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Abenomics: three years – the big ship turns slowly

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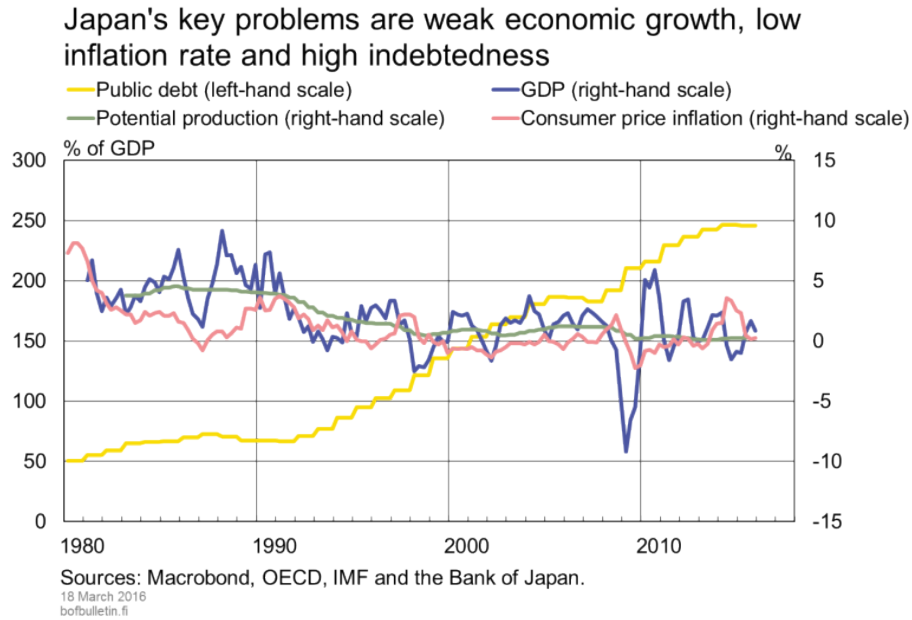
For the past three years or so, Japan has pursued an economic policy named after Prime Minister Abe as abenomics, with the intention of putting the country back on a path of sustainable economic growth via expansionary monetary and fiscal policy and structural reforms. These goals have not yet been achieved, but there has already been some progress. For the time being, economic growth has been sluggish, but the deflationary trend has been halted and structural reforms have moved forward. The preconditions for success of the programme are in place.

After World War II, Japan swiftly emerged to become one of the leading economic powers in the world. Its annual GDP growth rate over 1955--1970 was approximately 10%, and towards the end of 1980 it was still about 5%. The robust growth ended when the financial and real estate bubble, which had been expanding over a long period of time, finally burst at the end of the 1980s. Ever since, the economy has grown at an annual rate of about one per cent. Moreover, at the beginning of the 1990s, Japan sunk into a deflationary spiral, from which it is still trying to escape once and for all.

Japan's population is ageing at a rapid pace, while the birth rate is decreasing. As a consequence, the national support ratio is stretched, which is giving rise to increased public expenditures. The weak economic growth has also exacerbated the financial situation, as government tax revenues have decreased while public expenditures have increased. As a result, Japan has run up considerable debt in the past two decades (Chart 1). At present, government debt amounts to approximately 240% of GDP, and the budget has been in deficit ever since the early 1990s. The rise of the debt ratio was boosted further by a protracted period of low inflation, which lowered nominal GDP and slowed economic growth.

Chart 1.



The main challenge for the Japanese economy at present is debt sustainability. So far, Japan has been able to cope with its huge debt burden because the debt servicing costs are exceptionally low due to the low level of interest rates. In addition, about 90% of the country's public debt is domestic, so that the foreign exchange risk is minimal. However, Japan remains highly exposed to an increase in the level of interest rates, which will be in the offing when the central bank at some point begins to normalise its monetary policy. An increase in interest rates would increase the debt servicing costs and further expand the amount of debt. Furthermore, decisive and determined actions are required to halt the negative trend due to increased social expenditures resulting from population ageing and the concurrent downsizing of potential economic output.

Japan has fallen into a difficult spiral where an ageing population and growing deficit and debt ratios generate uncertainty and pessimism across the economy. This leads to a slowdown of economic growth and low inflation. As a consequence of the low inflation, wage growth is also slowing, which erodes consumers' purchasing power and reduces aggregate demand. All of this ultimately leads to an even greater budgetary deficit and increasing indebtedness.

Towards the rising sun – the three arrows of abenomics

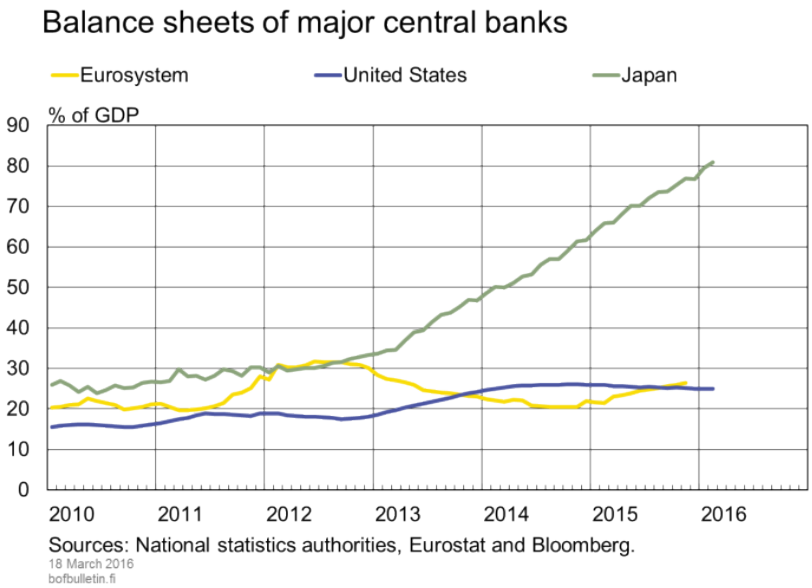
In 2013, Prime Minister Shinzo Abe launched the economic recovery policy known as abenomics. The objective is to stop the protracted deflation which has been weighing on Japan, and to put the national economy on a sustainable growth path. Ultimately, the goal is to reverse the rise of government debt. Abenomics is divided into three focal areas (arrows): 1) monetary easing, 2) fiscal stimulus and 3) structural reforms. The purpose of the monetary easing and fiscal stimulus is to boost inflation, so as to lower the level of interest rates and cause a depreciation of the yen. This is hoped to revive economic growth through the growth of investments, consumption and exports. The structural reforms are geared to bolstering business and consumer confidence and restructuring the Japanese economy to achieve sustainable economic growth also in the long run.

Tackling the deflation bogeyman with monetary policy

Monetary easing is intended to break the deflationary spiral in prices and to achieve a stable inflation rate in line with the price stability target. This is not the first time Japan has tried to prevent deflation by unconventional monetary policy measures. In 2001–2006 and 2007–2013, the Bank of Japan eased its monetary policy by expanding the monetary base, but the targets and amounts of the Quantitative Easing programmes (QE) were too small and so failed to get the desired outcome. In January 2013, the central bank set the new target for consumer price inflation at 2%, which was to be achieved by April 2015. In April 2013, the Bank of Japan launched an extensive securities purchase programme (Quantitative and Qualitative Easing, QQE), aimed at doubling the monetary base of the country by the end of 2014 (to approximately 50% of GDP) by acquiring government bonds of medium-term maturity. Due to the weak economic situation, the central bank announced in October 2014 that it would further expand the purchase program (QQE2). The size of the government bond purchase programme was increased to JPY 80 tr and the average maturity of the bonds purchased was extended to 7–10 years. The central bank has announced that the programme would be extended as much as it takes to reach the inflation target on a sustainable basis.

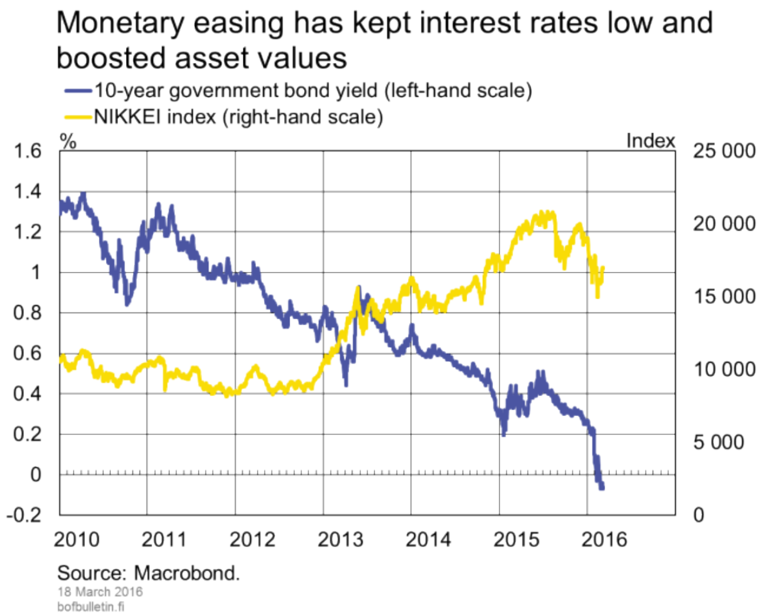
The size of the Japanese purchase programme is in a league of its own compared to the stimulation packages of the other main economic areas (Chart 2). Since the launch of the programme, the balance sheet of the Bank of Japan relative to the GDP has increased to almost 80%. The central bank is increasing its ownership in government bonds at an annual rate of 10%, and by the end of 2015, it already held a good 30% of the government debt.

Chart 2.



The purchase programme seeks to achieve the inflation target through three impact channels: lower interest rates (interest rate channel), encouragement of investment in higher-return assets (portfolio rebalancing channel), and an increase in inflation expectations (expectations channel). So far, the impacts have been bipolar. Long-term interest rates are very low, the external value of the yen has decreased clearly since the launch of the program, and equity prices have increased (Chart 3). However, inflation expectations, and consequently also actual inflation, remain sluggish.

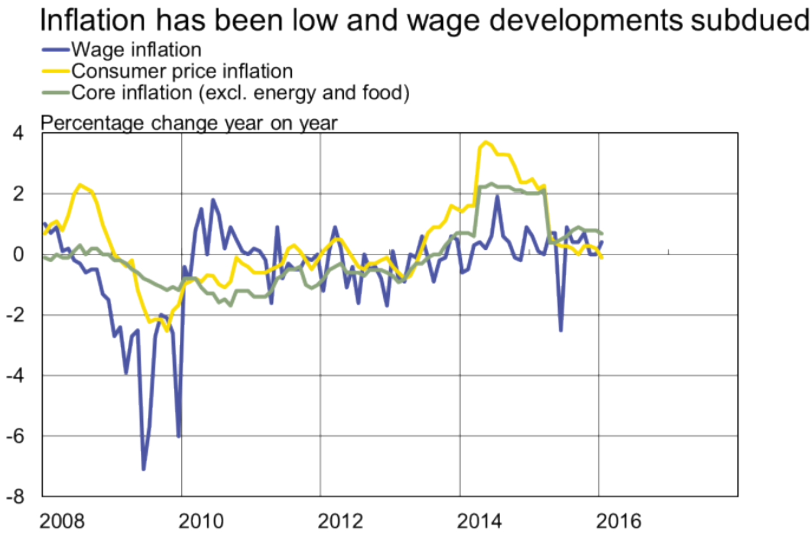
Chart 3.



In accord with the target of the central bank, inflation began to accelerate after the launch of the programme, reaching approximately 1.5% by the start of 2014 (Chart 4).

The increase in the consumption tax implemented in April 2014 first supported price increases, but gradually inflation slowed down to around zero. The low inflation recently is largely due to the impact of oil prices. Core inflation (excluding energy and food prices) accelerated in 2015 to about one per cent and is now at the same level as before the increase in the consumption tax. This generates the expectation that, once the temporary impact of the decline of oil prices gradually dissipates, the inflation target can be achieved via the QQE programme.

Chart 4.



Sources: Macrobond, Japanese Ministry of Health, Labour and Welfare and Statistics Japan.
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However, inflation expectations are still far from the target of 2 per cent set by the central bank. At first, inflation expectations turned positive on the back of the purchase program and inflation was expected to accelerate both in the short run and long run. Recently, the expectations have however dampened. During the last year and a half, short-term expectations have fluctuated largely in response to the decline in oil prices. In addition, longer-term expectations have dampened, and therefore expectations of Japanese inflation in the medium and long term continue to be sluggish. From the point of view of the credibility of the monetary policy program and monetary policy, it is paramount that long-term inflation expectations are anchored to the inflation target. This leads to wage increases which are necessary for achieving the inflation target on a sustainable basis. Wage growth sustains domestic demand and increases economic growth, which is ultimately also reflected in the price level and in higher inflation rates. For the time being, the rate of wage growth has been very muted, but on the basis of recent wage-setting negotiations and the tightness of the labour markets, an upturn seems to be in the offing.

The slowdown in inflation and sluggish inflation expectations induced the central bank to respond with additional measures. In December 2015, the Bank of Japan fine-tuned its purchase programme by extending the average maturity of bonds to be purchased to 7–12 years. In addition, the central bank expanded its toolbox in its December meeting by lowering the policy rate for the first time in its history below zero, to −0.1 per cent. As regards the purchase programme, the now-prevailing mood in the market is that we are close to the limits. The central bank is already the largest holder of government bonds, owning a good 30% of the country's sovereign debt. If the current level of purchases were sustained until 2020, the central bank's ownership of government bonds would rise to about 65 per cent.

Belt-tightening and debt resuscitation – the challenges of fiscal policy

With the second pillar of abenomics, fiscal policy, the government seeks, in the short-term, to revive and accelerate economic growth and pursue expansionary fiscal policy. At the same time, the longer-term objective is to halve the public-sector deficit relative to the GDP from 6.6 per cent in 2010 and to reach budgetary balance by 2020, and thereafter to seek to lower the debt ratio. Balancing public finances requires a significant reform of budgetary policy. Cuts are needed urgently especially in social expenditures, which have ballooned due to the rapidly ageing population. In other respects, the potential for cost-cutting is relatively limited. The reform pressures are therefore mounting on increasing government revenues, in which tax reform is key. Increases in the consumption tax are a step in the right direction.

The consumption tax rate in Japan is very low. In order to boost its tax revenues, the government hiked the consumption tax by 3 percentage points to 8 per cent in spring 2014. The intention was to raise the rate by a further 2 percentage points in October 2015, but the first tax hike immediately led to a contraction of GDP and pushed the economy into a so-called technical recession. Therefore, the next tax hike was postponed to April 2017, which is good for economic growth but will slow down the achievement of the fiscal policy objectives of the government. Delay of the tax base broadening hinders the achievement of a surplus budget by 2020. In order to alleviate the growth-contracting impact of the 2014 consumption tax hike, the government increased the budget deficit further by announcing a revival package of JPY 5,5 tr, and yet another package amounting to JPY 3,5 tr towards the end of the year (Table).

Table.

Japan's public budgetary expenditures			
	A	**B**	**A + B**
JPY trillion	Supplementary budget	Government budget (% fiscal year, annual growth)	Total public expenditures
2013	10.3 (2% of GDP)	92.6 (+2.5%)	102.9
2014	5.5 (1% of GDP)	95.9 (+3.5%)	101.4 (–1.5)
2015	3.5 (0.7 % of GDP) and approx. 3.0 (Total : approx 6.5 > 1.3% GDP)	96.3 (+0.5%)	99.8 (–1.5) (over 102,8 (approx. +1,4)

Source: Ministry of Finance, budget statistics.

Government expenditures have grown further in the period of abenomics, and the budget announced for 2016 is record large. At the same time, however, tax revenues have also increased. Since 2013, they have exceeded the value of government bonds issued. Hence, the Abe government has succeeded in increasing the general government primary balance. According to an estimate made by the government in January 2016, the target of cutting the deficit in half by fiscal year 2015 will materialise, but balancing of the budget by fiscal year 2020 is not possible. The calculation by the government is based on an assumption that real GDP growth of a good 2 per cent is achieved from 2018 onwards, which seems overly optimistic in light of the current economic situation. In addition, the achievement of the objective is hindered by the exclusion of food from the consumption tax hikes of 2017. This will reduce the tax revenues generated by the hike, and in the longer term, consumption taxes will probably have to be increased further.

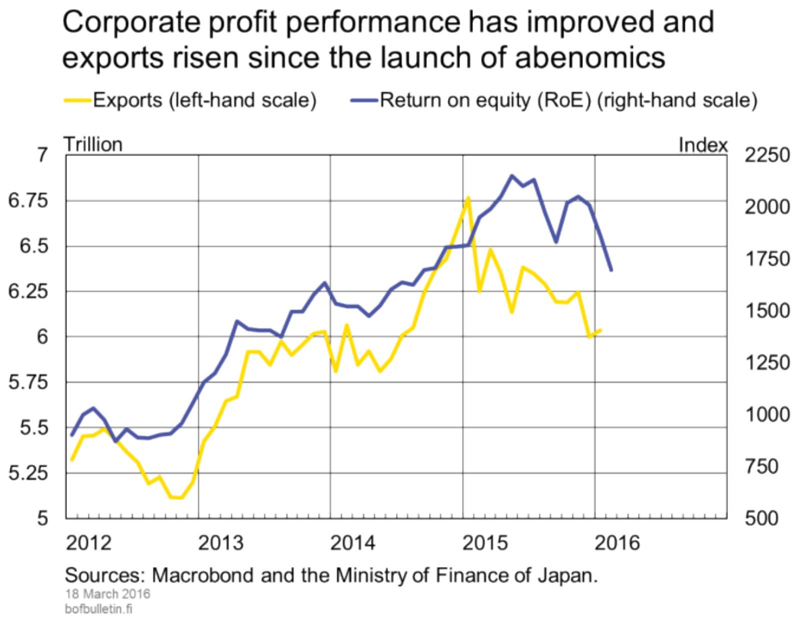
Structural reforms are key to sustainable growth

Monetary and fiscal policy revival can help with the start-up of economic growth and bring the deflationary trend to a halt. However, in order to reach a sustainable growth path and reduce indebtedness, Japan must make significant structural reforms, which are the third and most important pillar of abenomics.

The structural reform package was announced in June 2013, and it was further specified in June 2014. The objective of the reform was to achieve an annual real GDP growth of 2 per cent by 2022. The objective of the growth strategy is to 1) improve the effectiveness of ownership control of companies, reallocate the government pension insurance fund (GPIF) investment strategy to higher-return instruments, develop an atmosphere more favourable for entrepreneurship, reform corporate taxation and develop innovation, 2) increase women's participation in the labour force, reward work results rather than time spent working, attract foreign labour and 3) renew the energy sector, create a growth industry out of agriculture, and strengthen the health industry. The key reforms comprise the improvement of companies' profitability and operating environment, and labour market reform.

The reform of the corporate sector seeks to improve the efficiency of companies' activities and to encourage more investment by companies. The long-term rate of return of Japanese companies has been relatively low. In order to improve the profitability of companies, the Abe government has worked at reducing regulation, increasing the number of external directors, encouraging transparency and reporting to the owners, and increasing the influence of company owners. In addition, a decision has been made to gradually lower the country's burdensome corporate tax rate to less than 30 percent, which better corresponds to tax levels in rival countries – China and South Korea in particular. Furthermore, in January 2014, a programme was set up to encourage companies to invest by reducing their tax burden.

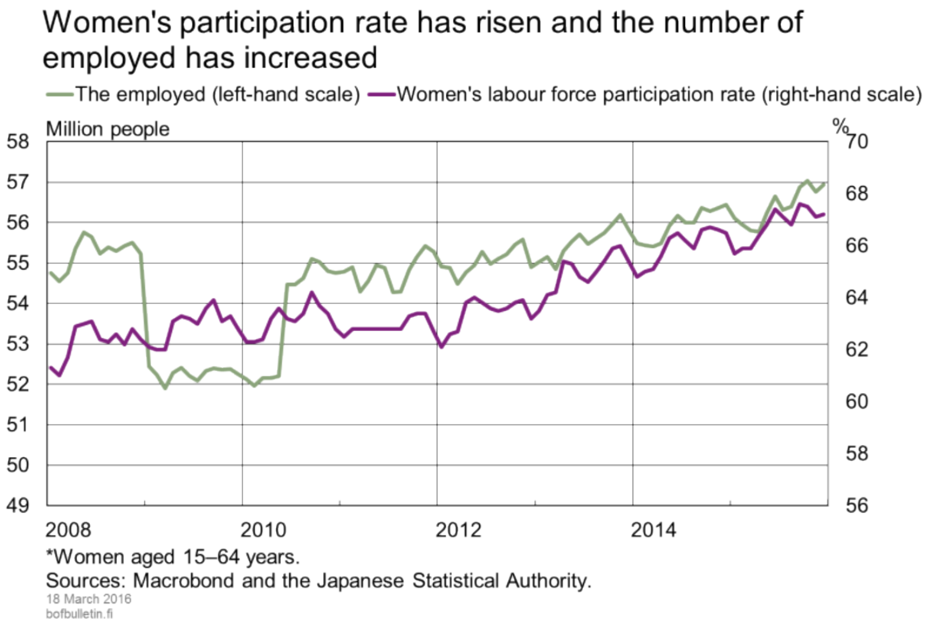
Chart 5.



The start of the corporate sector reforms has been promising (Chart 5). Corporate profitability has improved. For example, the return on equity has risen clearly since 2012. The efficiency improvements in corporate activities are also promoted by the free trade agreements sought after in the context of the reform. If these agreements materialise, they will open Japan's relatively closed markets and force companies to improve their productivity in order to be more competitive. In autumn 2015, Japan and the United States, together with ten other countries, signed the Trans-Pacific Partnership (TPP). The opening of the markets will also benefit the Japanese export sector, which has already grown markedly due to the depreciation of the yen.

As the population ages, the number of working-age (15–64) people in Japan has decreased considerably. The working-age population peaked at 87 million in 1995. By 2015, the number had contracted by a good 11 per cent to EUR 77 million. The most important challenge in the labour markets is indeed to increase women's labour force participation rate, which is one of the lowest among the OECD countries. Women's entry into working life is being made easier, among other things, by increasing the number of day care facilities and providing more flexible working hours, which enables and facilitates the reconciliation of work and family life. The government also encourages companies to appoint women to managerial and supervisory positions. In addition, the labour force is being increased by attracting more foreign workers, who are currently in short supply in Japan. The requirements for immigration have been eased, and the induction and training of foreign employees has been increased.

Chart 6.



Women's labour force participation rate has increased from 2012 onwards, and the decline in the total number of the employed has been halted (Chart 6). However, increasing the foreign labour force has been ineffective. For example, the quota of the programme attracting top professionals is 1,500 persons, which is indicative of the modest scope of the initiative. In addition, for example in the construction sector, which suffers from a labour shortage, the proportion of foreign workforce is only about 2 per cent. Hence, the government needs to take stronger measures to increase work-based immigration, and to change the overall attitude, which is negative towards immigration.

Despite the improvement in employment, there is the problem that the majority of job increases has been in part-time and fixed-term work. These jobs tend to be compensated clearly weaker in Japan compared to regular employment relationships. This undermines the economic growth potential, since a lower earnings level reduces the purchasing power of the consumers. An even bigger problem for the longer-term development of the economy is the development of the economy's aggregate wages. Contraction of the working-age population decreases the total of wages and reduces its growth potential. This impact is further amplified by the fact that an older working population on average has a higher earning level than a younger one. Therefore, as the ageing population retires, the wages of the replacing younger generation are not enough to compensate for the lost wages of retired workers. Therefore in order for purchasing power to remain unchanged, wages need to increase clearly in the future.

All hope is not yet lost

All in all, abenomics had a promising start in Japan. Optimism for the economic outlook was successfully brought about, the price level began to rise and economic growth picked up. However, the favourable development stopped with the consumption tax hike of spring 2014, as a consequence of which economic growth came to a halt and inflation also dropped back to around zero. Hence the 2% growth rates for inflation and real GDP targeted by the government have so far not been reached, and the country has continued to incur more debt. This reflects partly the recent sluggish development of the global economy and deterioration of the outlook of global economic growth, but the main challenge for achieving Japan's economic goals continues to be the implementation of structural reforms.

Even if the objectives of abenomics have still not been achieved, there are some signs of success. The core inflation has accelerated from the average level of –1 per cent at the beginning of the decade close to 1 percent, that is by nearly 2 percentage points, and the budget deficit has been successfully reduced. Companies have improved their profitability, and the decline in the number of the employed has been successfully slowed down by increasing women's labour force participation rate. This creates a solid foundation for wage growth, acceleration of inflation and ultimately also for more robust economic growth, which has so far remained sluggish. If the challenging and time-consuming structural reforms can be decisively put in place, the government still has a chance to achieve its objectives and enable the people of Japan to once again bask in the rising sun.

Tags

- monetary policy
- Japan
- economic growth
- inflation
- abenomics

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