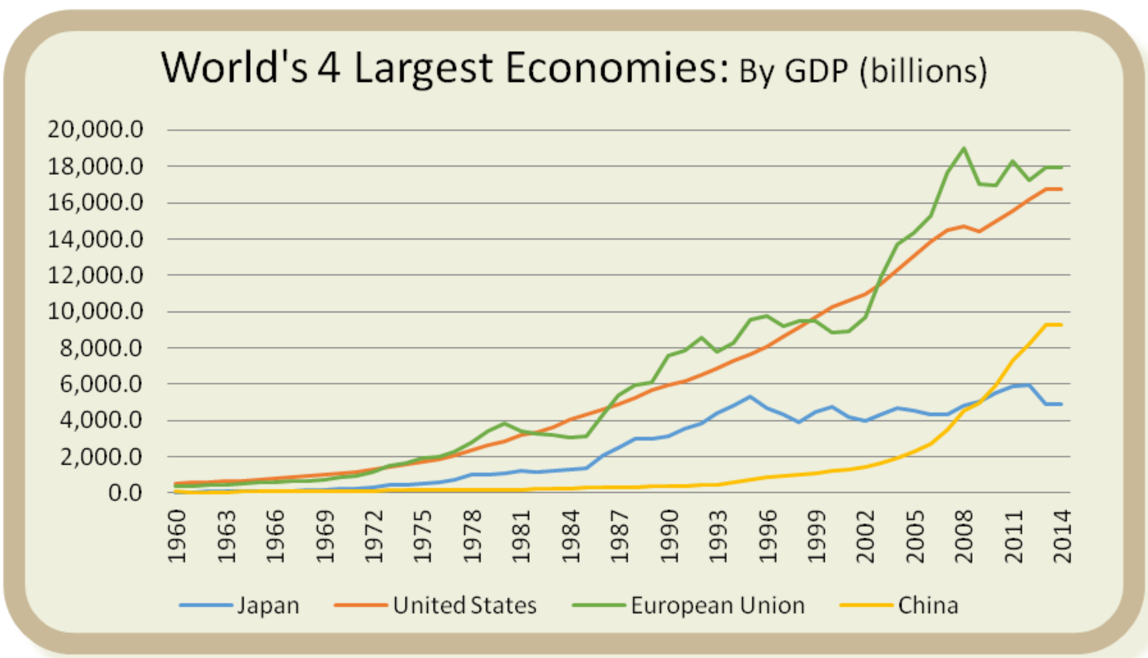
Japan

The Three Arrows of Abenomics

By Kevin Chambers

One of the most powerful, technologically advanced, and largest economies in the world has been in a depression for the last 25 years. Japan is the world's fourth largest economy behind the EU, US, and China. Japan's Nikkei 225 Index peaked in December 1989 at a value of 38,916 before dropping over 60% through August 1992. It has yet to recover. The Nikkei 225 hit an all-time low in April 2003, 80% below the previous peak. After years of the economy in the doldrums, currently the Nikkei 225 has been at about 20,000, or about 50% below the peak over 26 years ago. Japanese officials have tried many tactics to kick start the Japanese economy to no avail. How did they get here? How is their economy different then the US economy? What does Japan's future look like?

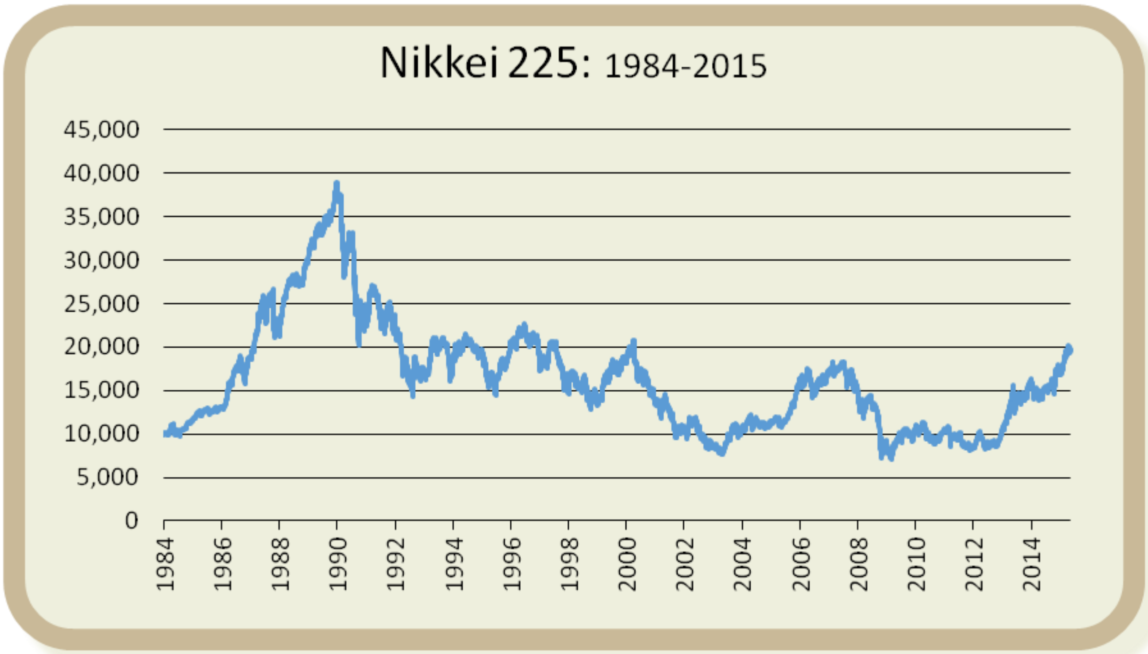


Source: World Bank

A Look at History

Modern Japanese economic history starts after World War II. World War II devastated much of Japan. They lost about 2 million lives in the conflict, which at the time amounted to about 4% of their population (Otsubo, 2007). Most of their industrial production and huge swaths of their major cities were destroyed by US bombing efforts in the closing months of the war.

After the war, the United States sought to democratize Japan. The post-war occupation and reconstruction was overseen by General MacArthur. Efforts were aimed to dismantle the militarization of Japan by limiting their forces and military ability. The US endeavored to stimulate private business interests by creating financial institutions, redistributing land, creating a dialog between business leaders and labor leaders, and providing financial support from the US (Freedman, 2006).



Source: Yahoo

Japanese Miracle

After reconstruction, a period of history referred to as the Japanese Miracle occurred. From 1952 to 1962, Japan's real national product increased at an average rate of 9% a year. The Economist published a piece called "Consider Japan" (The Economist, 1962), in which they explained why Japan had been successful in the previous decade and why they would continue to thrive. The Economist laid out their arguments in points (Kishi, 2007):

(1) The Japanese economy has not fully developed;

(2) Japan has inherited advantages from pre-war days;

(3) Influence of American occupation;

(4) Foresight of Japanese companies;

(5) Successful economic policies; and

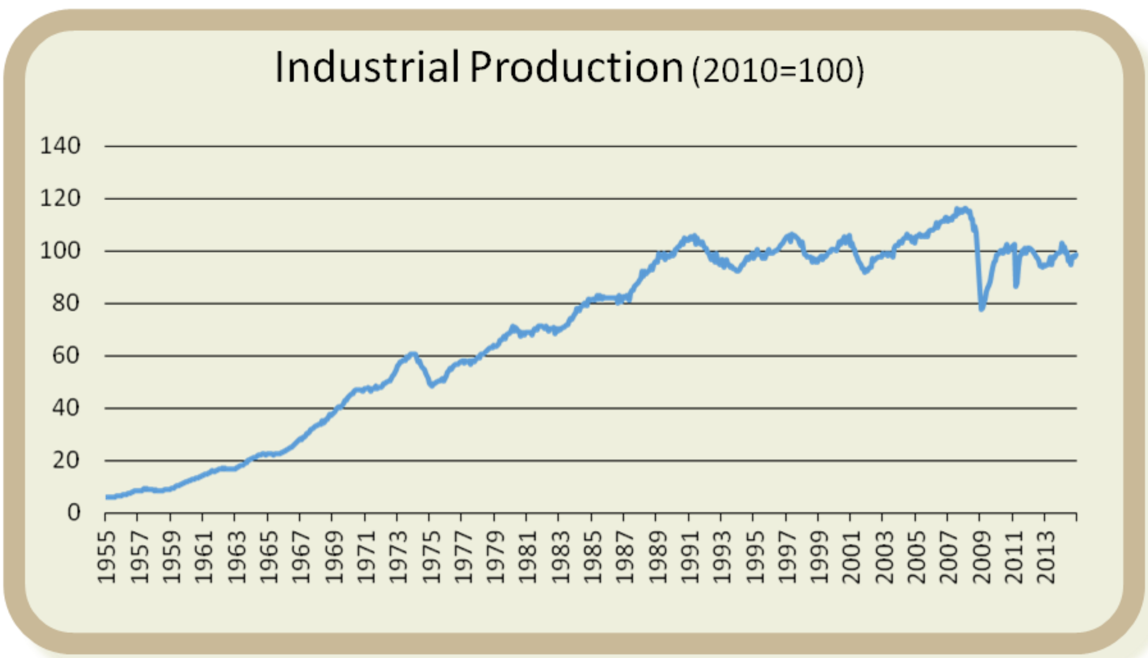
(6) The influence of social system in Japan.

(1) The Japanese economy has not fully developed

As Japan clawed their way out of the destruction of the war, many of Japan's workers were in jobs that did not utilize their full productivity. As solders came back from war and the industrial war machine shut down, millions of workers were ready to enter more productive industries. The Japanese economy was primed for rapid expansion. During this period, Japan would be considered what we now call an emerging market. As more jobs become available, especially at the lower end of the employment spectrum, countries can experience rapid growth that is driven by mainly manufacturing industries.

(2) Japan has inherited advantages from pre-war days

Japan's inherited advantages noted by the Economist included a highly developed educational system, a heavy chemical industry, and excellent logistical support. Japan's wartime needs forced their government to invest in heavy chemicals and other industrial sectors. These factories and labor forces were easily transitioned into creating less destructive products. The pre-war government had also invested heavily in their roads and railway systems, which allowed for easy and inexpensive transportation of goods around the country. After the war, reformation and modernization refocused Japan's educational system to promote industrial and science education (Institute for International Cooperation, 2004).



Source: FRED

(3) Influence of American occupation

From the end of the war until 1952, the United States implemented three important changes to the Japanese economy.

Land Reform: Land reform in post-war Japan is considered one of the most successful agrarian reform projects in world history. It broke up the structure of absentee land owners who owned large parcels of land throughout the country, giving more power to the farmers actually cultivating the land and converting tenants into owners. Before reforms, 50% of the land was cultivated by tenants. By 1955, these figure dropped to only 9%, and the number of owner cultivators increased to 70% (Kawagoe, 1999).

Inflation Control: Next, the US helped control the rapid inflation Japan experienced after the war. First, the United States spent almost $2 billion in humanitarian and economic aid to Japan from 1946-1950. The US occupiers tried to limit loans the Japanese Central Bank offered, and instead encouraged international financial support, reformed the tax system, and limited government expenditures. MacArthur and his economic advisors balanced Japan's national budget (Yamamura, 1967).

US Military Infrastructure: Finally, the start of the Korean War in 1950 was significant for Japan. The US and Japan negotiated the San Francisco Treaty that officially ended US occupation and signed the US-Japanese Security Treaty which allowed the US to keep troops in Japan. Due to the war in Korea and the US's increasing fear of communism, Japan became a central point for the US military. The US spent millions of dollars in Japan to develop necessary infrastructure.

(4) Foresight of Japanese companies

The magazine argued that Japanese business leaders had an ability to be forward looking beyond the economic climate they faced. Japan was very recently a global power, so despite their defeat in the war, they were able to see beyond their diminished global prominence. Japanese business focused on the global economy, striving to increase exports and develop new technologies. The Japanese government created large bureaucracies to collect and study statistics. They concentrated industries where growth was possible. The government also supported new industries by creating a tax code that supported innovation through tax exemptions on new products and industry protection (The Economist, 1962).

(5) Successful economic policies

Economists denote Japan's macroeconomic strategy during this period as "easy money" and "tight budget." They continued to keep a balanced budget and positioned their economy to be export-driven. Subsidies and trade controls were largely abolished, and companies were given more freedom to market their products. The monopolistic system called ***zaibatsu*** was broken up. The government also supported industry in a program called "rationalization." Through rationalization, the Japanese government helped companies restructure to increase efficiency, streamlined the importation of raw materials, aided domestic industries, and expanded national advertising (Okazaki, 2000).

Zaibatsu: the group or combine comprising a few wealthy families that controls industry, business, and finance in Japan. *(Source: dictionary.com)*

(6) The influence of social system in Japan

Finally, the last factor that the Economist mentioned concerned the general economic conservatism of the Japanese people. During the post-war period, Japan built their reputation as a nation of savers. The high savings rate in Japan during this period has been contributed to a few different factors. First, Japan had a large young workforce and a small aging population during the 1950s. The life expectancy in Japan was also very long. The social security system was underdeveloped, meaning people had to rely on their own savings in old age. The Japanese tax code taxed income from savings very lightly, encouraging individuals to keep these assets. Japanese culture includes a strong tradition of passing on and sharing family wealth, which could have further boosted the large savings rate (Hayashi, 1986). The Economist also pointed to a possible cultural conservatism and a societal emphasis on thrift and patience (The Economist, 1962). These types of factors are very hard to prove and quantify, but are worth including in this discussion.

Rapid Growth:

From 1960 to 1970, Japanese GDP grew by an average of 10%. The Japanese economy was bigger than the UK by 1970, and Japan passed France by 1975. Unemployment in Japan dropped to 1.2%. Industrial production increased by over 300%. From 1960 to 1980, Japan's GDP increased 305%. It was a time of extraordinary growth. Japan's most iconic companies established themselves as global enterprises during this period. Names such as Toyota, Mitsubihi, Honda, and Nissan (Datsun) got their foothold in the 1960s and 70s.

As their economy grew, Japan's industries changed. Japan realized the advantages of exporting labor. During the 1980s, Japan moved most of their heavy machinery industries to Korea and Taiwan, and focused their economy on the more technology intensive industries. By this point, Japan was once again considered a major global economic player (Midle East Institute, 2009). The 1979 oil crisis brought recession and turmoil to most of the globe. High oil prices caught most Detroit automakers off guard. Many consumers turned away from the large, gas guzzling American cars to the smaller more efficient Japanese models (Sawyers, 2013). Japan also started investing in nuclear power in the early 1970s. This allowed Japan to skate through the 1970s oil crises better than most other developed economies (Vivoda, 2011). This was all building to bring the Japanese stock market to its highest point on record of 38,916 in 1989. Many observers call this the Great Japanese Bubble.

As Japan was reaching its greatest economic point, it all came crashing down. Low interest rates and little oversight into borrower quality spurred large bubbles in the stock market and real estate markets (Krugman, 2009). The Japanese government decided to raise interest rates in an attempt to stem overvaluation. This precipitated many debtors to default and caused trouble for large financial and insurance institutions. Financial catastrophe followed. By June 15, 1990, just six months after the record highs, the Nikkei would close at 10,040, 75% off its previous peak. Real Estate prices also turned and started a slow downward trend that continues today. Real Estate prices have never bounced back to its peak in 1991. Japan has also experienced significant deflation.

Many people drew parallels between Japan's asset bubble and the 2008 crisis in the United States. However, in the US, the stock market recovered in less than 2 years, and in less than a decade, the economy seems to have recovered. So why hasn't Japan recovered? There are a few different explanations.

Lack of Demand and Growth:

Japan has a spending problem. After the 1990s collapse and into the 2000s, Japanese citizens where hesitant to invest and spend excess money. Japan continued to have the highest saving rate of any developed economy. The crisis amplified this tendency as individuals chose to save their money instead of committing it to private investment (Fukao, et al., 2014). Household consumption fell and private investment stagnated. Household disposable income also deteriorated and household wealth fell (Yuji Horioka, 2006).

Aging Population:

The working age population has been decreasing since the 1990s. Reducing the number of people in the workforce limits the need for companies to invest capital to fund equipment for new workers. It also makes it challenging for companies to quickly grow when they cannot find workers to fill their factories (Fukao, et al., 2014). Both of these factors limit growth, decrease production, and make it hard for the economy to grow. One estimate has half of the 900 municipalities in the country disappearing by 2040 as the people migrate to cities and are not replaced. The average age of Japanese farmers is 70 (The Economist, 2014 (2)).

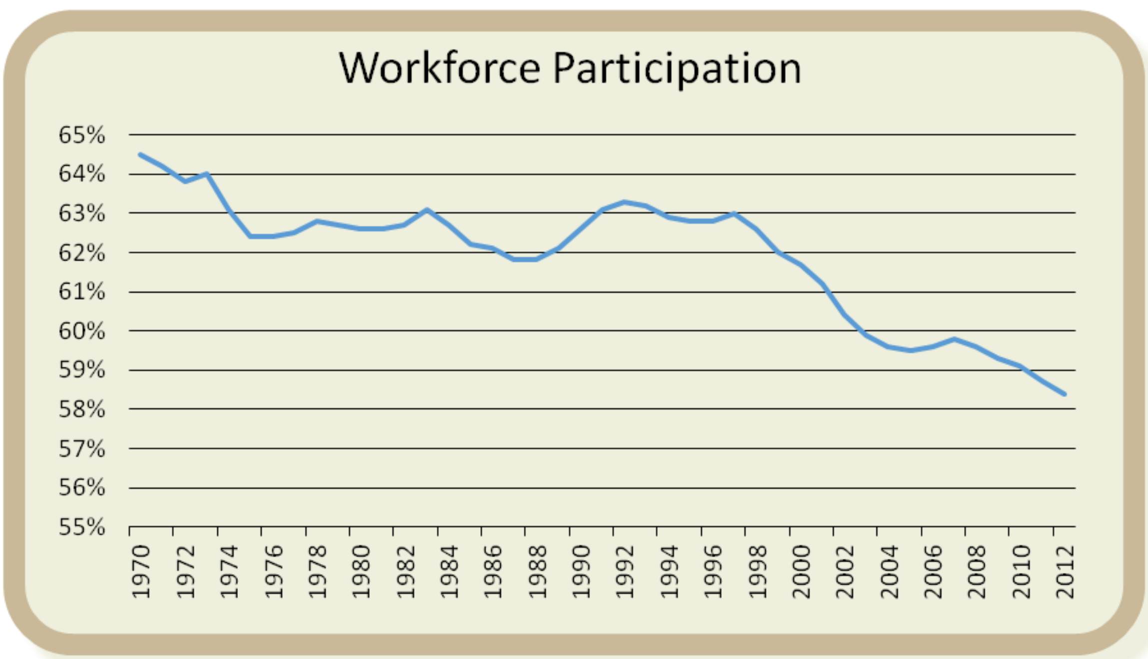
Liquidity trap: a situation in which prevailing interest rates are low and savings rates are high, making monetary policy ineffective. (Source: investopedia.com)

Liquidity Trap:

Paul Krugman called the Japanese problem a “Liquidity Trap.” Monetary policy is ineffective because consumers view the actions by the Japanese central bank as temporary (changing interest rates) and therefore choose not act. Consumers do not buy bonds because they want to wait for interest rates to go up (Krugman, Japan's Trap, 1998). Essentially, when interest rates are near zero, there is no cost to liquidity and the market gets saturated with easy flowing money. As the central bank tries to swap debt for liquidity, it has no effect (Krugman, Monetary Policy In A Liquidity Trap, 2013).

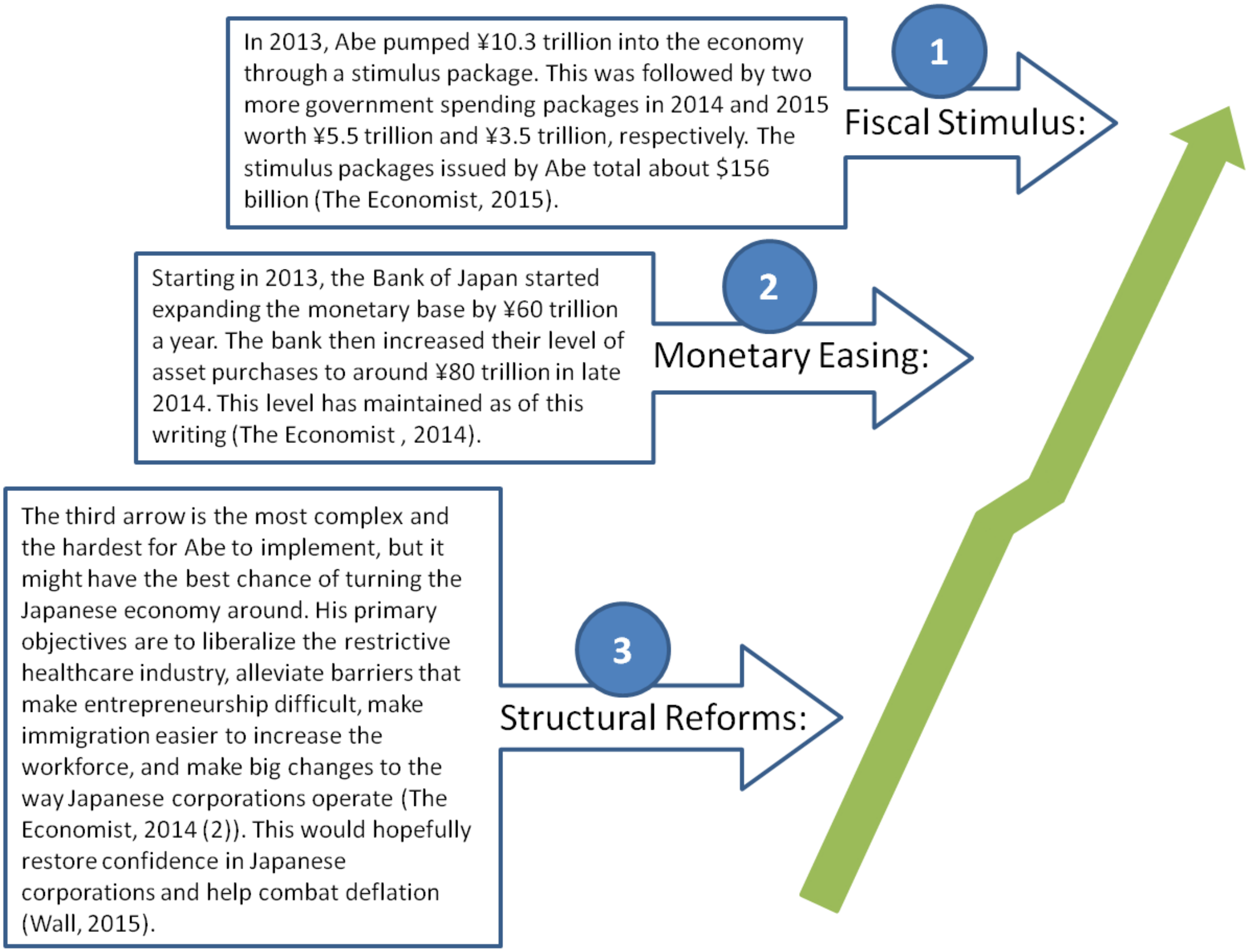
Abenomics Takes Over:

Recently, Japan has been experiencing an economic period called “Abenomics.” This is the nickname for the economic strategy of the current Prime Minister Shinzo Abe. Abe was



Source: FRED

re-elected to a second term in 2012. Abenomics consists of "three arrows" to revive the economy: (1) fiscal stimulus, (2) monetary easing, and (3) structural reforms.



Abenomics has been controversial. There are outspoken proponents that feel the changes could have a real positive impact on the Japanese economy. There are others that believe that Abenomics will hurt Japan more than it will help.

From when Abe took office in 2012 to the end of May 2015, the Japanese stock market is up 139%. The Yen has weakened against the dollar, which has increased exports. Unemployment has dropped from 4.5% at the beginning of 2012 to 3.5% at the end of 2014. GDP is up 3% over the same period. The six largest employers in Japan have started to change their governance systems and have started to increase pay (Wall, 2015).

All in all, Abenomics has worked generally well for the Japanese economy. However, some problems still exist. Inflation is still hovering around 0%, and deflation is still a risk factor. Approximately 50% of household assets are still held in cash, leaving growth from investments and capital still minimal and limiting the ability for monetary policy to be effective. The third arrow of Abenomics can continue to change and evolve Japanese companies, positioning them for the future. At some point, the first two arrows will have to come to an end, which may be the biggest hurdle for Japan's economic future prosperity. The positive outcomes of Abenomics have occurred as the government has implemented their massive security buying and stimulus spending programs. The big question mark is how the Bank of Japan and the Japanese government are going to slow down and stop their programs. There was a lot of anxiety surrounding the Fed's taper program in the US; in Japan, the anxiety is going to be multiplied. There is an informed fear that the loose monetary policy by Japan is just creating another bubble like in the 1980s. Going forward, it is going to be interesting to watch how the Japanese government continues to try to strengthen the economy.

Japanese Prime Minister Shinzo Abe

How this all affects your portfolio:

The portfolios at Headwater Investments include Japanese investments. Our main investment in international stocks currently is the Vanguard FTSE All-World ex-US ETF (VEU). This ETF has a 16.8% allocation to Japanese stocks, making it the single largest country allocation just above the UK (14.4%) and head-and-shoulders ahead of the third largest country France (6.5%). VEU holds 478 Japanese holdings, making it the largest allocation in this term as well. China (218) and the UK (132) are the next two largest. Furthermore, there is one Japanese company in the top 10 holdings. VEU has a 0.94% allocation to Toyota Motors, making it the 5th largest constituent. The next Japanese company is Mitsubishi Financial Group the 18th largest constituent.

Headwater Investments also invests in Japanese Bonds. The primary mutual fund that Headwater Investments uses is the PIMCO Foreign Bond Fund (PFUIX). This fund is now 38% in Japanese bonds, putting investment in Japan in front of Italy (16%) and France (16%). This mutual fund is overweight the long end of the Japanese curve and underweight the overall duration. This is because the monetary policy is very accommodating and yields are low, creating high bond prices and viable yields only on the long end. Japanese government bonds are yielding 0.4% for the 10-year and 1.5% for the 30-year bonds. The duration for Japan is 3.1 years.

Going forward, Japan will continue to be one of the most important economies in the world. Along with the US, EU, and China, the Japan economy will continue to be front page financial news. The changes in Japanese corporate culture and governance seem to have better positioned those companies for future growth. Japan still has some systemic problems with population and savings that may continue to be issues. The Japanese government will need to figure out how to back off from the first two arrows of Abenomics. Japan could recover and prove Abe successful, or we could be watching the accumulation of Japan's next bubble economy. The next few years should be an interesting and dynamic time for the Japanese economy. Headwater Investments will continue to watch the situation in Japan closely.

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