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PICTET WEALTH MANAGEMENT

Is Japan finally at an inflection point?

The economy could become structurally different if current trends are sustained

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SUMMARY

- After more than two decades of sluggish growth and deflation or very low inflation, there are signs that the Japanese economy may be finally reaching an inflection point, with a number of structural changes under way.
- External shocks due to the pandemic and the Russia-Ukraine war seem to have led to real changes in corporations' price- and wage-setting behaviour, which may support a more sustained inflation outlook in Japan.
- Given Japan's status as a US ally and its strength in some high-tech sectors, it could benefit from the on-going global supply-chain reshuffling against the backdrop of rising US-China tensions. The trend of "friend-shoring" and the Japanese government's financial support may attract more corporate investment to Japan.
- At the micro level, Japanese corporate profits have grown substantially since the mid-2010s, while labour productivity is also showing signs of improving. In addition, recent new initiatives by the Tokyo Stock Exchange to address listed companies' low valuations will likely enhance both management quality and capital efficiency.
- If sustained, recent increases in employee compensation and corporate capital investment could lead to a Japan that is structurally different from the past few decades.

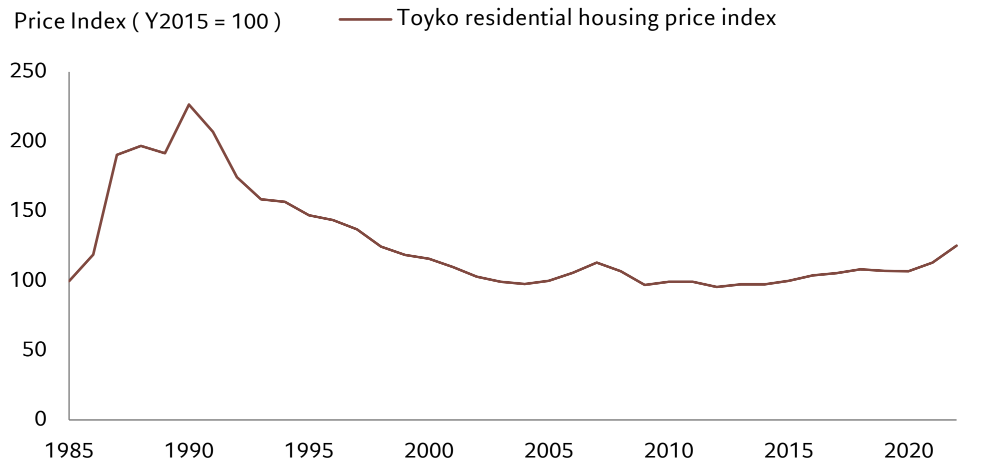
FROM 'ECONOMIC MIRACLE' TO THE 'LOST DECADE'

Rapid industrial growth in Japan post World War II led to an 'economic miracle' that was accompanied by a swift and substantial rise in asset prices since the 1980s. For example, Tokyo residential housing prices rose by an annual average of 25.4% during 1985-1990, while the Tokyo Stock Price Index (TOPIX) peaked at nearly 2,900 in late 1989, a rise of 215% from 1985. At its peak, the TOPIX index represented more than half of the entire world's equity market capitalisation. Japanese banks alone made up half of the TOPIX's market cap.

The massive asset bubble burst in 1990, bringing huge losses in asset values. The TOPIX index did not really find a bottom until 2022, by which stage it was down 76% from its late-1989 high. Residential real estate prices in Tokyo plummeted and continued to fall for two decades before stabilising in the mid-2000s at a level similar to 1985 *(Chart 1).*

The collapse in asset values left many asset owners' balance sheets deeply in the red. In other words, while the liabilities they incurred during the bubble days remained on their books at face value, the massive drop in values pushed balance sheets into negative equity territory.

Chart 1: Tokyo residential housing price index (Y2015 = 100)



Source: Pictet Wealth Management, Organization for Economic Cooperation and Development (OECD), as of 31.07.2023

In the following decade, the Japanese economy fell into a so-called "balance sheet recession"—a term coined by economist Richard Koo to describe a situation in which households and businesses prioritise debt minimisation over profit maximisation in order to repair their balance sheets. Indebted Japanese corporations that were still able to maintain positive cash flows opted to pay down their debt as quickly as possible. Households also attempted to rebuild their savings. They also cut down purchases of all kinds and refrained from taking on new debt. With both the corporate and household sectors turning into net savers and refusing to borrow, the economy lost growth momentum. Consequently, from roughly around 1991 to 2001, commonly referred to as the 'lost decade', the Japanese economy suffered sluggish growth and deflation.

OUT OF THE SHADOW OF BALANCE SHEET RECESSION

By the mid-2000s, after years of deleveraging, the debt-to-GDP ratio for Japan's private sector (non-financial corporates and households combined) dropped to around 160%, significantly below the peak of around 220% in the early 1990s. Over the same period, the public debt-to-GDP ratio rose substantially—to about 170% from less than 130% *(Chart 2).*

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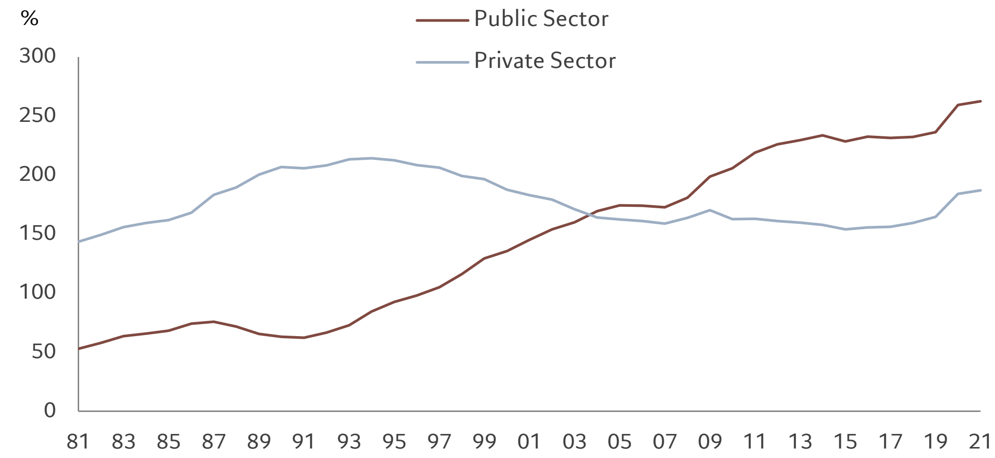
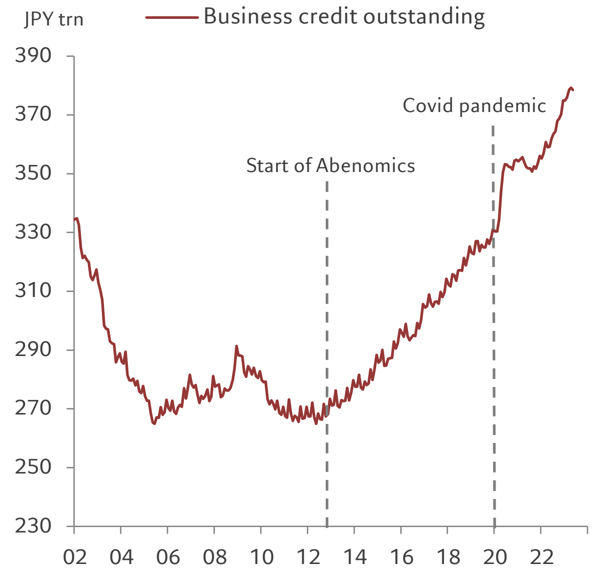
Chart 2: Japan's debt-to-GDP ratios for the public and the private sector



Source: Pictet Wealth Management, Bloomberg Finance L.P., International Monetary Fund (IMF), as of 31.07.2023

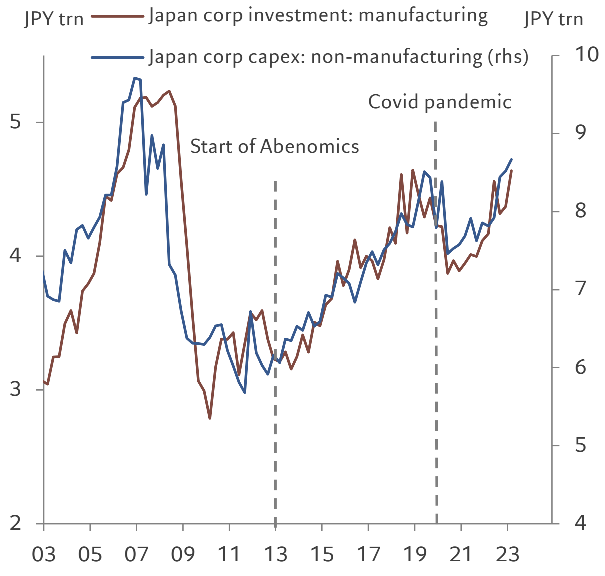
However, the balance sheet recession left a long-lasting scar on Japan, and external shocks (such as the Global Financial Crisis of 2008-2009) added to the woes. The debt-to-GDP ratio for Japan's private sector did not stop dropping until the mid-2010s, despite ultra-low interest rates. Japanese firms finally began to borrow again after 2013. Corporate capital investment also started to pick up around the same time *(Charts 3A & 3B).* It's worth noting that these developments coincided with the launch of so-called "Abenomics" in 2013. The "three arrows" of Abenomics (monetary easing by the Bank of Japan (BoJ), fiscal stimulus through government spending and structural reforms) may have helped to lift corporate confidence.

Chart 3A: Outstanding business credit in Japan



Source: Pictet Wealth Management, Bloomberg Finance L.P., Bank of Japan, as of 31.07.2023

Chart 3B: Japanese corporate capital expenditure



Source: Pictet Wealth Management, Bloomberg Finance L.P., Japanese Ministry of Finance, as of 31.07.2023

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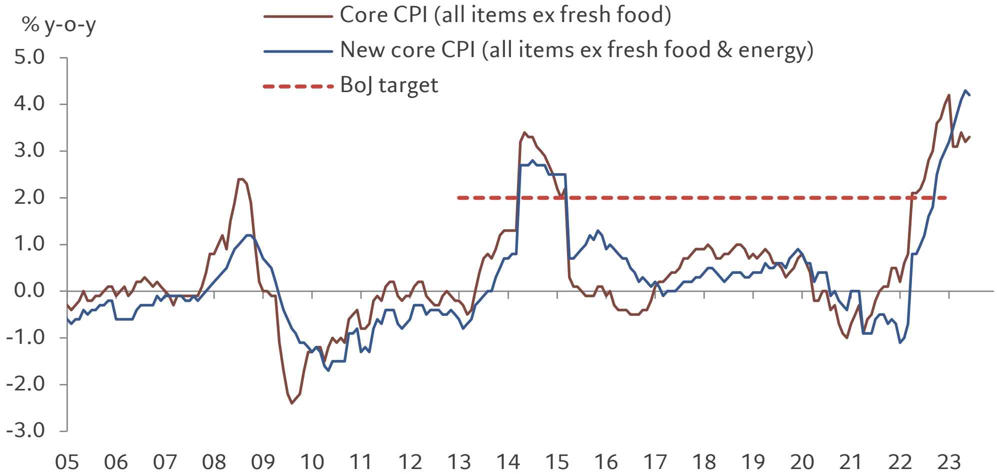
FIGHTING DEFLATION – LIGHT AT THE END OF THE TUNNEL

However, the BoJ's monetary easing alone did not manage to pull the Japanese economy out of low inflation. Japanese inflation continued to stay well below the BoJ's target of 2% for almost another decade despite arguably the most aggressive monetary easing of any major central bank (judged by the size of the BoJ's balance sheet expansion relative to GDP).

But inflation has risen since mid-2021—initially due to the supply-chain disruptions caused by the pandemic and the surge in energy prices due to the Russia-Ukraine war. In June 2023, the core consumer price index (CPI) was above the BoJ 's 2% target for the 15th straight month, while the "new core" CPI (which excludes fresh food and energy and serves as a key barometer of underlying price trends) rose by 4.2% year on year (y-o-y, *Chart 4).*

Chart 4: Japanese consumer price indices (core and new core)

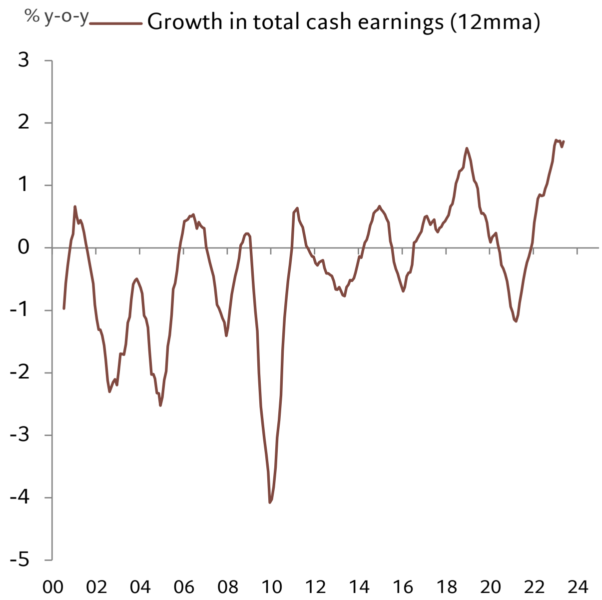


Source: Pictet Wealth Management, Bloomberg Finance L.P., Ministry of Internal Affairs and Communications, as of 31.07.2023
Note: The spike in inflation in 2014-15 was mainly due to the hike in consumption tax rate.

As in many other countries, the rise in Japanese inflation initially was caused by an "exogenous" shock, i.e., a major change outside of Japan's own economic system. But such strong and sustained price pressure, which has significantly pushed up the cost of living for ordinary people, has not been seen in Japan for decades. This has led to higher wage demands, supported by Prime Minister Fumio Kishida's call to raise employees' compensation under his so-called "New Capitalism" policy framework.

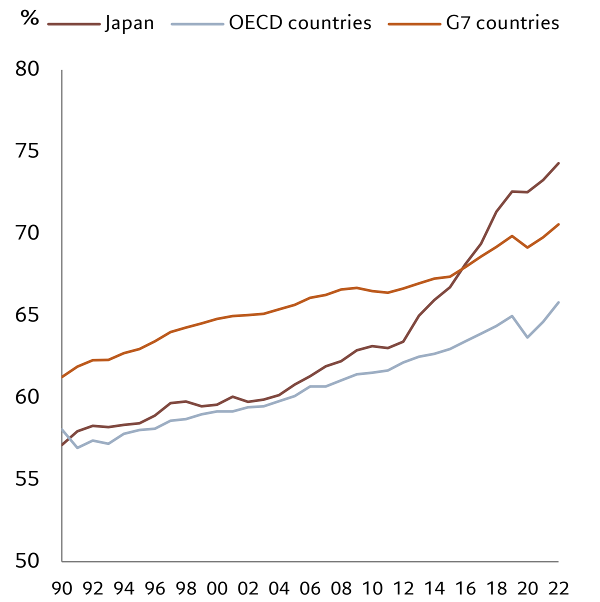
During the spring wage negotiations (Shunto) in 2023, Japanese labour unions and employers reached agreement to raise overall wages (including bonuses) by 3.8% on average, the largest rise since 1993. Of that, basic pay was set to rise by 2.3%, significantly higher than the previous year's figure of 0.5%. One cannot easily extrapolate the outcome of the Shunto as the vast majority of Japan's labour force is not unionised and many smaller companies are unlikely to raise wages so much. Nonetheless, the Shunto agreement this year may point to some fundamental changes in Japan's wage dynamics *(Chart 5A).*

Chart 5A: Growth in Japanese workers' total cash earnings (12m moving average)



Source: Pictet Wealth Management, Bloomberg Finance L.P., Japanese Ministry of Health, Labour and Welfare, as of 13.07.2023

Chart 5B: Women's labour participation rate (Age 15 – 64)



Source: Pictet Wealth Management, OECD as of 13.07.2023

Higher wage growth, if sustained, could lead to structurally higher inflation going forward. Japan's tight labour market also points in this direction. Japan's population has been shrinking since 2009. But Japan's total employment only peaked on the eve of the pandemic (at around 68 million), largely thanks to the rise in Japanese women's participation in the workforce. This followed the so-called "Womenomics" drive when Shinzo Abe was prime minister. This involved advancing gender equality and making it more attractive for women to join the labour force. But this boost may have largely run its course. In 2022, Japanese women's labour participation rate reached 74.3%, significantly higher than in other major developed economies *(Chart 5B)*. In our view, the room for further increases is likely limited. In short, with an unemployment rate of only 2.5% in June 2023, the tight labour market may support higher wage growth in Japan in the years ahead.

Meanwhile, inflation expectations among businesses and households have also moved up. In the Q1 2023 Tankan survey, companies further increased their five-year inflation outlook to 2.1%, compared to an average of 1.1% in 2016-21, while a survey by the Japanese Cabinet Office reported that more than half of households expect consumer inflation to exceed 5% in the next 12 months. From a business perspective, this suggests tolerance for retail price hikes has increased and may enable Japanese companies to structurally change their approach to price-setting. So far, Japanese household demand has proved resilient despite the price hikes in a broad range of products. This supports a more upbeat inflation outlook.

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A POTENTIAL BENEFICIARY OF US-CHINA RIVALRY

In an earlier flash note ("Supply Chain Regionalisation"), we discussed the on-going global supply-chain reshuffling against the backdrop of rising US-China tensions. In our view, Japan could benefit from this process as well given its status as a US ally and its strength in some high-tech sectors such as electronics and semiconductors. In addition, the Japanese government has in recent years sought to revive the semiconductor industry, with a 774 billion yen (USD6.8 bn) special fund set up under the Kishida administration in 2021 to support cutting-edge semiconductor manufacturing. According to news reports, around 400 billion yen will be allocated to financing the construction of the first semiconductor plant by TSMC in Japan. In our view, the trend towards "friend-shoring" and the Japanese government's financial support will likely attract more corporate investment in Japan, especially in the high-tech sectors.

In addition, Japan will likely benefit from its proactive participation in a web of economic and trade agreements, including its leading role in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which covers 11 major economies in the Asia-Pacific region. Japan also signed an Economic Partnership Agreement with the EU in 2018. This was by far the biggest trade agreement ever negotiated by the EU, with tariffs on 99% of Japan's imports from the EU to be removed over 15 years.

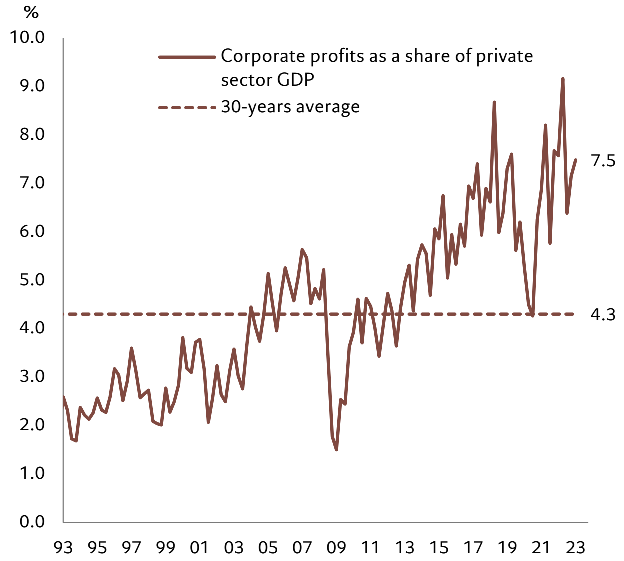
IMPROVING CORPORATE PROFITABILITY AND GOVERNANCE

At the micro level, there are also some encouraging signs. Japanese corporate profits have grown substantially since the mid-2010s—not only in absolute terms but also as a percentage of private-sector GDP. Since the covid-led interruption, the upward trend in profits has reasserted itself *(Chart 7A).*

Labour productivity in Japan has also shown some improvement on both an absolute basis and relative to G7 peers over the past few years *(Chart 7B).* This may partly reflect the acceleration in technology investments by Japanese corporates on foot of the digital transformation initiative promoted by the authorities since 2018 to combat Japan's demographic challenge.

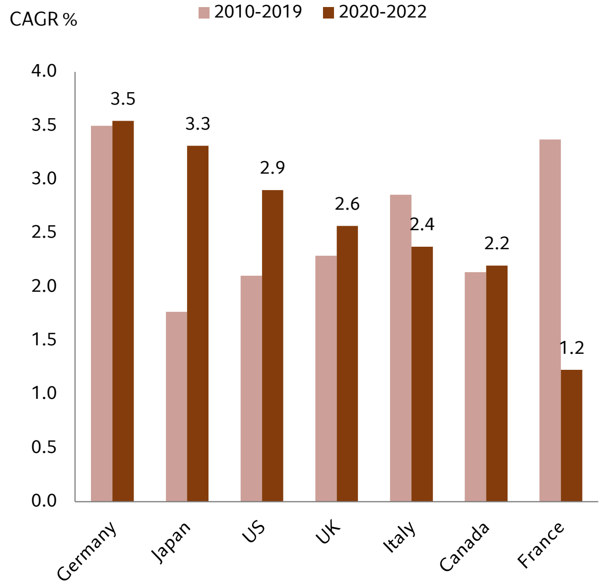
There has also been some notable progress in corporate governance since the Abe era. This includes a new Stewardship Code (2014) and a new Corporate Governance Code (2015), which have helped improve both management quality and capital efficiency. Recent new initiatives by the Tokyo Stock Exchange (TSE) to address some listed companies' low valuations have added further momentum to the reforms. In March 2023, the TSE requested listed companies to improve their capital efficiency and to manage their operations with due consideration for their return on equity and share prices. Specifically, the TSE asked companies trading below a price-to-book ratio of 1x to conduct analysis of their cost of capital and then draw up plans to improve their corporate value. Companies that fail to meet these criteria by March 2025 may be moved to junior indices or even be delisted from the TSE.

Chart 7A: Japanese corporate profits and capital investment



Source: Pictet Wealth Management, Bloomberg Finance L.P., Ministry of Finance, as of 13.07.2023

Chart 7B: Labour productivity growth (GDP per hour worked) of G7 countries



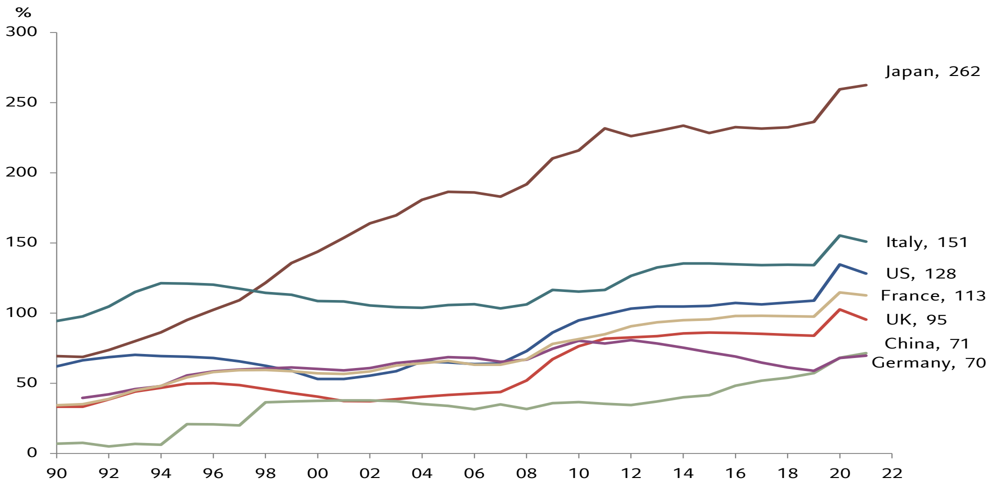
Source: Pictet Wealth Management, OECD as of 13.07.2023

Investor activism is also on the rise in Japan and may contribute to corporate governance reforms. The number of activist campaigns has increased steadily since 2015, rising to a record high of 52 in 2022. This is second only to the US. While it is still difficult to quantitatively assess the impact of all these changes, greater dialogue between companies and shareholders and heightened expectations for corporate governance improvement will likely help modify corporate behaviours and unlock corporate value.

RISK AND CHALLENGES AHEAD

While the developments outlined are encouraging, there are still some long-term challenges that the Japanese economy continues to face. An ageing, shrinking population will likely keep weighing on Japan's growth potential. Investment in technologies to increase productivity (including automation, artificial intelligence and robotics) and policies to boost labour supply (such as controlled immigration) could mitigate the downward pressure, but the headwind remains strong. For example, despite some relaxation in its immigration policies and a more welcoming stance on foreign workers in recent years, the number of foreign workers in Japan is still well below the level needed to achieve sustainable economic growth. According to a study conducted by the Japan International Cooperation Agency and other think tanks, Japan will need 6.74 million foreign workers in 2040, roughly four times more than it has today, to reach the government's nominal GDP target of 704 trillion yen (USD6 trn) for the same year.

Chart 8: General government debt as a % of GDP (2021)



Source: : Pictet Wealth Management, Wind, IMF, as of 18.07.2023

Another concern is the sustainability of Japan's public finances. Japan's public debt has expanded more than five-fold over the past three decades (1992-2022), ranking Japan the most highly indebted country in the developed world, measured as a percentage of GDP *(Chart 8).* This has been due to the Japanese government's large public expenditures since the 1990s to support the economy and the surge in social entitlement as a result of rapid population ageing. While the government has attempted to steer towards fiscal consolidation several times, its efforts have been interrupted by various external shocks, such as the Asian Financial Crisis in 1997-98 and the Global Financial Crisis in 2008-09. Consequently, when Shinzo Abe took office in 2012, an earlier commitment to achieve a primary surplus by FY2020 was pushed back to FY2025.

Last but not least, after years of massive monetary easing, how to normalise its monetary policy without causing significant market turbulence and derailing the economic recovery remains a daunting task for the BoJ. This is a topic that deserves a discussion of its own.

CONCLUSION

In our view, recent evidence shows that the Japanese economy may have finally reached a long-awaited inflection point. After years of near stagnation, the conditions may be in place to sustain a virtuous cycle of endogenous growth, despite several important structural headwinds. In essence, the Japanese economy may have finally moved out of the shadow of a balance-sheet recession after decades of deleveraging. The external price shock of the past couple of years seems to have led to real changes in corporations' price- and wage-setting behaviour. The possibility of a period of sustained inflation coupled with the right incentives and a changing geopolitical landscape could encourage further corporate investment in Japan. If sustained, the simultaneous increase in employee compensation and corporate capital investment seen recently could lead to a Japan structurally different from the past few decades.

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