Leaving the Two Lost Decades Behind with "Abenomics"

2013 Is the Year for Rediscovering Japan's Potential

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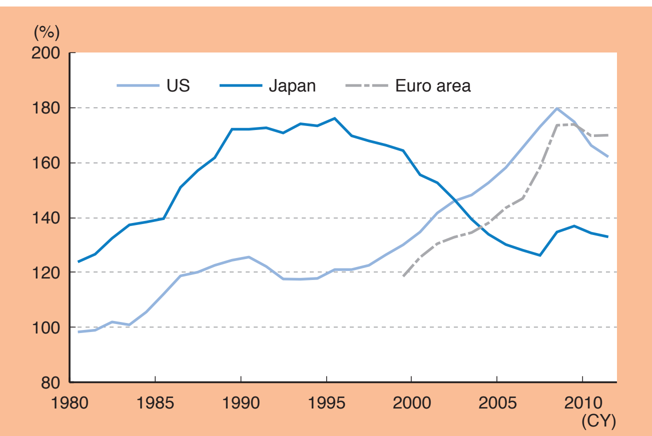
Credit expansion is a precondition of balance sheet adjustment; this is represented by the private debt-nominal GDP ratio, for which *Chart 1* provides a comparison of the figures for Japan, the United States, and Europe. Japan's economic bubble began to burst in 1990, triggering the long-term economic stagnation that accompanied the balance sheet adjustment. Meanwhile, the US and Europe went through their own bubble-generated booms beginning in the first half of the 1990s and entered a balance sheet adjustment phase around 2007 not dissimilar to Japan's. Now, by 2007, the Japanese balance sheet adjustment had by and large run its course and the Japanese economy was poised to put the "lost decade" behind it. However, external pressure arose in the form of overseas balance sheet adjustments led by the US. Its troubles compounded by a rising yen, the Japanese economy was pulled back into the "second lost decade" and the nation became ensnared in a pessimism trap. This essay will argue that, as the US balance sheet adjustment, now in its seventh year, finally draws to a close, the Japanese economy is also taking its first steps away from the "two lost decades". More specifically, "Abenomics", the new set of policies being deployed by Prime Minister Shinzo Abe and his administration, has been so effective because it has changed the Japanese mindset by taking the opportunity of the tidal shift led by the US economy to implement appropriate policy measures.

CHART 1

Private debt-GDP ratio for Japan, US & Euro area



Note: US and Europe data are for calendar year; data on Japan are for fiscal year. The private sector is calculated as the sum of the private non-financial sector and the household sector.

Sources: Mizuho Research Institute, based upon Haver, Cabinet Office, Eurostat and European Commission

As *Chart 1* shows, Japan's credit expansion peaked around 1990 while the subsequent adjustment took well over a decade, until the mid-2000s. Meanwhile, the US and Europe rapidly built up debt from the mid-1990s with the result that they, too, had to undergo balance sheet adjustments after 2007 in the aftermath of the bursting bubble. Japan's "second lost decade" happened because external pressure hit Japan in the form of overseas adjustments led by the US at the worst time possible, just as it had finished adjusting its debt overhang. Moreover, the yen trended up, entrenching the corporate orientation towards debt reduction and margin compression and pushing Japan into a deflationary equilibrium and a pessimistic mindset. The midpoint of 2012 marked the peak of this pessimism, the nadir of darkness.

By the mid-2000s, the disposition of excessive, mainly corporate, debt and balance sheet adjustment had more or less run their course in Japan and normalcy had returned to financial functions. Currently, nearly half the publicly traded companies in Japan have improved their finances to virtual debt-free status (fiscal year 2012), nearly twice the ratio of such companies at the beginning of the 1990s. This debt reduction behavior of Japanese firms made sense during the balance sheet adjustment after the economic bubble burst. However, this resulted in a decline in asset values and deflation, which generated and perpetuated a deflationary mentality. The challenge for the Abe administration in the escape from deflation is to reverse the negative Japanese mindset that evolved in response to the altered environment and return it to its state before the bubble burst. The emphasis on "regime change" under the rubric Abenomics stems from this need for a change in outlook.

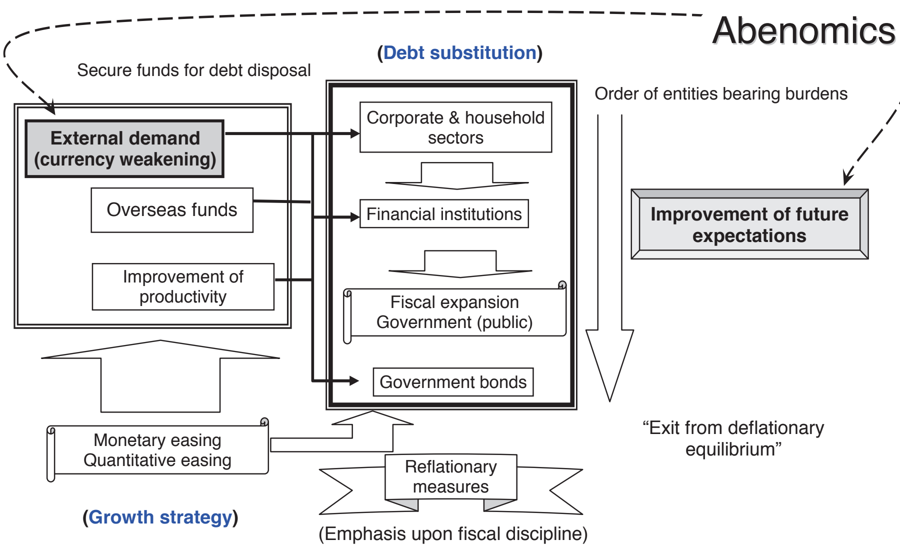
Fundamentals of Balance Sheet Adjustment

The fundamentals of balance sheet adjustment consist of the three principles in response to capital depletion as the result of balance sheet adjustment shown in *Chart 2* : (1) debt substitution, (2) growth strategy to secure funds for debt disposal, and (3) improving asset values though the improvement of future expectations. In Japan's case, (1) has already been taken care of during the last two decades. The remaining challenges are securing funds for debt disposal through a growth strategy and improving future expectations. Specifically, on the left side of the diagram is the necessity for a growth strategy that is needed to secure funds for debt disposal, while the right part indicates that the damaged capital is restored by enhancing asset values through the improvement of future expectations by achieving the growth strategy. The growth strategy would ideally consist of structural reforms generating productivity improvements and other benefits. Historically, however, revival at the national level has almost always relied on external demand through currency devaluation. The crucial problem for Japan over the last two decades was the high value of the yen, which made it impossible for it to rely sufficiently on external demand and resulted in a decline in future expectations.

The debt substitution in *Chart 2* was achieved in Japan through government bonds, but the two other challenges, which are shaded in the chart, remained: weakening the currency and improving the mindset. The essence of Abenomics lies in working to conquer these two remaining challenges. The reason that I identify Abenomics as the first step in escaping the "two lost decades" is that nearly six years after the adjustment in the US began in 2007, the debt adjustment process is entering its terminal phase there and the path to recovery in 2014 and beyond has emerged. As a result, the downside pressure on the dollar has been reversed. Last April, the Bank of Japan embarked on "a new phase of monetary easing". This was a joint expression by the government, the financial authorities, and the private sector of their powerful determination to slay deflation.

CHART 2

Diagram for balance sheet adjustment



Source: Mizhuo Research Institute

Phenomena belonging to a new phase do not materialize from Abenomics like magic. Rather, the key to Abenomics is that it captured the moment of the turning of the tide in the first half of 2012, when the headwind that Japan had been facing, the abyss of pessimism compounded by extreme upside pressure on the yen generated by the US-focused adjustment process, reversed itself and became a tailwind as the US exit began to materialize. And it was so highly effective because it imprinted "initiation" and "regime change" in the public mind to help this process along. Some may say that this means that timing has been everything for Abenomics and that it's all about luck. However, being able to take advantage of such timing is surely the most sought-after trait in a politician.

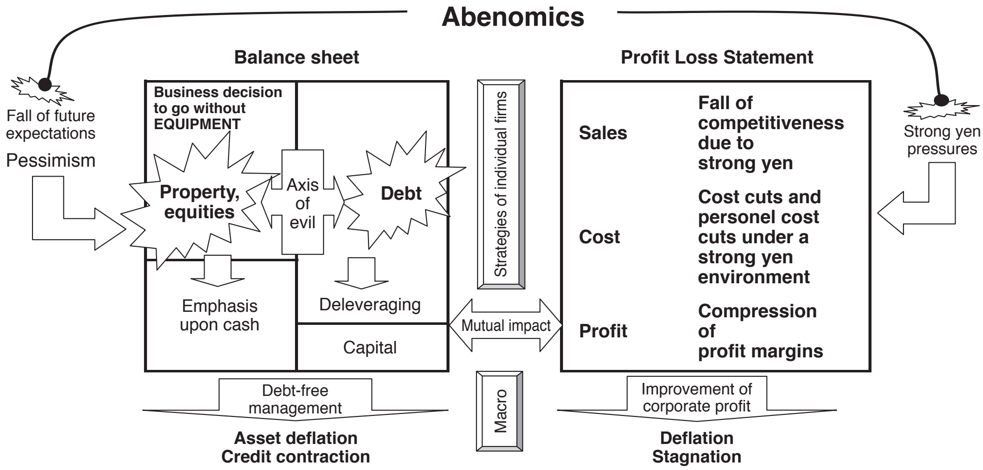
How Abenomics Will Change Corporate Behavior

The next challenge for Abenomics is in taking this opportunity of a change in the macro environment to influence corporate behavior. *Chart 3* depicts how individual corporate strategies for survival in the post-bubble decades resulted in a fallacy of composition that led to both asset deflation and deflation in the conventional sense. This occurred in connection with corporate balance-sheet management and actions reflected in profit-and-loss statements.

A couple of conditions paved the way to this outcome. In the balance sheet adjustment that began in the 1990s, future expectations turned downward, precipitating reductions on both sides of the balance sheet, in assets and debt, while firms, living under the threat of a strong yen, continued to harbor profit-and-loss-statement worries. The post-bubble threat from a strong yen was particularly decisive during the initial five years (1990-1995) and the last six years (2007-2012). The fundamentals of the Japanese economy justified a weak yen, as the economy foundered after the bubble burst. However, the first half of the 1990s were the worst of the postwar years as far as trade friction was concerned, with automobiles providing the harshest battleground; it is possible that this situation may have conspired to keep the yen strong. Much later, since 2007, deterioration in the Japan-US relationship may have pushed up the yen in addition to the impact of the weakening dollar as the result of US balance sheet adjustment. I have also argued with regard to balance sheets in the Japanese capital market that stock and real estate on the assets side and debt (leverage) on the liabilities side were subjected to further downside pressure because they were regarded as the “axis of evil”.

CHART 3

Diagram of post-bubble survival strategies of Japanese firms



Source: Mizuho Research Institute

Diminishing & Deflationary Equilibrium Caused by Evolution of Firms

Japanese firms did not stop at balance-sheet responses in the post-bubble years since the 1990s. Instead, they became attached to the practice of restructuring at the profit-and-loss level, in income and expenditures, in response to a strong yen.

At the balance-sheet level, this meant survival by slimming down: deleveraging by reductions on both sides of the balance sheet thorough asset disposal and debt reduction. At the same time, on the annual flow level, firms continued to take measures to reduce profit margins and costs, including wages, as depicted in *Chart 3*, in order to be able to develop the corporate fortitude to survive from year to year in a diminishing equilibrium environment generated by credit contraction of a balance sheet adjustment compounded by a perpetually strong yen. As a result, lean balance sheets have led approximately half of the publicly traded companies in Japan to become virtually debt-free and survive even under extremely high exchange rates for the yen. Competitive price-cutting can been seen as the result of the survival strategies of the individual firms.

However, at the macro level, this corporate behavior meant that the pressure that accompanies credit contraction was brought to bear particularly strongly on the asset markets, generating asset deflation. Simultaneously, cutting profit margins and costs including wages imposed deflationary pressures on goods and services transactions.

Herbivorous Evolution & Deflationary Equilibrium

The process that I have illustrated is the consequence of the survival strategies of individual firms; it is also a snapshot of the deflationary equilibrium in the Japanese that has settled in over the years as the consequence of a “herbivorous evolution”. I have been using *Chart 4* to outline my argument that Japan has become a nation of deleveraged, deflationary-minded herbivores as behavioral patterns reflecting lowered expectations took hold as a result of the post-bubble balance sheet adjustment. From a generational perspective, the only world that the Japanese in their 20s and 30s know is the post-bubble deflationary environment; they are the “herbivores” in *Chart 4*, the “children of deflation”. The Japanese in their 40s are the “children of restructuring”, who have spent their working years cutting costs and seeking a diminishing equilibrium. For my generation, the Japanese in their 50s, success has meant “surviving” through this restructuring process. There is a line drawn between all of these generations and the previous “carnivorous” generations that emerged victorious in the high-growth era and the bubble years.

Regime Change Necessary to Reverse Generational Herbivorization

The difficulties of overcoming deflation are the difficulties of reverting to the original conditions when the psychological bias that I have explained has taken root so firmly. Challenging Abenomics is the difficult process of first doing away with the lowered expectations for the future and the worries over a strong yen that triggered corporate balance-sheet and profit-and-loss behavior and reorienting the entrenched behavioral bias. The reason that I believe the Japanese economy has taken the first steps towards this conversion is that adjustment pressures from the US that generated worries over a strong yen have been subsiding coincidental with an increasing closeness in the overall bilateral relationship, creating

CHART 4

Behavior principles of herbivores & carnivores

	Herbivores	Carnivores
Social behavior	Lower expectation level	Pursuit of ideals
Financial behavior	Balanced contraction	Expansion
Price behavior	Deleverage	Leverage
Individual behavior	Deflationary mindset	Inflationary mindset

Source: Mizuho Research Institute

expectations of a positive environment in terms of external demand. It is also the change in the mindset that Abenomics and the BOJ under its new governor Haruhiko Kuroda are setting into motion by emphasizing regime change, taking "new phase" as the catchphrase.

Be Ready for a Long March

The reason that economic recovery has not, until now, led to improvements in employment and personal income or, when personal income did improve, consumption must have been the significant anxieties over expectations of the future. Even as stock prices went up as 2012 drew to a close, market participants continued to have doubts about its sustainability. One reason for this was the worries over political continuity. Indeed, there is no room for confidence for economic policy in a discontinuous political environment where, since 2006, prime ministers have been replaced every year and regime change has been repeated. The private sector had become inured to "managing with less" through reductions on both sides of the balance sheet as the result of two decades of deleveraging through balance sheet adjustment. At the same time, it had undergone the aforementioned "herbivorous evolution" as the survival-oriented behavioral patterns of the past two post-bubble decades of cutting costs and profit margins on the profit-and-loss statement took hold amid persisting worries of a strong yen.

Going forward, it is essential to erase worries over a strong-yen environment and to break away from the political pattern that sees a new prime minister every year. The results of the July 21 upper house election, which has finally put an end to the "twisted Diet", gives hope of three years of stable administration. At the same time, half a year of a weak-yen trajectory, plus confirmation of a steady US economic recovery, has pushed worries of a strong yen far into the background. Of course it will take time to improve mindsets. Moreover, given that decision-making in human society requires going through predetermined procedures, change will have a tendency to reach the margins of the income and employment environment only when business plans for the 2013 fiscal year and the second half of the fiscal year are revised. In other words, there is insufficient time and it is difficult to achieve results until then.

Japan Set for Positive Reappraisal in 2013

You cannot cure someone's depression just by telling that person to hang in there. Likewise, reversing a bias that has been generated and sustained over two decades is not easy. Only by re-identifying one's strong points and recovering self-confidence can that situation be reversed. The political leaders now in charge, beginning with Abe, have come together to form a cabinet with their failure in the past on their conscience. Likewise, the private sector has the failure of the last two decades on its conscience. What is the essence of Abenomics if not the quest for redemption of those with repeated failures in the past on their conscience? The key here is to recognize that Japan is well-endowed and to use the potential lying in that endowment as leverage. Effecting change in the real economy when we have the past on our conscience will take time. However, once change is set in motion, there may well be created a steady movement of a kind that has not been seen before. This movement can only be achieved by leveraging Japan's potential, the endowment that we have.

Japan is the only major developed country that has fallen into sustained deflation since World War II, making Abenomics a monumental financial and economic response to challenges never before encountered in the postwar period. However, the reason why this effort is already producing results is the fact that Japanese firms had already dealt with their debt issues and had maintained their technological, adaptive, and other powers. The resilience of the Japanese people manifested in the recovery from the Great East Japan Earthquake on March 11, 2011 was also a factor. Abenomics has awakened this potential in the Japanese economy. The year 2013 will mark the great turning point in the escape from the "two lost decades" as the one in which this potential will be activated – the year in which the Japanese economy will be the subject of positive reappraisal by the rest of the world. JS

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