

# IS JAPAN 'BACK'?

Japan Society of Northern California/Federal Reserve Bank of San Francisco, May 9<sup>th</sup> 2013

MAM

“It is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority. When you find any one agreeing with you, change your mind.” *Keynes, speaking of Investment, 1937*

# SUMMARY

- Causes of Japan's "Lost Decades"
  - First – Strategic irrelevance post-1989
  - Second – early '90s headwinds strong in proportion to the size of the bubble
  - Third - 1997-2012- persistent macro-economic policy mistakes.
- No insuperable "structural problems"
- Last headwinds dropped to nothing in 2009
- Senkaku spat marks Japan's recovery of a strategic role
- "Abe-nomics" represents reversal of the mistakes of 1997-2012
- Anyway, monetary policy has actually been loose since 3/11
- Deflation may already be over
- PM Abe may just be "in the right place at the right time"
- Both the initial, long period of error and its reversal echo the '30s.

# WHAT ACTUALLY HAPPENED?

Is Real Life lived in Real or Nominal Numbers?

Year	Nominal GDP (Y mil)	Population (Thou)	Nominal GDP/head (Y mil)	Real GDP (Y mil)	Real GDP/head (Y mil)
1995	501,707	125,570	4.00	455,460	3.63
2000	509,860	126,926	4.02	474,847	3.74
2005	503,903	127,768	3.94	503,921	3.94
2010	482,384	128,057	3.77	512,364	4.00
2011	470,623	127,799	3.68	509,450	3.99

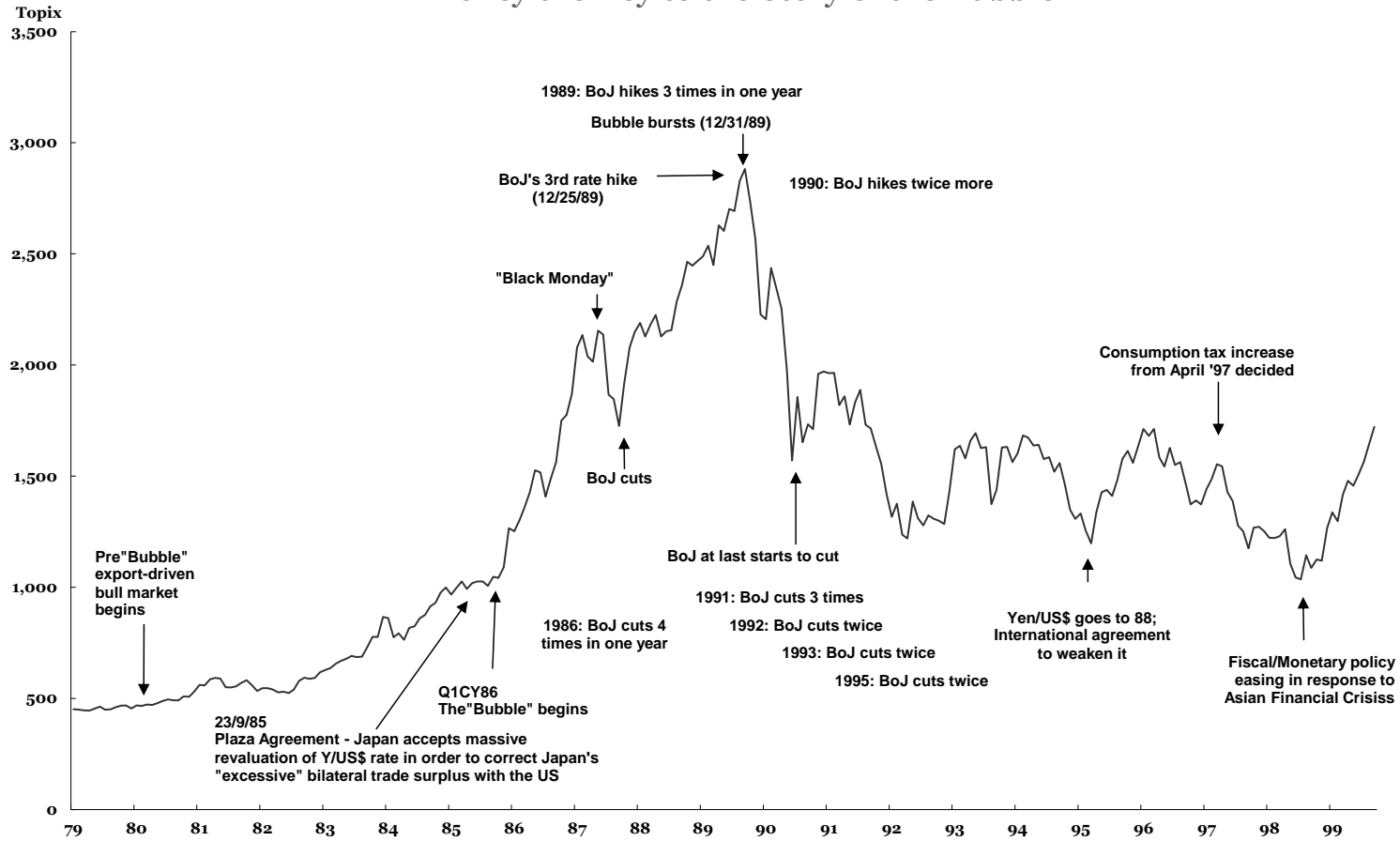
Change	Period	Nominal GDP per Capita	Real GDP per Capita
	1995-2011	-7.8%	9.9%
	2000-2011	-8.3%	6.6%

Note: GDP for Fiscal Years, Seasonally Adjusted; Population estimates as of October 1<sup>st</sup>

Source: Econostats, Statistics Bureau, Milestone Asset Management

# WHAT ACTUALLY HAPPENED?

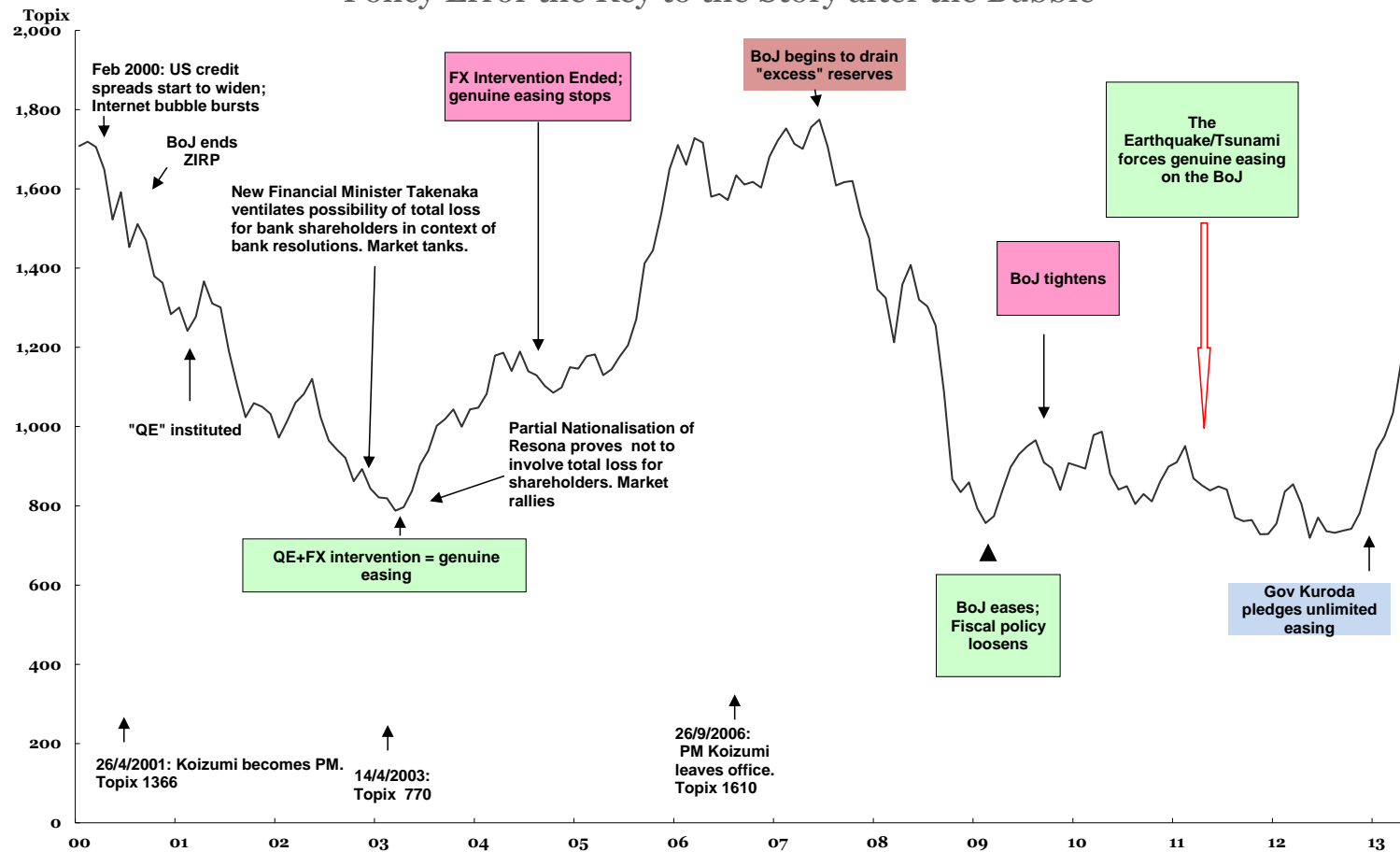
## Policy the Key to the Story of the Bubble



Source: Bloomberg. Milestone Asset Management

# WHAT ACTUALLY HAPPENED?

## Policy Error the Key to the Story after the Bubble



Source: Bloomberg. Milestone Asset Management

# WHAT ACTUALLY HAPPENED?

Another, very different, Narrative – All about Strategic Position



Source: Bloomberg, Milestone Asset Management

“Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” *Keynes, The General Theory of Employment, Interest and Money, 1936*

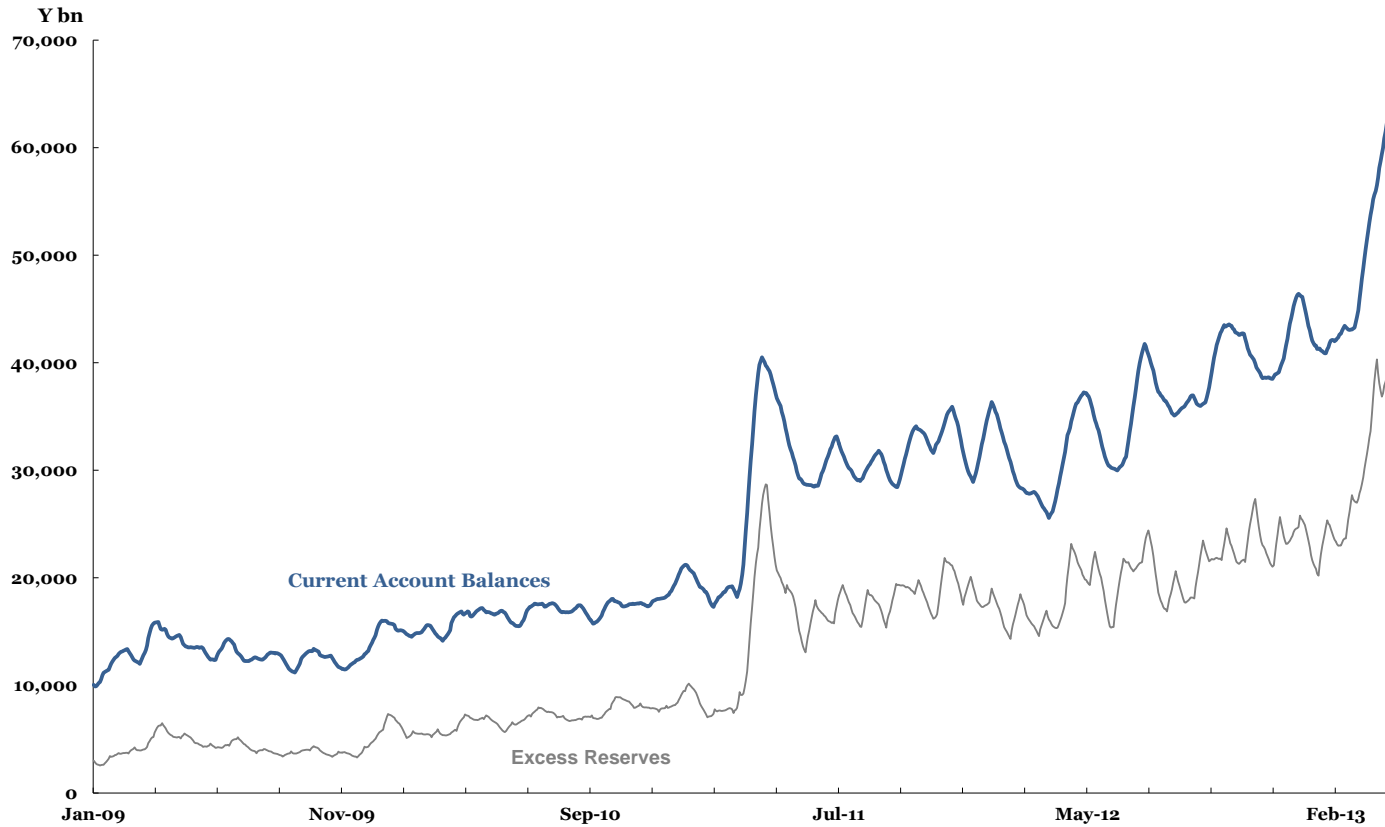


## WHAT IS “ABE-NOMICS”

- Do we know what it is?
  - Not really, but the fact that it is seen as a “-nomics” is an unconscious admission that it is relevant to the economy
  - Contrast with Koizumi – who was of no relevance
- Could it be an “cover band, reprising the LDP’s greatest hits”?
  - No. Something new, but echoes of the past are strong
- Is it any more than a currency policy?
  - Yes, but not much more
- Isn’t that enough?
  - Yes it is, so let’s forget irrelevant chit-chat about “reform”
- But isn’t it also little more than a case of “political luck”
  - Largely, but not entirely so.

# BANK RESERVES HEADING FOR DOUBLE THEIR 2007 PEAK

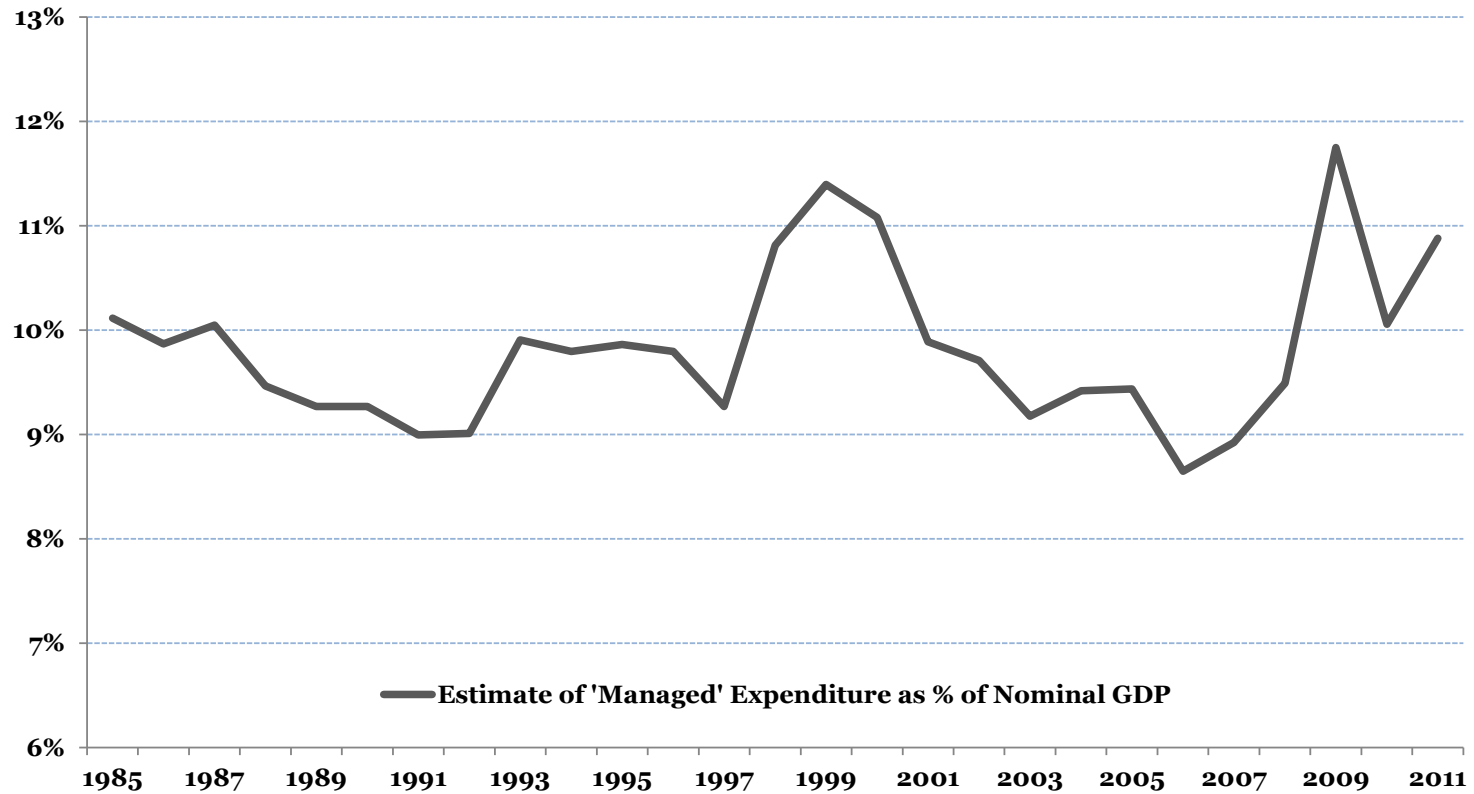
Easing has its Roots in Tragedy - the Tohoku Tsunami. Just as in 2003-7 real effects lagged...



Source: BoJ, Bloomberg, Milestone Asset Management

# “TRIED AND FAILED” – AUSTERITY FAILED, NOT SPENDING

Proactive Fiscal Policy used only Twice – and it “worked” when tried



Source: MoF, HM Treasury, Milestone Asset Management

# 4% OF GDP 'MONEY PRINTING' GAVE US THE '05 RECOVERY

Monetary policy works with long and variable lags



Source: BoJ, Bloomberg, Milestone Asset Management

# THE YEN IS KEY

## Yen over/under-valuation vs OECD Purchasing Power Parity Estimate



Source: OECD, Bloomberg, Milestone Asset Management

# INFLATION COULD BE EASY TO PRODUCE

Labour costs competitive: US and Japan now the cheap, developed, places to produce

## Minimum Wages (per hour)

In USD

Shanghai	2.28	(actual)
HK	3.87	(actual)
US	9.00	(proposed)
UK	9.50	(actual)
France	12.35	(actual)

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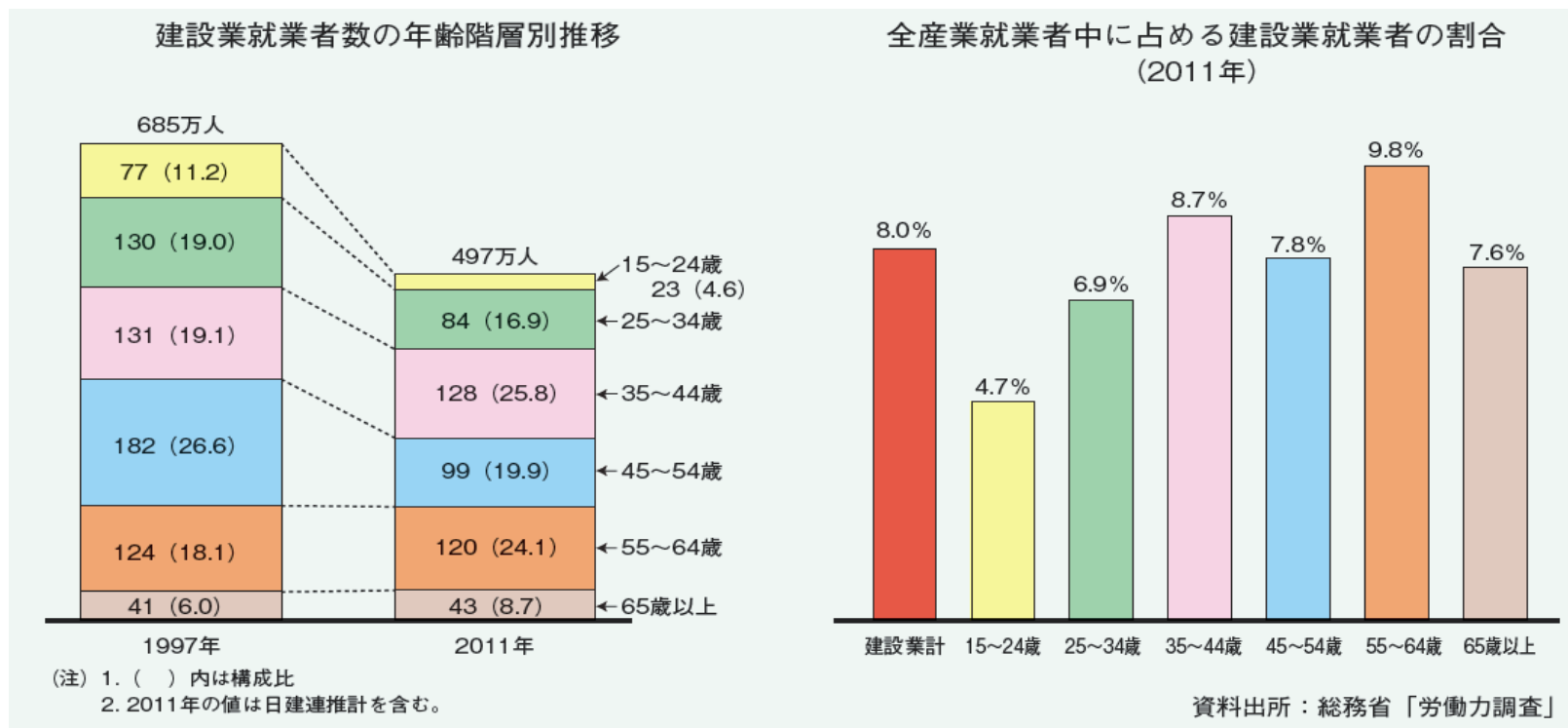
Japan	¥744	(nationwide average)
	<b>US\$7.67</b>	(at current FX)

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Source: National labour data, OECD, Bloomberg, Milestone Asset Management

# OLD INFRASTRUCTURE = MORE SPENDING = HIGHER WAGES

One third of construction workers now over 55



Source: Ministry of Land, Infrastructure and Transport

# INFLATION-ADJUSTED JGBS THINK DEFLATION IS OVER

Implied break-even inflation rate (5-year) on Inflation-adjusted JGBs

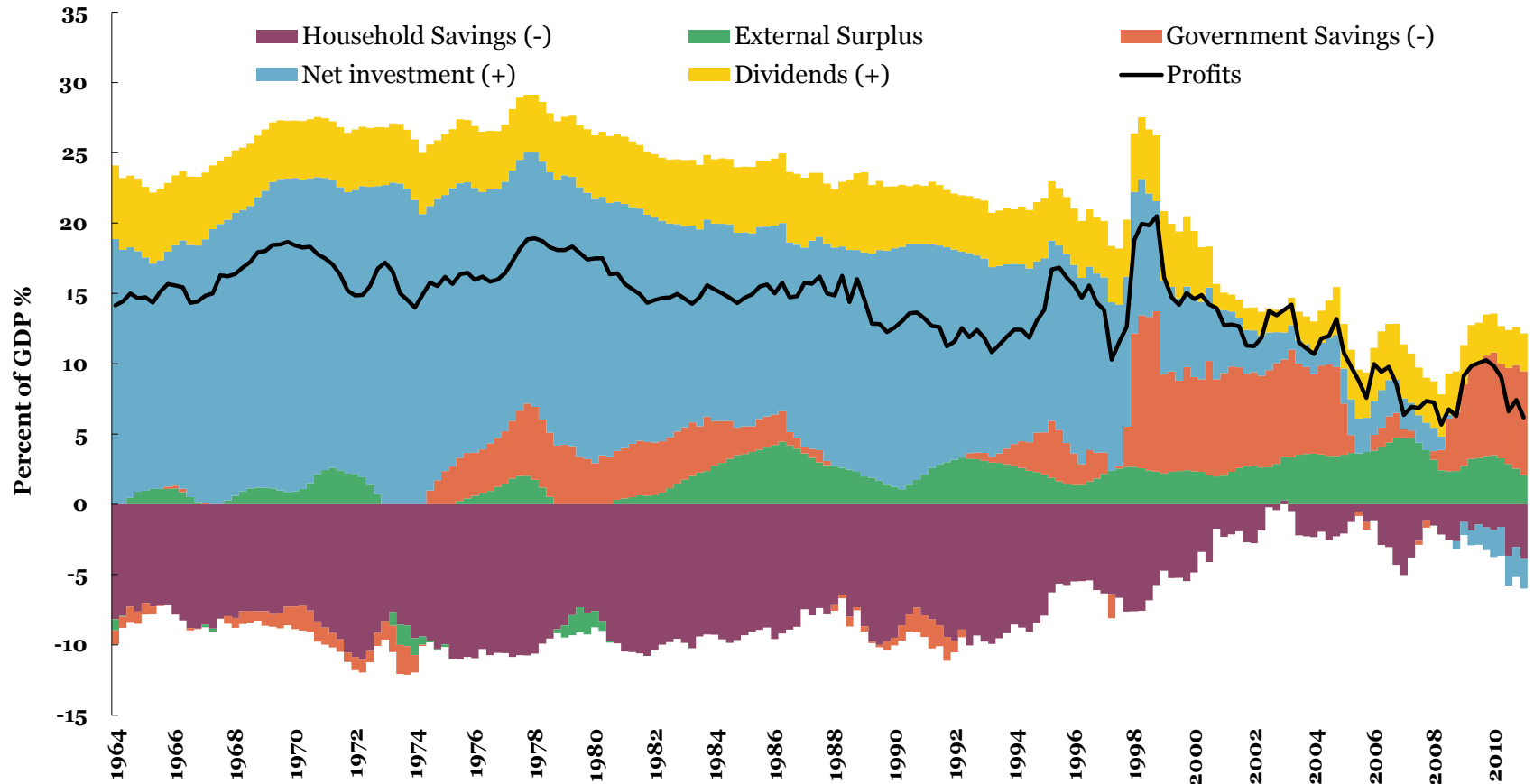


Source: Bloomberg, Milestone Asset Management



# HOW MUST STIMULATION WORK? KALECKI SHOWS US HOW

Kalecki's Profit Equation: Total profits = the sum of the consumption of capitalists & net investment & the public deficit & the net external surplus minus the savings of workers



Source: BoJ, MoF, Morgan Stanley, Milestone Asset Management

# HOW MUST STIMULATION WORK? KALECKI SHOWS US HOW

Kalecki's Profit Equation: Total profits = the sum of the consumption of capitalists & net investment & the public deficit & the net external surplus minus the savings of workers

If it isn't the interest rate alone that equilibrates savings and investment there is a function for other factors

This opens up a role for, for instance, Tobin's 'Q' arbitrage and for "animal spirits"

In Japan's case, net investment (investment less capital consumption (economic depreciation)) has fallen consistently since the onset of deflation and is now negative

A rise in investment is actually a 'good thing' when your starting point is capital consumption (let's glide over the data quality complications...)

Raising dividends would also be a 'good thing' for profits because it would increase the income of capitalists

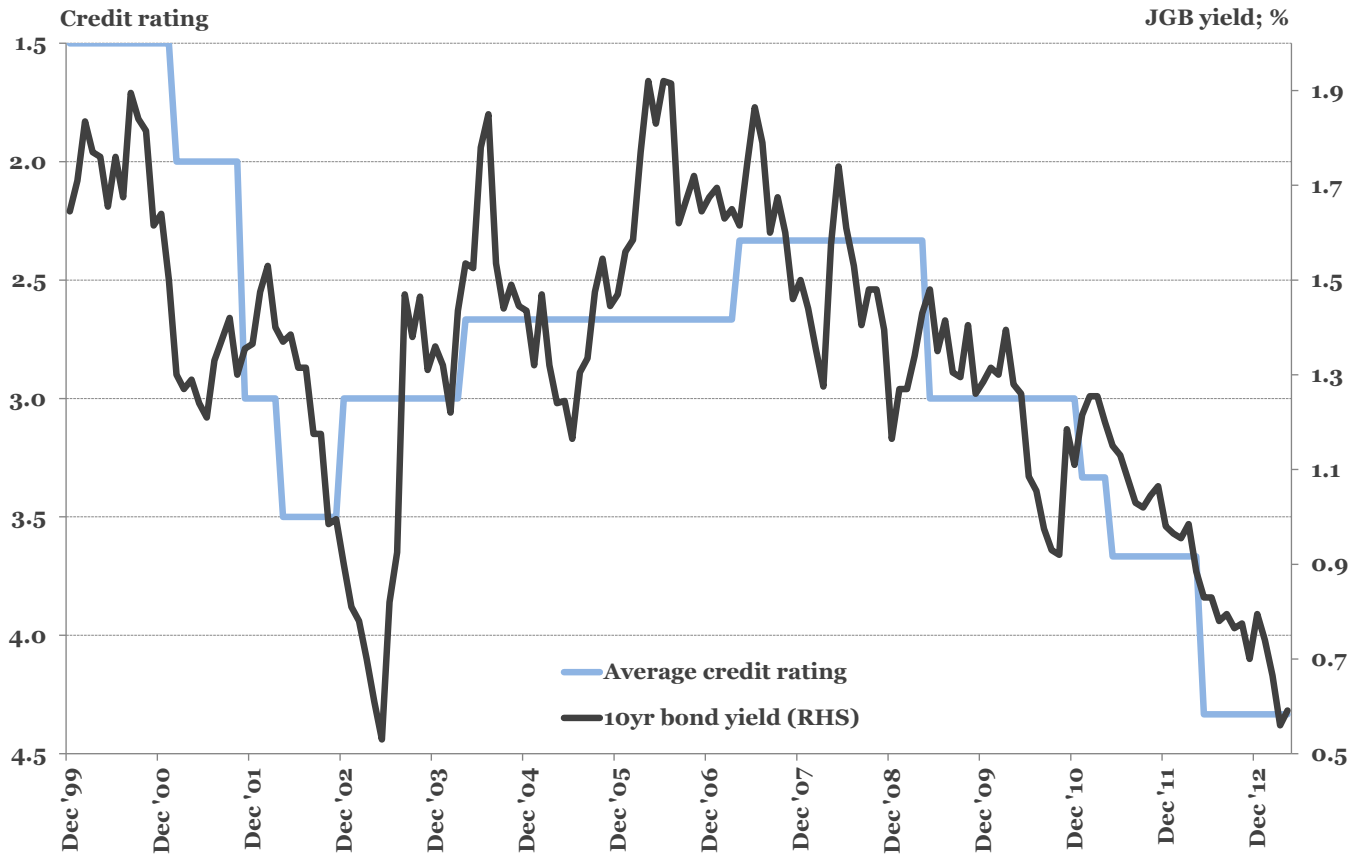
Implication is that 'Abe-nomics' will really work by stimulating the non-salariman portion of the country – it is inherently redistributionist.

The issue is how long the essentially non-capitalist salariman will consent to give up the gains he has made in relative terms over the past 16 years.

“It is astonishing what foolish things one can temporarily believe if one thinks too long alone, particularly in economics.” *Keynes, The General Theory of Employment, Interest and Money*

# DO RATINGS AGENCIES HAVE ANYTHING TO SAY?

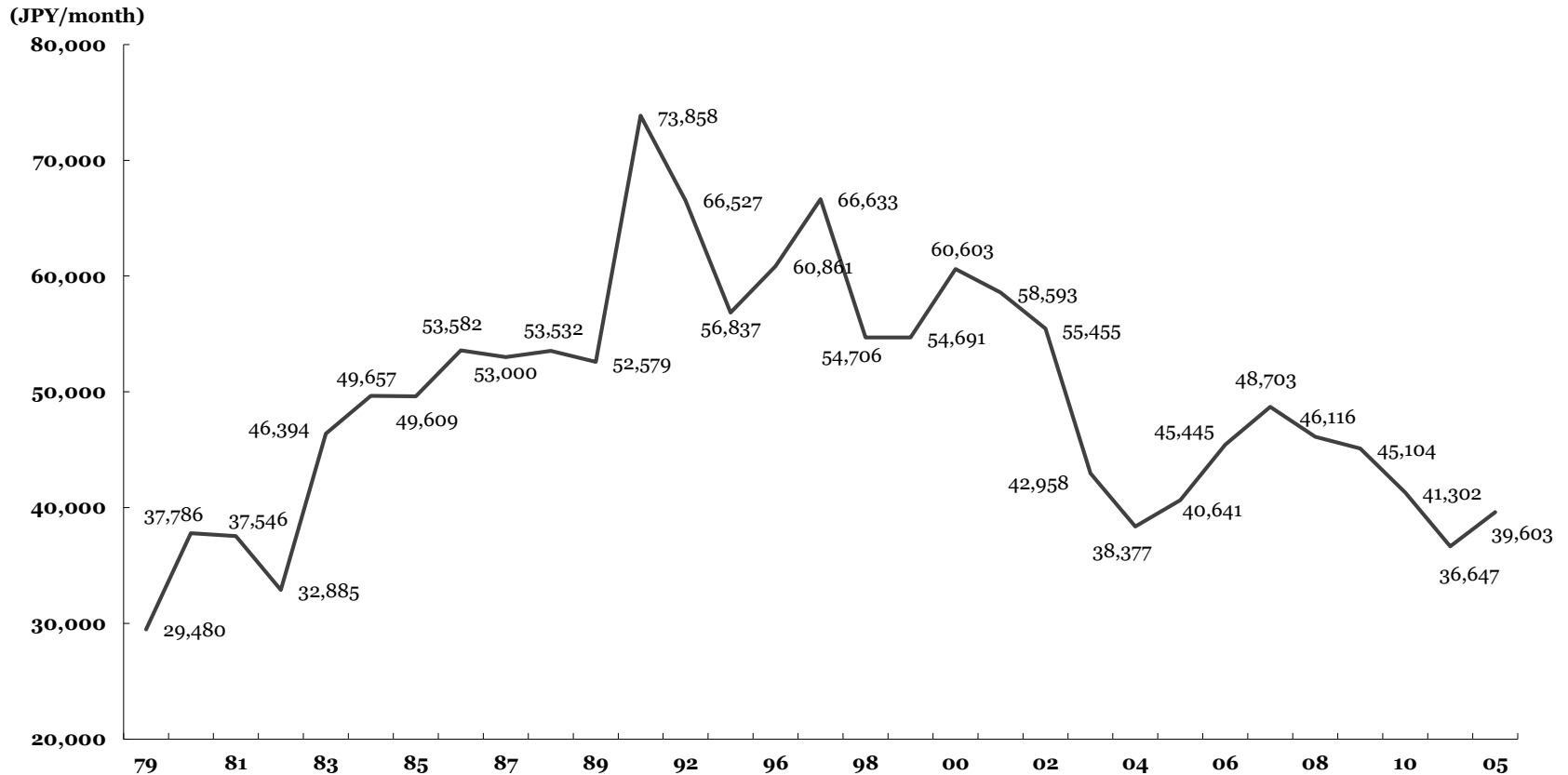
Or Are They Inadvertently Admitting that Deflation, Not Spending, is the Issue?



Source: CLSA , Milestone Asset Management

# JAPANESE ARE NOW `POOR`

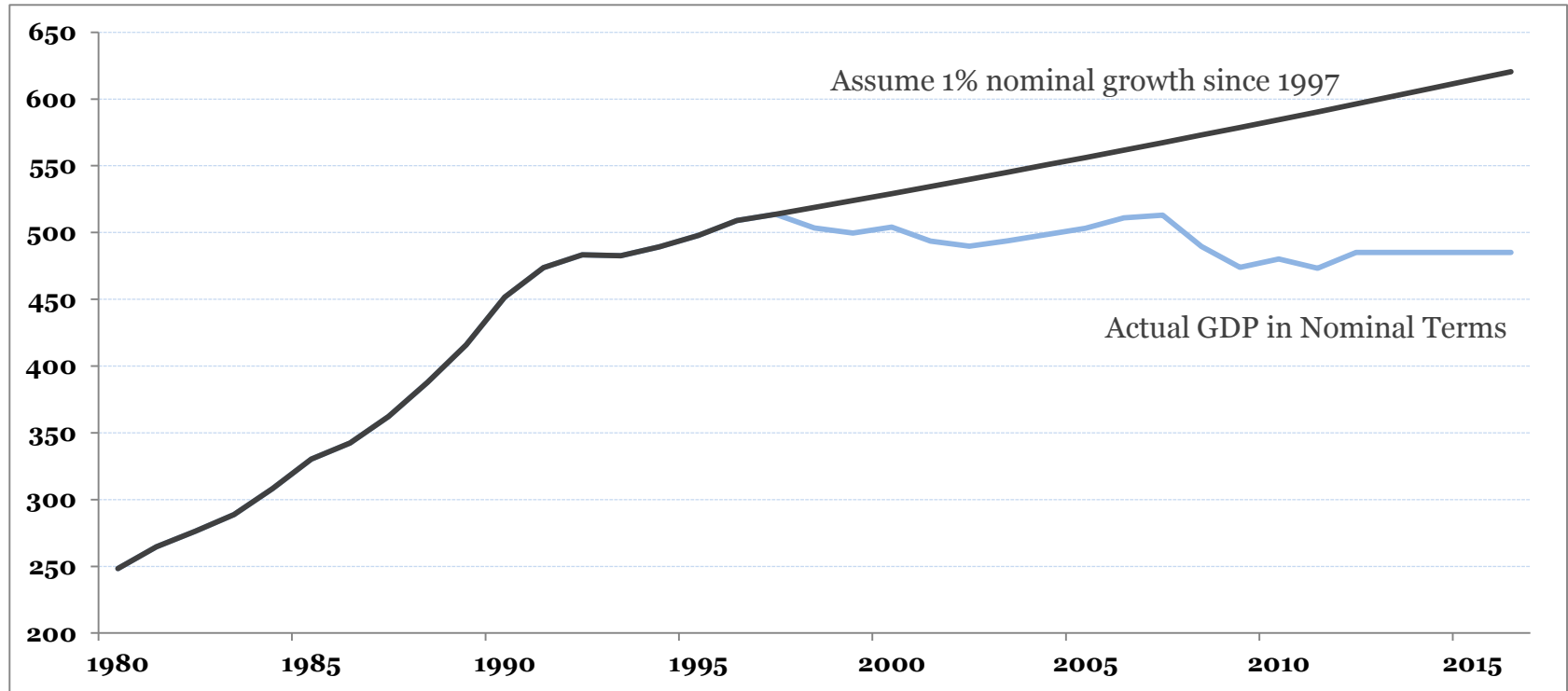
A "Salariman's" "Pocket Money" has halved in 20 years



Source: Shinsei Bank, Milestone Asset Management

# WHAT MIGHT HAVE BEEN.....

110 Trillion Yen of GDP Gone Missing = Depressed Tax Collections

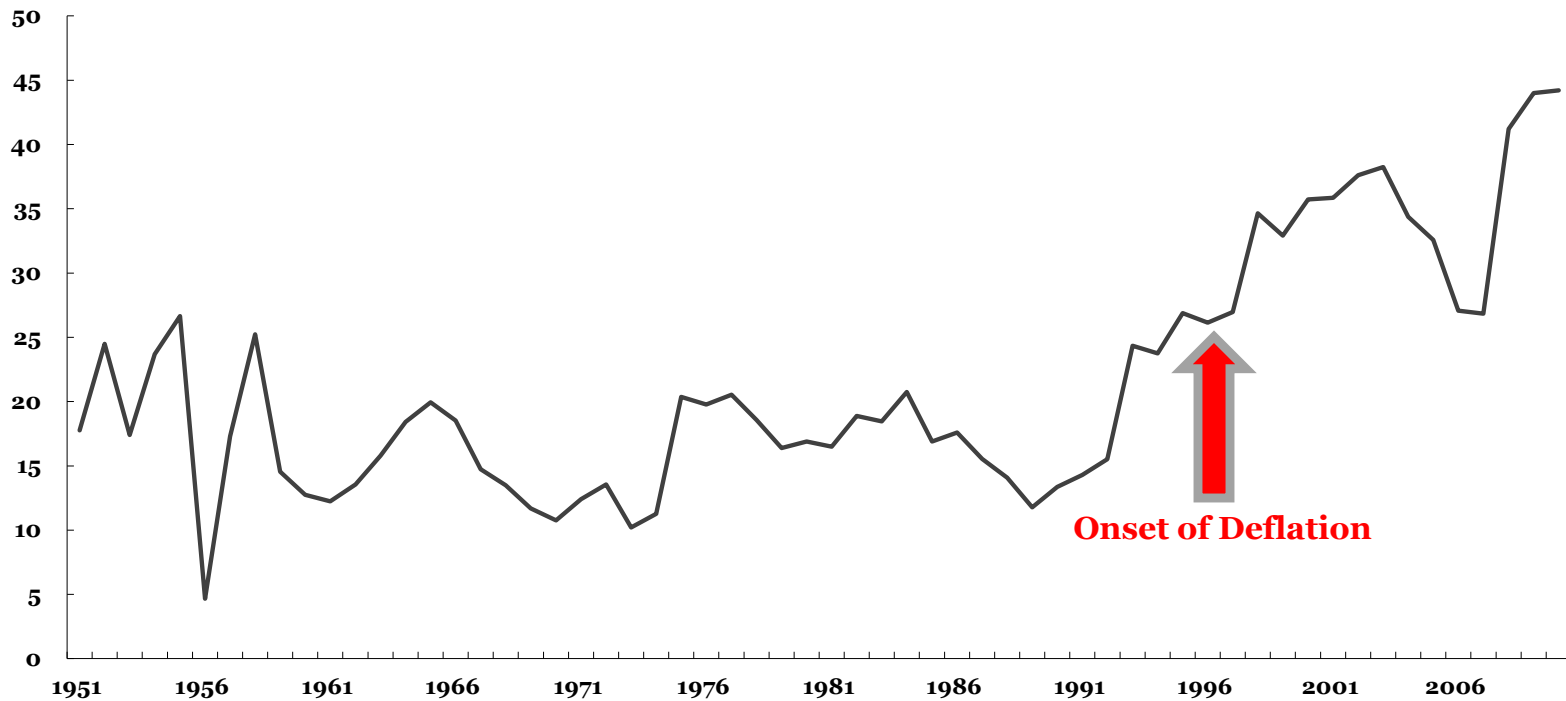


Source: Morgan Stanley, Milestone Asset Management

# DID JAPANESE SUDDENLY BECOME “TAX CHEATS” IN ‘96?

What changed was Deflation, not “Tax Evasion”

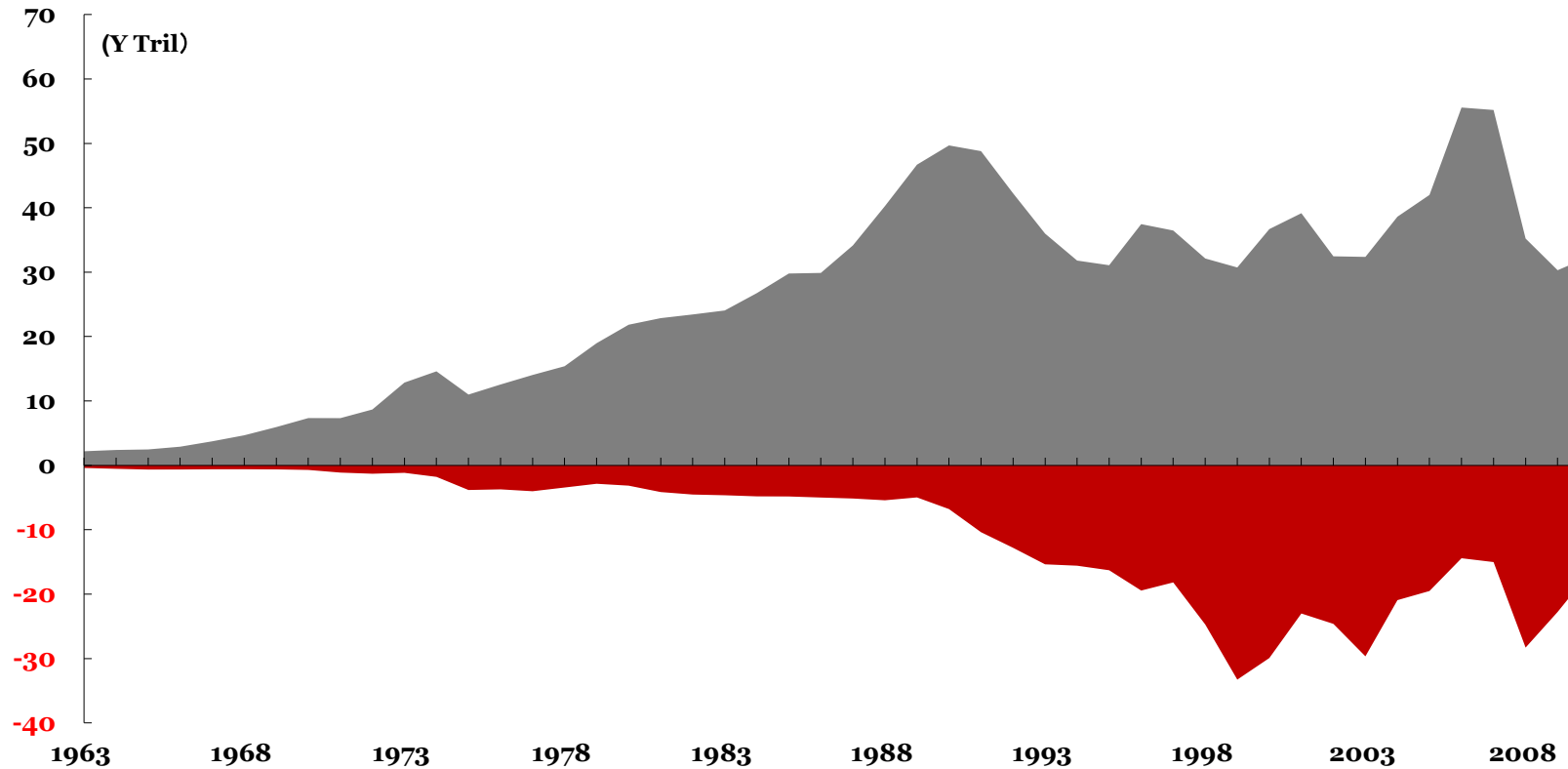
**% of Corporate Sector's Sales represented by Loss-making Companies**



Source: NTA, Morgan Stanley, Milestone Asset Management

# LOSSES OF LOSS-MAKING COMPANIES 4% OF GDP

Profits of Profitable Companies Essentially Unchanged post-1996

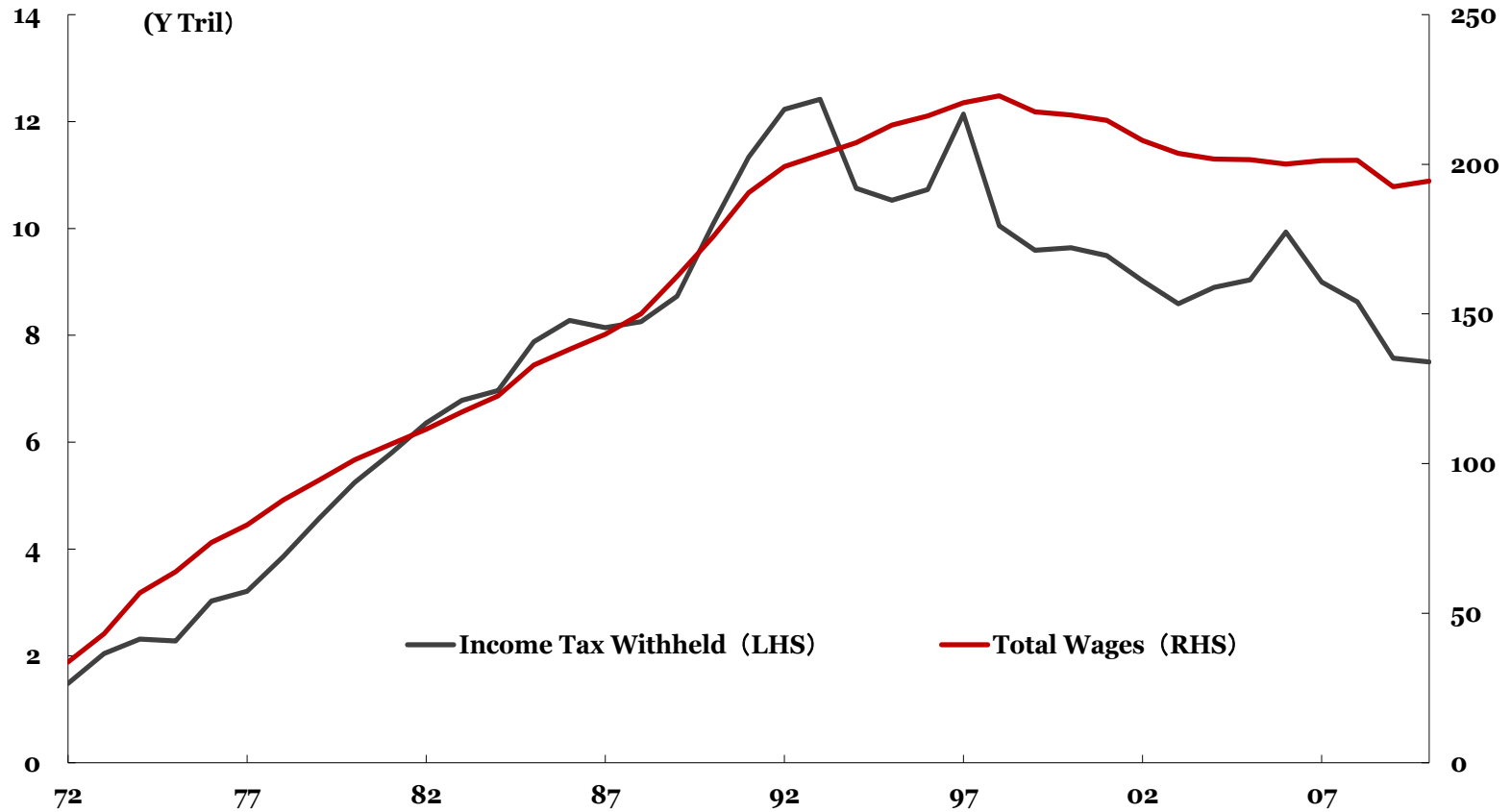


Source: NTA, Morgan Stanley, Milestone Asset Management



# 12% DECLINE IN WAGES LEADS TO 40% DROP IN TAX

## Income Tax Withheld at Source on Regular Wages



Source: NTA, Morgan Stanley, Milestone Asset Management

# CRUMMY ECONOMY = SPENDING UP & TAXES CRUSHED

FY 2011– Spending at deflationary period highs, revenues at secular lows

## % of Nominal GDP, Fiscal Years

	Average	1997-2011 High	Low	Last year Actual
Total Expenditure (As declared)	17.60%	21.30%	15.30%	21.30%
of which:				
Interest Payment	1.70%	2.10%	1.40%	1.70%
Social welfare	4.30%	6.30%	3.00%	6.30%
Local Gov. Tax Grants, Special Grants and others	3.30%	4.10%	2.60%	4.10%
All Other Expenditures	8.30%	10.10%	7.20%	9.20%
<b>Actual Total Expenditure less Interest Costs</b>	<b>15.90%</b>	<b>19.70%</b>	<b>13.20%</b>	<b>19.60%</b>
Tax and Other Revenue in Total	9.40%	10.50%	8.20%	9.10%
of which:				
Income Tax	3.10%	3.70%	2.70%	2.80%
Corporate Tax	2.20%	2.90%	1.30%	2.00%
Consumption Tax	2.00%	2.20%	1.80%	2.20%
Other revenues	2.00%	2.30%	1.90%	2.10%
Re-Stated Central Government Surplus/Deficit				-10.50%

Source: MoF, Milestone Asset Management

# BETTER ECONOMY = SPENDING DOWN & TAXES UP

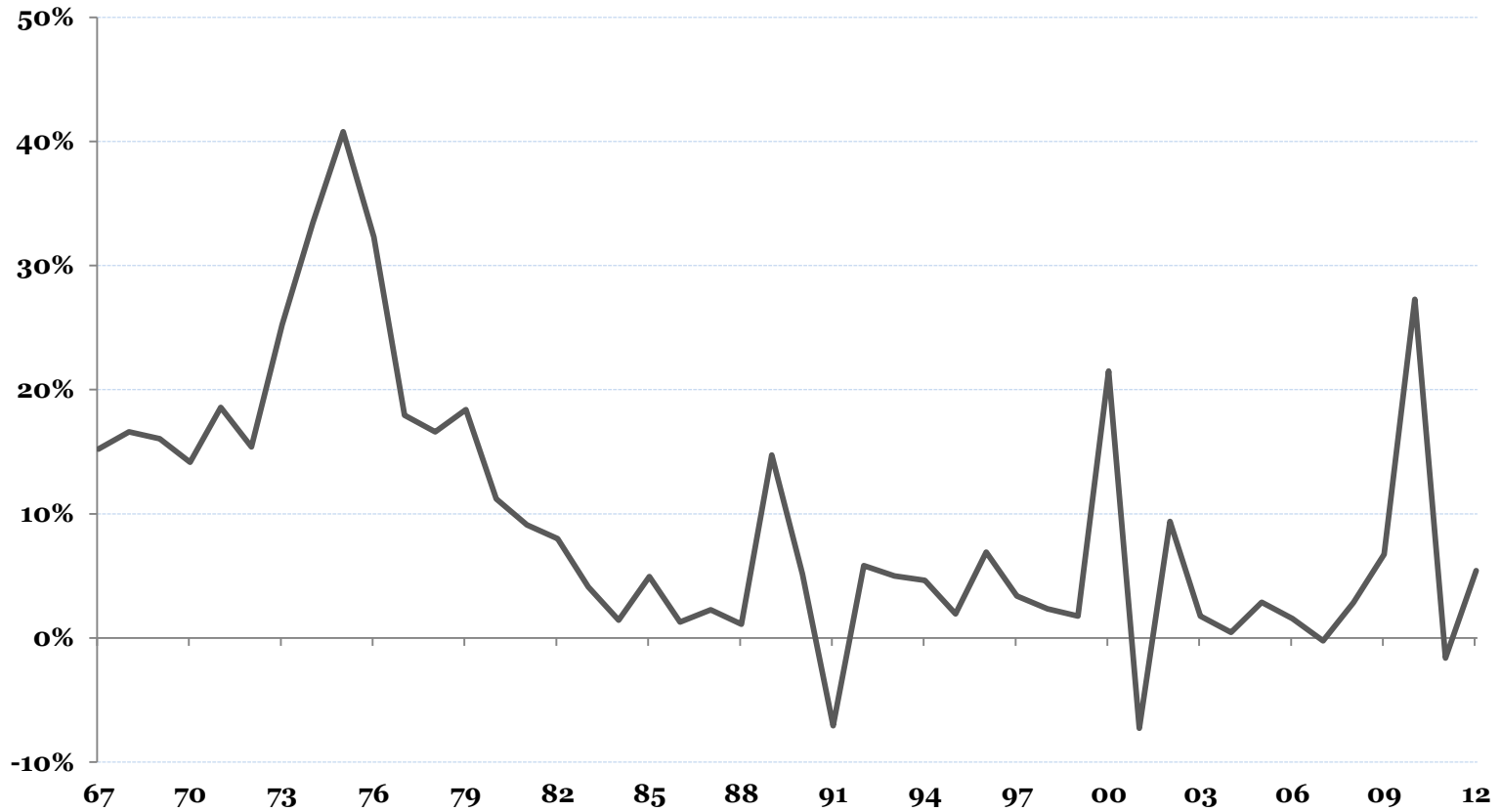
Let's remember that just as inflation is a "tax increase" so deflation is a "tax cut"

	Hypothetical Case		"Reflation Works"	
	Assumption		Assumption	
Total Expenditure (As declared)				
of which:				
Interest Payment	3.40%	Double FY2011	4.00%	2.35x FY2011
Social welfare	4.50%	Return to Mean	3.00%	Fall to lows
Local Gov. Tax Grants, Special Grants and others	3.50%	Return to Mean	2.60%	Fall to lows
All Other Expenditures	8.75%	Return to Mean	7.20%	Fall to lows
<b>Actual Total Expenditure less Interest Costs</b>	<b>20.15%</b>		<b>16.80%</b>	
Tax and Other Revenue in Total	13.00%		16.50%	
of which:				
Income Tax	4.60%	Pre-deflation Average	5.80%	Rise to pre-deflation highs
Corporate Tax	3.50%	Pre-deflation Average	4.80%	Rise to pre-deflation highs
Consumption Tax	2.00%	Average post-1997	2.20%	Rise to pre-deflation highs
Other revenues	2.90%	Pre-deflation Average	3.70%	Rise to pre-deflation highs
Re-Stated Central Government Surplus/Deficit	-7.15%		-0.30%	

Source: MoF, Milestone Asset Management

# SOCIAL SPENDING: NO LINK WITH “DEMOGRAPHICS”

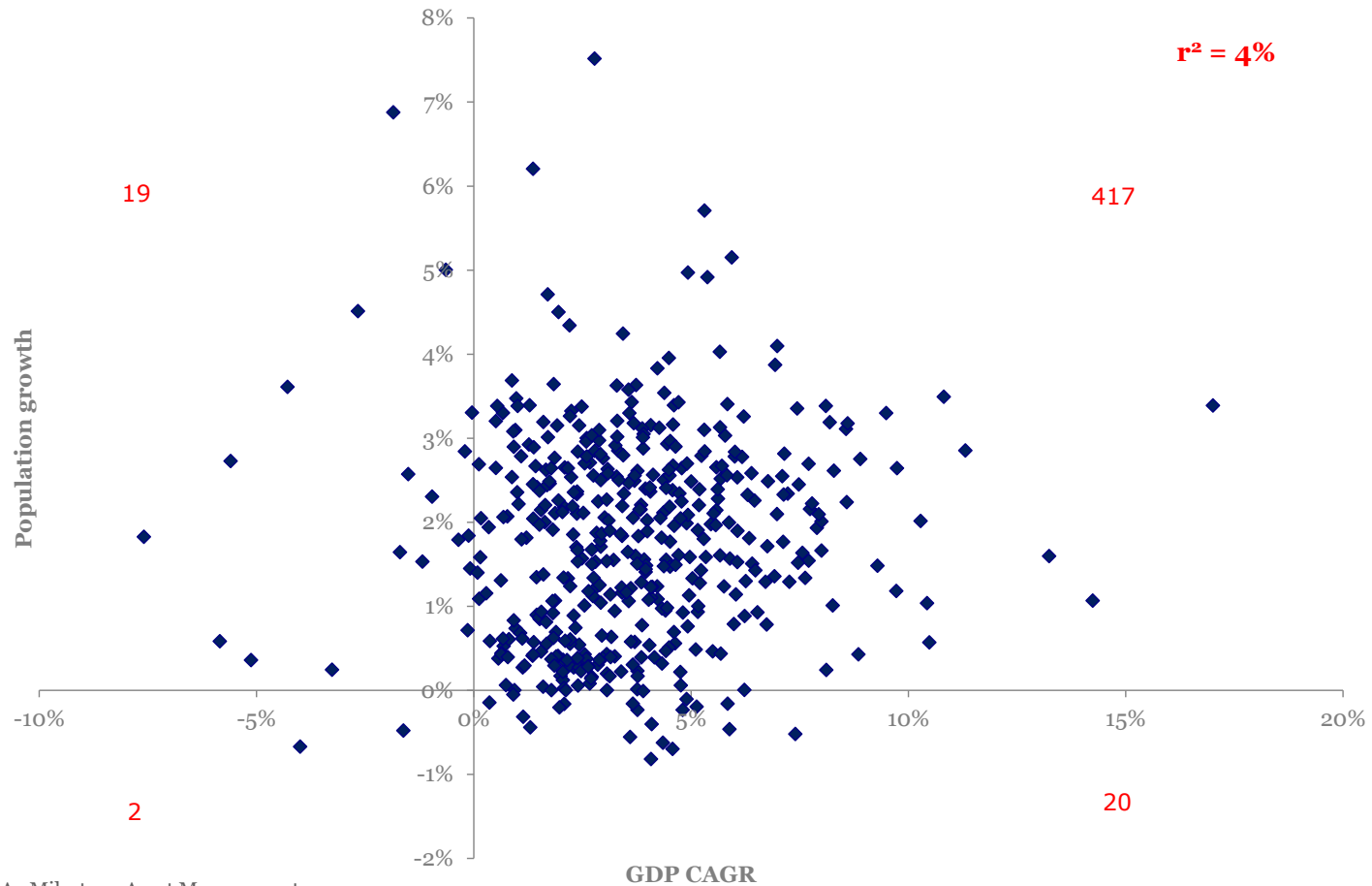
Year-on-year (FY) Change in Central Government “Social Welfare Expenditure”



Source: MoF, Milestone Asset Management

# THE GROWTH PROBLEM IS NOT “DEMOGRAPHICS”

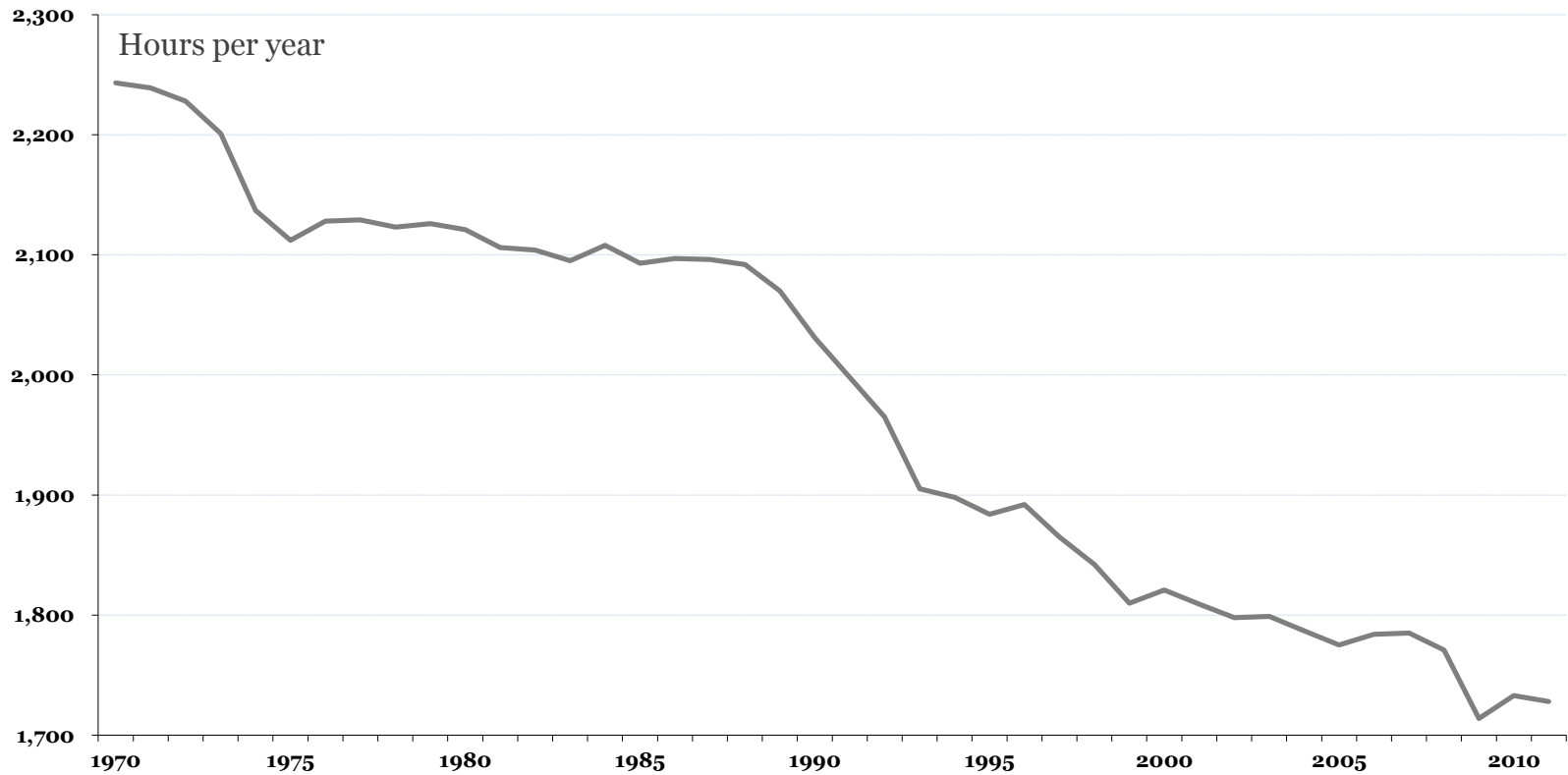
Growth and Population Change in 147 countries over the last 30 years - No Relationship



Source: IMF, CLSA, Milestone Asset Management

# RELAXING OR LAID OFF? BECOMING A “NORMAL” COUNTRY

Japanese Working Hours – Steep post-Bubble Decline; Now at OECD Average



Source: OECD, JP Morgan , Milestone Asset Management

# NUCLEAR POWER – SCARE STORIES TO BE IGNORED

Conventional sources of generation more or less cover Japanese power needs

Output (mn kWh)					
Peak	Total non-nuclear	Nuclear	Thermal	Hydro	Purchase
pre-quake	77,431	25,967	52,798	7,837	16,797
post-quake	90,344	17,083	64,445	7,239	18,660

*Assumptions : Output roughly = demand < supply capacity*

peak demand	<b>96,173</b>
	Aug-07

Pre-quake nuclear peak	25,967
Peak demand less non-nuclear supply	5,829
Probable need for nuclear/nuclear capacity	<b>22%</b>
(= peak demand minus post-quake non-nuclear supply as a % of pre-quake nuclear output)	

Source: METI, BAML, Milestone Asset Management





# HAS THE EARNINGS UP-SHIFT ALREADY OCCURRED?

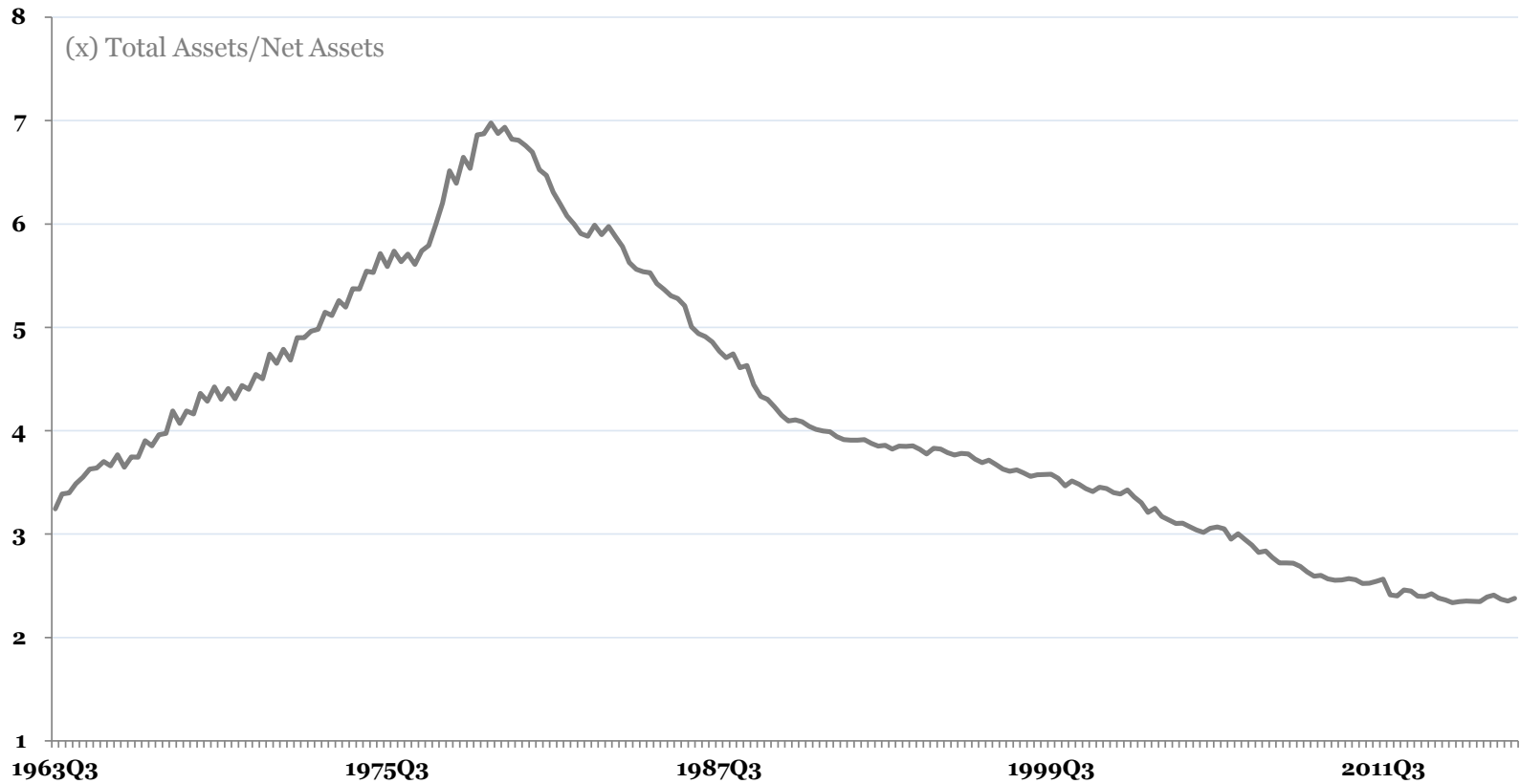
Trailing 10-year Average Real EPS since 1980



Source: Morgan Stanley, Milestone Asset Management

# 20 YEAR DELEVERAGING REDUCES ROE

Deflation = Deleveraging



Source: Ministry of Finance, Morgan Stanley, Milestone Asset Management

# 20 YEAR DELEVERAGING REDUCES CAPITAL EFFICIENCY

Renewed Rise in Leverage & Asset Turnover Requires the End of Deflation

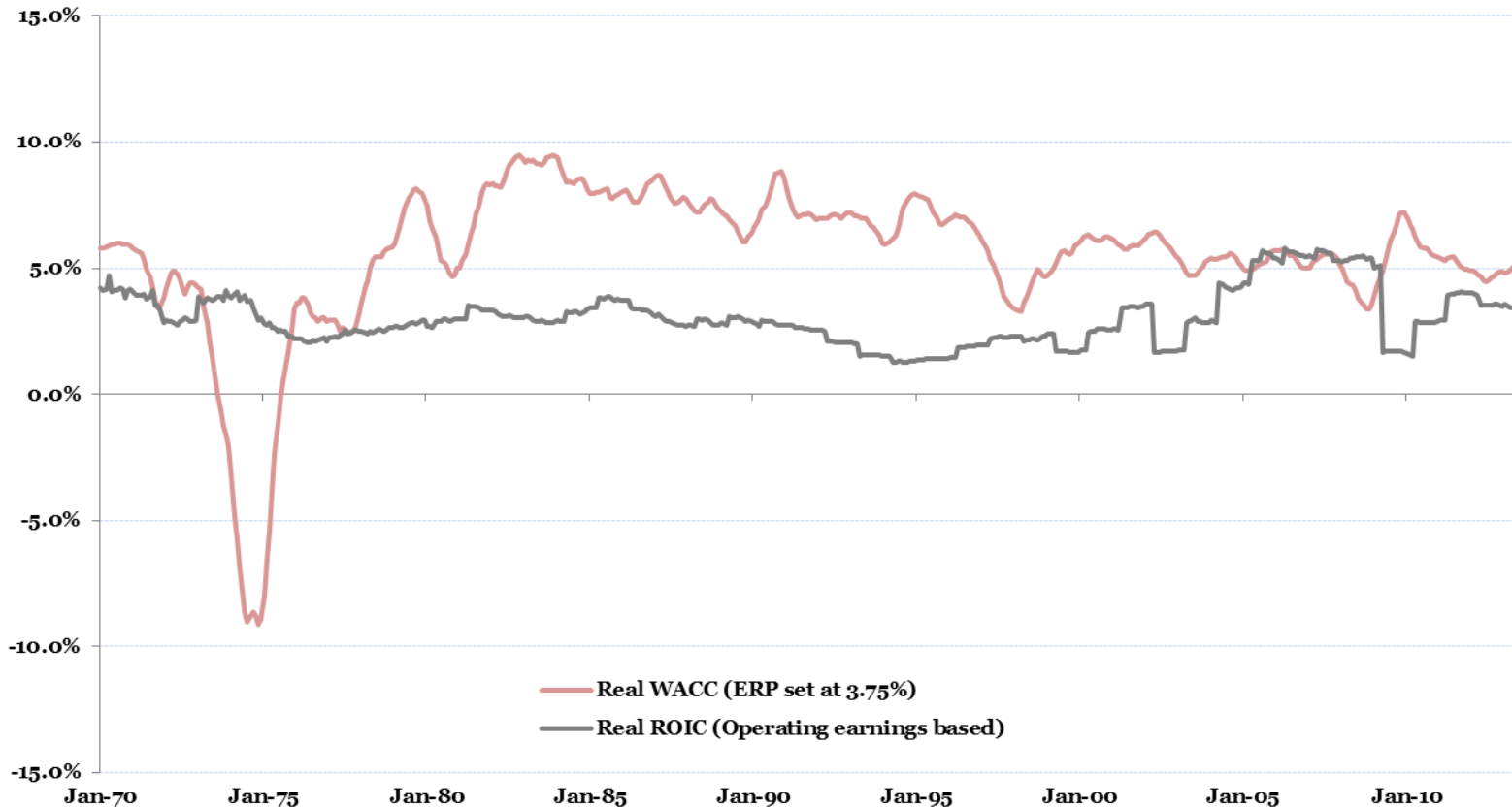
	1960s Average	1970s Average	1980s Average	1990s Average	2000s Average	2010s Average
<b>ROE (%)</b>	7.85	8.79	8.40	4.98	6.01	4.88
<b>Net Margin (%)</b>	1.7	1.2	1.4	1.4	2.5	3.3
<b>Asset Turnover</b>	111	120	129	97	89	78
<b>Leverage Ratio</b>	4.2	5.1	4.7	3.6	2.7	2.4

Scenario Analysis		Assume						
		Net Margin 3.30%						
Norm ROE		90%	95%	100%	105%	110%	115%	120%
<b>Asset Turnover</b>								
<b>Leverage (x)</b>								
	2.75	8.17%	8.62%	9.08%	9.53%	9.98%	10.44%	10.89%
	3.00	8.91%	9.41%	9.90%	10.40%	10.89%	11.39%	11.88%
	3.25	9.65%	10.19%	10.73%	11.26%	11.80%	12.33%	12.87%
	3.50	10.40%	10.97%	11.55%	12.13%	12.71%	13.28%	13.86%
	3.75	11.14%	11.76%	12.38%	12.99%	13.61%	14.23%	14.85%
	4.00	11.88%	12.54%	13.20%	13.86%	14.52%	15.18%	15.84%
	4.25	12.62%	13.32%	14.03%	14.73%	15.43%	16.13%	16.83%

Source: Morgan Stanley, Milestone Asset Management

# BIG COMPANIES DO NOT USUALLY EARN A RETURN

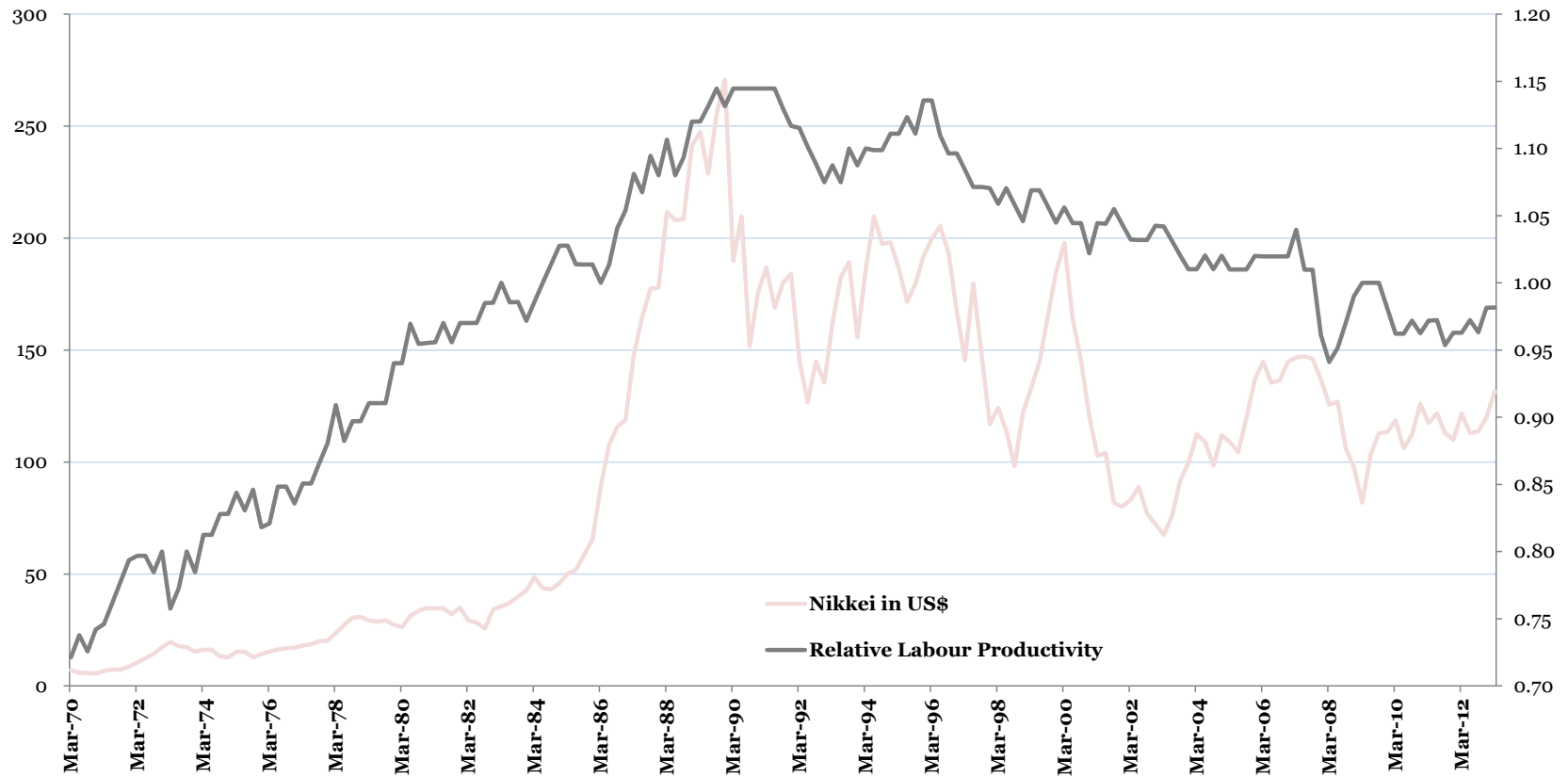
The “Good News” is that Returns should go back towards the 2006/7 level; the “Bad News” is that that will still only equal the Cost of Capital



Source: Bloomberg, Morgan Stanley, Milestone Asset Management

# PRODUCTIVITY REMAINS A MACRO PROBLEM...

## Relative Labour Productivity and the Stock Market



Source: Bloomberg, Mitsubishi UFJ Morgan Stanley, Milestone Asset Management

# ...WITH MICRO ROOTS - BLOATED WORKFORCES

	FY 2011		FY 2000	
	Workers (no.)	Sales/Worker (Ymn)	Workers (no.)	Sales/Worker (Ymn)
<b>Hitachi</b>	350,000	25.75	323,000	24.71
<b>Toshiba</b>	203,000	31.58	191,000	30.12
<b>Mitsubishi Electric</b>	114,000	31.85	117,000	32.37
<b>Panasonic</b>	348,000	22.22	290,000	25.13
<b>Sony</b>	168,000	42.69	190,000	35.25
<b>Sharp</b>	56,000	54.37	50,000	37.28
<b>TDK</b>	88,000	9.97	34,000	19.65
<b>Canon</b>	198,000	17.94	87,000	32.09
<b>Ricoh</b>	109,000	17.81	67,000	21.49
<b>Nissan</b>	159,000	55.03	136,000	43.84
<b>Toyota</b>	318,000	59.78	211,000	61.12
<b>Honda</b>	179,000	49.91	112,000	54.26
<b>NTT</b>	219,000	46.98	224,000	46.53
<b>Kajima</b>	15,000	87.89	19,000	92.23
<b>Fast Retailing</b>	33,323	24.62	1,853	185.74
<b>Shiseido</b>	32,595	20.94	24,495	24.36
<b>Fuji Photo</b>	81,691	26.88	37,151	37.73
<b>Shinetsu Chemical</b>	16,167	64.81	18,754	36.20
<b>Fanuc</b>	5,198	103.60	3,707	56.39
<b>SMC</b>	15,384	22.22	9,891	19.64
<b>Komatsu</b>	44,206	44.83	28,522	37.01
<b>HCM</b>	21814	37.46	9,503	33.85

Source: Bloomberg, Milestone Asset Management

# ...AND SPECIFICALLY WHITE-COLLAR OVEREMPLOYMENT

How Gross Cashflow has been Used by Selected Major Consumer Electronics Companies (Averages)

	Averaging Period	Depreciation	SG&A	R&D	Interest	Other non-Op costs	Tax	Dividend	Retained Earnings	Gross Cash Flow
<b>Panasonic</b>	10 years	11%	<b>58%</b>	<b>21%</b>	1%	7%	4%	2%	-3%	100%
	3 years	11%	<b>60%</b>	<b>21%</b>	1%	16%	4%	1%	-14%	100%
<b>Sharp</b>	10 years	<b>33%</b>	28%	<b>25%</b>	1%	8%	5%	3%	-3%	100%
	3 years	<b>39%</b>	29%	<b>26%</b>	1%	14%	8%	3%	-21%	100%
<b>Sony</b>	10 years	16%	<b>50%</b>	<b>27%</b>	1%	-4%	7%	1%	0%	100%
	3 years	16%	<b>52%</b>	<b>26%</b>	1%	1%	15%	2%	-14%	100%
<b>Philips</b>	10 years	9%	<b>62%</b>	<b>20%</b>	3%	-7%	3%	6%	4%	100%
	3 years	7%	<b>68%</b>	<b>17%</b>	3%	-2%	3%	7%	-3%	100%
<b>Siemens</b>	10 years	10%	53%	18%	4%	-3%	5%	6%	8%	100%
	3 years	8%	46%	17%	1%	-2%	8%	9%	10%	100%
<b>Samsung</b>	10 years	19%	40%	15%	1%	-3%	5%	2%	20%	100%
	3 years	19%	42%	15%	1%	-4%	5%	2%	21%	100%
<b>Apple</b>	10 years	3%	25%	8%	0%	-2%	18%	0%	48%	100%
	3 years	3%	19%	6%	0%	-1%	19%	0%	54%	100%
<b>Hon Hai</b>	10 years	13%	38%	11%	2%	-5%	7%	7%	27%	100%
	3 years	14%	42%	3%	1%	-5%	6%	5%	23%	100%

Source: Citi Investment Research, Milestone Asset Management

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(Continued overleaf)



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(Continued...)

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