JAPAN

2026, A YEAR OF CHALLENGES

The Japanese economy is caught between a rock and a hard place. Growth has begun to slow towards its potential level. Japan can boast full employment, a buoyant corporate sector and a reduction in its debt-to-GDP ratio. At the same time, inflation repeatedly overshoots the 2% target and real wages are declining, which negatively impacts consumption. US trade policy remains a risk factor, and ongoing structural issues related to weak domestic demand and limited supply in the labour market persist. Finally, long-term interest rates are rising steeply, partly due to expansionary fiscal policy, while the currency continues to depreciate. Faced with this dilemma, the central bank is expected to maintain a gradual rate-hiking approach until it achieves a terminal rate of +1.5% by mid-2027.

GROWTH RETURNING TO POTENTIAL IN 2026-2027

Japanese GDP growth is gradually returning to balance. The contraction in Q3 2025 (-0.6% q/q) interrupted a five-quarter period of growth (including +0.5% q/q in Q2). The underlying momentum in the last quarter is therefore more nuanced, with the overall result being dragged down by a correction in exports (see below) and a decline in business investment (-0.2% q/q, after solid progress in H1), as well as a significant drop in residential investment (-8.2% q/q) against a backdrop of regulatory changes (e.g. compliance of new buildings with energy efficiency standards). At the same time, public investment momentum remained negative, in contrast to public consumption.

Looking ahead, GDP growth is projected to be +0.2% q/q per quarter over the forecast period (ending in 2027). This is close to its potential level (estimated to be between +0.1% and +0.2%), i.e. an annual growth rate of 0.7% - 0.8%. The Takaichi government's fiscal stance (see 'A decline in the debt-to-GDP ratio that is likely to fade') should support growth. However, this support may not be sufficient to offset the impact of declining purchasing power on household consumption, while rising interest rates and foreign trade will also weigh on growth.

The business conditions, as indicated by the Tankan survey, reflect a recovery from a tariff shock that had less impact than initially feared: the national result has been stable (15) since Q1, and sentiment has improved over the course of the year (14 in Q3, +2 points year-to-date) for large manufacturing companies. The non-manufacturing sector continues to perform strongly (21, compared with an average of 11 from 2014 to 2019). On the other hand, negative trends in real wages are affecting household confidence: at 35.8 in October 2025, it has improved from its low of 31.2 in April but remains below its annual performance in 2024 (37.2) according to the Cabinet Office, penalised by the components 'overall likelihood' and, above all, the 'willingness to buy durable goods'.

THE POLICY MIX IS NOT HELPING TO REDUCE INFLATION

Core inflation (excluding fresh food) has been above 2% y/y since April 2022 and, according to our forecasts, will not return to its target before 2028 at the earliest – with the exception of a dip in Q2 2026 (to +1.9% y/y) due to energy support measures, before rising again. The increase in prices is the result of both imported inflation against a backdrop of a depreciating yen (USD/JPY around 100 at the beginning of 2021, now above 150) and the food component. Headline inflation is following similar patterns. The policy mix is contributing to the ongoing inflation, which is likely to continue with the adoption of a more expansionary fiscal policy in a context of full employment of production factors. Meanwhile, the central bank's interest rate hikes have been limited so far, maintaining an accommodative stance and reinforcing the perception of a 'behind the curve' monetary policy. Finally, market inflation expectations, as indicated by the 10-year breakeven inflation rate, are at an historic high of +1.6%.

GROWTH AND INFLATION (YEARLY AVERAGE)

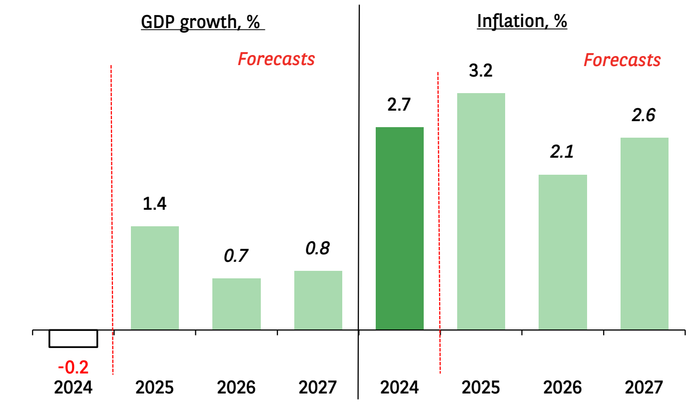

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

FULL EMPLOYMENT WITHOUT REAL WAGE GROWTH

The labour market is constrained by labour shortages, as illustrated by the Tankan index of factor utilisation hitting an historic low in Q4 2025. At the same time, the total number of hours worked continues to decrease (-1.2% y/y in Q1-Q3 2025). The unemployment rate remained low, at 2.6% in October, despite a slight rise (+0.3 pp in 2025 to date). Growth in scheduled contractual wages has averaged +2.0% y/y so far in 2025, a trend that is expected to continue in 2026. The Rengo trade union confederation has set the same target as last year for its annual negotiations, suggesting that current growth standards will be maintained for the coming year. However, this increase is inadequate in light of inflation: the real wage index has contracted by -1.5% y/y on average in 2025 to date (Chart 1), and the outlook for inflation remains unfavourable in this regard.

THE BANK OF JAPAN TO RESUME MONETARY ADJUSTMENT

Since 2024, the Bank of Japan (BoJ) has been carefully and gradually raising the key interest rate while 'adjusting the degree of monetary accommodation'. The upcoming meeting on December 18-19 is expected to result in a rate hike (+25bp), marking the first since January 2025, which will bring the policy rate to 0.75%. This adjusting process is expected to continue, albeit at a slow pace, with a 25bp increase every six months over the next 18 months, ultimately reaching a terminal rate of +1.5% by mid-2027, according to our forecasts. This rate, assuming inflation remains anchored at 2%, corresponds to a neutral monetary policy stance. For the time being, monetary policy therefore remains distinctly accommodative in real terms (around

2pp below neutrality). At the same time, since Q3 2024, the BoJ has been engaged in a process of reducing its purchases of Japanese Government Bonds (JGBs), with the monthly pace set to fall from an initial JPY 5.7 trn to JPY 2.1 trn by April 2027, in order to begin reducing the size of its balance sheet.

A DECLINE IN THE PUBLIC DEBT RATIO THAT IS LIKELY TO FADE

The appointment of S. Takaichi as Prime Minister, leading a minority cabinet (231/465 seats in the House of Representatives for the LDP/Ishin coalition), takes place within a specific context. Sovereign interest rates are rising sharply, resulting in a pronounced steepening of the yield curve: as of 8 December, 10-year and 30-year rates of +1.97% and +3.39% in 2025 had risen by 87 basis points (bp) and 101 bp respectively since the beginning of the year. This trend is associated with ongoing primary deficits, which are subject to upside risks, both structural (ageing population, defence needs) and cyclical (divided Parliament, inflation). Added to this is a monetary policy that is absorbing less JGB supply and appears to be responding too slowly to persistent inflation. These factors support our central scenario of a sustained increase in long-term yields, projected at +2.1% (10-year) and +3.5% (30-year) by the end of 2026 (Chart 2).

In light of these circumstances, the newly appointed Prime Minister, who boasts an approval rating of almost 70%, is determined to implement further fiscal support. An initial stimulus package, valued at JPY 21.3 trn (3.8% of GDP), has been adopted to support households amid inflationary pressures and to foster economic growth. The plan is divided between direct and indirect financial support for households, public investment and tax cuts. Half of this funding will be sourced from new bond issues. It is anticipated that supplementary budgets will be recurrent in the future, with Japan projected to maintain primary deficits of -2.4% in 2026 and -2.5% in 2027, exacerbated by an increasing interest burden that will contribute to a further deterioration in the total budget deficit (3.2% in 2026 and 3.7% in 2027, according to our forecasts). At the same time, the public debt ratio continues to decline, due to nominal GDP growth outpacing the apparent cost of debt (the 'r-g' effect), decreasing from 258% to 228% of GDP between 2020 and 2025 (according to our estimates). It is expected to reach 222% in 2027, prior to the disappearance of the favourable short-term differential between r and g.

FOREIGN TRADE FACING HEADWINDS

Net exports negatively impacted Q3 growth, with a reduction in imports (-0.4% q/q) failing to sufficiently offset the decline in exports (-1.2% q/q). However, 2025 should see a return to growth in goods exports after two years of contraction, helped by a frontloading effect in H1 (+4.1% y/y), before experiencing a partial correction from Q3 onwards. Looking ahead, 2026 may see a backlash due to the full effect of the US tariff shock, while the index of exports to the United States reached its lowest level since 2022 in Q3. However, this situation is likely to improve as economic agents adjust to the new conditions. At the same time, export growth to the European Union is picking up again after a year of contraction in 2024.

Growth in service exports is slowing, registering only +4.0% y/y in Q3 2025, after being a significant driver of growth in 2023 and 2024, where it recorded +28.1% and +12.3% respectively on an annual average. At the same time, imports of services, bolstered by digital technology, are growing at a robust and sustained pace. Exports may benefit from the depreciation of the yen, which has been ongoing since April 2025, with the USD/JPY exchange rate increasing from around 143 to 156. The JPY is expected to remain weak throughout 2026, potentially reaching 160 JPY per USD by the end of that year. Finally, in Q3 2025, the current account balance stood at 5.1% of GDP, well above the 2024 average of 4.5%, helped by the improvement in the current account balance, which was 5.2% of GDP compared with an average of 4.7% in 2024.

JAPAN: REAL WAGES STRUGGLE TO CATCH-UP

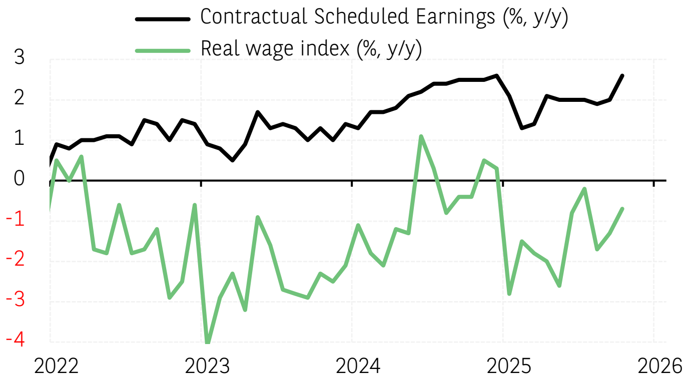

CHART 2 SOURCE: JAPANESE MINISTRY OF LABOUR, BNP PARIBAS

JAPAN: PRESSURE ON JGB'S LONG-TERM YIELDS (%)

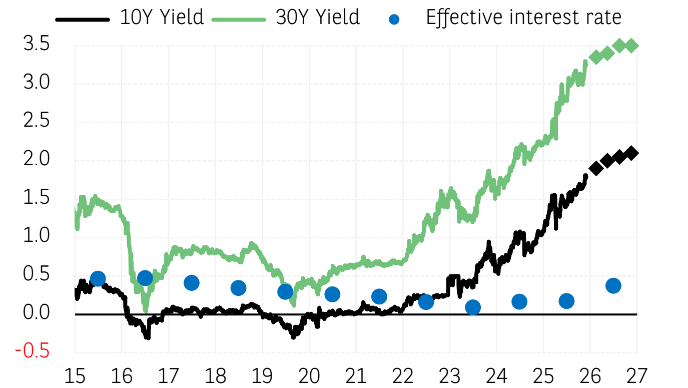

CHART 3 SOURCE: MACROBOND, BNP PARIBAS (FORECASTS, CALCULATIONS)

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