

Analysts

Simon Wong, +852 2821 1042
Standard Chartered Bank (Hong Kong) Limited
Regional Economist
Simon.Wong@sc.com

Vincent Tsui, +852 2821 1039
Standard Chartered Bank (Hong Kong) Limited
Research Analyst
Vincent.Tsui@sc.com

Japan – Election heat is on

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- The general election is scheduled for 30 August; the DPJ aims to end the LDP's 53-year political dominance
- We expect a DPJ-led government to focus fiscal spending on boosting household income and pursue deeper regional cooperation, especially with China
- Key near-term concerns: the failure of a single party to win a strong mandate, and the risk of market dissatisfaction with 'missing pieces' in DPJ's economic strategy

Aso's final call?

Following its stunning victory over ruling Liberal Democratic Party (LDP) in the Tokyo assembly election last weekend, the opposition Democratic Party of Japan (DPJ) was quick to submit a no-confidence vote to the lower house (House of Representatives). This prompted Prime Minister Taro Aso's announcement that he would dissolve the lower house next week at the earliest and call a general election on 30 August. Clearly, much can happen between now and then to turn the tide for the LDP; however, at this point, we believe its prospects do not look good. The Tokyo local election is widely perceived as a barometer of the national poll, and latest opinion polls show the DPJ commanding a 12% lead over the incumbent party.

To recap, the DPJ has held a majority in the upper house (House of Councillors) since 2007, and now holds 109 of its 242 seats. Although the upper house is less powerful than the lower house under the current political system, the DPJ has succeeded in delaying bills and budgets proposed by the LDP to the extent that, despite suffering scandals and defections of its own, the DPJ is now seen to have gained sufficient support to make a bid for control of the lower house. If the DPJ is successful in the August elections, Japan will experience the first true change in government in more than 50 years. In this OTG we outline our initial thoughts on the economic implications of a DPJ victory.

What the DPJ stands for

The DPJ has been criticised for a lack of specifics in its policies, and understandably so, in our view. The DPJ was originally formed by the merger of four social-democratic opposition parties in 1998, with the later addition of other smaller parties and independent Diet members. The political spectrum within the party is thus wide and, similar to the LDP, comprises various factions (see Table 1); indeed, much has been reported in the press of the shared heritage in terms of the current DPJ leadership and the ruling LDP. Yet a more important reason for this seeming lack of coherence in DPJ policies is that, as the long-running opposition party, it is defined more by what it is opposed to than by what it stands for. Broadly speaking, the DPJ sees itself as a proponent of small government and free market economy. In its rhetoric it seeks to restrain the government from crowding out private sector activities and redistribute the administrative power of the central government to local authorities.



Table 1: Main factions of the DPJ

	Political orientation	Remarks
Hatoyama Group	Centrist	• led by Yukio Hatoyama, secretary general of DPJ
Isshin-kai	Centre-right	• supporters of incumbent DPJ president Ichiro Ozawa
Kan Group	Left	• led by the former DPJ president Naoto Kan
Liberal Party Group	Centre-right	• led by Ichiro Ozawa and Hirohisa Fujii
Japan Socialist Party Group	Left	• formed by moderate members of the Socialist Party
Democratic Socialist Party	Left	• led by Takashi Yonezawa
Ryoun-kai	Right	• members from the now defunct Sakigake Party

Source: SCB Global Research

It is not just how much you spend, but how to spend it

This line of thinking is embodied in the DPJ’s latest fiscal policy agenda. The crux of its latest campaign pledges and spending plans (released 8 July, see Table 2) is that they are measures that aim to increase disposable income in a permanent way; thus they could be more effective in influencing spending behaviour. There is also a clear attempt to address some of the potential bottlenecks (e.g. the abolition of highway tolls) that could give domestic demand a much-needed boost. The DPJ puts the direct costs of its proposed measures at around 4% of GDP over a two-year horizon, yet we would expect at least part of the cost of their successful implementation to come from tax revenues from increased economic activity. As such, in terms of short-term fiscal policies, we expect a DPJ government to maintain or even expand the current level of fiscal stimulus, but to refocus its measures from infrastructure projects towards augmenting household incomes.

Table 2: DPJ’s campaign pledges and spending plans

• Abolish highway tolls
• Postpone raising the 5% consumption tax for another four years
• Pay JPY26,000 monthly allowances to families with children
• Provide free high school education
• Increase financial aid to farmers
• Temporarily halve the corporate tax rate for small and medium-sized business to 11%
• Ban wage discrimination between regular and irregular workers (this includes temporary and part-time workers)
• Increase Japan’s minimum wage by 30% over the next three years

Source: SCB Global Research

Financial strategy still lacks clarity

Whereas the DPJ has articulated its near-term fiscal agenda, at this point its stance on other economic policy matters is unclear. On monetary policy, by and large, it supports the current monetary stance of the Bank of Japan (BoJ) to keep the Overnight Target Rate close to zero, and the bank’s recent efforts to inject liquidity to the credit market. The DPJ also proposes lowering the reserve requirement ratios and temporarily suspending the mark-to-market requirement for stocks held by Japanese financial institutions.

In terms of FX policy, the DPJ still thinks currency intervention by the Ministry of Finance (MoF) is necessary to manage short-term volatility; yet its shift away from a pro-industry agenda and its emphasis on consumption- rather than export-led growth could lessen its resolve to counter JPY appreciation, especially if and when inflation risks re-emerge.



Good news for China, less so for the US

The DPJ supports the liberalisation of trade, investment, and other sectors within the WTO framework, and we expect it to actively pursue free trade agreements with the United States and other Asia-Pacific nations. This also extends to the broader sense of regional cooperation, as the DPJ is a proponent of establishing an Asian framework to deal with energy and trade issues.

The DPJ has repeatedly emphasised that the US-Japan relationship should be based on an equal footing, a line that current chief Hatoyama adheres to, as he claims that Japan now needs to shift from US-led diplomacy to diplomacy based on mutual cooperation. The party has criticised the LDP government for being too soft on the US on issues such as realignment of US forces in Japan and offering military assistance in terms of the war in Afghanistan. We still expect a DPJ-led Japan to maintain close ties with the US but to shift its focus to strengthen its regional alliances.

China is clearly one candidate for closer ties. The DPJ's close relationship with China dates back to ex-President Ozawa's 'Great Wall' programme in 1986, and a regular exchange mechanism has been established between the DPJ and the Chinese Communist Party. It has also taken a far more accommodative stance on controversial issues, such as official visits to the Yasukuni Shrine, which is clearly conducive for better Japan-China relations going forward. All this suggests a DPJ-led Japan will seek to develop a deeper partnership with China, among others, in economic and financial matters. The latest comments by the DPJ's shadow finance minister, that Japan should diversify its USD 1trn-strong reserve away from the USD, clearly echo recent concerns from China and contrast with the strong USD-supportive stance of current Finance Minister Yosano.

The near-term risks

While we could see a potential DPJ leadership open up new possibilities in terms of Japan's economic outlook, we are also aware of the potential risks associated with a DPJ government. First, if the DPJ wins but fails to secure a majority on its own, it will have to form a coalition, which may mean an even more fractured government structure than at present. Second, there remain many 'missing pieces' in the DPJ's economic strategy that leave considerable scope for market confusion and policy incoherency, a risk that the aforementioned shadow finance minister's comments clearly demonstrate. Finally, the question of how to fund the fiscal deficit could become an even greater concern, as the DPJ has so far been muted on how to finance its stimulus package. The party has vowed to cut down on wasteful infrastructure projects, but unless it has a strong enough mandate, it risks alienating existing vested industrial interests by doing so. Many of the DPJ's proposed policies, such as the generous allowance to families with children, hint at a strong resolve to address some of the economy's fundamental ills. Yet, in our view, even a victorious DPJ will face a long and arduous balancing act before it can hope to tackle these structural issues head on.



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