
JAPAN'S PRO-GROWTH AGENDA—HOW "ABE-ISM" WILL RE-IGNITE "ABENOMICS"

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After a period of relative calm and no new initiatives, Japanese politics is poised to move back into global headlines in the coming months. This is because Prime Minister Abe has now presented a concrete timeline for reforming Japan's constitution: the goal is to clear all the necessary Parliamentary hurdles by next summer (2018) so that the required national referendum can be called before end-2018.

This ambitious agenda will not only push Japan back into global headlines, but will reignite Japan's pro-growth policies into 2018/19. In our view, a "double election"—lower house and constitution referendum—seems likely in the autumn 2018, ushered in by added easing of fiscal policy in general, postponing the next tax hike in particular, as well as greater Bank of Japan (BoJ) commitment to push real rates down to at least 2%.

From "Abenomics" to "Abe-ism"—Interdependent policy activism

Both at home and abroad, Abe's newfound urgency to press for constitutional reform is poised to raise worries. Is "Abenomics" morphing into "Abe-ism", that is, will political capital now be squandered on a nationalist agenda rather than economic reform?

Personally, I am not worried about an "either or". Yes, there can be no doubt about the deep-rooted patriotic agenda driving "Team Abe," but this agenda is pragmatic and Machiavellian, inspired by the "Fukoku Kyohei—Strong Country, Strong Army" philosophy embraced by the Samurai leaders who led Japan's modernisation and reform in the late 19th century.

Clear speak: Yes, Abe's principal goal is to secure Japan's undisputed status as a tier-one nation, but to get there, Japan must have a top-tier economy. Just as the Meiji reformers did more than one century ago, "Team Abe" knows that to be taken seriously by the two big global powers—China and America—Japan's corporate, financial and human capital must be restructured to generate performance levels envied by the world. "Team Abe" is convinced—without successful "Abenomics," "Abe-ism" is doomed to fail.

More to the point: Abe's timeline on constitutional reform hints at the coming positive feedback between national agenda and pro-growth economic policy: not only can we safely rule-out a pre-mature policy tightening, but now the probability of added policy ease has risen. The more ambitious the constitutional agenda, the greater the imperative to create a stronger "feel good" factor for the voting public.

Power-politics with options

It is no coincidence that Abe's "constitution referendum end-2018" goal is in total sync with the most important macro policy decision facing Japan: by end-2018, the government must decide whether the next consumption tax hike will in fact go ahead. It's currently scheduled for October 2019, but the final decision will only be made in the 2019 draft budget debate, due to be completed by December 2018. Machiavellian bonus: PM Abe must call the next general election by the same December 2018.

Practically speaking, the threat of election will keep his LDP party in line, and the tax hike decision creates optionality. Empirically, tax hikes are three-for-three to trigger economic downturns, which is why Team Abe forced a postponement of one in early-2016. Standing-up against the powerful bureaucracy and its tax-hike lobby was a key factor securing his landslide victory in the Upper House election a couple of months later. A repeat performance is likely, in our view—postpone the unpopular tax hike as a bargaining chip for the controversial constitutional reform.

Fiscal dominance = no urgency to hike taxes

Here, it is important to note that Japan's current monetary policy regime has reduced the urgency of fiscal consolidation: the BoJ now explicitly guarantees zero-rate funding cost for treasury debt and promises to keep this anchor until inflation exceeds 2%. So real 10-year bond yields are poised to drop by at least 150 basis points, which in turn could cut real interest expense by as much as ¥15 trillion. With total consumption tax revenues at just above ¥17trn, fiscally conservative economists will be hard-pressed to convince Team Abe that they should risk an almost certain recession (by hiking the tax) against an almost certain "free ride"—provided the BoJ holds its course. A guarantee to stay the course would appear to be the minimum necessary job requirement for Abe's choice as the next BoJ Governor (Governor Kuroda's first term ends April 2018).

Market implications—higher risk, higher return

All said, a "double election"—lower house and constitutional referendum—coming in the autumn of 2018 looks like a reasonable assumption. This should be good news for Japanese risk assets—if we are right and the coming pick-up in Japan's political metabolism results in a revival of pro-growth policies.

Two important triggers: first, evidence of easier fiscal policy coming into 2018/19; and second, rising evidence that the BoJ will hold-on to its current target of pushing real rates to at least negative 2%. Easier fiscal policy plus easier monetary policy should result in both a weaker Yen and a rising equity market.

While economists may describe Japan as "Fiscal Dominance," "Political Dominance" may be a more appropriate description for what lies ahead for Japan over the coming 12-18 months. The fact that both the constitutional and the economic agenda are both controversial and unprecedented raises risks in Japan, and thus potential returns.

In our view, Abe's ambitious constitutional agenda "Abe-ism" is making the success of "Abenomics" more likely.

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