STANDARD & POOR'S RATINGS SERVICES

RatingsDirect®

Economic Research:

All You Need To Know About "Abenomics"

Credit Market Services:
Paul Sheard, Chief Global Economist and Head of Global Economics and Research, New York (1) 212-438-6262; paul_sheard@standardandpoors.com

Table Of Contents

Economic Research:

All You Need To Know About "Abenomics"

*(**Editor's Note:** The views expressed here are those of Standard & Poor's chief global economist. While these views can help to inform the ratings process, sovereign and other ratings are based on the decisions of ratings committees, exercising their analytical judgment in accordance with publicly available ratings criteria.)*

Second time-around Prime Minister Shinzo Abe has ignited interest in Japan with his economic policy agenda dubbed "Abenomics." Mr. Abe regained the leadership of the Liberal Democratic Party (LDP) last September and then, campaigning on a platform of policies to revive the Japanese economy, led the LDP back into power in a landslide victory in last December's general election. In an allusion to a Japanese fable, Mr. Abe has marketed his economic policy program as having three "arrows": a plan to end deflation and combat the strong yen; "flexible" (that is, somewhat expansionary) fiscal policy management for two to three years; and a growth strategy, centering on deregulation and attempts to promote innovation and improve industrial competitiveness (structural reforms). The aim, after years of deflation and low real growth, is to achieve 2% consumer price inflation and 3% nominal GDP growth. These are ambitious targets: over the past 15 years Japan's consumer price inflation has averaged -0.3% (average monthly year-on-year rate) and nominal GDP growth has averaged -0.6% (average quarterly year-on-year rate).

Overview

- "Abenomics" is a conventional policy mix: it aims to end deflation and arrest the decline in Japan's real growth potential.
- The radical part is that Mr. Abe and the new governor of the Bank of Japan (BOJ) have overturned the previous BOJ orthodoxy that held ending deflation hostage to pursuing structural reform.
- The stated goals of "Abenomics" correspond to the conditions stipulated in last August's consumption tax legislation as needing to be satisfied for the tax rate to be doubled, to 10%, by October 2015.
- The Abe administration's push to end deflation could either be the real deal or a sophisticated fig leaf for justifying the consumption tax hikes.
- If the former, a strong case can be made for delaying the implementation of the tax hikes until the economy has reflated; if the latter, the attempt to end deflation could yet be stymied.

"Abenomics" Is Just Economics

Despite its exotic-sounding appellation, "Abenomics," as a policy mix, is just conventional economics. It is two things: a pledge to use macro policy levers to end deflation and a pledge to implement supply-side reforms to raise Japan's real potential growth (or more accurately offset some of the preprogrammed drag on potential growth emanating from Japan's adverse demographics). Who could argue with that?

In modern sovereign states, the central bank plays a number of critical roles: banker to the government; banker to the banking system; issuer of fiat currency; guardian of financial stability and lender of last resort; and contributor to macroeconomic stability. In particular, a cornerstone of modern macro policy management is to assign central banks responsibility for regulating the rate of consumer price inflation, typically aiming to keep it increasing in trend terms at around 2%. Because central banks control the base of the monetary pyramid--reserves in the banking system (1)--and can increase or decrease the amount of reserves at will, it is taken for granted that central banks can control inflation (2). That is why they are assigned the job. High inflation is bad and central banks are supposed to make sure it does not happen; likewise deflation is bad and central banks are supposed to be even more averse to it.

You would be hard pressed to find a government anywhere on earth that didn't support structural reform to improve the supply side of the economy and lift the economy's potential productivity. Not all are anywhere near as vocal or passionate-sounding as Mr. Abe is, but Mr. Abe, while a standout, is in a grand tradition of Japanese prime ministers who hail structural reform and make revitalizing the economy a political rallying cry (in recent times, Junichiro Koizumi and Ryutaro Hashimoto particularly come to mind). New prime ministers routinely set up this economic task force or that policy issue "headquarters," and a veritable bureaucratic machine, centered on the Cabinet Office, supports these ad hoc bodies and a variety of standing advisory bodies and councils, churning out policy vision and economic revitalization plans (3). Mr. Abe is making full use of this approach. But he is by no means the first to do so.

Reflation: The Radical (For Japan) Part Of "Abenomics"

"Abenomics" may be conventional economics, but, when it comes to deflation, Japan has not been a conventional economy, and, up until Governor Haruhiko Kuroda took the reins, it hasn't had a conventional-sounding central bank. The radical part of "Abenomics" is to espouse "conventional" monetary policy thinking--deflation is bad and it is the central bank's job, aided by the fiscal authorities, to end it--and to turn this thinking into action by imposing it on the central bank.

"Abenomics" embodies two radical departures from Japan's recent economic policymaking past. Conceptually, it has decoupled reflation from structural reform. Both are key priorities of "Abenomics," but one is not held to be dependent on the other (4). In terms of the time-honored Tinbergen principle of economic policymaking, goals and instruments are aligned: monetary policy targets price stability, and structural reform targets potential real growth. Operationally, the new governor of the BOJ has upended the country's monetary policy, doing a 180-degree turn on the central bank's communications and backing that up with aggressive policy action of a kind not seen at the BOJ before.

Japan's economy has been stuck in macro price deflation since the mid- to late-1990s, depending on the price measure. The GDP deflator has fallen by a cumulative 18.4% since its peak in second-quarter 1994, and, reflecting that, the level of nominal GDP is 9.4% below its fourth-quarter 1997 peak (see table 1). The standard economic prescription to end a deflation is to use some combination of aggressively expansionary monetary and fiscal policy. That standard policy mix is captured by the first two "arrows."

Table 1

Measures Of Japan's Deflation And Comparison With The U.S., The Eurozone, And The U.K. (% Year On Year; 10-Year Average)

Inflation measure	Japan	U.S.	Eurozone	U.K.
CPI	(0.1)	2.4	2.1	2.6
GDP deflator	(1.3)	2.3	1.9	2.3
Nominal GDP	(0.4)	4.0	2.8	3.7

Sources: Bloomberg and Standard & Poor's.

Previous administrations, most notably the Koizumi Administration (April 2001 to September 2006), have espoused ending deflation as a key policy goal. But no prime minister has "owned" the issue like Mr. Abe has. Previous administrations may have harbored some frustrations with the BOJ's handling of attempts to end deflation, but, by and large, they left things to the central bank. By contrast, Mr. Abe has used the opportunity to appoint a new governor and two new deputy governors for five-year terms to radically shift the communication and policy action of the central bank.

The most radical, in the Japanese context but not in conventional economic thinking, aspect of "Abenomics" is the delinking of reflation from structural reform (5). Under the previous government and BOJ leadership, the issues of deflation and structural reform were intertwined, ending deflation being held hostage to executing structural reform. Mr. Abe has de-linked these and, most importantly, so has Mr. Kuroda. Why is this so significant?

Under the leadership of its previous governor, Masaaki Shirakawa, the BOJ's official line was that the cause of deflation in Japan was declining real potential growth, driven largely by the adverse demographics (a declining and aging population). The BOJ rejected the view that deflation was due to inadequate or insufficiently aggressive monetary policy and therefore amenable to cure by monetary policy alone. The BOJ held that the way to end deflation was to undertake structural reform to raise the real potential growth rate (6). The BOJ would help, by providing monetary easing support, but it was really up to the government to implement productivity-enhancing, supply-side reforms and to the private sector to respond. Governor Shirakawa espoused this line in numerous speeches, press conferences, and official pronouncements.

This pre-Abe/pre-Kuroda approach by the BOJ was problematic in a number of ways. From a monetary policy perspective, it was self-defeatist. Because the BOJ argued that it did not have the ability to end deflation by using monetary policy, naturally enough, it didn't take aggressive-enough monetary policy action to try end deflation (see table 2). That, in and of itself, imparted a self-fulfilling bias to the BOJ's monetary policy stance.

Table 2

Cumulative Balance-Sheet Expansion By The Shirakawa-Led BOJ Versus Other Major Central Banks Since The Financial Crisis (End-August 2008) And Other Measures Of Balance-Sheet Size

	Percent increase	Size of balance sheet as percent of nominal GDP (Q1 2013)	Bank deposits at the central bank as percent of nominal GDP (Q1 2013)
Bank of England	333.0	26.0	17.9
Federal Reserve	253.0	20.0	11.5
ECB	82.4	27.9	7.0
Bank of Japan	50.5	34.6	12.2

Table 2

Cumulative Balance-Sheet Expansion By The Shirakawa-Led BOJ Versus Other Major Central Banks Since The Financial Crisis (End-August 2008) And Other Measures Of Balance-Sheet Size (cont.)
Sources: Respective central bank websites, Bloomberg, and Standard & Poor's.

The psychological effect was even worse. Monetary policy works significantly through its effect on the inflation expectations of the public (including financial market participants). If a central bank communicates to the public that it is trying to target (that is, achieve and maintain) a certain rate of inflation--say 2% consumer price inflation--and signals to the public that it is confident in its ability to achieve the target (on average and over time) and is determined to do so, then half the battle is won. To the contrary, if a central bank faced with ongoing deflation says that it doesn't have the ability to end deflation, the effect on the public's deflation expectations is to validate, rather than overturn, them, making deflation an even more self-fulfilling phenomenon.

The "Shirakawa line" that the cause of Japan's chronic deflation lay in the real economy, not in the monetary realm, at one level, was perhaps understandable, from an organizational behavior perspective. It simultaneously provided an alibi for the central bank consistently not achieving its mandate and shifted the main responsibility for correcting this unfortunate state of affairs to the government.

The radical element in "Abenomics" is that Prime Minister Abe rejected this line of thinking and used the opportunity of his cabinet appointing new senior leadership to hold the central bank accountable for doing its job. While some of the political rhetoric at times may have lacked subtlety, this was not so much a case of the government usurping the independence of the central bank as of the government exercising its legitimate right to hold the central bank accountable for doing its job (7).

It remains to be seen whether Prime Minister Abe can and will implement (real) growth enhancing measures commensurate with the scale and potential significance of the monetary policy changes (the third arrow). What can be said is that, unlike "reflation," "structural reform" is not a single, well-defined concept. It is multifaceted, amorphous, and, because of vested interests, difficult and time-consuming to implement. It is also potentially very slow to yield tangible economic benefits.

"Abenomics": An Extension Of "Noda-nomics"

The Abe Administration appears to be a radical break with the previous administration of Prime Minister Noda, and in some ways it is, not least in political marketing and atmospherics. But, viewed from a different angle, there is a high degree of continuity and inter-temporal consistency in economic policymaking between the two administrations.

No one talks about "Noda-nomics," but, were they to do so, "Abenomics" could be seen as a natural extension of "Noda-nomics." To be sure, the Democratic Party of Japan's (DPJ) self-destruction and the return to power of the once-hegemonic LDP, likely firmly so after the upcoming half upper house election, were signal events. But the political upheaval and the heady political sloganeering mask a surprising continuity in core economic policymaking and execution between the two administrations. This is not all that surprising, given the nature of government in Japan and the strong role that the bureaucracy plays in economic policymaking. The continuity revolves around the fiscal policy agenda and the landmark legislation the Noda government passed last August to hike the consumption tax rate from 5% to 8% in April 2014 and then to 10% in October 2015.

The debate over raising the consumption tax rate, to help finance Japan's rising social welfare expenditures amid a rapidly aging society, has been going on for years, ever since the rate was hiked to 5% in April 1997 from 3% (the tax was introduced at 3% in April 1989). It is fair to say that the eurozone sovereign debt crisis gave fiscal hawks in Japan enough ammunition to sway legislative and public opinion. Former Prime Minister Yoshihiko Noda, who had been Minister of Finance, certainly bought in. Given the state of the economy and particularly the fact of entrenched deflation, with no hope in sight to that deflation being expunged, when Prime Minister Noda tried to get legislation through the split Diet to double the consumption tax in two stages by October 2015, he met considerable resistance. Opponents argued that to push ahead with a fiscal consolidation with deflation still entrenched would be economically suicidal. To overcome this opposition, the legislation was framed to include a conditionality clause and the flexibility to delay the tax increase, depending on the state of, and outlook for, the economy.

Specifically, the conditionality clause stated as follows (my translation of rather convoluted Japanese syntax and text):

"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."

In other words, the consumption tax legislation passed with government (then the DPJ) and opposition support (then the LDP and Komeito) last August authorizes the government to raise the consumption tax to 8% in April 2014 and to 10% in October 2015, but the implementation is conditional on the economy being deemed to be in a state, and being on a trajectory, of sufficiently strong real and nominal growth to be able to absorb the impact. Specifically, the government needs to deem, with a straight face, that policies are in place to produce 3% nominal GDP growth, comprising 2% real GDP growth and a 1% GDP deflator. These are very high hurdles, given that these three measures averaged, respectively, -0.4%, 0.8%, and -1.3% in the past decade (see table 3). And because the clock is already ticking on the fiscal-year (FY) 2011 to FY2020 decade, these hurdles are rising: taken literally, nominal GDP growth would have to average 3.9%, real growth 2.3%, and the GDP deflator 1.6% from second-quarter 2013 to first-quarter 2021 (that is, the remainder of the FY2011-FY2020 period) (see table 3).

Table 3

Japan's Nominal And Real GDP Growth: Actual And Targets (% Year On Year; Average Over Period)

GDP measure	Past 10 years	FY2011-FY2020 "target"	FY2013-FY2020 required rate to meet overall target
Nominal GDP	(0.4)	3.0	3.9
Real GDP	0.8	2.0	2.3
GDP deflator	(1.3)	1.0	1.6

Sources: Japanese government, Bloomberg, and Standard & Poor's.

The Abe government soon will release its major blueprint for economic management, which has been worked up under the auspices of the resurrected Council on Economic and Fiscal Policy. The draft of the report was released last week and includes the 3% nominal GDP growth, 2% real GDP growth, and 1% GDP deflator targets for the FY2013 to FY2022 decade.

Prime Minister Noda's singular achievement, and what his administration no doubt will be remembered for, was to pass the legislation authorizing the hikes in the consumption tax, even though implementation is conditional on policies being in place creating the expectation that deflation will be ended and the real growth raised, resulting in 3% sustained nominal GDP growth. The LDP supported that legislation. At one level, "Abenomics" is simply the manifestation of the kind of policy thrust required by the consumption tax legislation. In that sense, "Abenomics" flows seamlessly from "Noda-nomics," even if the politics don't.

Mr. Noda's push, bordering on a political crusade, to pass the consumption tax legislation was tantamount to an act of political suicide, both apparently at the time and as a result after the event. Had Mr. Noda not pushed the issue, Mr. Abe almost certainly wouldn't be prime minister today, and it is doubtful that Mr. Kuroda would be the governor of the Bank of Japan (8). To secure the support of the LDP to pass the legislation in the upper house, Mr. Noda was forced to cut a deal with the then-leader of the LDP, Mr. Sadakazu Tanigaki, to call a lower house election "soon," which he did on Nov. 16 for Dec. 16, 2012. Under Japan's constitution, Mr. Noda was not obliged to call a lower house election until Aug. 30, 2014, and, had he not staked everything on the consumption tax legislation, he would likely have delayed calling an early election. In that case, Mr. Abe wouldn't have been prime minister when the time came (March 2013) to appoint a new governor and two new deputy governors of the BOJ.

"Kuroda-nomics": A Big Thumbs Up, But Not Quite As Radical As It Seems

The new BOJ governor, Haruhiko Kuroda, has surprised the world with his clear and decisive communication and bold policy action. Taking a leaf out of the inflation-targeting playbook, with a central role accorded to expectations management, Mr. Kuroda did two things that he needed to and which were long overdue.

First, he ditched the previous message of the BOJ that overcoming deflation depended on the government's implementing structural reform and, as the governor of the central bank, took ownership of the inflation issue, thus adopting and projecting a "yes we can" attitude. In consensus-oriented, seniority-respecting Japan, drawing such a stark line with his predecessor, and doing so deftly, was no mean feat.

Second, he backed up this confident, determined message with action that appeared to be out of the box for Japan in terms of its aggressiveness and boldness: "The Bank will achieve the price stability target of 2% 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." (April 4, 2013, monetary policy statement).

Importantly, Mr. Kuroda has also seemingly adopted a "whatever it takes" attitude, a key ingredient in shifting the public's otherwise sticky deflation expectations. Mr. Kuroda engineered a change in the main operating target for money market operations from the uncollateralized overnight call rate to the monetary base, pledging to increase the monetary base at an annual pace of about 60-70 trillion yen (¥) (equivalent to about 13%-15% of current nominal GDP), with a view to achieving a 2% inflation rate and to continue with this approach "as long as it is necessary for maintaining that target in a stable manner."

As someone who for more than a decade has urged the BOJ to adopt such an approach in terms of communication and action (9), I tip my hat to the new governor and have trouble faulting his sprint start.

That said, a reality check suggests that the policy action is perhaps not quite as aggressive as it might seem. Whereas other major central banks such as the U.S. Federal Reserve and the Bank of England have implemented aggressive quantitative easing (QE) in order to counter disinflationary forces and mitigate the tail risk of deflation, the BOJ is trying to lift the economy out of a deflation that has continued for 15 years. That argues for much more aggressive policy action than that of other central banks. The doubling of the monetary base sounds aggressive and, at one level, it is. But even after it occurs, the degree of expansion of the balance sheet, relative to before the outbreak of the crisis (in September 2008)--an estimated 165% increase--will be less than what the Federal Reserve and the Bank of England have already implemented (see table 2). Mr. Kuroda starts from way behind the curve.

QE is not just about quantity; it is also about the nature of the assets purchased. The theory suggests that increasingly more QE bang for the buck or the yen comes when the central bank purchases assets that are increasingly less substitutable for the asset supplied in return (bank reserves or demand deposits), thus increasing the so-called "portfolio rebalance effect." The increase in the duration of JGBs purchased and the increase in the purchase of risk assets is in this spirit and is laudable. However, most of the BOJ's QE is focused on JGB purchases, where the portfolio rebalance effect, under already very low long-term nominal yields, is quite muted. The doubling of risk assets, from a very small relative base, speaks more to a signaling or announcement effect than to the central bank pulling out the stops in risk asset markets (see table 4).

Table 4

Bank of Japan's Planned Expansion Of Balance Sheet Under Governor Kuroda

BOJ balance sheet component (tril. ¥)	End-2012 (actual)	End-2013 (projected)	End-2014 (projected)	Percent increase from end-2012 to end-2014	Implied percent of BOJ total assets at end-2014
JGBs	89	140	190	113	65.5
Commercial paper	2.1	2.2	2.2	5	0.8
Corporate bonds	2.9	3.2	3.2	10	1.1
Exchange-traded funds	1.5	2.5	3.5	133	1.2

Table 4

Bank of Japan's Planned Expansion Of Balance Sheet Under Governor Kuroda (cont.)					
J-REITs	0.11	0.14	0.17	55	0.1
Loan support program	3.3	13	18	445	6.2
Total assets	158	220	290	84	100.0
Monetary base	138	200	270	96	93.1
Banknotes	87	88	90	3	31.0
Current deposits	47	107	175	272	60.3

Sources: Bank of Japan and Standard & Poor's Ratings Services.

Admittedly, the limitations of central bank QE when the assets purchased are another form of government debt holds for the Fed and the Bank of England too. But these central banks face a lower hurdle rate, "merely" aiming to prevent a deflation, not end an entrenched one (10). The BOJ may yet have to move further out of its comfort zone, more into domestic risk assets or even into foreign-currency denominated government bonds, if it is to achieve its goal. This would be particularly so if the tailwinds provided by the equity and currency market moves to date were to be reversed, for instance, because of foreign investor "disappointment" with the Abe government's structural reform and growth agenda (11).

MOF Reasserts Its Influence Over The BOJ

There is another subtext of recent policy developments in Japan: with Mr Kuroda's appointment, the Ministry of Finance (MOF) has reasserted a measure of control over the central bank.

The Bank of Japan Act was revised and modernized in 1997 to give more operational independence to the central bank. Prior to that, the BOJ, while having a certain degree of operational independence, was firmly in the sphere of influence of the MOF, the most important and powerful ministry in Japan. One way the MOF maintained a delicate balance of respecting a measure of central bank independence but keeping the central bank on a short leash was to make sure the governorship rotated between a BOJ official and a MOF official, specifically the vice minister, the top bureaucratic position at the ministry (see table 5).

Table 5

Background Of Bank of Japan Governors In The Post-War Period: The BOJ-MOF Nexus

Career background	Highest prior position	Name	Term	Comment
Bank of Japan	Deputy governor	Eikichi Araki	Oct. 1945 to June 1946	
Bank of Japan	Executive director	Hisato Ichimada	June 1946 to Dec. 1954	
Bank of Japan	Governor	Eikichi Araki	Dec. 1954 to Nov. 1956	
Ministry of Finance	Vice minister	Masamichi Yamagiwa	Nov. 1956 to Dec. 1964	
Mitsubishi Bank	President	Makoto Usami	Dec. 1964 to Dec. 1969	Only post-war governor not from the BOJ or the MOF
Bank of Japan	Deputy governor	Tadashi Sasaki	Dec. 1969 to Dec. 1974	

Table 5

Background Of Bank of Japan Governors In The Post-War Period: The BOJ-MOF Nexus (cont.)				
Ministry of Finance	Vice minister	Teiichiro Morinaga	Dec. 1974 to Dec. 1979	
Bank of Japan	Deputy governor	Haruo Mayekawa	Dec. 1979 to Dec. 1984	
Ministry of Finance	Vice minister	Satoshi Sumita	Dec. 1984 to Dec. 1989	
Bank of Japan	Deputy governor	Yasushi Mieno	Dec. 1989 to Dec. 1994	
Ministry of Finance	Vice minister	Yasuo Matsushita	Dec. 1994 to March 1998	Resigned to "take responsibility" for a scandal involving BOJ officials.
Bank of Japan	Executive director	Masaru Hayami	March 1998 to March 2003	First governor appointed under revised BOJ Act promoting independence and transparency of the central bank
Bank of Japan	Deputy governor	Toshihiko Fukui	March 2003 to March 2008	
Bank of Japan	Deputy governor	Masaaki Shirakawa	April 2008 to March 2013	Appointed governor after upper house of the Diet blocked successive nominations of two former MOF vice ministers
Ministry of Finance	Vice minister of finance for international affairs	Haruhiko Kuroda	from March 2013	First MOF official appointed governor not to be a former vice minister

Sources: Bank of Japan and Standard & Poor's Ratings Services.

The enactment of the revised BOJ Act in April 1998 provided an opportunity for the BOJ to use its new-found independence to have this unwritten convention consigned to the history books. It can be surmised that the MOF would not be taking all of this lying down and might be inclined to bide its time, looking for the right opportunity to reassert some measure of control.

Viewed through this lens of bureaucratic politics and rivalry, the appointment of Mr. Kuroda, a former vice minister of finance for international affairs, assumes an added dimension. The first governor appointed under the revised BOJ Act was a former BOJ official, Masaru Hayami. BOJ watchers eagerly awaited the appointment of the next governor in March 2003 to see if the pre-1998 convention would survive the BOJ's independence being strengthened. It did not: another former BOJ official, Toshihiko Fukui, was appointed governor. But it did not escape the attention of keen BOJ-watchers that, at the same time, former MOF vice minister Toshiro Muto was appointed deputy governor of the BOJ, positioning him as a strong candidate to take over as the next governor in March 2008. Indeed, the LDP Fukuda cabinet did nominate Mr. Muto for the governorship in 2008. But his nomination was blocked by the opposition-controlled upper house.

As a measure of how strongly the MOF had likely maneuvered behind the scenes to position itself to regain the governorship, not to be deterred, the Fukuda cabinet nominated another former MOF vice minister for the governorship, Koji Tanami; his nomination was also blocked by the upper house. Only then did the Fukuda cabinet nominate for governor (successfully so) the recently appointed deputy governor, Masaaki Shirakawa, a career BOJ official (12). From the MOF's point of view, Mr. Shirakawa's appointment, and the ministry's failure to regain the BOJ governorship, was a setback. This time around Mr. Muto's name was also widely floated as a leading candidate to succeed Mr. Shirakawa, but, in the event, Mr. Abe gave Mr. Kuroda the nod. In any event, the MOF has succeeded in breaking the streak of BOJ officials "monopolizing" the governorship position.

1144049 | 301765622

There may be more to all of this than just bureaucratic jostling for power. It can be surmised that the MOF has grown increasingly concerned about what it may have perceived as a blasé and dangerous attitude on the part of the BOJ toward deflation, given that deflation is likely an important part of a complex mix of factors behind Japan's ever-worsening fiscal position. The attitude may well have been: if an independent BOJ isn't going to end deflation, we will have to get back in the driver's seat and do it ourselves. By the same token, there may have been a perception at senior levels of the MOF, and in the broader political sphere, that both the deflation status quo (eventually) and an aggressive attempt to break out of deflation (sooner) could entail risks of the JGB market being destabilized and a fiscal crisis being precipitated. To the extent that this is true, the MOF likely was even more motivated to regain a measure of control over the central bank.

Next April's Slated Consumption Tax Hike: A Litmus Test For "Abenomics"

Something highly significant is going on in Japan; of that there can be little doubt. The question, however, is: what?

On the surface, the answer seems to be: some Japanese policymakers--ones like Mr. Abe who were able to grasp the reins of power--have gotten serious about ending deflation, and are going about ending it.

Another interpretation of recent events is that fiscal hawks are orchestrating a long hoped-for increase in the consumption tax, as a cornerstone of fiscal consolidation, with something akin to the policy stance known as "Abenomics" being a necessary condition for the legislated tax hikes to be consummated.

The two versions of reality are not necessarily incompatible, but there is high chance that they are. The second "arrow" of "Abenomics," as set out in the LDP's policy manifesto last November, having regard to the weak domestic economy and international risks, is a shift from a contractionary bias in fiscal policy to a more "flexible" stance for two to three years. It would seem more consistent with the spirit of this policy plank, and with the commitment to end deflation, to delay the implementation of the consumption tax hikes until it is confirmed that the battle against deflation has indeed been won. Otherwise, if policymakers put one foot on the fiscal brakes while they are pushing the monetary accelerator to the floor, they risk stymieing the attempt to end deflation. If Mr. Abe is his own man, and has the courage of his convictions, it would make sense for him to call time out on the consumption tax hikes, as is allowed by the legislation, and is required if rosy economic conditions are deemed not to be met.

However, if it is primarily the imperative to get the consumption tax hikes through, come hell or high water, that is driving policy in Japan--and if the reflation kerfuffle at the BOJ, at least for some, is a fig leaf obscuring that--things are likely to evolve according to a different script. In that case, expect the government to avoid the subject of the conditionality clause as much as possible and, to the extent that it does rear its inconvenient head, expect the government to argue that the conditionality clause is met because "Abenomics" satisfies precisely the stated conditions. There is no need to delay the hikes and, indeed, to delay them would be to undermine the credibility of the government's fiscal reconstruction plans and risk triggering a destabilizing JGB market sell-off that could torpedo the entire "Abenomics" exercise. Or so the argument would go.

For planning and implementation reasons, the government needs to decide by this year's fourth quarter whether to press ahead with next April's mooted tax hike. The stance Mr. Abe takes on this question will reveal a lot about

"Abenomics" and where it is likely heading: to a durable atmospheric change in Japan's macroeconomic performance, or to the sinking feeling that, appearances to the contrary, Japan's policymakers haven't yet kicked their habit of making policy errors.

Endnotes

(1) Bank reserves are deposits of commercial banks and other eligible financial institutions at the central bank. When central banks buy assets, they do so by creating bank reserves, with the tap of a keystroke or out of thin air; likewise they can "destroy" the reserves merely by selling assets to the public. When the public withdraws cash from a bank, reserves decline by that amount (and vice versa). Bank reserves are a liability of the central bank (and therefore of the consolidated government) and are not to be confused with foreign exchange reserves, which are an asset of the consolidated government (and may or may not be an asset of the central bank).

(2) Milton Friedman encapsulated this point, perhaps a little too simplistically and strongly, in his famous statement that "inflation is always and everywhere a monetary phenomenon."

(3) The author has some personal experience of this process. I served on the Economic Deliberation Council Committee on the Role of Economic Sectors during the Hashimoto Administration and on the Economic Deliberation Council Planning Committee during the Obuchi Administration.

(4) There is a certain irony here because this delinking of the reflation goal from the goal of enhancing real potential growth runs counter to the spirit of the fable of the three arrows. The lesson of the fable is that the three elements together can succeed, whereas in isolation they may not. This is more consistent with the Shirakawa line, which is slightly worrisome.

(5) I use the term "reflation" to mean "end deflation"--that is, to return the economy to a state of "operational price stability," usually taken to be around 2% measured consumer price inflation.

(6) For instance, the January monetary policy statement said: "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 entities to strengthen the economy's growth potential and support from the financial side." And elsewhere: "The Bank recognizes that the inflation rate consistent with price stability on a sustainable basis will rise as efforts by a wide range of entities toward strengthening competitiveness and growth potential of Japan's economy make progress."

(7) The BOJ Act stipulates the "purpose of the Bank of Japan [as being] to issue banknotes and to carry out currency and monetary control […] aimed at achieving price stability, thereby contributing to the sound development of the national economy" (Articles 1 and 2). While requiring that "the Bank of Japan's autonomy regarding currency and monetary control shall be respected" (Article 3), the Act also holds the following regarding the central bank's relationship with the government: "The Bank of Japan shall, taking into account the fact that currency and monetary control is a component of overall economic policy, always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy

shall be mutually compatible" (Article 4). A translation closer to the spirit of the original Japanese text would be: "The Bank of Japan shall, taking into account the fact that currency and monetary control is a component of overall economic policy, always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control shall be mutually compatible with the basic stance of the government's economic policy" [my translation].

(8) Had Mr. Noda remained prime minister, who knows who he would nominated for governor and who he would have been able to get through an opposition-controlled upper house? There is no guarantee that it would have been Mr. Kuroda.

(9) I have done that from three perches: as the Chief Economist Asia and Global Chief Economist for Lehman Brothers based in Tokyo until September 2006 and as the Global Chief Economist for Lehman Brothers based in New York until September 2008; as the Global Chief Economist for Nomura Securities (based in New York) until March 2012; and most recently as the Chief Global Economist at Standard & Poor's.

(10) I say "another form of government debt" because, at the consolidated government level, central bank reserves can be viewed as a form of (very short-term) government debt.

(11) The Japanese equity market looks particularly susceptible to a foreign investor-led sell-off, should policy follow-through disappoint. Prior to Prime Minister Noda announcing the election on Nov. 16 last year, foreign investors had been modest net buyers of listed Japanese equities, clocking up ¥853 billion for the year. After that, foreign investors poured into the market, being net buyers for 17 weeks in a row, clocking up a record (for the 17-week period) ¥5.540 trillion in net purchases. The TOPIX index rose by 38% in that period, compared with a rise of 14.5% in the S&P 500. In the 28 weeks for which there are data since the election announcement, foreign investors have bought a cumulative ¥9.626 trillion of Japanese listed equities (net), being net buyers in 23 of those weeks. The TOPIX is down by 17% from its recent (May 22) peak. The TOPIX has declined in each of the five weeks in which foreign investors have been net sellers in this period, and it has declined in only three of the 23 weeks in which they have been net buyers. The TOPIX index is now up 41% since the election announcement versus the S&P 500's 20% rise.

(12) The Fukuda cabinet nominated another former MOF official, Hiroshi Watanabe, who had been vice minister of finance for international affairs, as deputy governor to replace Mr. Shirakawa, but the upper house rejected the nomination.

Related Research

- Change Of The Guard--And The Deflation Storyline--At The Bank of Japan, March 28, 2013
- January Meeting Minutes Underscore How Little The Bank of Japan Has Yielded, Feb. 22, 2013
- What To Look For From The Bank of Japan’s New Leadership, Feb. 12, 2013
- The Bank of Japan's Moves: Less Than Meets The Eye, Jan. 28, 2013
- Japanese Reflation Is In Play, But Hurdles Galore Stand In The Way, Jan. 3, 2013

Copyright © 2013 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

McGRAW-HILL