Japan’s Dangerous Gamble: ‘Abenomics’ And Its Implications

By Gongpil Choi

Since 1990, Japan has been mired in a seemingly endless struggle to get its massive economy off of life support following the implosion of its asset-price bubble after it peaked in 1989. Prime Minister Shinzo Abe is determined to break that cycle, as is the Bank of Japan. But the bank’s decision to pump vast sums of money into the country’s financial system is fraught with risks that could backfire, harming the global economy, writes Gongpil Choi.

Throughout the Japanese economy’s roller-coaster ride of the past several months, many economists and other observers have become concerned about the future consequences of the Bank of Japan’s current policy of quantitative easing (QE), especially its spillover effects for the region and the impact it might have on Japan’s efforts to get out of its debt-deflation trap. The economic policies of Prime Minister Shinzo Abe — dubbed “Abenomics” — are being increasingly regarded by many as a threat to global financial stability, despite earlier positive responses due to their effect on Japan’s recovery.

Quantitative easing, which involves a central bank’s injection of liquidity into the banking system (primarily through the purchase of government bonds), is at the core of Japan’s latest attempt to extricate itself from chronic stagnation. The US Federal Reserve has been engaged in open-ended QE for several years now in an effort to spur the US recovery, and Japan only recently joined the pack. Unfortunately, the US is now considering a gradual exit from QE sooner rather than later, as the impact on the economy dissipates and the future burden of unwinding the policy becomes clearer. The Bank of Japan’s belated adoption of QE is seen as a last-ditch, desperate attempt to revive the Japanese economy. In this essay, I will provide the background behind Abenomics and draw implications for the future of the Asian regional economy.

Japan has been struggling for years with the repercussions of the domestic asset-price bubble that burst in the early 1990s, long before the current global financial crisis. This initial shock triggered a massive balance-sheet recession in Japan and brought about a liquidity trap, which the Japanese government sought to address by going into fiscal overdrive. Despite more than two decades of these unconventional measures, things have not stabilized. Given the temporary effects of bolder and stronger Abenomics, we have to consider whether Japan’s past responses were correct. The point is whether Japan could have chosen a different path. It is important to sort out the various causes of the current malaise to evaluate Abenomics in full detail.
A LONG HISTORY IN THE MAKING

One of the most visible factors behind Abenomics can be traced to structural impediments associated with the balance-sheet recession that has plagued the Japanese economy since 1990. Japan is mired in an intractable deleveraging process that blocks the path to a sustained economic recovery.

Certainly, Japanese authorities have tried their best to escape from the horrendous debt-deflation trap. The government’s fiscal crisis has been the most obvious consequence of its rescue operations, but the depletion of the government’s fiscal war chest has made ensuing rounds of stimulus less effective. It is in this vein that the current attempt to re-energize the economy via expansionary monetary policy, as well as renewed fiscal measures, has been seen as a prima facie case for drastic measures, and the Japanese authorities chose to weaken the yen through massive QE, a very dangerous policy that is temporarily possible because of massive QE rallies in the rest of the world. Essentially, it appears as though the Group of Eight (G-8) nations agreed on the need to allow Japan to catch its breath amid its relentless deleveraging process. In the past, Japan was instrumental in the global deleveraging process by allowing its currency to strengthen against the dollar. In retrospect, the road to the asset-price bubble and collapse started at the time of the Plaza Accord in 1985, when the G-5 wealthy economies agreed to depreciate the US dollar against the yen by intervening in currency markets. This put the yen on a steep appreciation path and has kept the yen an important linchpin, a sort of reset button to restore equilibrium in the current crisis-prone international financial system.

DIAGNOSING THE MALADY, EVALUATING THE REMEDY

Because the fundamental cause of Japan’s problems today lies in the lack of effective domestic demand, which has been held hostage to the country’s excessive debt burden, weakening the currency in the face of fiscal constraints has only limited effectiveness. The Abe government’s moves might make the macroeconomic numbers look great temporarily, but they do not put the economy on a sustainable recovery path. An increase in external demand may prove to be of some help, but certainly not enough to pull the Japanese economy out of its trap. Japan needs to stimulate domestic demand, and if it is to do so many of the structural constraints on the economy need to be addressed. However, it is difficult to find historical examples of this happening. During economic and financial crises, governments typically resort to policy measures rather than efforts to fix the structural problems that are often the root causes of economic weaknesses. But policy choices have always been a second-best option, globally and historically, compared to structural adjustments.

It is quite clear that the weakening yen has contributed to a ballooning of profits, signaling a roaring comeback of corporate Japan. Yet, the gradual adjustment to a weakening yen makes the comeback less enduring. The boost is bound to taper off, since the relative adjustments made by corporations in other countries are unavoidable and the world is sitting on massive central bank liquidity that finds few viable investment opportunities. All of the talk about a turnaround is based on a flimsy foundation of artificially sustained credit flows supported by authorities worldwide. Adding more central bank liquidity without serious changes in the inner workings of an economy will not brighten the picture for long. Lack of circulation and intermediation in the presence of abundant central bank liquidity means that the stimulus measures will prove to be only temporary. Put simply, we are creating a massive global liquidity bubble that will not help restore balance sheets, but instead will pose additional threats to already overstretched economies. This added pressure shows itself in the heightened probability of interest-rate hikes, liquidity pullback and inflationary expectations.

Financial market volatility is on the rise and our market window remains murky and uncertain. At this point, the critical question is: do we really want more central bank liquidity or normalized investment flows that help promote employment? Is the latter implausible when most private-sector players are sidelined as governments take center stage? The fact of the matter is we are adhering to choices that will not deliver the intended policy effects. In fact, we are complicating the situation since markets no longer deliver information on potential risk.

The weighty issues of unemployment and lack of investment opportunities have been sidelined for quite some time, and we are simply front-loading valuable resources to combat the...
last fight. Investing in outmoded economic paradigms, rather than addressing the structural roots of the problem, will not work. Lack of asset choices, bureaucratic governance, a dollar-sensitive exchange rate regime, rigid labor and financial markets remain intact, and policy efforts always come first, distorting incentive schemes and maintaining the status quo.

WHY IT WON’T WORK
All in all, Abenomics is a missed cue. Mimicking the strategy of the US will not work, because the proper foundations for a sustained recovery are missing in Japan. To put it bluntly, monetary expansion in the presence of fiscal constraints that cut into normal interest-rate paths to avert low financing costs will only backfire and put the economy in an even deeper depression. Abenomics cannot succeed because of its internal inconsistency. This is because interest-rate adjustments cannot be avoided when monetary expansion conflicts with fiscal constraints.

First, fiscal maneuverability is very limited in Japan, making it vulnerable to any kind of interest-rate hike perpetrated by a growing risk premium and/or heightened inflationary expectations. Inevitably, even if QE has successfully raised inflationary expectations, interest-rate hikes due to fiscal bottlenecks, as seen by foreign investors, would steer the economy in the opposite direction, worsening depression. This is a highly unusual situation.

Second, Japan’s QE in the wake of global easing comes too late to set the stage for a sustained recovery. Moreover, global easing means that deleveraging and balance-sheet restoration, which are crucial to sustained recovery, will not take place. We are simply making it more difficult for recovery to take hold since the rescue efforts do not help restore sectoral balance sheets. Instead, we are applying drastic and unconventional measures that distort the natural functioning of markets, so that normal investment flows aren’t taking place. This is an uneasy disequilibrium.

THE SPECTERS OF INFLATION AND INTEREST-RATE HIKES
Market anticipation of higher interest rates in the wake of massive quantitative easing stems from the status of the yen compared to the dollar. Most Japanese government bonds (JGBs) are held by domestic investors, and the international position of JGBs has been maintained not by wider demand but by an amazingly tenacious proclivity on the part of Japanese toward a buy-and-hold strategy.

In the US, inflation expectations remained stable even after the third round of QE, while in Japan, there are already signs of interest-rate hikes and higher inflationary expectations that would make the risk of a fiscal crisis more palpable. This is a reflection of the threshold level of government debt problems that has plagued Japan for over a decade. Even with the added stimulus of an asset-purchase program, markets simply would not buy into bonds with impending interest-rate hikes in recognition of JGBs’ over-sensitivity to interest rates. This is in stark contrast to the US, where the possible exit strategy rattles market sentiment not because of fear of interest-rate hikes but of asset-price meltdowns. Put simply, a fiscally constrained economy has a higher chance of seeing higher interest rates (see Figure 2), even with small changes in the policy mix or macro conditions. If Abenomics works and inflation reaches the targeted 2 percent, it would encroach upon any positive impact by raising funding costs via JGBs, thus canceling any expansionary effect of QE. If Abenomics does not work, then Japan will find itself embroiled in another round of deflation. Overall, it would be difficult to raise interest rates above 2 percent via Abenomics, since debt overhang is still serious, and even if it succeeds, it would not bring about the positive effect that we expect.

In reality, it is very difficult to imagine that the world economy will get back on a sustained recovery path in the near future. The artificial maintenance of financial stability leaves indelible marks on corporate and government balance sheets, making normalized credit flows extremely difficult. It is undeniable that policy measures that deal with a crisis situation cannot be all that different from what we all have been doing, but the choices are costly going forward, since we are left with the even more difficult task of dealing with structural reform issues or overhauling economic and financial paradigms, which is impossible given the prevailing global governance structure. The wrong policy mix will continue to distort credit flows and make the government’s role even greater — at the expense of achieving a fully functioning market economy.

Enough of a mess has been created already in a futile search for the right remedies. Even if we know the direction we should go, we appear una-
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A GLOBAL ASSET MELTDOWN?
Recent worries about Abenomics signal the last chapter before a fully-fledged global asset meltdown. The Fed has been engaged in QE longer and now realizes the limits of this unconventional support. Japan only recently was given a limited pass from the G-8 to engage in QE, but it has hit the wall with a renewed sense of fiscal reality. Now, the global economy is running out of options to provide economic stimulus. Authorities have simply wasted resources and time in favor of short-term fixes. We now see Japan, the final bastion of global financial support, beginning to rattle the markets, and it will continue to do so until its currency hits a bottom. The fragmented world of emerging markets will be the only start-point after a massive asset meltdown. The Fed has been engaged in QE longer and now realizes the limits of this unconventional support. Japan only recently was given a limited pass from the G-8 to engage in QE, but it has hit the wall with a renewed sense of fiscal reality. Now, the global economy is running out of options to provide economic stimulus. Authorities have simply wasted resources and time in favor of short-term fixes. We now see Japan, the final bastion of global financial support, beginning to rattle the markets, and it will continue to do so until its currency hits a bottom.

The world's dollar-dependent financial system channels asset accumulation into foreign exchange reserves that have limited investment capabilities. With these lingering structural vulnerabilities, the upcoming challenges will be hard to overcome without de facto regional co-operation in one form or another. Abenomics is neither a voluntary choice nor the deliberate strategy many see it as, but an endogenously contrived response. Some spillovers are unavoidable, but given the importance of Japan's economy, we cannot apply the usual beggar-thy-neighbor argument. We also have to recognize that Japan is plagued with serious constraints, in both the economic and non-economic spheres. Finally, the need to address some of Japan's long-term issues has become more urgent, because the current system must be overhauled in the short-run, lest it completely derail the world economy. Even with the best macro mix, structural issues call for structural reform. Unless there is a global consensus on the right responses, the world economy will continue to founder.

It should be very clear by now that Asia needs to evolve into a fully-fledged regional economy, where requisite market and financial capacity supports self-sufficient economic activities for its regional constituents. Regional issues need a regional solution, not a fragmented sovereign approach. Japan's approach to its economic problems needs to be revised and modified to embrace regional considerations in a bolder and more comprehensive framework to avoid the doomed future of Abenomics. In a similar vein, a regional agenda to marshal the region's vast foreign-exchange reserves to kick off regional mega-projects to boost sagging productivity in non-tradable sectors would be a welcome initiative.

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