Abenomics, the Japanese Economy & the Value of the Yen

Author Koji Sakuma

By Koji Sakuma

Measures to Tackle Deflation Before Abenomics

Before discussing "Abenomics", I want to touch briefly upon the history of reforms that Japan has taken since the bursting of the bubble economy in the early 1990s *(Chart 1)*. The fall of housing and real estate prices hurt bank assets, resulting in the cautious credit stances they adopted. They became reluctant to take new credit risks and this caused the economic activities of the real estate sector to shrink. The lack of decisive monetary policy is said to have prolonged this situation and trapped the economy in deflation.

The first policy response was a restructuring of the banking sector. It started in 1998 when the FSA was founded and effectively ended in 2005 when the ratio of non-performing loans of commercial banks fell below 3%. Some 98 trillion yen was written off in losses in the banking system, while public funds of 9 trillion yen were injected to recapitalize those banks. Such costs were comparable to 20% of GDP. Thirteen major commercial banks have been consolidated into the three so-called mega banks today, as well as a few others. This restructuring of the banking sector has strengthened Japan's banking institutions today, at a time when their European and American peers are in trouble due to the latest financial crisis.

The second reform was the so-called Koizumi Reform, taken under the leadership of Prime Minister Junichiro Koizumi between 2001 and 2006. This mainly addressed the supply side of the economy. Many zombie companies in the retail, construction and financial sectors were restructured, and as a result the corporate sector — with the exception of small and medium-sized enterprises — shaped up by cutting excessive debts, investments and employment.

A third reform was undertaken by the government of the Democratic Party of Japan in 2009. This mainly addressed the demand side of the economy by changing the redistribution channels of revenue. Their slogan was "From Concrete to People" — meaning the government would earmark more make public spending directly for households through various allowances or subsidiaries than for roads and bridges in rural areas whose contributions to productivity growth were limited. Long years of deflation had transformed the economic problem from structural weaknesses on the supply side to a weakness in demand. The government's policy was aimed in the right direction but failed to be carried through, as the DPJ was ousted from power in the latest general election in December 2012. But before losing the election, Prime Minister Yoshihiko Noda secured one of the biggest achievements in this history of reforms by deciding on a hike in the consumption tax rate from 5% to 8% in April 2014, and from 8% to 10% in October 2015. This became the starting point of Abenomics.

What is Abenomics?

Abenomics is generally regarded as having three "arrows". The first arrow is a bold monetary expansionary policy. This consists of a series of monetary policies announced by the new Bank of Japan (BOJ) governor, Haruhiko Kuroda, on April 4 this year: (a) to achieve a 2% inflation rate in two years, (b) to double the monetary base in two years, (c) to double the average remaining maturity of Japanese government bonds held by the BOJ, and (d) to purchase higher-risk assets such as exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at an annual pace of 1 trillion yen and 30 billion yen respectively. By providing a clear message of its determination, the BOJ aimed to change expectations about inflation from negative to positive.

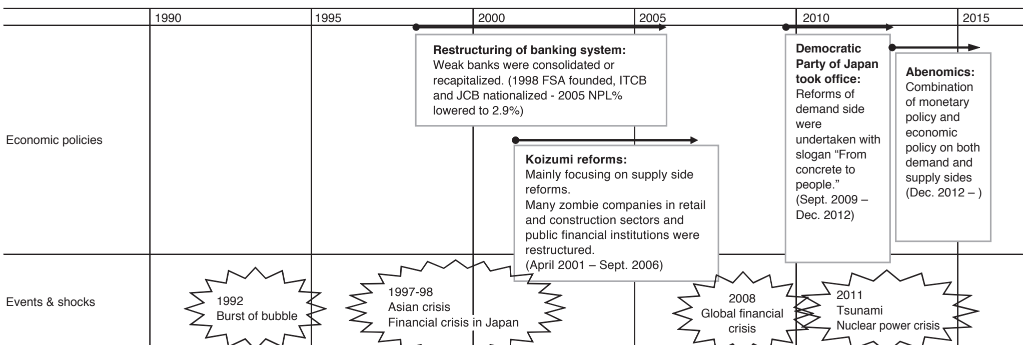
The second arrow is a flexible fiscal policy to stimulate demand, which was announced on Jan. 11. Some 13.1 trillion yen, comparable to 2.6% of GDP, was announced as a supplementary budget for fiscal 2012, 3.8 trillion yen of which is for the reconstruction of the Tohoku area and disaster prevention measures all over Japan.

The third arrow is a growth strategy, which was unveiled on June 14. The aim is to create new growth frontiers by combining technology, demand and deregulation mainly in four areas — healthcare services, clean energy supply, new infrastructure, and utilization of local resources.

What is really new among these three arrows is the monetary policy. Fiscal stimulus has been undertaken numerous times and in huge volumes in the past. Growth strategies have also been planned and attempts were made to implement them in various forms, though they were not as comprehensive as this time. But a bold quantitative easing in monetary policy has not been pursued before to the same extent as this time. Some people argue that the balance sheet of the BOJ is already the biggest among major central banks in terms of its comparative size to nominal GDP. But if you look at how far central banks boosted their assets during their quantitative easing policy compared to their conventional speed of growth, it can be seen that the BOJ's increase was the smallest *(Chart 2)*.

CHART 1

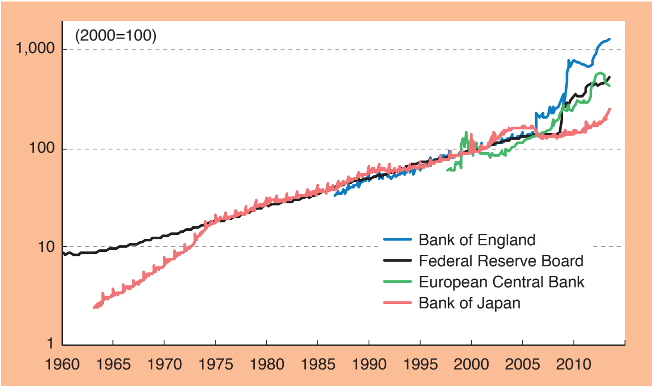
Economic policies & events in Japan (1990~)



	1990					1995					2000					2005					2010					2015	
GDP deflator (YY%)	2.3	2.6	1.6	0.4	0.1	-0.7	-0.6	0.6	-0.1	-1.3	-1.2	-1.2	-1.5	-1.7	-1.4	-1.3	-1.1	-0.9	-1.3	-0.5	-2.2	-1.9	-0.9	-0.7	?	?	?
CPI	3.0	3.3	1.7	1.3	0.7	-0.1	0.1	1.8	0.7	-0.3	-0.7	-0.8	-0.9	-0.3	0.0	-0.3	0.2	0.1	1.4	-1.3	-0.7	-0.3	0.0	0.1	?	?	?
Number of bankruptcies of banks		1	1	2	4	6	5	17	30	44	14	56		1													
Real GDP growth rate (YY%)	5.6	3.3	0.8	0.2	0.9	1.9	2.6	1.6	-2.0	-0.2	2.3	0.4	0.3	1.7	2.4	1.3	1.7	2.2	-1.0	-5.5	4.7	-0.6	2.0	1.6	?	?	?

Sources: IMF and various, compiled by author

CHART 2
Monetary base of major central banks



Sources: FFB, BOJ, Datastream

CHART 3
Exchange rate of yen against US dollar

Source: Datastream

How Is Abenomics Affecting Markets & Sentiment?

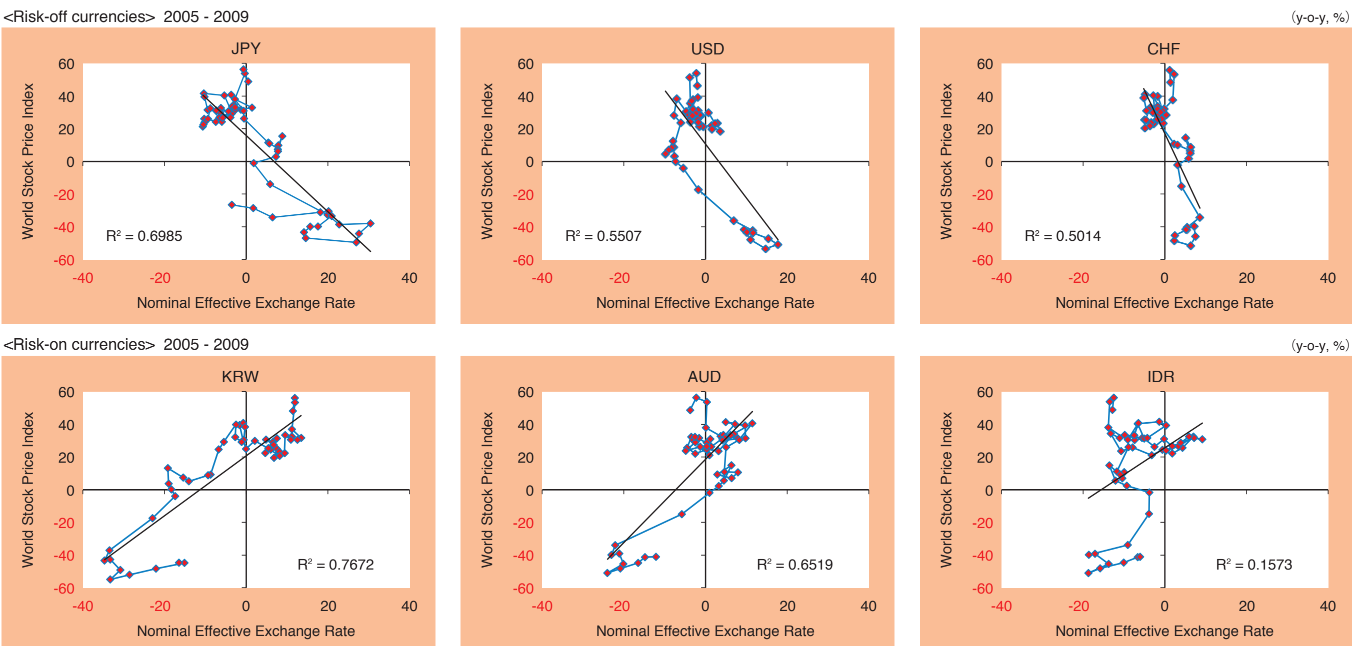
How these three arrows can lead Japan out of deflation is still unknown. But we have already seen some changes in financial markets. The value of the yen has fallen since last autumn when people started to expect that a new government led by Shinzo Abe would come into power in the near future, who firmly believed decisive monetary easing was indispensable to end deflation. The trend of the yen's depreciation was intensified when BOJ Governor Kuroda announced his policy. Share prices reacted quickly to this development in the foreign exchange market and positive sentiment spread both among households and the corporate sector.

The pace of the yen's depreciation was remarkable. It fell by 24% in eight months *(Chart 3)*. This is comparable to the 33% depreciation of the renminbi in the three years from 1992 to 1994, which became a distant cause of the Asian crisis in 1997-98. Apart from the immediate psychological effects on consumers and businesses, this does have an actual impact on the price competitiveness of Japanese exports. Although currency depreciation was not an intended result of the BOJ's policy and Japan should not depend too much on it for its economic recovery, we need to use this market environment to some extent to accelerate the change in price expectations.

The trend of the yen's depreciation was not created only by such domestic policy developments but also by the global market environment. The yen, together with the Swiss franc and the US dollar, is a typical safe-haven currency which investors want to buy in times of risk-averse sentiment and want to sell in times of risk-taking sentiment *(Chart 4)*. The global market has seemed to enter a time of risk-taking since the middle of 2012 when talks of an exit from the quantitative easing policy of the United States began.

Currently concerns are spreading in emerging markets that capital flows would reverse out of emerging economies because of the change in US monetary policy. Being affected by this cautious sentiment, the yen sometimes faces upward pressure again as a safe-haven currency. But the starting point of this concern is the talk of an exit from the US quantitative easing policy. This is basically good news for the world economy as the US economy is returning to normal where extraordinary easing is going to be unnecessary. We are, therefore, safe in expecting that the fundamental trend in risk-taking sentiment among global investors is likely to continue for the time being, and this will support the trend of

CHART 4
Risk-off currencies & risk-on currencies



Source: BIS, Bloomberg

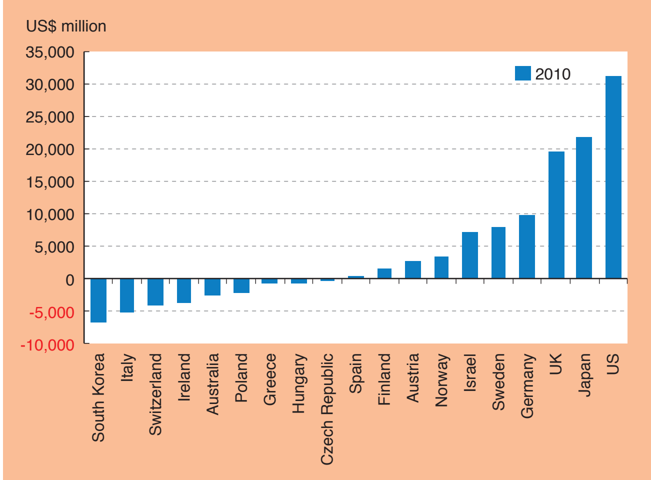
the yen's depreciation and Japan's economic recovery.

One may ask whether the yen's depreciation can really help Japanese exports because Japanese manufacturers have shifted production abroad to a considerable extent. We should not simply believe the exchange rate can clean up Japan's economic problems. But depreciation can nonetheless be a favorable factor for the Japanese economy. Domestic production of export goods has declined, but not so much that we should expect the yen's depreciation to have no positive impact. The size of exports compared to the whole economy has not shrunk in the last 15 years. Also, investment in domestic equipment and machinery by manufacturing firms remains at over 80% of their total investment. We sometimes read articles that tell us manufacturing companies are shifting their production base abroad, but this is not what has happened across the whole of Japan. These facts I have mentioned here are good evidence that manufacturing is still continuing in Japan and the notion of a hollowing-out does not exactly reflect the whole truth.

Looking forward, the Japanese disadvantage in production costs compared to its Asian peers will steadily narrow. Although there remain large gaps, the worst period is passing. The hike in labor costs in Asia means the rise of consumer power among its peoples too. This is the emergence of the Asian middle class, which is an advantage for Japanese manufacturers. It constitutes hundreds of millions of people and is growing rapidly. The richer such a class of the Asian population becomes, the more high-value products they will be inclined to buy. And it is in such products that Japanese manufacturers retain their competitiveness. As recent OECD statistics show, Japanese industries still retain technological advantages. Their analysis shows that Japan is the second-largest surplus country in terms of technological balance of payments, which represents trade in R&D-intensive products, patents, technological service fees, etc. *(Chart 5)*. The Japanese economy can make the best use of such an environment in expanding its exports if it is accompanied by a depreciation of the currency.

CHART 5

Technology Balance of Payments



Source: OECD

How Far Can the Yen Be Allowed to Depreciate?

As already mentioned, the yen's depreciation brings the Japanese economy certain benefits. According to a purchasing power parity (PPP) analysis on a nominal effective exchange rate basis, the yen at its peak in the autumn of 2011 was overvalued by approximately 15% on a trade-weighted basis. This gap has rapidly shrunk since the end of last year. In this regard, the depreciation since last year should be regarded as an adjustment of the overvaluation which emerged under the extreme strain on the global financial markets after the Lehman shock.

However, excessive depreciation beyond the level of PPP might not only annoy other nations but be harmful to the Japanese economy. There are three reasons for this.

First, excessive undervaluation will cause misallocation of domestic resources. When an investment method called "the yen carry trade" was widespread from 2005 to 2007, the yen was considerably undervalued. Strong demand for yen-denominated funding, which was exchanged into other currencies, caused downward pressure on the exchange rate of the yen. This development in financial markets brought a huge benefit to Japanese manufacturers. During this period, they expanded production capacity in Japan by investing in more production lines and hiring a larger workforce. If the depreciation of the yen had been a long-term trend, this decision to allocate more money and labor to domestic production would have been correct. But this was a temporary phenomenon which was followed by a major adjustment. This is a typical case of excessive undervaluation misleading companies into making the wrong decision concerning resource allocation.

The second reason is the benefit of currency appreciation for the entire national economy over a long period. Japan abandoned a fixed exchange regime in the early 1970s and the value of the yen against the dollar has kept rising since then. We all know very well about the negative impact of currency appreciation on export growth. However, at the cost of an export slowdown, Japan realized long-lasting modest growth in which the inflation rate was kept low and the income growth in real terms has been shared widely among the middle class. The current situation, being in deflation for many years, prevents us from appreciating this benefit. But we should not forget it given the fact that there is a different kind of economy, as seen in the US and South Korea, where they suffer from inflation, which has eliminated the growth of the real income of the middle class.

The third reason is that if the depreciation of the yen gains a certain momentum, it might give rise to concerns over a capital flight from Japan. Japan can fund itself thanks to the huge financial assets of the household sector. However, the government debt is over 200% of GDP. This level has been never observed in major countries except in times of global-scale wars, such as World War I and World War II. This exceptionally bad situation in Japanese government finances gives market participants a good reason to be concerned about a capital flight if the depreciation of the yen gains uncontrollable momentum.

Outline of Growth Strategy

Now I want to focus on the third arrow, a growth strategy. This was announced on June 14, and has three objectives and three action plans. The three objectives are (a) private sector-driven growth, (b) long-term development of human resources by public support, and (c) creation of new growth frontiers by combining technology, demand and deregulation. The three action plans are (i) revitalizing Japanese industries, (ii) supporting the globalization of Japanese companies, and (iii) creating new domestic markets that will lead the growth of the whole national economy.

Superficially it looks impressively wordy but not really convincing. The interesting part, however, is found in the so-called "Strategic Market Creation Plan" which is explored under the last objective of creating new growth frontiers. It plans to create new markets by vitalizing four areas of potential demand: 1) healthcare services (whose potential market size is $3,370 billion both domestically and overseas), 2) clean and efficient energy ($1,180 billion), 3) new infrastructure ($1,830 billion), and 4) Japan's numerous local attractions ($8,000 billion).

Although I will not go into further detail on each item, I found them comprehensive, well targeted and realistic, accompanied by potential technological development. Progress in these four frontiers will depend on strong government leadership, public support to mitigate long-term business risks and well-motivated engagement by the private sector. We need good players in the private sector as well as a good conductor who can orchestrate the whole plan.

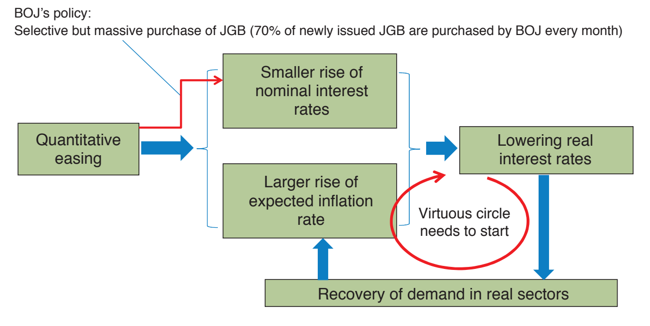
Can Abenomics Really Revive the Japanese Economy?

Some of my overseas economist counterparts do not see any convincing grounds for Abenomics and doubt the revival of the Japanese economy. What have occurred so far are quantitative easing, the depreciation of the yen and a revival of confidence in the stock market, and we still have to wait until we see the real effects of the growth strategy. They think it too easy if decades-long deflation can be solved by such simple methods and wonder why it took such a long time for the Japanese to reach this point.

There are two reasons for this delay. One is to do with monetary policy. When the BOJ was criticized because of its reluctance over quantitative easing before the

CHART 6

It is possible to raise expected inflation rate without raising real interest rates



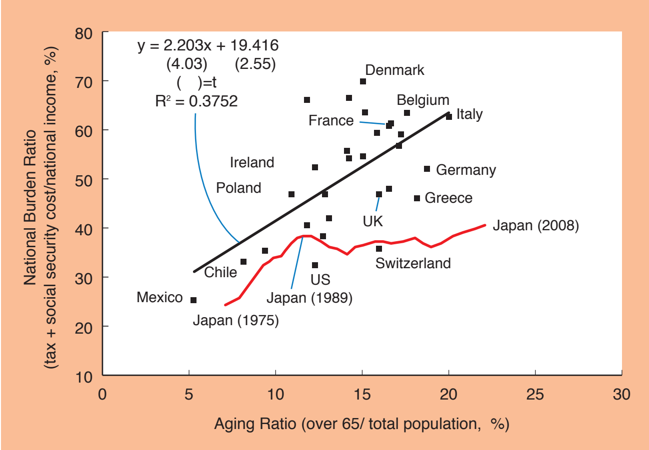
It is possible to win this game unless the rise of nominal interest rates exceeds the rise of the expected inflation rate. The precondition is international investors' confidence in the long-term sustainability of Japanese government debts.

Source: Author

CHART 7

Aging & national burden ratio

(Japan's trend & status of OECD countries in 2008)



Source: OECD, Ministry of Finance, National Institute of Population and Social Research, country statistics

Lehman Shock, the problem was only in Japan. In these circumstances it was understandable for any central bank to hesitate to take a big jump in its quantitative easing. The primary purpose of central banks is to maintain the value of the local currency. What quantitative easing seeks is just the opposite: effectively trying to damage the value of a currency. Taking a step toward doing something which is the opposite of your primary purpose is extremely difficult. There was no guarantee, and there is still no guarantee even today, that a quantitative easing policy will end in success. But seeing other major central banks now all taking this measure, the BOJ also finally decided to do it.

The other is to do with fiscal policy. Abenomics is described as having three arrows, but I would like to emphasize there is an important precondition. It is a commitment to restore fiscal discipline over the long term, which, as mentioned at the beginning of this article, was half realized by the previous prime minister, Yoshihiko Noda.

The primary objective of Abenomics is to create inflation, and creating inflation means raising interest rates, which is extremely bad news for Japan. The outstanding public debt is over 200% of nominal GDP and a higher interest rate even by 1% means 10 trillion yen in extra costs for servicing government debt every year. The burden will spread to the private sector, too, as the yield on government bonds is the base interest rate for every financial transaction in fixed interest rates.

In order to avoid this negative impact of inflation, we need to control the rise of nominal interest rates within the rise in the expected inflation rate so that the real interest rate remains neutral or lower. And in order to realize it, we need to convince investors that the Japanese fiscal position is sustainable. Otherwise the rise in nominal interest rates will outpace the rise in the expected inflation rate. This situation — if it occurred — would be the same as the experiences of peripheral countries in the Eurozone and would totally destroy the scenario of Abenomics where the increase in demand and the rise in the expected inflation rate are supposed to emerge in a virtuous circle *(Chart 6)*.

We arrived at Abenomics so late because it took a long time to establish the grounds of this precondition. When a society is already aging rapidly, remodeling of income redistribution channels for social welfare becomes extremely difficult, because the bigger the aged population becomes, the more difficult it becomes to impose the costs of social security on the current working generation instead of the future generation. This phenomenon is unavoidable in a democracy because as time goes by there are more aged people among voters and they become less concerned about a fiscal collapse in the future. Japan was about to fall into the trap of an inability to change. The previous government pushed hard to persuade the public that the current cost of the social safety net should be shared by the current working generation. This sense of urgency was spread throughout the nation and the law on a consumption tax hike was finally passed by parliament.

Therefore, the hike in the consumption tax rate was not something decided on in accordance with economic conditions but as a precondition for a change for the better. If we look at where Japan is positioned in a diagram on aging ratios and national burden ratios *(Chart 7)*, we notice it was moving away year after year from where it should be, and at the cost of future fiscal collapse. Japan needs to come back now to an appropriate position.

Long-Term Trend of the Yen

We will see a big change in coming decades in the Japanese economy, no matter whether the change proves to be controllable or unintended and even disastrous. How will such a change affect the exchange rate of the yen? Given the principle that exchange rates reflect the inflation gap between two countries in the long run, much depends on how inflation develops in Japan and other countries. While it is difficult to predict the inflation rates of other countries, that of Japan is very likely to rise in the future regardless of whether Abenomics is a success or failure.

The former can only happen if the hike in the consumption tax is introduced as scheduled and the confidence of global investors in Japan is maintained so that a rise in real interest rates will be successfully avoided. If the other policies of Abenomics are also successful and Japan achieves 2% inflation by the end of 2014 as the BOJ targeted, the yen will become a currency that faces more selling pressure than now because of the higher inflation rate. Under such price conditions, there will be less overvaluation of the yen than today. And these market conditions will support Japanese exporters so that the pace of shrinkage in the current account surplus, or expansion of its deficit, will be moderate. That in turn will make the pace of the yen's depreciation also moderate.

Alternative Scenario

But if the consumption tax is not raised and Japan fails to demonstrate long-term fiscal discipline, we will experience a sharp rise in government bond yields, which will make financial costs extremely heavy for all sectors. The result would be a serious burden on government debt servicing and a reluctance by private companies to make new investments. The public debt to GDP ratio will accelerate and end up in the total collapse of the credibility of the government of Japan. The yen will be sold even by Japanese residents and an uncontrollable fall in the exchange rate will give rise to uncontrollable inflation. Inflation will transfer wealth from creditors to debtors. The government will be saved at the expense of the nationwide savings of households. That is an alternative scenario for breaking the current impasse and the Japanese economy could find grounds for a new start. JS

Koji Sakuma is general manager and chief economist of the Institute for International Monetary Affairs. He was previously head of research in London at the Bank of Tokyo-Mitsubishi.