The Quality of Japan's Rising Interest Rates

Four Factors That Will Determine Whether the Rise Is Growth-Driven

Research Department
Mizuho Research Institute
Mizuho Research Institute is the name of an internal organization of Mizuho Bank, Ltd.

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Japan Is Entering a World of Inflation and Positive Interest Rates

- As the world shifts to a new normal of inflation and higher interest rates, Japan is also transitioning from an era of deflation and ultra-low interest rates to a world of inflation and positive interest rates.

	Deflation Era	New Normal
Prices	**Deflation / Low Inflation**	**Sustained Inflation**
Interest Rates	**Zero and Negative Interest Rates**	**Positive Interest Rates**
Demand for Credit	**Underinvestment / Persistently Weak Demand for Credit**	**Higher Capital and Inventory Investment / Stronger Demand for Credit**
Bank of Japan	**Large-Scale Monetary Easing / The BOJ as the Dominant Buyer of JGBs**	**Monetary Policy Normalization A Broader Investor Base for JGBs**

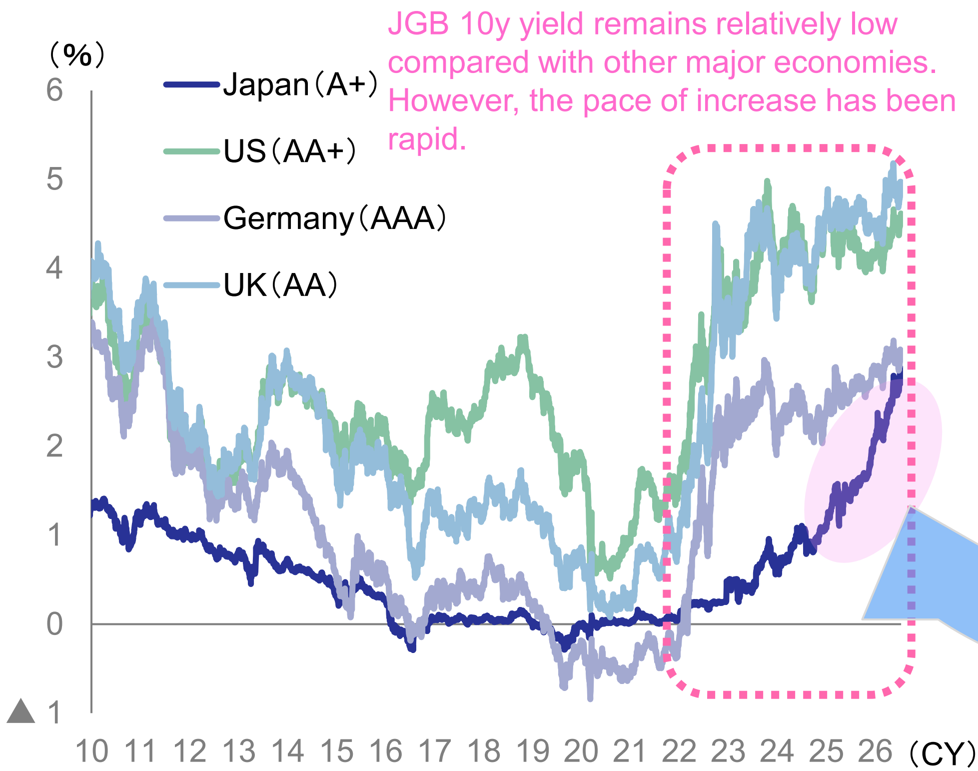
The return of positive interest rates is a normal part of Japan's economic transition. The key question is whether future rate increases will be driven by stronger growth or by higher risk premiums.

Source: Made by Research Department, Mizuho Research Institute

Japan’s Long-Term Yields Are Rising Faster Than Those of Its Peers

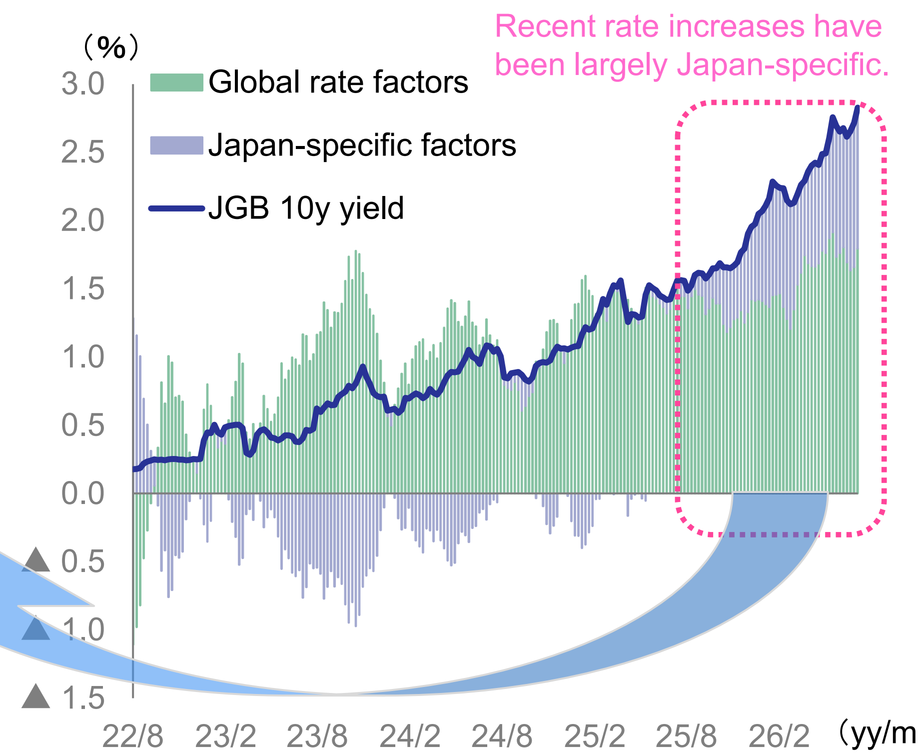
- Japan’s 10-year yield remains relatively low compared with other major economies.
- However, the recent pace of increase has been rapid. Since late 2025, Japan-specific factors have become the main driver of higher yields.
- This suggests that monetary policy normalization alone may not fully explain the rise.

10-Year Government Bond Yields



Notes: Letters in parentheses indicate S&P long-term sovereign credit ratings.
Source: LSEG; made by Research Department, Mizuho Research Institute

Drivers of the 10-Year JGB Yield



Notes: Factor decomposition based on principal component analysis of 10-year government bond yields in the U.S., Germany, and the U.K.
Estimation period: August 1, 2022–July 6, 2026.
Source: LSEG; made by Research Department, Mizuho Research Institute

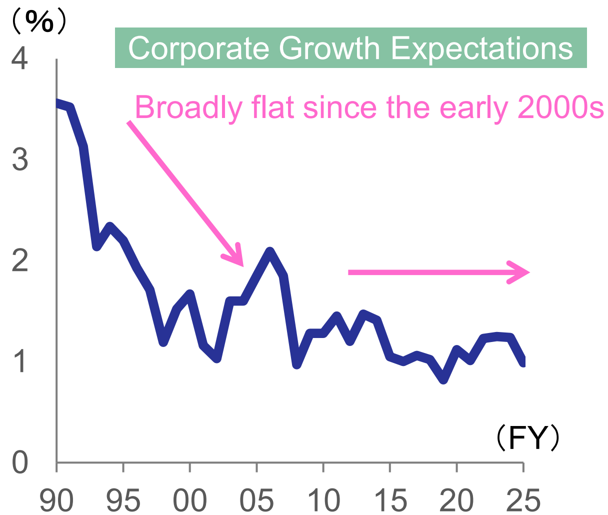
Stronger Growth Expectations Are Needed for a Growth-Driven Rise in Long-Term Rates

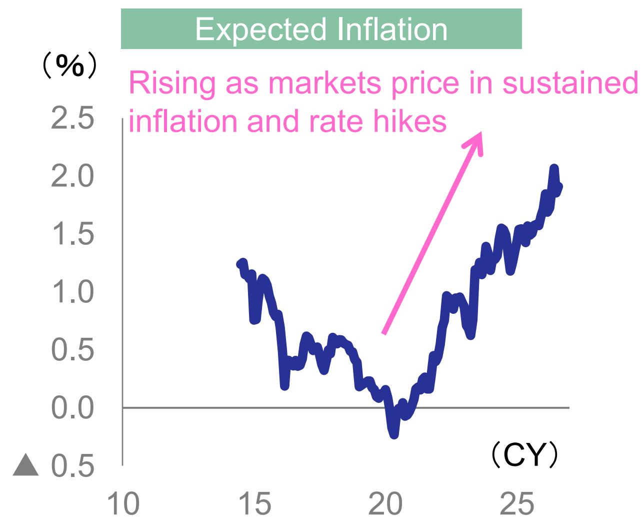
- A growth-driven rise occurs when stronger growth expectations stimulate investment and demand for credit.
- Corporate growth expectations have remained broadly flat, contributing to weak domestic investment.
- Meanwhile, the term premium has risen since late 2025, possibly reflecting fiscal and JGB market concerns.

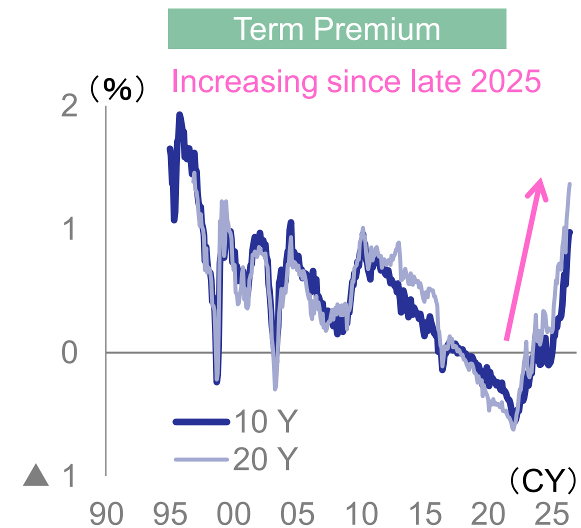
Illustrative Components of a Growth-Driven Long-Term Rate

Long-Term Interest Rate

＝ **Real Short-Term Neutral Rate** ＋ **Expected Inflation** ＋ **Term Premium**



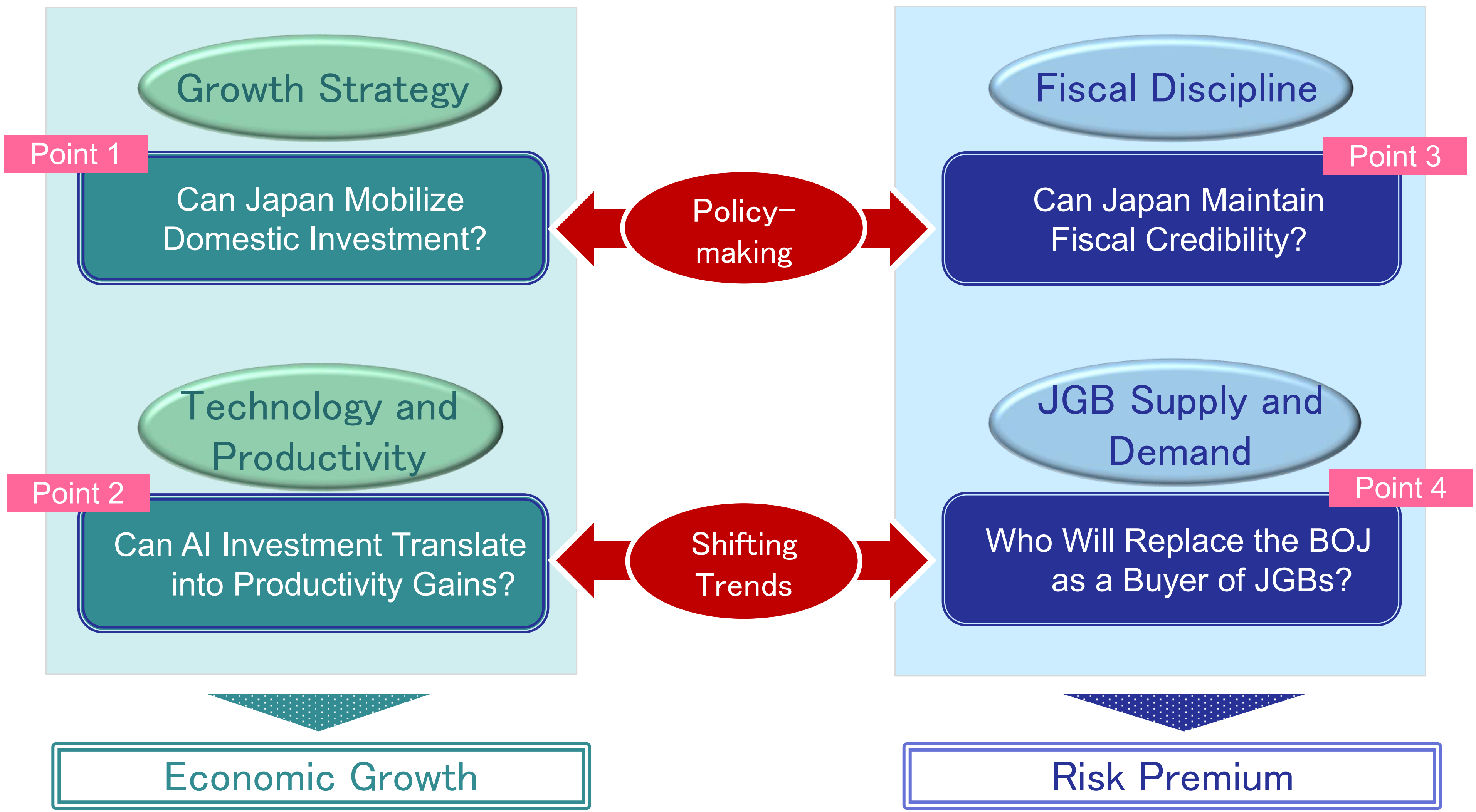




Notes: Corporate Growth Expectations: Listed firms' outlook for Japan's real economic growth rate (average over the next five years). Expected Inflation: 10-year break-even inflation rate (BEI). Term Premium: Derived by subtracting the expected path of future policy rates priced in by the market from long-term interest rates.

Sources: Made by Research Department, Mizuho Research Institute based upon 'Annual Survey of Corporate Behavior' (Cabinet Office); Nakajima (2025); Ichigami and Ueno (2013); LSEG

Four Factors Will Determine the Quality of Japan's Rising Interest Rates



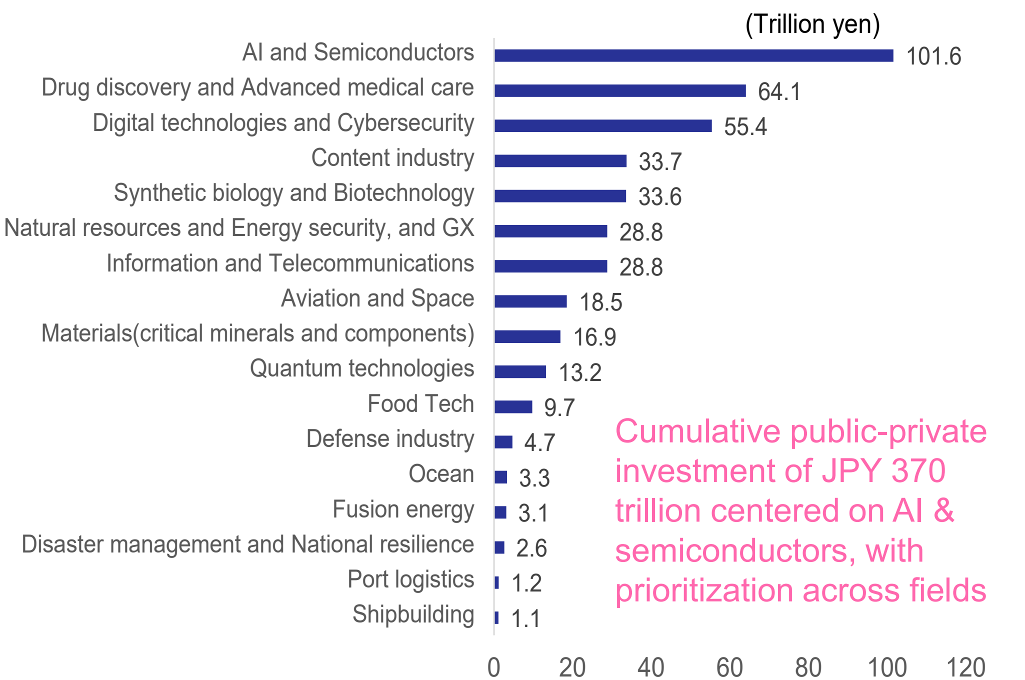
Stronger growth and a stable risk premium would allow Japan to achieve a sustainable, growth-driven rise in interest rates.

Source: Made by Research Department, Mizuho Research Institute

Point 1:Mobilizing Domestic Investment

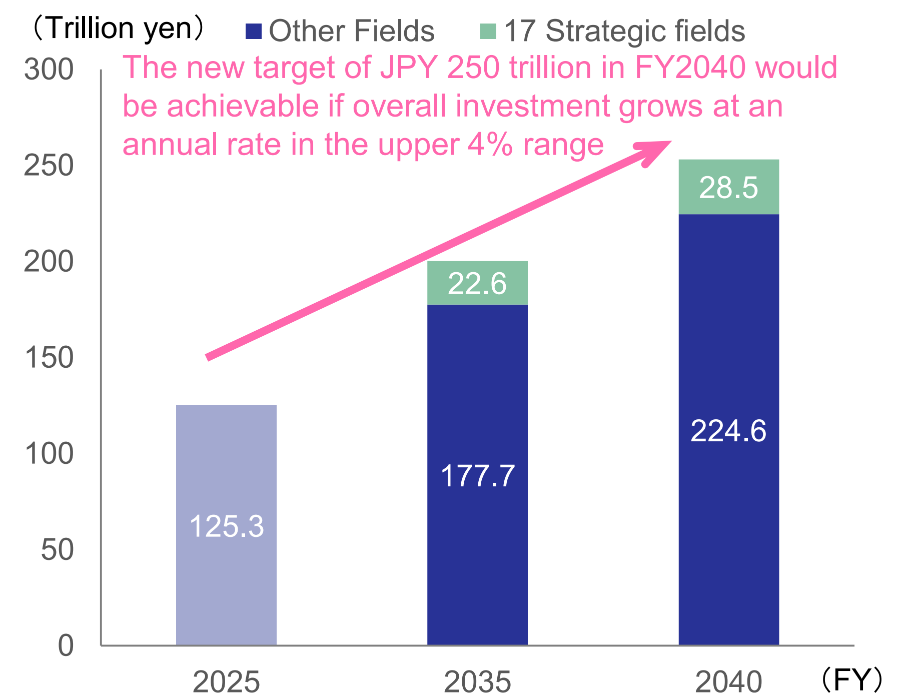
- Japan’s investment target is within reach, but returns will determine success.
- The government plans approximately ¥370 trillion in public and private investment across 17 strategic sectors through FY2040.
- The target implies annual growth of around 5% in nominal private capital expenditure—ambitious, but broadly in line with recent trends.
- Success will depend on competitive business models, attractive returns, and fewer labor and energy constraints.

Public and Private Investment Targets for 17 Strategic Sectors



Note: Figures include some double-counting between fields
Source: Made by Research Department, Mizuho Research Institute based upon ‘Reference materials for the Public-Private Investment Roadmap for Key Products and Technologies in the 17 Strategic Fields’ Headquarters for Japan's Growth Strategy (July 21, 2026)

Illustrative Path for Nominal Private Investment

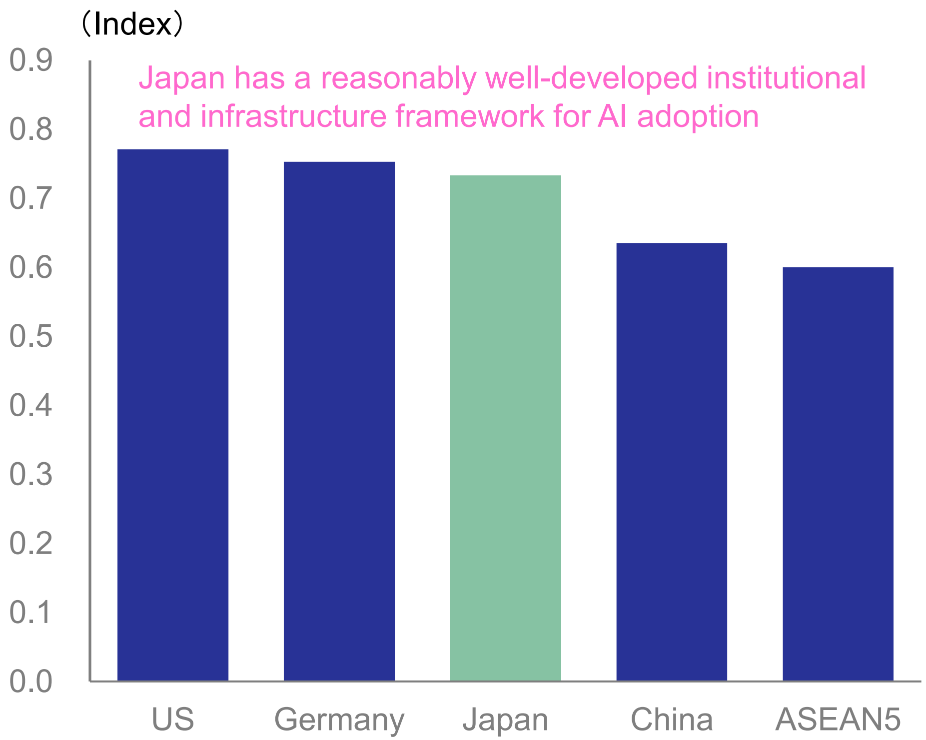


Note: Estimates mechanically assume total private non-residential investment grows at an annual rate of about 4.8%. The public-private investment mix in the 17 strategic sectors is assumed at 15% public and 85% private.
Source: Made by Research Department, Mizuho Research Institute based upon ‘Growth Strategy for Japan’ (Cabinet Decision, July 21, 2026)

Point 2:Turning AI Investment into Productivity

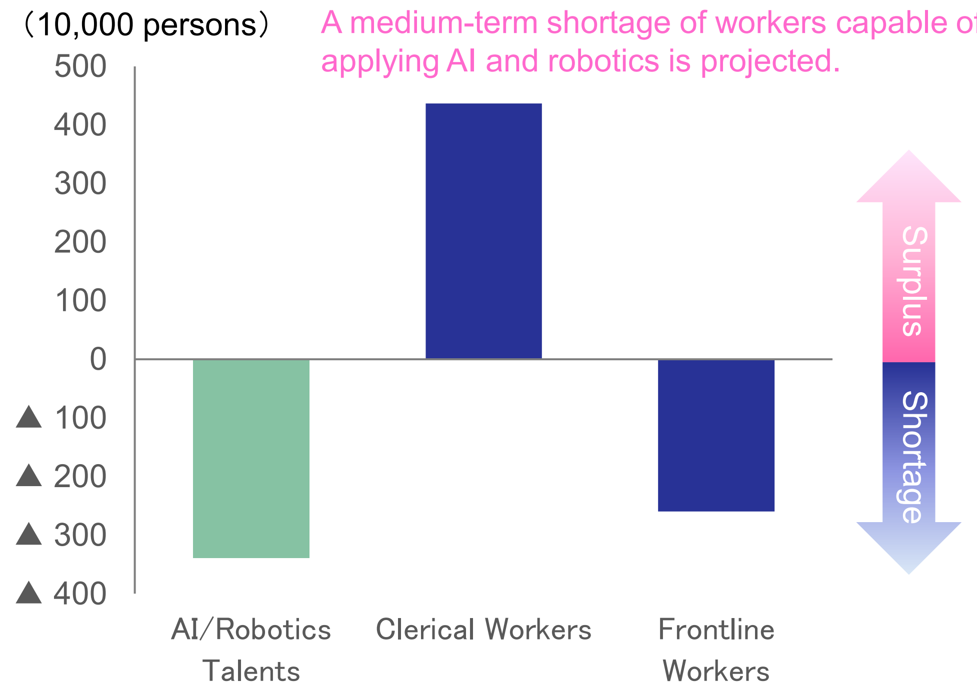
- Japan has relatively strong institutional and digital foundations for AI adoption.
- Its strengths in robotics, machine tools, manufacturing know-how, and operational data could amplify AI's productivity impact.
- However, shortages of workers capable of implementing and using AI may delay the gains.

AI Preparedness Index



Note: As of 2023. It should also be noted that the index may not fully capture shortages of AI talent or the extent of AI implementation by firms
Source: Made by Research Department, Mizuho Research Institute based upon 'AI Preparedness Index'(IMF)

Projected Occupational Labor Imbalances in 2040

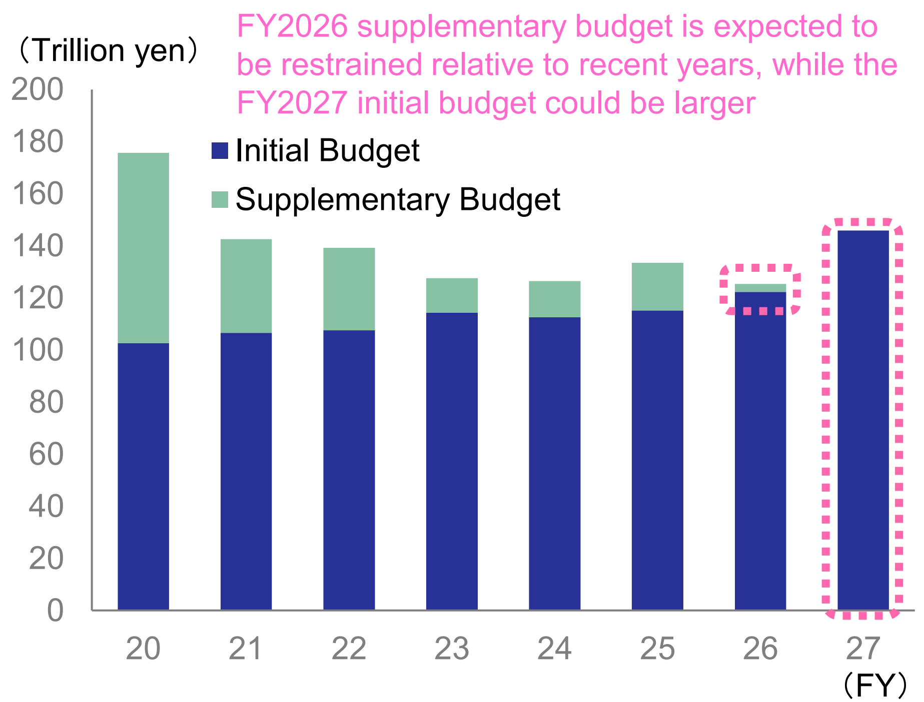


Note: AI/Robotics Talents include mechanical engineers and other information-processing and telecommunications professionals. Engineers engaged in system planning, development, implementation and operation, as well as network development are also included.
Source: Made by Research Department, Mizuho Research Institute based upon 'National Employment Structure Projections for 2040 (Revised Edition)' (Ministry of Economy, Trade and Industry)

Point 3:Maintaining Fiscal Credibility

- Fiscal policy has so far remained mindful of market concerns, including through restrained JGB issuance.
- New spending commitments will require credible and durable funding sources.
- Even with 3% nominal growth, persistent primary deficits could eventually push the debt-to-GDP ratio higher.
- Growth must therefore be accompanied by fiscal and social security reform.

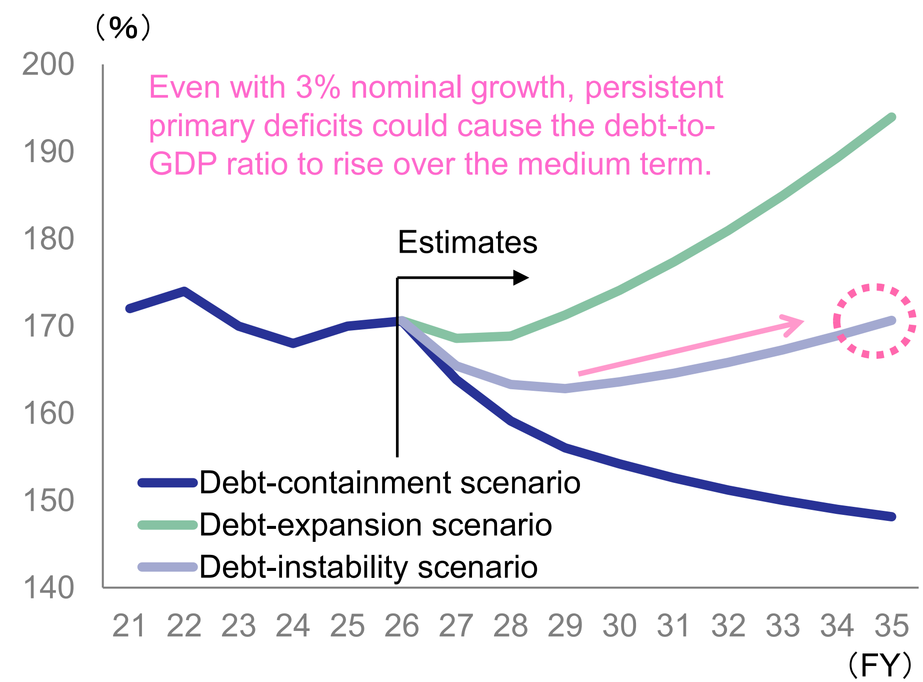
FY2026 Supplementary Budget and FY2027 Budget



Note: The FY2026 supplementary budget is assumed to total ¥3 trillion. The FY2027 initial budget is illustratively calculated by extending the FY2026 initial budget at the same growth rate and adding an amount equivalent to the scale of supplementary budgets in recent years

Source: Made by Research Department, Mizuho Research Institute based upon the Ministry of Finance

Debt-to-GDP Ratio Under Alternative Scenarios



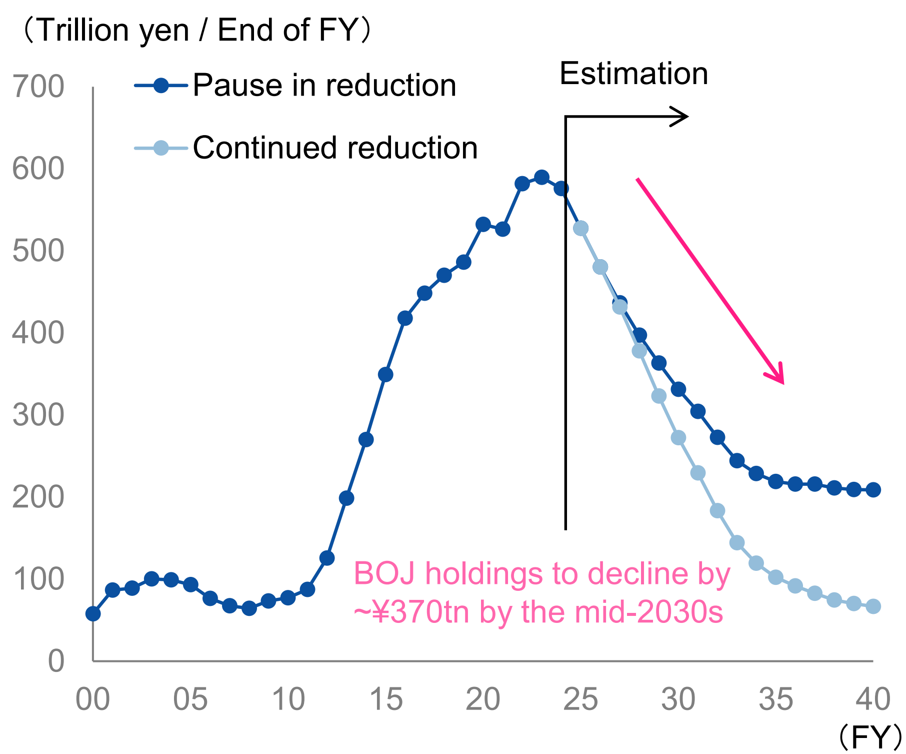
Note: Debt-containment scenario assumes the primary balance reaches balance in the 2030s, while Debt-expansion and Debt-instability scenarios assume a persistent deficit of around 2.5% of GDP. Nominal growth is assumed at 3% in the Debt-containment and Debt-instability scenarios and 2% in the Debt-expansion scenario. Long-term interest rates are assumed at 3.3% in Debt-containment scenario, 4.5% in Debt-expansion scenario, and 3.5% in Debt-instability scenario.

Source: Made by Research Department, Mizuho Research Institute based upon the Cabinet Office, the Ministry of Finance, LSEG, and other sources

Point 4:Broadening the JGB Investor Base

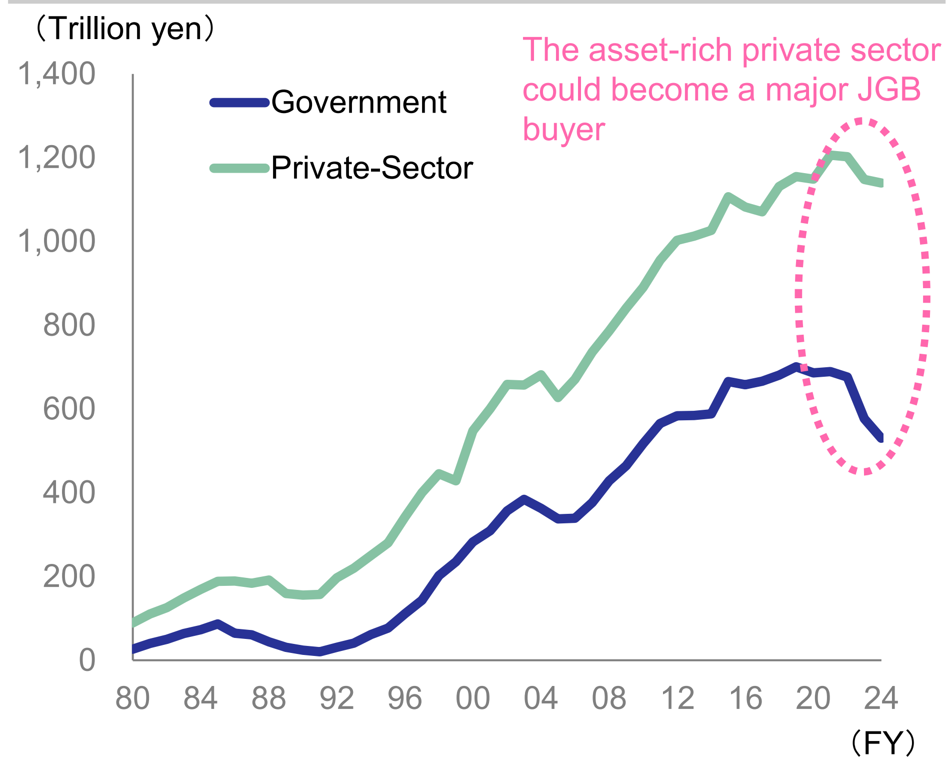
- The BOJ’s long-term JGB holdings could decline by around ¥370 trillion from their peak by the mid-2030s.
- Japan’s large stock of private financial assets provides substantial domestic capacity to absorb JGB supply.
- Higher yields could encourage households and institutional investors to increase their JGB holdings.
- The key question is whether domestic demand can keep pace with rising net supply.

BOJ Holdings of Long-Term JGBs



Note: Based on the currently announced pace of BOJ JGB purchase reductions.
Source: Bank of Japan; made by Research Department, Mizuho Research Institute

Government Net Debt and Private-Sector Net Financial Assets



Note: Private-Sector includes household, nonfinancial corporations, and financial institutions
Source: Bank of Japan; made by Research Department, Mizuho Research Institute

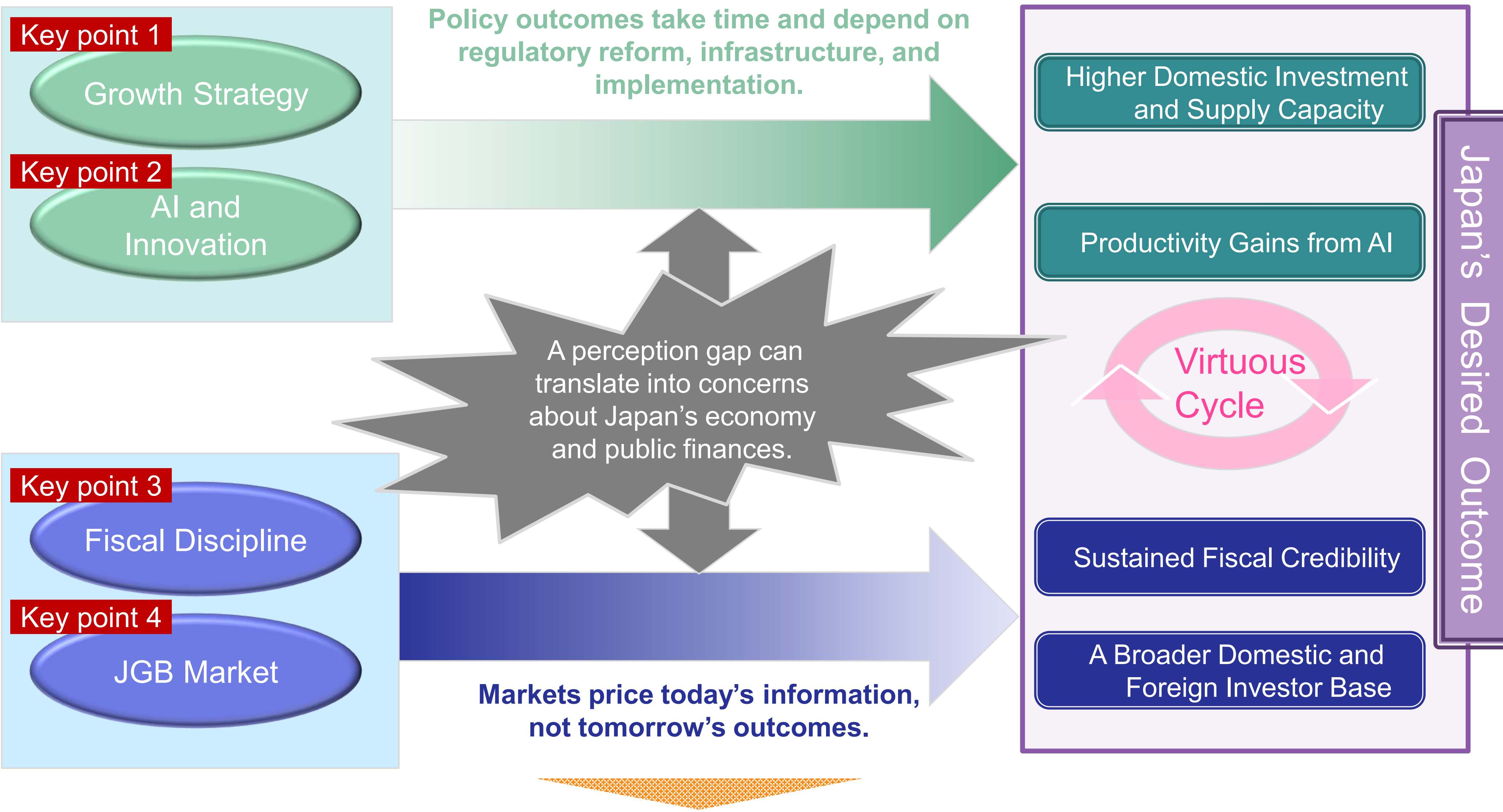
Japan Has Made Progress—but Execution Will Determine the Outcome

	Area	Progress	Key Challenge	Assessment
1	Domestic Investment	Shift toward investment-led growth	Returns and supply constraints	Positive
2	AI and Productivity	Adoption and investment are increasing	Talent and implementation gaps	Uncertain
3	Fiscal Credibility	JGB issuance remains contained	Permanent funding and reform	Monitor
4	JGB Market	Higher yields support investor demand	Absorbing rising net supply	Monitor

- Japan is moving in the right direction toward a growth-driven rise in interest rates.
- However, the outcome will depend on execution, particularly in addressing fiscal challenges and broadening the JGB investor base.

Source: Made by Research Department, Mizuho Research Institute

Policy Takes Time. Markets Do Not Wait.



Clear milestones and transparent evaluation will be essential.

Source: Made by Research Department, Mizuho Research Institute

Appendix1: Key Indicators to Monitor

	Area	Key Policy Actions	Market and Economic Indicators
1	Domestic Investment	Regulatory reform, energy supply, labor mobility	Growth expectations, capital expenditure, corporate returns
2	AI and Productivity	Skills, reskilling, power supply	Productivity, AI adoption, business transformation
3	Fiscal Credibility	Permanent funding, social security reform, fiscal governance	Budget size, primary balance, debt ratio, interest costs
4	JGB Market	Issuance management, BOJ balance-sheet reduction	Auctions, term premium, investor composition, foreign holdings

Market indicators reflecting assessments of the four areas above

Sovereign ratings | CDS | FX — yen depreciation | Term premium

Warning signal: A persistent rise in the term premium without stronger growth, leaving interest rates well above nominal growth.

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Source: Made by Research Department, Mizuho Research Institute

Appendix2: Global Economic Outlook（June 2026）

■ Global Economic Forecast Summary : AI and Resilience Investment Offset the Middle East Shock

	2025	2026 (Outlook)	2027 (Outlook)	2026 (Comparison with February 2026 outlook)	2027 (Comparison with February 2026 outlook)
	(Y-o-y % change)			(%pt)	
Global real GDP growth	3.4	2.9	3.1	▲ 0.4	-
Japan, US, Europe	1.7	1.4	1.7	▲ 0.3	-
US	2.1	2.2	2.1	▲ 0.2	-
Eurozone	1.4	0.8	1.4	▲ 0.6	-
UK	1.4	0.9	1.0	▲ 0.2	▲ 0.1
Japan	1.1	0.5	1.1	-	▲ 0.8
Asia	5.5	4.9	4.4	0.2	0.1
China	5.0	4.3	3.8	0.2	0.2
NIEs	4.1	4.6	2.5	1.6	0.3
ASEAN5	5.1	4.5	4.7	▲ 0.1	▲ 0.1
India	7.5	6.7	6.5	-	-
Australia	2.0	1.7	1.8	-	-
Japan (FY)	0.8	0.5	1.5	▲ 0.5	0.1

Despite the Middle East crisis, strategic petroleum reserve releases, alternative sourcing, and strong AI investment are cushioning the shock. Global growth slows only modestly and remains close to 3%, supported by continued AI and resilience investment.

Higher prices weigh on consumption, but AI, defense, and reshoring investment continue to support growth. Inflation remains persistent despite limited signs of a wage-price spiral, keeping the Fed cautious about rate cuts.

Higher energy costs weigh on growth, but fiscal support and defense and AI investment help avoid a sharp slowdown. The ECB is expected to raise rates twice in 2026 before beginning to ease in 2027.

Domestic energy production and inventories cushion the impact of supply disruptions. However, excess capacity and weak domestic demand keep deflationary pressure elevated.

Higher oil prices weigh on growth in FY2026, but AI-related exports and business investment limit the slowdown. Growth rebounds in FY2027 as geopolitical tensions ease, real incomes improve, and policy support strengthens domestic demand.

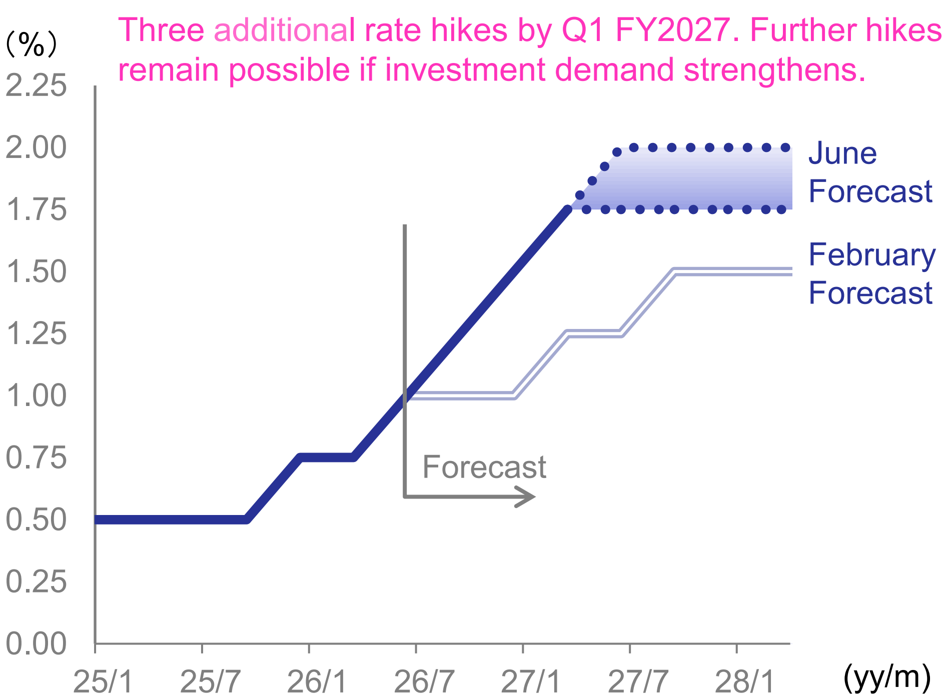
AI investment boosts exports and growth in the NIEs. ASEAN avoids a significant slowdown, although the impact varies considerably across countries.

Note: Shaded areas indicate forecasts. Global growth rates are calculated based on IMF GDP shares (PPP)
Source: IMF, national/regional statistics; made by Research Department, Mizuho Research Institute

Appendix3: BOJ's Policy Rate and USD/JPY

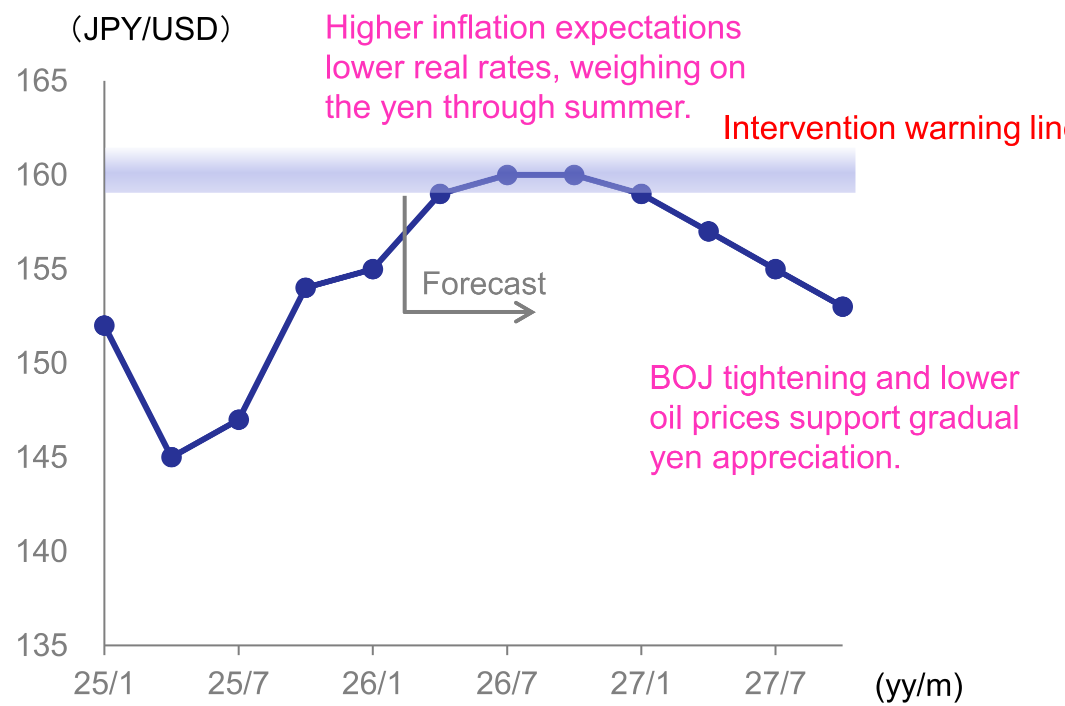
- The BOJ is expected to front-load rate hikes. Three additional rate hikes are expected by Q1 FY2027.
- The BOJ aims to prevent further easing in financial conditions and inflationary pressure from yen depreciation.
- The yen remains weak through FY2026 before gradually strengthening. Higher oil prices and lower real interest rates keep the yen weak in FY2026.
- BOJ tightening and lower oil prices support a gradual appreciation from FY2027.

BOJ's Policy Rate



Source: Bank of Japan; made by Research Department, Mizuho Research Institute

USD/JPY Forecast

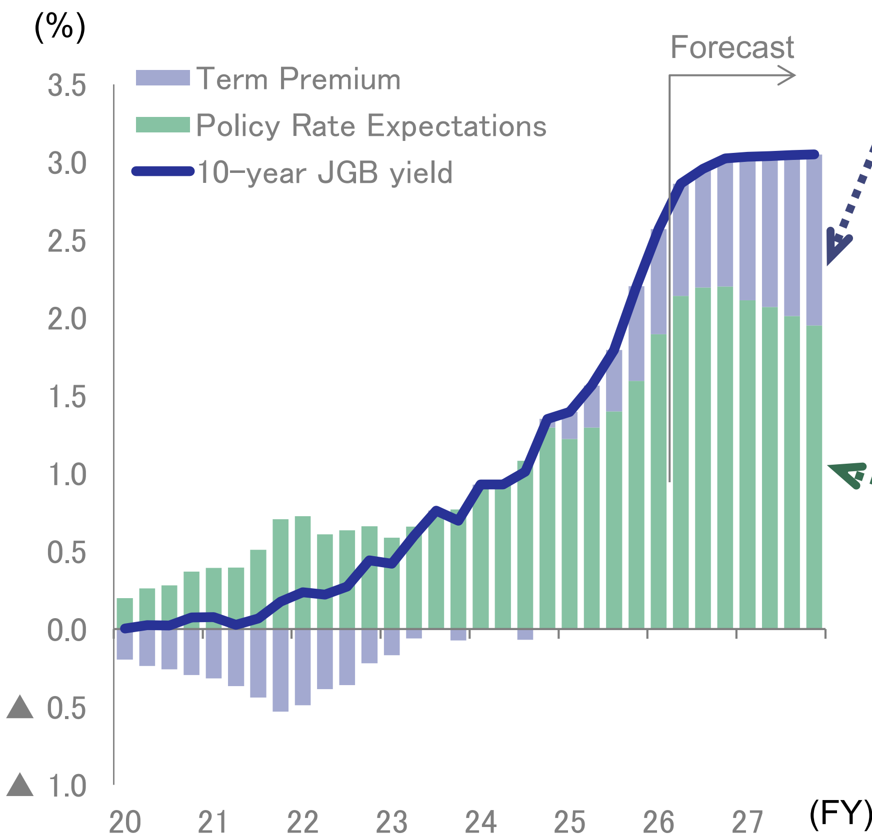


Source: LSEG; made by Research Department, Mizuho Research Institute

Appendix4: Long-term Interest Rates

- The 10-year JGB yield is projected to rise to around 3% in FY2026 and stabilize thereafter.
- Rate-hike expectations will lift the yield in FY2026, while BOJ balance-sheet reduction will gradually restore the term premium.
- A further sharp rise appears unlikely, given fiscal discipline and ample domestic savings. From FY2028, the yield is expected to rise gradually as the BOJ continues to reduce its balance sheet.

Key Drivers of 10-year JGB yield



Only a Gradual Rise in the Term Premium

BOJ balance-sheet reduction
Yield-curve normalization will gradually lift the term premium, but the BOJ's focus on market stability should prevent a sharp increase.

Fiscal deficit
At around 3% of GDP, the fiscal deficit remains manageable by advanced-economy standards and is unlikely to exert sustained upward pressure on the term premium.

Policy Rate Expectations Stabilize at Around 1.75%

Inflation expectations
Near-term inflation expectations will lift rate expectations, but excessive tightening expectations should unwind from FY2027.

Investment demand
Higher funding demand can be absorbed by Japan's ample domestic savings, limiting upward pressure on yields.

Source:Made by Research Department, Mizuho Research Institute based upon LSEG.

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