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Japan's Economy: Monthly Outlook (Jan 2026)

Medium-Term Outlook for the Economy, Fiscal Policy, Interest Rates, and Exchange Rates for FY2026–2035

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Summary

- We have revised our medium-term outlook for the Japanese economy for the first time in a year. Real GDP growth is projected to average +0.8% annually in FY2026–2035. In the first half of the forecast period, under accommodative fiscal and monetary policies, growth is expected to be driven primarily by private consumption, exports, and capital expenditure, supported by factors such as improvements in household income and steady global economic performance. In the latter half, while accelerating population decline and rising long-term interest rates will weigh on economic growth, consumption growth driven by wage increases is expected to provide support. The CPI inflation rate is projected to be +2.1% annually. The Bank of Japan is expected to gradually raise short-term interest rates to 1.75% by FY2027. Long-term interest rates are projected to rise above 4% toward the end of the forecast period, due to factors including loosening of the supply-demand balance for government bonds. The yen is expected to strengthen against the dollar, reaching the 111 yen/dollar range in the latter half of the forecast period.
- The primary balance (PB) for national and local governments is projected to remain around -2.5% to -1.7% of GDP throughout the forecast period. However, if measures such as consumption tax cuts and increased defense spending are implemented, the PB deficit could widen significantly beyond expectations. Furthermore, the impact of rising long-term interest rates will increase net interest payments. Consequently, the fiscal balance, which was -2.5% of GDP in FY2024, is projected to deteriorate to -6.0% of GDP in FY2035. While the ratio of outstanding public debt and borrowings to GDP will continue to decline until the early 2030s, it is expected to start rising thereafter due to the delayed increase in the nominal effective interest rate and the expansion of the PB deficit.
- The Sanae Takaichi administration plans to set new fiscal targets in Basic Policy on

Economic and Fiscal Management and Reform 2026. It may allow for a deficit in the average primary balance over multiple years or even abolish spending targets. If so, Japan would become the member of the major 20 countries with the weakest fiscal discipline, focusing solely on the debt-to-GDP ratio as its target. Managing the debt-to-GDP ratio, which is susceptible to economic conditions and interest rates, is difficult for the government. To prepare for scenarios where potential growth does not accelerate, while also ensuring the ability to smoothly expand fiscal spending during major disasters or economic crises, the government should continue to adhere to its primary balance surplus target. Furthermore, if the government were to abandon the primary balance surplus target, it would need to establish a mechanism, drawing on the practices of other major countries, to ensure the effectiveness of fiscal consolidation.