Abenomics

Policy lessons for the EU

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Chris Scicluna, Head of Economic Research
chris.scicluna@uk.daiwacm.com
+44 20 7597 8326

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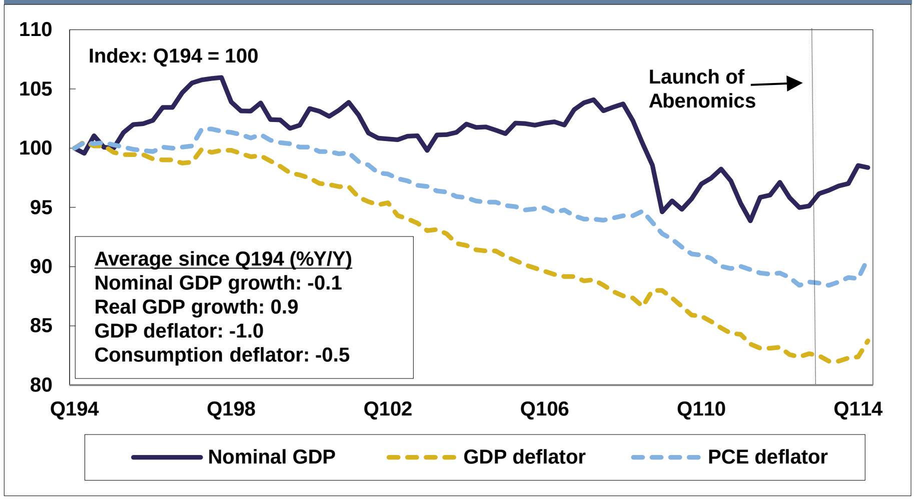
50 YEARS IN LONDON

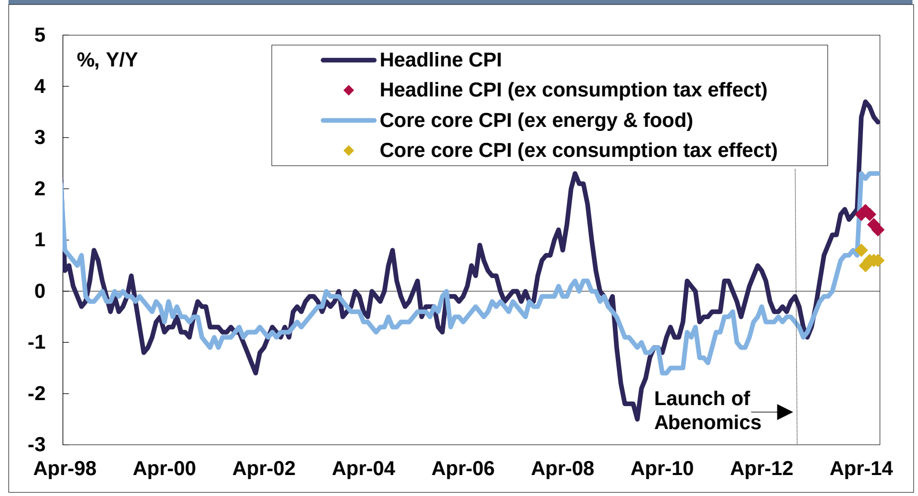
Japan: Remember life before Abenomics…

Japan: GDP and deflators



Source: Cabinet Office

Japan: Consumer price inflation

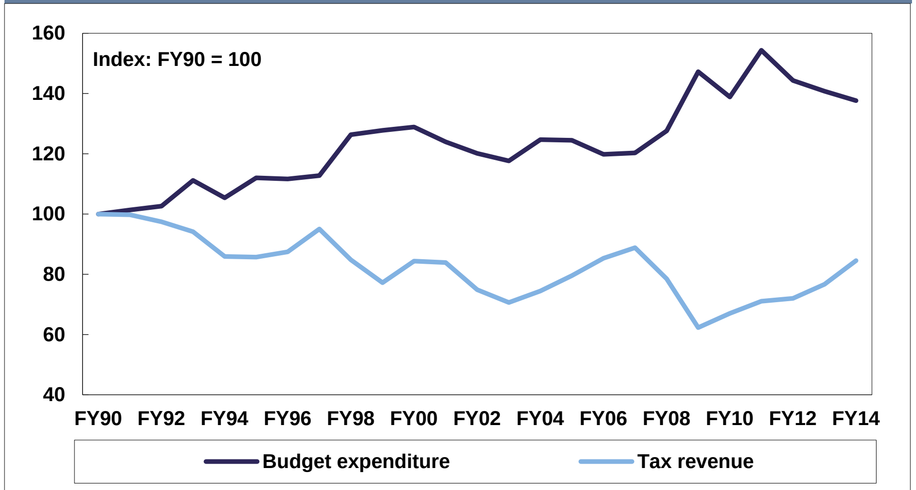


Source: MIC, BoJ and Daiwa Capital Markets Europe Ltd.

- Abenomics represents a long-overdue shot in the arm for the Japanese economy, which suffered from ‘self-inflicted paralysis’ for more than twenty years.
- Despite the growth and inflation generated over the past eighteen months, nominal GDP remains below its level twenty years ago. Underlying ‘core’ core inflation remains close to ½%Y/Y, too close to zero for comfort.

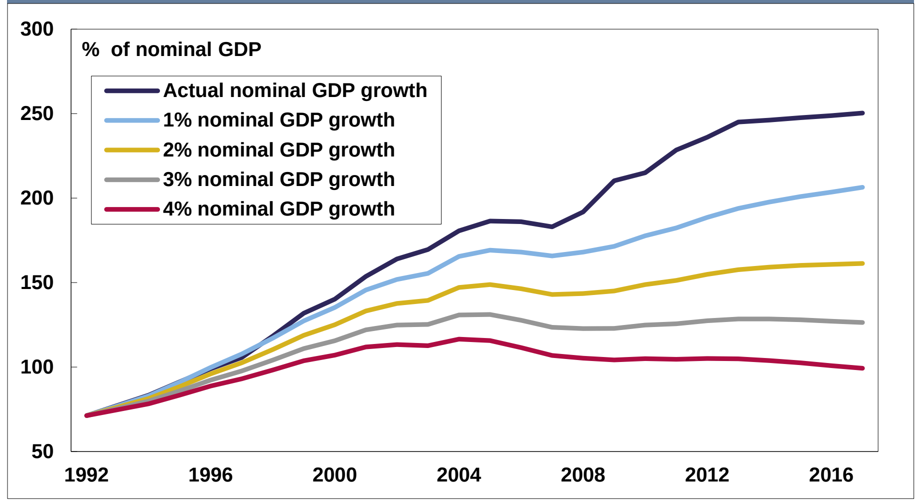
Fiscal sustainability: It's the denominator, stupid!

Japan: Fiscal indicators*



*Initial budget for FY14. Source: MoF and Daiwa Capital Markets Europe Ltd.

Japan: Illustrative gross debt scenarios*



*Excludes impact of real fiscal drag, etc. Source: MoF, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- Declining nominal GDP growth is a key cause of Japan's steadily increasing debt stock.
- Had nominal GDP grown on average by 3% per year since 1992 – the average rate in Germany until the Lehman Crisis – then the gross government debt ratio would be roughly half its present level. If it had grown at the same rate as the UK, gross debt would be less than 100% of GDP.

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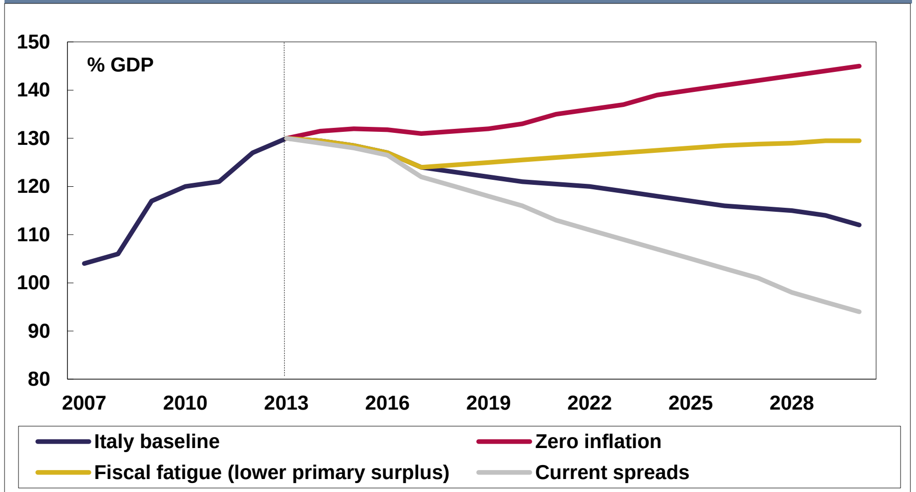
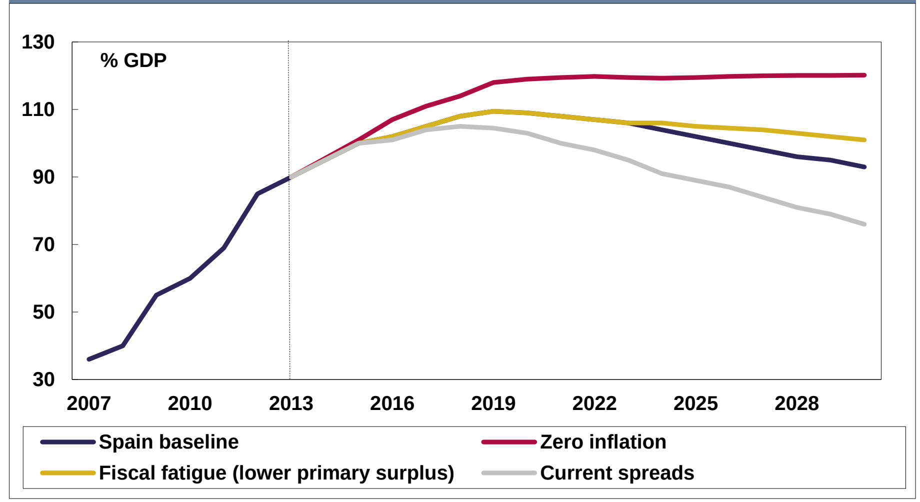
It's the denominator, stupid, even in Europe!

Italy: Government debt projections



Note: 'Current spreads' assumes 150bps spread against Bunds. Source: Darvas (2013) : "The euro area's tightrope walk", *Bruegel Policy Contribution*

Spain: Government debt projections



Note: 'Current spreads' assumes 150bps spread against Bunds. Source: Darvas (2013) : "The euro area's tightrope walk", *Bruegel Policy Contribution*

- Both Italy and Spain have relatively high starting debt positions, making them vulnerable to shocks. But in most scenarios debt stabilises at or below 130% of GDP. Maintaining spreads of 150bps brings debt well below 100% GDP in both countries by 2030.
- Italy is further ahead in terms of fiscal adjustment. But stabilising its higher debt ratio requires both growth and – crucially – inflation. With zero inflation, Italian debt is on an ever-increasing path, while Spain's will fail to fall.

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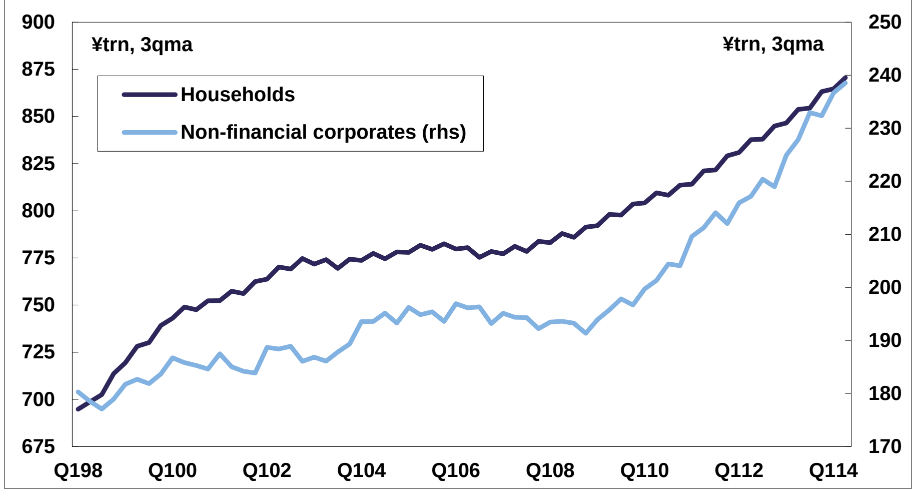
Deflation distorts!

Pernicious effects of deflation

- ***Households postpone purchases***
- ***Firms defer fixed investments***
- ***Wage rises the exception not the rule***
- ***Price-setting behaviour distorted***
- ***Portfolios full of low-risk assets***

Source: Daiwa Capital Markets Europe Ltd.

Currency & deposits: Households & NFCs*



Source: BoJ & Daiwa Capital Markets Europe Ltd.

- 15 years of deflation distorted economic behaviour, weighing heavily on actual and potential GDP growth. QQE aims to shock households, firms and investors out of their deflationary behaviour.
- The distortions are taking time to be overcome. E.g. Wages are responding relatively slowly to the tightening labour market; portfolio rebalancing has yet to begin, etc. So, the most important element of the third arrow is the first arrow!

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Abenomics: Policy lessons for the EU

Key point	• Avoid self-induced paralysis
Monetary policy	
Fiscal policy	
Structural reforms	

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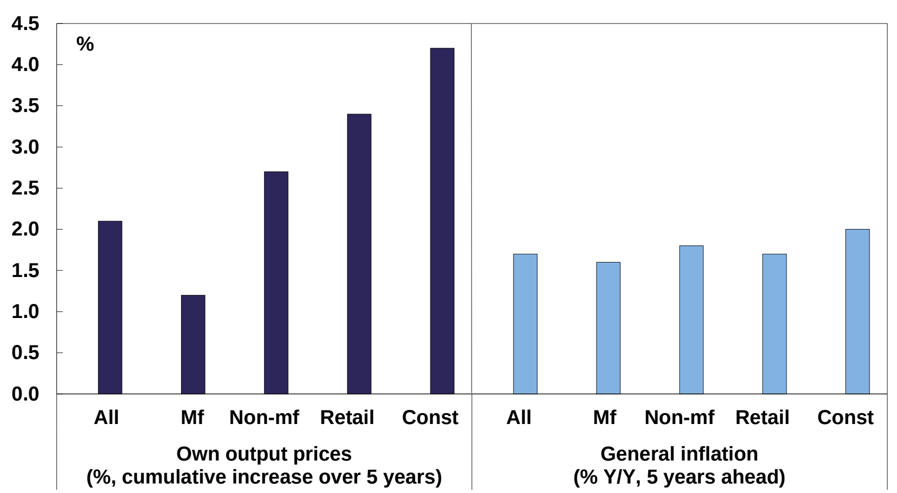
Japan: Inflation expectations higher, but still below target

Business price expectations



Source: BoJ Tankan Survey "Inflation Outlook of Enterprises" September 2014 and Daiwa Capital Markets Europe Ltd.

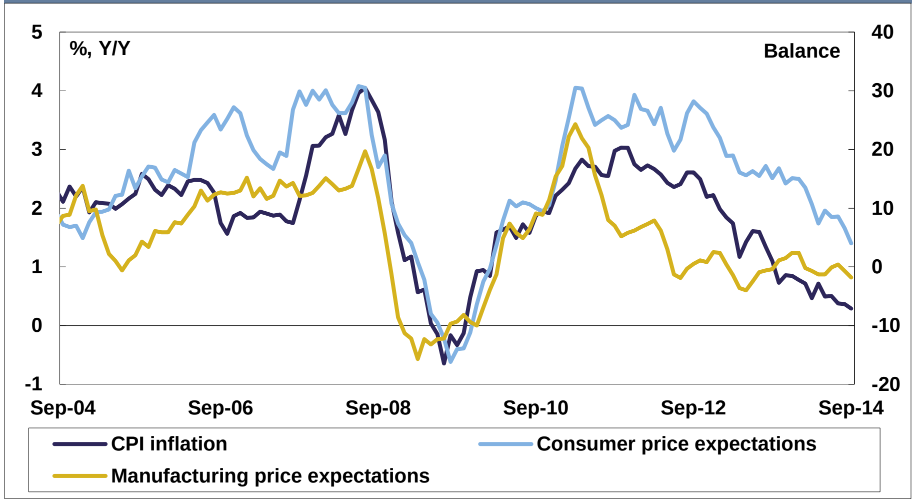
Market medium-term inflation expectations*

*5year/5year inflation swap rate. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

- Firms expect underlying inflation to pick up further over coming years to about 1.7%Y/Y in five years time. But they also expect their own prices to rise far less. Large manufacturers expect their own prices to fall over the coming five years.
- Market expectations of inflation (e.g. measured by swaps or linkers) are higher too, albeit partly reflecting the impact of recent and expected future consumption tax hikes. But they remain well below the BoJ target too.

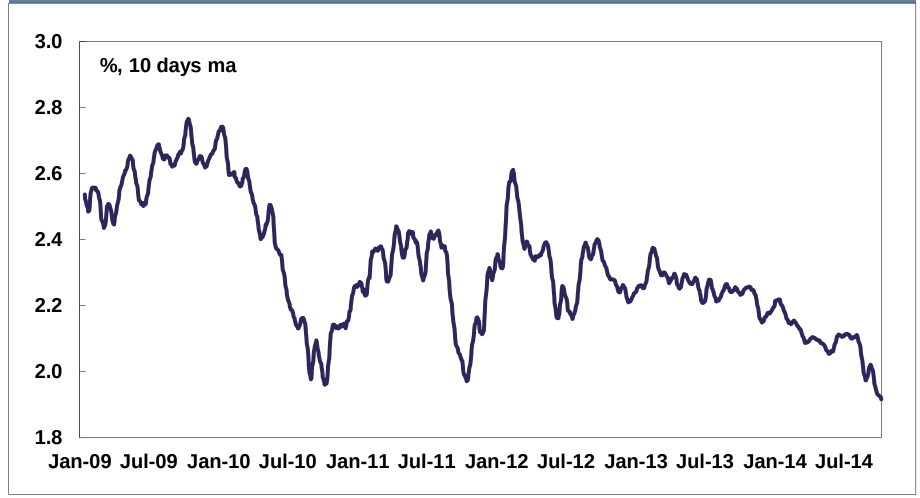
Euro area: Inflation expectations heading in wrong direction

CPI inflation and survey-based expectations*



*From the Commission Business and Consumer Survey. Source: Datastream and Daiwa Capital Markets Europe Ltd.

Market medium-term inflation expectations*

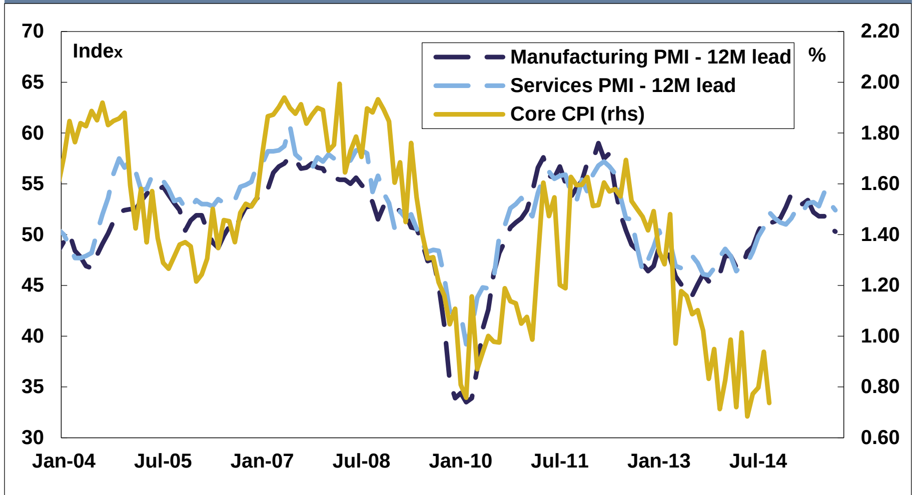


*5year/5year inflation swap rate. Source: Datastream and Daiwa Capital Markets Europe Ltd.

- The euro area has seen a trend decline in headline inflation over the past two years; some of this has been energy related, but core inflation has also fallen. No member state currently gets close to 2% inflation.
- Survey- and market-based expectations of inflation have become dislodged, as highlighted by Draghi at Jackson Hole.

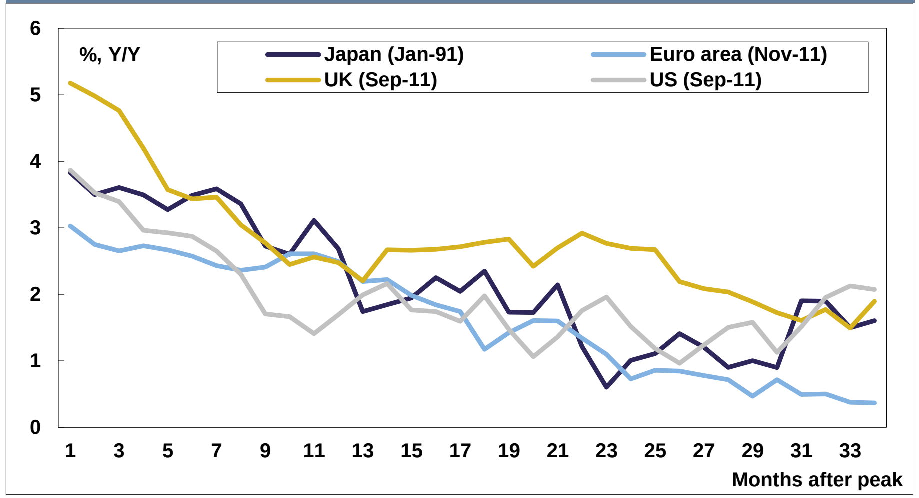
Is the euro area flirting with disaster?

Euro area: Inflation & the PMIs



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Inflation: A comparison with Japan



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

- The performance of euro area inflation has persistently disappointed. That is partly down to commodity price effects and the euro. But it also reflects a drop in core inflation rates. Previous relationships appear to have broken down.
- It took several years for Japan to succumb to deflation. Euro area inflation has fallen more swiftly than in Japan before deflation. It is arguably only one or two shocks from deflation.

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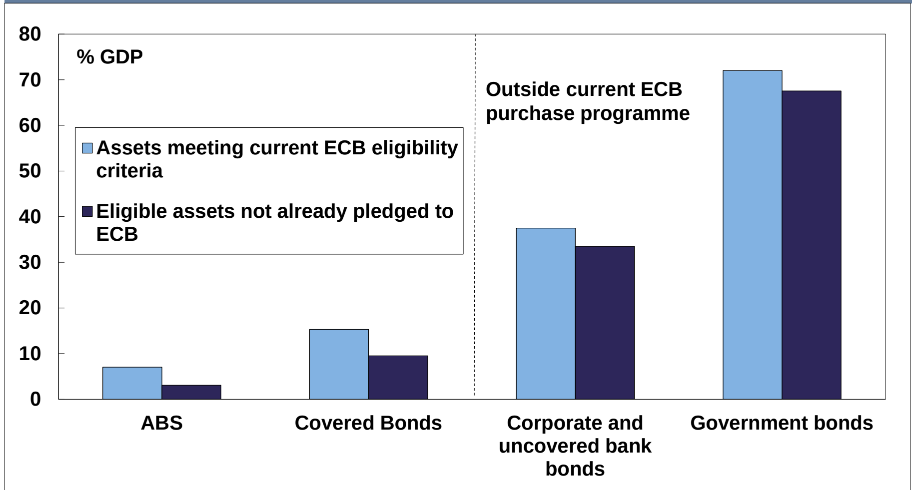
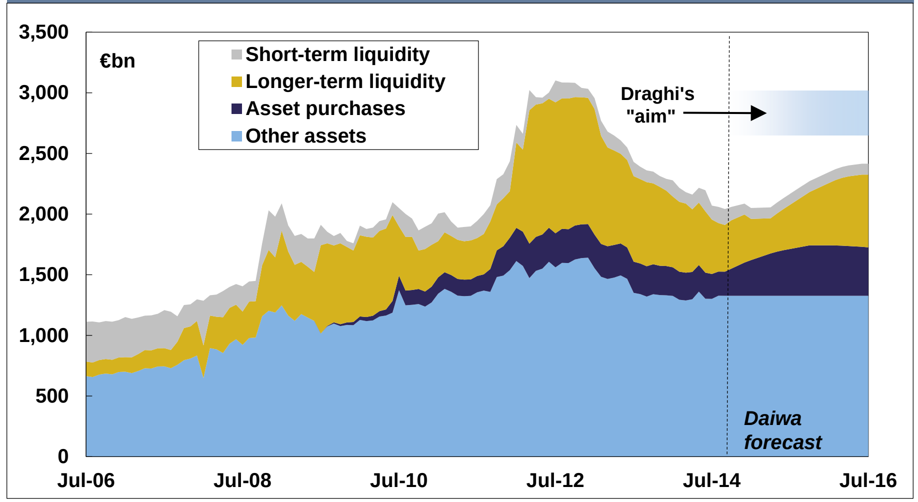
Is the ECB response fit for purpose?

Assets eligible for ECB purchase programme



Source: ECB, Datastream and Daiwa Capital Markets Europe Ltd.

ECB Balance sheet forecast



Source: ECB, Datastream and Daiwa Capital Markets Europe Ltd.

- Draghi aspires (and semantics matter!) to expand the ECB's balance sheet back to its 2012 peak. But the scope of the asset purchase programme looks excessively narrow.
- And is it really possible to expand the balance sheet to such an extent as long as the ECB charges a negative deposit rate? The BoJ never cut the interest rate on excess reserves below 0.1%!

ECB's efforts remain tiny by international comparison

Country	Programme	Size	% GDP	% of target achieved	
Japan	QE (Oct 10-Mar 13)	¥50trn (JGBs, T-bills, CP, CB, ETFs & J-REITS)	10%	100%	Followed 2001-06 QE programmes; targeted mainly sovereign bonds & bills
	QQE (Apr 13-)	¥96trn to date of which ¥87trn JGBs	20%	100%	Purchases due to increase at annual pace of ¥60-70trn (incl. ¥50trn annual increase in JGBs) until inflation is sustained at the 2% target
	Combined Total	***¥146trn, lots more to come***	***30% to date***		***Combined total set to reach ¥213trn (42% of GDP) by end '15***
US	QE1 (Nov 08-Aug 10)	$1.75trn (MBS + Treasuries)	12%	99%	Mainly agency MBS purchased. Fed trimmed MBS purchases by $25bn in Sep 09
	QE2 (Nov 10-Jun 11)	$600bn (Treasuries)	4%	100%	Longer-term bonds targeted
	QE3 (Sept 12-)	$1.7trn (MBS + Treasuries)	9%	n/a	Open-ended programme. Broadly even asset split
	Combined Total	***$4trn***	***25%***		Purchases expected to end in Oct 14
UK	**Mar 09-Oct 12**	**£375bn (primarily Gilts)**	**23%**	**100%**	Assets now 100% Gilts. Had earlier bought a small amount of corporate bonds
Euro area	SMP (May 10-Sep 12)	€218bn	2%	n/a	Government bonds of IT, ES, IE, PT, GR bought for financial stability reasons, sterilised until Jun '14. Only €33bn (0.3% of GDP) outstanding
	CBPP1 (Jul 09-Jun 10)	€60bn	0.7%	100%	Covered bonds
	CBPP2 (Nov 10-Oct 12)	€40bn	0.2%	41%	Covered bonds. Purchases halted due to rising private demand and declining supply
	APP1 (Oct 14-)	€200bn - €500bn?	2-5%?	?	Unspecified (both amount and timing) purchases of ABS and covered bonds
	Combined Total	***€400bn - €600bn?***	***5-8%?***		***Combined total in reality likely to be smaller due to run off of SMP holdings***

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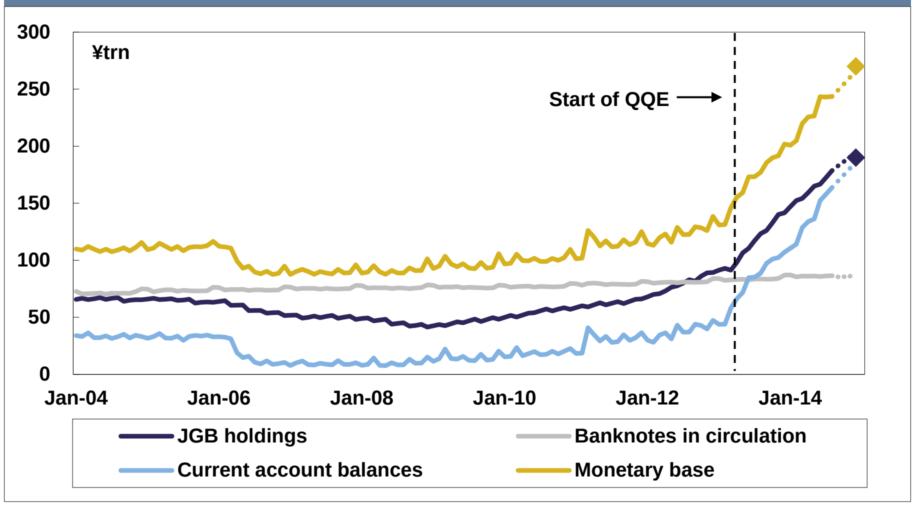
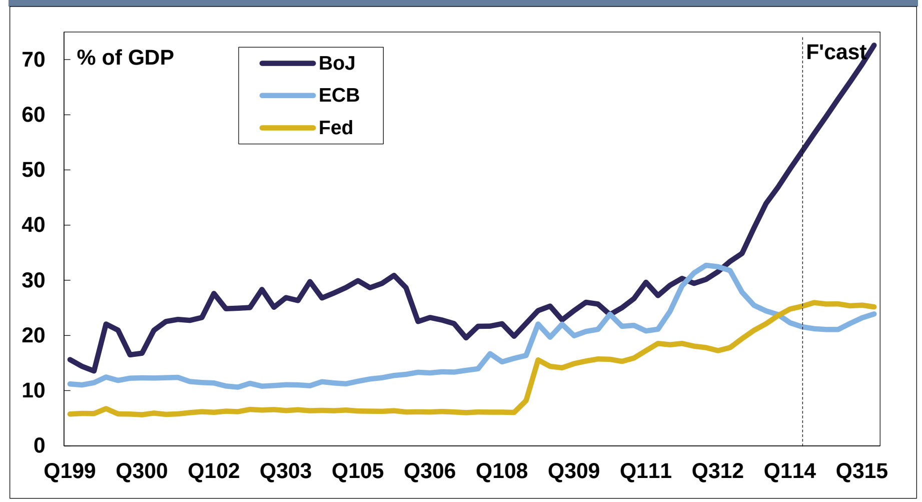
ECB reminiscent of pre-Kuroda BoJ?

BoJ JGB holdings and banknotes in circulation*



*Banknotes in circulation was previous self-imposed limit to amount of JGBs held on the BoJ balance sheet. Dotted lines are BoJ forecasts. Diamonds represent initial BoJ targets. Source: BoJ and Daiwa Capital Markets Europe Ltd.

Major central bank balance sheets



Source: Datastream and Daiwa Capital Markets Europe Ltd.

- The ECB resembles the pre-Kuroda BoJ in many ways. Its hands seem tied by self-imposed constraints. The communication of some members of the Governing Council often seems self-defeating.
- The current policy seems to lack ambition too, certainly compared to Kuroda's BoJ. And the ECB now seems to be missing the opportunity to provide a boost via the exchange rate.

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Abenomics: Policy lessons for the EU

Key point	• Avoid self-induced paralysis
Monetary policy	• Exceed expectations • Get communications right • Ensure policy consistency
Fiscal policy	
Structural reforms	

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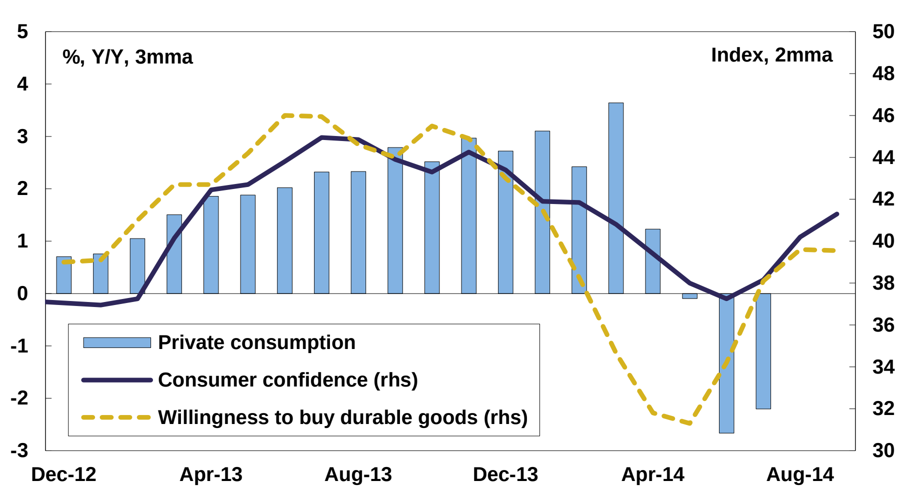
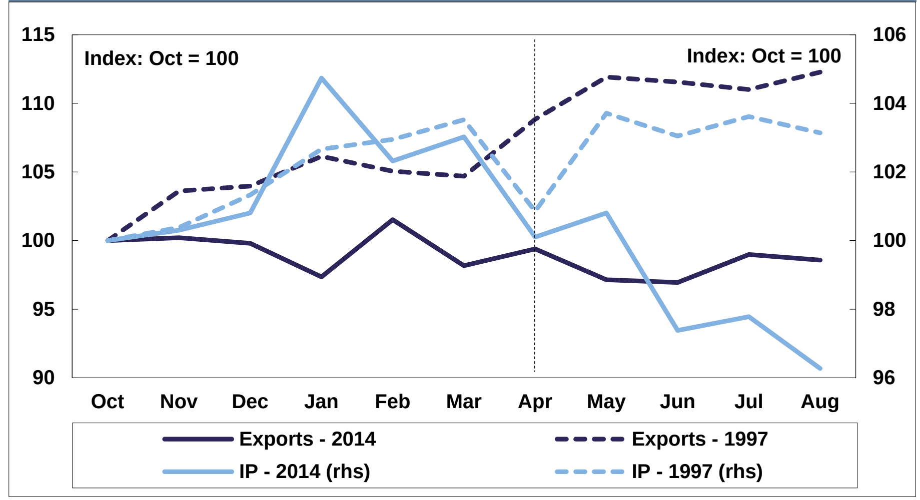
Japan: 1997 all over again? Or even worse?

Consumer spending and confidence



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd

Industrial output & exports: Pre- & post-tax-hike

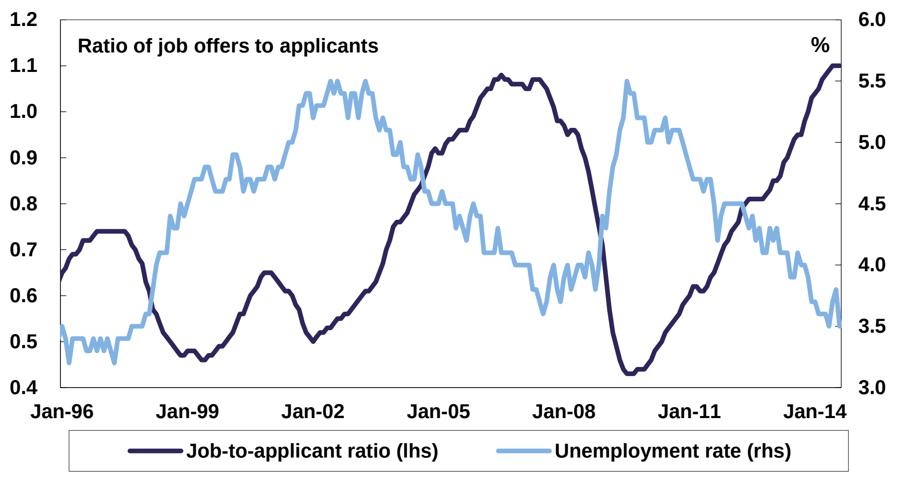


Source: Datastream and Daiwa Capital Markets Europe Ltd.

- Was fiscal policy tightened too soon in Japan? The decline in GDP and consumption in Q2 was sharper than in 1997, when the previous 2ppt consumption tax hike was followed by the lasting economic malaise and deflation which Abe is trying to escape. Consumer confidence has yet to return to pre-hike levels.
- Unlike in 1997, exports have failed to cushion the blow, weighing also on industrial output, which in August was around 6½% below its level in March. The BoJ downwardly revised its assessment of the recent performance of IP in successive Policy Board meeting statements.

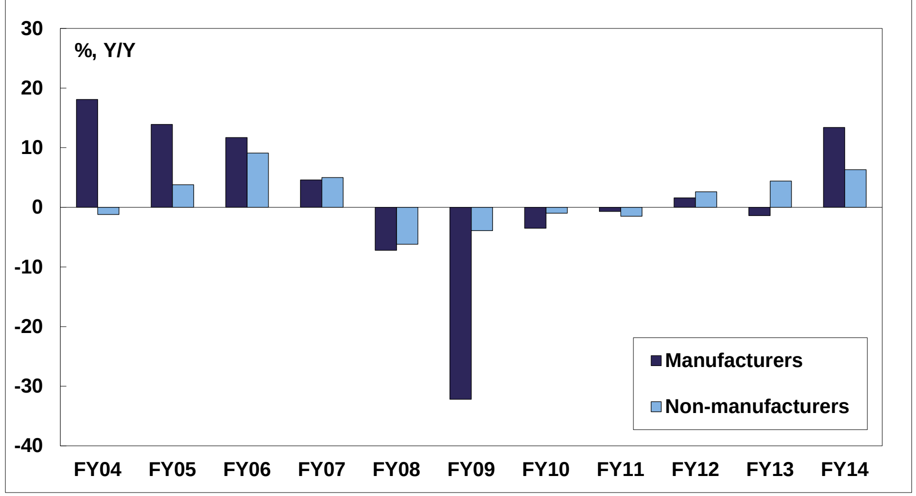
Japan: Will higher wages and capex save the day?

Japan: Labour market indicators



Source: MIC, MHLW and Daiwa Capital Markets Europe Ltd.

BoJ Tankan: Large firms capex plans*



*FY14 is current projection from September 2014 Tankan Survey. Source: BoJ

- There are some silver linings among the recent clouds. The labour market appears the tightest for two decades or more. That should support wage growth in coming months.
- Firms remain broadly upbeat about prospects for sales and profits. And judging from recent surveys, firms in many different sectors (manufacturers, construction and retailers) have revised up significantly their investment plans for coming quarters. But will they really invest more at home? Or pay higher wages?

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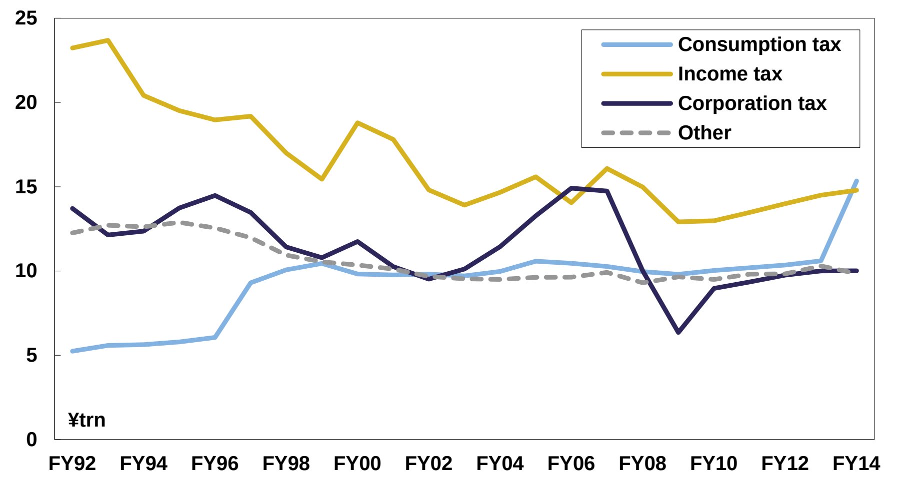
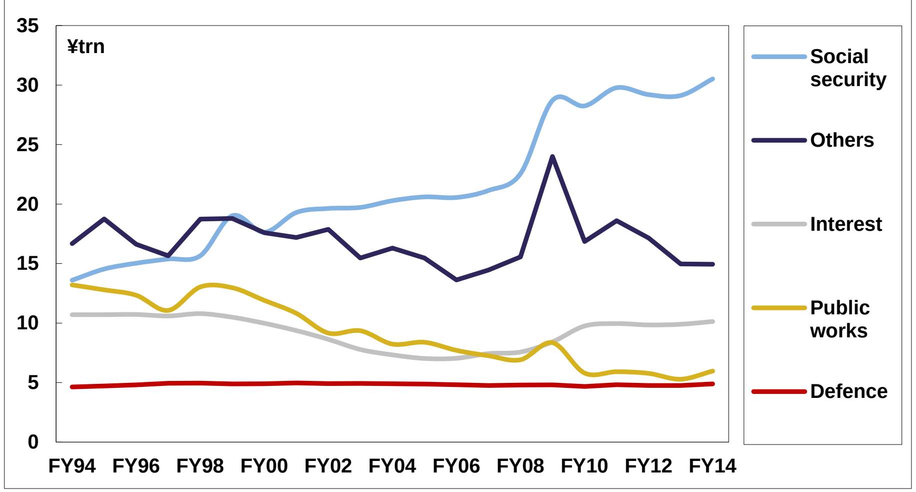
Japan: Ageing pressures crystal clear

Japan: Tax revenues



Source: MoF and Daiwa Capital Markets Europe Ltd.

Japan: Central government expenditure*



*FY14 initial budget expenditure. Source: BoJ

- The consumption tax has been the most reliable source of tax revenue over recent years. It has to rise further. Corporation tax reform is desirable. But is it affordable?
- Ageing by far represents the main source of consistent upwards pressure on public spending over the past two decades. Europe should tackle these pressures before it's too late.

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Abenomics: Policy lessons for the EU

Key point	• Avoid self-induced paralysis
Monetary policy	• Exceed expectations • Get communications right • Ensure policy consistency
Fiscal policy	• Don’t tighten too soon • Expansionary fiscal tightening is a myth • Deal with age-related pressures swiftly
Structural reforms	

Abe's 3rd arrow: Several worthy targets

Abe's third arrow: Selected key targets
➢ Achieve 3% average annual nominal GDP per capita growth over next 10 years
➢ Increase annual capital spending by 10% to ¥70trn over coming three years
➢ Increase R&D spending to 4% of GDP by 2018 & raise new business start-up rate
➢ Double inward investment to ¥35trn by 2020 & increase Ease of Doing Business ranking to 3rd in OECD
➢ Increase value of infrastructure projects involving PFIs by 2.5 times over next 10 years
➢ Reduce the number of workers unemployed for more than six months by 20%
➢ Increase the employment rate of females aged between 25 to 44 by 5ppts to 73% by 2020
➢ Eradicate waiting lists for childcare centres by 2017
➢ Negotiate free trade agreements to cover 70% of Japanese trade, up from 19% currently, by 2018
➢ Triple infrastructure exports to ¥30trn by 2020
➢ More than double agricultural exports to ¥1trn by 2020 & cut rice production cost by 40% over 10 years
➢ Aims to restart nuclear power stations to cut energy bills for households and industries
➢ Boost power-related investment one and half times to ¥30trn over the next ten years
➢ Liberalise power generation, allowing households and industries to choose an electricity supplier

Source: Office of the Japanese Prime Minister

Abe's 3rd arrow: The net cast wide, looking for easy wins

Abe's third arrow: Selected policies

Adopted

- Electricity system reform: Bills passed to allow more flexible use of national grid and facilitate retail market reforms
- Six National Strategic Special Zones for special deregulation selected, with, e.g., employment regulations clarified
- Other modest deregulation, e.g. easing of rules related to corporate field tests, online pharmaceutical sales
- Japan-Australia trade agreement reached in April; agricultural support mechanisms reformed
- Effective corporate tax rate cut by 2.4ppt from April through early abolition of reconstruction levy
- Initial corporate governance reforms, including Stewardship Code and GPIF fund allocation to JPX-Nikkei Index 400

In the pipeline?

- GPIF (Public pension fund) reforms to diversify portfolio into higher risk/return assets
- New Corporate Governance Code to be developed with TSE: Consistent with global best practice/OECD principles?
- Extra childcare facilities and tax changes to encourage female labour participation
- Modest immigration reforms to allow foreign workers in certain sectors including construction and R&D
- Electricity reform: Consumers choose supplier & charge system from 2016. Generation/distribution split from 2018?
- Flexible working arrangements, including performance-based pay, for higher earners
- Agricultural reforms to facilitate consolidation and allow non-food companies to play a greater role in the sector
- Measures to enhance competition in the medical services sector
- Efforts to facilitate growth in emerging or new sectors, e.g. 'integrated resorts' (casinos), crowd-funding, etc.

On the back-burner?

- Trans-Pacific Partnership trade liberalization
- Substantive deregulation to provide a major boost to competition, including via inward FDI, in over-protected sectors
- Substantive labour market reforms, including easing job protection legislation
- Substantive pro-growth tax reform

Source: Office of the Japanese Prime Minister and Daiwa Capital Markets Europe Ltd.

How to raise trend growth? Horses for courses

Selected reform recommendations

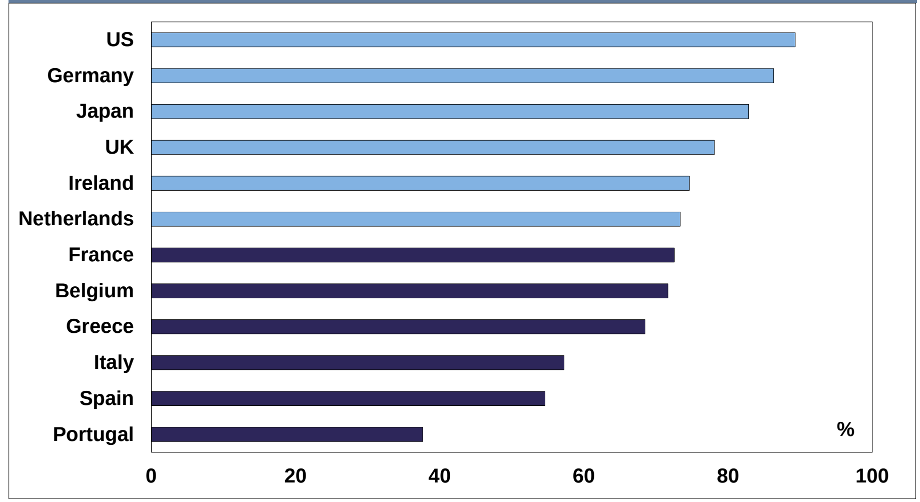
Germany
- Support domestic demand via public investment
- Improve labour market participation through better childcare
- Strengthen competition in services sector

France
- Lower non-wage labour costs
- Reduce tax burden
- Liberalise regulated professions and services

Italy
- Shift tax burden away from production onto indirect taxation
- Improve efficiency of public administration
- Deal with backlog of pro-business reforms (e.g. competition)

Source: European Commission and Daiwa Capital Markets Europe Ltd

Educational attainment: Upper secondary or above*



*Ages 25-64. Source: OECD and Daiwa Capital Markets Europe Ltd.

- In the medium term, faster trend growth requires structural reform. That is down to national governments. Reforms need to be carefully sequenced. Some can be deflationary. But there are many easy wins to be had if, like in Japan, the net is cast sufficiently wide.
- Progress can be slow – sometimes due to vested interests (cf Japanese agricultural reform!), other times an inevitable consequence of the time lags involved.

Not all structural reforms are deflationary!

Doing Business Report 2013: Rankings

Overall OECD Rank	Country	Rank out of 31 OECD countries			
		Starting a business	Registering property	Getting credit	Protecting investors
1	New Zealand	1	1	2	1
2	United States	6	8	2	3
…	…				
6	UK	8	23	1	6
13	Germany	26	25	9	24
15	**Japan**	**28**	**22**	**9**	**8**
…	…				
24	**France**	**15**	**28**	**20**	**22**
27	**Spain**	**30**	**21**	**20**	**24**
…	…				
29	**Italy**	**22**	**11**	**28**	**14**
30	Greece	12	30	27	22
31	Czech Republic	31	13	20	24

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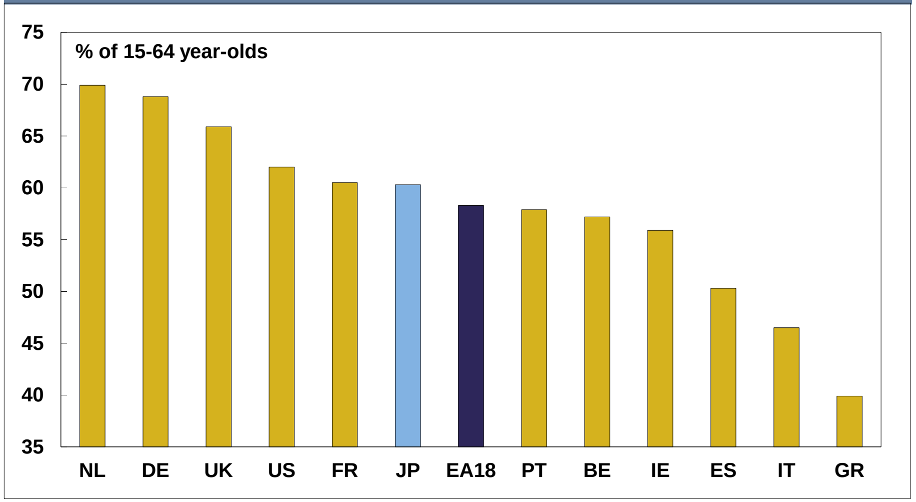
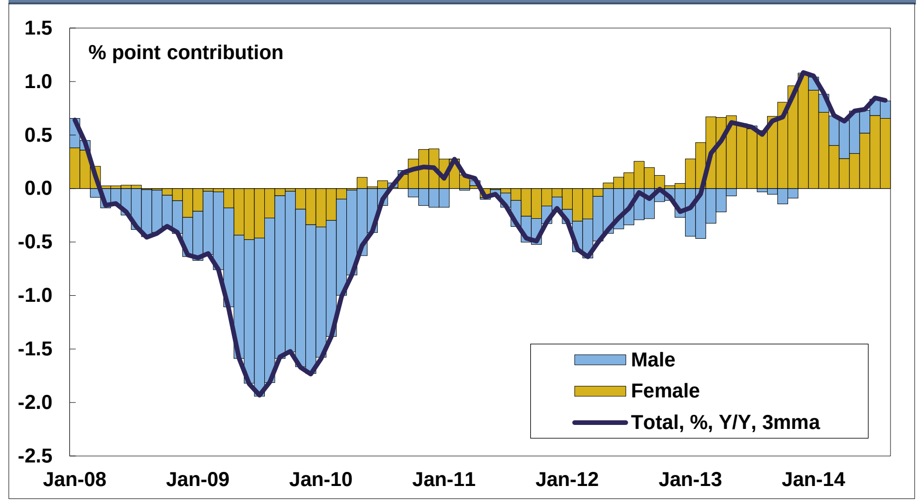
Womenomics: Governments can help tackle cultural taboos

Female employment rate (2013)



Source: Eurostat, OECD and Daiwa Capital Markets Europe Ltd.

Japan: Employment growth



Source: MHLW and Daiwa Capital Markets Europe Ltd.

- A challenge common to Japan and Southern Europe relates to female labour participation. But Japan already has traction. Since the start of 2013, Japanese employment has risen by almost 1mn, with the increase largely explained by women.
- Indeed, the female employment rate in June was a series high. While largely accounted for by non-regular employment, regular female employment rose by almost 1%Y/Y in July.

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Abenomics: Policy lessons for the EU

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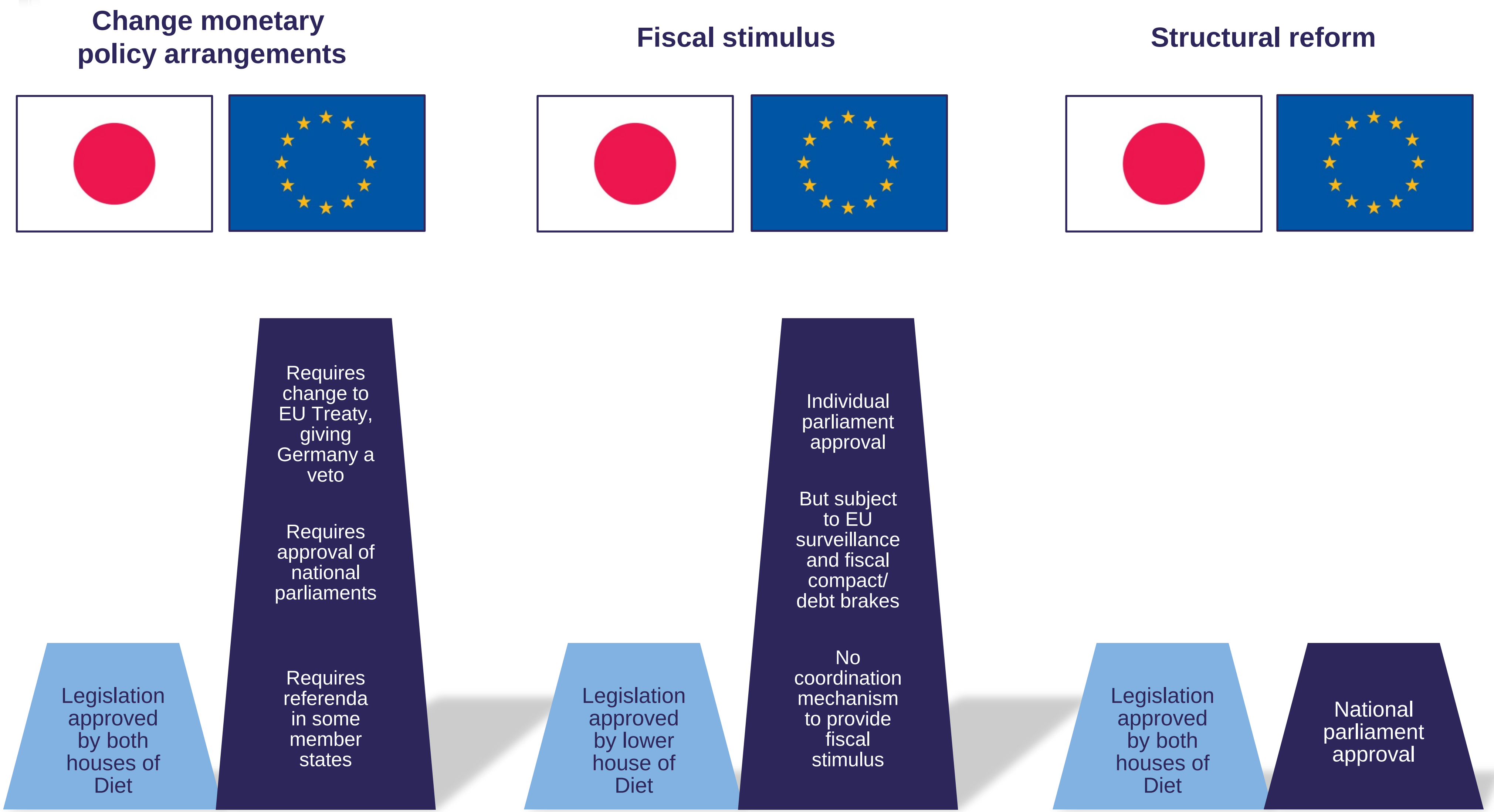
Monetary policy	• Exceed expectations • Get communications right • Ensure policy consistency
Fiscal policy	• Don’t tighten too soon • Expansionary fiscal tightening is a myth • Deal with age-related pressures swiftly
Structural reforms	• Cast the net widely • Sequence carefully – easy wins first • Tackle cultural taboos

Higher obstacles to shock treatment in the euro area



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