Daiwa Securities

Daiwa's Economic View

Japan's economic/price outlooks and BOJ's rate hiking path

- Japan's economy expected to grow at rate exceeding its potential growth rate, driven primarily by domestic demand
- Government's economic measures have led to downward price outlook revisions; Core CPI expected to clearly fall below 2% from 2026
- Maintain our view that policy interest rate will rise to +1% in Jul-Sep 2026; That said, potential barriers include inflation expectations, communication with government

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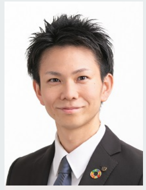

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On 21 November, the government decided on a comprehensive economic stimulus package totaling Y21.3tn. In this report, based on the outlook for the Japanese economy and prices reflecting the impact of these measures, we will consider a policy interest rate-hiking path to +1% via the BOJ's monetary policy normalization process.

Economic outlook: Domestic demand likely to drive growth exceeding potential growth rate

We estimate Japan's real GDP to grow by 1.0% in FY25 and 0.8% in FY26. Based on this economic stimulus package, the growth rate for FY26 has been revised upward by 0.2ppt (no changes for FY25 and FY27).

The main drivers of this future growth will be domestic demand, including private consumption and capex. In terms of income, we estimate that the 2026 spring labor/management wage negotiations to yield an overall increase of approximately 4.7% (including regular raises; 2025: +5.25%), with the basic salary portion at around +3.2% (2025: +3.7%). Government measures to address soaring prices are expected to significantly suppress future CPI, with real wages projected to turn clearly positive starting in Jan-Mar 2026. As a result, consumption is likely to follow a gradual recovery path. In particular, private consumption in Jan-Mar 2026 is expected to be supported by the effects of economic stimulus measures.

Also, GDP for Jul-Sep of 2025 shows that despite the tariff impacts, real private corporate capex increased significantly. Structural investments such as digital transformation (DX) and measures to address labor shortages, along with intellectual property investments, are contributing to the increase in capex. Moving forward, capex is likely to maintain its upward trend, given the strength of these investments, as well as the improved business environment due to reduced uncertainty in tariff policy, along with consumption support from economic measures.

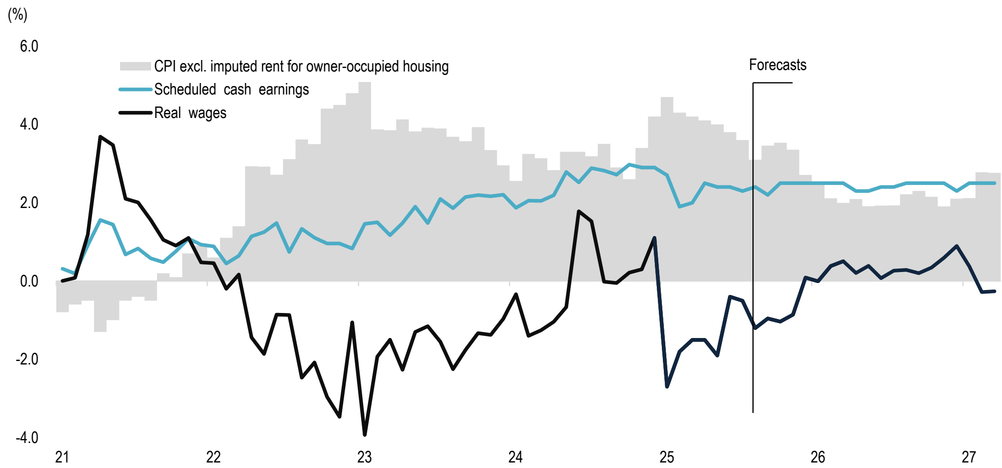
Forecasts for Japan's Economy and Prices (%)

⇒Forecasts* (quarterly: from FY25 Oct-Dec; fiscal year: from FY25)

	FY25				FY26				FY27						
	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	FY25	FY26	FY27
Real GDP growth rate (q/q)	0.6	-0.4	0.1	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	-	-	-
(annualized)	2.3	-1.8	0.3	1.1	1.1	1.0	1.1	1.0	0.8	1.0	0.8	1.0	1.0	0.8	0.9
Domestic demand contribution (q/q)	0.3	-0.2	0.3	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.3	1.2	1.2	1.1
Private consumption (q/q)	0.4	0.1	0.2	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.0	1.0	0.8
Private non-residential investment (q/q)	0.8	1.0	0.3	0.5	0.7	0.7	0.6	0.6	0.5	0.5	0.5	0.6	2.8	2.5	2.2
Foreign demand contribution (q/q)	0.2	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.4	-0.1
Exports (q/q)	2.3	-1.2	-0.3	0.1	0.3	0.5	0.6	0.6	0.5	0.7	0.6	0.6	2.5	0.8	2.4
Imports (q/q)	1.3	-0.1	0.3	0.7	0.8	0.7	0.7	0.7	0.7	0.7	0.8	0.7	3.1	2.5	2.9
Core CPI (y/y)	3.5	2.9	2.7	1.7	1.4	1.6	1.6	2.0	1.9	1.9	1.9	2.0	2.7	1.7	2.0
Core core CPI (y/y)	3.2	3.2	2.9	2.6	2.3	2.1	2.0	2.0	2.2	2.2	2.2	2.2	3.0	2.1	2.2
Uncollateralized overnight call rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.75	1.00	1.00

Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC), BOJ; compiled by Daiwa.
**Forecasts by Daiwa.*

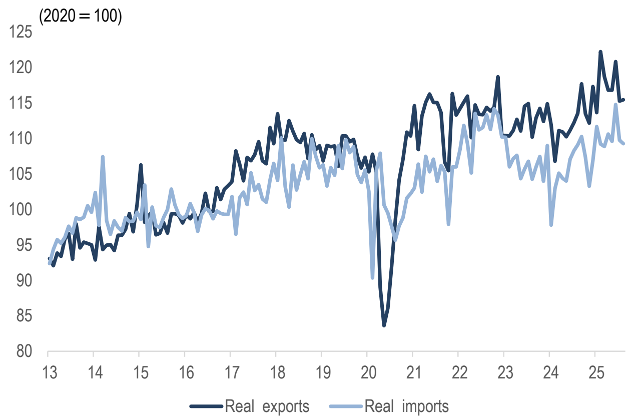
Forecasts for Real Wages



Source: MIC, Ministry of Health, Labour and Welfare; compiled by Daiwa.
Notes: (1) Based on data continuously collected from same establishments.
(2) Forecasts by Daiwa.

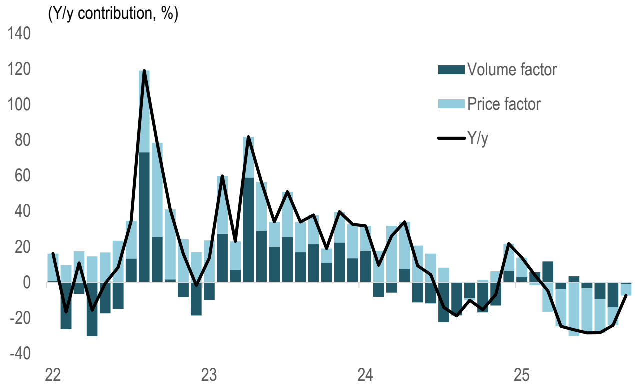
Meanwhile, due to the tariff policy impacts, real imports and exports of goods are trending downward. As such, external demand is expected to remain weak for now. That said, October 2025 trade statistics confirmed a recovery in the volume of automobile exports to the US. It is premature to judge a trend shift based on movements for just a single month, but the likelihood that tariff policies will exert only limited downward pressure on exports is increasing. Meanwhile, the slowdown for the US economy, supply chain restructuring (increased local production), and the decline in inbound demand from China and exports to China following Prime Minister Sanae Takaichi's remarks regarding a potential Taiwan contingency all require close monitoring as risk factors for the future.

Levels of Real Imports and Exports



Source: BOJ; compiled by Daiwa.

Y/y Contribution to Value of Automobile Exports to US



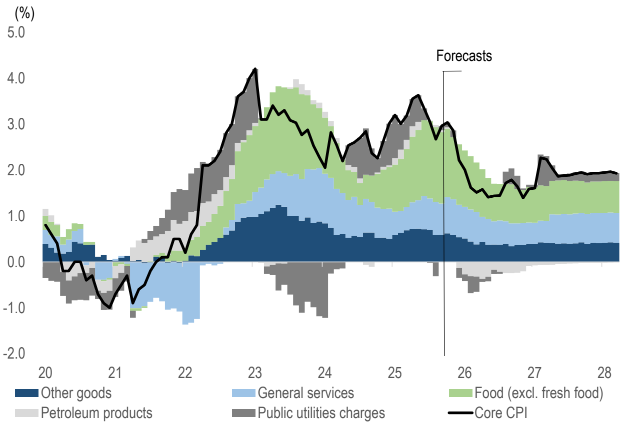
Source: MOF; compiled by Daiwa.

Price outlook: Government economic measures to significantly push down prices

We estimate core CPI of +2.7% for FY25 and +1.7% for FY26. Core CPI for both FY25 and FY26 have been revised downward from previous projections, primarily due to the government's economic stimulus measures.

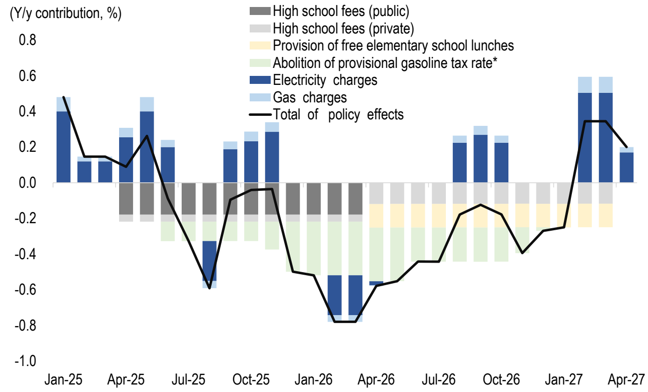
Specifically, electricity and gas subsidies will lower the Feb-Mar 2026 CPI by approximately 0.6ppt and the April CPI by roughly 0.2ppt. Also, the gasoline tax reduction will lower CPI by an additional 0.2ppt compared to previous measures. Furthermore, starting in April 2026, private high school tuition is expected to be effectively eliminated and elementary school lunches are also expected to become free of charge. Each of these measures is projected to have a downward effect of slightly more than 0.1ppt on CPI.

Core CPI Forecasts



Source: MIC; compiled by Daiwa.
Notes: (1) Our assumptions: (1) USD/JPY rate of Y149 for FY25, Y146 for FY26, and Y144 for FY27, and (2) crude oil prices remaining largely flat through the projection period.
(2) Forecasts by Daiwa.

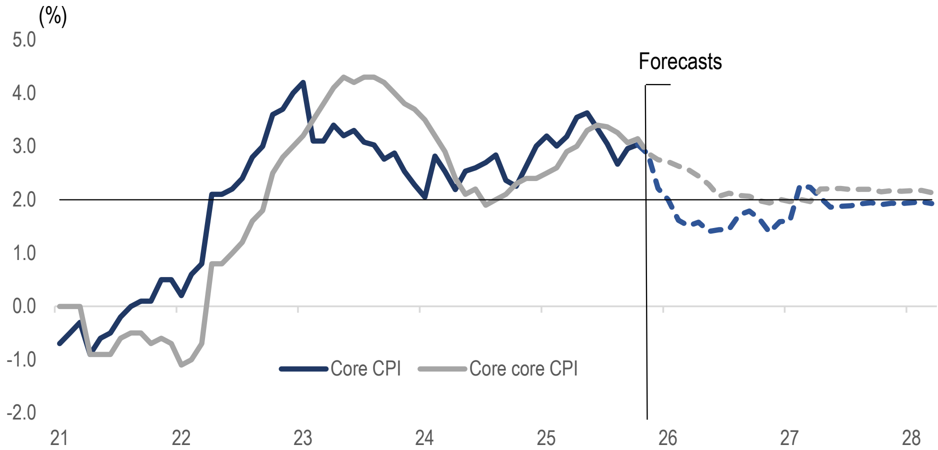
Impact of Government Inflation Measures on CPI



Source: MOF; compiled by Daiwa.
**Including the impact on gasoline prices since implementation of the "flat-rate fuel oil price reduction measure" in late May 2025.*

Meanwhile, we estimate core-core CPI to grow at a high rate of +3.0% in FY25 and +2.1% in FY26. While the effective elimination of private high school tuition fees and the provision of free elementary school lunches will lower FY26 core-core CPI by 0.2ppt to 0.3ppt, food prices are expected to remain elevated y/y compared to previous years and service prices are also projected to maintain a steady rate of increase, driven by rising labor costs.

Forecasts for Core CPI and Core Core CPI



Source: MIC; compiled by Daiwa.
Notes: (1) Our assumptions: (1) USD/JPY rate of Y149 for FY25, Y146 for FY26, and Y144 for FY27, and (2) crude oil prices remaining largely flat through the projection period.
(2) Forecasts by Daiwa.

Rate hike timing: Expect policy rate hike to +1% in Jul-Sep 2026

Based on the above economic and price outlooks, there is no change to our view that the policy interest rate will be raised to +1% in Jul-Sep 2026, after it is raised to +0.75% in Jan-Mar 2026. We expect core CPI to remain clearly below 2% for the time being, starting from February 2026. However, central banks, including the BOJ, fundamentally assess prices excluding temporary influences, including policy factors. For example, core-core CPI is expected to remain around 2% from February 2026. Considering that the Japanese economy is also expected to remain robust, driven primarily by domestic demand, we anticipate that the pace of interest rate hikes toward a policy rate of +1% will be approximately once every six months.

Factors slowing interest rate hiking pace

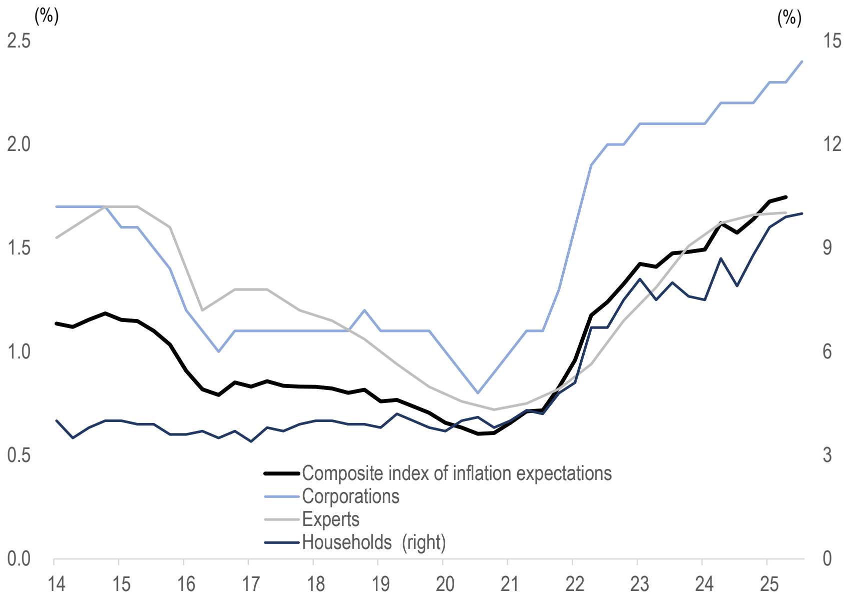
Meanwhile, factors that should be closely watched in terms of potentially delaying the timing of rate hikes towards a +1% policy rate are: (1) Declining inflation expectations and (2) Communication with the government.

As mentioned earlier, core CPI is expected to fall below 2% starting in February 2026. This is due to a decline in the y/y contribution from food items, coupled with a significant drop in energy prices (including electricity, gas, and gasoline) as a result of measures to address soaring prices.

BOJ monetary policy board member Junko Koeda pointed out during her 20 November speech, "Even if the year-on-year rate of increase in price decelerates, if the price level itself remains high, this could elevate perceived inflation and, consequently, inflation expectations." Indeed, the level of food prices themselves is likely to remain elevated, potentially serving as a factor supporting inflation expectations.

Meanwhile, energy prices, such as electricity, gas, and gasoline, are expected to be pushed down due to the impact of measures to address soaring prices. Furthermore, it cannot be ruled out that a situation in which core CPI continues to remain below 2% could lower inflation expectations and the BEI (break-even inflation rate) among households and businesses.

Inflation Expectations by Economic Agent



Source: BOJ, Japan Center for Economic Research; compiled by Daiwa.
Note: Composite index of inflation expectations is an extract of the first principal component via the principal component analysis regarding household inflation expectations (mean of inflation expectations over the next five years in the Opinion Survey on the General Public's Views and Behavior), corporate inflation expectations (general price outlook for the next 5 years in BOJ Tankan), and experts' inflation expectations (CPI growth rates for the next 2 to 6 years in ESP Forecast survey).

In addition, communication with the Takaichi administration could also be a factor that delays hiking the policy interest rate to +1%.

After his meeting with Takaichi on 18 November, BOJ Governor Kazuo Ueda explained that he was, "Gradually adjusting the degree of monetary easing to ensure the inflation rate sustainably and stably settles at 2%." He also stated that the prime minister did not make any specific requests. Additionally, policy board member Kazuyuki Masu gave an exclusive interview to the *Nikkei* newspaper that was released on 22 November. Here, he said, "I think we've been able to have them (government) understand that we're close to achieving that goal." There appears to be good progress in terms of coordination between the government and the BOJ regarding the next policy interest rate hike to +0.75%.

Meanwhile, if the background to these adjustments is high price inflation and a further yen depreciation, the government may not support rate hikes when the inflation rate (particularly core CPI) declines in FY26. A policy interest rate of +1% is the lower bound of the neutral interest rate, based on the BOJ's estimated natural rate of interest range (-1% to +0.5%), which is not necessarily considered an accommodative level.

These two factors (lower price increases and the policy interest rate level that is not necessarily accommodative) further heighten barriers to communication between the BOJ and the government.

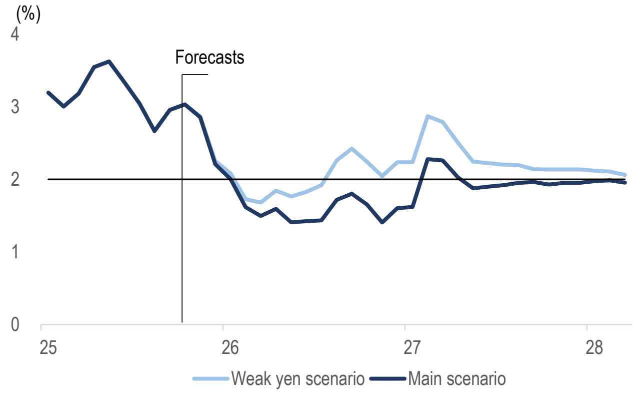
Risk of upward pressure on prices due to yen depreciation

Meanwhile, the government's aggressive fiscal stimulus measures and shift toward reflationary policies could intensify yen depreciation pressure. We used the exchange rates of USD/JPY149 for FY25, USD/JPY146 for FY26, and USD/JPY144 for FY27 to estimate the previously mentioned price outlook, based on the anticipated narrowing of the interest rate gap between Japan and the US.

Assuming the yen weakens through the end of 2025 and the exchange rate remains at USD/JPY160, we could expect core CPI to rise to +2.7% for FY25 (same as our main scenario) and +2.2% in FY26 (+1.7% is our main scenario). In particular, the impact of higher prices due to yen depreciation will become pronounced in the second half of 2026 and real wages may fall back into negative territory.

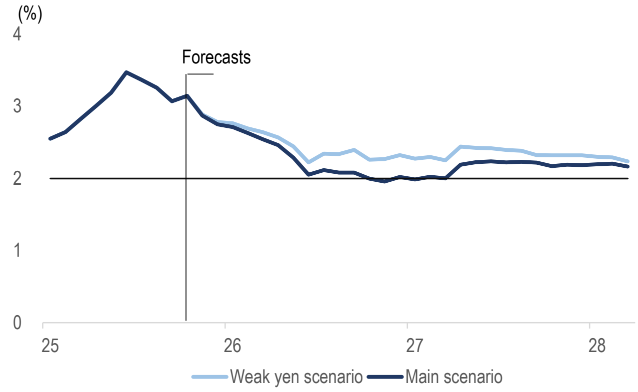
Under these circumstances, what is required of the Takaichi administration is not so much fiscal stimulus to suppress prices, but rather comprehensive price stabilization measures that include countermeasures against the risk of yen depreciation. We think that the impact of yen depreciation is extremely significant as an upside risk to the price outlook. As such, the government should prioritize communication with the market at this juncture. In the case of a weak yen scenario, the previously mentioned factors that could delay interest rate hikes are not expected to come into play, in our view.

Core CPI Forecasts (weak yen scenario)



Source: MIC; compiled by Daiwa.
Note: The weak yen scenario assumes that the yen weakens to Y160/$ by end-2025 and then stabilizes at that level.

Core Core CPI Forecasts (weak yen scenario)



Source: MIC; compiled by Daiwa.
Note: The weak yen scenario assumes that the yen weakens to Y160/$ by end-2025 and then stabilizes at that level.

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