

Daiwa's View

Policy gamble tipping point: “Gradual decline” rejected by public, asymmetrical risks reflected in super-long JGB yields

- Public has factored in inflation, which erodes value of cash/deposits, and opted for nominal growth regime
- Inflation and yen depreciation entail asymmetrical redistribution across generations, asset classes
- Super-long JGB yields reflect tail risk (premium) inherent in that choice
- Lesson from 1970s oil shock: Do not counter supply constraints with demand-stimulating measures

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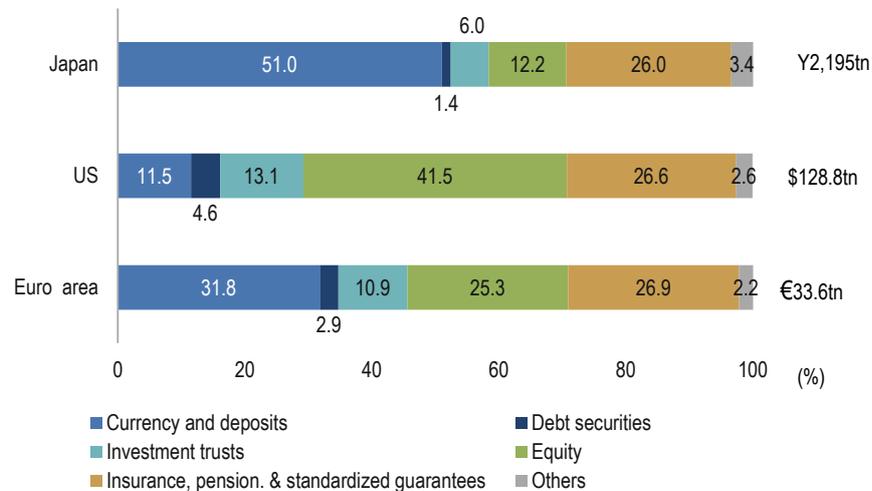
The results of Japan's recent historic election can be seen not so much as a judgment on specific policies, but rather as an indication of the vision for the future that the Japanese people have chosen in response to the prolonged stagnation faced by the Japanese economy. Amid stagnant real wages, concerns about the social security system, and a growing recognition that maintaining the status quo no longer guarantees stability, voters, particularly young people and those in the workforce, chose not to follow a path of gradual decline where “nothing happens, but we are certain to grow poorer.”

This choice is not necessarily an optimistic one. Rather, the opposite is true. For those who lack sufficient assets or vested interests for long-term protection, the traditional policy regime of low inflation, a strong yen, and suppressed interest rates has failed to deliver the benefit of effective asset preservation, while perpetuating a lack of growth opportunities. For such groups, a scenario in which nominal prices fluctuate due to inflation or yen depreciation, as well as the economy's relative price structure is restructured, leaves room for higher-than-expected outcomes, even if the risks are higher.

Behind the scenes, however, the impact of changes in relative prices caused by inflation and yen depreciation varies significantly depending on the composition of each asset portfolio. In particular, for the older generation, who hold a high proportion of cash/deposits, inflation erodes the real value of their assets. Meanwhile, young people and those in the workforce tend to rely more heavily on financial assets and future income and, during periods when nominal growth is advancing, they are better positioned to reap the benefits through wages and employment opportunities. It appears that the public this time has expressed a political judgment that implicitly accepts this redistribution mechanism, which works asymmetrically across generations (easier to understand recent election results when interpreted in context of generational conflict).

If households become increasingly aware of the erosion of their real value cash/deposits due to inflation and yen depreciation, that could lead to changes in the distribution of their financial assets. Even at this juncture, there are signs that people are beginning to shift from a focus on savings toward more investment-oriented approaches. If this trend continues to spread, it will likely have an undeniable impact on the business models and revenue structures for deposit-taking institutions, which have long relied on the steady accumulation of deposits. It is also important to note that redistribution through inflation may entail structural changes not only in the household sector but also across the entire financial system.

Financial Assets Held by Households in Japan, US, and Euro Area (as of end-Mar 2025)



Source: BOJ; compiled by Daiwa.

As a result, the public's decision in this election can be interpreted as a choice to bet on a policy environment where nominal growth and redistribution are possible, even while acknowledging the side effects such as inflation and rising interest rates. In other words, Japan has embarked on a kind of "policy gamble."

However, this gamble has been asymmetrical from the start. While the benefits of success would likely be somewhat limited (such as nominal wage increases and economic revitalization), failure could result in significant losses, including runaway inflation, soaring interest rates, and rapid yen depreciation. In the case of interest rates, in particular, while there is a 0% lower constraint, there is no theoretical upper bound. It is precisely this asymmetry that constitutes the essence of policy gambles.

[The Iran conflict unfolding right before our eyes](#) risks making this asymmetry even more pronounced. [Rising crude oil and LNG prices represent a classic negative terms-of-trade shock for Japan](#), specifically, supply constraint shocks that depress growth while pushing up prices. While monetary easing and fiscal expansion can be effective during periods of weak demand, such measures tend to destabilize inflation expectations in the face of supply constraint shocks. While the current war in Iran does not invalidate the concept of taking policy gambles, it is acting as an exogenous shock that is certain to amplify the losses incurred if the gamble fails.

The JGB market trends, particularly trends for the super-long zone and forward rates, reflect this situation calmly and matter-of-factly. The JGB market is not currently pricing in soaring inflation and uncontrollable budget deficit expansion as its main scenarios. However, even though the probability of such events occurring is low, the expected loss associated with a tail scenario, in which an extreme event for interest rates materializes, is reflected in prices in the form of super-long forward rates. This should be viewed not so much as a lack of trust in policymakers, but rather as a rational "premium" for a high-risk, high dispersion policy regime.

JGB Forward Yields



Source: Bloomberg; compiled by Daiwa.

What is even more significant, and complicates the matter, is that the current policy environment is in what is known as a period of “(extreme) interest rate bonus period.” While rising inflation is boosting nominal growth rates, the average effective interest rate on debt accumulated during the previous period of low interest rates remains low. As a result, despite the inflationary environment, there are instances where debt dynamics, such as the fiscal balance and the government debt-to-GDP ratio, appear, at first glance, to be improving.

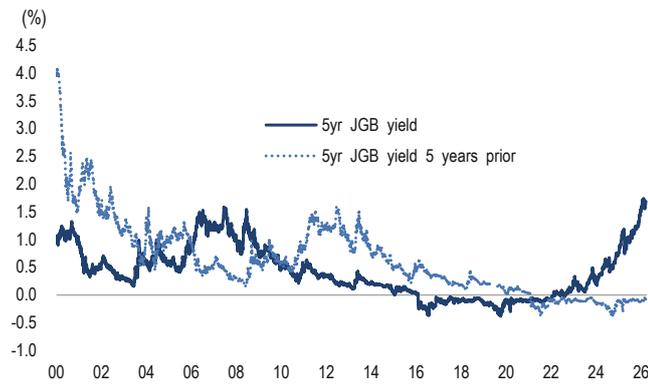
However, that situation is not permanent. As nominal interest rates rise and debt refinancing progresses, the interest payment burdens will increase after a certain lag. The moment the market determines that it has entered the “end of interest rate bonus period,” specifically the “interest rate onus period” at which interest rates act negatively rather than positively on public finances, all previous assumptions could collapse in an instant.

This tipping point does not necessarily coincide with a sudden deterioration in fiscal indicators. Rather, it is highly likely that signs of this will appear in super-long JGB yields and forward rates once the market begins to question the balance between future interest payment burdens and growth potential. At this juncture, super-long forward rates are precisely pricing in this “future outlook tipping point risk.”

It appears that the 5-year JGB yield five years prior has already started to rise, so the window of opportunity is likely limited. Unless the “responsible proactive fiscal policy” succeeds in boosting Japan’s potential growth rate (real growth rate trend) over the next four to five years, fiscal stability will likely depend not on growth, but on real adjustments driven by inflation.

In that case, policy gambles may turn out to be wagers that ultimately exacerbate distortions in the distribution structure, rather than challenges with rewards for success. Personally, the author believes that analyzing the current situation within the framework of the Fiscal Theory of the Price Level (FTPL) makes it easier to foresee various possible future developments (potential scenarios).

5yr JGB Yield vs. 5yr Yield 5 Years Prior



Source: Bloomberg; compiled by Daiwa..

10yr JGB Yield vs. 10yr Yield 10 Years Prior

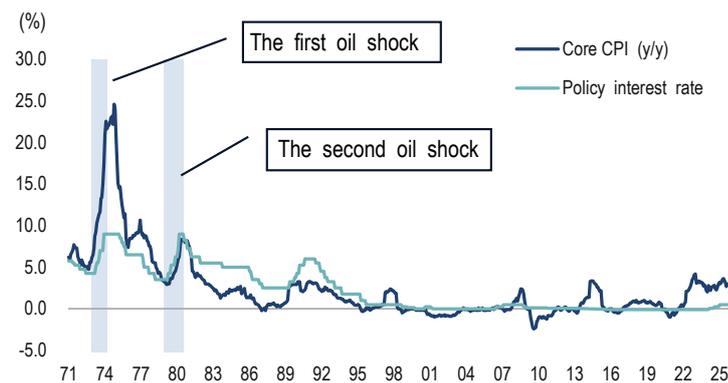


Source: Bloomberg; compiled by Daiwa.

When assessing the current situation, the oil shock of the 1970s, particularly the second oil shock of 1979-80, serve as important reference points. During the first oil shock, under the high-pressure growth orientation (prioritizing nominal growth) symbolized by the “Building a New Japan” plan, economic overheating coincided with expansionary fiscal policy and monetary easing. As supply constraints became apparent, inflation accelerated in an uncontrollable manner.

Meanwhile, during the second oil shock, even though crude oil prices rose sharply once again, social disruption was limited and the acceleration of inflation was not as severe as it had been during the first shock. That difference is no coincidence. Drawing on lessons learned from the first oil shock, monetary policy was conducted with caution from the outset during the second oil shock and excessive demand stimulation was deliberately avoided. At the same time, energy-saving investments and industrial restructuring were being driven by the private sector and the economy overall became better equipped to adapt to supply constraints. Furthermore, adjustments were made at that time to curb the secondary effects of inflation through wages (income policy). These adjustments are believed to have played a certain role in preventing cost-push inflation from becoming entrenched.

Nationwide Core CPI, Policy Interest Rate



Source: Ministry of Internal Affairs and Communications, BOJ; compiled by Daiwa.

Through this process, both policymakers and the private sector in Japan came to share the same lesson that “demand stimulus should not be used to counter supply shocks.” Of course, the Japanese economy today is not the same as it was in the 1970s. Demographics and growth rates are different. Wage inertia has also weakened. However, they share many commonalities in terms of their structural dependence on energy imports and their vulnerability to supply constraints caused by geopolitical factors. Under these conditions, if policy leans toward boosting nominal demand through monetary easing or fiscal expansion in response to a supply constraint shock, it would be a natural reaction for the market to recall the failures of the 1970s.

The public this time has rejected a path of “gradual decline” and instead opted for policy gambles that carry a certain degree of risk. This appears to include a decision to tacitly accept the redistribution of real value brought about by inflation and the weakening of the yen. The Iran conflict has raised the stakes and super-long forward rates are quietly revealing where the risks lie. The issue here is not the fact that gambles are being taken. The question is whether Japan can continue to follow the approach it adopted based on the lessons learned amid supply constraint shocks. It appears that we have entered a phase where the success or failure of these efforts will be put to a much tougher test through future movements involving interest rates, exchange rates, and wages.

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