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**Where Is The World Going?
How Do We Get There First?**

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Political Volatility Returns to Japan

Leadership Contested in Japan

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Among Prime Minister Shinzo Abe's many accomplishments in the nearly five years since he returned to power in December 2012, perhaps none is as remarkable as his stabilization of Japan's political system. Abe's return came after a period in which Japan was led by six prime ministers in six years (including Abe's tumultuous first premiership in 2006-2007). His long-ruling Liberal Democratic Party (LDP) was decisively driven from power by the Democratic Party of Japan (DPJ) in 2009, leading to a three-year interregnum characterized by foreign and domestic crises that was capped off by the devastation of the Tohoku region by an earthquake and tsunami, and the subsequent Fukushima nuclear disaster. During this period, new parties rose and fell with bewildering regularity, growing out of internal fissures in the major parties. Political volatility took its toll on policymaking, and Japan looked increasingly adrift, especially in the aftermath of the global financial crisis.

While Abe came to power pledging to address specific crises – rising tensions with China, economic stagnation, and the slow progress of reconstruction in Tohoku – he was also determined to exercise stable leadership. He succeeded mightily, deploying the institutional powers of the prime minister's office to their fullest extent to articulate policy and control the bureaucracy, taming the factional infighting that had long hindered LDP prime ministers, and taking advantage of unified control of the Diet and a supermajority in the House of Representatives to manage the legislative process. The LDP, meanwhile, was the center of what came to be called the "one large, many small" party system, facing an opposition DPJ that had shrunken in stature and was unable to regain the support of voters. With firm control of the political system, Abe was able to advance Abenomics and pursue more assertive foreign and defense policies, even withstanding occasional public backlash to his policies.

At the start of 2017, it seemed as if this situation could continue indefinitely. Abe began the year with approval ratings near their peak at roughly sixty percent. In recognition of his leadership, at its annual convention in March 2017, the LDP formally changed its rules to allow its leaders to serve for three, three-year terms, instead of two. This rule change would allow the prime minister to seek a third term as party leader when his term ends in September 2018. If successful, he would serve as prime minister through 2021, surpassing his great-uncle, Eisaku Sato, as Japan's longest-serving postwar prime minister. Few doubted that, after leading the LDP to four straight national electoral victories, Abe would be easily confirmed for a third term.

What happened instead, was the return of the political volatility that Abe seemed to have banished. Even as the LDP opened the door for a third term, the prime minister was hit with allegations that he had used his office to benefit friends and associates, including a steeply discounted land sale to a school with links to the prime minister and First Lady, Akie Abe, and allegations that senior officials pressured bureaucrats to approve a veterinary school license for a private school operator

headed by a longtime friend of the prime minister's. While in neither case was there definitive proof that Abe was aware of the activities of his subordinates, the impression of influence-peddling eroded public trust in the prime minister.

As a result, Abe's approval ratings –the self-reinforcing foundation for a government that prided itself on its stability – plummeted, his net approval swinging from nearly +30 percent to -15 percent. Tarnished by the prime minister's scandals, the LDP suffered a catastrophic defeat in Tokyo's metropolitan assembly elections on July 2, 2017, in which Tokyo Governor (and former LDP parliamentarian) Yuriko Koike cemented her status as a potential threat to LDP dominance with help from the local chapter of the centrist Komeito party, the LDP's coalition partner in the national government. Prominent LDP members, including not only one-time Abe cabinet member-turned-leading Abe critic, Shigeru Ishiba, but also Abe's longtime foreign minister, Fumio Kishida, critiqued the prime minister's policies and talked openly about their ambitions to lead the LDP. Polls showed that majorities opposed Abe's serving for a third term, and that nearly 70 percent of voters thought Abe's government was "arrogant."

But there was still worse to come. Buoyed by recovering approval ratings in August and September, thanks in part due to public anxieties regarding the intensifying North Korean crisis, and facing an increasingly rudderless Democratic Party (DP), Abe decided to dissolve the Diet's House of Representatives and call a general election for 22 October. This maneuver backfired almost immediately: the same day that Abe formally announced that he would call an election, Koike, who had been flirting with creating a national party, announced that not only would she back a new party called the Party of Hope, but she would personally lead it, while continuing to serve as Tokyo's governor. Days later, Seiji Maehara, who had struggled to assert control of the DP since his election as party leader on 1 September, announced that the DP would effectively dissolve itself to join the Party of Hope. Instead of going into a general election facing a disorganized opposition, the LDP would face an increasingly unified opposition led by a popular, experienced politician drawing from the populist playbook that earlier politicians had used to win major electoral victories.

At the time of this writing, the outcome of the general election is unknown. Even if Abe and the LDP are able to fend off Koike's challenge and preserve a majority, it is unlikely that Japan will return to the political stability that characterized much of Abe's tenure. A Koike-led opposition party will likely be a more potent challenger than the DP ever was – and far from quieting Abe's critics within the LDP, the decision to call an election in which the LDP will likely be diminished, will embolden his rivals and complicate the outlook for a third term as party leader.

Tough Decisions

The return of political volatility comes at a difficult time for Japan because the Abe government was already heading into a year full of difficult choices for Japan's economy and foreign policy. While a more competitive political environment may ultimately result in better policy and more effective leadership, in the near term, it will weaken Abe's leadership as he tries to chart the next steps for Abenomics, the multi-faceted economic program that helped cement his leadership when introduced in 2013, and articulate Japan's response to the increasingly perilous security crisis with North Korea.

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2018 will therefore be a pivotal year for Abe, Abenomics, and Japan. Even if his party suffers losses in the general election, Abe could still fight on to win a third term as LDP leader and prime minister. But his survival beyond 2018 is no longer as inevitable as it once seemed. In 2018, therefore, it may become increasingly necessary to think about not where Abe goes next, but rather what Japan will look like after Abe.

A Critical Monetary Debate

More than four years into Abenomics, monetary policy remains Abenomics's most radical experiment, but possibly also its biggest failure. From the birth of Abenomics, breaking free of deflation was central to the Abe government's project for revitalizing the Japanese economy. The Abe government has systematically remade the Bank of Japan (BOJ) since 2013, starting with the appointment of Haruhiko Kuroda and Kikuo Iwata as governor and deputy governor in 2013, and continuing with the replacement of outgoing policy board members leftover from the pre-Abenomics BOJ, with new board members committed to reflationary policies. As of July 2017, the BOJ's policy board has now been appointed entirely by Abe, theoretically giving Kuroda unanimous support.

But despite Kuroda's – and Abe's – control of the BOJ leadership, both men must increasingly reckon with a monetary policy dilemma. The fundamental problem is that despite the BOJ's easing policies, it has repeatedly delayed the timeline for achieving its 2 percent inflation target. Inflation remains barely positive, and market-based inflation expectations suggest that prices could dip again. With robust growth despite low inflation, the bank has been forced to consider whether it is worth retaining its 2 percent target and the policies it has introduced in order to achieve it. The question of how long the BOJ should persist with its easing policies in the face of stubbornly low inflation or disinflation is even more pressing considering that the BOJ already holds more than 40 percent of outstanding Japanese government debt. Critics warn that the bank could run out of bonds to purchase as soon as the second half of 2018. The BOJ could have little choice but to adjust its purchases or its inflation target, with potentially harmful effects on interest rates and financial markets more broadly.

A debate is brewing, centered on the future policies of Kuroda. This debate, which will intensify in the final months of 2017 and the first months of 2018, will not just have profound implications for the BOJ's decision making beyond April 2018; it will function as a critical assessment of a major component of Abenomics, and could therefore impact the prime minister's standing heading into the final months of his term.

An Awkward Fiscal Mix

Following the launch of a significant stimulus package shortly after taking power, the Abe government quickly shifted from fiscal stimulus to "fiscal flexibility," which meant an awkward mix of short-term stimulus and a medium-term commitment to deficit reduction in pursuit of the government's goal of a primary fiscal surplus by FY2020. The latter commitment includes the plan, which predates the Abe government, to raise the consumption tax rate from 5 percent to 10 percent in two phases.

In practice, however, fiscal flexibility has been the subject of an ongoing political conflict between growth-first advocates and fiscal consolidation supporters. There is no easy way for Abe to resolve the tension between these factions. The “growth-first” school in the Abe government also suffered a setback when tax revenues fell, unexpectedly, for the first time in seven years in FY2016, a warning sign that Japan may not be able to grow itself out of its debt problem. If the government can no longer count on the growing tax revenues that enabled it to reduce the deficit during the early years of Abenomics, the Abe administration will face the unpalatable choice of either cutting spending on the social safety net – politically difficult given Japan’s demographics – or issuing more debt and abandoning the 2020 target (but in the process further dividing the LDP).

During the run-up to the October 2017 general election, Abe has floated a plan to reconcile fiscal hawks and his growth-first advisers that will be at the center of the LDP’s election platform. Recognizing that it was already unlikely that the government would meet its 2020 target even in the best-case growth forecast, the prime minister has proposed to proceed with the two percent consumption tax increase scheduled for October 2019 as planned, but to redirect some of the anticipated tax revenues that had been earmarked for debt consolidation to a new plan to increase spending on early childhood education as part of broader “revolution in human capital formation.” This would make it impossible to meet the 2020 target, forcing the government to develop a new target and new mid-term fiscal plan, but in the meantime it would establish a fragile peace between the two factions. Keeping the tax hike would satisfy fiscal hawks; diverting some of its proceeds to redistribution on behalf of working families would satisfy the growth-first school.

But even if Abe and the LDP win the election comfortably and put this plan into action, the truce over fiscal policy is unlikely to be long-lived. The process of developing a new plan and target, a priority for 2018, will exacerbate tensions again, as will the broader debate over how to pay for the Abe government’s plans for more education spending. The LDP’s internal divisions could also be heightened by the changing political environment, both because the Party of Hope has placed opposition to the 2019 tax hike at the center of its platform and because the LDP’s 2018 leadership election could be contested on the issue of fiscal policy. Even more so than in the case of monetary policy, fiscal policy will provide would-be challengers a means for distancing themselves from – and criticizing – Abe’s record ahead of the LDP election.

Against the backdrop of significant fights over fiscal and monetary policy, there is little reason to expect the government to make significant progress with its growth, deregulatory, and industrial policies. While Abe has repeatedly identified the importance of raising productivity, he has been unwilling to invest political capital in reforms that would lower the barriers to entry and exit from the market or introduce significantly more flexibility in the labor market. With less political capital to spare, there is even less reason to expect that the prime minister will offer significant new measures. Instead, the government’s attention will be focused on passing “working style reform” legislation – a package of changes governing overtime, flexible working arrangements, and the pay gap between regular and non-regular workers, legislation that was supposed to pass the Diet in autumn 2017, but which has been delayed until spring 2018, at the earliest, as a result of the snap election.

Foreign and Security Policy Leadership

Political volatility could also have short-term consequences for Japan's foreign policy, since, by the end of 2017, the Abe government wants to finalize a Trans-Pacific Partnership (TPP) agreement without the U.S., the so-called TPP-11. It also must conclude an economic partnership agreement (EPA) with the European Union. If Abe emerges from the October election weakened, it could be harder for him to focus on these negotiations – which could prevent their successful conclusion, since Japan has played an important leadership role, especially in the TPP-11 talks. Even before Abe decided to call the snap election, it was by no means certain that the Abe government would find a way to convince the other ten remaining TPP members to accept a smaller agreement with minimal changes, particularly developing-country members like Malaysia and Vietnam that had been counting on improved access to the United States. If distracted by instability at home, it will be harder for Tokyo to manage these talks successfully.

While political volatility could affect Japan's ability to lead negotiations in the near term, it is unlikely to affect Japan's embrace of a regional and global leadership role in advancing global economic integration over the long term. Faced with a U.S. president inclined towards protectionism, Abe has been an unabashed supporter of global free trade and his government's pursuit of new agreements has had as much to do with upholding the liberal trading system as with improving market access for Japanese companies. Embracing this role is not without challenges for Tokyo, which has often been fiercely protective of its home market in trade negotiations and now finds itself trying to convince reluctant trading partners to open their markets and embrace higher-quality rules for trade and investment. Nevertheless, Japan's willingness to assume the mantle of leadership on free trade looks to be an enduring shift, one that will likely survive Abe's tenure.

The short-term impact on Japan's management of the North Korea crisis could be more limited. For the foreseeable future, Abe and his cabinet ministers will be preoccupied with ensuring that the U.S. and Japan work closely together on security issues. The prospect of North Korea's using the threat of an intercontinental ballistic missile attack on the continental U.S. to drive a wedge between the U.S. and Japan – reminiscent of cold war-era concerns about “decoupling” – will lead the Abe administration repeatedly to seek reassurance from Washington that the security relationship is sound and the U.S. nuclear “umbrella” intact. The same concerns will lead Japan to strengthen its missile defense capabilities, including through the purchase and deployment of the Aegis Ashore missile defense system. While Japan's defense ministry could receive its record-high \$5.25bn request for defense spending in 2018, defense spending would still be only roughly 1 percent of GDP, and would therefore not signal a significant quantitative increase in Japan's capabilities.

If anything, the emergence of the “reformist conservative” Party of Hope (whose ranks include several prominent defense hawks) as the main opposition party, could strengthen a political consensus in favor of developing more robust defense capabilities. In particular, the new party could pressure the Abe administration to commit to a serious debate on developing autonomous strike capabilities that would enable Japan to retaliate for attacks on its territory. Were Japan to pursue new strike capabilities, it would mark a significant step away from Japan's longtime

defensive security posture. But with the public divided on the merits and the prime minister's hand weakened, it is unlikely that the government would be able to acquire these capabilities in the near term.

Would Be Successors

Given these challenges, we should expect to see a broader debate regarding what post-Abe Japan should look like. The aspirants to the LDP's leadership – Ishiba, Kishida, newly-appointed Internal Affairs Minister Seiko Noda, and others – have already begun grappling with the legacies and unfinished work of Abenomics and articulating their own visions for Japan's economy. Even if she stays as Tokyo governor for the time being, Koike's leadership of the Party of Hope has dramatically improved her chances of one day serving as prime minister. Whoever succeeds Abe will have to reckon with the risks inherent in the BOJ's stimulus program; have to decide whether deficit reduction through tax increases and spending cuts is achievable in the near term; and whether there are reforms that have not yet been tried that could raise Japan's potential growth and offset the impact of its shrinking population.

To the extent that these debates will all intensify in 2018, it will be the year that post-Abe Japan truly comes into focus. Even if Abe recovers and seeks a third term, it is likely that not only will he face a serious challenge in the party election, but he will increasingly have to defend his government's policies from criticism from a reinvigorated opposition.



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