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Expectations and Concerns around Abenomics

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During the election period for the House of Representatives of Japan in December 2012, Liberal Democratic Party (LDP) president Shinzo Abe argued that the challenges faced by the Japanese economy, such as deflation or the strong yen, could only be overcome by economic growth policies. Abenomics, which is firmly based on this notion, has been embodied in "three arrows": aggressive monetary expansion, a big boost to government spending, and growth strategy to stimulate private investment. The first arrow, quantitative easing has already become a hot topic in Japan and abroad on whether it can actually revive the Japanese economy.

The economic effects of quantitative easing have been evident in the weakening of the yen and a rise in the stock market index. In the case of the yen to dollar exchange rate, it seemed that the yen would remain adamantly strong at under 80 yen per dollar on the back of a high preference for the yen by Japanese investors as a safety asset, especially in the wake of the Great East Japan Earthquake in March 2011. However, the continuous strengthening of the yen started faltering after LDP president Abe, during the run-up to the election in November, announced that he would mobilize every possible policy measure to adopt inflation targeting and escape deflation. In the statements released on January 3rd, 2013, the U.S. FOMC (Federal Open Market Committee) expressed the possibility of slowing down QE3, launched in September 2012, with regard to expectations for economic recovery. This view further accelerated the yen depreciation, and the Bank of Japan's announcement of the two percent price stability target (January 21st) and unlimited quantitative easing (April 4th) fixed this trend in place. On May 9th, the yen to dollar exchange rate surpassed the 100 yen mark, which has been considered the turning point between the strong and weak yen. This trend is sparking expectations for improved profitability among Japanese businesses, and this in turn is boosting stock prices. The LDP's December victory pushed the Nikkei 225 index over 10,000, the Bank of Japan's quantitative easing announcement lifted it over 13,000, and as of May 15th, the growth rate was over 50% compared to the index during the December elections, surpassing 15,000.

Quantitative easing, the head arrow of Abenomics, is expected to boost inflation and help the country emerge from its deflation slump by allowing for a weakened yen to lead to stock price increases, which would put the wealth effect mechanism into play, and boosting consumption, in turn boosting business sales, production and employment, which would again lead to higher consumption levels. In other words, there are expectations that Abenomics will serve as the key to break away from the vicious cycle of deflation, caused by a lack of effective demand in an economy that has been drowning in a recession for nearly 20 years since the bubble burst in the early 1990s. Such expectations have served as the background for the Bank of Japan setting its quantitative easing target at “two percent inflation within two years.”

There are, however, as much concerns as expectations over the side effects in the Japanese economy that the Abenomics quantitative easing initiative may bring. There are largely two concerns, the first being that even if the “two percent inflation within two years” target is met, inflation not coupled with the resolution of insufficient effective demand will only further burden the struggling working class. As seen in the case of the Bank of Japan's quantitative easing in the mid-2000s, expanding the monetary base and keeping interest rates low will not necessarily lead to increased investment, unless investment is encouraged by improved investment conditions. Likewise, there will be a limit to boosting consumption unless employment and wage income levels are raised, and higher import prices induced by a weakened yen may actually dampen purchasing power, consequently worsening living standards. The second concern is that contrary to the expectations of Abenomics advocates, quantitative easing may lead to soaring interest rates, and might even evoke a financial crisis. When central bank implements quantitative easing, the general expectation is that interest rates will fall, but since the Abenomics measures involve the Bank of Japan making large purchases of government bonds, financial markets may interpret this as a relaxation of fiscal discipline and even an undermining of fiscal sustainability. If this turns out to be the case, there is a risk of a plunge in government bond prices. If this worst-case scenario becomes a reality, not only will it sharply increase the Japanese government's fiscal burden, also give rise to an even more serious problem in the form of a financial crisis caused by fiscal distress in financial institutions, especially small and medium-sized banks whose asset management activities revolve around government bonds. Put briefly, the quantitative easing initiative, adopted to escape deflation, may unintentionally serve as cause for a financial crisis.

The Korean government has consistently expressed its concerns over the Abenomics quantitative easing measures. Even if Abenomics is not intended to weaken the yen as argued by the Japanese government, there is no denying that consequentially, the won value against the yen has jumped by over 20%. This is undoubtedly worrying news for Korean manufacturing sector, which compete with Japanese companies all over the world and now have to watch for declining exports due to weakened price competitiveness. From this viewpoint, Abenomics measures may well be considered as barriers to import as well as beggar-thy-neighbor policies. Moreover, this may only add weight to the arguments of East Asian countries that Japan's monetary policies, as in the past, stir unrest rather than spur the development of the East Asian economy.

Nevertheless, East Asian countries, including Korea, do not have much to gain from the failure of Abenomics. As seen in the Chinese economy's outstanding growth and the Asian currency crisis in the 1990s, the Asian economy is tightly knit together in an interdependent relationship. From this perspective, it is crucial that the Japanese government backs the success of Abenomics by enhancing the transparency of monetary policies, with an exit strategy to quantitative easing ready at hand, and by sustaining the financial market's trust in fiscal sustainability by executing prudent fiscal measures. In the mid to long term, if the Abenomics' third arrow of growth strategies are successfully employed by the Japanese government as policy measures that can help overcome the challenges of a low-fertility, aging and low-growth era, Abenomics could become the next new economic growth model to be bench-marked by Korea and other East Asian countries alike.