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Abenomics and Its Aftermath

After many years of stagnation and deflation, Japan's economy has shown signs of life in the year that has passed since Shinzo Abe — and his broad economic plan dubbed "Abenomics" — was swept into the prime minister's office in December 2012. Despite some positive indicators, including rising headline inflation, it remains unclear whether Japan will be able to overcome its "lost" decades.

Upon returning to office, Prime Minister Shinzo Abe and the Bank of Japan (BOJ) introduced a new set of policies with the ultimate objective of reviving economic growth and overcoming deflation. Abenomics consist of three components, described as its "arrows": 1) monetary policy, 2) fiscal policy and 3) structural reforms designed to induce private

investment and improve productivity. JGB yields became very volatile immediately after the BOJ's April 2013 announcement of its asset-purchase program, but that volatility has diminished notably and yields since have been range-bound and remain quite low. Japanese equity indexes performed remarkably well last year, surging more than 50% in yen terms. Meanwhile, after years of overvaluation the Japanese yen depreciated notably following the announcement of various measures that go under the rubric of Abenomics.

This article describes the prelude to Abenomics and its three arrows. It also assesses its achievements and risks, and urges the authorities to undertake policies to rekindle aggregate demand.

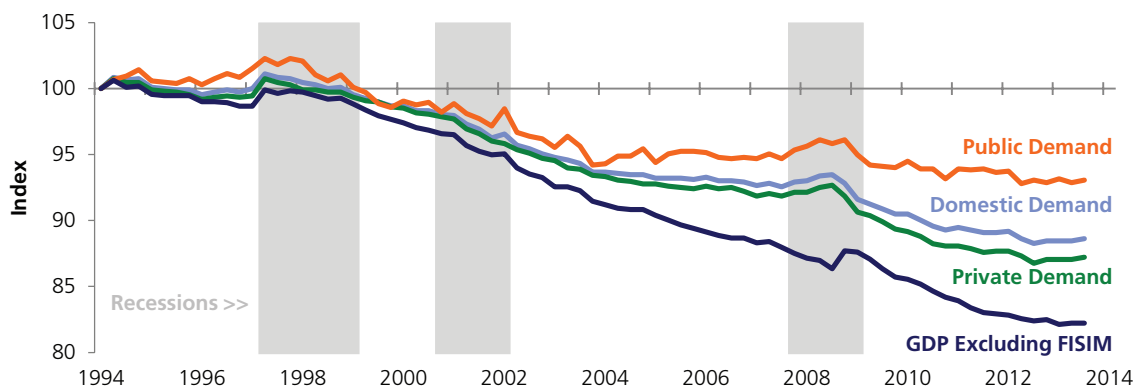
Figure 1. Since the Early 1990s, Japan Has Suffered from Abysmal GDP Growth...
Per Capita Real GDP Trend Growth Rates, %

	1960-1970	1970-1980	1980-1990	1990-2000	2000-2010	2010-2012	1990-2012
Canada	3.5	2.6	2.0	2.1	0.9	1.0	1.7
Germany	n/a	2.8	2.2	1.3	1.1	1.9	1.3
France	4.3	2.9	1.8	1.5	0.6	0.5	1.2
U.K.	2.3	1.9	3.0	3.1	1.3	-0.1	2.2
Italy	4.6	3.3	2.5	1.5	-0.2	-1.4	0.7
Japan	8.1	3.0	3.9	0.7	0.8	0.6	0.7
U.S.	3.5	2.2	2.7	2.3	0.9	1.5	1.7

Source: World Bank, Reuters EcoWin, ING U.S. Investment Management

Note: GDP trend growth rates in U.S. dollars at constant 2005 prices.

Figure 2. ...and Deflationary Pressures



Source: World Bank, Reuters EcoWin, ING U.S. Investment Management

Note: 1994 = 100; FISIM = Financial intermediation services indirectly measured.

The Prelude to Abenomics

It will be useful to quickly review some facts about Japan’s lost decades before examining three arrows of Abenomics. The Japanese economy has been mired in subdued growth and deflation, which in turn has resulted in large and chronic fiscal deficits that have led to elevated and rising ratios of government debt to national income.

Japan’s economy stagnated for more than two decades following the collapse of its asset bubbles in the early 1990s. Between 1990 and 2012 Japan experienced the slowest growth in per capita real GDP, measured in 2005 constant U.S. dollars, among the G-7 countries (see Figure 1). The economy has been under deflationary pressures as measured by various implied price deflators despite accommodative monetary policy (see Figure 2).

Japan’s tepid growth during the lost decades is due to both the slowdown of labor force growth and lower labor productivity growth, as shown in Figures 3 and 4 below. Figure 3 compares trend growth rates of real GDP growth, employed labor force and labor productivity in Japan and the U.S., showing that Japan’s growth slowed due to the combination of a rapid decline in labor force growth and a sharp falloff in labor productivity growth. Japan’s labor force growth had started slowing since the beginning of the 1990s and has been shrinking since the turn of the century. Figure 4 shows that Japanese manufacturing labor productivity growth, measured in terms of both trend growth in output per hours worked and output per employee, has slowed since the 1980s. This slowdown in manufacturing productivity growth stands in contrast to its post-war high-growth decades. Japan’s labor productivity growth in manufacturing also slowed during the 1990s and the 2000s in comparison with the higher growth in labor productivity in manufacturing in the United States during the same period. The tepid pace of productivity growth in Japan should be placed in the context of weak aggregate demand, declining real wages and stagnant real disposable income.

Abenomics and Its Three Arrows

In response to weak growth in past two decades, the Japanese authorities eased monetary policy, increased government spending and introduced various structural reforms, but often haphazardly and

incrementally. However, each time the economy began to recover, the authorities raised taxes in order to reduce the government deficit. As a result, growth never quite took off.

Abenomics is a response to decades of policy failure. It consists of three components, or “arrows”: 1) accommodative monetary policy, 2) fiscal stimulus followed by consolidation and 3) structural reforms to revive growth. The authorities have stated that they want to undertake these measures simultaneously, strongly and quickly.

Monetary policy. The Abe government appointed Haruhiko Kuroda, a proponent of accommodative monetary policy, as the new governor to the BOJ in February 2013. In early April 2013 the BOJ announced a program of Quantitative and Qualitative Monetary Easing (QQME), a series of measures designed to achieve its target of 2.0% year-over-year inflation rate within about two years.

As part of the QQME, the main operating target for the BOJ’s money market operation was changed from the uncollateralized overnight call rate to the monetary base; the monetary base is expected to double within two years, rising to ¥270 trillion by the end of 2014 compared to ¥138 trillion at the end of 2012. The BOJ also announced that it would increase its purchase of Japanese government bonds (JGBs) by about ¥50 trillion per year and extend the maturity of its JGB holdings with the aim to reduce interest rates across the yield curve. The BOJ’s holding of JGBs, hence, is expected to slightly more than double within a span of two years, rising to ¥190 trillion by the end of 2014, markedly up from its holding of nearly ¥90 trillion at the end of 2012. It would also more than double its holding of exchange-traded funds (ETFs) within two years, while increasing its purchase of Japan real estate investment trusts (J-REITs) to about ¥30 billion per year. The BOJ has stated that it will continue its program of QQME as long as it is necessary to achieve its 2.0% inflation target.

Fiscal policy. Fiscal spending was increased substantially in 2013, supporting economic activity, while at the same time the authorities announced their intention to raise consumption tax in the coming years. Consumption tax is set to rise to 8% in April 2014, from 5% currently, and to 10% in October 2015. The increase in fiscal spending follows the ruling Liberal Democratic Party’s (LDP)

Figure 3. Soft Japanese Labor Metrics Have Dragged Down Economic Growth

	Real GDP Growth (%)		Labor Growth (%)		Labor Productivity Growth (%)	
	Japan	U.S.	Japan	U.S.	Japan	U.S.
1980-1989	4.4	3.6	1.1	2.0	3.3	1.6
1990-1999	1.1	3.4	0.3	1.5	0.8	2.9
2000-2011	0.7	1.6	0.0	0.3	0.7	1.3

Source: Reuters EcoWin, ING U.S. Investment Management

Figure 4. Manufacturing Labor Productivity Has Lagged That of the U.S.

	Output Per Hours Worked (%)		Output Per Employee (%)	
	Japan	U.S.	Japan	U.S.
1950-1959	8.1	1.8	8.8	1.6
1960-1969	9.4	3.4	9.6	3.6
1970-1979	5.3	2.9	4.6	2.8
1980-1989	3.5	3.7	3.6	4.2
1990-1999	3.2	3.8	2.6	4.1
2000-2011	3.7	5.1	3.5	5.2

Source: Bureau of Labor Statistics, ING U.S. Investment Management

earlier pattern of spending for public projects, but it also includes reconstruction in tsunami-affected areas, repair of infrastructure and some new undertakings. There is ongoing debate in Japan on the effects of the proposed increases in consumption tax and whether various measures to offset the detrimental effects of consumption tax hike will be adequate.

Structural reforms. The third arrow of Abenomics consists of support for industrial revitalization, including restructuring, assistance for small and medium-sized enterprises, innovation, information technology and some labor market reforms, particularly incentives to raise labor force participation rates among female and elderly workers. It also is aimed at creating new markets in health care, energy, infrastructure, and the agriculture and fishing industries. Finally it emphasizes openness and globalization through support for regional free trade agreements, including the Trans-Pacific Partnership (TPP), both inward and outward foreign direct investment and the globalization of Japanese human resources.

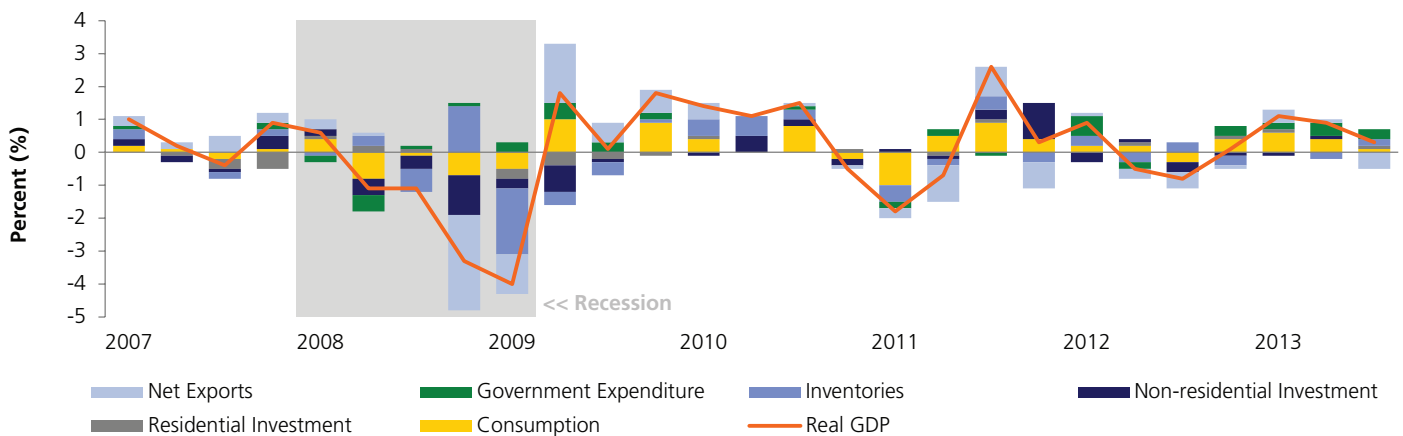
The structural reforms actually announced thus far, however, appear to be fairly timid. While there is considerable debate, there is neither consensus about the nature and the scope of structural reforms nor agreement on the priority for these measures.

The Effects of Abenomics

The introduction of Abenomics coincided with the improvement of the Japanese economy in 2013, with substantial monetary easing and fiscal stimulus and some rise in business and consumer confidence. The pace of growth has notably improved in 2013 due to increased public spending (see Figure 5) and other forms of domestic demand. Real exports picked up though did not contribute to growth, as real imports increased even more.

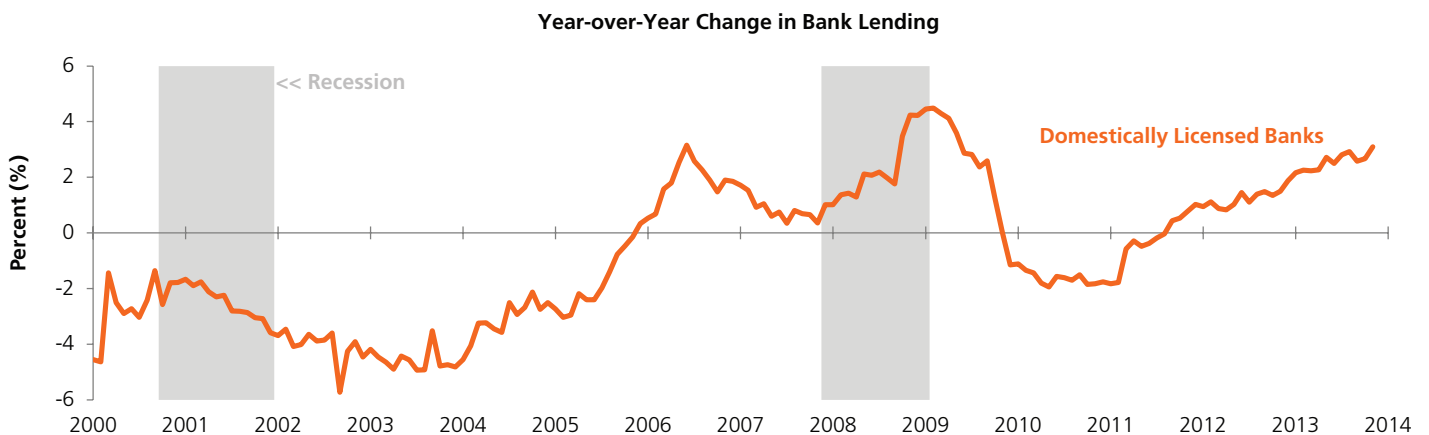
Bank lending started to pick up at a decent pace last year. Whereas in the past the high-powered monetary base rose without an increase in lending by domestic commercial banks, bank lending has been rising since the beginning of 2013 (see Figure 6). Lending to large enterprises has improved notably, though lending to small enterprises remains soft.

Figure 5. Fiscal Stimulus and Monetary Easing Helped Lift Growth in 2013



Source: Reuters EcoWin

Figure 6. Bank Lending Has Improved

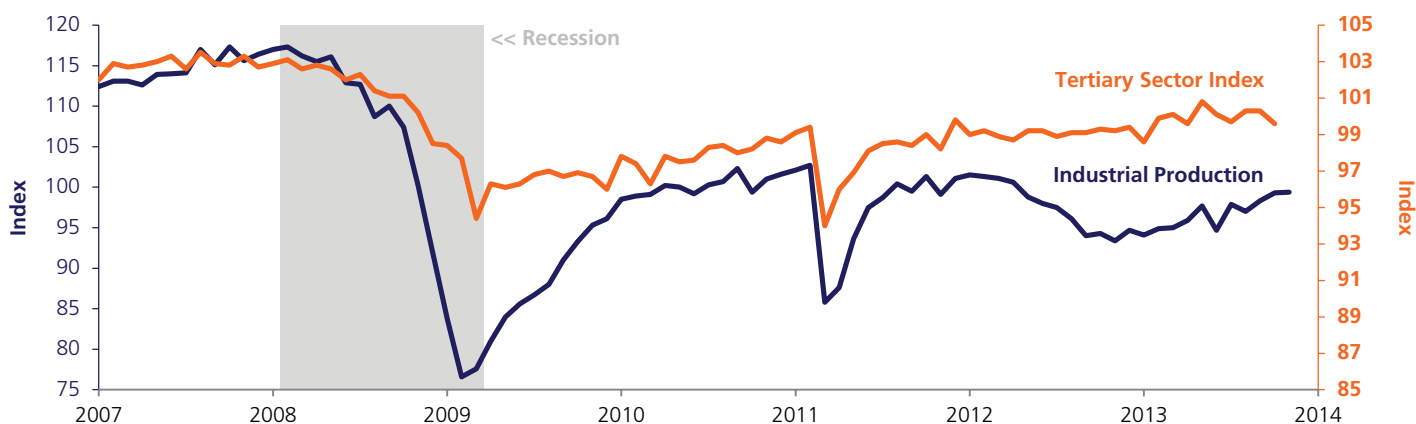


Source: Reuters EcoWin

Different from the typical post-war recoveries in Japan, the services sector has been leading the current recovery while industrial production remains soft (see Figure 7). Private consumption has risen, as has consumer confidence. The recovery in business fixed investment, however, has been fairly tepid so far (see Figure 8). Business conditions have improved in most regions of Japan, though the tsunami-affected Tohoku region has witnessed the least improvement in reported business conditions, according to the BOJ's September 2013 survey. Tokyo's successful bid for 2020 Olympics has provided a psychological lift, though it is far ahead in the future and the overall economic benefits will be fairly limited given Tokyo's already-excellent infrastructure.

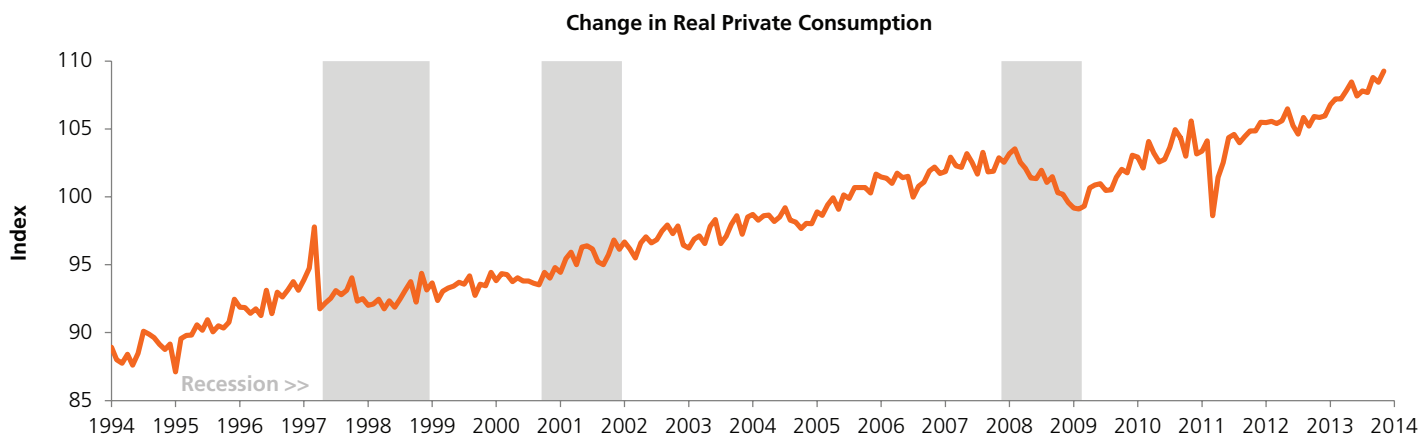
In the past, the economy tumbled whenever consumption taxes were raised to lower the deficit. The authorities believe that this time will be different and consumers will not be spooked by the prospects of planned higher sales taxes (slated for increases in April 2014 and October 2015). Corporate taxes, meanwhile, will be reduced. In total, the amount collected under the higher sales tax is expected to exceed the decline in corporate taxes, resulting in an overall increase in tax revenue. However, this analyst remains somewhat skeptical about the benefits of increasing sales taxes while the economy is still in a nascent recovery phase.

Figure 7. As Industrial Production Languishes, the Service Sector Is Leading the Recovery



Source: Reuters EcoWin

Figure 8. Private Consumption Has Risen Gradually



Source: Reuters EcoWin

Note: 2005 = 100.

The labor market has improved in recent months. The unemployment rate has declined slightly, while the ratio of active job openings to applications has risen. Firms have started to hire after several years of sustained cuts in payroll employment (see Figure 9).

Markedly weak during Japan's lost decades, employees' income has begun to improve recently (see Figure 10), as compensation and bonuses in some private industry, particularly in large multinational corporations, has risen. Public sector compensation, however, remains unchanged. Through the spring, it will be crucial to monitor compensation and any signs of increase in real disposable incomes that would create the basis for a sustained economic recovery.

The depreciation of the yen has had a favorable effect on the export sector. Not only has the yen depreciated with respect to the dollar, the nominal effective exchange rate (NEER) and the real effective exchange rate (REER) of the yen also has depreciated (see Figure 11). This has helped the export sector and large enterprises. However, the positive impact of yen depreciation on the domestic economy and domestic-focused enterprises has been limited. Indeed, input costs — particularly energy costs — have risen notably, and profit growth has been soft in the domestic industry.

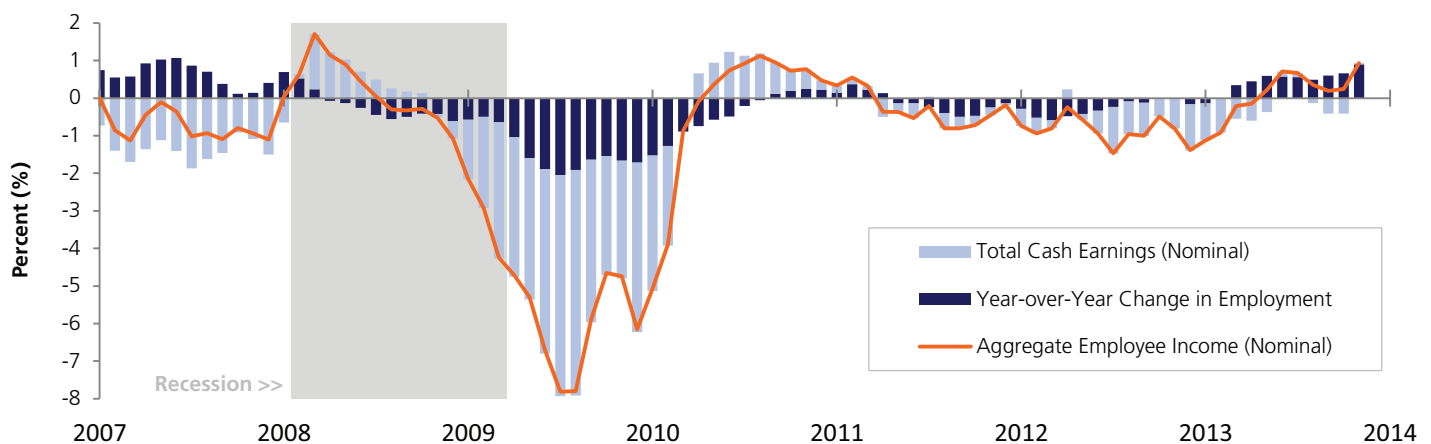
Inflation has risen since the beginning of 2013. However, while headline CPI and core CPI (excluding fresh food) have risen, core-core CPI (excluding both food and energy) is still low (see Figure

Figure 9. Job Growth Has Resumed After Several Years of Losses



Source: Reuters EcoWin

Figure 10. Aggregate Employee Income Began to Rise in 2013



Source: Reuters EcoWin

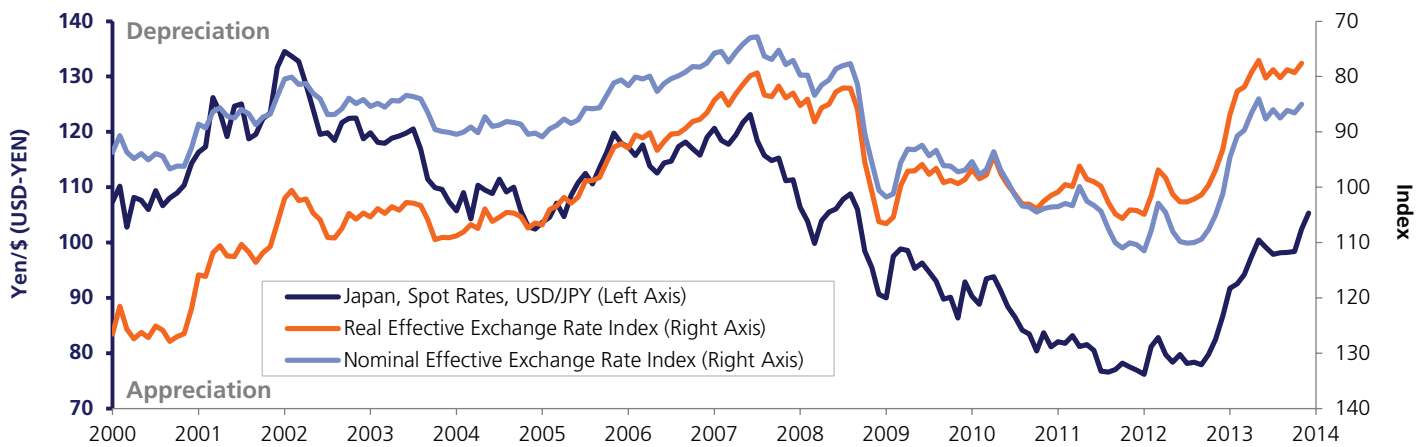
12), suggesting that deflationary pressures persist, if less severely. The limited pass through from a weaker yen to inflation has already occurred. Expectations of a slight increase in inflation have risen in recent months, as most households expect inflation will tick up in the coming year. But without a sustained increase in wages, the BOJ's target of 2% sustained inflation will prove difficult.

Bilateral trade between Japan and China has been steadily increasing in recent years (see Figure 13), and Japanese direct investment in China has also been growing. Japan's relationship with China has deteriorated due to the dispute over the Senkaku/Daiyou islands since 2012, when the Japanese government

purchased the islands from a private owner; this does not bode well for peace, security and stability in North Asia. It could also pose a serious risk to Japan's growth if its economic ties with China are jeopardized.

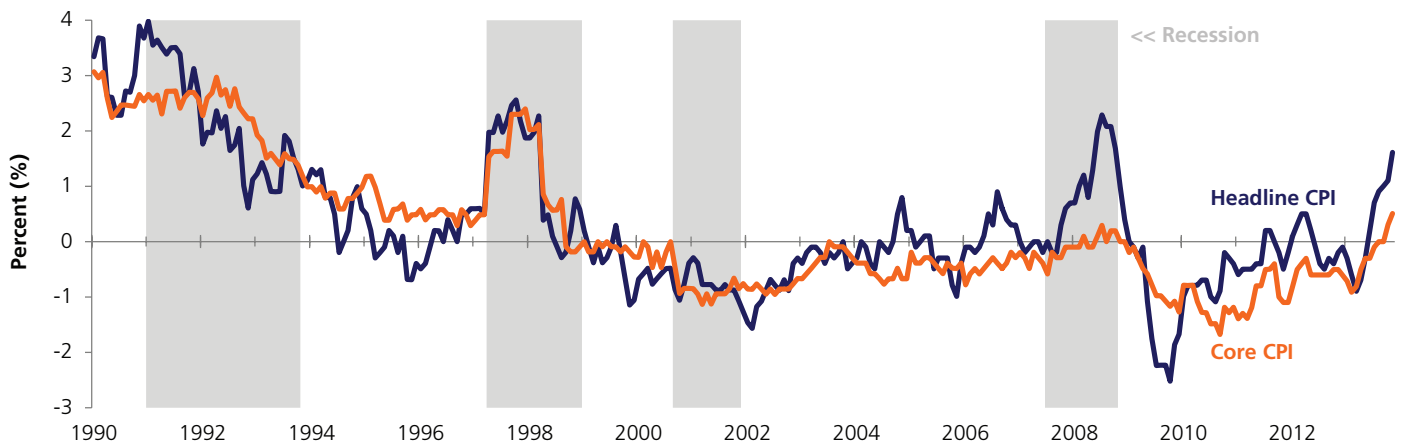
The BOJ is strongly committed to continue with QQME in pursuit of its 2% inflation target. The central bank has been expanding its balance sheet and its holding of JGBs (see Figure 14). The BOJ's Governor Kuroda has stated that "it is necessary for not only the observed inflation rate but also medium-to long-term inflation expectations to be about 2 percent." While Kuroda has reiterated the BOJ's commitment to achieving its inflation target in his

Figure 11. After Many Years of Overvaluation, the Yen Has Begun to Depreciate



Source: Reuters EcoWin

Figure 12. While Headline Inflation Has Picked Up, Inflation ex Food and Energy Remains Weak



Source: Reuters EcoWin

Note: 2005 = 100.

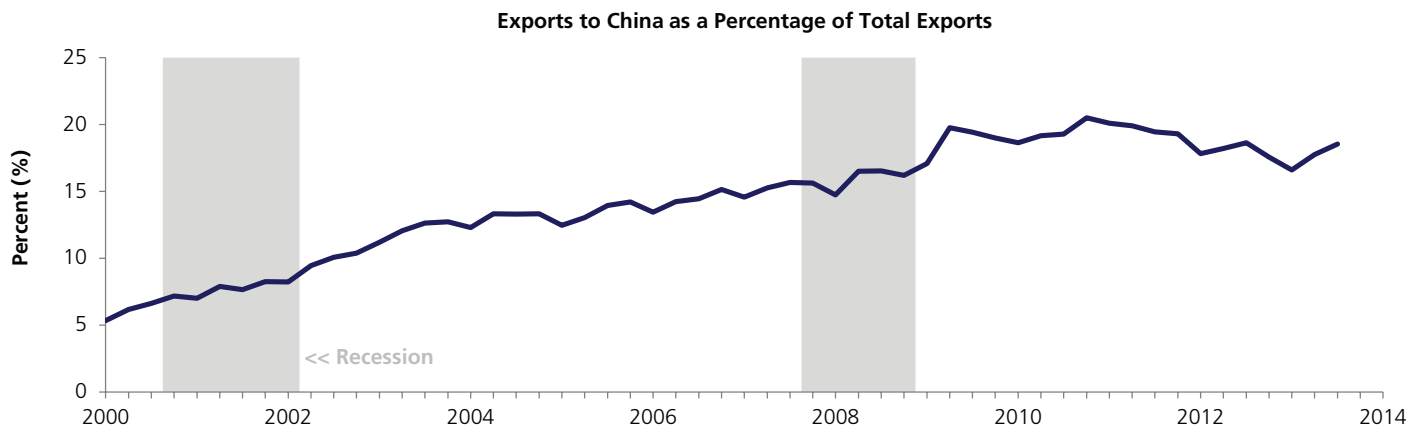
speeches, Japan’s experience in the past two decades shows that easy monetary policy without effective fiscal policy does not end deflation.

Policy Challenges Ahead for Japan

Even though growth in 2013 was decent, it remains to be seen whether this can be sustained. In fact, the pace of growth is likely to slow going forward; Japan’s potential growth is low — merely 0.5% to 0.7% — mainly due to unfavorable demographics owing to declining population and labor force growth.

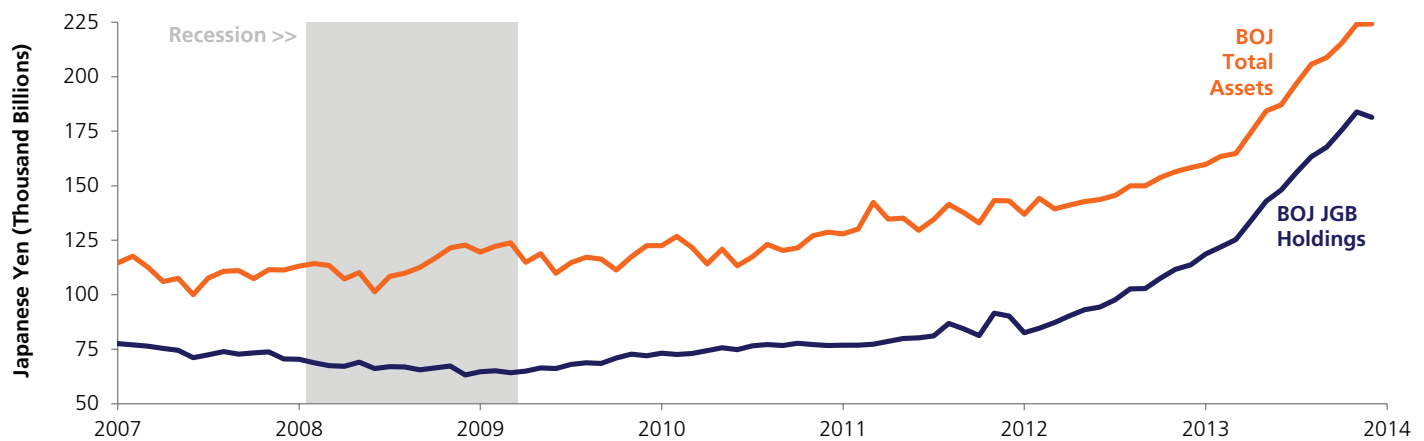
In order to rekindle growth the Japanese authorities should prioritize policies that strengthen aggregate demand, while recognizing that efforts to strengthen aggregate supply are secondary in importance. Increasing aggregate demand, real wages and real disposable income are the most important policy tasks. Indeed, increased aggregate supply of inputs and productivity without an ancillary increase in aggregate demand could lower real wages and real disposable income and raise the unemployment rate. Improving the efficiency, effectiveness and appropriateness of the public spending is important because public spending in

Figure 13. Given Deep-Seated and Increasing Trade Ties With China, Deteriorating Relations Is Alarming



Source: Reuters EcoWin

Figure 14. BOJ Is Committed to Expansionary Monetary Policy and Asset Purchases



Source: Reuters EcoWin

the past was often associated with political waste, patronage and corruption. The authorities may also want to undertake policies that could increase the efficiency of private investment. The key aims of public investment programs should be to improve productivity and open up new areas in production of goods and services for the private sector and support innovations based on Japan's comparative advantages. Public policies can also help reorient the country's energy infrastructure gradually away from nuclear power plants to safer forms of energy, reduce dependence on fossil fuels, encourage appropriate investment and raise energy efficiency.

Japan's destiny lies in peaceful coexistence and cooperation with its neighbors in emerging Asia; while intra-Asia trade and investment has flourished, Japan is also facing serious competition from Asian neighbors. Japan should seek to resolve disputes with its Asian neighbors through peaceful and diplomatic means. Strong growth in China and the rest of emerging Asia provides Japan with opportunities for trade, investment and the development of new markets. Vigorous growth in Japan in turn can lift growth in rest of Asia and indeed the rest of the world. Japanese needs pro-growth policies to rekindle aggregate demand. In 2014 and beyond, Abenomics alone may not be sufficient.

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