MORE NOTES FROM JAPAN ON INFLATION, THE YEN AND TAX POLICIES

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08/13/2013

I have written about my recent trip to Japan and discussed some takeaways from my conversations with investors on politics and monetary policy. Japan's economy grew slightly less than expected in this latest 2nd quarter, but still I believe the early indicators of economic data show that Abenomics has been working and is having a real impact on Japan's economy and inflation trends. I want to expand on this with anecdotes relating to this fight against deflation, thoughts on the yen moves and the implications of a key debate over the timing of a potential consumption tax increase. **Inflation Indicators Rising** One currency strategist told me he is starting to see inflation pop up in his everyday life. For instance, his barber raised prices on his haircut for the first time in memory—and of course apologized profusely that he had to do it. Raising prices is a foreign concept to many in Japan, and they are just remembering how to do this—as the barber's deeply apologetic approach showed. Another investor quipped, "If" people believe there will be inflation, there will be inflation." Central to what Abe and the Bank of Japan are attempting is the idea of re-anchoring expectations for future inflation. As inflation expectations change, a self-reinforcing feedback loop is initiated that helps cement those changes. Consumers begin to believe prices will rise in the future, so they go out and consume more today. This higher consumption and demand puts pressure on prices to rise, leading to inflation. As companies benefit from the increased demand, employees get wage increases that in turn support a further rise in inflation. This self-reinforcing feedback mechanism appears to have been set in motion. The recent inflation reading of +0.4%[1] is a sign of progress for a country that has experienced deflationary forces for well over a decade. One factor underpinning some of the inflation has been a weakening yen—given imports of commodities such as oil that are priced in U.S. dollars. And I see this trend of yen weakness continuing. **The Bank of Japan and the Yen** With its monetary policies, the Bank of Japan (BOJ) is clearly becoming one of the most aggressive central banks in the world. The BOJ balance sheet is expected to triple based on the bank's currently announced program to double the monetary base over the next two years.[2] This balance sheet expansion will be occurring predominantly during a time when the U.S. Federal Reserve is expected to slow its bond-buying program and its own balance sheet expansion. This change in the relative expansion of central bank balance sheets between the U.S. and Japan has the potential to weaken the yen against the U.S. dollar. Many people I spoke with in Japan would not be surprised to see the yen reach 110–120 against the U.S. dollar over the course of the next two years. This is a level for the yen I have often discussed as a potential target, given it was trading at these levels back in 2007, before the financial crisis really began, and I have already seen the U.S. financial markets return to their pre-crisis levels. The BOJ would likely be uncomfortable with a short-term spike to 120. But a gradual depreciation of the yen to that level should be less of an issue. I believe this gradual depreciation of the yen is the BOJ's ultimate desired outcome. The higher U.S. interest rates go—essentially meaning that Japan is pursuing a more aggressive monetary policy than the U.S.—the more likely the yen is to depreciate further over time. **2014 Consumption Tax Increase—Hinged upon Strong Growth but Likely** Many commentators are focusing on the expected consumption tax increase scheduled to come into effect in April 2014. This is a key tax policy that Japanese policy makers have discussed to raise revenue and help close the country's large fiscal spending deficits. This tax issue is a stress test for Abe to see how he can manage the complex dynamics of a policy that can improve Japan's fiscal position yet also have a negative impact by making goods more expensive and slowing down the progress he's made on his goal of raising economic growth. Abe has said the implementation of this tax hike depends on market conditions. One investment strategist I spoke with suggested that each 1% increase on the consumption tax only raises an additional 2 trillion yen (a small percentage of the deficit Japan needs to make up), and he believes there is a strong bias toward postponing the tax increase. Japan's second-quarter gross domestic product (GDP) numbers came in at 2.6%, a percentage point less than 3.6% expected. The Bank of Japan leaders have made statements that they believe the consumption tax could be implemented at the same time of achieving their goals of ending deflation. When I left Japan, I felt it was a high probability event for the consumption tax to be implemented as expected in April. But this week's 2nd quarter GDP report may give support to those who want to delay its implementation. We shall learn more in September and October what Abe has planned. **Market Forces** It is still early days for Abenomics, and the initial readings are just starting to come in on how the new economic policies are starting to impact the bottom lines of corporations and consumers. As we get further into the third arrow of Abenomics—the growth strategies—I think we may well be positively surprised by the agenda items Abe tackles. Abe has been bold thus far, and he cannot back down—especially when it comes to labor market policies and countermeasures to Japan's declining population trends and declining work force. [1]Source: Ben McLannahan, "Japan Posts Highest Inflation Rate since 2008," FT.com, July 26, 2013. [2]Source: Bank of Japan.

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DEFINITIONS

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.

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

Consumption tax : Tax applied to spending on goods and services.

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