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Abenomics' Second Act

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Abenomics' Second Act

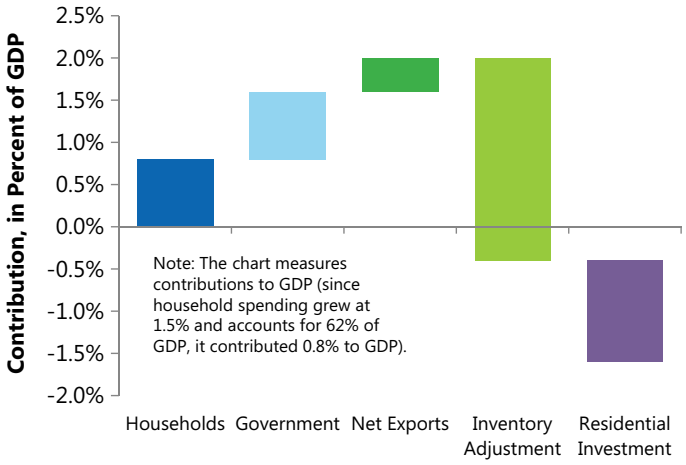
By Jason M. Thomas

On Sunday, voters in Japan again affirmed their support for "Abenomics," the three-pronged strategy for economic revival named after Prime Minister Shinzo Abe. The ostensible reason for the snap election was to seek approval for a delay in the next increase in the consumption tax to April 2017 from October 2015. But the main question for voters was whether the government should push forward with the structural reforms of the labor and product markets and tax system that constituted Abenomics' "third arrow."[1] Voters resounding reelected the Abe coalition to a more than two-thirds' majority in Japan's House of Representatives, providing the government with public support for its reform agenda.

Recent History

Institutional reforms are difficult to implement. Abenomics "three arrows" – fiscal stimulus, monetary easing, and structural reforms – were sequenced in recognition of this fact. Fiscal and monetary easing would come first to improve economic conditions and make the electorate more willing to trade current protections for greater economic flexibility. The initial results were decidedly favorable: the economy emerged from recession to grow at a 3% annual real rate between the end of 2012 and Q1-2014; stock prices rose by over 60%, on average, over the same period; and inflation and inflation expectations moved upward.[2] This positive momentum was interrupted in April 2014 when a 3% increase in the broad-based consumption tax took effect and caused real spending by businesses and households to contract sharply.

Figure 1: Contribution to Japan's Q3-2014 GDP by Category (Annualized) [3]



1 "Second Abe Poll Win Would Jump Start Reform Drive, Aide Says," Bloomberg, December 7, 2014.

2 GDP data from Japan Cabinet office; returns from S&P Capital IQ Database; inflation expectations from Bank of Japan Tankan Surveys, 2013-2014.

3 Japan Cabinet Office, Quarterly GDP Report.

The timing of the consumption tax increase was unfortunate. Domestic demand grew briskly since the end of 2012, but net exports declined by 9%. The unforeseen slowdown in the global economy erased the expected benefits from a weaker exchange rate. Global import growth slowed from an average of 7.4% in the three years prior to Abenomics to 3.4% in 2013 and 2014.[4] At the same time, the curtailment of nuclear power production following the Fukushima disaster increased the quantity of Japanese fuel imports at the same time a weaker exchange rate increase their (domestic) price. As a consequence, the economy failed to achieve the momentum necessary to absorb the tax increase without stalling.

While household spending recovered in Q3-2014, growing at an above-trend 1.5% annual rate, the shock from the April contraction led to a massive destocking at private businesses. The result was a fall in inventories that subtracted 2.4% from GDP (Figure 1). Thus, despite the rebound in household spending, the economy contracted again in Q3-2014, pushing Japan into a technical recession.

Policy Response and Near-Term Outlook

Policy failures over the past 15 years have conditioned Japanese households and businesses to expect disappointment. The recent slowdown raised the risk of self-fulfilling expectations, where doubts about the depth of authorities' commitment to economic recovery depress inflation expectations, spending, and business investment. To avoid this outcome, policymakers responded forcefully to the slowdown with another round of fiscal and monetary easing.

First, in October the Bank of Japan (BOJ) announced its intention to increase the size of its Quantitative and Qualitative Easing (QQE) by 30% and lengthen the weighted maturity of its Japanese Government Bonds (JGB) portfolio by three years.[5] Second, the ¥130.9 trillion Government Pension Insurance Fund (GPIF) announced a shift in its portfolio allocation away from JGBs, which once constituted 60% of total assets, towards risk assets like domestic and foreign corporate equity.[6] Finally, the government announced an 18-month delay in the timing of the consumption tax (and snap election) and a supplementary stimulus to provide additional time for the economy to gather momentum.

4 IMF, 2014 World Economic Outlook Database

5 Bank of Japan Policy Statement: https://www.boj.or.jp/en/announcements/release_2014/k141031a.pdf

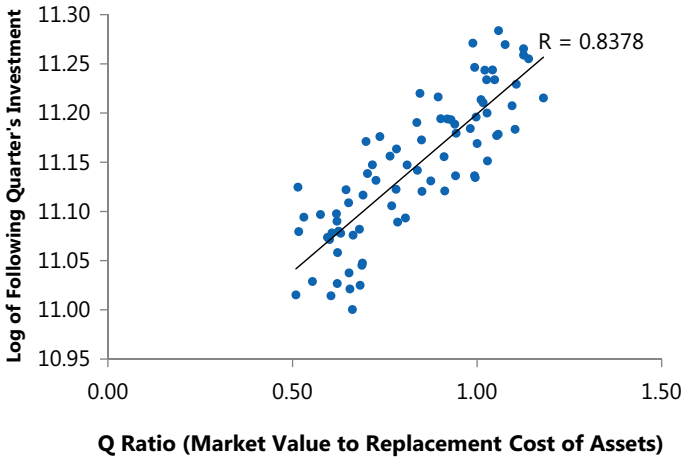
6 "GPIF assets swell to record ¥130.9 trillion in September," Japan Times, November 25, 2014.

The economic and investment environment are likely to improve materially in the short-run as a result of the recent policy response. The increase in BOJ purchases should push down longer-term interest rates, reduce risk premia, and assist with the rebalancing of the GPIF portfolio. The GPIF purchases are likely to provide a supportive bid for domestic stock prices and trigger similar shifts among other institutional portfolios, which will further support risk asset prices over the next several years.[7]

Japanese business investment has been sensitive to shifts in the stock market valuation of corporate assets (Figure 2). If the price of goods and equipment is expected to fall, forward-looking stock markets will incorporate that expected deflation into the current stock price. The resulting valuation discount depresses business investment by reducing the stock market-implied value of assets below their cost.[8] The recent 10% increase in stock prices since the BOJ and GPIF policy announcements should prevent the recent softness in business equipment orders from persisting into 2015.[9]

The BOJ policy announcement should also facilitate wage increases in 2015. Among large employers, wages increased by 2.3% in 2014, the largest increase in fifteen years.[10] The decline in inflation expectations made another round of increases unlikely, as wage increases in the absence of pricing power would erode margins and competitiveness. Yet, continued wage gains are essential to breaking deflationary expectations. In addition to added monetary stimulus, the Abe government also convened three-way discussions among the government, employers, and labor unions to support wage growth in 2015.[11]

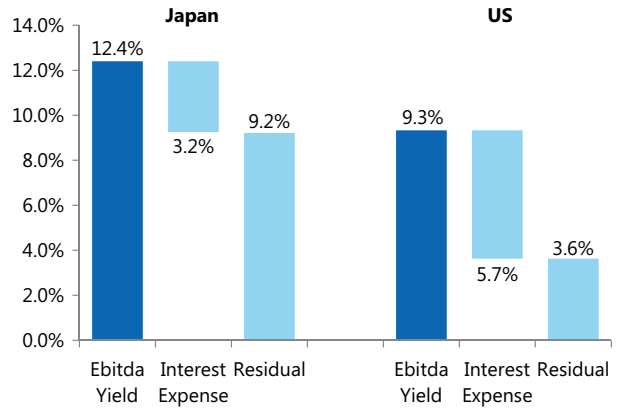
Figure 2: Stock Market Valuations and Business Investment, 1994-2014



Finally, by triggering an additional 9% slide in the foreign exchange value of the Japanese yen (JPY), the BOJ policy announcement should provide an added boost to net exports in 2015-2016. A gradual recovery in external demand, led by the U.S., was already evident in Q3-2014 when exports grew at a 5.3% real annual rate.[12] At the same time, Japan's fuel import bill is set to decline substantially thanks to the fall in global energy prices. Since June, the domestic spot price of crude oil has declined by 38%,[13] while the average price of liquefied natural gas imports has declined by 17%.[14] If sustained, these price declines will lower fuel imports by more than ¥5 trillion in 2015.[15] The improvement in net exports could be even greater if nuclear reactors are restarted next year, as some analysts anticipate.[16]

Despite the increase in stock prices in recent months, Japanese valuations remain low relative to U.S. averages. More significantly, lower corporate borrowing costs mean that a larger share of operating earnings flow through to equity holders (Figure 3). At the end of November 2014, the average Ebitda yield on Japanese corporate assets was 12.4%, compared to a 9.3% yield in the U.S., while the average interest rate on speculative grade debt was 3.2% in Japan compared to 5.7% in the U.S.[17] In conjunction, higher Ebitda yields and lower interest rates translate to higher expected returns for a given growth rate and capital structure.

Figure 3: Residual Cash Flow to Shareholders, 2014 Average



The Structural Reforms and Long-Run Growth

While near-term economic performance is likely to be supported by the recent monetary and fiscal policy action, the key to Japan's long-run outlook will be the structural

7 It is well known that the GPIF is a belleweather for Japanese institutions. C.f. "Japan to approve GPIF boosting domestic stocks to 25 pct," Reuters, October 30, 2014.

8 Why invest ¥100 million in new equipment if the market values it at ¥80 million, as was the case in late-2012?

9 Bloomberg. Measured from October 27 to December 11.

10 Japan Business Federation (Keidanren), 2014 Survey.

11 BOJ's Sato Sees Inflation Expectations Rising, Wall Street Journal, November 12, 2014.

12 Cabinet Office.

13 Tokyo Commodity Exchange (Tocom). The price per kiloliter of crude oil has fallen from ¥72,000 in June to ¥47,500 in December 2014.

14 World Bank, Commodity Markets Review, November 2014.

15 This assumes

16 "Nuclear Poised to Be Winner as Abe Eyes Broader Japan Majority," Bloomberg, December 9, 2014.

17 The Ebitda yield is the reciprocal of the Enterprise value-to-Ebitda multiple. This is measured on a trailing basis.

reforms advanced over the next few years. Japan faces two key problems that reform must address: (1) the working age population is declining, which will reduce potential GDP by growth by as much as 0.6% per year with no change in workforce composition;[18] and (2) Japan businesses tend to be less efficient, in the aggregate, than those in other advanced economies, as measured by operating margins. Successful reforms are likely to be those that open markets to competition, reduce employment protections for full-time workers, and promote labor market entry by women, immigrants, and the elderly

Japan's aging is not the intractable problem supposed by many. Female labor force participation and immigration rates are so low that reforms in these areas could offset the entire drag from the decline in people aged 25 to 54. An increase in female workforce participation rates to the G-7 average would raise potential GDP growth by 0.2%; increasing female workforce participation to northern European levels would add an additional 0.2%.[19] A shift in participation rates of this magnitude is not without precedent, as the Netherlands achieved a similar increase.[20] Japan currently provides few of the benefits associated with high female workforce participation in other economies: a more neutral tax treatment of second earners, child care subsidies, and paid maternity leave. Government officials have identified these policies as key reform priorities.[21]

The remaining drag must be offset through some reform of immigration and an increase in workforce participation among the elderly. Immigration remains politically toxic and it is unrealistic to assume a dramatic shift in sentiment. However acceptance of foreign workers in the construction industry already is a priority of the Abe government, with such workers eligible to enter Japan in 2015.[22] The government also wants to open Japan to highly skilled foreign workers to fill positions in academic research, health care specialties and technical activities, and management and administration.[23] Incremental changes seem quite possible even if wholesale reform is not.

To increase the productivity of the workforce, the Abe government will pursue global economic integration and labor market reform. Japanese businesses exposed to global competition in the automotive, finance, telecom, and general manufacturing sectors tend to be highly productive. The problem stems from protected domestic industries like agriculture. Inviting foreign firms to enter protected domestic industries would drive the innovations in supply chains, inventories, and transportation that have accounted for a large share of U.S. productivity growth since 1995.[24] To this end, the Abe government seeks to raise Japan's ratio of Free Trade Agreement (FTA) trade from 19% to 70% by 2018, by promoting a wide-range economic partnerships such as the Trans-Pacific Partnership (TPP), the Regional Comprehensive Economic Partnership (RCEP) and the Japan-China-ROK FTA.[25]

The Abe government is likely to address employment protections that impede the efficient allocation of labor across industries. Japan has a "dual" labor market: "full-time" or regular workers are legally protected from termination until retirement; "part-time" or contract workers can be dismissed, but can only be hired for limited periods in certain occupations. The Abe government has proposed expanding the circumstances where temporary workers can be hired and exempting some employees from work-hour regulations (and overtime pay).[26] While this would improve labor market flexibility in the aggregate, a bolder reform under consideration would involve the creation of a single open-ended employment contract for all newly hired workers.[27]

In addition to these reforms, the government is expected to finalize legislation to reduce the corporate income tax rate from 35% to less than 30%.[28] Action on the corporate income tax is expected early in 2015. The tax reduction will reduce Japan's overreliance on corporate income relative to its trading partners and increase the expected return to new investment and hiring.[29]

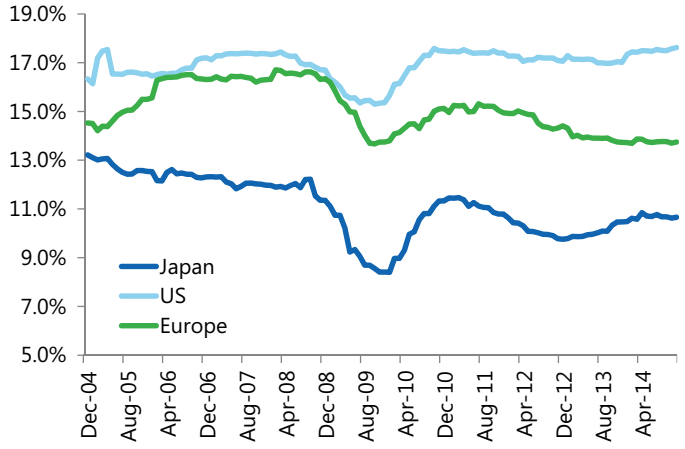
Assessing Reform's Impact on Investors

Structural reforms are not binary. Abenomics will fall somewhere on the continuum between the status quo and full implementation, with some disappointment a virtual certainty. Yet, it is important to consider that "structural reforms" do not depend entirely on government policy. For example, the looming succession crisis in Japan, where the average CEO is 63 years old,[30] presents an opportunity to transfer control of mid-cap companies to an entirely new generation of leaders more willing to embrace new methods of doing business. The restructuring of large conglomerates necessitated by the emergence of new competition could also prove transformative. Even modest reforms and improvements in management practices offer massive potential upside for investors. As shown in Figure 4, Ebitda margins (pre-tax operating cash flow to sales)

18 Projections from Japan IPASS. Available at: at http://www.ipss.go.jp/..
19 Steinberg, C. and Nakane, M. (2012), "Can Women Save Japan," IMF Working Paper 12/248.
20 Steinberg and Nakane (2012).
21 "Progress and Achievements of Abe Administration," Office of the Prime Minister of Japan, June 2014.
22 Office of the Prime Minister, 2014.
23 Office of the Prime Minister, 2014.
24 Gaur, V. and Kesavan, S. (2009), "The Effects of Firm Size and Sales Growth Rate on Inventory Turnover Performance in the U.S. Retail Sector," Retail Supply Chain Management.
25 Office of the Prime Minister, 2014.
26 Abe takes aim at labor regulations, Japan Times, December 10, 2014.
27 Aoyagi, C and Ganelli, G. (2014), "The Path to Higher Growth: Does Revamping Japan's Dual Labor Market Matter?" IMF Working Paper 13/202.
28 Eurasia Group, December 2014.
29 OECD, Revenue Statistics, 2014.
30 Keiko Hirata, Mark Warschauer, Japan: The Paradox of Harmony.

at Japanese public companies are currently about 40% below those in the United States and nearly 30% below those in Europe. Consider a business with zero revenue growth and a capital structure equally-weighted between debt and equity. Simply bringing this business' Ebitda margins to European levels over four years would generate an 11.8% internal rate of return, assuming no change in multiples.[31]

Figure 4: Ebitda-to-Sales, Public Companies, 2004-2014 [32]



Near-term Risks: Yen Depreciation, and Fiscal Solvency

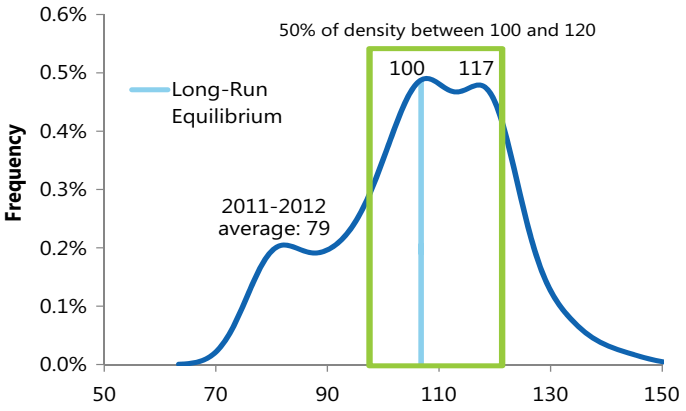
As many other advanced economies have discovered since the crisis, Japan's combination of high public debt levels and low interest rates is not particularly unusual. In fact, the same factors that slow tax receipts and inflation – high savings relative to desired investment – also place downward pressure on interest rates. Yet, instead of viewing high debt and low interest rates as two sides of the same coin, some investors believe recent fiscal and monetary easing will push Japan closer to a fiscal or foreign exchange crisis.

There's no question that monetary easing has weakened the exchange rate. But it's hardly obvious that the USD/JPY exchange rate will weaken materially from current levels. Figure 5 plots the historic distribution of the USD/JPY exchange rate. The cumulative 40% movement since 2012 has simply moved an overvalued JPY towards the heart of the historic distribution. Based on historic relationships, the exchange rate's "fair value" is in the 107-110 range, making the bulk of the move since 2012 quite natural. While further declines are possible, if not likely, in the near-term, eventual reversion to 107-110 remains a good bet over a three-to-five year investment horizon.

31 This assumes a 1.56x MOIC generated through 28% cumulative Ebitda growth over four years.

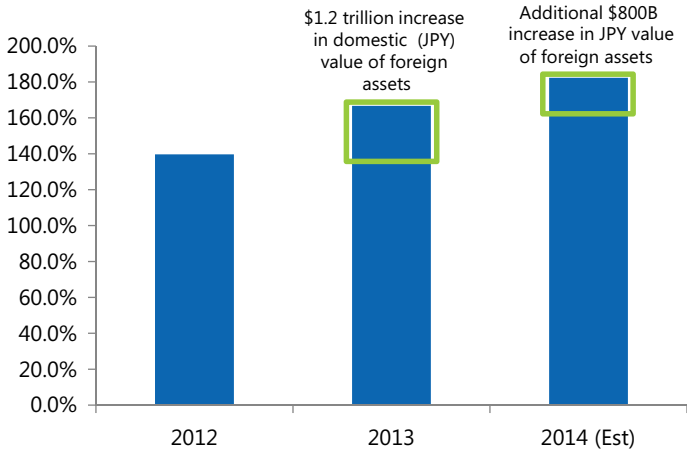
32 S&P Capital IQ. This is the market capitalization-weighted index for public companies. Interest rate from Bank of America Merrill Lynch, effective yield.

Figure 5: Probability Distribution, USD/JPY Exchange Rate [33]



The most significant bulwark against further, disorderly declines in the exchange rate is Japan's net international investment position. Japan is the largest creditor nation in human history.[34] Japan's households, businesses, banks, and government combine to own ¥889 trillion ($7.6 trillion) in foreign assets. At the same time, Japan owes ¥545 trillion ($4.7 trillion) to foreigners, about three-quarters of which are denominated in JPY. As a result, a decline in the exchange rate increases the value of foreign assets relative to liabilities and boosts Japan's net worth.

Figure 6: Japan: Foreign Assets as a Percentage of GDP



Far from risking a crisis, the decline in the JPY since 2012 has increased the domestic value of Japanese foreign assets by the equivalent of $2 trillion (Figure 6). Beyond a certain point, declines in the exchange rate create irresistible incentives for Japanese institutions to sell (relatively rich) foreign assets to fund (relatively cheap) domestic consumption, investment, or asset purchases. These remittance flows home can quickly overwhelm foreign exchange markets, as witnessed by the dramatic upward

33 This is the empirical density estimated from USD/JPY observations between 1987 and 2014.

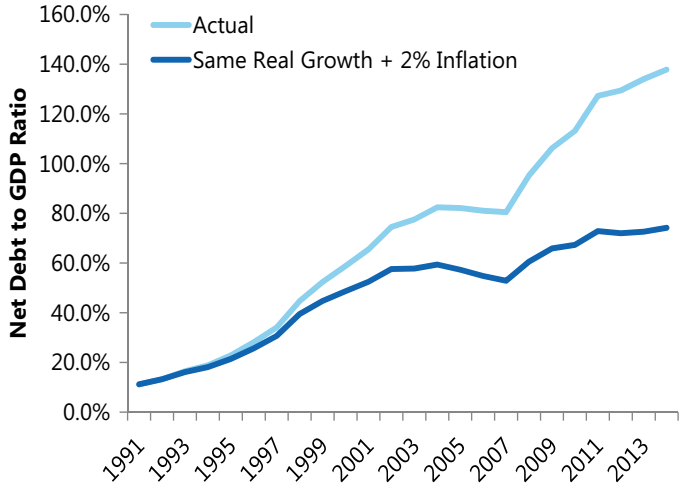
34 In nominal terms as measured by the International Monetary Fund.

adjustment in the JPY following the Fukishima distaser as Japanese insurers sold foreign assets to fund insured damage claims.

The decision to defer the consumption tax increase has also reignited fears about the sustainability of Japanese public finances. Moody's downgraded Japanese sovereign debt from Aa to A1 following the decision.[35] While long-run solvency concerns are entirely valid, the best way to stabilize debt ratios is to generate positive nominal income growth through fiscal and monetary stimulus.

In nominal terms, Japan's economy contracted by 3.5% over the twenty years ending in 2013. Even if one assumes that deflation does not change real spending decisions, it exacerbates debt ratios by depressing nominal income. If national income grew at a 2.8% annual rate since 1992 – 2% inflation plus the same real GDP growth rate of 0.8% – Japan's GDP would equal ¥907 trillion, almost twice its actual value of ¥523 trillion.[36] At this level of nominal GDP, the net public debt at the end of 2014 would equal 73% of GDP – the same net debt to GDP ratio as in the U.S.[37]

Figure 7: Japan Net Public Debt to GDP, 1991-2014



This analysis oversimplifies by holding the net debt constant. But the point is that the absolute value of public debt accumulated over the past two decades would not seem so large if nominal growth had been modestly positive. The best fiscal policy today would be one that achieves nominal GDP growth of 3% to 4% per year. With effective interest rates at 0.6%, nominal GDP growth at this rate could reduce the burden of the existing stock of debt by nearly 30% over ten years.[38]

Conclusion

Rather than counsel patience, the Abe government responded to recent economic weakness by easing policy and seeking voter approval for more ambitious reforms. Fiscal and monetary policy easing should improve the economic and investment environment in 2015-2016, while the election results and improved economy should create favorable conditions for structural reforms. While there are bound to be disappointments, even modest changes could generate sizeable returns to equity holders. Ownership succession issues and the restructuring of conglomerates also present opportunities to accelerate change independent of the political process.[39]

35 Moody's downgrades Japan's credit rating, Financial Times, December 1, 2014.

36 IMF, 2014 World Economic Outlook Database.

37 While this analysis oversimplifies by holding the value of nominal debt constant, the debt is artificially high as a result of persistent deflation.

38 The annual GDP growth to interest differential of 3.4% compounded over 10 years.

39 The annual GDP growth to interest differential of 3.4% compounded over 10 years.

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