RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

May 2, 2013

GLOBAL MACRO

Tenkan !

"Tenkan, ***a term in several martial arts for a swift, 180-degree pivoting move, has provided the economist and Asia specialist Jacques Gravereau with an analogy for illustrating the ability of the Japanese people to carry out radical changes in direction collectively, flexibly, and energetically."***

Does the policy shift initiated a few months ago by the Japanese authorities qualify as *tenkan?* On this one, the jury is still out, but in any event, this experiment already represents a key stage in the crisis affecting the developed countries.

To highlight its importance, we are publishing two papers on this question. The first one, a brief attempt to put Japan's deflationary episode into perspective, seeks to shed light on why the country was previously in so little of a hurry to deal with this affliction, and why it now feels compelled to take an entirely new tack.

The second paper is by Frank Benzimra, a specialist on the Japanese economy and financial markets based in Asia for about ten years, who has been kind enough to share his thoughts with us. He begins by explaining how Japan managed to make it through fifteen years of extremely high public debt without lapsing into chaos. He then goes on to discuss the pioneering aspects of Prime Minister Abe's new policy. In conclusion, he puts forward **three possible scenarios** for the outcome of "Abenomics," along with the **three investment strategies** they imply.

Departing from our usual practice, we are publishing this contribution in English.

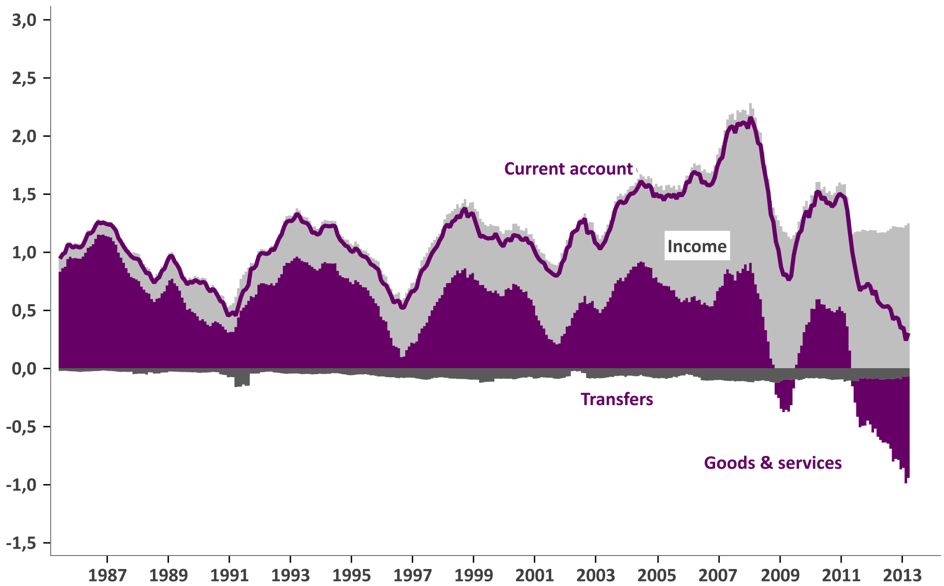
The Japanese Experience and its Relevance to the E.U.

While it's still too early to predict the ultimate impact of current Japanese policy, Europe would do well to take a much closer look at the messages conveyed by Shinzo Abe of late. Underlying the recent break with previous policy in Japan was a simple fact: the country could no longer afford to remain as unconcerned about deflation as it had been for some fifteen years. This point is particularly relevant to the Eurozone countries, where deflationary policies still seem to enjoy quite a following.

Until recently, Japan—an aging, overleveraged nation with a banking system burdened by a huge stock of bad debt—showed a fair amount of complacency toward deflation since it started roughly fifteen years ago. Because it guaranteed low interest rates, deflation helped reduce the exorbitant cost of debt service while raising the value of the government bonds so widely held by Japanese banks and retail investors. It was therefore viewed as a way of consolidating the country's ailing banking system and using the wealth effect to offset a decline in property values and current household income. In addition, lower real exchange rates—reflecting lower labor costs—gave Japanese companies a competitive advantage in the midst of a regional economic boom. Between 1997 and 2008, Japanese exports to China increased sixfold.

By running a comfortable current account surplus, the country maintained its financial independence and averted the risk of higher financing rates

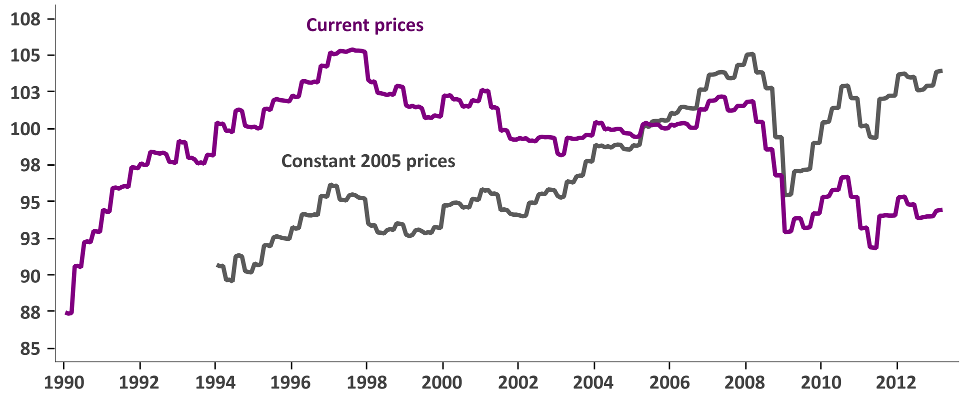
Japan's Current Account, Trn Yen



Sources: RichesFlores Research, Macrobond

This may have seemed like a winning strategy, but it obviously couldn't last. First of all, the adverse effect of deflation on investment would eventually weaken Japan's export capacity. Second of all, the erosion of nominal potential GDP growth would necessarily drive the structural debt level up. Last of all, a rapidly aging population was bound to save less than in the past. So sooner or later, the whole setup would prove unworkable. When exactly was a question of how long the country could keep running a trade surplus. As it turns out, that got harder in the wake of the financial crisis, and even more so following the Fukushima disaster and the resulting increase in national energy dependence. Japan's current account surplus, equal to 5 percent of GDP just before the crisis, is gone today—and tomorrow, it may give way to a deficit. **Indifference to deflation had clearly become an indefensible stance. This is what had changed, and therefore why economic policy had to change in response.**

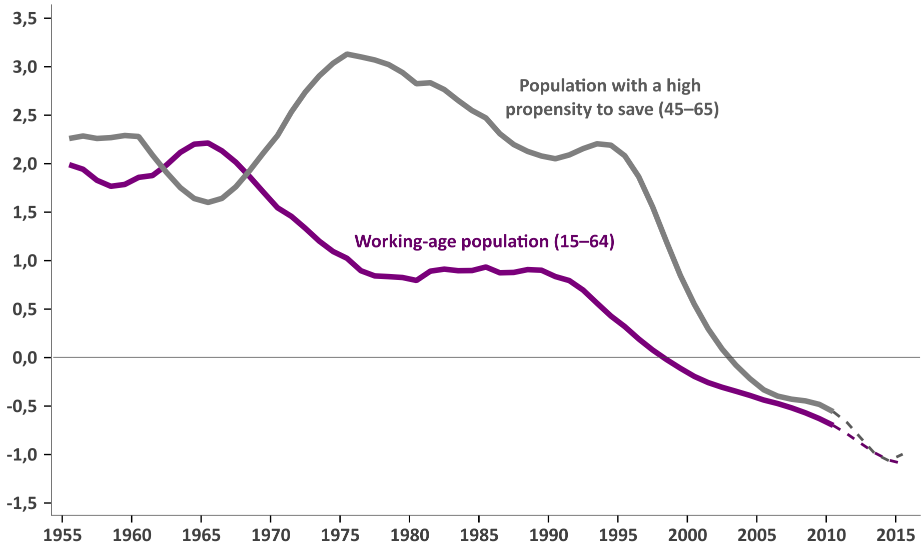
Per Capita GDP in Japan, 2005=100



Sources: RichesFlores Research, Macrobond

Japan's Population

AARG smoothed over 5 years, % points



Sources: RichesFlores Research, Macrobond

That the policy shift engineered by the Japanese authorities takes the form of a currency war is largely beside the point. The fact of the matter is that they have no other option than to pull out all the stops to stimulate growth, even if it is only nominal growth.

What are their chances of succeeding? No one can really say at this stage, especially since a decade of deflation has probably left the Japanese population with deeply ingrained habits. Before it pays off in competitive terms, a falling yen will accelerate the slide in the country's current account by raising the energy price tag. Conventionally referred to as the J-curve effect, this development could exert even stronger deflationary pressure on domestic demand—which only higher wages can possibly counteract. So the solution, assuming one exists, will have to be explicitly inflationary. And that means we're confronted with a sharp break, a 180-degree turn—a *tenkan* moment.

Véronique Riches-Flores
contact@richesflores.com