

MNI Analysis: Gaps in Japanese Fiscal

13 February 2025 – By Moritz Arold and Tim Davis

Executive Summary:

- **Financing the JPY5trn food consumption tax suspension with proceeds from the FX special account would likely open up gaps in the general budget**
- **This leaves the Japanese finance ministry with three options: Plug the gap through increasing the efficiency of the tax base and expenditure, net liquidation of parts of the FX special account, or higher JGB issuance through the backdoor**
- **Which one of these options it chooses may have substantial consequences for JPY as well as JGB yields. Special account partial liquidation would be a notable JPY positive**
- **If it wants to adhere to its new fiscal rules, Japan's headroom has an upper limit of roughly 8ppts of GDP through 2030 in total**

How much could the Japanese government take from the FX account to finance the JPY5trn food tax suspension?

- Finance Minister Katayama excluded higher JGB issuance and kept open using the FX Special Account for funding of the food consumption tax suspension (~JPY5trn, ~0.8% of GDP). The question was if PM Takaichi just plans to use more of the proceeds of the fund for expenditure, or pivot, and go ahead with a net liquidation of financial assets.
- 2024 proceeds of the account were JPY5.4trn. Under current legislation, 70% (3.8trn) of these can be used for the general budget, and 30% must be retained as a buffer. Ultimately, 3.2trn made their way to the FY2025 core budget. This means at max, with current legislation, ~0.6trn would have been left to fund additional policies; scrapping the 30% accretive minimum would let loose another ~1.6trn. Finance ministry documentation on the FY26 preliminary budget is vague on this, but it looks like transfers of similar magnitude had already been calculated in for this year already ahead of the tax suspension plans. Hence, just starting to use the current 30% buffer on top is too little to finance a ~5trn tax cut.
- The government also flagged other financing options: reviewing redundant tax breaks and subsidies. Generally, government claims to increase the efficiency of the tax base / expenditure should be met with caution. To what extent Takaichi can follow up here seems uncertain for the moment.
- If these other financing options turn out not to plug the gap to ~5trn, the Finance Ministry would need to divert to one the following.
 - 1. They could reduce net holdings of the special account, either through not reinvesting redemptions or actively selling securities held. Either way, this would result in net lower UST holdings, potentially troublesome from the perspective of relations with the US, and introducing a cross-asset angle to the matter. This comes besides JPY buying implicit in any higher usage of either proceeds or holdings; rising expectations of usage may have been one factor underpinning recent JPY strength. JP Morgan commented usage of the account "may not be impossible, but the hurdle is quite high, and legal revisions and various other changes would be required for implementation". From a legislative perspective, these hurdles will be lower after the LDP won a supermajority in the election but the process to getting there remains long.
 - 2. The other option would be to declare publicly the tax suspension is funded through the FX special account, but resort to higher JGB issuance for funding of the items currently financed through the FX surplus transfer. This would effectively just mean a tax cut on the back of higher issuance packaged a less blatant way but could be sold as permissible under Takaichi's new fiscal rules. The market would not like this option, resulting in higher JGB yields as well as a weaker yen.

What does Takaichi's pivot to new fiscal rules mean?

- On top of the FX special account considerations, Takaichi also announced a rotation in terms of fiscal rules towards spending as long as the debt/GDP ratio reduces over a multi-year period. Takaichi will be able to argue she kept with her target as long as the ratio doesn't stand higher than the current 229.6% in a couple of years, representing a loosening of fiscal prudence vs the previous equalised primary balance. This opens up two angles: that of the "r-g differential", from which the current trajectory seems reasonably sustainable, as well as the fact that Takaichi's own fiscal rules seem to limit her options in terms of planned easing somewhat.
- The "r-g differential" (average interest rate paid on debt outstanding minus nominal growth) is indicative if primary surpluses are required to keep debt/GDP from an exponential upward spiral. With inflation having picked up in Japan and

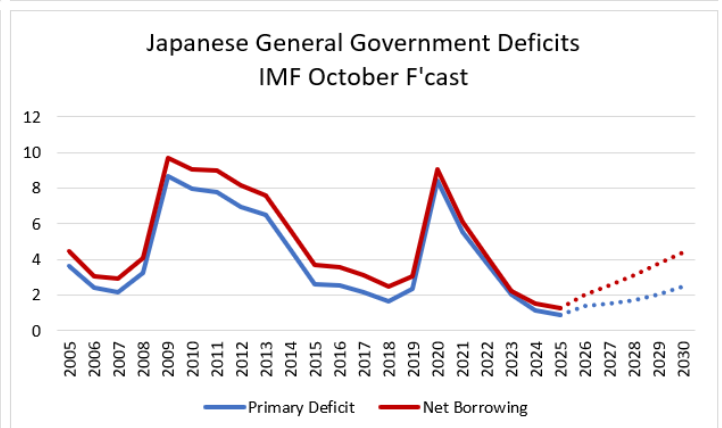
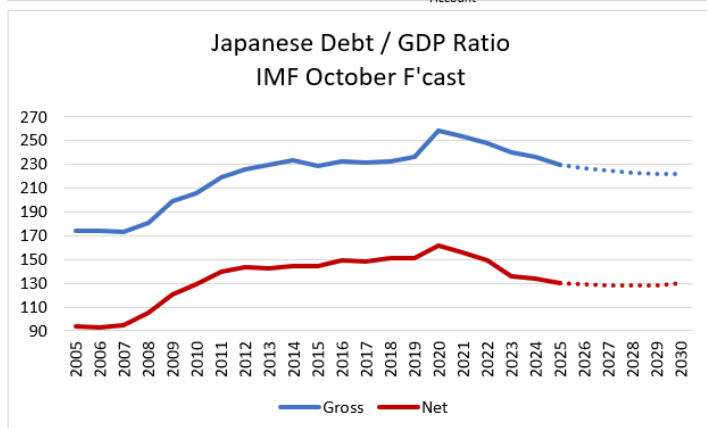
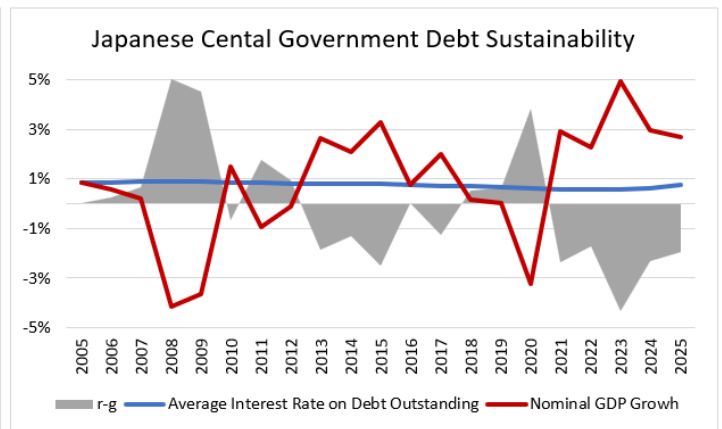
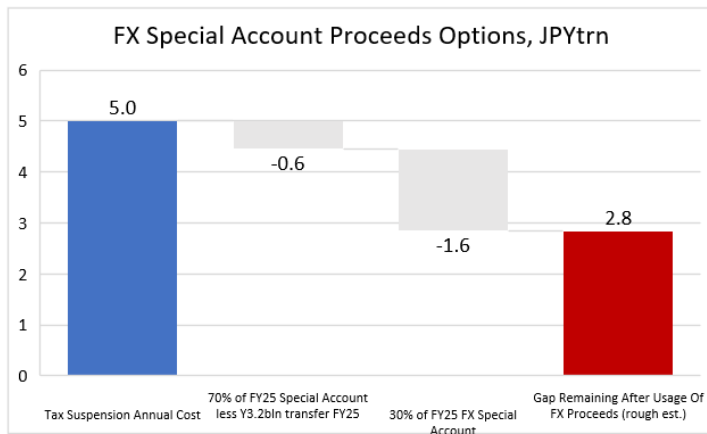
real growth likely above potential, the measure currently stands comfortably in negative territory. This means if the current state of play would persist, Japan would outgrow its debt burden slowly in the case of an equalised primary balance.

- Morgan Stanley projected in October the JGB weighted average interest rate is to increase from its current 0.8% to roughly 2.0% in 2030 and above that by 2040. This results in them seeing r-g roughly at zero by that horizon. Unfavourable risks would be a) higher rates or b) lower growth. In fact, 10-year JGB yields have increased by more than 100bps since the report was released, likely a firmer move than assumed. Still, this will impact only over time on an aggregate level especially since current net issuance is rather low in Japan on a historical comparison (bottom chart).
- The takeaway here is that from an "r-g" perspective, Japanese fiscal seems indeed on a better trajectory than for example some European countries. A factor helping here will be BoJ holdings pressuring yields lower.
- Now the IMF, also in October, projected the Japanese debt/GDP ratio to reduce by roughly 8 percentage points through 2029 but flatten out in the process, remaining stable in 2030. This was done assuming the old government's fiscal rules were based on a net zero primary balance, before PM Takaichi in November won the LDP vote and then promised to end "excessively tight fiscal policy".
- Taking these projections as a baseline, headroom for higher net issuance has an upper boundary of these ~8 percentage points over 5 years if Takaichi wants to avoid a clear clash with own fiscal rules. This means in theory, higher JGB issuance through the back door as a function of the food tax cut (upper bound of 2x0.8% as the policy will be phased out after two years) would be admissible in isolation, but reduce the headroom Takaichi has for additional easing programmes.

What will be the key events which realize prevailing uncertainty?

Near-term focus is on Takaichi's "General Policy Speech" next Friday. The speech will be made as part of her formal re-election as PM. Remain on the lookout for her to potentially codify what the approach of a stable debt/GDP ratio over a multi-year period means in the more near-term.

Further ahead, the government has vowed for a "national conference" on the tax suspension, with the aim to "produce an interim summary of the discussion" before this summer.



Sources: Japan MoF, IMF, Bloomberg Finance L.P., MNI

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