

## Economic Research View:

### Japan - Considering Fiscal Risk after the Lower House Election

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On February 8, the Liberal Democratic Party (LDP)-led ruling bloc won a landslide, achieving a two-thirds “supermajority” in the House of Representatives (Lower house). This strengthens the bloc's ability to enact policy even if the House of Councillors (Upper house) objects, reducing the need to rely on opposition cooperation and making their policy execution capacity a significant tailwind.

Market concerns about consumption tax cuts are likely to ease. Although the ruling bloc includes proposals for limited, cautious cuts; 0% tax on food for two years, their stance was more restrained than opposition parties and the need to adopt cuts to pass legislation has diminished. Cross-party deliberations will discuss this issue, but cuts could be shelved.

Prime Minister Sanae Takaichi has emphasized crisis management investments and growth investments rather than demand stimulus, which may be preferable given a near-balanced output gap. However, such investments as well as accelerated defense spending, imply fiscal expansion risks. Key factors for assessing that risk are (1) policy debates — details and roadmaps for 17 strategic investment fields, defense spending targets, and revisions in the “Honebuto” fiscal framework (Basic Policies for Economic and Fiscal Management and Reform) — and (2) the effectiveness of restraints — whether financial markets and external pressures (notably from the US) will discipline expansionary moves.

## Increased fiscal concerns before the election

Ahead of this Lower House election, financial markets' concerns about Japan's fiscal situation intensified. Because almost all political parties, including the ruling bloc, were advocating some form of a consumption-tax cut. Such policy debates were highly likely to have increased fiscal concerns, leading to a rise in the term premium of long-term JGB yields.

On February 8, the Lower House election was held and results became clear. This commentary touches on the issues surrounding fiscal risks following the election.

## Major victory of the ruling bloc increased its policy execution ability

The snap election resulted in a major victory for the ruling bloc of the Liberal Democratic Party (LDP) and Japan Innovation Party (JIP). Before the election, the ruling bloc (on a parliamentary group basis) had barely secured a majority; however, as a result of the election, the ruling bloc parties won 352 seats (LDP: 316 and JIP: 36) and reached a "supermajority" exceeding two-thirds of the Lower House seats (Fig.1 and Fig.2). This will be a great tailwind for the ruling bloc's policy execution going forward. This is because, even if a bill is rejected in the Upper House, where the ruling bloc does not currently secure a majority, it is sent back to the Lower House. With two-thirds of the seats, the ruling bloc can override the Upper House's rejection and secure re-passage of the bill.

Before the election, while there had been observations that the ruling bloc would win a "stable majority" or "absolute stable majority", both of which would enable smoother bill management, but a "supermajority" was not widely expected. However, the result was a historical victory for the ruling bloc.

Figure 1. The Lower House Election Result

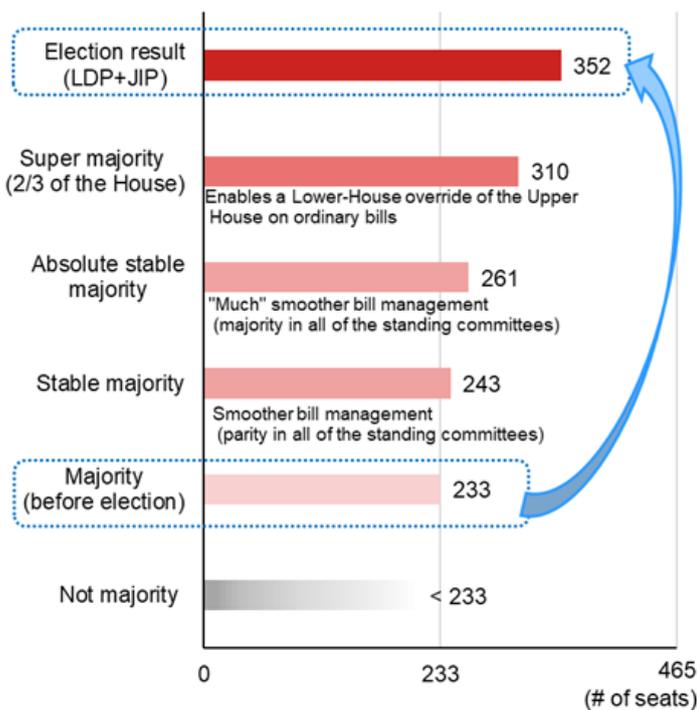
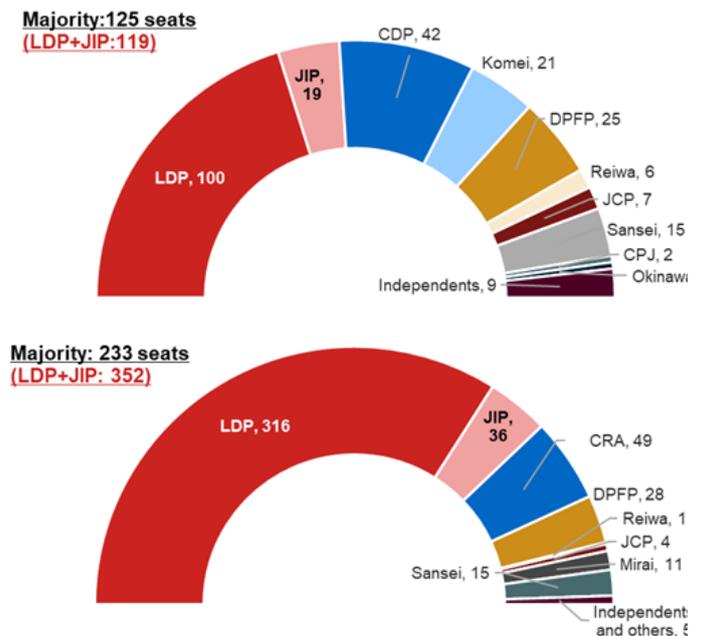


Figure 2. Seat Composition of Houses



Note: CDP is the Constitutional Democratic Party of Japan, CRA is the Centrist Reform Alliance (the alliance of CDP and Komei in the Lower House), and DPFP is the Democratic Party For the People. Source: Nomura Asset Management based on NHK

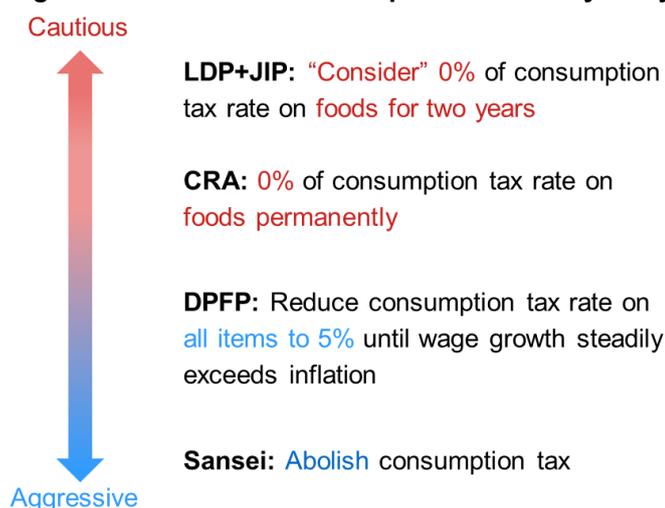
## Weakening tailwind for consumption tax cuts?

This result suggests that the tailwind for consumption tax cuts that financial markets were paying attention to will be weakening. Although the LDP and JIP put forward consumption-tax cut, their proposal was limited; for example “accelerate considerations of a 0% consumption-tax rate on food for two years,” and, compared with other parties, their stance was cautious toward consumption tax cuts (Fig.3 and Fig.4). Relatedly, it has been reported that there were almost no occasions on which PM Takaichi proactively argued for consumption tax cuts during the election campaign.

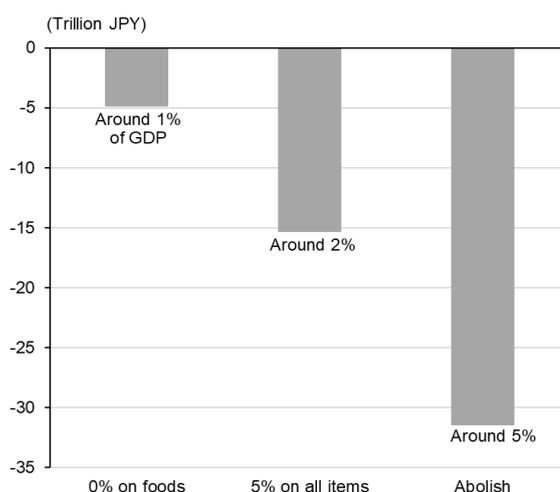
Because the LDP and JIP won, their necessity to cooperate with opposition parties to pass budgets and other bills has declined. Accordingly, it can be considered that the necessity to adopt consumption tax cuts for the purpose of policy execution has also declined.

Going forward, it is expected that a cross-party National Conference will be held regarding consumption tax cuts and an ideal form will be sought. There is a possibility that, during Conference deliberations, the idea will be shelved in a creeping, gradual manner. Having said that, there is another possibility that some consumption-tax cut could be decided. While the ruling bloc seems to be cautious about cuts, Takaichi herself seems less so.

**Figure 3. Stance on Consumption Tax Cut by Party**



**Figure 4. Effects of Consumption Tax on Annual Revenue**



Source: Nomura Asset Management based on NHK

Source: Nomura Asset Management based on Daiwa Research Institute

## The ruling bloc has limited proactive stance toward other tax cuts and fiscal measures. Rather, the bloc focuses on Japan’s economic resilience

The ruling bloc has not been proactive on other tax cuts and fiscal measures (such as reductions in social security premiums and rent subsidies advocated by some opposition parties). Rather, the bloc has been emphasizing the importance of strengthening the resilience of Japan. In fact, if I make “word clouds” using PM Takaichi’s policy speech and the LDP’s manifesto for this election, such words as “security (economic security, energy security, national security)”, “economy”, and “investment” are prominent (Fig.5 and Fig.6). This result indicates that Takaichi wants to prioritize crisis-management investments and growth investments for strengthening security and enhancing economic growth.



## **Issues going forward: how should we assess the risk of fiscal expansions?**

Although it might be better than demand-stimulus-type tax cuts, pursuing crisis-management investments and growth investments would lead to fiscal expansions. In this respect, by securing a "supermajority," the Takaichi administration could pursue sizable fiscal expansion for economic security on the grounds that its policies have obtained voters' confidence.

Therefore, fiscal expansion will remain a focus for financial markets, and market concerns may intensify. Based on the above, the issues going forward can be organized largely into two main areas, both crucial for assessing the risk of fiscal expansions.

### **Issue (1): Policy debates on major issues from spring to mid-year or summer**

The first issue is policy debates on major fiscal issues, which can be grouped into three points. First, crisis-management and growth investments. In order to realize a "strong economy", the Takaichi administration has already identified 17 strategic fields and has shown a policy to promote public and private investment in those fields. These fields include AI, semiconductors, shipbuilding, and others. According to reports, by spring, the details of investment content and implementation policies will be fleshed out with a road map, and by summer, a growth strategy will be compiled. How much these investments lead to fiscal expansion is very important.

Second, defense policy. The government reportedly will revise the Three Documents (the National Security Strategy, the National Defense Strategy, and the Defense Buildup Program) by end 2026. There are various points to watch, but from a fiscal perspective, whether and how the defense-spending target is set will be crucial. In the previous documents, the target was "2% of GDP in FY2027," but the Takaichi administration has decided to bring the target forward and states that it will "achieve the target within FY2025."

Third, the consistency between the investment strategy/defense policy and fiscal management policy. On this point, the "Honebuto" policy (the Basic Policy on Economic and Fiscal Management and Reform), to be published around mid-year, is important. The "Honebuto" policy stipulates the basic stance of the government's economic and fiscal management and direction of reforms, and we must see whether the fiscal stance set out there will ease market fiscal concerns. In the 2025 "Honebuto", it was set out that "by FY2030, the government aims to steadily reduce the debt-to-GDP ratio toward the level before the pandemic". Whether and how this target will be revised is the focal point.

### **Issue (2): Functionality of restraints on fiscal expansions**

The second issue is whether restraints on Takaichi's fiscal expansions function well, and there are two points.

First, financial markets, i.e., how much financial markets will become a restraint on fiscal expansion. In this regard, the Takaichi administration already appears to have been mindful of markets. That is why consumption tax cuts were hardly mentioned by her during the election period. Also, since crisis-management investments and growth investments are seen as being priced in to some degree by financial markets, if discussions on consumption tax cuts subside, there is a possibility that market fiscal concerns will settle down. Going forward, balancing pursuit of her ideal policies with avoiding market surprise will be crucial for Takaichi.

Second, pressures from the Trump administration, i.e., whether external pressures form the US function as a restraint on fiscal expansions. Actually, the US administration appears to have put pressures on Japan. For example, on January 20, US Treasury Secretary Bessent suggested that

Japan's interest rate rise is too large and could spill over to the US. Also, in the US foreign exchange report released on January 29, there was a mention of Japan's expansionary fiscal policy as one of the factors behind the JPY's depreciation. These statements suggest US concern that Japan's expansionary fiscal management could, through financial markets, affect US interest rates and the foreign exchange dynamics. If, going forward, the Takaichi administration implements expansionary policies and markets react strongly, pressures from the US side could increase, which I think financial markets should price in.

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The commentary is based on personal views and does not necessarily reflect the house view.

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