

Is Japan's Fiscal Trajectory Reaching an Inflection Point?

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Recently, Japan's long-term bond yields have climbed to their highest levels in decades. With sovereign debt levels already high, this development has raised attention about its fiscal profile.

Japan's fiscal challenges are not recent. Japan remains an outlier in sovereign debt dynamics, with its gross general government debt levels at ~236% of GDP in 2024, making it one of the highest among advanced economies. Certain supportive conditions have allowed the country to manage its high debt levels thus far. These conditions include ultra-low accommodative policy that kept the borrowing costs low and a reliance on domestic borrowings. Most of the government's debt is held by the central bank, which has kept the refinancing risks low, thus, sustaining the current debt levels.

However, Japan is currently undergoing a significant shift in its economic and fiscal policy landscape. The economy has exited its deflationary phase, with inflation returning and remaining persistently above target. In response, the central bank, Bank of Japan (BoJ) has ended its decades-long zero-interest-rate policy (ZIRP) and has gradually increased the policy rate to 0.5% in early 2025. Although this reflation has been a long-standing policy objective, the rise in prices and their stickiness have kept real incomes compressed, affecting private consumption and, consequently, economic growth. Additionally, external pressures, including risks from global tariffs, have contributed to uneven economic development.

To counter these risks, the current administration is adopting an expansionary fiscal policy stance. Meanwhile, the recently announced fiscal stimulus (~3.5% of GDP, one of the largest since the pandemic) could boost near-term growth prospects but has also raised concerns about fiscal slippage. Consequently, markets are reassessing the risks associated with Japan's fiscal trajectory, driving long-term government bond yields to multi-year highs.

With rising yields, the comfort of debt affordability provided by ultra-low borrowing costs is expected to decline gradually over the medium term. This rise intersects with structurally rigid public finances and macroeconomic headwinds, which could add to medium-term fiscal pressures. We believe that there are offsets available to these fiscal risks, including a robust external position and a deep domestic investor base. Yet the pace of change in policy rates, the fiscal stance, and the growth recovery will eventually determine whether the buffers can absorb the risks.

Despite high debt levels, what has navigated Japan's fiscal trajectory till now?

- Unconventional monetary policy (ZIRP, QE & YCC)
 - Policy mix sustains Japan's debt sustainability aided by
 - *Comfortable debt affordability*
 - *Negative (r-g) dynamics*
 - Reliance on domestic borrowings
- Together, these enabled Japan to become an international creditor

What has changed now?

- The enabling factors which have protected the economy for long are taking a pivotal shift now

What are the implications?

- Risk of reversal of the benefit of debt affordability
- Weakening of carry trade position

Are there buffers to offset these consequences?

- Structurally, Japan's public sector maintains robust balance sheet that supports its external position
- Japan's reducing, yet still-negative interest-growth differential (r-g)

The pace of the change will determine the adequacy of buffers.

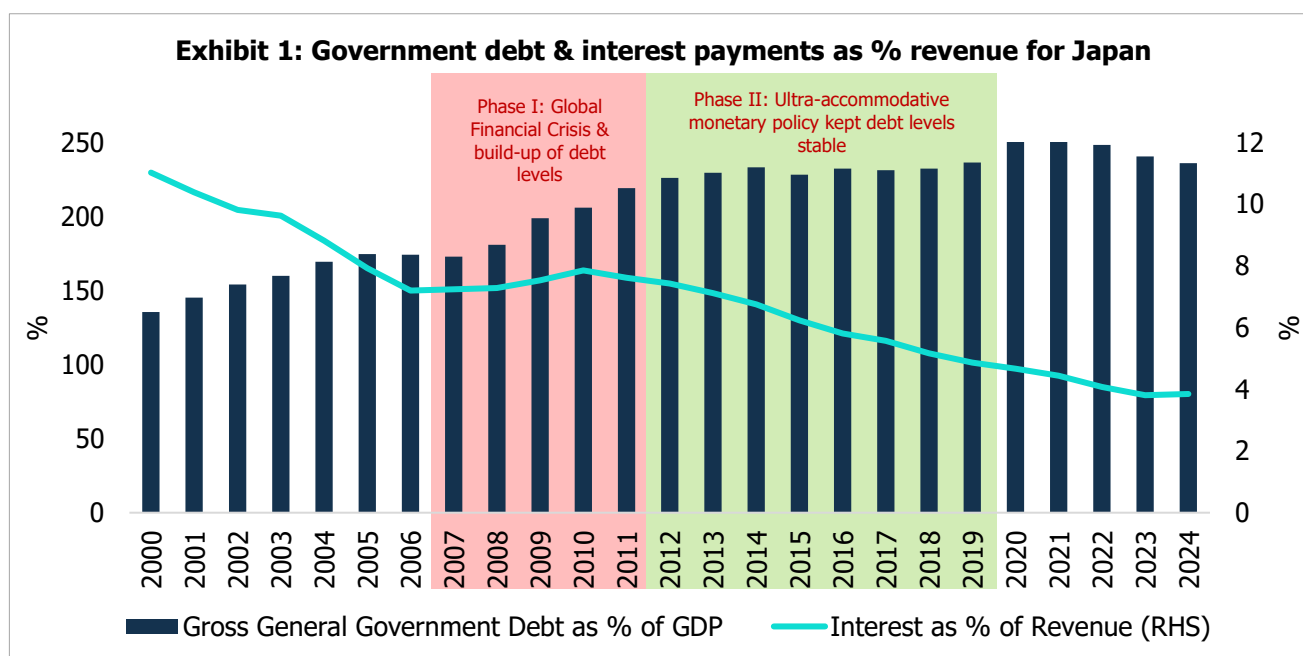
Despite high debt levels, what has navigated Japan's fiscal trajectory so far?

Japan's economic and fiscal path has been shaped by distinct structural factors. For over two decades, the country has faced near-zero real economic growth (averaging around 0.4% from FY2000-24) and persistent low inflation. One of the major challenges for the economy is the unfavourable demographic shift. The rapid ageing of the population, coupled with a shrinking workforce and limited immigration, has significantly restricted labour supply and reduced the economy's productive capacity. This declining labour input and stagnant total factor productivity have weakened Japan's manufacturing competitiveness, limiting the drivers of medium-term growth.

In response, Japan has relied on expansionary fiscal policy as its main stabilisation tool, with high public-funded social expenditures and elaborate subsidy schemes putting pressure on public finances. Moreover, Japan's populist stance has restricted its ability to raise additional revenues. This combination has led to large, recurring fiscal deficits and a steady accumulation of public debt, which has risen from nearly 135% of GDP in FY 2000 to around 236% in FY 2024.

Despite very high public debt levels, Japan's overall fiscal profile has remained sustainable and continues to support its credit profile (**CareEdge AA-/Stable**). This stability is the outcome of a specific combination of fiscal and monetary policy choices that have shaped Japan's debt dynamics over the past two decades.

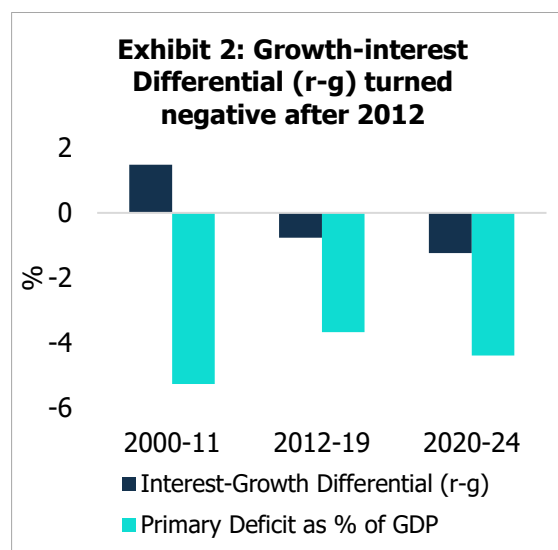
- **Unconventional monetary policy as an enabler:** Japan has relied on an ultra-accommodative monetary policy to support demand and sustain economic activity, as the traditional monetary policy tools remained ineffective. BoJ introduced a series of unconventional measures, including the ZIRP in 1999, Quantitative Easing (QE) in 2001, and Yield Curve Control (YCC) in 2016. These policies aimed to keep interest rates near zero.



Source: IMF, Economic and Social Research Institute, Japan, CEIC

- **Policy mix has sustained Japan's debt sustainability:** Japan's ability to carry very high debt levels without undermining its credit strength rests on two core pillars of debt sustainability:
 - **Comfortable debt affordability:** BoJ's ultra-accommodative monetary policy has maintained extremely low borrowing costs for Japan for over more than two decades. With interest rates anchored close to zero, the government's interest payments as a share of revenue (Exhibit 1) have decreased from nearly 11% in 2000 to 3.8% in 2024, well below levels in most advanced economies.

- **Negative (r-g) dynamics:** Another reason that Japan has been able to manage very high debt levels is the lower interest costs (r) compared to its nominal economic growth (g). As per the debt sustainability framework (IMF), debt remains manageable when the effective interest rate on government borrowing is lower than the rate of nominal GDP growth, i.e., interest-growth differential (r-g) is negative. This negative differential can partly/ fully offset the impact of primary deficits, thus keeping the debt ratio stable. This dynamic has supported Japan's debt trajectory during the FY 2012–19 period. Despite near-stagnant nominal growth, ultra-low interest rates kept (r-g) negative (Exhibit 2), partially offsetting the impact of persistent primary deficits and maintain stable debt levels.



Source: IMF, CGIL Calculations

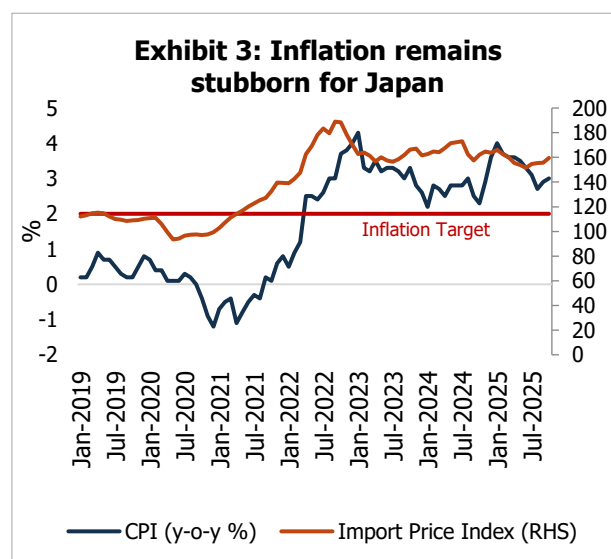
Note: r represents the Effective interest rate calculated as the ratio of interest expenditures to debt

- **Reliance on Domestic Borrowings:** Large-scale purchases of government bonds by the central bank through its YCC policy have further enabled smooth government financing. Nearly 87% of public debt is domestically held, with the BOJ alone accounting for around 45%. In addition, Japan benefits from a deep pool of institutional investors, such as the Government Pension Investment Fund (GPIF), supported by a strong household savings base. The relatively longer maturity profile of government bonds and the stable domestic investor base allowed the government to refinance obligations without facing the volatility associated with foreign-held debt. Moreover, the yen's role as a reserve currency provides an additional layer of stability, reinforcing investor confidence and mitigating refinancing risks.

These factors have enabled Japan to become an international creditor: By maintaining low domestic interest rates for decades, the economy has capitalised on the higher yield differential between Japan and global peers, particularly U.S. Treasury yields. This gap has supported **carry trade dynamics**, where Japanese investors borrow at very low domestic funding costs and invest in higher-yielding foreign assets. Additionally, the Japanese yen has remained stable from 2014-19. This capital export policy has helped build a strong and resilient external asset portfolio, reflected in a net international investment position (NIIP) of around 84.3% of GDP in 2024, one of the highest among peers with similar ratings. Japan is also among the largest holders of U.S. Treasuries and maintains over USD 1 trillion in foreign exchange reserves, providing additional buffer against external shocks.

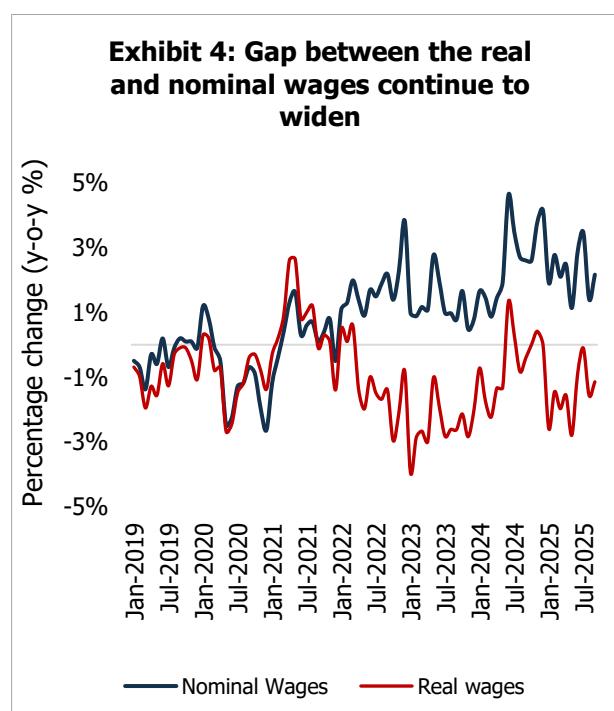
What has changed now? – The enabling factors which have worked well for the fiscal trajectory ...are taking a pivotal shift now:

- The decade-long deflationary trend ended, leading to the reversal of ZIRP:** As advanced economies adopted aggressive monetary tightening since 2021, their relative interest rates with respect to Japan increased. This divergence led to a faster outflow of capital, exerting sustained downward pressure on the Japanese yen (~55% cumulative depreciation from 2021-24). This weaker currency, coupled with global commodity shocks, sharply boosted import prices (Exhibit 3). Consequently, Japan's long-standing deflationary trend reversed. In response to high inflation, the BoJ began normalising its ultra-accommodative policy, raising rates gradually to nearly 0.5% in early 2025 and reducing bond purchases, signalling a cautious shift after decades focused on deflation policy.



Source: Ministry of Internal Affairs & Communications, Japan

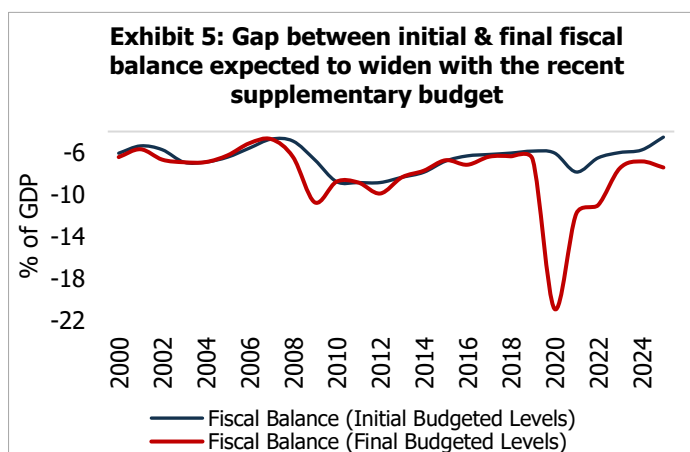
- Despite the policy rate increasing, inflationary pressures remain stubborn:** Japan's inflation dynamics are still mainly driven by cost-push factors. Despite the output gap staying negative (averaging around ~(-)0.9% between Q1 2021 and Q3 2025), price pressures have remained elevated, with inflation at ~3% in October 2025. This disconnect highlights persistently weak demand conditions, and therefore, even after increase in nominal wages, real wages have remained negative (Exhibit 4).



Source: Ministry of Health, Labour & Welfare, Japan

- Prolonged low growth scenario:** These lower wages are feeding into weaker growth outlook, as observed by the contraction of GDP by 1.8% (q-o-q, annualized) in Q3 2025 with the moderation in private demand (-0.3% q-o-q). Meanwhile, higher producer costs have kept business sentiment subdued. On the external side, emerging domestic supply constraints are aligning with rising global protectionism and trade tensions, adding more obstacles to Japan's export performance and overall growth trajectory.

- New government's policy stance towards fiscal expansion:** The current administration in Japan is running with a weaker majority and therefore, has shifted towards populist measures. The Takaichi Cabinet's recent approval of a USD136 bn (3.5% of GDP) stimulus package, including a USD113.2 bn supplementary budget, is the largest since the pandemic. While these policies are expected to improve growth in the near term moderately, this stance is likely to delay fiscal consolidation efforts.



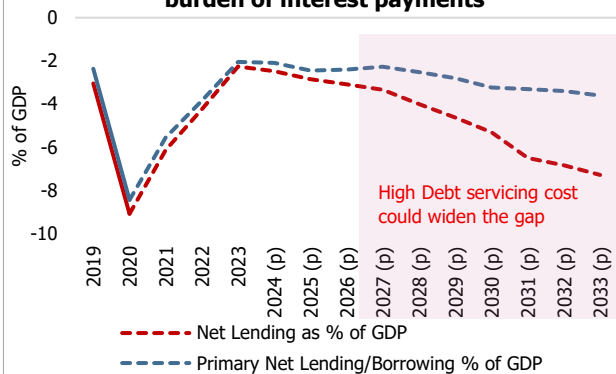
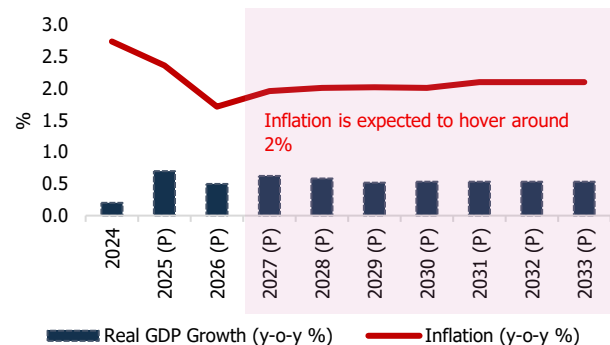
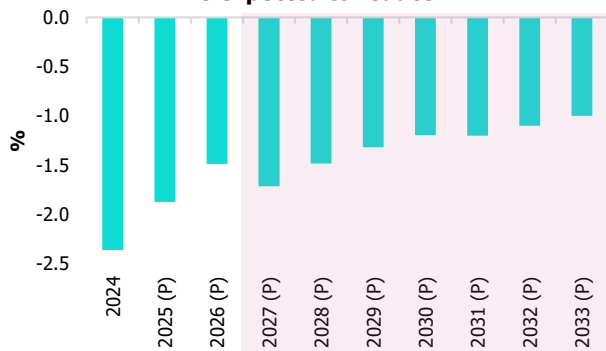
Source: Ministry of Finance, Japan; Note: (P) includes initial planned budget passed in March 2025 & Final budget includes the additional supplementary budget recently passed

Confluence of these factors has led to a rise in Japan's long-term yields to an all-time high (~1.7% in Nov 2025, from nearly zero before the pandemic). This shift signals that markets are repricing the risks related to Japan's debt situation and its ability to sustain its previous model of low-cost debt financing. This has intensified pressure on the yen. Further, abrupt shifts in global financial conditions, contributing to the pronounced increase in currency fluctuations in recent years.

What are the implications?

- It can reverse the benefit of Debt affordability:** Once these higher yields translate into higher borrowing costs, it can reverse the benefits of debt affordability. For instance, even an average increase in effective interest rate of 0.1 percentage point every year, could increase the interest burden significantly in the medium term. The resulting widening gap between the primary balance and overall fiscal balance reflects the higher interest burden, as shown Exhibit 6.

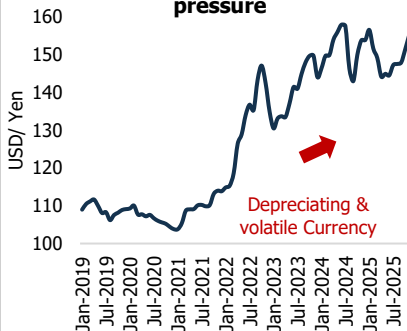
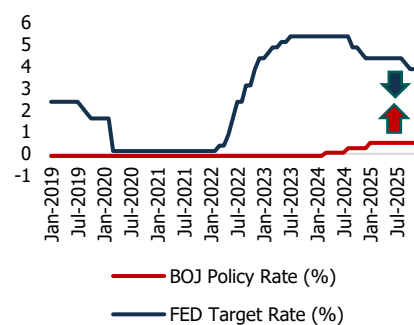
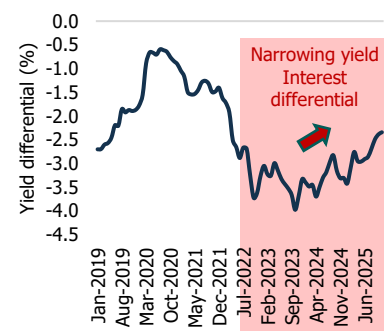
Consequently, the fiscal outlook is projected to turn less favourable, as Japan's fiscal rigidities are here to stay. The rising burden of public expenditure and a relatively populist policy stance are likely to further widen the fiscal balance (~6% of GDP). This could be compounded by continued low growth (Exhibit 7), which could test the interest-growth ($r-g$) dynamics. The narrowing of this differential (Exhibit 8) could occur at a relatively faster pace, thereby reducing the buffers. Should this materialize, debt ratios are expected to rise beyond 2029 (Exhibit 9).

Exhibit 6: Widening deficit with higher burden of interest payments

Exhibit 7: Growth momentum expected to be moderate

Exhibit 8: Interest-Growth (r-g) differential is expected to reduce

Exhibit 9: Debt Levels are expected to rise after 2029


Source: IMF, CGIL Calculations

Note: Projections are derived from Article IV, IMF, April 2025; Interest represents effective yield calculated as the ratio of interest expenditures to debt

- Carry trade position can weaken:** The reversal of the ZIRP and rising yields, along with volatile currency (Exhibit 10), could weaken Japan's carry trade mechanism (borrowing cheaply in Japan to invest in higher-yielding assets abroad). The BoJ continues to hold a hawkish stance, diverging from the recent dovish bias of other leading economies, including the United States (Exhibit 11). A narrower interest rate differential between Japan and the U.S. (Exhibit 12) can therefore challenge its carry trade position.

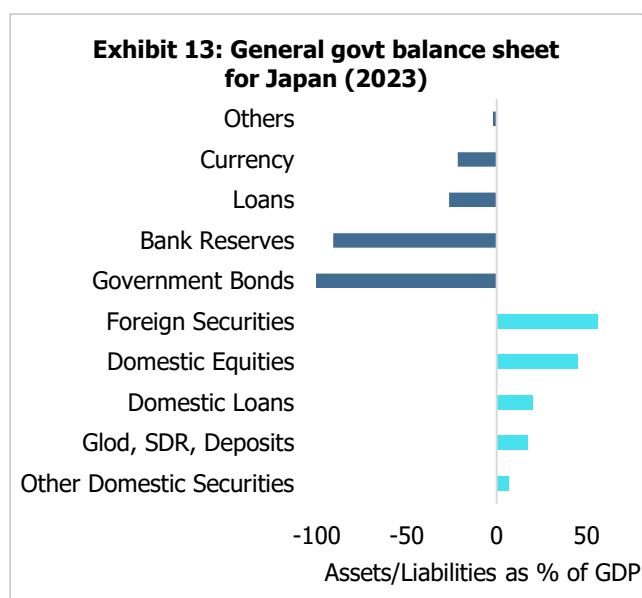
Exhibit 10: Yen has remained volatile with high depreciating pressure

Exhibit 11: BOJ & FED policy direction

Exhibit 12: Yield differential between US & Japan


Source: Bank of Japan, FED, CGIL Calculations; Note: Yield Differential represents the gap between 10-year yields for US & Japan

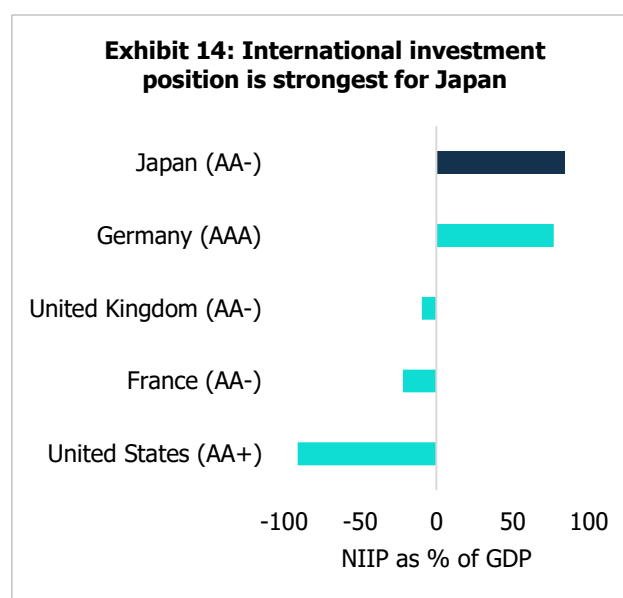
Are there buffers to offset these consequences?

Yes, in the form of a robust public sector balance sheet, a strong external position and a still negative growth interest differential.

- **Structurally, Japan's public sector maintains a robust balance sheet.** The exceptionally low borrowing costs have enabled the public sector to expand its balance sheet by investing in a wide array of assets, including domestic equities, foreign bonds, and overseas equities. These investments are now reflected in Japan's public sector balance sheet (Exhibit 13), where government and BoJ holdings together exceed 100% of GDP in financial assets.
- Japan's rising fiscal risks are also counterbalanced by its **strong external position** (Exhibit 14). Japan's extensive asset base, spanning highly liquid foreign exchange reserves and government deposits, semi-liquid pools provide buffers that can limit liabilities from translating into solvency concerns.



Source: Ministry of Finance, Japan, CEIC



Source: CEIC; Note: () represents Ratings provided by CGIL

- Japan's **still-negative interest-growth differential (r-g)** is expected to partially offset the negative primary deficit, thus could support the fiscal profile in the near term. While there is a shift away from accommodative policies, the recent pick-up in inflation has kept the effective nominal interest rate below the pace of nominal GDP growth. These dynamics could help manage the risks to the debt-to-GDP ratio in the near term.

The pace of the change in fiscal stance, interest rate trajectory and nominal growth will determine the adequacy of buffers. Weaker than expected outcomes on these fronts, could make the buffers inadequate:

- **Japan's policy stance of high public spending and welfarism could restrict fiscal discipline.** A rising stance for populist measures is expected to shift fiscal priorities further away from consolidation. This environment raises the likelihood of policy trade-offs, such as delayed tax hikes, expanded social transfers, or prolonged stimulus measures. It could compound the long-term burden on public finances.
- **Japan's long-term yields continue to have an upward bias,** due to the risks associated with the macroeconomic and political environment. In the near term, we believe the BOJ faces the divergent challenges of persistently high inflation and weak domestic consumption, thereby limiting its policy flexibility.
- **Prolonged weakness in nominal growth:** Should the yields on Japan's sovereign bonds continue to rise, at a faster pace than expected, it could push the debt trajectory into a non-linear path of increase and cause long-term adverse implications on Japan's fiscal profile. The risks could increase further should the nominal growth rate remain low due to a prolonged period of weaker real growth. Such a scenario would turn the interest-growth differential unfavorable and potentially increase debt levels in medium-long term.

Conclusion

With recent shifts in Japan's macroeconomic and policy direction, we see a clear market repricing underway, reflected in rising yields and adverse long-term implications for an otherwise comfortable debt affordability position, as well as a reversal of the carry-trade advantage. While several buffers continue to support Japan's credit profile, including a robust public-sector balance sheet, a strong external position that offsets elevated fiscal risks, and a still-negative interest-growth differential ($r-g$) that helps absorb persistent primary deficits, the durability of these strengths will depend on the pace of fiscal adjustment, trajectory of interest rates and nominal growth trend. The convergence of multiple risks, including high debt levels, rising interest expenses, limited fiscal flexibility, and potential compression of external income, could reduce buffers to Japan's credit profile over the medium term.

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