Japan

Abenomics, a dangerous cure

The Abe government has adopted a three-pillar strategy: renewed fiscal stimulus, more aggressive monetary easing from the Bank of Japan, and structural reforms to boost Japan's competitiveness. This has resulted in a sharp depreciation of the yen and a rise in stock prices. Business confidence has reached historically high levels. Supported by expansionary fiscal and monetary policies, GDP is forecast to grow by around 1% in both 2013 and 2014.The risky strategy may work if the government succeed in raising potential output and boosting private sector demand.

A three-pillar strategy

At the general election in December, the Liberal Democratic Party (LDP) obtained a landslide victory and its leader Shinzo Abe returned as prime minister, a job he lost in 2007. The LDP campaigned on a platform of renewed fiscal stimulus, more aggressive monetary easing from the Bank of Japan (BoJ), and structural reforms to boost Japan's competitiveness. This three-pillar plan has been dubbed "Abenomics".

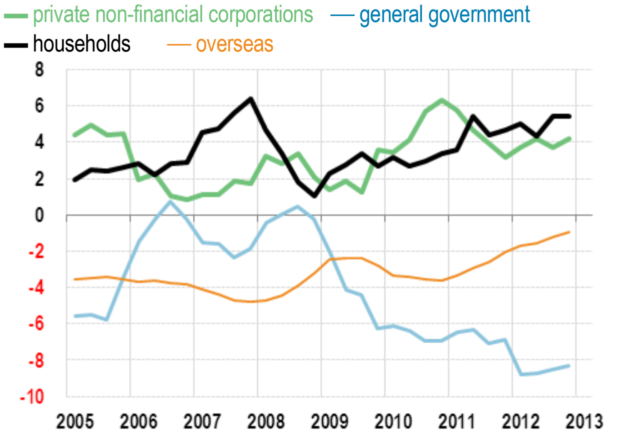
The government did not disappoint its supporters. Already in early January, the incoming Abe government presented a supplementary budget worth JPY 10.3 trillion (or 2% of GDP). Taking local government and private sector contributions into account, it could reach JPY20.2 trillion. However, the impact of the programme on GDP growth is likely to be limited, around 0.5 percentage point in 2013 and 0.2 percentage point in 2014.

Later in the month, the government and the BoJ issued a joint statement, announcing the raising of the inflation target from 1% to 2%. The BoJ promised to pursue monetary easing to achieve this target at the earliest possible time. The government, for its part, promised to formulate measures for strengthening competitiveness and the growth potential of the Japanese economy.

The supervision of macroeconomic policies including monetary policy was transferred to the Council on Economic and Fiscal Policy, an 11-member government body, which includes some ministers handling economic and fiscal policies, the BoJ governor and business leaders and academics. After having been dormant during the governments lead by the Democratic Party of Japan (DPJ) between 2009 and 2012, it has recently been revived by Prime Minister Shinzo Abe. This decision is an infringement of the BoJ's independence.

The new monetary strategy will be carried out by the recently nominated BoJ Governor Haruhiko Kuroda. During his confirmation hearings in Parliament, Mr Kuroda blamed the prudent policies of the central bank for the steady decline in prices over a 15 year period. He pledged to reaching the inflation target by stepping up the asset purchase programme and extending it to government bonds with more than three years to maturity. The bank could also buy more risky assets

1- High net lending by the private sector
Financial surplus as % of GDP



Source: Bank of Japan

like exchange-traded funds. However, he opposed the outright monetary financing of the budget deficit. Moreover, he was not in favour of buying foreign bonds, arguing that exchange rate policy is in the realm of the government.

An extraordinary confidence boost

The government's policy to impose a looser macroeconomic stance has led to a sharp depreciation of the yen, even before any concrete measure was announced. Since November, when the election was called which brought Mr Abe to power, the yen has lost about 17% against the euro and the dollar. It has given stock prices on the Tokyo stock exchange a boost. The government has welcomed this development as it claims that the currency is overvalued.

These developments have resulted in an extraordinary boost to business confidence. In recent months, the diffusion indices of the Economy Watchers Survey have reached record highs. Companies report improved profitability and regained competitiveness. Housing starts have been boosted ahead of the VAT hike in April 2014 (from 5% to 8%). Companies are confident that these favourable conditions will persist in the month ahead, despite some concerns about rising fuel prices.

Prime Minister Abe has asked domestic firms with improving profitability to consider raising compensation to make them consistent with the BoJ's inflation objective and the planned VAT hike. The increased in labour costs will be helpful in ending deflation. The prime minister's call has received a positive response from some retailers. Their hope is that a wage increase will stimulate domestic demand. However, manufacturers have been less forthcoming as many of them reported to be loss-making on their domestic operations only a couple of months ago.

A difficult balancing act

Supported by expansionary fiscal and monetary policies, GDP is forecast to grow by around 1% in both 2013 and 2014. Inflation is expected to rise to 2.2% in 2014, largely due to the 3 point VAT rate hike in April 2014. The yen could slightly appreciate in the coming months, as the foreign exchange market might have overshot. In 2014, the yen is likely to depreciate again on further quantitative easing by the BoJ while the Fed is expected to prepare the exit from its unconventional monetary policies.

The BoJ's policies are unlikely sufficient to get the economy out of deflation. Interest rates are already close to zero, but the financial surplus of the non-financial corporate sector is still at record high levels because of a lack of investment opportunities. Abenomics will only work if the government is also serious about the other pillars of its strategy.

For the recovery to become self-sustained, the private sector should replace the public sector as major engine of growth. This is partly addressed by this fiscal stimulus plan, which contains tax incentives for the private sector. Moreover, the weaker yen is certainly welcome for exporters, although not a panacea for overcoming deflation.

An important lever of the government's strategy is the raising of potential growth through product and labour market reform. However, it risks tackling vested interest of traditional LDP supporters. Recently, the government has decided to join the Trans Pacific Partnership talks despite strong opposition from the agricultural lobby. However, it could still drop out these negotiations as Prime Minister Abe has made it clear that he will do everything to protect Japanese farmers.

A major risk is the upward pressure on long-term rates once inflation starts to rise. Given the huge volume of government debt held by domestic financial institutions, a rise in bond yields could lead to severe losses for the banking sector. Moreover, the public sector debt, already well above 200% of GDP could become unsustainable. This will force the BoJ to continue buying government bonds to keep nominal interest rates down. In addition, the authorities could use financial repression by compelling financial institutions, as part of macro prudential regulations, to buy and hold government debt. The central bank might temporary sacrifice price stability for financial system stability. In this way, the public debt can be partly inflated away in real terms.

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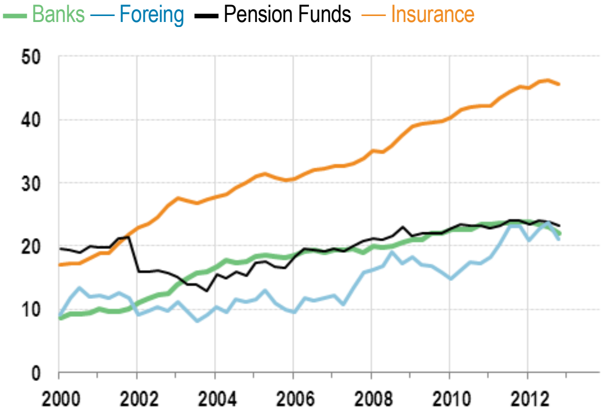
Insurance companies are major JGB buyers

Central government securities as % total financial assets



Source: Bank of Japan

Summary

Components of Growth

y/y, vol, %	2012	2013 e	2014 e
GDP	**2.0**	**0.9**	**1.0**
Private Consumption	2.4	1.0	0.3
Public Spending	4.3	2.2	2.4
Fixed Investment	2.3	1.0	1.1
Net exports (contribution)	-0.7	-0.5	0.0

Inflation & Labour

y/y, %	2012	2013 e	2014 e
Consumer Prices	-0.0	0.1	2.2
Consumer Prices (ex. F & E)	-0.6	-0.3	1.8
Unemployment Rate, %	4.4	3.8	3.7

External & public accounts

% GDP	2012	2013 e	2014 e
Current account	1.1	0.6	0.6
General Government Budget	-10.0	-10.5	-9.4
Debt ratio	213	222	229

e : BNP Paribas Estimates & Forecasts; vol: volumes