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Economics Group

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Special Commentary

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Japan's Economy & Structural Reform

After Priming the Pump, More Impactful Structural Change Needed

The first two arrows of Abenomics (large-scale fiscal stimulus and aggressive monetary easing from the Bank of Japan) were generally well-received. Four straight quarters of growth in real GDP plus CPI inflation of 1.1 percent offer hard evidence that the Japanese economy is on track to meet the stated goals of Abenomics (Figure 1 and Figure 2). The third arrow (structural reforms to boost Japan's competitiveness) has not met with the same initial success as the stimulative fiscal and monetary policy nor has it inspired big moves in the Japanese stock market as did the first two arrows. The modest reforms and development of deregulated economic zones fell short of high expectations for more sweeping reforms.

Still, the turnaround in the trajectory of the Japanese economy over the past year is arguably one of the most significant developments in the global economy during that time period. Moribund growth and nagging deflation have given way to slow, steady growth and modest inflation. Two out of three was enough to prime the pump; the fiscal stimulus and monetary policy easing alone exerted a positive boost on the Japanese economy. But now, as economic growth is beginning to cool and consumer sentiment is waning, more impactful structural reform is needed to make lasting change and self-sustaining economic growth.

Figure 1

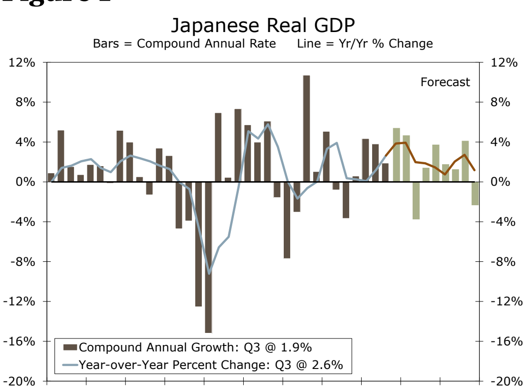
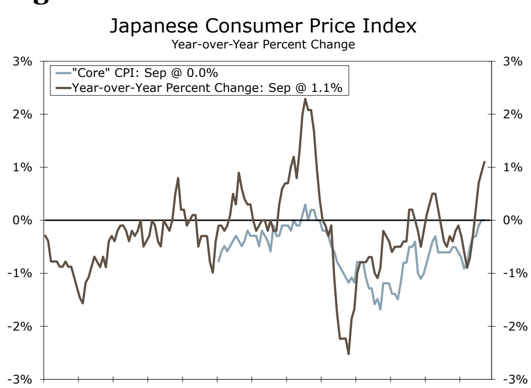


Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

We expect the Japanese economy will grow 1.9 percent in 2014.

In this report we update our near-term forecast and we consider structural reforms that might address Japan's most pressing problems for the long-term. We also evaluate the potential impact of the consumption tax increase set to go into effect in April 2014. Our analysis is informed by the last time the consumption tax was increased in 1997. As we will explain, the global backdrop today makes this cycle different. We expect the Japanese economy will grow 1.9 percent in 2014. Beyond that, the trajectory of growth will depend largely on whether or not the Japanese government is successful in rolling out more impactful structural reform.

Trade Was Primary Culprit for Slower Third Quarter Growth

In the third quarter, economic growth in Japan slowed to an annualized rate of just 1.9 percent, a marked slowdown from the 3.8 percent growth rate in the second quarter. While some market-watchers suggest the slower growth is a warning signal that Abenomics is failing to boost the economy, we take a slightly different view.

Consumer spending offered only a slight contribution to overall growth.

Despite the slower growth, the outturn was better than the consensus expected, and it also marked the fastest increase in total domestic demand in a year and a half. If there was a troubling domestic development in the third quarter, it was the fact that consumer spending increased at just a 0.4 percent annualized growth rate, resulting in only a slight contribution to overall growth.

Business investment in Q3 increased for the fourth consecutive quarter, boasting an 8.8 percent growth rate, the fastest clip for this series since 2011 and enough to account for 1.7 percentage points of the 1.9 percent GDP growth in the quarter. Inventories also increased, reversing three straight quarterly declines and helping to explain the strong total domestic demand figure. An upward trend in industrial production suggests modest sustained strength (Figure 3).

Figure 3

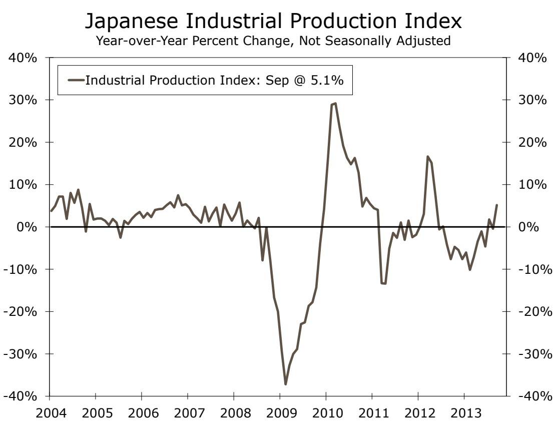
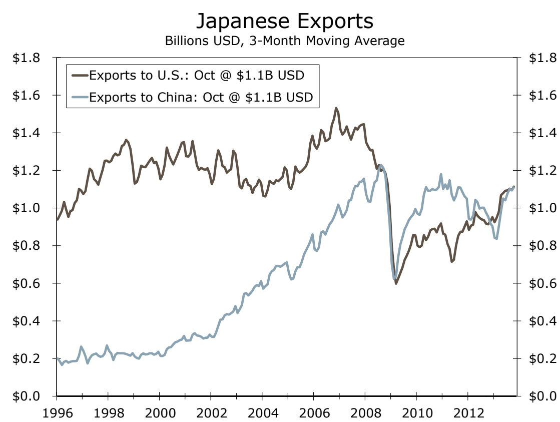


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

The albatross for third quarter output was a faster pace of import growth combined with an outright drop in exports. The net effect was a 1.7 percentage point drag on third quarter growth. More than any other factor, this dynamic best explains the disparity between second and third quarter GDP figures. Trade had been a 0.9 percentage point boost in the prior quarter before becoming a liability in the third quarter.

Amid ongoing Sino-Japanese diplomatic challenges, diminished trade with China is often cited as a headwind for trade. We have no doubt that improved relations might be a positive for exports to China, but it is not obvious to us that this was the problem in the third quarter. According to customs data from the Japanese Ministry of Finance, exports to China increased in July and August before giving up some ground in September (Figure 4). With just one month of data for the fourth quarter, it is too early to tell, but trade with China may help actually boost exports in the final quarter of the year. In October, exports to China rose to a high not seen since March of 2011.

The bigger driver for trade in our view is global economic growth.

The bigger driver for trade in our view is global economic growth. We expect a gradual pick-up in the rest of the world to help export growth outpace imports. Unfortunately that was not the case in October. Despite the fact that Japanese exports posted the biggest annual increase (+18.6 percent) in three years, the jump in exports was outdone by a 26.1 percent surge in imports resulting in the largest trade deficit on record—not a good start to the fourth quarter. Nearly half of the gain in imports was attributable to fuel imports. As we discussed in our previous essay, one of the enduring costs of the Fukushima disaster has been the dependence on foreign fuels as nuclear reactors in many parts of the country remain offline. Despite the weakness here in October, we do expect the firming in global growth over the next couple of years to help narrow the trade deficit over time. But as we discuss in the next section, strong consumer spending at home may result in more of what we saw in October: faster growth in imports.

Consumer Spending Outlook: Are We Facing 1997 All Over Again?

We identified the fact that total domestic demand actually improved in the third quarter even as headline growth slowed, suggesting that Abenomics is not failing. But the slower growth in consumer spending is troubling, particularly since early indications of fourth quarter consumer activity are weak. Sales fell 0.6 percent in October at department stores and 0.8 percent at convenience stores. Overall retail sales data for October are not yet available, but sales had momentum in September when they were up on a monthly and a year-over-year basis (Figure 5).

Slower growth in consumer spending is troubling.

Despite that gloomy backdrop, our expectation is that consumer spending will increase in each of the next two quarters. To a large extent this forecast is influenced by how we believe Japanese consumers will deal with the impending increase in the consumption tax. According to terms of a bill passed last year, the consumption tax in Japan is set to increase to 8.0 percent in April from the present 5.0 percent before climbing to 10.0 percent in October 2015. After some deliberation about trying to stop the tax hike, Prime Minister Shinzo Abe followed the counsel of BoJ Governor Kuroda and the urging of the IMF and removed his opposition to the planned tax increase. He did make a conciliatory gesture in the form of ¥5 trillion in public works spending, cash grants and other incentives. We have long held the view that raising the consumption tax is a necessary evil to combat the country's fiscal vulnerabilities.

The question now is how the tax hike will impact the economy. The most pronounced impact will likely be on consumer spending. This is not the first time Japanese consumers have faced a tax increase. There is some benefit then to consider how consumers reacted when the consumption tax was increased to 5.0 percent from the previous 3.0 percent rate in April of 1997. In that period, consumers were eager to get purchases in ahead of the increase and what resulted was the fastest quarterly growth rate for consumer spending of any time in the past 20 years.

Figure 5

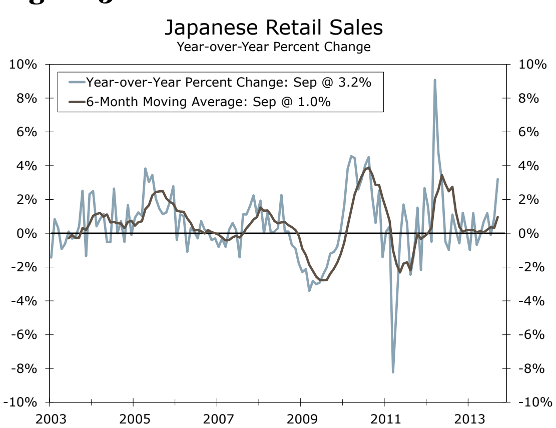
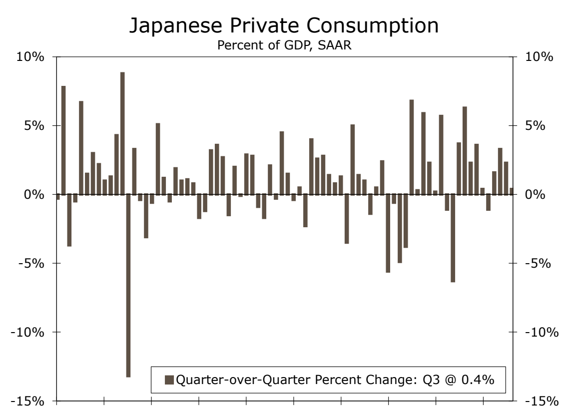


Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

After a surge like that, few analysts would have been shocked to see sales retreat somewhat in the quarter following the tax hike. What happened next was actually far worse. Sales cratered, falling at a 13.2 percent annualized rate in the second quarter of 1997 (Figure 6) and the Japanese economy plunged into recession leading some observers to blame the tax increases for the recession. Formal economic analyses of the period point to the broader Asian financial crisis as the catalyst for the recession.[1]

After the tax hike in 1997, sales cratered.

So do we expect to see a repeat of the 1997 experience in this cycle? No, but there may be some shared characteristics in terms of bringing forward purchases to get them in ahead of the tax

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[1] **"*Raising the Consumption Tax in Japan: Why, When, How?"*, IMF Staff discussion Note, Keen, Michael, with Mahmood Pradhad, Kenneth Kang and Ruud de Mooij, June 16, 2011.**

increase. The Asian financial crisis of 1997 may have been a key catalyst for the recession in that period, but it certainly played no role in the increased spending in the first quarter of 1997. In other words, it is not as though Japanese consumers had an impending financial crisis in mind when they went out and increased spending at 8.8 percent annualized rate in the first quarter of 1997. So similarly we can expect to see sales activity pick up prior to the April 2014 implementation of the tax increase.

The impact of the tax hike is likely to be a decent first quarter followed by a contraction in the second quarter.

Barring another exogenous shock as we had in 1997, we would expect consumers to retrench a bit in the second quarter of 2014 before returning to a rate of spending that is more or less in line with the average rate we have seen over the past few years. The bottom line in terms of the impact on economic growth then is likely to be a fairly decent first quarter followed by a contraction in the second quarter. Our forecast at present is a 4.5 percent annualized growth rate in the first quarter followed by a 3.7 percent rate of contraction in the second. Our full year growth forecast for 2014 is 1.9 percent.

Structural Reform

The first two arrows of Abenomics (large-scale fiscal stimulus and aggressive monetary easing from the Bank of Japan) were generally well-received. We were early advocates of Abenomics and at least so far, the economic data have lived up to our expectations. The third and final arrow (structural reforms to boost Japan's competitiveness) has been uninspiring. The modest reforms and creation of new deregulated economic zones fell short of high expectations for more sweeping labor reforms and new ways of dealing with agricultural regulation, free trade and immigration policy. A special session of Japan's Diet is underway as of this writing and a number of agenda items are on the table. We will forego comments on specific proposed legislation, but will certainly weigh in as soon as any new measures are passed.

At the outset of this incipient expansion two out of three was enough. The fiscal stimulus and monetary policy easing alone exerted a positive boost on the Japanese economy. But now as economic growth has cooled and consumer sentiment is waning, more impactful structural reform is needed to make lasting improvement in the rate of economic growth.

To that end, we explore now some of the structural challenges that presently restrict potential GDP growth and consider reform measures that might be part of a more muscular redesign of the third arrow.

There is a growing consensus that Abenomics needs to embrace structural reform.

There is a growing consensus view that, while off to a good start, Abenomics needs to embrace structural reform because "long-term economic problems need to be tackled in a convincing manner."[2] So what are some of the problems?

Fiscal Issues: How to Reverse 20 Years of Swelling Debt

To say that Japan has a debt problem today is an understatement; a look at some statistics from the OECD makes the point rather effectively. In 1992, when gross public debt amounted to 70 percent of GDP, Japan was already wrestling with considerable liabilities. But after two decades of chronic budget deficits, that figure has swollen to well-over 200 percent of GDP at present. Some might argue that gross debt measures need to be adjusted so that the liabilities are considered in the context of what the government owns as well. Even after subtracting all the assets of the Japanese government, as of 2012, the net public debt stands at 135 percent of GDP, which is more than any other country in the OECD, with the exception of Greece.

The insidious effects of deflation go a long way to explaining how government finances in Japan got so far off track. With a broad-based decline in prices, it is an uphill battle to maintain any kind of nominal GDP growth. If prices are falling 2 percent a year, output needs to grow at a 2 percent rate just to have nominal GDP finish the year unchanged. Japan's problem for the past two decades has generally been characterized by diminished private outlays in an environment of lackluster growth which has necessitated perennial increases in public spending. In short, the Japanese government has been taking in less in revenues even as it has increased its outlays.

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[2] "***Japan's Abenomics: Time to Take Stock"*, Sing, Anoop, IMF Direct, October 21, 2013.**
http://blog-imfdirect.imf.org/2013/10/21/japans-abenomics-time-to-take-stock/

In Figure 7 and Figure 8, we illustrate how the composition of government income and spending has changed since 1992, and consider what that means in the context of Japan's current fiscal challenges.[3]

When it comes to structural challenges facing the Japanese economy, an appreciation of these budget characteristics is critical to an informed understanding of Japan's fiscal predicament. The Japanese government announced in August a pledge to cut the budget deficit in half by fiscal 2015 (from the level in fiscal 2010) before running a budget surplus by fiscal 2020. It is easy to call for a balanced budget, but these figures demonstrate that not only would that require a reversal of nearly two decades of spending and revenue patterns, it would also require some very difficult economic choices that might not be politically feasible.

Balancing the budget would also require some very difficult choices that might not be politically feasible.

Figure 7

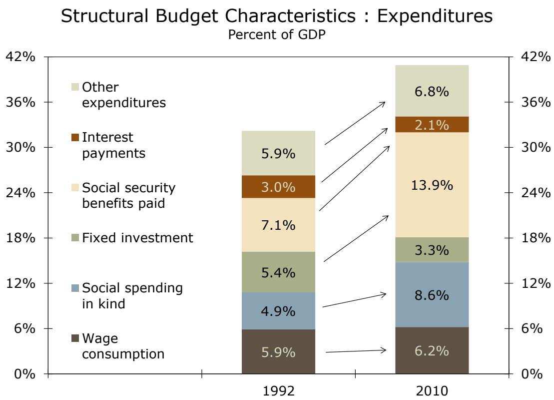
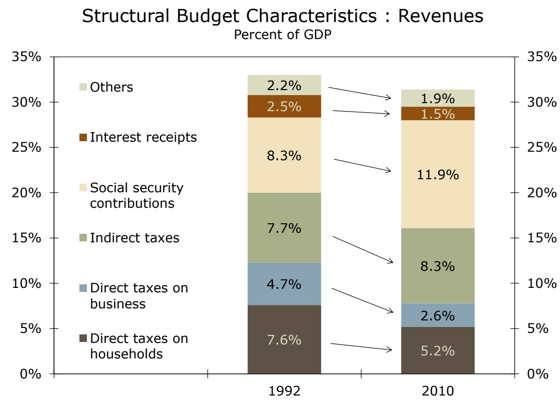


Figure 8



Source: Organization for Economic Cooperation and Development and Wells Fargo Securities, LLC

The most obvious problem in looking at these budget characteristics is that revenues comprise a shrinking share of GDP even as outlays command a larger share. The biggest factor driving this dynamic is the funding and drawdown of social security. In terms of spending, the share of social security outlays has nearly doubled, rising from 7.1 percent of GDP in 1992 to 13.9 percent in 2010. In the same time period, the share of revenue attributable to social security contributions has increased by a comparatively smaller amount, increasing from 8.3 percent of GDP in 1992 to 11.9 percent in 2010. Social security contribution rates were increased during the period and a portion of next year's consumption tax hike will go to funding social security. But according to many experts on Japan's fiscal situation, that will not be enough.

Revenues comprise a shrinking share of GDP even as outlays command a larger share.

The so-called Fiscal System Council is working on a set of recommendations for the Japanese Finance Ministry to consider as it sits down to plan next year's budget this December. Hiroshi Yoshikawa, the chairman of the council and an economics professor at the University of Tokyo, has publicly stated that because of social security imbalances it will be impossible to balance the budget by 2020, even with the April tax increase and the next planned tax hike in 2015. The council appears poised to recommend benefit cuts. Such advice would echo the prior recommendations from the OECD.[4] The OECD recommended accelerating the rise in the pension eligibility age and then linking it to longevity. Other fiscal policy recommendations from the international policy group included reforming health and long-term care programs which are part of social security in Japan.

One of the underlying structural issues that confound efforts to balance the budget and bring revenue in line with spending is Japan's current and growing problem of an aging population. A

[3] In Figure 7, "social spending in kind" is calculated from data for FY 1992 and FY 2010. Other government non-wage consumption is included in the category "other expenditures". Graph concept is originally that of the OECD.

[4] OECD (2013), "*OECD Economic Surveys: Japan 2013*", OECD Publishing, p. 44-45.

growing number of people on the receiving end and shrinking number of people on the contribution end is challenging the assumptions upon which the system is based.

The Incredible Shrinking Workforce

Japan is at an inflection point where the population is beginning to shrink.

Population statistics and methodologies differ, but it appears as though Japan is at an inflection point in terms of population growth. According to the Statistics Bureau of Japan, the official national population was 127.7 million as of November, down roughly 400,000 from the 127.3 million figure from June (Figure 9). The trajectory of population growth has been slowing and because of nearly no net immigration and falling birth rates, Japan is at an inflection point where the population is beginning to gradually shrink.

Figure 9

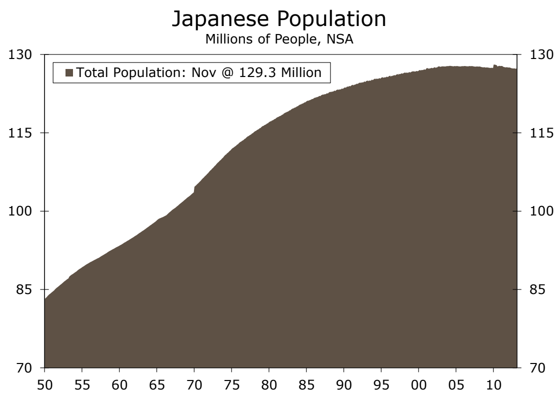
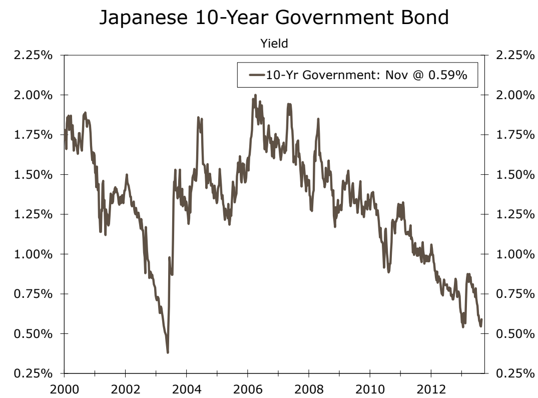


Figure 10



Source: Japanese Ministry of Internal Affairs and Communications, IHS Global Insight and Wells Fargo Securities, LLC

By 2050, the working-age population is projected to shrink to a level last seen at the end of World War II.

Compounding this problem is the fact that the average age of the population is getting higher and the nation grows older. While the overall population has only recently begun getting smaller, the labor force has been shrinking for more than a decade. This has serious implications for both the size of Japan's future workforce and for domestic demand. According to the IMF, the size of the working-age population is projected to fall from its peak of 87 million in 1995 to about 55 million in 2050. If realized that would roughly equal the size of the Japanese workforce at the end of World War II.

In addition to reducing potential growth, the aging of the population in Japan is having a downward influence on interest rates (Figure 10).[5] According to the IMF, elderly households prefer to avoid risk and feel more comfortable with safe assets such as Japanese Government Bonds; so much so that the downward effect on rates from elderly purchases has a bigger impact than purchases by the Bank of Japan.

The IMF has formally recommended that structural reforms should embrace measures to raise female labor participation. The Japanese government has mentioned plans to eliminate waiting lists on kindergartens and day-care centers, which would support women's employment. The lack of availability and affordability of quality daycare keeps many would-be working moms at home in Japan. Unfortunately there has not been much in the way of real structural reform in this area. Raising the employment of women "would give an important signal about the government's commitment to reforms."[6]

Other restructuring measures which the IMF endorses include deregulation in the agriculture and service sectors, financial sector reforms to promote a more efficient allocation of credit, and relaxation of immigration rules to address labor shortages.

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[5] **Arslanalp, Serkan and W. Ralphael Lam, "*Outlook for Interest Rates and Japanese Banks' Risk Exposures under Abenomics*", IMF Working Paper, WP/13/213, October 2013, page 8.**

[6] **International Monetary Fund, 2013 Article IV Consultation, "*IMF Country Report No. 13/253*", August 2013.**

Embrace Free Trade

Trade has been an inconsistent factor in Japanese GDP growth over the past several years. Through the end of last year when Abenomics was just getting started, the trade deficit had ballooned (Figure 11) and net exports had been a drag on Japanese economic growth in seven of the prior nine quarters. That reversed somewhat in in 2013, when Japanese exports picked up following depreciation in the yen (Figure 12). Net exports added to GDP in the first two quarters of the year before losing some ground in the third quarter and exerting a modest drag.

Figure 11

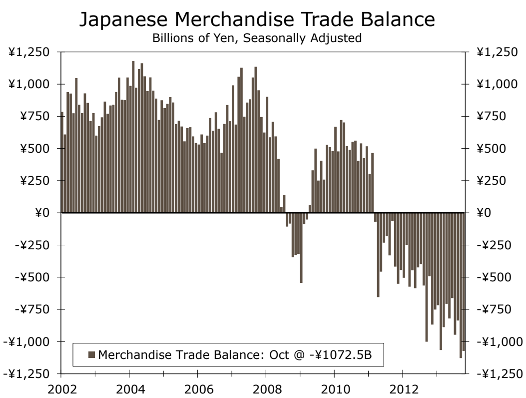
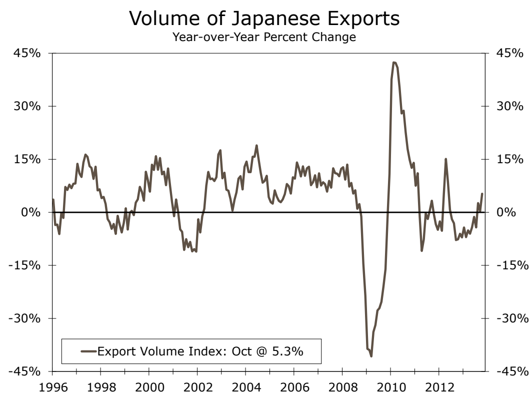


Figure 12



Source: IHS Global Insight and Wells Fargo Securities, LLC

The Trans-Pacific Partnership (TPP) is a proposed free trade agreement that has been in negotiation since 2010 and at present involves 12 countries in Asia and the western hemisphere. Japan was late to the negotiating table due to resistance from the domestic agricultural lobby. However, with a groundswell of support for Abe's other policies, Japan officially joined in on the 18th round of talks in July.

To assuage the agriculture lobby, it was highlighted in the initial resolution supporting Japan's involvement that any inclusion must maintain tariffs on key farm products, especially rice, wheat, beef, dairy products and sugar. That would be a non-starter as the TPP, like most free trade agreements, generally exist for the expressed purpose of breaking down barriers to trade. A statement following the meeting between President Obama and Prime Minister Abe noted that Mr. Abe made clear that tariffs will need to be part of any Japanese involvement.

The farm lobby has begun voicing its objection and insisting that tariffs be protected. The agriculture lobby has an entrenched record of influencing favorable legislation. The Organization for Economic Cooperation and Development compiles data on producer support estimates (government subsidies) as a percentage of gross farm receipts including support.[7] According to this data, Japan's farmers depend on government subsidy for a whopping 55.9 percent of their income. That is more than three times the 18.6 percent average across the OECD countries. U.S. farmers are among the least subsidy-reliant at just 7.1 percent.

We suspect that if Japan is to be included in the TPP, it would need to forego its insistence on broad ranging trade tariffs. While some industry sectors would ultimately need to adjust to remain globally competitive, the law of comparative advantage tells us that free trade permits mutual gains from the trade of goods and services.

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Japan's farmers would surely face competition from places where labor costs are lower, but they might also benefit from increased exports of their agricultural goods to a new group of overseas buyers. In announcing Japanese involvement in the trade talks, Prime Minister Abe stressed that

7 Organization for Economic Cooperation and Development, "*Agricultural Policy Monitoring and Evaluation 2013*", Agricultural Support Estimates, 1986-2012. http://www.oecd-ilibrary.org/agriculture-and-food/data/producer-and-consumer-support-estimates/agricultural-support-estimates-2013_data-00675-en

this was Japan's "last chance" for it to get involved at a stage where Japan can play a role in defining the terms of trade for what may be a very long time.

Bottom Line: A Father's Wisdom

Mōri Motonari was a prominent daimyo (territorial lord) in the Japan during the 16th century who had had three sons. In the legend that has been passed down, the father gave his sons three arrows with the instruction to snap them all at once. After realizing it could not be done, Motonari explained to his boys that while one arrow could be easily snapped on its own, three arrows held together could not. It was an admonition to them that if they stuck together, they would be stronger than they would be if they were divided.

Three arrows held together cannot be broken, but one arrow on its own could be snapped easily.

This story, of course, is the basis for Prime Minister Shinzo Abe's way of packaging his economic reforms. It is critical that structural changes (the third arrow) be implemented as close to simultaneously as possible with the stimulative fiscal policy initiatives and the accommodative monetary policy measures (the first two arrows). Three arrows held together cannot be broken, but one arrow on its own could be snapped easily.

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