

Daiwa's View

Scenarios in which defense spending is raised to 5% of GDP: Two points of divergence

- Stabilizing the debt ratio requires maintaining the current GDP benchmark and ratio of domestic production
- Expanded imports would exert upward pressure on superlong yields, while maintaining ratio of domestic production would put upward pressure on short- to medium-term yields

FICC Research Dept.

Ryoma Kawahara

81-3-5555-8777

ryoma.kawahara@daiwa.co.jp

**Kento Minami**

81-3-5555-8789

kento.minami@daiwa.co.jp



Daiwa Securities Co. Ltd.

Scenarios in which defense spending is raised to 5% of GDP

The former provisional tax rates on gasoline and diesel fuel are expected to be abolished in the upcoming supplementary budget. While this is projected to lower annual revenue by around ¥1.5tn, the fiscal impact from large-scale fiscal stimulus at the supplementary budget stage is likely to be limited due to time constraints.

However, there are significant concerns that the administration's intentions will be reflected in the compilation of the full-year budget, leading to fiscal expansion. Of particular interest was the fact that Prime Minister Sanae Takaichi made a commitment to bring forward raising the defense budget to the equivalent of 2% of GDP during President Trump's visit in late October. This merely signifies the achievement of a near-term goal, and, once the 2% target has been reached, a new plan might be incorporated into the three national security-related documents (the "new three documents") scheduled for revision next year.

In June 2025, the US requested that NATO member nations increase their national defense expenditures to 5% of GDP (a total of 3.5% for defense spending and 1.5% for related expenses). The US Department of Defense has expressed the view that spending 5% on defense would become the standard in Asia, and it is highly likely that Japan will be faced with a similar request. Although it is officially stated that the US has not made a specific numerical request, there is a real risk that a 5% target will be incorporated into the revision process for the new three documents.

This report conducts a simulation analysis to determine what the impact would be on public finances and yields if defense spending were raised to 5% of GDP. To state the conclusion at the outset, the conditions for stabilizing the debt ratio are limited, and there would be a need to meet two conditions simultaneously: (1) domestic production of equipment would have to be maintained, and (2) there would have to be a methodology for setting the GDP benchmark.

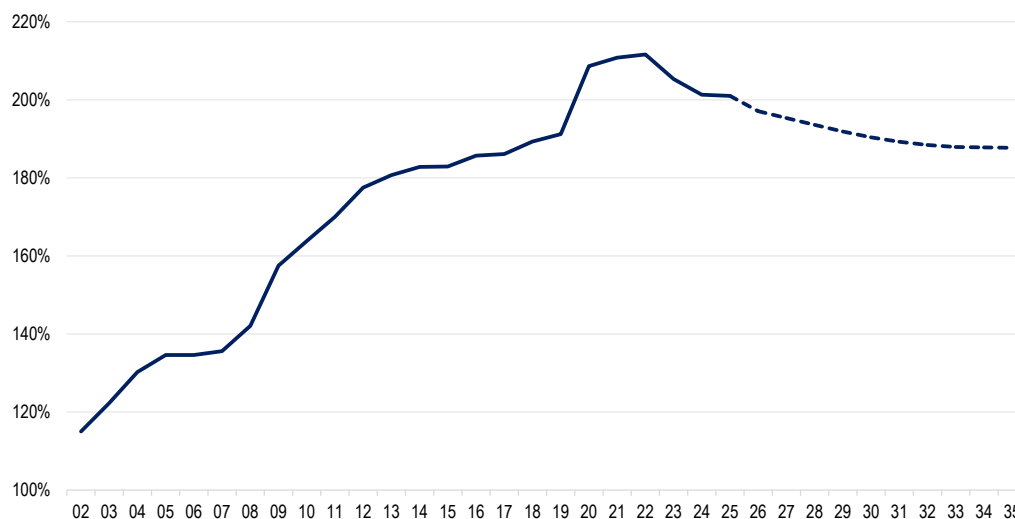
Baseline scenario: Criterion for fiscal sustainability

For this analysis, we referenced the "Economic and Fiscal Projections for Medium to Long Term Analysis" submitted by the Cabinet Office to the Council on Economic and Fiscal Policy on 7 August 2025. We think that the "Transferring to a New Economic Stage Case" and "Projection of Past Trend Case" in these projections represent optimistic and pessimistic extremes, respectively. With the aim of producing a realistic outlook, we set a baseline scenario that takes the middle ground between the two.

In this scenario, the government debt-to-GDP ratio declines moderately from 197.1% in FY26 to 189.3% in FY31. Then, the ratio remains largely flat, reaching 187.7% in FY35.

The thing that is crucial for determining fiscal sustainability is what happens with the debt-to-GDP ratio in the final year of the projection period. The key point is that it remains almost flat, moving from 187.8% in FY34 to 187.7% in FY35. If it turns upwards in the final year, even if it remains flat until the previous year, that suggests a high likelihood that the debt ratio will enter an upward trajectory. We evaluate the following 5% defense spending-to-GDP ratio scenario based on this criterion.

Our Forecasts for Government Debt-to-GDP Ratio



Source: Cabinet Office; compiled by Daiwa.

Analytical framework for scenario with ratio of defense spending to GDP raised to 5%: Two points of divergence

In analyzing the fiscal impact of expanding defense spending to 5% of GDP, there are two important points of divergence.

The first point of divergence is the ratio of total defense spending procured from imports. According to the Ministry of Defense, domestic spending currently accounts for about 80% of the defense budget, with the ratio of imports at only about 20%. Going forward, expansion of defense spending is expected to be achieved primarily through material costs—particularly highly variable expenditure items, such as equipment purchases, R&D, and base construction. This is because costs for personnel and provisions have limited flexibility, as the number of troops cannot be easily increased or decreased.

The second point of divergence is the methodology for setting the GDP benchmark used to calculate the ratio of defense spending. The current Defense Buildup Program uses the GDP for FY22 as the benchmark, and this value has not changed in subsequent years. However, future institutional changes could lead to a method that would use the GDP for the fiscal year in question instead.

In this analysis, we examined a total of four scenarios: two cases for the ratio of imports—one using the current level (20%) and another with a significant increase in response to US requests (50%)—and two cases for the GDP benchmark—one maintaining the FY22 benchmark and another switched to a benchmark using the GDP for the fiscal year in question.

We assume that the additional spending will be entirely financed by the issuance of JGBs. We also assume that defense spending will be increased by 0.3ppt each year through FY2035 in order to reach the target of 5% of GDP.

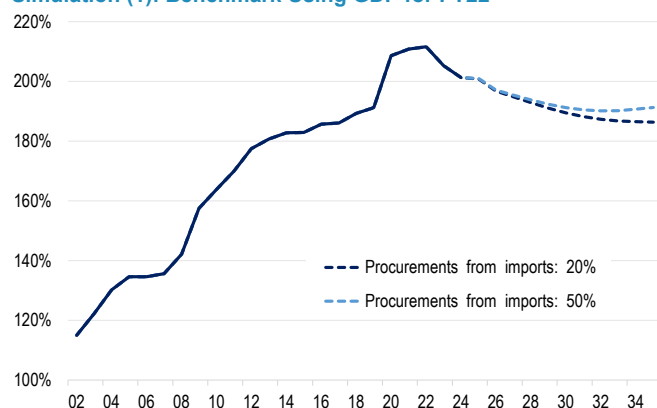
Simulation results: Strict conditions for debt ratio stabilization

The simulation results indicate that the conditions for stabilizing the debt ratio are limited if defense spending is raised to 5%.

Even if the FY22 benchmark were maintained, the results would differ significantly, depending on the ratio of imports. If the import ratio were to remain at the current 20%, the debt-to-GDP ratio in FY35 would be 186.4%, staying almost flat, at a level similar to the baseline scenario. However, if the import ratio were to rise to 50%, the debt ratio would turn upwards, rising from 190.7% in FY34 to 191.3% in FY35. This suggests that the debt ratio would have entered an upward trajectory.

The situation is even more severe if the benchmark is switched to the one using the GDP for the fiscal year in question. Even with an import ratio of 20%, the debt ratio trends slightly upwards to 186.4% in FY35. If the import ratio were to rise to 50%, the debt-to-GDP ratio would enter a clear uptrend from FY33 onwards, reaching 194.4% in FY35.

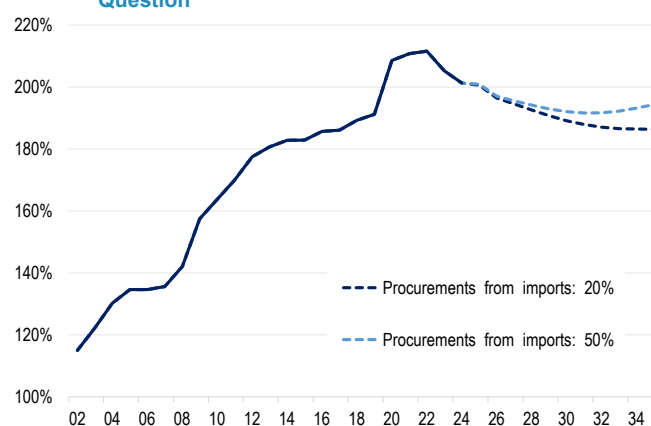
Simulation (1): Benchmark Using GDP for FY22



Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa.

Notes: (1) The boost to real GDP from increased defense spending is estimated using a standard input-output model with the Leontief inverse matrix. Calculated using tax revenue elasticity of 1.2.
 (2) We assumed that the defense-to-GDP ratio would reach 2% in FY25, then increase by 0.3ppt annually, reaching 5% in FY35.

Simulation (2): Benchmark Using GDP for Fiscal Year in Question



Source: Cabinet Office, MIC; compiled by Daiwa.

Notes: (1) The boost to real GDP from increased defense spending is estimated using a standard input-output model with the Leontief inverse matrix. Calculated using tax revenue elasticity of 1.2.
 (2) We assumed that the defense-to-GDP ratio would reach 2% in FY25, then increase by 0.3ppt annually, reaching 5% in FY35.

In summary, the debt ratio remains almost flat only if the FY22 GDP benchmark is maintained and the import ratio is kept at its current level of around 20%. If either of these two conditions is not met, the debt ratio follows an upward trajectory.

Importance of maintaining ratio of domestic production

The most important implication for policy indicated by the results of these simulations is that the key condition for stabilizing the debt ratio is to maintain the ratio of domestic production of equipment.

The US is asking its allies to increase defense spending, but it also expects them to expand purchasing of US-made equipment. If Japan were to continue to significantly increase its import ratio in line with US requests, there would be an outflow of a substantial portion of the increased defense spending towards overseas, limiting the boost to domestic GDP. As a result, the defense spending-to-GDP ratio would continue to rise amid a slowdown in the growth of the denominator (GDP), leading to a rise in the debt ratio.

What is particularly noteworthy is that, even if the FY22 benchmark were maintained, concerns about fiscal sustainability would arise if the import ratio increased to 50%. This means that even implementing institutional support in the form of this methodology for setting the GDP benchmark, that would not be able to completely prevent the negative impact from the rising ratio of imports.

Therefore, a crucial factor in determining whether defense spending can be expanded while keeping the debt ratio on a stable path will be the extent to which domestic production can be strengthened going forward. The domestic production of equipment is not merely an issue of industrial policy or security autonomy; it is also a critical policy choice with significant fiscal implications.

Importance of the GDP benchmark: Fiscal risks hidden in technical issues

The other important point of divergence is the methodology for setting the GDP benchmark for calculating the ratio of defense spending. While this may seem like a technical issue, it is, in fact, an institutional design choice that affects the trajectory of the debt ratio.

If the FY22 benchmark were maintained, a 20% import ratio would allow the debt ratio to remain almost flat. However, if the benchmark were switched to one using the GDP for the fiscal year in question, even with the same 20% import ratio, the debt ratio would trend slightly upwards, and the risk of a further rise in the debt ratio would grow, depending on changes in the conditions.

This difference arises from the impact that the methodology for setting the GDP benchmark has on the denominator of the defense spending-to-GDP ratio. Fixing the benchmark on the FY22 GDP means that subsequent nominal GDP growth effectively suppresses the real growth in defense spending. On the other hand, switching to the benchmark using the GDP for the fiscal year in question means that defense spending would continue to increase in line with nominal GDP growth, resulting in a heavier burden on public finances.

How this methodology for setting the GDP benchmark is decided during the process of revising the new three documents will be a critical point that will affect the future of public finances. If there were a switch to the benchmark using the GDP for the fiscal year in question, the debt ratio would trend upwards even if the import ratio were maintained at the current 20%.

Impact on yields: Two different mechanisms

Expanded defense spending has an impact on yields through different mechanisms, depending on the ratio of imports.

Upward pressure on superlong yields due to higher debt ratio

If the import ratio were to rise and the debt ratio entered an upward trajectory, concerns about fiscal sustainability would intensify. In this case, upward pressure would be expected to be applied specifically to yields in the superlong zone. Investors would likely begin to demand a risk premium, putting upward pressure on superlong JGB yields.

Based on the simulation results mentioned above, if the FY22 benchmark were maintained, a 50% import ratio would lead to a rise in the debt ratio. If the benchmark were switched to the one using the GDP for the fiscal year in question, a 50% import ratio would result in a more pronounced upward trend. In either case, there could be upward pressure on superlong yields.

Upward pressure on short- to intermediate yields via GDP boost

On the other hand, if the import ratio were maintained at its current level, the expansion of defense spending would act as fiscal policy, boosting the economic growth rate. Based on estimates using an input-output table, an expansion of defense spending to 5% of GDP with a 20% import ratio would boost the annual GDP growth rate by approximately 0.3ppt.

If the GDP growth rate were pushed up over the long term, the neutral interest rate would also rise. This means that the current policy rate would become more accommodative for the economy, increasing the likelihood of higher inflation than previously expected. The BOJ would be forced to raise its terminal rate for interest rate hikes higher than what it was before the expansion in defense spending took place. In this case, there would be upward pressure on short-term and intermediate yields.

Implications for bond investment: Limited conditions for stabilization

The most important point for investors is that the conditions for stabilizing the debt ratio would be limited if the ratio of defense to GDP were raised to 5%.

As shown by the simulation results, the debt ratio would remain almost flat only when the FY22 GDP benchmark was maintained and the import ratio was kept at its current level of around 20%. If these conditions were not met, the debt ratio would enter an upward trajectory, potentially creating upward pressure on superlong yields.

The following three issues will warrant close attention during the process of revising the three security-related documents scheduled for next year.

The first issue will be the level of defense spending itself. The initial point of divergence will be whether a 5% target is explicitly stated.

The second issue will be the policy for procuring equipment. The fiscal outlook will differ greatly, depending on whether a policy to maintain and strengthen domestic production is adopted, or whether the import ratio is expanded in response to US requests. While this issue will be officially discussed as a security-related procurement policy, it is, in effect, a critical policy choice that will influence the trajectory of the debt ratio.

The third issue will be the methodology for setting the GDP benchmark. The seemingly technical point of whether to maintain the FY22 benchmark or switch to a benchmark using the GDP for the fiscal year in question would, in fact, impact the trajectory of the debt ratio.

The impact on yields is likely to vary significantly, depending on the combination of these three factors. If both the ratio of domestic production and the FY22 benchmark were maintained, the debt ratio would remain stable, and the primary effect would be upward pressure on short- to intermediate yields due to a boost in GDP. On the other hand, if the ratio of imports were to rise to around 50%, the dominant factor would become upward pressure on superlong yields, driven by concerns over fiscal sustainability.

At present, it is unclear how these issues will be decided. However, as the simulation results show, the conditions for stabilizing the debt ratio are limited, and certain policy choices could put the debt ratio on an upward trajectory. The bond market is likely to continue closely monitoring the process of revision of the new three documents in order to gauge the impact of expanded defense spending on public finances and yields.

Expansion of defense spending to 5% of GDP would be not only a defense policy issue but also a policy change with the potential to have an impact on the trajectory of the debt ratio and the interest rate term structure. The direction that impact would take would be determined by seemingly minor policy details, such as the ratio of domestic production of equipment and the methodology for setting the GDP benchmark. Investors will have to recognize the importance of these issues with regard to the future of public finances, and monitor the policy process closely.

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings

Issues are rated 1, 2, 3, 4, or 5 as follows:

- 1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
- 2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
- 4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices

Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities

Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association