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Institute for International Monetary Affairs
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Abenomics and the Value of the Yen

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What is Abenomics?

Abenomics is a policy stance of Prime Minister Shinzo Abe. It is composed of fiscal stimulus, a bold stance favoring monetary easing and growth strategies to tackle the decade-long deflation in Japan.

(a) Fiscal stimulus

On the fiscal front, the government has announced a supplementary budget for FY2012 of 13.1 trillion yen, which is the second biggest supplementary budget in decades, and an initial budget for FY2013 of 92.6 trillion yen. This initial budget for 2013 is 0.3% smaller than the previous year's budget in total. However, there is a large increase in public works for infrastructure and reconstruction after the Tohoku earthquake. This is expected to have an immediate impact on short-term growth.

While the government tries to pump the weak economy with fiscal stimulus, they know it is also important to let markets believe that Japan will remember to exercise long-term fiscal discipline. The size of the bond issuance for FY2013 reflects this consideration; it is 170.5 trillion yen, -2.1% from the previous year.

Many know that providing fiscal stimulus can give the economy a one-time boost, but this would be followed by a contraction of the same size. Despite that, many think such a stimulus is needed to launch Japan on a virtuous cycle of demand, employment and income, and many people want to believe that it is possible to start such a cycle if it is accompanied by the positive effects of monetary policy and structural reforms.

(b) Bold monetary easing

On the monetary front, the Bank of Japan introduced an inflation target of 2% in January and decided on a 13 trillion yen monthly asset purchase. There was disappointment in the markets, which expected that the BOJ would buy riskier assets or a larger volume of long-term government bonds. Later, BOJ Governor Shirakawa expressed his intention to resign before the end of his term on April 8 2013. Market participants expect more decisive quantitative easing to start under a new governor[1].

(c) Growth strategies

As for the economic policy, it seems the government would address the area of Japan's competitiveness and creation of new domestic demand. These are, for example, policy supports for R&D, development of overseas business for SMEs and deregulation that helps new businesses emerge in the various service businesses. The details will be announced a few months later, probably after the upper house election in June. We need to wait and see what will develop.

Box 1: What's wrong with deflation?

Foreigners who visit Japan often ask the same question: 'If Japan has been in deflation for many years, what's wrong with deflation?' They find well-functioning infrastructure. Cars on the streets are mostly in good condition, and few buildings look dilapidated. The number of homeless is not particularly large compared with other countries. If foreign visitors go to a luxurious lounge in the Imperial Hotel for lunch, where they think they can be because it is at company expense, they see many Mrs. Watanabes who enjoy lunch at their own private expense. Looking at macroeconomic indicators, real GDP per worker has been growing as fast as in the US. The average life expectancy is one of the longest in the world, discounting the negative impact of the Tohoku earthquake and tsunami. The living standard of the population has been improving even during the decade-long deflation. What is the real problem with deflation?

The other side of the coin is the question of whether nominal maneuvering, such as setting the inflation target at 2% and raising the growth rate in nominal terms, can be a real solution for the deep-rooted economic problems.

[1] Haruhiko Kuroda, the former Vice Minister of Finance for International Affairs at the Ministry of Finance and the ex governor of the Asian Development Bank, is taking office as the new governor of the BOJ on March 20. He has expressed his strong commitment for further monetary easing. The market sentiment has been uplifted further, and the trends of the yen depreciation and stock price hike are continuing.

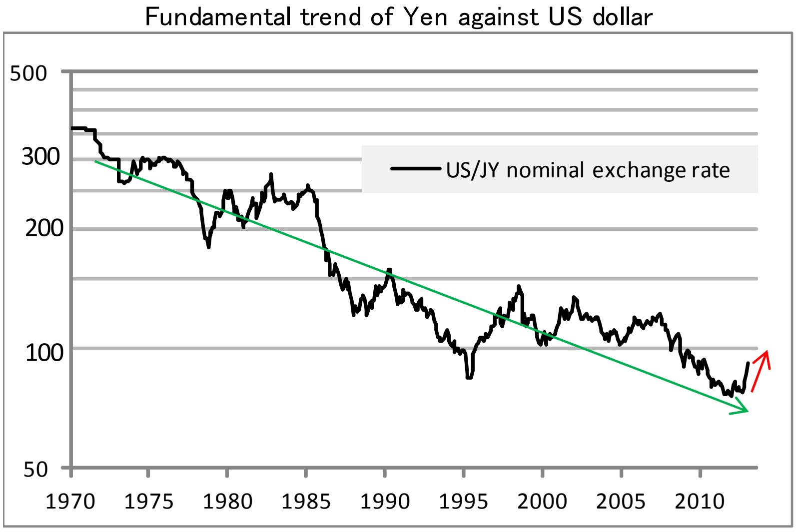
The answer can be yes. Inflation could change the landscape of the economy by diminishing the burden of debts via two channels. One is that we can create more room for an interest rate cut in real terms. The other is that the principle of the debt will be reduced automatically in real terms as time goes by. This change encourages those who have innovative ideas to borrow money and enables them to materialize their ideas into concrete businesses. The whole economy becomes more active and innovative under inflation than deflation in this mechanism.

Despite ongoing deflation, Japan displayed economic growth and the Japanese actually enjoy a better life than twenty years ago. How can you say that deflation works on the economy negatively? The answer is that Japan did grow, but the growth Japan achieved is not large enough to sustain the aging society. The productivity per worker is too small to sustain both the working generation and retired generation. The Japanese economy needs to boost its growth rate even further, and to realize this, we need to get rid of deflation so that the burden of having debt becomes smaller and fresh ideas for creating economic values can bloom in the actual business world.

How is Abe's policy affecting the yen's fall?

So far, the power that changed the market's sentiments is coming from the expectations regarding monetary policy. The strong commitment of the BOJ and the government to pursue expansionary monetary policy until Japan gets out of deflation is convincing the markets that this time is different. Since this expectation spread in the market December 2012, the yen started depreciating.

The historical trend of the yen against the US dollar is an appreciatory one. There are exceptional periods when the value of yen weakened, for example the years between 1980 and 1986 when high interest rates in the US attracted global money, resulting in strong appreciation of the US dollar, and the years between 2004 and 2007 when the so-called carry trade of funding in yen and investing in other asset classes was popular. But roughly speaking, the long-term trend of the yen against the US dollar is appreciation.

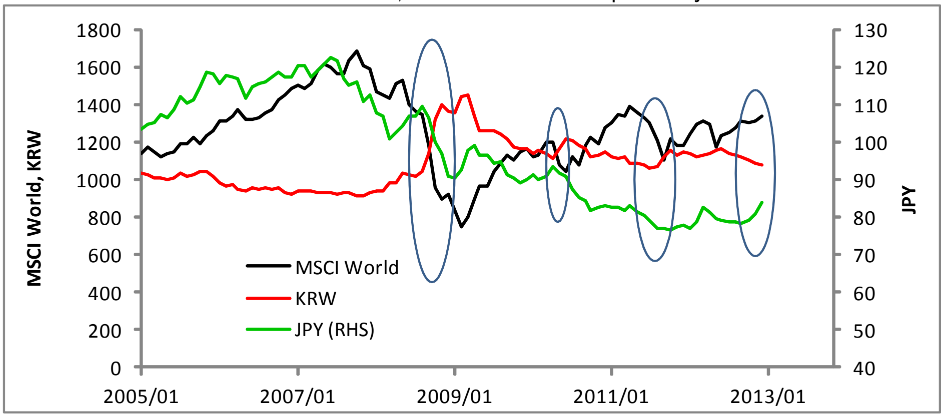


The reason is simple. This long-term trend comes from the inflation gap between the US and Japan. Inflation in Japan has been generally lower than that in the US since the mid-1970s. This means the US dollar has always lost its value against goods and services faster than the yen has, and the exchange development reflects this phenomenon. Despite this general trend, we have observed a depreciation of the yen recently.

Two factors have caused this recent change of direction. One is, as discussed above, Abe's bold stance to inflate the Japanese economy. However, this is a rather minor cause which accidentally came across as a major one. The major cause is the change in the sentiment of the global financial market.

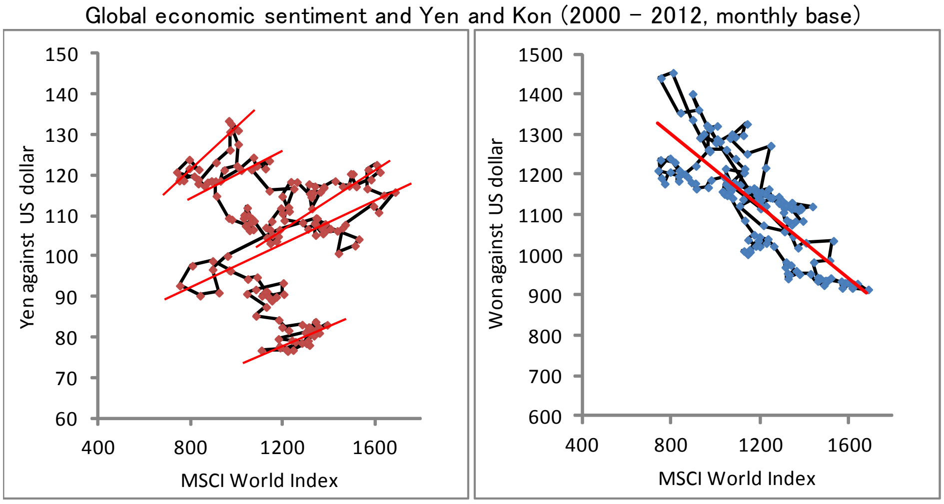
Looking back at the exchange rate development of the yen and the Korean won since the Lehman shock, there is a clear difference between the two currencies in how they have reacted to the sentiment of the global markets. When the sentiment of the market freezes, the yen often appreciates while the won depreciates, and when the sentiment improves, the opposite happens. Now, it is time for an improvement in the market sentiment.

MSCI World Index, Korean won and Japanese yen



(Source) Bloomberg

Global economic sentiment and Yen and Kon (2000 – 2012, monthly base)



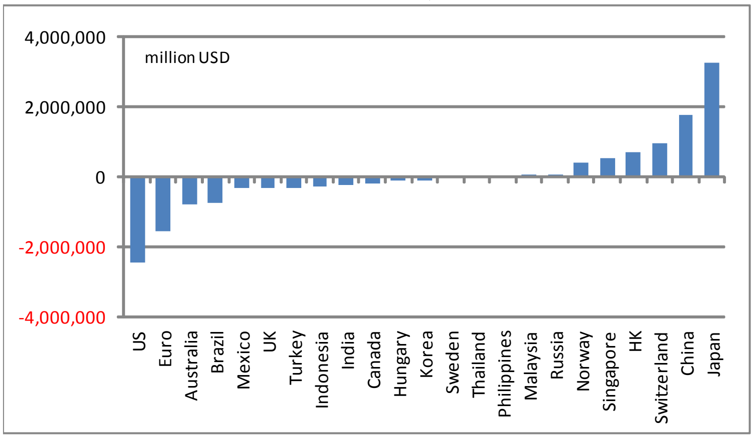
(Source) Bloomberg

How did the improvement of sentiment cause the fall of the yen?

Japan is a country with current account surpluses and net assets in the financial position of the nation overall. The reason why sharp appreciations of the yen have been observed in times of deteriorating global economic sentiment is because capital transactions tend to shrink suddenly under a frozen sentiment while the current account does not. Exports and imports cannot be stopped suddenly. This causes a decrease in capital outflow from a net asset country like Japan, which in turn causes appreciation of the currency. This means that under opposite circumstances, with the improvement of the sentiment, the reverse effect comes into force. The Korean won shows an opposite tendency. The won’s appreciation and the hike of global market sentiment tend to occur simultaneously because good sentiment and active global capital flows cause more inflows to a net borrower such as Korea.

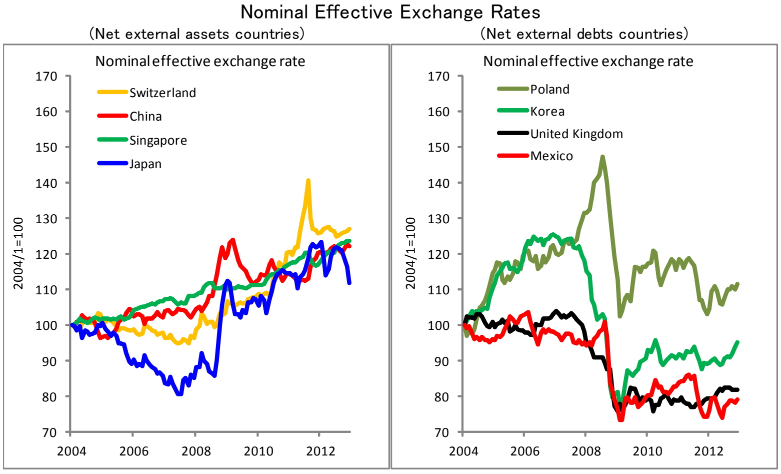
This tendency is observed in other currencies, too. The currencies that belong to the same group as the yen are the renminbi, Swiss franc, and Singapore dollar while those belonging to the same group as the won are the Polish zloty, UK pound, and so forth. The former group is composed of large net asset countries, and their currencies display the same tendency as the yen, while the latter group is composed of net debtor countries, and their currencies move in a similar way as the won.

Net external assets / liabilities



(Source) IMF

Nominal Effective Exchange Rates

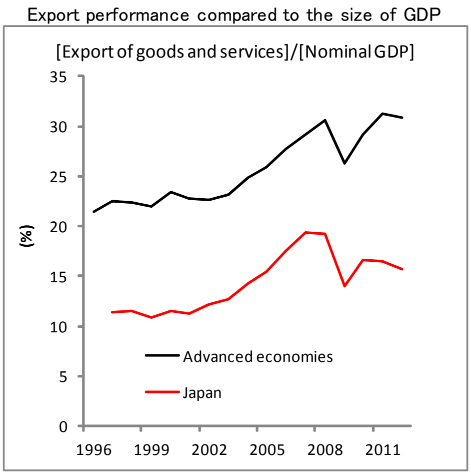


(Source) BIS

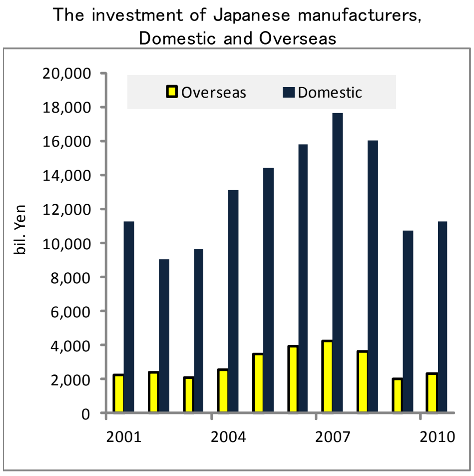
Will the depreciation of the yen revive the Japanese economy?

Some say that the yen depreciation will not help Japan's exports as the Japanese manufacturers have shifted their factories abroad to a considerable extent. Are they correct?

We should not be too optimistic, but the depreciation of the yen can still help the Japanese economy. Domestic production of exports declined, but not so much that we should expect the depreciation of the yen to have no positive impact. At the least, the percentage of exports compared to the whole economy has not weakened in the last 15 years. Also, domestic investments by manufacturers remain over 80% of their total investment. This means that the Japanese exporters continue to maintain their manufacturing bases in Japan to the same degree as 15 years ago. Japan is still exporting a considerable volume of manufactured products.



(Source) IMF

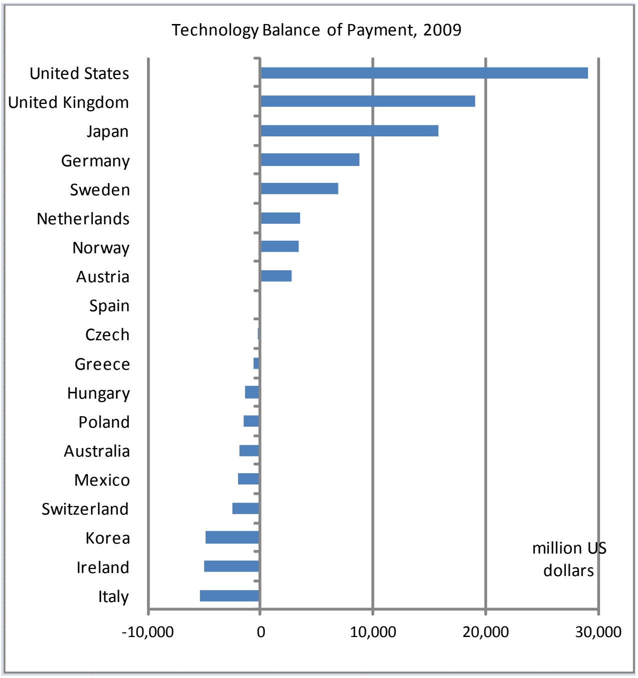


(Source) Ministry of Finance, Ministry of Economy, Trade and Industry

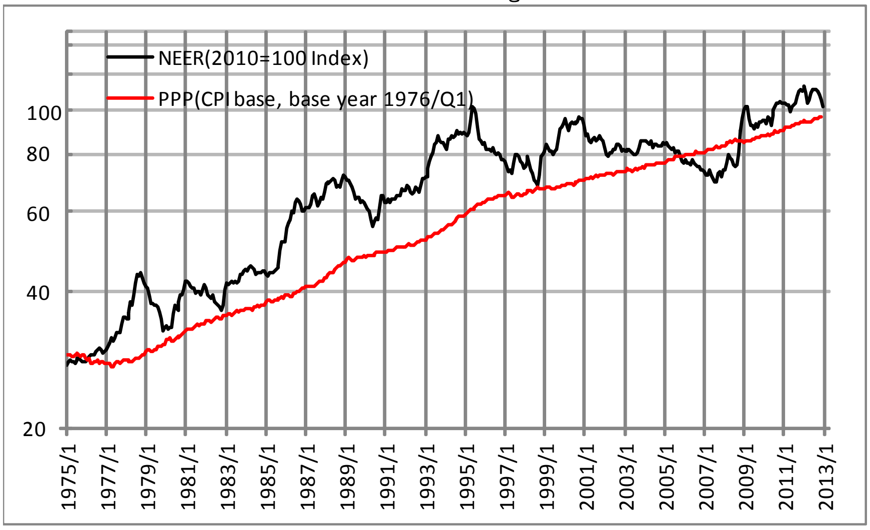
Looking forward, the Japanese disadvantage in production costs compared to its Asian peers will steadily narrow. Although there still remain large gaps, the worst is over. Technological advantages also still remain in the Japanese industries. A recent OECD report shows that Japan is the third largest surplus country in terms of technological balance of payments, which represents the trade in R&D-intensive products and service net receipt of patents as well as technological service fees, etc.

How far can the yen be allowed to depreciate?

The yen depreciation brings the Japanese economy a certain benefit, but how far can it be allowed to go without raising international conflicts? According to PPP analysis on a nominal effective exchange rate basis, the yen at its peak was overvalued by approximately 15% on a trade-weighted basis. This gap has rapidly shrunk since the end of last year, and the current level at around 95 yen against the US dollar is more or less a fair level. In this regard, the recent depreciation can be regarded as an adjustment of the overvaluation which emerged under the extreme strain of the global financial market after the Lehman shock and can be justified theoretically and internationally, therefore.



Yen Nominal Effective Exchange Rate and PPP



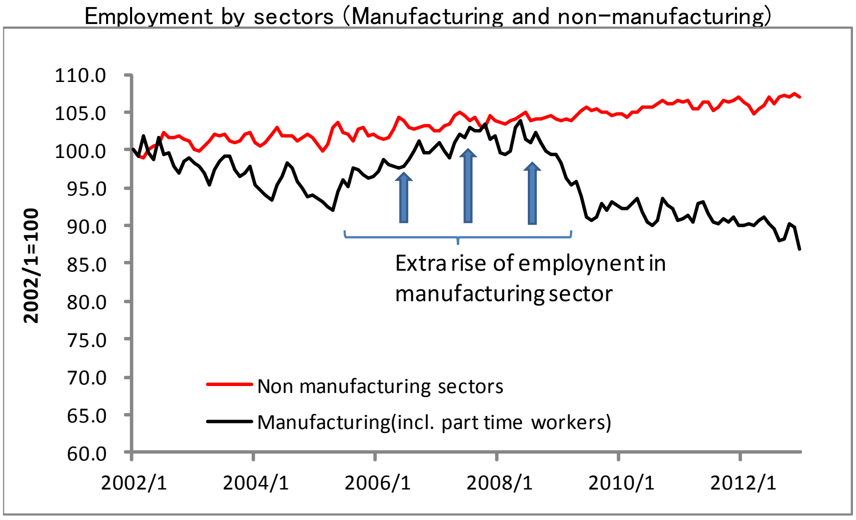
(Source) Bloomberg

However, excessive depreciation beyond this might annoy other nations and even be harmful to the Japanese economy.

There are three reasons for this. First, excessive undervaluation will cause misallocation of domestic resources. When an investment style called ‘the yen carry trade’ was widespread, the yen was considerably undervalued. Strong demand for yen-denominated funding, which was exchanged to other currencies, caused a downward pressure on the exchange rate of the yen. This development in financial markets brought a huge benefit to Japanese manufacturers. During this period, they expanded production capacities in Japan by investing in more production lines and hiring a large workforce. If the depreciation of the yen had been a long-term trend, this decision to allocate more money and labour for domestic production would have been correct.

However, this was a temporary phenomenon which was followed by a major adjustment. This is a typical case in which excessive undervaluation misled companies to make the wrong decision concerning resource allocation.

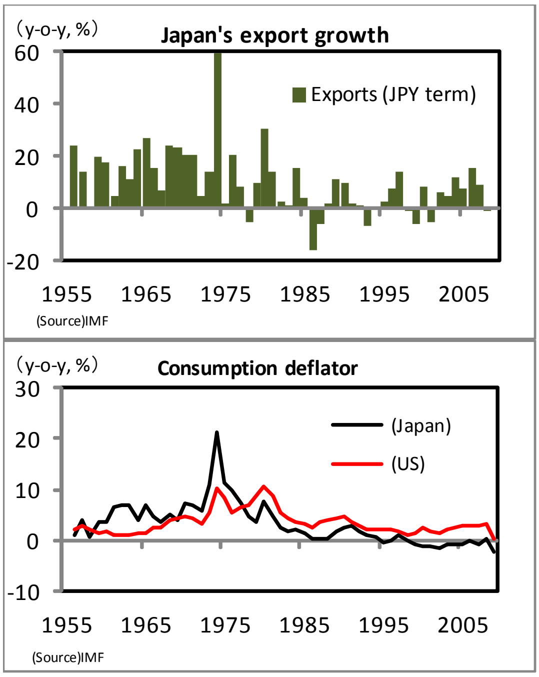
Employment by sectors (Manufacturing and non-manufacturing)



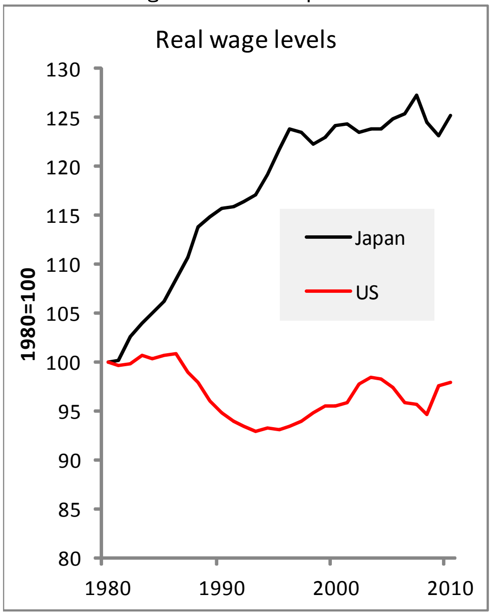
(Source) Statistics Bureau of Japan, Ministry of Health, Labour and Welfare

The second reason that we should not forget is the benefit of currency appreciation for the entire national economy over a long period. Japan abandoned a fixed exchange regime in the early 1970s, and the value of the yen against the US dollar has kept rising since then. Japan's currency appreciation did have a negative impact on export growth. However, at the cost of an export slowdown, Japan realized long-lasting modest growth in which the inflation rate was kept low and the income growth in real terms has been shared widely among the middle class. The current situation, being in deflation for years, prevents us from appreciating this benefit, but we should not forget it given the fact there is a different kind of economy, as seen in the US and Korea where they suffer from inflation which has eliminated the growth of the real income of general public.

The third reason is that if the depreciation of the yen gains a certain momentum, it might give rise to a concern over capital flight from Japan. Japan can fund itself thanks to the huge financial assets of the household sector. However, the government debt is over 200% of GDP. This level has been never observed before except during the exceptional times of global-scale wars. This exceptionally bad situation in Japanese government finances gives market participants a good reason to be concerned about capital flight if things happen to go wrong.



Real wage levels of Japan and US

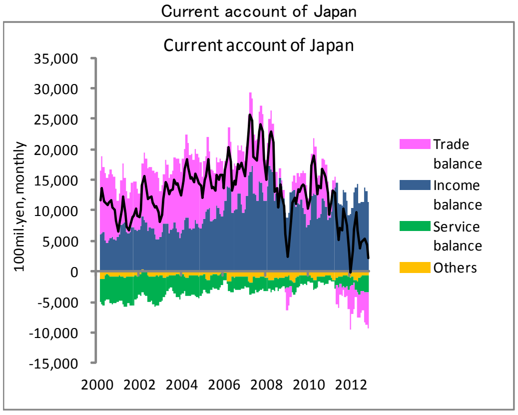


(Source) Bloomberg

The yen depreciation and the current account of Japan

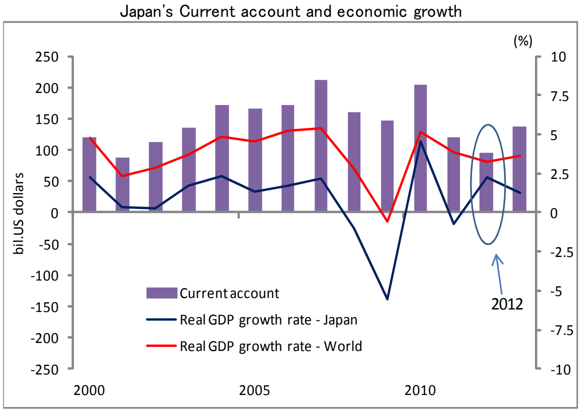
An issue related to this concern is the recent development of the current account. The year 2012 was a year in which Japan experienced a trade deficit in annual terms for the first time since 1980. The current account surplus also shrank rapidly because of the trade deficit. The question is whether this is a temporary phenomenon or whether it will become a long-term trend. The answer is that it is a temporary short-term to medium-term trend. The development of the balance of payments in Japan in 2012 reflects weak global demand and strong domestic demand due to the reconstruction after the Tohoku earthquake and unexpected demand for oil and gas because of the problem with nuclear power stations.

Current account of Japan



(Source) Bank of Japan

Japan's Current account and economic growth

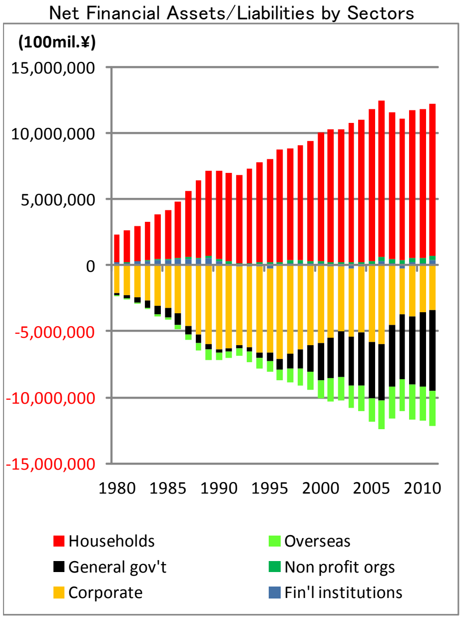


(Source)IMF. Figures in 2012 and after are estimated base.

In a long run, however, we need to count the structural change in Japan's balance of payments. The ageing society could cause lower savings in the household sector. This change in the I-S balance could result in a current account deficit in the long run. A current account deficit would change the landscape of the yen exchange market, and the yen would depreciate more easily than today.

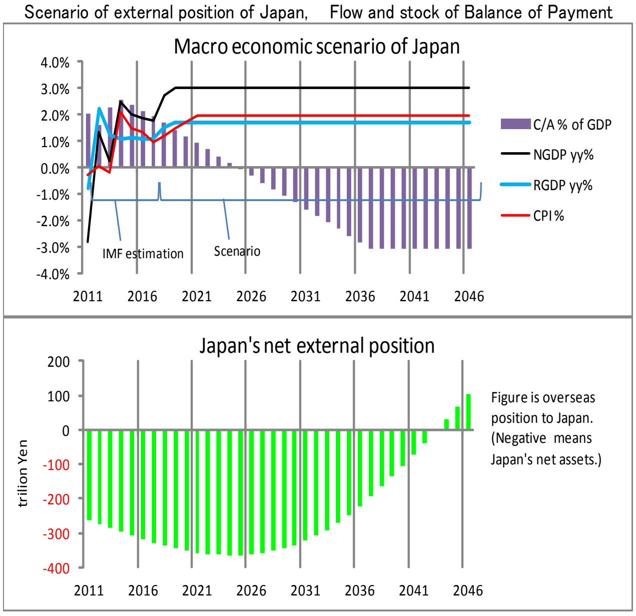
Although there is a fundamental change, it is still too early to worry about a 'capital flight' type of outflow accompanied by a sharp rise in interest rates and a fall in the foreign exchange rate. Japan is still a large net asset country. This enables Japan to finance itself for decades after its current account turns into a deficit.

Net Financial Assets/Liabilities by Sectors



(Source) Bank of Japan

Scenario of external position of Japan, Flow and stock of Balance of Payment



(Source) IMF

Note for the charts: Currently, the net external assets of Japan amount to 250 trillion yen, which is about 50% of the GDP. Under a scenario in which the Japanese economy turns the current account into a deficit in ten years and the deficit grows to 3% of the GDP in another ten years, Japan's net financial assets start to decline ten years from now and become zero in another 15 to 20 years.

Box 2: Inflation will cause higher interest rates. Is the negative impact serious?

There is concern over an interest rate rise if the Japanese economy successfully recovers and deflation is halted. The amount of debt service will increase for the Japanese government. As the outstanding debt is more than 200% of the GDP, the increased amount of the dept service is not insignificant at all.

However, so long as the hike in interest rates is in line with the hike in the inflation rate, the burden should be limited. If inflation occurs, the nominal amount of most economic transactions will increase at the same pace. So will the revenues of the government. Unless there is a sharp rise in the risk premium, which we saw in the case of peripheral countries in the Euro area, the impact of an interest rate hike will be nearly neutral. As for the principal amount of the government debt, this situation will be even better because the value of the debt will decrease as time goes by.

Regarding the evaluation losses which occur in financial institutions, the amount is so huge that a credit crunch could happen in the overall Japanese financial system if they realize these losses at the same time, as the rules require. However, it is not a real loss but an evaluation. This should not be lightly recommended, but confusion in the real economy caused by a sharp fall in financial confidence is better to be avoided if possible by changing the implementation of the rules.

Will today's expectation become a reality or end in illusion?

Changes in expectations concerning prices and incomes are necessary starters to escape from deflation. However, this has to be followed by real growth. Corporations need to be convinced that they can enjoy low costs and a less regulated business environment in Japan. Households need to be convinced that they can enjoy a sustainable social security system.

These convictions can be realized not by fiscal stimulus or monetary easing but by reforms of the real economy and decisive policy implementation. Internally, ideas for new businesses must be unlocked by deregulation. A less regulated economy is expected to encourage entrepreneurship to respond to new demands in an ageing society.

The value-added tax should be raised as planned to 8% in April 2014 from the current 5%, and then to 10% in October 2015 so that the Japanese people are convinced that the burden of the ageing society is not being transferred to future generations but is being shared by the contemporary population. This will effectively clear the current uncertainty that makes households conservative in consumption and fertility.

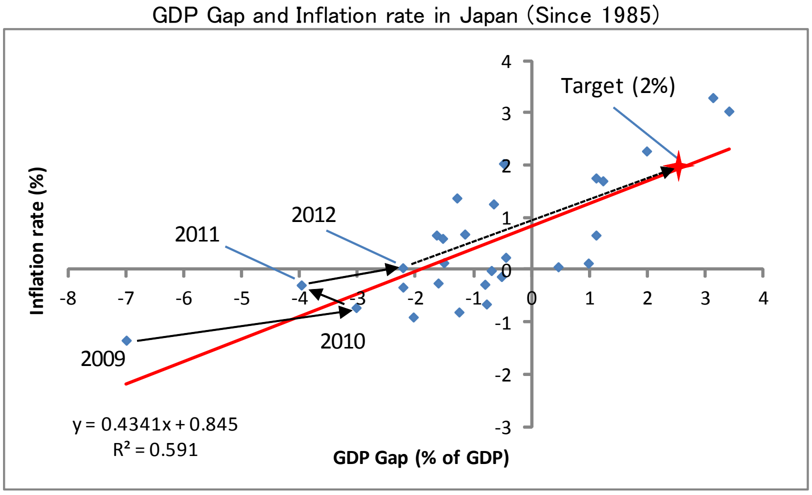
Many people know that the current social security system in Japan is unsustainable. This stalemate should be ended by accepting more taxation or inflation, or a mixture of the two. In any case, it should come at the expense of the present affluence of the Japanese.

The government and the Bank of Japan are in accord on the inflation target set at 2%. It is ambitious and faraway future, but Japan is on the right track for narrowing the GDP gap and the rising inflation rate, although it is moving very slowly.

Expectations will become a solid reality if the correct fiscal policy is taken and appropriate growth strategies are implemented to bridge the potential demands of the ageing society with an upsurge in new businesses. A higher inflation rate can help entrepreneurs in Japan to actualize real businesses by mitigating the debt burden. Activation of business will create higher growth and more jobs. So would start a vicious cycle of expectation of markets and reality of economic fundamentals.

The alternative choice is to do nothing today and accept severe inflation in the end. That could possibly result in a breakthrough of the stalemate of the public debt problem, too. However, the majority opinion is that it is better to manage the burden in a controlled way, e.g., hiking the VAT, than to lose financial assets in a disastrous way due to uncontrolled inflation.

GDP Gap and Inflation rate in Japan (Since 1985)



(Source)IMF

Reference

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