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The Implications of Abenomics for Europe

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Abstract

Europeans are watching Abenomics with a mix of hope and apprehension. The hope is that the economic strategy will succeed in reviving the Japanese economy. This would obviously be desirable for the global economy in general and for Europe in particular, where growth has been dismal for a while. At the same time, there is some apprehension that the yen, which has depreciated against most currencies by around 30% since September 2012, will continue to fall, unleashing declines of other Asian currencies against the euro. So far, the Japanese authorities have only implemented two of the "Three Arrows" of Abenomics, fiscal expansion and monetary easing. While the strategy has been successful, it has also been relatively easy to implement and to get short-term results. The third arrow, which is yet to come, concerns the implementation of growth-enhancing structural measures that would ensure that Abenomics is capable of delivering long-lasting effects. If, as one hopes, Abenomics succeeds, the real implication for Europe will be that reviving the economy requires a combination of bold macroeconomic and structural policies, with the right sequencing between the two.

1. Introduction

For two decades the Japanese economy has been mired in deflation and stagnant nominal GDP. Real GDP and per capita GDP have grown somewhat but only thanks to chronic fiscal deficits that have brought gross public debt to well over 200% of GDP. The new government of Prime Minister Shinzo Abe has decided to end this situation by adopting an economic strategy ("Abenomics") involving three measures: fiscal expansion, monetary easing and growth-enhancing structural reforms.

The first two legs of the strategy have already been adopted. In January 2013, barely a month after its election, the government adopted a fiscal stimulus of Y10.3 trillion (€85 billion) equivalent to about 2% of GDP. And in April the Bank of Japan under the leadership of its new governor Haruhiko Kuroda announced the launch of quantitative and qualitative easing aimed at fulfilling the PM's goal of 2%

[1] I am grateful to Carlos De Sousa for excellent research assistance.

inflation within two years.

So far the plan has worked. The Nikkei 225 stock market index has risen by more than 40% since Shinzo Abe was elected prime minister in December 2012 and by more than 60% since he was elected opposition leader on his Abenomics platform three months earlier. Also GDP growth forecasts for 2013 and 2014 for Japan were revised upwards by the IMF in April, although it revised them downwards for the rest of Asia. As a result of this good news, the PM enjoys a high approval rating at home which should enable him to adopt structural reforms, the third leg of his strategy, in June.

The international community has been watching Abenomics with great interest. Although somewhat worried that the yen has depreciated against other currencies by nearly 20% since Mr. Abe came to power (and by more than 30% since he was elected opposition leader), it obviously views positively the potential revival of the world's third largest economy. Thus, at their April Washington meeting, the G20 finance ministers and central bank governors gave their approval to "Japan's recent policy actions [that] are intended to stop deflation and support domestic demand".

In Europe the reaction to Abenomics has generally been positive as well. But concerns about the external value of the yen are also present because the economic situation there remains worrisome, with annual GDP growth in 2013 expected at -0.1% in the European Union and at -0.4% in the euro area. Both the hope of future Japanese accelerated growth and the apprehension about further yen depreciation are magnified by the prospect of more intense EU-Japan trade relations if the negotiations on a bilateral free trade agreement launched in March are successful.

The purpose of this short note is to examine what are the likely effects of Japan's new economic strategy on Europe and in particular on the euro area.

2. The international effects of Abenomics: a view from Europe

Japan's economic policies could have important economic repercussions for Europe. Some of the spillovers would operate via the trade channel, while others would result in a sort of coordinated monetary easing.

Trade spillovers

The IMF (2013) has attempted to analyze the spillover effects of Abenomics on the rest of Asia on the assumption that Japan's new economic strategy produces higher GDP growth, a more depreciated currency and lower interest rates in Japan than otherwise. Spillovers on Asian partners would occur through two main channels: financial markets and trade.

According to the IMF, a successful exit from deflation and persistent yen depreciation could reduce the home bias of domestic Japanese investors and lead to a rebalancing of their portfolios to include a larger share of foreign assets, especially from Asia. Hence, the financial market spillover of Abenomics on other Asian economies is likely to be positive.

At the same time, the IMF predicts that stronger growth in Japan would benefit exporters in other Asian countries, especially those supplying final goods to Japan. A weaker yen has less straightforward implications. For countries that directly compete with Japan, this may undermine their competitiveness. However, this effect is mitigated by the fact that yen depreciation also raises production costs in Japan due to higher costs of imported inputs. Likewise, many countries in Asia import intermediate goods from Japan, which become cheaper with yen depreciation, although possibly at the expense of domestic suppliers. Hence, the trade spillover effect of yen depreciation is unlikely to be uniform across Asian countries and would depend on each country's position in the supply chain.

As far as Europe is concerned, the main spillover channel is likely to be trade. Stronger demand growth in Japan should translate into higher exports for EU suppliers who would further benefit from the EU-Japan FTA when it is implemented. This might reverse the recent downward trend in the share of Japan as a destination of EU goods exports, which has fallen from 5.4% in 2000 to 3.3% in 2012. How much of this potential will be undermined by a weaker yen obviously depends partly on how much the yen depreciates against European currencies. The more it depreciates the more also it would boost Japan's exports potentially to the detriment of EU production.

Since the election of Mr. Abe as leader of the opposition and contender for the post of prime minister under the banner of Abenomics in September 2012, the yen has depreciated by, respectively, 31 and 32% against the dollar and the euro. On May 10, the yen was at 102 against the dollar and 132 against the euro, compared to, respectively, 78 and 100 on September 26, 2012.

Will the fall of the yen continue?

Japanese analysts generally regard the current yen level "fair", though they consider further depreciation problematic. For instance, Kazumasa Iwata, a former Bank of Japan deputy governor who is now president of the Japan Center for Economic Research, recently indicated that he "believes the yen is fairly valued at Y100 to the dollar, but that further weakness would represent a market "overreaction" and "could cause problems" for Japan's economy." (Ross et al., 2013). Similarly, Koji Sakuma, General Manager and Chief Economist at the Institute for International Monetary Affairs, recently wrote that "the current level at around 95 yen against the

US dollar is more or less a fair level. In this regard, the recent depreciation can be regarded as an adjustment of the overvaluation which emerged under the extreme strain of the global financial market after the Lehman shock and can be justified theoretically and internationally, therefore. However, excessive depreciation beyond this might annoy other nations and even be harmful to the Japanese economy." (Sakuma, 2013).

The IMF apparently shares the view that the current yen level is "appropriate". Yet with currency strategists (such as Alan Ruskin at Deutsche Bank and Beat Siegenthaler at UBS) predicting a yen at 110 against the dollar by year-end international dissatisfaction may be brewing. Two recent developments point in this direction.

First, the US Treasury has on several occasions warned that it is "closely monitoring" Japan's economic policies to ensure that it "refrain[s] from competitive devaluation and targeting its exchange rate for competitive purposes" (US Treasury, 2013). And while it is true that the US Federal Reserve has engaged in monetary policies similar to the Bank of Japan's, their exchange rate effects seem to have been small. A study of the international effects of unconventional US monetary policy such as "Operation Twist" (OT) by the IMF found that there was "a significant, but generally short-lived, impact on bilateral exchange rates. OT, on the other hand, was accompanied by a sharp appreciation of the US dollar as "flight to safety" by investors more than compensated for any depreciation effect from the Fed actions." (IMF, 2012). A similar effect is unlikely in the case of the yen. On the other hand, the Japanese authorities are well aware that further yen depreciation would endanger Japan's export competitiveness due to the rising cost of imports which are largely invoiced in US dollar.

Second, on May 9 the Bank of Korea unexpectedly cut interest rates, citing the damaging effect the weaker yen is having on its exports.[2] If this move were followed by a significant depreciation of the Korean won, and perhaps of other Asian currencies, like the Taiwanese dollar, it would likely raise concerns about 'Factory Asia' not only in 'Factory North America' but also in 'Factory Europe'.[3] Depreciation of the Chinese yuan is, however, generally regarded as less likely, both because it could fuel financial instability in China and because of the fear of trade retaliation.

So far, there has been little official (or otherwise) reaction in Europe about

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[2] The same week, New Zealand's central bank admitted intervening in the currency market to try to weaken its dollar, which has come under pressure in part because of the weaker yen. Moreover, Australia cut interest rates, having previously warned that its exchange rate was too strong.

[3] Factory Asia, Factory Europe and Factory North America are the three regional supply chains organized around, respectively, Japan (but also increasingly Korea and China), Germany (and other large EU countries) and the US that dominate global production and trade. See Baldwin and Lopez-Gonzalez (2013).

Abenomics and its consequences, except to say, as European Central Bank President Mario Draghi did in April, that Japan's policy of monetary easing is "determined by domestic policy considerations" and that "there is no currency war." In part this is due to the fact that last year Japan only accounted for 3.6% of EU merchandise imports and 3.3% of EU exports (compared to, respectively, 9.3% and 5.4% in 2000).[4] As a result, despite an appreciation of nearly 30% of the euro against the yen between September 2012 and April 2013, the Bank for International Settlement (BIS) estimates that the nominal effective exchange rate of the euro has "only" appreciated by 4.8% thanks to the euro's depreciation against, *inter alia*, the US dollar, the Chinese yuan and the Korean won. While this may not sound very much it certainly adds to the burden of some eurozone countries struggling with high debt levels and low competitiveness.

Coordination spillovers

While generally welcoming Japan's efforts to stem entrenched deflation through monetary easing and rejecting the idea that it constitutes an act of "currency war", the ECB has nonetheless indicated that it may trigger offsetting policy actions if it jeopardizes the ECB's objective of medium term price stability. Such actions would not constitute a "competitive devaluation" since the ECB does not target any particular exchange rate.

At the same time, the ECB has rejected calls that it emulates Japan's policy and engages in a monetary easing of its own to outweigh the eurozone's austerity measures. In other words, the ECB refuses to regard Japan's monetary easing as triggering either "competitive devaluations" or a "coordinated global easing" to borrow an expression from Duy (2013).[5]

Yet it may well turn out that the main spillover effect from Japan's economic policies on Europe would not be through the trade channel, but through unconventional monetary easing measures that the ECB could adopt to boost eurozone economic activity. We are not yet there but the success so far of Japan's own unconventional monetary policy is certainly giving food for thought to many in Europe.[6]

3. Conclusion

Europeans are watching Abenomics with a mix of hope and apprehension.

[4] The figures are obviously much bigger for Factory Asia, with China, Japan and Korea together accounting for 21.9% of EU imports and 14% of EU exports.
[5] See the recent speech by ECB board member Coeuré (2013).
[6] See the editorial in the French daily Le Monde of May 17 entitled "Japan's economy rebounds: a lesson for Europe?"

The hope is that the economic strategy will succeed in reviving the Japanese economy. This would obviously be desirable for the global economy in general and for Europe in particular, where growth has been dismal for a while. There is also some hope that European policy makers, especially in the eurozone, may emulate their Japanese counterparts and take bolder action to revive their own economy. At the same time, there is some apprehension that the yen, which has depreciated against most currencies by around 30% since September 2012, will continue to fall, unleashing declines of other Asian currencies against the euro.

But perhaps the most important conclusion concerns the sequencing of the "Three Arrows" of Abenomics. So far, only the first two arrows, fiscal and monetary policies, have been fired by the Japanese authorities. The strategy has been successful in jump starting the economy and in giving hope that Japan has finally begun turning the corner in its 20 year fight against deflation. This was, however, the relatively easy, but also short-lived part of the strategy. The more difficult part concerns the third arrow, namely the implementation of growth-enhancing structural measures that would ensure the long-lasting effect of Abenomics on the Japanese economy. If, as one hopes, Abenomics succeeds, the real implication for Europe will be that reviving the economy requires a combination of bold macroeconomic and structural policies, with the right sequencing between the two.

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