BANZAI !

Never have investors reached so high in price for so low a return. Never have investors stooped so low for so much risk.

–Bill Gross, PIMCO, 14 May 2013

This week we again focus on Japan. Their stock market has been on a tear, and their economy grew 3.5% last quarter. Is Abenomics really the answer to all their problems? Is it just a matter of turning the monetary dial a little higher and voila, there is growth? Why doesn't everyone try that? And what would happen if they did?

We tend to think that the next Japan is pulling on the trigger to the next global crisis !

Japan grew at a 3.5% annual pace last quarter, the fastest pace in a very long time. Of course, government officials see this development as vindication of their new policies and will no doubt decide that even more of the same will be needed in the future.

Retail sales in Japan are soaring as a "wealth shock" electrifies the economy. The Nikkei index has risen 70% since November, with foreign hedge funds among the first to jump on the bandwagon. The chart below provides some perspective on that rise. I can see several similar moves in the past 20 years. If this were a one-year rather than a 30-year chart, would everyone be so eager? I'm not saying that the move isn't real. A lot of money has been made, at least on paper.

The weaker yen is already delivering a powerful punch, accounting for almost half the growth in the recent quarter. The currency has dropped 30% against the dollar and against China's yuan since August, and 37% against the euro. Currency manipulation is against the G7 and World Trade club rules. Japan, they contend, is merely engaged in a domestic policy move to try to stop deflation and kick-start the economy. So anything that happens on the currency front is a complete coincidence.

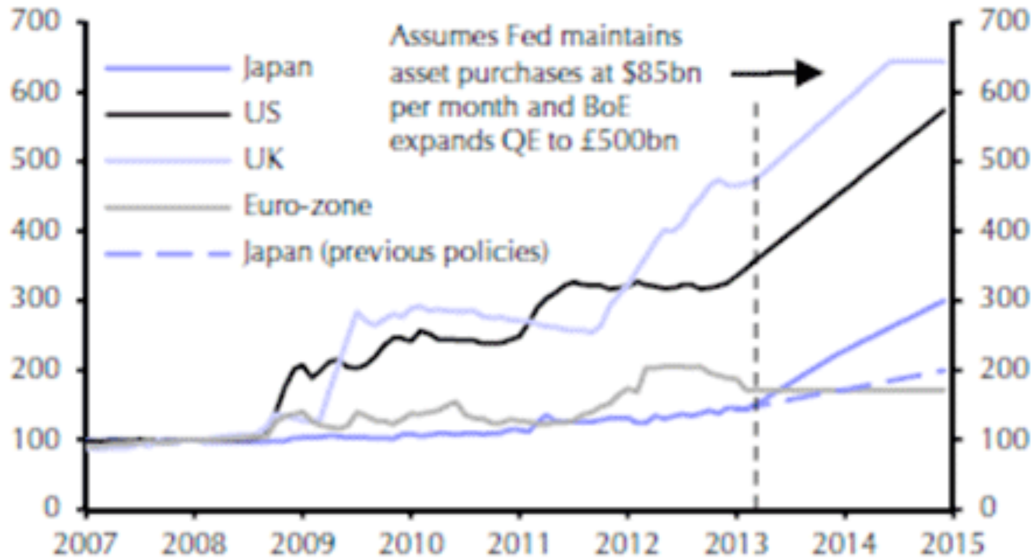
Except that it isn't.

Japan has been in a deflationary slump for over two decades. Nominal GDP has not grown. Government debt-to-GDP is now over 240%. Interest rates have been stuck at the zero bound. There has been no control of the fiscal deficit. The trade deficit has been rising. All this led me to start calling Japan "a bug in search of a windshield" a few years ago.

Prime Minister Abe has committed to a "three-arrow" approach to solve Japan's problem. The three arrows in his quiver are more-credible fiscal plans, aggressive monetary easing, and a growth strategy based on structural reform. The monetary easing is the easy part. Essentially, the Bank of Japan is engaging in almost as much quantitative easing as the US Federal Reserve but in a country 1/3 the size of the US.

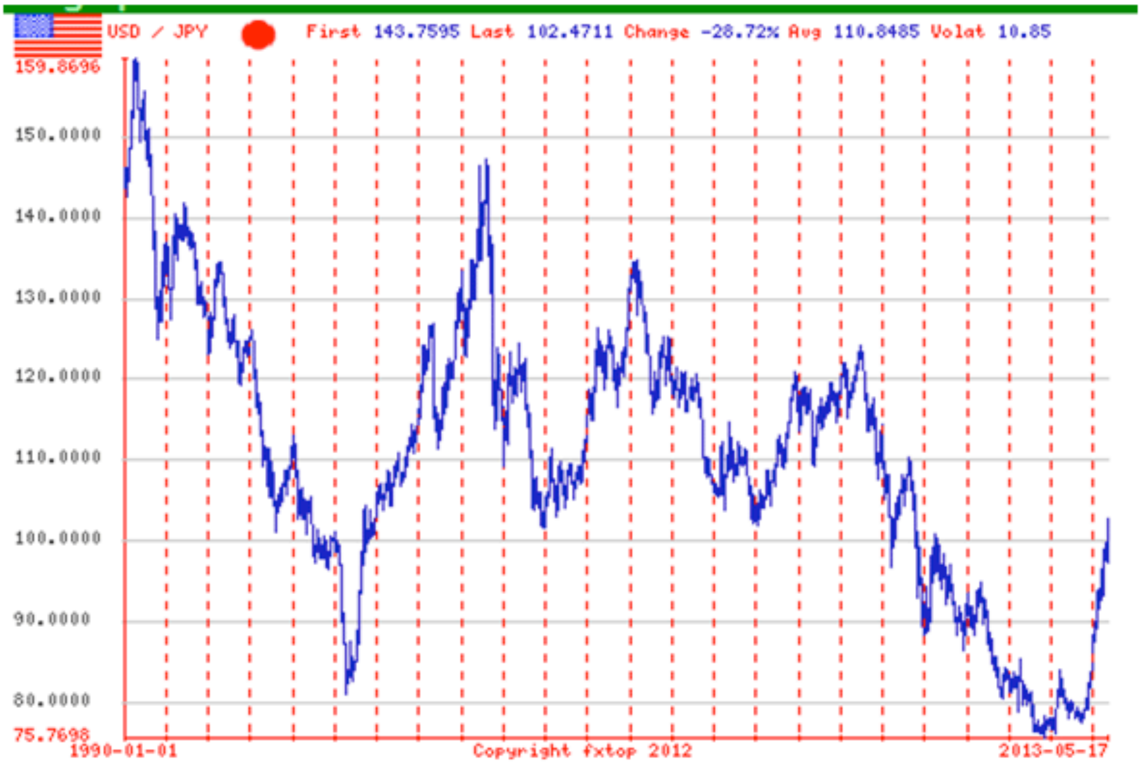
And while the headline number is rather startling, the Bank of Japan has a long way to go to catch up in the QE department. The UK and US are WAY ahead of Japan, as this chart from Capital Economics makes clear. (For those reading in black and white, the line that just reaches 300 in 2015 is Japan's current policy projection.)

CHART 9: MONETARY BASE (JAN. 2008 = 100)



Sources – Thomson Datastream, Capital Economics

Let's quickly review a few charts on the history of the yen. The first is the yen against the US dollar since 1990. Yes, the yen has fallen 35% or so against the dollar in its recent move, but it must fall another 20 yen to get back to where it was just six years ago. It traded at over 350 yen to the dollar when I was in school, back in the Dark Ages. The yen's four-decade appreciation of some 470% against the dollar puts the recent move of less than 25 yen into historical perspective.



The team at Mauldin Economics sent out this note:

Let's put the recent drop in the yen in context. The Nihon Keizai Shimbun, the main Japanese business newspaper, has reported that every one-yen fall in the yen/dollar rate will translate into a $2.7 BILLION increase in profits for the 30 largest Japanese exporters.

For every one yen the currency drops in value against the dollar, Toyota estimates that its profits will increase by $340 million. PER ONE-YEN DROP! Toyota reported $3.33 billion in profits last quarter, so that additional $340 million of profit per one-yen fall could send its second-half profits – and its stock – to the moon.

But those profits don't just magically appear; they come from sales. Sales that are in large part due to better terms of trade and lower costs. Those profits are from sales that might have gone to other companies based in other countries and that might have been valued in euros, dollars, yuan, or won. Which is why businesses and finance ministers all over the world are not happy with Japan.

China is becoming an ever larger part of global trade as the country continues to develop. And who exports the most to them? Japan, of course, and Japan competes directly with Korea, Hong Kong, and Taiwan for that business.

Profits in companies in Korea, Hong Kong, and Taiwan are getting hammered, as those companies have to lower prices to compete with resurgent Japanese firms. While the government of Japan will never publicly admit it, it will not be long until the yen is at 120 and then moving even higher, although the road to enyasu will get bumpier as the yen falls ever more and other countries respond. Japanese monetary policy is almost irrevocably committed to continuing to devalue the yen for a very long time at what will be an ever-increasing rate.

The next chart shows the euro-yen rate over the last 23 years. If the yen moves back to where it was just six years ago, Germany et al. are in deep schnitzel as far as their export trade is concerned.

Go back up to the chart that compares monetary bases. That will help you understand the muted response of the US and the UK to Japan's moves. We have heard from EU ministers, notably in Germany, who are very vocal in complaining about Japan. The ECB has an inflation mandate that is theoretically limiting them from quantitative easing on the scale of the US, UK, or Japan. I say theoretically because, when Germany joins France in a serious recession that is due in part to "currency tensions" (or at least that is where the finger will be pointed, because gods forbid we blame our own policies), I fully expect those very creative people at the European Central Bank to come up with a "legal" way to join the QE party. And everyone knows that when Draghi decides to stir things up, he does so with style and with a full orchestra in accompaniment. And the Bundesbank will be playing the bass fiddle and drums.

Let's Export Our Deflation

The number one export that Japan is offering is its deflation. It is trying to push deflation on every country that competes with it for trade. That is rather the point of an inflation target of 2%. It is just as if the leaders of Japan had got together and said, "We can't seem to get rid of our deflation. Let's see if we can export it." Capital Economics writes this interesting note on that goal:

Is 2% inflation achievable? This doesn't mean that inflation won't head towards 2% soon. There were two periods when inflation topped 2% even during the lost decades – when the consumption tax was last raised in 1997 and when the costs of imported oil surged in 2008.

Indeed, we expect inflation to climb above 3% in 2014 as a result of the planned consumption tax hike next year. However, the Bank of Japan will look beyond any tax effects when gauging progress towards its inflation target. While we do expect inflation excluding tax effects to pick up as well, this would largely be a result of the pass-through of yen weakness to import costs rather than any sustained increase in underlying inflation.

And that is the problem. Japan can generate inflation if it depreciates its currency. But that inflation will have particularly harsh effects on retirees. Energy and food (which are largely imported) and any other item that needs resources not found in Japan will rise in cost as the value of the yen falls. Those living on fixed incomes will be hurt the most, and that is a very large and growing part of the population of modern Japan.

Abe’s reforms require significant economic growth. Japan has had none for two decades, and now conditions for growth are even more difficult. Growth in GDP comes from two (and only two) sources: growth in productivity and growth in (working-age) population. Japan’s population is actually shrinking, and its working-age population is falling even faster as the country rapidly ages.

Because of the demographic problems of an aging Japan, economic growth will require even greater productivity growth than normal. Where is that going to come from? Real productivity growth (as opposed to nominal growth due to inflation) is not something you can just dial up with government policies and quantitative easing. It is incremental in nature. If you want 3% GDP growth in a country whose population is shrinking by 1%, you need 4% productivity growth, give or take. That just doesn’t happen on a sustained basis in a developed country.

And even with that growth, it would not be easy to achieve 2% inflation in Japan. Roubini Global Economics noted yesterday:

However, consumer service sector price deflation, arguably the most important gauge of general price level trends, accelerated for a third straight quarter, corroborating the weak CPI data we have seen so far this year. There is still a long road to sustained positive inflation.

The first thing that jumped out at us was the negative sign in front of the private nonresidential investment growth rate. At -0.7% q/q, private investment in plants and equipment recorded a fifth straight sequential contraction, a particularly ignominious result…. Given the slack still evident in the economy through Q1 (recall that deflation worsened over the quarter), this result isn't so surprising. The pace of contraction was considerably slower than H2 2012, and we expect to see this series return to growth in Q2. Still, this persistent weakness underscores the challenges to Japan's longer-term outlook. The pace of private nonresidential investment is now more than 17% below its Q1 2008 peak. (www.roubini.com)

What is one of the primary sources of increasing productivity? It is private capital investment (and yes, government can also be a source of capital and infrastructure). And as Roubini noted, private investment fell last quarter. The growth that occurred came from currently available industrial capacity. Clearly, Abe and company have decided that the spare capacity in Japan must be utilized (which will increase productivity because of past investment) so that new investment and a new growth cycle can start.

The Hard Part: Structural Reform

But new growth will also require concerted political and structural reform, something that Japan has been reluctant to tackle in the past. They would not restructure their banks or their debt after the bubble burst in 1989, and their failure to do so has been a main cause of the economic malaise of the last 24 years. The history of Japan since 1989 has been that they avoid real reform, preferring the easier option of more government spending.

The third arrow of Abenomics is a growth strategy based on structural reform. The challenge here will be to raise growth even though the working age population will be falling by up to 1% per year over the next ten to twenty years. The government has identified several priorities, including deregulation (with a focus on the labour market, energy sector and healthcare), reforming the corporate tax regime, and trade liberalization (notably by seeking to join the Trans-Pacific Partnership). However, the jury is still out on whether this administration will be any more successful in raising Japan's productivity than its predecessors, which were also mostly led by the LDP. Announcing another fiscal stimulus for 2013 and persuading the Bank of Japan to loosen monetary policy were relatively easy wins.

What Could Go Wrong?

In summary, "Abenomics" surely represents the right mix of policies to tackle Japan's problems. But at the risk of sounding perennially gloomy, there are still a number of things that could go wrong. In particular:

i. the consumption tax hikes could derail the recovery, but if they are delayed the government would lose credibility, including with the Bank of Japan;

ii. JGB yields could take off, although we are sanguine about the increases that have taken place so far;

iii. prices could rise well before wages and other incomes, depressing consumer confidence and spending power. Indeed, few households view the prospect of an end to deflation quite as positively as businesses and investors, while in Japan's case the wealth effects from higher equity prices are relatively small;

iv. the broad money and credit aggregates could remain subdued, despite the rapid expansion of the monetary base, undermining confidence in the effectiveness of the Bank of Japan's bold policy easing;

v. companies could still be reluctant to invest and hire in Japan itself, especially if the global backdrop deteriorates and local costs surge – the latter due in part to the slump in the value of the yen;

vi. the LDP-led government could disappoint on structural reform – again."

In short, the Japanese government has embarked upon an economic experiment in Keynesian theory that is breathtaking in its promised scope. They are betting that they can gear up enough growth to overcome deflation and demographics, allow the country to balance its budget, find an inflation level that will allow the Japanese debt to shrink relative to GDP, make Japan even more of an export powerhouse, and increase productivity on a scale never before seen in a developed country.