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# Japan's Economy: Monthly Review

## *How Should “Abenomics” Be Understood?*

**Taking account of such factors as improving sentiment following the formation of the Abe administration, economic outlook provisionally revised**

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### Summary

- **We have provisionally revised our economic outlook owing to such factors as improving sentiment following the formation of the Abe administration:** In light of the inauguration of the Abe administration on 26 December 2012, we have provisionally revised our economic outlook upward. We now forecast real GDP growth of +1.3% y/y for FY12 (previous forecast: +1.0%) and +2.2% for FY13 (+1.1%). As our first outlook for FY14, we forecast growth of +0.3%. We expect the economy to receive a boost from a large-scale supplementary budget for FY12 as well as aggressive monetary easing by the Bank of Japan.
- **How should “Abenomics” be understood?:** In this report, we examine the economic policies of the new Abe administration (so-called Abenomics). We believe that Abenomics has the potential of sparking the revival of Japan's economy. At the same time, we believe that it must address two paramount issues: (1) the implementation of policies to improve the foundations of Japan's economy, such as deregulation and participation in the Trans-Pacific Strategic Economic Partnership Agreement, and (2) selective investment in public works projects with the view of maintaining fiscal discipline.

# 1. Economic outlook provisionally revised

*We have provisionally revised our economic outlook owing to such factors as improving sentiment following the formation of the Abe administration*

In light of the inauguration of the Abe administration on 26 December 2012, we have provisionally revised our economic outlook upward. We now forecast real GDP growth of +1.3% y/y for FY12 (previous forecast: +1.0%) and +2.2% for FY13 (+1.1%). As our first outlook for FY14, we forecast growth of +0.3%. We expect the economy to receive a boost from a large-scale supplementary budget for FY12 and aggressive monetary easing by the Bank of Japan (BOJ).

The main points of the revision of our economic forecast are: (1) the upward revision of real GDP for Oct-Dec 2012 in view of basic statistics that are currently available, (2) the revision of our assumption for exchange rates to a weaker yen given the yen's depreciation since end-2012, and (3) the incorporation into our forecast of the stimulus effect of Emergency Economic Measures for the Revitalization of the Japanese Economy approved by the cabinet on 11 January 2013.

We now forecast that real GDP will grow an annualized +1.9% q/q in Oct-Dec 2012 (previous forecast: -0.3%), marking the first increase in three quarters. The principal reason for this upward revision is our outlook for personal consumption changing from contraction to growth. In our previous forecast, we believed that decreases in wages reflecting the worsening of the economy since the start of 2012 would place downward pressure on personal consumption. It now appears that, with the arrival of lower temperatures, consumption of seasonal goods, such as winter apparel, has been firm. Also, although automobile sales were foreseen to trend weakly due to the expiry of eco-car subsidies, while they have continued to decline on a quarterly basis, such sales rebounded rapidly in November, and their adverse impact on personal consumption in Oct-Dec 2012 appears to be smaller than anticipated.

We have revised our assumption for the average exchange rate from Y80/\$ (FY13) to Y88/\$ on account of the weakening of the yen. Since we now assume a weaker yen, we predict that exports will experience a boost compared to our previous forecast. Also, the improvement in corporate profits from the growth of exports will spread to capex and augment the growth rate of the economy.

The increase in public works spending from the emergency economic measures will lift real GDP by 0.7% in FY13. These measures are expected to give rise to fiscal expenditures of Y10.3 trillion. Of this amount, Y5.5 trillion will go for public sector projects (additional construction bonds matching to the amount to be issued), of which around Y4 trillion will impact GDP figures. With respect to FY14, since the effect of economic measures will taper off, we anticipate that the sharp decline in public works spending will place downward pressure on GDP.

## 2. How should “Abenomics” be understood?

### 2.1 Abenomics has the potential of sparking the revival of Japan's economy

*Abenomics represents policies prioritizing economic growth*

The election for the 46th House of Representatives held on 16 December 2012 set the stage for Liberal Democratic Party (LDP) leader Shinzo Abe to form a coalition government with New Komeito. In this report, we examine the economic policies of the new Abe administration (so-called Abenomics). We believe that Abenomics has the potential of sparking the revival of Japan's economy for two reasons.

First, Abenomics represents policies prioritizing economic growth. Economic policies can be broadly divided into the four quadrants of supply-side policies, demand-side policies, domestic demand, and

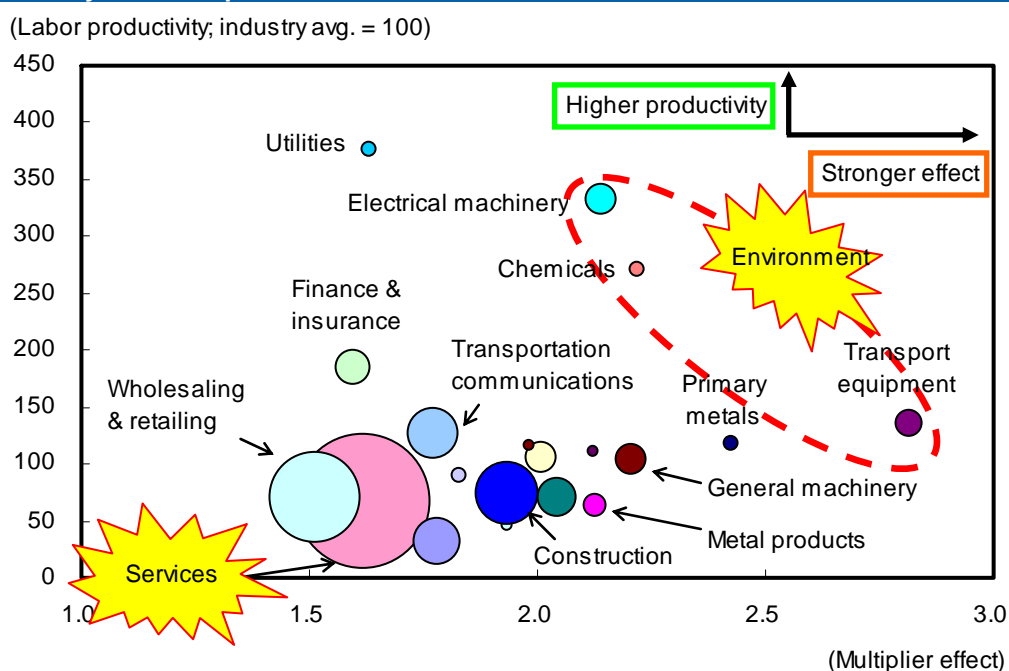
foreign demand. In short, supply-side policies are those that give due weight to business, while demand-side policies give weight to people/households. The Democratic Party of Japan (DPJ) administration inaugurated in 2009, in part as an antithesis to the LDP that gave some thought to the supply side and foreign demand, placed considerable weight on demand-side and domestic-demand policies. As a result, many foreign investors, key players in Japan's stock market, came to view the DPJ administration as not being well balanced and as being tilted toward the demand side of domestic demand centered on the child support subsidy—in other words, with an interest in only one quarter of the economy. Unlike the anti-business stance of the former DPJ administration, the clear pro-business stance of Abenomics can be highly commended.

### ***Priority areas are the environment and services centering on health care and long-term care***

As illustrated in Chart 1, in view of Japan's industrial structure, priority areas are likely to be (1) the environment, which promises efficiency, ripple effects to other industries, and high growth prospects, and (2) services centering on health care and long-term care which have a large capacity to create jobs.

In the chart, the size of circles indicates number employed. The capacity to create jobs is limited for environment-related industries (electrical machinery, chemicals, and transportation equipment). In addition, manufacturing industries only account for 26% of GDP. Therefore, to increase jobs, it is indispensable to stimulate services (centering on health care and long-term care; located in the lower left corner in the graph).

**Labor Productivity and Multiplier Effect** **Chart 1**



Source: Ministry of Economy, Trade and Industry; Cabinet Office; compiled by DIR.

Notes: 1) Multiplier effect: DIR estimate for some industries.

2) Size of circles indicates number employed.

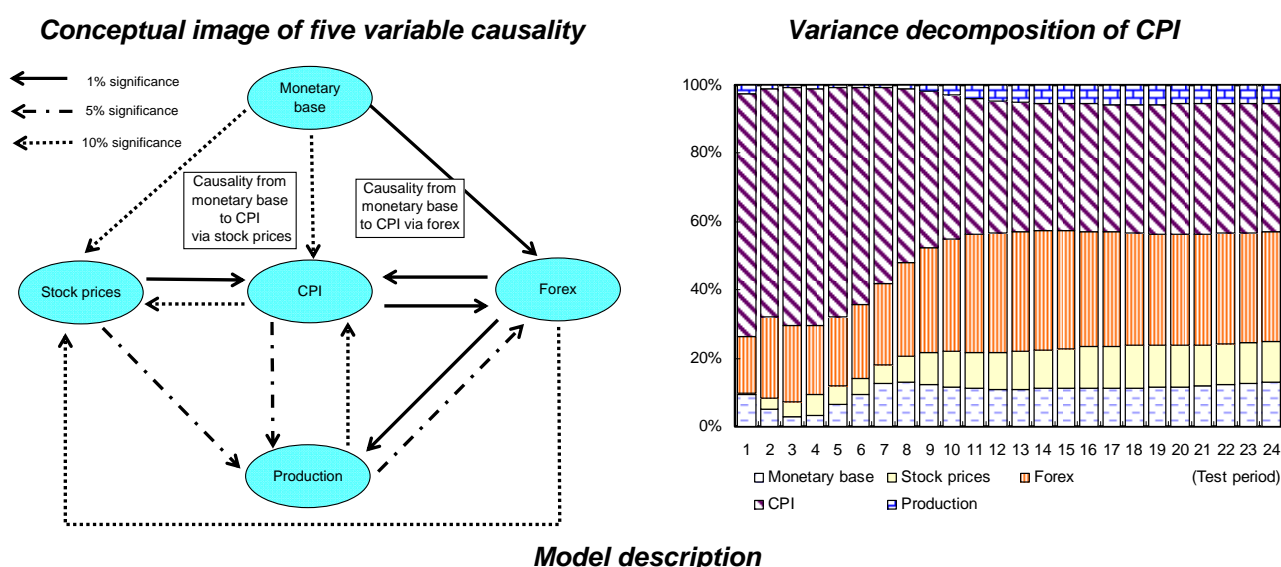
In growth strategy discussions, the pointless contest between manufacturing and non-manufacturing (services) industries or that between foreign demand and domestic demand often continues endlessly. While manufacturing industries and foreign demand promise efficiency and ripple effects to other industries, service industries and domestic demand have a large capacity to create jobs. Thus, the key

to Japan’s economic growth will be to first determine the potential advantages of each and then to implement strategies to fortify industries/demand on both sides as optimally as possible.

**Bold monetary easing by the BOJ**

Second, Abenomics can be highly rated for pressing the BOJ to take bold steps to ease monetary policy. We believe a weaker yen and higher stock prices ensuing from aggressive monetary easing will be effective in ending deflation. Chart 2 presents a five-variable model Granger causality test. To define Granger causality, variable X is viewed as Granger-causing Y when past information about variable X is useful in improving the forecast of variable Y. The analysis we performed suggests the possibility that expansion of the monetary base influences CPI through stock prices and forex. Also, a variance analysis of CPI points to the possibility of forex having a certain effect on prices.

**Granger Causality (y/y %)** **Chart 2**



**Model description**

Sampling period	Mar 2006-Feb 2011	
Lag	Quartic lag based on Akaike information criterion	
Variables	Monetary base	Avg outstanding balance, adjusted for reserve requirement ratio, seasonally adjusted
	Stock prices	Nikkei 225 (monthly avg)
	Forex	Nominal effective exchange rate (2010 benchmark; BIS regulation basis)
	Production	All-industry Activity Index (excl agriculture/forestry/fisheries & public service; 2005 benchmark; seasonally adjusted)
	CPI	Major category items (excl. fresh food; nationwide; 2010 benchmark)

Source: Bank of Japan, Ministry of Finance, Ministry of Internal Affairs and Communications, Ministry of Economy, Trade and Industry, *Nikkei*; compiled by DIR.

**2.2 Two issues for Abenomics**

**Structural reform and maintaining fiscal discipline are issues Abenomics must address**

First, at the present moment, Abenomics mainly consists of stimulus measures like public works spending and monetary policies. However, if the capacity for economic growth is to be strengthened in the medium to long term, efforts toward structural reform will be necessary, such as deregulation and participation in the Trans-Pacific Strategic Economic Partnership Agreement (TPP). Other essential steps will be reducing the corporate tax, tax breaks for investing in growth sectors, and establishing an environment that promotes entrepreneurship. If Japan’s economic foundations are not improved through such measures, there is concern that the ascent of share prices and the depreciation of the yen will come to be just passing phenomena.

Second, another key point is maintaining fiscal discipline.

The LDP has proposed a “national land strengthening plan” and intends to unleash massive public works spending on a scale of Y200 trillion over a 10-year period. Such infrastructure as bridges, roads, and ports reach a replacement period in about 50 years. Thus, Japan’s major infrastructure projects of the 1960s and 1970s will enter a full-fledged replacement period from around 2020. While there is no more important work for a nation than protecting the lives and assets of its citizens, investing little by little in unnecessary public works projects in the name of safety and security will reduce economic efficiency and expand fiscal deficits. What will be important is clearly separating the discussion of investments indispensable for protecting the lives and assets of citizens from other public works spending. There can be no doubt that the former will be necessary even if they are somewhat inefficient. The latter, however, should be undertaken on a pinpoint basis by carefully ascertaining economic efficiency according to their cost effectiveness.

Currently, prices of long-term JGBs, such as those with maturities of 20 and 30 years, have fallen sharply (long-term yields have risen). This underscores that participants in financial markets are becoming concerned that fiscal discipline will be lost through Abenomics. Aggressive monetary easing occurring together with the loss of fiscal discipline will take on the appearance of the *de facto* monetization of government debt. Should JGB prices fall sharply (yields to rise sharply), concerns about the unremitting and injurious depreciation of the yen or about stagflation ensuing from higher import prices might well arise.

To conclude, while we have great hopes for Abenomics, we also believe that it must address two paramount issues as discussed above, namely: (1) the implementation of policies to improve the foundations of Japan’s economy, such as deregulation and participation in TPP, and (2) selective investment in public works projects with the view to maintaining fiscal discipline.

### Outlook for Japanese Economy, Interest Rates

Chart 3

Indicator	2011	2012				2013		FY11	FY12	FY13	FY14
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Actual	DIR estimates			
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<b>Real GDP</b>											
Q/q %, annualized	0.3	5.7	-0.1	-3.5	1.9	1.7					
Y/y %	-0.2	3.4	3.9	0.5	1.0	-0.1	0.3	1.3	2.2	0.3	
<b>Current account balance</b>											
SAAR (Y tril)	6.7	5.9	6.1	3.8	4.8	5.3	7.6	5.0	6.6	9.6	
<b>Unemployment rate (%)</b>	4.5	4.5	4.4	4.2	4.2	4.2	4.5	4.3	4.1	4.0	
<b>CPI (excl. fresh foods; 2010 prices; y/y %)</b>	-0.2	0.1	-0.0	-0.2	-0.0	-0.0	-0.0	-0.1	-0.1	2.3	
<b>Unsecured overnight call rate</b>											
(period end; %)	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	
<b>10-year JGB yield</b>											
(period average; %)	1.03	0.97	0.85	0.78	0.75	0.80	1.05	0.79	1.00	1.20	

Source: Compiled by DIR.