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Japan

What is Ahead for Abenomics?



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Introduction

Japan has been drifting in the economic doldrums for years, beset by falling productivity, waning competitiveness, deteriorating fiscal imbalances, and bedevilling deflationary pressures.

Against this, the government of Prime Minister Shinzo Abe won office in late 2012 with a pledge to put the economy back on a path of growth. It launched its ambitious “Abenomics” programme made up of flexible fiscal policies and bold monetary expansion led by quantitative easing (QE) on a massive scale.

The results have been mixed. Some progress has been made. But there have also been setbacks and many complications, such as a general slowdown across the globe and a plunge in oil prices.

To date, Japan’s economic recovery has been modest, but it is also fragile. And that fragility has been a problem for the pace of Abe’s reform push. When the government raised the national sales tax rate by a few percent in 2014, growth collapsed dramatically and the economy fell into recession. Abe called, and subsequently won, a snap election, but only after he postponed plans for a second sales tax hike until 2017. Delaying this key revenue stream, however, could set back the government’s aim of achieving fiscal consolidation by 2020.

Things get even trickier when reform goes beyond policy management. To change and prosper, Japan must overcome some deeply ingrained societal and structural barriers, and attitudes.

With its ageing population and low birth rate, the proportion of productive workers among Japan’s people is shrinking year by year. To beat this, older workers may have to be pressed into keeping their jobs for longer, and more women encouraged to enter the workforce. Immigration – strictly limited by a country that sees itself as a largely homogenous society – might have to be opened up for skilled foreign labour. And, the long cherished Japanese ideal of having a job-for-life might have to go.

This report examines some of the big issues, prospects, and challenges facing the world’s third largest economy. ❌

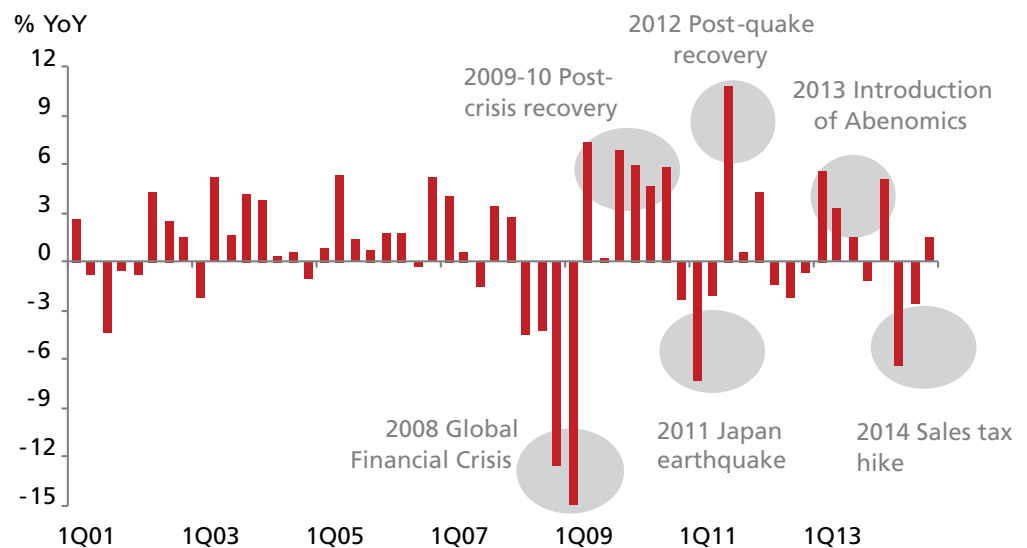
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Modest Recovery in 2015-16

Ups and Downs for Growth

Prime Minister Abe took office in December 2012 and introduced Abenomics to revive the Japanese economy. GDP growth rose to 1.6% in 2013 on the back of expansionary monetary and fiscal policies. But after a sales tax hike in 2014, growth fell quickly and sharply to 0% (Diagram 1).

Diagram 1: Japan's GDP growth



Source: CEIC, Bloomberg

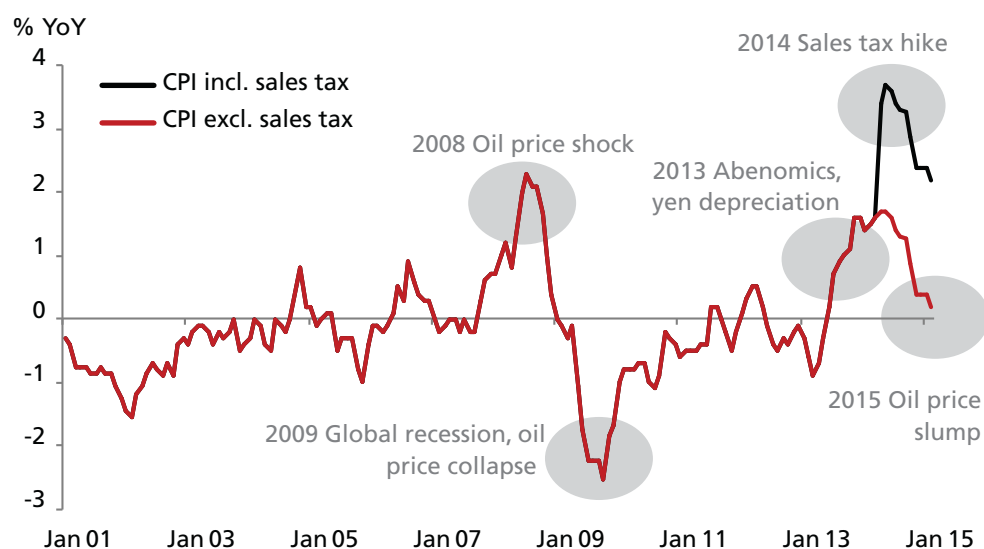
A modest economic recovery is expected in 2015-16, with annual GDP growth projected to be 1%. There should be no disruption from further fiscal policy tightening for this period as the government has postponed the second phase of its sales tax hike until 2017.

Since October 2014, the BOJ's QE expansion has boosted the stock market and weakened the Japanese yen. Both should bring about positive effects. This rise in equity prices should lift sentiment and create wealth for consumers. A weaker yen should boost corporate profits for export-oriented manufacturers, enabling them to increase capital spending and raise employee wages.

Inflation's Fall and Rise

On the prices front, the consumer price index (CPI) inflation rose marginally to 0.4% in 2013 and crept higher to 1.3% in 2014 (excluding the sales tax, Diagram 2). But this was the wrong type of inflation for Japan's needs, as it was mainly due to increases in import costs brought about by a weak yen.

Diagram 2: Japan's CPI inflation



Source: CEIC, Bloomberg

Inflation is expected to fall far below the 1% mark this year before ticking up in 2016. The slump in global oil prices has offset the inflationary impact of a weak yen, pushing down CPI figures to virtually 0% since the start of the year. Without a significant rebound in oil prices, CPI growth could stay around 0% through the rest of 2015.

Prices, however, should go up in the medium term. Ultimately, the fall in oil prices should be beneficial for the Japanese economy as it should improve the terms of trade, boost corporate profits for importers, and lift the real incomes of consumers. If GDP growth reverts to the trend rate in 2015-16, as has been forecast, aggregate demand will increase, the negative output gap will be closed, and wage-driven inflation will rise with a time lag.

Watching the BOJ

The BOJ is paying closer attention to medium term price developments rather than short-term price fluctuations. Theoretically, a recovery in real economic activities and a rise in wage growth should bolster inflation expectations and the medium-term prices trend. This would allow the BOJ to maintain the status quo on monetary policy and refrain from further easing.

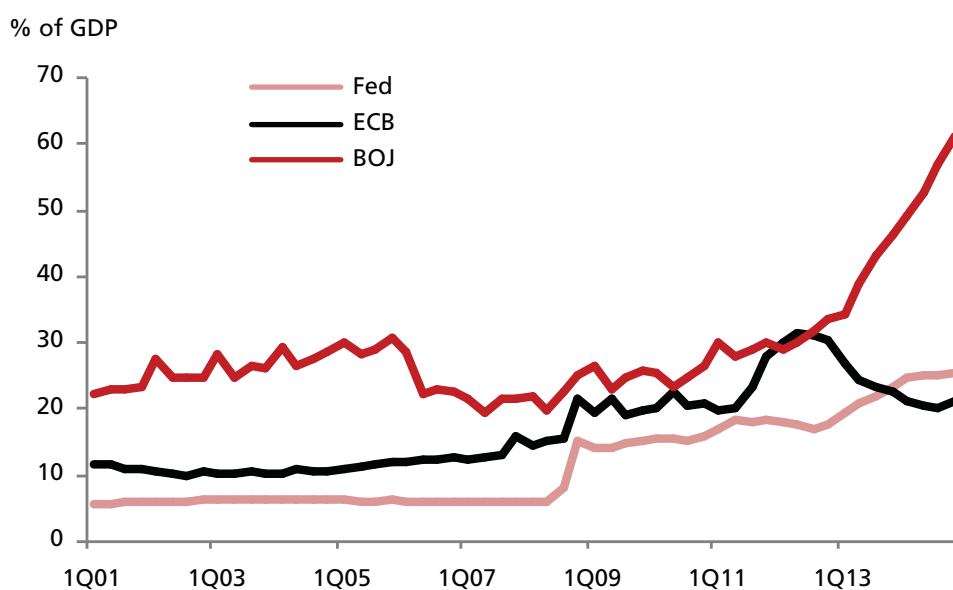
In reality, however, a prolonged period of weak (actual) CPI figures could negatively impact people's psychology and expectations. Low oil prices, if they persist, would

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suppress consumer prices. Moreover, if low oil prices were associated with weakness in global demand, Japan's exports outlook would be dampened. That would be a drag on economic recovery and wage growth. Under such a scenario, the BOJ would face greater pressures to ease policy in order to bolster growth and inflation expectations.

Regardless of whether the BOJ pursues extra easing, its policy is looser than its peers. The size of the BOJ's balance sheet expanded to an equivalent of 61% of GDP at the end of 2014. That was a big rise compared with 34% two years ago, and in stark contrast with the 20% to 25% level seen in the US and the Eurozone (Diagram 3). Based on the BOJ's current pace of QE, its total assets to GDP ratio could rise further to as much as 90% by the end of 2016. Divergent monetary policies and negative yield spreads between domestic and global markets would probably encourage capital outflows from Japan. That, in turn, would put downward pressure on the yen in 2015-16. ❌

Diagram 3: G3 central banks – scale of the balance sheets



Source: CEIC, Bloomberg

QE Is Not the Panacea

Bold monetary policy is a major part of Abenomics and so the BOJ introduced a new QE programme in April 2013. It set monetary base as the operating target and established an explicit goal of achieving 2% inflation within two years. The BOJ initially kept the pace of QE at 60-70 trillion yen per annum. That allowed it to double the outstanding size of base money between the end of 2012 and the end of 2014. In October last year, it announced an expansion of the easing programme and accelerated the pace of QE to 80 trillion yen per annum.

These bold measures by the BOJ have impressed investors and created announcement effects in the financial markets. Equity prices surged strongly and the yen fell sharply. Compared with the end of 2012, the Nikkei benchmark stock index is now up by 100% and the yen is 50% weaker against the US dollar.

Small Real Effects

But the effects of QE need to flow into the real economy. The BOJ is hoping that the public's inflation expectations will increase so consumers are encouraged to save less and spend more. In this way, the economy would be able to return to a virtuous cycle of rising prices and rising demand.

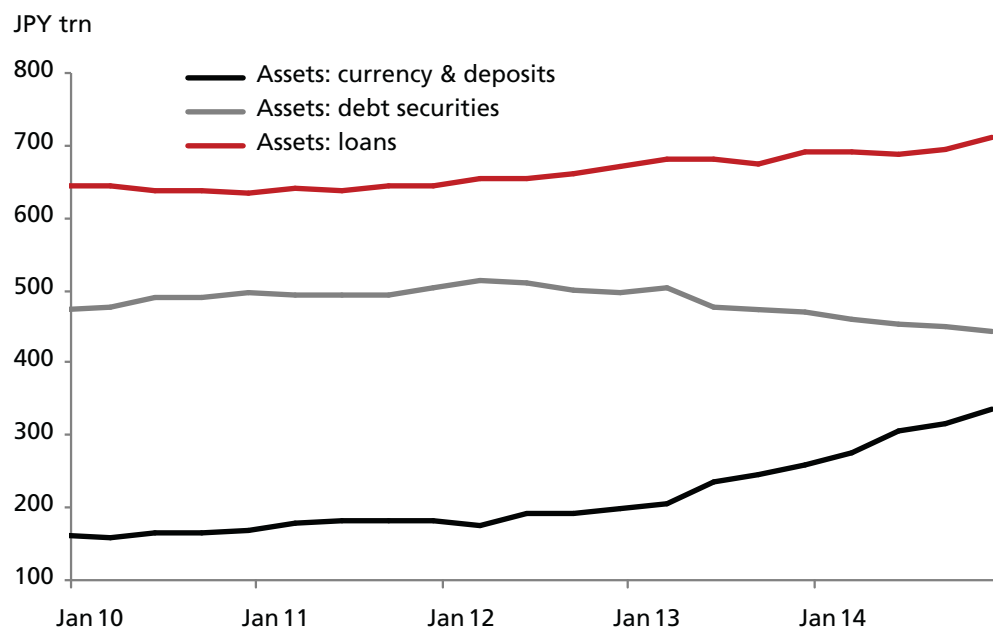
It is worth noting that the saving ratio among Japanese households has been falling sharply and persistently over the past two decades, from 10% in early-1990s to 2% in early-2010s. Much of this is due to a rapidly ageing population. The weakness in Japan's consumer spending in recent years was not caused by high savings, but by the stagnancy of income / wage growth.

To be sure, without a rise in wage growth, consumers could still increase spending via increasing borrowings. If inflation expectations increase, consumers should have stronger incentives to borrow and to invest in riskier assets. The problem here is that higher inflation expectations could also lead to a rise in nominal market interest rates, keeping the real capital costs from declining.

...the impact of QE on Japan's credit market has been small and limited

So far, the impact of QE on Japan's credit market has been small and limited. In the past two years, Japanese banks expanded their loan portfolios by a total of 41 trillion yen – equivalent to a modest annual growth rate of 3%. Due to aggressive asset purchases by the BOJ, the banks have been obliged to cut their holdings of Japanese government bonds. But they have continued to accumulate risk-free assets in the form of liquid reserves placed at the BOJ, instead of lending out (Diagram 4).

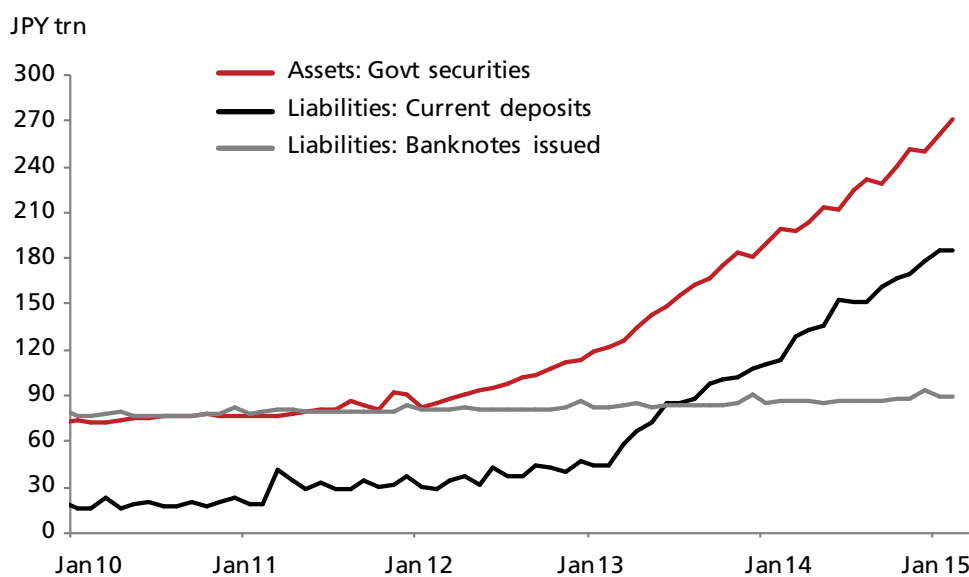
Diagram 4: Japanese depository institutions – composition of the balance sheets



Source: CEIC, Bloomberg

According to the central bank's balance sheet, the outstanding size of current deposits placed by financial institutions increased by 131 trillion yen between December 2012 and December 2014. In comparison, there was a 142 trillion yen expansion in the BOJ's total assets during the same period (Diagram 5). In other words, more than 90% of the QE funds were parked in the banks' accounts instead of being injected into the real economy.

Diagram 5: The BOJ – composition of the balance sheet



Source: CEIC, Bloomberg

Winners and Losers

Despite the limited transmission effects for the economy as a whole, Japan's QE programme has created side effects with winners and losers. For instance, the weak yen has boosted export revenues for large manufacturers. But it had also elevated the cost of imports for domestically-oriented small-to-medium enterprises (SMEs). Similarly, financial asset holders have fared well from the stock market's rally. However, wage earners and pensioners have lost some purchasing power as a result of currency weakness and the rise in living costs.

The value of the yen has swung from overvalued to undervalued. The yen was excessively strong during the 2008 Global Financial Crisis. But now the US dollar is trading at around the 120 yen mark, which is about where it was in 2007. Looking ahead, the benefits and costs of further yen weakness will need to be reassessed. ❌

Fiscal Consolidation Has a Long Way to Go

A flexible fiscal policy is another important component of Abenomics. The clearest demonstration of this has been in the government's handling of its controversial sales tax hike. In order to reduce the budget deficit and restore public debt to a sustainable path, the government raised the sales tax in April 2014, from 5% to 8%. But when this triggered a short-term economic contraction, the authorities postponed a second-stage hike (from 8% to 10%) from October 2015 until April 2017.

2020 Target

The sales tax hike is widely seen as a key source of revenue for Japan, and a way to cut the budget deficit and restore public finances. The delay of its second phase certainly means a slowdown in the country's fiscal consolidation process. In fact, even if the next sales tax hike were to be implemented as scheduled, it would remain challenging for the government to achieve the fiscal consolidation target by the 2020 fiscal year.

Lifting the sales tax from 5% to 10% would generate tax revenues worth an estimated 10 trillion yen a year. This is too small to cover the primary fiscal deficit, which registered 16 trillion yen in the latest fiscal year prior to the tax hike. Not to mention the government's expenses on interest repayments, which amounts to around 20 trillion yen per year.

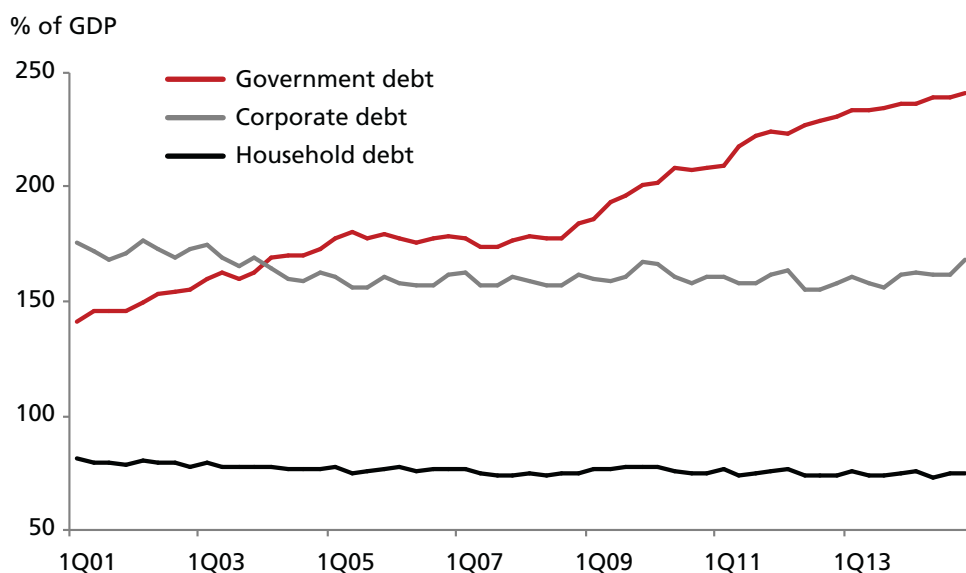
In another change to fiscal policy, the government wants the corporate tax rate cut progressively from the 2015 fiscal year. It hopes this can revive investment growth and therefore, broaden the tax base. However, a comparatively high tax rate is not the only factor impeding investment in Japan. There are many structural barriers in place that restrict investment.

Public Deleveraging – A Potential Drag on Growth

Japan's public debt is already the highest in the world. Public debt to GDP ratio has risen in the past two years from 231% in end-2012 to 241% in end-2014, notwithstanding the implementation of experimental tax reforms under Abenomics (Diagram 6). This ratio is likely to continue rising through the rest of this decade. Eventually that could generate concerns over public debt sustainability and sovereign credit risks.

So far, the government has shown the flexibility to manage fiscal consolidation at a gradual pace. This is because ample domestic savings have been able to finance public debt and keep yields low. However, this is changing as Japan's population ages. The country's gross

Diagram 6: Japan's public and private debt



Source: CEIC, Bloomberg

saving ratio has fallen steadily in the past two decades – from 30% in the early 1990s to 19% in the early 2010s. With the demographics deteriorating in the coming years, the domestic savings pool is likely to shrink further. Eventually this will lead to a rise in the ratio of foreign financing. A higher participation of foreign investors in the Japanese yen debt market will imply the risk of higher yields, which could in turn accelerate the process of public deleveraging and negatively impact the real economy.

There Is No Magical Fix

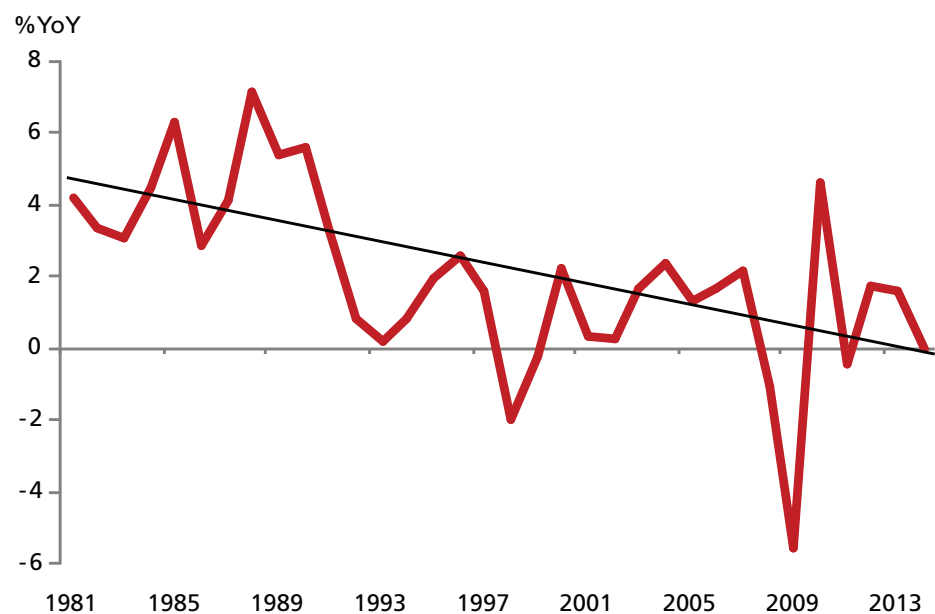
The optimists argue that public debt dynamics should automatically improve, because the BOJ's QE should reflate the economy and boost nominal GDP. This argument does not take into account a possible rise in bond yields triggered by higher inflation expectations. A synchronous rise in inflation, nominal GDP, and nominal interest rates cannot help reduce the debt load. A meaningful improvement in the debt dynamics will, essentially, require a sustainable rise in real GDP.

Moreover, there will be a limit on how many assets the BOJ can buy to maintain its reflation policy. Due to the aggressive QE programme under Abenomics, the BOJ has boosted its bond holdings to 25% of outstanding Japanese government bonds, significantly higher than the ratio of 10% two years ago. Based on the current pace of QE, the BOJ will own 40% of government bonds by the end of 2016. A persistent and rapid rise in the bond ownership ratio could fuel investors' concerns about public debt monetisation, and raise the risks of capital outflows and financial destabilisation. This will eventually put constraints on the BOJ's monetary policy. ❌

Tackling Tough Structural Challenges

Structural headwinds have been weighing on the Japanese economy for a long time. The country's potential growth has fallen to less than 1% since the 2000s, sharply down from more than 4% in the 1980s (Diagram 7). The ageing of the population has resulted in the shrinking of the domestic consumer market. This has dampened incentives for Japanese firms to invest in the home market and prompted them to explore opportunities in emerging economies overseas. Due to the rise in overseas production ratio, the depreciation of the yen during the last two years failed to lift domestic output and investment growth proportionately.

Diagram 7: Japan's long-term GDP growth trend



Source: CEIC, Bloomberg

Productivity has also been weakened by insufficient market openness and rigid labour market regulations. Weak productivity helped to explain why Japanese companies have been hesitant to raise base wages, notwithstanding the increase in their profits and the government's push for wage hikes. From a long-term perspective, the ageing population will bring about a shortage of labour supply and a structural increase in wage costs. Without a pickup in productivity growth, unit labour costs would increase and trade competitiveness would be eroded.

Reforms Are Not Easy

It is widely agreed that Japan needs comprehensive reforms to prevent a further decline in its growth potential and a loss in competitiveness. In reality, however, reforms are not easy to enact. Essentially, many of the structural issues are deeply rooted in Japan.

Comprehensive reforms may induce significant social and cultural changes, which could encounter resistance, not only from vested interest groups, but also the general public.

For instance, to tackle the challenge of the ageing population, the government would need to encourage a higher birth rate, increase the labour participation of women and older people, and open up immigration policies to bring in more foreign workers. To do this would require a major shift in conservative and traditional attitudes among the Japanese people.

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among the Japanese people*

The same goes for other reforms. To boost productivity, Japanese companies and workers would have to abandon many long-held ways and accept the lifting of many barriers against foreign investment. To make the labour market far more flexible, Japan's lifetime employment system and seniority-based pay system would have to be scaled right back.

The government has proposed a long-term growth strategy under Abenomics – the so-called "Third Arrow". Its focus is on bringing market-friendly measures, such as cutting corporate tax to boost investment and providing financial incentives to spur research and development. But little has been done on profound reforms such as immigration, investment access, and labour market deregulation.

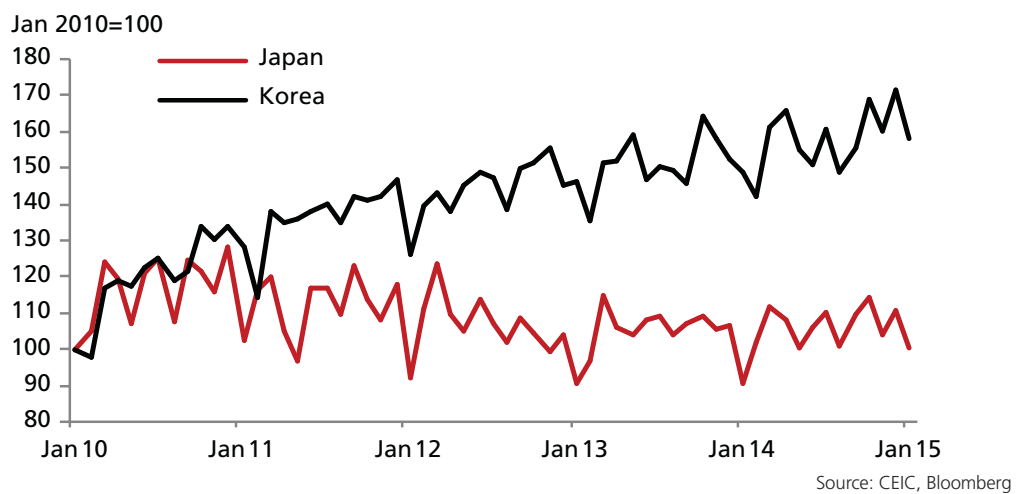
Given that public resistance to drastic policy changes is potentially high, it is understandable that the authorities prefer a cautious and gradual approach. As such, it would take a long time for reforms to be fully implemented and to engender positive results in the economy. There is a significant risk that the country's potential growth will continue to decline for the rest of this decade, because of these intrinsic drags. ❌

Impact of Abenomics on Asia

External Trade

When Abenomics was introduced two years ago, there was widespread concern that a much-depreciated yen would dramatically boost Japanese exports at the expense of the trade competitiveness of other Asian countries, particularly South Korea.

Diagram 8: Japan & Korea – export volume index



It was true that the fall in the value of the yen has boosted the export revenues of Japanese firms. Measured by the volumes, however, Japan's exports have continued to move sideways. They have also underperformed in comparison to Korean exports by a wide margin (Diagram 8). In terms of the market share in global trade, Japan's has declined, while South Korea's has remained steady (Diagram 9).

Diagram 9: Leading exporters in world merchandise trade

	2011			2012			2013		
	Rank	Value (USD bn)	Share (%)	Rank	Value (USD bn)	Share (%)	Rank	Value (USD bn)	Share (%)
China	1	1898	10.4	1	2049	11.1	1	2209	11.7
US	2	1480	8.1	2	1546	8.4	2	1580	8.4
Germany	3	1472	8.1	3	1407	7.6	3	1453	7.7
Japan	4	823	4.5	4	799	4.3	4	715	3.8
Korea	7	555	3.0	7	548	3.0	7	560	3.0
Hong Kong	12	456	2.5	10	493	2.7	9	536	2.8
Singapore	14	410	2.2	14	408	2.2	14	410	2.2
Taiwan	18	308	1.7	18	301	1.6	20	313	1.7
India	19	305	1.7	19	294	1.6	19	305	1.6

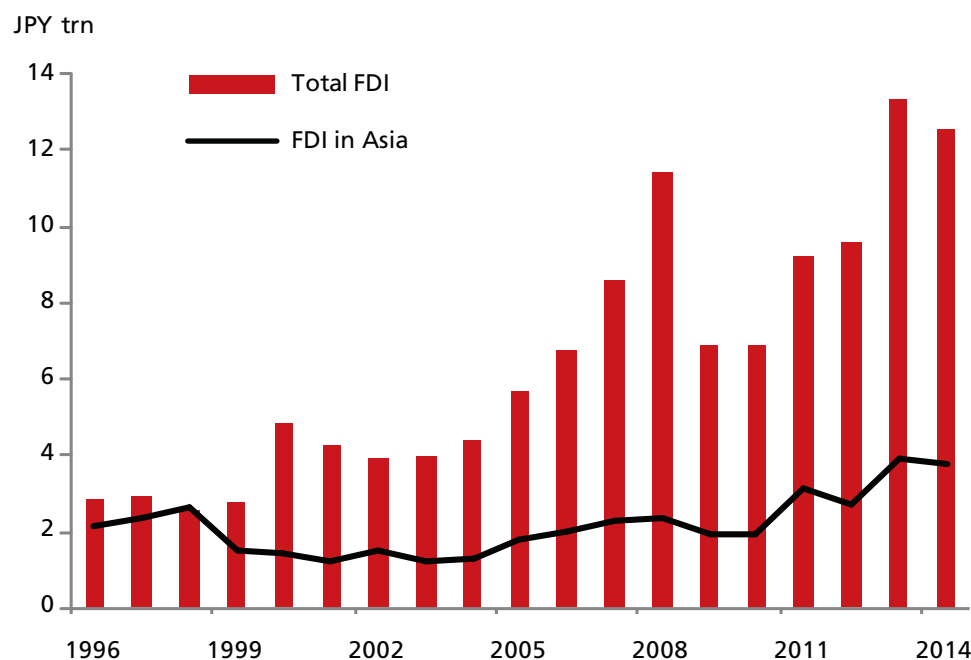
Source: WTO International Trade Statistics

As it has turned out, competitiveness does not just depend on exchange rates. It is also dependent on wage costs, productivity, and non-price factors, such as technology, product quality and brand. In order to enhance core competitiveness, Japanese firms will need to spend the profits they make from a weak yen in the right areas, such as technology advancement, innovation and human resource development. It will be a long-term process, and success is not guaranteed.

Weak Yen and FDI Fears

There were also fears that a weak yen would see a decline in Japan's foreign direct investment (FDI) in the region. But these concerns, too, were overstated. The annual FDI flows from Japan to emerging Asia amounted to 3.8 trillion yen in 2014, close to the 3.9 trillion yen level in 2013 and exceeding the 2.7 trillion yen in 2012 (Diagram 10). Japan's investment in China has declined due to political tensions, but that has been offset by an increase in FDI to ASEAN countries.

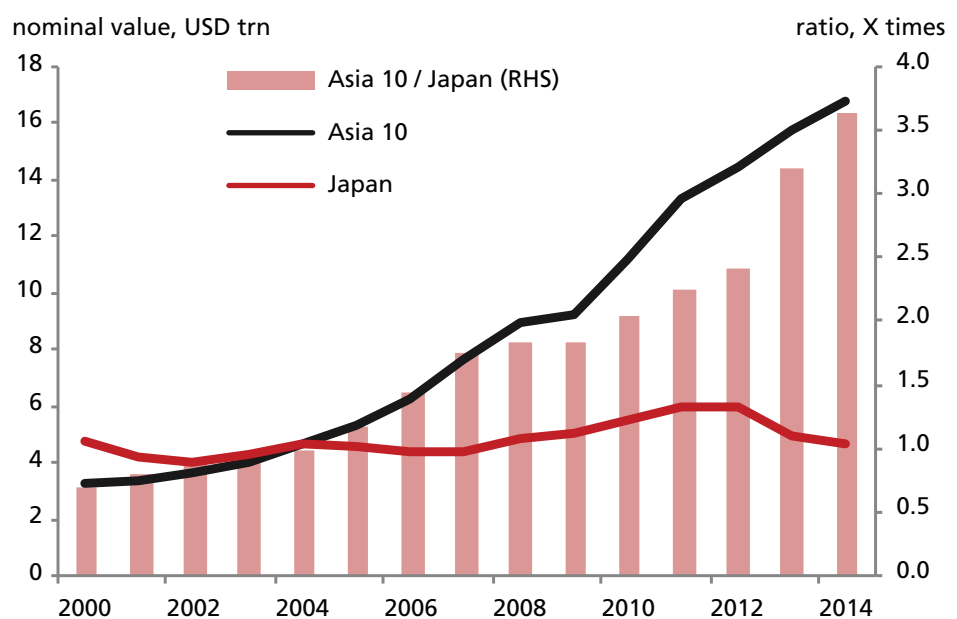
Diagram 10: Japan's outward FDI



In fact, FDI flows from Japan to emerging Asia have maintained a general uptrend during the past three decades, except for the periods of 1999-2001 and 2009-2010 when the region entered a severe economic downturn due to unexpected shocks. To Japanese firms, emerging Asia offers an attractive business prospect because of its relatively superior growth performance and high investment returns. Although Asia's GDP growth has come off the peak in recent years, its growth gap with Japan has remained positive and significant.

Moreover, the gap between emerging Asia’s economic size and Japan’s is widening. The sum of Asia-10 GDP has surpassed Japan’s GDP since 2005. And the ratio between the two has risen further to 2.0 in 2010 and 3.6 in 2014 (Diagram 11). The enormous market size and potential demand in Asia should be enough to entice Japanese corporate investors in the foreseeable future.

Diagram 11: Asia-10 & Japan – GDP gaps



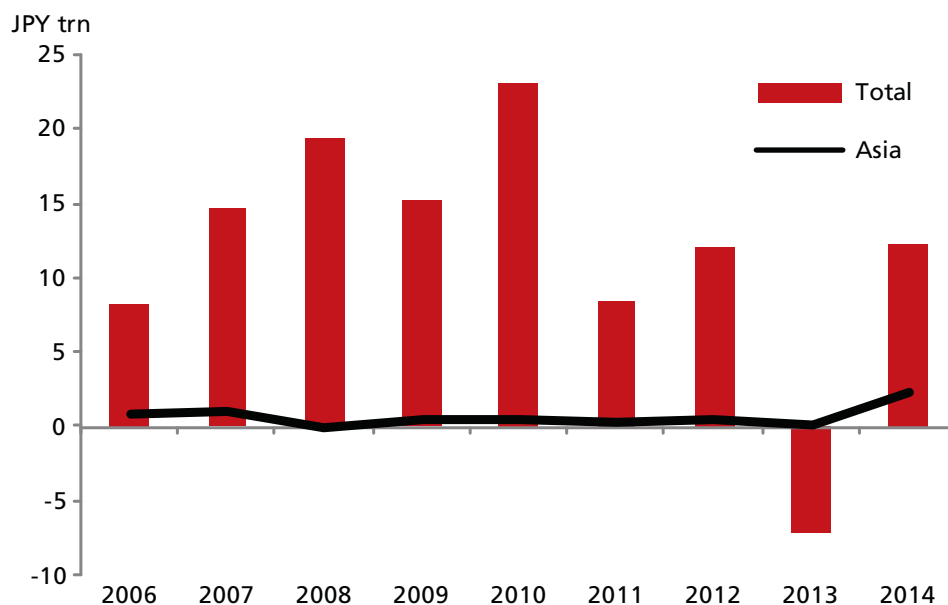
Source: CEIC, Bloomberg
 Note: Asia-10 represents Greater China, Korea, ASEAN 5, India

Portfolio Capital Flows

Many had also expected that the BOJ’s QE would induce more capital outflows from Japan to other parts of the region. In reality, Japan’s investment in foreign equities and bonds decreased at the initial stage when the new QE was introduced in 2013 (Diagram 12). Compared with FDI, short-term financial investment is more susceptible to the exchange rate movements. The rapid depreciation of the yen in 2013 prompted Japanese investors to sell overseas financial assets, in order to convert them into the yen to take profits. As the decline of the yen became gradual in 2014, Japanese investors started to reconsider overseas investment opportunities and portfolio capital outflows increased again.

As long as there is not another round of foreign exchange fluctuations, Japan’s outward portfolio investment should continue to increase. This should not be associated with the BOJ’s QE per se.

Diagram 12: Japan's outward portfolio investment



Source: CEIC, Bloomberg

On the fundamental front, the negative growth and interest rate differentials between Japan and the rest of the world should provide sufficient incentives for Japanese investors to invest abroad.

Note that in order to enhance the return performance, the Government Pension Investment Fund has adjusted its investment strategy for the next five years, reallocating portfolios towards domestic equities, foreign equities and foreign bonds. This could serve as a guide for the entire pension funds industry (which manages assets of 340 trillion yen in total). That should lead to a more significant rise in portfolio capital outflows in the coming years. ❌

Conclusion

So what lies ahead for Abenomics and the Japanese economy? From the short-term cyclical perspective, it will likely stay on a modest recovery path in 2015-16, thanks to a loose monetary policy and the postponement of fiscal consolidation.

A continued improvement in aggregate demand, employment and wage growth will increase the chances of the economy climbing out of deflation. That said, the inflation numbers are still likely to miss the BOJ's ambitious target of 2% by a wide margin.

Further ahead, the downside risks facing the economy remain significant for the medium to long term. A resumption of the sales tax hike implementation and fiscal policy tightening could disrupt the recovery and trigger a temporary economic contraction in 2017. Further afield, attention should also be given to the possibility of rising interest rates and higher risk premium, due to a further shrinking of the domestic savings pool and deterioration of the sovereign credit profile.

In order to achieve a sustainable recovery and preserve investor confidence, it will remain crucial for the authorities to enact the supply-side reforms to directly revive the country's growth potential. Much still depends on the "Third Arrow" of Abenomics, i.e., the progress of structural reforms to address the ageing population and the weakening of productivity and competitiveness.

Among all the uncertainties for the longer term, a clear trend is that Japanese companies and institutional investors will continue to explore opportunities in other parts of Asia in an active manner. Relatively fast growth, high yields and expanding market size would make emerging Asia increasingly attractive as an investment destination in the coming years. ❌

*Much still depends on the
"Third Arrow" of Abenomics*



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