Challenges to Abenomics: Japanese Growth Rides on Potentially Elusive Productivity Gains

A spotlight shines very brightly on Japan at the moment – and especially on Prime Minister Abe – not unexpected of course when an economic policy bears your name. Abenomics was sold to the electorate in December 2012 partly on hope and partly on a willingness to give change a chance based on the frustrations of the past two decades. There is a burning desire in Japan to regain some of the past economic glory and to attain annual real GDP growth rates above 2% and possibly higher.

Abenomics consists of “three arrows”. The first arrow is the massive asset purchase program of the Bank of Japan – quantitative easing. The second arrow has been increased government spending for public works projects. The third arrow encompasses structural reforms designed to spur productivity growth through an array of avenues including policy changes in agriculture, labor markets and the health care sector. A year and a half into the Abenomics experiment, what is on the line is the Prime Minister’s credibility. The difficulty in delivering on bold (and well meaning) promises of economic growth and revitalization arises when said policies collide with some harsh realities of demographics and cultural traditions.

A. Labor Force Growth and Productivity Gains

Labor productivity gains are pivotal to the success of Japan’s economic reforms because there is virtually no labor force growth. The arithmetic of real GDP growth can be decomposed into the sum of labor force growth and productivity growth. There is nothing causal about this observation, but for a country whose labor force is stagnant, it is suggestive that the only policies that will work to increase the real GDP growth rate on average and over time are those that enhance labor productivity.
The primary reason the labor force is not growing is simply because population growth has stalled in Japan (not uncommon for a mature, developed economy). Moreover, as the birthrate has fallen and people are living longer, a greater percentage of the population is above 65.

Immigration, of course, can ease the challenges of an aging demographic pattern, but Japan is not open to encouraging wholesale immigration. Although, it is fair to note PM Abe has argued for allowing more foreign nurses to care for the growing number of elderly, but this is a small program.

The only other avenue to increase the labor force is through greater female participation. The female labor force participation rate in Japan is currently 48%, compared to 57% in the U.S and 56% in the U.K. And, women in Japan are typically in lower-paying, less productive jobs, adding a labor productivity component to this policy avenue. Thus, there may be some limited scope for encouraging higher economic growth through policies with the “third arrow” that enhance the role of women in the workforce. Essentially though, without labor force growth, the question is whether any of the policies in the three arrows can make a meaningful change in labor productivity on average and over time.

B. QE, Fiscal Policy, and the Uncertain Link to Labor Productivity

The first arrow of Abenomics is quantitative easing (QE) from the Bank of Japan. The Bank of Japan (BoJ) adopted zero short-term interest rates in the mid-1990s to prevent a strengthening yen from adding to deflationary pressures. But the BoJ resisted quantitative easing until recently. Despite receiving advice from then Professor Bernanke in 2000 to adopt QE, the BoJ was concerned about the potential for unrealized portfolio losses if it bought billions of government bonds and then inflation started to rise, taking bond yields higher and prices lower. The same longer-term risks are present now, but Prime Minister Abe’s choice to head the BoJ, Governor Haruhiko Kuroda, is willing to take the chance and has opted for massive QE.

The economic channel from QE to higher real GDP growth is fraught with some heroic assumptions. In Japan’s case, the concept is to create a little inflation, break the psychology of deflation, and then hope for higher consumption to lead to stronger growth.

First, there is the issue of whether QE can even create inflation. Japan has experienced some inflation pressure since Prime Minister Abe won election, but this is most likely attributable to the weakness in the yen from the period a few months before the election in late 2012 until April 2013. In that time frame, the yen went from below 80 versus the US dollar to the 97-103 range, where it has been stuck ever since. QE did not commence until April 2013, after the yen move had already occurred. One could interpret the yen move as anticipating QE, but it may also have been a response to the new Japanese government’s welcoming of a weaker yen. In any case, the actual implementation of QE has not led to further yen weakness. And, the inflation that has been created is mostly coming from imported energy. The nationwide general consumer price index is up about 1.5% over a year ago, while the core price index, excluding food and energy, is only up 0.7%. Our analysis of the core inflation rate is that it may actually slide a little lower over the second half of 2014, after adjusting for the increase in the national sales tax. And, after April 2015, the sales tax hike will drop out of the year over year comparisons, and absent another round of yen weakness between now and then (which is definitely possible), Japan’s core inflation rate in mid-2015 might still be stuck in the 0% to 1% range.
At the same time the yen weakened in late 2012 and early 2013, Japanese equities staged a big rally. The link between yen weakness and equity strength, notably, does not necessarily flow through expectations of export growth.

Big Japanese multinational companies have substantial production facilities outside of Japan, as well as huge non-yen balance sheet items, including property, plant, equipment, and non-yen financial assets. A weaker yen may contribute a little to exports, but it definitely means the non-yen assets of Japanese multinationals should be valued higher in yen terms. Also, the non-yen free cash flow of Japanese multinationals would also be revalued higher in yen terms. What is not clear is if expected export growth had any role at all in the equity rally. Indeed, with China still seeing decelerating economic growth, the most recent data for export volume suggests weakness, not strength in the sector.

One impact of QE that is crystal clear is that QE has caused the BoJ’s balance sheet to expand through the purchase of Japanese Government Bonds (JGBs). Bank lending or other signs of credit expansion, however, have not followed suit. And JGB yields, after some initial volatility, are still well below 1% on the 10-year. So, while the BoJ now owns a much higher percentage of outstanding government bonds than before QE, and the private sector owns a correspondingly lower percentage, not much else has changed. From our perspective, the linkage to higher labor productivity from QE looks very elusive.

With regard to the second arrow, Japanese fiscal policy is a study in conflicts. Expanded public works projects, as part of the second arrow, represent more stimulus. While the decision to allow the increase in the national sales tax, however, is clearly restrictive. Even though the sales tax increase was passed by a previous government, PM Abe allowed it to go into effect, in part, because he feared a negative reaction in the credit markets if this step to address the massive public debt was not taken. The result is that fiscal policy is now restrictive.

Finally, let’s review the logic that breaking the psychology of deflation is likely to increase consumption and in turn real GDP. First, we would argue that the aging demographic pattern in Japan is probably the real reason consumption is not growing as fast as before. With the average age of the country in the mid-40s and a quarter of the population now over 65, spending on the latest fad or style, or even buying a new car every few years is not going to happen at its former pace. Second, even if consumption demand were to increase, there is a strong possibility that the extra demand might raise imports and not domestic production.

C. The Third Arrow: Market Reforms

The specifics of the Abenomics’s third arrow are actually very nuanced – composed of an Industry Revitalization Plan, Strategic Market Creation Plan, and Strategy of Global Outreach. The last of these measures is designed to facilitate new and broader free trade agreements, while the first two initiatives are meant to address drags on business and foster productivity domestically.

The chosen industries being focused on in the Strategic Market Creation Plan include healthcare, energy, infrastructure, agriculture and tourism. While some reforms in these selected industries are occurring now, much of the plan revolves around considering the issues and remedies necessary to bring about impactful reform in the future. Indeed, the long term effort required to overhaul and make meaningful changes in some of these industries will likely take effect in a target range of 2020-2030. This is not a timeline that many market participants or voters will be thrilled about.
There has been some headway in the agriculture sector with the recent abolishment of subsidies for rice production. We consider this quite the feat considering rice subsidies have been in place for the last 40 years. Another law just passed has made it significantly easier to consolidate farmland, with the expectation of increasing productivity in the agriculture sector. And, there has been limited bi-lateral progress with Australia on agricultural trade, although a broader deal with the US and European Union is going nowhere.

Changes made to regulations in the health care sector revolve around increasing competitiveness and investment. A very specific example includes making it possible to sell medicine over the internet, and augmenting the specifics of availability of drugs under the state-wide universal health care coverage. And, as previously noted, there are plans to import foreign nurses to help care for the growing population of the elderly.

The Industry Revitalization Plan emphasizes reforming the employment system. Focus is on science and technology, providing resources to small and medium sized enterprises (SMEs), and pushing Japan’s megacities as business hubs and the world’s leader in information technology.

Interestingly, in regards to reforming the employment system – the plan cites examining issues in this area without stating any initiatives, and thereby ignoring an often and well cited deregulation request from the private sector on the rules of firing and hiring, in an effort to ease the often high cost of doing business in Japan. Meanwhile, perhaps to appease the business sector, the corporate tax rate was decreased by 2.4% in April of 2014, from 38% to 35.6%. While lower corporate taxes may increase after-tax profits and shareholder value, the link between lower corporate taxes and higher domestic capital investment is not completely clear, and far from a sure thing in fostering labor productivity gains.

It is not evident that any of the above reforms in the third arrow will meaningfully increase labor productivity, as they are not guaranteed to lead to large amounts of capital investment or technological progress. Progress made thus far in the agricultural sector is looking promising in unlocking new efficiencies, while any new reforms in the health care sector could potentially lead to increased investment, as the incentives to care for Japan’s ever-growing elderly population spurs a concentration of efforts in advancing technological progress.

D. Conclusions: The Challenges to Abenomics and the Future of the Yen

When we put our analysis of each of the three arrows in PM Abe’s quiver, we are left with a sense that Abenomics may well disappoint on economic growth. Quantitative easing has raised the proportion of government debt owned by the Bank of Japan and lowered the proportion for banks and pension funds, but that has not led to more bank lending or any signs of stimulus. Fiscal policy turned austere when the national sales tax was allowed to go into effect in April 2014. Competitive market reforms have been few and far between, with only some limited success in health care and agriculture. Moreover, the timeline for long-term reforms is measured in decades, not years.

If this analysis is correct, then one economic scenario gaining probability is that real GDP growth will not be robust in 2014 and that imported inflation from the lagged depreciation of the yen will soon run its course. This leads to the possibility that PM Abe will push for a further depreciation of the yen, which at the least might raise yen-denominated equity prices even if higher real GDP growth rates remain elusive.

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