Market Review

Market Views

8th July 2010

Threadneedle's outlook for the Japanese economy

In response to the pledge of Japan's new Prime Minister, Naoto Kan, to beat deflation and achieve stable economic growth of 2% a year, **Ian Burden, fund manager of Threadneedle's Japan Fund**, comments on the challenges facing Naoto Kan and his government and the longer term outlook for the Japanese economy.

"New prime ministers in Japan, as elsewhere, tend to assume office with relatively aggressive targets which are subsequently often not achieved. Japan is on an unsustainable fiscal path and the first thing Mr Kan needs to do is to reverse fiscal and monetary policy, by this I mean achieve tighter fiscal and looser monetary settings, with higher nominal growth rates also required.

"It may seem odd to characterise monetary policy as "tight" yet relative to CPI, which has been negative, "real" interest rates in Japan have been high. This is a prime reason why the domestic government bond market (JGB's) has been extremely attractive to domestic institutions.

"At present Japan's tax base is too narrow, with the current sales tax of 5% needing to rise over the longer term towards VAT levels seen in the EU. At the same time, and to avoid a sales tax increase being too deflationary, there is potential for a reduction in corporate tax levels."

Burden continues, "The issue of deflation is problematic in the sense that we believe the Bank of Japan does not have the view that this is purely a monetary manifestation, since Japan has a structural output gap in the domestic economy which may increasingly be a function of demographics.

"We also believe the Bank of Japan is both extremely mindful of the fiscal profligacy which has resulted from domestic political vested interests and the fact that very low nominal interest rates in 10 year JGB's allow a large fiscal deficit to be relatively easily funded in the short term, i.e. the positive side effect of deflation . This makes the Bank of Japan very reluctant to have looser monetary policy or accept an inflation target.

"Against this background and from a demographic perspective it's virtually impossible to quantify the sustainable nominal growth rate of the economy. Whilst clearly the zero nominal growth shown over the last decade is unacceptable, a 2% level seems high."

Burden concludes, "Japan finds itself confronting a series of fiscal, monetary and growth challenges which will be very difficult to balance. However, whilst this is no different to Europe and the US, the magnitude is sometimes overstated. In addition, Japan's current account surplus and domestic savings means it has more time than western institutions generally acknowledge. This is not necessarily positive as the default position is inertia. Overall I believe Japan's long-term prospects are sound, but it will be a challenge to achieve 2% economic growth in the near future."

For further comment please contact:

Julie Seytre, Global PR officer + 44 (0) 20 7464 5964
Julie.Seytre@threadneedle.com

About Threadneedle

Threadneedle was founded in 1994. It actively manages £64bn* of assets providing investment solutions for pension schemes, insurers, private investors, corporations, mutual funds and affiliate group companies. (US$97bn, €71.8bn). Source: Threadneedle, as at 31.03.10.

Threadneedle has investment expertise across equities, bonds, property and hedge funds with over 140 talented investment professionals. As a truly international asset manager, Threadneedle reaches customers in over 80 countries and its distribution reaches across four continents.

For more information, visit www.threadneedle.com

Threadneedle is the international investment platform and subsidiary for Ameriprise Financial, a leading US financial planning and services company with more than 12,000 financial advisors and registered representatives that provides solutions for clients' asset accumulation, income management and insurance protection needs. Ameriprise Financial was formerly known as the American Express Financial Corporation. It is an independent, publicly traded company (NYSE: AMP). For more information, visit www.ameriprise.com.