Japan's defence sector reaches an inflection point

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Key Takeaways

- Japan's defence spending is accelerating. It reached its previous target two years early, and February's decisive election win gives the government room to go further.
- New defence special taxes should provide additional funding in fiscal 2027, which provides further support for the view that higher defence spending could prove durable.
- Export reform lets Japanese firms compete abroad, with Australia's frigate order an early win and a possible US frigate opportunity ahead.
- Faster spending, additional funding and wider markets suggest 2026 is an inflection point, with Japan's defence cycle becoming larger and more durable.

For decades, Japan kept its defence ambitions deliberately modest. That began to change in 2022, and spending has risen sharply since. For investors, the question now is whether this becomes a long-lasting industrial cycle. Developments in 2026 suggest it might. The spending increase is accelerating and has stronger political backing. New taxes are giving it a dedicated source of funding. Export reform is also opening overseas markets to Japanese manufacturers, and the first large orders are already arriving.

Figure 1: Japan’s defence policy shift accelerates in 2026



Source: Japan Ministry of Defence.

Faster spending, firmer political backing

For most of the period after the Cold War, Japan's defence budget sat at or below about 1% of GDP1. The cap was informal, but it held until 2022.

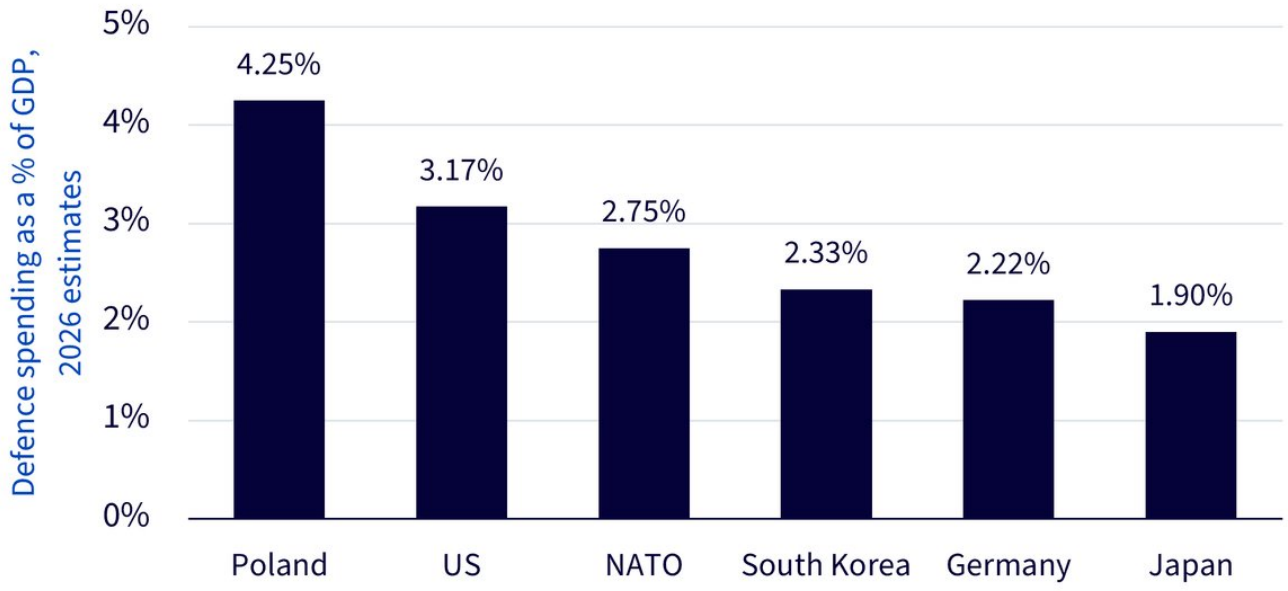
That changed in December 2022. The government published three new security documents. They set a goal of lifting defence and related spending, by FY2027, to a level equal to 2% of FY2022 GDP2. Total defence spending over FY2023 to 2027 was set at ¥43 trillion.

Since then, the pace has picked up. Under Prime Minister Sanae Takaichi, a long-standing defence hawk, Japan reached that target in FY2025, two years ahead of schedule, helped by a supplementary budget. As the previous target is fixed to 2022 GDP and includes related items such as coast guard spending, the ratio on current GDP is slightly lower than 2%, but the direction is still clear.

The February general election strengthened the political foundation. The Liberal Democratic Party won a two-thirds majority in the lower house on its own, and together with its coalition partner, the ruling bloc holds a commanding position. The main opposition alliance, which includes Komeito, a long-time brake on defence expansion, lost around two-thirds of its seats. Japan's build-up began before the vote. The result gives the government scope to go further as it prepares to revise its security policy by December 2026. The question now is how far it will go.

Washington has been pushing hard and has urged Japan to spend 3.5% of GDP on defence3. Japan is also reported to be considering a medium-term target of 3.5% of GDP, in line with NATO and other US allies4. That would mean more than double current levels.

Figure 2: Defence spending as a percentage of GDP, 2026 estimates



Source: NATO, Japan and South Korea Defence Ministries. Core defence spending for NATO nations, overall defence spending for Japan and South Korea.

A dedicated way to pay

A fair investor question is whether Japan can keep paying for this. Japan's public debt is the highest among advanced economies and roughly double the G7 average. With debt at that level, spending plans without a clear funding source tend to fade.

Part of the answer lies in a new set of defence taxes. The first measures took effect on 1 April 2026. The Defence Special Corporate Tax is charged at 4% of a company's corporate tax bill, after a deduction of ¥5 million. For a large company paying the standard 23.2% national rate, that adds just under 1% (23.2% x 4%)5. The deduction means most small companies are exempt. The Finance Ministry expects the tax to raise ¥923 billion in 20276. Tobacco tax also rose in April, with a second increase due in October. Another new tax is the Defence Special Income Tax. From January 2027, individuals will pay a surcharge equal to 1% of their income tax bill.

Together, the new taxes should raise about ¥1.3 trillion in fiscal 20277. That covers only part of a defence budget that has reached a record ¥9 trillion in FY2026.

The signal matters more than the sum. Governments rarely raise taxes for a temporary programme, and Japan had avoided doing so for defence for decades. A dedicated revenue stream may make higher levels of defence spending harder to reverse. It also makes it easier for companies to plan capacity around.

From one customer to many

For decades, Japanese defence companies had essentially one customer. Export rules limited most sales to five categories covering rescue, transport, warning, surveillance and minesweeping equipment. Production runs were small and unit costs high.

In April 2026, the government scrapped those categories, opening the way for exports of warships, missiles and other weapons. Each lethal export will be reviewed by the National Security Council and limited to countries with defence technology agreements with Japan.

Mitsubishi Heavy Industries (MHI) has already shown what this can mean. It has signed a contract to build three upgraded Mogami-class frigates for Australia, with the first due by December 2029. Canberra has committed up to AUD 20 billion to a fleet of 11 ships8. It is Japan's largest-ever defence export.

A bigger opportunity may follow. The US Navy is studying frigate designs from Japan, South Korea and Turkey, including the export version of MHI's Mogami. Up to two ships could be built abroad before production moves to US yards. This is at an early stage. Congress could still limit the waiver that allows foreign-built warships9.

MHI is the most direct beneficiary so far. Kawasaki Heavy Industries, which builds submarines and military aircraft, and IHI, a leading maker of military jet engines, remain tied mainly to domestic spending for now. The new rules give both a route to foreign customers over time.

Conclusion

Japan's defence story has moved beyond the policy shift of 2022. Spending is rising faster than planned, with a strong political mandate behind it. Dedicated taxes suggest the higher budget is here to stay. Export reform and the Australian order show that the market is getting bigger. For Japanese defence companies, this adds up to a larger and more durable source of demand than at any point in the post-war era.

What WisdomTree offers

For investors looking to access this theme, the WisdomTree Asia Defence UCITS ETF (WDAF) offers a focused route. The fund tracks the WisdomTree Asia Defence UCITS Index, which covers defence companies across Asia Pacific, excluding China. It concentrates on firms with material defence revenues, which avoids the diluted exposure that comes with broad industrial conglomerates. Japan accounted for about 15.5%10 of the fund, alongside larger weights in South Korea and India. The fund is weighted by market capitalisation, adjusted for defence revenue exposure and rebalanced quarterly, making it a targeted way to capture the region's structural defence upswing.

Investors should also consider the risks associated with the strategy. The fund provides targeted exposure to the defence sector and may therefore be more sensitive to political, regulatory and government spending developments affecting defence companies. Investments in equities can fall in value, and investors may lose some or all of the amount invested. Currency movements may also affect investment returns. Please refer to the KID and Prospectus for full details of the risks associated with the fund.

1 Source: Stockholm International Peace Research Institute.
2 Source: The National Security Strategy.
3 Source: Japan scraps US meeting after Washington demands more defence spending.
4 Source: Japan Eyes Defense Spending at 3.5% of GDP After US Pressure.
5 Source: PwC: Corporate - Taxes on corporate income.
6 Source: Ministry of Finance, Japan.
7 Source: Ministry of Finance, Japan.
8 Source: Australian Department of Defence.
9 Source: Japanese, South Korean, Turkish Warships Under Consideration for New U.S. Frigate Competition.
10 Source: WisdomTree, as of 25 September 2026.

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