July 31, 2026
Bank of Japan

Outlook for Economic Activity and Prices (July 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 crude oil 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 crude oil 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 from the second half of fiscal 2026. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices to date 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 recent depreciation of the yen 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, it is projected that the mechanism in which wages and prices rise moderately in interaction with each other will be maintained, and that medium- to long-term inflation expectations will rise. In this situation, underlying CPI inflation is expected to increase gradually, coming to a level that is generally consistent with the price stability target between the second half of fiscal 2026 and fiscal 2027 and remaining at around that level thereafter.
- 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 2026 is lower, due to factors such as the effects of the government's measures to reduce the household burden of higher energy prices (electricity and gas charges) during summer.
- There are various risks to the outlook. For the time being, it is necessary to pay particular attention to the impact of the situation in the Middle East on financial and foreign exchange markets and on Japan's economic activity and prices. In addition, it is necessary to pay attention to the effects of developments in global AI-related demand and of future 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 for underlying CPI inflation, there is a risk that it will deviate upward to a level above the price stability target of 2 percent, given factors such as firms' behavior shifting more toward raising wages and prices and medium- to long-term inflation expectations continuing to rise. 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 July 30 and 31, 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 and industrial production have continued to be more or less flat as a trend. Against the backdrop of factors such as a solid increase in global AI-related demand, corporate profits have been at high levels, and business sentiment has also been at a favorable level. Under these circumstances, business fixed investment has been on a moderate increasing trend. Private consumption has been resilient against the background of an improvement in the employment and income situation, although weakness has been seen in household sentiment. On the other hand, 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, 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) has recently been at around 1.5 percent due to factors such as the effects of the government's measures to reduce the household burden of higher energy prices. Inflation expectations have risen moderately.

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 crude oil 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 solid wage increases achieved in the annual spring labor-management wage negotiations. Against this backdrop, Japan's economy is expected to continue growing moderately, albeit at a decelerated rate.

In the corporate sector, exports and production, despite the impact of the situation in the Middle East, are likely to be more or less flat for the time being, pushed up by strong global AI-related demand. Corporate profits, despite the impact of the deterioration in the terms of trade reflecting the rise in crude oil prices, are likely to remain at high levels on

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[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 80 U.S. dollars per barrel to around 70 dollars per barrel toward the end of the projection period.

the back of factors such as strong AI-related demand. In this situation, business fixed investment is expected to remain on 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 the growth in nominal wages is projected to remain at around its current pace, mainly reflecting the outcome of this year's annual spring labor-management wage negotiations. Private consumption is expected to be more or less flat due to the impact of price rises, particularly in energy prices, 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 crude oil prices will wane and that the virtuous cycle from income to spending will gradually intensify. Exports and production are likely to increase 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 improve, 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 AI-related areas, for capacity expansion, 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 from the second half of fiscal 2026. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices to date 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 recent depreciation of the yen 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, it is projected that the mechanism in which wages and prices rise moderately in interaction with each other will be maintained, and that medium- to long-term inflation expectations will rise. In this situation, underlying CPI inflation is expected to increase gradually, coming to a level that is generally consistent with the price stability target between the second half of fiscal 2026 and fiscal 2027 and remaining at around that level thereafter. Given that underlying CPI inflation has been approaching 2 percent, it will be important, from the perspective of sustainable and stable achievement of the price stability target, to examine whether it becomes 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. 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 transportation costs associated with the securing of alternative sources of supply from regions other than the Middle East, it is 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

[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.

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 to date is expected to push up prices, mainly of goods, and the rise in the prices of semiconductors and other items and the recent depreciation of the yen 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 2026 is lower, due to factors such as the effects of the government's measures to reduce the household burden of higher energy prices (electricity and gas charges) during summer, while the projected year-on-year rates of increase in the CPI (all items less fresh food and energy) are more or less unchanged throughout the projection period.

The main factors that determine underlying inflation are assessed as follows. The output gap, which captures the utilization of labor and capital, has followed an improving trend, albeit with fluctuations, and has been slightly positive recently. 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 have risen moderately. Regarding the outlook, as firms' active wage- and price-setting behavior is expected to continue on the back of factors such as the tightening of labor market conditions, inflation expectations are likely to continue to rise moderately. Medium- to long-term inflation expectations are expected to come to a level around 2 percent between the second half of fiscal 2026 and fiscal 2027 and remain at around that level thereafter.

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 <u>the impact of the situation in the Middle East on Japan's economic activity and prices</u>. While the situation in the Middle East remains unclear, crude oil prices have declined compared with a while ago. As a result, the significant downside risks to economic activity and the significant upside risks to prices, both of which were pointed out in the previous Outlook Report, have decreased. In particular, the risk that large-scale disruptions in supply chains will occur, exerting a significant impact on the production activity of Japanese firms, has decreased, partly due to progress in securing alternative sources of supply for raw materials that are highly dependent on the Middle East. However, attention continues to be warranted on the impact of the rise in crude oil prices to date 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 stemming from high crude oil prices has been progressing at a relatively fast pace in business-to-business transactions, which is highly likely to spread to an increase in consumer prices across a wide range of items. In addition to these factors, taking into account that medium- to long-term inflation expectations have also continued to rise, there is a risk of underlying CPI inflation deviating upward to a level above the price stability target of 2 percent.

Meanwhile, crude oil prices have continued to see large fluctuations. Attention continues to be warranted on how changes in crude oil prices will affect Japan's economic activity and prices.

The second risk is developments in economic activity and prices at home and abroad, including 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 is likely to push 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. In addition, while the positive impact of the expansion in AI-related demand has so far been observed mainly in areas such as revenue growth in the IT-related sector and the wealth effects from higher stock prices, it is necessary to pay attention to whether the benefits will spread across a wide range of sectors through, for example, enhanced productivity associated with the use of AI.

Moreover, attention also needs to be paid to the impact that developments such as recent moves toward fiscal expansion in various economies, including in the United States and Europe, 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.

The third risk is <u>the effects of developments in foreign exchange rates on Japan's economic activity and prices</u>. 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, the year-on-year rate of increase in import prices has recently risen substantially due to the depreciation of the yen as well as developments in commodity prices, such as high crude oil prices. The impact of this rise requires due attention, since it is expected to push up the prices of a wide range of items, including durable goods.

In addition to these risks, a risk considered from a somewhat long-term perspective is <u>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</u>. 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.[4]

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 from the second half of fiscal 2026. This is because, with moves to pass on wage increases to selling prices continuing, the rise in crude oil prices to date 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 recent depreciation of the yen 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, it is projected that the mechanism in which wages and prices rise moderately in interaction with each other will be maintained, and that medium- to long-term inflation expectations will rise. In this situation, underlying CPI inflation is expected to increase gradually, coming to a level that is generally consistent with the price stability target between the second half of fiscal 2026 and fiscal 2027 and remaining at around that level thereafter.

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, real interest rates have been negative, mainly in the short- to medium-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, Japan's financial conditions have remained accommodative and are expected to continue to firmly support economic activity.

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. For the time being, it is necessary to pay particular attention to the impact of the situation in the Middle East on financial and foreign exchange markets and on Japan's economic activity and prices. In addition, it is necessary to pay attention to the effects of developments in global AI-related demand and of future developments in foreign exchange rates on Japan's economic activity and prices. With regard to the risk

[4] 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."

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 approaching 2 percent, there is a risk that it will deviate upward to a level above the 2 percent price stability target, given factors such as firms' behavior shifting more toward raising wages and prices and medium- to long-term inflation expectations continuing to rise. It is necessary to pay due attention to keep such a risk 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 of AI-related investment, and developments in the foreign non-bank financial intermediary (NBFI) sector have on the financial system through various channels.

As for the conduct of monetary policy, given that underlying CPI inflation has been approaching 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 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.

(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	+0.6 to +0.7 [+0.6]	+2.3 to +2.7 [+2.5]	+2.3 to +2.6 [+2.5]
Forecasts made in April 2026	+0.4 to +0.7 [+0.5]	+2.8 to +3.0 [+2.8]	+2.5 to +2.7 [+2.6]
Fiscal 2027	+0.7 to +0.8 [+0.8]	+2.2 to +2.5 [+2.4]	+2.2 to +2.7 [+2.6]
Forecasts made in April 2026	+0.6 to +0.8 [+0.7]	+2.3 to +2.4 [+2.3]	+2.6 to +2.7 [+2.6]
Fiscal 2028	+0.7 to +0.8 [+0.8]	+2.0 to +2.2 [+2.0]	+2.1 to +2.3 [+2.2]
Forecasts made in April 2026	+0.7 to +0.8 [+0.8]	+2.0 to +2.2 [+2.0]	+2.1 to +2.4 [+2.2]

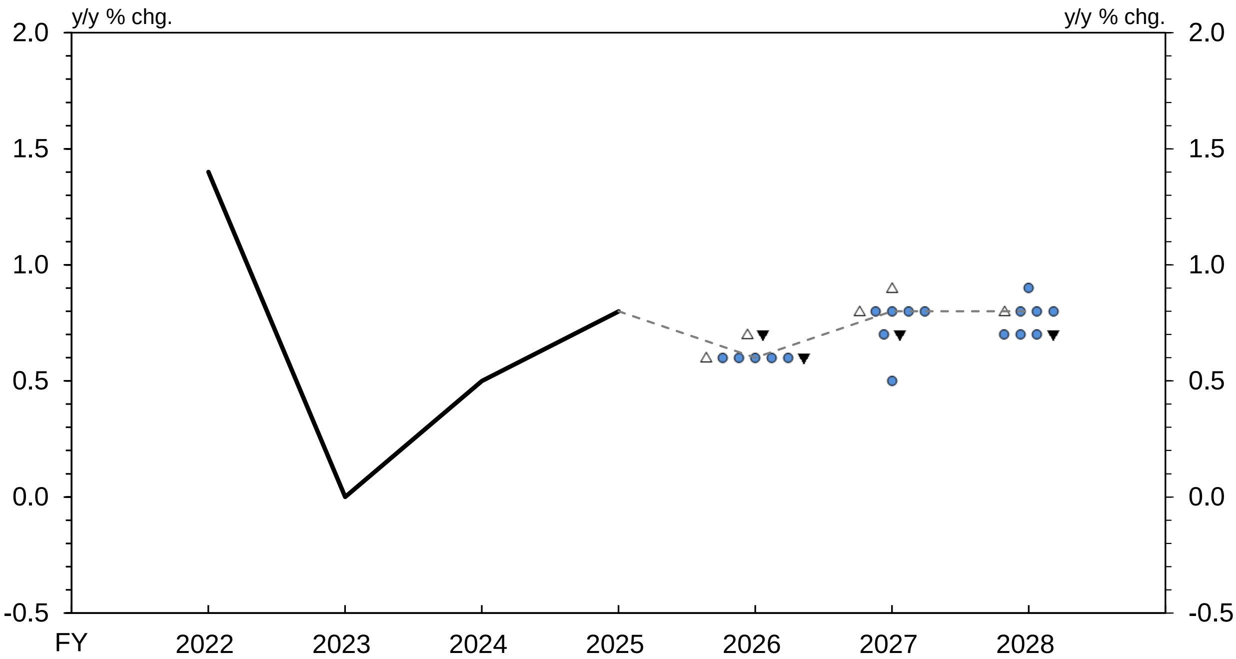
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

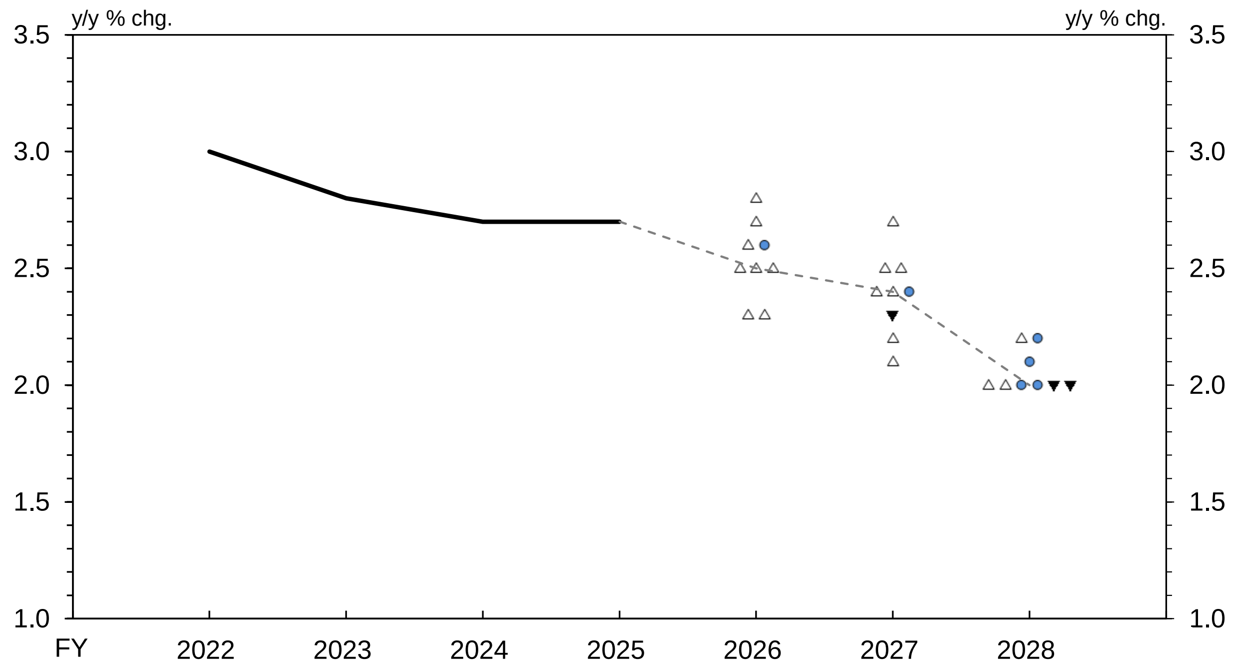
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."