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Abenomics after Four Years:

Formidable Challenges ahead with Limited Policy Tools

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Abenomics after Four Years: Formidable Challenges ahead with Limited Policy Tools

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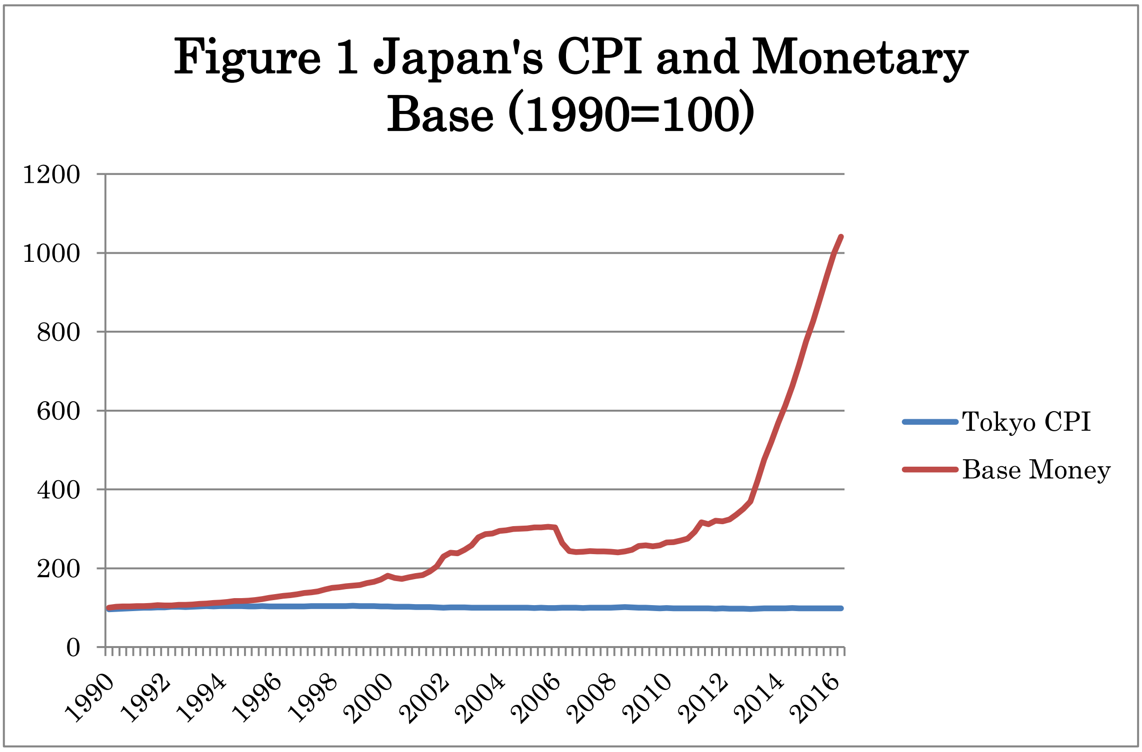
Abstract

Japan's ruling coalition recently won the upper house election and Prime Minister Shinzo Abe has declared that he would accelerate the government's attempt to revitalize the economy, especially its fight against deflationary forces in the economy. To this end, the government has decided to provide a fiscal stimulus that is expected to exceed 28 trillion yen. The Bank of Japan (BOJ) has joined in the effort by its decision to ease monetary policy further on July 29, 2016. The joint monetary-fiscal stimulus has come after almost four years of policy stimuli to raise inflation and economic growth. I discuss the backgrounds for the failure of Abenomics to achieve its goals so far and limitations the government/the BOJ face in their attempts to stimulate the economy further.

Japan’s ruling coalition recently won the upper house election and Prime Minister Shinzo Abe has declared that he would accelerate the government’s attempt to revitalize the economy, especially its fight against deflationary forces in the economy. To this end, the government has decided to provide a fiscal stimulus that is expected to exceed 28 trillion yen. The Bank of Japan (BOJ) has joined in the effort by its decision to ease monetary policy further on July 29, 2016. Let us evaluate such policy moves from both short- and long-term perspectives.

1, Failure to stimulate the economy

The joint fiscal-monetary stimulus, which some have dubbed as a “helicopter money”, however, has come after three and a half years of policy stimulus under the guise of Abenomics. It is almost an acknowledgement that policy stimuli so far have failed to work as expected.



Relative to the 2% inflation target, the actual CPI inflation rate (excluding energy and foods) is running at 0.4% as of June 2016. This is despite an almost tripling of the monetary base during the last three years. Figure 1 presents the two variables over a longer period—since 1990. There appears to be zero correlation between the two variables, in clear rejection of the quantity theory of money. In a zero interest rate environment, base money expansion per se does not seem to achieve much.

The growth rate of real GDP has averaged at a meagre 0.7% over the 2013-15 period. Worse still, there is no sign that the supply side of the economy has been stimulated; labor productivity growth remains stagnant—an indication that growth policies (the Third Arrow) of Abenomics has so far failed to bear significant fruits.

To be sure, initial attempts at monetary reflation met with some success. Beginning in the last few months of 2012, the yen started to weaken significantly, exerting positive effects on Nikkei as investors anticipated prospective muscular monetary stimulus measures. The same type of response was observed back in 2001 when the BOJ started its first round attempt at quantitative easing. But the market response was much larger this time around. The market responded further to the second round of the BOJ easing carried out in late 2014.

Yet, the economy, inflation and output growth, has not been as strong as the initial movements in the yen and Nikkei had suggested. Why is this?

2, Absence of growth/inflation expectations

It appears that Abenomics has failed to stimulate inflation/growth expectations among the public at least so far. Inflation expectations rose somewhat during the initial months of Abenomics, but have been falling since. For example, the BOJ's Tankan asks the respondents of their inflation expectations. In the latest survey they stood at 0.2% at the one year horizon and at 0.8% at the three year horizon. Household inflation expectations as captured in another survey by the BOJ are also subdued. The BOJ's easing has attempted to work through the economy by raising inflation expectations. But it has not succeeded. After a long period of zero to negative inflation, inflation expectations are stuck at around zero. It appears that the public needs to be exposed to a sustained period of rising inflation before changing their inflation expectations.

The same is true of firms' growth expectations. The cabinet office carries out a survey of corporates including a question on expected growth rates of the economy. The expected average growth rate in the next five years was 1.2% in 2012, went up a bit to 1.5% in 2013, but was back at 1.1% in 2015.

Thus, the rise in asset prices has been propelled by lower interest rates and reductions in risk/term/liquidity premiums. However, the absence of inflation/growth expectations has prevented the real side of the economy from responding significantly to asset price changes. The contrast between the nominal variables and the real variables in Japan is stark.

3, Struggling to offset demography trends

Without doubt demography has been a major determinant of growth expectations. Japan's population has started to fall and the pace of the decline is expected to accelerate beyond 2025. As a result, the labor market has been very tight despite lackluster growth rates in output. Hence, the government has been keen on, and successful to some extent in, raising the participation rate of the female and the old—one of the key targets of the third arrow. But many feel that rising participation rates per se are not sufficient to offset the decline in the population.

Given the society's reluctance to accept large-scale immigration, the average Japanese will have to work more efficiently to raise output. The rigidity of the labor market, however, has been a major obstacle to this end. Attempts at reforming corporate governance, such as the adoption of the stewardship code and the heavier reliance on external directors, would not be very effective unless reshuffling of workers within a firm and across firms can be done flexibly.

To be fair, the Japanese labor market has become more flexible over the last two decades with the expansion of the so-called non-regular workers. Their share is now close to 40% of the market. Their wages are more flexible and they can be laid off more easily than the rest of the workers. This is one of the reasons why Japan has not seen any major increases in the unemployment rate despite two decades of stagnation in the economy. The workers in the core part of the labor market, however, have still enjoyed traditional life-time employment and remained the source of the rigidity in the market.

Japan's income distribution has evolved in a distinct pattern. Unlike in the U.S. or the U.K., workers at the top end of the distribution have not enjoyed a rising share in total incomes of the economy. Rather, the lower end of the distribution has become significantly fatter; more and more workers earning less than the average wage in the economy.

In the U.S. rapid innovations, especially in IT related areas, have produced an M-shaped distribution of income whereby winners enjoy higher wages and those replaced by the

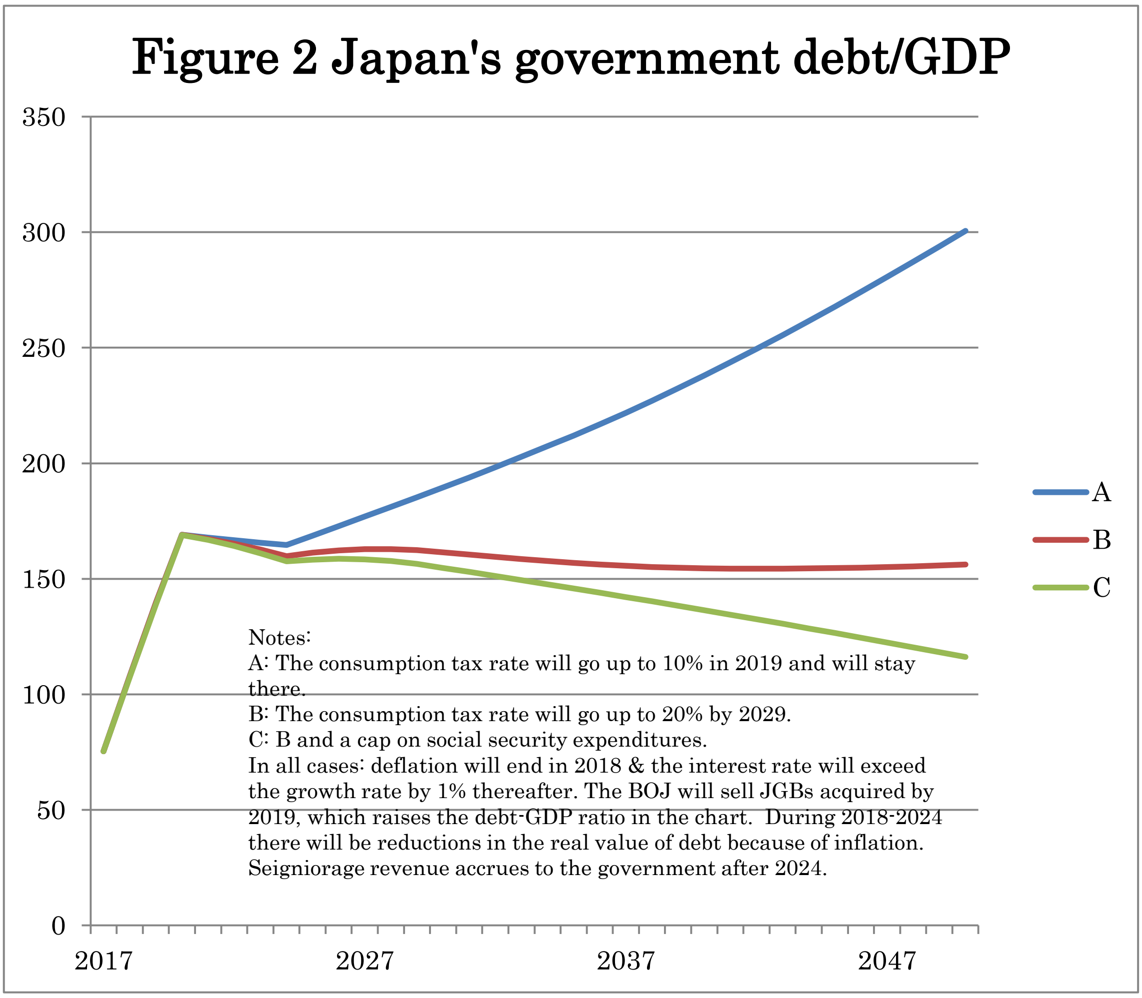
IT technology suffer from much lower wages. Income distribution implications aside, however, the workers earning top incomes have played increasingly pivotal roles in generating new technologies. In contrast, these high wage earners, if not absent, are not increasing in numbers or are not receiving higher wages in Japan. The pattern of Japan's income distribution suggests that the labor market rigidity and/or some other factors have prevented talented workers from becoming leaders in technological development, while the stagnation of the economy and the inevitable adoption of new technologies, if at a slower pace than in the U.S., have lowered the wages of a significant number of workers in the non-core part of the market.

Such an analysis paints a rather pessimistic picture concerning the likelihood of rapid productivity improvements in the Japanese economy. The economy has been built on cooperation/trust among core workers. Technology, however, has recently shifted to heavier reliance on a small number of talented individuals. Japan's labor market and other infrastructure of the economy including education are not best fit to such an environment. It is easy to repeat the mantra of "Japan needs reforms." It is more important, however, to come up with specific plans to develop young talents, scrap and re-build the core part of the labor market so that the talents are effectively used and the coexistence of core and non-core workers become possible in a socially non-destructive manner. The Abe government does seem to realize these points, but its emphasis has been to mitigate the pain of the non-core workers and has not addressed the inefficiency of the core part of the labor market.

4, Continued deterioration in the fiscal situation

The absence of a solid growth prospect and the mountain of existing government debt combined, result in a fairly gloomy outlook for fiscal sustainability. Many simulations indicate that in order for, say, the government debt-GDP ratio to level off and decline significantly the country needs to increase taxes substantially and contain social security spending, especially, public pensions and medical expenses. And, these will have to be done without lowering economic growth. In terms of consumption tax, the tax rate will have to rise at least to a 20-25% range from the current level of 8%.

Figure 2 shows an example of such a simulation of the debt-GDP dynamic. The government debt is net of financial assets held by the government and the JGB held by the BOJ. It assumes, just for the sake of calculation, that a 2% inflation will be achieved fairly soon, by 2018. The rise in inflation allows moderate declines in the real value of government debt for a while. The consumption tax rate is assumed to rise to 10% in 2019. The simulations also assume that the interest rate will rise to levels one percentage point higher than the nominal growth rate after the achievement of the inflation target. Some more specific assumptions are made about the time path of social security expenditures.



The figure reveals that, if the consumption tax rate is kept at 10% beyond 2020, the debt-GDP ratio will explode. With a rise in the consumption tax rate to 20%, the debt-GDP ratio will cease to explode during the period of the simulation, but will not go down significantly. In addition to the 20% consumption tax rate, we will need to contain social security expenditures so that they will not grow more rapidly than GDP, if we want to lower the ratio significantly.[1]

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1 The Cabinet office has recently put out a rosier fiscal outlook. But it assumes a very slow rise in the interest rate despite the assumption of the achievement of 2% inflation

At the moment, no politician seems to be willing to spend his/her political capital to start the discussion on raising taxes or cutting social security expenditures substantially. Low to negative interest rates on government bonds, which are largely a result of the BOJ's monetary policy, are also allowing politicians and policymakers to sit idle. Japan's fiscal situation is deteriorating by the day.

5, Policy options in the short run

The room for short-run stimulus is extremely limited on both monetary and fiscal policy fronts. The problem is perhaps more serious for monetary policy. There is just not too many options left to deploy.

The BOJ now holds more than one third of the outstanding government debt. The ratio will approach 50% by the end of 2017. Signs of stress are already apparent. In early July interest rates were below zero up to the 20 year horizon. There is not much trading of JGBs between private agents. Those who still buy do so mostly for the purpose of reselling them to the BOJ. Many expect that the BOJ will soon have to slow down the pace of JGB purchases. That will most likely mean abandoning the intermediate target on base money.

Reflecting such a difficulty with quantitative easing, the BOJ decided to lower the interest rate on bank reserves to negative territory back in January 2016. This decision, however, has been vastly unpopular among the public, especially financial institutions. Deposit holders have been alarmed by the prospect of deposit rates going into negative territory. Politicians have shown sympathy with such a concern. Thus, it appears that negative deposit rates are not a near-term possibility. As JGB rates and some money market rates falling to negative levels, bank lending rates have come down significantly, especially with tough competition among banks. So have net interest margins, given the zero lower bound on deposit rates. The margins are now around 100 basis points. Japanese megabanks' 2016Q2 profits have reportedly declined by 30% over last year. Banks' traditional business, taking deposits and lending them out, is becoming increasingly unprofitable. This is in sharp contrast to Europe where margins are still much wider. The lower bound on the BOJ's interest rate on bank reserve seems to be much shallower than in Europe.

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by 2018. Also, their simulation is limited to 2024.

The zero lower bound has been important for investors at large as well. Many, including banks, have chased positive yields across the globe with perhaps less than adequate attention to the risks involved; thus, they have turned to JGB duration risks and then interest rate risks of foreign bonds, but with currency risks hedged. The huge foreign currency hedging needs have raised hedging costs significantly and are exposing Japanese financial institutions to a serious foreign currency funding risk. Such behaviors have produced only minor benefits to the Japanese economy.

Helicopter money?

Given the technical limits of quantitative easing and NIRP as discussed above, popular discussions of Japan's monetary policy have shifted to the possible use of "helicopter money." What is meant by this varies from person to person. Traditionally, it has meant huge fiscal expansion supported by monetary policy. The monetary policy support can take the form of underwriting government budget deficits by the central bank, or using monetary operations to keep government bond yields at low levels. The former is illegal in Japan, while the latter has been more than adequately done by the BOJ. The obvious conclusion seems to be that helicopter money in Japan means fiscal expansion for a sustained period. In fact, fiscal policy has been slightly more tight than neutral during the Abenomics period.

History tells us that with unlimited fiscal expansion and monetary policy support, hyperinflation will eventually ensue. Some current proposals under the guise of helicopter money involve measures to deprive the BOJ of its ability to tighten monetary policy. An example is the swapping of JGBs held by the BOJ for zero coupon perpetuities. If done on a small scale, this will not achieve anything. One has to remember that central bank revenues including interest payments on government debt it holds, is rebated to the government. Thus, the level of the interest rate on JGBs the BOJ holds is immaterial for government budget, be it positive or zero.

Being perpetual also is not important. The BOJ can always "issue quasi government paper" by paying interest on bank reserves, which is a close substitute for "selling perpetuities" the BOJ holds. Things change if the swap is done on a large scale and if the BOJ attempts to tighten policy by raising the interest rate on bank reserves. Given that the BOJ is not receiving much interest income on its assets and that it is paying interest to private banks, the bank will run deficits and soon become insolvent. The assumption here is that the government will not come to the rescue. Beyond a certain point the BOJ will have to stop tightening monetary policy.

Thus, if done on a large scale, this swap will make it difficult for the BOJ to tighten policy when necessary. If accompanied with a sustained period of large fiscal stimulus, the swap will likely lead to runaway inflation, at some point. It effectively destroys the very foundation of central banking and is not a recommended option.

Would a milder version of helicopter money be deployable and bring benefits to the economy? The basic contradiction here is the need for a short-run stimulus and long-run consolidation. As we argued with Figure 2, the benefit to the fiscal authority of 2% inflation is non-negligible but unlikely to be as large as to meaningfully change the outlook for fiscal sustainability. To provide more details, with the average duration of JGBs of 7-8 years, an unanticipated 2% increase in inflation will lower the real value of government debt by about 15%. But if the BOJ owns 50% of JGBs, the net benefit would be half as large. On the other hand, the amount of short-run fiscal stimulus required to generate 2% inflation could be intolerably large.

The recent package: fiscal policy teams up with monetary policy

Given all these discussions, we may be in a position to evaluate the recent "joint easing" by fiscal and monetary authorities. Its main feature is that fiscal policy will join monetary policy to provide stimulus to the economy at least for a while. It appears, however, that by itself it will not be enough to raise inflation to 2% in the near term. Revitalizing the economy substantially is even harder to achieve.

The fiscal package looks very large, at more than 5% of GDP. The immediate addition to aggregate demand by the government sector, however, will be perhaps around two tenth of the face value because only a small portion will go into the supplementary budget. A significant portion is expected to be included in the 2017 initial budget; but it is difficult to precisely gauge the size of the stimulus in this respect given the absence of the budget without the stimulus. The remainder of the package consists of increases in lending limits by public financial institutions, expected increases in private firms' expenditures as a result of government subsidies and bringing forward future public investments. Just how much of these will actually end up in increased demand for goods and services in the near term is very uncertain. Apparently, the dire fiscal situation has limited the true size of the package.

The fiscal package is also somewhat disappointing in that many of its components will not serve much to bring about the desired transformation of the economy as discussed above. There are outright transfers to the poor, various measures to help non-regular workers in the economy and old-fashioned public investment type expenditures which are really transfers.

On the monetary policy front, the BOJ has announced to raise the purchases of equity linked ETFs and expand the scheme to help Japanese financial institutions with their dollar funding. The bank, however, has not changed the interest rate on bank reserves, nor the amount of JGB purchases.

The BOJ was under pressure to act to meet the expectation that it would move jointly with the government. The technical limitations with JGB purchases and NIRP as discussed above must have forced the bank to concentrate on ETF purchases and the dollar funding scheme. The rather unexpected expansion of the dollar funding scheme was timely in light of the stresses in this area as discussed above. The expanded scheme effectively allows the BOJ to act as a counterparty for Japanese financial institutions' foreign currency swaps. We have to recognize, however, that stresses in the foreign currency funding market has not been the root-cause of the failure to achieve the inflation target. It is another proof that while central banks can mitigate financial stresses by carrying out QE1/credit easing type measures, they are not quite in possession of powerful tools to stimulate the economy in more normal financial conditions, but at around the zero lower bound on interest rates.[2]

The bank has kept the expectation of further easing alive by saying that it will carry out a comprehensive review of the effects of its policy measures on the economy by the next meeting. It is, however, difficult to avoid the impression that the bank is close to its capacity limit.

The joint stimulus is most likely not enough to raise inflation to the target. If inflation does increase significantly, however, it will generate the obvious risk of aggravating the fiscal situation. The rise in interest rates associated with higher inflation may allow the market to charge large risk premiums on JGBs. Then, the debt-GDP ratio could move in

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[2] See, for example, Ueda (2012) "Deleveraging and Monetary Policy: Japan since the 1990s and the United States since 2007," Journal of Economic Perspectives, Vol. 26, No.3.

much more devastating ways than in Figure 2. Thus, the whole attempt could end up in opening Pandora's Box.

No question that challenges facing Japan are formidable. Let us end with some hopeful notes. One obvious possibility for Japan to proceed with less pain is for the global economy, especially the U.S. and Asia, to expand more solidly than in the last couple of years. This would take pressure off from the yen and also from the BOJ. Japan may do OK even without effective macro policies. In fact, some recent data such as the U.S. employment report, Japan's exports and industrial production are encouraging.

Another more medium-term hope would be that a 2% inflation rate for the first time in two decades, if achieved, will animate business spirits and lead to a substantial rise in investment and growth. Orthodox economic theory does not support such an argument. Real interest rates are already fairly low unless one resort to the argument that the natural rate of interest is negative. But we will see.