Is "Abenomics" Working?

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This is a question on many people's minds, both in Japan and in the rest of the world. It is difficult to give an unequivocal answer – parts of the policy package are having their intended effects, but the impact on private consumption and investment and inflation has remained subdued. To put these conflicting signals in perspective, we need to recognize that "Abenomics" is trying to accomplish a very difficult feat: decisively ending the deflationary mindset, restoring government debt sustainability, and increasing the economy's growth potential, while maintaining financial sector stability. This regime shift needs to occur against the background of Japan's aging and declining population as well as generally subdued global growth momentum. An additional layer of complication stems from the fact that over the longer term the three arrows of Abenomics create mutual synergies, but in the near term there may be tensions: some structural reforms could be deflationary and even gradual fiscal consolidation is likely to dent growth. As such, there is a clear recognition that the amount of emphasis on each policy area needs to be state-dependent. With two and a half years having passed since the launch of Abenomics, it is an opportune time to take stock of Japan's economic challenges, the effectiveness of measures taken so far, and to consider how the policy mix should be recalibrated for lasting success.

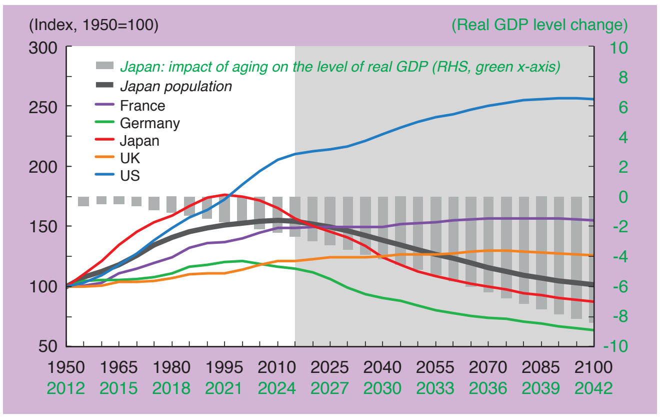
The Legacy: Structural Changes During the Lost Decades

Most Japan followers will be familiar with the following striking statistic: in 2013, Japan's level of nominal GDP was about 6% below its mid-1990s level. During this period, three important structural changes have put a brake on growth and efforts to get out of deflation:

- *Population aging*, which started in earnest around the mid-1990s, has been a drag on growth by reducing labor input, land prices, and aggregate demand. Over the next three decades it is expected to shave off another 8% of GDP *(Chart 1)*. It has led to deflationary pressures, contributed to the erosion of the traditional tax base and increased government outlays on health care and social security, adding to Japan's fiscal woes. It also raised demand for "safe assets", limiting the financial sector's ability to be a catalyst for growth by providing risk capital. More recently, Japan's aging has been compounded by the decline in the total population, further depressing land and property prices, collateral values, and — with weakening confidence in future prospects — investment.
- *Production offshoring*, initially part of the corporate deleveraging process, in recent times has resulted in lower domestic investment and exports from Japan *(Chart 2)*, while higher corporate profits of large firms are increasingly retained as cash holdings.
- *Labor market fragmentation*. Japan used to be famous for its

CHART 1

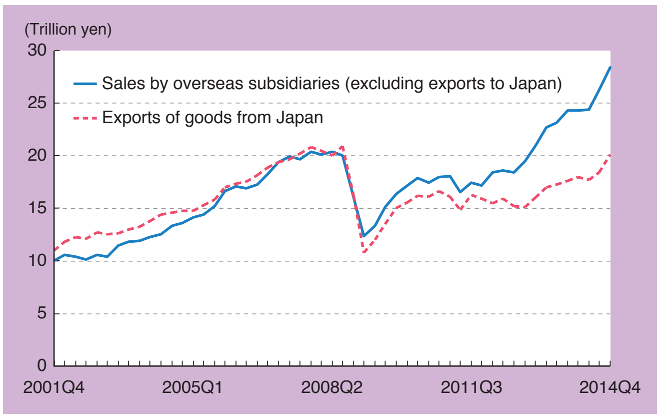
Working-age & total population, 1950-2100



Sources: U.N.; Anderson, Botman, and Hunt (2014), IMF WP 14/139

CHART 2

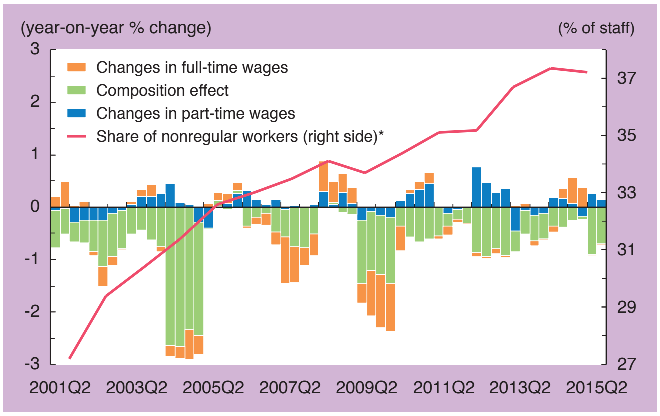
Exports vs. sales of overseas subsidiaries



Sources: Ministry of Economy, Trade & Industry; IMF staff estimates

CHART 3

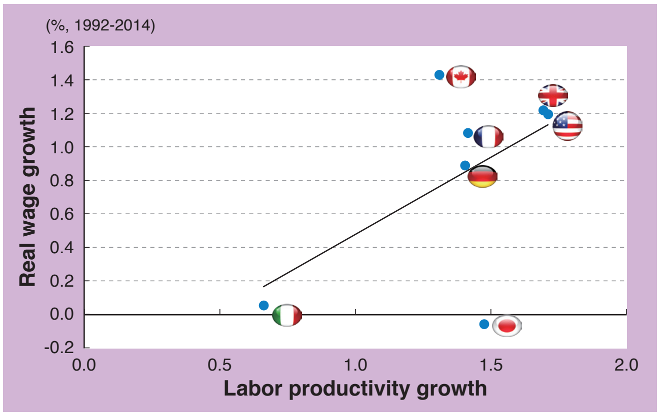
Nonregular workers & wage growth



Note: Yearly average
Sources: Haver Analytics; and IMF staff estimates

CHART 4

Real wage & productivity growth



Sources: OECD; and IMF staff calculations

lifetime employment model, especially for men in large companies, but a dramatic change has occurred in recent years with the emergence of nonregular workers, especially women and older workers. Excessive labor market duality can hurt efforts to get out of deflation by limiting aggregate nominal wage and productivity growth *(Chart 3)*. Indeed, for most countries, real wage growth tends to follow productivity growth quite closely, but not in Japan where workers got the short end of the stick *(Chart 4)*.

Past policy efforts to end deflation and rekindle growth have been unsuccessful, in part because they did not directly address these structural headwinds, but also because reforms were too tepid and implemented in a stop-go and generally uncoordinated manner. Large shocks also contributed, occurring at times when Japan seemed poised to turn the corner, including the Asian financial crisis, the bursting of the dot-com bubble, the global financial crisis, and the 2011 earthquake and tsunami.

A Fresh Start: Abenomics

With the launch of Abenomics in early 2013, Japan embarked on a comprehensive and coordinated set of policies, the so-called three arrows of Abenomics, comprising aggressive monetary easing, flexible fiscal policy, and ambitious structural reforms.

The idea behind the first arrow is that ending deflation would reduce the government debt ratio, restore the effectiveness of conventional monetary policy, rekindle animal spirits and stimulate productivity growth. With this aim, in April 2013 the Bank of Japan (BOJ) introduced the quantitative and qualitative monetary easing (QQE) framework and on Oct. 31, 2014, expanded it further by accelerating its purchases of Japanese government bonds (JGBs), extending the average remaining maturity of JGB purchases, and tripling its purchases of EFTs and J-REITs. The BOJ has said that it will maintain its QQE program for “as long as it is necessary” to maintain its 2% inflation target in “a stable manner”.

On the second arrow, there remains a very active debate about the appropriate role of fiscal policy in Japan. To some, “flexible fiscal policy” implies stimulus to ensure that growth is sufficiently above potential to create inflation pressures. This argument is supported by recent research which suggests that the effects of fiscal policy tend to be stronger when central banks have reached limits in terms of lowering interest rates. Further, the argument goes that large fiscal stimulus when debt is already unsustainable could help to raise inflation expectations which will be essential for the BOJ to reach its objectives.

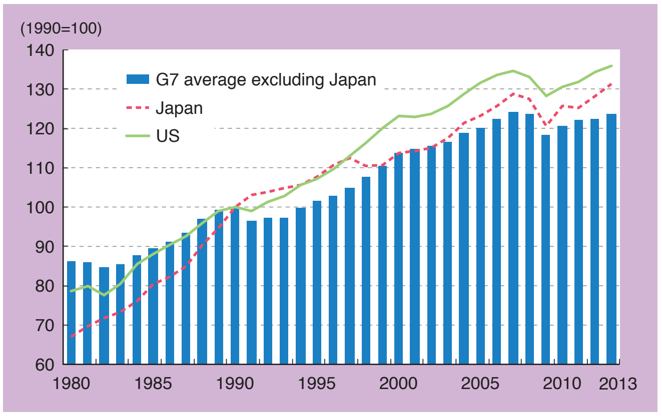
To others, flexible fiscal policy suggests a need for steady fiscal consolidation in light of Japan’s elevated fiscal risks. They point to concerns about the effectiveness of further stimulus in Japan in light of labor shortages, the absence of clear public investment bottlenecks, and evidence which suggests that even well-targeted income support tends to be mostly saved rather than consumed. Also, the continuation of low government bond yields cannot be taken for granted especially once actual and expected inflation have durably increased. Indeed, managing the normalization of interest rates along all asset classes and maturities in a way that maintains economic and financial stability will depend, in no small part, on the credibility of the government’s medium-term fiscal adjustment strategy. A rising risk premium could have serious repercussions for the financial sector through capital losses on bond holdings.

Regarding the third arrow, ambitious structural reforms are pivotal for both the near-term and longer-lasting success of Abenomics. Groundbreaking structural reforms could actually support demand in the near term as confidence and expectations of permanent income would rise. Furthermore, as we have seen recently in Europe, fiscal consolidation without faster growth is unlikely to succeed. However, this too is not an easy task: growth in Japan will continue to be held back by population headwinds. Furthermore, based on output per worker employed, Japanese workers are already very productive, not far behind “growth leader” the United States and well ahead of the G7 average *(Chart 5)*.

Arrow I: Broadly Working as Intended…

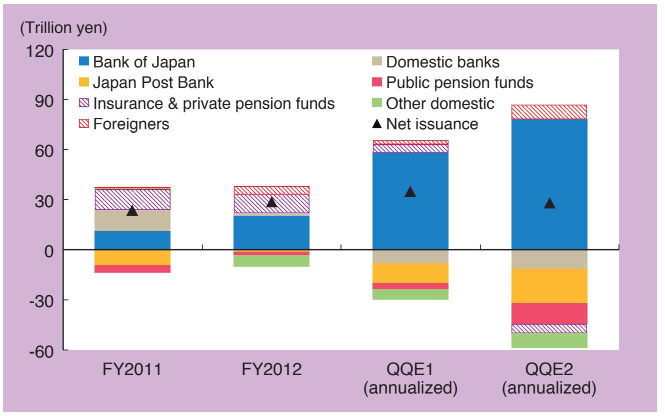
The transmission channel of QQE has four interconnected components:

CHART 5
Real GDP per adult 15-64



Note: Real GDP is based on constant PPP, 1990=100.
Sources: OECD database; and IMF staff calculations

CHART 6
Net purchases of Japanese government bonds



Notes: Fiscal year ends at end-March of following year.; QQE1 = April 2013-September 2014; QQE2 = October 2014-March 2015.
Source: Bank of Japan (Flow of Funds)

- **Reducing long-term real interest rates and risk premiums** through purchases of longer-dated government securities and risk assets (commercial paper, corporate bonds, exchange-traded funds, and Japan real estate investment trusts).
- **Portfolio rebalancing.** BOJ purchases exceed net issuance of government securities, particularly in the 5–10 year segment, which would lead to portfolio rebalancing among investors and financial institutions including toward riskier assets and credit expansion at home or abroad.
- **Raising inflation expectations**, including through stronger BOJ communication, would further lower long-term real interest rates, stimulating near-term activity.
- **Exchange rate depreciation.** Exchange rate depreciation, which is a product of these channels, is a crucial mechanism for QQE to work as it would raise import prices and was expected to contribute to closing the output gap through higher net exports.

In terms of what has actually happened, first, 10-year JGB yields have remained stable at low levels, despite at times volatile bond market movements in other advanced economies. Together with rising inflation, this suppressed real lending rates and corporate bond yields, contributing to a modest recovery in credit growth including to small and medium-sized enterprises. The exchange rate depreciated sharply, reversing the overvaluation that had undermined competitiveness prior to Abenomics, contributing to rising consumer and business sentiment including from higher stock market valuations.

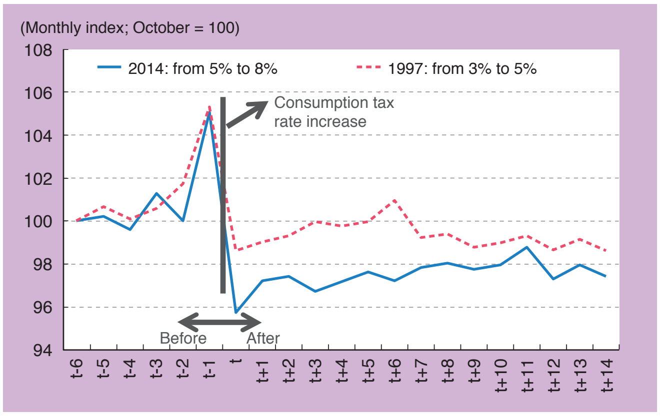
Second, market and survey based measures of inflation expectations initially rose quickly, suggesting that the BOJ's new "shock and awe" approach was gaining credibility. However, inflation expectations started to reverse in the aftermath of the consumption tax increase to 8%, in line with declining actual inflation, converging to levels well below the BOJ's inflation target. This suggests the transition to more forward-looking inflation formation remains incomplete.

Third, portfolio rebalancing is progressing. Under the first wave of QQE launched in April 2013 (QQE1), domestic banks — in particular Japan Post Bank — were the main sellers of JGBs to the central bank, weakening bank-sovereign linkages as anticipated and contributing to a further expansion of overseas lending. In contrast, insurance companies and regional banks maintained a strong appetite for JGBs during this episode. After the BOJ further expanded its monetary easing program in October 2014 (QQE2) and the Government Pension Investment Fund (GPIF) changed its asset allocation targets towards domestic equities and foreign securities, portfolio rebalancing broadened, slowly pulling in insurance companies and private pension funds. For example, under QQE1, only around 5% of the BOJ's net JGB purchases from the market came from institutional investors. This rose to close to 40% between October 2014 and March 2015 *(Chart 6)*.

Arrow II: Unanchored Fiscal Policy…

Given the aforementioned difficult balancing act, the fiscal policy stance has been broadly appropriate. In February 2014, the Diet approved 1.4% of GDP in new debt-financed spending to be executed during 2013–2014. This stimulus was intended to help jumpstart the economy, complementing the BOJ's new policies and target. Then, in 2014, the fiscal position turned contractionary, primarily as a result of the increase in the consumption tax. At the time, growth and inflation momentum appeared sufficiently strong to withstand the intertemporal consumption switching effect of the tax increase: frontloading of durables ahead of the tax hike, followed by a sharp but temporary contraction in its aftermath. Such a pattern was also observed during Japan's tax hike in 1997 *(Chart 7)*. However, the collapse in consumption (and investment) after the tax hike was deeper and more prolonged than anticipated, contributing to the recession Japan experienced in the second half of 2014. With weak private sector growth momentum and the reemergence of deflation risks, the authorities decided to delay the second consumption tax increase to 10% until April 2017 and adopt further fiscal stimulus while placing greater emphasis on formulating a medium-term consolidation plan to maintain fiscal credibility.

CHART 7
Private consumption around the tax increase



Sources: Cabinet Office; and Haver Analytics

Arrow III: Some Progress but Not in Areas with "Biggest Bang for the Buck"

There has been a steady stream of policy initiatives under the Third Arrow to rekindle growth and animal spirits. The most notable reforms include:

- The conclusion of the **Trans-Pacific Partnership (TPP)** trade agreement, which could provide a boost to activity, provided it leads to deregulation of agriculture and domestic services sectors and elimination of most tariffs and non-tariff and investment barriers in Japan.
- Significant progress with **corporate governance reforms**, which is expected to unlock large corporate cash positions, which exceed levels observed in other G7 economies *(Chart 8)*. While important, so far there has been little evidence that these reforms have significantly increased dividends, wages, or investment.
- Efforts to increase **female labor force participation** (FLFP) got a further boost with Abenomics, possibly as a result of increased availability of child-care facilities and cash transfers to families with children. However, it should be noted that FLFP had already been rising steadily for the past three decades and that overall labor input in the economy has remained on a declining trend *(Chart 9)*.

Effects on Growth & Inflation

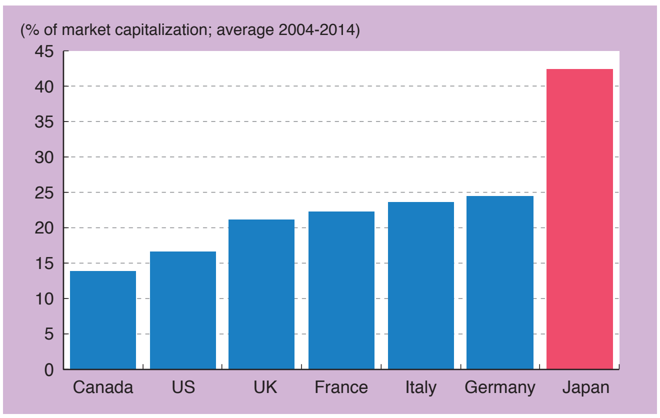
In general, the pace of real GDP growth under Abenomics has remained similar to the post-bubble period at about 1% and potential growth remains far below what is required to realize the authorities' "revitalization" scenario. The effects of the sharp yen depreciation and lower interest rates on exports and domestic investment have been weaker than expected due to the increase in production offshoring and headwinds from the shrinking and aging population.

Furthermore, deflation risks remain, albeit partly due to external shocks, including slower global growth and the collapse in commodity prices as well as more recently elevated global financial volatility which has led to safe-haven appreciation of the yen. Low inflation is also reflected in disappointing nominal wage growth despite very tight labor market conditions. As such, the aforementioned transmission channels of monetary easing are not yet feeding into higher private-sector activity and favorable wage-price dynamics.

Reloading Abenomics

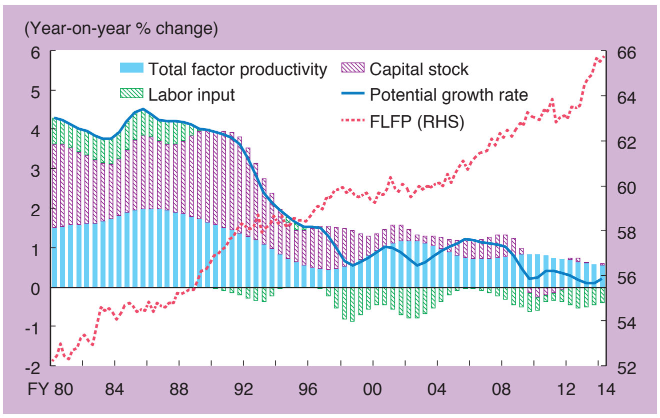
Ultimately, the main challenge for Japan is to put government debt on a declining path. Higher growth and inflation are intermediate targets to facilitate orderly deleveraging of public debt and prevent either stagnation or stagflation. Absent swift progress in structural reforms, the demographic headwinds, weak nominal wage growth, and production offshoring will continue to undermine domestic demand (stagnation). If, on the other hand, continued aggressive monetary easing and further yen depreciation raise inflation, expectations of monetary policy normalization could arise at a time when potential growth is low and fiscal deficits are large

CHART 8
Listed companies' cash & cash equivalent holdings



Source: Bloomberg, L.P.

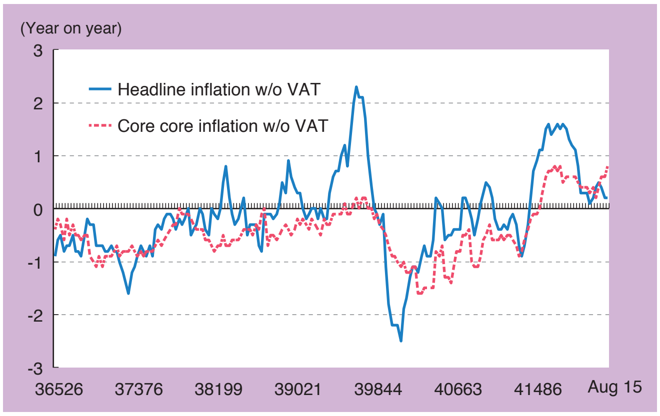
CHART 9
Japan: potential annual growth rate



Notes: As of 2014 Q2; Female labor force participation rate; 15 to 64 years old, in percent (SA)
Source: Bank of Japan

CHART 10

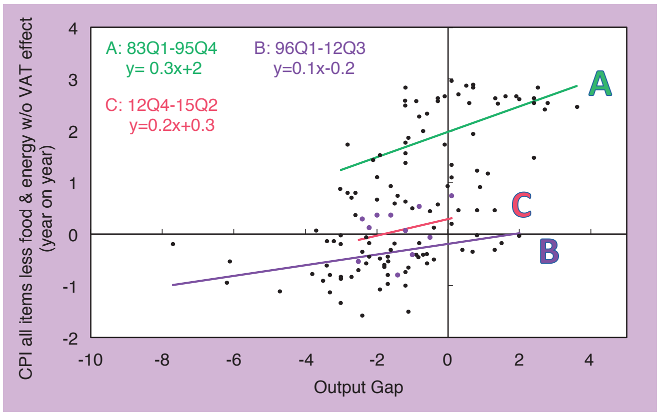
Headline & core inflation



Sources: Haver analytics; and IMF staff estimates

CHART 11

Japan: Phillips curve



Sources: Cabinet Office; Bank of Japan; and IMF staff estimates

(stagflation). In both cases, doubts about long-term fiscal sustainability could lead to a jump in the sovereign risk premium, forcing abrupt further fiscal adjustment with adverse feedback loops between the financial system and the real economy. This could trigger excessive volatility in the JGB and currency markets. Such an outcome would have important adverse spillovers via reduced demand for imports and tighter financing conditions in Japan and overseas.

Monetary Policy: Preparing for a Marathon Not a Sprint

Although headline inflation is hovering near deflationary territory, underlying inflation (stripping out energy and fresh food) is accelerating and running at the highest level in more than a decade *(Chart 10)*. Further upward pressure would come from the gradual closing of the output gap, given that actual growth is expected to exceed potential (0.4%). However, this effect is likely to be small given that Japan's Phillips curve remains relatively flat, although it has steepened and shifted upward under Abenomics *(Chart 11)*. A further upward shift of the Phillips curve is unlikely as long as actual inflation has not settled in a sustained manner near the target. Accelerating inflation will therefore depend critically on whether the tight labor market conditions will finally accelerate base wage payments (requiring labor market reforms, discussed below) and the extent to which firms would raise prices in response to such cost-push pressures (requiring corporate governance and product market reforms, also discussed below).

All things considered, there are various arguments why the BOJ should refrain from expanding its easing policies under the baseline: (i) the transmission channel is impaired; (ii) inflation is already set to rise gradually under current policies; (iii) accelerating the attainment of the inflation target depends on structural reforms; and (iv) there are limits to how many JGBs the BOJ can buy, stemming mainly from portfolio rebalancing constraints of financial institutions who need government bonds for collateral purposes (banks), for asset-liability management (insurers), and to satisfy the announced asset allocation targets of major pension funds. At the current pace, the BOJ will already own more than 60% of the outstanding JGBs by 2019 *(Chart 12)*.

Nonetheless, to underscore its commitment, the BOJ needs to stand ready to ease further in the form of increased asset purchases and lengthening their duration in the event of downside risks to its inflation forecast. Macroprudential policies should be readied to mitigate financial stability risks. The BOJ should communicate more clearly the drivers that underpin its forecasts, including the output gap and wage-price dynamics and the factors that are believed to raise inflation expectations. Similarly, being more predictable by clarifying the conditions that would trigger additional actions would be helpful as this would help guide expectations when there is a need to adjust the asset-purchase program and facilitate preparations for an eventual exit.

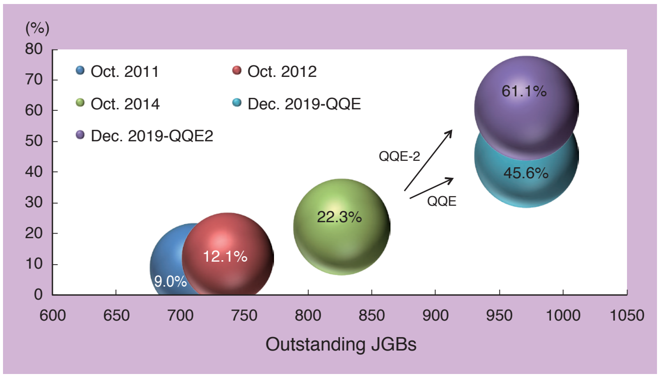
Fiscal Policy: Need for Clarity & Commitment

As noted above, credibly committing to irresponsible fiscal stimulus could in theory push up actual and expected inflation and therefore nominal GDP growth, creating a favorable backdrop to eventual fiscal consolidation. The stimulus would need to be very large, however, given the aforementioned flat Phillips curve. Regarding the risks of such a strategy, recent research shows that deficits and inflation do increase government bond yields substantially, although this can be masked for some time by central bank purchases and demand for safe assets by an aging population *(Chart 13)*. As such, larger deficits to push inflation higher could lead to rising government bond yields and be self-defeating in terms of its impact on debt dynamics. This pressure on yields is compounded in the medium term by the expected decline in the domestic savings rate, which implies that foreign investors will need to increasingly finance Japan's deficits and maturing debt. At the same time, flexible fiscal policy may not work either, as on-off fiscal stimulus and consolidation will achieve neither "escape velocity" for the economy nor much in terms of restoring debt sustainability.

Therefore, what is urgently needed and still missing is steady, but very gradual fiscal consolidation, which is sufficiently credible and concrete. Such a strategy would remove uncertainties about fiscal

CHART 12

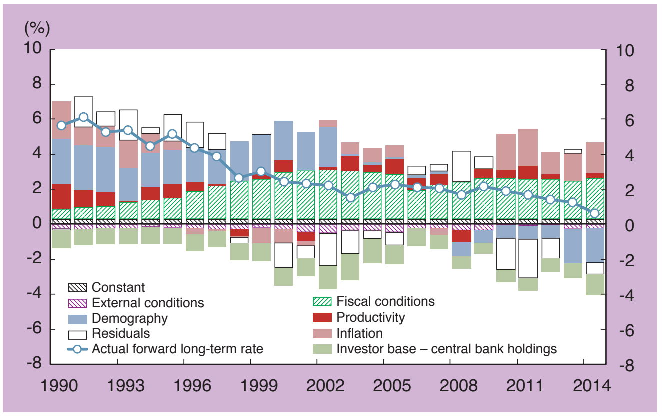
Share of JGB holdings by Bank of Japan



Note: Uses deficit projections to forecast outstanding amount of JGBs (size of the bubble).
Source: IMF staff calculations

CHART 13

Japan: decomposition of long-term forward rates



Note: Based on a panel regression of 10 advanced countries.
Source: Arslanalp and Lam (2013), IMF WP/13/213

intentions, which could be hampering domestic demand.

Stronger fiscal institutions will be necessary to impart credibility to such a plan. Continuous large deficits, the record-high level of public debt, the use of optimistic growth assumptions, and the uncertainty introduced by recurrent recourse to supplementary budgets suggest large benefits from anchoring fiscal discipline in a more rules-based fiscal framework, including independent assessments of the outlook and budget projections by the Fiscal System Council. This would prevent procyclical policies, remove a source of volatility, and establish clear visibility about the direction of policies.

Structural Policies: Remove Impediments to Wage-Price Dynamics

There remains a need to boost labor supply to at least partially offset the drag from the declining labor force. Female labor force participation can be increased further by eliminating tax-induced disincentives to work and raising the availability of child-care facilities through deregulation. Drawing more aggressively than currently planned on foreign labor by relaxing immigration restrictions as well as incentivizing older workers to remain in the workforce would help address labor shortages that hamper investment. New hiring should take place under contracts that balance job security and flexibility to reduce labor market duality and raise horizontal mobility, contributing to higher productivity and wage growth. The authorities should move quickly to clarify the legal and regulatory environment surrounding these “intermediate” contracts.

Conventional and “out of the box” policies should be considered to ensure much faster base wage growth. With productivity growing at around 1% per year, base wages should rise by close to 3% to create the cost-push pressures consistent with the BOJ’s inflation target. Measures to spur faster wage growth include raising all administratively controlled wages and prices, calling for a supplementary wage round, and converting some of the seemingly permanent bonuses into base wages. Higher-than-usual minimum wage increases as well as strengthening tax incentives for firms that raise wages should also be considered.

Firms and managers also need to face the right incentives to raise prices once input costs, including from labor, start to increase. In this context, there remains room to further strengthen corporate governance including more ambitious requirements for independent directors, greater transparency of beneficial ownership, introducing regulatory limits to discourage excessive cross-shareholdings, removing bottlenecks which prevent takeovers, and introducing prepackaged reorganization plans for bankruptcy procedures. The financial sector should take advantage of the recent corporate governance reforms to unwind cross-shareholdings, foster consolidation in the enterprise sector, and promote the exit of unviable enterprises.

Conclusion

With much at stake and multiple goals, Japan needs to revamp its comprehensive and coordinated set of reforms to make Abenomics a success both for Japan and the rest of the world. The main message that policymakers should use all policy levers at their disposal in a coordinated manner when faced with persistently weak demand and high public and private balance sheet vulnerabilities extends to other important parts of today’s global economic landscape. As such, policymakers around the world have much to learn from Japan’s experience so far and from how Abenomics unfolds from here onwards. JS

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