
The Economic Implications of Koizumi's Election Victory

Adam S. Posen

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The resounding victory of Japan's Liberal Democratic Party (LDP), led by incumbent Prime Minister Junichiro Koizumi, in Sunday's Lower House election is very good news for the Japanese economy. It promises not only continuation of Koizumi's constructive policies in financial and fiscal affairs (not least avoiding mistakes), and of his backing of the Bank of Japan's antideflation commitment, but also raises hopes for the passage of a new agenda of reforms. Given Heizo Takenaka's successful clean-up (with Koizumi's backing) of the banking-system problems in Japan, there is no reason to hesitate pursuing an aggressive agenda. Once implemented, such reforms are likely to add a couple of tenths of a percent to the average annual rate of Japanese growth for the next few years.

Koizumi's victory is historic in three senses. First, by winning 296 of the total 480 seats, while purging and defeating those old-line LDP members who opposed his postal savings proposal, he has command of an effective majority larger than seen in decades. Second, by having a combined 327 seats in his coalition (with Komeito party's 31), he has control of more than two-thirds of the Lower House seats, which means that the coalition will have sufficient votes to overrule the Upper House, if that body were to vote against a proposal. Third, by attracting not only a high turnout but also many younger and urban voters to the LDP for the first time, he has set the groundwork for a truly new LDP. The main opposition Democratic Party of Japan (DPJ), which ran mostly on a foreign policy platform (to withdraw Japanese troops from Iraq, among other things), has become a nonfactor.

The new reform agenda that the prime minister will pursue is still unclear; Koizumi did not offer much more than a commitment to remaking the LDP and to pushing through postal reform during the campaign, probably because he had no expectation of receiving such a decisive mandate. A constructive Koizumi agenda is likely to include some subset of the following ambitious but politically feasible proposals:

- **A better postal reform bill**—The current version stretched out privatization all the way to 2017 and had other failings. A new version would speed up privatization, more aggressively constrain the range of Postal Savings' subsidized

product offerings, and make more room for competition to Postal Life Insurance. Since life insurance remains the weakest part of the Japanese financial system, privatization of the Postal Insurance system could be combined with more thorough clean-up of that part of the financial sector.

- **Fiscal consolidation**—Getting Japanese public finances back onto a path to long-run sustainability is more tractable than many realize but will take action. Lasting cuts in public spending would be more conducive to long-run change, as well as less damaging to the short-term outlook, than an increase in taxes. Given the political impetus for Koizumi to continue cutting off the traditional LDP rural districts' pork projects and his commitment not to raise the value added tax (VAT) until 2007, one can hope for strong movement in this direction. Another possibility for rapid reform is simplification of the fiscal transfers between central and local levels of government in Japan, which would allow better accounting.
- **Pension reform**—Along with reduction in public works spending, bolstering social security is a key step to fiscal sustainability. As with the overall fiscal picture, the viability of Japan's current pension system is higher due to recent reforms than many recognize. Further efforts should focus on raising the retirement age.
- **Agriculture protection cuts**—In mid-2004, Koizumi pushed hard against Japanese agricultural privileges during negotiations for a Japan-Mexico free trade agreement (FTA) (though he ultimately failed to remove them). Since these supports also follow the old LDP political logic like public works spending, there is good reason to think that this may be the opportunity to do away with Japan's most extreme protection in this area. It would also offer Koizumi a way to assert leadership on a global stage in the Doha trade round and reach out to less developed countries (LDCs), as well as ally with the United States for the Doha round.
- **Promotion of inward FDI**—A long-stated goal of Koizumi's has been to increase the amount of foreign direct investment coming into Japan, particularly from the United States. While many regulations already have changed to make mergers and investments easier, the implementation still relies on case-by-case acceptance by Japanese authorities (and public opinion). Privatization of the postal system itself would give two major opportunities for there to be sales to foreigners that could have clear demonstration effects:
 - First, the postal delivery system itself could be sold in part to a Fedex, DHL, UPS, or the like and have significant efficiency-enhancing effects on backwards distribution and logistics, which currently impose substantial costs on all commercial transactions in Japan.
 - Second, privatization of postal savings and insurance could be used to expand the variety of investment products made directly available to the holders of the system's \$3.5 trillion in deposits and \$1 trillion in insurance

policies (outright sale of part of postal savings to a foreigner remains politically impossible). Koizumi's emphasis on good relations with the United States—and the electorate's rejection of the DPJ—should lead to more openness in this regard, and thus attract reentry by US financial firms.

- **Strengthening of Diet over the bureaucrats**—Koizumi has to reward those LDP members who stood by him as well as those 'assassins' who took on the rebel old-line members. For a long time, the LDP has spoken of 'administrative reform,' which has meant in part reducing the ability of the ministries to set policy with disregard for the elected officials and with unduly high regard for relationships with interest groups in the private sector. Giving the Diet members more control over the creation of policy and increasing transparency of policymaking would play to the younger LDP politicians. Koizumi has a record of strengthening his own hand (such as creating the expanded Cabinet Office out of the former Economic Planning Agency) and taking on the ministries he deems arrogant (such as his battles with the Ministry of Foreign Affairs early in his term) and may go further.
- **Targeted immigration of Asian health care workers**—This remains more of a hope than of a current proposal but has more chance of becoming real now than at any previous time. Japan remains short of skilled and affordable health care workers (nurses, techs, etc.) while having a rapidly aging population. Thailand and the Philippines, among other neighboring nations, have large available pools of such workers who would be available for long-term guest worker status. Recognition of the advantages of importing such services is proceeding apace in Japanese public discussion. Properly played, this could be the first step toward a more sensible and slightly more open immigration policy in Japan.

One cautionary note to go with this avowedly optimistic appraisal: This note ignores the foreign policy issue of current tensions between Japan and China, South Korea, and some other Asian nations over symbolic and historical issues (as well as over military commitments and energy exploration in the region). Some policies Koizumi has pursued or at least encouraged in this area do have the potential to throw a wrench into trade and investment flows between Japan and its neighbors, beyond their serious diplomatic implications.