Bruegel-Graduate School of Economics, Kobe University Conference

Abenomics – stock-taking and lessons for the EU

The effectiveness of macroeconomic policy: evaluation of the first and second arrow and implications for Europe

Handout by Paul Sheard, Chief Global Economist, Standard & Poor's

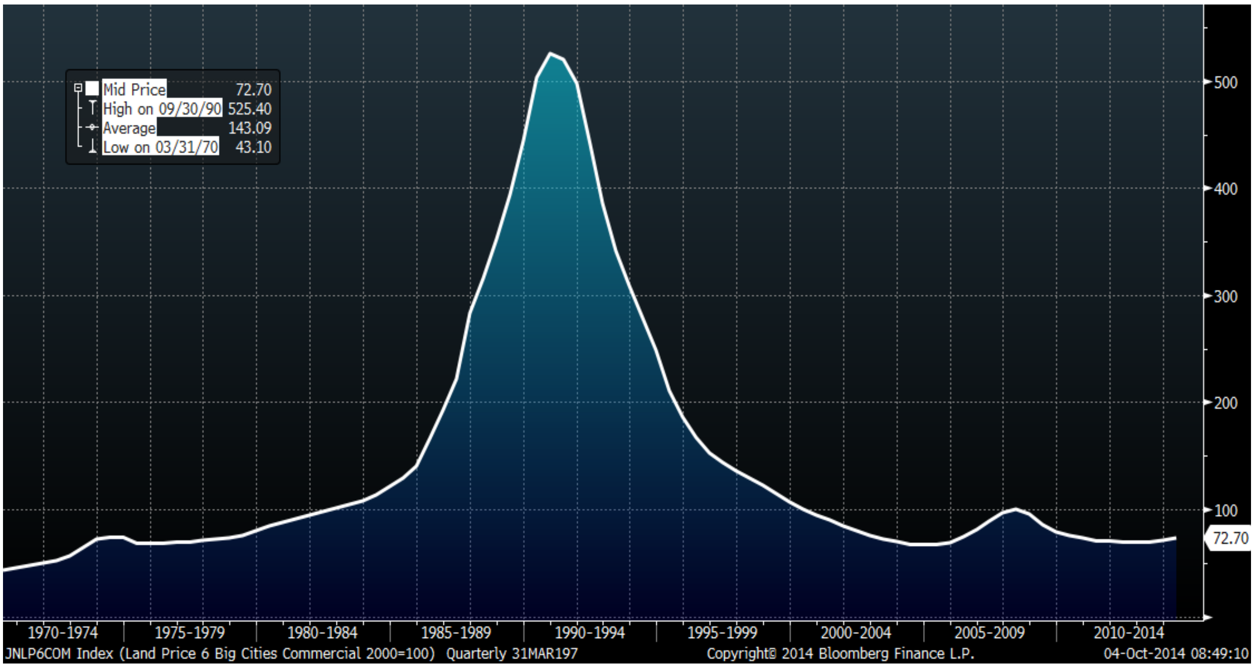
Abenomics First arrow: "bold monetary policy"; BOJ aims for 2% inflation using QQE

Second arrow: "flexible fiscal policy" – "generate effective demand in order to exit from deflation smoothly" (Cabinet Office homepage)

December 2012 LDP policy "manifesto": "flexible economic and fiscal policy management"

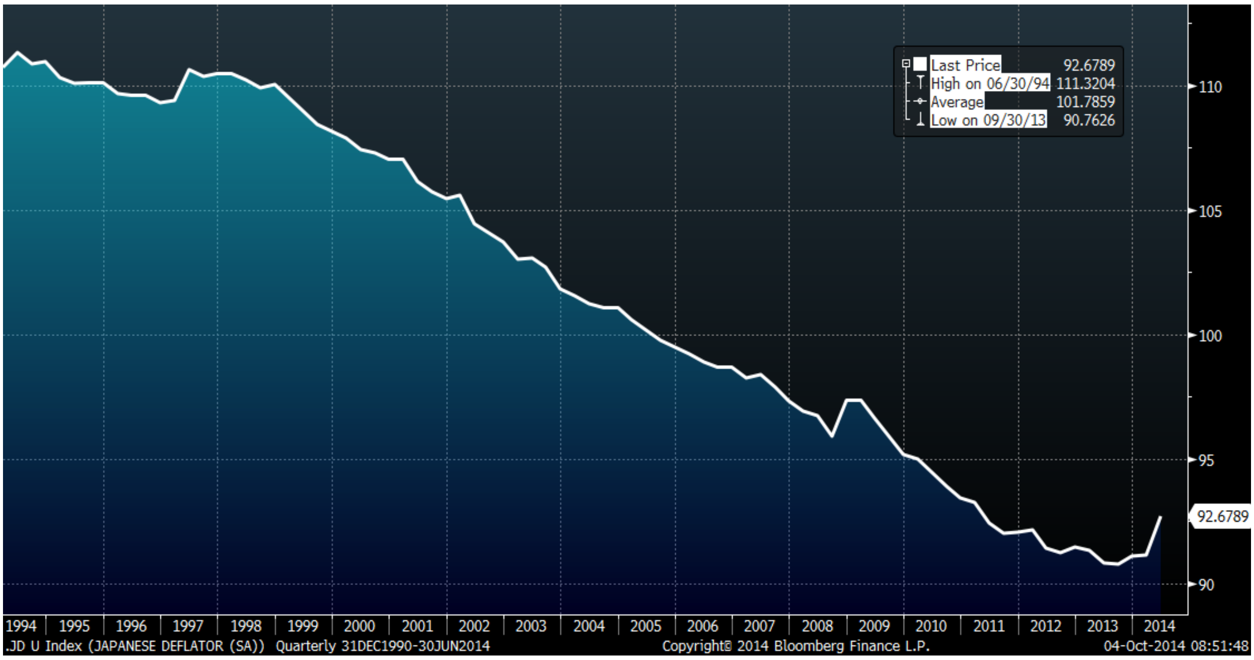
- "promote more flexible economic and fiscal policy management for two to three years in order deal with the decline in domestic economic conditions and international risks (the eurozone crisis and the slowdown in emerging markets";
- "after forming a new government, put into effect the first emergency economic package and implement economic policies continuously by combining a bold supplementary budget with the budget for the new [2014] fiscal year"

Japanese commercial land prices in six major urban areas, 1970-2014 (index; 2000=100): down 86% from Q3 1990 peak (nationwide, all uses index down 65%)



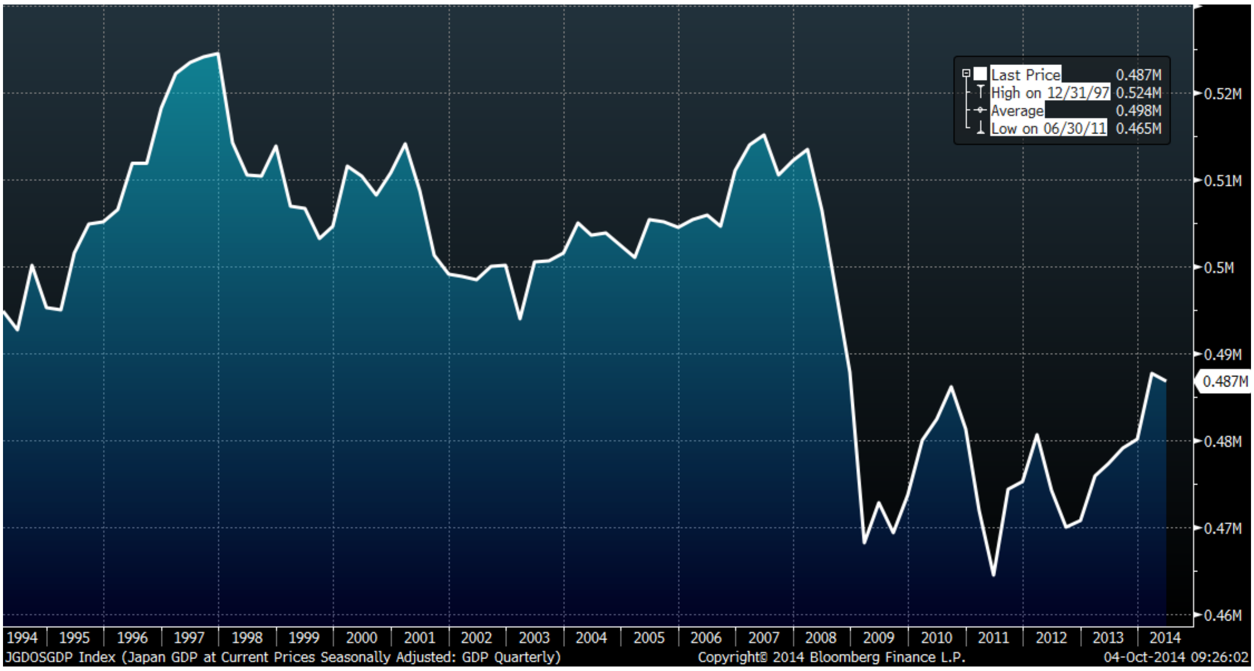
Source: Japan Real Estate Institute; Bloomberg.

Japan's GDP deflator (index): 17% below Q2 1994 peak; (index): US GDP deflator is up by 47% in same period, UK is up by 60%



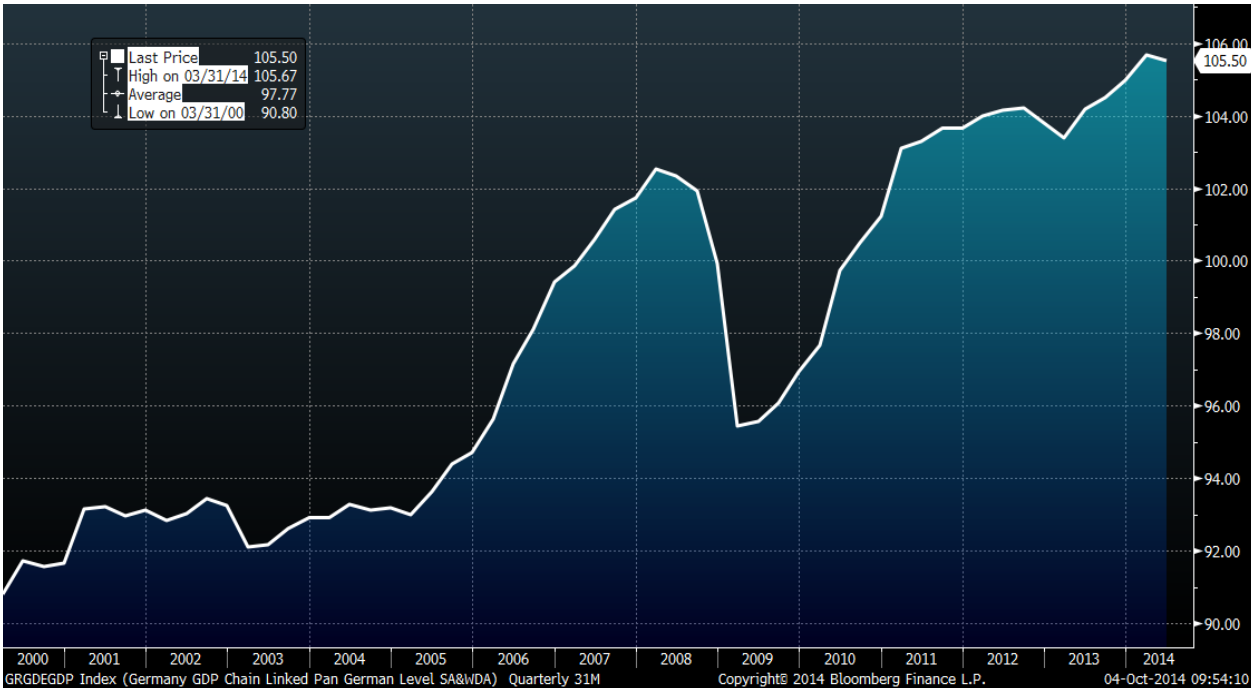
Source: Japanese Cabinet Office; Bloomberg; Standard & Poor's Ratings Services.

Japan's nominal GDP (latest: ¥486.8 trillion): 7.2% below Q4 1997 peak; US nominal GDP is up by 97% in same period and euro area GDP is up by 61%



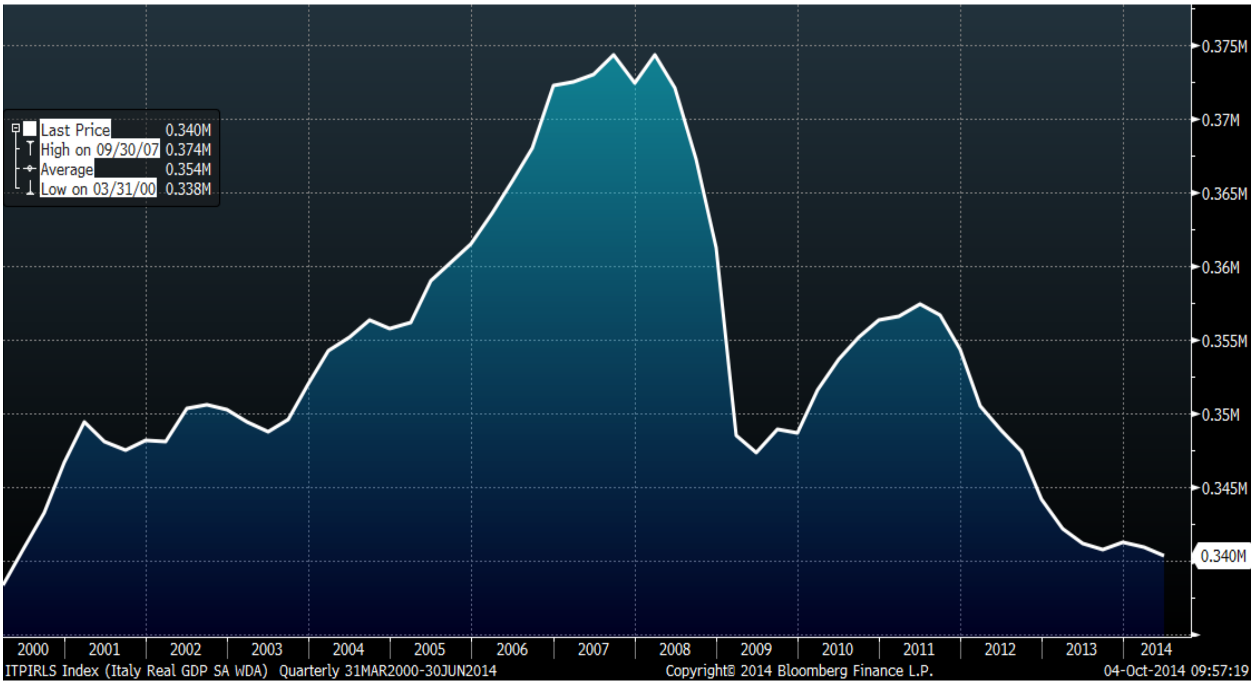
Source: Japanese Cabinet Office; Bloomberg.

German real GDP, 2000-2014: fell 6.9% in crisis, rose 10.5%, now 2.9% above pre-crisis peak



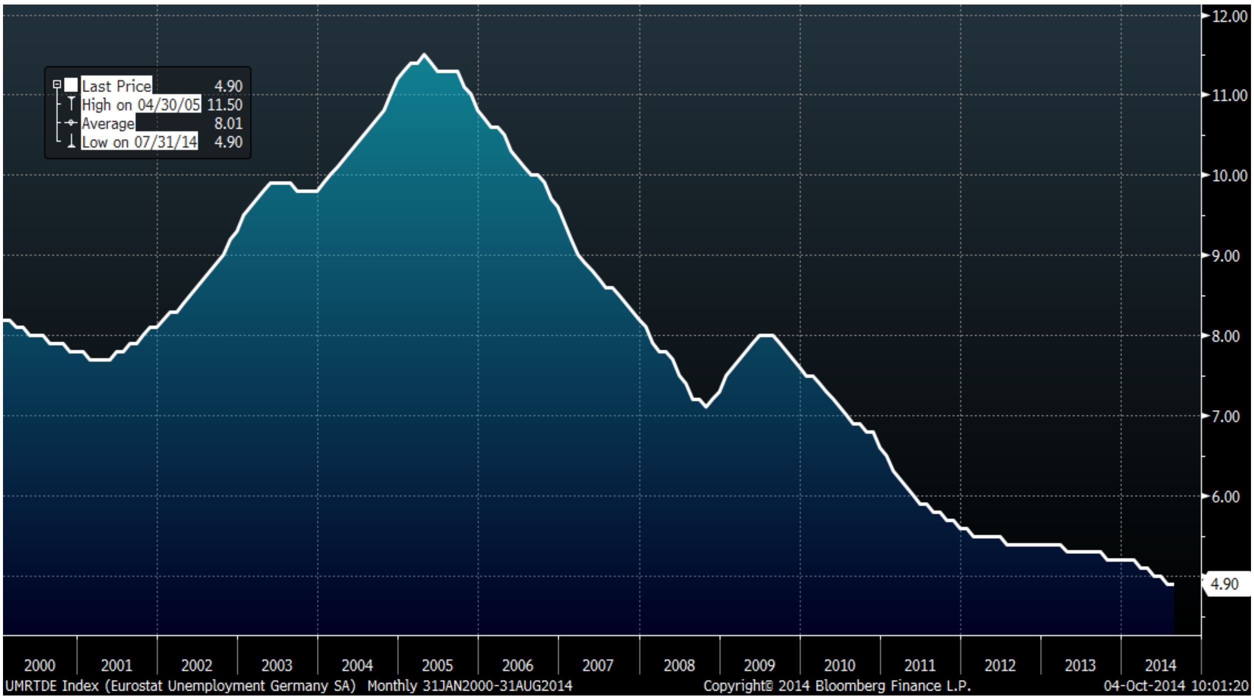
Source: German Federal Statistical Office; Bloomberg

Italian real GDP, 2000-2014: fell 7.2% in crisis, fell another 2%, now 9.1% below pre-crisis peak



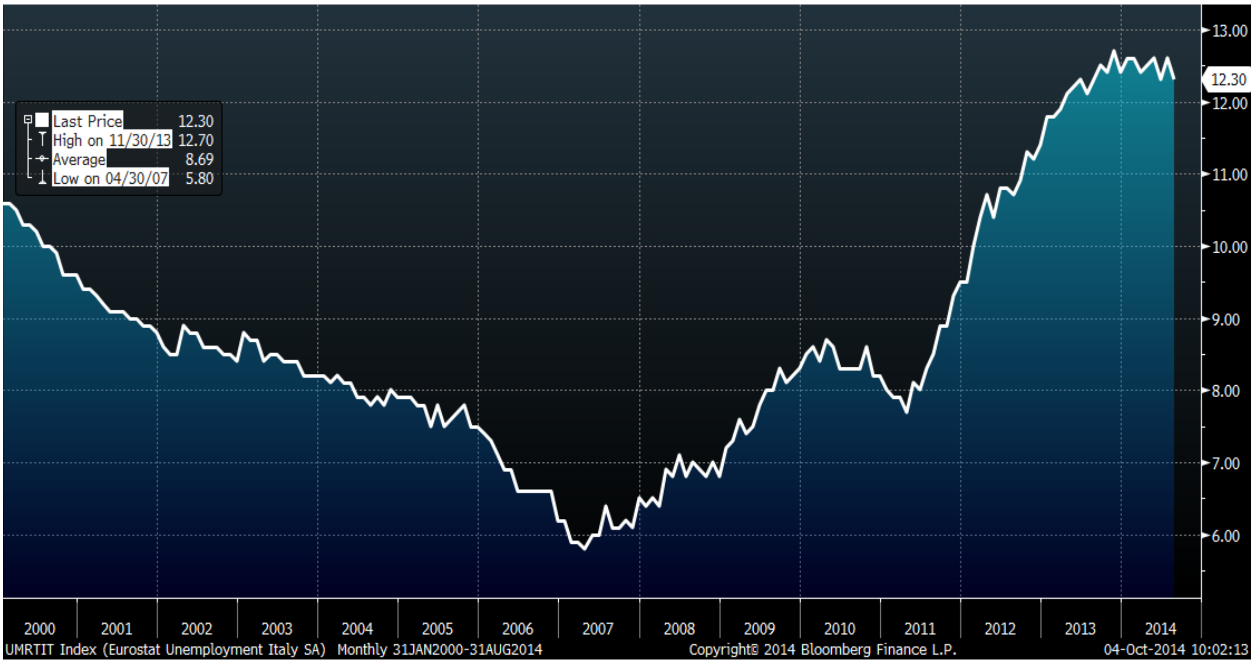
Source: ISTAT; Bloomberg.

German unemployment rate, 2000-2014: latest 4.9%, 2.4pp <u>below</u> Q3 2008 average



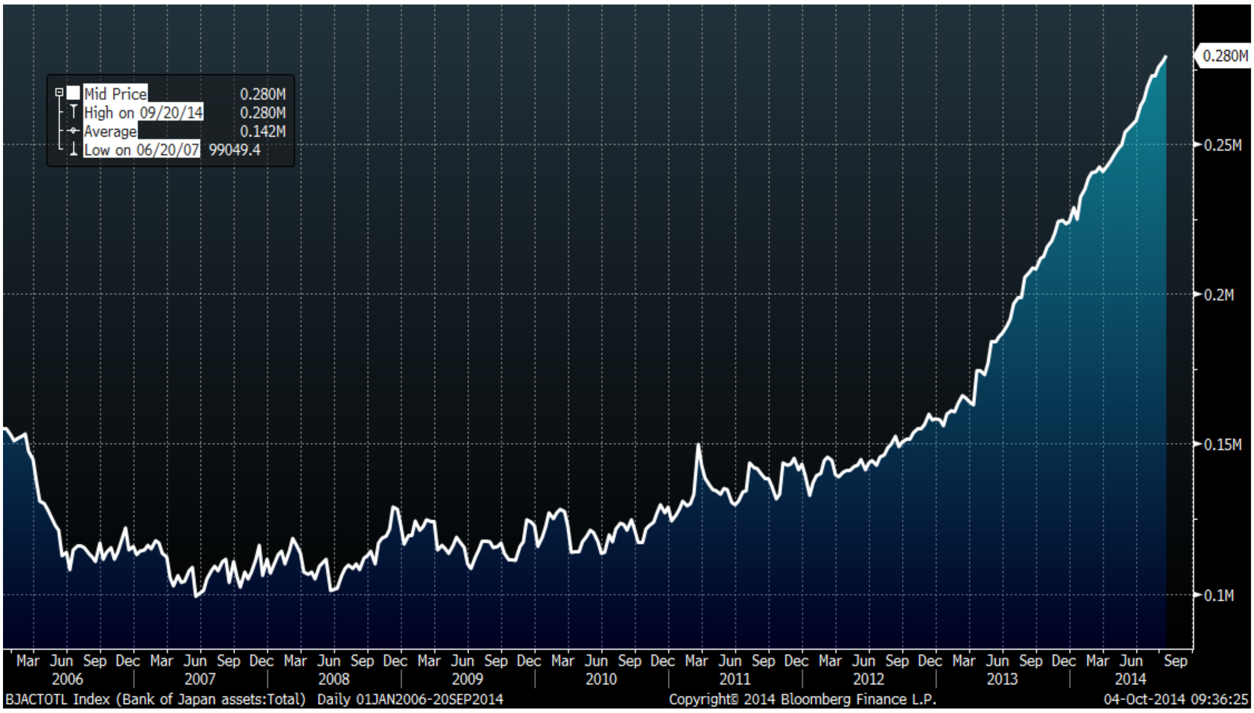
Source: Eurostat; Bloomberg.

Italian unemployment rate, 2000-2014: latest 12.3%, 5.4pp above Q3 2008 average



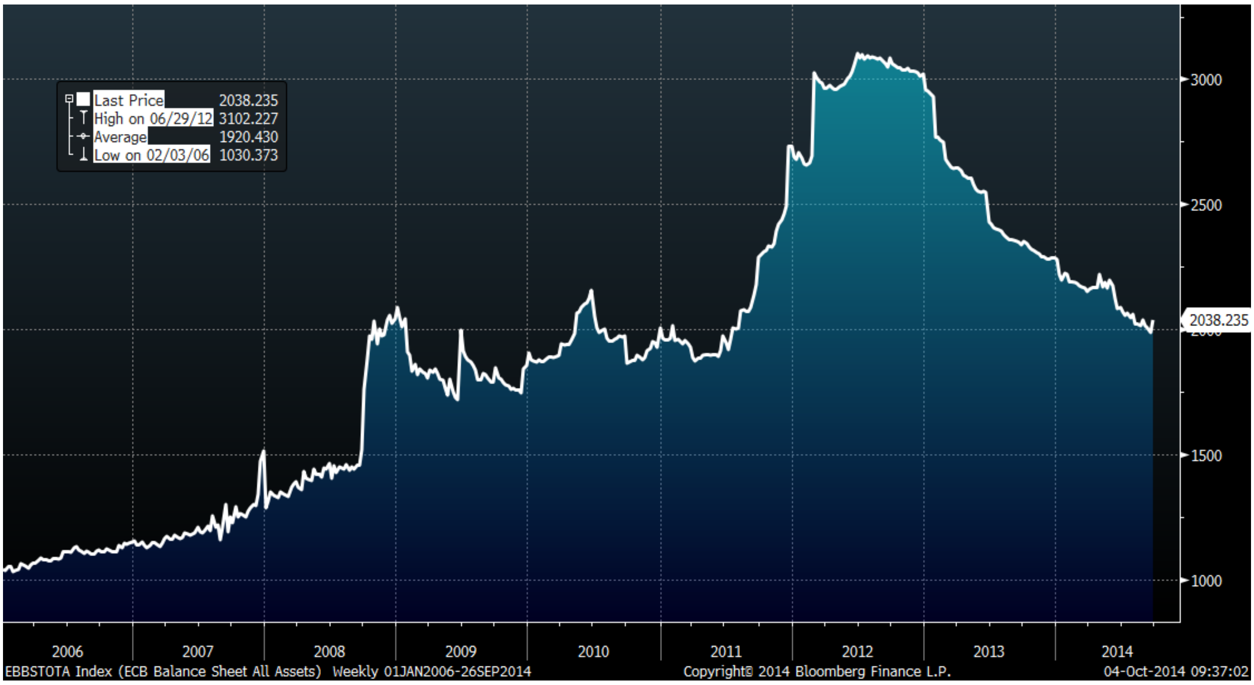
Source: Eurostat; Bloomberg

BOJ balance sheet, 2006 to now (latest: €2038.2 trillion): up 159% since Lehman failed; up 69% since Mr Kuroda became governor



Source: Bank of Japan; Bloomberg.

ECB balance sheet, 2006 to now (latest: ¥280 trillion): up 40% since Lehman failed; down 13% since Mr Drahgi became president



Source: European Central Bank; Bloomberg.

180-degree shift at the BOJ: from “no we can’t/no we won’t” to “yes we can, yes we will”

Governor Shirakawa’s philosophy: the cause of deflation is in the real economy (declining real potential growth); monetary policy can help but it cannot end deflation

20 December 2012: Enhancement of monetary policy easing

"The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation as early as possible and returning to the sustainable growth path with price stability. This challenge will be met through the combination of efforts by a wide range of economic agents to strengthen the economy's growth potential and support from the financial side. Based on this recognition, while the Bank will provide support for financial institutions' efforts to strengthen the foundations for economic growth and to increase their lending, it will pursue aggressive monetary easing in a continuous manner by conducting its virtually zero interest rate policy as well as steadily increasing the amount outstanding of the Asset Purchase Program."

Governor Kuroda's philosophy: monetary policy can end deflation; the key is to act on the public's inflation expectations

4 April 2013: The introduction of the "quantitative and qualitative monetary easing"

"The Bank will achieve the price stability target of 2 percent in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years. In order to do so, it will enter a new phase of monetary easing both in terms of quantity and quality. It will double the monetary base and the amounts outstanding of Japanese government bonds (JGBs) as well as exchange-traded funds (ETFs) in two years, and more than double the average remaining maturity of JGB purchases."

"The quantitative and qualitative monetary easing, introduced by the Bank today, will underpin the Bank's commitment, and is expected not only to work through such transmission channels like longer-term interest rates and asset prices but also to drastically change the expectations of markets and economic entities."

Mr Draghi sounds more like Mr Kuroda
Speech at Annual central bank symposium in Jackson Hole, 22 August 2014

"I have said in principle most of these effects [putting downward pressure on inflation] should in the end wash out because most of them are temporary in nature - though not all of them. But I also said if this period of low inflation were to last for a prolonged period of time the risk to price stability would increase. Over the month of August financial markets have indicated that inflation expectations exhibited significant declines at all horizons. The 5year/5year swap rate declined by 15 basis points to just below 2% - this is the metric that we usually use for defining medium term inflation. But if we go to shorter and medium-term horizons the revisions have been even more significant. The real rates on the short and medium term have gone up, on the long term they haven't gone up because we are witnessing a decline in long term nominal rates, not only in the euro area but everywhere really. The Governing Council will acknowledge these developments and within its mandate will use all the available instruments needed to ensure price stability over the medium term."

But sometimes there are flashes of Mr Shirakawa:

Introductory remarks at the EP's Economic and Monetary Affairs Committee, ECB president Mario Draghi, Brussels, 22 September 2014:
"As I have indicated now at several occasions, no monetary – and also no fiscal – stimulus can ever have a meaningful effect without such structural reforms."

Paradox 1: Abenonomics appeared before Abe (Abenomics had its genesis in the August 2012 consumption tax legislation)

August 2012 consumption tax legislation; "Conditionality clause" (Article 18)

> When it comes to hiking the consumption tax, because implementation is dependent on bringing about an improvement in economic conditions, with a view to escaping from a situation where the price level is continuously falling and to revitalizing the economy, as well as taking other necessary steps, comprehensive policies will be implemented in order to soon approach a state of desirable economic growth aiming for nominal economic growth of about 3% as well as real economic growth of about 2%, on average, over the decade from FY2011 to FY2020.
>
> After this law is promulgated, from the viewpoint of responding flexibly to sudden changes in economic and fiscal conditions as well as carrying out a judgment of economic conditions pertaining to the hikes of the consumption tax rate, before

> putting into effect the respective hikes in the consumption tax rates stipulated in articles two and three, with regards to the improvement in economic conditions, nominal and real growth rates, price trends, and various economic indicators will be checked, and, after a comprehensive consideration of economic conditions in the light of the measures stipulated in the previous section, necessary steps, including suspending putting it into effect, will be taken. [my emphasis; my translation]

10 year growth targets:

Nominal GDP: 3%
Real GDP: 2%
GDP deflator: 1%

Trailing 10 year actual at time consumption tax legislation passed:

Nominal GDP: -0.4%
Real GDP: 0.9%
GDP deflator: -1.4%

Implied "lift" required

Nominal GDP: 3.4pp
Real GDP: 1.1pp
GDP deflator: -2.4pp

Paradox 2: the consumption tax hike agenda is not part of Abenomics, but Abenomics is part of the consumption tax hike agenda

High level lessons from Japan (rules that Japan did not follow)

Act quickly
Act forcefully
Act in a consistent, coordinated fashion

- If deflation is the problem, don't put one foot on the monetary accelerator and the other on the fiscal brakes
- Macro (aggregate demand management) policies and micro (structural reform/supply side) policies both have their place: it is not "either/or" and one is not dependent on the other

Bottom line:

Europe resembles Japan, but the policy/political challenges it is facing (relating to building a "genuine economic and monetary union") are orders of magnitude more complex than Japan faced or faces.