If you believe the bond markets, we are all Japanese now

By Peter Tasker

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Low yields have an easy explanation: declining growth and low inflation, writes Peter Tasker

When William Gibson, the cyberpunk novelist, declared at the turn of the century that “Japan is still the future”, he was probably not thinking of bond yields. Yet recent action in bond markets is a sign that the global economy risks following Japan’s unhappy path.

Back then, Japan’s super-low interest rates were a unique phenomenon that observers struggled to rationalise. Was it patriotism that led Japanese investors to plough money into government bonds that paid a pittance, even as public debt grew? Surely it was only a matter of time before yields would soar. This belief was common not just among hedge funds and rating agencies but in Japan itself, where Japanese Bonds, Main Kouda’s novel of financial apocalypse, became a bestseller in 2001.

What has happened since the financial crisis of 2008 is the exact reverse. The rest of the world has converged with Japan. Today 10-year bond yields are 0.4 per cent in Switzerland, 0.9 per cent in Germany and 1.2 per cent in France. Outside the troubled eurozone, the picture is not much different. The UK and the US are currently the best performing developed economies, but bond yields remain close to multi-century lows at about 2 per cent. What was once an anomaly has become standard.

It once seemed that Asia’s growth momentum might steer it clear of the deflationary sludge in which the developed world was mired. If bond markets are any guide, such optimism is no longer warranted. Local currency bonds issued by Thailand, the focal point of the 1997-8 Asian crisis, yield just 3.3 per cent. Bonds in Singapore, South Korea, Hong Kong and Taiwan pay even less.

Bond prices, which move inversely to yields, are high, but not without reason. If there is a bubble, it is not in government debt but internet stocks, prime property and contemporary art. As in Japan since the mid-1990s, low bond yields have a fundamental explanation: the prospect of declining growth and low inflation almost everywhere.

Consumer prices are already falling not just in eurozone countries such as Belgium, Spain and Italy, but in Sweden and Poland too. This year the UK is expected to grow at 3.5 per cent, the fastest among the developed countries, yet the Bank of England recently halved its forecast of wage growth to 1.25 per cent. As Albert Edwards, a Société Générale strategist, points out, US inflation expectations have declined precipitously since the summer even as the Federal Reserve plots its exit from quantitative easing. Meanwhile the Chinese economy appears to be slowing.

What has brought us to this unhappy juncture? Factors often cited include globalisation and increasing inequality. The new economy itself appears to have a deflationary influence as it destroys intermediaries such as bookshops and concentrates wealth in a few hands.

Even so it is worth recalling that the Japan that slid into deflation in the 1990s was not particularly globalised, had a fairly egalitarian distribution of wealth and negligible exposure to internet commerce. The paramount factor was the knock-on effect of an unprecedented asset market collapse. Bad policy compounded the damage and spawned a feedback loop between the asset markets and the real economy that continued for the best part of 20 years. Japanese authorities were too slow to clean up the banking system, too cautious in using monetary policy and too scared of Ms Kouda’s bond blow-up to use fiscal policy creatively. Sadly, this last tendency remains; the administration of Shinzo Abe increased the consumption tax by 3 per cent this spring.

The message of the bond markets is clear. There is not a whiff of inflationary risk and governments have the most favourable borrowing terms imaginable for funding targeted tax cuts, infrastructure projects – whatever is needed to prove Mr Gibson wrong.

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