Abenomics – Myths, Rhetoric and Reality

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Slide 1. Introduction.

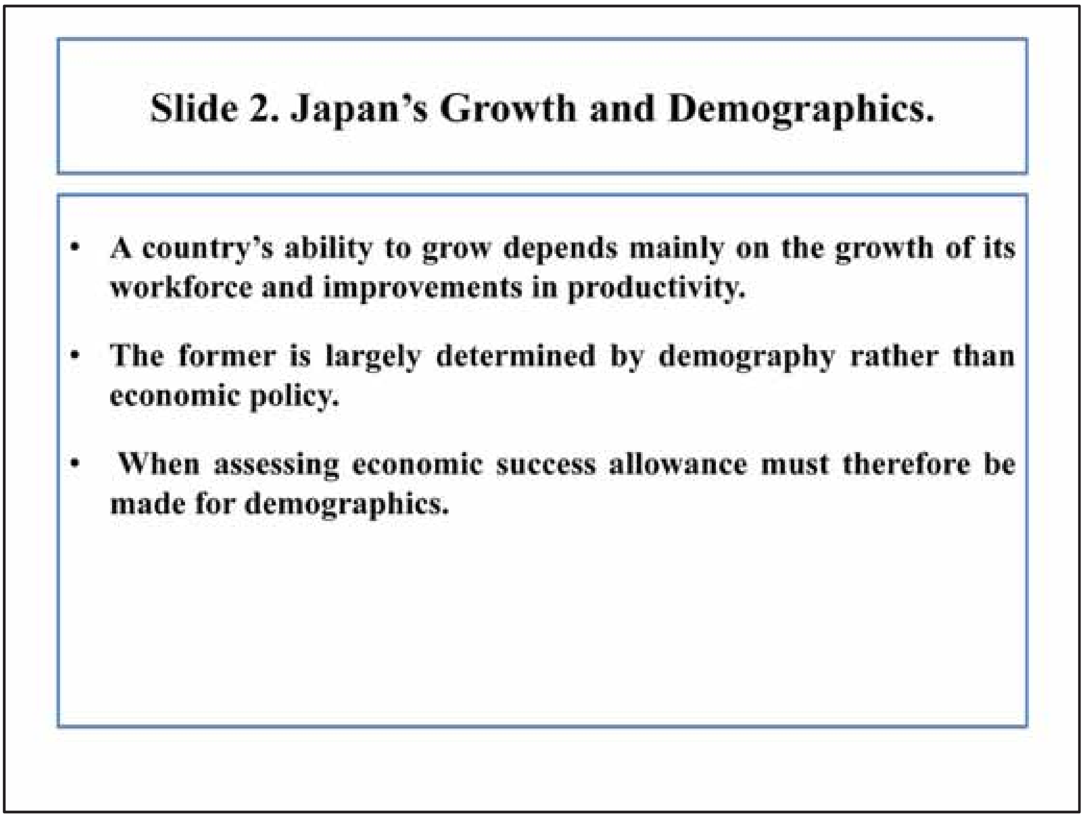
- I see Abenomics as being based on two myths.
- Myth 1 – The Japanese economy has underperformed relative to other G5 countries.
- Myth 2 – That this non-existent poor performance is due to deflation.
- Being myth based, current policies are failing to address Japan's key issues.

Comment

I was duly flattered by Spencer Dale's invitation to talk on Abenomics, but in view of my heterodox views I am also suitably nervous.

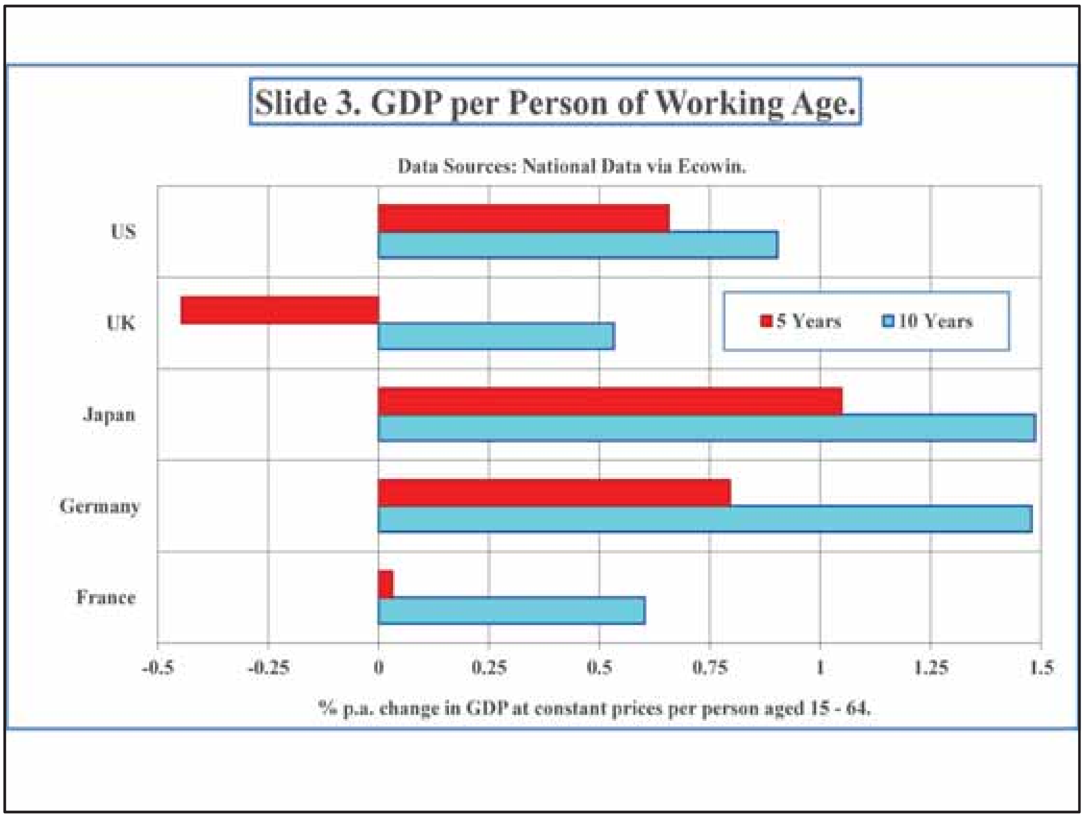
I am not optimistic about Abenomics unless Step 3 involves a major reform of corporation tax, centring on depreciation allowances. Judging from recent discussions with members of the Government and its advisors I fear that the point I am making is not yet on the agenda for discussion. I may of course be wrong, but it seems reasonable for me to ask that this should be demonstrated and, without discussion, this is obviously unlikely. I am therefore grateful to have this opportunity to state my case.

If I am right and policy does not change, the outlook for Japan seems to me to be poor. Not immediately I must stress, but over the next few years.



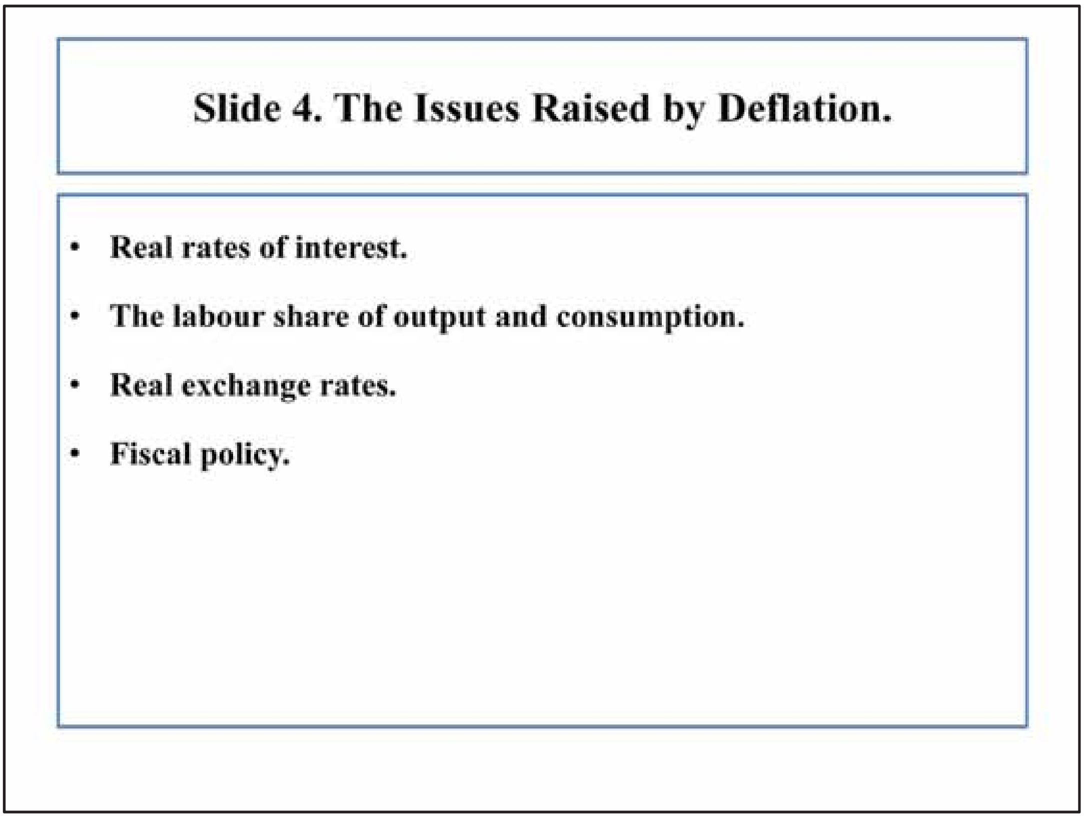
Comment

Provided allowance is made for the impact of its demography, Japan’s economy appears to have been one of the best performers among G5 countries. Japan’s population of working age (15 to 64) has fallen at 0.5% p.a. over the past 15 years, while that of the US has risen by 1.1% p.a.



Comment

As Slide 3 shows, Japan has grown faster than other G5 countries, if allowance is made for demographic change, over the past 5 or 10 years and, even over 15 years, is second only to Germany by a small margin.



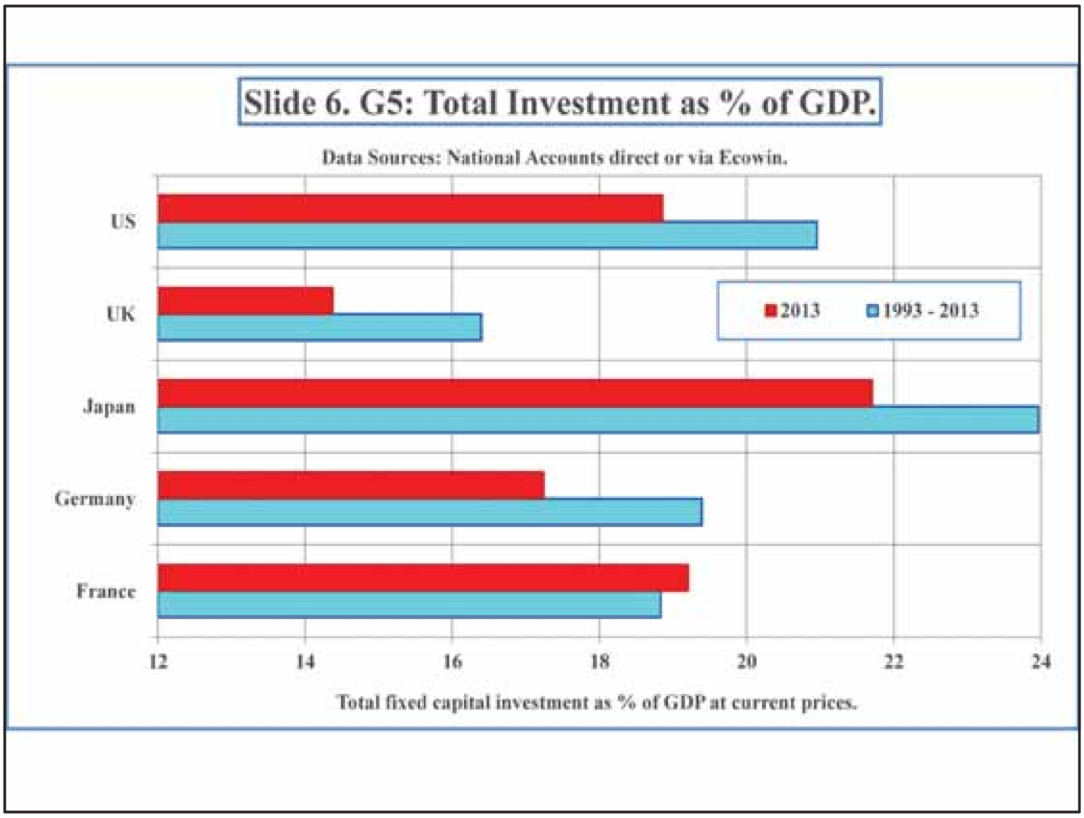
Comment

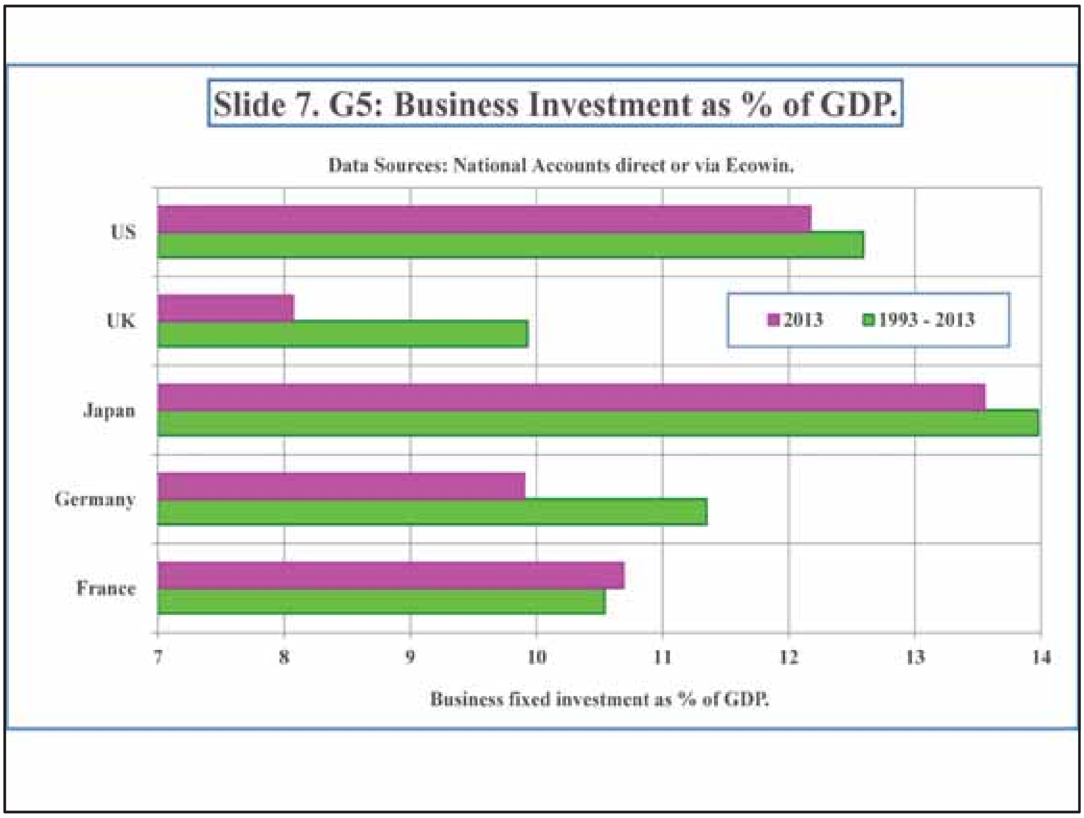
Deflation provides a good example of economists' bad habits. They habitually seek to apply general models rather than considering the individual circumstances of different countries at different times.

An assessment of the potential costs and benefits of deflation requires analysis of each of these issues applied to the individual circumstances of Japan.

Slide 5. Real Rates of Interest.

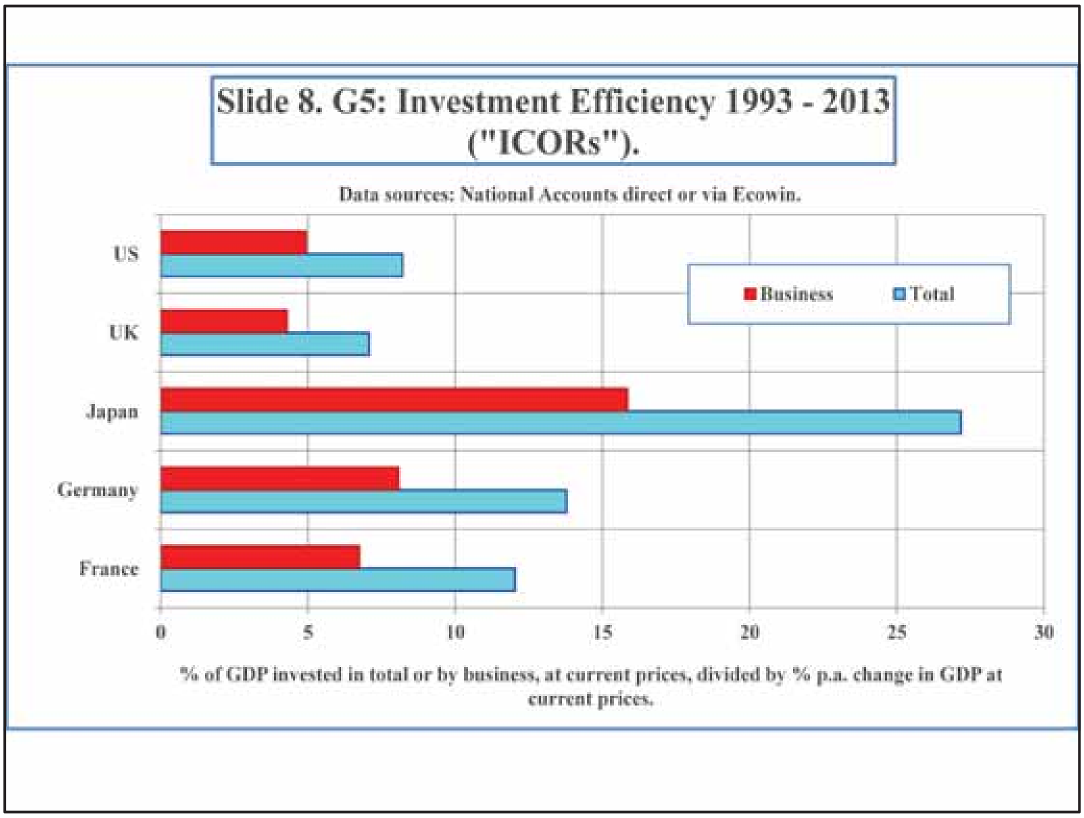
- Deflation prevents real rates of interest being negative.
- This may depress business investment.
- But Japan invests too much.


Slide 6. G5: Total Investment as % of GDP.
Data Sources: National Accounts direct or via Ecowin.
US
UK
Japan
Germany
France
2013
1993 - 2013
12
14
16
18
20
22
24
Total fixed capital investment as % of GDP at current prices.



Comment

As Slides 6 and 7 show, Japan invests more of its GDP than other G5 countries, despite its demographic hindrance to growth, whether investment is measured in total or just in terms of business spending.



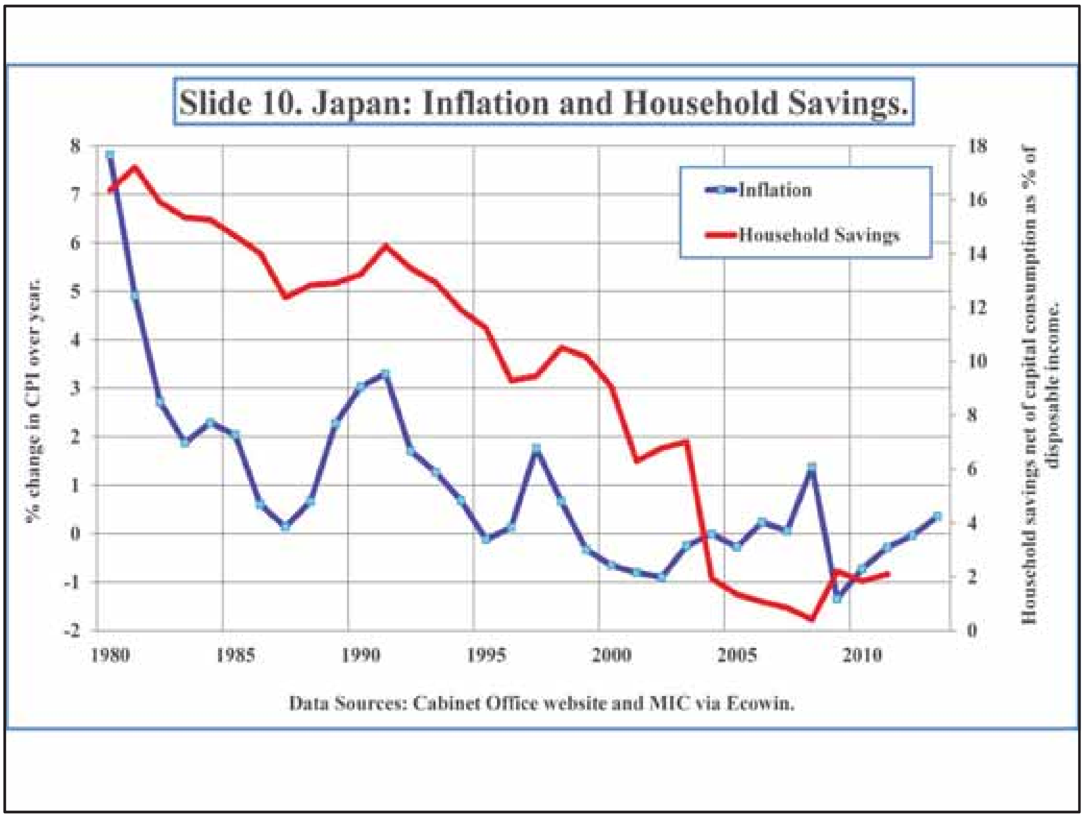
Comment

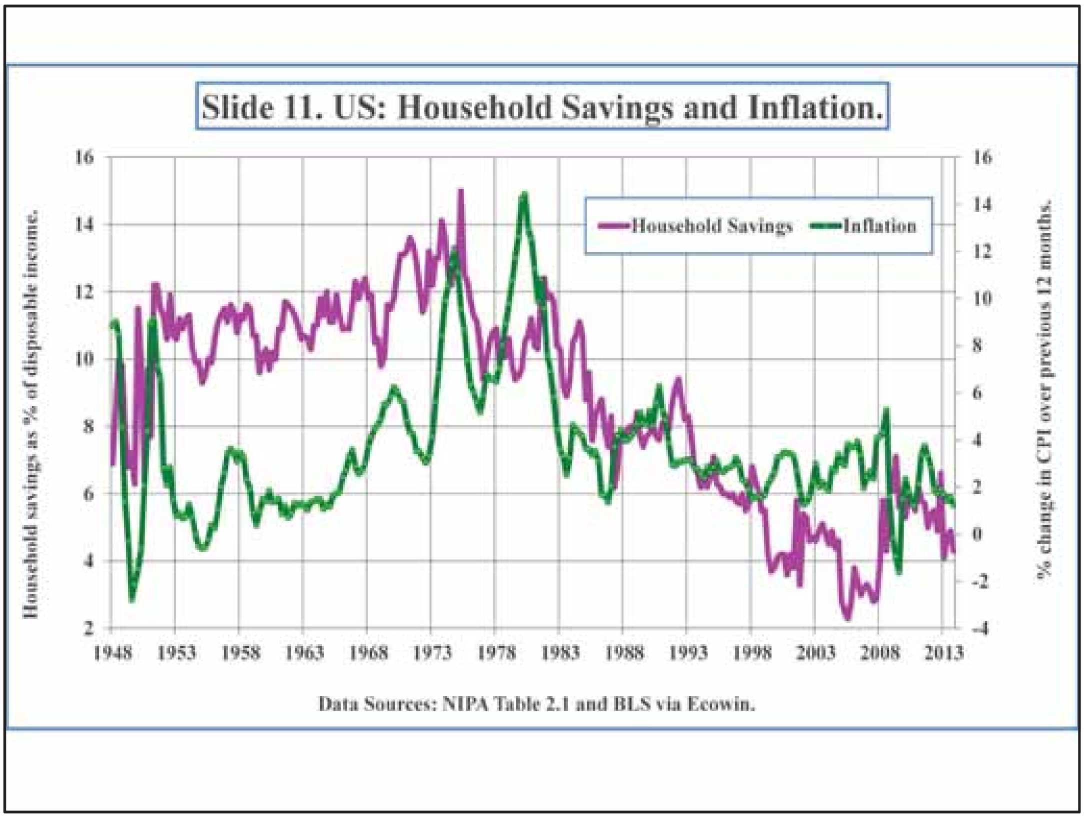
As a result Japan invests very inefficiently. Its incremental capital/output ratio for business investment is between twice to three times worse than that of other countries. The return on investment is the product of the capital/output ratio and the profit share. As profit shares are similar in Japan to those of other G5 countries, Japanese companies have, as a result, had the worst return on capital.

Lower investment is essential to raising the return on capital to internationally competitive levels. Seeking to raise investment is like trying to push water uphill.

Slide 9. Deflation and Consumption.

- Wages are generally "stickier" than prices. So labour incomes are helped rather than hurt by deflation.
- Contrary to many claims, deflation lowers rather than increases household savings.
- Deflation does not therefore hinder consumption.


Slide 10. Japan: Inflation and Household Savings.
Inflation
Household Savings
% change in CPI over year.
Household savings net of capital consumption as % of disposable income.
8
7
6
5
4
3
2
1
0
-1
-2
18
16
14
12
10
8
6
4
2
0
1980
1985
1990
1995
2000
2005
2010
Data Sources: Cabinet Office website and MIC via Ecowin.

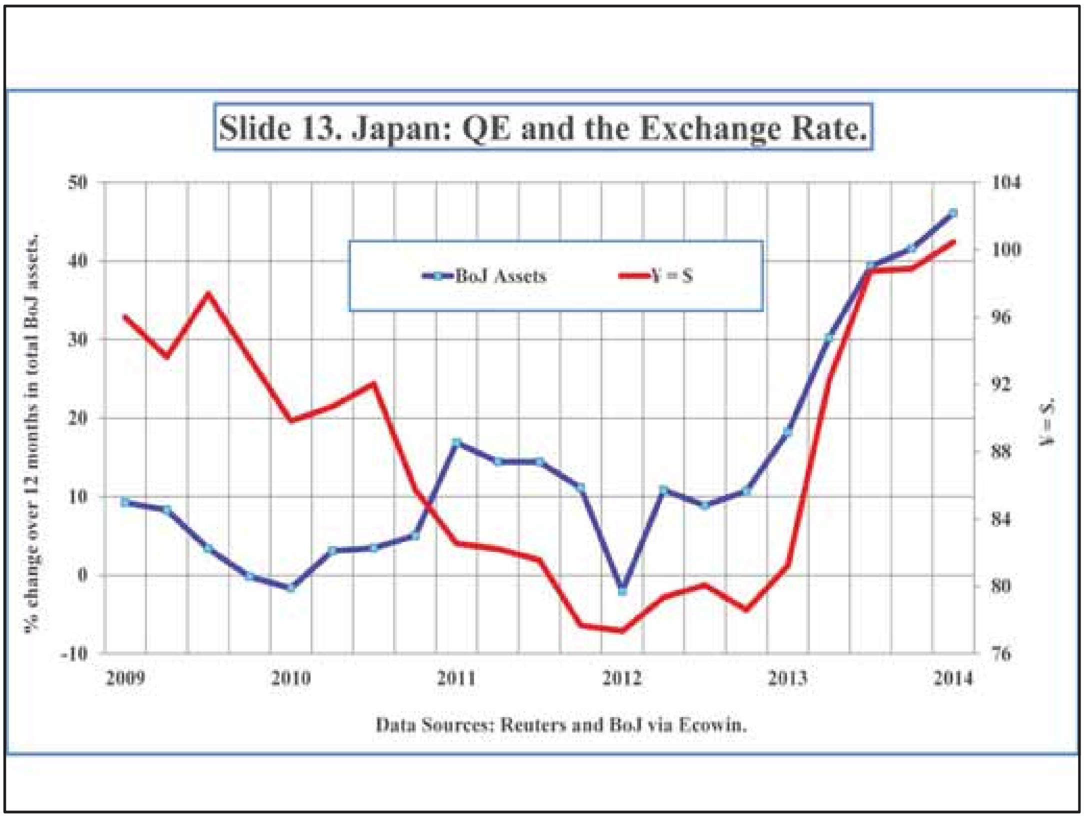


Comment.

Japan's household savings' rate has fallen as inflation has turned to deflation and this is reflected in most of the blips as well as the trend (Slide 10). The US shows a similar pattern with household savings seeming to rise rather than fall with deflation (Slide 11).

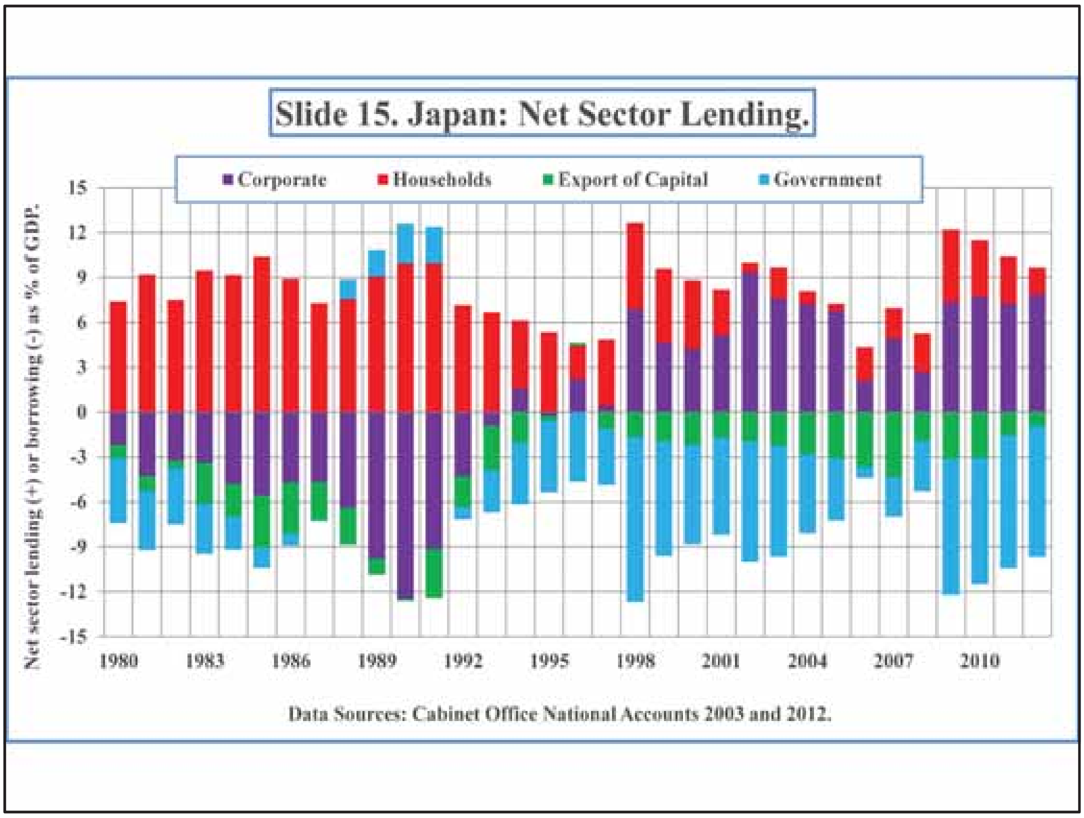
Slide 12. The Real Exchange Rate and The Triumph of Rhetoric.

- **Japan badly needed a lower real exchange rate.**
- **Inflation hinders rather than helps this as, at any nominal exchange rate, higher inflation raises the real rate.**
- **The rhetoric was that QE was needed for inflation.**
- **This disguised the real benefit of the nominal devaluation (Slide 13).**

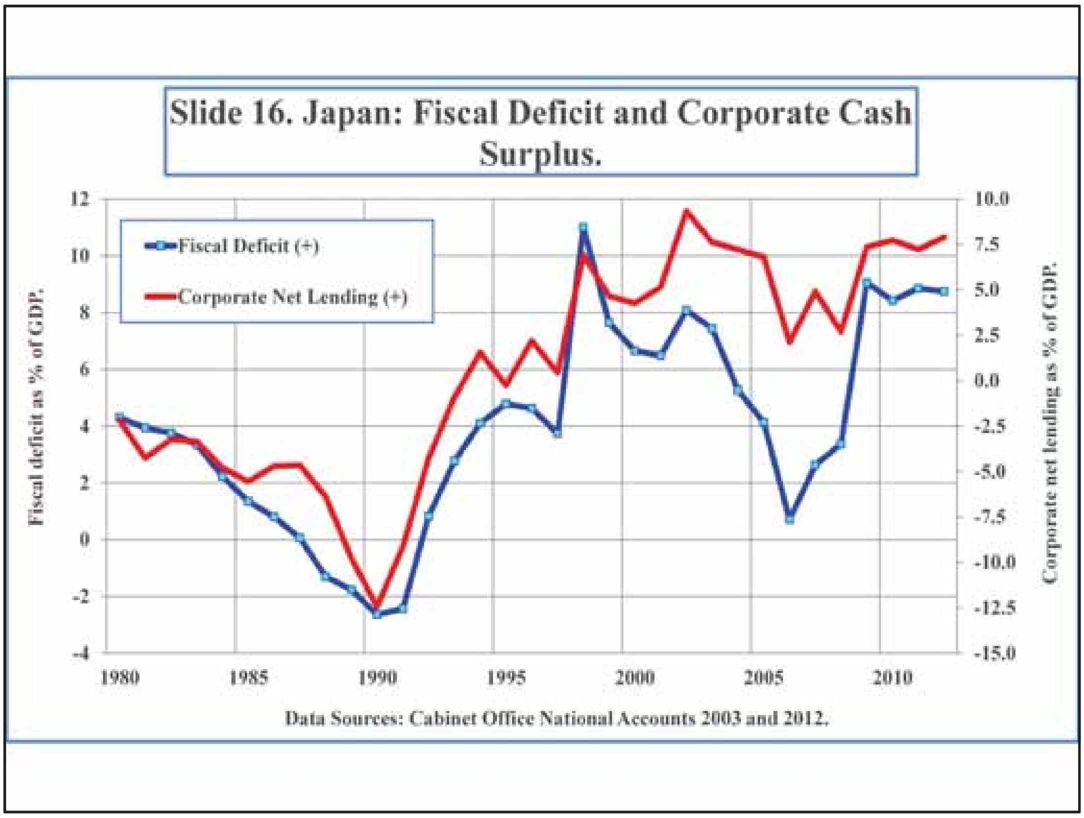

Slide 13. Japan: QE and the Exchange Rate.
BoJ Assets
¥ = $
% change over 12 months in total BoJ assets.
¥ = $
50
40
30
20
10
0
-10
104
100
96
92
88
84
80
76
2009
2010
2011
2012
2013
2014
Data Sources: Reuters and BoJ via Ecowin.

Slide 14. Japan's Fiscal Challenge.

- To reduce the fiscal deficit without recession.
- As sector cash flows sum to zero, this means reducing business cash flow, where the surplus largely lies (Slide 15).
- It has been highly correlated with the fiscal deficit (Slide 16).

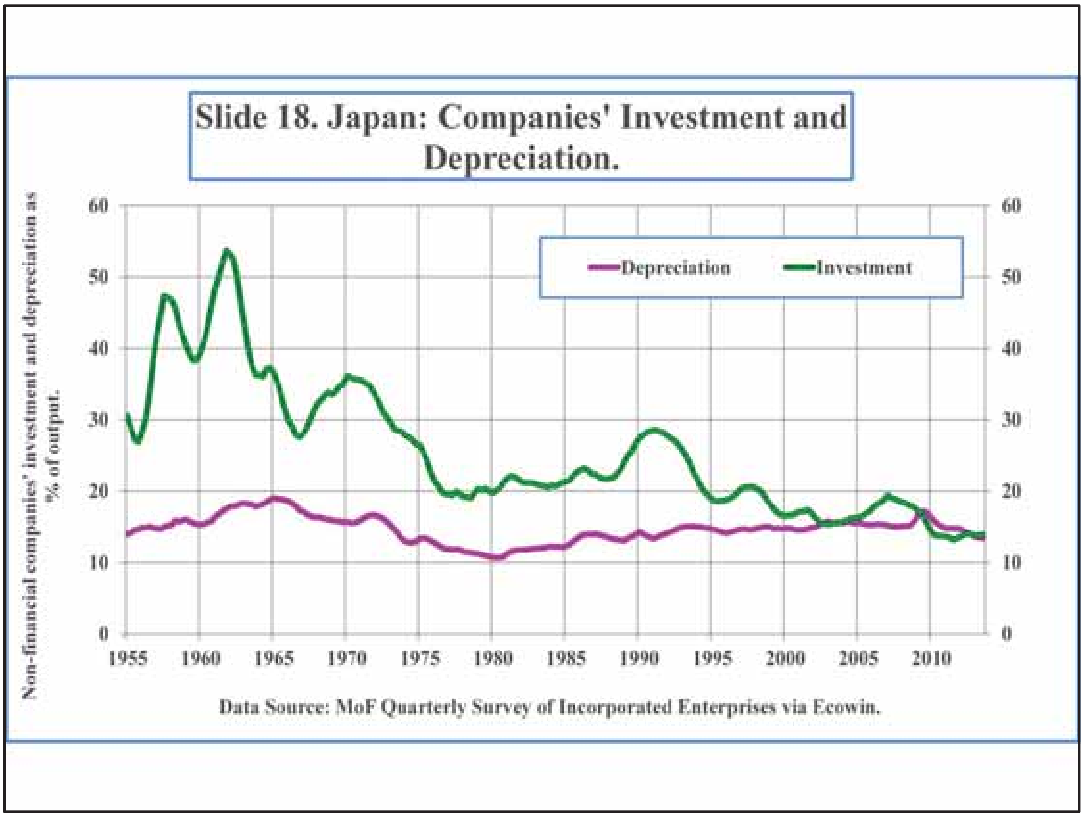


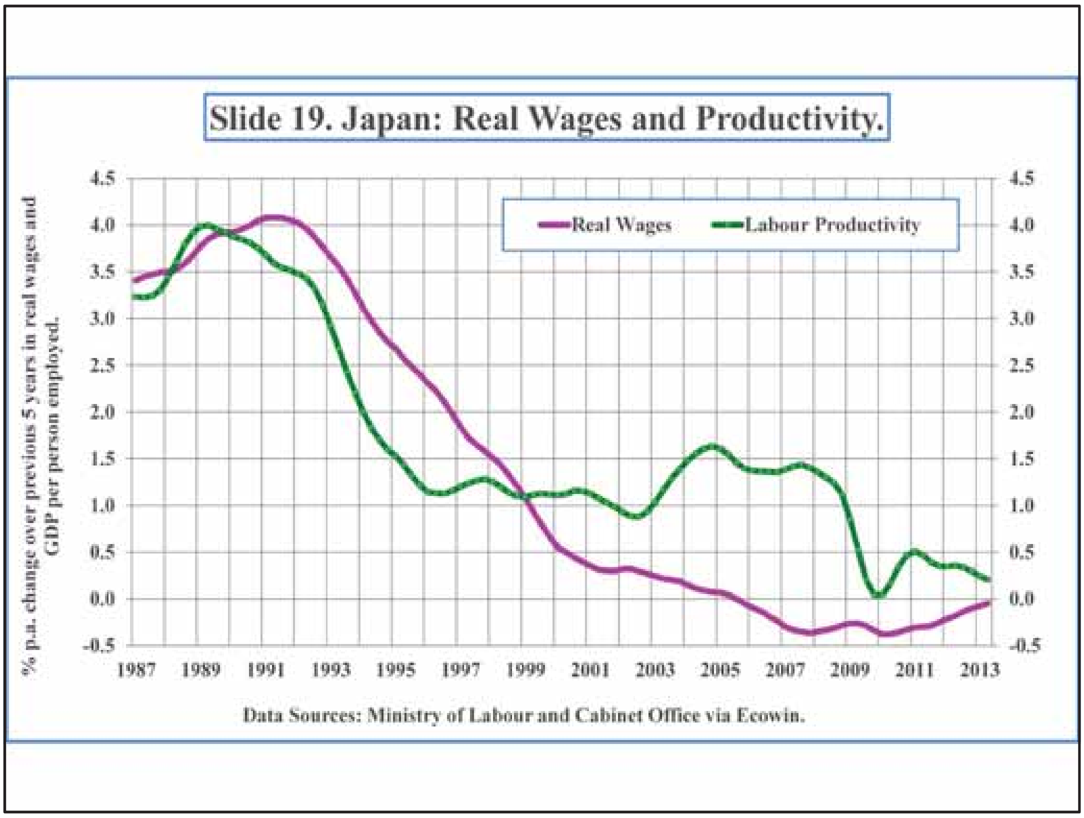
Slide 15. Japan: Net Sector Lending.
Corporate
Households
Export of Capital
Government
Net sector lending (+) or borrowing (-) as % of GDP.
15
12
9
6
3
0
-3
-6
-9
-12
-15
1980
1983
1986
1989
1992
1995
1998
2001
2004
2007
2010
Data Sources: Cabinet Office National Accounts 2003 and 2012.


Slide 16. Japan: Fiscal Deficit and Corporate Cash Surplus.
Fiscal Deficit (+)
Corporate Net Lending (+)
Fiscal deficit as % of GDP.
Corporate net lending as % of GDP.
12
10
8
6
4
2
0
-2
-4
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
-7.5
-10.0
-12.5
-15.0
1980
1985
1990
1995
2000
2005
2010
Data Sources: Cabinet Office National Accounts 2003 and 2012.

Slide 17. Cutting Business Cash Flow.

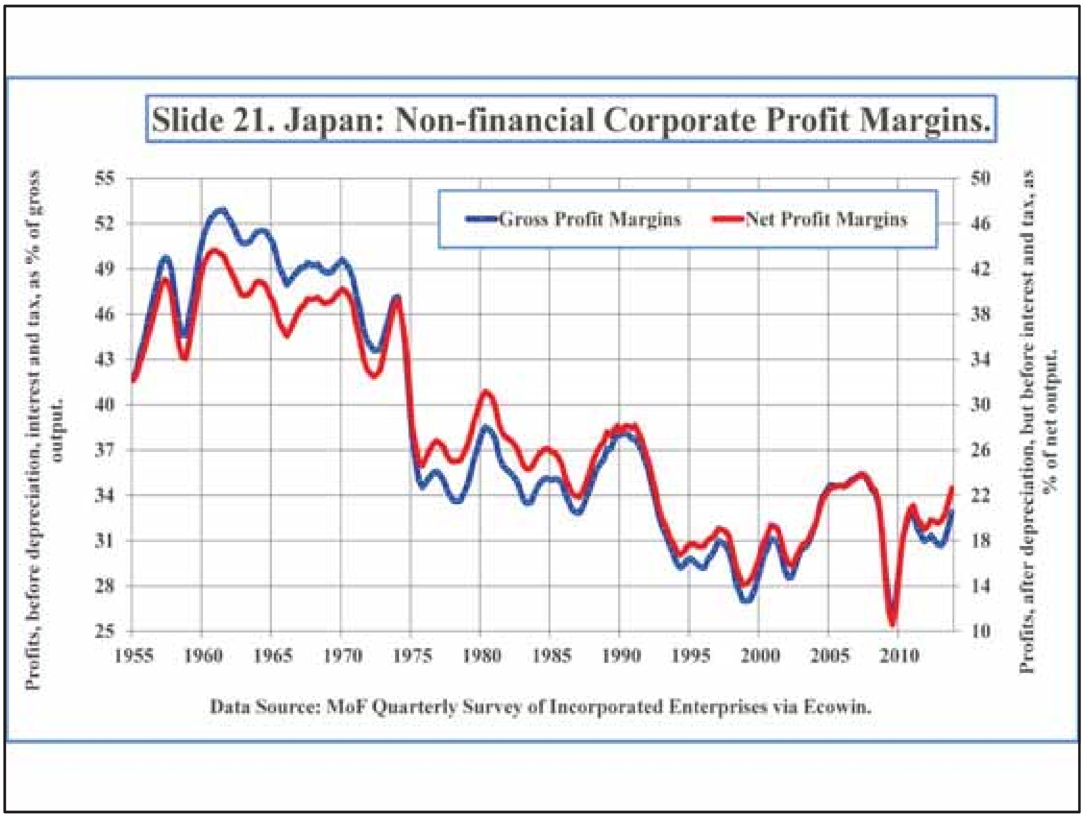
- Requires either higher investment, which is no solution as Japan invests too much, or
- Lower depreciation – the key reform needed.
- Companies can pay for all their excessive investment from depreciation (Slide 18).
- The corporate sector is therefore a net lender unless dividends are 100% of profits.


Slide 18. Japan: Companies' Investment and Depreciation.
Depreciation
Investment
Non-financial companies' investment and depreciation as % of output.
60
50
40
30
20
10
0
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
Data Source: MoF Quarterly Survey of Incorporated Enterprises via Ecowin.


Slide 19. Japan: Real Wages and Productivity.
Real Wages
Labour Productivity
% p.a. change over previous 5 years in real wages and GDP per person employed.
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013
Data Sources: Ministry of Labour and Cabinet Office via Ecowin.

Slide 20. Capital Consumption and Depreciation.

- **Plant and equipment have embodied in them the technology of their time.**
- **Old plant becomes uneconomic as real wages rise.**
- **Japan's plant should therefore be lasting much longer than before as the growth of productivity and real wages have slowed (Slide 19).**
- **So, depreciation allowances should be cut heavily.**


Slide 21. Japan: Non-financial Corporate Profit Margins.
Gross Profit Margins
Net Profit Margins
Profits, before depreciation, interest and tax, as % of gross output.
Profits, after depreciation, but before interest and tax, as % of net output.
55
52
49
46
43
40
37
34
31
28
25
50
46
42
38
34
30
26
22
18
14
10
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
Data Source: MoF Quarterly Survey of Incorporated Enterprises via Ecowin.

Slide 22. The Need for a Higher Labour Share of Output.

- If business savings are to fall, then the labour share of output must rise, i.e. profit margins must fall.
- But profit margins have already fallen to around those of other mature economies (Slide 21).
- Without a fall in depreciation, a rise in the labour share means a fall in profits.
- Companies respond to falling profits by cutting bonuses, next year's "Shunto" and employment.

Slide 23. How to Increase the Labour Share.

- A fall in depreciation allowances would allow both profits after tax and the labour share of output to rise.
- This would also provide room for a cut in the corporate tax rate, while the revenue from the tax rises.
- With a rise in the labour share, income and consumption tax revenue would also rise.

Slide 24. Conclusion - The Win Win Situation.

- **Cutting depreciation allowances would:**

1. **Increase tax revenue and reduce the fiscal deficit.**
2. **Allow a rise in the labour share of output, without a negative response from companies.**
3. **Demonstrate the extent to which Japanese profits are understated (particularly compared with overstated US profits).**
4. **Lead to a sharp rise in the stock market and a consequent boost to confidence.**