Economics Focus

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Japan: a steep yield curve is not driven by fiscal concerns

- **There are six possible reasons why Japan's yield curve steepened earlier than expected. A short-term rate of 2%, a long-term rate of 3% and a super-long-term rate of 4% are considered to represent the shape of the yield curve once the Japanese economy has fully emerged from its structural stagnation. These six factors have caused the normalisation of the yield curve towards this shape to proceed faster than expected. The steepening of the yield curve is not driven by concerns about Japan's fiscal position.**

- **The BoJ's premature rate hikes are expected to slow real GDP growth in 2026 and 2027 to the 0% range, down from the 1% range in 2025. This is weighing on the government's ability to achieve its goal, as outlined in the Basic Policies for Economic and Fiscal Management and Reform (Honebuto), of "establishing and further raising real economic growth exceeding 1% and nominal growth exceeding 3% as early as possible, under the achievement of the 2% price stability target."**

- **Even if the BoJ raises rates, the yield curve would flatten, but long-term yields will not decline unless the economy deteriorates significantly. If the BoJ hikes in September and October, real GDP growth in 2027 would likely slow further to around +0.5%, in line with potential growth, from +0.8% in 2026. A slowdown in growth would put downward pressure on the yen. It should not be forgotten that even as the BoJ has continued its overeager rate hikes, yen depreciation and rising long-term rates have persisted.**

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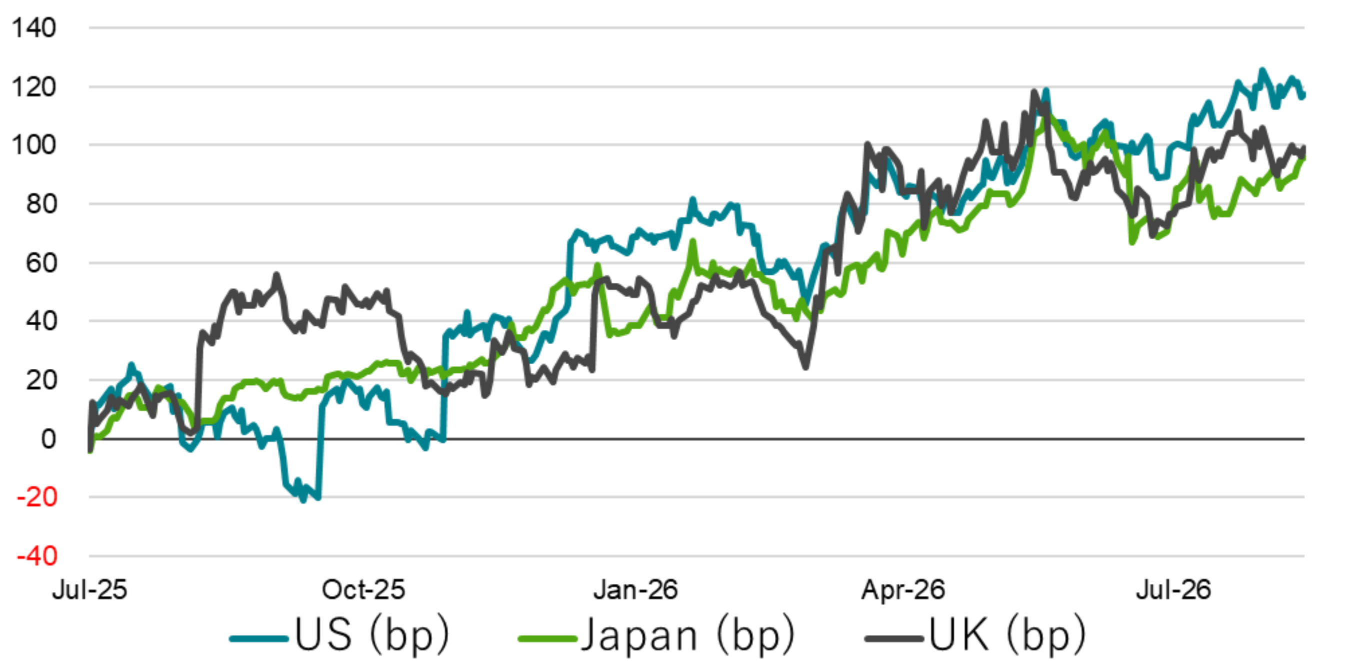
There are six possible reasons why Japan's yield curve steepened earlier than expected. A short-term rate of 2% range, a long-term rate of 3% range and a super-long-term rate of 4% range are considered to represent the shape of the yield curve once the Japanese economy has fully emerged from its structural stagnation. These six factors have caused the normalisation of the yield curve towards this shape to proceed faster than expected. The steepening of the yield curve is not driven by concerns about Japan's fiscal position. The spread between the 10-year JGB yield and the policy rate has moved similarly to those in the US and the UK, indicating that this is a global development.

The BoJ's premature rate hikes are expected to slow real GDP growth in 2026 and 2027 to the 0% range, down from the 1% range in 2025. This is weighing on the government's ability to achieve its goal, as outlined in the Basic Policy, of "establishing and further raising real economic growth exceeding 1% and nominal growth exceeding 3% as early as possible, under the achievement of the 2% price stability target." Even if the BoJ raises rates, the yield curve will flatten, but long-term yields will not decline unless the economy deteriorates significantly. If the BoJ hikes in September and October, real GDP growth in 2027 would likely slow further to around +0.5%, in line with potential growth, from +0.8% in 2026. A slowdown in growth would put downward pressure on the JPY. It should not be forgotten that even as the BoJ has continued its overeager rate hikes, JPY depreciation and rising long-term yields have persisted.

1. The emergence of a government pursuing proactive public finance has raised expectations that nominal GDP growth of 3% would be sustainable. Interest rates have risen first at the super-long end, which is less affected by the policy rate.

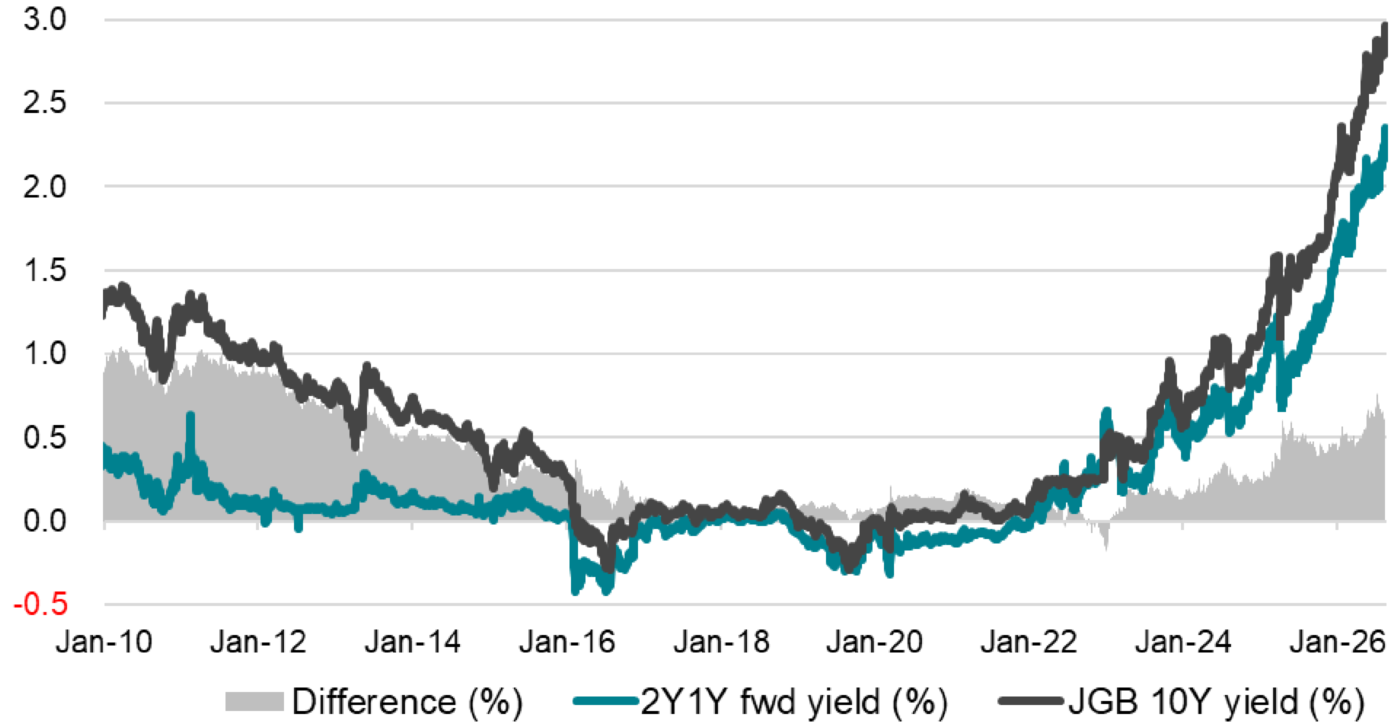
2. The global economic policy trend has shifted from insufficient investment caused by neoliberalism's emphasis on efficiency towards competition in strategic public-private investment and long-term investment is expanding. Fiscal deficits are large in the US and Europe, where investment is further ahead.
3. Because interest is paid on current account balances held at the BoJ, there is the adverse effect of discouraging investment in JGBs when interest rates are expected to rise during the BoJ's rate-hiking cycle. Rate hikes involving interest payments on current account balances steepen the yield curve more than rate hikes without such payments, creating a risk that their tightening effect would be stronger. They could also restrain long-term investment.
4. As the BoJ is reducing its JGB purchases, there are concerns that the supply of money to support growth could become insufficient relative to the increase in nominal GDP. The need to supply growth currency is thought to be the reason behind the BoJ's decision to halt its tapering.
5. The expansion of pension funds under the pay-as-you-go system indicates that the government is absorbing long-term funds that should otherwise be available to the private sector. As 50% of the long-term funds absorbed from the private sector are being allocated overseas, there are concerns that Japan could face a shortage of long-term funding as long-term investment is expected to expand.
6. The rise in long-term yields has been broadly in line with the increase in terminal rate expectations driven by the BoJ's overeager rate hike stance, and is not primarily driven by a widening of the term premium due to fiscal concerns. The term premium is returning to levels seen prior to the large-scale monetary easing of 2013.

Fig 1. Spread between 10Y government bond yield and CB policy rate (Jun 2025 = 0)



Source: Bloomberg, Crédit Agricole CIB

Fig 2. Market implication on BoJ terminal rate and JGB 10Y yield



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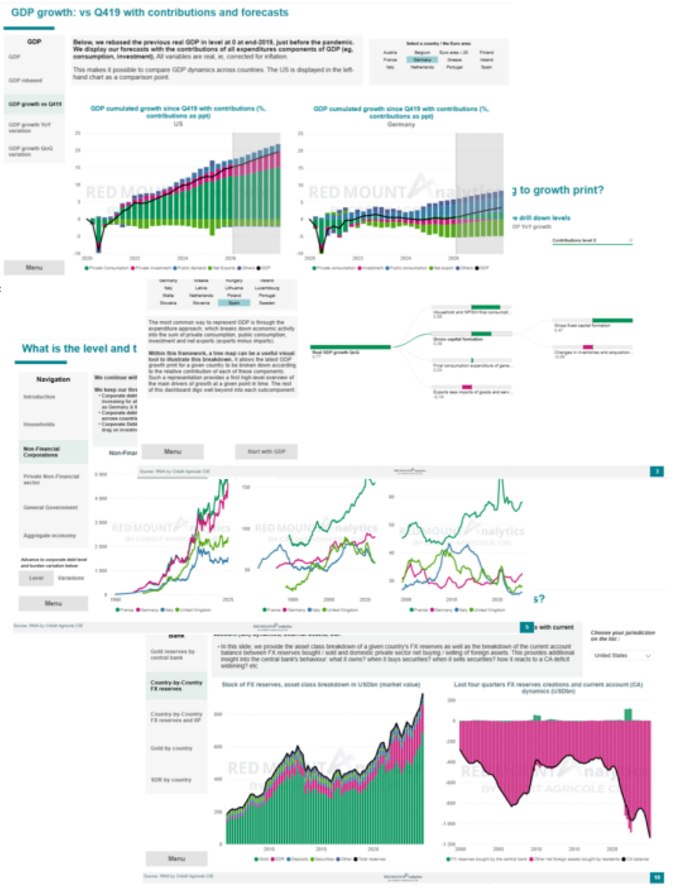

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