

Daiwa's View

Surging 10-year JGB yield: Fiscal “free lunch” is over

- 21bp increase over past week marks biggest 10yr JGB yield jump in 23 years
- Arising fiscal concerns due to supplementary budget considerations
- Damar condition deteriorating due to rising 10yr JGB yield and end of fiscal “free lunch”
- Despite no major changes to our 10yr JGB yield outlook, see risk of higher-than-expected upside

Shun Otani

81-3-5555-8764
shun.otani@daiwa.co.jp



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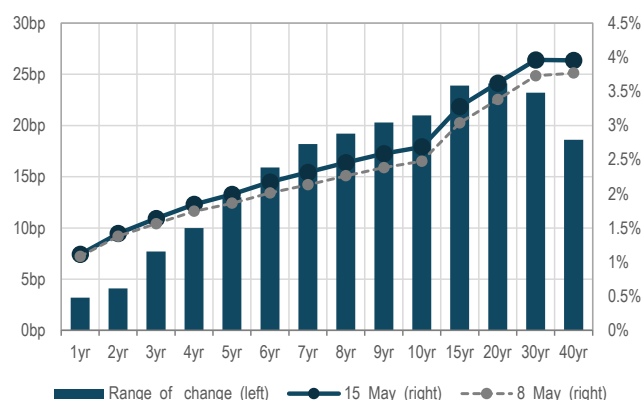
Surging 10-year JGB yield: Fiscal “free lunch” is over

The 10-year JGB yield surged 21bp on a weekly basis, marking its largest weekly increase since the VaR shock of 2003. Japan's BEI is rising despite falling real yields, which contrasts with the real yield-driven trends in other major economies. This trend has been driven by rising fiscal uncertainty stemming from speculation about a supplementary budget, which possibly resulted in higher JGB yields driven by BEI. In a world in which yields are rising and there are no zero lower bound (ZLB) constraints, the fiscal “free lunch” is likely to end and fiscal expansion is likely to produce higher JGB yields. Even though the target range for the 10-year JGB yield remains in the mid-to-high 2% range, we should remain vigilant about the risk of upward deviations given the volatile market conditions.

Last week's JGB market: Steepening, higher yields led by BEI

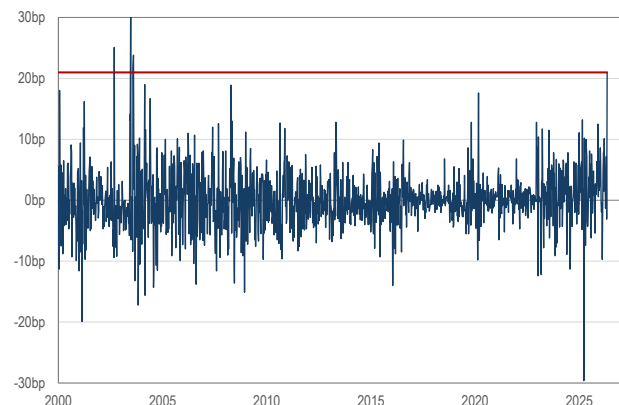
Looking back at last week's JGB market, the 10-year JGB yield rose 21bp (compound yield basis). This rise of more than 20bp for a single week topped the largest increases since the COVID-19 shock in March 2020 (17.6bp), the period following the introduction of QQE in May 2013 (12.8bp), and the global financial crisis in April 2008 (18.9bp). Indeed, this is the largest such rise since August 2003 (23.8bp), when a VaR shock occurred and destabilized the market.

Chart 1: Changes in JGB Yield Curve (8 May → 15 May)



Source: Bloomberg; compiled by Daiwa.

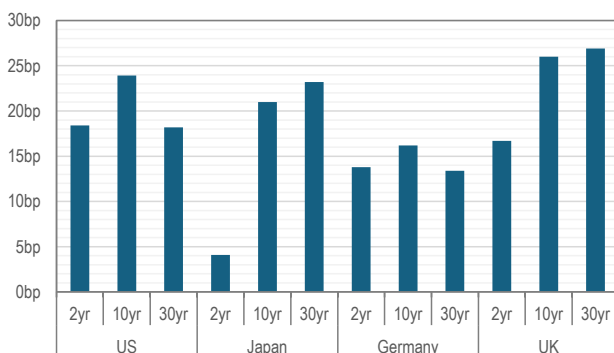
Chart 2: Weekly Changes in 10yr Yield



Source: Bloomberg; compiled by Daiwa.

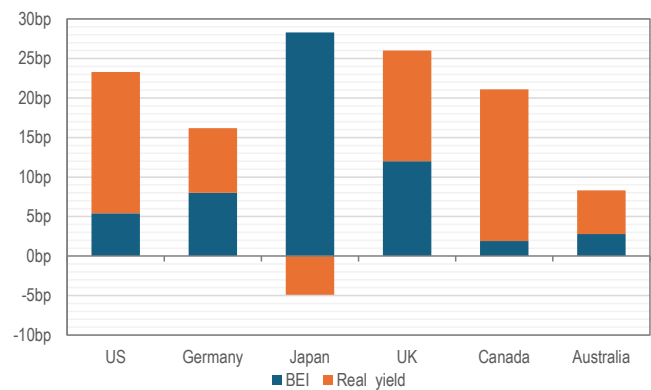
Government bond yields have risen significantly, by about 20bp, in major economies such as the US, Germany, and the UK. However, when examining yield curve changes for the 2-, 10-, and 30-year sectors, we see that the US and German yield curves are rising roughly parallel to each other, while the long- and super-long zones of Japan's and the UK's yield curves are steepening. Furthermore, a decomposition of the 10-year yield change reveals a striking contrast. In many cases, the rise in yields has been led by real yields. In Japan, however, the trend is notably different: a sharp increase in the BEI stands out, occurring even as real yields have slightly declined. With the exception of the UK, where the higher yields are being driven more by political concerns, the rise for JGB yields differs somewhat in nature from the global trend, due to yield curve steepening and higher yields led by BEI.

Chart 3: Changes in Yield Curves in Major Countries (8 May → 15 May)



Source: Bloomberg; compiled by Daiwa.

Chart 4: Changes in 10yr BEI and Real Yields (8 May → 15 May)



Source: Bloomberg; compiled by Daiwa.

Fiscal deterioration concerns due to supplementary budget

On 14 May, there were reports in Japan that the government was considering a supplementary budget. On 18 May, it was also reported that Prime Minister Sanae Takaichi plans to announce the compilation of a supplementary budget in order to provide gasoline subsidies and support for electricity and gas bills. During her Diet testimony at the end of April, Takaichi not only dismissed the need for a supplementary budget but also voiced reservations about fiscal management based on the assumption of a supplementary budget. Of course, while there is a sense of urgency this time, given the conflict in Iran and the de facto closure of the Strait of Hormuz, which have triggered supply shocks not seen since the 1970s, the early compilation of a supplementary budget came as a surprise to the market. Indeed, this was one of the factors behind the sharply higher JGB yields led by BEI. Going forward, the focus will turn to the size of the supplementary budget, as well as whether or not the government issues additional JGBs and how that could impact JGB yield formation through inflation expectations and term premiums¹.

Theoretical arrangement and fiscal leeway based on Dormer condition

According to a basic understanding of the Domar condition², in a world where the interest rate is lower than the growth rate ($r < g$), there is fiscal leeway to reduce the government debt-to-GDP ratio even while running a fiscal deficit. Meanwhile, in a world where $r > g$, achieving a primary balance surplus is a necessary condition for fiscal consolidation. Assuming that Japan's potential growth rate is between 0.5% and 1.0% and that the stable inflation rate is between 1.5% and 2.0%, a long-term nominal GDP growth rate of between 2.0% and 3.0% would serve as a target. It is important to recognize that the response function regarding the sustainability of debt due to fiscal spending could be entirely different depending on whether the long-term interest rate is in the low 2% range or the high 2% range.

¹ For details on the supplementary budget, please refer to our 15 May 2026 report [Economic Commentary \(supplementary budget\): Considering early supplementary budget scale and funding](#) by Koji Hamada.

² Shun Otani (26 Aug 2025). [Daiwa's View: Rising long-term interest rates and fiscal sustainability](#).

In Mian, Straub, and Sufi (2025)³, published in the American Economic Review, a leading economics journal, it is argued that fiscal sustainability depends heavily on the ZLB in addition to the relationship between r and g . As of 2019, in the US, where nominal yields were positive and the ZLB constraints were weak, fiscal expansion directly led to a decline in debt sustainability. Meanwhile, in Japan, which was operating under ZLB constraints, fiscal spending did not lead to higher nominal yields, allowing for a flexible fiscal response to the COVID-19 shock.

Disappearing fiscal “free lunch”

That said, seven years have passed since Mian et al. conducted their study in 2019 and, in Japan, both the policy interest rate and the long-term interest rate have moved clearly into positive territory and are no longer subject to the ZLB constraints. Also, given the rise in r (long-term interest rate), the fiscal leeway that was available during the COVID-19 pandemic has diminished. In response to the unprecedented crisis in the Middle East, while financial support is justifiable on welfare grounds, from a macroeconomic perspective it risks exacerbating inflation by stimulating demand. As such, its scale and scope must be carefully considered. Above all, this involves the painful reality of higher long-term interest rate levels and we must understand that fiscal stimulus is shifting from a “free lunch” to a matter of choice.

Future outlook

Market concerns are mounting. These concerns include the 10-year JGB yield rising more than 20bp over the past five business days. Given that bond yields on overseas markets also rose sharply on 15 May, we expect the JGB market to remain volatile from here. However, there is no significant change to our basic outlook that the 10-year JGB yield will stabilize in the mid- to high-2% range, assuming that appropriate fiscal and monetary policies are implemented. Meanwhile, there are growing risks for higher-than-expected 10-year JGB yield levels due to (1) inflation as a “global factor” and (2) an overlapping of “fiscal factors” Our Senior Economist Koji Hamada estimates the size of the supplementary budget at around Y4.0tn. This amounts to approximately 0.6% of Japan's nominal GDP. In addition to details from the government regarding the size of the supplementary budget and whether additional JGBs will be issued, we plan to pay close attention to any information released regarding the government's rationale.

³ Atif Mian, Ludwig Straub, and Amir Sufi (2025). [“A Goldilocks Theory of Fiscal Deficits.”](#) American Economic Review Vol115 (12).

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