Why was Japan not engulfed by antiglobalist tide?

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Abstract

Antiglobalization has gained momentum in the West in recent years, including the introduction of protectionist trade policies and stricter controls on immigration, but so far Japan has set itself apart from such political trends. Why was Japan not engulfed by antiglobalist tide? We first discuss the general backgrounds how antiglobalization trend emerges from the perspective of real economy as well as global financial market development and will try to sort out the reason why Japan so far has been immune to antiblobalism. With those backgronds in mind, we will next discuss the risk that the favorable conditions that have kept antiglobalization at bay in Japan can be lost in the future.

Introduction

"A specter is haunting Europe — the specter of communism."

Thus begins the Communist Manifesto of Karl Marx and Friedrich Engels. If we replaced "communism" by "antiglobalization," it would be an apt description of the current state of affairs worldwide. In the US, which one might have expected to act as the global hegemon, the Trump administration has pursued increasingly protectionist trade policies ever since it was formed. Similarly, there have been moves to tighten the rules governing immigration, as symbolized by "the wall" (with Mexico). In Europe there have been markedly similar developments. Brexit can be seen as an example of antiglobalization, while the rise of populist, far-right, anti-immigration movements in the EU is not a recent development.

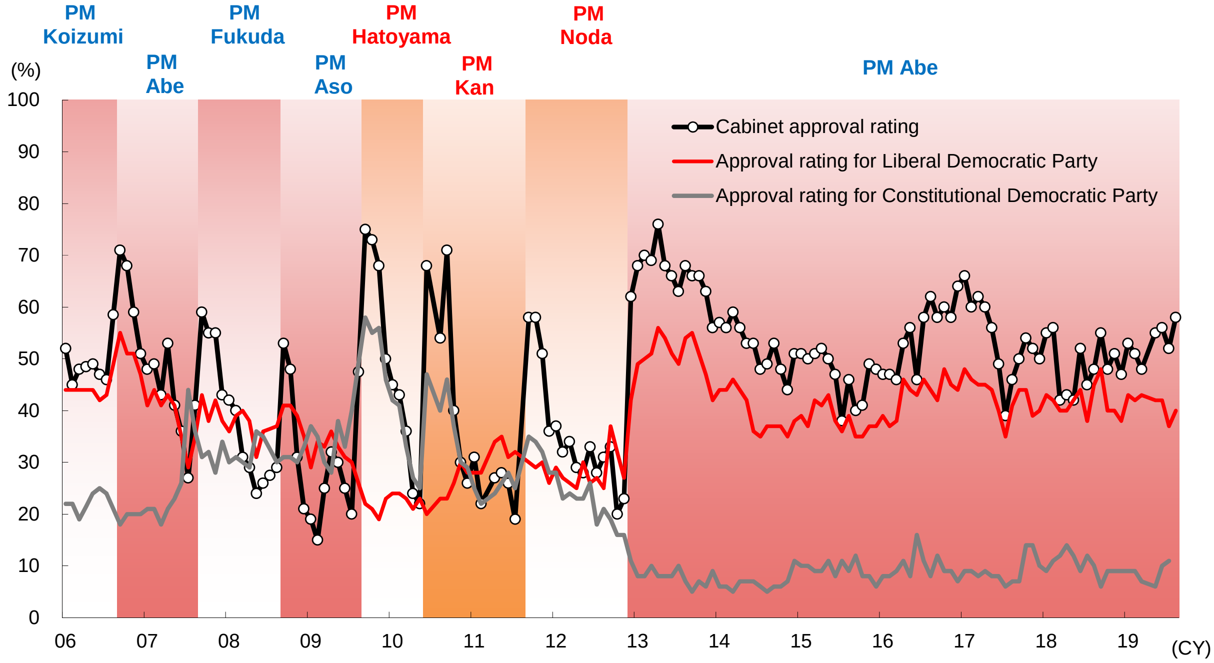
One country, however, would appear to have been spared the specter of antiglobalization. That country is Japan. With scarcely a sideways glance at the increasingly protectionist policies pursued by the US, Japan has taken a lead in forming a Trans-Pacific Partnership (TPP) of eleven countries and resolutely pursued multilateral trade agreements.

Domestically, too, the second Abe administration has enjoyed a fair degree of stability in terms of its approval ratings (Figure 1) and ability to govern in the seven years since it was formed in December 2012, while Japanese politics have been largely free of the populism behind much of the antiglobalization elsewhere.

Indeed, in contrast to the increasing calls for tighter controls on immigration in Europe and the US, Japan has been one of a minority of countries that have eased restrictions on the flow of labor, goods, and capital by, for example, reforming its Immigration Control Act with effect from April 2019 to allow more foreign workers to enter the country with the new status of "specified skilled workers."

It will be interesting to see whether Japan is able to continue to be spared the specter of antiglobalization. In this report we analyze the origins of antiglobalist movements around the world in an attempt to identify the factors that have kept Japanese politics largely free of antiglobalization. We then consider whether Japan could, at some point in the future, also be engulfed by the antiglobalist tide.

Fig. 1: Approval ratings of Japanese cabinets and ruling and opposition parties



Note: (1) The names are those of the prime ministers that headed each administration. (2) The names in red are those of non-LDP prime ministers (Yukio Hatayama, Naoto Kan, Yoshihiko Noda). (3) Data for months when no survey was carried out have been extrapolated from previous and subsequent surveys. (4) The approval ratings of the Constitutional Democratic Party are for the period since November 2017, when the party's approval rating was first surveyed. The data for the period before then are for the Democratic Party and the Democratic Party of Japan.

Source: Nomura, based on Nikkei data

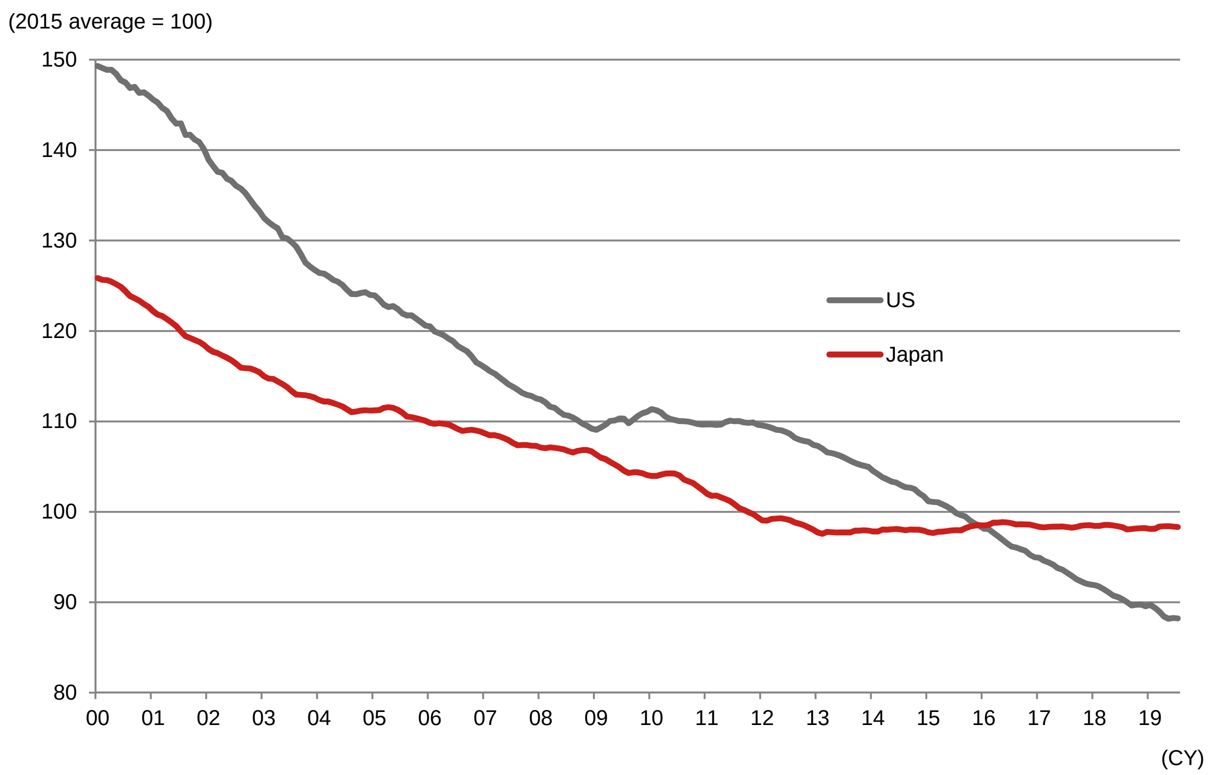
1. The origins of antiglobalization (1): real economic aspects

Ultimately, the origins of antiglobalization can, in our view, be found in a rejection by many people of some of the negative effects of globalization. These negative effects take a variety of forms. We begin by considering the effect of globalization on prices.

By stimulating growth in emerging economies, opening up the markets of these economies, and substantially increasing the supply of relatively unskilled manufacturing labor, globalization appears to have caused a supply shock. Not only did this supply shock have the negative effect of reducing the demand for unskilled labor in the advanced economies: it also had the positive effects of boosting the purchasing power of consumers in these economies by depressing the price of finished goods and of increasing the value added by companies in these economies by depressing the price of intermediate goods.

However, monetary policies aimed at maintaining inflation rates in these economies may have had the unintended consequence of accelerating a rise in service prices as goods prices declined in relative terms as a result of globalization (Figure 2). And, while overall levels of employment may have been maintained or increased as unskilled workers moved from manufacturing to services, wage levels may not have risen significantly.

Fig. 2: The price of goods relative to services (CPI basis, ex food and energy)



Source: Nomura, based on Ministry of Internal Affairs and Communications, US Department of Labor data

As a result, real wages in the economy as a whole can be expected to decline in proportion to the relative increase in service prices. It is therefore possible to see the dissatisfaction of many people, especially in the US, with their standard of living and their support for antiglobalization, even though the country has full employment, as the result of such developments.

2. The origins of antiglobalization (2): financial aspects

The above assessment of the effect globalization has had as a result of its impact on prices is now generally accepted. In contrast, the financial effects of globalization and their repercussions are probably a relatively new argument.

As a result of globalization, there was a shift in the production of goods by unskilled labor to emerging economies as well as a transfer of income from the advanced economies as the global value chain deepened, with external imbalances as reflected by current account surpluses and deficits widening across the board (Figure 3).

The transfer of income to emerging economies and their current account surpluses have been largely in the form of claims on advanced economies, with the lion's share in US dollars as the currency used to settle transactions as global value chains have deepened (Figure 4). This accumulation of dollar assets by emerging economies has probably exerted downward pressure on US interest rates, especially the natural rate of interest, as well as on goods prices. If we reverse the cause-and-effect relationship of the global savings glut hypothesis advanced by former Fed chair Ben Bernanke in 2005 as an explanation of widening current account imbalances, especially in emerging economies, we can see that these imbalances resulted in the global savings glut, depressing US interest rates in particular.

This decline in the natural rate of interest may also have contributed to the increase in emerging economies' dollar liabilities (Figure 5). As this increase would result in capital outflows from emerging economies in the event of a financial shock, making it more difficult for them to borrow dollars, it gives them an added incentive to increase their dollar reserves in readiness for such an event.

The resulting further decline in the US natural rate of interest may have prolonged the unconventional monetary accommodation that followed the global financial crisis of 2008-09 by reducing the effectiveness of the conventional monetary policies adopted by central banks, and especially the Fed, in the face of declining goods prices. Ironically, however, the prolonged period of ultra-low interest rates produced by this unconventional monetary accommodation probably contributed to the mechanism whereby emerging economies accumulated more dollar liabilities.

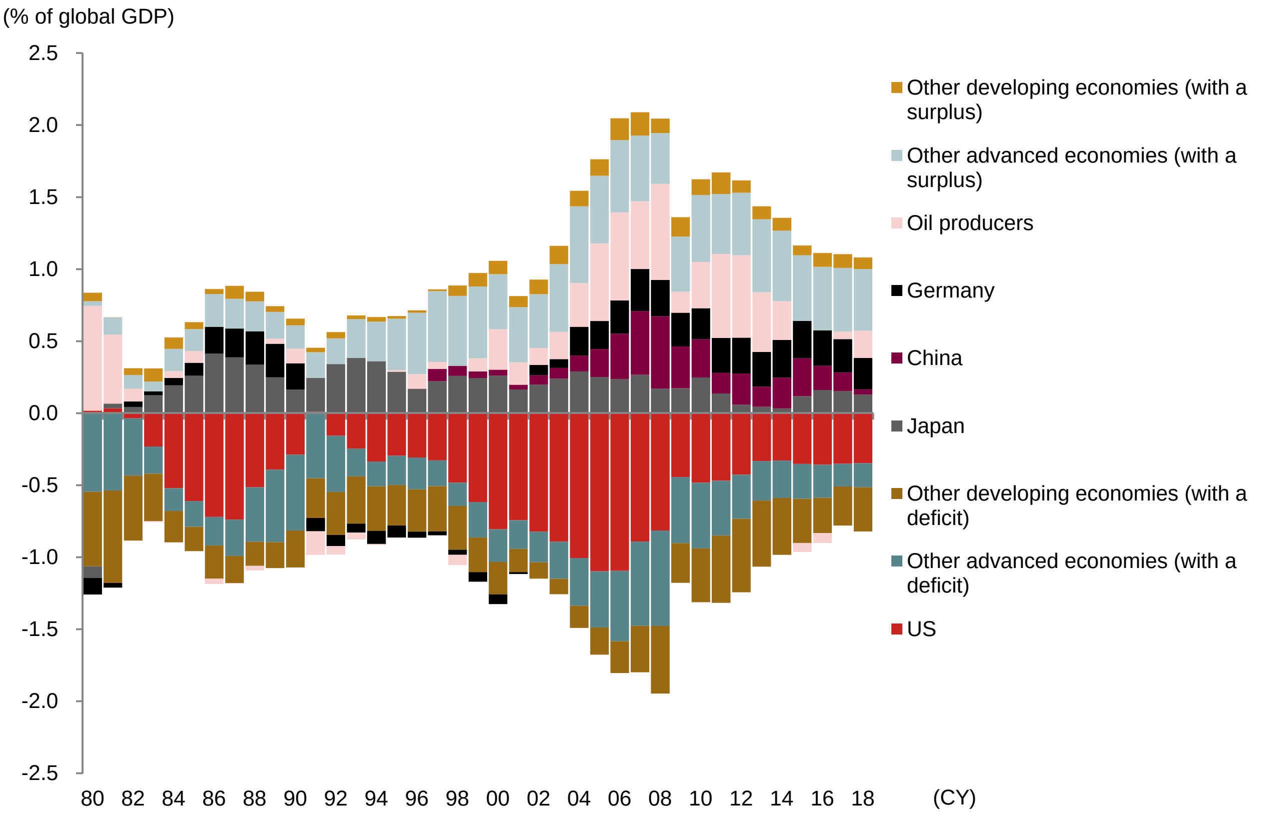
Those economies whose dollar assets and liabilities have both increased have increasingly felt the impact of fluctuations in US monetary policy even if their currencies were not originally tied to the dollar. In other words, they faced tighter monetary conditions when the US shifted from unconventional monetary policies to a more normal monetary policy in 2015-18. US dollar monetary conditions probably tightened more than actual normalization in 2018, when the Trump administration expanded fiscal policy by cutting taxes and increasing infrastructure investment at a time when the US output gap was already very narrow.

Also, despite increasing expectations that the Fed will loosen its monetary policy, with the FOMC actually cutting rates at its July meeting, there has been little sign of a shift of funds from US dollars to emerging economy currencies, and the US dollar effective exchange rate has remained stubbornly high because of aversion to risk, including a continued increase in emerging economies' dollar liabilities (Figure 6).

One of the reasons the Fed moved to cut interest rates was concern that the uncertainty created by the Trump administration's antiglobalist trade policies, especially on China, might slow economic growth. Ironically, concern that this uncertainty could affect emerging economies more than the US has resulted in monetary conditions remaining tight with no sign of any major change in capital flows to and from emerging economies despite lower US interest rates.

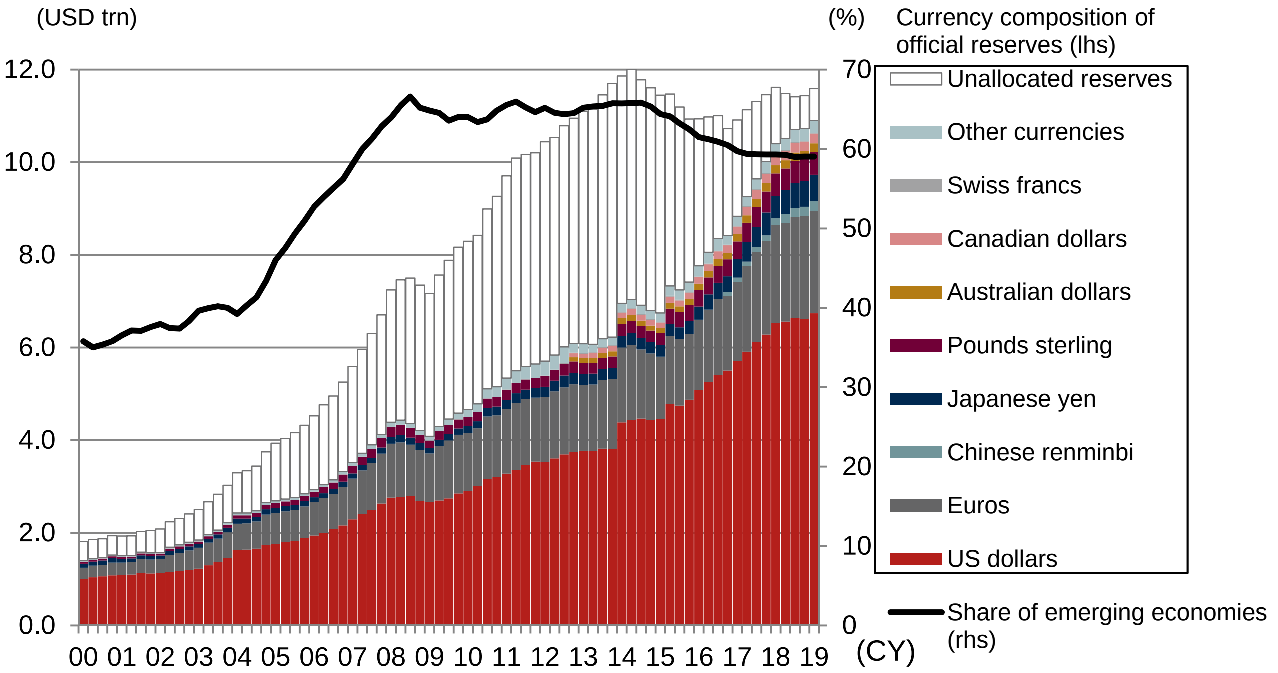
If this structural accumulation of US dollar assets and liabilities, especially by emerging economies, is the reason why dollar-based monetary conditions have remained tight, it may have contributed to the smoldering discontent reflected in antiglobalization by inhibiting economic growth.

Fig. 3: Breakdown of global current account balances by country or group of countries



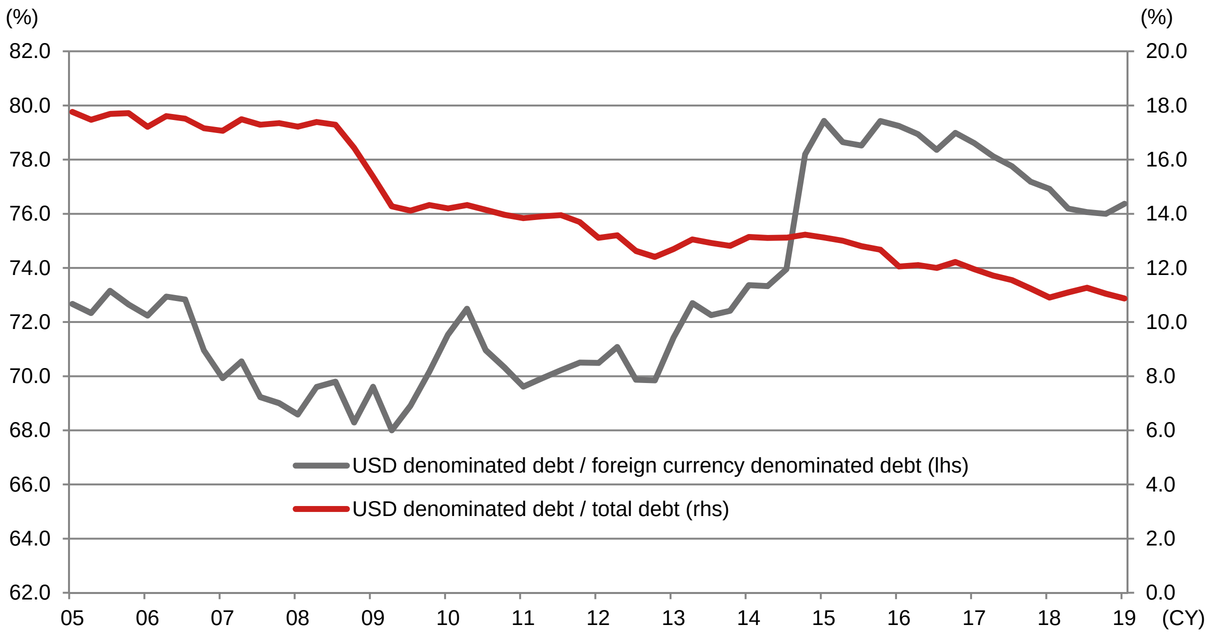
Source: Nomura, based on IMF data

Fig. 4: Currency composition of global foreign exchange reserves and the proportion belonging to emerging economies



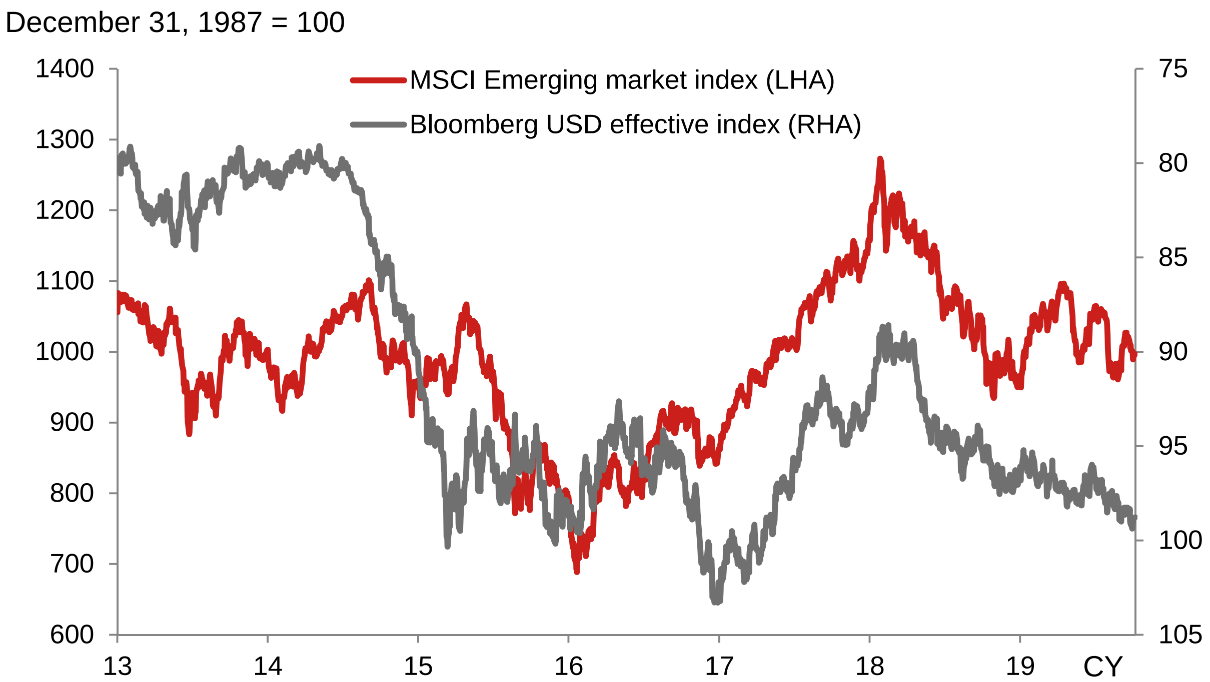
Source: Nomura, based on IMF data

Fig. 5: US dollar debt as a proportion of emerging economy debt



Source: Nomura, based on IIF data

Fig. 6: US dollar effective exchange rate and emerging economy share prices



Source: Nomura, based on Bloomberg data

3. The reasons Japan has remained largely free of antiglobalization

This analysis sheds some light on why the antiglobalization movement has not gained much support in Japan.

If we compare Japan with the US, we see that in Japan the decline in the price of goods relative to services has been gentle and has more or less trended sideways since 2012. This may indicate that in Japan the downward pressure on unskilled job opportunities and the decline in real purchasing power as a result of the relative increase in service prices have been gentle and could explain why there has generally not been much support there for antiglobalization.

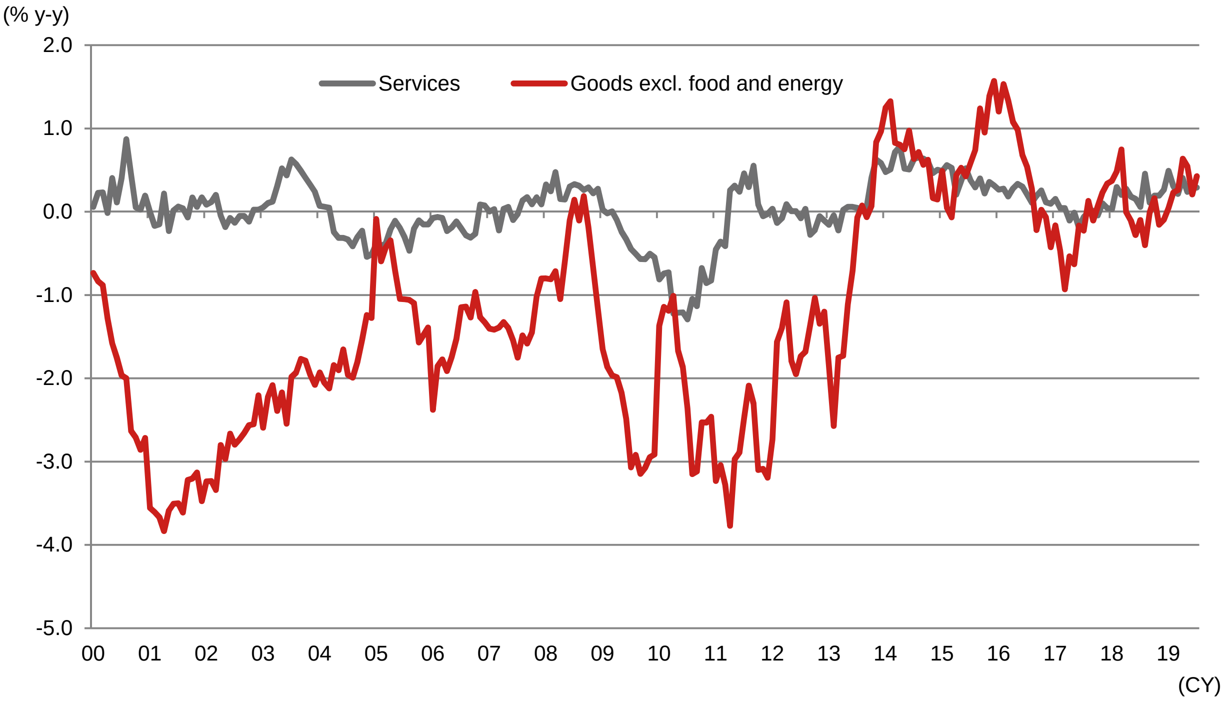
We see the following as possible reasons for the gentle decline in the relative price of goods and its sideways trend in recent years in Japan.

First, because of major waves of yen appreciation in the past, Japan probably experienced the marked acceleration in the relative decline of goods prices and the outsourcing of manufacturing that other advanced economies have experienced since the 2000s sooner than these other economies. Furthermore, there may have been downward pressure on service prices as well as goods prices because of extensive and prolonged deflationary pressure from an increasingly negative output gap. Downward pressure on public service prices as a result of deregulation, mainly under the Koizumi administration, may also have contributed (Figure 7).

Yet another possibility is that monetary policy since the formation of the second Abe administration at the end of 2012 may have been more effective than in other economies. The fact that goods prices in Japan stopped declining and began to rise was the result of the yen's depreciation versus the dollar, which itself was the result of the BOJ's aggressive monetary easing.

Nor should we forget yet another aspect of globalization: namely, dollarization. Although Japan's dollar and other foreign assets have continued to accumulate, its current account surplus has meant that it has not accumulated dollar and other foreign-currency liabilities. This may explain why Japan has remained unaffected by the dollarization that has accompanied globalization and partly account for the effectiveness of the BOJ's monetary policy since Haruhiko Kuroda became governor in 2013.

Fig. 7: Japanese CPI-based goods and service prices



Source: Nomura, based on Ministry of Internal Affairs and Communications data

4. Is Japan likely to remain free of antiglobalization?

As a result of the aforementioned advantages, Japan has not been engulfed by the antiglobalist tide. However, can Japanese politics remain largely free of antiglobalization?

While there are unlikely to be any major changes any time soon in the structural factors that have enabled Japan to avoid antiglobalization (eg, its social stability as exemplified by its low crime rate and its political stability as a result of the ruling coalition's stable majority), we cannot rule out the possibility that the favorable economic conditions that have kept antiglobalization at bay may one day cease to exist.

As we have pointed out, Japan experienced globalization in the form of outsourcing manufacturing jobs at a time when other advanced economies had yet to experience the rise of antiglobalization. However, there is a risk that Japan's service industry and the jobs that depend on it could be hit by a wave of globalization, with painful repercussions for ordinary Japanese. Because of various technological advances, the outsourcing of service jobs that would once have been problematic is now a realistic possibility. Furthermore, moves already in train to slowly open up Japan's labor market to ease the structural labor shortages resulting from a declining labor force could contribute to such a development, even though it might look like opening the windows just as the global economy is about to be buffeted by the storm of antiglobalization.

Even the fact that Japan's financial markets have not become dollarized, which has helped to stem the tide of antiglobalization, should be seen as slowly changing.

In recent years the proportion of JGBs held by nonresident investors has risen. We think that one of the reasons for this, in addition to the premium that dollar-based investors have been able to earn by hedging the exchange rate risk of holding yen bonds ever since the BOJ adopted a negative interest rate policy, has been the increasing relative return that such investors have been able to earn as a result of a widening of the dollar-yen basis, a development that we attribute partly to global dollarization (ie, the increasing structural demand for dollars as a low-risk asset). Therefore it is hardly surprising that the proportion of investment in JGBs by nonresident investors, especially those, such as hedge funds, with a short investment horizon, rather than central banks managing official reserves with a long investment horizon, has increased, even though both are by definition "nonresident investors." (Figure 8)

This invisible dollarization of the yen interest rate market could reduce the effectiveness of the BOJ's monetary policy.

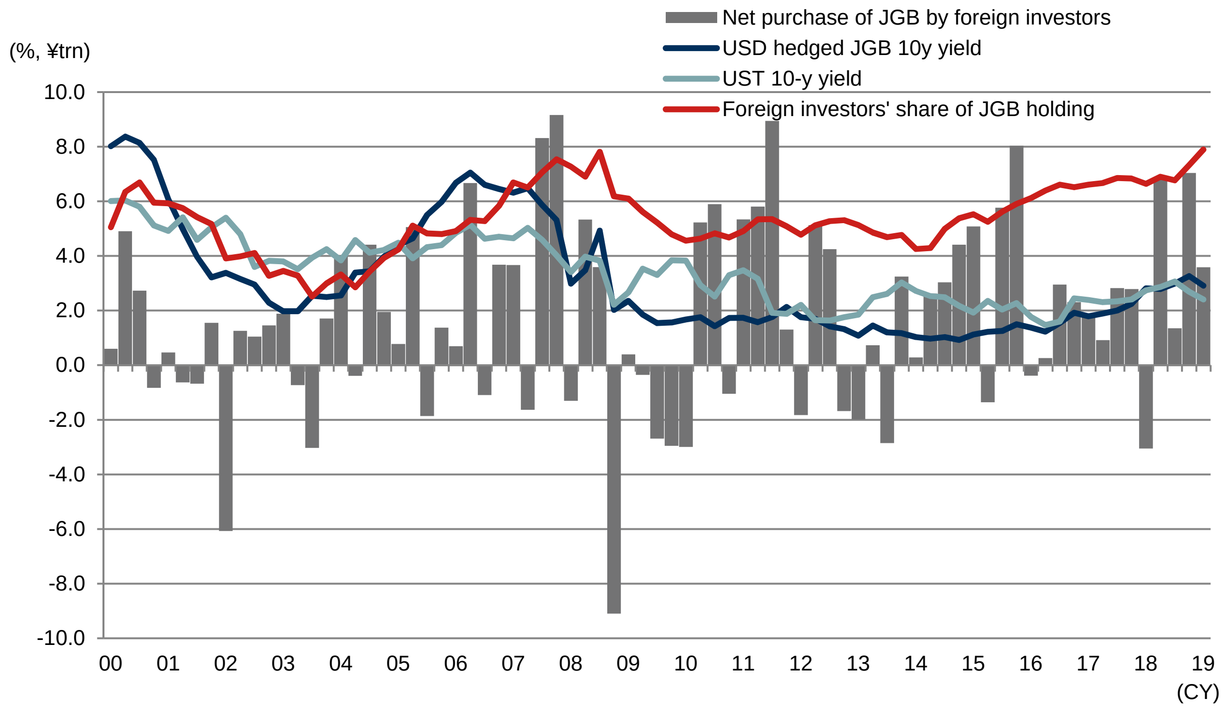
Under its current policy of QQE with yield curve control the BOJ has continued to ease monetary conditions by controlling the JGB yield curve in what it considers to be the best way to achieve economic growth and raise the inflation rate. In pursuit of this policy it has adopted the rate on current account balances (currently set at -0.1%) as its short-term policy interest rate and a target (currently around 0%) for the yield on 10-year JGBs as its long-term policy interest rate.

However, as a result of (1) the Fed's decision to lower interest rates because of the increasing uncertainty surrounding the global economy as a result of the intensification of the US-China trade dispute and (2) the market's increasing expectations that the Fed will continue to ease its monetary policy, dollar interest rates have declined substantially. In response to this, yen interest rates, including JGB yields, have also declined substantially, as a result of which the yield on 10-year JGBs is now significantly lower than the BOJ's target.

We therefore think that this invisible dollarization of the yen interest rate market has impaired the effectiveness of the BOJ's monetary policy not only by restricting the BOJ's scope to control interest rates but also by making it more difficult for the BOJ to achieve the original aim of yield curve control: namely, to mitigate the negative impact on Japanese financial institutions and institutional investors of an excessive decline in long and super-long interest rates as well as an excessive flattening of the yield curve.

This is not to say that the aforementioned two factors will have an immediate and tangible impact on the Japanese economy and people's daily lives. However, we cannot rule out altogether the possibility that at some point in the future the negative aspects of globalization could affect Japan and lead politicians to adopt increasingly antiglobalist policies.

Fig. 8: Nonresident investors' JGB holdings and comparison of US Treasury yields and US dollar-hedged JGB yields



Source: Nomura, based on BOJ and Bloomberg data

Conclusion

Antiglobalization has gained momentum in the West in recent years, including the introduction of protectionist trade policies and stricter controls on immigration, but so far Japan has set itself apart from such political trends.

Generally speaking, the background to antiglobalization is said to lie in the real economy, in that a hollowing out of industry and employment occurs as the value chain deepens as a result of globalization, leading to low-skilled jobs being transferred to emerging economies. Globalization of the production of goods results in lower prices of goods, but a relative increase in the price of services, leading to a decline in the effective purchasing power of households in more economically developed regions, and this can also lead to people feeling more dissatisfied. In addition, we think monetary factors have also had an impact as the increase in US dollar-denominated assets and liabilities resulting from faster growth in emerging economies exerts downward pressure on the US natural rate of interest, and lowers the effectiveness of monetary policy in many regions.

In Japan, it could be that the detrimental impact on households from globalization has been eased somewhat by state regulations being eased, reining in the relative rise in service prices. With Japan unaffected by the dollarization of foreign debt, we also think that antiglobalization momentum in Japan was kept in check by the effectiveness of the Bank of Japan's quantitative and qualitative easing (QQE) program under Governor Haruhiko Kuroda from 2013 to boost growth and normalize inflation.

The favorable conditions that have kept antiglobalization at bay in Japan may one day cease to exist. This could be triggered by the outsourcing of service industry jobs, allowing more foreign workers to enter the country with the new status of "specified skilled workers" in stages, and a rising dependence of yen interest rates and monetary policy on the US dollar resulting from nonresident investors holding more JGBs.