

# Abenomics: good for Japan, good for investors and good for Australia

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## Key points

- > Japan's economy appears to be weathering the April sales tax hike well and Abenomics looks to be working.
- > Third arrow supply side reforms are very positive.
- > The success of Abenomics augurs well for Japanese shares, which are now cheap. It's also positive for Australia as Japan is our second largest export market.

## Introduction

It's now over 18 months since Japan embarked on a program designed to reinvigorate its economy under Prime Minister Shinzo Abe, which has become known as "Abenomics". Growth has rebounded, deflation has given way to inflation and Japanese shares are up around 70%. But is Abenomics working or are we just seeing another cyclical bounce? And what does it mean for investors?

## Three arrows

Since the Japanese bubble economy burst at the end of the 1980s, it has wallowed with sub-par growth, six recessions, chronic deflation and a secular bear market in shares and property. Many reasons have been given: a failure to realise how serious the problem was; a conservative approach to policy making; a focus by the dominant Liberal Democratic Party on protecting special interests; revolving door political leadership with 16 prime ministers since 1990; and a declining population. Regardless of the drivers, Shinzo Abe and the LDP were elected with a mandate to fix up Japan in December 2012 and with voters giving him control of the upper house of the Diet, Japan's parliament, in July 2013. Abe is both an economic rationalist and a Japanese nationalist. A key motivation is likely his desire to see Japan's regional standing strengthened in the face of China's rise and North Korean threats. He has acted very decisively. His policy response has been characterised by "Three Arrows": fiscal stimulus, monetary stimulus and supply side economic reforms. All with the aim of boosting inflation to 2% pa and real economic growth to 2% pa.

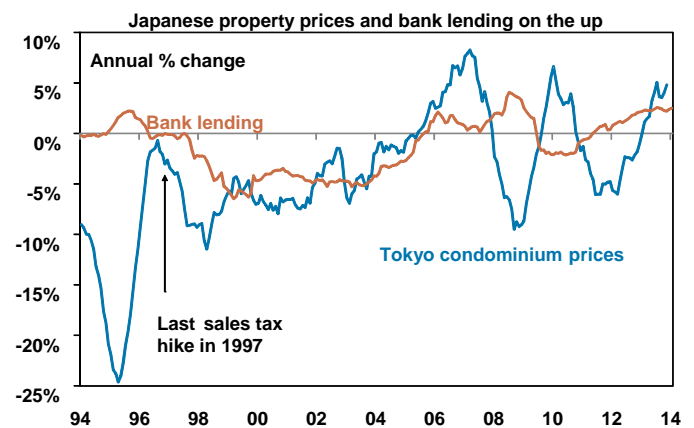
Given Japan's large public debt, any fiscal stimulus has to be modest and supply side reforms always take time so the initial focus has been on monetary stimulus. On this front, the approach has been very aggressive with the Bank of Japan announcing a 2% inflation target in January last year, Abe appointing ultra dove Haruhiko Kuroda as central bank governor and the BoJ announcing a massive quantitative easing program (pumping cash into the economy by purchasing \$US75bn/month of assets using printed money) in April last year. Adjusted for the size of the economy this was more than double the size of the Fed's then quantitative easing program and with the latter being reduced now swamps it. The program has seen the Yen fall by 21%.

The initial response has been positive with the economy growing 3% over the year to the March quarter and inflation

(ex the impact of an April 1 sales tax hike) running at 2.2%. But concerns remain: that the sales tax hike from 5% to 8% will drive a slide back into recession as the last sales tax hike in 1997 arguably did; that boosting inflation has only led to a fall in real wages; that the BoJ's success in achieving sustained inflation will depend on the Yen continuing to fall; that Japan's poor fiscal position dooms it long term; and that the Government has not delivered enough in terms of the third arrow reforms. Let's look at each of these in turn.

## Japan weathering the sales tax hike well

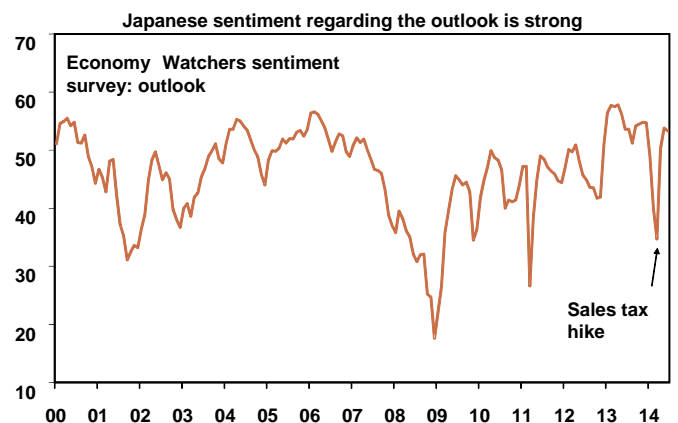
A return to recession as followed the 1997 sales tax hike is unlikely because unlike in 1997 Japan now has quantitative easing, unemployment is falling, property prices are rising, bank lending is rising, banks now have small non-performing loans and business confidence has been rising.



Source: Bloomberg, AMP Capital

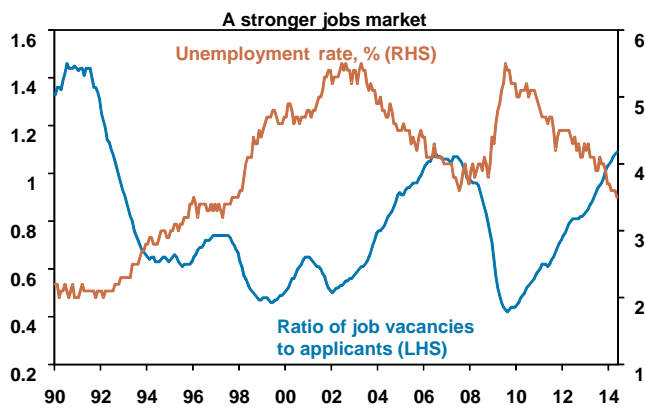
A range of indicators have bounced back solidly from their recent sales tax related fall:

- The Economy Watchers outlook index is up strongly;



Source: Bloomberg, AMP Capital

- The outlook components of the BoJ's Tankan survey are strong and business investment plans have improved;
- The unemployment rate has fallen to 3.5%, its lowest since 1997, and the ratio of job vacancies to applicants is at its highest since 1992.



Source: Bloomberg, AMP Capital

- While overall household spending remains weak after the tax hike, retail sales rose solidly in May.

The overall impression is that the Japanese economy has weathered the sales tax hike reasonably well and that a re-run of the 1997 experience is unlikely.

### Ending deflation is key

Rising real wages, when inflation was negative, didn't exactly help Japan. Rather, deflation was the much bigger problem because it zaps spending – why spend or invest today when you know it will be cheaper tomorrow? The key was to first end deflation and institute an inflationary mindset and Japan has done this with the introduction of a 2% inflation target for the BoJ and backing this up with unprecedented monetary printing. Inflationary expectations are now starting to rise in response and with the labour market starting to look tight wages growth is likely to pick up. Large firms already seem to be starting to put through faster wage increases.

### More domestic focus going forward

The decline in the Yen was clearly important in initially driving inflation higher. Our assessment is that a further decline in the Yen is likely - as the BoJ's huge money printing program, which likely won't be increased but will be extended beyond its two year timeframe, and the Fed's taper means that the supply of Yen is rising relative to the supply of US dollars. However, with an inflationary mentality starting to become more entrenched a falling Yen won't be as important in driving Japanese inflation going forward. In fact this is evident in a breakdown in the negative correlation between the Japanese shares and the Yen recently.

### Japan's fiscal problems bad, but not that bad

Japan's public debt looks horrible with gross public debt of 244% of GDP (compared to just 31% in Australia!). However, it's not nearly as bad as it looks. First, its gross public debt of 244% of GDP falls back to 137% once assets such as Japan's foreign exchange reserves are allowed for. Second, Japan borrows from itself, with public borrowing being a mirror image of private sector savings. Thirdly, various reforms over the last decade will limit growth in pension and health spending. Fourthly, tax as a share of GDP is low by OECD standards in Japan and there is plenty of scope to further increase the sales tax rate from 8%. Finally, while some fret that rising bond yields will blow out Japan's interest bill this won't be a problem if the back up in yields reflects stronger growth & inflation as it will mean higher tax revenue.

### Third arrow reforms are being understated

A critique of Abe seems to be that he has been lax in delivering "third arrow" reforms. But several points are worth noting. First, it was always second order. Japan's problem is a lack of demand not supply, as evident in falling prices. And

supply side reforms often make things worse before they get better. So it was right to first focus on reflation.

Second, Japan's third arrow reforms may seem more like a "thousand needles" but they are adding up. A range of reforms have been announced in recent months, eg easing visa requirements, cuts to rice subsidies and eased factory regulations. On top of this the Government has released its "New Growth Strategy" which includes a range of measures including a plan to cut the corporate tax rate from currently 36% to in the 20-30% range, measures to boost female workforce participation and measures to allow more foreign workers in certain sectors. These are all far reaching and while one "big bang" reform should not be expected the gradualist "thousand needle" approach is very positive. For example, the cut to Japan's corporate tax rate could boost Japanese earnings per share by between 10 to 30 percentage points over the next 4 years.

Finally, Abe's huge popularity, stable Government, control of both Diet houses and fading resistance to reform – eg farmers, who have been strong resisters of allowing a more efficient agricultural sector, now have an average age of 70 – means the reforms have a strong chance of success.

### Good reason for optimism on Japan

Japan will not grow as fast as China as it is already a rich country and the success of Abenomics should not be judged mechanically by the 2% inflation and growth targets (as they are just lights on a hill). But when assessed broadly there are good reasons to believe Japan is throwing off the malaise of stop start growth and deflation seen over the last 20 years: the BoJ is doing all the right things to entrench inflation, the longer term reforms it is introducing are broad based and Abe appears to have the support required to deliver.

### Implications for investors

There are two major implications for investors. First, a reinvigorated Japan is positive for Japanese shares. After a 57% gain last year, Japanese shares had become overbought and due for a correction, which is what we have seen this year with a 15% fall into April. Having worked off the excess, Japanese shares are now attractive again. While the boost to Japan's economy and share market last year was driven more by monetary easing, economic reform looks likely to be a major driver over the longer term.

Second, Japan is still the world's third largest economy, so stronger more sustainable growth in Japan is positive for the global economy at a time when Europe is gradually recovering and the pace of growth in the US is picking up. This in turn is positive for global shares generally.

### Japan and Australia

Japan takes 16% of Australia's exports and is our second largest export market, so a continuing exit from deflation and stronger growth in Japan is positive for Australia. This also comes at a time when a free trade deal with Japan is being signed. While the trade deal does not change the near term growth outlook for either country, its benefits will accrue over time. The main beneficiaries are beef and dairy farmers, service industries (such as finance) and consumers as tariffs on imported cars, household and electronic goods from Japan fall to zero.

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