
JAPAN EARLY ELECTION WOULD DELAY BOJ EXIT FURTHER

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The Japanese media are speculating that Prime Minister Shinzo Abe may call a snap election, possibly as early as October 22.¹ Although Abe has, so far, not commented on the speculation—and it is at the prime minister's discretion to dissolve parliament—our sources suggest a reasonable probability of an early election. If so, the key implication for markets would be an almost certain change in Japan's [macro](#) policy mix: The probability of taxes going up in 2019 would rise, which in turn would raise the odds that the Bank of Japan (BOJ) will have to do more for longer to ensure against the inevitable recession that has always followed consumption tax hikes.

The political decision on the next consumption tax hike must be made in November or December next year. This is by far the most significant macro policy decision Japan faces because all tax hikes in the past forced recessions (as well as equity [bear markets](#)).

Abe has already once used his powers to delay the unpopular tax hike as a bargaining chip for voter popularity (2015). It seemed reasonable to assume he would do so again, particularly since the tax hike decision basically coincides with when he must call an election anyway (Japan's lower house has a maximum term of four years, and the terms are up in December 2018).

Under this scenario, which was more or less the consensus expectation before the last couple of days, there was a possible window for the BOJ to exit by end-2018/early 2019—if fiscal policy stays accommodative (by Abe delaying the tax hike once again), [monetary policy](#) has the flexibility to change.

Now, if Abe plays the election card this year, the probability is very low that he'll call another election within little more than a year. That in turn makes a tax hike an almost certainty, which leaves the BOJ alone in charge of accommodation and insurance against a 2019 recession.

In our view, a possible snap election in the coming months would raise the probability that the BOJ's exit discussion will have to be pushed back further. For global money flows, that raises the likelihood of "de-synchronized" monetary policy (i.e., the BOJ staying hard on the accelerator while the Federal Reserve and the European Central Bank test ever more assertively the monetary policy brakes). At the Group of Seven (G7) or in bilateral discussions with the U.S., Japan's position would actually strengthen, as it's hard to be accused of being a currency manipulator when changing the policy mix to address fiscal imbalances.

A second policy effect from a snap election would be on the constitutional reform agenda. Right now, Abe's Liberal Democratic Party (LDP) does have the necessary two-thirds majority in parliament to attempt a revision of the constitution. Most pundits expect Abe will easily win a simple majority in a snap election now but doubt the LDP could maintain a supermajority.

If so, markets would probably cheer an early election, as many investors see constitutional reform as a "vanity project" that has distracted Abe's attention away from the structural growth strategy. A solid but smaller parliamentary majority

would effectively kill the vanity project and thus might force a welcome refocus on economic and structural reform.

However, in my view, one should not rule out the LDP actually maintaining its supermajority for two reasons: The opposition parties are in disarray and face a severe shortage of parliamentary candidates, and the combination of North Korean nuclear ambitions and China's response to those ambitions plays well into Abe's fundamental and emotional popularity base.

Be that as it may, for markets, what matters is that policy activism is back in Japan, and an early election is bound to prolong the relentless liquidity creation by the BOJ to ensure against a tax hike-induced 2019 recession, in our view.

¹Source: Leo Lewis, "Shinzo Abe considers Japan snap election to shore up power," Financial Times, 9/17/17.

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