

【Fixed Income Commentary - Japan Economic & Financial Weekly Special Issue】

Q&A report: Ask MUMSS!

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Q1: [Yen bonds] What are these “non-marketable government bonds” that have been gaining attention lately? 2

A1: This refers to government bonds that cannot be traded on the market. They can be broadly categorized into savings bonds for individuals and non-marketable government bonds for the public sector and other entities. A well-known example of the latter is the US, where two types are issued. (Muguruma)

Q2: [Yen bonds] What is current status of the Japan-US Strategic Investment Initiative? How will it impact the JGB market? 4

A2: It appears that US banks will join the lending effort. This is expected to ease the further widening pressure on the negative USD/JPY basis. At the same time, this serves as a factor that curbs investment in JGBs by overseas real-money investors. (Otsuka)

Q3: [Yen bonds] What is the impact of rising life insurance surrenders? 6

A3: Increased life insurance policy surrenders could reduce the funds available for investment and force the sale of bond holdings to fund surrender value payments. However, the increase in surrenders is due in part to customers switching to products with higher expected rates of return. Sales of single-premium whole life insurance also remain solid, suggesting that the impact of increased surrenders has been limited thus far. (Tsuruta)

Q4: [Yen bonds] How much will fiscal expenditures rise due to defense spending hike? 8

A4: A 3.5% GDP ratio could lead to an increase of over JPY10 trillion in fiscal spending. (Onizawa)

Q5: [Japanese economy] How will food consumption tax cut affect CPI and GDP? 10

A5: We estimate that if the tax cut is passed fully on to consumers, it could push down core CPI by 1.3ppt YoY. The downward impact, however, could be diluted by simultaneous hikes in pre-tax prices. The boost to real GDP growth in FY27 is likely to come to around 0.2ppt, buoyed by the stimulus effect on consumption and the rebound after a period of restrained spending. (Morimoto, Tonouchi)

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 these “non-marketable government bonds” that have been gaining attention lately?

A1: This refers to government bonds that cannot be traded on the market. They can be broadly categorized into savings bonds for individuals and non-marketable government bonds for the public sector and other entities. A well-known example of the latter is the US, where two types are issued.

Speculations that MoF is considering issuance of non-marketable JGBs

As the BoJ's share of JGB holdings continues to decline, the question of who will absorb these bonds in the future has become a point of debate. Amid this situation, on July 15 the *Finance Facsimile News* reported that the MoF was considering Issuing non-marketable JGBs, bringing to light the term “non-marketable government bonds,” which is not widely known in Japan. Non-marketable government bonds cannot be bought or sold on the market. These bonds currently outstanding in major countries, including Japan, can be broadly categorized into two types: savings bonds for individuals and non-marketable government bonds for public-sector entities and other institutions. In Japan, JGBs for retail investors are classified as non-marketable JGBs, while non-marketable JGBs intended for the public sector are currently not being issued.

In US, non-marketable Treasuries are utilized in government accounts

The US provides a good example of non-marketable government bonds issued for government agencies and other entities. In the US, non-marketable Treasuries are issued primarily for government accounts. The outstanding balance is as shown in Graph 1. From the perspective of how yields and prices are determined, non-marketable government bonds issued for government accounts can be classified into two types: par value special series and market-based special series.¹ As explained below, both series can be redeemed before maturity by the holder account. Par value special series refer to non-marketable government bonds, which are purchased and redeemed at par (100) and for which the coupon rate is determined in accordance with statutory formulas. In order to issue par value special bonds, the laws and regulations governing the management of a specific fund must explicitly state that such bonds are to be issued for that fund and must prescribe the formula for determining their coupon. Early redemption is permitted solely for the purpose of covering the payments of the specific fund. Market-based special series is a non-marketable government bond that reflects the yields and maturities of specific Treasury securities traded in the market. Market-based special bonds can be purchased or redeemed prior to maturity at a price determined by the US Treasury, based on the market price of the marketable securities to which they are linked.

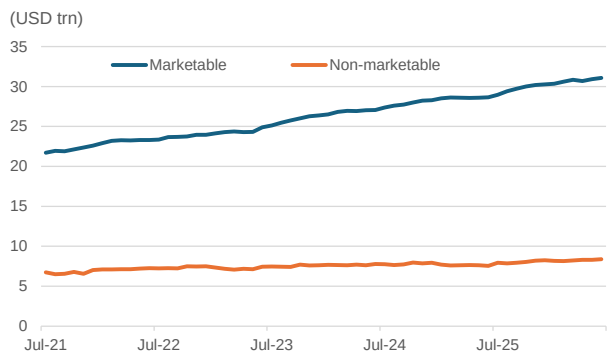
Advantages, disadvantages of non-marketable government bonds

In terms of the government's goal of ensuring the stable absorption of government bonds, we see two potential benefits to issuing US-style non-marketable government bonds. First, it would curb the issuance of marketable government bonds, possibly helping the improvement of supply/demand conditions. Second, we think that having the government sector invest in non-marketable government bonds will help prevent their trading activity from disrupting the bond market. There are also two potential drawbacks to consider. First, because the government can issue bonds without going through the market, there is a risk that fiscal discipline could be undermined. Second, a decline in the outstanding balance of non-marketable government bonds resulting from the holders reducing their holdings

¹ Reference: Sudo, Tokihiko. *New Developments in Government Debt Management Policy: A Comparison of Japan, US, and UK Systems*. Nippon Hyoronsha, August 2007. (Japanese only; title translated by MUMSS)

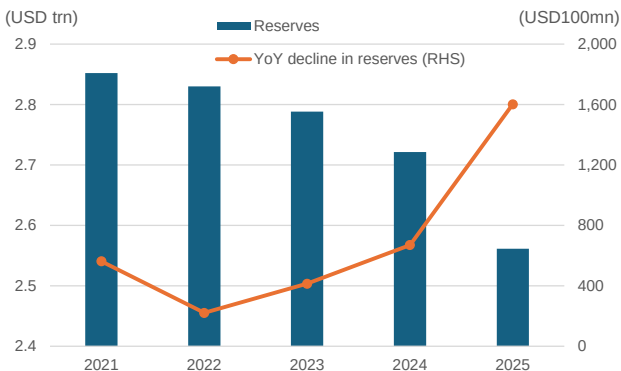
could lead to an increase in the issuance of marketable government bonds. In the US, the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund have in recent years been covering their shortfalls, where expenditures have exceeded premium revenue and other incomes, by drawing down the fund's reserves (Graph 2). Approximately USD160 billion was drawn down in 2025. We believe that the decline in the outstanding balance of non-marketable government bonds issued for these funds is creating pressure to issue more marketable government bonds.

Graph 1: Outstanding balance of US marketable and non-marketable Treasury securities



Note: Monthly data. Non-marketable securities include savings bonds.
Source: MUMSS, from US Department of the Treasury

Graph 2: Reserves of the Old-Age and Survivors, and the Disability Insurance Trust Funds



Note: Annual data based on calendar year.
Source: MUMSS, from US Social Security Administration data

Naomi Muguruma

Q2: [Yen bonds] What is current status of the Japan-US Strategic Investment Initiative? How will it impact the JGB market?

A2: It appears that US banks will join the lending effort. This is expected to ease the further widening pressure on the negative USD/JPY basis. At the same time, this serves as a factor that curbs investment in JGBs by overseas real-money investors.

Progress for the Japan-US Strategic Investment Initiative

In Q2 of our June 10 *Q&A report: Ask MUMSSI!*, we provided an overview of the financing for the USD550 billion Japan-US Strategic Investment Initiative. As shown in the Graph below, the methods for raising funds can be categorized into four types, from (A) through (D). Of these, the currency swap components in (B) and (C) are the ones that could have a direct impact on the USD/JPY basis market. Since yen is being used to acquire dollars, in theory, this should exert pressure to further widen the negative USD/JPY basis. As part of the first round of investments, the Japanese and US governments have announced three projects: natural gas power generation (approximately USD33.3 billion); infrastructure for the export of US-produced crude oil (approximately USD2.1 billion); the manufacturing of industrial synthetic diamonds (approximately USD600 million). The total amount comes to roughly USD36 billion (about JPY5.6 trillion). According to the *Nikkei*, this will be co-financed with the Japan Bank for International Cooperation (JBIC) and three mega banks, based on a loan ratio of one to two between JBIC and the three major banks combined. Also, as part of the second round of investment, projects totaling up to USD73 billion (approximately JPY11.5 trillion) have been announced, including the construction of small modular reactors as well as the construction of natural gas power plants in two states.

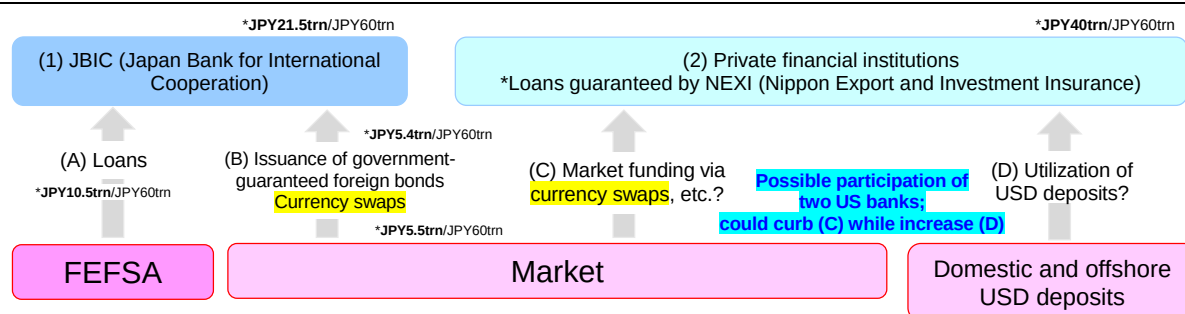
Two US banks expected to participate in financing

Amid these developments, the *Nikkei* reported on July 25 that two US banks will participate in providing financing for investments in the US. According to the article, the two banks will serve as the primary lenders for the projects in the second round investments, and, together with JBIC, will initially provide a total of approximately JPY500 billion in financing for the natural gas power plants. The article also noted that the two banks will each contribute one-third, and that Japanese banks will not participate in the financing.

Pressure to widen negative spreads on USD/JPY basis likely to ease, but . . .

The participation of US banks in the loan eliminates the need for Japan banks to raise dollars (blue text in Graph). The degree to which US banks will provide funding remains unclear, including for future projects, but their participation is likely to mitigate, to some extent, the widening pressure on the negative USD/JPY basis going forward. At the same time, this could have the effect of reducing the additional yield earned by dollar-based investors when swapping JGBs into dollars, potentially discouraging JGB investments, especially by overseas real money investors.

Graph: Overview of methods for funding the USD550bn US-Japan strategic investment initiative



- Of the approx. JPY80trn total, around JPY60trn disclosed in Joint Fact Sheet for Japan-US Investment (Oct 28, 2025)
 - ... Approximate breakdown, JBIC : NEXI = 1 : 2
 - ... (1) JBIC project size: JPY21.5trn (FY2025 supplementary budget, additional JPY7.15trn; FY2026 budget, additional JPY14.35trn)
 - ... (2) NEXI portion: Approx. JPY40trn
- JBIC's USD funding for US investment to be sourced roughly half from borrowings from the Foreign Exchange Fund Special Account (FEFSA), and half from government-guaranteed foreign bond issuance and currency swaps. Based on currently available Ministry of Finance materials, the amounts are estimated as below.
 - ... (A) Borrowings from FEFSA, etc.: JPY10.5trn (total of additional amounts in FY25 supplementary budget and FY26 budget, same below)
 - ... (B) Government-guaranteed foreign bond issuance: JPY5.4trn
 - ... (B) Currency swaps: JPY5.5trn

Note: Based on explanatory materials by the Japan Bank for International Cooperation presented at the Fiscal System Council (FILP Subcommittee, December 5, 2025). Amounts indicated in yen taken from the same materials, thus do not match the amounts calculated using the prevailing exchange rate.

Source: MUMSS, from MoF materials

Takahiro Otsuka

Q3: [Yen bonds] What is the impact of rising life insurance surrenders?

A3: Increased life insurance policy surrenders could reduce the funds available for investment and force the sale of bond holdings to fund surrender value payments. However, the increase in surrenders is due in part to customers switching to products with higher expected rates of return. Sales of single-premium whole life insurance also remain solid, suggesting that the impact of increased surrenders has been limited thus far.

Life insurers' surrender value payments are trending higher

The surrender value paid by life insurers to policyholders upon policy termination has recently been rising. From January to May, surrender value payments by the 41 members of the Life Insurance Association of Japan totaled JPY6,019.0 billion (Graph). On a semiannual basis, this figure is likely to be the largest since 2013. One contributing factor is growing household appetite for investment amid increased adoption of the new NISA tax-advantaged investment account, which has prompted a shift of funds into equities and investment trusts in pursuit of higher returns. If policy surrenders continue to increase, life insurers could find themselves with fewer funds to invest and may be forced to sell bond holdings to fund surrender value payments.¹ They may also decide to build up short-term liquidity in preparation for further increases in surrenders or take greater risks in their investment operations to enhance the competitiveness of their insurance products.² These developments could have an impact on the bond market.

Effect of increased surrenders on investment activity appears limited for now

However, the factors cited above are not the only reasons for the increase in surrenders. The falling yen and rising interest rates also appear to have played a significant role. A weak yen tends to lead to early redemptions of foreign currency-denominated savings-type products, and there are also more customers who surrender such policies and convert them into yen. With respect to interest rates, more policyholders are switching to products offering higher expected rates of return. It is therefore important to take into account sales trends as well as surrenders (Graph). Sales of yen-denominated savings-type policies, including single-premium whole life insurance, have reportedly been solid, indicating that insurers are also capturing new demand. As a result, the total volume of policies in force does not appear to have declined.

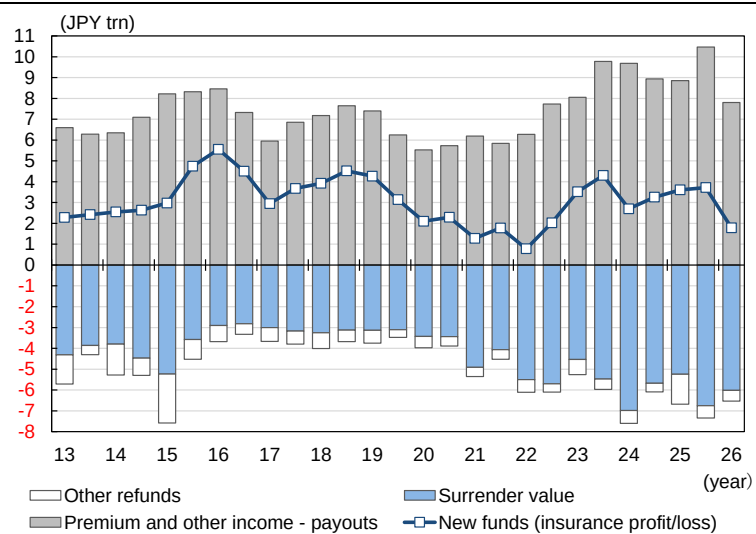
Insurance policy trends warrant continued attention

We think it will be important to keep an eye on the insurance environment given the ongoing changes in household asset-allocation behavior. A shrinking and aging population and falling birth rate mean the structural constraints on demand for protection-type products (particularly death-benefit policies) remain in effect. In our view, it is therefore essential to monitor insurance policy trends when assessing the outlook for life insurers' investment activity.

¹ To address the risk of capital impairment due to bond sales prompted by policy surrenders, insurers are selling more products with a market value adjustment (MVA) feature. The surrender value of such policies fluctuates in line with the level of interest rates at the time of surrender, effectively transferring a portion of the interest rate risk to policyholders.

² In recent years, investments in and acquisitions of asset management companies have become more common, as have reinsurance transactions with insurers specializing in private asset management (asset-intensive reinsurance).

Graph: Surrender value payments at life insurers (semiannual basis)



Note: Actual payments through May for 1H FY26.

Source: MUMSS, from the Life Insurance Association of Japan

Keisuke Tsuruta

Q4: [Yen bonds] How much will fiscal expenditures rise due to defense spending hike?

A4: A 3.5% GDP ratio could lead to an increase of over JPY10 trillion in fiscal spending.

Three Strategic Documents revision could spur higher defense spending

The Takaichi administration has expressed its intention to revise the nation's three key national security documents by the end of this year. Japan's Three Strategic Documents consist of the National Security Strategy, National Defense Strategy, and Defense Buildup Program. The last of those outlines the direction of defense capability development and budgeting over the following five years. The current plan, approved by the Cabinet in December 2022, allocated a total of JPY43 trillion for defense expenditures over the five-year period from FY23-27. It assumes that the combined total of expenses covered by the Defense Buildup Program and supplementary costs would be roughly JPY11 trillion, equivalent to 2% of Japan's projected nominal GDP of JPY560 trillion for FY22. However, the timeline for achieving a ratio of 2% versus nominal GDP was moved forward due to additional defense spending included in the FY25 supplementary budget.

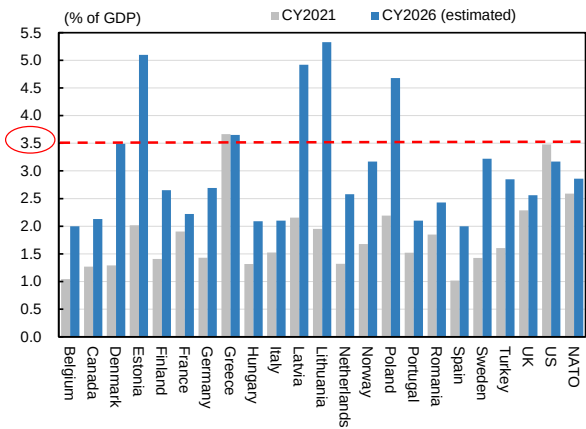
Defense spending could be raised to 3.5% of nominal GDP

An agreement was reached at the NATO summit meeting in June 2025 to boost defense spending to 3.5% of nominal GDP (or 5% including military-related infrastructure development costs) by 2035. This move follows the US administration's call on allied nations, including Japan, to increase their defense spending. Given that Japan has accelerated its schedule for achieving its 2% nominal GDP target, it may also advance its next Defense Buildup Plan by one year from the original FY28 start date. Under that scenario, a new plan commencing in FY27 could aim at a further increase in defense spending toward the 3.5% nominal GDP goal.

3.5% nominal GDP defense spending implies JPY13trn increase (JPY2-3trn per year) from present level

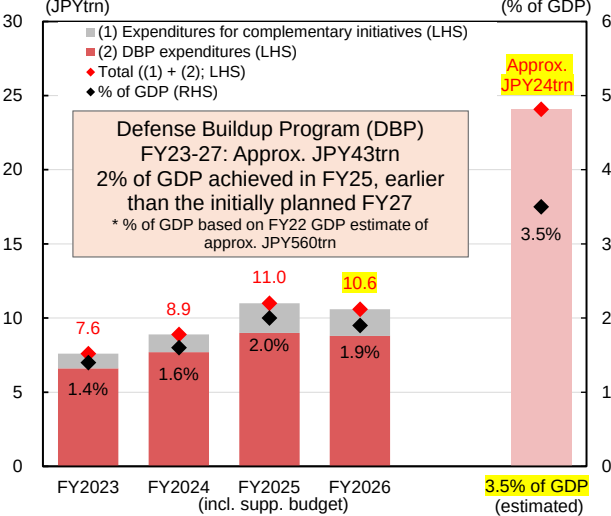
As such, the magnitude of the defense spending increase in the new plan could be driven higher not only by raising the target ratio from 2% to 3.5% of nominal GDP but also by an expansion in the nominal GDP figure used as the baseline for the calculation. For instance, if the reference nominal GDP is changed from the JPY560 trillion projected for FY22 (the basis for the current plan) to the approximately JPY690 trillion forecast for FY26, defense spending would grow by nearly JPY3 trillion even if the target ratio remains 2%. Factoring in these elements, we find that defense spending equivalent to 3.5% of projected FY26 nominal GDP would amount to some JPY24 trillion, an increase of about JPY13 trillion compared to the JPY11 trillion required to reach the 2% target (Graph 2). If this increase were spread evenly over five years, defense spending would rise by JPY2-3 trillion per year. Furthermore, when accounting for growth strategy investments and a consumption tax cut, total fiscal expenditures could require additional annual costs of well over JPY10 trillion. Consequently, concerns over fiscal expansion could continue to simmer in the markets for the foreseeable future.

Graph 1: Defense spending by NATO member countries (as % of GDP)



Note: Shows selected member countries only.
Source: MUMSS, from NATO data

Graph 2: Japan's defense spending (assuming 3.5% of GDP)



Note: Amount for 3.5% of GDP calculated using nominal GDP for FY26 (outlook based on ESP Forecast survey)
Source: MUMSS, from Ministry of Defense, Cabinet Office, and Japan Center for Economic Research data

Takuya Onizawa

Q5: [Japanese economy] How will food consumption tax cut affect CPI and GDP?

A5: We estimate that if the tax cut is passed fully on to consumers, it could push down core CPI by 1.3ppt YoY. The downward impact, however, could be diluted by simultaneous hikes in pre-tax prices. The boost to real GDP growth in FY27 is likely to come to around 0.2ppt, buoyed by the stimulus effect on consumption and the rebound after a period of restrained spending.

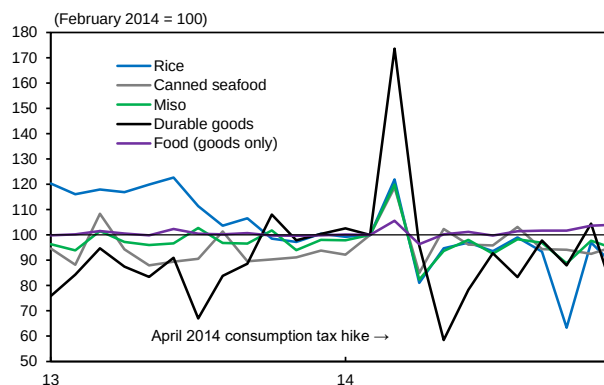
The Cabinet gave its approval on August 5 to a reduction in the consumption tax on food items to 1% starting next April. In our February report, we estimated the effect on CPI and GDP of an outright elimination of the consumption tax on food for two years. We are now updating those estimates to reflect the revision of the tax rate from 0% to 1% and the shift to a new CPI base year.

We estimate (using 2025 base-year weightings and resetting the index to 2025 = 100) that if the cut in the tax rate from 8% to 1% is passed fully on to consumers, the resulting drop in CPI food prices excluding fresh foods and eating out would push down core CPI YoY inflation (inclusive of tax) by 1.3ppt. In reality, however, we anticipate companies to hike prices at the same time, meaning that the tax cut will only be passed partially on to consumers. If we assume a pass-through rate of 80%, consistent with the case of the VAT reduction in Germany in 2020 (February report, Table 1), the impact on core CPI YoY inflation would come to around -1.0ppt.

We analyze the impact of private consumption on GDP through (a) the increase in household income and (b) intertemporal substitution (in this case, pre-tax-cut spending restraint and subsequent rebound). Regarding (a) household income, the marginal propensity to consume for one-off tax cuts or cash payouts in Japan is estimated at 10-20% (February report, Table 2). A mechanical estimate of the proposed tax reduction of JPY4.4 trillion per year suggests a boost to real GDP growth of around 0.1ppt. As for (b) intertemporal substitution, data from the internal affairs ministry's Family Income and Expenditure Survey indicate that rush spending prior to past consumption tax hikes and the subsequent backlash were concentrated primarily in durable goods, but similar patterns were discerned to some extent in food products, particularly those with a long shelf life like canned goods and rice (Graph 1). A Cabinet Office study in 2015 shows that rush spending and the resulting backlash in connection with the permanent (i.e., not one-off) consumption tax hike from 5% to 8% in 2014 each amounted to JPY500 billion in real terms. In the case of a permanent tax cut on food products from 8% to 1%, we estimate the deferred spending and subsequent reactive upswing using a simplified calculation for each of JPY500 billion in real terms $\times \{ \text{change in tax rate } (1.08/1.01) / (1.08/1.05) \} \times \{ \text{food (excluding eating out) as share of nondurable goods } (2,754 - 508) / 3,740 \text{ based on CPI weightings} \}$. The result comes to roughly 0.05% of real GDP. The deferred purchasing at end-FY26 and reactionary increase at the start of FY27 would both serve to lift real GDP growth in FY27, so the combined effect would be just over 0.1ppt. However, as the measure this time is for a limited term of two years, the scale of the deferred purchasing and reactive backlash would be smaller. As such, we assume an impact of just under 0.1ppt. We believe that (a) and (b) together would lift real GDP growth by around 0.2ppt in FY27.

The proposed tax cut has raised alarm within the ruling party over a deterioration in public finances. It is possible that the government will turn to spending cuts or increases in other taxes to secure sufficient revenues, which could leave no growth at all in nominal disposable income. We should also be aware that higher prices driven by the weak yen could discourage real consumption.

Graph 1: Rush spending and backlash at the time of 2014 consumption tax hike



Source: MUMSS, from MUMSS, from Ministry of Internal Affairs and Communications data

Daiki Morimoto
Shuji Tonouchi

Appendix A

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