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From the perspective of monetary and fiscal policy, upward pressure on interest rates is likely, but it will be restrained

6 June 2025

- With the Upper House election scheduled for July this year, there is likely to be increased awareness of the need for fiscal expansion. In addition, the Bank of Japan (BoJ) is expected to raise interest rates after 2026, which is likely to put upward pressure on long-term interest rates for the foreseeable future.
- However, considering that (1) the BoJ's interest rate hike will remain within the scope of adjusting the degree of monetary easing for the time being, and (2) fiscal stimulus will support a virtuous cycle of wages and prices, leading to an increase in nominal GDP and tax revenue and contributing to fiscal consolidation, upward pressure on interest rates from monetary and fiscal policy is likely to be contained.

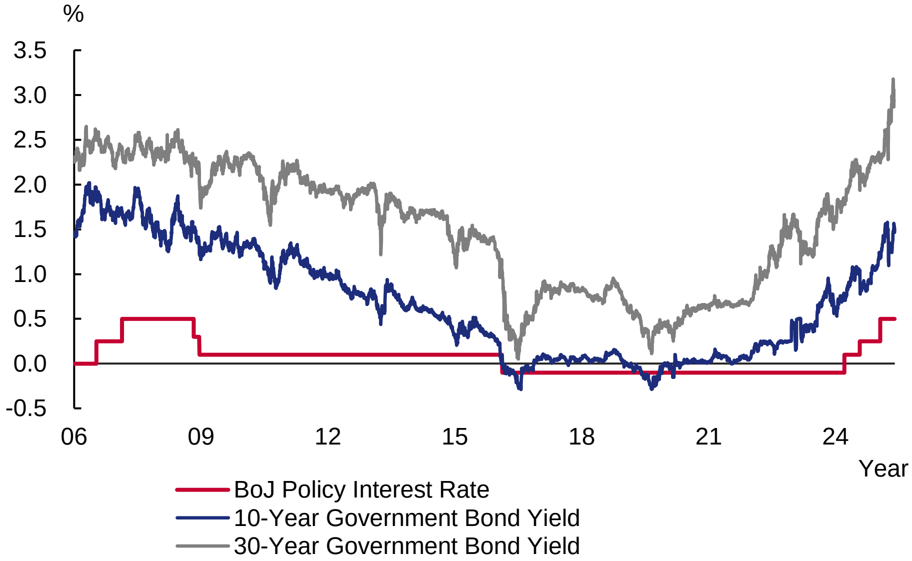
Yuko Iizuka, Economist

Super-long government bond yields rise

Japan's super-long interest rates are surging with 30-year government bonds yields rising above 3.0% at times (Figure 1). This is attributed to a loosening of supply and demand for the super-long government bonds. Specifically, the following factors are cited: (1) the observation that demand for super-long bonds from life insurance companies has peaked, (2) adjustments to holdings by domestic financial institutions and overseas investors in response to revisions in expectations regarding the BoJ's interest rate hikes, and (3) the low ratio of the BoJ's purchases relative to issuance amounts. According to reports, the Ministry of Finance is considering revising the maturity structure of its government bond issuance plan to address the sharp rise in interest rates, and concerns over the supply-demand dynamics for super-long government bonds are beginning to ease.

However, with the US and Germany moving toward fiscal stimulus, the global focus is likely to shift to the easing of government bond supply and demand against the backdrop of fiscal expansion. As a result, long-term interest rates, which are more sensitive to policy trends, are expected to face upward pressure. This report summarizes the key points to watch in monetary and fiscal policy in the near term.

Figure 1:Japan's policy interest rate and government bond yields



Source: LSEG Data & Analytics, Bloomberg, Asset Management One Co., Ltd.
Note: 1. Daily data from 2 January 2006 to 28 May 2025
2.The uncollateralized overnight call rate for BoJ Policy Rate
3. Includes the period of quantitative easing and the period during which negative interest rates were applied to a portion of the balance of current account deposits at the BoJ

BoJ may raise interest rates in early 2026

Since the BoJ raised interest rates in January of this year, economic indicators such as wage and price increases have strengthened, leading to heightened expectations of further interest rate hikes by the BoJ. The market was also aware of the possibility that the neutral interest rate, which is the target for interest rate hikes, may be rising. (Please refer to the report “The Bank of Japan will continue interest rates hikes with the aim of reaching 1%, which is thought to be the lower bound for the neutral interest rate”, published on April 2, 2025).

However, at the BoJ's Monetary Policy Meeting held on April 30-May 1, the Bank revised its economic and price outlook downward and indicated that it would wait and see before raising interest rates. This was due to concerns that the tariffs imposed by US President Trump on many countries and regions would put downward pressure on the global economy.

Subsequently, as of the end of May, the tariff rates (additional tariffs) for each country were temporarily suspended, and the US and China agreed to temporarily suspend the significant tariff increases and enter into negotiations. Japan is also engaged in negotiations aimed at reducing tariffs. Tensions between the US and China have temporarily eased, and concerns about a global economic downturn have somewhat subsided. Following negotiations between Japan and the US, it is expected that while the complete removal of additional tariffs on Japan may be difficult, some tariff reductions will be implemented.

Under these circumstances, we expect domestic demand, supported by (1) income increases due to high wage hikes in this Shunto, Spring's labor negotiations and (2) investment in labor-saving measures in response to labor shortages, to underpin the domestic economy, which is expected to remain resilient.

If financial markets and domestic political conditions stabilize and the slowdown in the global economy remains limited, the BoJ is expected to consider additional interest rate hikes.

Even if the Japan-U.S. trade negotiations are resolved in a conciliatory manner, we believe that the timing of additional interest rate hikes will be in January 2026, taking into account the following factors: (1) it will take some time to assess the impact on the domestic economy and prices, and (2) it will not be possible to confirm that wage increases will continue in 2026 until the end of this year.

The BoJ is unlikely to raise interest rates quickly

However, it is important to note that the BoJ's monetary policy will, for the time being, be limited to adjusting the degree of monetary easing. Whether or not interest rates will be raised will depend on tariffs and their impact on the economy, but the timing will likely depend on the pace of inflation. Currently, consumer prices are rising significantly above 2% due to increases in food prices, particularly rice, but we expect them to fall back to around 2% in the near future. Looking ahead, given that the yen's depreciation, which is one of the factors driving up import prices and contributing to rising prices, is expected to be limited, the likelihood of a hasty interest rate hike is low. In addition, the BoJ considers that, from the perspective of the impact of interest rate fluctuations on economic activity, short- to medium-term interest rates have a greater impact than super-long-term interest rates, and therefore it is unlikely that it will raise interest rates beyond the scope of easing adjustments (reduction of the negative real interest rate up to medium-term interest rates). After resuming interest rate hikes in early 2026, we expect gradual interest rate hikes approximately once every six months.

Many opposition parties are calling for a reduction in the consumption tax rate

Ahead of the Upper House election scheduled for July, there is growing awareness of the increase in Japan's fiscal spending. The ruling Liberal Democratic Party (LDP) and junior coalition partner Komeito Party plan to formulate economic measures before the Upper House election and compile a supplementary budget to back them up after the election in the fall. The compilation of a supplementary budget in the fall has become an annual tradition, and last year a supplementary budget of approximately 14 trillion yen was approved..

Opposition parties are proposing to lower or abolish the consumption tax rate as a measure to address rising prices ahead of the Upper House election (Figure 2). Consumption tax revenue is projected to reach approximately 24 trillion yen in the 2024 fiscal year, accounting for about 30% of general account tax revenue (Figure 3). If the consumption tax were completely abolished, the loss in tax revenue would be significant. As a measure to address rising prices for food items, abolishing the consumption tax on food items alone would result in an annual revenue loss of approximately 6 trillion yen. However, given that general account tax revenue is expected to reach a record high, it is also important to increase fiscal spending necessary to put economic growth back on track.

Figure 2: Each political party's stance on consumption tax

Political party	Consumption tax reduction policy
LDP	Executive committee cautious about tax rate reduction Some within the party advocate reducing the tax rate on food products to 0%
Komeito	Tax cuts, including a reduction in the reduced tax rate Consideration of handouts
CDP	Zero consumption tax on food for one year Uniform handouts of 20,000 yen
JIP	Temporary suspension of consumption tax on food products for two years
Democratic Party For the People	Reduce the consumption tax rate to a uniform 5%
Japanese Communist Party	Aiming for eventual abolition, emergency reduction to 5% across the board
Reiwa	Abolish consumption tax

Source：Asset Management One Co., Ltd. based on various media reports

At present, Prime Minister Ishiba and the LDP leadership are keeping their distance from lowering the consumption tax rate. However, if the LDP's projected gains in the Upper House election are unfavorable, the LDP may decide to launch a large-scale fiscal stimulus as an economic measure. Additionally, regardless of the Upper House election results, the ruling coalition lacks a majority in the Lower House, meaning that opposition cooperation will remain necessary for the passage of supplementary budgets.

For the 2025 fiscal year budget, the government aims to secure the cooperation of the Japan Innovation Party (JIP), which advocates for free high school tuition, and to incorporate the Constitutional Democratic Party (CDP)'s proposal into pension reform legislation during the current Diet session. While there are differences in the scale of fiscal stimulus and views on fiscal discipline among opposition parties, an expansion of fiscal spending is expected to be seen as a factor contributing to rising interest rates in the near term.

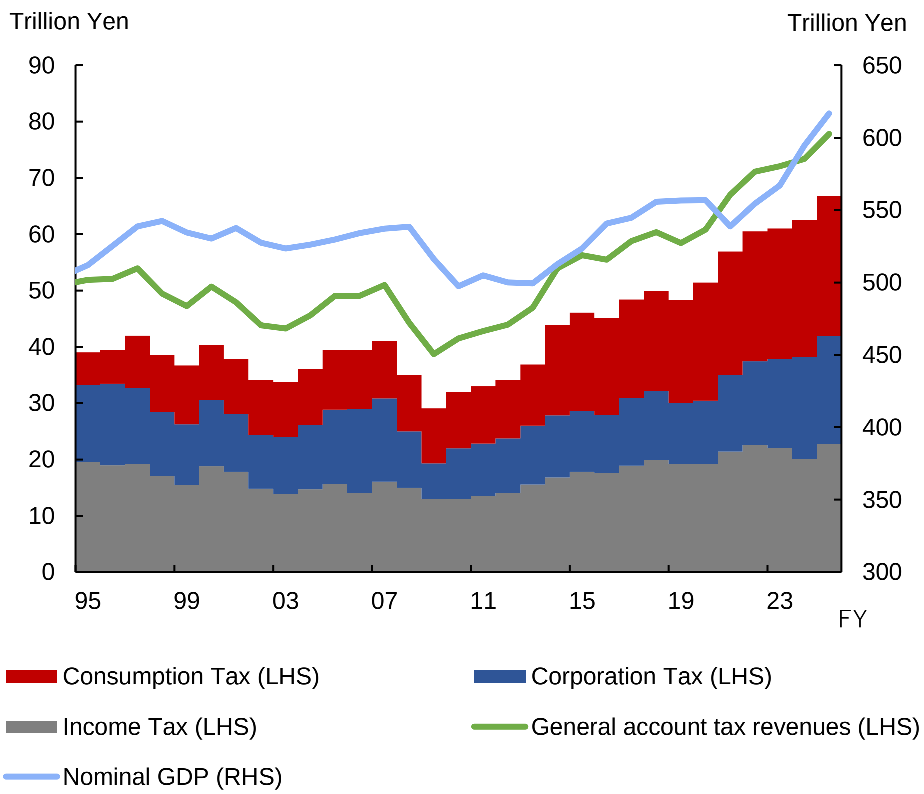
In the near term, the timing for achieving fiscal consolidation targets will be closely watched in the “Basic Policy on Economic and Fiscal Management and Reform” (known as the “Basic Policy”), which is decided by the Cabinet around June each year. Last June's Basic Policy set two key objectives: (1) achieving a primary balance surplus for the central and local governments combined by fiscal year 2025, and (2) steadily reducing the ratio of debt to GDP.

It also reaffirmed the commitment to advancing economic revitalization and fiscal consolidation in a way that balances both goals. According to reports, the government plans to revise the timing for achieving the primary balance surplus target slightly in this year's Basic Policy.

Key points to watch

With the Upper House election approaching, there is a heightened awareness of increased fiscal spending, and with the BoJ expected to raise interest rates after 2026, long-term interest rates are likely to remain under upward pressure. Additionally, with the US and Germany moving toward fiscal stimulus, there is a heightened focus on interest rate increases globally amid a backdrop of fiscal expansion. However, there is a relationship between increases in nominal GDP and increases in tax revenue (Figure 3).

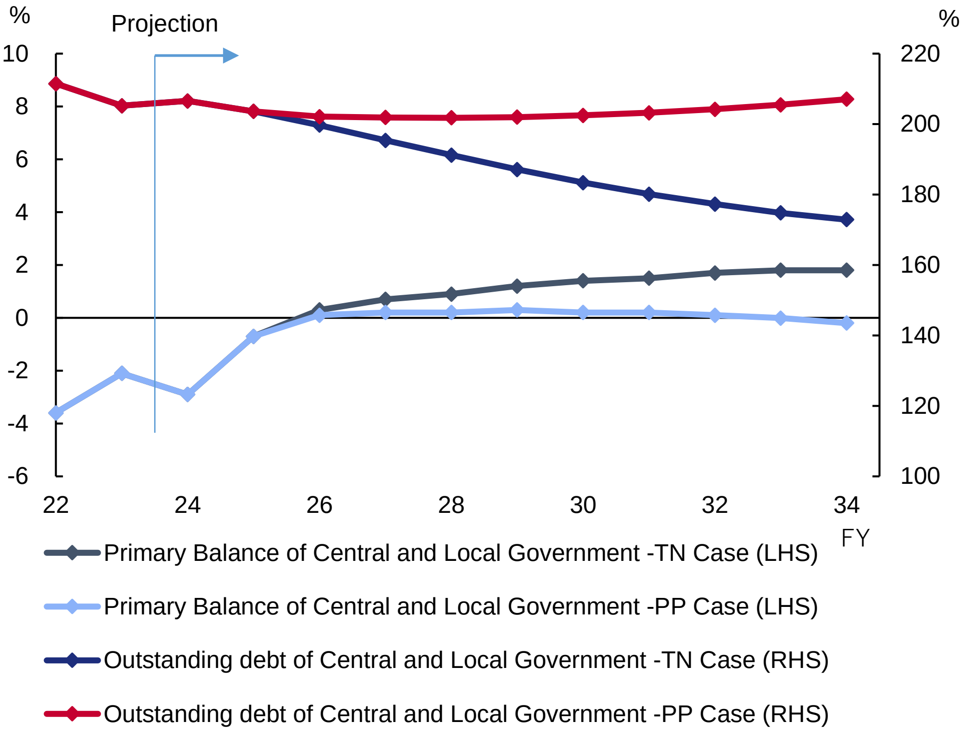
Figure 3: Trends in tax revenue and nominal GDP



Source: Ministry of Finance Japan, Asset Management One Co., Ltd.
Note: 1. Annual data from FY1995 to FY2025
2. Data until FY2023 are on a settlement basis, data in FY2024 are on a revised basis and data in FY2025 are on a budgeted basis

In the Economic and Fiscal Projections for Medium to Long Term Analysis released in January this year, the fiscal projection under the Transferring to a New Economic Stage (TN) Case—which combines a nominal GDP growth rate of around 3% with a gradual rise in long-term interest rates (10-year government bond yields)—showed that the primary balance would achieve a surplus on a sustained basis and that the ratio of public debt to GDP would decline (Figure 4, next page). In order to achieve fiscal soundness in Japan, it is also important to maintain fiscal consolidation policies while taking necessary fiscal measures to ensure a virtuous cycle of wages and prices and aim for nominal GDP growth.

Figure 4: Fiscal Projection as of January 2025



Source: Japan Cabinet Office, Asset Management One Co., Ltd.

Note: 1. Annual data from FY2022 to FY2034

2. All figures are the ratio to nominal GDP

3. In the Transferring to a New Economic Stage (TN) Case, the growth rate of TFP (Total Factor Productivity) is assumed to steadily go up to around 1.1%, which is the average rate for the last 40 years in Japan
Transitioning to a growth-oriented economy driven by the wage increase and investment, the real GDP growth rate is projected to be around mid-1% in the late 2020s and stably higher than 1% in the 2030s (the nominal growth rate is projected to be in the upper 2% range in the medium to long term)

4. In the Projection of Past Trend (PP) Case, the growth rate of TFP is assumed to stay around 0.5%, which is the average in the most recent business cycle. The GDP growth rate is projected to be around mid-0% in real terms and upper 0% range in nominal terms in the medium to long term

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