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Economy

The First Year of Abenomics – Part 3

The impact of monetary easing has been limited

— The actual role of monetary easing has been to assist in fiscal policies.

— The economy has expanded on the back of public investment.

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<Key Points>

- Despite the correction of the strong yen, export volumes have not increased.
- With monetary easing, long-term interest rates have declined, facilitating smooth sales of government bonds.
- The profitability of bank lending has deteriorated due to falling long-term interest rates.

It's been a year since the inauguration of the administration of Prime Minister Abe Shinzo. During this period, the economy has been staging a very steady recovery. However, this latest economic recovery is believed to be slightly different due to the fact that it has mainly been led by domestic demand, whereas most of the previous economic recoveries in recent years were driven by external demand.

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That is to say, despite the approximate 20% correction in the strong yen since the start of the Abe administration, there have been almost no increases in export volumes. The instruments that have been leading the current economic recovery are household spending and public investment.

With expectations of positive effects from Abenomics—the economic policies advocated by the Abe administration—household confidence has improved significantly, resulting in an increase in private consumption in the first half of 2013. However, so far this economic improvement has not come with an increase in real income. As a result, the pace of growth in private consumption has been slowing since the summer of 2013.

However, given the last-minute demand before the consumption tax hike and other factors, housing investments have been progressing steadily. Increases in public investment have also significantly contributed to economic growth.

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Immediately after its inauguration, the Abe administration compiled a supplementary budget for fiscal 2012 to increase public investment. It also increased public investment in the fiscal 2013 budget. As a result, public works spending reached approximately \7.7 trillion on a 15-month budget basis when combining the supplementary budget for fiscal 2012 and the fiscal 2013 budget.

The execution of these public investments is now getting into full swing and has resulted in an economic expansion. The reality is that, of the three arrows of Abenomics, the second arrow, flexible fiscal policies, has been almost solely contributing to this economic growth.

Public spending can have a positive impact on the economy by stimulating economic activities, but at the same time it can cause a deterioration in the fiscal balance. For this reason, amid the continually ballooning fiscal deficit, which is significant, the government decided that it could not continue to make large-scale public investments in light of its limited public spending capacity. Consequently, efforts have been made in recent years to forcefully restrain public spending.

The point is that the reason why the current government is able to increase public investments once again is not because Japan's fiscal balance has improved. In fact, with this increased public spending, the fiscal balance is expected to deteriorate further. The government has only been able to increase public spending because selling government bonds has become easier thanks to the falling long-term interest rates prompted by the first arrow, aggressive monetary easing.

In this sense, it is believed that, through the simultaneous implementation of the first arrow, aggressive monetary easing, and the second arrow, flexible fiscal policies, no matter what its intention, the government has opted for a policy that looks like a fiscal financing policy (also called a "helicopter money policy") in which fiscal spending is expanded based on the central bank's credit.

The implementation of a fiscal financing policy works to stimulate the short-term economy and has actually been contributing to the current economic recovery. However, even with financing from the central bank, the fact that the fiscal deficit has increased as a result of this additional fiscal spending will not go away, and it is suspected that the cost to be paid in the future due to this policy will be noticeably large.

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As described above, it was decided to introduce quantitative and qualitative monetary easing on April 4, 2013 as a tool to embody aggressive monetary easing, and this has served to support increased fiscal spending. Putting this aside, however, with no other choices, monetary easing itself is believed to have only had a very limited impact.

The Bank of Japan has pointed out that its quantitative and qualitative monetary easing will show its effects through three routes. The first route is the creation of a lower overall yield curve. This is based on the theory that lowering not only short-term interest rates, but also medium- to long-term interest rates, will have economic stimulation effects.

It appeared that the Bank of Japan initially had serious difficulty lowering long-term interest rates, but recently, it has finally started to successfully guide lower interest rates in a stable manner.

However, because not only short-term interest rates, but also medium- to long-term interest rates, had already fallen significantly even before the recent monetary easing, room for further declines is limited. Regrettably, it is hard to believe that a small new decline in interest rates will have significant economic stimulation effects.

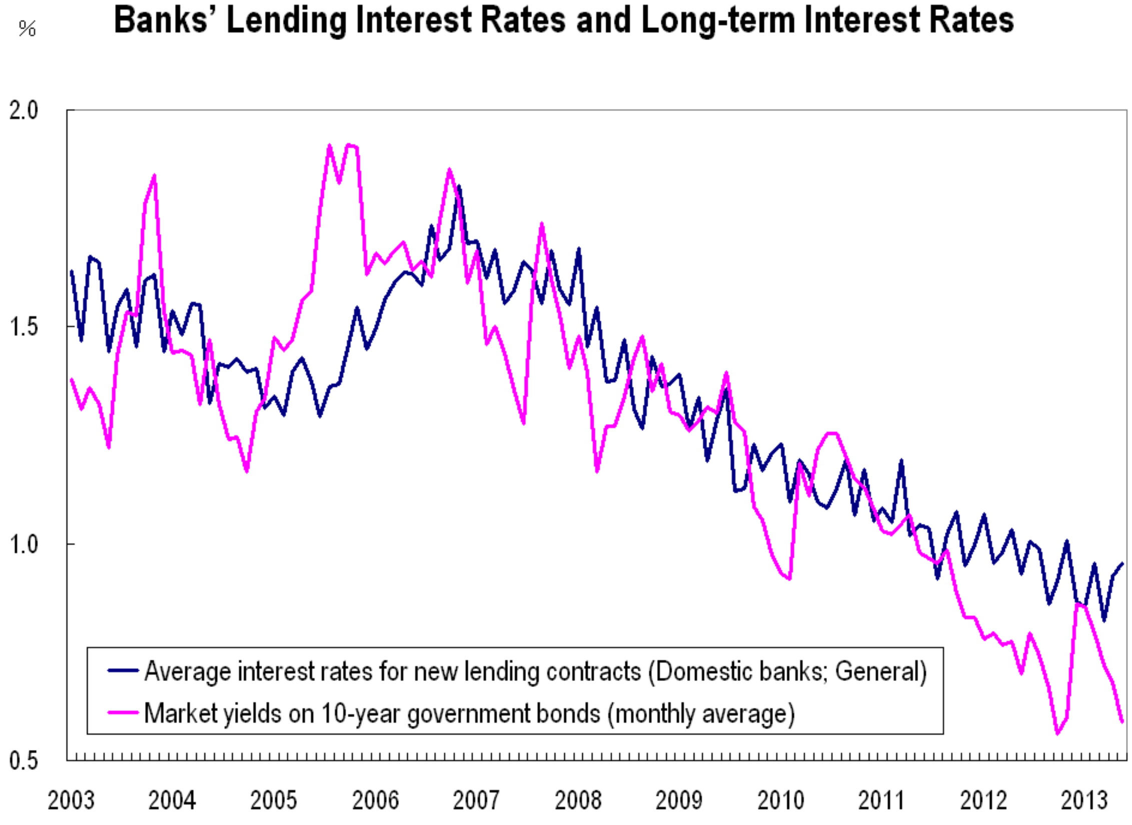
The second route is a development called portfolio rebalancing. The reason why the recent monetary easing is related to the word "qualitative" is because the bank intends to purchase government bonds that have a longer remaining maturity period compared with the government bonds purchased under existing operations.

Up till now, long-term government bonds had been positioned at the center of private financial institutions' asset management. Purchasing a large amount of these long-term government bonds was expected to encourage private financial institutions to rebalance their portfolios. It was believed that these institutions would be forced to manage assets involving riskier instruments because their profitability would decline if they maintained funds in reserve deposits instead of long-term government bonds.

However, so far a full-scale portfolio rebalancing has not taken place, and the proceeds from the sales of long-term government bonds have been funneled directly to reserve deposits. This situation will still help the Bank of Japan to meet its goal (increasing the amount of government bonds held and the base money or money supply), but it can't be considered to have a meaningful impact on the real economy.

Competition among financial institutions is severe. Therefore, private Japanese financial institutions can't consider setting lending interest rates by adding the required costs to their funding costs (short-term interest rates). Therefore, it is a reality that lending interest rates are generally set at a level linked to long-term interest rates (see graph).

Banks' Lending Interest Rates and Long-term Interest Rates



Sources : The Bank of Japan and the Ministry of Finance Japan

Therefore, if monetary easing is adopted while there is still room for short-term interest rates to fall, because long-term interest rates don't fall to the extent that short-term interest rates do, banks will enjoy improved profitability in lending, as they can raise funds at short-term interest rates and lend funds at long-term interest rates. This give banks the incentive to increase the amount of their lending.

In contrast, if monetary easing is adopted when short-term interest rates have already reached bottom—zero—only an additional drop in long-term interest rates can take place and bank profit yields would decline instead, causing a deterioration in lending profitability. It is not logical to expect financial institutions to increase their lending when the profitability of lending is falling.

The third route is to instill expectations. This seeks to lower real interest rates by raising expectations for inflation. This initiative is a totally unprecedented challenge and is one of the reasons why the latest monetary easing is called aggressive monetary easing.

However, the theory that if the base money supply increases, expectations for inflation will rise is logically baseless in a zero-interest-rate environment. In this sense, the third route through which monetary easing is filtered is limited to the spiritual belief that if the central bank takes a serious lead, expectations should change.

In fact, expectations for inflation have increased slightly by taking into account certain developments, such as concerns over imported inflation due to the weak yen and the consumption tax hike. However, evidence is still lacking that expectations for medium- to long-term inflation are rising significantly.

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As described above, none of these three routes appears to have created noticeable results. Consequently, it must be said that the impact of the latest monetary easing has been limited as a monetary policy. However, because the latest monetary easing has been adopted along with fiscal spending, objectively, its actual role is believed to be to aid fiscal policies.

Even if a policy such as a fiscal financing policy continues to be followed, its negative aspects are not likely to become apparent as long as monetary easing remains necessary. Problems will surface when monetary easing is no longer required. At that time, if a clear plan to achieve a sound fiscal footing has not been developed, the government may be forced to face the risk of not being able to effectively adopt exit strategies, causing a sharp rise in interest rates or rising inflation.

*Translated from "Abenomics no Ichinen [part 3]: Kinyukanwa no Koka, Genteiteki (The impact of monetary easing has been limited),"*Nihon Keizai Shimbun, *p. 27 December 4, 2013 (Courtesy of Nihon Keizai Shimbunsha)* [2013]

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