

Box 1

RECENT ECONOMIC DEVELOPMENTS IN JAPAN

Almost two years have passed since the government of Japan announced its ambitious strategy to revive the economy from a state of low growth and mild deflation. The programme, which is commonly known as “Abenomics” after Japan’s Prime Minister, Shinzō Abe, involves policy efforts on three fronts (the three “arrows”): monetary policy, fiscal policy (short-run stimulus followed by medium-term consolidation) and growth-enhancing structural reforms

aimed at securing a pick-up in trend growth (both nominal and real). This box reviews recent developments in Japan in the light of this new strategy, starting by revisiting the main steps taken and the impact they have had on the overall economy thus far.

Current state of implementation

In implementing Abenomics, the initial focus has been to a large extent on the first two pillars, namely the provision of monetary and (short-term) fiscal stimulus. To date, monetary policy (the first arrow) has been a key element of the programme. Following the adoption of a 2% inflation target in early 2013, the Bank of Japan (BoJ) introduced Quantitative and Qualitative Monetary Easing (QQE) in April of that year, with the aim of reaching the inflation target as early as possible within a time horizon of about two years. The BoJ changed its main operating target from the uncollateralised overnight call rate to the monetary base and increased the amount outstanding and the average remaining maturity of the Japanese government bonds to be purchased. With asset purchases being executed at the planned pace under QQE, the BoJ's balance sheet had expanded by over 50% by the end of July 2014.

Turning to fiscal policy (the second arrow), the Japanese government has delivered short-term fiscal stimulus to the economy, largely through the adoption of two stimulus packages in early 2013 and 2014. It has also taken some encouraging steps towards consolidating public finances, including the implementation of a VAT hike from 5% to 8% in April 2014. A second increase to 10% is scheduled for October 2015, but is still to be confirmed. According to the IMF's Article IV Consultation, the cyclically adjusted primary balance is projected to narrow from -7.0% in 2013 to -6.0% in 2014.¹ The government has pledged to halve the primary deficit of 6.6% for the fiscal year 2010 by the fiscal year 2015 and to achieve a primary surplus by the fiscal year 2020 as part of its G20 commitments.

Progress on the implementation of growth-enhancing structural reforms (the third arrow) has been more gradual. On the one hand, some important measures were announced in areas such as agriculture, energy and corporate governance, as well as in social security (namely investment reforms at the Government Pension Investment Fund). On the other hand, progress has been slower in areas such as labour market reform, where fewer concrete measures have been introduced so far. In June the government also adopted a revised growth strategy, which includes, among other things, plans to reduce the corporate income tax rate, but many details are still to be finalised.

Recent developments in economic activity and prices

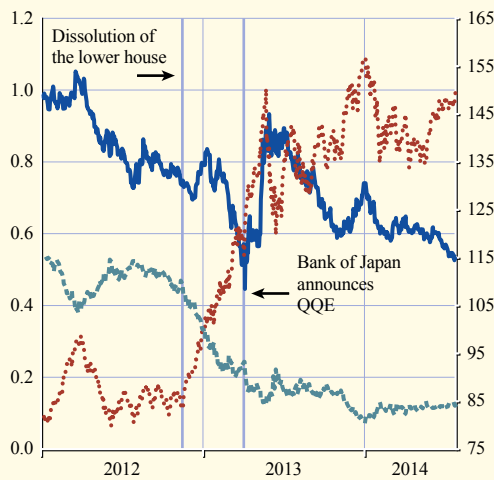
The expectation in late 2012 of a change in economic policy had a pronounced impact on Japanese stock prices and the exchange rate of the yen (see Chart A). The currency depreciated significantly (by about 20% in nominal effective terms), and equity markets rallied (at the end of August the Nikkei index stood at around 63% above its level at the end of November 2012). Ten-year Japanese government bond (JGB) yields have remained at relatively low levels.

¹ *Article IV Consultation – Staff Report and Press Release*, IMF, 2014.

Chart A Financial market developments

(left-hand scale: percentages; right-hand scale: index; January 2013 = 100, daily data)

— JGB ten-year yield (left-hand scale)
 NIKKEI (right-hand scale)
 - - - - JPY NEER¹⁾ (right-hand scale)

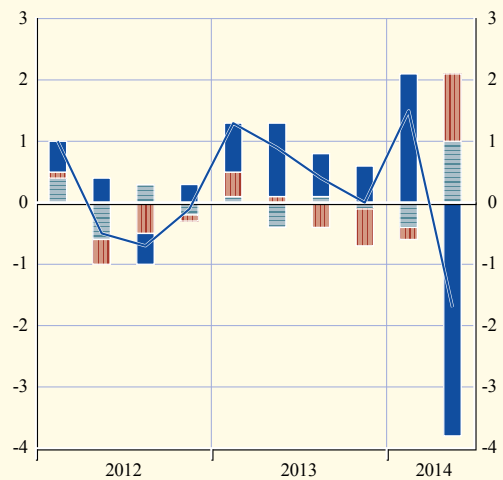


Sources: Haver Analytics and ECB.
 1) Nominal effective exchange rate vis-à-vis Japan's 20 main trading partners.

Chart B Contributions to real GDP growth

(quarter-on-quarter; percentage points)

■ domestic demand
 ■ net exports
 ■ stocks
 — real GDP growth



Source: Haver Analytics.

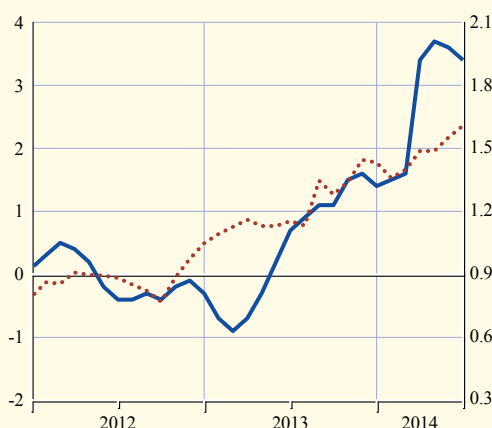
Economic activity picked up considerably in the early stages of Abenomics, albeit supported to a certain extent by a number of factors that are likely to fade over time. Real GDP expanded in the first half of 2013 at an average quarter-on-quarter rate of about 1% (see Chart B), partly driven by the provision of fiscal stimulus, a moderate pick-up in exports and improved sentiment. However, it lost momentum during the second half of the year, as some of these factors started to fade. Activity rebounded considerably in the first quarter of 2014 largely on account of frontloaded demand ahead of the VAT hike scheduled for April of this year, but the rebalancing of private demand in the second quarter more than reversed the previous gains. Moreover, despite the marked depreciation of the yen, the recovery in export volumes has remained weak overall, while private non-residential investment has only recently shown signs of a tentative recovery.

Inflation and inflation expectations have also risen significantly (see Chart C). Annual CPI inflation increased steadily from -0.2% in November 2012 to 1.6% in March 2014, while the narrower measure of CPI inflation (excluding food and energy) rose from about -0.5% to 0.7% over the same period. Model estimates – based on historical regularities – suggest that about half of the increase in annual CPI inflation since November 2012 can be explained by the exchange rate depreciation. Following the VAT increase in April 2014, annual CPI inflation jumped from 1.6% in March to 3.7% in May, but has eased somewhat in recent months. The increase in inflation has also coincided with a considerable pick-up in inflation expectations. For instance, between October 2012 and July 2014 ten-year-ahead inflation expectations as measured by the QUICK survey increased from 0.8% to 1.6%, indicating an enhanced credibility of the 2% inflation target.

Chart C Inflation and ten-year-ahead inflation expectations

(annual percentage changes)

— CPI inflation (left-hand scale)
..... ten-year-ahead inflation expectations (right-hand scale)

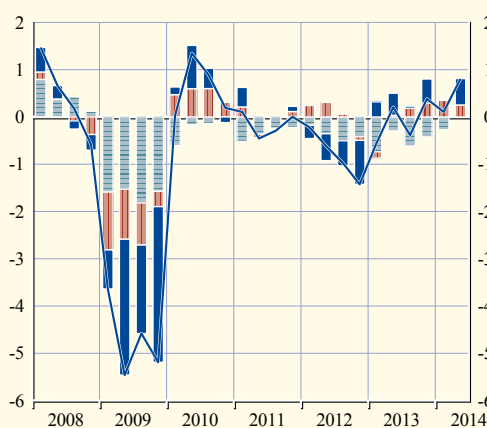


Sources: Haver Analytics and QUICK Survey.

Chart D Breakdown of total cash earnings

(annual percentage changes)

■ special earnings (including bonuses)
■ non-scheduled earnings
■ scheduled earnings
— total cash earnings



Source: Haver Analytics.

While inflation and inflation expectations have been picking up, wage growth has lagged somewhat, despite growing tightness in the labour market. The recently completed annual spring wage negotiations (“Shunto”) resulted in wage increases of 2.2% for the fiscal year 2014, up from 1.8% in the fiscal year 2013, although broader measures of wage growth remain much more contained, with the year-on-year growth rate of total cash earnings climbing to just 0.8% in the second quarter (see Chart D). However, a significant part of the increase has been driven by non-scheduled payments (e.g. overtime) and bonus payments, whereas basic wage growth has remained relatively muted – although data for July show signs of a pick-up.

The shift in expectations regarding the policy stance was also associated initially with strong portfolio investment flows into Japan, in particular into equity markets. Overall, however, the portfolio rebalancing effect among domestic financial intermediaries – away from JGBs and into higher yielding (possibly riskier) assets, a key transmission channel of QQE – appears to have been limited thus far. JGB holdings in the portfolios of banks have declined somewhat. However, this was not followed by a substantial improvement in the lending attitude of financial intermediaries, as the share of loans in banks’ total assets has remained broadly unchanged at around 50% since October 2012, while deposits accumulated rapidly at the BoJ. Changes within insurance companies and corporate pension funds have been less rapid, as their portfolio allocation remained broadly unchanged.

Outlook for activity and prices

Despite the strong contraction in activity in the second quarter of 2014, a moderate recovery is likely to resume in the second half of the year. Economic activity is expected to bounce back following the downturn in the wake of the VAT hike in the second quarter, mainly supported by a pick-up in private consumption and private investment. Looking further ahead, the Japanese

economy is expected to remain on a moderate recovery path, as the pick-up in exports and the accommodative monetary policy are likely to offset the fiscal drag from 2015 onwards.

Regarding fiscal policy, the authorities have pledged to halve the primary deficit by the fiscal year 2015 from the fiscal year 2010 before closing the primary deficit by the fiscal year 2020. From 2015 fiscal policy is likely to exert a drag on growth, as the support provided by the most recent stimulus fades. According to the most recent projections published by Japan's Cabinet Office, a primary deficit relative to nominal GDP of 5.2% is projected in the fiscal year 2014, and this is expected to fall to between 3.2% and 3.4% in the fiscal year 2015 depending on the macroeconomic outcome. Looking further ahead, the Cabinet Office also projects a primary deficit of between 1.9% and 3.1% by the fiscal year 2020.² Consequently, further discretionary measures are likely to be needed for the authorities to close the primary deficit by the fiscal year 2020.

As far as prices are concerned, the latest median forecasts³ of the majority of the BoJ's Policy Board members indicate that annual CPI (excluding fresh food) inflation is likely to exceed 2% in the near term, largely on account of the two VAT hikes, while the underlying trend (i.e. excluding the direct impacts of the VAT increases) could reach 1.9% by the fiscal year 2015, on the back of an improving output gap and a continued pick-up in medium to long-term inflation expectations, which are expected to converge towards 2%. Overall, the outlook for the Japanese economy is, however, not purged of uncertainties and risks, as the IMF has recently detailed in their latest Article IV Consultation.

² "Statement on Monetary Policy", Bank of Japan, 15 July 2014.

³ "Economic and Fiscal Projections for Medium to Long-Term Analysis", Cabinet Office Japan, 20 January 2014.