tax and financial **ISSUES**

December 2014 | Why everyone should be paying attention to what is happening in Japan and avoid being on the receiving end of a haircut.

Everything Else is Noise

Background

In 2014 Japan embarked on a dramatic increase in their money supply, labeled in the financial press as Abenomics after Prime Minister Shinzo Abe.

Abenomics is quantitative easing on steroids. QE involves a central bank buying of assets with newly created money, which injects currency into the economic system. The asset sellers then have cash to redeploy. The hope is that they will do something good with it. The public face of QE is that it is done to reduce interest rates and stimulate economic activity. The reality of QE is something entirely different. (More on that later.)

In the US, quantitative easing involved our central bank increasing its balance sheet from $800 billion to $4 trillion from 2008 to 2014. The absolute amount of currency created is not the key issue. It is the size of the increase relative to the size of the economy. This increase over six years amounted to 21.7% of US GDP.

In Japan, the amount of currency created was less, but the ratio to the size of the economy was much greater (36%), and was done over a much shorter period of time (2013-2014). The Japanese are clearly the most aggressive in the use of Monopoly money.

Japan is an insular place.

- Immigration is not permitted.
- It has a rapidly aging population.
- Domestic markets are protected from foreign competition.
- Savers by and large have invested in Japanese government bonds. This has given the government a captive source of cash for financing deficits.

Insularity has its problems.

- There is no increase in population that would give a boost to domestic markets. The population has actually declined every year since 2007.
- Senior citizens tend not to be big consumers, and this has led to a low growth economy.
- Because of protected domestic markets, there is little incentive for Japanese businesses to restructure.

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So if the Japanese are not interested in doing the structural things needed to boost their economy, what did they try to bring back growth?

- The country adopted the Keynesian solution to dealing with stagnant demand... running chronic budgetary deficits. The extent of this can be shown by the increase in Japan's debt to GDP ratio.

1980	50%
1990	67%
2000	133%
2010	200%
2013	227%

It should be no surprise that big time deficit spending occurred after the crash of the Nikkei average in 1989.

- There has been no brake on runaway government spending through an increase in interest rates. Under normal conditions as a borrower takes on more debt and becomes less creditworthy, lenders charge higher interest to compensate for the risk.

10 year JGB (Japanese Government Bond) yield:

1985	7.5%
1990	7.5%
1995	3.0%
2000	1.9%
2005	1.8%
2010	1.4%
2013	0.5%

As debt to GDP skyrocketed, interest rates tanked.

- This decline in the bond rate has masked deterioration in government finances.

	Debt/GDP	**JGB Yield**	**Government Interest Cost/GDP**	**Interest Cost/GDP @ 7.5% Yield**
1990	67%	7.5%	5.0%	5.0%
2000	133%	1.9%	2.5%	10.0%
2010	200%	1.4%	2.8%	15.0%
2013	227%	0.5%	1.1%	17.0%

To put the interest cost to GDP figures in perspective, since 1990 the ratio of Japanese tax revenue to GDP has averaged about 28%. Any normalization of interest rates would consume over 50% of the government's tax revenue.

This is eerily reminiscent of Americans borrowing to purchase homes with adjustable rate mortgages. Their position became untenable when the teaser rates expired. Interest rates can't be suppressed forever.

What could cause interest rates to increase from their current level?

- Domestic investors could demand protection against currency devaluation.

  Since the start of 2011, Japanese government bond investors have lost 28% of the value of their investments through currency devaluation, with the bulk of this happening in 2014. This is hardly a way to attract new capital. New investors will clearly require protection against devaluation via higher rates. Another possibility is that Japan will be forced to borrow in other currencies, or issue gold backed obligations.

- The government could exhaust the Japanese saving pool.

  A key reason why JGB bond rates have remained at low rates is the captive savings pool. Exhaust that saving pool, and you will have to find money elsewhere. You can only loot the savers once. New money is likely to demand a higher interest rate.

- The market for Japanese government bonds could disappear, leaving the central bank as the only buyer.

  When this happens, the currency will go into a free fall. The value of anything denominated in yen will collapse. It would be a replay of what happened in the Weimar Republic in 1923.

  One has a vision of their central bank buying up all Japanese government debt in exchange for yen. The challenge for the sellers is to buy something as soon as possible with soon to be worthless yen. The act of holding yen becomes a game of hot potato.

  Those who are surprised by the recent strength of the US stock market should understand that dollar denominated assets are the beneficiaries of Japanese investors playing hot potato . . . . . selling yen denominated assets and buying dollar denominated assets. US stocks with the largest capitalization are the biggest beneficiaries.

What is the importance of what is happening in Japan to Americans?

Japan is a test case of what happens when a major economic power becomes over indebted and needs to take steps to move forward. Behind the public relations veneer of quantitative easing is the reality that it amounts to default via devaluation.

This is an ability that we would all like to have.
- Borrow money for deficit spending
- Spend money on things with no long-term payback, and get over your head with debt service obligations
- Buy back the debt with a depreciating currency.

The problem with all this is that everyone’s obligation is someone else’s asset. So far the process in Japan has been a looting of the worth of savers. For the Japanese government to devalue its obligations by 28% (as it has done since the start of 2011), Japanese savers must be given a comparable haircut.

In 2011 considering the potential loss from devaluation was the most important thing to the Japanese investor. Consider that in 2010 JGB yielded 1.5%. This is a rounding error in comparison to the 28% loss administered via devaluation of the yen. The bond income is just background noise. It's like picking up nickels in front of a steamroller.

The cruel joke on Japanese consumers is that the cost of imported goods will increase by at least 28%, and domestic inflation will take off. The only people that this benefitted were those who were first in line to dump yen denominated assets in 2011. The impact of all this on wage income is uncertain at best.

The question for US investors is whether a similar haircut could be administered here...

Like Japan, the US has a capital pool of savings (AKA the Social Security trust fund). It is required to invest exclusively in US government securities.

To date America has benefitted from the safe haven status of its currency despite an expanding debt to GDP ratio. When foreign countries run into trouble, capital runs to the dollar.

Think about...

- Commodity dependent countries (Russia)
- Corruptly managed countries (Argentina, Venezuela)
- Countries with chronic budget deficits and shaky banking systems (the entire Eurozone)

Countries with strong currencies tend to have the lowest borrowing costs. (A strong currency and a good credit rating are due to the same factors.) This leads to an unnatural appearance of prosperity.

USA	Debt/GDP	Avg. Yield	Government Interest Cost/GDP	Interest Cost/GDP @ 4.5% Yield
1990	58%	7.8%	4.5%	2.6%
2000	58%	4.4%	2.6%	2.6%
2010	96%	3.1%	2.9%	4.3%
2013	102%	2.5%	2.5%	4.6%

Like Japan, the US has had a large increase in its debt to GDP ratio (mostly in 2008-2010 where the change was from 74% to 96%), making it a candidate for a rolling default. However, there are some key differences.

- US government debt to GDP is less than half that of Japan (102% vs. 227%).
  Less harsh measures than an abrupt devaluation will be needed to bring debt down to a manageable level. One of these is a managed suppression of interest rates, which is effectively an annual confiscation of the value of a bond. (At least it isn't a quick 28%.)

- The dollar is a reserve currency that is widely held outside of the US.
  In Japan the brunt of devaluation is shouldered by domestic savers. The impact of a dollar devaluation is borne by any trading partner holding dollars. There is resentment in other countries regarding our ability to pass along the cost of our bad financial behavior.

- As a reserve currency, if the dollar were to be devalued, it would have to be devalued related to real assets (general inflation).

  Countries tend to keep their currencies at levels that keep their products competitive. Currency devaluation does not happen in a vacuum.

These things being said, the differences between the US and Japan are more a matter of style than substance. In the US we have been treated to successive iterations of quantitative easing. Timelines are given for the program to end, but it never does. (It just gets renamed.)

Japan did not exercise fiscal discipline because the government had access to a captive pool of savings. The US has that plus the ability to devalue the world's dollar denominated assets. With power like that, why would politicians bother to go through the contentious process of curtailing deficit spending? The reserve currency has become our crutch. It's easier just to have Federal Reserve officials come up with explanations for why devaluing our currency is good for us. The Fed is the ultimate enabler of bad behavior.

Unless we develop the stomach for restructuring what we do in our economy (spending tax revenue only on the most important things), financial repression (suppressed interest rates and money printing to produce inflation) is the only game in town.

The bottom line... we are Japan in slow motion. The timing will be different, but the results will be the same. Act accordingly.

- Recognize quantitative easing as currency devaluation.
- Take every opportunity to redeploy assets denominated in depreciating currencies into assets whose replacement cost is increasing... but do this only at reasonable prices.