WHITEHELM
ADVISERS

JULY 2019

THOUGHT LEADERSHIP:
TURNING JAPANESE? WE DON'T REALLY THINK SO

INTRODUCTION

Japanification is a thing. And we are not talking about a global proliferation of cat cafes. Rather, Japanification means an economic environment of persistent low growth and low inflation, where interest rates are low, zero or even negative and central banks pump liquidity into financial markets primarily through significant asset purchasing programs.

This article looks at the Japanese economy over the past 30 years, since the housing bubble burst. We consider the key economic indicators that led the Bank of Japan (BoJ) to undertake extraordinary actions as it pioneered unconventional monetary policy.

We then look at the Australian economy, searching for similarities, including signs of a liquidity trap. We also consider whether the world has structurally changed enough that old paradigms are no longer useful. And finally, we consider what this lower for longer world means for investors.

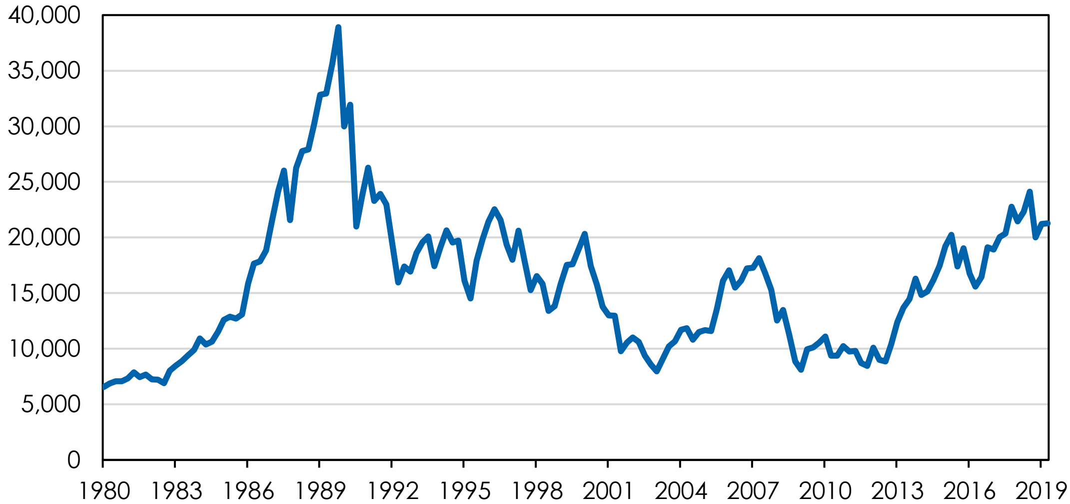
Cutting to the chase, is Australia turning Japanese? We don't really think so[1].

[1] With apologies to the Vapors.

THE LOST DECADE (OR TWO)

On 29 December 1989, the Nikkei peaked at 38,957. It has never returned (or come close) to its 1989 high, as shown in Chart 1 below. Riding high on cheap credit, Tokyo property prices were booming. Local banks had a limitless appetite for real estate investors, who continued to borrow against the increasing value of their property portfolio. Consumers developed a taste for global luxury brands and high technology companies became a symbol of the Japanese economic miracle.

Chart 1 –Nikkei 225 Index, 1980 - 2019

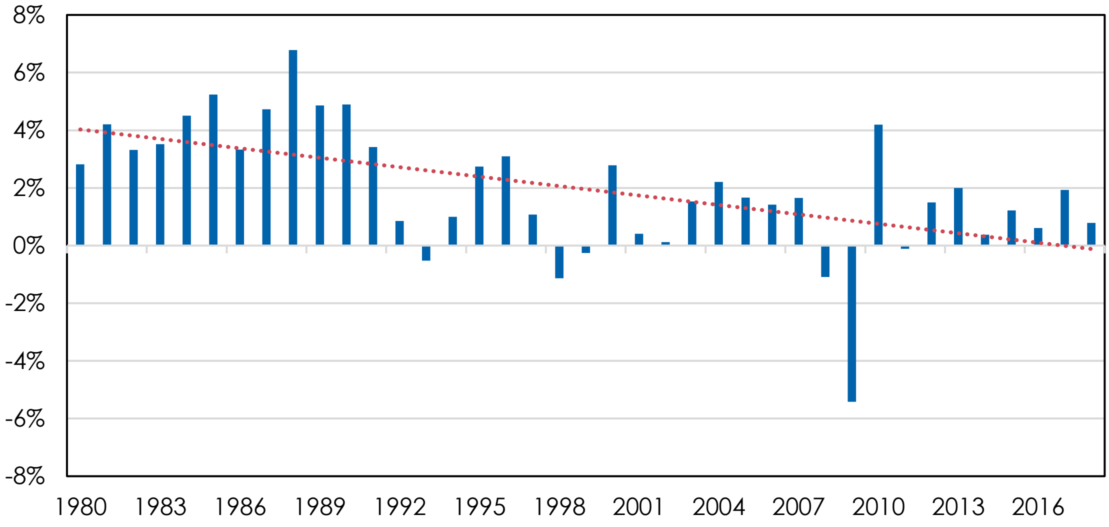


Source: Bloomberg, Whitehelm Advisers

But then a sharp increase in interest rates – intended to take some of the heat out of the boom - burst the housing bubble. And the Japanese economy still bears the wounds of the excesses of the 1980s. It has been characterised by low growth and low inflation since 1991. And despite extraordinary (or unconventional, as it is known) central bank intervention for more than two decades, the economy remains stuck in a liquidity trap.

Chart 2 shows GDP growth in Japan since 1980. In the almost 30 years since Japan's property bubble burst, its economy grew an average of just 0.9% each year. In comparison, Australia's average annual GDP was 3.2% for the same period.

Chart 2 – GDP growth in Japan 1980-2018 (including trendline)



Source: World Bank, Whitehelm Advisers

What is a liquidity trap?

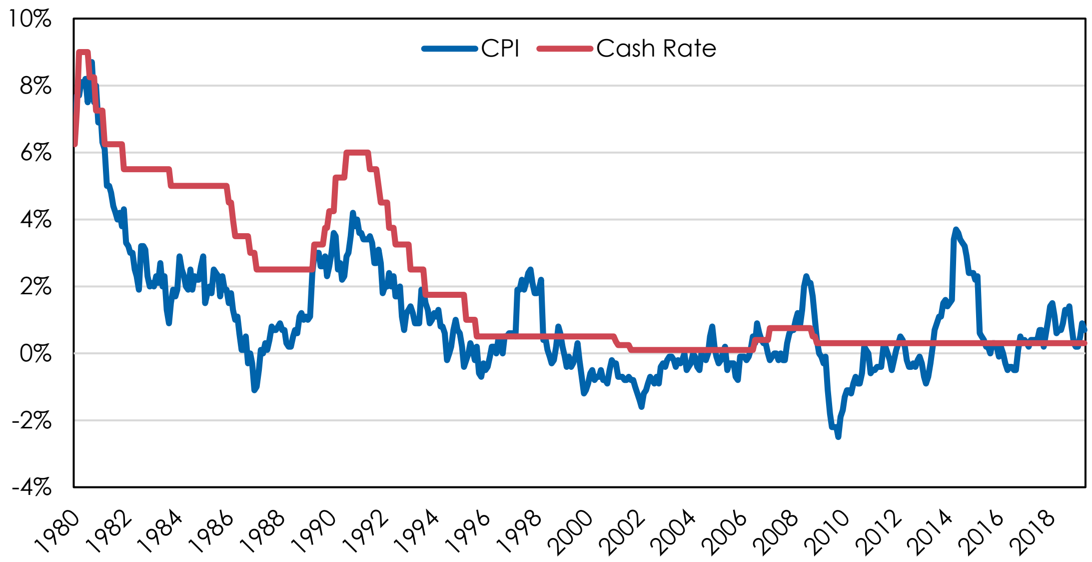
In normal market conditions, consumers make a trade-off between liquidity and yield. The cost of liquidity is lost earnings, so a rational consumer allocates savings to cash (for liquidity) and to short term government debt (for yield).

A liquidity trap happens when nominal interest rates are low or at zero. If interest rates are zero, there is no penalty for liquidity - in effect, cash and debt become perfect substitutes. Consumers are incentivised to save rather than borrow, because any increase in interest rates would see bond prices fall, a clear disincentive for investing in debt. Therefore, no matter what central banks do to monetary supply, consumers will not switch from cash to debt. In this scenario, monetary policy is rendered ineffective, unable to kickstart demand or increase prices.

Low inflation has also characterised Japan since the mid-1990s. Chart 3 below shows how low inflation - and, at times, deflation - has persisted despite interest rates going low and staying low. The only exception was in April 2014 when the consumption tax was increased to 8% (from 3%) and this is reflected by the spike in CPI at that time.

Low inflation (or worse, deflation) is bad for economies because it means low demand for goods and services. This means slower GDP growth and lower wages and ultimately an increased possibility of a recession. But high inflation is also bad, as significant price growth can also slow the economy and increase unemployment, also increasing the risk of recession. So central banks in developed economies have tended to target inflation rates around the 2-3 per cent mark.

Chart 3 – Inflation and interest rates in Japan 1980-2019



Sources: OECD, Bank of Japan, Whitehelm Advisers

So, we now know that Japan has been plagued by low growth and low inflation since the early 1990s – it has been stuck in a liquidity trap that it cannot seem to get out of.

Next we turn to the interventions of the Bank of Japan in trying to shift the economy out of this malaise, an extraordinary history of unconventional monetary policy that should serve as a cautionary tale to the Morrison Government in Australia and the rest of the world.

UNCONVENTIONAL MONETARY POLICY

Unconventional monetary policy can be thought of as what central banks do when their traditional levers – interest rates – are not proving effective in achieving policy objectives. There is evidence to suggest that monetary policy is less effective in a low interest rate environment, because there are economic headwinds anyway when interest rates are low but also due to the non-linear relationship between interest rates and economic activity.

The BoJ first acted unconventionally in 1999 by instigating zero interest rates and then followed up with quantitative easing (QE) from 2001. In both instances, the BoJ gave very clear signals that it was willing to continue these accommodative monetary measures for as long as they were needed. This practice of providing markets with comfort around the central bank's long-term strategy – by having well-defined targets for certain economic indicators, for instance inflation or unemployment - has become a key tenet of unconventional monetary policy around the world.

In 2010, the BoJ intervened in Japanese financial markets, purchasing Japanese government bonds (JGBs) and corporate bonds as well as exchange traded funds (ETFs). It significantly enlarged the scale of its asset buying in 2013 through a program known as Quantitative and Qualitative Easing (QQE) – effectively ramping up its purchasing of JGBs and ETFs in a bid to decrease long-term interest rates.

In 2016, the BoJ set interest rates below the zero-lower bound – that is, negative interest rates – in a further bid to tackle Japan's persistently low inflation. This was not an unprecedented move. Central banks in Switzerland, Sweden and Denmark had undertaken a negative interest rate policy in previous decades and years with some success. And the European Central Bank (ECB) ventured into negative interest rates in July 2014, as part of its unconventional monetary stance that has spanned much of this decade (starting with ECB President Mario Draghi's famous '*whatever it takes*' promise two years earlier).

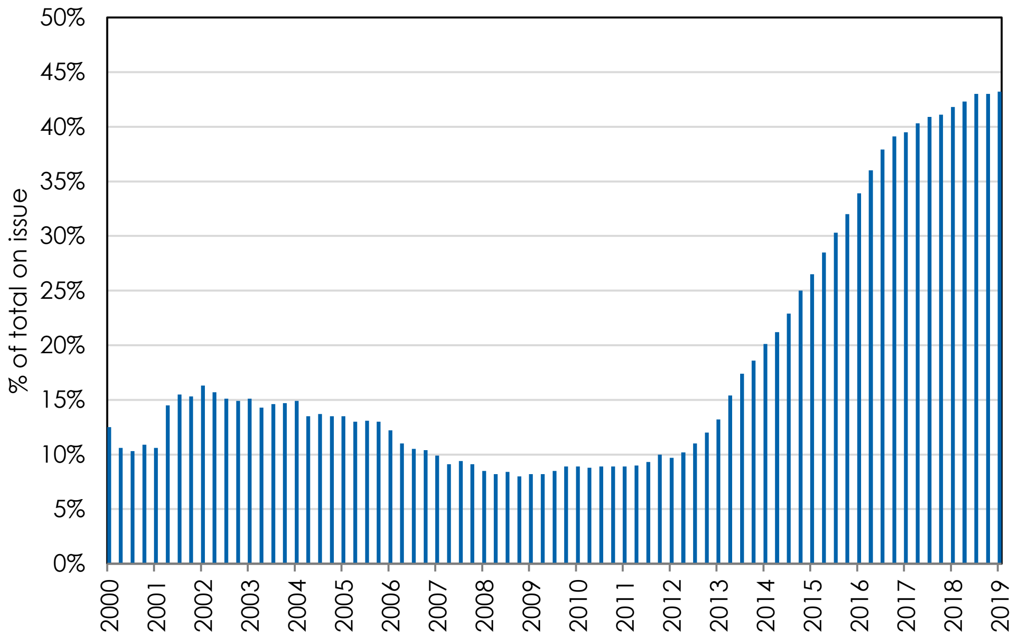
Negative interest rates seem counterintuitive. Literally, they mean borrowers are paid to borrow and savers are charged to save. But they make more sense when considering how banks would act when they were being charged interest on the deposits they hold with the central bank.

Banks would prefer to lend that money out to consumers and businesses, rather than pay to have it sit with in the central bank coffers. For this reason, negative interest rates should mean bank lending jumps, consumer spending and business investment increases and these factors combine to kickstart the economy. But a negative interest rate policy is not without costs – they can do significant damage to the banking sector by squeezing lending margins.

More recently, in late 2016, the BoJ targeted long-term interest rates through a yield curve control policy. The objective of this policy was to keep long-term interest rates at zero – the next step in the series of unconventional tactics thought to be necessary after the zero-lower bound of short-term rates was crossed. This long-term targeting aimed to steepen the yield curve (which was flat with negative short- and long-term interest rates).

So, the BoJ has been the pioneer of unconventional monetary policy and is now fundamentally embedded in Japan's financial markets. The central bank currently owns close to half of the total amount of JGBs on issue (see Chart 4). In addition, the BoJ owns more than 5% of the Tokyo Stock Exchange and has an annual ETF buying target of ¥6 trillion (close to A$80 billion).

Chart 4 – Japanese Government Bonds and T-Bills held by Bank of Japan



Source: Bloomberg, Whitehelm Advisers

What will the BoJ do next?

No doubt there is creative thinking going on inside the walls of Japan's central bank. But the central bank is in a real bind.

With an enormous balance sheet brimming with its own government bonds, eerily stable debt markets largely devoid of volatility, ETF exposure to the point where the BoJ features as a top five shareholder in 43% of Topix-500 Japanese companies[2] and interest rates below or at zero, there is still no significant upwards movement in the inflation rate. In fact, inflation remains well outside the 2% inflation target with core inflation of 0.8 per cent for the year to May 2019 (down from 0.9 per cent the previous month)[3].

Going further, the quantum of this entrenchment in Japanese debt and equity markets means any hint of a taper has the potential to shake markets to their core. Even more worrying is recent evidence that, on days when the Nikkei falls heavily in the morning, the BoJ will buy ETFs in the afternoon to stabilise the market.

Japan – the central bank and the Government as a whole – now faces two weighty questions. Firstly, what policy or intervention or exogenous factor will eventually break Japan's liquidity trap? And secondly, how and when will the BoJ disentangle itself from financial markets.

[2] According to CLSA via the ft.com. The TOPIX (or Tokyo Stock Price Index) tracks all companies on the First Section of the Tokyo Stock Exchange.

[3] Not including food prices

A NEW PARADIGM?

Is the world different now? It is dangerous to start thinking that tried and tested theories do not apply anymore because the world has structurally changed. But – bear with this idea for a moment – what if we are entering a world of lower forever where Japan is the frontrunner, but the world is following behind? Lower forever entails low interest rates, low inflation, low wage growth and lower regard for the risks of high leverage and debt. What if debt does not matter anymore?

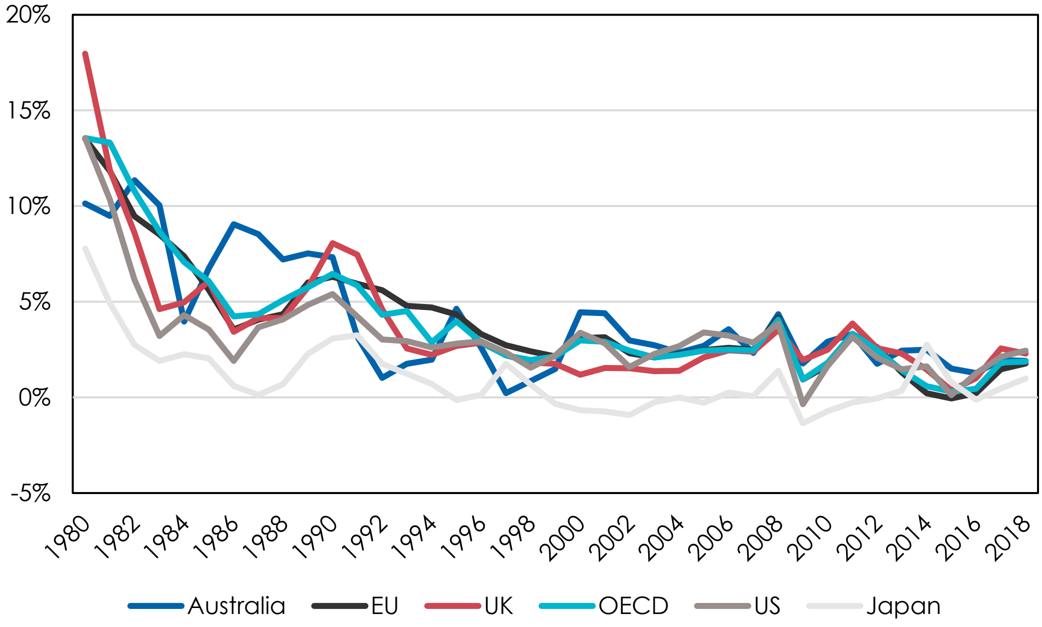
Modern monetary theory, or MMT as it is known, is a new buzz phrase being thrown around in these lower for longer times. Its central thesis is that the public sector in a modern advanced economy should never default on its sovereign debt in its domestic currency, no matter how big its outstanding debt or its budget deficit.

This is because the government can always instruct its central bank to print enough domestic banknotes to service or repay any quantity of public bonds that have been issued. Even in our disrupted world, this feels like a dangerous idea.

But what if it is just the case that Japan is just a few steps ahead of other developed economies, including Australia? This means lower for longer economic fundamentals and sustained central bank intervention but also changing demographics.

Japan is no longer alone in its battle against deflation and low inflation. Europe, the US and many other developed nations (including Australia, as elaborated on in the box below) are now experiencing persistent low-price growth, as shown in Figure x. There are several structural reasons for the recent phenomenon of persistently low inflation in developed countries, including globalisation, technological change and changing demographics.

Chart 5 – Comparing inflation amongst developed countries since 1980



Source: World Bank, Whitehelm Advisers

Retail prices in Australia

The RBA[4] identified that retail prices in Australia have actually declined since 2015, underpinned by increased competition and technological change. And this fits with the writer's own experience.

Foreign retailers have launched local websites with low shipping costs and easy returns policies. But this is not just restricted to the internet, with foreign retailers also setting up bricks and mortar stores – think Zara, H&M and Cos. While any seasoned shopper is excited to get access to these brands, local retailers have had to compete with their arrival and this has changed the mindset of local shoppers, who will not pay full price because there is sure to be a spend and save or 20% off knitwear sale coming soon. And the number one reason why these goods can be sold at lower prices is the low cost of labour in the countries where they are produced, including China, India and Bangladesh.

The internet makes it easier for consumers to make price comparisons. So, it is easy for shoppers to identify a desired item (possibly having examined it or tried it on instore) and then buy online at the lowest price. Or wait until the item inevitably goes on sale and buy it at the reduced cost. Anecdotal evidence suggests similar trends in supermarkets in recent years - pricing strategies by the major Australian chains include regular discounting and easy price comparison via their websites.

Further, technological advances have reduced the costs of electronic goods over time, with smart phones and tablets being the obvious example.

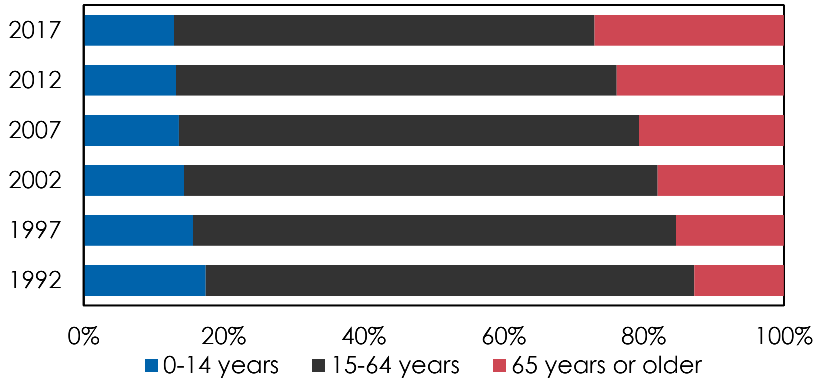
[4] https://www.rba.gov.au/speeches/2018/sp-dg-2018-08-22.html

Why an ageing population matters

Put simply, an ageing population drags down GDP. The labour force shrinks. There are less consumers buying goods and services (because typically older people spend less). And government spending on healthcare and welfare payments can increase, depending on the welfare structures in place.

Chart 6 below shows how Japan's demographics have changed since 1992, with the black section (representing the labour force and consumers) getting squeezed over time and the red component (the percentage of those aged 65 or older) becoming more dominant.

Chart 6 – How Japan's population has aged since 1992

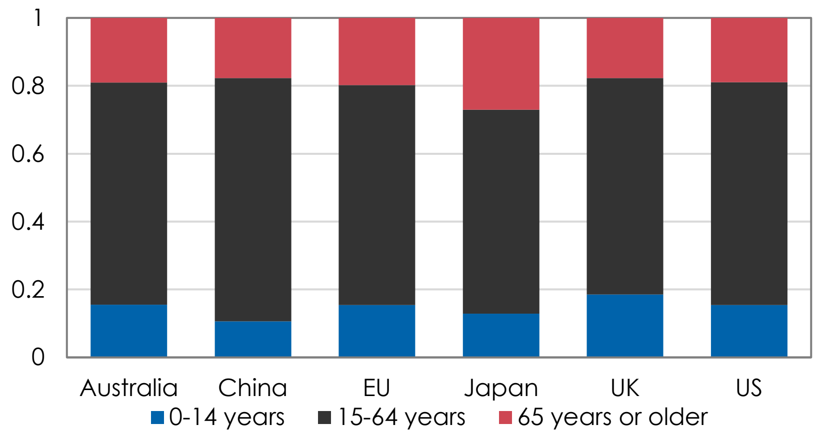


Source: World Bank, Whitehelm Advisers

Another aspect to this demographic timebomb is its ability to spiral. Young people who struggle to find stable employment or earn persistently low wages are less likely to buy a house or start a family. These decisions weaken the housing market, keep birth rates low and reduce overall consumer spending, reinforcing deflationary pressures as well as disenfranchising young people.

In 2017, 27% of the Japanese population was aged 65 years or older. This compares unfavourably with other nations, as shown in Chart 7.

Chart 7 – Comparing Japanese demographics to other major economies (2017)

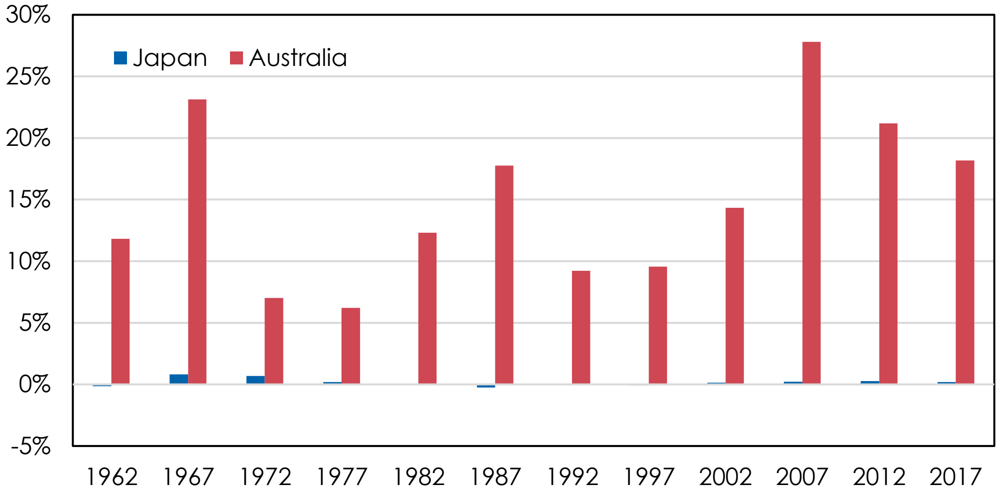


Source: World Bank, Whitehelm Advisers

There is also a stark difference between Australia and Japan in terms of net migration. Japan's net migration barely registers – never coming close to even one per cent - while Australia's demographics have been underpinned by migration, as shown in Chart 8.

However, whilst the proportion of Australians aged 65 years or over is much lower than in Japan, there is no doubt that the population is getting older. This is underpinned by Australia's falling birth rate and despite the healthy inflows of skilled, young migrants. This trend, common to many developed countries, has irrefutable implications for future economic growth.

Chart 8 – Australia and Japan's net migration (as a percentage of total population)



Source: World Bank, Whitehelm Advisers

FOLLOW THE LEADER .....

Japan's economic experience over the past 30 years has become known as Japanification. Up until the GFC, Japan was a case study, an outlier whose condition was not considered contagious. The BoJ was breaking new ground, using unconventional monetary policy to try to shift the malaise of persistent stagflation and low growth that characterised its economy since the property bubble burst. And economists in universities around the world were watching (but not too many others).

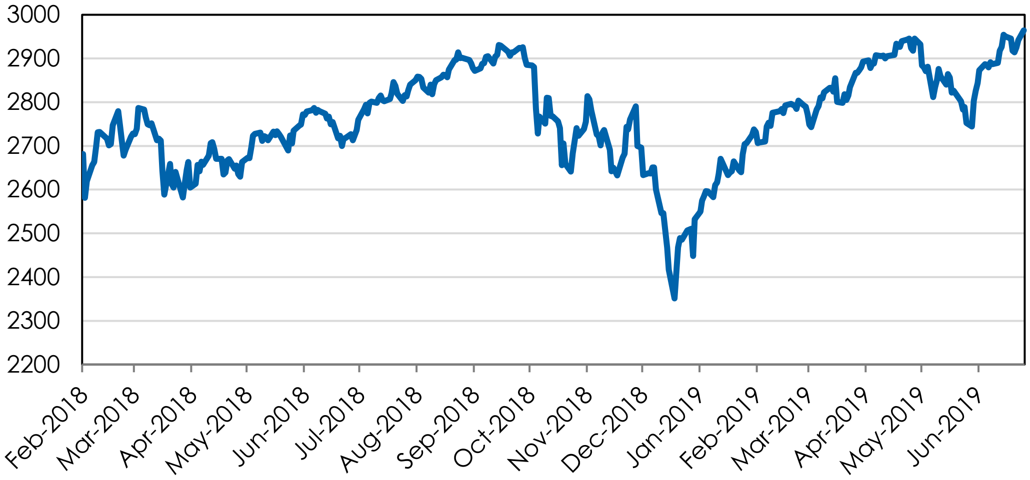
But then the GFC happened and other central banks, most notably the Fed and the ECB, waded into these unconventional policy responses. While the objective was short-term market support and liquidity to soften the effects of the worst credit crisis since the Great Depression, ten years on these central banks remain fundamentally emmeshed in global financial markets.

In 2013, then Federal Reserve Chairman Ben Bernanke signalled the beginning of the end of QE, saying the Fed would be reducing its purchase of debt securities. In response, markets had a so-called 'taper tantrum' with global bond yields jumping in fear at the prospect of lower central bank support.

Fast forward a few years to the 2018 appointment of now Federal Reserve Chairman Jerome Powell who immediately pledged a '*consistent, substantial roll-off this year and next year*', signalling to markets that under his stewardship the Fed would be normalising its balance sheet after almost a decade of quantitative easing. Markets expected that Chairman Powell would allow markets to function with more volatility than his predecessors and they seemed okay with this. The Fed raised rates four times throughout 2018, and signalled further increases lay ahead.

However, following the carnage in equity markets in the last quarter of calendar 2018, the Fed turned dovish, pledging to be 'patient' in light of 'cross-currents' including slower growth and uncertainties around trade, the government shutdown and Brexit. Markets rallied on this U-turn and have been on an upwards trajectory ever since (except for the Mexican tariff related blip in May) as shown in Chart 9. Now markets seem to have a lower regard for fundamentals, reacting more to central bank signals and actions.

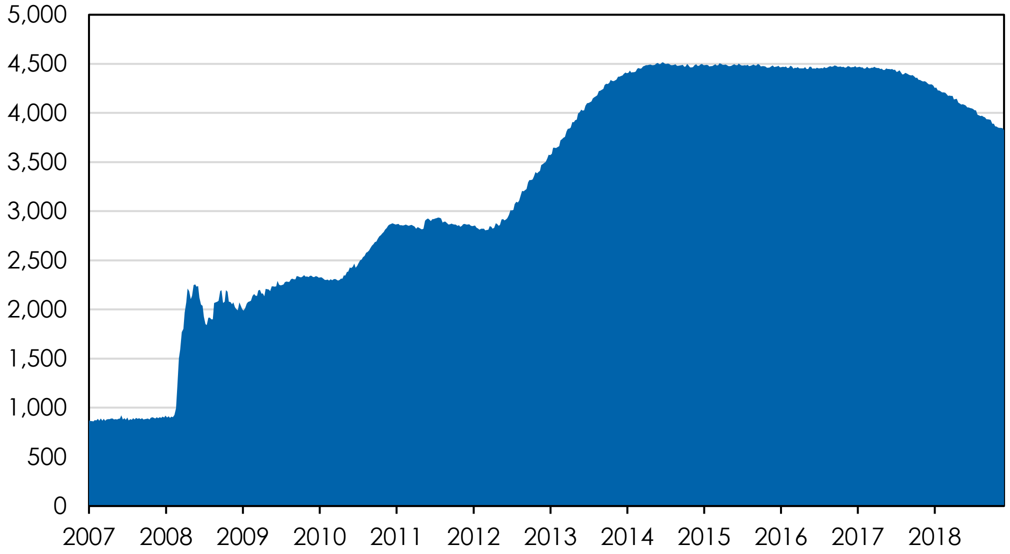
Chart 9 – The S&P500 since Jerome Powell's appointment as Chairman of the Federal Reserve



Source: Bloomberg, Whitehelm Advisers

However, there does seem to be more acceptance now in markets that the Fed will taper one day – or at least let bonds roll off the balance sheet as they mature. However, the Fed still has a balance sheet of close to US$4 trillion (or four and a half times its pre-GFC size) as shown in Figure x and its rhetoric remains supportive.

Chart 10 – Total assets of the Federal Reserve (US$ billions)

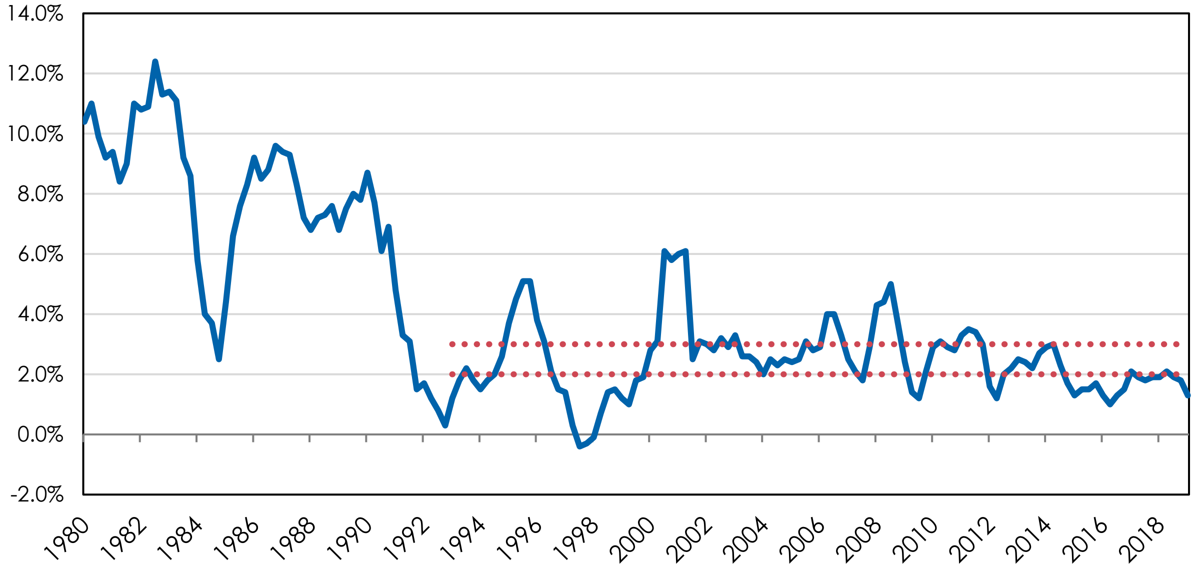


Source: Federal Reserve, Whitehelm Advisers

HOW AUSTRALIA IS DIFFERENT

Inflation has largely remained below the RBA's 2-3% target range since 2015, as shown in Chart 11. The RBA has responded to current economic conditions (including but not just low inflation) by using its conventional monetary policy lever – that is, by lowering the cash rate. The bank has considered this to be ammunition enough, mostly because the cash rate was still far enough from zero. But with two recent reductions taking the cash rate to its historic low point of 1.0%, the RBA's firepower is running out and speculation around the future need for unconventional policy is growing.

Chart 11 – Inflation in Australia since 1980 (including target inflation bracket since 1993)



Source: Reserve Bank of Australia, Whitehelm Advisers

Quantitative easing would not be unprecedented for Australia. The Australian Office of Financial Management (AOFM) undertook an asset purchasing program during and after the GFC, buying Australian registered mortgage backed securities to provide liquidity and market support. However, Australia has not undertaken a sustained, more broad-based QE programme in the same way as the US and EU. Just this month, RBA Governor Philip Lowe has signalled his distaste for QE, saying he thinks it is 'really quite unlikely we're going to have to go down that route.'

So, where Australia fundamentally differs from Japan (as well as the US and EU) is that our central bank has stuck to conventional monetary policy so far. It has not undertaken sustained QE, rates are not negative and, most importantly, the RBA has not become a major participant in financial markets.

The outlook for Australian investors depends on what the RBA does next. The central bank has clearly stated its current focus on getting the unemployment rate at or below 4.5 per cent (the May seasonally adjusted figure was 5.2%) so it seems likely that some other monetary policy tweak will come if the data doesn't change. And if that tweak takes the form of QE, investors can expect bond prices to fall (assuming debt securities are the focus of any asset purchasing program that the RBA undertakes).

Longer term sustained central bank entanglement in financial markets de-couples asset prices and economic fundamentals. This phenomenon already exists to some degree in Australian markets due to global contagion, but would likely become more pronounced in the unlikely event that the RBA followed the path of the BoJ, the Fed and the ECB in pursuing unconventional monetary policy.

More generally, investors in a lower for longer world should focus in on risk assessment. If expected returns across all asset classes have structurally adjusted down, investors can either engage in a chase for yield – thereby taking on a higher risk - or reduce return expectations to fit the new paradigm. For direct investment, accepting a lower return (somewhere above the risk-free rate but below historic returns for similar assets) for a quality asset makes good sense. The current danger for direct investors lies in paying top dollar for a lower quality asset in a bid to lock in a return reminiscent of a decade or more ago.

Where we are is good for infrastructure investors

The Morrison Government's 2019 Budget outlined infrastructure spending of A$100 billion over the next decade, with just under half of this spend happening in the next four years. As evidence builds that all is not well with the economy – pounded home by the 50-basis point drop in the cash rate over the past two RBA meetings – the case for bringing forward some of this spending forward is growing stronger.

This month, RBA Governor Lowe continued his advocacy for fiscal stimulus, saying that '*there are options other than monetary easing for putting us on a better path*[5]'. He went further in recent comments made at the ANU, saying '*increased spending on infrastructure and fiscal expansion in the current environment is going to be better than further monetary easing*[6]'.

So, it seems the RBA's preferences on where the next policy response should come from is clear. And the political rhetoric in Canberra, particularly from the Opposition, supports this. 'Shovel-ready' must be a candidate for the 2019 word of the year.

Fingers crossed Prime Minister Morrison can somehow fit a bigger and sooner infrastructure spend in with his seemingly immutable promise to deliver a budget surplus, ironically a contractionary fiscal stance made pre-election when the Coalitions line was that all was rosy. (Who can forget the new Treasurer Frydenberg's bolshy claim in April this year that '*the budget is back in the black and Australia is back on track*[7]').

This true believer thinks infrastructure investors will see new projects in Australia coming online sooner rather than later. Besides the obvious economic case for fiscal stimulus, the political reasons stack up too. Prime Minister Morrison has more authority now than any Australian PM since John Howard following the Coalition's surprise election win in May this year. And any pundit will tell you this sort of political capital does not last forever.

Now is the time for the Morrison Government to undertake some nation building, legacy creating reforms that might just continue Australia's enviable economic run. It has been a long time since the Hawke-Keating reforms of the 1980's, much discussed recently following the death of former Prime Minister Bob Hawke, who is revered as the father of Australia's current 28-year golden economic run. And with 30-year Australian Government bonds currently trading at under two per cent, the case becomes even more compelling.

---

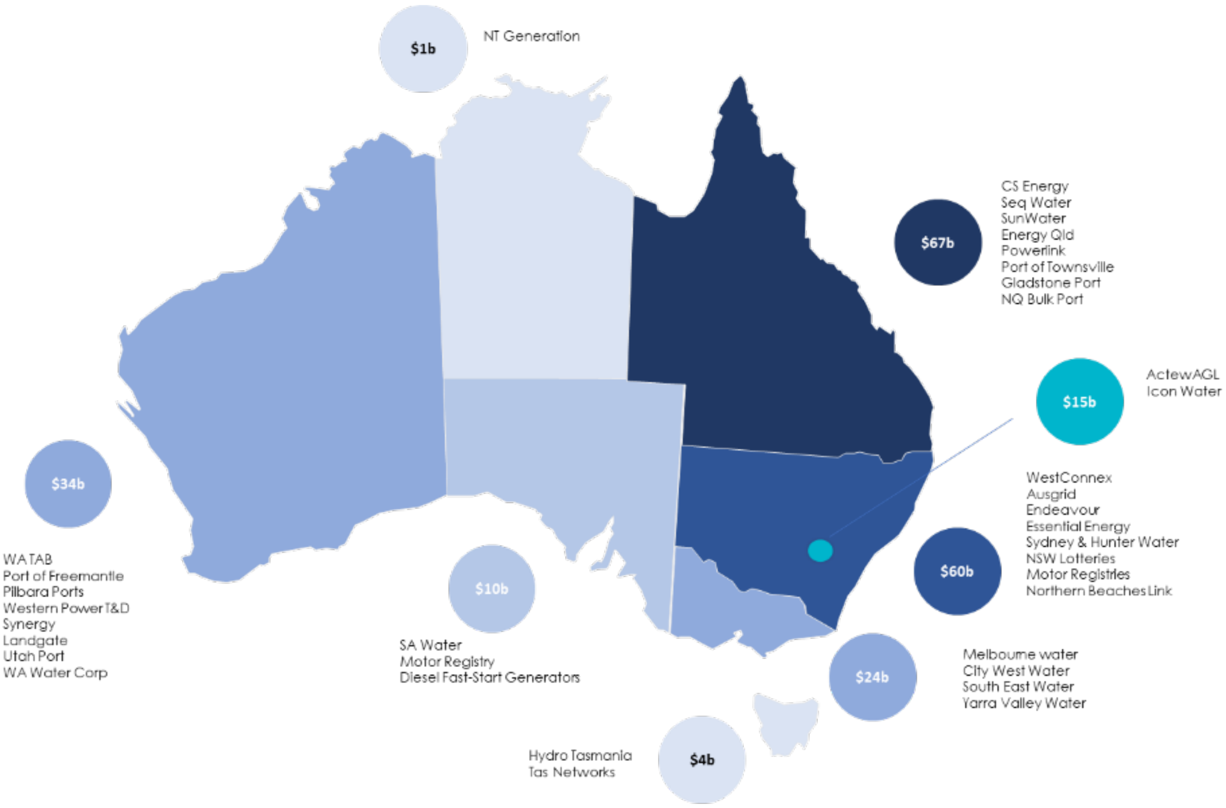
[5] https://www.rba.gov.au/speeches/2019/sp-gov-2019-07-02.html
6 https://webcasting.boardroom.media/broadcast/5d10153a1160886198366990

[7] http://jaf.ministers.treasury.gov.au/speech/002-2019/

Another wave of asset recycling?

Many investors in the Australian infrastructure sector have been advocating for the Australian federal government to reintroduce its 2014 asset recycling program, rewarding state governments that divested their public assets with a 15% federal contribution to fund future infrastructure projects in an effort increase jobs and productivity. Australian state governments have all laid out ambitious plans for capital works programs in their recent state budgets and as illustrated in figure x below have a sizeable war chest of assets that could be privatised to unlock capital for future infrastructure spending.

Chart 12 – State Assets that could be privatised for capital recycling



Source: Australian Financial Review

CONCLUSION

Australia is not Japan. But lower for longer economic indicators are characterising Australia right now – inflation below the RBA's preferred band, low economic growth and chronically low wage growth. If Australia was to start down the path of unconventional monetary policy, it risks becoming 'Japanified'. But the early signals out of Canberra suggest Australia will seek to avoid a liquidity trap by using fiscal stimulus now that monetary policy is approaching the end of its conventional showcase.

However, other developed economies who have employed unconventional monetary policy since the GFC may not be as lucky. Europe in particular risks Japanification as economic data remains flat and central banks remain embedded in markets with no near exit sign. The US is less easy to predict given the 2020 election and the prospect of more big fiscal spending as President Trump seeks re-election. But there is no doubt that the Fed remains dovish and thoughts of tapering are a distant 2018 memory.

Japan's unconventional monetary policies implemented over the past two decades are astonishing to consider. It is hard to imagine how the BoJ will disentangle themselves from financial markets without irreparably damaging the economy in the process. That the Japanese bond market now operates largely devoid of volatility and that price signals in the equities markets are concealed by regular central bank ETF purchases suggests that these markets will not function efficiently for the foreseeable future.

So, while the Japanese economy appears to be at the end of history.[8] Australia's is not. But clever policy and long term-ism in Canberra is needed to navigate the economy through a time of significant global headwinds. And infrastructure investors can expect to be the beneficiaries of the Australian economy's current need for fiscal stimulus. The bottom line? Lower for longer is now but probably won't turn into longer forever, at least in Australia.

[8] To borrow Francis Fukuyama's concept of direction - meaning Japan's economy is now in its final form.

Disclaimer