Japan | Fixed Income

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Daiwa Securities

Daiwa's Economic View

BOJ returning to its baseline scenario (2)

- Robust AI-related demand and private consumption shift the focus to the timing of the next rate hike

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Bloomberg report confirms the BOJ's return to its baseline scenario

According to a Bloomberg report on 16 July citing people familiar with the matter, the BOJ is likely to raise its real GDP growth forecast for FY26 in the *Outlook for Economic Activity and Prices* report (*Outlook Report*) to be released at the end of July. As already indicated by Reuters and other source-based reports, concerns within the BOJ about downside risks to the economy from supply constraints and higher crude oil prices resulting from the deterioration in the Middle East situation have receded. Meanwhile, the BOJ appears to be moving toward confirming its return to the baseline scenario, reflecting expanding AI-related demand and the resilience of domestic demand. The latest Bloomberg report can be viewed as further corroborating the BOJ's assessment.

According to the report, the BOJ may also revise its assessment of the balance of risks, previously described as "skewed to the downside." The BOJ's assessment of the economy appears to be converging once again toward the baseline scenario presented in its *Outlook Report*, moving away from the downside scenario had raised concerns in early spring. A person familiar with the matter also noted that "the likelihood that the economy and prices will move in line with the BOJ's scenario is increasing."

◆ **Apr BOJ *Outlook Report* (28 Apr 2026)**

- With regard to the risk balance -- particularly for fiscal 2026 -- risks to economic activity are skewed to the downside, and risks to prices are skewed to the upside. While these risks could both heighten, it is necessary to pay due attention, in particular, to keep the risk of inflation significantly deviating upward from materializing and thereby exerting an adverse impact on the economy afterward, given factors such as underlying CPI inflation approaching 2 percent and firms' behavior shifting more toward raising wages and prices.

The assessment of prices is also broadly consistent with previous reports. While the decline in crude oil prices has reduced the risk of an upside surprise to inflation arising from supply shocks, the BOJ remains alert to the risk that underlying inflation could exceed its 2% target, owing to an improvement in the output gap driven by AI-related demand and rising inflation expectations among corporations and households. The latest Bloomberg report suggests that the BOJ remains mindful of demand-driven inflation risks.

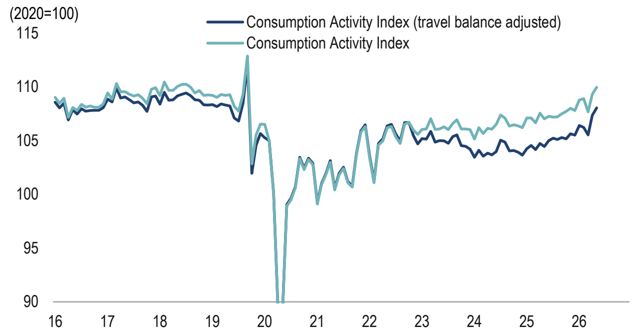
Indeed, corporate inflation expectations have been rising steadily. The composite index of inflation expectations based on inflation expectations of corporations, households, and experts is estimated to have exceeded 2% in the Apr–Jun quarter. The entrenchment of inflation expectations indicates that the "virtuous cycle between wages and prices" envisaged by the BOJ remains intact, providing support for the path toward further rate hikes.

Apr–Jun growth may exceed expectations, led by private consumption

The BOJ's return to its baseline scenario also reflects the fact that the Apr–Jun economy has proved more resilient than expected. Private consumption, the main pillar of domestic demand, has been stronger than anticipated. The BOJ's real Consumption Activity Index rose sharply in April and continued to increase in May. Consumption increased not only for durable goods but also for non-durable goods and services, suggesting that private consumption may have performed well in the Apr–Jun quarter.

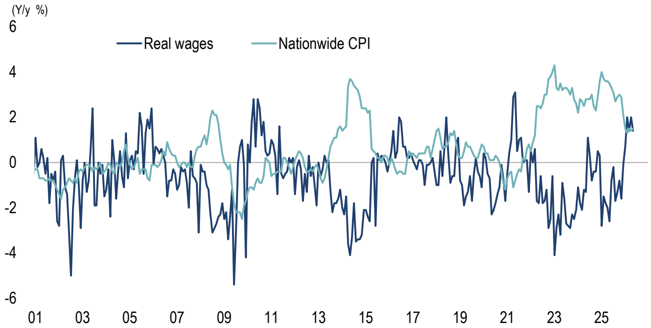
The most important factor supporting private consumption is the improvement in the income environment (the wealth effect may also be a partial contributor). With nominal wages continuing to rise strongly and inflation slowing, real wages have returned to positive y/y growth. Household purchasing power, which had previously been constrained by rising prices, is gradually recovering, and this improvement is beginning to lead to higher consumer spending.

BOJ's Real Consumption Activity Index



Source: BOJ; compiled by Daiwa.

CPI, Real Wages

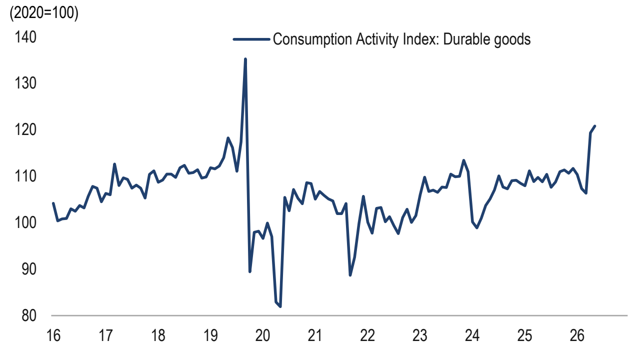


Source: Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by Daiwa.

By category, the recovery in non-durable goods consumption, which had remained weak until last year, is particularly noteworthy. This is because slower food price inflation has eased the pressure weighing on real food consumption. Durable goods consumption has also been strong, supported by increased sales of automobiles and air-conditioners. Although there are some temporary factors, such as the abolition of the environmental performance levy on the automobile tax and front-loaded demand ahead of tighter energy-efficiency standards, consumption momentum remains stronger than expected even after accounting for these factors.

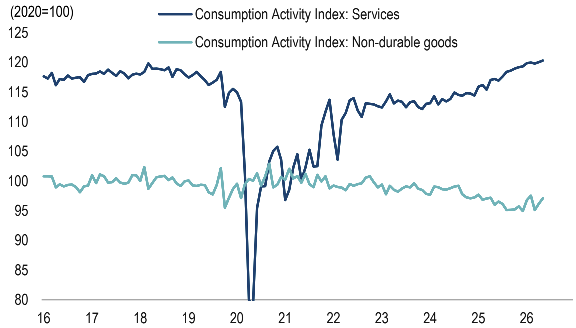
The BOJ also appears to hold the view that private consumption has remained resilient overall despite rising prices. A pullback from the front-loaded demand will be a key area of attention, but it is not expected to be comparable in scale to the surge in demand immediately before previous consumption tax hikes. Its potential to destabilize the overall economy is therefore considered limited.

BOJ's Real Consumption Activity Index: Durable Goods



Source: BOJ; compiled by Daiwa.

BOJ's Real Consumption Activity Index: Services, Non-durable Goods



Source: BOJ; compiled by Daiwa.

Considering these circumstances, GDP growth for the Apr-Jun quarter is highly likely to exceed market expectations. The figures should be interpreted with caution due to temporary factors boosting services exports. Even so, the underlying strength of the Japanese economy is considerably more favorable than it appeared a few months ago, when concerns were mounting that the worsening situation in Iran could cause an economic slowdown.

Focus shifts to an additional rate hike from September onward, while inflation risks remain skewed to the upside

As Kyodo News has already reported under the headline "BOJ set to keep policy rate unchanged," an additional rate hike at the July meeting is unlikely. The prevailing view within the BOJ appears to be that it should assess the impact of the June rate hike on the economy and financial markets, while also examining corporate inflation expectations in the September Tankan survey, scheduled for release on 1 October. Although corporate inflation expectations are rising, they are currently within the range envisaged in the BOJ's scenario and are not judged to be at a level that would immediately compel an additional rate hike.

Nevertheless, upside risks to prices remain. Business sentiment in the manufacturing sector has recently remained resilient, supported by AI-related demand. The July Reuters Tankan survey released last week also showed that corporate sentiment remained strong, particularly in AI-related sectors such as electrical machinery, precision machinery, and chemicals. Meanwhile, higher costs resulting from wage increases and yen depreciation are weighing on corporate earnings.

The key question is how much of these higher costs will be passed on to selling prices. Companies' output price DI and corporate inflation expectations have risen, and companies have become more proactive in their price-setting behavior. Although crude oil prices have declined, there has been little movement to reverse price increases that have already been implemented. Upward pressure is particularly likely to persist in service prices, which are more sensitive to wage hikes. The price environment is changing, and it is no longer the same as it was during the deflationary period"

The BOJ is closely monitoring the fact that the pass-through of higher costs to prices is occurring more rapidly than in previous inflationary episodes. This reflects an environment in which higher corporate costs can more readily feed through to consumer prices, compounded by the impact of yen depreciation on import prices. Although real wages currently remain in positive territory, a renewed acceleration in inflationary pressure could slow real wage growth and place downward pressure on household purchasing power and private consumption. The BOJ appears to be carefully assessing both the upside risks to inflation and their potential impact on the household sector.

The resilience of demand is also important. In the Reuters Tankan survey, manufacturing sentiment remained at a high level, supported by AI-related demand, while an increasing number of companies cited rising wages and raw material prices. If domestic demand remains resilient, higher costs are more likely to be passed through to consumer prices.

Against this backdrop, BOJ Executive Director Koji Nakamura stated at a meeting of the House of Councillors Committee on Financial Affairs on 16 July that "if the necessary adjustment to the degree of monetary accommodation is delayed, upside risks to prices could materialize and subsequently place downward pressure on the economy." This may indicate that discussions within the BOJ are placing greater emphasis than before on the costs of leaving upside inflation risks unaddressed.

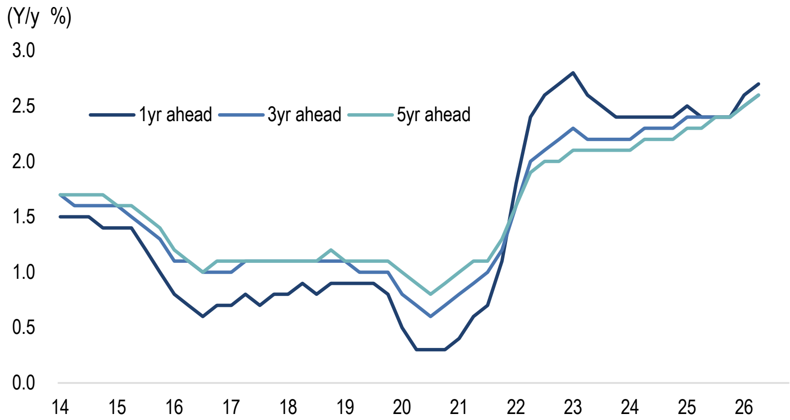
A September rate hike or an October rate hike?

Meanwhile, the BOJ appears to believe that it has time to assess the impact of the June rate hike and intends to determine whether corporate inflation expectations will rise further. Although corporate inflation expectations increased in the June Tankan survey, part of that rise may have reflected higher crude oil prices. The BOJ therefore appears to want to confirm whether inflation expectations remain elevated in the September Tankan survey following the subsequent decline in crude oil prices.

In light of these considerations, we maintain our previous forecast that the next rate hike will take place in October. If the BOJ attaches significant weight to the findings of the September Tankan survey, the hurdle for a September rate hike would be relatively high. However, the possibility of an earlier move would remain if new risks emerged, such as further yen depreciation. The market's focus is increasingly shifting toward any clues that Governor Kazuo Ueda and the *Outlook Report* may provide at the July Monetary Policy Meeting regarding the timing of the next rate hike.

The economy is more resilient than expected, and inflation expectations are rising steadily. The focus is shifting from "whether to raise rates" to "when to implement an additional rate hike from September onward." As the BOJ confirms that the economy is returning to its baseline scenario, it is considering the timing of its next policy adjustment.

Inflation Outlook of Enterprise in BOJ Tankan (all-size enterprises, all industries)



Source: BOJ; compiled by Daiwa.

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