Daiwa Securities

Daiwa's View

Japanese economy, inflation, and a "phase shift" in monetary policy driven by AI demand

- Expanding AI-related demand is improving corporate sentiment and easing concerns about an economic slowdown
- BOJ is also focusing on rising semiconductor prices as a new source of upside inflation risk
- Coordinated forex intervention and expanding AI demand are ushering monetary policy into a new phase

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AI demand shock drives improvement in business sentiment

Business sentiment among Japanese companies has strengthened over the course of this summer. In the August Reuters Tankan survey, the manufacturing DI rose by 5 points from the previous month to +18, recovering to its highest level since the second half of 2021. The non-manufacturing DI also rose by 3 points to +28, confirming an improvement in sentiment across a broad range of industries, including services.

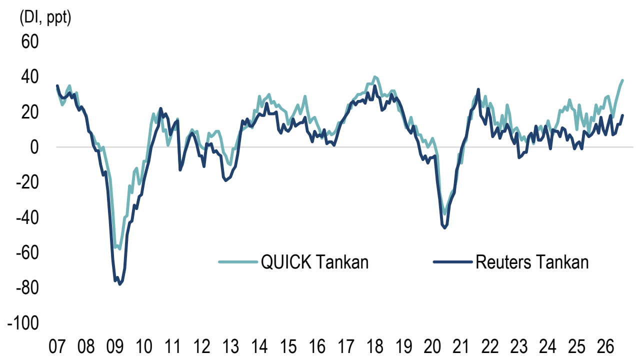
A notable feature of the latest improvement is that a significant number of companies cited expanding AI-related demand as a contributing factor. Companies across a wide range of industries, including chemicals, machinery, electrical machinery, and precision instruments, pointed to strong semiconductor demand. One machinery manufacturer reported "brisk orders for products used in the semiconductor market," while an electrical machinery manufacturer noted that "demand in the semiconductor market, particularly for memory-related applications, is favorable." One precision instrument manufacturer responded that "since April, the order environment has improved substantially both in Japan and overseas, with orders running at twice their normal level."

These developments are not confined to a limited number of industries. The Reuters Tankan showed particularly pronounced improvements in chemicals and petroleum & ceramics, with many companies commenting on "buoyant semiconductor market conditions" and "strong demand for semiconductor-related applications." This suggests that the expansion in AI-related investment is spreading beyond semiconductor manufacturers to peripheral industries, including materials and semiconductor manufacturing equipment.

The improvement is also becoming more broad-based in the non-manufacturing sector. Sentiment improved in services, including hotels, tourism, and restaurants, supported by factors such as increased domestic airline ticket sales and stable booking flows. A department store reported that sales to domestic customers were approximately 10% higher than a year earlier. Although consumer spending continues to be affected by rising prices, it has remained resilient. In addition, a company in the transportation & utilities sector cited "strong semiconductor performance" as a reason for the improvement in its business sentiment. The benefits of AI-related demand appear to be beginning to spread beyond manufacturing to logistics and services.

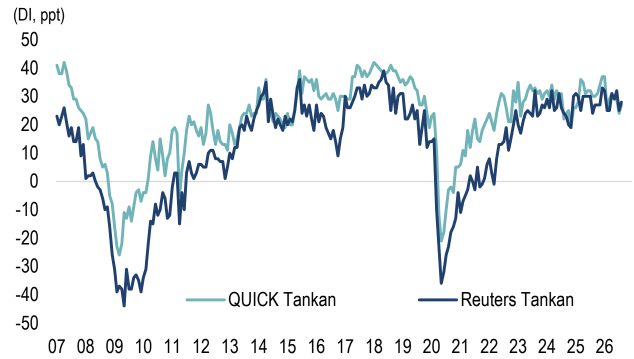
A similar trend can be observed in the QUICK Tankan. The manufacturing business conditions DI stood at +38, its third-highest level since the survey began. Companies also continued to report pronounced shortages of production capacity and labor, suggesting that corporate activity remains at a high level.

Reuters Tankan, QUICK Tankan (manufacturing sector)



Source: Reuters, QUICK; compiled by Daiwa.

Reuters Tankan, QUICK Tankan (non-manufacturing sector)



Source: Reuters, QUICK; compiled by Daiwa.

Until recently, a widely held market view was that higher crude oil prices arising from developments in the Middle East and a deterioration in Japan's terms of trade would weigh on the economy. More recently, however, expanding demand generated by the global AI investment boom appears to be supporting corporate earnings and capital expenditure, thereby offsetting a substantial portion of these negative effects. The Summary of Opinions from the BOJ's July Monetary Policy Meeting (MPM) stated that "With the economy experiencing an upswing driven by the demand shock from the global expansion in AI-related demand, the deterioration in the terms of trade reflecting higher crude oil prices has been mitigated, and concerns over an economic slowdown have subsided." The results of the corporate sentiment surveys are consistent with this assessment.

AI demand is becoming a new source of upside inflation risk

The impact of AI-related demand, however, is not limited to economic activity. In its July *Outlook for Economic Activity and Prices* report (*Outlook Report*), the BOJ explicitly identified "the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand," as a factor pushing up durable goods prices in its discussion of the outlook for consumer prices.

Until now, the BOJ's explanations of the factors behind inflation have focused primarily on the pass-through of higher wages to prices, rising energy prices, and increases in import prices caused by yen depreciation. What is distinctive this time is that AI-related demand has been identified separately as a new source of upside inflation risk.

The global race to invest in AI continues. Against the backdrop of growing demand for data centers and AI servers, semiconductor and memory prices have been on an upward trend. Because these prices are determined in global rather than domestic markets, price increases spill over not only into the US but also into Japan. The BOJ's reference to rising semiconductor prices presumably reflects its recognition that expanding AI-related demand is beginning to generate global inflationary pressure. This concern is also evident in a Box in the latest *Outlook Report.*

Indeed, this concern is not unique to Japan. At the ECB, discussions have begun regarding the possibility that increases in semiconductor and memory prices associated with expanding AI-related demand could feed through to inflation via the prices of electronic equipment and durable goods. The AI investment boom is often discussed as a theme boosting US economic growth and corporate earnings, but its effects are also increasingly spreading to inflation in other countries through the semiconductor market. The BOJ's explicit incorporation of rising semiconductor and related prices into its inflation outlook is closely linked to this global shift.

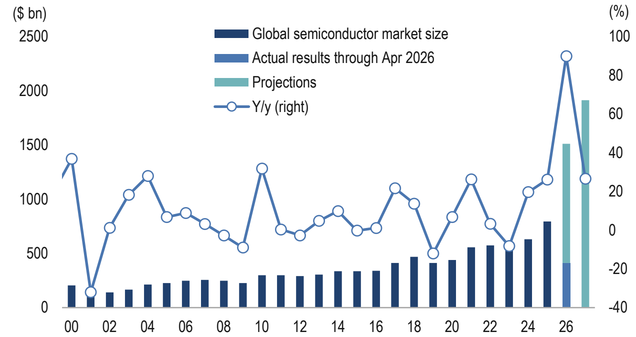
Japan relies heavily on imports for many types of AI-related equipment and high-performance semiconductors. As with crude oil and natural gas, higher prices for AI-related goods could affect domestic inflation through higher import prices. The BOJ's increasingly frequent references to semiconductor and durable goods prices likely reflect its awareness of this transmission channel.

AI demand, however, differs in nature from conventional import inflation. Higher crude oil and other commodity prices primarily squeeze the real incomes of companies and households and exert downward pressure on economic activity. By contrast, the expansion in AI demand increases demand for semiconductors and stimulates capital expenditure, while also contributing to higher corporate earnings and increased production activity. This is presumably why the BOJ characterized AI-related demand in the Summary of Opinions from its July MPM as exerting "upward pressure on the economy" and "upward pressure on prices."

Viewed from another perspective, this represents a shock that pushes up both economic activity and inflation. Its defining feature is that it is accompanied by strong demand, rather than acting as a pure cost-push shock such as a surge in oil prices.

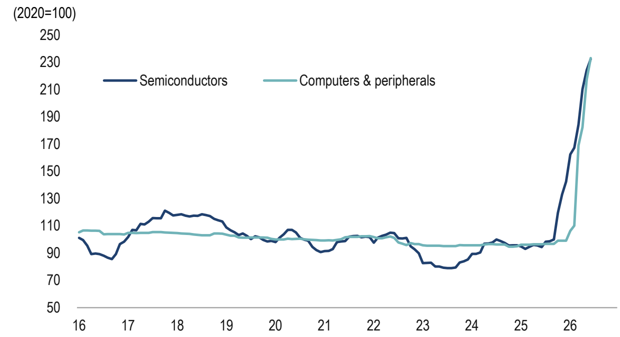
What is particularly noteworthy is that this assessment links the BOJ's views on both economic activity and inflation. In the Reuters Tankan, companies in both manufacturing and non-manufacturing reported benefiting from semiconductor demand. The recent improvement in corporate sentiment suggests that AI-related demand is boosting the economy as a whole. Meanwhile, the BOJ views the same phenomenon as a factor pushing up inflation through higher semiconductor and durable goods prices.

Global Semiconductor Market Size



Source: WSTS; compiled by Daiwa.

South Korean PPI: Semiconductors, Computers & Peripherals



Source: Bank of Korea; compiled by Daiwa.

The expansion in AI demand could push up not only economic growth but also the inflation rate. The simultaneous improvement in business sentiment and emergence of upside inflation risks can be attributed to the same underlying AI demand shock.

The BOJ's latest communication suggests that it views AI not merely as a theme affecting individual industries, but as a macroeconomic factor affecting both economic activity and prices. Until now, wages and services prices have played a central role in monetary policy discussions concerning the assessment of underlying inflation. Going forward, however, developments in global AI-related demand and changes in semiconductor prices are also likely to be regarded as important variables influencing the inflation outlook.

Conclusion

As of summer 2026, the global expansion in AI-related demand is becoming an important factor supporting the improvement in corporate sentiment in Japan. In the Reuters Tankan, companies in both manufacturing and non-manufacturing reported benefiting from semiconductor demand, indicating that the improvement in sentiment is becoming more broad-based. Concerns have eased over the previously prominent view that higher crude oil prices and a deterioration in the terms of trade would weigh on the economy. Instead, the potential for expanding AI-related demand to push economic activity above expectations has recently become more evident.

At the same time, the BOJ has begun to view AI-related demand as a source of upside risk not only to economic activity but also to inflation. In its July *Outlook Report*, the BOJ explicitly identified “the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand,” as a factor pushing up durable goods prices. Similar discussions have begun in Europe regarding the possibility that higher semiconductor prices associated with AI-related demand could feed through to inflation. AI is therefore increasingly being viewed not only as a factor improving business sentiment, but also as a new source of inflationary pressure.

These developments are also beginning to affect the monetary policy debate. The Summary of Opinions from the July meeting indicated that the expansion in AI-related demand was pushing up both economic activity and prices. It also contained a notable number of remarks pointing to the need to adjust the degree of monetary accommodation in light of upside developments in economic activity and prices. As the sustainable achievement of the price stability target comes increasingly into view, the policy debate appears to be shifting from “whether the BOJ should implement its next rate hike” to "the pace at which the policy rate should move toward the neutral rate."

The coordinated forex intervention on 31 July represented a phase shift in the sense that it created an environment in which the BOJ could more readily proceed with monetary policy normalization. At the same time, however, attention should also be paid to the fact that the macroeconomic fundamentals underpinning economic activity and inflation are themselves beginning to change as AI-related demand expands. In earlier discussions, each rate hike was accompanied by concerns about its adverse impact on the economy and the tightening of financial conditions. More recently, as AI demand pushes up corporate earnings, capital expenditure, and inflation, the focus of caution has increasingly shifted from downside risks to economic activity to upside risks to both economic activity and prices.

Of course, the future conduct of monetary policy will also be affected by wages, services prices, developments in the Middle East, and exchange rate movements. However, if the expansion in AI demand persists for longer than expected and continues to feed through to corporate earnings, capital expenditure, and inflation, the BOJ may have no choice but to consider not only additional rate hikes but also a subsequent increase in the pace of rate hikes.

The latest corporate sentiment surveys and the BOJ’s recent communication suggest that the debate surrounding Japan’s economy and monetary policy is entering a new phase. While coordinated intervention has brought about a change in the forex environment, the expansion in AI demand is beginning to alter the underlying trends in economic activity and inflation themselves. The key question for the BOJ and the market is the extent to which this shift should be regarded as sustainable. If the expansion in AI demand continues for longer than expected and upside developments in economic activity and inflation persist, the pace of monetary policy normalization could be faster than previously anticipated.

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