

All about Abenomics

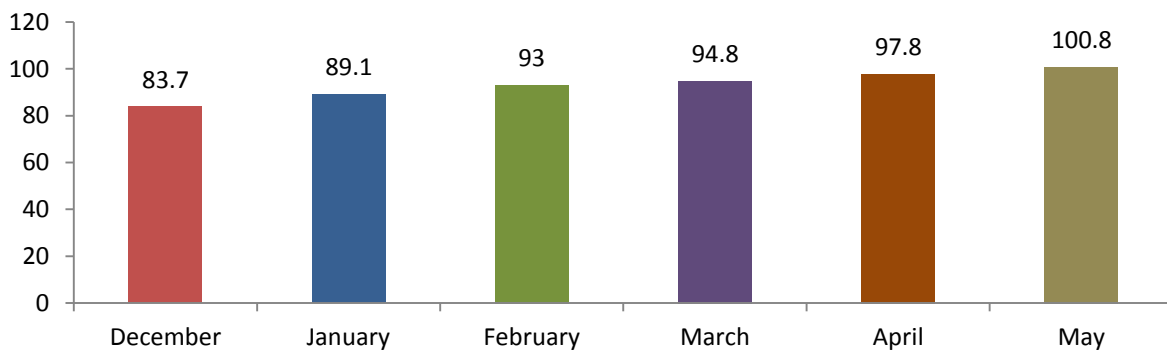
Abenomics is a term coined to represent the Economics of Japanese PM, Shinzo Abe. The objective is to get Japan's economy out of deflation and what has become a serial recession.

There are essentially three proposals here.

- The first is to print lots of money. In April, the Bank of Japan spoke of injecting as much as \$ 68 bn of bonds a month through buyback and double the monetary base. By doing so one can increase spending to the extent that inflation begins as deflation ends with the process continuing until such time that inflation reaches 2%. Japan has been in a deflationary phase for over 20 years where both prices and wages have been declining. Under these conditions investment is not taking place as companies do not want to invest in things that will be worth less tomorrow. The scenario is quite circular in nature because as consumers delay purchases, businesses see lower demand and defer investment. This has contributed to a stagnant economy since the property crash in the early 1990s.
- Second the government is also increasing spending to try to raise GDP by 2%. This boost to demand is designed to encourage firms to invest rather than hoard cash, another important part of ending the deflationary cycle.
- The third is to bring about structural reforms. Abe's government is set to get through a series of reforms to make labor markets more flexible, encourage immigration, bring nuclear power plants back online and draw more Japanese women into the workforce.

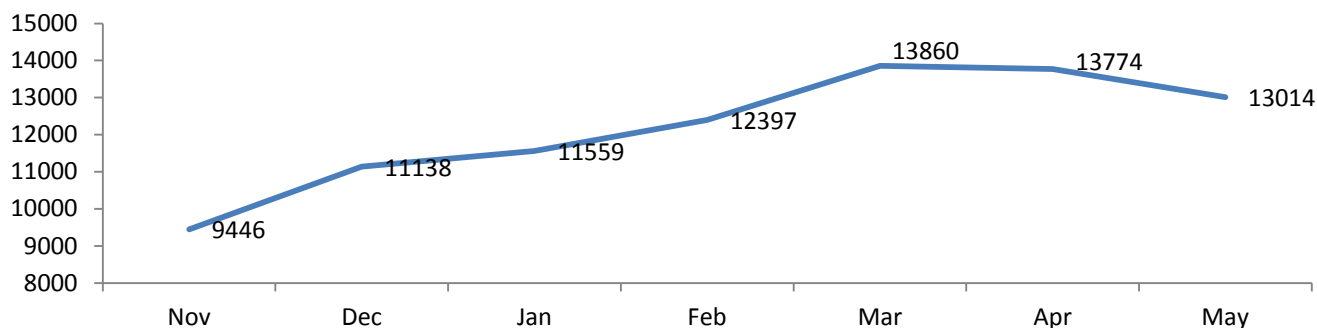
The program has helped weaken the yen and also boosted the profits of exporters, hence positively impacting the Nikkei in the process, which has also turned fairly volatile. In the few months since Japan embarked on its ambitious Abenomics experiment, stocks have taken off and a free-falling yen has improved the prospects for exporters.

Chart 1: Exchange rate: Yen/Dollar



The stock market has reacted more than positively as can be viewed in the chart below on movements since November. Clearly the market sees this as a positive that will take the economy on the upward path. Growth in the first quarter of the year was 3.5% which may be partly attributable to these measures.

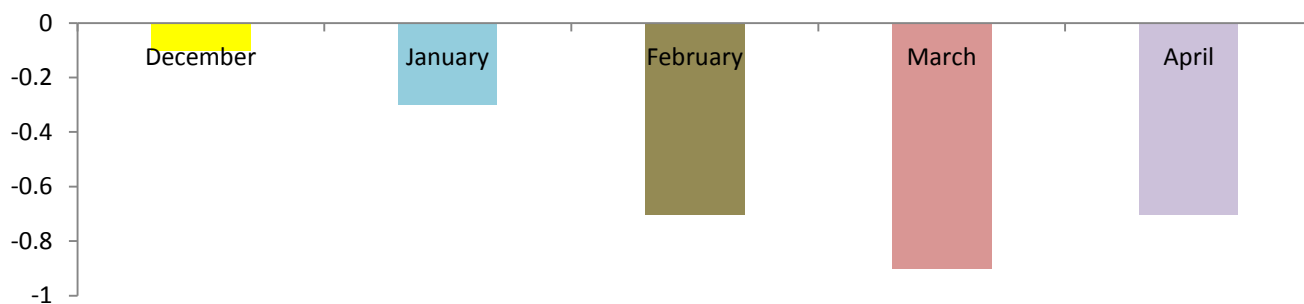
Chart 2: Nikkei Movement



The issue open for debate is whether this three pronged approach will really work and pull the world’s most indebted nation out of the abyss. While two of Abenomics’ policy props are already in place, with the government increasing spending and the central bank injecting money into the economy on a massive scale, reforms have not yet begun.

It may also be premature to term the approach a success as prices are still falling in the country, and there is little evidence to suggest Japan's famously cautious savers are starting to spend or that promised structural reforms will be implemented.

Chart 3: Inflation



A concern

The gross public debt is projected to hit 230% of GDP by 2014 after years due to high deficits. It has been suggested that simultaneously the government must address this issue by probably looking at raising taxes and trimming welfare benefits. The IMF has supported the Japanese approach but has warned that the absence of concrete fiscal measures to bring down public debt, or a delay in the consumption tax increase, could elevate risks of a rise in government bond yields, which would undermine fiscal and financial sector stability.

An imperative

For Abenomics to work, bond prices have to stay high. The Bank of Japan is currently buying long-term debt hoping that its purchases will keep long-term yields low. The goal is to encourage investors to look at investment avenues other than government bonds in a bid to seek higher returns, a pattern that will encourage investment in capital and result in economic growth. But after months of stability, bond prices dropped recently. Yields on 10-

year Japanese government bonds hit 1% in late May, the highest level in more than a year. The spike in bond yields is disconcerting, and some analysts view this as a failure of the overall approach.

Some economists say the central bank is pursuing contradictory objectives. As the bank works to lower interest rates, it is also trying to push up inflation, a trend that would push rates higher. In fact holders of bonds who think that the inflation target will be achieved will respond by selling that will push up yields, which could be one force working today. If this happens, it could work against growth rather than support the process.

Going forward

While expectations for Abenomics have not worn off the investors are still cautious given the recent decline in stocks in May as well as increase in bond yields. But to maintain hope the government may have to take forward the structural reforms mentioned earlier, which however have not yet found mention in the growth strategy. This is also in line with the IMF which has averred that it did not see a weak yen as a problem provided monetary easing was aimed at domestic goals and accompanied by fiscal and structural reforms – in short, the BOJ should not be buying back debt to finance fresh debt.

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