JAPAN

GROWTH UNDER PRESSURE

There is no longer any doubt that the period of stagnation and deflation is coming to an end. Growth, buoyed by the global AI cycle, is expected to exceed its potential rate (0.6%) once again in 2026 (+1%) and in 2027 (+1.2%). The end of deflation is now confirmed: notwithstanding mitigation through government intervention, inflation is expected to reach 2% in 2026, followed by 2.5% in 2027. A fundamental tension remains between expansionary fiscal policy and the acceleration of monetary tightening, with a terminal rate of 2.5% (above the neutral benchmark) in 2028. These circumstances support an ongoing rise in interest rates.

GROWTH: ABOVE POTENTIAL

Japan's GDP growth is expected to exceed its potential rate (0.6% according to the IMF), reaching 1% in 2026 followed by 1.2% in 2027, according to our forecasts. An expansionary fiscal policy has offset the impact of rising oil prices. This has resulted in a sharp rise in public spending (+1.7% q/q in Q2) and support for household purchasing power (notably through domestic energy subsidies and a cap on petrol prices). At the same time, the global artificial intelligence (AI) cycle is supporting Japan's growth through investment, and is expected to drive it increasingly through exports. Non-residential investment stagnated in H1 (-0.4% followed by -0.9% q/q) following a strong 2025 (+2.7% y/y in Q4). However, the recovery is already underway: capital goods (transport, machinery) rebounded as of Q2. Furthermore, business confidence remains at its highest level since 1991, with large companies revising their investment plans upwards for the 2026 financial year (+11.5% y/y, +8.2 pp according to the Tankan survey). On the household front, however, confidence has fallen from its highest level since 2019 (reached in February) and has only partially recovered since then (39.2, compared with 32.2 in March and 35.5 in August). However, government support for energy and wage growth (*see below*) is acting as a buffer. This prevented consumption from contracting in Q2 2026.

INDUSTRY: EXPANSION FOLLOWING RESILIENCE

Japanese industry has emerged from recession despite tariff and energy shocks. In H1 2026, manufacturing output rose by 1.6% y/y (+0.2% in 2025). This recovery is primarily driven by the AI investment cycle, with Japan benefiting from a privileged position in associated capital goods. Indeed, production growth for machinery and electronic equipment stands at 3.5% y/y (*Chart 2*). The increase in production in the automotive sector (+2.2% y/y, following +1.9% in 2025) is also noteworthy. At the same time, energy-intensive sectors (petroleum products, steel) continue to decline. Furthermore, businesses are reporting increasing capacity and labour constraints. The manufacturing PMI points to an acceleration: the three-month moving average stood at 54.8 in August, compared with 50.1 in January. This trend is being driven by both production and new orders, suggesting that the momentum is set to continue.

External demand linked to investment in AI is expected to become a driver of growth, while the United States and China remain the main destinations for Japanese exports. Foreign trade has been making a positive contribution to growth since the end of 2025 (0.5 pp in Q2 2026) *via* exports of services and a fall in imports of goods. AI is expected to make a greater contribution to this, with a 62% y/y increase in orders for machinery from abroad in H1 2026. In addition to the expected volume effect, there is also an existing price effect. The rise in imports (components) is offset by the rise in exports (finished goods). It therefore does not exacerbate the negative impact on the terms of trade (-10.2% since January 2026) caused by the rebound in energy prices.

Growth and inflation

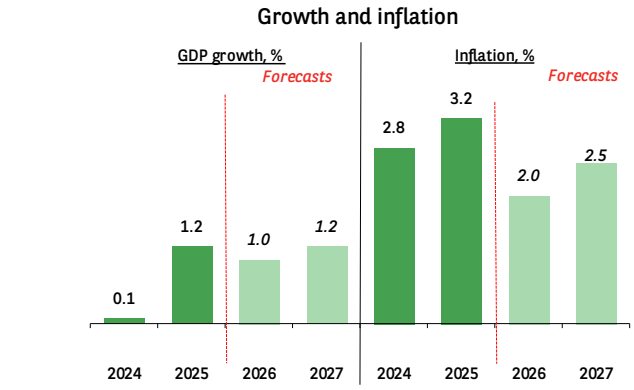


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

AI-related machinery and electronics are the main drivers underpinning the industrial recovery

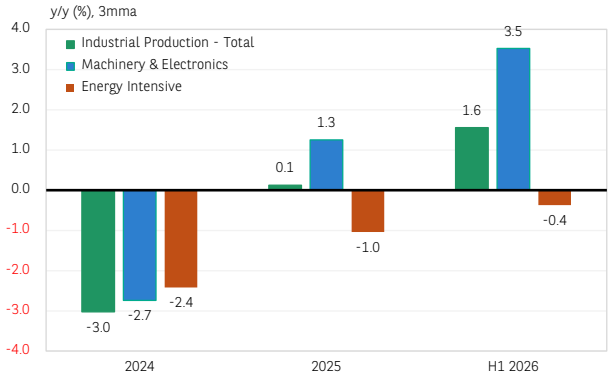


CHART 2 SOURCE: JAPANESE METI, BNP PARIBAS

LABOUR MARKET: WAGE GROWTH IS NOW FIRMLY ESTABLISHED

Nominal wage growth has exceeded 3% y/y since the start of 2026, marking a historic turnaround following decades of decline (an average of -0.3% per annum between 2000 and 2019). At the same time, real wage growth has returned to positive territory thanks to moderating inflation. However, this momentum is expected to come to an end in 2027 as inflation rebounds. The 'wages-prices' mechanism appears to be robust. On the one hand, many businesses are planning to raise

prices (+3.7% over one year according to the Q2 2026 Tankan survey). On the other hand, the recent outcomes of the annual wage negotiations known as 'Shunto' (exceeding 5% since 2023, the highest level in 35 years) reflect an increase in workers' bargaining power. This trend is underpinned by tensions in the labour market: the Tankan diffusion index ('excess employment' minus 'insufficient employment' from the businesses' perspective) remains strongly negative, and the unemployment rate reached 2.4% in July 2026 (down 0.2 pp so far in 2026).

INFLATION: MODERATION IS ONLY SUPERFICIAL

Fiscal policy has led to a recent decline in inflation, which fell to 1.5% y/y in H1 2026, down from 2.8% in H2 2025. The 'energy' component is down (-4.5% y/y) despite the rise in oil prices, due to subsidies aimed at reducing energy costs. However, core inflation (excluding unprocessed food), which excludes institutional factors, stood at +2.4% y/y in H1, compared with +1.6% for the official measure from the Statistics Bureau.

We expect inflation to rebound over the coming quarters, peaking at +3.8% y/y in Q1 2027, as the impact of fiscal support fades and wage-price dynamics take hold. Subsequently, the temporary reduction in the tax on food consumption is expected to lead to a further decline from Q2 2027 onwards. Beyond these fluctuations, inflation expectations have shown a significant and widespread rise since 2022, whether among households, businesses or the markets (*Chart 3*). This reinforces the view that the end of secular deflation is here to stay and shifts the focus to the risk of a sustained deviation above the 2% target.

ACCELERATION IN KEY INTEREST RATE RISES

The Bank of Japan (BoJ) is now focusing on stabilising core inflation around its 2% target in order to counter the risk of a sustained 'upward deviation'. It raised its key interest rate twice in 2026, in June and September, bringing it to 1.25% (its highest level since 1995). We expect two further increases (25bp each) before the end of Q1 2027. This acceleration in the 'adjustment of the degree of monetary accommodation' reflects a paradigm shift. Previously, concerns that tightening too quickly might jeopardise the exit from deflation had prevailed and led to a cautious approach (85bp of cumulative rate rises between 2024 and Q1 2026). We now expect the BoJ to adjust its monetary policy beyond the neutral rate (1.75%–2.0%), with further rate rises from December 2027 and a terminal rate of 2.5% to be reached in 2028. One of the challenges facing the BoJ will be to implement this policy without exacerbating tensions in the bond and foreign exchange markets.

According to our forecasts, the USD/JPY is expected to trend towards 163 by the end of 2026 (155 as of 16 September), and then remain at that level in 2027, as the spread between the Fed's and the BoJ's key interest rates narrows relative to historical levels. Intervention by the authorities – as illustrated by JPY 27,000 bn in transactions in H1 2026 (according to the Ministry of Finance) and the operation carried out jointly with the US Treasury in July – has not brought about a lasting change in the trend. Indeed, so far in 2026, the USD/JPY has averaged 158, its lowest level since 1986.

However, there are upside risks for the yen while the current account balance remains in significant surplus (3.6% of GDP in 2026 according to the IMF). The new interest rate regime could also increase the allocation of capital by domestic investors to Japanese assets and, as a result, boost demand for the yen.

A significant and widespread rise in inflation expectations

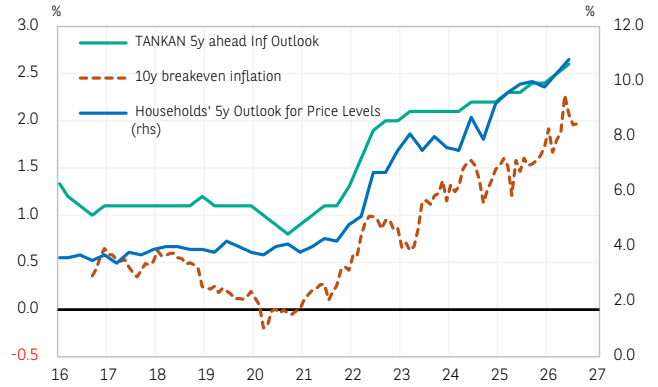


CHART 3

SOURCE: BANK OF JAPAN, MACROBOND

ACCOMMODATIVE FISCAL POLICY AND BOND MARKET TENSIONS

The Takaichi government's fiscal policy is openly expansionary. It is based on two major initiatives:

1/ a two-year reduction, from April 2027, in the tax on food consumption from 8% to 1% (fiscal cost: 0.6% of GDP), aimed at supporting household demand in the short term;

2/ a public-private investment plan totalling over JPY 370,000 bn by 2040 to boost potential growth.

The 'reflationary' nature of the government's policy is evident in its budgetary framework document (Basic Policy), in which the primary deficit takes a back seat. The focus is now on the ratio of public debt to GDP. However, this ratio can improve without any adjustment being required provided that the apparent interest rate is lower than nominal growth ($r < g$), which is currently the case.

According to our estimates, the debt-to-GDP ratio is expected to stand at precisely 203% in 2026 and 199% in 2027, despite a widening of the primary deficit (-1.5% of GDP, then -2.3%, compared with -0.9% in 2025) and the overall deficit (-2.2% of GDP, then -3.4%, compared with -1.1% in 2025).

However, this favourable window of opportunity is expected to close by the end of the decade as the average interest rate paid on public debt (or apparent rate)—which has an average maturity of around 10 years—rises. Against this backdrop of rising expenditure, combined with global pressure on yields and domestic monetary normalisation, long-term rates are expected to continue to rise. The 10-year rate, which has already returned to its 1996 level, is forecast to reach 2.9% by the end of 2026 and 3.25% by the end of 2027. Debt servicing costs are expected to reach nearly 2% of GDP in 2030 (compared with 0.2% in 2025), pushing the total budget deficit above 4% of GDP. The debt-to-GDP ratio is expected to continue to fall (to 194% in 2030), but at a slower pace, as the negative spread between interest rates and growth is set to narrow: nominal growth would no longer exceed the apparent rate by more than 1 pp, compared with 4 pp at present.

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