FAWKES CAPITAL MANAGEMENT

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Japan: This Time is Different

Dear Investors,

Japan's economic landscape is shifting dramatically as bold policies and political pressures drive a departure from decades of stagnation. In this note, we take a deeper look at the major changes currently underway in Japan

Historical Context and the Economic Bubble

To understand the significance of current developments, we start with events in the 1970s. During this decade, excessive liquidity provided by the central bank fuelled booms in both the land and stock markets. Following World War II, Japan's fixed currency regime and rapidly advancing technological base made its exports highly competitive. By the 1980s, Japan had quickly turned into the second largest economy of the world. By the 1980s, Japan had become the second-largest economy in the world. Leading the way were its consumer electronics and industrial giants, such as Mitsubishi, Toyota, Sony, Panasonic, and Hitachi. At its peak, the Japanese economy was roughly 80% of the size of the US economy (a similar ratio to China today). At its peak, the land value of the Imperial Palace in central Tokyo was valued at more than the entire real estate value of California.

However, by the mid-to-late 1980s, the situation began to change. President Reagan, aiming to address the weak yen, pressured Japan to revalue its currency higher. Echoing the protectionist policies now advocated by Republican nominee Trump, Reagan favoured fair trade over free trade. Concurrently, the Bank of Japan (BoJ) started to normalise its monetary policy. With a stronger yen, driven by American intervention and tariff threats, and the need to ration capital, Japan’s export competitiveness began to decline compared to the newly industrialized countries of the Pacific Basin. The primary drivers of Japan’s growth started to reverse.

At the beginning of 1990, after the BoJ began to raise interest rates, the economic bubble began to burst. The following chart illustrates the Nikkei 225 stock index during that period:

Source: TradingView

Between 1990 and 2013, Japan suffered from secular stagnation. Deflation, low wages, low levels of economic activity, high levels of government debt and low birth rates reinforced one another for more than 20 years, creating a prolonged economic malaise. It took 34 years for the Nikkei to reach a new high

The Emergence and Failure of Abenomics

The first genuine policy-driven attempt to lift Japan out of this stagnation came in 2013. Shinzo Abe’s second term as Prime Minister reflected the electorate’s desire for change. “Abenomics” was born. The plan aimed to stimulate the Japanese economy through all available policy measures to increase inflation, wages, and consumption. The BoJ was to print money to achieve this goal, while the government was to provide fiscal stimulus. The third arrow in the

Abenomics quiver was structural reform to improve Japan's export competitiveness and equity market transparency to encourage stock investment. Capital, on net, flew out of Japan to encourage a weaker yen. Because population growth was stagnant and would take too long to increase, Japanese policymakers relied on exports to restart the economy.

Abe's policies did not succeed. The primary reason was that the monetary and fiscal authorities did not implement them with enough vigour. Not enough money was printed to weaken the yen to a level that made exports extremely competitive, and not enough fiscal stimulus was provided to kick-start private-sector spending. Policymakers were too tepid to do enough.

Impact of the Pandemic on Fiscal and Monetary Policy

The pandemic, however, marked a turning point for what was considered acceptable in terms of fiscal and monetary policy. With other developed nations running wartime-like budget deficits and printing trillions of dollars, it became politically palatable for Japan to adopt similarly aggressive policies. Consequently, the BoJ began printing money on an unprecedented scale. Over the course of the last decade, relative to the size of its economy, the BoJ has now printed around twice as much money as the Federal Reserve and European Central Bank put together.

What did this lead to? Ever since the deflationary bust of the 1990s, Japanese consumers have been saving. This surplus needed to be invested somewhere. Recently, this task had become difficult. The BoJ had bought so many domestic assets that it crowded out the private sector. Despite the government continuing to run sizeable budget deficits (around 5% of GDP annually), by 2023, the BoJ owned approximately 50% of all Japanese Government Bonds (JGBs) outstanding. Prior to Abenomics, Japanese savings would be invested back into JGBs. But since Abenomics, over US$4 trillion of bonds had been taken off the market by the BoJ. With significantly fewer domestic assets available to buy, pension funds, insurance funds, and retail investors had no choice but to invest overseas.

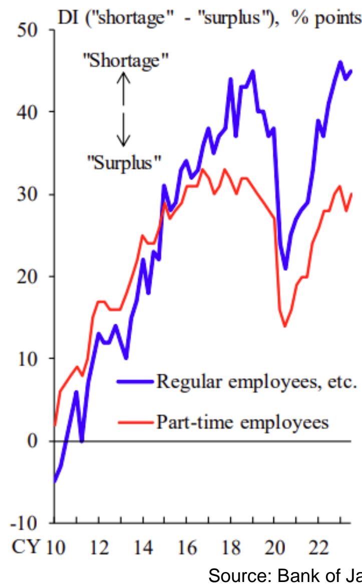
From the start of Abenomics in 2013 to today, around US$1.2 trillion in Japanese savings have been forced to find a new home. On top of that, Japanese policymakers increased the foreign asset allocation of their major pension funds from around 20% of total assets in 2013 to around 50% today. A massive amount of Japanese money has been parked overseas.

These capital outflows led to a weak Japanese yen. The US dollar rose from a value of around 70 Japanese yen to 150 Japanese yen. By some measures, on a trade-weighted basis, the yen is now about 50% undervalued. Exports began to rise, and combined with significantly larger fiscal stimulus, the economy has started to boom.

Current Economic and Monetary Trends

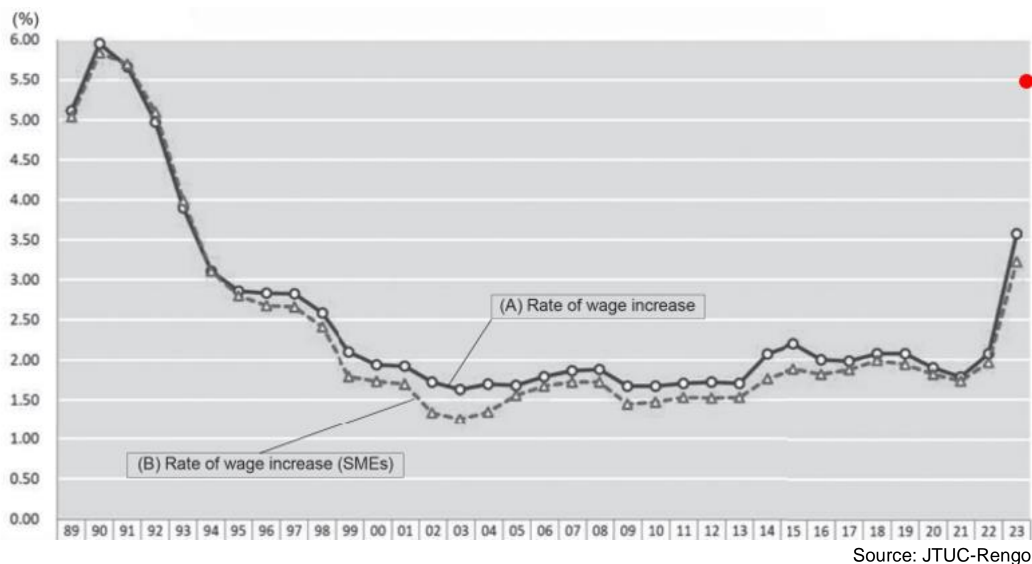
The Japanese economy is different today. Around 80% of households now expect inflation to rise by more than 2%. The net percentage of businesses expecting inflation to rise is now similar to the early 1980s:

Alongside this, labour markets have tightened significantly. The unemployment rate has fallen to 2.5%, which is a secular low. The reason this is astonishing is because the unemployment rate fell at the same time Japan's labour force participation rose to secular highs (from around 72% to 81%). Japanese women have joined the labour force in droves. But now, that supply is likely to have been exhausted. The following chart shows corporate perceptions of full-time labour shortages:



Source: Bank of Japan

As a result of these developments, wage growth is now starting to spike. In the forthcoming spring Shunto (the annual spring wage negotiations), the rate of wage increases among major corporations is expected to be around 5.5%, the highest rate of growth since 1990. The chart below shows realised wage increases by major corporations in Japan, with the red dot indicating the most recent negotiated outcome for 2024:



Source: JTUC-Rengo

The rise in wages has caused stickier, intermediate Japanese services inflation to increase above 3%. By comparison, between the early 1990s and 2013, services inflation averaged around 0%. The picture today looks very different. Japan, today, looks more like the booming economy of the US coming out of Covid than the secular stagnation of the 1990s and 2000s.

Policy Reversals and Future Outlook

Against this backdrop, the BoJ has begun to reverse course. The BoJ no longer believes it needs to shepherd investors into offshore assets to weaken its currency. Instead, at its most recent monetary policy meeting, the BoJ pledged to reduce the size of its enormous balance sheet and continue hiking interest rates.

Specifically, the BoJ has pledged to reduce the size of its balance sheet by around 8% of GDP over the next 15 months. This alone will provide private sector investors with an additional US$300 billion or so of assets to buy. This

represents a significant change, as the private sector will move from being forced to buy overseas assets to having surplus domestic assets available for investment.

The second reason for the BoJ's policy reversal is political pressure. The weak yen has become increasingly unpopular with the electorate due to cost-of-living challenges and swarms of foreign tourists. Politically, Japan now appears divided into “two Japans” – one for foreigners with their strong currencies and one for local Japanese. Shortly after Kishida called BoJ Governor Ueda in for an emergency meeting in May, BoJ board member Adachi suggested that the bank might be forced to use monetary policy to respond to currency weakness. There are far more consumers who vote than there are businesses.

Prime Minister Kishida’s recent resignation due to low approval ratings is likely to mark the end of Abenomics. While the race for power is wide open, the candidates likely to win (Ishiba and Koizumi according to public and party polls) have taken positions against yen weakness. After all, the yen’s slide that accentuated the social inequality side-effect from Abenomics, is partly responsible for Kishida’s demise. Almost all candidates share the opinion that some degree of economic policy normalisation from the BoJ and MoF is appropriate. Given that Kishida’s term is nearly over, the best he can do for the party is to try and strengthen the yen before the new Prime Minister takes over.

Our assessment is that the BoJ's policy change will unwind the decade and a half of Japanese foreign asset accumulation. Much of this build up was on a currency unhedged basis. Japan’s booming economy will be in contrast with a US economy that appears set to enter a downturn. Consequently, we believe the US dollar should weaken considerably against the yen.

Japanese money managers, holding hundreds of billions in foreign assets, will need to decide what to do with these investments. With the US economy potentially weakening and a strong Japanese economy, the incentive to repatriate assets will be hard to resist. The sheer volume involved in hedging Japanese risk will likely add pressure to global markets.

If there is widespread market turmoil, the BoJ may slow the pace of policy normalisation. And when markets return to more normal states of calm, the objective and direction of the BoJ and Prime Minister Kishida is clear.

The BoJ now recognises that “this time is different.” In a speech on May 27, senior BoJ Deputy Governor Uchida noted that "labour market conditions have changed structurally and irreversibly," leading him to conclude that "this time is different." For the medium term, we tend to agree.

Kind Regards,
Fawkes Capital Management

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