

**Abenomics sailing ahead, but with a risk of stagflation**

Japan Risk Forum (JRF), a voluntary association of risk managers from Japanese businesses and academia, updated its assessment on Japan's economic future scenarios as of December 2013. JRF (we) first published the framework of its risk assessment tool, "Risk Scoring Vector" in May 2013, followed by the score results for June 2013. The current December release is the first update. In the "Risk Scoring Vector" framework, JRF assesses three stylized economic scenarios for Japan, namely "Abenomics to succeed", "Stagflation" and "Back to deflation". JRF then gives scoring on each scenario based on the actual performance of economic variables as well as our assessment on policy directions. For more details on this method, we encourage our readers to see our past publication on the tool "Mapping Japan's Economic Future".

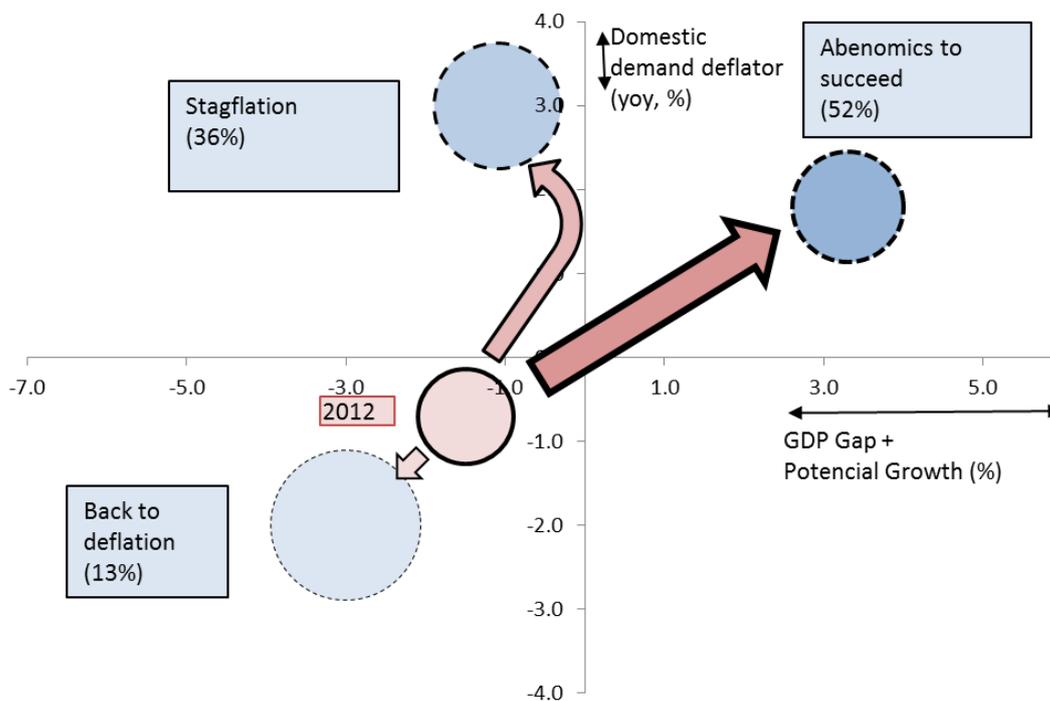
December 2013 results

**Relative score** (The sum of scores adds up to 100 points)

|       | Abenomics to succeed |          | Stagflation |          | Back to deflation |          |
|-------|----------------------|----------|-------------|----------|-------------------|----------|
|       | Jun 2013             | Dec 2013 | Jun 2013    | Dec 2013 | Jun 2013          | Dec 2013 |
| Total | 47                   | 52       | 29          | 36       | 24                | 13       |

note: decimal points are rounded up.

Japan Risk Typhoon Map (as of December 2013)



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Compared with our assessment in June 2013, we see Japan's economic performance more aligned with what we expect to see under "Abenomics to succeed" scenario. However, an important result to note is that there is a sizable rise in the score for "Stagflation" risk. In fact, the margin of the rise in scores for "Stagflation", 7 points, is larger than that for "Abenomics to succeed scenario", 5 points.

In the table below, we provide breakdown of scores and we see why "Stagflation" scenario picked up the largest score gains between June and December.

Breakdown of factors contributing to December results

**Absolute score(scoring done independently for each scenario)**

|                     | Abenomics |          | Stagflation |          | Deflation |          |
|---------------------|-----------|----------|-------------|----------|-----------|----------|
|                     | Jun 2013  | Dec 2013 | Jun 2013    | Dec 2013 | Jun 2013  | Dec 2013 |
| <b>Growth</b>       | 4         | 3        | 3           | 4        | 2         | 1        |
| Current situation   | 1         | 1        | 0           | 1        | 0         | 0        |
| Financial indicator | 2         | 2        | 1           | 1        | 0         | 0        |
| Structural reforms  | 0         | 0        | 1           | 1        | 1         | 1        |
| Global factor       | 1         | 0        | 1           | 1        | 1         | 0        |
| <b>Inflation</b>    | 4         | 5        | 2           | 2        | 2         | 1        |
| Current situation   | 1         | 2        | 1           | 1        | 1         | 0        |
| Financial indicator | 2         | 2        | 1           | 1        | 0         | 0        |
| Global factor       | 1         | 1        | 0           | 0        | 1         | 1        |

We see that the growth factors were overall not favorable for "Abenomics to succeed" scenario. The downgrade came from global factors. For example, IMF's global growth outlook for 2013 was downgraded from 3.5% at the beginning of 2013 to 2.9% at the end of the year. Its outlook for 2014 were also downgraded from 4.1% to 3.6%. A weaker global growth means less pull from export demands for Japan. We also continue to put zero point for structural reforms.

On the other hand, inflation scores turned favorable for "Abenomics to succeed" scenario. Domestic demand deflator turned positive YoY in mid-2013 and there was also a modest sign that finally wages have started to rise.

While the growth factor and inflation factor offset each other for "Abenomics to succeed scenario", there was no such misalignment for "Stagflation" scenario. The output gap for Japan continued to narrow, to -1.6% points as of July-September 2013, diminishing the deflationary pressure in Japan. The weak capital expenditure growth in Japan is another factor that contributed to the higher score for "Stagflation" scenario. Unless production capacity grows within Japan, supplies will eventually lag behind the rising

demands, leading to a “demand pull” inflation. In similar way, the lack of structural reform positively contributes toward “Stagflation” scenario as it means less productivity gains and less production capacity for Japan.

“Back to deflation” scenario lost scores in both growth as well as in inflation factors. While the scenario definitely remains one of the “possible scenarios” for Japan, there is little fact in the field that indicates Japan is heading back toward the deflation.

**Conclusion: Japan pulling itself away from deflation, but with a cost of stagflation risk**

The December results suggest that the “Abenomics to succeed” remains the main scenario for Japan and its plausibility has increased from June. However, at the same time, it is interesting to note that the score for “Stagflation” scenario has gained even larger points. Under the current economic direction, Japan is certainly succeeding to pull itself away from the “Deflation” scenario, but it seems uncertain which of the two inflationary scenarios, “Abenomics to succeed” and “Stagflation”, Japan is moving toward. We also note that the consumption tax rate hike in April will quite likely weaken growth and raise inflation, at least temporarily. A weak growth coupled with a higher inflation is, by definition, a step toward stagflation. We currently schedule the next update of our assessment for June 2014. By June, we should have some evidence of how the consumption tax rate hike in April is affecting the Japanese economy and we look forward to publish our revised assessment for the three alternative economic scenarios for Japan.

Japan Risk Forum member

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Note: We like our readers to note that the “Risk Scoring Vector” as well as its periodical assessments results are developed by Japan Risk Forum, and not by Japan Macro Advisors. Takuji Okubo, JMA’s Chief Economist, is a member of JRF, and he is one of the chief architects of the Risk Scoring Vector framework.