

# BOJ ACTION: TEAM ABE PROVIDES A COORDINATED PACKAGE

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Key Japan macro policy decisions are coming into sight. On Friday, July 29, we will get the Bank of Japan (BOJ) policy board decision as well as the annual performance report from the [Government Pension Investment Fund \(GPIF\)](#). Then, Prime Minister Abe is expected to reshuffle his cabinet (expected August 3rd but not confirmed). While markets are, as always, obsessively focused on central bank action (or the lack of it), we continue to stress that the principal priority of “Team Abe” is policy coordination. The decision is not about monetary easing on its own but about linking the central bank’s balance sheet with an added fiscal boost, as well as more steps to promote structural reform. We expected the BOJ easing would come only after concrete plans for the extra budget are finalized, which we estimated to be around mid-September. However, Prime Minister Abe surprised the market on Wednesday by unveiling the size of a fiscal package of 28 trillion yen. The timing of this announcement, while the full package was yet to be approved by the cabinet, suggested this was done to coordinate with the Bank of Japan meeting this Friday. **BOJ Cannot Do It Alone** Market expectations are high for added BOJ action coming this Friday, with 32 of 41 analysts surveyed by Bloomberg predicting an added stimulus. However, we understand that basically all advisors to the prime minister agree that monetary policy alone is yielding increasingly diminishing returns and that the key to move up both aggregate demand and the potential growth rate lies in greater linkage between the central bank balance sheet and fiscal stimulus. BOJ governor Haruhiko Kuroda stated as much at last weekend’s G20 meeting by saying the BOJ would be ready to support added fiscal stimulus. **Size Matters—Or Does It?** The size of the extra budget has been subject to much media speculation recently. We are sticking with an expected ¥8–10 trillion in real new stimulus. Our yardstick here is de-facto the increase in the public sector borrowing requirement—i.e., net new issuance of public sector debt. Note here that the Ministry of Finance (MOF) is opposed to issuing deficit finance bonds, but it’s prepared to issue both construction bonds and Fiscal Investment and Loan Program (FILP) bonds. In Abe’s announcement on Wednesday, one of the key details that remain unclear was this exact size of the real new stimulus. Note here that, for [Japanese government bond \(JGB\)](#) markets, the accounting treatment of the bond issues makes no difference—both construction and FILP bonds are project specific and will have to be redeemed from project revenues (while deficit bonds can be redeemed from future tax revenues). The difference between construction bonds and FILP bonds is that the former are part of the general account budget balance, while the latter are not—i.e., FILP bonds are off-balance sheet. That said, we expect about ¥4–5 trillion of added construction bonds and ¥5–6 trillion of added FILP bonds—which implies an added public sector borrowing requirement of ¥10 trillion, or 2% of the [gross domestic product \(GDP\)](#). **Linking MOF to the BOJ** The increase in effective bond supply is the key to the program. It is where the treasury’s aggregate demand boost gets linked to the BOJ’s balance sheet. As the rough details of the budget were now outlined, we expect the BOJ will follow suit and raise its bond-buying target from the current ¥80–¥90 trillion. Although technically not [monetizing](#) (i.e., not buying directly from the treasury), the BOJ will add to its current practice of buying in the [secondary market](#). **Half Public Works, One-Quarter “New Industry 4.0” and One-Quarter “Drone Money”** What will the money be spent on? In our view, the biggest single item is likely to be reconstruction for the recent earthquake damage, which could be as high as .75% to 1% of GDP. This is “shovel ready” public works. In addition, we expect around .3% to .5% of GDP for regional development and “Japan Industry 4.0” initiatives designed to build out the “Internet of Things” ecosystem in Japan. Finally, we expect some “drone money”—cash transfers from the treasury to specific targets of the population such as the working poor, poor pensioners, single mothers, etc. The possibility of “premium vouchers”—vouchers that allow consumption of specific services or goods within a specific time frame—also appears to still be on the table. **Bigger, Better or Not Credible?** One final word on size: it is common practice in Japan to boost the headline yen value of supplementary fiscal action. This is done by “pretending” to know the likely demand multiplier of all line-item programs. So, for example, ¥1 trillion spent on a new road can be expected to yield an additional ¥1.5–¥2 trillion of private demand, as companies build new shopping malls, factories or hotels. At best, this is an imprecise exercise and at worst outright misleading (for

every new road there is an old road now less traveled, for example). Another way to inflate the numbers is by adding in future commitments. For example, if a new tax incentive for single mothers is introduced in the supplementary package, the value presented could be not just this current year but the value over the life of the policy, plus the expected demand multiplier. As they say in Japan, “the making of fiscal policy is like preparing sushi—a bloody and highly refined business.” What matters, in our view, is the actual increase in the public sector borrowing requirement—by how much does the public sector savings-investment gap actually grow? As discussed, we expect net new borrowing of around 2% of GDP, de-facto funded by added bond buying from the BOJ. **GPIF: Last but Not Least** We also expect important “good news” from the GPIF annual performance report. There should be no surprise from a negative performance for the fiscal year that ended March 31, 2016. Expectations appear to be for a negative return of around 4%, which, in our view, appears perfectly respectable, given the approximately 11% drop in [TOPIX](#) and the nearly 7% appreciation of the yen (against the U.S. dollar)<sup>1</sup>. More important, Friday’s GPIF report is set to bring more concrete steps the GPIF will take to improve Japan’s corporate governance. Specifically, look for leadership to question corporate management on capital stewardship; the implementation of specific policies to lead on environmental, social and governance (ESG) issues in Japan; and leadership requests for Japanese asset managers to lead by example on governance. How can an asset manager whose governance structure has neither outside director nor independent supervisory committees be credible in requesting better governance from companies he invests in? How to implement and drive structural reform is a deep, fundamental question. Japan’s GPIF, in our view, is taking very seriously its leadership mandate to demonstrate that Japan’s new stewardship code and corporate governance code are very much for real. We expect Friday’s annual report to reveal that the governance revolution is just getting going here in Japan. The leadership and determination from the GPIF’s new management team should not be underestimated. **Abe’s Fiscal Stimulus Shows Japan Political Leadership** News first broke about Abe releasing details for Japan’s fiscal stimulus package during the final moments of the Democratic National Convention in Philadelphia. The coordinated leadership between Japan’s government and central bank shows how Team Abe serves as a stark contrast to the more challenging political environments elsewhere in the United States and Europe. It is clear to us that Japan is set to be the global leader in providing support for its economy, while others struggle with politics. <sup>1</sup>Source: Bloomberg. Data is from 3/31/15 to 3/31/16.

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## **DEFINITIONS**

**Government Pension Investment Fund (GPIF)** : Japan's largest public pension fund.

**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.

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

**Monetizing** : When a central bank purchases debt with the consequence of increasing the money supply.

**Secondary market** : A market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets.

**Tokyo Stock Price Index (TOPIX)** : A free float-adjusted market capitalization-weighted index that is calculated based on all the domestic common stocks listed on the Tokyo Stock Exchange First Section.