

Asset Price Deflation

Is Japan the model?

By John Robertson

Reading time: 6-11 mins

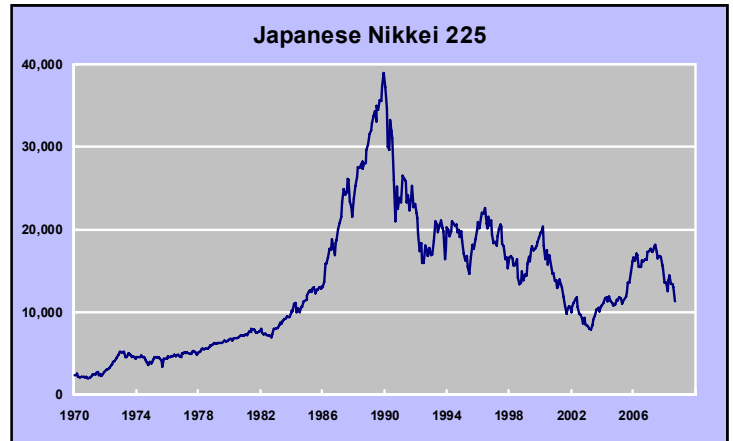
Investors face critical judgments about how quickly more normal economic conditions will resume in the USA. Japan's experience should not be ignored.

Despite the dramatic and possibly catastrophic shutdown in US bank lending, there is a sense among policymakers and commentators that the worst of the potential impacts can be averted, monetary conditions stabilised and more normal growth re-established quickly thereafter.

On this view, once the toxic housing loans have been cauterised, monetary policy will combine with an exuberant entrepreneurial class and the natural momentum of an expanding population to restore the economy to an acceptable growth path. Prosperity might be longer in coming to the housing market itself, but, within a few years, housing prices should have stabilised and resumed their upward path. Such a view is not uncommon and, to a large extent, understandable, especially among investors who have seen all the major economic threats of recent years shrugged off as asset values have continued their ascent.

The Japanese experience

An observer of the Japanese economy could have a different perspective. An asset price bubble burst in Japan nearly 20 years ago and economic life there has never been the same again.



The 1980s was a decade of unparalleled growth and prosperity in Japan. Annual **Japanese GDP growth** averaged 4.2%. US growth of 3.4% was more modest and growth of 2.8% in Western Europe over the same period of time was lower still. Manufacturing wages expanded at an annual 8.8% rate. Japanese inflation over the same time was 5.7%.

Japan laid claim to a global leadership role. The yen was talked of as a potential rival to the US dollar as an international currency. Japanese businesses were case studies for envious managers in Europe and the USA tried to match their growing commercial firepower.

The obvious bonds between government officials and Japanese business leaders were considered a strength by those looking from outside trying to glimpse the secret of their economic and business success.

Confidence was high. Business investment increased at an 11% annual rate during the latter stages of the 1980s cyclical rise.

Japan's financial institutions supported rising asset values and business capacity expansions through their lending and Japanese individuals signed mortgages which they bequeathed to subsequent family generations because they were too large to manage in just one lifetime.

Japanese financial institutions such as Nomura had the largest balance sheets in the world. Assets of private financial institutions grew at an average rate of 14.7% over the four years to 1989.

The **Nikkei 225 stock market index** peaked just short of 40,000 in December 1989, when companies in the Tokyo stock exchange 1st section had a P/E ratio of 71, after rising at an annual rate of 19.6% for the prior 10 years. The market has never come close to that level again. The chart (next page) shows the monthly track of the Nikkei 225 from 1970 to September 2008. Nearly 20 years on, the index is still 72% lower than at its cyclical peak.

The steep change in conditions was not confined to equity markets. In the nearly 20 years after the bubble burst, annual GDP growth has averaged just 1.6% in a recession prone economy. It has not reached 3% since 1991 when it was near the beginning of its downward track.





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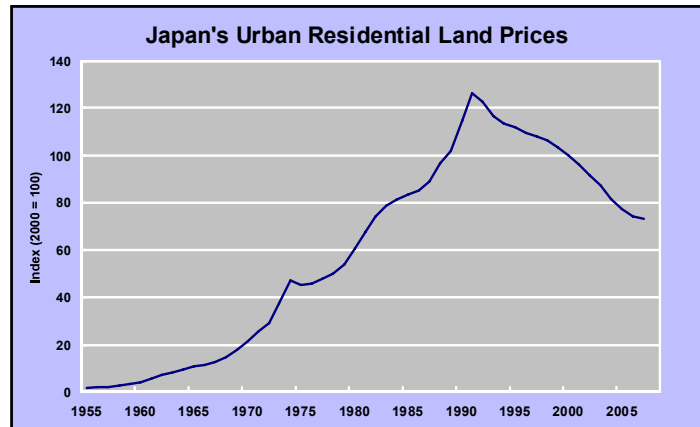
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Over the same time, the OECD economies, including Japan, have grown at 2.6% per annum, the newly industrialised Asian economies have expanded at 5.5% a year and growth in developing countries in the region has exceeded 7.5%.

In the ensuing 17 years, business non-residential investment has never exceeded the level it reached in the first quarter of 1991. Yearly growth in the assets of private financial institutions slowed dramatically to just 1.8% in the decade after 1989. At times, there seemed a danger of a deflationary spiral. Retail price inflation has averaged just 0.5% since the 1980s. Japanese have often longed for more inflation to help stimulate activity.

In 1990, there had been a government surplus of 2% of GDP. By 2003, the balance had swung emphatically in the opposite direction. Japan had a fiscal deficit of 8% of GDP after a decade of government attempts to breathe life into an unresponsive economy through a succession of failed fiscal stimulus packages. The deficit is now lower because anything more would have given rise to longer term adjustment problems and policymakers were forced to concede that pump priming was simply not working.

Government debt, which had been a comfortable 14.5% of GDP in 1989, was 91% of GDP at the end of 2007 and forecast to go higher.



In a chilling parallel with the current circumstances in the USA, urban residential land values in Japan had risen at an average annual rate of 12.8% a year through the 1980s.

The **residential land price index** published by the Japan Real Estate Institute has fallen every year since reaching a peak in early 1991. Nearly two decades later, it remains 40% below its 1991 value.

This did not happen to some obscure regional centre. This was one of the largest national economies on the planet and a business and economic role model for the rest of the world.

The Japanese post-bubble experience runs counter to the judgment that policymakers can extricate the US economy from its current bind and put it back securely on a path consistent with its historical growth trajectory some time in the first half of 2009.

Making a choice

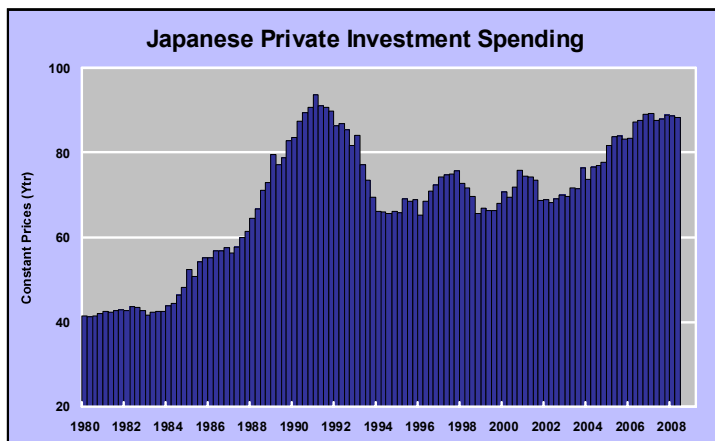
Investment advisers need to make an important judgment about whether the US economy is running parallel to the Japanese track or whether there are critical differences which make for a less arduous and more conventional cyclical economic recovery.

Similarities

There are some marked similarities between Japan in the late 1980s and the USA today which are cause for pessimism about the outcome.

- ▼ The bubbles have clearly burst.
- ▼ Government lacks leadership. The Japanese political leadership was faulted for its tardy and timid policy response to both bank reform and macroeconomic adjustment. The US presidential election has left George W. Bush as little more than an observer while members of Congress, preoccupied with short-term politicking, fluffed a chance to take the initiative when they dithered over a potentially dramatic bank rescue package. Even after the presidential election, one characteristic of the US system of government presents a disconcerting parallel with the Japanese experience: the executive does not command a majority in a legislature notoriously willing to concede national principles for the sake of local politics¹.

▼ In Japan, the bonds between big business and government appeared to stymie recovery as business and banking interests tried to sandbag the adjustments that a market would have driven.



¹ According to Citizens Against Government Waste, a Washington-based watchdog, there were 11,610 individual tax or spending earmarks with a total value of US\$17.2 billion inserted at the behest of individual members of the House of Representatives or Senate into legislation passed by the US Congress during fiscal 2008.

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▼ Similar bonds in Washington between members of Congress and lobbyists have become so deeply embedded that they were a focal point of the recent presidential election campaign. One of the criticisms of the first draft of the *Emergency Economic Stabilization Act* of 2008 partly responsible for its delay by Congress was its perceived bias in favour of the troublemakers and its disregard for the interests of victims and, with that, its potential failure to support an economic shakeout which would require the burden of adjustment to fall on the original risk-takers.

▼ In Japan, there was a concerted attempt to hide the magnitude of the asset deflation problem among the banks through corporate reorganisations and changed reporting practices. In the U.S., there is pressure to move away from accounting practices requiring asset values to be marked to market. This would allow institutions to maintain higher valuations in their balance sheets to minimise required changes to their business models.

▼ After the bubble burst in Japan, an aging Japanese population still needed to fund its retirement years. This would require a relatively high savings rate. US households have been spending more than their earnings. With the bursting of the US asset bubble, there will be pressure on them to raise their savings rate for different reasons than applied in Japan, but at a time when the underlying momentum of the US economy is similarly slowing and in need of additional spending momentum.

Differences

There are also some substantial differences between the circumstances faced in the USA and what happened in Japan.

▼ Despite attempts to alter the accounting rules, there is greater underlying transparency in US corporate reporting than existed in Japan. Existing US reporting requirements help to speed economic adjustment as companies have to make clear the consequences of their decisions, or at least leave them open to scrutiny. That said, there is also a lengthy history of companies being able to conceal the most parlous circumstances until they move to the very edge of failure.

▼ The US has a long history of being more open to foreign capital and is, therefore, more used to foreign interests buying US assets and replenishing the capital bases of its businesses and banking institutions.

▼ US population growth is more supportive of economic activity than the Japanese demographics. **Japanese population growth** had been declining throughout the 1980s. The trend continued through the 1990s and absolute numbers contracted for the first time in 2006, according to the International Monetary Fund. The United Nations Population Division has projected an absolute decline in the size of the Japanese population by as much as 25 million people (or 20%) between 2005 and 2050. US population growth is also slowing, but not to the extent of a contraction in numbers.

The UN expects US population numbers to continue to grow by over 40 million between 2005 and 2020 and by another 60 million in the succeeding 30 years.

▼ Other countries have a mutual interest in sustaining the US capital market. Japanese gross savings are estimated to have been 28.6% of GDP in 2007 and have remained between 25% and 35% of GDP throughout the period since the bubble burst. Savings in Asia and the Middle East are currently as high as 49% of GDP, according to the International Monetary Fund. The rest of the world needs a sophisticated capital market through which it can invest its accumulated savings, at least until alternative market arrangements can be put in place.

Overall, Savings = 0

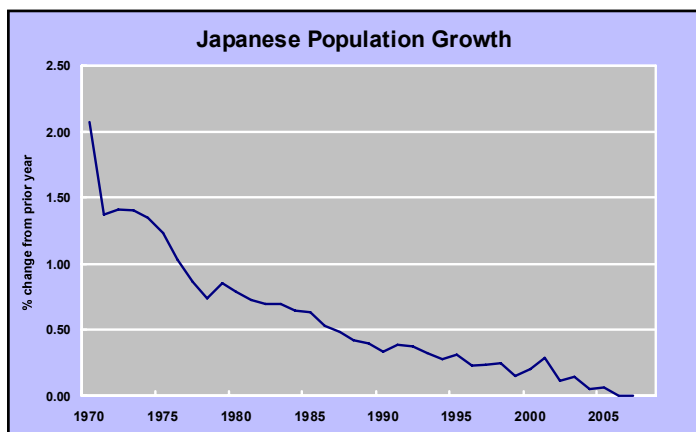
Globally, net savings must sum to zero. Saving countries, such as those in Asia and the Middle East, need dissaving countries, such as the USA, to sustain their positions. The global economy simply cannot function in any other way.

Current US deficits have their mirror images in surpluses and national savings elsewhere. If US households, governments and businesses start to save more, the surpluses of China, Japan and the Middle East will have to decline, everything else being unchanged. This is not an especially attractive proposition for this latter group of countries. Given the choice, they would currently just as soon keep funding US deficits.

The ability of the US authorities to extricate their economy from its current bind probably hinges on the status of the US as the home of the global capital market.

This status is changing somewhat as Middle Eastern and Asian capital begins to fund a larger share of the investment monies being deployed by US-based institutions, but much of this funding is being used to rejuvenate existing US financial institutions rather than supplant them.

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In-house Assets

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Lease or lease arrangements

Two exemptions potentially apply to pre-11 August 1999 leases or lease arrangements:

1. An asset of a super fund was leased to a *related party* (either via a single lease or an uninterrupted sequence of leases) and the asset was being leased to a related party before 11 August 1999. If “lease renewals” are being used then there can be no gap between them. However, the related party does not always have to be the same.
2. A rule which ceased before July 2001 (which I will not examine in any detail here).

Security trusts used for instalment warrant borrowings

This is the final exemption.

If the underlying asset in a security trust is not an IHA of a fund (because of any of the above rules), then the security trust and the underlying asset will be deemed not to be IHAs of the super fund. However, the converse is also true. If the underlying asset would be an IHA of the fund (because of any of the above rules), then the security trust and the underlying asset will also be IHAs of the super fund.

IHA market value test

This is simply: the market value (MV) of a super fund’s IHAs divided by the MV of all the super fund’s assets, multiplied by 100 to make it a percentage.

What must trustees do when they breach the IHA MV Test?

Where the IHA MV calculation produces a result greater than 5%, the trustees must produce a written plan which must set out the steps that trustees propose to take to ensure that:

1. one or more of the fund’s IHAs will be disposed of during the next financial year; and
2. the value of assets disposed is equal to the excess.

If 5% limit exceeded

If the IHA MV test has already been exceeded, then a super fund trustee must not acquire another IHA.

Further, if a fund already has some IHAs, then the trustee must not acquire any further assets that would see the 5% IHA MV test exceeded.

Anti-avoidance provisions

The IHA asset rules contain a particularly aggressive anti-avoidance provision. This anti-avoidance measure is designed to provide that any process or scheme that would reduce the IHA MV, and the artificial reduction in IHAs, would result in an artificial reduction of the value of the IHAs to avoid the maximum allowed being breached. Severe penalties will apply for anyone falling foul of this provision.

Words of warning

1. Other superannuation rules impact on your ability to use these IHAs. For example, you may want to acquire shares in a private company and those shares are owned by one of the fund’s members. If this is the case, then the acquisition of assets from members will have an impact.
2. **Wording of your trust deed** – In the first instance it is very important to check what a fund’s trust deed says. It would be unusual for a trust deed not to contain some powers that permit a trustee to invest the fund’s money in a list of authorised assets, but prohibit the dealing in unauthorised investments. If a trust deed is silent about a particular type of investment, or silent about all investments, then the trustee must have regard to the range of investments authorised by the relevant state or territory legislation. A super fund’s trustee cannot breach the investment powers conferred on them. To do so may be a breach of trust and also possibly a violation of specific super law which says that a person involved in the running of a fund must not infringe any governing rule of a particular fund.
3. **State Trustee Acts** – Any trust that wishes to enter into any transaction needs to be careful about the relevant State Trustee Act. If a super fund’s trust deed is silent on a particular transaction and the super laws allow it, a State Trustee Act may disallow it

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Think Big – Asset Price Deflation

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For the time being, there is no ready substitute for the capital market institutions found in the world’s largest economy.

Some of the distinctions between the Japanese experience and current US conditions might end up being enough either separately or in combination to differentiate the Japanese experience from the US predicament.

However, the unique positioning of the US as an investment centre stands out as being the single critical factor which, with the others, could possibly make the difference between the Japanese post-bubble experience in the two decades after 1989 and the US post-bubble experience over the coming 20 years. Whether that unique positioning is enough is currently a matter of conjecture. We have very little analysis on which to fall back to make firm judgments on this point.

The unique positioning of the US as the headquarters of the global capital market continues at the discretion of the world’s saving countries. So far, they have judged it in their best interests to keep it intact. They could withdraw the special status by deciding not to fund attempts by the US and UK authorities to recapitalise their financial systems. In that case, the Japanese and US paths will converge.

Funding is critical. The liquidity infusion being attempted needs to accomplish two objectives: it must be strong enough to compensate for the liquidity drain elsewhere; and it must also be strong enough to engender optimism about the future.

On this view, the US will remain heavily (and increasingly) dependent on the world’s saving countries for its economic prosperity and its ability to forestall a Japanese-like outcome after the bursting of its asset price bubble.

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