

For distribution

Abenomics

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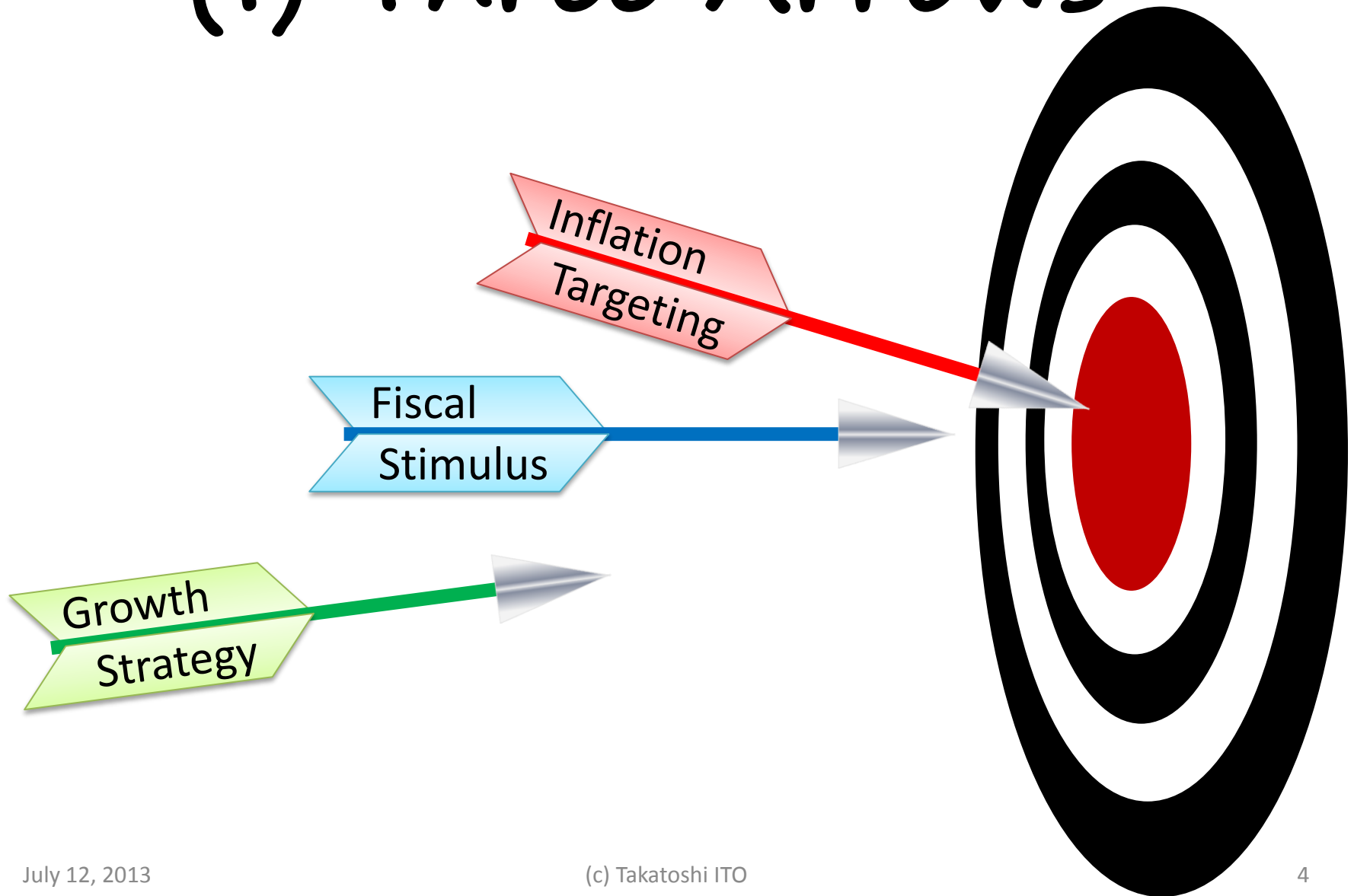
Takeaways

- **(0) Abenomics, early success**
 - Yen depreciation (by 25%) and Stock prices increases (by 50%)
 - In May, sliding back slightly. But, substantial yen depreciation and stock prices stay, giving substantial a breathing room.
- **(1) Three arrows: *Abenomics* is a package of**
 - **Monetary policy:** Inflation targeting backed by drastic easing
Japanese monetary easing is NOT targeting the exchange rate
 - **Fiscal policy:** Short-run stimulus followed by Medium-run consolidation
 - **Growth strategy:** Structural reforms to make industries strong again; this is a key for long-term success of the Japanese economy including fiscal consolidation;
- **(2) Economic theory**
 - **A Jump** from a bad (deflation) to a good (normal) equilibrium
- **(3) Success hinges on how “the jump” can be achieved**
 - It is likely to happen if all things proceed as planned
 - Risk, possible distraction to political agenda after July election

What is *Abenomics*?

- A package of economic policies advocated by Mr. Shinzo Abe, who became PM on Dec 26, 2012.
 - He was PM in 2006-07, that was episode I.
- *Abenomics* consists of “3 arrows”
 - Monetary Easing
 - Fiscal Stimulus
 - Growth Policy
- Markets strongly welcomed *Abenomics* so far.
 - Yen depreciated
 - stock prices rose
- Consumption is rising; and mood is getting better
 - The market started to change in mid-2012 when then PM Noda dissolved the Diet (LDP led by Abe was expected to win the election.)

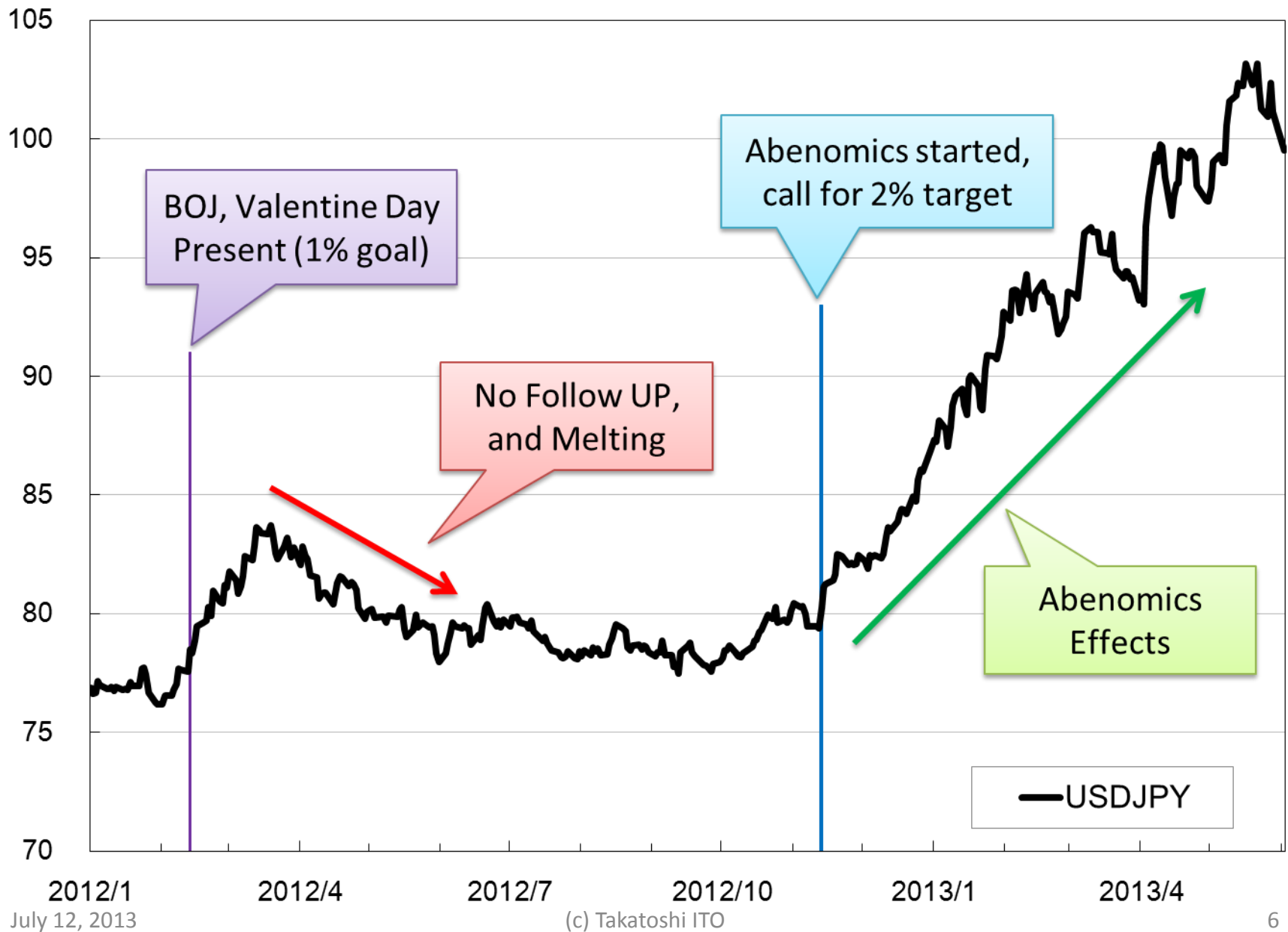
(1) Three Arrows



Inflation Targeting

- Objective. To break “deflationary expectation”
 - The **real interest rate** ($= \text{nominal rate} - \pi^e$) **will decline**, &
 - Investment and Consumption will be stimulated
- BOJ, important developments
 - 2% Inflation targeting on January 22, 2013, under Gov. Shirakawa
 - **April 4, 2013: Quantitative and Qualitative Easing (QQE) under Gov. Kuroda**
 - April 24, 2013: Outlook, forecast of 1.9% by 2015
- Is it credible?
 - Credible as the BOJ under Gov. Kuroda is committed to QQE
- (Skeptic) Does QQE work?
 - (Answer) It worked in FRB, BOE, ECB preventing deflation.
 - (Answer) Timing and communication is important

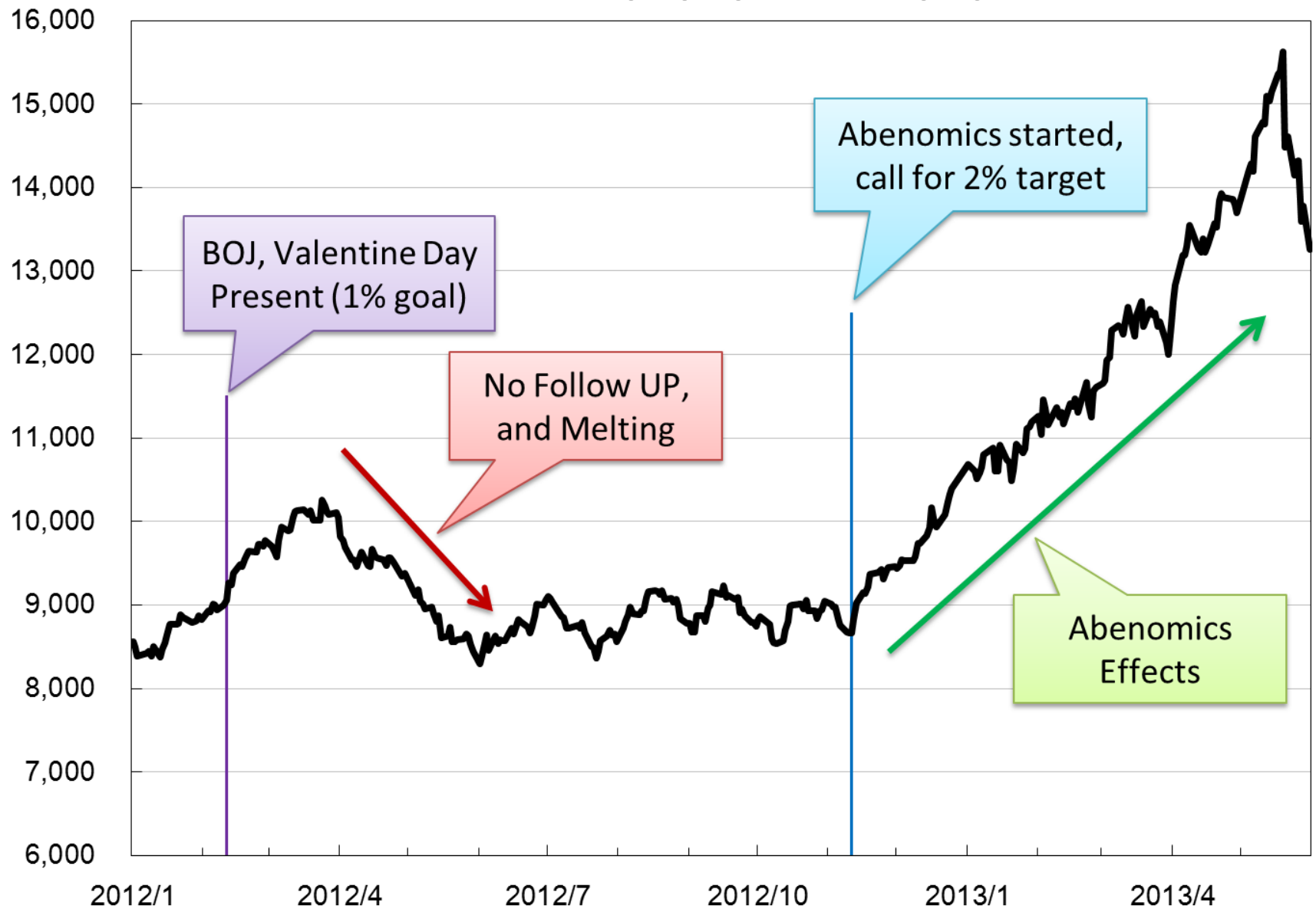
USDJPY 2012/1/1/ - 2013/6/3



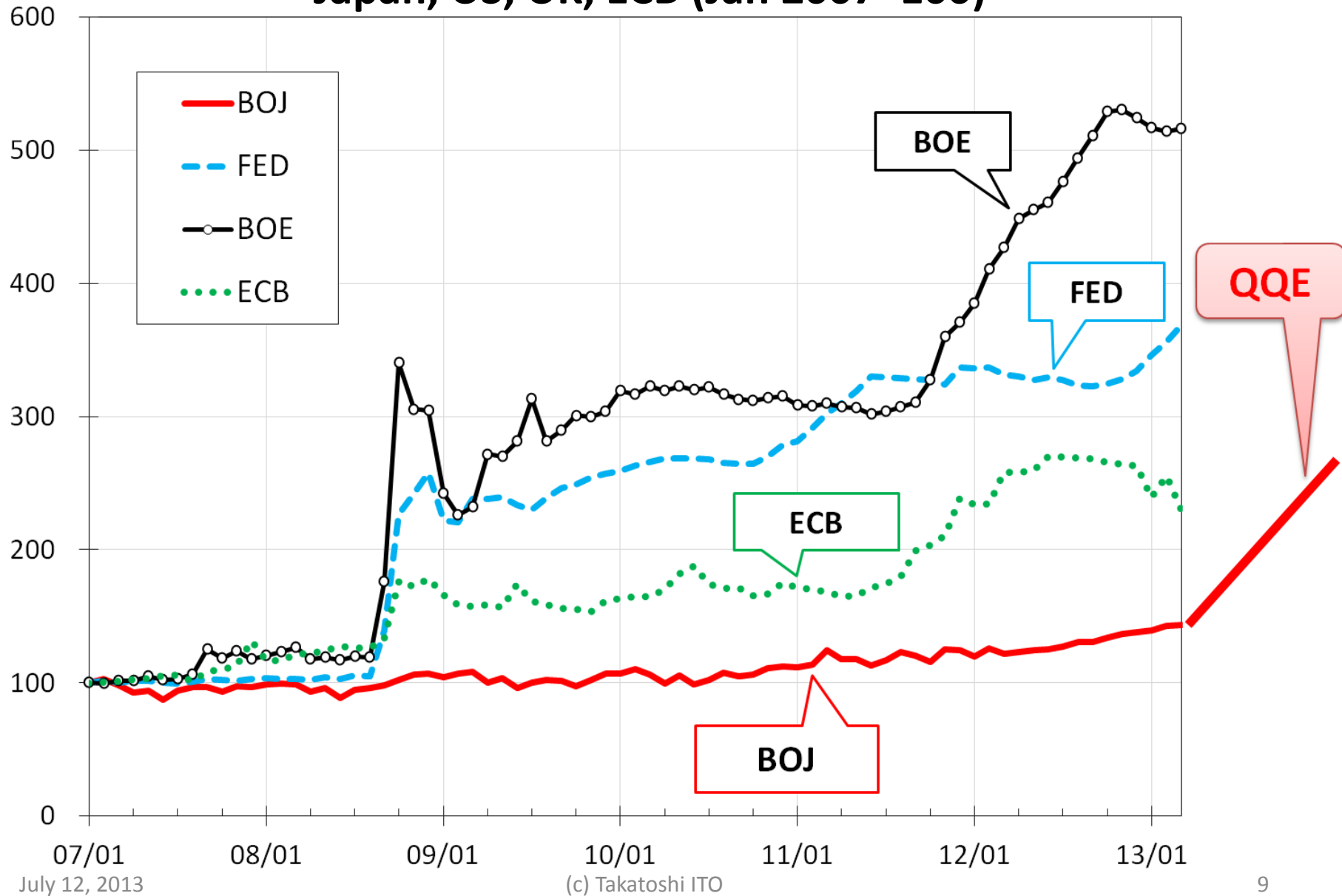
Yen depreciation = fundamentals + expectation

- Correction of over-valuation + Expectation of further *Abenomics*
- Fundamentals: Yen was overvalued
 - Trade balances went deficits, as nuclear power was lost
 - It should have depreciated earlier
 - Safe Haven effect
 - As Europe being stabilized, risk money went back
 - US economy
 - A sign of recovery. Early “exit” from QE III?
- Expectation: Promise of further monetary easing
 - Any economic model says monetary easing will result in depreciation
 - Abenomics, esp. the first arrow

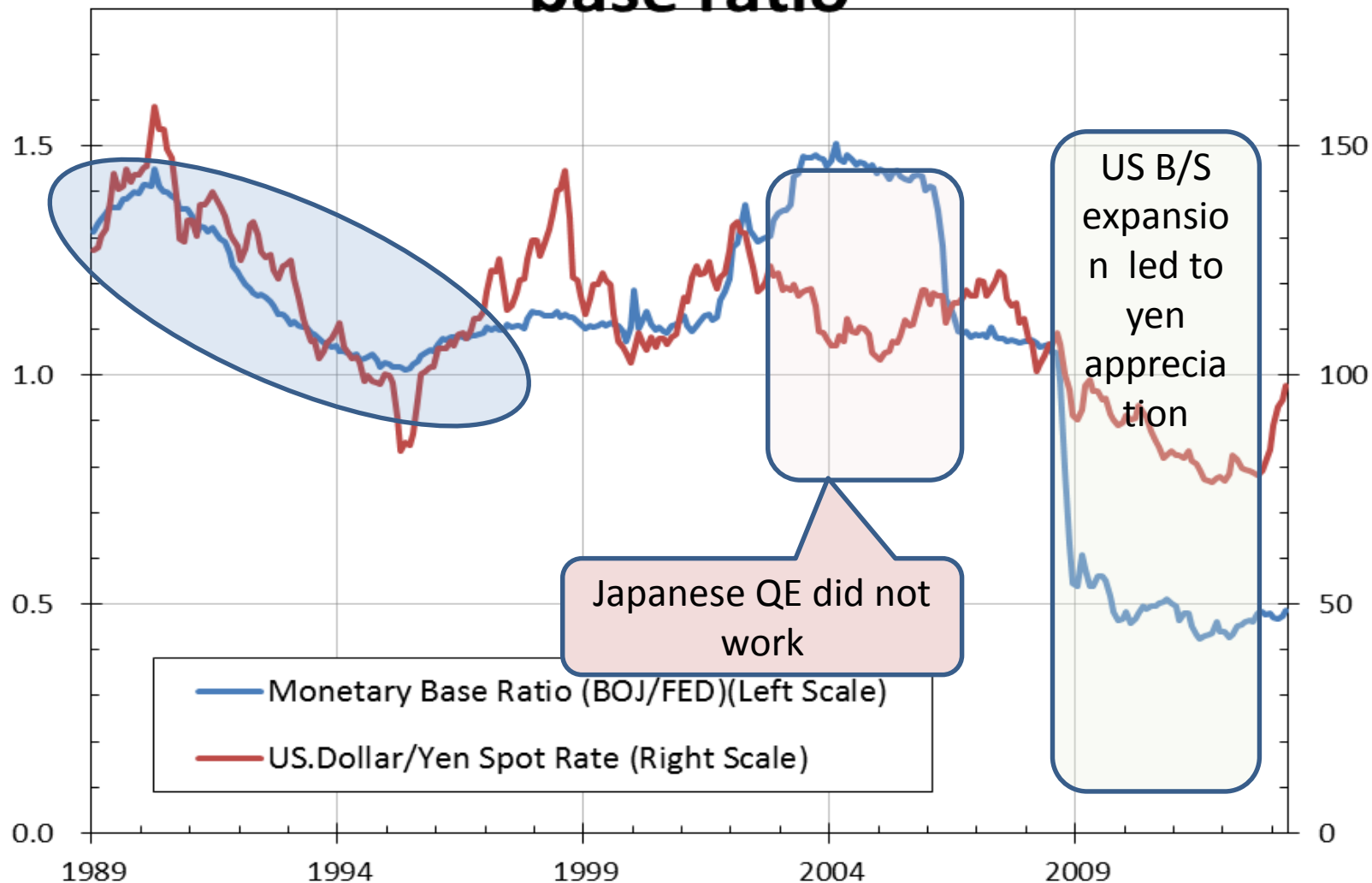
USDJPY 2012/1/1/ - 2013/6/3



Central bank balance sheet: Japan, US, UK, ECB (Jan 2007=100)



Yen/Dollar and the monetary base ratio



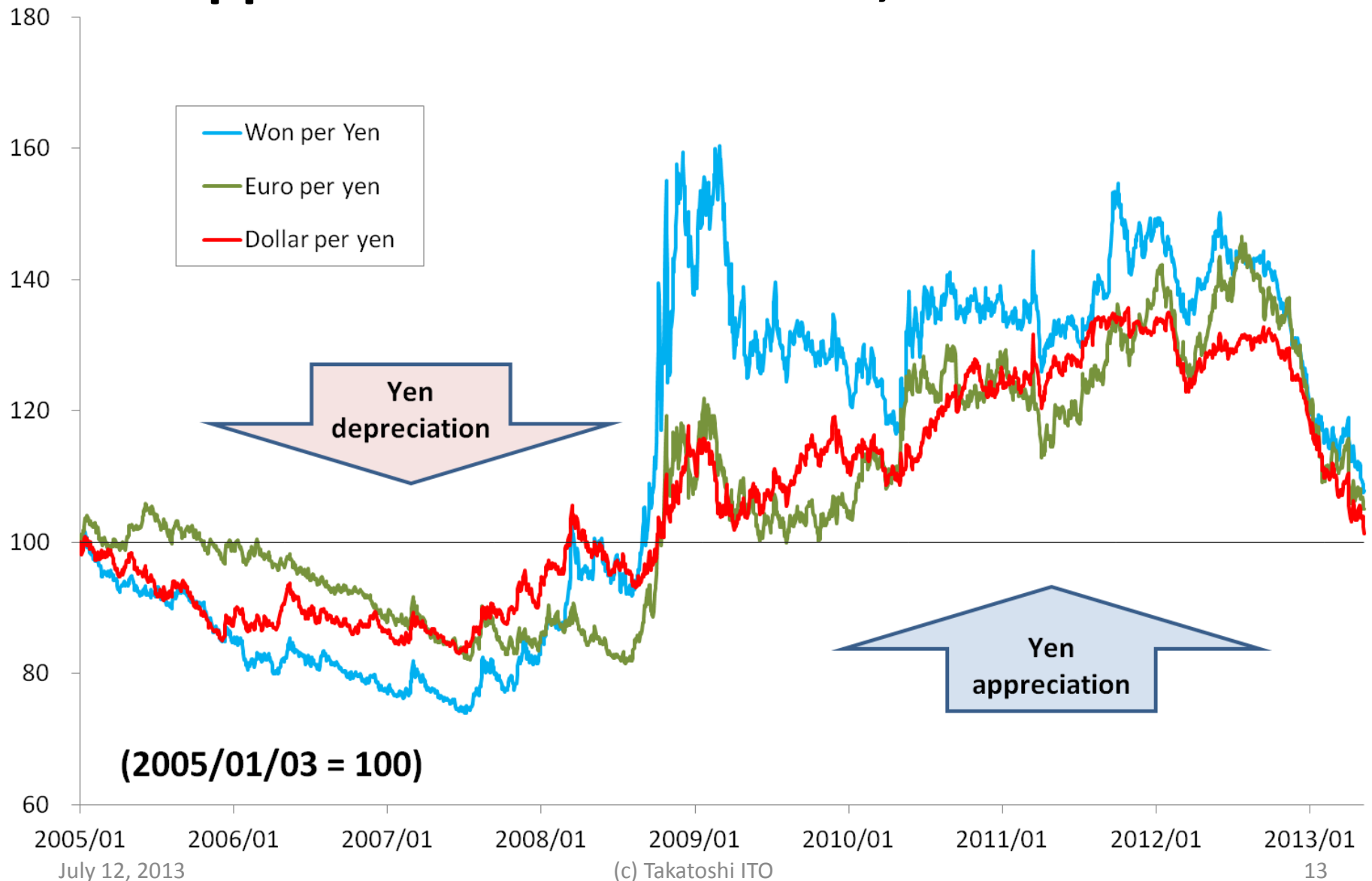
Currency Wars ?

- “Currency wars,” Minister Mantega of Brazil, September 2010
 - Criticizing QE in advance economies (US, UK, ECB) causing capital to flow into emerging economies
 - Japanese yen also appreciated because no additional QE, the “safe haven” effect
- *Abenomics*, 2012-current
 - Yen depreciated by 20%
 - Is it an act of currency wars? Or correction of overvaluation?
- No surprise that monetary easing leads to currency depreciation, **but depreciation is not an objective of QQE**
- Is it any different from “beggar-thy-neighbor policy” of the 1930s?
- Is it a problem because capital goes from advanced economies to emerging economies?

Won/Yen dramatic changes

- Lehman Brothers shock
 - Won depreciation
 - Yen appreciation
- Favored Korean industries
- Abenomics depreciation is just a correction of the past won depreciation over yen – no currency war

Yen appreciation vis-à-vis Won, Euro and Dollar





- Quick fix: a short-run stimulus to raise the growth rate, 2013Q2
 - Important data for a decision of “a go” or “a no-go” for consumption tax increases will be decided in October 2013
 - In concerted effort with BOJ to raise π
 - Supplementary budget will be mostly spent by end-June
- But controversial
 - Contents. Public works reminds of “Old style LDP (pre-Koizumi)”
 - But, that is an only way to disburse quickly
- (Skeptic) Could this hasten an eventual fiscal bust?
 - (A) Mostly maintenance and repair of infrastructure
 - But, yes, fiscal consolidation is needed in medium-term
 - In the medium term, growth policy will work to replace fiscal stimulus
- Important: Short-term stimulus and Medium-term consolidation

Fiscal Policy: Defying Gravity

Medium-term consolidation needed

- Takeo Hoshi and Takatoshi Ito, “Defying Gravity: How Long Will Japanese Government Bond Prices Remain High?” NBER wp. 18287, August 2012.
- Take-away
 - Japanese financial institutions buy most JGBs
 - Domestic holding, more than 90%
 - They are extremely risk-averse
 - Household saving is already flat and will be declining
 - An increase in corporate saving goes into saving
 - A ceiling of stable JGB increases is the sum of Private Sector (Household and Corporate) saving (mostly bank deposits)
 - **Simulation exercises show that the ceiling will be hit by 2021**
 - A crisis will happen before that date

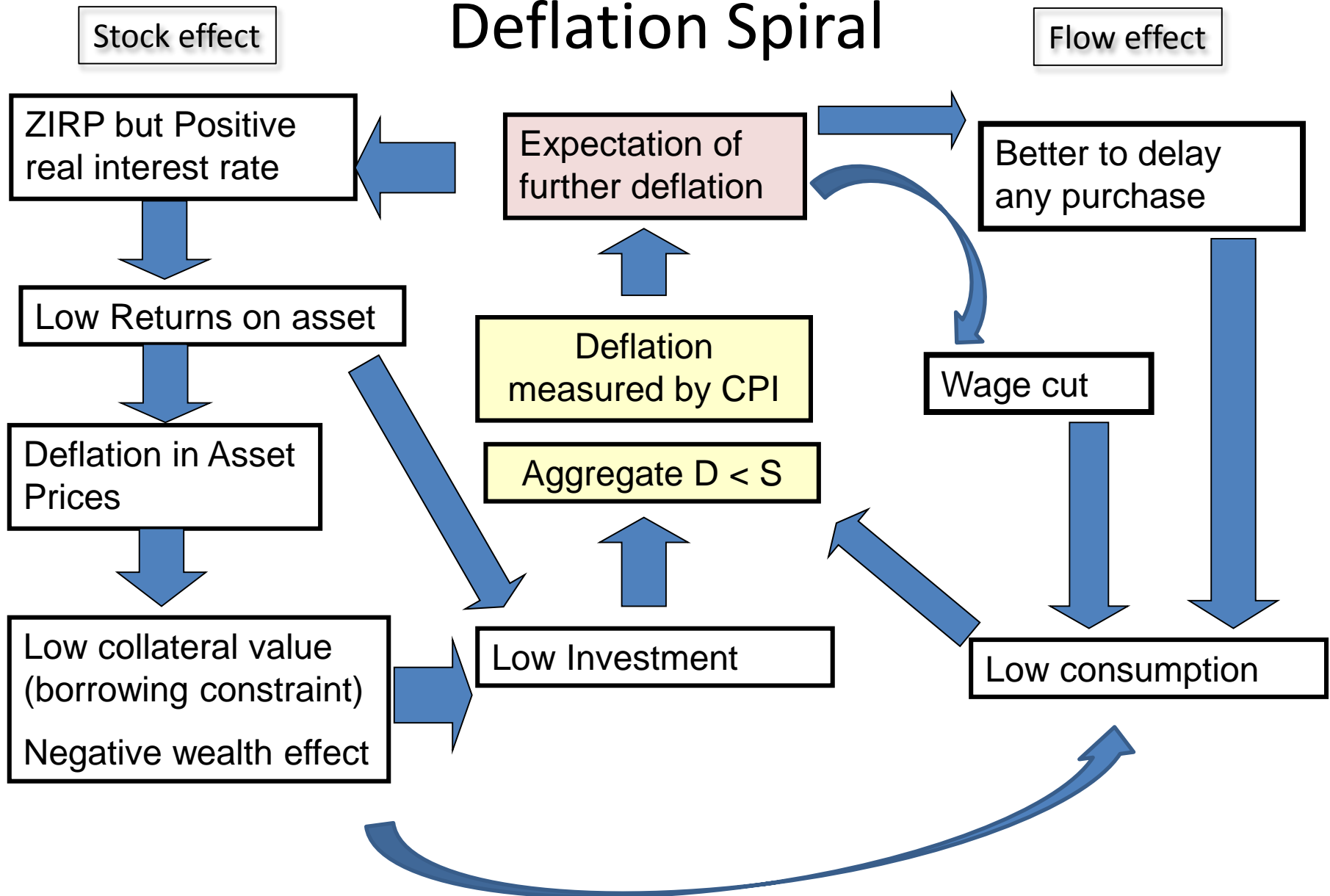


- In the medium- to long-run, the economy needs
 - Consumption and Investment increases
 - **Productivity gains & Wage increases**
 - Growth **without fiscal stimulus**
- But which industries? –Remember Episode I
 - Backward Industries due to lots of regulations are the hopefuls
 - Health and medical care
 - Agriculture
 - Energy
 - FTA and TPP
 - Pension fund reform
- *Nike* moment:
 - We have a long list of growth strategies in the past 6 yrs
 - No more study, but Just Do It!

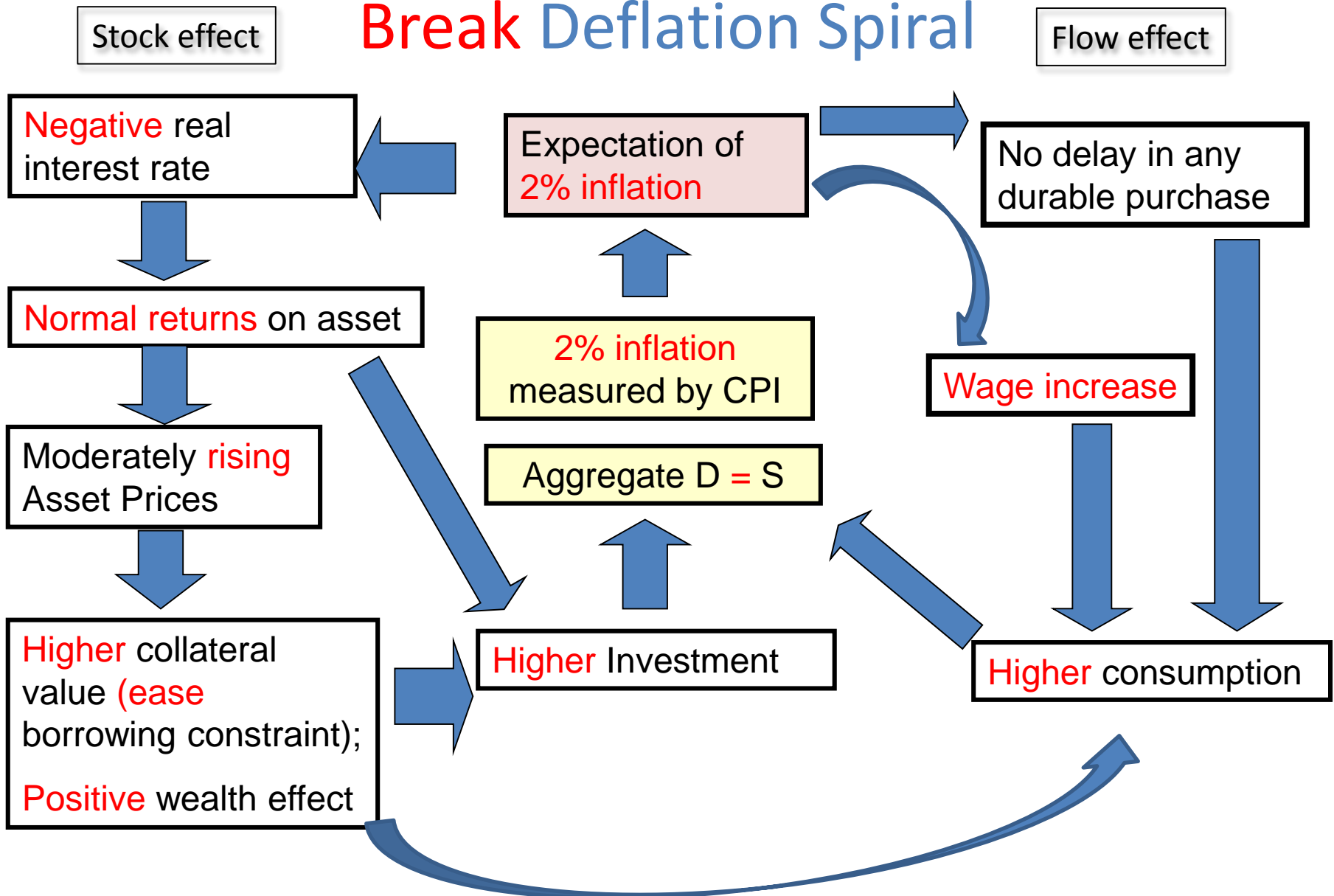
(2) Multiple Equilibria

- Deflationary trap (spiral)
 - Deflationary expectation
 - Shrinking Consumption and Investment
- A normal economy
 - 2% inflation rate
 - 2% growth

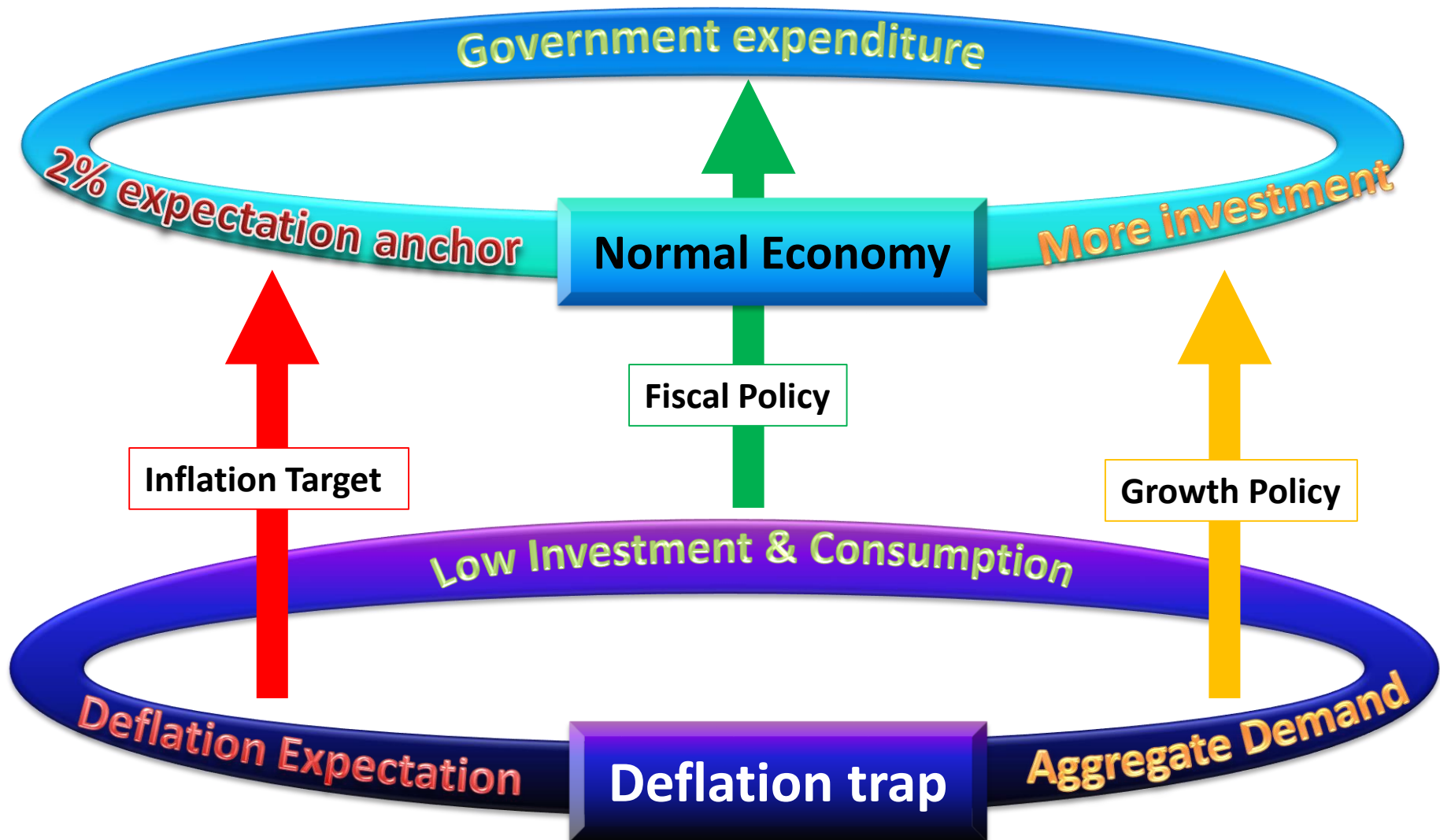
Deflation Spiral



Break Deflation Spiral



Multiple equilibria & a Jump



(3) Growth policy

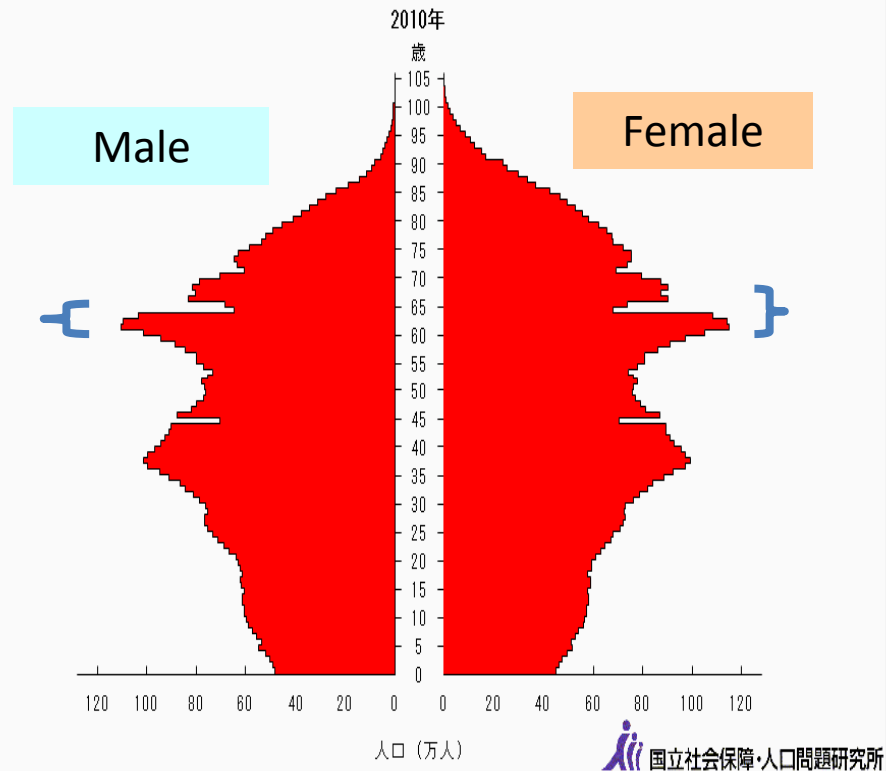
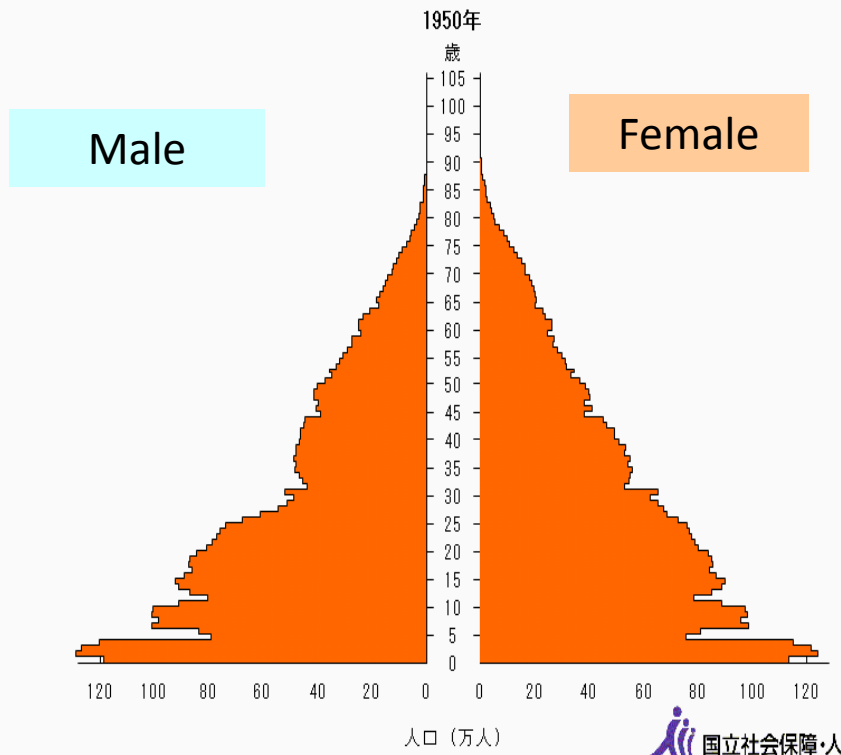
- What is the Japanese potential growth rate?
 - Adverse impact from demographic change
- How to raise it?
 - Deregulation; structural reform
 - Challenge; Open; and Innovation
 - Which industries?
 - Agriculture
 - Medical and health care
 - Energy
 - Join TPP and FTA
- Growth is important in avoiding a fiscal crisis
 - JGB defying gravity—Hoshi and Ito (2012, NBER wp)

BUT, Population is now declining, due to low fertility rate

1950

2010

{ Baby boomers are at
the stage of highest
earnings of life }



Negative “demographic dividend”

- Economic Growth:
= Demographic dividend + Per-worker productivity increase
- Demographic dividend
 - 1950s and 60s. +2.0%
 - 1970s +1.2%
 - 1980s +0.8%
 - 1990s +0.3%
 - 2000s -0.5%
 - 2010s -1.0%
 - 2020s -0.8%
 - 2030s -1.6%
 - 2040s -1.5%

Policies backed by growth theory

- **Measures have been discussed in Episode I (2006-07)**
- **Labor.** Policies to increase:
 - Raise women participation, age 30-40 (need more nurseries)
 - More foreign workers (esp. health care workers)
 - Continue working 65+ workers (delay retirement)
- **Capital.** Prevent hollowing out
 - Lower corporate income tax
 - TPP and FTA (incentive to produce in Japan)
 - Capital market reform (encourage taking risk)
- **Technological Progress**
 - Innovation/deregulation in backward industries
 - Releasing potentials in agriculture, health care services
 - Rectify the problem in the energy sector
 - Can nuclear power plants be restarted?

One example: TPP and FTA

- TPP and FTA are of course good for Japanese manufacturing firms, like auto, electronics and machine tools
- How about negative effects on agriculture? Or are there?
- Does high tariff “protect” farmers?
 - Rice, 778%
 - Kon-nyaku roots (like taro), 1,706%
 - Beef, 38.5%
 - Pork, (difference of domestic and import prices)
 - Materials for cheese, 35%
- They may discourage innovation for better products, lower cost (scale economy), and efficient distribution, brand name strategy and export promotion
- TPP and FTA will be catalyst for domestic agricultural reforms

Agricultural policy

- Regulation and subsidies to limit supply
 - Limiting acreage of rice paddies to be planted (*Gentan*)
 - Highly productive farmers/regions suffer most
 - Limiting raw milk production and cross-regional movement
 - Highly productive farmers/regions suffer most
 - Lesson of EU and Australia, abolishing cross-border movement of raw milk
- Deregulation will raise the aggregate productivity of rice farming and dairy industry
 - “branding” of high quality products which can be exported with premium; mass-production for other purposes
- Japan will be ready for substantial tariff reduction once these domestic deregulation takes place

Financial Times article

FINANCIAL TIMES THURSDAY JUNE 13 2013

COMMENT

Abe should aim his third arrow at Japan's farmers

Takatoshi Ito

The "third arrow" fired last week by Shinzo Abe, the Japanese prime minister, was a huge disappointment. Global investors certainly thought so – the Nikkei slid after Mr Abe's much-anticipated, but ultimately disappointing, speech. The list of reforms that Mr Abe has revealed that he intends to implement contained no surprises – and details were left for later. All we got were mere targets.

So the third arrow of Abenomics – the structural reforms to the economy that are meant to follow the first two arrows of monetary and fiscal expansion – looks more likely to land harmlessly in the weeds than to hit its target. Mr Abe needs to fire again, this time with a truer aim.

Optimists argue that he is holding his cards close to his chest and waiting until he consolidates his political power after the July upper house elections before announcing more radical plans. Let us hope so. But investors, both foreign and domestic, are impatient to know the true content of reform.

It is important for the prime minister to keep investors as an ally. If Japan is to escape its deflationary trap, it must change expectations and keep confidence high. Early expectations have so far been rewarded by higher growth. On Monday, first-quarter growth was revised up – to a very creditable 4.1 per cent on an annualised basis. Abenomics is working. It is having a genuine effect on sentiment, precisely what it was designed to do.

But Mr Abe must maintain the momentum. There is one possible way forward. The prime minister has already shown strong leadership by deciding this spring that Japan would join negotiations for the Trans-Pacific Partnership, a free-trade agreement to be concluded among Pacific nations. That was a brave thing to do given the opposition from powerful lobby groups, especially farmers. Outside these lobbies, support for joining negotiations is quite high, especially among urban voters.

Talking is one thing; concluding an agreement is quite another. To gain most from the TPP, Japan must lower its tariff barriers on agricultural products. That would

force other countries to lower their tariffs on Japanese manufactured goods. It would also induce needed domestic reform of Japan's agricultural sector.

Of course, the country needs to implement many other economic reforms in order to raise its productivity, particularly in the service sector. Labour reform,

Allowing corporations to own agricultural land would show investors the prime minister is serious about structural reform

making it easier for mothers to work through better provision of childcare, and shortening the approval procedures for new medicines and medical devices have all been mentioned. These are important. But reducing agricultural protection is a measure of great symbolic importance in Japan, where Mr Abe's Liberal Democratic party has for decades put political expediency (and even sentimentality about small-scale

farmers) above economic rationality.

That is why Mr Abe should seize this issue now. Rather than waiting for the TPP negotiations and July's election, he should implement structural reform in agriculture immediately. Such a bold initiative would prove to investors that he is serious about structural economic reform overall.

We know what needs to be done. Mr Abe should issue a prime minister's directive to change the law so that (non-agricultural) corporations are allowed to own agricultural land. At present, only small-scale farmers can do so. Such a simple change could spur important changes. Japan's general trading companies, such as Mitsubishi and Mitsui, would likely seize the opportunity to produce, distribute and export agricultural products under one roof.

Of course, they would need the expertise of existing young farmers, so larger-scale farmers need not lose out on either jobs or income. Those who have only small plots of land with a high cost of production – most Japanese rice farmers are 65 or older – can be compensated for their land, which could then be absorbed

into much larger and more productive units.

Government statistics show that large farmers' production costs are half those of small-lot farmers. According to one estimate, the production costs of rice in Japan could be cut by one-third if forced limits of cultivation – known as *gentan* – were abolished and economies of scale implemented. That would make it possible not only to reduce tariffs but also to increase Japan's exports.

The economy needs Abenomics to succeed if it is to avoid a possible sovereign debt crisis down the road. Success, however, can be assured only by a display of strong leadership. Mr Abe should prove his mettle before the election – and not wait until he has a comfortable majority. After all, he has been bold in firing off the first two arrows of his economic reform so successfully. He should step up to the mark and fire the third with the same conviction.

The writer is dean of the Graduate School of Public Policy at the University of Tokyo and an economic adviser to the 2006 Abe government

Conclusion

- *Abenomics* is working fine, so far
 - [1st arrow] Monetary policy is right on the target
 - [2nd arrow] Fiscal stimulus works in the short run
 - 2013Q1, growth rate (QtoQ) 0.9% (or annualized 3.5%)
- *Abenomics*, the **success means a jump** from a **bad, deflationary equilibrium** to a **good, normal equilibrium**
- Once in the good equilibrium, fiscal stimulus will not be needed
- [3rd arrow] Growth strategy will be a key to raise growth potential; to erase fiscal debt concern; to raise wages; and to complete the jump
- Risk is too much a distraction to political agenda