

Japan early election would delay BOJ exit further

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Japanese media are speculating that PM Abe may call a snap election, possibly as early as October 22. Although the Prime Minister himself has, so far, not commented on these speculations—and it is at the Prime Minister's discretion to dissolve Parliament—my 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 raises the odds that the 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 will have to be made in November/December next year (2018). This is by far the most significant macro policy decision Japan faces because all tax hikes in the past did force recessions (as well as equity bear markets).

PM 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 this again, particularly since the tax hike decision basically coincides with when he will have to call an election anyways (Japan's lower house has a maximum term of four years, and these 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 already this year, the probability is very low that he'll call another election with little more than a year. This in turn makes a tax hike an almost certainty, which leaves the BOJ alone in charge of accommodation and insurance against a 2019 recession.

Clearspeak, in my view, a possible snap election in coming months would raise the probability that the BOJ's exit discussion will have to be pushed back further. For global money flows, this raises the likelihood of "de-synchronised" monetary policy, that is, BoJ staying hard on the accelerator while the Fed and ECB test ever more assertively the monetary policy brakes. At the G7 or in bilateral discussions with the US, Japan's position would actually strengthen as it's hard to be accused a currency manipulator when you're 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, PM Abe's LDP does have the necessary two-thirds majority in parliament to attempt a revision of the constitution. Most pundits expect PM 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 re-focus on economic and structural reform.

However, in my personal 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 second, the combination of the North Korean nuclear ambitions and China's response to it, 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 poised to prolong the relentless liquidity creation by the BoJ to ensure against a tax-hike induced 2019 recession, in my view.

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