Daiwa's Economic View

Principles and challenges for PM Takaichi's "responsible expansionary fiscal policy"

- Principle of reducing government debt-to-GDP ratio by increasing fiscal stimulus for GDP (denominator) is correct
- Aim to achieve specific target each fiscal year? Should target be set at certain debt-to-GDP ratio level? Challenge lies in whether fiscal stimulus will reliably increase GDP
- Measures to combat rising prices, support wage increases, revitalize regional economies, and other immediate challenges must also be addressed
- Igniting Japanese companies' investment mindset is a challenge

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When Prime Minister Sanae Takaichi talks about "responsible expansionary fiscal policy," what exactly does she mean? To put it simply, the principle of reducing the government's debt-to-GDP ratio by increasing GDP (denominator) through fiscal stimulus is correct. That said, there are various challenges. Specific challenges likely include goal setting, assessing the effects of fiscal stimulus, addressing cost-push inflation, and fostering a more upbeat corporate mindset.

This means attracting private investment, while using as little of the budget as possible, and placing the economy on a path to full-fledged growth. Faced with the immediate challenge of cost-push inflation, it is imperative that the new administration quickly delivers results, while public support remains high.

Principles are sound, but some issues in terms of goal setting

The concept of fiscal consolidation (reducing government debt-to-GDP ratio) is already widely known. Domar's theorem is often noted for the condition where the growth rate exceeds the interest rate, but it was originally derived as a condition for reducing "the government debt-to-GDP ratio."

Achieving the government's target of a primary balance surplus would enable it to (1) cover expenditures without relying on JGB issuance and (2) halt the growing government debt balance. The government setting a target year for achieving this goal demonstrates its commitment to fiscal consolidation. That said, if the primary balance achieves a surplus by the target fiscal year, there is a risk that additional issuance of JGBs during that process would not be viewed as problematic. The fact that a primary balance surplus keeps getting delayed without being realized by the target year makes it all the more concerning.

The Takaichi administration aims to reduce the government debt-to-GDP ratio, but it is unclear whether it aims to achieve that target every fiscal year and whether it sets a target level for the ratio itself. The government debt-to-GDP ratio expands at a faster pace as the debt balance (numerator) increases, driven by rising interest payments. There are concerns that GDP growth (denominator) will not keep pace.

Challenges verifying effects of expansionary fiscal policy

Takaichi's "responsible fiscal stimulus" aims to reduce the government debt-to-GDP ratio by increasing GDP (denominator) through growth investments and other measures. Historically, the amount of JGBs issued has decreased during periods of economic expansion when tax revenues increase. The notion of "prioritizing economy over fiscal policy" is probably correct.

The question is whether expansionary fiscal policy will actually increase GDP. It is unacceptable that reckless fiscal spending increases the government's debt balance (numerator), while GDP (denominator) barely grows.

Takaichi's "responsible expansionary fiscal policy" means that the key to success lies in ensuring GDP growth through fiscal stimulus. This is reflected in the fact that fiscal stimulus has been limited to security-related and growth investments.

However, it takes time for investments to translate into GDP growth. The attraction of TSMC to Kumamoto Prefecture appears to be invigorating local companies' capex. Still, attracting semiconductor factories to other locations in Japan requires time for negotiations with the partner companies and securing suitable sites.

It takes time for results to materialize, so verifying effectiveness also takes time. Thorough verification is required before investment results materialize (indeed, even before investment begins).

Moreover, government fiscal stimulus merely serves as a spark to ignite private sector capex. Fiscal policy itself does not drive the economy. The challenge lies in how to best increase GDP with minimal spending, incorporating deregulation and other measures.

Addressing the immediate challenge of cost-push inflation

Former Prime Minister Fumio Kishida also championed the principle of "prioritizing economy over fiscal policy," specifically working to increase GDP (denominator). His administration tried to create a virtuous economic cycle by supporting corporate wage increases. By establishing long-term funds and issuing GX bonds, the government demonstrated that its support is not temporary. That helped to create an environment where companies can confidently invest in equipment/facilities. We believe that was the correct approach.

However, rising global raw material costs and a weak yen caused prices to rise faster than wages, making life difficult for the general public. Political and financial scandals also erupted within the Liberal Democratic Party (LDP), which forced Kishida to step down before achieving economic results.

The immediate challenge of addressing cost-push inflation has persisted, even after Takaichi became prime minister. The government has been forced to allocate a considerable amount of public spending on measures to combat inflation, which are "ineffective painkillers" for the most part. Measures to combat rising prices, support for wage increases, regional revitalization, and challenges related to disaster prevention and national resilience remain largely unchanged.

Will public support continue until the fruits of robust economic growth are realized? The Takaichi administration, like the Kishida administration, is also facing a race against time.

Challenge of responding to conservative, cautious management policies of Japanese firms

Japanese companies, for the most part, are currently adhering to conservative and cautious management practices that prioritize financial discipline. Capex should generally not exceed the scope of a company's cash flow. Many companies plan to reduce their financial leverage back to its original level during the remaining period of their medium-term business plans, even if they temporarily increase it through capex involving corporate bonds and bank loans.

Japanese companies have repeatedly faced critical business environments, including the collapse of the asset bubble in the 1990s, Japan's financial crisis, and the Global Financial Crisis triggered by the Lehman Brothers bankruptcy in the 2000s. That is why they maintain cautious management stances.

Corporate financial conditions improved significantly during the Abenomics era of the 2010s. This is why companies were able to overcome the COVID-19 pandemic of the 2020s, but sentiment that their financial bases are already sufficiently strengthened has not yet taken hold.

In addition to this succession of crises, Japan's projected population decline and nearly three decades of deflation have significantly dampened growth expectations for the domestic market. Globally, the US is now the only market expected to continue growing.

In order to ignite Japanese companies' appetite for domestic investment, it would be essential to instill confidence in future growth, as was the case when Japan lured chip manufacturing giant TSMC to Kumamoto.

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