Japan

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With a better than expected start to the new year some observers have been hailing a long awaited flickering light at the end of the tunnel. However, one swallow does not make a summer, and there is more work to do to turn around Japan's battered economy and financial imbalances.

Summary and conclusion

Upbeat signals: Following a shallow recession in 2014 when the economy contracted by 0,1% in response to the 3pp VAT hike, the 1% expansion in Q1 2015 over the previous quarter came as a long awaited relief. That was so not least because the recovery was driven by broad based domestic demand. Thus, for the rest of the year we expect the momentum to continue. The labour market has tightened further seeing unemployment fall to 3,2%, as the market is losing 1mn. workers a year due to ageing. Wage growth remains minimal, but that could change before long.

Loose fiscal policies set to continue: After several year of ultra-loose fiscal policies, the new government under PM Abe since 2013 has begun to reign in the government deficit which last year ticked in at 8.5%/GDP. In April 2014 it hiked the VAT by 3pp to 8% as the first step of this policy with the intention to continue with another 2pp hike in 2015. However, seeing the sharp negative response on the economy, courage failed. The central bank in return ramped up its own ultra-loose monetary policy by increasing its annual purchase of government bonds (JGB) from JPY50trillion to JPY80trillion in an effort to shore up demand and kick-start growth. Structural policies, by contrast have seen less vigour from the government. The impression is therefore that the government so far has opted for politically easy measures but shied away from more controversial steps including structural reforms.

Near term light: The near term future looks reasonably good with growth gradually picking up to 1,8% in 2016 buoyed by new reductions in corporate taxes, some wealth effects of stock market strengths and perhaps a revival of the property market. The question mark remains, however, how this recovery will meet the shock of the delayed VAT rise now scheduled for early 2017. In the meantime a possible sharper slowdown in China and/or global financial turmoil when the US eventually hikes interest rates over the next 6-12 months dominate downside risks. Possible market contagion from the latter would see the government financing cost escalate quickly while banks may incur significant revaluation costs on their large bond holdings.

Long term shadows: The longer term scenario, by contrast, is overshadowed by two intertwined threats: inability to stop the further rise of the government debt ratio, already standing at 244%/GDP in gross terms and the possible explosion of social security expenses for a rising elderly population.

Over recent months the sovereign has suffered two downgrades by the rating agencies, each by one notch in the lower A-category coming in both cases on the heels of the postponement of the second scheduled VAT hike raising to 2017 on concerns about the government's commitment to arrest its growing debt burden. We see those rating actions primarily related to the sovereign but with relevance also for the country.

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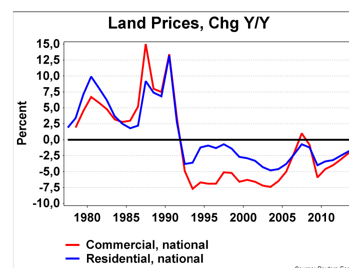
Recent developments

Following a shallow recession in 2014 when the economy contracted by 0,1% in response to the 3pp VAT hike, the 1% expansion in Q1 2015 over the previous quarter came as a long awaited relief inasmuch as it was driven by broad based private domestic demand. For the rest of the year we expect the upbeat momentum from Q1 to continue.

Growth revival: Last year ended with a shallow recession of 0,1% yoy (year-on-year) as the economy reacted with a steep downturn after the government had hiked the VAT rate by 40% from 5pp to 8pp (percentage points) in April. This had immediate negative effects on private consumption and investments despite some band aid from the government in terms of a supplementary fiscal package. So far this year, however, growth momentum has revived as manufacturers revved up inventory building in anticipation of rising pent-up demand from households as they now benefit from reduced oil prices compared with a year ago and wealth effects from a booming stock market. In return, tax cuts for companies will boost profits and business sentiment in support of investment demand. As a result, observers have adjusted whole year growth for 2015 up by 0,2pp to 1%. That is despite continued headwinds from fiscal consolidation, less upbeat data for consumer confidence in April and the apparent continued drag from net exports in real terms.

Inflation still much below government targets: In 2014, the consumer prices jumped 2,7% yoy as measured by headline CPI from only 0,4% one year earlier. The jump was clearly related to the VAT hike in Q2, without which prices would have remained almost unchanged in line with the development of the last two decades. In the first three months of the current year, prices were still up by more than 2% yoy reflecting base effects, but when these dropped out in April and May the annual inflation rate was back to trend only slightly above zero. That is much below the government's target of 2% annual inflation -- a linchpin of its effort to put the economy and the fiscal balance back on sustainable paths. It is also remarkably low in view of the 30% depreciation of the yen over the last two years. According to government calculations, that should now have raised price pressure above 0,5% yoy. That said, the effect of the new drop in the yen since last fall may have yet to work its full way to price formation. In return, it is encouraging that prices in the property market seem to have bottomed out last year.



Labour market tightening: Since the Global Financial Crisis (GFC) in 2008-9, the rate of unemployment has dropped significantly and is now down to only slightly above 3%. That is below the estimated full employment number of around 3,5% meaning that competition for workers should start to pick up and show off in higher wages. While recent Spring wage negotiations ended with pay awards around 2-3%, this was limited to so-called regular workers who are employees with permanent work contracts. They represent a minority as well as a diminishing share of the total labour market. Non-regular workers are poorly organized with less influence on wage formation. On average, in last April wages rose around 0,9% yoy, thus falling by almost 2% in real terms.

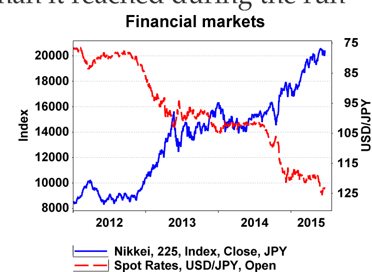
Shrinking workforce: On its own merits, this should be a welcomed development inasmuch that it should improve the functioning of the labour market by reducing the protected status of regular workers which hampers flexibility and mobility. Then

in return, the compositional shift has the side effect of limiting the average pay check, at least in a transitional period, thus working against the government's objective of supporting household incomes to boost private consumption. But the labour market is now losing 1mn workers a year, or about 1,5% of the labour force due to ageing. This secular tightening will at some point in time begin to drive up wages. Some observers are even beginning to worry that cost-push inflation could be around the corner and that the authorities should be careful about what they wish for unless the succeed in raising low participation rates among elderly and women – the latter standing at only 65%.

Current account surplus recovers: Last year the current account balance ended at only 0,5%/GDP, the lowest since the early 1980s, because imports outpaced exports. In the four first months of the current year the current account surplus was already up $45mn. about twice as much as the result for the entire 2014. This was mainly a reflection of low oil prices and further gains in the income and services accounts. Since late 2014, inbound tourism has boomed as visitors have taken advantage of the cheap yen. In 2014, income from overseas investment also soared to $150mn and indications are that this momentum is poised to continue. Manufacturing exports, by contrast, are more of a mixed bag. In Q1 they ended up 9% yoy, but in April-May they were down almost 4% on the previous quarter largely as a result of weaker import demand in China which represents the second largest Japanese export destination with 18% of the total.

Large reserves continue: Since 2012, reserves at Bank of Japan (BoJ) -- central bank -- have remained relatively stable at about $1200bn – enough to cover the import bill for a year and a half. In view of the current account surplus that suggests net capital outflows. The reserve level of almost 25%/GDP represents almost half of Japan's strong net international position at 60%/GDP.

Stock exchange soaring: Over recent years the Tokyo Stock exchange's headline Nikkei Index has sky-rocketed 150%. That is higher than it reached during the run-up to the GFC but still clearly shy of the elevated heights during Japan's heydays of the late 1980s. The first rise, in early 2013, occurred before serious debate had come to dominate public discourse about economic revival. It may also seem preposterous to claim that investors have been much enthused about economic fundamentals since mid-2014 -- the time of the second surge. At least a part of the rise can be explained by technical factors including the depreciation of the yen that
has offset much of the stock market gain.

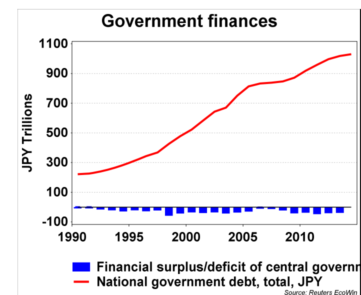


Financial policies

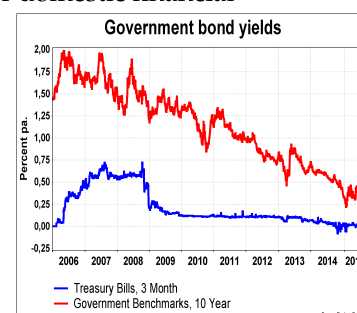
After several years of ultra-loose fiscal policies, the new government under PM Abe since 2013 have begun to rein in the central government deficit. In April 2014, it hiked the VAT by 3pp to 8% as the first step with the aim to continue with another 2pp hike in 2015. However, courage failed seeing the stark reaction of the first hike on domestic demand. In 2013, the central bank launched an ultra-loose monetary policy with the aim to double the monetary base over two years by buying an annual amount of JPY50trillion worth of JGB (Japanese Government Bonds) from the market. In 2015, this was raised further to JPY80trillion in an effort to shore up demand and kick-start economic growth. Structural policies, by contrast have seen much less vigour from the government. The impression so far is therefore

that the government has opted for the politically easy measures but tiptoed around steps that could prove more controversial.

Slowly reining in the deficit*:* Last year the government deficit dropped 0,5%/GDP to 8,5% after the VAT boosted revenues by 1,5% which in turn was offset by a stimulus package worth about 1%/GDP. The effect on the deficit would clearly have been larger without the sharp downturn in the economy during the three last quarters of the year and the corporate tax cut of 2,5pp. For the current year, the government apparently still lives by the original target of halving the deficit to less than 4% and justifies this by pointing to rising corporate tax revenues which in return reflect a strengthening moment of profit growth since late 2014. Observers see a more moderate development but estimate an improvement to the fiscal situation by at least 1,4%/GDP to about 6% also supported by very low financing costs in response to monetary loosening. Last year the government paid only 0,9%/GDP in interest cost, implying a primary deficit around 5%/GDP.



Government debt rising steadily: According to some measures government debt has now reached 240%/GDP of which about 20% is local governments (LG) liabilities. Those numbers are presented in gross terms. Netting out significant government assets, the measures differ widely depending on definitions. OECD cites an estimate of 129% of GDP[1], while others put the number much higher, at 226%, then including LG. A reasonably "safe" method of net debt calculation independent of definitions is to accumulate over time all annual fiscal balances which in our calculation (data for 1980-2014) yields a present debt ratio of 144%. The latter is higher than any other OECD country except Greece and calls for vigilance about the Japanese government debt situation. With a primary deficit last year of 5%/GDP and a nominal growth in the economy at only 1,5%, debt accumulation may have continued to the tune of 3-4% -- again higher than most OECD countries except Greece. So far, however, deficit financing remains unchallenging with interest rates as low as 0,4% on 10 years GJBs. Half of them are held within the broader public sector, and the rest mostly with banks and other domestic financial institutions. Foreign investor still own less than 10% -- a ratio which has remained quite stable in recent years. Average maturity is quite short, estimated at 3,8 years. Neither CDS prices nor interest rate differentials indicate budding investor nervousness.



What is the future of the fiscal debt situation? The recent hike in the government debt ratio is in part linked to special circumstances, including the GFC and the following anti-crisis measures but also the Great East Japan Earthquake in 2011 which prompted reconstruction and rescue operations of more than 5%/GDP. However, the deterioration of the fiscal situation has a longer history. While revenues have kept their share around one third of GDP over the last two decades, public social spending has doubled from 12% in 1990 to 24% in 2013. As the ageing of the society is set to continue for more decades to come, social security spending will continue rising by about 0,2%/GDP per year. Without corrective policies, the

[1] OECD Economic Surveys –Japan – Overview, OECD April 2015

OECD projects that gross debt could rise to more than 400% of GDP before the middle of the century.

Monetary easing getting more aggressive. Seeing the weak underlying inflation trend following last year's VAT hike the BOJ has accelerated its monetary expansion by 60% since last October. It has stepped up its annual speed of asset purchases – mainly JGBs -- from the private sector by JPY30trillion to JPY80trillion with the objective to achieve its goal of raising the annual rate of consumer price inflation to 2% by the end of the current year. That is now obviously quite unrealistic and so the mile-post has been moved to 2016. The policy has been nick-named by its acronym QQE – Quantitative and Qualitative Easing.

Is the easing effective? The intention has been to double the monetary base which includes deposits with the central bank from other banks in the hope this would induce banks to lend out more money. To some extent that has been achieved, but with so far limited evidence that the new money have found their way to the real sector of the economy. In return, they have rather buoyed the stock market. That may have provided some support to private consumption and investment but then weakened the exchange rate thereby raising import prices with negative effects on the households purchasing power. The positive effect on exports, by contrast, seems so far to have been contained by the weaker than expected global economy. Opponents of BoJ's monetary easing argue that not only is QQE relatively inefficient in supporting real economic growth, but also carries risk in terms of disrupting the normal functioning of the capital market while fuelling asset bubbles. The central bank already owns a quarter of the JGB market and its balance sheet has ballooned to 65% of GDP.

Exchange rate policies: BOJ does not officially take a stand on the exchange rate. After its present drop of some 30% in effective trade weighted terms since the peak of the yen in late 2012, the IMF recently described the external position of Japan as being "…broadly in balance". That seems as a halfway appreciation from the international institution of the new and lower exchange rate level of the yen.

Banks regaining health: Banks have regained much health since the lost decades that followed Japan's financial and economic crisis in the early 1990s. They have taken advantage of a strong domestic funding position to grow to almost twice the size of annual GDP. Supported by a high private sector propensity to save with local financial institutions, deposits have grown to more than two thirds of their liabilities limiting banks' recourse to market funding. Banks' loan books, in contrast, are well diversified: Households dominate 29%, real estate 14% and manufacturing 12% with a variety of sectors in the balance. Non-performing loans (NPL) from zombie companies of the past have been worked down by now. However, a significant part of banks' recent expansion has been placed in government debt instruments almost tripling their holdings of JGBs to a quarter of total assets. That has caused worries among observers in case interest rates should rise for other reasons and then produce sharp drops in bond valuations. Since last year, however, banks' JGB holdings have begun to shrink as a result of BOJ's buying spree.

Structural policies in limbo: Structural policies, the so-called "third arrow" in PM Abe's economic strategy has made less progress than the two others -- fiscal consolidation and monetary easing – since first launched in the summer of 2013 under the heading *Revitalization Strategy*. That program had several elements:

- Raise the low rate of female participation in the labour force

- Increase labour market flexibility and mobility
- Open the agricultural sector to more foreign competition
- Improve corporate governance
- Raise more venture capital
- Reduce domestic product market regulations, impediments to new entries.
- Conclude more trade agreements including the TPP

Cultural roots and vested interests: Many of those issues are likely to have deep cultural and societal roots meaning that policies to change them could be long in their gestation. In other cases vested interests are at play. A case in point is agriculture which is protected by strict import quotas with the result that Japanese consumers pay about 1,8 times more for their food basket than households in comparable countries. But the average age of Japanese rice farmers is close to 70 years and their political influence will eventually fade.
Foreign trade: Over recent decades Japan has concluded 15 foreign trade agreements, but their coverage has not reached beyond 25% of its foreign trade. At the present it is engaged with the US in the TPP negotiations. It also hopes to conclude a similar framework with the EU.
Productivity: Japan's main problem, however, is its declining rate of total factor productivity (TFP). Despite spending an unusually high 3,4% of GDP on research and development, TFP has stayed low at only 0,7% annual growth for most of the last decade and is not expected to improve in the next. The OECD points in particular to low firm creation as older companies dominate and only one quarter of small and medium-sized companies are younger than 10 yrs. That is in part due to high public support for SMEs in the past with the objective to keeping non-viable "zombie" firms afloat. As another indicator of the same – lack of renewal and "creative destruction", the Paris-based institution notes that the number of bankruptcies are eye-catching low at a third below its 2007 level while in other OECD countries it is up 66%.

Politics

The present coalition government since late 2012, is supported by the long-standing right-of-centre Liberal Democratic Party (LDP) and a more recent new-comer, the centre party Komeito with roots in Budhism. Next parliamentary elections are scheduled for 2016. In a recent lower house election late 2014, the ruling coalition upholds its super majority in the legislature thus facilitating new policies initiatives although the three arrows policy is anyway basically supported by the much of the Parliamentary opposition.

Security policies have recently focused on loosen up the former strict interpretation of Japan's defence policy to allow the army support allies in case of military confrontations in the region. That would break with the country's pacifist stance since WW2 but has been prompted by the intensifying conflict with China over maritime borders which has the potential to pull in the US because of its defence agreement with Japan.

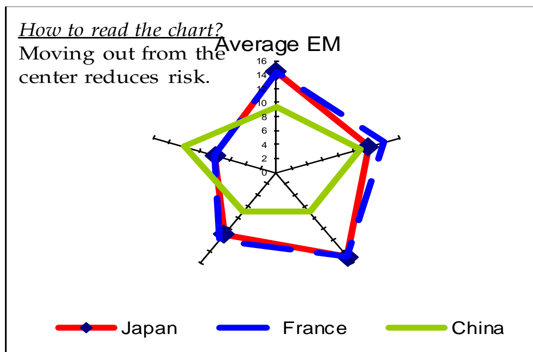
Outlook

Near term light: The near term future looks reasonably good with growth gradually picking up to 1,8% in 2016 buoyed by new reductions in corporate taxes, a possible revival of the property market and perhaps some wealth effects of the stock market. The question mark remains, however, how this recovery will meet the shock of the delayed VAT rise now scheduled for early 2017. In the meantime, a possibly sharper

slowdown in China and/or global financial turmoil when the US eventually hikes interest rates over the next 6-12 months dominate downside risks. Possible market contagion from the latter would see the government financing costs escalate quickly while banks may incur significant revaluation costs on their large bond holdings.

But long term shadows: The longer term scenario, by contrast, is overshadowed by two intertwined threats: inability to stop the further rise of the government debt ratio, already standing at 244%/GDP in gross terms and the possible explosion of social security expenses for a rising elderly population. In Box 1 we explore the consequences of a possible rise in the premium on JGBs in a short to medium term scenario.

Key ratios	**2015**
Population (mill.)	126.8
GDP/capita ($)	31 771
GDP(% change)	1.0%
Inflation	0.3%
Curr.Acc. Balance/GDP	1.8%
Reserves/imports (months)	37
Budget balance/GDP	-7.1%
Government net debt/GDP	230%



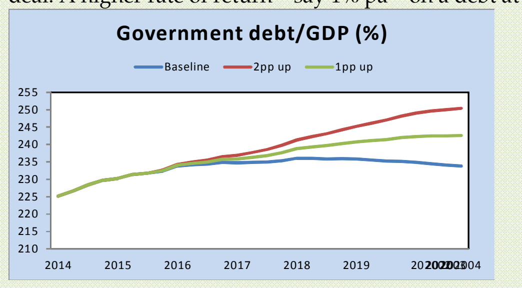
External ratings:
Fitch: A
Moody's: A1
S&P: AA-/neg.

Peers:
USA
France
China

Graph: The graph shows Japan as a strong country with much the same risk profile as France, and much less so with China. Both have weak macro balances mainly due to high fiscal deficits, but low event risks although in the ascendance. .

Box 1: Effects of higher interest rates on JGBs: The market for Japanese government bonds is one of the largest security markets in the world estimated at almost $10trillion. For its entire modern times history, it has remained calm as domestic financial institutions have been happy to buy new issues without demanding lower prices, tantamount to higher interest rates. On the contrary, recent year's acceleration in the growth of outstanding JGBs has occurred hand in hand with lower interest rates. Admittedly, that may also have been a consequence of declining inflation.

Some observers argue that as long as Japanese have few alternative placements, or for some reason refuse to invest in other than domestic claims, the market can remain stable at least for another 10 years. At that point the savings surplus of the population and Japanese corporates will run out and they will have no more money to invest in JGBs. Today they have excess net savings of around 240% of GDP, while the government has a savings deficit of 160%/GDP. At a rate of 8% annual deficit the domestic demand for JGBs will run out in ten years. Should that happen the government will have to take its bonds abroad to find buyers and the fear is that foreigners will demand a much lower price (higher rate of interest) to accept the deal. A higher rate of return – say 1% pa – on a debt at



more than 300% of GDP in ten years' time, would raise the annual deficit by more than 3%/GDP with the annual deficit into double digit territory, provided the deficit continues at the present rate.

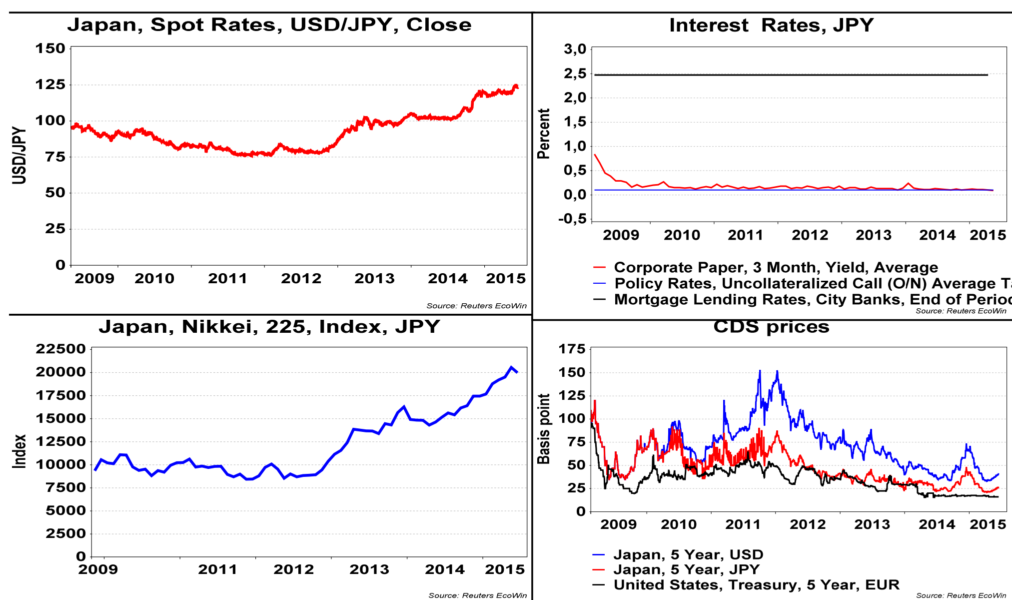
There are many qualifications to such a scenario. First, the budget deficit may gradually decline as in our base line scenario, thereby putting off the day of reckoning perhaps for another decade or more. Second and to the contrary, there is no law of nature to force Japanese investors to place their last yen in a government bond. In the early 2000s, before the GFC, Japanese housewives were the notorious investors in high yielding foreign currencies. With the rate of return offered on domestic savings today, they might be much tempted to try overseas adventures again.

Outside events could also trigger such a change of mind. One is a new bout of higher global interest rates following US monetary policy tightening expected in the near future and with contagion spreading to the JGB market. Using the Oxford global econometric model, we find that at about 1,5pp. interest hike on the outstanding government debt, the debt ratio begins to grow too fast for stabilization at least within our forecast horizon without further corrections to fiscal policies than foreseen at this point in time, i.e. including the VAT hike in 2017. In such a situation we believe that at least shareholders of the large corporations, many of them foreigners, will demand greater diversification of the financial surpluses of the companies they have trusted with their money, including more into foreign assets. 1,5pp in real terms, and that essentially is what matte,r is not a triviality, but worse has been experienced by peers in the past. The simple upshot is that the domestic demand for JGBs may dry up much earlier than in the oft-cited "next one or two decadesor so".

Key data:	2010	2011	2012	2013	2014	2015	2016	2017
GDP (bill. US$)	5 513	5 925	5 959	4 927	4 615	4 028	3 821	3 774
GDP/capita (US$)	43 287	46 539	46 838	38 759	36 346	31 771	30 188	29 883
GDP (change)	4.7%	-0.4%	1.7%	1.6%	-0.1%	1.0%	1.8%	0.8%
Investments/GDP	19%	20%	20%	20%	21%	21%	20%	21%
Budget balance/GDP	-8.3%	-8.8%	-8.7%	-9.0%	-8.5%	-7.1%	-6.2%	-4.4%
Govt debt/GDP	190%	205%	213%	219%	226%	230%	233%	234%
CPI inflation (%)	-0.7%	-0.3%	0.0%	0.4%	2.7%	0.3%	0.6%	2.0%
Money demand (%)	3%	3%	3%	4%	3%	4%	6%	6%
Stock prices (%change)	886	821	769	1123				
Interest rates	0%	0%	0%	0%	0%	0%	0%	0%
Exch. Rate ($)	88	80	80	98	106	124	132	136
Trade/GDP (%)	25%	27%	27%	30%	33%	32%	35%	37%
Oil price (Brent)	$80	$111	$112	$109	$99	$62	$69	$71
Billions US $								
Export of goods	731	789	770	686	693	626	624	650
Imports of goods	640	809	843	795	811	680	696	731
Other:	130	148	135	149	141	126	111	112
Current account	**221**	**128**	**62**	**40**	**23**	**71**	**39**	**31**
as % of GDP	4.0%	2.2%	1.0%	0.8%	0.5%	1.8%	1.0%	0.8%
FDI	-72	-118	-119	-133	-111	-97	-92	-91
Loan repayments (MUSI	-210	-258	-281	-255	-260	-246	-236	-235
Net other capital flows (I	85	342	426	341	364	289	345	347
Balance of payments	**24**	**93**	**88**	**-8**	**16**	**17**	**56**	**52**
Reserves	1 019	1 112	1 200	1 192	1 208	1 225	1 280	1 332
Total debt	2 329	2 871	3 126	2 836	2 891	2 737	2 619	2 612
o/w short term debt	466	574	625	567	578	547	524	522

Rating history					
Fitch (eoy)	AA	AA	A+	A+	A+
Moodys	Aa2	Aa3	Aa3	Aa3	A1

Type of government: Constitutional Monarchy
Next elections Parliamentary 2016
Other:
Latest PC deal None
Latest IMF arrangement: None



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