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Japan: Bystander, Victim or the Umami Salt of the Earth?

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Japan on the sidelines

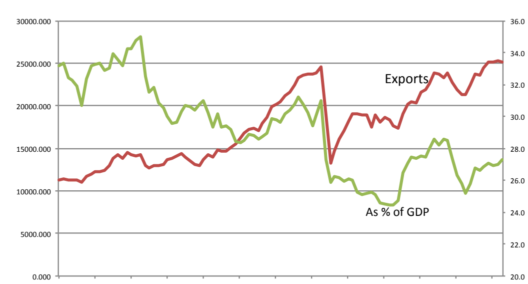
Just when it seemed as though Abenomics finally began to boost the Japanese economy's growth rate into acceptable territory, the economies around the world suddenly started to sputter. At the end of 2018, I predicted that the global economy would succumb to the political calamity that was fermenting in all the most critical places. Japan alone stood out for not contributing to the political melee that was bursting forth around them, and threatening to end the present global economic expansion.

Japan has the third largest country-wide economy in the world, eclipsed only by the US and China. Since political morass is affecting the economies of the US, China, the EU and the UK, Japan stands in position to either hold back the tide of global economic collapse or be swept up by it.

External trade matters

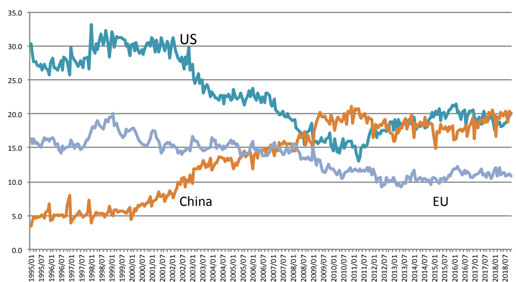
External trade is a critical component of the Japanese economy. It was the driving force behind their fabulous economic success in the post WW2 era, and today external trade contributes approximately 28% to Japan's GDP. In comparison, twenty years ago external trade accounted for 34% of GDP.

Japan: Exports as % of GDP



Slightly more than half of Japan's exports are shipped to the US, China and the EU. All three are undergoing substantial political turmoil. Although their relative importance for Japan's exports has changed substantially over the past three decades, the importance of the US has diminished, gradually replaced by the flourishing development of China's economy, and exports to the EU have diminished marginally in importance, the three economies still account for 50% of Japan's exports.

Japan: Biggest Export Markets
(% of Total Exports)



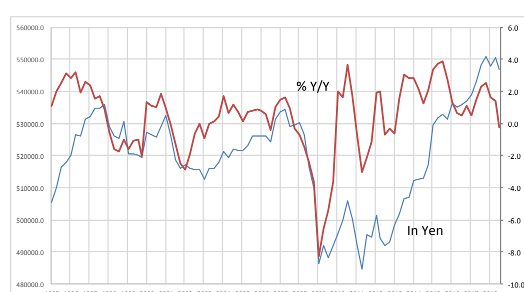
In the current stressed political economic environment, all three of Japan's biggest export markets are being seriously challenged by man-made turmoil. The growth rates of all three of these economies, the largest in the world, are in the process of slowing significantly. The risk is that at least the US and the EU economies stumble into recession this year, and that China's economic growth decelerates significantly because of the US imposed trade tariffs. Consequently, the natural demand for imported goods within these economies will stall, leaving Japan's export engines sputtering.

GDP growth is starting to slide downward

After several aggressive fiscal policy programs initiated by Prime Minister Abe during the past few years, the Japanese economy finally responded. GDP growth accelerated in 2017, and then decelerated sharply in 2018 because the Government did not initiate any new fiscal programs. Year over year growth in GDP slipped to minus 0.3% in Q2 2018 and then fell again in Q3 by 0.6% from the previous quarter. This second consecutive quarterly contraction was much more than forecast. Economic growth in Q4 is not expected to improve, as the drop in global growth and trade will probably impact Japan's economy more significantly than in the previous quarters.

The most conspicuous cause for the overall fall-off in Japan's economic growth was the 2.8% plunge in business investment, a sharp manifest of the deterioration in Japan's overall business confidence. Moreover, a profusion of corporate earnings reports by companies conducting business in China, advised investors that diminishing consumption in China has collapsed their revenues.

Japan: GDP Growth Is Slipping Fast

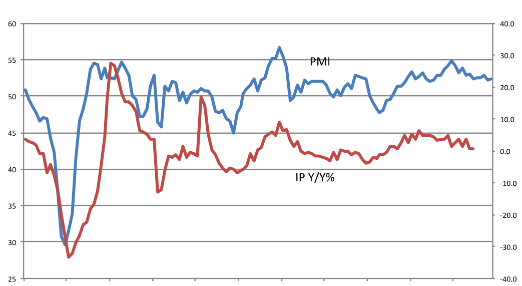


Capex had been a bright spot in the Japanese economy for the past few years perhaps in response to Abenomics. Capex was underpinned by investment in automation and labor-saving technology in order to cope with growing labor shortages in Japan. Investment was concentrated in all-purpose machinery, production equipment and automobiles. Now that tariffs imposed by the US are disrupting normal supply chains, global companies are uncertain where they should invest to replace their broken supply chains.

Industrial production is retreating

Another indication of the overall slowdown in Japan's economy is the abrupt falloff in industrial production growth. Since the end of 2017 industrial production has declined by an annualized rate of 2.4%. Moreover, the Japanese Purchasing Managers' Index (PMI) has been falling steadily from its peak early in 2018, confirming a significant reduction in business confidence over future profitable opportunities.

Japan: Production Is Declining



Budget deficit stabilizing

It appears as if Prime Minister Abe's economic stimulus program has run out of steam. Government spending, as a percent of GDP, has been dwindling. The Prime Minister now seems focused on improving the government budget deficit over the next few years rather than promoting economic growth. Consequently, there have been no new economic programs announced to boost economic growth.

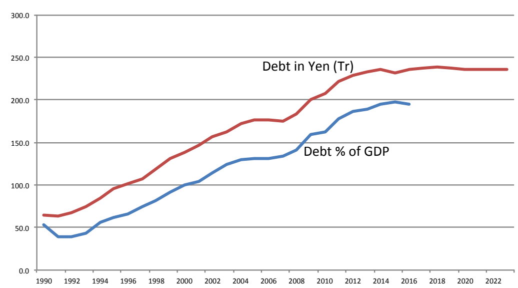
Despite a batch of unquestionable data proving the slump in economic activity, Prime Minister Abe announced in Q3 2018 that Japan will increase the value-added tax (VAT) to 10% from 8% in October 2019. The additional government revenues are needed to finance the advance in social security costs and public works spending due to escalating incidents of natural disasters. This appears to be the worst time to boost government revenues in order to reduce the immense Japanese budget deficit. The PM did indicate that he would partially soften the estimated negative economic impact on consumers by enacting a supplementary budget for FY19/20.

Debt growth projected to stabilize

Because there are no massive new spending initiatives, the government's humungous debt burden is finally beginning to stabilize. For the past several decades, Japan has carried the largest government debt burden relative to GDP of all the advanced economies in the world. At more than 200%

of GDP it implies immense negative implications. The concern is assuaged by the fact that nearly all the government's debt is denominated in yen and it is mostly owned by Japanese institutions.

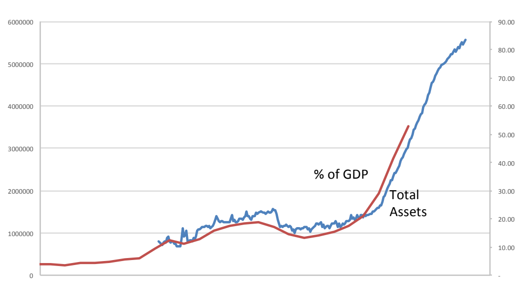
Japan: Gross Government Debt



BOJ still actively buying government debt

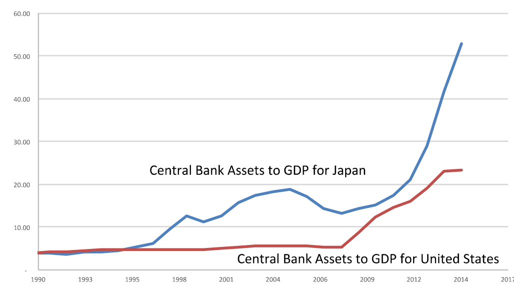
The BOJ has been an extremely active adherent of quantitative easing, the latest fashionable instrument of monetary policy. The BOJ has purchased 3.5 trillion yen of assets, mostly Japanese government securities over the past 5 years, thus raising their total assets to almost 6 trillion yen. In their last monetary policy meeting debriefing, the chairman of the BOJ indicated that the BOJ would continue its present policy of purchasing more JGBs.

Bank of Japan Assets Soaring (Yen)



The BOJ's purchase of assets has greatly exceeded all the other central banks acquisitions, as shown in the following chart. This makes the BOJ the most ardent user of quantitative easing and the most vulnerable to unanticipated side effects that presently are unknown.

Bank of Japan Assets Greatly Exceeds Fed's, Relative To GDP

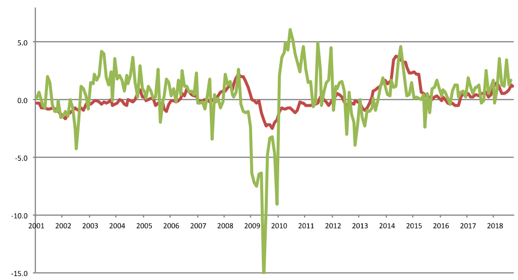


Deflation has been the biggest obstacle to growth

For the past few decades the most consequential issue confronting economic policy makers in Japan was deflation. Major inflation indexes had hovered around zero for most of this period or turned negative. Deflation fears stoked Japanese buyers' decision to defer purchases until prices tumbled further, making it nearly impossible for government policies to boost GDP growth. The BOJ finally addressed this problem by announcing that they would seek inflation growth of 2% as their primary policy target. It is a similar commitment to statements made by other developed countries' central banks.

Wages and inflation are finally increasing

Japan: Wages and Inflation Turn Positive



The crucial complication contributing to persistent deflation was the contraction in nominal wages over the past few decades. Despite extremely low unemployment rates, wages remained static at best, or lower at worst.

Finally, there are abundant indications that wages are increasing, as shown in the chart above. Consequently, inflation has finally accelerated. The latest data reveals that the CPI is increasing at a year-over-year rate of 1.1%. The good news for the economy and the central bank is that inflation is finally advancing towards the BOJ's stated policy objective. However, if inflation continues to accelerate, it may quickly cause the present pro-growth stance of monetary policy to reverse.

The free money country

For decades the Bank of Japan has kept its official policy interest rate at zero. This policy helped to reduce the financing costs of the mounting government debt position and encouraged the private sector to borrow at low, or no cost, to finance new business. GDP growth didn't respond until Prime Minister Abe's aggressive fiscal policy accelerated government spending. Of course, one of the known downsides of zero policy rates and negative yields on JGB securities is that it diminished the profitability of Japanese banks that hold trillions of yen of these securities.

Conclusion: The Japanese economy will not escape

With the growth of the rest of the developed world's economies rapidly slowing, Japan's export-led economy will not be able to escape the clutches of its dependence on foreign demand for its products. Moreover, with monetary policy already straining, it is unlikely to be able to do more than it currently is. And, since fiscal policy is starting down on a path to withdraw stimulus from its impact upon the economy, the Japanese economy will become a prisoner of the global slowdown.

Nevertheless, I wish all of you a Happy Lunar New Year and some good umami dining!

For more information, please contact camri@nus.edu.sg

	KEY INDICATORS TABLE (AS OF 28 DECEMBER 2018)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2485.74	-9.81%	-9.81%	-5.21%	-5.21%	3MO LIBOR	2.80	65.08
FTSE	6733.97	-3.40%	-3.81%	-8.70%	-14.27%	10YR UST	2.72	13.00
NIKKEI	20014.77	-10.33%	-7.71%	-10.39%	-8.63%	10YR BUND	0.24	-43.39
HANG SENG	25504.20	-3.77%	-3.84%	-11.73%	-11.94%	10YR SPG	1.426	-9.64
STI	3053.43	-1.86%	-1.43%	-6.94%	-8.99%	10YR SGS	2.09	4.31
EUR	1.14	1.12%		-4.67%		US ISM	54.10	0.00
YEN	110.27	-2.91%		-2.15%		EU PMI	51.40	-14.52
CMCI	1139.48	-3.46%		-10.58%		JP TANKAN	16.00	-6.25
Oil	45.33	-11.00%		-24.98%		CHINA IP	5.40	-12.90

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency