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Japan has not (yet) failed

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The news we are currently hearing about Japan's economy sound dramatic: after the second consecutive contraction in Japanese gross domestic product, the country is now in recession. Japan's Prime Minister Abe, who was elected in 2012 with ambitious plans for reviving the Japanese economy, hereupon postponed not only the VAT increase planned for next year, but also initiated the dissolution of parliament and called early elections. This raises the question of whether Abe's economic policy ("Abenomics") has failed. We think it is still too early to draw such conclusions. Furthermore, the Japanese economy is by no means on its knees, despite what is suggested by critical reports.

To evaluate the outlook for the Japanese economy and the prospects of success for Abenomics, it makes sense to explore the essence of the economic problems in Japan first. If we compare Japan to the other G7 states, it becomes clear that the economic performance of the third largest economy in the world has been decent in important areas. Despite persistent deflation, the international financial crisis and a tsunami catastrophe, Japanese GDP per capita has increased by a good 10 % in the past 10 years – only marginally weaker than in the USA or Great Britain. Unemployment in 2013 was the lowest of the main economies, and is showing a downward trend. Accordingly, Japan is doing well in having as many people participate in working life as possible.

Problem number one: public debt

Thus the urgent need to stimulate the Japanese economy with a massive deployment of economic policy instruments lies elsewhere: at more than 240 % of GDP, Japanese gross public debt is extremely high. The situation is somewhat better in terms of net public debt (134 % of GDP), but the risk that the debt becomes unsustainable continues to persists. Despite extremely low interest rates, debt is increasing every year due to permanently inflated budget deficits since the Asian crisis. Another albeit politically motivated reason for Abenomics might be the fear of losing international influence due to weak economic growth, both internationally and especially vis-a-vis China.

Abenomics: objectives and instruments

Against this background, the Abenomic' goals can be understood as follows:

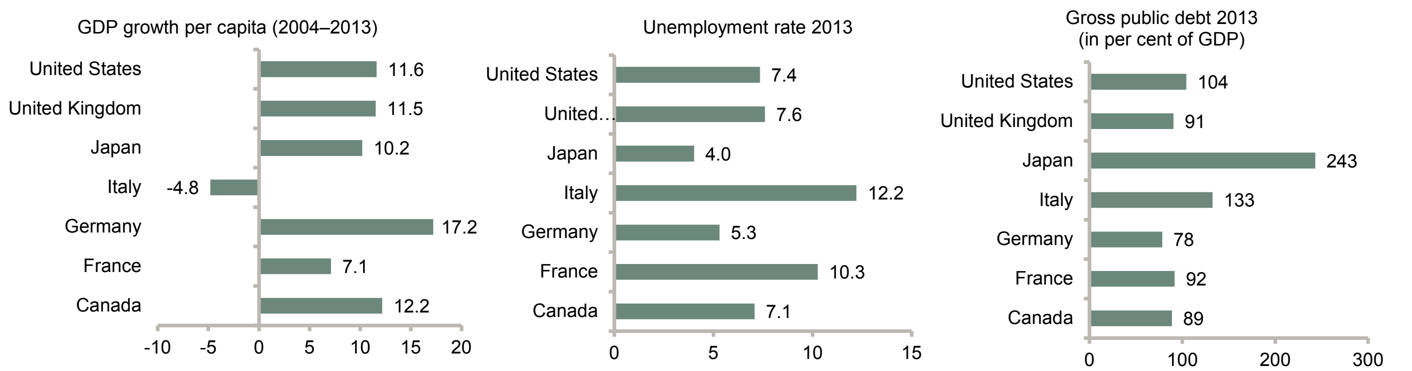
(1) Japan should move on from deflation. The Bank of Japan (BoJ) is targeting an inflation rate of 2 % already within the fiscal year of 2015.

(2) Real GDP should grow more strongly, by 2 % on average between 2013 and 2022. This would be significantly more than in the past 10 years, when GDP increased by no more than 0.6 % per year (2004–2013).

(3) The gross government debt ratio should be stabilised by 2020. This includes reducing the primary budget deficit by half to some 3.5 % of GDP in the fiscal year 2015, and a balanced primary budget in 2020.

While inflation and growth objectives are obviously crucial per se, in Japan's case they play another important role: Their fulfillment makes it far easier to consolidate the budget. Rising inflation for instance directly reduces the real value of existing government debt. Higher real growth leads to a lower government debt ratio and makes it less painful to reduce the budget deficit. Equally important is the effect that ending deflation can have on the stimulation of real growth. Amidst

Figure 1: Comparison of economic key indicators



Source: IMF

an environment of rising prices, it is less attractive to accumulate nominal assets and more appealing to accumulate debt, which should affect investment and consumption demand positively. Furthermore, this facilitates structural change because relative prices can adjust freely, unhindered by the downwards rigidity.

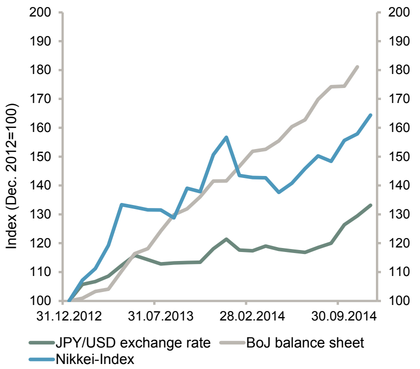
To reach its goals, Abenomics plans on making use of all the economic policy instruments available. In addition to an extremely loose monetary policy as well as an initially stimulating then consolidating budgetary policy, deregulation and structural reforms are expected to accelerate growth.

What has been achieved so far? And what hasn't?

The centerpiece of Abenomics has thus far been a strong monetary stimulus. Through additional purchases of securities, the balance sheet total of the Bank of Japan has increased by more than 80 % since December 2012 (for comparison: ECB balance sheet total: -30 % in the same period). This had a positive impact on equity markets (+64 % since December 2012) and on the yen (33 % depreciation). So far the yen depreciation has had only a limited positive effect on real export growth. It has to be taken into account, however, that exports are of less importance for the Japanese economy than for example for Germany (export share in relation to GDP in 2013: Japan: 16 %, Germany: 46 %).

With reference to the fight against deflation, the results of Abenomics are mixed. Due to the depreciation-induced rise in import prices and the VAT increase, the headline inflation currently amounts to 3.2 % yoy, but the underlying price trend lags behind at 1¼ % at present, clearly below the inflation target of 2 %. To anchor the inflation rates *permanently* on a higher level, a self-sustaining economic upswing accompanied by higher wage growth is required. So far, this is still missing in Japan.

Figure 2: Central bank balance sheet and financial market indicators



Sources: Bloomberg, Feri

Figure 3: Wages and inflation

Source: Bloomberg

While temporary fiscal stimulus measures had been taken in the initial stage of Abenomics**,** fiscal policy has become more restrictive this year. In view of the high public debt burden the VAT increase in April (from 5 to 8 %) was justified (2014: reduction in deficit ratio by about 1 % of GDP), but in terms of timing, this step was premature. The tax-induced upturn in the inflation rate could not be offset by Japanese private households due to still weak wage growth. As a result, Japan has slipped into a technical recession. Real GDP growth may only amount to 0.3 % yoy in 2014. In 2015, however, Japanese economic growth is likely to pick up again.

What should Japan do now?

More has to be done to stimulate growth in Japan and achieve a *permanently* higher inflation rate in the medium term. In particular, little progress has yet been made in the area of structural reforms. The following points should be addressed:

(1) Ensure higher wage growth: even though the unemployment rate has declined sharply since the beginning of Abenomics (currently: 3.6 %), nominal wage dynamics remains weak and real wages are falling (see figure 3). There are several reasons for the weak wage growth, including a low degree of trade union membership, the consensus-oriented culture and a high proportion of part-time and temporary employees with lower social security and significantly lower salaries than permanent employees.

Wages are a lagging economic indicator. Given the shortages of labor supply, nominal wages are likely to post stronger increases in future. The respectable productivity growth and the comfortable profit situation of many Japanese companies also offer leeway for wage hikes. If necessary, the government must exert pressure on companies to bump up wages, because efforts to boost inflation can only be successful if wages rise more strongly.

(2) Respond to demographic trends: The Japanese working population shrinks by about 1 % every year, thus limiting Japan´s long-term growth potential; the domestic labor supply must be used more efficiently by reducing part-time and temporary jobs, and improving education and training. Fortunately, the participation rate of women has already increased. This can be further improved by offering a more favorable tax framework (eliminating tax disadvantages for married women that want to work full time). In addition, Japan has to open up for an at least limited inflow of foreign workers.

(3) Exploit efficiency potentials in protected economic sectors: Low productivity in domestic economic sectors could be increased through deregulation measures. Corresponding plans have already been drawn up.

(4) Use high cash holdings of companies: Large export-oriented Japanese enterprises are sitting on large cash reserves. If these are not invested, a part could be collected in the form of taxes on retained earnings or repatriated into the economic cycle via higher dividend payments. However, it would make sense to stimulate the investment activities of non-financial companies. Their investments fell behind write-downs between 2009 and 2011 and were therefore not high enough to preserve the value of capital stock.

(5) Strengthen capital efficiency of companies: The capital efficiency of many companies is unsufficient. Via equity investments the “Government Pension Investment Fund” (GPIF) is expected to exert pressure on companies to strengthen their innovation activities and increase profitability.

(6) Encourage internationalisation: The Trans-Pacific Partnership (TPP) could be an important trigger in opening up the Japanese economy to more international competition and breaking up antiquated structures in some domestic economic sectors. Yet this is encountering significant political resistance.

Preliminary conclusion

A consistent implementation of structural reforms would help to increase the medium-term growth potential of the Japanese economy. Yet we cannot expect any miracles. Solely as a result of demographic trends, the growth objective of 2 % set by the Japanese government is unrealistic. The scope for increasing productivity growth is limited as Japan is already showing respectable increases here by international standards: according to OECD statistics, the increase in “multi-factor productivity” in Japan averaged 0.7 % between 1995 and 2012 and was therefore roughly on par with Germany (+0.8 % in the same period).

The overall assessment of the IMF is thus rather bleak: Potential growth may only be lifted from 0.5 to 1 %.[1] To keep the public deficit ratio on a sustainable level in the medium term, it is therefore of outstanding importance that Japan achieves its inflation goal besides pursuing a moderate fiscal consolidation course.

Further economic policy steps

Monetary policy will play a key role. The BoJ is determined to take the necessary measures to achieve the inflation objective. A further increase in monetary stimulus was already decided: the BoJ will purchase assets worth 80 trillion yen (previously: 60–70 trillion yen). Virtually all newly issued government bonds are thus bought up by the BoJ.

In reaction to the recent downturn in economic growth, Japan is taking one step back in fiscal policy. The VAT increase scheduled for October 2015 is now postponed to spring 2017. In addition, another fiscal stimulus package is already being discussed (worth 3–4 trillion yen). These are bad news given the difficult public budget situation.

Japan will have to tighten its fiscal policy stance moderately in the medium term. But this should only take place once the economy is on a more stable footing. Timing will remain a great challenge. A clear strategy for medium-term fiscal consolidation is still missing.

Japan still has time, but not an unlimited supply

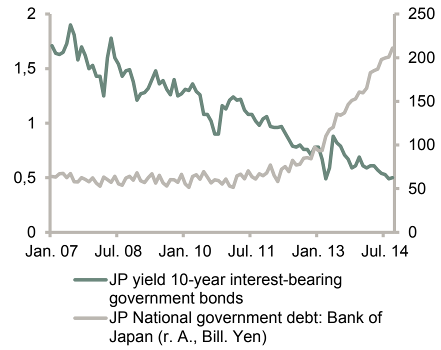
Japan still has enough time to end deflation and get public debt under control, because the financial markets still do not doubt the creditworthiness of the Japanese sovereign. On the contrary, Japanese bond yields are at historically low levels (term of 10 years: 0.46 %).

This is partly due to the massive bond purchases by the central bank, which currently holds more than 21 % of the government bonds on its balance sheet. On the other hand, due to the high volume of savings capital held by the Japanese households and a strong preference for national investments, the Japanese state sources about 90 % of its refinancing on the domestic market.

The pressure on fiscal consolidation is likely to increase. This will become a problem as soon as Japan needs capital imports from abroad. Two developments are at play here. Firstly, Japan’s current account has been diminishing for years and threatens to slip into a permanent deficit. Secondly, the savingsof Japanese households are increasing more slowly than public debt due to the ageing population. Estimates[2] conclude that in roughly 10 years, domestic financial capital will no longer be sufficient to absorb public debt. We should ultimately not forget that the BoJ made its bond purchases subject to the condition of sustainable public finances.

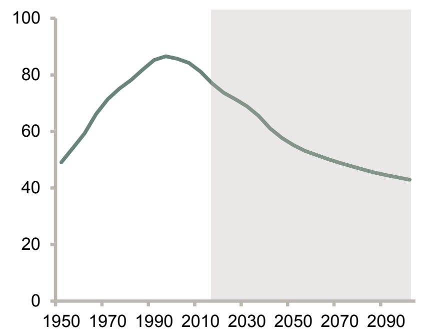
Against this background, it is clear that the lack of pressure from financial markets can also have its disadvantages. Despite the governing party having an overwhelming political majority, crucial reforms are not implemented. We can only hope that new elections will provide the government with a strong mandate so they can finish what they have started. The more time passes, the fewer opportunities they will have to take action and the more painful the adjustment process will become. ■

Figure 5: Interest rates and BoJ’s government bond holdings



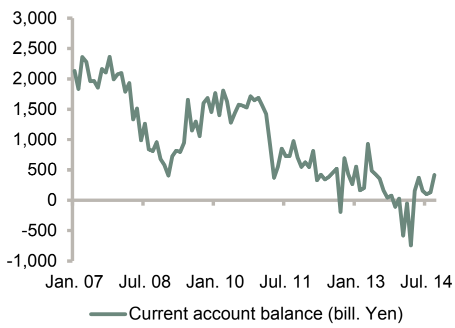
Source: Datastream

Figure 4: Workforce in Japan (15–64 years, in million)



Source: U.N.

Figure 6: Current account balance



Source: Datastream

[1] IWF(2014), Japan: Article IV Consultation – Staff Report, IMF Country Report No. 14/236.

[2] Lam, R. W. and K. Tokuoka (2011), Assessing the Risks to he Japanese Government Bond (JGB) Market, IMF Working Paper No. 11/292.