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**Turning Japanese: The Risk of US Deflation**

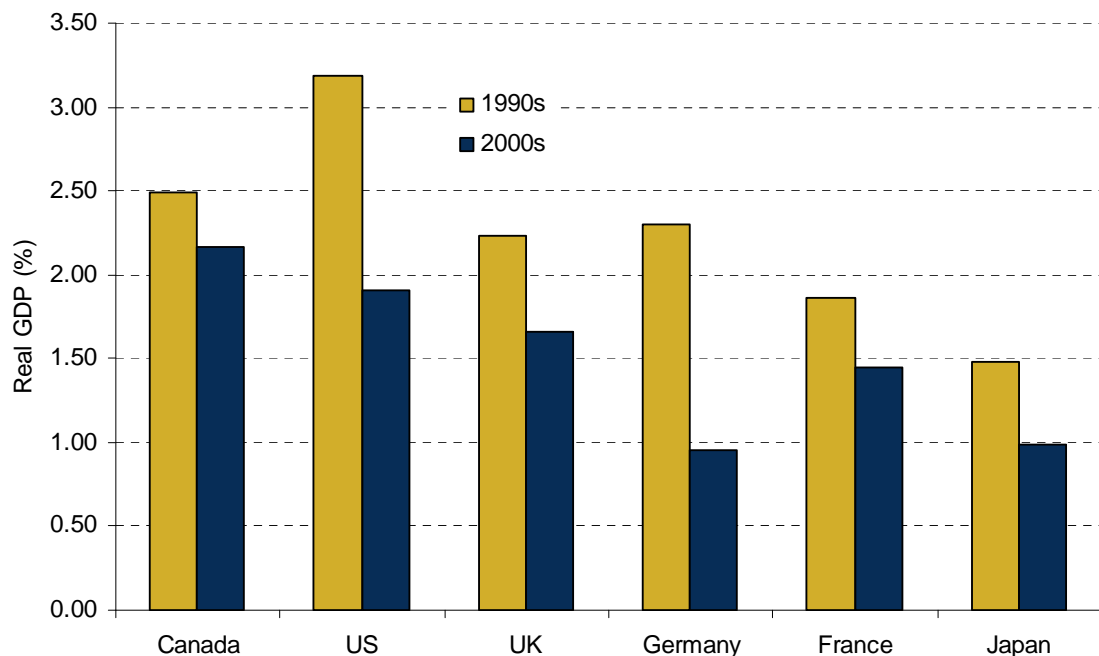


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Mr. Mather is a managing director in the Newport Beach office and head of global portfolio management. Previously, he led portfolio management in Europe, managed euro and pan-European portfolios and worked closely with many Allianz-related companies. He also served as a managing director of Allianz Global Investors KAG. Prior to these roles, Mr. Mather co-headed PIMCO's mortgage- and asset-backed securities team. Prior to joining PIMCO in 1998, he was a fixed income trader specializing in mortgage-backed securities at Goldman Sachs in New York. He has 16 years of investment experience and holds a master's degree in engineering, as well as undergraduate degrees, from the University of Pennsylvania.

The risk is rising that the US will enter a prolonged period of stagnant growth combined with a risk of outright deflation – similar to the environment that Japan entered in the 1990s. As Federal Reserve Bank of St. Louis President James Bullard recently noted, “The US is closer to a Japanese-style outcome today than any time in recent history.” (Quote from his paper, *Seven Faces of “The Peril.”*)

Is the US turning Japanese? Before rendering judgment, consider that although “Japanification” may not be the desired outcome for the US, it is far from the worst outcome. Despite having lost its economic vibrancy decades ago, Japan has managed to maintain positive real growth, though lower than other countries (Chart 1).



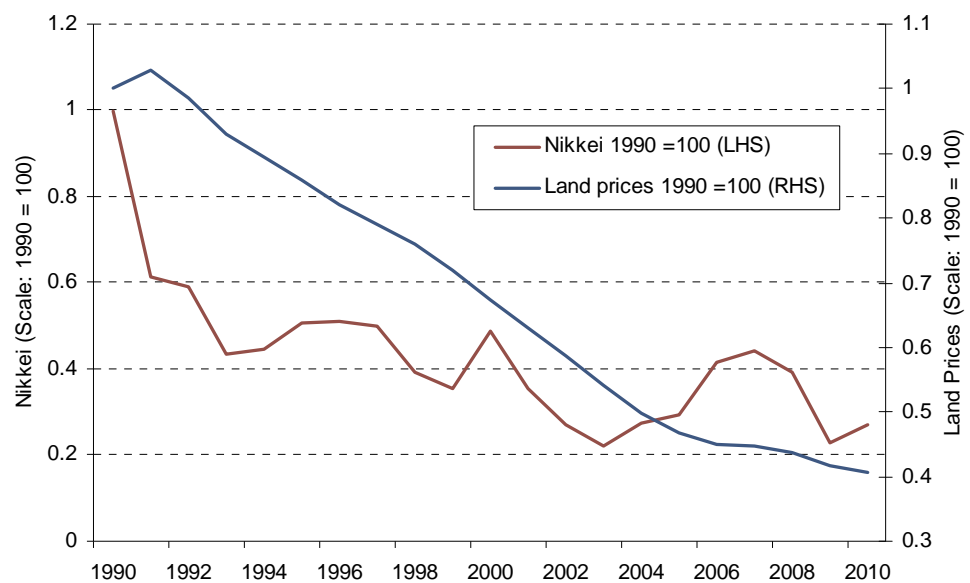
Source: Bloomberg

**Chart 1**

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Despite being positive, real growth was not enough to prevent deflation and the so-called Lost Decade in Japan. Indeed, moderating trend growth and deflation feel very bad even if real growth is on average positive. Importantly, the last 20 years in Japan have seen continuously deflating real estate and equity prices. The fall in asset prices has been punctuated with a few reversals, but prices are down more than 70% from peak levels (Chart 2). Deflation has reigned through most of the period and the general price level in Japan today is the same as in the early 1990s.



Source: Bloomberg

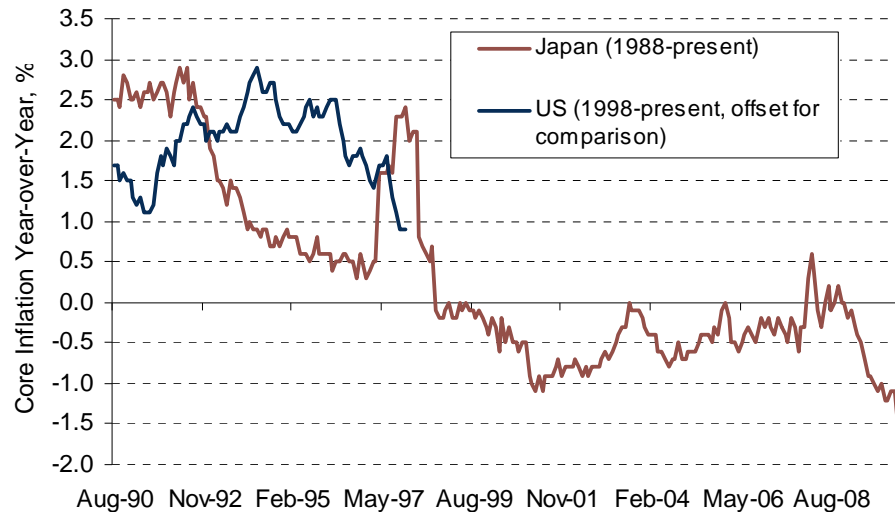
**Chart 2**

To be sure, the opposite could occur in the US – inflation sparked by accommodative monetary policy or rising demand for goods that companies have scaled back their ability to produce, and PIMCO is also incorporating this possibility in the set of long-term scenarios.

Still, we must appreciate Japan's Lost Decade, which resulted in an economic malaise and embedded a deflationary trend that is now in its second decade (Chart 3). And if a Japan-like deflationary scenario becomes the baseline for the US, it would have profound implications for asset prices. The US may yet escape such an outcome, but a comparison between the two countries reveals an uncomfortable similarity with respect to the roots of the crisis, the progression of economic turmoil and the policy response.

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Source: Bloomberg

**Chart 3**

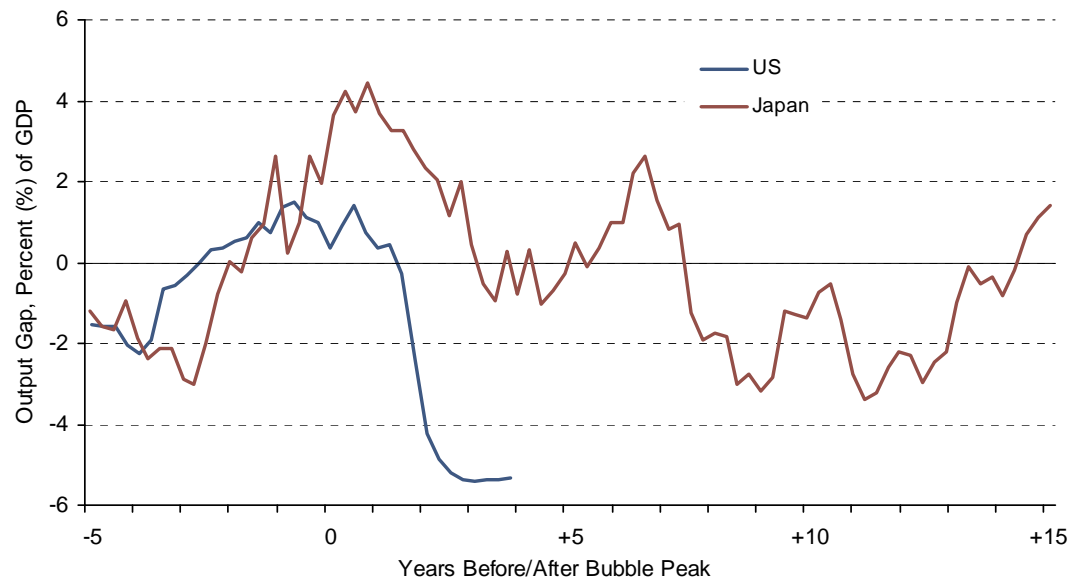
### Similarities and Differences

There are striking similarities between the US and Japan with respect to fundamental causes of the crisis. Both economies experienced rapid growth in debt, which fuelled bubbles in real estate (residential and commercial) and equity markets. Income did not grow fast enough to service the increasing debt load, which resulted in growing delinquency and defaults. Falling asset prices exacerbated the problem. For both countries, the toxic mix triggered a banking crisis and ushered in an era of economic turmoil.

Yet, there are important differences between the US and Japan. Chronologically, the US looks to be following a high-speed version of the Japanese scenario. The immediate economic crisis unfolded more quickly and was deeper in the US than Japan. The US experienced much larger loss of employment and developed a larger output gap than Japan did (Chart 4). On the optimistic side, the policy response in the US (both fiscal and monetary) has occurred much more quickly and with greater force than it did in Japan.

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Source: OECD (Organisation for Economic Co-operation and Development)

**Chart 4**

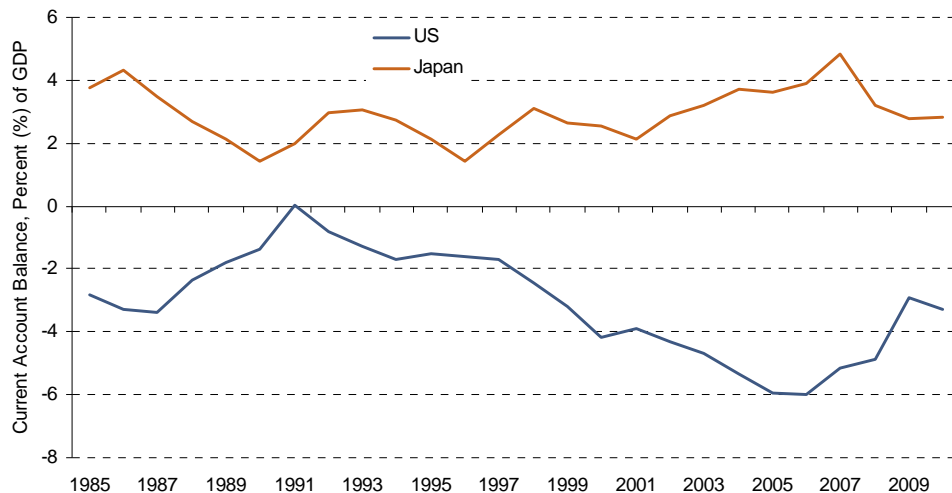
Demographic differences are frequently cited as the reason the US will fare differently than Japan. It is true that the Japanese population is now significantly older and declining in size while the US still has close to 1% population growth. But it is important to remember that the demographic composition of the US today is not so different from that of Japan in the early 1990s. So demographic differences alone cannot be used to argue for a completely different outcome for the US with respect to deflation. Demographic trends are creating especially strong deflationary impulses as the US undergoes a demographic shift that Japan confronted more than a decade ago.

Another important difference, and one that should not be dismissed, is the difference in national savings rate. Japan is a savings surplus country. It entered its crisis as creditor nation; it still runs a current account surplus; and so far it has continued to build national savings on yearly basis, despite the economic crisis. In contrast, the US is a debtor country on a national basis (Chart 5).

The US spends more than it earns every year and borrows the difference. Some might dismiss this, since the US benefits from having the world's reserve currency and maintains special borrowing privileges. This is probably true over the short term; but the US current account deficit is another manifestation of economic imbalances that have been allowed to build as if by virtue. As this situation is ultimately unsustainable, it presents an added vulnerability and an important difference to the Japanese experience.

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Source: IMF (International Monetary Fund)

Chart 5

### Limits to Policy Effectiveness

The limitations of policy action are currently being borne out in Japanese style. Despite record monetary and fiscal policy stimulus, economic growth remains very weak in the US. Just as in Japan, where arguably far too much of fiscal stimulus went to maintaining employment in uncompetitive industries and unproductive infrastructure, it is easy to now see that much of the US stimulus has *not* gone toward productive investment or increased the structural growth potential of the economy.

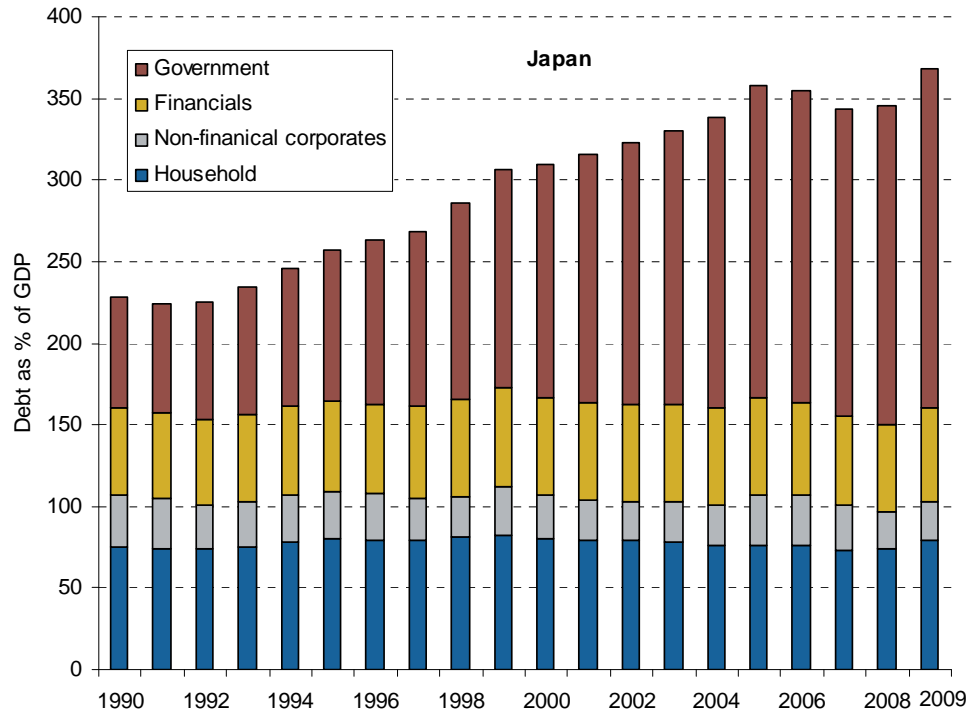
On the monetary policy side, conventional policy has been exhausted with rates at zero percent. Quantitative easing aggressively expanded the central banks' balance sheet but credit growth and broader money creation are failing. Any new monetary policy action will increasingly belong to the realm of experimentation, which is inherently unstable and prone to error.

In the second half of the 1990s, it was the rapid withdrawal of fiscal stimulus that led to a double-dip recession in Japan. Similarly, fiscal stimulus in the US is scheduled to be rapidly withdrawn over the coming quarters, and there is reason to doubt that the handoff from government spending to private sector growth will happen quickly enough to avert an economic slowdown.

Although the debate rages on in policy circles, Japan seems to have shown there are limits to the effectiveness of fiscal spending. This follows logically; having too much debt relative to income results in the need to delever at the national level. And while the government can temporarily offset the economic contraction that comes from loss of private sector demand, it becomes increasingly powerless over longer periods of time. Keynes' notion of "animal spirits" and private sector confidence are necessary to promote investment and job creation. Uncertainty regarding unsustainable debt dynamics are damaging unless the debt stock can be lowered or national income raised.

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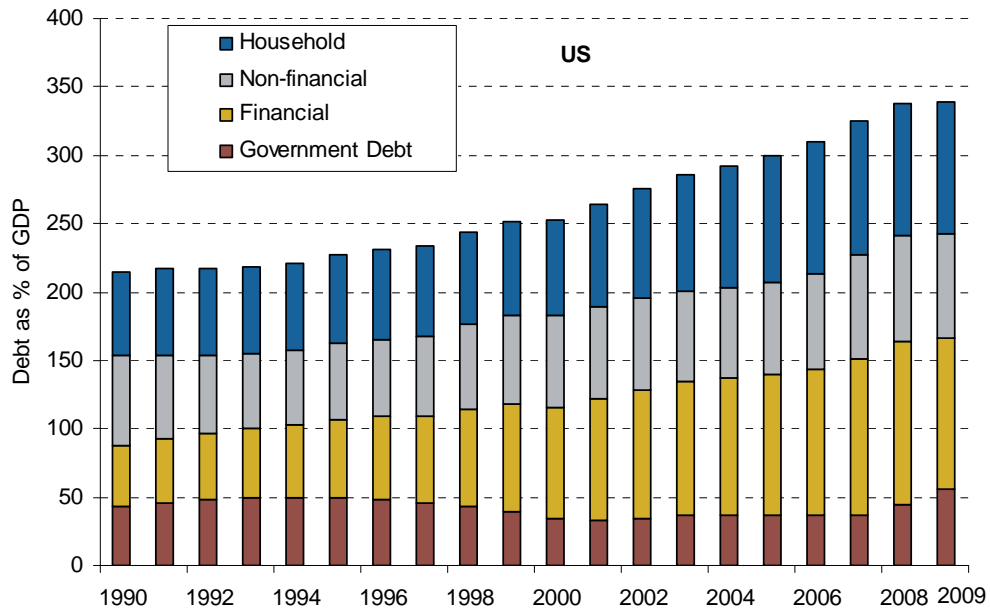
In Japan, debt-financed government spending has prevented delevering on a national level (Chart 6). Deflation caused the problem to become more ensconced. So far, the US is heading down a similar path with private sector delevering being more than offset by government borrowing so that national debt is continuing to rise (Chart 7).



Source: Cabinet Office, Japan

**Chart 6**

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Source: Haver

**Chart 7**

**Without Growth Strategy, Deflation Risk Grows**

Longer term, it is likely the US (and indeed much of the rest of the developed world) will be plagued with a muted rate of growth (PIMCO's New Normal economic outlook) coupled with rising deflationary risks.

Growth that allows debts to be serviced and reduced in an orderly way is the only realistic way to truncate the Japanese-style outcome. Of course, this is much easier said than done. But it would be refreshing if it were more often said. Instead, the policymaking debate seems hopelessly mired in short-term quick fixes designed to support the pre-crisis bubble economic structure.

Too much of the US economy is geared toward consumption and has become globally uncompetitive. Much of the capital stock has been mal-invested, and the industrial base that traditionally served as a breeding ground for innovation has been depleted and thereby lowered the potential growth rate of the economy. Far too much human capital is unproductively employed or completely idled while looking for jobs that do not exist. The social and economic costs of this lost potential are enormous and very deflationary.

Structural economic changes are needed to increase the growth profile of the US. Large-scale infrastructure projects involving sustainable energy would move the needle away from oil imports while also creating much-needed jobs. We need to take the global initiative on solar, wind and clean coal; China alone is expected to do more than the US this year on clean energy. Major investment in air and rail travel would also help improve US productivity and competitiveness over a long horizon.

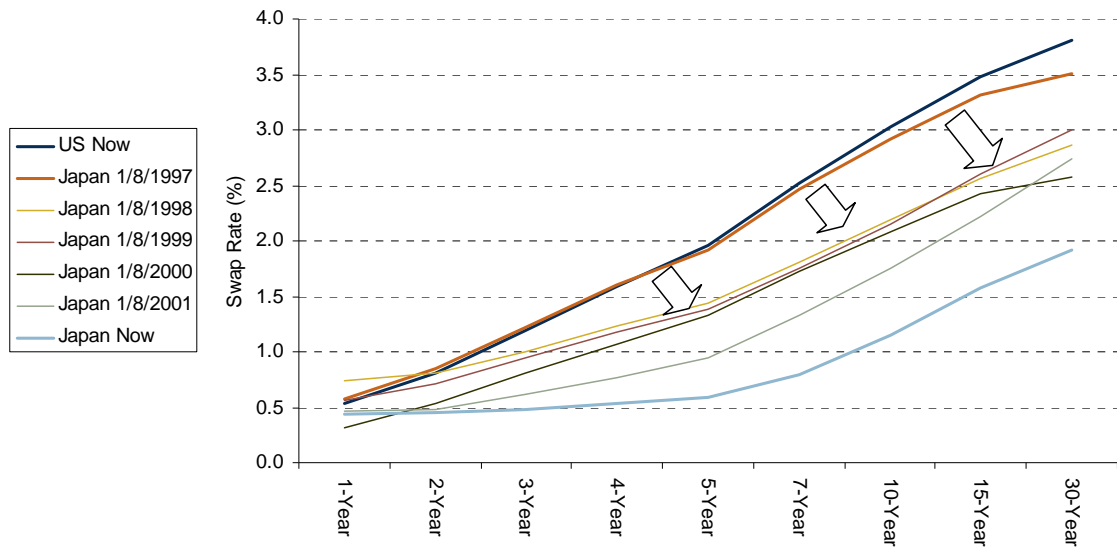
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But locked in an ideological political quagmire, the US risks heading down the same path that Japan followed. Deflation risks continue to rise. In this scenario, and just as with Japan, the monetary authority ends up being forced to do some heavy extended lifting.

It is likely the Federal Reserve will have no choice but to keep rates on hold for a very long period. Perhaps the Fed will ultimately specify a longer extended period or commit to capping rates at a very low level until a certain level of inflation is reached (as did Japan, with only partial success). Ultimately, more experimental monetary policy may be called for. As a first step this might involve more purchases of Treasuries by the central bank, as suggested recently by Fed President Bullard.

Preparing for the possibility of deflation is an important step at this juncture. As was the case in Japan, if deflation materialises, it will not be kind toward real estate and equity markets that assume positive inflation to support valuations. With respect to nominal bonds, the case of Japan provides an interesting roadmap. A focus on the intermediate maturity of the US Treasury market (five- to 10-year maturities) is warranted if the yield curve evolves as the Japanese curve did (Chart 8). In this environment it is this part of the yield curve that initially performs the best as deflation risks rise. In addition, capital gains may be harvested from rolling down the steep part of the yield curve even if the rate structure only changes slowly (as was the case in Japan). If more experimental monetary policy is conducted at some stage, it is likely to benefit this maturity bucket more than longer maturities.

**US Now Compares to Japan in 1997**



Source: Bloomberg

**Chart 8**

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