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Abenomics's Solitary Arrow: Easy Money

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OVERVIEW

Bottom Line: Many experts hope that December snap elections will reenergize Japan's structural-reform agenda, but the barriers to implementation remain high. Without progress on this "third arrow" of Abenomics, growth will remain almost fully dependent on easy money, intensifying global currency tensions in 2015.

Most analysts are optimistic that this month's elections in Japan could represent a turning point for the faltering Japanese economy. They argue a strong showing by Prime Minister Shinzo Abe's Liberal Democratic Party (LDP) will provide a clear mandate to reinvigorate Abe's structural-reform agenda. Indeed, the polls recently have moved in the LDP's favor, and now suggest that the government could win well over three hundred seats in the lower house of parliament, nearly a two-thirds majority (the party currently holds 294 seats). Should Abe make economic reform a priority, he appears to have a mandate to make significant progress.

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Recall that structural reform was the ambitious third arrow of Abenomics, complementing monetary policy (the first arrow) and fiscal consolidation/reform (the second arrow). The government was committed to agricultural reform as part of a Trans-Pacific Partnership (TPP) agreement, as well as comprehensive labor and product market reforms. Many other governments, as well as market participants, linked their support for Abenomics to this third arrow in hopes of a supply-side effect that would allow a sustained increase in growth. To date, though, little has been accomplished.

Given the continuing vested interests and political impediments to reform, my concern is that, though the government will "wave the flag" of structural reform in the coming months, the focus will quickly turn to domestic constitutional reform of the electoral system and regional defense concerns, sapping the energy behind economic reform.

The fiscal arrow, in contrast, aimed to restore fiscal sustainability through upfront stimulus coupled with a multistage increase in the consumption tax. However, following weak growth numbers, the consumption tax has been delayed (though the government has committed to an increase in 2017). Although that makes a lot of sense on cyclical grounds, the government will still need to worry about fiscal credibility with government debt already in excess of 250 percent of gross domestic product (GDP).

In that case, what is left to drive economic growth? Abenomics, which generated strong support based on its comprehensive three-arrow approach, would be reduced to a single arrow—aggressive monetary easing.

A SEA CHANGE FOR MONETARY POLICY

Japan's monetary policy is indeed extraordinary. At the end of October, by a five-to-four vote, the Bank of Japan (BOJ) surprised nearly everyone with a dramatic expansion of its unconventional monetary policy, citing renewed risks of deflation. If the program is fully implemented, bond holdings will be over 40 percent of GDP,

adjusting for duration of the debt purchased, which is more than twice the size of the Federal Reserve's three quantitative easing programs between 2008 and 2013. For a small, open economy such as Japan's, easier money works in large part through the exchange rate. I would not argue that the central bank is aiming for exchange-rate depreciation, but at play is a central bank that—while motivated by domestic considerations—is taking advantage of the Fed's turn toward normalization to make a dramatic move that ensures a substantial market impact by emphasizing the divergence of policy.

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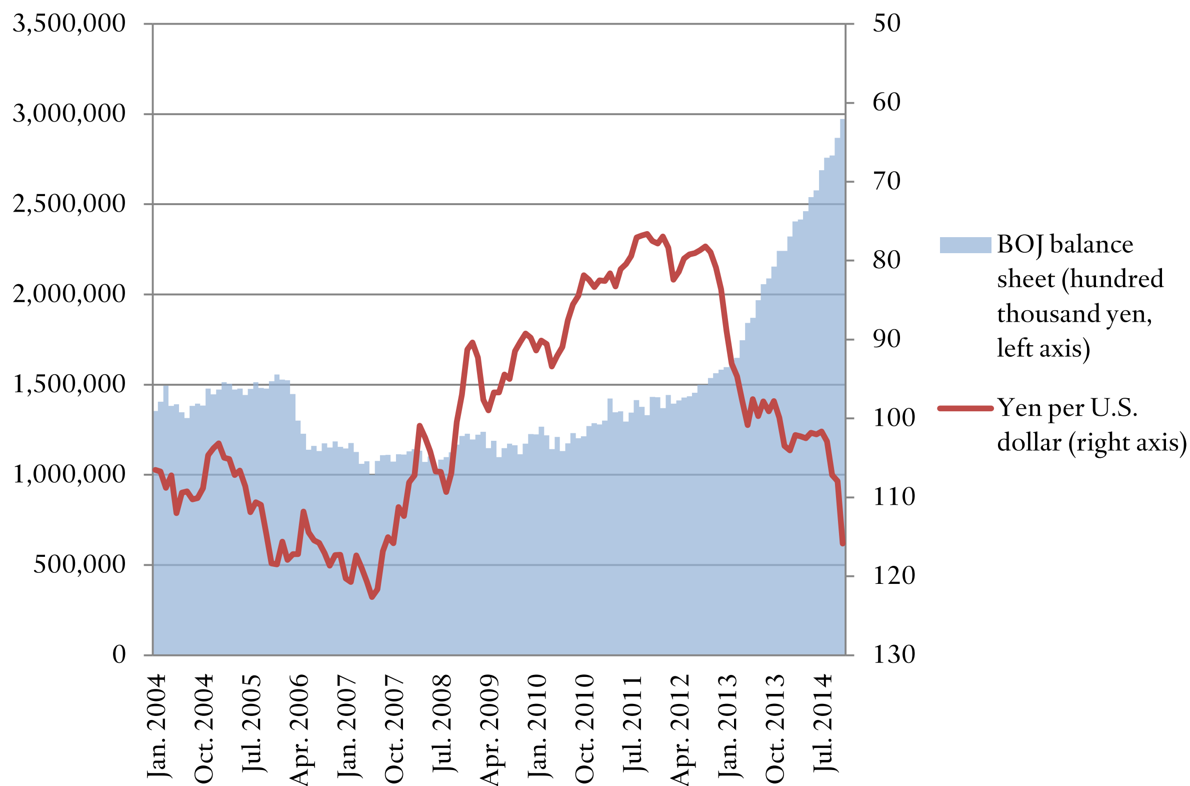
As shown in Figure 1, the yen's recent moves closely track movements in the Bank of Japan's balance sheet. Japan has experienced sharp fluctuations in the past and there is reason to believe this time will be no different. Although some market commentators would argue that investors are already stretched, holding substantial investments that would do well in the case of a yen depreciation, from a fundamental perspective there is still some way for the yen to fall if the BOJ meets its asset-purchase targets.

Still, Japan faces an uphill battle to reach its inflation target. A sharp and continuing decline in retail gasoline prices in yen, as well as the deflationary effect as the earlier consumption-tax hike wears off, has by some measures reduced underlying inflation to below 1 percent.

FIGURE 1: THE DOLLAR–YEN EXCHANGE RATE AND THE BANK OF JAPAN'S BALANCE SHEET



Source: Bank of Japan; Oanda.

EXCHANGE-RATE INTERVENTION

In a coordinated announcement, the Japanese Government Pension Investment Fund (GPIF) announced a shift away from government bonds and toward equities, both domestic and foreign, doubling the share of equities to 50 percent. As a general rule it is not such a good idea to use government wealth funds as an instrument of monetary policy in this way: insurance and savings for future generations should be insulated from the short-term decisions that drive monetary policy. However, given that government policy has skewed previously toward support of the bond market, it can be argued that this is a good move from a longer-run perspective, and it does arguably strengthen the near-term wealth effects of quantitative easing. But it is worth highlighting that from an economic perspective, combining monetary easing with foreign asset purchases is the same as directly intervening in exchange markets, something the Group of Twenty (G20) has clearly opposed.

In the context of weak global demand, it is unclear how Japan's trading partners will respond to a sharp and continuing depreciation of the yen. To date, a number of Japan's Asian trading partners have expressed concern, but we have not seen significant moves or the advent of a "currency war." Credit is due to the Chinese government, which has held fire so far. But, amid softening domestic demand (the Chinese government this week lowered its growth target to 7 percent, despite substantial stimulus), any move by China to moderate the pace of renminbi appreciation against the dollar or other currencies as a response to the yen's move would likely trigger a chain reaction in the region. Europe also will be watching the yen's move closely. Although there are good reasons close to home for the European Central Bank to ease monetary policy, on the margin the Japanese move contributes to deflationary pressures in Europe.

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The United States is in a different position. Trade is a relatively small share of its economy, and so even a material appreciation is unlikely to undermine the strong growth outlook and continued strengthening of the labor market. So why worry? Indeed, U.S. policymakers appear broadly supportive of Japanese monetary policy, and see stronger growth in Japan, however achieved, as a positive contribution to the global outlook.

The problem is as much political as economic. A sharp appreciation of the U.S. dollar against its major trading partners, driven by expectations that the Federal Reserve will begin to normalize policy while others ease, is bound to be contentious. There could be particular ramifications for trade. Congress is likely to produce a bill granting the president trade promotion authority (TPA), which is essential for any meaningful agreements on TPP or other trade negotiations underway. This case for bipartisanship on this issue is based on the historical Republican support for free trade, and recognition that Democrats have been the primary hurdle to passage of free trade agreements to date. Perhaps optimism is justified, but do not underestimate the risk that negotiations could go off track. In the past, both parties have pressed for tough language requiring any trade deal to address exchange-rate misalignments, and that pressure is likely to mount if dollar strength is seen as a risk for the economy. Such exchange-rate language could be a dealbreaker, as it is hard to see Japan or other U.S. trading partners making the tough concessions needed to agree to these conditions.

There is much to commend the Bank of Japan for as it reverses decades of orthodox policy in order to jump-start growth with aggressive monetary easing. But relying on only one arrow presents both economic and political risks at home and abroad. Let us hope that optimism about the structural arrow proves correct.

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

Draghi needs to start acting
European Central Bank (ECB) President Mario Draghi has been promising to do whatever it takes to restore growth and achieve price stability, and needs to deliver now, beginning with the ECB's December meeting.

Greek elections loom
Snap elections highlight Greece's continuing economic challenges and could reinvigorate a debate over the adequacy of Europe's crisis response.

Cheap oil burns holes in government budgets
Falling oil prices are putting significant pressure on a number of exporters' government finances, including Russia, Venezuela, and Nigeria.