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Tomoya Masanao Discusses Japan's New Government and Implications for Japan's Economy and Markets



Tomoya Masanao

Mr Masanao is an executive vice president in the Tokyo office and head of portfolio management Japan. He is also a chairman of PIMCO's Asia-Pacific Committee. Mr Masanao joined PIMCO in 2001 as a global portfolio manager and has been based in Tokyo since 2002, managing global and Japanese portfolios. Prior to joining PIMCO, he was an executive director and senior portfolio manager at Goldman Sachs Asset Management in London. He was also associated with Sumitomo Bank as a proprietary trader in London and a credit analyst in Osaka. He has 19 years of investment experience and holds an MBA from Boston University. He also holds a master's degree and an undergraduate degree, both in engineering, from Osaka University.

Japan's general election for the parliament's lower house on August 30 resulted in a landslide victory for the Democratic Party of Japan (DPJ), an opposition party that has decisively seized control from the established Liberal Democratic Party (LDP), which has governed Japan since 1955 (except for 11 months in 1993–1994). In the following interview, PIMCO's Tomoya Masanao, head of portfolio management in Japan, discusses Japan's new government and its implications for the Japanese economy, financial markets and investment strategies.

Q: The media are calling the LDP's defeat a historic moment in Japanese politics. What has Japan chosen? Is the new leadership likely to bring meaningful changes to Japan's economy?

Masanao: Possible. But there are a lot of uncertainties. Japan has simply chosen to end the LDP's policy complacency, rather than seeing their future in the DPJ's policies. In the most demographically challenged and fiscally constrained economy in the world, there will unfortunately not be easy and quick solutions to the problem of secular economic stagnation, anyway. But this still is a historic event in that democracy has caused a change of the government in Japan.

The DPJ's populism has won the day, while the LDP successors of former Prime Minister Junichiro Koizumi, who four years ago led his party to win a majority of the Lower House, were neither able to pursue structural reforms to boost Japan's long-term economic growth nor able to deliver sound solutions to its economic challenges, including the worsening fiscal condition, and the health care and pension problems. Critics even blamed Mr Koizumi's pro-capitalism policies as a cause of growing inequality of wealth and a lower labour share of income, rightly or wrongly. The macroeconomic environment was well set for populism to win. Remember, Mr Koizumi was shouting, "No pain, no gain!" when selling his reform agenda. Japan has chosen to take "pain-killers".

A victory of populism and a rebalancing of wealth between capital and labour, by the way, are not unique to Japan. It is a global phenomenon in this post-crisis world.

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Q: What are the main points of the DPJ's policy agenda? What will be the implications for the Japanese economy?

Masanao: There are two main points here.

First, the DPJ's overarching policy aim is to redistribute wealth to the household sector, but this will most likely come perhaps at the expense of reducing long-term nominal growth. For 2010–2013, a total of ¥16.8 trillion (or 3.4% of GDP) is expected to be used to subsidise households, which will primarily benefit lower income earners. For example, the DPJ intends to introduce child care allowances worth ¥5.5 trillion, and farming subsidies totalling ¥3 trillion. The DPJ claims they will finance the subsidies by suspending fiscal investment already budgeted for this year, cutting future investment, abolishing tax deductions (i.e. increasing tax), and withdrawing fiscal reserves.

Second, the DPJ seeks a stronger tie with China and the rest of Asia than the LDP did while de-emphasising US market-oriented capitalism and re-defining the US-Japan security alliance. A stronger tie with China and the rest of Asia will no doubt be desperately needed, given that regional economic integration is expected to be more, not less. However, it will probably be challenging for Japan's new administration to make a successful foreign policy transition without jeopardising the Japan-US security alliance and economic relationship.

As for the near-term economic implications, the new ruling party's policies will likely lift GDP growth in 2010 and 2011 because of a planned mismatch between the timing of the subsidies to the household sector and the funding for it (through spending cuts and tax increases). For now, this strategy should help mitigate the risk of the economy falling into a "double-dip" in 2010, but it will likely reduce growth by a similar magnitude in 2012–2014.

Over the long term, we do not believe that the DPJ's policy will meaningfully boost Japan's potential growth rates.

First, we are particularly worried that the DPJ economic policy agenda is going to be less friendly for large corporations than the LDP's: The new administration intends to impose re-regulation of part-time labour and increase minimum wages, which will likely reduce labour flexibility and increase costs for corporate Japan. The administration's ambitious target of cutting the nation's greenhouse gas emission by 25% by 2020 would also present the risk of reducing corporate Japan's competitiveness unless other countries also follow suit. Manufacturers therefore may have more incentives to shift their production abroad than in the past.

Second, optimists argue that the DPJ's policy may help counter Japan's demographic problem of low birth rates, as the DPJ's childcare allowance should encourage people to have more children. That's a possibility, but we are not that optimistic. Japan's total fertility rates (1.34 in 2008), or the average number of children that are expected to be born to a woman over her lifetime, have been in a secular declining trend, and well below the replacement rates of a little over 2.0. Yet, the birth rate of married women has not declined much in the last decade, which means that it is the increasing number of unmarried women that is contributing to

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the lower overall fertility rate in Japan. We are not sure if the childcare allowance can change this situation dramatically.

Q: What are risks to the DPJ's policy agenda and its economic implications?

Masanao: We see more risks to the downside than the upside.

First, the DPJ may fail to deliver the income subsidies that the party promised, which would increase the risk of a double-dip scenario for 2010 and destabilise the political situation. This could happen either because of public concerns over the funding source for income subsidies or through a compromise with the small coalition parties.

Second, the income subsidies may get delivered as planned, but the financing for the programme may prove to be problematic, which would raise the fiscal risk premium and could "crowd-out" the economic stimulus effects. There is also a risk that the subsidies to the lower income earners may just end up as savings in the world of increased uncertainties.

Third, the new administration may mishandle the Japan-US partnership, which could potentially damage Japan's export sector and increase the geopolitical risk in East Asia. The DPJ's foreign policy stance appears to be much more hawkish toward the US than the LDP's. Smaller ruling coalition partners could complicate the DPJ's position vis-à-vis the US even more. Though Japan's economy has become much more integrated with the rest of Asia, a large part of the economy still remains G-2 dependent, since the major exports are high-end consumer and capital goods.

Fourth, a proposal to force banks to offer a "debt moratorium" to weak small and medium enterprises (SME) is unlikely to be implemented as currently proposed, but the idea perhaps demonstrates the new administration's policy focus on subsidising the weak sector of the economy. Such government intervention is likely to prolong misallocation of capital and labour in the economy.

A potential upside risk? It would be an acceleration of Japan's economic partnership with China and the rest of Asia.

Q: How will the Bank of Japan's (BoJ) policy stance be different? Will the new administration change the BoJ's plans for the bank's exit policy?

Masanao: I do not think that a change of the administration or its policies will have *direct* influence on the BoJ's policy. What matters is price stability and the health of the financial system and markets. Growth may be put forward by the DPJ's policy in 2010–2011, but the output gap will likely remain very wide so that there will not be inflation pressures. We expect some of emergency measures that the BoJ has conducted to be unwound if the financial system and markets further stabilise; however, we continue to expect the BoJ's low interest rate policy to remain in place for a considerable period of time, and even more so in case the downside risks in the economy that we discussed above materialise.

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Q: What will the consequences of the new government's policies be for investors in the Japanese markets?

Masanao: The new administration's unfriendly policy for large corporations suggests that a cautious risk posture in the Japanese credit market in general will be appropriate, particularly given the current valuations in the credit market. We have been cautious about Japanese corporate credit given the macroeconomic backdrop. The new administration's policy raises potential medium- to long-term concerns for corporate Japan in general, which in turn underscores the importance of bottom-up issuer and issue selection for our client portfolios.

The BoJ's policy of low rates for an extended period of time coupled with the potential downside risks in the economy suggest the intermediate part of the Japanese government bond (JGB) curve will continue to be a prudent duration. Yet, the longer end of the yield curve looks vulnerable as we believe it requires a higher fiscal risk premium due to the new administration's policies.

The DPJ's foreign policy bias toward Asia and away from the US and economic policy focused more on households than on large corporations should translate into medium- to long-term tolerance for yen appreciation, which seems likely to parallel other Asian countries' increasing tolerance for their own currency appreciation. However, we will continue to favour a basket of selected ex-Japan Asian currencies that are cheaper than the yen on a valuation basis.

Thank you, Masanao-san.

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