Daiwa Securities

Daiwa's Economic View

Prolonged concerns about fiscal expansion, political instability due to LDP-Komeito breakup

- Komeito's departure from LDP-Komeito coalition is already a reality
- Takaichi still favorite to become Prime Minister
- LDP must negotiate with multiple opposition parties to pass budgets, bills in the Diet
- Fiscal expansion/political instability concerns likely to persist over medium/long term, putting upward pressure on long/super-long JGB yields

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.

Komeito's withdrawal from the LDP-Komeito coalition became a reality as early as 10 October. (See our 10 Oct *Daiwa's Economic View "Potential risk of Komeito leaving coalition deserves more attention than DPP leader Tamaki's political future."*)

The nomination of Japan's next Prime Minister has become increasingly uncertain, but at this point, Takaichi remains the frontrunner, while Tamaki's chances are seen as slim.

However, if the Liberal Democratic Party (LDP) were to govern on its own as a minority party, passing budgets and bills in the Diet would require even more complex negotiations with multiple opposition parties, more so than under the Ishiba administration. The FY25 supplementary budget will be the first test, while the FY26 initial budget will present an even higher hurdle for negotiations.

Far from regaining a majority through an expanded LDP-Komeito coalition (See our 6 Oct *Daiwa's Economic View "Fiscal policy of new Takaichi administration and its impact on JGB market"*), the LDP will instead become an even smaller minority ruling party. Concerns about fiscal expansion and political instability are likely to persist over the medium to long term. The JGB market will likely see upward pressure on yields, particularly in the long- and super-long zones, making it difficult to determine where yields will eventually settle.

Takaichi or Tamaki to become next PM, with Takaichi still viewed as frontrunner

The withdrawal of Komeito from the LDP-Komeito coalition has further clouded the prospects for selecting a Prime Minister. In particular, there is increasing attention on whether Democratic Party for the People (DPP) leader Yuichiro Tamaki, whom the Constitutional Democratic Party (CDP) is rallying behind as a unified opposition candidate, can become Prime Minister. However, even in that case, Takaichi is still probably the frontrunner.

An extraordinary Diet session for appointing the next Prime Minister is expected to be convened on 20 or 21 October. If no candidate secures a majority in the first round of voting, a runoff election will be held between the top two candidates. In such a runoff, even if a candidate fails to secure a majority, the candidate with the most votes becomes Prime Minister.

The composition of the Lower House seats is as follows: 196 for LDP, 148 for CDP, 35 for Japan Innovation Party (JIP), 27 for DPP, and 24 for Komeito. The decisive factor will be whether the number of votes for Tamaki from an opposition coalition can surpass the LDP's 196 votes in a runoff election.

At this juncture, we expect Takaichi to be the frontrunner. The probability of her winning is likely around 70%. The reason is that the probability of successfully making Tamaki the unified candidate, a scenario envisioned by the CDP, is only about 30%.

Tamaki has stated that he is prepared to become Prime Minister. However, as for the CDP, he insists that a coalition is impossible without alignment on fundamental policies and demands that policy changes be made through decisions made by the governing body. It would likely be very difficult for the CDP to accept nuclear power and the right of collective self-defense (two policies that it opposes).

The JIP has stated that a coalition with the LDP is unlikely. The reason is the similar to that provided by the DPP. With Komeito out of the picture, even a coalition with the LDP would fail to secure the needed majority.

Meanwhile, regarding the call for a unified opposition candidate from the CDP, the JIP has stated they would listen to the CDP and DPP, provided that their policies align. However, their policies will probably not align, so the likelihood of the JIP voting for Tamaki is slim.

However, negotiations between the LDP and opposition parties, as well as among opposition parties themselves, will continue until a Prime Minister is nominated. Moves by Komeito, which just left the LDP-Komeito coalition, are also a cause for concern. We should note that the situation could remain fluid going forward.

FY25 supplementary budget and likely ballooning of economic measures

If a Takaichi administration is formed, it would immediately formulate economic measures and compile a supplementary budget for FY25. However, it is difficult to predict the scale and content that the overall Diet would find acceptable. This is because the LDP will need to reach agreements with multiple parties as Komeito has now left the coalition. Negotiating with opposition parties will be more time-consuming and complex, more so than the struggles to reach agreements with just a single coalition partner, as was the case under the Ishiba administration.

The abolition of the provisional tax rates on gasoline and light oil is a policy that every opposition party supports and so must be included. There is a strong likelihood that raising the annual income threshold will be included to secure the support of the DPP. However, will that alone be enough?

For the FY25 supplementary budget, since Komeito held discussions to agree on common policies with the LDP during the July Upper House election, there is reason to expect their support. However, the fate of the initial budget for FY26 remains to be seen.

JGB market concerns about fiscal expansion/political realignment likely to persist over medium/long term

If the LDP were to become the sole ruling party, the JGB market would likely become wary of fiscal expansion every time a budget is formulated. We must also remain vigilant about the possibility of another snap election and political realignment.

All told, if a Takaichi administration were to take power, the scale of fiscal expansion would likely expand due to the need to reach agreements with multiple opposition parties. There are also significant concerns that parliamentary operations could become unworkable, leaving no choice but to dissolve the Diet and call for a snap general election. The Takaichi administration itself would have an incentive to increase fiscal expansion in preparation for a snap general election.

It is difficult for JGB market participants to pinpoint which party's fiscal policy to focus on. That in turn heightens uncertainty about fiscal expansion. When would a Takaichi administration's management of the Diet become unsustainable? When might opposition parties table a motion of no confidence in the Cabinet? We must vigilantly monitor how such questions unfold. The LDP remains a minority ruling party, so if the opposition parties unite, a motion of no confidence in the Cabinet could pass.

If a snap general election were to be held, the LDP could lose even more seats due to the loss of electoral cooperation from Komeito. A change of government would occur once the ruling party loses its position as the largest party. Furthermore, the possibility of a major realignment of the Japan's political world could emerge.

For the JGB market, concerns about (1) fiscal expansion lacking a clear end point and (2) political instability will likely persist for several months. There may be concerns about upward pressure on JGB yields, especially in long- and super-long zones, where fair value is more difficult to understand.

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