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CIO Viewpoint

Avoiding Japanification

Investment Solutions

9 October 2019

Japan has been pulled into a generation-long period of zero-to-negative interest rates amidst significant ageing of its population. Once inside what former US Treasury Secretary Larry Summers calls "black hole monetary economics," it's hard to escape from zero rates. With Europe struggling to avoid the gravitational pull of this black hole and the US "only one recession away from 'Japanification'," Mr Summers said recently, what can the rest of the world learn from Japan's efforts?

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Key takeaways

- Japan is trying to escape from a negative-rate environment and 'Japanification'
- A consumption tax hike represents part of the broader attempt to achieve inter-generational rebalancing
- The jury is out on the ultimate success of Japan's policy against deflation
- Similar cases in other industrialised countries warrant caution
- Policymakers worldwide are watching for clues to escaping Japanification.

Japan has suffered from 'Japanification' - stagnant inflation, depressed growth, and a low interest-rate economy - for three decades as its demographic profile worsened. Over the stretch from the 1990 bubble-burst to the start of Abenomics in 2012, workers' wages, excluding bonuses, rose by meagre 7.5% and measured since the mid-1990s, actually declined dramatically. In comparison, US average hourly wages over the same period nearly doubled. With the exception of a peak of 3.6% in 2014, Japan's headline inflation rate has hovered around zero for more than 20 years.

Persistent deflationary pressures triggered a ballooning public debt as the value of much of the government's debt obligations did not change while tax revenues stagnated amidst anaemic growth and inflation. Indeed, after the three decades of deflationary struggle, Japan is one of the most indebted nations in the world, with gross public debt just below 240% in 2018, compared with 106.1% for the US and an average of 85.1% for the eurozone.

After a deflationary scare in 2011-12 following the Great East Japan earthquakes, Prime Minister Abe and his Liberal Democratic Party (LDP) returned to power promising to help Japan overcome this 'Japanification' trend through a combination of monetary policy easing, flexible fiscal policy, and structural reforms. The programme, widely referred to as Abenomics, has had some successes, making Abe one of Japan's longest serving prime ministers.

Long-awaited tax

On 1 October, Japan imposed a long-awaited increase in Value Added Tax, raising the rate from 8% to 10%, the first increase since 2014 and the fourth since 1989. The consumption tax applies to goods and services, with the exception of food and beverages, and it may also fund social welfare including schooling.

The 2% tax hike, especially after the economic difficulties that followed 2014's 3% hike, has been viewed by many analysts as an "own goal" as consumption is impacted, and so Abe's reflation agenda too (see chart 1). Supermarket data points to an immediate 10-20% fall in sales, compared with a year ago, suggesting these concerns are legitimate.

However, the government's decision is not without merit. A consumption tax has the advantage, compared with income tax, of being more efficient, stable, and predictable. The measure creates a new tax base, provided the impact can be smoothed through short-term policy support, adding a permanent revenue source for the government and additional room for fiscal flexibility ahead.

Critics also overlook that the much-criticised 2014 increase marked the peak in Japan's public debt trajectory, which has been moving sideways as a share of GDP since (see chart 2). Furthermore, the government was able to go ahead with the tax rise because first-half economic growth was healthier than expected (expanding 1.3% in the second quarter on an annualised basis).

The government has learned from 2014 and anticipated more volatile consumption in the coming months with a series of countermeasures, including incentives to shift spending away from cash (Japan is one of the highest-users of cash in the world), and fiscal support for households. In fact, Abe's measures tend to help younger households more as the increase puts more burden on older consumers and re-directs the resources to programmes such as free schooling.

The government also enjoys a large enough majority in the national parliament to enact new short-term measures if needed, including welfare reforms designed to reassure the older population. After all, the political discontent of the older generation will not be easy for the ruling LDP to ignore.

Central bank constraints

Where Abe's government enjoys some political flexibility in managing the impact of the VAT increase, Japan's central bank faces more constraints, even though they are more political in nature. Unlike the Swiss National Bank, the Bank of Japan (BoJ) isn't allowed to buy foreign assets, and the Abe cabinet, which has the legal power to do so, will not do so for fear of irritating the US and other G7 peers. Meanwhile, the BoJ is progressively running out of domestic assets to buy as it owns nearly half of Japanese government bond market. The logical next step is a further interest rate cut into negative territory with a more clearly tiered reserve system, similar to the European Central Bank.

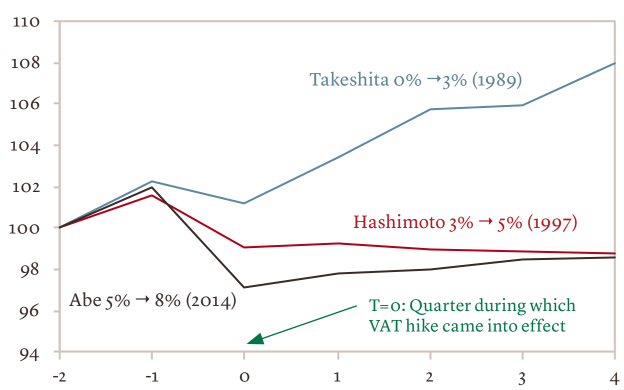
The problem with this option is the banking sector's deep discomfort with negative rates. After recording substantial declines in interest margins since the BoJ introduced negative rates in 2016, Japan's banking lobby continues to oppose deeper cuts and recently even welcomed the BoJ's inaction.

All of this means that the first response to substantial downturn may be primarily fiscal and the BoJ's next move may focus on supporting the Abe cabinet's stabilisation measures. Due to persistent lobbying by banks, some speculate that the BoJ may cut short-term rates and reduce long-term JGB purchases simultaneously. This rumour led to a brief technical sell-off in the JGB market recently.

The upshot is that the BoJ will not expend too much of its political capital to fight these constraints unless a severe economic risk materialises and forces its hand. Besides, we expect that the post-tax hike slowdown will not be as dramatic as five years ago.

Chart 1 – VAT impact will be felt in Q4 2019

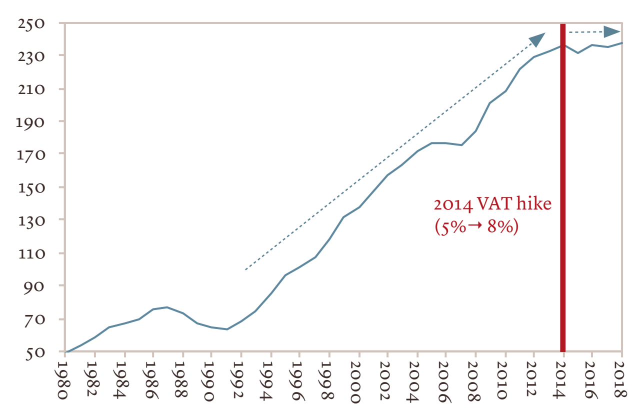
Real consumption level in previous VAT hikes (level at t-2 = 100)



Sources: CEIC, Bloomberg, Lombard Odier

Chart 2 – Japan's notorious public debt burden actually stabilised

Japan's gross general government debt as % of GDP



Sources: Bloomberg, Lombard Odier

Ageing, negative rates, and immigration

The ultimate driver of Japan's "Japanification" is of course its demographic ageing. The fertility rate is below replacement level and the total population is ageing, shrinking and closely watched by other nations as a guide to what to expect.

In addition to mechanically lowering the headline growth rate via fewer productive workers in the economy, ageing encourages excessive saving as most workers plan for post-retirement living on fixed income. Relentless declines in Japan's bond yields look then like the simple result of the savings and liquidity demands of a greying generation that are overwhelming a working generation in the process of building new families.

In this light, it can be argued that the BoJ's increasing repression of yielding assets is, implicitly, an attempt to cap this saving trend. The bank is certainly not alone. Negative rates, ageing populations, and anaemic business cycles are also visible in Switzerland, Germany, and Nordic nations. The persistence or intensity of negative rates in these economies, however, highlights the limits of this strategy. More troubling is that other industrialised Asian countries appear to be following Japan's footsteps, rather than avoiding them.

A simpler solution would be to boost the working population. Surprisingly, the Abe cabinet has had a limited success in increasing immigration. The proportion of foreigners resident in Japan rose 6.6% in 2018 to a record 2.73 million people thanks to foreign apprentice programmes and a looser visa regime for skilled labour. While Japan's 2% foreign population does not compare well with 12% in Germany and 14% in the US, it marks an interesting shift in a society known for its homogeneity.

Still, Japan's immigration policy shift does not appear to be a model for its industrialised peers. Immigration policy in the US and Europe is increasingly more restrictive. Furthermore, Japan's immigration may not be aggressive enough, especially if reforms falter after Abe's possible retirement in 2021.

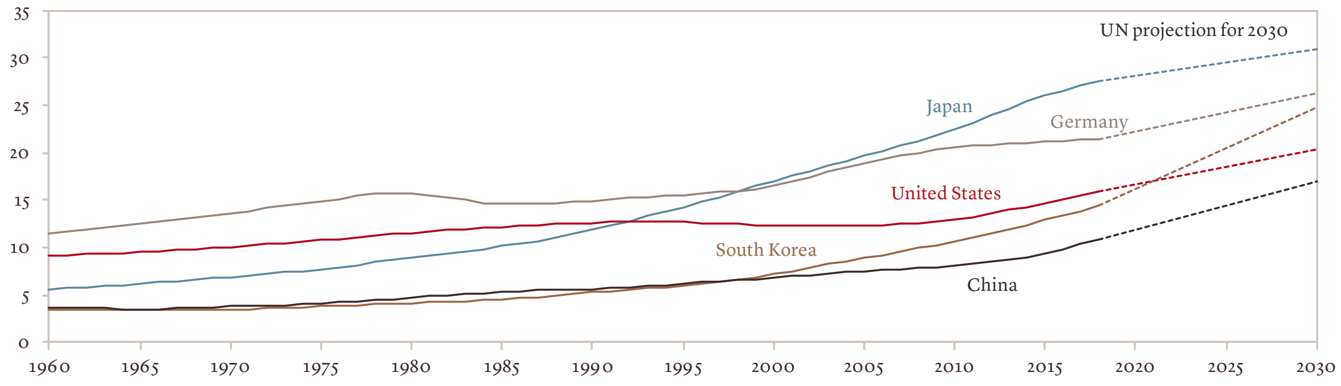
Is demography a destiny?

Physics tells us that nothing can escape a black hole. So far, Japan has not yet escaped its own black hole of demographic ageing and its gravity on financial markets.

How Japan can fight Japanification in this unusual period of political stability and counteract the effects of an ageing society continues to grab policymakers' attention worldwide. While Japan has generated some domestic growth and stemmed a decline in inflation, its fundamental challenges remain. The recent tax hike represents another step in Japan's long journey.

It is probably too early to conclude that Japan can either defy its black hole, or yet show the rest of the world how to avoid its gravitational pull. This is a troubling thought for investors everywhere, as we look at the prospect of decades of ageing societies ahead of us (see chart 3).

Chart 3 – Ageing to become a global phenomenon
Proportion of population 65 years old or above



Sources: CEIC, UN, Lombard Odier

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