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Japan’s Economic Outlook: Navigating Massive Fiscal Expansion, Inflation Pressures, and Monetary Tightening

By

Lāsma Kokina

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For information about Rosa&Roubini Associates, please send an email to info@rosa-roubini-associates.com or call +44 (0)20 7101 0718.

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Executive Summary

- Prime Minister Sanae Takaichi introduced a 14-year roadmap aiming for over 370 trillion yen in combined investments by March 2041 across 17 strategic sectors like technology and defense.
- This initiative seeks to end decades of economic stagnation and lower a public debt-to-GDP ratio that surged past 260 percent by 2020 while reducing trade reliance on China.
- Significant capital is directed toward AI and semiconductors to combat domestic labor shortages and modernize industries with projected economic spillovers reaching hundreds of trillions of yen by 2040.
- The strategy also allocates roughly 64 trillion yen to pharmaceutical and medical advancements alongside another 34 trillion yen specifically for content industries such as gaming.
- The government plans to use targeted bridging bonds backed by dedicated future revenue streams to handle interim financing deficits without immediately overhauling the broader national budget.
- Economists remain skeptical of the unusually long timeline because predicting long-term conditions is unreliable and official estimates omit potential future expenditures like defense hikes or tax cuts.
- The Bank of Japan is simultaneously preparing to raise interest rates and accelerate its tightening cycle due to rising inflation risks linked to global spending and a persistently weak yen.

Key Picture: Japan's Surging 10-Year Bond Yields

Source: MacroMicro

Fiscal Ambitions and Monetary Realities in Modern Japan

Takaichi's 14-Year Economic Roadmap: Investment, Challenges, and Fiscal Scepticism

In June, Japanese Prime Minister Sanae Takaichi introduced a massive 14-year economic roadmap aiming for over 370 trillion yen (£1.7tn) in combined public and private investment through March 2041 across 17 areas of focus.[1] These include a variety of sectors extending across technology, defence, energy, and life sciences. The initiative aims to enhance Japan's economic security, reinforce supply chains, and boost long-term growth by shifting fiscal priorities toward reducing the nation's debt-to-GDP ratio.[2]

Takaichi's ambitious strategy is driven by a desire to finally break decades of economic stagnation and heavy public debt that began with the 1991 property bubble collapse and deepened through subsequent financial crises. Following massive bank bailouts and persistent deficits, exacerbated by the 2008 financial shock and the rising costs of an aging population, Japan's debt-to-GDP ratio increased from 60% in the late 1980s to over 260% by 2020. By directing massive funding into critical sectors, Takaichi aims to boost Japan's overall productive capacity, secure a leading position in global artificial intelligence, and reduce Japan's growing trade reliance on China.[3]

A significant portion of the capital is allocated specifically to artificial intelligence and semiconductor developments to address domestic labour shortages and modernise key industries. At the core of the strategy is a push into semiconductors and specialised AI applications, which the government projects will generate hundreds of trillions of yen in broader economic spillover effects by fiscal year 2040. This framework builds on Japan's ongoing efforts to revitalise its chip sector, which has already seen billions allocated to state-backed projects since 2021.[4] Roughly 64 trillion yen are also expected to be allocated to pharmaceutical and medical advances, and 34 trillion yen to content industries like gaming.[5]

To support expanded spending without immediately overhauling the broader budget, the government plans to rely on targeted debt mechanisms to cover short-term financing needs. Spending will be raised by issuing government bonds that are secured by future revenue designated for their repayment. To maintain a reputation for fiscal discipline while expanding spending, the government plans to issue bridging bonds backed by dedicated repayment sources to meet short-term financing demands.[6] Bridging bonds are created to handle interim financing deficits under the assumption that prospective revenue streams can be obtained.[7]

However, the proposal's unusually long timeframe has drawn scepticism from market analysts and economists, who note that predicting economic conditions over such an extended period is nearly impossible and makes the plan's overall reliability difficult to assess. Government models outline three potential economic scenarios under this framework, with the debt ratio declining steadily only in the most optimistic case, which assumes 10 trillion yen in annual government spending. Meanwhile, market reactions remain mixed: while the strategy has helped drive stock indexes to record highs, ongoing concerns regarding fiscal sustainability have simultaneously pushed super-long government bond yields to multi-decade highs. Because the government's official estimates omit potential expenditures such as defence budget hikes or tax cuts, the plan leaves open questions about the true extent of future fiscal pressures.[8]

The Bank of Japan's Dilemma: Rising Inflation Risks vs Political Pressure on Bond Yields

Driven by escalating concerns over inflationary pressures linked to Middle East tensions, high global spending on AI technology, and persistent weakness in the yen, the Bank of Japan is preparing to potentially raise interest rates as early as its September meeting while considering a faster tightening cycle than its previous twice-a-year pace. Following warnings that underlying inflation could surpass its two percent target, further evidenced by elevated wholesale inflation, rising inflation expectations, and continued import cost pressures, policymakers are growing increasingly wary of lagging behind price increases. Even though the central bank previously kept interest rates unchanged due to worries about a weak economy, recent comments from Governor Kazuo Ueda and bank officials show they are now ready to raise rates sooner. This news caused short- and medium-term government bond yields to jump, as financial markets now fully expect interest rate hikes to happen quickly.[9]

Although the Bank of Japan is contemplating an earlier interest rate hike, its efforts to normalise monetary policy face increasing friction from political pressure to stabilise the domestic bond market. Concern surrounding Takaichi's large-scale fiscal program has driven Japanese government bond yields higher, increasing borrowing costs for Japan's immense public debt and drawing criticism from US officials over spillovers into American Treasury markets. In response, Takaichi promised to improve market communication to boost fiscal confidence, while reportedly urging Ueda to purchase more bonds when needed to suppress long-term rates. Her administration and key advisors continue to express anxiety over surging yields and the central bank's swift balance-sheet reduction, emphasising quantitative controls over traditional rate adjustments to manage economic stability.[10]

As such, the Bank of Japan finds itself trapped between economic necessity and political pressure. On one hand, mounting inflationary risks are forcing the central bank toward quicker interest rate hikes and balance-sheet reductions to keep prices under control. On the other hand, the administration's massive fiscal spending program is driving bond yields higher, prompting political leaders to push back against rapid monetary tightening and urge bond purchases to manage public debt costs. Thus, this friction has the risk of creating market confusion and could weaken the central bank's fight against inflation, as buying bonds to keep public borrowing costs down directly undermines the rate hikes needed to stop rising prices.

Q2 Growth Deceleration, Weak Yen Pressures, and the Case for September Rate Hikes

Official data released in August revealed that Japan's economic growth slowed down in the second quarter due to weak consumer demand and sluggish business investment. The economy grew by 0.3 percent between April and June compared to the prior three months. Although this marked a third straight quarter of growth, it was lower than the previous quarter's 0.5 percent expansion and fell short of the 0.5 percent rate expected by analysts.[11] On an annualised basis, economic growth was reported at a rate of just 1.1% in the second quarter, missing forecasts because of unexpected drops in household spending and business investment.[12]

However, experts view this weakness as temporary - partly caused by minor factors like government education subsidies that briefly lowered recorded consumer spending, while strong global demand for Japanese hybrid cars and AI tech kept exports solid. Recognising this underlying strength, investors looked past the weak growth numbers, pushing long-term government bond yields to a 30-year high in anticipation of higher interest rates.[13]

Financial market pressure pushing up bond yields and forcing a rate hike is fuelled in large part by the weakness of the Japanese yen, which recently hit a 40-year low against the US dollar and significantly worsened cost pressures for domestic consumers. Because Japan imports nearly all of its crude oil, the depreciated currency amplifies the impact of high global energy prices, threatening to drag on economic growth as businesses pass these expenses down to households. Raising the benchmark interest rate at the Bank of Japan's upcoming policy meeting could help relieve this ongoing yen weakness by narrowing the large borrowing gap between Japan and other major economies, particularly the US.[14]

Thus, despite the economic slowdown reports, the Bank of Japan is still expected to raise interest rates as soon as September to fight growing inflation. Higher oil prices from Middle East tensions and a weak yen are driving up the cost of imported goods, threatening to affect household budgets. Because rising prices pose a bigger long-term threat than the temporary drop in spending, financial markets fully expect the central bank to move forward with rate hikes.[15]

NOTES

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