The Impact of "Abenomics" on Emerging Markets in East Asia

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Background

In December 2012, Prime Minister Shinzo Abe announced a bold plan to stimulate the Japanese economy. Dubbed "Abenomics", the plan consists of three main strategies: a fiscal stimulus, indefinite quantitative easing, and structural reforms to spur economic growth. Prime Minister Abe even symbolically described his strategies as "three arrows" in reference to an old legend from Yamaguchi. This alludes to the success of the plan if all three strategies together are implemented.

This paper assesses the impact of Abenomics on emerging markets in East Asia. The primary channels would be the exchange rate mechanism, trade volumes, especially intraregional trade, and capital flows from Japan. The potential impact of the stimulus package on the Japanese economy is cited. Abenomics should also be assessed in terms of previous stimulus packages and the global economic situation when it was implemented.

The key elements of Abenomics are as follows.

Fiscal Policy Reforms

The first step of Prime Minister Abe was a ¥10.3 trillion fiscal stimulus package in January 2013. The stimulus package was higher than what was expected by the majority of international investors. However, any concerns were mitigated by the pledge to have a flexible fiscal policy over the coming years.

Abe plans to pay for these stimulus measures and other spending programs by doubling the consumption tax to 10% in 2014-15. This concerned some economists who believe that the increase may end up neutralizing the stimulus in the medium term. Moreover, stabilizing the country's debt may require moving from a deficit of 8% to a surplus of more than 3% before interest payments.

Monetary Policy Reforms

Monetary policy reforms under the new governor of the Bank of Japan (BOJ) were aimed at reducing real interest rates and increasing the inflation rate in Japan. The economic stagnation since 1991 was accompanied by a debilitating deflation that hurt creditors and curtailed consumption expenditure. Meanwhile, the appreciation of the yen since 1985 *(Chart 1)* contributed to a hollowing-out of the Japanese manufacturing sector, and this was exacerbated when the yen appreciated sharply after 2008.

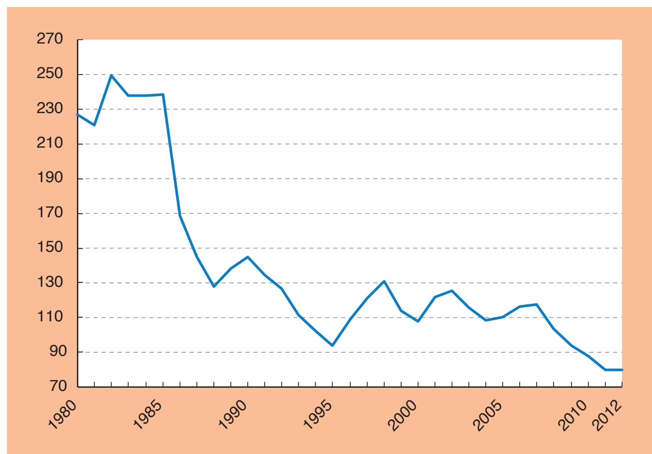
In April 2013 the inflation target was doubled to 2% per year. By implementing open-ended asset purchases like the U.S. Federal Reserve, the BOJ made significant progress in weakening the yen in the first eight months of 2013 *(Chart 2)*, which helped the Nikkei jump sharply. Willem Thorbecke argues that the yen began depreciating on Nov. 13, 2012 when then Prime Minister Yoshihiko Noda announced he would call for new elections ("Investigating the Effect of Exchange-Rate Changes in Japan, China, East Asia and Europe", *Vox*, Feb. 26, 2013). Investors anticipated the next administration would implement a looser monetary policy.

Structural Reforms

Arguably, the most critical aspect of Abenomics is structural reforms, which could prove to be the most difficult to implement. While the first two sets of measures are designed to stimulate the demand side, structural reforms address supply-side constraints. The agriculture sector has become one of the key priorities, with its high tariffs on rice and dairy and land laws limiting the size of farm plots, among other issues in the sector. By expressing Japan's intention to join the Trans-Pacific Partnership (TPP), Abe's government has signaled its seriousness in implementing structural reforms not only in the agriculture sector but in the entire economy as well.

CHART 1

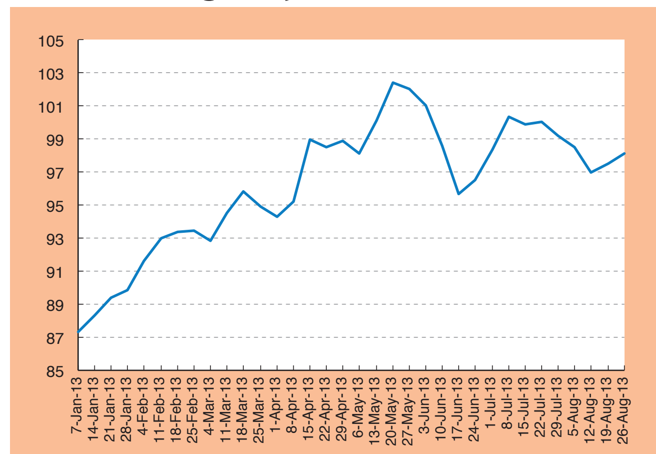
Yen/Dollar exchange rate: 1980-2012 (annual average)



Source: IMF online database

CHART 2

Yen/Dollar exchange rate: Jan. 1, 2013 to Aug. 26, 2013 (weekly average)



Source: OANDA foreign exchange online database

What Makes Abenomics Different?

The Japanese government has implemented many stimulus packages since 1991 in an effort to revive a stagnant economy. This passage from L. Larry Liu ("What's the Matter with Japan? The Japanese Economy from a Historical Perspective", *Penn Asian Review*, Dec. 18, 2012) summarizes the Japanese experience with stimulus packages in the past two decades:

"The 1990s were marked by an economic malaise as growth rates remained low, unemployment rates increased, and bank failures occurred… An overhang of bad debt was burdening the Japanese economy, as indebted banks were unwilling to lend money to companies. In 1994, the government permitted banks to write off over $400 billion in debt and made the taxpayers provide new funds for the banks to continue lending… The number of banks receiving loan assistance sharply increased from seven cases in 1997 to 51 cases in 2002. The amount of bad debt disposition had reached a peak in 2001, and by the end of 2005 was lowered to 4.6% of total bank assets. In order to stimulate the economy, the government passed several fiscal spending packages over the course of the 1990s, totaling 122 trillion yen in stimulus. They were designed to create public works projects. However, the fiscal programs were not sufficient, and most funds only benefited the political clientele rather than the general economy. The Bank of Japan lowered the official interest rate from a high of 6% in 1991 to a low of close to 0.15% in 1999 in the hopes of halting deflation and stimulating the economy. It also pursued the strategy of quantitative easing, which increased the Bank's balance of current account from five trillion yen in 2001 to 30-35 trillion yen in 2004. The policy of countering deflation had been a failure, and the zero interest rates have lost their effectiveness, because it could not go even lower. Japan was in a liquidity trap, because no interest rate was low enough for scared borrowers and reluctant lenders to engage in transactions, which is a pre-requisite to growing the economy. Deflation has weakened the Japanese economy, because it lowered investment spending. It raised the real rate of interest, making the Japanese debt burden even worse…

"As the economy improved slightly in the mid-1990s, the Japanese government became worried about the ballooning deficit, and embarked on a fiscal austerity program, involving spending cuts and tax increases. However, this measure led to a sharp decline in GDP between 1997 and 1998. The government under Koizumi (2001-2006) implemented a policy of further government spending reduction, deregulation and liberalization. He privatized the postal services and the highway systems, reduced the number of public employees and delegated greater administrative responsibilities to the local governments. Despite those austerity policies that temporarily reduced the deficit, the deficit and debt continued to rise after 2008, following the collapse of the US housing bubble and economic crisis. By 2010, the government budget deficit increased to 10.5%, and 43% of government revenues were devoted to debt service payments. Despite the debt commitments, interest rates on government bonds have been low. In July 2012, the 10-year yield on Japanese bonds decreased to 0.79%, the lowest rate since 2003, partly because the Bank of Japan eagerly bought government bonds. The main reason why Japan's high public debt burden has not resulted in higher interest rates was because the Japanese people had a generally high savings rate, allowing the government to draw heavily from their savers without upsetting foreign investors, who are more sensitive to expectations about debt levels. However, the fairly stable fiscal position of the Japanese government might be upset by the fact that the nation's historically high saving rate is shrinking. While Japan's household saving rate has historically been high, averaging 14% of disposable income in the 1990s, this rate has shrunk to 2% in the last few years. Japan's economic and fiscal troubles were compounded by the earthquake catastrophe in 2011."

Obviously, the impact of past stimulus packages has been mixed. There would be no need for Abenomics if they were unequivocally successful. What is important is to determine whether there is a significant difference between the current stimulus package and past efforts. At face value there seem to be only minor changes. After all, as Liu points out, "the government passed several fiscal spending packages over the course of the 1990s, totaling 122 trillion yen in stimulus." The BOJ "also pursued the strategy of quantitative easing, which increased the Bank's balance of current account from five trillion yen in 2001 to 30-35 trillion yen in 2004." Meanwhile, some of the reforms of Prime Minister Junichiro Koizumi addressed supply-side constraints.

The key difference is that Abenomics was preceded by massive quantitative easing by the Federal Reserve Bank (FRB) of the United States. Between November 2008 and January 2013 the FRB engineered four quantitative easing (QE) episodes that resulted in an expansion of approximately $2.4 trillion in base money. At the same time, the yen appreciated from 104.3 per dollar in September 2008 to a peak of 76.36 per dollar in January 2012, in line with its role as one of the three major global currencies. This has resulted in economic difficulties for Japan, which will be discussed in more detail in the next section.

Hence it is no surprise that the BOJ countered with a planned QE of $1.4 trillion over a period of two years beginning in April 2013. The ambitious scale of the operation can be gleaned from the relative size of Japan's economy which is a third of the size of that of the US. Moreover, the time frame of two years is half that of the US program.

Economic Impact of Quantitative Easing

The first phase of the US quantitative easing program was the largest. Apart from the yen appreciation, the other major consequence was a surge in portfolio capital flows to emerging markets *(Table 1)*. There was a turnaround of $232

TABLE 1

Emerging market economies: private external financing (million $)

	2005	2006	2007	2008	2009	2010	2011	2012e	2013f	2014f
External financing										
Private flows, net	692,439	813,317	1,241,801	658,749	677,152	1,184,993	1,145,743	1,180,619	1,144,776	1,111,525
Private flows, net (old measure)	573,213	575,056	961,653	411,778	410,123	896,162	883,726	860,845	769,497	754,675
Equity investment, net, net	257,166	203,826	295,213	198,866	265,994	381,345	335,836	350,205	255,550	275,929
Direct equity investment, net, net	211,778	170,583	322,901	319,495	215,166	290,137	351,452	279,228	224,817	236,443
Inward, net	301,789	352,514	489,872	529,060	384,336	523,603	592,936	545,464	541,469	523,201
Outward, net	-75,348	-145,614	-162,243	-209,565	-169,170	-233,467	-241,484	-266,236	-316,652	-286,758
Portfolio equity investment, net, net	45,388	33,243	-27,687	-120,629	50,828	91,208	-15,616	70,978	30,734	39,486
Inward, net	74,604	89,572	85,489	-83,222	148,687	146,573	4,917	124,515	89,361	109,578
Outward, net	-28,993	-56,329	-113,208	-38,728	-97,859	-55,364	-20,517	-53,537	-58,627	-70,093
Commercial banks, net	190,600	233,593	449,255	69,840	-7,388	167,332	194,659	120,530	144,482	153,557
Other private creditors, net	125,446	137,638	217,185	143,071	151,517	347,485	353,231	390,110	369,465	325,188

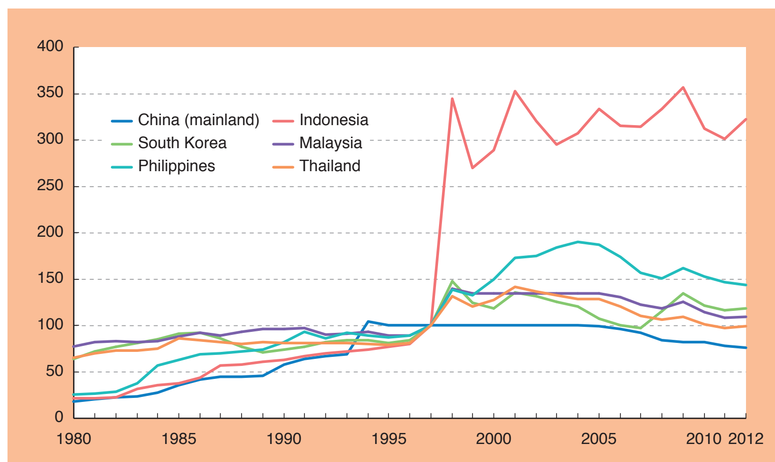
f = IIF forecast, ... = not available, e = estimate
Sources: Institute of International Finance, http://www.iif.com/emr/global/capflows/

billion in net inflows between 2008 and 2009. This momentum was sustained as portfolio inflows reached $146 billion in 2010. Investors sought higher returns in response to plummeting interest rates and stock prices in the US. The portfolio flows caused stock prices in emerging markets to increase sharply. The MSCI Emerging Markets Index, which is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets, rose by 93.5% from its level at the beginning of QE1 in November 2008 to its peak during the implementation period (April 14, 2010). It further increased 14% at its peak during QE2 (April 26, 2011). With news of the imminent "tapering" of US monetary policy and tension in the Middle East, the index has fallen 24.3% below the peak level (as of Aug. 30, 2013).

The surge in portfolio flows has contributed to the appreciation of currencies. *Chart 3* shows the currencies of China, Indonesia, South Korea, Malaysia, Thailand, and the Philippines which are part of the MSCI Emerging Markets Index. The currencies all appreciated after 2008. Hence, currencies in East Asia appreciated in response to the QE in the US.

CHART 3

Exchange rates 1980-2012: selected Asian countries (1997=100)



Source: IMF, IFS online

Thorbecke reports that the Japanese real effective exchange rate appreciated by 30% between June 2007 and March 2009 ("The Contribution of the Yen Appreciation Since 2007 to the Japanese Economic Debacle", *CEPII Working Paper No. 31*, 2012. Paris: Centre d'Etudes Prospectives et d'Information Internationales). At the same time, Japanese real exports fell 40%, industrial production dropped 35%, and the Nikkei index lost more than 80% of its value. Thorbecke presents empirical evidence showing that the appreciation of the yen caused exports to fall significantly, especially for the automobile sector. His analysis found that the appreciation of the Japanese currency caused yen export prices to fall much more than yen costs in the automobile and electronics sectors. Finally, he argues that *endaka* — when the value of the yen is high compared to other currencies — caused stock prices in these two industries to plummet. Since the automobile and electronics industries have long been the leading sectors of the Japanese economy, this evidence indicates that the appreciation of the yen since the global financial crisis has substantially contributed to the economic difficulties in Japan.

Japan is the hub of regional production networks in East Asia. Arguably, regional production networks are the heart of economic integration in East Asia. This has given rise to the phenomenon of processing trade. Processing trade consists mainly of East Asian economies shipping parts and components to China for assembly and re-export. For example, Thorbecke cites data where China has been running deficits in processing trade of about $100 billion with East Asian supply-chain countries and surpluses of $100 billion with Europe, $165 billion with the US, and more than $200 billion with Hong Kong. Other countries in the region of course also re-export to the US and Europe.

Thorbecke, in his 2013 article, argues that since both China and East Asia have high value-added in processing trade, it is not surprising that recent research indicates that exchange rates in both China and East Asia matter for processed exports. He cites a 2009 study that shows a 10% appreciation of the yuan relative to non-East Asian countries would reduce China's processed exports by 17% and a 10% appreciation in East Asian supply-chain countries against non-East Asian countries would reduce China's processed exports by 15%. The study concludes that the fall in processed exports would be much larger if exchange rates throughout emerging Asia appreciated together. Meanwhile, a 2011 study cited by Thorbecke finds that a 10% appreciation of the yuan relative to importing countries would decrease exports by 12.4% and a 10% appreciation of the yuan relative to East Asian supply-chain countries would reduce Chinese exports by 11.5%. If the large surpluses of both China and East Asia running against OECD countries caused a generalized appreciation in Asia, the empirical results imply that processed exports would drop significantly. Thorbecke refers to his previous research that observes a 10% percent appreciation of either the yuan or the currencies of East Asian supply-chain countries would reduce processed exports by about 17%. These results imply that a concerted appreciation across the value chain would significantly reduce processed exports.

To summarize: the four QE episodes engineered by the US led to the weakening of the dollar and an appreciation of the currencies of East Asia including the yen *(Charts 1 & 3)*. This has adversely affected the economies in the region primarily through the export sector. It should be noted that there are other channels by which a currency appreciation can hurt a country. For example, the appreciation of the Philippine currency has reduced the peso equivalent of remittances from overseas. In addition, part of the appreciation of currencies of emerging markets in East Asia was caused by portfolio capital inflows. This could lead to macroeconomic instability similar to the financial crisis in 1997.

The depreciation of the Japanese yen in response to Abenomics has caused most currencies in the region to stabilize in the first quarter of 2013. Since May 2013, however, there has been a marked depreciation of these currencies *(Chart 4)*. The exception is China but the yuan has been fairly stable during this period. The major reason for the depreciation is the strengthening of the dollar relative to the yen, with exchange rates normally benchmarked against the dollar. As of this writing, the Indonesian rupiah has depreciated 14% since the start of the year with added pressure from Indonesia's widening current account deficit. At the same time, the emerging market stock prices are decreasing at a fairly rapid rate. One of the reasons is the tension in the Middle East. However, many investors are wary of the "tapering" of US monetary policy and these factors have led to a reversal of capital flows. Volatile capital flows are one of the consequences of QE in the US and they may cause a degree of exchange rate overshooting.

Based on the discussion in this section, it should be clear that the primary reason for Abenomics was the aggressive QE program of the US. The sharp appreciation of the yen had debilitating effects on the Japanese economy. Hence, the BOJ had no choice but to counter the QE in the US. There were spillover effects of the weakening of the dollar on the other economies in the region largely because of processing trade. In the context of the depreciation of the currencies in the region, East Asia should be thankful for Abenomics.

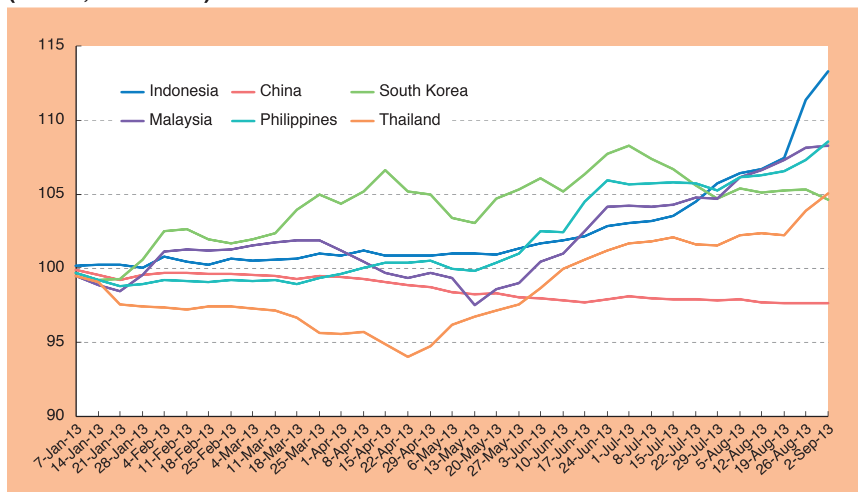
Will Abenomics Affect Japanese FDI to East Asia?

There was a notable increase in Japanese outward foreign direct investment (FDI) between 2004 and 2008 *(Table 2)*. The value in 2008 as measured in current dollar value was even a historical peak. This trend was disrupted by the

CHART 4

Exchange rates: selected Asian currencies, weekly average (Jan. 1, 2013-Sept. 2, 2013)

(Jan. 1, 2013=100)



Source: http://www.oanda.com/currency/historical-rates/

global financial crisis. However, there was a robust recovery in 2011 and 2012. Some analysts attribute this surge in FDI to a merger and acquisition (M&A) spree by Japanese companies in developed countries.

This pattern was not reflected in Asia where Japanese FDI has been on a general downward trend since 1990 ("The Fall and Fall of Japanese FDI into Asia", Development Bank of Singapore group research, Feb. 19, 2013). The main reason is that the 10 Asian economies with this trend were 2.3 times smaller than Japan in the 1980s (the list includes China, India, and the major economies of Southeast Asia). Today, these 10 Asian economies are 2.3 times larger than Japan. In other words, these countries do not need as much investment from Japan as they did 25-30 years ago.

TABLE 2

Outward FDI from Japan

Year	Outward FDI flows (million $)
1990	50,774.90
1991	31,638.30
1992	17,304.25
1993	13,913.02
1994	18,120.89
1995	22,630.33
1996	23,426.40
1997	25,993.67
1998	24,151.10
1999	22,744.87
2000	31,556.63
2001	38,333.24
2002	32,280.60
2003	28,799.39
2004	30,949.32
2005	45,781.09
2006	50,264.40
2007	73,548.24
2008	128,018.85
2009	74,699.08
2010	56,263.45
2011	107,600.84
2012	122,550.93

Source: UNCTAD, FDI online

Japanese FDI in Southeast Asia is also experiencing a sectoral shift, from manufacturing to services. Since the services sector is not as capital intensive as manufacturing, the amount of FDI tends to be lower. Finally, South Korea and Taiwan have become major exporters of capital, in some cases crowding out Japanese investment.

A critical question is whether the quantitative easing in Japan plus the recent increase in outward FDI from Japan can reverse the downward trend in Asia. There are three factors that will likely prevent this from happening. One, the depreciation of the yen makes foreign investment by Japanese firms more expensive. More importantly, outward FDI is also encouraged by growth of the domestic economy which implies higher profits. Unless Abenomics spurs the Japanese economy to a significantly higher growth path, the increase in money supply and credit will not translate into higher FDI to East Asia. And three, M&A activity, which dominated Japanese FDI in the recent surge, has little impact on East Asia.

Abenomics & Rebalancing in East Asia

The most significant aspect perhaps of Abenomics will be its contribution to rebalancing in East Asia. One major problem of heavy reliance on processing trade is that the economies of East Asia are vulnerable to the vagaries of the OECD countries. Conventional wisdom states rebalancing implies less dependence on exports for economic growth.

However, rebalancing means different things for different countries. For countries like Malaysia and Singapore, rebalancing would definitely emphasize less dependence on trade. In the case of China, rebalancing would mean more consumption-driven growth and a lower investment rate. The opposite is true for the Philippines. With its large population, Indonesia can rely more on its domestic market for economic growth.

The main issue is that countries should implement policy measures to achieve rebalancing. East Asian countries can also dovetail rebalancing at the domestic level with rebalancing at the regional level. The latter would mean less reliance on industrialized countries of the West as markets for their exports. How can structural reforms in Japan assist the process of rebalancing?

A less-protected agriculture sector in Japan will open up export opportunities for countries with high-productivity agriculture sectors. The countries in the Greater Mekong Subregion stand to benefit from higher Japanese food imports. Lower food prices will also mean higher disposable incomes for the Japanese consumer leading to higher imports. Intraregional trade in East Asia should be "rebalanced" to meet the higher imports of consumer goods from both Japan and China.

Japan's health care and energy sector are other targets of structural reform. For example, the government wants to encourage competition in the provision of renewable energy as well as in a national infrastructure for imports of natural gas. This can benefit countries in the region with comparative advantage in these sectors.

A sensitive area is the issue of immigration to address the problem of Japan's aging population. Opening up the labor market was already initiated by allowing foreign nurses to work in Japan provided they meet certain requirements including language proficiency. The Philippines is one country that can benefit from a laxer Japanese immigration policy.

Abenomics if implemented to its fullest extent will benefit the East Asian region. The ASEAN Economic Community, which will be established at the end of 2015, will definitely receive a boost from a more open Japanese economy.

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