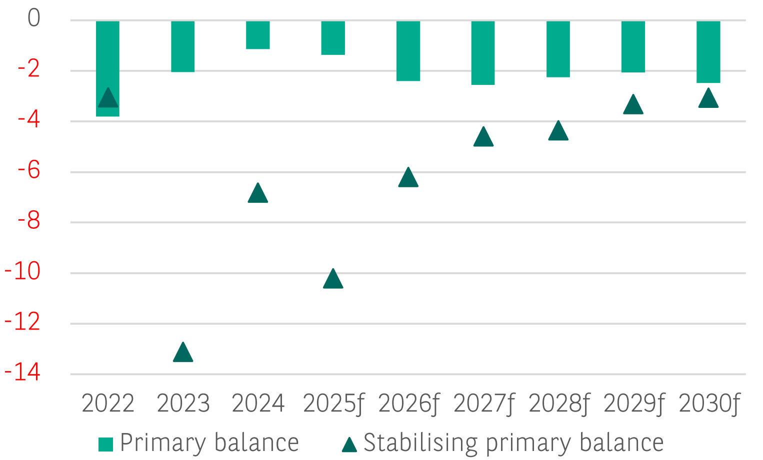
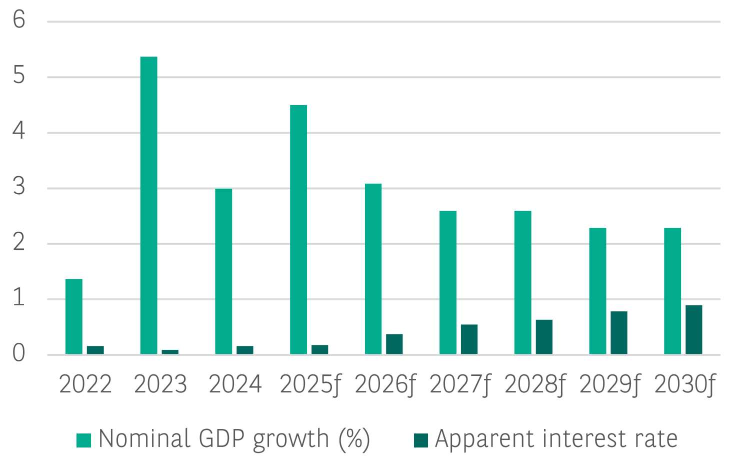
JAPAN: Decline in debt ratio based on fragile foundations (1)

Primary balance (% GDP)



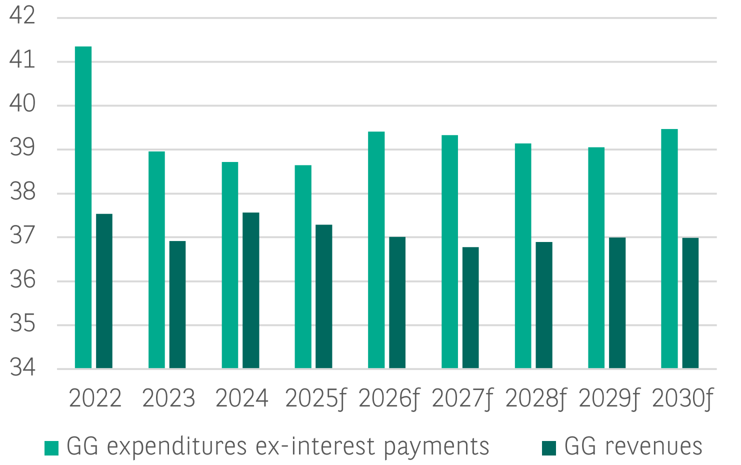
f: forecasts *Source: BNP Paribas*

Apparent interest rate vs. nominal growth (%)



f: forecasts *Source: BNP Paribas*

Revenue and expenditure trends (% of GDP)



f: forecasts *Source: BNP Paribas*

Japan's primary deficit is expected to narrow in 2025 but is likely to increase again to around 2% of GDP in the coming years due to upward pressure on public spending.

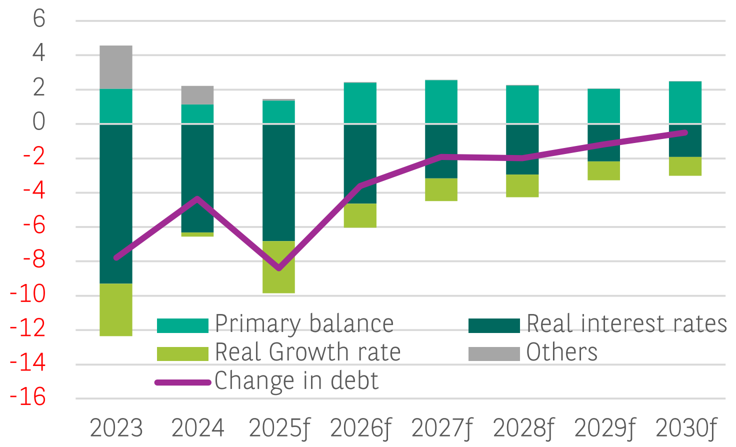
These deficit levels would not prevent, at least in the short term, a reduction in public debt enabled by higher inflation, which will not be offset by higher interest rates in the short term.

The gap between nominal growth and the apparent interest rate is expected to narrow but remain significant. This is the main consequence of the new inflation regime (above 2% y/y since April 2022, compared with an average of 0.1% between 2000 and 2021) and an economy growing at around its potential level (estimated at 0.6% annual). The effect of the recent rise in bond yields will gradually feed through to the apparent rate. Thus, the gap with nominal growth should remain favourable, enabling public debt to decline despite the continued primary deficit.

Japan's primary public expenditure is expected to remain significantly high (above 39% of GDP) compared to its pre-pandemic level (36.5% in 2019), due to the needs associated with an ageing population and defence requirements. It should be supported by the regular passing of supplementary budgets aimed at supporting households against inflation. On the revenue side, we expect revenues to remain stable after the sharp post-pandemic increase driven by higher repatriated profits.

JAPAN: Decline in debt ratio based on fragile foundations (2)

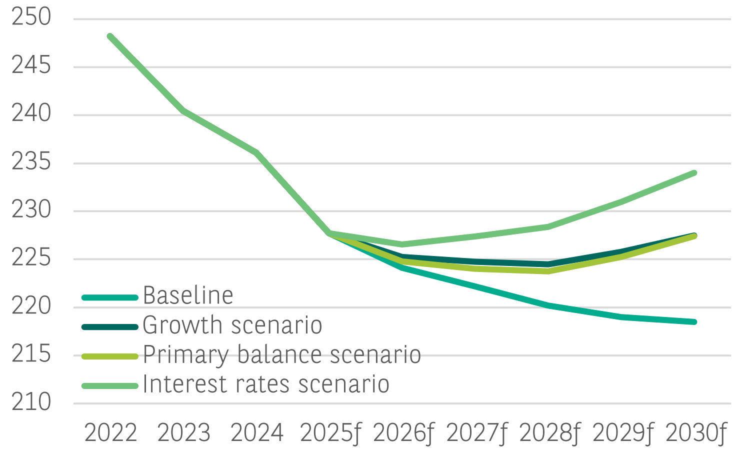
Contributors to the change in the debt ratio (pp)



f: forecasts Source: BNP Paribas

The decline in the public debt-to-GDP ratio is expected to slow, with public debt stabilising at the end of the decade. Initially, the nominal effect linked to inflation (negative real interest rates) will continue, supporting the sustainability of primary deficits. As this effect dissipates, against a backdrop of debt rollover at higher rates coupled with limited growth prospects, the primary deficit will gradually gain more weight in the dynamics of public debt.

Sensitivity of public debt (% of GDP)

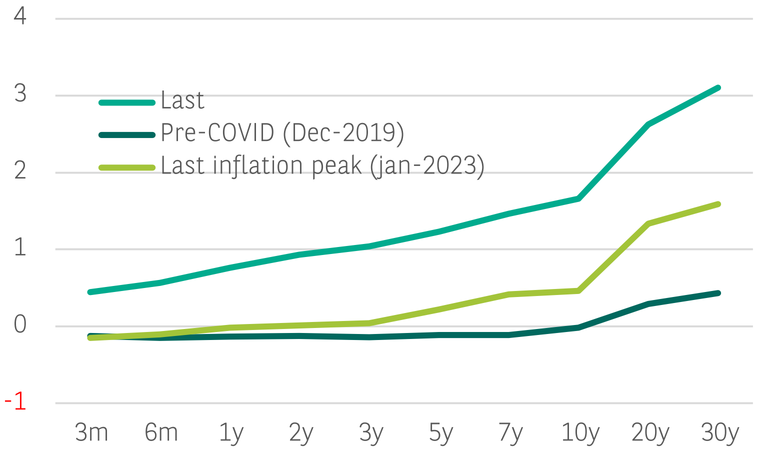


f: forecasts Source: BNP Paribas

Please note: the "growth" and "primary balance" scenarios incorporate a negative shock to growth and to the deficit of 0.5 pp of GDP per year compared to the central scenario, respectively; the "interest rate" scenario incorporates a 1 pp increase in the apparent interest rate.

The alternative scenarios highlight the fragility of Japan's situation, despite the significant decline in the public debt-to-GDP ratio that we anticipate in our central scenario. A more significant interest rate shock would cause the public debt ratio to rebound sharply from 2028 onwards. A more marked deterioration in the primary balance or a deterioration in growth would have a similar impact, preventing any further reduction in public debt beyond 2026.

Yield curve (%)



Note: data are smoothed over one month Source: LSEG, BNP Paribas

Japan now has to contend with significantly higher interest rates. These have risen sharply in recent years due to a combination of factors: post-pandemic inflation, deteriorating public finances and a reduction in the pace of purchases by the Bank of Japan (BoJ). The steepening of the current yield curve on longer maturities reflects growing concerns about the sustainability of Japan's public debt, despite its recent decline.