

## Economic Commentary (outlook for prices/policy rate)

### Inflation overshoot to drive faster BOJ hiking cadence; raise terminal rate call to 1.75%

- Pass-through from PPI to CPI likely faster and larger than past episodes
- Core CPI to peak in Jan-Mar 2027 at high end of +3% y/y range, then gradually moderate
- Expect next BOJ hike in June, then three hikes per year to 1.75% terminal rate

#### Kento Minami

81-3-5555-8789  
kento.minami@daiwa.co.jp



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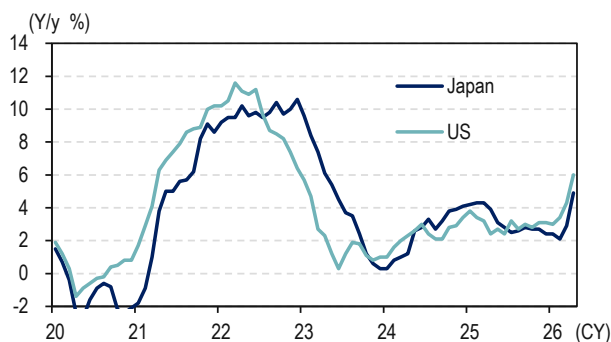
### Pass-through from PPI to CPI likely faster and larger than in past episodes

Rising import prices caused by heightened Middle East tensions already began feeding through to producer prices in April. However, the May Tokyo-area CPI shows that the impact of the Middle East crisis remains limited for now, and pass-through to consumer prices has yet to gather pace in earnest. To forecast inflation from here, we need to assess how fast and how strongly upstream cost increases will feed through to consumer prices, and how long that impact will persist.

In 2021, inflationary pressure intensified globally as a post-pandemic demand recovery coincided with supply-chain constraints. Russia's invasion of Ukraine in February 2022 then drove up international prices for oil, natural gas, and wheat, further intensifying global inflation pressure. During that episode, producer prices rose sharply in both Japan and the US, but a notable feature was that pass-through to consumer prices proceeded relatively swiftly in the US, while in Japan consumer prices were slow to increase relative to the rise in producer prices.

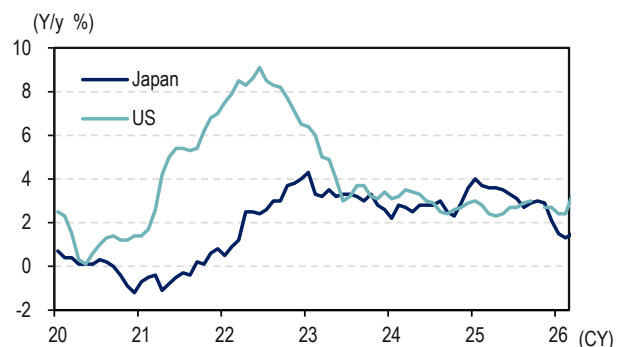
Are conditions in Japan now more conducive to pass-through to consumer prices than in 2021 and other past episodes? To state our conclusion up front, we think these past examples did not simply reflect consumers tightening their belts and refusing to accept price hikes. Rather, we think they reflect the substantial drag on the CPI from entrenched deflationary corporate pricing behavior, which affected the value-added components (employee compensation and operating surplus). Conditions have now changed, however, and pass-through to consumer prices is likely to be faster and larger.

Japan's Corporate Goods Prices, US Producer Prices



Source: BOJ, US Department of Labor; compiled by Daiwa.

Consumer Prices in Japan and US (all items)



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

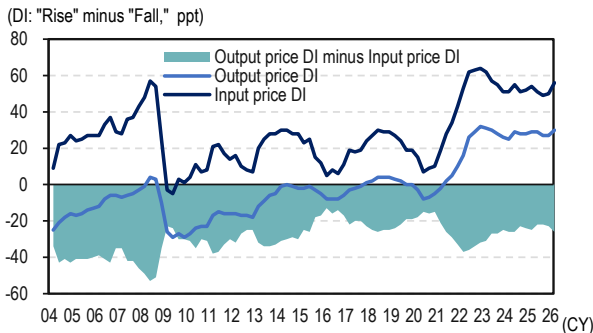
### Past episodes: Insufficient pass-through to CPI reflected gradual absorption via lower value-added

In the 2021-22 episode, the gap between the output-price DI and the input-price DI widened, suggesting pass-through from rising input prices into selling prices was insufficient. However, the producer price series for final goods and consumer goods (observable in the Final Demand-Intermediate Demand (FD-ID) Price Index) moved broadly in step with consumer prices for goods at the time. Given that producer prices for final and consumer goods represent shipment prices to the distribution and retail stages, the data contradicts the view that consumers were alone in rejecting price hikes.

Rather than pass-through stalling at one particular stage in the past, it is more natural to think that a portion of the cost increase was sequentially absorbed at each stage from upstream to downstream. Goods and services prices include both intermediate input costs and value-added components (such as employee compensation and operating surplus); even when intermediate input costs rise, there is scope for them to be absorbed at each stage through adjustments to labor expenses and profit margins. We conclude that this resulted in a limited pass-through to consumer prices.

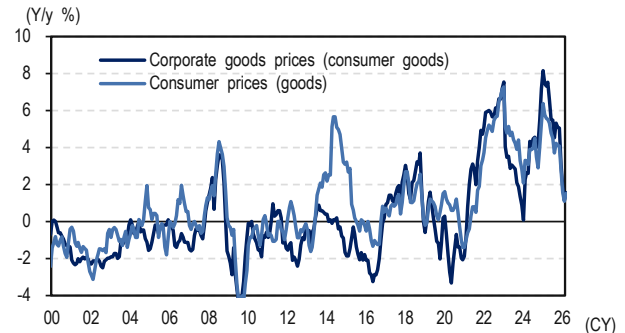
A breakdown of the contribution to the GDP deflator shows that the contribution of unit profit (profit per unit of output) declined from 2021, confirming that companies absorbed cost increases by compressing margins. We think weak wage growth at the time also meant that this squeeze on the value-added components had a broad-based effect across the economy.

**Output Price DI, Input Price DI (all-size enterprises, all industries)**



Source: BOJ; compiled by Daiwa.

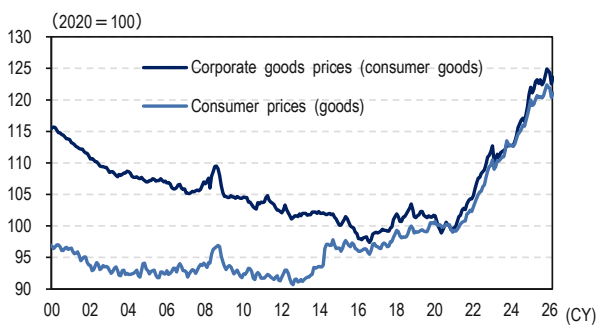
**Y/y Change in Corporate Goods Prices (consumer goods) and Consumer Prices (goods)**



Source: MIC, BOJ; compiled by Daiwa.

Note: Consumer prices are for goods, while corporate goods prices are "final goods and consumer goods" in Final Demand-Intermediate Demand (FD-ID) Price Index.

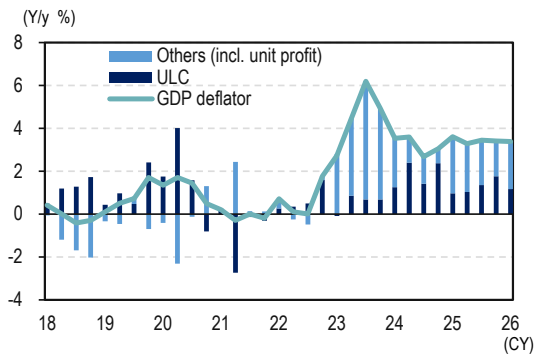
**Levels of Corporate Goods Prices (consumer goods) and Consumer Prices (goods)**



Source: MIC, BOJ; compiled by Daiwa.

Note: Consumer prices are for goods, while corporate goods prices are "final goods and consumer goods" in Final Demand-Intermediate Demand (FD-ID) Price Index.

**Contribution Decomposition of GDP Deflator**



Source: Cabinet Office; compiled by Daiwa.

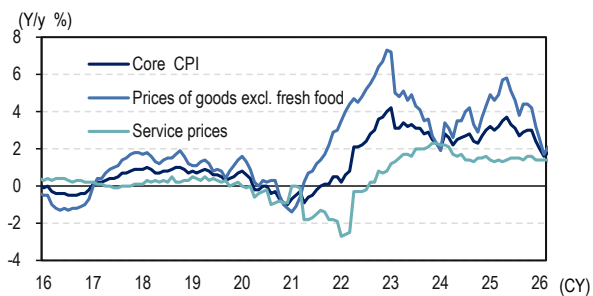
## Current episode: Less room to absorb costs, structurally higher pass-through rate

Conditions have now changed. Firms were previously able to absorb costs by curbing both labor expenses and profit margins, but while corporate profits are currently high, rising wages mean that they have less scope to absorb higher costs by controlling labor costs. These conditions mean that if firms sought to absorb cost increases only via thinner margins, the hit to profits would be greater than in the past. In other words, they may have less capacity to absorb higher costs within value-added components in general.

We also ran a regression analysis using y/y log differences for consumer prices (goods) and producer prices (consumer goods) to test the elasticity of consumer prices to changes in producer prices (the strength of pass-throughs). The results confirmed that this elasticity has clearly risen versus the pre-COVID period. This suggests that firms' pricing behavior toward consumers has become structurally more assertive, with cost movements feeding into the CPI more readily than before.

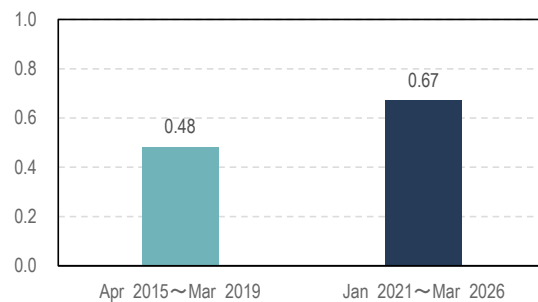
Driven by these structural changes, a picture is now emerging in which both goods and services are pushing up consumer prices. Services price inflation has remained steady at just under +2% y/y, reflecting wage gains, and for goods we also see firms passing through costs at a higher rate. Taken together, the current supply shock is likely to feed through more quickly than past episodes and at a higher pass-through rate.

Core CPI, Prices of Goods and Services



Source: MIC; compiled by Daiwa.

Elasticity of Consumer Prices (goods) to Corporate Goods Prices (consumer goods)



Source: MIC, BOJ; compiled by Daiwa.

Note: Consumer prices are for goods excl. fresh food, while corporate goods prices are for consumer goods.

## Inflation outlook: Inflation to overshoot earlier, then gradually moderate from FY27

Given these structural shifts, we think April's upside in producer prices is an important signal for the consumer price outlook. That said, this does not mean that inflation will remain elevated on a sustained basis.

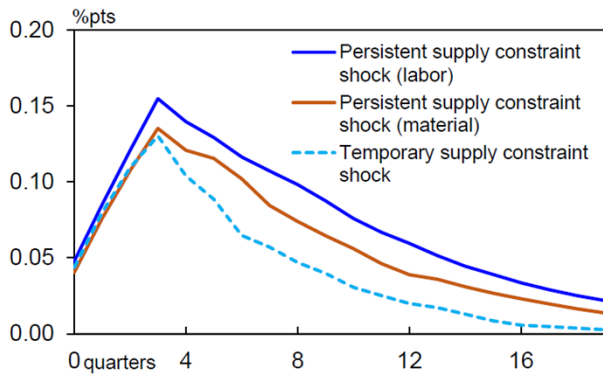
We think that in past episodes, a lack of progress with short-term pass-throughs to consumer prices meant that pass-throughs per se were drawn out over a longer period. In the current episode, however, more assertive corporate pricing behavior means that pass-throughs from the supply shock are likely to proceed at a faster pace than before. As a result, while price levels will step up over a short period, the y/y growth rate will then be compared against this higher base and is therefore likely to peak relatively early.

The BOJ's working paper '[Supply Constraints and Price Fluctuations](#),' published in February 2026, also shows that a supply-constraint shock lifts the y/y rate for roughly one year before the impact subsides. If pass-throughs accelerate again this time, the y/y boost will likely emerge earlier, and the subsequent slowdown will also come sooner.

On this basis, we expect the impact of the worsening Middle East crisis to gradually feed through from summer 2026, with the monthly core CPI climbing to the high end of the +3% y/y range

during Jan-Mar 2027. Thereafter, as the step-up in price levels runs its course, we expect the y/y growth rate to gradually moderate. We forecast the FY26 core CPI at +2.5% y/y, core-core CPI at +2.4% y/y, FY27 core CPI at +2.4% y/y, and core-core CPI at +2.4% y/y. We think the core-core CPI will keep growing at a relatively elevated pace through FY27 but should slow to roughly +2% by the end of the fiscal year.

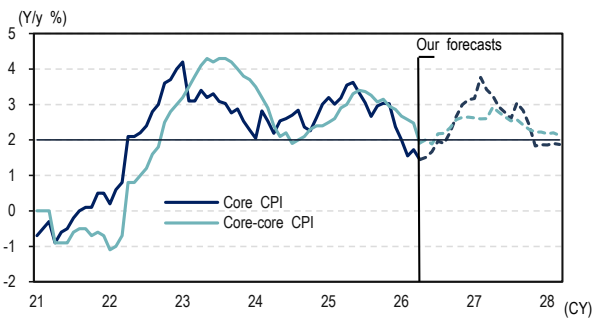
#### Impulse Response of CPI Inflation Rate (excl. fresh food/energy)



Source: Reprinted from BOJ materials.

Note: The median impulse responses of the y/y rate of change in core-core CPI to one standard deviation supply constraint shocks. Figures are calculated by aggregating the responses of the q/q changes over four quarters.

#### CPI Forecasts



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

Notes (1) Forecasts are based on assumptions of average USD/JPY rate of ¥158 in FY26 and ¥156 in FY27, and average WTI crude oil price of \$85/bbl in FY26 and \$76/bbl in FY27. (2) Figures include effects of the government's subsidies for electricity and gas bills scheduled to be implemented in summer of 2026. However, they do not include effects of the consumption tax cut currently under consideration by the government.

### Policy rate outlook: Raising terminal rate call to 1.75%, faster pace of hikes ahead

On the basis of this inflation outlook, we are revising our policy rate forecast. We raise our terminal rate call from 1.5% to 1.75% and move up our expected path for rate hikes (we previously forecast one hike every six months).

While the current inflation episode originates in a supply shock, accelerating pass-throughs could increase underlying inflation pressure. For this reason, we think the BOJ will be alert to upside inflation risk and move toward an early hike. The Summary of Opinions for the April Monetary Policy Meeting (MPM) indeed showed the majority of views emphasizing upside risks to inflation, suggesting that Policy Board members may be converging on the need for an early hike. We therefore expect the next rate hike in June.

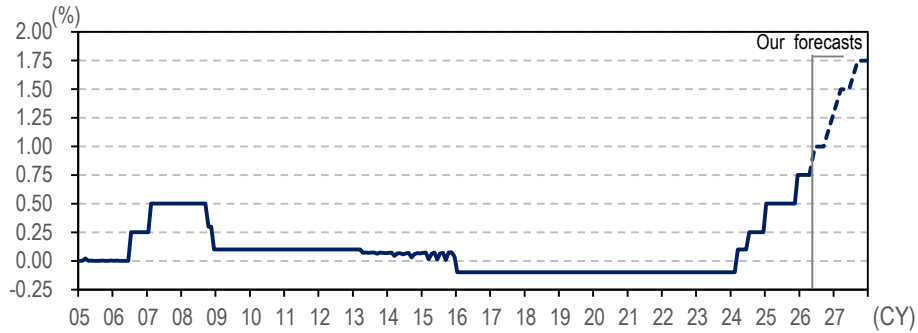
Beyond that, with inflation accelerating due to the Middle East crisis, concerns are growing that the one hike every six months we previously assumed would leave the BOJ behind the curve on risk management. With the core CPI set to overshoot substantially through the second half of FY26, we think the BOJ will keep one hike every six months as a floor while accelerating somewhat above that pace to contain upside inflation risk.

On that basis, we think the BOJ will aim to raise the policy rate as quickly as possible to a 'well-positioned' level appropriate for staying ahead of upside inflation risk. We assume it will target +1.75%, the midpoint of the estimated neutral rate range of around +1.0% to +2.5%. Specifically, we expect roughly three hikes per year after the June 2026 hike, with the policy rate reaching +1.75% in Jul-Sep 2027. After that, we think the rate-hike cycle is likely to run its course as inflation converges to around 2%.

In his 27 May speech, Governor Kazuo Ueda cited four factors behind sustained inflation since 2021: (1) the broad scope of the supply shock, (2) amplification of the shock by yen weakness, (3) tighter labor supply-demand, and (4) changing norms around prices and wages. He appears to be growing more vigilant about persistent inflation given that at least factors (2) through (4) remain relevant in the current episode.

That said, if rising inflation expectations, further yen weakness, or stronger-than-expected economic activity create upside risks to inflation, we would not rule out larger hikes, a faster pace, or further upside to the terminal rate.

#### Policy Rate Forecasts



Source: BOJ; compiled by Daiwa.

Note: The policy interest rate refers to the target for the uncollateralized overnight call rate for the periods of Mar 2006–Mar 2013 and from Mar 2024 onwards. For the period of Jan 2016–Feb 2024, the interest rate on the Complementary Deposit Facility is used. For all other periods, the actual uncollateralized overnight call rate is used.

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