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## Growth Strategy Council shows Takaichi's vision taking shape

### Key takeaways

- The Takaichi government's growth strategy is increasingly focused on physical AI – boosted by the defense sector – as the key to its broader ambitions for Japan's economy.
- The government also appears increasingly focused on encouraging start-up activity rather than building national champions.
- The Growth Strategy Council (GSC) is exploring new frameworks for fiscal policy that will facilitate the government's "strategic investments," though the process of rolling out a new budgetary framework could be contentious.

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The prime minister's Japan Growth Strategy Council (hereafter, GSC) met for the fourth time on Wednesday, 22 April for a session that sought to outline the strategy's basic thinking as the drafting process heads into its final weeks. The strategy will be released along with the basic policies on economic and fiscal policy management ("honebuto") for the FY2027 budget in late June or early July.

### One sector to rule them all?

The Takaichi government's growth strategy is structured around spurring greater private investment in sectors needed to make Japan more secure and resilient as well as in "deep tech" growth sectors that can power Japan's future prosperity. Nevertheless, despite the paramount importance of the growth strategy for Prime Minister Takaichi Sanae's ambitions, there remain significant questions about how the prime minister's vision will be translated into policy, including how the government will prioritize among the seventeen "priority" sectors identified after Takaichi took office, what tools the state

will use to support activity in priority sectors, and how the government will finance its programs in areas that require greater fiscal outlays.

The deliberations last week did not necessarily single out the highest priority sectors among the seventeen – which range from advanced sectors like AI, semiconductors, quantum computing, and information technology to adjacent sectors like defense, energy, biotech, and space to less competitive sectors like agriculture, shipbuilding, and construction – but rather identified what it sees as common challenges and a common set of tools for promoting investment across these sectors.

It is increasingly apparent that the focus on the seventeen priority sectors may be a red herring. While the government has identified high-profile projects in all seventeen sectors, it clearly views physical AI as the key to unlocking gains across these priority sectors, and the defense sector as a vehicle for supporting the physical AI sector. The GSC deliberations show the importance of artificial intelligence as a cross-cutting priority for the government, with AI transformation (AX) becoming the government's "third x" in industrial policy after green transformation (GX) and digital transformation (DX). A report prepared by the GSC secretariat for last week's meeting points to Japan's low levels of AI investment and adoption as an obstacle to achieving faster growth across the economy. As a submission drafted by the Ministry of Economy, Trade, and Industry (METI) phrases it, the aim is "achieving economic growth by strengthening competitiveness and building a new technology superpower centered on AI." METI and the government more broadly are particularly focused on "physical AI," i.e. the integration of software with robotics and other physical systems, in the belief that Japan still enjoys a competitive edge. To this end, the government envisions encouraging the society-wide adoption of physical AI, including by local governments and small- and medium-sized enterprises, using fiscal policy tools and tax incentives and regulatory measures to promote this adoption, essentially creating a robust national market for Japanese businesses.

Furthermore, to a greater extent than it appeared earlier in the growth strategy deliberations, the strategy appears aimed at encouraging start-up activity in priority sectors instead of replicating the Rapidus model in the semiconductor sector. The strategy envisions expanding the use of the startup/small business innovation research (SBIR) program that supports basic research and R&D by start-ups; giving start-ups greater access to defense procurement and facilitating their access to capital (including foreign capital) at every stage of growth, not least through regulatory reforms in the financial sector. It also envisions certain changes to the corporate governance code – "growth investment guidelines" – to incentivize qualitative and quantitative improvements in corporate investment that raise corporate value over the medium to long term. It is not difficult to see how the pending national security strategy's focus on Japan's defense industrial base – which could call for not just larger overall budgets but more spending on defense R&D, particularly for dual-use technologies, "government-owned, contractor-operated" (GOCO) facilities, and greater arms exports – will dovetail with the growth strategy and industrial policy to an extent not seen before in Japan. Meanwhile, documents from last week's meeting also highlight the importance of labor

policies, both in terms of reskilling the workforce to support the AX program and labor market reforms to encourage labor mobility to higher productivity sectors. These latter policies, however, are less well defined than some of the other proposals aimed at boosting start-up activity.

### **Fiscal policy reform for strategic investment**

Finally, as the Takaichi government has repeatedly signaled, it will use “responsible fiscal expansion” to make strategic investments in sectors that can boost growth and resilience. At this stage, the GSC is more focused on preparing the framework for deploying fiscal resources in this fashion than on articulating how fiscal resources will be used in service of the growth strategy, which may be more of a task for the Council on Economic and Fiscal Policy (CEFP) as it draws up the *honebuto* and the ministries as they enter the budgetary cycle for FY2027.

There are two ways in which the government will look to expand its fiscal room for maneuver. First, it could seek alternative ways of targeting fiscal sustainability, as both Takaichi and Finance Minister Katayama Satsuki have suggested since taking office. In a presentation submitted to last week’s GSC meeting, council member Aida Takuji, chief economist at Credit Agricole’s Tokyo office, proposes abandoning the primary fiscal surplus target and using an alternative measure of the government’s debt burden. He instead calls for a standard based on the Bank of Japan’s (BOJ) flow-of-funds data, which uses international-standard System of National Accounts methodology and is marked to market. This change would among other things undermine attempts by the Ministry of Finance (MOF) to alarm the public with warnings about Japan’s gross debt; MOF would no longer be the exclusive watchdog of fiscal rectitude.

Meanwhile, Aida also proposes, referencing Olivier Blanchard, who recently briefed the CEFP, separating out government spending on current operations and debt service from a new long-term strategic investment framework that can be expected to crowd in private investment and raise tax revenues over the long term. This framework would not just allow for multi-year budgeting but would provide long-term support for major strategic projects. (Aida outlines how, for example, a long-term commitment to advanced particle accelerators could have spillover effects across the government’s priority sectors.) While it is unclear whether the government’s final plan for strategic investment through fiscal policy will match Aida’s proposal, the prime minister herself referred to a “new strategic investment framework” in her remarks at the meeting and multiple GSC documents suggest that the Takaichi government is thinking in this vein. That said, the GSC’s consensus view may be less radical than Aida’s proposal, leaning more towards a GX fund-style arrangement using “bridge bonds” to provide for up-front funding and designated sources of repayment.

### **Conclusion**

The growth strategy may not be final, but in these documents the Takaichi government’s efforts to both reorient industrial policy towards its long-term strategic priorities and

reduce MOF's ability to block fiscal policy from being deployed towards these ends are taking shape. The GSC's deliberations reaffirm the scale of Takaichi's ambitions in both areas, but the real battle will come not in the drafting of the growth strategy but in its implementation in the 2027 budgetary process. The government may be especially tested if it pushes for a new fiscal framework at the same time as it not only pushes for new strategic investments but also larger defense budgets and a consumption tax cut on foodstuffs, among other outlays. After all, as the Aida proposal suggests, the government can signal its commitment to fiscal sustainability by balancing current expenditures with current revenues, using fiscal deficits for long-term investment. However, if the government's policies produce near-term deficits on top of debt-funded strategic investments – policies like the tax cut aimed at satisfying public demands – Takaichi will have a harder time selling her program as “responsible” and her government could invite a growing backlash from financial markets. Takaichi faces a major test in not only convincing investors and the private sector that the government is making sound investments in Japan's industrial future – METI's history could give some investors pause – but that it is prepared to be disciplined in how it deploys fiscal resources.

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