

Japan to No Longer Meet the Domar Condition in 2030 Amid Rising Long-Term Interest Rates

— Policy Management Premised on Monetary Policy Normalization —

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〈Summary〉

- ◆ In Japan, long-term interest rates have been rising, and the government's interest payments have also been increasing. The Domar condition, under which the long-term interest rate, or effective interest rate, remains below the nominal economic growth rate, is an important premise for stabilizing the government debt-to-GDP ratio. In Japan, this condition held throughout the 2010s, but the environment is changing significantly.
- ◆ An analysis covering OECD countries confirms that the Domar condition tends to be less likely to hold in countries with large government debt and low potential growth rates. It also tends to be less likely to hold in countries with high inflation volatility and low central bank holdings of government bonds. These results suggest that, in a phase in which supply constraints intensify and monetary policy normalization proceeds, maintaining the Domar condition will become more difficult than in the past.
- ◆ According to future simulations, in Japan the Domar condition will cease to hold on a persistent basis around 2030, and by 2040 the effective interest rate will exceed the growth rate by 2 percentage points. In this case, the long-term interest rate is calculated to rise to the low 4 percent range. This result largely reflects the effects of monetary policy normalization. In addition, the failure of the Domar condition to hold can push up government debt and, through an increase in the fiscal risk premium, can create a self-reinforcing vicious cycle that makes the condition even less likely to hold. The United States, the United Kingdom, Germany, and other countries are also expected to face phases in which the Domar condition does not hold, but Japan, which has government debt that is exceptionally high even among major countries, is more susceptible to such a process.
- ◆ In an environment in which the Domar condition does not hold, the government is likely to have an incentive to make the central bank postpone monetary policy normalization and thereby restrain interest payments. However, this could impair market confidence and instead reduce fiscal sustainability. It is desirable for the government to shift to fiscal management premised on monetary policy normalization and to position the Domar condition as an axis for evaluating policy management.

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1. Government interest payments increase sharply as interest rates rise

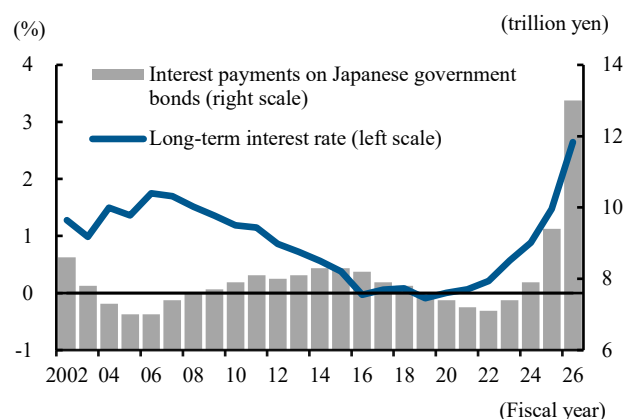
Japan's long-term interest rates have risen sharply. The yield on newly issued 10-year Japanese government bonds temporarily rose to 2.9 percent in July 2026, reaching a level not seen since 1996. Higher long-term interest rates push up the government's interest payments and put pressure on fiscal management. Interest payments in the FY2026 General Account Budget are expected to surge to 13 trillion yen and account for 10 percent of total expenditure (Figure 1).

The Domar condition is important when considering the sustainability of government debt. The Domar condition refers to the relationship between the effective interest rate paid on government debt, namely the effective interest rate, and the nominal economic growth rate. It determines whether the government debt-to-GDP ratio stabilizes. When the effective interest rate is lower than the growth rate, that is, when the Domar condition holds, interest payments are smaller than the increase in GDP. Therefore, even if the primary balance, or PB, is in a certain deficit, the government debt-to-GDP ratio stabilizes.

Conversely, when the effective interest rate exceeds the growth rate, that is, when the Domar condition is not satisfied, interest payments increase at a pace exceeding GDP. Therefore, as long as the primary balance remains in deficit, the government debt-to-GDP ratio continues to rise. Stabilizing this ratio requires a primary balance surplus above a certain level.

Fiscal management in the 2010s was supported by the Domar condition holding. In 2019, former IMF Chief Economist Olivier Blanchard argued for fiscal stimulus on the grounds that long-term interest rates

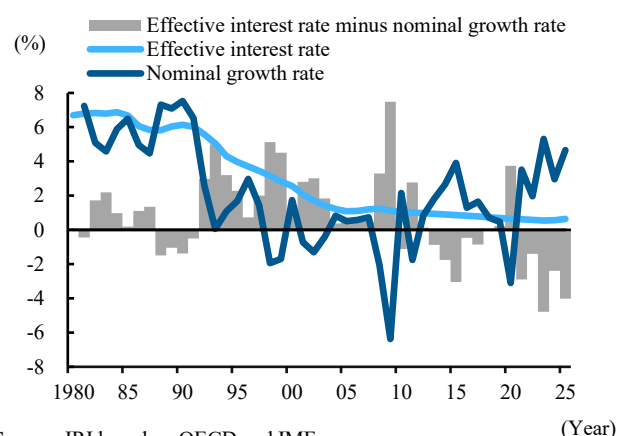
Figure 1. Long-term interest rates and interest payments on Japanese government bonds



Source: JRI based on Cabinet Office, Ministry of Finance, and Bank of Japan

Note: The long-term interest rate for FY2026 shows the June average.

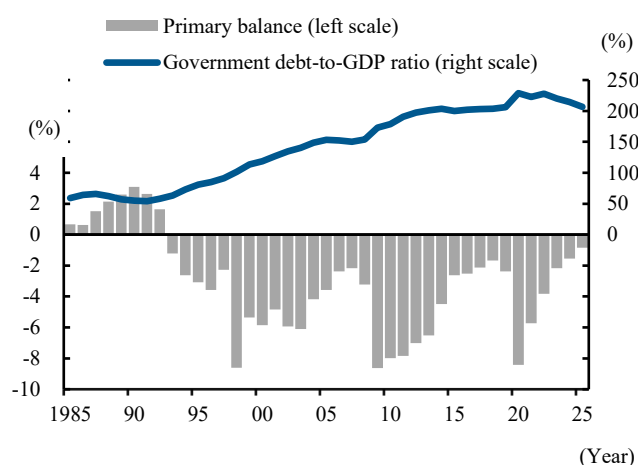
Figure 2. Effective interest rate and nominal growth rate



Source: JRI based on OECD and IMF

Note: The effective interest rate is calculated by dividing general government interest payments by general government gross debt.

Figure 3. Primary balance and government debt



Source: IMF "World Economic Outlook, June 2026"

Note: The government debt-to-GDP ratio is on a general government basis.

were below growth rates in many countries, which increased global interest in the Domar condition (Blanchard [2019]). In Japan as well, over more than the past decade, the effective interest rate remained below the growth rate, meaning that the Domar condition held. As a result, even amid persistent large fiscal deficits, increases in the government debt-to-GDP ratio were contained, and in recent years the ratio has turned downward (Figures 2 and 3).

However, in response to global inflation and monetary policy normalization following the COVID-19 pandemic, the economic environment surrounding the Domar condition has changed significantly. Today, the Domar condition is becoming more important not as an indicator for discussing fiscal space, but as an indicator for assessing risks in fiscal management. In Japan as well, economists expect the nominal economic growth rate for the current fiscal year to be in the high 2 percent range, and it would not be surprising if this fell below the long-term interest rate. The Bank of Japan has also recently strengthened its willingness to move further toward monetary policy normalization. If the premises that have supported the Domar condition change, there could be significant impacts on the sustainability of government debt.

2. The economic environment that determines the Domar condition

Going forward, Japan may face an economic environment in which the Domar condition is less likely to hold. An analysis of OECD countries using data from 1981 to 2023 confirms that the following factors have relatively strong effects on the Domar condition: 1) the size of government debt, measured by the government debt-to-GDP ratio; 2) growth and prices, including the TFP growth rate, inflation rate, and standard deviation of inflation; and 3) monetary policy, including short-term interest rates and the central bank's share of government bond holdings (Figure 4; see the Appendix for details of the estimation).

First, the higher a country's government debt-to-GDP ratio, the less likely the Domar condition is to hold. Since the difference between the interest rate and the growth rate is close to the concept of the term premium, an expansion of government debt is considered to push up long-term interest rates through increases in the fiscal risk premium and inflation risk premium¹. In fact, among OECD countries, a relationship is observed in which countries with higher government debt-to-GDP ratios have shorter periods during which the Domar condition held over the past 30 years (Figure 5). In Japan, where the size

Figure 4. Estimated effect of factors affecting the Domar condition

Variables	Coefficient	Standard errors
Government debt-to-GDP ratio	0.01***	(0.006)
TFP growth rate	-1.72***	(0.095)
Inflation rate	-1.21***	(0.061)
Standard deviation of inflation	0.34**	(0.143)
Short-term interest rate	0.59***	(0.042)
Central bank share of government bond holdings	-0.10***	(0.02)

Note: Using panel data from 18 OECD countries, the impact of each variable on the Domar condition (effective interest rate minus nominal growth rate) is estimated using a fixed-effects model. The sample period is 1981–2023. The sample size is 774. *** and ** indicate statistical significance at the 1% and 5% levels, respectively.

¹ Mian et al. [2025] analyze the relationship among government debt, interest rates, and growth rates using an economic model that incorporates the convenience benefits of government bonds, such as safety and liquidity, into households' utility function. They show that when government debt is sufficiently large, the interest rate exceeds the growth rate and the Domar condition ceases to hold.

of government debt is large, the share of the period during which the Domar condition held was only 37 percent, the second shortest after Italy (Figure 6). Japan can therefore be described as one of the countries where the Domar condition has been relatively unlikely to hold by international comparison.

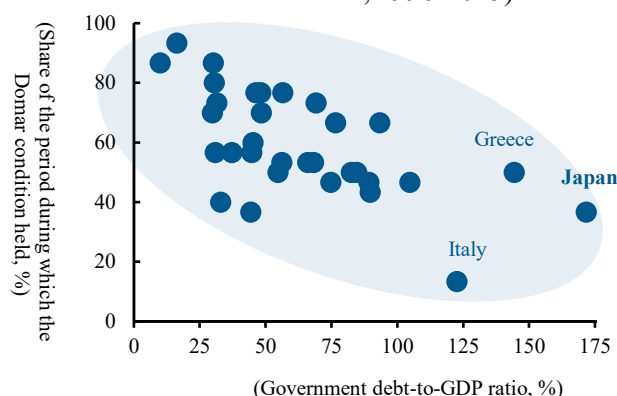
Movements in growth and prices also exert a large influence on the Domar condition. A decline in TFP growth tends to lower nominal economic growth more than interest rates, thereby making the Domar condition less likely to hold². In addition, a decline in the potential growth rate may worsen market perceptions of fiscal sustainability and raise the fiscal risk premium.

On the price side, not only the inflation rate itself but also the magnitude of inflation volatility is important³. A rise in the inflation rate to a certain degree makes the Domar condition more likely to hold, including by raising the nominal economic growth rate. By contrast, greater inflation volatility heightens the inflation risk premium and uncertainty over monetary policy, thereby acting in the direction of higher long-term interest rates. Therefore, not only the level of prices but also their stability is an important factor determining fiscal sustainability.

Monetary policy also has a large effect. The higher the short-term interest rate, and the lower the central bank's share of government bond holdings, the less likely the Domar condition is to hold. Monetary tightening pushes up long-term interest rates through increases in the policy interest rate, while a reduction in central bank holdings of government bonds pushes up the term premium, thereby acting in the direction of higher long-term interest rates⁴.

These analytical results suggest that the economic environment that has supported Japan's Domar condition

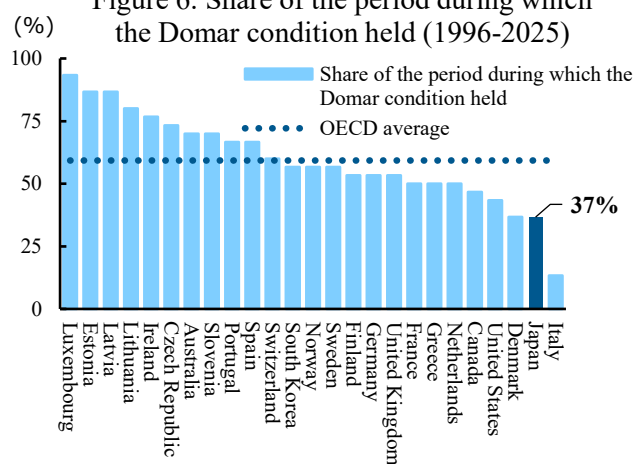
Figure 5. Government debt and the period during which the Domar condition held (32 OECD countries, 1996-2025)



Source: JRI based on OECD and IMF

Note: The government debt-to-GDP ratio is the average for 1996-2025.

Figure 6. Share of the period during which the Domar condition held (1996-2025)



Source: JRI based on OECD and IMF

Note: The OECD average is the average for 32 countries for which the effective interest rate can be calculated. Major countries are selected and shown.

² Since a decline in TFP growth lowers both interest rates and growth rates, its theoretical effect on the Domar condition is not clear. However, Checherita-Westphal and Domingues Semeano [2020] and Heylen et al. [2024] also report empirical results similar to those in this paper.

³ Because inflation volatility affects both interest rates and growth rates, its theoretical effect on the Domar condition is not clear. However, Nishioka [2022] analyzes data for OECD countries and points out that the difference between long-term interest rates and growth rates tends to move closely with the standard deviation of the inflation rate.

⁴ Adrian et al. [2025] use a DSGE, or dynamic stochastic general equilibrium, model incorporating segmented asset markets and show that central bank quantitative easing, or QE, makes the Domar condition more likely to hold through lower interest rates and higher output.

is changing. The intensification of supply constraints against a backdrop such as population decline and the normalization of monetary policy accompanying the entrenchment of inflation are likely to shift the environment in a direction in which the Domar condition is less likely to hold⁵. It is expected to become increasingly difficult to conduct fiscal management on the premise of a low-interest-rate and low-inflation environment as in the 2010s.

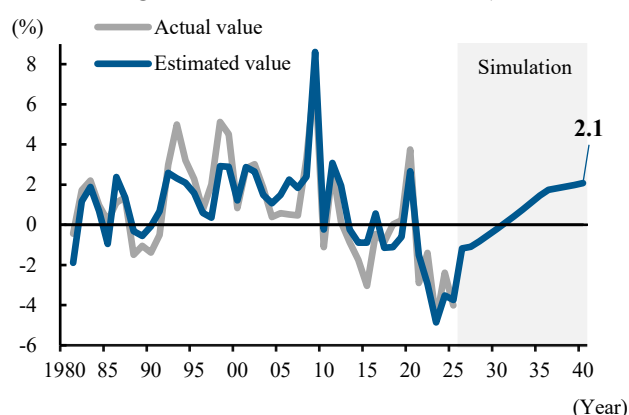
3. The Domar condition ceases to hold from 2030

Under a scenario in which supply constraints intensify, the Domar condition is likely to cease holding persistently in Japan from around 2030. A simulation based on the estimation results in the preceding section indicates that the effective interest rate will exceed the nominal economic growth rate in 2031 and that the gap between them will continue to widen thereafter (Figure 7). By 2040, the gap is projected to widen to 2.1 percentage points, and the long-term interest rate is expected to rise to the low 4 percent range.

The simulation uses the 2040 economic outlook, no-reform scenario, in Inoue et al. [2026] as the premise for the standard scenario. The potential growth rate is assumed to fall from the current level of 0.5 percent to around 0.2 percent, while the inflation rate is assumed to remain near 2 percent. In addition, reflecting the intensification of supply constraints amid factors such as population decline, the simulation assumes that inflation volatility will remain at a high level similar to the current level.

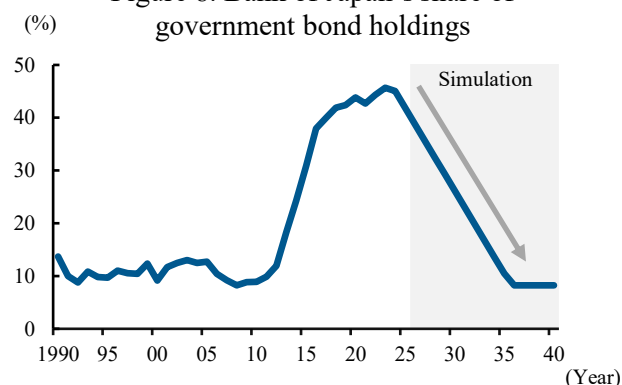
Regarding monetary policy, the policy interest rate is assumed to be raised to around 2 percent following the entrenchment of the price stability target. In addition, the Bank of Japan is assumed to gradually reduce its government bond holdings and

Figure 7. Future simulation of Japan's Domar condition (Effective interest rate minus nominal growth rate, standard scenario)



Source: JRI based on OECD, IMF, and other sources
Note: Estimated values are calculated from the estimation results in Figure 4.

Figure 8. Bank of Japan's share of government bond holdings



Source: Sovereign investor base estimates by Arslanalp and Tsuda [2014] (Date of last update: May, 2026)
Note: The graph shows holding shares of consolidated general government gross debt and includes not only government bonds but also Fiscal Investment and Loan Program (FILP) Bonds and Treasury Discount Bills (T-Bills).

⁵ Under supply constraints, fluctuations in economic activity and prices may become larger. When demand fluctuates, firms can absorb shocks to some degree flexibly through adjustments in operating rates, inventories, and working hours. Governments can also more easily stabilize economic activity and prices through fiscal and monetary policies. However, when supply constraints arise, it is difficult for firms to increase supply and procurement capacity in a short period. In addition, when supply chains are complex, some supply constraints can spill over to other transactions and easily generate large production fluctuations. Governments also find it difficult to respond directly on the supply side and face a trade-off between economic activity and prices, making economic countermeasures more difficult.

to return by around 2035 to a holding share close to the level before the introduction of Quantitative and Qualitative Monetary Easing (QQE; Figure 8). Meanwhile, regarding fiscal policy, the simulation assumes that social security systems, tax systems, and other current frameworks continue unchanged, and that the primary balance remains in deficit at around 2 percent of GDP.

According to the simulation results, the largest factor causing the Domar condition not to hold is monetary policy normalization (Figure 9). Greater inflation volatility due to supply constraints and a decline in the potential growth rate also act in the direction of making the Domar condition less likely to hold, but the raising of the policy interest rate and the reduction of government bond holdings by the Bank of Japan push up the effective interest rate substantially.

Moreover, the expansion of government debt also has a non-negligible effect on the Domar condition. Once the Domar condition ceases to hold, the government debt-to-GDP ratio continues to rise unless the fiscal balance improves. This pushes up the fiscal risk premium and further raises the effective interest rate. As a result, the Domar condition becomes even less likely to hold, and the country could fall into a self-reinforcing vicious cycle in which the debt stock grows increasingly rapidly. In the simulation here as well, the government debt-to-GDP ratio is estimated to turn upward in the early 2030s and reach 243 percent in 2040 (Figure 10).

The failure of the Domar condition to hold may apply not only to Japan but also to other advanced economies. Conducting a similar estimation for major OECD countries indicates that in the United States, the United Kingdom, France, and Germany, the effective interest rate will exceed the growth rate in 2040 in each case (Figure 11). In the United States and the United Kingdom, the gap between the effective interest rate and the growth rate is large, reflecting the relatively high level of short-term interest rates and the fact that government debt reaches a high level. Meanwhile, Japan's government debt-to-GDP ratio is exceptionally high even among

Figure 9. Factors behind changes in Japan's Domar condition

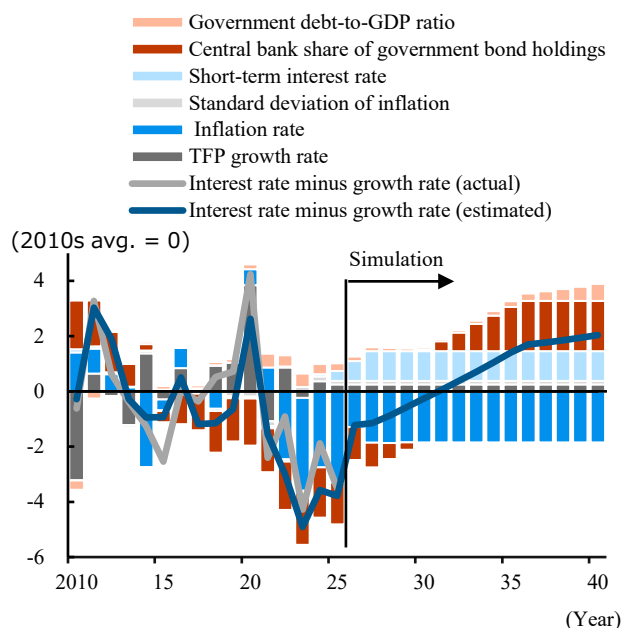
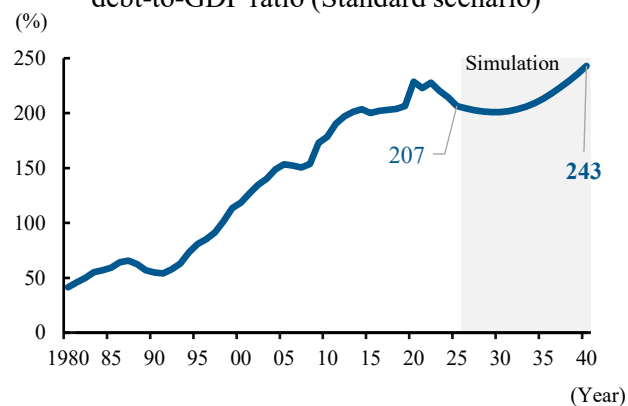


Figure 10. Future simulation of Japan's government debt-to-GDP ratio (Standard scenario)



major advanced economies. Particular attention should be paid to the fact that Japan faces a greater risk than other countries of the Domar condition no longer being met and this becoming not merely a temporary phenomenon, but a self-reinforcing process in which debt and interest rates adversely affect each other.

4. Policy management in an era in which the Domar condition is no longer met

As described above, Japan may shift to an environment in which the Domar condition does not hold persistently from the 2030s. In such an environment, policy management must be considered from perspectives different from those in the past.

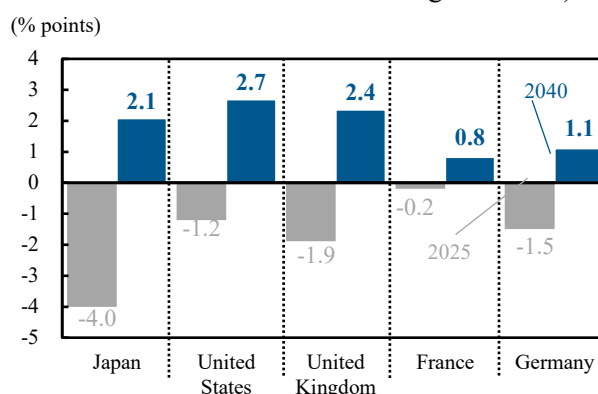
The first important point is to shift to fiscal management premised on monetary policy normalization. As is clear from the estimation results, the Domar condition is strongly affected by monetary policy. Therefore, in an environment in which the condition is less likely to hold, the government is likely to have an incentive to make its central bank postpone monetary policy normalization in order to restrain increases in debt

service costs. However, such policy management could give markets the impression of fiscal dominance, impair market confidence, and instead reduce fiscal sustainability. The government needs to respect central bank independence and proceed with fiscal management premised on normalization (Nishioka [2026]).

To this end, the government and the Bank of Japan should clarify their respective roles, including through revisions to the Joint Statement of the Government and the Bank of Japan. It is essential for the Bank of Japan to focus on price stability and distance itself from policy management that suggests excessive consideration for fiscal conditions. The government needs to promote fiscal consolidation and strengthening supply capacity in an integrated manner. Such policies will also contribute to improving the economic environment that supports the Domar condition.

According to the simulation, if the potential growth rate were around 1 percentage point higher than in the above scenario and the primary balance were balanced, the gap between the effective interest rate and the

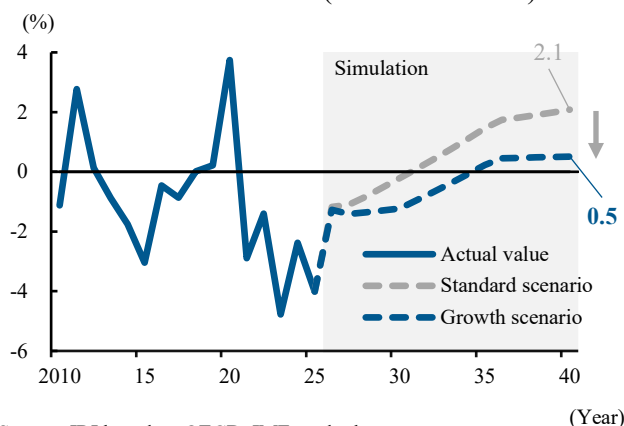
Figure 11. Future simulation of the Domar condition in major countries (Effective interest rate minus nominal growth rate)



Source: JRI based on OECD, IMF, and other sources

Note: In the simulation, the divergence between current actual values and estimated values is adjusted.

Figure 12. Future simulation of Japan's Domar condition (Growth scenario)



Source: JRI based on OECD, IMF, and other sources

Note: The growth scenario assumes, relative to the standard scenario, an upside deviation in the potential growth rate and a decline in inflation volatility.

nominal economic growth rate would decline substantially and approach zero (Figure 12, growth scenario⁶). As a result, the government debt-to-GDP ratio would remain stable below the current level through 2040 (Figure 13, growth scenario).

From this perspective, the axes for evaluating fiscal management also need to be reconsidered. Until now, the primary balance and the government debt-to-GDP ratio have been used as indicators for fiscal consolidation. In addition to these, it is desirable to position the perspective of whether an economic environment in which the Domar condition is maintained is secured as an important

axis for evaluating policy management⁷. The Domar condition cannot be controlled by the government alone, but policy management aimed at maintaining it provides an effective guide for considering fiscal policy, monetary policy, and growth strategy in an integrated manner.

In an era in which supply constraints become entrenched, fiscal sustainability is not determined by fiscal policy alone. For the government and the Bank of Japan, breaking away from the integrated conduct of fiscal and monetary policy aimed at overcoming deflation and separating their respective roles is the most reliable path for securing market confidence and enhancing fiscal sustainability.

Appendix: Estimating the Domar condition

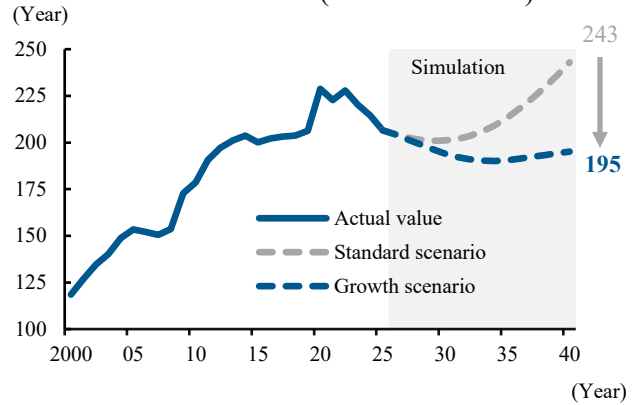
Future projections of the Domar condition were conducted based on the estimation results of the following equation.

$$(r - g)_{i,t} = \alpha + \beta X_{i,t} + \mu_i + \varepsilon_{i,t} \quad (1)$$

Here, $(r - g)_{i,t}$ denotes the difference between the effective interest rate and the nominal economic growth rate in country i in year t , α denotes the constant term, β denotes parameters, $X_{i,t}$ denotes economic indicators that affect the Domar condition, μ_i denotes fixed effects specific to each country, and $\varepsilon_{i,t}$ denotes the error term.

For economic indicators affecting the Domar condition, based on the economic theory mentioned in Section 2 and empirical studies on determinants of the Domar condition, including Heylen et al. [2024], the estimation used the TFP growth rate, the government debt-to-GDP ratio⁸, the inflation rate (measured as the year-on-year

Figure 13. Future simulation of Japan's government debt-to-GDP ratio (Growth scenario)



Source: JRI based on OECD, IMF, and other sources

Note: In the growth scenario, the simulation assumes the forecast values for the Domar condition, namely the effective interest rate minus the nominal growth rate, estimated in Figure 12 under the growth scenario, and a balanced primary balance in the 2030s.

⁶ The growth scenario is based on the reform scenario in Inoue et al. [2026]. It assumes that reforms are implemented to strengthen the labor force, stimulate private investment, and utilize advanced technologies such as AI. Under this premise, the potential growth rate in 2040 is assumed to rise to 1.3 percent.

⁷ Fernández-Gallardo and Payá [2025] analyze data for 18 advanced economies from 1870 to 2017 and point out that when evaluating risks to government debt sustainability, not only the level of debt but also the Domar condition is important.

⁸ To account for endogeneity with the dependent variable $r-g$, the government debt-to-GDP ratio in the previous year was used as an explanatory variable.

change in the Consumer Price Index), the standard deviation of inflation (calculated from monthly data on the year-on-year change in the Consumer Price Index over the past five years), short-term interest rates, and the central bank's share of government bond holdings^{9 10}.

The estimation used annual data for 18 OECD countries for which long-term economic indicators are available¹¹, with a sample period from 1981 to 2023. The data were obtained from OECD and IMF databases, Penn World Table, and other sources. As shown in Figure 4 of Section 2, the estimation results are significant for all explanatory variables, and the signs are consistent with economic theory and prior studies.

In the future projection of the Domar condition, the outlook for $r-g$ was simulated by substituting forecast values for the explanatory variables into the estimated equation (1). Among the explanatory variables, future forecasts for variables other than the central bank's share of government bond holdings and the government debt-to-GDP ratio were based on the forecasts in Inoue et al. [2026] for Japan and on the forecasts in the IMF World Economic Outlook, and OECD Economic Outlook for the United States, the United Kingdom, France, and Germany. The central bank's share of government bond holdings was assumed to continue declining at the current pace, namely the year-on-year change in 2025, until returning to the 2008 level. The government debt-to-GDP ratio was calculated based on forecast values for the primary balance and forecast values for $r-g$ derived from the estimated equation.

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⁹ To detect the effects of quantitative easing in recent years, the change in the holding ratio from 2008 was used as an explanatory variable, and values before 2008 were set to zero.

¹⁰ The estimation uses the dataset of Arslanalp and Tsuda [2014], which estimates investor-specific holding shares of general government gross debt on a consolidated basis. Therefore, the dataset includes general government debt securities other than government bonds.

¹¹ Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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