Abenomics Has Entered the Second Stage

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In November 2012, the Abe administration was established and this new administration has been implementing a package of economic measures called Abenomics. Following the launch of this economic initiative, the Japanese economy can be divided into two stages.

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The first stage is the period until March 2014. During this period, the economy expanded steadily and Abenomics bore significant fruit. This was supported by the yen's depreciation, strong stock prices, public investment and a last-minute rise in demand.

After the establishment of the Abe administration, the mood surrounding the economy changed and the yen's depreciation and strong stock prices progressed rapidly. I think that this was caused by the announcement effect and the surprise effect triggered by the change of government. That is, under the administration of the Democratic Party of Japan, especially in its initial stage, the party focused on happiness over growth, popular living over businesses and anti-public works projects, and sought to realize a shift from administration controlled by the initiative of bureaucrats to politician-led state governance. I suspect that many ordinary citizens, as well as business leaders and administrators, were deeply concerned about whether or not the policy would really be all right.

In such a situation, the Abe administration clearly showed its orientation toward growth, companies and more public works projects. The administration reestablished the Council on Economic and Fiscal Policy (CEFP) and also stabilized its relationship with public employees. That is, if you broadly consider Abenomics a policy package friendly to companies and bureaucrats, it is conceivable that this way of thinking created a bright atmosphere surrounding the economy as a surprise to many people, which led to stability for the policy management of the new administration.

The market reaction to the announcement and surprise effects resulted in the yen's depreciation and strong stock prices. The progress of the yen's depreciation increased profits in the manufacturing industry and pushed up prices through a rise in the price of imported products.

The increase of public investment also contributed to economic expansion. The fiscal 2013 government fixed capital formation (public investment, the same shall apply hereinafter) marked an increase of 15.1%. The growth rate of the whole economy was 2.3% and 0.7% of it was caused by the increase of public investment.

Household economic consumption also increased in fiscal 2013. The fiscal 2013 private final consumption expenditure showed a 2.5% increase compared with that of the previous fiscal year. This was the highest consumption increase in more than twenty years. However, household income did not increase so much. Real employee compensation (almost equal to wages) based on the System of National Accounts (SNA) declined in its rate of increase from a 0.9% increase (the author's calculation on a quarterly basis, the same shall apply hereinafter) in fiscal 2012 to a 0.4% increase in fiscal 2013. The following are two conceivable reasons for this consumption increase despite the non-existence of an income increase.

The first reason is an assets effect due to a rise in stock price. The price of stocks listed on the Tokyo Stock Exchange increased by 1.5-fold in 2013 and the market capitalization of stocks increased by as much as 162 trillion yen. According to the Shareownership Survey conducted by the Tokyo Stock Exchange and other stock exchanges, the individual shareholding ratio was almost 18.7% in 2013. This means that the overall household economy gained stock appraisal profits of about 30 trillion yen. This can be considered to have stimulated consumption in 2013.

The second reason is a last-minute rise in demand in the face of the upcoming consumption tax rate hike. The consumption tax rate was raised from 5% to 8% in April 2014. In this situation, people went out to buy things 3% cheaper before the tax rate hike and a forward-spending demand could be seen in fiscal 2013. In particular, in the case of housing and expensive durable consumer goods (for example, automobiles), people were able to save a large amount of money and the last-minute demand must have been strong. The Annual Report on the Japanese Economy and Public Finance 2014, which was published by the Cabinet Office in July 2014, states that the last-minute demand before the consumption tax rate increase ranged from 2.5 trillion to 3 trillion yen (0.5 to 0.6% of GDP) and analyzes that three-fourths of it was durable consumer goods.

As noted above, the four combined effects of the yen's depreciation, strong stock prices, public investment and a last-minute rise in demand produced a high-level of economic growth in the first stage of Abenomics and the consumer price increase rate was able to stably break away from a minus figure.

Abenomics entered the second stage this April. The trend of the yen's depreciation and strong stock prices temporarily stopped and seemed to restart around August. However, the yen's depreciation, which received a totally favorable response from the market in the first stage, has recently received a negative assessment. This is probably because the yen's depreciation in the first stage was a correction of excessive yen appreciation whereas the yen's depreciation in the second stage is considered to be moving toward excessive yen depreciation.

Public investment, which has already reached its limit, is no longer capable of further driving growth. In addition, the last-minute demand has slowed down the economy since April.

In this situation, the economic management in the second stage of Abenomics is facing the following difficult challenges.

First, future economic prospects are getting murky. The government projected the fiscal 2014 real growth rate of 1.2% in its economic outlook in July 2014. However, according to the Japan Center for Economic Research's ESP Forecast Survey, private economists projected an average 2014 real growth rate of 0.3% as of October 2014. There has been a gradual increase in the number of economists who argue that the economy has already entered a recessionary phase.

The government will decide whether to further raise the consumption tax rate to 10% or not on the basis of economic indicators in November. Given the above-mentioned economic outlook, the current market condition is not good enough for the government to increase the consumption tax rate without worry. However, if the government postpones its consumption tax rate hike, it will hardly be able to achieve the goal of fiscal reconstruction, which may shake public confidence in national finance.

Second, trade-offs among different policies will become clear. For example, the Bank of Japan set the inflation target goal of inducing the consumer price increase rate to 2% within two years (by March 2015). However, many economists think that it would be difficult to achieve the goal. If it becomes clear that it will be difficult to achieve the goal of 2% in the future, it will be necessary to revise the goal itself or to conduct additional monetary easing. If the Bank of Japan postpones the target year, it means that the bank is admitting it made a mistake in monetary policy. In the case of additional monetary easing, what its effects would be is unclear and it will also become more difficult to find an exit in the future.

In addition, for the increase of public investment, its consistency with fiscal reconstruction goals is becoming difficult to secure. In particular, the fiscal reconstruction goal of realizing a surplus in the primary balance by fiscal 2020 is difficult to achieve even now. As time passes, it will become clear that the goal is even more difficult to achieve.

Third, policy that is accompanied by some deal of pain on the part of the people will be necessary. Strong stock prices, easy monetary policy and the increase of public investment in the first stage bothered nobody. However, deregulation and structural reform will be required to resolve the restrictions of supply power in the second stage. Further tax hikes are unavoidable for fiscal reconstruction. To realize the goal of securing a 100 million population, it is necessary to increase family-related expenditure by reducing social security costs for old people. It is inevitable that all of these measures will force the burden of costs on a particular stratum of the people. Taking economic policy leadership in the second stage of Abenomics is likely to be quite difficult.

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Born in 1947. Graduated from the University of Tokyo and joined the Economic Planning Agency (currently the Cabinet Office), Japanese Government. Served as Director General of the Research Bureau at the Agency and Director General of the National and Regional Planning Bureau at the Ministry of Land, Infrastructure, Transport and Tourism. Has served as Professor at Hosei University since 2003.
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