

"Abenomics: Great Escape from Deflation to Growth"

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For Seminar at the University of Chile, Faculty of Economics (FEN)
Santiago, Chile
August 18, 2015

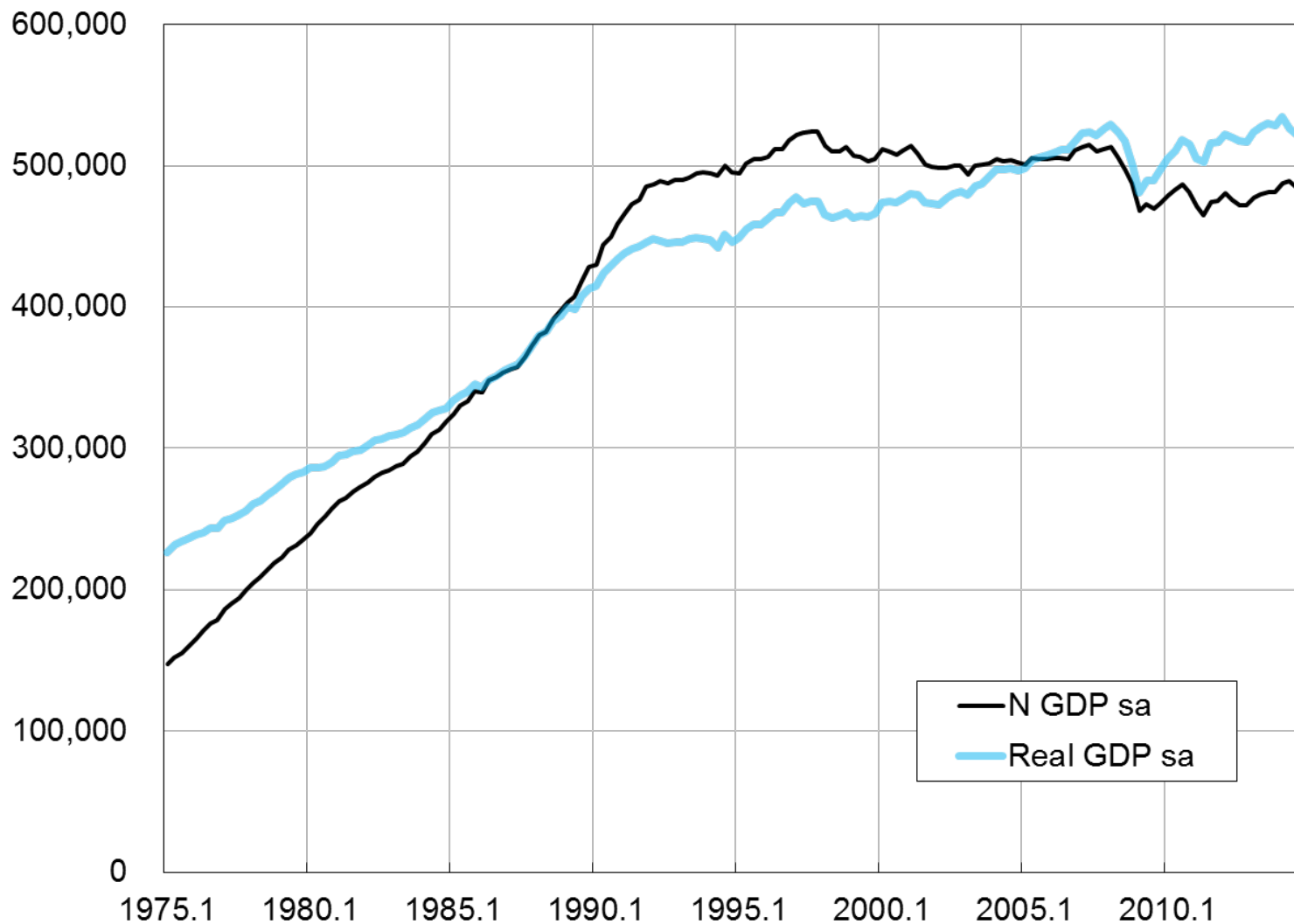
Summary

- Japan was suffering from stagnation and deflation → “Japanization”
- Japan was caught in a deflationary equilibrium
- Abenomics is concerted efforts of monetary, fiscal and structural policies to lift the economy out of deflation into a normal growth path
- It has made progress but up to a half way

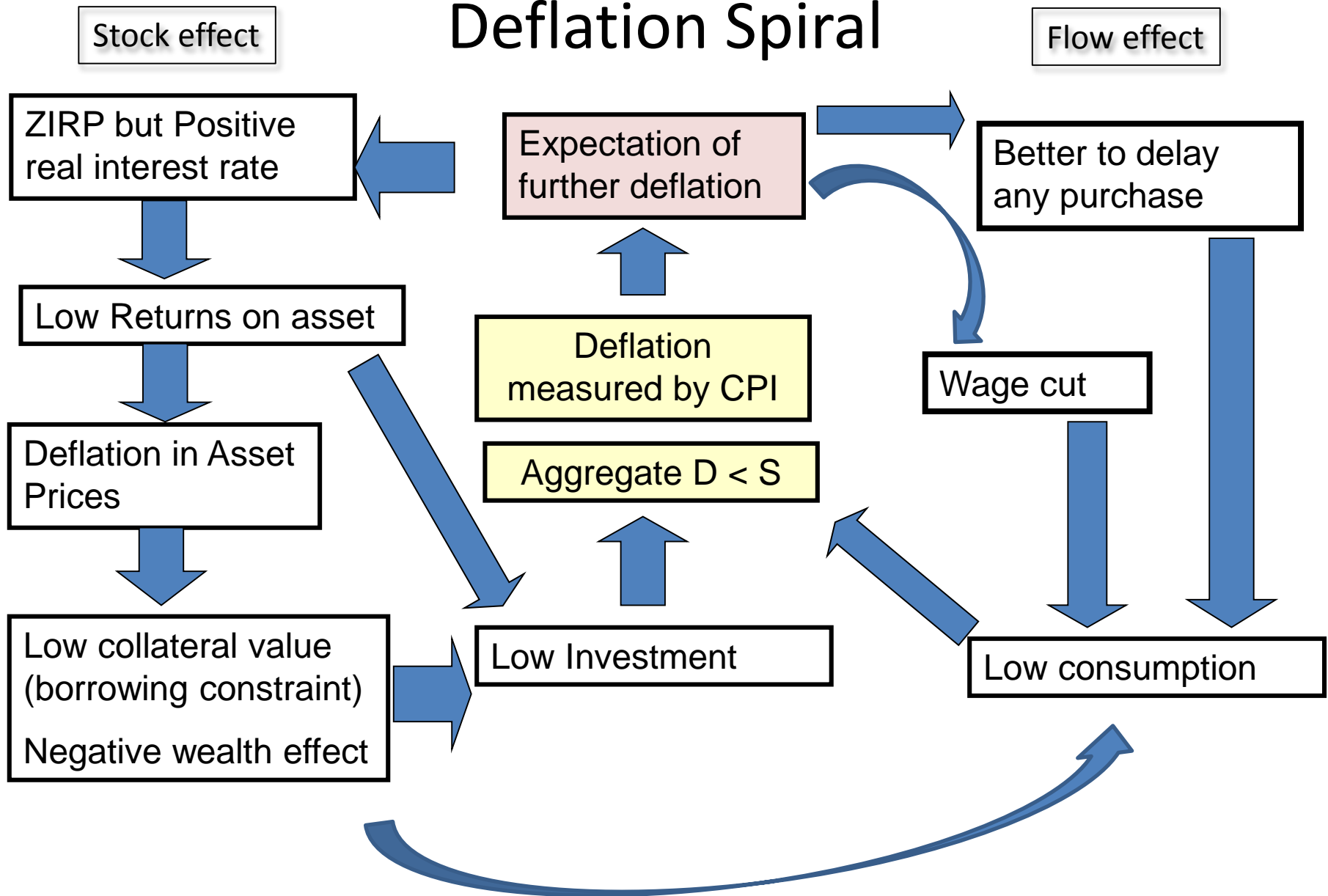
Stagnation and deflation

- Japanization: A period (a decade or two) of
 - Sustained **deflation**. Below targeted inflation rate ($\pi < 0 < \pi^*$)
 - Sustained **stagnation**. Growth rate below potential ($g < g^*$)
 - **Low nominal interest rate**. At or near Zero Lower Bound ($i = 0$)
 - With deflation, real interest rate is positive
 - Flattening yield curve
 - 10-yr bond rate becomes lower
 - Trapped in a deflationary equilibrium (a bad equilibrium)
 - First country to face (working-age and total) population decline
- Policy.
 - Monetary policy: ZIRP and QE
 - First country to apply ZIRP (1999-2000; and 2001-2006; and 2008-)
 - First country to apply QE (2001-2006)
 - But, QE alone did not work: no inflation targeting
 - Fiscal policy: Fiscal stimulus
 - But, fiscal stimulus ends up with large debt

Stagnation: Japanese nominal and real GDP



Deflation Spiral

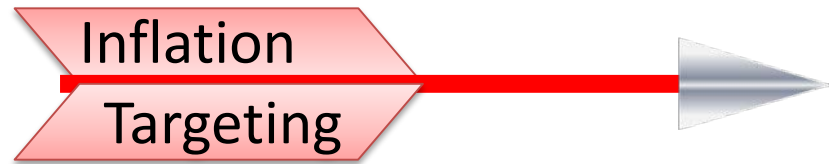


Abenomics, the beginning

- LDP won a general election in 2012; ending the three year DPJ rule
- Mr Abe became Prime Minister in December 2012
 - He was PM from 2006 to 2007
 - He had to resign in 2007 for health reasons.
- He advocated “three arrows” to revive the long-stagnated Japanese economy
- He asked BOJ to adopt the inflation targeting framework with 2% target (in core CPI)
- He appointed Governor Kuroda in March 2013
- He won an upper house election in July 2013; LDP won
- He surprised many by calling a snap general election in December 2014; LDP won

Progress 2012/11-2015/08

- **First** Arrow: Big Success 2012/11 – current
 - Correction of Overvaluation of the yen (80 → 120)
 - Raise the stock prices (8,000 → 20,000)
 - Wealth Effects → Consumption increase
 - Investment increase, as the depreciated yen continues
 - Increase inflation rate* (-0.5 in 2013/03 → +1.5 in 2014/04) toward 2% target (* inflation rate adjusted for VAT hike); but declined to 0.0% in 2015/05, due to oil price declines
 - Challenge to increase the inflation rate to the 2% target by end-2016
- **Second** Arrow: Short-term, counter-cyclical fiscal stimulus
 - Medium-term, fiscal consolidation (VAT from 5% to 8%)
 - However, delayed the second stage of VAT increase
 - Challenge to increase VAT rate further; and slow down social security expenditures
 - Possibility of a fiscal crisis in 2021-2015
- **Third** Arrow: Slow but steady
 - Focus on 10 areas in 2014 growth strategy
 - Concrete progress from 2013-15
- All three arrows combined: Jump from a bad (deflation) equilibrium to a good equilibrium



- First Arrow
 - Aggressive Monetary Policy
- Objective: to get out of a deflation spiral and get back on an moderate inflation economy
- Two tools
 - 2% inflation targeting framework
 - QQE (Quantitative and qualitative easing)
 - Governor Kuroda's radical change of monetary policy

- Objective. To break “deflationary expectation”
 - The **real interest rate (= nominal rate – π^e) will decline**, &
 - Investment and Consumption will be stimulated
- Is it credible? Yes, if done properly
 - Similar to QE (**B/S expansion**) at BOE, FRB, and ECB
 - Timing and communication is important
 - Credible as the BOJ under Gov. Kuroda is a good communicator
- BOJ, important developments
 - 2% Inflation targeting on January 22, 2013, under Gov. Shirakawa
 - **April 4, 2013: Quantitative and Qualitative Easing (QQE) under Gov. Kuroda**
 - April 24, 2013: Outlook, forecast of 1.9% by 2015
 - Did not achieve this
- Early success:
 - **Yen depreciation**
 - **Soaring stock prices**
 - **Increasing inflation rate (-0.5 in 2013/03 to +1.5 in 2014/04)**
- See also, Takatoshi Ito, “Abenomics: Early Success and Prospects” Spotlight, September/October 2013, pp. 4-7.
- But, the inflation rate declined from April 2014 to April 2015; mostly due to oil price declines

Impact of First Arrow

- Big success !!
 - Yen depreciation and stock price increases
 - Wealth effect
 - Contributed to wealth effect, consumption growth and economic growth
- Now, moving forward. Do we need additional easing?
 - USD/JPY has been flat for more than a year at around 100
 - Then rose to 120-125 yen in the summer of 2015
 - Nikkei 225 has been around 14,000-15,000 for a year
 - Then rose to 20,000 by July 2015
- Inflation rate still low (partly due to oil price declines)
 - Projected to increase toward 2% in 2016



- Flexible Fiscal Policy
 - Stimulate when the economy is in a recession
 - A quickly introduced, large supplementary budget in FY 2012
 - Fiscal consolidation when the economy is in a strong position
 - Consumption tax (VAT) increase, April 2014
 - But postpone the second hike scheduled in October 2015 hike to April 2017
 - Very high debt-GDP ratio remains a major concern in the medium term

- Important: **Short-term stimulus and Medium-term consolidation**
- Short-term stimulus to boost demand for
 - Getting out of deflation in Q2-Q3 in 2013
 - Mitigating consumption tax increases in Q2-Q3 in 2014
- Medium-term consolidation is needed to restore fiscal sustainability
 - Fiscal condition (debt/GDP ratio) is the worst among OECD
 - Fiscal deficits are still large
 - Need to raise consumption tax (VAT) and control social security expenditures
 - Economic growth would help generating tax revenues
- Likely option is to raise consumption tax rate
 - 5% to 8% in April 2014
 - 8% to 10% in October 2015
 - Then to 15%; and to 20%?
- Hoshi, Takeo and Takatoshi (2013). “Is the Sky the Limit? Can Japanese Government Bonds Continue to Defy Gravity?” Asian Economic Policy Review, vol. 8: 218-247.

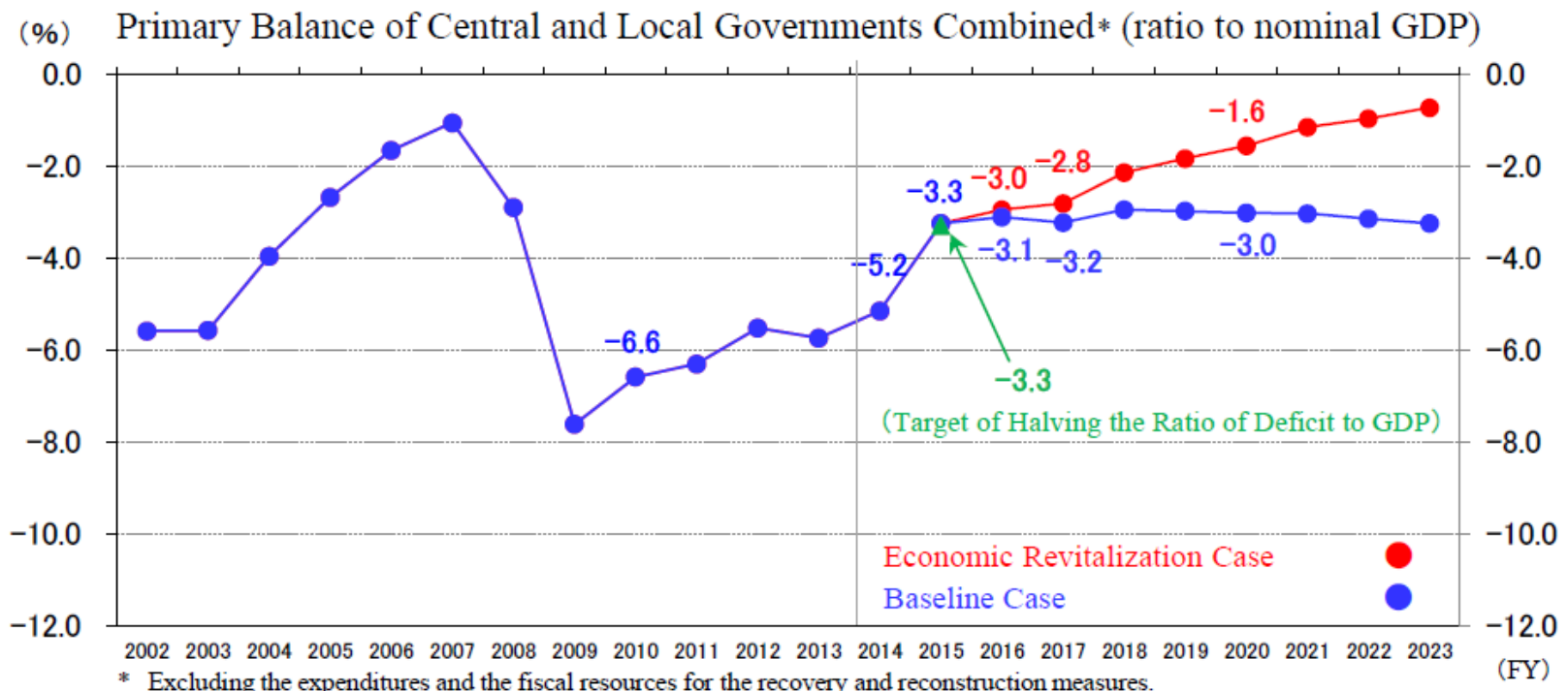
Fiscal Policy

- Current fiscal consolidation target is
 - Primary Balance (PB) = 0% by 2020
 - Currently PB = -3.3% of GDP
- Current projection (Feb 2015, Cabinet Office)
 - PB/GDP = -2.1% in 2018 and -1.6% in 2020
- New projection (CEFP, June 30, 2015)
 - Additional expenditure reform → but no “ceiling”
 - PB/GDP = -1.0% in 2018 and 0.0% in 2020
- The new projection is highly optimistic
- Will fiscal crisis come to Japan?

PB balance projection

Cabinet Office, February 12, 2015

- “Revitalization Case” Assumptions: Nominal growth 3%; real growth 2%; consumption tax (VAT) hike to 10% from 8% in April 2017



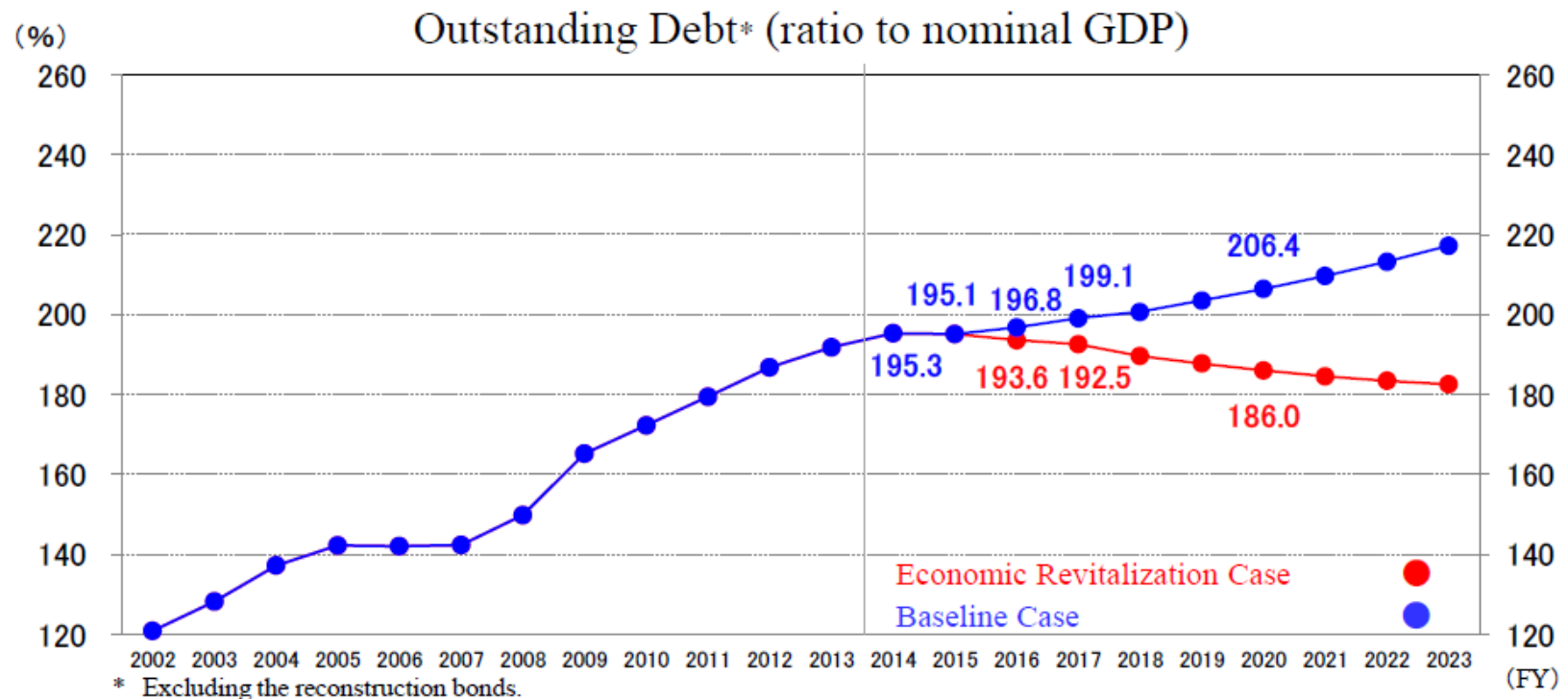
PB Balance soft target

CEFP, June 30, 2015

- Target of $PB/GDP=0\%$ in 2020 is maintained
- As a midway checking point (soft target),
 - $PB/GDP = -1.0\%$ in 2018
- However, the projection in Feb 2015,
 - $PB/GDP = -2.1\%$ in 2018
- What is the difference?
 - No new tax measures, but revenues may be higher due to the sensitivities
 - Expenditures will be cut
 - Many ideas of how to suppress social securities related expenditures
 - But no commitment from the Ministry of Health, Labor and Welfare
 - Although $PB/GDP < 0$, the $Debt/GDP$ will be decreasing in 2017 and beyond, because growth rate $>$ the average bond interest rate

Debt

- Central and Local Government long bonds



Second Arrow

- Success, so far.
 - Consumption tax rate hike was realized in April 2014, generating fluctuation
 - Q1. Large increase in consumption
 - Q2. Large decline in consumption
 - Q3-Q4 should recover from temporary downturn
 - In December, another decision will be made for the tax rate hike of October 2015



- In the medium- to long-run, the economy needs
 - Consumption and Investment increases
 - Productivity gains & Wage increases
 - Growth without fiscal stimulus
- But which industries?
 - Backward Industries due to lots of regulations are the hopefuls
 - Health and medical care
 - Agriculture
 - Energy
 - Mobilizing women and the aged as labor force
 - FTA and TPP
 - Pension fund (esp. GPIF) reform
- But so far, SLOW

Growth Strategy (Japan Revitalization Plan), June 30, 2015

- Economic Growth: 3 factors
 - Capital (K)
 - Labor (L)
 - Innovation (A)
- The plan should increase a potential growth rate
 - Important for fiscal consolidation and social security sustainability
- Progress in reforms under *Abenomics* has been good
 - Most successful are:
 - GPIF; corporate governance
 - Labor reform; agricultural reform; efforts to conclude TPP
 - Most disappointing are
 - Helping working women
 - Allowing more foreign workers
 - A list of deregulation is short

Efficient Use of Capital (K)

- GPIF reform
 - Benchmark portfolio reform: Domestic equity 12% → 25% (done)
 - Governance reform: (not yet done)
- Corporate governance reform
 - Adopting corporate governance code → Done
 - Hire outside Board of Directors (at least two)
 - Encouraging corporations to increase ROE → in process

Increase Labor input (L)

- Flexible employment rules
 - Make explicit firing/layoff rules (currently, legal uncertainty)
 - Rules of Dispatched/leased workers became flexible
- Women
 - To prevent female workers from dropping out of labor force when they have babies and raise children
 - Increase childcare workers; so that childcare facilities can be used by all who apply
- Foreign workers
 - Highly skilled workers are welcome → In process
 - Professions too limited
 - Unskilled workers → Not discussed
 - Domestic help; nanny/baby sitter → not addressed

Innovation (A)

- Agriculture cooperatives
 - Agricultural cooperative central → abolish their right for supervision of all 700 agricultural cooperatives
 - Prefectural federations → possible to be corporatized
 - Unit (local) cooperatives → increase freedom
- Rice, production quota was abolished
- Use of IT; big data; robots; Artificial intelligence

Assessment of the Revitalization Plan

- Too many targets are mentioned
- Short on concrete steps to achieve target
- Quantitative assessments are not
- Too much industrial policy
- A list of deregulation is short

Conclusion

- *Abenomics* is working fine, so far
 - [1st arrow] Monetary policy is right on the target
 - [2nd arrow] Fiscal stimulus works in the short run
 - Need consolidation in the medium-run
- *Abenomics*, the success means a jump from a bad, deflationary equilibrium to a good, normal equilibrium
 - Once in the good equilibrium, fiscal stimulus will not be needed
- [3rd arrow] Growth strategy will be a key to raise investment and growth potential; to erase fiscal debt concern; to raise wages; and to complete the jump

Related articles

- Takatoshi Ito, “Abenomics: Early Success and Prospects” Spotlight, September/October 2013, pp. 4-7.
- Takatoshi Ito, “Abe should aim his third arrow at Japan’s farmers” Financial Times, June 13, 2013.
- Takatoshi Ito, “Japan Must be brave—it is time to put up taxes,” Financial Times, September 9, 2013.
- Takatoshi Ito, “Consumption tax fears risk stalling Abe’s ‘three arrows’ East Asian Forum, September 8, 2013.
- Takeo Hoshi and Takatoshi Ito, “Is the Sky the Limit? Can Japanese Government Bonds Continue to Defy Gravity?” Asian Economic Policy Review, vol. 8, December 2013: 218-247.