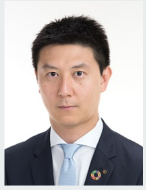
Daiwa Securities

Daiwa's View

Fiscal capacity and JGB market

- Fiscal capacity from perspective of Domar condition
- Importance of achieving primary balance surplus
- Economic stimulus package of around Y10tn would have only limited impact on JGB market
- Risk of 10-year JGB yield topping 2%

FICC Research Dept.



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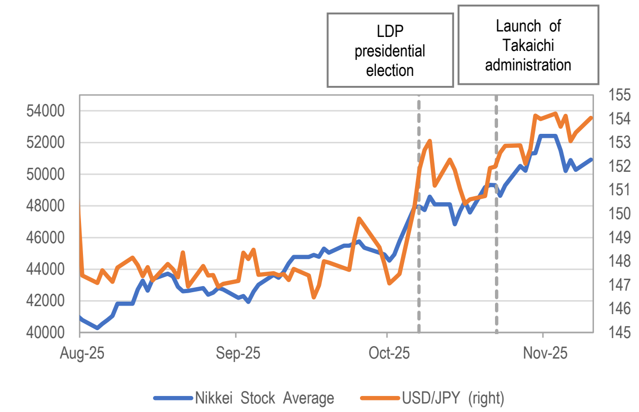
Reflation trade gap between stock/forex and JGB market

Since the launch of the Takaichi administration, reflation trades have gained considerable momentum in the stock and foreign exchange markets. Indeed, the Nikkei Stock Average has held above the 50,000 line despite corrections (selling) among high-tech stocks, while the dollar-yen exchange rate, which was around USD/JPY148 in early October, has shifted to a USD/JPY153-154 range amid concerns about potential forex market intervention. Last week, Takuji Aida of Crédit Agricole Securities and Goushi Kataoka (appointed as a BOJ monetary policy board member under the Abe administration in 2017)—both viewed as reflationists—were named as experts for the Japan Growth Strategy Council spearheaded by Prime Minister Sanae Takaichi. Meanwhile, former BOJ Deputy Governor Masazumi Wakatabe and Dai-ichi Life Research Institute Chief Economist Toshihiro Nagahama were appointed to the Council on Economic and Fiscal Policy, which serves as the command center for economic policy. Initially, it was thought that appointing figures such former Finance Minister Taro Aso and LDP Diet member Shunichi Suzuki to key party positions would provide the administration with more balance as those two men favor fiscal consolidation (as opposed to Takaichi's reflationary policies). Market participants are now reading the government's intentions from the personnel selections for key policy committees.

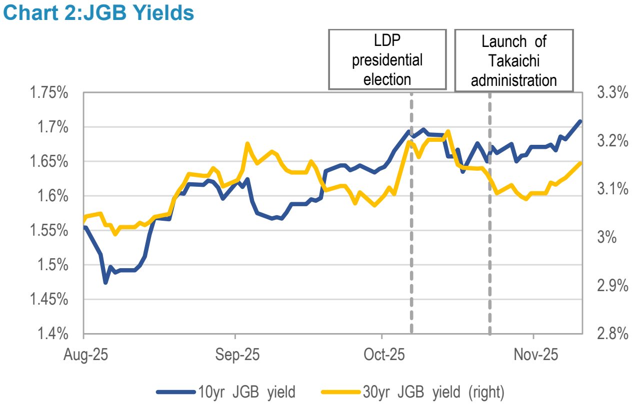
Meanwhile, reflation is expected to significantly impact the JGB market through expansionary fiscal policy. However, while the 10-year JGB yield has been rising gradually, it remains within the scope of the impact from rising UST yields. Even super-long JGBs, which are thought to strongly reflect fiscal risks, have not entered a state of volatility like that seen this spring and summer. This gap between stock/forex markets and the JGB market appears to reflect fiscal capacity (leeway) based on the Domar condition.

Chart 1: Stock Price, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Chart 2:JGB Yields



Source: Bloomberg; compiled by Daiwa.

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Fiscal capacity from perspective of Domar condition

The Domar condition, which indicates fiscal sustainability, depends heavily on the size relationship between *r* (nominal interest rate) and *g* (nominal economic growth rate)[1]. The nominal GDP growth rate for FY24 was 3.7% (0.7% real growth + 3.0% GDP deflator). According to the mid-year economic projections released by the Cabinet Office in August, the nominal GDP growth rate is projected to be 3.3% (0.7% + 2.6%) for FY25 and 2.7% (0.9% + 1.8%) for FY26. A simple application of the Domar condition—setting the nominal interest rate (r) at the current 10-year JGB yield of 1.7%—indicates that the government's 200% debt-to-GDP ratio would not worsen, even with a primary balance deficit of approximately Y24tn (assuming a nominal economic growth rate (g) of 3.7%) or Y12tn (assuming a 2.7% growth rate projected for FY26). While these are just rough estimates, the impact on the market from an annual fiscal deficit of around Y10tn to Y20tn is viewed as limited.

When considering the longer-term nominal economic growth rate (g) level, the Cabinet Office estimates the latest potential (real) growth rate at 0.6%, while the BOJ's estimate is 0.66%. Assuming that the 2% CPI target is achieved, the GDP deflator will have a downward bias. Therefore, if we assume that this is 1.5%, the long-term nominal economic growth rate level that comes to mind is 2.1% (= 0.6 + 1.5). A fiscal balance in which *r* : 1.7% and *g* : 2.1% are balanced results in a deficit of approximately Y5tn.

Chart 3: Relationship Between *g*, *r*, and Primary Balance that Stabilizes Government Debt-to-GDP Ratio

The case of a 200% government debt-to-GDP ratio

Nominal economic growth rate			Long-term yield	Primary balance	
(g)	Real growth rate	Deflator	(r)	Ratio to GDP	FY24 standard (Y tn)
3.7%	0.7%	3.0%	1.7%	-3.86%	-23.8
3.3%	0.7%	2.6%	1.7%	-3.10%	-19.1
2.7%	0.9%	1.8%	1.7%	-1.95%	-12.0
2.1%	0.6%	1.5%	1.7%	-0.78%	-4.8
2.1%	0.6%	1.5%	2.0%	-0.20%	-1.2
2.1%	0.6%	1.5%	2.5%	0.78%	4.8

Source: Compiled by Daiwa.

Sustainability of r<g

Hatayama, Iwasaki, Nakagami, and Okimoto (2024)[2] analyzed the factors behind the decline in the natural rate of interest as a BOJ Working Paper. Since the 1980s, Japan's natural rate of interest has declined by approximately 3%. Beyond the decline in productivity (= *g*), this decrease is explained by the convenience yield and the working-age population ratio. As for the latter factor, the ongoing aging of the population will likely continue to exert downward pressure on the natural rate of interest. Meanwhile, the convenience yield indicates demand for safe assets (primarily US Treasuries), particularly the need for foreign exchange reserves[3]. Considering the risk of USD sell-offs following Trump's tariffs announced on 2 April and the surging gold prices, it seems prudent to be aware that this factor could act as a driver for an increase in *r* going forward. If the 10-year JGB yield rises to 2% based on the above analysis, fiscal capacity would shrink to Y1.2tn. Naturally, if this yield were to exceed 2.1%, this relationship would reverse, necessitating the recording of fiscal surpluses each year.

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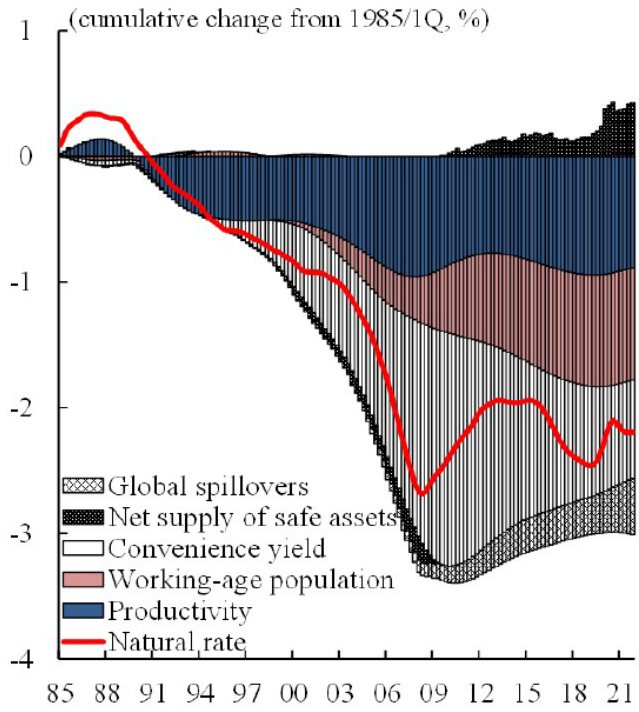
[1] *Daiwa's View: Rising long-term interest rates and fiscal sustainability (26 Aug 2025).*
[2] Yudai Hatayama, Yuto Iwasaki, Kyoko Nakagami, Tatsuyoshi Okimoto (2024). *Globalization and Its Growing Impact on the Natural Rates of Interest in Developed Economies*. Bank of Japan Working Paper Series.
[3] The model in this paper incorporates the mechanism through which a decline in *r* in the US has a global spillover effect that includes Japan.

Chart 4: Decomposition of Natural Rate of Interest (Japan)



Source: Reprinted from Yudai Hatayama, Yuto Iwasaki, Kyoko Nakagami, Tatsuyoshi Okimoto (2024). Globalization and Its Growing Impact on the Natural Rates of Interest in Developed Economies. Bank of Japan Working Paper Series.

Importance of achieving primary balance surplus

Regarding the target for achieving a primary balance surplus, Prime Minister Takaichi stated at a Lower House budget committee on 7 November that, "We intend to withdraw the concept of a single-fiscal year primary balance." Meanwhile, on 10 November she made a course correction and stated, "This does not mean an immediate withdraw." We believe that the primary balance surplus target is important in terms of fiscal discipline. It is well known that Japan's government sector carries a massive debt burden. Meanwhile, the stable balance of payments from overseas, expressed as the current account surplus, along with abundant personal financial assets, underpin its creditworthiness. However, that does not mean the government can directly use that for debt repayment. By setting the goal of achieving a primary balance surplus, we think the government is signaling its intentions to the market. We should pay attention to the direction stated by Takaichi as, "We are considering a revision toward confirming the balance over a multi-year period."

Implications for JGB investors

In summarizing these implications for JGB investors, based on the above considerations, we should note that it was reported that the government will finalize a comprehensive economic stimulus package within this month. If the fiscal impact is around Y10tn, the effect on the JGB market would be limited, while exceeding Y20tn would be considered a warning level. Also, if the 10-year JGB yield were to rise above 2%, the long-term relationship between *g* and *r* could reverse, posing a risk in which the market rapidly prices in fiscal deterioration. So, we should keep an eye on 2% as a key threshold for the 10-year JGB yield.

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