

Bond vigilantes strike in Japan

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The Japan 10-year government bond yield's recent surge to 3% compels Prime Minister Takaichi to face a harsh policy reality.

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For years, Sanae Takaichi was the foremost advocate of reflationary policies in Japan. Her economic blueprint relied on keeping interest rates low, injecting fiscal stimulus into the veins of the economy and downplayed monetary tightening. Yet, faced with the cold arithmetic of modern global markets – which recently sent Japan's 10-year government bond yield to a three-decade high of 3% – even the Takaichi administration is suddenly caught between domestic policy ambitions and unforgiving market realities. After all, for a nation saddled with a mountain of public debt, a 3% yield isn't just a statistical milestone; it is a fiscal emergency.

When a grand vision meets fiscal gravity

Japanese Prime Minister Takaichi's ambitious economic agenda relied on a delicate balancing act. She hoped to slash Japan's food consumption tax from 8% to 1% while simultaneously maintaining aggressive fiscal spending. However, bond investors refused to play along. Concerned by the prospect of unconstrained fiscal expansion paired with policy-suppressed rates, market sentiment shifted. Borrowing costs soared, leaving the Takaichi administration with a grim choice between stabilising the bond market by allowing policy rates to rise and watching the nation's fiscal credibility disintegrate.

Compounding this pressure is the persistent strain of a weaker Japanese yen. While a weak currency once boosted Japanese exporters' profits, its prolonged undervaluation now functions as a domestic tax on consumers. Moreover, imported inflation has driven up the cost of energy and everyday groceries, making Takaichi's monetary stance increasingly difficult to sustain politically.

Beyond domestic shores, international tolerance for Tokyo's hyper-easy monetary stance has seemingly evaporated. US Treasury Secretary Bessent's explicit calls for "decisive" monetary action from Tokyo signal that Washington would no longer tolerate a weak yen undercutting global trade dynamics. Relenting on interest rates has thus become the diplomatic price of admission for coordinated currency interventions.

Letting the Bank of Japan (BoJ) take the lead

With the writing clearly on the wall, Prime Minister Takaichi's team is giving the BoJ greater room to lead monetary tightening. By emphasising that monetary policy "should be left to the BoJ," the Takaichi administration is carefully managing the fallout from its aggressive fiscal spending plans. Takaichi's advisers have mapped out a strategic window this September to clear a rate hike to 1.25%, deliberately timed before an extraordinary session of parliament in October. It is a sharp, clever manoeuvre – allowing the central bank to manage higher borrowing costs today while ensuring parliament remains clear to pass her popular food tax cuts tomorrow.

The recent surge in Japanese government bond yields is prompting a pragmatic reassessment of

Takaichi's long-standing policy approach. Bill Clinton's former political adviser James Carville once famously said that if there was reincarnation, he "would like to come back as the bond market. You can intimidate everybody." With bond-market pressures now shaping the policy debate, Takaichi's quiet capitulation on BoJ interest rate hikes marks a defining moment, steering Japan into a post-zero-rate world with far-reaching implications for global fixed-income strategies. Against this backdrop, we expect a quarterly pace of further BoJ rate hikes well into next year to tame domestically driven inflation – a trajectory that should strengthen the yen.

Source: <https://www.sc.com/en/news/wealth-retail-banking/bond-vigilantes-strike-in-japan/>