

IN DEPTH

Judging Japan's Experiment

Prime Minister Shinzo Abe's economics project tested as markets roil

Japanese Prime Minister Shinzo Abe's economic plan seemed to sail off almost flawlessly this year as stocks soared and the yen tumbled from levels late last year. Investors world-wide were excited that this might be Japan's long-awaited revival after 15 years of deflation and decline.

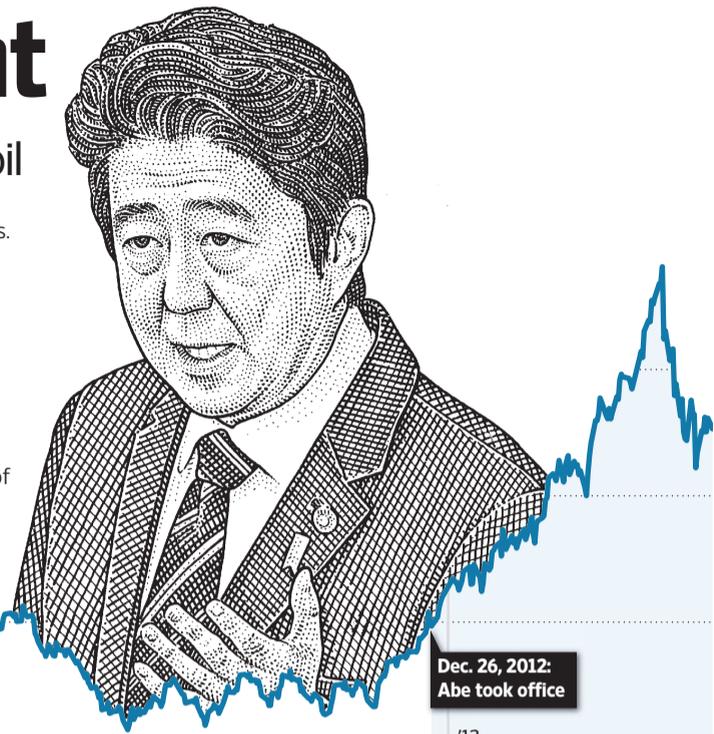
But has Japan really turned a corner?

The ride is suddenly bumpier as volatility jolts the markets, sending bond yields and the yen higher and the Nikkei Stock Average into a bear market. Skeptics question Mr. Abe's resolve to deliver radical growth strategies, while gyrations in asset prices

have raised doubts about the Bank of Japan's handle on markets.

It will take months, and even years, before the official data show whether the grand Abenomics experiment—a newly aggressive central bank, big new government spending, and economic restructuring—is working as planned, stalling out, or heading off the rails. Here are the key factors, and some important data—from household inflation expectations and banking lending patterns, to golf-club membership prices and wages—to watch for valuable early clues to gauge the success of Abenomics.

—Kana Inagaki and MinJung Kim

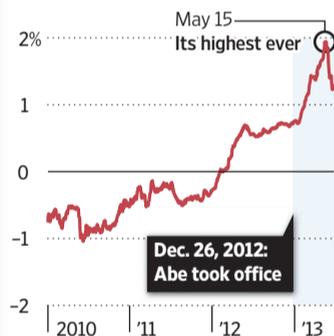


Dec. 26, 2012: Abe took office



PSYCHOLOGY

Expected inflation rate in inflation-indexed bond market

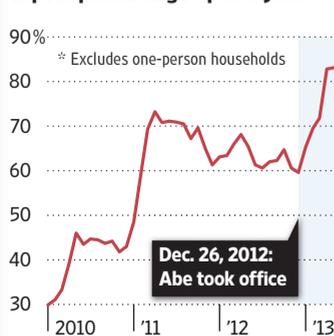


Japan's slump has been a vicious circle. After years of decline, consumers expected more of the same, and behaved accordingly by curbing spending and awaiting ever-lower prices and wages. One goal: break the deflationary mind-set. One success measure: the market for inflation-sensitive bond markets in the inflation-sensitive bond market. Another is a government survey showing more households expecting rising prices in the year ahead. Both show sharply rising inflation expectations.

It is necessary to eliminate deflationary expectations.

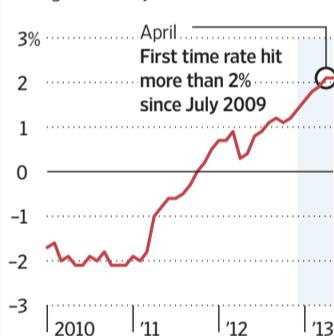
—BOJ Gov. Haruhiko Kuroda

Share of total households* that expect prices to go up in a year



FINANCIAL SECTOR

Bank lending growth rate, change from a year earlier



Lending is our core mission, and we will work to increase it.

—Takeshi Kunibe, chairman of Japanese Bankers Association and CEO of Sumitomo Mitsui Banking Corp.

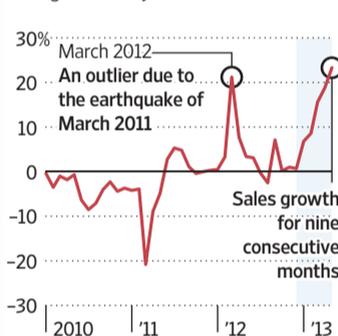
One key factor in Japan's recession has been the broken financial system. Risk-averse banks stopped lending and parked their deposits into safe government bonds, essentially keeping money out of circulation, even as the Bank of Japan pumped up supply. Signs of change include rising bank lending activity. Life-insurance firms also indicate they may step up buying of foreign bonds, taking money out of JGBs and employing them for more productive uses.

Net purchases/sales of foreign securities by Japanese investors



HOUSEHOLDS

Luxury item sales, change from a year earlier



Are consumers ready to pull money out of the bank and spend? Rising equity prices until May sharply boosted sales of luxury items such as watches, artwork and jewelry. Sales of these goods at department stores jumped 23% in May, the ninth consecutive monthly increase and the longest streak ever. Spending is also spreading to golf-club memberships—hints of the 1980s asset bubble.

Whether rising sales of luxury items will have a knock-on effect on broader consumer spending is debatable.

—Toru Suehiro, market economist at Mizuho Securities Co.

Golf-club membership fee in Kantou region, in millions of yen



COMPANIES

Monthly base salary*

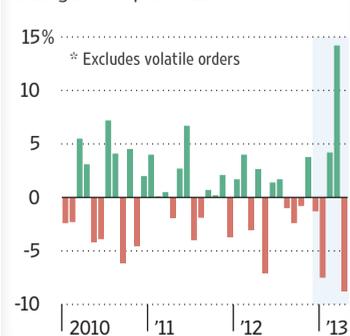


We are investing an incredible sum, particularly in new factories.

—Honda Motor Co. Executive Vice President Tetsuo Iwamura

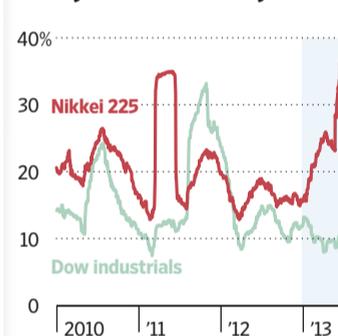
For a clear turning point, economists say companies need to spend more, particularly by raising wages. So far, evidence here is mixed. Summer bonus payments are on the rise, but the monthly base salary for Japanese firms in January fell to its lowest level since 1991 before recovering slightly in April. Another measure to watch: core machinery orders, a key, though volatile, indicator of corporate investment, which rose for two months before tumbling in April.

Core-machinery orders*, change from previous month



VOLATILITY

60-day historical volatility

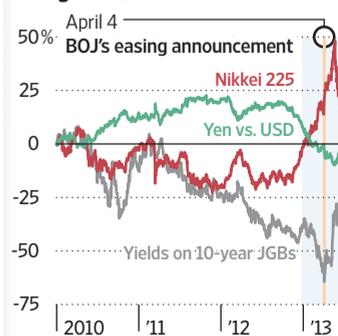


What could go wrong? One worry: market volatility in Japanese bonds, stocks and currencies that could slow efforts to bolster the economy. Yields on 10-year JGBs rose in May after initially dropping on the BOJ's bond-purchasing plan released in April. The Nikkei Stock Average fell into a bear market on June 13, with volatility levels rising higher than they did after the 2011 earthquake.

This volatility started with the central bank and ends with the central bank.

—Itay Tuchman, head of foreign-exchange and rates trading at Citigroup Inc. in Tokyo

Performance of stock market, yen and government bonds



Sources: Japan Bond Trading Co. (expected inflation rate); Cabinet Office (household price expectations and core-machinery orders); Bank of Japan (bank lending); Ministry of Finance (net transactions of foreign securities); Japan Department Stores Association (luxury item sales); Juchi Golf Co. (golf-club membership fee); Ministry of Health, Labor and Welfare (monthly salary); Nikkei Quick (60-day historical volatility for Nikkei 225 and Dow industrials); FactSet (Nikkei 225, yen-U.S. dollar exchange rate and 10-year government bonds)