On Abenomics and the Japanese Economy

Motoshige Itoh
Member, Council on Economic and Fiscal Policy and Professor, University of Tokyo

The purpose of this brief overview is to summarize some of the major points of the economic policies of the Abe cabinet and to provide materials for further discussion. I am now a member of the Council on Economic and Fiscal Policy, the inner circle of the Abe cabinet's policy decision-making process, and I am therefore not in a good position to comment on the policies from a neutral perspective. However, I can provide a deeper perspective on each of the policies being discussed by the cabinet from the position of an insider.

Abenomics consists of what are termed "three arrows": Aggressive monetary policy, timely fiscal stimulation, and growth strategies to promote investment by the private sector. In addition to these policies, other initiatives such as participation in the TPP (Trans-Pacific Partnership) and reform of the labor market are also among the major policies of the Abe cabinet. Fiscal reform will receive focused attention after the upper house election in July.

It is impossible to cover this wide range of policy issues with any pretense of providing deep and insightful analyses. I will therefore restrict myself to offering an overall picture and providing food for thought for the discussions in this symposium. Even then, space is limited, and so the choice of policy issues must be very selective, and will be based on my own judgment.

The lost three-and-a-half years

The 20 years since the collapse of the bubble economy in the early 1990s are often called the lost two decades. Japan has suffered a difficult adjustment from a rapidly growing economy to an older, mature economy. It has been unable to adapt quickly to the changing trend of globalization, the emergence of rapidly growing neighboring countries, and demographic change in Japan itself.

The target of the economic policies of the Abe cabinet is to institute a process of recovery from the lost two decades. A variety of policy measures must be applied, including drastic deregulation policies in various areas, promotion of internationalization of the social and economic systems, and the establishment of a sustainable social security system compatible with an aging society. These reforms will generate various frictions, and they are therefore politically very difficult to implement.

Although departure from the lost two decades is the final target of Abenomics, so far it is more appropriate to say that Abenomics has placed greater emphasis on recovery from the "lost three-and-a-half years." This refers to the period following the Lehman crisis during which the Democratic Party of Japan (DPJ) was in government. The performance of the Japanese economy during this period was clearly very different from that of other major developed nations. The yen rate appreciated drastically during this period, and stock prices were markedly stagnant. If one were to set the stock price indices of Japan, the US and Germany to 100 for the sake of comparison, one would see very similar performance in the three indices before 2008, but following this, while the indices of the US and Germany have continued to follow similar paths, Japan's stock index alone has displayed very poor performance.

It has been a great achievement of the monetary policy of Abenomics to lay the groundwork for recovery from the lost three-and-a-half years. The direction taken by the Bank of Japan (BOJ) under Governor Kuroda is what should have been done three-and-a-half years ago under former Governor Shirakawa. Setting an inflation target of 2% and drastically expanding the monetary base was the strategy implemented by the FRB and by the ECB after the Lehman crisis. Japan had to wait three-and-a-half years for these drastic measures.

<u>Monetary policy: Stronger commitment to anti-deflation policy</u>

It is not easy to dispel the deflationary expectations that have become widespread and deep-rooted during the lost two decades. Public expectations must be changed.

In order to change the prevailing mindset, it will be necessary to show that the present monetary policies are different to those instituted in the lost three-and-a-half years. Two points are noteworthy. The magnitude of monetary expansion is far greater this time, and the announcement of the expansion was made at one time rather than the piecemeal expansion implemented under the previous governor. Another important point is that the BOJ has now announced its intention to aggressively purchase longer-term JGB.

A similar approach of buying longer-term bonds has been adopted by the FRB, but the BOJ did not adopt this policy stance in the past. This may have reflected the bank's concerns regarding exit strategy. If the BOJ holds a large amount of long-term bonds, it may be difficult to sell them even after general prices begin rising; if the BOJ sells the bonds, or if there is any expectation of such a move in the market, the price of the bonds would be negatively affected. Concern over this would make it difficult for the BOJ to sell JGB.

Buying only short-term JGB would offer the BOJ a free hand to exit from monetary expansion. It is a policy action with an exit path prepared. On the other hand, the purchase of a large amount of longer-term JGB means that the BOJ has destroyed its exit path. In other words, it represents a strong commitment to maintain a large monetary base for a longer period. It is a commitment not only to monetary expansion at present, but also a promise that monetary expansion will continue for the foreseeable future.

Will prices increase soon?

It is one thing for the exchange rate and stock prices to respond to monetary policy, but it is another for the general price level and wages to increase. The fact that the long-term interest rate has fallen since the implementation of the monetary expansion policy suggests that the market still does not believe that general prices will respond quickly; inflationary expectations are generally built-into the long-term interest rate.

It is not easy to predict how quickly general price levels will begin rising. Surveys indicate rising inflation expectation. Members of the policy board of the BOJ are expressing an optimistic view regarding the speed of price increase.

General price levels and wages have rigidity. The response of the exchange rate and stock prices to change in monetary policy is rapid, but it will take some time for prices and wages to adjust. It is also important to note that the expansion in demand in the real economy is essential for prices; in this respect, growth strategy is quite important in realizing continued economic expansion.

Wage levels have attracted considerable attention among the policy community. How quickly wages will rise is a crucial question in relation to the distributional aspect of anti-deflation policy. People who criticize Abenomics often claim that only big companies and the wealthy will benefit from Abenomics. Noting that stock prices and the exchange rate are not important for ordinary people, they indicate that if prices start rising and wages do not rise much, ordinary people will face greater difficulties.

The important question is which begins rising earlier, prices or wages? The two have a very strong correlation, but it is not easy to say which will move earlier. The Abe cabinet has placed some emphasis on promoting earlier increases in wages, although there are no effective policy measures for the promotion of wage increases.

In general, deflation offers beneficial distribution effects for the older generation. They are also the dominant power in elections: It is not easy to convince people of the benefits of anti-deflation policy in Japan, where the average age of voters is quite high.

Changes in asset markets

It takes some time for monetary policy to achieve movement in prices and wages. Developments in financial markets are therefore crucial in enabling monetary policy to spread its influence to the economy.

The household sector has accumulated financial assets under a deflationary economy. The average amount of financial assets of the household sector relative to annual disposable income is about 400 % at present; it was about 300 % ten years ago. The household sector in Japan has accumulated a huge amount of savings in the last ten years.

Under deflation it is rational to save in bank deposits, which is what has actually happened in Japan in the last ten years. However, if prices start rising, the opportunity cost of holding bank deposits will become higher. If stock prices keep rising and general price levels start rising, people may begin shifting some of their assets from bank deposits to equities and mutual funds. If this kind of shift in saving behavior occurs on a large scale, the real economy will gain some momentum.

It is also important to note that the corporate sector has saved even more than the household sector recently; how the saving behavior of the corporate sector will change is another important point.

Will the BOJ finance the government deficit?

Does the purchase of a large amount of JGB by the BOJ mean the financing of government deficit by the bank? This is a point which many people raise. If the market believes so, confidence in fiscal solidarity will become weaker, and the risk of rising interest rates on JGB will increase. Fortunately, this is not what has happened so far.

The purchase of a large amount of JGB from the market by the BOJ is within the scope of monetary policy, whether what is bought are short-term or longer-term bonds. It does not represent financing of the budget deficit. However, if this kind of behavior by the BOJ sends the wrong message to the government, i.e. that it can run a budget deficit for a longer period, then the market will perceive this as financing of the budget deficit by the BOJ. The more aggressive the purchase of JGB by the BOJ, the more sensitive the market will be to fiscal management by the government.

Financial consolidation is also crucial for expansion of financial transactions. The implementation of expansionary monetary policy by the BOJ is expected to promote financial transactions and the use of savings for private investment. Increasing private investment is a critical factor in exiting from deflation.

The more savings go towards private investment, the less savings funds are left for buying JGB. In the past, an ample amount of savings were available for the purchase of JGB, which is what made the interest rate so low. However, if revitalization of private investment draws savings away from the JGB market, the long-term interest rate will rise and the economy may suffer from “crowding out.” In order to prevent this type of crowding out, the government must make the budget deficit smaller to enable more savings to move smoothly to private investment.

The second arrow: Timely fiscal stimulation

The second arrow of Abenomics is timely use of fiscal stimulation policy. Criticism of this policy is natural. Is it really necessary to expand fiscal stimulation in the face of the enormous amount of government debt? However, it is important to note that issuing an additional five trillion yen in JGB for financing timely fiscal stimulation and the presence of a debt of more than 1,000 trillion yen are matters of fundamentally different dimensions. It is possible for the government to pursue timely fiscal stimulation policy now and at the same time to implement a fiscal consolidation program.

In the first two years of the Abe cabinet we can expect very dynamic change in macroeconomic conditions. The BOJ is targeting an inflation rate of 2 % by 2015. The Consumption tax rate will be raised from 5% to 10% during these two years. The government also intends to shrink the primary budget deficit (the budget deficit excluding the bond financing component), that is, the budget deficit in the primary balance concept relative to GDP, to half its 2010 level by 2015.

Achieving these targets in two years will not be an easy task. Delicate macroeconomic policy management will be essential. Recession was expected in 2013, which was not politically good for of the implementation of an increase in the consumption tax rate. The second arrow, timely fiscal stimulation policy, was necessary to evade the recession and to gain political approval for a tax increase.

Does anti-deflation policy promote fiscal consolidation?

Many industrial countries, including Japan, face serious financial problems due to increasing social security costs resulting from the aging of their populations. There seem to be two approaches available in this situation. One approach is austerity, under which expenditures are cut drastically and taxes are increased. European countries are following this approach in spite of rising unemployment. Abenomics follows the other approach, under which deflation must be ended prior to fiscal consolidation. There is heated controversy over which approach is better. I am not prepared to enter this controversy, except to discuss one point. This is whether anti-deflation policy is necessary for fiscal consolidation.

There are many reasons to believe that anti-deflation policy is a necessary step for fiscal consolidation. Under deflation, the real value of government debt increases, so-called debt deflation. If the inflation rate shifts from a negative level to around 2 % in two years, there will be a substantial reduction of the real value of debt. The real value of JGB will decline at the pace of the inflation rate until they are reissued for redemption. This is an inflation tax which bond holders suffer.

The interest rate on JGB will rise if people expect an increasing rate of inflation in the future; the government will therefore pay higher nominal interest. However, it is important to note that the amount of the increase in the nominal rate will be smaller than the increase in the inflation rate; that is, the so-called Fisher effect does not apply when the nominal interest rate is near zero. Remember that the nominal interest rate does not fall as much as prices fall during the deflation process; the real interest rate has actually risen under deflation. The reverse process will commence when prices are increasing. The real interest rate will fall as prices increase as long as the inflation rate is below 2%. If this is what happens, it will be aid the government greatly.

However, it goes without saying that inflation is only of partial assistance in fiscal consolidation. The size of the government debt, more than 200 % of Japan’s GDP, is too massive to shrink by modest inflation. Furthermore, the expansion of social security payments with the aging of the population has nothing to do with inflation. If prices increase, social security payments will also increase by the inflation rate. Therefore, with or without inflation, reform of the social security system is necessary.

The government has decided to introduce a macroeconomic slide mechanism for the pension system under which pension payments will increase at the pace of the inflation rate minus 0.9%. This adjustment is critical to enabling the size of pensions to be controlled against the background of a declining working population. Unfortunately, such a macroeconomic slide mechanism could not be implemented under deflation. It is desirable to introduce this slide mechanism as soon as possible; exiting deflation is a necessary condition for the earlier implementation of the mechanism.

Some people are concerned about the potential effect of drastic monetary expansion in triggering a collapse in JGB prices. What paths can we consider by which drastic monetary expansion would lead to a collapse in JGB prices? One possible path is the exit strategy of the BOJ, which I have already mentioned. Another important channel is through the political process. Politicians may say "exiting deflation is the most important matter now, so we must postpone the increase in the consumption tax," or "If we can exit deflation, fiscal consolidation will become much easier, so we can slow down the implementation of austerity policy." This is common to any country, and Japan is no exception. If the political process is moving in the direction of postponing fiscal consolidation, the market may start selling JGB.

Stages of fiscal consolidation

There are two important elements related to fiscal consolidation in Japan. The first is that Japan has already accumulated a huge amount of government debt, more than 200 % of GDP. The other is that Japan will experience a rapid aging of its population, and social security payments will continue to increase.

The stages of fiscal consolidation must follow the sequence of short-term, mid-term and long-term targets. In the short-term, the government will realize an exit from deflation and decrease the budget deficit to enable it to achieve its primary balance target by 2015 (as already mentioned). Increasing the consumption tax rate will be essential for this stage. The market is watching how the government realizes this target.

With its huge amount of debt, it is vital for Japan that the interest rates on JGB stay low. The confidence of the market is essential. The government must show the will and capability to implement its fiscal consolidation plan. Reform of the social security system will be the most important part. A further increase in tax rates may be discussed in the near future.

I will note in passing that Japan's government expenditure, excluding social security-related expenditure, is now the lowest among OECD countries in terms of its ratio to GDP. This means that increasing social security expenditure has compressed government expenditure in other areas, which possibly represents a substantial misallocation of government resources. Reform of the social security system should be discussed from this perspective also.

The third arrow: Growth strategy

Although growth strategy is very important I will touch on it only briefly due to space limitations. It goes without saying that mobilization of the private sector economy is essential for the activation of the economy. Filling the macroeconomic gap between supply and demand by expanding private sector demand will be necessary to stop deflation and to continue the growth process.

It should be noted that during the lost two decades the balance sheet positions of the private, household, and corporate sectors and financial institutions underwent substantial adjustment. They are all now ready for active consumption and investment as far as their balance sheet position is concerned. What is necessary is to offer them stronger incentives to move. In that respect, exiting deflation is crucial; changing the macroeconomic environment will stimulate an increase in financial transactions and private investment. What the government should do is to implement drastic reform policies. However, I will not go into details of the necessary reform policies here due to limitations of space.