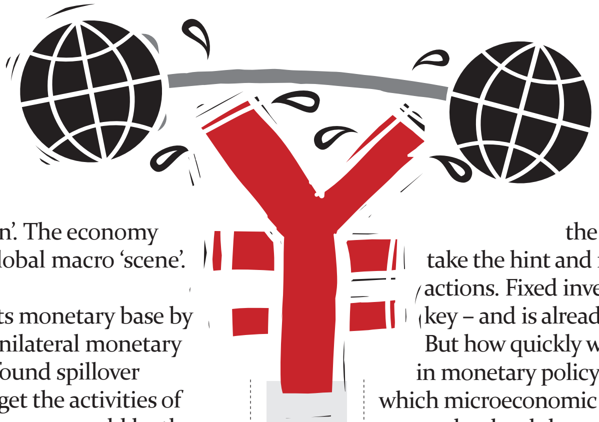
WHY JAPAN MATTERS

The decision of the world's third-largest economy to double its money base in less than two years could seriously affect global capital markets



Author TS Eliot once wrote: "However certain our expectations, the moment foreseen may be unexpected when it arrives." For almost 20 years, investors – and corporate treasurers – have dismissed Japan as a market you wanted to 'rent', but never 'own'. The economy was 'a taker' rather than 'a maker' of the global macro 'scene'. That is, until now.

The Bank of Japan's decision to double its monetary base by the end of 2014 is extraordinary. This is a unilateral monetary easing of global reach that could have profound spillover effects and unintended consequences. Forget the activities of the US Federal Reserve: the Bank of Japan's move could be the exogenous monetary shock of 2013. Corporate treasurers need to get to grips with the Japanese experiment because it has the potential to transform the global financial landscape.

Not everyone may be familiar with Japan's economic plan, which has a straightforward, if unorthodox, narrative. The radical Japanese government (supported by the US) seeks to revitalise Japan in the face of China's rapid expansion. The problem is that boosting growth through microeconomic reform is tough to do at the best of times, and a deflationary environment does not make things any easier. So it has instructed the Bank of Japan to adopt a radical shift in monetary policy to end deflation. Doubling the money base in less than two years (something that's never been seen in Japan over the past four decades) ought to go some way to taking Japan towards 2% inflation. The combination of micro reforms (especially labour market reforms), disincentives to hold cash (via negative interest rates thanks to higher inflation) and a 20%+ depreciation of the currency should be sufficient to persuade corporate Japan that the world has changed.

The hope is that Japanese companies will stop 'saving' and start 'spending' to take advantage of the opportunities that this new policy ought to create. Increased fixed investment should go hand-in-hand with increased employment into a relatively tight labour market, which should boost real wages. The combination of rising incomes and rising asset values should, in turn, boost tax revenues and reduce the budget deficit. Japanese bond yields are likely to rise over the next three years towards 2-3%, but that need not be a disaster provided the economy is growing more strongly.

The reaction in the developed world has been fairly positive. While the Bank of Japan's move is not synchronised with other central banks in terms of timing, it is nonetheless bold, unconventional and unorthodox… and therefore sits comfortably with the 'War on Deflation' that central banks have been waging.

The yen's weakness is 'collateral damage' – and should only last until Japan's Asian trading partners follow suit with their own policy easing. So what is there not to like?

A major uncertainty of this strategy is the speed with which corporate Japan will take the hint and respond rapidly to the Bank of Japan's actions. Fixed investment by Japanese corporates holds the key – and is already historically low relative to consumption. But how quickly will corporate Japan respond to this change in monetary policy? Will corporates hold back until they see which microeconomic reforms are forthcoming? Will they wait to see at what level the yen stabilises? Having spent years outsourcing production to other parts of Asia because of the strong yen, just how quickly will corporate Japan move to onshoring? This is one of the biggest uncertainties, with some investors saying they need to be confident of double-digit capex growth next year before buying into the government's new strategy.

The longer the Japanese real economy takes to respond to the shift in Japanese economic policy, the more we should be focused on the investment implications outside of Japan. If the Bank of Japan is supplying liquidity at a faster rate than Japan can absorb it, that excess liquidity is likely to flow overseas – and that's where things could get interesting.

You do not need to decide whether this Japanese policy experiment will succeed or fail. But what you do need to appreciate is that this has the potential to impact countries outside of Japan, and the potential to affect global capital markets. Could Japan's new policy stance disrupt the Japanese bond market in a way that increases volatility in the US treasury market? What does the dramatic collapse in the yen mean for Asian trade flows and supply chains? Could a change of regime in Japan exacerbate or even destabilise a regime change in China through the violent depreciation of the yen against the Chinese renminbi? If Japan's economy does not absorb the monetary ease, could that liquidity simply aggravate the global search for yield in a way that further misprices the global cost of capital?

The fact is that corporate treasurers have got away without thinking about Japan for much of their careers. Yet to ignore the spillover effects and unintended consequences of Japan's policy now could ultimately prove career-limiting. Maybe TS Eliot was on to something.

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