【Fixed Income Commentary - Japan Economic & Financial Weekly Special Issue】
Q&A report: Ask MUMSS!

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A1: Item-only requests are budget requests submitted by government ministries and agencies without specifying the required amount. Such requests are permitted for the "Strong and Prosperous Japan" investment framework in the FY27 budget formulation process, and are drawing attention. (Ikeda, Muguruma)

A2: On the Japan (JPY) side, in addition to the BoJ's balance sheet reduction, we think increased issuance of foreign-currency-denominated bonds by Japanese companies, and the associated need to convert the proceeds into yen, may also have had an impact. (Tsuruta)

A3: 2.5% (BoJ's upper-bound natural rate estimate of 0.5% plus 2% price target) should be near-term guide, but pricing could exceed 2.5% if inflation expectations rise. (Onizawa)

This report is compiled in a Q&A format, addressing timely topics of interest in the financial markets based on the insightful questions we have received from our clients. We hope you find it useful.

Q1: [Yen bonds] What are the "item-only requests" drawing attention in the FY27 budgeting process?

A1: Item-only requests are budget requests submitted by government ministries and agencies without specifying the required amount. Such requests are permitted for the "Strong and Prosperous Japan" investment framework in the FY27 budget formulation process, and are drawing attention.

Role of item-only requests in budgeting process

An item-only request specifies a program in a ministry or agency's budget request to the Ministry of Finance (MoF) for the following fiscal year without stating the amount required. Ministries have traditionally used it in cases where policy details are not yet settled and the government and ruling parties have still to reach agreement. The budget request guidelines cap requests (the ceiling), but an item-only request carries no figure at the request stage and so falls outside that ceiling. Item-only requests increased in the FY21 and FY22 budget requests, as ministries sought to secure funding for the COVID-19 response and for priority measures for the post-COVID era. That set a pattern which has continued from FY22: ministries file priority measures as item-only requests at the request stage, then book the amounts needed at the budgeting stage or in a supplementary budget (Table). In the FY26 budget requests, ministries filed free high school tuition and cost-of-living measures as item-only requests, along with programs under the medium-term plan for national resilience.

Why item-only requests matter in FY27 budgeting process

The FY27 budget is the first the Takaichi cabinet will draw up based on its own Basic Policy on Economic and Fiscal Management and Reform. Its budget request guidelines cover a "Strong and Prosperous Japan" investment quota for crisis-management and growth investment. For that quota the guidelines state explicitly that ministries should set no request ceiling and request the amounts required as appropriate, including through item-only requests. Ministries duly filed the crisis-management and growth investment items that carry no stated amount as item-only requests. The FY27 budget aims to merge the initial and supplementary budgets into one, so ministries appear to have included in item-only requests some items that they would previously have put in a supplementary budget. The ceiling has also been scrapped. Even so, if total requests far exceed the JPY138.1 trillion of spending in the Cabinet Office's end-July projections, this could trigger a "budget requests shock", driving the yen and bond prices lower. Ministries also appear to have used item-only requests partly to leave MoF some room to adjust. General account budget requests for FY27 total JPY143.1 trillion, above the JPY140.6 trillion combined total for the FY25 supplementary budget and FY26 initial budget. Ministries have already requested roughly as much as a typical year's initial and supplementary budgets combined, and the amounts behind the item-only requests will be filled in during the budgeting process. We will be watching how large the final budget ends up after MoF's adjustments.

Table: Provisions on item-only requests in the budget request guidelines

	Main provisions on item-only requests in the budget request guidelines
2021	For urgent expenditures, among them the COVID-19 response, ministries may submit the necessary requests separately.
2022	On COVID-19 measures, ministries are to make requests as appropriate depending on how infections develop, including item-only requests where necessary.
2023	For priority policies, among them COVID-19 measures and measures to combat high crude oil prices and inflation, ministries are to make requests and submissions as appropriate, including through the priority policy promotion quota and item-only requests, for consideration during the budgeting process. Spending on the new Medium-Term Defense Buildup Program, measures to tackle the declining birthrate and child policy, and investment in green transformation (GX) is to be considered during the budgeting process.
2024	For priority policies, among them measures to combat inflation, ministries are to make requests and submissions as appropriate, including through the priority policy promotion quota and item-only requests, for consideration during the budgeting process. The plan to accelerate support for children and child-rearing is to be considered during the budgeting process.
2025	For priority policies, among them measures to combat inflation and steps to create an environment that encourages wage increases, ministries are to make requests and submissions as appropriate, including through the priority policy promotion quota and item-only requests, for consideration during the budgeting process.
2026	For priority policies, including cost-of-living measures, ministries are to make requests and submissions as appropriate, including item-only requests where necessary, for consideration during the budgeting process. Free high school tuition, free school meals, and support for early childhood education and childcare are to be considered during the budgeting process.
2027	For priority policies, among them permanent measures that need to be funded in the initial budget so that fiscal management can break its reliance on supplementary budgets, ministries are to use the “Strong and Prosperous Japan” investment quota and, where necessary, make requests and submissions as appropriate including item-only requests, for consideration during the budgeting process.

Source: MUMSS, from MoF materials

Yutaro Ikeda
Naomi Muguruma

Q2: [Yen bonds] What factors have driven the USD/JPY cross-currency basis to become less negative?

A2: On the Japan (JPY) side, in addition to the BoJ's balance sheet reduction, we think increased issuance of foreign-currency-denominated bonds by Japanese companies, and the associated need to convert the proceeds into yen, may also have had an impact.

USD/JPY cross-currency basis widening since start of 2026

Since the start of this year, the USD/JPY cross-currency basis has been widening (becoming less negative) (Graph 1). The USD/JPY cross-currency basis is an indicator of USD funding costs for Japanese investors holding yen, and the JPY funding premium available to USD-based overseas investors. Its level can impact investor behavior. We therefore view it as one of the key indicators for assessing JGB supply/demand trends.

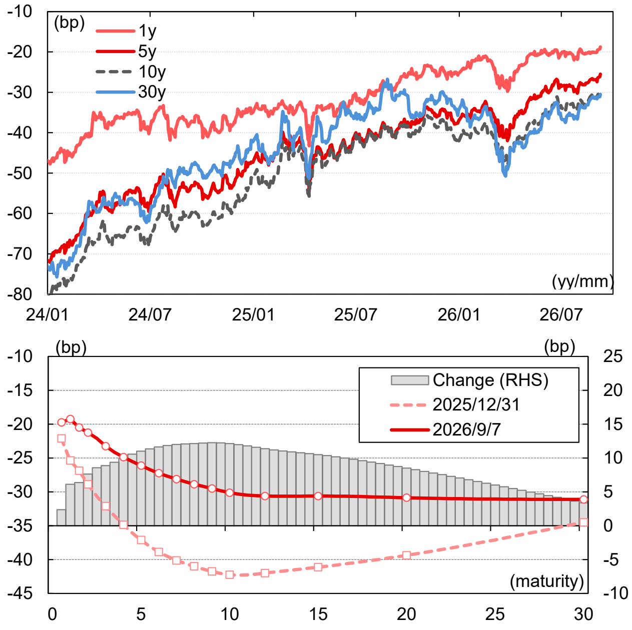
Domestic factors: BoJ's balance sheet reduction, increase in foreign-currency bond issuance by Japanese firms

The USD/JPY cross-currency basis measures the deviation from covered interest parity (CIP). It is generally considered to reflect imbalances in the supply and demand for funding within currency pairs.[1] Since no widening trend has been observed in the basis between the USD and other currencies (GBP, EUR, AUD, CAD), we believe that the widening of the USD/JPY basis is driven by factors specific to Japan (JPY). Specifically, this includes the BoJ's balance sheet reduction (decline in the supply of yen funding) resulting from the Bank cutting its JGB purchases. Furthermore, the increased issuance of foreign-currency-denominated corporate bonds by Japanese companies may also be a contributing factor. The value of foreign-currency corporate bond issuance by Japanese companies has been on a clear uptrend in recent years (Graph 2, upper chart), even allowing for the inclusion of refinancing issuance. This is likely due to growing demand to finance M&A deals and capital investment in overseas businesses. Companies are also issuing foreign-currency bonds in order to diversify funding methods. As a result, in many cases, a portion of the proceeds may be converted into yen.[2] Meanwhile, the increase in yen-denominated bonds issued by non-Japanese entities (Samurai bonds) has remained limited (Graph 2, lower chart). Consequently, the balance of cross-currency basis trades related to corporate bond issuances is "pay (yen procurement) > receive (foreign currency procurement)," which may be exerting widening pressure on the basis. By maturity, a relatively large share of foreign-currency-denominated corporate bonds issued by Japanese companies is concentrated in the medium/long-term zone. This seems consistent with the relatively large widening of the cross-currency basis in these sectors. USD supply/demand factors, such as US financial regulations and monetary policy, have attracted attention as the key drivers of the cross-currency basis. While this is unlikely to change going forward, we believe that Japanese companies' foreign-currency bond issuance will also increasingly come into focus as one factor impacting the USD/JPY basis.

[1] Some view that counterparty risks and market risks are priced into the cross-currency basis.

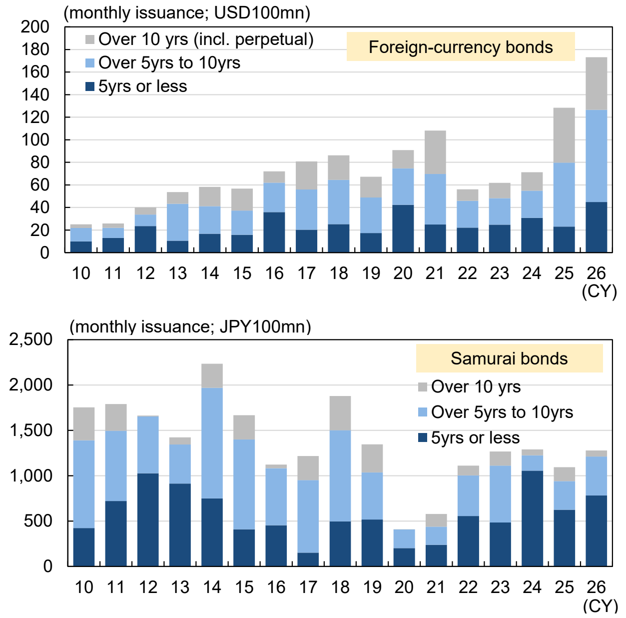
[2] For example, the Nikkei reported on July 25, 2026, that foreign-currency-denominated corporate bond issuance by Japanese companies reached JPY18 trillion in Jan-Jun 2026, a record high for a six-month period, with the issuer base wideining to include companies such as Terumo and Sony Group.

Graph 1: USD/JPY cross-currency basis (TONA vs. SOFR)



Source: MUMSS, from Bloomberg data

Graph 2: Average monthly corporate bond issuance



Note: 2026 data through end-August.
Source: MUMSS, from Bloomberg data

Keisuke Tsuruta

Q3: [Yen bonds] How high can market pricing of terminal rate go?

A3: 2.5% (BoJ's upper-bound natural rate estimate of 0.5% plus 2% price target) should be near-term guide, but pricing could exceed 2.5% if inflation expectations rise.

Terminal rate pricing has risen to around 2.4%

The 2y1y forward rate (the one-year rate two years forward) is a closely watched proxy for the terminal rate, the end point for the Bank of Japan's (BoJ) policy rate during this hiking cycle. It rose to around 2.5% at one point and is now around 2.4% (Graph 1). Pricing of the terminal rate has moved up since the Japan-US coordinated intervention in July, as the market has increasingly focused on the potential for the BoJ to hike at a faster pace.

2.5% likely near-term upper bound

The terminal rate should settle broadly close to the nominal neutral rate, on the assumption that the BoJ raises rates in a way that keeps inflation stable near its 2% target. The nominal neutral rate is roughly the level of rates that neither accelerates nor slows inflation. It is calculated as the natural rate of interest (the real neutral rate) plus expected inflation. The BoJ's estimate range for the natural rate is −0.9% to +0.5%, and setting expected inflation at the 2% target gives a neutral rate range of +1.1% to +2.5%. On that basis, the market is likely to treat +2.5% as the upper bound for now.

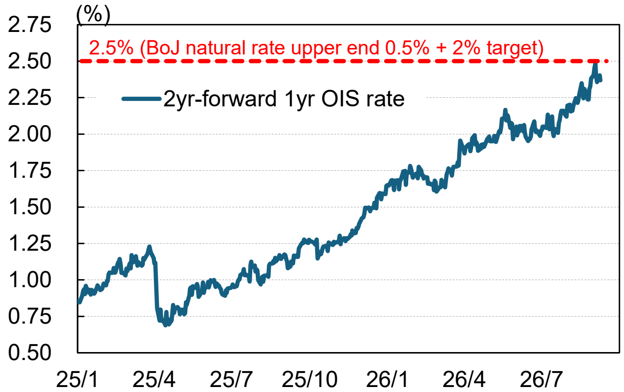
Terminal rate pricing could rise above 2.5% if inflation expectations overshoot 2%

We also consider cases in which terminal rate pricing could rise above 2.5%. The first is when the natural rate rises above the upper end of the BoJ's estimated range. The natural rate approximates the potential growth rate over the long run, under certain assumptions. Some scenarios in the Cabinet Office's Economic and Fiscal Projections for Medium to Long Term Analysis do envisage a higher potential growth rate. However, there is considerable uncertainty about whether government spending actually raises productivity, and judging that will likely take several years. The second case, in which inflation expectations overshoot the 2% price target, is the one we will be watching more closely. Our own composite measure of 10-year inflation expectations has risen to close to 2%. The August 2026 ESP Forecast Survey also shows that economists expect core CPI inflation to accelerate through 2H FY26. Their forecasts rise from 1.90% YoY in Jul–Sep 2026 to 2.50% in Oct–Dec, then 2.98% in Jan–Mar 2027. Inflation expectations are already near 2% and rising, and they could increase further to adapt to prevailing conditions if actual inflation remains above the 2% target. The BoJ might then need to raise rates above the nominal neutral rate to bring inflation back to the 2% target, as the Taylor rule implies,[1] taking policy into tightening territory. Terminal rate pricing could therefore rise above 2.5% if inflation expectations overshoot 2%.[2]

[1] The Taylor rule is a monetary policy rule that indicates the appropriate level of the policy rate in response to changes in economic variables such as inflation and the output gap.

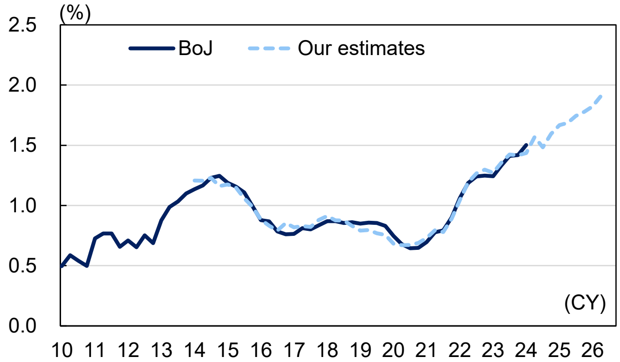
[2] It should be noted that if the terminal rate exceeds the nominal neutral rate, markets may subsequently price in rate cuts.

Graph 1: 2yr-forward 1yr rate



Source: MUMSS, from Bloomberg data

Graph 2: Composite inflation expectations (10-year)



Note: Latest data are as of June 2026.
Source: MUMSS, from QUICK Monthly Survey (Bonds), Osada and Nakazawa (2024), and BoJ data

Takuya Onizawa

Appendix A

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