he selected Haruhiko Kuroda, then president of the Asian Development Bank, as new BOJ governor. The first Monetary Policy Board meeting took place on April 3-4. The new policy was agreed and announced on April 4. Governor Kuroda explained the new policy termed "Quantitative and Qualitative Easing" (QQE) at a press conference with charts — an innovation in communication. On April 4, the stock index closed at 12,635 yen, some 43% up from Nov. 15; and the yen was at 96 to the dollar, a 16% depreciation since the same date.

The main instrument of conventional monetary policy, under a positive interest rate regime, is the policy interest rate. Monetary tightening raises the interest rate, discouraging bank loans and demand for investment among non-financial corporations. When the interest rate is stuck at zero, an additional policy instrument is quantitative easing, namely asset purchases by the central bank. Purchases of assets that are not conventionally purchased are supposed to change the expectations of investors and encourage them to rebalance their portfolios. Unconventional transmission channels — the exchange rate, stock prices and expectations — would become more important. Kuroda and his team laid out the April 4 policy change in such a framework.

Impressed by the BOJ's decision, investors sold the yen, but purchased Japanese equities. On May 9, the yen/dollar rate crossed the 100 yen line. Stock prices continued to rise and the yen continued to depreciate. On May 22, the Nikkei 225 closed at 15,627 yen (up 77% since Nov. 15), and the exchange rate became 103 yen to the dollar (a 21% depreciation). Some critics thought the pace of yen depreciation and stock price increases had become too fast.

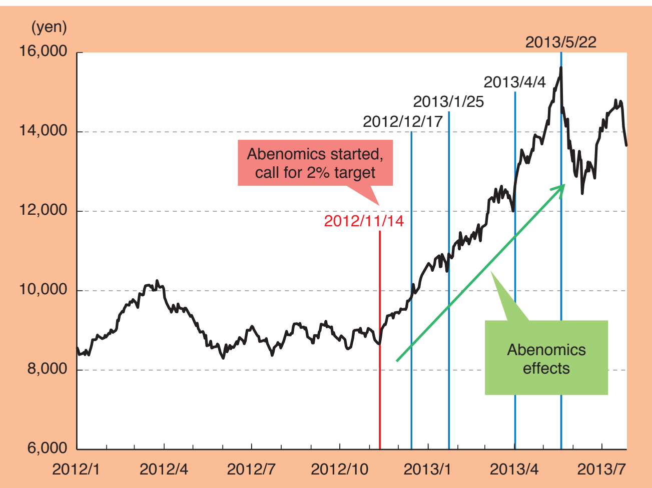
On May 22, in the United States, "tapering" — that is reducing the pace of asset purchases by the Federal Reserve — became a possibility, or so thought market participants, based on the remarks of Chairman Ben Bernanke. The yen started to appreciate and stock prices started to decline. By mid-June, the yen and stock prices returned to the level of April 4. Critics thought that a mini bubble caused by QQE was over. However, the yen again depreciated to 100 and the Nikkei 225 index rose above 14,000 yen. So the critics have so far been proven wrong.

How should we understand these movements in stock prices and exchange rate? One element was fundamentals. The level of the yen at around 80 yen to the dollar was widely considered to be an overvaluation of the Japanese currency. Hence, depreciation since mid-November can be understood as an act of fundamentals. The safe-haven effect — fleeing from the US dollar since late 2008 and from the euro since late 2010 — seems to be finally over. Although this was driven by fundamentals, Abe's insistence on aggressive monetary easing and criticism of the BOJ triggered herd behavior.

The other element was expectations. Persistent talk of 2% inflation

CHART 1

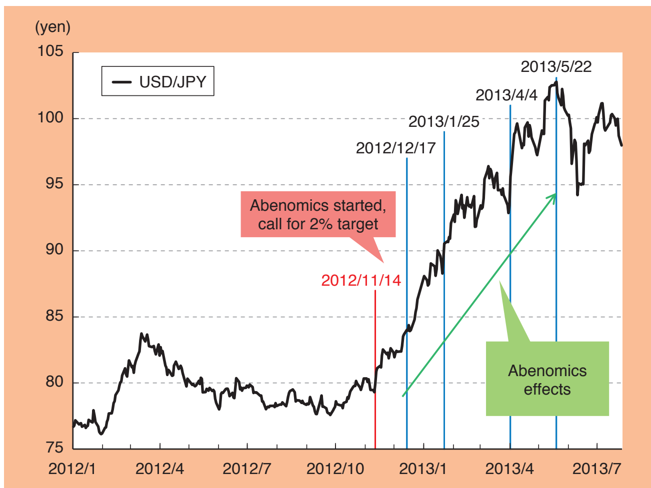
Nikkei 225



Note: Graph created by the author.
Source: Daily closing prices, published by Nikkei

CHART 2

Yen/dollar rate



Note: Graph created by the author.
Source: Yen/dollar rate at 17:00 JST, published by BOJ

and aggressive monetary policy made the market believe that such a policy would be adopted by the new governor. So by the time the new policy was announced on April 4, some of the effects of aggressive easing had already been priced in. It is difficult to argue whether fundamentals or expectations contributed more. The sharp decline in stock prices and appreciation of the yen from May 23 to mid-June were caused mostly by US "tapering" fears and a slowdown in the Chinese economy.

The depreciated yen brought a strong sense of relief and regained confidence among Japanese manufacturing firms. Rising stock prices made consumers feel wealthier and consumption rose sharply. The growth rate of the first quarter of 2013 was 4.1% (annualized quarter-to-quarter growth rate). Second-quarter growth is also expected to be high (2.5% to 3%). This would be growth from a large slack (GDP gap) to normal, but even so it is evidence in support of the success of the first arrow.

Challenge for Fiscal Policy: Second Arrow

With the GDP gap being large and prices declining, fiscal stimulus as a counter-cyclical policy makes sense. It makes even more sense when the interest rate is already zero. The fiscal multiplier is supposed to be at maximum when the economy is caught in a liquidity trap. So argue those who favor fiscal stimulus as a quick fix to overcome deflation.

The Japanese debt-to-GDP ratio, at around 200% and rising, is at a very high level never seen before among advanced countries without a war debt. Greece, Argentina, and Russia defaulted on their sovereign debt at much lower debt-to-GDP ratios. It has been sustained only because the yield is low, and therefore the interest payment burden on the government. The low interest rate has been supported by risk-averse, home-biased ample savings by households. However, baby boomers are about to retire and household savings are expected to shrink in the next decades. By the mid-2020s, savings will not be able to absorb the increasing amount of government bonds, and a crisis will occur. So argue those who worry about debt sustainability.

How can these two views be reconciled? One answer is a "flexible" fiscal policy, the second arrow. Fiscal stimulus, of about 10 trillion yen, or 2% of GDP, has been applied in the first half of this year, with a supplementary budget that passed the Diet in February 2012. Quick disbursement in the second quarter will make sure that second-quarter growth numbers are good.

There are three reasons for this pinpoint stimulus. First, fiscal stimulus will ensure that the GDP gap will shrink quickly to hasten an exit from deflation. The early application combined with QQE by the BOJ will move the sluggish economy. Second, it would help the government win votes in the July election (as seemed to be the case). Third, a high growth rate will be used in the decision on a "go" or "no-go" for the planned consumption tax hike. The consumption tax rate is scheduled to rise from 5% to 8% in April 2014, and again from 8% to 10% in October 2015. The legislation for this, already on the books, has a footnote that says a final decision to go ahead will be based on the economic conditions at the time. This is widely interpreted as a final "go" for the April 2014 increase to be decided in September this year. Hence, the growth numbers available at that time, namely the second-quarter rate, will be important.

In a sense, this pinpoint fiscal stimulus has two roles: the economic role of a big push toward an exit from deflation and the political role of medium-term fiscal consolidation. The consumption tax rate hike is crucial for regaining fiscal sustainability.

Income and corporate taxes are difficult to raise. The corporate tax rate is the highest among OECD countries. It has been argued, indeed, that the rate should be lowered due to the hollowing-out of manufacturing companies. Higher personal income tax would discourage workers from working longer hours at a time when a labor shortage is around the corner due to the aging population. Moreover, pensioners who are receiving unfairly large pensions due to past miscalculation of growth and demographic changes would not contribute to fiscal consolidation. Cutting wasteful expenditure is always good, but this had already been tried by the Democratic Party of Japan when it was in government and not much was achieved. Social security expenditures are the only big item that could be substantially cut, but political resistance will be also very great. So a consumption tax hike is the answer.

But there are critics of this arrow. They argue that fiscal spending under a supplementary budget is a revival of old-style LDP politics. Money would be spent on wasteful public works. However, it has been clarified that fiscal expenditure would be mostly for repair and maintenance work on existing infrastructure and reconstruction of tsunami-devastated areas.

Skeptics would point out that fiscal stimulus in order to buy fiscal consolidation is tricky. If consolidation does not follow, for some reason, then the action would hasten an eventual fiscal bust. So a judgment needs to be made on whether fiscal stimulus would make people's lives easier so that politically bitter medicine can be taken or whether fiscal stimulus would make people more relaxed about the fiscal situation.

The second arrow is also on target with the quick disbursing of budgets. But the risk is the second part, fiscal consolidation. The success of this arrow is not as straightforward as the first arrow. It will be a success only after fiscal consolidation gets on track. If the consumption tax rate hike is delayed or scrapped, there will be a significant risk in medium-term sustainability. If the consumption tax hike is successful, the probability of achieving medium-term fiscal sustainability significantly increases.

Yet to Be Released: Third Arrow

The third arrow is designed to increase productivity in several key industries. Higher potential growth is a key for revival of a stagnant economy, like the Japanese economy of the past two decades. Higher productivity growth makes it possible for firms to pay higher real wages. This is politically important as critics of the 2% inflation target argue that inflation hurts workers with nominal wages being constant. A higher growth rate is also important for fiscal sustainability (with less pain), since all major taxes, especially income tax and corporate tax, are sensitive to economic growth.

A growth strategy is not new. In each of the last seven years, a growth strategy paper was issued by the Ministry of Economy, Trade and Industry (METI). For example, in August 2010, under the DPJ government, METI issued "100 Actions to Launch Japan's New Growth Strategy: Maximize the Market's Functions through Reimagined Public-Private Cooperation". Many of the items for change have been similar during the past seven years.

But one important distinction between a growth strategy and a fiscal policy is that a growth strategy should be based on regulatory reform and not require too much taxpayers' money. Careful reexamination of a heavily regulated economy will result in increased production and higher income.

So which industries will be targets of regulatory reform? The following four areas have been identified as promising: labor; agriculture; health and medical care; and energy. First, labor reform, in particular mobilizing the female labor force, is high on the agenda. The working age population, that is 20 to 64, is decreasing fast, with 7.8 million people (10% of the population in that age bracket) lost in the decade from 2010 to 2020, and another 5 million people (8%) in the following decade. Women of child-bearing age should be able to continue working if infant/child daycare facilities are readily available. The scarcity of such facilities and waiting lists, especially in metropolitan areas, have been discussed for years but never solved. This should be addressed immediately. Making the retirement age flexible is also important to enable healthy elderly workers to continue working.

Second, agriculture is conventionally considered to be a backward industry. Many people think that agriculture in Japan involves high costs and can in no way compete against possible cheap imports from Australia, New Zealand, and the US. The notion of an unproductive industry has contributed to Japan's past behavior of strongly protecting agriculture in GATT/WTO/FTA negotiations, at substantial political cost. However, various measures have been proposed to increase productivity and lower production costs. Allowing the entry of non-agricultural firms and encouraging (with carrots and sticks) large scale operations will be key elements in reviving agriculture from a losing industry to a winning operation. Allowing low-cost producing areas/farmers to produce more (rather than imposing quotas) and spurring the exit of high-cost producers (possibly with limited severance pay) are necessary. Branding for high quality is also promising. With increasing numbers of the middle-class in Asia and rising consciousness of food safety, some Japanese agricultural products, typically high-priced fruits, have become exports. This recent trend can be enhanced by regulatory reform. The success and confidence of Japanese farmers is vital for Japan to conclude trade deals, such as the Trans-Pacific Partnership and an FTA with the EU.

Third, health and medical care is also an industry under regulation. Although keeping costs down, in order to limit government subsidies, is important, compensation for the industry needs to be raised to maintain the level of workers. The growing demand due to the aging population needs to be satisfied without proportionally increasing government expenditure. A comprehensive reform of social security and pensions is now being discussed, and a report is expected this fall.

Fourth, the energy sector needs reforming and strategically re-thinking. Prior to the tsunami and the Fukushima nuclear power plant disaster, energy strategy was dependent on expanding nuclear power. However, since the disaster this has become unrealistic. There is significant support for promoting renewable energy, but costs would be devastatingly high, at least with current technology. Electricity demand has been met by high-cost natural gas imports. In the medium term, a re-evaluation of how to generate and distribute electricity efficiently is necessary.

Is there any risk? Obviously, the first risk is the failure of implementation. Policymakers are familiar with the list of wonderful ideas, and there is a reason why each idea has not been implemented, often political resistance due to vested interests. Regulatory reform often involves introducing competition into the market or industry. Politicians have to make big decisions to overcome resistance. A safety net may have to be prepared before regulatory reform, if more competition means some people have to exit from the market. A package deal has to be crafted, and that is the difficult part.

The second risk is that a growth strategy becomes a new type of industrial policy with allocation of new expenditures. Realistic reforms involve both carrots and sticks, but if the carrots are introduced ahead of the sticks the growth strategy could cause the budget situation to deteriorate rather than improve.

A growth strategy, ideally, is aimed at increasing productivity without government expenditures. Political leaders who are advancing Abenomics have to consult experts and economists so that they can prioritize the reforms using criteria that will have maximum impact on growth, without too much government expenditure, and then implement them. Prioritization and implementation are the key.

Conclusion

Taking the three arrows together, Abenomics has a chance of lifting the economy out of the deflationary trap. The first arrow is on target, and the second arrow has also been successful in short-term stimulus. The crucial question now is the implementation and effectiveness of the third arrow. If a successful third arrow is applied, the Japanese economy will once and for all jump from a deflationary equilibrium into a normal growth economy. JS

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