



ABE'S ECONOMIC EXPERIMENT

BREAKINGVIEWS





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ON THE COVER

Japan's Prime Minister Shinzo Abe stands in front of a picture of Japan's national flag as he speaks to the media at the Parliament in Tokyo December 18, 2012. REUTERS/Toru Hanai

INTRODUCTION

SECOND COMING



Japan's current Prime Minister Shinzo Abe prepares to cast a vote during the party presidential election in Tokyo September 26, 2012. REUTERS/Toru Hanai

Shinzo Abe is conducting an economic experiment on Japan. Since his dramatic return to power last December, the prime minister has electrified investors with his three-pronged plan to shock the country out of its economic malaise. The bold gamble has profound implications for Japan and for economic policy around the world.

For two decades, Japan has been the cautionary tale of international macroeconomics. The country's failure to shake off its prolonged economic slump offered a checklist of how not to handle the aftermath of a financial crisis. That perspective has now been inverted. As the West continues to grapple with its own financial hangover, Abe's "three arrows" of economic reform – a violent shift in monetary policy, vigorous fiscal stimulus and longer-term structural changes – offer a possible road map for revival.

Abe did not enjoy high expectations. For a country still reeling from the 2008 financial crisis and Fukushima disaster, the return to office of a prime minister whose previous tenure had ended in disappointment offered little prospect of change. His campaign promises were dismissed as the latest in a series of false dawns.

Yet Abe's first months in office have defied sceptics. New Bank of Japan chief Haruhiko Kuroda – installed ahead of schedule – shocked investors with a pledge to double the country's monetary base in an effort to push inflation to 2 percent. The yen has plunged against the dollar, providing relief to exporters and eliciting complaints from other Asian countries. Abe has also challenged entrenched interest groups at home with a pledge to reduce trade barriers.

Japan still has a long way to go. Higher inflation expectations will only be meaningful if workers demand – and spend – higher wages, if companies boost investment, and if Japan can offset its shrinking population by persuading more women to join the workforce. At the same time, Abe and the BOJ must avoid a loss of confidence in Japanese government bonds that could trigger a self-fulfilling crisis.

This matters in Japan, but also in the rest of the world, where public debt levels have risen dramatically in the past five years. There are many differences between Japan and the West. The country has suffered genuine deflation – rather than merely disinflation – suggesting a bigger shock is required. Its companies and households have also had more time to reduce their borrowings, which improves the chances of a revival in investment and consumption. And most government debt is still held by Japanese investors, which means that losses on bonds are mostly a domestic concern.

Even so, Abe's policies have effectively turned Japan into a test case for whether a wealthy, ageing nation with a heavily indebted government can revive growth, or must accept inevitable decline. The rest of the world will be watching closely.

*Peter Thal Larsen,
Asia Editor, Reuters Breakingviews
May 2013*

ABE OLD AND NEW

ABE DEFEAT COULD LESSEN YEN CARRY TRADE'S APPEAL

BY EDWARD HADAS

Weak governments usually go hand-in-hand with weak currencies. But the electoral enfeeblement of Shinzo Abe's administration in Japan may strengthen the yen.

At first glance, investors shouldn't care much about Abe's crushing defeat in upper house elections on July 29. The Liberal Democratic Party did even worse than expected, winning 37 of 121 contests, but voters didn't seem to be protesting the government's reform agenda. Even if they were, the pace of reform has been glacial, so any change would hardly be noticed.



People at an electronics shop watch a live broadcast of Japanese Prime Minister Shinzo Abe as he announces his resignation from his first term in office in Tokyo, September 12, 2007.

REUTERS/Yuriko Nakao

BREAKINGVIEWS

As for interest rates, the election results shouldn't matter, since rates are set by the independent Bank of Japan, not the government. But most observers think that the doves in the central bank have been strengthened by the government's resistance to higher rates. The post-election resignation of Hidenao Nakagawa, leader of both the party and the anti-hike rhetoric, could give the hawks more ammunition.

In turn, the more immediate prospect of higher Japanese interest rates would frighten foreign investors who have been borrowing in yen in order to invest in higher-yielding currencies. The growth of this so-called carry trade explains a good part of the Japanese currency's weakness – a drop of 10 percent against the dollar in the year before global markets started to wobble in mid-June.

Those wobbles dented the appeal of the carry trade, even before the election. In the last month, the yen gave up about half of the previous year's gains. Investors started to shun all risks and US rate cuts started to look a little more likely. Now the potential gains from the carry trade are also being cut from the Japanese side.

If global optimism were still in full swing, the post-election focus would be quite different. Japanese domestic investors would be seen as losing confidence in the local economy, and more likely to sell yen in order to invest overseas. But when the market winds change, investors' arguments follow.

The carry trade could give way to the fundamental trade, changing the focus to Japan's huge trade surplus and minimal inflation. The yen could be a rock in troubled markets.

30 July 2007

JAPAN'S ELECTIONS: A GUIDE FOR THE PERPLEXED

BY ANDY MUKHERJEE



Japan's current prime minister and leader of the Liberal Democratic Party's Shinzo Abe (L) speaks next to Yoshihiko Noda, who was at that time prime minister and leader of the ruling Democratic Party of Japan in Tokyo November 30, 2012. REUTERS/Yuriko Nakao

For once, the outcome of a Japanese election may actually matter. The country's politicians have proved largely powerless to reverse two decades of economic stagnation. Now voters, dismayed by the centre-left, may hand power back to the conservative Liberal Democratic Party. But patience with cosmetic change is running thin.

What will a conservative win mean for Japan's politics?

The LDP, given up for dead just three years ago, has found a new lease of life. Opinion polls suggest it will emerge from the Dec. 16 elections as the largest party – though a fifth of the electorate have yet to make up their minds. The emergence of the nationalist Japan Restoration Party as a potent third force alongside the incumbent Democratic Party of Japan suggests that politics is becoming more, not less, competitive.

BREAKINGVIEWS

Voters are tired of what Stanford University political scientist Phillip Lipsky describes as Japan's paradox: political change doesn't lead to changes in policy. LDP leader Shinzo Abe and former Tokyo governor Shintaro Ishihara, who leads the Restoration Party, have responded by promising more muscular policies. Ishihara's party wants to scrap the upper house of parliament, the culprit for much of Japan's policy paralysis. Abe's plan for ending deflation is a lot bolder than expected from a conservative politician.

Can the new government end deflation?

Fifteen years of falling prices have shrunk the economic pie by 10 percent and entrenched deflation in the consumer psyche. The financial crisis and the March 2011 earthquake and tsunami haven't helped. Safe-haven demand for the yen is choking exports. The economy slipped into a technical recession in the third quarter, its third since 2008. Meanwhile, spooked by Japan's public debt, which is approaching 237 percent of GDP, Prime Minister Yoshihiko Noda has pushed through a law to double the country's 5 percent sales tax by 2015. A squeeze on stagnant incomes could undermine private consumption, further adding to deflationary pressures.

Government spending is the obvious remedy. For all the criticism of Japanese governments building bullet trains to nowhere, the share of public expenditure in GDP was falling before 2008. Government spending has temporarily risen because of shocks from the financial crisis and the earthquake, but needs a sustained boost to beat deflation. Yet welfare policies, such as a universal child-care allowance proposed by the DPJ, have been diluted. With yields on 10-year government bonds below 0.7 percent, Tokyo can afford to expand debt-financed spending.

Where does the Bank of Japan fit in?

With interest rates stuck near zero, it's crucial that the government and the central bank coordinate their responses. Supported by creation of new money, 100 yen in deficit spending could boost GDP by 380 yen, Gauti Eggertsson, an economist at Federal Reserve Bank of New York, has estimated. Without such monetary-fiscal coordination, extra spending will be a waste.

Abe, who has been prime minister once before, gets this. He wants to deficit-finance a construction-spending binge, while pushing the BOJ's inflation target to 3 per cent – three times the monetary authority's own goal of 1 per cent, and higher even than the 2 per cent target set out in his own party's manifesto. That may sound reckless. But five years of 3 per cent inflation would only return prices to where they were in 1998.

What have the other parties got in mind?

The DPJ's manifesto merely says the government and the BOJ will join forces to defeat deflation. And while the party promises "decisive action" against excessive yen appreciation, it is Abe's call for unlimited monetary easing that has weakened the yen in recent weeks.

The Restoration party rejects the LDP prescription of public works spending, and wants the sales tax to rise to 11 per cent. That may be risky. Over time, Japan must raise its revenue-to-GDP and expenditure-to-GDP ratios, both of which are among the lowest in OECD. Higher levies, though, must wait, while the increase in spending must occur now. Getting the sequence wrong would hurt the economy.

Restoration's call for Japan to amend its pacifist constitution and increase defence spending could be a growth-booster, although those gains may be lost if rising regional tensions weaken trade and investment ties with China.

How long will the new government last?

The omens are poor: Japan has had 14 prime ministers in the last 20 years. But one of them – Junichiro Koizumi, who preceded Abe's first stint – served for five years and left a large imprint on policy-making. It will be up to the new prime minister to show that strong and stable political leadership in Japan doesn't have to be a rarity.

11 December 2012

ABE ERA WILL HERALD A THREE-DIGIT YEN

BY ANDY MUKHERJEE



An employee of a foreign exchange company walks past a monitor displaying the Japanese yen's exchange rate against the U.S. dollar in Tokyo April 5, 2013. REUTERS/Toru Hanai

The Shinzo Abe era will herald a spectacular decline in the yen. The promise by Japan's newly elected prime minister to end the country's chronic deflation spells curtains for the half-hearted quantitative easing that has been the Bank of Japan's hallmark for more than a decade. At some point in 2013, one U.S. dollar will buy 100 yen or more.

Since 1997, the BOJ has expanded Japan's monetary base from 10 percent to 27 percent of GDP. Yet it has failed to convince markets that it would tolerate a sustained rise in prices. The election changes that. Investors will soon realize that the BOJ has become as reckless a money-printer as the U.S. Federal Reserve has been under Chairman Ben Bernanke.

The yen had already started its slide during the campaign, as opinion polls predicted a resounding Abe victory. Nevertheless, a three-digit yen still represents a near-20 percent swing from pre-election levels. The last time

the currency's value changed so dramatically was in the 15 months following the collapse of Lehman Brothers. Back then, the yen strengthened as the financial crisis and Europe's sovereign-debt woes boosted Japan's status as a safe haven.

Abe's strategy will be to ratchet up deficit-financed construction spending, with the central bank buying a big chunk of government-issued debt from the market. He has also talked about lifting the BOJ's inflation target from 1 percent to 3 percent – though his Liberal Democratic Party's manifesto promised a 2 percent goal.

Confirmation of the shift will come in April, when Abe replaces outgoing BOJ Governor Masaaki Shirakawa with someone more comfortable with at least five years of 3 percent inflation, required to return prices to their 1998 levels. Then, after the summer of 2013, when the LDP gains control of the upper chamber of parliament, Abe will introduce a bill that will allow the BOJ to buy foreign securities – a job currently reserved for the finance ministry. That will make Japan's currency intervention more powerful.

Timing is on Abe's side. Unless the U.S. economy jumps off the fiscal cliff, the Federal Reserve is unlikely to unveil any new easing measures in 2013. One strong push from Abe, and the yen will tumble.

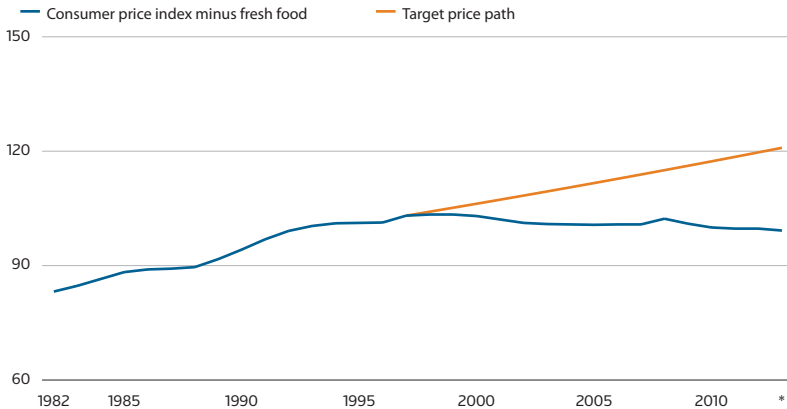
17 December 2012

A HOW-TO GUIDE FOR JAPAN TO ESCAPE DEFLATION

BY ANDY MUKHERJEE

Japan has a real chance of ending deflation. But the authorities need to act boldly. It will be hard for the Bank of Japan to dispel a decade of accumulated pessimism by merely adopting a formal inflation target. The goal of the central bank and the finance ministry should be to make people believe that price gains that didn't occur in the past 10 years will now take place. A de facto currency peg may be the way to engineer those expectations.

Using a price target to end Japan’s deflation



* 2013 (Feb)
 Note: Target based on annual 1% increase starting 1999
 Source: Thomson Reuters

Nurturing the green shoots of inflation expectations is crucial for Japan. Even with nominal rates at zero, real interest rates have been positive because of expectations of deflation. Once people start anticipating inflation, real interest rates will turn negative, stimulating investment.

At its two-day monetary policy meeting starting Jan. 21, the central bank is expected to debate the merits of entering into an accord with the government. Such a deal, which Japan’s new Prime Minister Shinzo Abe is pushing for, will specify a formal inflation target of 2 percent and may even include a commitment to job growth.

While an improvement on the status quo, this new arrangement still may not be enough. Since February last year, the BOJ has said it will seek 1 percent inflation “for the time being.” The central bank’s excuse for not adopting a formal target is that it would not be able to hit it because short-term interest rates – the most potent weapon in any modern central bank’s arsenal – are near zero. And while the BOJ has engaged in quantitative easing since 2001, money-printing is not a reliable strategy for meeting an

inflation objective because the private sector views the excess liquidity supplied by the central bank as temporary. As a result, any inflation target runs the risk of being missed year after year. Since inflation can only be targeted annually, cumulative misses will not necessarily put pressure on the BOJ to strive harder. Pretty soon, the target won't be credible.

A better strategy would be to announce that the BOJ's goal over an unspecified "medium term" is for an index of consumer prices to rise by 1 percent a year. To make amends for the deflation that Japan has already suffered, the clock could start in 1999, when prices began to plateau. Just to eliminate the accumulated deflation, the BOJ would be required to deliver a 16 percent increase in prices.

The advantage of this approach, first proposed by former Princeton economist Lars Svensson, is that if the BOJ undershoots the goal, it will have to work even harder to get the economy on the desired price path. The BOJ will only be off the hook when it gets prices back on track. A price target has the added benefit of being easy for the public to understand.

Setting a target is one thing. Having the tools to achieve it is another. Until now, the BOJ's favoured approach has been to print money to buy domestic assets. This has shown little sign of working so far: quantitative easing has increased base money in the economy to 27 percent of GDP without stimulating inflation.

But the BOJ could also engineer inflation expectations by using the currency. One strategy, advocated by Stanford University economist Ronald McKinnon, calls for Japan and the United States to agree to keep their bilateral exchange rate stable for a very long time. That would help to eradicate the deflationary expectations that have become entrenched in the Japanese consumer psyche.

If the yen extends the slide that started before the tough-talking Abe took office, the currency could well hit 100 to the dollar by the time a new BOJ governor is appointed in April. That could become a de facto peg. If the yen strengthens from that level, the finance ministry, which in Japan has the authority to intervene in currency markets, should be prepared to sell unlimited quantities of yen, newly printed by the BOJ. Better still, the BOJ law could be changed to enable the central bank to directly intervene in the currency market.

Explicitly targeting the exchange rate raises the spectre of currency wars. But Washington is unlikely to be overly upset. First, 100 yen to the dollar isn't a shockingly low level. Second, if Japan is able to tame deflation, it will eventually import more goods and services.

With the right target and the right tool, Japan can escape its deflationary trap. Right now, it has neither.

10 January 2013

TEN WAYS TO TELL WHETHER ABENOMICS IS WORKING

BY ANDY MUKHERJEE

Shinzo Abe wants to stem the rot – and quickly. Less than four months into the job, Japan's new prime minister has launched one of the world's most ambitious programmes of fiscal and monetary easing. His goal is to defeat the scourge of deflation that has corroded the once-dynamic economy, shrinking it by 9 percent in 15 years. But is Abenomics having its desired effect?

Breakingviews' Abenomics Index

Is Japan's economic stimulus having the desired effect?



Source: Reuters graphic/A. Mukherjee, C. Trevethan 12/04/2013

Entrenched deflation won't overnight give way to inflation. There is much else that needs to happen first: Wages and consumption will have to rise, demand for credit and new investments will have to grow, and expectations of future price gains will need to harden. Equity and bond investors will need to keep their faith.

Breakingviews has combined 10 such indicators of "animal spirits" into a composite Abenomics Index, which will be updated monthly. Users can customize the index by removing components they believe to be less useful.

How would the index have fared in the past? Over the last 12 years, the year-on-year change in the index has closely tracked Japan's "output gap," an official measure of whether actual output is above or below the economy's potential, and by how much. Movements in the index can explain about half of the variation in the output gap.

So what's the verdict on Abenomics so far? The early prognosis is encouraging. After rising for three straight months since Abe's election, the index had a value of 94.6 in February. There is still much work ahead, though. For the economy to return to its pre-Lehman level, the index will need to reach about 96. To recover the ground lost since early 2000, the index will need to hit triple digits.

That will be a hard slog if credit does not flow more freely. Junichiro Koizumi, prime minister between 2001 and 2006, did fix the nation's broken banking system, but an incipient recovery in loan growth was cut short by the 2008 financial crisis. It's only after the private sector feels more comfortable with leverage that Abe can shift gear and start cutting the government deficit. The index suggests the time for such belt-tightening is at least a few years away.

15 April 2013

ABENOMICS CAN CLEAR JAPAN'S DEMOGRAPHIC HURDLE

BY ANDY MUKHERJEE



Elderly women walk in a shopping mall in downtown Tokyo September 17, 2006, on the eve of Japan's Respect for the Aged Day. REUTERS/Toshiyuki Aizawa

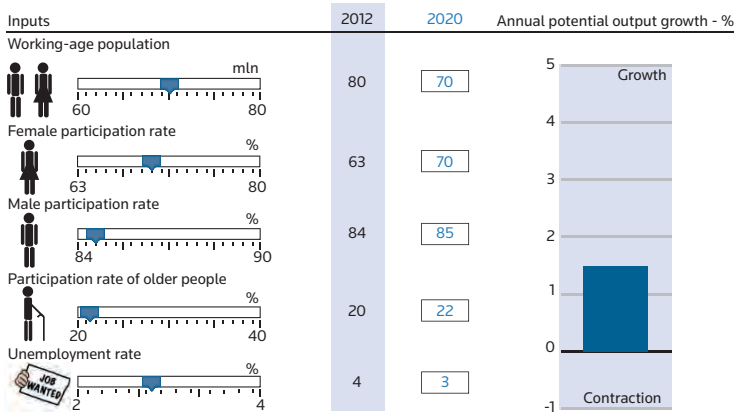
Japan has a serious demographic disadvantage: its population is both shrinking and ageing. But the situation is not so dismal – at least not yet – that it will wreck Prime Minister Shinzo Abe's plans to revive the economy.

The population of Japanese workers aged between 15 and 64 has contracted by 6 percent in the past decade. Over the next quarter century, the fall may be steeper, according to projections by Tokyo's National Institute of Population and Social Security Research. But even if it shrinks by 13 percent, or 10 million people, over the next decade, Japan still has the potential for annual GDP growth of 1.5 percent, according to a Reuters Breakingviews calculator. That's double its actual growth rate over the past 18 years.

A country's growth potential is partly determined by the number of additional labour hours that go into producing more output: in short, the expansion in employment. Other factors also play an important role: whether workers have

Demographics versus Abenomics

How fast can Japan's economy grow between 2012 and 2022?



Data sources: Statistical Bureau, Director General Policy Planning (Japan), A. Mukherjee, C. Trevethan 12/03/2013

better skills, and access to more capital and superior technology. Even then, however, growth can fall behind its potential due to deficient demand. That's the case in deflationary Japan: people have postponed spending because they expect things to cost less in future.

Abe's big bet is that boosting demand will not only end deflation, but lift the supply side of the economy too. Aggressive fiscal and monetary easing, designed to create a virtuous cycle in which companies invest more and create new, better-paying jobs, should draw more people into the workforce. But given Japan's poor demographics and its aversion to immigration, are there any people left to do the work?

To answer the question, start with working women. Female participation in Japan's workforce is currently 63 percent, among the lowest in the developed world. If Abe's policy supports working mothers, for instance with state-funded kindergartens, that figure should rise. Cultural restrictions will still make it hard for Japan to emulate Sweden, where eight in 10 women of working age have a job or are looking for one. But an increase in the participation rate to 70 percent looks achievable.

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It won't be as easy for men. Already 84 out of 100 working-age Japanese men are employed or looking for work. Some countries do better: in Switzerland, the male participation rate is 89 percent. But if Abenomics is successful, some Japanese men might choose to work less. A slight increase to 85 percent appears a reasonable forecast.

Then there are the elderly. Lifting the retirement age above 65 years would induce them to work for longer. The return of inflation, which devalues retirement savings, could also prove a powerful incentive to keep earning. The example of Finland – where 34 percent of elderly people are workers or jobseekers – may be too much for Japan to emulate. Still, it's not unreasonable to think that proportion of over-65s in the workforce will rise from 20 percent to 22 percent over the next decade.

Finally, Abenomics could squeeze unemployment. This is not a huge problem in Japan – despite years of sub-par growth, the jobless rate was still just 4.3 percent at the end of last year. Even so, improved economic prospects should lower this to 3 percent.

Drawing more people into the workforce won't entirely offset the demographic decline: the calculator's central scenario suggests total employment in Japan will shrink to 61.15 million in 2022, from 62.73 million today – a reduction of 0.25 percent a year. However, that's better than the 1 percent shrinkage that would be likely to occur if the proportion of working men, women, elderly and unemployed remains unchanged.

How, then, can Japan grow? That depends in part on the factors that make workers more or less productive: skills, capital and technology. Though Japanese workers are already well educated, labour quality has improved by 0.45 percent annually in recent years. Assume that continues.

In a developed economy like Japan, it's unreasonable to expect huge growth in capital per worker. But the 1 percent annual increase between 2000 and 2006, the latest period for which data is available, can be expected to persist.

Finally, there's technological progress. Japan's record on improving total factor productivity has been a paltry 0.4 percent a year. A better

performance is possible if a weak yen prompts Japan's electronics and auto exporters to spend more on research.

But even if productivity improvements remain sluggish, the combination of these factors should make it possible for Japan's economy to expand by 1.5 percent a year for the next decade. While the country's demographics are a drag on the revival promised by Abenomics, they should not be an insurmountable obstacle.

14 March 2013

JAPANESE WORKERS NEED TO GO BACK TO THE 1980S

BY ANDY MUKHERJEE

Japanese workers are hoping for a 1980s revival. If the Bank of Japan's 2 percent inflation goal appears daunting, meeting it in two years – as promised by new chief Haruhiko Kuroda – is even more of a challenge. For the central bank to succeed, wages will have to grow faster than they have in the past two decades.

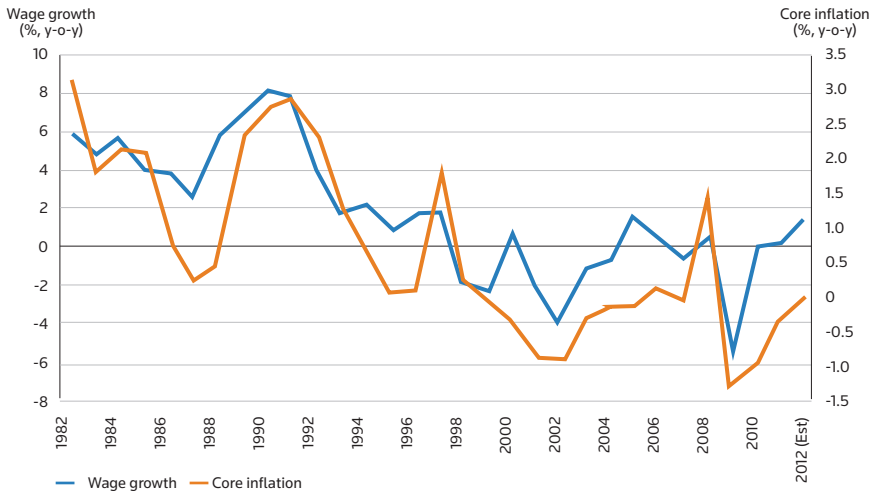
The past relationship between inflation and wages in Japan has been remarkably tight. In order for prices to rise at a 2 percent annual pace, workers' pay will need to expand by about 5 percent a year, Breakingviews calculations show.

It's been a long time since Japanese workers enjoyed such a bonanza. Total wage income has declined 15 percent since 1997 as baby boomers have retired without sufficient younger workers to replace them. This has led to a downward spiral where consumer prices fall in tandem with declining incomes, while falling prices crimp employees' wage-bargaining power.

But a shrinking workforce may now help. Japan's shallow pool of potential jobseekers means that if the BOJ's policies unleash new investment, the unemployment rate could slide quickly. For 5 percent wage growth, the jobless rate will need to fall to below 2.7 percent, from 4.3 percent at present, according to UBS economist Daiju Aoki.

BREAKINGVIEWS

Wages hold the key to ending Japan's deflation



Source: Thomson Reuters Datastream, A. Mukerjee, R. Mak 22/04/2013

But why would Japanese companies, which do not fire employees in bad times, hire more of them in good times? One reason is that the labour market is getting tighter. The ratio of job advertisements to applicants is higher now than its three-decade average, and for the first time since the 2008 financial crisis, more companies reported a shortage of workers than an excess in the first quarter of this year.

The 20 percent slide in the yen against the US dollar since last November will also allow Japanese exporters to raise pay without sacrificing margins. By contrast, however, importers will face pressure on earnings. Only 8 percent of companies responding to a recent poll by Reuters said they were considering lifting wages as a result of the weaker yen.

That should worry the BOJ. If wages take time to recover, Kuroda's promise of 2 percent inflation in two years may go unfulfilled, and the central bank's credibility will take a knock.

22 April 2013

ABENOMICS LOOKS LIKE SOLUTION IN SEARCH OF PROBLEM

BY EDWARD HADAS



A pedestrian walks past a sale poster at a street in a shopping district in Tokyo March 1, 2013. REUTERS/Yuya Shino

Shinzo Abe wants to “invigorate the economy”. To the Japanese prime minister, that means ending deflation and increasing the GDP growth rate. But the problems that his so-called Abenomics are supposed to address are not so severe. And his proposed policies will not address the country’s genuine challenges.

Japan is not suffering from serious or debilitating deflation. In fact, it is not obviously suffering from any sort of deflation. Over the last 20 years, the monthly reading of the consumer price index, set at 100 in 2005, has ranged only from 98.9 to 104.2. The most recent reading was 99.2. There has been a little more deflation in the so-called core index, which excludes food and energy, but the annual rate of decline over the last decade is still less than 1 percent.

Serious deflation, like the 27 percent decline in U.S. prices in four years during the Great Depression, destroys banks and disrupts consumers. But

BREAKINGVIEWS

it's hard to see what harm almost stable prices have done to Japan. The financial system is intact and the infrastructure in good shape. Defenders of Abenomics argue that GDP growth would have been better if prices had been rising gently. But has Japan's growth actually been inadequate?

At first glance, it looks like Abe's call for an urgent "revival of the economy" is justified. Japan's real GDP was 2 percent lower in 2012 than in 2007. Even stretched over the last decade, the annual GDP growth rate has been an unimpressive-sounding 0.7 percent.

Like other already rich countries with ageing populations, Japan's potential growth rate is very low. It is lower than in Germany, which has more immigration to counter a similar decline in the domestic population. It is lower than in Italy, which has a large, poor southern region that could catch up with the North, boosting the national growth rate.

What Japan has is a declining number of workers: 6 percent fewer 20- to 65-year-olds now than in 1999. At the younger end, workers aged between 20 and 34 years, the decline is particularly striking: down 22 percent from its 2001 peak, with another 13 percent drop almost certain over the next 15 years.

Adjusted for demographics, the Japanese record looks more impressive. GDP per working-age person has increased at a 1.2 percent annual rate over the last decade. That is well ahead of the 0.7 percent rate in the United States, where the number of people of working age has risen by 10 percent.

Japan's GDP growth rate could be higher, even without letting in more immigrants. The country could put more women into paid work, delay retirements, reduce the unemployment rate and perhaps squeeze out a bit more productivity. But why bother?

The decline in the number of young families means that the same quantity of GDP goes further in Japan than in countries with increasing populations. To keep lifestyles constant, every year Japan needs fewer new houses, cars, appliances, roads and schools. As the population shrinks further, GDP could even start to fall while overall prosperity continues to increase.

Defenders of Abenomics argue that higher GDP will help the country deal with the challenges of an ageing population. That is backwards. The Japanese government and society will indeed have to allocate more people and resources to medical and personal care, and that shift might increase GDP. But any rise will be an effect, rather than a cause, of making the economy senior-friendly.

A more persuasive argument for Abenomics is that faster nominal GDP growth is the best way to erode Japan's vast sovereign debt burden – currently about 237 percent of GDP, almost all held inside Japan. Defenders admit that Abenomics' deleveraging will be slow, especially as it cannot even start until the fiscal deficit falls sharply from the current 10 percent of GDP, but they see no plausible alternative.

That is too pessimistic. It should not take decades of unnecessarily high real growth to resolve a problem which is solely monetary and almost entirely domestic. What is needed is a political agreement for truly radical monetary action. For example, the Bank of Japan could use newly printed cash to buy a large portion of very low-yielding debt – 0.6 percent on 10-year bonds. If that retroactive policy change, from borrowing to money-printing, proved unduly inflationary, the BOJ could use its power to control bank balance sheets to keep unwanted money from being spent.

At least Abenomics could theoretically lighten Japan's sovereign debt burden. For the overall economy, Abenomics is a solution in search of a problem.

1 April 2013

CENTRAL BANK REVOLUTION

BOJ'S CONUNDRUM IS HOW TO BE MORE IRRESPONSIBLE

BY ANDY MUKHERJEE

The Bank of Japan has a conundrum: how to make a credible commitment to recklessly printing more money. The central bank wrote the primer on unconventional monetary policy a decade ago when it pioneered quantitative easing. But as other central banks have embraced loose money, the BOJ has become an increasingly forlorn figure in a crowded rogues' gallery.

The U.S. Federal Reserve has set the tempo by promising near-zero interest rates until mid-2015. It has also made an open-ended commitment to buying mortgage bonds at the rate of \$40 billion a month until the labour



Masaaki Shirakawa, former Bank of Japan governor, leaves a news conference in Tokyo February 14, 2013. REUTERS/Yuya Shino

market shows sustained improvement. Meanwhile, the European Central Bank has vowed to buy short-term government bonds of all euro zone countries that officially seek help.

In such a merry season of central bank liberation, the BOJ is stuck with the straitjacket of a predefined, 80 trillion yen (\$1 trillion) asset-purchase programme that does expand from time to time – but only when the economy threatens to slip further into its deflationary funk. The result is a Sony Walkman pretending to be an iPhone 5; since the second quarter of 2008, the Bank of Japan has increased its supply of currency and bank reserves by 42 percent. The Fed has more than tripled its monetary base over the same period.

Even the target of the BOJ's limited asset-buying plan is problematic. The most recent monetary easing plan, announced on Sept. 19, added 10 trillion yen in treasury bills and government bonds to the monetary authority's shopping list. That's inadequate for two reasons. First, the BOJ will be making these purchases next year, when they will no longer have any shock value. Second, Japanese banks will be reluctant to part with a three-year government bond that pays a precious 1.4 percent annual coupon if the most likely alternative is to deposit the proceeds with the central bank at a rate of 0.1 percent.

One option is for the BOJ to offer a more generous price – something the central bank has allowed itself to do by scrapping a limit on the minimum yield (and therefore maximum price) it could pay at auctions. But even a negative yield isn't novel any more. Mildly negative nominal interest rates have already appeared in Denmark, Switzerland and Germany, and deeply negative ones will be impossible as long as currency – a competing security that pays zero interest – isn't outlawed.

So what will shock Japan? A new inflation target of, say, 2 percent would induce a yawn, considering that few analysts expect the BOJ to hit even the 1 percent goal it adopted in February. Embracing a new target, such as nominal GDP, lacks the simplicity of aiming for higher prices. The central bank could raise the share of corporate bonds, exchange-traded funds and property-backed securities in its asset-purchase programme from their current 8 percent level. That would pile more credit risk onto the BOJ's balance sheet, but would also channel liquidity to non-banks that may use it to boost credit.

A bolder move would be for the monetary authority to use printed money to buy U.S. Treasury bonds until it hits its inflation target. Such a plan would help exporters by weakening the yen, even as it generates domestic liquidity. Currently, the finance ministry orders purchases of foreign securities out of funds that the government borrows and parks in a special account. This roundabout way of weakening the yen through a fiscal operation – rather than a monetary one – only works temporarily, until a fresh bout of global risk aversion makes the yen a compelling haven again.

Purchasing U.S. Treasuries by printing yen would require changes in the institutional arrangements between the BOJ and the finance ministry. It would also be bound to evoke protests in the United States about Tokyo's blatant currency manipulation. Then again, Japanese purchases would play the same role that outsized Chinese demand for U.S. government and agency debt did until a few years ago: they will help to keep long-term U.S. interest rates low.

The BOJ needs to change its failing strategy. Risks of a new recession are mounting. If the central bank doesn't come up with a new policy, Japanese consumers will continue to hoard cash and deny the economy what it has craved since 1999: a little bit of inflation.

11 October 2012

JAPAN'S FISCAL STIMULUS IS CALL FOR ACTION TO BOJ

BY ANDY MUKHERJEE

Japan's new prime minister has thrown the country's central bank a \$117 billion challenge.

Shinzo Abe's government took the lead in the fight against deflation on Jan. 11, announcing its biggest fiscal stimulus package since the 2008 crisis. That leaves the Bank of Japan with no excuse to delay adopting a stiffer inflation target than the 1 percent annual price increase goal it is currently pursuing.

The central government's 10.3 trillion yen spending boost, which it expects to lift real economic growth by 2 percentage points, will require it to issue a

further 5 trillion yen of sovereign bonds in the current fiscal year. More borrowing will come later. To prevent risk-free yields from rising, the central bank will have to mop up the excess supply from the debt market using newly printed money. An increase in the BOJ's 101 trillion yen asset purchase programme at its next monetary policy meeting on Jan. 21-22 now looks a foregone conclusion. Doubling the central bank's inflation target to 2 percent, which Abe has been pushing it to do, is also almost certain.

But while the combination of government spending and money-printing represents a step in the right direction, coordination between fiscal and monetary authorities on exchange rate targeting might help the economy more.

Holding the yen's exchange rate down at about 100 to the dollar – about 12 percent weaker than the current level – would boost Japanese exports, which have suffered a severe loss of competitiveness in recent years. Stronger exports would lift employment and wages, which in turn would put upward pressure on prices. Exchanging printed yen for dollars would also engineer higher expectations of inflation by boosting the money supply.

But in Japan, the finance ministry decides currency intervention, while the central bank prints money. Pending coordination between the two authorities, Abe has done the best he can.

The stimulus will further increase the public debt, which is already an eye-watering 237 percent of GDP. But to have shied away from additional fiscal spending would have been a mistake. Abe's prognosis is quite right: without an economic revival Japan will neither have fiscal consolidation, nor much of a future.

11 January 2013

INTERVIEW QUESTIONS FOR THE NEW BOJ CHIEF

BY ANDY MUKHERJEE



Haruhiko Kuroda attends a group media interview in Tokyo February 11, 2013, before his appointment as Bank of Japan governor. REUTERS/Toru Hanaï

Japanese Prime Minister Shinzo Abe's war on deflation will soon have a new general. A hard-charging Bank of Japan governor with strong conviction and oodles of savvy could help bring Abe's plan to fruition.

The leading candidates to replace Masaaki Shirakawa when he steps down in March are all impressive. Kazumasa Iwata and Toshiro Muto are former BOJ deputy governors. But having been central-bank insiders also carries with it the stigma of policy failures. Heizo Takenaka, who was point man for banking reforms under former Prime Minister Junichiro Koizumi, has a proven track record. Meanwhile Haruhiko Kuroda, the president of the Asian Development Bank, has a weighty Rolodex that might help Japan avoid international censure for its policies.

The nomination will have to be approved by both chambers of Japan's parliament. But here are some interview questions the prime minister can use to test the candidate's commitment to "Abenomics".

What will you tell critics who accuse you of debasing the yen?

Correct answer: Thank you. The new governor must eschew the puritanical notion that he must preserve the purchasing power of the Japanese currency. While that would indeed have been the job description in normal times, Japan is stuck in a deflationary quagmire. Only when people understand that their yen will be able to buy less, not more, tomorrow than today, will consumers spend more, employees demand higher wages and investors stop sitting on piles of cash or risk-free bonds.

What will you do if inflation leads to higher interest rates and losses on BOJ's holdings of public debt?

Correct answer: I don't care. One of the reasons the BOJ's response to deflation has been inadequate is because policy makers have agonised over the size and quality of the institution's balance sheet. The new governor, too, will undoubtedly face warnings from hawks that a mere 5 percent drop in the value of the central bank's government bonds will wipe out its capital. But running out of capital is a worry for private institutions, not a money-printing central bank.

Won't debt markets get jumpy if the BOJ chalks up large losses?

Correct answer: No. What matters to investors is the consolidated balance sheet of the government and central bank, and that will look better if higher inflation causes interest rates to increase. The \$1.27 trillion of government paper held by the central bank is a fraction of the net outstanding public debt of about \$7 trillion. Higher yields will reduce the present value of this liability. True, there will be pain at the state pension fund, whose assets are largely government bonds. But that problem will need a separate response.

How will you allay the euro zone's concerns that a weak yen is an assault on its competitiveness?

Correct answer: By buying Italian and Spanish bonds. To resist international opposition to a weak yen policy, the new governor should champion the Abe administration's idea of a foreign bond fund. If the fund is large – say the equivalent of \$500 billion a year – and a fifth of it is used to buy sovereign debt in the euro zone, about 5 percent of the annual gross borrowing requirement of all the governments of the single-currency area will find an assured lender. Under no circumstance, though, must Japan get dragged into another Plaza Accord, which led to a massive appreciation in the yen in 1986. That would risk extending Japan's deflation.

The next governor's place in history is assured. What remains to be seen is whether posterity views him as the peace-time hero who helped to end Japan's chronic deflation or a failure like Masaru Hayami, who became governor in 1998 and did incalculable damage to the economy by refusing to believe – until it was too late – that Japan's deflation was a bad thing.

A final question that Abe might want to slip in at the end of the quiz is:

What will you do after I ratchet up deficit spending and rating agencies downgrade Japan again?

The correct answer: a shrug.

12 February 2013

NEXT BOJ CHIEF SHOULD ACCEPT MONETIZATION

BY ANDY MUKHERJEE

The Bank of Japan has a morbid fear of directly financing fiscal deficits. But this “no monetization” creed sits ill with the \$1 trillion or so of public debt – roughly a fifth of the Japanese GDP and about 14 percent of the net outstanding public debt – which it has already turned into money. The next

BOJ governor, who will take over when the incumbent Masaaki Shirakawa steps down on March 19, should be more realistic.

The BOJ owns about \$1.3 trillion in government bonds, which it has paid for by creating money. Of this money, about \$375 billion is voluntarily held by banks as excess reserves. If banks suddenly find a more exciting use for these funds, the BOJ will be forced to raise compensation on excess reserves from its present level of 0.1 percent. And if that is not enough, the central bank will have to sell liquid government bonds in the market and extinguish an equivalent amount of money.

But the private sector has no control over the remaining \$1 trillion or so of public debt owned by the BOJ. On the central bank's balance sheet, these assets are backed by three near-permanent liabilities: currency issued by the central bank; zero-interest balances banks are required to keep with the monetary authority, and the BOJ's capital and loss reserves.

None of the three liabilities pays anything. None can be redeemed: bank notes can only be exchanged for different bank notes; financial institutions can't recall mandatory balances, and the private sector has no claim on the BOJ's capital. This is how a modern central bank monetizes debt - by creating a large, positive net worth for itself while loading up on government bonds. The crude method of a government dumping its debt on its central bank is history.

While the Federal Reserve has been an even bolder pursuer of unconventional policies than the BOJ, the extent of debt monetization in the United States is quite low compared with Japan. If depository institutions were to balk at the 0.25 percent interest they receive on their balances with the Fed and draw down their entire \$1.6 trillion in excess reserves, the Fed would have to sell almost all the treasury securities it owns, removing an equivalent amount of money from the economy.

US Federal Reserve economist David Lebow introduced this method of measuring debt monetization almost a decade ago. Interestingly, even as the value of monetized public debt in Japan has risen to 20 percent of GDP from 12 percent in 1997, there has been no upheaval in the bond market. Yet, the BOJ orthodoxy believes that if bond purchases by the central bank

are seen to be motivated by a desire to help the government finance itself cheaply, investors would demand higher interest rates.

The BOJ is not loath to share this view with others. An August 2012 report by the International Monetary Fund cites central bank officials as telling the IMF staff that “in the absence of fiscal reforms further increases in JGB purchases (by the BOJ) could be viewed as monetization of the fiscal deficit and push interest rates up.” But there is no evidence to support this claim. The government announced an additional 2 percent of GDP in fiscal stimulus in January, and the BOJ said it would buy unlimited amounts of bonds, starting 2014. Yet, 10-year Japanese government bonds currently yield 0.75 percent.

The real danger of monetization is that the government, once it’s allowed to bypass the discipline of bond markets, would become a reckless borrower. But this argument doesn’t hold for present-day Japan. The government’s large deficits have compensated for two decades of private-sector deleveraging. If the state had lived within its means, nominal GDP, which is only 10 percent lower than it was in 1997, might have collapsed.

Monetization of public debt has posed little danger to Japan so far, and is unlikely to be much of a threat before the economy exits deflation. Then the private sector might have reason to complain about being crowded out by government borrowings.

The BOJ could be even bolder by implementing a proposal by Koji Ishida, a member of the central bank’s monetary policy board, to scrap interest on excess reserves. If banks still leave idle money parked at the BOJ, it will only mean that lenders have no desire to swap zero-interest cash for anything else. And that will send a strong signal to both the government and the BOJ that the Japanese may be ready for more helicopter money.

For the BOJ to hold back on monetary expansion now in anticipation of future problems is not prudence. It’s just an irrational fear the next governor must overcome.

14 February 2013

WHY KURODA IS A BETTER CHOICE FOR BOJ CHIEF

BY ANDY MUKHERJEE



Current Bank of Japan Governor Haruhiko Kuroda speaks in Tokyo, February 11, 2013, pictured before his appointment to the BOJ. REUTERS/Toru Hanai/Files

The Bank of Japan's next governor will need to be both a bold money printer and a wily defender of Prime Minister Shinzo Abe's economic policies. Haruhiko Kuroda, currently president of the Asian Development Bank, fits the bill.

Kuroda is likely to be Abe's nominee to replace Masaaki Shirakawa, Reuters reported on Feb. 25. Investors, who were beginning to believe that Kuroda was going to lose out to former Bank of Japan deputy governor Toshiro Muto, gave their stamp of approval by pushing up Japanese equities to a 4 ½-year high while pulling the yen to a 2 ½-year low.

Kuroda has spent the past eight years at the ADB, hobnobbing with finance ministers and central bankers from around the world. Such diplomatic savvy should stand him in good stead when it comes to deflecting criticism that the BOJ's policies amount to competitive devaluation.

His other advantage is his willingness to experiment with unconventional policy tools. Ten years ago, when defenders of the independence of Japan's central bank still had a religious fervour, there was little support for Columbia University economist Joseph Stiglitz's suggestion that the BOJ should directly finance the government's deficit. Kuroda, then an adviser to the government, said he found the idea "very interesting".

Muto has also vowed to slay deflation. But investors have trouble believing that pledge. As one of the BOJ's two deputy governors between 2003 and 2008, he did not disagree when policy makers dumped quantitative easing in March 2006 and tightened interest rates – not once, but twice – in July 2006 and February 2007.

As late as January 2008, three months before the Japanese economy was about to start shrinking again, Muto said in a speech that it was reasonable to expect that "the world economy will continue to expand robustly" and that, at 0.5 percent, Japan's interest rates were "extremely accommodative."

While Muto might have learned from those past mistakes, Kuroda won't have the luxury of making any new ones. Expectations will run high from the first rate-setting meeting under the new governor – and his two new deputies – on April 3 and 4. If the new regime fails to make a good impression, it may not get a second chance.

25 February 2013

KURODA DOES WHAT HE CAN FOR BOJ'S INFLATION GOAL

BY ANDY MUKHERJEE

The Bank of Japan's new chief has dumped his predecessor's timid script. Haruhiko Kuroda has crafted an ambitious new plan to end the country's chronic deflation.

The BOJ has long had its policy rate at zero, so it cannot cut. But it can print money, and at its April 3-4 policy meeting, Kuroda's first as governor, it decided to do so – in scale. The monetary base, the sum of currency in circulation and commercial banks' reserves with the BOJ, will double in just two years, from 138 trillion yen at the end of last year to 270 trillion yen by the end of 2014.

The newly created funds will be used aggressively. Masaaki Shirakawa, the bank's former governor, had a squeamish preference for buying less risky, shorter-dated securities. Kuroda will even buy government debt maturing in 40 years. The BOJ will also "temporarily suspend" a 12-year-old self-imposed rule, which calibrated the central bank's holdings of government debt to the value of banknotes issued by it. The rule limited the BOJ's purchases of longer-dated bonds.

Japan's yen over the years



Source: Reuters. C. Trevethan 11/04/2013

The BOJ's aggression will make emerging-market policymakers squirm as cheap yen liquidity pours into their shallow asset markets. Advanced nations, as well as China, will accuse Japan of launching a currency war. But cheapening the yen to promote new investments in export-oriented industries is crucial for Japan to slay its deflation scourge.

Now that he has embraced Prime Minister Shinzo Abe's anti-deflation mandate, Kuroda must stand ready to do more. His new strategy is hyper-aggressive by Japanese standards, but the U.S. Federal Reserve's balance sheet has tripled since the 2008 collapse of Lehman Brothers. Kuroda could resurrect equity-buying, which the BOJ experimented with in 2002 and 2009.

But while Kuroda can do more, he can't do it alone. By this time next year, big-ticket consumer purchases in anticipation of an April 2014 consumption tax increase will have come to an end. To prevent yet another slide down the deflationary slope, the Abe administration needs to aim for public expenditure-funded growth in 2014. With Kuroda's bond buying keeping borrowing costs in check, such a strategy carries little danger, even for the most indebted government among advanced nations.

04 April 2013

BOJ ADDS TO GLOBAL FINANCIAL TIDAL WAVE

BY EDWARD HADAS

The Bank of Japan is making up for lost time. The Japanese monetary authority long resisted outside calls for a massive campaign of asset purchases. But Haruhiko Kuroda, the BOJ's new governor, has enthusiastically joined his peers in the United States, United Kingdom and – to a lesser extent – the euro zone, in the global contest to pour the most money into the financial system.

The BOJ's planned monthly purchase of 7.5 trillion yen of government debt amounts to an annual outlay equivalent to 19 percent of GDP and 190 percent of Japan's fiscal deficit. While the U.S. Federal Reserve started

earlier, its current campaign looks modest in comparison, at 6.5 of GDP and 105 percent of the deficit.

Kuroda has plausible domestic reasons to join the global print-fest. More money could revive Japanese inflation and GDP growth, which would eventually reduce the government's debt burden, currently a huge 237 percent of GDP.

But while central banks are thinking locally, their actions reverberate globally. In a world of freely moving capital and floating exchange rates, every monetary move ripples around the world. Cheap leverage can magnify the effect of relatively small amounts of money.

The economic effects of these policies are unclear. The U.S. and UK economies seem to have responded sluggishly to monetary stimulus, but things might have been much worse without it.

The financial effects are clearer, but unpredictable. The dollar fell during the first round of quantitative easing, but has risen in the third. Ample money initially propped up global commodity prices, but now seems to be helping stock markets more. Gold, an early beneficiary of money-printing, is now falling. And while bond yields have generally fallen, there are exceptions – as some euro zone members have discovered.

The contest in monetary easing could ultimately benefit everyone by reviving growth, and the subsequent tightening could go without a hitch. But the longer it goes on, the more countries that play, and the larger the sums involved, the more likely the financial tidal wave will prove disruptive. The BOJ's new policies have increased those odds.

15 April 2013

BONDS, STOCKS AND THE YEN

THREE-DIGIT YEN NO LONGER A ONE-WAY BET

BY ANDY MUKHERJEE

The yen is no longer a one-way bet. The Japanese currency has slumped to 100 against the dollar for the first time in four years. That's a 16 percent slide since Shinzo Abe's landslide election victory in December. At the time, Breakingviews predicted his victory would herald a three-digit yen. But there are good reasons to be sceptical about a further decline.

The first reason for caution is monetary aggression. Until six months ago, the U.S. Federal Reserve was a far more audacious money printer. This



Light is cast on a Japanese 10,000 yen note as it's reflected in a plastic board in Tokyo, February 28, 2013. REUTERS/Shohei Miyano

changed during the election campaign, when Abe denounced the Bank of Japan and promised 2 percent inflation. On April 4 Haruhiko Kuroda, the new BOJ governor, announced plans to double the monetary base in two years.

More yen means cheaper yen, but how much cheaper depends in part on the Fed's next move. If sub-par employment and disinflation prompt the Fed to expand its \$85-billion-a-month quantitative easing plan, the dollar could weaken. And if the euro zone debt crisis worsens, investors may again view the Japanese currency as a relatively safe haven.

Japan's dependence on imported fossil fuels – which has increased since the 2011 Fukushima nuclear accident – is another factor. Politicians won't want a sudden spike in energy costs to drag on consumer spending, offsetting gains from exports.

Then there's currency diplomacy. The United States has so far taken a benign view of Abenomics. The G20, too, has refrained from criticizing the BOJ's aggressive monetary easing. But if the yen weakened by, say, another 20 percent, accusations that Japan is waging a currency war would prove harder to resist. That is something Abe wants to avoid as he tries to forge a stronger trade relationship with the United States.

Finally, a weak yen could become too much of a good thing. The yen's sharp decline in the mid-1990s saw speculative flows of cheaply borrowed Japanese money cause a credit-fuelled boom – and painful bust – in Southeast Asia. The whole point of Abenomics is to boost Japan's economic power in Asia and the world. The last thing the prime minister wants is to be known as the man who caused Asia's next financial crisis.

10 May 2013

JAPAN COMES DANGEROUSLY LATE TO CURRENCY WAR

BY AGNES T. CRANE

Yen trash-talking in Japan has pushed the currency down some 12 percent against the dollar since September. But the world's third-largest economy is a Johnny-come-lately. It belatedly joins a long list of nations which hope that weaker currencies will beat down economic woe. Opening another front at this point makes this currency war more dangerous.

Japan can make a good case that the world has been too harsh to its currency. Foreign exchange buyers are punishing the country for virtuously dodging the financial crises of the last five years. Traders have been buying yen since mid-2007, pushing the currency up nearly 60 percent against the dollar over the next five years. That has hardly helped exports. They've fallen 31 percent from their peak in early 2008, while the trade balance has been in the red for five consecutive months. With prices drifting steadily downward, the nation's debt load of more than 500 percent of GDP looks like a huge burden for a declining and rapidly ageing population. No wonder new Prime Minister Shinzo Abe wants inflation and a weak yen.

Abe's effort to use currency-weakening financial techniques to promote economic strength differs in detail but not in principle from the efforts of the United States, the UK, Switzerland and China. Each additional entrant makes the contest more futile. Japan's new government could struggle to keep the yen down against such worthy competitors in a race towards the bottom.

Higher inflation and a weaker yen might be popular inside Japan, where consumer prices have been almost flat for two decades. However, if Abe goes too far and Japanese exporters do too well, the new policies could ruffle feathers further afield – in South Korea, China or even the United States.

The yen still has plenty of room to run before anyone can call it undervalued. According to the OECD's measure of purchasing power parity, the yen is 16 percent above its fair value. But Japan's foray into the currency wars could make that battle far messier than investors currently expect.

7 January 2013

JAPAN'S INFLATION WORRYWARTS GOOD FOR RISKY ASSETS

BY ANDY MUKHERJEE



A foreign exchange dealer watches a monitor as she talks on the phone at a trading room in Tokyo January 22, 2009. REUTERS/Kim Kyung-Hoon

Japanese Prime Minister Shinzo Abe's war on deflation is producing results. Green shoots of inflation expectations are forcing investors to pare their exposure to the country's government bonds and scout for more profitable opportunities overseas. As Abe intensifies his campaign, risky assets around the world — from Italian bonds to Russian roubles — will find new buyers.

The yen has already declined by 21 percent against the dollar since mid-September. The slide may continue once Abe appoints a more pliant central bank governor in March, further hardening inflation expectations. Already, the future inflation rate implied by the difference in yields between regular and inflation-protected government securities has shot up to 1 percent. A year ago, it was minus 0.02 percent.

But with the Bank of Japan aggressively buying government bonds with newly printed money in an attempt to hit its new target of 2 percent annual inflation, it's quite likely that risk-free yields will remain capped. Japanese government bonds, which offer an abysmal 0.8 percent nominal yield for 10-year securities, may become a money-losing trade.

That's why investors are thinking again. The Japanese Government Pension Investment Fund, which has stuffed two-thirds of its \$1.2 trillion portfolio in government bonds, will review its investment strategy around April. Other Japanese investors may do the same. Domestic equities are one alternative. But the Nikkei 225 index is already up 28 percent over the past three months. Going overseas might make more sense. If Japanese investors increase the pace of their overseas asset purchases by 25 percent to 2006 levels, about \$250 billion will be coming out of the country in a year.

The Japanese shopping destination in 2013 will be different from what it was at the previous peak of domestic monetary expansion in late 2005 and early 2006. Commodity currencies like the Australian dollar do not look as appealing as they used to: the country's already-low interest rates may fall further as a fading resources boom cools the economy.

The bonds of peripheral euro zone governments will be attractive destinations for Japanese money, according to Morgan Stanley analysts Gabriel de Kock and James Lord. High-yielding currencies like the Russian rouble and Mexican pesos are also among the investment bank's top picks. Japanese investors may be pickier than they were during the boom before the 2008 crisis. Even so, the shakeup in their portfolios will be felt around the world.

6 February 2013



TOKYO STOCKS: THIS TIME COULD REALLY BE DIFFERENT

BY ROBERT COLE



An employee of the Tokyo Stock Exchange watches a stock index board as she waits for the opening of the stock market in Tokyo August 8, 2011. REUTERS/Kim Kyung-Hoon

Once bitten, twice shy. In fact, investors in Japan have been bitten many times by the seductive notion that the land of the rising sun is emerging from its bear-market night. They would be forgiven for shying away this time.

The temptation is there, though. The MSCI Japan index is up by a third since mid-November, helped by the yen's steep decline against the dollar. Investors are drawing confidence from the promise of reflation by the new government of prime minister Shinzo Abe. Starmine data suggests that Japanese corporate earnings are on course to strengthen by 22 percent over the coming year – nearly twice the global average.

An analysis of valuation metrics also offers convincing reasons to be cheerful about Japanese stocks. The forward-looking price earnings ratio for the MSCI Japan index sits just below 14. That is a little higher than the equivalent for Europe and about the same as for the United States. But it is less than global average p/e ratio for the last two and a half decades. And today's multiple is way below the Japanese average for the last 25 years – which sits at a princely 30. It is also lower than nearly 90 percent of all weekly readings for Japanese stocks since 1988.

Dividend yields tell a similar story. Thomson Reuters Datastream data show that Japanese shares pay an average 2.2 percent at present. For nearly two-thirds of the period since 1988, they have yielded less than 1 percent.

How do current circumstances compare with previous points of hope? One of the biggest false dawns broke in May 2003: the MSCI Japan index more than doubled over the subsequent four years before sliding all the way back. At the start point, however, Japanese equities were more expensive than they are now – trading on an earnings multiple of 16 and yielding 1.2 percent.

Investment decisions can rarely be distilled into an exact, numerical science. Abe's reflationary promises may fade. Companies may fail to take advantage of the cheaper yen. There is, however, good evidence in the valuation data to suggest that now is a good time to buy Japanese equities. This time really might be different.

8 February 2013

JAPAN CASH EXODUS REMAINS HOPE RATHER THAN REALITY

BY ANDY MUKHERJEE

Japan's fondness for yen has survived the central bank's vow to print the currency with abandon. In the week after the Bank of Japan's declaration that it would double the monetary base, large resident investors sold a net 548 billion yen (\$5.6 billion) in foreign bonds, bills and equities. That suggests they either don't believe the inflation threat – or are even more wary of foreign assets.

The initial response to the BOJ's money-printing is counterintuitive. If the central bank's promise of 2 percent inflation in two years is credible, Japanese investors ought to be heading overseas in search of a better real return. Analysts at HSBC calculated in March that a relatively small shift in portfolios would require Japanese institutions to buy \$1 trillion in overseas bonds. Government bond yields across the developed world have fallen in recent weeks as investors anticipated a Japanese cash exodus.

One possible explanation is that Japanese investors don't expect the BOJ to succeed. If deflation persists, then even close-to-zero nominal returns on Japanese government bonds may have their appeal. But other market signals suggest otherwise. The expected future inflation rate, implied by the yield difference between 5-year government bonds and inflation-protected securities of same maturity, has trebled to 1.56 percent since last August.

A more plausible reason may be that, adjusted for risks, world markets are still not attractive enough for Japanese investors to shed their home bias. Expectations of an economic revival have brought the domestic equity market to a boil – the TOPIX index is up 41 percent in the past year. And long-term Japanese government bonds have still provided higher yen-denominated returns this year than US Treasuries.

The latest data is not totally conclusive. Though large investors, including banks and asset managers, account for 80 percent of net outbound investments, smaller investors don't always behave the same way. A fuller picture of outflows will emerge when the first-half balance-of-payment data is released in August. For now, however, Japan's cash exodus remains more hoped-for than real.

18 April 2013

CURRENCY WAR IS NOT WORTH FIGHTING

BY EDWARD HADAS



Anti-Japan protesters tear a banner depicting Japan's Prime Minister Shinzo Abe during a rally in front of the Independence Gate in Seoul March 28, 2013. REUTERS/Kim Hong-Ji

Is monetary and fiscal stimulus a weapon for hurting rival nations? It depends who you ask. The conjugation goes like this: I am helping the economy; you are engaging in competitive devaluation; he is starting a currency war. It's a discouraging difference of perception, particularly as weaker currencies often do not boost growth.

As the conjunction suggests, no government or central bank of a developed economy is currently pursuing a policy of devaluation. Switzerland comes closest: its central bank is using the exchange rate as a policy tool. However, the goal is not devaluation, but to avoid a rapid appreciation. For Japan, the United States and the United Kingdom, lower currencies are a side effect of expansive monetary policies designed to stimulate domestic economic activity.

Still, that side effect is often welcomed, and can be dramatic. Since August, the dollar and the yen have fallen by 9 and 19 percent, respectively, against the euro. The threat of further moves will remain as long as economies stay weak enough for the authorities to print more money.

The irritation caused by this side effect is completely justified. A unilateral approach to domestic policy is inappropriate for countries which participate in the global economy. Even if the devaluation is unintentional, it is like a cloud of toxic smoke blown across a national border: the stimulating or emitting nation bears some responsibility. In addition, while authorities may be willing to take their chances on the possible inflationary effect of cheap money and big deficits, foreign creditors rightly see an experiment in which they have more to lose than to gain.

Economically, the case for competitive devaluation is much less strong. The effect of currency values on the economy is subtle – and mixed.

There is excellent empirical evidence that relatively cheap currencies are good for poor nations. Leading development economists such as Dani Rodrik and Surjit Bhalla have shown that it is much easier to nurture exports and attract foreign investment if the exchange rate is low enough to make things cheaper for foreigners.

There is also good evidence that extreme and rapid currency appreciation distorts economies, and that a reversal can speed growth. The yen's 40 percent rise against the euro in three months in 2008 was a severe blow to Japan's exporters. Even after the recent decline, the yen is still 8 percent more expensive against the euro than the average since 2003.

More often than not, however, moves in the freely floating currencies of rich countries have little effect. The response of the UK economy to the 20-25 percent drop of the pound against the euro and dollar in 2007-8 is not unusual. Both exports and imports have increased since, but the trade deficit has not narrowed. True, the deficit might have been wider with a stronger pound. But it does not look like the change was enough to reverse the decline in the UK's trade position which started around 1998.

Broader research confirms devaluation is no panacea. A 2008 study by four Turkish economists, published in the *International Research Journal of Finance and Economics*, showed devaluation had a modest long-term negative effect on output in six countries and a small positive effect in three. Using a slightly different methodology, Michael Hoffman, who now works for the U.S. government's Center for Economics, concluded in 2005 that there is "very little, if any, relationship" between the value of the dollar and trends in the U.S. current account.

This should not be surprising. Countries with strong economies usually have strong currencies. Countries looking for currency advantage often have economies with structural weaknesses which limit the advantages of devaluation. For example, domestic wages often rise to compensate for higher import prices, reducing the export price advantage.

In addition, trade among developed economies is rarely a matter of "built here and delivered there". As much as half the price of technically sophisticated products reflects sales and service expense in the destination country. Another significant fraction comes from imported components. Even when currency provides a price advantage, it's often not enough to compensate for a quality disadvantage.

Authorities looking for a quick export jolt from a falling currency should be careful what they wish for. Good short-term news serves as an excuse for not making long-term helpful reforms. Besides, when the exchange rate drops because of weakening faith in a country's ultimate solvency, the gain is bought at a high price.

29 January 2013



CORPORATE CONUNDRUM

WEAKER YEN WON'T HALT JAPAN INC'S OVERSEAS SPREE

BY PETER THAL LARSEN

A weaker yen won't reverse Japan Inc's overseas M&A drive. While a strong currency, low interest rates and a stagnant home market fuelled an international shopping spree in 2012, the promise of a domestic revival under new Prime Minister Shinzo Abe has caused buyers to temporarily put away their wallets. But even so-called Abenomics can't cure Japan's ageing and shrinking population.

Last year marked a high point for globetrotting Japanese merger advisors. Deals like SoftBank's audacious \$20 billion takeover of U.S. mobile operator Sprint –



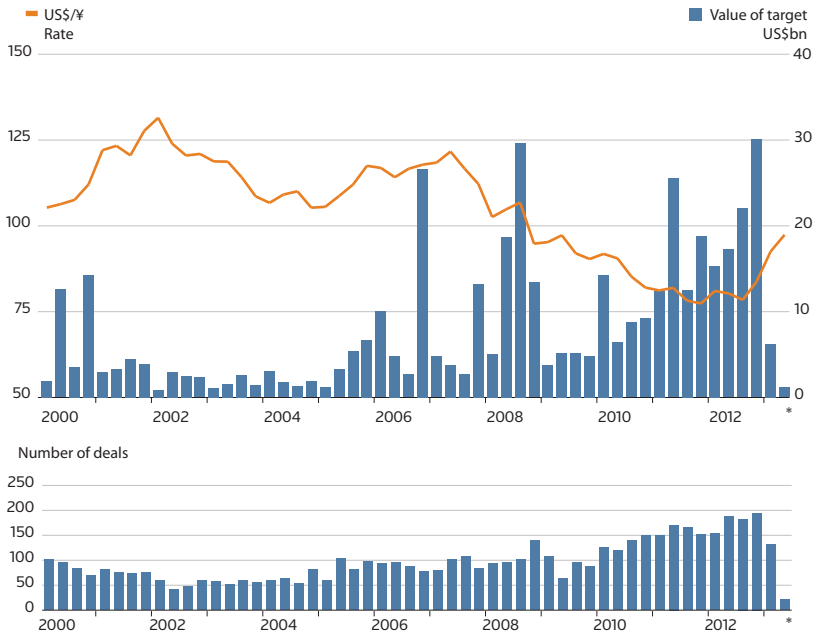
SoftBank Corp President Masayoshi Son speaks in front of a screen reading "Country Risk" during a news conference in Tokyo October 31, 2012. REUTERS/Toru Hanai

BREAKINGVIEWS

now facing a counterbid from pay TV operator Dish Network – lifted overseas purchase activity to a record \$84.6 billion. With Japan stuck in a deflationary slump and the strong yen hollowing out the country's manufacturing base, a growing number of companies chose to gamble on foreign expansion.

Abe's arrival has temporarily slowed the exodus. The prime minister's policy of central bank money-printing, fiscal stimulus and structural reform may have prompted some companies to revisit their plans. The yen's slide hasn't helped: it has dropped roughly 15 percent against the dollar since Abe was elected, crimping Japanese companies' spending power. In the first quarter, they discharged just \$6.2 billion on foreign acquisitions, down from \$15.3 billion in the same period of 2012.

Outbound Japanese M&A



* YTD

Source: Thomson Reuters. C. Trevethan 15/04/2013

Yet there are good reasons to believe the foreign investment drive will continue. First off, the yen isn't that weak. Six years ago, it was 20 percent lower. Japan's buoyant stock market – the Nikkei 225 index is up 37 percent since mid-December – has boosted confidence and may allow companies to finance deals with equity as well as debt. Besides, a bit more inflation won't reverse Japan's demographic decline. Companies that rely on selling more stuff to consumers will have to look towards other markets.

Hopes of a revival of foreign interest in Japanese companies also look premature. Some troubled industries will find it harder to retain non-core businesses: ailing electronics group Panasonic, for example, is considering a sale of its healthcare operations. Western private equity groups are also increasingly active in Japan. But foreign companies hoping to buy in Japan still face formidable cultural and regulatory hurdles. Whether or not Abe's policies are a success, the balance of Japanese M&A will remain overwhelmingly outward bound.

16 April 2013

JAPANESE ECONOMY NEEDS NUCLEAR SECOND CHANCE

BY CHRISTOPHER SWANN

Japan needs to give nuclear energy a second chance. Prime Minister Shinzo Abe's goal of weakening the yen will make electricity even pricier in a country that imported over 80 percent of its energy even before the Fukushima disaster in 2011.

In September 2012 the government of former PM Yoshihiko Noda finally bowed to the backlash against nuclear energy and set the goal of closing all Japan's reactors by 2040. Abe, who took office in December, wants to turn public opinion the other way again. In reality, his expansionary economic plan essentially requires it.

The nuclear industry's share of Japanese electricity generation dived from an average of 30 percent between 1987 and 2011 to just 2 percent in 2012, according to the U.S. Energy Information Administration, as reactors were closed while new safety measures were put in place. Japan's bill for energy imports

spiked, with the cost of liquefied natural gas jumping 25 percent to \$66 billion in 2012, according to the World Nuclear Association. Major regional utilities like Kansai Electric Power, meanwhile, hiked electricity prices by close to a fifth.

Abe's policies aim for a weaker currency and could bring a burst of inflation. But if energy costs, particularly electricity, surge upward then the resulting drag on companies and consumers could easily squelch the growth the prime minister hopes will follow.

Before Fukushima, Japan hoped to increase the proportion of its electricity generated from nuclear power to about half. For a nation recovering from one of the worst reactor accidents in history, it might seem a tough political sell to revive that goal. But policymakers managed to win support for the industry in the decades before 2011 despite the national trauma caused by the atomic bombing of Hiroshima and Nagasaki at the end of World War Two. By 2010 Japan was generating more electricity from nuclear reactors than anywhere else except the United States and France.

Of course the Fukushima accident, triggered by an earthquake and devastating tsunami, was a huge blow to confidence. It has also revealed the financial risks of nuclear power, reducing former stock market behemoth Tokyo Electric Power to a quasi-nationalized zombie company. Ordinary Japanese may take a lot of persuading that the dangers are worth it. But Abe's plans for a broader revival could falter without a hefty – and safety-conscious – nuclear programme.

05 April 2013

WEAK YEN MAKES JAPANESE ELECTRONICS FIRMS GIDDY **BY PETER THAL LARSEN**

Japan's assault on the yen has produced some clear winners: investors in the country's beaten-up consumer electronics industry. Shares in Panasonic jumped 17 percent on Feb. 4 after the group reported a less-severe-than-expected quarterly loss. The hope is that stronger exports and recent cost-cutting will transform earnings. But with revenue still shrinking, the recent rally is largely based on hope.



Sharp Corp's President Takashi Okuda attends a news conference in Tokyo November 1, 2012.

Panasonic's cost-cutting measures are clearly beginning to have an effect. Though revenue fell 8 percent year on year in the three months to December, the company reported an operating profit of 34.6 billion yen (\$370 million), compared with an operating loss in the same period a year earlier. Sharp, an even more troubled rival, also managed to eke out a small operating profit.

Investors may hope that the weaker yen may boost demand from overseas while making Japanese products at home more attractive relative to pricier imports. Any improvement in sales would have an immediate effect on the bottom line: high costs and an inflexible workforce means that Japanese companies have the highest operating leverage in the world, according to Deutsche Bank. That helps explain why Thomson Reuters' Japanese electronics index is up almost 70 percent since mid-November.

Yet the revival remains uncertain. Almost every one of Panasonic's divisions generated less revenue in the final nine months of 2012 than in the same period of 2011. Lower export prices should help the group compete against rivals from South Korea and elsewhere. However, grabbing back lost market

share also requires the kind of innovation that has been largely absent from Japanese firms in recent years. It's telling that both Panasonic and Sharp did not adjust their own forecasts of hefty losses for the year to March 2013. Sharp remains financially fragile, too, with 900 billion yen of debt maturing this year, according to Fitch Ratings, and just 164 billion yen of cash in the bank.

Valuations remain low. Panasonic's market capitalisation is less than a quarter of the company's forecast full-year revenue of 7.3 trillion yen, even after its recent bounce. Five years ago, its price-to-sales multiple was twice as high. But without a revenue revival it's hard to justify a return to those days.

4 February 2013

CAN SONY JOIN A JAPANESE RESURGENCE?

BY ROBERT CYRAN

Like Japan as a whole, Sony needs a resurgence. The electronics giant has been humbled. It has seen upstarts like Apple and Samsung Electronics claim markets it once dominated. It has lost its innovative edge, and its brand is tarnished. Prime Minister Shinzo Abe's hopes of revitalizing the economy could rub off. But even Sony's turnaround plan under newish Chief Executive Kazuo Hirai seems depressingly familiar.

Sony has lost about half its market value over the past 10 years, and the company is now worth about \$17 billion. Samsung and Apple are worth about 12 and 25 times as much, respectively. And that's after a weak yen and aggressive central bank easing have goosed the market. Sony's stock is up nearly 50 percent since January.

The company needs more than that to rediscover its former strength. A glance around in most big cities is unlikely to reveal many passers-by using a Sony phone or tablet. Instead of developing the gadgets of the future, the company has spent the past decade thinking about the past and itself. Apple and Samsung, primarily, have claimed the lead in innovation and quality. That's a sad result for a company that invented the Walkman and was once atop the world in consumer electronics and miniaturization.

Sony's dogged nature, far from unique in corporate Japan, is partially at fault. Once in a market, it has been reluctant to drop out. It has lost money on television production for nearly a decade. True, the company sold its stake in an LCD venture to partner Samsung in 2011, and other bits to the government and to Hon Hai Precision Industry. But Sony still lost more than \$800 million on televisions in the last fiscal year.

Over-diversification is also to blame. Forays into areas like chip production, finance, music and movie production absorbed capital and management time and made the company unwieldy. These ventures also encouraged the company to push its own standards rather than signing up for global norms. Its digital Walkmans, for example, couldn't play ubiquitous MP3 tracks for years. This may have discouraged piracy, but it made the devices unappealing to consumers.

Third, Sony is essentially a hardware company in an increasingly software-dominated world. Despite its desirable devices, Apple's biggest strength may be in the development of new code. Sony has occasionally shown the knack – its PS2 is the best-selling video game console of all time. But the PS3 sold only about half as many. The omens aren't good for the next generation either.

So, in addition to Abenomics nationally, Sony needs some Haraism at the corporate level if it's going to re-emerge. The CEO's plan to focus on digital imaging, games and mobile devices is a good start. Buying out Ericsson from the two companies' mobile phone venture offers particular promise. Sony's new Xperia Z smartphone has been a surprise hit, selling out in Japan.

And the company's movie and music divisions are profitable. They probably generated about \$11.5 billion of revenue in the past fiscal year. Put this on the same multiple that Parlophone was sold for earlier this year, and these divisions might be worth about \$18 billion. If so, that means investors are attaching minimal value to the rest of Sony's operations, giving Hirai scope to make things a lot better.

Unfortunately, history suggests Sony investors shouldn't get their hopes up. Former boss Howard Stringer, who took the reins in 2005, also suggested the company trim down its operations and make its different divisions work better together. The global crisis of 2008 and the tsunami and the Fukushima nuclear disaster in 2011 didn't help Stringer. Hirai may have better luck with the backdrop and he's also Japanese, which still counts for something in a Japanese multinational. But something radical like selling off Sony's entertainment business could still be a step too far.

Furthermore, electronics is a difficult industry in which to mount a comeback. Competition is cut-throat, and operating margins rarely exceed single digits. Rivals like Samsung are willing to take heavy losses to gain or retain market share. That could mean that Sony's goal of a 5 percent margin will be difficult to achieve.

Sony's best hope is probably the development of new devices – much as the Walkman powered the company's success back in the day. Its new health-gadget joint venture with Olympus is one potential bright spot. Or Sony could yet show that it hasn't forgotten how to create new mobile gadgets that people want above any others.

That could, though, be said of a lot of firms – Blackberry, Google's Motorola and Nokia, for instance – searching for renewed life. Abenomics and a weaker yen may smooth Sony's path. But as in so much of corporate Japan, the products and culture that could help the company leave its lost decade behind remain elusive.

17 April 2013

RETURN TO GLORY DAYS MAY ELUDE JAPAN'S AUTOMAKERS

BY ANTONY CURRIE



Toyota Motor Corp's remodeled "Crown Athlete" appears between curtains during an unveiling in Tokyo December 25, 2012. REUTERS/Yuriko Nakao

The weakening yen is good news for Japan's automakers. The more than 20 percent drop in the currency's value against the dollar since early October will boost profit from overseas sales – and probably market share, too. A return to the glory days of 2006, though, is likely to prove elusive.

Back then, Toyota's market value was greater than the combined worth of its eight major western rivals – Ford, General Motors, Fiat, Renault, Peugeot, BMW, Daimler and Volkswagen. Though the yen may be heading back towards 115 to the dollar, as it was then, virtually everything else has changed.

Seven years ago, Chrysler, GM and Ford were a mess. Now all three companies are back on the road, the first two with the help of a government bailout. They are earning decent money after slashing costs and cranking out better vehicles.

The strong yen of recent years also prompted Japan's big three automakers to shift more production overseas. Some two thirds of the cars that Nissan and Toyota sell in North America are now made there, while for Honda the ratio is 90 percent. That reduces the benefit of being able to export Japanese-made cars at a lower exchange rate.

The weakening currency still provides some fillip. At 100 yen to the dollar, Japanese automakers' top lines will receive a \$2,000 boost for each car they sell in the United States, according to Morgan Stanley. How the manufacturers use this benefit will be crucial. Simply allowing it to accrue to the bottom line would flatter earnings, but may tempt executives to put efforts to cut costs on hold.

Offering discounts to U.S. buyers would risk starting a price war which would hurt American carmakers' bottom lines, but carry no guarantee of a market-share shift. Using some of the currency benefit to add more features to cars could be more effective, though it may take several years for the effects to show in market share and profit.

The final option is to boost dividends or investment. Expectations of increased largesse have already sent Japanese auto stocks up some 70 percent since October. Absent another big drop in the yen, though, there doesn't seem to be enough horsepower left to take Toyota up by another third to its 2006 high.

23 April 2013

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