

Daiwa's Economic View

Economy vs. inflation dilemma: Conditions for 2% trend inflation

- Conditions for 2% underlying inflation: Focus on general services, utility fees, rents, food
- Need to assess economic trends, but inflation overshoot a concern
BOJ's scenario of flat underlying inflation may not materialize
- Market should be wary of the fact that BOJ price forecasts have been revised upwards systematically

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Conditions for 2% underlying inflation: Focus on general services, utility fees, rents, food

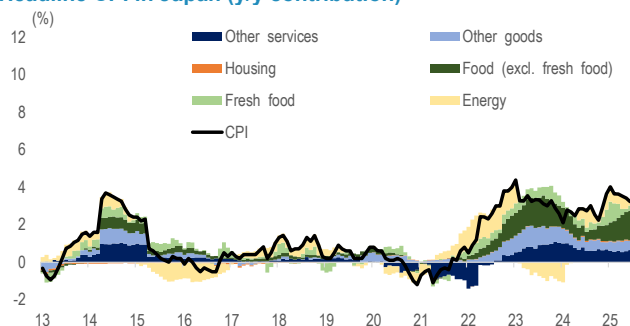
At its July Monetary Policy Meeting (MPM), the Bank of Japan (BOJ) noted that uncertainty about US tariff policy has receded but remains "high". However, with the economic outlook still uncertain, we think it will be difficult for the BOJ to raise rates until visibility improves.

Meanwhile, we see a growing risk that underlying inflation could exceed the BOJ's expectations (as we discuss in detail below).

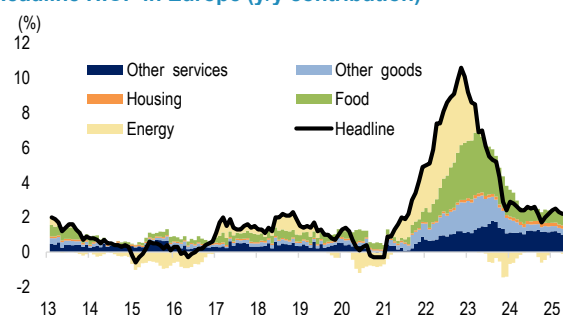
We see the key conditions for underlying inflation to reach 2% as a faster uptrend in (1) general service prices, (2) utility fees, and (3) rents. This reflects our awareness that while goods prices are readily affected by external factors such as import prices, the above items need watching because they reflect wage growth and other domestic factors. The sustained uptrend in food prices, where increases are typically cost-push and transitory in nature, is also increasingly likely to have a greater impact on underlying inflation.

General services: Inflation could continue despite forecast slowdown in FY26 wage hikes

The BOJ focuses on the mechanism of underlying inflation in which "wages and prices rise moderately in interaction with each other". The increase in costs caused by these wage hikes will have a particularly major impact on the price of services, which have a high labor cost weighting. However, Japan's service price inflation remains low compared with Europe, where inflation has remained at 2%, suggesting a need for service prices in general to rise more rapidly.

Headline CPI in Japan (y/y contribution)

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

Headline HICP in Europe (y/y contribution)

Source: Eurostat; compiled by Daiwa.

We acknowledge that growth in general service prices in the nationwide CPI has accelerated since April, mainly on price hikes for eating out and telecoms (mobile phone) charges, to +1.9% y/y in June. In general service prices, we would also note that the move to scrap income caps for both public and private high school tuition subsidies from April is depressing private high-school fees.

However, we think wage hikes in the 2026 spring labor negotiations are likely to fall short of 2025 due to the negative impact on corporate earnings from US tariffs. At this point, we still expect companies to raise base pay by just under 3% (versus 3.7% in 2025) given structural labor shortages, but this will at least limit the percentage increase in their labor costs compared with 2025.

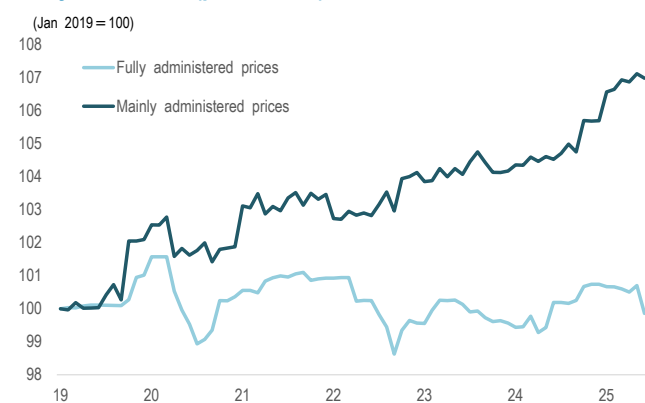
Given the above context, we will be watching whether general service prices continue rising (or indeed accelerate) through FY26 as a key checkpoint in assessing whether underlying inflation is on its way to 2%.

Utility fees: Signs of change in trend for fully administered prices

Companies' lack of freedom to set utility fees in Japan compared with the US and Europe has continually been cited as a reason for its low inflation. A July 2016 Bank of Japan Review paper, "[Administered Prices in Japan: Institutional Comparisons with Europe and the United States](#)" (by Kohei Shintani, Yoshiyuki Kurachi, and Shinichi Nishioka) noted that Japan's constant subsidies have meant that costs are not fully reflected in prices, and that the Japanese government's considerable influence results in a slow process for determining utility fees.

Japan's "fully administered prices"--which are determined by laws and regulations, and heavily influenced by the government--remain broadly flat. However, the uptrend in "mainly administered prices" (which require government approval or notification) is accelerating due to price hikes for fire, earthquake, and auto insurance.

Utility Fee Trends (price levels)



Source :MIC; compiled by Daiwa.

Note: Our trial calculation excludes items that fluctuate significantly due to government economic measures—such as electricity and gas charges, public high school fees, and nursery school fees.

Classification of Utility Fees

Classification	Major items
Fully administered prices (Determined by central or local government)	Medical fees, nursing care fees, public high school fees, nursery school fees, water & sewerage charges, charges for driving license, etc.
Mainly administered prices (Approved by or reported to government)	Ordinary passenger fares (incl. Japan Railway companies, bullet trains), fixed route bus fares, taxi fares, telecommunication charges, charges for NHK TV license, fire & earthquake insurance premium, automotive insurance premium, electricity charges, manufactured & piped gas charges, etc.

Source: Consumer Affairs Agency, Cabinet Office, MIC; compiled by Daiwa.

However, we do think utility fees, which are fully administered, are likely to rise. Many local governments are raising water charges to reflect falling revenue for water utilities as Japan's population shrinks, and rising renewal costs for aging facilities and labor/materials costs. Media reports indicate that some local governments are set to raise water charges by 20-30% between FY25 and FY26.

In medical and nursing care, the government's 2025 Basic Policy (published in June) explicitly states that it will raise government-determined medical, nursing care, childcare, and welfare fees to encourage wage hikes in the medical, nursing care, and disability care sectors. Of these, medical fees in particular have a relatively high nationwide CPI weighting of 2.29% and will have

a major impact on overall consumer prices. The government plans to discuss the above in detail by end-2025.

It is difficult at this point to factor price hikes for which details are lacking (e.g., for medical and nursing care fees) into our forecasts, and an increase in government-determined prices would likely cause inflation to materially exceed forecasts. These price hikes would also be driven by rising wages and likely to put sustained upward pressure on prices.

Plans to Raise Utility Fees

Items	% price increase	Timing
Water charges	Many local governments rolling out price hikes	
Automotive insurance premium	Tokio Marine & Nichido Fire Insurance (8.5% on average)	Oct-25
Ordinary passenger fares Commuter fares	East Japan Railway (7.1%)	Mar-26
Medical fees	2025 Basic Policy explicitly includes increase in govt-determined medical/nursing care/childcare/welfare fees; will discuss medical/nursing care fees by end-2025.	Around Jun 2026
Nursing care fees		Around Apr 2027 (but, fees may be revised in Apr 2026)
Nursery school fees		—

Source: Cabinet Office, various media reports; compiled by Daiwa.

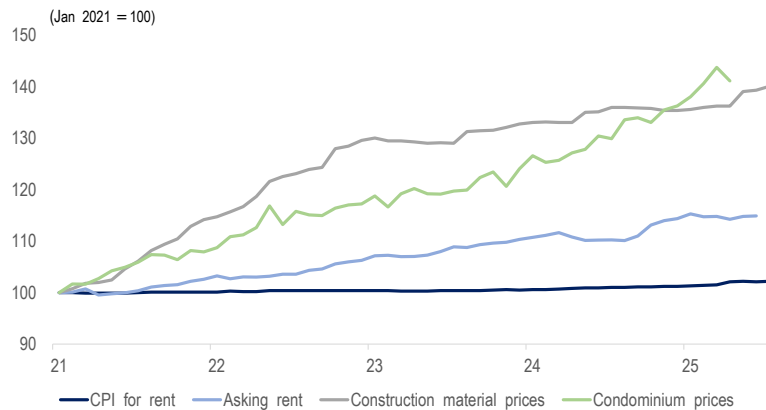
Rents: Inflation to gradually accelerate

As with utility fees, private-sector rents in Japan have been cited as a factor behind the lack of a pickup in inflation. Observers have noted that data for private-sector rents includes continuing rents for existing tenants, meaning that factors such as long leasing periods and a lack of opportunities for tenant turnover preclude an uptrend in rents. Rents have a high 18.3% weighting in the nationwide CPI, and are another factor impeding inflation in Japan.

However, there are recent signs of an inflection point for rents. July Tokyo CPI private-sector rents jumped by +1.7% y/y.

That said, the increase in central Tokyo CPI rents was limited compared with private-sector data for asking rents (=new tenants only). As noted, this is because the CPI survey also includes continuing rents for existing tenants.

However, we surmise that the jump in building material prices has caused condo prices to rise faster than asking rents, resulting in a decline in rental yields for property owners. Given the above, we expect a further increase in asking rents in Tokyo's central 23 wards as landlords seek to secure yields, which we also expect to gradually feed into Tokyo CPI rents (which include continuing rents).

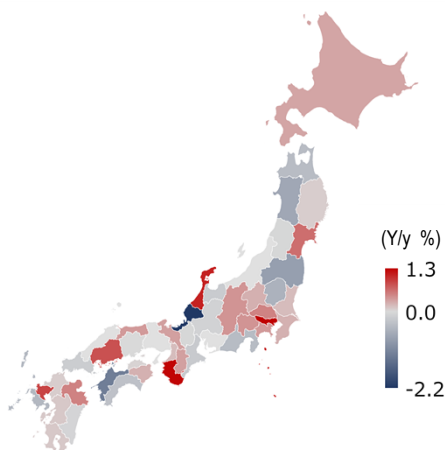
CPI for Rents, Asking Rents, Building Material Prices, Condominium Prices (Tokyo metropolitan area)


Source: MIC, Construction Research Institute, Ministry of Land, Infrastructure, Transport and Tourism (MLIT), At Home Lab; compiled by Daiwa.

Note: All price and price index data is for Tokyo's central 23 wards. Asking rents are a composite index based on data on average Tokyo condo rents (by size) from At Home Lab, weighted by the number of units (stock) by size in the 2023 Housing and Land Survey.

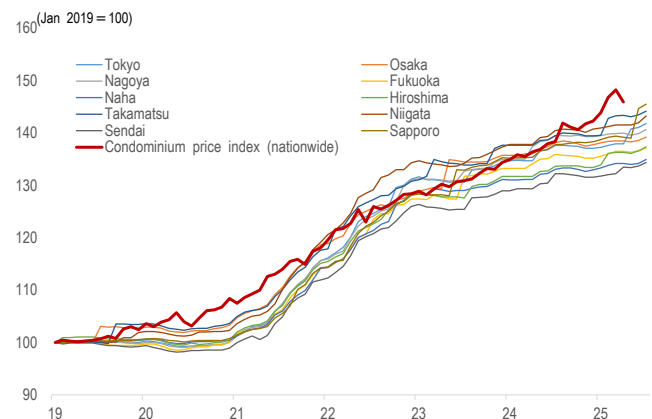
However, rents in the nationwide CPI have risen less rapidly. Private-sector rents in the June nationwide CPI were up +0.4% y/y, below the +1.7% for Tokyo's 23 wards. By region, prices generally rose in Kanto (the region around Tokyo), Osaka, and the prefectures that include Japan's four main regional cities (Sapporo, Sendai, Hiroshima, Fukuoka), but there was no consistent percentage increase in other regions. Demand in the Tokyo metropolitan area in particular remains upbeat due to rising construction costs and ongoing population inflows, including from overseas, which are contributing to higher rents. Elsewhere, falling demand is capping rent growth in (mainly regional) areas with declining populations.

However, we think the sharp rise in building material and condo prices is a nationwide phenomenon that has resulted in a far greater drop in yields on rental income for regional landlords than in the Tokyo metropolitan area. Whether or not rent growth accelerates nationwide will depend on the balance between falling demand in areas with declining populations and falling rental yields caused by rising condo prices. In the long term, we surmise that a decline in rental yields will reduce the supply of residential investment properties and improve the supply-demand balance, putting upward pressure on rents.

Growth of CPI for Rents by Region


Source: MIC; compiled by Daiwa.

Note: Average during Apr-Jun 2025, and rents include private rent and public rent, etc.:

Nationwide Condominium Prices, Building Material Prices by Region


Source: Construction Research Institute, MLIT; compiled by Daiwa.

Food: Concerns about broader cost pass-throughs, more supply shocks

The BOJ's July *Outlook for Economic Activity and Prices* report (*Outlook Report*) included a section in Box 3 titled "Background and Impact of the Recent Rise in Food Prices". Its analysis shows that rising rice prices and import prices made a major contribution to the increase in food prices, which combined with a more aggressive approach to price-setting "may have contributed to a rise in short-term inflation expectations."

We think the BOJ currently expects food to have little impact on long-term inflation expectations given its assumption that the uptrend in food prices will wind down in 2H FY25. However, signs are emerging that prices of fresh food (mainly summer vegetables) could rise again due to this year's high temperatures. Water shortages and heatwaves could also result in a smaller rice harvest. (See below for details.)

While we do not expect prices for rice and other items to rise as rapidly as in 2024, the additional supply shocks we discuss above could preclude the scenario of a pause in the uptrend in food prices and affect long-term inflation forecasts. If yearly heatwaves driven by global warming become the baseline scenario, supply shocks could also become a yearly occurrence, including the increased cost for farmers from needing to switch to more resilient crop varieties. We see the risk that broader-based moves to pass on higher food prices and renewed supply shocks could result in above-forecast inflation through autumn.

Economy vs. inflation dilemma

As we noted at the beginning of this report, we will continue to monitor economic data, including the economic impact of tariffs in Japan and overseas. On the inflation front, we note the upward pressure on prices for items that have thus far remained low, such as the utility charges and rents that were traditionally viewed as the 'bedrock of prices'; this suggests the potential for a further pickup in inflation for these items. Utility fee hikes partly reflect rising wages, and the pass-through of higher costs into rents has been relatively slow, suggesting that these moves are likely to be prolonged. Given the above conditions, we think underlying inflation is likely to rise toward 2%.

We also note the risk of above-forecast inflation driven by the renewed recent uptrend in food prices. Given the above, [we would bear in mind the risk that underlying inflation may not pause as the BOJ's baseline scenario assumes.](#)

(Minami)

Risk of systematic upward revisions in BOJ price forecasts (Kawahara)

At the July Monetary Policy Meeting, the BOJ raised its FY25 CPI projection (core CPI excluding fresh food) substantially to 2.7% y/y, up 0.5ppt from 2.2% in April. In his press conference, BOJ Governor Kazuo Ueda explained that the upward revision to the FY25 price projection was due mostly to food, such as rice, and stated that the BOJ did not believe that monetary policy was influenced by that alone.

However, what should be noted here is the fact that the BOJ's price forecasts have been revised upwards systematically since FY22. Comparing the forecasts made in April each year with the actual figures in the following April shows that the BOJ has made upward revisions to its forecasts for core-core CPI—a reference indicator of underlying inflation—almost every time it has published its *Outlook for Economic Activity and Prices* report (*Outlook Report*). Compared to forecasts in April, the average degree of upward revision was about 0.4% in July, 0.8% in October, and 0.9% in January. Furthermore, this diverged as much as 1.0% from the actual figures in the following April.

This systematic overshoot might stem from structural changes that the BOJ has not fully captured. Firstly, there is the upward pressure on prices due to continued de-globalization. As noted by former University of Tokyo professor Tsutomu Watanabe, during the three decades preceding the Global Financial Crisis, globalization suppressed the inflation rate worldwide by

supplying inexpensive goods and labor from countries like China. However, de-globalization, which has continued since around 2010, has prompted companies to reshore production, triggered by the supply chain disruptions during the pandemic, putting upward pressure on costs.

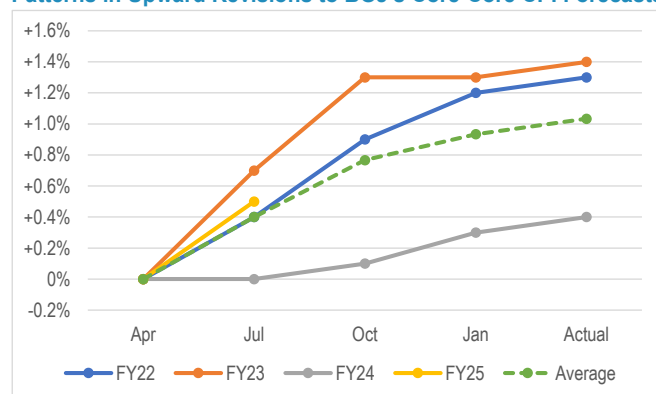
Secondly, there is the impact of climate change on food prices. According to analyses by a research team including the ECB, extreme weather events such as heatwaves, droughts, and heavy rainfall around the world from 2022 to 2024 have triggered a surge in food prices. In Japan, rice prices jumped by 48% y/y in September 2024 following the heatwave in August of that year. According to data from the Japan Meteorological Agency, the average temperature in Japan in 2024 was 1.48°C above the baseline, the highest since the recording of such data began in 1898. July also saw record-high monthly temperatures, and precipitation on the Sea of Japan side of the Tohoku region was only 13% of the average, the lowest since 1946. The impact from these climate conditions has already emerged—the price of tomatoes and green peppers is up about 10% and 30% y/y, respectively, and domestic pork is trading at its highest price level in about 50 years in the Tokyo market.

Recognizing that much of current inflation is driven by supply-side factors, Governor Ueda is indicating a cautious stance towards responding to the situation by raising interest rates. It is true that tightening monetary policy to address supply-driven inflation could dampen economic activity and income. However, Governor Ueda also stated that it was necessary to pay closer attention to the possibility that the headline CPI might impact underlying inflation and inflation expectations.

When making forecasts, it is difficult for economists to reflect uncertain structural changes in the figures. Having worked as an economist at the Ministry of Finance, I know well how difficult it can be to do this. However, market participants need to acknowledge the empirical fact that the BOJ's inflation forecasts have been revised upwards systematically. Given that the FY25 forecast has already been revised upwards significantly, we should be fully aware of the risk that upward revisions could be made to forecasts during the current projection period (from FY26 onwards) due to structural factors like de-globalization and climate change. The BOJ's cautious stance with regard to policy operations is understandable, but we must not forget that there could be a risk of underlying changes in prices being underestimated again.

(Kawahara)

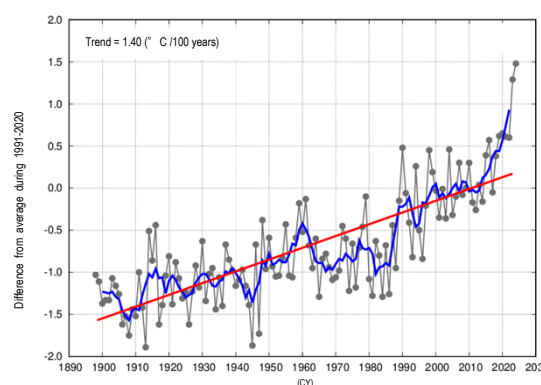
Patterns in Upward Revisions to BOJ's Core-Core CPI Forecasts



Source: BOJ; compiled by Daiwa.

Note: Chart shows the extent of revisions at each point relative to the baseline (April forecasts = 0%).

Deviations in Annual Average Temperature in Japan



Source: Japan Meteorological Agency materials; compiled by Daiwa.

Notes (1) Black line indicates deviations of annual average temperature from baseline, blue line denotes 5-year moving average of deviations, and red line shows long-term trend.
 (2) The baseline is the 30-year average during 1991-2020.

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