

# Economics IN ACTION

UC San Diego  
Department of Economics

## James Hamilton *honored by* International Association for Energy Economics

*by the Department of Economics*

### Chair's Corner

Welcome to *Economics in Action*.



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**Paola Avila '97**

Chamber of Commerce director advances by exploration and connection

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UC San Diego

## Paola Avila '97

### **Chamber of Commerce Director Advances by Exploration and Connection**

By Jenelle Dean, Alumni Director, Division of Social Sciences



Paola Avila graduated from Eleanor Roosevelt College in 1997 with a Bachelor of Arts in economics. In 2013, she joined the San Diego Regional Chamber of Commerce as the director of public policy, and earlier this year, she became the chamber's Mexico Business Center director. In her new position, she "will focus on developing domestic and international public policies that enhance economic prosperity through cross-border trade, an efficient border, and robust business, political and cultural relationships between the two countries," according to a statement in *U-T San Diego*. Previously, Paola served as the deputy chief of staff to former San Diego Mayor Dick Murphy, and communications director to Sen. Ben Hueso, providing counsel on policy issues such as energy, water and economic development.

A Mexico City native, Paola has dual U.S. and Mexican citizenship and is fluent in Spanish and French. She is married to Troy Gorostiza. They have two daughters, ages 15 and 11, who aspire to attend UC schools, and two French bulldogs, Bandit and King. Both of Paola's siblings also graduated from UC San Diego. She proudly said, "Triton blood runs strong in our family!"

#### **What were your experiences like in the Department of Economics? Which courses/faculty/opportunities made an impact on you?**

I say with great confidence that the faculty and advisors were an excellent resource, supportive and flexible. At the time (1995-97), computers were not as easily available off-campus as they are now, and I did not own a computer, so I spent many evenings in the department computer lab.

There was a mandatory Excel class that I took that had a huge impact on my career: I quickly became known as the expert in Excel (and therefore Access) at work at a time when these were the only known programs that could manipulate data.

#### **How did UC San Diego prepare you for your transition after graduation?**

UC San Diego prepared me overall for each and every one of my professional roles. Since I was working throughout college, I found that what I learned in the classroom was directly applicable to what I did at work. I tested economic theories in real-time applications in the financial markets. In addition, the time-management and writing and presentation skills I gained at UC San Diego were, in particular, a tremendous asset in the workplace.

#### **What was your career trajectory?**

I began working at a financial services firm – PaineWebber – during my junior year. My interest in economics at that time was centered on global markets and the stock exchange. I was fascinated by the investment trends and how politics and world events guided the markets. I enjoyed my two years working in this field but quickly realized the burn rate and emotional investment would remain a constant and decided it was not for me.

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I planned to take some time off after completing my last course in the fall of 1997 and went to work at a public affairs/communications firm at the recommendation of my boss at the financial services firm. This was not something I was familiar with and, in fact, I felt much apprehension. I did not think I would enjoy it but took it as an intern post while I figured out what I wanted to do. As it turned out, I was immediately hooked. I loved the policy component and high energy of the field.

I made numerous business contacts, one of whom became my mentor and No. 1 teacher. He recruited me to work for him at another public-affairs firm that ran political campaigns for individuals and ballot initiatives. I dived right into a heavily contested mayoral race where we narrowly made it to the primary and then inched toward victory in the general election by another tight margin. Our client, the new mayor, asked me to work for him as his deputy chief of staff, a position which had never before been held by someone of my young age. I happily accepted and served in that position for five years.

When I left, I took a year off and focused on raising my two daughters. This also allowed me to fulfill the one-year restriction from lobbying city officials, so it worked out very well.

After that year, I began my own government- and community-relations consulting business, and I worked on a variety of interesting projects and political campaigns. One of the last campaigns I ran was a state-assembly race. That led to a position at that state assembly office as communications director while still maintaining some clients from my own business.

A couple of years later, I realized that I missed the private sector and was thrilled to join the Chamber of Commerce working for a fabulous team that our former Mayor Jerry Sanders had put together.

### **What were you involved in while you were here on campus?**

I competed on the cross-country and track teams. In track, my events were the 5K and 10K races. Being a part of the overall athletic community at UC San Diego was one of the best experiences, and where I spent the majority of my time. Reflecting back on my time on campus, I recall receiving a warm welcome by other sports teams at functions outside of our specific activities. I also worked full time while I was in school.

### **What are some of your favorite things about UC San Diego?**

UC San Diego's reputation! It is easy to boast about my alma mater because its academic reputation is solid. Whether in a conversation at work or in a social setting, I love the immediate credentials I gain when I tell people that I graduated from UC San Diego.

Additional favorites:

The fact that so many alums stay in San Diego, so our network here is substantial and strong. Especially when considering that the UC San Diego family extends to the Scripps Institution of Oceanography, Birch Aquarium, hospitals, etc.

Location, location, location! The proximity to the beach goes without saying.

Some of my favorite things about the campus itself are Geisel Library, Che Café, running the trails in the eucalyptus trees and catching a show at La Jolla Playhouse.

### **What are your future professional goals?**

I feel like I have met many of my professional goals and am at a place that fits me perfectly. I can see myself in this position for many years to come, but if I were to look 10 years into the future, I see myself working in Washington D.C., focusing on national/international policy.

### **Any advice for economics students?**

The best advice I have to offer is to seek internships and employment opportunities. What you learn outside of the classroom is just as important. Gaining hands-on experience and skills in a professional setting will help you narrow down your optimal career path, build your resume and make invaluable professional relationships.

Sometimes an internship or job will introduce you to a career you had not previously considered or help you realize that a job you thought would be perfect for you really isn't. Making these discoveries early can sometimes save you years of working in a job you do not like. Be willing to take on responsibilities you might not have considered and may not be interested in. You never know, you may actually find your true calling.

Foster business relationships with everyone, even outside of your interest area or with people you think

you not will see again. You will be surprised to know how often we are wrong in assuming that. You may find yourself working with that person again in the future - it's a small world and relationships are everything.

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UC San Diego



# Economics

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## Chair's Corner

Welcome to this edition of *Economics in Action*. In our featured articles, James Hamilton discusses the continuing influence of the price of oil on U.S. booms and busts, and Johannes Wieland analyzes the recent attempts of Japan to escape from a bust that never seems to end. We introduce our new assistant professor Isabel Trevino, and shine our alumni spotlight on Paola Avila, who graduated with an economics degree in 1997 and is now executive director of the Mexico Business Center of the San Diego Regional Chamber of Commerce.

### Faculty Honors

*Econometrica* is the flagship journal for research in econometrics and economic theory. These are areas of historic and current strength for the UC San Diego Department of Economics. Many path-breaking articles by current and former faculty have been published in *Econometrica*, including the research that led to the 2003 Nobel Memorial Prize in Economic Science, awarded to our time-series econometricians Clive Granger and Robert Engle. The editor-in-chief of *Econometrica* is one of the most prestigious positions in the entire economics profession. Now, for the first time, that position is held by one of our own: Professor Joel Sobel. This is a major honor for Joel and a major milestone for our department. Congratulations!

UC San Diego was founded in 1960, and every fall the campus holds a celebration of this event. This year, Professor Richard Carson was chosen to be one of the "extraordinary minds" the university placed front and center at its annual Founders Symposium. Building on his world-leading research in the field of environmental economics, he gave a TED-style talk on one of the themes of the UC San Diego Strategic Plan: Understanding and Protecting the Planet.

### Undergraduate Program: Math-Econ Major, Rising Leaders, and Microeconomics on Video

A hallmark of the Department of Economics has always been its quantitative emphasis. This has served our students well as they have emerged with better training than their peers at other competitive universities. In the late 1990s, we introduced the joint mathematics-economics major for students who want an even higher level of technical rigor. Initially only a handful of students enrolled in the major. As late as Fall 2009, Math-Econ majors were still less than five percent of all Economics majors, including the regular Economics major and the Management Science Major. Recently, however, there has been a surge of interest in the Math-Econ major, and this fall enrollments topped ten percent of all Economics majors for the first time. Students have learned that the higher level of technical training better prepares them for doctoral programs in economics and for many other careers. We are pleased to see the validation of the vision that we had 15 years ago, and we will continue to search for innovative ways to serve our students.

The Department of Economics and its alumni Economics Leadership Council celebrate the fourth year of the Rising Leaders Program. The program is designed to bring together top employers with our brightest undergraduate students, and provides an academic scholarship to each Rising Leader selected. In 2014 the program was expanded to include two tracks in order to better align with industry-specific internship deadlines: investment banking and general finance/business. In spring 2014 two students were selected as Rising Leaders in investment banking: Brian Dzou, joint math-econ major, and Jason Masong, international studies-economics major. In fall 2014 we welcomed applicants for the inaugural general finance/business track of the Rising Leaders Program.

UC San Diego's Department of Economics is leading the University of California in bringing technology to economics education. A team of UC San Diego economists led by Professors Melissa Famulari and Joel Watson has produced the first installments of the *Intermediate Microeconomics Video Handbook*, a

### CHAIR'S CORNER



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comprehensive set of cross-referenced, short video lectures presenting the material in our core intermediate microeconomics sequence. Students can learn some of the material that would ordinarily be taught through in-class lectures, freeing up class time for problem-solving, question and answer, and other more in-depth interactions between students and faculty. These videos will be made available to students throughout the entire UC system.

## Graduate Program Successes

In last fall's *Economics in Action*, we mentioned the success that our recent graduate students have had in obtaining jobs in the very best economics departments in the country. Recent research published in the *Journal of Economic Perspectives* shows that our success in training graduate students is broad as well as deep. The research tracked publications in professional economics journals by students from the best 30 departments for six years after they obtained their doctoral degrees. For most departments, little publication activity is found beyond the top five percent of their students. In contrast, publication activity is substantial throughout the entire upper half of UC San Diego Ph.D.s. The median UC San Diego Ph.D. publishes more than the median Ph.D. from any other department except Princeton University!

We have an extraordinarily talented and balanced incoming class of graduate students. There is an equal division between domestic and foreign (12:12), and an almost equal split between male and female (13:11). One of the domestic students is a National Science Foundation Fellow. We also have a record 26 graduate students on the job market.

## Outreach and Alumni

We completed the 2014 Economics Roundtable series with a compelling presentation about financing retirement by John Shoven, the Trione Director of Stanford University's Institute for Economic Policy Research. The 2015 series will begin in February with Devajyoti Ghose, senior vice president of investments and capital markets, and treasurer of Federal Home Loan Mortgage Corporation.

The Allied Social Sciences Associations conference will be held in Boston, Jan. 3-5, 2015. We look forward to seeing many of our doctoral alumni there – especially at our cocktail party, which will be held on Saturday, Jan. 3, 6:30-8:30 p.m., in the Commonwealth Room at the Sheraton Boston Hotel (headquarters hotel).

Sincerely,



James Rauch

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## Isabel Trevino

### *Understanding Decision-Making During Financial Crises*

#### FACULTY SPOTLIGHT



Isabel Trevino was born in Colorado but lived in Mexico from an early age. In Mexico, she studied mathematics and economics as an undergraduate and worked at the Central Bank for two years. In 2008, she moved back to the United States and completed her doctorate in economics at New York University in 2014.

#### Research: Microeconomic Theory, Experimental and Behavioral Economics

Isabel's research areas are microeconomic theory, and experimental and behavioral economics. She likes to use microeconomic theory as a basis for her experimental work, and to make use of the quick feedback between theory and experiments to enrich the models she works with. She uses the insights derived from experimental evidence to develop new theoretical models that account for the behavioral anomalies found in the data.

Isabel is especially interested in using the techniques of these areas of economics to understand problems related to macroeconomic and financial questions: how agents use and choose information in environments of high speculation and information asymmetries, such as financial crises. Her interest developed from her childhood in Mexico during a period of a severe financial crisis and through her work in the macroeconomic analysis division at the Bank of Mexico.

One example of Isabel's work is the study of fundamental links and social learning as informational channels of financial contagion. This project is composed of a theoretical model of game theory that makes clear predictions about when and how each of these channels should lead to contagion, and an experimental investigation aimed at studying how real people use the information related to these channels to make decisions when faced with similar trade-offs, as in episodes of contagion.

The results of the experiment show departures in behavior that are not captured by the theory. In particular, information-processing biases play a crucial role in understanding how these two channels operate, since agents do not extract information optimally. One of these systematic biases weakens the effect of fundamental links, while a second bias strengthens the effect of social learning. These behavioral biases help to explain the behavior observed in episodes of contagion that cannot be accounted for in the existing models.

Isabel is very excited about joining the faculty at the Department of Economics and to have the opportunity to learn from such accomplished colleagues. She will be teaching behavioral economics at the graduate and undergraduate levels during her first year as an assistant professor.

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UC San Diego



# Economics

## IN ACTION

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## Department Awards

Each year the Department of Economics honors students and faculty with awards for scholarship and teaching. Please join us in congratulating the 2013-14 winners.

## Undergraduate Students

The Department of Economics grants one annual award to the top graduating senior from each of our three undergraduate majors: economics, management science and joint mathematics-economics. Recipients are chosen by faculty vote from a pool of top students in the graduating class of each major. The award is mentioned at their college commencement ceremonies, and awardees receive a total cash award of \$500. For more information on these annual awards, email [economics@ucsd.edu](mailto:economics@ucsd.edu).

### Seymour Harris Award for Excellence in Economics

Recipients: Kevin Cheung and Hannah Rosenthal

This award commemorates Seymour E. Harris, a prominent government advisor from the 1940s through the 1960s. He was a noted member of the Harvard University Department of Economics faculty and the founding chair of UC San Diego's Department of Economics.

### Joel Dean Award for Excellence in Management Science

Recipient: Jimmy Dinh

This award commemorates Joel Dean, a prominent management scientist who was also a noted faculty member of the business school at Columbia University. He was a visiting professor at UC San Diego's Department of Economics throughout the 1970s and was one of the pioneers of our management science major.

### Award for Excellence in Joint Mathematics-Economics

Recipient: Richard Sun

This award was established in 2008 and is granted to our most outstanding joint mathematics-economics student.

### Teaching Assistance Excellence

Recipient: Ming Wei "Max" Chua

Normally awarded only to graduate students, the department recognizes Teaching Assistants who demonstrate great efforts in their teaching, as emphasized by glowing evaluations from peers, graduate students and their faculty supervisors.

## Graduate Students

### Walter Heller Memorial Prize (Best Third-Year Paper)

This award is given annually in memory of [Dr. Walter Perrin Heller](#) (1942-2001). Dr. Heller was a leading 20th-century economic theorist and an early member of the UC San Diego faculty. He joined the department in 1974 and remained active until his death in 2001. This award formally recognizes our graduate students who have shown the most promise in their future careers in research.

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**First Prize**  
**Qihui Chen**

“Partially Linear IV Regression with Partial Identification”

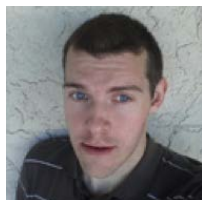
**Runner-up**  
**Shanthi Manian**

“Conflict and HIV Risk: The Impact of Mexico’s Drug War”

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**Best Graduate Student Research Seminar Presentation**

Graduate Student Research Seminars are organized by the students for the students to encourage presentation of early research in order to receive feedback from peers and to keep projects on track. This award is designed to encourage graduate students to present research projects at all stages of development, especially projects that have not yet been presented. The best presentation at the Graduate Student Research Seminars is selected annually by a committee of peers.



**Kilian Heilmann**

“The Effectiveness of International Trade Boycotts”

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**Teaching Assistance Excellence**

Annually the department recognizes graduate students who demonstrate great efforts in their teaching, as emphasized by glowing teaching evaluations from undergraduates, graduate peers and their faculty supervisors. Nominations are solicited from the faculty and awards are made by the graduate committee. Each of these recipients for the 2013-14 academic year showed clear commitment to the teaching mission of UC San Diego.



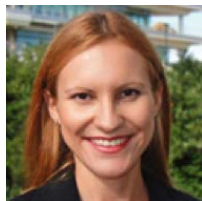
**Andrew Chamberlain**

Undergraduate teaching



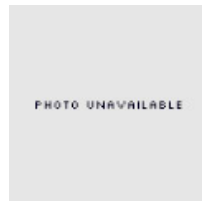
**David Coyne**

Undergraduate teaching



**Marina Kutuyavina**

Undergraduate teaching



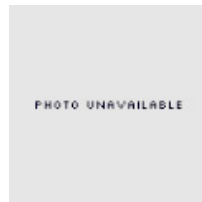
**Vincent Leah-Martin**

Undergraduate teaching



**Oleksiy Mnyshenko**

Undergraduate teaching



**Andrew Walcher**

Undergraduate teaching

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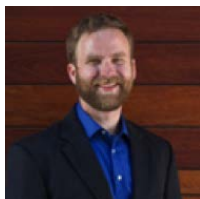
**Clive Granger Research Fellowship**

Six fellowships, named after Nobel Prize winner and longtime Department of Economics faculty member Sir Clive Granger, are awarded each year for the most promising graduate student research.

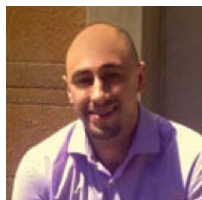
The fellowship carries a small stipend and allows the student to make more rapid dissertation progress by minimizing work obligations for a quarter. Nominations are made by the faculty running the thesis workshops (in consultation with their colleagues) and awards are made by the Graduate Committee.



**Qihui Chen**



**Matthew Gibson**



**Matthew Goldman**



**Nelson Lind**



**John Rehbeck**

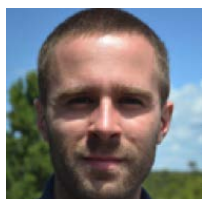


**Tamara Sheldon**

## Faculty

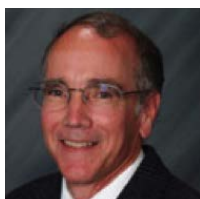
### Undergraduate and Graduate Teaching Awards

In recognition of faculty and graduate students who demonstrate great effort in teaching, the department awards annual prizes for the best undergraduate and graduate teaching. Awards for undergraduate teaching are given to the best faculty member(s), lecturer(s) and associate-in(s) teaching undergraduate courses. Recipients of undergraduate teaching awards are selected by a committee composed of the department chair and past faculty awardees who review undergraduate student evaluations. Awards for graduate teaching are given to the best core course instructor(s) and the best elective course instructor(s). Recipients of the graduate teaching award are selected by current doctoral students.



**Simone Galperti, Ph.D.**

Honorable Mention for  
Advanced Elective Course  
teaching  
Faculty



**James Hamilton, Ph.D.**

Graduate Core Course  
teaching  
Faculty



**Mark Machina, Ph.D.**

Undergraduate teaching  
Faculty



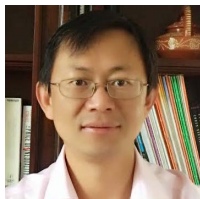
**Marc Muendler, Ph.D.**

Advanced Elective Course  
teaching  
Faculty



**Andres Santos, Ph.D.**

Advanced Elective Course  
teaching  
Faculty



**Yixiao Sun, Ph.D.**

Graduate Core Course  
teaching  
Faculty

**Emily Tang, Ph.D.**

Undergraduate teaching  
Lecturer



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# Economics

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UC San Diego Department of Economics Professor James Hamilton was honored with this year's Outstanding Contributions to the Profession Award from the International Association for Energy Economics. Here are the remarks he made at the Awards Dinner at the 37th annual IAEE conference held in New York City in June.

In 1980 this organization was three years old, and I was in my third year in the economics Ph.D. program at Berkeley. There was a lot of interest in what was going on in energy markets at that time. The oil embargo by the Organization of Arab Petroleum Exporting Countries in 1973-74 and the Iranian revolution in 1978-79 were both associated with significant disruptions in world oil production and big spikes in energy prices. Many of us were persuaded that these events made a contribution to the two economic recessions that followed the two oil supply disruptions.

I was supposed to write a third-year empirical paper at Berkeley. As I was looking into these events, I was surprised to find that this wasn't the first time something like this had happened. The Suez Crisis of 1956-57 resulted in a significant disruption in the flow of oil, and that had also been followed by an economic recession. There were quite dramatic increases in oil prices in 1947-48, and these were followed by the first of the postwar U.S. recessions. In fact, as of 1980, we'd seen seven recessions in the United States since World War II, and six of those had been preceded by a spike in oil prices. I thought, "OK, maybe I should use this for my third-year paper."

As I was working on this topic, Iraq invaded Iran, knocking out even more global oil production, and sending oil prices to all-time highs. The National Bureau of Economic Research declared that the U.S. entered an eighth recession just 12 months after we got out of recession No. 7. I thought, "OK, maybe I should use this for my dissertation."

And so I did. I was resolved that once I finished the dissertation I was going to move on to other areas of research. But world events kept dragging me back. In 1990, after eight years of falling oil prices, and eight years without an economic recession, Iraq invaded Kuwait, knocking out two of the world's biggest oil producers. Oil prices rocketed back up, and it was déjà vu all over again as the U.S. fell into postwar recession No. 9. There was another dramatic move up in oil prices prior to the 2001 recession. And you're all very familiar with the spectacular oil price spike of 2007-08, which was as big in magnitude as any of these other episodes, and which was followed by what we have now come to refer to as the Great Recession. So the count is now up to 10 out of 11 postwar recessions that were preceded by a spike in oil prices. I think there's something to this.

But what could account for this apparent relation? It's easy to write down a model in which energy shouldn't be all that important for the economy. In a frictionless neoclassical model, the key parameter is the dollar share of energy out of total spending, and this is a relatively small number. According to neoclassical theory, equilibrium prices persuade firms and consumers to reduce their energy consumption in response to an exogenous disruption in supply, and any economic costs associated with voluntary reductions in energy use should be smaller than had the users decided just to pay the higher price and go on using energy the way they had been. The total economic loss should be less than the dollar cost of the lost energy.

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But a frictionless neoclassical model won't get you very far in understanding economic recessions no matter what kind of shocks you're looking at. Most of us are persuaded that there are important inefficiencies associated with recessions, as labor and capital become underutilized relative to the efficient frontier. Once you start thinking along these lines, it's easy to see how an energy shock could make a contribution. For example, we often see consumers suddenly stop buying the larger, less fuel-efficient vehicles that have historically been key to U.S. auto industry profits. Loss of income and layoffs in the auto sector then become a separate factor contributing to the overall decline in economic activity.

Certainly many of the economic developments in 2007 and early 2008 were consistent with the patterns in earlier oil shocks. Sales of larger vehicles plunged, and consumer sentiment and overall consumer spending responded to higher gasoline prices in much the same way we had seen them do in previous episodes.

But there was one important difference. Many of the historical oil shocks that I mentioned were associated with dramatic geopolitical events such as wars in the Middle East. But there were none of these in 2007-08. Instead, what happened was that global oil production stagnated even as demand from the emerging economies continued to surge, and this produced the dramatic spike in oil prices.

I think it's clear today that this episode marked the beginning of a new era in which it has been hard for oil production to keep up with growing demand without big increases in oil prices. Since 2005, field production of crude oil has increased very little worldwide, with U.S. shale-oil production accounting for more than 100 percent of the increase – in the absence of these new sources of supply, global production today would be lower than it was in 2005. Add to this the challenges of dealing with the consequences for the world's climate of our fossil fuel consumption, and also add this week's news coming out of Iraq, and it seems pretty clear that it is extremely important to study what is going on in energy markets right now, just as it was in 1980.

So, I think all of you are in the right place at the right time. The right place being the International Association for Energy Economics, the right time being June 2014. The world is in real need of the insights that each of you can bring to these challenges.

Thank you very much for this great honor.

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## Can Japan End Two Decades of Stagnation?

By Johannes Wieland, Ph.D.

A great monetary experiment is taking place in Japan today. In early 2013, the Bank of Japan announced a monetary policy regime change. Along with this monetary expansion, the government is enacting complementary fiscal policy and structural reforms. The hope is to end two decades of stagnation and deflation.

In a recent Brookings paper with Josh Hausman (University of Michigan), we provide a preliminary evaluation of these policies as of April 2014. We argue that Abenomics ended deflation in 2013 and raised output growth by 0.9 to 1.8 percentage points. Going forward, Abenomics will continue to have benefits but so far appears unlikely to close Japan's large output gap. In part this is because the monetary regime change is not (yet) fully credible.



### Abenomics

That Japan needs some new policies is clear. The Japanese economy has stagnated since 1992. Between 1993 and 2012, real gross-domestic-product growth averaged just 0.8 percent. Prices have fallen most years since 1998. Many economists have blamed Japanese policymakers for an insufficiently aggressive response to these trends. No longer.

Shinzo Abe became prime minister on Dec. 26, 2012. A member of the Liberal Democratic Party, Abe campaigned on a platform of radical action to end economic stagnation. His economic program (dubbed "Abenomics") consists of monetary expansion, fiscal stimulus and structural reforms. In a reference to a Japanese legend, these components are referred to as "three arrows."

### Three Arrows of Abenomics

The first arrow is a monetary policy regime change. Beginning in Nov. 2012, then-candidate Abe argued that the Bank of Japan should increase its inflation target and engage in "unlimited easing." The Bank of Japan acceded to Abe's demand, announcing a 1 percent inflation target at its meeting on Jan. 22, 2013. While hardly extreme, 2 percent inflation would be the highest year-on-year inflation rate in Japan since 1991.

The second arrow is fiscal policy. In Feb. 2013, the Diet passed a two percent of GDP "supplementary budget," although the actual stimulus being carried out is much smaller than this headline number suggests. Our preferred measure suggests actual stimulus in 2013 of 1 percent of GDP. This stimulus is dwarfed by tax increases. Consumption taxes rose from 5 to 8 percent in April 2014 and will rise by a further 2 percentage points in Oct. 2015.

The third arrow consists of structural reforms to increase Japan's potential GDP growth. The proposed reforms are thus far mostly vague but include relaxations of labor market rigidities, less protection for farmers, and utility deregulation.

### Monetary Policy Regime Change

We focus primarily on the first arrow of Abenomics: the monetary policy regime change. Our analysis suggests that there is substantial scope for expansionary monetary policy. We find that the current output gap – the difference between current output and potential – is in fact quite large, in the range of 4.5 percent to 10 percent. Thus it can at least be hoped that the monetary regime change will have large effects.

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Financial markets and inflation expectations responded as hoped in 2013. Over the year, the yen fell 21 percent against the dollar, and the Nikkei 225 stock market index rose 57 percent. Measured by inflation swaps and surveys of professional forecasters, long-run inflation expectations in early 2014 were between 1 and 1.4 percent. Combined with a small decline in nominal interest rates, this means ten-year real interest rates have fallen roughly a percentage point.

Growth was also decent. A comparison with professional and statistical forecasts suggests that Abenomics raised 2013 growth by 1.1 to 1.8 percentage points. Our analysis suggests that expansionary monetary policy accounts for a significant part of 2013 consumption growth, perhaps contributing as much as a percentage point to overall GDP growth.

## Assessment

In the medium and long run, Abenomics, and Japan's new monetary policy in particular, is likely to continue to pass a cost-benefit test. We argue that the costs of higher inflation are likely to be small whereas the benefits both to output and the government budget are potentially large. But, as of yet, it appears unlikely that Abenomics will fully close the output gap.

An important caveat to all our analysis is that the full effects of Abenomics are not yet visible because many observers are concerned that the policy will be reversed. The current lack of credibility means that if the Bank of Japan does succeed in raising inflation expectations to 2 percent, output effects are likely to be larger than current indicators suggest.

We will continue to follow Abenomics closely. In twelve months we will write an update for Brookings on the outcomes in 2014. That data should shed further light on the credibility of Abenomics as well as on how the Japanese economy has weathered the consumption tax hike in April 2014.

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