JAPAN: FINANCIAL CLIFFS AND CURVES
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In Akira Kurosawa's famed film "Seven Samurai", a poor village recruits seven unemployed samurai to protect it against an attack by bandits. A character comments: "Danger always strikes when everything seems fine."

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CONCLUSION

The major bull charge by the Japanese 10 year government bond (JGB) to lower yields probably ended in late July 2012, or will do so soon. The Japanese Yen's long run bull trend (effective exchange rate basis, Bank of England data) likewise probably ceased in midsummer 2012.

AN EDGY PERSPECTIVE

For many years, and well before the mid-2007 eruption of the global economic disaster, Japanese deflationary forces propelled the country's government interest rate yields on their twisting yet downward trajectory. Although the Bank of Japan's highly accommodative monetary policy (including majestic money printing) during the worldwide financial crisis did not arrest yield declines or definitively weaken the Japanese Yen, its aggressive easing over the past few years has helped set the stage for interest rate increases and Yen depreciation. Why?

All else equal, massive money printing tends to raise nominal prices (low real interest rate returns can assist this process). That deflation or very low inflation (and depressed marketplace interest rates in general) exist during a loose central bank policy does not demonstrate that such lax policy is not inflationary. Reduced deflation ("a less negative number") via such methods still is an inflationary consequence. And the longer and more significant such central bank easing, the more likely that such policy will have even greater inflationary and thus higher interest rate consequences when other inflationary variables emerge and closely intertwine with it.

Four significant inflationary variables have or likely will entangle with the massive Japanese easing to date. First, major central banks around the world via various methods have engaged in extravagant easing. Consider the money printing (QE1, 2, 3), low interest rates, and other accommodative weapons of the United States Federal Reserve. The economic wizards at the Fed have heralded they will not change to a tightening course anytime soon. Don't forget the European Central Bank's gradual even if roundabout surrender to easy money principles (especially over the last year). Recall the generous central bankers of China, the United Kingdom, and Switzerland. In the interconnected global economy, the more widespread and sustained the money printing and related policies, the more likely that there eventually will be upward price moves in consumer prices (and similar measures) as well as interest rate increases.

A more specific focus on the Japanese situation reveals the three other considerations. For starters, the Japanese business community (exporters especially) has become extremely upset (not merely worried) by the Yen's sustained strength. This dismay increased due to a recent noteworthy GDP slump. Business interests (Japan, Inc.) significantly influence Japanese political policies. Second, Japan likely will enshrine a new governing political party after its December 2012 elections. These incoming political leaders apparently seek an even easier monetary policy than presently exists.

The third relates to the towering Japanese government debt and ongoing substantial budget deficits. Most political pundits and marketplace mavens bemoan the looming United States fiscal cliff. Japan, unlike America, wins praise as being a nation of savers (creditors) rather than debtors (borrowers). However, the Japanese government, unlike its citizens, does not incarnate thriftiness.

The current and medium term Japanese fiscal outlook, even without a change in government policies, is no cause for complacency. The Japanese political (economic) establishment, regardless of party, engages in brinkmanship, for it has shown little inclination to subdue that substantial deficit spending and massive and growing government debt. Compare the United States awesome near term and long run federal debt vista. Thus Japan probably already is fairly close to the border of a fiscal crisis.

Japan admittedly has managed to finance this government debt so far. Yet financial crises, including the recent one in Europe's "periphery", indicate that this fortunate situation may not last forever and can change fast.

Moreover, Japan's likely new government arguably will pressure the Bank of Japan to engage in a policy of yield repression alongside a quest to manufacture more significant inflation than the current one percent benchmark target. Negative real returns on Japanese debt will not please Japanese savers, the key financers of Japan's government deficits. Suppose these domestic savers become less inclined to finance government budget deficits. Then the nation probably will come even closer to a fiscal precipice than it already is (and may even tumble over it). This in turn, all else equal, further encourages a trend toward higher interest rates (despite yield repression) and a feebler Yen. The greater the yield repression (the lower the real return from owning debt securities), the more probable and substantial will be the Yen depreciation.

JAPAN'S GOVERNMENT DEBT SWAMP

The International Monetary Fund's "Fiscal Monitor" (October 2012, Table 1), reveals Japan's untamed deficit spending. After Japan's still notable budget gap of -4.1pc in 2008, deficit spending spiked higher. The nation's general government overall fiscal balance (federal, plus state and local) in 2009 was -10.4pc of nominal GDP. In 2010, the budget deficit was -9.4pc, with 2011's a bulging -9.8pc (compare the US level of -10.1pc) and 2012's estimate of -10.0pc (America's -8.7pc is likewise lofty). The IMF forecasts Japan's 2013 deficit at -9.1pc (with the US one at -7.3pc). See the "Fiscal Monitor's Statistical Table 1 for subsequent years. Five years from now, out in 2017, Japan's deficit hole remains a substantial -5.8pc.

Japan is a creditor nation with an incredible debt. Japan's general government debt was 191.8 percent of nominal GDP in 2008 (US 76.1pc), 229.6pc in 2011 (US 102.9), with 2012's a gargantuan 236.6pc (US 107.2pc). The IMF clairvoyants believe 2013's will ascend to 245.0pc (US 111.7). ("Fiscal Monitor", Table 3). Even by 2017, it will not decline versus 2013; note 2017's enormous 250.3pc estimate (Statistical Table 4). Many believe a sustained general government debt relative to nominal GDP exceeding 100 to 120 percent is dangerously high. There may be special circumstances that may make such levels less scary. Yet Japan's having about double such levels hint that one should not be complacent about the country's debt risk and its consequences.

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Not only do Japan's budget deficit and debt trends underscore that Japan has a severe debt problem and very little momentum toward solving it. Important policy guides continue to warn regarding the issue. The phased increase in Japan's consumption tax to ten percent by 2015 from

five pc was approved in August 2012. The first increase, to eight pc, is expected in April 2014. However, reading between some recent IMF lines, the country nevertheless lacks a credible plan. "Japan faces the challenge of medium-term fiscal consolidation…But the challenge is to develop a credible fiscal or medium-term consolidation plan. There has been an important first step. The gradual increase in the VAT rate. We think more is needed." ("World Economic Outlook", "Press Conference", 10/9/12). First steps do not equal a comprehensive credible approach. See also the "Global Financial Stability Report", "Executive Summary" (October 2012, p xi). The IMF's "Fiscal Monitor" (October 2012, p1) states that the consumption tax increase "will not be sufficient…to put Japan's record high debt ratio on a downward path."

EASY MONEY, POLITICAL (BUSINESS) UNEASE

"Everybody's after easy money", remarks a farmer in the movie "Yojimbo". (Akira Kurosawa, director).

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In February 2012, the Bank of Japan expanded its asset purchase program and established a one percent goal for inflation. Quantitative easing did not stop there. It boosted its quantitative easing program in mid-September by Yen 10 trillion (about $126bb), making the overall total Yen 80 trillion. The Bank of Japan announced in October 2012 that it would add on a further Y11 trillion in asset purchases under its bond buying program, thus making the total about Yen 91 trillion (see the Bank of Japan table). It has extended its purchase program to end 2013.

On 11/20/12, the BoJ underlined: "The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation as early as possible". It "will pursue aggressive monetary easing in a continuous manner by conducting its virtually zero interest rate policy as well as steadily increasing the amount outstanding of the Asset Purchase Program."

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The IMF forecasts Japan's real GDP will rise 2.2 percent in 2012, with a 1.2pc climb predicted for 2013 ("World Economic Outlook", October 2012; Chapter 1, Table 1.1). It believes 2017's will march 1.1pc higher ("Statistical Appendix", Table A1). These figures look wonderful compared to 2009's dreadful -5.5pc decline.

Despite these Japanese central bank actions and statements, despite the IMF's mildly sunny forecast for some economic growth, many Japanese economic leaders and politicians recently have become increasingly nervous about their country's financial prospects. Japan's real GDP contracted at an annual rate of 3.5pc in calendar 3Q 2012 (down .9pc from previous quarter; 11/12/12 release). This was the first contraction in three quarters.

For a nation that thrives on its exports, declining current account surpluses are worrisome. What does Japan's current account trend indicate? Japan's yearly current account surplus for the 2004-2010 span averaged 3.7pc of nominal GDP, with the lowest year 2009's 2.9pc. However, 2011's surplus slipped to 2.0pc. And 2012 dips to 1.6pc. What about the future? For 2013, the IMF weathervane 2013 proclaims a 2.3pc surplus, with 2017's merely 1.0pc. (See WEO, "Statistical Appendix", Table A10). Won't a depreciating Yen probably assist exports?

Therefore, to spark and sustain sufficient economic growth, much of the Japanese business (and political) community craves an even easier central bank policy than now exists (which probably entails even more money printing).

In the recent worldwide economic crisis, Japan, unlike many European nations, thus far has not faced widespread social unrest. However, unrest within the Japanese business community nowadays looks quite significant. As the US is a debtor nation, it is perhaps unsurprising that the Federal Reserve policies in recent years have favored debtors. Despite its massive government debt, Japan is a creditor nation. Some of its central bank (and government spending) policies have resembled American ones. At least some of these Japanese creditors (or at least many business interests), when confronted by the nation's recent GDP statistics and current account trends, currently seem willing to reduce real interest rate returns to Japanese creditors in general.

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Japan's Prime Minister recently called a general election for December 16. Most expect that his Democratic Party of Japan probably will lose to the Liberal Democratic Party (LDP), although any winner may need to establish a coalition (which probably will be shaky) with smaller parties. The LDP's leader, former Prime Minister Abe, has called for interest rates to be set below zero (negative yields). He wants the central bank inflation goal to jump to as much as three percent from the current one pc (Financial Times, 11/21/12, p3). Reports also state that Abe has pushed for greater government control over the central bank, including the power to fire the Governor.

Japan consumer prices from 1994-2004 averaged no increase (flat), with an average zero increase also over 2005-07 (IMF, WEO, "Statistical Appendix", Table A6). This inflation yardstick became positive in 2008, reaching 1.4 percent. However, deflation in this measure appeared the next year with 2009's -1.3pc, continuing with 2010's -.7pc and 2011's -.3pc. Consumer prices are forecast unchanged in 2012, with deflation reappearing again (-.2pc) in 2013. The IMF predicts one percent inflation for 2017. Perhaps upon achieving power, the LDP may temper its fiery campaign for its currently declared interest rate and inflation policies. However, the former prime minister's comments nevertheless reflect an ardent determination to banish deflation even if it means the introduction of negative real yields for creditors. Compare the consequences for creditors/savers of the current Fed policy for much of the US government yield curve.

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The Governor of the Bank of Japan has resisted this pressure from the current opposition party, insisting on the merit of central bank independence (FT, 11/21/12). However, his term expires in April 2013.

The next Bank meeting is December 20. Will there be more easing then?

FLIGHTS TO AND FROM "QUALITY"

If there can be a flight to quality, there can be a flight from quality. And opinions regarding so-called absolute (true, genuine) and relative quality can change significantly.

The 10 year government notes of the United States and Germany achieved yield bottoms in late July 2012. The Japanese 10 government bond (JGB) also made a low around that time on 7/25/12 at.72 percent. The current JGB yield is about this. In the ongoing worldwide financial crisis, the government securities of these three nations have represented a flight to quality refuge. This helped to drive yields to very low nominal levels. Japan's safe haven status thus helped to finance its ominously large budget deficits and towering debt. This flight to quality also encouraged the substantial rally in and sustained strength of the Japanese Yen.

During the ongoing worldwide economic crisis, Japanese banks increased their government bond holdings. The IMF fears the consequences of a sharp jump in Japanese government bond yields.

"The rising concentration of government bond risk in the domestic banking system is a central financial stability concern for Japan." (GFSR, Chapter 1, p16).

With Japanese inflation flat to negative, many Japanese households and institutions are fairly content with low nominal yields since they thereby earn a real return. However, if inflation increases while policy rates remain near (or even under) the floor, these domestic savers eventually will be less inclined to see Japanese government securities as a blessed oasis of quality. Suppose they closely stare at the nation's debt mountain and spending patterns. Will they see Japanese (and other) stocks as relatively attractive alternatives to debt securities (compare the US situation)?

What about overseas owners of Japanese government debt? If inflation climbs while interest rate yields remain low- and especially if the Yen begins to erode- many will exit from Japanese government securities.

Even if Japanese interest rates do not leap dramatically, they still can increase moderately.

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Japan's enormous ownership of US Treasury securities evidences Japan's status as a big international creditor. It holds about $1.13 trillion in UST as of September 2012 (US Treasury International Capital System report, 11/16/12).

Suppose yield repression by the Federal Reserve continues, and that US inflation increases. Might some Japanese holders of US sovereign debt elect to become net sellers, or at least acquire fewer of them? The Yen versus US dollar cross rate level and trend of course will influence Japanese decision making in this context.

Consider another scenario. Suppose the Japanese government owns a great sum of UST. What if they decide to sell some of these and devote the proceeds to help spark Japan's economic recovery? Or, with that goal in mind, the government instead may merely reduce its net UST buying and devote the relevant cash "difference" to boosting Japanese growth. In any event, why not spend the money in Japan rather than hold it in US debt securities? Institutions likewise could choose to become net sellers or smaller net buyers to promote recovery.

In all these cases, substantial net selling or reduced net buying of UST by Japan would help to push US interest rates on an upward path.

JAPANESE YEN: TURNING THE CURVE

In recent years, Japan's status as a creditor nation with ongoing current account surpluses and substantial domestic savings has underpinned the Yen's status as a high quality/safe haven currency. However, Japanese Yen strength has been so substantial from the historical perspective that in the country's current and near term environment, where downturns and further deflation are feared, significant Yen effective exchange rate weakness relative to its 2012 peaks would be tolerated, even encouraged.

The Bank of England's Japanese Yen effective exchange rate ("EER", monthly average, 1990=100) achieved its record summit at 185.6 in January 2012. This represented a hefty advance of 27.5 percent from June 2009's 145.6 bottom (and that depth still was rather elevated from the long run historical viewpoint). In addition, it smashed above the April 1995 ceiling of about 171.0

and substantially exceeded the 161.4 January 2009 level attained in the depths of the economic crisis.

The EER was 179.7 for October 2012, down about 3.2pc from the January pinnacle and still near the second plateau at 183.7 July 2012/183.4 August 2012. However, the EER (daily data) plummeted quickly from 11/12/12's 180.2 to 11/22/12's 172.5 (watch the April 1995 support level). Current levels still hover significantly above the 161.4 January 2009 and June 2009 145.6 range.

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Admittedly many nations wish to depreciate their currencies, or maintain them at relatively weak levels. Such policies help to support the Yen to some extent. Not everyone can depreciate at once.

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Many watch the Yen versus US dollar cross rate. Over the past year or so, the Yen has established a peak versus the US dollar. Note the key high against the US dollar on 10/31/11 around Yen 75.4. Then see its highs on 6/1/12 (Y77.7) and 9/13/12 (Y77.1; the day the Federal Reserve unveiled QE3).

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