

Japan snap election: Takaichi victory expands political capital; market credibility is the next test

After big win, Takaichi faces task of converting political capital into market credibility

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Japanese Prime Minister Sanae Takaichi's Liberal Democratic Party (LDP) secured a decisive landslide victory in the lower house election on 8 February, winning 316 of the 465 seats. Together with its coalition partner, the Japan Innovation Party, the ruling bloc cleared the 350-seat threshold to secure a two-thirds super-majority, giving it significant legislative latitude. The election represents a strong voter mandate for the ruling coalition.

The Takaichi administration now faces the task of converting political capital into market credibility. The key question is not if the government will deploy more stimulus (something that equity markets have been reacting to), but whether Japan can deliver credible, incentive-compatible fiscal choices while the Bank of Japan (BOJ) manages inflation risks—including imported inflation via an extremely weak yen.

A crash course in incentive compatibility constraints

A strong LDP mandate expands the set of policy options that are feasible for the government. However, assuming that this mandate automatically translates into a decisive fiscal easing impulse risks oversimplification. The temptation to embrace populist vote-winning strategies may have been greater when political capital was scarce. Yet once political capital has been greatly increased, the calculus shifts.

In economics, the coordination of fiscal and monetary policy typically relies on two sources of policy credibility. First, that monetary policy is the most efficient tool for stabilising prices, and second, that this creates space for fiscal policy to manage the country's long-term finances. And while fiscal authorities face constant temptation to break with long-term fiscal rules, markets may bring enforcement to bear. This makes deviation from fiscal responsibility more costly than the possible near-term political gains from populist spending measures. Now is the time for the "real work" of policy coordination to begin. Optimal policy under reflation may be more complex than it was under deflation, when both fiscal and monetary stimulus were employed to lift both nominal and real growth.

The surprising calculus of political vs. fiscal credibility

As mentioned above, a strong electoral mandate broadens the administration's range of policy options. However, it does not eliminate the macro constraints. In fact, the political capital that the LDP secured under Takaichi may actually create greater room for fiscal restraint, not more largesse. Under minority rule, the temptation to deviate from fiscal restraint and pursue short-term, populist fiscal measures was stronger because the political returns from being fiscally credible are smaller (the minority party has less to lose).

A better economy means a tougher choice than under Abenomics

Although wages are yet to catch up with year-on-year price rises, the Japanese economy has been in recovery mode for several years. Paradoxically, this may make today's policy environment more difficult than during Prime Minister Shinzo Abe's tenure, when maximal fiscal and monetary stimulus were both elements of optimal policy.

Following the logic of incentive-compatibility constraints, the optimal mix now may mean allowing the BOJ room to fight inflation independently, while keeping fiscal stimulus limited to short-term, cycle-smoothing measures. These steps could allow growth to continue boosting corporate confidence until real wage gains buoy consumer confidence. The government may need to spend its newly earned political capital by getting out of its own way. This would mean avoiding expansionary fiscal policy that could work against the goal of reducing the cost of living, which remains the greatest challenge for households.

Counter-intuitively, political capital may enable better fiscal quality

The election outcome may actually reduce tail risks—not by enabling sizeable fiscal stimulus as initially anticipated, but by limiting it. The election results give the Takaichi administration the option for more disciplined, credibility-preserving fiscal choices alongside a more autonomous BOJ. In fact, Japan may have edged further away from the feared "fiscal dominance" scenarios than it was prior to the election. It now simply remains up to Takaichi's administration to act on this mandate.

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