AQUILA

Flash

Japan's economic reform program is not working

Two and a half years after its introduction the impact of Abenomics on the Japanese economy still fails to convince. With government indebtedness at record levels and the debt dynamic negative, any leeway the government had on the fiscal policy front has been used up. As meaningful structural reform seems increasingly unlikely, the government has to pin its hopes on an even more expansionary monetary policy. With liquidity set to be pumped into markets at an even faster rate we are staying overweight in Japanese equities.

Government plans for both growth and inflation are not being met.

Two and half years ago Prime Minister Shinto Abe announced his Abenomics – whereby easier monetary policy, a more expansionary fiscal stance and structural reform should combine to put the Japanese economy on a higher growth path. But Abenomics does not seem to be working. While GDP growth was over 2% in 2013, the economy slipped back into recession last year, contracting by 0.8%. Current business cycle indicators, such as the Purchasing Managers indices, don't give cause for much optimism and most analysts are forecasting a growth rate for this year of between 0% and 1%. Moreover, there is no sign that inflation is moving towards the Bank of Japan's 2% target. If one subtracts the impact of the rise in the consumption tax last year, inflation is precisely 0%. Financial markets are now indicating an inflation rate of just 1.06% pa. over the next 10 years – which is well below what the Bank of Japan would like to see. Given the absence of success so far, one might ask what more the authorities can do to try and achieve their targets.

Any leeway the government did have for more fiscal expansion has now been used up.

Public sector indebtedness running at a massive 240% of GDP is a big restraint on the government's scope for action. Moreover, tax receipts now cover just half of government expenditure. The other half has to be financed by more borrowing. And nearly a quarter of all government expenditure is accounted for by debt service payments. Our analysis suggests that, should the government's borrowing costs rise by 1%, the portion of all government spending accounted for by debt service would rise to 35%. Demographic trends are also unfavorable for government finances as the proportion of over-65s in the population will continue to grow in coming decades. Welfare payments already represent 30% of all government spending, and with the population ageing rapidly, this percentage will rise. The truth is that the government now has no scope to boost the economy through fiscal policy. But the more important question is how long will investors keep their faith in Japanese government debt.

The Bank of Japan's tidal wave of liquidity remains "stuck" in the financial markets.

Since the start of its second bond-buying program in April 2013 the Bank of Japan has purchased over USD 1'100 bn. worth of securities, chiefly Japanese government bonds. Relative to GDP, Japan's QE program is the most aggressive of all the central banks. The Bank of Japan has said that QE will be continued until inflation has reached 2% on a sustainable basis. If the current rate of bond purchasing – around USD 60 bn. a month – is seen as clearly insufficient to reach the 2% target, we would expect the Bank of Japan to set its purchasing targets at an even higher rate. However, the size of the existing program makes its further expansion difficult as the Bank of Japan already owns nearly half of all Japanese government bonds outstanding and for some time has been buying all new issuance of government debt. The central

bank's liquidity injections have led to a 30% decline in the yen against the dollar and a 70% rise in the Nikkei stock index since April 2013. Meanwhile the yield on 10 year Japanese government bonds has fallen from 0.5% to 0.3%. Despite this powerful impact on financial markets, the effect on the broader economy seems to have been both limited and temporary. One doubts whether a more aggressive QE would have much impact beyond the financial markets.

There is a big danger that meaningful structural reform will remain "off the table".

There are several reasons why the Japanese economy has not quickened its tempo despite all the aggressive fiscal and monetary policy measures aimed at boosting it. First is the ineffectiveness of a cheap yen policy, though this is not a surprise to us. In a Flash article published more than two years ago we warned that the impact of a cheaper yen on higher import costs would more than offset any economic boost arising from increased exports. Beyond the negative mathematical effect on the Japanese trade balance, a cheaper yen erodes consumer purchasing power. Moreover, Japanese companies have reacted to their increased competitiveness not by investing more and trying to gain market share but rather by increasing their margins. The wealth effects of Abenomics are limited too. Although the Nikkei is up 70% over 2 years, Japanese households own just 9% of the Japanese stock market. But the biggest reason why Abenomics has not worked is that the nettle of structural reform has not been grasped. There is no effective plan to halt or offset the decline in the population at work. More child nurseries and attempts to tempt older persons back into work (who already retire later than in any other OECD country) are merely cosmetic. A targeted liberalization of immigration policy, which could meaningfully address the problem, is as far away as ever. Similarly, the rules on foreigners' direct investment remain largely untouched. As a result, overseas direct investment in Japan is just 5% of GDP, whereas the OECD average is nearly 35%. There is also no sign of a liberalization of the bureaucracy and regulation that relates to products and markets. The World Bank, in its "Ease of Doing Business" index, ranks Japan at 19th out of 34 OECD countries. In fact, Japan has moved down the rankings since Mr. Abe came to power. Finally, there is no convincing plan to bring the government's finances under control. Messrs. Rogoff and Reinhart suggest that government borrowing levels above 80% to 90% of GDP tend to mean weaker economic growth (and Japan stands at well over twice this threshold). Given that Mr. Abe has not managed to implement structural reform in over two years, there is now a big danger of stasis. We believe that, for the time being, Japan will be unable to sustain an economic growth rate of more than 0.5% pa.

We remain overweight in Japanese equities

With structural reform unlikely and room for fiscal expansion exhausted, the government is left with more monetary expansion as its only means to boost growth. Faster monetary expansion will weaken the yen and allow the Japanese exporters to further boost their margins. For this reason we stay overweight in Japanese stocks, favoring the exporters and hedging the currency exposure.

Aquila & Co. AG, 29. April 2015