Japan

Abenomics: A failure called too early

- **Over the latest quarters, the Japanese economy sent positive signals. Growth accelerated, supported by domestic demand. The performance is striking, with a potential rate of growth closed to zero.**
- **The Bank of Japan took another step in the "irresponsibility" praised by Paul Krugman, with a commitment to significantly and lastingly overshoot its 2% inflation target.**
- **For some, Abenomics has reached its limits. The implementation of policy tools has proved unbalanced: insufficient structural reforms with too much weight on the monetary pedal.**
- **Rooms for manoeuver are said to be diminishing, notably because the very high public debt load would limit the potential support from fiscal policy, not mentioning the opportunity to use such a policy tool.**
- **It appears that the high level of government debt is to be nuanced. It is even more so the case because the active BoJ policy ensures easy financing conditions.**
- **It remains too soon to call Abenomics effective or ineffective. On top of that, the tool box is not empty…**

Growth speeds up…

Since 2013, Abenomics has aimed to pull Japan out of the deflationary spiral by creating a growth shock. The balance between the three arrows of Abenomics – fiscal policy, monetary policy and structural reforms – has often been the target of criticism, along with the strategy's effectiveness. The Bank of Japan's latest effort has also drawn sharp criticism.

On 21 September, the Japanese central bank announced a new phase in monetary easing: the introduction of yield curve controls, notably with a 10-year bond yield target, and above all a pledge to overshoot its 2% inflation target over the long term by increasing the monetary base by as much and as long as it deemed necessary.

In recent quarters, the Japanese economy has shown signs of acceleration. In the first three quarters of 2016, the economy grew at an average quarterly rate of 0.4% (annualised growth of 1.7%). The breakdown of growth shows a shift in the contribution of final domestic demand and foreign trade, illustrating the robust momentum of household spending. After Abenomics was introduced, foreign trade was the main growth engine, fuelled by the depreciation of the yen by more than 30% (in real effective terms). Since mid-2015, however, the yen has rebounded (the cumulative depreciation since year-end 2012 narrowed to 18%), and foreign trade is no longer such a powerful growth engine. Yet thanks to the fiscal impulse and a dynamic job market, household spending was able to pick up the slack.

Activity picking up

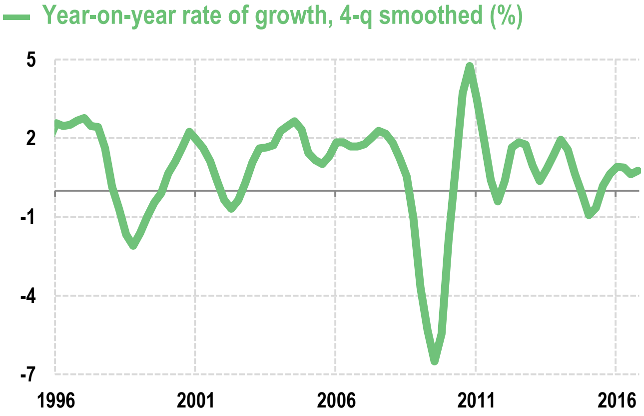

Chart 1 Source: Japanese Cabinet Office

Contributions to GDP growth

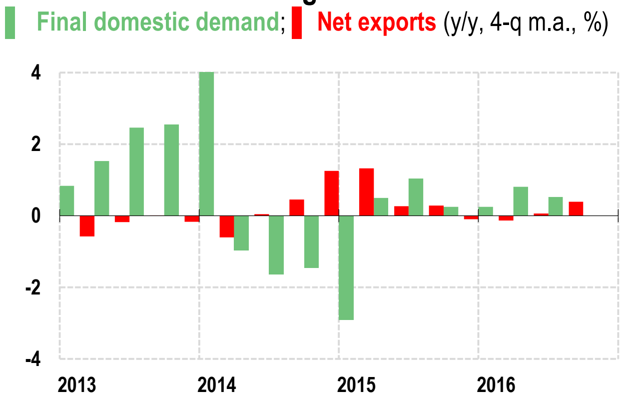

Chart 2 Source: Japanese Cabinet Office

Structural challenges

Japan's recent performances are noteworthy given the numerous structural hindrances to growth. Japanese society is aging rapidly, and despite an increase in the labour participation ratio for the 15-64 age group, the growing proportion of seniors has led to a decline in the labour force.

Japan is also suffering from decades of under investment: gross fixed capital formation as a share of potential GDP declined by more than 14 points between 1990 and 2010, while productive capital has stagnated since 2009. In addition to these two specific problems, Japan, like the other advanced countries, has also been hit by dwindling productivity gains since the 2007-2009 economic and financial crisis. All in all, Japan's potential growth rate is virtually nil.

Heavy debt load that has to be nuanced

According to the IMF's most recent data, the public debt ratio stands at 248% of GDP. Net of assets, Japan's public debt is much smaller, but still very high at 125% of GDP. Yet we should not attach too much importance to these figures. First, Japan's debt is held domestically (non-residents hold only 10% of JGBs), and what are liabilities for some are assets for others: between 1980 and 2014, the net liabilities of the government sector increased by 130 points of GDP, while the net financial assets of Japanese households increased by 125 points of GDP.

Japan's public debt is not so much a matter of solvency, but a question of redistribution. Japan is still a net creditor, but more importantly, we should not forget that 35% of JGBs are now held by the BoJ, a proportion that should continue to rise in the years ahead, since the BoJ's plans for net purchases exceed the government's projected financing needs. It is also worth noting the relative stability of debt servicing as a share of spending (4.7% of GDP). The BoJ's new target ensures that the government will be able to continue borrowing at reduced rates.

The average maturity of Japanese debt is currently a little more than 8 years, and the yield on securities maturing in 8 years is -0.19%. Without changing its debt management policy, the Japanese government will continue borrowing at a rate below its nominal potential growth rate. Moreover, this spread is bound to widen as the BoJ approaches its inflation target. This means the apparent debt rate, currently at 0.95%, would narrow even further, thereby improving the sustainability of debt.

BoJ: wisely irresponsible

The success of Abenomics depends largely on the effectiveness of BoJ policy. Rather than jump to the conclusion that the monetary arrow has been used disproportionately, we can better understand the central bank's activism. What is crucial today is its capacity to raise inflation expectations, a challenge the BoJ willingly admits. The credibility of new measures is an essential factor, notably the stated goal of overshooting the 2% inflation target for as long as necessary.

Some may have preferred the bank to announce a new inflation target – 4% for example – as this would be synonymous with an irreversible increase in money supply. The BoJ has chosen not to be so specific, at least for the time being. Although we cannot be certain, we can imagine that the BoJ is worried about its credibility, which might be lastingly damaged if it were to fail to reach an overly ambitious target, the realisation of which also depends on such exogenous factors as energy prices and the yen's external value. There will always be time to specify a new target later, should that prove to be necessary.

Just as welcome, if not more so, is the announcement that the next consumption tax hike would be postponed from April 2017 to year-end 2019. We would even encourage further fiscal "irresponsibility", as long as it is conditioned on the BoJ respecting its inflation target, and the government abandons its increasingly unrealistic target of generating a primary surplus by 2020. It would simply suffice to admit that the debt problem is not one, or at least, that it can best be resolved by pulling out of the deflationary spiral.

Yen, real effective exchange rate

2010 = 100

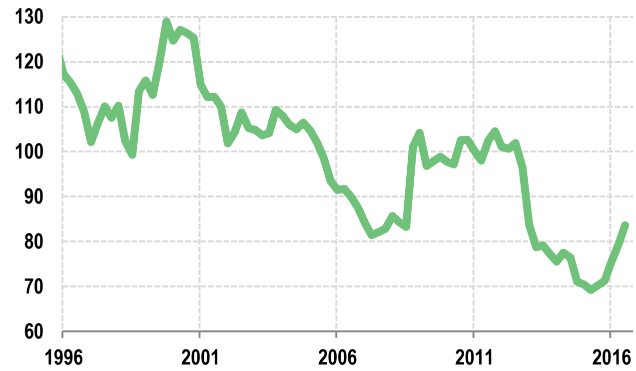

Chart 3 — Source: Bank of Japan

Public finances (% of GDP)

Gross government debt ; — Gross debt service

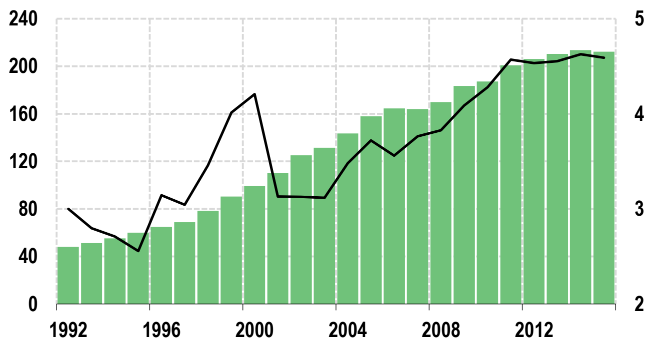

Chart 4 — Source: Japanese Ministry of Finance

Japanese yield curve (%)

November 24th, 2016

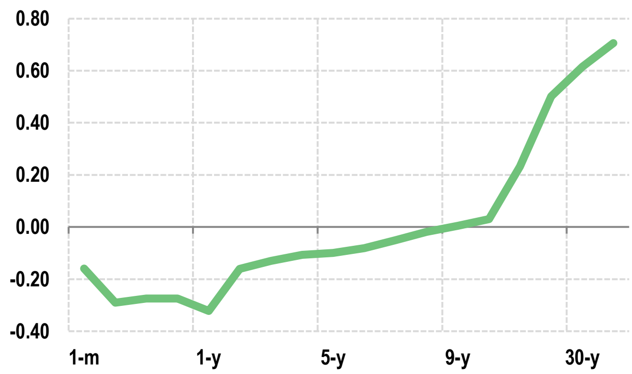

Chart 5 — Source: Macrobond