Launching the third arrow of Abenomics

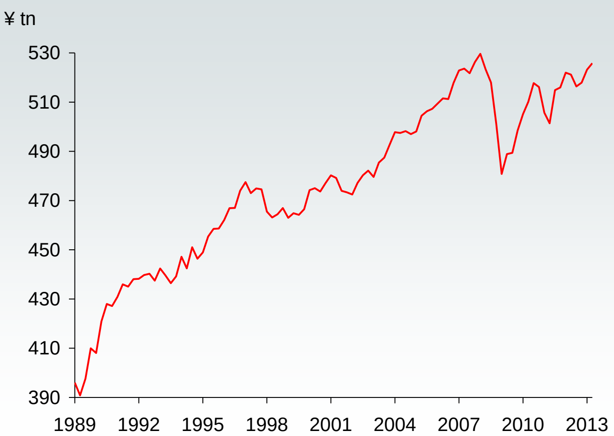
Shinzo Abe was elected Prime Minister of Japan last December on a programme intended to end two decades of deflation and lost growth in Japan. His regime, dubbed 'Abenomics', consists of three arrows: a monetary stimulus, a fiscal stimulus and structural reform. The first two are well under way. The third has yet to be fired. But following his party's victory in July's Upper House election, Mr Abe has all the backing he will need – or ever get – to forcefully launch the third arrow of Abenomics. This scenario alert examines the potential upsides for the Japanese economy if Abenomics succeeds. Although the economy will not return to the 4%+ growth rates seen in the 1980s, it could secure growth in the 2-3% range. This would be a major improvement on its dismal performance of less than 1% average real growth a year since 1993.

The Japanese economy is smaller than it was fifteen years ago

The Japanese economy never convincingly recovered from the bursting of property and stock market bubbles at the end of the 1980s. Although in real terms output is not far from its pre-global-financial crisis high reached in the first quarter of 2008, in nominal terms the economy has flat-lined since the crisis struck. It is still 9% smaller than at the end of 1997, over fifteen years ago, thanks to persistent deflation.

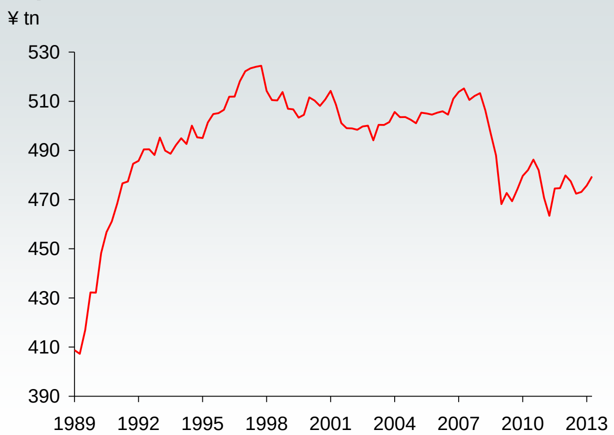
Successive governments have tried to tackle the economy's problems, and failed. Voters have expressed their dissatisfaction, resulting in a doubling of the prime ministerial turnover rate since the late 1980s, compared with the previous 20 years. The election victory of the Liberal Democratic Party's (LDP) Shinzo Abe in December 2012 and the launch of Abenomics marked the start of yet another attempt by Japanese policymakers to improve the economy.

Japanese real GDP



Source : Oxford Economics

Japanese nominal GDP

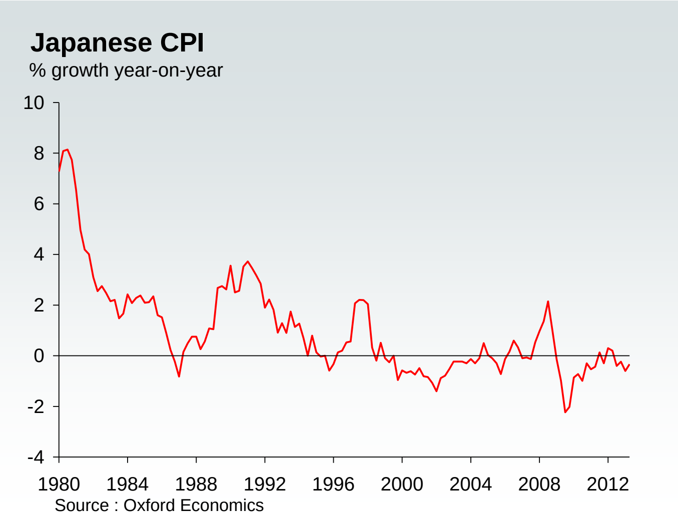


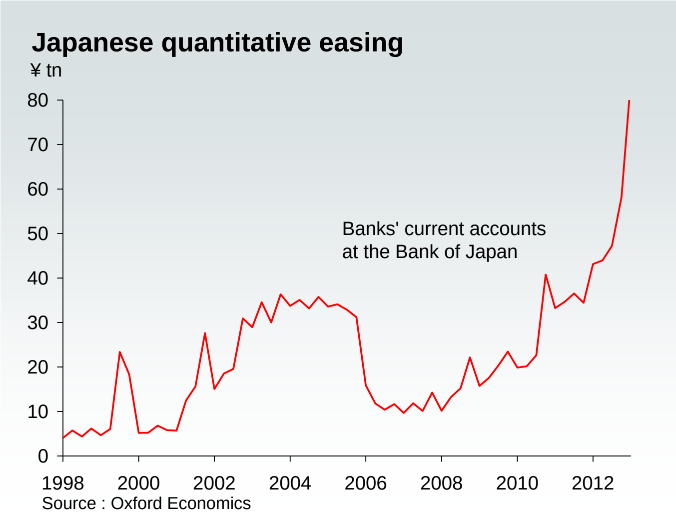
Source : Oxford Economics

The three arrows: monetary, fiscal and structural reform

Abenomics is a three-pronged approach to tackling the poor performance of the Japanese economy by combining monetary expansion, fiscal stimulus, and supply-side reforms aimed at creating 600,000 new jobs over the next two years. It includes a hefty fiscal stimulus package with new spending worth 10.3 trillion yen, much of it focused on infrastructure investment. However, there is a limit to how much fiscal stimulus can be engaged in given that Mr Abe has promised to honour his predecessor's pledge to halve Japan's primary budget deficit – which excludes interest payments – as a percentage of GDP by March 2016.

In addition, the Bank of Japan is committed to doubling the monetary base over two years by buying seven trillion yen of government bonds a month. The intention is to push inflation up to 2%, from its current 0.2%. The government's plans for supply-side reform are not yet as clearly mapped out as the rest of the package, and when Mr Abe announced a rather limited reform package in June financial market were disappointed.





The extent of supply-side reform will determine whether Abenomics succeeds

The LDP's victory in the Upper House elections last month gave the party control of both houses of the Diet for the first time in six years. With no new elections for another three years, Mr Abe now has firm control of the legislative agenda and an opportunity to enlarge his structural reform plans. An expanded package is expected to be announced later this year. It is the effectiveness of these supply-side reforms rather than cheap money that will determine whether Abenomics ultimately succeeds in improving the long-term performance of the Japanese economy.

The revised structural reform plan may include steps to ease the rules against firing workers. This would help the flow of labour from under-performing sectors to more productive ones. Japanese agriculture could be made more competitive by lifting government limits on rice production, or by allowing companies to buy, not just rent, farmland from ageing and often inefficient small farmers. Healthcare is another area ripe for reform. In June the government proposed some easing of the tight regulations on medical treatment, which prevent patients from combining state-covered and private care. But these reforms could go much further. In addition, the insurance sector could be opened up to foreign competition. Foreign insurers' share of Japan's non-life insurance market is estimated to be only 6% compared with 57% in the UK and 26% in France.

With an eye to getting the corporate sector to spend its cash pile, which is equivalent to a whopping 174% of GDP (compared with 120% in the US and 118% in the UK), Mr Abe has asked Japanese companies to raise wages and commit to greater domestic investment. And in an attempt to drive domestic reform he has embraced international economic integration. For example, he has brought Japan into talks on membership of the US-led Trans-Pacific Partnership (TPP). Once finalised, the TPP would provide Japanese businesses with enhanced access to other member countries, including the US, Canada, Mexico, Chile and Australia.

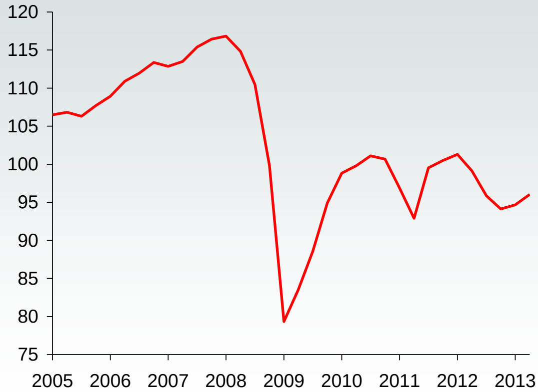
The first two arrows look set to hit their target…

Since the election in December, the trade-weighted exchange rate has fallen by 14% and the Japanese stock market has risen by 40%. Bond yields are little changed: 10-year bond yields, which were 73bp on the day before Mr Abe's election victory, are currently 79bp. The Bank of Japan's bond-buying pledge has stopped Japanese government bond yields from rising in tandem with yields in other major countries since Ben Bernanke, the chairman of the US Federal Reserve, made it clear that the Fed was starting to consider slowing its own asset purchase programme. As a result, 10-year yields JGBs are now 177bp below US Treasury yields compared with 107bp in late May.

Abenomics' impact on the real economy has been almost as marked as its effect on the yen and the equity market. Measures of business confidence have risen sharply. The Shoko-Chukin survey of small and medium-sized business confidence, for example, has picked up rapidly since November and now stands at its highest level for seven years. Consumer confidence has followed a similar pattern, buoyed by rising equity prices and more optimism about employment prospects. Consumers' willingness to spend is up; department store sales have risen 6.4% since December, following a prolonged period of decline. Industrial production, which was in a triple dip, has stabilised, reflecting an 11.6% rise in the volume of goods exports – itself a reflection of the fall in the yen.

Japanese industrial production

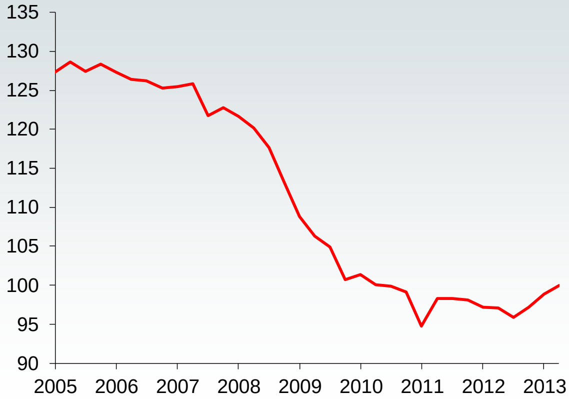
Index 2010=100



Source : Oxford Economics/Haver Analytics

Japanese department store sales

Index 2010 = 100



Source : Oxford Economics/Haver Analytics

… as Abenomics provides a tangible – but short-lived – boost to activity

Under Oxford Economics' baseline forecast the Japanese economy grows by 1.4% in 2013 and then accelerates to 1.7% in 2014 and 2% in 2015. But, because we do not expect Abenomics to materially boost Japan's potential growth rate, we then expect growth to fall back to average 0.8% over the following five years. Japan's potential GDP growth is low by international standards due to comparatively slow growth in its capital stock and a falling working age population. In other words, Abenomics provides a tangible, but short-lived, boost to activity.

Inflation rises above the 2% inflation target for a year from the second quarter of 2014 before dropping back to 1.3% in 2016 and 0.7% in 2017. However, that is primarily due to the weaker yen and to the implementation of plans to increase the sales tax from its current 5% to 8% in April 2014, and then again to 10% by October 2015, rather than to a sustained rise in inflation pressure.

The third arrow could boost productivity and labour market participation

The key to the long-term success of Abenomics is whether the supply-side measures of the third 'arrow' increase potential GDP. We have used the Oxford Economics' Global Economic Model to generate an upside scenario for the Japanese economy in which structural reform boosts Japan's potential growth rate.

This upside scenario assumes productivity growth and rising investment

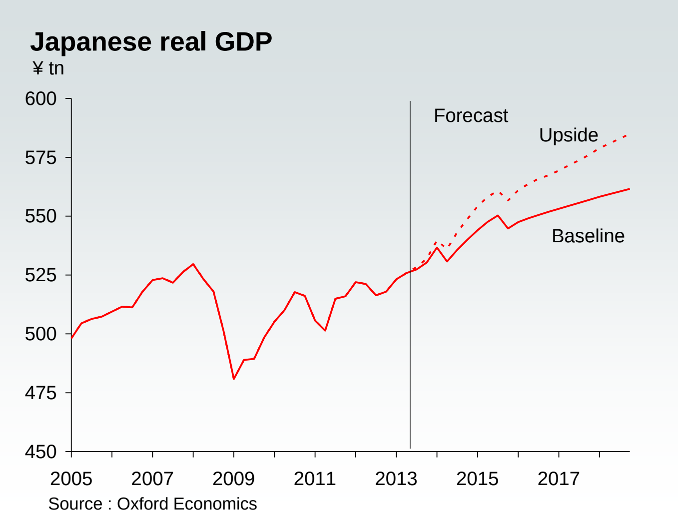
There are several important assumptions underlying our upside scenario.

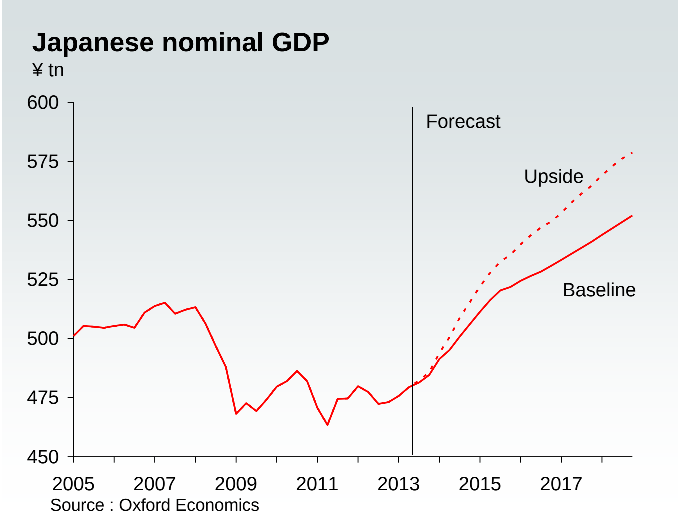
- Total factor productivity growth increases to average 2.1% between 2013 and 2018, rather than the 1.7% assumed under our baseline forecast.
- The labour market participation rate rises from 82.5% at the end of 2012 to 86.2% at the end of 2018, two percentage points higher than under the baseline forecast. This rise is assumed to be driven by an increase in female labour market participation, which at 69% is much lower than the male participation rate of 94%. While this is not enough to prevent a fall in the Japanese labour supply (due to a 5.7% decline in the working age population) it does reduce the size of the fall from 3.9% to 1.4% between the end of 2012 and the end of 2018.
- Corporate confidence and expected return on equity both increase, encouraging Japanese companies to invest more of their cash pile. Consequently, the growth rate of fixed investment increases such that investment as a proportion of nominal GDP rises from 21% in 2012 to 23% in 2018. As a result, the Japanese capital stock is 1.2% larger than assumed under our baseline forecast by the end of 2018.
- Thanks to the stronger economy, household earnings rise by a cumulative 10% between the end of 2013 and the end of 2016.
- The two planned increases in the sales tax are postponed, in each case by a year.
- There is a further 10% depreciation of the yen over next 12 months.
- It is assumed that Japan joins the TPP and that its introduction causes world trade to grow on average by 7.6% each year between 2014 and 2018, 0.5 percentage points faster than under our baseline forecast.
- It is assumed, as in the baseline forecast, that the Bank of Japan does not start to increase interest rates until the first quarter of 2015 and that the policy rate rises from its current 0% to 1.0% at the end of 2016 and then 1.7% at the end of 2017.

Supply-side reform would enable the Japanese economy to put deflation behind it at last

GDP growth rises more strongly than under our baseline forecast due to the combined impact of faster fixed investment growth (included as part of the scenario), stronger consumer spending and exports. The increase is from 1.5% in 2013 to 2.7% in 2014 and 3.2% in 2015, compared with our baseline forecast of 1.7% next year and 2% in 2014. By the end of 2016 the level of GDP is 3.4% higher than our baseline. Although GDP growth then slows as the temporary boost from monetary and fiscal policy fades, growth still averages 1.4% between 2015 and 2018. This is 0.6 percentage points higher than the baseline, reflecting the boost to the potential growth rate from supply-side reforms.

The combination of faster total factor productivity growth, a larger rise in the capital stock and a smaller fall in the labour supply raises the productive potential of the Japanese economy. Potential output growth averages 1.5% between 2013 and 2018 compared with 0.9% under our baseline forecast.

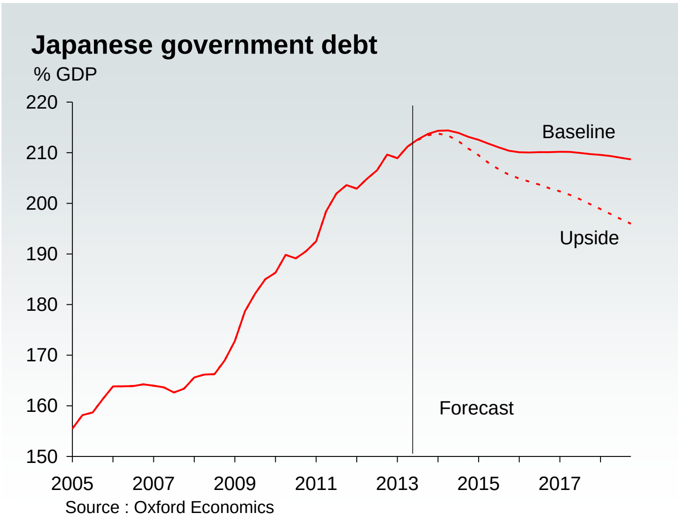




The level of employment is 2% higher at the end of 2015 than under our baseline forecast – an additional 1.255 million people working. This boosts household incomes and drives higher consumer spending growth of 1.7% in 2014 and 2.3% in 2015 compared with 1.2% and then 1.5% under our baseline.

The level of exports is 3.8% higher by end of 2015 than under our baseline. This is mainly due to the completion of the Trans-Pacific Partnership negotiations. Although global output growth is likely to remain sluggish over the next few years (with some bright spots, notably in the United States), the combination of a weaker yen and the removal of further trade barriers within the most dynamic area of the world economy should significantly boost Japanese exports. This is the more likely as South Korea, one of Japan's main competitors, has declined to be part of the TPP. (This boost is therefore partly conditional on a rapid conclusion of the TPP talks; but the current aim is to have them wrapped up by the end of 2013.)

Inflation averages 1.8% between 2014 and 2018. This is 0.4 percentage points higher than under our baseline scenario as the additional currency depreciation pushes up import prices. At the same time the stronger labour market boosts domestically-generated inflation. The stronger economy generates higher tax revenues, the government deficit is therefore smaller both in absolute terms and as a proportion of GDP. The government deficit falls from 10% of GDP at end of 2012 to 1%, rather than to 2.9% under our baseline. This reduces the debt to GDP ratio from 210% at the end of 2012 to 196% at the end of 2018. By comparison in the baseline scenario the ratio is virtually unchanged.



The Japanese equity market would end 2018 24% above its current level in this scenario, 4% higher than the baseline forecast. Ten-year bond yields rise from 0.79% now to 2.5% by the end of 2018, but that is around 20bp lower than assumed under the baseline due to the improvement in the public finances.

Japan: Baseline and upside scenario forecasts								
	GDP real (% year)		GDP nominal (% year)		Government debt as % GDP		CPI (% year)	
	Baseline	Upside	Baseline	Upside	Baseline	Upside	Baseline	Upside
2012	1.9	1.9	1.0	1.0	193	193	0.0	0.0
2013	1.4	1.5	1.0	1.1	194	193	0.0	0.2
2014	1.7	2.8	3.8	5.0	197	194	2.0	1.7
2015	2.0	2.9	3.8	4.9	200	196	1.6	2.7
2016	0.6	1.3	2.0	2.9	201	195	1.3	1.8
2017	1.0	1.5	1.8	2.6	202	194	0.7	1.8
2018	0.9	1.6	2.0	2.7	204	192	1.1	1.0

Source: Oxford Economics

Rewards for the right policy are potentially high

This analysis indicates that there is substantial potential upside to Japanese developments. However, they depend on a number of factors, not all of which are within the Japanese government's power to change. But there are some things the government can do. One is to postpone the planned sales tax hike. Japan has been there before, when the sales tax was raised in 1997 – immediately aborting a nascent recovery. Reports that the government may be considering how it can use additional sales tax receipts are therefore worrying. A second, more important measure is to ensure the labour market and trade-related reforms are actually implemented. Perhaps most importantly – and this is connected to the structural reforms – the enormous financial surplus of the Japanese corporate sector (currently estimated at 7-8% of GDP) needs to be freed up, whether in the form of higher investment or higher dividends, in order to stimulate domestic consumption.

Japan will not return to the 4%+ growth rates seen in the 1980s. But growing in the 2-3% range would be a major improvement from its dismal performance of less than 1% average real growth a year since 1993.

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