

Daiwa's View

FICC Research Dept.

Japan's economy maintaining baseline despite negative terms-of-trade shock

- Supply shock in form of high crude oil prices, but growth scenario unchanged
- Headwinds for materials, but domestic demand, services providing support
- Market expectations for rate hikes have subsided on their own; BOJ adopting wait-and-see approach

Kenji Yamamoto81-3-5555-8784
kenji.yamamoto@daiwa.co.jp

Daiwa Securities Co. Ltd.

The sharp rise in crude oil prices due to tensions in the Middle East has produced a classic negative terms-of-trade shock for the Japanese economy. The reduced crude oil supply resulting from the blockade of the Strait of Hormuz amounts to approximately 2% of annual consumption, a scale comparable to that of the oil crisis of the 1970s. Still, there are not necessarily clear signs at this point that the Japanese economy as a whole is slowing down significantly.

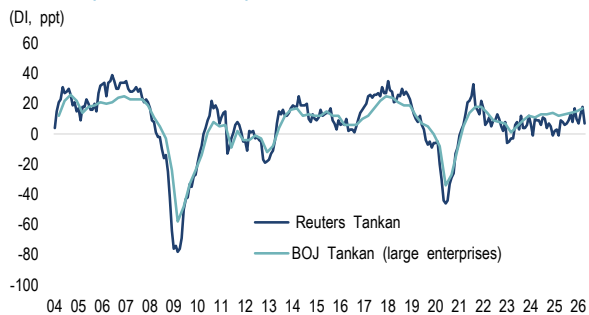
In its latest *World Economic Outlook*, the IMF projected Japan's real growth rate at 1.2% for 2025, 0.7% for 2026, and 0.6% for 2027. Even with the addition of new headwinds such as the Middle East conflict and high crude oil prices, growth forecasts have not been significantly revised downward from those made six months ago. The IMF views the Japanese government's fiscal stimulus measures and fuel cost containment measures as offsetting downward pressure caused by sluggish overseas demand and geopolitical risks.

IMF Chief Economist Pierre-Olivier Gourinchas acknowledged that the scale of the decline in crude oil supply is comparable to that of the 1970s, but pointed out that the situation has not descended into the same level of chaos as that seen in the 1970s. He cited as background factors a decline in dependence on crude oil, improvements in energy efficiency, and increased confidence in central bank policy management resulting from the successful anchoring of inflation targets. Japan should have sufficient oil reserves, provided that high crude oil prices are temporary. In that case, the IMF assumes that Japan could absorb those shocks.

This assessment by the IMF is consistent with current corporate trends. In the April Reuters Tankan survey, the business conditions DI for manufacturing fell 11 points m/m, while that for non-manufacturing improved by 6 points. As for manufacturing, concerns are growing regarding the procurement of crude oil-derived raw materials and energy, particularly among materials-intensive industries such as chemicals, textiles/paper pulp, iron & steel/nonferrous metals. The situation is such that procurement concerns and rising costs are directly dampening business sentiment.

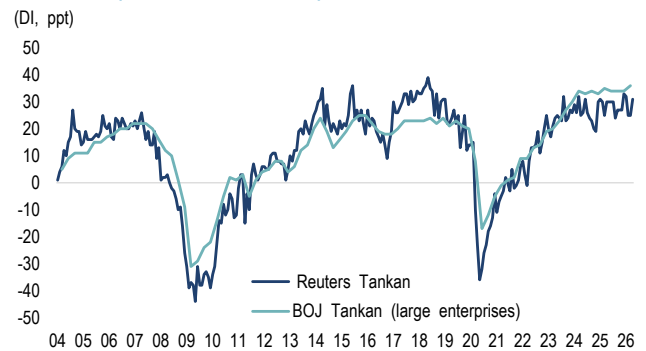
Meanwhile, as for non-manufacturing, business sentiment has improved notably in industries such as transportation, services/other, information/communications, and real estate/construction, driven by demand from overseas visitors to Japan and robust private consumption. Domestic demand for services, which is less susceptible to rising import prices, is helping to underpin the economy. Clearly this negative shock to Japan's terms of trade is not uniformly dragging down the economy as a whole, but is instead having a concentrated impact on energy-intensive industries.

BOJ Tankan's Business Conditions DI (large manufacturers), Reuters Tankan's Business Conditions DI (manufacturers)



Source: BOJ, Reuters; compiled by Daiwa.

BOJ Tankan's Business Conditions DI (large non-manufacturers), Reuters Tankan's Business Conditions DI (non-manufacturers)



Source: BOJ, Reuters; compiled by Daiwa.

As for inflation, while the IMF acknowledges the temporary upward pressure caused by high crude oil prices, it expects the inflation rate to decline within the year and converge toward the BOJ's 2% price target by the end of 2027. There is no assumption that inflation expectations will become unstable, nor is there any indication that negative supply shocks will lead to a downward spiral in prices and the real economy. This is a key difference compared to the 1970s.

Based on these assumptions, [the IMF expects the BOJ's monetary policy to continue pursuing gradual interest rate hikes with the policy rate moving toward a neutral level of around 1.5% at a slightly faster pace than projected six months ago](#). It has been pointed out that the protracted situation in the Middle East may complicate short-term policy decisions. Still, there is no view that the medium-term monetary policy normalization path itself is in doubt.

Even in the face of these negative terms-of-trade shocks, the fact that the baseline for growth, inflation, and monetary policy all remain intact is a defining feature of the current Japanese economy. Rather than reflecting the "weakness" of the Japanese economy, this situation again shows where shocks are concentrated and where they are absorbed.

Monetary policy implications: Assessing current uncertainties, market expectations

As for the recent rise in crude oil prices, the IMF has indicated that a wait-and-see approach is appropriate for the time being (stance shared by central banks in general). Gourinchas stated that the need to closely monitor how movements in crude oil prices impact underlying inflation and inflation expectations. He also expressed caution regarding hasty policy responses. ECB officials, while acknowledging that the energy shock falls between the baseline and risk scenarios, rejected the view that they have a clear bias toward raising interest rates.

The BOJ's current policy stance is also broadly consistent with this international policy environment. According to a Bloomberg report citing sources, the BOJ is considering a significant upward revision to its inflation outlook in this month's *Outlook Report* in response to soaring crude oil prices. If the crude oil price assumptions are raised, the headline price outlook will be revised upward. The accompanying modest downward revision pressure on growth prospects would be an automatic consequence with no specific policy intent behind the revision itself.

Rather, what deserves attention is the internal deliberation regarding interest rate hike decisions and market expectations. As BOJ Governor Kazuo Ueda has previously indicated, officials believe that the impact of high crude oil prices on underlying inflation is not one-sided. While rising energy prices could exert higher-than-expected pressure on inflation, there is also a possibility that deteriorating trade conditions and downward pressure on the economy could result in lower-than-expected underlying inflation. The Bloomberg article quoted a BOJ official as saying that high crude oil prices could exert upward or downward pressure on underlying inflation. It went

on to note that regarding the decision on interest rate hikes, the Bank maintains a stance of monitoring the impact of high crude oil prices on underlying inflation and the developments in the Middle East right up until the meeting (maintaining the option to raise rates).

However, as conveyed in a Jiji Press speculative report about the BOJ, market expectations for an interest rate hike in April have fallen sharply. Even amid such circumstances, there has been no indication that BOJ leadership is showing any impatience regarding the market's reduced expectations for rate hikes. Furthermore, the Bank has not stepped up its messaging to bolster expectations for a rate hike. A source cited in a Bloomberg report said, "Given the current fluid situation, there is a view within the BOJ that it would not be wise to fuel market expectations for interest rate hikes." These comments represent the policy authorities' stance at this juncture.

As for these points, Rahul Anand, IMF's mission chief for Japan, said, "Clear communication is essential for stabilizing market expectations." He added, "The BOJ has been doing well in terms of communicating its monetary policy, but this becomes even more important during times of high uncertainty.

Also, Jiji Press, amid deteriorating sentiment indicators, reported that some within the BOJ are saying that they want to avoid a situation where they rush to raise interest rates and then the economy takes a turn for the worse. Rather than the pros or cons of a rate hike itself, the BOJ is concerned about the risk of making decisions at the wrong time amid high uncertainty about the economic outlook.

On his way to attend the IMF-World Bank meetings, Ueda also indicated his intention to assess the impact of uncertainties surrounding the situation in the Middle East on economic, price, and financial conditions, as well as the risks and likelihood of the baseline outlook materializing. The degree of uncertainty remains high as we do not know if hostilities will resume or if progress will be made towards a political solution.

Therefore, when the market scales back expectations for interest rate hikes on its own, due to uncertainty, that produces an environment in which the BOJ can more easily decide against raising rates. There is no evidence that the BOJ has adjusted its policy stance due to the market pricing in a reduced likelihood of rate hikes (factor that BOJ cannot control). While the Bank has not ruled out further rate hikes, it is now at the stage of assessing its decisions.

As the IMF pointed out, the Japanese economy has demonstrated a certain degree of resilience to negative terms-of-trade shocks. [The conduct of monetary policy is now at the stage of compiling various assessments, while monitoring underlying inflation trends and the impacts of external shocks.](#)

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings

Issues are rated 1, 2, 3, 4, or 5 as follows:

- 1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
- 2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
- 4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices

Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities

Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Investment Management Association of Japan, Type II Financial Instruments Firms Association, Japan Security Token Offering Association