Is Europe going full Japan?

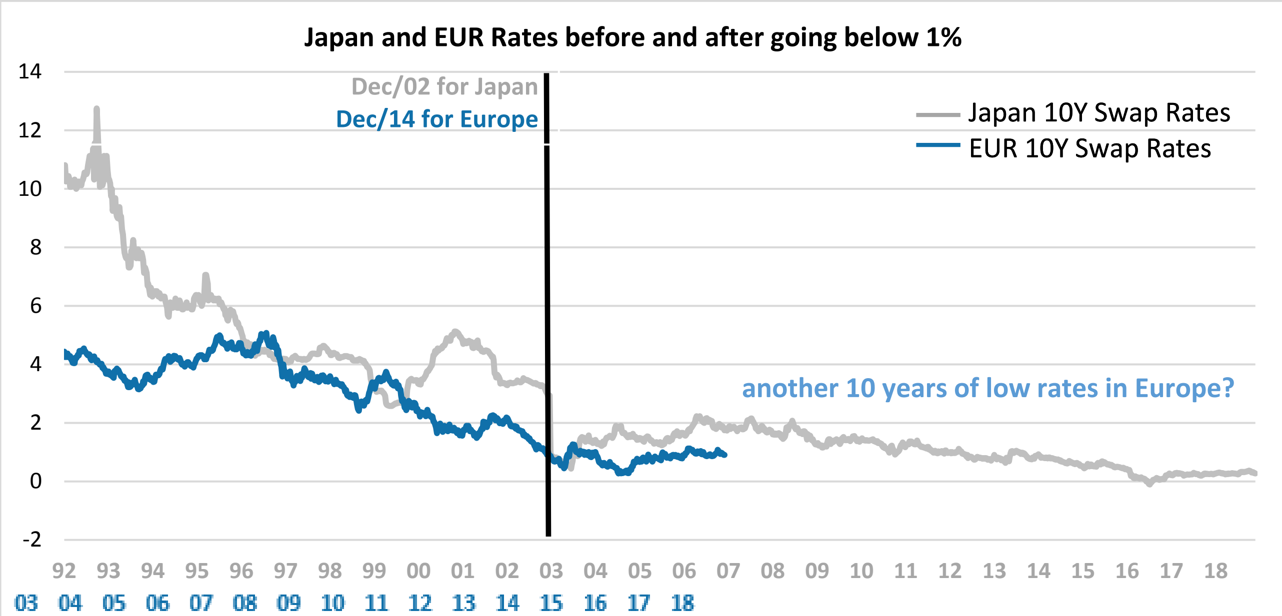

Figure 1 Source Bloomberg. Own calculations.

Is this your worst nightmare yet?

In the 1990s Japan experienced a so-called balance sheet recession, i.e. a recession caused and fed by a continuous need to deleverage the private sector balance sheets due to losses on the asset side. This kind of loop inevitably entrenched banks because they are the agents extending the leverage (e.g. loans) to the other entities in the economy. These kinds of recessions can be very protracted and involve large sectors of the economy and therefore, activity can be depressed for a long time. For example, Japan is still waiting today to see a sustainable pick-up in inflation, almost 30 years after the first recessionary wave.

Sometimes pundits make a comparison between what happened to Japan from the 1990s onwards and what is happening to European countries after the Great Financial Crisis of 2008. Is this the path Europe will inevitably take? Are the parallels between the two economic areas fit and proper? What are the differences that can make the prospects for Europe better or worse?

Understanding the similarities between these economic areas is not just an exercise in developing respectable opinions for the festive season parties' conversations, but also a possible effective way of figuring future paths for our economies; for instance, the Japanese experience shows that lengthy, blown up balance sheet adjustments can significantly weaken economic activity for a prolonged period of time, with serious implications for all markets.

The usual reasoning behind the Japan-Europe similarity is that, after a strong credit expansion, Europe has gone through a very deep recession (from which some countries are still struggling with the consequences) and like Japan, the weak activity has gone hand in hand with a sharp correction in asset prices, higher debt levels (both public and private), very low interest rates and quantitative easing, decreasing saving rates and negative demographic trends.
So, let's have a look at those indicators to see how they compare.

We have identified, rather arbitrarily, December 2014 for European time-series as being equivalent to December 2002 for Japan time-series on the basis of the 10yr swap rate going steadily below 1%. This event marks an important threshold, even more than, for example, the short-term rates in my opinion, because

the long rates are less driven by monetary policies (traditional ones anyway) and more by market forces. Therefore, we could consider that the 10yr swap rate incorporates future expectations better than the short-term rate in periods of massive central banks' interventions.
Clearly other dates can be identified based on equally good or better rationales, but my impression is that moving few months back or forth would not change the main conclusions of the analysis.

Growth and Debt

In Figure 2 we plotted the GDP growth for Japan and Eurozone countries[1] and it is clear that **Eurozone is following by and large the Japanese growth path** with a lag of 1½ years more or less. Based on this metric, we have a big problem looming in Europe: another deep recession around 2020! Something that makes you hope that this comparison is spurious! And it might well be, since **the big drop** would correspond to the 2008 crisis, which, **can be argued, was mostly an exogenous event for Japan**. In any event, even if such a dramatic event does not materialize in the next couple of years, **the long-term expected growth remains low, nested in a narrow channel between 0% and 2%**.

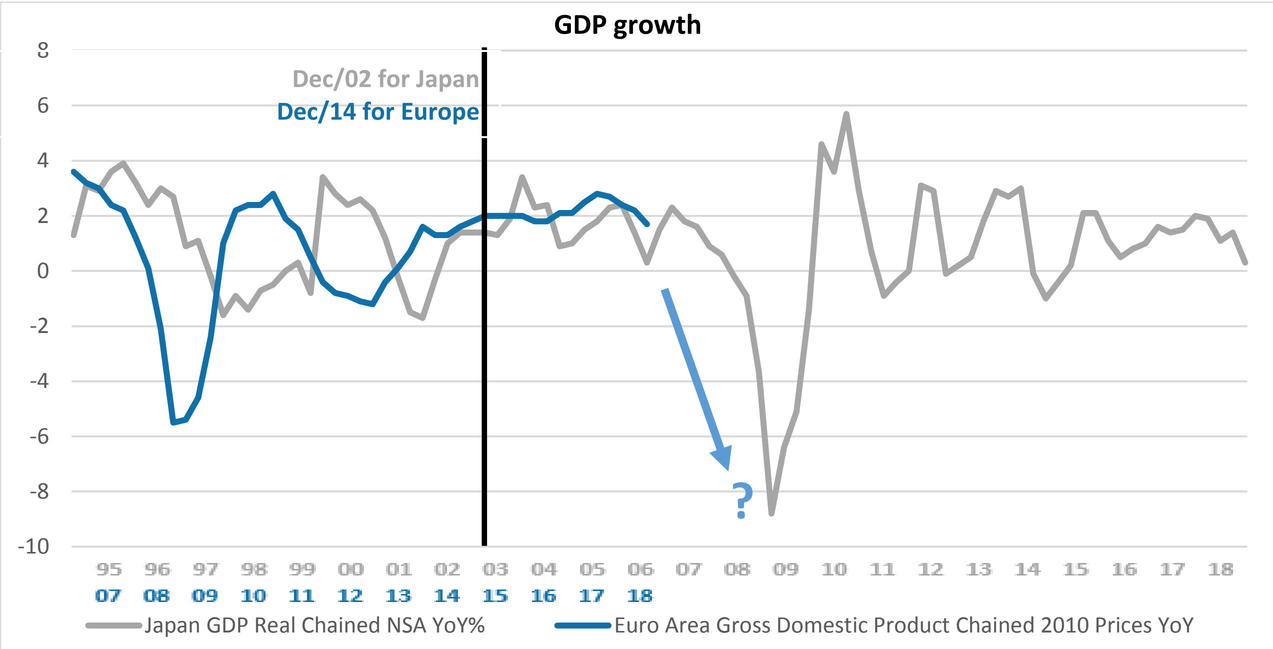

Figure 2 Source Bloomberg, Economic and Social Research Institute Japan, Eurostat. Own calculations.

The government debt/GDP ratio of Japan is often cited as an example of mammoth debt burden and if that is where European countries are headed then we have a problem, especially in the Eurozone. But that ratio, which stands at around 240%, needs to be debunked: the debt is almost all in JPY and once one strips out the BOJ holdings, the ratio is 80%/90% lower. Hence not far from other highly indebted countries in Europe, but without the constraint of a common monetary policy.

[1] The comparison here is with Eurozone, as opposed to European, countries because their aggregated data is more easily available and they represent a big part of the European economy, including a cross section of the biggest and smallest economies.

Additionally, debt as percentage of GDP has gone up almost everywhere in the world and what typically brings it back into balance are inflation flares, that reduce its real burden. However, inflation is still something that fails to show up consistently in developed economies.

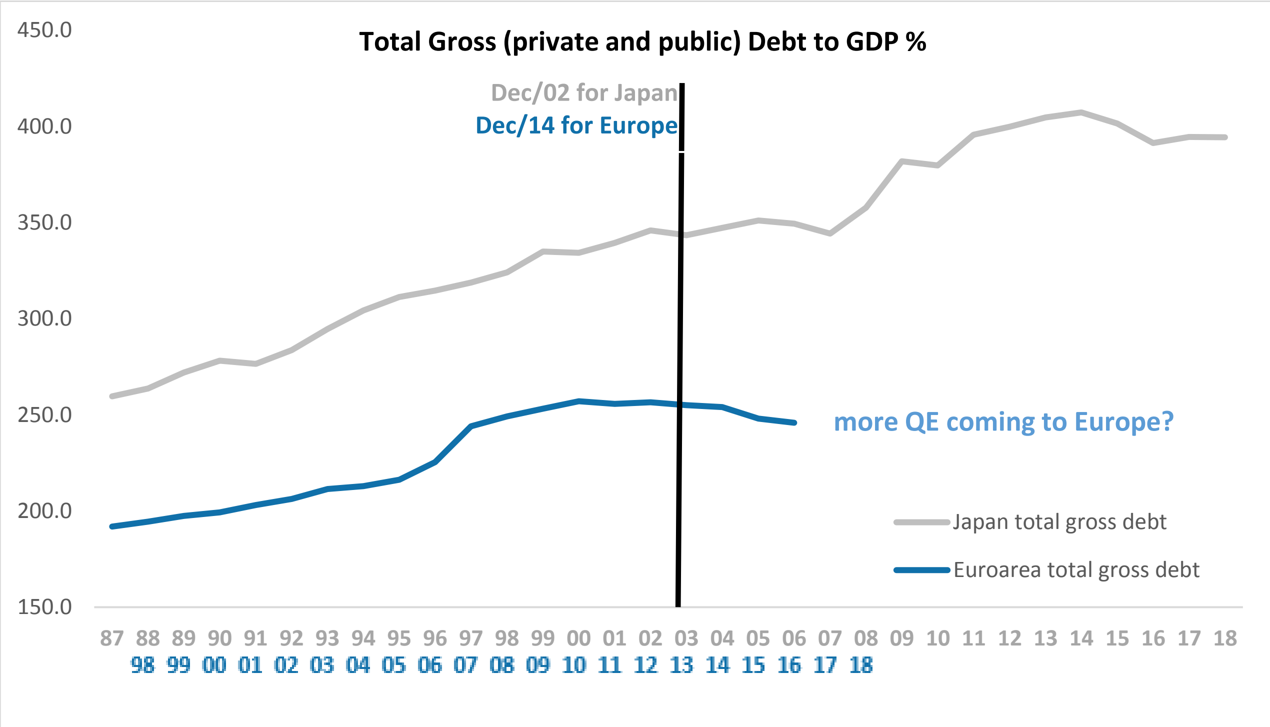

Figure 3 Source Bloomberg, BIS, IMF. Own calculations.

Figure 3 shows the evolution of the total debt/GDP ratios for Japan and Eurozone countries. These ratios sum the government and private debt as, in our opinion, they are more representative of how the leverage of the entire economy is trending. As it can be seen, the two ratios have almost identical trends with a stable spread between the two of around 80 percentage points. On one hand, it is no surprise that a recession almost inevitably leads to an increase in the debt/GDP ratio; on the other hand, **Japan has never retraced with its total debt now at 400% and even if Europe seems to show a much more sustainable level, the trend still seems to be upwards**. Much of the latest increase in the Japanese debt is due to the QE/monetization[2] push launched by PM Abe and BOJ governor Kuroda. Can we imply that something similar will happen in Europe as well?

The ECB is still overwhelmingly dovish, even if it is stopping (for the time being) the QE, but the problem with the Eurozone data is that they are an average of the single countries' numbers and hence can mask significant heterogeneity among states. This complicates the central bank response. To show this we add a chart of the government debt dynamics of Italy and France. On one hand, we have chosen Italy because it is a country that, like Japan, has suffered from generalized real estate valuation declines and has huge problems with non-performing loans portfolios in the banking system. On the other, we picked France because with the latest fiscal measures to appease the "Yellow Vest" protests, it is projected to breach the European limits on

[2] Traditionally, i.e. before 2008 in US and Europe, it was deemed a dangerous game if done on a big scale, because monetization lead to higher inflation. Higher inflation means a decrease of the real value of the government debt: in other words, a "sneaky" way of financing government deficits. A decisive inflation pick-up has not showed up in Japan (and even in US and Europe after 2008).

deficit and, since a) its debt/GDP is already close to 100% and b) it is the second biggest economy in Europe it seems a relevant comparison.

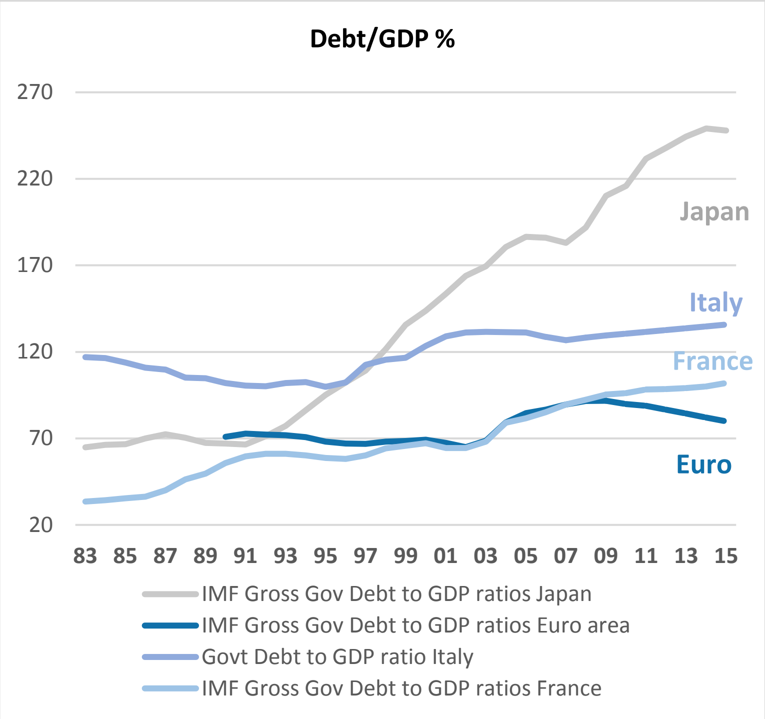

Figure 4 Source Bloomberg, IMF. Own calculations.

Even Italy, and its ever-increasing forecast for the debt/GDP ratio, pales in comparison with the Japanese trend. A fundamental difference between the two countries is that Japan can print how many JPY it likes, while Italy has no control over its monetary policy and this puts effectively a cap on the amount of debt that Italy can sustain without defaulting.

Going back to total debt, we think that it is more interesting to look at the indebtedness of the private (non-financial) sector because the deleveraging of the balance sheets and the extent of the NPL problems are more strictly connected to it, rather than to the government debt. **Actually, the debt level of the private sector in Europe has never reached the peaks seen in Japan before and during the recession, but it has steadily increased, nonetheless**. The heterogeneity in Europe is such that the countries which experienced housing bubbles are currently deleveraging, while others are increasing their leverage. This is another reason why there is, and there will be, economic divergence within the common currency.

Interest rates and inflation

On the interest rate side, it is clear from Figure 5 that the European monetary policy has responded in a similar way to the Japanese one; in fact, **one of the criticisms that the BOJ received ex-post is that it had not been bold enough**. From this chart it **seems that ECB has acted pretty much in the same fashion**, even though some claims that it acted more quickly and decisively. The 10yr swap rates in Figure 1 tell us a similar story. If we had to extrapolate, we would be inclined to think that **interest rates are going to be at very depressed levels for many more years**, which is what the consensus expectation is nowadays.

Again the Euro zone is a patchwork of different economies with a single monetary policy, which does not have a one-size-fits-all feature, hence, while the common monetary policy has been successful so far, it might be creating differing

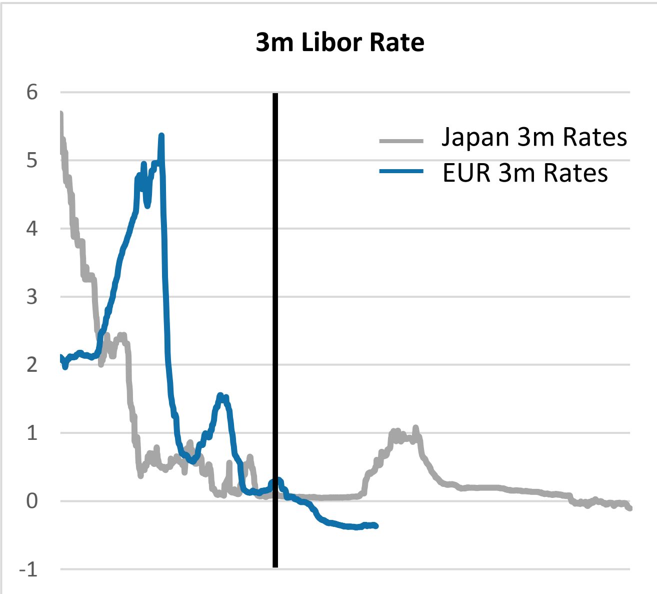

Figure 5 Source Bloomberg. Own calculations.

underlying dynamics and incentives in the various economies, for example “zombie” banks and rolling over of loans with little probability of being repaid - similarly to what happened in Japan.

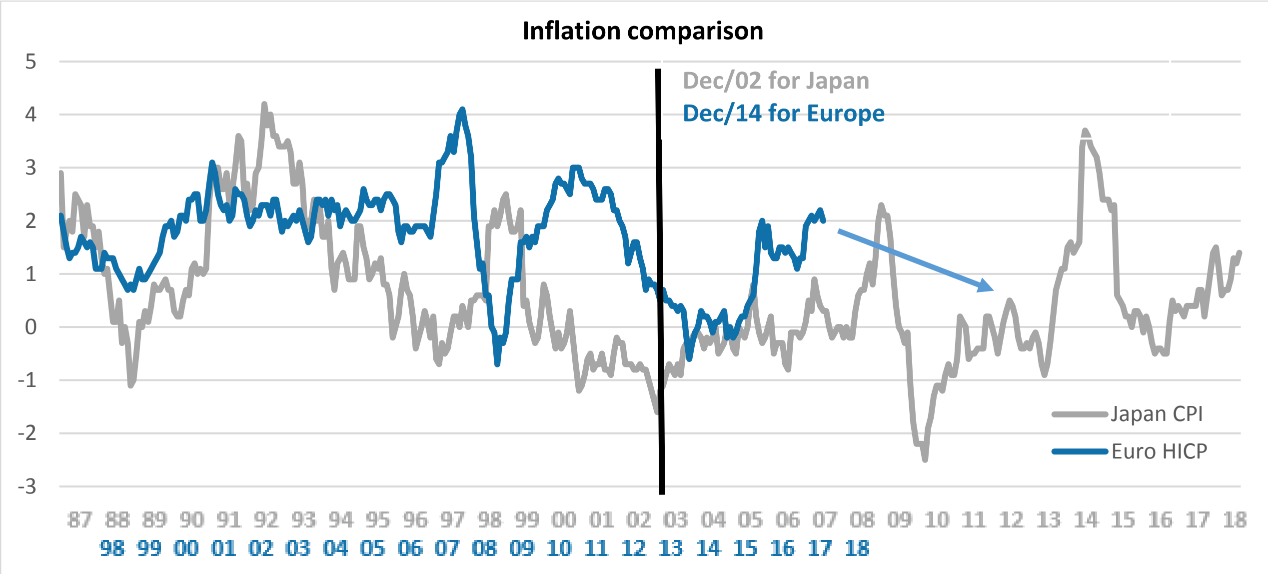

Figure 6 Source Bloomberg. Own calculations.

What can make a real difference in the future path of interest rates, debt and growth is the evolution of the inflation rates. Lately the Eurozone is experiencing a return toward the 2% target, but this also happened in Japan with a lag of couple of years, and it was followed by a steep decline into negative inflation rates. Again, this event was a reflection of the Great Financial Crisis and, as such, it was the result of mostly exogenous inputs.

Equity and FX markets

The chart in Figure 7 that compares the STOXX Europe 600 and the TOPIX, looks like Europe is slightly lagging behind and it might look scary. It shows that, even within an environment of very low both long and short rates, equity markets can still show meaningful weakness.

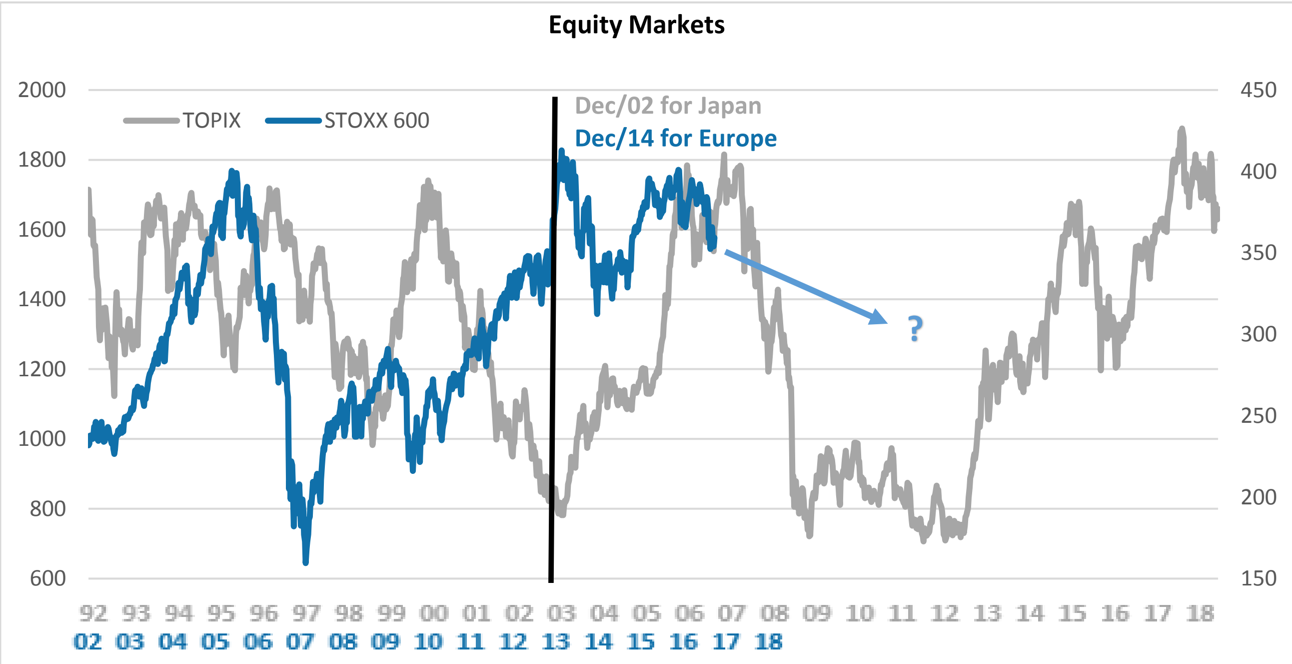

Figure 7 Source Bloomberg. Own calculations.

Perhaps more **interesting are the dynamics of the exchange rates**. We are presently living in a market that sees the USD fundamentally overvalued vs developed markets based on budget deficits and balance of payments equilibriums. Nonetheless the trend has been decisively towards more USD appreciation, not least because of the strength of the US economy and the consequent tighter monetary policy. On average the **consensus sees the USD weaker by around 10% over the next five years**, mostly by following the forward rates. The **comparison with Japan suggests a much weaker USD, namely by 50%, over the same period of time.**

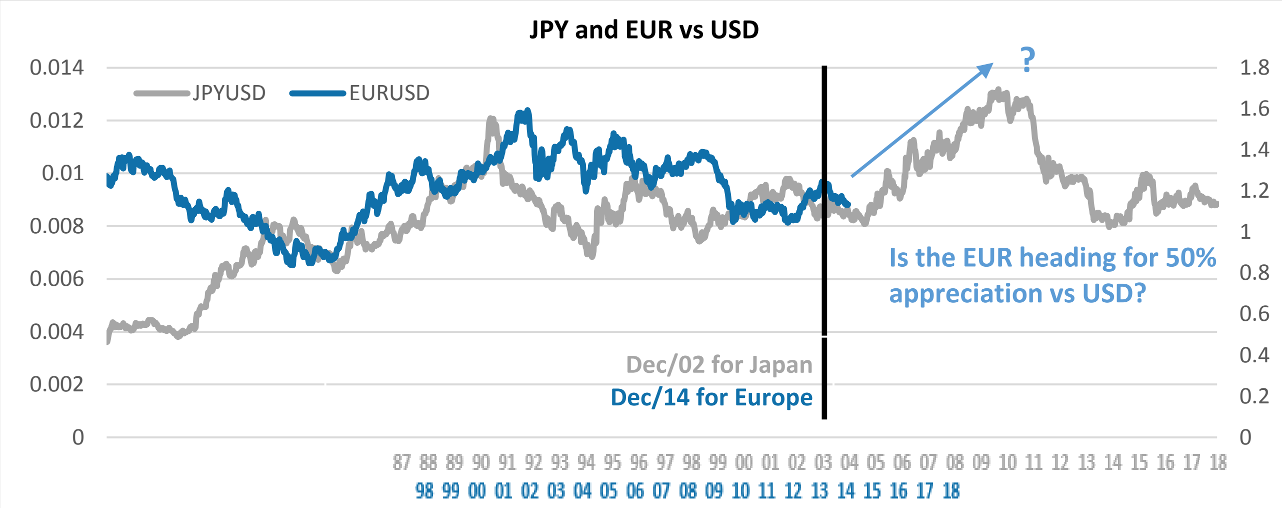

Figure 8 Source Bloomberg. Own calculations.

Saving rate

The high saving rate was another prominent feature of the Japanese society as well as of many European countries. Maybe surprisingly the Japanese saving rate has steadily decreased since the 1990s and is now around 2%. The European one has, on the other hand, remained at fairly high(er) levels for all the 2000s, at around 12%.

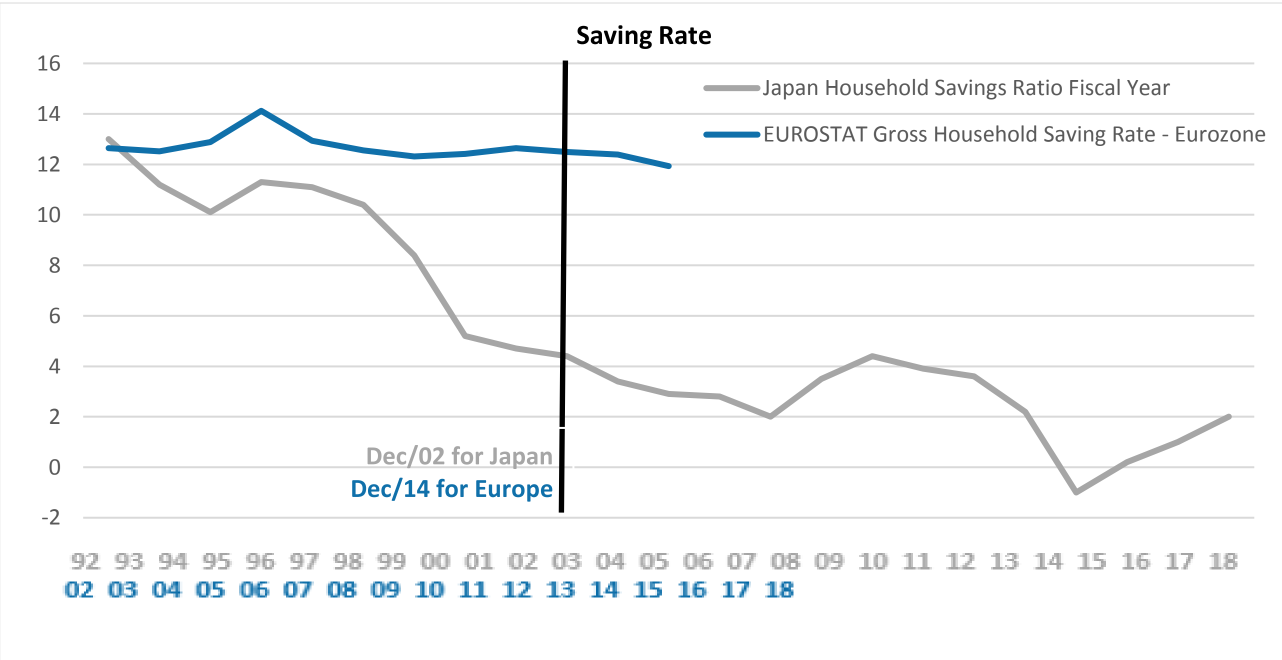

Figure 9 Source Bloomberg, Economic and Social Research Institute Japan, Eurostat. Own calculations.

Demographic trends
As recently as last year the United Nations have published their updated World Population Prospects (2017) with very interesting demographic information about the trends (and their forecasts) for the world.

Japan population is decreasing and is expected to shrink by 15% by 2050; Europe seems a bit lagging in this respect: it is currently peaking and is expected to decrease by 5% 2050.

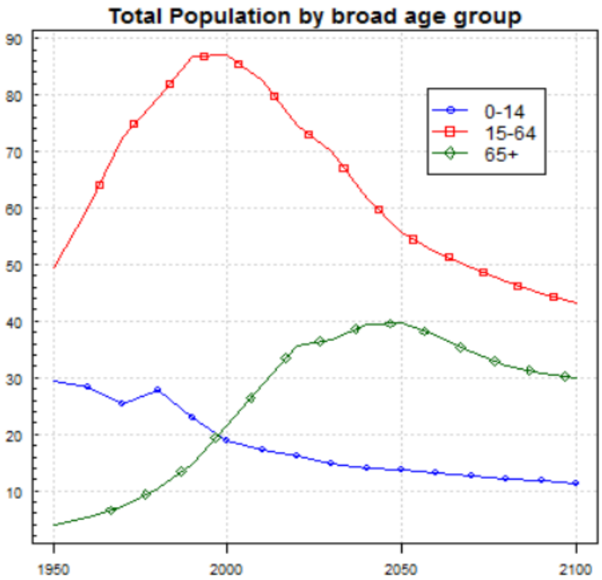

Figure 5 Japan. Source United Nations.

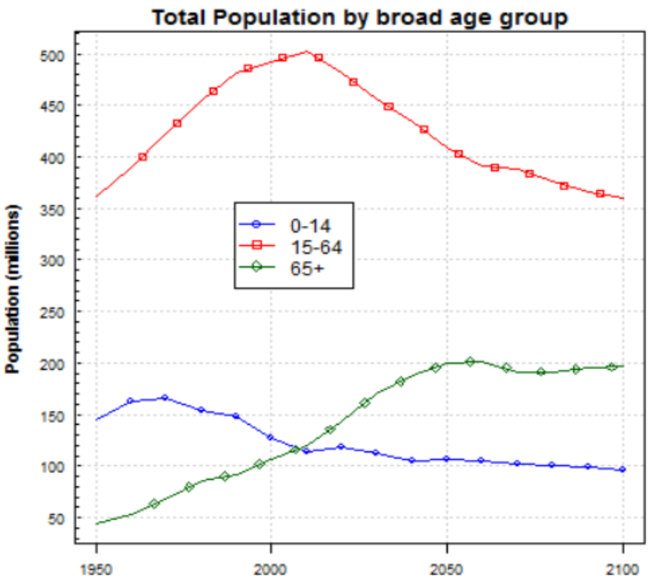

Figure 4 Europe. Source United Nations.

The share of population over 65 is rising in Japan (currently around 28%) and is expected to rise at least until 2050 to around 40%. Again, Europe is following the same trends with a lag: currently the over 65 are around 20% and they are expected to increase to 30%.

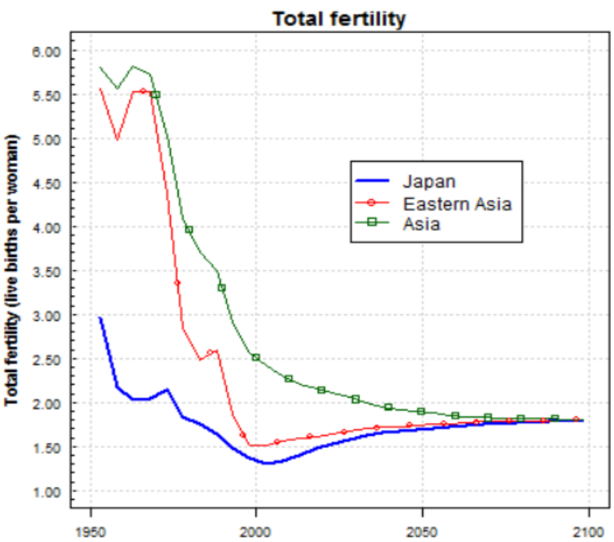

Figure 7 Japan. Source United Nations.

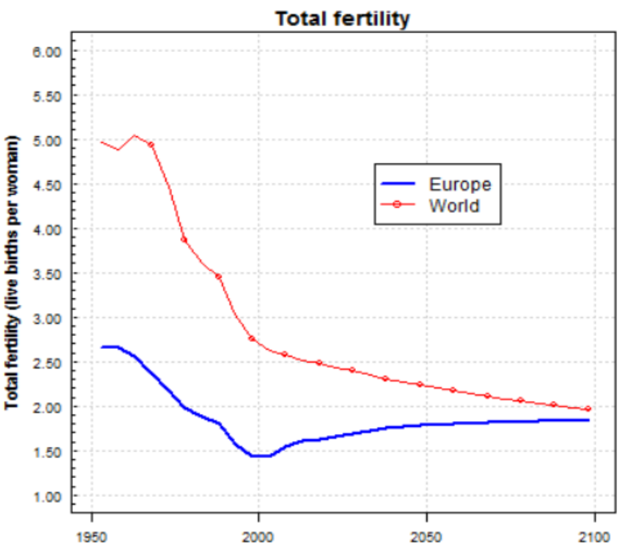

Figure 6 Europe. Source United Nations.

Interestingly, fertility rates are almost identical in Japan and Europe.

Conclusions

There is no conclusive answer to the question of whether Europe will follow Japan with regards to the consequences of the Great Financial Recession and the ensuing deleveraging process. Some countries show patterns that are more similar to Japan, but not necessarily all the signs of the sickness that plagued the Asian economy. Authorities in Europe are quick to dismiss the question by saying that we have been much quicker and deeper in taking countermeasures, but at the same time they do not answer the "what if" one or more of the countries who are in a worse position will need a completely different policy response from the rest of the union. One way or the other a common monetary policy will either force a convergence of the countries fiscal policies or a break-up of the union.

Finally, we think that the **most striking similarities are within the interest rate/inflation and demographic trends, which might be enough to warrant that the European monetary policy will remain loose for much longer**, with all the relevant implications on wider markets. In practical terms, **over the short term we might see a resurgence of the TLTRO**, which is an easy way to obtain term financing for banks, while in the longer term we could see a new QE program should a recession hit the economy.

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