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Outlook for Economic Activity and Prices

October 2026



(English translation prepared by the Bank's staff based on the Japanese original)

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Outlook for Economic Activity and Prices (October 2026)

The Bank's View[1]

Summary

- Japan's economy is expected to continue growing moderately, albeit at a decelerated rate, in fiscal 2026. This is because, although the rise in energy and raw material prices since early spring reflecting the impact of the situation in the Middle East is expected to push down economic activity, the economy is likely to be underpinned by factors such as the government's various measures and accommodative financial conditions, in addition to an increase in global AI-related demand. Japan's economic growth rate is likely to rise moderately from fiscal 2027 onward, since it is projected that the adverse effects of high energy and raw material prices will wane and that a virtuous cycle from income to spending will gradually intensify.
- The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to accelerate to a level clearly above 2 percent. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices is expected to push up prices, mainly of energy and goods, and the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand, and the depreciation of the yen thus far are likely to lead to an increase in prices, mainly of durable goods. Thereafter, with the waning of the effects of high crude oil prices, the rate of increase is expected to decline toward around 2 percent in the second half of the projection period. Meanwhile, with a sense of labor shortage continuing to be strong, the mechanism in which wages and prices rise moderately in interaction with each other has been operating, and medium- to long-term inflation expectations are at around 2 percent. In this situation, underlying CPI inflation is at a level that is generally consistent with the price stability target of 2 percent, and is expected to remain at around that level.
- Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected real GDP growth rates are more or less unchanged. The projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2027 is somewhat higher, reflecting factors such as the effects of the rise in crude oil prices since the summer.
- There are various risks to the outlook. It is necessary to continue to pay attention to the impact of factors such as the situation in the Middle East, the expansion in AI-related demand, and developments in foreign exchange rates on Japan's economic activity and prices.
- With regard to the risk balance, risks to economic activity are generally balanced. Regarding the outlook for the CPI, risks are skewed to the upside. With underlying CPI inflation being at a level that is generally consistent with the price stability target of 2 percent, there is a risk that medium- to long-term inflation expectations will rise and underlying CPI inflation will deviate upward to a level above the price stability target, given that firms' behavior has been shifting more toward raising wages and prices and there are various factors that could drive up prices. It is necessary to pay due attention to keep such a risk from materializing and thereby exerting an adverse impact on the economy afterward.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 29 and 30, 2026.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has recovered moderately, although some weakness has been seen in part, partly due to the impact of the situation in the Middle East. Overseas economies have grown moderately on the whole, although some weakness has been seen in part. Exports have increased moderately, against the backdrop of a solid increase in global AI-related demand. Corporate profits have been at high levels, and business sentiment has also been at a more favorable level. Under these circumstances, business fixed investment has been on a moderate increasing trend, despite being affected by a rise in construction costs. Private consumption has been resilient against the background of an improvement in the employment and income situation, despite the impact of factors such as price increases. Housing investment has been on a declining trend. Public investment has continued to be more or less flat. Meanwhile, labor market conditions have remained tight. Financial conditions have been accommodative. On the price front, despite factors such as the effects of the government's measures to reduce the household burden of higher energy prices, the year-on-year rate of increase in the CPI (all items less fresh food) has been rising moderately, being at around 2 percent recently, as the effects of a rise in import prices have been emerging, with moves to pass on wage increases to selling prices continuing. Inflation expectations are at around 2 percent.

II. Baseline Scenario of the Outlook for Economic Activity and Prices in Japan[2]

A. Baseline Scenario of the Outlook for Economic Activity

In fiscal 2026, although the rise in energy and raw material prices since early spring reflecting the impact of the situation in the Middle East is expected to push down corporate profits and households' real income through factors such as a deterioration in the terms of trade, Japan's economy is likely to be underpinned by factors such as the government's various measures (e.g., measures to reduce the household burden of higher energy prices) and accommodative financial conditions, in addition to an increase in global AI-related demand and the improvement in the employment and income situation. Against this backdrop, Japan's economy is expected to continue growing moderately, albeit at a decelerated rate.

In the corporate sector, exports, despite the impact of the situation in the Middle East, are likely to continue increasing moderately, with the solid increase in global AI-related demand spreading to a broader range of areas. Corporate profits, despite the impact of the deterioration in the terms of trade reflecting the rise in crude oil prices, are likely to remain

[2] Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy. Based, for example, on developments in futures markets, Dubai crude oil prices are expected to decline from around 105 U.S. dollars per barrel to around 70 dollars per barrel toward the end of the projection period.

at high levels on the back of factors such as strong AI-related demand. Business fixed investment, despite being affected by the rise in construction costs, is expected to maintain a moderate increasing trend, as the government's economic measures and accommodative financial conditions, together with firms' moves to clear order backlogs from existing projects, are expected to provide support.

In the household sector, regarding the employment situation, labor market conditions are likely to remain tight, and nominal wages are projected to continue increasing steadily, with base pay increases being realized at around the same level as in 2025. Private consumption is expected to be more or less flat due to the impact of price rises, particularly in energy prices, and weather conditions, although it is likely to be underpinned by income transfers to households through the government's various measures, in addition to wage increases and the wealth effects from higher stock prices. Housing investment is expected to follow a moderate declining trend, mainly reflecting a rise in housing prices and demographic developments. Meanwhile, public investment is expected to be more or less flat, and government consumption is expected to increase moderately reflecting factors such as an uptrend in healthcare and nursing care expenditures and a rise in defense-related spending.

From fiscal 2027 onward, Japan's economic growth rate is expected to rise moderately, since it is projected that the adverse effects of high energy and raw material prices will wane and that the virtuous cycle from income to spending will gradually intensify. Exports are likely to continue increasing moderately, partly supported by factors such as strong global AI-related demand, as the impact of the situation in the Middle East eases and overseas economies continue to grow moderately. Corporate profits are likely to remain on an uptrend, supported by an improvement in the terms of trade reflecting a decline in crude oil prices and by an increase in domestic and external demand. In this situation, business fixed investment is likely to remain on an upward trend, pushed up by labor-saving investment to address labor shortages, investment in growth areas, such as investment related to AI and data centers, and investment projects to adapt to changes in the trade structure and supply chains, among other investments. Looking at the employment and income situation, labor market conditions are likely to remain tight, and nominal wages are expected to continue increasing steadily. In addition, with the pace of price rises expected to moderate gradually, private consumption is projected to return to a moderate increasing trend.

Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rates are more or less unchanged throughout the projection period.

Meanwhile, the potential growth rate is expected to remain slightly positive.[3] This is mainly because productivity is likely to increase due to advances in digitalization and investment in human capital, and because capital stock is projected to increase steadily. Potential growth is likely to be supported by the government's various measures and other factors.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to accelerate to a level clearly above 2 percent. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices is expected to push up prices, mainly of energy and goods, and the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand, and the depreciation of the yen thus far are likely to lead to an increase in prices, mainly of durable goods. Thereafter, with the waning of the effects of high crude oil prices, the rate of increase is expected to decline toward around 2 percent in the second half of the projection period.

Meanwhile, with a sense of labor shortage continuing to be strong, the mechanism in which wages and prices rise moderately in interaction with each other has been operating, and medium- to long-term inflation expectations are at around 2 percent. In this situation, underlying CPI inflation is at a level that is generally consistent with the price stability target of 2 percent, and is expected to remain at around that level.[4] Against this backdrop, it will be important, from the perspective of sustainable and stable achievement of the price stability target, to examine the degree to which underlying CPI inflation is anchored at a level around 2 percent.

The outlook for the CPI (all items less fresh food) is also affected by developments in crude oil prices and the effects of the government's various measures.[5] Crude oil prices are assumed to decline moderately toward the end of the projection period, based, for example, on developments in futures markets. However, considering the increase in costs, such as for transportation, associated with the securing of alternative sources of supply, it is

[3] Under a specific methodology, Japan's recent potential growth rate is estimated to be around 0.5-1.0 percent. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are high uncertainties over how factors such as advances in digitalization will affect the trends in productivity or labor supply.

[4] Looking at various indicators related to underlying CPI inflation (e.g., indicators for core CPI, inflation expectations, and trend inflation), many of these indicators are at around 2 percent.

[5] The forecasts in this Outlook Report do not take into account the impact stemming from factors such as the proposed temporary reduction in the consumption tax on food and beverages, which is currently being deliberated in the Diet. Assuming that the consumption tax cut will be applied to the prices of all items specified in the policy outline on tax reforms decided by the Cabinet in September 2026, the effects of the consumption tax cut on the year-on-year rates of change in the CPI figures for fiscal 2027 are estimated to be around minus 1.3 percentage points for the CPI (all items less fresh food) and around minus 1.4 percentage points for the CPI (all items less fresh food and energy). In this context, it is highly likely that upward pressure will be exerted on the economic growth rate, although the degree of impact is highly uncertain.

projected that the procurement costs faced by Japanese firms will not decline as much as international market prices. Regarding government measures, those to reduce the household burden of higher energy prices, such as fuel oil subsidies, and policies concerning the provision of free education, among other initiatives, are being implemented, and these are expected to exert downward pressure on the year-on-year rate of increase in the CPI in fiscal 2026.

Looking at the CPI (all items less fresh food and energy) -- which is not directly affected by fluctuations in energy prices -- the year-on-year rate of increase is likely to be at a level exceeding 2 percent. This is because the rise in crude oil prices is expected to push up prices, mainly of goods, and the rise in the prices of semiconductors and other items and the depreciation of the yen thus far are likely to lead to an increase in prices, mainly of durable goods. Thereafter, the rate of increase in this CPI is likely to decline, with the waning of the effects of high crude oil prices.

Comparing the projections with those presented in the previous Outlook Report, the projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2027 is somewhat higher, reflecting factors such as the effects of the rise in crude oil prices since the summer. The projected year-on-year rates of increase in the CPI (all items less fresh food and energy) are more or less unchanged from those presented in the previous Outlook Report.

The main factors that determine underlying inflation are assessed as follows. The output gap, which captures the utilization of labor and capital, has been slightly positive. Based on the aforementioned outlook for economic activity, the output gap is likely to remain positive at around its current level. Meanwhile, labor market conditions have tightened to a greater extent than can be explained by the changes in the output gap, partly due to a deceleration in the pace of increase in labor force participation of women and seniors. In this situation, upward pressure on wages and prices likely has become stronger than suggested by the output gap, given that firms -- particularly in labor-intensive industries -- have started to face labor supply constraints.

Medium- to long-term inflation expectations are at around 2 percent. Regarding the outlook, inflation expectations are likely to remain broadly around their current level, as firms' active wage- and price-setting behavior is expected to be maintained on the back of factors such as the tightening of labor market conditions.

III. Risks to Economic Activity and Prices

Regarding the aforementioned baseline scenario of the outlook for economic activity and prices, the main upside and downside risks that require attention are as follows.

The first is the impact of the situation in the Middle East on Japan's economic activity and prices. The situation in the Middle East remains unclear, and crude oil prices have continued to see large fluctuations. Partly due to progress made to date in efforts to secure alternative sources of supply for raw materials, the risk that large-scale disruptions in supply chains will occur and exert a significant impact on the production activity of Japanese firms has been contained thus far. However, with concerns remaining over global crude oil supply, and amid a decline in crude oil reserves, attention continues to be warranted on the impact of a further rise in procurement costs for crude oil on economic activity and prices. On the real economy front, it is necessary to monitor whether price rises for raw materials and other items reflecting high crude oil prices will push down corporate profits and households' real income to a greater extent than expected. On the price front, the price pass-through in business-to-business transactions stemming from high crude oil prices, as well as factors such as the effects of AI-related demand and of developments in foreign exchange rates described below, is highly likely to spill over into consumer price increases across a wide range of items. There is a risk of these developments leading to a rise in medium- to long-term inflation expectations and underlying CPI inflation deviating upward to a level above the price stability target of 2 percent.

The second risk is developments in AI-related demand. Regarding AI, amid the continued increase in global demand alongside the rapid expansion in the range of AI applications, strong business fixed investment could further push up the global economy. On the other hand, if profits do not expand in line with such investment, adjustment pressure could arise, accompanied by, for example, changes in asset prices. On the price front, the recent rise in semiconductor prices has pushed up the price of related durable goods. Moreover, the prices of copper and other materials as well as machinery prices have also risen in business-to-business transactions. Looking ahead, there is a possibility that these developments could lead to an increase in consumer prices across a variety of items. Should such domestic and external demand for AI-related materials and parts increase more than expected, there is also a risk that upward pressure on prices will further heighten.

The third risk is the effects of developments in foreign exchange rates on Japan's economic activity and prices. There are various possible channels in this regard. While a depreciation of the yen would have a positive impact on, for example, the profits of global firms, it would also push down households' real income and exert downward pressure on the profits particularly of small and medium-sized firms, mainly through a rise in import prices. Attention should also be paid to the point 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, and that such moves could affect underlying CPI inflation through changes in inflation expectations. In this context, although foreign exchange rates have been somewhat volatile since the summer, the year-on-year rate of increase in import

prices has remained high due to the depreciation of the yen thus far. The impact of this continued increase in import prices requires due attention, since it is expected to push up the prices of a wide range of items, including durable goods.

Other risks regarding developments in economic activity and prices at home and abroad include the following. Given that global inflationary pressure has intensified and that many central banks, including those in the United States and Europe, have shifted to a policy of raising interest rates since the summer, it is necessary to pay attention to how these changes in global financial conditions will affect Japan's economic activity and prices, through global financial markets and other channels. Moreover, attention also needs to be paid to the impact that worldwide moves toward fiscal expansion have on global economic activity and prices as well as financial markets. Regarding the Chinese economy, there remain high uncertainties surrounding the future pace of growth, as adjustment pressure has continued in the real estate and labor markets. In addition, it is necessary to pay attention to how excessive supply capacity for some goods will affect global economic activity and prices. Meanwhile, the recent uptrend in grain prices due to factors such as heightened geopolitical risks including the situation in the Middle East and global weather conditions warrants attention as a potential upside risk to prices.

A risk considered from a somewhat long-term perspective is the impact of various changes in the environment surrounding Japan on firms' and households' medium- to long-term growth expectations and on Japan's potential growth rate. Intensifying labor shortages -- which are partly due to structural demographic changes -- could accelerate labor-saving investment, such as for digitalization and the use of AI, and this, together with efforts taken by the government to increase investment in growth areas, could push up growth expectations and the potential growth rate. In this regard, many have pointed out that investment has been constrained by factors such as the surge in material prices, in addition to labor shortages. Taking this into account, achieving price stability through the appropriate conduct of monetary policy is also important from the perspective of supporting the expansion of growth investment in Japan. On the other hand, attention is warranted on the risk that, if the substitution of labor with capital does not sufficiently progress in an economy facing labor shortages, supply-side constraints will push down the growth rate. Meanwhile, the trade policies announced so far in each jurisdiction have partly led to a change in the trend of globalization, and depending on the future course of these policies, this change may accelerate.

IV. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[6]

The first perspective involves an examination of the baseline scenario of the outlook. The year-on-year rate of increase in the CPI (all items less fresh food) is likely to accelerate to a level clearly above 2 percent. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices is expected to push up prices, mainly of energy and goods, and the rise in the prices of semiconductors and other items, reflecting the increase in global AI-related demand, and the depreciation of the yen thus far are likely to lead to an increase in prices, mainly of durable goods. Thereafter, with the waning of the effects of high crude oil prices, the rate of increase is expected to decline toward around 2 percent in the second half of the projection period. Meanwhile, with a sense of labor shortage continuing to be strong, the mechanism in which wages and prices rise moderately in interaction with each other has been operating, and medium- to long-term inflation expectations are at around 2 percent. In this situation, underlying CPI inflation is at a level that is generally consistent with the price stability target of 2 percent, and is expected to remain at around that level.

Given that the level of the policy interest rate has risen compared to the past, it is also important to examine how financial conditions change under such circumstances. In this regard, although real interest rates have been rising recently, they have remained at low levels, mainly in the short-term zone, and firms' funding costs have remained sufficiently low relative to profitability on the whole. Meanwhile, firms' and other entities' demand for funds has increased, and financial institutions' lending attitudes have also remained proactive. Moreover, issuance conditions for CP and corporate bonds have remained favorable. In light of these developments as well as recent developments in asset markets, such as stock and foreign exchange markets, Japan's financial conditions have remained accommodative.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. There are various risks surrounding Japan's economic activity and prices. It is necessary to continue to pay attention to the impact of factors such as the situation in the Middle East, the expansion in AI-related demand, and developments in foreign exchange rates on Japan's economic activity and prices. With regard to the risk balance, risks to economic activity are generally balanced. Regarding the outlook for the CPI, risks are skewed to the upside. As mentioned earlier, with underlying CPI inflation

[6] As for the examination from two perspectives in the context of the price stability target, see the Bank's statement released on January 22, 2013, entitled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

being at a level that is generally consistent with the price stability target of 2 percent, there is a risk that medium- to long-term inflation expectations will rise and underlying CPI inflation will deviate upward to a level above the price stability target, given that firms' behavior has been shifting more toward raising wages and prices and there are various factors that could drive up prices. When the Bank was in the process of raising underlying CPI inflation toward 2 percent, downside risks to prices warranted considerable attention. However, there has recently been a shift in the phase of monetary policy, and looking ahead, it is necessary to pay due attention to keep the risk of underlying CPI inflation deviating upward to a level above the price stability target of 2 percent from materializing and thereby exerting an adverse impact on the economy afterward.

Examining risks on the financial side, financial intermediation activities, such as lending, have operated smoothly, and no major financial imbalances have been seen in current financial activities, although attention continues to be warranted on developments in asset prices, such as real estate and stock prices. Japan's financial system has maintained stability on the whole. Even in the case of an adjustment in the real economy at home and abroad and in global financial markets, the financial system is likely to remain highly robust on the whole, mainly because Japanese financial institutions have sufficient capital bases. In this regard, it is necessary to carefully monitor the impact that factors such as the future situation in the Middle East, the profitability and financing of AI-related investment, and developments in the foreign non-bank financial intermediary (NBFI) sector have on the financial system through various channels.[7]

As for the conduct of monetary policy, given that underlying CPI inflation is at a level that is generally consistent with the price stability target of 2 percent and financial conditions have been accommodative, the Bank will continue to raise the policy interest rate and adjust the degree of monetary accommodation, in response to developments in economic activity and prices as well as financial conditions. In this regard, it will consider the timing and pace of adjustment, while examining the likelihood of realizing the baseline scenario of the outlook for economic activity and prices and the risks to the outlook, including the impact of factors such as the situation in the Middle East, the expansion in AI-related demand, and developments in foreign exchange rates. In particular, the perspective of stabilizing underlying CPI inflation at a level around 2 percent becomes important in order to keep the risk of underlying CPI inflation deviating upward to a level above the price stability target of 2 percent from materializing and thereby exerting an adverse impact on the economy afterward. With the price stability target of 2 percent, the Bank will conduct monetary policy as appropriate from the perspective of sustainable and stable achievement of the target.

[7] For details, see the Bank's *Financial System Report* (October 2026).

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2026	+0.7 to +0.8 [+0.7]	+2.4 to +2.6 [+2.5]	+2.4 to +2.5 [+2.4]
Forecasts made in July 2026	+0.6 to +0.7 [+0.6]	+2.3 to +2.7 [+2.5]	+2.3 to +2.6 [+2.5]
Fiscal 2027	+0.6 to +0.8 [+0.7]	+2.4 to +2.7 [+2.6]	+2.4 to +2.7 [+2.7]
Forecasts made in July 2026	+0.7 to +0.8 [+0.8]	+2.2 to +2.5 [+2.4]	+2.2 to +2.7 [+2.6]
Fiscal 2028	+0.7 to +0.9 [+0.8]	+2.0 to +2.1 [+2.0]	+2.2 to +2.4 [+2.3]
Forecasts made in July 2026	+0.7 to +0.8 [+0.8]	+2.0 to +2.2 [+2.0]	+2.1 to +2.3 [+2.2]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

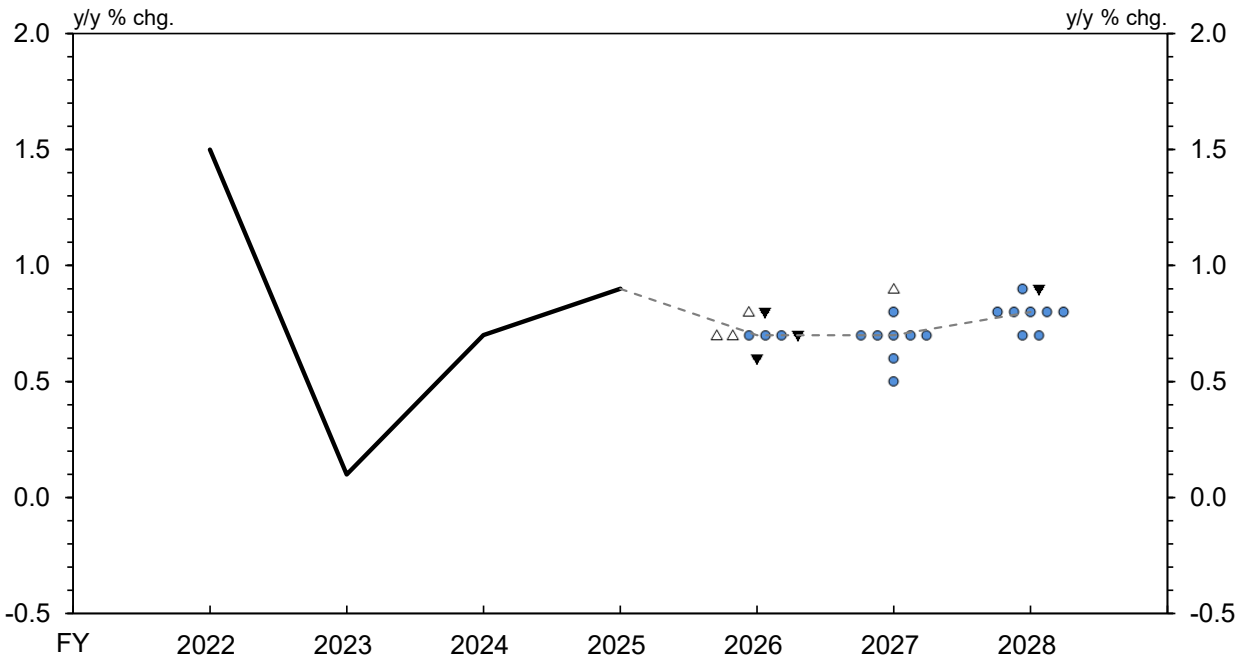
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

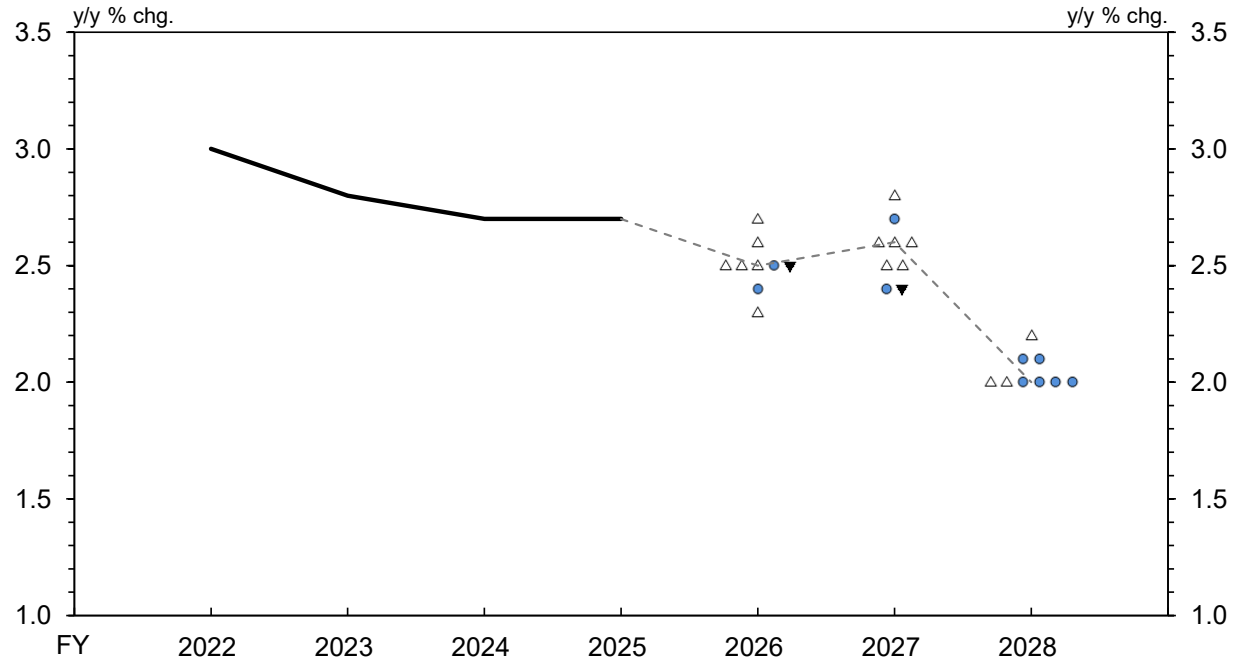
4. The forecasts in this Outlook Report do not take into account the impact stemming from factors such as the proposed temporary reduction in the consumption tax on food and beverages, which is currently being deliberated in the Diet. Assuming that the consumption tax cut will be applied to the prices of all items specified in the policy outline on tax reforms decided by the Cabinet in September 2026, the effects of the consumption tax cut on the year-on-year rates of change in the CPI figures for fiscal 2027 are estimated to be around minus 1.3 percentage points for the CPI (all items less fresh food) and around minus 1.4 percentage points for the CPI (all items less fresh food and energy).

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The solid lines show actual figures, while the dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2. The locations of ●, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which they attach the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."

The Background[8]

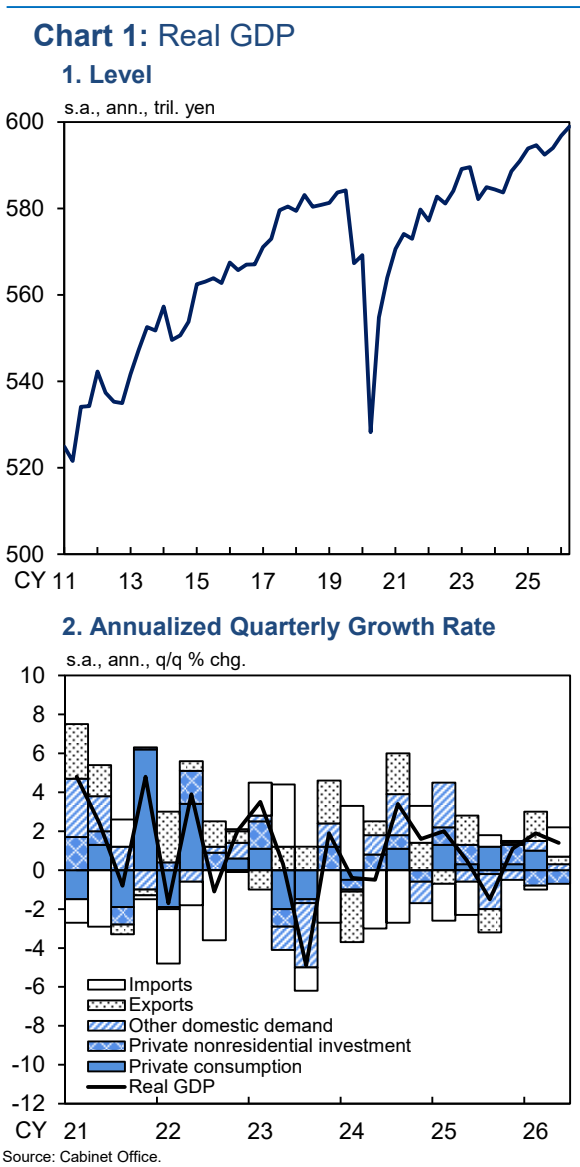
I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

Japan's economy has recovered moderately, although some weakness has been seen in part, partly due to the impact of the situation in the Middle East.

The real GDP growth rate for the April-June quarter of 2026 was 0.4 percent on a quarter-on-quarter basis and 1.4 percent on an annualized basis, registering positive growth for three consecutive quarters (Chart 1). By demand component, exports increased, led mainly by capital goods, on the back of the expansion in global AI-related demand, while exports have been affected by the impact of the situation in the Middle East. Domestic private demand, such as private consumption and business fixed investment, remained resilient, as the impact of the deterioration in trading gains reflecting higher crude oil prices was mitigated by the government's measures to reduce the burden of higher energy prices, while the growth momentum in domestic private demand decelerated due partly to the effects of temporary special factors. In this situation, labor market conditions have continued to be tight, and the output gap -- which captures the utilization of labor and capital -- was

Chart 1: Real GDP



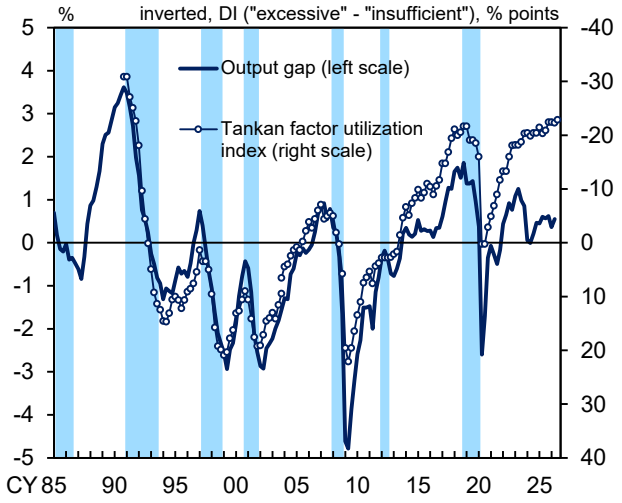
Source: Cabinet Office.

[8] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on October 29 and 30, 2026.

at around 0.5 percent in the April-June quarter (Chart 2).[9]

Monthly indicators, high-frequency data, and anecdotal information from firms since July suggest that the recovery trend in economic activity has been maintained, mainly due to robust developments in the corporate sector reflecting the expansion in global AI-related demand; however, it is highly likely that the pace of improvement in economic activity has temporarily been sluggish due to slower growth in private consumption reflecting factors such as weather conditions. In the corporate sector, exports have increased moderately, driven by solid exports of capital goods, including semiconductor production equipment. Against this backdrop, corporate profits appear to have been at high levels, despite being affected by downward pressure from the rise in energy and raw material prices. Moreover, the diffusion index (DI) for business conditions for all industries and enterprises in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan) continued to be at the most favorable level since August 1991, with further improvement being seen particularly in manufacturing. Business fixed investment appears to have increased moderately. While the growth momentum in construction investment has been weak due in part to the impact of a rise in construction costs and delays in construction projects, firms -- as shown in the

Chart 2: Output Gap



Source: Bank of Japan.
Notes: 1. Figures for the output gap are staff estimates.
2. The *Tankan* factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all industries and enterprises. The capital and labor shares are used as weights. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
3. Shaded areas denote recession periods.

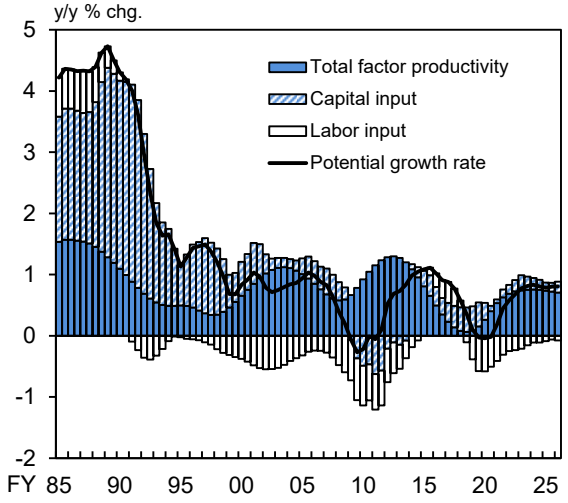
[9] The output gap and the potential growth rate should be interpreted with considerable latitude because they are estimated based on specific assumptions regarding trends in production factors. For details on the estimation method, see the following paper: Research and Statistics Department, Bank of Japan, "Updates on the Output Gap and Potential Growth Rate, and Monitoring Labor Market Indicators," Bank of Japan Research Paper (June 2026).

September *Tankan* -- have maintained their active investment stance, and research and development (R&D) investment has also increased following the substantial decline in the previous quarter. Meanwhile, in the household sector, private consumption appears to have remained resilient as a trend, supported by summer bonuses being at high levels, the government's various support measures, as well as higher stock prices. That said, with somewhat increased thriftiness, particularly among elderly households, who are highly dependent on pension income, it is highly likely that private consumption has decreased. Consumption of durable goods (air conditioners and automobiles) has turned to a decline following the increase in the previous quarter, which was partly due to special demand. Moreover, the weakness in consumption of seasonal products (e.g., beverages and clothing) reflecting irregular weather (low temperatures, as well as torrential and heavy rains) has also exerted downward pressure. With the recovery trend in economic activity being maintained as described earlier, labor market conditions have remained tight, and the employment conditions DI for all industries and enterprises in the September *Tankan* continued to show net "insufficient employment" at about the same level as in the early 1990s, particularly in nonmanufacturing. As a result, the weighted average DI for production capacity and employment conditions also continued to show a significantly large net "insufficient" (Chart 2).

With regard to the outlook, Japan's economic growth is likely to decelerate temporarily from the second half of fiscal 2026 through fiscal 2027 because the economy is expected to be pushed

down by the deterioration in the terms of trade reflecting the rise in energy and raw material prices stemming from the situation in the Middle East. That said, Japan's economic growth is likely to remain at a pace around the same level as the potential growth rate, supported by the expansion in global AI-related demand and the government's various measures. Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rates are more or less unchanged.

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Figures are staff estimates. Figures for the first half of fiscal 2026 are those for 2026/Q2.

The estimate of the potential growth rate has been around 0.5-1.0 percent since the recovery from the COVID-19 pandemic, and it is expected to remain at around that level (Chart 3). The breakdown of the outlook for the potential growth rate is as follows: (1) although the decline in potential working hours will come to a halt reflecting the diminishing effects of working-style reforms, the growth in potential labor input will be slightly negative, since the labor force participation of women and seniors will gradually level off and growth in the number of potential workers will decelerate; (2) capital stock will continue to increase steadily, partly supported by the government's various measures, although the pace of increase will decelerate, reflecting the rising share of intangible fixed asset investment, for which economic value depreciates quickly; and (3) growth in total factor productivity (TFP) will remain positive at around its current level, supported by an improvement in productivity due to the use of tools such as AI and by more efficient reallocation of production factors. Based on the aforementioned projections of economic developments and the potential growth rate, it is expected that the output gap will remain positive

at around its current level throughout the projection period.

Details of the outlook for each fiscal year are as follows. In the second half of fiscal 2026, Japan's economic growth is likely to decelerate somewhat. This is because it is projected that, while exports will follow a moderate increasing trend on the back of the expansion in global AI-related demand, the growth momentum in domestic private demand will decelerate, as the rise in energy and raw material prices leads to a pushing down of corporate profits and a decline in households' real purchasing power. However, in addition to a buffer from high levels of corporate profits, which have been further boosted by the expansion in AI-related demand, Japan's economy is likely to be underpinned by the government's measures and accommodative financial conditions, and the decline in the economic growth rate is thus expected to be only small. Against the backdrop of solid global AI-related demand, goods exports are likely to continue increasing moderately, mainly led by capital goods and IT-related goods. The growth momentum in business fixed investment is likely to remain subdued due to factors such as the impact of higher prices of imported capital goods, the rise in construction costs, and delays in construction projects, although business fixed investment is expected to be pushed up as a trend by factors such as moves to clear order backlogs for existing investment projects, in addition to investment related to AI and data centers. Nominal wages are highly likely to continue rising steadily, with the rate of increase in scheduled cash earnings remaining at around the current level, and supported by an increase in

bonuses reflecting the improvement in corporate profits. The number of employees is also highly likely to continue increasing moderately. In addition to such improvement in employee income, the wealth effects from higher stock prices and the government's various measures such as those to reduce the household burden of higher energy prices are also likely to underpin private consumption, which is expected to remain resilient; however, private consumption is projected to decline temporarily, as price rises are expected to exert increased downward pressure on real purchasing power. Meanwhile, although demand for home renovation is expected to provide some support, housing investment is likely to follow a declining trend, reflecting demographic developments and the rise in housing prices.

In fiscal 2027, Japan's economic growth is likely to be at around the same level as in fiscal 2026. This is because it is expected that, while downward pressure from price rises will remain in the first half of the fiscal year due in part to the impact of crude oil prices rising again, the increasing trend in domestic private demand will gradually become more pronounced in the second half of the fiscal year, supported by an improvement in trading gains due to a decline in crude oil prices. Goods exports are expected to continue increasing moderately against the backdrop of solid global AI-related demand. Corporate profits are likely to remain on an uptrend, supported by the increase in domestic and external demand and the decline in crude oil prices. In this situation, business fixed investment is likely to remain on an upward trend, pushed up by investment related to AI and data centers,

digital- and labor-saving investment to address labor shortages, and investment projects to adapt to changes in the trade structure and supply chains, among other investments. The rate of increase in nominal wages is likely to decelerate somewhat, particularly in special cash earnings (bonuses, etc.), pushed down by the earlier slowdown in growth momentum in corporate profits with some time lag. Although downward pressure is likely to be exerted by factors such as the waning of the effects of the government's support measures implemented through 2026 and the reactionary decline following the front-loading of demand for durable goods, as well as the impact of price rises, private consumption is likely to pick up through the second half of fiscal 2027, supported by a recovery in real disposable income reflecting a decline in the inflation rate.

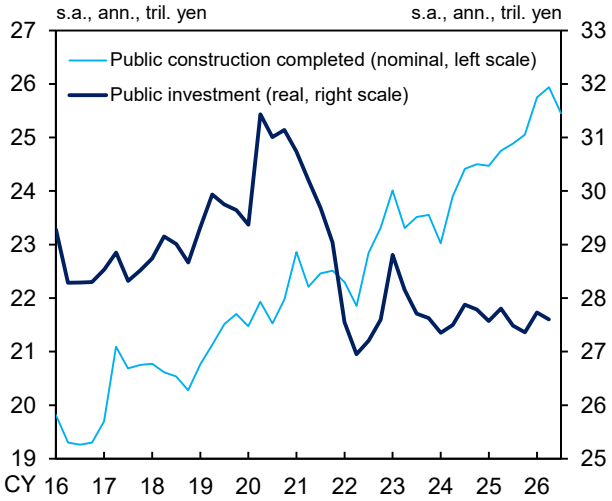
In fiscal 2028, Japan's economic growth is likely to remain at a pace around the same level as the potential growth rate, with the diminishing yet remaining cumulative effects of past monetary easing. Goods exports are expected to continue increasing moderately against the backdrop of moderate growth in overseas economies. With a continued improvement in corporate profits, business fixed investment is likely to remain on a steady upward trend. Employee income is likely to increase firmly, as growth in nominal wages accelerates again reflecting the improvement in corporate profits. In this situation, private consumption is expected to return to a moderate increasing trend, as real disposable income continues to improve.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has continued to be more or less flat (Chart 4). While construction based on the government's economic measures, including construction related to building national resilience, has progressed, the amount of public investment (in real terms) has continued to be more or less flat when fluctuations are smoothed out. The amount of public construction completed (in nominal terms) -- a coincident indicator of public investment -- has been on a moderate increasing trend, reflecting the rise in construction costs.

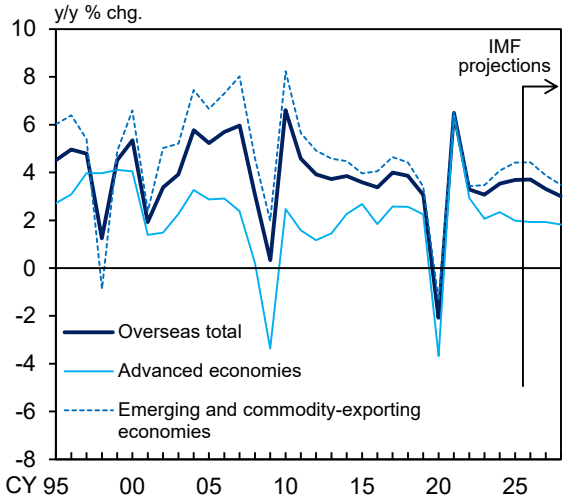
Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2026/Q3 is the July-August average.

Considering the developments in various leading indicators, public investment is likely to be more or less flat. Government consumption is projected to continue increasing steadily, partly due to a rise in defense-related spending, in addition to an uptrend in healthcare and nursing care expenditures.

Chart 5: Overseas Economies



Sources: IMF; Ministry of Finance.
Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. The real GDP growth rates are compiled by the IMF, and the rates from 2026 onward are its projections in the October 2026 *World Economic Outlook* (WEO). Figures for advanced economies are those for the United States, the euro area, and the United Kingdom. Figures for emerging and commodity-exporting economies are those for the rest of the world.

Overseas Economies

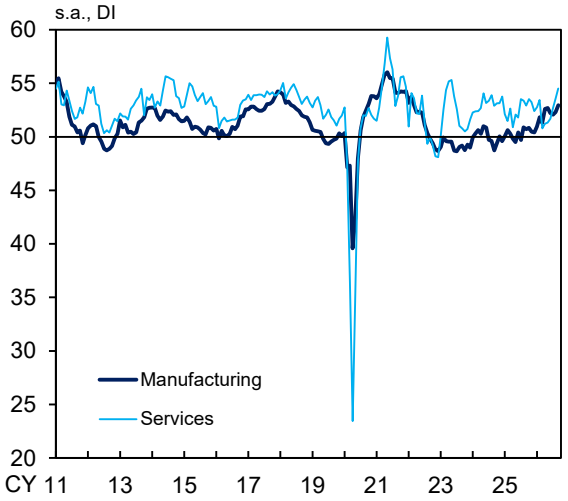
Overseas economies have grown moderately on the whole, although some weakness has been seen in part, partly due to the impact of the situation in the Middle East (Chart 5). By region, the U.S. economy has maintained solid growth on the whole, although some weakness has been seen in part. European economies have remained resilient on the whole, but downward pressure on domestic demand has been observed reflecting the impact of the situation in the Middle East. The Chinese economy has picked up on the whole, mainly supported by an increase in exports,

although consumption has lacked momentum. Growth in emerging and commodity-exporting economies other than China has improved moderately on the whole, although some weakness has been seen in part. Among those in Asia, which have close links to Japan's economy, the NIEs and ASEAN economies have improved, driven by global AI-related demand; however, consumption and production have been affected in part, reflecting the situation in the Middle East.

Looking at the Global PMI to see the current situation for the global economy, figures for the manufacturing industry have remained above 50 -- the break-even point between improvement and deterioration in business conditions -- against the backdrop of factors such as solid AI-related demand. Meanwhile, figures for the services industry have also remained above 50 (Chart 6).

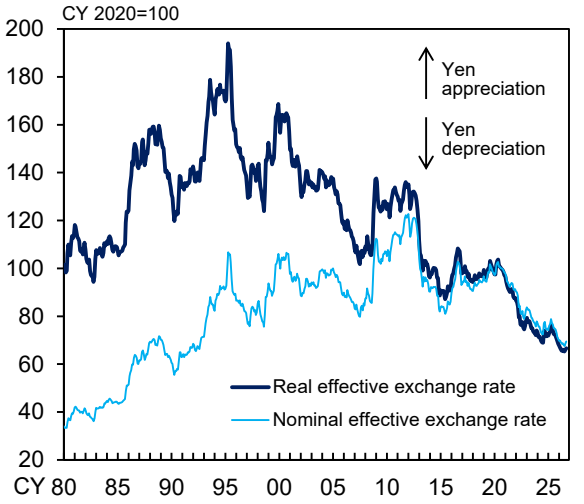
As for the outlook, overseas economies are expected to come under downward pressure for the time being due to the impact of the situation in the Middle East. Thereafter, however, based on the assumption that the impact of the situation in the Middle East will ease, overseas economies are projected to continue growing moderately, partly supported by global AI-related demand. By region, the U.S. economy is expected to continue growing firmly, supported by AI-related demand and the rise in stock prices thus far, although the economy is likely to be affected by the situation in the Middle East for the time being. European economies are projected to see a gradual acceleration in their growth rate, partly reflecting support from economic policies, although these economies are likely to be affected by the

Chart 6: Global PMI



Source: Copyright © 2026 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.
Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.

Chart 7: Effective Exchange Rates



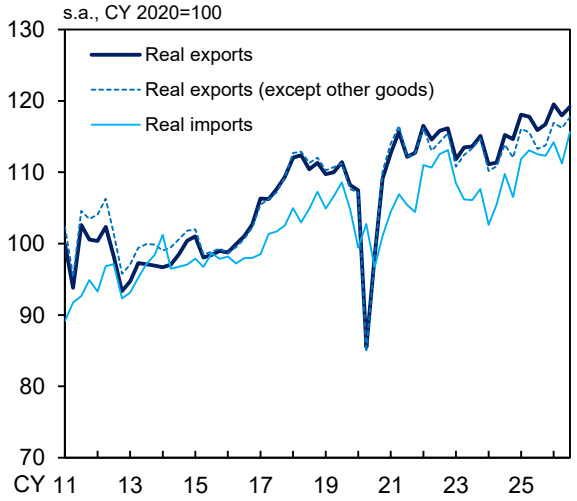
Source: BIS.
Note: Figures are based on the broad effective exchange rate indices. Figures prior to 1994 are calculated using the narrow indices.

situation in the Middle East for the time being. The Chinese economy is likely to improve moderately, partly reflecting support from economic policies, although the economy is likely to be affected by the situation in the Middle East for the time being. Emerging and commodity-exporting economies other than China are likely to improve moderately, partly supported by global AI-related demand, although downward pressure is likely to be exerted mainly on Asian economies, which are highly dependent on energy imports from the Middle East.

Exports and Imports

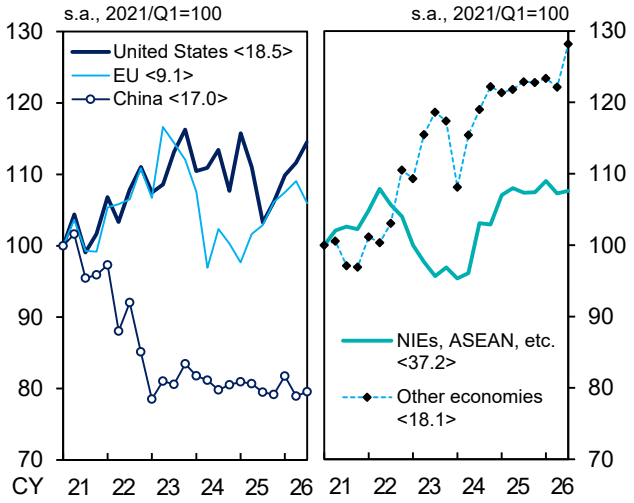
Exports have increased moderately, against the backdrop of the solid increase in global AI-related demand (Chart 8).[10] By region, exports to the United States have increased, reflecting an uptrend in exports of automobile-related goods on the back of solid demand for hybrid cars in the country, as well as upward pressure from an increase in exports of capital goods including semiconductor production equipment (Chart 9). Exports to Europe have been on an increasing trend, mainly led by automobile-related goods, partly reflecting the effects of the introduction of new car models. Exports to China have stayed more or less flat, albeit at a low level. This is because, although local production of automobiles, IT-related goods, and other products by Chinese manufacturers reflecting their increased competitiveness has exerted downward pressure, exports to the country have recently been supported by the increase in exports of semiconductor production equipment.

Chart 8: Real Exports and Imports



Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Other goods include gold and re-export goods.

Chart 9: Real Exports by Region

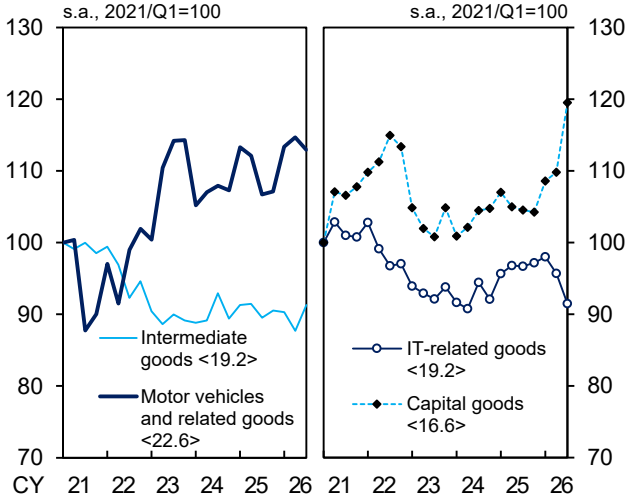


Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2025.

[10] Real exports excluding "other goods" have also increased moderately, where "other goods" include, for example, re-export goods that are not recorded in the GDP statistics.

Exports to the NIEs, ASEAN, and some other Asian economies have been resilient, supported by solid exports of capital goods (semiconductor production equipment) on the back of the expansion in global AI-related demand. Exports to other economies have recently increased fairly substantially, mainly because exports to the Middle East (automobile exports) have continued to pick up from the significant decline seen through April, reflecting the securing of alternative transport routes. By type of goods, exports of automobile-related goods have been on an increasing trend, as those to the United States and Europe have been solid reflecting the stronger demand for hybrid cars and the effects of the introduction of new car models, and as exports to the Middle East have picked up (Chart 10). Exports of capital goods have increased significantly, pushed up by recent exports of ships, in addition to an increase in exports of semiconductor production equipment and equipment for power facilities reflecting the solid expansion in global AI-related demand. Exports of IT-related goods had been resilient, supported by solid AI-related demand, such as for data servers; more recently, however, these exports have been declining, affected by subdued demand for smartphones reflecting price hikes and by a rise in the prices of memory chips.[11] Meanwhile, although production activity in the chemical industry has picked up reflecting the progress in securing alternative sources of supply for items such as crude oil and naphtha, exports of

Chart 10: Real Exports by Type of Goods



Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each type of goods in Japan's total exports in 2025.

[11] The recent figures for real exports of IT-related goods likely somewhat understate underlying export activity. This is because, while the export price index -- which serves as the deflator -- for electronic parts such as semiconductors within the IT-related goods category has been driven up by the significant rise in market prices of memory chips, the nominal export unit value for electronic parts such as semiconductors, particularly for semi-finished products, has not risen in line with market prices.

intermediate goods have been at low levels, pushed down as a trend by excess production capacity in China.

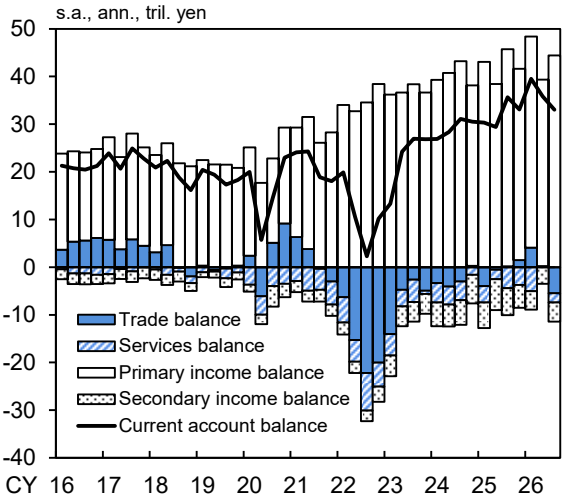
As for the outlook, exports are likely to continue increasing moderately, led mainly by capital goods and IT-related goods, against the backdrop of solid global AI-related demand.[12]

Imports have returned to a moderate uptrend, reflecting resilient domestic demand, as progress has been made in securing alternative sources of supply for raw materials (Chart 8). As for the outlook, imports are likely to follow a moderate uptrend, supported by an increase in domestic demand, including inventory restocking pressure, in addition to the recovery in imports of raw materials owing to progress in securing alternative sources of supply.

External Balance

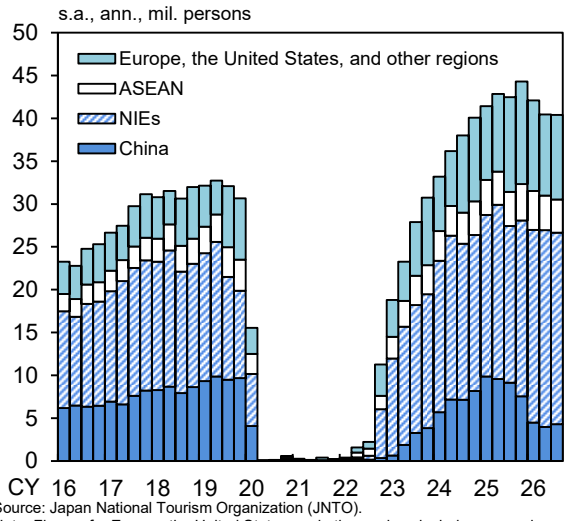
The nominal current account surplus has been at a high level (Chart 11). The trade balance has recently turned to a slight deficit, as the increase in nominal import values, mainly of mineral fuels, has outweighed the increase in nominal export values reflecting a rise in the export price per unit for memory chips and other items. Looking at the services balance, while the travel balance -- supported by inbound tourism demand (Chart 12) -- has marked a surplus, it has remained on a slight deficit trend on the whole, as payments for digital-related services have been at high levels. Meanwhile, the primary income balance surplus

Chart 11: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2026/Q3 are July-August averages.

Chart 12: Number of Inbound Visitors



Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

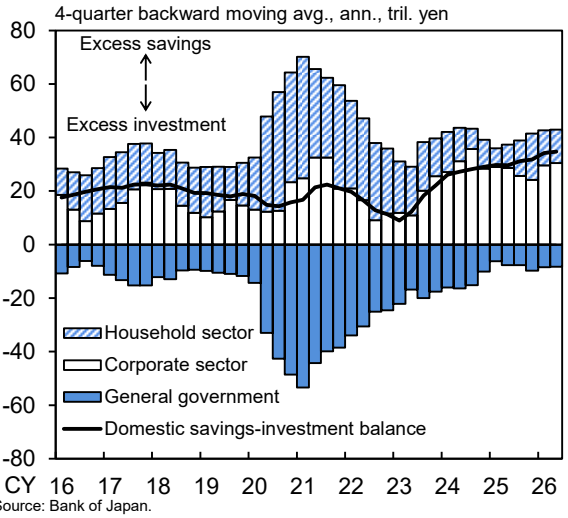
[12] See Box 1 for developments in AI-related demand and risks to the outlook for Japan's economy.

has remained at a high level, pushed up by the depreciation of the yen, as well as by higher receipts of, for example, direct investment income and portfolio investment income.

With regard to the outlook for the nominal current account balance, the surplus is likely to decline for the time being, mainly due to the increase in imports of mineral fuels. Thereafter, however, the nominal current account surplus is likely to continue increasing moderately on the whole, reflecting that the trade balance is expected to improve due to a decline in crude oil prices, and that the primary income balance surplus is expected to expand due to an improvement in overseas economies.

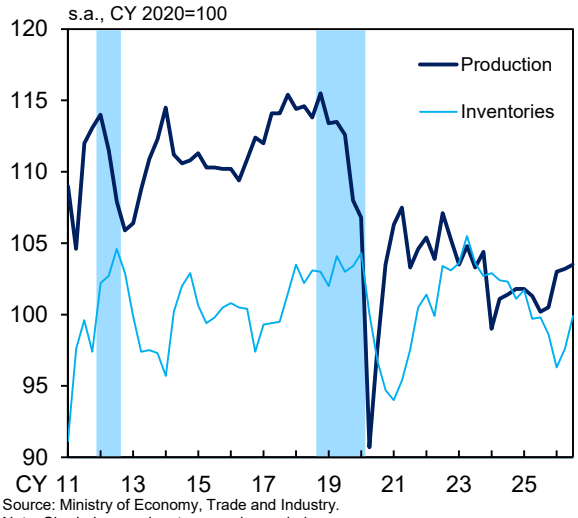
Meanwhile, in terms of the savings-investment balance, which by definition equals the current account balance, overall excess savings in Japan have been on a moderate expanding trend, mainly due to the expansion in excess savings in the corporate sector reflecting the increase in corporate profits (Chart 13). Looking ahead, overall excess savings are expected to continue on a moderate expanding trend, against the background of factors such as an improvement in corporate profits.

Chart 13: Savings-Investment Balance



Source: Bank of Japan.

Chart 14: Industrial Production



Source: Ministry of Economy, Trade and Industry.
Note: Shaded areas denote recession periods.

Industrial Production

Industrial production has increased moderately, against the backdrop of the solid increase in global AI-related demand (Chart 14). By major industry, production of "transport equipment" -- despite the impact of the temporary suspension of operations at factories due to the 2026 Kumamoto

Earthquake -- has been at a high level, amid resilience in demand from the United States and Europe as well as in domestic demand, and pushed up by a pick-up in exports to the Middle East. Production of "general-purpose, production, and business-oriented machinery" has increased significantly, mainly led by production of semiconductor production equipment, with the solid expansion in global AI-related demand spreading to the production of a wider variety of items. Production of "electronic parts and devices" has also been on an increasing trend, albeit with fluctuations, on the back of solid AI-related demand. Production of "electrical machinery, and information and communication electronics equipment" has increased moderately, supported by solid production of semiconductor measuring instruments and air conditioners. Production of "chemicals (excluding medicine)" has been on a declining trend from a long-term perspective, reflecting the impact of oversupply, particularly in Asia; recently, however, it has picked up due to an increase in plant utilization rates reflecting progress in securing alternative sources of supply for raw materials. Meanwhile, although inventories had seen a clear decline, they have recently increased, reflecting inventory restocking of chemical products and an increase in inventories of automobiles awaiting shipment.

As for the outlook, industrial production is expected to follow a moderate increasing trend on the back of solid global AI-related demand.

Corporate Profits

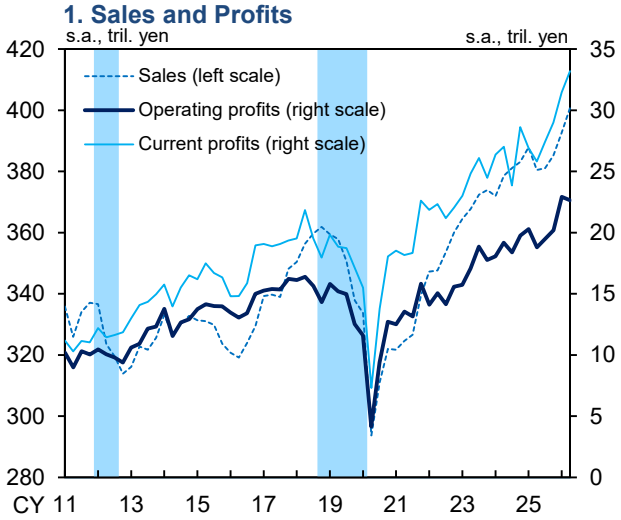
Corporate profits have been at high levels against the backdrop of factors such as the solid increase

in global AI-related demand, despite the impact of the situation in the Middle East. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, operating profits for all industries and enterprises in the April-June quarter declined, albeit slightly, compared with the previous quarter, due to the impact of the rise in energy and raw material prices stemming from the situation in the Middle East; however, they have remained at high levels, supported by resilience in domestic demand and progress in the pass-through of cost increases to selling prices under such conditions, in addition to the solid increase in global AI-related demand (Chart 15). By industry, operating profits of manufacturers have continued to increase firmly, mainly in electrical machinery, and information and communication electronics equipment, as well as in nonferrous metals. This is because the solid increase in AI-related demand has pushed up profits through its impact on both prices and quantities. As for nonmanufacturers, operating profits have been at high levels, reflecting resilient domestic demand, but recently, operating profits in sectors such as transport as well as electricity, gas and water supply have seen a decline, reflecting factors such as the rise in crude oil prices stemming from the situation in the Middle East. Meanwhile, current profits for all industries and enterprises in the April-June quarter rose from the previous quarter, marking a record high. This rise mainly reflects the increase in non-operating profits of large manufacturing firms (e.g., dividend income from overseas subsidiaries) due to the yen's depreciation.

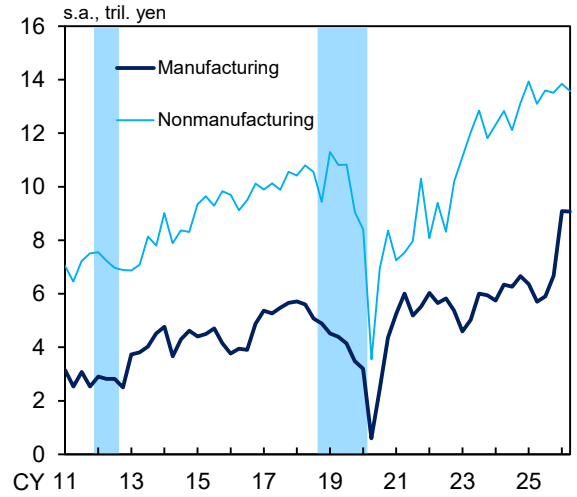
Against the backdrop of factors such as the solid increase in global AI-related demand, business

Chart 15: Indicators Related to Corporate Profits

1. Sales and Profits



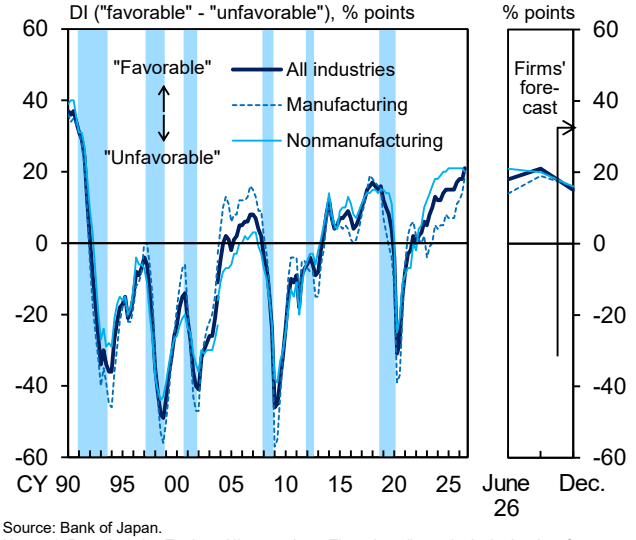
2. Operating Profits by Industry



Source: Ministry of Finance.
Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance" and "pure holding companies."
2. Shaded areas denote recession periods.

sentiment has been at a more favorable level, despite the impact of the situation in the Middle East. Looking at the September *Tankan*, the business conditions DI for all industries and enterprises improved to a net "favorable" value of 21, from the previous value of 18 in the June *Tankan*, marking its highest level since August 1991. As for the outlook, however, business conditions are projected to deteriorate by a somewhat large degree as compared with previous projections, with the forecast DI registering a value of 15, mainly reflecting concern over a rise in energy and raw material prices due to the resurgence of tension over the situation in the Middle East (Chart 16). By industry, the business conditions DI for manufacturing as a whole has improved further, as the positive impact of the expansion in AI-related demand has spread from large firms to even small and medium-sized ones, as reflected in the DIs for the electronics and capital goods sectors in particular. The forecast DIs for a wide range of manufacturing industries indicate that business conditions are expected to deteriorate, reflecting factors such as the effects of an increase in input costs. The business conditions DI for nonmanufacturing has been at a high level on the whole, supported by resilient domestic demand and progress in the pass-through of cost increases to selling prices, although the adverse effects of the rise in energy and raw material prices have been seen in the DIs for a wide range of industries and negative effects due to irregular weather have been seen in the DIs for industries related to private consumption in particular. The forecast DI for nonmanufacturing indicates that business conditions are expected to deteriorate, with some concern over a rise in interest rates, in addition to concern over the increase in input costs.

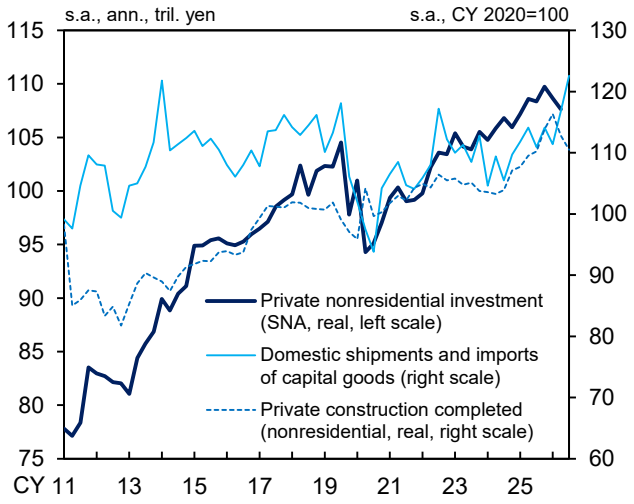
Chart 16: Business Conditions



Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
2. Shaded areas denote recession periods.

Regarding the outlook, although the rise in energy and raw material prices is expected to exert downward pressure on a wide range of industries for the time being, corporate profits are likely to continue on an increasing trend, underpinned by the government's measures to reduce the household burden of higher energy prices, and pushed up by solid global AI-related demand. Thereafter, corporate profits are likely to remain on an uptrend, supported by the increase in domestic and external demand and the decline in crude oil prices.

Chart 17: Coincident Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The figure for private construction completed for 2026/Q3 is the July-August average.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

Business Fixed Investment

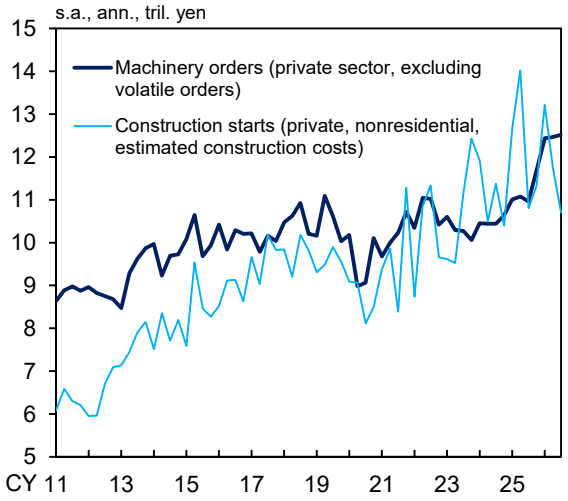
Business fixed investment has been on a moderate increasing trend, despite being affected by the rise in construction costs (Chart 17).[13] The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has increased markedly, albeit with fluctuations in investment in semiconductor production equipment and other goods, as the aggregate supply of capital goods has been supported by solid demand for AI- and labor saving-related investments. Private construction completed (nonresidential, real) -- a coincident indicator of construction investment -- had continued on a moderate uptrend, supported by strong construction demand, mainly demand for logistics facilities, demand related to urban redevelopment, and demand related to data centers and electricity. However, the growth momentum in private construction completed has recently levelled off, reflecting the impact of moves to revise investment plans due to factors such as high

[13] See Box 2 for the impact of the recent rise in investment costs and the intensification of supply-side constraints on business fixed investment.

construction material prices and of delays in construction projects due to labor shortages.

Machinery orders (private sector, excluding orders for ships and orders from electric power companies; in nominal terms) -- a leading indicator of machinery investment -- have increased significantly, due in part to the effects of large-scale projects (Chart 18). Developments in machinery orders by industry are as follows. In manufacturing, orders have increased firmly on the back of solid demand for investment in growth areas, such as semiconductor components and AI-related areas. Orders from the nonmanufacturing industry have increased markedly, mainly in industries such as information services and finance and insurance, supported by strong demand for digital- and labor saving-related investments. Meanwhile, orders from electric power companies have been on a clear increasing trend, albeit with fluctuations, reflecting factors such as increased electricity demand related to data centers, orders to address decarbonization, and orders associated with safety measures for nuclear power plants. Construction starts (in terms of nominal planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have been on a moderate increasing trend, mainly in nonmanufacturing, supported by solid demand related to urban redevelopment and demand for construction such as of new logistics facilities and new data centers; more recently, however, the growth momentum in construction starts has slowed, reflecting the impact of the rise in construction costs. Looking at business fixed investment plans (in nominal terms) in the September *Tankan*, business fixed

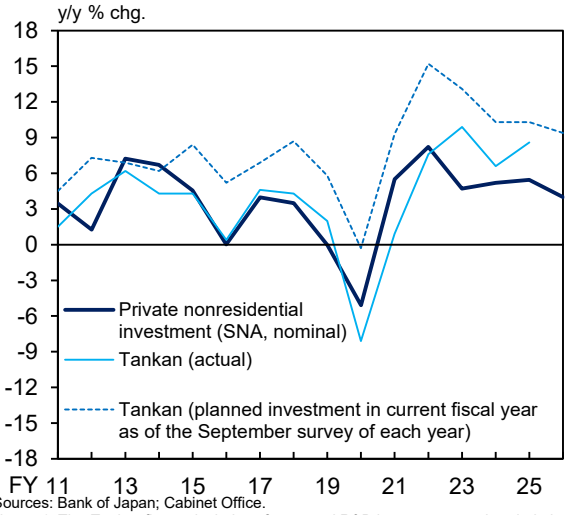
Chart 18: Leading Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. Figures for 2026/Q3 are July-August averages.

investment (on a basis close to the GDP definition; business fixed investment -- including software and R&D investments but excluding land purchasing expenses -- for all industries and enterprises including financial institutions) for fiscal 2026 registered a year-on-year rate of increase of 9.4 percent, which represents an overall solid increase similar in size to that in fiscal 2025, although investment plans by small enterprises show some weakness due to factors such as the impact of the rise in material prices and delays in construction projects (Chart 19). However, the rate of increase in business fixed investment for fiscal 2026 in real terms is highly likely to decelerate compared with that in fiscal 2025, given that investment goods prices and construction costs have risen further recently.

Chart 19: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
Notes: 1. The *Tankan* figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries including financial institutions.
2. The figure for private nonresidential investment for fiscal 2026 is that for 2026/Q2.

Regarding the outlook, the growth momentum in business fixed investment is likely to remain subdued for the time being, due to factors such as the impact of higher prices of imported capital goods, the rise in construction costs, and delays in construction projects, although business fixed investment is expected to be pushed up as a trend by factors such as moves to clear order backlogs for existing investment projects, in addition to investment related to AI and data centers. Thereafter, with the growth momentum in corporate profits increasing on the back of a rise in domestic and external demand and a decline in input costs, business fixed investment is likely to follow a moderate uptrend, supported in part by the effects of the government's earlier economic measures. Medium- to long-term investment that is expected to support business fixed investment during the projection period includes (1) labor-saving investment to address structural

labor shortages and IT-related investment to digitalize business activities; (2) construction investment in logistics facilities, resulting from expanding e-commerce, and in offices and commercial facilities related to urban redevelopment; (3) machinery investment and R&D investment in growth areas, such as AI- and semiconductor-related areas; (4) R&D investment related to decarbonization and to science and technology support; and (5) investment mainly aimed at strengthening supply chains.

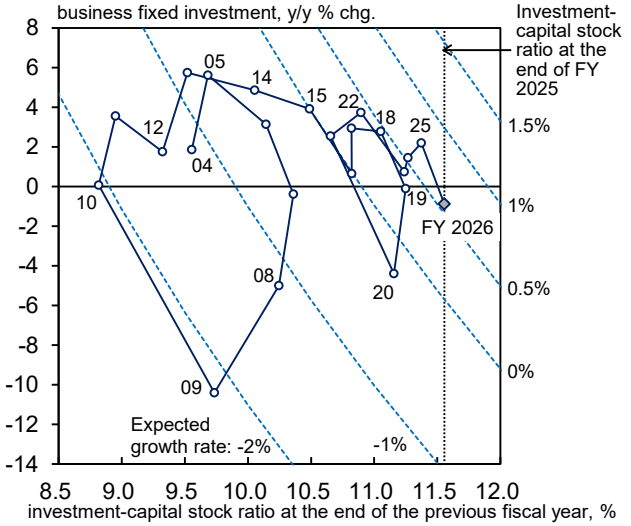
Firms' expected growth rate derived from the pace of increase in capital stock has been at around 0.5 percent, a level generally consistent with the potential growth rate (Chart 20). Although capital stock is likely to accumulate reflecting the uptrend in business fixed investment, the pace of increase in such stock is expected to be moderate, due in part to an increase in the weight of intangible fixed asset investment, which has a high depreciation rate.

Employment and Income Situation

The employment and income situation has improved moderately.

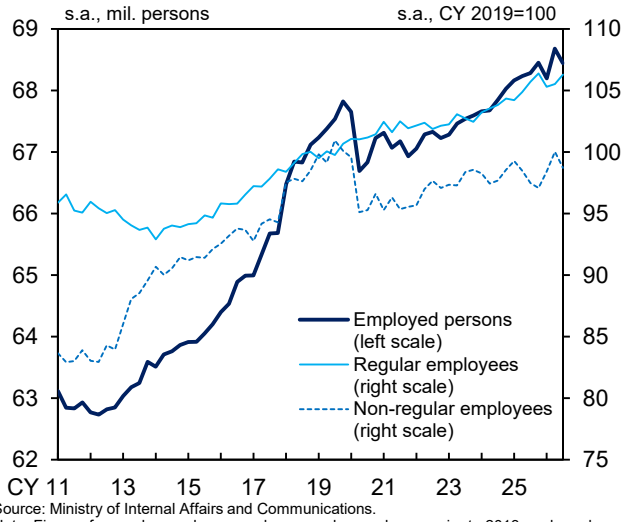
The number of employed persons had continued to increase at a year-on-year rate of around 0.5 percent, reflecting an increase in the number of employees; more recently, however, the growth momentum in the number of employed persons has slowed, reflecting a decline in the number of self-employed workers and family workers, which has a tendency to fluctuate (Chart 21). Among employees, the number of regular employees has

Chart 20: Capital Stock Cycles



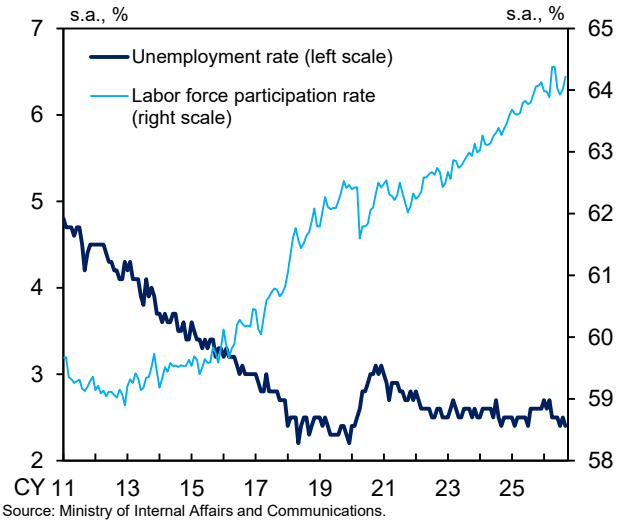
Source: Cabinet Office.
Note: Each broken line represents the combination of the rate of change in business fixed investment and the investment-capital stock ratio at a certain expected growth rate. The figure for fiscal 2026 is that for 2026/Q2.

Chart 21: Number of Employed Persons



Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*.

Chart 22: Unemployment Rate and Labor Force Participation Rate



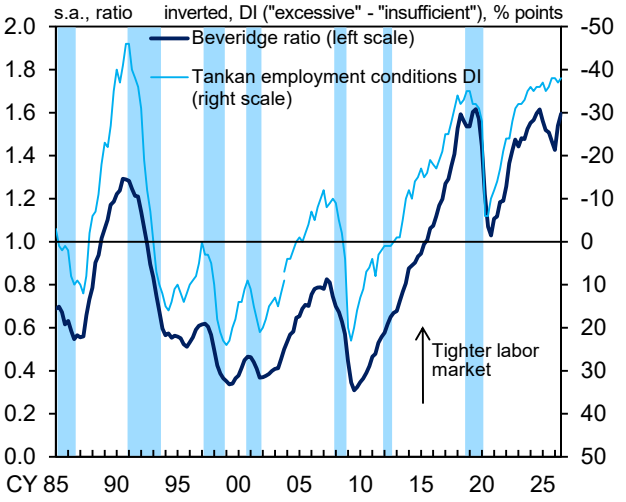
Source: Ministry of Internal Affairs and Communications.

been on an increasing trend, particularly in the medical, healthcare, and welfare services industry, which has faced severe labor shortages. The pace of increase in the number of non-regular employees has remained lower than that of regular employees, albeit with fluctuations, as firms have shifted toward regular employment.

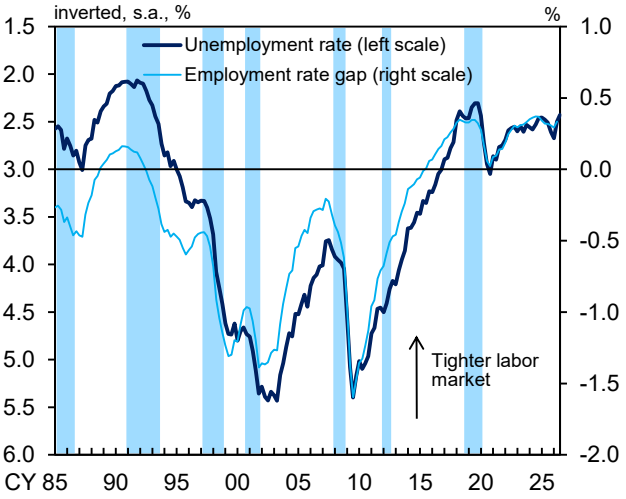
Labor market conditions have remained tight. The unemployment rate has been at a low level of around 2.5 percent (Charts 22 and 23[2]). The estimate of the employment rate gap -- which is calculated as the gap between the actual unemployment rate and the structural unemployment rate, the latter reflecting factors such as mismatches in the labor market -- also suggests that labor market conditions have remained tight by historical standards (Chart 23[2]). The DI for employment conditions in the *Tankan* has shown a significantly large net "insufficient" at about the same level as in the early 1990s, particularly in nonmanufacturing, indicating firms' continued strong sense of labor shortage. In this situation, the accession-separation rate gap -- the gap between the accession rate and the separation rate at establishments -- has remained at a high level, suggesting strong labor demand on the part of firms, although the rate gap has declined compared with a while ago (Chart 23[3]). The Beveridge ratio had declined slightly from a high level, due to factors such as a decline in the job vacancy rate reflecting progress in labor-saving investment, but has recently been on a rising trend again (Chart 23[1]). Meanwhile, the pace of increase in the labor force participation rate has somewhat decelerated recently, although the rate

Chart 23: Labor Market Indicators

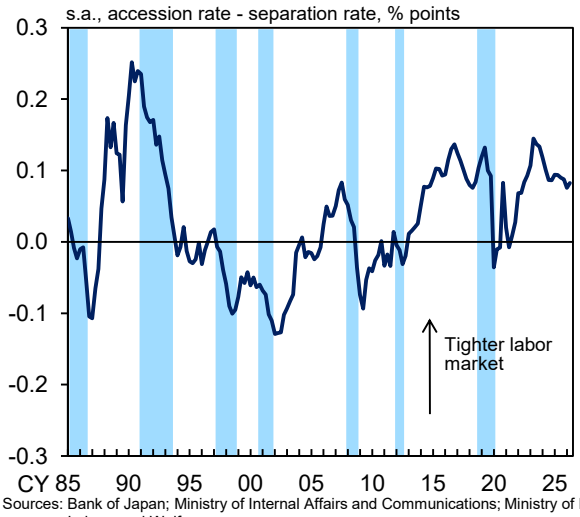
1. Beveridge Ratio and *Tankan* Employment Conditions DI



2. Unemployment Rate and Employment Rate Gap



3. Accession-Separation Rate Gap



Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

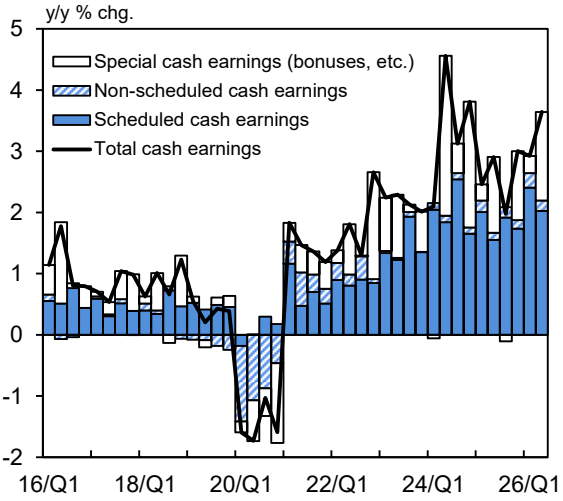
Notes: 1. Beveridge ratio = Vacancy rate / Unemployment rate excluding self-employed and family workers. Figures are calculated using vacancy rates calculated based on the *Employment Referral Statistics* until 2019/Q4, and using the *Survey on Labour Economy Trend* from 2020/Q1 onward. Figures from 2025/Q3 onward are estimates based on the DI for enterprises' employment conditions in the survey.
2. Figures for the *Tankan* employment conditions DI are for all industries and enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
3. Figures for the accession-separation rate gap (for 1989 and earlier, establishments with 30 or more employees) are 3-quarter central moving averages (the figure for 2026/Q3 is the July-August average).
4. Shaded areas denote recession periods.

has remained on a moderate uptrend, particularly for women (Chart 22).

With regard to the outlook for the employment situation, the number of employees is expected to continue increasing moderately, mainly for regular employees in industries with a strong sense of labor shortage, despite downward effects from the situation in the Middle East. However, with labor force participation of women and seniors having advanced to a high degree thus far, the pace of increase is highly likely to decelerate, because the room for additional growth in labor supply is likely to diminish from a demographic perspective. Under these circumstances, the unemployment rate -- despite the impact of the situation in the Middle East -- is expected to follow a very moderate declining trend.

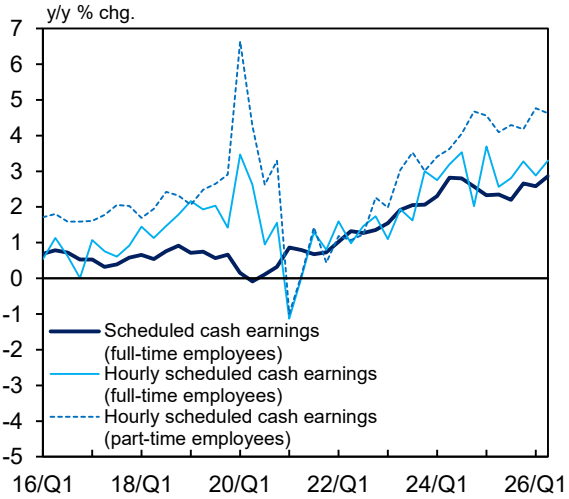
On the wage side, nominal wages per employee have continued to increase steadily, albeit with fluctuations (Chart 24). [14] Looking at the breakdown, the year-on-year rate of increase in scheduled cash earnings has been at around 3 percent recently (Chart 25). Specifically, the year-on-year rate of increase in scheduled cash earnings per employee for full-time employees has been in the range of 2.5-3.0 percent. Looking at hourly scheduled cash earnings for full-time employees, the rate of increase has been somewhat above that of scheduled cash earnings per employee, being in the range of 3.0-3.5

Chart 24: Nominal Wages



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures are based on continuing observations following the sample revisions.

Chart 25: Scheduled Cash Earnings



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures are based on continuing observations following the sample revisions.
3. Figures for hourly scheduled cash earnings (full-time employees) are seasonally adjusted.

[14] Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less susceptible to fluctuations due to sample revisions. Nonetheless, the effects of such revisions can still be observed to a certain degree among establishments with fewer than 500 employees, and the data for these establishments are also subject to fluctuations stemming from the small sample size.

percent when fluctuations are smoothed out. The year-on-year rate of increase in hourly scheduled cash earnings for part-time employees has remained at a relatively high level, at around 4-5 percent, on the back of wage revisions for existing part-time employees reflecting minimum wage increases. On the other hand, the year-on-year rate of increase in the average hourly wage for temporary and part-time jobs at the time of recruitment has recently been lower than that in hourly wages of part-time employees, partly due to firms becoming cautious about posting new vacancies. The growth momentum in non-scheduled cash earnings has somewhat increased recently, pushed up by an increase in hourly wages for overtime work and a rise in overtime hours associated with increased production activity in manufacturing. Meanwhile, looking at special cash earnings (bonuses, etc.) for June through August -- which are broadly equivalent to summer bonuses -- the year-on-year rate of increase was around 5 percent, representing firm growth and exceeding the rate in the previous fiscal year, reflecting the improvement in corporate profits in the second half of fiscal 2025 and a rise in the rate of base pay increases.

With regard to the outlook for wages, the year-on-year rate of increase in scheduled cash earnings per employee is highly likely to remain at around its current level for the time being, reflecting the results of this year's annual spring labor-management wage negotiations, which show that the rate of base pay increases agreed in the negotiations was at about the same level as in the previous year. Thereafter, the rate of increase in scheduled cash earnings per

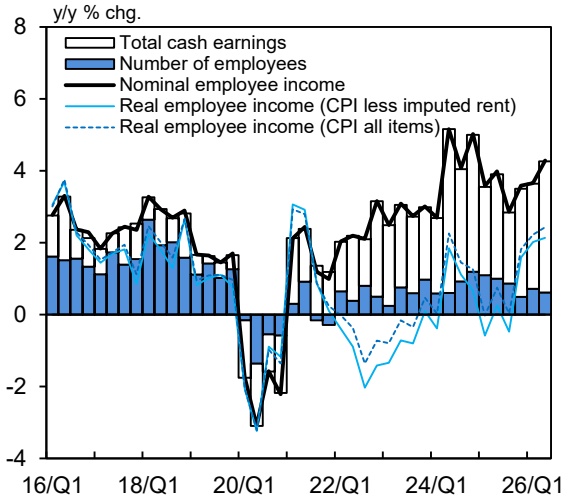
employee is likely to remain at around the same level, reflecting an improvement in corporate profits, tighter labor market conditions, and price rises. Meanwhile, the rate of increase in special cash earnings (bonuses, etc.) is expected to continue increasing firmly against the background of an improvement in corporate profits driven by the expansion in AI-related demand, despite being affected by the rise in energy and raw material prices.

In light of the aforementioned employment and wage conditions, nominal employee income has continued to increase steadily at a year-on-year rate of around 4 percent, despite being affected by fluctuations in bonuses (Chart 26). The year-on-year rate of change in employee income in real terms -- based on the CPI (all items less imputed rent) -- has picked up since the end of last year, and has been at around 2 percent recently. With regard to the outlook, nominal employee income is likely to continue increasing steadily, albeit with fluctuations, with corporate profits remaining on an uptrend. In real terms, the year-on-year rate of change in employee income is expected to slow and turn negative for a time, reflecting a rise in the inflation rate; however, it is expected to accelerate again toward the end of the projection period, as the pace of price rises moderates.

Household Spending

Private consumption has been resilient against the background of the improvement in the

Chart 26: Employee Income

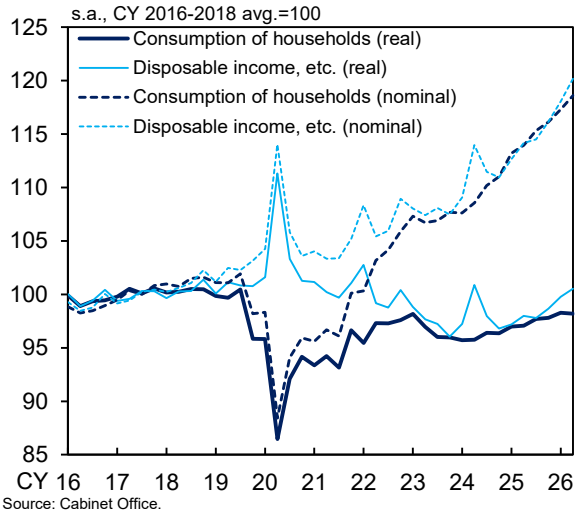


Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Nominal employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*)
3. Figures are based on continuing observations following the sample revisions of the *Monthly Labour Survey*.
4. Figures for real employee income are based on staff calculations using the price indicators shown in parentheses.

employment and income situation, despite the impact of factors such as price increases.[15]

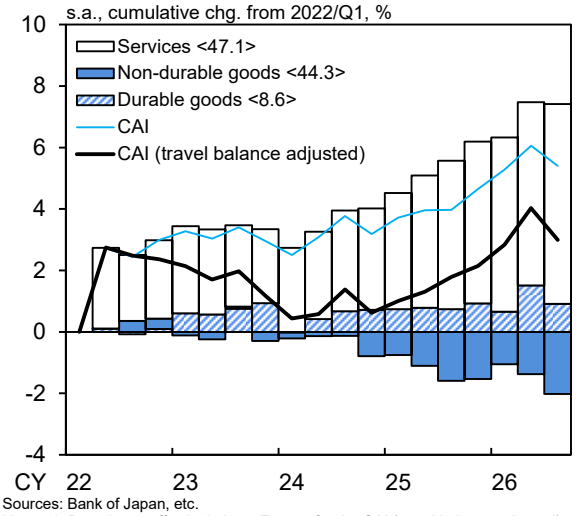
The Consumption Activity Index (CAI; real, travel balance-adjusted) -- which is calculated by combining various sales and supply-side statistics -- increased for six consecutive quarters through the April-June quarter, due to a temporary increase in consumption of durable goods, such as automobiles and air conditioners, in addition to the improvement in real income and the wealth effects from higher stock prices.[16] However, the index declined on average in the July-August period relative to the April-June quarter, due to weather conditions such as typhoons, torrential rains, and prolonged rainfall, as well as the effects of increased thriftiness, particularly among pensioners, in response to price rises (Charts 27 and 28). Looking at recent developments in private consumption from various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, it appears that private consumption has remained in a deceleration phase on the whole (Chart 29). While higher stock prices have continued to have a positive effect on sales at, for example, department stores, irregular weather in September (typhoons and prolonged rainfall) and increased thriftiness, particularly among pensioners, have led to continued weakness in sales volumes at supermarkets and convenience stores. In addition, special demand

Chart 27: Consumption of Households and Disposable Income



Source: Cabinet Office.
Notes: 1. Figures for consumption of households exclude imputed rent.
2. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements. Real values are based on staff calculations using the deflator of consumption of households.

Chart 28: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
Notes: 1. Based on staff calculations. Figures for the CAI (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. Figures for 2026/Q3 are July-August averages.
2. Non-durable goods include goods classified as semi-durable goods in the SNA.
3. Figures in angular brackets show the weights in the CAI.

[15] See Box 3 for the background to the recent sluggishness in private consumption, particularly in spending on non-durable goods.

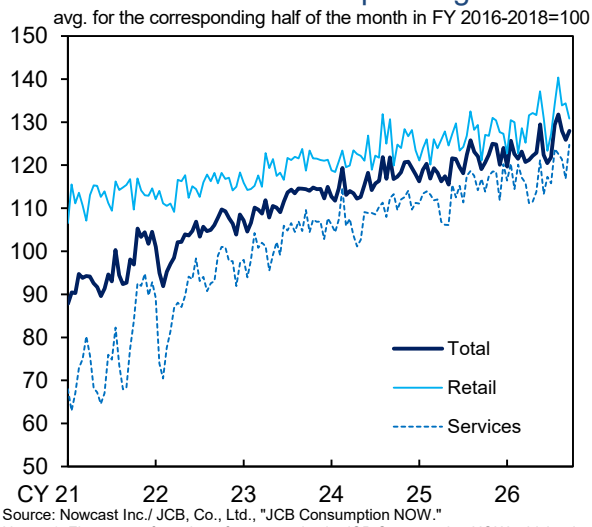
[16] Regarding the CAI, see the following paper: "Revision of the Consumption Activity Index Following the 2020 Base Revision of GDP Statistics," Bank of Japan Research Paper (June 2026).

for durable goods such as air conditioners and automobiles has been waning.

By type, consumption of durable goods had increased substantially, led mainly by spending on automobiles and air conditioners, but has recently declined to a somewhat lower level, with demand for these items waning (Chart 28). Automobile sales, despite recently being weighed down by the dissipation of the pent-up demand following the abolition of the environmental performance levy on automobiles, have remained at relatively high levels supported by factors such as the effects of the introduction of new car models. With regard to sales of household electrical appliances, sales of air conditioners had been at high levels on the back of an expansion in subsidies provided by some local governments for their purchase and the front-loading of demand in view of the changes in environmental standards scheduled for next year, but have recently declined, as the impact of low temperatures during the summer coincided with the effects of waning demand for air conditioners. Consumption of non-durable goods (e.g., "beverages and food" and "clothes") has been relatively weak due to increased thriftiness among consumers, and more recently, reflecting the reactionary decline following the stockpiling of daily necessities (e.g., medicine and cosmetics) in response to the situation in the Middle East, and the effects of a decline in the sales of seasonal products caused by irregular weather.

Services consumption has increased moderately (Charts 28 and 29). With the shift to dining-out continuing as a trend, dining-out has increased

Chart 29: Consumption Developments Based on Credit Card Spending



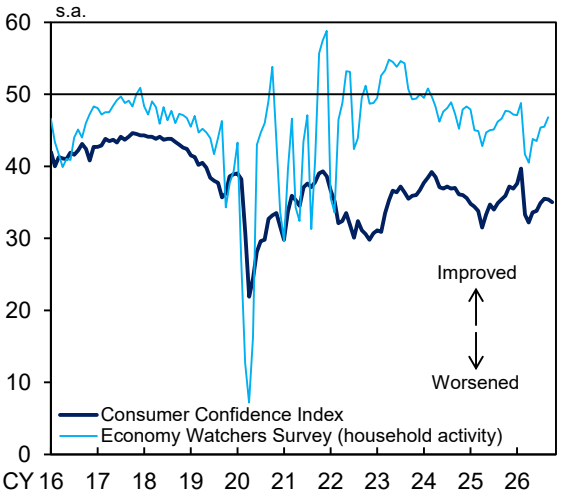
Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account.
2. Figures exclude telecommunications and energy (fuel, electricity, gas, heat supply, and water). Based on staff calculations.

moderately, supported in part by the improvement in real income. Domestic travel -- despite the impact of irregular weather -- has been at a relatively high level, reflecting a strong willingness to travel among working households who have benefited from wage increases, as well as the boost from the long holidays. Overseas travel has continued to be somewhat weak, mainly reflecting relatively high travel costs due to factors such as the depreciation of the yen.

Looking at confidence indicators related to private consumption, the Consumer Confidence Index in the *Consumer Confidence Survey* -- which asks consumers for their views on the outlook for the coming six months -- deteriorated sharply around the spring, reflecting the unstable situation in the Middle East and a rise in inflation expectations; however, the index has generally been picking up since then (Chart 30). The current economic conditions DI (household activity-related) of the *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- had declined sharply through April; subsequently, however, despite the impact of irregular weather, the DI has picked up gradually on the back of factors such as strong sales of durable goods and the wealth effects from higher stock prices.

Regarding the outlook, private consumption is expected to remain resilient from a somewhat long-term perspective, owing to factors such as the effects of the government's various support measures, in addition to the wealth effects from higher stock prices. However, private consumption is likely to remain in a deceleration phase for a while, mainly due to sluggish growth

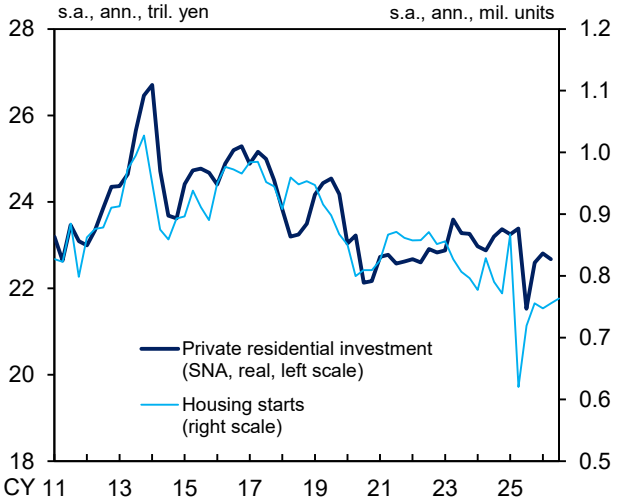
Chart 30: Confidence Indicators Related to Private Consumption



Source: Cabinet Office.
Note: Figures for the *Economy Watchers Survey* are those for the current economic conditions DI.

in real disposable income reflecting price rises. Toward the middle of the next fiscal year, private consumption is likely to decline temporarily, pushed down by a decline in real purchasing power due to price rises and the waning of the effects of the government's support measures, and reflecting the impact of the reactionary decline following the front-loading of demand for goods such as air conditioners; subsequently, however, private consumption is projected to return to a moderate increasing trend, supported by a recovery in real disposable income reflecting a decline in the inflation rate.

Chart 31: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2026/Q3 is the July-August average.

Housing investment has been on a declining trend (Chart 31). When fluctuations stemming from the enforcement of revisions to the Building Standards Act and other regulations are smoothed out, the number of housing starts -- a leading indicator of housing investment -- has followed a declining trend, mainly reflecting demographic developments and a rise in housing prices. As for the outlook, although demand for home renovation is expected to provide some support, housing investment is likely to follow a moderate declining trend, due to the effects of demographic developments and the rise in housing prices.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The producer price index (PPI) has risen by around 7 percent on a year-on-year basis, pushed up by a large increase in prices of petroleum and coal products and of chemicals and related products reflecting the impact of the situation in the Middle East, as well as by the rise in prices of nonferrous metals and machinery driven by the expansion in global AI-related demand (Charts 32 and 33). With moves to pass on the rise in personnel expenses and other factors to selling prices continuing, the year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has been at around 3 percent (Charts 32 and 39).

With moves to pass on wage increases to selling prices continuing, the year-on-year rate of increase in the CPI (all items less fresh food and energy) has accelerated due to the impact of the rise in import prices, and has been at around 2.5 percent recently (Charts 32 and 34).[17] The year-on-year rate of increase in the CPI (all items less fresh food) has been at around 2 percent recently due to factors such as the effects of the government's measures to reduce the household burden of higher energy prices (Charts 32 and 35). Meanwhile, looking at the CPI (all items less food and energy) -- which is not affected by fluctuations in food and energy prices -- the

[17] In August 2026, the base year for the CPI was changed from 2020 to 2025. In line with this change, the annual CPI inflation rate for January 2026 onward was retroactively revised. The year-on-year rate of change in the CPI (all items less fresh food) from January through June 2026 was more or less unchanged between the 2020 base and the 2025 base.

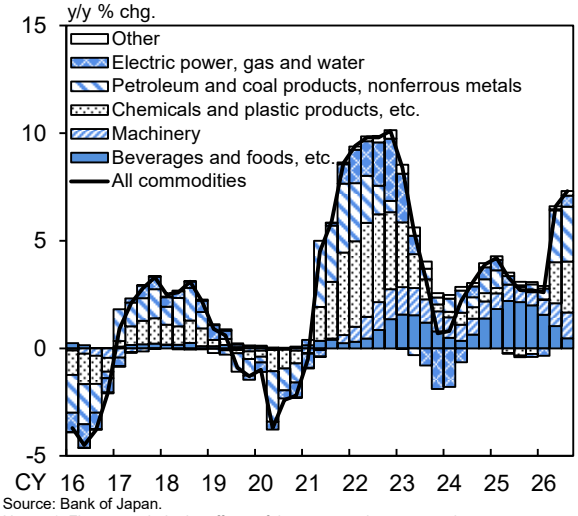
Chart 32: Inflation Indicators

y/y % chg.

	25/Q4	26/Q1	26/Q2	26/Q3
Consumer Price Index (CPI)	2.7	1.4	1.5	2.0
Less fresh food	2.8	1.7	1.5	1.9
Excluding institutional factors	2.7	2.1	2.7	2.7
Less fresh food and energy	3.0	2.5	1.8	2.1
Excluding institutional factors	3.2	2.6	2.1	2.4
Less food and energy	1.5	1.5	1.2	1.7
Excluding institutional factors	1.8	1.7	1.4	1.9
Producer Price Index (PPI)	2.7	2.6	6.6	7.3
Services Producer Price Index	2.7	2.7	3.2	3.0
GDP Deflator	3.4	3.2	2.6	
Domestic demand deflator	2.6	2.4	3.0	

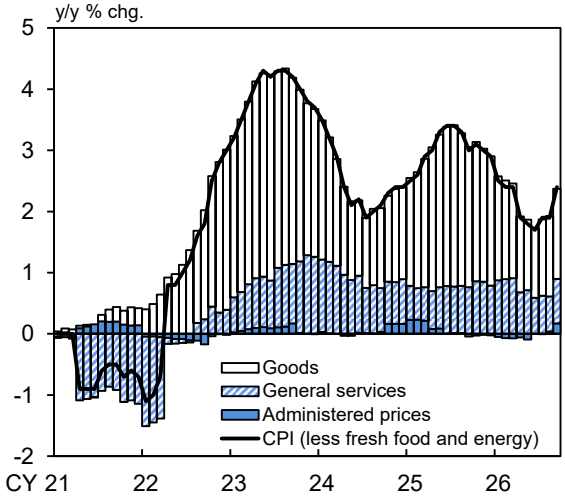
Sources: Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan, etc.
Notes: 1. CPI figures "less food and energy" include alcoholic beverages. Institutional factors = the effects of policies concerning the provision of free education (including the free school lunches starting in April 2026) + measures to reduce the energy cost burden (such as gasoline prices, electricity and gas charges). Figures are staff estimates.
2. Figures for the services producer price index (SPPI) exclude international transportation.

Chart 33: PPI



Source: Bank of Japan.
Notes: 1. Figures exclude the effects of the consumption tax rate change.
2. Figures for "beverages and foods, etc." include agriculture, forestry and fishery products.

Chart 34: CPI (Less Fresh Food and Energy)

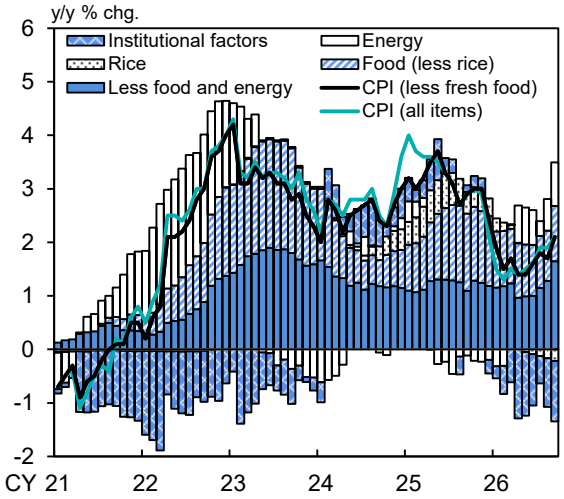


Source: Ministry of Internal Affairs and Communications.
Note: Administered prices consist of "public services" and "water charges."

year-on-year rate of increase has been in the range of 2.0-2.5 percent recently (Charts 32 and 35).

Regarding the breakdown of the CPI (all items less fresh food and energy), the year-on-year rate of increase in goods prices had been on a declining trend, mainly due to the decline in the rate of increase in food prices; more recently, however, the rate has seen an upturn reflecting moves to pass on the rise in import prices to selling prices (Chart 34).[18] While rice prices have declined significantly, the rate of increase in the prices of durable consumer goods has increased reflecting the expansion in AI-related demand and the depreciation of the yen, and the rates of increase in the prices of goods related to daily necessities and food products have also accelerated, reflecting moves to pass on the rise in energy and raw material prices associated with the situation in the Middle East to selling prices. The rate of increase in general services prices has accelerated. This is because prices for dining-out and services related to domestic duties have continued to rise, against the backdrop of wage increases and the rise in raw material costs, and more recently, price increases, including hotel charges, have been observed due to long holidays. The year-on-year rate of increase in administered prices (less energy) has accelerated, reflecting the discontinuation of measures to reduce, or provide exemptions for, water charges in some areas, in addition to a rise in medical fees.

Chart 35: CPI (Less Fresh Food)

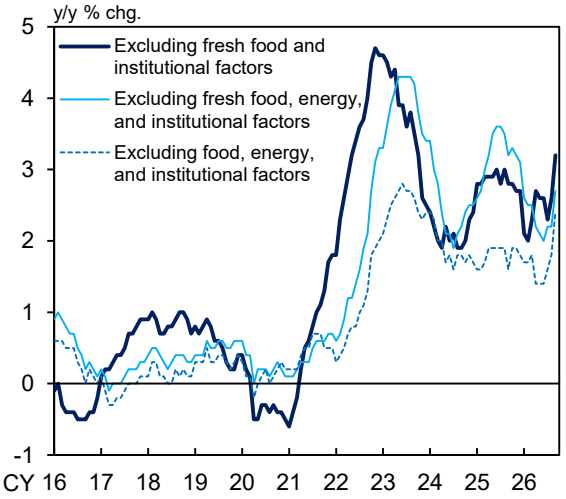


Sources: Ministry of Internal Affairs and Communications, etc.
Notes: 1. Figures for energy consist of those for petroleum products, electricity, and gas, manufactured & piped. Figures for food (less rice) exclude fresh food and alcoholic beverages.
2. Institutional factors = the effects of the consumption tax rate change and policies concerning the provision of free education (including the free school lunches starting in April 2026) + measures to reduce the energy cost burden (such as gasoline prices, electricity and gas charges) + the reduction in mobile phone charges in 2021 + travel subsidy programs. Figures are staff estimates.

[18] See Box 4 for developments in the spread of upward pressure on prices from business-to-business transactions to consumer prices.

From the perspective of capturing the underlying trend in the CPI,[19] looking at core indicators that exclude institutional factors -- such as the government's measures to reduce the household burden of higher energy prices and the provision of free education -- the year-on-year rate of increase in the CPI (all items less fresh food and energy, excluding institutional factors) had declined for a time to around 2 percent, mainly due to the decline in the rate of increase in food prices; however, the rate of increase has recently risen markedly to the range of 2.5-3.0 percent, reflecting the rise in the prices of durable consumer goods and goods related to daily necessities. Similarly, the year-on-year rate of increase in the CPI (all items less food and energy, excluding institutional factors) has also accelerated fairly substantially to around 2.5 percent. The year-on-year rate of increase in the CPI (all items less fresh food, excluding institutional factors) has been high recently, being in the range of 3.0-3.5 percent. This is because the rate reflects the impact that higher energy prices would have had if the government's measures to reduce the household burden of higher energy prices had not been implemented (Chart 36).[20] Core indicators calculated using information such as the price change distribution

Chart 36: CPI (Excluding Institutional Factors)



Sources: Bank of Japan, etc.
Note: Institutional factors = the effects of the consumption tax rate change and policies concerning the provision of free education (including the free school lunches starting in April 2026) + measures to reduce the energy cost burden (such as gasoline prices, electricity and gas charges) + the reduction in mobile phone charges in 2021 + travel subsidy programs. Figures are staff estimates.

[19] See Box 5 for an assessment of the degree to which underlying CPI inflation is anchored at the 2 percent level.

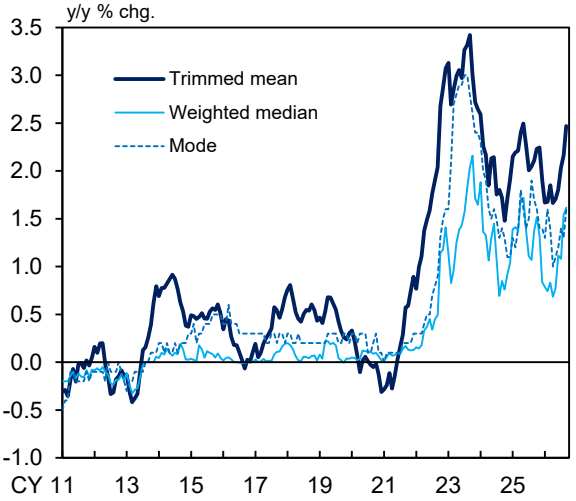
[20] Institutional factors refer to the effects of the consumption tax rate changes and policies concerning the provision of free education (including the free school lunches starting in April 2026), measures to reduce the energy cost burden (such as gasoline prices, electricity and gas charges), the reduction in mobile phone charges in 2021, and travel subsidy programs. The effects of institutional factors are staff estimates.

exhibited the following developments (Chart 37).[21] The rate of increase in the trimmed mean of the year-on-year rate of change in the CPI bottomed out in the range of 1.5-2.0 percent around this spring, and has recently risen to around 2.5 percent reflecting price rises for a wide range of goods related to daily necessities and other items. The rate of increase in the weighted median also bottomed out in the range of 0.5-1.0 percent around this spring, and has recently risen to around 1.5 percent. Similarly, the rate of increase in the mode declined to around 1 percent around this spring, but has recently accelerated to around 1.5 percent. Looking at the year-on-year price changes across all CPI items (less fresh food), the share of items whose prices have increased minus the share of items whose prices have decreased has increased since the middle of this year, reflecting an increase in the number of items whose prices have increased due to the pass-through of the rise in import prices to selling prices (Chart 38). Meanwhile, looking at the relationship between wages and services prices, with progress in the pass-through of wage increases to services prices of a wide range of items, both wages and services prices have been on a moderate increasing trend (Chart 39).

Indicators of medium- to long-term inflation expectations, which represent people's perceptions of price developments, have

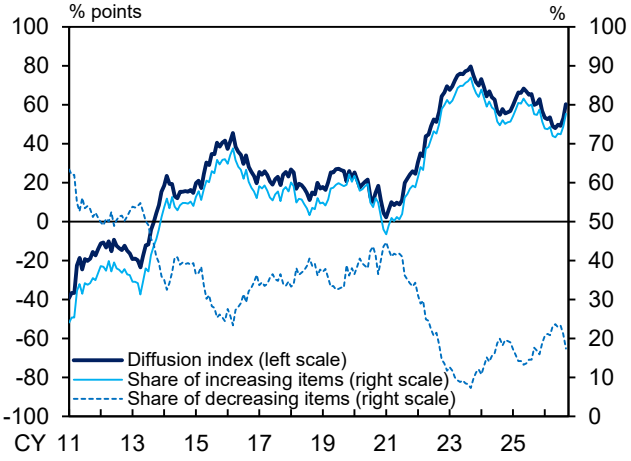
[21] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density in the price change distribution. The weighted median is the average of the inflation rates of the items at around the 50th percentile point of the cumulative distribution in terms of weight. Each indicator is calculated using data for each CPI item with the effects of institutional factors excluded.

Chart 37: CPI: Trimmed Mean, etc.



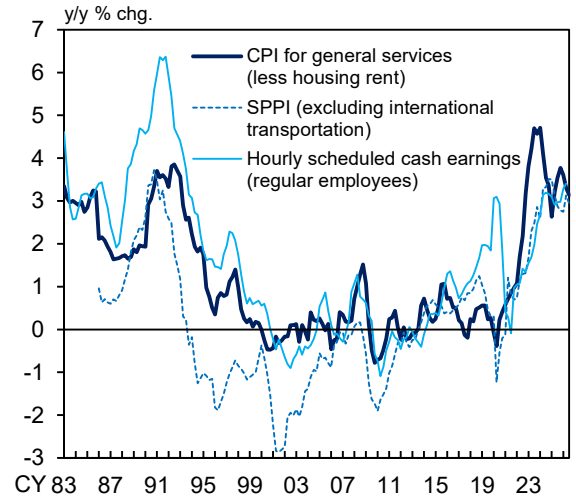
Sources: Bank of Japan, etc.
Note: Based on staff calculations using the CPI. The CPI figures are staff estimates and exclude institutional factors.

Chart 38: Diffusion Index of Price Changes



Sources: Bank of Japan, etc.
Note: The diffusion index is defined as the share of increasing items minus the share of decreasing items. The share of increasing/decreasing items is the share of items for which price indices increased/decreased from a year earlier. Based on staff calculations using the CPI (less fresh food). The CPI figures are staff estimates and exclude institutional factors.

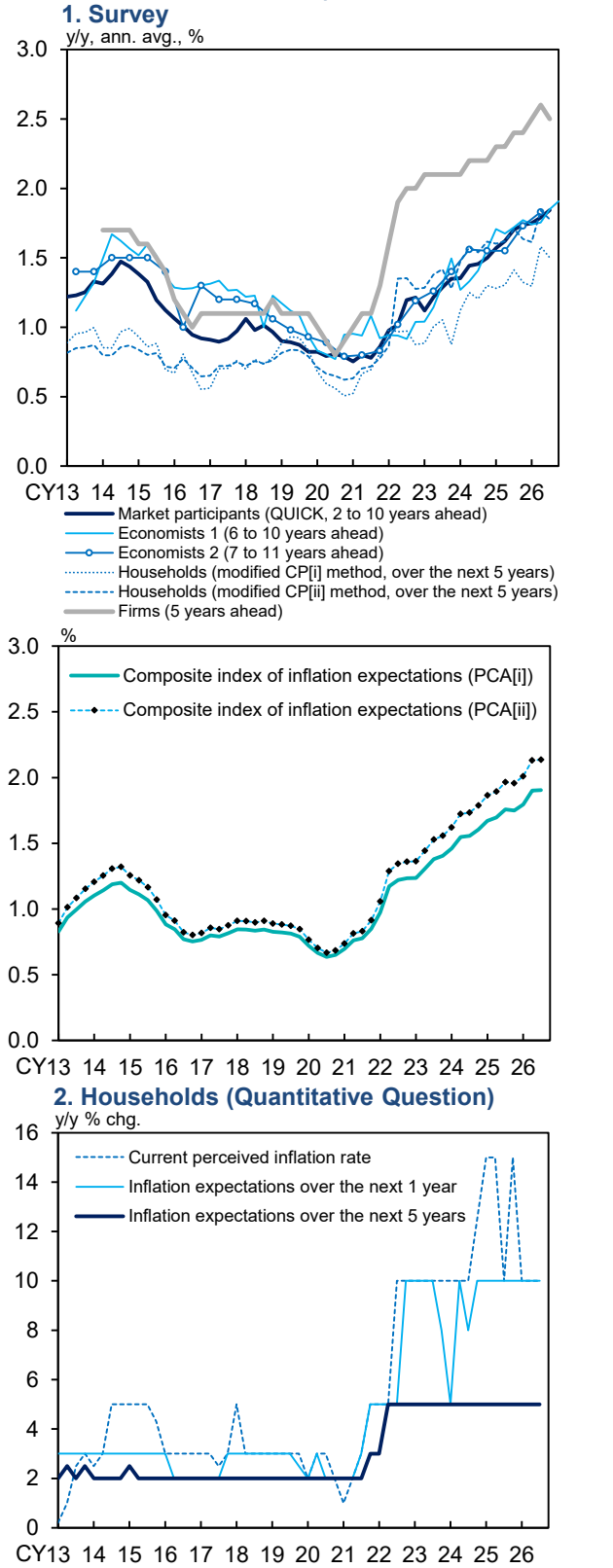
Chart 39: Wages and Prices



Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.
Notes: 1. Figures for the CPI for general services (less housing rent) are staff estimates and exclude institutional factors.
2. Figures for the SPPI (excluding international transportation) are estimated excluding the effects of the consumption tax rate changes.
3. Figures for hourly scheduled cash earnings (regular employees) are seasonally adjusted (3-quarter central moving averages). Moreover, figures from 2016/Q1 onward are based on continuing observations following the sample revisions.
4. The figure for hourly scheduled cash earnings (regular employees) for 2026/Q3 is the July-August average.

increased moderately on the whole, and are at around 2 percent (Chart 40).[22] Medium- to long-term inflation expectations of firms have remained on a moderate uptrend and have been above 2 percent. Medium- to long-term inflation expectations of experts have continued to rise moderately, and have been approaching 2 percent. As for medium- to long-term inflation expectations of households, estimates based on responses to qualitative questions have continued to rise moderately.[23,24] Meanwhile, responses to quantitative questions indicate that medium- to long-term inflation expectations of households have continued to be well above 2 percent.[25] The break-even inflation (BEI) rate, derived from inflation-indexed government bonds, has been at around 2 percent, albeit with some fluctuations. Regarding trend inflation estimated from economic models, all of the models have shown a

Chart 40: Inflation Expectations



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.

Notes: 1. "Economists 1" shows the forecasts of economists in the *Consensus Forecasts*. "Economists 2" shows the forecasts of forecasters surveyed for the *ESP Forecast*.
2. Figures for households (modified CP[i] method) are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method for a five-choice qualitative question. The modified CP[ii] method additionally accounts for time variation in the distribution of responses. Figures for the quantitative question, which are from the same survey, show trends in the median.
3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.
4. The composite indexes of inflation expectations are for 10-year-ahead expectations. They are staff estimates and are obtained by extracting the common component, using principal component analysis (PCA), from the inflation expectations of households (modified CP[ii] method), firms, and experts. For details on PCA[i] and PCA[ii], see "The Concept and Measurement of Underlying Inflation," Bank of Japan Monetary Affairs Department, March 2026.

[22] For details on the concept and measures of underlying inflation, see the following paper: Monetary Affairs Department, Bank of Japan, "The Concept and Measurement of Underlying Inflation," *Bank of Japan Review Series*, March 2026.

[23] The estimates are based on the *Opinion Survey on the General Public's Views and Behavior* (Opinion Survey), and are calculated using the modified Carlson Parkin method to quantify the results of the five-choice question asking respondents whether and how much they expect prices to rise or fall.

[24] When estimating households' inflation expectations based on qualitative survey responses, the modified Carlson Parkin method is used. Previously, estimates were made under the assumption that the inflation rates that respondents associate with the response options in the survey ("will go up" or "will go down") remain constant over time. However, given that quantitative responses to the questions on respondents' perceptions of inflation have been rising in recent years, it appears highly likely that the assumption that the inflation rates associated with these response options remain constant over time no longer holds. Therefore, Chart 40 also presents estimates that relax this assumption by employing a smooth transition model. A comparison of the new estimates with the previous ones shows that, although the pattern over time is broadly unchanged, the new estimates are around 0.3 percentage points higher than the previous estimates from around 2022 onward.

[25] The data are based on the Opinion Survey, and represent the medians of numerical values for expected inflation rates provided by respondents.

moderate uptrend, with estimates at around 2 percent (Chart 41).[26]

Based on the above developments in various indicators, underlying CPI inflation is at a level that is generally consistent with the price stability target of 2 percent.

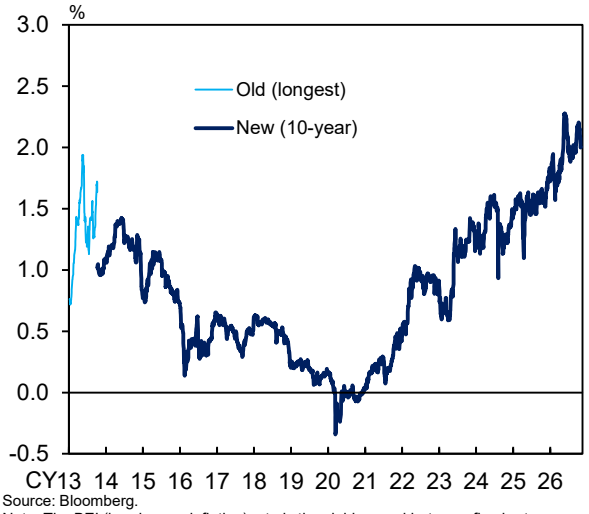
Meanwhile, a decomposition of changes in the GDP deflator from the distribution side shows that, while the acceleration in the rate of increase in the GDP deflator observed in 2023 was mainly led by unit profits as firms passed on cost increases, the contribution of unit labor costs has intensified since 2024, reflecting wage increases (Chart 42). More recently, while the positive contribution of unit profits has decreased reflecting the rise in energy and raw material prices, unit labor costs have continued to increase steadily. In this situation, the year-on-year rate of increase in the GDP deflator has been at around 2.5 percent.

Environment Surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is expected to remain positive at around its current level throughout the projection period (Chart 2). Meanwhile, it is likely that labor market conditions have tightened to a greater extent than can be explained by the changes in the output gap, mainly due to a

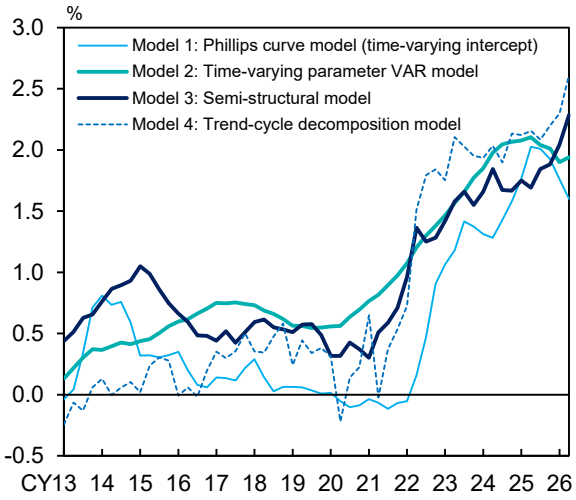
[26] Trend inflation should be interpreted with some latitude, taking into account the following points among others: (1) the estimates are susceptible to being influenced by the most recent data; and (2) there is the so-called "real-time problem," in which past estimates are subject to substantial revisions whenever the data used for the estimation are updated.

3. BEI



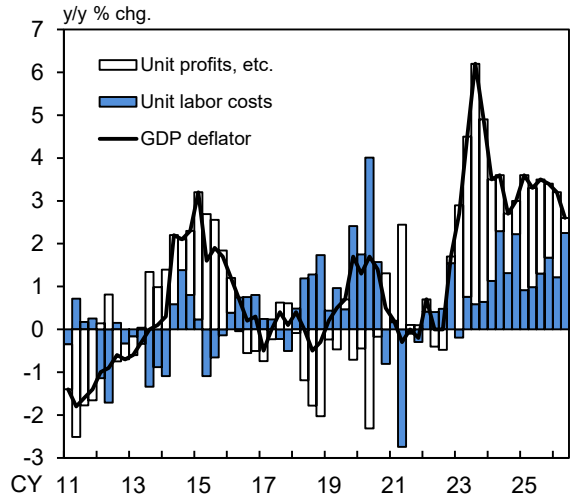
Source: Bloomberg.
Note: The BEI (break-even inflation) rate is the yield spread between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of inflation-indexed JGBs, which matured in June 2018.

Chart 41: Trend Inflation



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Cabinet Office; Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg; Google Trends.
Note: Figures are staff estimates.

Chart 42: GDP Deflator



Source: Cabinet Office.
Note: Unit labor costs = Nominal compensation of employees / Real GDP

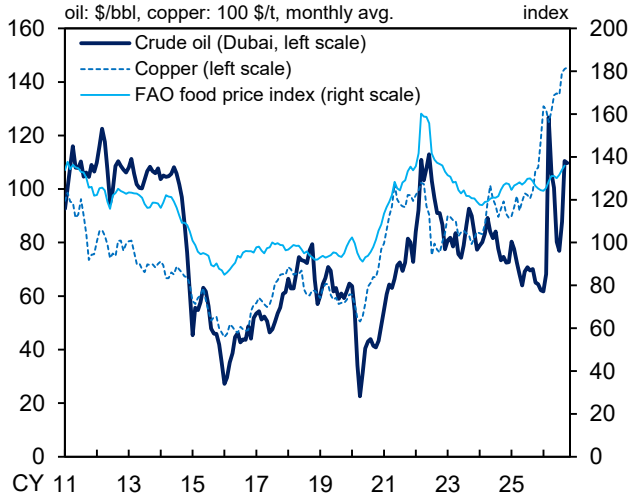
deceleration in the pace of increase in labor force participation of women and seniors (Chart 23). In this situation, upward pressure on wages and prices likely has become stronger than suggested by the output gap, given the current situation that labor shortages have begun to cause supply-side constraints, mainly in industries in nonmanufacturing that are labor-intensive.

Second, medium- to long-term inflation expectations are at around 2 percent (Chart 40). Regarding the outlook, inflation expectations are likely to remain broadly around their current level, as firms' active wage- and price-setting behavior is expected to be maintained on the back of factors such as the tightening of labor market conditions.

Third, the year-on-year rate of increase in the import price index on a yen basis has increased substantially due to a rise in the rate of increase in the index on a contract currency basis reflecting the situation in the Middle East and the expansion in global AI-related demand, as well as to the impact of the yen's depreciation (Charts 43 and 44). For the time being, import prices are likely to continue to see a significant pace of increase at around the current level. Subsequently, the rate of increase in the import price index is projected to decelerate gradually, reflecting a decline in commodity prices, including crude oil.

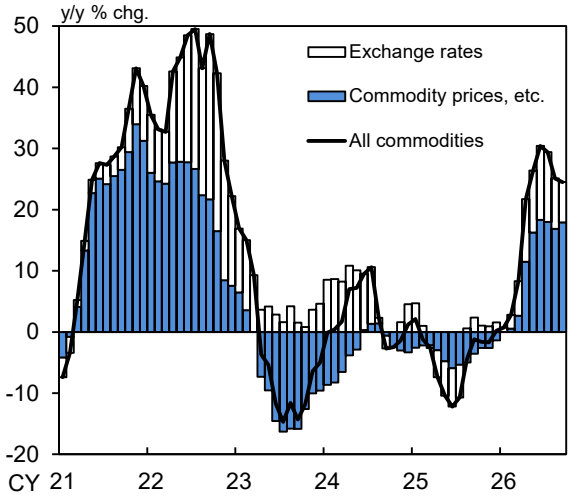
Meanwhile, the year-on-year rate of change in energy prices (e.g., gasoline prices and electricity charges) has been at around 0 percent, as the impact of the rise in crude oil prices has been

Chart 43: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg; FAO.
Note: The FAO food price index is a price index comprising meat, dairy, cereals, vegetable oils, and sugar (CY 2014-2016 average=100).

Chart 44: Import Prices (Yen Basis)



Source: Bank of Japan.
Note: The contribution of changes in commodity prices, etc. is calculated using changes in the import price index on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between the import price index on a yen basis and that on a contract currency basis.

contained owing to the government's measures to reduce the household burden of higher energy prices, such as fuel oil subsidies. Assuming that foreign exchange rates will remain at around the current levels, and given price developments in crude oil futures and the government's measures to reduce the household burden of higher energy prices, the year-on-year rate of change in energy prices is likely to increase significantly through around the end of this fiscal year, mainly reflecting rises in electricity and gas charges. Thereafter, reflecting the decline in crude oil prices, the year-on-year rate of change in energy prices is likely to follow a decelerating trend, albeit with fluctuations, and turn negative toward the end of the next fiscal year.

Outlook for Prices

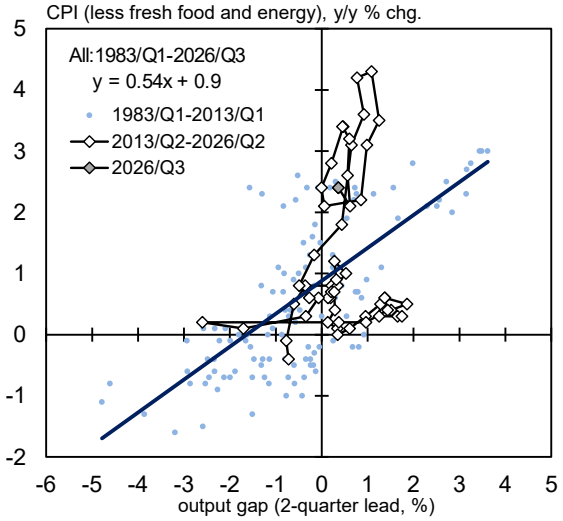
Based on the aforementioned environment surrounding prices, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is expected to accelerate to a level above 3 percent toward the beginning of the next fiscal year. This is because (1) the rise in energy and raw material prices reflecting the situation in the Middle East is expected to exert even greater upward pressure on the prices of goods, such as food, durable goods, and daily necessities, and some services prices and (2) moves to pass on the rise in the prices of semiconductors, copper, and other items, reflecting the expansion in AI-related demand, and the depreciation of the yen thus far to selling prices are expected to become more evident, particularly among durable goods. Subsequently, the rate of increase in this CPI is likely to decline, as firms' price-setting stance becomes more cautious reflecting a slowdown in consumption with some time lag.

Toward the end of the projection period, the rate of increase in this CPI is likely to be in the range of 2.0-2.5 percent, as the impact of the rise in import prices is expected to wane, with moves to pass on wage increases to selling prices taking hold in a wide range of items in both goods and services (Chart 45).

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to accelerate at a faster pace than the CPI (all items less fresh food and energy), as the upward contribution of energy prices is expected to increase markedly through the second half of this fiscal year, mainly due to the rise in electricity and gas charges. Thereafter, toward the end of the projection period, the rate of increase in the CPI (all items less fresh food) is expected to follow a decelerating trend and be at around 2 percent, when fluctuations are smoothed out, as energy prices turn to a decline reflecting a decline in crude oil prices.

Firms' behavior has shifted more toward raising wages and prices, and it is likely that the mechanism in which both wages and prices rise moderately will be maintained if the economy develops as assumed in the baseline scenario. That said, since changes in foreign exchange rates have exerted a greater impact on domestic prices partly reflecting a rise in the import penetration ratio, if the yen depreciates further, or if upward pressure on prices strengthens from the demand side as a result of AI-related demand rising further than expected, there is also a possibility that the rates of increase in wages and prices will both deviate upward from the baseline scenario, accompanied by a rise in medium- to

Chart 45: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude institutional factors.
2. Figures for the output gap are staff estimates.

long-term inflation expectations. On the other hand, if the downward effects of a deterioration in trading gains on corporate profits, for example, become amplified and prolonged, this could lead firms to focus on cost cutting to a greater extent than expected; consequently, upward pressure on wages could weaken, and inflation could decline from a somewhat long-term perspective.

III. Financial Developments in Japan

Financial Conditions

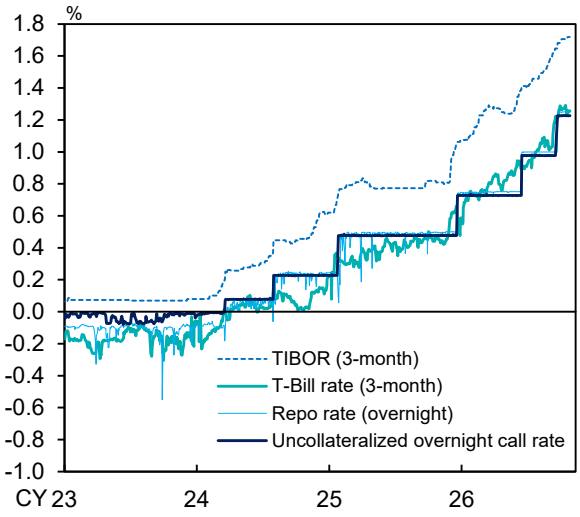
Financial conditions have been accommodative.[27]

Looking at short-term interest rates, the uncollateralized overnight call rate had been at around 1.0 percent and has been at around 1.25 percent since the policy interest rate was raised at the September Monetary Policy Meeting (Chart 46). Regarding interest rates on term instruments, both the 3-month TIBOR and the 3-month treasury discount bill (T-Bill) rate have risen.

Real interest rates have been rising recently but have remained at low levels, mainly in the short-term zone (Chart 47).

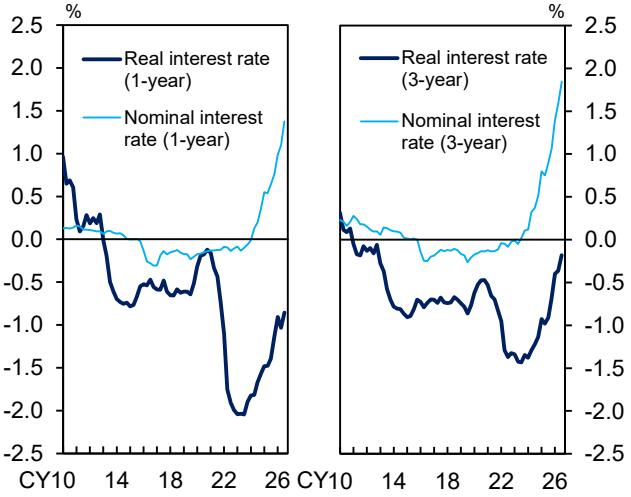
Firms' funding costs have increased (Chart 48). As for lending rates (the average interest rates on new loans and discounts), both long-term and short-term ones have risen, due to a rise in market interest rates, which serve as base rates. Issuance rates for CP have increased, in tandem with the rise in short-term interest rates. Issuance rates for corporate bonds have risen, reflecting the increase in their base rate. Meanwhile, looking at funding costs on a stock basis, the average interest expense rate for corporates has remained sufficiently low relative to firms' profitability, such as return on assets (ROA) (Chart 49).

Chart 46: Short-term Interest Rates



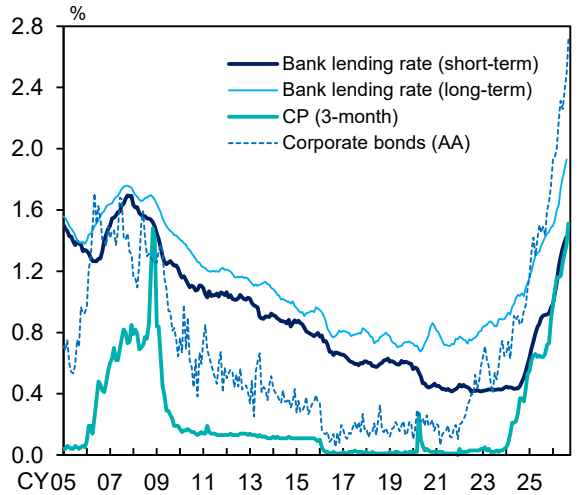
Sources: Bank of Japan; JBA TIBOR Administration; Bloomberg.
Note: Figures for repo rate are the *Tokyo Repo Rate*.

Chart 47: Real Interest Rates



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.
Note: Real interest rates are calculated as nominal government bond yields minus the composite index of inflation expectations (staff estimates).

Chart 48: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



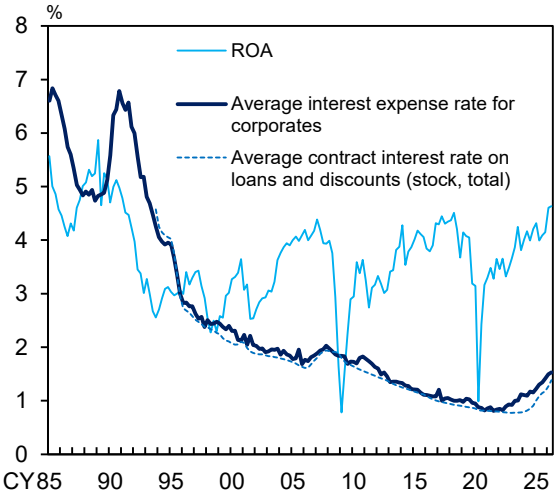
Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.
Notes: 1. Figures for issuance yields for CP up through September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 onward are the averages for CP (3-month, rated a-1).
2. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc. are excluded.
3. Figures for bank lending rates are 6-month backward moving averages.

[27] See Box 6 for the framework for assessing financial conditions, and the assessment of recent financial conditions in Japan.

The DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 50). The DI for issuance conditions for CP has continued to show net "easy" conditions. As suggested by the latter, issuance conditions for CP and corporate bonds have been favorable. Meanwhile, the DI for firms' financial positions in the *Tankan* suggests that they have been at favorable levels on the back of the recovery in economic activity and progress in the pass-through of cost increases to selling prices (Chart 51).

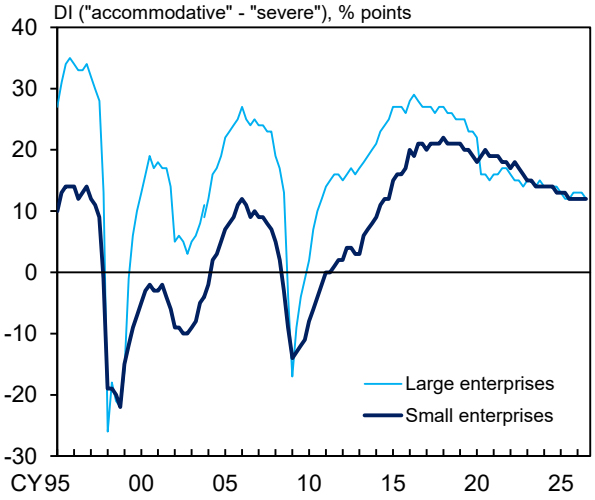
According to surveys such as the *Tankan* and anecdotal information from firms gathered by the Bank's staff at the Head Office and branches, the number of firms that point to a rising interest payment burden has increased somewhat compared with a while ago in industries with a large number of firms that are small in size and have a high ratio of interest-bearing debt.

Chart 49: Firms' Funding Costs and Profitability



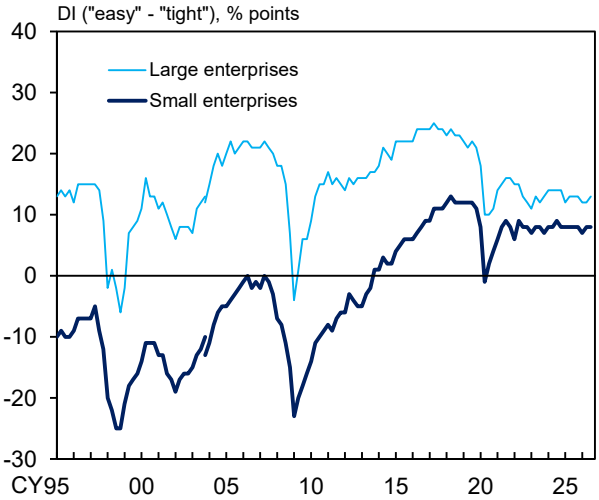
Sources: Ministry of Finance; Bank of Japan.
Notes: 1. ROA is calculated as operating profits divided by total assets. The average interest expense rate for corporates is calculated as interest payments divided by interest-bearing debt. Figures for these items are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. All enterprises. Figures exclude "finance and insurance" and those for 2009/Q2 onward also exclude "pure holding companies." Seasonally adjusted.
2. The average contract interest rate on loans and discounts is based on domestically licensed banks.

Chart 50: Lending Attitudes of Financial Institutions as Perceived by Firms



Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Chart 51: Firms' Financial Positions

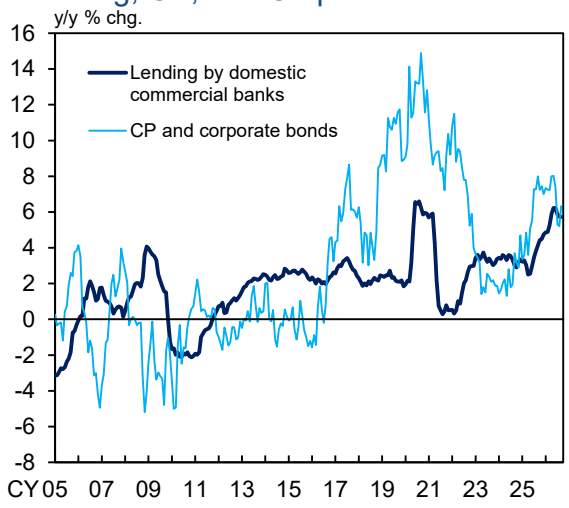


Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Firms' demand for funds has increased on the back of, for example, the recovery in economic activity as well as mergers and acquisitions of firms. In this situation, the year-on-year rate of increase in the amount outstanding of bank lending has remained high, in the range of 5.5-6.0 percent (Chart 52). The year-on-year rate of increase in the aggregate amount outstanding of CP and corporate bonds has continued to be elevated, in the range of 5.0-6.5 percent, although the rate of increase has decelerated due to factors such as the dissipation of the effects of large-scale issuances. Meanwhile, the average maturity of newly issued corporate bonds has shortened slightly, partly reflecting a decrease in the issuance amount of super-long-term corporate bonds compared with a while ago.

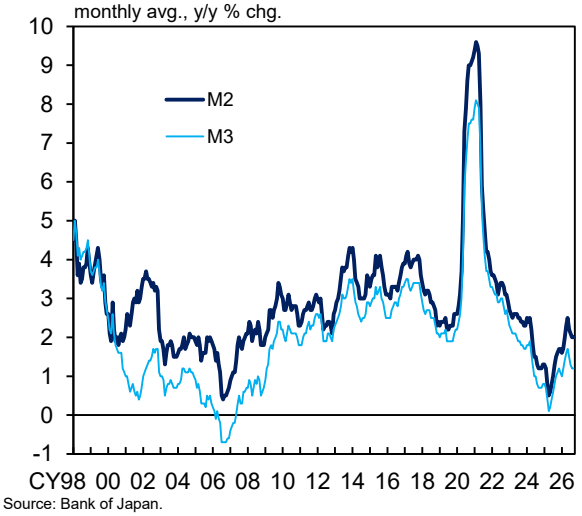
The year-on-year rate of change in the money stock (M2) has been at around 2 percent, as an increase in the amount outstanding of bank lending has continued to push up the rate (Chart 53).

Chart 52: Amounts Outstanding of Bank Lending, CP, and Corporate Bonds



Sources: Bank of Japan; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems.
Note: Figures for lending by domestic commercial banks are monthly averages. Figures for CP and corporate bonds are those at the end of the period.

Chart 53: Money Stock



Source: Bank of Japan.

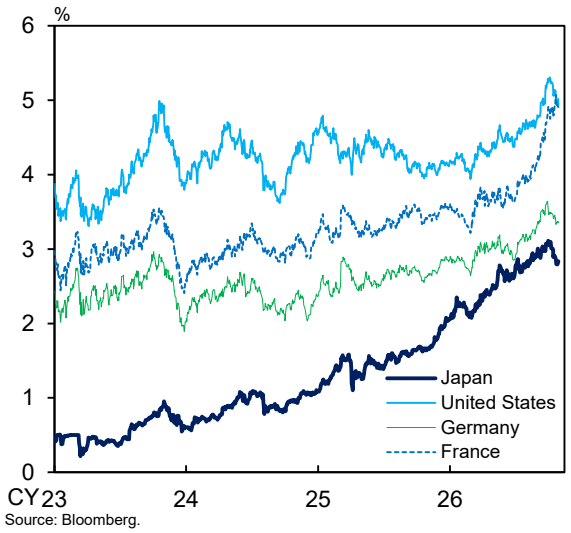
Developments in Financial Markets

In global financial markets, although a recovery in global economic sentiment and solid corporate profits have been having the effect of improving market sentiment, attention has focused on factors such as the uncertainties over the situation in the Middle East.

Yields on 10-year government bonds in the United States rose significantly through early October, mainly due to heightened inflationary pressure stemming from the situation in the Middle East and generally favorable economic indicators (Chart 54). Thereafter, with moves to buy back U.S. treasuries strengthening, mainly reflecting growing concern over the finances of some AI-related firms, those yields have declined recently. In Europe, yields on 10-year government bonds in France have risen significantly, reflecting growing concerns over the country's fiscal policy and political situation. In this situation, yields on 10-year government bonds in Germany have declined recently due to investors' risk aversion. In Japan, yields on 10-year government bonds rose through early October, with attention being drawn to heightened inflationary pressure, as in the United States and Europe. Thereafter, they have declined, mainly due to the decline in U.S. interest rates and the solid results of Japanese government bond auctions.

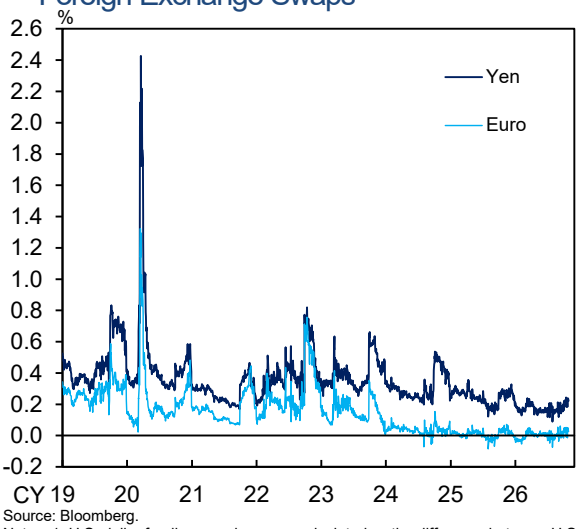
Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have generally been at low levels (Chart 55).

Chart 54: 10-Year Government Bond Yields in Selected Advanced Economies



Source: Bloomberg.

Chart 55: Dollar Funding Premiums through Foreign Exchange Swaps



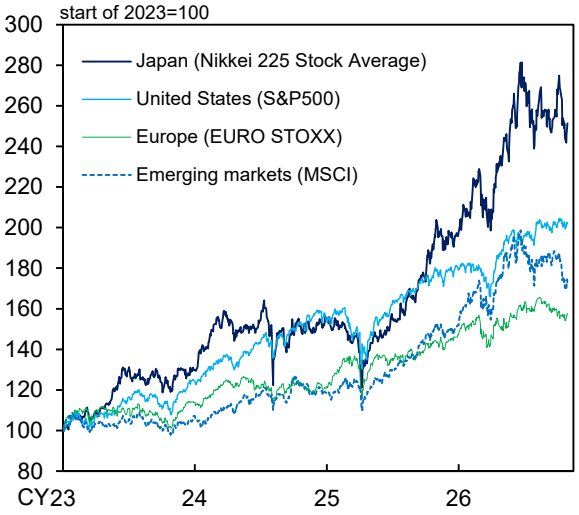
Source: Bloomberg.

Notes: 1. U.S. dollar funding premiums are calculated as the difference between U.S. dollar fundings rates (3-month) in the dollar/yen or euro/dollar foreign exchange swap market and those in the money market.

2. The interest rates used for the calculation are as follows: for the yen, the OIS rate; for the euro, the EONIA-referencing OIS rate before October 4, 2019, and the €STR-referencing OIS rate thereafter; for the U.S. dollar, the OIS rate before January 3, 2019, and the SOFR thereafter.

Stock prices in the United States, after rising significantly on the back of factors such as favorable economic indicators and solid corporate profits, have recently declined, mainly reflecting growing concern over the finances of some AI-related firms (Chart 56). Stock prices in Europe have declined, partly reflecting market attention to, for example, concerns over the fiscal policy and political situation in France. Stock prices in Japan, after rising on the back of factors such as solid corporate profits, have recently declined in line with U.S. stock prices. Meanwhile, stock prices in emerging economies have declined slightly.

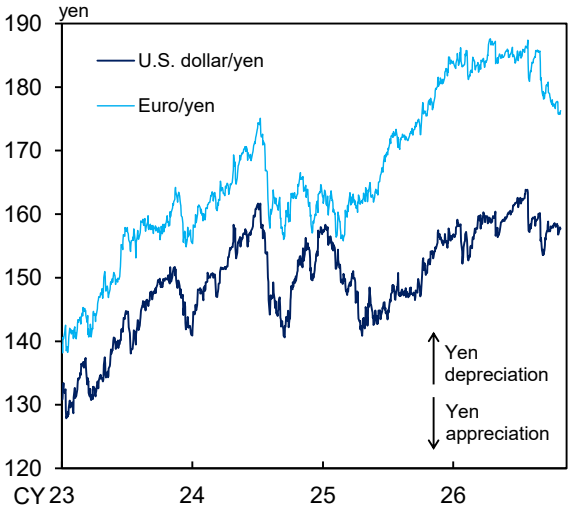
Chart 56: Selected Stock Price Indices



Source: Bloomberg.
Note: Figures for emerging markets are those for the MSCI Emerging Markets Index (local currency).

In foreign exchange markets, the yen appreciated significantly against the U.S. dollar through mid-September, reflecting developments such as the coordinated foreign exchange intervention by Japan and the United States. Although it depreciated at times thereafter, reflecting, for example, market speculation over the Federal Reserve's monetary policy, the yen has appreciated against the U.S. dollar over the observed period (Chart 57). The yen has also appreciated against the euro.

Chart 57: U.S. Dollar/Yen and Euro/Yen

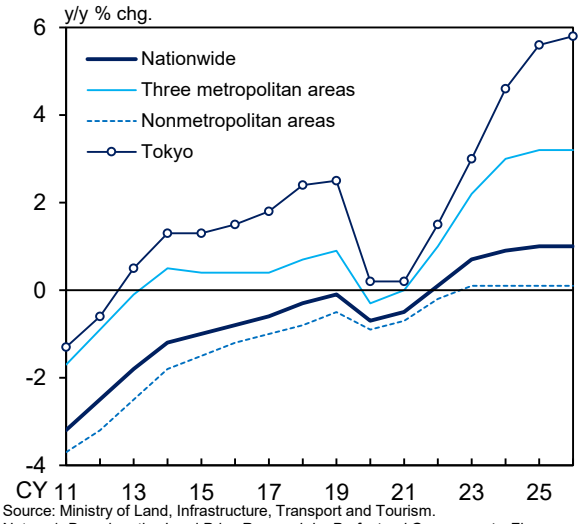


Source: Bloomberg.

Land Prices

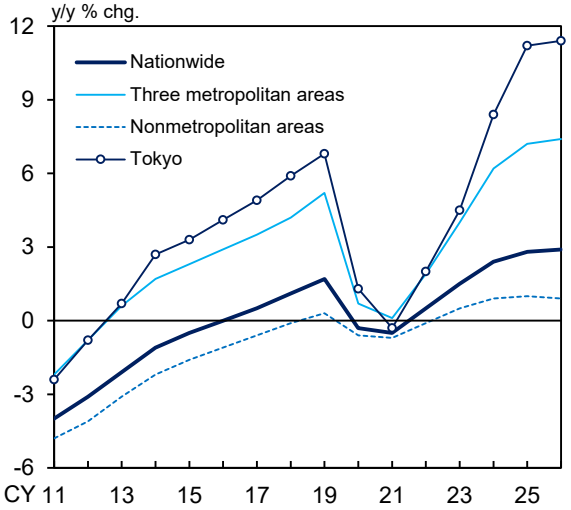
Land prices, mainly commercial land prices in the three major metropolitan areas (Tokyo, Osaka, and Nagoya), have increased, reflecting the economic recovery. According to the *Land Price Research by Prefectural Governments* for 2026 (as of July 1), the year-on-year rate of increase in residential land prices has been flat, whereas that in commercial land prices has accelerated slightly (Charts 58 and 59). In the three major metropolitan areas, as is the case nationwide, the year-on-year rate of increase in residential land prices has been flat, whereas that in commercial land prices has accelerated slightly. In nonmetropolitan areas, the rate of increase in residential land prices has been flat, while the rate of increase in commercial land prices has decelerated slightly.

Chart 58: Residential Land Prices



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Based on the *Land Price Research by Prefectural Governments*. Figures are as of July 1.
2. The three metropolitan areas are the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Nonmetropolitan areas are areas other than the three metropolitan areas.

Chart 59: Commercial Land Prices



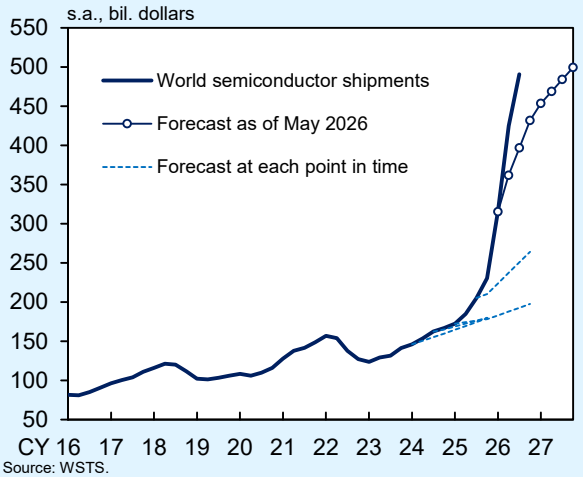
Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Based on the *Land Price Research by Prefectural Governments*. Figures are as of July 1.
2. The three metropolitan areas are the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Nonmetropolitan areas are areas other than the three metropolitan areas.

(Box 1) Developments in AI-Related Demand and Risks to the Outlook for Japan's Economy

Global AI-related demand has expanded further since the previous Outlook Report, positively affecting Japan's exports and production as well as corporate profits in the manufacturing industry (Chart B1-1). This box reviews the current state of Japan's AI-related exports and then examines the risks that the global AI investment boom poses to Japan's economy from a medium- to long-term perspective.

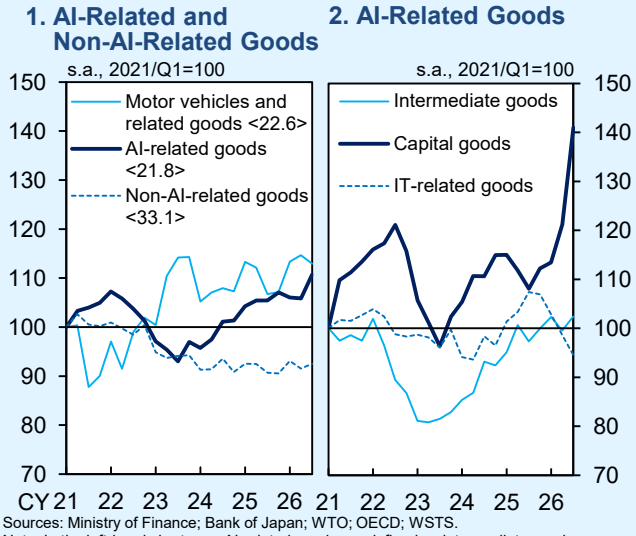
A breakdown of Japan's exports into items driven by AI-related demand (hereafter, "AI-related goods"),[28] and items that are not, shows that growth in exports of AI-related goods has accelerated recently, driving the increase in overall exports (Chart B1-2). Strong investment in data centers by hyperscalers has steadily widened the scope of induced demand, starting with demand for semiconductor-related goods and extending to that for supporting equipment. Among Japan's exports, capital goods -- particularly semiconductor production equipment, industrial robots, and equipment related to electric power and air conditioning -- have been enjoying greater benefits from this investment. Sources such as the September 2026 *Tankan* and the October 2026 *Regional Economic Report* suggest that the positive effects of the expansion in AI-related demand have been feeding through to

Chart B1-1: World Semiconductor Shipments



Source: WSTS.
Notes: 1. Based on staff calculations using WSTS data.
2. The figure for world semiconductor shipments for 2026/Q3 is the July-August average.
3. Figures for the "forecast at each point in time" are as of May 2024, November 2024, May 2025, and November 2025.

Chart B1-2: Real Exports of AI-Related Goods



Sources: Ministry of Finance; Bank of Japan; WTO; OECD; WSTS.
Note: In the left-hand chart, non-AI-related goods are defined as intermediate goods, capital goods, and IT-related goods excluding AI-related goods. Figures in angular brackets show the share of each type of goods in Japan's total exports in 2025.

[28] For details on AI-related goods, see Box 4 of the April 2026 Outlook Report (Impact of Increased AI-Related Demand on Japan's Exports).

small and medium-sized firms, particularly in the electronics and capital goods sectors.

Regarding the outlook, capital goods exports are expected to continue growing firmly for the time being, given that machinery orders from overseas -- a leading indicator of capital goods exports -- have increased substantially since the second half of 2025 (Chart B1-3).

However, attention is warranted on the possibility that the global AI investment boom is being supported by financial markets' expectations regarding the future profitability of AI-related firms and productivity gains from AI as a general purpose technology. In fact, in the United States, the current phase is characterized by more pronounced increases in both stock prices and the business fixed investment-to-GDP ratio than in past economic expansions (Chart B1-4). The risk index for financial markets estimated and published by the IMF in its *Global Financial Stability Report* (GFSR) has also declined to its lowest level apart from the period before the Global Financial Crisis or during the dot-com bubble, reflecting higher stock prices of AI-related firms in particular (Chart B1-5).[29] This suggests that, on the back of expectations for the future of AI technology, investors may have been more

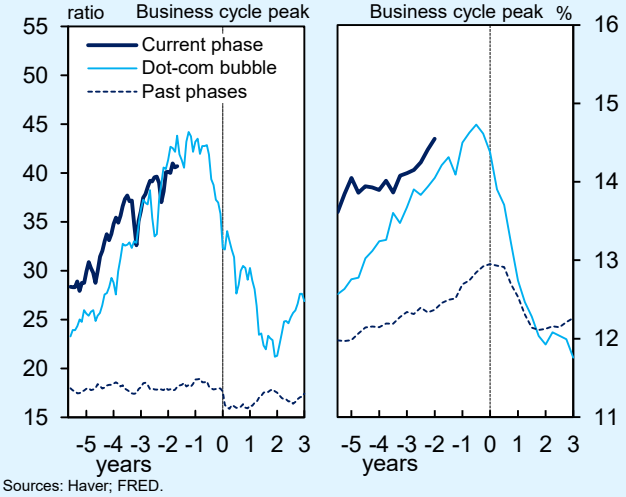
Chart B1-3: Exports of Capital Goods and Machinery Orders from Overseas



Sources: Ministry of Finance; Cabinet Office.
Note: The figure for machinery orders from overseas for 2026/Q3 is the July-August average.

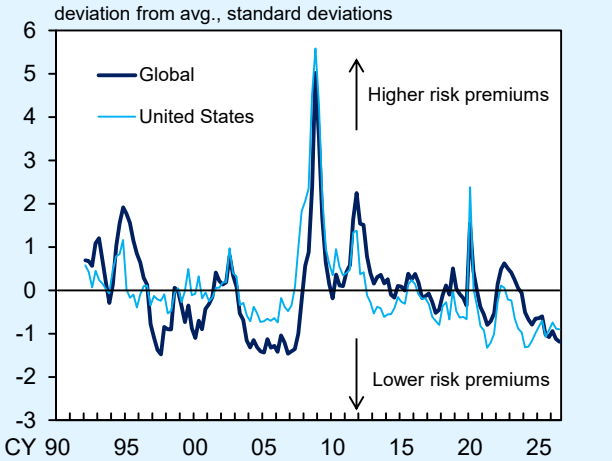
Chart B1-4: Historical Comparison (U.S.)

1. CAPE (S&P) **2. Investment-to-GDP Ratio**



Sources: Haver; FRED.
Notes: 1. The "past phases" lines show the average values around recession phases (excluding the post-dot-com bubble period) from 1960 onward. The "dot-com bubble" and "current phase" lines start in August 1995 (1995/Q3), when Windows 95 was released, and in November 2022 (2022/Q4), when a conversational generative AI service was released, respectively. The latest figures are as of October 2026 in the left-hand chart, and 2026/Q2 in the right-hand chart.
2. CAPE is calculated as the current stock price divided by the average earnings per share (adjusted for inflation) over the past 10 years.

Chart B1-5: Risk Index for Financial Markets



Source: IMF.
Note: Figures are from the IMF's Financial Conditions Index. Figures are normalized using the average and standard deviation over the entire sample period for each series.

[29] As explained in the GFSR, the IMF's Financial Conditions Index (FCI) is an index constructed to capture the price of risk. Therefore, the FCI primarily includes price-based indicators in financial markets, such as stock prices (i.e., price-to-book ratios) and various interest rate indicators, while it does not include balance sheet- or credit-related indicators, such as debt levels or leverage. Given these features of the FCI, this box refers to it as the "risk index for financial markets."

active in risk-taking in global financial markets, particularly in the United States.

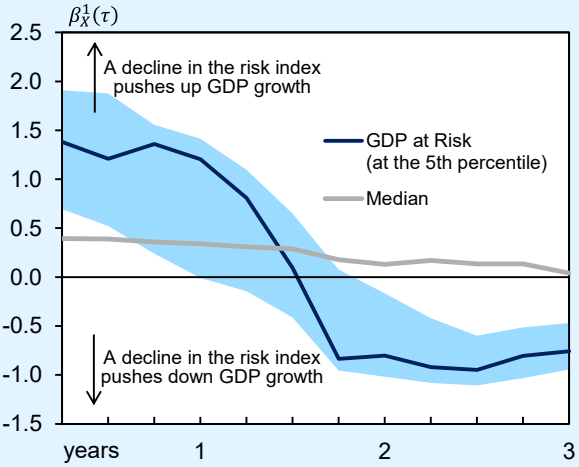
To assess risks to Japan's future economic growth posed by these global financial market conditions, the GDP-at-Risk (GaR) approach was used to estimate risks to GDP growth (Chart B1-6[1]).[30] The results show that the recent decline in the global risk index for financial markets significantly pushes up the growth rate at the fifth percentile of the predictive distribution for Japan's real GDP growth over the next year but significantly pushes it down over the next two to three years (Chart B1-6[2]). In fact, estimates of the predictive distribution for Japan's GDP growth reveal that incorporating the global risk index for financial markets results in a thinner lower tail over the next year (indicating reduced downside risks) but a thicker lower tail over the next three years (indicating greater downside risks) (Chart B1-6[3]). The risk index for financial markets does not, however, have a significant effect on growth rates near the median (i.e., the more likely scenarios). The above results therefore relate specifically to downside tail risk, as measured by the fifth percentile of the predictive distribution.

Chart B1-6: GDP at Risk

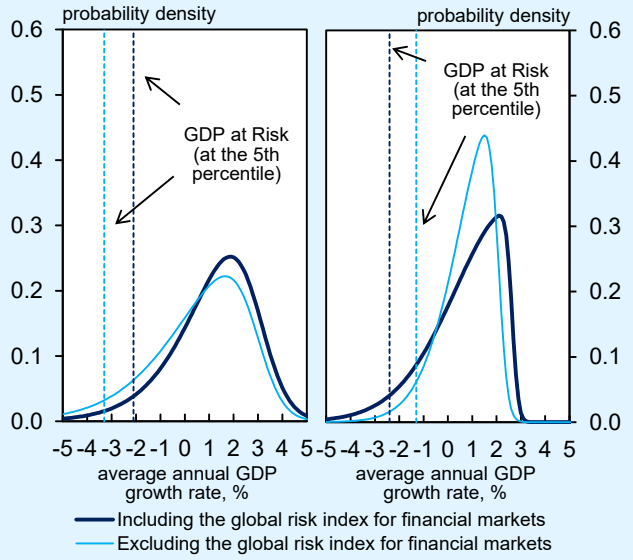
1. Estimation Method

Average growth rate of real GDP
for each country over the next X years (τ)
$= -\beta_X^0(\tau)$ × Country-specific risk index for financial markets
$- \beta_X^1(\tau)$ × Global risk index for financial markets
$+ \beta_X^2(\tau)$ × Country-specific credit expansion dummy
+ Country-specific control variables + Error term
The estimation sample covers 11 advanced economies, including the United States, Germany, France, and Japan.
The estimation period is from 1992/Q1 to 2026/Q2.

2. Coefficients on the Global Risk Index for Financial Markets



3. Japan's GDP at Risk



Sources: IMF; BIS; OECD.
Notes: 1. The country-specific credit expansion dummy takes a value of 1 for periods in which the credit-to-GDP ratio over the past eight quarters falls within the top 30 percent for each country. The control variables are the interaction term between the risk index for financial markets and the credit expansion dummy, the inflation rate, the GDP growth rate, and country fixed effects at each quantile.
2. In the upper chart, the shaded area indicates the 90 percent confidence interval calculated using the bootstrap method.
3. In the lower charts, figures are estimated assuming that the credit-to-GDP ratio for 2026/Q2 is unchanged from the previous quarter. The distributions excluding the global risk index for financial markets are calculated by removing its contribution.

[30] Specifically, drawing on the methods in the following papers, panel data for major advanced economies, including Japan, were used to estimate the effects of the risk index for financial markets on real GDP growth across different quantiles and forecast horizons:

Adrian et al. (2022), "The Term Structure of Growth-at-Risk," *American Economic Journal: Macroeconomics*, 14(3), pp. 283-323.

Ma et al. (2026), "Transmission Growth-at-Risk: How Foreign Financial Vulnerabilities Shape U.S. Growth Prospects," International Finance Discussion Papers, 1442, Board of Governors of the Federal Reserve System.

The expansion in AI-related demand has recently gained momentum and could therefore present an upside risk to Japan's economy in the near term, particularly in terms of exports, production, and corporate profits. Over a somewhat longer horizon, however, if growth expectations for AI decline substantially, there is a risk that a tightening of global financial conditions, accompanied by a rapid repricing of stocks and a sharp slowdown in the race for AI development, could have a significant adverse impact on Japan's economy through a plunge in exports and production. In particular, as Japan's non-AI-related exports have remained subdued against the backdrop of improvements in China's export competitiveness in recent years, a slowdown in AI-related exports could substantially depress overall exports (Chart B1-2).

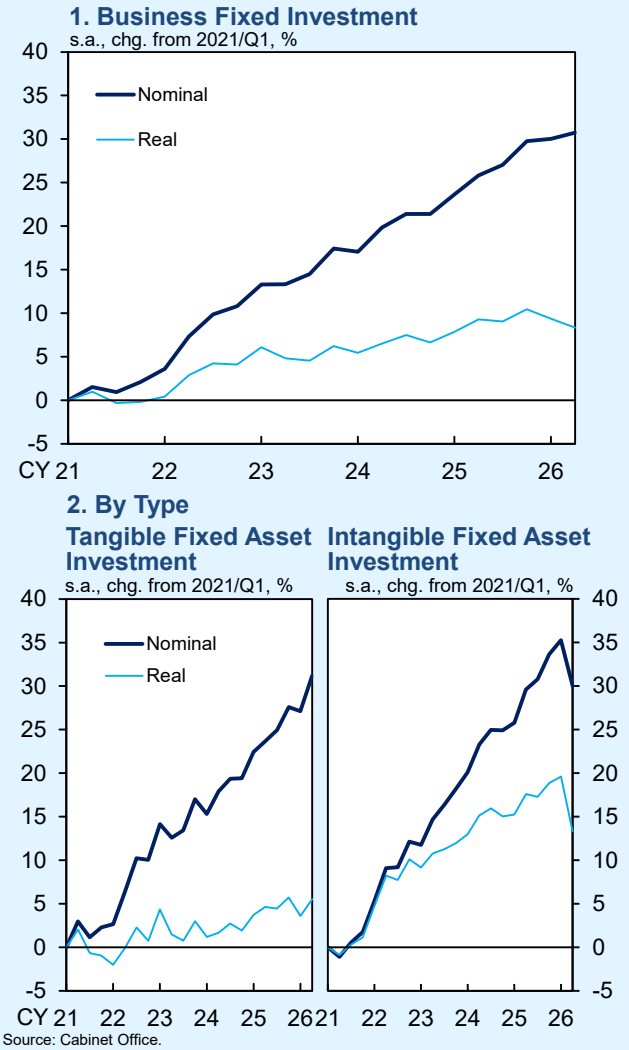
(Box 2) Supply-Side Constraints and Business Fixed Investment

Real business fixed investment in the April-June GDP statistics declined for the second consecutive quarter, primarily due to a significant fall in research and development (R&D) investment associated with the sale of patent rights abroad. However, even after excluding such temporary special factors, the growth momentum in real business fixed investment has recently been slower than that in nominal terms. This box examines recent developments in business fixed investment from the perspective of the impact of supply-side constraints.

Looking at the level of business fixed investment in GDP from a somewhat long-term perspective, in nominal terms, there has been a clear increase in such investment of around 30 percent, relative to the January-March quarter of 2021. However, about two-thirds of this increase has been offset by the rise in prices, i.e., the business fixed investment deflator, leaving the real growth rate limited to slightly below 10 percent; moreover, the sluggish trend in real investment has been intensifying recently (Chart B2-1[1]). By type of investment, the gap between nominal and real investments is prominent in tangible fixed assets (i.e., machinery and construction), which constitutes slightly over 60 percent of total business fixed investment for fiscal 2025 (Chart B2-1[2]).

Among tangible fixed asset investment, the dependence on imports for machinery investment has been increasing further following the

Chart B2-1: Nominal and Real Business Fixed Investment



Source: Cabinet Office.
Note: In the lower charts, figures for intangible fixed asset investment are calculated using the estimated values for the common estimate items of business fixed investment and the intellectual property products deflator. Figures for tangible fixed asset investment are calculated by subtracting intangible fixed asset investment from total business fixed investment.

COVID-19 pandemic, with digital-related investment serving as a driver (Chart B2-2). In this context, the degree to which nominal spending growth is offset by price hikes has been intensifying as a result of the significant increase in yen-denominated import prices of capital goods that reflects the recent yen depreciation and the rise in the price of memory chips and metals accompanying the expansion in AI-related demand (Chart B2-3).

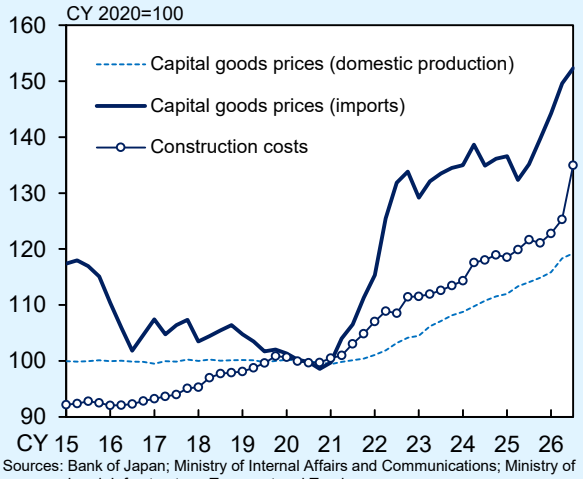
With respect to construction investment, supply-side constraints owing to labor shortages in the construction sector, coupled with the rise in material prices stemming from Russia's invasion of Ukraine and increased tension over the situation in the Middle East, have resulted in higher construction costs (Chart B2-3). In fact, total labor input in the construction sector -- that is, the number of employees multiplied by working hours per employee -- has fallen by around 10 percent from pre-pandemic levels, due not only to a decline in the number of employees with the retirement of baby boomers, but also to a significant decline in working hours per employee in recent years following the regulatory cap on overtime work (Chart B2-4).[31] There has been a surge in construction demand for AI-related data centers, e-commerce-related logistics facilities, and urban redevelopment at a time when supply-side constraints have intensified, as described above, and this in turn seems to have resulted in extended construction timelines and selective or restrictive order-taking by contractors,

Chart B2-2: Import Penetration Ratio for Capital Goods



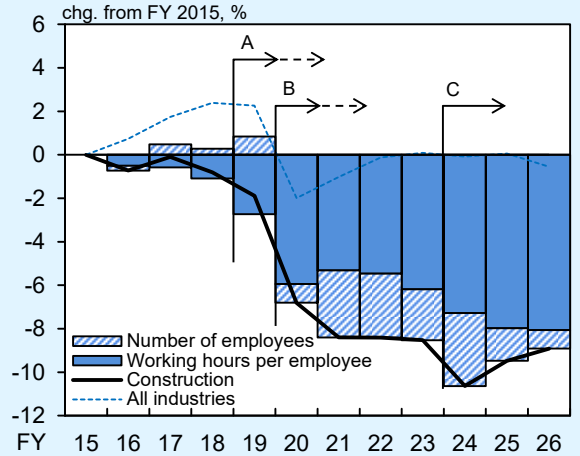
Source: Ministry of Economy, Trade and Industry.
Notes: 1. Import penetration ratio = Imports / Domestic shipments and imports
2. The figure for 2026/Q3 is the July-August average.

Chart B2-3: Investment Costs



Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Land, Infrastructure, Transport and Tourism.
Note: Capital goods prices before 2020 are based on the Index by Stage of Demand and Use and those from 2020 onward are estimated using the *2020 Input-Output Tables for Japan*. Construction costs are calculated as weighted averages of the costs of integrated non-housing and other civil engineering. The figure for construction costs for 2026/Q3 is that for July.

Chart B2-4: Labor Input in Construction



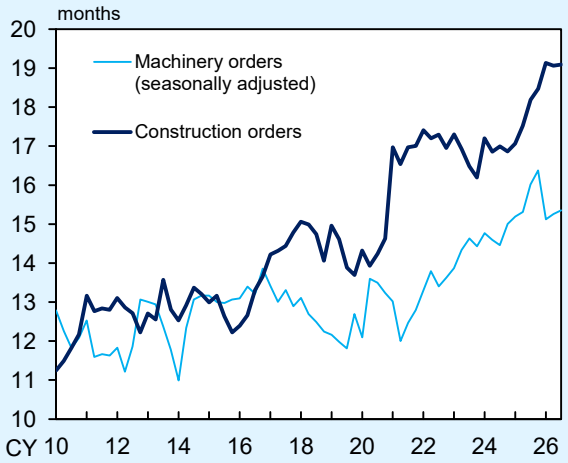
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.
Notes: 1. Labor input = Number of employees × Working hours per employee. Figures for working hours per employee are based on the *Labour Force Survey*. Figures are seasonally adjusted. Figures for fiscal 2026 are April-August averages.
2. The letters denote the following: (A) the application of the upper limit to overtime work to large firms; (B) the application to small and medium-sized firms; (C) the end of the grace period for construction and other industries.
3. The dashed arrows indicate the transitional periods.

[31] For labor supply constraints in the construction sector, see also Box 2 of the January 2026 Outlook Report (Tightness in Labor Market Conditions and Differences between Industries).

in addition to a sharp increase in construction costs.

As outlined above, the recent sluggishness in real business fixed investment can be attributed mainly to supply-side factors such as rising investment costs and delays in construction projects, and does not appear to signal weakness in underlying demand. Despite a lack of momentum due to the impact of price rises, real business fixed investment is highly likely to remain on a moderate uptrend over the long term, considering such factors as the following: (1) delayed construction investments are likely to proceed, albeit over a longer period (Chart B2-5); (2) corporate profits are expected to rise steadily, particularly in manufacturing (Chart 15); and (3) as suggested by business fixed investment plans in the *Tankan*, demand remains robust for investments, such as software investment to address labor shortages and R&D investment related to AI technology and decarbonization (Chart 19). That said, as noted in the previous Outlook Report, attention is warranted on the possible decline in the degree to which higher corporate profits stimulate business fixed investment, considering the relatively low spending propensity of large manufacturing firms, particularly in the capital goods sector, which benefit significantly from AI-related demand.[32]

Chart B2-5: Investment Order Backlogs



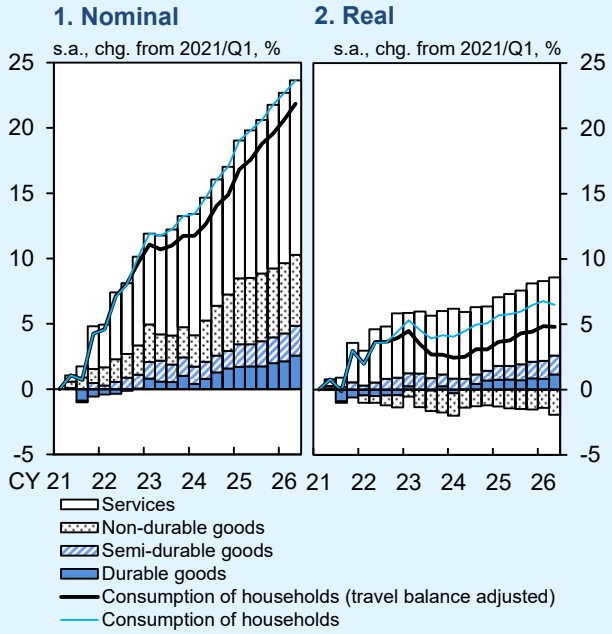
Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Figures for machinery orders are calculated as the value of orders yet to be executed at the end of the last month of the quarter divided by the average sales over the preceding three months.
2. Figures for construction orders are calculated as the value of construction work yet to be executed at the end of the last month of the quarter divided by the average value of construction work executed over the preceding 12 months.
3. Figures for 2026/Q3 are as of end-August for machinery orders and as of end-July for construction orders.

[32] See Box 2 of the July 2026 Outlook Report (Impact of Increased Global AI-Related Demand on Japan's Economy).

(Box 3) Private Consumption amid Inflation

While private consumption is expected to remain resilient as a trend, it is likely to continue to be in a deceleration phase for a while, mainly due to the impact of rising import prices owing to the situation in the Middle East and the yen's depreciation. This box outlines characteristics of recent private consumption from the perspective of the impact of inflation.

Chart B3-1: Private Consumption by Type



Source: Cabinet Office.
Note: Based on the SNA.

Private consumption has recently been sluggish in real terms, mainly due to a decline in non-durable goods consumption, even with a rise in real employee income reflecting the government's measures to address rising prices and increased summer bonuses (Chart B3-1). This sluggishness can also be attributed to (1) weather conditions during this summer, such as typhoons, torrential rains, and prolonged rainfall, and (2) increased defensiveness toward spending by seniors and pensioners, reflecting their concerns over price rises.

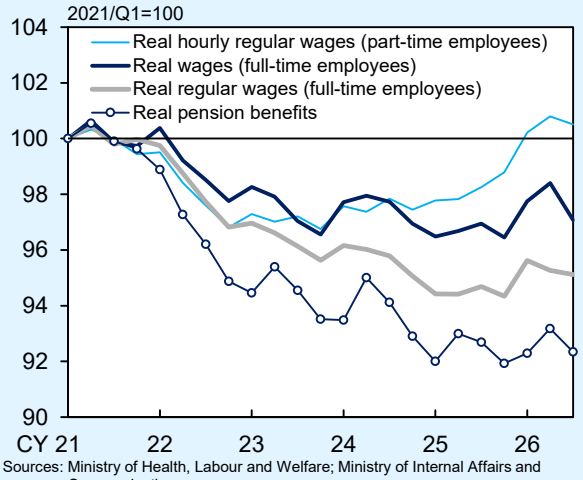
Developments in real income for full-time employees, part-time employees, and pensioners, show that (1) real hourly regular wages of part-time employees have generally kept up with inflation, due to the rise in nominal wages reflecting the tightening of labor market conditions and minimum wage increases; (2) regular wages of full-time employees have not fully kept up with inflation, showing a moderate downtrend in real terms, but their wages overall, including bonuses, have recently been increasing at a pace generally compensating for inflation, being flat in real terms;

and (3) in accordance with benefit-containment mechanisms such as the macroeconomic slide, real pension benefits have declined considerably over the past few years (Chart B3-2).

In this situation, developments in consumption by age group indicate that, up until around 2023, the withdrawal of the so-called forced savings, which had accumulated during the COVID-19 pandemic, served to underpin consumption, regardless of age group (Chart B3-3). Thereafter, however, the income variations mentioned above seem to have resulted in varied consumption levels.[33] In particular, real consumption has fallen notably among individuals in their 50s, whose wage growth rate has been relatively low due to the flattening of the wage curve, as well as among those aged 60 and over, many of whom are pensioners.

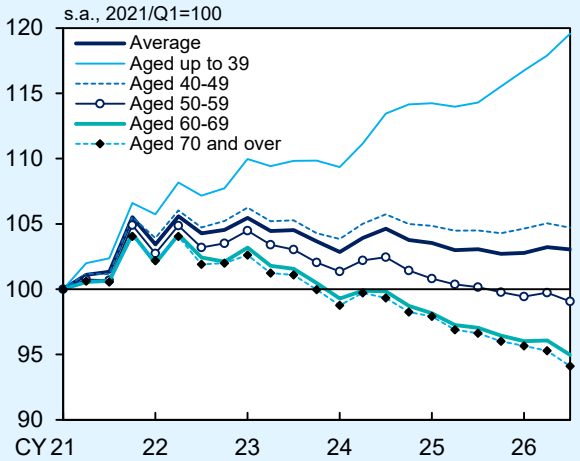
Attention should be paid to the fact that income levels and consumption trends have also varied significantly among seniors, depending on the size of their asset holdings. In fact, looking at income developments for those aged 75 and over, who make up around 60 percent of the senior population, the majority of this age group appear to rely heavily on pension income; however, there is also a certain proportion of wealthy individuals, albeit fewer in number, who generate income from dividends and capital gains through their

Chart B3-2: Real Wages and Real Pension Benefits



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.
Notes: 1. Figures are based on staff calculations using the CPI (less imputed rent).
2. Figures for real pension benefits are based on the revision rates applied to the Old-age Basic Pension for existing beneficiaries.
3. Figures other than those for real pension benefits are based on continuing observations following the sample revisions, and seasonally adjusted.
4. Figures for 2026/Q3 are July-August averages.

Chart B3-3: Real Consumption by Age

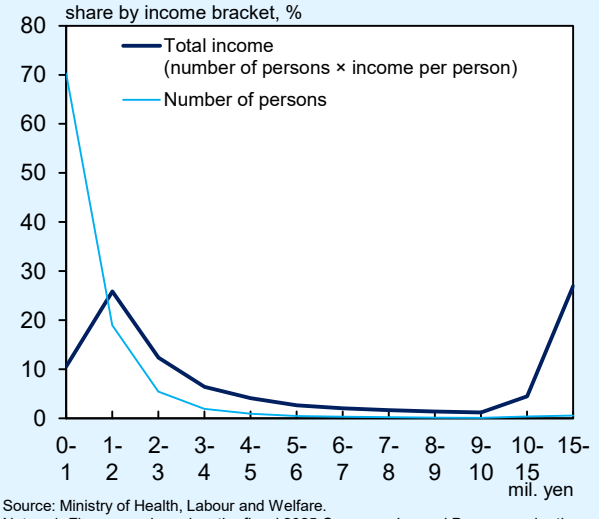


Sources: Ministry of Internal Affairs and Communications; Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures show expenditure per person. Figures for each age group are simple averages of the original data, which are compiled by five-year age group.
2. Figures are based on staff calculations using the CPI (less imputed rent).

[33] Real consumption shown in Chart B3-3 is derived by deflating nominal consumption by age group with a shared consumer price index. When applying a price index adjusted for differences in spending baskets by age group, weakness in real consumption among seniors is expected to become more apparent, reflecting their high Engel coefficient -- a large proportion of food expenses in total spending -- and the recent surge in food prices.

substantial holdings of stocks and other financial assets (Charts B3-4 and B3-5). Sales trends by business type of retailers show that the sales volume of department stores has been solid since fall 2025, encouraged by strong spending by wealthy individuals, stemming from recent high stock prices (Chart B3-6). In contrast, the sales volume of supermarkets and convenience stores, which offer necessities such as food as their core products, seems to have been pushed down by increased thriftiness among pensioners, who constitute the majority in terms of the number of consumers.

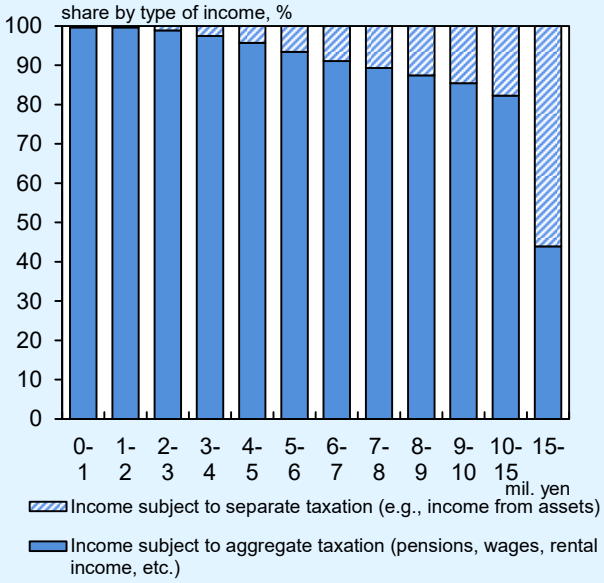
Chart B3-4: Income Distribution for Seniors Aged 75 and Over



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Figures are based on the fiscal 2025 *Survey on Insured Persons under the Medical Care System for Seniors Aged 75 and Over*. The horizontal axis shows income brackets.
2. Income is calculated by subtracting necessary expenses, the employment income deduction, the deduction for public pensions, etc. from gross receipts, before applying the basic deduction. The number of persons is the number of insured persons under the Medical Care System for Seniors Aged 75 and Over.

As described above, trends in private consumption have become increasingly varied across income categories, age, business types, and other factors. Looking ahead, these disparities are expected to persist for some time amid inflation. However, private consumption as a whole is likely to remain resilient, supported by such factors as the government's measures to reduce the household burden of higher energy prices, tightened labor market conditions, and higher stock prices. In addition, with underlying CPI inflation being at a level around 2 percent and upside risks to prices warranting attention, policy interest rate hikes by the Bank in response to developments in economic activity and prices as well as financial conditions are considered to alleviate upward pressure on prices and thereby underpin private consumption.

Chart B3-5: Breakdown of Income for Seniors Aged 75 and Over

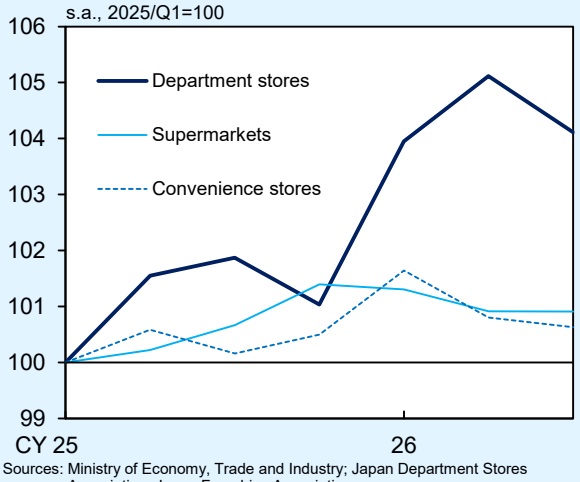


Source: Ministry of Health, Labour and Welfare.
Notes: 1. Figures are based on the fiscal 2025 *Survey on Insured Persons under the Medical Care System for Seniors Aged 75 and Over*. The horizontal axis shows income brackets.
2. Income is calculated by subtracting necessary expenses, the employment income deduction, the deduction for public pensions, etc. from gross receipts, before applying the basic deduction.

However, from a demographic perspective, attention should be paid to the point that, to begin with, it is difficult to expect robust growth in aggregate private consumption as a trend.

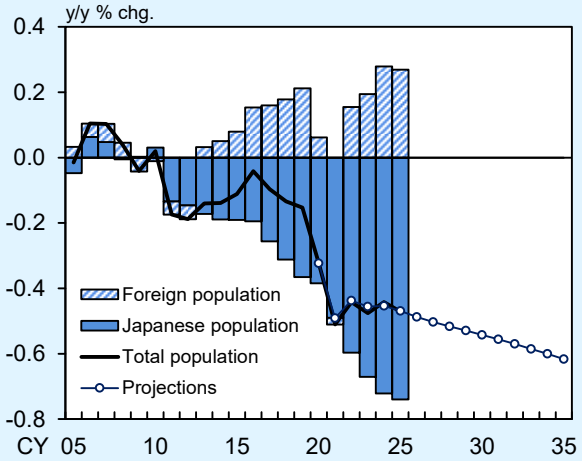
Specifically, the rate of decline in Japan's population has been accelerating since around 2020, with the annual rate of decline remaining at about minus 0.5 percent over the past few years (Chart B3-7). This is considered to have constrained growth in consumption in recent years, particularly in non-durable goods, which are prone to being influenced directly by the number of consumers.[34] In fact, a look at the level of consumption per capita suggests a steady uptrend that surpasses pre-pandemic levels, which stands in contrast to the aggregated level (Chart B3-8).

Chart B3-6: Retail Sales by Business Type



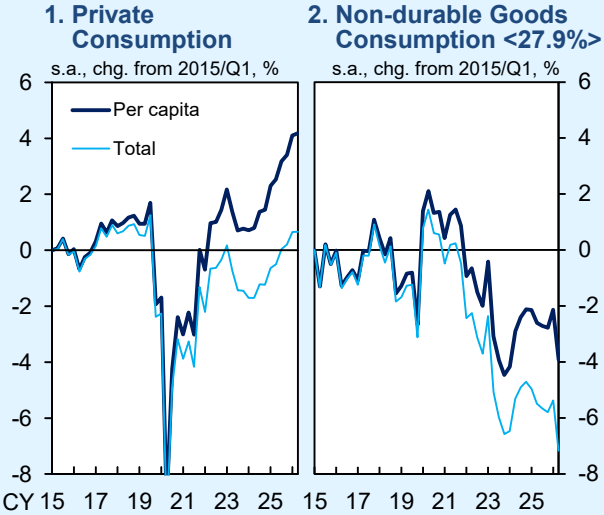
Sources: Ministry of Economy, Trade and Industry; Japan Department Stores Association; Japan Franchise Association.
Notes: 1. Figures are adjusted for the number of stores.
2. Figures for sales at department stores exclude duty-free sales.

Chart B3-7: Population Growth



Sources: Ministry of Internal Affairs and Communications; National Institute of Population and Social Security Research.
Note: As of October of each year. Projections are based on the medium-variant projections by the National Institute of Population and Social Security Research.

Chart B3-8: Real Private Consumption per Capita



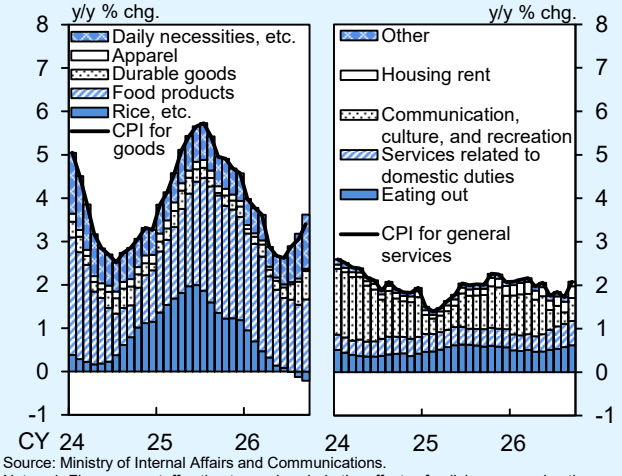
Sources: Ministry of Internal Affairs and Communications; Cabinet Office.
Note: In the right-hand chart, the figure in angular brackets shows the share of non-durable goods consumption in the domestic final consumption expenditure of households in fiscal 2025.

[34] In contrast, as the number of households continues to grow, durable goods such as air conditioners and refrigerators, which are prone to being influenced by the number of households, have remained firm despite the population decline.

(Box 4) Spread of Upward Pressure on Prices from Business-to-Business Transactions to Consumer Prices

With firms' behavior shifting more toward raising prices, the producer price index (PPI) has risen substantially since early spring, when tension over the situation in the Middle East heightened. Since summer, this inflationary pressure in business-to-business transactions has gradually been spreading to consumer prices (Chart B4-1). This box examines the pass-through of cost increases from upstream to downstream prices by assessing price developments by goods.

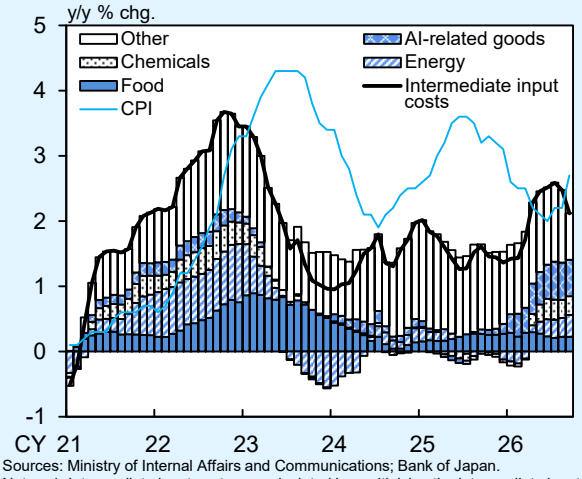
Chart B4-1: CPIs for Goods and Services



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures are staff estimates and exclude the effects of policies concerning the provision of free education (including the free school lunches starting in April 2026) and travel subsidy programs.
2. In the left-hand chart, figures for rice, etc. include meat and chicken eggs.

Inflationary pressure driven by higher import prices is likely to spread from upstream to downstream prices through, (1) an indirect channel, namely, a rise in intermediate input costs for the domestic production of consumer goods and services; and (2) a direct channel, that is, an increase in import prices of final goods. In the former channel, estimates based on input-output tables show that growth in intermediate input costs has accelerated significantly since around spring (Chart B4-2). A breakdown of the intermediate input costs indicates that costs of chemicals and plastics as well as energy have boosted their positive contribution, driven by the impact of the situation in the Middle East. In addition, on the back of the expansion in AI-related demand, cost increases of electrical machinery, information and communications-related parts, and of non-ferrous metals (e.g., copper), have also become noticeable recently.

Chart B4-2: Intermediate Input Costs

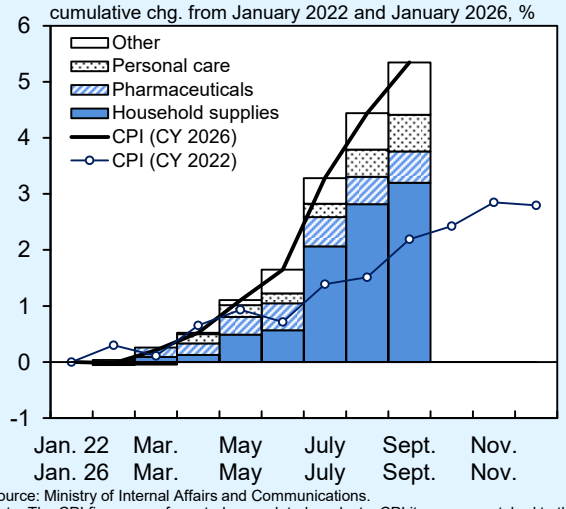


Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. Intermediate input costs are calculated by multiplying the intermediate input ratio of each sector in the *Input-Output Tables for Japan* by price data from the corporate goods price index or the services producer price index and then taking the weighted average using consumption expenditure shares as weights. Figures for food exclude "grains," "flour and grain mill products," and "livestock products." Figures for chemicals are those for "chemical products" and "plastic products and rubber products." Figures for AI-related goods are those for "electronic components," "electrical machinery," "information and communication electronics equipment," and "non-ferrous metals."
2. The CPI figures exclude fresh food and energy. The figures are staff estimates and exclude the effects of the consumption tax rate change and policies concerning the provision of free education (including the free school lunches starting in April 2026), the reduction in mobile phone charges in 2021, and travel subsidy programs.

Regarding petroleum-derived chemical products and plastics, as noted in the previous Outlook Report, the pass-through of cost increases in business-to-business transactions has been progressing at a faster pace than that observed following Russia's invasion of Ukraine in 2022.[35] It can be confirmed that such price increases in business-to-business transactions have also recently been rapidly spreading to consumer prices, particularly of household supplies such as detergents (Chart B4-3).

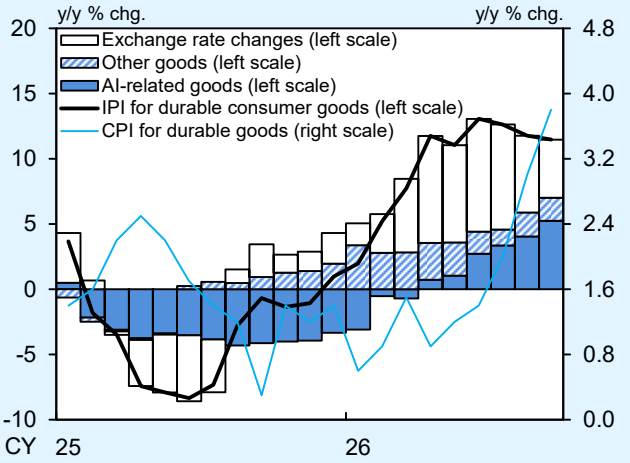
Looking at durable consumer goods for which the final product typically has a high import ratio, import prices of such goods have marked a high year-on-year increase of over 10 percent since April 2026. Of this increase, about half is attributed to the yen's depreciation, while the majority of the remainder is driven by the rise in foreign currency-denominated prices of semiconductor-containing products in the wake of the recent expansion in AI-related demand (Chart B4-4). Upward pressure stemming from these import price rises is already beginning to emerge in durable consumer goods prices, as seen in growing moves toward price hikes in items such as tablet devices and air conditioners. Drawing from experience that swings in import prices are passed on to consumer prices with a lag of about four months, the rate of increase in durable consumer goods prices is expected to accelerate further toward the end of 2026.

Chart B4-3: Price Pass-Through to Petroleum-Related Products



Source: Ministry of Internal Affairs and Communications.
Note: The CPI figures are for petroleum-related products. CPI items are matched to the categories in the *2020 Input-Output Tables for Japan* and grouped based on their intermediate input ratios for "chemical products" and "plastic products and rubber products." Figures in the chart are the weighted averages of CPI items that fall within the top 5 percent on a CPI-weighted basis.

Chart B4-4: Price Pass-Through to Durable Goods



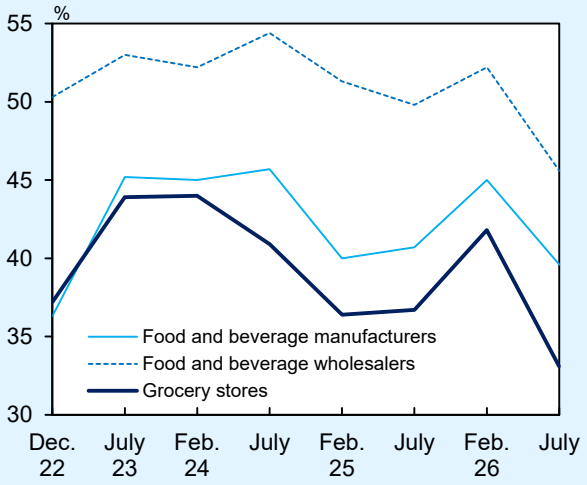
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Note: The contribution of changes in the import prices of AI-related goods and other goods to changes in the import price index (IPI) for durable consumer goods are calculated using changes in the IPI on a contract currency basis. Figures for AI-related goods are those for "household electric equipment" and "information and communications equipment" (including "cellular phones," "personal computers," and "external storages"). Figures for other goods include "passenger motor cars" and "wooden furniture." The contribution of exchange rate changes is calculated using the difference between the IPI on a yen basis and that on a contract currency basis.

[35] See Box 3 of the July 2026 Outlook Report (Background to and Impact of Upward Pressure on Prices in Business-to-Business Transactions).

Meanwhile, in terms of food products, a look at related firms' price-setting stance shows that downstream grocery stores have recently taken a somewhat cautious stance on price pass-through of cost increases, compared to upstream food manufacturers, due possibly to being on the front lines of consumer spending and experiencing firsthand households' entrenched thriftiness (Chart B4-5). In addition, as grocery stores increasingly offered discounts to stimulate demand during this summer, owing in part to the impact of irregular weather, the rate of increase in the price of food products has not accelerated markedly. That said, given the substantial increase since September in the number of food manufacturers implementing price hikes in view of higher prices of energy and packaging materials, these hikes are highly likely to permeate the retail level with some time lag, thereby accelerating the year-on-year rate of increase in food product prices (Chart B4-6).

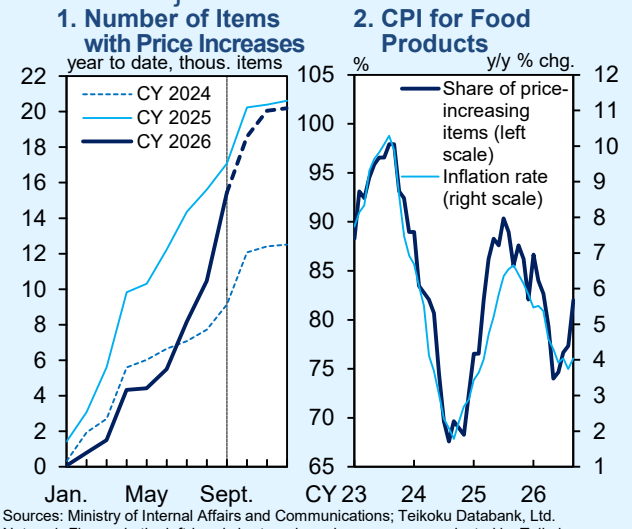
In light of the above observations, it appears that the mechanism is operating as projected in the previous Outlook Report, whereby the following factors spread to consumer prices from this summer through the second half of fiscal 2026: (1) the rise in energy and raw material prices reflecting the situation in the Middle East; (2) higher prices of semiconductors, copper, and other items reflecting the expansion in global AI-related demand; and (3) inflationary pressure stemming from the depreciation of the yen thus far.

Chart B4-5: Price Pass-Through by Food-Related Firms



Source: Teikoku Databank, Ltd.
Note: Figures are the pass-through rates of cost increases to selling prices. The rates are calculated as weighted averages of the midpoint values for each response category regarding the extent of pass-through, using the corresponding response shares as weights.

Chart B4-6: Number of Food and Beverage Items Subject to Price Increases



Sources: Ministry of Internal Affairs and Communications; Teikoku Databank, Ltd.
Notes: 1. Figures in the left-hand chart are based on a survey conducted by Teikoku Databank, Ltd. The broken line for 2026 represents projections as of the end of September 2026.
2. In the right-hand chart, the share of price-increasing items is the share of items for which price indices increased from a year earlier.

(Box 5) Assessing the Degree to Which Underlying CPI Inflation Is Anchored at the 2 Percent Level

In conducting monetary policy, the Bank considers it important to achieve the price stability target of 2 percent in a sustainable and stable manner. It therefore focuses on developments in underlying inflation, which excludes the effects of temporary factors (Chart B5-1).[36] As described in "The Bank's View" and "The Background," developments in various indicators related to underlying CPI inflation suggest that underlying CPI inflation is currently at a level that is generally consistent with the price stability target of 2 percent. This box sets out how the Bank will assess the degree to which underlying CPI inflation is anchored at a level around 2 percent.

Chart B5-1: Overview of Underlying Inflation

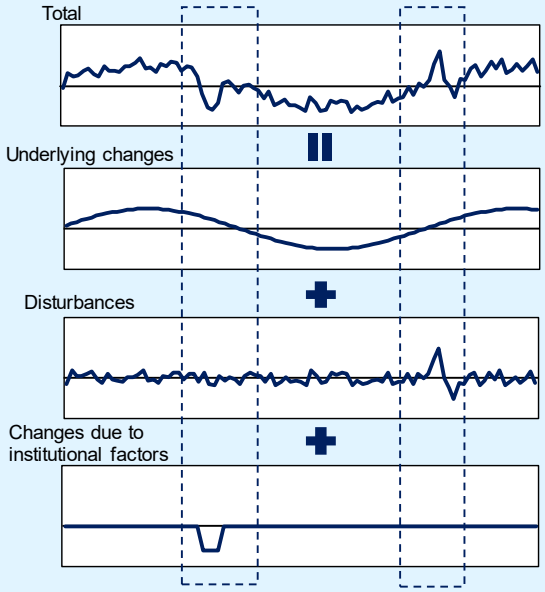


Chart B5-2: Assessment Criteria for the Anchoring of Inflation Expectations

Level Anchoring	Whether the average or median of long-term inflation expectations is consistent with the price stability target
Higher-Moment Anchoring	Whether disagreement of inflation expectations among agents is contained Whether uncertainty and tail risk surrounding inflation expectations are contained
Shock Anchoring	Whether long-term inflation expectations do not co-move excessively with short-term inflation expectations or temporary shocks

Note: Based on ECB, *Economic Bulletin*, Issue 5, 2026.

Referring to underlying CPI inflation as being "anchored at a level around 2 percent" describes a situation in which underlying CPI inflation is around 2 percent and is also expected to remain stable at around that level. In such a situation, even if an exogenous shock occurs, underlying CPI inflation would be unlikely to rise substantially above or fall substantially below 2 percent. In assessing the degree to which underlying CPI inflation is anchored at that level, it is important to examine, along with developments in various relevant indicators, factors such as whether 2 percent inflation (1) is reflected in the formation of inflation expectations and (2) is consistent with firms' wage- and price-setting behavior. As a

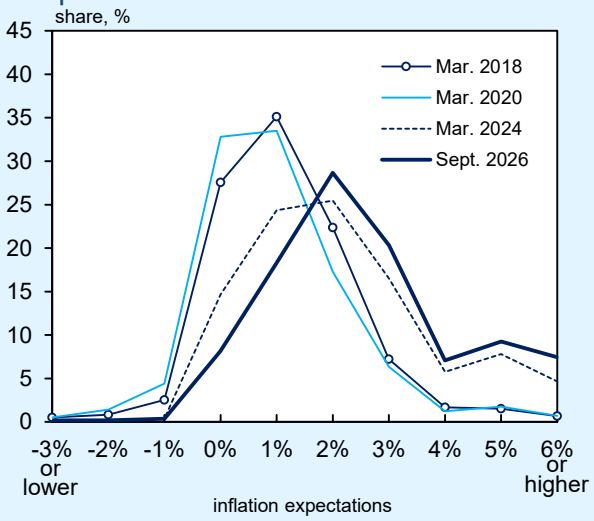
[36] For details, see Monetary Affairs Department, Bank of Japan, "The Concept and Measurement of Underlying Inflation," *Bank of Japan Review Series*, March 2026.

supplementary factor closely related to these points, it is also useful to examine (3) the spread of economic practices and norms that are based on the assumption that prices will continue to rise at the rate of 2 percent.

Regarding the first point, expectation formation, it is important to examine whether inflation expectations are "anchored" at a level around 2 percent. On this point, drawing on frameworks set out by overseas central banks and other sources, it is necessary to examine such aspects as the level of medium- to long-term inflation expectations, their distribution by economic entity, and the sensitivity of inflation expectations to exogenous shocks (Chart B5-2).[37]

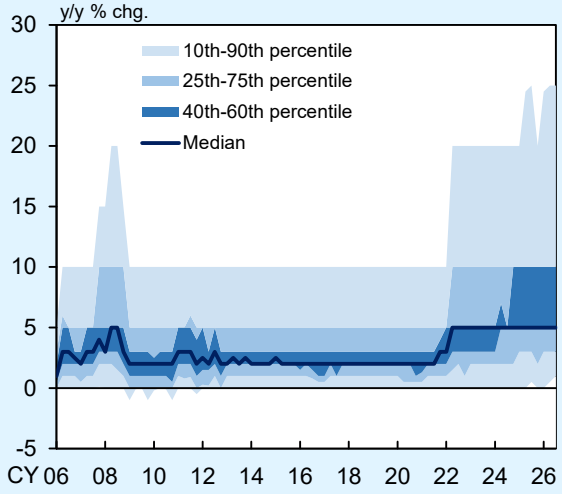
Looking first at the distribution of inflation expectations by economic entity, the lower tail of the distribution of firms' inflation expectations has shifted from around 0 percent into positive territory over the past several years, and firms' inflation outlooks appear to be gradually converging toward around 2 percent (Chart B5-3). On the other hand, households' inflation expectations continue to vary relatively widely (Chart B5-4). Meanwhile, among experts, there has recently been an increasing number of views that expect inflation of around 2 percent. Next, from the perspective of examining the stability of inflation expectations in the face of exogenous shocks, the impact of changes in experts' short-term inflation expectations on those in their medium- to long-term inflation expectations was

Chart B5-3: Distribution of Firms' Inflation Expectations



Source: Bank of Japan.
Note: Figures show enterprises' inflation outlook for general prices for five years ahead in the *Tankan*. All industries and enterprises. Horizontal-axis labels indicate response categories expressed as "around" the stated percentages. Shares are calculated excluding responses of "Don't have clear views on general prices."

Chart B5-4: Distribution of Households' Inflation Expectations



Source: Bank of Japan.
Note: Figures are based on responses to quantitative questions (average annual changes in price levels over the next five years) in the *Opinion Survey on the General Public's Views and Behavior*.

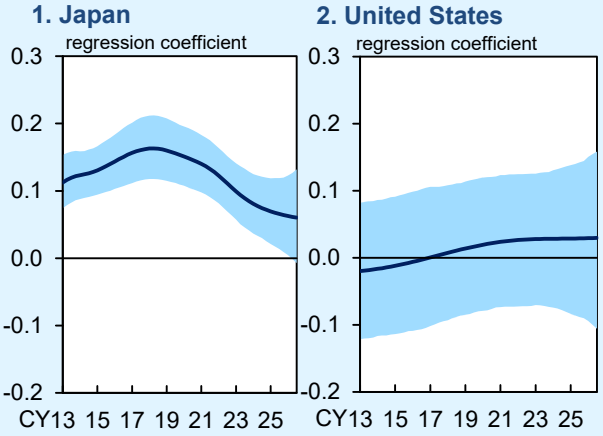
[37] See European Central Bank (ECB), *Economic Bulletin*, Issue 5, 2026.

estimated. The results show that the co-movement between the two has recently weakened and that the difference in the size of the impact as compared with that in the United States has begun to narrow (Chart B5-5). With the rate of increase in the CPI expected to rise clearly above 2 percent, it will be necessary to examine carefully whether these tendencies continue.

Regarding the second point, firms' wage- and price-setting behavior, it is necessary to examine whether firms' wage- and price-setting stance has become generally consistent with 2 percent inflation, drawing on indicators such as the distribution of wage growth by firm size and the distribution of price changes across items.

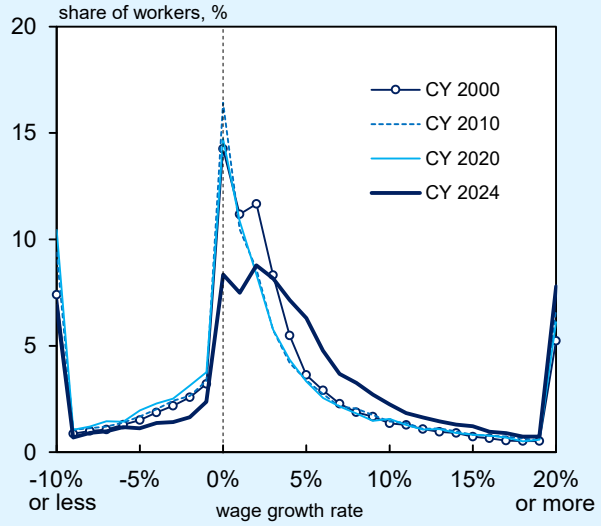
On this point, examining firms' wage-setting behavior through the distribution of wage growth shows that the lower tail of the distribution for scheduled cash earnings has, as a whole, shifted from 0 percent into positive territory compared with a while ago. In recent years, the share of wage increases at levels broadly consistent with 2 percent inflation plus labor productivity growth has risen, as seen in the data for 2024 (Chart B5-6). That said, the distributions for large firms and for small and medium-sized firms differ somewhat, with the mode, for example, being lower for small and medium-sized firms, and it will remain necessary to examine future developments. Next, firms' price-setting behavior has remained active in recent years, as seen, for example, in progress in moves to pass on increases in input costs to selling prices. Against this backdrop, the distribution of price changes in

Chart B5-5: The Impact of Short-term Expectations on Long-term Expectations



Sources: QUICK, "QUICK Monthly Market Survey <Bonds>"; Federal Reserve Bank of Philadelphia.
Note: Microdata on experts' inflation expectations are used to estimate the impact of changes in short-term expectations (revisions from the previous survey) on those in long-term expectations using a state-space model (with respondent heterogeneity taken into account in the regression coefficients and measurement error variances). The solid lines indicate estimated values (posterior means) and the shaded areas indicate the 95 percent credible intervals, both of which are calculated using the Markov chain Monte Carlo (MCMC) method.

Chart B5-6: Distribution of Nominal Wage Growth Rates

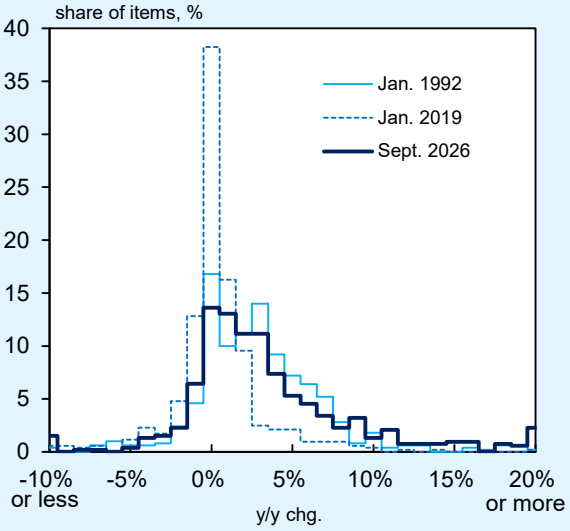


Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications; Abe, Hirano, and Kaihatsu (2026).
Note: Estimated by Abe, Hirano, and Kaihatsu (2026) using microdata from the *Basic Survey on Wage Structure* released by the Ministry of Health, Labour and Welfare, and from the *Economic Census for Business Frame* and the *Establishment and Enterprise Census* released by the Ministry of Internal Affairs and Communications. Wages refer to scheduled cash earnings of full-time workers.

the CPI has also changed: while it was once concentrated at 0 percent, its shape has recently come closer to that in 1992, when inflation in Japan was around 2 percent (Chart B5-7).

Regarding the third point, the spread of economic practices and norms that are based on the assumption that prices will continue to rise at the rate of 2 percent, it is useful to examine such aspects as the stance of both labor and management in wage negotiations and developments in legal and institutional frameworks.

Chart B5-7: Distribution of Price Changes across CPI Items



Source: Ministry of Internal Affairs and Communications.
Note: Items included in the calculation are those adopted in each base year. Figures are for the CPI for all items less fresh food.

In this regard, the stance of labor and management in the annual spring labor-management wage negotiations shows a shift toward wage increases becoming a firmly established practice. Specifically, the Japanese Trade Union Confederation (Rengo) has set a target for wage increases of "5 percent or more" for the past several years, and it declared its policy for 2026 of making wage increases "the norm" (Chart B5-8). On the management side as well, the Japan Business Federation (Keidanren), for example, set out a policy for 2026 of further establishing strong momentum toward wage increases. Meanwhile, there have also been developments in legal and institutional frameworks, such as the implementation in January 2026 of the Act on Preventing Delay in Payment to Small and Medium-Sized Entrusted Business Operators in Relation to Manufacturing Consignment. These and other developments are helping firms to shift away from the long-standing practice of keeping prices unchanged, and this is fostering an environment where it is easier to set

Chart B5-8: Stance in Annual Spring Labor-Management Wage Negotiations

	Rengo Wage increase target (Base pay increase target)	Keidanren Approach to wage increase
CY 2023	Around 5% (Around 3%)	Starting point
CY 2024	5% or more (3% or more)	Acceleration
CY 2025	5% or more (3% or more)	Establishment
CY 2026	5% or more (3% or more) <Establishing a "wage-increase norm">	Further establishment

Sources: Japanese Trade Union Confederation (Rengo); Japan Business Federation (Keidanren).
Note: Rengo's target is based on the description in its basic policy for annual spring labor-management wage negotiations. Text within angular brackets is based on the opening section of the 2026 policy. Keidanren's approach to wage increase is based on the description in the Report of the Special Committee on Management and Labor Policy.

selling prices that reflect factors such as increased input costs.

Based on the above, underlying CPI inflation in Japan has risen toward a level around 2 percent over the past few years, and there has been gradual progress toward anchoring it at that level. In order to conduct monetary policy as appropriate toward sustainable and stable achievement of the price stability target, the Bank will continue to carefully examine developments in inflation expectations and in wages and prices and to assess the degree to which underlying CPI inflation is anchored at a level around 2 percent.

(Box 6) Assessment of Financial Conditions

In the conduct of monetary policy, it is important to assess financial conditions appropriately. The relationship between the real interest rate and the natural rate of interest provides one measure for assessing the degree of monetary accommodation or tightening (Chart B6-1). However, the natural rate of interest cannot be observed directly, and it is difficult to pin down its level, or its distance from the real interest rate, in advance.[38] On this premise, the Bank closely examines developments in financial conditions, which can be considered to serve as a transmission channel of monetary policy to the real economy. This box first outlines the framework the Bank uses to assess financial conditions and then takes a look at recent financial conditions in Japan.

The Bank uses two main measures to assess financial conditions: (1) developments in nominal and real interest rates, starting with short-term interest rates, which monetary policy can control; and (2) indicators of the funding environment (funding costs, the availability of funds, and funding volumes) (Chart B6-2).

Regarding interest rate developments, which are the first measure, safe-asset interest rates -- such as the policy interest rate and the yield curve of

Chart B6-1: Overview of the Relationship between the Real Interest Rate and the Natural Rate of Interest

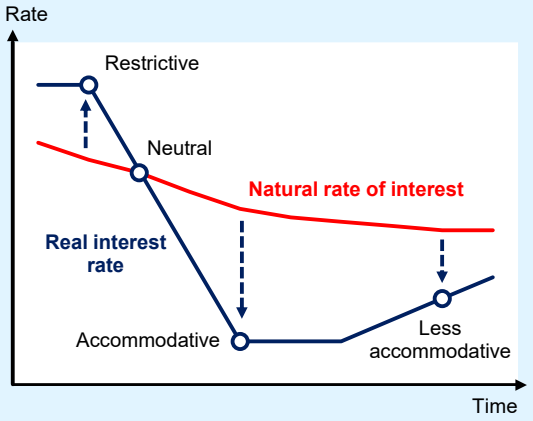
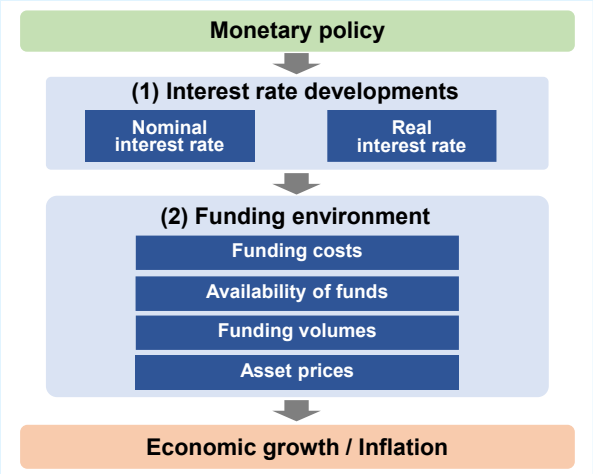


Chart B6-2: Framework for Assessing Financial Conditions

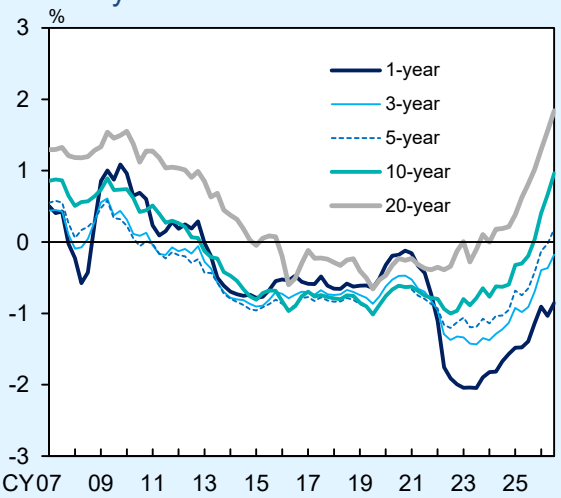


Note: Examples of frequently used indicators are illustrated for each stage.

[38] See Monetary Affairs Department, Bank of Japan, "Developments in the Natural Rate of Interest and the Assessment of the Degree of Monetary Accommodation," *Bank of Japan Review Series*, March 2026.

government bonds -- affect a variety of lending rates. Moreover, it is important to examine real interest rates, that is, nominal interest rates minus inflation expectations, since these have a greater influence on economic agents' consumption and investment decisions. In doing so, in terms of maturity, the Bank needs to pay closer attention to interest rate developments in the short- to medium-term zone, since these maturities account for a large share of firms' and households' funding and therefore have a greater impact on the economy.

Chart B6-3: Real Interest Rates by Maturity



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.
Note: Figures are calculated as nominal government bond yields minus the composite index of inflation expectations (staff estimates). The 20-year real interest rate is calculated using the same inflation expectations as those used for the 10-year rate.

Looking at recent developments, real interest rates have risen across all maturities, with particularly large increases in long-term and super-long-term rates (Chart B6-3). However, the weighted average of real interest rates across maturities, with weights based on their impact on the output gap, remains at a low level (Chart B6-4).

Chart B6-4: Weighted Average Real Interest Rate



Source: Bank of Japan.
Note: Figures are calculated as the weighted average of real interest rates across maturities, with weights based on the estimated effects of changes in each rate on the output gap in the natural yield curve model of Imakubo, Kojima, and Nakajima (2015) and Nakajima et al. (2023).

Regarding the funding environment, which is the second measure, the Bank carefully examines (1) funding costs, such as lending rates, consisting of safe-asset interest rates plus various spreads; (2) the availability of funds, such as financial institutions' lending attitudes and firms' financial positions; and (3) indicators of the volume of funding, such as bank lending and CP and corporate bond issuance.

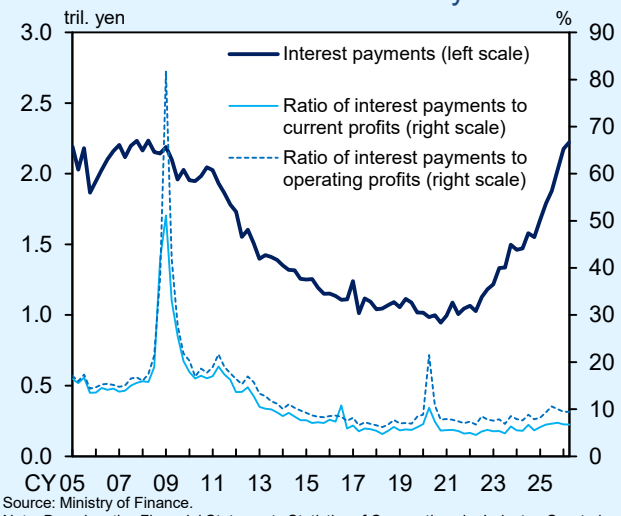
Looking at recent developments in funding costs, firms' interest payments have increased: lending rates and issuance rates for CP and corporate bonds have risen in response to the rise in market

interest rates (Chart 48). Relative to current profits, however, interest payments remain at a low level (Chart B6-5). Interest costs on a stock basis also remain sufficiently low relative to firms' profitability (Chart 49). Under these circumstances, financial institutions' lending attitudes remain proactive, and firms' financial positions continue to be favorable (Chart B6-6). Meanwhile, looking at developments in private-sector funding, demand for funds has increased across the board with the recovery in economic activity, and funding has also been boosted by robust demand related to corporate acquisitions. Against this backdrop, growth in funding, particularly bank lending, has remained high (Chart B6-7).

In addition to these indicators, asset prices such as stock prices and exchange rates could also affect firms' and households' decision-making and, by extension, the real economy, through channels such as changes in these economic agents' balance sheets and profit expectations. In light of this, the Bank also examines developments in asset prices as one element in assessing financial conditions.

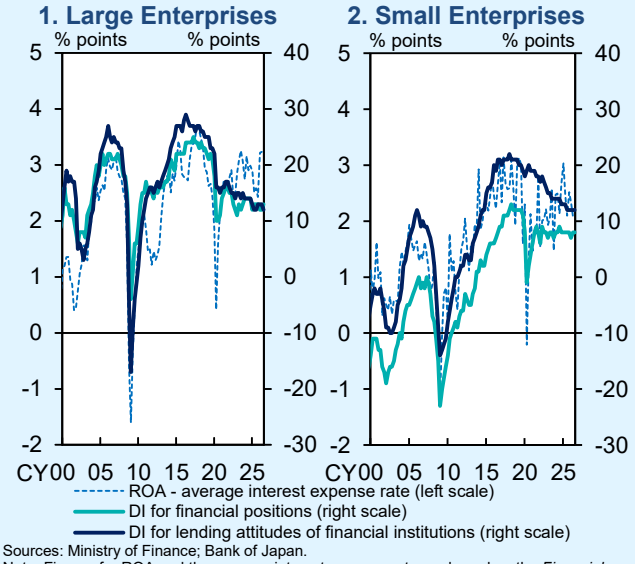
For example, the uptrend in stock prices has likely contributed to a decline in firms' cost of capital, and has helped support private consumption through wealth effects. While the yen's depreciation trend is likely to exert downward pressure on households' real purchasing power and small and medium-sized firms' profits through higher import prices and other factors, it likely has

Chart B6-5: Firms' Interest Payments



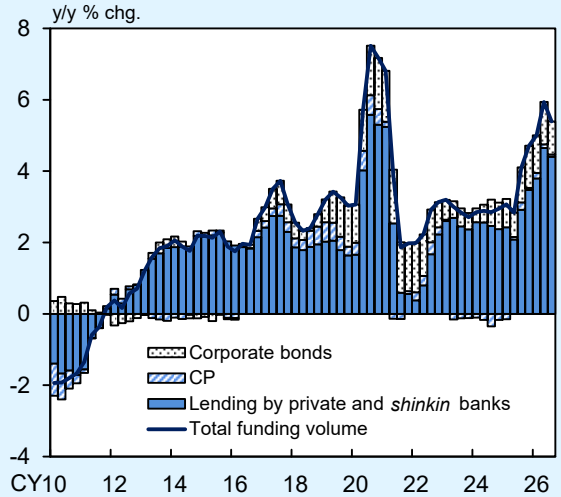
Source: Ministry of Finance.
Note: Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. All enterprises. Figures exclude "finance and insurance" and those for 2009/Q2 onward also exclude "pure holding companies." Seasonally adjusted.

Chart B6-6: Funding Costs Relative to Profitability, and Availability Indicators



Sources: Ministry of Finance; Bank of Japan.
Note: Figures for ROA and the average interest expense rate are based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. They exclude "finance and insurance" and those for 2009/Q2 onward also exclude "pure holding companies." Seasonally adjusted.

Chart B6-7: Total Funding Volume by the Private Sector



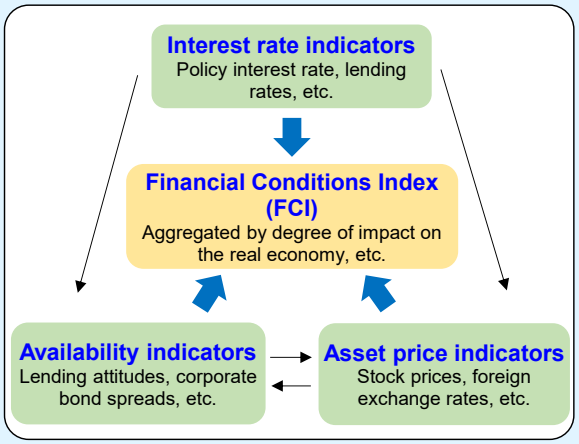
Sources: Bank of Japan; Japan Securities Depository Center; I-N Information Systems.

a positive impact on the profits of global firms and firms related to inbound tourism.

As noted earlier, when assessing financial conditions, the Bank uses interest rate developments and the funding environment as its main measures, and, based on developments in these indicators, it assesses that Japan's financial conditions have been accommodative. In addition, while it should be borne in mind that factors other than monetary policy also play a large role, recent developments in asset markets, taken as a whole, are likely making financial conditions more accommodative, for example by improving firms' and households' balance sheets.

Some overseas central banks use a financial conditions index (FCI) as an indicator to assess financial conditions comprehensively. An FCI combines a variety of indicators, such as interest rates, corporate bond spreads, stock and real estate prices, and exchange rates, by taking their weighted average based on their impact on GDP (Chart B6-8). While an FCI has the advantage of providing a simple way to grasp the overall picture of financial conditions, (1) it can give a different assessment of financial conditions depending on which indicators are included and how each one is weighted, and (2) the impact of each indicator on financial conditions may change as the structure of the economy changes. For these and other reasons, concerns persist about assessing financial conditions mechanically on the basis of developments in an FCI, and major central banks

Chart B6-8: Overview of FCIs



do not tie FCIs directly to the conduct of monetary policy.[39]

With these points also in mind, the Bank considers it important, when assessing financial conditions, not to rely on any single indicator but to carefully examine a wide range of information, including information gathered through interviews by its Head Office and branches.

[39] See, for example, Bank of England, "How Do We Monitor UK Financial Conditions?" *Bank Overground*, April 23, 2021.

