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Industrial and Monetary Policy Implications for the Yen and Yields

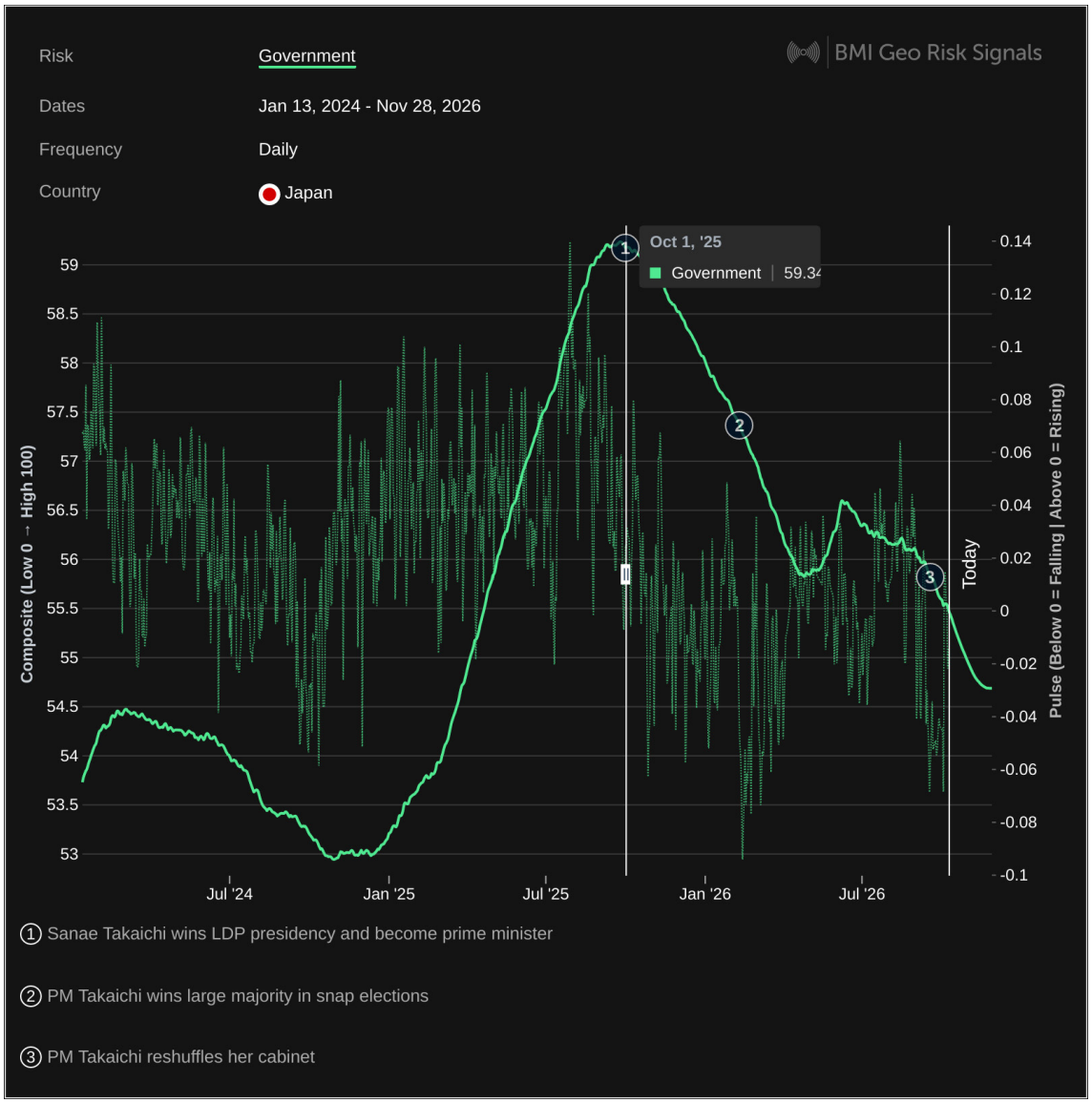
Spotlight Japan

Key Points:

- PM Takaichi's cabinet reshuffle, lower-house supermajority, and continued public support enable her to pursue fiscal expansion in strategic sectors such as semiconductors and AI, strengthening supply-chain and defense resilience.
- Takaichi's industrial policy may stimulate corporate investment, growth, and tax revenue by mobilizing accumulated private savings. However, it also raises fiscal, trade-distortion, and inflation risks.
- Fiscal expansion complicates the BoJ's efforts to meet its inflation target, but stronger domestic demand may give it greater scope to raise rates, support the yen, reduce imported inflation, and improve household purchasing power.
- The industrial policy could push JGB yields higher, particularly if it boosts growth, inflation expectations, and bond issuance. BoJ tightening and a stronger yen could encourage capital repatriation, reducing demand for overseas sovereign debt and placing upward pressure on global long-dated yields.

PM Sanae Takaichi reshuffled her cabinet on September 17 but retained her economic ministers in their respective roles ahead of the introduction of her industrial policy blueprint on 5 October. The blueprint calls for fiscal expansion to support corporate capital investment across 17 sectors designated as strategic, including semiconductor manufacturing and AI, with the aim of strengthening the economic security of Japan's supply chains and defense industry.

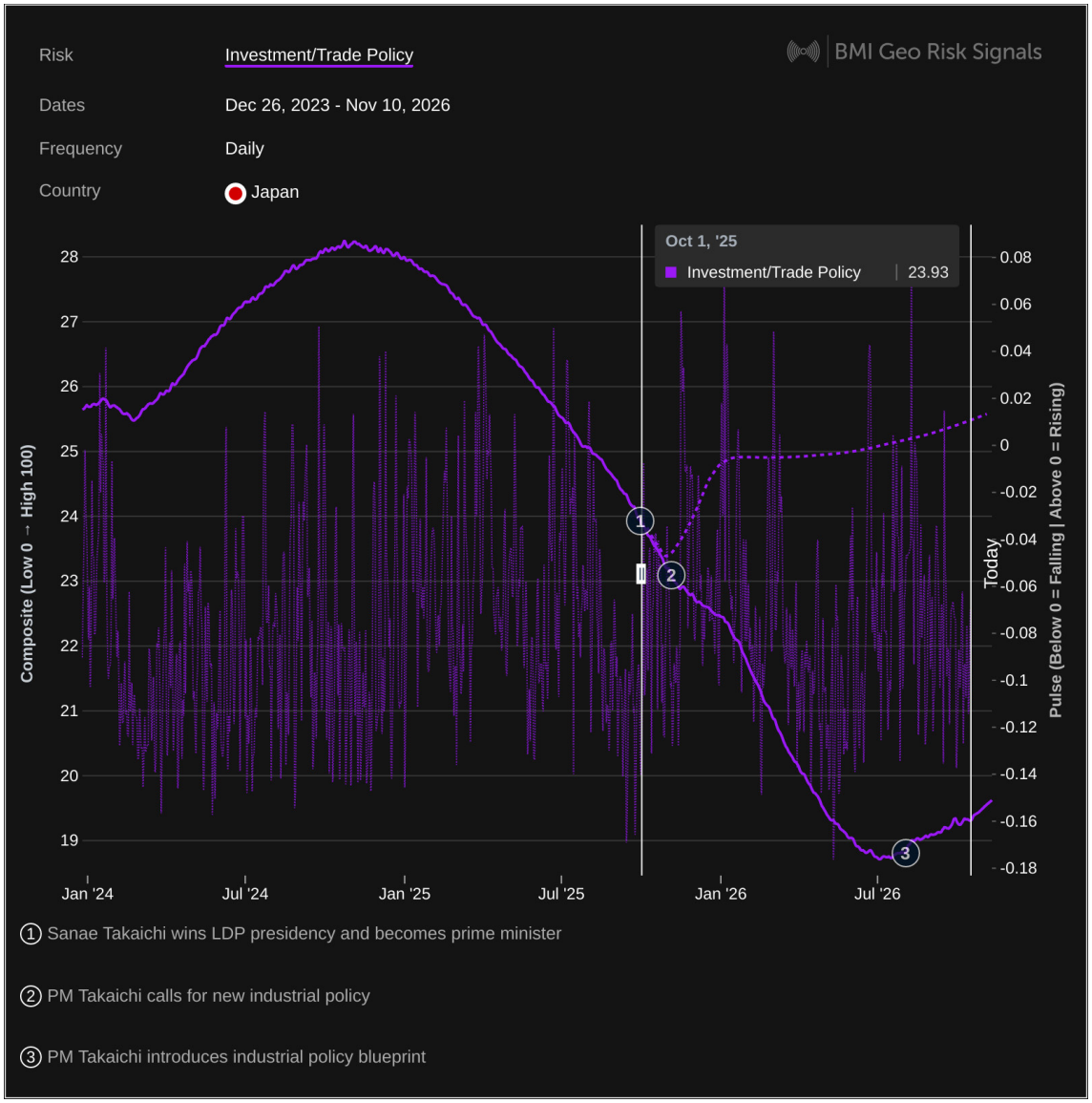
While many commentators have viewed the cabinet reshuffle as an effort to improve the government's flagging popular support, Government Risk has continued its steep net decline since Takaichi came to power in October 2025 and secured a strong majority in a snap election in February. Takaichi's approval ratings have fallen below 50% but remain high relative to nearly all of her predecessors. With public support holding up and a lower-house supermajority, Takaichi and her ruling Liberal Democratic Party (LDP) have the capacity to pursue her economic agenda, though whether her supply-side policies reflate its weak-demand economy remains to be seen.



Industrial policy redux and fiscal concerns

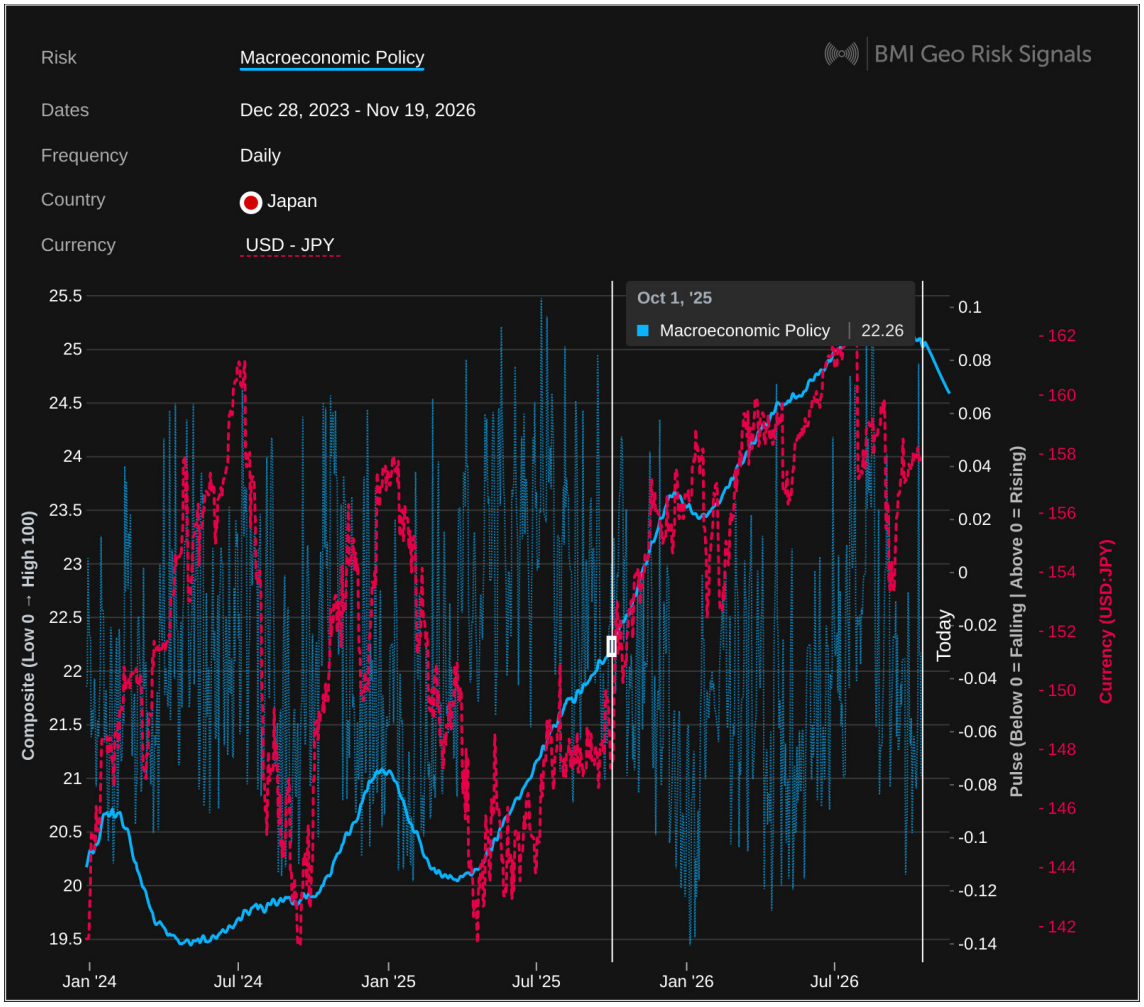
PM Takaichi's industrial policy will expand government spending by supporting corporate capital expenditure across 17 sectors designated as strategic, coinciding with shifts in related risks. The proposed industrial support has pushed previously rising Macroeconomic Policy Risk downward. Under the policy, most capital is expected to come from corporate balance sheets, which have accumulated substantial cash after decades of saving during deflation. Falling-price expectations discouraged firms from deploying this cash domestically. The return of inflation, alongside government support, could unlock it for investment, boosting economic activity and tax revenue.

By contrast, Investment/Trade Risk has inflected upwards, as the industrial policy expands Japan's long-standing – and distortionary – export-promotion strategy into a global environment marked by apparent excess capacity. Maintaining a cutting-edge manufacturing base is valuable from an economic-security perspective, but it entails real costs that should be weighed when assessing the policy. Moreover, such subsidies distort investment behavior, making investment allocations deviate from those that would arise in a competitive market, in turn making them negative from an Investment/Trade Risk perspective. These costs are real and likely inflationary, all else equal, although tighter monetary policy could offset the effect.



Monetary policy response

Macroeconomic Policy Risk had been rising as the Bank of Japan (BoJ) sought to prevent the economy from slipping back into deflation by being more inflation tolerant than most economies experiencing post-Covid inflation. However, given pressure on consumers and economic activity, the BoJ's policy, though useful for some in the business community, has been a political albatross for recent governments, reflected in a weak yen and higher prices for voters. PM Takaichi's fiscally driven industrial policy complicates the BoJ's efforts to keep inflation at its 2% target but provides an expansionary impulse that BoJ policy can lean against. This could usefully counter persistent USDJPY weakness given its strong relationship with Macroeconomic Policy Risk (figure below; corr. = 0.83 since January 2023). If the BoJ increases rates, yen appreciation should eventually reduce external inflationary pressures, helping to contain consumer price pressures and strengthen households' purchasing power abroad. Of course, U.S. inflation will spur higher rates there as well, potentially constraining yen appreciation, at least against the USD.



Implications for yen and knock-on effects for global sovereign yields

Japan's expansionary industrial policy could weigh on the yen if investors remain focused on higher borrowing needs. However, stronger domestic demand and investment would give the BoJ greater room to raise rates without risking a return to deflation. Narrower rate differentials with the US and other economies would reduce carry-trade incentives and, over time, support yen appreciation. A stronger yen would also lower imported inflation and improve household purchasing power, both of which would likely increase government popular approval.

Finally, if the policy succeeds and pushes long yields higher, that could encourage Japanese investors to retain more capital domestically or repatriate funds from overseas bonds. This would reduce demand for US treasuries and other developed-market sovereign debt, potentially placing upward pressure on global long-dated yields and term premia.

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