TEAM ABE CHALLENGES—INCOMES UP, SAVINGS UP, BUT INVESTMENT DOWN

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Japan's GDP report confirmed the de facto zero-growth status of the overall economy since the start of the new fiscal year (April 1). At the same time, the details of the report highlight several forces now in play that should affect forward-looking financial markets and policy makers. **Policy Mix Boosts Housing** Private residential investment shot up 5.0% quarter-over-quarter (25% annualized rate), by far the biggest contribution to growth. More importantly, this was the first positive growth quarter for housing since July–September last year. There can be little doubt that the trigger for this sharp positive snapback was pulled by the Bank of Japan (BOJ). After it adopted a negative rates policy at the end of January, mortgage rates dropped by record amounts: By mid-March, a 10-year fixed mortgage fell to 0.7%, down from 1.4% in December 2015. Make no mistake—BOJ policy does have a positive impact on residential investment and, by implication, residential real estate. Positive wealth effects via a sustained upturn in real estate in general, and residential property prices in particular, are poised to boost consumer confidence. Recall here that Japanese consumers have lived through with de-facto one- generation of home-price deflation. While the upturn may be too short-lived to turn around home-price inflation expectations, the fact that BOJ action did almost instantly feed a positive turnaround should allow for further progress in the battle against the deflation mindset for homes and property, in our view. **High Marks for Team Abe—Sound Countercyclical Demand Management** In general, the GDP report sends a very positive note on the countercyclical effectiveness of Japanese policy making. In addition to timely monetary policy, fiscal policy was also eased with great effect: Public investment boosted GDP by an annualized 9.5% in the April–June quarter. This was due to the "front-loading" of public works projects Prime Minister Shinzo Abe ordered in mid-February. In short, without the BOJ-induced boost to housing and the front-loading-induced boost to public demand, the economy would have contracted by about 1.5% to 2% (annualized), in our view. So to give praise where praise is due, "Team Abe" deserves high marks for effective short-term countercyclical management of the economy. **Low Marks for Team Abe—No Business Investment, No Sustainable Growth** Unfortunately, the GDP report also confirms the de-facto ineffectiveness of "Abenomics" to positively incentivize private corporations, and thus Japan's secular growth potential. The overall response from the business and corporate sector to Abenomics remains negative. Business investment fell for a second consecutive quarter, down 1.5% annualized in the April–June period. Moreover, we know from several leading indicators, such as machinery orders and corporate loan growth, that the outlook for business investment remains negative. This is troubling for several reasons. First of all, business investment is the absolute necessary condition to bring about an improved potential growth rate. Without private capitalists and risk takers investing in more productive and better factories, offices, hospitals, logistics centers, trucks, IT centers, etc., the capacity of Japan to generate growth and competitiveness cannot rise. Without a pickup in corporate private investment, Abenomics will fail. Second, Japan's policy mix continues to fail to trigger a positive investment response from corporations. In spite of a cut in corporate taxes (effective this year) and record declines in the cost of debt, corporations continue to cut back both domestic investment and balance sheet leverage. Call it "pushing on a string" or "balance sheet recession" or "secular stagnation" or "a post-industrial trap" or whatever else—the reality remains that policy makers appear to be without tools to encourage a sustained domestic capex cycle. Of course, Team Abe is fully aware of this conundrum and has decided to try a new and more aggressive tack—public investment and fiscal policy will be eased aggressively to help "prime the pump" and show the way for private investment to follow. The fiscal package ratified by the cabinet on August 2 is expected to ensure that public demand boosts aggregate demand by about 0.8% to 1.0% over the coming 15–24 months. Whether this renewed commitment to fiscal stimulus can deliver positive multipliers for private investment—and thus an uptick in potential growth—remains to be seen, in our view. To become more optimistic, we would want to see a more aggressive and decisive commitment to deregulation and privatization, as well as concrete incentives for companies to sell off noncore businesses and subsidiaries. The latter is particularly important, in our view, as the dominance of multilayered and overly complex business models de-facto forces a "conglomerate discount" on the valuation multiples of many listed companies in Japan. **Incomes Up – But NO to Consumption and YES to Savings** The key force driving Japanese consumer spending – or lack thereof – is the relentless up-turn in consumer savings. Workers' total compensation has been rising faster than consumer spending every quarter since July–September 2014. Between then and April–June 2016, total compensation was up by ¥9.5 trillion (a 3.7% rise), but consumer spending was up only ¥1.5 trillion (a 0.1% rise). Make no mistake—Japan's consumer spending is weak NOT because wages and employment are not growing, but because consumers are increasing savings (i.e., increasing their precautionary balances). While the upturn in residential property investment is a clear bright spot, from an economist's perspective, the overall rising gap between incomes growing and spending slowing is a clear vote of no confidence from households. To be specific, contrary to general commentary on weak labor markets, the GDP report is very clear in demonstrating that the tight labor market is actually delivering consistent income growth for workers. Workers' total compensation—wages plus employment—rose 0.3% QOQ (1.5% annualized) in the April–June quarter. More importantly, this best indicator of workers' purchasing power has been rising consistently—up for 11 consecutive quarters in nominal terms and up for eight consecutive quarters in real terms. In fact, this is the longest consecutive positive growth in workers' compensation since 1996, when Japan implemented radical labor market reform that allowed part-time employment across all industries. Recently, the BOJ has done some outstanding work that demonstrates possible underestimation of GDP-based consumer spending.[1] So it is possible that the gap between rising household purchasing power and actual spending may not be as large as suggested from the current GDP report. However, the main message for Team Abe remains the same: Japanese households are benefitting from the very positive demand-supply conditions in the labor market. The purchasing power of the people is rising—up 3.7% in the last year and a half for its strongest growth in 20 years—but the people are opting to save rather than spend, which must be due to growing fears over the future. While there are many reasons to be worried about the future, policy makers should respond to this rise in the savings rate by stepping up reform efforts to build a more credible and sustainable pension and healthcare system, as well as deliver a believable plan for overall fiscal sustainability. Team Abe is under pressure to deliver a full and credible entitlement reform program, in our view. In addition, given the negative interest rate parameters, there should be a greater effort by policy makers to incentivize Japan's financial services industry to create and deliver more transparent and more cost-efficient investment products to the Japanese people. Without a push toward a more dynamic and end-user-focused financial services industry, the vast majority of the newfound household savings boom could just end up in zero-interest-bearing deposits, in our view. **Bottom Line: More Policy Coordination but No More Action by BOJ Alone** Financial markets remain, as always, obsessed with the question of what all this means for central bank policy. In our view, the message is very clear: Yes, BOJ policy still can—and does—deliver positive impact, especially in the housing market. To broaden the base of this impact out to corporations, BOJ policy alone cannot deliver. More specific tools are needed to get companies to reinvest here in Japan—incentives for new investment and deregulation and privatization, as well as penalties for keeping underutilized assets and "zombie divisions" are needed, in our view. For the September BOJ policy review, this suggests an asymmetric risk—no major added action should be expected, other than more pressure on Team Abe to deliver credible investment and pro-growth strategies. [1]Source: Fujiwara and Ogawa, BOJ Working Paper No. 16-J-9, 7/16.

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DEFINITIONS

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Negative interest rates : Usually borrowers make regular interest payments to their lenders for the money they owe. Under a system of negative interest rates this relationship would be reversed and the lender would pay the borrower for the privilege of lending.

Deflation : The opposite of inflation, characterized by falling price levels.

Inflation : Characterized by rising price levels.

Abenomics : Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Capex : Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Zombie Companies : A term used for companies that are operating in debt, near bankruptcy.