Northern Trust

# ECONOMIC UPDATE

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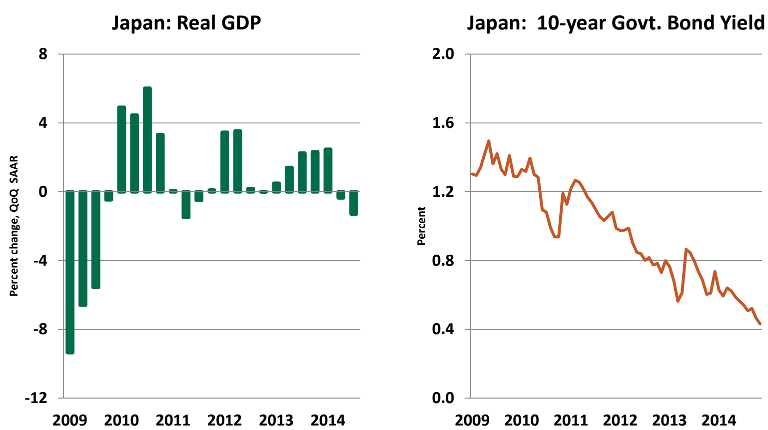
## • Japan elections: Abe's bet pays off

Prime Minister Shinzo Abe's got what he wanted as his Liberal Democratic Party (LDP) triumphed in snap national elections held on Sunday. Buoyed by a lackluster opposition effort and an apathetic electorate, the LDP–Komeito coalition maintained its two-thirds supermajority in the lower house of parliament, even managing to gain one seat. However, the bigger concern – and likely the real reason for early elections – is the need to overcome opposition to the government's initiatives from powerful bureaucrats and LDP backbenchers.

On the economic front, Japan is in very much the same situation it was before elections. The country will manage a shallow recovery in the fourth quarter, as the impact of the consumption tax increase in the second quarter continues to weigh on the outlook. We expect that the economy will see negligible expansion of 0.1% this year and 0.9% growth in 2015. The full benefits of delaying the second leg of sales tax increases and the expansion of quantitative easing should show up in 2016.

Japan's trade balance will be a bright spot as lower energy prices provide some relief and exports continue the solid recovery witnessed in recent months. Sunday's election will provide the prime minister with the political capital needed to push a restart of nuclear reactors, which would reduce oil imports and have a positive impact on the trade balance.

A key weakness in the external outlook is the economic prognosis from China, which currently takes 18% of Japanese goods exports; continued weakness in its largest trading partner will weigh on a sustained recovery in exports.




*Source: Haver Analytics*

On the policy side, the delay of the second phase of the consumption tax will almost certainly result in Japan missing its goal of halving the primary deficit by fiscal year 2015. As a result, Japan finds itself in a ratings downgrade cycle, with Moody's downgrading the sovereign one notch and downward movement from Fitch considered imminent. Moody's has cited uncertainty over the achievability of fiscal deficit reduction goals; doubts about the effectiveness of growth-enhancing policy measures; and concerns about the accompanying risk of rising Japanese government bond (JGB) yields and reduced debt affordability. Ironically, JGB yields fell after the announcement.  This follows a precedent in which Japan has traditionally been able to shrug off ratings downgrades with little to no impact on yields.

Japan has more than 90% of debt held locally and is a net external creditor, so its bond yields are relatively insulated from changes in global investor sentiment. In addition, with monthly Ministry of Finance debt issuances at ¥10 trillion and Bank of Japan asset purchases budgeted at ¥8 trillion to ¥12 trillion per month, there is no shortage of demand, and yields will remain extremely low with the possibility of negative yields on longer-term JGBs.

This latest electoral triumph could give Abe the firepower needed to push through some of his structural initiatives, especially agricultural reform and eventual Trans-Pacific Partnership membership.  However, the prime minister will still find it hard to manage backbenchers who are beholden to vested interests and have little incentive to toe the line now that the opposition is in disarray and elections are a distant prospect.

Finally, and at the risk of sounding like a broken record, the success of Abenomics depends on creating a “virtuous cycle” that relies on increasing wages.  The program will fail if Abe cannot persuade corporations to loosen the purse strings and provide meaningful wage increases.