Japan Monetary Policy Outlook—One Dream, One Team

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Pro-growth economic policy making is poised to make a comeback in Japan over the coming six to eight weeks, in our view. With the controversial new security bill now largely in the rearview mirror, “Team Abe”1 will want to re-establish economic policy-making credentials as quickly as possible. The sense of urgency is heightened by the fact that both domestic and external demand has fallen below expectations in recent months. Specifically, the Cabinet Office now estimates that Japan’s "output gap" was stuck at a deflationary -1.6% between January and March 2015, and the 1.6% contraction in gross domestic product (GDP) from April through June must have pushed the output gap further down the deflationary pit.2 **Yes, Fiscal Policy** The first focus of counter-policy is likely to be added fiscal stimulus. Here, “shovel-ready” public works projects have recently returned center stage due to various typhoon-damage related rebuilding needs. Specifically, the outdated and failing river dam infrastructure in many regions has become a bit of a national embarrassment, as has the growing awareness of outdated and increasingly dangerous road and rail tunneling in many of the regional economies. All said, a ¥2–3 trillion boost to public works via a supplementary budget is probably in the cards. Add to that increased spending for more general regional economic development and support for the elderly, and we are likely to see a headline supplementary budget of at least around ¥5 trillion, i.e., around 1% of GDP. **Yes, Monetary Policy** The Bank of Japan (BOJ) is very likely to complement the supplementary budget and increased public spending with stepped up liquidity provisions. A de-facto matching of the increased fiscal deficit by added BOJ bond purchases is very likely, in our view. Philosophically, the BOJ, in our view, is very much opposed to using monetary stimulus as the only added reflation tool, but it is not opposed to support a reflationary policy push in combination with increased public spending. Increasing debt monetization for specific projects is welcome, but not for general budget overruns. In our view, the key to Team Abe’s credibility rests exactly here: to regain confidence and credibility among market players, they must demonstrate that both the Ministry of Finance and the BOJ are indeed working toward the same goal of an all-out pro-growth policy. This is the real challenge for Team Abe in the coming four to six weeks: one team, one dream. **Timing & Catalysts** Timing upcoming policy events is relatively straightforward. First of all, Prime Minister Abe is due to make several presentations to U.S. investors while in New York for the UN General Assembly. Then, from mid-October on, the basic platform of a supplementary budget is poised to be presented. Then, on October 30, the BOJ will present its semiannual review of its board members’ central tendency forecasts (which is likely to result in further revisions to both the Consumer Price Index (CPI) and growth outlook). Whether the BOJ will act as early as October 30 depends primarily on the state of the supplementary budget debate. In addition, international money flow developments in response to changing Federal Reserve policy will also be monitored carefully, although the BOJ debate's main focus is domestic, in our view. In short, we think it likely that added stimulus from both money and fiscal policy will be in place by the end of November. Importantly, the coming policy activism in Japan is an extra effort, over and above the normal budget and tax policy cycle that culminates in the presentation of a draft budget by the end of December. Here, a cut in corporate taxes (expected to be around 3 percentage points to basically 29%) is the hallmark for investors, effective from next fiscal year. For Team Abe, the key issue now is to demonstrate a sense of urgency to get growth going again, and that requires the supplementary action outlined above. The coming six to eight weeks are key, in our view. ***Unless otherwise stated, all sources are Bloomberg, as of 9/17/15.*** 1Refers to Japanese prime minister Shinzo Abe and his supporters. 2Source: Japan's Cabinet Office.

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