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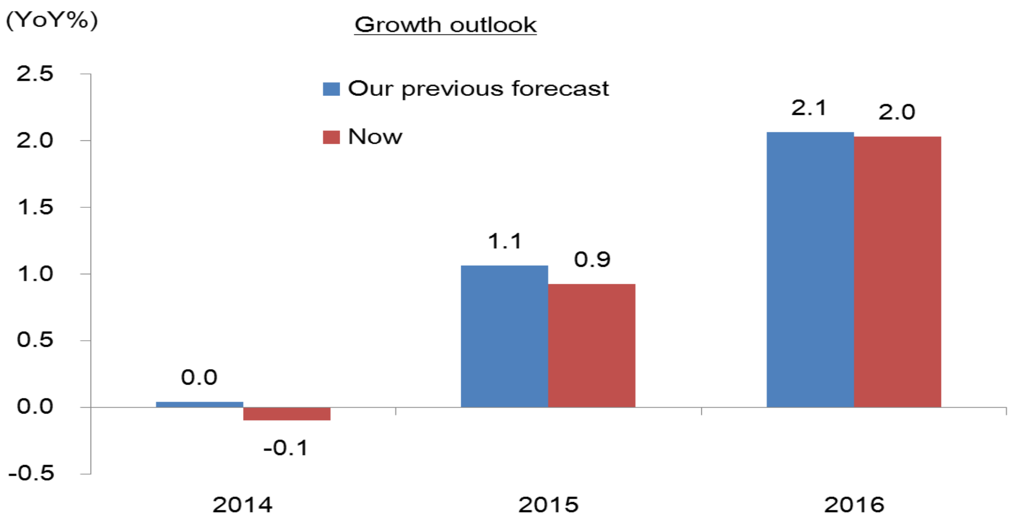
Abenomics nearing its expiry date

On the surface, our views are little changed since we last revised our forecast in February 2015. We currently forecast Japan to grow by 0.9% in 2015 and by 2.0% in 2016. These figures are moderately weaker than our previous forecast, but hardly a big change.



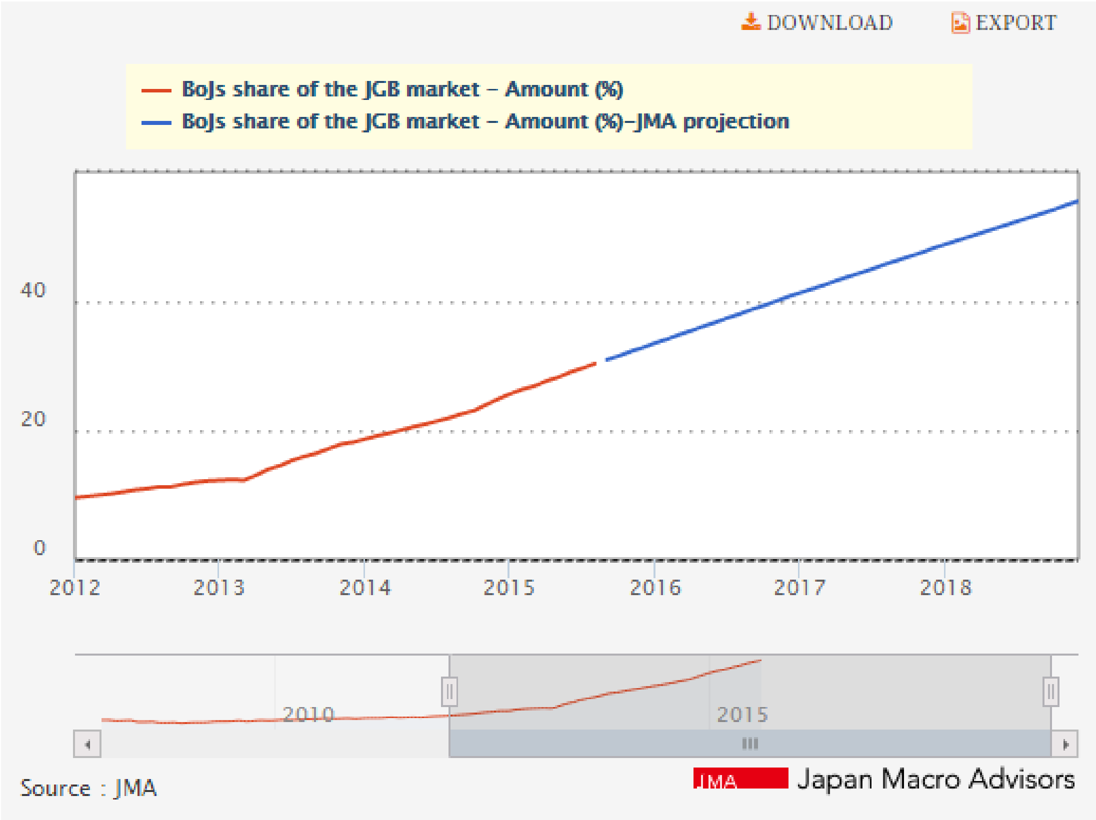
However, on the broader issue of Abenomics, the policy mix pursued by Prime Minister Shinzo Abe, we think its chance of success has become much slimmer. In our view, it will not be long before the credibility of Abenomics as a sustainable policy package expires.

A number of factors affected our assessment on Abenomics, but the following three factors stand out. 1) Abenomics policies are becoming unsustainable or already withdrawn to some extent 2) Policies are not having their expected economic effects, 3) Policy makers seem to be losing their resolve.

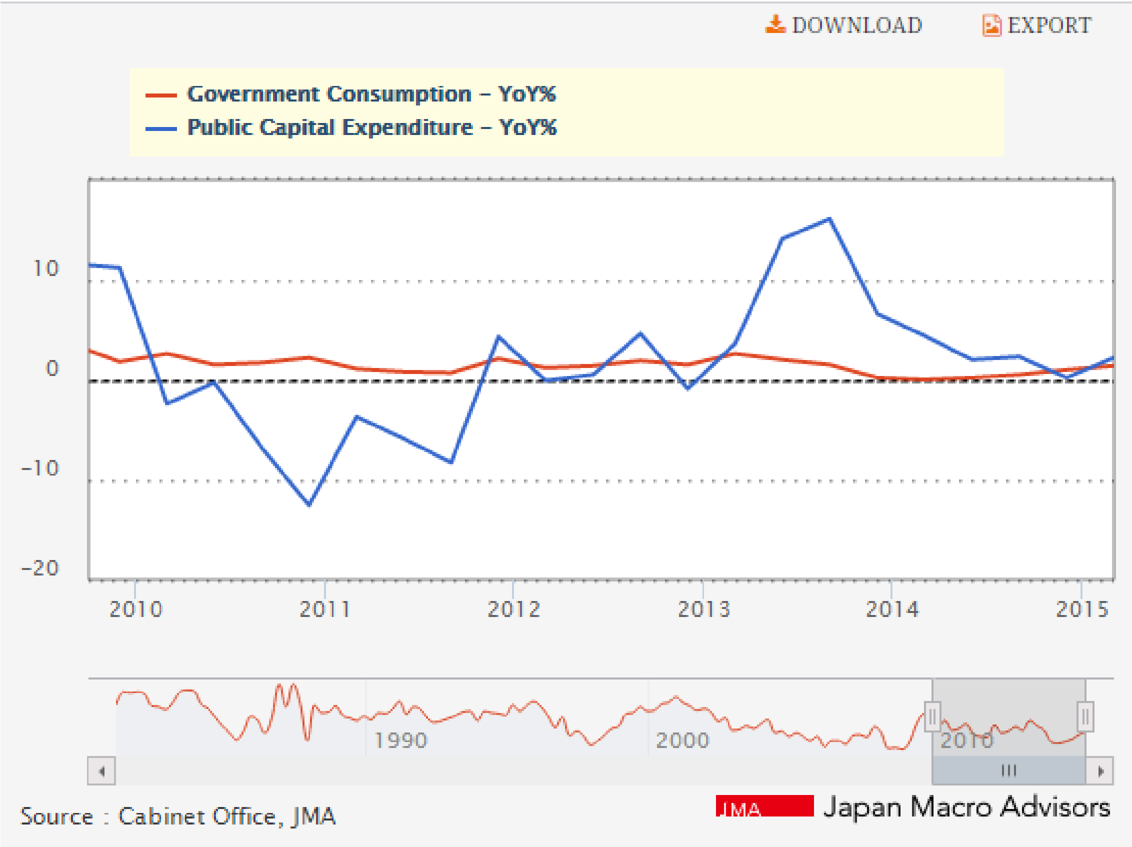
1) Abenomics policies are becoming unsustainable

Out of so-called three arrows of Abenomics, only the first arrow, the monetary easing, was effectively deployed and remains in effect. The Bank of Japan's massive purchase of JGB successfully flattened its yield curve and yen depreciated to its 40 years low when measured in real terms.

However, the cost of executing the massive quantitative easing is becoming visible as a dramatic rise in the central bank's market share in the JGB market. At the beginning of 2013, the BoJ held slightly over 10% of the whole JGB market. By August 2015, it market share has risen to 30%. At the current pace, it will reach 40% by the end of 2016 and 50% by early 2018. While we think there is no alternative as long as deflation plagues Japan, the higher the market share, the more fragile the JGB market will become against possible future shocks, including the eventual tapering by the BoJ itself. As the 50% mark approaches, we expect that the voice against QE will grow to such extent that the BoJ itself probably cannot ignore it. A sense that the QE has to stop to stem the rise in its market share in itself will harm the effectiveness and the credibility of its monetary policy.

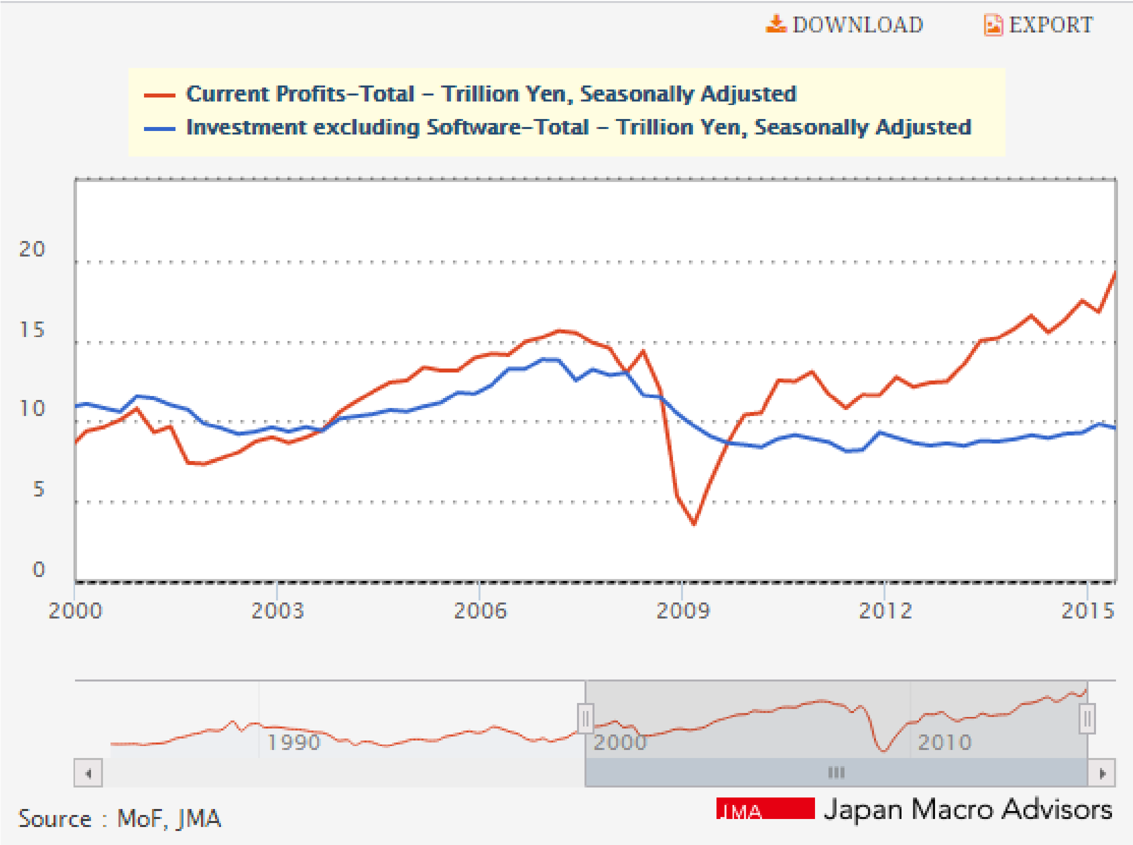


The second arrow, the fiscal stimulus, was implemented in 2013, the first year of Abenomics, but it was not pursued in an effective scale and duration. The fiscal easing policy is also already withdrawn in 2014 when the sales tax was raised.



As for the third arrow, structural reforms, it is difficult to make a conclusive argument either way as any reforms take time to make a progress and bear fruit. However, when we see all the poster children of so called reforms pursued under Abenomics, we see that most issues are those whose progress are inevitably slow or hard to measure. Promoting a wider female labor participation is certainly an important issue, but the female labor participation in Japan is already relatively high. At 66% in 2014, it is higher than OECD average of 62.8% and is comparable to 67.1% in US. It is not as if there are millions of housewives idle at home. In order to increase the supply of labor, raising retirement age will be far more effective. Immigration could provide another big potential break. However, these issues are currently shut out from the policy debate. One could argue that the Womanomics under Abenomics is about the quality of the female labor, pointing to its target to fill 30% of socially leading positions by female by 2020. One unknown fact is that the target has been Japan's official policy since 2003 when Prime Minister Koizumi adopted it. It progress has been slow, rising from 9.7% in 2003 to 11.2% in 2013. In 2014, it rose to 11.3%. Raising it to 30% by 2020 is simply an unrealistic target and we do not see any novel policy that could significantly speed up the process. TPP is another poster child, but its immediate economic effects are not big. In 2013, the Japanese government estimated it to be 0.66% of the GDP even assuming all tariffs are immediately removed. While we do believe trade liberalization is highly important, TPP is definitely not a game changer. The current Japanese government are also using TPP as an excuse to increase agricultural subsidies.

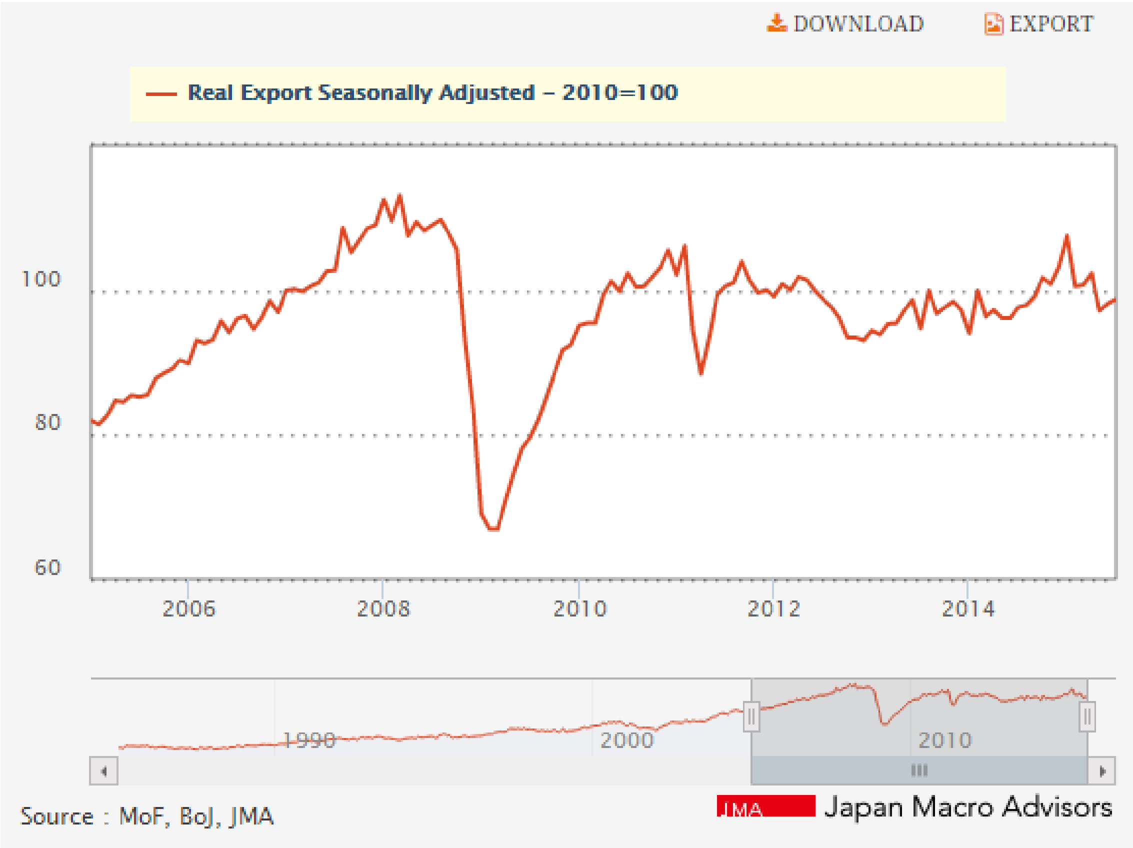
Rather than arguing over each policy, we could use the strength of private capital investment as an indirect measure for the effectiveness the third arrow. If the structural reforms are actually working, it should have raised the expectation of future growth in Japan, encouraging Japanese companies to increase their investment. However, despite the record profits, their capital investment only saw a moderate increase, unlike the period 2003-2006 when investment grew with profits.

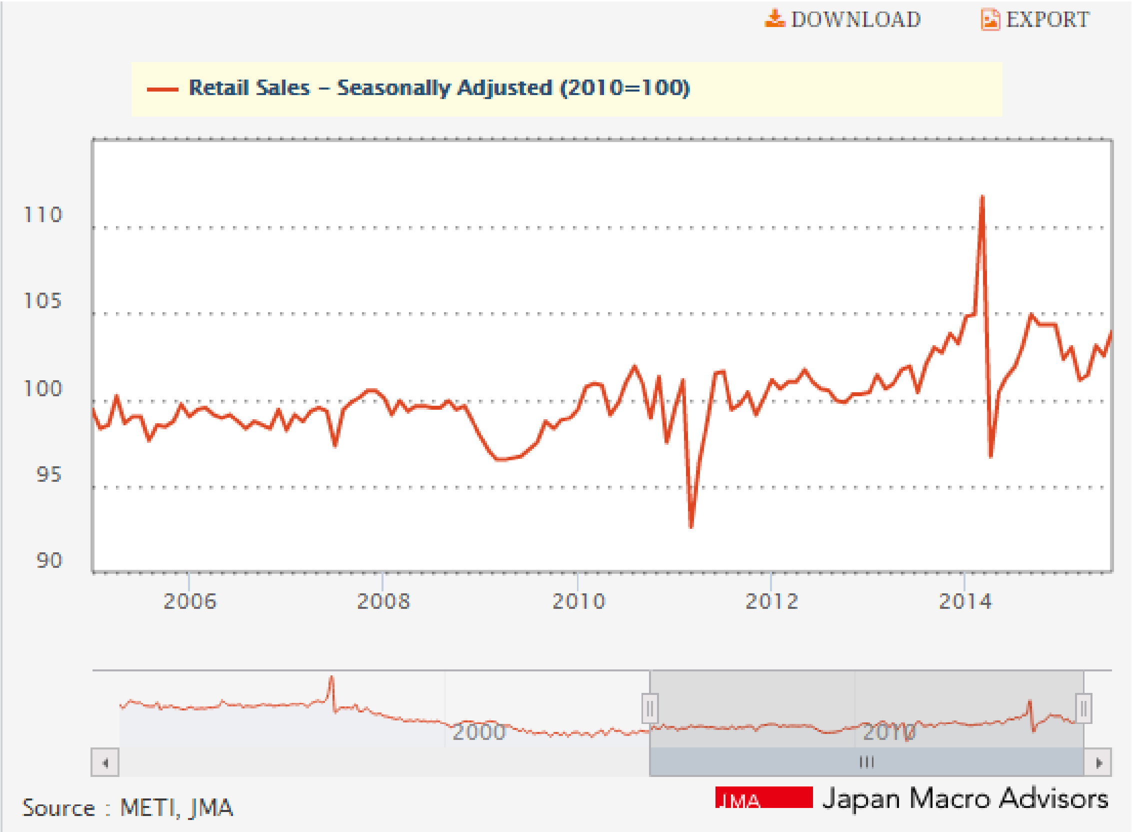


To summarize, the monetary policy has been effectively deployed as Abenomics promised but its sustainability is increasingly in question. The second arrow, the fiscal stimulus, was only deployed in limited scale in 2013 and it is already withdrawn. As for structural reforms, our perception is that so far, there has been no reform worthy to be called structural.

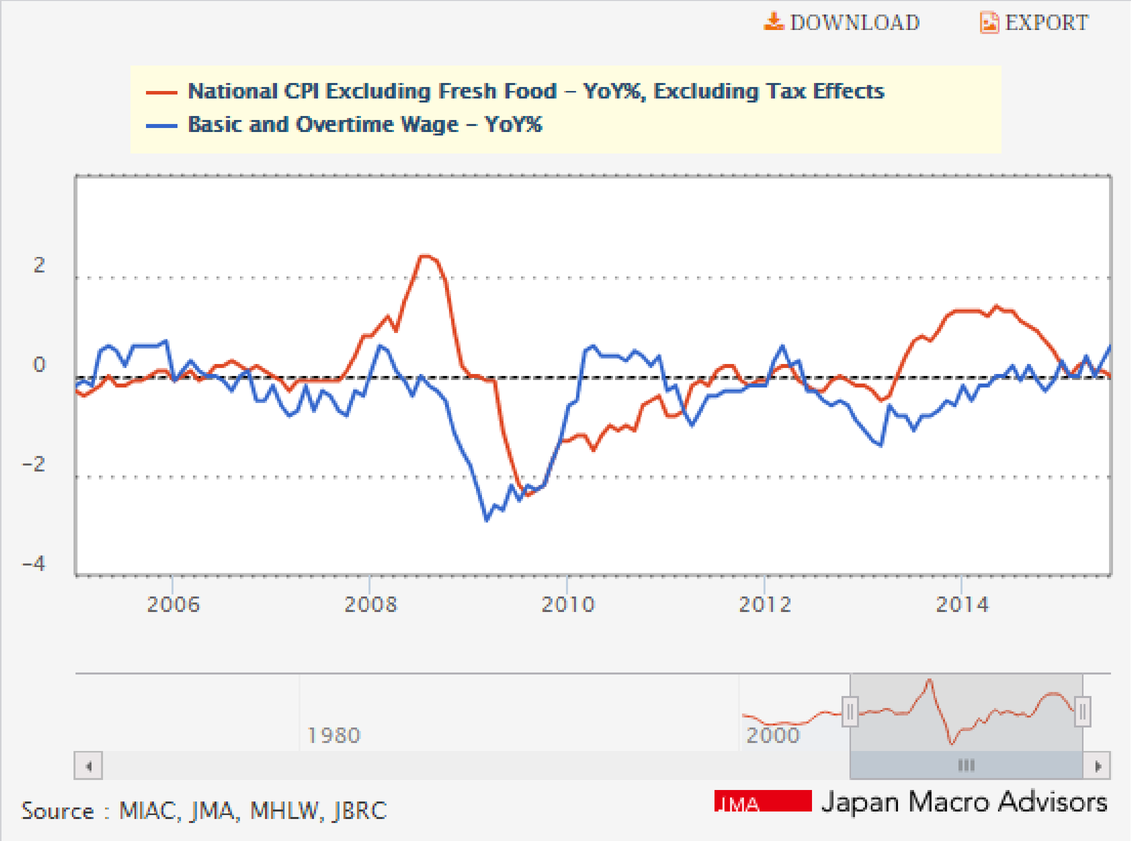
2) Policies are not having its expected effects

When Abenomics got rolling, the theory was that the monetary easing and the resulting weak yen would spur exports, private investments and private consumption. The high growth should diminish the negative output gap and eventually raise inflation both in consumer prices as well as in wages. Almost three years since the advent of Abenomics, the results are rather dismal. Exports never took off. Private investments are growing, but the magnitude of its growth has been disappointing. Private consumption initially lived up to the expectation, but the shock of the sales tax rate hike in 2014 seemed to have deprived its life out of it.





On the inflation front, the consumer price inflation initially rose till early 2014, probably mostly as a result of imported inflation through weak yen. However the recent decline in commodity prices seems to have killed off the inflationary momentum. Meanwhile, despite the tightening in the labor market, there seems to be no sign of any meaningful wage inflation. The expectation for low inflation among the Japanese population seems quite entrenched and neither corporate managers nor workers seem to feel that any marked rise in wages is in order.



3) Policy makers seem to be losing their resolves.

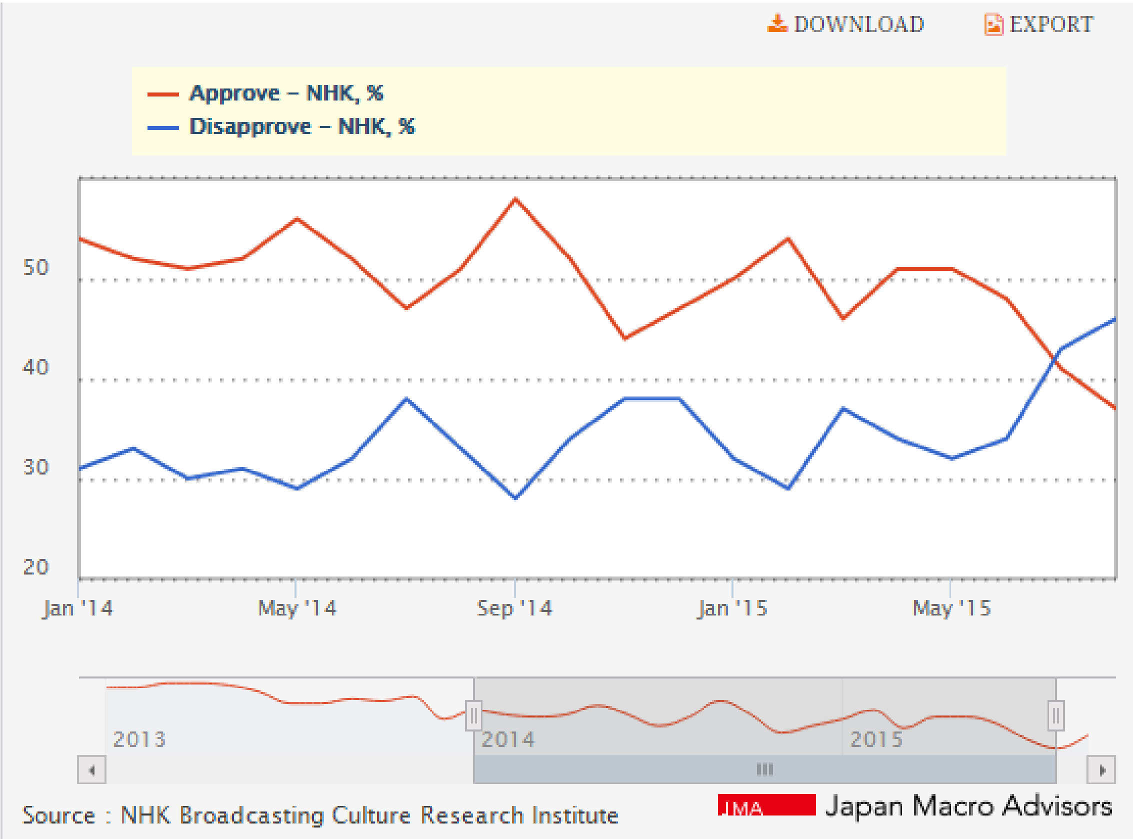
The following sentence was in one of the first speeches Mr. Kuroda made after becoming the BoJ governor.

First, the Bank decided -- as I mentioned earlier -- to convey a strong and clear commitment. The Bank clearly announced in a statement that "[it] will achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years." This is the decision of the Bank's Policy Board -- namely, it expresses the will of the Bank as an institution.

(Haruhiko Kuroda, Governor of the Bank of Japan, April 12, 2013)

The end of the time horizon of "about two years" was 4 months ago. Since October 2014, he has maintained that his expectation is that the BoJ will meet its inflation target in the first half of fiscal year 2016. Of course, the juries are still out to see if this delayed commitment would be met, but we must say that it is starting to look unlikely. There is a saying that goes "fool me once, shame on you, fool me twice, shame on me". At this point, the longer the governor Kuroda maintains that the inflation target will be met in 2016, the lower the market will regard the credibility and the "will of the Bank as an institution".

Of course, the BoJ is neither the only nor the most important institution whose credibility is deteriorating. As we commented earlier, the third arrow misfired or it was not in the quiver in the first place. And since early 2015, Prime Minister Abe seems to have all but lost his interest in the economic agenda, and seem to be spending most of his attention to formulating and passing the security bill, the bill that would enable Japan to engage in collective use of force. The unpopular bill seems to be costing a significant portion of his political capital. In August 2015, his approval rating has dipped below his disapproval rating for the first time since he became PM this time, according to the survey of NHK, Japan's public national broadcaster.



While his approval rating is yet recoverable, it will take a careful political maneuvering to recover his popularity. With the Upper House election approaching in the summer of 2016, he will probably dislike the idea of risking further decline in his popularity by embarking on structural reforms such as labor market deregulation or pension reforms.

What will follow Abenomics?

In our view, Abenomics still has some shelf life left, a year, may be a bit longer. As our forecast show, the Japanese economy is likely to do reasonably well till 2016. The BoJ could even inject another monetary stimulus, although their arsenal will be quite depleted once they do. However, it is difficult to see how Abenomics policy mix could go on beyond 2017. The economy, and the inflation will likely cool down again with the rise in the sales tax rate currently scheduled for April 2017. At that point, it will be clear to any economy watchers' that the Japan's policies are not sustainable.

Is there any way out of this conundrum? One possibility is a cancellation of the scheduled sales tax hike in 2017. If the Japanese government decides to postpone the tax rate hike again, it may prolong the shelf life of Abenomics, and it could even help reach the original goal of reflating Japan, although it may be temporary. The labor market is already tight, and two or three more years of robust growth should be enough to ply upward the entrenched low inflation expectation in Japan. Whether the BoJ could solve the problem of exiting from its QE policy, with over 50% of the JGB market in its balance sheet and in a reflationary environment, is a big if though.

In our view, the time is not yet ripe to declare Abenomics a failure, but we must say that we are getting there.

Forecast summary	Calendar Year			Fiscal Year			2015			
	2015	2016	2017	FY15	FY16	FY17	Q1	Q2	Q3E	Q4E
Real GDP (QoQ saar)	0.9	2.0	-0.2	1.5	2.2	-1.3	4.5	-1.2	2.8	1.7
Private Consumption	-0.7	1.4	-0.1	0.5	1.9	-1.4	1.5	-2.7	2.0	1.6
Residential investment	-2.1	8.2	-2.9	4.2	8.4	-6.9	7.0	8.0	8.2	6.1
Non-residential investment	2.2	6.5	2.7	3.9	7.9	-0.8	11.0	-3.6	10.4	4.1
Government consumption	1.2	0.9	0.8	1.2	0.8	0.8	1.1	2.0	0.8	0.8
Government investment	0.5	1.3	0.0	1.2	0.1	1.1	-5.3	8.9	-3.9	2.0
Exports	2.3	4.0	4.3	0.4	5.3	4.3	6.7	-16.6	6.1	4.1
Imports	0.8	6.0	5.3	1.3	7.3	4.4	7.3	-10.1	4.1	6.1
Contribution										
Inventories (ppt)	0.5	0.1	-0.3	0.3	0.0	-0.3	0.5	0.3	-0.3	0.2
Net exports (ppt)	0.3	-0.4	-0.3	-0.2	-0.5	-0.1	-0.1	-0.3	0.3	-0.5
Real GDP (YoY)	0.9	2.0	-0.2	1.5	2.2	-1.3	-0.8	0.9	1.8	1.9
CPI (% yoy)	0.7	1.1	2.5	0.4	1.2	2.7	2.3	0.5	0.0	0.2
excl. food & energy (% yoy)	1.0	1.3	2.3	0.8	1.4	2.5	2.1	0.4	0.7	0.9
Unemployment rate (%)	3.3	2.9	2.9	3.1	2.9	3.0	3.5	3.3	3.2	3.1
Employment (%yoy)	0.5	0.6	0.4	0.5	0.6	0.5	0.6	0.2	0.6	0.7
Bank of Japan Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

Takuji Okubo
Managing Director and Chief Economist
Japan Macro Advisors
www.japanmacroadvisors.com