

FROM “ABE ENVY” TO “JAPAN PREMIUM”

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Japanese Prime Minister Shinzo Abe won a decisive victory in Sunday's Upper House polls. His ruling coalition now holds a “supermajority” in both houses of Parliament, i.e., he de facto holds more than two-thirds of all Parliamentary seats.¹ In contrast to many Western democracies that appear to have entered a cycle of power vacuums and leadership uncertainty, “Team Abe” has emerged as the undisputed power champion among democratically elected global leaders. “Abe envy” is now spreading among the global political elite. If, as I expect, Team Abe demonstrates strong economic policy leadership in the coming three to four months, a “Japan premium” should start to develop in Japanese risk asset markets. In my personal view, Japan's stimulus will be sizable, creative and coordinated—a total stimulus of around 2% of [GDP](#); the start of “drone money” direct cash transfers to targeted groups of households; and de facto direct funding from the Bank of Japan (BOJ). **What will Prime Minister Abe Do with His Historically Unprecedented Parliamentary Power?** Many commentators worry that the prime minister will now focus on an issue dear to his heart: constitutional reform. Technically, the two-thirds majority allows him to do so; and it is true that Abe is deeply convinced that Japan deserves a constitution written by its own people rather than the current one which was given to Japan by the Americans after the Pacific War. Abe has been very open about this, and there is no question that the constitutional reform agenda remains a key part of his Japan agenda.² However, the view that political capital will be spent primarily on constitutional reform is a profound misunderstanding of Abe's fundamental philosophy and vision for Japan, in my view. Prime Minister Abe's basic philosophy and vision is modeled on the rallying cry of the old Meiji elite “Fukoku Kyohei”—“rich nation, strong army.” It is not a zero-sum game of either-or but a highly interdependent relationship: without a strong economy, constitutional reform becomes meaningless. **Global Ambition** In my understanding, Abe knows that constitutional reform carries a high risk of backfiring politically—both at home and abroad—if the economy continues to stagnate. His goal is to make Japan a country that is admired and respected by Asian and global leaders. This becomes impossible without a strong economy. Neither America nor China will have respect for a leader who promises growth and prosperity but fails to deliver. From a global power perspective, if [Abenomics](#) fails, Japan slides back into irrelevance. After all, nationalism based on economic stagnation poses neither a threat nor an opportunity to the outside world. Without Abenomics succeeding, Abe simply cannot finance his national ambitions. If anything, the weaker the economy gets, the greater Japan's dependency on global capital, technology and labor will become. **Domestic Credibility** At home, a nationalist agenda and a lopsided focus on constitutional reform would also become meaningless without the success of Abenomics. If Abe cannot create a “feel-good factor” for the people and corporate stakeholders, they are bound to turn against him sooner or later. Japan is, after all, a functioning democracy with plenty of local, regional and national elections. If Abenomics fails to deliver, strong-arming constitutional reform would quickly be viewed as a one-party power grab, which is bound to unify and incentivize opposition forces. If at all, the clear mandate given to Abenomics in yesterday's election has raised the stakes for strong economic leadership from Abe—he now has no

excuse and has to deliver that feel-good factor he promised to the people and corporate stakeholders. The pressure is on—Abe's term expires in two years (September 2018).

Abe's Agenda—Linking BOJ and Ministry of Finance (MOF) into a Single Agenda From here on out, the economic policy agenda is relatively straightforward. First and foremost, fiscal policy will need to be expanded. Prime Minister Abe has already ordered the compilation of a supplementary stimulus package. Here, the focus is not just on size but on actually linking fiscal expansion with added [monetary stimulus](#). Almost all of Abe's economic advisors agree that monetary policy alone has become increasingly ineffective in stimulating growth. The key focus is on Team Abe actually linking the BOJ agenda directly to the MOF agenda. In short: the next BOJ move is poised to be the de facto financing of the coming supplementary budget. It's also important to note that, unlike previous years, Japan has no excess tax revenues that could be used to fund added expenditures. [Deficit finance](#) is therefore the only option, although Japan also has an off-balance option: added public investment can be funded by the Fiscal Investment and Loan Program (FILP), which would issue so-called [zaito bonds](#). The technical difference to deficit bonds is that these are project based and cannot be paid back using tax revenues. However, for the bond market the zaito bonds trade just like any other [Japanese government bonds \(JGB\)](#)—and the BOJ is allowed to buy zaito bonds.³ Assuming a supplementary budget of around ¥8–10 trillion, or 1.5% to 2% of GDP, we expect the BOJ to raise its [quantitative easing](#) balance sheet growth target from the current ¥80 trillion to ¥ 88–90 trillion.

Size Matters How big will the supplementary budget be? Government economists estimate the current GDP output gap to be around ¥5–6 trillion, i.e., about 1% to 1.2% of GDP. This is the baseline. Perhaps not coincidentally, technocrats estimate that reconstruction projects to fix the recent earthquake damage in Kumamoto may add up to around ¥4–5 trillion. In addition, promotion of Abe's new "Industry 4.0" initiative—fintech, robotics, health care, R&D, etc.—could add up to ¥1–3 trillion.

Drone Money Beyond this, there is the Abenomics focus on economic inclusion for the working poor, women, poor pensioners and youth. Direct cash transfers to these constituents are now part of the policy debate. While the media refers to this as "[helicopter money](#)," we prefer the term "drone money," as it is pinpoint delivery to specific targets of the population. Technical details of how exactly funds will be transferred from the Treasury to these targeted constituents will still have to be worked out, but in my view, a total of around ¥1.5–2 trillion of direct cash transfers to the household sector could be expected.

When to Expect What The technical aspects of compiling an unorthodox fiscal package—one that includes drone money cash transfers to specifically targeted groups among households—will take at least four to six weeks to work out. Prime Minister Abe also appears to have hinted at reshuffling his cabinet around mid-August.⁴ Here the focus will fall on the Ministry of Finance portfolio, the Ministry of Health, Labor and Welfare, as well as the Economic Coordination Minister, in our view. Moreover, the Advisory Council on Rules and Regulations is also due a reshuffle, including private-sector leaders. Team Abe is very conscious of the need to revitalize the public image of the economic leadership team, in our understanding. Either way, a firm commitment to specific fiscal spending is unlikely to come before the new ministerial portfolio responsibilities have been allocated. That said, we expect full details of added fiscal and money stimulus to be presented in early September—just before Prime Minister Abe delivers a keynote speech at the annual UN General Assembly. In our view, Team Abe is determined to demonstrate strong economic policy leadership to the world. The stimulus will be sizable, creative and coordinated—total stimulus of around 2% of GDP; the use of drone money direct cash transfers to targeted groups of households; and de facto direct funding from the Bank of Japan. Add to this the reality of [Japanese equities having become inexpensive](#), and you have a solid case for raising allocations to Japanese equities, in our view.

¹Yoko Wakatsuki and Juliet Perry, "Japanese Election: Shinzo Abe Declares Victory," CNN, 7/11/16. ²Yoko Wakatsuki and Juliet Perry, "Japanese Election: Shinzo Abe Declares Victory," CNN, 7/11/16. ³Jiji, "Japan Mulling Cut in Minimum Interest on 'Zaito' Fiscal Loans," The Japan Times,

6/11/16. ⁴Isabel Reynolds and Andy Sharp, "After Convincing Election Win, Abe Faces Tough Battles," Bloomberg, 7/11/16.

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DEFINITIONS

Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

Abenomics: Series of policies enacted after the election of Japanese Prime Minister Shinzo Abe on December 16, 2012 aimed at stimulating Japan's economic growth.

Monetary stimulus: refers to attempts to use monetary policy like lowering interest rates or quantitative easing to stimulate the economy.

Deficit Finance: Instead of raising taxes, government borrows money to finance public expenditure.

Zaito Bonds: Low interest rate bonds issued through the Fiscal Investment and Loan program, which is designed to fund public investin.

Japanese Government Bond (JGB): A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Quantitative Easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Helicopter money: has been proposed as an alternative to Quantitative Easing (QE) when interest rates are close to zero and the economy remains weak or enters recession. Economists have used the term 'helicopter money' to refer to two very different policies. The first set of policies emphasizes the 'permanent' monetization of budget deficits. The second set of policies involves the central bank making direct transfers to the private sector financed with base money, without the direct involvement of fiscal authorities.