

# Daiwa's Economic View

## Critical thresholds for yen weakness: Weak yen/price mechanism

- Import penetration ratio steadily rising
- Exchange rate has nonlinear impact on consumer prices; inflation risk rises at Y165/\$
- Need for policy conduct that avoids understating forex impact

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### [The Summary of Opinions from the Bank of Japan's \(BOJ\) December Monetary Policy Meeting](#)

(MPM) indicated growing concerns within the central bank about upside risks to inflation from forex and fiscal policy. The yen's weakness YTD has further aggravated these concerns. In this report, we examine the impact of yen weakness on consumer prices (CPI) from two perspectives: (1) the marginal cost channel, and (2) the nonlinearity (state dependence) of exchange rate pass-through.

### Weak yen/price mechanism: Marginal cost channel

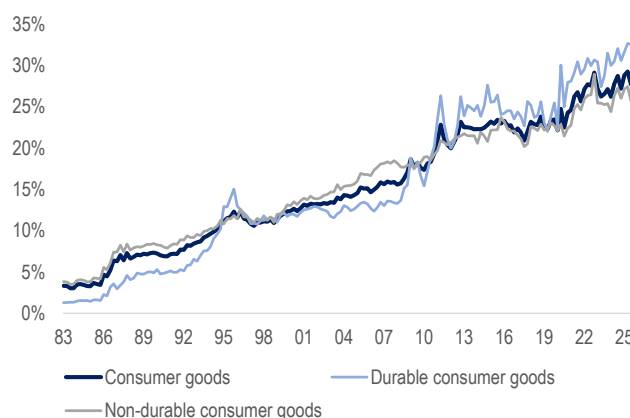
The impact of a weaker yen on the CPI is determined by how much it directly boosts marginal costs by increasing import costs, and to what extent these cost increases are passed through to prices. In other words, the key factors are how much the change in exchange rate increases production costs (the marginal cost channel) and how much of this increase companies pass on into final prices (price sensitivity).

To quantify these points, we looked at Japan's import penetration ratio (the percentage of imports for each consumer good), which we found has risen for consumer goods over the long term. In short, we think the impact of rising import prices on consumer prices has steadily increased. The effect is particularly pronounced for consumer durables.

However, the impact has remained broadly flat since 2022, with no major change in the structural effect of import costs compared with the phase of yen weakness in 2022.

**USD/JPY Rate**

Source: Bloomberg; compiled by Daiwa.

**Import Penetration Ratio**

Source: Ministry of Economy, Trade and Industry; compiled by Daiwa.

## Weak yen/price mechanism: Nonlinear change in price sensitivity

A weaker yen pushes up import prices and increases the cost of raw materials and intermediate goods. However, companies also need to consider the adjustment costs (menu costs) involved in revising prices. Menu costs include both the physical costs of updating price displays and upgrading IT systems, and psychological costs such as customer backlash and competition with peers. Companies essentially decide to raise final prices when they can no longer offset increases in the cost of raw materials and intermediate goods.

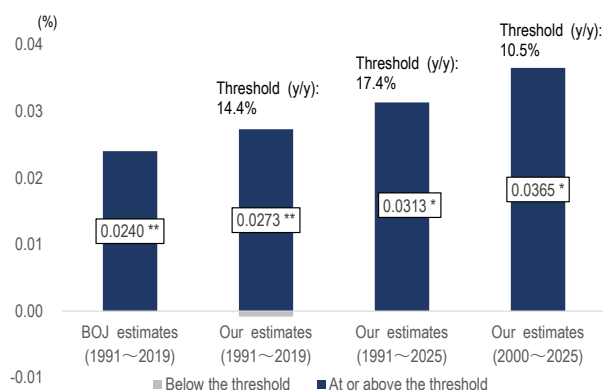
When cost increases are sufficiently large or price pass-throughs are widespread, menu costs likely have a relatively smaller impact, and we would expect price sensitivity to cost increases to rise. In other words, companies' price-setting behavior is state-dependent (nonlinear), and substantial changes in exchange rates may increase the pass-through to consumer prices.

[A May 2023 BOJ Working Paper, Nonlinear Input Cost Pass-through to Consumer Prices: A Threshold Approach](#), identified possible nonlinearity in the pass-through to CPI inflation of increases in firms' input costs.

In this report, we draw on the BOJ's analysis to examine this nonlinearity across multiple periods, using data from Jan-Mar 1991 to Jul-Sep 2025. Our results confirmed that nonlinearity exists: when changes in the exchange rate are below a certain threshold, they have a minimal impact on the CPI, but the effects rapidly increase once the threshold is exceeded. Extending the analysis to recent periods shows that pass-through rates have risen; by our estimate, a 1% change in exchange rate leads to a roughly 0.0365% change in the core CPI. The threshold for y/y change in exchange rate ranged from 10.5-17.4%.

The BOJ's analysis used data for Jan-Mar 1991 through Oct-Dec 2019; its nonlinear model suggested virtually no impact on the core CPI when changes in the exchange rate are below the threshold, but that when they exceed the threshold, a 1% move has a roughly 0.024% impact on the core CPI. The BOJ estimated this threshold (in y/y terms) at around 15%.

**Impact of 1% Fluctuation in Forex Rate on Core CPI (nonlinear model)**



Source: Ministry of Internal Affairs and Communications (MIC), Ministry of Health, Labour and Welfare, BOJ; compiled by Daiwa.

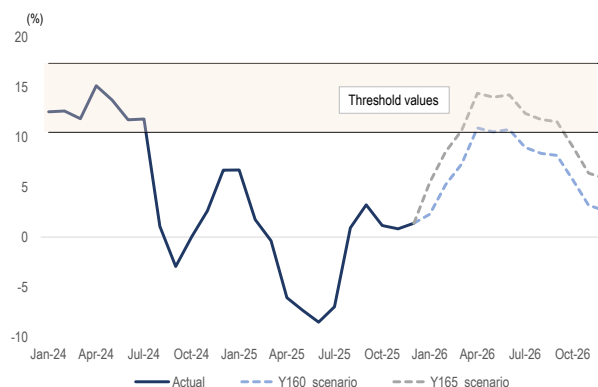
Notes: (1) The data used includes core CPI, average hourly earnings, the Corporate Goods Price Index (all commodities), and the monthly average USD/JPY rate. For the period from 2022 onward, the Core CPI figure is an index calculated by the author, which excludes the estimated impact of subsidies for gasoline, electricity/gas, and accommodation.

(2) \*\* indicates statistical significance at the 1% level, while \* indicates significance at the 5% level.

(3) In line with the analysis by the BOJ, the estimation period begins in 1991.

Furthermore, to account for structural changes in the Japanese economy, estimations were also conducted for the period following the collapse of the asset bubble economy.

**Scenarios for USD/JPY Rate**



Source: Bloomberg; compiled by Daiwa.

Based on these estimates, the sensitivity of prices to an exchange-rate shock will likely differ substantially depending on the magnitude of the shock. If USD/JPY settles at 160, the y/y change would likely fall within our estimated threshold range (10.5-17.4%) from April 2026. If it trends at 165, the y/y change would stay within our range for a long period, substantially increasing the upside risk to consumer prices.

As noted, we also think more widespread moves to pass through higher costs reduce the friction (menu costs) of raising prices in relative terms. On that point, we would note that the percentage of CPI components where prices are rising indicates that current price pass-throughs are widespread compared with historical levels, and roughly in line with levels when the yen weakened from 2022.

#### Percentage of CPI Components for Which Prices Rose



Source: BOJ, Bloomberg; compiled by Daiwa.

Note: Shaded areas indicate periods when the yen depreciated against the dollar by 10% or more y/y.

#### How much will BOJ acknowledge upside risks to prices at January MPM?

The rise in the import penetration ratio has structurally increased the impact of yen weakness on consumer prices. A broad range of companies are already passing through higher costs into prices, and the yen's recent slide has driven another substantial increase in costs, heightening the potential for a nonlinear increase in exchange rate movements' effect on consumer prices.

In its October 2025 *Outlook Report* and elsewhere, the BOJ has indicated its awareness that "with firms' behavior shifting more toward raising wages and prices recently, exchange rate developments are, compared to the past, more likely to affect prices." Given the nonlinear nature of pass-throughs, it is crucial not to underestimate the impact substantial changes in exchange rates can have on inflation.

A 16 January Reuters report indeed cited a BOJ source who noted that further yen weakness has made it more alert about the risk of inflation. This suggests that the BOJ is increasingly concerned about upside risks to prices. With the yen continuing to weaken, our focus [at the January MPM](#) will be to what extent the BOJ acknowledges upside risks to inflation in its *Outlook Report* forecasts and assessment of the balance of risks.

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