

March 2010

Japan Economics

Scent of Morning: Eight Questions for Japan Investors in 2010

1. Will global recovery continue?
2. Will major central banks exit QE?
3. Where will the yen go?
4. What global themes benefit Japan?
5. Will Japanese growth rise, deflation end?
6. Will BoJ expand aggressively?
7. Will JGB yields rise?
8. Will the DPJ government be effective?

Our answers:

1. Yes, 2. Yes, except BoJ, 3. Y109/US\$, 4. Energy, food, Asia, 5. Modest progress 6. Yes, 7. Modestly. 8. Not clear

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The Japan Market View

Money rates: Kan / Shirakawa comments imply more dissonance. We see major easing over time, with more government coaxing.

JGBs: We are positive on JGBs. Loose monetary policy gives govt room to act on fiscal reform.

Japan Equities: Dead money for now, as leading indicators retreat; eventual BoJ easing bullish.

Yen/US Dollar: Zigzag path to Y109/US\$ as foreign CBs exit QE while BoJ eases more.

For important disclosures, refer to the Disclosure Section.

The Challenge for Asia: Productivity must rise, or else living standards will fall.

$$Y = (Y/L) \times (L)$$

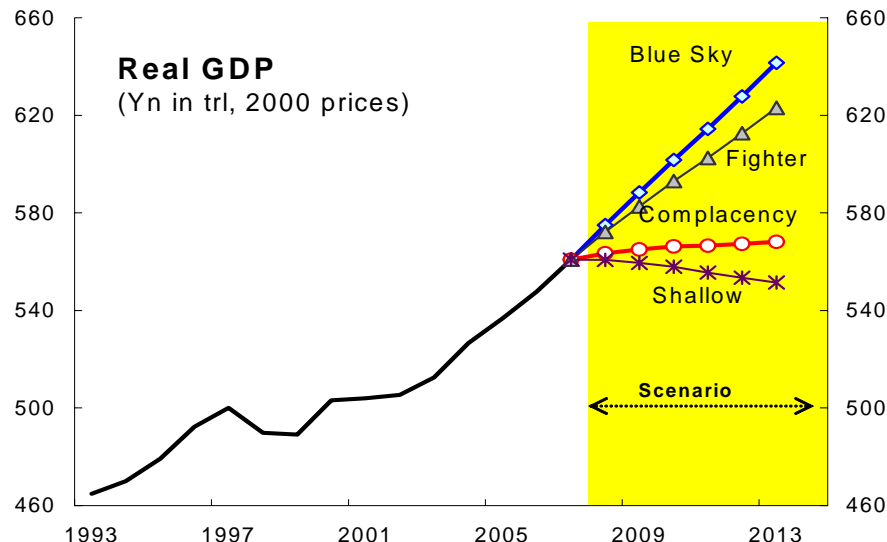
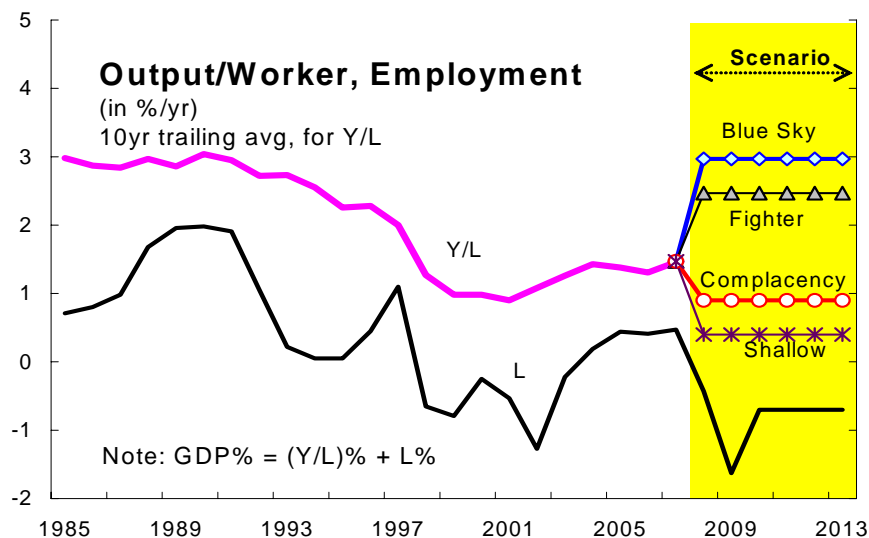
Output Productivity * Employment

$$Y/P = (Y/L) \times (L/P)$$

Standard of living = Productivity * Participation rate

$$Y\% = L\% + Y/L\%$$

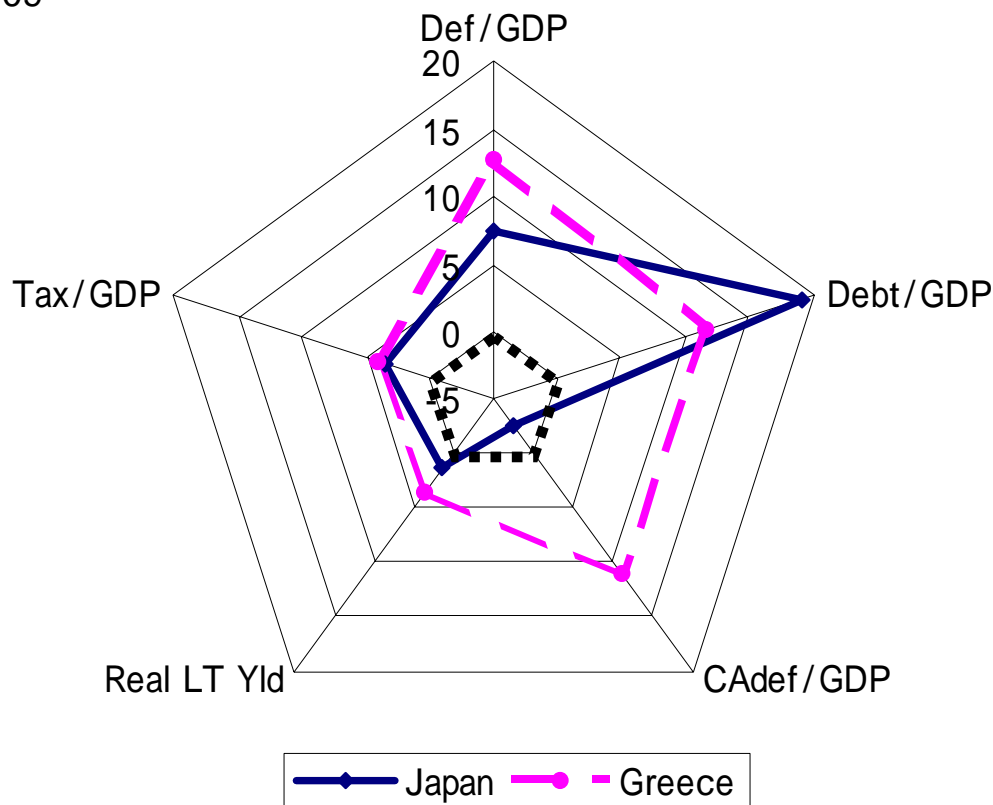
$$\left\{ \begin{array}{l} 2.3\% \\ 1.8\% \\ 0.3\% \\ -0.2\% \end{array} \right\} = -0.7\% + \left\{ \begin{array}{l} 3.0\% \\ 2.5\% \\ 1.0\% \\ 0.5\% \end{array} \right\}$$



Hence, policies of the new government must be evaluated on whether they raise or lower productivity growth. So far, the news is mixed.

Sovereign Risk : Comparison of Fiscal Indicators

OECD Estimates
for 2009



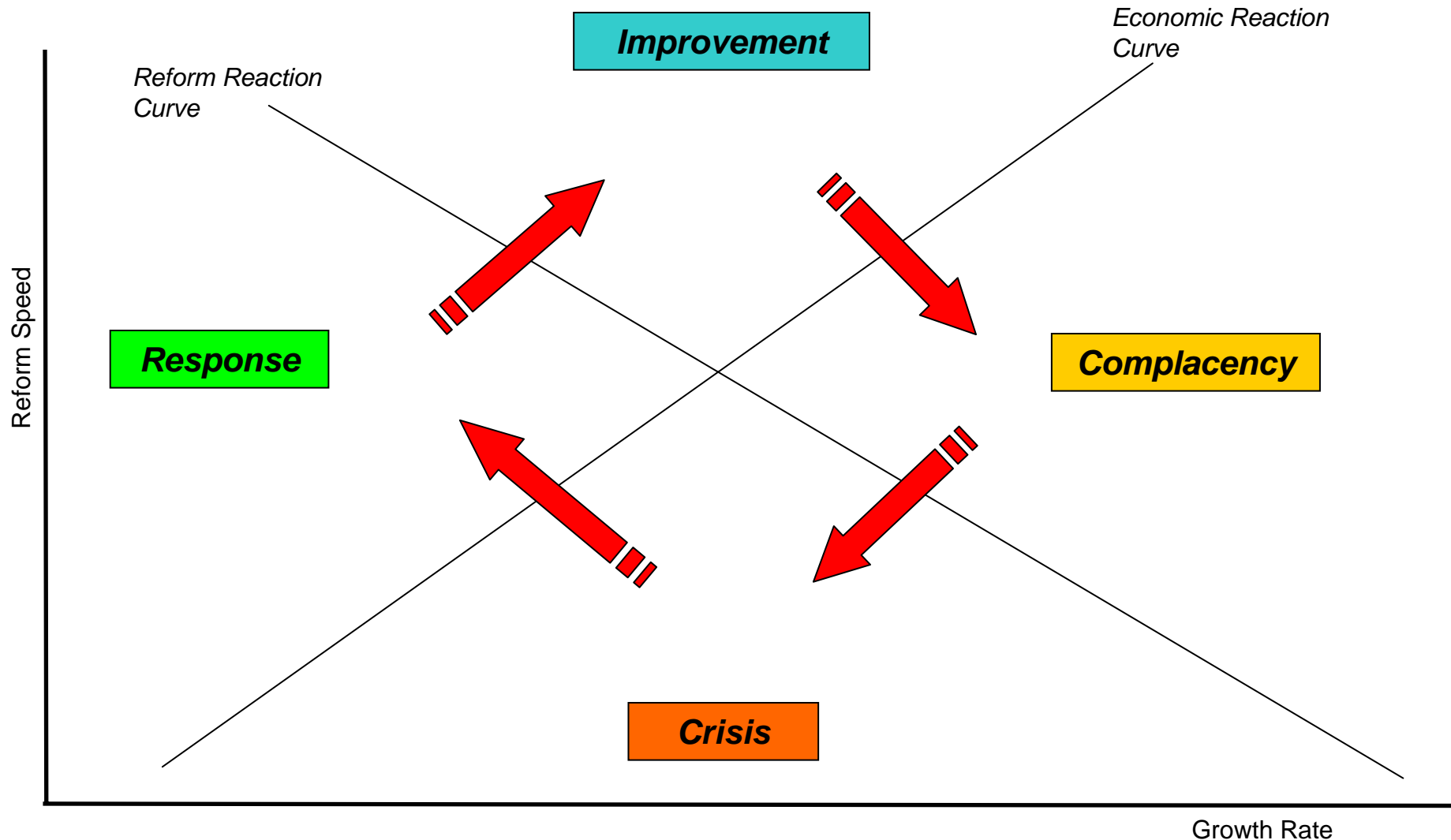
The figure compares Japan and Greece on five indicators relevant to fiscal policy:

1. Deficit / GDP (in %)
2. Government Debt / GDP (10% units – "20" means 200%)
3. Current account deficit / GDP (in %)
4. Real long term yield (10yr yield less % chg of GDP deflator)
5. Tax revenue / GDP (in %)

Except for the Debt/GDP ratio, the Greek line lies outside the Japanese line in all other indicators. This means that the Greek fiscal situation is worse than the Japanese.

Note: Thick, dashed, black pentagon denotes 0. Japan's current account surplus shows up as a negative current account deficit.
Source: OECD data, Morgan Stanley Research

Political Economy of Reform: CRIC Cycles Are Endemic



Source: Morgan Stanley Research

New Growth Strategy: Asia Needs to Balance Demand and Supply Sides

“Ending deflation requires a positive interaction of demand creation and enhanced supply capability.”
[DPJ’s “New Growth Strategy, Dec. 30, 2009, p.3]

The DPJ slogan “from concrete to people” means “less K and more L”

$$\begin{array}{c} \text{Keynesian Economics} \\ \hline f(K, L) = Y = C + I + G + (X - M) \\ \hline \text{Growth Economics} \end{array}$$

The left hand side is the production of the economy, generated by technological application of capital (K) and labor (L) to producing the items that consumers, investors, and others want.

The middle item, Y, is income generated by the economy.

The right hand side shows the standard demand components, consumption, investment, government spending, etc.

A crucial assumption of Keynesian economics is that output is demand determined – i.e. that whenever C or I or G etc rises, the production side of the economy will automatically respond.

In contrast, growth economics focuses on factors of production (K and L), and the technology of how they interact (the production function $f[\bullet]$). Whether demand exists to absorb the supply is ignored.

Note: “Japan Economics: Japan Policy Scorecard: Policy Evolves to Enhance Productivity”, Robert Alan Feldman, February 5, 2010

Source: Morgan Stanley Research

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