Daiwa's Economic View

BOJ returning to its baseline scenario

- AI demand is supporting growth and prices, keeping the conditions for further rate hikes in place

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Possible upward revision to the FY26 real GDP forecast

Reuters reported on 10 July that "the Bank of Japan may revise up its economic growth forecast for fiscal 2026" in the *Outlook for Economic Activity and Prices* report (*Outlook Report*) to be released at its 30-31 July Monetary Policy Meeting (MPM). According to the article, this reflects a decline in downside risks to the economy stemming from heightened tensions in the Middle East, as well as support for economic activity from AI-related demand. Meanwhile, although the BOJ may revise its inflation projections slightly downward to reflect lower crude oil prices, it BOJ remains alert to upside risks to inflation arising from yen depreciation and AI-related demand. Its policy of continuing to raise interest rates is therefore expected to remain unchanged.

When the April *Outlook Report* was released, the deterioration in the Middle East situation and supply constraints were viewed as downside risks to the economy. Since then, however, companies have made progress in securing alternative sources of supply, substantially reducing uncertainty surrounding energy supplies. In addition, the global expansion of AI investment is boosting Japan's exports, production, and business fixed investment.

These developments have already been confirmed in the latest BOJ Tankan survey and the *Sakura Report* released last week. At the BOJ's meeting of branch managers, there were many positive comments about economic conditions from across the country, with the strength of AI-related demand cited as a common theme. Demand is expanding across a broad range of fields, including data center products, semiconductor manufacturing equipment, optical fiber, and semiconductor cleaning solutions. The BOJ also believes that the spillover effects of AI demand are spreading nationwide.

Of particular importance is the fact that AI demand is manifesting itself not only in increased exports but also in demand for business fixed investment. In the Tankan survey, companies' business fixed investment plans remained at high levels, while the *Sakura Report* included comments from various regions indicating that AI-related investment was continuing. If the BOJ's previous economic scenario can be viewed as a "wage hike-led recovery in domestic demand," an "expansion in external demand and business fixed investment driven by AI investment" is now being added.

Considering these circumstances, the recent speculation about an upward revision to the economic forecast can be seen as evidence that the BOJ's assessment at its June MPM—that Japan's economy and prices have been developing generally in line with the baseline scenario—is beginning to take more concrete shape.

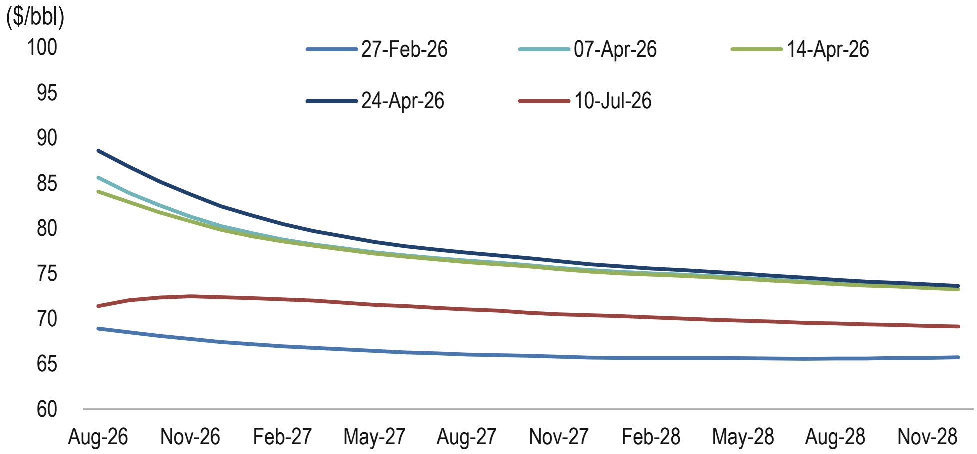
Strong vigilance regarding underlying inflation despite possible downward revisions to price projections

Meanwhile, the FY26 core CPI projection may be revised slightly downward in the July *Outlook Report*. The primary reason is the decline in crude oil prices. Dubai crude oil was trading at around $105/bbl when the April *Outlook Report* was released, but subsequently fell sharply following the ceasefire agreement between the US and Iran. The Reuters report also noted that the current price is approximately 30% below its April level. Focusing solely on headline inflation, lower energy prices would exert downward pressure on inflation.

Within the BOJ, however, there remains a strong sense of vigilance regarding the risk that underlying inflation could rise above 2%. There are three reasons for this. The first is yen depreciation. The yen has remained on a depreciating trend since the June meeting, maintaining strong upward pressure on import prices. Even though crude oil prices themselves have fallen, yen depreciation has partially offset the impact on yen-denominated import prices. Moreover, yen weakness also raises corporate costs by increasing the prices of overall imported goods.

The second is supply constraints. Companies have arranged alternative sources of supply in response to the situation in the Middle East, but this has left costs such as freight charges and insurance premiums higher than before. Within the BOJ, there is a view that "even though crude oil market prices have fallen, companies' actual procurement costs have not declined to the same extent." The *Sakura Report* also noted that, although progress in alternative procurement had broadly resolved supply constraints, elevated logistics costs persisted.

Dubai Crude Oil Prices (futures curve)



Source: Bloomberg; compiled by Daiwa.

Will the AI inflation wave reach Japan?

However, the upside risks to prices that the BOJ is wary of are not limited to the weak yen and logistics costs. A third factor is the possibility that the "AI inflation wave" associated with the global expansion of AI investment could eventually spread to Japan. Reuters also introduced the BOJ's view that "brisk global AI demand is pushing up prices of semiconductor chips and electronic equipment, which could eventually lift consumer goods prices."

Indeed, the producer price index (PPI) accelerated to +7.1% y/y in June. The data confirmed that the pass-through of higher costs was spreading to intermediate stages of production, affecting not only petroleum and chemical products but also plastic and wood products. Prices of technology-related products have also risen, suggesting that AI demand is beginning to push up the prices of certain intermediate inputs. These developments indicate that AI-related demand may be starting to affect not only economic activity but also prices.

At present, there is little evidence in Japan that AI demand is pushing up consumer prices. However, this does not mean that there is no AI inflation wave. Rather, it suggests that the wave may simply have yet to reach Europe and Japan.

Prices of memory products such as DRAM and NAND flash memory, as well as certain final goods such as smartphones and game consoles, are determined in global markets. Prices increases driven by expanding data center investment in the US are therefore likely to spill over to other countries, albeit with a time lag. As previously reported, AI-related demand has already begun to push up US inflation. By contrast, central banks in Europe and Japan continue to discuss inflation primarily in the context of energy price shocks, with AI inflation still treated as a theoretical risk.

If the AI inflation wave spreads beyond the US over the next several quarters, the inflation outlooks for Europe and Japan could shift toward a narrative of "multiple inflation waves." Under such a scenario, AI demand would partially offset the disinflationary pressure from falling energy prices. The magnitude and timing of the impact would vary depending on exchange rates and corporate pricing behavior, but AI demand could well exert upward pressure on Japan's core inflation.

In terms of timing, the AI inflation wave appears to be reaching Japan later than the US. Its impact in the US is expected to peak between the second half of 2026 and the first half of 2027, whereas the effects are likely to reach Japan thereafter. Therefore, the absence of a visible impact from AI inflation in current inflation data does not mean that future inflation risks are absent. If the BOJ is beginning to regard AI demand not merely as a factor supporting economic growth, but also as a potential source of future upside risk to inflation, this would be one of the important new elements in the July *Outlook Report*.

Financial conditions remain accommodative even after the rate hike to 1%

Another noteworthy point is that financial conditions have remained accommodative in real terms even after the June rate hike. The BOJ Tankan survey showed no significant changes in the companies' financial positions or financial institutions' lending attitudes. BOJ officials have also explained that "there is a certain time lag before the effects of a policy change become apparent" (Jiji Press).

That said, the *Sakura Report* noted that although the BOJ raised its policy rate to 1% in June, "there were no reports from companies in the housing and capital investment-related sectors, which are particularly sensitive to interest rate hikes, that they had reconsidered investment because of the rate hike" (BOJ Research and Statistics Department). "Although not all corporate views were captured because of the compilation period of the *Sakura Report*, the prevailing view appeared to be that the impact of the rate hike was limited" (Jiji Press).

Furthermore, bank lending continues to grow at a high rate, with both corporate lending and loans for business fixed investment expanding steadily. Although nominal interest rates have risen, real interest rates—or real borrowing costs—remain low when underlying inflation is taken into account. Overall financial conditions are therefore still considered supportive of economic activity.

Key to the next rate hike is whether price increases take hold

The Reuters report strongly suggests that, even if the BOJ forgoes a rate hike at its July meeting, it is likely to maintain its policy of continuing to raise interest rates. The economy remains more resilient than anticipated, while financial conditions are still accommodative. Although the inflation forecast may be revised slightly downward due to lower energy prices, upside risks to underlying inflation arising from yen depreciation, AI demand, and further progress in cost pass-through have, if anything, increased.

The focus going forward will be whether the price hikes for food and beverages scheduled to intensify from the summer onward can become entrenched without significantly reducing household consumption. What matters to the BOJ is not the price level itself, but how companies set prices and how households accept them. If these developments are confirmed, the conditions for the next rate hike will become more firmly established.

Ultimately, the main point to watch in the July *Outlook Report* is not whether the BOJ makes modest downward revisions to price projections. Rather, the more important question is whether the BOJ maintains its assessment that "the economy is resilient, financial conditions remain accommodative, and risks to underlying inflation are skewed to the upside."

If the Reuters article is accurate, the July *Outlook Report* is likely to indicate that the BOJ's baseline scenario is once again shifting in a more bullish direction. Rather than suggesting that the rate-hiking cycle has ended, the report is likely to confirm that the conditions for additional rate hikes remain in place.

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