

## Investment Insights

# The Latest from Japan and Hope for a Fiscal Solution



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## Highlights

- The Bank of Japan Friday announced further monetary easing, this time in the form of greater purchases of equity Exchange-Traded Funds (ETFs)
- The BoJ decision, in our view, suggests that central bankers more broadly are losing faith in Negative Interest Rate Policy (NIRP) to effectively stimulate growth and inflation
- Focus going forward — in Japan and elsewhere — is on fiscal stimulus to boost growth and reduce deflationary risk
- Recent comments from Japanese Prime Minister Abe leave us hopeful, but devil will be in the details

## Bank of Japan Eases Policy, but with More Caution

Early Friday, the Bank of Japan (BoJ) announced further easing measures, doubling its purchases of Japanese equities via ETFs to ¥6 trillion from ¥3 trillion previously. Most economists expected other easing measures as well, such as a further decline in already negative interest rates or expansion of the BoJ's purchase program of government bonds. The announcement was in a sense disappointing to some market participants, sending the yen higher versus the dollar by 1.5% (monetary easing is usually aimed in part on weakening the local currency to generate more

inflation). However, the market reaction was not all bad — Japanese equities rose by nearly 1% on the day. In our view, the onus has shifted to fiscal rather than monetary policy in Japan given the complication of easing policy further with rates already in negative territory.

Looking back, 2016 has proven challenging for the BoJ. In January, the market and Japanese society at large loudly opposed the Bank's move to negative deposit rates. After a brief rally, Japanese equities declined sharply — by more than 12% over the following 10 trading days, with the yen strengthening by more than 5% over that same period. This reaction was a sharp contrast to previous easing from the BoJ; for example, on Halloween 2014, the Bank surprised with an expansion of Quantitative and Qualitative Easing (QQE), weakening the yen by 6% and sending Japanese equities nearly 12% higher over the subsequent 10 days. Additionally, rather than supporting inflation expectations, a key goal of monetary policy given Japan's decades-long experience with deflation, the shift to negative rates earlier this year also coincided with a downturn in inflation expectations.

The difference with negative rates, explaining the less enthusiastic reaction, is two-fold. First, the BoJ adopting negative rates in a sense signals the end of the road of interest-rate focused policy easing, and with limited lasting effect in terms of supporting growth and inflation, the market has priced in perpetual disappointment. Second, negative rates have numerous side effects which can complicate the transmission of monetary policy to the real economy. Banks suffer a high share of the burden, consumers may react by hoarding cash (as there is some evidence of in Japan), and there are systems and other logistical complications with a negative rate regime.

## Fiscal Policy Now in Focus

**Monetary policy is one aspect of Prime Minister Shinzo Abe's plan to recharge Japan's economy, but fiscal policy is arguably more important.** One of the reasons that easy monetary policy has not been more successful in rejuvenating Japan's economy is because fiscal policy has been ineffective. Tax increases in recent years have stymied consumers' willingness to spend amid a very low interest rate environment; the VAT tax was increased in 2014, and Abe only recently announced plans to push back further planned increases. The problem is not that the Japanese government is not spending a lot of money. Gross government debt as a share of GDP is the highest of the largest countries in the world, and more than double the next highest (Exhibit 1). Rather, the challenge is that in part due to demographic issues, with a very large elderly population and generally small workforce relative to overall population size, that spending on social security and related measures has skyrocketed. Meanwhile, spending on public works has been declining since the late 1990s.

**It is likely that greater fiscal stimulus, with more of a focus on infrastructure and public works, will be coming soon.** Early on Wednesday, perhaps in an effort to set the stage for the Friday BoJ meeting, Abe announced a fiscal stimulus program of ¥28 trillion. The market is focused on how much of this is actual expenditure for this fiscal year (expectations are in the range of ¥7 to 13 trillion). Ministries are reportedly debating details of the plan, and parliament should consider a bill in mid-September. Given Abe has a supermajority in both the Lower House and Upper House of the country's parliament, or Diet, the bill is highly likely to pass without much opposition. This suggests that another potential boost for Japanese assets could come in September, but it is possible that the government releases more details of its plan as early as next week.

**Exhibit 1: General Government Gross Debt as a Share of GDP for the 20 Largest Countries by GDP size in 2015**

Country	Gross Debt as a Share of GDP
Japan	249%
Italy	133%
United States	105%
Spain	99%
France	96%
United Kingdom	88%
Canada	86%
Germany	75%
Netherlands	68%
India	66%
Brazil	63%
Mexico	50%
Switzerland	46%
China	41%
Korea	35%
Australia	34%
Turkey	34%
Indonesia	25%
Russia	16%
Saudi Arabia	2%

As of April 12, 2016. General government gross debt consists of all liabilities that require payment or payments of interest and/or principal by the debtor to the creditor at a date or dates in the future. This includes debt liabilities in the form of SDRs, currency and deposits, debt securities, loans, insurance, pensions and standardized guarantee schemes, and other accounts payable.

Source: International Monetary Fund

## Helicopters Circling?

There was much speculation in the past several weeks that Japan would adopt a policy of "helicopter money," or the Bank of Japan directly monetizing government debt. Former U.S. Federal Reserve Chairman Ben Bernanke, also known as Helicopter Ben, was meeting with officials in Japan over this period, and reportedly pushing the idea that Japan could accomplish more direct monetization of debt by issuing a floating rate, perpetual bond with no maturity in order to change the public's mindset about the government's ability to spend money. In theory, if the government can spend an unlimited amount of money that will be funded by the central bank printing money, inflation expectations can only go higher.

Leaving aside a more in-depth academic discourse on helicopter money, we believe that on one hand, there is not political or popular support for more direct helicopter money in Japan, and on the other, Japan is already monetizing debt at a very fast rate. The Bank of Japan is purchasing roughly two to three times the annual net issuance of Japanese government bonds. For context, at the peak of quantitative easing in the U.S., the Fed was purchasing the equivalent of roughly 70% of net U.S. Treasury issuance. Given low issuance in key countries like France and Germany, the figures there are starker, with the European Central Bank (ECB) purchasing about five times net government bond issuance.

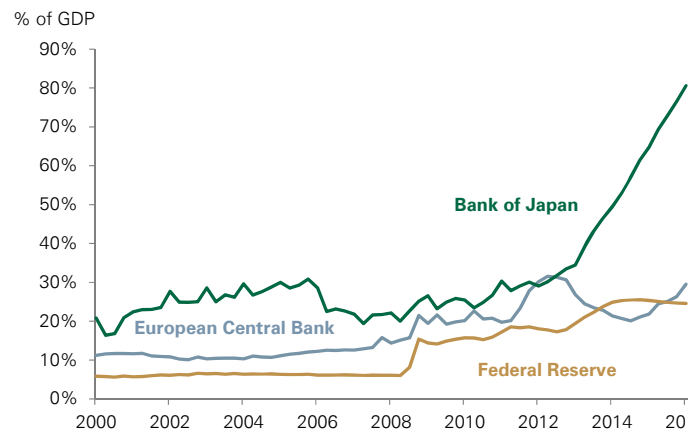
A quick comparison of central bank assets is more striking (Exhibit 2). The assets held on the Bank of Japan's balance sheet are the equivalent of 80% of nominal GDP versus 20 to 30% for the Fed and the ECB, which are themselves at historically unprecedented levels. There are some differences with actually writing off government debt all together, but the BoJ is already extremely aggressive in its attempts to boost inflation and inflation expectations.

In our view, this backdrop really puts the onus on fiscal policy to deliver both effective stimulus for near-term results and structural change for long-term sustainability. The coming weeks will provide some clarity on this angle of Japan's story.

## Portfolio Implications

Japanese equities account for roughly 5% of client portfolios with a Balanced Growth profile; this position is slightly underweight relative to the benchmark, especially after considering the low volatility nature of the Japanese holdings within mandates. Additionally, Bessemer mandates hold several individual Japanese equities which are less exposed to the country's macro headwinds. We will be reviewing portfolio holdings and currency hedges in the coming days and weeks, incorporating developments in fiscal policy to our framework.

**Exhibit 2: Central Bank Assets as a Share of Nominal GDP**



As of March 31, 2016.

Source: Bloomberg, Bank of Japan, Economic and Social Research Institute Japan, European Central Bank, Eurostat, Federal Reserve, U.S. Bureau of Economic Analysis

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