

# For all his shortcomings, Abe has the right economic policies

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## Executive Summary

On September 25, Prime Minister Abe officially announced that he is dissolving the Lower House. A national election will be held on October 22. Given the disarray among opposition parties, PM Abe is likely to maintain a comfortable majority in the Lower House after the election.

As far as Japan's economic policy is concerned, PM Abe is right to continue on his expansionary fiscal and monetary policy. An unfavorable election outcome for him could risk a serious financial disruption as markets start to speculate an abrupt change in Japan's policy mix. It is perhaps fortunate for Japan that PM Abe probably chose a right time to call an election after shrewdly weathering political scandals this summer.

## Why is he calling an election?

Even if he did not take this action, a Lower House election had to be held before December 2018 when the four-year terms of Lower House parliamentarians expire. PM Abe must have judged that he has the best chance of winning an election than to wait till later dates. His popularity plummeted between April and July this year, as his cabinet was embroiled in a series of political scandals. The most serious scandals involved allegations that the Japanese government extended undue favors to two separate educational institutions both of whose owners had personal relationships with PM Abe and his wife.

## Abe is winning back popularity



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His popularity recovered through August and September while the parliament was in recess, but there was a risk that the scandals would have flared up again when the parliament was due to reconvene on September 28th.

Instead, he decided to dissolve the Lower House to face the judgment by voters. The fact that Democratic Party of Japan (DPJ), the main opposition party, was in disarray under a new leader, Seiji Maehara, may also have encouraged PM Abe to call the election. According to opinion polls by seven major news organizations in Japan, the approval rate for PM Abe recovered to 43.9% in September on average, exceeding the disapproval rate for the first time since July.

**What could be the election outcome?**

The ruling coalition, Abe’s Liberal Democratic Party (LDP) and its junior partner Komei, will most likely lose some seats. The last time a Lower House election was held in 2014, the coalition won a landslide victory, winning 326 out of a total of 475 seats, gaining a supermajority defined as 2/3 of the total. A supermajority in the Lower House enables a ruling party to pass legislation even when the Upper House opposes them. Perhaps more importantly for PM Abe, a supermajority allows the parliament to propose a Constitutional Revision for a national referendum. As of September 25, LDP and Komei together held 322 seats in the Lower House.

**Distribution of parliamentary seats by political parties**

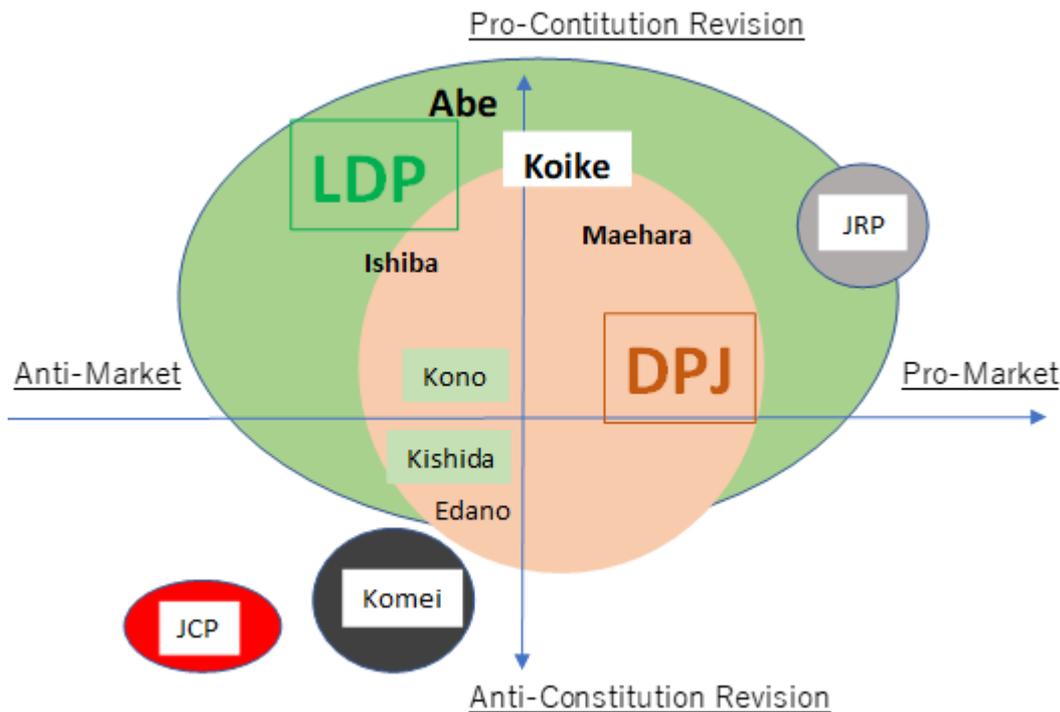
Upper House (Total 242)		Lower House (Total 475)		ruling coalition total: 322
LDP	126	LDP	287	
Komei	25	Komei	35	
DPJ	50	DPJ	87	
JRP	11	JRP	15	
JCP	14	JCP	21	
others	16	others	30	

The election on October 22 will be over the total of 465 seats, as ten seats were eliminated after an electoral reform passed in June 2017. Unlike in 2014, some of the opposition parties are coordinating between themselves to unite the votes of their respective supporters into a single candidate to win in single-seat constituencies. This would probably prevent the ruling coalition from holding onto the supermajority this time. However, the ruling coalition is still expected to comfortably win a simple majority. Another favorable factor for PM Abe is that the policy preference of two of opposition parties, Japan Restoration Party, and Hope Party, are not so dissimilar with that of PM Abe. Thus, even when the ruling coalition loses the supermajority, PM Abe would probably be able to negotiate a compromise with these two “opposition” parties to support his agenda if he requires a supermajority.

In our view, the likely outcome will be for the ruling coalition to lose 20-40 seats, but comfortably exceed the majority of 233. It is also likely that a supermajority of 310 could be achieved if JRP and Koike’s new party joins the ruling coalition. Another important arithmetic will be if LDP, JRP and Hope Party could achieve a supermajority without Komei. Komei has been a reluctant ally for PM Abe, especially when it comes to the issue of constitution revisions. If Abe could pull together a supermajority without Komei, he can credibly threaten to cut off Komei from the ruling coalition.

The map below provides our view on how political parties and major individual leaders are scattered across policy spectrum. We used two important policy spectrum to define the political landscape. One is the issue of Constitution Revision. Whether and how to revise the Article 9 is the focal point when it comes to the Constitution issue, but there is a broader issue of whether Japan should continue on the post WWII framework. While JCP, Komei and some elements within both LDP and DPJ seek to maintain a pacifist attitude where Japan imposes strong restraint on the possession and the use of military force, the majority of LDP and DPJ, spear-headed by Abe, seems to want to remove such self-imposed restriction, together with other values they feel were imposed upon Japan after WWII. The other policy spectrum is a trust or distrust placed on Market-mechanism. While JRP, significant element of DPJ and some elements of LDP seem to favor liberal, market-based mechanism, JCP, Komei and significant element of LDP tend to distrust market mechanism. The attitude toward TPP is an good example where JCP fiercely argued against TPP while both LDP and DPJ were divided. For more detailed description of policy inclination of political parties and its leaders, please see our [Who is who](#) in politics and [Overview of politics](#).

**A political map of Japan: Koike and JRP aligned with Abe on constitution revision**



**What could be considered as “defeat” for PM Abe?**

While we believe that the most likely outcome will be such that PM Abe loses 20-40 seats for the coalition but still able to claim a “victory” with a comfortable majority, what would be the line where LDP parliamentarians become critical enough to demand Abe to step down? In his press conference on September 25, PM Abe said he would step down if the ruling coalition falls short of a simple majority, i.e. 233 seats. However, 233 seats seem too low a target. Perhaps a tally of seats lower than 261 will probably be considered as a defeat as it will mean

that the ruling coalition will lose control of at least one of the sub-committee in the Lower House.

**Ranges of potential changes to Lower House seat distribution**

Before the election			After	Important threshold
LDP	287		225-280	
Kom ei	35		30-35	Supermajority: 310
DPJ	87		70-95	Majority ++: 261*
JRP	15	→	10-15	Majority +: 244**
JCP	21		20-30	Simple majority: 233
Hope (Koke)	11		25-50	
others	19		-	
<b>Total</b>	<b>475</b>		<b>465</b>	

\*Majority ++' gives chairs and majority in all sub-committees

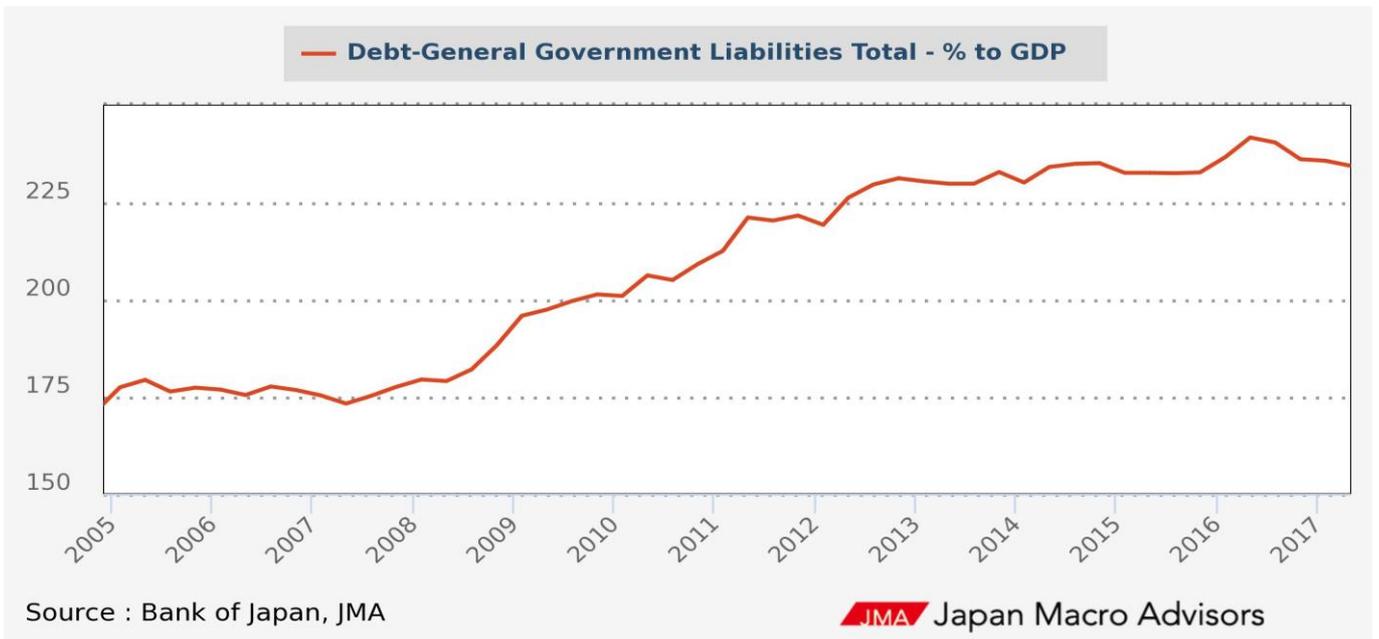
\*\*Majority +' gives all sub-committees chairs.

Source: JMA estimates

**What are the economic implications for Abe's likely "victory"?**

While we have serious misgivings for some of PM Abe's policies, especially his handling of North Korea, we consider his economic policies to be better than his oppositions'. PM Abe's opponents, both within and outside his party, have criticized his apparent lack of enthusiasm to balance the budget. Eliminating a primary fiscal deficit by 2020 has been Japanese government's official pledge for some time, but PM Abe has never seriously pursued it, in our understanding. Since PM Abe took office in late 2012, the Japanese government never projected an elimination of the primary fiscal deficit, even in its rosier scenario. However, in our view, trying to achieve a fiscal sustainability through austerity measures have almost proven not to work, as we can see in the unfortunate example of Mediterranean countries in Europe. On the other hand, stabilizing debt to GDP ratio by expanding GDP, rather than reducing debt, seems to be working for Japan. Even though Japan continued to run deficits of 3-5% of GDP in the last few years, the debt to GDP ratio has been stable and seems to have started to decline in the last four quarters.

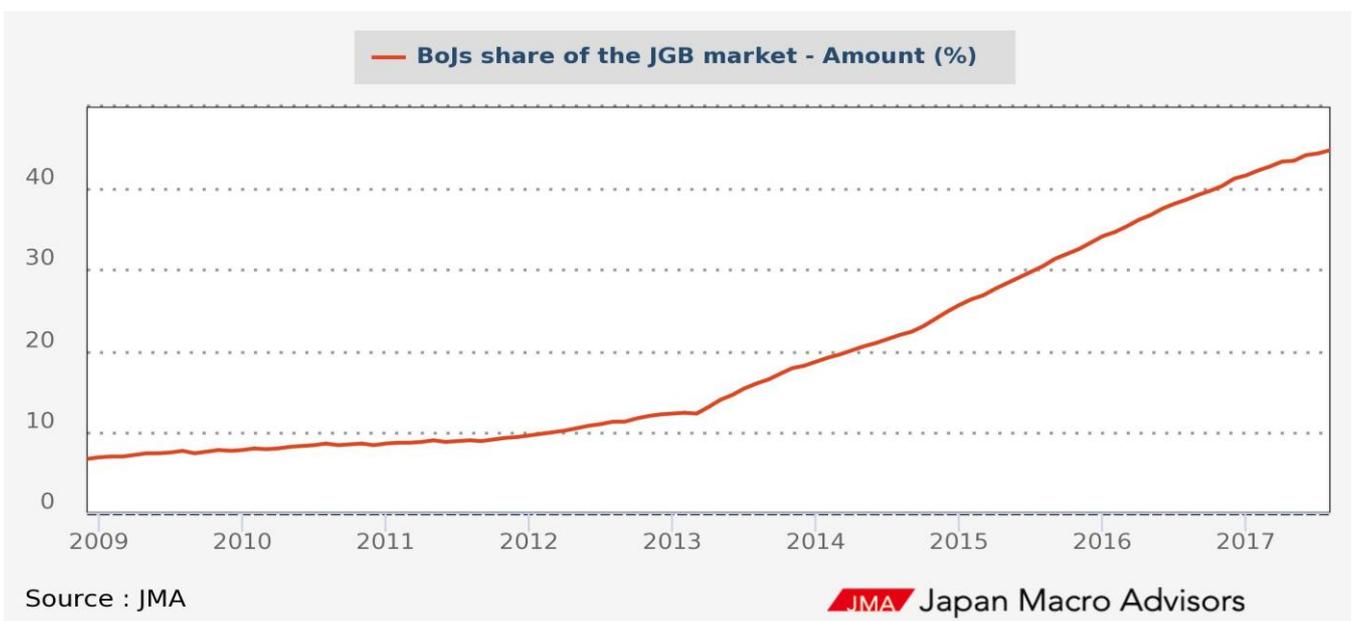
**Debt-General government Liability Total % to GDP**



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PM Abe’s economic policy has also come under indirect criticism as BoJ has not succeeded in igniting inflation, despite having aggressively pursued a quantitative easing policy. Bank of Japan (BoJ)’s balance sheet has nearly quadrupled in the last 4 years. Perhaps more importantly, BoJ is now effectively monetizing fiscal debt by owning close to 50% of government bond market.

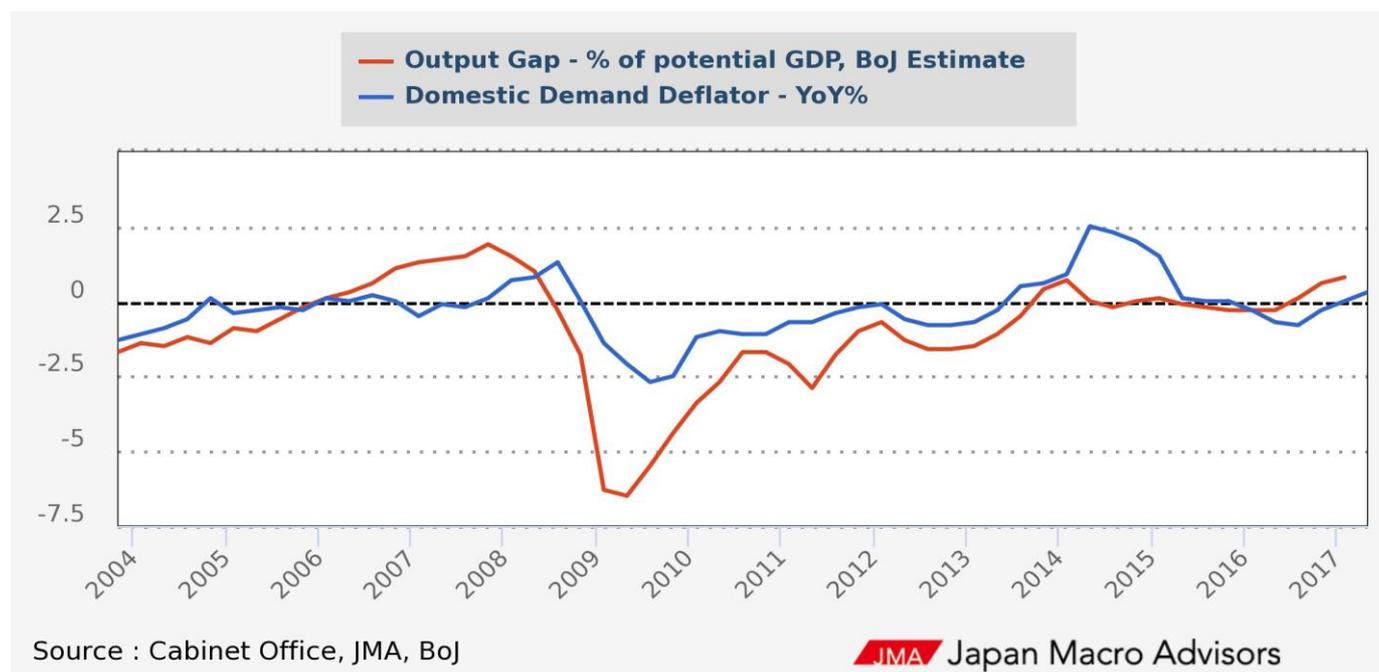
**BoJ owns 45% of total JGB market by August 2017, up from 12% in early 2013**



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In our view, while BoJ could have managed its quantitative easing more effectively, its effort was not for naught as its critics often claim. While there is yet hardly any inflation to speak of, the inflationary pressure is likely to be building up beneath the surface. The unemployment rate is at 2.8%, its 23 year low, and the output gap has turned positive. In our view, it is critical than ever for the Japanese government to maintain its stimulative policies, both monetary and fiscal.

### Inflation should be in the pipeline as output gap turn positive



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As we wrote in the report “[Can Abe recover his popularity?](#)” in July, the unseating of PM Abe would probably mean a withdrawal of political support for BoJ Governor Kuroda. Governor Kuroda has been coming under fierce criticism from the Japanese financial industry who blames him for hurting their profitability. As Governor Kuroda’s first term approaches an expiry in March 2018, a potential removal of political support for Kuroda could lead to a serious financial instability as the market speculates an abrupt change to the current monetary policy. For sure, the current monetary policy could use some adjustment, such as tapering the equity ETF purchase, but the aggressive use of monetary policy tools to pursue 2% inflation target is the right policy for Japan, in our view. If the continued reign of PM Abe is the cost, we think the Japan should close its eyes and embrace his reign until reflation is achieved.

**Important Political/Economic schedule for Japan**

<b>Date</b>	<b><u>Political schedule</u></b>	<b><u>Economy-related schedule</u></b>
2017 September 28	- Abe to dissolve Lower House	
October 22	- Lower House election	
December		- Economic stimulus package ?
2018 January	Regular Diet session begins	
March		- 2 BoJ vice governors' term expires - BoJ. Kuroda's term expires
First half	- LDP to propose constitutional changes?	
September	- LDP Leadership election	
2019 July	- Crown Prince to become Emperor - <u>Upper house election</u>	
October		- Consumption tax rate hike
2020		- Tokyo summer Olympic

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