

The Economic Environment Surrounding Yen Interest Rates

26 May 2026

Long-term interest rates are rising

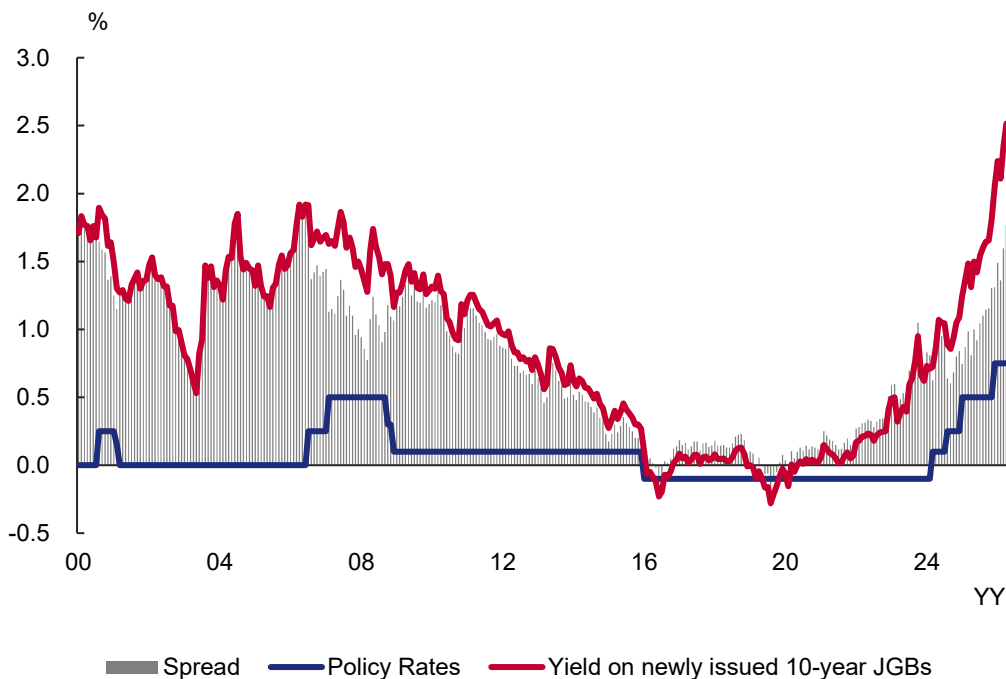
The yield on newly issued 10-year government bonds, a key indicator of long-term interest rates, rose to 2.8% in May, its highest level in nearly 30 years (Figure 1). Domestic factors contributing to this trend include: (1) concerns about rising inflation driven by soaring crude oil prices; (2) speculation that the Bank of Japan (BoJ)'s monetary policy response may be behind the curve; and (3) expectations of fiscal stimulus to offset the adverse effects of the situation in the Middle East.

The main factors influencing interest rates can be grouped into: (1) expected real economic growth (potential growth rate), (2) expected inflation, and (3) risk premiums (related to fiscal policy, government bond supply and demand, etc.). Based on the potential growth rate and expected inflation, we believe that a range of around 2.5% to 3.0% appears reasonable for long-term interest rates in Japan.



Yuko Iizuka
Economist

Figure 1: Long-term Interest Rates and Policy Rates



Source: INDB, Asset Management One Co., Ltd.

Note: 1. Monthly data from January 2000 to April 2026

2. The spread is the difference between long-term interest rate and the policy rate

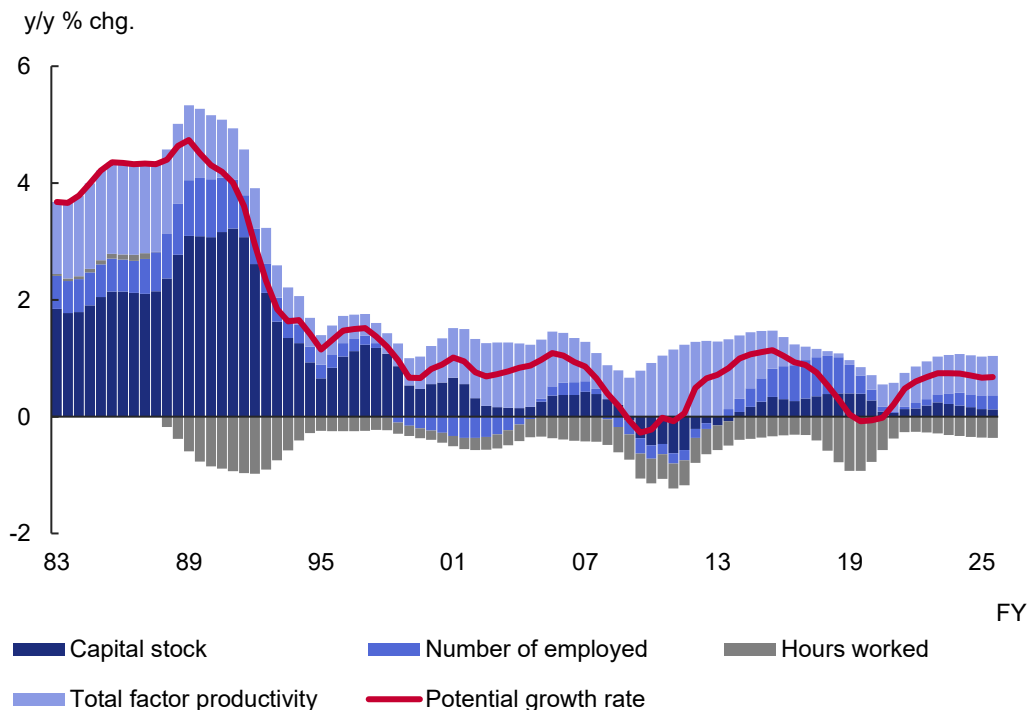
The Takaichi administration aims to raise the potential growth rate

According to BoJ's estimates, the potential growth rate turned positive in the first half of FY 2021 and is projected to be +0.68% year-on-year as of Q4 2025 (Figure 2). The breakdown shows that labor input contributed -0.12% (number of employed +0.25%, hours worked -0.36%), capital stock contributed +0.12%, and total factor productivity contributed +0.67%. The contribution from capital stock is smaller than during the bubble era around 1990, when the potential growth rate was elevated.

Prime Minister Takaichi has pointed to insufficient capital investment, specifically insufficient domestic investment, as the reason why Japan's potential growth rate lags that of other major developed economies. It is also said that a weak capital stock (a lack of resources available for export) is one of the factors limiting the extent to which the recent yen depreciation has translated into an increase in export volumes.

To address this situation, the Takaichi administration has adopted a policy focusing on promoting domestic investment. While it has long been argued that Japan's potential growth rate is likely to decline due to the projected shrinkage of the working-age population, there is a strong possibility that an increase in capital investment, including investments aimed at improving efficiency, and the resulting rise in productivity could boost the potential growth rate.

Figure 2: Potential Growth Rate (BoJ estimates)



Source: INDB, Asset Management One Co., Ltd.

Note: 1. Semi-annual data from the first half of FY 1983 to the second half of FY 2025

2. Figures for the second half of FY 2025 are those for Q4 2025

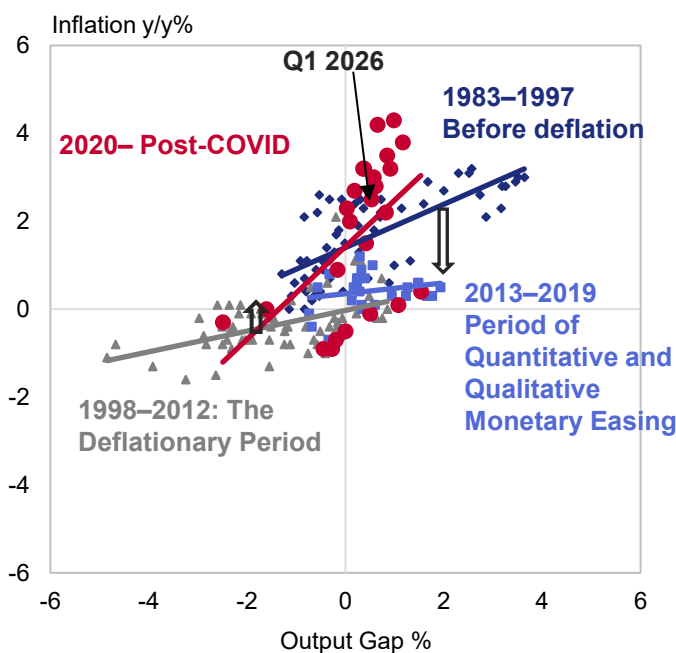
Underlying Inflation Trends

To assess the level and persistence of underlying inflation, we examine (1) the Phillips curve (Figure 3) and (2) service prices (Figure 4).

According to the BoJ's estimates, the output gap turned positive in Q1 2022 and stood at +0.65% in Q4 2025. During the deflationary period, the Phillips curve, which illustrates the relationship between the inflation rate and the output gap, became nearly horizontal, while the impact of the output gap on inflation became negligible. However, since 2020, the curve has begun to steepen again, and inflation associated with a small positive output gap has been around 2%, broadly consistent with the BoJ's 2% price stability target.

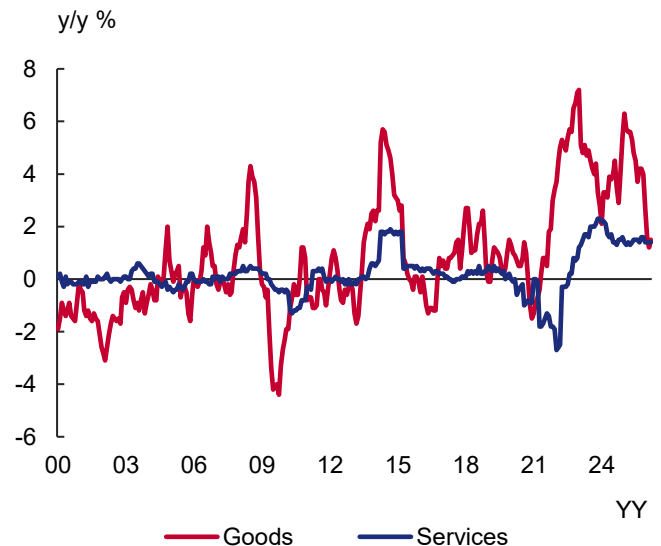
Service prices, which are closely linked to wages (labor costs), have been rising by more than 1% year-on-year since around 2023. Unlike goods prices, which are highly volatile and influenced by factors such as international commodity markets, service prices tend to be more resilient as they reflect wage trends. Consequently, while they had previously remained at nearly 0% year-on-year, reflecting zero base wage increases, they have since risen clearly year-on-year against the backdrop of wage increases.

Figure 3: The Phillips Curve



Source: The Ministry of Internal Affairs and Communications, the Bank of Japan, INDB and Asset Management One Co., Ltd.
 Note: 1. Quarterly data from Q3 1983 to Q1 2026
 2. Output gap is BoJ estimates and is two quarters ahead
 3. The lines in the figure are trend lines
 4. Inflation refers to the consumer price index (excluding fresh food and energy), excluding the impact of factors such as the consumption tax rate hike since 2014

Figure 4: Consumer Prices (Goods and Services)

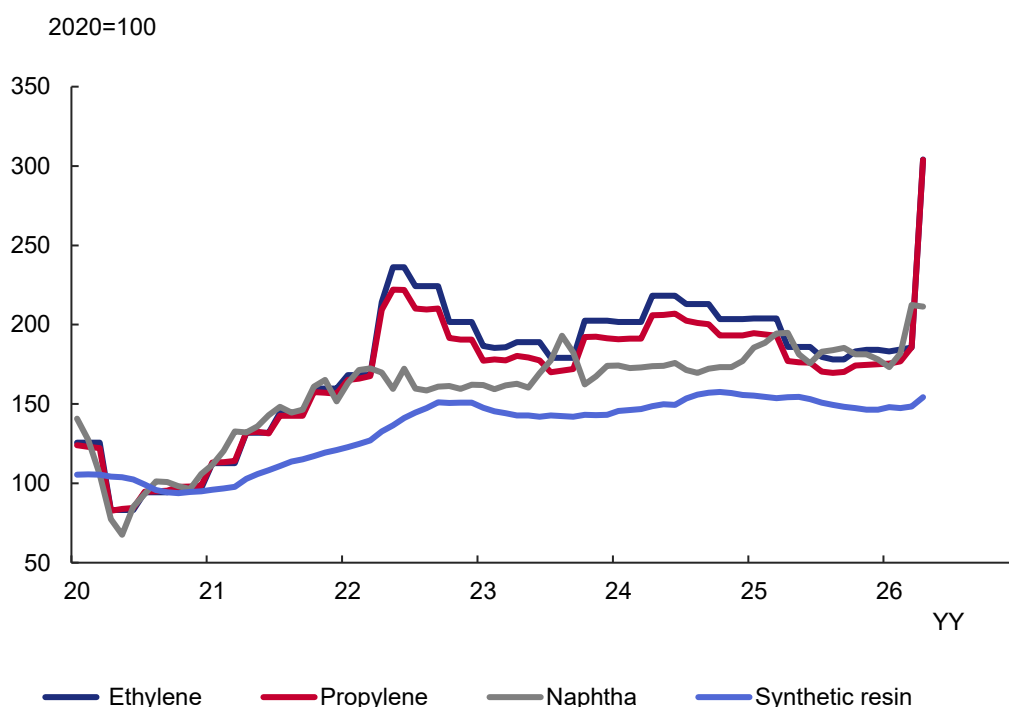


Source: INDB, Asset Management One Co., Ltd.
 Note: 1. Monthly data from January 2000 to March 2026
 2. Include the impact of the consumption tax rate increase

Factors that could push prices higher

Although the current year-on-year consumer price index, excluding fresh food, remains below 2%, the surge in crude oil prices is likely to have a ripple effect in the future. According to the Corporate Goods Price Index (Figure 5), naphtha prices rose 8.5% year-on-year in April, while prices for basic chemicals such as ethylene and propylene rose by 60% to 70% year-on-year. Synthetic resins, which account for 60% of Japan’s demand for petrochemical products (and are processed into items such as PET bottles and food containers), saw only a limited increase in April. However, as companies pass these costs through, it is highly likely that these price increases will eventually trickle down to consumer prices, albeit with a time lag.

Figure 5: Corporate Goods Price Index for Major Petrochemical Products



Source: INDB, Asset Management One Co., Ltd.
Note: Monthly data from January 2020 to April 2026

The BoJ is set to raise interest rates sooner or later

At the BoJ’s Monetary Policy Meeting in April, the central bank decided against raising interest rates but emphasized its vigilance regarding upside risks to inflation, such as second-round effects. Unless there are clear signs of an economic slowdown, such as significant supply chain disruptions, we expect the policy interest rate will be raised sooner or later.

Disclaimer

For this Presentation Material

- This documentation was prepared by Asset Management One Co., Ltd.
- This documentation is required to be used only by the investor to whom it is distributed.
- This documentation is only for the purpose of providing information and is not intended to be used to solicit investments.
- This documentation was prepared using data that Asset Management One Co., Ltd. has judged to be reliable including data from third-party sources. However, Asset Management One Co., Ltd. does not guarantee its completeness or accuracy. Additionally, the published data is only indicative of past performance and does not provide a guarantee of future performance.
- The contents included in this documentation are only current as of the date this documentation was prepared (May 26, 2026) and are subject to change without notice.
- The intellectual property and all other rights pertaining to the data published in this documentation including benchmark indices shall remain the property of the publisher and licensor.