Japan Q&A: the BoJ's projected terminal rate of 2.5% and VAT cuts as part of expansionary fiscal policy to expand investment

- **What is the basis for the terminal rate forecast of 2.5%? Would a terminal rate of 2.5% still be reached even if the BoJ accelerates its rate hikes and the risk of an economic slowdown increases? Would the government accept a faster pace of rate hikes and a policy rate of 2.5%?**
- **Would expansionary fiscal policy in an inflationary environment accelerate inflation? Would VAT cuts be offset by price increases?**

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Question 1: ***What is the basis for the terminal rate forecast of 2.5%? Would a terminal rate of 2.5% still be reached even if the BoJ accelerates its rate hikes and the risk of an economic slowdown increases? Would the government accept a faster pace of rate hikes and a policy rate of 2.5%?***

Our view:

The Japan Growth Strategy and Honebuto have clarified medium- to long-term investment plans involving public-private collaboration, while previously rigid fiscal management guidelines, such as the target of achieving an annual primary balance surplus, have become more flexible. Maintaining the currently low level of real interest rates would stimulate economic activity, particularly capital investment. We expect the real policy rate to move out of negative territory in 2028 as the corporate savings rate turns negative again. Taking the inflation target into account, the terminal rate in real terms should be around the potential growth rate. Honebuto states: "With the achievement of the 2% price stability target, establish economic growth exceeding 1% in real terms and 3% in nominal terms as soon as possible, and raise it further." Achieving this would mean raising the potential growth rate from its current level of around 0.5%.

Accelerating the pace of rate hikes in response to external factors, such as rising oil prices, while domestic demand, including investment activity, remains weak would weigh on economic growth. Partly reflecting the effects of the premature rate hikes to date, real GDP growth would remain below 1% in 2027. Growth would continue to slow from 1.2% in 2025 and 0.8% in 2026. The next rate hike would likely take place alongside a review of economic and price developments in the Outlook Report next January. However, with growth below the government's target, oil prices falling and inflation stabilising, subsequent rate hikes would likely return to a pace of around once every six months. This would bring monetary policy into line with the government's economic policy, which calls on the BoJ to fulfil a dual mandate of "stable inflation" and "strong economic growth".

Economic growth would accelerate as the BoJ slows the pace of rate hikes and government budgets from FY27 onwards, incorporating strategic investment through public-private collaboration and industrial policy, are implemented. Real GDP growth would be lifted to between 1% and 2% from 2028 onwards. Economic growth would substantially exceed the potential growth rate of around 0.5%, shifting the economy towards a "high-pressure economy" in which an expansion of capital input through public-private collaboration also raises potential growth. PM Sanae Takaichi's administration appears willing to accept gradual rate hikes accompanying strong investment expansion. As the Japanese economy recovers and companies shift from excess savings to excess investment, the policy rate would reach the terminal rate of 2.5% by 2029, with the real policy rate turning positive to the 2% inflation target.

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Question 2: ***Would expansionary fiscal policy in an inflationary environment accelerate inflation? Would VAT cuts be offset by price increases?***

Our view:

Current inflation is primarily driven by cost-push factors, including higher import costs and energy prices. As indicated by still-weak real wage growth and the low household savings rate, household fundamentals are not strong, and demand may have become more price-elastic. The risk that expansionary fiscal policy centred on strategic investment with a long-term horizon would accelerate consumer price inflation is low. Even after VAT cuts, food prices could naturally rise amid moderate inflation. However, this is a separate issue from the effects of VAT cuts and does not change their role in returning excessive tax revenue collected by the government to the private sector. Previously, funds channelled to households through post-pandemic fiscal expansion made demand less price-elastic, allowing companies to implement substantial price increases. Those funds have already been depleted.

The Takaichi administration's Japan Growth Strategy aims to raise supply capacity, or potential growth, through investment expansion. Improving supply capacity is disinflationary, so expanding investment and containing inflation are compatible. In the short term, investment expansion provides a strong boost to demand and raises the output gap. Over the medium to long term, however, it expands supply capacity, raises potential growth and stabilises inflationary pressures. The Takaichi administration's expansionary fiscal policy strengthens supply capacity through investment expansion, rather than simply boosting demand through reflationary policies. Unless an increase in the output gap driven by stronger investment demand is tolerated, investment would not succeed in raising supply capacity and potential growth.

Expanding supply capacity stabilises inflation and the exchange rate and is a source of national strength. The government has made clear that it would expand investment through public-private collaboration, including "crisis management investment" and "growth investment", to address economic and social challenges. By presenting a medium- to long-term investment strategy, it would improve companies' visibility and growth expectations, encouraging them to expand investment. The JPY is currently weak because Japan has fallen behind Europe and the US in strategic investment through public-private collaboration and industrial policy, and its investment expansion remains weak. A correction towards a stronger JPY would naturally accompany investment expansion. The current weak level of the JPY would not pose a major problem as long as investment expansion is expected to increase supply capacity.

It takes considerable time for the benefits of investment expansion to reach households through higher labour productivity and strong real wage growth. Strong real wage growth requires investment expansion, but because investment expansion initially increases demand, it keeps inflation elevated in the short term. Expansionary fiscal policy, including VAT cuts, would ease the burden on households during this period. VAT cuts are an important part of the strategy to revive the Japanese economy through investment expansion, rather than indiscriminate handouts. If JPY depreciation accelerates amid concerns that Japan is falling behind in the competition over strategic investment through public-private collaboration and industrial policy, eroding its supply capacity, it would be difficult to stop. If concerns over the weak level of the JPY and inflation restrain investment expansion, the result would be higher inflation and greater JPY depreciation in the future.

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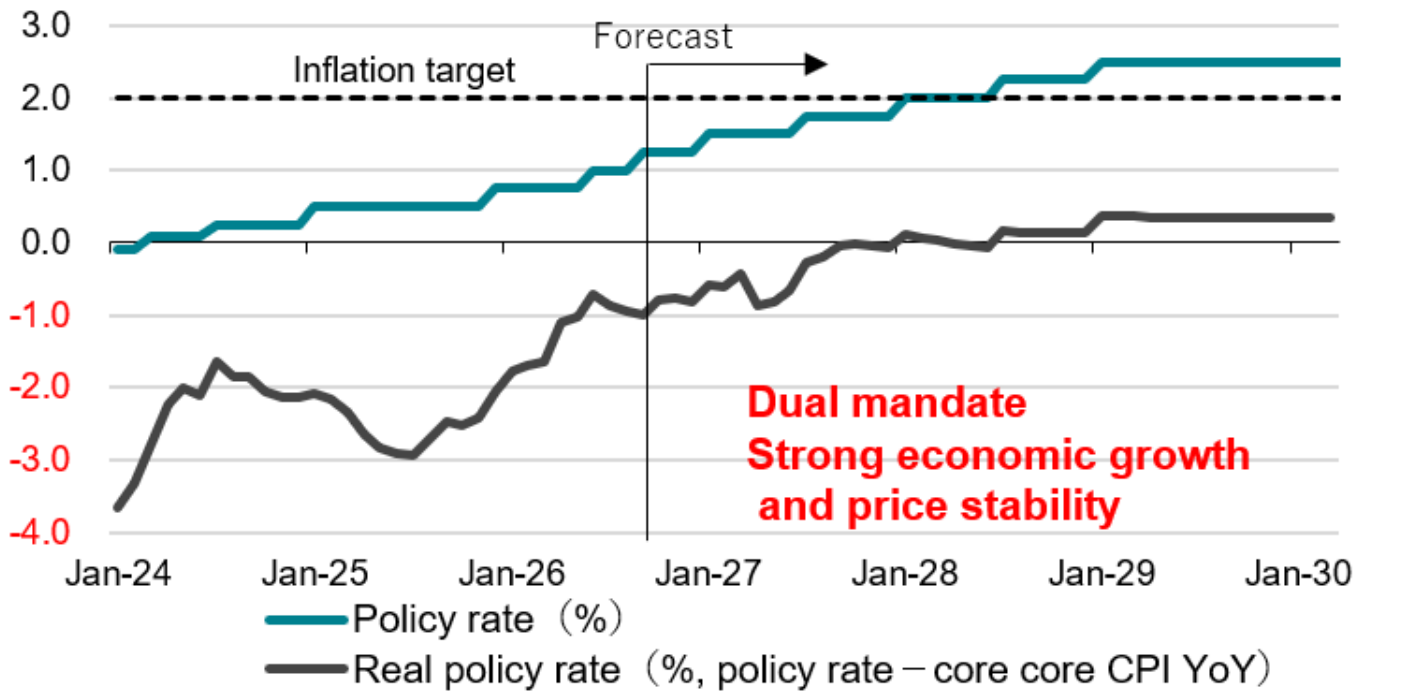
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Fig 1. Effects on USD/JPY from capex cycle

- **Press conference by Minister of State for Economic and Fiscal Policy, Minoru Kiuchi, upon his inauguration** (22 Oct 2025) : "It is extremely important that the government and the BoJ work in concert and in close cooperation to conduct responsible macroeconomic management, while also implementing appropriate monetary policy to achieve both strong economic growth and price stability."
- **PM Takaichi's first remarks at the Council on Economic and Fiscal Policy** (12 Nov): "Appropriate monetary policy management is crucial for achieving both strong economic growth and stable price increases in the future. We request that the Governor of the BoJ continue to provide regular reports to this Council on Economic and Fiscal Policy."
- **Comprehensive Economic Measures** (21 Nov): "It is very important that appropriate monetary policy management be implemented to achieve both strong economic growth and price stability in the future. The Government will continue to cooperate closely and work together as follows with the BoJ in order to achieve sustainable economic growth with price stability that will not slip back into deflation."
- **Government statements at the BoJ MPM** (23 Jan 2026) : "Toward achieving both strong economic growth and stable inflation, it is extremely important that monetary policy be conducted as appropriate."
- **Government statements at the BoJ MPM** (28 Apr): "Toward achieving both strong economic growth and stable inflation, it is important that monetary policy be conducted as appropriate.
- **"Honebuto"**(21 July) : "The management of economic and fiscal policy aims to achieve a "strong economy," and it is therefore of the utmost importance that this be accompanied by appropriate monetary policy conduct conducive to realising "stable price increases." The BoJ is expected to liaise closely with the government in accordance with the spirit of Article 4 of the BoJ Act and the Joint Statement of the Government and the BoJ". "Under the achievement of the 2% price stability target, the aim is to establish, as early as possible, real economic growth exceeding 1% and nominal economic growth exceeding 3%, and to raise these further".

Source: Cabinet Office, BoJ, Credit Agricole CIB

Fig 2. BoJ policy rate projection



Source: BoJ, Credit Agricole CIB

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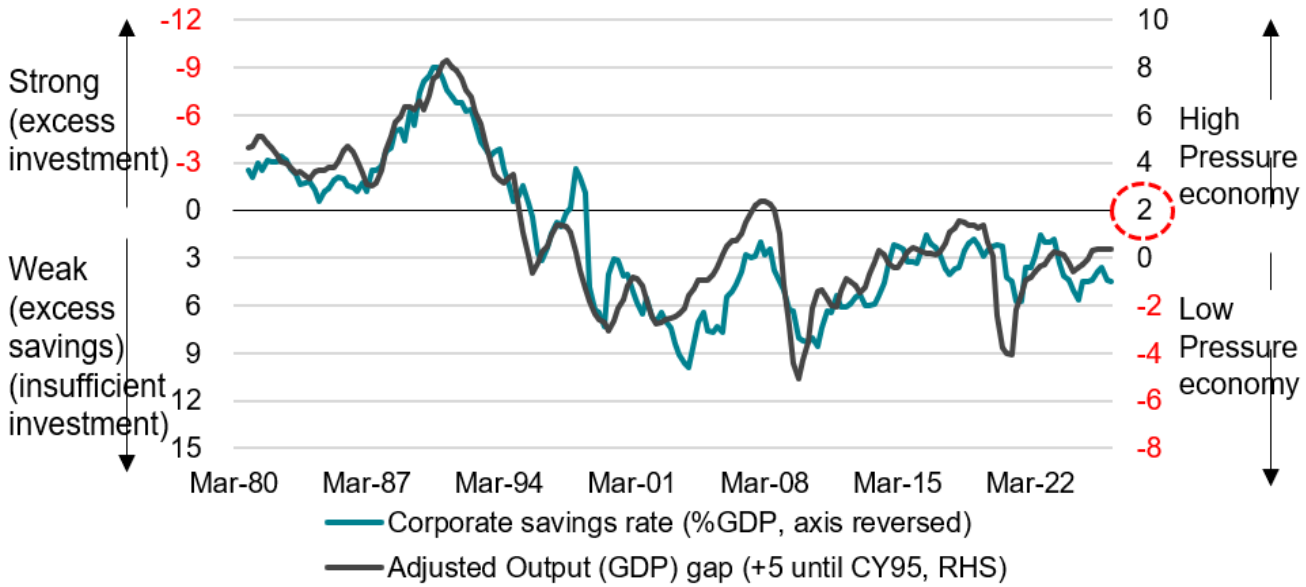
Fig 3. CACIB forecasts

CACIB	Real GDP	CPI (ex fresh food)	CPI (ex fresh food and energy)
FY26	+0.8 (+0.8)	+2.0 (+1.8)	+2.0 (+2.1)
FY27	+0.8 (+0.6)	+0.7 (+1.2)	+0.7 (+1.1)
FY28	+1.5 (+1.3)	+2.1 (+1.7)	+2.1 (+1.7)

*parenthesis denote CY forecast; Units: yoy%

Note: CACIB CPI forecasts take into account VAT cut on food to 1% from Apr 2027
Source: Cabinet Office, MIAC, Credit Agricole CIB

Fig 4. Corporate Savings Rate and Output Gap



Note: Due to the revision of the GDP standard, the output gap before 1995, including the financial bubble period, is adjusted by +5.

Source: Cabinet Office, Bloomberg, Credit Agricole CIB

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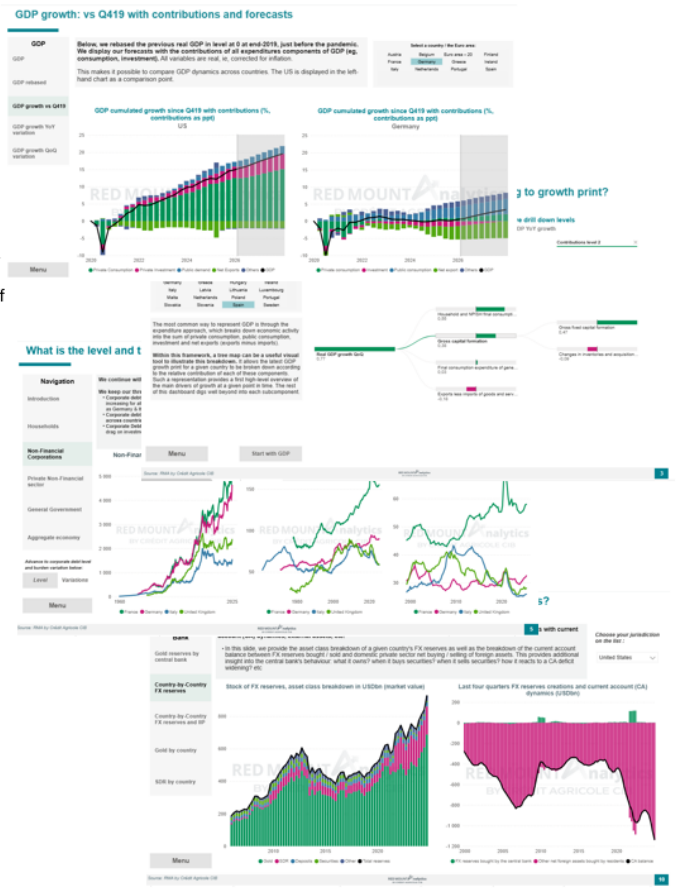
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