Economic Analysis

Hard-Boiled Wonderland: Will ‘Abenomics’ make it past winter?

Le Xia / Carlos Casanova

Upcoming elections could reinforce Abe’s influence in Japan’s Lower House

Prime Minister Shinzō Abe announced his plan to call for a snap general election on November 18 and dissolved the Parliament on November 21, surprising observers who were expecting anticipated elections to take place later in 2015. Abe’s call for a snap election is a response to the government’s decision that it would postpone the next sales tax hike (initially planned to become effective on October 2015), as disappointing data outturns lead to mounting pressures from detractors in the opposition. Campaigning started on December 2 and voting will take place this Sunday.

The elections will reconstitute the lower house of Japan’s Parliament, the Diet, where Abe’s ruling coalition already wields a majority until 2016. Should Abe’s Liberal Democratic Party (LDP) win the anticipated elections, this will give him enough leverage to push forward necessary fiscal as well as structural reforms over the next term. The move is bold but the stakes are high: Japan’s last snap election took place in 2005, when Junichiro Koizumi won enough support to push forward a plan to privatize the country’s postal services. The opposition is admittedly not looking in good shape, but it remains to be seen whether Abe will be able to secure 66% of seats given the mixed opinions about the performance of his flagship economic program, “Abenomics”.

Sales tax drives Japan into technical recession for the fourth time since 2008

On April 2014, Japan raised sales taxes from 5% to 8%, with a second hike from 8% to 10% scheduled to take place on April 2017. In contrast, the European Union’s average value added tax (VAT) is around 20%, making Japan’s tax hike modest in relative terms. Despite relatively low consumption tax levels, the Japanese economy seemed too weak to withstand the hike. On an annualized SA basis, the tax rate hike tipped the Japanese economy into a technical recession (defined as two consecutive quarters of negative growth), as the GDP contracted by -7.3% q/q and -1.9% q/q respectively. This is the fourth time that Japan slips into recession since 2008 (Figure 1).

Sluggish business investment and stubborn deflation have been exerting downward pressure on the Japanese economy. Weakening domestic demand stemming from the consumption tax hike just adds to the woes. Retail sales plunged by -12% in April, resulting in a -1.8 y/y fall in Q214, recovering moderately to 1.4% in Q314. Inflation excluding food process increased as a consequence of the tax hike, reaching 3.57% y/y in 3Q14, but moderated again to 2.90% y/y in October. However, excluding the impact of the sales tax, core inflation actually grew by 0.9% y/y, meaning that Japan will need to do more in order to achieve its 2.0% target for core inflation by 2015 (Figure 2).

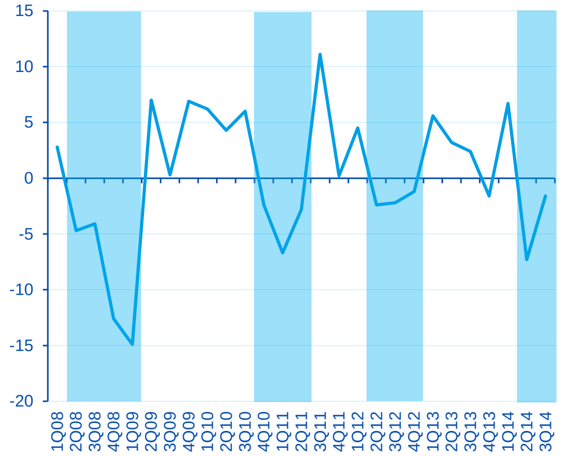
Bold monetary measures have been deployed to boost growth and raise inflation

On October 31, the Bank of Japan (BoJ) unveiled a new set of Quantitative and Qualitative Easing (QQE) measures, including a target to enlarge the country's monetary base by 80 trillion Yen (705 billion USD) annually, up from previous 60-70 trillion Yen. Furthermore, BoJ announced that it would shift its portfolio holdings; purchasing exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs), so that their amounts outstanding will increase at an annual pace of about 3 trillion Yen and 90 billion Yen respectively.

BoJ's bold move coincided with the issuing of a statement by Japan's 127 trillion Yen (1.14 trillion USD) Government Pension Investment Fund (GPIF) that it would reduce holdings of domestic bonds from 60% to 35% of its portfolio, while increasing its equity holdings from 24% to 50%. In other words, BoJ is indirectly financing this by buying JGBs owned by the GPIF.

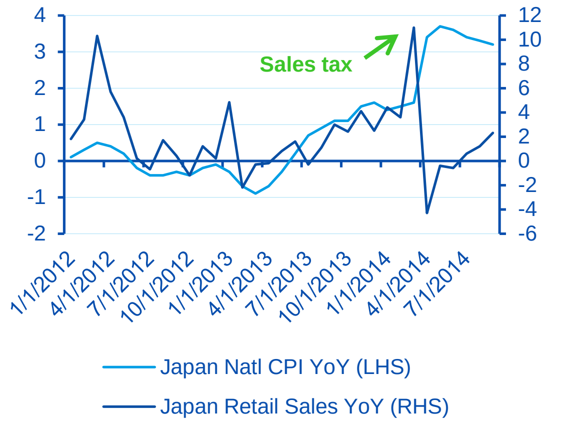
Japan's QQE is set to be bigger than the United States Federal Reserve's (US Fed) Quantitative Easing program on a per GDP basis (Figure 3). BoJ's assets to GDP stand at 59% of Japan's GDP and will reach 70% by the end of 2015. In contrast, the US Fed expanded its assets from 6% to 26% of GDP between 2008 and 2014, while the Euro zone's 1 trillion EUR expansion will elevate the European Central Bank's assets to 30% of GDP by 2016. Japan's QQE is an unprecedented move that reinforces Abe's image as a strong leader capable of pushing reform despite resistance from the opposition.

Figure 1
Japan has entered into recession for the 4th time since 2008 (Annualized QoQ SA GDP %)



Source: Bloomberg and BBVA Research

Figure 2
Deflationary pressures and weak demand following April's sales tax hike



Source: CEIC, Bloomberg and BBVA Research

Beyond monetary policy: More structural reforms are necessary in order to spruce up Japan's economy in the near term

Abe's audacious move to call a snap election may grant him greater leverage in the Diet. However, in order to successfully garner more support from detractors and prove the efficacy of his economic program, he will have to focus more on structural reforms, or the "third arrow" of Abenomics:

1. **Achieve the right balance between fiscal consolidation and structural reform:** Further sales tax increases are likely given Japan's widening government deficit (-9.2% of GDP), which raised the public-debt-to-GDP ratio to a new record-high of 227% of GDP. They could, however, have been implemented in a more gradual way to avoid sharp negative impacts on growth. A good example of how incremental consumer tax rises can be implemented without momentous downward pressure on GDP can be seen in the cases of the UK (17.5% to 20% in 2011) and Spain (16% to 21% in two rounds between 2012 and 2014).

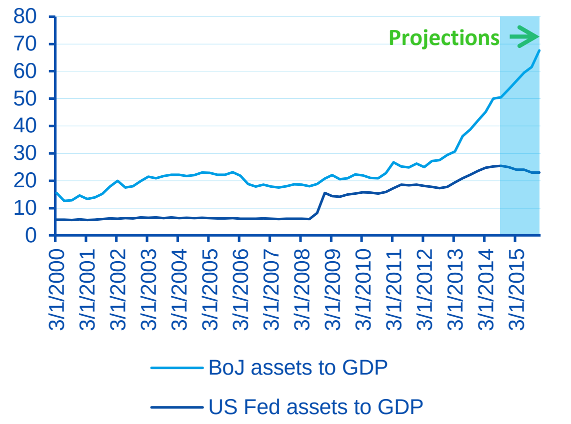
2. **Tackle excessive savings in the corporate sector:** Japanese companies are notorious cash-hoarders. According to a recent report by The Economist, Japanese firms hold 229 trillion Yen (2.1 trillion USD) in cash (44% of GDP). Putting these savings to more productive use could give Japan's economy a real boost without worsening the fiscal burden, thus helping to lower Japan's debt-to-GDP ratio. Policies that stimulate investments by the corporate sector are a good start. However, Japanese companies are already big domestic investors according to some estimates. Japanese corporate investments were equivalent to circa 14% of GDP in 2013, compared to 12% in the US and an anemic 8% in the United Kingdom. Further increases in corporate investments may be insufficient, as diminishing marginal returns on investments limit the amount of extra output created. Another option would be to implement policies that promote corporate governance in listed companies and increase dividend pay-out ratios. Japan's dividend payout ratio is 26.82%, which is relatively low compared to that of other economies (US: 33.50%; UK: 54.15%; Spain: 65.29%). Higher dividends could help to spur economic growth by boosting lackluster consumer spending and attracting foreign capital inflows.

3. **Prop-up wages to revive domestic consumption demand:** A recent sharp depreciation of the Yen (Figure 4) stemming from Japan's latest monetary expansion might have some detrimental effects on the economy which need to be addressed. A weaker Yen worsens Japan's terms of trade and reduces household incomes (more than the potential gains in net exports). Japanese wages have been falling in real terms for over a year, contracting by -2.9% y/y in September. Coupled with high levels of savings and low investments, this increases the risk of secular stagnation. In other words, fast fiscal consolidation may hamper real consumption; prompting Japan's shrinking working-age population to save more and spend less, thus tilting real interest rates into negative equilibrium.

Ultimately Japan needs to implement policies that facilitate real wage growth to offset the negative effects of the worsening terms of trade, higher inflation and increased sales taxes.

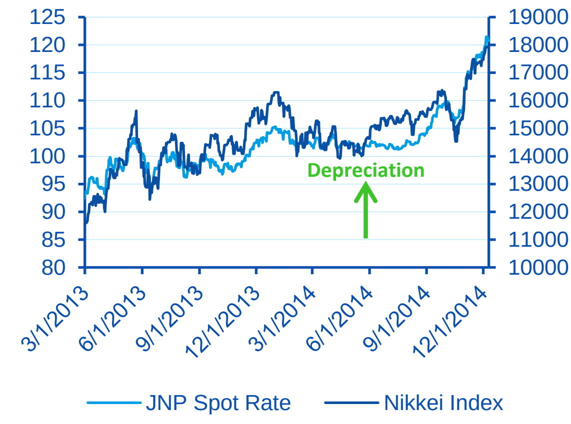
4. **Address the demographic burden and unleash the potential of Japan's female workforce:** Japan has one of the lowest rates of participation of women in the labor force in the developed world. By promoting policies that encourage female participation in the workforce from circa 50% currently to 70% in 2020, Japan could increase its potential GDP growth. However, while this is a relatively accessible way to alleviate some of the labor shortages in the short term, it is hardly the golden bullet for Japan's shrinking labor force. According Japan's Internal Affairs Ministry, its population declined by 0.17 percent in 2013; reaching 127.3 million. People aged 65 or older made up circa 25% of the total population, a trend which is set to worsen on the back of low birth rates and retiring post-war baby boomers. Immigration policies that facilitate the influx of younger demographics are needed in order to maintain the population size around 100 million within 50 years.

Figure 3
Japan's monetary expansion set to be bigger than the US Fed's QE program (% GDP)



Source: Bloomberg, IMF and BBVA Research

Figure 4
Japanese stocks surge while the Yen depreciates versus the USD



Source: Bloomberg and BBVA Research

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