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Abenomics: A New Beginning or a Black Swan?

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OVERVIEW

Bottom line: Abenomics had an impressive start, but the structural reform agenda has bogged down, raising questions about whether macro policies alone can float the Japanese economy. Against the backdrop of geopolitical tensions with China and entrenched interests at home, now could be the time to go short on the Japanese economic miracle.

Why the new pessimism about Abenomics? Launched to fanfare late last year, the policy's three "arrows"—monetary, fiscal, and structural—delivered impressive early returns. Growth rose above 2 percent from April to September, equities soared 50 percent between November and May, and a weaker yen boosted export competitiveness. But recent concerns over the government's commitment to structural reform, anxiety about a possible fiscal cliff in 2014, and rising political tension with China have dampened sentiment. Some analysts have even suggested that a Japanese debt crisis is an underappreciated potential black swan event for the global economy over the next few years.

At the core, these developments confirm the limits of macroeconomic policy. Abenomics' shock easing of monetary policy, reinforced by a convincing commitment that policy will remain easy, was a clear and substantial break with the past. In parallel, a necessary and appropriately gradual rebalancing of fiscal policy allows the government to begin the process of consolidation while continuing to provide insurance against future downturns. Together, these macroeconomic policies will ensure a strong cyclical recovery. However, the trend growth rate of an aging and sclerotic Japan is unlikely to improve without effective structural reform. And, absent that change, sentiment may sag and an overwhelming government debt is likely to drag on economic performance.

ARROW ONE: STRAIGHT AND TRUE

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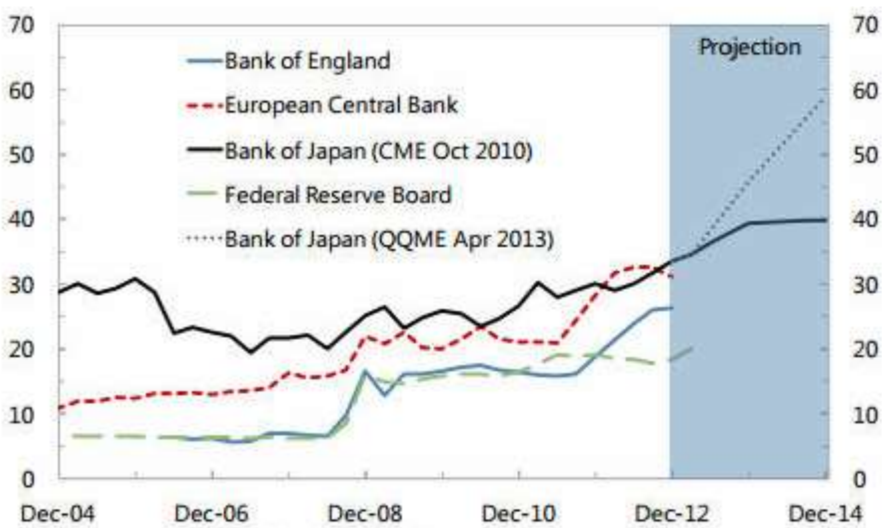
Early optimism was clearly driven by monetary policy, the first of the three arrows highlighted by Prime Minister Shinzo Abe. The monetary policy arrow represented a sea change in policy: a commitment to eliminate decades of deflation and restore growth through unconventional monetary policy. The centerpiece of the policy was a commitment by the Bank of Japan (BOJ) to "two-by-two-by-two": inflation of two percent through a twofold increase in the balance sheet of the central bank (in effect, doubling the money supply) in two years (see Figure 1). The announcement combined an easy-to-understand commitment with a promise to keep rates low until the target is achieved—powerful "forward guidance" in the language of modern central banking. The promised monetary stimulus will not guarantee, by itself, the demand required to sustain 2 percent inflation, and recent BOJ minutes show concerns that household incomes are not keeping pace with higher consumer prices. Ultimately, success of the reflation agenda will depend on higher wages and incomes, overcoming opposition from business groups, and entrenched deflationary expectations. Officially, the Bank of Japan remains optimistic that inflation will pick up, based on a wage round that is underway and will be subject to a fair degree of moral suasion. There are good reasons to be skeptical about this rosy outlook, but there's also comfort in the fact that if inflation does not meet expectations, the Bank of Japan will buy more assets of longer duration and maturity than previously envisaged. The BOJ's own version of "do whatever it takes" remains the core building block of Abenomics. In return for this promise, Japanese corporations will need to deliver on wages.

FIGURE 1. CENTRAL BANK BALANCE SHEETS (IN PERCENT OF GDP)



Source: Estimates from the central banks and IMF; CME 2010 was BOJ's cumulative monetary easing exercise.

Note: The BOJ's April 2013 forecast breaks with the past and may outperform other central banks.

ARROW TWO: SPEED BUMPS, NOT CLIFFS

The second arrow of Abenomics, fiscal policy, remains a complex story. On one hand, a central tenet of the policy is fiscal consolidation over the medium term to reduce gross government debt that now stands at over 240 percent of gross domestic product (GDP). A gradual increase in the value-added tax (VAT) was the prime tool of that adjustment, which also advanced a structural agenda to shift the burden of taxation away from income and toward consumption. Conversely, fiscal stimulus at the start of Abenomics was a critical buffer for growth, ahead of the planned first increase in the VAT in spring 2014.

Given concerns over debt sustainability, the decision to front-load fiscal stimulus was always a risky move and complicated the timing of a shift toward fiscal restraint. Prime Minister Abe's decision to go ahead with the consumption tax hike as scheduled similarly was contentious; market experts expressed concern about the effects of too-rapid fiscal consolidation on the recovery. In the end, the decision to go ahead with the hike and offset a portion of the resulting fiscal drag with discretionary stimulus looks to have struck the right balance between support for the recovery and long-run fiscal stability. The Observatory Group has a neat dissection of concerns that Japan faces a fiscal cliff in 2014. Their bottom line is a modest fiscal contraction in 2014, on the order of 1 percent of GDP.

ARROW THREE: MUCH ADO ABOUT NOTHING (YET)

While recent news suggests the monetary and fiscal arrows remain on course, the news is not so good for the structural agenda. Several early efforts saw setbacks: a recent draft proposal for removing a ban on sales of over-the-counter drugs fell short of expectations, prolonging restrictions on more than two dozen popular medicines (in some cases permanently). A taxi reregulation law and slow progress on national economic zones—hinting at past unsuccessful government efforts—have also raised concerns. Further, proposals for labor market and agricultural reform appear to have stalled. On the labor side, the government is targeting an increase in female labor-force participation, a laudable long-term goal that policy is likely to affect only gradually. The government also continues to place high importance on the successful conclusion of the Trans-Pacific Partnership (TPP) with eleven other countries, including the United States, which is scheduled for agreement by year-end. But that agreement appears likely to be delayed, or watered down in areas such as agriculture that are crucial to Japan.

A realistic assessment of the record must acknowledge that structural changes in the Japanese economy are usually the result of custom, not law. Consider, for example, proposed changes in the law to make it easier to hire and fire workers. Significant legal changes now look unlikely, and even if laws are passed, the rigidity of the labor market in Japan, reflecting custom and reinforced by culture, makes it difficult for firms to lay off workers. If Abenomics transforms labor markets, it will be because of the signals it sends that times are changing, rather than the literal change in laws.

It is often said that structural reform of the Japanese economy to raise trend growth is the most critical to the long-term success of Abenomics. Though these reforms will have a limited impact on economic performance in the near term (that is the realm of macro policies), the debt dynamics will not be sustainable unless there is a material increase in the growth rate over time. Conversely, for those who believe that debt sustainability concerns are overblown because, for example, the debt is owned primarily by the Japanese themselves, a weak performance on the structural agenda may not be a devastating blow to the

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program.

Robert Feldman of Morgan Stanley sees the recent slippage as the result of complacency as the government shifts its focus away from economics and toward security issues. Noting the recent decline in Prime Minister Abe's support to below 50 percent, Feldman looks toward an end to the complacency phase and wonders how long and deep the crisis will be before the prime minister responds with a renewed economic focus.

LOOKING AHEAD

It is almost a year since the world woke up to the prospect of Abenomics transforming Japan. Its success in bringing back inflation and boosting demand has been transformative. If success is measured by those criteria, Abenomics gets high grades, though it will present risks for policymakers globally. However, the hard choices on the structural agenda remain, and the government will need to show more courage than it has demonstrated recently.

Coming against the backdrop of weak global growth, Abenomics could contribute to already strong tensions within the G20 about competitive depreciation, intervention, and capital controls.

Markets seem largely unworried by the recent setbacks. After stalling out during the fall, Japan's equity market rose 6 percent in the last two weeks as the yen resumed depreciating against the U.S. dollar. Gains were led by financials and exporters and are most likely to benefit from improved trade prospects. The yen depreciated by around 3 percent, ending just above the 102-yen-per-dollar level for the first time since early September. Foreign purchases of domestic bonds have returned to levels recorded this summer.

One explanation for benign market conditions is the argument that all that matters in the short term is monetary policy. For hedge funds in particular, a long-Nikkei/short-yen trade has worked well, and expectations that the BOJ will ease monetary policy further, possibly at a time when the Fed is cutting back on its stimulus (i.e., tapering), is reason enough for cheer (and for pushing speculative yen shorts to three-year highs). Another more subtle argument, as noted earlier, is that markets assume that Japan's high level of debt—and the constraints on policy it imposes—are less severe than the numbers suggest because of the high degree of domestic ownership. The argument goes that Japan can work out of its debt problems through a managed process of financial repression, lowering real returns on government assets to maintain a sustainable debt profile. That may be the case, but a crisis can materialize quickly if the assumption that domestic investors are willing to accept negative real returns proves false.

Is Abenomics the "black swan" of 2014? Probably not. But structural reforms are likely to disappoint and the pressure will then shift to the BOJ to do more. A further easing of monetary policy will be a positive for growth, but means a weaker yen. At some point, coming against the backdrop of weak global growth, such policies could present global concerns and contribute to already strong tensions within the G20 about competitive depreciation, intervention, and capital controls. All this suggests that it could be an interesting 2015.

Looking Ahead: Kahn’s take on the news on the horizon

Fed Revisits Taper
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Emerging Market Debt
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European Revival
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