

# JAPAN ECONOMICS FOCUS

27<sup>th</sup> Aug. 2009



## Two cheers for the DPJ

- **Confirmation of a decisive Democratic Party of Japan (DPJ) victory in Sunday's general election in Japan should provide a further near-term boost to the Nikkei and possibly the yen too, but this outcome is already widely anticipated.** The upside may therefore now be limited, especially as doubts creep in about what the new government will actually do.
- The latest opinion polls and recent local election results indicate that the opposition DPJ will comfortably win enough seats for an outright majority in the House of Representatives, and possibly enough for a two-thirds majority that would allow the new government to override any veto from the upper House of Councillors.
- The equity markets have already reacted positively to this prospect, although more because of dissatisfaction with the LDP rather than any great enthusiasm for the alternative. The DPJ itself comprises at least seven factions with little in common other than a desire to overthrow the LDP.
- **Talk that the DPJ would adopt a more stimulatory fiscal policy and boost consumer spending more than the LDP has done (or would do) certainly seems wide of the mark.** Japan has already put in place the largest fiscal stimulus of any G7 country.
- Less positively, the DPJ has indicated it would rollback many of the improvements in labour market flexibility that have helped the economy in recent years. **DPJ leader (and likely next PM) Yukio Hatoyama's criticism of the deregulation carried out by the Koizumi government is not very encouraging.**
- There is some sense in the argument that any government would be better than the lame duck administration of current PM Aso. But the end of the LDP's practically continuous period of government since 1955 is still a leap into the unknown. Indeed, **it is not clear that a change of governing party alone will be able to achieve more than Koizumi did *within* the LDP.**
- Some commentators have speculated that a funding crisis could soon follow if the new government fails to come up with a credible plan to reduce the huge public debt over the longer term. We think any such crisis is still a long way off.
- Aside from the supply concerns that the Bank of Japan can help address, the fundamentals for JGBs remain positive. But there is a clear risk that **the equity market's enthusiasm for a new government could soon unravel if bond yields start to head significantly higher.**

Julian Jessop

### North America

2 Bloor Street West, Suite 1740  
Toronto, ON  
M4W 3E2  
Canada  
Tel: +1 416 413 0428

### Europe

150 Buckingham Palace Road  
London  
SW1W 9TR  
United Kingdom  
Tel: + 44 (0)20 7823 5000

### Asia

#26-03 Hitachi Tower  
16 Collyer Quay  
Singapore 049318  
Tel: +65 6595 5190

Managing Director  
Chief International Economist  
Senior International Economist

Roger Bootle (roger.bootle@capitaleconomics.com)  
Julian Jessop (julian.jessop@capitaleconomics.com)  
Kevin Grice (kevin.grice@capitaleconomics.com)

## Two cheers for the DPJ

This short *Focus* looks ahead to Sunday's general election in Japan, which is widely expected to mark the end of the Liberal Democratic Party's practically continuous period of government since 1955 (there was a brief schism in 1993-94). A victory for the opposition Democratic Party of Japan would therefore be a leap into the unknown. But for now at least, Japanese voters - and most in the financial markets - appear to welcome the prospect of change.

### A quick primer on Japanese politics

Sunday's elections are for all 480 seats of the House of Representatives, whose members serve four-year terms. Of these, 300 are elected from single-member constituencies and the remainder from eleven multi-member constituencies under a system of proportional representation (PR). The 2005 results are shown in Table 1.

**TABLE 1: RESULTS OF 2005 ELECTIONS  
(HOUSE OF REPRESENTATIVES)**

	Seats	% PR Vote
Liberal Democratic Party (LDP)	296	38.2
New Komeito (NKP)	31	13.3
<b>Government</b>	<b>327</b>	<b>51.5</b>
Democratic Party of Japan (DPJ)	113	31.0
Communists	9	7.3
Social Democratic Party	7	5.5
Peoples New Party	4	1.7
New Party Nippon	1	2.4
New Party Daichi	1	0.6
Independents/Others	18	-
<b>Opposition/Others</b>	<b>153</b>	<b>48.5</b>

Source – House of Representatives

The House of Representatives is the lower of the two chambers of parliament (the other is the House of Councillors), but in most respects it is the more powerful. In particular, the House of Representatives is responsible for electing the Prime Minister and has the last word on budget matters and foreign treaties. On other issues it requires a two-thirds majority to override any veto from the House of Councillors.

The latest opinion polls suggest that the opposition Democratic Party of Japan (DPJ) is heading for a landslide victory, winning more than 300 seats. The Liberal Democratic Party's (LDP's) share could fall to little more than 100 (essentially reversing the current standings of the two parties). The inclusion of a substantial element of PR and the hard evidence from a surge in support for the DPJ in recent local elections both suggest that the opinion polls will prove to be reliable.

**There is therefore little doubt that the DPJ will win more than the 241 seats required for an outright majority.** Indeed, there is a good chance that the DPJ will win the 320 seats required for a two-thirds majority that would allow it to override any veto from the House of Councillors. If not, the DPJ may have to rely on the support of some of the smaller parties. However, this should not be an issue for very long: the DPJ is already the largest single party in the upper house with 109 of the 242 seats, and will probably be able to convert this into an outright majority when the next elections for the House of Councillors are held in 2010.

### Time for a change?

In the run up to the elections a decisive victory for the DPJ has been widely heralded as the best possible outcome, both within Japan and by foreign commentators (ourselves included). However, **this largely reflects dissatisfaction with the LDP rather than any great confidence in the opposition.** The LDP has been in power almost continuously since 1955. During this time it has become unhealthily close to special interests, notably the larger export-oriented manufacturers, the construction industry, the civil service bureaucracy, and Japan's heavily-protected farmers. There is also a widespread perception that the LDP is a "cold war relic" well past its prime.

However, there are plenty of ways in which the DPJ could disappoint. Many of its leaders are actually ex-LDP politicians, and others come from

a wide range of factions with little in common other than a desire to get rid of the LDP. Indeed, the limited track record to date is not great. Since 2007 the DPJ has used its strong position in the House of Councillors to frustrate the LDP government (for example, holding up postal privatisation). While this may have been good politics at the time, it was not necessarily good for the economy or financial markets. The DPJ's statements on economic and foreign policy have also been inconsistent. In particular, the party has switched from advocating fiscal discipline to a policy of tax and (especially) spend.

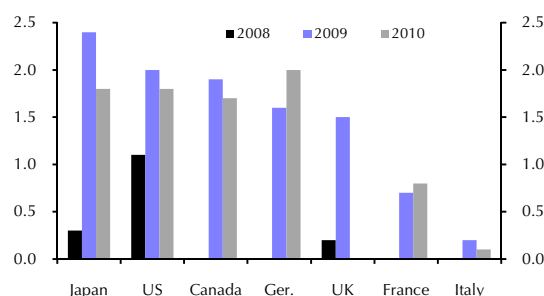
**The emphasis in the DPJ's election manifesto is certainly on populist fiscal measures.** The party has promised an additional ¥7,100bn of social spending and tax cuts for smaller businesses in the fiscal year 2010-11 (around 1.5% of GDP), building to ¥16,800bn (3.5% of GDP) by 2013-14.

Most attention has focused on a package of subsidies for families with young children, costing ¥5,500bn a year, designed to boost Japan's low birth rate. However, this will not be implemented until 2011-12 and any economic benefit from more rapid population growth will obviously take decades to come through.

The DPJ says it will finance the eventual ¥16,800bn stimulus by eliminating wasteful spending (saving ¥9,100bn, but easier to say than to do), asset sales (¥5,000bn) and efficiency savings from the introduction of a new tax code (¥2,700bn). Any increase in the consumption tax will be delayed for at least another four years (after the next elections for the Lower House).

The approach is seen by many as a fundamental change from what the LDP has been doing (or would do). Indeed, there is a lot of talk about a fresh stimulus to the economy and to consumer spending in particular. We are sceptical. For a start, **the LDP government has already implemented the largest fiscal stimulus of any G7 country**, worth around 2.4% of GDP in 2009 and 1.8% of GDP in 2010. (See Chart 1.)

**CHART 1: DISCRETIONARY FISCAL STIMULUS (% GDP)**



Source – IMF

Many of the measures were much the same in effect as those proposed by the DPJ, including cash handouts for families and support targeted at small businesses. It seems likely that if the LDP were still in power and facing the same economic conditions, it would respond in much the same way as the DPJ. Successive LDP administrations have delayed any increase in the consumption tax and pushed back targets for balancing the budget.

What's more, the bulk of the additional spending and tax cuts in the DPJ manifesto will not kick in for several years and, if the DPJ's own plans are to be believed, the stimulus will be largely offset by savings (expenditure cuts and higher tax receipts) elsewhere. **Suggestions that a DPJ government would provide an immediate fiscal boost to the economy worth as much as 3.5% of GDP are therefore simply wrong.**

Less positively, the DPJ has indicated that it will seek to rollback many of the improvements in labour market flexibility that have helped the economy in recent years, notably the increase in part-time and temporary working. We are less concerned than some about the DPJ's proposals to introduce a minimum wage, because it is already clear that Japan cannot compete head-to-head with other Asian economies on cost alone. But **DPJ leader (and likely next PM) Yukio Hatoyama's criticism of the deregulation carried out by the Koizumi government (in power until 2006) is not very encouraging.**

The other main plank of the DPJ's programme is "administrative reform", aimed in part at weakening the power of the bureaucracy and special interests. This is of course hard to argue against. The focus will be on giving elected politicians more power relative to civil servants, but whether this power will no longer be exercised in favour of special interests remains to be seen. The proposed rationalisation of the budget process and reform of the pensions system are at least long overdue. Overall, though, it is far from clear that a change of governing party alone will be able to achieve more than Koizumi did *within* the LDP.

### First thoughts on market implications

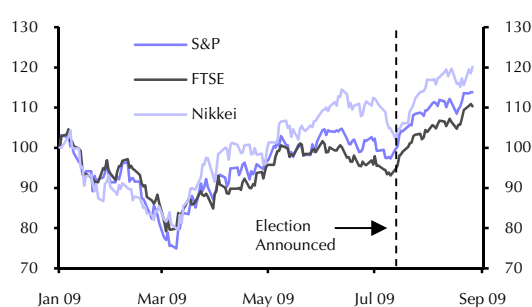
The equity markets have already decided that any new government would be better than the lame duck administration of PM Aso. The Nikkei has rallied (and outperformed other major indices) since elections were called in mid-July. (See Chart 2.) Confirmation of a decisive DPJ victory should therefore provide a further short-term boost, probably supporting the yen too. However, as a DPJ victory is now widely expected the upside may be limited, especially as doubts are soon likely to creep in about what the new government will actually do.

**term.** We have some sympathy with this view, but any such crisis is still a long way off. After all, no government in any other country has come up with a credible plan either.

**Japan's dire fiscal position is hardly news, but bond yields have remained very low.** Aside from the supply concerns that the Bank of Japan can help address by increasing its outright purchases, the fundamentals for JGBs (including near-zero short-term interest rates, price deflation and relatively low foreign participation in the market) remain positive for now. Finally, the economic recovery is still too fragile for any party to contemplate tightening fiscal policy any time soon.

Nonetheless, Japan's huge public debt is a genuine concern that we shall return to in another *Focus* shortly. The equity market's enthusiasm for the DPJ would certainly unravel if bond yields start to head significantly higher.

CHART 2: JAPAN, US & UK EQUITY INDICES (1<sup>ST</sup> JAN. = 100)



Source – Thomson Datastream

The reaction of the Japanese government bond (JGB) market may also prove to be more significant. **Some commentators have speculated that a funding crisis could soon follow if the new government fails to come up with a credible plan to reduce the huge public debt over the longer**