Daiwa Securities

Daiwa's View

Sudden rise in super-long JGB yields and fiscal impact

- Super-long JGB yields rose sharply again in Tokyo on 7 July
- Fiscal policies of each party in Upper House election
- 1% deterioration in Japan's fiscal balance results in 26bp JGB yield rise
- July JGB market aware of political risks

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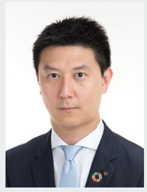
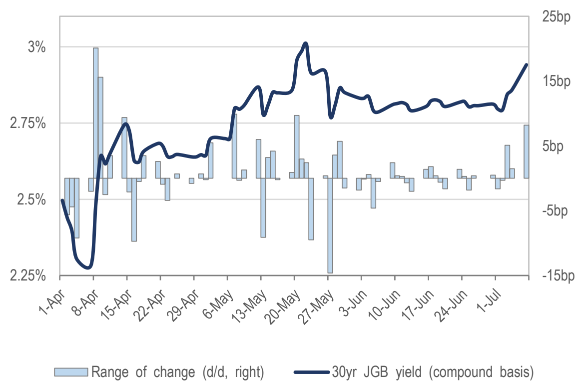


30-year JGB yield surges

Super-long JGB yields once again rose sharply, this time on 7 July. At the close of that day, the 30-year JGB yield was up 8.2bp (compound basis) from the previous day at 2.941% and the 20-year JGB yield was up 5.5bp at 2.431%. Looking back on the super-long JGB market this year, conditions have remained unstable since the 2 April tariff shock. Then, the 20-year JGB auction on 20 May produced a historically poor result, causing a sharp rise for super-long JGB yields. Indeed, the 30-year JGB yield exceeded 3.0% (compound basis), the highest level since the initial issuance in 1999. However, on 9 June it was reported that MOF was considering reducing its issuance of super-long JGBs in FY25, which triggered repurchases of super-long JGBs. Also, the quarterly plans for JGB purchases ("Quarterly Schedule of Outright Purchases of Japanese Government Bonds"), announced after the BOJ's 18 June Monetary Policy Meeting, did not have any changes for purchasing amounts for JGBs with residual maturities of more than 10 years, despite the Bank's ongoing quantitative tightening (QT). Then, MOF's Meeting of JGB Market Special Participants on 20 June showed a plan for a greater reduction in the issuance of 20-year JGBs, from the initially reported Y100bn per month to Y200bn[1]. These price actions occurred amid a growing sense of confidence among buyers.

When we look at the factors impacting super-long JGB yields, dividing them into short-term factors such as supply/demand and long-term factors such as potential growth rate and fiscal risk, it seems that fiscal factors have been influencing yields after the BOJ and MOF took policy measures to address supply/demand factors, such as QT and reducing issuance, in June. In particular, as for the Upper House election, which will be held on 20 July, various media outlets noted over the weekend that the ruling Liberal Democratic Party (LDP) is facing an uphill battle.

Chart 1: 30yr JGB Yield (compound basis), Range of Change (d/d)



Source: Bloomberg; compiled by Daiwa.

[1] Refer to *Daiwa's View: Unexpected plan to reduce issuance of 20-year JGBs* (23 Jun 2025) by Kazuya Sato.

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Upper House election and fiscal implications of each political party

The ruling LDP/Komeito coalition currently holds 75 uncontested seats in the upcoming election. As such, if it can secure 50 of the 125 contested seats, it will be able to maintain a majority in the Upper House. Initially, the prevailing belief was that the ruling coalition would maintain its majority, but according to reports over the weekend, the outcome is now uncertain due to many single-seat constituencies, which tend to determine the overall outcome in close races.

We confirmed those election promises that are seen as likely having significant fiscal impacts, such as measures to address high prices. The ruling LDP will only offer cash handouts of Y20,000 per person (Y40,000 for children and tax-exempt households), while the Constitutional Democratic Party of Japan (CDP) has pledged to reduce the consumption tax on food to 0%, abolish the provisional gasoline tax, and provide cash handouts of Y20,000 per person. The Japan Innovation Party has also promised to reduce the consumption tax on food to 0% and abolish the provisional gasoline tax. The election pledges of the Democratic Party for the People include abolishing the provisional gasoline tax, lowering the consumption tax to 5%, raising the level for which no income taxes are required (income tax threshold), and issuing Y5.0tn in education bonds each year. We will leave accurate estimates to financial analysts and economists. Still, we should recognize the risk that Japan's fiscal deficit could swell to more than Y10tn if the political landscape changes after the election and the policies of opposition parties are implemented.

Impact of fiscal deficits on long-term JGB yields

As we introduced in previous reports[2], Rachel and Summers (2019) estimated the impact of fiscal balances and government debt balances on long-term government bond yields in advanced economies, mainly the US. According to their estimates, a 1% deterioration in the fiscal deficit-to-GDP ratio results in an average government bond yield increase of 38bp.

Chart 2: Impact of Fiscal Deficit and Government Debt on Long-term Interest Rate

Study	Country/region	1pp increase in deficit/GDP		1pp increase in debt/GDP	
Gale and Orszag (2002)	US	**50-100**	bps	-	
Laubach (2009)	US	**20-30**	bps	**3-4**	bps
Engen and Hubbard (2004)	US	**18**	bps	**3**	bps
FRB/US model	US	**40-50**	bps	-	
Faini (2006)	Euro Area	**40**	bps	-	
Brook (2003)	Advanced economies	**20-40**	bps	**1-6**	bps
Kinoshita (2006)	19 OECD economies	-		**4-5**	bps
Average		38	bps	3.5	bps

Source: Rachel and Summers (2019); compiled by Daiwa.

Relationship between fiscal deficits and long-term JGB yields

Kameda (2014)[3] prepared a paper that analyzes the fiscal impact of the JGB market. Regression analysis explaining long-term JGB yields shows that a 1% deterioration in the fiscal deficit-to-GDP ratio results in upward pressure of 26-27bp on JGB yields. Meanwhile, in terms of the stock aspect, the effect of the deterioration of the 1% government debt-to-GDP ratio is estimated to be limited to around 1.2bp even in the model that has the greatest impact. The latest nominal GDP announced by the Cabinet Office is Y625tn, so a fiscal deficit of approximately Y6.0tn would result in a roughly 30bp JGB yield rise.

This paper was published in 2014 and the data covers the period from 1981 to 2008, so it is somewhat outdated. As such, it is possible that the market structure has changed. However, if the sensitivity of long-term JGB yields to fiscal deterioration has declined due to large-scale monetary easing since 2013, the market reaction function for a 26bp yield rise with a deficit of Y6.0tn in the

[2] Rachel and Summers. 2019. "On Secular Stagnation in Industrialized World." NBER.
[3] Kameda, Keigo. 2014. "Budget deficits, government debt, and long-term interest rates in Japan." The Journal of Japanese and International Economies 32 105-124.

current QT phase cannot be considered excessive. Also, the above analysis is based on the 10-year (long-term) JGB yield, but given that the stock effect is likely to remain for the intermediate/long-term, the impact on the super-long zone, which is thought to reflect the term premium (fiscal premium) more strongly, could be even greater.

Chart 3: Impact of Fiscal Deficit and Government Debt on 10yr JGB Yield

Cointegrating relations of primary deficit/GDP, debt/GDP and 10-year JGB yield.

Normalized variable	10-year JGB Yield							
Estimation method	FMOLS				OLS			
Projected deficit/GDP	0.264** (4.802)				0.201** (2.874)			
Current deficit/GDP		0.269** (3.450)				0.236** (2.775)		
Projected primary deficit/GDP			0.337** (5.896)				0.246** (3.046)	
Current primary deficit/GDP				0.334** (4.473)				0.246** (2.759)
Current debt/GDP	0.001 (0.324)	0.006 (1.699)	0.007** (3.081)	0.012** (4.441)	0.005 (1.210)	0.008* (2.105)	0.010** (3.169)	0.014** (4.272)
Trend growth	1.060** (18.478)	1.046** (13.981)	1.263** (31.444)	1.244 (24.937)	1.166** (16.408)	1.133** (14.256)	1.307** (22.281)	1.293** (21.647)
Expected inflation	1.002** (11.368)	1.064** (8.847)	1.000** (13.094)	1.097** (10.047)	0.912** (7.964)	0.981** (7.464)	0.917** (8.167)	0.985** (7.414)
Equity premium	−0.455** (−5.046)	−0.613** (−4.698)	−0.503** (−6.337)	−0.679** (−5.640)	−0.576** (−5.544)	−0.704** (−5.377)	−0.618** (−5.742)	−0.743** (−5.255)

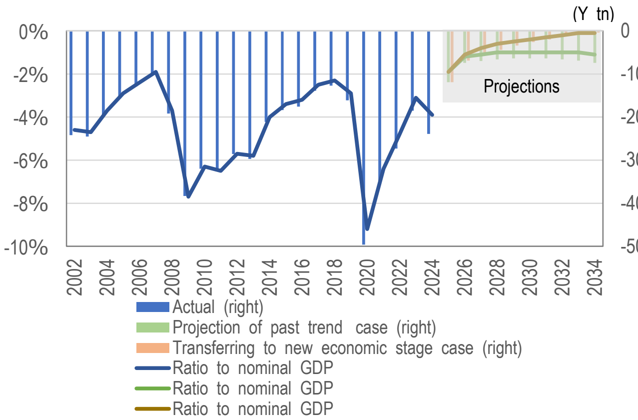
Notes: (1) Sample period is from fiscal years 1981 to 2008. *t*-values are shown below the coefficients.
(3) OLS estimates are just a reference, since the distributions of coefficient estimates are biased when the first difference of the explanatory variables are correlated with the disturbance term. See Hamilton (1994) for details.
* Statistical significance at the 5% level.
** Statistical significance at the 1% level.

Source: Reprinted from Kameda (2014).
Note: Red squares added by Daiwa.

Politics-focused July

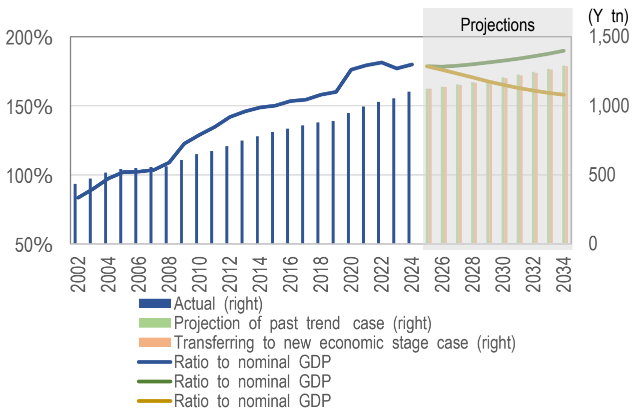
On 7 July, US President Donald Trump announced that he would impose a 25% tariff on imports from Japan. The effective date of the tariffs has been set for 1 August. This is just 12 days after the 20 July Upper House election, at which time prompt actions will be required. A 30-year JGB with yield exceeding 3% is seen as an attractive long-term investment[4]. As a "bond vigilante," it looks like July will be a hot month for the market, with all eyes fixed on politics.

Chart 4: Fiscal Balance



Source: Cabinet Office's Economic and Fiscal Projections for Medium to Long Term Analysis; compiled by Daiwa.

Chart 5: Government Debt



Source: Cabinet Office's Economic and Fiscal Projections for Medium to Long Term Analysis; compiled by Daiwa.

[4] Daiwa Memorandum: Factor analysis for the 30-year JGB yield (26 May 2025) by Shun Otani, Daiwa's View: Skeptical of view that super-long JGB yield can reach 4% (26 May 2025) by Eiichiro Tani, and Daiwa's View: European firm ranked top at 30-year JGB auction, clearly showing dependence on overseas players (6 Jun 2025) by Ryoma Kawahara.

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