

Daiwa's Economic View

Fiscal policy of new Takaichi administration and its impact on JGB market

- Takaichi pulled off a surprise victory, becoming the new LDP President, but she will likely follow a realistic and moderate path regarding fiscal policy
- Fiscal spending in FY25 supplementary budget estimated to be around Y16-18tn; scale of calendar-based market issuance could remain flat y/y, or see a slight increase
- In the medium to long term, fiscal policy and JGB issuance are expected to be influenced by expansion of the ruling coalition, easing of cost-push inflation, and success or failure of growth investments

FICC Research Dept.

Koji Hamada

81-3-5555-8791

kouji.hamada@daiwa.co.jp

**Kenji Yamamoto**

81-3-5555-8784

kenji.yamamoto@daiwa.co.jp



Daiwa Securities Co. Ltd.

The Liberal Democratic Party (LDP) presidential election on 4 October resulted in a surprise victory for Sanae Takaichi. She is known as a proponent of expansionary fiscal policy, which means a negative surprise for the JGB market. However, considering her position within the party, she is likely to lean towards adopting a more realistic course regarding the actual policies she implements.

Based on the FY24 budget, fiscal spending in the FY25 supplementary budget is estimated to be around Y16-18tn. Through the utilization of measures such as the front-loading issuance of refunding bonds, the scale of the calendar-based market issuance is likely to remain roughly flat y/y, or be only slightly larger.

In the medium to long term, fiscal policy and JGB issuance are expected to be influenced by the expansion of the ruling coalition, the easing of cost-push inflation, and the success or failure of growth investments.

Fiscal policy is likely to soften, and go in a more realistic direction

New LDP President Sanae Takaichi is known for taking a positive stance regarding fiscal expansion. However, she is very likely to adopt a more realistic and moderate way forward with regard to the policies she implements after becoming Prime Minister for the following three reasons.

Firstly, while the authority of Japan's Prime Minister is certainly significant, it is limited compared to that of the US President due to Japan's parliamentary cabinet system. Consensus within the ruling parties is indispensable in order to pass budgets and bills in the Diet.

Secondly, Takaichi's power base within the party is by no means strong. Her victory this time depended heavily on support from the LDP's Supreme Advisor, Taro Aso. This is why she shelved her long-held proposal for a consumption tax cut on food products, which was included in her platform during the presidential election. After assuming the office of Prime Minister, she will likely need to coordinate policy with party members like Aso.

Thirdly, the appointment of key party executives and cabinet ministers will likely act as a brake limiting the adoption of fiscal expansionary policies. General Council Chairperson Shunichi Suzuki, who is focused on fiscal consolidation, is reportedly seen as a promising candidate for the crucial role of Secretary-General. The people chosen to fill the roles of the party's Policy Research Council Chairman and the Minister of Finance will serve as factors in forecasting the direction of the new administration.

Outlook for the FY25 supplementary budget and JGB issuance plan

While the FY25 supplementary budget will be the focus of attention in the JGB market in the near-term, the scale of the calendar-based market issuance may remain largely flat y/y, or increase by only a few trillion yen.

Takaichi will very likely be nominated as the new Prime Minister during the extraordinary Diet session currently slated for 15 October. This is due to a lack of successful coordination among opposition parties.

Once Takaichi is nominated Prime Minister and her cabinet is formed, her administration will immediately move to formulate an economic package and compile the FY25 supplementary budget. The economic package is expected to be announced in November, with the cabinet decision on the supplementary budget and the revision to the JGB issuance plan anticipated sometime between late November and early December.

The scale of the economic stimulus portion of the supplementary budget will be considered after the new administration is launched. It was Y13.9tn in the FY24 supplementary budget, which included measures to address high prices, support for wage hikes, regional revitalization, disaster recovery, disaster prevention/mitigation and national resilience, and responses to changes in the diplomatic and national security environment. These are the same policy issues faced today.

The FY25 supplementary budget is estimated to come to about Y16-18tn, assuming the economic stimulus portion of the budget is of basically the same scale as it was in FY24, and the government adds programs prioritized by Takaichi, such as the transformation of Japan into an investment-driven nation. Regarding funding, if around Y5-7tn were secured through increased tax revenues and other sources, the issuance of new government bonds would be around Y9-13tn.

The FY25 JGB issuance plan includes an "Adjustment between fiscal years" of –Y6.9tn. This indicates that the scale of the calendar-based market issuance for this fiscal year is approximately Y7tn more than the amount required by the budget. Furthermore, the amount of front-loading issuance of refunding bonds stood at Y24.9tn at end-FY24. The fiscal authorities will determine how much of this will be utilized. However, if there were no strong demand from market participants for increased issuance in specific maturities, the scale of the calendar-based market issuance could likely be kept largely flat y/y, or limited to an increase of only a few trillion yen.

Medium- to long-term perspectives: Expansion of coalition, easing of cost-push inflation, and success of growth investments

The following three factors will be key in influencing medium- to long-term fiscal expansion: (1) the expansion of the coalition, (2) the future course of inflation, and (3) the success or failure of growth investments.

The first factor is the expansion of the ruling coalition. Currently, the ruling coalition lacks a majority in both the House of Representatives (Lower House) and the House of Councillors (Upper House). If the opposition parties were to unite, they could pass tax-cut bills in the Diet. In the Lower House, opposition parties could pass a no-confidence motion against the cabinet at any time. If a snap general election were held under the current circumstances, the Democratic Party for the People (DPP) and Sanseito would likely gain more seats, pushing the LDP-Komeito coalition further from a majority. This would make it even easier for the opposition parties' demands for tax cuts to be approved.

Expanding the ruling coalition could serve as a brake on fiscal policy. By regaining a majority, the ruling coalition could block the opposition parties' tax-cut bills and no-confidence motion against the cabinet. The next Upper House election is scheduled for July 2028, and the term for Lower House lawmakers ends in October 2028, giving the ruling parties time to produce results.

Fortunately, Takaichi is open to expanding the coalition. However, fiscal policy will change significantly depending on whether she partners with the Japan Innovation Party or the DPP. This warrants attention due to the collapse of the Koizumi administration's coalition scenario with the JIP.

The second factor is the easing of cost-push inflation. The public's strong desire for tax cuts stems from the fact that people's lives have been made more difficult due to inflation outpacing wage growth. Moreover, many people forecast that prices will increase going forward. If the rise in food and energy prices were to stabilize, large-scale measures to address inflation would become unnecessary.

The third factor is the success or failure of the growth strategy. Takaichi is not of the view that simply expanding the fiscal policy will solve problems. She thinks that if growth investments lead to increased tax revenues, the debt-to-GDP ratio will decrease. Furthermore, she is a policy expert who spoke for about an hour on specific measures in her growth strategy at her press conference announcing her candidacy.

Therefore, even if price increases for items like food stabilize, Takaichi will likely continue with investments in growth and crisis management. It would be ideal if the economy were to get on a growth trajectory quickly, but there is also concern that Japan might not escape deflation, even with increased spending. It is unknown whether the government will be able to achieve the "wise spending" pledged in her campaign, which aims to maximize tax revenues from minimal government investment.

Summary of key points in the JGB market

The market is concerned that, with Takaichi as the new Prime Minister, fiscal expansionary policies could entail risks such as an increase in JGB issuance, fiscal deterioration, and a downgrade of Japan's sovereign credit rating. However, such risks may be smaller than the market currently anticipates. The following are key points to look out for in order to determine if these risks are, in fact, smaller than anticipated.

First are the personnel appointments for key party and cabinet posts, such as the Secretary-General and the Minister of Finance. If individuals who emphasize fiscal discipline were appointed to key positions, the market would likely experience a spreading sense of relief, and upward pressure on yields would likely ease.

Next is the scale of the economic package and the FY25 supplementary budget. There are still many policy issues, such as inflation measures and wage hikes. The budget will reach a certain scale regardless of who becomes Prime Minister. The economic stimulus portion of the supplementary budget was ¥13.1tn in FY23 and ¥13.9tn in FY24. If the new budget is not significantly larger than this, the scale of the calendar-based market issuance could remain largely flat y/y. This will be the first test of the new administration.

To sum up, the medium- to long-term focus of attention will be on three things. First, can the ruling coalition be expanded? Its expansion would prevent the passage of opposition-led tax-cut bills and no-confidence motions, and obviate the need to respond to demands for tax cuts. Also, will the coalition partner be the JIP? Second, will the cost-push inflation that is driving the need for inflation measures subside? Third, can "wise spending," in which growth investment leads to increased tax revenues, actually be achieved?

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings

Issues are rated 1, 2, 3, 4, or 5 as follows:

- 1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
- 2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
- 4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices

Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities

Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association