VAKIFBANK GLOBAL ECONOMY WEEKLY

Will US be next Japan?

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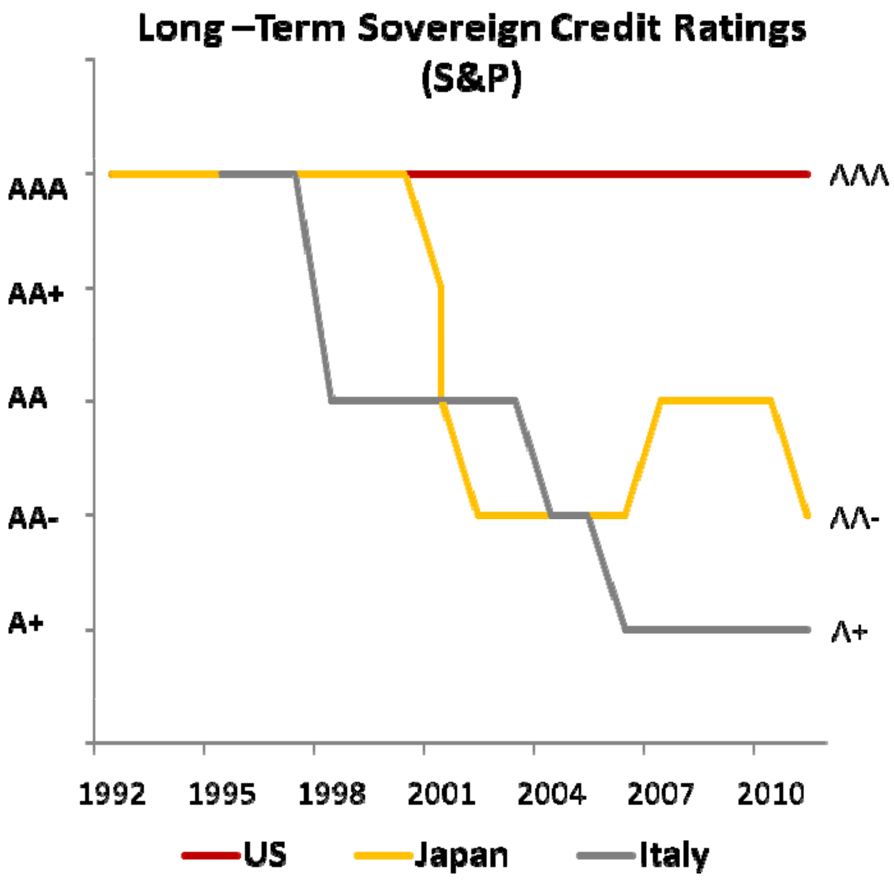
S&P's Japan downgrade raised fears that US will be the next...

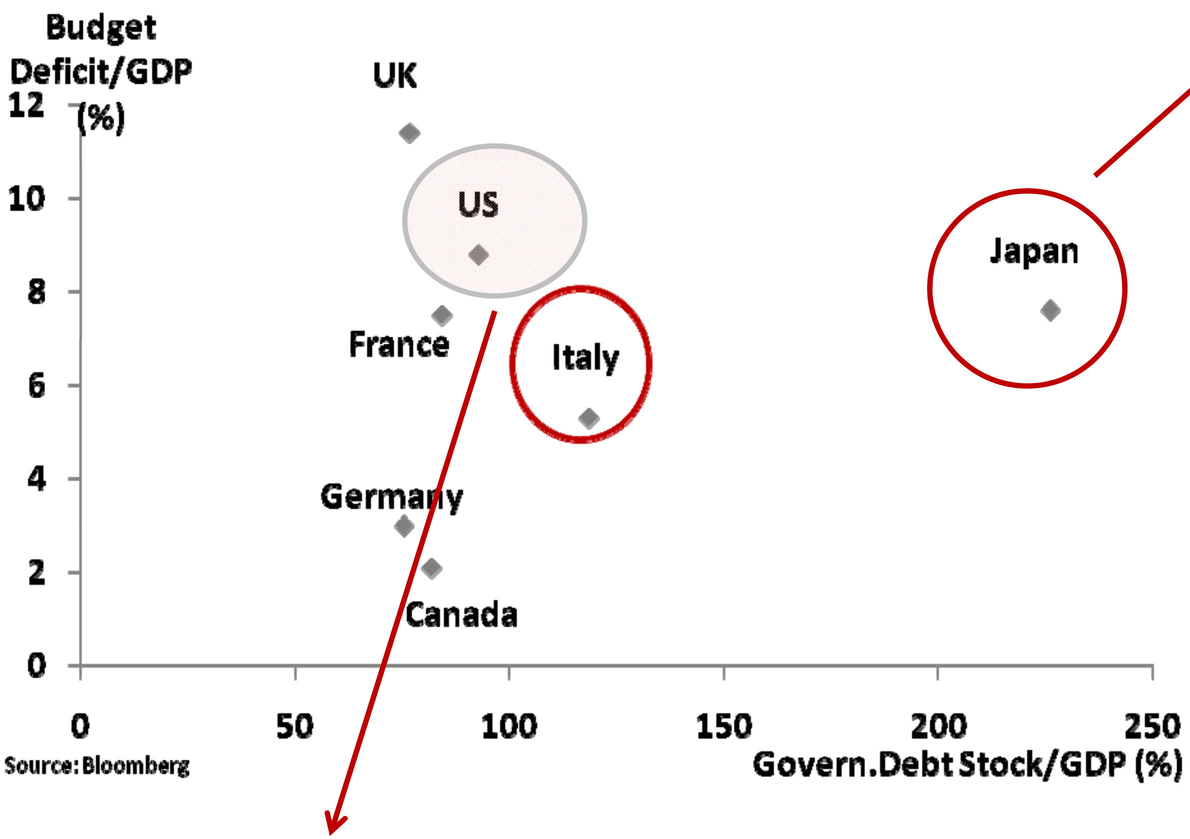


Source: Bloomberg

- S&P downgraded Japan's long term sovereign rating from 'AA' to 'AA-' while affirming the outlook as stable.
- The reasons for the downgrade;
  - ✓ Government debt ratios will continue to rise and reach the highest level in the mid-2020s.
  - ✓ Fast-aging population and deflation are risky factors for the economy.
  - ✓ Government doesn't have a sufficient strategy to challenge the debt problems.
- Among G7 countries, after Italy's downgrade (from 'AA-' to 'A+'), Japan is the first country which was downgraded by S&P.

Will US with high debt, high unemployment rate and deflation face downgrade like Japan?

1- Budget Deficit and Government Debt Stock Problems …

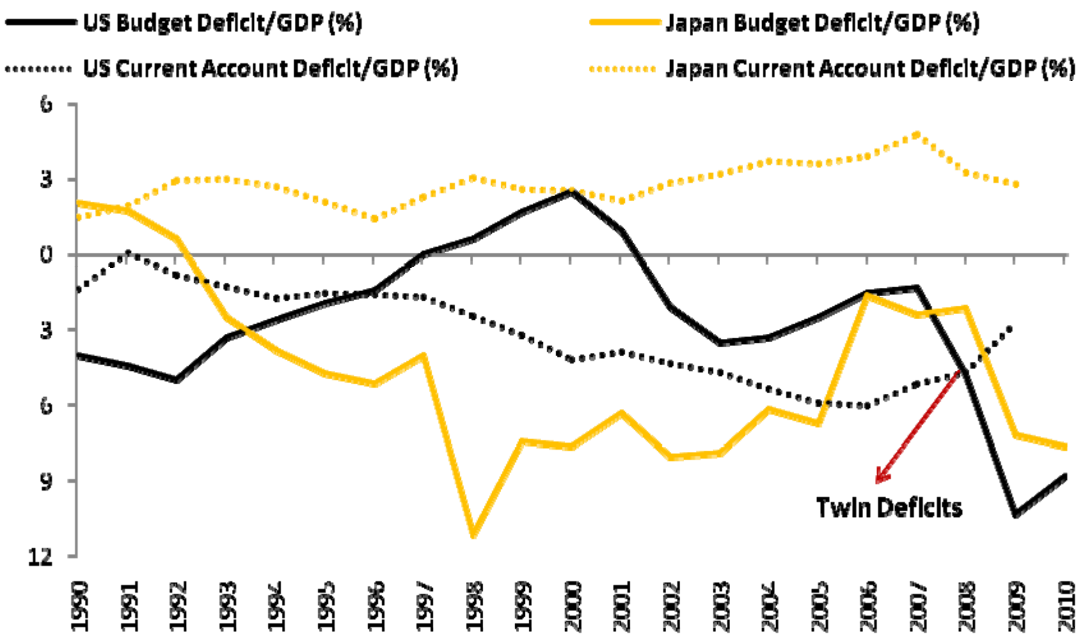


- When the Japan economy collapsed in 1980s, the government launched a massive borrowing program in the hope of stimulating the economy. Government debt grew from 65-70% of gross domestic product in 1990s to 226% in 2010. Despite the high government spending, Japan's economy was not able to exit from deflation which is the biggest problem of the economy for many years.

- Unlike Japan, US Government debt is still below 100% of gross domestic product (GDP), thus the risk of a downgrade of the US is very low at that moment. However any downgrade would become reality only if US can not stop its debt stock grow higher and sustain low growth for decades just like Japan.

2- Twin Deficits and Reserve Currency…

- When we compare US and Japan in terms of the budget deficit/GDP and the current account deficit/GDP ratios, the US's twin deficits draw attention in contrast to Japan's current surplus and high budget deficit.
- The main reasons of the ongoing twin deficits problem in US are;
  - ✓ US's having much more public expenditure than tax revenues and the low exports to imports ratio.
- Despite these structural problems in US, S&P has not changed the US sovereign credit rating since 1992.



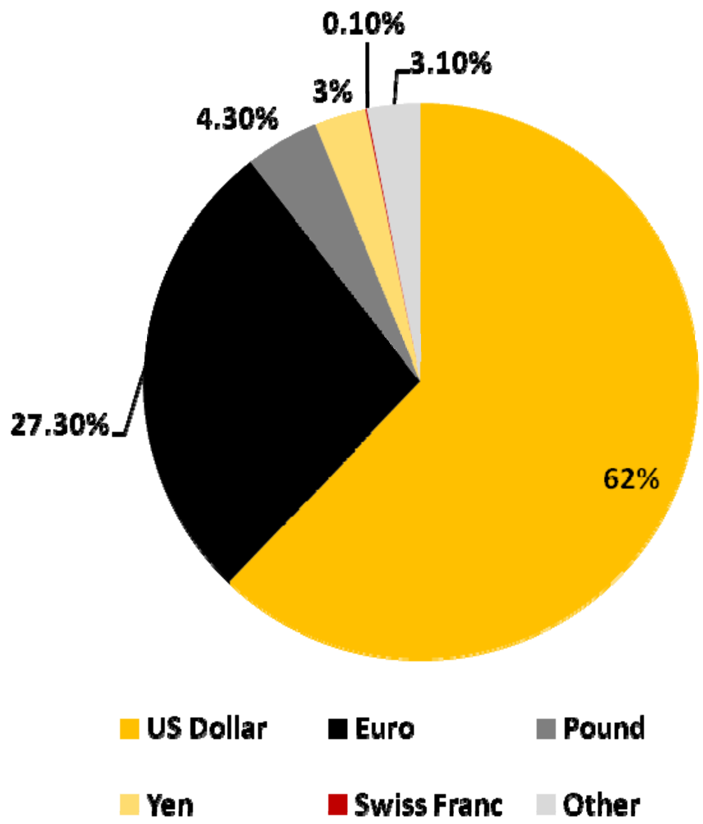
Source: Bloomberg

- The most important reason of this is that 'US national currency is also an international reserve one'.

US national currency is also an international reserve currency …

- When a currency is used as an international reserve one, it is likely that there may be a conflict between national and international economic interests.

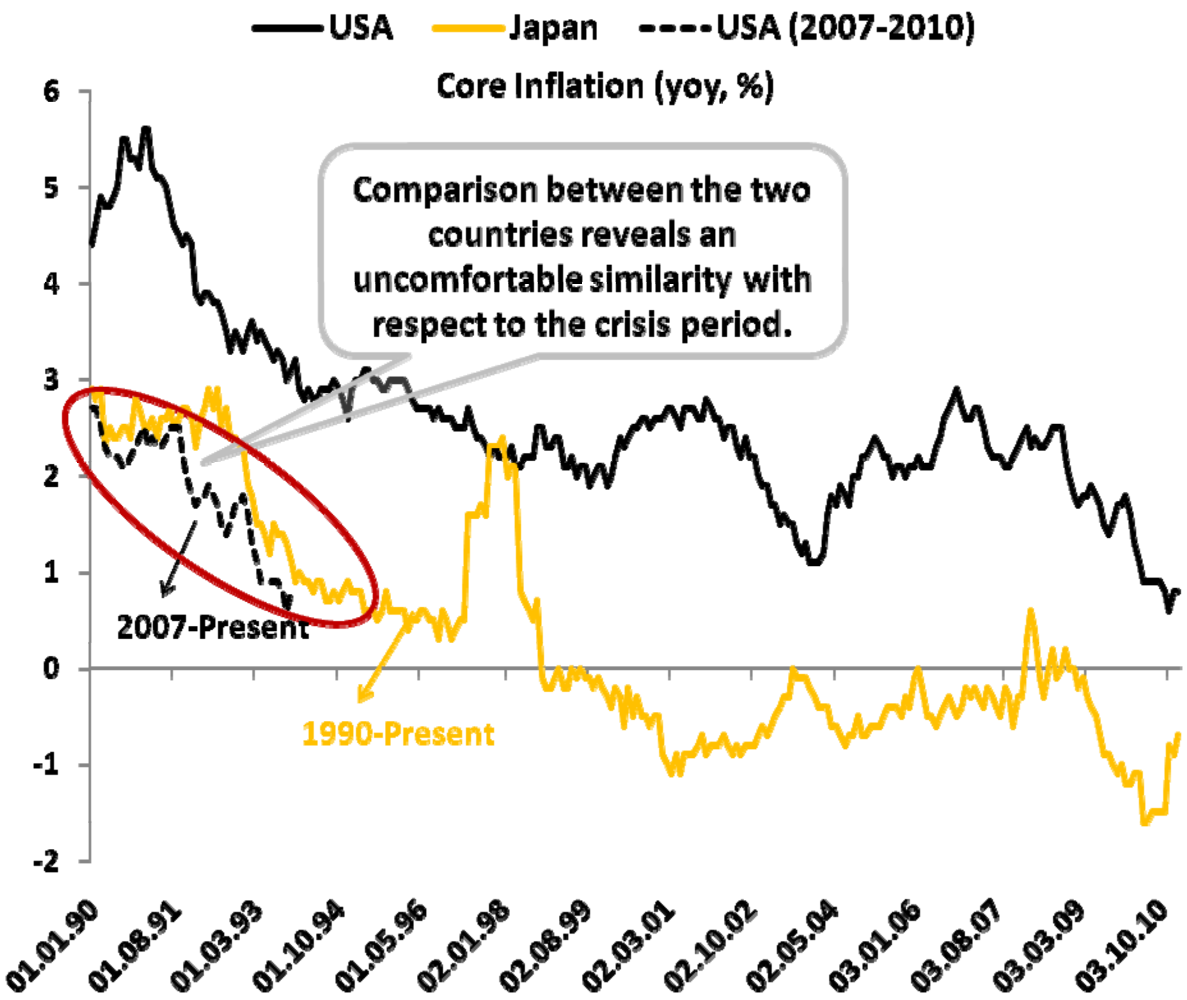
Currency composition of official foreign exchange reserve(%)



Source: IMF

- A country with the global reserve currency will oblige to give high trade and current account deficit to satisfy the demand for its money in the world.
- As shown on the graph left hand side, US dollar has 62% share in global foreign exchange reserve, so it is possible to ignore the risks of current account deficit, as current-account deficit is being financed by foreign central banks and short-term money.
- The fell of the dollar's share of global foreign-exchange reserves (from 80% in 1970s to 60% in 2000s) and the depreciation of the dollar after global crisis (at the end of 2007) raised questions about the dolar based reserve system.
- Moreover, almost all products and commodities in global markets such as oil, gold, etc. have been traded in dollars. Taking all these into account, as there is no alternative currency for the dollar in this terms, high dollar demand in global markets will continue at least in the near future.

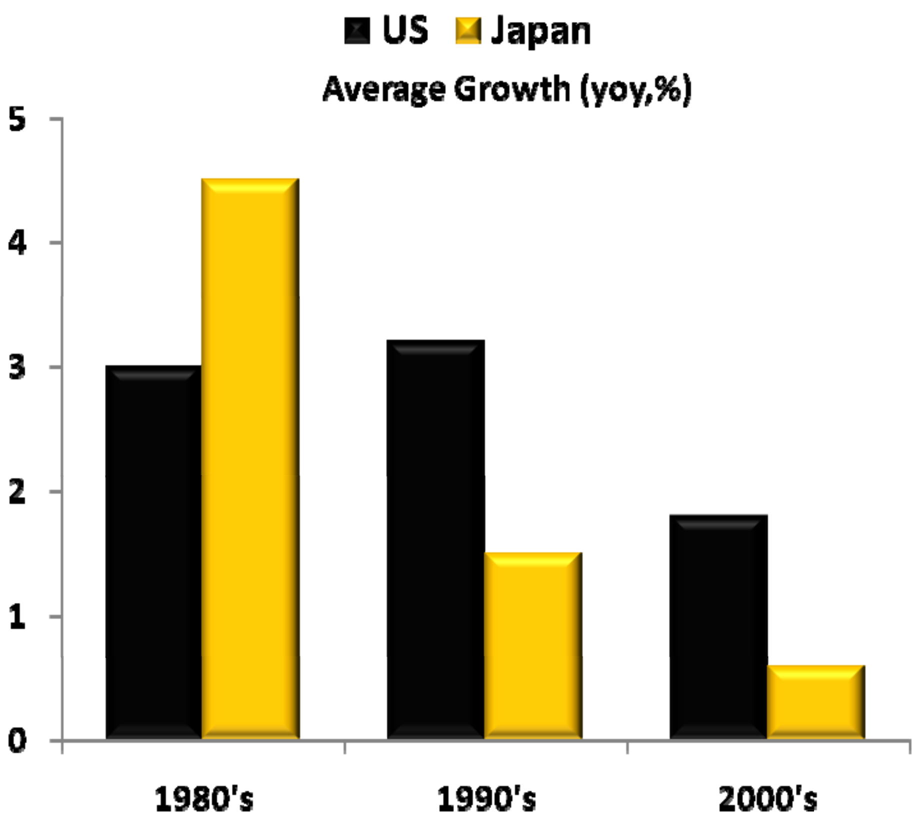
3- Deflation worries…



Source: Bloomberg

- A closer look into how the US and Japan's inflation behaved after the crises period has an uncomfortable similarity .
- In spite of this similarity, the US may yet escape such an outcome since it took necessary precautions faster than Japan.
- In sum, US's sovereign rating could be downgraded only if US budget deficit increased and US fought with deflation for quite a long time.

4- Lower Growth...

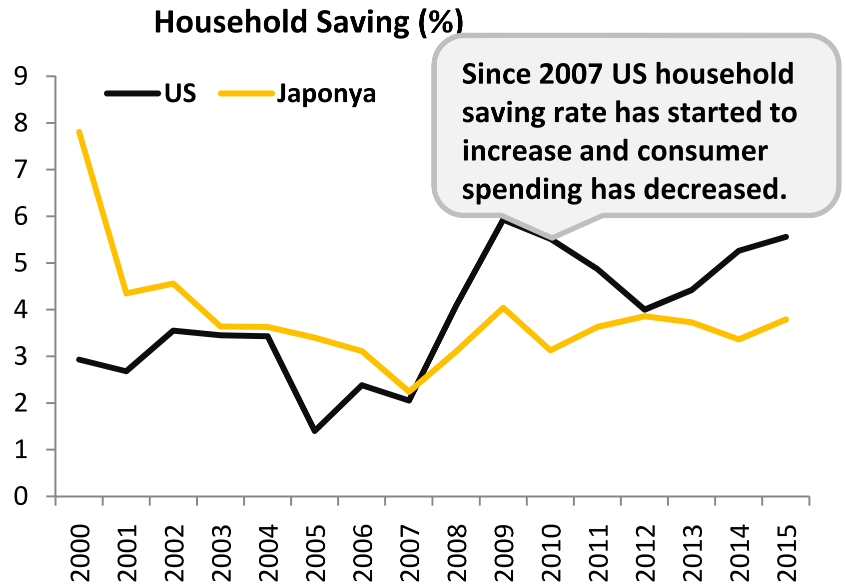


Source: Bloomberg

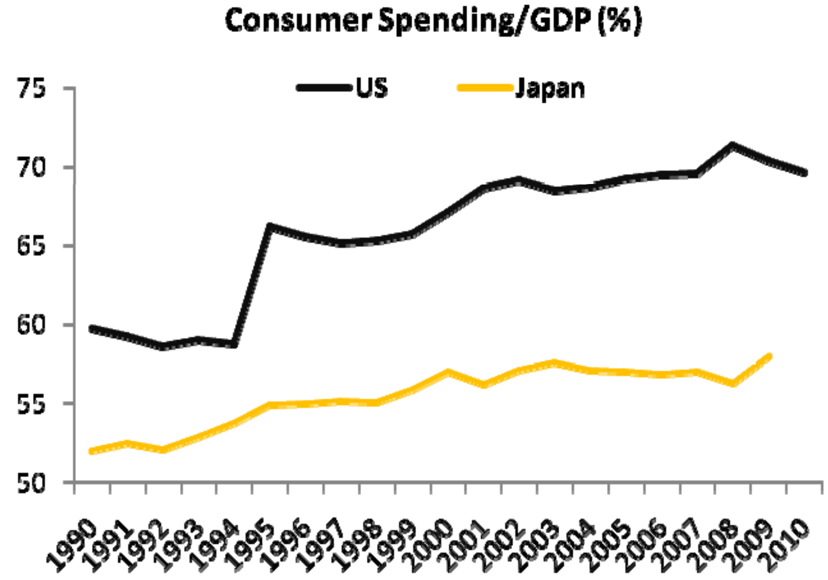
- While Japan economy grew an average of 4-4.5% in 1980's, the growth rate fell to an average of 1-1.5% in 1990's, this ten years period is so-called as 'lost decade'. In 2000's, the average rate of growth in Japan decreased to 0.6%.
- The positive real growth was not enough for japan to prevent deflation and to enter into the so-called lost decade in Japan.
- Similar to Japan, US economy grew an average of 3.2% in 1990's, and the growth rate fell to an average of 1.8% in 2000's.
- After the recent global crisis started in 2007, both Japan and US's growth rate have decreased .
- But the recent macro economic data releases in US indicate that the economic recovery has strenghtened.

Once the sustainable recovery is maintained, the increase in government spending may slow down.

5- Different saving and consumption behaviors of the two countries...



Source: Bloomberg

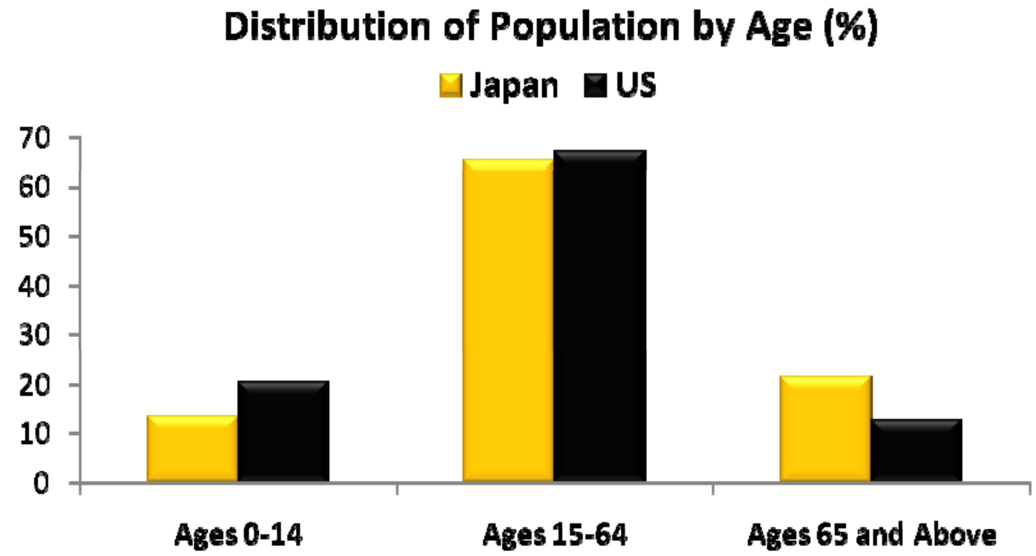


Source: Bloomberg

- Japan is known as a savings surplus country whereas US is a debtor country and spends more than it earns.
- Since 2007 US household saving rate has started to increase and consumer spending has decreased. For many economies, any raise in savings could have positive effects on economy, but in the case of US where consumer spending accounts for 70% of economic activity, the increase of household saving would lead to a decrease in consumer spending thus slow down growth rate. This would cause a negative effect on economy as strong consumer spending is a necessity for US growth.

Different saving and consumption behaviors of the two countries indicate the low probability of US to be next Japan.

6- Population Structure…



Source: World Bank

- Growth of the elderly population is higher in Japan than US. Those at the age of 65 and above of the total population increased to 11% in 1990's, 17% in 2000's and 21.41% in 2008.
- On the other hand, in US, those at the age of 65 and above has been constant around 12% of the total population since 1990.
- Moreover the rate of working population over the age of 15 is very low in Japan and it causes structural demographic problems.
- US has a younger population structure and the rate of working population over age of 15 is higher than Japan. Because of these reasons any downgrade in US in the short and medium term is very remote at that moment.

In conclusion...

When the last twenty years of Japan and US economy are compared, some similarities emerge…

However in the short and medium term, the downgrade risk of US is low due to the advantages of US economy explained before…

But, the monetary and fiscal policies implemented in the US have raised expectations of further deterioration of the US budget and debt ratios. In this regard, the long-term concerns about the US economy is increasing as US does not take necessary measures to narrow its budget deficit...

Hence, recent sell-off in long term US treasury bonds indicates that market players are quite nervous about the US future economic performance.

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