

Japan snap election: it's not about fiscal dominance (yet)

Fiscal dominance narrative unlikely to describe imminent policy

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Look beyond the noisy narrative of "fiscal dominance"—at least for now

Recent headlines—from US political pressure on the Federal Reserve (Fed) to the prospect of a snap election in Japan—have amplified talk of "fiscal dominance". This fiscal dominance narrative appears to be shaping markets' asymmetrically benign expectations about how slightly more accommodative central bank policies may interact with fiscal expansion. However, this narrative is unlikely to accurately describe imminent policy in Japan or in the US.

Academically, fiscal dominance is far more than a loose market metaphor. In academic terms, fiscal dominance assumes a loss of control over both monetary policy and fiscal discipline. In such a scenario, primary surpluses become politically and administratively unfeasible, leaving inflation as the only mechanism to reduce fiscal deficits. In other words, fiscal dominance implies a structural failure of macroeconomic institutions.

Thankfully, despite the noise, markets are *not* pricing in wholesale institutional breakdown. Rather, markets remain risk tolerant, and it is the reflation tilt that remains negative for the yen as well as for Japanese government bonds (JGBs)— not fears of capital flight from Japan. Clearly, deflation is no longer the most imminent risk to real incomes in Japan; instead, the challenge today is persistent, above-target inflation.

Stocks surge on "high-pressure fiscal policy" expectations: it's still risk-on

Japanese stocks reacted positively to media reports that Japanese Prime Minister Sanae Takaichi intends to dissolve the lower house and call a snap election. The schedule reported by Japanese media—pointing to a potential vote on 8 February—suggests an effort to consolidate political authority ahead of the passage of Japan's fiscal 2026 budget.

Markets are interpreting the prospect of a snap election as a sign of Takaichi's confidence in her ability to consolidate political power. Investors are extending this logic by expecting the Takaichi administration to take a significantly more aggressive fiscal policy stance. The ruling party's intention may indeed be to signal a shift toward "high-pressure fiscal policy". However, even if the administration does gain greater political support, the government still needs to issue a large amount of deficit-financing bonds; this means that a mandate to rule does not equate to a blank cheque for fiscal profligacy.

Yen, JGBs under pressure: price discovery continues, and the ball is in the BOJ's court

The markets' reaction to the administration taking a potentially more aggressive fiscal stance should be interpreted neither as a panacea for Japanese growth nor a "sell Japan" signal. The buoyancy of stocks and firm economic fundamentals argue against any resurgence of a "Japan premium". At the same time, inflation running above comfortable levels presents a more powerful headwind to future real incomes than nominal wage growth alone—even though wage negotiations this spring are widely expected to result in continued gains.

The Bank of Japan (BOJ) is aware of this distinction. Governor Kazuo Ueda has signalled that rate hikes remain on the table if the central bank's outlook for ongoing growth accompanied by wage and price rises materialises. Markets continue to engage in price-discovery as Japan's economy continues to reflate. The path still points to higher rates, and despite the attractive carry dynamics currently weighing on the yen, real rates are unlikely to remain negative indefinitely.

A rewind to Abenomics remains inappropriate

If it does happen, a dissolution may prompt markets to recall former Prime Minister Shinzo Abe's lower house dissolutions in 2014 and 2017, both perceived at the time as referenda on Abe's mandate to reflate the economy. However, as we argued at the time Takaichi took office, it would be misguided to assume Abe's no-holds-barred deflation-fighting policy will be revived. As we pointed out in October, today's reflationary macroeconomic conditions are fundamentally different from those that shaped "Abenomics". In this context, the traditionally supportive role of yen weakness for Japanese stocks is likely to be less popular with households. Real purchasing power matters to households; a prolonged period of yen weakness may amplify imported inflation, which in turn would strengthen the case for the BOJ to hike rates sooner rather than later.

Short-term yen-selling dynamics and the role of foreign hedgers

This does not mean that foreign investors will stop pressuring the yen in the short term, whether to test the BOJ's resolve or probe the Ministry of Finance's tolerance for further yen weakness. However, it is worth keeping in mind that Japan does not require constant inflows from abroad to finance its bond issuance. Japan is a net surplus-holding nation, and the ongoing yen carry trade remains a firm indicator that investors—both domestic and foreign—remain risk tolerant. In our view, this environment continues to support risk assets, including Japanese equities, rather than undermine them.

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