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A Tenkan Moment for Japan

Jacques Gravereau, a French economist and specialist of Japan, defines the word *tenkan* as the Japan collective ability of making radical U-turns, adapting to new conditions in a both flexible and vigorous way. Such changes, far from being cosmetic, are deeply rooted in a new and intimate conviction. Japan conversion from insularity to embracing overseas knowledge in 1868 or from militarism to pacifism in 1945 illustrates this remarkable feature of the Japanese society.

Growing fiscal imbalances and shrinking current account surplus have created the conditions for yet another *tenkan* moment. Taro Aso, the Finance Minister and strong man in the Abe administration has explicitly referred to Takahashi[1] economic policy in the 1930s as a template for exiting deflation and reviving growth. It indeed indicates a truly new approach in dealing with the country's economic issues.

While inflationary policy would hurt retirees, the landslide LDP parliamentary victory suggests popular support for exiting deflation, the main pillar of Abe policy -along with a renewed nationalistic stance in diplomacy. The first decisions of Haruhiko Kuroda as new Bank of Japan Governor and the soaring popularity of Abe since general elections, an oddity in recent times, reinforce the case for the new Administration's determination to deliver on its promise with full support from voters. **The July Senate elections will be the key event to monitor.**

Markets believe in *Abenomics* but the uncertainty of its outcomes is exceptionally high: by committing to numerical targets of inflation and nominal growth rate, the Abe economic platform indeed questions the circle of soaring public debt, nil nominal rates, low yields and rising yen, which has been a fixture of Japan in the last fifteen years. Breaking this circle could bring the Japanese economy and financial assets into unknown territories and lead the JPY to much weaker levels.

The first part of the article examines the reasons for the sustainability of the seemingly unsustainable fiscal imbalances, the second analyses the innovative nature of *Abenomics* and the third describes three scenarios for financial assets: success (the inflation and growth targets are achieved), relapse (deflation remains entrenched) and meltdown (inflation rises well above the target). While the number of financial assets' trajectory is naturally infinite and probabilities on each of them hard to attach given the novelty of the political commitment and the radical nature of monetary policy, the risk-reward profile of selling the yen has considerably improved.

[1] Finance minister in the 1930s, who famously led the BOJ to monetize government debt.

The amazing sustainability of Japan fiscal imbalances

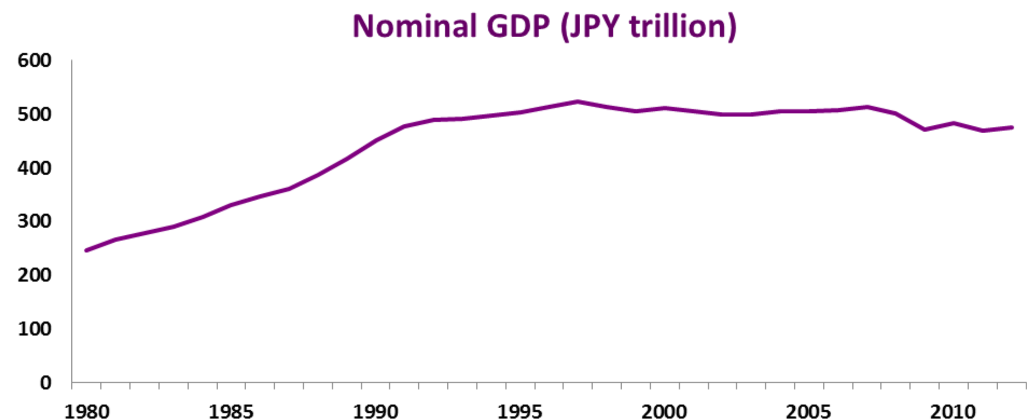
Historical perspective….

While sometimes forgotten after the infamous two last decades, Japan used to be a dynamic economy, enjoying between 1973 and 1991 a more than 4% growth, a balanced budget, low unemployment and moderate consumer price increase. As the JPY soared and interest rates were quickly reduced in the second half of 1980, equity and land prices bust and economic growth collapsed. To maintain global output, government spending compensated for weak private demand. Stimuli were successful as jobless rate never rose above 5.5% -better than the lowest level of most OECD countries- but were achieved at the price of massive fiscal imbalances.

Fiscal deficit rose from an average 1.7% of GDP in the 1990s to 5% in the period 2000/07. Public debt soared from 67% to more than 200% and the net public debt reached 130% in 2012. As a result of the massive deleveraging process, the government dissaving was offset by a corresponding private sector financial surplus comprising large household savings and corporate surplus.

In spite of the government massive spending, nominal GDP barely grew as private demand remained bridled by poor demographics and corporate deleveraging.

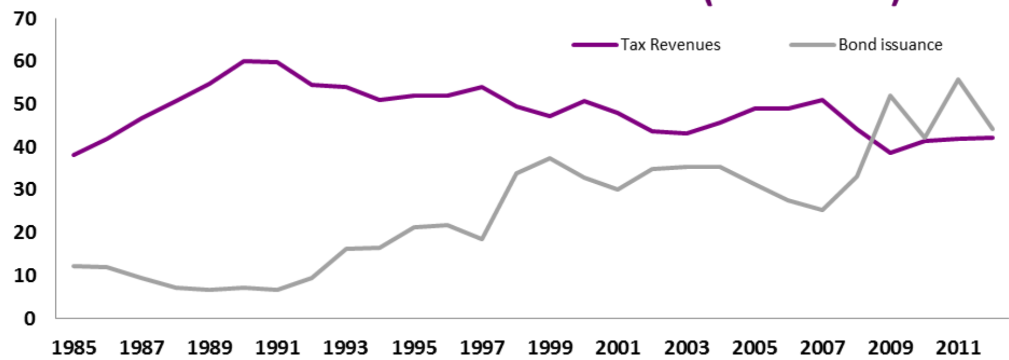
For comparison purposes, Japan's nominal GDP grew by 0.2% between 1990 and 2012 versus 2.9% in France, 3.2% in Germany and 4.4% in the UK and the US.



Private sector atone growth led to growing fiscal imbalances:

- Tax revenues declined from JPY 60 trillion in 1991 to 44 trillion in 2012 as a result of lackluster growth, unfavorable tax revenues mix and ageing population.
- Public spending continued rising, leading to a widening in the primary deficit and larger bond issuance to finance it. As a result JGB issuances have been exceeding tax revenues for the first time in 2010 while servicing debt has been absorbing a quarter of the budget.

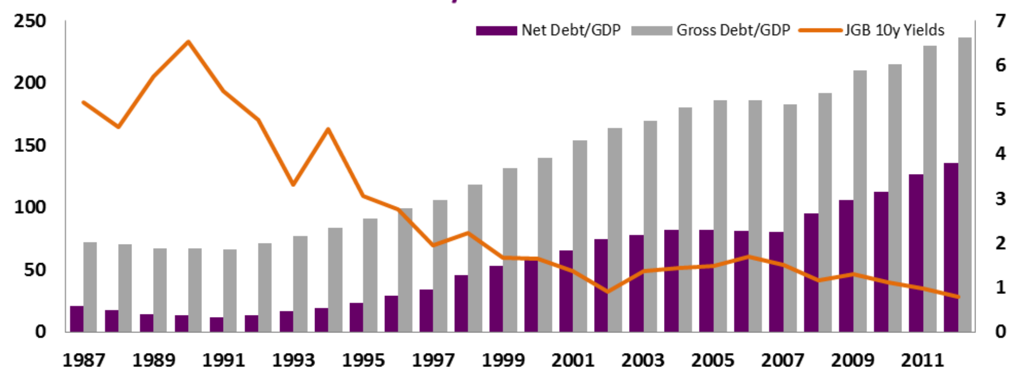
Tax revenues and bond issuance (JPY trillion)



Sources: Ministry of Finance

Compared to its OECD countries peers, Japan ranks alarmingly low on most metrics of fiscal discipline: worse GDP/Debt ratio, worse primary deficit, worse tax revenues to public debt issuance ratios, etc. Yet, government bonds yields have remained among the lowest in the world; and contrary to standard (Keynesian) theory, yields move have shown little sensitivity to deficits.

Debt/GDP and JGB



Sources : IMF, Bloomberg

Private sector savings and home bias

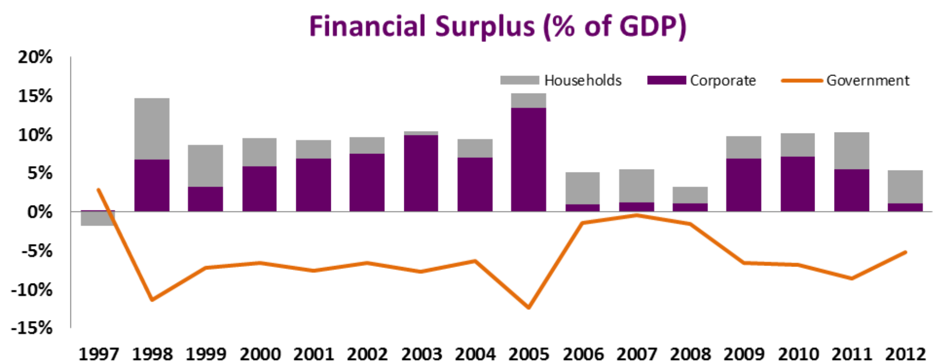
Usual explanations for such divergence include two specificities of the Japanese economy and financial institutions.

- **Firstly, Japan enjoys abundant private savings, coming from household and corporate agents.** Flow of funds statistics show that financial assets held by corporate and households amount to nearly JPY 3,000 trillion (450% of GDP) versus liabilities of less than JPY 1,000 trillion.

  Analysis of Japan private savings generally tend to focus on the rapidly declining rate of household savings, quickly becoming negative and fuelling the most catastrophist theories. There are two flaws in such view.

- It ignores deflation when measuring the household savings rate. Japan is in an "upside down" world, and when the savings rate is adjusted by some price measures such as the inflation or the GDP deflator, it jumps by several percentage points. In an inflationary world, the declining savings rate would become truly alarming.

- The second and still more crucial flaw consists in equating private savings with household savings. In fact, as it could be expected in a "balance sheet recession", corporate savings (i.e. assets of the corporate sector minus their liabilities) have largely offset the declining rate of household savings resulting from decaying demographics. While nominal household saving rate has declined from 10% in 1981 to 3% in 2009, the corporate savings rate has increased by more than 8% percentage points to 21% over the same period. Unusually for a normally well-functioning economy, the corporate sector turned from being a net borrower in the 1980s/1990s to being a net creditor thereafter. The financial crisis, while compressing earnings, has actually resulted in rising corporate savings as firms further held back on investment and hoarded more cash.



Sources : Bank of Japan, flow of fund statistics, IMF

- **Secondly, the government has benefited from a large home bias.**
  Unlike most large sovereign bond markets such as those of the US, Italy, Spain, France or the UK, Japan government debt is mostly held by domestic investors. The IMF estimates in a 2010 working paper that households hold more than half the JGB stock, marginally directly and massively indirectly through banks (including the Japan Post Bank) while foreign investors hold a mere 7% of the stock of JGB.
  Among domestic financial institutions, the Japan Post Bank and the Japan Post Insurance, two publicly-owned enterprises, have been very large and captive purchasers of JGB as not being subject to the same regulatory disclosure and controls than other financial institutions in exchange for holding "safe assets".

The corporate financial surplus, the bias of households towards holding JGB and the lack of any meaningful foreign investment, all together, made the cost of financing the debt manageable despite the even expanding debt level and debt to GDP ratio.

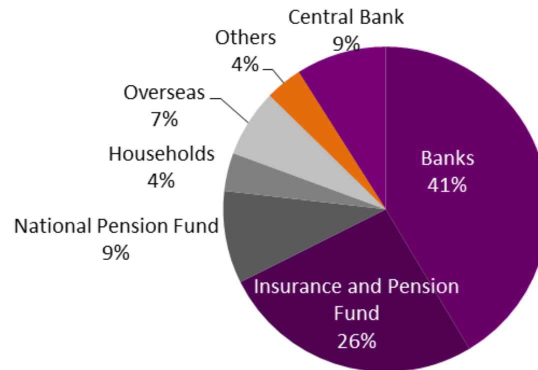
When do fiscal imbalances become unsustainable?

The growth/interest rate "equilibrium", the current account balance and fiscal deficits worsening are key factors to be considered.

- **Economy growing less rapidly than interest rates**
  Whatever the anemic GDP growth, as long as it remains superior to the interest rate levels (the debt is denominated in local currency), the primary deficit can be financed. This has been the situation of Japan over the last five years.
  The combination of generous fiscal policy and more aggressive quantitative monetary easing in a low growth high indebted country may have unintended consequences as such a mix in post-bubble Japan can potentially modify the equilibrium between high debt and low interest rates. A key risk would be excessive JPY weakness having a recessionary impact because of higher energy prices.
- **Massive capital outflows and shrinking current account surplus**
  Expectations of higher inflation and lower JPY may trigger a large diversification of household and corporate assets overseas. Corporate may be tempted to accelerate overseas acquisitions given shrinking domestic opportunities. One may wonder whether the purchase of Sprint by Softbank (although being currently challenged), instead of being the exception, could become the norm and could pioneer further international acquisitions.
- **Fiscal deficit worsening in a context of reluctant JGB buyers**
  Abenomics are to be implemented at a time when major financial institutions holding large percentage of JGB have been reformed: the Japan Postal Bank and the Japan Postal Insurance have been allowed to diversify to other assets; the Government Pension Investment Fund has no longer any obligation to purchase the JGB issued by the FILP for infrastructure projects. The IMF estimates that a relative moderate allocation switch of 10% from JGB to other assets could amount to JPY 20-30 trillion or 4-6% of GDP.

The current fiscal stimulus, while exceptionally large (JPY 11 trillion, the second largest of such packages since the bubble bust), has so far not created any JGB spike. However it may not be the last stimulus. Another one may be needed in the fiscal years of 2014 and 2015 to compensate for income and VAT tax increases if growth has not yet resurrected.

Japan: Shares of JGB Holdings (as at December 2011)



Sources : MOF, 2012 Debt Management Report

Abenomics: An unusually strong stance on inflation

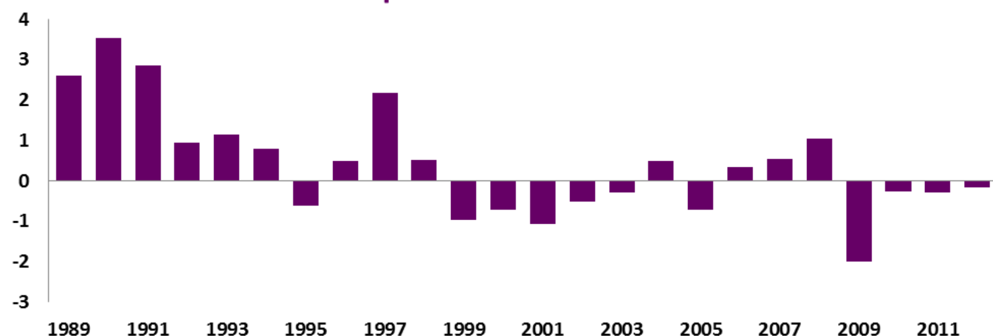
Since deflation appeared in Japan in the second half of the 90s, policymakers have not been fully committed to combat it. They might not have a strong political interest to do so.

A deflation bias

With hindsight, Bank of Japan policies have not been successful in ensuring price stability and still less in ending deflation.

- **Before the credit crisis-** the Bank of Japan has introduced quantitative policy measures in March 2011, three years after inflation has turned negative. Rates were prematurely hiked in August 2000 and in August 2006 at a time when the price regime remained highly uncertain.

Japan Inflation Rate



Sources: IMF end-year

- **The credit crisis-** Although Japan's output has declined more brutally than most other OECD members', the extent of quantitative easing measures fell short of expanding the Bank's balance sheet to the same extent that the FED's, BOE's and the ECB's.

The deflation bias has been well engrained in the Bank's thinking. It could be even fair to say that Japan Central Bankers have not tried hard enough to restore inflation. In a speech given in March 2000 by Masaru Hayami (then BOJ Governor), a key differentiation was between "good" deflation, typically brought from technological progress and rising productivity, and "bad" deflation coming from an imbalance between supply and demand:

"We need to consider the possibility that major industrial countries, including Japan, are entering a "new price revolution era." Such development has been born of the rapid expansion of economic activity related to information and telecommunications, in other words the "IT revolution." This is characterized by extremely rapid technological innovation which induces price declines through the improvement in productivity and the development of new products […] If the IT and distribution network revolutions continue under the current situation of zero inflation, ***we cannot rule out the possibility that the economy could recover while the inflation rate is negative in terms of the existing price indexes****, even though they may not sufficiently incorporate these revolutionary changes"*

Scenarios

There are at least three possible outcomes for financial assets. In the first, *Abenomics* succeed. In the other two, it fails either for the usual reasons that Japan markets have experienced since the bubble bust (growth relapse) or for more unconventional reasons (inflation rising more than growth).

First scenario: success- This is the scenario that the financial markets are currently inclined to believe in: policymakers successfully jump start the economy by weakening the JPY, price inflation raises corporate profits and stimulates private demand while keeping JGB yield rise under control. The Bank of Japan could go as far as monetizing the debt[2]. In such scenario growth would increase more quickly than interest rates and the public debt would be kept under control. A moderate rise in inflation would spark bond market's volatility but the pick-up in yields would be more than offset by a commensurate increase in private demand, which would increase tax collections.

Investment strategy in a successful scenario: buy equities hedged in USD, sell JPY and keep JGB holdings

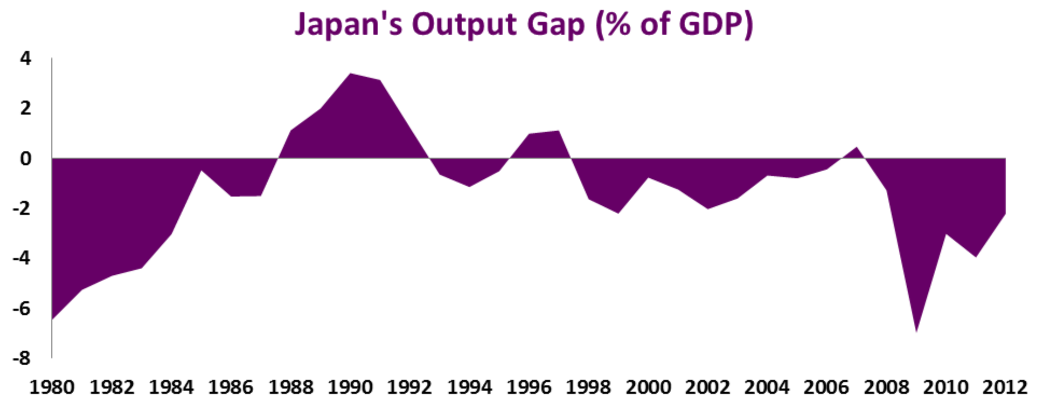
Second: relapse- A possible outcome would imply a failure of the Administration to inflate the economy. So far, Abe pledge to inflation remains just what it is: words.

- Politically, Abe may not have the clout to dictate economic policy to BOJ/MOF civil servants, who have traditionally been the effective economic policy managers. Abe, like Aso, does not have a history of successfully conducting the economic policy as their past short tenure as Prime Minister is suggesting. The failure of the Democratic Party of Japan to make any meaningful change to conduct economic policy, although it swept to power on an anti-technocratic move, should be a reminder of political leadership fragility.

- Economically, there is no example of inflation targeting when the economy is in deflation. While inflation targeting may alter expectations of economic agents (consumers), it could be argued that it cannot be obtained by decree and commitment. Deflation is both a cause and a symptom of Japan economic malaise. Given the size of the output gap, the 2% target may be extremely hard to achieve in a context of mediocre global growth, sluggish private demand and rising energy prices. March CPI numbers have come at a depressingly -0.9% and underline the difficulty of the BOJ task.

Investment strategy in the relapse scenario: sell equities, buy JPY and JGB. This should be only a tactical trade. The return to status quo is unlikely given deteriorating current account surplus.

[2] Within the new "Quantitative and Qualitative" easing policy framework announced on 4 April, the Bank of Japan has not only decided to double the purchase of outstanding JGB to JPY 50 trillion and to more than double the maturity of JGB purchased (above 7 years) but it has also suspended the "Banknote Principle" according to which the outstanding amount of long term government bonds effectively held by the BOJ be kept below the outstanding balance of banknotes issued.



Sources : IMF

Third scenario: a domestic and global markets meltdown- The IMF[3] describes a still more worrisome scenario, which would materialize when nominal rates rise faster than growth as inflation could exceed the target. In some way, the danger of *Abenomics* is that it succeeds beyond expectations of moderate inflation. Bond investors would then require higher interest rates to hold JGB and inflation would rise. The classical short JGB trade may finally become alluring when seen from the lens of the new government agenda.

Following the IMF frame, we can assess the consequences on both public and private balance sheets, both domestically and internationally.

- **On Japan domestic assets, inflation would weaken further the JPY, which would be potentially disruptive for bonds and highly uncertain for equities.**
  - On public balance sheets, a return to inflation would lead to higher nominal rates as investors would require a higher risk premium to hold government bonds.
  - On private balance sheets, consequences could also be devastating given the weighting of JGB among financial institutions (15% of their balance sheets). Banks' capital would be under threat as losses should be marked to market.

- On internal domestic assets, a nightmare scenario could easily be contemplated given the size of Japanese institutions' holdings in US Treasuries, more than USD 1000 billion and the role of Japanese banks in international lending. Some funding issues could then be seen in Korea and Europe.

Investment strategy in the meltdown scenario: buy put on JGB futures, steepeners and inflation linked-bonds; sell equity and the JPY

The second scenarios has a sense of *déjà vu* as equity markets have experienced numerous periods of economic recovery and equity market bust over the last twenty years. The current equity market upturn would then be just another false dawn.

[3] IMF, Japan Sustainability Report, November 2011

The third scenario, while often contemplated in the past, has never materialized. Odds of inflation rising and growth faltering have however increased given the Administration desire to end the status quo. While the third scenario may have the lowest probability of occurring, the consequences for the domestic and global economies may be the most devastating. This is yet another reason to sell the yen.

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