

## CIO Flash Bulletin

## Abe's choice: constitutional re-write or economic consolidation

### Investment Solutions

3 December 2018

**Japan's Prime Minister Shinzo Abe built his argument for economic reform on national security as the country stagnated and neighbouring China expanded. After a series of economic changes, the logical next step in his third and final term in office may be to overhaul the country's pacifist constitution.**

In September Abe's Liberal Democratic Party re-elected him as leader, making him likely to become the country's longest-serving prime minister, assuming he reaches the seven-year mark in November next year. Political analysts and economists speculate that he may use his last years in office to push for changes to Japan's so-called Article 9 'peace clause' of the country's 1947 constitution which prohibits Japan from taking part in war or maintaining military forces. Since the ruling party lacks a two-thirds majority to pass such a reform, the effort may exhaust his political capital. Analysts argue that it makes more sense to tackle problems ranging from national debt, climate-change related natural disasters, the demographic challenges of an aging society, and Tokyo's Olympic 2020 games.

When Abe was elected to a second term in December 2012 after a nuclear accident and a tsunami, he presented the 'three arrows' of 'Abenomics': boosting monetary supply by printing currency, structural reforms to make the world's third-biggest economy more competitive, and fiscal stimulus through government spending. **Designed to kick-start the Japanese economy out of its decades-old "suspended animation," the reforms have clearly succeeded in a number of areas**, helping the country to the longest spell of sustained economic growth since 2006.

### Money, workers and Olympics

The first of the measures, increasing money supply, was designed to manage deflation while implementing structural reforms. Abe's labour reforms changed employment law to discourage the jobs-for-life approach at big firms, improve boardroom transparency, and encourage women into the workforce. The reforms have also increased the share of foreign workers in a labour market that remains undersupplied, while wage-boosting measures and consumer spending have fallen mostly flat. Next year, the government may work to raise the retirement age to 70 and additional changes to immigration may ease the arrival of more workers from abroad ahead of the Olympics.

Abe's reforms have clearly had a positive impact. Data published last week showed Japanese industrial production rising 2.9% in October, more than double the consensus forecast, while job growth accelerated to over 2% year-on-year, supporting expectations for a recovery in fourth-quarter gross domestic product. Government debt in 2017 was 253% of GDP, a record, albeit relatively stable, level over Abe's mandate.



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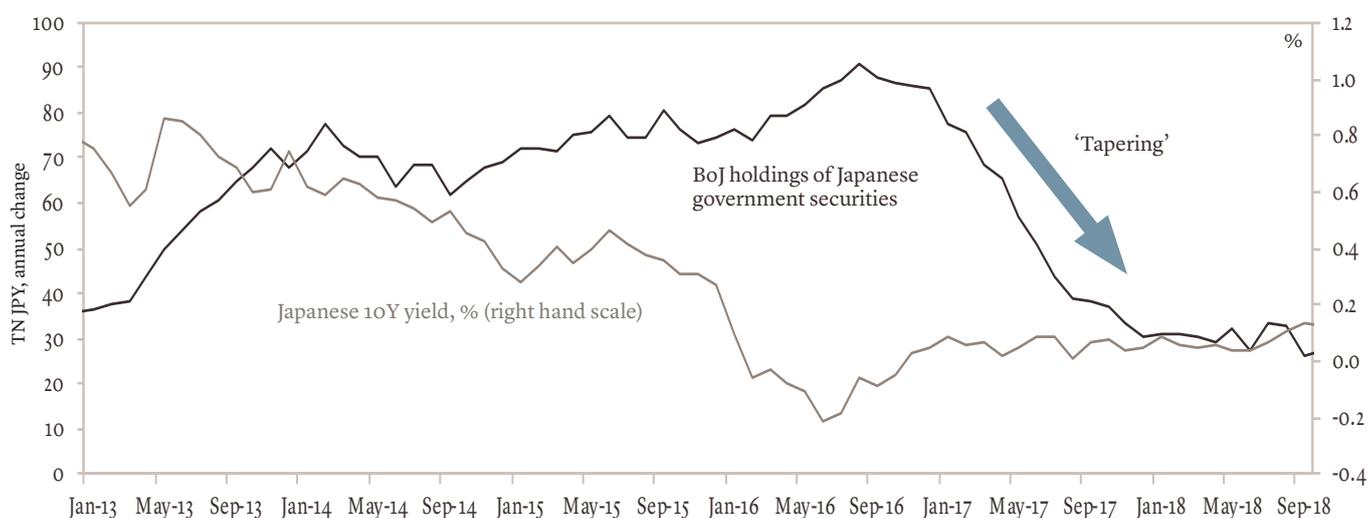
Japan nevertheless remains the country most exposed to the global economy, though it has proven structurally resilient. Part of its economic vulnerability is visible in Japan's interest in maintaining a strong free trade agenda, and Abe has sometimes referred to trade in national security terms. This resonates with an electorate conscious of its neighbour and traditional rival, China, which overtook Japan as the world's second-biggest economy in 2010. The tariff dispute between the US and China has potentially destabilising effects on Japan, and this explains why Abe has worked to rescue the Trans-Pacific Partnership trade accord after the US's unilateral withdrawal and following its free trade accord with the European Union. Both trade deals will take effect in 2019.

### BoJ's tapering

In the face of these challenges, the Bank of Japan (BoJ) has provided some of the most accommodative monetary policy in the developed world. Under Governor Haruhiko Kuroda, the central bank started buying assets in 2013, in particular government bonds, in a bid to cut interest rates and encourage consumer spending. On 10 November total BoJ holdings, according to its own filings, were JPY 553.6 trillion (of which JPY 469.1 trillion is Japanese government securities). **The central bank aimed at expanding its balance sheet by 80 trillion yen per year, yet since early 2017 there has been a steady decline in buying** (see chart). We expect a slow adjustment to monetary policy in late 2019, reflecting the already-tight labour market and as some increases in wage growth appear.

The BoJ has already slowed its asset purchases, but only because this policy has undermined regular trading in the asset class and commercial banks' efforts to make profits. Unlike the Fed, which started raising interest rates in 2015 and announced an end to its bond buying in 2014, and the ECB whose asset purchase programme stops within weeks, there is no explicit promise of an end to the BoJ's buying.

### BoJ "tapering" is well under way



Sources: Datastream, Lombard Odier calculations

"We have absolutely no plan to change our zero percent target for 10-year government bond yields," said Kuroda, on 30 October. The BoJ has maintained its -0.1% short-term rate target since January 2016. Investors will be looking for signs of the central bank stepping away from that policy next year.

### Currency hedging

Our central scenario remains for a strengthening Japanese currency in the medium term, in line with our expectation for a weaker USD. We think the late-cycle economy in the US will trigger a defensive outlook among investors, and coupled with a slowly tightening BoJ monetary policy in response to rising wages, the yen will gain. Any negative shock to the world economy would of course amplify the demand for haven assets, including the JPY.

We held a short EURJPY (long yen) position for two months, through to the end of November to help provide some cushion from equity market volatility and especially to reflect the political risks of Italy's budget frictions with the European Commission. While this political discussion has not yet been resolved, Italian government bond spreads have narrowed as the market begins to price in some positive developments, pointing to a decline in the political risks. As a result, we have let this position expire and instead have initiated a short exposure to USDJPY. This, we think, offers investors a hedge against any short-term weakness in equities and is in line with our expectation for a weaker USD through 2019.

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