Shane Oliver, Head of Investment Strategy & Chief Economist

AMP CAPITAL

Japanese reflation

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Key points

- While it likely still has more to do, the Bank of Japan is on a path towards major policy reflation for the Japanese economy.
- This is likely to see further downwards pressure on the yen and strong gains in Japanese shares.
- It is also positive for the global economy as Japan will likely no longer be a drag on global growth going forward.
- While Japanese monetary reflation adds to upwards pressure on the Australian dollar, a stronger Japan will be positive for Australia overall as it remains our second biggest export market.

Introduction

The announcement that the Bank of Japan (BoJ) is raising its inflation target to 2% and adopting open-ended quantitative easing is very positive.

Options for further fiscal stimulus in Japan are severely limited by an already world beating budget deficit and public debt levels. Currently, the budget deficit is running around 10% of gross domestic product (GDP) and net public debt is around 135% of GDP compared to 73% in Europe and 84% in the US. Half-hearted monetary stimulus from the BoJ has played a major role in driving the deflationary malaise the Japanese economy has been in for the past two decades. So, apart from structural reform, it is really all up to monetary policy in Japan to pull the economy out of its long-term malaise.

The BoJ's move reflects ongoing pressure from the new Japanese Government under Prime Minister (PM) Abe, which received a resounding mandate to reflate the economy at last December's election. This is now resulting in aggressive action from the BoJ and highlights that Japanese economic policy is undergoing a dramatic turn for the better. Key to this change is PM Abe's comment that the Japanese economy is not going to change "unless we display a firm commitment to escape deflation."

While some quibble that the pressure from the new government has violated the BoJ's independence I view this as entirely appropriate. Central bank independence should be conditional on the central bank achieving stable prices and thereby contributing to economic growth and full employment. However, the BoJ has failed in this regard overseeing years of chronic price deflation. As such, it is entirely appropriate that the Japanese Government intervene to refocus the BoJ on achieving an inflation objective.

More to do

The big news from the BoJ was its adoption of an official 'target' of 2% inflation agreed with the government. This is a far more substantive commitment than its previous 'goal' of 1% inflation.

Having boosted its monthly asset purchase program (basically buying government bonds and other assets using printed money) for 2013 to levels that matched the US Federal Reserve at its December meeting, it also announced the program would become open ended starting in 2014 with ¥13 trillion in asset purchases a month.

On the downside though, with no increase in the size of its 2013 program and the 2014 program focused on short-term bills and likely to be diluted by redemptions, the BoJ will probably still need to do more if it is to achieve its 2% inflation target.

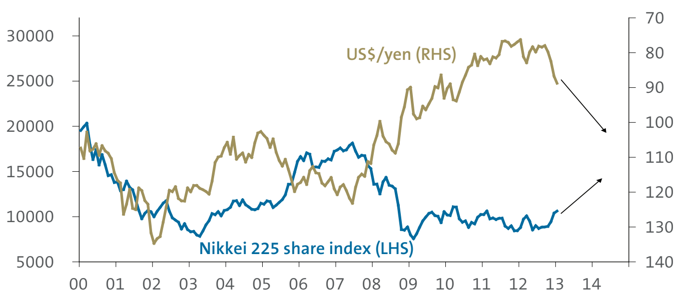
However, the move by the BoJ should be seen as another step along the way to much more aggressive policy reflation. The first step was the big expansion of its quantitative easing program at its December meeting. This has now been followed by the adoption of a firm 2% inflation target. Further easing is likely once a new more dovish BoJ governor takes over in April and finds that he has little choice but to further ramp up quantitative easing if the agreed inflation target is to be met.

Global implications

The adoption of aggressive monetary reflation in Japan aimed at exiting deflation has a number of mostly positive implications globally:

- The Japanese yen is likely to fall another 10-20%, after the current short-term correction runs its course. This would take it to around ¥105 against the US dollar and to around ¥110 against the Australin dollar (just surpassing its 2007 high of ¥107.8). Such a fall in the yen will be necessary if Japan is to achieve its 2% inflation target in the next few years and this in turn means that Japan will need to continue its open-ended quantitative easing for quite some time.
- Japanese shares are likely to perform well. A 30% or so gain is feasible this year. As can be seen in the next chart the relationship between value of the yen and the Japanese share market has been inverse over the last ten years, so a weaker yen will provide a big boost to Japanese shares. This largely occurs because a weaker yen provides a huge boost to Japanese exporters.

Japanese shares likely to rise further as yen falls further



Source: Bloomberg, AMP Capital

- A stronger Japanese economy helped by a weaker yen and an end to deflationary expectations.
- Japan will no longer be a drag on global economic growth.
- Easier monetary policies in Japan will add to ultra easy global monetary conditions.
- Yen weakness will put more pressure on competitor countries, notably Korea and Taiwan, which may in turn put more pressure on their central banks to further ease policy too.
- Aggressive easing from the BoJ adds further fuel to the global carry trade of borrowing cheap in Japan and investing in higher yielding currencies like the Australian dollar.

While the immediate reaction to the BoJ's announcement has been for Japanese shares to fall a bit and the yen to rise this looks like a classic example of short-term profit taking after the strong moves in both markets over the past few months. As the pace of BoJ easing continues and probably steps up the rising trend in Japanese shares and falling trend in the yen will likely resume.

Concluding comments

Japan takes 19% of Australia's exports and is our second largest trading partner, so notwithstanding the risk of more upwards pressure on the Australian dollar, an exit from deflation and stronger growth in Japan will be positive news for Australia.

This year has already seen a number of positive developments for the global economy, including: the avoidance of the fiscal cliff in the US; indications that the US debt ceiling will be extended; the relaxation of the Basel bank liquidity requirements; and solid data releases from the US and China. Aggressive Japanese policy reflation just adds to this list. As such it's little wonder that share markets have started the year on a strong note.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital

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