Japan

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Statistical revisions suddenly show a brighter picture of last years' perfomance and have prompted the IMF to use a more upbeat language of Japan's future prospects. With the exception of one rating agency observers do not seem convinced that we have reached a turning point yet and rather warn of an impending crisis when the central bank starts to rein in ultra-loose monetary policies.

Summary and conclusion

An upgrade to recent years' growth performance: Revised national accounts data paint a brighter picture of recent years' economic performance during 4 years of Abenomics. That has led to an upgrade of growth for the current year to 1,4%, 1pp greater than predicted a year ago and to 0,7% economic expansion for 2018. Both investments and consumption appear to have been more buoyant while net exports should provide an extra pull in line with rising global trade. That should help lift inflation to 0,5%, still modest but at least beating last year's deflation of 0,1%. A surge in tourism also contributes to a rising current account surplus.

Abenomics continue unabatted: Abenomics' three arrows are far from achieving goals set in late 2012. As such the policies will likely continue unabatted with a fiscal deficit about 4-5%/GDP on the back of a substantial supplementary budget introduced in late 2016. That will see the government debt rise 3pp further to 223%/GDP and soaked up by the central bank, Bank of Japan (BOJ) in growing measure. It already holds some 40% of the total outstanding in what is named *Quantitative* easing.

The future of quantitative easing: That easing is much larger than the equivalent of the Fed which at the most held only 13% of outstanding Treasuries. Moreover, since early 2016, it has been complemented with negative interest rates including on the growing amount of excess reserves banks now hold in BoJ as the counterpart to sold Japanese government bonds (JGB). Growing numbers of observers, in particular domestic, are now raising concerns about how to unravel and exit these policies without disruptive consequences. (Conf. *Outlook* section in main text.) Various forms of default and debt restructuring are debated including possible spillover effects on the global economy.

Structural policies making some headway: While often underrated, structural policies have actually made some headway and were the basis for the IMF's recent appreciation of "the success of Abenomics". While still a strictly separated two-tier market, the unregulated labor market has grown fast over recent years with more dynamic wage-setting. It may soon be close to the point on the Philipp curve where wage inflation takes on a life of its own. In addition, even if rising, recent years' employment growth has only staved off the day when the ageing of the population makes a sharp dent into the workforce. Other reforms, by contrast, have been lagging and Japan is still far from the point where higher productivity growth can become self-sustaining.

Ratings: New statistics recently prompted one rating agency to change the outlook from negative to stable in part on the national account statistics. We believe this may be premature and see no significant turnaround in particular for financial balances.

Recent developments

Over recent years projections including our own have turned volatile with the only excuse we can think of referring to controversial politics. This environment of surprises has been further exasperated by new national accounts data painting a brighter picture of recent years' economic performance under Abenomics. Growth for the current year, deep in the doldrums only a year ago, is once again upgraded to more than 1% followed by a modest but still positive 0,6% economic expansion for 2018.

Growth upgraded: At this time last year we foresaw only modest expansion for 2016 which now turn out to have been an underestimation of almost 0.7 percentage points (pp). For 2017 the expectations were that growth could rise only to 0.6%, but most observers now believe this will be well above 1%. Some of those forecast errors were due to revised national accounts statistics which now hopefully provide a more exact picture of the real developments and underlying trends. (Box 1) Sudden and substantial financial policy initiatives have also played a role including a significant supplementary budget of late 2016.

Box 1: GDP revisions have raised average GDP growth from 0.6% to 1% since 2014 mainly reflecting higher private consumption and investments the latter including improved accounting for research and development costs. Interestingly, the new numbers suggest that the VAT hike in 2014 had less an impact on private consumption than previously assessed. This revision has also raised the estimate of total GDP by more than 6%, thereby reducing debt ratios by 15pp in the case of government debt from 230%GDP to 215%/GDP.

Economic momentum continues: Even though first quarter growth for 2017 was recently cut by 0,2pp from first estimates, numbers released so far for the second quarter support continued momentum. Exports rose more than 6% year on year in April, while consumer and investor sentiment staid strong. In particular investors see rising capacity utilization and shrinking inventories of finished products and surveys indicate some may take advantage of ultra-low interest rates. In its latest reporting of June 2017 the IMF refers to some uptick in banks' credit extension in late 2016 while the Institution's own detailed statistics still show outstanding bank claims on the private sector about the same in last November compared with 12 months earlier. That said, most observers warn of growth trailing in the second half of the current year that will see economic expansion decelerating to less than 1% in 2018.

Labor market dynamics: The more positive developments in the product markets has supported employment growth in the labor market with the effect to reduce unemployment to 2,8% of last April halving the rate from the beginning of the decade. Jobs offers now stand 43% higher than the numbers of job seekers, almost double of the rate seen at the beginning of the decade. Unsurprisingly, there are reports of employers beginning to hike wages. This development has so far attracted little attention due to the specifics of the Japanese labor market with a distinct separation between a traditional regulated one and a newer unregulated.

A two-tier market is keeping average wages down: Low wages over recent years are an indication of a tightening labour market which has spurred much debate among economists and other observers. The regulated part of the market is a legacy of the bubble years some 25-30 years ago when companies competed so hard for workers that they were willing to offer life-time employment in addition to a good salary. Today this segment is dominated by elderly workers who are beginning to retire in droves. They apparently prefer their coveted privileges over higher wages. By contrast, the other part of the market, the unregulated one, is growing fast but attracted mainly younger workers and retirees. They are more interested in their pay check, knowing that permanent employment offers have become short in supply anyway. The combination of these two is a seemingly tightening market with stagnant average wages. But that masks a reality that could surface soon, perhaps before the end of the decade, as the unregulated market becomes the dominating. Traditional Phillips curves show wage growth starting at about 2,5% unemployment rate. That could be the case as early as next year with the present labour supply dynamics. One caveat, though, is that such curves are estimated over a long period, the last four decades, and it is uncertain if the behaviour of the bubble years, i.e. the steepening part of the curve is still relevant.

Price pressure remains weak: Last April, the headline CPI (Consumer Price index) was up 0,4% yoy while the core CPI, excluding volatile food and energy prices seemed stuck in negative territory having been in decline for three consecutive months in marked contrast to the development in early 2016 when core prices had been growing by an annual rate of 1%. This is all a far cry from the promised 2% inflation rate when Abenomics was launched four years ago and the goal may seem as far as ever. That said, however, company surveys are still upbeat on future price trends over the 1-3 years horizon although shy of the government's target. For the current year we pencil in a 0,5% uptick in part based on higher international energy prices.

Continued surplus on the current account: Growing exports in parallel with brighter prospects for the global economy as optimism continues for both the US and European economies while emergers like Brazil and Russia may seem to be through their recent crises for now, is set to strengthen Japan's external accounts in 2017. This is further underpinned by buoyant tourism revenues from a growing flow of visitors numbering 24mn in 2016, up five times from 2011. As a result, the current account balance is expected to rise to almost $200mn. or 4.1%/GDP, up 0.4pp from 2016. Capital transactions will follow in past tracks with a significant deficit on net foreign direct investments (FDI)as Japanese companies continue to invest much more abroad than foreigners do in Japan. With net loan repayments and portfolio transactions in the balance, reserves should remain stable at around $1,2tr, the largest in the world, second only to China, and enough to cover the import bill and short term debt for a whole year. That is barring no unforeseen capital outflows that may prompt the Bank of Japan (BoJ) to intervene by selling dollars from reserves.

Financial policies

Abenomics' two first arrows are far from achieving goals set in late 2012 and the policies seem poised to continue in the same tracks. That has raised questions how to exit BoJ's quantitative easing without creating disruptive financial developments. The third arrow, though, may be given some credits. The labour market is about to change leaving it with a more flexible unregulated market as the old regulated is set to "retire".

Budget balance set to weaken: The implementation of a supplementary budget announced in late 2016 will see the government budget balance weaken in FY2017, the fiscal year ending March 2018, from 4,0% to 4,6% of GDP. As such, the government has taken another step back from its goal of achieving primary balance by the end of FY2020 needed to stabilize the debt to GDP ratio. That is unless the government delivers on its promise to implement the second VAT hike from 8% to 10% in FY2019. Not many observers believe that is likely, however, due to a feared repeat of the economic slump that followed the first VAT hike in 2014 although new data have changed that picture somewhat (Conf. Box 1 above.) Such a hike would have the potential to reduce the annual deficit by 0,9%/GDP every year thereafter (ceteris paribus) and reduce the debt ratio by 9pp in one go. That is unless the measure would have devastating effects on the economy and therefore decrease government's tax revenues more than they gained from the tax hike. Instead, last August, the government introduced a supplementary budget including an extra JPY6tr. on infrastructure. This has hiked the primary deficit by 1.1%/GDP at least for the current year.

Smooth budget financing despite growing debt: Despite pushing back budget consolidation, the financing of the shortfall for the current year is unlikely to cause any headache. Since quantitative easing was launched in 2013, BoJ has come to buy almost all new government debt on the day after issuance. The rate of return is therefore effectively set by the central bank under its negative interest policy (NIRP). At such a low interest, debt affordability is technically very high regardless of high and rising debt. The latter was standing at 215%/GDP in late 2016 after having dropped from 230% because of new national accounts statistics raising the denominator in that ratio.

Net or gross debt? Many observers also decrease this measure of gross debt by netting it against assets held by the general public sector including the central bank's foreign assets. This, however, demands some qualifications. It is unusual to consolidate any two entities by cherry-picking in the balances. BoJ's foreign assets have their counterpart in issued money and other liabilities of the bank which then should also be consolidated with the government debt. Moreover, should the government try to use BoJ's foreign assets to buy back its debt from the market it may unduly affect the local exchange rate and push it up against other currencies, an action that would create economic problems on its own with repercussion on the budget balance. Gross debt is therefore in our view still the right term for gauging the government debt obligations.

Is the government interest burden that low? A more relevant issue in our view is the question of the right rate of interest to apply when calculating the government's interest burden in the longer run. At the face of it is very low and since 2016 even negative on maturity up to 10 years. Today the government pays only 0,5%/GDP as interest on its debt obligations to holders, including the BoJ. Because of long maturity, any change in market conditions will affect the average rate of interest with a lag of many years. However, should interest rates go up in some years from now, either as a consequence of a rise in global rates or because the government succeeds in lifting inflation, the BoJ would be forced to raise the rate on banks excess reserves which may represent some half of its total liabilities in a few years. The counterpart of that is mainly made up of JGB on BoJ's asset side. That means BoJ will have to be compensated by the government to defer future insolvency. As a result the government will end up paying short term market interest rates to avoid either its central bank or its banking system going bankrupt. The first may not matter, but the second would likely trigger a banking crisis. In effect, it may turn out that at the end of the day through quantitative easing the government has – unnoticed so far -- swapped long debt into super short funding.

Unconventional monetary policy: Since introduced as the first arrow in 2013, loose monetary policy with quantitative easing received two more legs in 2016: Negative Interest Rate Policy (NIRP) and Yield Curve Control (YCC). In part because of that but also as a result of dwindling market supply of JGBs, quantitative easing was last year scaled back from an annual expansion of JPY80tr. to JPY70tr. BoJ now holds about 40% of the total issued JGBs -- some 80% relative to GDP. Of the JPY70tr. it will buy this year about half goes to covering the financing needs of the government, including rolling over debt falling due (JPY13tr.) while the rest comes directly from existing holdings in the market, mainly the banking system. NIRP was introduced to psh banks to extend more lending to private sector borrowers while YCC, introduced in the fall of 2016 aims at reducing their longer term borrowing costs. So far these measures have had limited effects on overall credit extension. Official statistics as published by the IFS shows outstanding claims of banks on non-financial private sector virtually at the same level in November 2016 as 12 months earlier, while the IMF reports of a small increase in the last quarter of 2017.[1]

Not only JGBs: Last year BoJ also included purchases of other private market assets, exchange traded funds (ETF), in its portfolio under quantitative easing. In 2017 it is expected to by JPY6tr. of such securities.

Exchange rate policies: The exchange rate is essentially free floating. After it appreciated substantially in 2015 and 2016 it has reached a level consistent with medium term fundamentals accoding to the IMF.

Stable banking sector so far: The Japanese banking system is dominated by the mega banks which are overall regarded as liquid and stable with adequate profitability although the latter is increasingly under pressure due to narrowing interest margins prompted by the BoJ's low interest rate policies, NIRP and YCC. This has led banks to search for yield elsewhere raising concerns they may too fast be entering new lending areas with less understood risks. In contrast, several regional and so called *Shinkin* banks may face some solvency problems going forward.

Structural policies still in the waiting room: With the exception of labor market policies as noted above, the structural reform effort remains the weakest of Abenomics' three arrows. That said Japan was also one of the first countries to sign up to the TPP agreement and has urged other regional countries to renew the initiative after it was called off by the US since Trump entered the White House. The TPP would have had a major impact on both the agricultural and the retail sectors of Japan.

Politics

LDP infighting: In a country where one party, the Liberal Democratic Party (LDP) has been in government for almost the entire post WW2 period, faction politics can be more important than open party politics. To keep the balance among the various factions to prevent party splits it is then vital to make sure a certain circulation of important posts within government. As a result, with a few important exceptions though, Japanese governments have tended to be short-lived. Mr. Abe has already been Prime Minister for almost four years and must step down or stand for re-election by the end of 2018 at the latest. That also means that there is little prospect of the opposition retuning to power anytime soon.

The main issue on his ticket is likely to be constitutional reform regarding the role of the military. Abe has since long advocated that Japan's self-defence forces should be awarded a similar role as in other democratic countries to prepare for the challenge of a more assertive Chinese foreign policy in the next decade. This is a contentious issue for the electorate that could be negatively affected by sluggish growth and as such presenting another argument for the PM to support the economy. PM Abe's approval ratings have generally remained strong since he first came to power, but was recently hit by a scandal related to funding of a school in Tokyo.

Outlook

Our outlook for the next few years is for continued, but weak growth clearly below the targets set by the government. As such, fiscal and monetary stimuli are needed to prevent collapse of domestic demand. That, however, will increases vulnerabilities with ramifications for financial sector stability.

[1] International Financial Statistics, IMF, Washington DC, May 2017 and May 2016

Weaker growth absent more government stimuli: Several observers, including the IMF, see growth almost halving to 0,7% in 2018 as fiscal supports fades without a new supplementary budget and as the global economy expands at a slow pace. That will also reduce domestic price pressure with CPI growth falling to 0,6%. This means a new setback for the macroeconomic arrows of Abenomics and raises the question where this policy initiative is going. A number of observers point out that the emphasis of Abenomics on yen-weakening – tactical devaluation – has undermined domestic demand as the gains have not trickle down to consumers but remained as cash being hoarded within the companies. As such corporates have become the great savers of the economy – annually saving some 8%/GDP, while households are no longer able to save much reflecting demographic changes.

It might be argued that such a scenario could change before long. The labor market is about to tighten so much that cost pressure for companies will start to become visible. As such inflation may start to rise by the end of the decade, fulfilling one of Abenomics main goals. But this raises another question: how to end Abenomics -- or at least the monetary policy part of it.

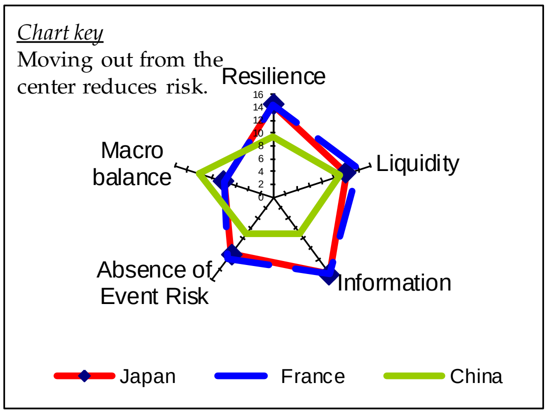
An IMF study of 2013 suggested that quantitative easing (QE) modestly boosts demand when in operation but then threatens “savage contraction” on exit. QE in Japan has been much greater than similar policies in the US or the Eurozone over the recent decade. It could theoretically end with the central bank holding almost 200% of GDP in government debt while the private sector, mainly banks, sit with the counterpart as excess reserves in the central bank. That means that either the government will have to compensate the central bank for the losses it will make when it has to pay a higher market rate on these reserves to avoid jeopardizing the stability of its banking system. The compensation will be expensive – up to 5%/GDP annually – pushing any fiscal debt stabilisation further into the future. The alternative would be to let the central bank become insolvent thereby undermining its monetary integrity.

None of this will pose an immediate threat on its own but market reactions could. So far the Yen has been regarded as safe haven. When the BoJ announced its negative interest rate policy in early 2016, markets reacted with appreciating the currency after a short-lived dip in the exchange rate, and so far market measures of credit risk have remained among the region’s best. It is hard to say how long that may last but concerned voices are growing louder.

On a knife’s edge: William White, the special advisor to the BIS who predicted the financial crisis in the US of 2008 with ample advance notice, recently pointed out that Japan is in need of an eventual restructuring of its government debt or a reduction in real terms through very high inflation. Moreover, continued expansive monetary policy would eventually prompt loss of confidence to see inflation and rates rise sharply. However, should BoJ withdraw its financing anytime soon market rates could rise sharply and trigger the crisis everyone wishes to avoid. The only rescue would be in a sharp improvement to productivity that could raise underlying growth to some 2%/year.

Working Japanese are not lazy but their numbers are shrinking too fast: On the last issue, however, it can be intervened that labour productivity in Japan is not that low. Actually, if measured over the active working population growth per worker has been higher than in the US for the last few decades. But, unfortunately, that is also just another way of saying that a shrinking part of the population will be forced to continue working harder to pay for the government debt and its continued financing.

Key ratios	**2017**
Population (mill.)	126.0
GDP/capita ($)	38 311
GDP(% change)	1.4%
Inflation	0.5%
Curr.Acc. Balance/GDP	4.1%
Reserves/imports (months)	43
Budget balance/GDP	-5.2%
Government net debt/GDP	223%



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

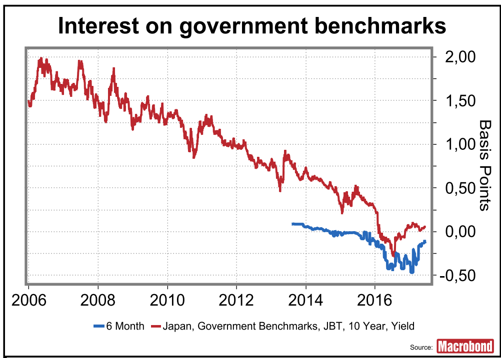
Peers:
USA
France
China

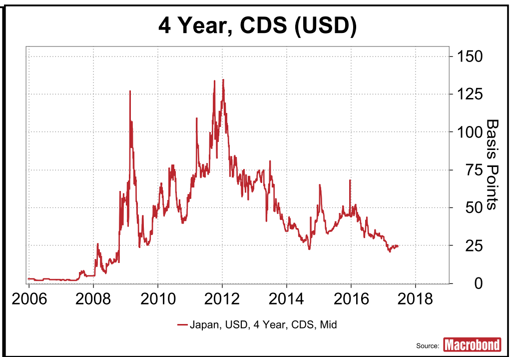
Graph: The graph shows Japan as a strong country with much the same risk profile as France, and much less so with China. Like France, Japan has a weaker macro balance than China, but lower event risks although that is rising gradually..

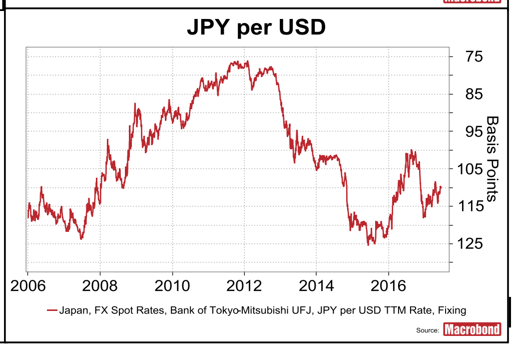
Key data:	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP (bill. US$)	6 206	5 165	4 862	4 380	4 945	4 828	4 771	4 773
GDP/capita (US$)	48 817	40 681	38 352	34 611	39 158	38 311	37 957	38 079
GDP (change)	1.5%	2.0%	0.2%	1.1%	1.0%	1.1%	0.7%	0.9%
Investments/GDP	22%	23%	24%	23%	23%	23%	24%	24%
Budget balance/GDP	-8.3%	-7.6%	-5.4%	-3.5%	-4.6%	-5.2%	-5.6%	-4.9%
Govt debt/GDP	202%	206%	211%	215%	220%	223%	224%	225%
CPI inflation (%)	-0.1%	0.3%	2.8%	0.8%	-0.1%	0.5%	0.6%	1.0%
Money demand (%)	3%	4%	3%	4%	3%	4%	3%	3%
Stock prices (%change)	769	1123	1263	1554				
Interest rates	0.2%	0.2%	0.1%	0.1%	0.0%	0.0%	0.0%	0.3%
Exch. Rate ($)	80	98	106	121	109	112	116	119
Trade/GDP (%)	26%	29%	31%	29%	25%	27%	27%	28%
Oil price (Brent)	$112	$109	$99	$52	$44	$52	$52	$59
Billions US $								
Export of goods	777	695	700	622	635	672	678	698
Imports of goods	830	784	799	629	584	626	630	655
Other:	115	135	136	141	132	151	146	142
Current account	**62**	**46**	**37**	**134**	**183**	**197**	**193**	**185**
as % of GDP	1.0%	0.9%	0.8%	3.1%	3.7%	4.1%	4.0%	3.9%
FDI	-117	-145	-118	-131	-135	-150	-148	-148
Loan repayments (MUSI	-281	-255	-260	-257	-311	-312	-309	-309
Net other capital flows (N	424	346	357	232	266	243	274	285
Balance of payments	**88**	**-8**	**16**	**-21**	**3**	**-22**	**10**	**12**
Reserves	1 199	1 192	1 207	1 186	1 189	1 167	1 177	1 189
Total debt	3 126	2 836	2 891	2 850	3 455	3 470	3 431	3 437
o/w short term debt	625	567	578	570	691	694	686	687

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

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







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