more give, less take

Japan Economic Brief

NAB Group Economics

May 2015

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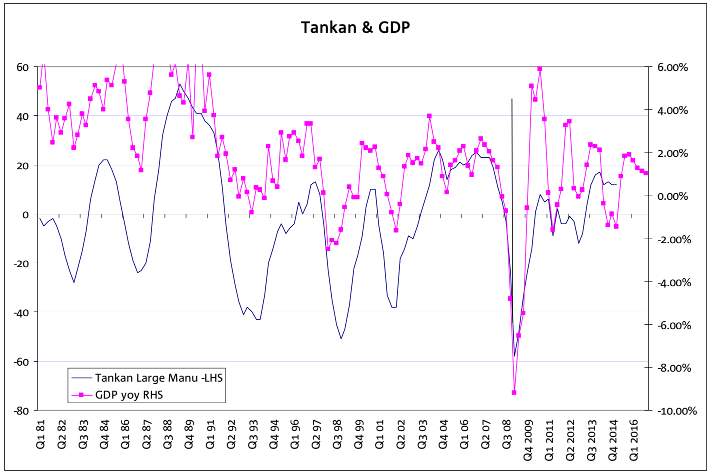
National Australia Bank

- *The Japanese economy recorded a 0.6% quarterly expansion in March 2015, the fastest pace since June 2013. However, it contracted -1.4% over the year to March 2015 due to recessionary conditions in the June and September quarters of 2014, following the Consumption tax rise.*
- *Leading indicators such as machinery orders are pointing to an improved outlook. NAB Economics is forecasting a 0.8% increase in 2015, followed by an improved 1.3% in 2016.*
- *Unemployment has fallen to a low of 3.4% .However, real wages have continued to contract.*
- *Japan's weak currency has benefitted its Current account (which is expected to maintain a surplus) and led to a surge in the stock market.*
- *Japan's stock of FX reserves and International Investment position reveal a very strong external position.*
- *Core Inflation (ex Consumption tax) rose a modest 0.2% over the year to March, 2015. The BOJ has committed to maintaining its ¥80 trillion of JGB purchase to boost activity and prices.*
- *There are concerns that BOJ is in effect monetizing the debt, and bond purchases may lose their efficacy over the next 2-3 years.*
- *Japanese banks are stable, well-capitalised and moderately profitable.*
- *Credit risks are contained, however, interest rate risks are significant. Further, there are funding gaps for Japanese banks with overseas operations.*
- *Japan's substantial public debt stock (~246% of GDP) is the biggest concern facing the economy. <u>If the public debt is not stabilized</u> , there could be continual downward pressure on the Yen and higher interest rates. This would substantially raise Government debt servicing costs, cause massive capital losses among Japanese banks and potentially trigger a recession.*

Activity & Prices

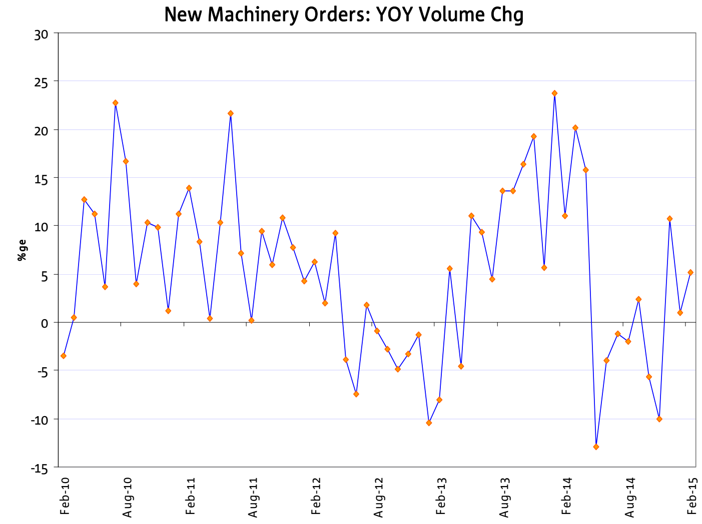
- The Japanese economy expanded by 0.6% (in real, quarterly terms) in the March quarter, a considerable improvement on the 0.3% increase in the December quarter.
- This was the quickest increase since June quarter 2013, and comes on the heels of a Consumption tax-induced recession in the 2nd and 3rd quarters of 2014. The recession was responsible for a -1.4% contraction in year-ended terms, notwithstanding the strong results in the March quarter.
- Consumption, accounting for around 60% of GDP, rose by 0.4%, driven by sales of household durables and electronics: refrigerators and televisions.
- Housing investment (1.8%) recorded the first increase in 4 quarters; private non-residential investment expanded by 0.4%. Boosting capital expenditure is a high priority for the Government.
- Export growth was solid (2.4%), but was outpaced by imports (2.8%).
- Finally, there was a sizeable contribution from inventories, 0.5% of GDP.
- GDP tends to follow broad movements in the BOJ (Bank of Japan's) *Tankan* Business Survey.
- Business conditions for large manufacturers remained stable at 12 index points for the June quarter, according to the most recent Tankan.
- Corporate bankruptcies remain muted, having fallen -6% over the year to March, 2015. Bankruptcies have declined continuously, in year- ended terms , from June 2012 onwards.
- Leading indicators point to upward momentum in the Japanese economy, with the volume of new machinery orders increasing by 5.2% over the year to February, 2015.
- Corporate profits remain healthy, with Japanese enterprises earning ¥18 trillion worth of profits during the October- December 2014 period; the ratio of profits to sales was 5.3%.
- Further, the low interest rate environment, and the sizeable stock of corporate cash (¥231 trillion) are supportive of further corporate spending.
- NAB Economics is forecasting a 0.8% increase in Real GDP in 2015, followed by a somewhat quicker 1.3% in 2016.

GDP and Tankan



Source: Datastream

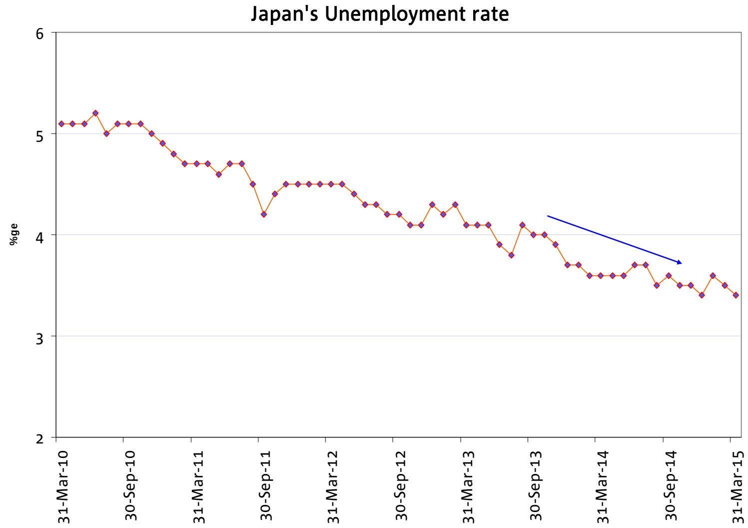
New Machinery Orders



Source: DX

Labour Market Indicators

- Labour market indicators have improved over the past year. The unemployment rate has fallen to a low of 3.4%, as at March, 2015.
- This has been achieved through employment growth of around 0.7%. Further, there is evidence of increasing labour force participation, an encouraging outcome, given Japan's population peaked at 128.057 million in 2010.
- Another sign of an improving labour market can be seen in the ratio of Job Offers to applicants, which was 1.15 as at March, 2015.
- Despite these strong indicators, labour earnings growth remains weak. This is particularly the case for real cash earnings, which contracted by -2.6% over the year to March.
- It is hoped that the tight labour market would boost earnings and thereby consumer spending and growth.
- Improving wages growth would be the 'positive' sort of inflation that Japanese authorities are after, given the favourable spillover effects on consumer spending. This would be preferred to , for example, a stagflationary environment in which prices are rising due to supply shocks (e.g. higher commodity inputs), and real economic activity remains depressed.
- On a related issue, Core CPI (CPI less fresh food) rose marginally, by 0.2% over the year to March, 2015 – abstracting the impact of the Consumption tax rise in April, 2014.
- The move away from deflation is encouraging, however, more needs to be done to achieve the 2% target. Hence the BOJ is likely to maintain its Quantitative Easing program.
- According to the BOJ projections, Core CPI is expected to remain at current levels in the near term. The 2% target is likely to be achieved in the 2016-17 period.
- **Raising the inflation rate is important in stabilising Japan's vast public debt stock.**



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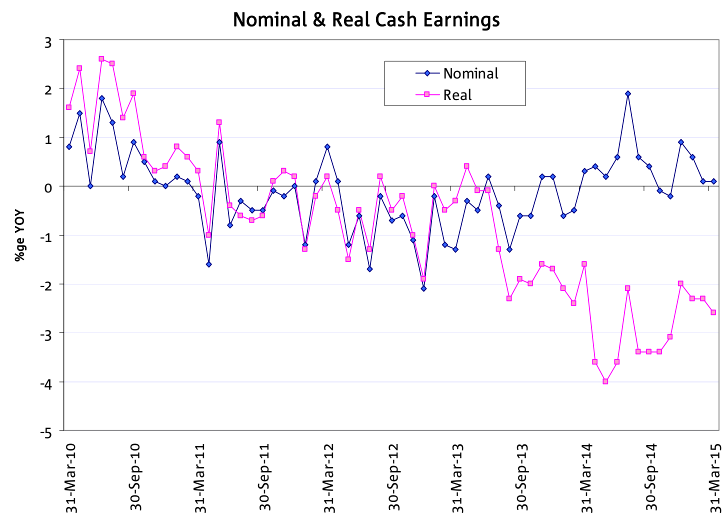
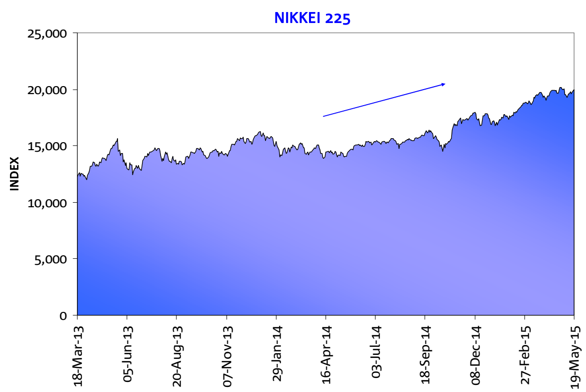


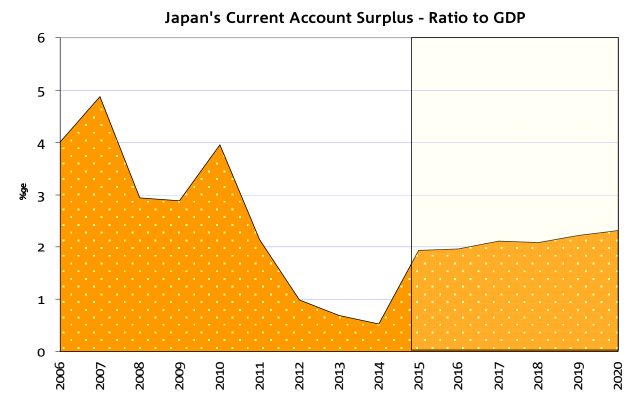
Source: Bloomberg

External conditions – Very strong

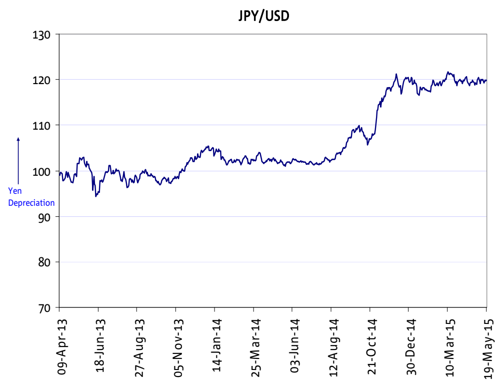
- Japan's current account recorded a ¥7.81 trillion surplus in the 2014-15 financial year, the first increase in 4 years. In addition to overseas income and a positive services balance, the trade deficit shrunk due to lower oil prices and export stimulation from a weaker Yen. In particular, automobile exports to Britain, and semiconductor parts to Hong Kong recorded an improvement.
- Japan is forecast to record Current account surpluses around 2%, based on IMF projections, over the period to 2020.
- The Japanese Yen has been trading around 120 JPY/USD, with the weaker Yen impacted, in part, by the BOJ's Quantitative Easing program.
- The weaker Yen has been beneficial to Japan's exports, and has been a factor in the sharp run in the *Nikkei 225* Stock Index, which breached the 20,000 level.
- And it is not just Flows which are positive. Japan's stock of *FX reserves* is high at USD1.25 trillion.
- Further, its *Net International Investment position*, a measure of Net foreign assets - is +67% of GDP. In other words, Japan owns significantly more overseas assets than its overseas liabilities.
- To summarise, Japan's external position is very strong, and helps partially mitigate the negative impact of its high public debt stock.



Source: Bloomberg



Source: IMF



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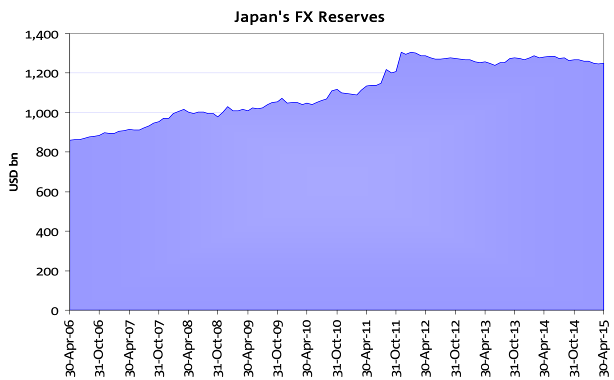
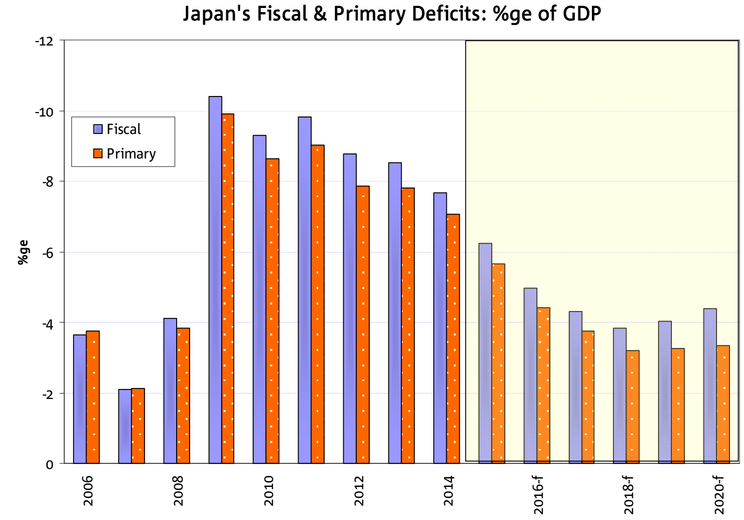


Source: Bloomberg

Fiscal policy

- Japan's fiscal deficit is estimated at 7.6% of GDP as at 2014. According to the IMF, it is expected to decline to 4.4% by 2020.
- The Primary Deficit (excluding interest payments) is also forecast to decline: from 7% in 2014 to 3.4% by 2020.
- To better manage its huge stock of Government debt, Japan need to reduce its primary deficit and aim to move towards a primary surplus.
- According to the OECD, there is scope to improve the Government's fiscal situation from both the revenue and expenditure.
- On the revenue side, it suggests gradually increasing the VAT (Value added tax), as it is less distortionary than taxes on capital and labour.
- The Japanese authorities are planning to raise the VAT rate from 8% to 10% in April 2017.
- On the expenditure side, the OECD is advocating controlling public social spending on items such as pensions and long-term health care, which is somewhat impacted by Japan's ageing population.
- Raising the retirement age and reducing hospital stays (particularly for curative care) were some of the suggestions provided by the OECD to contain healthcare costs.



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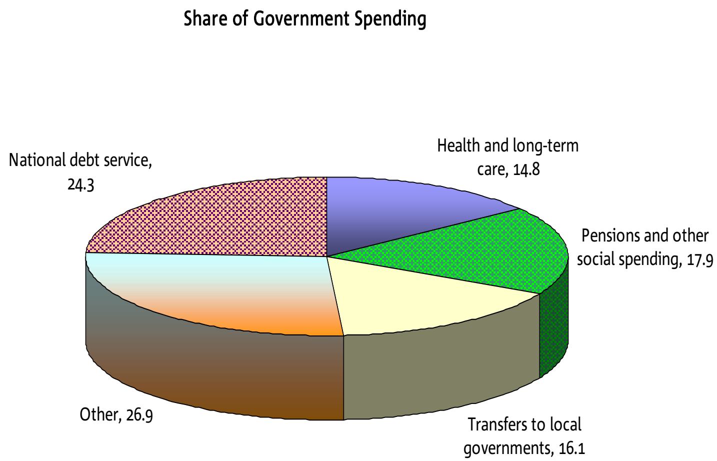


Source: OECD

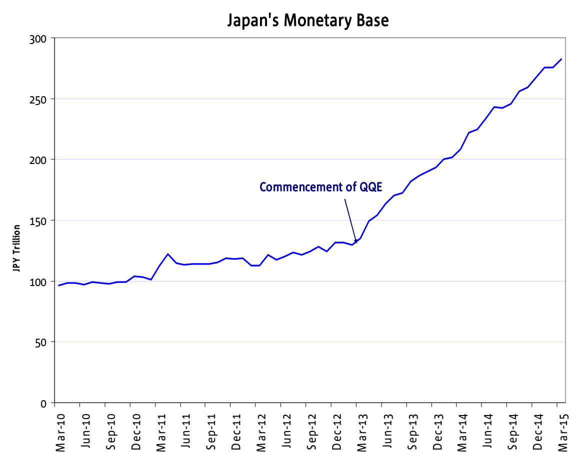
JGB Yields and Monetary Base

- Benchmark 10-year bonds yields have been trading around 0.4%. The recent sell-off in bonds pushed them to around 0.45%, but they have stabilised since then.
- The relatively low yields have ensured that the effective interest rate on Government debt was 0.9% in 2014, with net interest payments at 1% of GDP, well below the OECD average of 1.6%.
- Whilst yields have remained low, the same cannot be said for JGB volatility. The most recent spike in volatility was observed in early May, when yields started to rise.
- The relatively low yields have been largely supported by the QQE (Qualitative and Quantitative Easing) program from the Bank of Japan.
- This process commenced in April 2013, under the Governorship of Haruhiko Kuroda and entails BOJ purchases of ¥80 trillion of Government bonds per year.
- This has swelled the Monetary base to ¥282.1 trillion by March, 2015.
- The BOJ now holds 25% of Government bonds (including JGB’s & treasury bills), the second largest group after banks (34%). Insurance companies (Life and Non Life) hold close to 20%. A further 9% is held in Pension funds (including Public Pensions). Foreign holdings are still modest at 9.3%, and are largely in short-dated T-bills.

JGB Yields: 10 Year

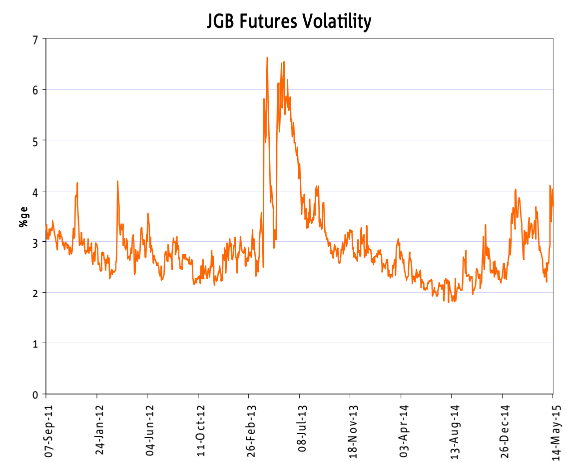
Source: Bloomberg

Monetary Base



Source: BOJ

JGB Futures Volatility



Source: Bloomberg

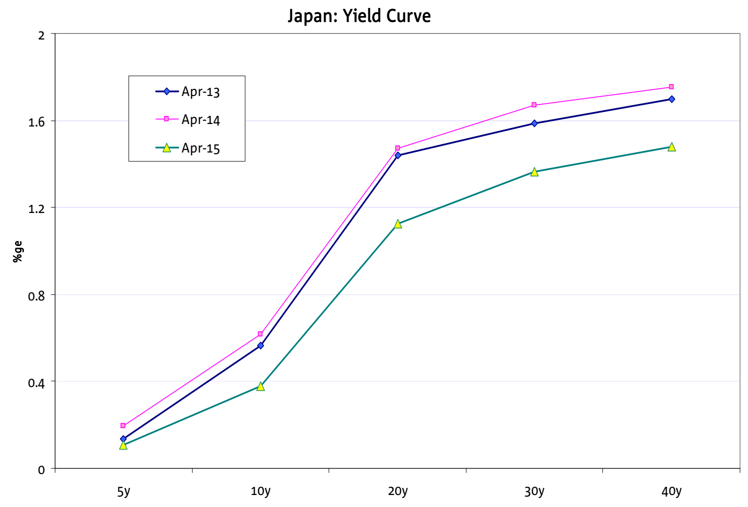
Yield Curve and Government debt

- The Yield Curve has shifted lower, and this is most readily apparent in the data for 2015. This has helped lower private and Government borrowing costs.
- Japan's public debt stock is very high, with the Gross debt to GDP currently estimated around 246%.
- According to the IMF, it is expected to rise further to 252% by 2020. The corresponding figure for Net Debt is estimated at 139%.
- Clearly, the large stock of public debt is one of the main challenges faced by Japan.

KEY RISKS

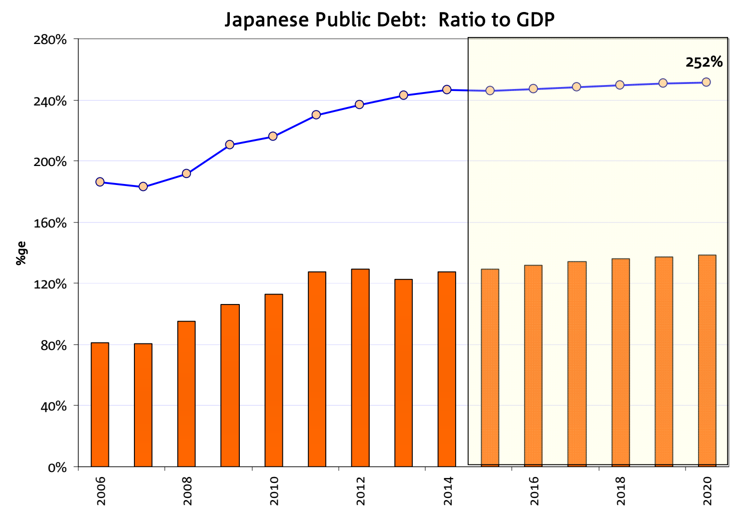
- It is critical that Japan boosts its Nominal GDP <u>and</u> adopt a viable fiscal consolidation strategy to ensure its debt sustainability.
- Adopting a contractionary fiscal stance without first bolstering growth will not prove sustainable, as the recent example of the rise in the Consumption Tax so amply demonstrates.
- Further, concerns abound that the BOJ might fail to sustain its target of ¥80 trillion worth of JGB purchases by early, 2017 (based on *Barclays Japan* analysis) due to a shortfall of JGBs available to purchase. Further, a separate analysis from *Mizuho* research indicates the BOJ will own 70% of outstanding JGB's by 2020, assuming it is able to maintain its ¥80 trillion purchase target.
- It was this concern that prompted BOJ member Takahide Kiuchi to suggest slowing the pace of bond purchases to ¥45 trillion. His proposal was rejected by other BOJ members.
- If the public debt stock continues to accelerate, the situation could prove very challenging.
- In fact, there are already concerns that the BOJ is, being forced to monetise the debt. This is likely to manifest in persistent downward pressure on the Yen, an outflow of funds from Japan and higher rates from a steepening of the Yield curve.

Yield Curve



Source: IMF

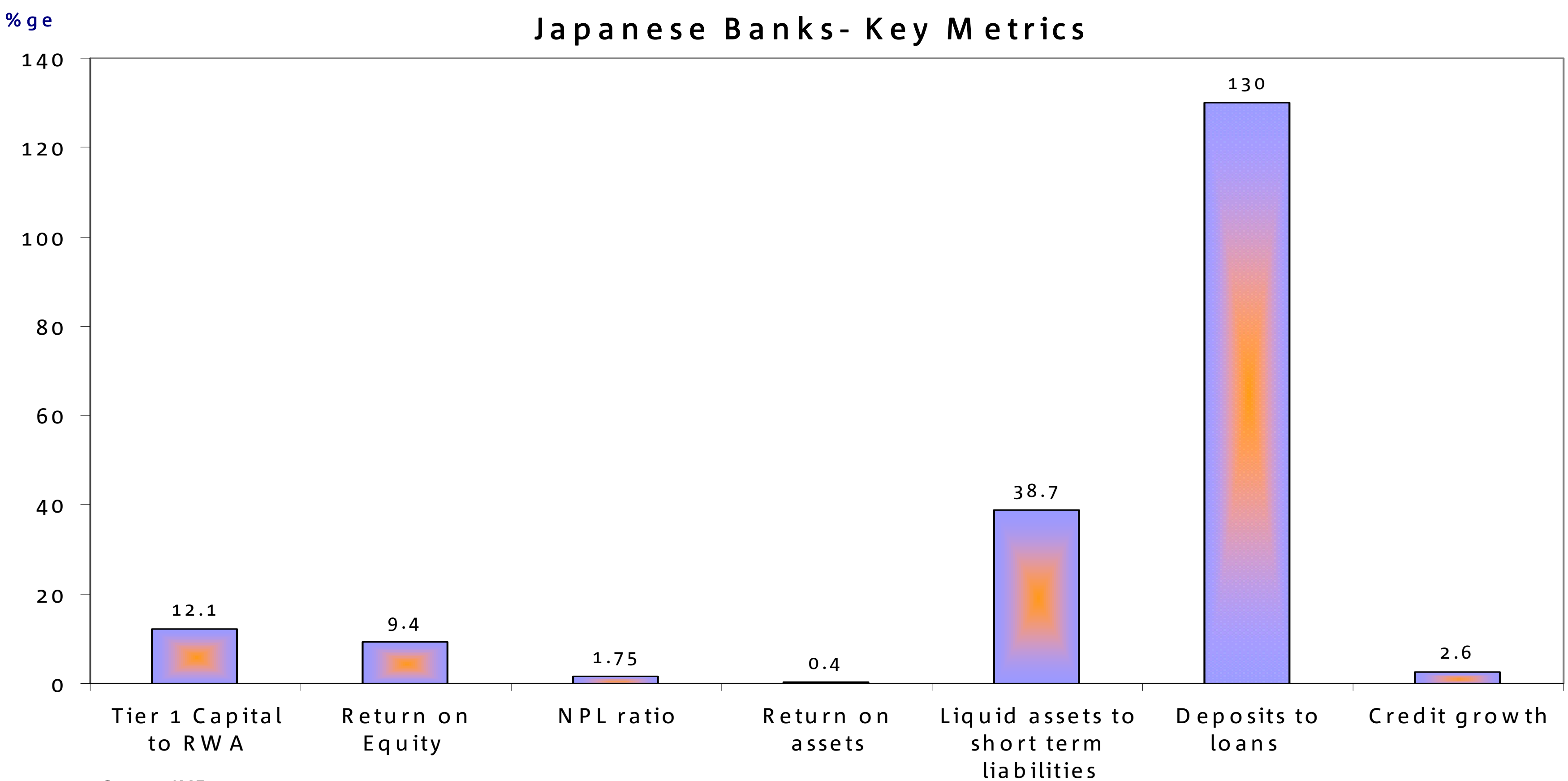
Public Debt Outlook



Source: IMF

Banking Sector Summary

- Japanese banks are broadly stable, well capitalised and modestly profitable.
- The ration of Tier 1 Capital to Risk weighted assets is 12.1%; the ratio of non-performing loans is 1.75% of gross loans.
- Banks are well funded, with the ratio of Deposits to Loans at 130%.
- However, credit growth is tepid, at 2.6% per annum.
- Profitability is moderate, with the Return on Equity at 9.4%.

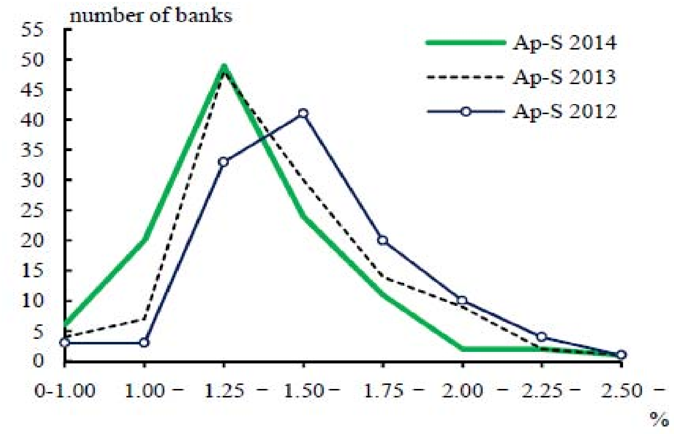


Source: IMF

Margins – Getting compressed

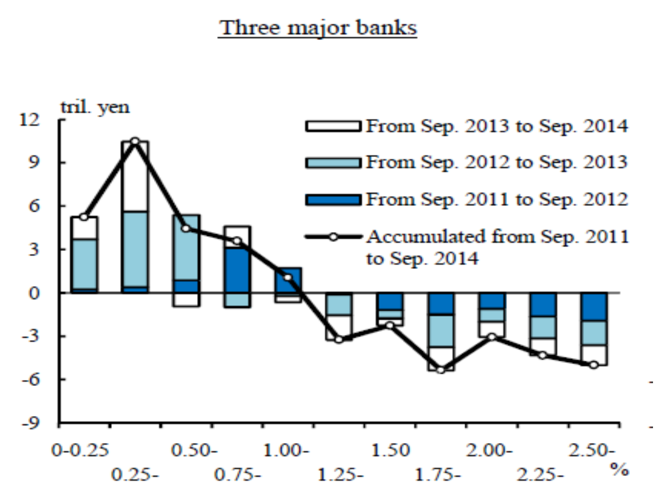
- Interest rate spreads on domestic loans continues to trend downward.
- This largely reflects the supply of funds in excess of demand, principally due to the easing lending stance among Financial intermediaries.
- According to BOJ (Bank of Japan) data the distribution of interest rate spreads over time clearly shows this trend towards lower spreads.
- Looking at outstanding loans over the past 3 years, the majority of growth has been in loans with interest rates of 0.5% and below.

Distribution of interest rate spreads on domestic Business loans



Source: BOJ

Change in loans outstanding by interest rate

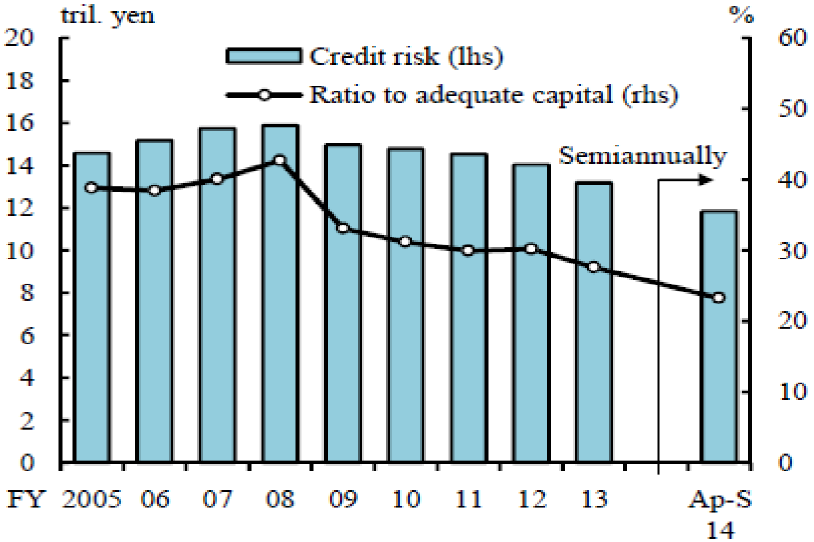


Source: BOJ

Credit and interest rate risks

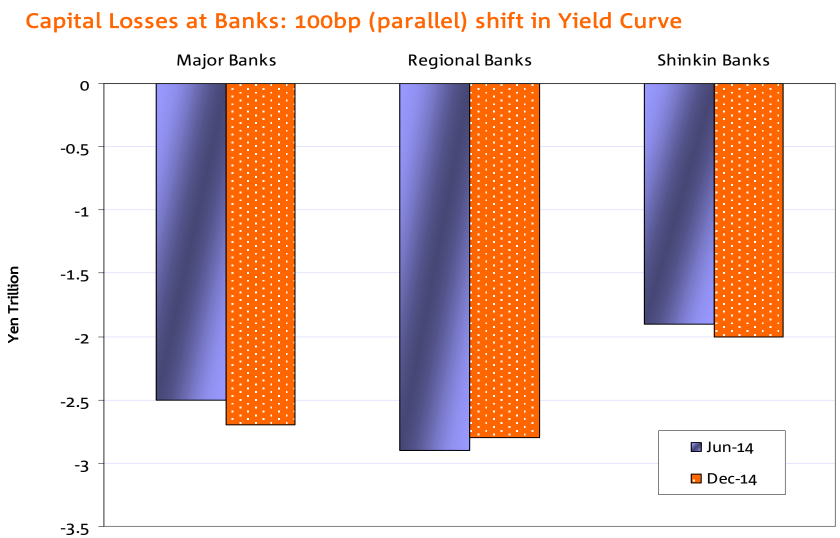
- According to the BOJ, Credit risks are diminishing. This largely reflects improved asset quality due to strengthening economic activity in Japan, as well as improving financial conditions among firms.
- However, interest rate risks remain elevated. This measures risks on Yen-denominated bonds held by Financial Institutions.
- In the event of a 100bp upward parallel shift in the yield curve, there will be substantial capital losses on bondholdings across the Japanese banking sector.
- Major banks are anticipated to lose ¥2.7 trillion; Regional banks ¥2.8 trillion, and Shinkin (Local, Co-operative) banks ¥2.0 trillion.
- Given Japan's sizeable public debt, the possibility of rising yields will remain and ongoing challenge, both for financial institutions, as well as the Sovereign.
- Japan's 4 **major banking groups** are: Mitsubishi UFJ Financial Group; Sumitomo Mitsui Financial Group; Mizuho Financial Group and Japan Post Bank.

Credit risk among financial institutions



Source: BOJ

Interest rate risk among financial institutions



Source: BOJ

Overseas funding

- Japanese banks with overseas exposure could be subject to funding vulnerabilities, albeit less so than their Chinese counterparts.

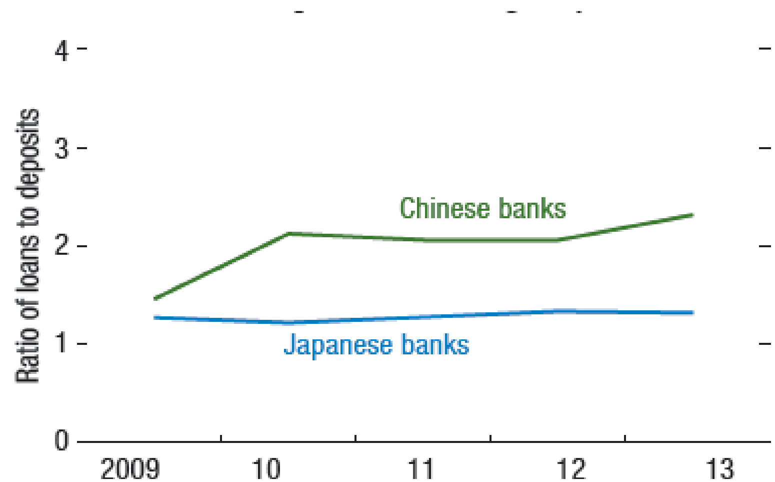
- According to the IMF, the overseas loan-to-deposit ratio is 1.3. with little variation across banks. However, for Chinese banks this has risen from 1.5 to 2, driven largely by expansion in the Agricultural Bank of China, the least globalised among the Big 4 in China.

- The funding vulnerability in Japan is also evident in the 'Stability gap' measure constructed by the Bank of Japan.

- The Stability Gap measures the difference between the amount of illiquid loans and stable funding, through for example, customer deposits, medium to long-term FX swaps and corporate bonds.

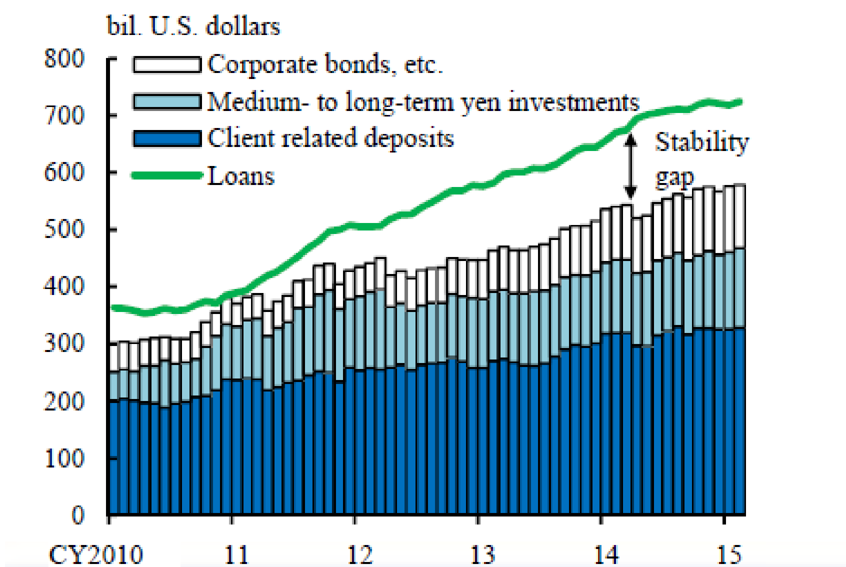
- Whilst there has been no further widening since mid-2014, it is still a concern and warrants ongoing monitoring.

Ratio of foreign loans to deposits



Source: IMF

Stability gap among major Japanese banks



Source: BOJ

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