



R&R Weekly Column
By Brunello Rosa



Abe's Resignation Opens A Period Of Potential Instability For Japan

Japanese PM Abe Shinzo resigned at the end of last week, suffering as he is from a pathology (ulcerative colitis) that had already previously caused him to resign [in September 2007](#), back when he had only been in office for one year. This institutional crisis could not come at a worse time for Japan, which is facing a second wave of Covid and is in the middle of the worst economic contraction in decades, with GDP having fallen by 7.8% q/q in Q2, the third consecutive quarterly drop in the country's GDP.

Abe's second term in office started in December 2012, with the resounding victory in the general election that led to a solid majority for his party, with 328 MPs out of 480 in the House of Representatives of the Diet. With the support of a strong cabinet featuring former Prime Minister Tarō Asō as Deputy Prime Minister and Finance Minister, Yoshihide Suga as Chief Cabinet Secretary and Akira Amari as Economy Minister, Abe launched his celebrated Abenomics, consisting of three "arrows": ultra-loose monetary policy, initial fiscal stimulus followed by fiscal consolidation, and structural reform.

As generally happens, the policy package started with the lower-hanging fruits, i.e. massive monetary easing in 2013, which led to the adoption of QQE (quantitative and qualitative easing), followed by the introduction of various forms of forward guidance, credit easing, negative policy rates and (last but not least) yield curve control. All these monetary innovations led to the weakening of the JPY, and the massive rise in Japanese equity valuations (Nikkei and Topix), with Japanese companies recording record profits, often hoarded abroad.


The other two arrows proved less successful: following an initial JPY 10tn stimulus package, fiscal consolidation came with the rise in the consumption sales tax, from 5% to 8% in April 2014. That fiscal tightening led to the Japanese economy to a stall and, eventually, a recession in Q2 and Q3 of that year, which plagued Abe's second term in office. The decision to proceed with the planned second hike in the sales tax rate (from 8% to 10%) in 2019 led to similar results, with the ongoing recession aggravated by the arrival of Covid. The pandemic has also forced the government to postpone the flagship event with which Abe wanted to conclude his period in office: the Olympic games in Tokyo. They will now have to wait until 2021 at least.


The third arrow has been even less successful, as the planned and implemented structural reforms were watered down and ineffective at best, in a country where the population is rapidly ageing and shrinking ([from almost 130 million today to around 100 million only a few decades from now](#), barring a significant change in birth rates or immigration). As a result of all this, the overarching aim of bringing the deflationary period to an end after almost thirty years has miserably failed, with [inflation struggling to remain above zero](#). Other notable failures of Abe's second term in power were the attempt to hold a referendum to change article 9 of the constitution in order to allow Japan to re-arm, and the failure to settle an old territorial dispute with Russia.

However, Abe's period in office also saw some important successes, such as his ability to remain in power for 7 years in a row, ending the endemic instability of Japanese governments that had defined the decades before Abe's ascent. The re-vitalisation of the Trans-Pacific Partnership (TPP) after Trump ditched it in 2016 was another success (it has been relabelled the Comprehensive and Progressive Agreement for Trans-Pacific Partnership). One could also classify as a success Abe's ability to forge a good working and personal relationship with US President Trump, which may have helped lead the US to engage with North Korea, and stop North Korea's missile tests of rockets sent over the Japanese territory.

What lies ahead for Japan? Next year, the general election was supposed to bring a new LDP leader and PM to power; now the process is accelerated. The race has begun, with credible contenders being Fumio Kishida (LDP's head of policy), Shigeru Ishiba (former defence minister), Yoshihide Suga and the old Tarō Asō, who would not mind a final stint in power before retiring. More than their personalities, it is Japan's policies that will matter. Assuming that for the time being monetary and fiscal policies will remain amply accommodative, one needs to understand how Japan will position itself strategically in international affairs, at a time when the US election is as uncertain as ever and China has become more assertive than ever. The next few months will determine the path Japan will follow in coming years.

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Looking Ahead

The Week Ahead: US Unemployment To Fall While In The EZ Services PMI Are Expected To Rise

In the US, August's labor market data are forecasted to show: *i)* average hourly earnings rising to 5.8% y-o-y (p: 4.8%); *ii)* the unemployment rate falling to 9.9% (p: 10.2%); and *iii)* nonfarm payrolls dropping to 1.55m (p: 1.76m).

In the EZ, August's composite PMI data is expected to remain unchanged at 51.6, while services PMI is likely to rise to 55.1 (p: 50.1).

The Quarter Ahead: Rising Geopolitical Tensions And Threats Of De-Globalization While CBs Remain Accommodative

In the US, a new wave of layoffs is likely, as large companies: 1) prepare for further pandemic-related disruption and uncertainty; 2) reassess staffing plans for thousands of furloughed workers. The Trump administration is increasingly portraying China as America's primary global foe. President Trump: *i)* suggested that - if re-elected - "the world's two largest economies could go their separate ways"; *ii)* pledged to "bring 1 million jobs back from China"; and *iii)* promised to deny federal contracts to US companies "that shift jobs there" - because "we don't have to do business with China". The US Fed Chairman Powell stated that the Fed will move to 'average inflation targeting', and hence "allow overshoots of the 2% inflation target, in order to offset undershoots". The policy will effectively allow the Fed to keep rates at the current near-zero level for a longer period - without raising them to pre-empt inflation.

In the EZ, the EU will threaten Turkey with fresh sanctions - including tough economic measures - unless progress is made in reducing tensions with Greece and Cyprus in the Eastern Mediterranean. The EU's measures, meant to limit Turkey's ability to explore for natural gas in contested waters, could restrict: *i)* individuals; *ii)* ships; or *iii)* the use of European ports.

In the EZ, the ECB - which is conducting a strategic review of its own policy, now extended until the middle of next year - will likely follow the Fed's lead and re-affirm the "symmetric" nature of the inflation target.

In Japan, Shinzo Abe, the nation's longest-serving prime minister, announced he will step down from his post due to health reasons but "will stay until his successor is decided". The process is likely to be fast, given the urgency and the constraints imposed by the coronavirus outbreak. Key policies - such as diplomacy and economic measures - are unlikely to change drastically.

Last Week's Review

Real Economy: COVID-19 Resurgence In Europe And Geopolitical Risks Threaten The Recovery

In the US, the economy shrank in Q2 by an annualized -31.7% (c: -32.5; p: -5.0%) - an improvement from the initial -32.9% estimate, but still the largest contraction on record. In July, new orders for US 'manufactured durable goods' rose by 11.2% m-o-m (c: 4.3%; p: 7.7%), recovering from the lockdown-lows of March and April - lifted by rising orders for transport equipment, such as: *i)* motor vehicles and parts; and *ii)* defense aircraft and parts. In July PCE prices rose for a second month to 1.0% y-o-y (c: 1.2%; p: 0.9%), due to higher services costs. Core PCE - the Fed's preferred inflation gauge - rose to 1.3% y-o-y in July (c: 1.2%; p: 1.1%), still well below the 2% target.

In the EZ, in August the economic sentiment indicator rose by 5.3 points m-o-m to 87.7 (c: 85; p: 82.4) - further away from the 11-year low of April, but still below pre-pandemic levels. By sector, morale improved among: *i)* service providers; *ii)* retailers; *iii)* manufacturers; and *iv)* consumers.

In Japan, the leading economic index - a key gauge of the economy's outlook - was revised down to 84.4 in June (c: 85; p: 78.3), the highest reading in three months, helped by a gradual lift of COVID-19 restrictions and the resumption of non-essential businesses.

Financial Markets: Economic Data And Vaccine Hopes Spur Investor Sentiment, Stocks Rise

Market drivers: improving economic sentiment and news of a potential vaccine by AstraZeneca and Oxford University supported the markets, and led to a jump in stock prices of key airlines.

Equities: w-o-w, global stocks rose (MSCI ACWI, +2.1%, to 583) driven by the US, where the S&P 500 (+3.3% to 3,508) - up: *i)* 52% since the March 23 bear market bottom; and *ii)* nearly 9% for the year - is on track to display its best August performance in 34 years. European shares rose on further economic stimulus in France and Germany and news of improved COVID-19 treatments (Eurostoxx 50, +1.7% to 3,316).

Fixed income: w-o-w, global debt indices fell (BAML Global, -0.5% to 296.2). In the US, after Powell's speech led to inflation worries Treasury yields rose (10y UST, +9bps to 0.79).

FX: w-o-w, the USD weakened against most currencies (DXY, -0.9% to 92.371; EUR/USD, +0.9% to 1.190). EM FX rose (MSCI EMs FX, +0.9% to 1,687); the TRY stabilized (USD/TRY, 0% to 7.333).

Commodities: oil prices rose (Brent, +1.6% to 45.1 USD/b) as an expected decrease in US crude oil inventory downplayed investors' fears about falling demand. Gold kept its safe-haven appeal (Gold, +1.3% to 1,964USD/Oz.).



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Abbreviations, Acronyms and Definitions

| | | | |
|-------|---------------------------------------|---------|---|
| a | Actual | LN | Northern League, Italy |
| AKP | Justice and Development Party, Turkey | MSS | Five Star Movement, Italy |
| ann. | annualized | m-o-m | Month-on-month |
| ARS | Argentinian Peso | mb | Million barrels |
| avg. | Average | mb/d | Million barrels per day |
| bn | Billion | MENA | Middle East and North Africa |
| BoC | Bank of Canada | MHP | Nationalist Movement Party, Turkey |
| BoE | Bank of England | mn | Million |
| BoJ | Bank of Japan | MPC | Monetary Policy Committee |
| bpd | Barrels per day | NAFTA | North-American Free Trade Agreement |
| bps | Basis points | NATO | North Atlantic Treaty Organization |
| BS | Balance sheet | OECD | Organization for Economic Cooperation and Development |
| c | Consensus | Opec | Organization of Petroleum Exporting Countries |
| C/A | Current account | p | Previous |
| CB | Central bank | P2P | Peer-to-peer |
| CBB | Central Bank of Bahrain | PBoC | People's Bank of China |
| CBK | Central Bank of Kuwait | PCE | Personal Consumption Expenditures |
| CBT | Central Bank of Turkey | PE | Price to earnings ratio |
| CDU | Christian Democratic Union, Germany | PM | Prime minister |
| CNY | Chinese Yuan | PMI | Purchasing managers' index |
| CPI | Consumer Price Index | pps | Percentage points |
| DJIA | Dow Jones Industrial Average Index | pw | Previous week |
| DJEM | Dow Jones Emerging Markets Index | QCB | Qatar Central Bank |
| d-o-d | Day-on-day | QAR | Qatari Riyal |
| DXY | US Dollar Index | QE | Quantitative easing |
| EC | European Commission | q-o-q | Quarter-on-quarter |
| ECB | European Central Bank | RE | Real estate |
| ECJ | European Court of Justice | RBA | Reserve Bank of Australia |
| EIA | US Energy Information Agency | RRR | Reserve Requirement Ratio |
| EM | Emerging Markets | RUB | Russian Rouble |
| EP | European Parliament | SWF | Sovereign Wealth Fund |
| EPS | Earnings per share | tn | Trillion |
| EU | European Union | TRY | Turkish Lira |
| EUR | Euro | UAE | United Arab Emirates |
| EZ | Eurozone | UK | United Kingdom |
| Fed | US Federal Reserve | US | United States |
| FOMC | US Federal Open Market Committee | USD | United States Dollar |
| FRB | US Federal Reserve Board | USD/b | USD per barrel |
| FX | Foreign exchange | UST | US Treasury bills/bonds |
| FY | Fiscal Year | VAT | Value added tax |
| GCC | Gulf Cooperation Council | VIX | Chicago Board Options Exchange Volatility Index |
| GBP | British pound | WTI | West Texas Intermediate |
| GDP | Gross domestic product | WTO | World Trade Organisation |
| IMF | International Monetary Fund | w | Week |
| INR | Indian Rupee | w-o-w | Week-on-week |
| IPO | Initial public offering | y | Year |
| IRR | Iranian Rial | y-o-y | Year-on-year |
| JPY | Japanese yen | y-t-d | Year-to-date |
| k | thousand | ZAR | South African Rand |
| KSA | Kingdom of Saudi Arabia | 2y; 10y | 2-year; 10-year |



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