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Ascertaining the truth of China’s economic recovery / the last resort for the FRB as it faces imminent reverse yield

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Summary

- In this report, we examine themes which are essential in predicting the rate and extent of Japan’s economic recovery, and the possibilities for growth. These are the recovery of China’s economy and the effects of reverse yield in the US.

- **Ascertaining the truth of China’s economic recovery (report on research trip):** The writer of this report visited China just as the curtain rose on the National People’s Congress from March11 to March 15. The writer surveyed the situation in Beijing, Xiong'an New Area, and Qingdao, and exchanged opinions with local experts. In this report we share insights gained on this research trip. First of all, US-China trade friction was not a major factor in the loss of momentum in China’s economic growth in 2018. It would be more accurate to say that China was hit with tariff hikes right at a time when domestic demand was losing speed due to policy changes, thereby adding to a preexisting condition. The stalling of domestic demand can be attributed to the following: (1) strengthening of regulations regarding wealth management products, (2) putting the squeeze on infrastructure projects, (3) introduction of regulations regarding inter-individual consumer finance, and (4) suspension of tax reduction on automobile purchases. The first two items in this list have a political aspect, and once into the current year (2019) have been on the way to being relaxed somewhat. This has contributed to a turn toward recovery for the Chinese economy.

- However, China’s domestic inventory level is high. Hence it will take time before China’s economic recovery begins to bring benefits to Japanese corporations. Meanwhile, factors (3) and (4) remain, so it is highly possible that recovery in consumption will be delayed. Therefore, it will take some time for Japanese corporations with a high dependence on Chinese consumption to recover. Possibilities are great that the pace of recovery will be relatively slow.

- **The last resort for the FRB as it faces imminent reverse yield:** In late March the long-term interest rate on US Treasuries fell momentarily below the short-term rate (in other words reverse yield occurred). Directly related to this phenomenon was the FRB’s turning dovish, announcing that it would bring an early halt to its asset reduction policy. However, considering the business cycle, as well as the structural problems in the labor market where there is a negative history effect, it would seem rather difficult to sit back and expect a significant increase in the long-term interest rate to simply naturally occur for some time to come. If the yield curve continues extremely flat, the possibility that the credit expansion cycle could reverse increases, in which case a recession could occur.

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- Even with imminent reverse yield, the FRB will likely plan additional monetary tightening with the purpose of reigning in the debt leveraging activities of American corporations. However, due to the factors already mentioned above, it will be difficult to raise the policy interest rate for some time to come. And they have also abandoned quantitative policy. The only thing they have left is qualitative policy – that is, steepening the curve by shortening the maturity of the average term of its assets (US Treasuries). It is only for the time this mode of market adjustment is functioning that the reverse yield to recession scenario can be avoided.

1. Ascertaining the truth of China's economic recovery (report on research trip)

The degree of reliability with which the Chinese economy is recovering is also one of the major keys to the future of Japan's economy[1]. It is with this understanding that the writer of this report visited China just as the curtain rose on the National People's Congress from March11 to March 15. The writer of this report surveyed the situation in Beijing, Xiong'an New Area, and Qingdao, and exchanged opinions with local experts. In this report we share insights gained on this research trip. To describe our conclusions in the briefest way possible, we would say that first of all, the trade talks between the US and China will likely be tougher going than it has been assumed. However, China is determined to shore up its economy through the use of fiscal and monetary policy. The recent move toward recovery in China's economy shows the influence of government policy in shoring up the brisk financial market, improvements in corporate finance, and the increase in orders for infrastructure projects. We were had the strong impression that this plan can, through policy measures, offset the shock of the *New Economy's* bubble bursting, and allow China to return to the days of restoring the *Old China*.

US-China Summit – US Talking Points **Chart 1**

Statement from the Press Secretary Regarding the President's Working Dinner with China

1st, Dec 2018

The President of the United States, Donald J. Trump, and President Xi Jinping of China, have just concluded what both have said was a "highly successful meeting" between themselves and their most senior representatives in Buenos Aires, Argentina.

Very importantly, President Xi, in a wonderful humanitarian gesture, **(1) has agreed to designate Fentanyl as a Controlled Substance, meaning that people selling Fentanyl to the United States will be subject to China's maximum penalty under the law.**

On Trade, President Trump has agreed that **on January 1, 2019, he will leave the tariffs on $200 billion worth of product at the 10% rate, and not raise it to 25% at this time**. **(2) China will agree to purchase a not yet agreed upon, but very substantial, amount of agricultural, energy, industrial, and other product from the United States** to reduce the trade imbalance between our two countries. China has agreed to start purchasing agricultural product from our farmers immediately.

President Trump and President Xi have agreed to **(3) immediately begin negotiations on structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture**. **Both parties agree that they will endeavor to have this transaction completed within the next 90 days. If at the end of this period of time, the parties are unable to reach an agreement, the 10% tariffs will be raised to 25%.**

(4) It was also agreed that great progress has been made with respect to North Korea and that President Trump, together with President Xi, will strive, along with Chairman Kim Jong Un, to see a nuclear free Korean Peninsula. President Trump expressed his friendship and respect for Chairman Kim.

(5) President Xi also stated that he is open to approving the previously unapproved Qualcomm-NXP deal should it again be presented to him.

President Trump stated: "This was an amazing and productive meeting with unlimited possibilities for both the United States and China. It is my great honor to be working with President Xi."

Source: https://www.whitehouse.gov/briefings-statements/statement-press-secretary-regarding-presidents-working-dinner-china/ (Colors, underlining and numbers added by writer.)

[1] For details see the following DIR report dated 26 March 2019. *Japan's Economy: Monthly Outlook (March 2019), Doubts regarding five prevailing views on Japan's economy*, by Shunsuke Kobayashi & Yota Hirono.

US-China trade talks may be tougher going than expected

One of the things the writer learned on this research trip is that some are of the opinion that the US-China trade talks represent a negative surprise for China. To put it simply, China's domestic expected value is too high. In other words, local opinion has it that China has already made concessions to the US on many points. Anymore demands on the part of the US would constitute interference in another nation's domestic affairs. President Trump is a businessman, so he should know that, considering economic rationality, a suitable agreement has been reached. There is even a good possibility that the tariffs imposed last year may be abolished. The writer was given the impression that a consensus has formed.

Four out of five of the terms demanded by the US had already reached concession at the US-China summit held in December. These include China's agreement to place controls on the export of highly toxic substances, to purchase more agricultural products from the US, cooperate on the North Korean problem, and to stop interfering in US telecommunications companies attempts to do business in China (Chart 1). Remaining problems are associated with structural reforms associated with the protection of intellectual property, but China insisted that this issue was already settled by its having enacted the Foreign Investment Law.

However, China's Foreign Investment Law merely provides guidelines. Considering China's twenty years of fending off US criticisms by implementing deliberately ambiguous measures, or by raising the issue of the China Threat Theory in US public opinion and politics, without a commitment to real improvements it seems that the US would think first before agreeing to a settlement.

But with the expected value of Chinese public opinion on the high side, making any more concessions could cause the Chinese government to lose face. On the other hand, the US cannot make any concessions regarding the terms submitted by the Chinese government as of this point. This creates concerns that the US-China trade talks will be tough going.

US-China Summit – Results Published by China **Chart 2**

Xi, Trump hold 'very successful' meeting on ties, trade

2nd, Dec 2018

President Xi Jinping and his US counterpart Donald Trump held a "very successful" meeting in Buenos Aires, Argentina on Dec 1 and agreed to continue to maintain close contact.

At the working dinner after the conclusion of the 13th Group of 20 summit, Xi and Trump had an in-depth exchange of views on China-US relations and international affairs of mutual concern in a friendly and candid atmosphere, **reaching important consensus and agreeing not to impose new additional tariffs**.

The two sides agreed to expand cooperation based on reciprocity and mutual benefit and manage differences based on mutual respect so as to jointly advance China-US relations with coordination, cooperation and stability as the defining features.

Xi pointed out that China and the United States shoulder important responsibilities in promoting world peace and prosperity.

Sound China-US relations, Xi said, are in line with the fundamental interests of the two peoples and the general expectation of the international community.

Cooperation is the best option for the two countries, Xi said.

Xi called on both China and the United States to handle the development of bilateral relations from an overall perspective and push for long-term, healthy and stable development, delivering more and better benefits to the two nations and people around the world.

Trump said he agrees with Xi on his evaluation of bilateral relations.

US-China relations are very special and important, Trump said, adding that it is in the interest of the two countries as well as the world that the United States and China, both countries of significant influence, maintain a good cooperative relationship.

The US side, he added, is ready to increase cooperation with China through consultations and actively seek mutually beneficial solutions to their problems.

The two heads of state are willing to maintain close exchanges in various forms to jointly chart the course of the development of China-US relations.

Source: http://english.gov.cn/news/top_news/2018/12/02/content_281476415821808.htm (Colors and underlining added by writer.)

Of course, the reassuring point is that neither China nor the US have any incentive to break off negotiations as of this point. As will be explained further in this report, China is eager to provide more support for its economy. Neither is the US in a position to allow the talks to go down in flames with midterm elections now in progress, and the presidential primary elections to follow. This is a political phase in which it will be important to encourage recovery in the economy and the financial markets, as well as to provide increasing support for the Trump administration. Hence the talks may be rough going, but negotiations will not be broken off. On the other hand, they could be delayed or prolonged. And if the talks go on for too long, then they will drag on into 2020, which is when the primary election for the US presidential election takes place, and at that point the option of breaking off negotiations or using a "flaming" strategy will arise.

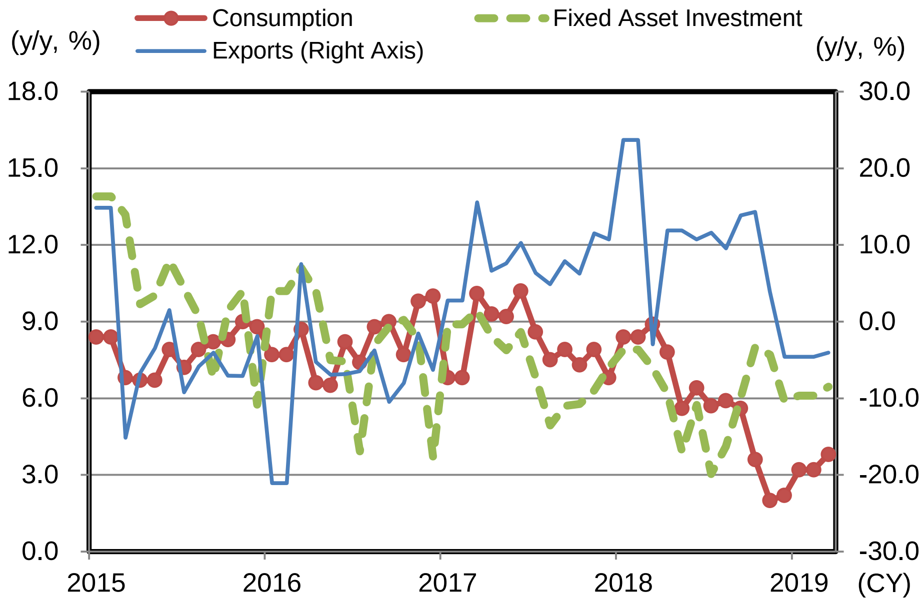
The true reason China's economy stalled in 2018, and degree of seriousness in providing support for the economy in 2019

The fact that US-China trade talks may be tough going is of course not good news for the Japanese and the global economies. However, on this research trip the writer discovered a positive surprise which more than offsets the negative surprise of the talks. That is the intense determination of the Chinese government to implement measures to support the economy.

But before covering these in more detail, let us take a quick look at the past. As is shown in Chart 3, Chinese exports began to decline significantly in November of 2018. In contrast, consumption and fixed asset investment began losing speed at the beginning of 2018. Consumption slowed further in October of the same year. In other words, domestic demand became distorted before overseas demand. It is difficult to associate the slowdown in domestic demand with US-China trade friction. It is a fact that concerns in Qingdao, a major port for shipping household electronic exports, were more for the falling back of domestic demand than overseas demand.

Changes in China's own policies were behind the slowdown in domestic demand. The major causes were (1) strengthening of regulations regarding wealth management products, (2) putting the squeeze on infrastructure projects, (3) introduction of regulations regarding inter-individual consumer finance, and (4) suspension of tax reduction on automobile purchases.

China: Changes in Fundamental Economic Statistics **Chart 3**



Source: National Bureau of Statistics, General Administration of Customs; compiled by DIR.

The essence and power of deleveraging (strengthening of regulations regarding wealth management products)

First we look back at what was behind the strengthening of regulations regarding wealth management products. In November 2017 the authorities announced government guidance regarding standardization of asset management business of financial institutions. Legislation went into effect in April 2018. This measure prohibits “rigid redemption” and management of pooled funds.

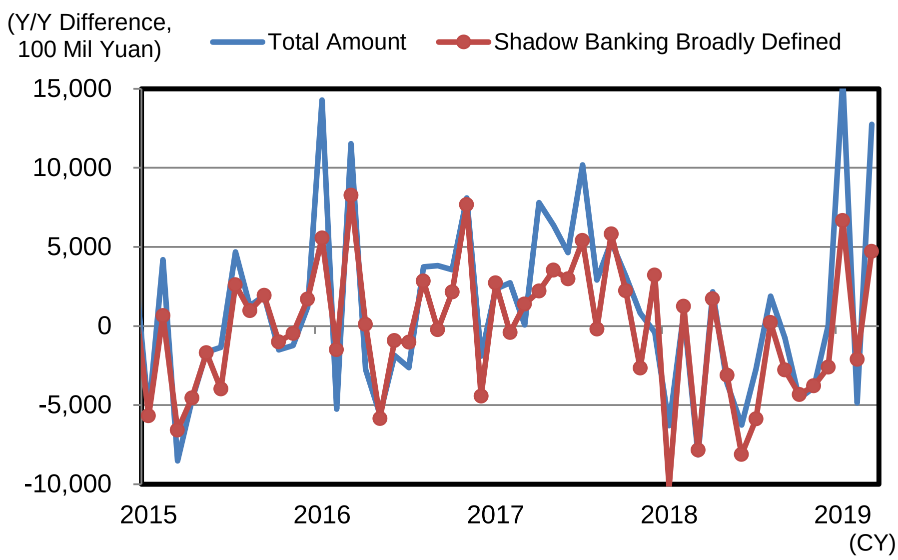
Both of these are wealth management products. In other words, the purpose of the new ruling is to regulate shadow banking. The term “rigid redemption” indicates the practice of guaranteeing the principal. Management of pooled funds is where multiple asset management products are placed together and batch managed. When managed in this way, earnings and risk associated with individual products becomes unclear.

As is shown in Chart 4, there is little room to doubt that investment in wealth management products of this sort ballooned between 2016 and 2017, causing risk in the financial system to expand significantly. Sensing a crisis in the making, the authorities strengthened regulations and punished financial institutions that were carrying out compensation for losses. The authorities began to demand one-to-one correspondence in the handling of asset management products.

As a result, the growth rate in investment in wealth management products, as well as the total amount of social financing experienced a major slowdown in 2018. This generates the collapse of asset prices on the financial markets. Then the collapse in asset prices causes the circulation of funds through private equity to deteriorate, and the number of private corporations struggling with financing increases. Meanwhile, the deleveraging activity of banks due to operating losses progresses. This describes one of the important factors behind China’s stalled economy in 2018.

At the same time, the strengthening of financial regulations and the slowdown in infrastructure investment are not exactly unrelated. It is not difficult to deduce that the situation was such that the banking system, whose risk tolerance had decreased, could not increase credit to provincial governments. Meanwhile, with the central government seeking debt relief and environmental measures, it became difficult to gain authorization for infrastructure investment projects in the first half of 2018.

China: Increase and Decrease in Total Amount of Social Financing **Chart 4**



Source: People’s Bank of China; compiled by DIR.
Notes: 1) Increase and decrease in amounts of fundraising in social capital is based on net growth and decline in capital supplied to the economy by the banking system.
2) Shadow banking in the broad sense is the total minus lending in Chinese renminbi and lending in foreign currency.

The major factors that stalled consumption were the strengthening of regulations regarding P2P consumer financing and abolishing the vehicle purchase tax reduction

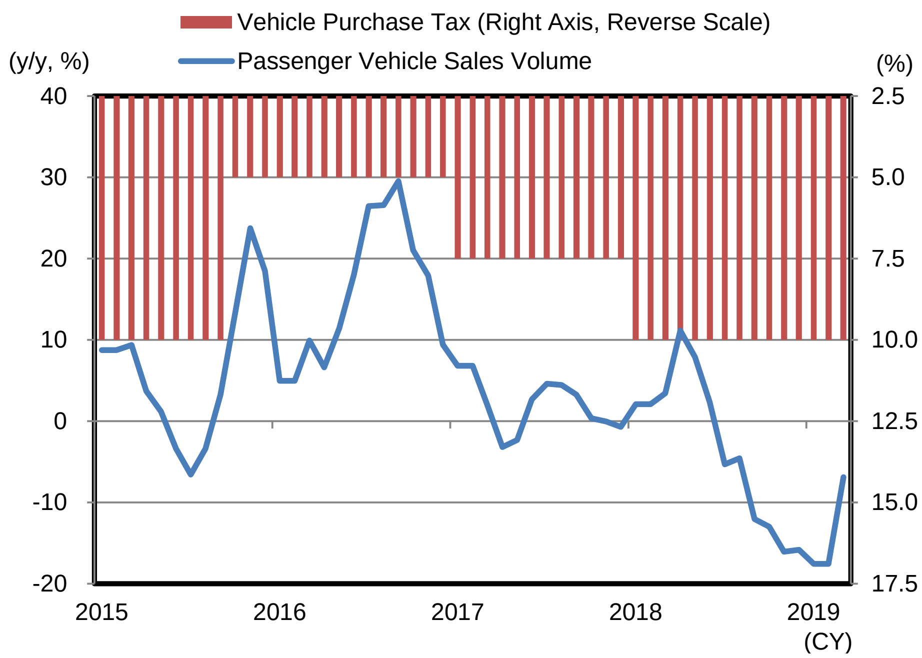
Of course, all of these developments are associated with the slowdown in fixed asset investment and the slump in the financial markets. It is also a fact that most likely, this has had an indirect relationship with the slowdown in growth in employment and improvement in wages, as well as suppression of consumption through the negative wealth effect.

Another lesser-known fact was also present, having an even more direct effect on holding down consumption, and that is regulations regarding P2P consumer financing. P2P consumer financing is the carrying out of lending and borrowing between individuals. There were many businesses in China providing platforms for the matching of loans. During the time we have been discussing here, the scale of that market had already reached 20 tril yen. The Chinese government was concerned about the unbridled expansion of this market, and therefore strengthened regulations. The policy to regulate this market was itself announced in August 2016, but details of the regulations were not indicated until August 2018. Businesses involved in this market were then forced to deal with the new regulations by the end of 2018.

As a result, most of the unscrupulous businesses were pushed out of the market, but it appears that the businesses that remained were unable to avoid the devastating blow to the balance sheet total. Of course, consumption on the part of borrowers was therefore impeded, but lenders who got burned may also have contributed to the holding down of consumption.

In addition to these developments, the purchase of automobiles, which was supported between 2015 and 2017 by a tax reduction measure, returned to the normal tax which had been charged before that time. It is apparent that this decision may also have contributed to the slump in automobile sales in 2018 (Chart 5).

China: Overview of Automobile Sales **Chart 5**



Source: CEIC; compiled by DIR.

Unexpected (and unembarrassed) reversal of regulatory decision brings expansion in financing

In a complete turnaround from 2018 when factors contributing to economic slowdown were piled high one on top of the other, 2019 saw the Chinese government launch policies to support the economy in rapid succession beginning early in the year.

First, as can be confirmed to be especially evident by taking a look at Chart 4, soon after entering the year 2019, the total amount of social financing was increased significantly. The government adopted the stance that they would not be averse to the fact that most of that would likely flow into the shadow banking market. This actually provides backup for the recovery of the financial market. Not only does it provide indirect support for the recovery of the asset effect, but the implications are that it can bring a stop to unemployment in startup companies (young highly educated white collar workers).

However, the government guidance previously mentioned has not yet been abolished. The term for that measure ends on January 1, 2021. Therefore, it should be kept in mind that the more one carries out a sudden, unembarrassed expansion of financing, the tougher going will be the coming adjustment phase in 2020.

Two important political dates in 2019

But the real reason that the Chinese government has been so eager to shore up the economy is more likely two important political dates in 2019.

One of these is October 1, China's National Foundation Day and the 70th anniversary of The People's Republic of China. A huge parade and ceremony are planned to celebrate this day, and the government needs to demonstrate that the economic slowdown has been overcome by this date.

The other date occurs around June. This is the date that a new stock market is established, the Science and Technology Innovation Board oriented toward high tech startups. If stock prices are still low when the new exchange opens and funding stagnates, the country's leadership will completely lose face.

Assuming that the Chinese government is eager to support the economy due to these political concerns, then policy could experience a major turnaround early in 2019.

Recovery and expansion of infrastructure investment triggers tax reduction policy

Infrastructure investment is getting going again in addition to monetary easing. Net issuance of local government special bonds in 2019 is expected to reach 2 tril, 150 bil yuan, 800 bil yuan more than last year. Everywhere one goes one hears about major infrastructure projects getting started. This includes new airports and highways in the major cities, as well as development projects in the south, such as the Yangtze River Delta development, the Pearl River Delta development, and construction of the Xiong'an New Area.

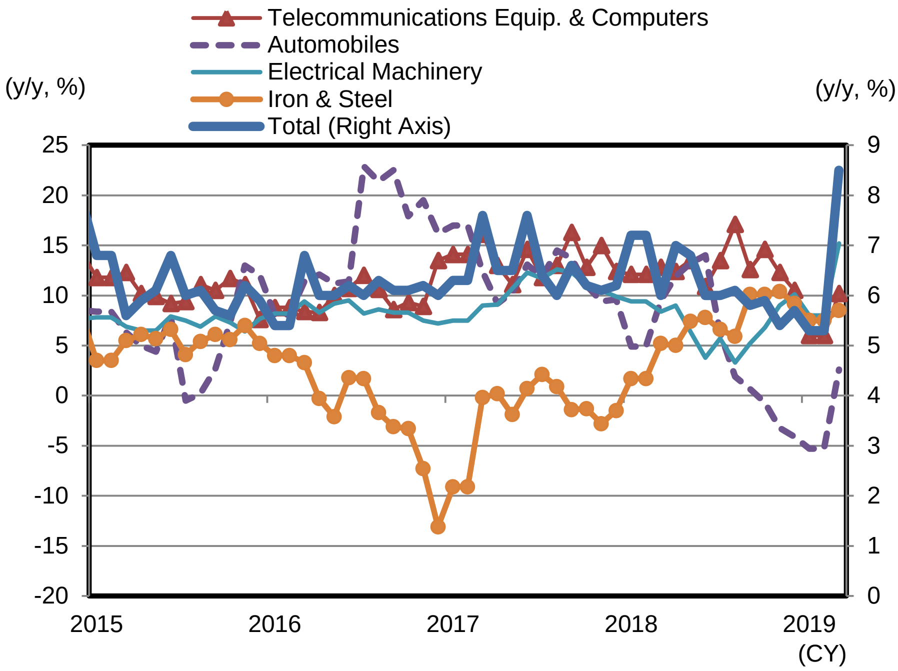
Meanwhile, the scale of the tax reduction is also major. The 2019 tax cut totals 2.0 tril yuan (approximately 33.4 tril yen), including a reduction in the value-added tax (the manufacturing industry tax will be cut from the current 16% to 13%, while the transportation and construction industries will be cut from 10% to 9%). The social insurance burden of corporations will also be reduced significantly.

Time lag expected before Japanese corporations reap benefits

There is just one thing to remain aware of – there will be a natural time lag before Japanese corporations reap the benefits of the Chinese economy's recovery in infrastructure projects and other areas. The reason is simple – China's domestic inventory level is still high. As is shown in Chart 6, the Chinese government provided support to accelerate iron & steel production during the second half of last year due to the economic slowdown. As a result, inventory accumulation of raw materials produced at that time has likely occurred. Japanese corporations are expected to reap the benefits of China's economic recovery after this excess inventory has been reduced somewhat.

One possible conclusion we can draw from the previous arguments is that a recovery of consumption will likely take a while. This will be a heavy burden for Japanese corporations which have become dependent on final consumption demand in China. In comparison with the recovery of the stock market and infrastructure demand, which are hoped to experience an early recovery associated with the change in deleveraging policy, the factors behind the slowdown of 2018 were the regulation of consumer financing and the halting of the tax reduction policy. What remains now is the recovery of consumption, but there is a very good chance that this will remain sluggish for some time. A representative item closely linked with China's consumption is cosmetics. Demand for cosmetics has been unexpectedly slow, and as can be seen in Chart 7, even in Japan's domestic market, inventory accumulation in the chemical industry, which includes cosmetics, has continued since 2018. Assuming that recovery in demand will be gradual, there is a very good possibility that inventory adjustment in this industry will continue to be difficult for some time to come.

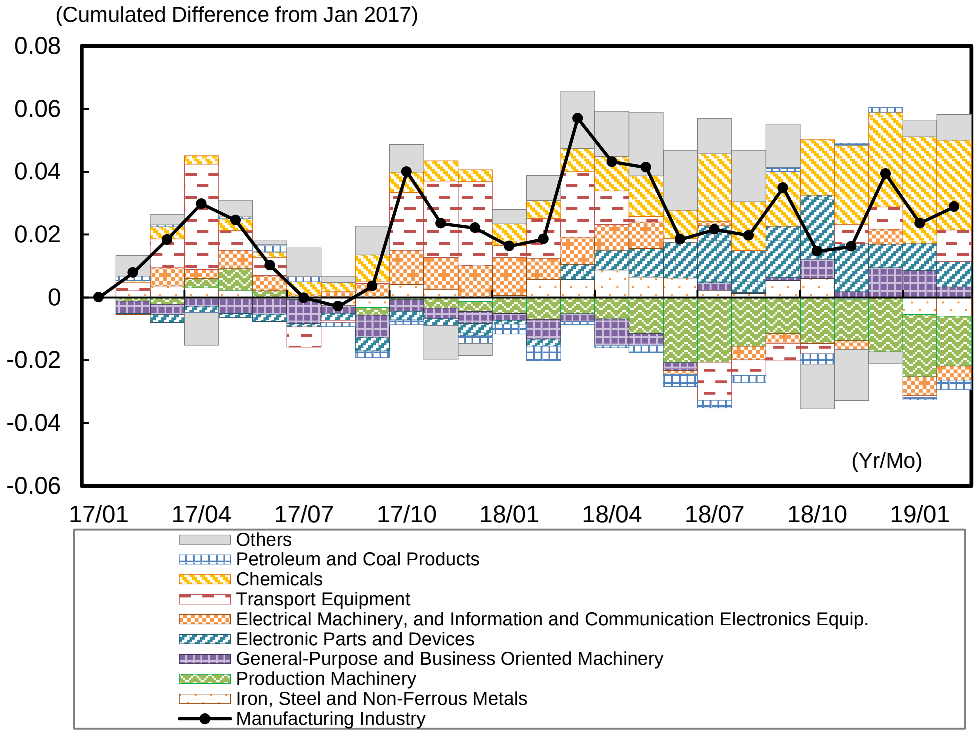
China: Status of Industrial Production **Chart 6**



Source: National Bureau of Statistics; compiled by DIR.

On the bright side, in contrast to the chemical industry, inventory adjustment is progressing for some Japanese corporations. For instance, electronic parts and devices saw its inventory levels increase through the middle of 2018, and then inventory adjustment progressed throughout the second half of that same year. Meanwhile, it is quite possible that the transport equipment, and electrical machinery and Information and communication electronics equipment industries have already completed adjustment of excess inventory. These industries had already reached a high level of inventory by the first half of 2018. Reduction of inventory through the adjustment process is remarkable, reaching as far as the production machinery industry. The comeback for China's economy may very well lead to the bottoming out of Japanese corporate business results in these industries.

Japan: Number of Inventory Months – Breakdown by Industry **Chart 7**



Source: METI; compiled by DIR.

Notes: 1) Inventory months = real inventory value (end month balance) / real shipment value (monthly amount, 12-month backward moving average).

2) Real inventory value and real shipment value were calculated using values from the METI Census (2015) and extending those figures using the Indices of Industrial Production.

2. Last resort for the FRB as it faces imminent reverse yield

In predicting the rate and extent of Japan's economic recovery and the possibilities for growth, one of the essential points is the yield curve in the US (for details see Japan's Economy: Jan. 2019[2]).

Looking at the current condition of the global economy based on the capital stock cycle suggests that we are about to enter a maturation phase. Working behind the scenes is the credit cycle, which is in agreement with this conclusion. It is highly possible that expansion and growth are nearing an end. And as the expansion cycle approaches its demise or collapse, there is concern that the reversal of US long and short-term interest rates could trigger a recession. As is shown in Chart 8, in the past, almost without exception, the phenomenon of reversal of long and short-term interest rates[3] occurs at the end of an economic expansion phase immediately before entering a recession in the US whose economy tends to determine trends in the global economy.

However, this finding tells us nothing new. It's a chicken or the egg question, but looking at the reversal of short and long-term interest rates from the viewpoint of the bond market, it is a sign that an economic slowdown (or recession) will occur in the future. Speaking in even more fundamental terms, from the viewpoint of credit institutions, the reversal of short and long-term interest rates means that the more one increases lending the more losses one incurs. As a result, a credit crunch occurs, including withdrawal of credit, and as was previously explained, expansion equilibrium collapses. In this way we end up falling into recession as a result of self-fulfilling prophecy.

Is there anything to the argument that the FRB's turning dovish means we're in a risk-on phase, so we have nothing to worry about?

The instance of reverse yield referred to in this report occurred in late March, and caused temporary turmoil on the global financial markets. However, market turmoil was brought quickly under control. As of the writing of this report, it appears that investors have already recovered their risk appetite. The argument behind this claim is based on a view point held by many. That is (1) the recent reverse yield situation occurred merely as a result of the FRB having changed its monetary policy to one of easing, and is a transient phenomenon, (2) if the main reason for the reverse yield is uncertainty regarding the future of the economy, then the stock and bond markets should be in decline, yet they are in fact on the

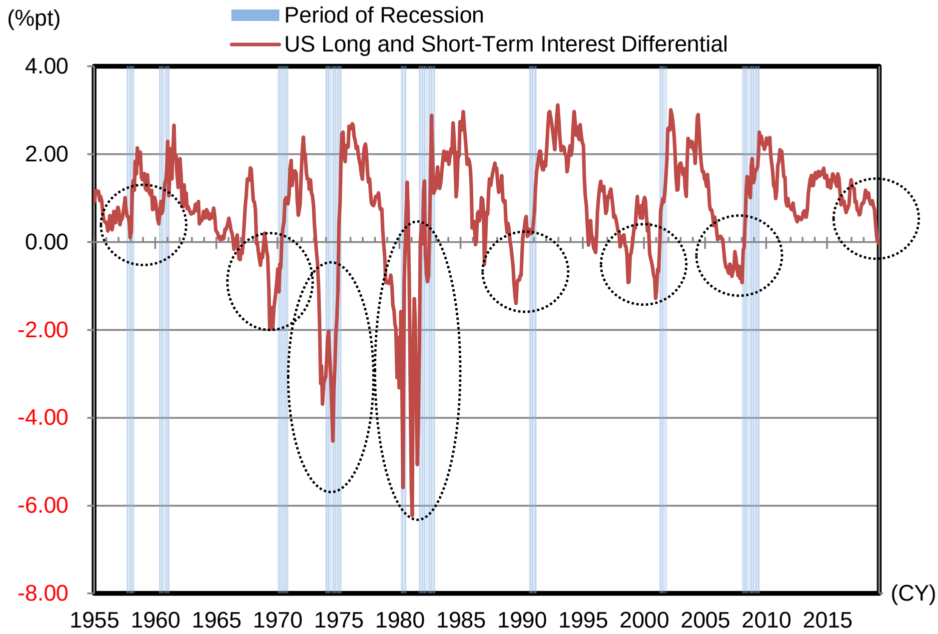
[2] For details see the following DIR report dated 25 January 2019. *Japan's Economy: Monthly Outlook (January 2019), What will bring an end to global economic growth?*, by Shunsuke Kobayashi & Yota Hirono.

[3] There is room for doubt as to whether in calculating the interest differential between the short and long-term interest rate, one needs to know what kind of interest each of them is using. However, based on the arguments discussed up to this point, it is best for each one to become the proxy variable of the lending rate and the procurement rate. Properly speaking, the differential between the lending rate and the procurement rate is the sum of the period risk premium (the required rate of return in relation to period risk) and the risk premium (the required rate of return in relation to default risk). The latter depends on the credit worthiness of the borrower and the risk tolerance of the credit institution. It is therefore difficult to immediately determine a standard which would become the dividing line between the good and the bad. On the other hand, the former would clearly be a loss for the credit institution, and therefore clearly represents adversity. Therefore, the most reliable method of choosing a risk free rate is to take the differential between the yield on the government bond on fixed term (2 and 5 years) lending, and the short-term interest rate (FF rate etc.) for the procurement rate. This is a bit of a digression, but the media has recently taken up the problem of negative spreads on 5 and 10 year loans, and 3 and 5 year loans. Our opinion is that the fact of negative spreads on these loans does not provide a very reliable index for understanding what is going on. There are also arguments for looking at the differential between the nominal potential growth rate and the FF rate, but this is clearly too imprecise to use as a judgment criterion. The nominal potential growth rate normally exceeds the lending rate. Otherwise, it would be impossible to gain excess earnings on assets having a higher risk than securities such as financing and bonds. The differential between the nominal potential growth rate and the FF rate is the sum of all of these three factors – the excess return rate, the period risk premium, and the enterprise risk premium. It is self-evident that if this figure moves into the negative numbers, it means that the situation is hopeless and the economy has already fallen into a recession. However, the reverse is not necessarily true. In other words, there is no logic to the statement that "as long as a reversal of the nominal potential growth rate and the FF rate relationship does not occur, a recession will not occur."

way up, and (3) the risk-on trend will eventually push the long-term interest rate up, so there is no reason for concern.

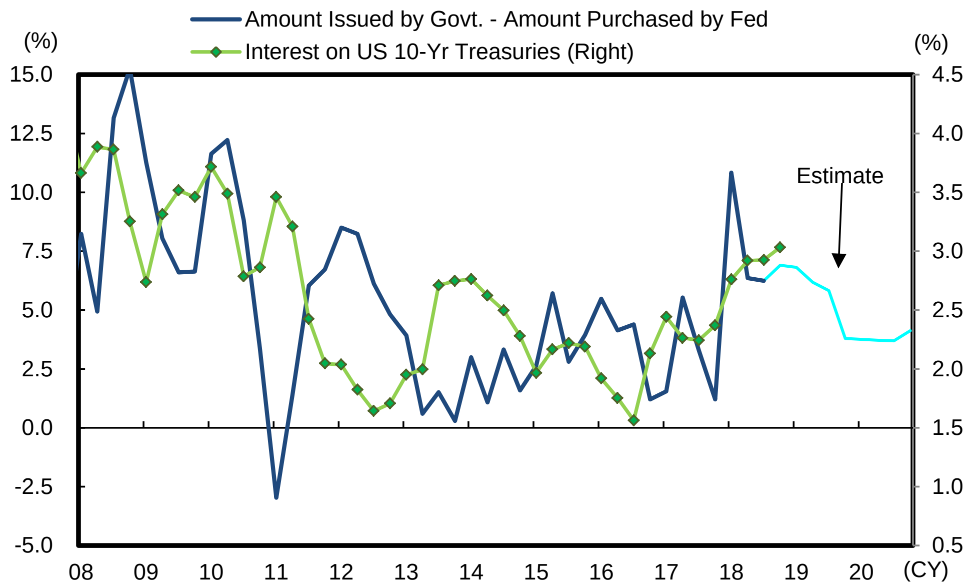
Of the statements listed above, we might possibly be able to agree with (1). As is shown in Chart 9, the supply of US Treasuries on the financial markets worsened continually from the end of 2017 to the end of 2018 due to two factors: supply grew when taxes were cut, then demand declined when the FRB accelerated its asset reduction process. Few would question the fact that there was excessive upward pressure on the long-term interest rate. After this point the FRB made major corrections to its March 2019 FOMC and announced an early suspension of its asset reduction policy. As a result, the supply of US Treasuries is tightening accordingly for some time to come. It is therefore probably safe to say that the recent decline in the long-term interest rate reflects the change in the FRB's policy.

US Long and Short-Term Interest Differential and the Business Cycle **Chart 8**



Source: NBER, Haver Analytics; compiled by DIR.
Note: The long and short-term interest differential is yield on the US 5-yr bond minus the FF rate.

Net Issuance of US Treasuries (as a Portion of GDP), and Trends in Interest on 10-Yr Bond **Chart 9**



Source: FRB, CBO, Haver Analytics; compiled by DIR.
Note: Figures after 2018 calculated by DIR based on FRB and CBO estimates.

Stock prices highs after reverse yield unsurprising – doesn't mean we can relax

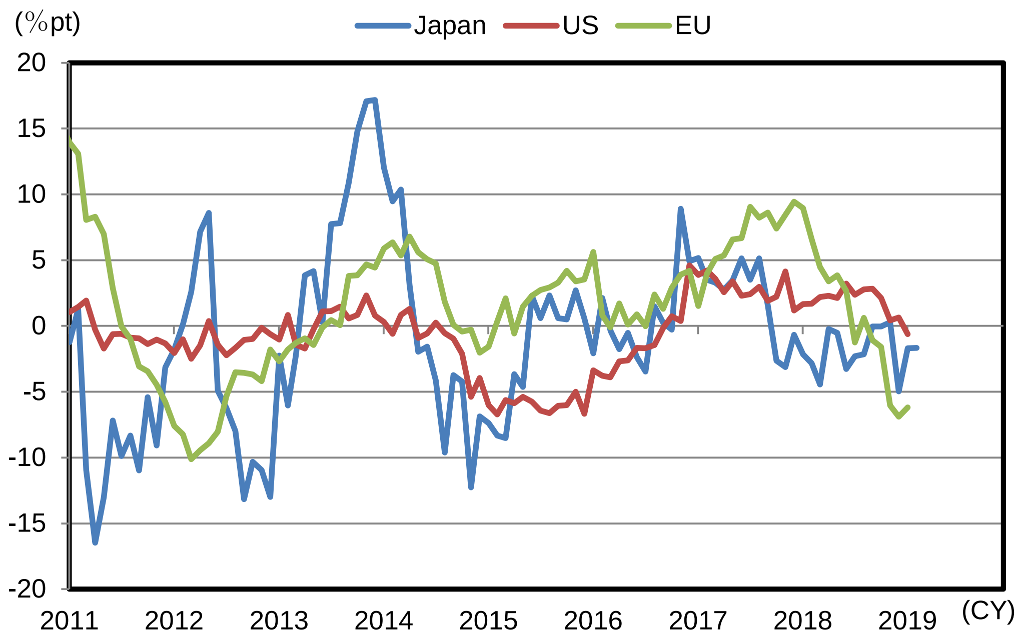
As for arguments (2) and (3) listed in the previous section, there is something that is important to keep in mind – that is no matter what was behind the situation, both a reduction in the differential between long and short-term interest rates and a reverse yield will do harm to the earnings of credit institutions.

Moreover, growth in stock and bond prices in a reverse yield environment is a common pattern. It goes without saying that in an environment where the yield curve is flat due to a change in the FRB's policy, banks and investors in bonds will willingly take on a credit risk to protect their yield. Commonly called "search for yield", it is a policy of last resort, and this tends to temporarily push up stock and bond prices. But then later, profit & loss statements deteriorate and investors begin to feel the consequences of excessive risk-taking. Ultimately, deleveraging occurs followed by the slip into recession – it's a familiar pattern. Bond prices and a rise in the stock market cannot be considered reassuring factors.

In fact, bond prices and a rise in the stock market only make it even more difficult for the long-term interest rate to achieve an increase. When long-term bonds are sold in order to purchase other assets, it is then that the interest rate begins to rise. If the prices of other risk assets are already high (≒ low yield), the flow of funds would be limited. Ultimately, the future of the long-term interest rate will be determined by a combination of factors: the extent to which the demand for financing in the real economy recovers, in other words the question of how strong the real economy is, and whether or not, in response to these questions, the FRB makes another change in its policy. Finally, there are two reasons why it is impossible to sit back and expect the real economy to overheat on its own.

One of these is a short-term issue. That is the effect of the tax reduction in the US, which is gradually dissipating. This will very likely cause a slowdown in the US economy for some time. Meanwhile, as is shown in Chart 10, due to the growth in demand associated with the tax reduction, the US economy in 2018 was spared the pressure of inventory adjustment in contrast to Japan and Europe. However, as the effect of the tax reduction gradually disappears, it is highly possible that production adjustment for the purpose of reducing inventory will begin in the US in 2019.

US, Japan, and Europe: Balance of Inventory and Shipments **Chart 10**



Source: Major statistics from each of the above mentioned countries; compiled by DIR.
Notes: 1) Shipment and inventory balance = shipments (y/y) – inventory (y/y).
2) Due to natural disasters in Japan in 2018, data is averaged for the months of September and October.
3) Europe data from EU28. Difference between production index (y/y) – inventory DI (y/y) used for Europe only.

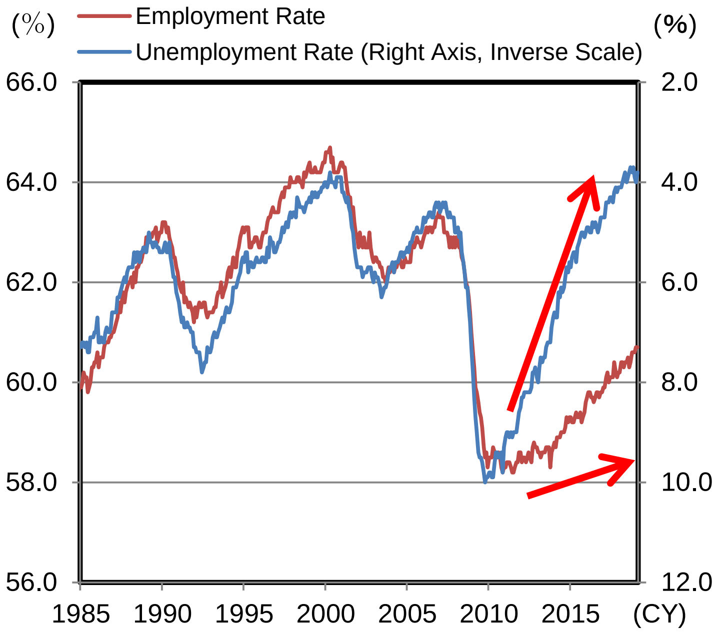
The US economy is expected to most likely experience a slowdown in the future, moving toward a level below the potential growth rate. (This is assuming that there are no external shocks, such as the expansionary fiscal policy as represented by President Trump's infrastructure expansion plan, one of the few decisions he leaves behind as his public legacy.)

Pitfalls of a hopeful theory: Declining unemployment rate and growth in wages

There is one more problem that is even more fundamental as well as structural. The US labor market is still seriously slack due to insufficient demand, and it will take some time for growth in wages, as well as growth in prices, to begin rising. The fact that growth in wages has not sped up despite the US unemployment rate being at a historic low, has been debated until recently as if that were a fathomless mystery. However, looking at Chart 11 we can see that the cause is actually quite clear. The unemployment rate is no longer significant.

The US unemployment rate is at a historic low, but at the same time, the employment rate is also at a historic low. This means that a serious change to non-labor is occurring[4]. This trend has progressed since the global financial crisis of 2008. It is remarkably similar to a phenomenon that appeared in Japan since the end of the 1990s. In other words, people who could not find jobs during the "employment ice age" which occurred after the global financial crisis of 2008 became part of the non-labor population, and have been "on standby" outside the labor market. This is the reason that there is a huge slack in the US labor market[5].

Changes in Unemployment Rate and Employment Rate in the US **Chart 11**



Source: BLS; compiled by DIR.

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[4] By definition, all members of the population are classified as either working population, unemployed population, or non-labor population. Although the ratio of unemployed population is on the decline, so is the ratio of the working population. This means that the ratio of the non-labor population is growing.

[5] The growth of non-labor following a financial crisis can lead to a long-term decline in the potential growth rate and a disinflation trend. Awareness has been recently growing regarding this phenomenon, which is considered to be a kind of "hysteresis effect". Once a part of the non-labor population, the longer people remain in this situation without education and training, including OJT, the more macro labor productivity declines due to the deterioration of the quality of labor. Even seen from the micro viewpoint this has consequences – cases where workers without special skills are forced to accept negative terms of employment, beginning with lower wages, increase. As a result, a disinflation trend in wages can occur.

As a result, the situation in the US economy is such that the growth rate of wages is moving at a sluggish pace. Meanwhile, the inflation rate has not reached the level of 2% even for an instant. Still, there is nothing unusual about doubts arising regarding the fact that the policy interest rate has been increased a total of nine times. This explains why top officials of the FRB have made repeated statements since early in 2019 regarding concepts such as the average inflation rate target, the inflation target being subject to ups and downs, and the high pressure economy. It will likely take some time before another policy interest rate hike takes place, or growth occurs in the long-term interest rate.

The real purpose of the FRB is to release some pressure from the economic bubble

But another question arises here. To begin with, improvement is slow in coming for both the employment rate and wages, and the inflation rate has never reached its target of 2%, but even so, the FRB has carried out hasty interest hikes nine times. Why is this? The FRB itself has given an answer in its Financial Stability Report, which is to tackle the problem of corporate financial leveraging. As is shown in Chart 12, outstanding debt of US corporations as a proportion of GDP now exceeds a level comparable to that of the eve of the collapse of past bubble economies.

The outstanding debt of US corporations has grown as a result of the FRB’s monetary easing policy which has continued since the global financial crisis of 2008. This policy has kept the cost of corporate borrowing at an extremely low level. Of course, encouraging an increase in corporate borrowing was exactly the FRB’s intent, so this is not a problem in and of itself. The problem is how funds that were borrowed were used. The purpose of the FRB decreasing the cost of borrowing for corporations was to encourage them to increase capital expenditure and hiring. However, growth in capital expenditure and hiring has been moderate at best. This is not unrelated to the decline in the potential growth rate as a result of the hysteresis effect associated with the last economic crisis. In other words, neither capital investment nor hiring is as necessary as had once been predicted. This is the result of declining growth outlooks for the US market on the part of corporations.

So now the question is where did all the capital go if increased borrowing on the part of US corporations did not go into capex or hiring. The answer is the stock market. Issuing stocks is a cost for corporations. So if the cost of borrowing is relatively lower than the cost of capital through the issuance of stock shares, an increasing number of corporations borrow money for a share buyback. The outstanding debt of US corporations grew as a result. At the same time, net worth should also have been eroded, but in fact, it has grown as a result of growth on the stock market and the use of market-value accounting. This allows corporations to maintain the appearance of financial soundness. But in the end this has led to low credit spreads which are highly leveraged. This further boosted leverage circulation in which debt continued to balloon followed by more share buybacks.

Former FRB Chairman Yellen implemented monetary tightening as a means of releasing pressure from this process of ballooning debt and bubble formation[6]. Moreover, it is understood that former Chairman Yellen felt that financial regulation was necessary in order to keep overly easy risk-taking under control, but under the Trump administration financial regulations have been continually eased. The purpose of monetary tightening was simply to release pressure from the process of ballooning debt and bubble formation.

[6] Former FRB Chairman Yellen implemented monetary tightening as a means of releasing pressure from this process of ballooning debt and bubble formation. However, the understanding was that she was always ready to stop at the last minute in order to avoid this pressure release method causing stock price lows and growth in bond yields to the degree that it would lead to a reversal of the credit cycle. Looking at current FRB Chairman Powell’s performance during his first year after taking office, he has continued to make inconsistent remarks, hence there are doubts as to the degree to which he has actually continued his predecessor’s policy.

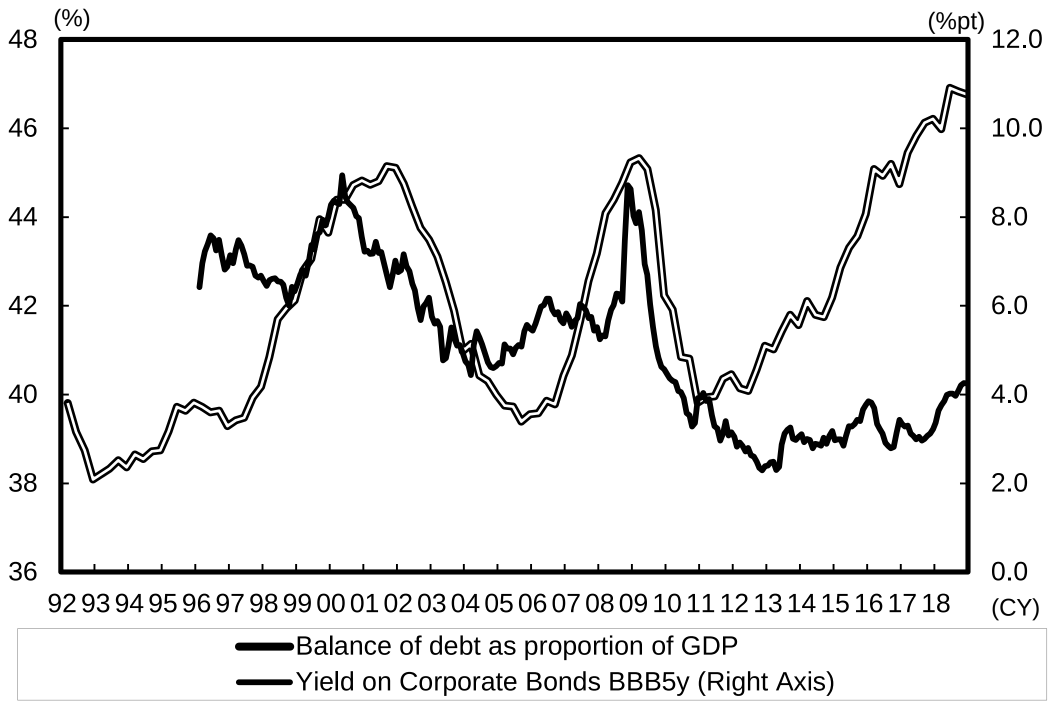
Only choice remaining is a stealth Reverse Operation Twist

Monetary tightening was almost too effective in 2018, ultimately leading to the turmoil on the financial markets that year. But as they say, *once bitten, twice shy* – the FRB chose to go dovish on policy in March 2019. However, going dovish on policy contradicts the FRB's original purpose of releasing pressure from the economic bubble. In addition to the decline in interest on US Treasuries, the search for yield phenomenon explained earlier in this report holds down yield on corporate bonds. This increases the possibility that US corporations will further expand their credit leveraging activities. The FRB is not left with many options in dealing with this problem. As was indicated earlier, it would be difficult to raise the policy interest rate any higher at this point. Moreover, the FOMC abandoned quantitative policy in March 2019.

The only thing they have left is qualitative policy – that is, changing the maturity of the average term of its assets (US Treasuries). They have already carried out a twist operation in which the average term of asset holdings was lengthened as a means of flattening the yield curve. Next is to perform the opposite, in which the average term of assets is shortened as a means of steepening the yield curve. It is the only choice remaining for the FRB, and it tends to be an effective measure.

At this point in time the FRB has yet to set a policy target for in regard to average term of its assets. Moreover, this question had not been discussed until very recently, but that goes without saying. This is the only method of adjusting the market that the FRB has left to it, and the only one that allows discretion. Hence the FBR will likely maintain the yield curve of US Treasuries in the future by using a stealth Reverse Operation Twist. It is only for the time this mode of market adjustment is functioning that the reverse yield to recession scenario can be avoided.

Outstanding Debt of US Corporations as a Proportion of GDP, and Yield on Corporate Bonds Chart 12



Source: FRB, BEA, Haver Analytics; compiled by DIR.

Japan's Economic Outlook No.200 Update

	FY18 (Estimate)	FY19 (Estimate)	FY20 (Estimate)	CY18	CY19 (Estimate)	CY20 (Estimate)
Main economic indicators						
Nominal GDP (y/y %)	0.4	1.5	1.3	0.7	1.2	1.5
Real GDP (chained [2011]; y/y %)	0.6	0.7	0.6	0.8	0.5	0.7
Domestic demand (contribution, % pt)	0.8	0.7	0.5	0.8	0.9	0.5
Foreign demand (contribution, % pt)	-0.3	-0.1	0.0	-0.0	-0.3	0.1
GDP deflator (y/y %)	-0.1	0.9	0.7	-0.1	0.7	0.8
Index of All-industry Activity (y/y %)*	0.7	0.7	0.6	0.8	0.8	0.6
Index of Industrial Production (y/y %)	0.3	0.3	1.0	1.0	-0.3	1.2
Index of Tertiary Industry Activity (y/y %)	1.2	0.9	0.5	1.0	1.4	0.4
Corporate Goods Price Index (y/y %)	2.4	2.4	3.0	2.5	1.9	3.4
Consumer Price Index (excl. fresh food; y/y %)	0.8	0.4	0.5	0.8	0.4	0.6
Unemployment rate (%)	2.4	2.4	2.4	2.4	2.4	2.4
Government bond yield (10 year; %)	0.07	0.07	0.07	0.07	0.07	0.07
Balance of payments						
Trade balance (Y tril)	1.1	2.8	3.0	1.2	2.4	3.2
Current balance ($100 mil)	1,703	1,832	1,861	1,729	1,786	1,876
Current balance (Y tril)	19.0	20.5	20.9	19.1	20.0	21.0
(% of nominal GDP)	3.5	3.7	3.7	3.5	3.6	3.7
Real GDP components (Chained [2011]; y/y %; figures in parentheses: contribution, % pt)						
Private final consumption	0.6 (0.3)	0.4 (0.2)	0.5 (0.3)	0.4 (0.2)	0.6 (0.4)	0.4 (0.2)
Private housing investment	-4.2 (-0.1)	2.0 (0.1)	-1.8 (-0.1)	-5.7 (-0.2)	2.5 (0.1)	-2.0 (-0.1)
Private fixed investment	3.6 (0.6)	1.7 (0.3)	0.8 (0.1)	3.9 (0.6)	2.3 (0.4)	0.9 (0.1)
Government final consumption	0.9 (0.2)	0.8 (0.2)	0.8 (0.2)	0.8 (0.2)	0.8 (0.2)	0.8 (0.2)
Public fixed investment	-3.6 (-0.2)	3.0 (0.1)	0.7 (0.0)	-3.2 (-0.2)	1.6 (0.1)	1.7 (0.1)
Exports of goods and services	1.8 (0.3)	1.3 (0.2)	1.2 (0.2)	3.1 (0.6)	0.8 (0.1)	1.4 (0.3)
Imports of goods and services	3.3 (-0.6)	1.9 (-0.3)	1.0 (-0.2)	3.3 (-0.6)	2.7 (-0.5)	0.7 (-0.1)
Major assumptions:						
1. World economy						
Economic growth of major trading partners	3.7	3.5	3.4	3.9	3.5	3.5
Crude oil price (WTI futures; $/bbl)	63.2	55.0	55.0	64.9	55.3	55.0
2. US economy						
US real GDP (chained [2012]; y/y %)	3.0	2.4	1.8	2.9	2.6	1.9
US Consumer Price Index (y/y %)	2.3	2.1	2.4	2.4	1.9	2.5
3. Japanese economy						
Nominal public fixed investment (y/y %)	-1.9	4.4	1.3	-1.6	3.2	2.5
Exchange rate (Y/$)	111.3	111.9	111.9	110.4	111.9	111.9
(Y/€)	128.8	127.3	127.3	130.0	127.3	127.3

Source: Compiled by DIR.
Note: Due to rounding, actual figures may differ from those released by the government.
* Excl. agriculture, forestry, and fisheries.
Estimate: DIR estimate.