JAPAN AFTER THE ELECTION — FOCUS ON ECONOMY, NOT CONSTITUTION

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Japanese prime minister Shinzo Abe and his ruling coalition won a very comfortable majority, but fell short of gaining the two-thirds supermajority required for fast-track constitutional reform, in Sunday's Upper House election. In our view, this is good news for financial markets as "Team Abe" will now stay focused on economic policy to maintain a strong "feel-good" factor, rather than divert even more political capital (and parliamentary time) to preparing to revise the constitution.

The record-low voter turnout—less than 50%—and the fact that the Liberal Democratic Party (LDP) returns to Parliament with fewer seats than it controlled before the election both suggest that PM Abe will have to work harder to get Japanese people excited about his policies and future vision. Make no mistake: In Japan, complacency is far more popular than Western-style populism.

Lack of credible (or unified) opposition is probably a key political factor behind his victory and the complacency that we expect. There appears to be no alternative to the LDP and Abe. On the economic policy front, the combination of record-high corporate profits, record-low unemployment and a steadfast rise in the purchasing power of the people has given "Team Abe" some of the most enviable leadership credentials in the G20. There's no need to fix something that is not broken.

Of course, Prime Minister Abe was quick to comment after the election that, in his view, the popular mandate for constitutional reform remains strong. He still would like to try to complete the process during his premiership. However, in my view, the combination of the low voter turnout and the LDP's relative (albeit modest) losses in the Upper House election suggest concrete progress is unlikely to be made in the next one or two sessions of Parliament.

Constitutional Reform Endgame

For Abe's constitutional reform endgame, it is possible that he will eventually stake his legacy on the issue and call a snap election in the Lower House. In my view, this is a risk scenario to consider seriously for sometime after the 2020 Tokyo Olympics (September 2020) and before Abe's term as LDP President ends (September 2021). Between now and September next year, Team Abe will stay focused on the economy, particularly immediate and urgent challenges that exist.

Here are the key signposts and challenges immediately ahead for Japan:

- **Consumption tax freeze at 10%**

PM Abe made an election pledge of freezing the consumption tax at 10% for at least 10 years (after the tax goes up to 10% on October 1). In the coming months, it will be important to see repeated confirmation of this new policy, with both Ministry of Finance (MOF) and broader LDP next-gen leaders following PM Abe’s lead. Signs of MOF officials contradicting Abe’s pledge would be a potential red flag for post-Abe LDP resolves.

- **Japan-Korea trade war escalation**

  The imposition of tight controls for essential high-tech components on Japanese exports to Korea has sparked fears of not just short-term supply chain challenges, but potential further escalation of trade disruption between the two most advanced countries in Asia-Pacific. If the free flow of goods can no longer be taken for granted across Asia, both Asia and Japan markets may be forced to reprice required risk premia. It is not easy to see how much political capital Team Abe will be prepared to invest in creating a resolution given the broad-based loss of trust between both nations.

- **Response to U.S. Weak Dollar Policy**

  If U.S. monetary policy begins to shift toward outright stimulus, Japan will need to formulate a response. Cooperation between the MOF and Bank of Japan (BOJ) is running smoothly, and coordinated action involving added monetary easing via increased government bond issuance (i.e., a de facto monetized extra budget) is one possibility. The BOJ extending the duration of its yield curve cap is another (i.e., moving to cap the 15-year or 20-year yield, rather than just the current 10-year). We agree with Governor Kuroda that the BOJ has plenty of policy ammunition left, though we think markets still underestimate Japan’s special coordination powers, including the ability to link monetary action directly to added fiscal expansion. After the election, Abe made clear that there is plenty of new potential fiscal power available to boost domestic demand, should further economic momentum be lost.

- **Revival of Pro-Growth Structural Reform Policies**

  PM Abe does remain committed to promoting structural reform in general, and entrepreneurship and innovation policy in particular. I am hopeful that added tax incentives for venture capital, special economic zones and other measures to boost entrepreneurship will reemerge at center stage in the policy debates running up to the creation of next year’s budget. In addition, new tax incentives for retail and pension investors to rebalance portfolios toward higher domestic equity allocations are poised to be forthcoming for 2020-21.

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G20 : Group of 20 of the world's largest economies that meets regularly in order to coordinate global economic policies.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.