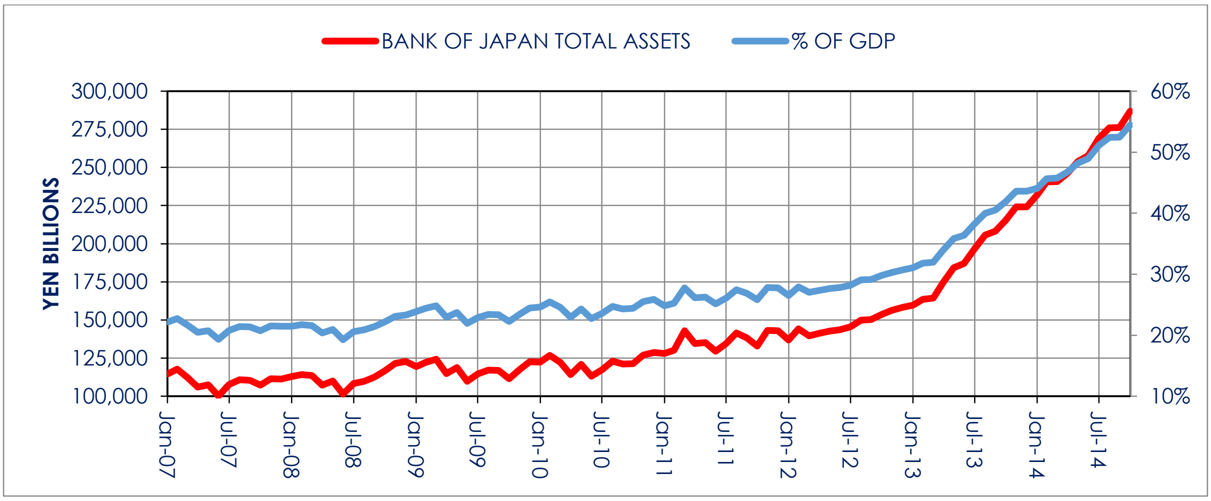
Japan - Prospect of a loss of confidence a step closer.

Recent policy adjustments in Japan were not part of the original plan.

That plan was founded on an expansion of the Bank of Japan's balance sheet that would "drastically change the expectations of markets and economic entities" (BOJ April 2013). A positive feedback loop was envisaged whereby a weakening of the Yen and an upward shift in inflation expectations, equity and real estate prices would lead to increased consumption and investment through higher wages and profits. As the economy strengthened, fiscal policy could be consolidated and structural reforms enacted improving medium and longer term growth prospects and bringing the worrisome debt to GDP ratio under control.

The first attempt at fiscal consolidation has blown the economy off course. Real GDP is on course to contract in 2014 despite a 90% expansion of the BOJ's balance sheet, a 1/3 depreciation of the trade weighted Yen and a doubling of the Nikkei since late 2012 when the current government was elected.

Chart 1: BOJ Balance Sheet Expansion



Given a projected budget deficit of 7.6% in 2014 the ratio of gross debt to GDP is likely to be close to 230% this year. Tighter fiscal policy has undermined GDP growth. Yet in the absence of fiscal consolidation gross debt will continue to expand. It's not easy to see how the ratio can be turned around.

The recent expansion of the BOJ asset purchase program together with this week's decisions to postpone a further increase in the sales tax and to dissolve parliament emphasise the urgency of Japan's predicament. The general election appears to be politically opportunistic and should be a positive in that politically unpopular structural reforms are more likely in the short term if the next election is in 2018 rather than 2016. Even so, Japan has a lot to do and one feels a loss of confidence in its capacity to extract itself from its predicament is a step closer. We remain short of the Yen.

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