

Daiwa's Economic View

Lower House election still tough to call

- LDP strengths and vulnerabilities
- New party's strengths and vulnerabilities
- When will visibility on election outlook emerge?
- Differences in quantity and quality of fiscal stimulus

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.

There have been two major recent surprises on the political front: the snap Lower House election called at the start of the ordinary Diet session, and the merger of the Constitutional Democratic Party (CDP) and Komeito to form the Centrist Reform Alliance (CRA). The market has also shifted from expecting a convincing win for the ruling Liberal Democratic Party (LDP) to acknowledging the potential for a decisive victory by the CRA.

It will take time to determine which party is likely to come out on top. Both the LDP and CRA have advantages and vulnerabilities. Given the suddenness of the election, many aspects have yet to be decided or are unclear. A clear picture of the election landscape may not emerge until just before the official candidacy announcements that mark the start of the campaign. At this point we expect the coalition between the LDP and Japan Innovation Party (JIP) to scrape a majority, but the situation could change from day to day.

We expect pressure for more procyclical fiscal policy to increase irrespective of the election result, but the focus will likely be action on the consumption tax. We also expect the LDP to focus on supply capacity and the CRA on consumers. We think a future pickup in economic growth would only be possible if the LDP wins.

LDP strengths and vulnerabilities

When the initial media reports of a snap election emerged, many expected a landslide victory for the LDP due to Prime Minister Sanae Takaichi's popularity. Some observers even suggested the LDP could win 260 seats on its own.

However, we also see several vulnerabilities for the LDP.

- The survey predicting 260 seats appears to lack precision.
- Ms. Takaichi's sudden and virtually unilateral decision to call a snap election threw the LDP into chaos; the party is poorly prepared and there was no internal consensus. The fact that Shunichi Suzuki, the LDP's secretary-general with responsibility for election strategy, had not been informed is particularly significant.

The shift of Komeito's support base from the LDP to the CRA will also have a substantial impact. However, elections do not always follow the rules of simple addition and subtraction. The crucial factor will be whether voters (mainly independents) rally to keep the Takaichi administration in power at all costs. In this sense, the message and enthusiasm Ms. Takaichi conveys at the press conference scheduled for 19 January is likely to significantly influence the election's outcome.

New party's strengths and vulnerabilities

A recent Jiji Press article simulating the election outcome prompted considerable debate. It states that if the CDP and Komeito's surprise formation of the new CRA party shifts Komeito's support base from the LDP to the CDP, voting data from the last Lower House election suggests that the CDP could win more seats than the LDP.

As noted, elections are not determined by simple addition and subtraction; the support of independent voters is crucial. A closer analysis reveals the following vulnerabilities for the CRA.

- The upcoming election will be about choosing a government, not just about punishing the LDP (in contrast to last summer's Upper House ballot).
- Will the CRA's "centrist" mission resonate with voters? Will they perceive the CDP, the core of the party, as centrist?
- Komeito will push for the CRA to accept Japan's right to collective defense, constitutional reform, and nuclear power plant replacements; how many liberal CDP members will accept these and join the new party?

Clarity unlikely until eve of campaign

The market is concerned about the election outlook given that the ballot will determine the next government. However, it will likely take somewhat longer for visibility on the likely outcome to emerge. The runup to the official candidacy announcements may serve as a key indicator.

The suddenness of the snap election means that parties have yet to firm up their entire roster of candidates. While party affiliation can be crucial in determining election outcomes, individual candidates' personal qualities are also important. The full lineup of candidates for each party will likely not be finalized until just before the official campaign period begins.

The CRA is also apparently facing a backlash from Komeito supporters who are suddenly being called on to back candidates from the CDP, which they have campaigned against for more than 20 years. It will likely take more time for them to sort out their feelings and determine how seriously they will support these candidates. As noted, it will also take time to see if CDP members accept the new party's policies given the top-down move to shift them substantially toward the center.

At this point we expect the LDP and JIP to scrape a majority, but the situation remains difficult to read.

Quantity and quality of fiscal stimulus

Market participants initially expected a landslide victory for the LDP that strengthened Ms. Takaichi's power base, allowing her to further advance her "responsible and proactive" fiscal policy. We now see a decisive win as unlikely, which may leave the Democratic Party for the People (DPP) with considerable influence. While media reports suggest the LDP is exploring a consumption tax cut, internal party negotiations are yet to begin, making it too early to draw any conclusions.

The CDP committed to eliminating the consumption tax on food for two years in its platform for the 2025 Upper House election. Komeito had initially pledged to cut the consumption tax but later removed it from its promises to align with the LDP. The CRA is highly likely to include a consumption tax cut in its pledges.

The LDP and CRA's fiscal policies differ both in terms of quantity (scale of fiscal stimulus) and quality (focus). Under Ms. Takaichi's direction, the LDP aims to protect citizens' livelihoods while enhancing supply capacity. In contrast, the CRA's focus is skewed considerably toward citizens' livelihoods. While the Takaichi administration's ability to create a strong economy remains debatable, we think the LDP's approach would be more likely to result in economic growth.

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