Japan: Recent Macroeconomic Developments and Outlook

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Mizuho Investment Conference
September 13, 2013, Tokyo

This presentation is based on the findings of the 2013 Article IV Consultation between Japan and the IMF

IMF Executive Board Concludes 2013 Article IV Consultation with Japan
Press Release No. 13/296, August 5, 2013
http://www.imf.org/external/np/sec/pr/2013/pr13296.htm

Japan, 2013 Article IV Report
http://www.imf.org/external/pubs/cat/longres.aspx?sk=40856.0

Japan, 2013 Article IV, Selected Issues Papers
http://www.imf.org/external/pubs/ft/scr/2013/cr13254.pdf

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The “three arrows of Abenomics” provide a unique opportunity to exit deflation and revive growth

Aggressive monetary easing, flexible fiscal policy, and structural reforms

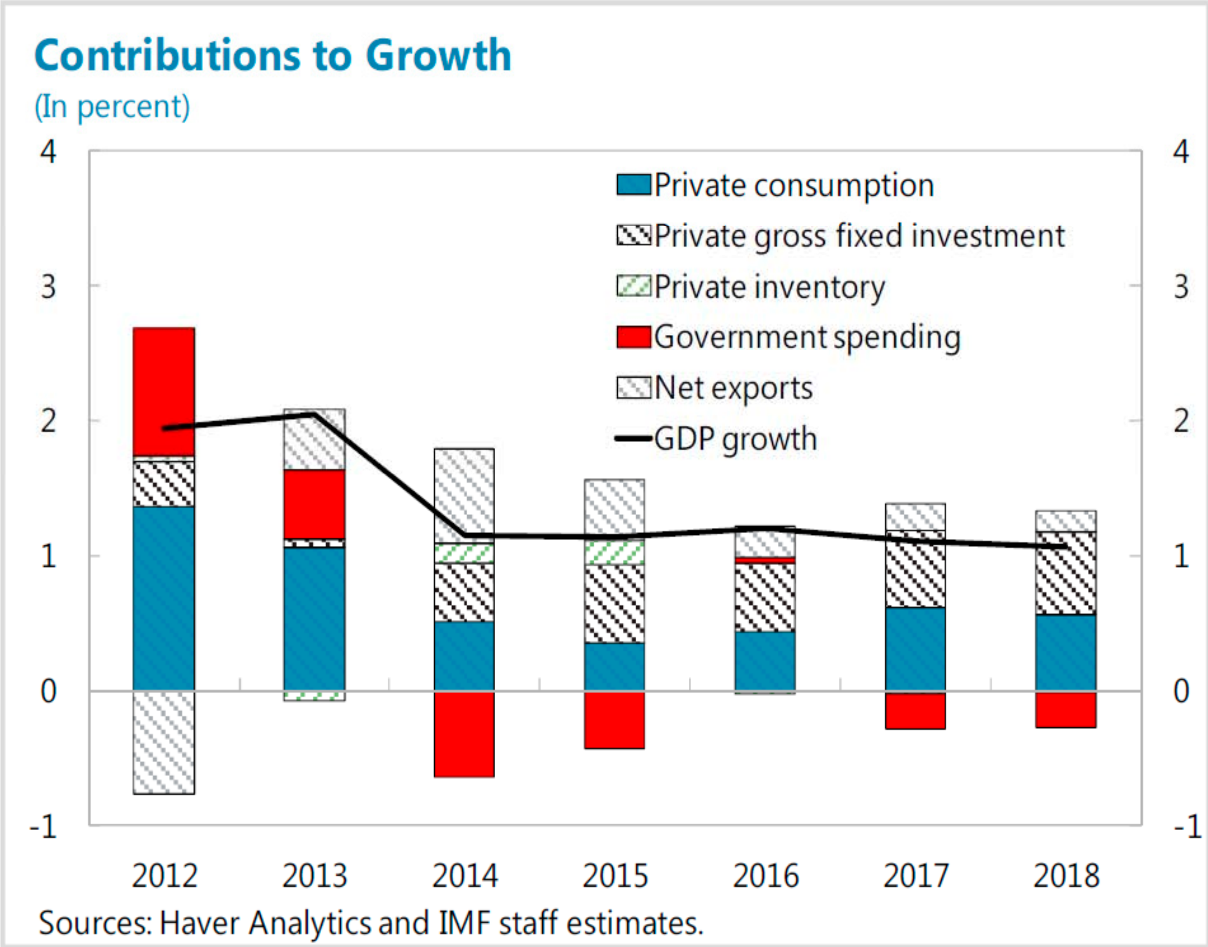
All three arrows should be launched for the new framework to be successful

The first arrow has already been launched: the Bank of Japan's Quantitative and Qualitative Monetary Easing (QQME) framework

The unprecedented monetary easing by the BoJ contributed to a pick up in demand, and growth accelerated in 2013

Wealth effects from rising equity values stimulated consumption, while strong regional demand and a weaker yen resulted in an export rebound

However, private investment and wages have not yet picked up yet



External risks are on the downside:

- Slowdown in emerging markets (especially China);
- Protracted period of slow growth in Europe

However, domestic risks dominate:

- Absence of credible fiscal consolidation and growth plans
- Credible fiscal consolidation plans, but Abenomics does not work
- A self-fulfilling sell-off of JGBs due to a lack of a convincing debt-reduction strategy (tail risk)

IMF Staff's baseline projections are based on:

- Effects of aggressive monetary easing
- Fiscal consolidation through 2015 (but no further consolidation after that)
- Only modest gains from structural reforms (higher investment in anticipation of TPP membership)

As a result, inflation gradually converges to the target as the output gap closes over the medium term and inflation expectations rise, but there are only modest gains in reducing fiscal risks and raising potential growth

Table 4. Medium-Term Projections

	2011	2012	2013	2014	2015	2016	2017	2018
			Projections					
			(Percent change)					
Real GDP	-0.6	1.9	2.0	1.2	1.1	1.2	1.1	1.1
Total domestic demand	0.3	2.8	1.7	0.5	0.7	1.0	0.9	0.9
Net exports (contribution)	-0.8	-0.8	0.5	0.7	0.5	0.2	0.2	0.2
Unemployment rate (percent)	4.6	4.4	4.1	4.1	4.1	4.1	4.0	4.0
Headline CPI inflation (average)	-0.3	0.0	0.1	2.9	1.9	1.9	2.0	2.0
memo item: without planned consumption tax increases	-0.3	0.0	0.1	1.2	1.6	1.9	2.0	2.0
Output gap (in percent of potential output)	-3.7	-2.3	-0.9	-0.5	-0.3	0.0	0.1	0.1
			(In percent of GDP)					
Overall fiscal balance	-9.9	-10.1	-9.8	-7.1	-6.0	-5.2	-5.1	-5.4
Primary balance	-9.1	-9.3	-9.0	-6.3	-5.1	-4.0	-3.5	-3.2
General government debt								
Gross	232.9	238.0	246.9	247.5	249.0	249.0	248.4	248.3
Net	127.4	134.4	144.3	148.3	152.2	154.6	156.2	158.2
External current account balance	2.0	1.0	1.3	1.7	1.9	1.8	1.7	1.7
National savings	22.0	21.6	22.2	22.5	22.7	22.9	23.1	23.5
Private	24.3	23.5	23.7	21.5	21.2	20.7	20.9	21.7
Public	-2.3	-1.9	-1.4	0.9	1.5	2.3	2.2	1.8
National investment	20.0	20.6	21.0	20.7	20.8	21.1	21.4	21.8
Private	15.6	15.7	15.9	16.4	17.1	17.5	17.9	18.4
Public	4.4	4.9	5.0	4.3	3.8	3.7	3.5	3.4

Sources: Global Insight, Nomura database; and IMF staff estimates.

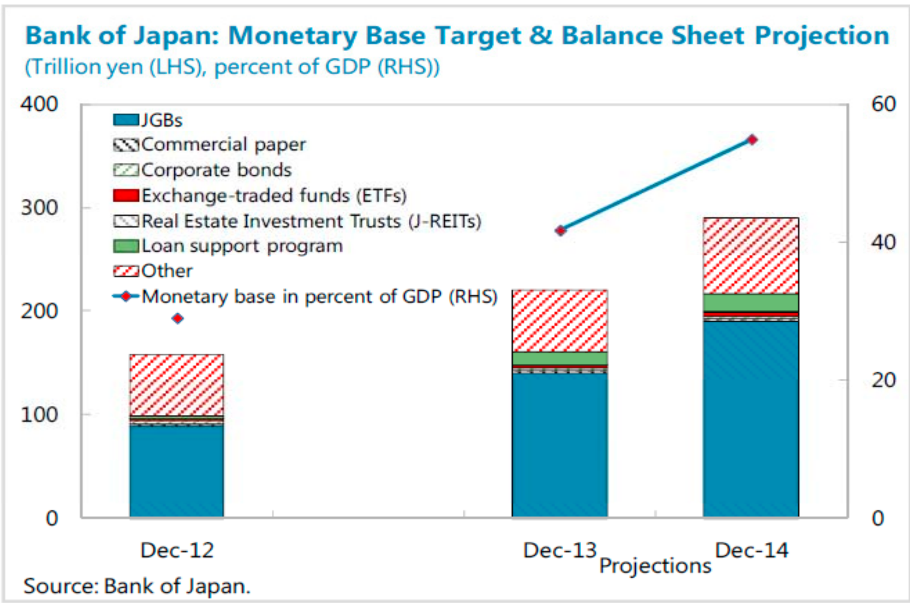
Downside scenario:

Incomplete Abenomics package: fiscal stimulus boost activity in the short term; inflation expectations adjust to QQME, but in a sluggish manner; potential growth remains stuck due to absence of ambitious structural reforms; the risk premium rise.

Upside scenario:

Complete Abenomics package: the authorities adopt ambitious structural reforms that raise potential growth from 1 to 2 percent; structural reform and fiscal consolidation reinforce each other; government financing requirement fall; the risk premium is stable

The "first arrow": QQME



The BoJ has embarked on an unprecedented effort to raise inflation above historical levels

The transmission channel of QQME has four interconnected components:

- Reducing long-term real interest rates and risk premia
- Portfolio rebalancing
- Raising inflation expectations
- Exchange rate depreciation

Transmission is in its early stages, with some positive signs

Compared to the previous Asset-Purchase Program, QQME's impact is expected to be larger as a result of:

- A departure from gradualism
- Strong communication and forward guidance

The BoJ should recalibrate its easing policies in the event inflation does not pick up or JGB market volatility rises

Complementary growth and fiscal reforms are essential

The BoJ should begin planning early to address exit risks. While exit is still far off now, when the time comes near strong communication will be key

The "second arrow": flexible fiscal policy

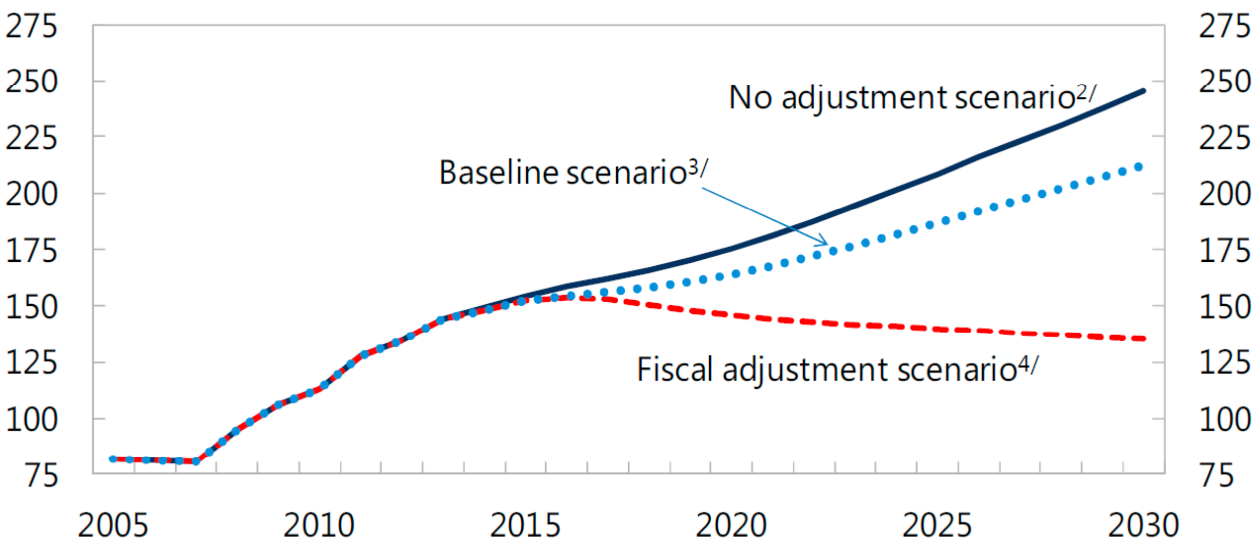
Fiscal risks have risen in the past as stimulus has delayed adjustment

Raising the consumption tax as planned is an essential first step to contain fiscal vulnerabilities

To bring public debt firmly on a downward path, an ambitious and concrete consolidation plan beyond 2015 is urgently needed

Japan: Net Public Debt [1/]

(In percent of GDP)



Sources: Cabinet Office; and staff estimates and projections.

1/ Net debt of the general government including the social security fund.

2/ No consumption tax increases but automatic withdrawal of fiscal stimulus.

3/ Consumption tax increases to 8 percent in 2014 and 10 percent in 2015.

4/ Policy adjustment scenario assumes an 11 percentage points of GDP improvement (baseline scenario+5½ points) in the structural primary balance between 2011 and 2020.

Options for Fiscal Adjustment Between end-2011 and 2020
(Excluding reconstruction spending, in percentage points of GDP)

	Staff Estimates of Authorities' Current Plan	Adjustment Options	
Consumption tax rate (In percent, currently at 5 percent)	10	15	
Corporate tax rate (In percent, currently at 35 percent) 1/	35	25-30	
Fiscal consolidation measures			
Revenue			
Increase consumption tax	2.5	5.0	
Cut corporate tax		-0.75	
Broaden personal income tax base		0.75	
Eliminate preferential tax treatment for pension benefit income		¼	5/
Collect pension contributions from dependent spouses of workers covered by the Employees' Insurance		¼	5/
Collect health insurance premiums from dependent spouses of workers covered by the Employees' Insurance		✔	
Reduce pension payroll tax		-0.5	
Introduce carbon tax 2/	✔	✔	
Raise inheritance tax further		✔	
Expenditure			
Withdraw financial crisis fiscal stimulus	1.0	1.0	
Withdraw the recent stimulus	1.0	1.0	
Curb growth rate of nominal non-social security spending (excluding interest payments)	1.5	2.5	3/
Limit annual nominal growth in social security spending (excluding the items below)	-0.5	1.0	4/
Raise pension eligibility age to 67 or higher		¼	5/
Reduce benefits for wealthy retirees		¼	5/
Total savings	5.5	11.0	

1/ Excluding the temporary tax increase for reconstruction.
2/ The fiscal savings are assumed to be around 0.1 percentage points of GDP or lower. The savings are assumed to be spent on energy saving initiatives.
3/ Freezing expenditure in nominal terms.
4/ Annual nominal growth at 1-1½ percent.
5/ Lower bound estimate of Kashiwase, Nozaki, and Tokuoka, 2012, IMF Working Paper 12/285.

The "third arrow": growth enhancing structural reforms

Ambitious structural reforms are essential for the overall success of the new policies

The government growth strategy approved in June 2013 includes several ambitious goals, but specific measures or a concrete timetable remain to be formulated

The next round of announcements should include more concrete and decisive steps to create broader growth synergies

The “third arrow”: growth enhancing structural reforms

Some recent welcome steps taken by the government are:

- Participation in TPP negotiations
- Intention to support female labor supply by eliminating waiting lists at kindergartens and day-care centers

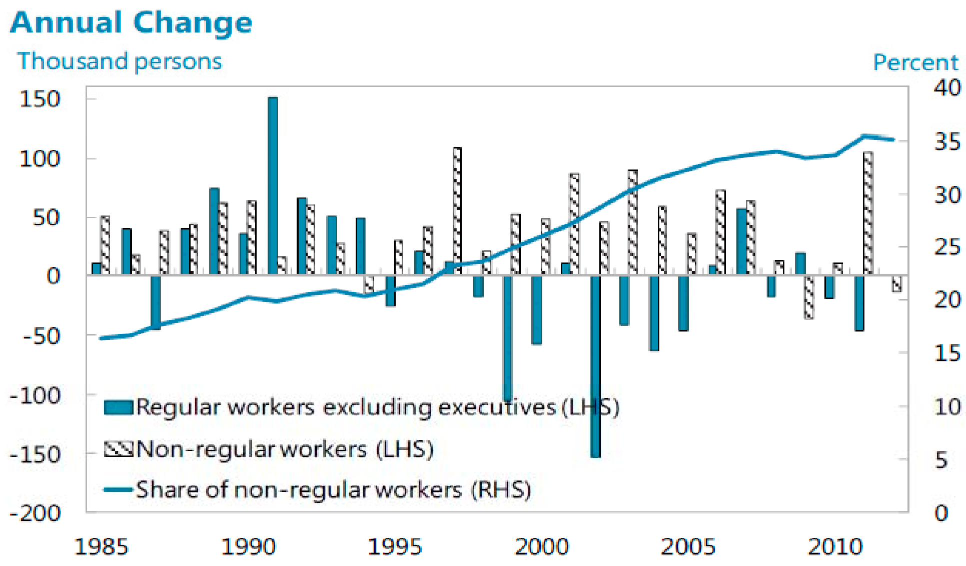
Going forward, the strategy should avoid a sector-specific approach (“picking winners”) and over-reliance on tax incentives/subsidies

The “third arrow”: growth enhancing structural reforms

Key measures should include:

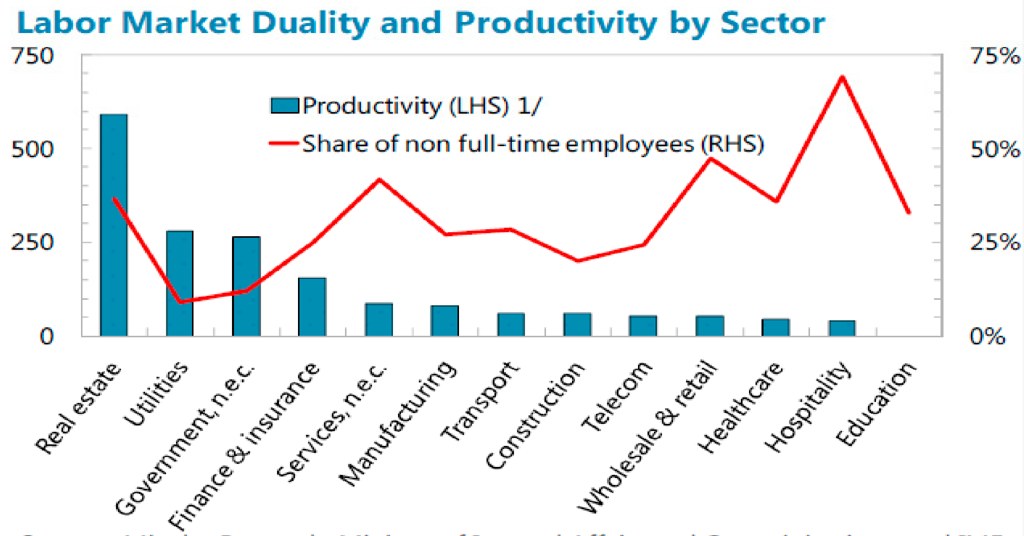
- Implementing steps to reduce labor market duality and increase labor productivity
- Deregulating agriculture and domestic service sectors to raise productivity and encourage FDIs
- Enhancing the dynamism of the SME sector: phasing out costly government guarantees, increasing risk capital for start ups
- Expand recent relaxation of immigration requirements to areas where there are labor shortages (e.g. nursing)

Why revamping Japan's dual labor market matters



Sources: Ministry of Internal Affairs and Communications and IMF staff calculations (Feb. 1985-2001, 2002-2012 Jan.-Mar. average).

Why revamping Japan's dual labor market matters



Sources: Mizuho Research, Ministry of Internal Affairs and Comminications, and IMF staff estimates.
1/ Productivity measured as value-added per worker.

Enhancing financial sector stability

A complete package of reforms could further strengthen financial sector soundness

Declining JGB holdings as a result of QQME could reduce risk exposure to interest rate risk, but banks will also need to strengthen their credit-assessment capabilities

However, the new framework also presents challenges, particularly if the reforms remain incomplete

Enhancing financial sector stability

Possible increased reliance on interest income from long-duration JGBs, especially if credit demand in the regions remains sluggish

Maturity mismatch risks as many banks still rely on short-term funding to finance foreign loans

Enhancing financial sector stability

Recent progress on regulatory reform (improvement in stress testing methodology; increasing large exposure limits for banks; deeper cross-border risk monitoring) will help contain risks for financial stability

Going forward:

- Strengthen capital standards beyond current plans (regional and shinkin banks)
- Mitigate foreign-exchange funding risks

Conclusions

All three arrows of Abenomics need to be launched for the new policy framework to succeed

With its new monetary policy framework, the BoJ has made an important contribution to end deflation and revive growth

A credible medium-term fiscal plan should be adopted as quickly as possible

Structural reforms plans need to be concrete and comprehensive

Thank you for your attention