"Abenomics" to Date & Going Forward

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The House of Councilors election on July 21 led to a sharp increase in the number of seats held by Prime Minister Shinzo Abe's Liberal Democratic Party. As a result, the ruling coalition of the LDP and the New Komeito Party captured the 122 seats needed for a majority (including those uncontested) and put an end to the "twisted Diet" wherein the House of Councilors and House of Representatives were controlled by opposing parties. One of the issues at play in the election was how voters would evaluate Abe's signature economic policies dubbed "Abenomics". The results can certainly be read to suggest that most, setting aside the issue of how great their enthusiasm may be, supported them.

But how much has Abenomics actually buoyed the Japanese economy today? And how are business conditions likely to develop from here? This paper answers these questions by examining a variety of data and private-sector think tank forecasts.

Three Arrows of Abenomics

Abenomics is made up of three policies: the so-called "three arrows". The first is a "bold" monetary policy. The thinking is that greatly increasing the amount of money provided to financial institutions by the Bank of Japan (BOJ) — the monetary base — will increase the amount of money circulating in society — the money stock — and enable the Japanese economy to break free of deflation.

The second is a "flexible" fiscal policy. A supplementary budget totaling 10 trillion yen, dubbed "Emergency Economic Measures for the Revitalization of the Japanese Economy", was approved on Feb. 26.

The third is a growth strategy that "promotes private investment", a plan for which was recently put together in June.

These policies — particularly the first and second arrows — are Old Keynesian, the sort of traditional policies that invariably appear in textbooks on economic theory. In an open economy like that of Japan today, in which trade and capital movements are conducted freely, the Mundell-Fleming model tells us that engaging in fiscal policy without sufficient monetary easing will lead to a rise in the value of the yen that mitigates its effect.

The third arrow of the growth strategy, however, is looked to for its promised medium- to long-term effects. Critics argue that the plan offers nothing new, or that its regulatory reforms do not go far enough, but it is in any case unlikely to have any direct relationship to short-term trends in the Japanese economy.

Let us then turn to what effect the first and second arrows are having on the real economy.

Will Yen-Dollar Rate Return to Purchasing Power Parity?

First let's look at the impact of the first arrow. Haruhiko Kuroda assumed his position as the new governor of the BOJ in March 2013 and adopted a policy of "quantitative and qualitative monetary easing" the following month. This policy aims to engage in quantitative and qualitative monetary easing of an entirely different dimension, doubling the size of the monetary base and of long-term government bond and ETF holdings over a period of two years and more than doubling the average remaining maturity period for purchases of long-term government bonds. The monetary base expanded rapidly and in June marked a 36% increase year-over-year *(Table 1)*. This is comparable to the peak of the "quantitative monetary easing" policy implemented from March 2001 through March 2006 (April 2002: 36.3%). The current policy may seem to have gotten off to a rapid start relative to this earlier period, but this may be somewhat related to the fact that the expansion of the monetary base had already begun based on the joint statement by the government and the BOJ issued in January 2013 (Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth). Meanwhile, by June 2013 the year-on-year rate of growth in M2, the representative index of the money stock, had expanded to 3.8% *(Table 1)*. This is also comparable to the peak of the "quantitative monetary easing" period (March 2002: 3.7%).

The exchange rate and stock prices were quick to react to this posture of monetary easing. The trend toward a depreciating yen and appreciating dollar that began around the time the Abe administration was formed accelerated momentarily with the adoption of "quantitative and qualitative monetary easing". However, after depreciating to around 103 yen to the dollar in mid-May, the yen has since held steady at around 100 yen. Based on Tokyo market closing prices, the 102.79 yen to the dollar mark set on May 22 remains the weakest recent level as of this writing (Aug. 20). The same is true for stock prices, which have risen as the yen has fallen. After reaching its highest recent closing price of 15,627.26 yen, the market has since been at a standstill.

How are we to interpret these recent movements in the exchange rate and stock prices? Those who are critical of the current policy of monetary easing have begun to say that the policy is ineffective because the yen/dollar rate and stock prices have temporarily returned to where they were when the policy of "quantitative and qualitative monetary easing" began. Still, at the very least it seems to have been an effective corrective to the excessive appreciation of the yen and decline in stock prices.

This can be confirmed through the relationship between purchasing power parity and the yen/dollar rate *(Chart 1)*. The most recent figure for

TABLE 1
Key data over time

	2012			2013					
	October	November	December	January	February	March	April	May	June
Market data									
Nikkei stock average (end of month)	8,928.29	9,446.01	10,395.18	11,138.66	11,559.36	12,397.91	13,860.86	13,774.54	13,667.32
Yen/Dollar rate (end of month)	79.73	82.63	86.32	90.92	92.36	94.04	97.83	100.63	98.83
Soft data									
BOJ Tankan business sentiment DI (all enterprises)		▲9.0			▲8.0			▲2.0	
Economy watchers survey: current economic sentiment DI	39.0	40.0	45.8	49.5	53.2	57.3	56.5	55.7	53.0
Consumer Confidence Index	*39.1*	*38.9*	*39.0*	*38.8*	*42.1*	*43.1*	*44.5*	*45.7*	*44.3*
Hard data									
Indices of industrial production (seasonally adjusted, month-on-month)	0.3	▲1.0	1.4	▲0.6	0.9	0.1	0.9	1.9	▲3.1
Private consumption integrated (seasonally adjusted, month-on-month)	0.5	0.1	▲0.3	0.7	0.6	0.1	0.4	0.6	▲0.7
Machinery orders (private-sector demand, excluding electric power & shipbuilding, seasonally adjusted, month-on-month)	▲0.8	3.8	▲1.3	▲7.5	4.2	14.2	▲8.8	10.5	▲2.7
BOJ real exports (seasonally adjusted, month-on-month)	▲2.3	▲0.2	▲0.4	2.5	▲2.4	2.8	2.0	▲0.2	2.0
Number of employed (seasonally adjusted, month-on-month)	0.3	▲0.1	▲0.4	0.5	0.1	▲0.0	0.1	0.0	0.0
Total unemployment rate (%)	4.2	4.2	4.3	4.2	4.3	4.1	4.1	4.1	3.9
Nominal wage index (5 employees or more, year-on-year)	▲0.4	▲0.8	▲1.7	0.1	▲0.8	▲0.9	0.0	▲0.1	0.6
Domestic corporate goods price index (year-on-year)	▲1.1	▲1.1	▲0.7	▲0.4	▲0.1	▲0.5	0.1	0.5	1.2
Consumer price (general, excluding fresh food, year-on-year)	0.0	▲0.1	▲0.2	▲0.2	▲0.3	▲0.5	▲0.4	0.0	0.4
Money stock (M2, year-on-year)	2.3	2.1	2.6	2.7	2.9	3.1	3.2	3.5	3.8
Money base (year-on-year)	10.8	5.0	11.8	10.9	15.0	19.8	23.1	31.6	36.0

Note: Survey methods for the Consumer Confidence Index were changed beginning from April 2013. Therefore, figures through March are month-on-month based on the old survey method.
Source: Ministry of Internal Affairs and Communications Statistics Bureau; Ministry of Economy, Trade and Industry; Cabinet Office, BOJ, etc.

yen/dollar purchasing power parity as calculated by the Institute for International Monetary Affairs was 97.57 yen for May 2013. Interpreting the depreciation of the yen that began last autumn as a return to purchasing price parity makes the current standstill understandable.

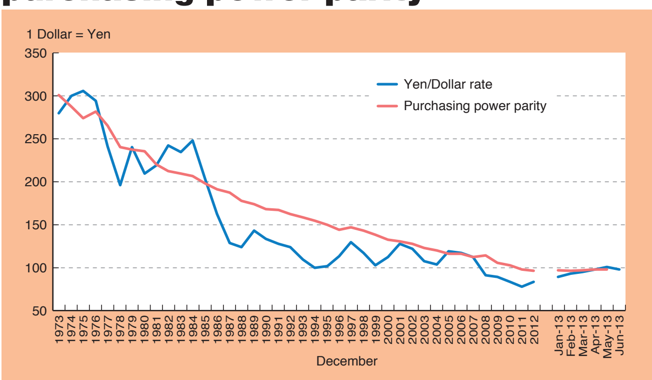
Going forward, the near-term focus on the yen/dollar rate will center on 1) whether the current policy of monetary easing, including the run-up period under previous BOJ governor Masaaki Shirakawa, will surpass the previous period of "quantitative monetary easing", and 2) whether Japan's anticipated rate of inflation will rise, eliminating US-Japan inflation rate disparity and changing the purchasing power parity trend into a depreciating yen.

Wealth Effect Centered on Elderly

The first arrow — correcting the high yen and low stock price — is also expected to have a positive effect on the mindset of households and corporations. For now, this effect has been seen in households, particularly elderly households, but remains unclear among other age groups and corporations.

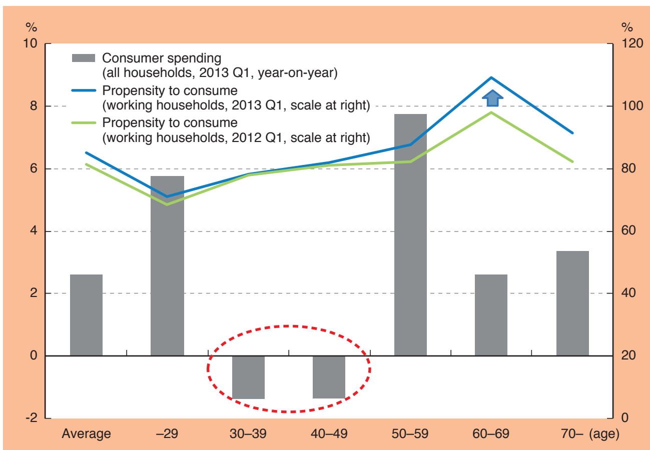
According to the Ministry of Internal Affairs and Communication's Family Income and Expenditure Survey, consumer spending per household for the January–March 2013 period rose 2.6% year-on-year, a huge improvement over the 0.8% year-on-year decline for the October–December 2012 period. Nevertheless, as shown in *Chart 2*, this recovery has not been uniform. Improvement has been centered on middle and older age groups of 50 and above; for those in their 30s and 40s, consumption is actually declining. Seeking the reasons in terms of either growth in disposable income or a rising propensity to consume, the

CHART 1
Yen/Dollar rate over time & purchasing power parity



Note: The yen/dollar rate is a monthly average; purchasing power parity is as calculated by the Institute for International Monetary Affairs.
Source: The yen/dollar rate comes from the BOJ; purchasing power parity comes from the Institute for International Monetary Affairs

CHART 2
Consumption trends by age group of head of household



Source: Produced by the author based on the Ministry of Internal Affairs and Communication's Family Income and Expenditure Survey. Propensity to consume is calculated by dividing consumer spending by disposable income.

improvement in consumption among those in their 50s and older can be largely attributed to a rising propensity to consume. Given that the bulk of Japan's financial assets are owned by the elderly, we can understand Abenomics to have been effective in driving greater consumption by the elderly.

For those in their 30s and 40s, however, propensity to consume is unchanged from the previous year, with changes in consumer spending linked directly to changes in disposable income. One likely focus for the future is whether or not the expansion of personal consumption driven by the elderly will, through improved corporate earnings, lead to rising wages but we had not seen a solid wage recovery until June.

Improved Business Sentiment Centered on Non-Manufacturing Industries

According to the July 1 BOJ Tankan survey of corporate sentiment for June, the business sentiment DI — an indicator of management mindset — was -2 for enterprises of all sizes, a six point improvement over the -8 recorded in the March survey. The business sentiment DI remains negative, with more managers believing current conditions to be "unfavorable" than "favorable" but still represented continued improvement after the March survey. In addition, forward-looking business sentiment DI was plus or minus 0, suggesting further improvement is expected.

It was hoped that the first arrow of Abenomics — a bold monetary policy — would make it easier for companies to raise funds by lowering interest rates. Indeed, the financial position sentiment DI ("easy" minus "tight") for all enterprises in all industries improved slightly over the March survey (+4 points) to +6 points. The forward-looking change in interest rate on loans sentiment DI ("rise" minus "fall") for all enterprises in all industries, however, was +13, suggesting concern about rising interest charges.

Improvement in the business sentiment DI seems to be driven instead by the depreciating yen and the second arrow of an aggressive fiscal policy. As indicated in *Chart 3*, the business sentiment DI by industry over time has improved for large, medium, and small enterprises in non-manufacturing industries even beyond the levels seen before the Lehman Shock (June 2008 survey), but remains just shy of pre-Lehman Shock levels for manufacturing industries. Looking more closely at which non-manufacturing industries were bullish reveals a marked improvement for construction and real estate.

Such movements in the business sentiment DI are related to demand trends since the Lehman Shock. Because of economic measures and earthquake recovery, the level of real government spending for the April–June 2013 period was 13% higher than before the Lehman Shock. Furthermore, spending under the supplementary budget for "Emergency Economic Measures for the Revitalization of the Japanese Economy" comes in addition to this. Nevertheless, the forward-looking business sentiment DI for construction and real estate is flat or negative. This appears to reflect concerns that profits will fall as the rapid increase in public works leads to higher wages and an increase in the cost of construction materials.

At the same time, the exports and capital investment that drove Japanese economic growth in recent years remain far behind pre-Lehman Shock levels. For the April–June 2013 period exports were 7% and private capital investment 21%, below pre-Lehman Shock levels. Exports, of course, continue to recover against the backdrop of a depreciating yen, with the April-June period being the second consecutive quarterly increase. Still, factors such as the stagnant economy in China, a major destination for exports, means there is no shortage of cause for concern.

Cautious Fixed Investment Plans

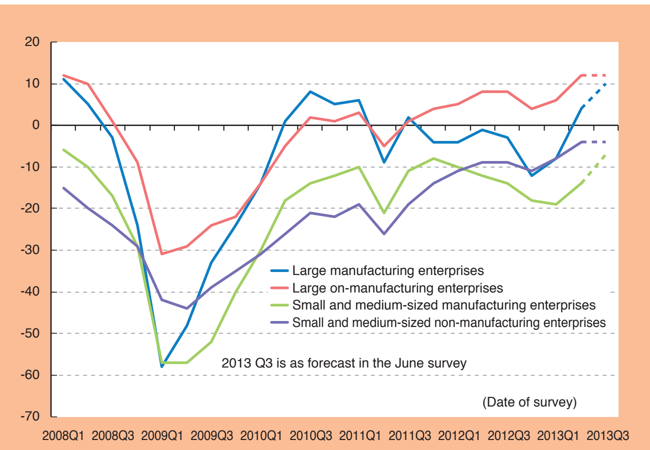
As Prime Minister Abe himself has said, trends in corporate fixed investment are an important key to whether the economy is really on track for recovery under Abenomics. There is still, however, no sign of any movement in earnest toward increased corporate fixed investment within Japan.

Fixed investment plans for fiscal 2013 as seen in the BOJ Tankan were revised upward in the June survey, but this is a pattern seen every year that might be called a quirk of the Tankan. Fixed investment plans for fiscal 2013 are actually even more constrained than for fiscal 2012, which ended sluggish *(Chart 4)*. The pace is up relative to fiscal 2012 for large non-manufacturing enterprises but notably constrained for large manufacturing enterprises whose profits are more influenced by exports.

It is not, however, that there is no encouraging news. Machinery orders (private sector demand excluding volatile orders), a forward indicator of

CHART 3

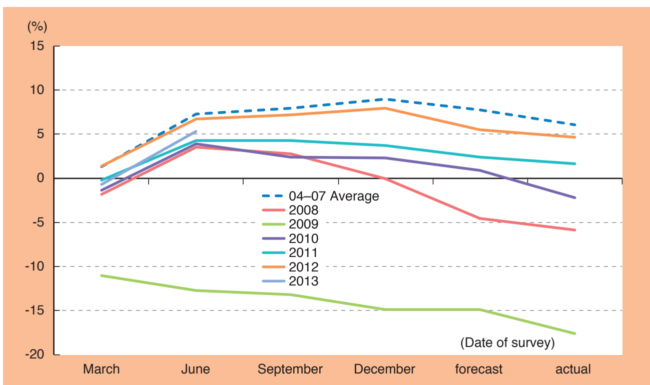
Trends in business sentiment DI after Lehman Shock



Source: BOJ Tankan

CHART 4

Fixed investment plans (BOJ Tankan)



Note: Total for all enterprises of all sizes. Includes software investment; excludes land investment.
Source: BOJ Tankan

fixed investment, were up 6.8% in April–June over the January–March period. But in the July-September period private-sector orders, excluding volatile ones, were forecasted to fall by 5.3% from the previous quarter.

Hiring Improvement Not Yet Seen

No clear improvement has yet been seen in the labor market, which is last to enjoy the benefits of an improved economy. The recent increase in the number of people employed has only just made up for the decline in the second half of last year. The total unemployment rate, which indicates the balance of supply and demand for labor, has declined only slightly since the start of the year *(Table 1)*.

TABLE 2

Average private-sector outlook for FY2013 over time

	2012	2013							
Release date	Dec 7	Jan 16	Feb 12	Mar 7	Apr 10	May 14	Jun 6	Jul 11	Aug 8
Real GDP growth rate	1.4	1.6	2.0	2.2	2.3	2.4	2.7	2.8	2.8
Domestic demand	1.4	1.6	1.9	2.1	2.2	2.4	2.3	2.3	2.4
Private demand	1.3	1.3	1.4	1.5	1.6	1.7	1.6	1.7	1.7
Public demand	0.1	0.3	0.5	0.6	0.6	0.6	0.7	0.7	0.7
Foreign demand	▲0.0	0.0	0.1	0.1	0.1	0.1	0.4	0.4	0.5
Nominal GDP growth rate	1.0	1.2	1.6	1.8	1.9	2.0	2.2	2.3	2.3
CPI inflation rate	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.4	0.4
Total unemployment rate	4.2	4.1	4.1	4.0	4.1	4.0	4.0	4.0	4.0

Source: Japan Center for Economic Research "ESP Forecast Survey"

Furthermore, there are no signs of the wage increases that Abenomics argues will materialize. The year-on-year nominal wage index (total for workplaces with five employees or more) for January 2013 was slightly positive, but shifted negative for February and March. The positive figure for January 2013 is also presumed to have resulted from a discrepancy in the timing of bonus payments between last year and this year. The index has been flat since April, but year-on-year fixed wages continue to be negative.

The corporate mindset toward hiring as seen in the BOJ Tankan is even more cautious. That the employment conditions DI ("excessive" minus "insufficient") is -1 for all enterprises of all sizes certainly suggests more companies feel that current employment is insufficient. However, this sense of insufficiency is strongest for small and medium-sized enterprises; large enterprises feel their number of employees is excessive.

The improving household perception of the employment outlook also took a step back in June. The employment outlook as seen in the Cabinet Office's Consumer Confidence Survey had been rising since last October as consumers hoped Abenomics would lead to improved employment conditions, but then deteriorated in June.

Real Economic Growth Rate Accelerates, But Depends on Public Spending

As the various data shown above confirm, the first and second arrows of Abenomics have, through a depreciating yen and higher stock prices, improved the mindset in some households and enterprises and begun to influence some consumption and fixed investments. However, it appears that more time will be required for across-the-board improvement.

Now let us turn to where Abenomics will go from here, using forecasts by the government and the BOJ as well as the Japan Center for Economic Research's ESP Forecast Survey, which compiles forecasts from various private research institutes.

The private research institute forecast of the real GDP growth rate for fiscal 2013 was 2.0% in February this year, lower than the government economic forecast of 2.5% *(Table 2)*. At that point the average bullish forecast was 2.5%, but most private institutes were skeptical about the effectiveness of Abenomics. In the most recent figures released on Aug. 8, however, they forecast a growth rate of 2.8%, the same as the revised government forecast on Aug. 2. If their forecast comes true, it will be the strongest growth since fiscal 2010 (3.1%).

Comparing the details of the private and government forecasts, each attributes 1.7 points to private sector demand. While the government attributes 0.8 points to public sector demand, the private forecast is slightly lower at 0.7 points, perhaps anticipating that some public works will be left undone due to a shortage of workers. On the other hand, foreign demand account for 0.3 points in the government forecast but 0.5 points in the private forecast. The government economic forecast presumes a fiscal 2013 yen/dollar rate of 98.3 yen while the private forecasts presumes around 100 yen, a difference that also probably affects the results. Meanwhile, the consensus forecast by members of the BOJ policy board in its mid-term review released on 11 July was 2.8%, the same as the private sector average. Nevertheless, this is a downward revision from the 2.9% forecast in April and can be read as incorporating a recognition that the effects of monetary policy have been delayed in appearing.

Both Government & BOJ Forecast Higher Inflation Rate

On the other hand, the most recent private research institute forecast of the nominal GDP growth rate for fiscal 2013 is 2.3%. As with the real GDP growth rate, the nominal figure has gradually been revised upward, but it is still expected to trail the real rate. The government's revised forecast, however, was 2.6% in January of this year.

For the consumer price inflation rate, the government forecasts 0.5% and the BOJ 0.6% while private research institutes forecast 0.4%. The difference is slight but both the government and the BOJ forecasts are higher. That the BOJ's forecast is a downward revision of its April forecast, however, suggests that it believes it will take time to achieve the ultimate aim of Abenomics: breaking out of deflation.

The BOJ forecast of a 1.3% real GDP growth rate for fiscal 2014 — when the consumption tax is scheduled to rise to 8% — suggests that it does not see a major setback to the economy, while the private sector forecast of 0.6% implies concern about the rebound from increased consumption before the rise.

If the effects of Abenomics spread to the employment market and domestic demand firms up, it may be possible to overcome the negative effects of the rise in the consumption tax. We will have to keep a close watch on the data to see whether things proceed in accordance with the government's and the BOJ's calculations. JS

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