Is Abenomics finally revitalising Japan's economy?

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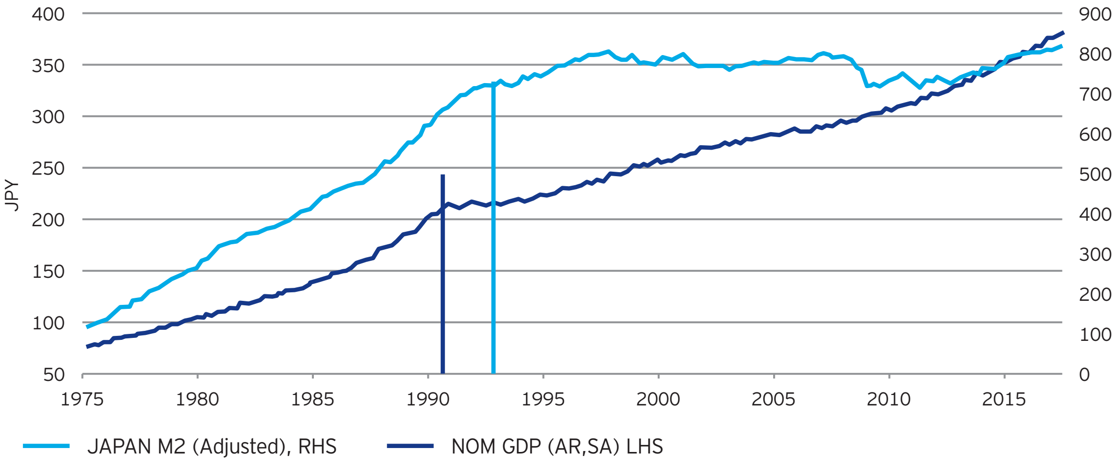
Japan's economic output is still the world's third largest by country after the United States and China. However, consistent growth has been elusive. The most common explanations are headwinds such as a declining population and deflation. Japan's real output growth has only averaged 0.8% annual growth since 1991, the beginning of the lost decade.

JAPAN: NOMINAL GDP & BROAD MONEY (1975=100)



Source: Macrobond

Abe's "three arrows" plan

The country has tried to escape this cycle by employing fiscal deficits in the 1990s, zero interest rates (1999-2000), Quantitative Easing (QE, 2001-06), and numerous restructuring proposals. Along the way the government has had to reverse course and increase the goods and services tax (GST) twice (in 1997 and 2014) to narrow the fiscal deficit. Prime Minister Shinzō Abe came to power in December 2012, on the back of a promise to arrest the economic stagnation. In order to achieve this, he laid out his "three arrows" plan: firstly, monetary easing, secondly, fiscal stimulus and thirdly, structural reform.

So far, the massive QE programme of the Bank of Japan (BOJ) has been the most obvious example of the strategy's implementation. There has been some increase in government spending, but also an increase in tax revenues due to the GST hike in April 2014. Structural reforms have been much harder to implement. For example, the proposal to increase Japan's net immigration has been met by much resistance and little enthusiasm.

JGBs dominate BOJ's asset purchase

In November 2017, Japanese Government Bonds (JGBs) and T-Bills accounted 95% of the stock of assets bought by the BOJ under QQE. However, the key problem is not the composition of the BOJ's purchases but the counterparty from which the securities were bought. By buying from banks instead of from non-banks, the BOJ has missed the chance to create new money (i.e. M2 deposits) in the hands of households and private sector companies. In the domestic and local conditions of the past two decades, this has been a forlorn hope.

Asset prices still below peaks

Asset prices have been subdued in Japan for nearly three decades. In the five years since November 2012, the Nikkei 225 is up 147%, but it is still only 57% of its peak level in December1989. The price of land in the 6-big cities is now only a third of its value in December 1990. In recent years, property prices have largely been flat, seeing a rise of just 2% since 2010. The stagnant property market is viewed as a consequence of slow money and credit growth since the bursting of the asset bubble in 1991.

Broad money growth still too slow

Since the equity bubble burst in December 1989, the economy has suffered from rates of money growth that have been persistently too low for the economy. From 1991-2008, M2 grew at an average annual growth rate of just 2.4%. Despite the massive increase in the BOJ'S QE programme from 2013, M2 money growth has only increased to 3.1% year-on-year since 2010. The BOJ's failure to boost the supply of broad money (M2) is the reason why inflation is still far below target. With the average annual change of income velocity at -2.3%, and real GDP potential growth of 1.5%, money growth would have to accelerate 6% p.a. to generate a 2% inflation rate.

Longest run of GDP growth in decade

The most recent data shows that the economy has now been growing for seven consecutive quarters, its longest growth streak for more than a decade. Real GDP growth in 2017 Q2 was an annualized 0.3% quarter-on-quarter, and 1.6% greater than 2016 Q3, resulting in the economy growing at its fastest pace in two years.

Current business activity data appears to be reinforcing of the proposition that the Japanese economy has "turned a corner". 2017 Q2 has seen strong growth of corporate profits, up 22% year-on-year. The increase in corporate profits has fed through to improved business sentiment, reaching its highest level since 1991 Q3. With both soft and hard data increasingly positive, real capital expenditure is up 18.7% since its low point in 2009 Q4, and can be expected to continue its upward momentum.