December 2, 2013

“ABENOMICS” and the exit from the “lost two decades”

Japan’s balance sheet adjustment and JGB market

Hajime Takata
Chief Economist

Mizuho Research Institute

8 Key issues today

•Japan’s “lost two decades”

•Balance sheet adjustment and Japanisation

•JGB as a “sacrificial substitute”

•Two “wolves” at the world’s doorsteps

•A JGB crash and “the love to the markets”

•Lessons from the Great Depression

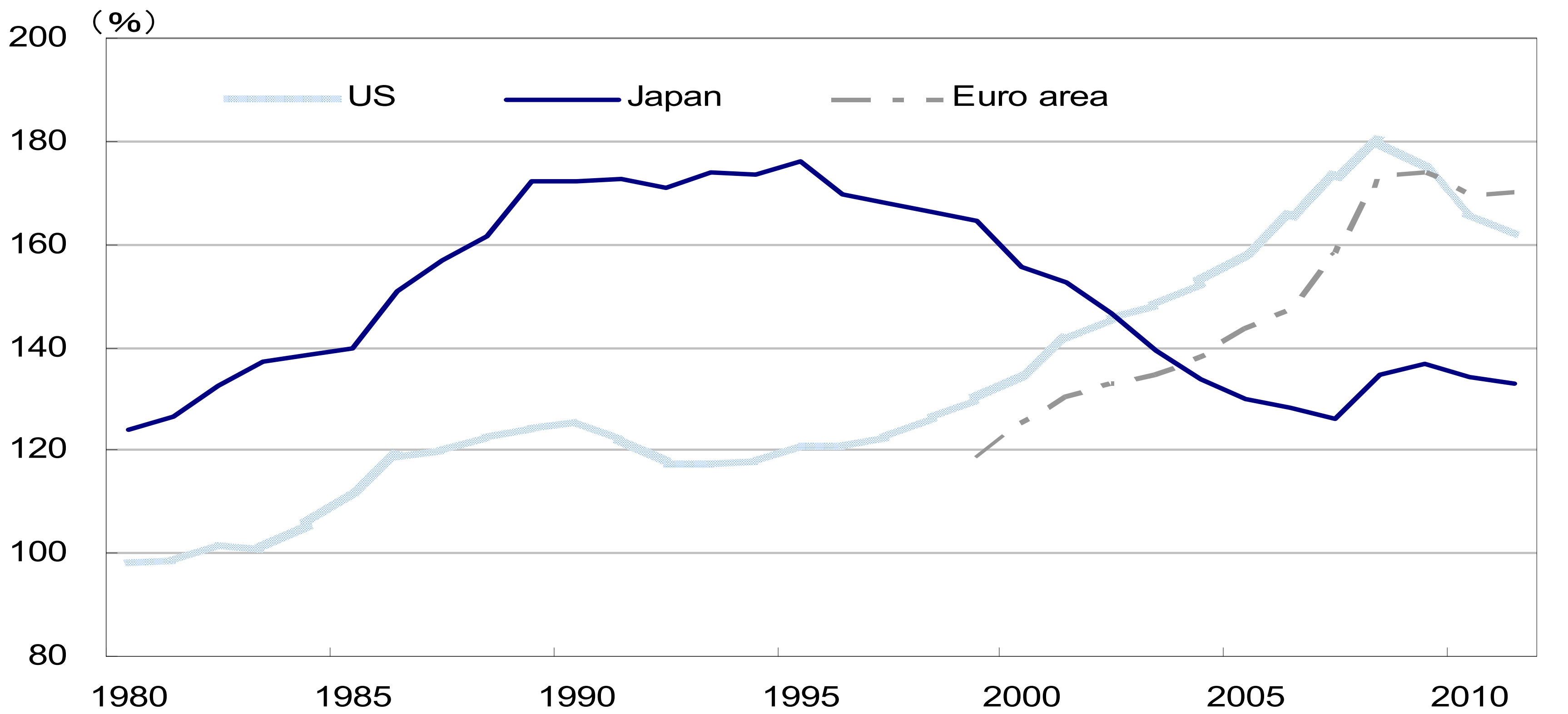
•Pegging and financial repression

•Goldilocks

Japan's "lost two decades"

- The starting points of balance sheet adjustment were 1990 in Japan and 2007 in the US and Europe ⇒ a parallel shift of conditions 17 years ago in Japan?
- Japan's balance sheet adjustment process was completed in 2007. However, the start of the adjustment in the US and Europe pushed Japan into a further pessimistic state of mind.

[Private sector debt (% of nominal GDP)]

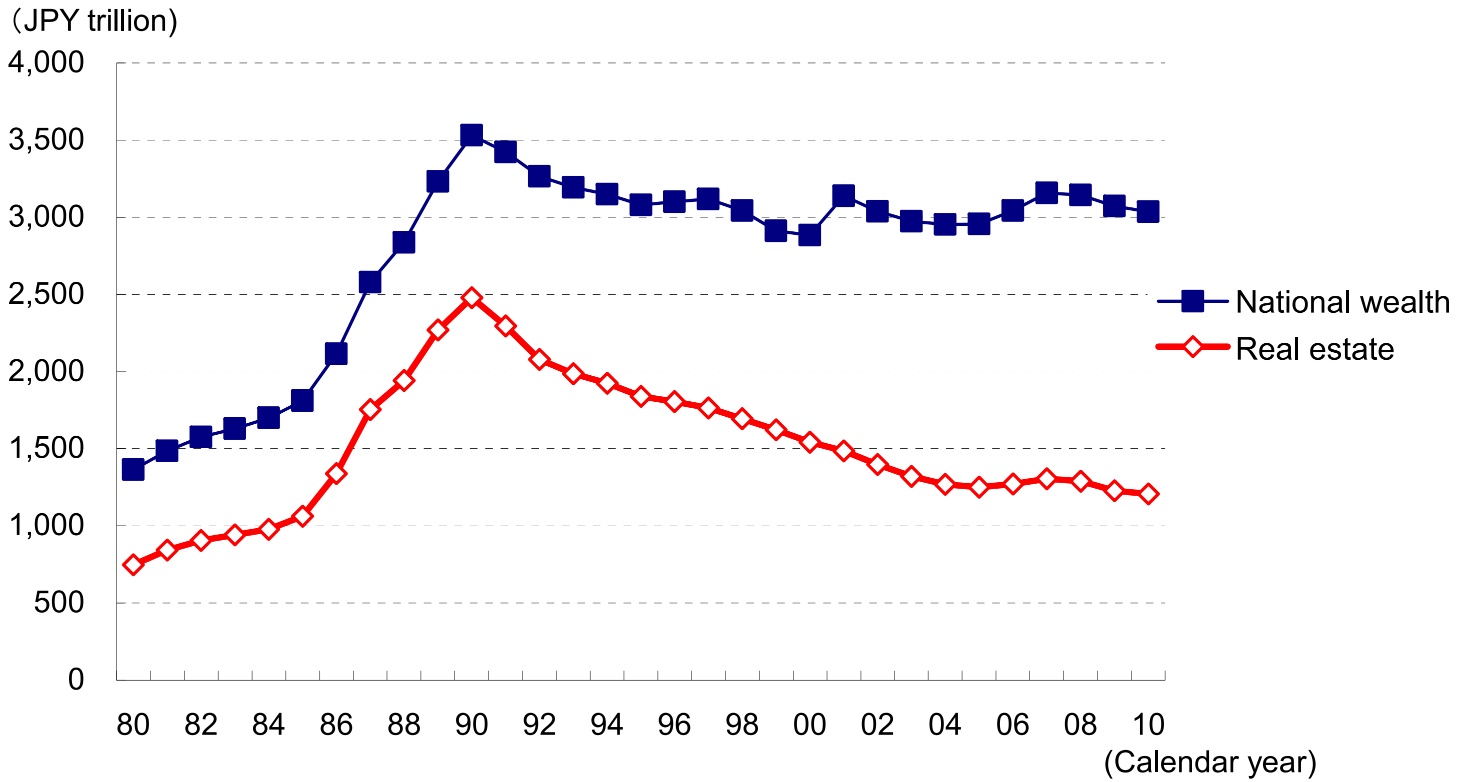


Note. US and Euro area data are calendar year data. Data on Japan are fiscal year data.
The private sector is calculated as the sum of the private non-financial sector and the household sector.
Sources: Made by Mizuho Research Institute based upon Haver, Cabinet Office, Eurostat and European Commission

ASSET DEFLATION AND LOSS OF NATIONAL WEALTH

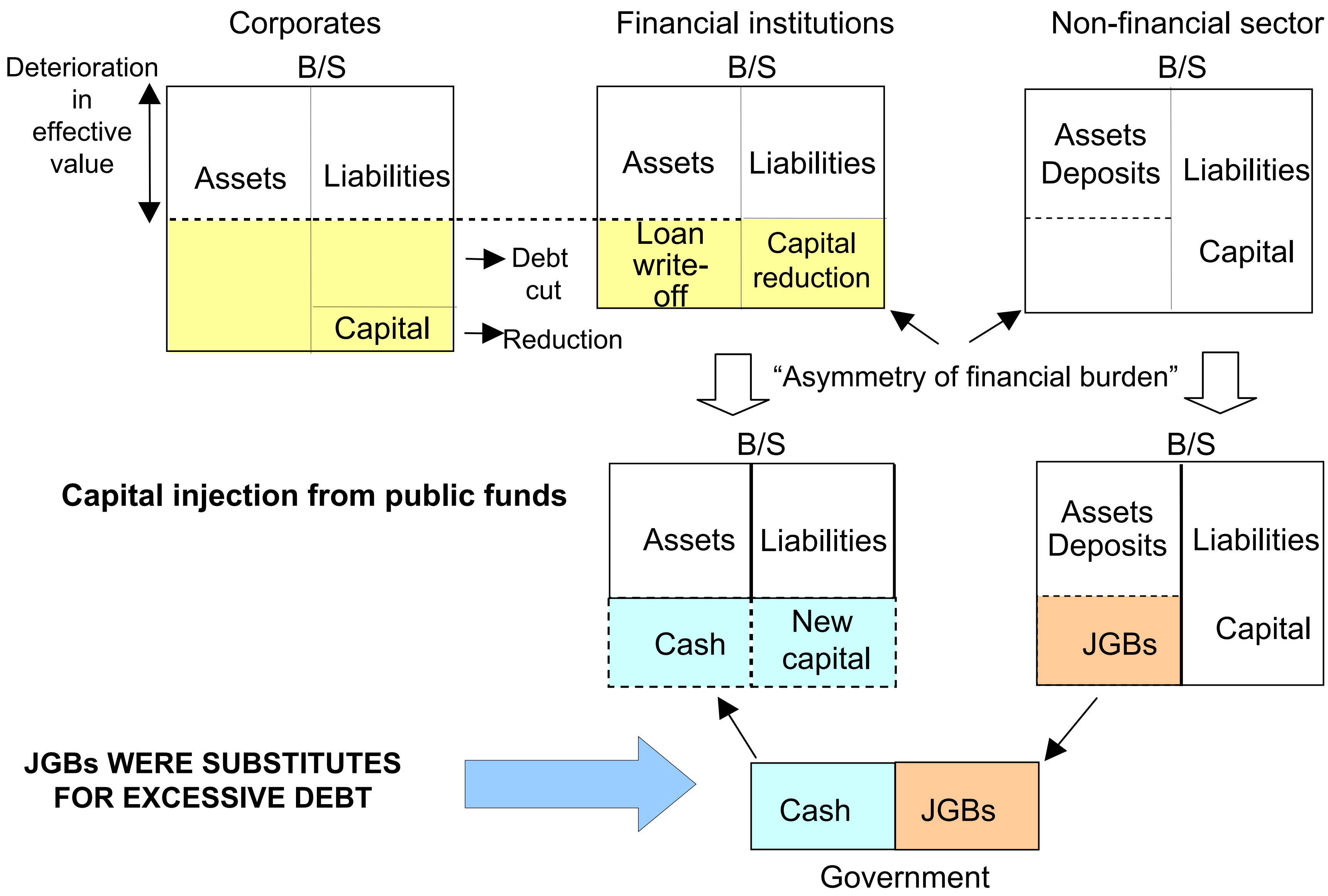
- Japan’s structural problems caused real estate losses exceeding JPY1,000 trillion

[Market value of national wealth and real estate, calculated on basis of GDP]



Notes: 1. Data up to 2000 are benchmarked at 2000 and data from then onward are benchmarked at 2005.
2. "Real estate" includes land, underground resources, fishing grounds, etc.
Sources: Made by Mizuho Research Institute based upon Cabinet Office, National Accounts.

JGBs WERE SUBSTITUTES FOR EXCESSIVE DEBT

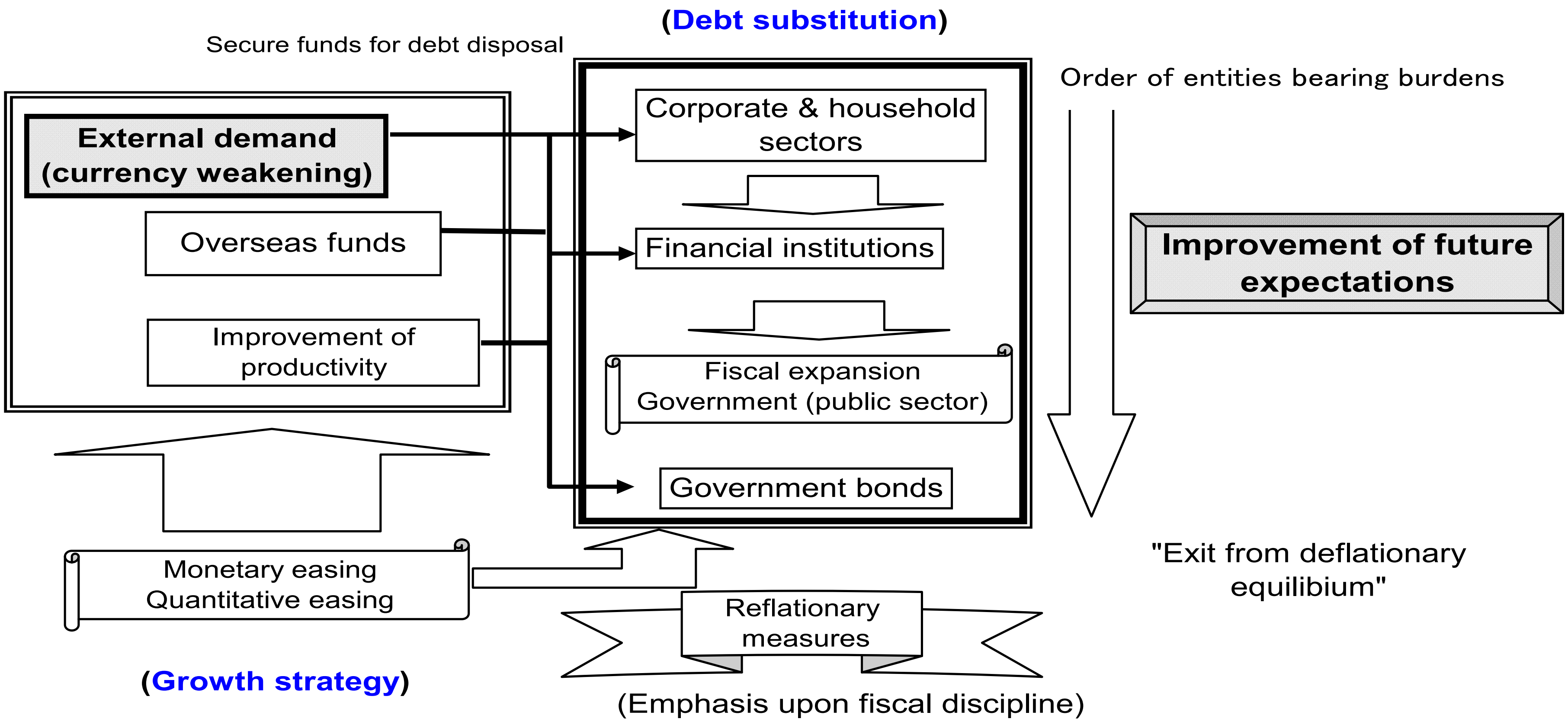


Source: Mizuho Securities

Balance sheet adjustment and Japanisation

- The fundamentals of balance sheet adjustment are “debt substitution”, “currency weakening” and “improvement of future expectations”

[Diagrammatic representation of the “burden” and “financial sources for debt disposal” in the debt disposal process]

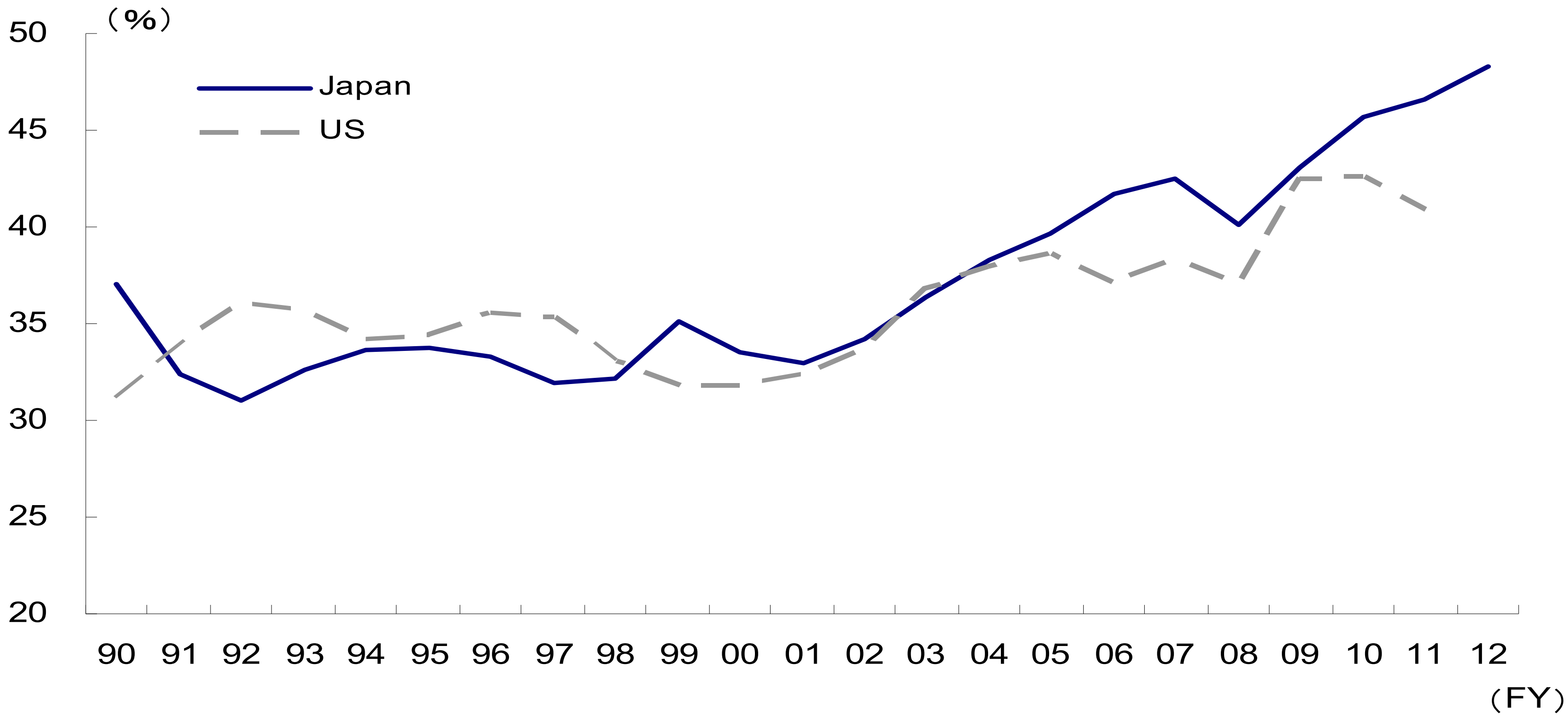


Source: MHRI

The financial conditions of Japanese corporate enterprises have improved

- Financial conditions of approximately 50% of Japan's listed corporations
  The percentage are debt-free has surpassed that of their US counterparts .

[Percentage of debt-free corporate enterprises (Japan, US)]

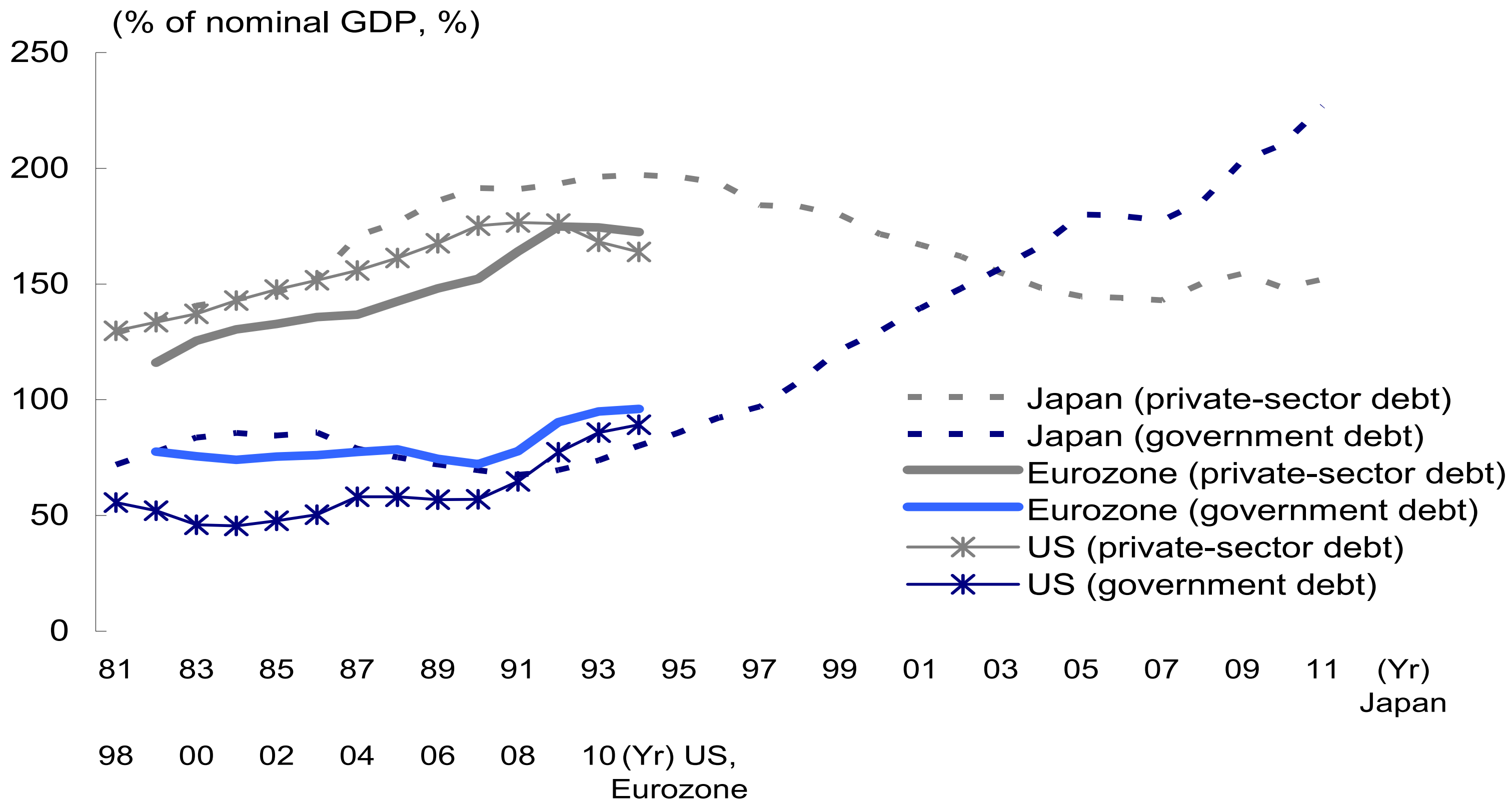


Note: Subjects of survey are listed corporate enterprises ex finance: Japan (1,719 enterprises), US(1,153 enterprises)
Sources: Made by Mizuho Research Institute based upon NEEDS-FQ, OSIRIS

JGBs were a "sacrificial substitute"

- During Japan's balance sheet adjustment process, government debt ballooned in the place of private-sector debt

[Government and private-sector debt outstanding as a percentage of nominal GDP (Japan, US, Eurozone)]

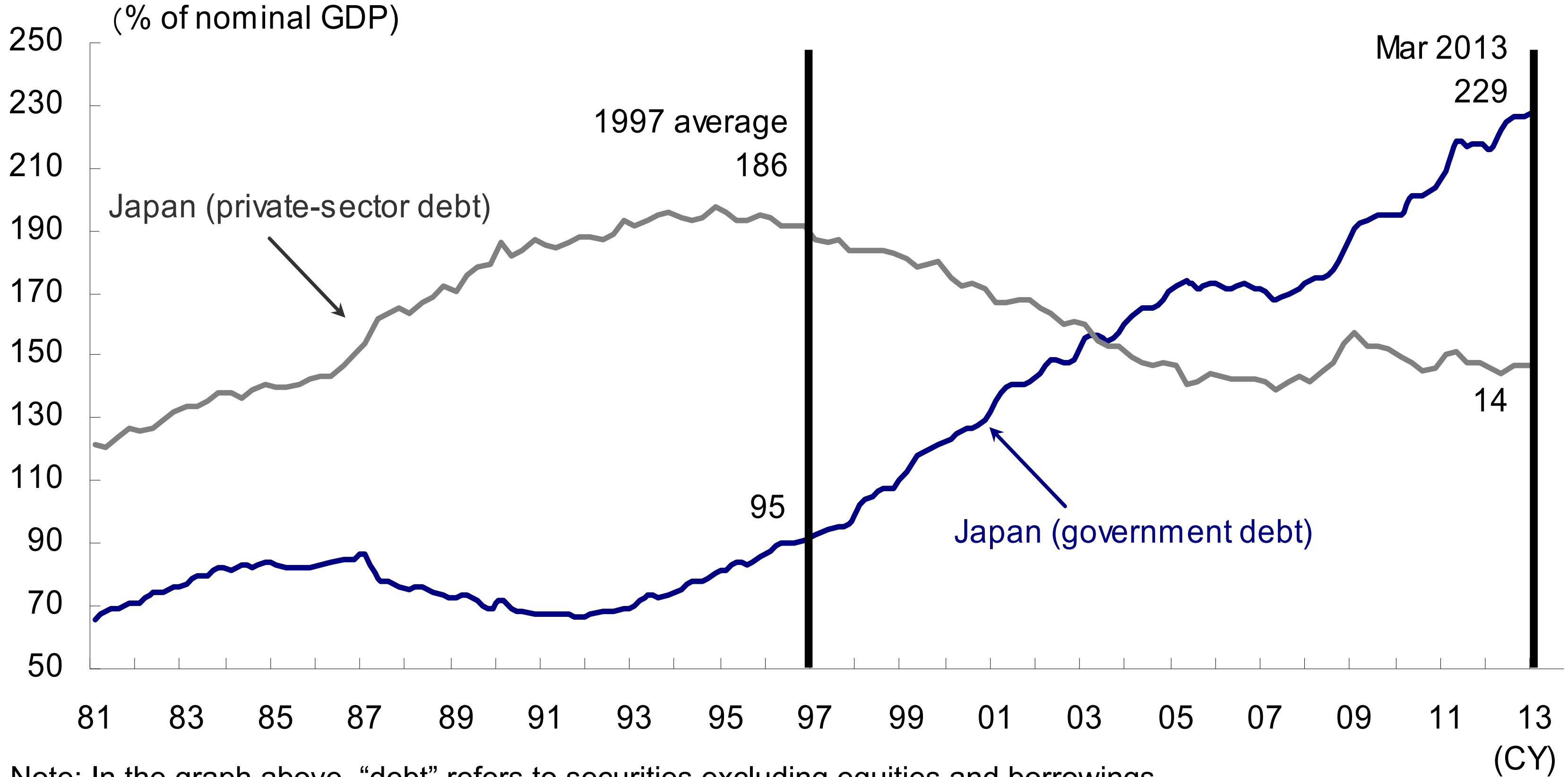


Note: "Debt" refers to borrowings and securities (ex equities).
Sources: Bank of Japan, FRB, ECB.

Fiscal discipline and tax hike

- There is a considerable gap between conditions today and 1997 from the perspective of balance sheet adjustment.
- The state of the economy today is characterized by the dramatic improvement of the private sector and the large fiscal burden

[Japan's government / private-sector debt outstanding]



Note: In the graph above, "debt" refers to securities excluding equities and borrowings.
Source: Bank of Japan

TWO “WOLVES” AT THE WORLD’S DOORSTEPS

- The first wolf: JGB collapse

  The second wolf: US dollar collapse

- Both Japan and US are running deficits

  A fiscal deficit in Japan and a trade deficit in the US

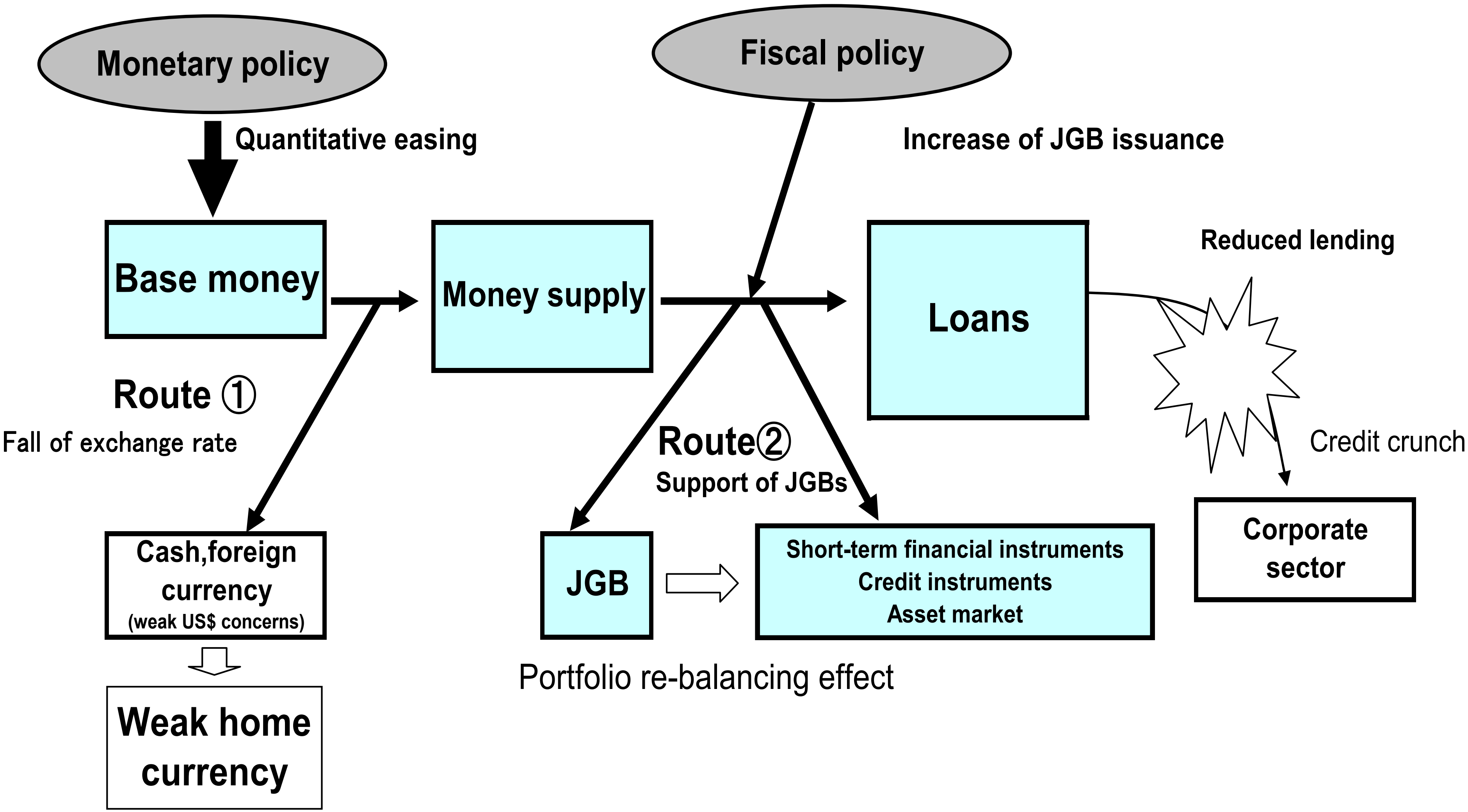
- Stability requires liquidity and ability to fund deficits

  Japan can finance its deficit locally : US enjoys liquidity derived from the US dollar being a key currency

- Japan’s stability is based on its ability to fund deficits : US national strength is supported by the US dollar

Kuroda Bigbang leads to lower Yen and asset price boom

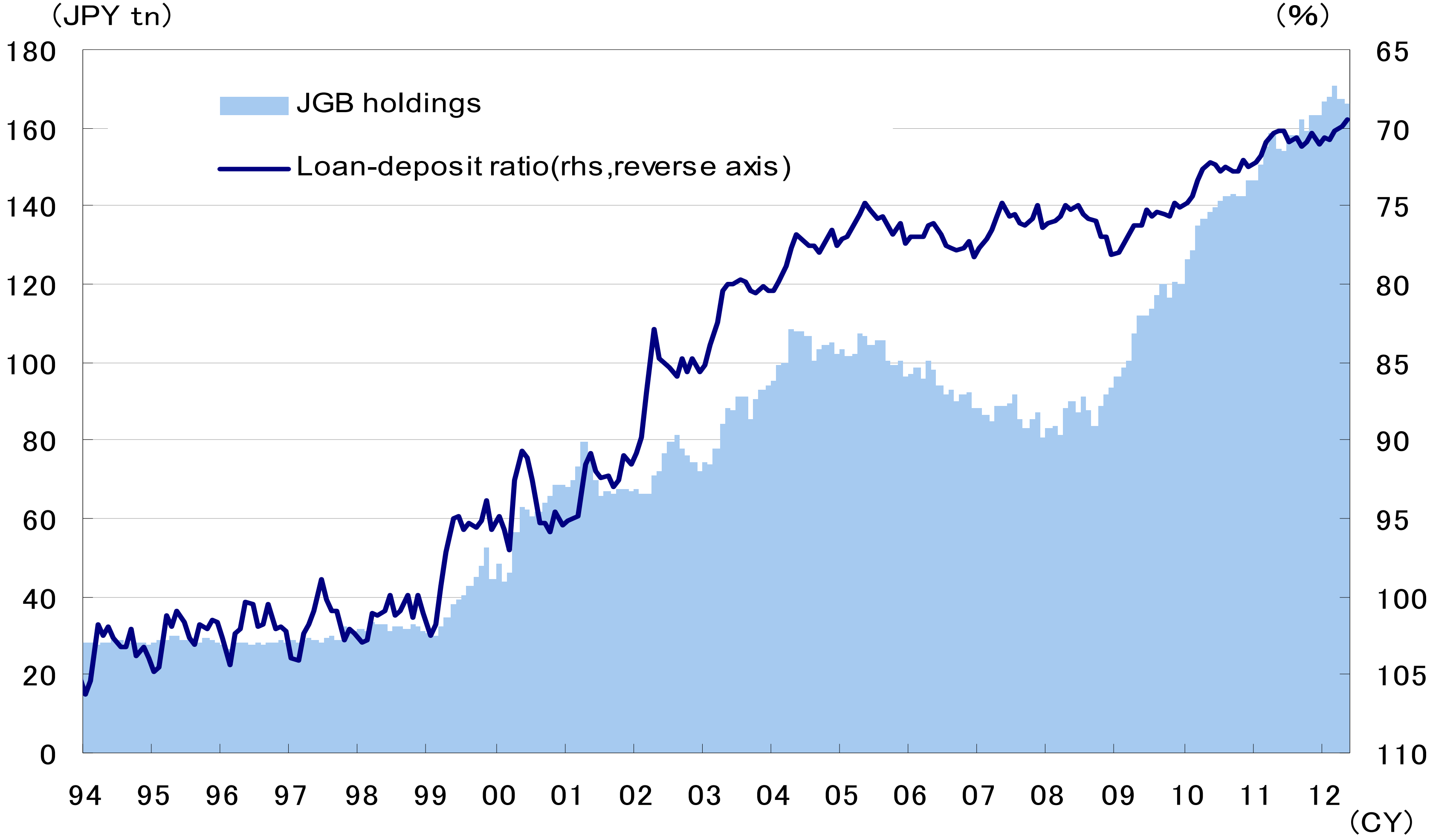
[Diagrammatic representation of money flow (concerns about fiscal policy and hyper-inflation)]



Source: MHRI

INCREASE IN LOAN-DEPOSIT GAP AND JGB-HOLDINGS OF JAPANESE BANKS

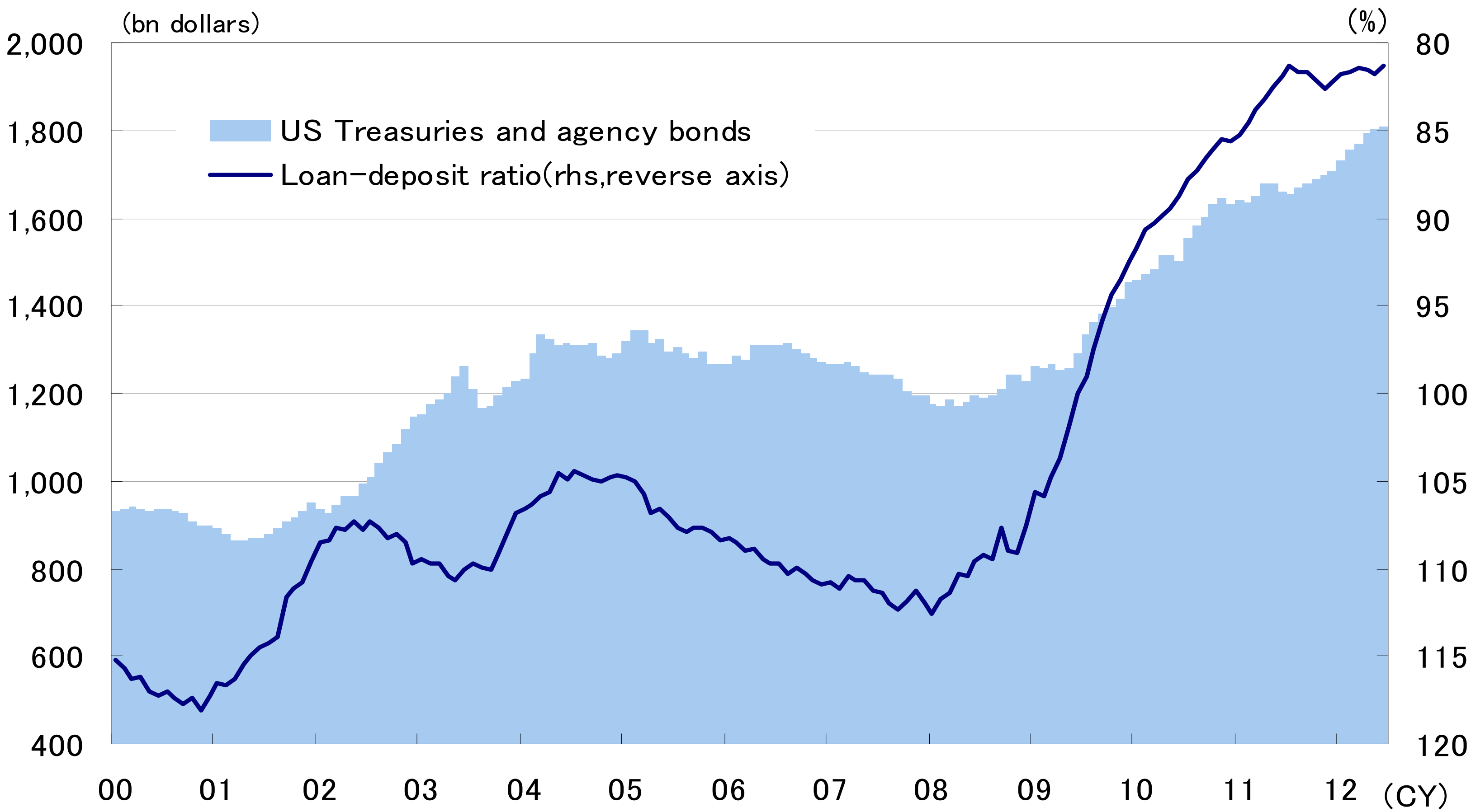
[Loan-deposit ratio and JGB holdings of Japanese banks]



Source: BOJ

INCREASE IN US LOAN-DEPOSIT GAP AND GOVERNMENT BOND HOLDINGS OF US BANKS

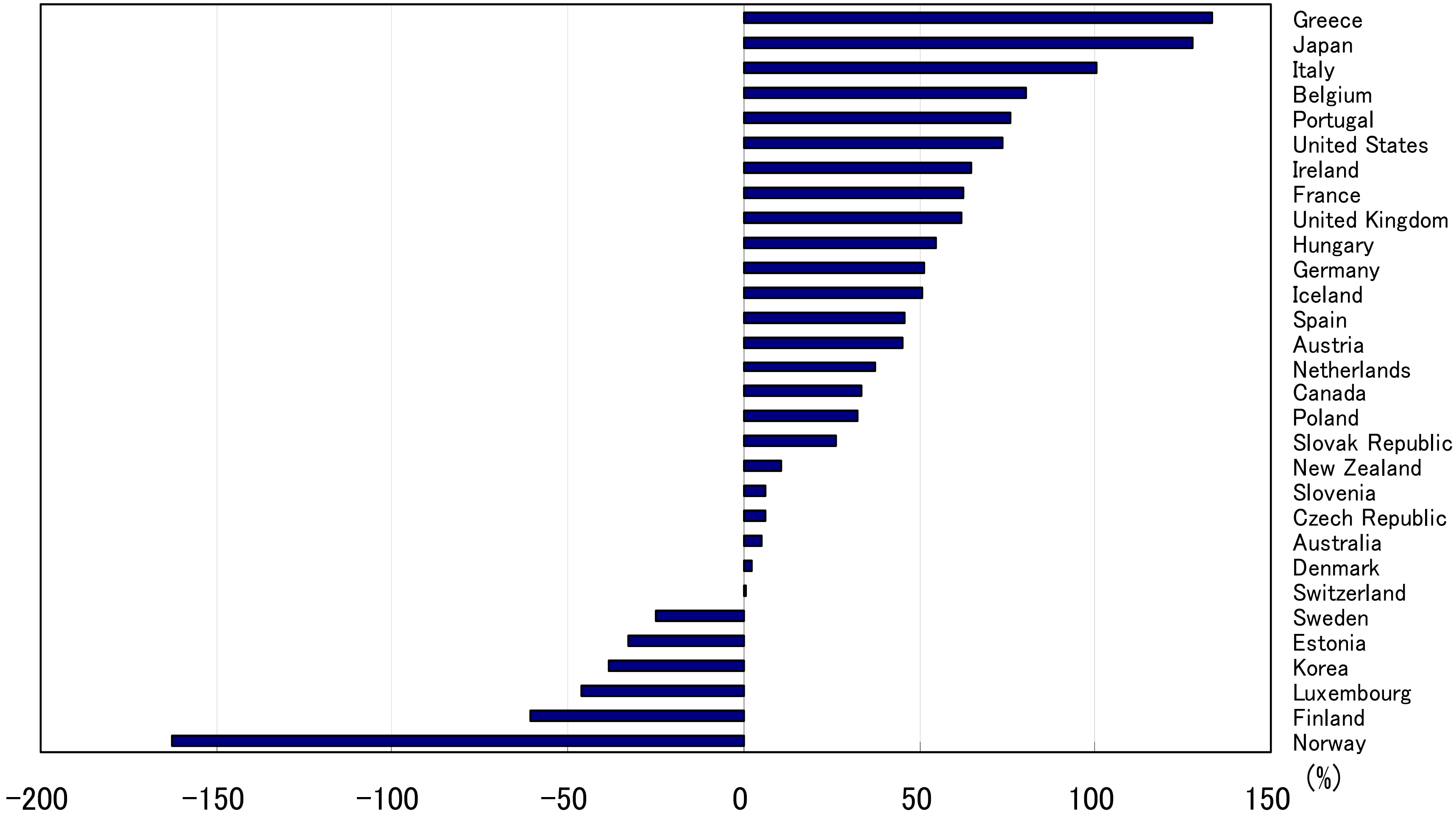
[Loan-deposit ratio and government bond holdings of US banks]



Source: Compiled by Mizuho Research Institute from Haver

JAPANESE DEBT AMONGST WORLD'S HIGHEST

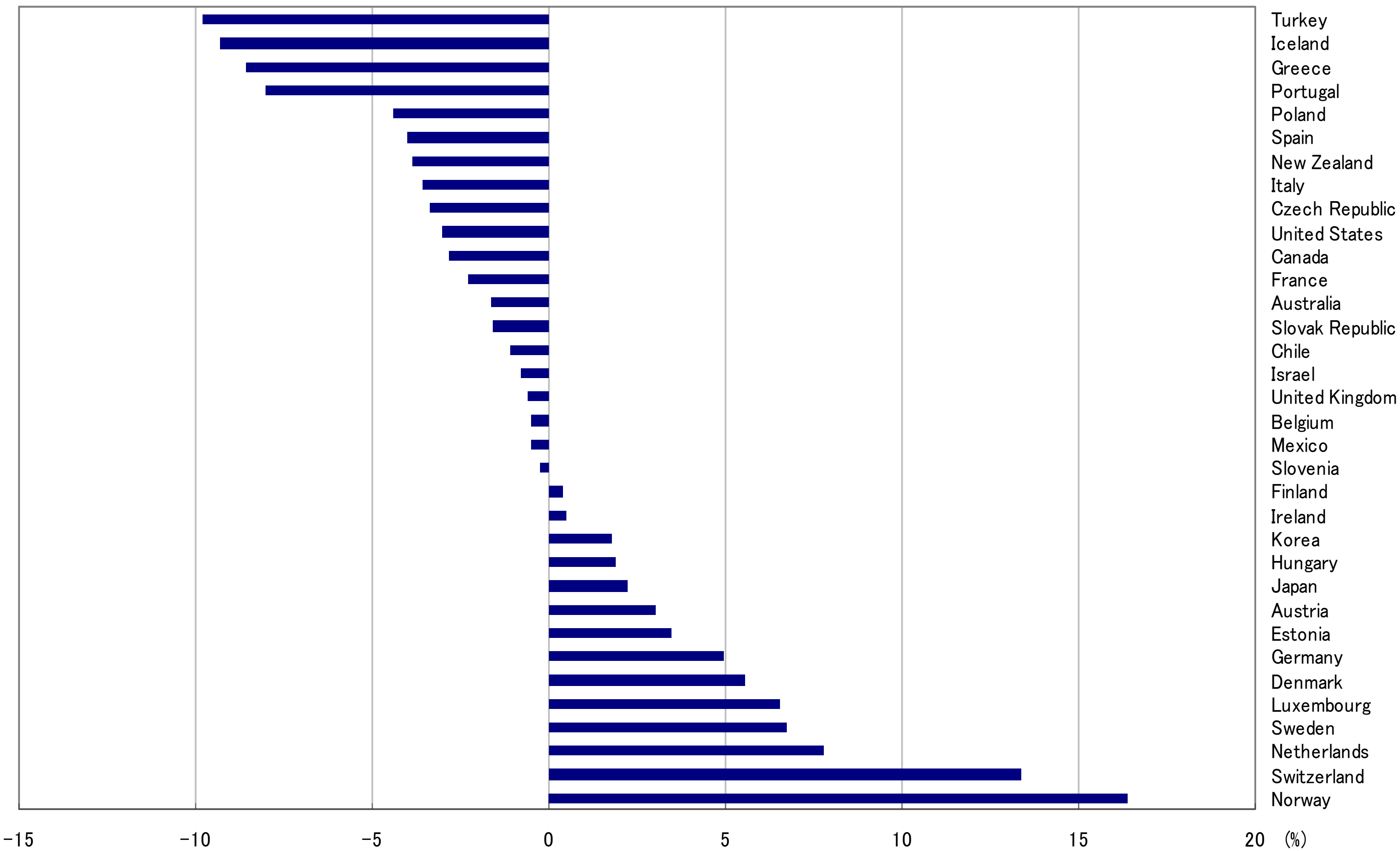
[Net government debt (relative to GDP, OECD 2011 forecasts) by country]



Source: *OECD Economic Outlook*

PIIGS' PROBLEMS: CURRENT ACCOUNT DEFICITS

[Current account balances (relative to GDP, OECD 2011 forecasts) by country]



Source: *OECD Economic Outlook*

JAPAN’S JGB-HOLDING STRUCTURE RESEMBLES FAMILY FINANCES

- Japan has no debt if it is viewed as a single ‘household’
- JGB-holdings resemble fund transactions between a husband and his wife
- But sometimes one spouse worries
- Japan has time
- But even within the same household, ‘trust’ and ‘love’ are required
- Trust (origin of finance) engenders liquidity

A JGB crash? Necessary fiscal discipline, and “love to the markets”

- A current account surplus is a major premise for confidence in Japanese government bonds (JGBs).
- JGBs averted a crash due to implicit confidence in JGBs lingering in the market.
- A “growth scenario”, domestic confidence, “love to the markets” are indispensable.
- The TPP, fiscal discipline (consumption tax, comprehensive reforms), electrical power supply measures are all directly linked to confidence in JGBs.
- The growth scenario and confidence – indispensable for the avoidance of a JGB crash – is supported by fiscal discipline.

[Three conditions for Japanese investors’ implicit confidence in JGBs]

① Japan will eventually return to a growth track ⇒ TPP etc.

② Then, in view of economic growth, the government will decide to exercise its taxation rights
⇒ consumption tax hike etc.

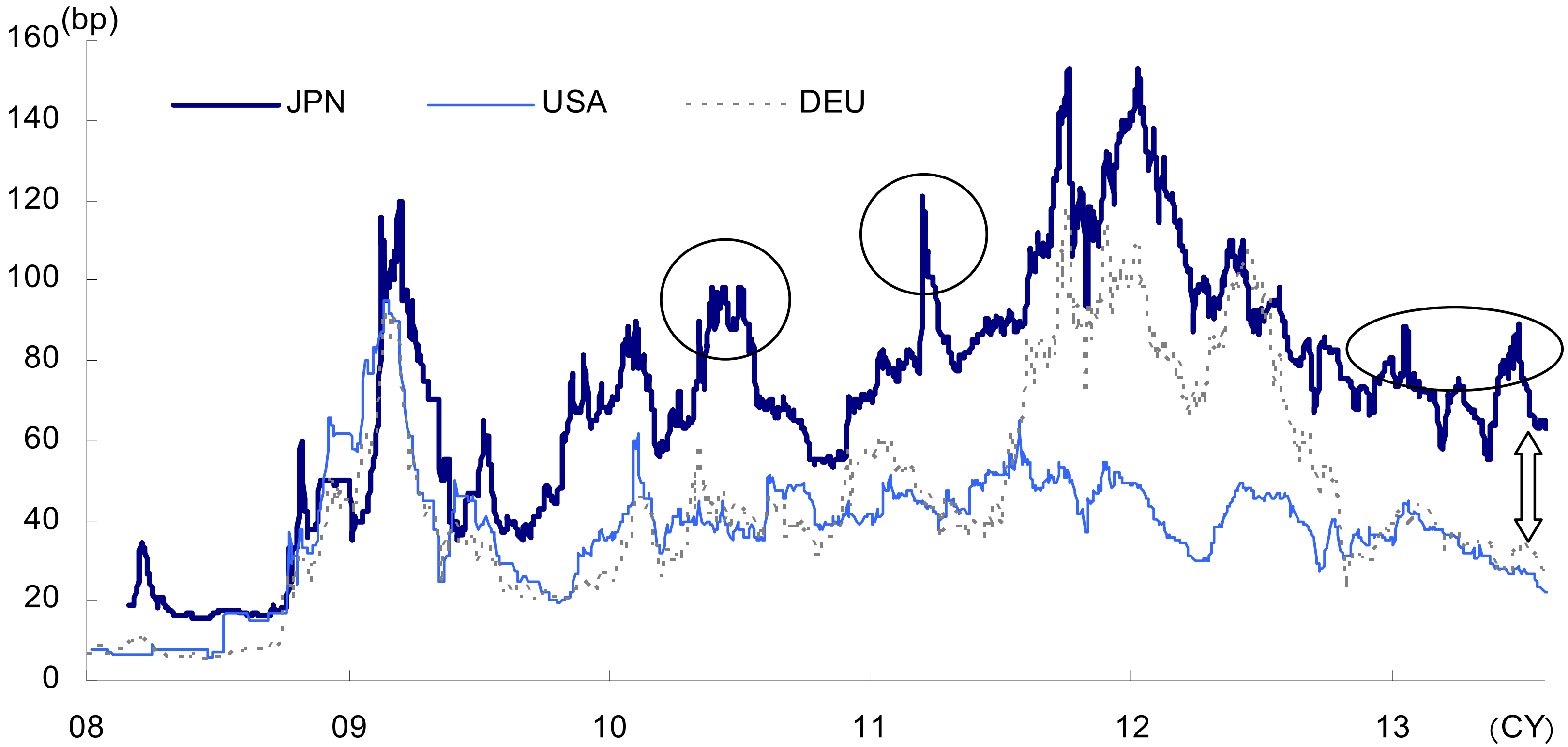
③ The administration possesses governance enabling the government to make decisions

Source: MHRI.

Confidence in JGBs?

- The CDS spread – an indicator of confidence in JGBs – remains relatively high this year.
- This may reflect Japan's stance toward fiscal discipline.

[Trends in CDS spreads]

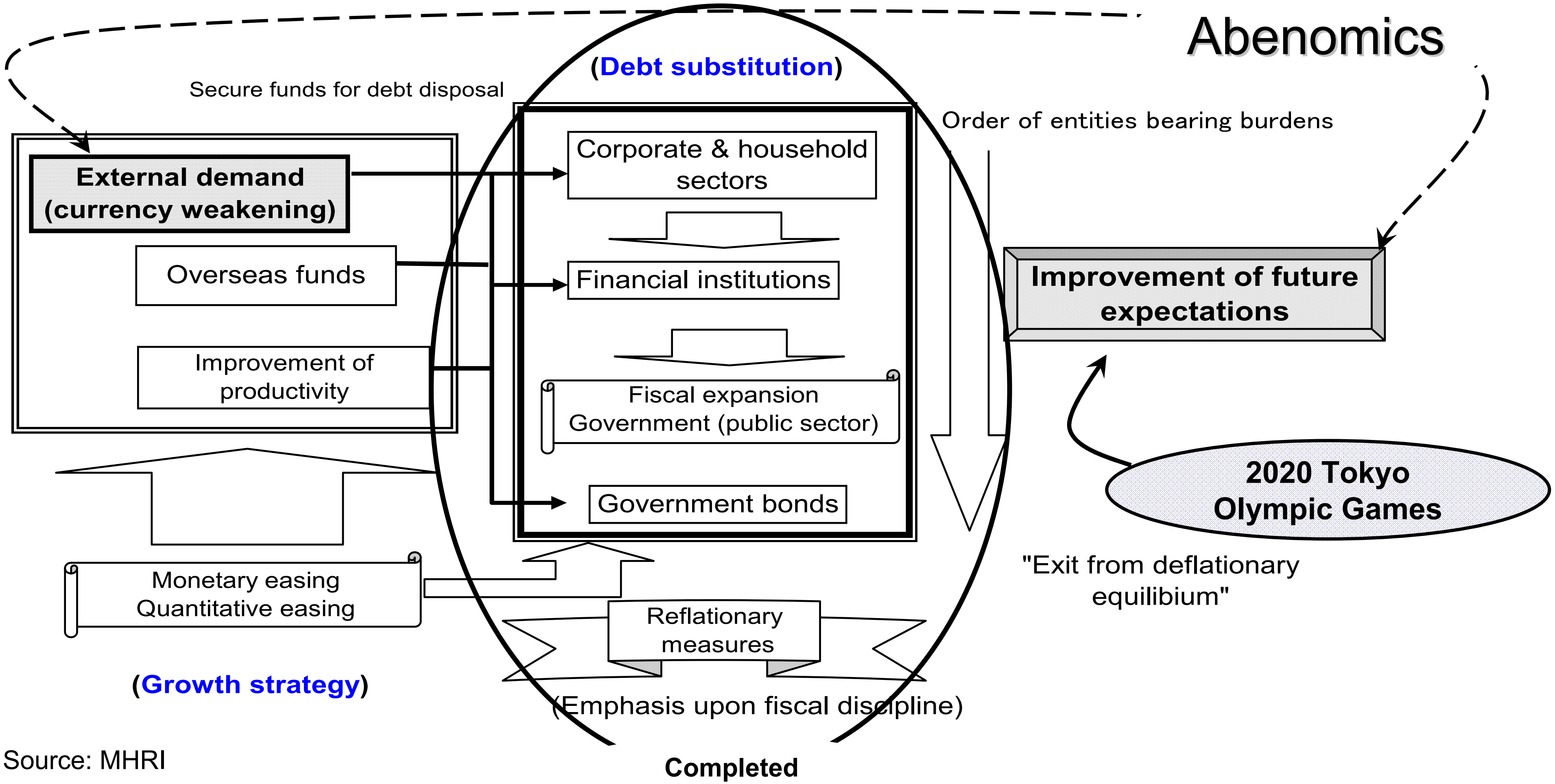


Note: 5-yr CDS.
Source: Datastream.

“Abenomics” and the exit from the“ lost two decades”

- For the Japanese economy , the remaining issues are the growth strategy (lower yen) and the improvement of expectations, where Abenomics plays an important role.

[Diagrammatic representation of the “burden” and “financial sources for debt disposal” in the debt disposal process]

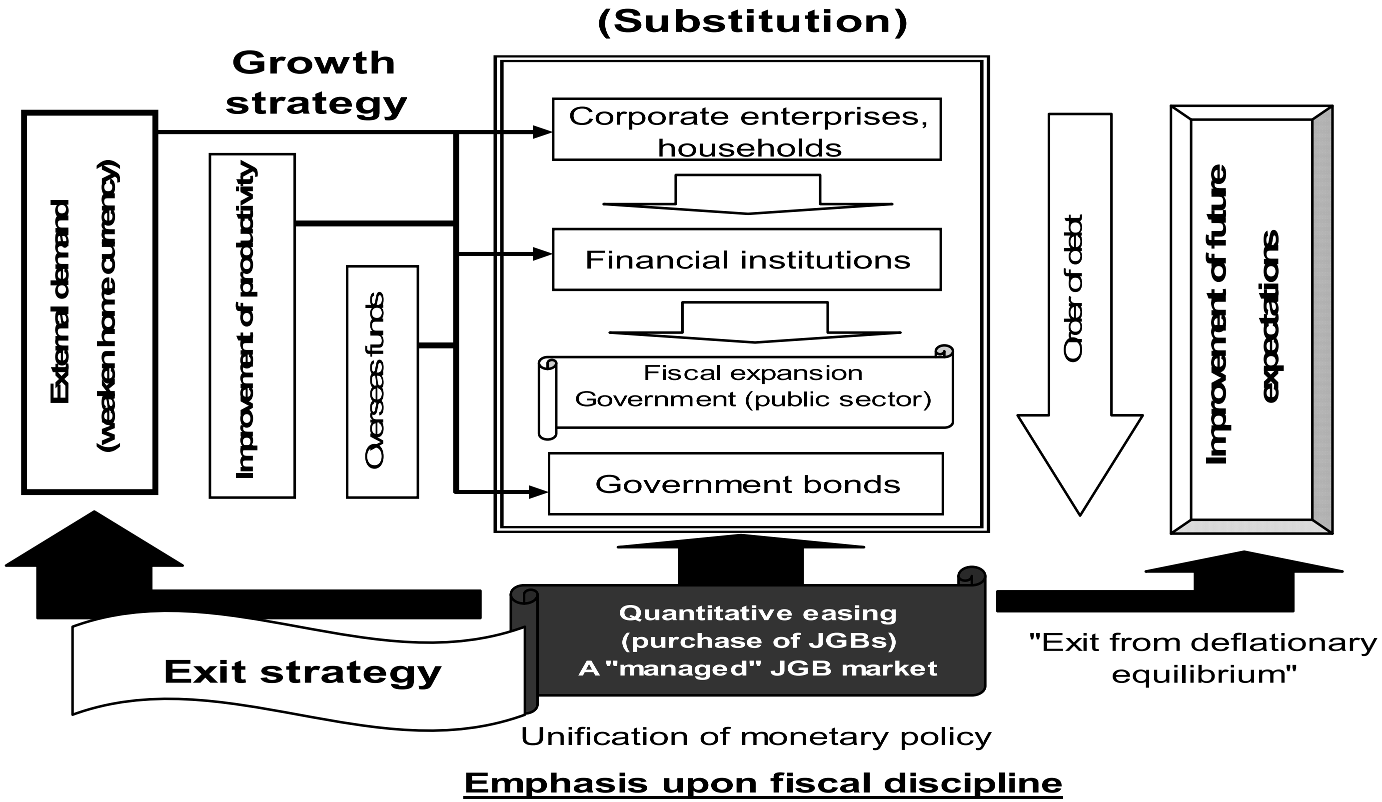


Source: MHRI

Exit strategy requires alignment with monetary policy and fiscal discipline

- "Substitution" – the exit strategy for JGBs requires alignment with monetary policy.
- Measures to eradicate deflation are "asymmetric" with those to fight inflation, requiring the BOJ's involvement in the government bond market.
- However, it is important to pay due regard to fiscal discipline in terms confidence in the JGB market.

[Diagrammatic representation of the "burden" and "funds for disposal" in the debt disposal process]

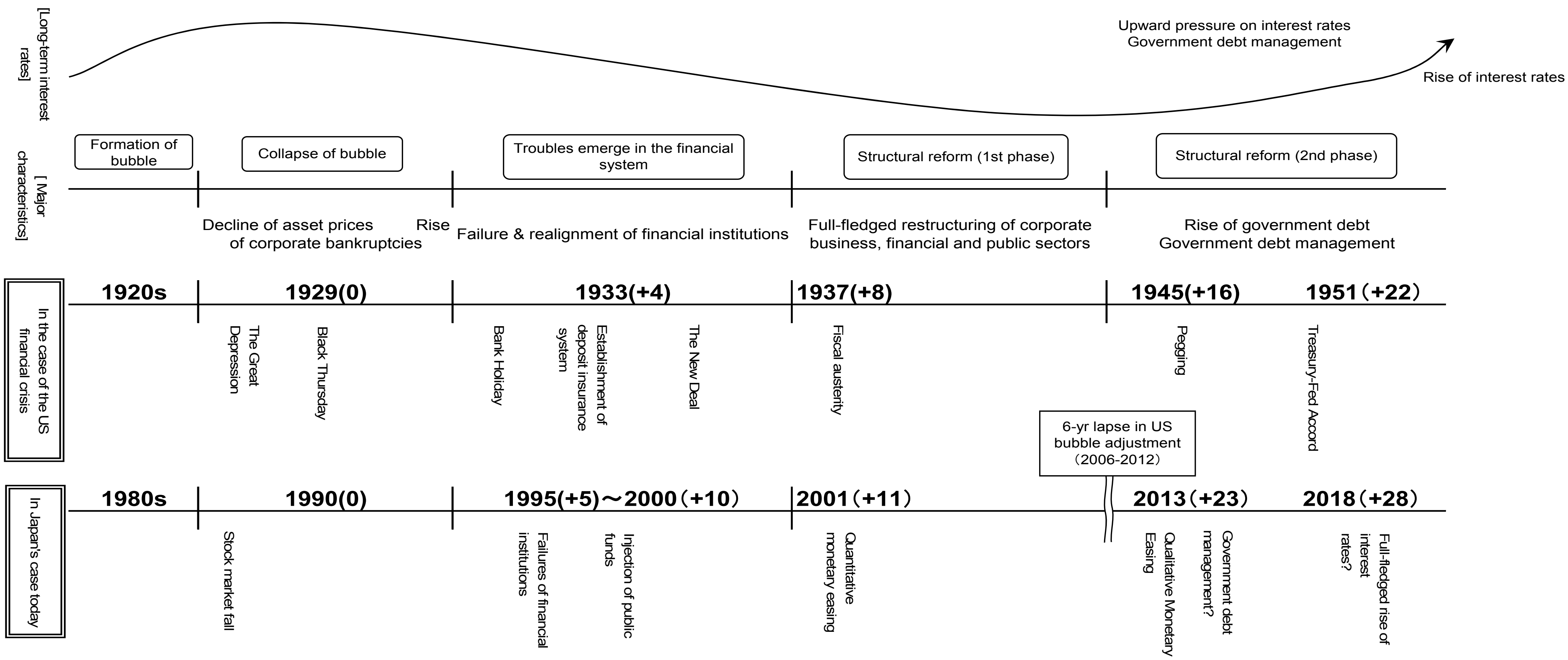


Source: MHRI

Lessons from the Great Depression: importance of "pegging" and government debt management

- Similarities with the US after the Great Depression in the balance sheet adjustment process.
- Japan may turn to long-term government debt management accompanying "pegging" in the US.
- Government debt management and fiscal discipline will become increasingly important for Japan.

[Government debt management in the US in the Great Depression and Japan since the 1990s]

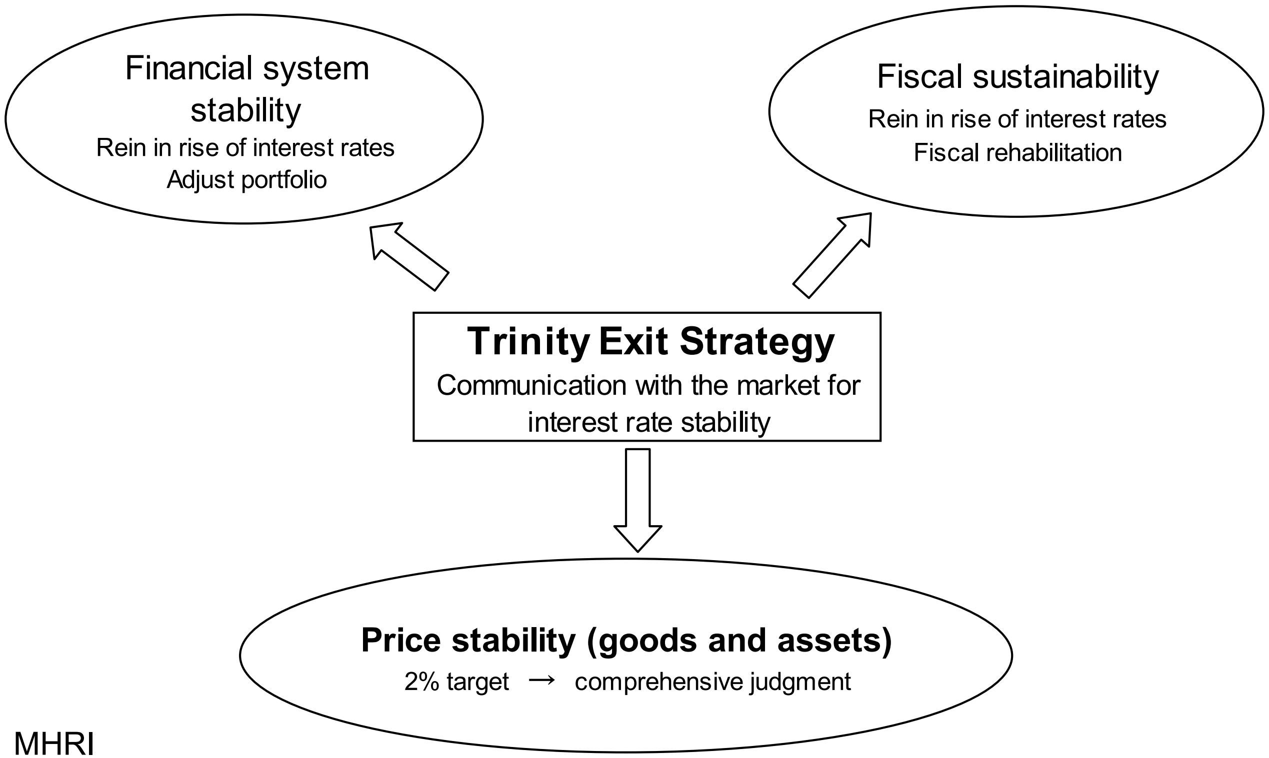


Source: MHRI

Interest rate stability is a must for an “exit strategy”

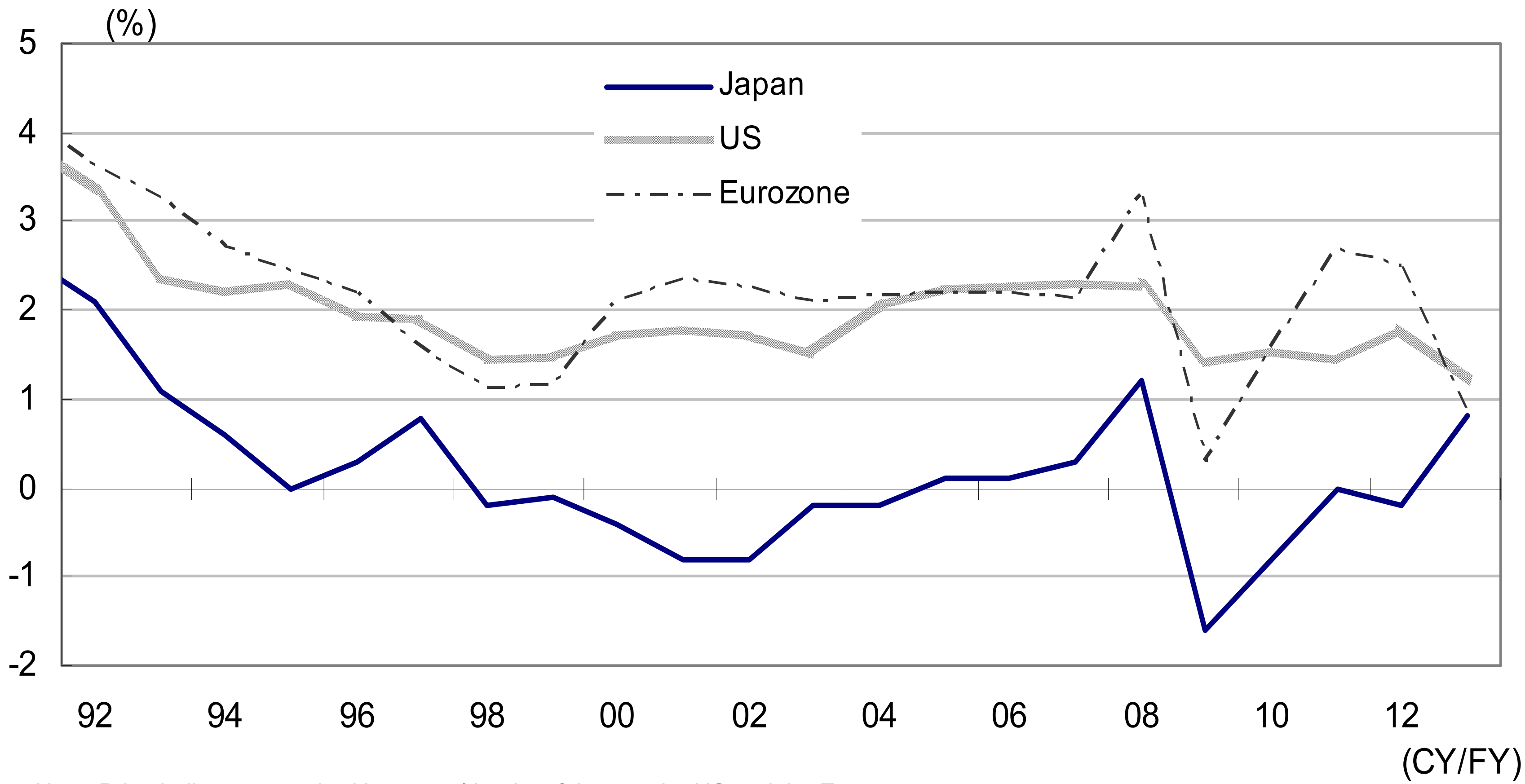
- At the exit, interest rate stability is necessary from the perspective of the financial system and fiscal discipline.
- On the other hand, price stability in view of asset prices is also necessary.
- The BOJ is eyeing a shift from the “2% CPI target” to a “comprehensive judgment”.

[Diagrammatic representation of the Trinity Strategy at the Exit]



Source: MHRI

A rise of the CPI to 2% is a very distant goal in any of the economies below



Note :Price indicators watched by central banks of Japan , the US and the Eurozone.

Japan : CPI (y-o-y) (excluding the impact of the consumption tax hike for the general CPI (excluding fresh food)

US : PCE deflator (y-o-y) (general excluding energy and food)

Eurozone : HICP (y-o-y)

Figures pertaining to 2013 are based upon latest data releases.

Sources: Ministry of Internal Aflairs and Communications (Japan), U.S. Department of Commerce, Eurostat.

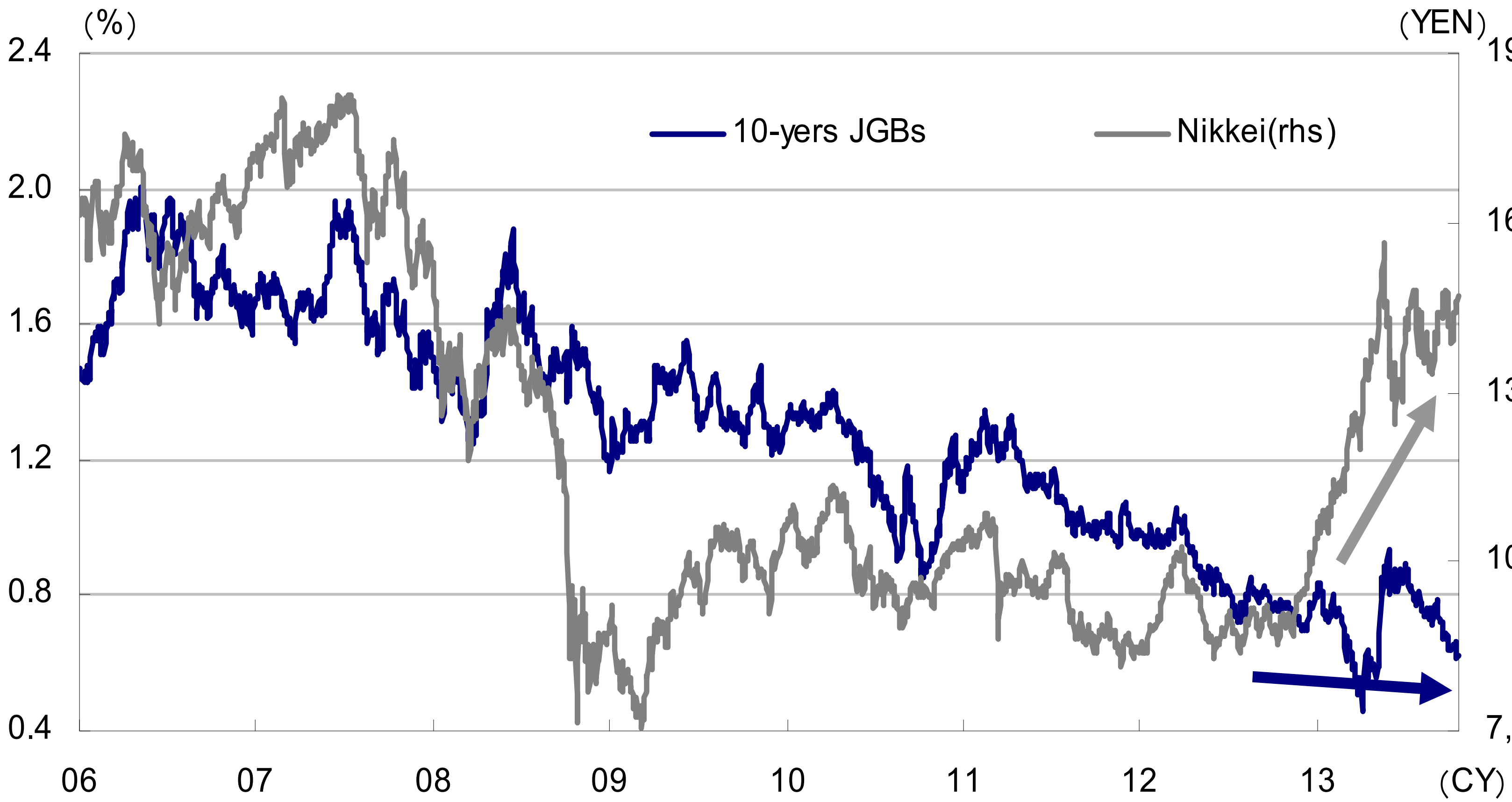
“GREAT ROTATION” VS “GOLDILOCKS”

・Stabilization of interest rates is necessary for the exit strategy out of the balance sheet adjustment process

（pegging after WWⅡ）

・A “Goldilocks” state elves to Financial Repression accompany central banks government bond purchases today.

【 10 – yr government bond yields and stock market in Japan 】



Source: Bloomberg