Japan: The problem of success

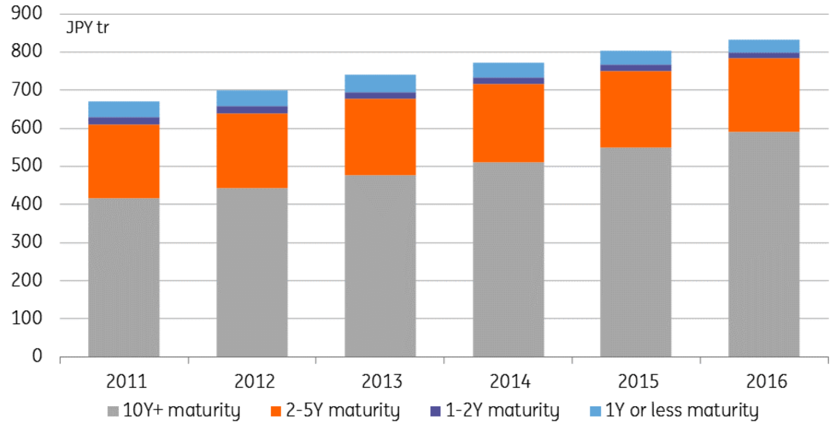
Japanese GDP remains very strong. That's raising thoughts about the end of quantitative easing and negative rates

Source: Shutterstock

2017 growth set to be strongest since 2010

With only one slight blip in 3Q16, when the economy grew at 0.9% quarter-on-quarter (annualised), Japan has recorded growth of above 1.0% (actually at or above 1.4%) in each of the last seven quarters. The revised 3Q17 GDP growth figures of 2.5% come hard on the heels of a 2.9% growth rate in 2Q17. Full year growth looks likely to come close to 2.0% (ING forecasts 1.8%), which would be the strongest growth performance since 2010, when Japan emerged from the global financial crisis. The extent, and persistence of Japan’s growth is leading some to question what this means for Bank of Japan (BoJ) policy. Currently, this targets 10-year Japanese government bonds (10Y JGBs) at about zero percent, and keeps the interest rate on policy-balances held by banks with the BoJ at -0.1%.

Central government debt outstanding



Source: Macrobond

10-year government bond yields are on the rise

Like the yields on other G-3 bonds, Japan's government bonds have not escaped the recent rise in global yields, nosing up to about 0.05% from a recent trough of about 0.01%. That owes partly to overseas influences, the markets' reluctant acceptance that the Fed's 'dot-plot' of interest rate expectations is not so unrealistic and the beginning of the end of quantitative easing in the Eurozone. But is it reasonable to imagine that the BoJ could follow suit in 2018? Shorter maturity Japanese government bond yields remain negative, but they too have been nosing higher, suggesting some expectation of higher rates in the not-too-distant future. Sure, growth data are remarkably strong, and matched by similarly tight labour market data, but the BoJ has so far made little headway in raising inflation towards its 2% target.

With a debt stock more than double GDP, won't raising rates create mayhem?

If Japan does eventually make some progress on inflation, or the BoJ eventually decides that 2% is simply the wrong inflation target and starts to raise rates, what then? When total government debt is in excess of a quadrillion yen (more than double GDP), shouldn't this cause problems? What happens next depends on a number of moving parts, none of which are clear. Does inflation actually rise, lifting bond yields, but also likely raising nominal GDP. Does real GDP growth remain good, but inflation, and bond yields remain low, even as the BoJ hikes rates? Do we get something in between?

Rate hike this year is perfectly plausible

With the lion's share of outstanding Japanese government debt of 10 years of longer maturity, even a return to 2% inflation and benchmark bond yields rising to a similar level will take some time to feed through into the government's effective debt financing rate. But in our 'high' scenario, where bond yields and inflation both rise to around 2.0%, this adds a full percentage point of GDP to government debt service costs by 2028. Still, this isn't a catastrophe, and if government revenues are also rising in line with nominal GDP, this should be quite manageable. In our 'low' scenario, where inflation and bond yields remain low, despite good real GDP growth, then the debt service costs will simply converge on the weighted average of long- and short-term bond yields times the debt stock as a proportion of GDP. There is, therefore, a perfectly plausible scenario in which the BoJ hikes rates this year. We don't think it will, however. We suspect the BoJ will wish to see current real growth rates maintained for longer before relinquishing the comfort blanket of quantitative and qualitative monetary easing. And it will want to see some improvement in inflation. We doubt the latter will be forthcoming, even if the former remains strong. But it is not as silly an idea as it once sounded.

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