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PERSPECTIVE

Abenomics and Japan's Growth Prospects

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Mr Abe's Inheritance: Two Lost Decades

Prior to Mr Abe's appointment as Prime Minister of Japan in December 2012, Japan had suffered two decades of economic stagnation and deflation. This economic malaise came immediately after the housing and stock price bubble collapses of the 1990s. In November 2012, the Tokyo Stock Exchange sat at around 8,000, less than a quarter of its peak in 1989, and land prices in urban commercial sectors were at one-fifth of their high water mark. Throughout these two decades, the real economic growth rate was less than 1 per cent per annum and the rate of inflation fell into the negative after the global financial crisis of 2008. What was particularly frustrating to the Japanese business community was the rampant appreciation of the yen, which accelerated despite such poor growth and the earthquake and tsunami of March 2011. After his election, Abe pressed the Bank of Japan to embark on a bold policy of monetary easing, succeeding in achieving both a weaker yen and a rising stock market.

Short-lived Excitement over »Abenomics«

The new economic policies of the Shinzo Abe administration produced two immediate results that surpassed expectations: a sharp rebound of stock prices and a fall in the yen's exchange rate. This was achieved by pressing the Bank of Japan to embark on a bold policy of monetary easing. In just six months from the autumn of 2012, when it seemed likely that Abe would become the next prime minister, the dollar appreciated by 25 per cent against the yen, moving. The Nikkei Stock Index rose from 8,600 to over 15,000 in May. Replacing Bank of Japan Governor Masaaki Shirakawa, who was reluctant to engage in aggressive monetary easing, with Haruhiko Kuroda, who had been arguing for quantitative expansion for some time, ensured the desired policy. This was a relief to Japanese export industries, which had struggled through years of a strong yen, and seemed likely to improve corporate profits. Rising stock prices brought a surge in consumption. In May 2013, it looked like a virtuous cycle was finally beginning to take hold.

From 23 May, however, everything started to move backwards. Stock prices fell to 13,000 yen in less than a month. The yen soared again to 93 yen/dollar from 103. More surprisingly, despite quantitative easing, long-term interest rates rose from 0.3 per cent to 0.8 per cent during this period. Following ultra-easy monetary policy and fiscal stimulus, Abe released his third arrow in June. But this third arrow – the structural reform programme – failed to convince the market of the long-term growth viability of the Japanese economy, since it stopped short of the most desired reforms, such as liberalisation of farm land, labour regulation and strict control over the medical service industry. Tokyo stock prices tumbled even further. Abe hastily announced that there would be more reform initiatives to come in the second half of 2013 and indicated that further corporate tax cuts and investment incentives were likely.

Risk Factors of Abenomics

Seen from an economic perspective, Abenomics is characterised by a number of serious risk factors. The first concerns whether the Japanese economy will really be that much improved by a weaker yen and rising stock prices alone. Certainly a weaker yen means profits for export businesses, but what about imports? The prices of the gasoline and food that Japan imports are already beginning to rise. In fiscal year 2012, Japanese exports totalled 64 trillion yen and imports 72 trillion yen. With exports exceeding imports by 8 trillion yen, a weaker yen is a negative for the Japanese economy. Conversely, because the balance on income – the sum of dividends and interest on financial assets, such as stocks and bonds and overseas factories and offices owned by Japanese companies – is denominated in foreign currency, it increases in yen terms when converted into a weaker yen. When all these factors are combined, the weaker yen has almost no overall effect. Over a longer period of time, it may well be that a weaker yen would boost Japanese exports and eventually the entire economy. However, to what extent this would happen is far from clear. Japanese manufacturing now prefers to produce locally rather than produce at home and export. The benefit of a cheap yen thus may be much less than expected.

No End of Deflation in Sight

The second risk factor is that a weaker yen and rising stock prices may not necessarily beat deflation on their own. A weaker yen results in higher prices for imported goods that, to some degree, are probably shifted to consumers. The degree to which they shift depends on how far prices can rise without impacting sales. The income of ordinary workers, which makes up 60 per cent of Japan's GDP, has fallen consistently for the past 15 years, declining by 13 per cent from 1998 levels. Whether imported or made at home, if the prices of products rise, consumers simply cut back further on their spending; the inability to raise prices will make it impossible to do away with deflation.

Wages Not Increasing

The third risk factor is wages. In order to compensate for deflation, it is essential that the incomes of ordinary consumers – that is, their wages – rise. This is why Prime Minister Abe and his principal cabinet ministers called upon the leaders of the business community to raise wages. This appears to have led a number of large corporations to increase their bonuses, but they remain reluctant to raise base wages. With conditions still difficult for small and medium-sized companies, the overall increase in wages this year is negligible and the outlook for next year and beyond is uncertain. If prices rise in the absence of an increase in wages, people will have a harder time getting by and the economy is likely to slow down once again.

Abenomics Is Silent on Fiscal Issues!

In January 2013, Abe's government decided the supplementary budget for fiscal year 2012, which included 10 trillion yen of public infrastructure building and other spending to boost local economies. This action, the so-called second arrow of Abenomics, was made possible by issuing 5 trillion yen of Japanese government bonds. The interest rate on these bonds rose in March and April. For fiscal year 2013, the size of the general budget is 93 trillion yen, of which 43 trillion yen – or 46 per cent – is financed by debt. This is equivalent to 9 per cent of GDP.

Abe must present a credible plan to rein in government debt, which is already twice as large as GDP. The official position of the Japanese government is that it will stick to the plan to eliminate the deficit in the primary balance and to reach a positive primary balance by 2020. This plan was drawn up by the previous government and already Abe's administration has strayed from the course by spending an additional 5 trillion yen to finance Abenomics' second arrow. Abe promised to present his own fiscal plan in the autumn of 2013. In October, he announced that consumption tax is to be raised from 5 per cent to 8 per cent in April 2014. It remains open, however, whether the tax will be raised further to 10 per cent in October 2015, as the consumption tax law assumes. As a result, there may be greater scope for cutting back the deficit. Still, restoring the primary balance in six years' time is a challenge.

To accomplish this, greater tax increases would be necessary, coupled with spending cuts. These spending cuts would come from streamlining and cutting back social welfare programmes. On the revenue side, a further increase of consumption tax from 10 per cent to 15 or 20 per cent is an option. Other increases in inheritance tax and income tax are under consideration. All these tax increases and spending cuts will probably have a depressive effect on the economy and thus they should be implemented only when the economy is strong enough to bear the burden.

Will Japan Replicate the Fates of Greece and Portugal?

Given this gloomy prospect, some economists and experts in the Japanese government argue that Japan will become like Greece and Portugal, unless it takes bold measures to reduce the deficit very soon. Two of Abe's predecessors, former Prime Ministers Naoto Kan and Yoshihiko Noda of the Democratic Party of Japan (DPJ), share this view. They had both been finance minister before becoming prime minister.

For a long time, there have been two sharply opposed views of the Japanese fiscal deficit, which is the largest in the world both in absolute volume and relative to GDP. One school of thought contends that such a large deficit poses an immediate threat to the Japanese economy. Proponents of this view, most notably finance ministry officials, believe in a balanced budget and have called for tax increases and spending cuts in social welfare programmes as soon as possible. They fear that unless Japan takes action immediately to cut the fiscal deficit, the country will soon follow in the footsteps of Greece and Portugal.

The other school argues that, although the current fiscal deficit may be unsustainable in the long run, there is not much to worry about at present. This is because the Japanese fiscal deficit is fully financed by domestic savings. The fact is that the Japanese private sector, households and corporations generate savings equivalent to 10 per cent of Japanese GDP, while the government of Japan borrows 8 per cent. The remaining 2 per cent is funnelled into foreign countries as current surplus. This is the complete opposite of Southern European nations such as Greece or Portugal, which borrow heavily from abroad to finance their fiscal deficit. The interest rate on Japanese government bonds is the lowest in the world. It is difficult to argue that Japan's situation is similar to those of Southern European countries.

This debate on fiscal discipline versus economic growth seems to be identical to the discussion under way in Europe. While many economists take the view that consumption tax should be increased as planned, some of Abe's most trusted advisors are more cautious. Both Japan and European countries must carefully calculate the effects of aging populations on public expenditure. Many social welfare programmes, including pensions and medical insurance, must be streamlined and cut back or taxes will need to be raised unbearably high.

The Surplus in the Current Account Is Dwindling

Japan has been running a current account surplus for the past four decades. The composition of such a surplus, however, has evolved greatly. Until the middle of the 1990s, the trade surplus – that is, exports minus imports – was the major component of the current surplus, but since then it has tapered off and begun to decrease slowly. In its place, income revenue from the assets Japan holds overseas has generated an increasing amount of dividends and interest revenue.

Since the earthquake and tsunami of 11 March 2011, Japan has been forced to import huge volumes of gas to offset the closure of its nuclear power plants. Consequently, since 2011 the trade balance has fallen into the red, cutting into the income surplus. Now, Japan's current account surplus is about 1 per cent of GDP, down from 5 per cent in 2007. Economists and policymakers are beginning to worry that, sooner or later, Japan will become unable to finance its fiscal deficit with domestic savings. It is imperative for Japan to reduce the level of its fiscal debt to a manageable level before its current account is wiped out.

Problem for Japanese Banks

A massive injection of money by the Bank of Japan was supposed to lower the interest rate, increase borrowings and stimulate investment and personal spending. The primary goal of Abenomics is to stop deflation and create modest inflation of around 2 per cent per annum. With overall price levels going up, interest rates must go up, too, which means that bond holders will suffer losses. Given that banks and other financial institutions have a high ratio of Japanese government bonds to total assets, rising interest rates may drive them into a banking crisis similar to those seen in Southern Europe recently.

In Europe, what began as a fiscal problem developed into a banking crisis because many European banks held a substantial amount of sovereign bonds of peripheral countries. Will the same banking crisis occur in Japan?

Perhaps not. The Japanese government can always pay the interest on Japanese government bonds and the principal when due. They can print the money, if necessary, since all Japanese government bonds are denominated in Japanese yen, including those held by overseas buyers.

However, this does not mean that there will not be a problem for the Japanese banking sector. It is plain that the lion's share of Japanese government bonds is held by Japanese banks, pension funds and other institutional investors. There is a lot to suggest that the price of Japanese government bonds is likely to fall and the holders will suffer losses. Already, the so-called megabanks are cutting back on their holdings of long-term Japanese government bonds, but small, local banks remain exposed to much greater risk, as they still hold a large amount of the bonds.

No Exit Strategy in Sight

At present, there is no clear vision of how these swollen assets can be scaled back to a normal level. Mr Kuroda has said publicly that it is still premature to discuss an exit strategy. It is widely feared that the Japanese government bond market may collapse under its own. This might happen if holders were to sell their Japanese government bonds in a rush due to fears of sudden interest rate hikes.

Given the basic principles of Abenomics, which purports to cause inflation of 2 per cent, it is inevitable that sooner or later interest rates will rise. The only questions are if and how to avoid a massive sell-off of Japanese government bonds. It is absolutely necessary for the Bank of Japan to present a credible plan to reduce its asset level in an orderly manner.

Success of Abenomics Depends on Structural Reform

While views are divided on the effectiveness of monetary easing and additional spending on public works, economists are in unanimous agreement that the most important part of Abenomics is its third arrow, namely, structural reform. This includes bold initiatives that should cut into the staunch vested interests of labour unions, medical doctor associations, farmers' associations and the like. Abe has yet to disclose the details of his reform programme.

At present, Japan is conducting a series of trade negotiations with the EU, Canada, Australia and neighbouring Asian countries. But by far the most important is the Trans Pacific Partnership (TPP). Abe's decision to join the TPP negotiations has been much welcomed by business leaders and economists, but vehemently opposed within his own party. Trade liberalization negotiations will enter a critical stage this fall, when he must decide on liberalization of imports of products that have been protected by high tariffs or other forms of barriers in the past. This includes such items as rice, beef, pork, wheat and sugar. Traditionally, these products have been regarded as sacrosanct and no prime minister has ever dared to touch them. But more and more people, including farmers, are beginning to realize that Japanese agriculture cannot survive under the current regime anyway. If Abe can bring these reform-minded farmers onto his side, he has a chance of winning enough support to see the negotiations through. Such liberalization will bring in more competition in the Japanese agricultural industry and create an environment for innovative farmers to take a greater slice of the market and even venture into the export business.

Medical and care services is a sector in which bold reform is urgently needed. This is a much larger industry than agriculture and a growing industry due to Japan's aging population. This industry is heavily regulated by cumbersome rules and regulations, which today work to the detriment of new technology and services. While Japan's technology and equipment are internationally competitive, very few products have been allowed into the domestic market. The resistance to reform in this field comes not only from government agencies, but also from medical practitioners and pharmaceutical companies that enjoy dominant positions under the present system. They have the money and political connections to mobilize strong opposition, if they wish to do so.

Another area which deserves a lot of attention is the labour market. In Japan, although it is legally possible, historically it has been very difficult to lay off workers. The law considers lay-offs to be an absolute last resort. In fact, mid-career lay-offs are almost unheard of. If a case is brought to court, the employer must prove that the company has exhausted all other options to avoid a lay-off. This is an impossible task. A proposal is being made by employers to amend labour law to pave the way for lay-offs with monetary compensation. This is being met by fierce opposition from labour unions.

The electricity industry will also see major changes over the next decade. A law has already been passed that will split the current vertically integrated nine regional monopolies into electricity generating companies and transmission companies. New companies are allowed to generate and sell electricity, opening up the entire electricity market for competition. There will be more supply from renewable sources such as solar, wind, biomass and geo-thermal. This will be particularly beneficial to Japan, as it must find alternative energy sources to fill the gap left by the closure of its nuclear power plants.

Following through with all of these reforms will take a much greater effort than the first and second arrows. We will have to wait and see how Mr Abe spends his political capital to that end.

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