

ABENOMICS 2.0—MORE THAN MEETS THE EYE

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Last week, Japanese prime minister Shinzo Abe presented an update on his economic policy priorities for 2016 and beyond. The key takeaway brought no positive surprises that could force upward revisions to the 2016 growth outlook. However, the new details of Japan's "Abenomics 2.0" policy discussion suggest to us that structural growth policy is very much moving in the right direction, with Team Abe making concrete progress on building credible alliances with business leaders for his growth strategy. Progress on the political economy toward broad-based buy-in and consensus between government and the private sector should not be underestimated as a key force driving the medium- to longer-term momentum for the structural [bull](#) market in yen risk assets—"Japan Inc." is back, in our view. **The Hard Facts** On the numerical and factual front, last week's policy statements came well within what had been flagged over the past four or five weeks in various media reports: • Abe formally instructed the Cabinet ministers to compile a supplementary budget of around ¥3.5 trillion, or around 0.7% of [gross domestic product \(GDP\)](#); • Abe de facto committed to cutting the corporate tax rate from 32.11% to below 30%, effective fiscal year 2016; • Abe confirmed his determination to raise the minimum wage by 3% every year to get it from the current ¥798 per hour to ¥1,000. In the immediate future, the minimum-wage push and the supplementary budget are probably most impactful for their positive influence on domestic demand in 2016 in general, and in particular during the run-up to the July 2016 upper house elections. Specifically, the supplementary budget is now confirmed to contain a cash subsidy to low-income pensioners of as much as ¥30,000. Exact details are likely to be presented around December 10, but given the high propensity to consume for low-income people, this could boost consumer spending by as much as 0.25%, according to our estimates. The impact of the minimum wage hike is likely to be of similar magnitude. The Cabinet Office estimates that around 5% to 9% of Japan's total payroll is on the minimum wage right now, so a 3% hike should translate into a boost in aggregate incomes of around 0.35%. Again, the propensity to consume could be relatively high, in our view. **The Return of "Japan Inc."** More important than the modestly positive growth arithmetic outlined above is the positive and focused decision making dynamics that are driving the priorities of Abenomics 2.0. After years of mistrust and noncooperation, last week's announcements demonstrate the revival of Japan Inc.—cooperation between the business leaders and the prime minister's office is starting to fall into place. Concrete, tangible results came through last week: • Japan's Keidanren—the key large business association—agreed to commit to raising both capital investment as well as workers' base pay. Specifically, it promised to boost capex from ¥71.7 trillion to ¥81.7 trillion over the coming two years, an increase of around 7% per annum; at the same time, workers' base pay is promised to be raised by more than the 2% hike granted this year. • In return, the Keidanren got agreement from Prime Minister Abe to focus and deliver on nine key policy priorities:

- Early cut in corporate taxes (done; see above)
- Cut fixed asset tax on new equipment purchases
- Remain focused on pro-business deregulation
- Promote free trade potential of the Trans-Pacific Partnership (TPP) and expand free trade further
- Secure cheap and stable supply of energy
- Promote next-generation technology
- Expand tax support for research and development
- Promote more active labor participation among women, young, elderly and non-Japanese
- Raise labor market liquidity and mobility through deregulation

It is important to note that Japan's big-business lobby is now openly putting more active labor participation on the agenda, including non-Japanese. In other words, slowly but surely the de facto taboo of discussing immigration is beginning to erode. By now, both policy makers and business managers are fully aware of how tight the labor market has become, and sheer pragmatism is starting to come into play, in our view. While, in our experience, many global investors

remain focused on judging the progress of Abenomics by whether Japan will start to rely on non-Japanese labor to boost the domestic growth potential, the domestic priority is clearly tax code changes: Three of the nine demands by the Keidanren involve tax reform (e.g., lower effective rate, lower new [equipment fixed asset tax](#) and more tax support for research and development [R&D]). As always, tax code changes are complex and need to be studied closely. Full details will start to come through as the debate on next year's national budget climaxes over the coming three to four weeks. For now, what matters is that the [headline rate](#) will be cut to below 30% next year, and the correct tax policies to engender more business equipment investment and R&D spending are on the agenda, with the big-business lobby committed to delivering more than 7% capex growth from next year—if Abe delivers on his part of the bargain. For investors, growing transparency of concrete tax support for equipment spending could mark a positive turning point for Japanese capital goods companies after a disappointing 2015, in our view. **What about the Bank of Japan?** Last week's policy announcements did not involve the Bank of Japan (BOJ) directly. However, indirectly, the growing certainty of a fiscal boost for both household incomes and business investment has probably strengthened the case for added [monetary policy stimulus](#) coming somewhat later, rather than sooner. An added factor in the timing of the next move is the upcoming decision by the Federal Reserve (Fed) in December. Given BOJ governor Haruhiko Kuroda's vast experience and network in the international finance community, he may very well take a wait-and-see approach. Clear speak: If the Fed can do part of the BOJ's job by changing relative monetary policy through higher U.S. rates, Japan may get a "free ride" stimulus as rising U.S.-Japan rate differentials restart a [carry](#) trade that pushes the yen lower and the dollar higher. **Just as Business Leaders, the BOJ Is an Integral Part of "One Team, One Dream"** We maintain our call that added [monetary stimulus is likely from Japan](#), with the timeline now probably March to May 2016, rather than in 2015. Here, we continue to emphasize that the principal driver goes beyond the debate around "[CPI](#) inflation arithmetic" and what the proper index basket should look like. It rests on our conviction that Prime Minister Abe is leading all parts of Japan's political economy—business leaders, fiscal policy leaders, monetary policy leaders and regulatory leaders—toward "One Team, One Dream." The most clear-cut verification of our central thesis would be if the BOJ incorporates Abe's ¥600 trillion nominal GDP target into its monetary policy target. More tangibly, the tools of the BOJ's 2016 pro-growth strategy contribution could be, in our view, boosting the BOJ's exchange-traded funds (ETFs) buying budget from ¥3 trillion to ¥6 trillion, broadening the options of bonds eligible for BOJ purchases to include "zaito" and regional [government bonds](#), as well as possibly adopting negative rates to encourage shifts in private sector cash balances toward productive and riskier assets. In our view, all or part of these monetary tools are likely to be in place in Japan by mid-2016 at the latest. ***Unless otherwise noted, source is WisdomTree as of 11/30/15.***

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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.

Bullish : a position that benefits when asset prices rise.

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

Equipment Fixed Asset Tax : A tax is charged on equipment part of the fixed asset.

Headline Rate : A basic rate of taxation before distorting factors have been removed.

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

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

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.