

Daiwa Memorandum

FICC Research Dept.

LDP's coalition talks with JIP and impact on yields

- JIP's policy requests total around ¥7tn, consistent with market's pricing-in of fiscal deterioration equivalent to about 1% of GDP
- However, if DPP were to cooperate to secure a majority in Upper House, total scale could reach ¥10.5tn, potentially adding about 10-20bp worth of upward pressure on 30yr JGB yield

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Introduction

The formation of a Takaichi administration, which was jeopardized by Komeito's departure on 10 October, has once again become a realistic possibility due to coalition talks with the Japan Innovation Party (JIP). In the policy discussions that began on the 16th, the JIP submitted a written request listing twelve items, with the expectation that the matter will be concluded by the 20th. Although the political situation has been chaotic, from the perspective of the scale of fiscal policy, the situation has not changed significantly from the scenario outlined in [our 6 October report](#) about Takaichi's victory in the Liberal Democratic Party (LDP) presidential election. In this report, we quantitatively assess the JIP's policy requests and re-examine the impact on the bond market. We also point out that a new factor causing uncertainty has emerged—the constraint of not having a majority in the House of Councillors (Upper House).

Scale of JIP's policies: Comparison with our estimates

Included among the main items related to fiscal policy in the written request that was submitted by the JIP were the abolition of the provisional gasoline tax rate, the reduction of the consumption tax on food to zero for two years, and subsidies for electricity and gas bills. These can be quantified in the following way: the abolition of the gasoline tax would cost approximately ¥1tn, reduction of the consumption tax on food to zero would cost about ¥5tn annually, and electricity and gas subsidies would be about ¥1tn annually, amounting to a total fiscal burden of approximately ¥7tn.

Major Economic Policies of JIP and DPP

Party	Policies	Fiscal burden
Japan Innovation Party (JIP)	Abolition of the provisional tax rate on gasoline	¥1.0tn
	Subsidies for electricity and gas bills	¥1.0tn
	Reduction of the consumption tax on food to zero	¥5.0tn
Democratic Party for the People (DPP)	Abolition of the provisional tax rate on gasoline	¥1.0tn
	Abolition of the provisional tax rate on diesel fuel	¥0.5tn
	Raising the annual income threshold	¥3.0tn

Source: Various media reports; compiled by Daiwa.

Note: Scale of fiscal burden is approximation based on our estimates.

Price Trend of 30yr JGB (JX87)



Source: Bloomberg; compiled by Daiwa.

In the analysis in [our 6 October report](#), we estimated that the market had priced in a fiscal deterioration of about 1% of GDP (about Y6tn). The scale of the JIP's policies, amounting to Y7tn, exceeds what the market had priced in by around Y1tn, which only represents a difference of around 0.1-0.2% of GDP. This is smaller than the upside risk (Y9-10tn) that we noted in that report. Consequently, this level is largely consistent with what the market had priced in.

In fact, movements of the 30-year JGB yield justify this assessment. Immediately after the inauguration of Takaichi as the new LDP President, yields rose sharply, climbing by about 14bp on 14 October compared to pre-inauguration levels. Thereafter, there was somewhat of a correction to this reaction, and, as of 16 October, the yield traded at a level of about 5bp higher than before her inauguration. Fiscal expansion of about 0.1% of GDP corresponds to an impact of around 2-3bp on the 30-year JGB yield. Therefore, the current 5bp rise is generally reasonable when considering the scale of the JIP's policies.

In other words, while the political situation may have become chaotic, we can confirm that our estimates as of 6 October were correct with regard to the essential part—the scale of fiscal policy. The market is also making a correction to its initial overreaction, and settling at an appropriate level.

Issues in Upper House: Resurgence of upside risk

However, the LDP's coalition with the JIP alone is not enough to pass legislation. The LDP's 196 seats and the JIP's 35 seats in the House of Representatives (Lower House) total 231 seats, just two seats shy of the 233 needed for a majority.

The issue lies with the Upper House. Even with the LDP's 101 seats and the JIP's 19 seats, the total only comes to 120, five seats short of the 125-seat majority. Since they do not have a two-thirds majority in the Lower House, their bills will not pass if they are rejected in the Upper House. Therefore, cooperation from other parties will be essential to pass important legislation.

LDP President Takaichi is requesting cooperation from the Democratic Party for the People (DPP). In addition to the abolition of the provisional gasoline tax rate, the DPP is demanding an increase in the "annual income barrier" (up to Y3tn) and the abolition of the provisional light oil tax rate (Y0.5tn). If these were to be achieved, it would mean an additional fiscal deterioration of Y3.5tn. Combined with the JIP's Y7tn, the total would come to Y10.5tn, which aligns exactly with the upside scenario (Y9-10tn) we pointed out in [our 6 October report](#).

The market currently appears to be pricing in the scale of the JIP's policies, around Y7tn. If cooperation with the DPP were achieved, that would mean an additional fiscal deterioration of Y3.5tn. Assuming [a relationship](#) in which fiscal expansion worth 1% of GDP leads to a 20-30bp rise in the 30-year JGB yield, the additional Y3.5tn deterioration would be equivalent to about 0.6% of GDP. This calculation suggests that this would apply an additional approximately 10-20bp worth of upward pressure on the 30-year JGB yield.

Furthermore, LDP President Takaichi is also requesting cooperation from Sanseito. Sanseito advocates for more aggressive fiscal policy funded by JGB issuance, and the scale of its policies is unclear. While cooperation may focus on conservative policy issues like an anti-spy law and policies on foreigners, the risk that it could also affect fiscal policy cannot be ruled out. At this stage, with Sanseito's specific policy requests not yet clear, this uncertainty becomes an additional risk factor for the market.

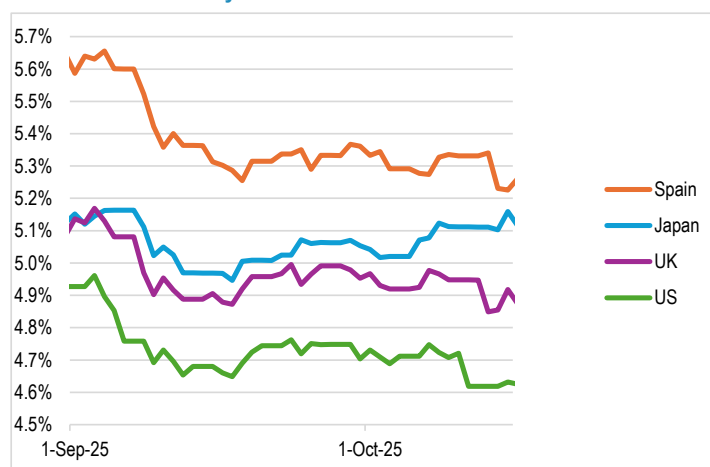
While it is unclear whether the DPP or Sanseito will cooperate, either way, the fiscal burden is expected to increase. It would be premature to only look at the JIP's policies, and feel relieved. The upside risk we pointed out on 6 October still exists.

Market assessment as seen from international comparison

While the 30-year JGB in the Japanese market can be judged to have settled at a level that is largely consistent with the anticipated fiscal burden, a different picture emerges when we perform an international comparison. Comparing the 30-year bond yields of major countries on a USD-denominated basis shows that other major nations have seen their yields trend downwards, with Japan being the only nation whose yield has remained at an elevated level since the inauguration of Takaichi as LDP President.

This suggests that foreign investors are wary of fiscal expansion in Japan. While Japanese investors assessed the scale of the JIP's policies as being within expectations, overseas investors may still be very concerned about Japan's fiscal deterioration. This divergence in assessments will be an important point to watch in forecasting future bond market trends.

USD-denominated 30yr Government Bond Yields



Source: Bloomberg; compiled by Daiwa.

Note: JX87 was used for Japan, because data periods for JX88 were insufficient for a time-series comparison.

Conclusion

The formation of a Takaichi administration has once again become a realistic possibility due to coalition talks with the JIP. From the standpoint of the scale of policies, the JIP's requests of about ¥7tn do not differ significantly from the ¥6tn that the market had priced in as of 6 October. Movements of the 30-year JGB yield (+5bp compared to levels before Takaichi's inauguration) are also largely consistent with the anticipated fiscal burden.

However, the constraint of not having a majority in the Upper House necessitates cooperation with the DPP or Sanseito, which has emerged as a new factor causing uncertainty. If cooperation with the DPP were achieved, the scale of fiscal policies would come to ¥10.5tn, creating room for an additional rise of about 10-20 bp in the 30-year JGB yield. Cooperation with Sanseito would further increase market uncertainty due to the scale of its policies being unclear.

Moreover, based on an international comparison, Japan is the only nation maintaining a rise in yields, indicating that foreign investors are wary of fiscal expansion in Japan. While the political situation may have become chaotic, the essential aspects of fiscal policy have not changed from [our estimates on 6 October](#). Furthermore, the upside risk we pointed out at that time still exists, now in the form of issues in the Upper House.

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