Economics

JP: Abenomics – one achievement, three challenges

DBS Group Research | 17 April 2013

- **Monetary easing has boosted sentiment and ignited financial markets. This lifts the short-term economic outlook**
- **Challenges remain longer-term. Creating new surprises in the financial markets will be difficult. The stimulus effects of equity price increases and yen depreciation can't last long**
- **Fiscal tightening will be unavoidable, not only due to the government's self-imposed target, but also due to market forces**
- **Comprehensive structural reforms won't be easy to push through**

Since winning the lower house election in Dec12, Prime Minister Shinzo Abe and his ruling LDP party have been pushing for economic stimulus policies, aimed at pulling Japan out from the two-decade long deflation and stagnation. Dubbed "Abenomics", the stimulus policies contain three pillars – monetary easing, fiscal stimulus, and structural reform.

One achievement

Aggressive monetary easing has been taken by the Bank of Japan. Under the new governor Haruhiko Kuroda, the BOJ announced "a new phase of quantitative and qualitative easing" on April 4th. The BOJ will double the size of base money in two years, from JPY 138trn in end-2012 to JPY 270trn in end-2014. The scale and the pace of easing are unprecedented. Since the global financial crisis in 2008-2012 (four years), the BOJ increased base money by only 45%. During the 2001-2006 QE episode, the BOJ boosted base money by 70% over five years.

The BOJ is also aggressive compared to the US Fed. The Fed tripled its monetary base between 2008 and 2012 (outstanding size: USD 2.7trn as of end-2012). By end-2014, the BOJ will also triple its monetary base versus 2008, and the size of base money will also equal to USD 2.7trn (JPY 270trn, assuming USD/JPY=100, Chart 1). Considering that Japan's economic size is only 1/3 of that of US, base money as a percentage of GDP in Japan will be three times of that in US.

Meanwhile, under the "quantitative and qualitative easing", the BOJ will lengthen the remaining maturity of its holdings of government bonds (JGBs) to an average of seven years in 2014, from slightly less than three years currently. This will be different from 2008-2012 when the BOJ mainly focused on buying short-term JGBs. Compared with the Fed, the BOJ will also catch up in terms of the composition of bond purchases – the average duration of the Fed's bond holdings is about ten years at present.

Moreover, the BOJ set a two-year timeframe for achieving the 2% inflation target at April's meeting. This sent a strong message to the markets and the public that the central bank is determined to end deflation. In the past, the

Ma Tieying • (65) 6878-2408 • matieying@dbs.com

Chart 1: Base money: BOJ to catch up with the Fed

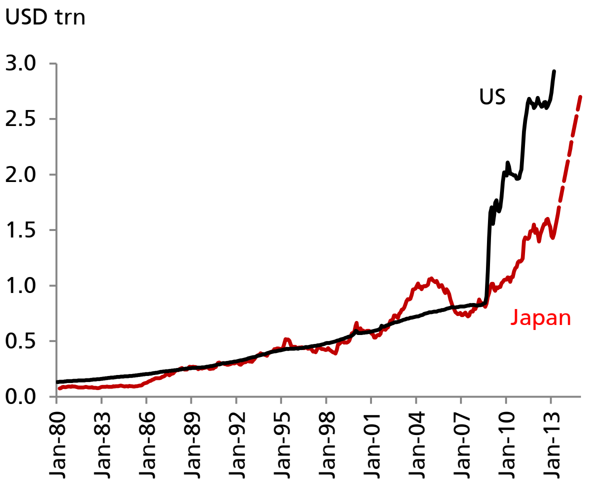
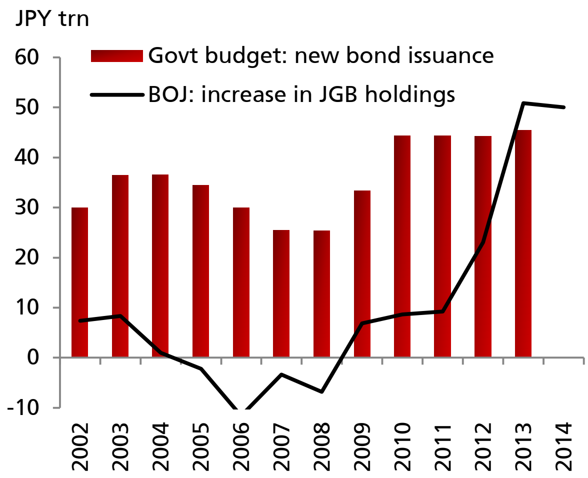


Chart 2: QE helps government financing



BOJ failed to convince people that it would succeed in overcoming deflation. When introducing the 2% "price stability goal" in Feb12, the central bank emphasized that 2% is a medium-to-long term goal and the short term target is 1%. In Jan13 when raising the inflation target to 2%, the BOJ only said it will achieve this target "at the earliest possible time". In fact, the former Governor Shirakawa often publicly expressed the view that deflation in Japan is related to structural economic weakness (thus the effectiveness of monetary policy is limited).

Thanks to the BOJ's stronger commitment to ending deflation and the implementation of aggressive QE, expectations have been boosted in the financial markets this time. Equity prices have risen and the yen has weakened. Compared to mid-Nov12, the Nikkei is up by 50% and yen is 20% weaker against the dollar. Financial market movements should offer a short-term boost to the economy, as the stock market rally generates positive wealth effects for consumers and the weaker yen benefits exporters.

Monetary easing also creates favorable financing conditions for the public and the private sectors. The BOJ's increase of JGB holdings this year (JPY 51trn) can fully cover the new bond issuances required by the FY2013 fiscal budget (JPY 45trn, Chart 2). In the private sector, there is also a hope for releveraging, should inflation expectations increase amongst consumers / businesses and real interest rates decline. Thanks to the deleveraging in the past two decades, the debt-to-asset ratio in Japan's corporate sector has fallen sharply to 63% from 80% in 1980s (Chart 3). The household debt-to-asset ratio of 23% and household debt-to-GDP ratio of 75% today are also lower than the comparables in the US (25% and 85% respectively, Chart 4).

Three challenges

1: Monetary policy reaches its limit

By pursuing quantitative and qualitative easing, the BOJ has already taken all the "necessary and possible" easing measures, as said by Governor Kuroda after April's policy announcement. Creating new surprises to financial market expectations and generating a new round of market rally will become increasingly difficult. The stimulus effects on the real economy as a result of equity price increases and yen depreciation can't last for long.

Chart 3: Japan's corporate sector has deleveraged

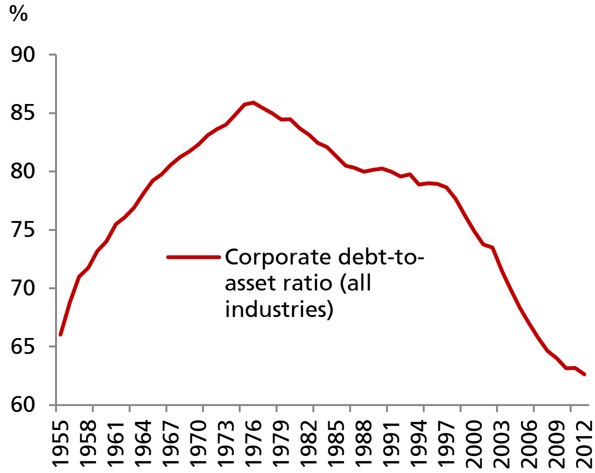
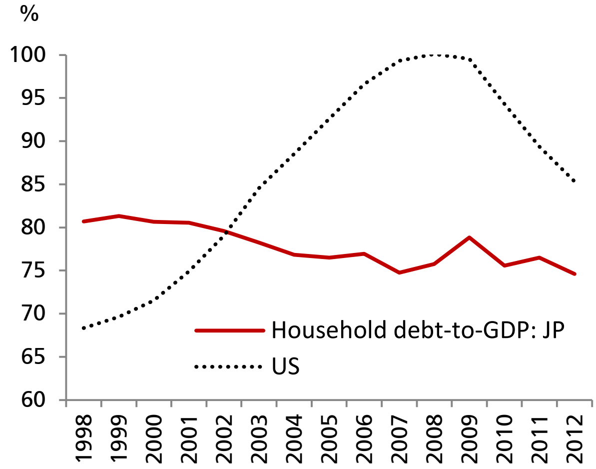


Chart 4: The household sector also deleveraged



2: The public sector faces deleveraging pressures

Fiscal expansion cannot be sustained either. While the private sector has deleveraged in the past two decades, public sector debt has risen to 227% of GDP, currently the largest such load in the world (Chart 5). The government has a self-imposed target of balancing the budget by the end of this decade. As the first step towards fiscal consolidation, the former administration under Prime Minister Noda has legislated to hike consumption taxes in April 2014 and October 2015 (from 5% to 8% and then to 10%). Despite Abe's ambiguous stance over the consumption tax plan, he has pledged to maintain the target of balancing budget deficit by 2020. This means even if the consumption tax hike is postponed / suspended, some other forms of tax increases or spending cuts would replace them. The public sector's deleveraging will kick start in 2014 at the earliest and the economic impact will be negative – unless the private sector can releverage to offset.

Importantly, the market forces prompting public deleveraging may also surface in mid-2010s. Japan's public sector that heavily depends on domestic financing will need to borrow externally to a larger extent in the coming years. The country's gross saving ratio has fallen to a record low of 20% in 2010, from 25% in 2000s and 30% in 1980s-1990s (Chart 6). Based on the worsening demographic profile, the saving ratio is likely to drop further to 15% in mid-2010s. Given the investment ratio of a steady 20% in recent years, the saving-investment gap may turn negative and the current account would fall into a structural deficit.

As the public (and also the private) sector's dependence on foreign financing increases, domestic market yields will be more susceptible to global liquidity conditions and foreign investors' risk-rating on JGBs (and other JPY assets). Due to a larger participation of foreign investors in the JGB market, the BOJ would also need to be prudent on monetary easing, due to concerns about creating the perception of debt monetization, weakening foreign investors' confidence, and triggering excessive capital outflows and disorderly currency depreciation. In short, higher dependence on external financing implies the risk of higher yields. This will increase government financing pressures and accelerate the process of public deleveraging. The prospects of private sector releveraging would also be weakened due to rising interest rates.

3. Structural reforms are not easy

The room for monetary and fiscal policies is both limited in Japan. What the country really needs is a long term growth strategy that addresses the struc-

Chart 5: But the public sector has leveraged

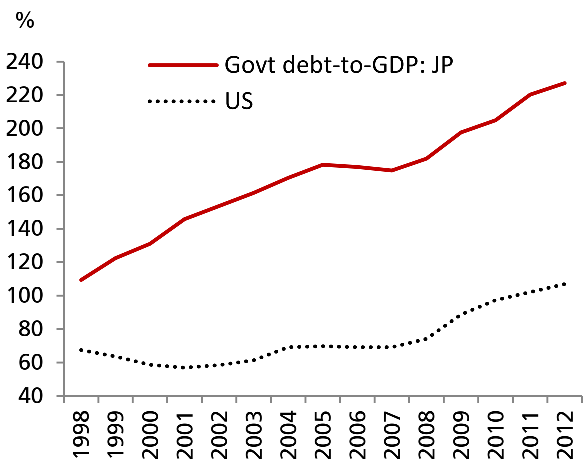
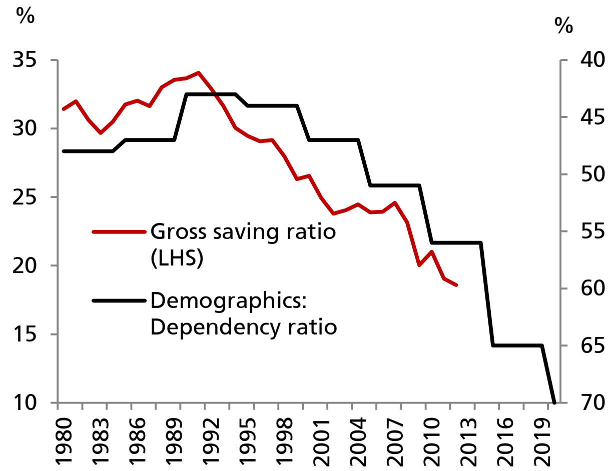


Chart 6: The saving ratio is on a structural decline



tural economic weakness and the lack of competitiveness. This points to the supply-side reform measures to boost population growth, labor participation, private investment and productivity.

Abe will present a long term economic plan in Jun13. In the supplementary budget unveiled in Jan13, Abe has proposed some measures to promote productivity via R&D, innovation and human capital development. The government has also made a step towards increasing trade openness / competitiveness, announcing in Mar13 that Japan will join the negotiations of Trans-Pacific Partnership (TPP, a regional free trade agreement).

Reforms still face hurdles. The government will continue to confront pressures from domestic lobby groups during the free trade negotiations, surrounding sensitive topics such as agricultural tariffs and foreign investors' access to domestic services industry. One major drag to Japan's potential growth is actually the rapid aging of population. Tackling this requires measures to boost the birth rate, increase the labor participation of female / old people, or relax immigration policies, the latter two of which are socially controversial.

Strong leadership, political stability and policy continuity are crucial conditions for the long term growth strategy to be implemented successfully. Ironically, dealing with the controversial reform issues involves the risks of losing public support and provoking political conflicts. Comprehensive reforms will not be easy to push through.

Sources:

All data are sourced from CEIC, Bloomberg, and forecasts are DBS Group Research.

Recent Research

CN: Deepening economic ties with Russia	9 Apr 13
MY: Sing-Iskandar: Creating synergies	8 Apr 13
SGD policy - a balancing act	5 Apr 13
IN: Where to inflation?	4 Apr 13
PH: Harnessing liquidity	3 Apr 13
US Treasuries: Expensive	1 Apr 13
TW: Is Taiwan exiting China	27 Mar 13
CNH: RQFII will not deplete offshore liquidity	21 Mar 13
CN: A global RMB: Inventing the necessary	11 Mar 13
CN: Interest rates must rise	8 Mar 13
IN: Pragmatic budget, tough to meet	1 Mar 13
TH: Keeping an eye on excesses	27 Feb 13
SG budget: Another push on restructuring	26 Feb 13
CN: The new push for urbanization	22 Feb 13
CNH: Singapore and Taiwan style	19 Feb 13
The fall and fall of Japanese FDI into Asia	19 Feb 13
SG budget: Another push on restructuring	26 Feb 13
CN: The new push for urbanization	22 Feb 13
CNH: Singapore and Taiwan style	19Feb13
SG Budget: focussing on the longer-term	18Feb13
Asia: cyclical dashboard	14Feb13
IN: Exception to the rule	6 Feb 13
CNH: Eclipsing the NDF market	4 Feb 13
JP: USD/JPY to go triple-digit	31 Jan 13
Asia: Weaker JPY does not imply weaker AXJ	30 Jan 13
US unemployment: Which trend is your friend?	29 Jan 13
ID: Fuel price pressures	23 Jan13
Asia: towards a better 2013	18Jan13
SG: Lowering property market risk	18Jan13
KR/TW: Is yen depreciation a big worry?	18Jan13
Asia: Curves pricing interest rate risk	15 Jan13
TH: Government-sponsored growth	14 Jan13
US: 2013 inflation risks? Not so much	27 Dec12
Qtrly: Economics-Markets-Strategy 1Q13	13 Dec 12
JP: Gauging the QE impact	30 Nov 12
ID: Foreign interest returns	19 Nov 12
CN: How efficient is China's investment?	12 Nov 12
US: Deleveraging progress report	30 Oct 12
CN: The importance of industrial policy in the rebalancing process	29 Oct 12
CNH: How will HK maintain its RMB edge?	25 Oct 12
Asia: 3 questions	16 Oct 12
CN: Pessimism misplaced	11 Oct 12
SG: Recession and competitiveness	2 Oct 12
TW: Thoughts on CNT prospects	28 Sep 12