Japan – The Land of the Rising Sum… of Debt!

"Some things change, some stay the same"
(Chrissie Hynde)

"*Some things change, some stay the same*" sings Chrissie Hynde in the Pretenders' song 'Hymn to Her'. In Japan, things stay the same!

Japan is a centrally controlled copycat economy. Its trade policy was created by the once all-powerful MITI (Ministry of International Trade and Industry) and its business relationships orchestrated by a coterie of keiretsu, whose shady operations are something akin to the Italian mafia. The outcome is pretty similar (in mafia controlled Sicily, economic performance is woeful).

After compiling the data for this note, I read some of our earlier pieces on Japan. Depressingly, I could have just re-published my note of 8th July 2010 ('Japan – The Lost Decades'). Aside from a few statistical updates, the observations would have stayed the same, apart from Prime Minister Shinzō Abe's Three Arrows policy (introduced in 2013), which seeks to tackle his country's malaise through:-

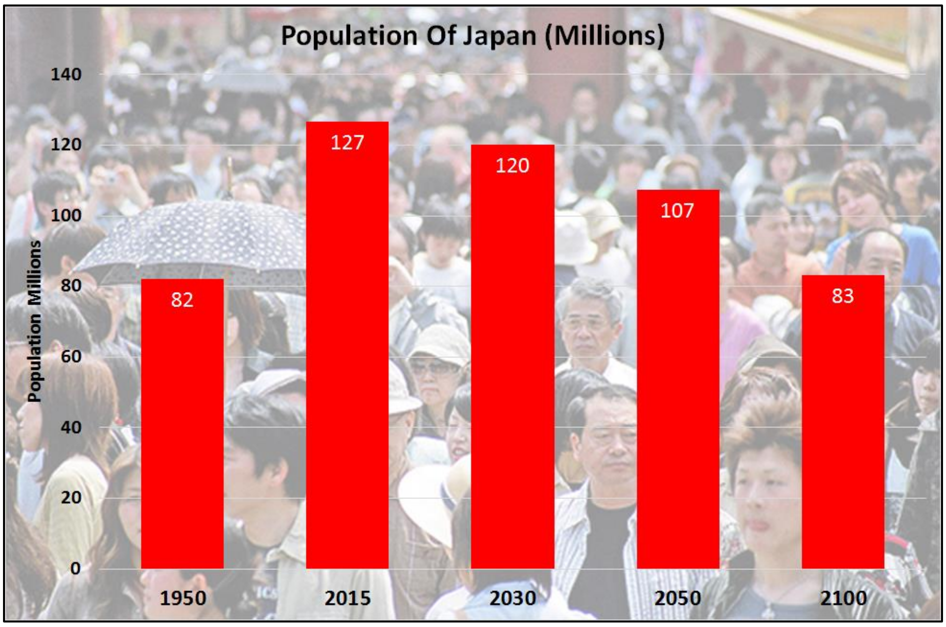
1) Fiscal stimulus
2) Monetary easing
3) Structural reforms

He has certainly got stuck into number one with plentiful fiscal stimulus (politicians just love spending your money) and number two (monetary easing, or QE (quantitative easing)) is free-flowing with the Bank of Japan buying up JGBs (Japanese Government Bonds) like they are going out of fashion. Prime Minister Abe must have lost the third arrow because there is no sign of reforms. The keiretsu system is alive and kicking and Japanese domestic businesses, ever protected by the Japanese government, continue to enjoy fat profits at the expense of the Japanese consumer, who sees no increase in real income. In short, it's a mess.

Demographics

Japan is an old country full of old people (at least compared to other countries). The population is likely to decline for the rest of the century, as highlighted by Chart A below which shows the population of Japan falling from 127 million to 83 million by 2100.

Chart A: Population of Japan (millions)

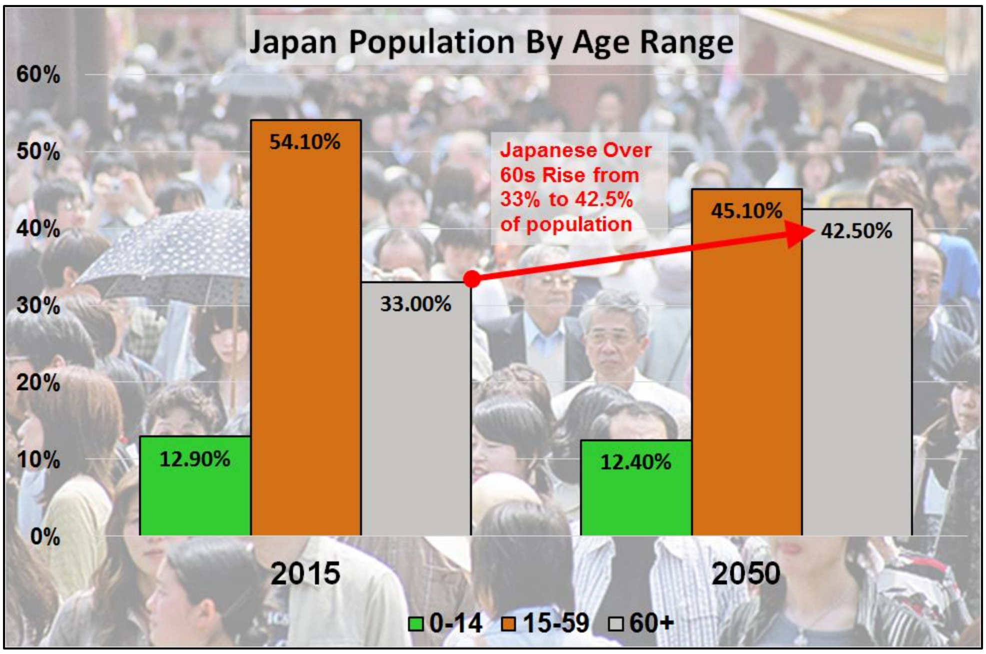


Source: United Nations World Population Prospects 2015

As most of you will realise, the path of Japan's population decline is not consistent with the rest of the world, where the population is forecast to grow from 7.35 billion in 2015 to 11.21 billion in 2100.

Whilst Japan's population decreases it will also see a structural shift in the distribution of that population amongst the different age groups. The median age in Japan is 46.5, which makes it the oldest population in the world (the global median is 29.6). The position for Japan will deteriorate. By 2050 its median age will have risen to 53.3. To make matters worse, the over 60s, which currently account for 33% of the population will, by 2050, account for 42.5%.

Chart B: Population of Japan by Age Range



Source: United Nations World Population Prospects 2015, COURTIERS

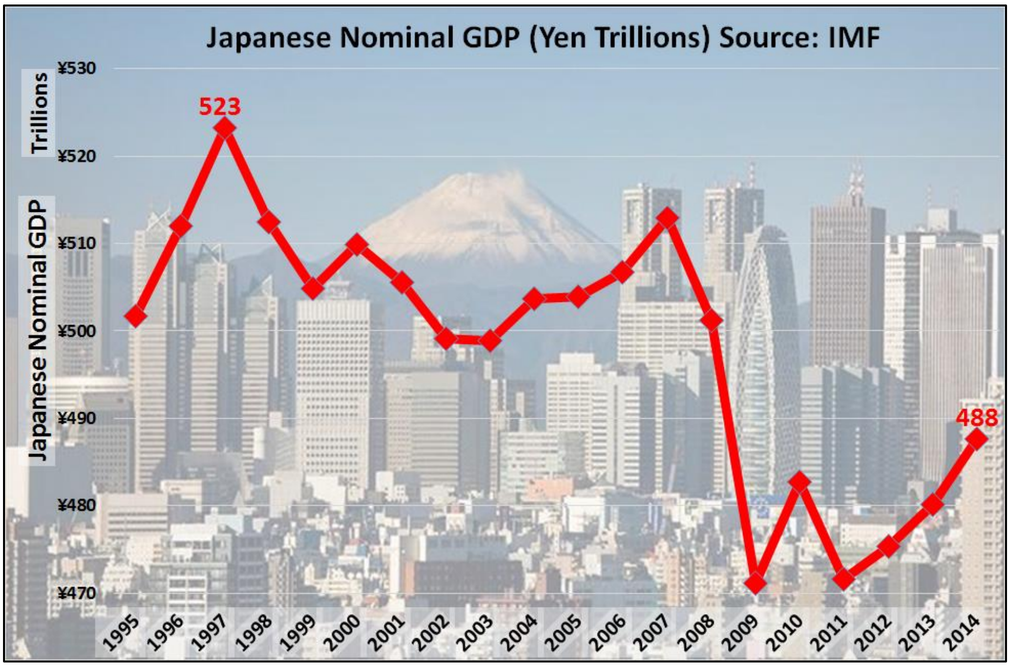
A fall in population is bad for the economy for all sorts of reasons, the most obvious being that a decline in one of the factors of production (in this case, labour) means that the others (land/natural resources, capital and entrepreneurship) will have to work harder if the economy is to grow. The problem with a declining population is two-fold, firstly the stock of labour is falling, secondly people create demand, and with the population dropping the rate of growth in demand is likely to be slow, or turn negative.

One possible solution is to boost the population through positive net migration (something Mrs Merkel has adopted for Germany, a country that faces similar demographic problems to Japan). The World Bank shows Japanese net migration (total immigrants minus total emigrants) as 350,000 for the five years ending 2012. That is equivalent to an average annual rate of 0.055% of the total population. Net migration in the US has been 0.31% p.a., nearly six times higher than that in Japan.

GDP Growth

As I mentioned back in 2010, Japan has been experiencing deflation since the 1990s. Chart C below shows total annual Japanese nominal GDP since 1995.

Chart C: Japanese Nominal GDP

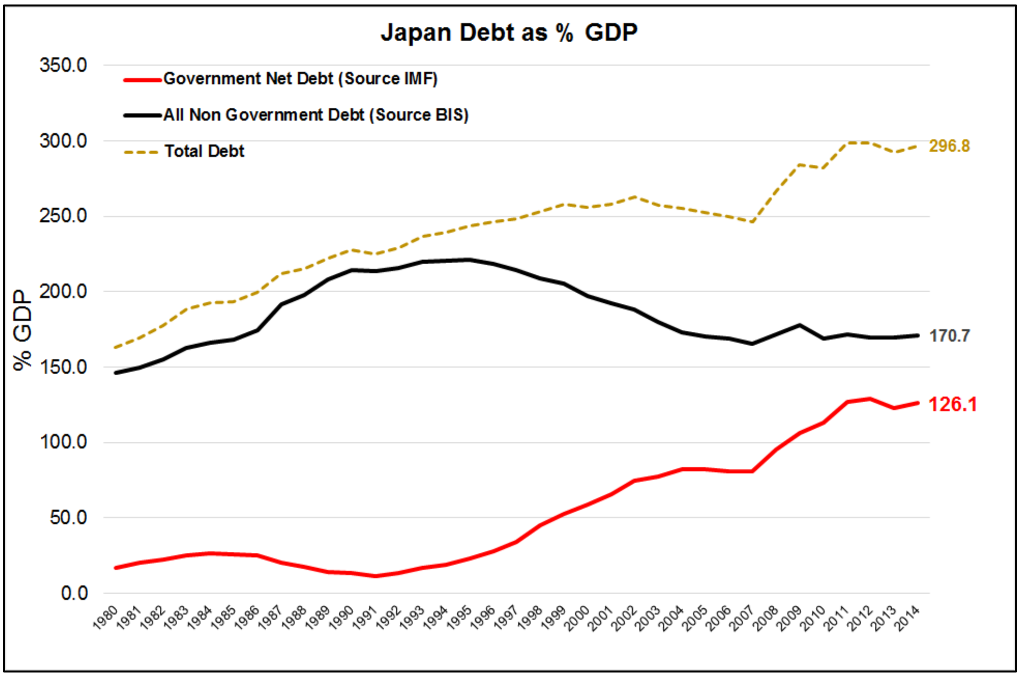


Source: ESRI Japan, Bloomberg

Nominal GDP peaked at 523 trillion yen in 1997. By 2014 it was just 488 trillion. Japan has been wrestling with deflation for nearly a quarter of a century.

The latest solution (the Three Arrows) smacks of an opportunistic politician re-crafting a modern, overseas practice for use in their own country. Unfortunately for Japan, copycat economic policies will prove significantly less profitable than copycat cars and cameras. QE is most successful when it is used to balance the effects of other government policies, such as a shrinking money supply as public expenditure is cut in an attempt to re-balance the nation’s finances (which is what happened in the US and the UK after the global financial crisis of 2008). Japan is using QE alongside a policy of fiscal expansion, and the effects can be clearly seen in the changes to the stock of debt.

Chart D: Japan's Debt as Percentage of GDP



Source: BIS, IMF, COURTIERS

The solid black line (private debt) has been declining for 25 years as consumers have saved rather than spent. Government debt, on the other hand (the solid red line), has been growing steadily over the same period and at a higher rate than the decline in non-government debt, so total debt has increased as a percentage of GDP and now stands at nearly 300%.

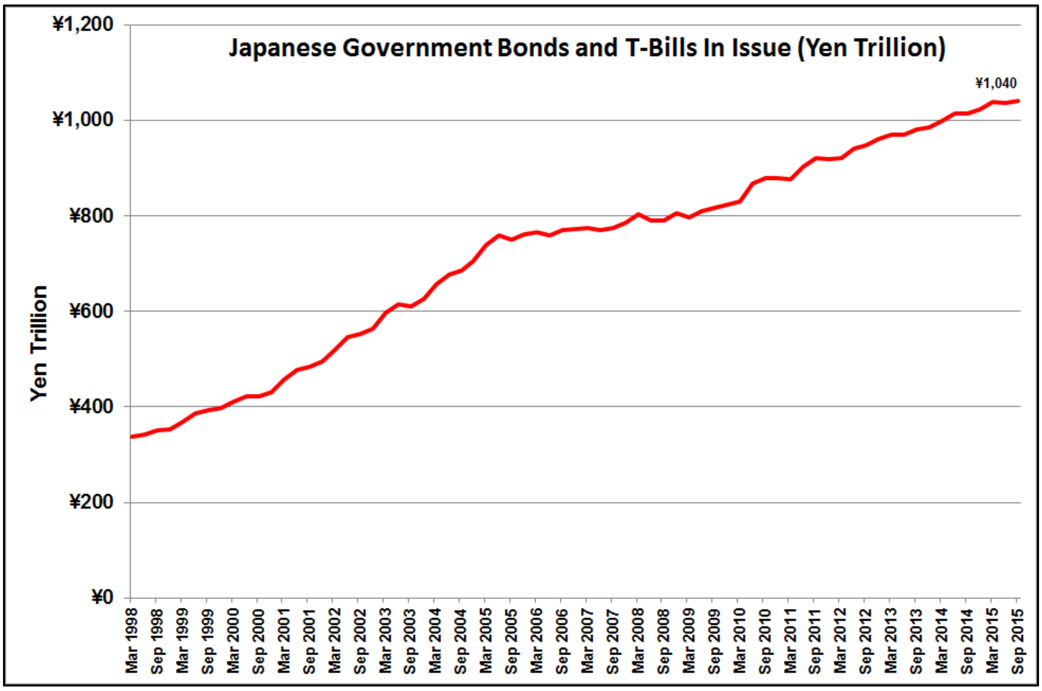
There is a conventional view among economists that total government net debt in excess of 100% of GDP acts as a drag on the economy. Japan is now well above that figure, which is likely to keep rising under Mr Abe. Most of the borrowing is centred domestically (the Japanese government borrows mostly from the Japanese people), and Japan has accrued significant foreign reserves after years of running large trade and current account surpluses, so it can arguably sustain rapidly increased borrowing for many years to come. Nonetheless, Japan's current account balance declined from 4.86% at the end of 2007 to -0.06% by the summer of 2014. It has subsequently re-bounded to 2.94% in September 2015, aided by a falling yen (the yen has declined against the US dollar by -37% over the last four years), which has been a deliberate outcome of Mr Abe's QE, but the heady days of big trade surpluses are not going to return to bail-out a weak domestic economy.

Is Abe's QE Working?

Before I comment on the effects of Prime Minister Abe's Three Arrows, it is worth taking a look at what is happening with the Japanese government's finances and the Bank of Japan's (its central bank) balance sheet.

The total stock of government debt has been rising in Japan for many years. The following chart shows steady appreciation since the late 1990s.

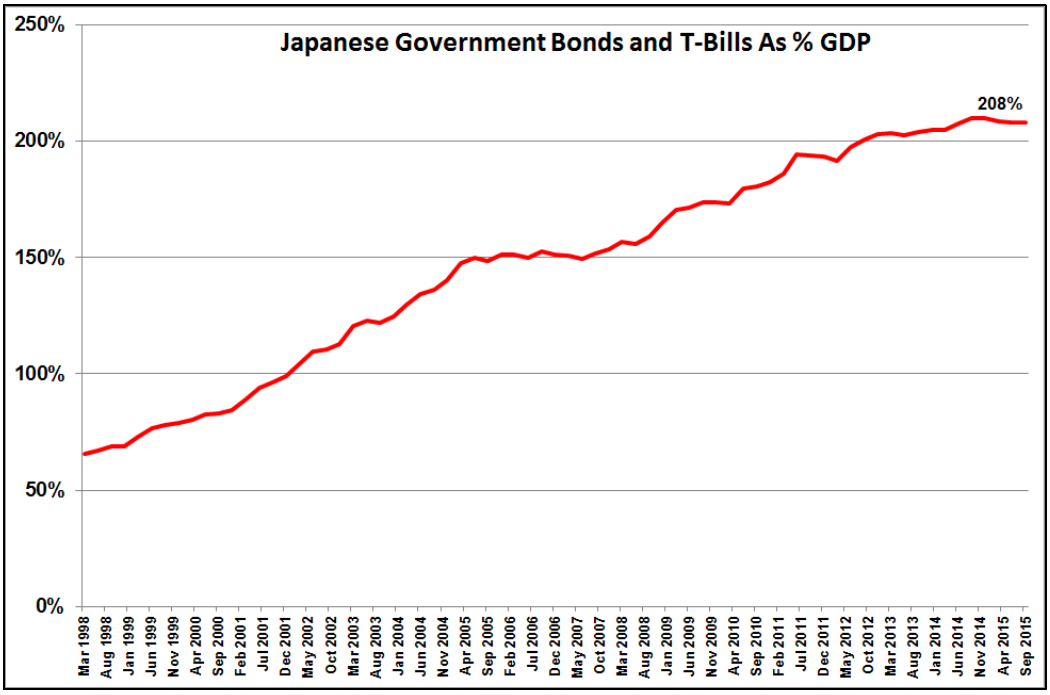
Chart E: Japanese Government Bonds and T-Bills in Issue



Source: Bank of Japan, Bloomberg

To get this increase in the stock of debt in perspective, it is worth looking at it as a percentage of GDP. The next chart shows total Japanese government bonds and T-bills (Treasury bills) in issue as a percentage of Japanese GDP.

Chart F: Japanese Government Bonds & T Bills as % of GDP

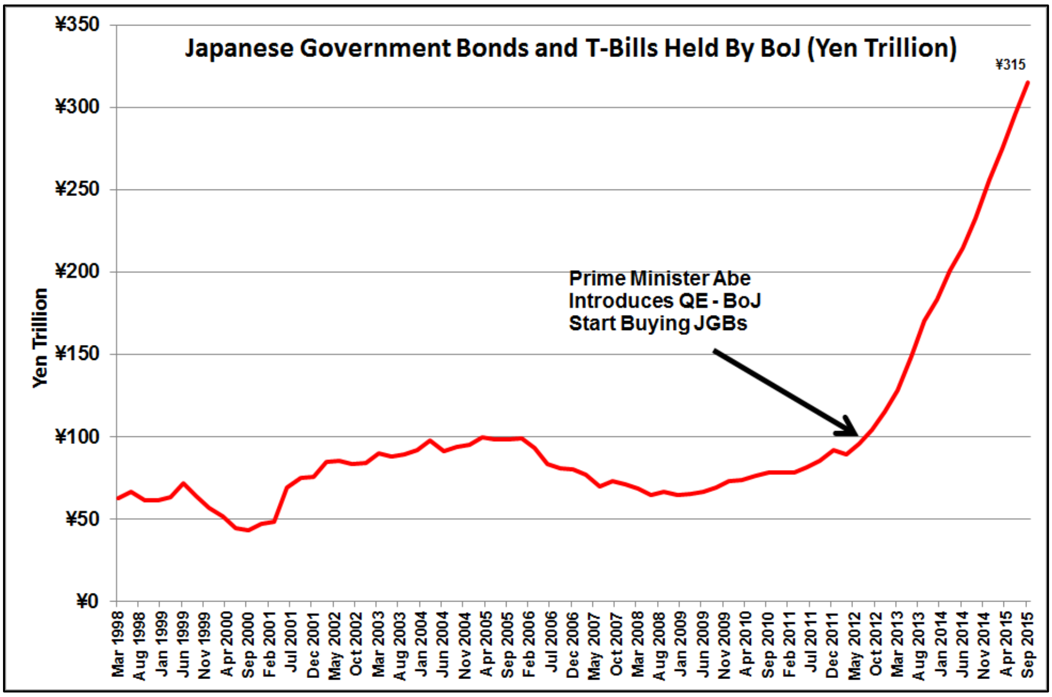


Source: Bank of Japan, ESRI Japan, COURTIERS

Abe's Three Arrows policy does not change the trajectory of the increase in Japanese government debt by very much at all, it was rising steadily long before "Abenomics" kicked-in in the spring of 2013.

The effect on the Bank of Japan's balance sheet, however, is extreme, as highlighted by the following chart.

Chart G: Japanese Government Bonds & T-Bills Held by Bank of Japan

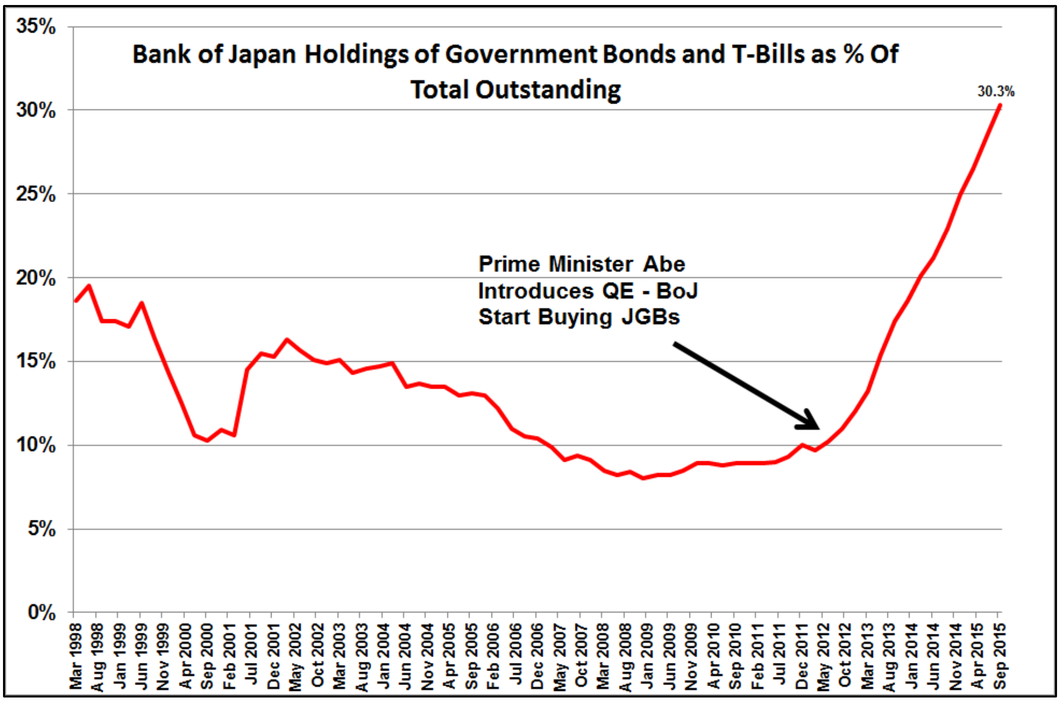


Source: Bank of Japan, ESRI Japan, COURTIERS

The amount of government securities held by the Bank of Japan has increased by over 200 trillion yen in just under four years.

To put this in perspective, the next chart shows the total holdings of Japanese government bonds and T-bills by the Bank of Japan, as a percentage of the total outstanding.

Chart H: Bank of Japan Holdings of Government Bonds & T-Bills as % of Total Outstanding

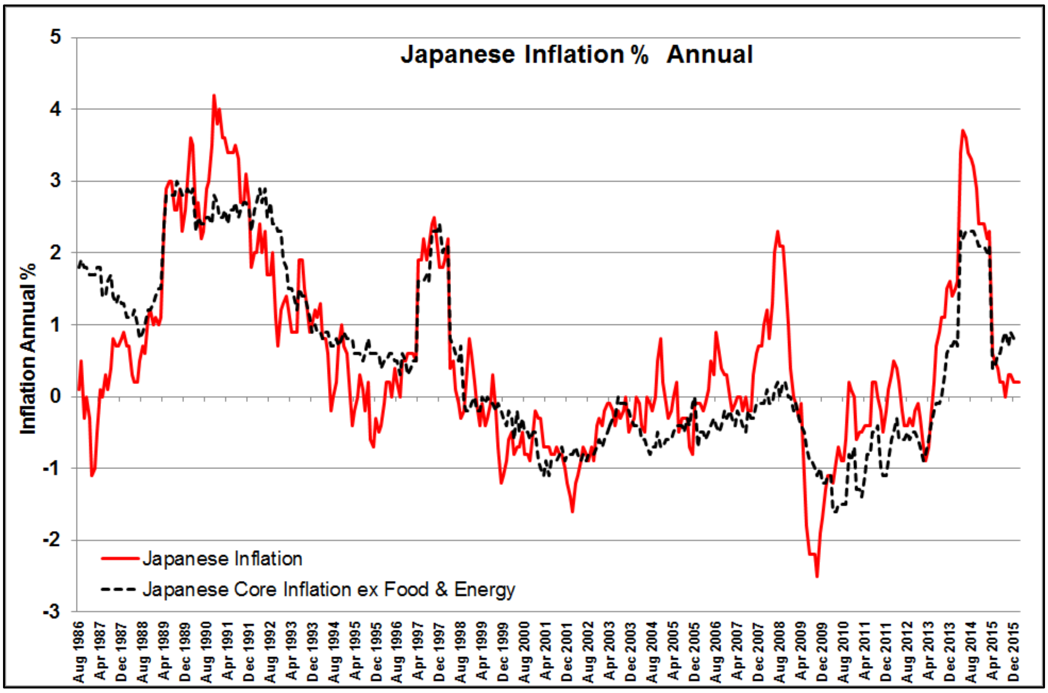


Source: Bank of Japan, COURTIERS

At September 2015, The Bank of Japan held 30.3% of the total issuance of government bonds and T-bills and that figure will continue to rise steadily as QE remains in place.

Has QE worked? One of its key objectives is to end a quarter century of Japanese deflation, so the most immediate sign of success would be an increase in the rate of inflation, which the Japanese government are targeting at 2%. The next chart shows the rate of headline, and core, inflation in Japan over the last 30 years.

Chart I: Japanese Inflation % Annual



Source: MIAC Japan, Bloomberg

In the spring of 2013 both headline inflation and core inflation (core inflation removes food and energy from the quoted inflation figure as these two items tend to be quite volatile) were negative, ie., Japan was continuing to experience deflation. Headline and core inflation did increase quite quickly after the introduction of QE in March 2013, and for a while both were in excess of the target rate of 2%. Subsequently, the headline rate has fallen back to near zero (it is currently 0.2%), which can be largely explained by the dramatic fall in oil and commodity prices. That does not, however, explain the reduction in core inflation (which excludes energy) which, although higher than headline inflation, is nonetheless just 0.8%.

The fairly paltry improvement in the rate of inflation could perhaps be ignored if the economy was picking up, but it is not: the rate of growth over the last 12 months is just 1.6%, and prospects for the future are not great either.

Conclusion

Mr Abe is an opportunistic politician that dreamed up the "Three Arrows" policy, fired-off the two easy darts (increase in public expenditure and QE) and left the most important, structural reform, in his quiver. The bad practices in corporate Japan are alive and well. Cross-holdings persist which put management under little pressure to either specialise, or make assets work effectively. As a result, shareholders in Japanese companies get a raw deal, with business owners wasting capital while Japanese ROE (return on equity) is among the worst of all developed markets. Depressingly, these problems are not new and were discussed in Brian Reading's book, "Japan: The Coming Collapse", published in 1992 and Michael Porter's book, "Can Japan Compete", published in 2000.

The lack of urgency for reform is mainly due to Japan having considerable reserves and its private sector having large savings, both of which the government are able to call on to fund public expenditure. This is why Japanese government finances can begin to rival those of Greece as among the world's most toxic, without suffering the ignominy of a junk credit rating and being shut out from global markets, at least not yet!

There is another issue that bothers me. What if Abe succeeds and pushes inflat ion beyond 2% per annum? If inflation anchors at this level, Japanese government bond yields will need to increase drastically (10 year bond yields are currently just 0.057% per annum) in order to provide investors with protection against inflation, and a return for lending money to the government in the first place. This would significantly increase the Japanese government's cost of borrowing and, with it, its fiscal deficit. What happens then? In truth, no-one is quite sure. We are all uncertain as to what the medium to long-term effects of QE will be in the West, although we generally accept that it helped to avert a depression, after the 2008 global financial crisis, that may have otherwise rivalled that which followed the 1929 crisis. One possible outcome for Japan is that it actually gets a huge bout of inflation due to its low rate of unemployment and an inefficient domestic economy that is unable to meet any increase in demand. With an ever-falling yen (which is undoubtedly one target of Abenomics) the poor domestic consumer may find overseas goods simply too expensive as an alternative to a scarcity of domestic supply.

There may be smart people out there that can make money from trading Japanese bonds, the Japanese yen and Japanese shares. Good luck to them! Apart from being highly selective in choosing certain Japanese stocks for our Global (ex-UK) Equity Income fund, I will certainly not be recommending buying Japanese assets in the foreseeable future. There are better opportunities around the world, and without the Mount Fuji size pile of toxic, uniquely Japanese, risks.

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