



# Ending deflation in Japan vs. containing deflation in the euro area

2<sup>nd</sup> JEF-DGAP International Symposium

*Passion to Perform*

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# Agenda



**1**

Abenomics

**2**

Euro area adjustment

**3**

Lessons

# The Japanese economy in perspective



The Japanese economy is exiting from a bad equilibrium (1990-2013) and is entering a benign equilibrium from 2014 onwards

Real GDP growth declined from above 4% on average in the 80s, to 1.5% in the 90s, to 0.6% in the 2000s but recovered to 1.4% in 2010-2014 (F) thanks to a special effect of the rebound. 2014 is turn.

The path forward should be characterized by 1% growth potential (2% nominal growth, 2% wage increase and 1% inflation).

In the next 2-3 years, growth and inflation might “overshoot”. Real GDP growth will be 1.5-2% and the output gap will close. Inflation may be above 1%.

The policy of “Abenomics” has been performing well until now.

Fiscal stimulus worked initially in supporting demand.

Monetary policy broke the long-held deflation expectations of firms by announcing a 2%-target (within 2 years) in 4/13 and by buying bonds.

Household still hold deflationary expectations due to history of falling nominal wages. Wage deal this spring crucial. A tight labour market helps.

# Completing „Abenomics“ will be important



Consumption has picked up and wealth effects kick in.

Investment is likely to follow upwards, bank lending and money supply (M2) turned positive in 2011/12. Structural reform would be an important “signal” supporting capital expenditure.

Productivity and wages might follow but brake in wage setting behaviour important.

Monetary policy will maintain its course and may need to deepen.

Base money increase might well replace depreciation effect on inflation.

Communications might have to be stepped up.

Fiscal policy will have to move from stimulus and the two-step VAT tax hike to a comprehensive medium-term fiscal adjustment path lowering the public sector deficit gradually to balance. A tax-oriented strategy is quite appropriate given the low tax-GDP ratio.

VAT will increase from 5% to 8% in Q2/14 and to 10% in Q4/15.

Fiscal tightening in 14: 0.3%, in 15: 0.5% (IMF)

# Medium-term prospect



Real and nominal growth may now go together. Good news. Core inflation is trending up but remains still below 1%

Fiscal target of a primary balance in 2020 should be supported by medium-term plan. Fiscal policy might be a small drain for many years

Structural reforms (“third arrow”) of product and labour markets should support medium-term trend growth prospects.

This is essential for success beyond 2016/17.

Microeconomic, trade and innovation policies should promote growth and are essential to cement positive inflation expectations, too

Big gap between strength of corporate Japan and troubles of Japan as production site (similar to Germany)

Political opposition to structural reform is politically well-established, hard to break (sometimes by “gaiatsu”) and poses substantial downside risks to the economy

The monetary powder has been shot already...

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# Euro area adjustment: the key factors



## Euro area crisis countries must, and do, adjust and rebalance

Demand deflation and internal devaluation, bank and corporate deleveraging, reallocation of investment into tradables, turn-around in trade and current account balances, gradual fiscal adjustment and structural and institutional reforms must, and do, occur

Recession and subsequent soft patch of output, employment, prices, wages and credit for a period of 5-7 post-crisis years “normal” given combination of credit, real estate and sovereign debt crisis

Financial repair took too long, but has been faster than in Japan (14 years) and generally been performed within 4 years after the crisis

Spain 2012, Greece 2012, Portugal 2011, Germany, Ireland and UK 2010

Final repair in 2014 (ECB/EBA approach) and banking union

Financial, corporate and household balance sheet repair takes much longer than cyclical improvement and constrains growth

— Bank lending to SMEs in crisis countries still constrained

# Euro area adjustment: the key factors



The growth outlook has substantially been clouded by the crisis

Growth potential was cut by half a percentage point to 1.5% despite structural reforms

Enhanced institutional and structural reforms are necessary

Fiscal policy is on a medium-term consolidation path in most countries

Exceptions: Cyprus, France, Slovenia and Spain which will see the structural budget balance increase in 2015 (to 2014)

Monetary policy faces heterogeneous environment

Prolonged adjustment in crisis countries bears risks for euro area inflation objectives, inflation expectations, monetary transmission channel and public finance (debt dynamics)

Aggressive monetary policy may become necessary

Downside risks remain substantial

The current account improves, and the euro strengthens



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# What are the lessons of recent policy?



- (1) Dramatic economic situations require comprehensive and dramatic responses. „Abenomics“ fulfils this criterion, if fully implemented. EA adjustment policies still incomplete.
- (2) Growth-, productivity- and innovation-oriented policies are important in crisis times, too.
- (3) Fiscal adjustment should follow financial stabilization and economic recovery. Follow it should, however! Design matters!
- (4) The Japanese crisis response to the 1992-2001 financial crisis was not sufficient and led to two decades of sub-standard economic performance on growth, inflation, income and public finance.\*
  - Per capita GDP growth was only 0.6% in 1992-2011.
  - Labour productivity trend growth (per worker hour) declined to about 1 per cent but not much more than in OECD countries.
  - Asset and consumer prices declined substantially.

\* See Masahiro Kawai, Peter Morgan. Banking Crises and “Japanization”. In: Changyong Rhee, Adam S. Posen, eds., *Responding to Financial Crisis*. Peterson Institute & ADB. 2013.

# What are the lessons of recent policy?



- The 1992 crash depressed bank lending from 1994-2006. It is still below the level of 1997! Growth of lending since Abenomics modest
- Net investment declined from some 15% of GDP before the crisis to zero in 2010, gross investment fell from 30% to 20% of GDP
- Gross public debt increased from <75% of GDP pre-crisis to >200%
- (5) The main factor was tight monetary policy coupled with inappropriate banking policy leading to prolonged “deleveraging” and deflation. There was not a sufficient amount of structural reforms, too
- The Bank of Japan took years to start aggressively fighting inflation
- Financial deleveraging and weak investment are twins
- Falling prices and wages lead to behavioural changes, this is bad
- Appropriate banking policy occurred no earlier than under Koizumi
- Structural reforms occurred but were not broad-based and well targeted. Several issue areas remained politically blocked

# What are the lessons of recent policy?



## (6) Euro area adjustment went through several phases

- Bank rescues, stabilization of financial markets, counter-cyclical policies, sovereign debt crisis management, fiscal adjustment and structural reforms, governance reforms, banking union

## (7) There are monetary and banking policy problems for supporting the recovery through lending as long as the private sector keeps repairing its balance sheet by deleveraging.

- Draghi speech:
  - Bank lending to SMEs usually recovers 3-4 quarters after the cyclical turnaround
  - ¼ of viable Spanish and 1/3 of Portuguese SMEs face funding constraints

## (8) The reallocation into tradables works well and fast but does not pull the sluggish domestic economies along as domestic demand keeps constrained

# What are the lessons of recent policy?



(9) Continued economic divergence creates problems in monetary and fiscal policy fields for the EA

(9) Governance issues have real consequences, in the positive and in the negative. A credible fiscal and banking framework is crucial.

- Advances in the field of banking union are substantial
- Institutional progress on budgets at the national and EU level
- Shift towards establishing a federal counter-cyclical fiscal facility at the EU politically blocked.
- Integration of macro-prudential policies into the current toolbox is incomplete

(10) Due to the incomplete and, partly, delayed policy response to the governance, economic, monetary and banking issues in the EA , the return of the EA to acceptable paths of output and employment growth is very slow, leading itself to enhanced political instability as evidenced by the elections to the European Parliament.

# Appendix: Additional material on Japan



# Growth, per capita income and productivity in the long run



## Japan's real growth experience, 1972-2011

average annual growth rate in %

	1972-1981	1982-1991	1992-2001	2002-2011
GDP	4,3	0	0,6	0,1
Per capita GDP	3,2	3,5	0,3	0
Per worker hour GDP	4,1	3,2	1,5	0,8

Source: Rhee, Posen, Responding to Financial Crisis, Peterson Institute and ADB 2013

Trend output growth fell already in the 1980s to very low levels and never recovered

Growth might sustainably resume for the first time since the 1980s

Per capita income was flat over the last two decades

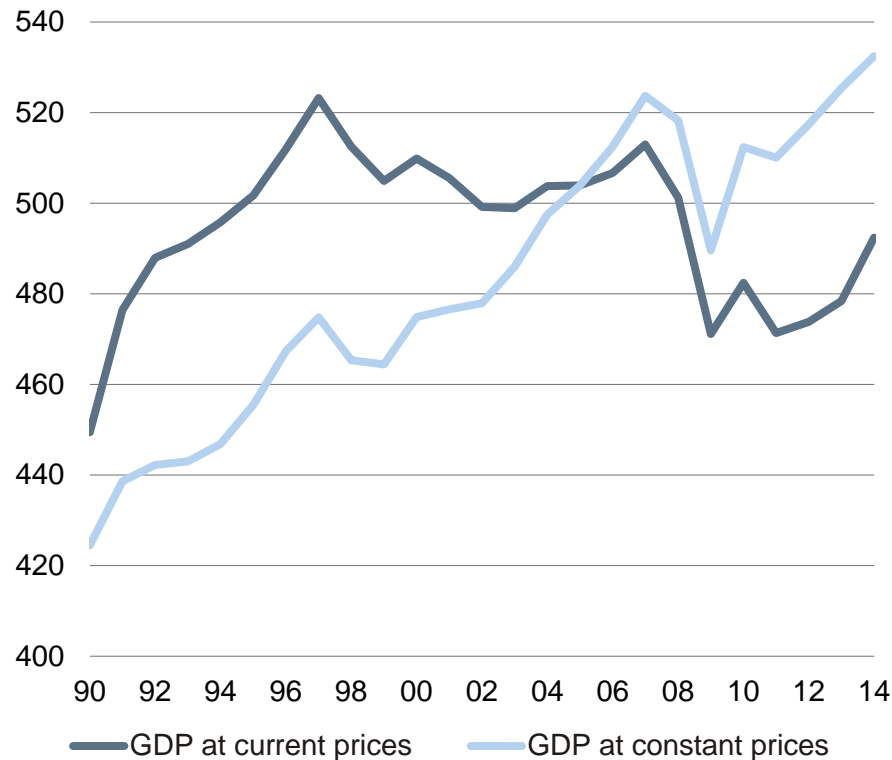
Productivity performance (measured per hour) softened in the 1990s and is now average

# Nominal and real growth in GDP



## Japan: Nominal and real GDP

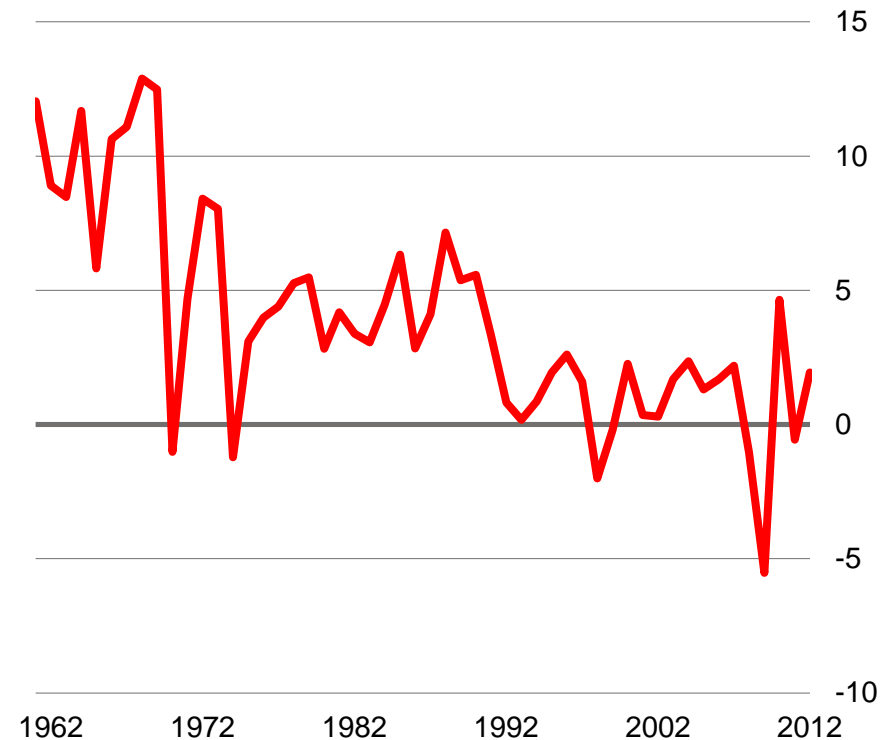
in Yen tn



Source: IMF

## Japan: Real GDP growth

in %



Source: World Bank

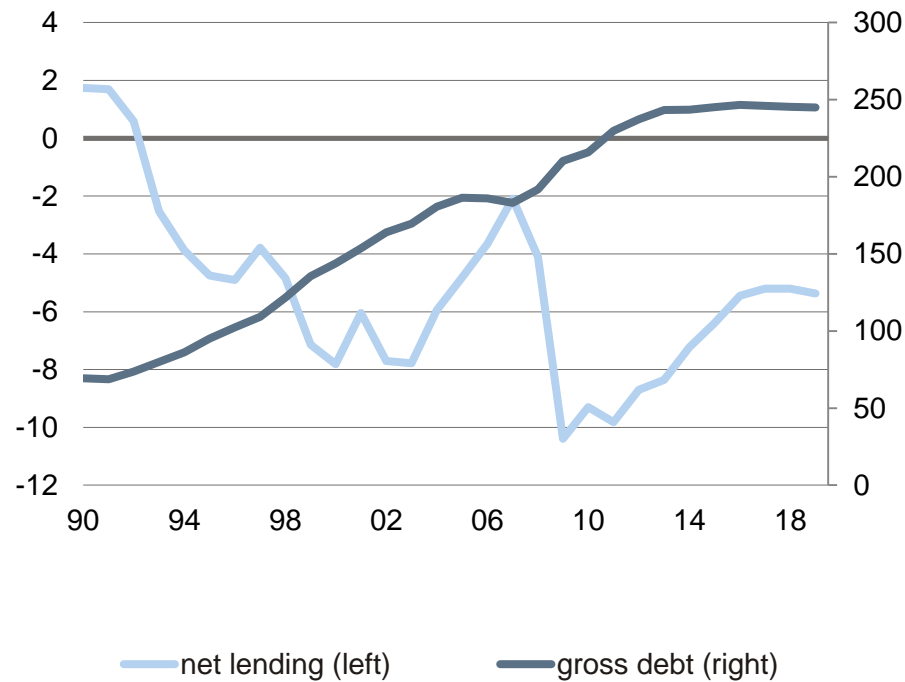


# Public finance: deficits and debt in the long run



## Japan: gross public debt and public borrowing

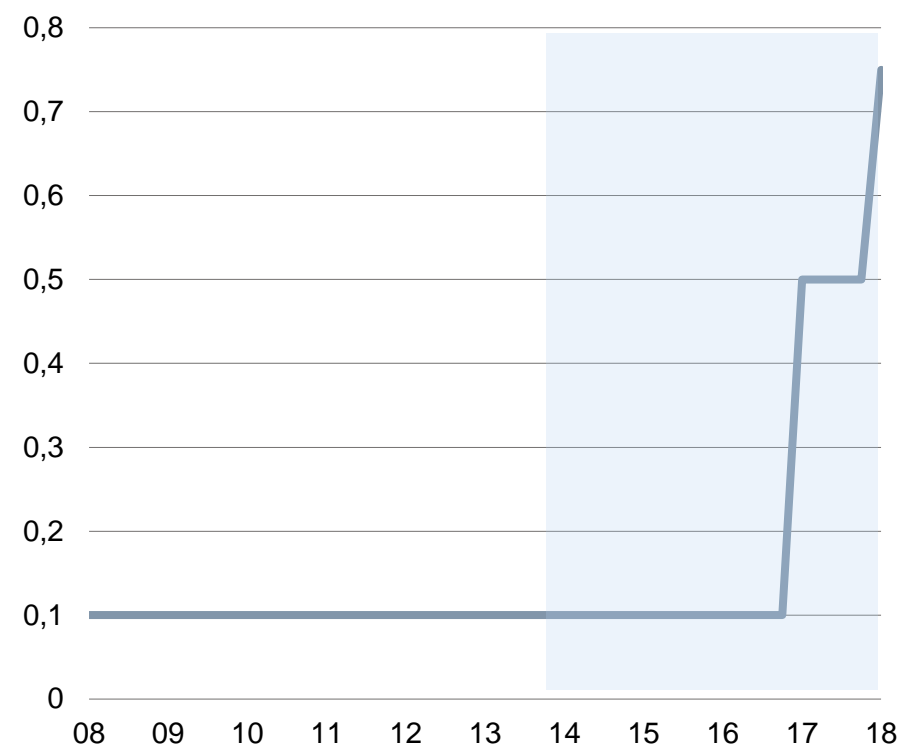
in Yen bn



Source: IMF

## Key interest rate - Bank of Japan

in %



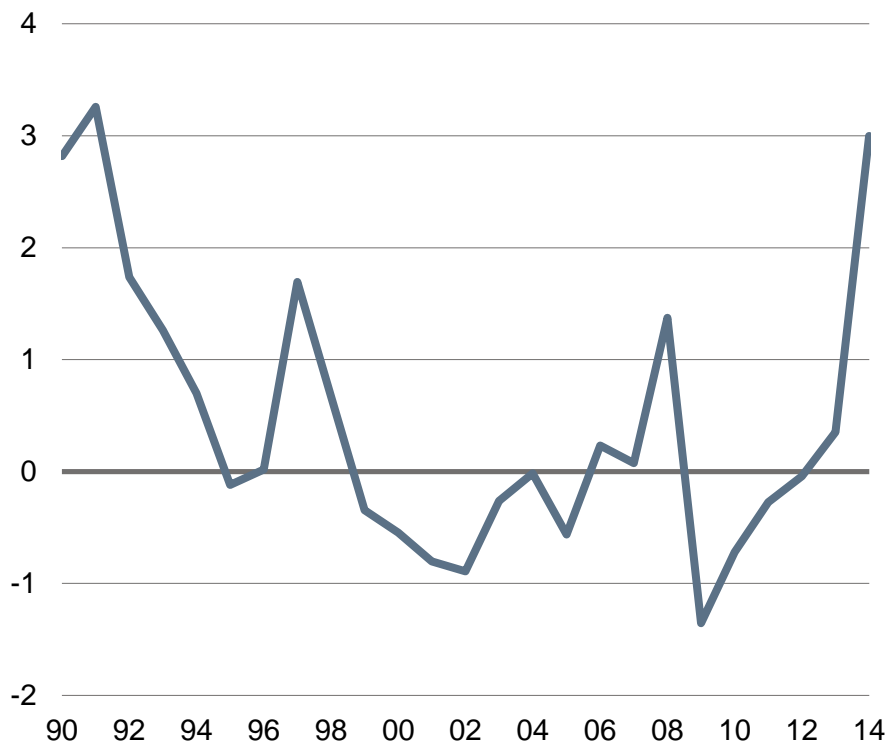
Source: Deutsche Bank Research

# Inflation and the exchange rate



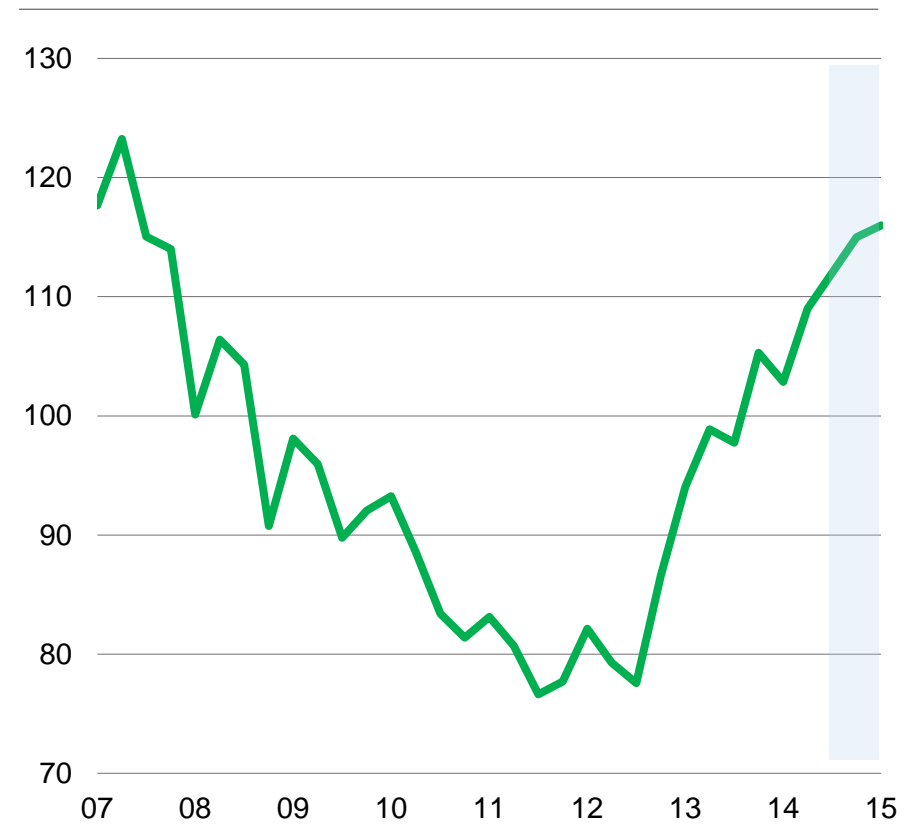
## Japan: inflation rate

in % of GDP



Source: DB Forecasts

## FX rate ¥/USD



Source: Deutsche Bank Research

# External accounts in soft patch but improvement consistent with fundamentals and policy



## Japan: Current account and trade balance

in % of GDP



Sources: IMF, Deutsche Bank Research

Export growth sluggish despite large devaluation due to sluggish world demand

Fukushima, import demand for fuels, and weak Yen lead to an expensive import bill

Interest income is high (some three per cent of GDP) cushioning the CA

Japanese companies and financial institutions are large capital exporters receiving a high stream of income on a net basis

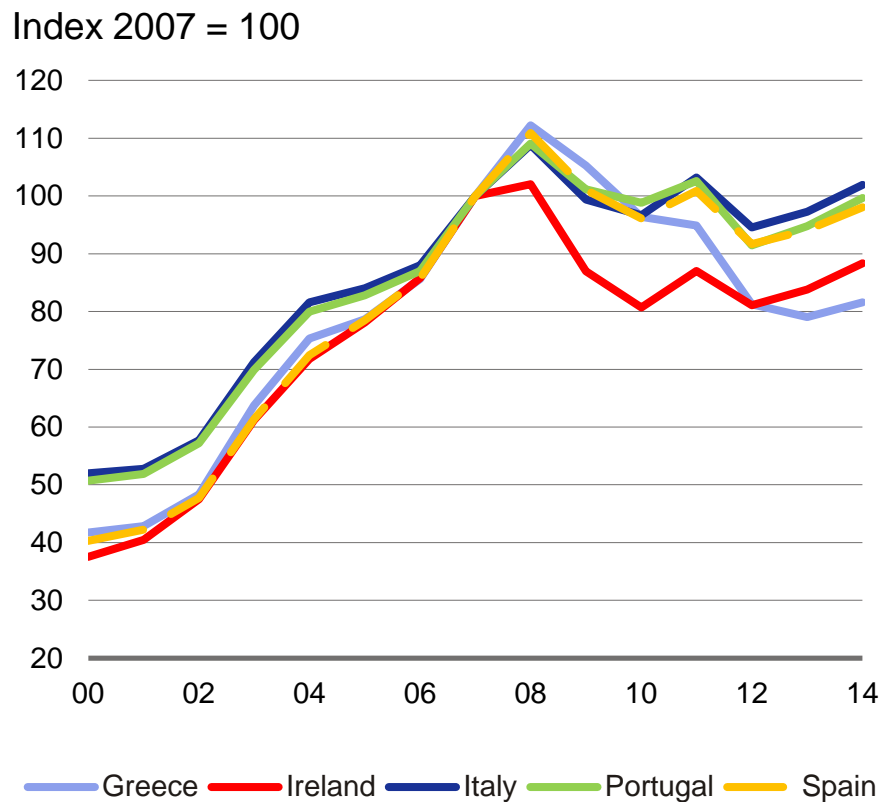
# Additional material on the euro area crisis countries



# Nominal and real GDP growth of euro area crisis countries

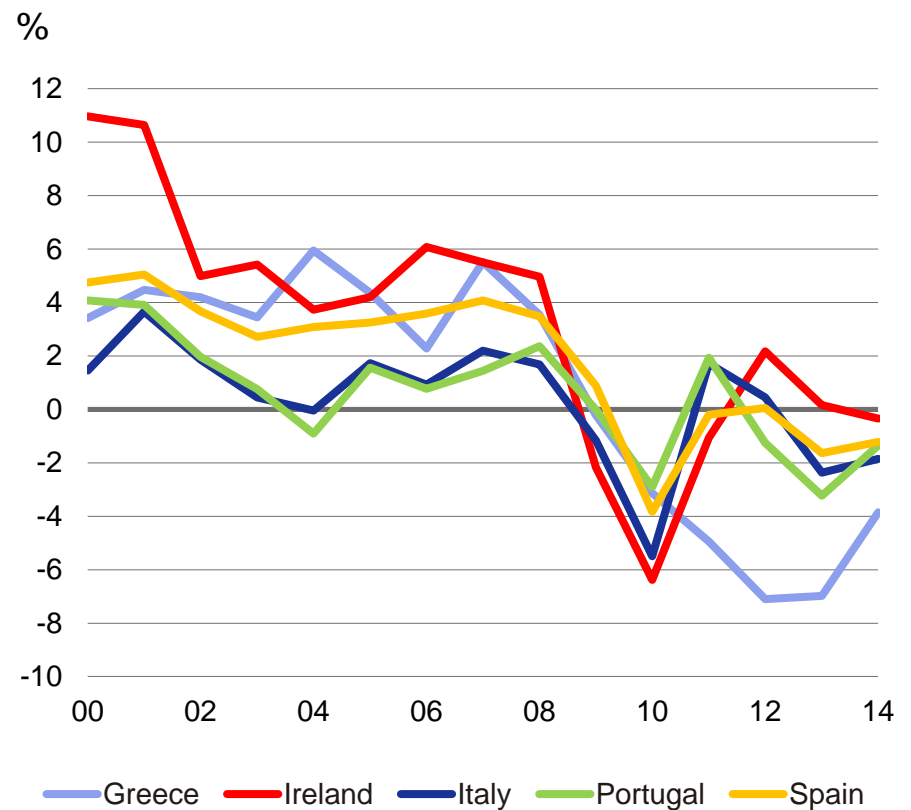


## GDP at current prices



Source: IMF

## GDP at constant prices



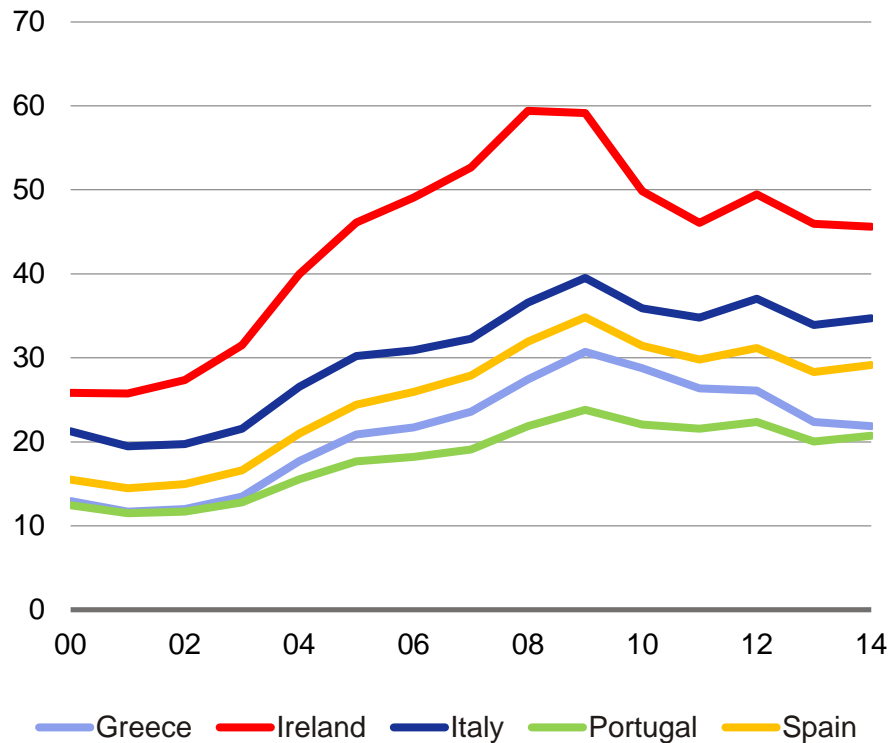
Source: IMF

# Per capita GDP growth



## GDP per capita

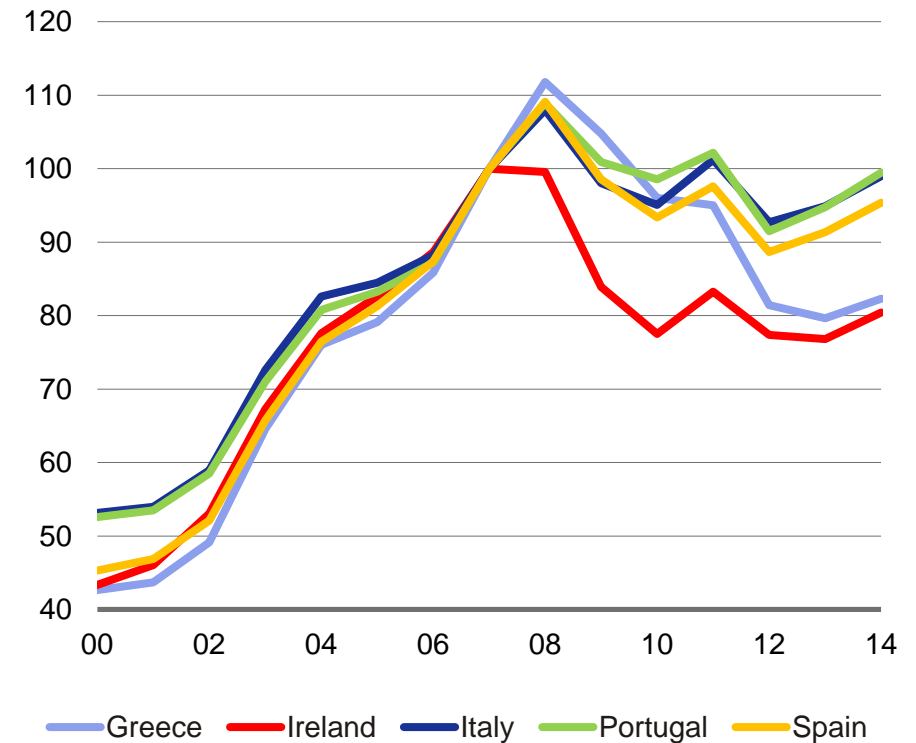
USD k



Source: IMF

## GDP per capita

Index 2007 = 100



Source: IMF

# EMU: Out of recession – but muted recovery



## EMU: Economic growth

% yoy

	2012	2013	2014F	2015F
Euroland	-0.6	-0.4	1.1	1.5
Germany	0.7	0.4	1.8	2.0
France	0.4	0.4	1.0	1.4
Italy	-2.4	-1.8	0.6	1.1
Spain	-1.6	-1.2	0.7	1.5
Netherlands	-1.3	-0.8	0.9	1.4
Belgium	-0.1	0.2	1.4	1.6
Austria	0.9	0.3	1.4	1.8
Finland	-1.0	-1.4	0.3	1.4
Greece	-7.0	-3.9	1.0	2.2
Portugal	-3.2	-1.4	1.4	1.1
Ireland	0.2	-0.3	1.8	2.2

Sources: IMF, Deutsche Bank Research

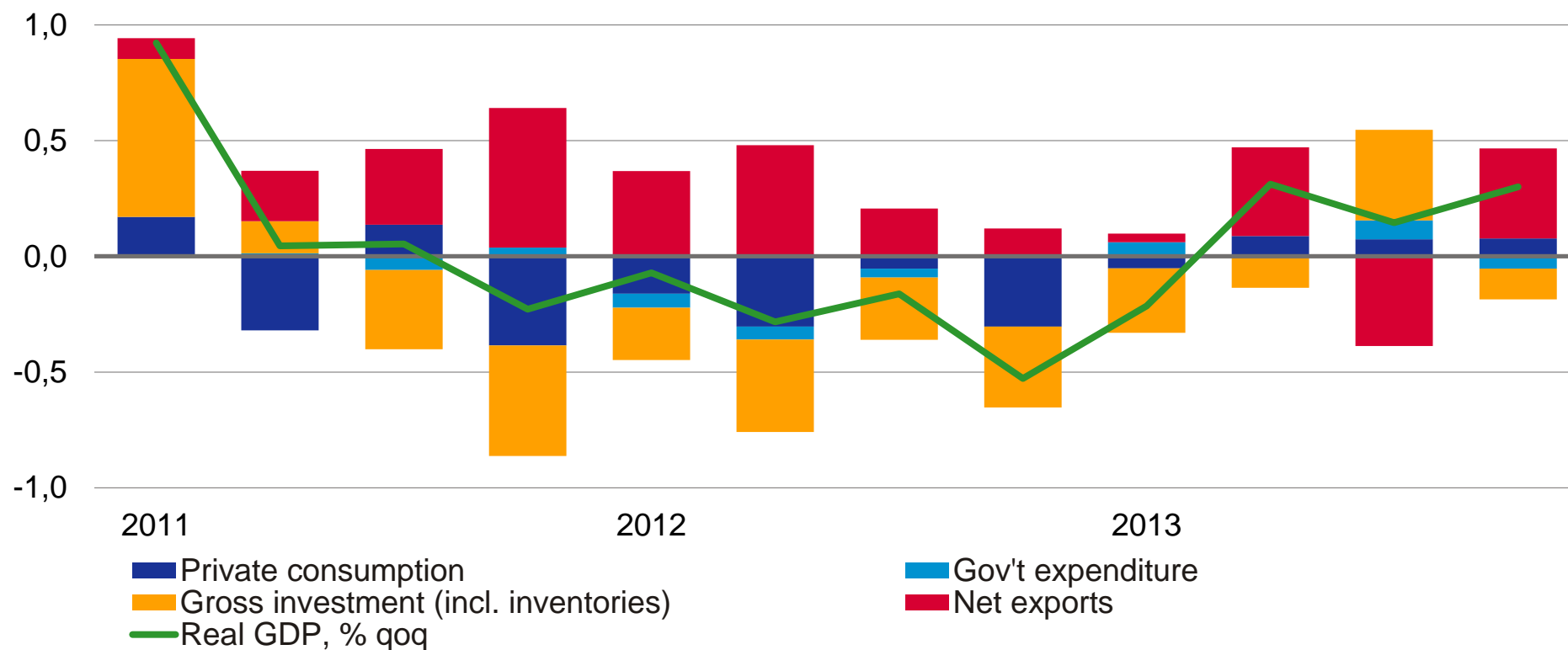
- Ongoing moderate recovery in EMU
- Reasons:
  - Reduced austerity
  - Turn in the credit cycle
  - End of de-stocking
  - Stronger global growth to support European exports
- Rebalancing in the public and private sector and hysteresis effects will weigh on trend growth for several years.

# EMU came out of its longest recession on record in Q2 2013



## EMU growth contributors

Contribution to real GDP growth, qoq, pp



Source: Federal Statistical Office

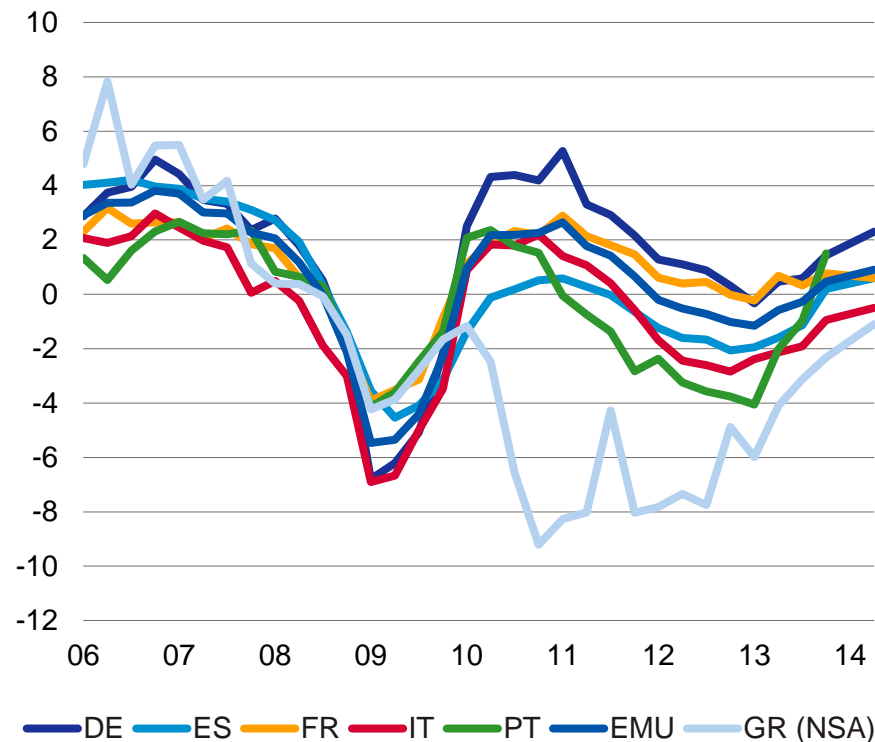


...but recovery unlikely to pick up momentum soon



## EMU: Economic growth

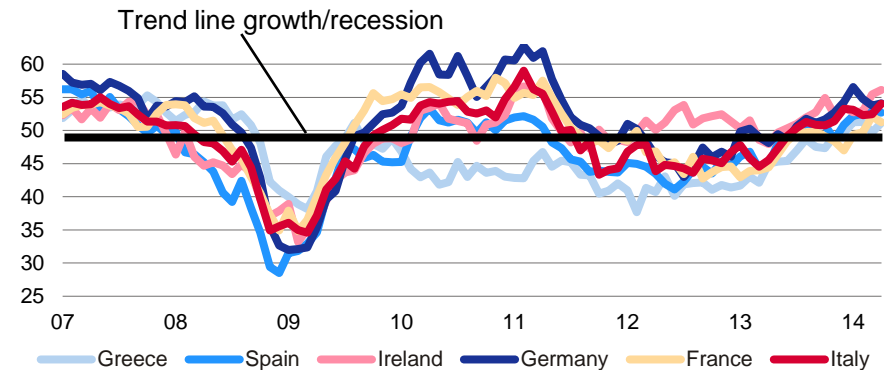
Real GDP, % yoy



Source: Eurostat

## EMU: Manufacturing PMIs

Index points



Source: Markit

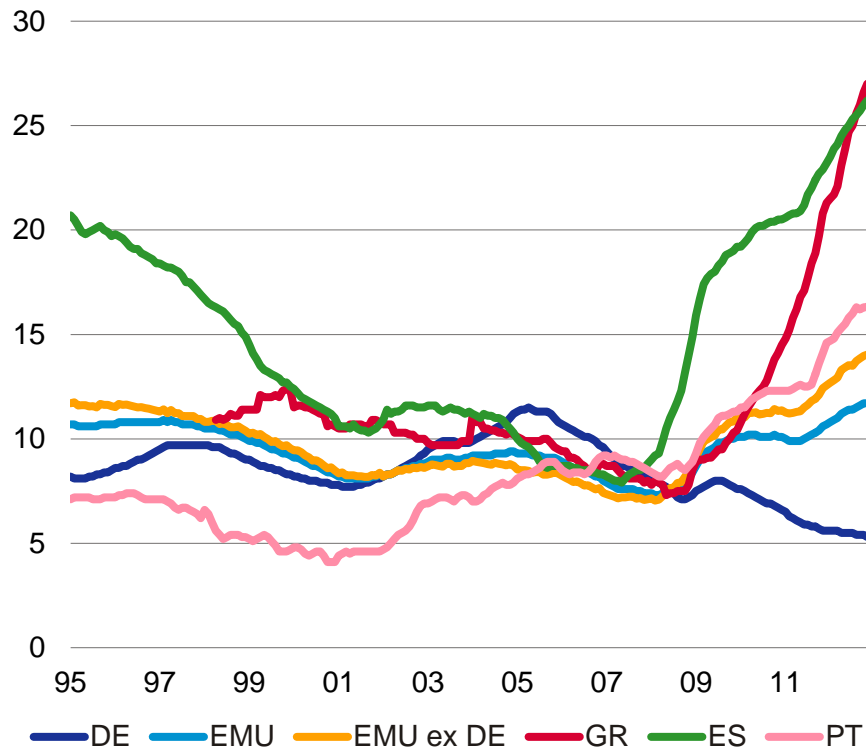
- GDP in Q1 0.2% qoq (0.9% yoy) still lacklustre
- France (0.0%) and Italy (-0.1%) especially disappointing

# Unemployment still stuck at high levels



## Unemployment

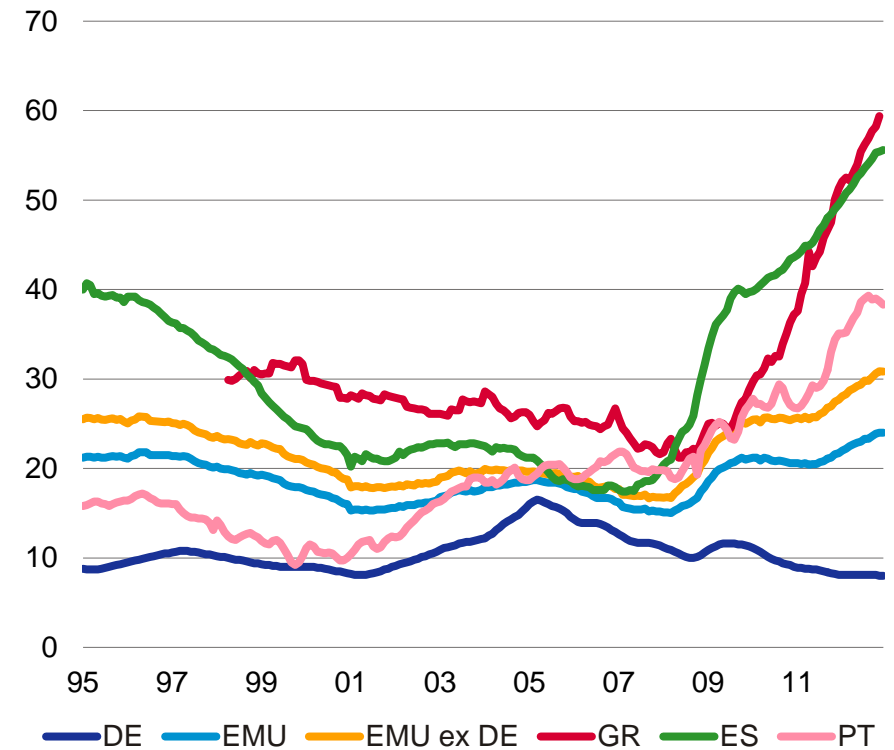
sa, %



Sources: Eurostat, DB Research

## Youth unemployment

sa., %



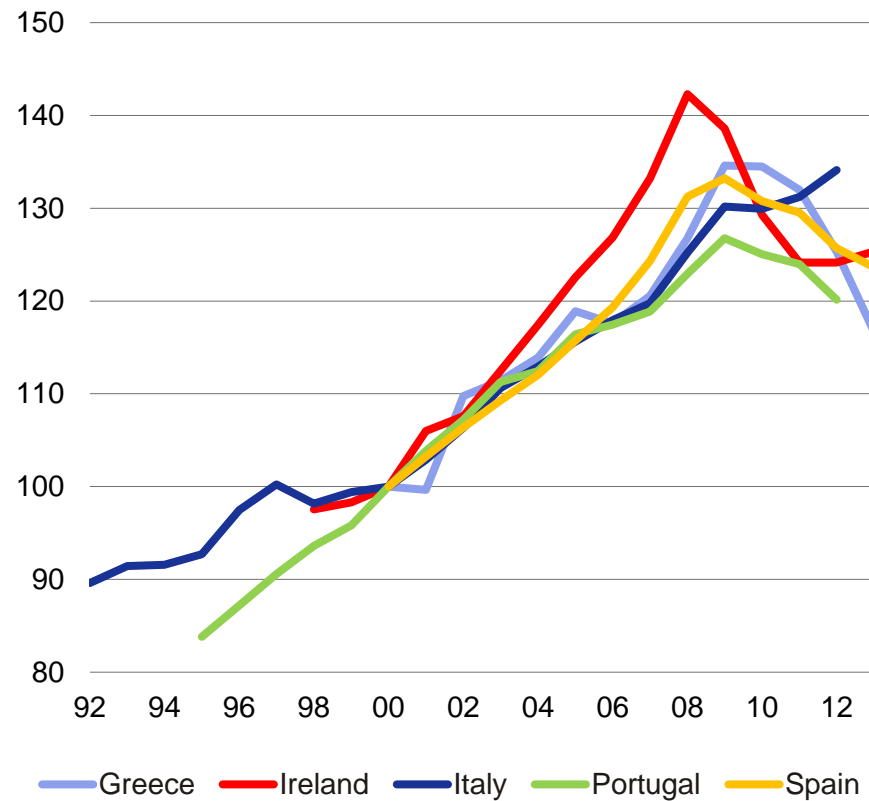
Sources: Eurostat, DB Research

# Cost adjustments and improvements in external accounts of EA crisis countries



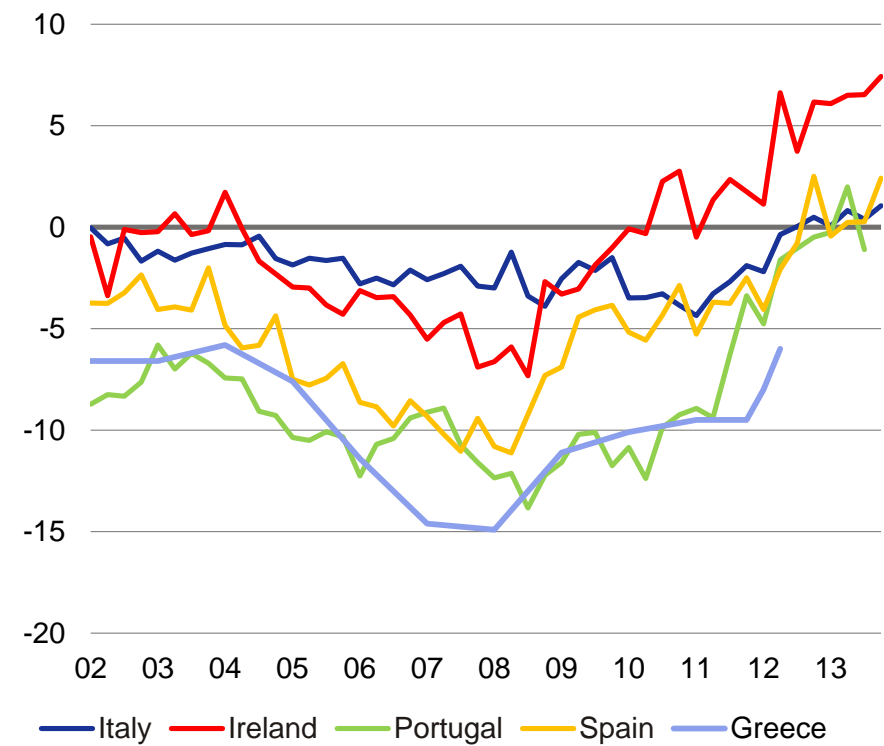
## Unit Labour Costs

2000=100



## Current account balance

% of GDP



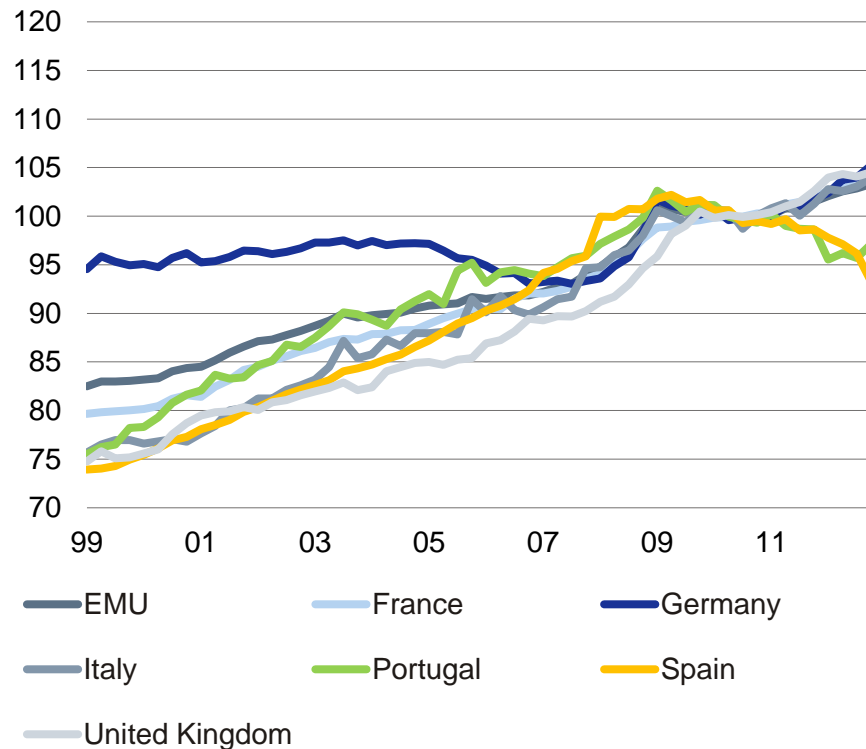
Source: OECD

# Spain: Doing its homework



## Adjustment in Spain and Portugal but not in Italy

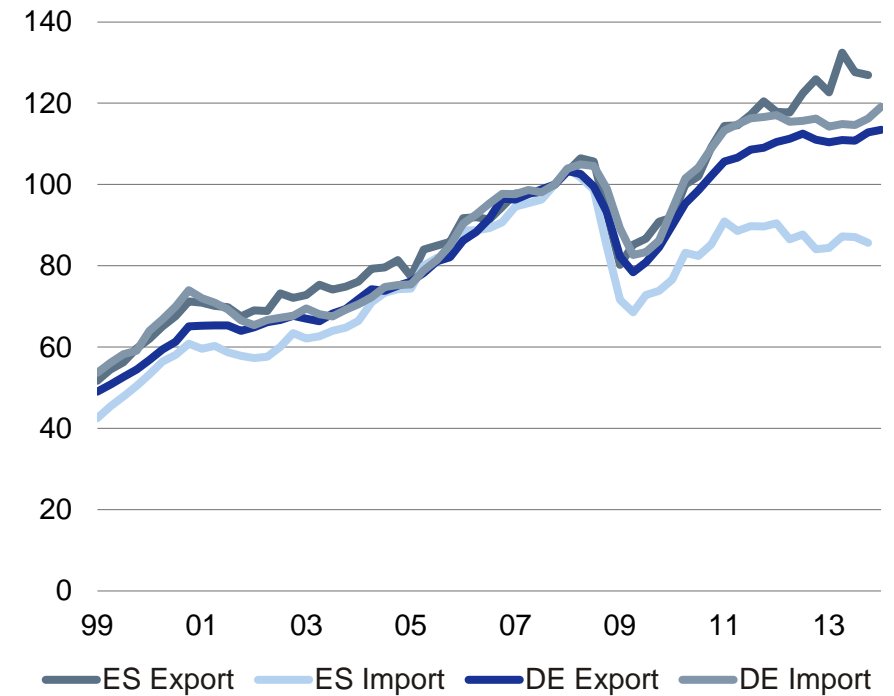
Nominal unit labour costs, 2010=100



Source: OECD

## Spanish exporters outperformed German ones

Goods trade, Q4 2007=100, nominal



Sources: Federal Statistical Office, Deutsche Bank Research, Spanish Ministry of Finance

# Primary budget balance of selected EA states



## Primary balance

in % of GDP	5-year average		Spring 2014 forecast					
	2000-04	2005-09	2010	2011	2012	2013F	2014F	2015F
Ireland	2.9	-2.0	-27.5	-9.9	-4.5	-2.5	-0.1	0.6
Greece	0.6	-4.0	-5.1	-2.4	-3.9	-8.7	2.8	4.1
Spain	2.2	-0.3	-7.7	-7.0	-7.6	-3.7	-2.1	-2.6
France	0.1	-1.1	-4.6	-2.5	-2.3	-2.0	-1.5	-1.0
Italy	2.7	1.3	0.1	1.2	2.5	2.2	2.6	2.9
Portugal	-1.0	-2.8	-7.0	-0.3	-2.1	-0.6	0.3	1.9
Euro area	1.3	0.3	-3.4	-1.1	-0.6	-0.1	0.4	0.6

Source: European Commission

# Structural budget balance of selected EA states



## Structural budget balance

in % of GDP	5-year average	Spring 2014 forecast					
	2005-09	2010	2011	2012	2013F	2014F	2015F
Ireland	-3.5	-9.3	-8.4	-7.9	-6.2	-4.5	-4.2
Greece	-9.1	-9.1	-6.0	-1.0	2.0	1.0	-0.4
Spain	-2.4	-7.1	-6.5	-4.1	-2.8	-2.4	-3.4
France	-4.8	-5.9	-4.8	-3.8	-3.0	-2.3	-2.0
Italy	-4.4	-3.8	-3.7	-1.5	-0.9	-0.8	-0.7
Portugal	-5.3	-8.4	-6.1	-3.5			
Euro area	-3.0	-4.4	-3.5	-2.1	-1.3	-1.1	-1.2

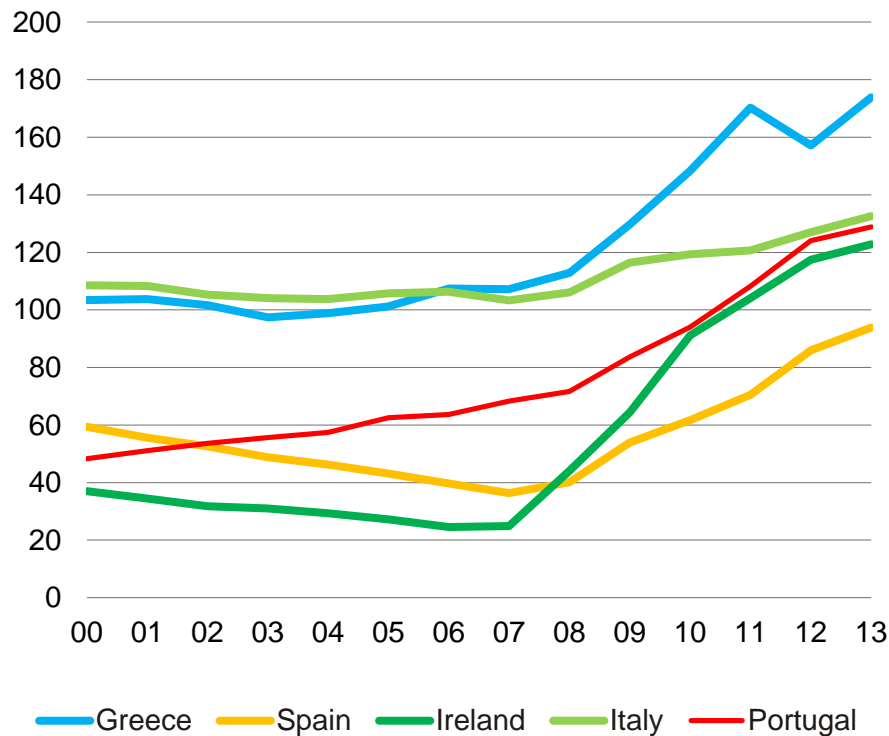
Source: European Commission

# Debt ratios might reach their peaks



## Debt

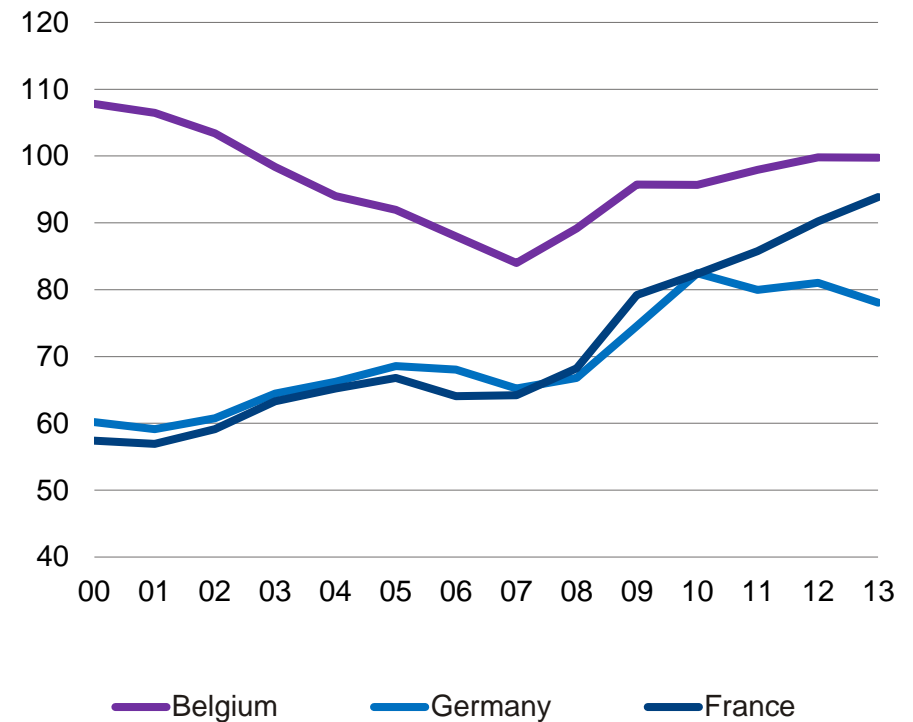
in % of GDP



Source: IMF

## Debt

in % of GDP



Source: IMF

# Gross debt in selected EA states



## Gross debt

in % of GDP	5-year average		Spring 2014 forecast					
	2000-04	2005-09	2010	2011	2012	2013F	2014F	2015F
Ireland	32.7	37.1	91.2	104.1	117.4	123.7	121.0	120.4
Greece	102	113.5	148.3	170.3	157.2	175.1	177.2	172.4
Spain	52.5	42.7	61.7	70.5	86.0	93.9	100.2	103.8
France	60.4	68.5	82.7	86.2	90.6	93.5	95.6	96.6
Italy	106	107.6	119.3	120.7	127.0	132.6	135.2	133.9
Portugal	56.5	72.2	94.0	108.2	124.1	129.0	126.7	124.8
Euro area	68.9	71.1	85.7	88.1	92.7	95.0	96.0	95.4

Source: European Commission

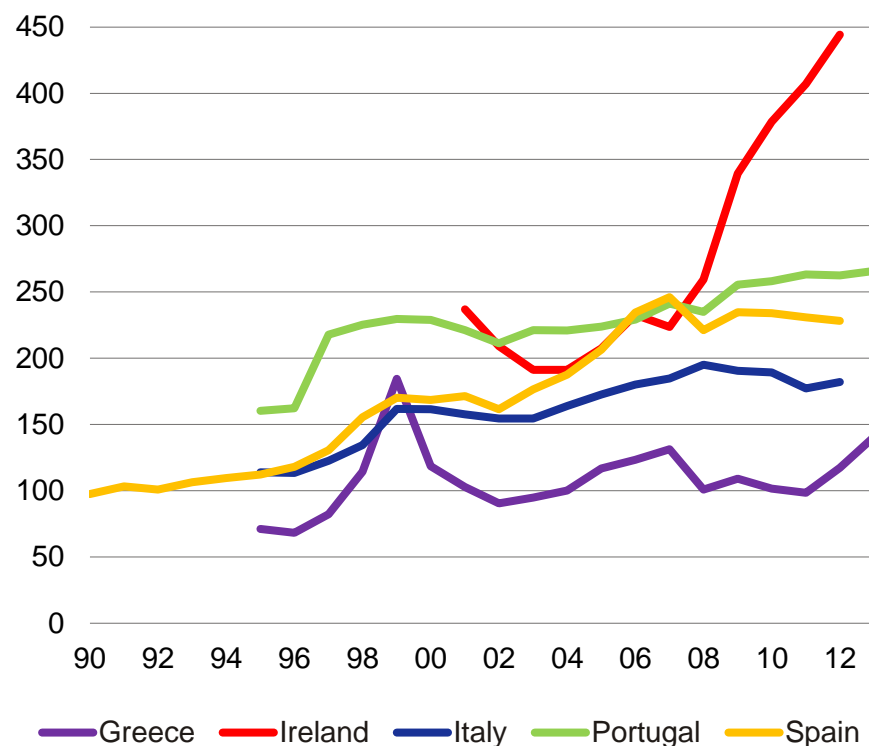


# Private sector debt too high, deleveraging will continue in crisis countries



## Corporate debt

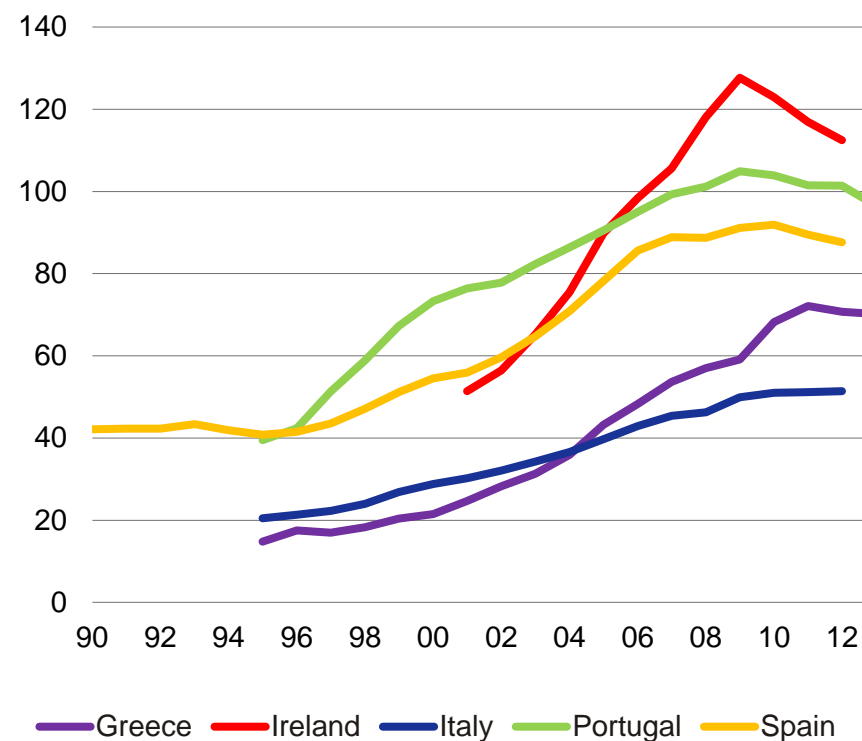
in % of GDP



Source: Eurostat

## Household debt

in % of GDP



Source: Eurostat

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