

## Turbulence in the Japanese financial markets

Even after the parliamentary election, fears of overly loose fiscal policy remain a key factor behind the elevated levels of Japanese government bond yields. Increased volatility may persist.

### IN A NUTSHELL



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- Concerns about an overly expansionary fiscal policy by Prime Minister Sanae Takaichi's government have driven yields on long-dated Japanese government bonds sharply higher in the run-up to the parliamentary elections.
- Although the market has since calmed somewhat, we expect increased volatility in JGBs and the yen even after Takaichi's convincing election victory.
- Japan's financial market is not facing any acute stability issues, but it is no longer the steady anchor it was considered to be for many years.

### Following Sanae Takaichi's clear election victory, fiscal concerns remain a major source of uncertainty

We see the recent turbulence in the Japanese financial market as a watershed moment – one that may have repercussions that extend far beyond the short-term market reaction. The volatility was triggered by a potent combination of political timing, fiscal rhetoric and structural shifts in the market for Japanese government bonds (JGBs). Since Prime Minister Sanae Takaichi took office in October 2025, investors have gradually begun to price in a (significantly) more expansionary fiscal policy. This reassessment accelerated abruptly when Takaichi unexpectedly called a snap election for February 8, 2026, in mid-January, while simultaneously signaling tax relief – in particular a two-year suspension of the 8% value-added tax on food. After Takaichi's clear election victory, which secured a two-thirds majority for her Liberal Democratic Party in parliament<sup>1</sup>, the implementation of the plans has become significantly more likely – although the associated uncertainty remains. In a country with the highest public-debt ratio among developed economies, this combination was enough to sharply heighten markets' sensitivity to fiscal risks. In our view, however, while the recent events should certainly be taken seriously, they are unlikely to constitute an acute systemic threat, fiscally or for the Japanese banking system.

## 1 / Ambitious fiscal plans raise concerns

At the center of the current fiscal debate in Japan stands Prime Minister Sanae Takaichi's proposal to fully suspend the 8% consumption tax on food for a period of two years. This measure was announced alongside the decision to call early elections for February 8, 2026.<sup>2</sup> Following Takaichi's decisive election win, the implementation of the plans is now considerably more likely. According to the government, the tax suspension is intended to ease the burden on households facing higher living costs. It would apply to all food items currently subject to the reduced value added tax rate and would cost the government

<sup>1</sup> Reuters, Japan's 'Iron Lady' Takaichi forges historic election win as of 2/8/26

<sup>2</sup> CNBC.com, Japan's snap election and tax pledge keep the nation's finances in the spotlight as of 1/19/26

around 5 trillion Japanese yen (JPY) (which is approximately 32.5 billion U.S. dollars) in revenue per year, creating a substantial funding gap.

In parallel to the planned tax suspension, the government had already adopted a large stimulus package worth approximately JPY 21.3 trillion in November 2025<sup>3</sup>, which includes energy subsidies and household relief measures. Taken together, the combination of foregone tax revenue and additional fiscal expansion would place considerable strain on public finances – and Japan’s public debt ratio already exceeds 230 percent of gross domestic product (GDP). The market disruption, with Japanese ultralong government bond yields spiking, reflected the fact that the question of how the measures would be financed was left entirely unresolved. But Takaichi repeatedly stressed that the proposed tax suspension would not result in additional government borrowing. The prime minister further indicated that existing subsidies and budget items would be reviewed and that structural savings would be made to offset the revenue loss. Again, however, no specific funding sources were identified, and there is no detailed fiscal projection so far showing how the forecast budget shortfalls would be covered.

It is noteworthy that Japan’s opposition parties are largely moving in the same direction as the prime minister, calling for a reduction of the tax on food.<sup>4</sup> A newly formed opposition bloc is even advocating for a permanent abolition of the food tax and has proposed the creation of a new sovereign investment fund that could generate ongoing income to finance future tax relief.<sup>5</sup> However, since the opposition parties failed to make gains in last weekend’s election, the issue of a permanent tax suspension appears to be off the table for now. Nevertheless, the tax question is no longer merely part of the government’s agenda – it has effectively become a cross-party issue. Takaichi announced that she would raise the matter with the opposition parties as soon as possible.

Despite the expected fiscal strain, government officials emphasize that Japan – due to its large domestic savings pool, stable current-account surpluses and the continued dominance of domestic holders of JGBs – should be able to absorb the financial challenges, at least in the short term. But these structural factors, though they might prevent an immediate liquidity crisis from developing, were not sufficient to prevent a substantial repricing along the JGB curve.

## 2 / Japanese government bonds: Repricing at the (ultra-)long end of the JGB curve

### 2.1 Record-level yield surge

The immediate stress erupted end of January in the segment of long- and ultra-long-dated Japanese government bonds. Within days, yields on 30- and 40-year JGBs surged to record levels, with the 40-year yield temporarily breaking above the 4% threshold.<sup>6</sup> At times it appeared as though a self-fulfilling dynamic was taking hold, pushing yields ever higher. A weak auction of 20-year JGBs at the same time acted as an additional catalyst and exposed what had already been developing beneath the surface: a structural demand gap at the long end of the curve. Although the market calmed down again after a few chaotic trading sessions, yields remain elevated, reflecting investor worries. Takaichi’s decisive election victory over the weekend has indeed brought political clarity, but it has not dispelled investors’ fiscal policy concerns. Moreover, the attractiveness of the ultra-long segment of the Japanese yield curve – which some had already begun to promote again due to the higher yield levels – does not yet appear to have convinced the majority of market participants.

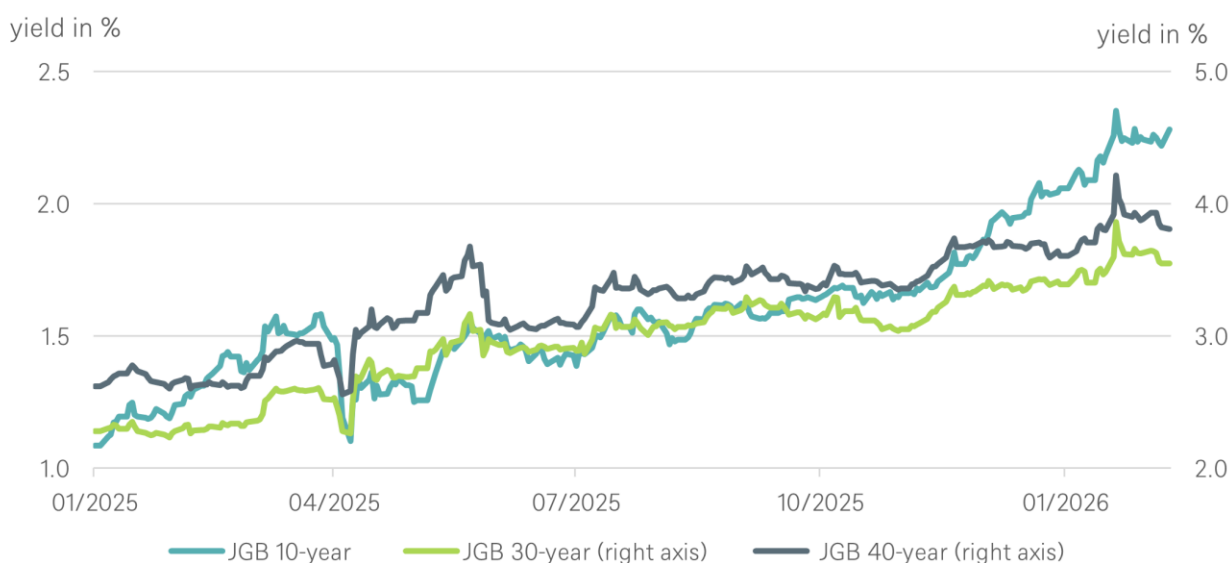
<sup>3</sup> Reuters, Japan’s stimulus to be worth \$135 billion, largest since pandemic, draft shows as of 11/20/25

<sup>4</sup> The Mainichi, Tax cut pledges in Japan’s election put fiscal sustainability in doubt as of 1/31/26

<sup>5</sup> MarketScreener, Japan can permanently abolish sales tax on food, opposition party official says as of 1/18/26

<sup>6</sup> All financial data – unless otherwise stated – from Bloomberg Finance L.P. as of 2/2/26

Chart 1: Yield surge – concentrated in the ultra-long segment of the JGB curve (in %)



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 2/9/26

#### Holder structure with significant influence on the market stability of JGBs

In our view, understanding which investor groups hold which shares of JGBs (see chart 2) is not only important for analyzing this market segment, but also essential to making a good assessment of the recent development. The strong dominance of domestic investors among JGB holders plays a key role in the long-term stability of the market – less than 7% of all Japanese government bonds are held by foreigners. This limits external capital outflows or international contagion effects even in periods of stress, and market dynamics are shaped predominantly by domestic, structurally stable investors.

Furthermore, the Bank of Japan holds around half of all outstanding JGBs<sup>7</sup>, which acts as a substantial buffer against market turbulence. Since a significant portion of the debt stock is therefore effectively not freely traded, both refinancing/rollover risks and the likelihood of self-reinforcing sell-offs are reduced. In addition, the BoJ can manage its holdings in a way that helps to dampen sudden yield spikes.

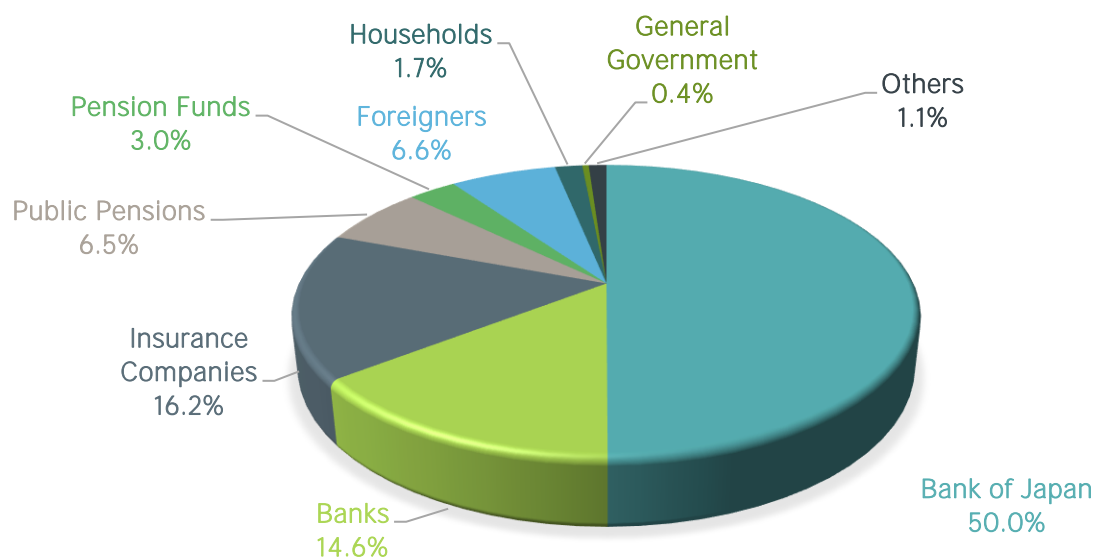
Insurers and pension funds – traditionally major buyers of long-dated maturities – hold their JGB portfolios primarily for balance-sheet and duration-matching reasons and tend to act less procyclically than international funds. Although they have recently scaled back their presence at the long end due to declining duration requirements (see section 2.2), they remain important and comparatively stable market participants whose behavior tends to smooth out volatility rather than amplify it.

Banks, especially major and regional banks, concentrate their holdings in short-dated JGBs, which tend to carry minimal price risk when long-term yields rise. This structure limits potential valuation losses and helps ensure that the interest-rate shocks simulated in the most recent stress tests keep capital ratios across all banking groups comfortably within regulatory thresholds.

Although foreign investors hold only a small share of JGBs, their importance in trading volume has increased, driven in particular by the activity of hedge funds. Through leveraged positions, these investors contribute to higher short-term volatility, but due to their small overall holdings they are unlikely to trigger structural instability. The risk is therefore more tactical in nature: volatile market episodes can be amplified, but do not readily evolve into a systemic crisis.

<sup>7</sup> Bank of Japan as of 12/17/25

Chart 2: Ownership structure in the JGB market – foreign investors play only a minor role



Sources: Bank of Japan, DWS Investment GmbH as of 12/17/25

## 2.2 “Duration gap” has been weighing on the JGB market for some time

One factor that may have helped fuel the recent sell off – but was not genuinely new at the time yields surged – is the issue of the “duration gap.” Traditionally, Japanese life insurers are the natural buyers of ultra-long-dated (i.e. 40-year) JGBs. Yet this very investor group has sharply reduced its demand since 2024 and has recently even turned into a net seller at times. The reason lies less in tactical considerations than in balance-sheet mechanics. As yields rise, the negative duration gap between the asset and liability sides of insurers’ balance sheets narrows. The higher the yield level, the lower the pressure to add duration through long-maturity bonds. This effect can become self-reinforcing: rising yields reduce hedging needs, which in turn dampens demand and facilitates further increases in yields.

The Japanese Ministry of Finance has responded to these tensions by noticeably reducing issuance of ultra-long-dated bonds. However, these supply adjustments have so far not been sufficient to fully offset the structural decline in demand from insurers. Added to this is an increased risk and term premium. In an environment in which Japan’s inflation and interest-rate path is, for the first time in decades, no longer firmly to the downside, investors are demanding greater compensation for uncertainty – particularly at very long maturities.

The recent easing of market pressures should therefore, in our view, be interpreted less as an all-clear and more as a temporary stabilization. Communication from the Bank of Japan – signaling a gradual tightening path but no abrupt monetary-policy pivot – as well as technical factors such as position adjustments, have helped provide this stability. But the underlying forces that drove the rise in yields have not disappeared.

## 3 / Yen: Stabilization or trend reversal?

### 3.1 Intervention fears halt the yen's depreciation – at least temporarily

The turmoil in the JGB market was also reflected in the foreign-exchange market, although the movements were initially far less dramatic. The yen traded with elevated volatility but initially remained within a comparatively narrow range. On 23 January, however, USD/JPY suddenly dropped – meaning the yen strengthened sharply – as speculation intensified that Japan might intervene to stem the currency's decline. According to reports, U.S. involvement in the intervention was also being considered. The Japanese currency appreciated markedly, including after reports circulated about potential “rate checks” by both countries, in which the positioning of key market participants is surveyed.

These expectations were abruptly dampened a few days later when U.S. Treasury Secretary Scott Bessent stated that the United States would “absolutely not” intervene in the dollar/yen exchange rate<sup>8</sup>, triggering a modest fall back for the yen. Japan's Ministry of Finance also confirmed on 30 January that no interventions had taken place between 29 December and 28 January to support the weakening currency. Nevertheless, Japanese officials appear to have succeeded – through skillful communication strategies that leaned heavily on a “U.S. deterrence factor” – in giving the yen some short-term breathing space without having to intervene directly in the market. Following the parliamentary elections, the Japanese currency has shown a slight renewed strengthening, although the move can still be described as moderate.

Beyond the continuing possibility of government intervention in the market, another stabilizing factor is that many institutional investors are reviewing their positioning ahead of the new Japanese fiscal year starting in April. Given the now attractive JGB yield levels, it is increasingly plausible that Japanese insurers and pension funds might reallocate part of their foreign bond portfolios into domestic government bonds. This would tend to provide additional support for the yen.

Chart 3: The yen appears to have ended its nearly 9-month phase of weakness against the dollar, at least for now



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 2/9/26

In our view, the yen is likely to appreciate slightly in the short term, supported by continued fears of potential government intervention and by current market positioning. The Bank of Japan's recently published inflation expectations also point to the possibility of further policy-rate increases in the coming months, which should likewise be supportive for the yen.

Over the medium term, however, neither the government nor Japanese corporates have a strong interest in a materially stronger yen. There are believed to have been around 40 million foreign visitors to Japan in 2025, providing a boost to tourism

<sup>8</sup> CNBC.com, U.S. dollar rebounds after Bessent shuts down report of potential yen intervention as of 1/28/26

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and the domestic economy as a whole. Meanwhile, Japanese corporates, for their part, are, according to the latest Tankan survey, expecting some appreciation of the yen. They are basing their calculations for the coming year on an exchange rate of roughly 146 yen per dollar.<sup>9</sup>

In our view, even that would leave the yen cheap. We do not expect the yen to return to what we would consider a fundamentally fair level in the 130s against the dollar.

## 4 / The question of debt sustainability: Market stress versus economic reality

The central question arising from the recent turbulence concerns Japan's debt sustainability. At first glance, yields of around 3.5% for 30-year and just under 4% for 40-year government bonds appear alarming, particularly with a debt-to-GDP ratio of around 237%. However, what matters is not only the current market level of individual maturities, but the interplay between nominal growth and the effective average interest rate on the entire stock of government debt.

Japan's government interest burden adjusts only slowly to rising market yields, as a large share of outstanding bonds were issued with extremely low coupons and long maturities. Even a sharp increase in long-term yields therefore feeds into interest expenses only gradually. At the same time, the end to deflation and return of moderate inflation has boosted nominal growth, causing the debt ratio to move onto a slightly declining trajectory recently.

### Exhibit: Japan's debt remains broadly sustainable despite its already elevated level

Debt-to-GDP ratio in 2050 under different interest-rate and primary-balance scenarios

Primary Balance	Rates (%)					
	-4	-3	-2	-1	0	1
0.0	196	179	164	148	132	116
0.5	213	196	179	163	146	129
1.0	231	213	196	179	161	144
1.5	251	233	214	196	178	160
2.0	273	253	234	215	196	177
2.5	296	276	256	236	216	196
3.0	322	301	280	259	238	217
3.5	350	329	307	285	263	241
4.0	381	358	335	312	289	266

#### Assumptions and data used in the simulation:

Primary balance (1980-2024)	-3.03%
Primary balance (2025-2030)	-1.68%
Debt/GDP (2024)	237%
Long-term inflation	2.00%
Long-term potential real growth	0.50%

Sources: International Monetary Fund (IMF), Haver Analytics, DWS Investment GmbH as of January 2026

The color coding refers to the development of the debt-to-GDP ratio: red = rising exponentially; yellow = stabilizing at elevated levels; green = stabilizing at sustainable levels / red circle: scenario that appears most likely, based on our assumptions

With regard to headline debt levels, Japan remains a special case. Despite the extraordinarily high debt ratio of around 237% of GDP, the burden appears surprisingly manageable at very low interest rates (2025: 0.54%). As long as average funding costs remain close to zero – or at most between 1 and 1.5% – Japan's debt ratio should stabilize or even begin to decline gradually. The situation could become critical only if the government's funding cost rose permanently toward 2% or above; in that case, even moderate fiscal deficits could trigger a rapid escalation of public debt. Japan's debt sustainability is therefore underpinned less by fiscal strength than by monetary conditions. Over the long term, however, sustainability

<sup>9</sup> Bank of Japan, Tankan Survey, as of December 2025

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depends heavily on the assumption that inflation remains at around 2% and a return to deflation is avoided. Should the recent return of wage and price increases prove temporary and inflation fall significantly below the 2% level over time, the prospective debt dynamics would become considerably more challenging.

As long as nominal growth outpaces the effective interest rate and the primary fiscal balance – the budget balance before interest payments – does not deteriorate sharply, the debt trajectory should remain broadly stable. The main risk therefore lies less in current market movements than in a scenario in which inflation falls well below target while interest rates remain elevated. In such a case, debt sustainability likely would come under pressure. This is not our baseline scenario at present.

#### Suspension of the consumption tax with negative implications for debt dynamics

However, it should be noted that the suspension of the value-added tax on food, proposed by Prime Minister Sanae Takaichi and now highly likely following her decisive election victory, would have a negative impact on debt dynamics. The tax break will cost roughly JPY 5 trillion per year, or about 0.8% of GDP. Of this amount, JPY 3 trillion would fall on the central government budget – increasing the primary deficit by that amount if no alternative financing source is identified. For 2027, the International Monetary Fund projects a primary deficit of JPY 10.3 trillion; the measure would therefore represent an increase of roughly 29%.

The impact that suspending the tax would have on nominal growth must also be considered. Estimates suggest that the tax suspension (in the first year) would reduce inflation by around 1.5 percentage points and raise real GDP by approximately 0.2 to 0.6 percentage points. Given that demand for food is typically inelastic, the growth effect is likely to be toward the lower end of that range. Multipliers used by the Japanese Cabinet Office indicate that the drop in the GDP deflator (driven by lower prices) would outweigh the rise in real GDP, resulting in a decline in nominal GDP. This, in turn, would have an additional negative indirect effect on Japan's debt dynamics: the debt-to-GDP ratio would rise, and the budget deficit – measured as a share of GDP – would also increase.

## 5 / Summary and critical assessment

### 5.1 Burden on the banking system: limited and manageable

Despite the sharp rise in long-term yields in the JGB market, our calculations indicate that, as things stand today, no unmanageable strains are emerging for the Japanese banking system. While corporate financing in Japan is traditionally highly bank-based – around 70 to 72% of all corporate debt is financed through banks, with regional banks playing a particularly important role – the structure of JGB portfolios significantly mitigates the impact. Major banks hold predominantly short-dated government bonds with one- to three-year maturities, and regional banks are likewise primarily invested in securities with remaining maturities of under three years. This pronounced short-duration focus means that the recent rise in long-term yields feeds into valuations of bank holdings only to a limited extent.

Only the regional Shinkin banks are more exposed, as they hold comparatively longer-dated bonds in their portfolios and are thus more sensitive to mark-to-market losses. Nevertheless, the Bank of Japan's latest stress test, which assumes a parallel 100 basis point increase in interest rates, paints an overall robust picture. Capital ratios across all banking groups – including Shinkin banks – remain clearly above the regulatory minimum requirements even under more severe assumptions. Valuation losses remain manageable, and the impact of potentially rising credit costs also appears moderate. Overall, this points to a resilient banking system whose portfolio structure provides solid cushioning against recent market moves, even if specific segments such as the Shinkin banks warrant continued monitoring.

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## 5.2 Financial stability and market implications: risks present, but no acute stress scenario

From a macro-financial-stability perspective, the rise in yields does not currently imply an acute risk scenario. A credit crunch is not expected under current conditions, as such a development would only become realistic if regional banks were to face significant distress. Given their short JGB maturities, this appears unlikely. The only institutions that could come under more noticeable pressure from recent yield movements are again the Shinkin banks. However, their contribution to aggregate credit provision is limited, meaning that elevated stress in this segment would not automatically translate into a system-wide tightening of credit.

International contagion risks also appear limited. Less than 7% of all JGBs are held by foreign investors, which sharply restricts direct global transmission channels. Although the share of hedge funds in trading volume has increased significantly – raising the likelihood of heightened volatility through rapid deleveraging during periods of market stress – global spillovers would likely remain moderate unless the Japanese banking system itself were to enter a crisis. Only in such a scenario would the risk of international spillovers rise markedly, due to Japanese banks' growing exposures to foreign non-bank financial institutions.

## 5.3 JGBs and the yen: between necessary adjustment and stabilizing anchors

Against this backdrop, the outlook for Japanese government bonds and the yen remains two-sided. On the one hand, the market has undergone an important correction: the era of artificially suppressed term premiums has ended, and political risks – particularly in connection with the Takaichi administration's ambitious fiscal plans – are once again being priced more visibly. On the other hand, several key stabilizing anchors remain in place, making an uncontrolled market dislocation unlikely. These include the still-dominant role of domestic investors, the Bank of Japan's substantial JGB holdings, and the potential for further supply-side adjustments by the Ministry of Finance.

In the near term, however, we think volatility is likely to remain high – not least against the backdrop of questions surrounding how the suspension of the value-added tax on food will be financed, but also in light of the Bank of Japan's further monetary policy communication. A sustained easing of tensions at the long end of the curve would be most likely if expectations of fiscal stimulus were to be dampened, or if the central bank were to signal more clearly that it is prepared to address inflation risks more forcefully. Until then, investors should expect that Japan does not face an acute stability problem – but is also no longer the predictable anchor it was for many years. In our assessment, Japan is likely on a path toward normalization in both inflation and interest rates. However, the main risk remains that a “deflationary mindset” could once again gain the upper hand.

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## Glossary

The **Bank of Japan (BoJ)** is the central bank of Japan.

One **basis point** equals 1/100 of a percentage point.

The **current account** includes trade in goods and services, a net-factor-income balance (e.g. earnings on foreign investments and cash transfers from individuals working abroad) and transfers (e.g. foreign aid). It is a part of the balance of payments.

**Deflation** is a sustained decrease in the general price level of goods and services.

**Duration** is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

**Fiscal policy** describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

FX or **foreign exchange** is the currency – literally foreign money – used in the settlement of international trade between countries.

**Government funding costs** refer to the interest and other expenses a government incurs to finance its operations, including deficits and maturing debt.

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

A **hedge fund** is an investment vehicle less regulated than a mutual fund that pools capital from different investors and uses different investment strategies.

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The **International Monetary Fund (IMF)**, created in 1945 and headquartered in Washington, D.C., is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

The **Japanese yen (JPY)** is the official currency of Japan.

**Japanese Government Bond (JGB)** is issued by the government of Japan.

**Liquidity** refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

In economics, a **nominal** value is not adjusted for inflation; a real value is.

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

The **term premium** is the expected return on an investment minus the return that would be earned on an investment with a shorter term/maturity.

**Volatility** is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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