

Daiwa's Economic View

Takaichi administration to frontload defense spending increase

- New administration to frontload increase in defense spending to 2% of GDP within FY25
- Would increase FY25 supplementary/FY26 initial budgets by around Y4tn each versus initial FY25 budget, but no automatic increase in JGB issuance
- Administration to revise defense spending plans from FY27 by end-2026; we focus on budget size, funding

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New Prime Minister Sanae Takaichi will reportedly announce plans to frontload an increase in defense spending to 2% of GDP within FY25 as part of her initial policy speech to the extraordinary Diet session that began this week. This would increase defense spending in the FY25 supplementary budget by nearly Y4tn, and the initial FY26 budget would also increase by just over Y4tn versus the initial FY25 budget. However, the current approach involves funding the increase via spending reforms, the previous year's budget surplus, and non-tax revenue. It is unclear at this point whether it would lead to an increase in JGB issuance.

The administration will reportedly revise its defense spending plans from FY27 by end-2026, bringing the current targets forward by a year. The JGB market's focus through end-2026 will be whether the administration raises its spending target beyond 2% of GDP and if so how it funds the increase.

Defense spending to reach 2% of GDP during FY25

Ms. Takaichi apparently intends to frontload Japan's target for increasing defense spending to 2% of GDP to within FY25. Media reports indicate that this will form part of her initial policy speech in the extraordinary Diet session.

We think the 2% figure for defense spending will be relative to nominal GDP in the government's economic forecasts for the corresponding fiscal year. Its FY25 forecast is Y629tn, 2% of which would be Y12.6tn.

This compares with the initial FY25 defense budget of Y8.7tn, and would require a Y3.9tn increase as part of the supplementary budget.

The administration would also need to secure 2% of GDP for defense spending in the initial FY26 budget. Assuming its FY26 nominal GDP forecast is around Y648tn, 2% of this would be around Y13tn. This would be around Y4.3tn higher than the initial FY25 budget.

However, these increases in defense spending in the FY25 supplementary/FY26 initial budgets would not automatically lead to an increase in new JGB issuance. The five-year Defense Buildup Program for FY23-27 that the Kishida cabinet approved in December 2022 states that funding for the increase in defense spending versus FY22 will come from spending reforms, budget surpluses, non-tax revenue, and tax measures (i.e., tax hikes to fund defense spending).

It is unclear at this point how the Takaichi administration would secure funding if it opts to frontload these defense spending plans. If it sticks with the approach of the current Defense Buildup Program, JGB issuance would not increase. The program aims to increase spending to 2% of nominal FY22 GDP in FY27, its final year. The Takaichi administration's plans would increase this figure considerably. If the administration cannot secure the required funding via the approach laid out in the current program, it could issue JGBs to cover part of the shortfall.

Takaichi administration to consider frontloading defense spending plans from FY27 by one year

Media reports also indicate that the Takaichi administration will consider frontloading defense spending plans from FY27 by a year.

Japan's three strategic documents (National Security Strategy, National Defense Strategy, and Defense Buildup Program) define its national security and defense strategies and the defense capabilities they require. The current strategy documents were approved by the Kishida cabinet in December 2022. The Defense Buildup Program includes defense spending and funding methods for the five years from FY23 through FY27.

The Kishida cabinet's three strategic documents assumed a roughly 10-year timespan. However, the Liberal Democratic Party's (LDP) coalition agreement with the Japan Innovation Party (JIP) includes a decision to frontload revisions to the three documents. Ms. Takaichi will reportedly announce in her policy speech to the Diet that the administration aims to complete these revisions by end-2026.

This would also mean that the Defense Buildup Program is frontloaded by a year, affecting the defense spending budget from FY27 onwards. As December 2026 approaches, JGB market participants would therefore also need to watch whether the administration increases its defense spending budget beyond 2% of GDP, and whether part of the funding will come from JGB issuance.

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