March 24, 2026

52nd Medium Term Economic Forecast (FY 2025-40)

Growth Acceleration through AI; Fiscal Balance should be attained in both the Earned Income Tax Credits (EITC) and the Defense Expenditures Increases

Executive Summary

1. Baseline Scenario: Moderate Growth Driven by Increased Domestic Demand

Even amid stagnating productivity growth, the continued net inflow of approximately 340K to 240K immigrants per year is expected to expand the labor force, underpin domestic demand, and stabilize economic growth (Table 1). Despite heightened uncertainty in global trade caused by tariff policies under the second Trump administration in the United States, rising crude oil prices and supply risks due to instability in the Middle East, and concerns over a slowdown in trade with China, the forecast indicates that the Japanese economy will maintain moderate growth over the next 15 years.

On the other hand, the primary balance (PB) of both central and local governments is expected to remain in deficit, and with long-term interest rates being broadly aligned with nominal GDP growth rates, the government debt-to-nominal GDP ratio is projected to follow an unstable path, declining temporarily before rising again. Furthermore, expansion in imports of goods and services associated with increased domestic demand will continue to push down the current account surplus as a share of nominal GDP.

Table 1. Overview of Baseline Scenario Forecast: Moderate Growth Driven by Increased Domestic Demand

	Annual average growth rate, * stands for period average (Fiscal Year)					
	11-15	16-20	21-25	26-30	31-35	36-40
Real GDP	1.2	-0.4	1.3	0.8	0.5	0.3
Nominal GDP	1.6	0.1	3.7	2.7	1.9	1.6
CPI (All items)	0.7	0.3	2.4	1.8	1.4	1.4
Compensation of employees, per capita	0.2	0.3	2.3	2.8	2.3	2.4
Labor force	0.0	0.8	0.3	-0.1	-0.4	-0.7
Unemployment rate *	3.9	2.7	2.6	2.5	2.5	2.6
Primary balance (Central and Local Government) (Ratio to nominal GDP) *	-4.8	-3.9	-3.0	-0.6	-0.2	-0.2
Government debt to GDP ratio *	178.1	188.9	197.7	182.0	183.1	189.7
Current account (Ratio to nominal GDP) *	1.6	3.5	3.6	3.9	3.5	3.3
10-year government bond yield *	0.7	0.0	0.8	2.2	1.9	1.6
Crude oil price (WTI, USD/bbl, calender year) *	85.8	51.1	76.1	63.3	69.9	76.6

Note: Percentages unless otherwise stated
Source: Estimates by the Japan Center for Economic Research (JCER)

2. Reform Scenario: Growth Acceleration through AI; Fiscal Balance should be attained in both Earned Income Tax Credits (EITC) and Defense Expenditures Increases

The reform scenario simultaneously considers reforms in both the macroeconomic and policy domains.

Macroeconomic Perspective: Although the expanded use of generative AI and the introduction of next-generation AI (Artificial General Intelligence, AGI) are assumed as presented in the long-term economic outlook, delays in adoption relative to other countries are expected to erode

Japan's competitive advantages. Consequently, the productivity gains from AI are expected to attain only one-third of their theoretical potential.

Policy Perspective: An early introduction of a possible form of EITC, social insurance premium refund–type EITC, is assumed, with the minimum taxable income set at approximately ¥2 million to support low-income households. To finance the resulting shortfall of ¥0.8 trillion, additional income taxation on high-income households (as well as higher inheritance tax) is assumed, placing the burden primarily on households. Consumption tax cuts are not adopted.

With respect to defense Expenditures, based on the agreement reached at the June 2025 NATO Summit (the Hague Summit Declaration) and the U.S. National Defense Strategy (NDS) released in January 2026, Japan's core defense expenditures (those covered by the Defense Buildup Program) are assumed to be increased ahead of schedule to 3.5% of nominal GDP over FY2027–FY2035 (an increase of roughly ¥15 trillion compared with the initial FY2026 budget). The financing of this increase assumes primarily corporate contributions, including a ¥14.5 trillion increase in the Special Defense Corporate Tax and a ¥0.4 trillion increase in tobacco tax. Ultimately, it will be necessary to review taxation frameworks from the perspective of the responsibilities borne by both citizens and corporations in national defense.

As a result, the Reform Scenario shows an improvement in the macroeconomic environment relative to the Baseline Scenario (Table 2). In the Baseline Scenario, while potential growth and real GDP growth remain positive, they decline to the low-0% range. In contrast, under the Reform Scenario, accelerated total factor productivity (TFP) growth raises the potential growth rate to around 1.1%, and stimulus to demand from preceding increases in the defense expenditures keeps real GDP growth around 1.0% (Figure 1).

However, it should be noted that the average performance of generative AI and software/physical AGI used domestically may lag behind that of the United States, China, South Korea, Taiwan, and others, potentially widening the competitiveness gap (GDP being merely a measure of quantity).

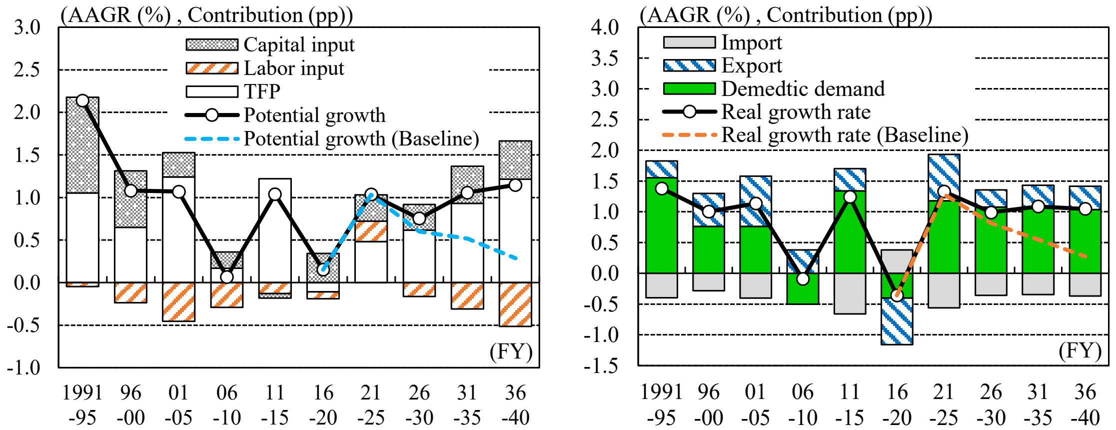
Table 2. Overview of Reform Scenario Forecast: Growth Improves to Around 1%

	Annual average growth rate, * stands for period average (Fiscal Year)					
	11-15	16-20	21-25	26-30	31-35	36-40
Real GDP	1.2	-0.4	1.3	1.0	1.1	1.0
Nominal GDP	1.6	0.1	3.7	2.9	2.4	2.1
CPI (All items)	0.7	0.3	2.4	1.9	1.5	1.4
Compensation of employees, per capita	0.2	0.3	2.3	3.0	2.9	2.9
Labor force	0.0	0.8	0.3	-0.1	-0.4	-0.7
Unemployment rate *	3.9	2.7	2.6	2.5	2.4	2.6
Primary balance (Central and Local Government) (Ratio to nominal GDP) *	-4.8	-3.9	-3.0	-1.2	-0.2	0.8
Government debt to GDP ratio *	178.1	188.9	197.6	183.3	182.4	186.1
Current account (Ratio to nominal GDP) *	1.6	3.5	3.6	3.0	3.3	3.4
10-year government bond yield *	0.7	0.0	0.8	2.4	2.5	2.2
Crude oil price (WTI, USD/bbl, calender year) *	85.8	51.1	76.1	72.7	76.7	83.5

Note: Percentages unless otherwise stated
Source: JCER

Figure 1. AI Adoption and the Defense Expenditures Raise Both Potential and Real Growth to Around 1%

＜Potential growth rate＞ ＜Real GDP growth rate＞

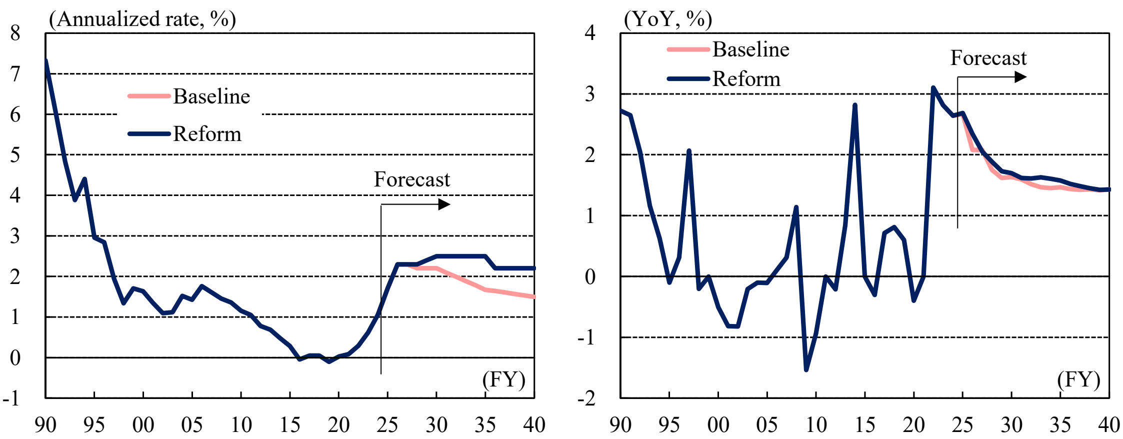


Source: JCER

Rising crude oil prices driven by instability in the Middle East pose a significant short-term risk and require close monitoring. Over the medium term, however, although early increases in the defense expenditures heighten inflationary pressures, monetary tightening progresses under normalized monetary policy framework. Then, long-term interest rates are projected to remain around 2.5% during FY2030–FY2035 (Figure 2). As a result, core CPI gradually declines and stabilizes in the mid-1% range, contributing to stable growth in consumption.

Figure 2. Under Monetary Tightening, CPI Stabilizes

＜10-year government bond yield＞ ＜Core CPI＞

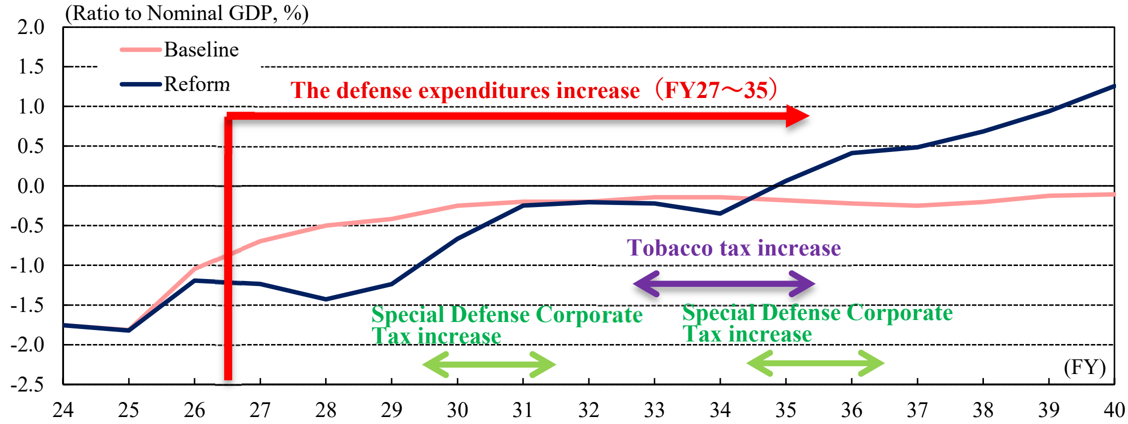


Source: JCER

In terms of policy-related fiscal flows, the EITC is assumed to be revenue-neutral from its first year of introduction and therefore has no impact on the PB. The defense expenditures covered by the Defense Buildup Program are assumed to increase at an annual rate of about 12% during FY2027–FY2035, contributing to a deterioration in the PB. However, revenue measures—including increases in the Special Defense Corporate Tax in FY2030–FY2031 and FY2035–FY2036, and higher tobacco tax rates during FY2033–FY2035—lead to fiscal balance by FY2036, contributing to the PB improvement (Figure 3).

Consequently, the PB turns into surplus in FY2035, averaging approximately 0.8% of nominal GDP over FY2036–FY2040. Even as nominal GDP growth remains broadly aligned with long-term interest rates, the central and local government debt-to-GDP ratio shows signs of decline toward the end of 2030s (Figure 4).

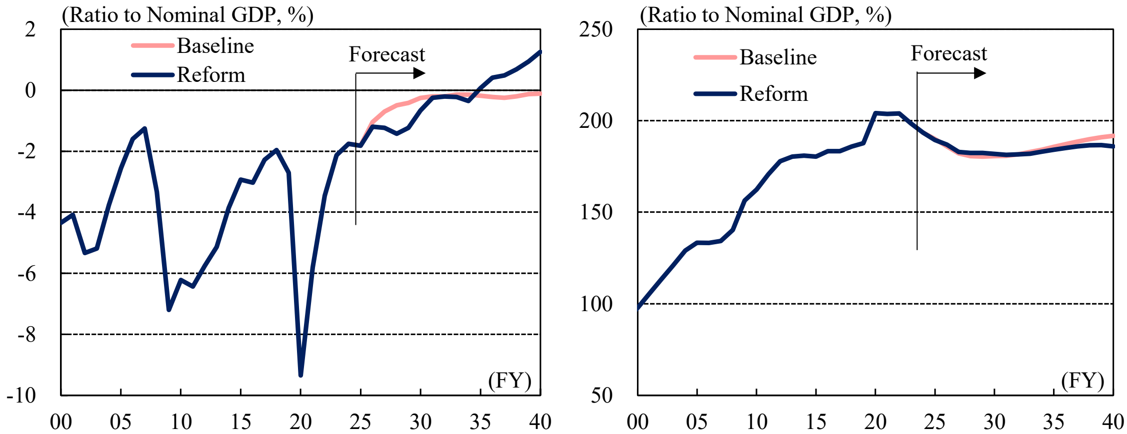
Figure 3. Revenue Measures to Finance the Defense Expenditures Lead to PB Surplus



Source: JCER

Figure 4. The PB Turns Positive in FY2035; Debt Outstanding Shows Signs of Decline Toward the end of 2030s

＜The Central and Local PB＞ ＜The Central and Local Debt Outstanding＞



Source: JCER

In summary, even if productivity and growth rise through expanded AI utilization, achieving a PB surplus would be difficult without revenue measures corresponding to the increased defense expenditures. The decline in the debt-to-GDP ratio remains limited to early signs in the late 2030s. Further reductions would require secured funding sources alongside measures to raise growth potential, particularly through expanded AI investment, startup support, work-style reforms, wage increases, and higher public expenditure on education.

Private Construction Investment Outlook to 2040: Residential -7% and Non-Residential -21%

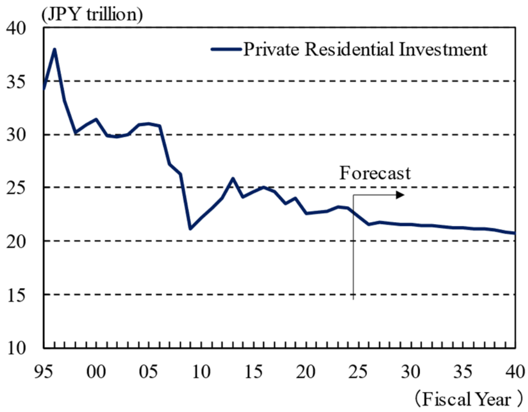
Productivity Gains and Value Enhancement of Existing Buildings as Key Drivers under Population Decline

Kazuki Iisaka

Highlights

- The forecast indicates that private construction investment in Japan will decline over the long term. By FY2040, residential investment will fall by about 7.2% and non-residential by 21% relative to FY2025.
- With population decline and structural changes in households and industry, new construction demand is unlikely to grow. Demand is expected to shift toward renovation, energy efficiency, and high-performance buildings.
- With rising renovation needs and a declining labor force, sustained investment in productivity will be essential. Government and industry must strengthen supply capacity through ICT and more efficient construction.

Figure: Outlook for Private Construction Residential Investment



Notes: Figures are expressed in real terms (2020 prices).
Source: JCER estimates

The Value of Sports Investment: Economic Growth and Lower Healthcare Costs

Developing Sports Habits Could Reduce Healthcare Costs by ¥451.5 Billion

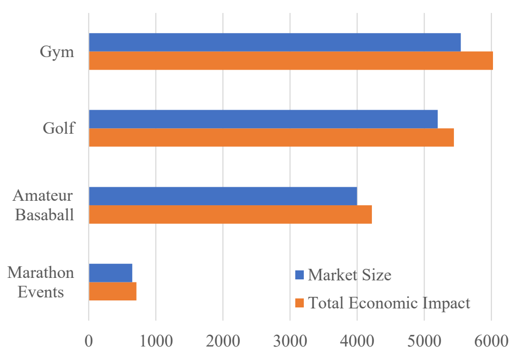
Rika Ishihara

Highlights

- Input-output analysis demonstrates that consumer spending within the sports sector stimulates demand across a broad range of industries, generating an economic multiplier effect of 1.1 times the initial market size. This indicates that sports should be recognized not merely as a leisure activity, but as a strategic industry that drives stable domestic demand and contributes to macro-economic growth.
- Existing literature suggests that higher sports participation rates correlate with improved public health outcomes and a subsequent reduction in healthcare spending. If the current participation rate of 52.5% were to reach the Japan Sports Agency's target of 70%, an additional 12.9 million individuals would establish regular exercise habits. This shift is estimated to reduce annual healthcare costs by approximately ¥451.5 billion. Furthermore, targeted interventions for individuals at risk of lifestyle-related diseases could yield an additional annual saving of ¥93.3 billion.
- Promoting sports participation stimulates economic activity while reducing healthcare costs. In particular, integrating sports into corporate health management (*Kenko Keiei*) is a key strategy. By targeting the working-age population—who tend to have lower sports participation rates—these initiatives function as an investment in human capital, supporting long-term fiscal sustainability through reduced medical expenditures.

Figure: Estimated Effects of Sports Promotion on the Economy and Healthcare Costs

< Economic Multiplier Effect >



< Healthcare Cost Reduction by Disease >

Category	Diabetes	Hyper-tension	Kidney Disease
At-risk Population	~7M	~20M	~13.3M
New Cases (Annual)	210K	1.5M	200K
Prevented Cases	88K	627K	83K
Cost Reduction	~¥19.1B	~¥65.8B	~¥8.4B

Source: JCER estimates

Industry–Academia Collaboration Drives Increases in Joint Research (+6%) and Patents (+9%)

Evidence from the Cross-Appointment System

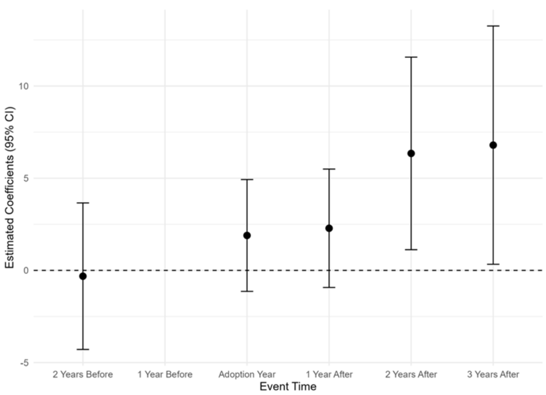
Kaya Okuyama

Highlights

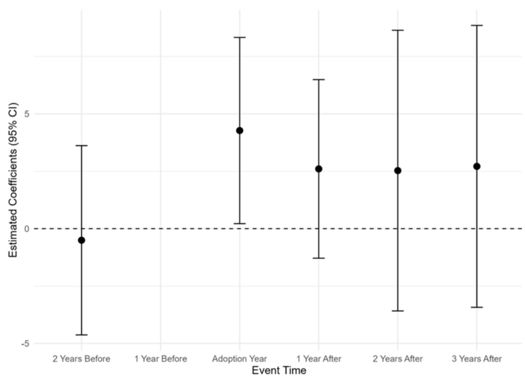
- The cross-appointment system enables researchers to hold positions at multiple organizations—such as universities, public research institutes, and private companies—and work across them. By allowing activity beyond organizational boundaries, it enhances researcher mobility and bridges academic knowledge with corporate resources, promoting technology transfer and industry–academia collaboration.
- The introduction of this system improves industry–academia collaboration outcomes at some universities. Institutions that adopted it in FY2020 saw joint research projects increase by about 6% after two years and patent applications by about 9% within the same fiscal year. However, promoting innovation requires not only introducing the system but also ensuring its active use.
- The findings also suggest that administrative burdens associated with regulations on industry–academia collaboration may discourage the implementation of joint research. Therefore, reducing administrative burdens on universities—such as by streamlining procedures—is necessary.

Figure: Estimation Results

< Number of Joint Research Projects>



< Number of Patent Applications>



Source: JCER estimates

VC-Backed Startups Are 50% More Likely to Go Public

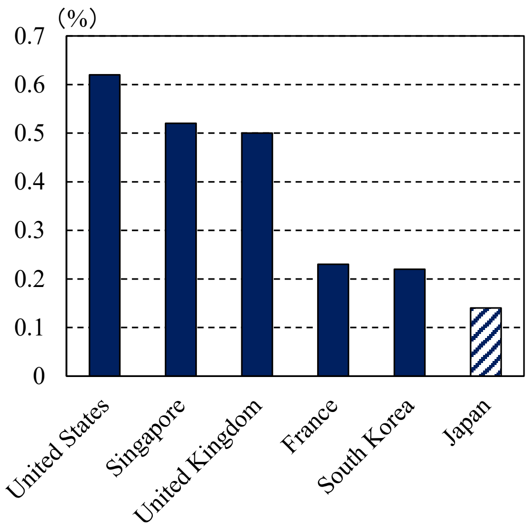
Beyond financing, hands-on guidance and business networks may help young firms grow faster and move closer to an IPO

Akira Kitado

Highlights

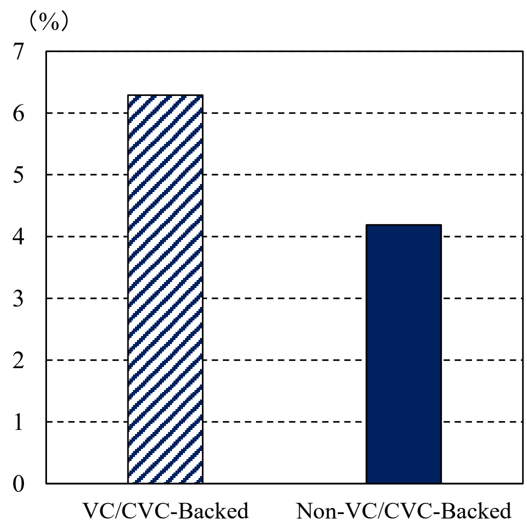
- The analysis finds that startups backed by venture capital (VC) or corporate venture capital (CVC) are 50% more likely to reach an initial public offering (IPO), but less likely to exit through mergers and acquisitions (M&A).
- The analysis suggests that startups that secured VC or CVC funding early on tended to post stronger valuation growth than those that did not. The advantage may reflect not just the capital itself, but also hands-on support such as strategic advice and network-building.
- Compared with other major economies, Japan has a relatively high share of startups exiting via IPO. Policy should strengthen fund support and late-stage financing while easing barriers to M&A to give startups a wider range of exit options.

<Japanese Startups Raise Less Funding>
(As a share of GDP, 2024)



Source: Ministry of Economy, Trade and Industry (METI), Secretariat Materials (Tax Issues Related to the Supply of Growth Capital to Startups) (2025)

<VC/CVC-Backed Firms More Likely to List>
(Estimated Probability of IPO)



Notes: Estimates are based on logistic regression with observable characteristics of the treatment and control groups adjusted using propensity score matching.
Source: JCER estimates

Reaching 76 Million Inbound Visitors by 2040

Structural Investments Financed by the International Tourist Tax

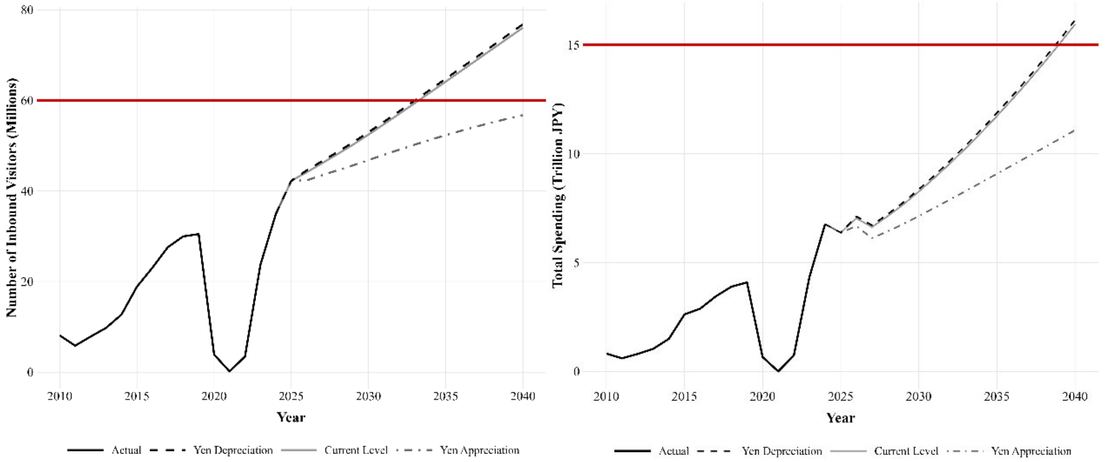
Sara Sekiya

Highlights

- Estimates in this paper indicate that by 2030, inbound visitors will reach 52.47 million and spending will total approximately 8.26 trillion yen. The forecast indicates that, while visitor numbers will reach 87% of the 60-million government target, spending will remain at 55% of the 15-trillion-yen goal, constrained by supply-side factors such as labor shortages and limited accommodation capacity.
- The forecast indicates that, by 2040, inbound visitors and spending will reach 76.06 million and 16 trillion yen, respectively, and that even under a yen-appreciation scenario, total spending will be 1.68 times the 2025 actual figure.
- To develop sustainable tourism infrastructure, strategic investment financed by international tourist tax revenue is essential. Beyond labor shortage countermeasures, Japan must urgently expand supply capacity through labor-saving technologies to prevent these from becoming constraints on growth.

Figure: Forecasts of Inbound Visitors and Their Spending through 2040

< Reaching 2030 Visitor Target by 2034>　　< Reaching 2030 Spending Target by 2040>



Notes: The real effective exchange rate during the forecast period is set at 73.0178 for the "Current Level" scenario and 70.8383 for the "Yen Depreciation" scenario. For the "Yen Appreciation" scenario, values from 2025 onwards are linearly interpolated to reach 130.3 by 2040.
Source: Japan Tourism Agency (JTA), "Inbound Post-Consumption Survey", Japan National Tourism Organization (JNTO), "Inbound Visitor Statistics," JCER estimates.

Municipal Forestry Expenditure Increase by Up to 35% due to the Reform of the Forest Environment Transfer Tax Allocation Criteria

Reallocation of Unused Funds Could Generate CO_2 Absorption with an Economic Value of Approximately JPY 53 Billion by 2050

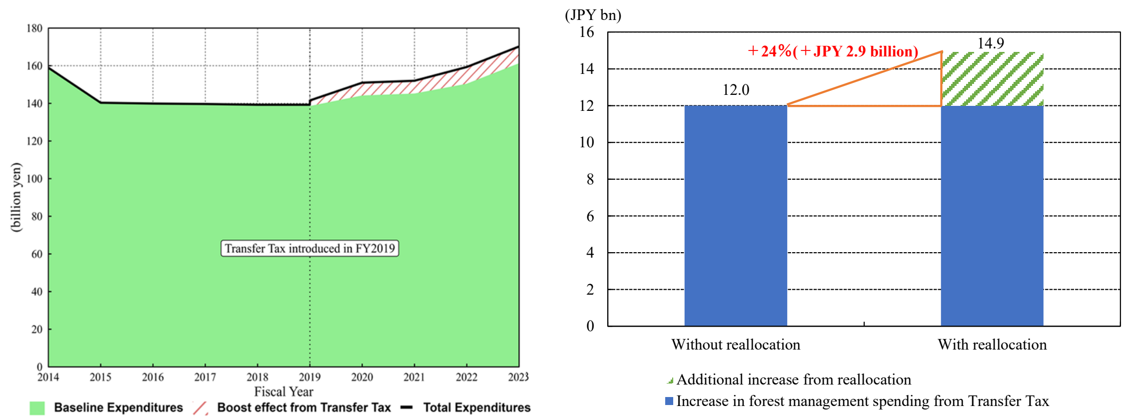
Kazuya Yanaba

Highlights

- The Forest Environment Transfer Tax aims to secure financial resources for forest management. Under this system, JPY 1,000 is levied annually per person as the Forest Environment Tax (national tax). The revenue is then distributed to municipalities as the Forest Environment Transfer Tax based on three criteria: private forest plantation area, number of forestry workers, and population.
- Municipalities with large populations and small forest areas have large amounts of unused funds. In FY2024, allocation criteria were revised, increasing the weight of private forest plantation area and decreasing the weight of population. This revision is estimated to have increased forest management expenditures in some municipalities by up to 35%.
- Reallocating unspent FY2024 transfer tax funds without implementation plans to municipalities with larger forest areas is estimated to boost forest management expenditures by approximately 24%. If fully allocated to tree planting, this increase is estimated to generate CO_2 absorption with an estimated economic value of approximately JPY 53 billion by 2050.

Figure: Transfer Tax Boosts Expenditures, and Reallocation Could Boost Them Further

<Transfer Tax Boosts Expenditures>　**< Reallocation Could Boost Spending Further>**



Source: MIC "Survey on State of Local Public Finance", JCER estimates