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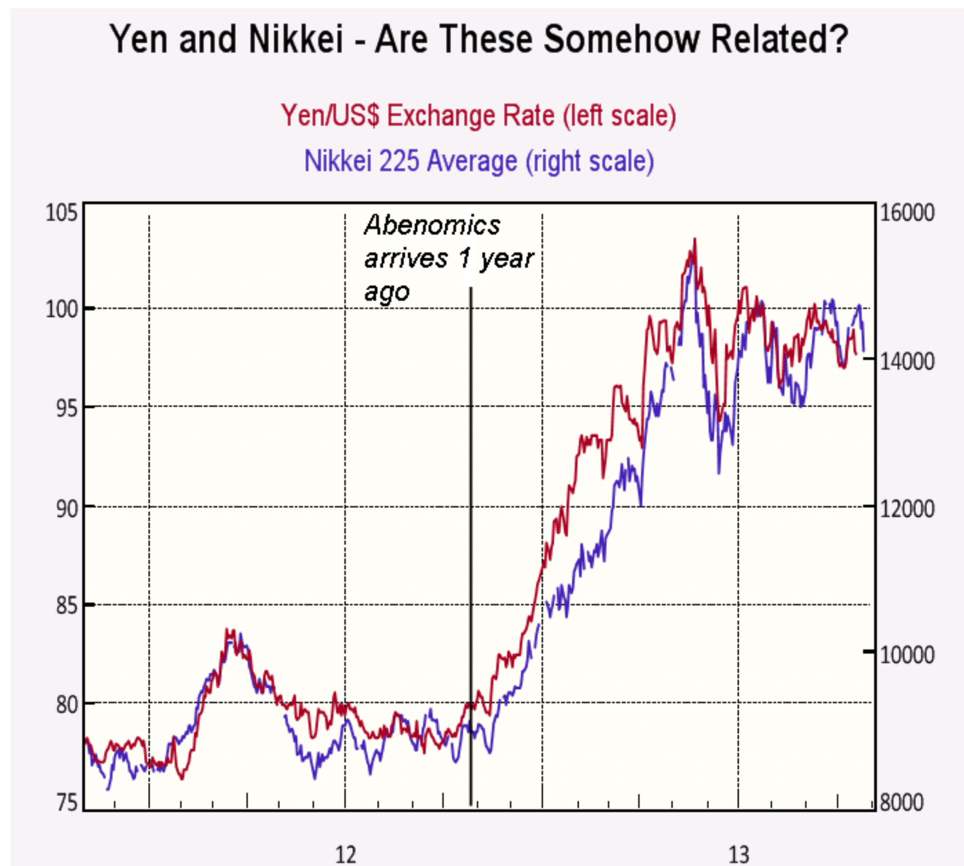
Abenomics One Year On

Exactly a year ago this week, the markets woke up to the fact that Shinzo Abe would become the next Prime Minister of Japan, and would introduce the most far reaching set of economic reforms seen in that country since the similarly audacious Takahashi reforms in the 1930s. A year later, some progress has been made, but crucial issues have been ducked and much greater challenges lie ahead.

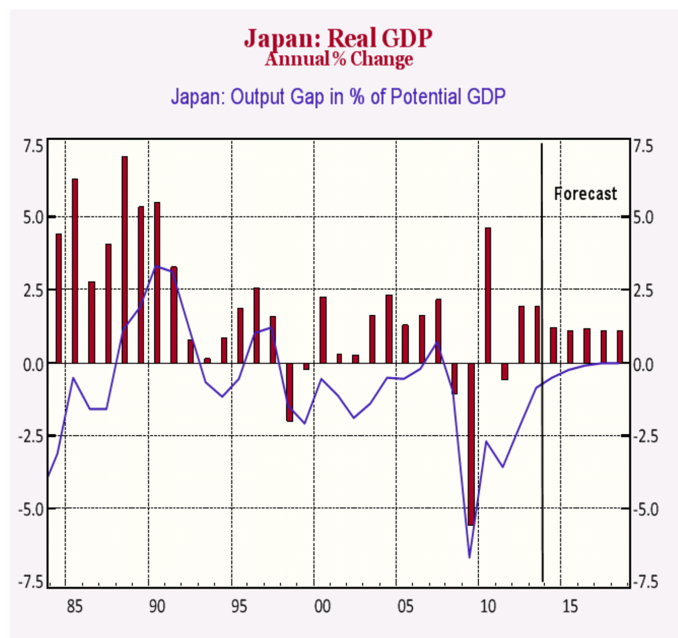


The new administration under Mr Abe immediately fired the first and easiest of his three “arrows” (see David Pilling), a dramatic expansion in the BoJ balance sheet that will be maintained until inflation reaches 2 per cent. The second arrow, a temporary fiscal support programme, has also been implemented.

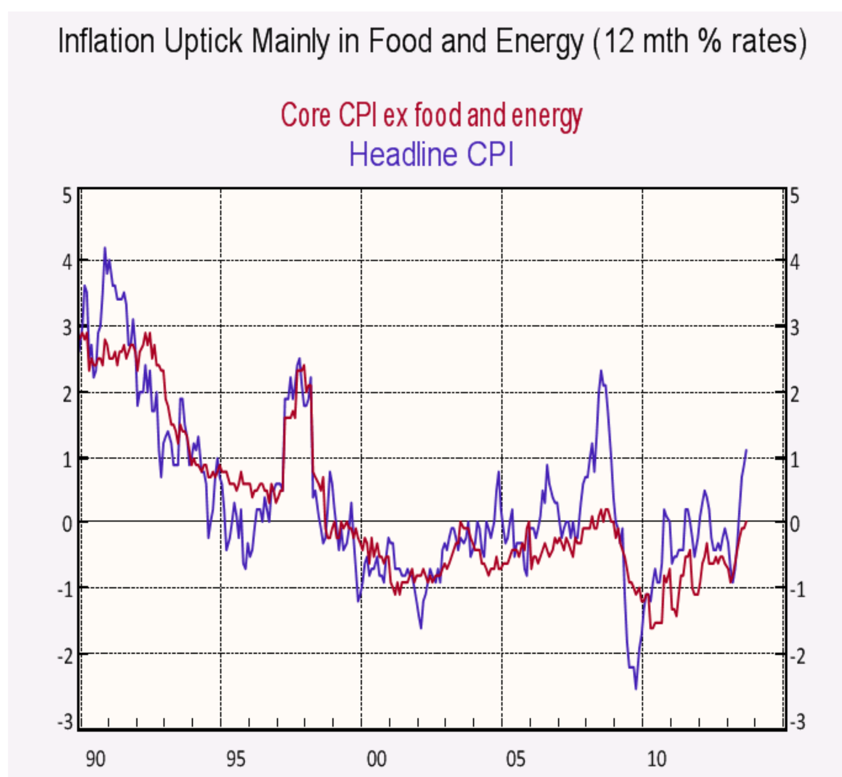
The third arrow, structural reform, has not even been removed from its quiver. And by far the most difficult task of all, now being termed the fourth arrow, stretches far into the future. That arrow is the tax increase needed to attain long term fiscal sustainability.

The Monetary Arrow

The early results of the BoJ policy changes have been encouraging. Although the huge balance sheet expansion has had the usual limited effects on bank lending, it has sent a powerful signal to the foreign exchange markets, which have devalued the yen by about 22 per cent. It is this devaluation which has been responsible for the 59 per cent rise in the equity market. Devaluation was not the stated objective of the new strategy, but it has been by far its most important instrument so far.



The recovery in GDP growth to about 4 per cent at an annualised rate in the first half of 2013 has also been encouraging. Some of this has been due to the temporary fiscal stimulus, and to a partial normalisation of exports to China after last year's rows with the Chinese (which this week have continued to simmer and could get much worse). But the devaluation has improved trade competitiveness and the rise in the Nikkei has had positive wealth effects on consumption, so the central bank can claim some of the credit for the recovery.



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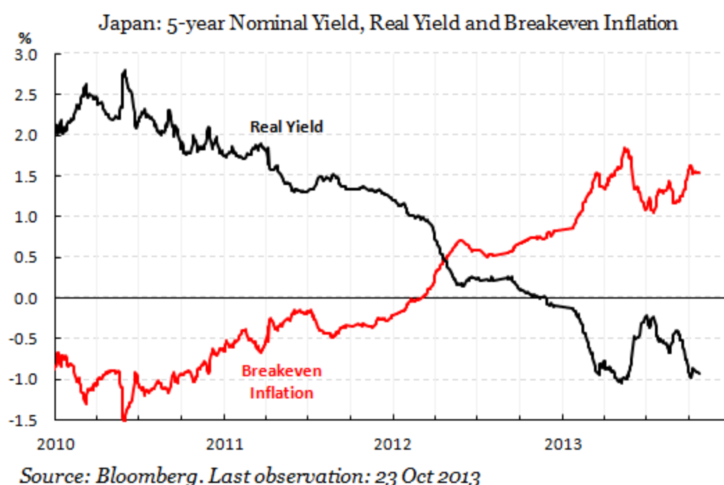
More important for the long term strategy, inflation has broken into positive territory after many years below zero. Unfortunately, much of this change has been due to the rise in import prices, which will be a one-off boost unless wages rise in response, which they are not yet doing. Core inflation is barely at zero. But inflation expectations have risen in most parts of the economy, and that is quite an achievement in Japan.

This has had the crucial effect of reducing the real rate of interest in the bond market and elsewhere. The main risk with the first arrow was always that inflation expectations in the bond market would rise while real yields stayed unchanged, thus pushing up nominal bond yields and increasing fears about debt sustainability.



In fact, the exact opposite has happened, with inflation expectations rising but real yields nose-diving into negative territory. Certainly, this can be classified as financial repression, with painful consequences for retired people living on bond investments, but it does improve the chances of digging the public sector out of its deep financial hole. And monetary policy at the zero lower bound for interest rates has been shown to be effective, via Michael Woodford's preferred route of using balance sheet expansion as a kind of forward guidance that reduces real interest rates through raising inflation expectations.

In recent months, however, the responsiveness of inflation expectations to the BoJ balance sheet expansion has broken down. This seems to have been triggered by the market's disappointment about the second arrow when the Abe "growth strategy" was announced in July.

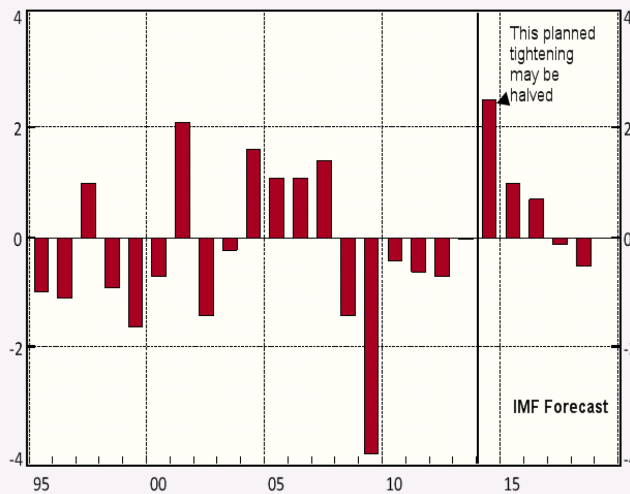
The Structural Arrow

Structural reforms to boost labour market flexibility, productivity in the services sector, free trade and female labour participation are a critical part of the strategy (see Steven Rattner and the IMF's Sanoop Singh, for example), but they are showing signs of getting bogged down in a familiar political quagmire. The extraordinary session of the Diet that began on 15 October will be an important signal whether Mr Abe can do any better than his predecessors on this. Scepticism is in order for now.

The Fiscal Arrow

Without significant structural reforms, the markets may focus their attention back onto the sustainability of fiscal policy, which is very far from being fully addressed. In fact, when combined with the ageing of the population, this is by a long distance the most intractable problem which Japan faces.

After a great deal of deliberation, the Prime Minister has decided to go ahead with the increase in the sales tax from 5 per cent to 8 per cent next April, with a likely further jump to 10 per cent in October 2015. The IMF reckons that this and some spending cuts would tighten fiscal policy by over 2 per cent of GDP next year, bringing the GDP growth rate back down to its trend at about 1 per cent per annum.



But Mr Abe is unwilling to accept this, so he plans to introduce another temporary fiscal package of infrastructure spending and corporate tax relief, amounting to Y5 trillion, or about 1 per cent of GDP. This will halve the planned fiscal tightening in 2014, and perhaps allow the GDP growth rate to come in at about 2 per cent. But it will also postpone the start of the fiscal consolidation that will have to be undertaken at some point.

Japan is not alone among the developed economies in facing fiscal problems, but it has left it much later to begin to address them. (See, for example, Martin Wolf on why the US fiscal problem in the next decade is much less serious than many think.) According to the IMF, Japan is running a structural budget deficit of about 9.2 per cent of GDP in 2013, and that will still be as high as 5.7 per cent even if the sales tax increases are implemented in full, and the temporary fiscal boost is ended, by 2015. In fact, the IMF's latest Article IV Report on Japan says that the full fiscal adjustment needed in Japan is about 11 per cent of GDP, only half of which has even been earmarked. This would be the biggest such adjustment ever undertaken by a modern democratic country.

Conclusion

The great unknown for Mr Abe and his successors is whether this fiscal tightening can be accomplished without tipping the economy back into recession. If not, the future may eventually hold further monetisation of the debt, with an even bigger devaluation and much higher inflation. Mr Abe cannot continue to rely on only one of his three arrows if he wants Japan to avoid that fate.

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by Gavyn Davies