BEYOND THE BANK OF JAPAN: FISCAL WOES TO KEEP THE YEN WEAK

Jesper Koll – Senior Advisor
10/22/2015

The yen is poised to remain a structurally weak currency. In coming weeks, yen volatility is expected to rise as short-term market players position for potential changes in central bank policy. Here we maintain our call for added ease from the Bank of Japan (BOJ) to be in place by the end of the November 18–19 policy board meeting. More importantly, beyond this short-term outlook, the case for a continued structural depreciation in the yen remains strong because of the dismal outlook for Japanese government finances, in our view. **Immediate Focus—Will They or Won't They?** The BOJ will hold two policy board meetings in the coming four weeks. The first is a one-day meeting on October 30. The second is a regular two-day meeting on November 18 and 19. For October 30, the main agenda item is the semiannual revision in the board members' "central tendency forecast" for inflation and growth. The November 18–19 meeting will follow the release of the July–September gross domestic product (GDP) report on November 16. Expect more pundit commentary and jockeying for market positioning in the run-up to these dates. In our view, added ease is likely at either the October or November meetings. Our rationale here is not primarily the continued weakness in Japanese domestic economic indicators—industrial production fell to 1.4% below the April–June quarterly average in July and August, following a sharp 2.8% drop in April–June from the January–March average. The real reason is political: Prime Minister Shinzo Abe and his team are very focused on reasserting a coordinated pro-growth policy drive. In our view, a switch in BOJ priorities from de facto Consumer Price Index (CPI) targeting toward targeting nominal GDP—that is, the BOJ explicitly falling in line with Abe's new ¥600 trillion target for Japan's nominal GDP (currently approximately ¥500 trillion)—is possible. Of course, merely changing the target from 2% inflation to ¥600 trillion nominal GDP will not do much in itself. An increase in BOJ asset purchases is likely, in our view, centering on both exchange-traded funds (ETFs) and adding municipal, regional and "zaito" government bonds to the BOJ's bond buying options (which are currently limited to national government debt only). If so, the short-term case for added yen depreciation rests on this added quantitative ease. **Structural Focus—Fiscal Unsustainability** The more medium-term case for yen depreciation rests on more fundamental economic grounds: Japan's fiscal dynamics appear locked in a vicious cycle of endless budget deficits running around 2% to 5% of GDP in the foreseeable future. Why? To understand Japanese government finances, we have looked at the past 35 years of data on both expenditures and revenues as a share in nominal GDP (see table below). This historic perspective shows that increasingly heroic assumptions are needed to escape from permanent deficit financing. Specifically, over the past 35 years, total expenditures exceeded revenues by an average of 5.1% of GDP, with expenditures averaging 18.1% of GDP and revenues 13.0%. **Japan's Fiscal Realities**

Budget		Average	High	Low
Total Expenditures		18.1%	22.6%	13.8%
	Social Welfare	4.5%	6.3%	3.0%
	Local Transfers	3.5%	4.1%	2.6%
	Others	8.8%	10.1%	7.2%
	Debt Services	1.3%	2.1%	1.0%
Revenues		13.0%	16.7%	7.7%
	Income Tax	4.6%	5.8%	2.7%
	Corporate Tax	3.5%	4.8%	1.3%
	Consumption Tax	2.0%	2.2%	1.8%
	Others	2.9%	3.7%	1.9%

Source: Japan Ministry of Finance, 1980–2014.

To understand the difficulty of getting back to a budget surplus, look at the “high” and the “low” of both spending and revenues. Expenditures peaked at 22.6% of GDP and troughed at 13.8%, while revenues peaked at 16.7% and bottomed at 7.7% of GDP. So to get toward a budget surplus, spending would have to be cut back to within 1 percentage point of GDP to the historic low, while revenues would have to rise to within 1 percentage point of the historic high. Given the realpolitik on both the expenditure and revenue sides, these seem like increasingly heroic assumptions, in our view. In other words, prospects are for the budget deficit to remain within 2% to 5% of GDP in the foreseeable future. **Japan's "Twin Deficit" to Keep the Yen Weak** Japan thus faces the combination of both a “perma-deficit” from the government and a structural deficit from the household sector (which is dictated by the demographics—that is, the aging society forcing dis-savings and a negative savings rate currently running at around 1.5% of GDP). The net result is an economy that must attract global capital to fund its domestic savings deficit. The necessary adjustment could come via higher interest rates or a weaker currency. In our view, the BOJ is poised to maintain its iron grip on interest rates in general, Japanese government bond (JGB) yield in particular—we do not want to fight the BOJ. In turn, we do expect that the currency will bear the brunt of the adjustment. Japan's “twin deficits” of both the public and household sectors argue that global investors should hedge their Japan asset exposure, in our view.

Important Risks Related to this Article

Investments focused in Japan increase the impact of events and developments associated with the region, which can adversely affect performance.

Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but can hurt when the foreign currency appreciates against the U.S. dollar.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Zaito institutions : Public corporations participating in the government's fiscal investment and loan program, known as “zaito.&rdquo.

Twin Deficit : a macroeconomic occurrence where a country runs both a current account deficit and a government budget deficit.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.