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# Economic Watch

## Japan

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Economic Analysis

Asia

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# Will Japan succeed in its bold push for growth?

## Summary:


- **"Abenomics" seeks to end deflation and revive the economy**
  Prime Minister Shinzo Abe was elected in December 2012 on promises to end more than a decade of deflation and economic stagnation. With his team of economic advisors, he designed a three-pronged strategy of aggressive monetary easing, fiscal stimulus (with medium-term consolidation), and structural reforms. The strategy is bold in scope, and reflects a refreshing departure from the policy stalemate of previous governments.

- **Though controversial, the strategy has gained increasing acceptance…**
  Two elements in particular drew early criticism from the private sector and international financial community. First, monetary easing on the scale announced by the Bank of Japan in April – a doubling of the monetary base over two years – was viewed as a potentially destabilizing and "beggar-thy-neighbor" policy, the latter for its impact in depreciating the currency. Second, fiscal stimulus was viewed as irresponsible given the substantial public debt burden (240% of GDP in 2013). Over time, however, the strategy has gained increasing acceptance given the urgency of reviving growth and the need for bold measures. Moreover, at its core the strategy entails rather traditional measures.

- **…and appears to be working so far**
  While there remains well-founded scepticism about whether the strategy can work on a sustained basis, especially given the difficulties Japan has had in the past with failed stimulus efforts, so far it appears to have worked to lift business and consumer confidence, restore growth momentum, and raise inflation expectations. Though high frequency indicators are mixed and investment has yet to revive convincingly, growth has accelerated to 4.1% and 3.8% (annualized) in the first two quarters of the year, respectively, from 2.0% in 2012, and inflation has turned positive.

- **Upward near-term revisions, with caution on the medium term**
  If accompanied by significant structural reforms, we believe that Abenomics can achieve its objectives, as seen in the pickup in growth momentum and improving consumer and business confidence to date. Accordingly, we have marked up our near-term growth and inflation projections for 2013-14. For the medium term, however, we maintain our previous projections, pending evidence of more convincing structural reforms.

- **Important challenges and risks remain**
  Of crucial importance is the structural reform agenda, which has not yet been fully articulated, and without which fiscal and monetary policies alone will likely fail. Labor market reforms and deregulation are needed to unlock longer term growth, and steps to ensure medium-term fiscal sustainability, including implementation of a planned consumption tax hike in 2014-15, are urgently needed. Without these, investors could lose confidence in the ability of the government to service its debts, and sooner or later Japan could find itself in a debt crisis and downward economic spiral.

# Abenomics and its three arrows

- "Abenomics" is the term popularly used to describe the strategy of Prime Minister Shinzo Abe, who was elected on December 26, 2012, to end 15 years of deflation and revive Japan's sluggish economy. The strategy involves three "arrows": monetary easing, fiscal stimulus (with medium-term consolidation), and structural reforms. The strategy is bold in terms of both its scope and content. Specifically:

    - First arrow: aggressive monetary easing. Last April, under the leadership of its new Governor, Haruhiko Kuroda who was installed in March, the Bank of Japan surprised markets with the announcement of an unexpectedly large increase in its asset purchase program, accompanied by the establishment of a formal 2% inflation target over the medium term (the latter had been expected). The BoJ aims to double the monetary base by end-2014 (Chart 1) through monthly purchases of long-term government bonds and other securities with an average maturity of three to seven years at an annual pace equivalent to 12% of GDP (compared to the US Fed's easing of 6½% of GDP). Monthly purchases would amount to USD 600-700 billion per year (around 2/3 of the absolute scale of purchases of the Fed), resulting in an increase in the BoJ's holdings of total JGBs to 20% by the end of 2014.

    - Second arrow: On the fiscal side, last January the government launched a ¥10.3tn stimulus package (2.2% of 2012 GDP) with a focus on public works, estimated by the government to add 2 percentage points to growth during 2013-14 and create 600 thousand jobs.

    - Third arrow: On the structural reform front, a set of measures was approved by the cabinet in June. The overall strategy aims to boost private investment and international trade (through participation in the Trans-Pacific Economic Partnership), and contains some reforms in the health care and energy sectors. However, the measures announced so far have generally failed to impress markets, who have been anticipating a bolder set of reforms, including much-needed steps toward medium-term fiscal sustainability, deregulation in the agricultural and services sectors, and enhancements to labor market flexibility.

The elements described above, in our view, reflect an important departure from the policy stalemate that existed in previous governments. In particular, the Bank of Japan's willingness to engage in aggressive monetary easing is a significant policy shift. It has paved the way for the government, who can no longer blame the BoJ's inaction for deflation, to move ahead on politically difficult structural reforms. Further, the victory of Abe's governing coalition in upper house elections in July has raised hopes that further reform measures will be adopted in due course. The election results, moreover, give the coalition control of both houses of parliament and provide much-needed political stability, which has been lacking for the past six years.

# How has Abenomics fared so far? So far so good.

- There remains skepticism in many quarters about whether the strategy will work to revive growth on a sustained basis, especially given the difficulties Japan has had in the past with failed stimulus measures. Of crucial importance is the structural reform agenda, without which fiscal and monetary policies alone will likely fail. Moreover, given the substantial public debt burden of over 200% of GDP (Chart 2) and the pressing need for medium-term consolidation, fiscal stimulus measures and the BoJ's aggressive monetary easing entail risks.

- Despite these risks, and the absence of convincing reform plans (third arrow), so far the strategy has been working to lift business and consumer confidence, restore growth momentum, and raise inflation expectations.

- After rising to 4.1% saar in Q1, underpinned by private spending and exports, Q2 growth momentum was sustained at 3.8% (the latter was revised up from a disappointing preliminary outturn of 2.6% saar in the second quarter) (Chart 3). Although private consumption weakened a little in Q2, non-residential investment, which had been the missing ingredient so far in the economic pickup, accelerated noticeably. Recent high frequency indicators for exports, industrial production, and retail sales have also generally been moving in the right direction (Chart 4).

- In the clearest sign of an improvement in market sentiment, the stock market surged by 80% in the six months following Abe's election victory in November 2012, although since May it has corrected by around 15%. Meanwhile, the yen – which has traditionally appreciated on risk aversion -- depreciated by 30% against the USD through May, before stabilizing at around 100 per USD (Chart 5).

- Inflation expectations have picked up (as measured by inflation indexed bonds), and headline inflation turned positive in June and July (0.7% y/y), ending a prolonged period of deflation (Chart 6). Nevertheless, there is still a long way to go to achieve the official 2% inflation target in the next two years.

- The BoJ's aggressive liquidity injection and purchase of government bonds can be expected to generate capital outflows as domestic investors, who currently hold 90% of the stock of JGBs, sell their positions and look overseas for higher returns. However, data through August do not reveal a strong trend in outflows (Chart 7). There have been periods of bond sales, but these have been offset by equity inflows.

- Financial market instability has been a concern, especially when long-term government bond yields rose by 40 bps in a short time span in mid-May to 0.8%, apparently due to the rise in inflation expectations and rise in US Treasury yields. Since then, however, yields have fallen back and have been remarkably stable, even as 10-year US treasury yields have continued to surge (Chart 8). Nevertheless, prospects of rising bond yields have generated concern among some investors that the strategy underlying Abenomics could backfire if rising inflation expectations cause bond yields to rise, and put downward pressure on bank capital and add to the government's debt servicing costs.

Table 1
**Baseline economic outlook (% growth unless otherwise indicated)**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013F | 2014F |
|---|---|---|---|---|---|---|---|
| Real GDP | -1.1 | -5.5 | 4.7 | -0.6 | 2.0 | 1.9 | 1.6 |
| Private consumption | -0.9 | -0.7 | 2.8 | 0.5 | 2.4 | 2.0 | 1.1 |
| Public consumption | -0.2 | 2.3 | 1.9 | 1.4 | 2.4 | 1.6 | 2.4 |
| Investment | -3.3 | -17.0 | 4.4 | -1.2 | 4.8 | 1.1 | 0.9 |
| Inflation (YoY%, avg) | 1.4 | -1.3 | -0.7 | -0.3 | 0.0 | 0.0 | 0.7* |
| Foreign exchange rate (JPY/USD, eop) | 90.3 | 92.1 | 81.5 | 77.7 | 86.6 | 108.0 | 118.0 |
| Policy rate (%, eop) | 0.10 | 0.09 | 0.08 | 0.08 | 0.08 | 0.10 | 0.10 |
| Fiscal balance (% of GDP) | -4.2 | -10.3 | -9.5 | -10.0 | -9.5 | -10.0 | -8.0 |
| Current account (% of GDP) | 3.2 | 2.8 | 3.6 | 2.3 | 1.7 | 1.2 | 1.5 |

* Excludes the impact of the proposed consumption tax hike, which would add 1.5-2.0 ppts to headline inflation in 2014.
Source: Haver Analytics and BBVA Research

# Important challenges and risks lie ahead

- We remain optimistic that, if accompanied by structural reforms, Abenomics can achieve its objectives. Given the results so far, we have revised our growth and inflation projections cautiously upward for 2013-14 (see Table above). Further upward revisions to the near-term outlook would require evidence of rising wage rates, needed to generate inflation and boost consumer spending. For the medium term, however, pending evidence of more convincing structural reforms, we are inclined to maintain our medium-term growth projection as previously estimated at 1.0-1.5% per year, in line with potential growth.

- Key to the outlook are the following policy priorities and risks:

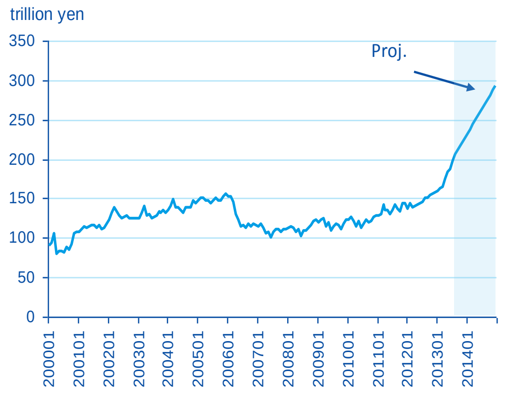
  - Medium term fiscal consolidation is needed to contain the explosive rise in public debt. An important element of the strategy is the planned hike in the consumption tax, from 5% to 8% in 2014, and further to 10% in 2015. The Parliament approved the hike last year under the previous government, with the caveat that the hikes should proceed as long as they do not unduly threaten GDP growth. The current government has been evaluating the strength of the recovery, with a final decision on the tax hike expected in early October. For the time being, it appears likely that the hike will proceed as scheduled, given the strong Q2 GDP outturn and the recommendations of a government advisory panel that concluded in recent weeks. The authorities have scope for policy manoeuvre, including accompanying the tax hike with additional short-term fiscal stimulus measures (spending and/or temporary investment incentives) and further BoJ monetary easing. Beyond the hike in the consumption tax, further fiscal reforms will be needed, including a broadening of the tax base and cuts in social security and health care spending.

  - Strucutral reforms need to be deepened to boost Japan's growth potential (the government aims to bring medium-term growth to 2% versus current estimates of potential growth in the range of 1.0%-1.5%). Given declining population and low labor participation rates, especially among women, it will be difficult to revive growth on an enduring basis without deeper reforms than currently envisaged.

  - Financial market volatility, though having eased for the time being, remains a threat to the government's strategy. In particular, if investors become unnerved and as QE tapering by the Fed proceeds, there could be a selloff of Japanese bonds, which could cause yields to soar, in turn undermining bank balance sheets and curtailing their capacity to step up lending and support growth.

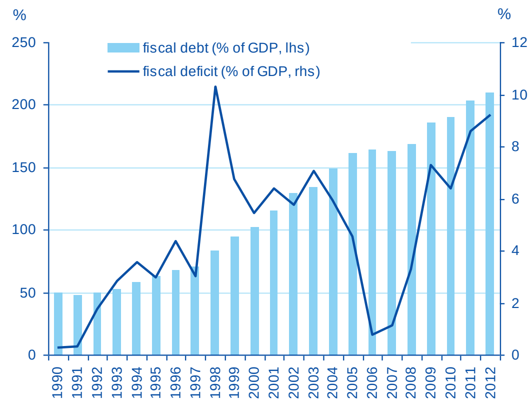
- A stronger breakthrough in structural reforms and progress in addressing medium-term fiscal consolidation could yield growth above our baseline and closer to the government's real growth target of 2%. On the other hand, the strategy entails significant risks if policy implementation lags. In particular, if growth fails to materialize investors may lose confidence in the government's ability to service its large debt burden. In such a scenario, bond yields could rise, adding further pressure on the public finances and headwinds to growth. Japan would find itself in a debt crisis and a downward economic spiral.

Chart 1
## The BoJ aims to double the monetary base within two years



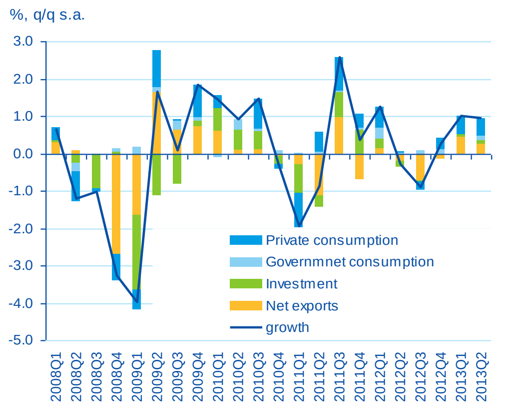

Source: Haver Analytics and BBVA Research

Chart 2
## However, the large public debt burden remains a source of risk



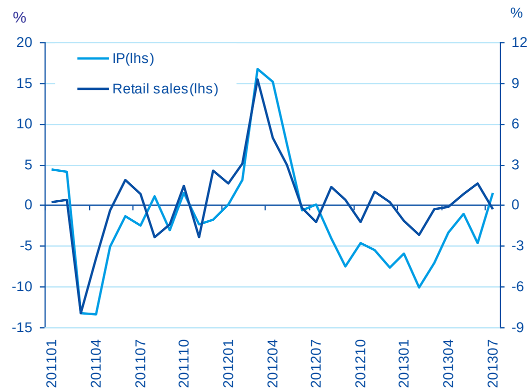

Source: Haver Analytics and BBVA Research

Chart 3
## GDP growth has picked up on fiscal and monetary stimulus…



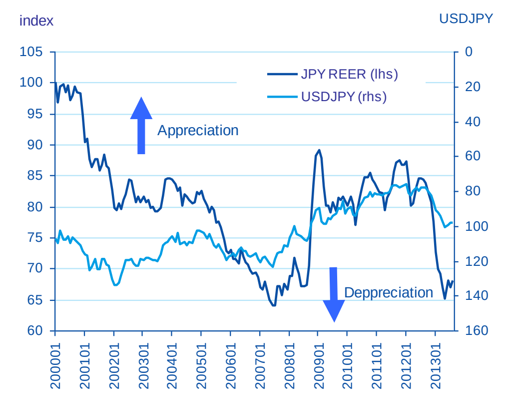

Source: Haver Analytics and BBVA Research

Chart 4
## Economic activity is gradually improving



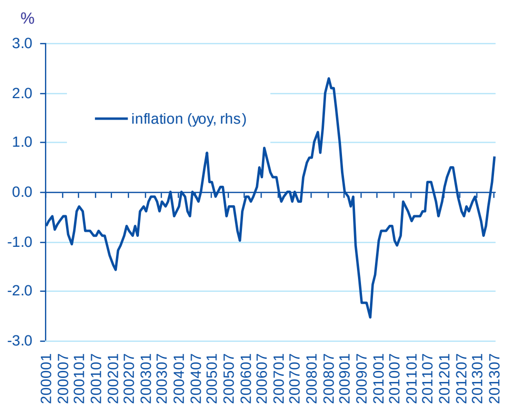

Source: Haver Analytics and BBVA Research

Chart 5
## The yen has depreciated from the BoJ's aggressive monetary easing



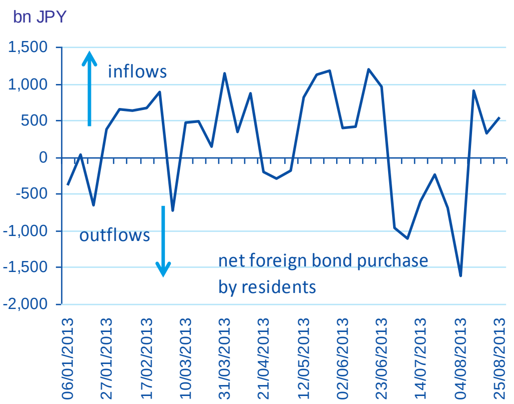

Source: Haver Analytics and BBVA Research

Chart 6
## … with tentative signs that deflation is coming to an end



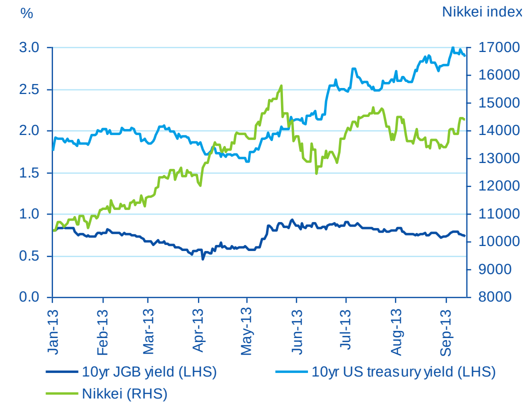

Source: Haver Analytics and BBVA Research

Chart 7
**There is not strong evidence yet of capital outflows**




Source: CEIC and BBVA Research

Chart 8
**JGB yields have eased despite the rise in US yields, and the stock market remains buoyant**




Source: Bloomberg and BBVA Research

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