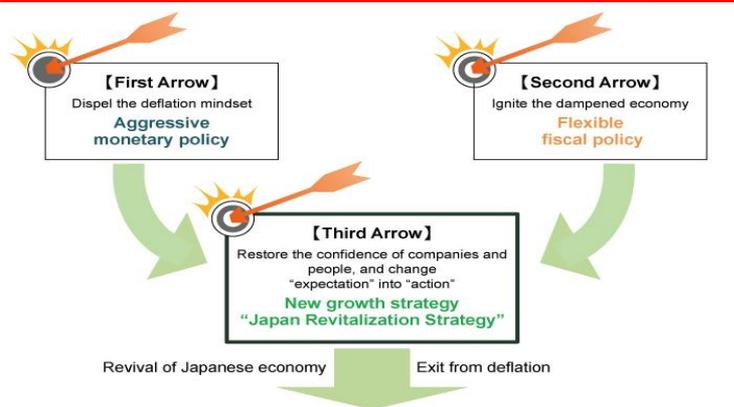


# *The Outlook for Japan under Abenomics and Abenationalism*

David L. Asher, Ph.D

September 27, 2013

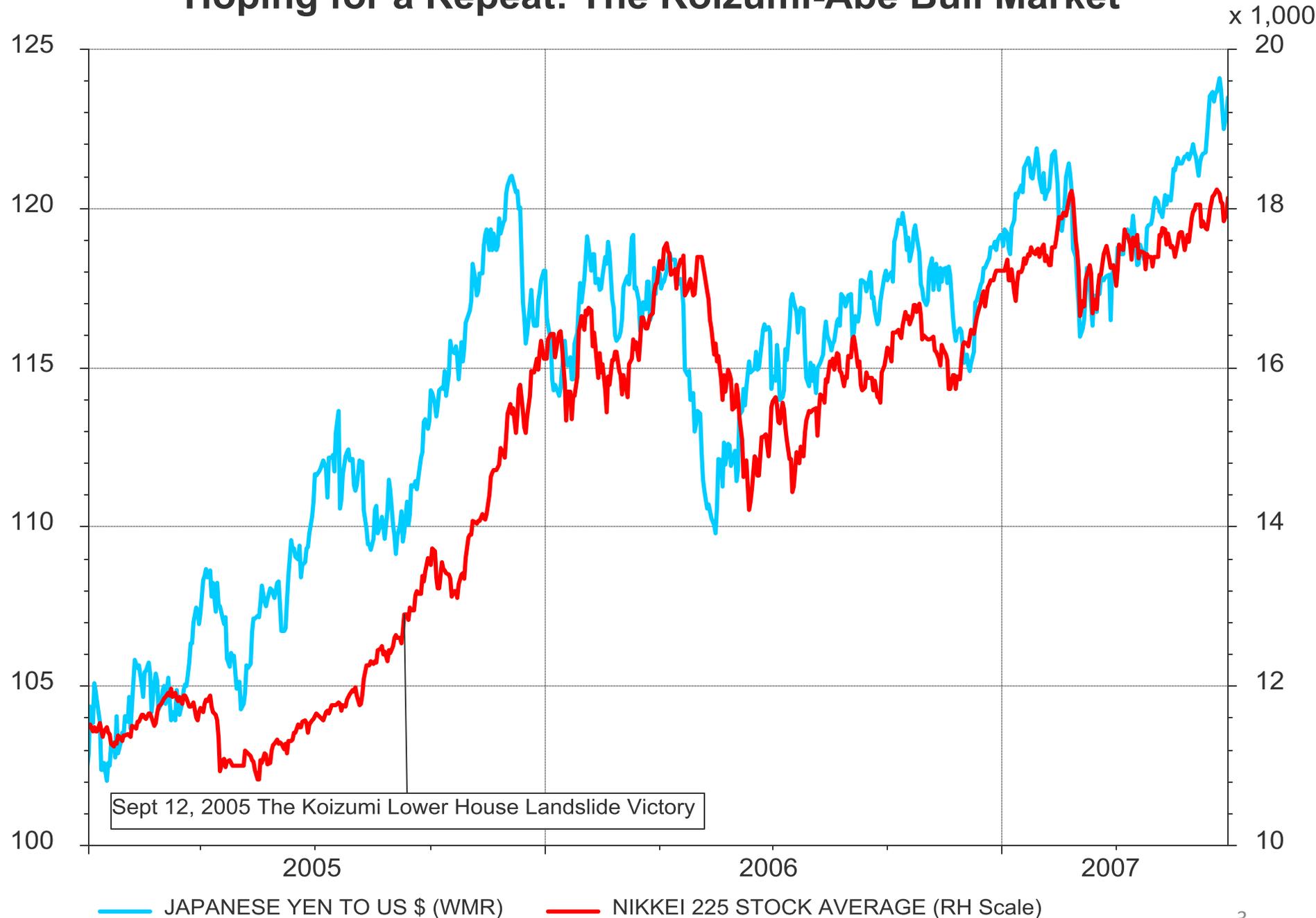


The administration aims to achieve an average **3% nominal GDP growth** and **2% real GDP growth** over the next ten years. This is expected to **increase the per capita nominal gross national income (GNI) by no less than 1.5 million yen** in ten years.

# Sharpening the Third Arrow

- PM Abe has produced the biggest electoral landslide victory since PM Koizumi in Sept 2005, putting the LDP solidly in charge of both houses for 3 years.
- PM Koizumi's big win set off a two year bull market. PM Abe's victory could as well.
- Abe's Third Arrow needs sharpening. Foreign investors, who have driven the out-performance of the TOPIX globally—now fear that the Third Arrow is dull, not sharp.
- Raising the consumption tax will take ¥7 trillion off growth next FY. The expected corporate tax cut will add back only ¥1.2 trillion. The math is not complicated....
- Abe promises more pork barrel stimulus but that has never worked. Japan needs sustainable growth engendered via structural reform, total tax reform, and supported by monetary easing, more than another fiscal shot in the arm. Japan should follow the Korean-German reform example.
- The key metrics for success are boosting *asset* reflation, productivity growth—capital, labor, and total factor— and nominal GDP growth. Monetary easing is only a supporting element.
- The Yen is the single biggest determinant of successful reflation and recovery in capital expenditure, asset markets, and overall confidence and remains at least 15% overvalued.
- TPP, deregulation, corporate tax reform, introduction of ISAs, gift tax reform transfers, recovered corporate confidence, and additional stimulus in the fall can *potentially* trigger a bull market in 1Q 2014, despite fiscal headwinds (including consumption tax).
- Key risks are consumption slowdown, Syria crisis triggering Middle East war (and oil shock), China-NK tension, 10% cap gains tax increase on TSE, ISA selling at year-end, and JGB bubble bursting.
- Abe may turn more nationalistic in 2014 if economic reforms fail to bite. This will affect China and North Korea primarily. He is not anti-ROK.

# Hoping for a Repeat: The Koizumi-Abe Bull Market



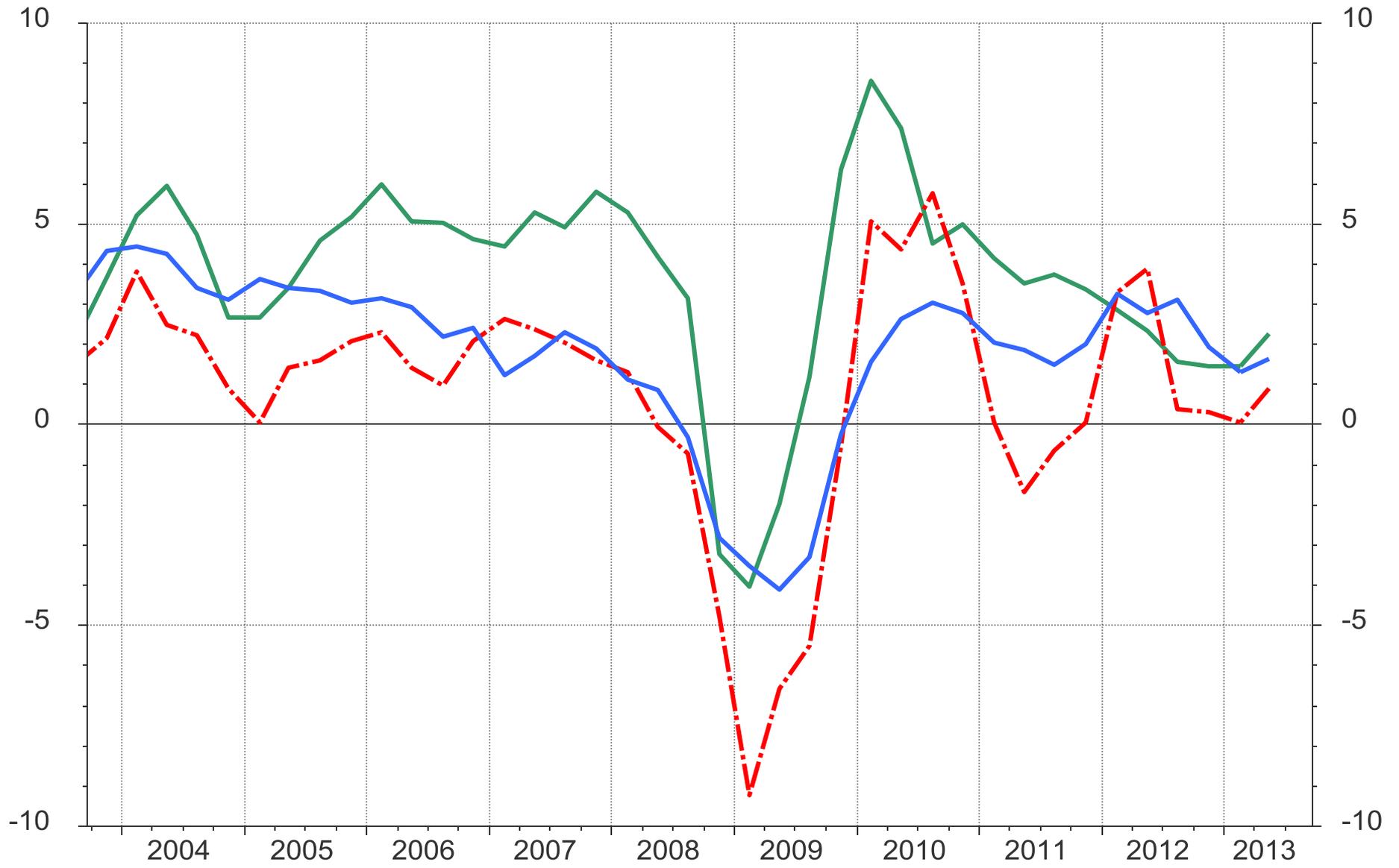
Sept 12, 2005 The Koizumi Lower House Landslide Victory

JAPANESE YEN TO US \$ (WMR)

NIKKEI 225 STOCK AVERAGE (RH Scale)

Source: Thomson Reuters Datastream

# Japan's Lagging Growth Continues

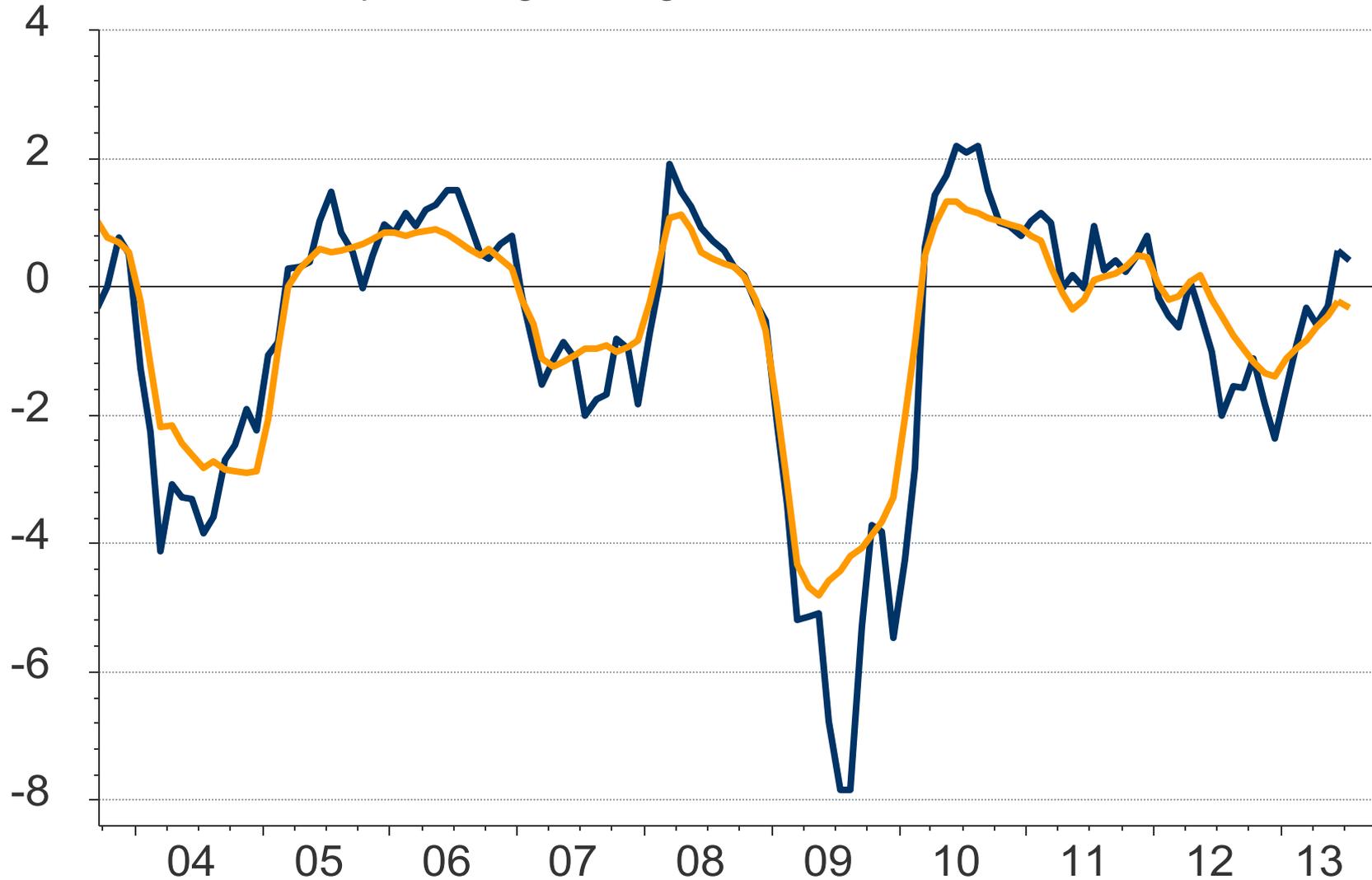


- CLI GROSS DOMESTIC PRODUCT GDP YEAR ON YEAR GROWTH RATE : South Korea
- · - CLI GROSS DOMESTIC PRODUCT GDP YEAR ON YEAR GROWTH RATE : Japan
- CLI GROSS DOMESTIC PRODUCT GDP YEAR ON YEAR GROWTH RATE : United States

Source: Thomson Reuters Datastream

# Japan labour cash earnings growth

Twelve-month percentage changes



- Average monthly earnings (3-mma)
- Average contractual monthly earnings (3-mma)

Source: Thomson Reuters Datastream

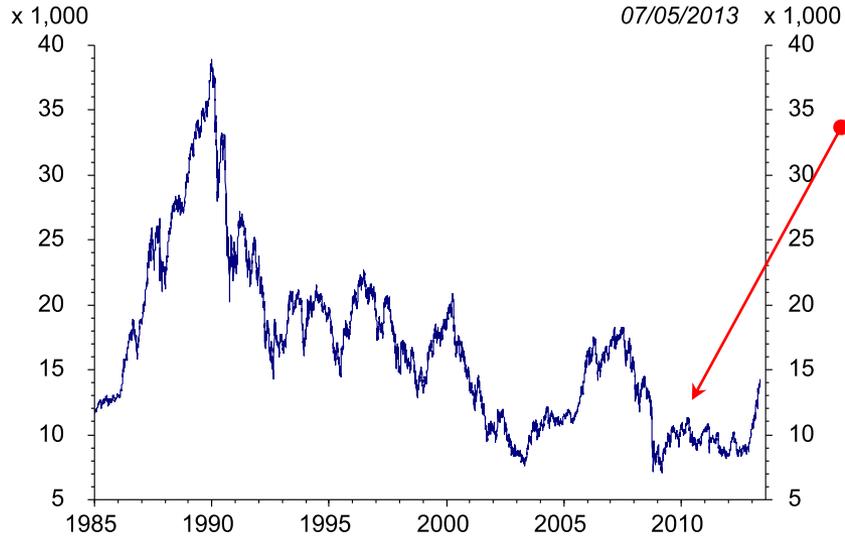
# The 5 D's: Determinants of Growth

- Deflation
- Demography
- Deregulation
- Debt
- Declining hope



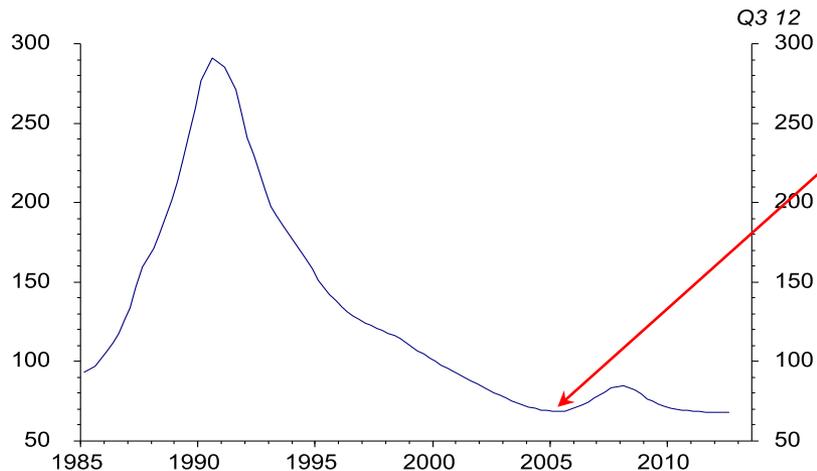
# Reversing Asset Deflation is Key

## Nikkei 225 Stock Index



*Japanese investors and corporations are scarred from the post-bubble fallout. The stock market is still down 63% from the 1989 peak, and land prices are down 77%. The entrenched cautious mentality has been a key factor in holding back Japan's recovery, leading to low investment/ high savings ... and it will be hard to change.*

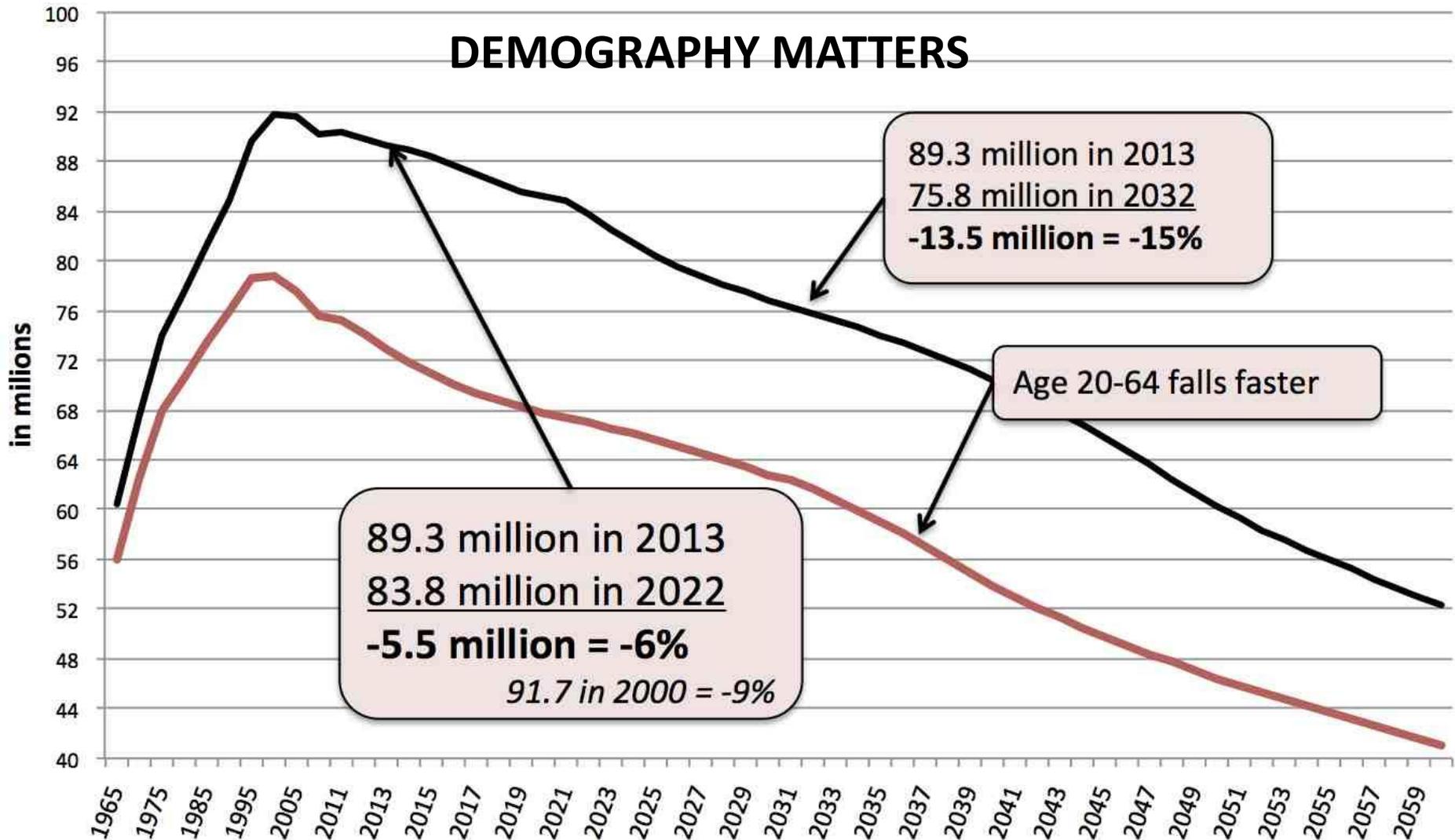
## Japan Land Price Index: Big Cities



*Japanese investors and corporations are scarred from the post-bubble fallout. The stock market is still down 63% from the 1989 peak, and land prices are down 77%. The entrenched cautious mentality has been a key factor in holding back Japan's recovery, leading to low investment/ high savings ... and it will be hard to change.*

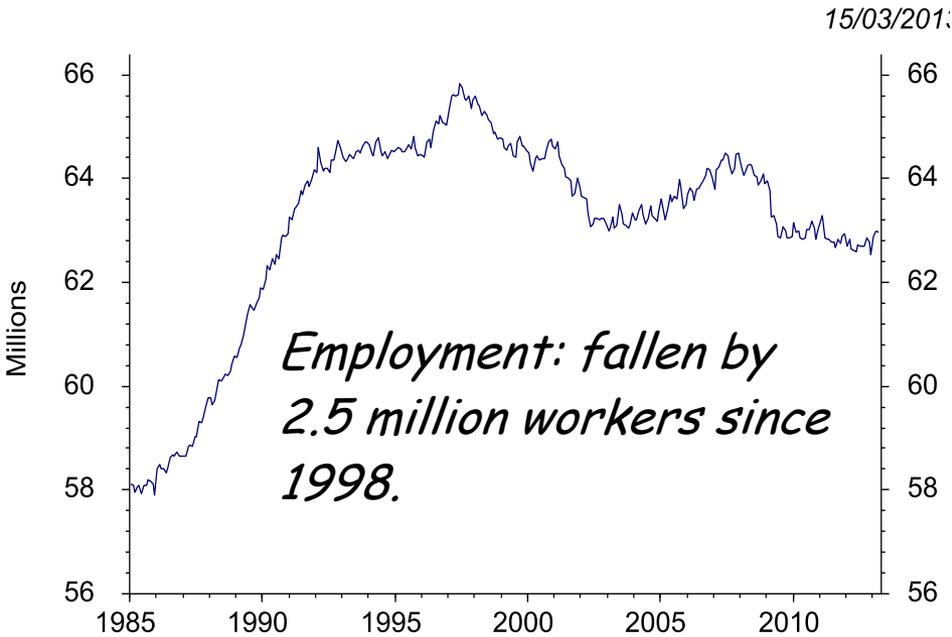
# Japanese Potential Driving Population

Ages 20-75 (Middle Projections, 2012)



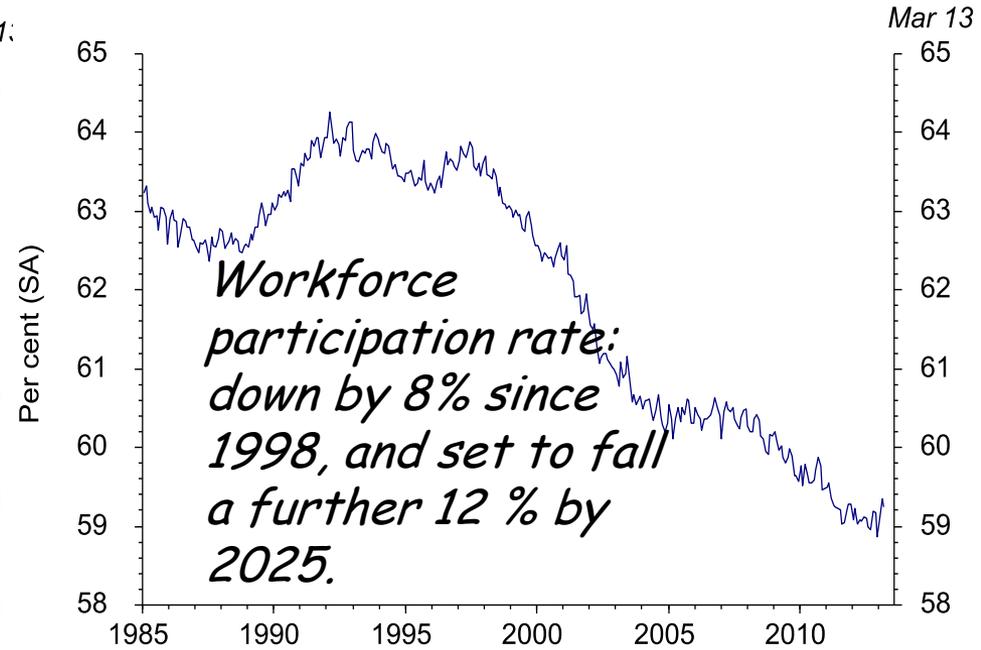
# Workforce in Decline

## Japan Employment Level



Source: Thomson Reuters Datastream

## Japan Participation Rate

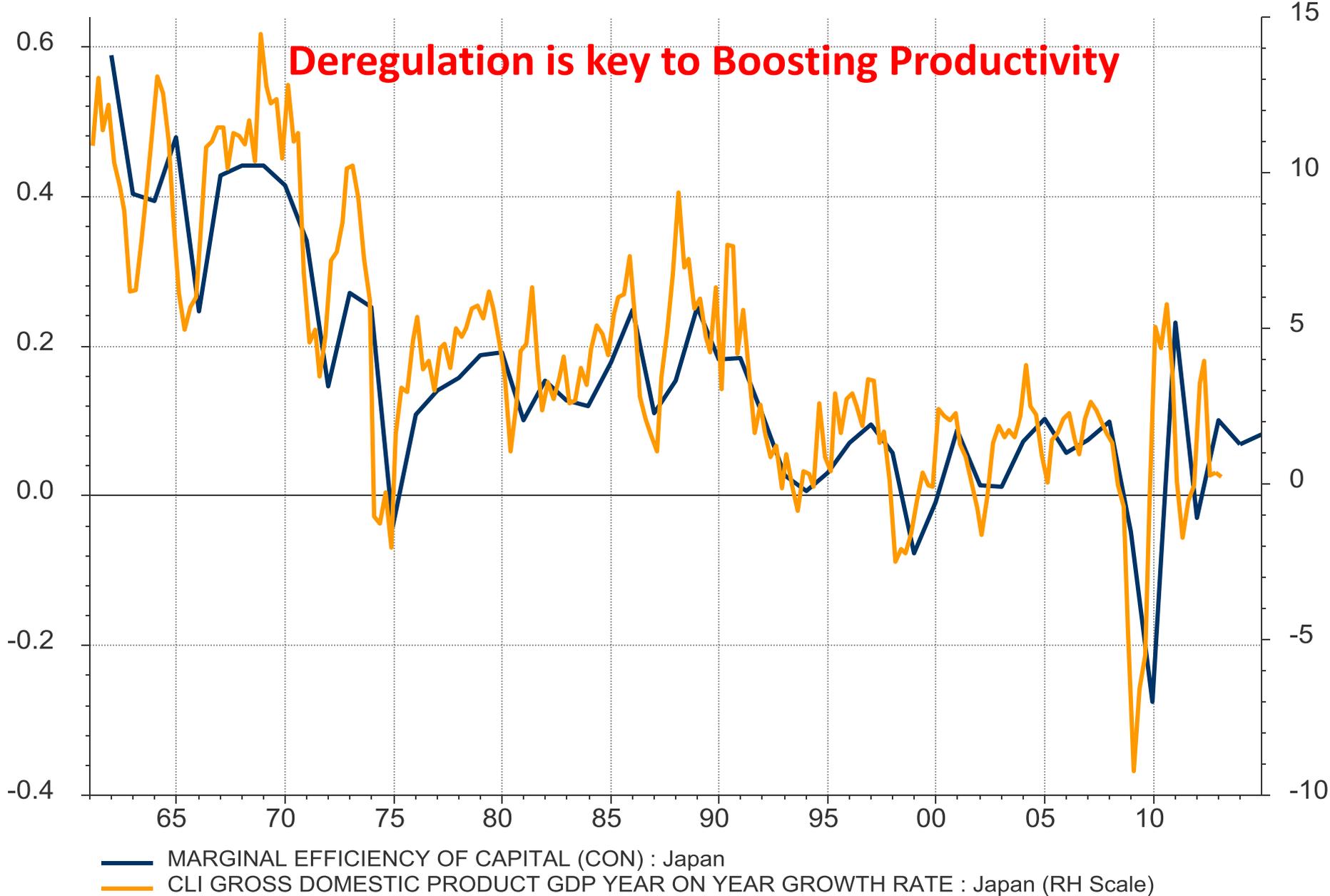


Source: Thomson Reuters Datastream

**25% of all Japanese are older than 65!!**

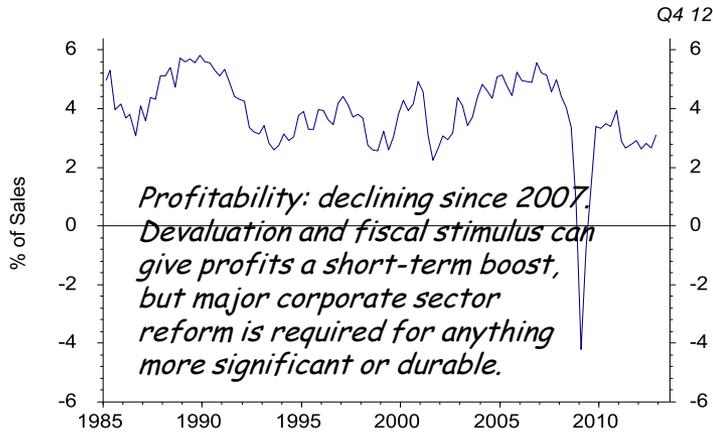
# Japan: Marginal Efficiency of Capital and GDP Growth

Marginal efficiency of capital: total economy (Change in GDP at constant market prices of year T per unit of gross fixed capital formation at constant prices of year T-.5.)

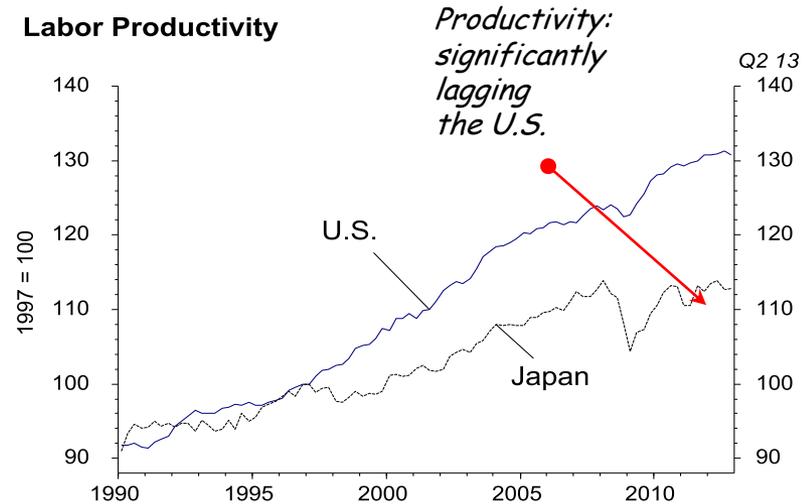


# Declining Corporate Fundamentals

Japan Operating Profits, Manufacturing



Labor Productivity



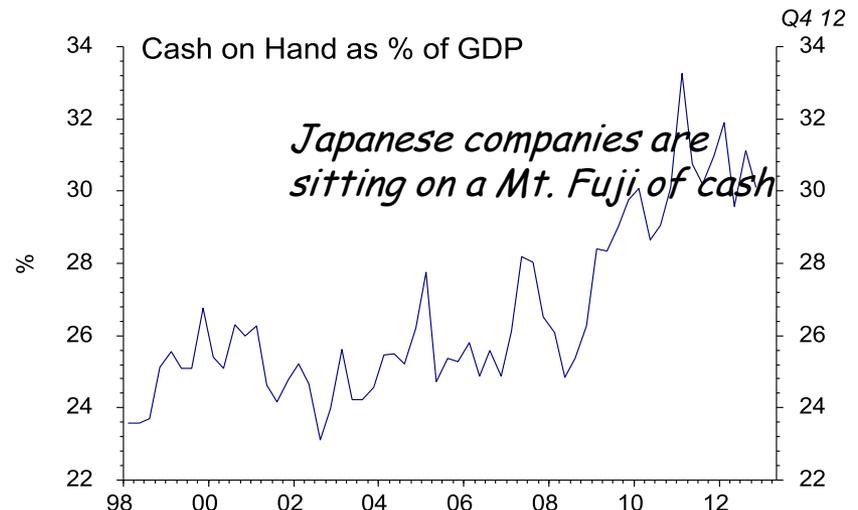
Source: Thomson Reuters Datastream

Japan share of world exports



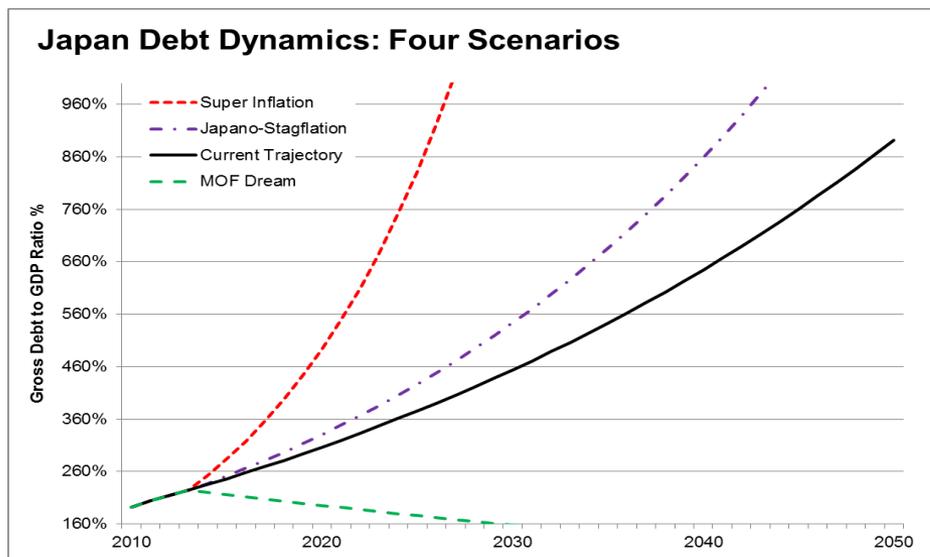
Source: Thomson Reuters Datastream

Japan: Corporate Liquidity - All Industries

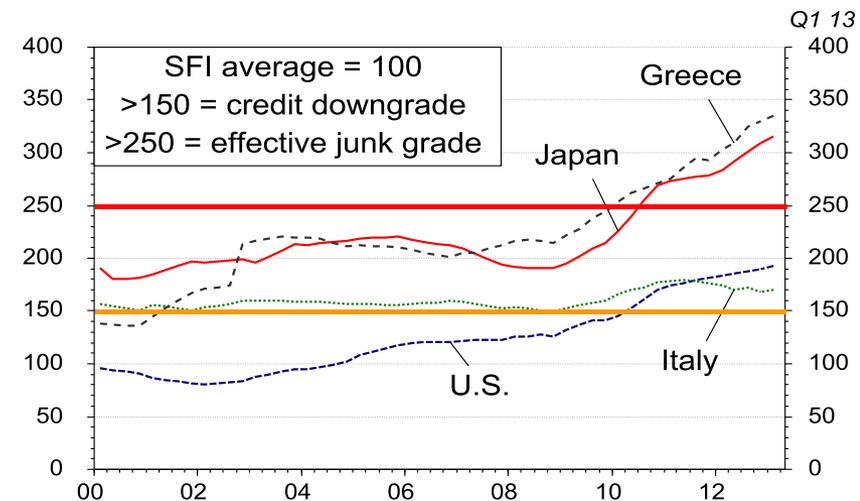


Source: Thomson Reuters Datastream

# Financial Mt. Fuji: Government Debt Mountain



## Sovereign Fragility Index



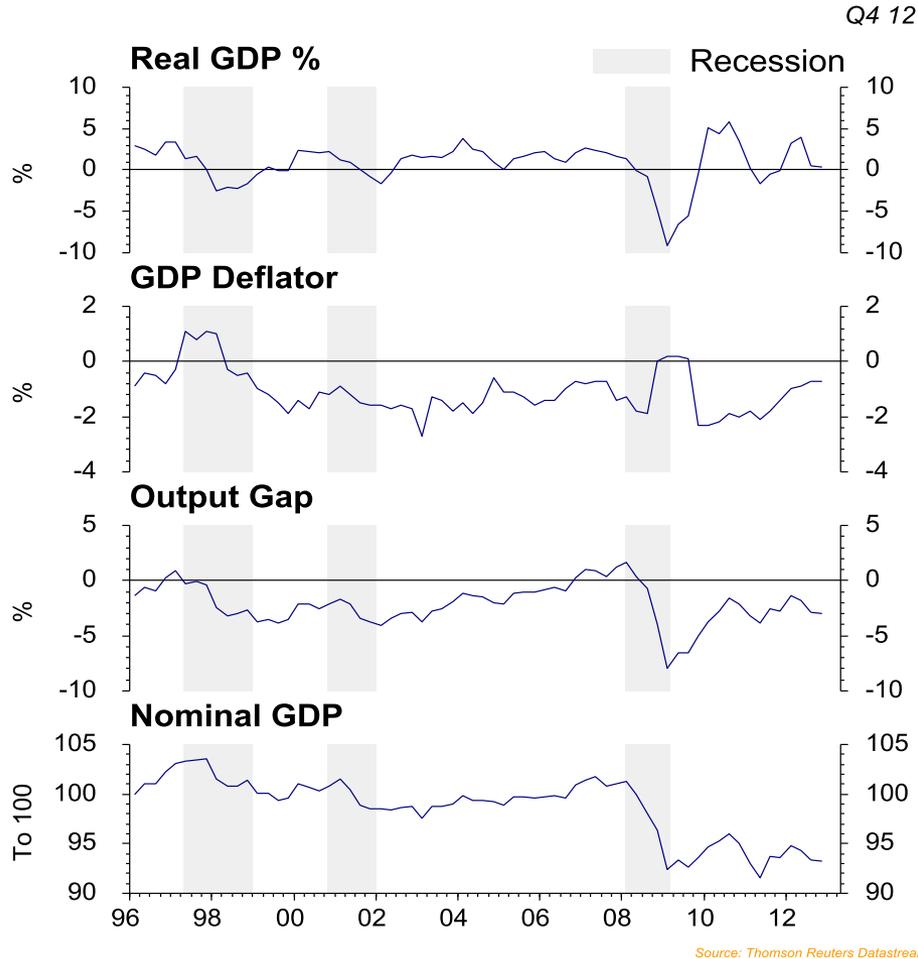
Source: Thomson Reuters Datastream/Fathom Consulting

**Table 1: Four Debt Scenarios**

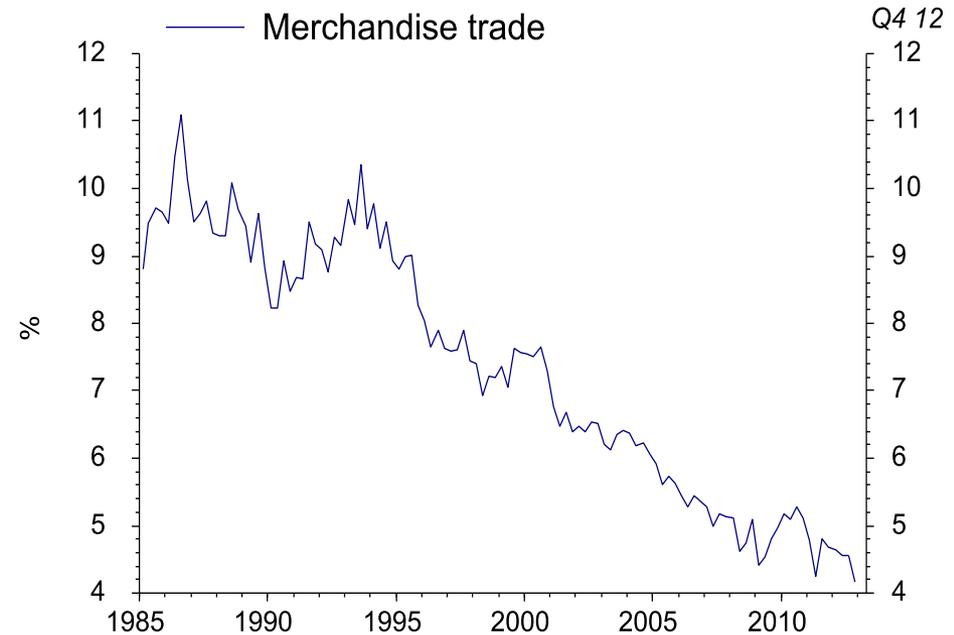
	Nominal GDP Growth Rate	Primary Budget Surplus (+) or Deficit (-)	Avg. Interest Rate on o/s National Debt
<b>Current Trajectory</b>	-1%	-5%	1.6%
<b>MOF's Dream</b>	4%	2%	3%
<b>Japano-Stagflation</b>	0%	-4.5%	4%
<b>Super Inflation</b>	-2%	-6%	8%

# Reversing Japan's Decline won't be Easy

## Japan: Deflating GDP



## Japan share of world exports



**Japanese nominal GDP today is 12% lower than it was in 1998!**

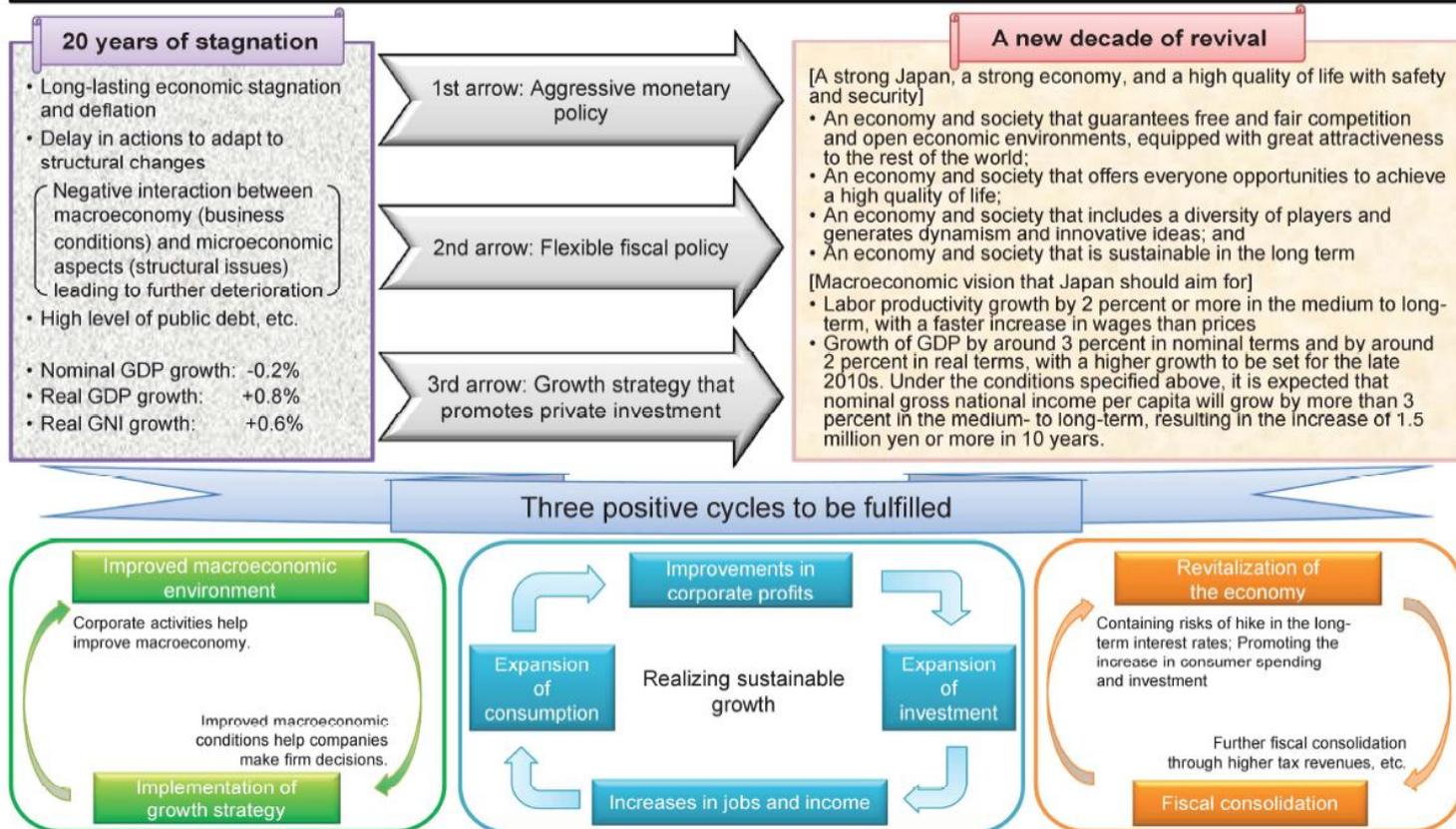
# Can Abenomics Stop Japan's Economic Decline?



# The Economic Backdrop for Abemonics

## Key points of the Basic Policies for Economic and Fiscal Management and Reform Economic and fiscal policy management and its basic strategy for “a new decade of revival”

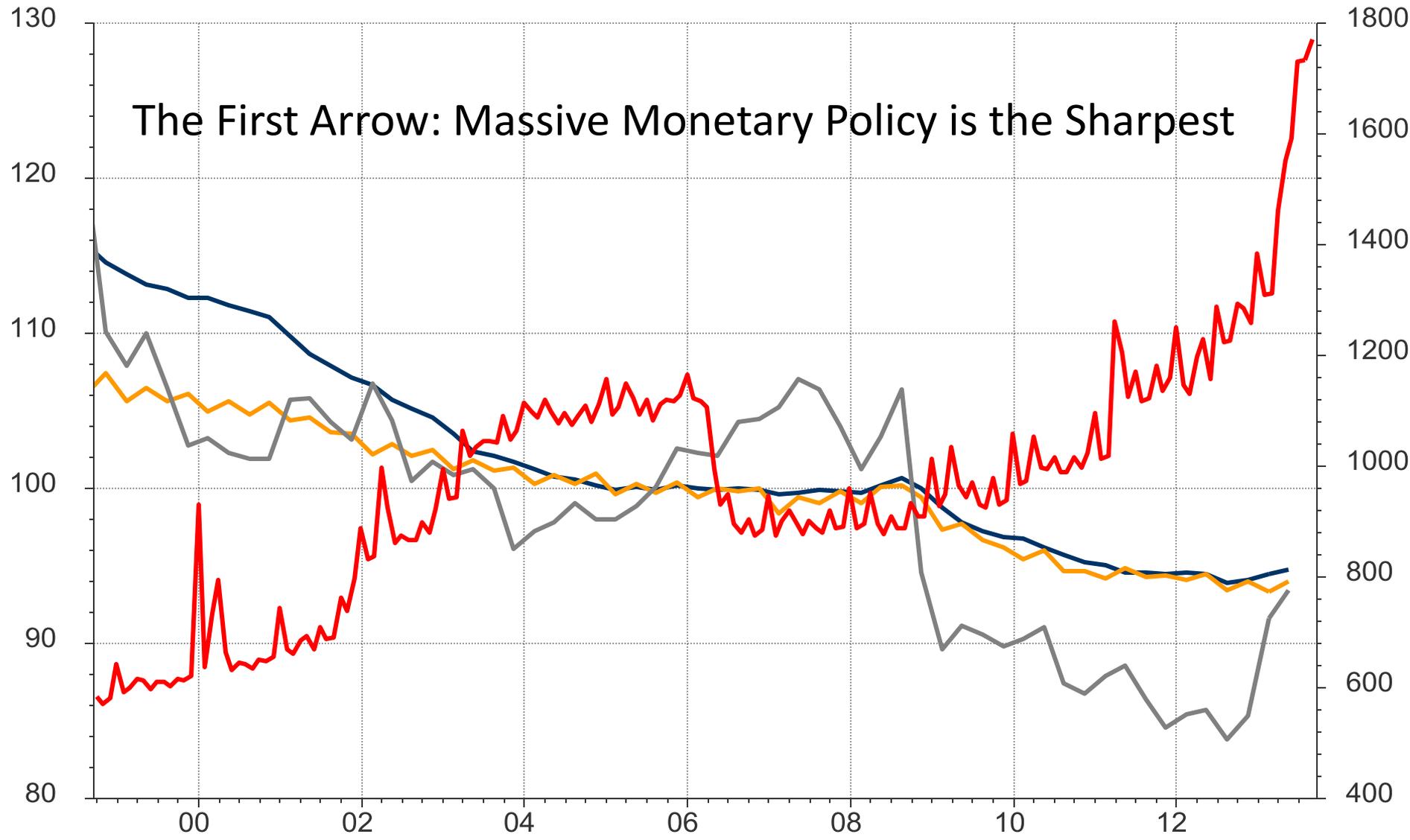
- The “three-arrows” strategy or “Abemonics”, whose components work to complement each other, has been implemented in an integrated manner. This has already significantly changed market expectations. The real economy is also picking up. The *Basic Policies* presents macroeconomic vision and the path to be followed to achieve that vision.
- The government is committed to the steady and persistent implementation of the growth strategy, as well as priority policy measures stated in the *Basic Policies*. It aims to end deflation as early as possible and revitalize its economy. The *Basic Policies* presents the economic and social vision that Japan should pursue through the implementation of policies.



# Deflation and the Monetary Base

x 1,000

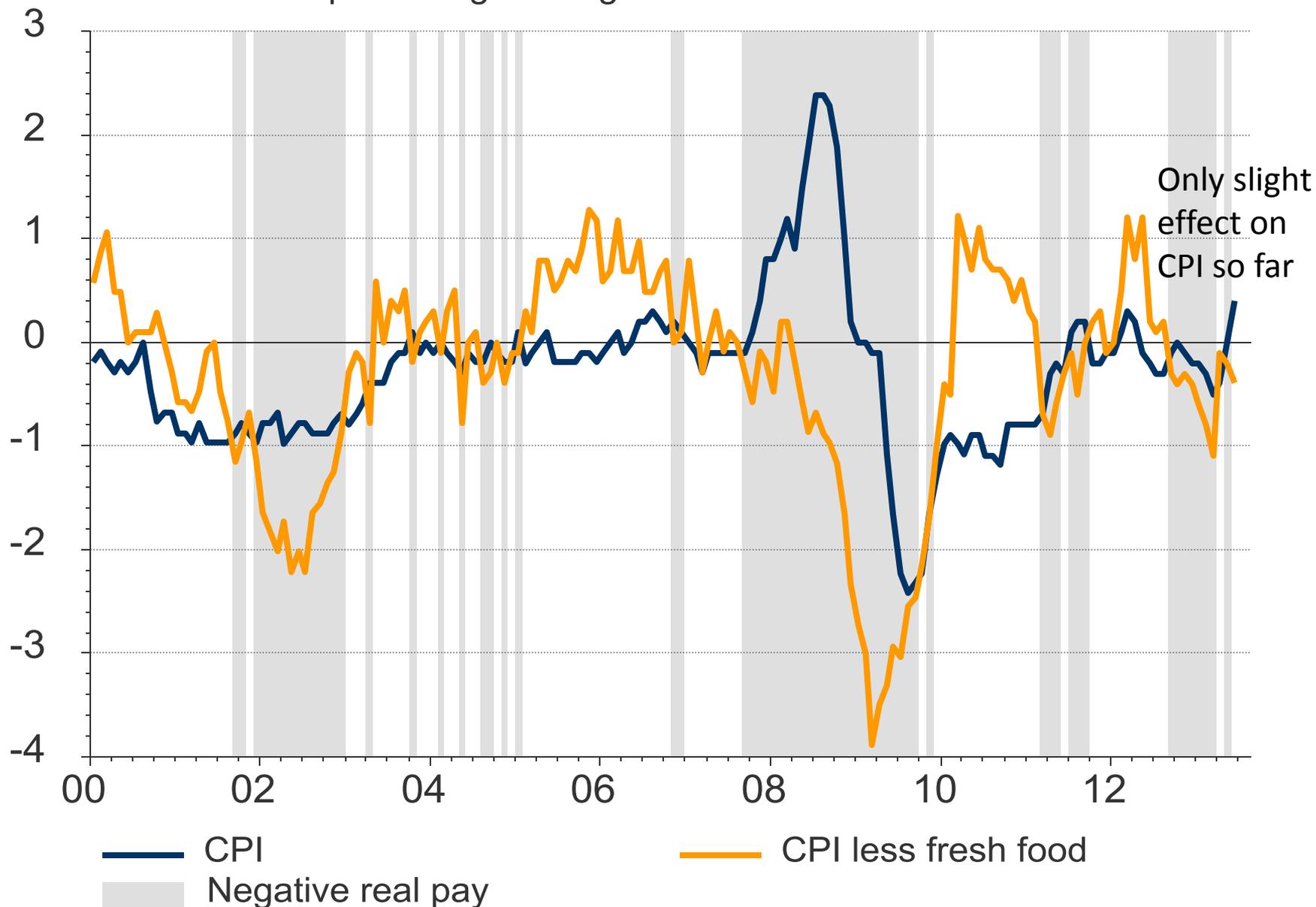
## The First Arrow: Massive Monetary Policy is the Sharpest



- DEFLATOR - PRIVATE NON RESIDENTIAL INVESTMENT : Japan
- DEFLATOR - CNSMPT. EXPND., HH. EXCL. IMPUTED RENT : Japan
- DEFLATOR - EXPORTS OF GOODS & SERVICES : Japan
- MONETARY BASE - STOCK : Japan (RH Scale)

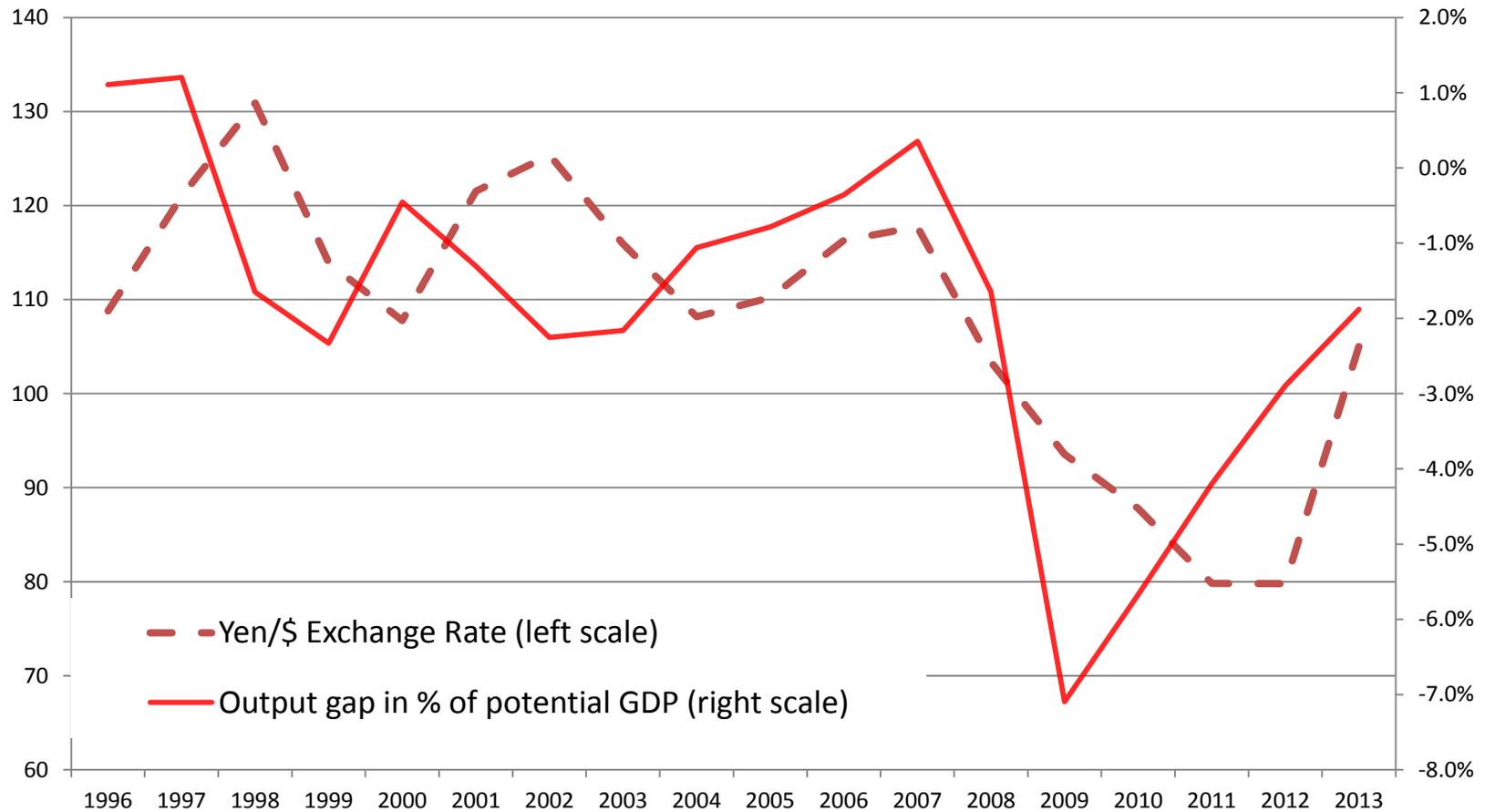
# Japan inflation and wages

Twelve-month percentage change



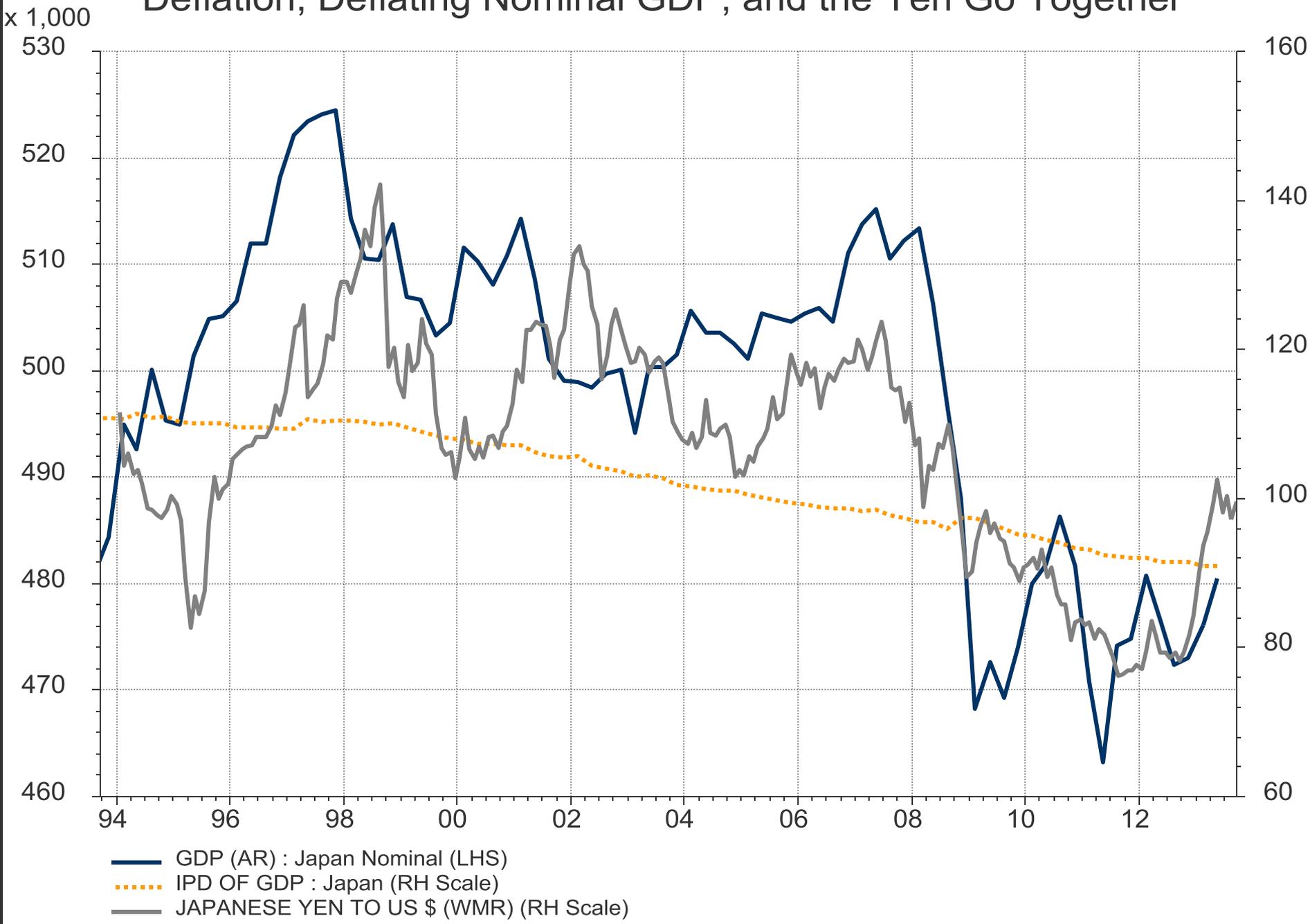
# The Yen Liquidity Trap

## The Yen-Dollar Exchange Rate and the Output Gap



Source: IMF and author's estimate for 2013 ¥/\$

# Deflation, Deflating Nominal GDP, and the Yen Go Together



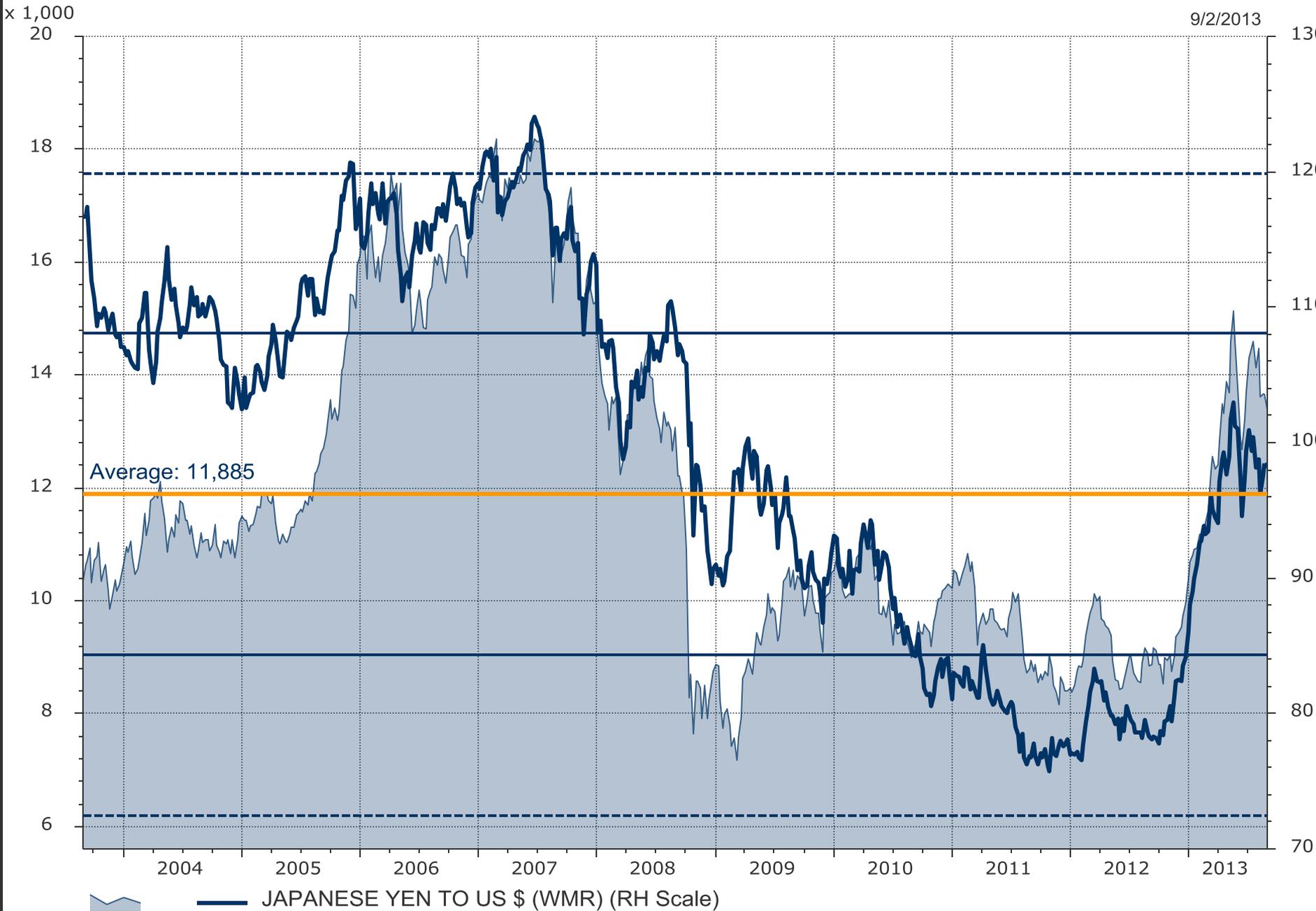
Source: Thomson Reuters Datastream

# Deflation and the Yen-Dollar



Source: Thomson Reuters Datastream

# Nikkei 225 vs. Yen-Dollar: The Yen Drives the Nikkei

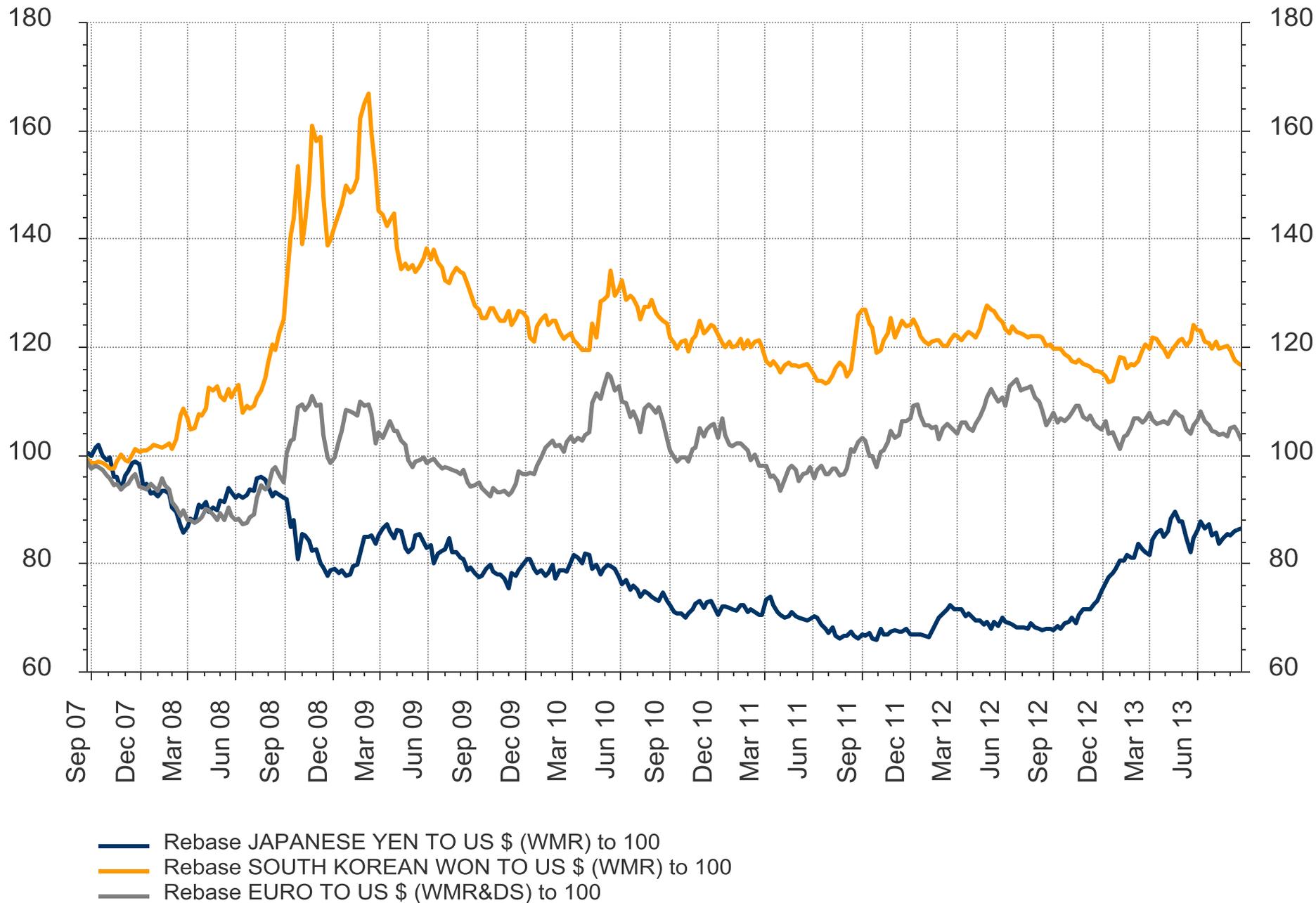


9/2/2013

Average: 11,885

JAPANESE YEN TO US \$ (WMR) (RH Scale)

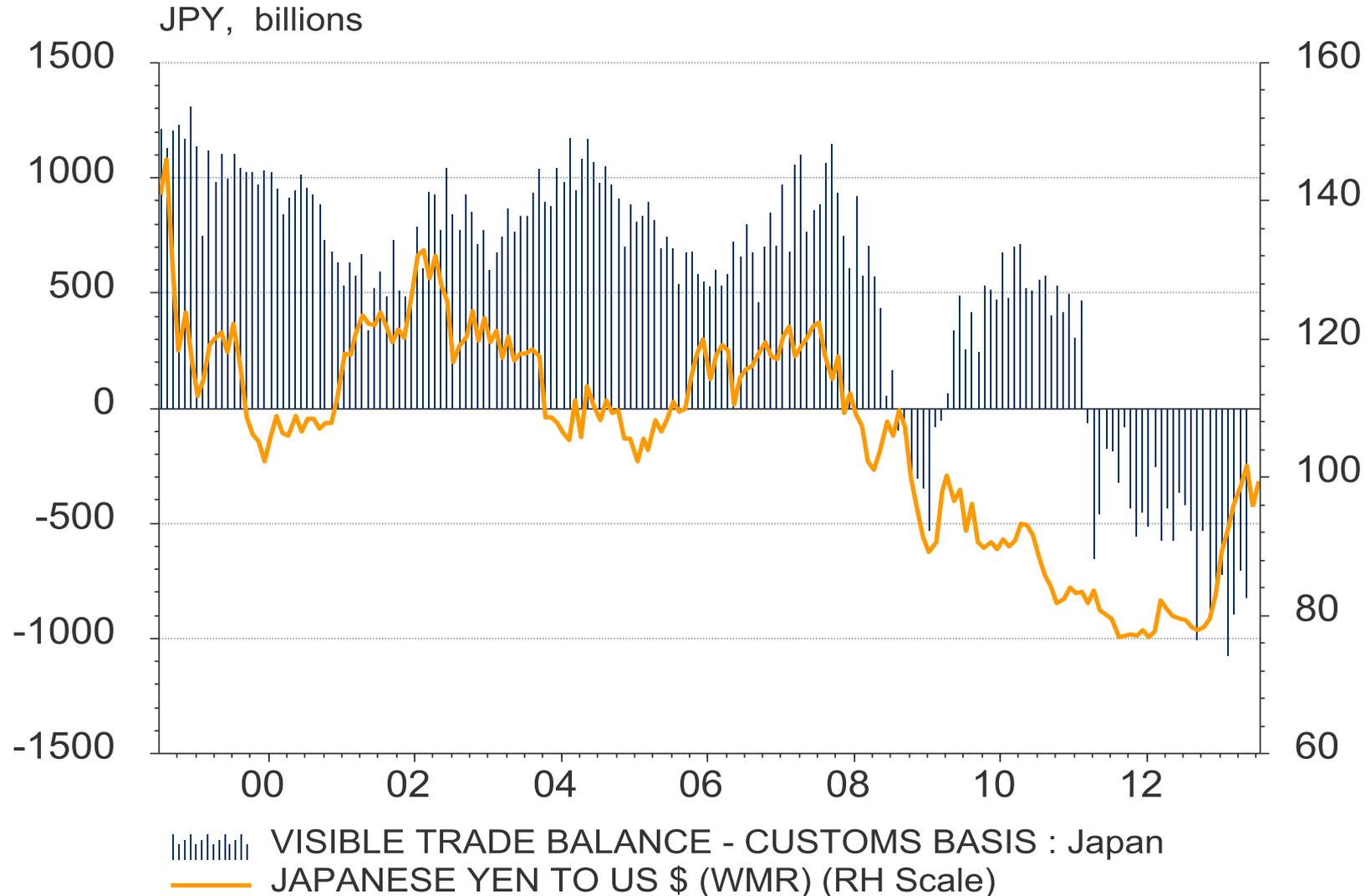
# Yen, Won, and Euro vs Dollar since 2007



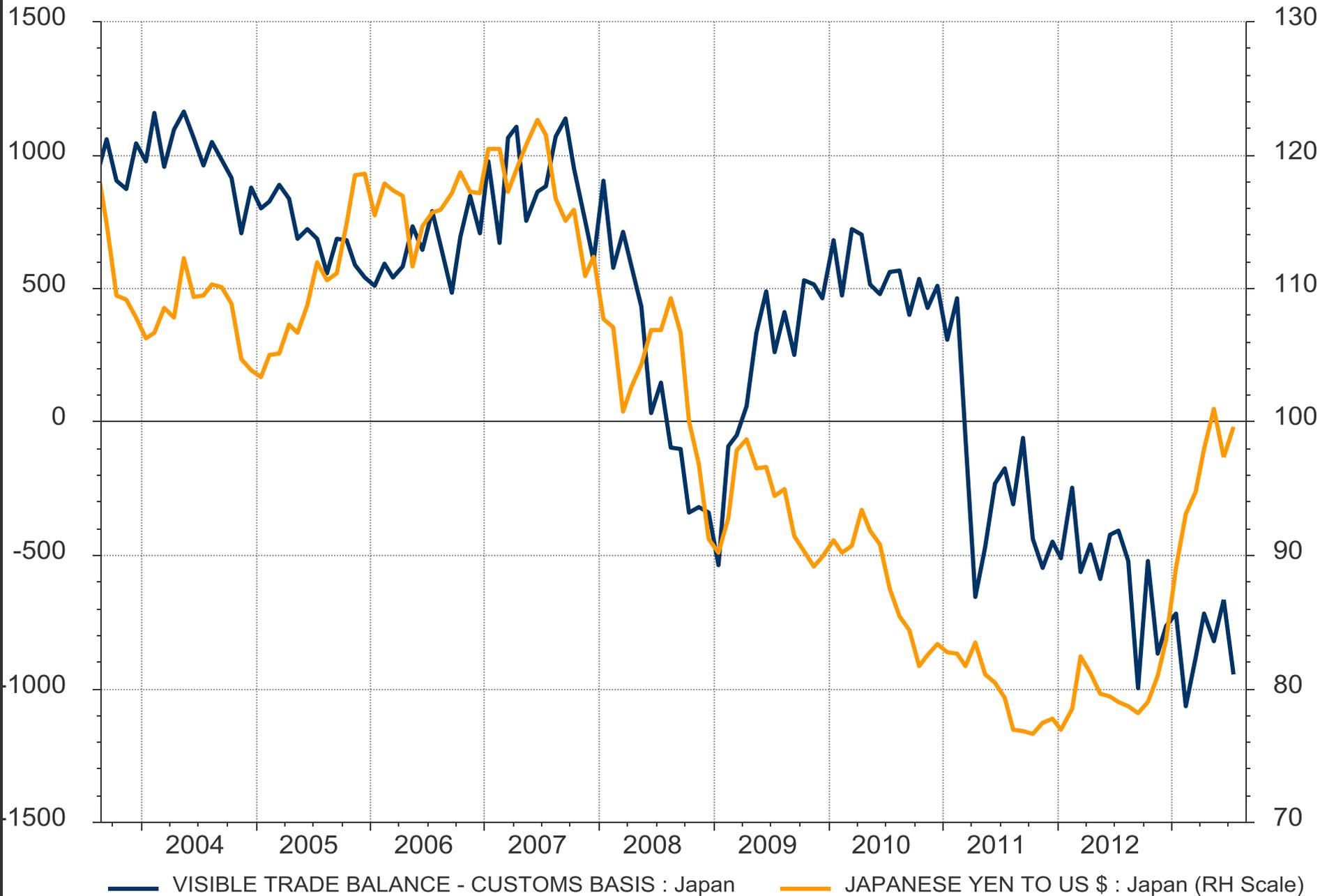
Source: Thomson Reuters Datastream

# Endaka & Japan Export Competitiveness

## Japan trade balance and Yen-Dollar



# Enyasu not Yet Reflected in Japan Trade Balance

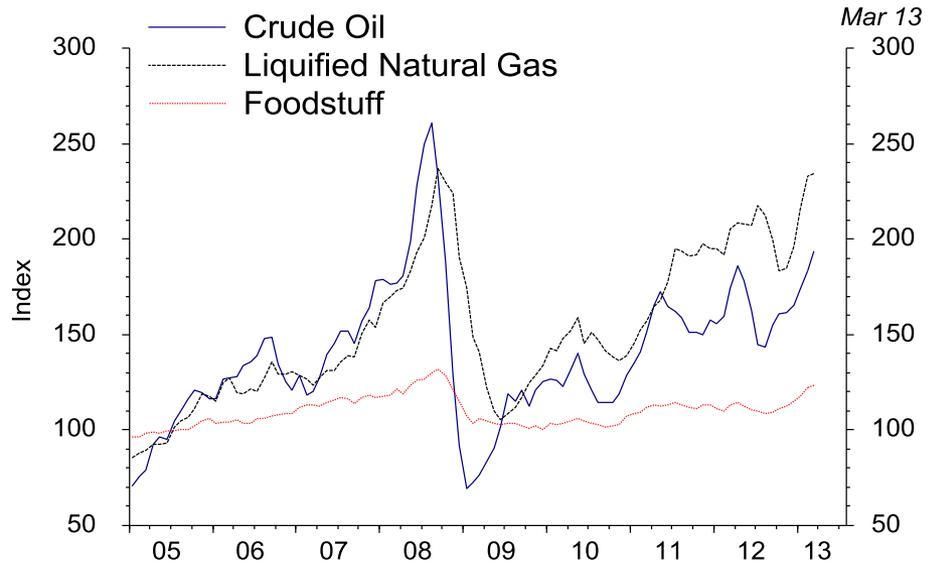


— VISIBLE TRADE BALANCE - CUSTOMS BASIS : Japan      — JAPANESE YEN TO US \$ : Japan (RH Scale)

Source: Thomson Reuters Datastream

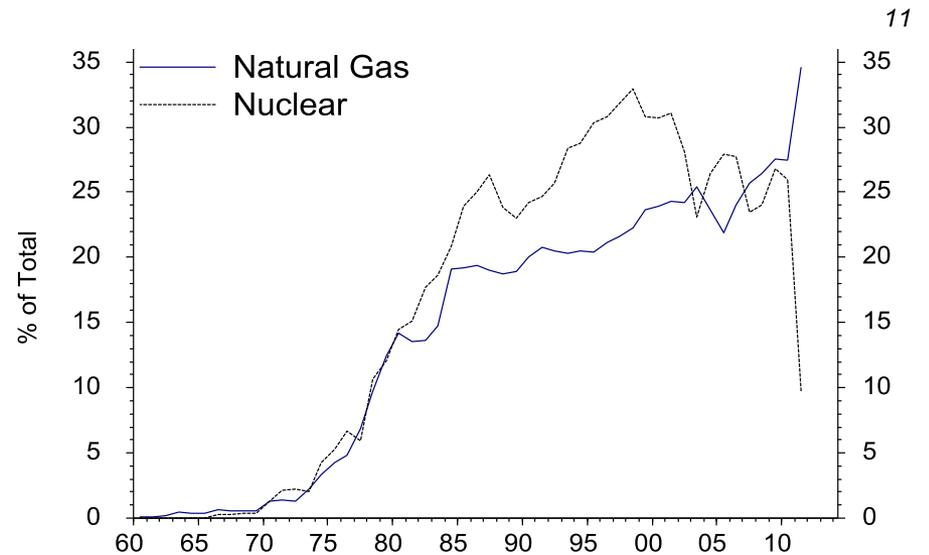
# Enyasu Negative: Dependence on Energy Imports Rising

## Japan: Import Value by Type



Source: Thomson Reuters Datastream

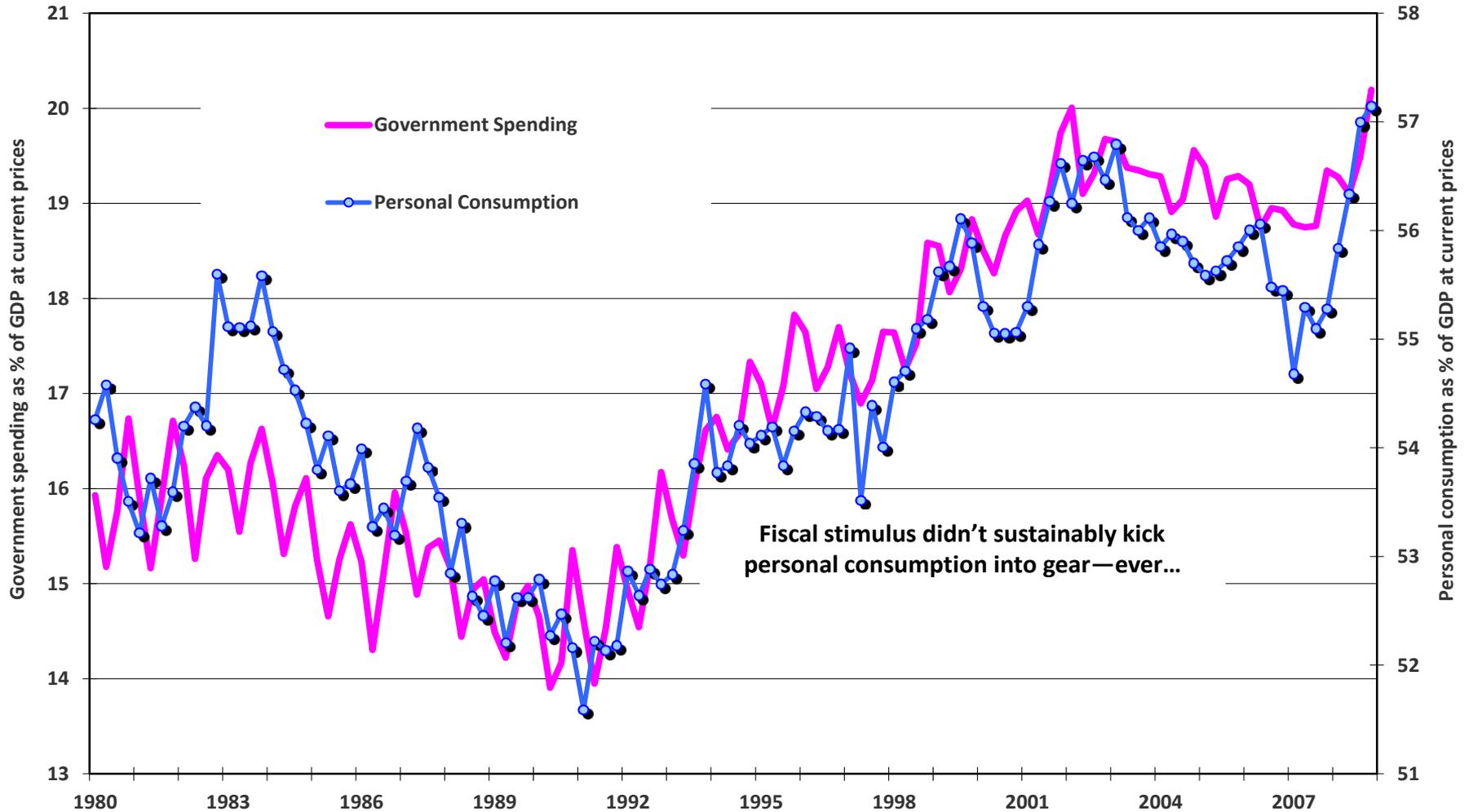
## Japan: Electricity Production



Source: Thomson Reuters Datastream

# Second Arrow: Fiscal Stimulus:

## Will this time really be different?

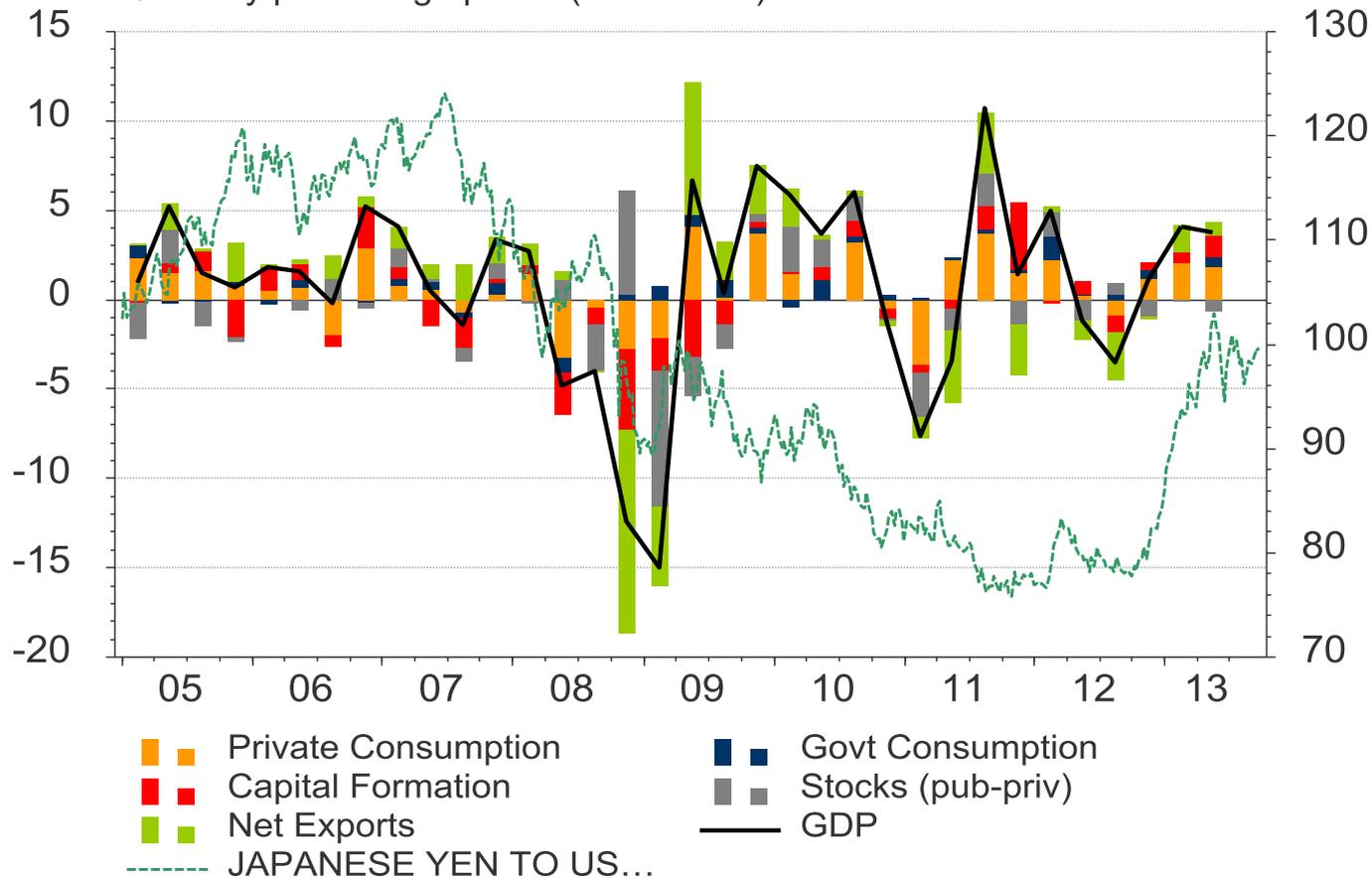


Source: © *Smithers and Company* based on Cabinet Office data via *Ecwin*

# The Third Arrow: Hoping for the Consumer and Capex Recovery

## Contributions to Japanese GDP growth

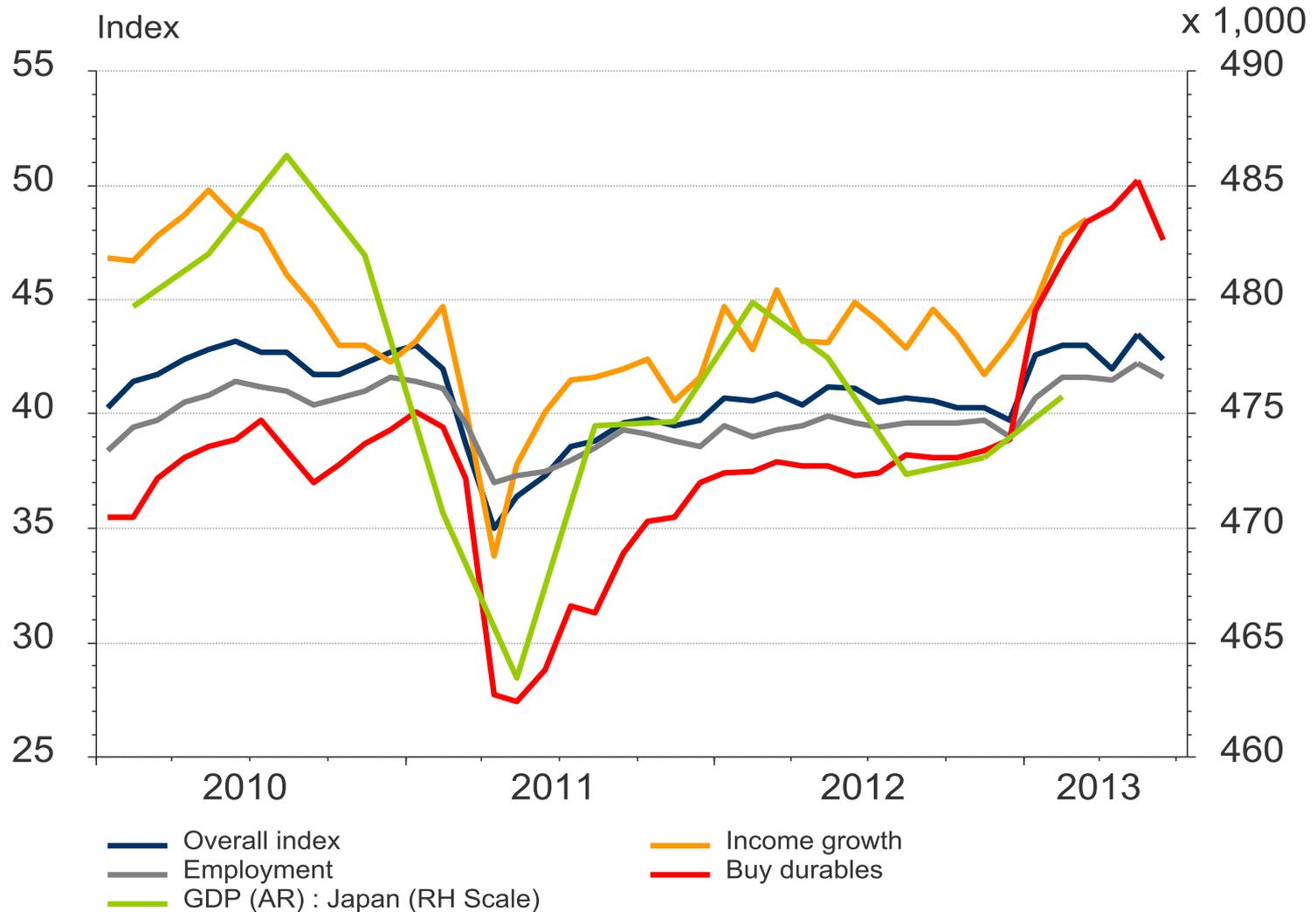
Quarterly percentage points (annualised)



Source: Thomson Reuters Datastream

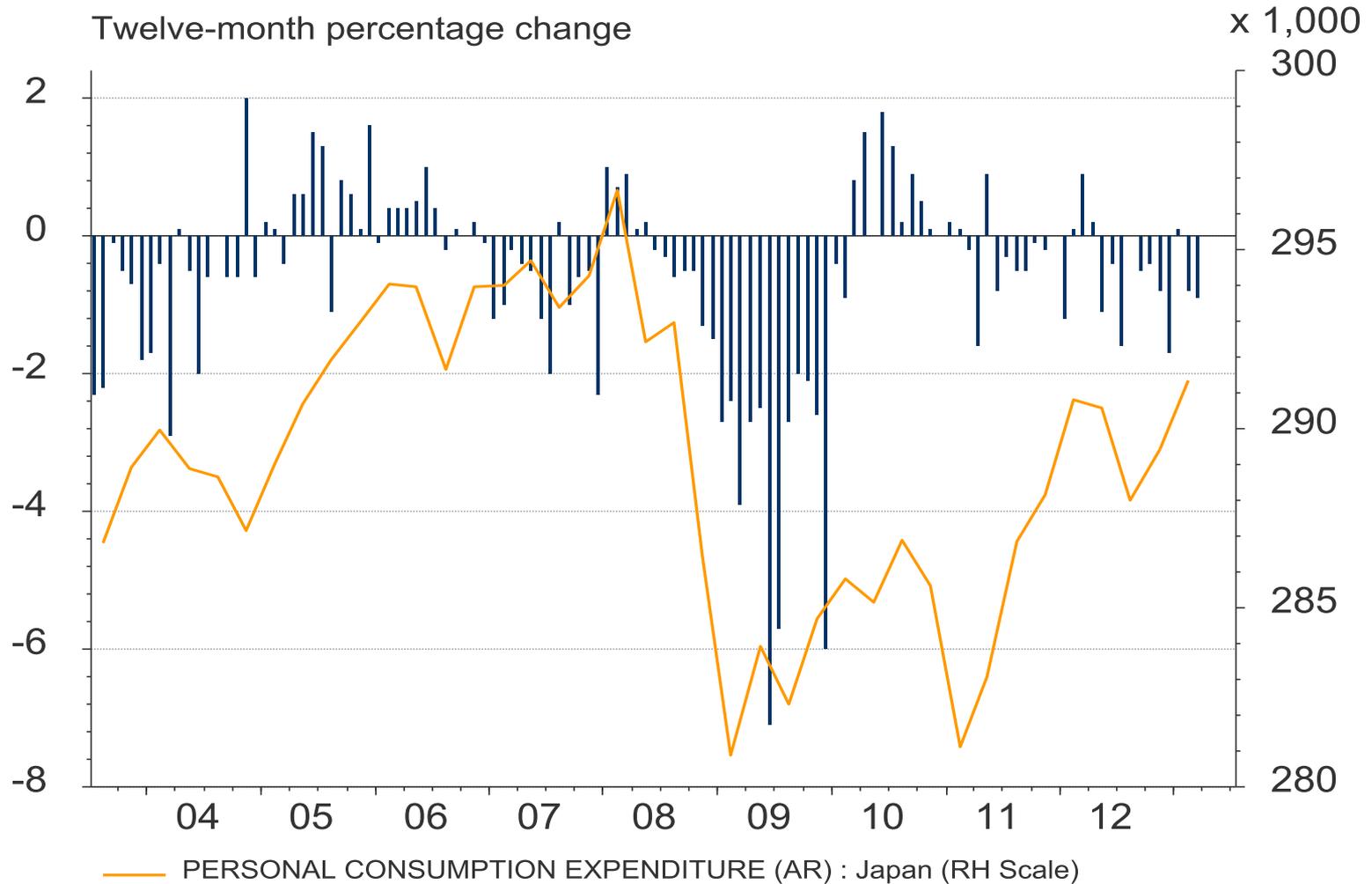
# Consumer Confidence = GDP Growth

Japan consumer confidence and Nominal GDP, Hand in Hand



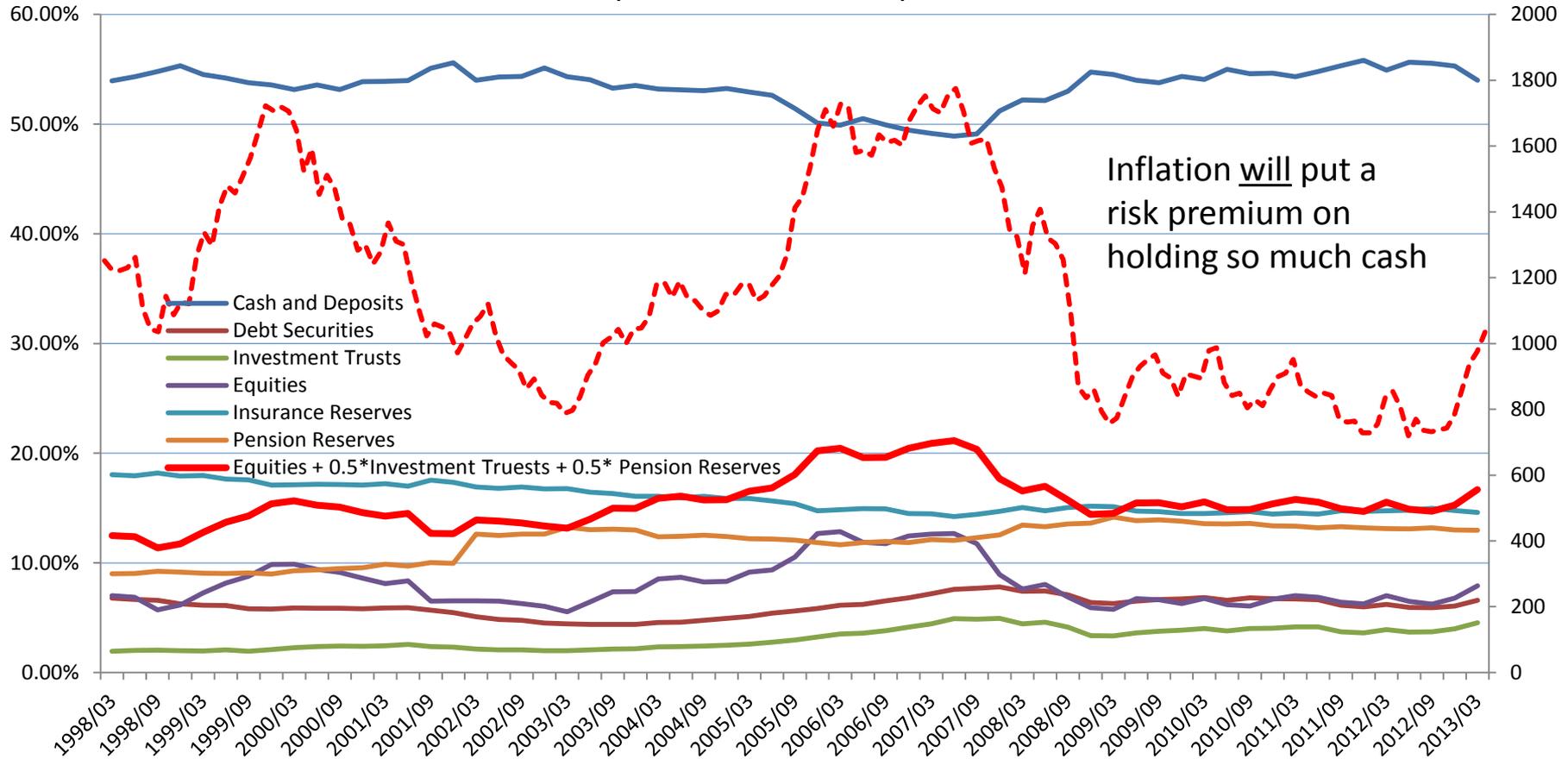
# Consumer not Deterred by Wages

## Japan average monthly wages



# Japanese Household Cash Mountain

Composition of Household Financial Assets  
(% of Total Financial Assets)



# Introduction of ISAs

- **“Individual Savings Accounts (ISA) have already reached 1.5mn applications, at Y1mn per account = Y1.5 trn (\$15.7bn) set to hit the markets in early January. The accounts will be opened by October and ready for investing in January 2014.**
- ISAs to be funded by new cash transfers since existing trust investments (mutual funds) cannot be transferred to an ISA. This will be repeated each year, Y1mn per account per year, for the next 5 years.
- **The big kicker is for the government to finally change tax rules to allow for the netting off of financial asset gains and losses.”** (Arif Imam, ML)

Exhibit. Overview of Japanese ISAs

Highlight	Tax-free treatment of dividends and capital gains from assets in ISA
Inception date	January 2012*, when the reduced (10%) tax rate on dividends and capital gains from investments in publicly traded equities will be abolished (ISAs may be opened during the 3 years through 2014, with tax-free treatment extending for 10 years)
Eligibility requirements	Eligibility is limited to Japanese residents aged 20 or older (as of January 1 of the year the ISA is to be opened)
Eligible products	Publicly traded equities, equity investment trusts
Contribution limit	¥1 million per year
Number of accounts	Individuals may open one ISA per person per year at a financial institution (e.g., bank, securities brokerage)
Withdrawals	Assets may be withdrawn tax-free at anytime

\*The application period for opening an ISA in a given year is from October 1 of the previous year through September 30 of the year.

Graphic of Japanese ISA



# Gift Tax Reform

- “In March, Japan enacted a gift tax reform, which included an important exemption: from Apr 2013 to Dec 2015, grandparents can open a tax-free educational trust fund of up to ¥15,000,000 tax (\$150,000) for each grandchild. In order to use the fund, parents need to submit a receipt, i.e., a lump-sum withdrawal is probably difficult. In any event, in just three months after the enactment, major trust banks have opened accounts totaling \$1.25b. As more people become informed/interested in educational trusts, we believe **\$20b or more of wealth will be transferred from grandparents to their grandchildren, which could lift consumer spending** by reducing financial obligations for education on the grandchildren’s parents.”

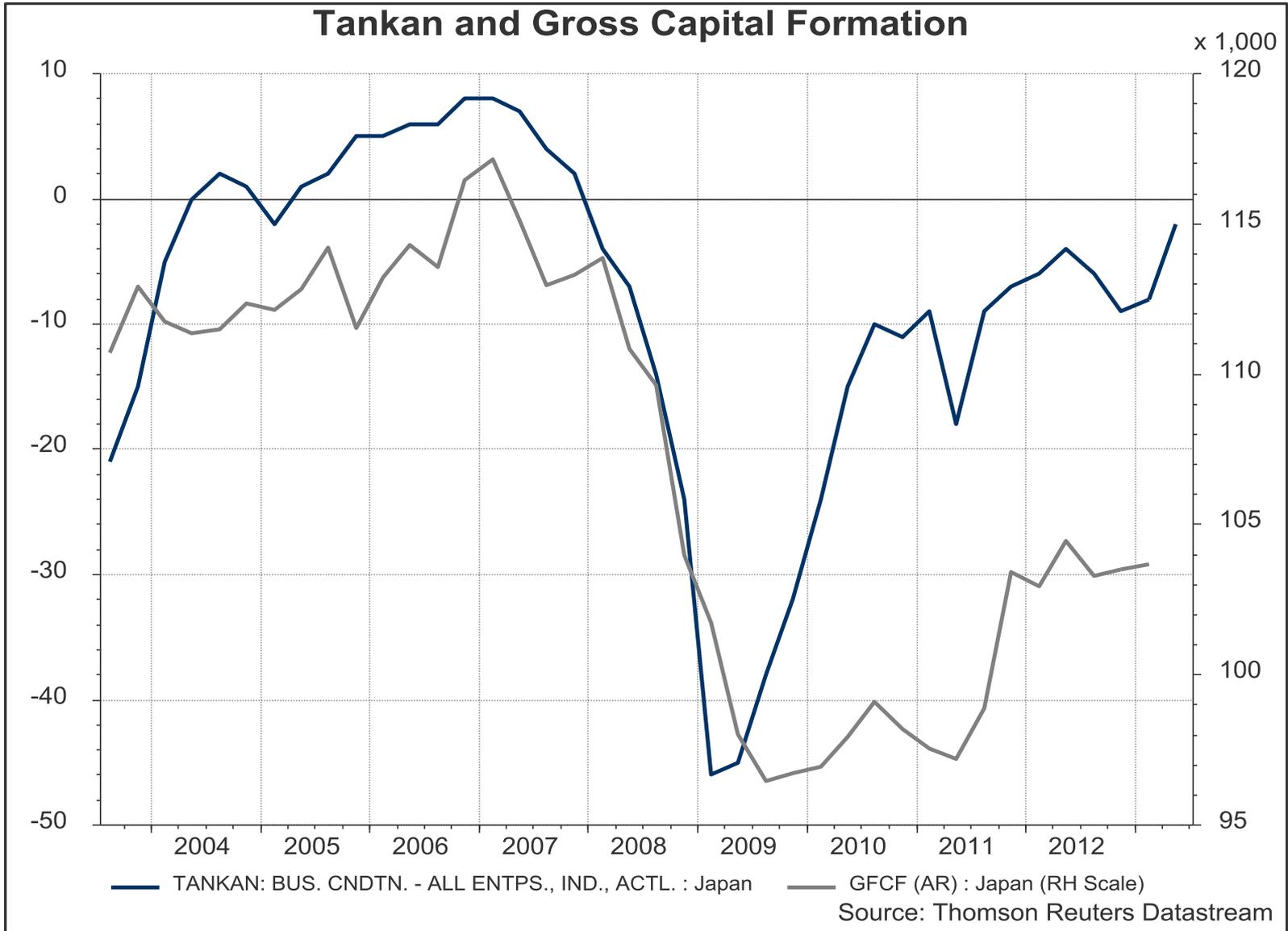
Jaewoo Nakajima, ISI

# Japanese Equities: Cheaper than they Look

**Table 1. PEs of Japanese and US Non-financials as at 31<sup>st</sup> March 2011 as Published and Adjusted for Differences in Accounting.**  
(For details of calculations and sources, see Report No. 401).

	<b>Japan</b>	<b>US</b>
<b>PE as published</b>	17.65	17.43
<b>Depreciation as % of earnings</b>	188.7	64.2
<b>PCE as published</b>	6.11	10.62
<b>PE adjusted to US accounting with tax adjustment (A)</b>	12.60	17.43
<b>PE adjusted to US accounting without tax adjustment (B)</b>	8.87	17.43

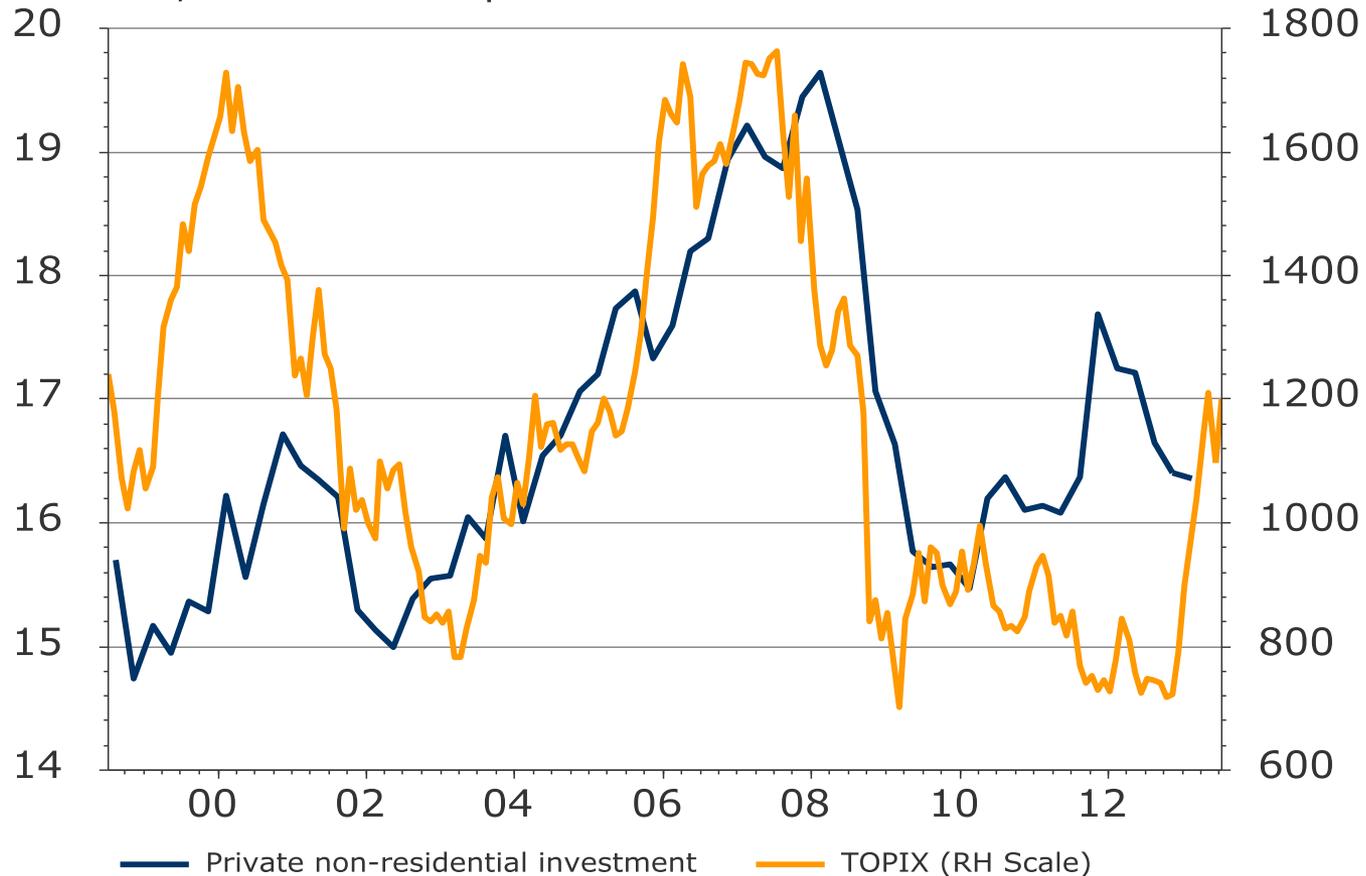
# Tankan Pointing to Capex Recovery



# TOPIX also Points to Capex

## Japanese investment and the TOPIX

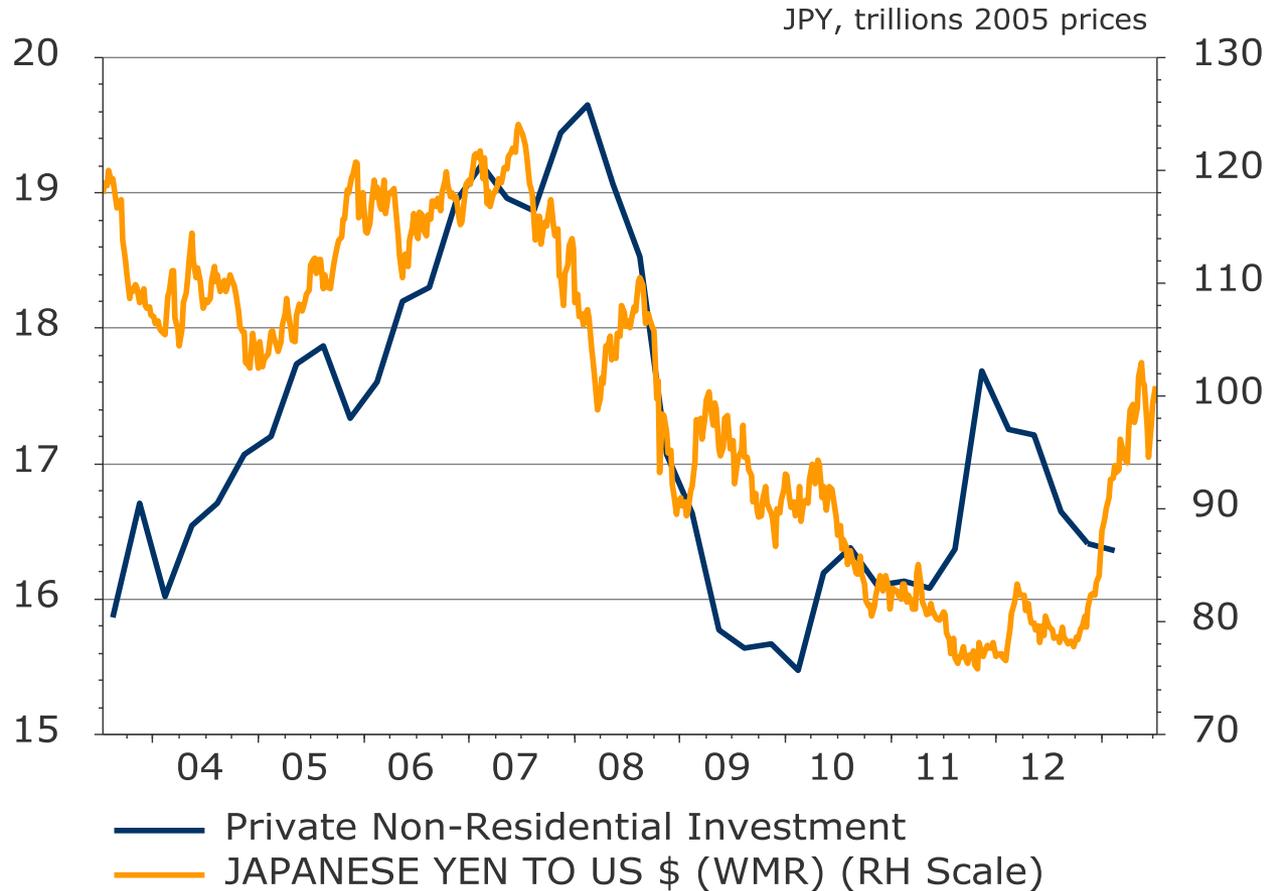
JPY, trillions 2005 prices



Source: Thomson Reuters Datastream

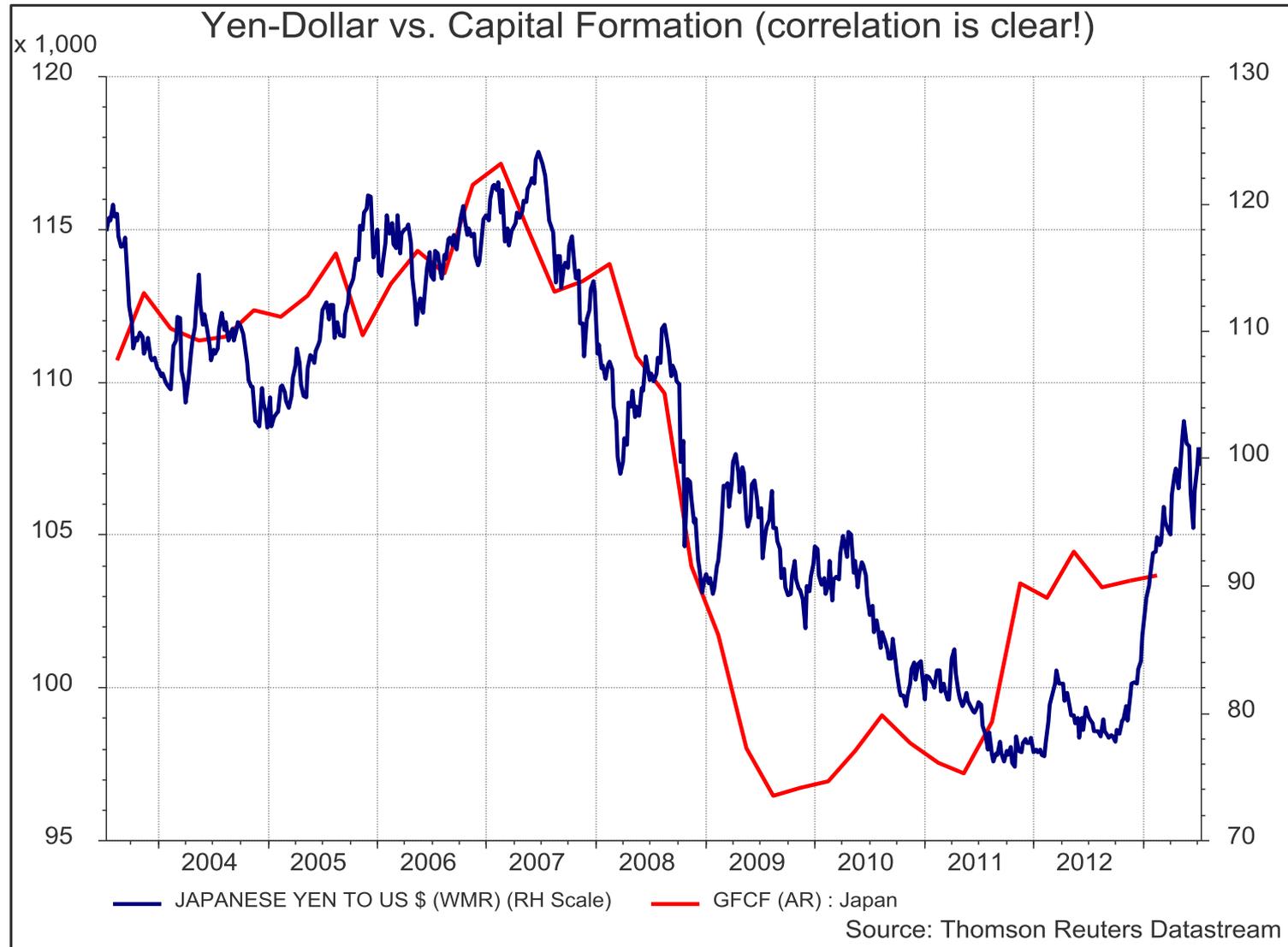
# Yen Weakening Augurs well for Cap Ex

## Yen-Dollar vs. Japanese investment



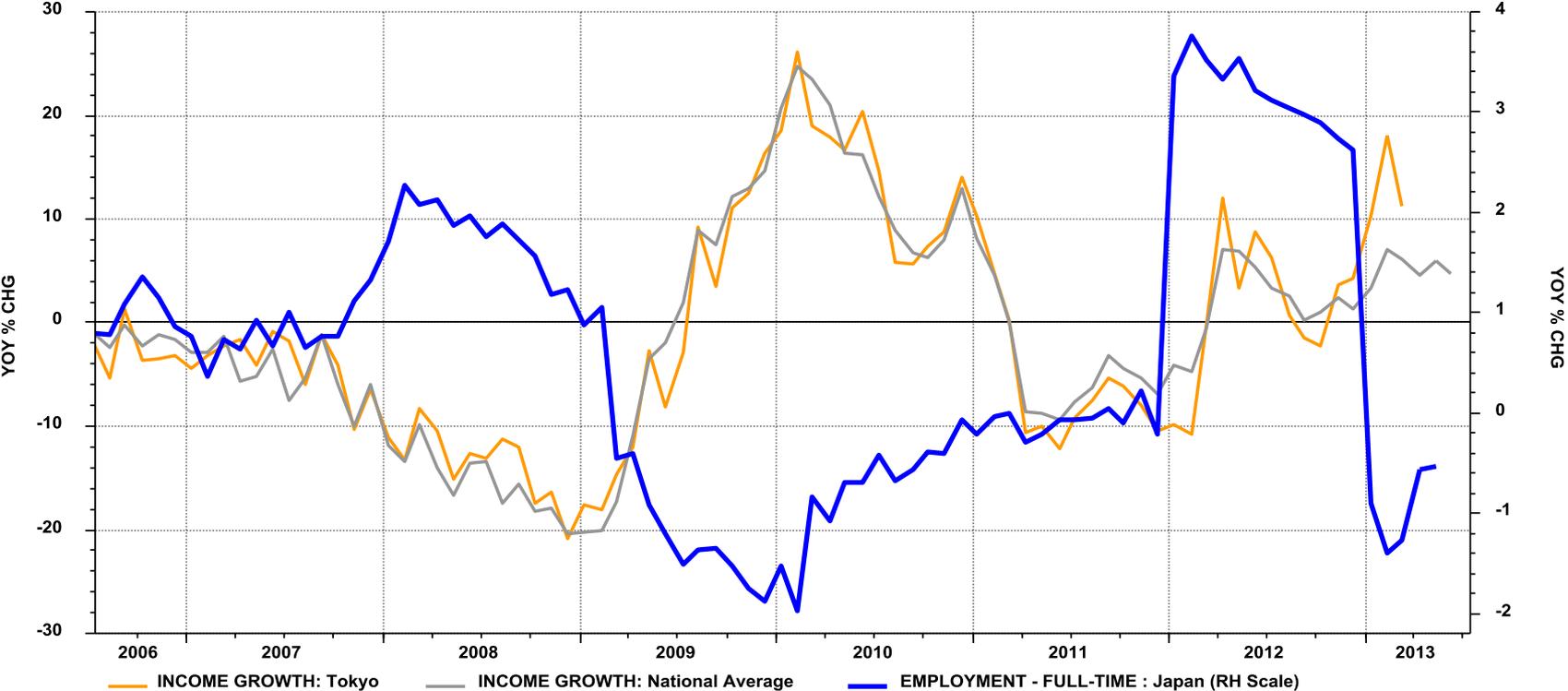
Source: Thomson Reuters Datastream

# Yen vs. Capital Formation

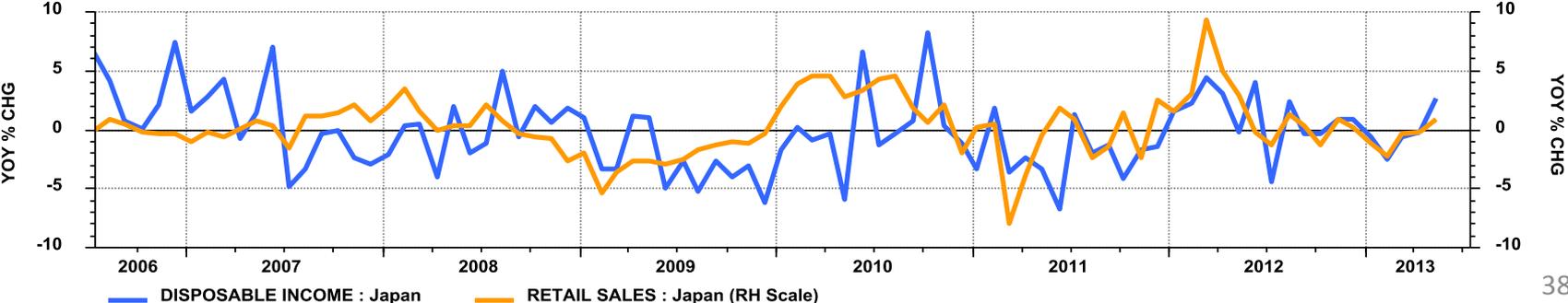


# Employment Growth Poised to Recover

## Income Growth vs Employment



## Retail Sales vs Disposable Income



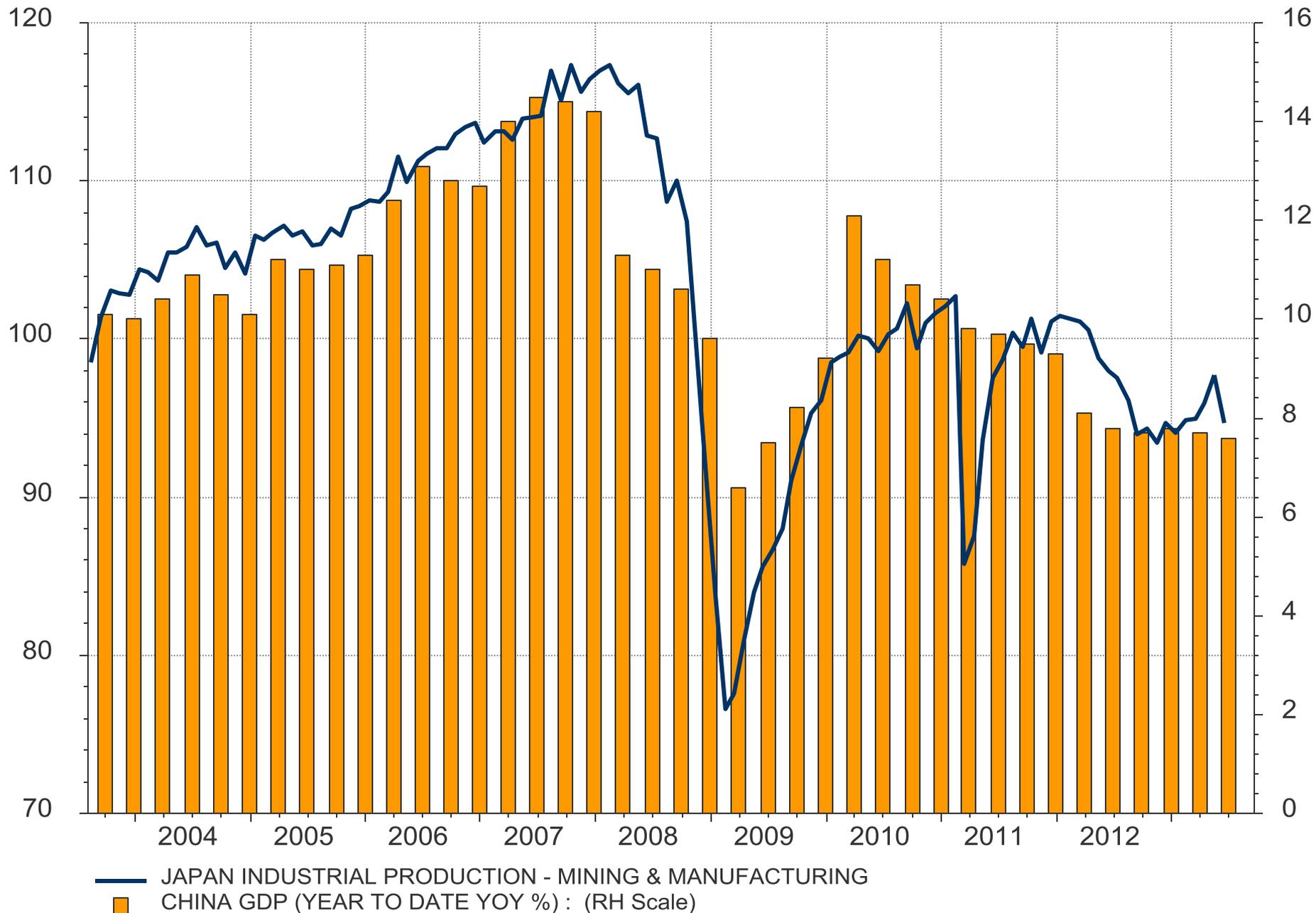


# Threats to the Recovery

## China Crisis & The new Muddle East

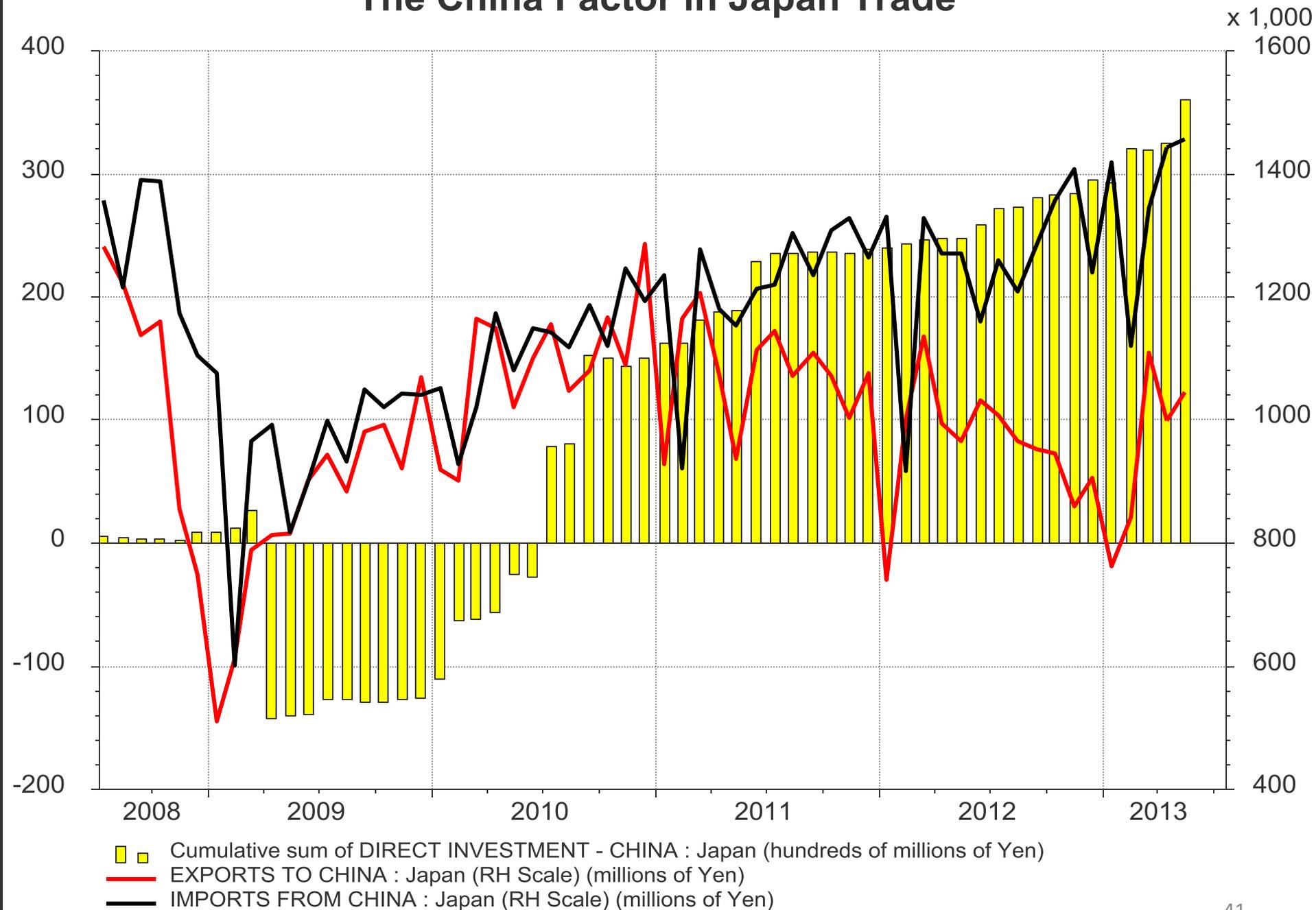


# The China Factor in Japanese Industrial Production

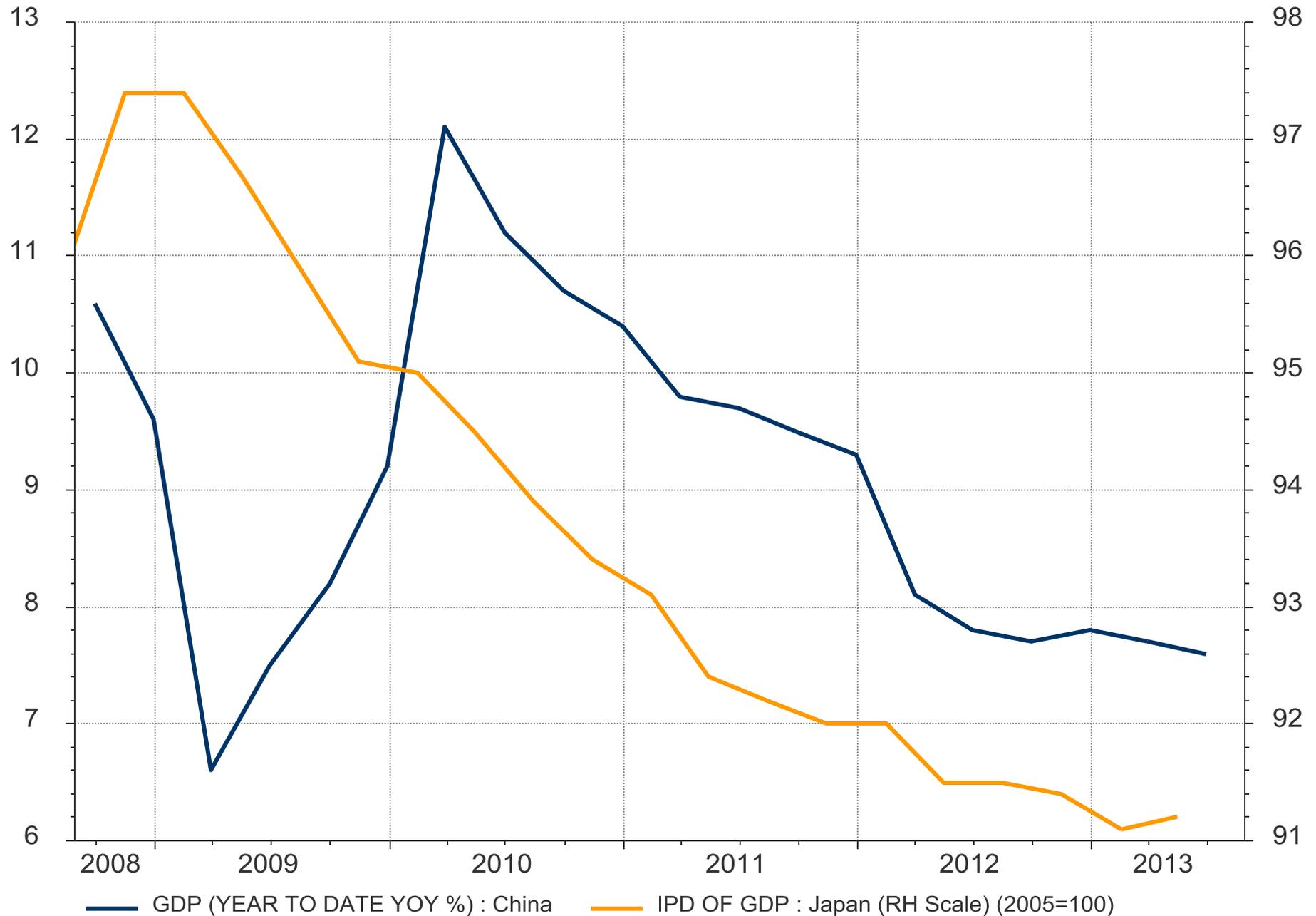


Source: Thomson Reuters Datastream

# The China Factor in Japan Trade



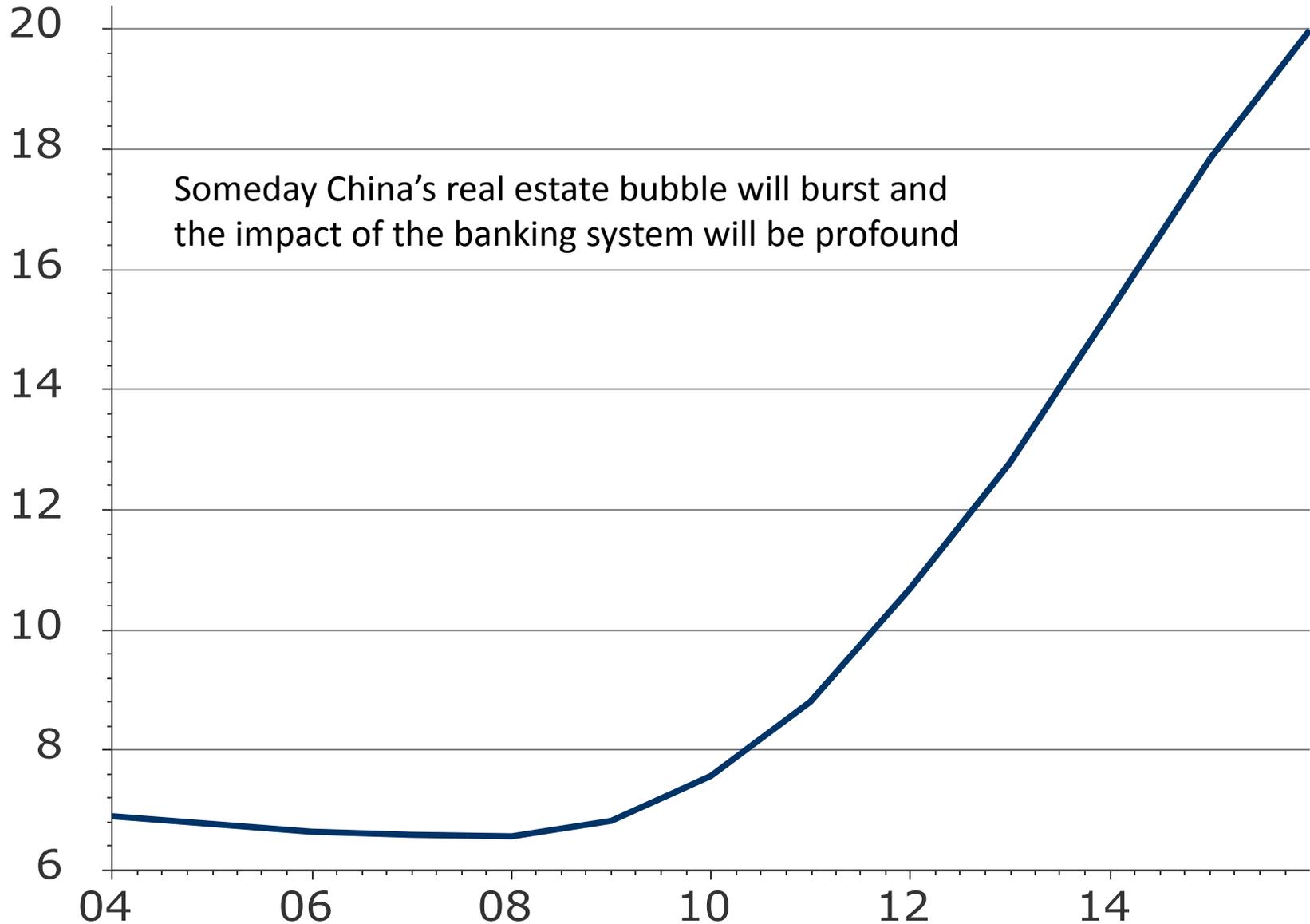
# Chinese GDP Growth Y/Y and Japan Implied GDP Price Deflator



Source: Thomson Reuters Datastream

# Chinese non-performing loans

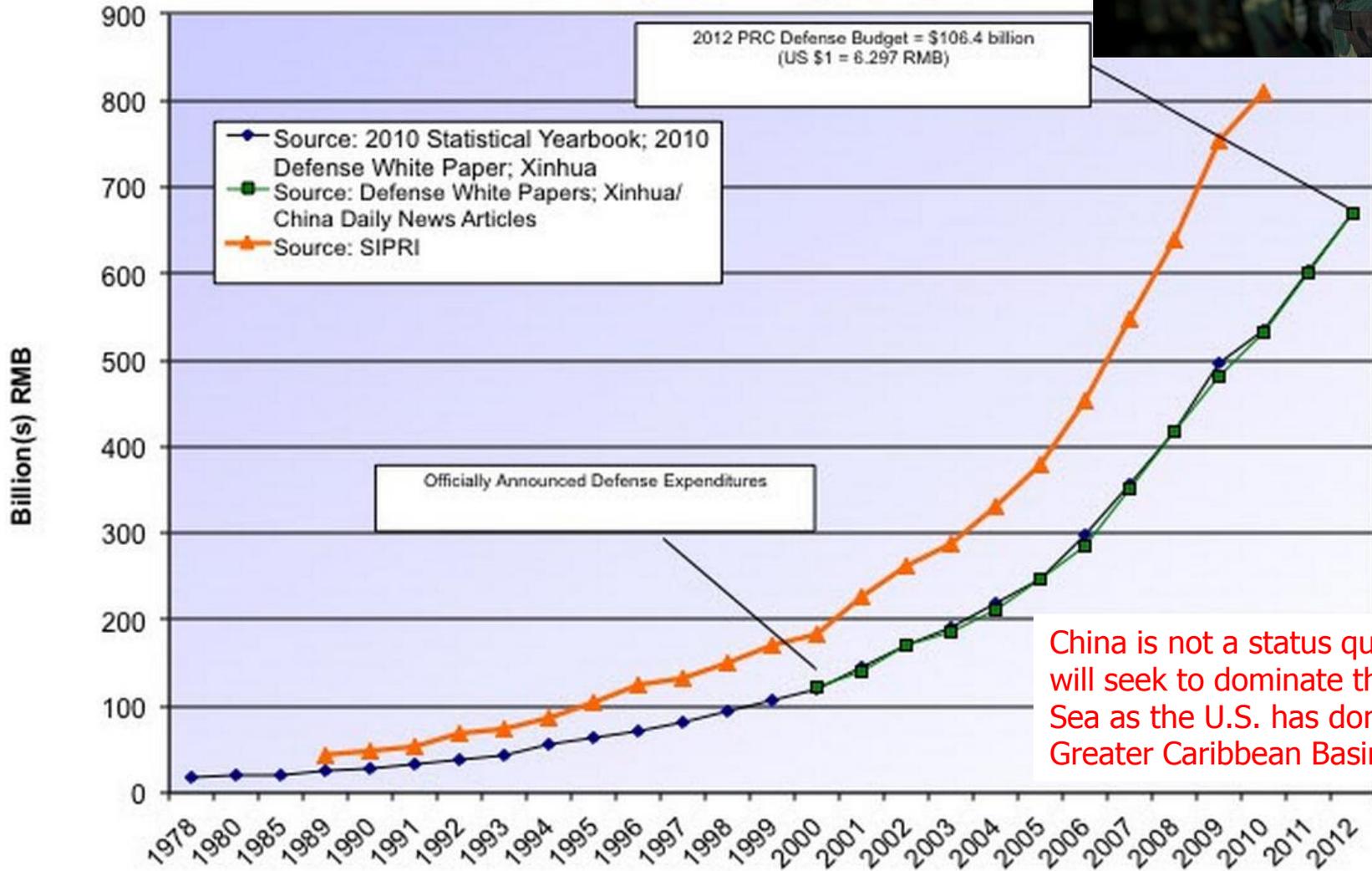
Per cent of GDP (projected based on same NPL levels as Japan 1990s)



“For the first time, in modern history at least, Asia’s military spending is poised to overtake Europe’s... China is doubling its defence budget every five years and India has just announced a 17% rise in spending this year, to about \$40 billion.” *Economist*, March 24, 2012



# Chinese Defense Spending



China is not a status quo power. It will seek to dominate the South China Sea as the U.S. has dominated the Greater Caribbean Basin

# South China Sea Incidents Rising



# The Growing Clash in the Muddle East



“AS THE influence of the United States in Baghdad wanes, that of Iraq’s three beefiest neighbours—Iran, Saudi Arabia and Turkey—has begun to wax. All three fear lest the vacuum left behind be filled by a regional rival.” *The Economist*, “Iraq- A Regional Cockpit,” 19 Nov 2009.

**Syria crisis could be the doorway to Sunni-Shia region-wide conflict.....**



## What forces and scenarios could set the free world back?

### War:

Historically wars have had the greatest impacts on global economic conditions and broken long cycles

War is the most likely of the most impactful forces but often hardest to foresee.

### Potential scenarios:

Syrian war turns in Gulf-wide conflict: Sunni vs. Shia

Israel vs. Iran – Gulf Conflict = “Muddle East Meltdown”

“Implosive Conflict” on the Korean peninsula

South China Sea - Chinese “Monroe Doctrine” vs. US/Japan

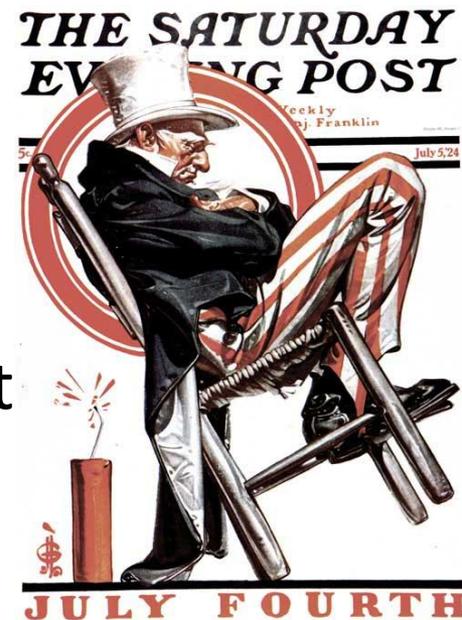
India vs. Pakistan nuclear war

Catastrophic cyber attack

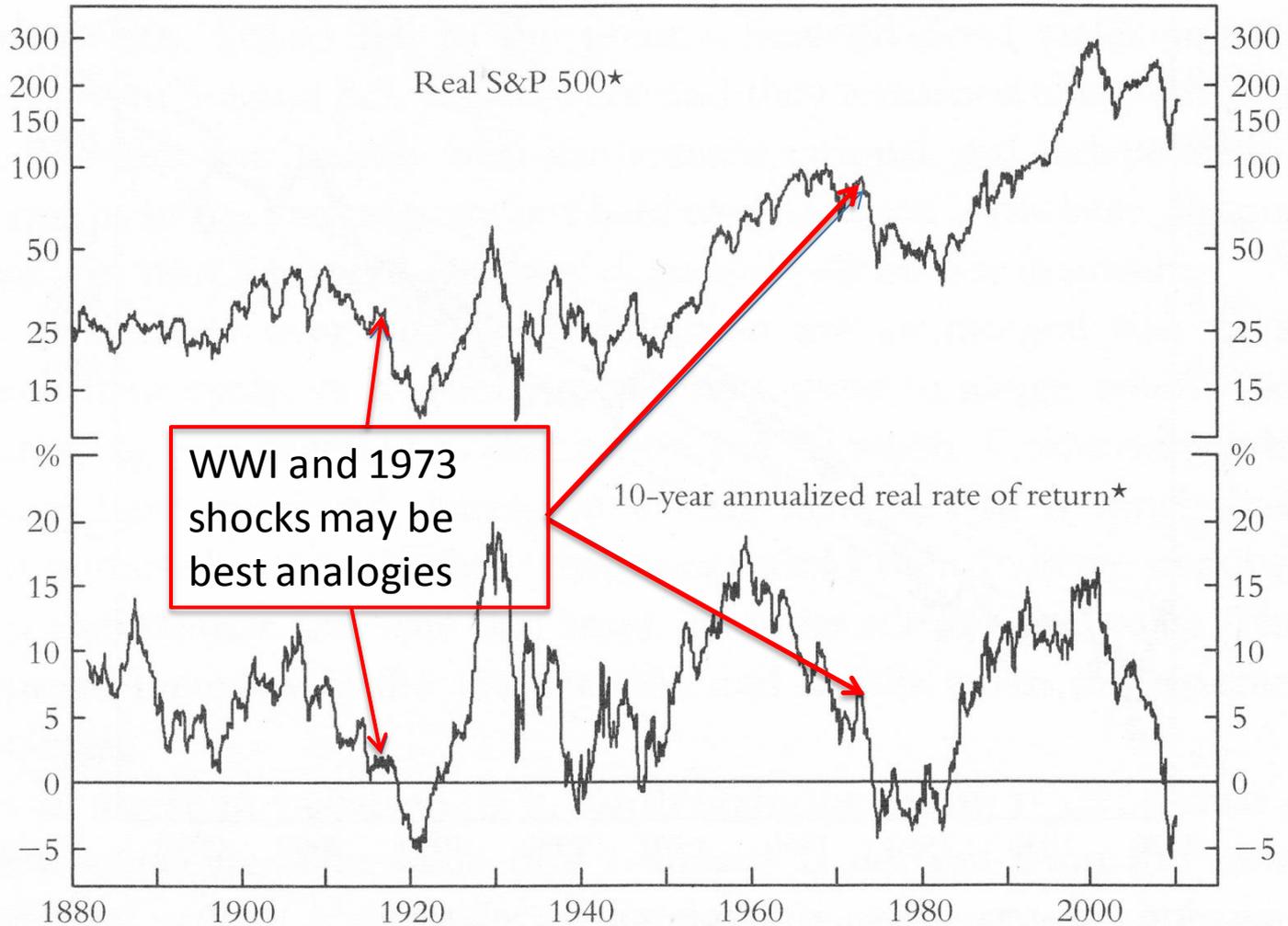


## US Hegemony Under Stress:

- Free trade system in decay
- Global financial status diminished
- Declining use of the dollar
- Bulging fiscal imbalances
- Anemic economic recovery compared to norm
- Involvement in long, costly wars
- Fraying alliance systems in Europe and Asia
- Increased isolationist thinking
- Rising strategic rivals in Asia and Middle East
- Shrinking US naval power
- Similarity to post WWI interwar era



# Previous War Shocks to the Long Financial Cycle



S&P 500 and 10-Year Annualized Real Rate of Return

\*Deflated by consumer prices.

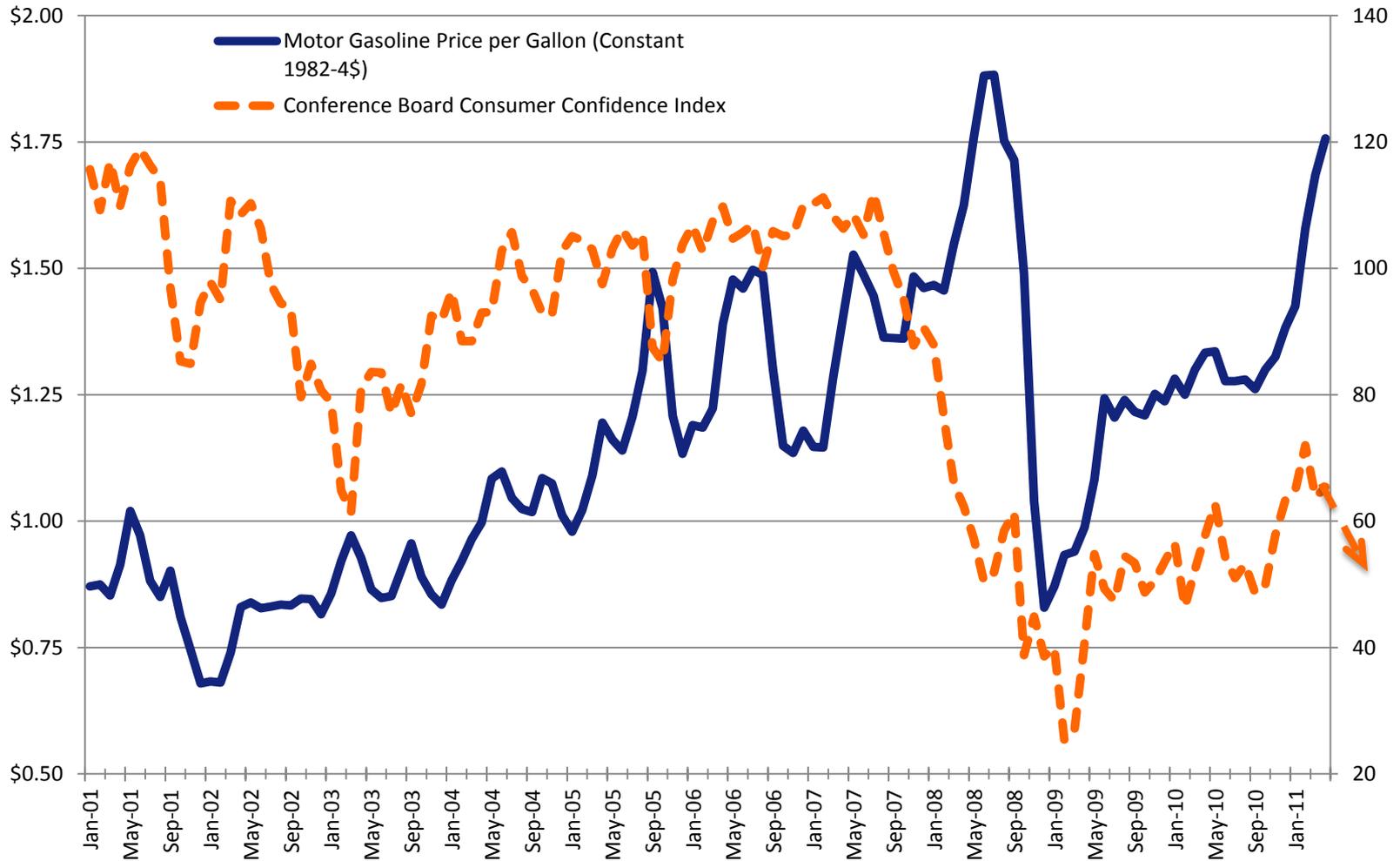
Source: Chart courtesy of BCA Research Inc.

Source: Anthony Boeckh, *The Great Reflation*

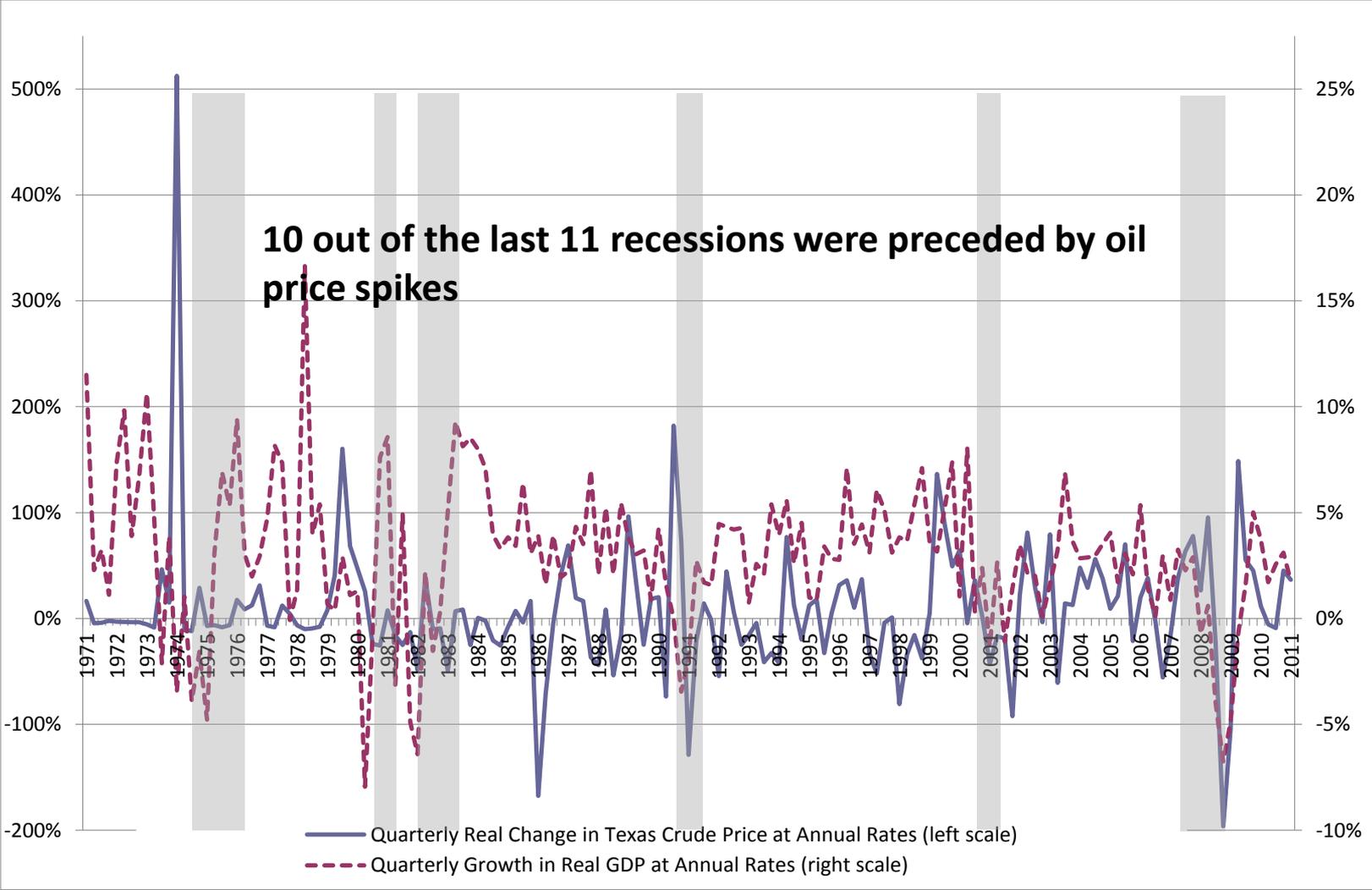


The US economy still runs on oil

# Gasoline and Confidence Go Together



# US Real Change in Crude Prices vs. Real Change in GDP





# North Korea: Global Menace

- North Korea threatens to deploy nuclear warheads on its missiles, setting off a possible nuclear arms race in NE Asia
- North Korea's growing stockpile of highly enriched uranium is sufficient to manufacture dozens of weapons
- There is no internal need for HEU bombs, there is a sufficient plutonium bomb arsenal. HEU is for sale...
- North Korea and Iran signed a Science and Technology Treaty on September 1, 2012. Attending the ceremony was the head of the Iranian Nuclear Program and the Chief of Staff of the Revolutionary Guard.
- The last time North Korea signed a Science and Technology Agreement it was with Syria in July 2002, marking the start of development of the Al-Kibar facility....



# Conclusion

- Monetary policy is the only Japanese arrow hitting the mark.
- Fiscal stimulus has failed to trigger sustainable domestic demand before and likely will again. Deregulation, TPP, etc. won't fill the growth gap in FY 14 created by the consumption tax. A large corporate tax cut is essential in FY14, not FY15.
- Despite much hype, the Third Arrow needs to be significantly sharpened to be successful. For investors, Abenomics is really just a Yen-dollar trade unless and until we see TPP, structural, and tax reform.
- Japan should follow the ROK liberalization and German Schroeder reform examples....
- Abe should focus on 富国 before 強兵. He may choose 強兵 as a substitute if his Third Arrow fails to hit the mark.