

Executive Summary

Theme: Beyond ultra-low interest rates – Japan's next economic chapter amid external uncertainty and high public debt

1. Japan's economy is transitioning toward a more domestically driven growth model, underpinned by strengthening private investment and consumption. Following a slight contraction in 2024, growth momentum has firmed, with business investment emerging as a key driver. Private consumption has begun to recover on the back of higher wages amid lingering cost-of-living pressures. AMRO projects GDP growth to strengthen to 1.2 percent in 2025, before easing to 0.8 percent in 2026, as the initial boost from export frontloading fades and the full-year impact of tariffs weighs on external demand. With external uncertainty going forward, growth will rely on private investment and consumption supported by positive business sentiment and rising real wages.

2. Japan's inflation momentum has strengthened, reflecting a more entrenched wage–price cycle supported by tight labor market conditions and rising inflation expectations. While the spike in inflation in 2025 was driven largely by transitory food-related supply shocks and high import costs amid a weak yen, underlying price pressures have become more broad-based, with the core-core CPI staying above 3.0 percent for much of 2025 even as headline measures eased. Medium-term inflation expectations have continued to rise, suggesting that firms and households are moving steadily towards a positive inflation environment. High nominal wage growth amid a tight labor market and government support is expected to persist into 2026, although real wages have so far remained negative as inflation has outpaced nominal earnings. Looking ahead, CPI (excluding fresh food) inflation is expected to remain elevated at 3.0 percent in 2025 and moderate to 2.2 percent in 2026, as government measures ease cost-of-living pressures, although firm wage growth continues to exert upward pressure on inflation.

3. Japan continues to run a sizable current account surplus supported by a large primary income surplus. Following the unwinding of frontloading ahead of US tariffs, export performance has softened, although the goods trade balance remained broadly stable as import growth also moderated. The current account surplus continues to be underpinned by the large and rising primary income surplus from Japanese direct investment abroad, which reached 5.1 percent of GDP in Q1–Q3 2025, up from 4.5 percent of GDP at end-2024. Looking ahead, the current account surplus is projected to remain elevated at about 4.7 percent of GDP in both 2025 and 2026, supported by strong primary income receipts.

4. Japan's monetary policy is entering a “new normal” of higher interest rates, marked by a gradual normalization following the exit from negative interest rates and yield-curve control in 2024. The policy rate has been raised to around 0.75 percent in December 2025, its fourth hike in the current cycle. Alongside these rate moves, the BOJ has continued to taper its Japanese Government Bond (JGB) purchases. The BOJ has also taken another incremental step toward balance sheet normalization by announcing plans to sell its holdings of exchanged-traded funds (ETFs) and real estate investment trusts (J-REITs). Short-term market rates and lending rates have risen broadly in line with the policy rate, though deposit rate pass-through remains more gradual.

5. The banking sector has shown improved performance during the gradual interest rate upcycle. Banks significantly improved their earnings in March 2025, supported by strong net interest income following the rise in interest rates. Meanwhile, non-performing loan

(NPL) ratios have continued to improve as economic momentum gathered strength. Banks have maintained adequate capital and liquidity buffers.

6. The fiscal deficit is projected to stabilize in FY2025, though increased spending pressures are expected to push the fiscal deficit higher in the future. AMRO projects the general government fiscal deficit at about 1.7 percent of GDP in FY2025, broadly unchanged from FY2024, with the projection reflecting economic measures announced in November 2025. It is anticipated that fiscal policy will turn expansionary from FY2026 with the launch of the government's comprehensive growth strategy. Public debt remains high but is easing from 227 percent of GDP in FY2024 to around 221 percent in FY2025.

7. Risks to Japan's growth outlook are tilted to the downside, driven mainly by external uncertainties in the short term. Despite the US–Japan trade agreement in July 2025, uncertainties over its implementation continue to cloud the outlook. Other external risks include a sharper global slowdown, renewed commodity price shocks, and tighter or more volatile global financial conditions. Meanwhile, Japan's high public debt and rising interest rates could pose fiscal risks. Over the longer term, demographic headwinds and climate-transition needs could further strain public finances and growth potential.

8. Proactive credit and interest rate risk assessment should be encouraged, at the same time, property price increases warrant close monitoring. Banks should deepen their interest rate risk management, especially for longer-tenor yen exposures. Close monitoring of foreign-currency funding positions and currency mismatches remains essential. The continued increase in property prices, particularly in the major metropolitan areas, warrants close monitoring. Information sharing and close coordination among relevant agencies would provide a strong foundation for formulating macroprudential and property-related policies, should the need arise.

9. Monetary policy normalization should proceed at a measured pace and remain data-driven, balancing inflation and growth risks. With a positive output gap, elevated headline inflation, and gradual increases in underlying inflation and inflation expectations, BOJ should continue to reduce the degree of monetary accommodation through gradual upward adjustments of the policy rate. Durable wage-price dynamics, the impact of US tariffs, and core inflation trends should guide the pace of further hikes. The ongoing tapering of government bond purchases, along with the announced plans to sell ETFs and J-REITs, should emphasize predictability, effective communication, and operational agility.

10. Fiscal policy should remain committed to addressing near-term risks, pursuing growth-friendly consolidation and tackling structural challenges. In the near-term, fiscal policy should be agile and targeted, supporting vulnerable groups while preserving fiscal discipline. Over the medium-term, consolidation efforts on revenue mobilization and expenditure rationalization should continue. In the long run, fiscal policy must address aging-related spending pressures as well as strengthen climate transition and growth-enhancing structural reforms. Debt consolidation can help contain debt repayment ratios through lower risk premia.

11. Structural reforms should be implemented with greater urgency to enhance growth potential. Structural reforms to raise productivity, foster innovation, and accelerate digital and green transformation are vital. Continued efforts to enhance labor-market flexibility and skills upgrading will help lift potential growth and strengthen Japan's resilience.