

What Is the Primary Cause of Inflation? – Signs of “Fiscal Inflation” Lurking in the Background

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Negative Real Interest Rates & Pressure for Yen Depreciation

The Japanese economy has long suffered under a deflationary environment, experiencing a period of stagnation dubbed the “Lost 30 Years”. However, in recent years, although the government has not yet declared an end to deflation, prices have been on a sustained upward trend, with the inflation rate (Consumer Price Index) consistently exceeding 2% year on year. While wages have also risen in nominal terms, assessing the cause of this inflation is critically important for policy decisions.

The media generally report that the current inflation is a “cost-push type driven by soaring resource prices and yen depreciation”. Certainly, the impact of rising resource prices following the Ukraine war and the yen’s depreciation was significant at one point. But is that explanation truly sufficient? (*Chart 1*).

First, crude oil prices stood at approximately \$63 per barrel for WTI early in September 2025, a significant decline from the peak of over \$110 per barrel in 2022. Despite falling resource prices, Japan’s inflation rate remained at around 3.1% (July 2025, core CPI).

So, what about the impact of yen depreciation? Generally, exchange rate fluctuations are related to changes in Japan’s current account balance and trade structure, but interest rates also play a significant role. Comparing the long-term interest rates and inflation rates of Japan as of July 2025 to those of other major nations

reveals Japan’s unique position.

In the United States, the 10-year Treasury yield is approximately 4.2%, with inflation at about 2.7% (core inflation around 3.1%), resulting in a positive real interest rate. In the European Union, centered on Germany and France, 10-year bond yields are in the 2.5% to 3% range, with inflation rates around 1.9% to 2.2%. Real interest rates are converging from near zero to positive levels. In the United Kingdom, 10-year bond yields are around 4% to 4.5%, with inflation at approximately 2.3%. Here too, real interest rates are positive.

In contrast, Japan’s 10-year government bond yield stands at approximately 1.5%, while its inflation rate is around 3%, resulting in a real interest rate of roughly -1.5%, which is negative.

This negative rate has created persistent downward pressure on the yen in the foreign exchange market. For investors, it is only natural to prefer the dollar or euro, which offer higher real returns for the same level of risk. As a result, downward pressure on the yen persists, creating a cycle that fuels import inflation.

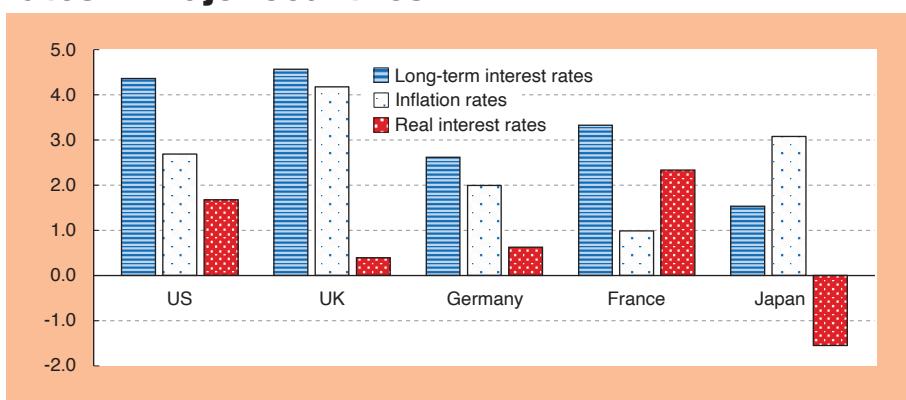
Monetary Policy with Elements of Fiscal Dominance

So why is Japan the only country consistently stuck with negative real interest rates? The fundamental reason lies in the “fiscal constraint” stemming from its massive government debt.

Government debt-to-GDP ratios have already exceeded 200%, reaching levels that stand out among advanced economies. In this environment, if long-term interest rates rise autonomously, the rapid expansion of government bond interest payments would significantly undermine fiscal sustainability. Consequently, monetary policy inevitably takes on a character of “fiscal dominance”. Indeed, when yields on ultra-long-term government bonds rose in June 2025, the Bank of Japan (BOJ) adjusted the pace of its bond-purchase reductions to curb sharp market fluctuations.

BOJ Governor Kazuo Ueda has

CHART 1
Comparison of long-term interest rates & inflation rates in major countries



Source: Compiled by the author based on OECD data

suggested a terminal target rate of around 1% for the policy interest rate. However, the current policy rate is only 0.5%. Even if raised to 1%, with inflation exceeding 3%, the real interest rate would remain negative (around -2%), limiting its restraining effect. On the other hand, raising interest rates further would increase fiscal costs. With the national debt exceeding ¥1,000 trillion, a rise in long-term interest rates from the current level of around 1.5% to around 3% might still be tolerable. However, if rates jump to 5-7%, interest payments on government bonds would surge sharply, potentially plunging fiscal management into a crisis. (If long-term interest rates reach 7%, interest payments would approach the total tax revenue of the national general account budget.) As fiscal and monetary policy become increasingly interdependent, the risk grows that the BOJ will be forced to prioritize fiscal stability over price stability.

Even at an inflation rate of around 3%, public dissatisfaction with rising prices is significant, but the most serious situation would likely arise if inflation exceeds 5%. The BOJ would be forced to choose between two options: “significantly raising interest rates to curb inflation” or “effectively tolerating inflation while considering the impact on fiscal policy”. Choosing the former could lead to a fiscal crisis, while choosing the latter risks accelerating yen depreciation and price increases, creating a vicious cycle. If markets anticipate the latter, speculative yen selling could accelerate, potentially triggering historically significant exchange rate fluctuations.

This situation is not merely a matter of monetary policy, but also a structural problem stemming from a lack of fiscal discipline. The current inflation may be attributable to structural constraints such as fiscal and monetary policy.

During periods of deflation, the problem of massive government debt did not surface, but in an inflationary environment its vulnerability becomes apparent. While inflation boosts tax revenues and makes fiscal reconstruction appear to progress, the very “fiscal structure burdened by massive government debt” is robbing Japan’s monetary policy of its freedom.

Furthermore, the impact of domestic policy cannot be ignored. The government is considering household support measures such as tax cuts and cash handouts to counter rising prices. These measures aim to boost household disposable income in the short term and maintain purchasing power. However, they simultaneously carry the risk of stimulating aggregate demand across the entire macroeconomy, potentially further intensifying inflationary pressures. Caution is warranted regarding the potential for a

paradoxical situation where economic stimulus measures actually fuel inflation during periods of rising prices.

Inflation has boosted tax revenues and nominal wages, but the benefits have not been distributed equally to all citizens. For many households, nominal wage growth has failed to keep pace with rising prices, causing real wages to decline and making daily life increasingly difficult. For low-income households and pensioners in particular, rising prices for essential goods like food and energy are a major blow. Therefore, it is essential in policy design to appropriately control inflationary pressures while ensuring targeted redistribution to households in genuine need. Rather than simply providing uniform benefits, targeted assistance and complementary support through social security systems will be required.

As outlined above, Japan’s shift toward inflation stems not merely from exogenous cost-push factors, but from a complex interplay of structural issues: negative real interest rates, pressure for yen depreciation, and massive government debt. If short-term policy responses – such as tax cuts and cash handouts to counter rising prices – are applied excessively, they could stimulate aggregate demand across the macroeconomy and further intensify inflationary pressures. At the same time, we must also acknowledge the existence of numerous households facing declining real wages and squeezed living standards.

Therefore, future policy must simultaneously meet the dual demands of paying attention to inflationary pressures while strengthening redistribution for those who are truly struggling.

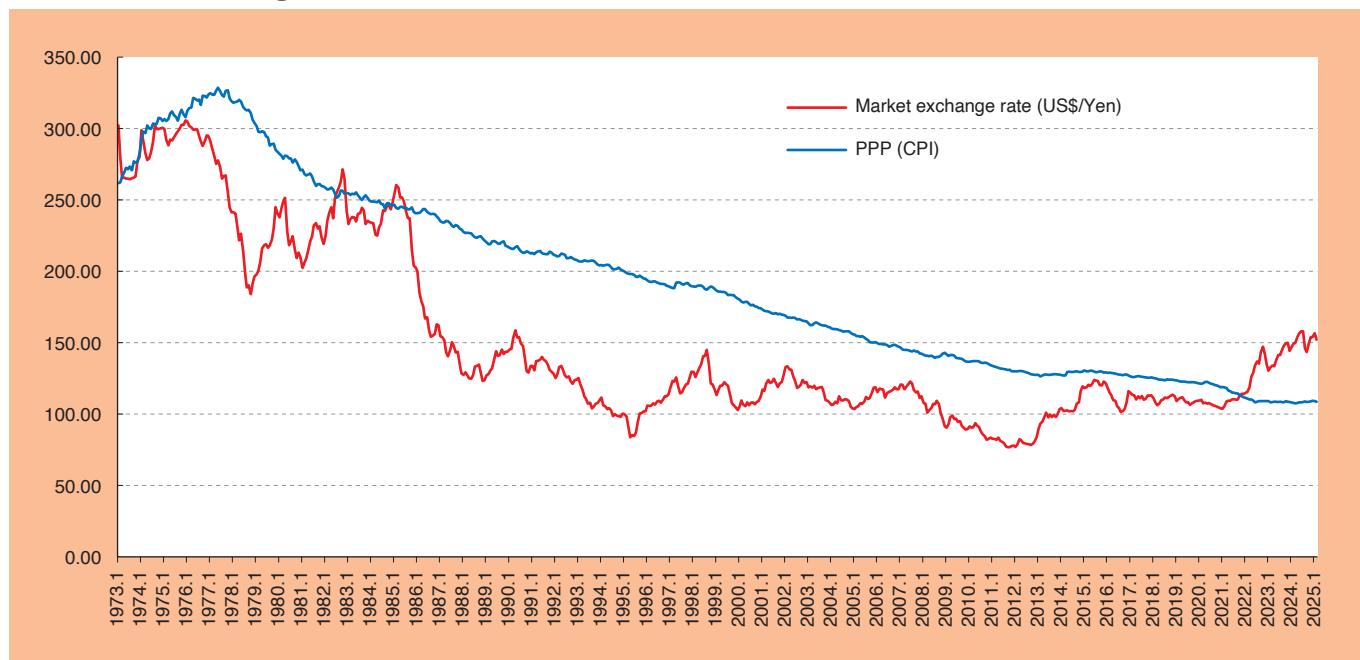
The Japanese economy is finally emerging from deflation, but the harsh reality awaiting it is the risk of fiscal and monetary policies colliding with each other. While the “Fiscal Theory of the Price Level” exists, the current inflation and yen depreciation pressures resemble the mechanism by which a sick patient fights off viruses through fever. This also appears to be a sign that fiscal policy is autonomously attempting to improve its balance.

Implications of the Deviation Rate Between Market Exchange Rates & Purchasing Power Parity

Some argue that inflation is temporary, but that is not necessarily the case. So, what is the probability that the current inflationary trend will persist? While forecasting the future is difficult, one clue for examining this point is the divergence rate between the market exchange rate and Purchasing Power Parity (PPP).

CHART 2

Market exchange rates & PPP trends



Source: Compiled by the author based on data provided by the Institute for International Monetary Research

Until a few years ago, the dollar-yen rate hovered around 100 yen per dollar. However, since 2022, rapid yen depreciation has progressed, with the rate temporarily exceeding 160 yen per dollar. Yen depreciation is one factor increasing domestic inflationary pressure through higher import prices. However, to accurately gauge this inflationary pressure, observing foreign exchange market movements alone is insufficient; it is necessary to consider PPP.

PPP is an indicator that compares the purchasing power of currencies across different countries and regions. For example, if a Big Mac costs approximately \$6 in the US and ¥480 in Japan, the PPP based on Big Mac prices (dollar-yen rate) would be $\$1 = ¥80$. However, calculating the exact PPP is difficult as it requires comparing prices of various goods and services. Consequently, many reports estimate PPP ranges between $\$1 = 90$ yen and $\$1 = 130$ yen. Assuming a reasonable PPP value of $\$1 = ¥110$ (the average of these estimates), when the market exchange rate is $\$1 = ¥150$, the deviation rate reaches approximately 36% ($¥40 ÷ ¥110$).

What does this deviation rate signify? Since the market exchange rate and PPP are mutually aligned through arbitrage in trade transactions, the following three scenarios are conceivable over the medium to long term (*Chart 2*).

- ① Market exchange rates converge toward PPP.
- ② PPP converges toward the market exchange rate.
- ③ Both parties move closer to each other.

Given the current decline in Japan's economic competitiveness and structural changes in its current account balance, while the market exchange rate might temporarily return to around ¥130 per dollar, a scenario (①) where it permanently falls back below ¥110 per dollar seems unlikely. In that case, the probability of scenarios ② or ③ occurring would be higher. In either scenario, this implies that the PPP value (= Japan's prices ÷ US prices) will rise, converging toward the market exchange rate. For the PPP value to increase,

Japan's inflation rate must remain higher than that of the US.

What Are the Anticipated Medium-Term Risk Scenarios?

In addition to the factors mentioned above, attention must also be paid to other elements contributing to inflationary pressures. Currently, against the backdrop of shifts in the international order, such as the US-China rivalry and the Russia-Ukraine war, the fragmentation of the global economy is progressing from an economic security perspective. Furthermore, in Japan, where rapid population decline is advancing, the economy has already entered a full-fledged labor shortage phase, and pressure for wage increases is likely to intensify. If such wage increases generate price rises, creating a chain reaction akin to a "wage-price spiral", it is conceivable that inflation rates could remain persistently elevated.

Broadening our perspective further, the uniqueness of the Japanese economy becomes even more apparent in historical and international comparison. For example, during Japan's postwar period, particularly throughout its high economic growth era, price increases and wage increases progressed almost in parallel. This so-called "wage-price spiral" functioned as one of the key drivers propelling Japan's economic growth. However, under the current conditions of a declining birthrate and aging population coupled with a lower potential growth rate, we are now observing price increases that do not accompany the kind of sustained real growth seen in the past. This point represents the watershed separating "healthy inflation" from "unhealthy inflation", and the possibility that we are approaching the latter cannot be ignored.

Organizing the "risk scenarios" anticipated in the medium term, the following three points come to mind. First is the risk scenario of "sluggish stagflation". This scenario involves real GDP growth stagnating below 1%, while inflation remains stubbornly high at 3-4% and real wages trend downward. Second is the risk scenario of "fiscal-driven inflation". This occurs when the fiscal deficit loses market confidence, causing government bond yields to surge sharply. Consequently, the BOJ is forced to intensify its bond purchases, leading to a decline in the currency's value and a situation where the price level is determined by fiscal balance. The third is a risk scenario of "exchange rate-driven inflation". This case involves further yen depreciation as the gap with PPP is corrected, leading to imported inflation permeating the domestic price

structure. These three risk scenarios are not mutually independent; they could interact and shake the Japanese economy in a complex manner.

Internationally speaking, the link between fiscal policy and inflation is by no means unique to Japan. In the 1970s, the combination of "big government" and "high inflation" in the US triggered stagflation. In recent years, emerging economies have seen numerous instances of high inflation stemming from a vicious cycle of currency depreciation and fiscal deficits. However, Japan's unique characteristic lies in the fact that, despite its exceptionally large debt stock, the majority of its government bonds are held by domestic investors, meaning it does not immediately face a foreign currency debt crisis. Conversely, this also suggests that the delicate balance sustained by domestic financial circulation, where the public's asset composition is excessively skewed toward government bonds, is beginning to unravel under inflationary conditions. If households and institutional investors shift from government bonds to other assets as an inflation hedge, rising long-term interest rates will be unavoidable, further tightening fiscal and monetary constraints.

Ultimately, the current situation surrounding inflation in Japan cannot be simply understood in terms of an extension of the traditional policy goal of "escaping deflation". Rather, it should be viewed as a phase where the distortions in fiscal and monetary policy, preserved during the deflationary period, are now becoming apparent in the inflationary phase. In other words, inflation is also a process that reveals the consequences of continually avoiding fiscal reconstruction. What matters is whether we can face this reality squarely and devise a strategy to address both inflationary pressures and fiscal constraints through medium-term fiscal and social security system reforms, rather than relying on short-term economic stimulus or one-off benefit measures.

That said, it is also true that inflation contributes to increased tax revenues and rising nominal wages. Whether we can achieve sustainable growth and a sustainable fiscal structure by implementing appropriate redistribution while paying close attention to fiscal stimulus relative to aggregate demand, ensuring the inflation rate settles at an appropriate level, will depend entirely on policy responses over the next few years.

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