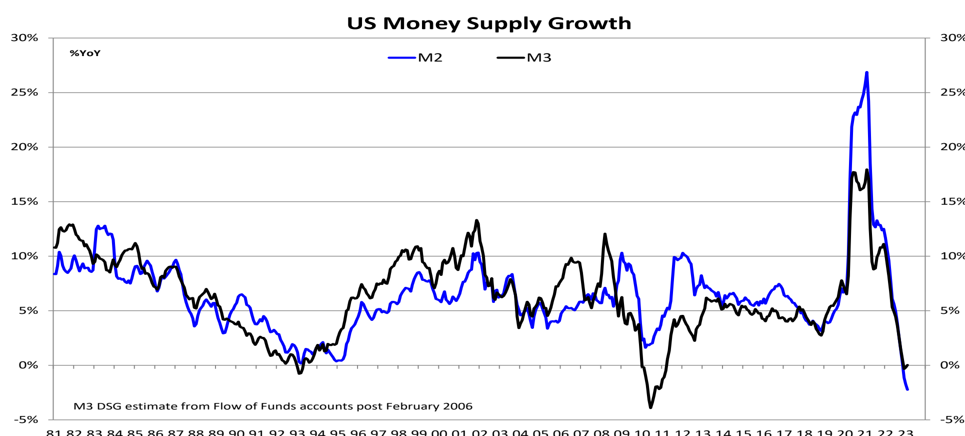
The Sun also Sets on YCC

About a month ago, after more than three years away, I had just returned from a most enjoyable and enlightening research trip to Japan.[1] I had been poised then to release this note but subsequently mayhem erupted across financial systems on both sides of the Atlantic and I took the executive decision that no-one would have the time or the motivation to read it.[2] Well Delay No More as my Cantonese football buddies always politely encourage me….

I recently returned from a most enjoyable and enlightening research trip to Japan

Before turning to matters Japanese though, some brief comments on developments further afield seem warranted. Accompanying this article is the latest iteration of our ever-evolving chart pack which seeks to provide both visual and intellectual stimulation. As I posited at the beginning of the year, in the context of a troubled wider world, the region's macroeconomic fundamentals generally continue to look relatively sound. Absent further financial, geopolitical or pathogenic shocks, the major question for Asia is how the region fares between likely recessions in America and Europe and the more positive drivers of a China re-opening.

How will Japan and the wider region fare between likely recessions in America and Europe and the more positive drivers of a China re-opening

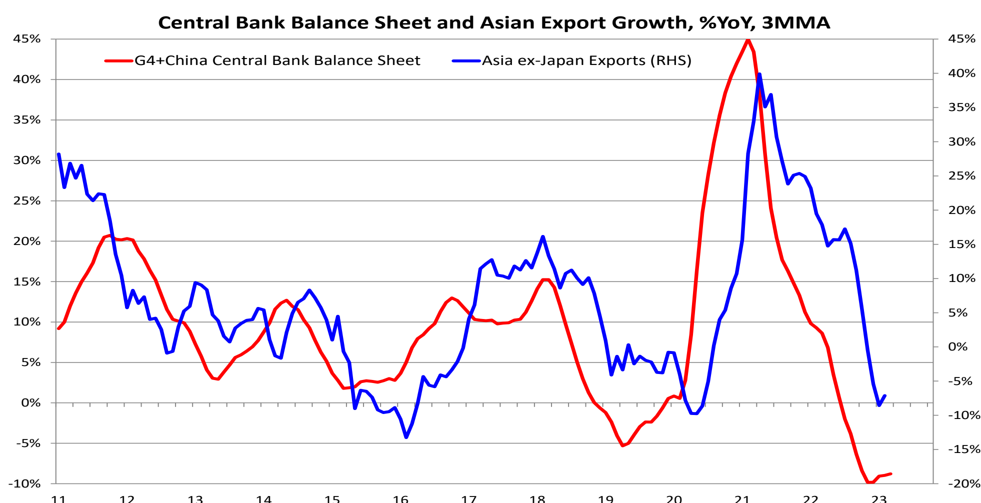


The "absent further" caveat – especially the financial one – is, of course, very much alive. As a card-carrying monetarist dinosaur, my inflation being far

[1] And a first research trip anywhere since 2019 with members of **DSG*Asia***'s intrepid and estimable client base. Primary research and partying; the fun aspects of the business for sure.

[2] This footnote serves to pre-empt our snarkier readers from chiming in with "so what's the difference?" In fact, in the spirit of my efficiently lazy ethos, I originally pondered asking ChatGPT to produce the article for me but the effort produced was, frankly, risible. If the cutting edge of machine learning fails to insert even one obscure 1980s cultural reference into a footnote linked to a highly discursive paragraph of syntax, then humanity can breathe easily for now. Admittedly, the jokes generated were better….

from transient argument of 2020 was predicated on the break-out surge in broad money resultant from the fusion of monetary and fiscal policy as the Marat-Sade[3] MMT lunatics were finally granted the keys to the asylum. The Fed has belatedly sought to retrieve the fob and haunted by memories of the 1970s, has presided over the sharpest decline in the broad monetary aggregates since the 1930s. Nothing much broke initially while US labour markets remained strong, hence understandably, the Fed kept going. How much damage has been caused beneath the surface is beyond my area of expertise. However, my simple assessment would be that even if the financial system has been stabilised by the recent interventions, funding conditions have tightened considerably further. I am hardly alone in believing a recession seems likely to follow; its depth and duration remain harder to determine.



Although the Fed has been at the forefront of the tightening efforts, other developed world central banks have also been scaling-back their extraordinary monetary accommodations. For highly trade-dependent Asia, the damage to export prospects has been both predictable and painful. Fortunately, most of the region was both more parsimonious than America and Europe when it came to monetised-fiscal disbursements during covid, and was also slower to exit from control measures. The result has been far-less embedded inflation and more-delayed rebounds in consumption, tourism and investment timed, serendipitously, to somewhat offset the contractions is manufacturing exports. Export prospects could, of course, still worsen materially further in the event of renewed mayhem in Western financial

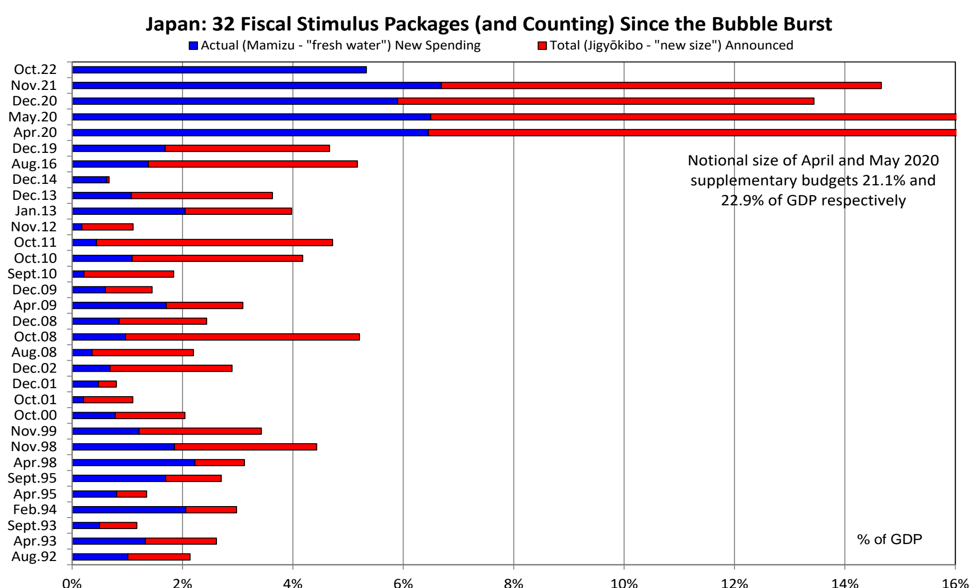
The Fed has presided over the sharpest decline in the broad monetary aggregates since the 1930s

[3] https://www.youtube.com/watch?v=Sdeg5j8UMxA

systems. Absent such an occurrence though, the region should generally enjoy a reasonably stable economic environment.

Most of the comments in the previous paragraph would also seem to apply to Japan absent the fiscal parsimony. Not that Tokyo has managed to generate all that much sustainable activity from the thirty-two separate packages rolled-out since the bubble burst, though it has managed to become a world leader in government indebtedness. And pertinent to today's discussion, how can an official debt pile of 260% of be sustained given the BoJ's baby steps away from yield curve control or YCC?

For highly trade-dependent Asia, the damage to export prospects has been both predictable and painful



Although it was probably sub-optimal for Shinzo Abe himself, his assassination will potentially be viewed by historians as being rather timely for the broader polity. Given his "colourful" family background,[4] a personal stick with which to beat Japan has been removed from the neighbours and a less emotionally-charged debate about international relations and security policies can now ensue.[5]

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[4] Please get in touch if you would like a reminder primer on 19th and 20th Century Japanese history.

[5] Abe was never the impediment to a US-Japan FTA. Trade agreements remain a hard sell in DC but there are geo-strategic reasons for America to at least seek to place Tokyo on a similar footing to Seoul at a time when the two are trying to patch up relations.

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As for monetary policy, Abe's passing also eliminated the principal backer for supremely self-confident BoJ Governor Haruhiko "It is no exaggeration that 'QQE with a Negative Interest Rate' is the most powerful monetary policy framework in the history of modern central banking" Kuroda. Given Japanese inflation dynamics, it had been my contention since early last year that YCC was heading for the scrap heap once it was confirmed that Kuroda was out of his way through the door. Rather like China's sudden abandonment of covid controls, that the transition away from YCC began in December 2022 as opposed to the end of Q1 2023, was somewhat of a surprise and likely reflected the Governor being politely informed that he needed to commence the process before he left office. Irrespective, what has begun has begun, and in my long-standing assessment, it will be far less disruptive (for Japan) than the worrywarts fear.

Abe's passing eliminated the principal backer for supremely self-confident BoJ Governor Haruhiko Kuroda

The new team at the BoJ is both less ideologically-charged/compromised than its predecessor and arguably has far greater international finance and financial stability credentials and linkages.[6] Nevertheless, on the surface at least, it has inherited a difficult hand. Thanks principally to international developments and, until recently, a currency being deliberately undermined by its own central bank (with DC remarkably quiet), a long-desired for inflation target has finally been hit.

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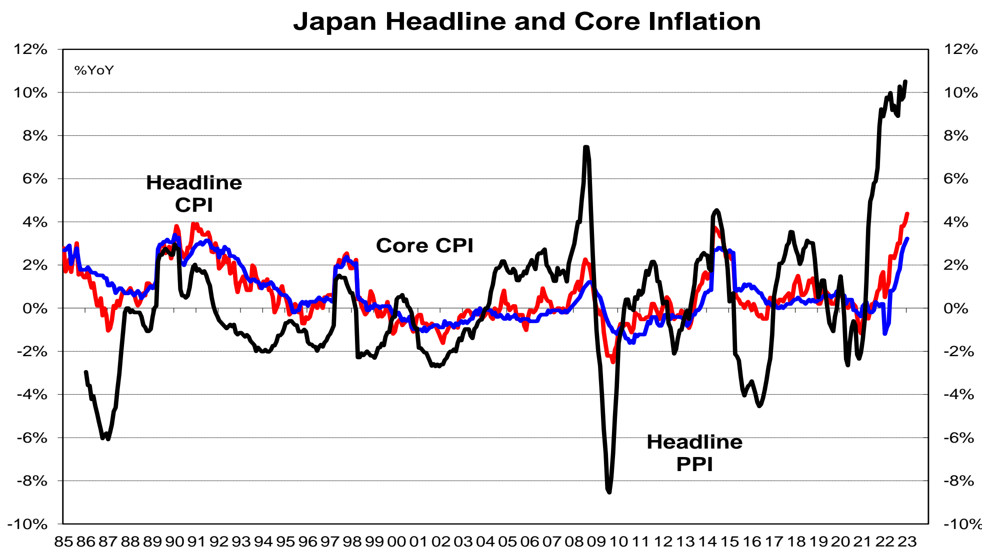

[6] Again, should you wish to ruminate over the individual personalities involved based on the discussions conducted at my various meetings with my local contacts, drop me a line.

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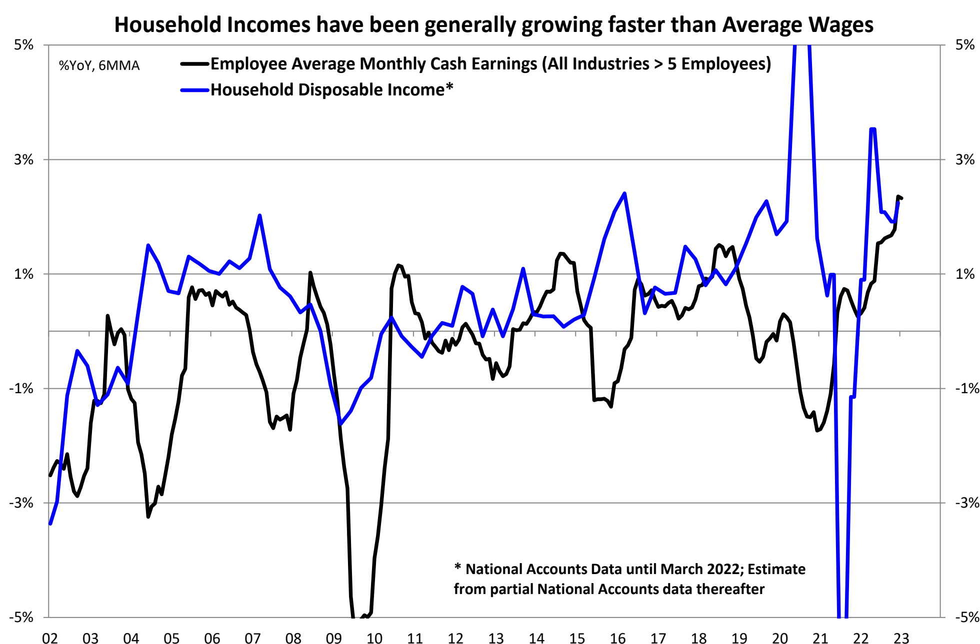
It seems reasonable to question whether higher rates of inflation will perpetuate given that decades of central bank balance sheet expansion have serially failed to translate into sustainably higher broad money growth. Should the global economy indeed move into recession, this will hardly be internationally-traded goods price supportive either. Yet there seems burgeoning evidence that labour market conditions have tightened sufficiently to deliver the somewhat higher headline nominal wage growth the BoJ has long-desired.[7]

Have labour market conditions have tightened sufficiently to deliver the somewhat higher headline nominal wage growth the BoJ has long-desired?



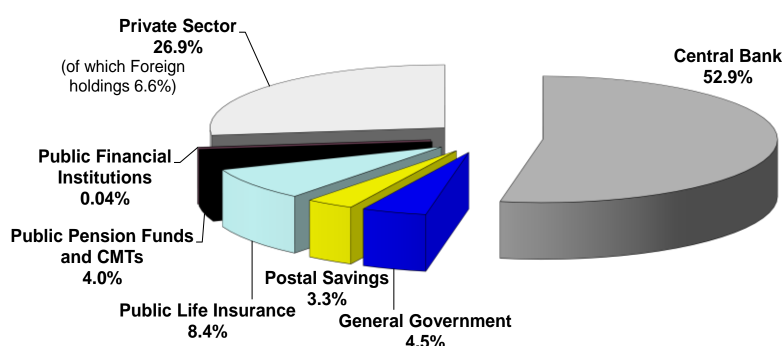
The Spring round of *shuntō* negotiations between the labour unions and management are about halfway concluded and according to Rengo, the Japanese Trade Union Confederation, the average monthly pay hike agreed, including increases in pay scales and regular wages, has been 3.70%

The ongoing *shuntō* negotiations suggest they have

[7] Regular readers – hello to you both – will know that for many years I have been conducting an ongoing dialogue with the central bank over whether their preferred measure of average monthly cash earnings understates the true rate of worker household income growth. My contention has been that the entrance into the workforce of increasing numbers of lower-paid-on-average female and foreign workers, and the retirement and re-employment on different contracts of older permanent employees, all bias down average wages even as broader household incomes increase.

compared to the 2.11% average negotiated in Spring 2022.[8] Curmudgeons will point out that this still represents a *fall* in *real* wages while, moreover, smaller companies are in a far weaker position to be able to afford such rises. Fair comments and we will return to the small-versus-large company dichotomy in due course. But in the context of providing cover for a further move away from YCC policies that have arguably achieved little beyond grotesquely distorting local financial markets, these are welcome developments nonetheless.

Sectoral Holdings of Central Government Debt (December 2022)



Source: Japanese Government Flow of Funds Data

At the end of 2022, the BoJ owned approximately 53% of the government debt stock while other public entities owned a further 20%. I have long believed that given this peculiar ownership structure in combination with Japan's inherent financial patriotism – the money comes home when asked – the country might – *uniquely?* – be positioned to get away with a grand netting off and recapitalisation exercise.[9]

At the end of 2022, the BoJ owned approximately 53% of the government debt stock while other public entities owned a further 20%

[8] https://www.japantimes.co.jp/news/2023/04/05/business/unions-win-wage-hikes/

[9] See, for example, "Japan – Don't try this at home", November 25th 2016.

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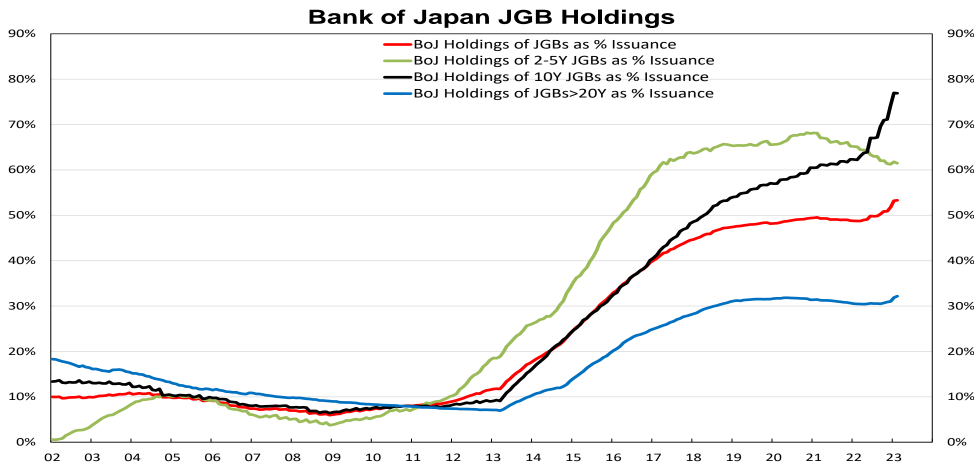
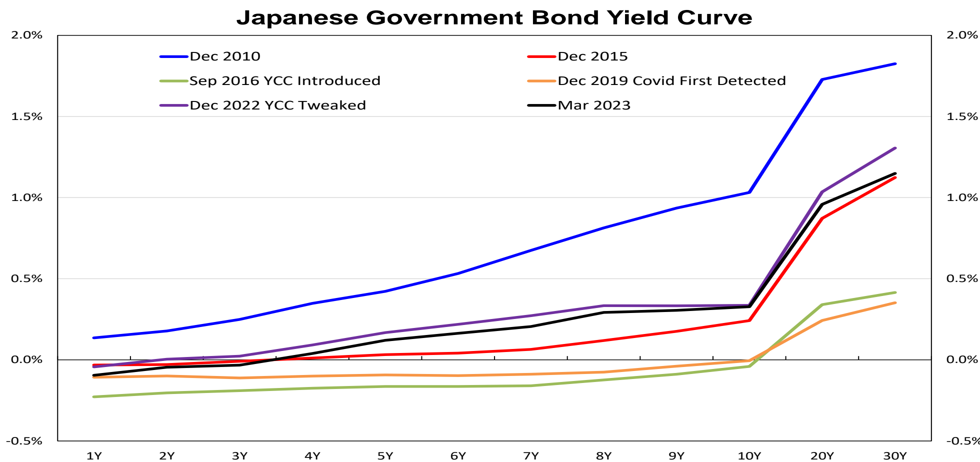
Drilling down further, the central bank owns a highly disproportionate share of the shorter-dated JGBs in issuance including almost 80% of the 10-year note that remains the focus of its interventions.[10]

The BoJ owns 80% of the 10-year note that remains the focus of its interventions



Ray Davies of the Kinks once sang "I'm not like everybody else." And neither is the Kink on the JGB curve. In the part of the market that is more privately-owned, longer-term yields have already moved up relatively significantly. Granted, should inflation expectations shift up substantially further, then the whole curve is at risk of a further re-pricing. I have no claims whatsoever to be a bond strategist but, on the surface, absent such a broader upward shift, ironing out of the kink would not seem to be an impossible endeavour.

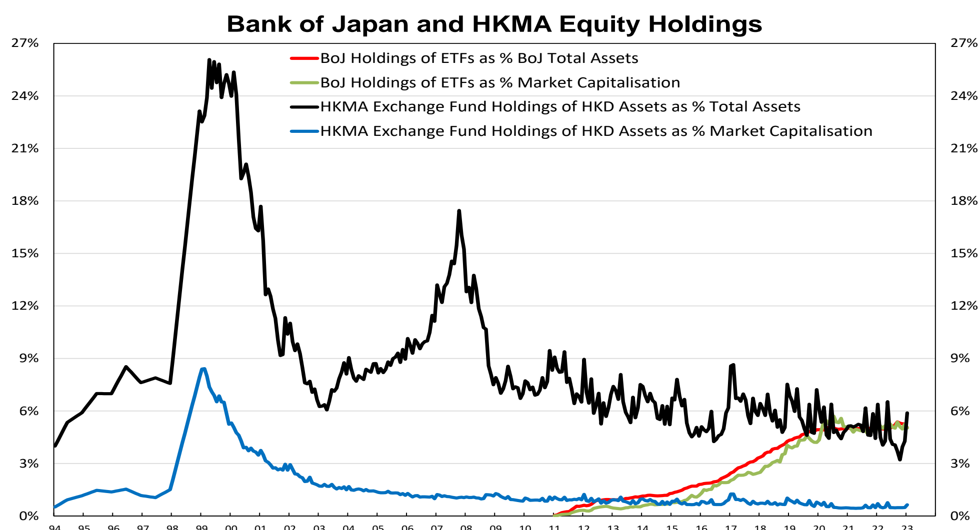
Ray Davies of the Kinks once sang "I'm not like everybody else"



[10] Who owns the other 20% is an open question but to quote my good friend James Aitken, "they must be seriously desirous of losing money."

A similar argument can be made for the BoJ to subsequently unwind its equity holdings, in a relatively smooth manner, assuming this can be executed against a backdrop of a generally rising stock market.

The BoJ can arguably unwind its equity holdings in a relatively smooth manner



The experience of the HKMA is illustrative. Compared to contemporary Japan, at the peak of its stock market interventions in 1998, Hong Kong's *de facto* central bank held a significantly higher share of equity assets both as a percentage of the market and, especially, its own balance sheet. These were subsequently packaged up into the Hong Kong Tracker Fund which was sold to retail investors at a slight discount to NAV to encourage widescale participation. Admittedly, the equity risk tolerance of your average SAR citizen is rather higher than your average Japanese. Nevertheless, the bull case one hears from local brokers (and one has been hearing the case for many, many years), is this can only go in one direction.

The experience of the HKMA is illustrative

As for the currency, with the Yen having seemingly turned with the initial "refinements" to YCC announced, Team Japan has more of an incentive to bring some of its USD10 trillion pot of foreign assets home. Behind the scenes – especially in the light of the recent *débâcle* at SBV – regulatory pressure to do the same is also apparently being cranked up.

Team Japan now has more of an incentive to bring some of its USD10 trillion pot of foreign assets home

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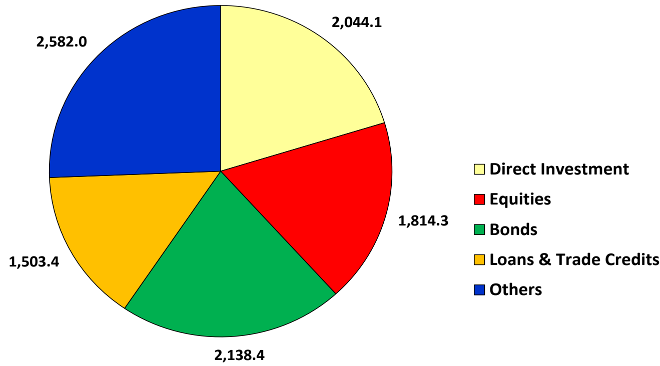

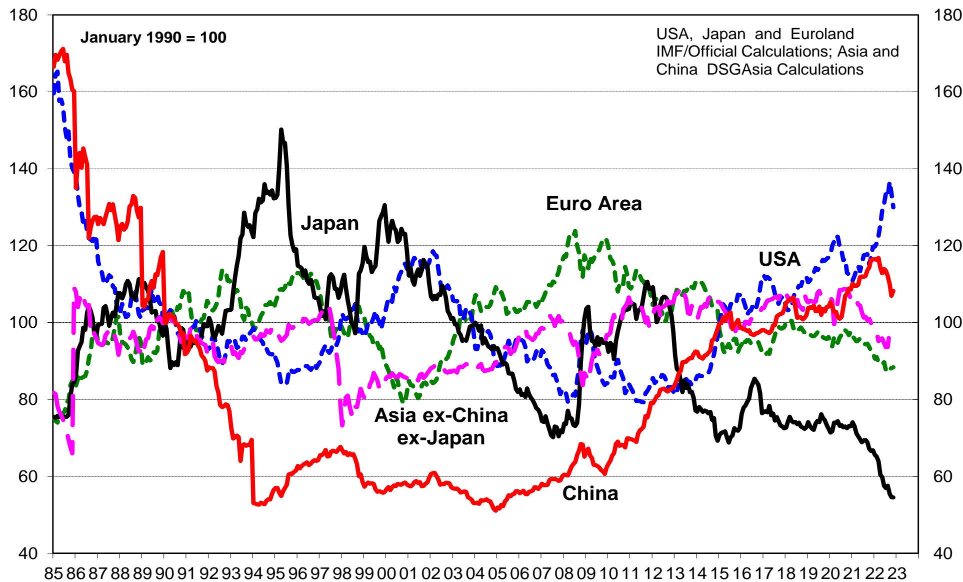

The slight recovery in USD/JPY has yet to be reflected in any meaningful uptick in Japan's egregiously undervalued real trade-weighted exchange rate as charted above. New Governor Kazuo Ueda seems likely to continue to move rather cautiously away from YCC yet, should his pace of transition disappoint even extremely tame market expectations, the risk is that the Yen starts to slide again. Further out, I believe the Yen (and the equally-inexpensive Korean Won) will move materially higher both against the dollar and on a trade-weighted basis. But we probably need to get through to the other side of the manufactured exports slowdown first.

The slight recovery in USD/JPY has yet to be reflected in any meaningful uptick in Japan's egregiously undervalued real trade-weighted exchange rate

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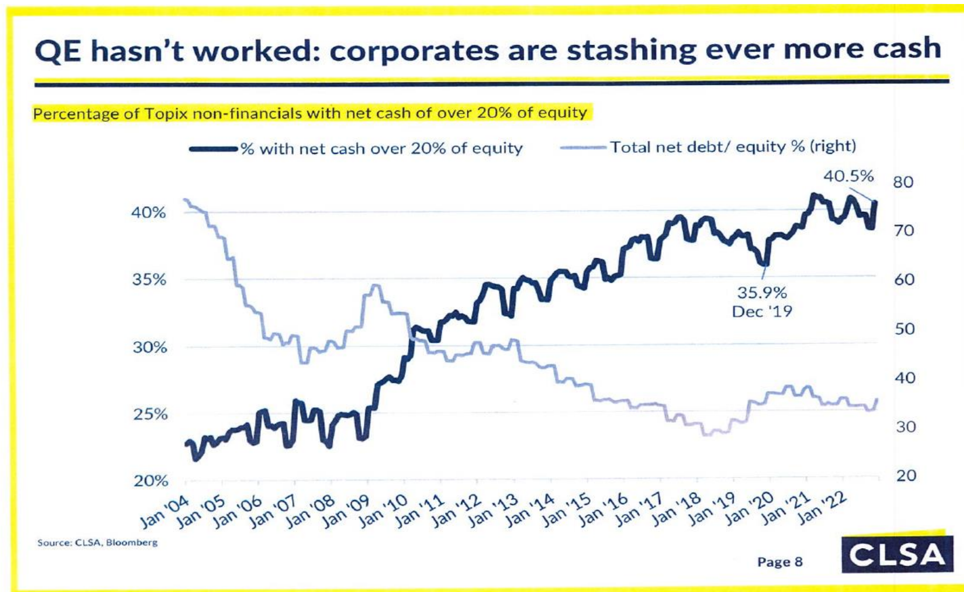
Questions have been, not unfairly, raised as to whether some of Japan's more exotic or weaker financial institutions have disproportionate interest rate risk – domestic and overseas – on their books. The answer, given Japan's proclivity to accumulate toxic assets (a north Asian speciality) is almost certainly a "yes." Then again, when was the last time you heard of a Japanese financial institution being taken down by a mark-to-market stipulation? Do not stir my sweet Prince of Extend and Pretend.

When was the last time you heard of a Japanese financial institution being taken down by a mark-to-market stipulation?

The same logic cannot be reasonably applied to a corporate Japan that will likely need to adjust to a somewhat higher cost of capital. Rather analogous to the brief discussion of wages earlier, this is not really an issue for the larger companies as the chart below from CLSA's indefatigable Nicholas Smith suggests.

Large Japanese corporates are cash rich



At around 100% of GDP (source Flow of Funds), Japan's corporate indebtedness in total is twenty percentage points lower than it was in 1990 and compares favourably to China's 140% or the Eurozone's 110%. (As an aside, Japanese households are also amongst the OECD's least-indebted.) The implication from the total corporate debt aggregate and the chart above though is that SME indebtedness is rather higher. So, will a transition to higher rates – assuming that the regional banks will continue to look kindly on the Mom n' Pop charges – finally set off the raft of small corporate failures that have been studiously avoided for the past three decades?

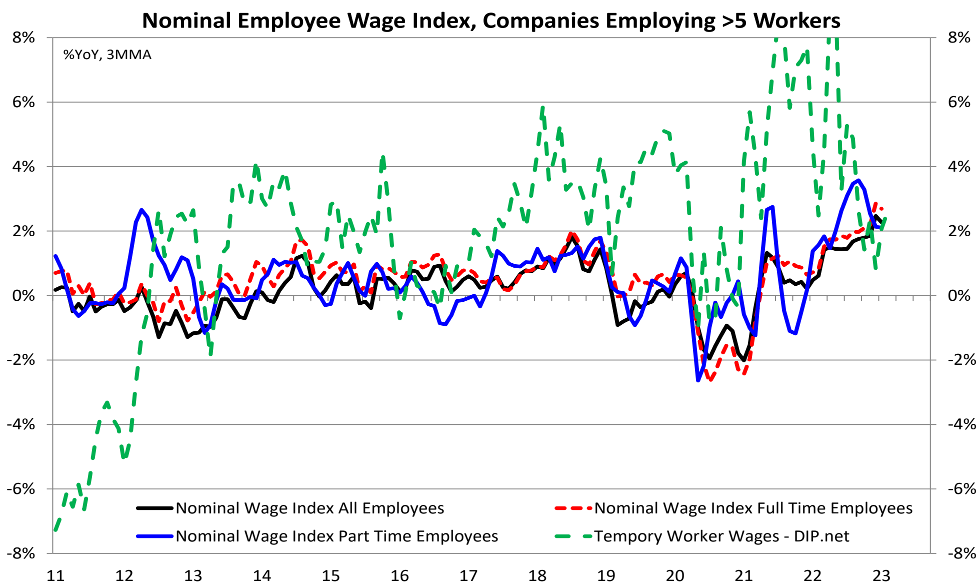
Japanese households are also amongst the OECD's least-indebted

Accepted wisdom on the ground is that smaller companies will be generally able to eke out sufficient cashflow to at least pay potentially higher interest costs, assuming we are only talking about rises of 100 basis points or so. Nevertheless, what will really do for them will be higher labour costs as the majority will be unable to keep up with the increases now being offered by larger corporations.

What could really do for smaller Japanese will be higher labour costs not higher interest rates

The optimistic interpretation proffered was that smaller zombie companies – especially those owned by aged self-proprietors – will finally shut their doors freeing up a reservoir of hoarded labour to be re-distributed across a broader economy desperate for workers. This sounds a little too neat and painless to me given skill-mismatches are likely to be widely-prevalent. However, if the process can be handled with sufficient empathy and forbearance, then perhaps Japan's estimable social fabric *can* accommodate the changes required relatively painlessly.

Will this allow the reservoir of hoarded labour to be re-distributed across a broader economy desperate for workers?

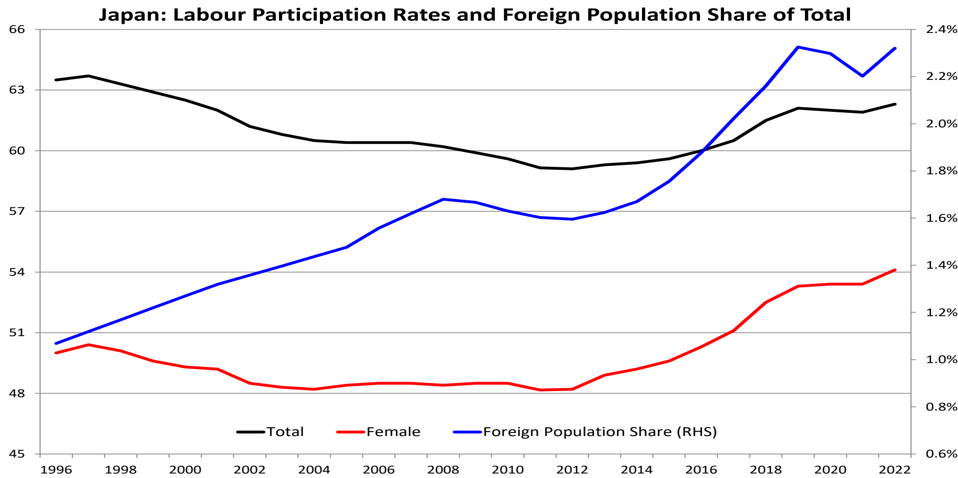


As a final note, how tight really is the labour market? Because of Japan's traditionally rigid seniority-based employment policies, workers – grudgingly or otherwise – have tolerated the burgeoning of a two-tier labour market. Full-time, older workers have been seemingly willing to serenely work out their "permanent" years in return for minimal wage growth while salaries for part-time and temporary workers, with less secure contracts and benefits, have risen at a considerably faster rate.

How tight really is the labour market?

As noted earlier, over the past decade, a larger cohort of female and foreign workers has also entered the workforce while many of the elderly employees who have reached the end of their contractual permanent contracts have been hired back at often considerably lower-cost packages.

Higher female employment, older Japanese working longer



It helps that your average Japanese is rather healthier and spritelier than your average American (and arguably rather more motivated to continue working than your average Frenchman – the pension age is going to 70 with seemingly minimal fuss albeit with probably some attendant tooth-sucking). Although Japanese and American male participation rates were almost identical before covid, the surge in over-60s employment in the Land of the Rising Son compares starkly to that in the Land of the Septics.

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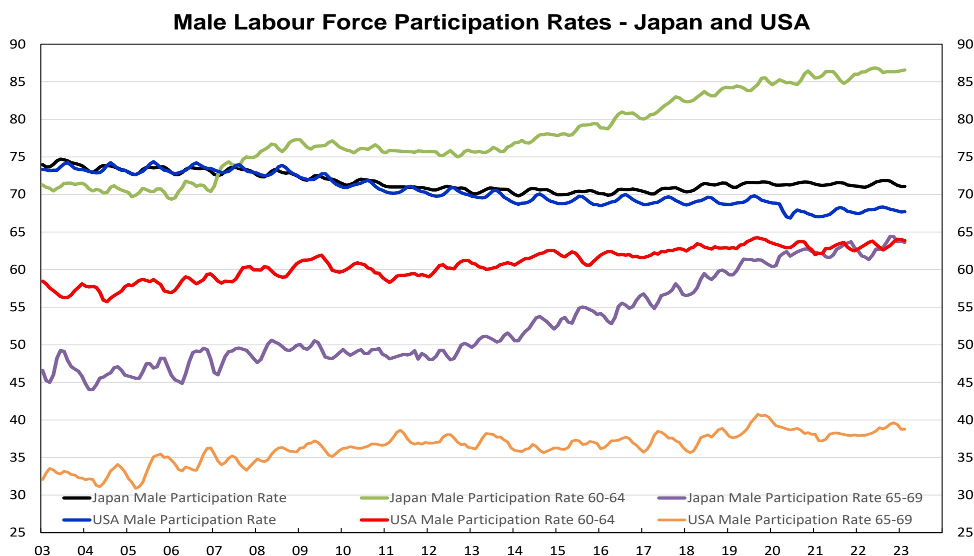
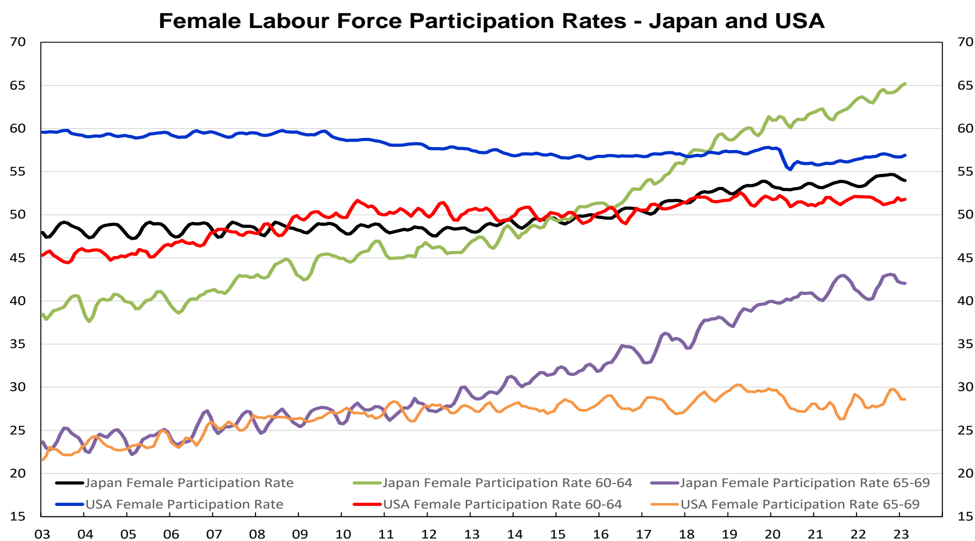


The potential remains to further raise the participation rate of the most productive female cohorts

The more radical changes have been witnessed amongst female cohorts. Two decades ago, there was a twenty percent difference between Japanese and American female participation rates which has all but closed today. Similarly, older Japanese ladies seem far more willing/compelled to work for longer. The mathematical implication from the above is that Japan still has significantly lower female participation rates amongst the most fecund age groups. Attempts have been made, with some success, both to address misogynistic societal attitudes and, more granularly, to improve childcare facilities for working age mothers.[11] Progress has been slow but should such initiatives bear more fruit over time, the potential is there to further raise the participation rate of the most productive female cohorts.



[11] It is harder to say the same for South Korea – the OECD's champion sexists year-in, year-out – where one of the first actions of the incoming government was to abolish the Ministry for Gender Equality. As Japan has shown, this is a relatively easy lever to pull should the willingness be there.

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