

Daiwa's Economic View

Impact of renewed Middle East risks on Japan's economy, monetary policy

- 50% crude oil price increase would likely push up CPI by 0.6% and lower real GDP by 0.3%
- Prolonged Middle East risks could further complicate BOJ's communication with government

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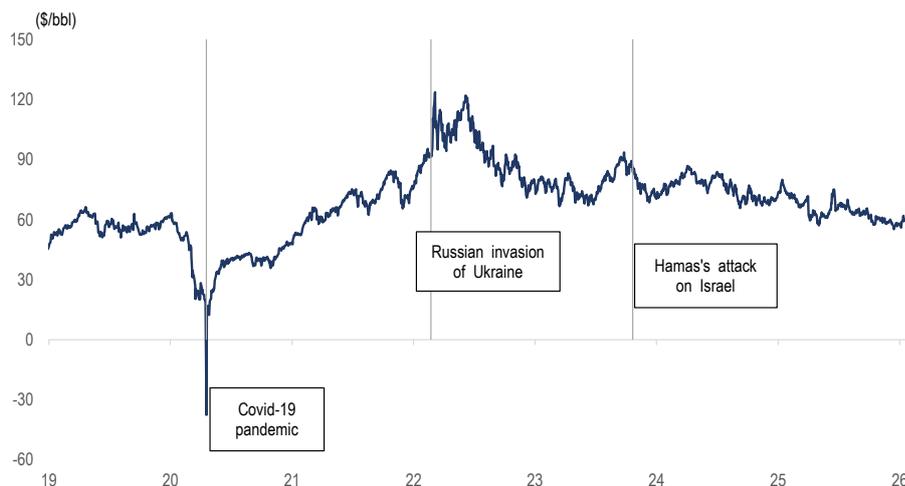
Daiwa Securities Co. Ltd.

On 28 February, the US and Israel launched an attack on Iran with the aim of preventing that nation from acquiring nuclear weapons. As a result, Japan's three major shipping companies have decided to suspend navigation through the Strait of Hormuz.

If the Strait of Hormuz were actually blocked, it would significantly impact China (Iran's largest crude oil importer and friendly nation) making the feasibility of a full-scale blockade uncertain. However, Japan is very dependent on the Middle East for its energy supply. According to the Petroleum Statistics Bulletin (Jan 2026), the Middle East accounted for 95.1% of Japan's crude oil imports. Data from the Petroleum Federation (2023) indicates that 73.7% of crude oil imports passed through the Strait of Hormuz. Given these conditions, if energy supply constraints from the Middle East persist for a long time, the impact on the Japanese economy would likely be significant.

In the BOJ's January 2026 *Outlook Report*, the Bank provided its view that, "Crude oil prices are assumed to be more or less flat toward the end of the projection period." At that time, WTI crude oil prices were generally hovering around \$60 per barrel. In this report we examine the impact on Japan's economy and prices assuming that the WTI crude oil price hovers around \$90/bbl (50% increase vs Jan), while also considering the implications for monetary policy.

WTI Crude Oil Prices



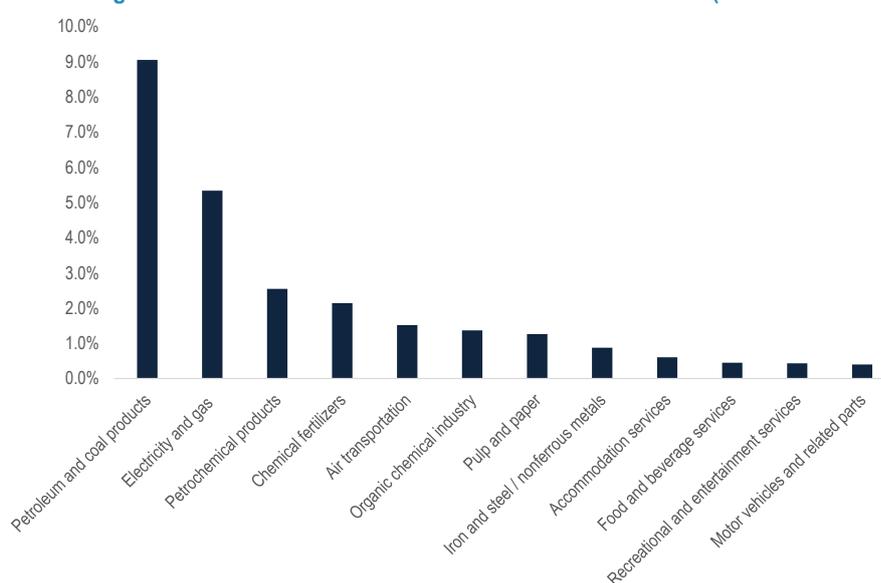
Source: Bloomberg; compiled by Daiwa.

Prices: 50% crude oil price increase could raise CPI by about 0.6%

In this report we estimate the impact of rising crude oil prices on domestic prices using an equilibrium price model based on input-output tables. The equilibrium price model is an analytical approach that assumes quantities are fixed. This approach assumes that industries mutually supply each other with raw materials/services and that price fluctuations in some industries ripple through to others, ultimately determining equilibrium prices across all industries. In this calculation, the price pass-through rate for companies was set at approximately 50%, based on the Follow-up Survey Regarding Price Negotiation Promotion Months (Jun 2025) provided by the Ministry of Economy, Trade and Industry in November 2025.

First, if the crude oil price rises by 50%, the output prices (roughly equivalent to corporate prices) could increase by 9.1% in the petroleum and coal products industries and 5.3% in the electricity and gas industries. The impact is expected to spread across a wide range of sectors, including lodging/food services and entertainment, among others.

Price Changes Across Industries from a 50% Rise in Crude Oil Prices (selected industries)



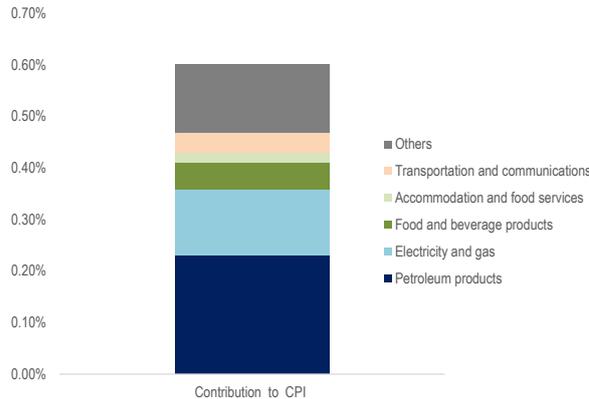
Source: Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa.

Note: This estimate is calculated using the 2015 input-output tables. It is therefore based on the assumption that Japan's economic structure, particularly in terms of corporate input and output, has not changed significantly since 2015.

Higher corporate prices would likely spread to downstream consumer prices, with our estimates indicating a potential increase of approximately 0.60% in overall consumer prices. The breakdown includes, first, the direct upward pressure on prices caused by higher petroleum product prices, such as gasoline, as well as electricity and gas fees. Also, rising energy costs and transportation expenses are being passed on to processing and distribution costs, exerting upward pressure on prices for food and beverages as well as food service and lodging. Similar effects are expected to spread across a wide range of service sectors, including transportation and communications.

For our estimates we used an equilibrium price model based on input-output tables, assuming a price pass-through rate of approximately 50% for companies. As such, it is important to note that actual consumer price movements can fluctuate due to demand-side reactions, differences in how companies pass on higher costs to prices, and factors such as international markets and exchange rates. If energy price increases persist over the long term, a decline in real purchasing power could exert downward pressure on the economy, which in turn could exert downward pressure on prices.

Contribution to CPI from a 50% Rise in Crude Oil Prices



Source: MIC; compiled by Daiwa.

Note: This estimate is calculated using the 2015 input-output tables. It is therefore based on the assumption that Japan's economic structure, particularly in terms of corporate input and output, has not changed significantly since 2015.

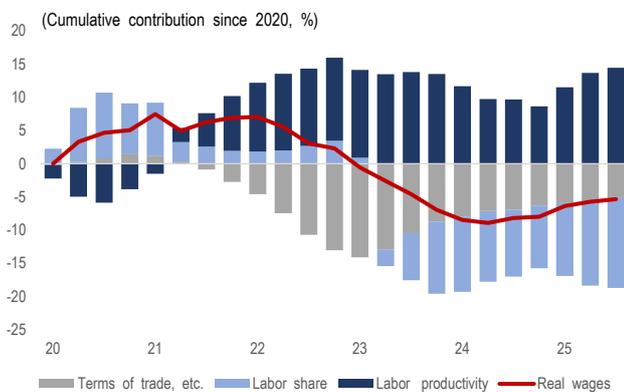
Economy: 50% crude oil price increase could reduce real GDP by 0.3%

The impact on the Japanese economy can be broadly categorized into two main areas. First is the decline in real purchasing power due to deteriorating terms of trade. Second is the deterioration in corporate profits due to rising costs.

As for the first impact, Japan relies almost entirely on imports for its crude oil. Any rise for crude oil prices significantly pushes up overall import prices, leading to a deterioration in the terms of trade (calculated by dividing export prices by import prices). Deteriorating terms of trade mean increased payments to foreign countries and, as capital outflows to foreign countries expand, the real income remaining domestically decreases. As a result, the likelihood of price increases outpacing wage growth is rising, which could lead to a decline in households' real purchasing power.

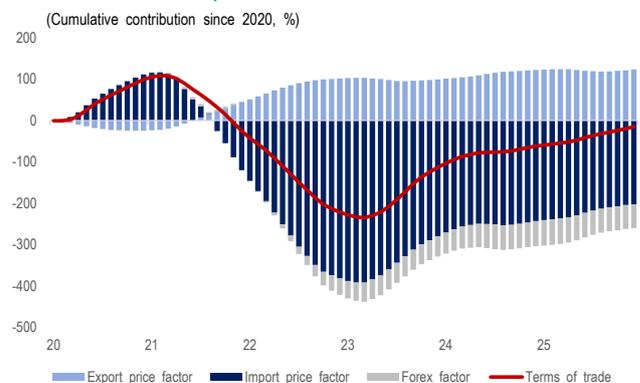
Even though real wages are expected to turn positive and stabilize from 2026 due to the government's measures against rising prices, if further increases for crude oil prices worsen the terms of trade, that recovery trend could be hindered. According to calculations based on the Cabinet Office's short-run macro econometric model of the Japanese economy (2022 version), real GDP is estimated to decline by approximately 0.3% over the next year if crude oil prices rise by 50%.

Decomposition of Contribution to Real Wages (cumulative contribution)



Source: Cabinet Office, BOJ, MIC, Ministry of Health, Labour and Welfare (MHLW); compiled by Daiwa.

Decomposition of Contribution to Terms of Trade (cumulative contribution)



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

Implications for monetary policy

After learning that US and Israeli military forces had attacked Iran, Prime Minister Sanae Takaichi said, "The Japanese government will prepare for all risks and take thorough measures." Moreover, she has also apparently instructed the identification of "anticipated economic impacts going forward." As mentioned earlier, we assume that the Japanese economy will face two adverse impacts stemming from rising crude oil prices, specifically, cost-push inflation and downward pressure on real GDP, potentially heightening the risk of stagflation.

The government appears to be increasing pressure on the BOJ, as evidenced by the proposed appointments of dovish candidates for the Bank's Monetary Policy Board presented to the Diet on 25 February. Under these circumstances, should the recent US/Israel military strikes against Iran become protracted, the BOJ's ability to smoothly communicate with government could become more difficult.

High crude oil prices also have dual aspects for BOJ policy decisions. If corporate profits are squeezed and real purchasing power declines, there is a risk of pushing down the underlying inflation rate. Meanwhile, primary cost-push inflation could also lead to higher-than-expected prices through secondary effects such as inflation expectations and wages.

That said, as indicated at the January meeting, the BOJ is already mindful of higher-than-expected price risks. Also, even if crude oil prices were to rise by around 50%, the negative impact would be somewhat mitigated by the lingering effects of the government's measures to combat rising prices (such as gasoline tax cuts and subsidies for electricity and gas). So, this would not constitute a major shock to the Japanese economy. Furthermore, if tensions in the Middle East ease within a short period, the shock for Japanese companies would likely be limited, as those companies maintain a certain level of crude oil inventory. Amid the ongoing yen depreciation trend, we expect the BOJ to maintain its stance of continuing to hike rates toward the neutral rate of interest, while remaining mindful of higher-than-expected price risks.

BOJ Deputy Governor Ryozi Himino will deliver a speech on 2 March. Attention is focused on the BOJ's interest rate hike stance amid the current economic and inflationary conditions, as well as the US and Israeli military attacks on Iran. That said, at this stage, the situation remains unclear, including whether the conditions in the Middle East will intensify for a longer period of time. If tensions subside within a short period, the impact would be limited. We anticipate that a certain degree of hawkish communication will be employed to maintain market expectations for rate hikes, while keeping an eye on higher-than-expected price pressures.

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