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Fiscal Management at a Crossroads: Part 2

Issues in Japan's Fiscal Situation: Sustainability of coexistence of PB Deficit and Decline in Govt. Debt-to-GDP Ratio

A temporary coexistence observed due to the transition to an inflationary state, but its sustainability is low.

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Summary

- This report, the second in a three-part series titled “Fiscal Management at a Crossroads,” examines the sustainability of the concurrent state recently observed in Japan, where both the national and local primary balance (PB) deficit and the decline in the net debt-to-GDP ratio coexist.
- The key to achieving this coexistence lies in the so-called Domar debt sustainability condition, where the nominal effective interest rate falls below the nominal GDP growth rate. When this condition holds, the net debt-to-GDP ratio can decline even with a PB deficit. This situation has recently emerged primarily because the economy has transitioned from a deflationary/low-inflation state to an inflationary state. However, our calculations indicate that the nominal effective interest rate is expected to continue rising, albeit gradually. Consequently, the Domar condition may cease to hold in the latter half of the 2020s.
- Furthermore, when estimating the impact of inflation on the PB, inflation appears to improve the PB in the short term while having a largely neutral effect in the long term. In the current Japanese economy, the shift to an inflationary state has significantly improved the PB in the near term, but this effect is not expected to last.

- Given the above, it is reasonable to conclude that the net debt-to-GDP ratio has only been temporarily pushed down by the economy's transition into an inflationary state, and its sustainability is low.