Election unlikely to revive Abenomics

- Victory for Prime Minister Abe in this month’s election would keep Japan on the same track it has been on since 2012, pursuing fiscal tightening, loose monetary policy and tentative structural reform. Given the economy’s relatively strong recent growth performance that might seem welcome. But we believe that holding to the status quo on policy will result in Japan’s growth disappointing over coming years.

- While Japan’s economy has performed well in recent quarters, it has fallen well short of the targets that Mr Abe set when he returned to power in late 2012. Goals for nominal and real GDP growth have both been missed. Inflation has not reappeared.

- While the growth underperformance can be blamed in part on demographic factors (though these were known in 2012 too), Japan’s growth performance has also been underwhelming in terms of output per worker, which shouldn’t be affected by the shrinking population.

- One reason is that, contrary to much of the government’s rhetoric, fiscal policy has been continually tightened. Monetary policy has played a more supportive role, offsetting the fiscal drag, keeping interest rates low, and triggering a currency decline that – for a time – boosted both inflation and corporate profits.

- But even the aggressive steps taken by the Bank of Japan have failed to create a lasting increase in inflation or to lift inflation expectations. And there is a growing sense that it has few policy options now if it wanted to ease further.

- This puts the onus onto the “third arrow” of Abenomics – structural reform – which held out the greatest hope for generating a lasting improvement in the economic outlook but which has been the most disappointing.

- Admittedly, there have been a few successes. Corporate governance reforms and corporate tax cuts have contributed to a surge in profits, which has supported investment. Policy changes have contributed to an increase in the share of women in paid employment and in the number of foreign workers.

- But the most important road blocks to stronger growth have not been addressed. Red tape remains prevalent, Japan remains unwelcoming to foreign direct investment, and the government has taken few meaningful steps to liberalise the labour market.

- Mr Abe has pledged more of the same – although his decision to offset the sales tax hike scheduled for October 2019 with spending increases implies the fiscal drag could be lessened. Monetary policy is unlikely to shift course, whether or not Governor Kuroda remains at the Bank of Japan.

- Given where we are in the economic cycle, a near-term slowdown in growth seems likely – we expect GDP growth to slow from 1.7% this year to 1.0% in 2019. More importantly though, without more ambitious policy changes than Mr Abe has proposed so far, the economy’s sustainable growth rate is likely to fall back towards zero further ahead.
Election unlikely to revive Abenomics

Prime Minister Abe appears to be on course to win a solid majority in the Lower House elections on 22nd October. Many commentators are hoping that his victory will provide fresh momentum for “Abenomics”. In this Focus, we take stock of what his government has achieved so far and assess the outlook for Japan’s economy for the coming years.

Ruling coalition will probably emerge victorious

The upcoming election has developed into a two-horse race between Mr Abe’s Liberal Democratic Party and the “Party of Hope” headed by popular Tokyo Governor Yuriko Koike. Ms Koike caught many by surprise on the day that Mr Abe announced snap elections by announcing that her newly-formed national party would enter the race. Ms Koike’s local “Tokyoites First” party dealt a severe defeat to the LDP in recent elections in the capital. The new leader of the Democratic Party (DP), which formed the government as recently as 2012 but whose popularity has since crumbled, pledged two weeks ago to join forces with Ms Koike’s new party.

Initial polling put support for the “Party of Hope” at 18% in the proportional section of the vote. However, respondents to these initial polls may have hoped that Ms Koike would challenge PM Abe directly by seeking a seat in the Lower House. She has since reiterated that she will remain governor.

In a more recent poll published last week, just 12% of respondents voiced support for the Party of Hope, while Mr Abe’s LDP received 35%. (See Chart 1.)

Admittedly, a lot of voters say they are still unsure who to vote for. But at this stage, the most likely outcome is that the ruling coalition emerges victorious on Sunday 22nd, though it may not be able to defend its two-thirds majority. If the current government remains in power, then “Abenomics” too should have a renewed lease of life.

Growth performance underwhelming

Mr Abe returned to power in December 2012 pledging that Abenomics would lift the economy’s nominal growth rate to 3% on average over the coming decade, compared to an average annual fall of 0.5% in the previous decade. This was to be achieved through a combination of higher real GDP growth (2% per year on average compared to 0.8% in the previous decade) and stronger price gains. He would use three arrows: “flexible” fiscal policy, aggressive monetary easing, and a “Third Arrow” of structural reform.

Nominal GDP growth has averaged 1.9% per year since Mr Abe returned to power. That is short of the target but still much faster than the 0.2% annual rise during the previous recovery from 2002 to 2008. (See Chart 2.) However, this pick-up partly reflected one-off factors. 2014’s sales tax hike lifted the price level by 2%. The slump in crude oil prices between 2014 and 2016 also boosted the value of output as firms didn’t lower output prices accordingly. These tailwinds have now faded and the GDP deflator has started to fall again. (See Chart 3.)

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In terms of real output, Mr Abe enjoyed initial success. But domestic demand slumped when the sales tax was raised in 2014, and it took nearly two years for output to rise above the pre-tax-hike level. For the five years of Mr Abe’s current tenure, the economy has grown by just 1.1% in real terms per annum, far short of the target and of the performance of other large advanced economies. (See Chart 4.)

The target may have been unrealistically high. The main reason for Japan’s underperformance relative to other rich economies is the continued rapid decline in Japan’s working-age population. (See Chart 5.) But this demographic headwind does not explain everything. Output per person employed has also risen at a markedly slower pace than in the UK and the euro-zone and no faster than in the US since Mr Abe became prime minister in 2012. (See Chart 6.)

As such, while the economy has performed better under Abe than under his predecessors, a lasting break with the slow growth, low inflation past is still elusive.

**Monetary policy has offset fiscal tightening**

In asking why Abenomics has (so far) failed, we’ll look in turn at the three arrows.

The “flexible” fiscal arrow was always the least well-defined but its impact has in fact been consistent. Immediately after Prime Minister Abe returned to power, he launched a ¥10.3 trillion (2% of GDP) supplementary budget that was widely interpreted as a fiscal stimulus. However, this followed even larger spending in the previous year in the wake of the Great East Japan Earthquake. The government has continued to reduce the size of supplementary spending since then. Last year’s three supplementary budgets totalled just ¥4 trillion.

This pullback in supplementary spending mirrors a broader retrenchment in fiscal policy under Mr Abe. The most severe fiscal tightening was 2014’s sales tax hike which lifted tax revenues by around 1.5% of GDP. While the government has repeatedly trumpeted fiscal packages, fiscal policy has been tightened every year since PM Abe returned to power. (See Chart 7.)
The impact of tighter fiscal policy on domestic demand has been mitigated by looser monetary policy.

The government and the Bank of Japan agreed to introduce a 2% inflation target in January 2013, and the Bank launched its policy of “Quantitative and Qualitative Easing” (QQE) under newly-appointed Governor Kuroda three months later. The policy consisted of large-scale purchases of Japanese Government bonds (JGBs) and its aim was to achieve 2% inflation within two years. This wasn’t achieved, and the Bank responded with a flurry of further measures. First, it increased the pace of its JGB purchases in October 2014. In January 2016, it started to apply a negative interest rate on a portion of commercial banks’ reserve balances. And a year ago it pledged to anchor 10-year government bond yields at zero.

QQE was supposed to boost demand by lowering nominal interest rates as well as by lifting inflation expectations. It is hard to tell to what extent the policy lowered bond yields until the launch of Yield Curve Control. After all, the decline in bond yields between mid-2013 and last autumn was a global phenomenon. (See Chart 8.) Nonetheless, bank lending rates have fallen to record-lows, and surveys suggests that banks’ willingness to lend is the highest it has been since the early 90s bubble. As a result, credit growth has picked up and is the strongest it has been since the early 1990s. (See Chart 10.) This can be chalked up as a success for Abenomics.

However, Japanese bond yields would probably have surged alongside US yields following the election of President Trump if the Bank hadn’t kept a tight rein on the bond market.

Less positively, inflation expectations have if anything weakened since the programme was launched. (See Chart 9.) Another channel through which QQE supported demand was the slump in the exchange rate. (See Chart 11.) This didn’t boost the competitiveness of Japanese exports as much as is generally thought. The main reason is that more than 60% of exports are invoiced in foreign currency, and exporters didn’t make drastic cuts to export prices. The flipside...
though is that exporters reaped substantial translation gains on their overseas shipments as well as the profits generated by their overseas subsidiaries, which provided a fillip to corporate profits and investment.

**Chart 11: Real Effective Exchange Rate (2012 = 100)**

![Graph showing the real effective exchange rate from 2008 to 2017, with a downward trend indicating a weaker yen.](source: Thomson Reuters)

All in all, exceptionally loose monetary policy has allowed the economy to weather the headwind of tighter fiscal policy. It has helped keep interest rates low in Japan, supporting strong credit growth. And the demand it generated drew many new workers into the labour force while also pushing the jobless rate down to a 23-year low. According to calculations by the Bank of Japan, capacity shortages are the most pronounced in a decade. (See Chart 12.)

**Chart 12: Output Gap (% of GDP)**

![Graph showing the output gap from 1994 to 2017, with a peak in excess capacity in the early 2000s and subsequent shortages.](source: Bank of Japan)

But monetary policy has been less successful in stoking price pressures. It delivered a significant boost to nominal GDP by precipitating yen depreciation but this was short-lived. Inflation expectations haven’t risen. And inflation remains well below the Bank’s 2% target. (See Chart 13.)

**Chart 13: Consumer Prices (% y/y)**

![Graph showing consumer prices from 2000 to 2018, with a dip during the early 2000s and a recent upward trend.](source: Thomson Reuters, Capital Economics)

Third Arrow has mostly disappointed

While monetary stimulus has been supportive, it can’t alter the economy’s sustainable growth rate in the long-run. Abenomics’ Third Arrow of structural reform was therefore always the crucial one if the long-run economic outlook was to be transformed.

There have been two areas where PM Abe can claim success. The first is the surge in the share of women and elderly in paid employment. (See Chart 14.)

**Chart 14: Labour Force Participation Rates (Seas. Adj., %)**

![Graph showing labour force participation rates from 2012 to 2017, with a significant increase in the share of women and the elderly.](source: Thomson Reuters, Capital Economics)

This partly owes to policy changes. One is a more generous tax treatment of married second-earners. (See our Weekly, “Part-time earnings point to mounting wage pressure”, 16th Jun. 2017.) The government has also spent to improve the availability of child-care. The share of children of preschool age who attend childcare jumped from 31% in 2007 to 40% last year. Meanwhile, the number of women who would like paid work but are not actively looking for a job because they are...
looking after children has fallen by 30% during this period.

There have also been some tentative signs that policymakers are allowing more foreign workers to enter the country in order to ease labour shortages. Since 2012, the number of foreign workers has soared by 60%. Last year’s net increase in the number of foreign workers was equivalent to 0.3% of the workforce.

The second area of success in structural reform is the surge in corporate profits (see Chart 15) to which corporate governance reforms and corporate tax cuts have contributed.

Since 2015, the Tokyo Stock Exchange has recommended that listed firms have at least two independent Board members. The response has been dramatic: the share of companies with no or just one independent director has fallen from nearly 90% in 2012 to below 40% last year. Meanwhile, the government slashed the corporate tax rate from close to 40% in 2012 to just under 30% now. Empirical evidence suggests that corporate profitability is an important driver for investment, so the recent improvement may have contributed to the continued rise in the investment/GDP ratio.

But Abenomics doesn’t deserve all the credit for these positive developments. The share of women aged 45 to 64 engaged in paid employment has actually risen by even more than the share of younger women, which suggests that it is not all about childcare provision.

We suspect that the main driver for increased female employment has instead been a shift in cultural norms. In 1992, more than 40% of married women agreed with the statement that “husbands should work and wives should take care of the home after marriage”. This share had fallen to 28% by 2002 and has remained low since then.

Whatever the driver, the perhaps more important point is that this increase in the share of women available for paid employment is a tailwind that will eventually fade – the share cannot rise indefinitely, and it is no longer low in Japan compared to other rich economies, as we discuss below. Higher profits will also not boost investment indefinitely.

The bigger picture is that Abenomics has not generated the faster productivity gains that are needed for sustainably stronger economic growth. GDP per employed person has risen at a slower pace than in the euro-zone and the UK and no faster than in the US. (See Chart 3 again.) Given that Japan’s output per employed person is just two-thirds of the US level, this is disappointing.

There are number of reasons why the productivity gap relative to the US is not closing. One is that Japan’s business sector is very static. Around three quarters of firms are older than 10 years, the highest share in a sample of 18 OECD countries examined in a recent OECD policy paper.1 An aversion to entrepreneurship plays a role. But public policies are also to blame.

The Abe government has made no progress in efforts to cut red tape. Japan ranked 14th among OECD members in The World Bank’s Doing Business Surveys in 2012 but has since fallen back to rank 26th. What’s more, the government provides generous credit guarantees for small and medium firms that encourage banks to lend to non-viable firms.

A low presence of foreign firms is also holding back productivity: foreign firms are much more productive than domestic ones. To be sure, the government will probably reach its target of doubling the stock of inward FDI by 2020. But this is not because it has made it any easier for foreign firms to set up shop. According to the WEF’s Global Competitiveness Report, for example, Japan ranks a

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poor 91st in terms of the extent to which regulations encourage FDI, a touch worse than the 87th rank in 2012. And even if the target is met, the stock of inward FDI would remain the lowest in the OECD at just 6% of GDP.

Meanwhile, progress on free trade agreements has been slow, though this is hardly Japan’s fault. Since Mr Abe returned to power, Japan has only signed an FTA with the European Union. This agreement covers around 10% of Japanese trade so it is quite significant. But Mr Abe’s main thrust has been on the Trans Pacific Partnership, from which the US has now withdrawn. The remaining eleven countries may still press ahead, but the agreement’s main draw was access to the US market: the US accounts for around 60% of Japan’s combined exports to TPP countries. The planned Regional Comprehensive Economic Partnership is less ambitious in scope and progress in the talks has been slow.

Finally, empirical evidence shows that strong employment protection reduces labour turnover and holds back productivity. According to the WEF, Japan ranks 115th out of 138 countries in terms of “hiring and firing practices”. The government has shown no willingness to reduce employment protection for regular employees.

The outlook
Japan’s working-age population will continue to shrink in coming years. However, the labour force will probably continue to expand as the number of women and elderly in paid employment continues to expand. (See Chart 16.) A further increase in the number of foreign workers would help as well. The Japanese people are more open to immigration than generally thought: according to a Gallup poll conducted between 2012 and 2014, 29% of Japanese were in favour of higher immigration, the third-highest share in the G20.

Eventually though, the labour force participation rate will stop rising. The share of women available for paid employment is no longer low compared to other G7 economies: Japan has overtaken the US and France in recent years. What’s more, the share of women not in the labour force is now close to the share of wives who think that they should take of the home after marriage. (See Chart 17.) Unless attitudes towards paid employment shift again, we think that any further gains in the female participation rate will be less rapid.

Meanwhile, one reason why the number of employed people aged 65 or over has risen sharply in recent years is that baby-boomers have continued to work beyond the official retirement rate. But even if the labour force participation rate among the elderly continues rising at the same pace as it has over the last five years, the number of employed people in this age group will rise at a much slower pace in coming years. (See Chart 18.) The upshot is that the demographic headwinds to growth will soon become stronger again.

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Turning to Abenomics’ three arrows, fiscal policy will probably be tightened further in coming years. Granted, the government no longer intends to balance the primary budget balance by 2020. Nonetheless, Prime Minister Abe has pledged to press ahead with the sales tax hike currently scheduled for October 2019. The tax hike will generate around ¥5 trillion in additional revenue. ¥2 trillion will be used to make child care for three to five year olds free and to further enhance the availability of child care. Increased public spending will dampen the blow of a higher sales tax on the economy. And further enhancing the capacity of child-care centres and lowering their cost should encourage more women to engage in paid employment. Nonetheless, there is still a risk that the economy will slow sharply once the tax has been raised.

By contrast, monetary policy is set to remain very loose. Inflation is likely to remain below the Bank’s 2% target for the foreseeable future. (See Chart 19.) Even if price pressures strengthen more rapidly than we currently anticipate, the Bank would be reluctant to tighten policy ahead of 2019’s tax hike.

But nor do we see scope for looser policy. The Bank believes that lowering its 10-year yield target further would do more harm than good. And policymakers seem to believe that cutting the short-term policy rate further wouldn’t be of much help either. After all, the Bank didn’t cut rates last summer when headline inflation turned negative and the yen was strengthening sharply.

One potential source of uncertainty is that Mr Kuroda’s term ends in March, and it is unclear whether he will be reappointed (no BoJ governor has ever served consecutive terms). But even if he isn’t, PM Abe will certainly choose a supporter of aggressive monetary easing.

The sales tax hike should contribute to a further decline in the budget deficit, which we expect to shrink from 4% of GDP this year to 3% in 2019. But with price gains set to remain subdued, nominal GDP growth will remain sluggish and the ratio of government debt to GDP will remain high. (See Chart 20.)

Meanwhile, anyone hoping that the elections will provide a fresh boost to the Third Arrow of structural reform will be disappointed. The LDP’s election manifesto states that the government wants to create a “productivity revolution” through artificial intelligence, robots and information technology but contains no details on how this should be achieved.

The one area where some progress may be made is trade liberalisation. Japan and other countries may press ahead with the TPP even though the US has withdrawn from the agreement. And an agreement on the Regional Comprehensive Economic Partnership is possible after six years of negotiations.

But momentum for sweeping regulatory changes has long since subsided, and the government’s latest
update of its “Revitalisation Strategy” contained few concrete policy proposals. According to press reports, PM Abe is mulling further reductions in the corporate tax rate, which at the margin should boost investment and make Japan more attractive as a destination for foreign direct investment. But the government will refrain from taking those steps most needed to lift growth – cutting red tape, reducing employment protection for regular employees, and creating a framework for large-scale immigration.

All in all, we believe that Japan’s recent strong pace of economic growth won’t be maintained. Expansions tend to become less vigorous as they mature. For one thing, GDP growth tends to be stronger when there is a lot of spare capacity. But when the economy is operating above its sustainable level, as it is now, output has often started to decline. (See Chart 21.) We are forecasting a slowdown in GDP growth from 1.7% this year to 1.0% in 2019. But given where we are in the economic cycle and how tight capacity appears to be in many areas, a slower outturn wouldn’t be a huge surprise. In fact, it is quite possible that the sales tax hike will trigger a recession in 2020.

Conclusions
Japan has coped well with the strong demographic headwinds since PM Abe returned to power as more women have engaged in paid employment and baby boomers have put off retirement. Very loose monetary policy has ensured that the economy continued to recover despite prolonged fiscal tightening. Meanwhile, corporate governance reforms and lower corporate tax rates have boosted corporate profits. But there has been little progress on structural reform to boost the economy’s sustainable growth rate.

Looking ahead, the planned sales tax hike is not necessarily a disaster as some of the additional revenue will be used to finance spending rather than to lower the budget shortfall. And monetary policy will remain supportive as price pressures will strengthen only slowly. However, there is a growing risk that the current expansion will simply die of old age. On some measures, the economy is already running into capacity shortages.

The bigger picture is that the recent surge in the number of women engaged in paid employment can’t continue for much longer. Structural reforms to remove roadblocks could offset this, but the outlook for sweeping regulatory changes is dim. Nothing in the LDP election manifesto suggests that Mr Abe will be a more aggressive proponent of “Third Arrow” reforms in his next term. If the government sticks to the status quo on policy, the economy’s sustainable growth rate is likely to drop back towards zero in coming years.
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