

Beyond the Bank of Japan: Fiscal Woes to Keep the Yen Weak

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The yen is poised to remain a structurally weak currency. In coming weeks, yen volatility is expected to rise as short-term market players position for potential changes in central bank policy. Here we maintain our call for added ease from the Bank of Japan (BOJ) to be in place by the end of the November 18–19 policy board meeting. More importantly, beyond this short-term outlook, the case for a continued structural depreciation in the yen remains strong because of the dismal outlook for Japanese government finances, in our view. **Immediate Focus—Will They or Won't They?** The BOJ will hold two policy board meetings in the coming four weeks. The first is a one-day meeting on October 30. The second is a regular two-day meeting on November 18 and 19. For October 30, the main agenda item is the semiannual revision in the board members' "central tendency forecast" for inflation and growth. The November 18–19 meeting will follow the release of the July–September gross domestic product (GDP) report on November 16. Expect more pundit commentary and jockeying for market positioning in the run-up to these dates. In our view, added ease is likely at either the October or November meetings. Our rationale here is not primarily the continued weakness in Japanese domestic economic indicators—industrial production fell to 1.4% below the April–June quarterly average in July and August, following a sharp 2.8% drop in April–June from the January–March average. The real reason is political: Prime Minister Shinzo Abe and his team are very focused on reasserting a coordinated pro-growth policy drive. In our view, a switch in BOJ priorities from de facto Consumer Price Index (CPI) targeting toward targeting nominal GDP—that is, the BOJ explicitly falling in line with Abe's new ¥600 trillion target for Japan's nominal GDP (currently approximately ¥500 trillion)—is possible. Of course, merely changing the target from 2% inflation to ¥600 trillion nominal GDP will not do much in itself. An increase in BOJ asset purchases is likely, in our view, centering on both exchange-traded funds (ETFs) and adding municipal, regional and "zaito" government bonds to the BOJ's bond buying options (which are currently limited to national government debt only). If so, the short-term case for added yen depreciation rests on this added quantitative ease. **Structural Focus—Fiscal Unsustainability** The more medium-term case for yen depreciation rests on more fundamental economic grounds: Japan's fiscal dynamics appear locked in a vicious cycle of endless budget deficits running around 2% to 5% of GDP in the foreseeable future. Why? To understand Japanese government finances, we have looked at the past 35 years of data on both expenditures and revenues as a share in nominal GDP (see table below). This historic perspective shows that increasingly heroic assumptions are needed to escape from permanent deficit financing. Specifically, over the past 35 years, total expenditures exceeded revenues by an average of 5.1% of GDP, with expenditures averaging 18.1% of GDP and revenues 13.0%. **Japan's Fiscal Realities**

Budget		Average	High	Low
Total Expenditures		18.1%	22.6%	13.8%
	Social Welfare	4.5%	6.3%	3.0%
	Local Transfers	3.5%	4.1%	2.6%
	Others	8.8%	10.1%	7.2%
	Debt Services	1.3%	2.1%	1.0%
Revenues		13.0%	16.7%	7.7%
	Income Tax	4.6%	5.8%	2.7%
	Corporate Tax	3.5%	4.8%	1.3%
	Consumption Tax	2.0%	2.2%	1.8%
	Others	2.9%	3.7%	1.9%

Source: Japan Ministry of Finance, 1980–2014.

To understand the difficulty of getting back to a budget surplus, look at the “high” and the “low” of both spending and revenues. Expenditures peaked at 22.6% of GDP and troughed at 13.8%, while revenues peaked at 16.7% and bottomed at 7.7% of GDP. So to get toward a budget surplus, spending would have to be cut back to within 1 percentage point of GDP to the historic low, while revenues would have to rise to within 1 percentage point of the historic high. Given the realpolitik on both the expenditure and revenue sides, these seem like increasingly heroic assumptions, in our view. In other words, prospects are for the budget deficit to remain within 2% to 5% of GDP in the foreseeable future. **Japan’s “Twin Deficit” to Keep the Yen Weak** Japan thus faces the combination of both a “perma-deficit” from the government and a structural deficit from the household sector (which is dictated by the demographics—that is, the aging society forcing dis-savings and a negative savings rate currently running at around 1.5% of GDP). The net result is an economy that must attract global capital to fund its domestic savings deficit. The necessary adjustment could come via higher interest rates or a weaker currency. In our view, the BOJ is poised to maintain its iron grip on interest rates in general, Japanese government bond (JGB) yield in particular—we do not want to fight the BOJ. In turn, we do expect that the currency will bear the brunt of the adjustment. Japan’s “twin deficits” of both the public and household sectors argue that global investors should hedge their Japan asset exposure, in our view.

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Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but can hurt when the foreign currency appreciates against the U.S. dollar.