April 29, 2014

ABENOMICS SCORES SOME EARLY SUCCESSES BUT REQUIRES MORE TIME

Highlights

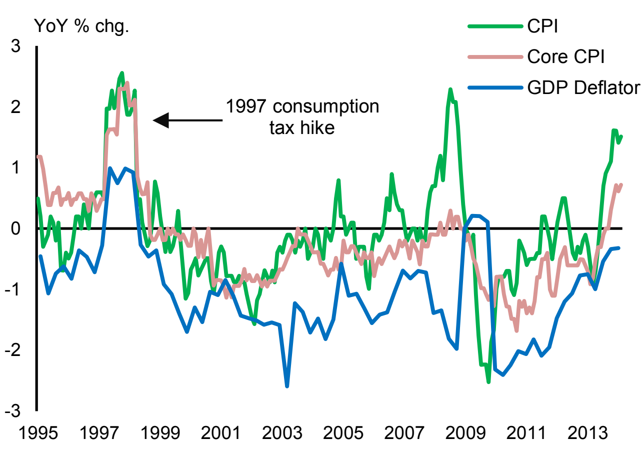
- Sixteen months have now elapsed since the Prime Minister of Japan, Shinzo Abe, established the set of policies popularly known as "Abenomics". The goal of Abenomics was twofold: to generate inflation and to increase the pace of economic growth.
- Abenomics has successfully generated inflation with consumer prices rising 1.6% year-over-year in March. Meanwhile, the Japanese economy grew 1.5% in 2013, much higher than its historical average of 0.8%.
- However, a great deal of the inflation has been due to a fall in the Japanese yen, with other price measures pointing to much more subdued inflation. Moreover, after beginning 2013 with a bang, economic growth slowly fizzled out as the year progressed, bringing into question the sustainability of achieving growth above its long-run average.
- Ultimately, Abenomics requires more time, both to allow greater wage growth and to help further raise inflation expectations to target. Therefore, a more credible commitment from the Bank of Japan on maintaining stimulus beyond 2015 would be beneficial.

It has now been 16 months since the Prime Minister of Japan Shinzo Abe established a set of policies popularly known as "Abenomics". The goal of Abenomics was twofold: 1) to reflate an economy where core[1] consumer prices had declined in every year save one since 1999, and 2) to kickstart an economy that had grown by an average of just 0.8% from 1992-2013.

In terms of these dual objectives, the attempt to reflate the economy has shown some success, although inflation remains below the goal. Sustaining a higher inflation environment at 2% will require stronger wage growth, which has not yet materialized. Meanwhile, after an early boom in 2013, economic growth has fizzled out. By this score, Abenomics has so far only partially achieved its objectives.

Adding to the economic uncertainty is a consumption tax hike that took hold on April 1st. Should consumer spending fail to rebound and real exports fail to pick up, additional stimulus from the Bank of Japan is likely to occur perhaps as early as midyear. In the end, a decelerating economy may be what finally pushes Abe to unleash the third arrow of Abenomics.

CHART 1. INFLATION HAS RISEN BUT REMAINS LOW



Source: MIC, Cabinet Office.

Deflation has ended but inflation remains low

Inflation has finally risen in the Land of the Rising Sun. On a

Andrew Labelle, Economist

year-over-year basis, consumer prices rose 1.6% in March. This is a remarkable achievement given Japan's past pattern of declining prices. However, the achievement is somewhat diminished by the fact that it required a more than 20% fall in the yen (relative to the U.S. dollar). A depreciation of the yen raises the cost of imported goods, and therefore raises the consumer price index. Because the yen is unlikely to continue to depreciate indefinitely, once it stabilizes, its ability to raise inflation will diminish.

Other measures of price growth that are less sensitive to the value of the yen point to inflation being much more subdued. By excluding food and energy, which are particularly yen-sensitive, CPI rose by a much lower 0.7% in March. Similarly, the GDP deflator, which excludes the direct impact of imported prices, rose by 0.1% QoQ and -0.3% YoY in the fourth quarter of 2014 (see chart 1). All this suggests that while the Bank of Japan has been successful at generating mild inflation, much of it has been due to a fall in the yen. For instance, among CPI subcomponents, the housing and medical care categories are statistically insensitive to the value of the yen, and remain mired in negative territory.

In order to ultimately reach (and more importantly maintain) the 2% inflation target, two elements will be required. First, inflation expectations will need to be anchored at this level. Second, wages will need to rise in order to provide sustained upward pressure on prices.

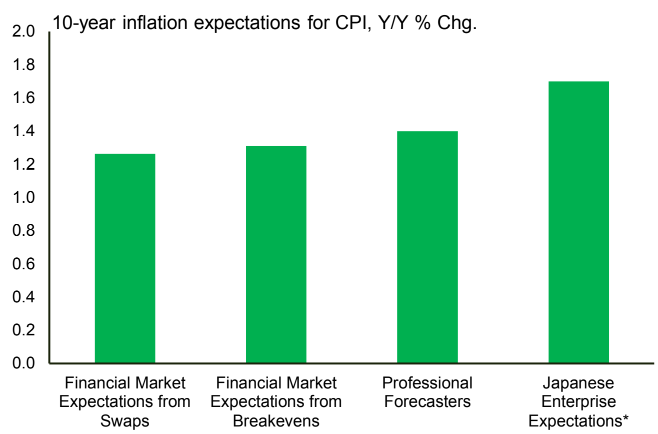
In terms of inflation expectations, several measures suggest that they have risen and are not far from target (see chart 2). In terms of wage growth, the evidence is less convincing. Average monthly earnings were flat YoY in February. Of course, wages are slower to change than market expectations, which can turn on a dime. Anecdotal evidence from annual spring wage negotiations, suggest that earnings may rise 0.5% over the next year. This marks a step in the right direction, but it is likely insufficient to anchor higher inflation expectations on a longer term basis if wage growth doesn't continue to pick up in future years.

Textbox: What is Abenomics?

Abenomics is a number of policy prescriptions brought forward by Prime Minister Shinzo Abe, consisting of "three arrows": fiscal stimulus, monetary easing and structural reform. As of now, two of the threes arrows have been unleashed. Fiscal stimulus consisted of a 2% of GDP supplemental budget passed in February 2013. Monetary easing, which has received the most attention, involved the Bank of Japan first setting a target rate for inflation of 2% in January 2013. Later in April, it pledged to reach this target within two years by conducting open-ended purchases of assets, including Japanese government bonds, corporate bonds, commercial paper, ETF's and Japanese REIT's. So far, the last arrow, structural reform, has been delayed (or altogether put off) owing to differing opinions on which reforms to undertake, and reticence at upsetting established/entrenched interests.

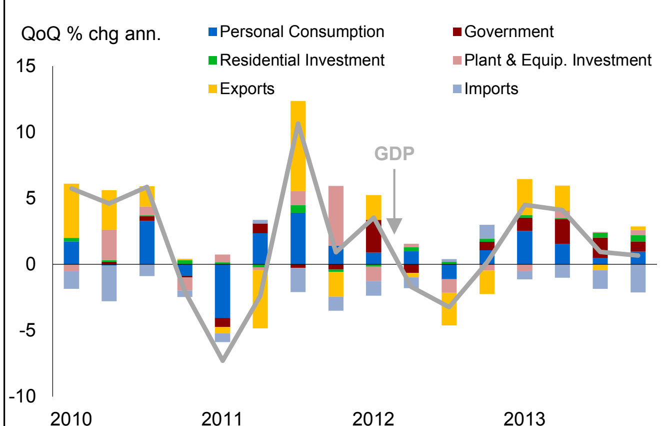
Separately, in order to tackle Japan's rising deficit which is expected to hit 232-242%[2] of GDP this year, Japan raised its consumption tax from 5% to 8% on April 1st. A second increase from 8% to 10% is planned for October 2015. Although these tax increases were passed prior to Abe coming to power, they are generally considered as part of "Abenomics".

CHART 2. INFLATION EXPECTATIONS HAVE BEEN RAISED BUT REMAIN BELOW TARGET



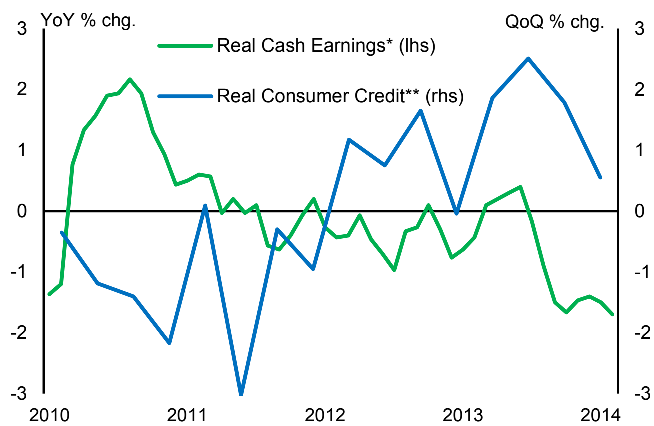
Source: Bloomberg, Consensus Economics, Bank of Japan.*5-year ahead expectations.

CHART 3. CONTRIBUTIONS TO JAPANESE GDP GROWTH



Source: Japan Cabinet Office, TD Economics. Tally does not add up total GDP because inventories omitted.

CHART 4. NEGATIVE REAL INCOME GROWTH WEIGHING ON CONSUMER SPENDING



Source: Ministry of Health, Labor and Welfare, Bank of Japan.
*3month MA. **From domestic banks, inflation-adjusted.

Thus, the goal of reaching a sustained 2% level of inflation remains elusive.

Economic growth has been raised, but sustainability is in question

The Japanese economy grew 1.5% in 2013. This is considerably faster than its long-term average of 0.8%. A recent paper by Hausman and Wieland at Brookings suggests that Abenomics contributed between 0.9-1.7pp to output in 2013[3]. According to this estimate, in the absence of Abenomics, economic growth would have been meagre to non-existent in 2013.

However, the annual figure showing solid growth masks a disconcerting trend. After starting off with a bang in early 2013, economic growth slowly fizzled out as the year progressed. From an expansion of 4.5% in Q1 2013, economic growth sharply decelerated, to 0.7% annualized in Q4. While a slowdown in government spending was expected as fiscal stimulus faded, consumption also slowed down significantly (see chart 3). Most surprisingly, export volumes growth decelerated in spite of the much depreciated yen, partly reflecting the slowdown in the global economy.

The primary channel through which Abenomics monetary stimulus is supposed to work is by lowering the real rate of interest, which should spur business investment and consumer spending. With the rise in inflation expectations brought on by Abenomics, the real cost of borrowing has been lowered. This raised demand for consumer credit and in addition to positive wealth effects from a rising Nikkei, led to strong growth in consumption in early 2013. However, consumer borrowing fell as the year progressed. Negative real income growth, in addition to weighing on consumer spending, may also be limiting the desire of households to borrow (see chart 4). Business investment did slightly rise in 2013, suggesting that at least some firms are taking advantage of lower borrowing costs (see chart 5).

Overall, Abenomics has been shown to have had a strong initial positive impact on economic growth, but questions surrounding its sustainability remain.

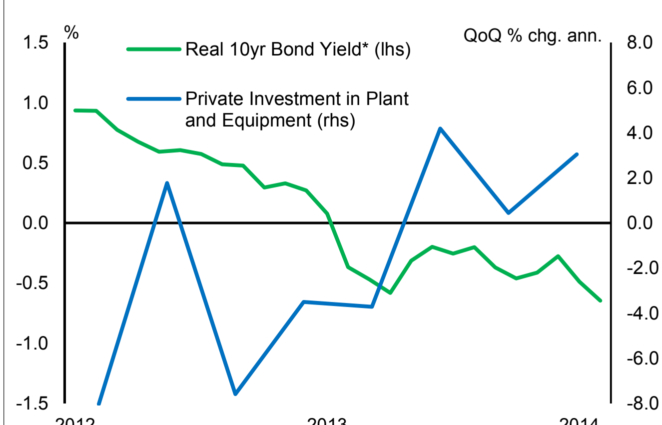
Near term growth prospects

The consumption tax hike from 5% to 8% that went through on April 1st will directly impact both inflation and economic growth. Firstly, it will unambiguously raise inflation. The consumption tax is applied to roughly 70% of the items in the CPI basket. It will likely raise CPI by between 1.6 - 2.1pp.

The impact of the tax hike on inflation will be of a year-long one-time boost, similar to its impact in 1997 (See chart 1). In April-May 2015[4], inflation will simply fall back down to where its trend rate would be ex-tax hike. Of course, if Abe goes ahead with the second planned tax increase in October 2015, this would cause another one-time boost to inflation[5].

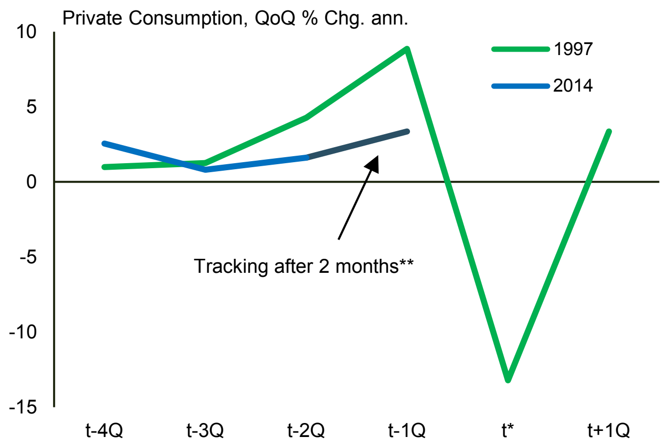
In other words, for the next 2.5 years, measures of inflation may be blurred by the impact of the tax hikes. The Bank of Japan's inflation target is for 2% YoY growth in CPI excluding the tax influence. This means that it will be targeting an inflation rate by inferring what the underlying (ex-tax hike) rate of inflation is from the headline CPI. This will increase the difficulty of conducting inflation-targeting monetary policy.

CHART 5. LOWER BORROWING COSTS HAS LED TO GREATER BUSINESS INVESTMENT



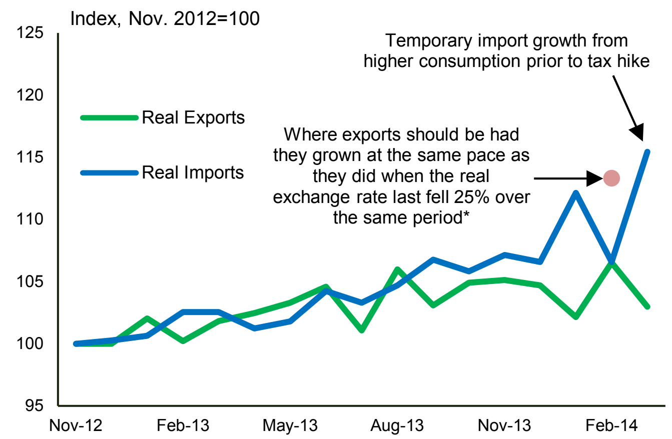
Source: Cabinet Office of Japan, Bloomberg.
*10yr Nominal bond yield - 10yr inflation swap.

CHART 6. CONSUMPTION PLUNGED IN 1997 BUT THEN REBOUNDED FOLLOWING TAX HIKE



Source: Cabinet Office of Japan. *t denotes quarter of tax hike.

CHART 7. REAL EXPORTS HAVE FAILED TO OUTPACE REAL IMPORTS FOLLOWING DEPRECIATION

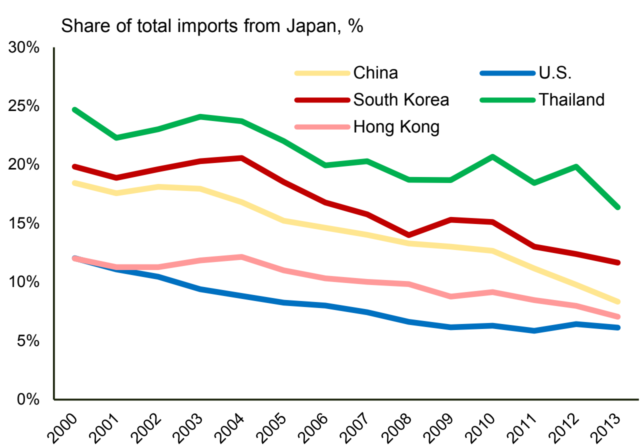


Source: Bank of Japan, BIS.*Japan's real exchange rate depreciated slightly less than 25% from October 1995 to February 1997.

More relevant to the success of Abenomics, the consumption tax hike will weigh on economic growth in 2014, as it reduces household purchasing power. In Q1 2014, spending was frontloaded in anticipation of the tax hike. As a result, GDP growth is tracking at slightly above 4% QoQ annualized. However, this front-loading will lead to pay-back and a fall in output in Q2, as was the case following the tax hike in 1997 (See chart 6). In 1997, consumption plunged in the quarter following the tax hike, before rebounding in Q3. This suggests that while the drag may be large, it may also be short-lived. Nonetheless, given negative real earnings growth, unless wages significantly rise, the bounce-back is likely to be small.

In order to soften the impact of the consumption tax hike, Abe passed another fiscal stimulus in October, equivalent to roughly 1% of GDP. This will only roughly halve the fiscal tightening that was to proceed in 2014.

CHART 8. JAPANESE EXPORTS LOSING MARKET SHARE AMONG MAIN EXPORT PARNERS



Source: Local central banks, national statistical agencies.

Therefore, the engines for economic growth, at least in the short term, will necessarily need to be exports and business investment. So far in Q1, strong core capital goods shipments point to a continued rise in business investment. On the other hand, trade remains very weak. Japan's trade deficit in nominal terms steadily deteriorated throughout 2013, posting its highest trade deficit on record in Q1 2014. A higher initial trade deficit following a currency devaluation is not unexpected, as prices typically adjust faster than volumes. However, even omitting the bounce in imports in March, due to strong consumption ahead of the tax hike, export volumes have failed to meaningfully outpace real imports (see chart 7). Relative to early 1997, when Japan's real exchange rate last depreciated roughly 25% over the same period, Japan's real exports have underperformed.

Part of the poor performance in exports can be explained by slowing external demand - economic growth in three out of four of Japan's top exporting partners decelerated or remained flat in 2013. However, there is also evidence that Japan may be facing competitive issues (see chart 8).

While stronger export growth is not a requirement for Abenomics to be successful, achieving its objectives would be aided by stronger external demand. As such, should exports fail to pick up and consumption remain weak in Q3, further stimulus from the Bank of Japan could come as early as midyear.

Bottom Line

So far, Abenomics has been successful at generating mild inflation, however the 2% target remains elusive. Meaningful inflation will likely require greater wage growth, which may take several years to achieve. Economic growth was successfully bolstered in early 2013, but momentum was not sustained. In other words, Abenomics has only been partially successful at achieving its dual objectives.

Sustaining real economic growth above 1% in Japan will be difficult under current circumstances. A rapidly-aging population will be a headwing on the economy. Estimates of 2013 potential GDP for Japan from the OECD and the IMF range from 0.6%- 0.8%. On the surface, as long as economic growth is faster than this, it should at least be successful in generating higher inflation. However, given that inflation remains subdued, Japan's output gap may be considerably higher than expected.

Ultimately, Abenomics requires more time, both to allow greater wage growth and to help further raise inflation expectations to target. Therefore, a more credible commitment from the Bank of Japan on maintaining stimulus beyond 2015 would be beneficial.

Finally, structural reforms would help raise productivity growth. While this may not help raise inflation, it would increase potential output, allowing for higher sustained economic growth. More details on structural reforms will be known in June when Abe has said he intends to "move forward on reform with my third arrow". In the end, a decelerating economy may be what finally pushes Abe to unleash the third arrow of Abenomics.

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End Notes

1. CPI less food and energy.
2. Last IMF estimate of general government gross debt for 2014 is 242%. OECD estimate of gross financial liabilities is 232%.
3. Abenomics Preliminary Analysis and Outlook, Joshua K. Hausman and Johannes F. Wieland, http://www.brookings.edu/about/projects/bpea/papers/2014/abenomics-preliminary-analysis-and-outlook
4. The consumption tax was raised on April 1st, however electricity and gas utility rates will be raised only in May. Therefore, it will take an additional month to determine the full impact of the tax hike on inflation.
5. In the Bank of Japan's October 2013 "Outlook for Economic Activity and Prices", it estimated that the impact of both tax hikes will be to raise CPI by 2pp in fiscal 2014 and 0.7pp in fiscal 2015 (+1.3pp in H2 FY 2015).