Economist Insights

Abe-no-mics

The aim of the three arrows of Abenomics was to shock Japan out of entrenched deflation expectations and boost confidence. The announcement last year was successful at boosting confidence but this is waning again now that structural reforms have been difficult to implement and fiscal stimulus seems to be going in the wrong direction.

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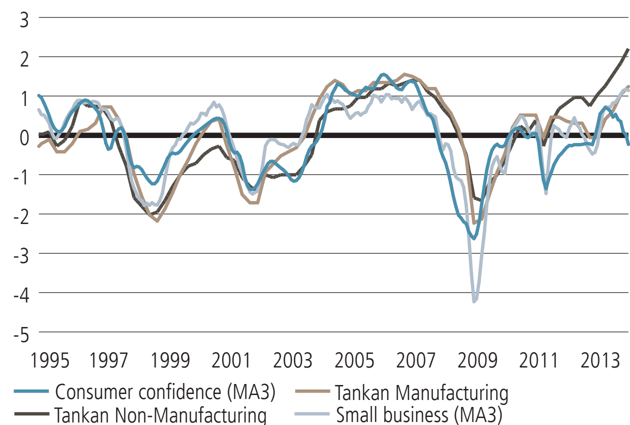
Economic policy is arguably all one big confidence trick. If policy makers can convince everyone that things are getting better, then households are likely to spend more and firms are more likely to hire and invest. Sure enough, the economy then improves. Unfortunately, the reverse is also true. If everyone is convinced that things will get worse (or stay bad) they save their money and the economy will surely worsen. Japan is a classic case of the second situation: expectations of deflation became entrenched and became self-fulfilling. The whole point of Abenomics was to shock Japan out of this entrenched way of thinking.

Abenomics was designed as a 'shock and awe' set of policies to boost confidence. The first arrow of monetary expansion fits the description well – after two decades of being behind the curve the Bank of Japan is now putting the Federal Reserve to shame in terms of activism (see *Economist Insights*, 8 April 2013). The second arrow of fiscal expansion was significant, but hardly shocking or awesome in 2013 – and is turning the wrong way in 2014. The third arrow of structural reform has been less of a shock and more of a stumbling block.

As a confidence booster, the announcement of the three arrows by Prime Minister Shinzō Abe was a success. It gave a clear sense that here was someone who was going to run economic policy differently, and most importantly do it on a larger scale. Consumer confidence almost immediately began to rise (chart 1), and small business confidence followed shortly thereafter. Large businesses, as measured by the BOJ's Tankan survey, were more cautious or sceptical, but were gradually won over. Large manufacturers were no doubt pleased by the depreciation of the currency, but large service companies were also convinced and at last reading were more optimistic than they have been since 1991.

Chart 1: Happy for a while

Measures of Japanese confidence, expressed as standard deviations from the mean (estimated since 1989)



Source: Japanese Cabinet Office, Bank of Japan, UBS Global Asset Management

Confidence rose in part because the easiest things to achieve were also the fastest. Appointing a new head of the Bank of Japan with a new mandate meant monetary policy was revolutionised almost immediately. Adding a bit of fiscal stimulus in 2013 was also relatively straightforward. But structural reform is a lot harder: the concepts are straightforward but the politics are fraught with risks.

The former Prime Minister of Luxembourg Jean-Claude Juncker put it wonderfully, in what might be the most candid and honest statement in politics in recent years: "We all know what to do, we just don't know how to get re-elected after we've done it".

The trick with structural reforms has usually been to promise more than you are likely to deliver. Reforms usually take so long to implement that people will not know which ones will actually happen. Given the rigidities and market distortions in the Japanese economy, the structural reforms announced by Mr Abe were distinctly underwhelming. A few economically important policies were announced, such as the Trans Pacific Partnership trade deal, but many other key issues were left off the table: labour market flexibility, female participation rate, pensions and healthcare amongst others. Perhaps this simply reflects realistic political calculation on the part of Mr Abe. But political promises are a bit like curriculum vitae sent in for job applications: it is usually better to "talk up" what you say because the reader will assume you exaggerated and discount what you wrote.

Snatching defeat from the jaws of victory?

The misfiring of the third arrow might well have been survivable for Abenomics, especially given the success of the first arrow and the initial success of the second arrow. But now it looks like the second arrow may be hitting the Japanese economy in the foot. Japan went from enjoying a fiscal loosening of 0.3% of GDP in 2013 to a fiscal tightening of 1.8% in 2014 and a predicted further 2.2% of tightening in 2015 according to the OECD.

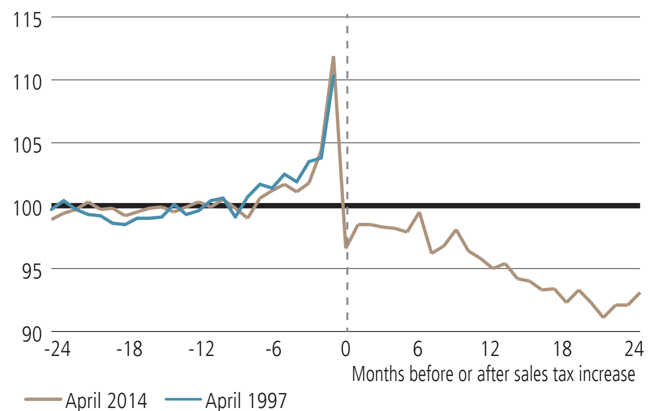
Consumers have been reacting to April's sales tax increase in almost exactly the same pattern as last time sales tax was increased (in 2007). Expenditures that can be brought forward (such as durable goods) are indeed brought forward to the months before the sales tax (chart 2). But thereafter retail sales are lower. Last time round there was a worrying subsequent decline in retail sales, but this could have had more to do with the Asian Financial Crisis that hit about six months after the sales tax was increased.

While the direct impact of the fiscal tightening is debatable, at a time when you are trying to increase confidence the effects could be disastrous. Asking a patient with a broken leg (or an arrow in their foot) to walk before they are ready is dangerous. Japanese confidence had improved but was not firmly established.

Sure enough, the increase in the sales tax hit consumer confidence badly, and it is now below where it was when Mr Abe was re-elected. Small business confidence held on a bit longer, probably thanks to increased business as consumers brought spending forward, but following the sales tax increase their confidence has collapsed. Only large businesses still look optimistic, but the Tankan survey is only quarterly so we will not know how they have been affected until 1 July.

Chart 2: Same again, please

Level of Japanese nominal retail sales (re-based to 100 in period 18 to 6 months prior to sales tax increase)



Source: Japanese Cabinet Office

Defenders of the sales tax increase have sometimes argued that fiscal tightening is needed to preserve the fiscal credibility of the government. It is hard to see where these concerns come from: investors are still willing to lend to the Japanese government for 30 years at just 1.7% (only Switzerland borrows more cheaply). Raising the sales tax is also not going to make a fundamental difference to Japan's debt sustainability – only addressing long-term pension and healthcare obligations is likely to do that. Certainly delaying the tax increase until a new sense of confidence had become entrenched would have had marginal impact on debt sustainability.

Abenomics had so far been successful at increasing inflation. Both the national and core (excluding food and energy) measures of CPI inflation turned positive over the last year, moving from a long-standing trend of about -1% up to about +0.5% (year-on-year). The sales tax increase will push up the measured rate of inflation, but the impact on underlying inflation will be negative – it has effectively made everyone poorer so sustained increases in prices are less likely unless wages can rise.

Perhaps Mr Abe will be lucky, and confidence will recover as the pain of the sales tax increase recedes into memory. Perhaps the impact will be temporary and the pattern of 1997 will be avoided (because hopefully there will be nothing like the Asian Financial Crisis over the next year). But the risks of undoing all the good work of the first arrow seem far too high to justify the benefits. The sales tax increase may yet put the 'no' into Abe-no-mics.

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