Daiwa Securities

Daiwa's Economic View

Q&A: Japan's economy, prices, and monetary policy in 2026

- Overall picture of economy/prices in 2026 and risks from prolonged inflation
- Outlook for "responsible expansionary fiscal policy"
- Expect next rate hike in Jul-Sep quarter of 2026, with two rate hikes anticipated for FY26

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Q: What is overall picture of economy/prices in FY26?

A: In FY26, real GDP growth is expected to be +0.9%, exceeding the potential growth rate. The main driver of growth will be domestic demand, with the economy being supported by a recovery in personal consumption against a backdrop of an improving income environment, as well as robust capex in labor-saving and DX (digital transformation) initiatives driven by labor shortages. Meanwhile, external demand, while affected by tariff policies, is expected to remain generally solid as overseas economies recover, supported by fiscal spending in various countries.

Regarding prices, core CPI (all items less fresh food) is projected to be around +1.8%, and core-core CPI (all items less fresh food and energy) is expected to be around +2.2% in FY26. While core CPI is likely to temporarily fall below 2% due to government measures to address high prices, core-core CPI is expected to remain above 2% for the time being partly due to strong cost pass-through on food prices.

Forecasts for Japan's Economy and Prices (%)

	FY25		⇒Our forecasts		FY26				FY27				⇒Our forecasts		
	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)	0.5	-0.6	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	-	-	-
(annualized)	2.1	-2.3	0.7	1.3	1.2	1.2	1.1	1.1	1.0	1.0	0.9	1.0	0.9	0.9	1.0
Domestic demand contribution (q/q)	0.4	-0.4	0.2	0.4	0.4	0.3	0.3	0.3	0.2	0.2	0.2	0.3	1.0	1.1	1.0
Private consumption (q/q)	0.3	0.2	0.1	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.2	0.9	0.8
Private non-residential investment (q/q)	1.3	-0.2	0.1	0.4	0.7	0.6	0.5	0.6	0.5	0.5	0.5	0.6	1.6	1.9	2.1
Foreign demand contribution (q/q)	0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Exports (q/q)	1.9	-1.2	0.3	0.4	0.4	0.5	0.7	0.6	0.6	0.7	0.6	0.6	2.6	1.4	2.5
Imports (q/q)	1.4	-0.4	0.2	0.7	0.8	0.6	0.7	0.7	0.6	0.7	0.7	0.7	2.9	2.3	2.7
Core CPI (y/y)	3.5	2.9	2.8	2.0	1.7	1.9	1.7	2.1	2.0	1.9	1.9	1.9	2.8	1.8	1.9
Core core CPI (y/y)	3.2	3.2	3.0	2.9	2.5	2.3	2.2	2.0	2.2	2.2	2.1	2.1	3.1	2.2	2.2
Uncollateralized overnight call rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	0.75	1.00	1.25

Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC), BOJ; compiled by Daiwa.
Note: Based on the assumption that WTI crude oil price will stay around $60/bbl, and USD/JPY rate will be Y150 for FY25, Y148 for FY26, and Y146 for FY27.

Q: Why is only core CPI expected to fall below 2% in FY26?

A: The main reason is the effect of the government's measures to address rising prices. Core CPI will be directly affected by these measures, including reductions in energy prices.

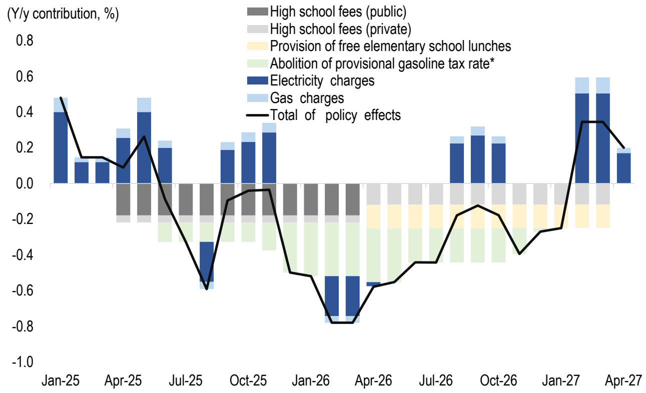
In the FY25 comprehensive economic package, the government has set out the abolition of the provisional gasoline tax rate and support for electricity and gas bills.
These measures are expected to push down core CPI by around 0.8ppt in Feb-Mar 2026. On the other hand, core-core CPI will not experience a similar downward effect and is expected to remain above 2% for the time being, due to the stickiness of price pass-through in food items.

Q: When are food price increases expected to stabilize? What is the outlook for rice prices?

A: Judging from the number of food items with price hikes, as indicated by Teikoku Databank's survey, we expect the trend of food price increases to moderate from 2026 onwards. In particular, we assume a gradual slowdown through spring 2026, under which the y/y rate of core-core CPI should also decline step by step toward 2%.

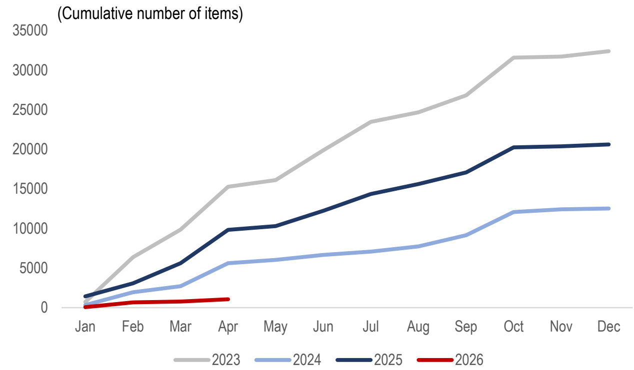
Furthermore, rice inventories are currently accumulating, making it highly likely that rice prices will remain flat or follow a slight downward trend. We currently forecast that rice prices will be roughly flat. However, if rice prices were to fall to around Y3,500/kg, the contribution of rice to core CPI could decrease to about -0.1ppt (contribution of rice in Nov nationwide CPI was +0.36ppt). Moreover, considering the ripple effects of a decline in rice prices, the downward pressure on core CPI is estimated to be around -0.1ppt to -0.2ppt.

Impact of Government Inflation Measures on CPI (incl. base effects)



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

No. of Food Items with Price Hikes



Source: Teikoku Databank data; compiled by Daiwa.

Q: What is the impact of core CPI decline on underlying inflation, and what is the future outlook?

A: Underlying inflation refers to the sustainable rate of price increase that can be achieved in a steady state, after excluding temporary or less-persistent factors. Therefore, a temporary downturn caused by policies that push down prices does not directly alter underlying inflation. However, there are potential indirect channels through which it could affect underlying inflation; for example, an improvement in the output gap due to fiscal stimulus could push up underlying inflation, while a decline in the actual inflation rate could push down inflation expectations.

We do not think that underlying inflation, centered on inflation expectations, will decline even if core CPI falls. First, while household inflation expectations tend to be strongly influenced by price changes encountered in daily life, particularly for essential goods like food and utilities, we think that the main factor currently influencing household inflation expectations is the decline in purchasing power—that is, the high level of prices relative to income. In other words, even if the rate of price increases slows, as long as the price level remains high and purchasing power does not recover, household inflation expectations are likely to remain elevated.

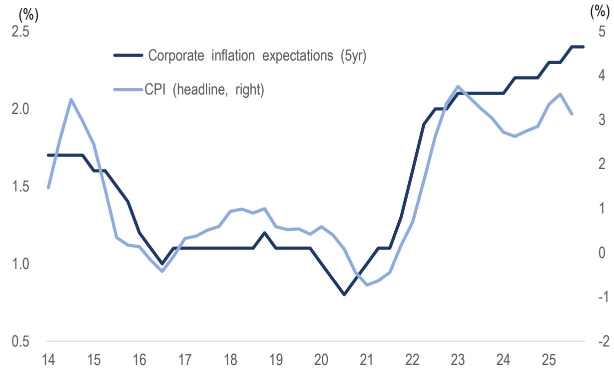
On the other hand, it is suggested that corporate inflation expectations have traditionally been strongly influenced by the formation of adaptive expectations (forming expectations based on past performance). We believe that we are now at a turning point in determining whether the rise in corporate inflation expectations is due to a change in the norm (the standard for expectation formation) or merely a reflection of a temporary price upswing.

That said, even as the consumer price inflation rate has been declining since 2025, corporate inflation expectations have maintained an upward trend. This suggests a shift in the norms of how companies form their inflation outlook. In light of this situation, it is unlikely that a future decline in core CPI would have a significant impact on corporate inflation expectations.

Meanwhile, inflation expectations among experts may rise. Experts appear to make judgments based on whether prices will trend upward in the long term, excluding the direct effects of measures to address inflation. In this regard, we assume that risks of prolonged inflation from a weaker yen and fiscal stimulus could push up long-term inflation rates, accompanied by a change in the norm, thereby raising experts' inflation expectations.

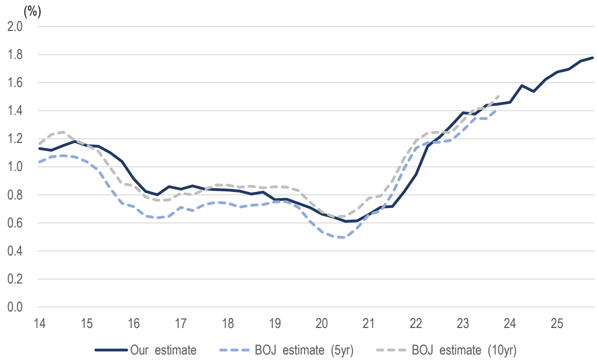
We currently estimate underlying inflation based on inflation expectations to be around 1.78%. Considering the situation described above, along with the improvement in the output gap due to fiscal stimulus, it is highly likely that underlying inflation will continue to rise into FY26. Here, it should be noted that if the yen's depreciation accelerates, there is a risk that underlying inflation could rise faster than anticipated.

Corporate Inflation Expectations and CPI



Source: MIC, BOJ; compiled by Daiwa.
Note: Headline CPI shows the y/y change in 6-month backward moving average.

Composite Index of Inflation Expectations



Source: BOJ, Japan Center for Economic Research (JCER); 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 (average 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 this estimate, the contribution ratio for the first principal component was 0.788.

Q: What are the trends in personal consumption and wages?

A: On the wage front, against the backdrop of strong corporate earnings, high wage hikes on par with the previous year (over 5%) are expected in the 2026 spring wage negotiations. With inflation slowing down, partly due to the effect of price-containment measures, real wages are expected to turn positive from the beginning of 2026. This improvement in the income environment is expected to support personal consumption.

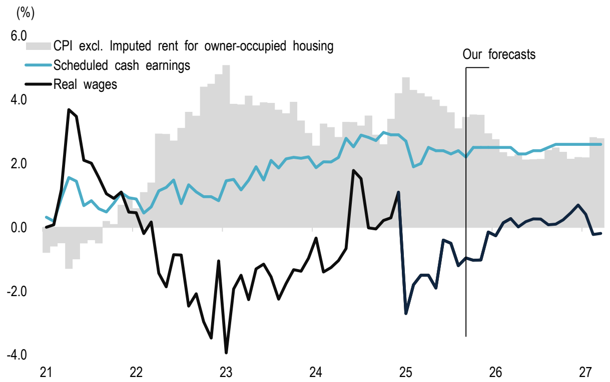
In addition, in the FY25 tax reform, it was decided to raise the "annual income threshold," and the minimum taxable income was increased from the previous Y1.03mn to Y1.60mn. The effect of this measure will become apparent through year-end tax adjustments, so it is expected to boost personal consumption mainly from Jan-Mar 2026 onwards. The effect of raising the annual income threshold to Y1.78mn, which is discussed for the FY26 tax reform, is expected to become apparent from Jan-Mar 2027 onwards.

The support for electricity and gas bills decided in the FY25 comprehensive economic package will be implemented in Jan-Mar 2026 (with billing to consumers in Feb-Apr). As such, the government's household support measures are expected to become apparent mostly in the first half of 2026. Therefore, personal consumption in the first half of 2026 will be supported by the turn to positive real wages and the effect of household support measures, while the improved income environment is likely to continue to be a tailwind in the second half of 2026.

Q: Can Japan escape the "recovery without a sense of improvement" in FY26?

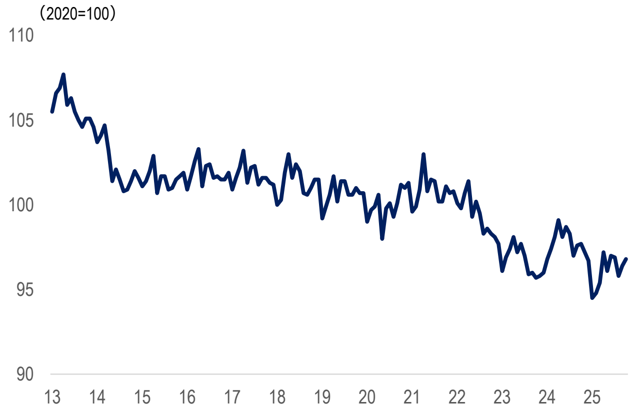
A: It is expected to take time for households to experience a tangible improvement in their living standards. Currently, the main burden strongly felt by households is inflation that outpaces income growth. The real wage index has fallen significantly since 2022. To recoup this decline in purchasing power, even if real wages were to rise at a pace of +1% y/y, it would take two to three years.

Forecasts for Real Wages (based on Monthly Labour Survey)



Source: MIC, Ministry of Health, Labour and Welfare (MHLW); compiled by Daiwa.
Note: Data continuously collected from same establishments.

Real Wage Index (contractual cash earnings)

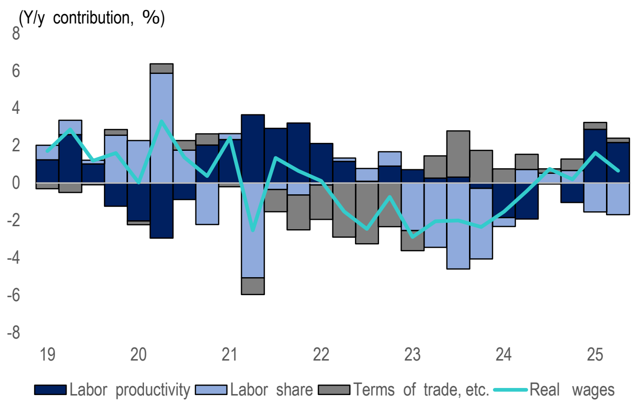


Source: MHLW; compiled by Daiwa.

However, it remains unclear whether positive real wage growth will become firmly established. The factors driving real wage fluctuations can be broken down into labor productivity, the labor share, and the terms of trade. In particular, looking at the factors behind the decline in real wages since 2021, deterioration in the terms of trade was the main driver initially, and subsequently the decline in the labor share has contributed as a downward factor.

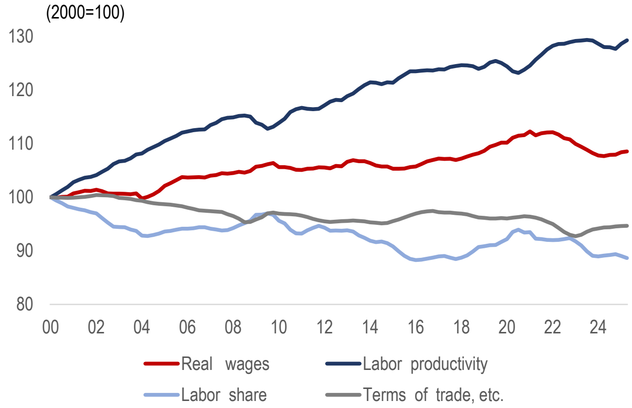
Going forward, if the yen's depreciation accelerates, the terms of trade (export prices / import prices) would deteriorate, potentially strengthening downward pressure on real wages. For Japan to escape the "recovery without a sense of improvement," the government is likely to need to pay attention to exchange rate trends and implement policies that fundamentally boost real wages by improving labor productivity and the labor share.

Breakdown of Contributions to Hourly Real Wages



Source: Cabinet Office, MIC, MHLW; compiled by Daiwa.

Levels of Real Wage Components (12-month backward averages)



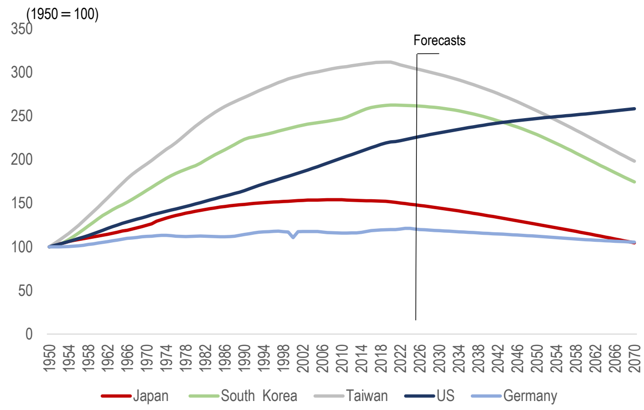
Source: Cabinet Office, MIC, MHLW; compiled by Daiwa.

Q: What are the risk factors for the outlooks?

A: Downside risks for Japan's economy include a US economic downturn and deteriorating Japan-China relations. Meanwhile, we view prolonged inflation driven by factors such as yen depreciation as the greatest risk factor for the outlooks. First, prices from FY26 onward are expected to be influenced by the combined effects of global and domestic inflationary pressures.

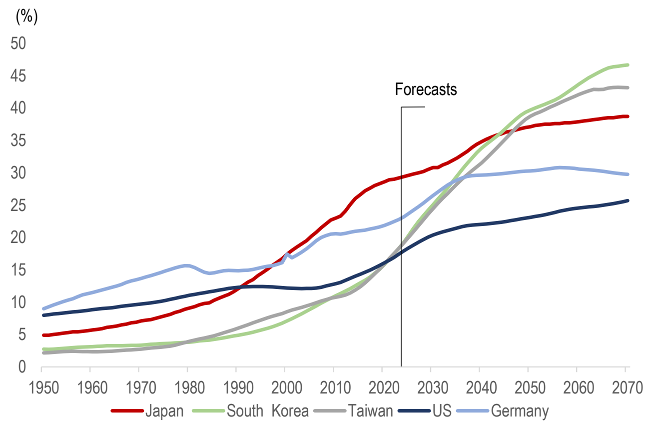
The following points can be cited as global and structural upward factors: (1) Further intensification of labor supply constraints due to the progression of aging and labor shortages, primarily in developed nations, (2) Rising procurement costs and fixed expenses due to protectionism and enhanced economic security, (3) Increased short-term capex demand and electricity demand associated with the expansion of generative AI-related investments (that said, over long term, increased productivity also expected to exert downward pressure on prices). These factors are common to Japan as well and they particularly impact Japan's prices, given its high dependence on energy and food imports.

Population Estimates



Source: United Nations; compiled by Daiwa.

Percentage of Population Aged 65 and Over



Source: United Nations; compiled by Daiwa.

In this context of increasing structural upward pressure on prices, as a domestic factor, rising demand due to the increasing depreciation of the yen and fiscal stimulus could push up prices. Assuming the yen weakens further with the exchange rate holding at USD/JPY160, we would expect core CPI to rise to +2.8% in FY25 (main scenario also +2.8%) and to +2.2% in FY26 (main scenario +1.8%).

In particular, external cost pressures stemming from yen depreciation could dampen domestic demand by lowering real wages and undermining the sense of improvement among households. (Refer to above section "Can Japan escape the 'recovery without a sense of improvement' in FY26?")

Q: How to view "responsible expansionary fiscal policy" in FY26?

A: The FY26 tax reform guidelines include raising the "tax-free annual income threshold" and establishing a tax system to promote capex. Tax system revisions promoting wage increases for large corporations and an increase in the international tourist tax will also be implemented. All told, a well-balanced tax policy was presented.

Also, the FY26 initial budget is expected to be formulated with a focus on curbing new JGB issuance. The Takaichi administration is emphasizing fiscal "responsibility" in light of the current rise for yields and yen depreciation. These moves demonstrate a restrained aspect mindful of the market. We believe that it is highly unlikely that the Takaichi administration will proceed with unconditional fiscal expansion going forward.

That said, it is hard to say that changes in these behaviors alone will be sufficient to gain the market's trust. Given the economic conditions in FY26, the sense of economic well-being among households is not expected to improve and populist tendencies are likely to persist in Japan. This situation provides the Takaichi administration with an incentive to maintain its "expansionary fiscal policy." Meanwhile, as long as it continues to champion that policy, it is unlikely that markets will completely abandon their vigilance regarding fiscal discipline.

In order to assess the sustainability of Takaichi administration policies, there is the need to either keep real interest rates low or commit to long-term growth. That said, the existence of the term premium makes it difficult for the government to fully control real interest rates, while long-term growth only comes to light after-the-fact.

Taking these points into consideration, the Takaichi administration must not only implement "responsible expansionary fiscal policy" with growth as a guaranteed outcome, but also conduct appropriate fiscal management, while anticipating scenarios where growth remains low. In particular, the "Basic Policies for Economic and Fiscal Management and Structural Reform" due out in June 2026 will be a key event in terms of demonstrating the Takaichi administration's approach to "responsibility."

Q: Rate-hiking pace and terminal rate?

A: At his press conference following the December Monetary Policy Meeting, BOJ Governor Kazuo Ueda indicated a stance of continuing rate hikes, while maintaining a data-dependent approach to monetary policy as usual, including the future terminal rate level. The timing of the next interest rate hike is expected to be determined by a comprehensive examination of the economic and price conditions, including impacts on households and businesses when the policy interest rate is hiked to 0.75% and trends for passing on higher wages to prices, in addition to upside price risk such as yen depreciation.

First, regarding the passing of higher wages to prices, small and medium-sized enterprises (SMEs) tend to closely monitor the actions of large corporations before deciding on and implementing wage increases. Consequently, the timing when overall wage increases, including those at SMEs, are transferred to prices is generally expected to be delayed until the summer or later. Also, as for the impact of interest rate hikes, floating-rate mortgages do not immediately reflect increases in the short-term prime rate, with most being reviewed in April or October. So, in order to accurately gauge the impact of interest rate hikes on household finances, it will be crucial to monitor household sentiment and consumption trends starting in April. Taking all these factors into account, we expect the next rate hike to occur in the Jul-Sep quarter of 2026.

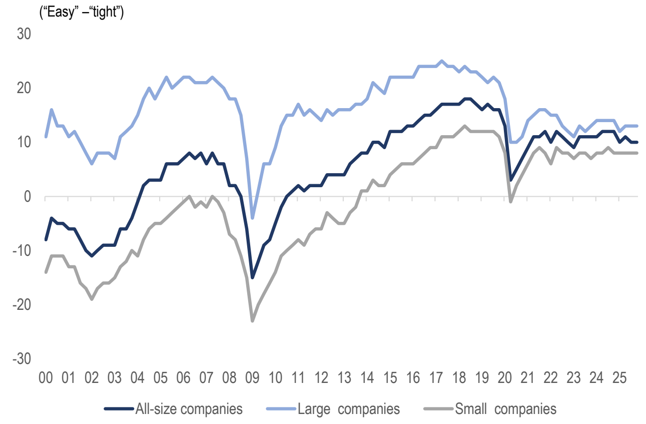
Meanwhile, based on lending, corporate financing, and bankruptcy trends, "There is currently no evidence that the degree of monetary easing is rapidly diminishing." In addition to the sustainability of wage increases supported by high corporate profits, fiscal spending is expected to bolster the Japanese economy. Therefore, even if the policy interest rate reaches 1%, we see little likelihood of a clear deterioration in macroeconomic conditions.

Given the risk of higher-than-expected inflation due to such factors as yen depreciation and fiscal stimulus, the BOJ will likely need to continue raising the policy interest rate at a steady pace even after it reaches 1%. We also expect a 0.25% interest rate hike in the Jan-Mar quarter of 2027, with a total of two rate hikes anticipated for FY26. At this juncture, we expect a terminal rate of 1.25% with the price trends for FY27 projected to stabilize at roughly 2%.

Y/y Change in Average Outstanding Loans (total of major, regional, and *shinkin* banks)

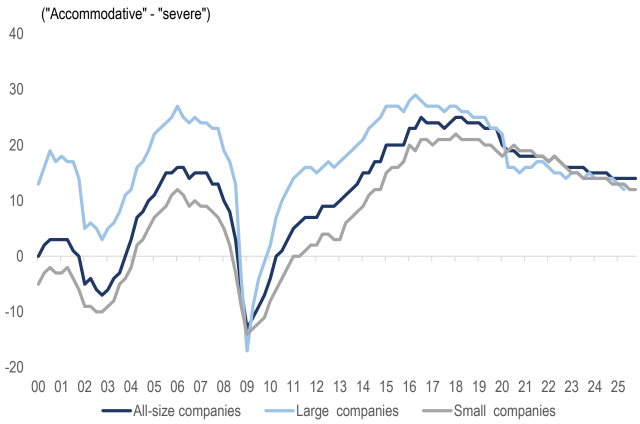
Source: BOJ; compiled by Daiwa.

BOJ Tankan: Financial Position DIs



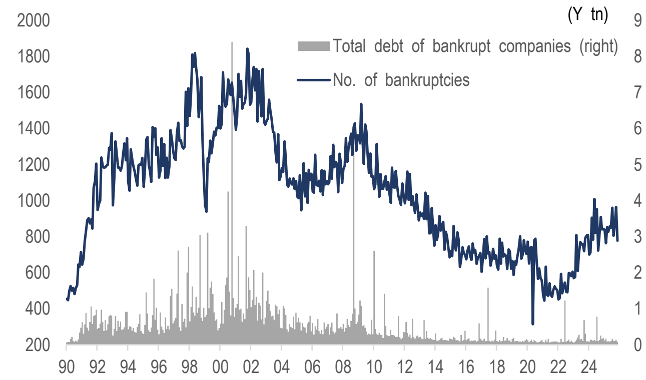
Source: BOJ; compiled by Daiwa.

BOJ Tankan: DIs on Lending Attitude of Financial institutions



Source: BOJ; compiled by Daiwa.

No. of Corporate Bankruptcies



Source: Tokyo Shoko Research; compiled by Daiwa.

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