Abenomics: A Qualified Success?

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November 21, 2013

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So Far, So Good

- Near-term forecasts of growth and inflation have been marked up.
- Long-term inflation compensation is way up.
- Nominal yields are little changed.
- Market pricing implies that debt burden will be eroded through moderate inflation.
- Existing measures stabilize debt over medium term.
- But, nothing to raise long-run growth yet.

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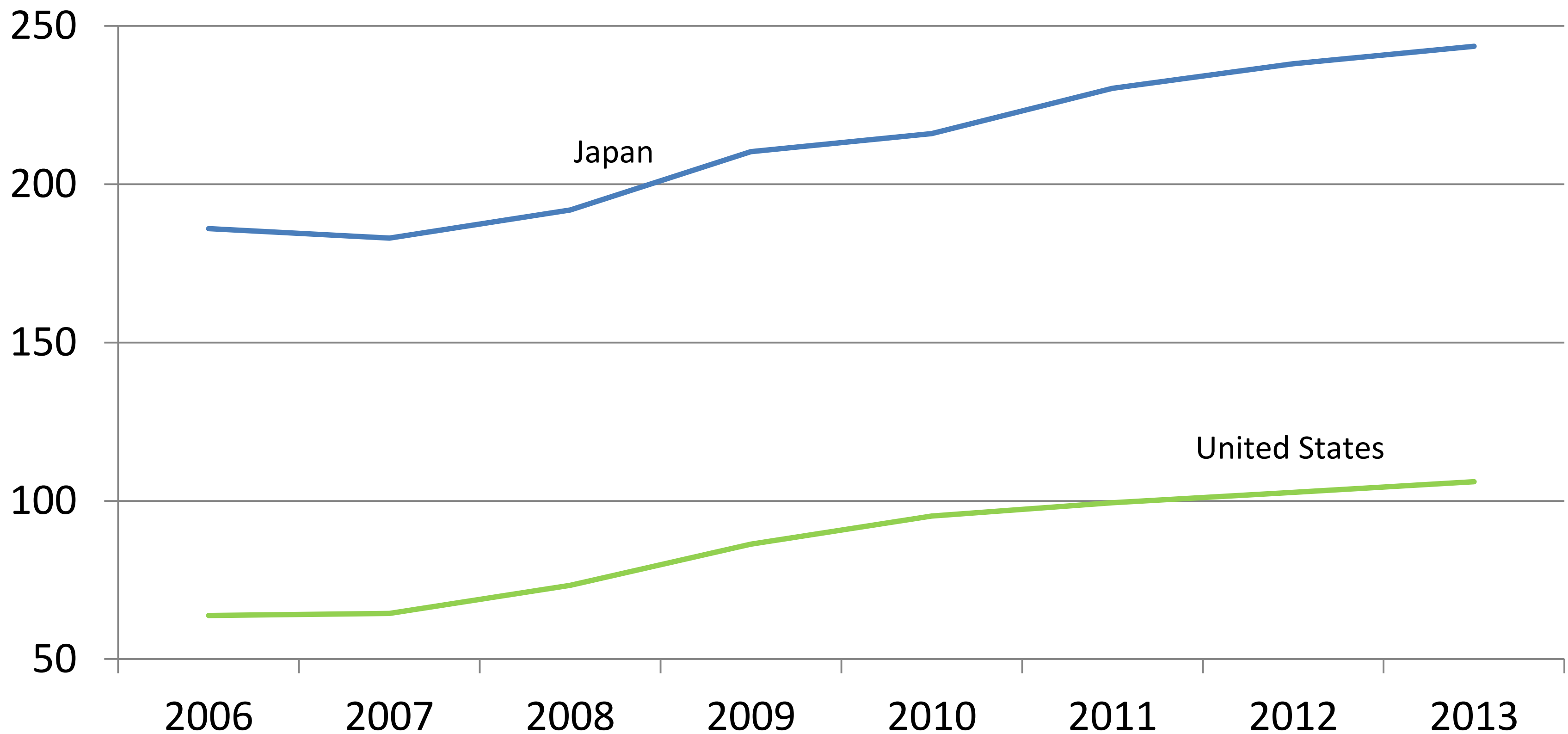
Japan's Government Debt Problem



Source: IMF *Fiscal Monitor*

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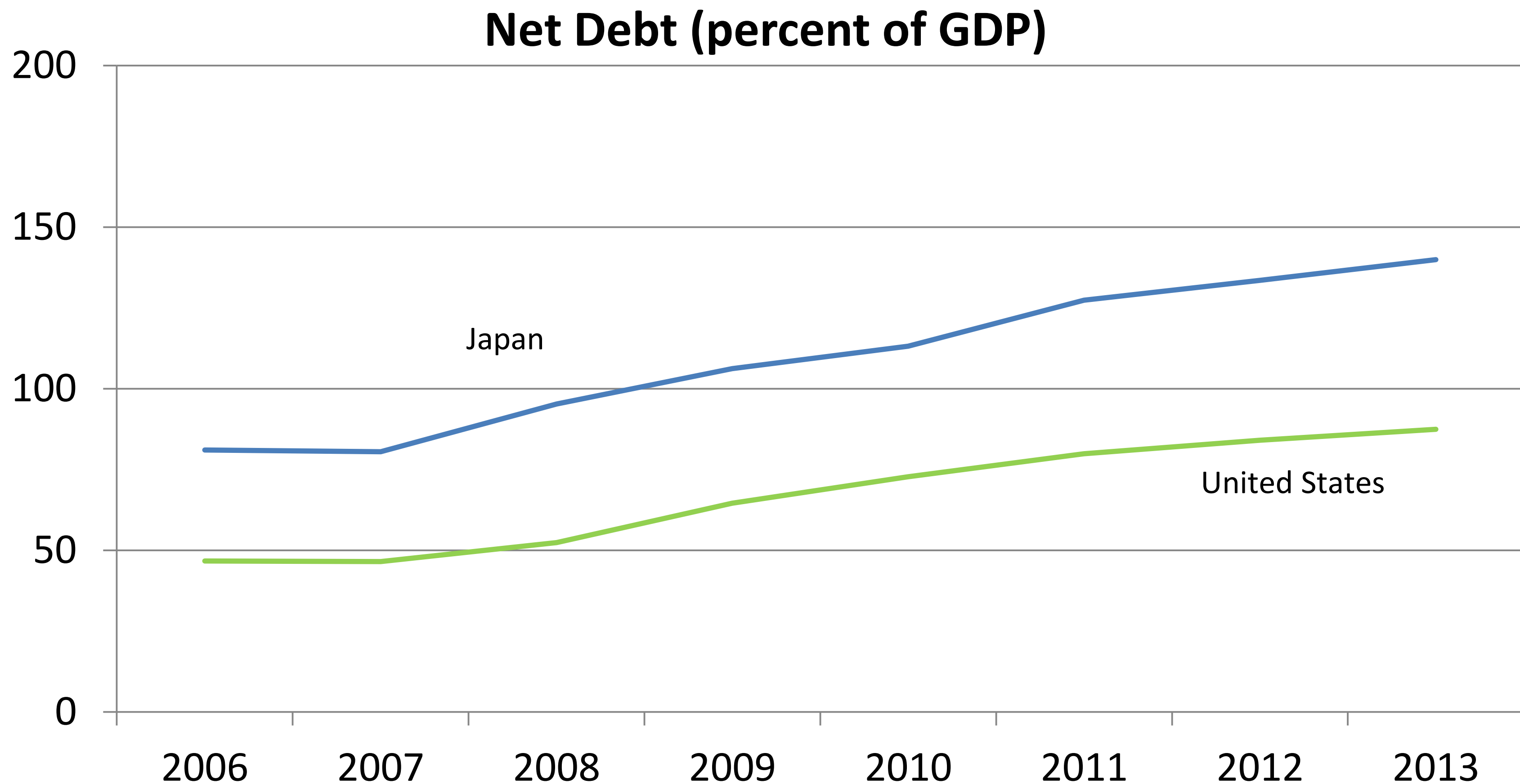

Source: IMF *Fiscal Monitor*

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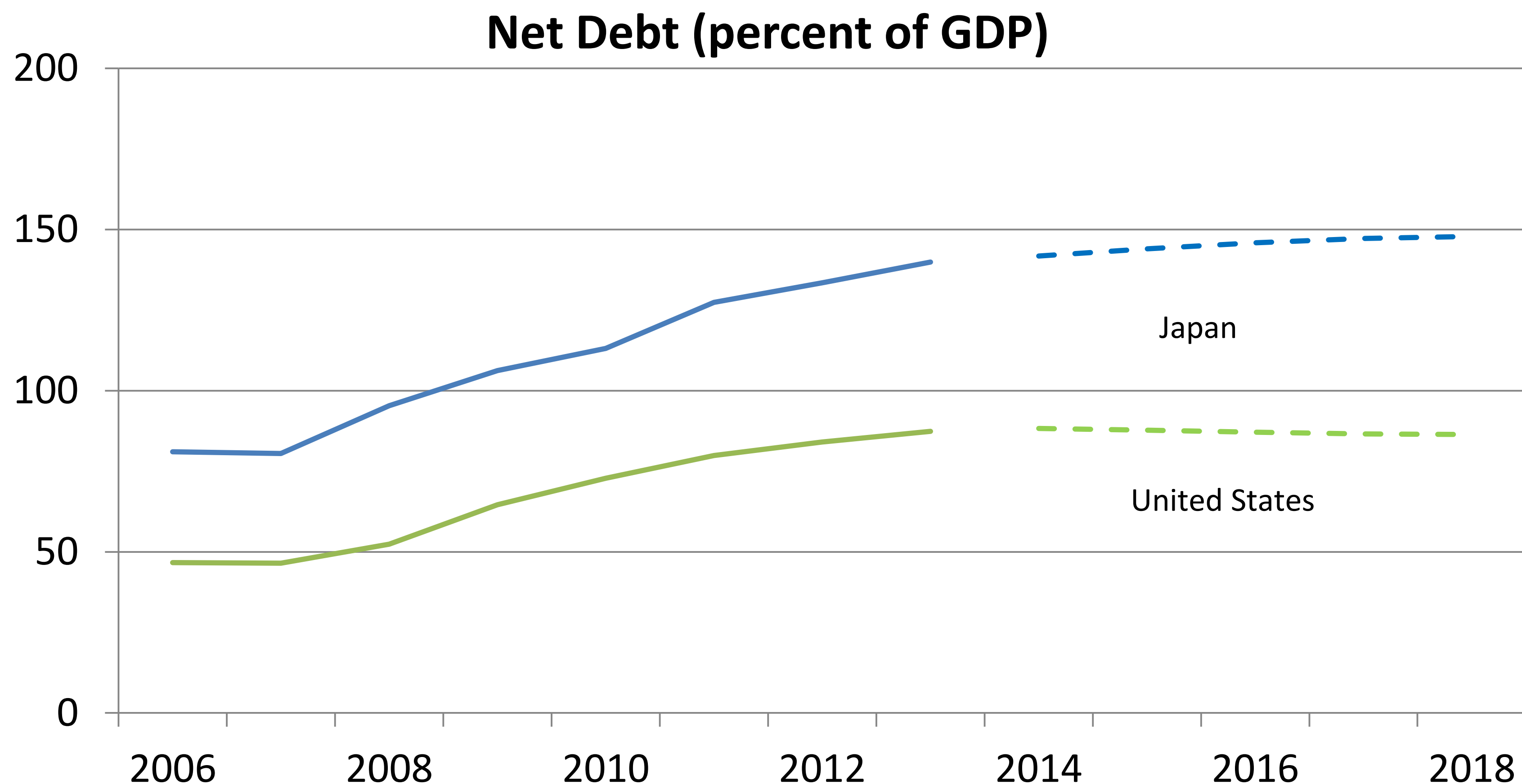

Source: IMF *Fiscal Monitor*

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Debt Arithmetic

$$\frac{Debt}{GDP}(2013) = \frac{(1+r)}{(1+g)}\frac{Debt}{GDP}(2012) + \frac{PrimaryDeficit}{GDP}(2013)$$

r : Interest rate

g : Growth rate

Primary Deficit : Non-interest Spending

- Tax Revenue

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Debt Arithmetic

$$\frac{Debt}{GDP}(2013) = \frac{(1+r)}{(1+g)}\frac{Debt}{GDP}(2012) + \frac{PrimaryDeficit}{GDP}(2013)$$

To stabilize Debt/GDP:

If $r = g$, need primary deficit = 0.

If $r > g$, need primary deficit < 0 (surplus).

If $r < g$, primary deficit may be > 0.

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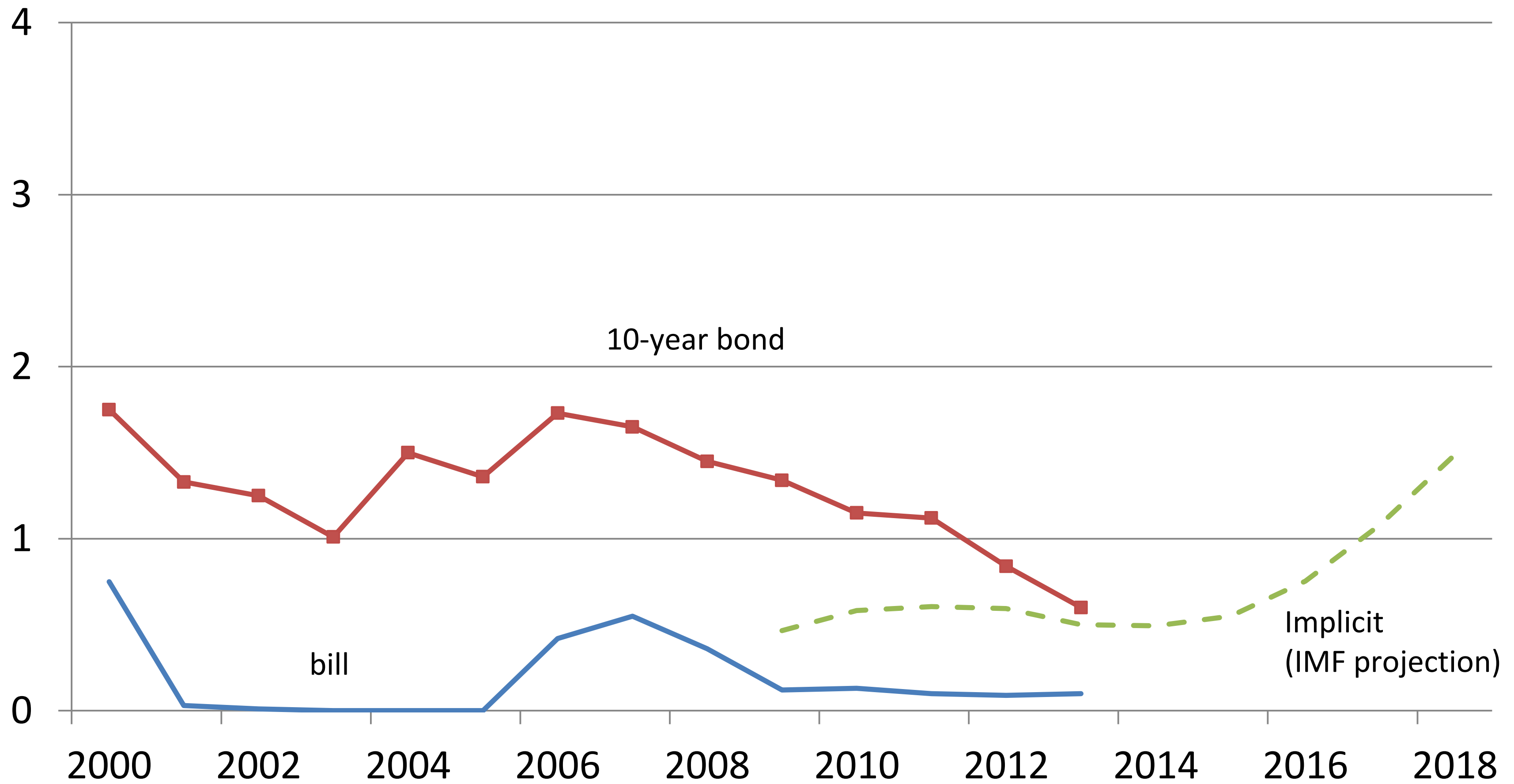
Japanese Government Yields -- r



Source: IMF *International Financial Statistics* and *Fiscal Monitor*

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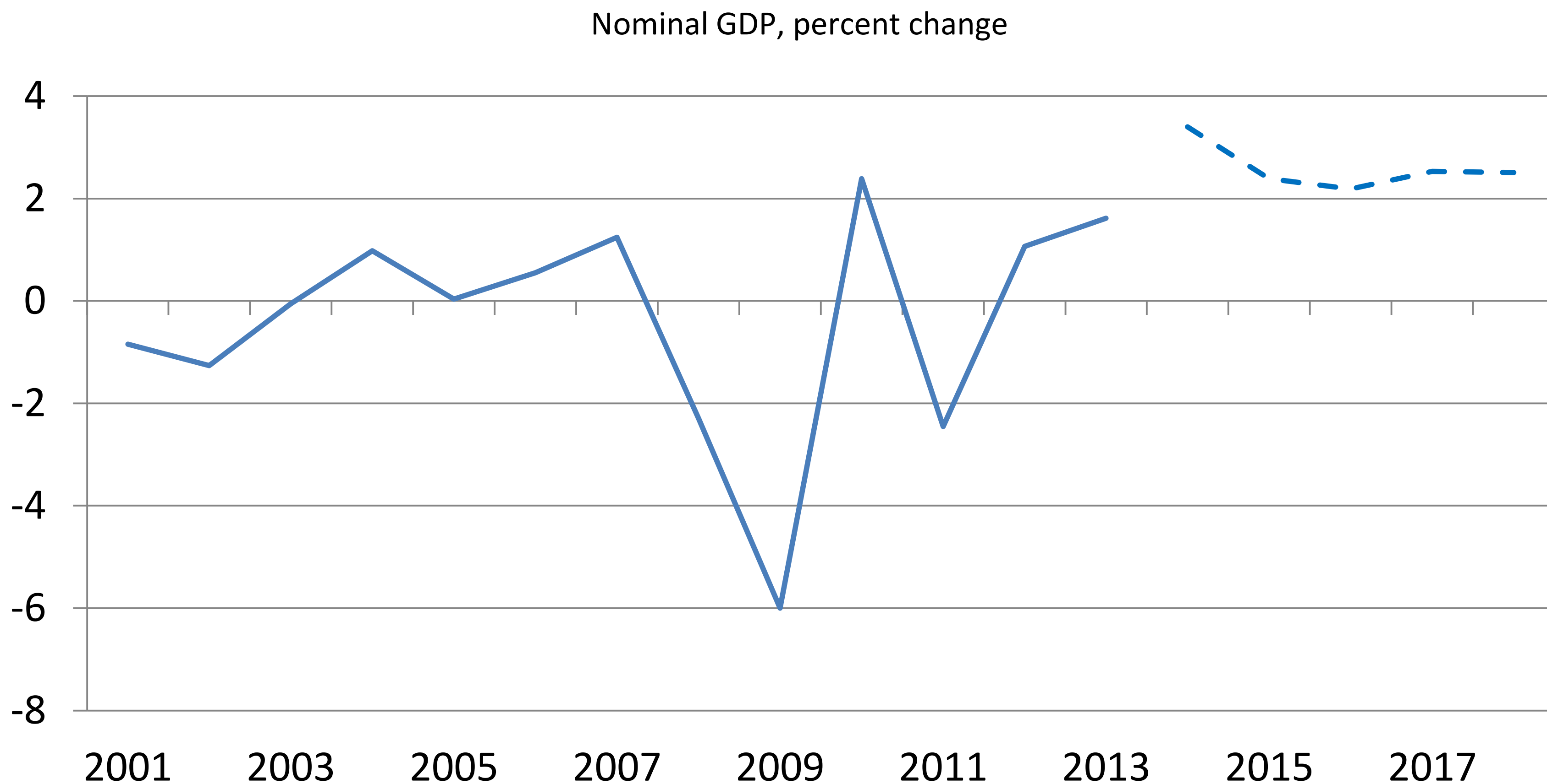
Japan's Nominal Growth Rate -- g



Source: IMF *World Economic Outlook*

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Debt Arithmetic

$$\frac{Debt}{GDP}(2013) = \frac{(1+r)}{(1+g)}\frac{Debt}{GDP}(2012) + \frac{PrimaryDeficit}{GDP}(2013)$$

To stabilize Debt/GDP at 150%:

If r=0.5 and g=2.5, need primary deficit = 3%.

IMF assumes r=4.5 and g=2.5, then need primary deficit = -3%. Too pessimistic.

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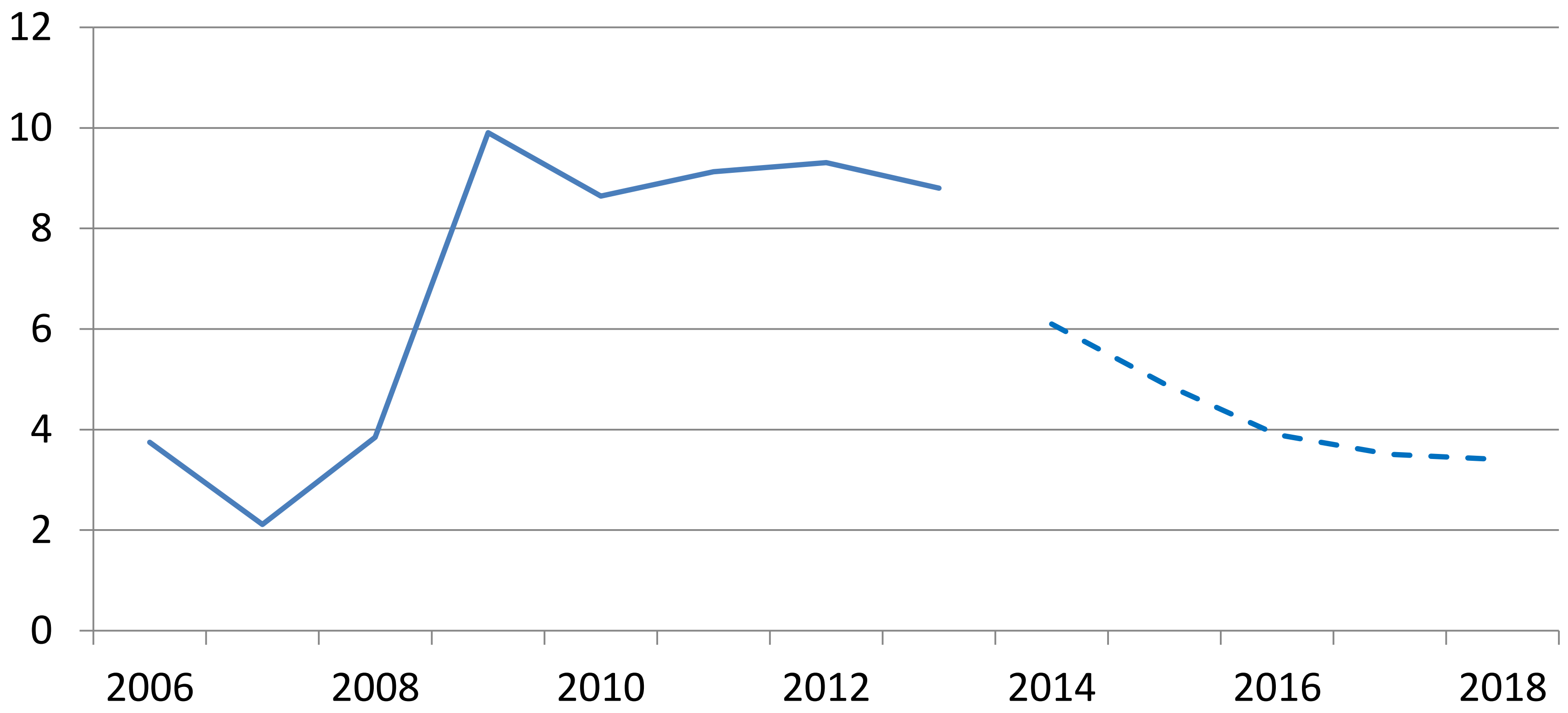
Japan's Primary Fiscal Deficit



Source: IMF *Fiscal Monitor*

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2014 Stimulus Package

- Consumption tax hike and expiration of earthquake stimulus equal about 2% of GDP in 2014.
- Last month, Abe proposed about 1% of GDP in temporary tax cuts and extra spending to cushion the blow.
  - Mainly investment tax credits
  - May end corporate tax surcharge early

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QE: Japan vs. United States

	July 2007	December 2012	November 2013	March 2015 ??
Japan				
CB Assets (% of GDP)	21	33	45	57
10-year Bond Yield	1.8	0.8	0.6	??
United States				
CB Assets (% of GDP)	6	19	24	26
10-year Bond Yield	5.0	1.7	2.7	??

Sources: Bank of Japan, Federal Reserve Board, IMF *International Financial Statistics, Bloomberg,* and author's projections for 2015.

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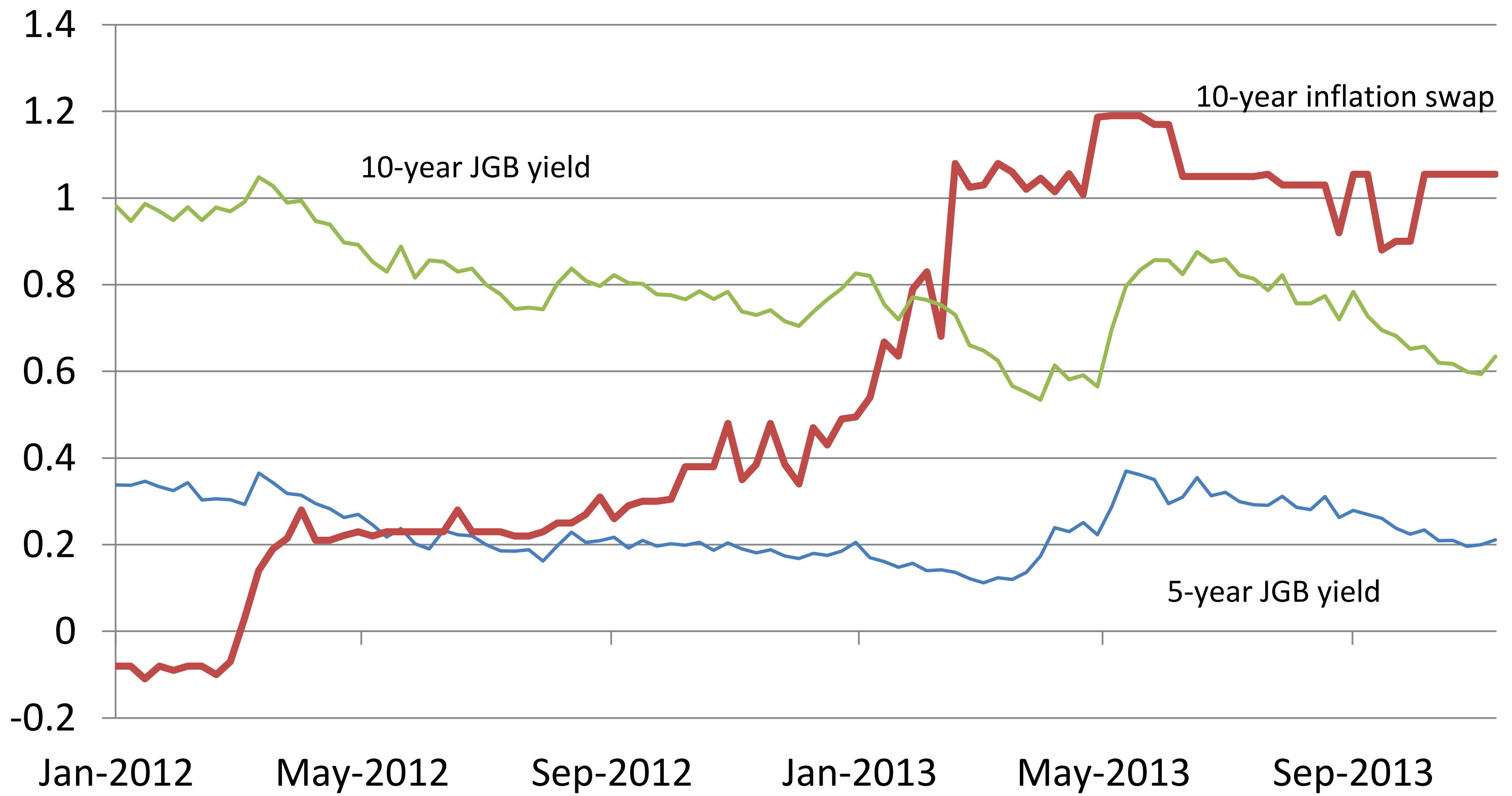
BOJ Policy Success?



Source: Bloomberg

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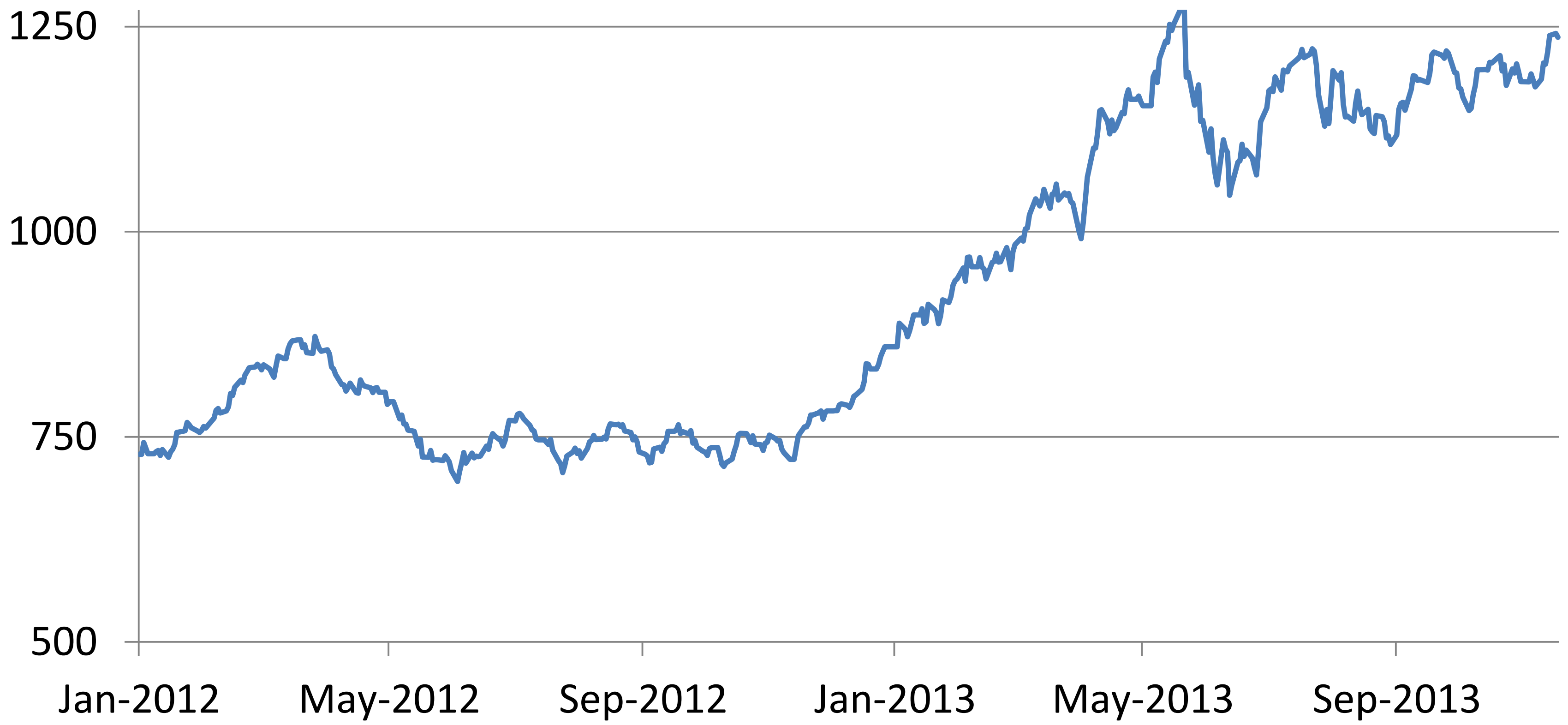
BOJ Policy Success?



Source: Datastream and Financial Times

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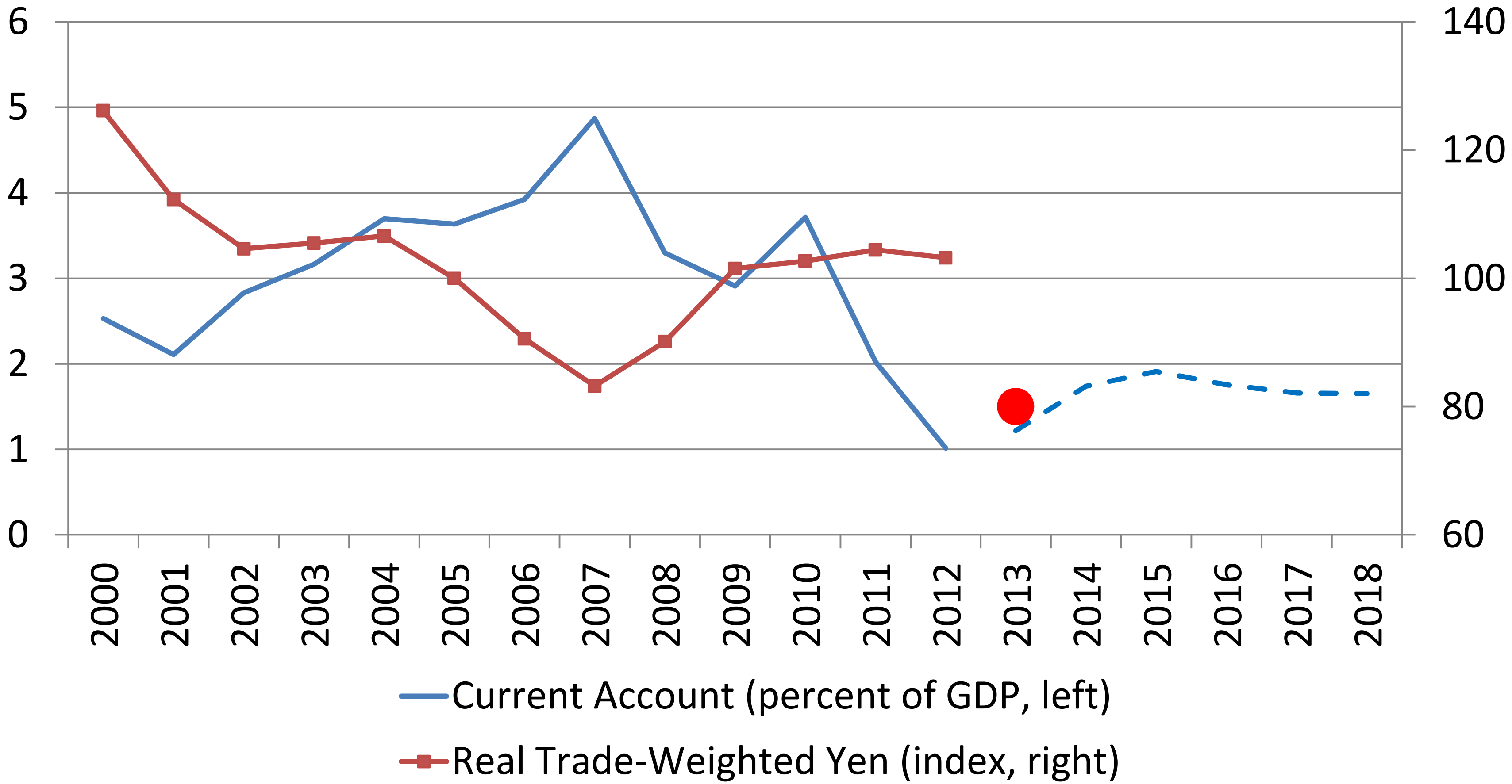
Yen and Trade Balance



Source: IMF *International Financial Statistics* and *World Economic Outlook*

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End Deflation and Stabilize Debt? Probably Yes

- Higher equity prices, lower real interest rates, fiscal stimulus will boost spending.
- Weaker yen will boost exports.
- Stronger growth will allow rising inflation.
- Bond markets resigned to large negative real returns.
- Debt is stabilizing, but long-run aging costs still rising as in US and Europe.

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Permanently Boost Growth? Probably Not by Much

- So far, Abe's third arrow is a grab bag of modest initiatives with little major substance.
- Perhaps the most likely to be significant are
  - Increasing female labor force participation
  - Increasing size and efficiency in agriculture

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Joseph E. Gagnon

Joseph E. Gagnon, a senior fellow at the Peterson Institute for International Economics since September 2009, was visiting associate director, Division of Monetary Affairs (2008–09) at the US Federal Reserve Board. Previously he served at the US Federal Reserve Board as associate director, Division of International Finance (1999–2008), and senior economist (1987–1990 and 1991–97). He has also served at the US Treasury Department (1994–95 and 1997–1999) and has taught at the Haas School of Business, University of California, Berkeley (1990–91).

He is author of *Flexible Exchange Rates for a Stable World Economy* (2011) and *The Global Outlook for Government Debt over the Next 25 years: Implications for the Economy and Public Policy* (2011). He has published numerous articles in economics journals, including the *Journal of International Economics*, the *Journal of Monetary Economics*, the *Review of International Economics*, and the *Journal of International Money and Finance*, and has contributed to several edited volumes.

He received a BA from Harvard University in 1981 and a PhD in economics from Stanford University in 1987.

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