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Yen Depreciation, If Continued, Might Spark Secular Economic Revival

The recent emergence of a trade deficit, the swooning yen, the perennial worries about the gargantuan and growing Japanese government debt, and the aggressive, pro-inflation rhetoric of the new Japanese government are reviving fears about the future of the Japanese economy. An ascendant view is that Japan is on the verge of imploding and that aggressive monetary policy will only hasten an inevitable flight from the yen and mark the transition from a deflationary Scylla to a hyperinflationary Charybdis.

Actually, as we have written, a substantial depreciation in the yen, if sustained, could be the catalyst for a secular revival in Japan. Japan's private sector has largely completed the balance sheet retrenchment started in 1990. The private sector in Japan is in a great position to power a durable expansion but is being held back by entrenched pessimism about sales and income prospects, aggravated by the strength of the yen.

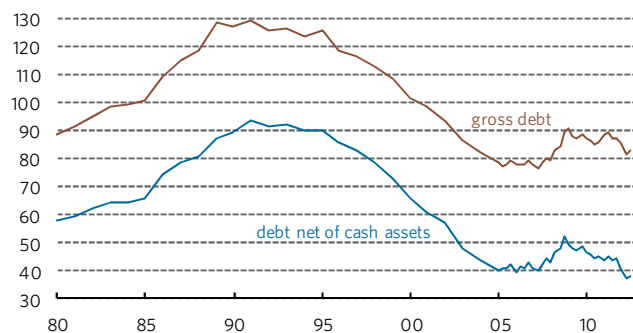
After two decades of contained depression, Japan's nonfinancial private sector balance sheet excesses have been largely worked off. Most notably, the private nonfinancial business sector has made tremendous progress in paring down its debt and improving profitability. Private nonfinancial business debt, scaled to GDP, is near its lowest level on record, and debt net of cash is at a record low (chart 1). Profits and profit margins have

rebounded smartly from the 2008-2009 crisis and are near record levels (charts 2 and 3).

Meanwhile, chronic overcapacity—the physical manifestation of Japan's big balance sheet economy—also appears to have been largely worked off. Net fixed investment fell precipitously in the 1990s and stayed depressed through the 2000s (chart 4), turning negative over the past three years. Thus, even with essentially stagnant sales, the ratio of sales to tangible assets has been on a secular uptrend over the past several years (chart 5), indicating that excess capacity has dwindled. If sales and the sales outlook were to improve, then investment could surge.

Lean Business Balance Sheets CHART 1

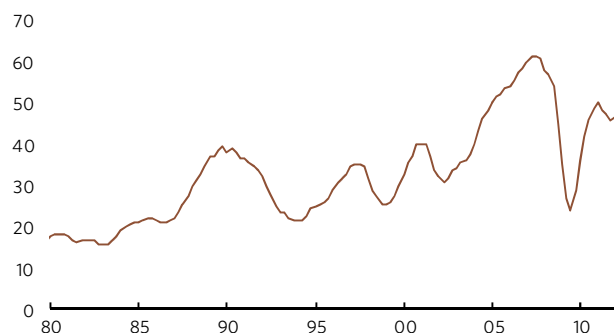
Bank of Japan: Private NF Corp. Loans and Securities Other Than Shares
% of GDP, fiscal years 1980-2005, quarterly data 2005 to present



Rebound in Profits CHART 2

Japan Ministry of Finance: Net Profits

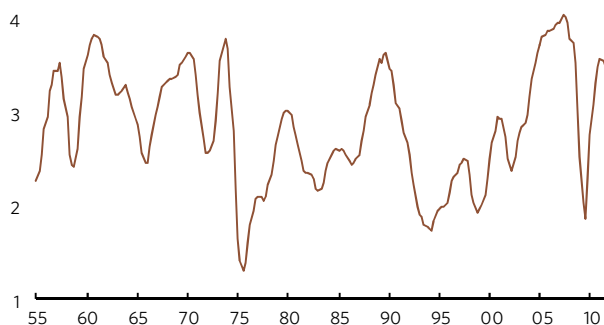
¥ trillions, not seas. adj., annual rate, 4-quarter moving avg., last data point Q3 2012



Profit Margins Nearing Multi-Decade Highs CHART 3

Japan Ministry of Finance: Net Profits as % of Sales

not seasonally adjusted, 4-quarter moving average, last data point Q3 2012



In fact, Japan had been slowly emerging from its contained depression in the mid-2000s; what set back the tentative recovery was weakness in the global economy and a relentless strengthening of the yen. The yen's rise exacerbated the Japanese export decline in 2008 and 2009 and has been a major reason why Japan's export recovery since then has been far weaker than that seen in other developed countries (chart 6). Japan's real exports are still down 13% from their 2008 peak, a lackluster performance to be sure, but nominal exports are down nearly 30% from their 2008 peak (chart 7), as export price declines have added to the weakness. (Keep in mind that profits are a nominal measure and that the nominal trade surplus/deficit expressed in the domestic currency is the relevant profit source; see chart 8.)

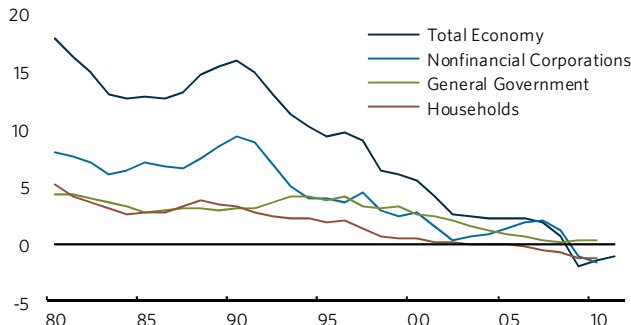
A substantial and sustained depreciation in the yen could bring about a resurgence in Japan's exports and, if coupled with fiscal stimulus and investment in energy infrastructure, may well be the catalyst that reignites domestic private sector balance sheet expansion. Once the economy begins to improve there is huge potential for a broad-based revival in fixed investment.

The protracted period of weak investment in Japan has created vast pent-up demand for investment as the cumulative effect of technological progress has created compelling incentives to update outdated capital stock. Moreover, the 2011 tsunami added a new impetus. As Japan seeks to reduce its dependence on nuclear power, the need to shift to other sources of energy and to improve energy efficiency is creating a pressing need to invest in energy infrastructure and energy efficiency. Because private nonfinancial balance sheets are lean, such investment can be readily financed with credit. A robust rise in sales once initiated could begin to break the deep-seated pessimism about sales prospects, boost business confidence, and unleash a virtuous cycle of private sector balance sheet expansion.

Japan's aging and declining population, its massive public debt, and the potential for banking system instability caused by surging government bond yields are perennial sources of worry for Japan observers. In our view, these challenges are not as daunting as commonly perceived, and we will address them in future writings.

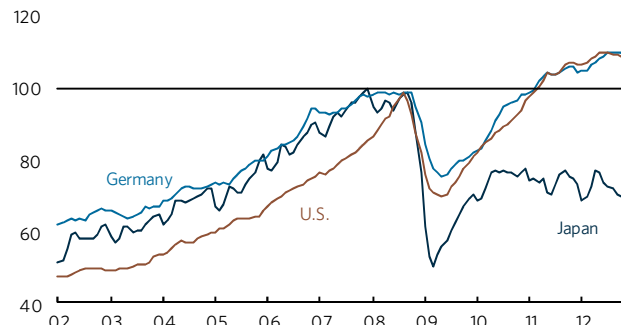
Need for Investment in Japan CHART 4

Japan: Fixed Capital Formation Net of Capital Consumption by Sector
% of GDP, annual data, calendar years (total through 2011, sectors through 2010)



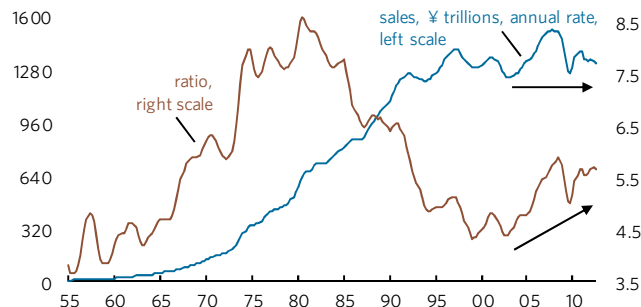
Japan Is the Laggard Exporter CHART 6

Nominal Goods Exports
indexes, respective 2008 peaks = 100, seasonally adjusted, 3-month averages



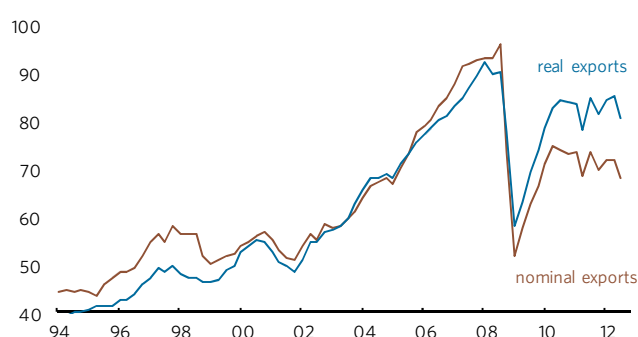
Sales Stagnant but Sales Turnover Improving CHART 5

Japan Ministry of Finance: Nonfinancial Corporate Business: Sales Ratio of Annualized Sales to Fixed Tangible Assets (ex. land)
not seasonally adjusted, 4-quarter moving averages, last data point Q3 2012



Nominal Exports Worse Than Real CHART 7

Japan Exports of Goods and Services
¥ trillions and trillions of chained 2005 ¥, seasonally adjusted, annual rate



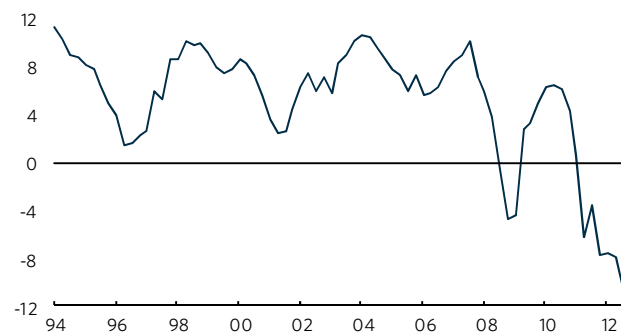
A critical question is whether the Bank of Japan will follow through in driving the yen substantially lower. The answer is not clear. After all, past programs for weakening the yen have not been pursued aggressively and on a sustained basis. To be sure, just as the Swiss Central Bank has weakened the franc, the Bank of Japan has the ability to deliver a weaker yen if it has the political will.

Japan offers tantalizing prospects, and a sustained decline in the yen would go a long way toward translating that potential into reality. It is impossible to say with high conviction when Japan will revive, but the potential if triggered is enormous.

Record Trade Deficit

CHART 8

Japan Nominal Trade Balance in Goods and Services
¥ trillions, seasonally adjusted, annual rate



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