

Not to be released until 2:00 p.m.
Japan Standard Time on
Monday, August 3, 2026.



Outlook for Economic Activity and Prices

July 2026



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

Please contact the Secretariat of the Policy Board, Bank of Japan, in advance, to request permission to reproduce or copy the content of this document for commercial purposes.

Please credit the source when quoting, reproducing, or copying the content of this document.

Outlook for Economic Activity and Prices (July 2026)

The Bank's View¹

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 Japan²

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

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 the impact of the situation in the Middle East on Japan's economic activity and prices. 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 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, 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 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.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.

Forecasts of the Majority of the Policy Board Members

y/y % chg.

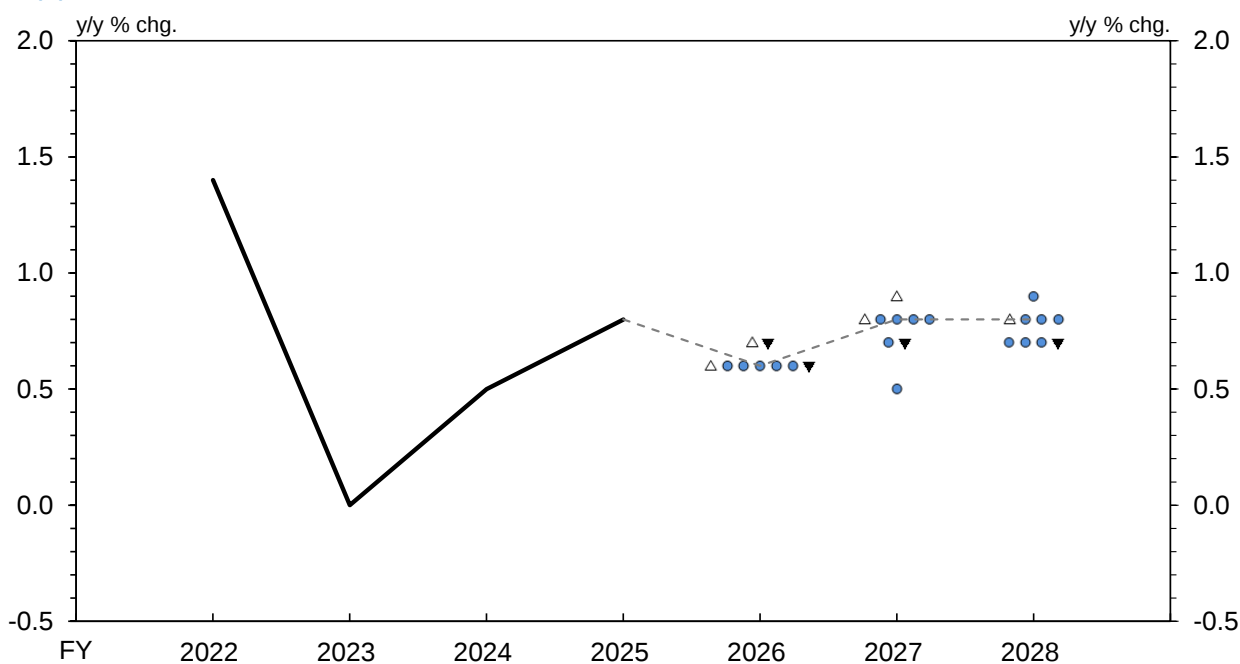
	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2026	+0.6 to +0.7 [+0.6]	+2.3 to +2.7 [+2.5]	+2.3 to +2.6 [+2.5]
Forecasts made in April 2026	+0.4 to +0.7 [+0.5]	+2.8 to +3.0 [+2.8]	+2.5 to +2.7 [+2.6]
Fiscal 2027	+0.7 to +0.8 [+0.8]	+2.2 to +2.5 [+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).

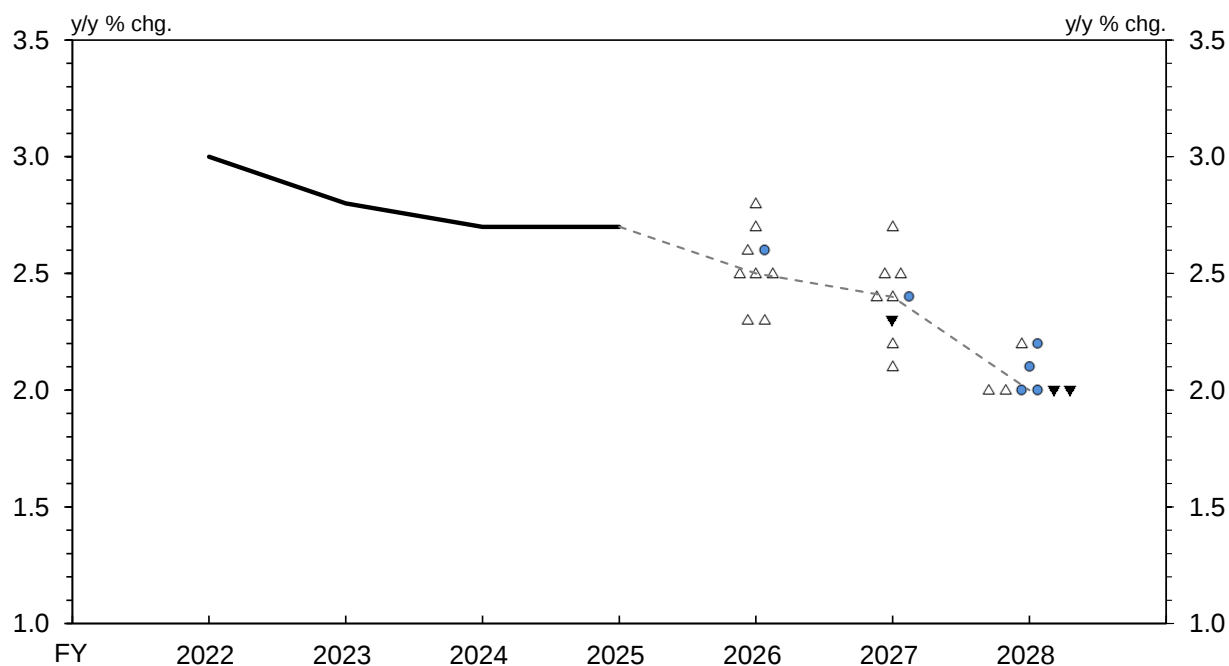
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest 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."

The Background⁵

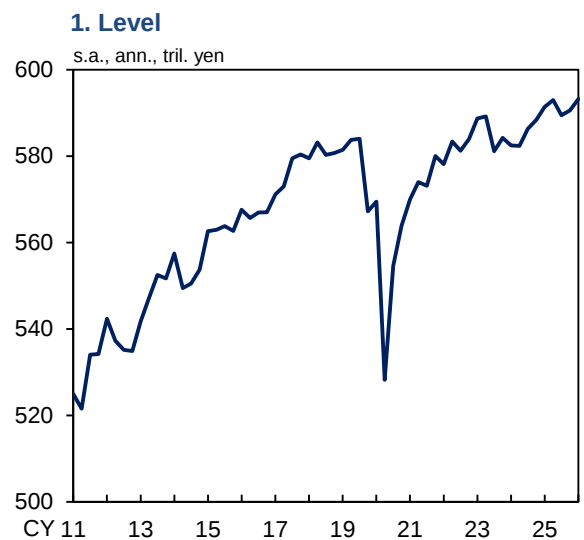
I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

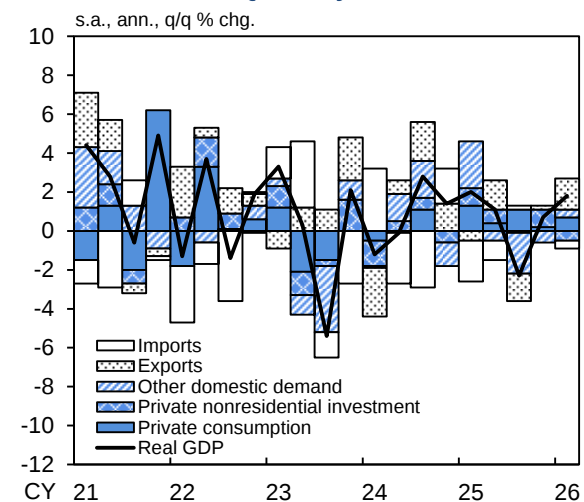
Japan's economy has recovered moderately, although some weakness has been seen in part, partly due to the impact of the situation in the Middle East.

The real GDP growth rate for the January-March quarter of 2026 was 0.5 percent on a quarter-on-quarter basis and 1.8 percent on an annualized basis, registering positive growth for two consecutive quarters (Chart 1). By demand component, (1) although business fixed investment turned to a decline reflecting delays in the progress of construction projects due to labor shortages and a surge in material prices, (2) private consumption continued to increase against the background of an improvement in real disposable income, and (3) exports also increased firmly, mainly in goods, on the back of a solid increase in AI-related demand, with the impact of the increase in tariffs last year having largely subsided. In this situation, labor market conditions have continued to be tight, and the output gap -- which captures the utilization of labor and capital -- was at around 0.5 percent in the January-March quarter (Chart 2).⁶

Chart 1: Real GDP



2. Annualized Quarterly Growth Rate



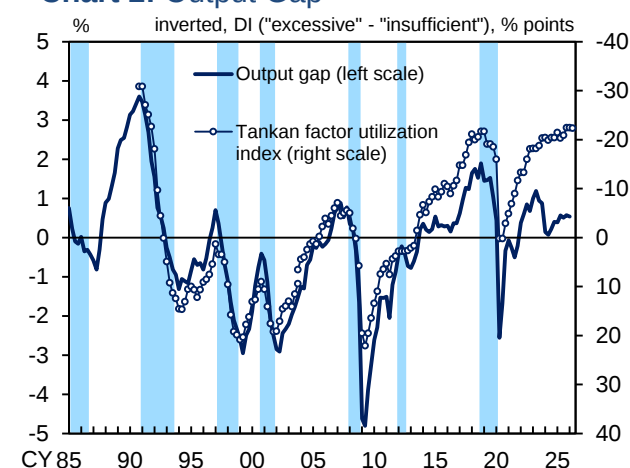
Source: Cabinet Office.

⁵ "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on July 30 and 31, 2026.

⁶ 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).

Monthly indicators, high-frequency data, and anecdotal information from firms since April suggest that the decline in imports of raw materials and the rise in energy and raw material prices, both reflecting the situation in the Middle East, have adverse effects on certain areas of exports and production and on sentiment; however, domestic and external demand has remained resilient, as large-scale disruptions in supply chains have been avoided owing to progress in securing alternative sources of supply, while the solid increase in global AI-related demand has also provided support.⁷ Exports and production have continued to be more or less flat as a trend. This is because, while the decline in exports and production of intermediate goods (e.g., chemicals) reflecting bottlenecks in logistics has been only small, exports and production of capital goods and IT-related goods have increased on the back of solid global AI-related demand. Against this backdrop, corporate profits appear to have been at high levels, and the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for business conditions for all industries and enterprises has remained at the most favorable level since August 1991, as in the previous survey. While firms -- as shown in the June *Tankan* -- have maintained their active business fixed investment stance, shortages in, and the rise in prices of, construction materials reflecting the situation in the Middle East, coupled with ongoing labor shortages, appear to have led to delays in the progress of construction investment in certain projects. In the household sector, while indicators of consumer sentiment have continued to show weakness, private

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.

⁷ See Box 1 for developments in raw materials imports in response to the situation in the Middle East.

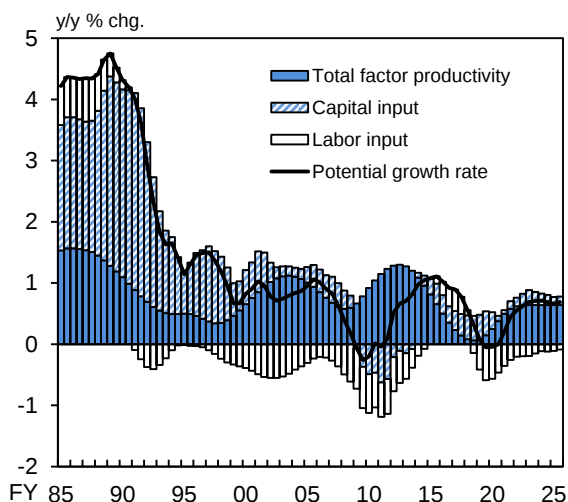
consumption has increased recently, pushed up by the government's various support measures, the wealth effects from higher stock prices, and the front-loading of demand for some goods, as well as the increase in the number of employees and in nominal wages. In reflection of the aforementioned developments in domestic and external demand, the employment conditions DI for all industries and enterprises in the June *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). As explained, although the adverse effects reflecting the situation in the Middle East have been observed in part, Japan's economy has been underpinned by the positive effects of factors such as solid global AI-related demand, the increase in stock prices, and the government's various support measures.

With regard to the outlook, Japan's economic growth is likely to decelerate somewhat for a time. This is because, although solid global AI-related demand and the government's various measures are likely to provide support, 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. In addition, attention is warranted on the possibility that production, particularly of transport equipment and of electronic parts and devices, could be pushed down in the near term due to supply-side constraints from the 2026 Kumamoto Earthquake. Thereafter, based on the assumption that crude oil prices will continue on a declining trend,

Japan's economic growth rate is likely to rise moderately, partly supported by the solid increase in global AI-related demand, and be at around the same level as the potential growth rate.⁸ Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rates are more or less unchanged.

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.

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Figures are staff estimates.

⁸ See Box 2 for the impact of increased global AI-related demand on Japan's economy.

Details of the outlook for each fiscal year are as follows. In fiscal 2026, Japan's economic growth is likely to decelerate somewhat from the previous fiscal year. This is because it is projected that, while exports will follow a moderate increasing trend on the back of solid 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 factors such as higher export prices for AI-related goods, 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. Goods exports are likely to remain more or less flat for the time being due to downward pressure on exports of intermediate goods and other items reflecting the impact of the situation in the Middle East; however, as the impact of the situation in the Middle East eases, goods exports are expected to follow a moderate increasing trend, mainly led by AI-related goods. Business fixed investment is likely to follow an upward trend, underpinned by factors such as moves to clear order backlogs for existing investment projects, in addition to investment in AI-related areas for capacity expansion. That said, for the time being, the growth momentum in business fixed investment is likely to remain subdued due to the impact of the slower growth in corporate profits reflecting higher energy and raw material prices, the rise in construction costs, and delays in construction projects. Nominal wages are highly likely to continue rising steadily, with base pay increases

being realized generally at around the same level as in 2025, and due to the impact of higher wages of part-time employees reflecting minimum wage increases. The number of employees is also highly likely to continue increasing moderately. In addition to such increases in employee income and the government's various measures such as those to reduce the household burden of higher energy prices, the front-loading of demand for durable goods is also likely to push up private consumption, which is expected to increase moderately for the time being; however, private consumption is highly likely to slow toward the second half of the fiscal year, as price rises are expected to exert increased downward pressure on real purchasing power. Meanwhile, housing investment is likely to follow a declining trend, mainly reflecting the rise in housing prices and demographic developments.

In fiscal 2027, Japan's economic growth is likely to accelerate somewhat to around the same level as the potential growth rate. This is because it is expected that, while downward effects due to price rises will remain, particularly in the first half of the fiscal year, the increasing trend in domestic private demand will gradually become more pronounced, supported by an improvement in trading gains due to elevated export prices for AI-related goods and a decline in crude oil prices. Goods exports are expected to follow a moderate increasing trend, mainly led by AI-related goods, as the impact of the situation in the Middle East eases. Corporate profits are likely to remain on an uptrend against the background of the increase in domestic and external demand and the decline in energy and raw material prices. 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 AI-related areas for capacity expansion, 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, pushed down by the earlier slowdown in growth momentum in corporate profits with a time lag. Private consumption is likely to remain more or less flat due to 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, although a recovery in real disposable income, reflecting a decline in the inflation rate, is expected to underpin private consumption.

In fiscal 2028, Japan's economic growth is likely to remain at a pace around the same level as the potential growth rate, with crude oil prices projected to remain more or less flat. 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

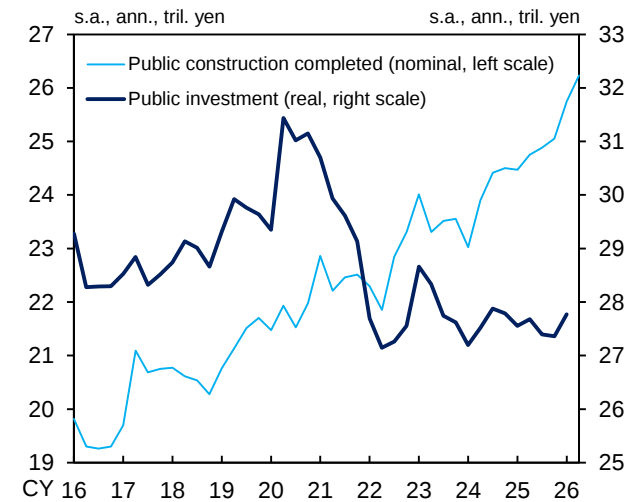
Public investment has continued to be more or less flat (Chart 4). While construction based on the government's economic measures, including construction related to building national resilience, has progressed, the amount of public investment (in real terms) has continued to be more or less flat when 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 a rise in construction costs.

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, reflecting an increase in spending on the government's economic measures and a rise in defense-related spending, in addition to an uptrend in healthcare and nursing care expenditures.

Overseas Economies

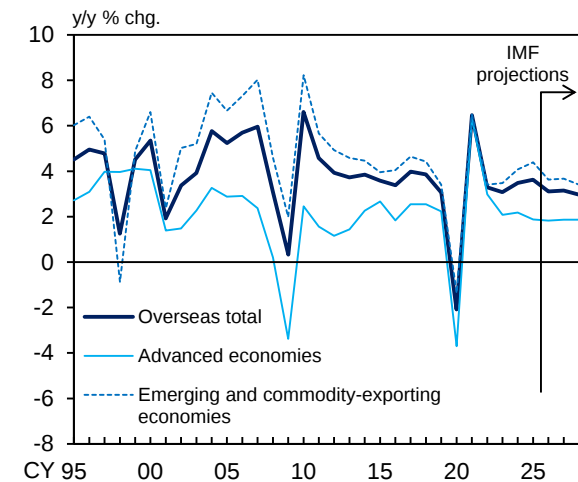
Overseas economies have grown moderately on the whole, although some weakness has been seen in part, partly due to the impact of the situation in the Middle East (Chart 5). By region, the U.S. economy has maintained solid growth on the whole, although some weakness has been seen in part. European economies 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 recently, mainly

Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2026/Q2 is the April-May average.

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 April 2026 *World Economic Outlook* (WEO) and the July 2026 WEO Update. 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.

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 services industry declined, affected by the situation in the Middle East, but have recently been slightly above 50, the break-even point between improvement and deterioration in business conditions. Meanwhile, figures for the manufacturing industry have 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 factors such as 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 impact of the situation in the Middle East is likely to exert downward pressure for the time being, mainly on Asian economies, which are highly dependent on energy imports from the Middle East. Thereafter, based on the assumption that the impact of the situation in the Middle East will ease, the U.S.

Chart 6: Global PMI

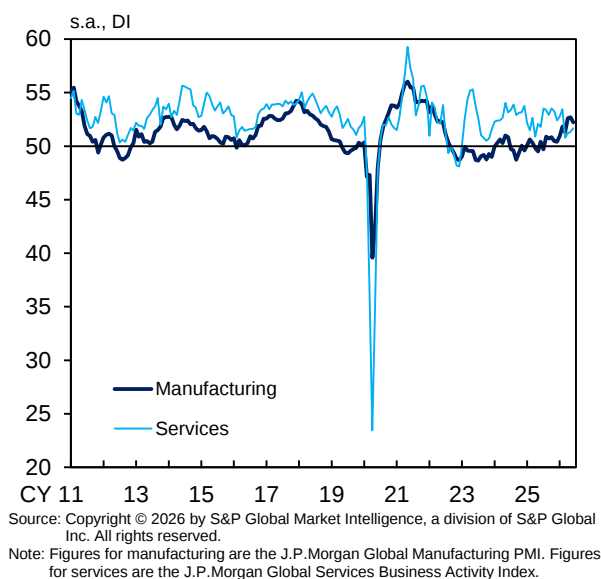
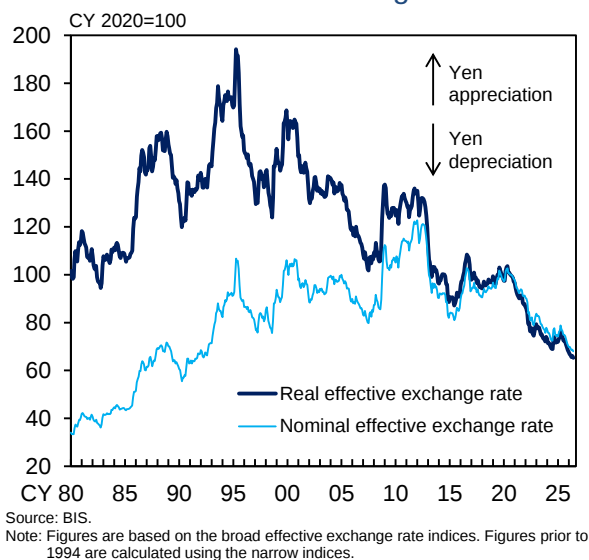


Chart 7: Effective Exchange Rates

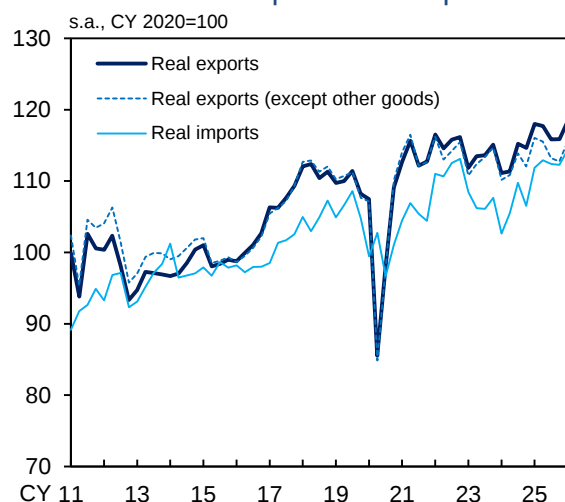


economy is expected to continue growing firmly, partly reflecting AI-related demand and support from economic policies. European economies are projected to see a gradual acceleration in their growth rate, partly reflecting support from economic policies. The Chinese economy is likely to improve moderately, partly reflecting support from economic policies. Emerging and commodity-exporting economies other than China are likely to improve moderately, partly supported by global AI-related demand.

Exports and Imports

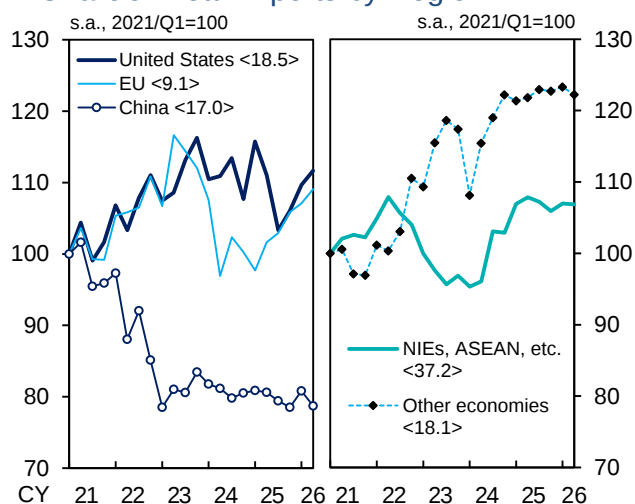
Exports have continued to be more or less flat as a trend, with downward effects from the situation in the Middle East and upward effects from global AI-related demand largely offsetting each other (Chart 8).⁹ By region, exports to the United States have increased, boosted by factors such as an increase in exports of capital goods for data centers, in addition to an increase in exports of automobile-related goods reflecting the resumption of production lines at some automakers (Chart 9). Exports to Europe have increased, especially of automobile-related goods, reflecting resilient domestic demand in the region and the effects of the introduction of new car models. Exports to China have remained at a low level, due to greater local production of automobiles, IT-related goods, and other products by Chinese manufacturers reflecting their increased competitiveness, and pushed down by the peaking-out of demand for semiconductor production equipment. Although exports to the NIEs, ASEAN, and some other Asian economies

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

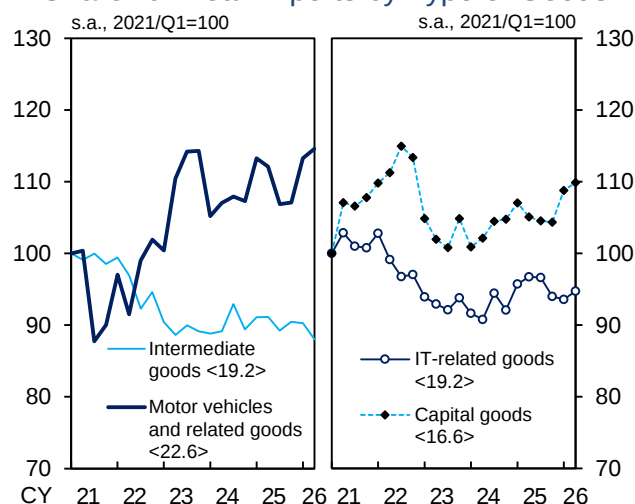


Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2025.

⁹ Real exports excluding "other goods" have also been more or less flat, where "other goods" include, for example, re-export goods that are not recorded in the GDP statistics.

have recently been pushed down by a decline in exports of mineral fuels (e.g., gas oil and jet fuel oil), they have been resilient as a trend, supported by solid exports of capital goods (semiconductor production equipment) on the back of global AI-related demand. Exports to other economies decreased in the April-June quarter, mainly due to the significant decline in exports of automobiles to the Middle East, although the extent of the overall decline was only small. In this regard, looking at monthly developments in exports to the Middle East, exports declined significantly through April, especially of automobile-related goods; since May, however, they have turned to a pick-up, reflecting progress in securing alternative export routes. By type of goods, exports of automobile-related goods -- despite downward effects from the situation in the Middle East -- have increased, particularly those to the United States and Europe, reflecting factors such as the resumption of production lines at some automakers and the effects of the introduction of new car models (Chart 10). Exports of capital goods have increased, particularly of semiconductor production equipment and equipment for power facilities, reflecting the solid increase in global AI-related demand. Exports of IT-related goods have been resilient, supported by solid AI-related demand, such as for data servers. Meanwhile, exports of intermediate goods had been more or less flat at low levels, due to continued oversupply, particularly in Asia, against the background of excess production capacity in China; more recently, exports of intermediate goods have declined further to a lower level due to a decline in the capacity utilization rate in the basic materials industry reflecting the impact of the situation in the Middle East.

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.

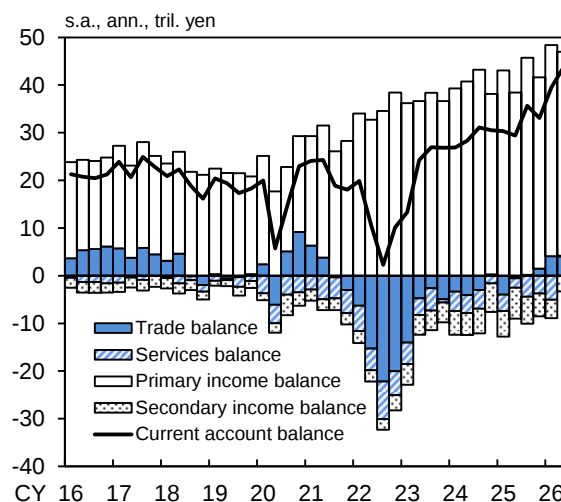
As for the outlook, exports are likely to remain more or less flat for the time being. This is because, while solid global AI-related demand is expected to push up exports of IT-related goods and capital goods in particular, the impact of the situation in the Middle East is expected to push down exports of intermediate goods and other items. Thereafter, as the impact of the situation in the Middle East eases, exports are projected to follow a moderate increasing trend, mainly led by AI-related capital goods and IT-related goods.

Imports have declined recently, mainly due to the decline in imports of raw materials reflecting the impact of the situation in the Middle East (Chart 8). As for the outlook, for the time being, imports are expected to pick up owing to progress in securing alternative sources of supply, despite the impact of the situation in the Middle East. Thereafter, imports are likely to follow a moderate uptrend, supported by an increase in domestic demand, including inventory restocking pressure, in addition to the normalization of logistics reflecting the easing of tension over the situation in the Middle East.

External Balance

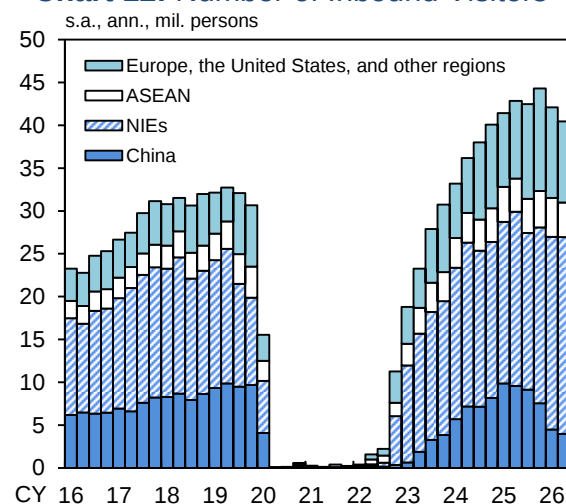
The nominal current account surplus has increased recently (Chart 11). The trade balance has registered a slight surplus, as nominal export values have increased due to a rise in the export price per unit for memory chips and other items and, more recently, the volume of imports of raw materials has declined, reflecting the situation in the Middle East. Looking at the services balance, while the travel balance -- supported by inbound tourism demand (Chart 12) -- has marked a

Chart 11: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2026/Q2 are April-May averages.

Chart 12: Number of Inbound Visitors



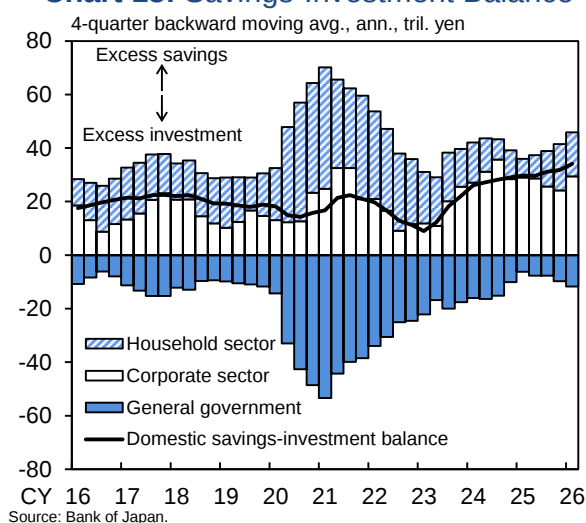
Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

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 has remained on an expanding trend, 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, in the near term, the surplus is likely to decline temporarily, as the trade balance is expected to deteriorate against the backdrop of factors such as the rise in crude oil prices. Thereafter, however, the nominal current account surplus is likely to increase moderately again, reflecting that the trade balance is expected to recover 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, as the expansion in excess savings in the corporate sector reflecting the increase in corporate profits has outpaced the expansion in the general government deficit (Chart 13). Looking ahead, overall excess savings are expected to continue expanding moderately, against the background of an improvement in corporate profits and a decrease in the fiscal deficit in the government sector.

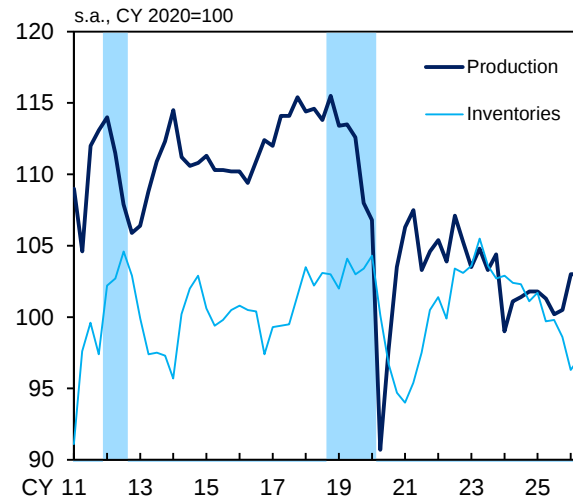
Chart 13: Savings-Investment Balance



Industrial Production

Industrial production has continued to be more or less flat from a somewhat long-term perspective (Chart 14). By major industry, production of "transport equipment" -- despite the impact of the decline in exports to the Middle East -- has been at a high level, amid resilience in demand from the United States and Europe as well as in domestic demand. Production of "general-purpose, production, and business-oriented machinery" -- despite being affected by fluctuations stemming from production of semiconductor production equipment and other items -- has been on an increasing trend, with the solid increase in global AI-related demand spreading to the production of a wider variety of items. Production of "electronic parts and devices" has been on an increasing trend, mainly led by production of memory chips and electric circuits, on the back of solid AI-related demand. Production of "electrical machinery, and information and communication electronics equipment" has increased, mainly for semiconductor measuring instruments and air conditioners. On the other hand, production of "chemicals (excluding medicine)" has declined further, as it has been pushed down by oversupply, particularly in Asia, as a trend, and more recently by the impact of the decline in plant utilization rates reflecting disruptions in imports of raw materials from the Middle East. Meanwhile, inventories have seen a clear decline recently, since AI-related demand has been more solid than firms had expected. The decline also reflects inventory drawdowns for chemical products stemming from the situation in the Middle East and the front-loading of demand for air conditioners in view of changes in environmental standards.

Chart 14: Industrial Production

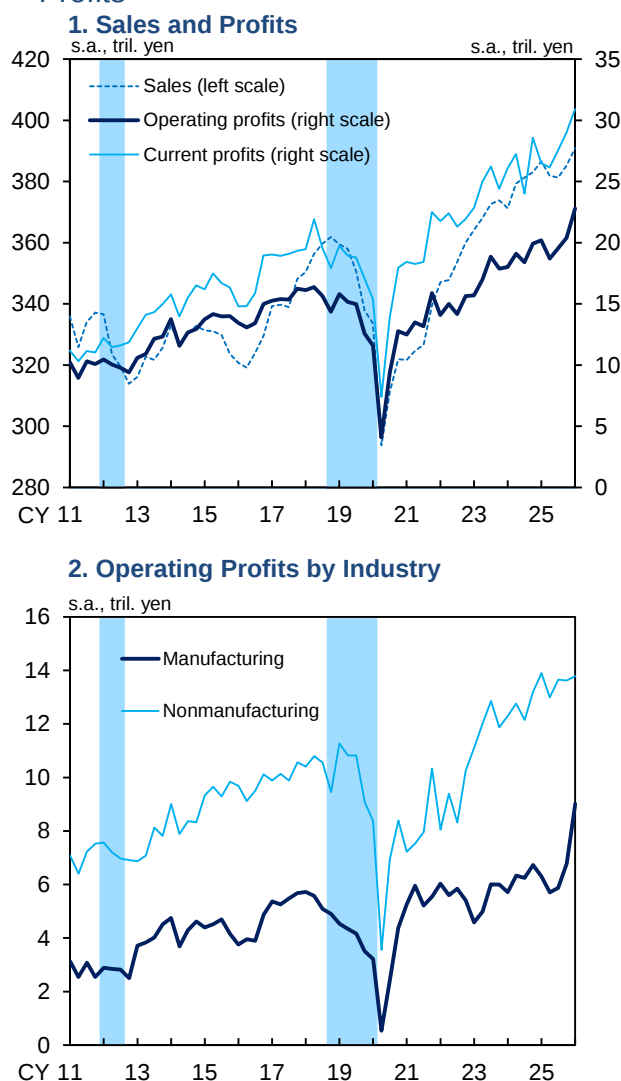


As for the outlook, industrial production is expected to remain more or less flat for the time being, with upward effects from the solid increase in global AI-related demand and downward effects from the situation in the Middle East offsetting each other. Thereafter, however, industrial production is expected to increase moderately, as the impact of the situation in the Middle East eases.

Corporate Profits

Corporate profits have been at high levels against the backdrop of factors such as the solid increase in global AI-related demand. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, operating profits for all industries and enterprises have increased further to a higher level, marking a record high in the January-March quarter, 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 increased markedly, mainly in electrical machinery, and information and communication electronics equipment, as well as in general-purpose, production, and business-oriented machinery. This is because the solid increase in AI-related demand has pushed up profits through its impact on both prices and quantities, although in transportation machinery adverse effects from the deterioration in export profitability due to the increase in U.S. tariffs have been observed. As for nonmanufacturers, operating profits have been at high levels, mainly in the construction and real estate-related sectors, against the backdrop of resilient domestic

Chart 15: Indicators Related to Corporate Profits

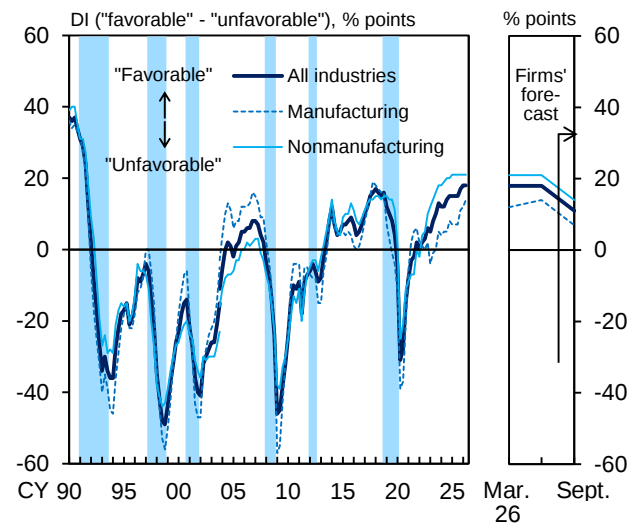


Source: Ministry of Finance.
 Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance" and "pure holding companies."
 2. Shaded areas denote recession periods.

demand and progress in the pass-through of cost increases to selling prices.

Business sentiment has been at a favorable level against the backdrop of factors such as solid global AI-related demand, while it has been affected by the situation in the Middle East. Looking at the June *Tankan*, the business conditions DI for all industries and enterprises was unchanged from the March *Tankan* at a net "favorable" value of 18, remaining at its highest level since August 1991. As for the outlook, however, business conditions are projected to deteriorate by a relatively large degree, with the forecast DI registering a value of 11, reflecting concern over an increase in input costs due to the impact of the situation in the Middle East and over a reactionary decline following the front-loading of demand (Chart 16). By industry, the business conditions DI for manufacturing as a whole has improved. This is because, although adverse effects of the rise in raw material and energy prices reflecting the situation in the Middle East have been seen in the DI for basic materials, the solid increase in AI-related demand has pushed up 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 the effects of the rise in energy and raw material prices and expectations of a reactionary decline following the front-loading of demand. The business conditions DI for nonmanufacturing has been at a high level, supported by resilient domestic demand and progress in the pass-through of cost increases to selling prices, although the effects of the rise in raw material and energy prices and of the difficulty in securing

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.

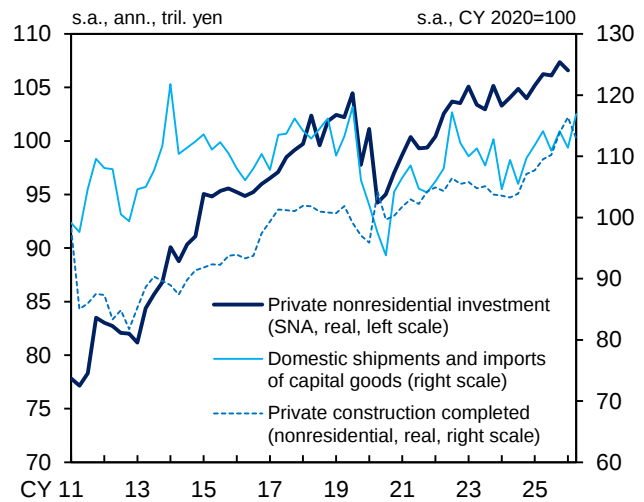
sources of supply for raw materials have pushed down the DI for small enterprises in particular. The forecast DI indicates business conditions are expected to deteriorate reflecting concern over the increase in input costs.

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 remain on an uptrend, underpinned by the government's measures to reduce the household burden of higher energy prices, and pushed up by solid global AI-related demand.

Business Fixed Investment

Business fixed investment has been on a moderate increasing trend (Chart 17). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has been on a moderate increasing trend, 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. Despite being affected by delays in construction projects due to high construction material prices and labor shortages, private construction completed (nonresidential, real) -- a coincident indicator of construction investment -- has continued on a moderate uptrend, supported by strong construction demand, mainly demand for logistics facilities, demand related to urban redevelopment, and demand related to electricity.

Chart 17: Coincident Indicators of Business Fixed Investment



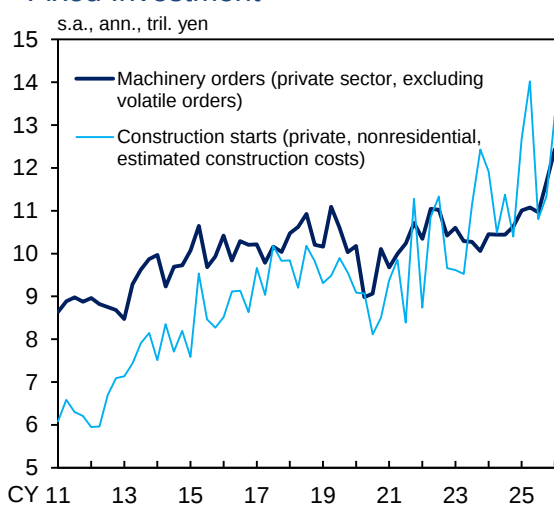
Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.

Notes: 1. The figure for private construction completed for 2026/Q2 is the April-May average.

2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

Machinery orders (private sector, excluding orders for ships and orders from electric power companies) -- 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, supported by large-scale investments by the chemical, nonferrous metal, and shipbuilding industries in addition to solid demand for investment in growth areas, such as semiconductor components and AI-related areas, for capacity expansion. 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 increased significantly, pushed up as a trend by increased electricity demand related to data centers and orders to address decarbonization, and more recently boosted by large-scale projects. Construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have been on an increasing trend, mainly in nonmanufacturing, albeit with fluctuations stemming from large-scale projects, as construction starts have been supported by solid demand related to urban redevelopment and demand for construction such as of new logistics facilities and new data centers. Looking at business fixed investment plans (in nominal terms) in the June *Tankan*, business fixed 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

Chart 18: Leading Indicators of Business Fixed Investment

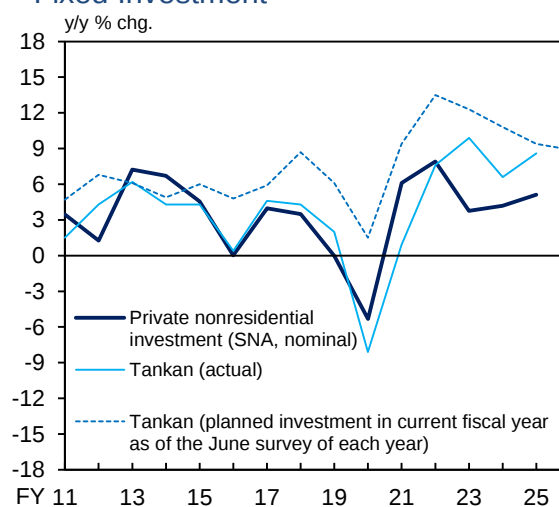


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
 Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
 2. Figures for 2026/Q2 are April-May averages.

enterprises including financial institutions) for fiscal 2025 increased firmly at a year-on-year rate of 8.6 percent, which represents a rate somewhat higher than that recorded in the previous fiscal year (Chart 19). Although investment plans by small enterprises show some weakness due to factors such as the impact of the situation in the Middle East, the year-on-year rate of increase in business fixed investment plans for fiscal 2026 reported in the *Tankan* registers 8.9 percent, which represents an overall solid increase.

Regarding the outlook, business fixed investment is likely to follow an upward trend, underpinned by factors such as moves to clear order backlogs for existing investment projects, in addition to investment in AI-related areas for capacity expansion. That said, for the time being, the growth momentum in business fixed investment is likely to remain subdued due to the impact of a slower pace of growth in corporate profits reflecting higher energy and raw material prices, a rise in construction costs, and delays in construction projects. 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

Chart 19: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
 Note: 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.

urban redevelopment; (3) investment in growth areas, such as AI- and semiconductor-related areas, for capacity expansion; (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 rate of increase in the number of employed persons has accelerated recently, reflecting a recovery in the growth momentum in the number of employees (Chart 21). Among employees, the number of regular employees has been on an increasing trend, driven by the medical, healthcare, and welfare services industry, which has faced severe labor shortages, and recently by the manufacturing industry, which has experienced solid AI-related demand. Although the number of non-regular employees declined to a somewhat lower level as firms shifted toward regular employment, it has recovered recently,

Chart 20: Capital Stock Cycles

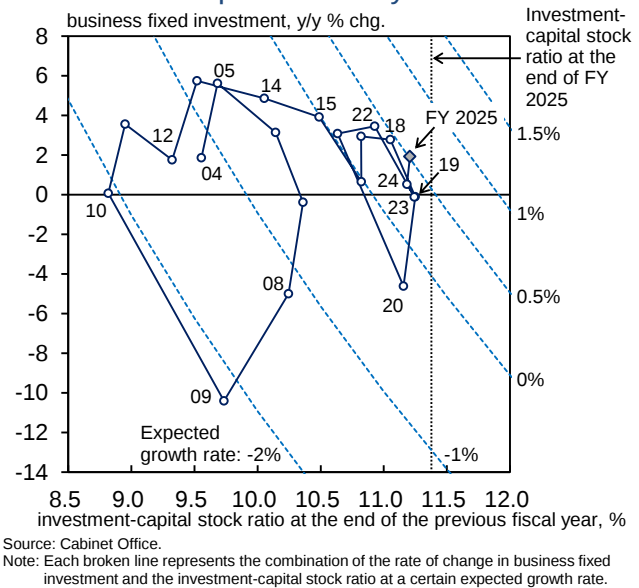


Chart 21: Number of Employed Persons

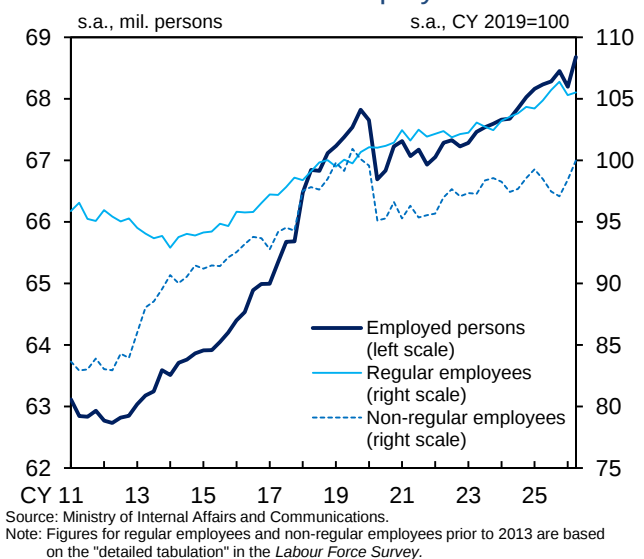
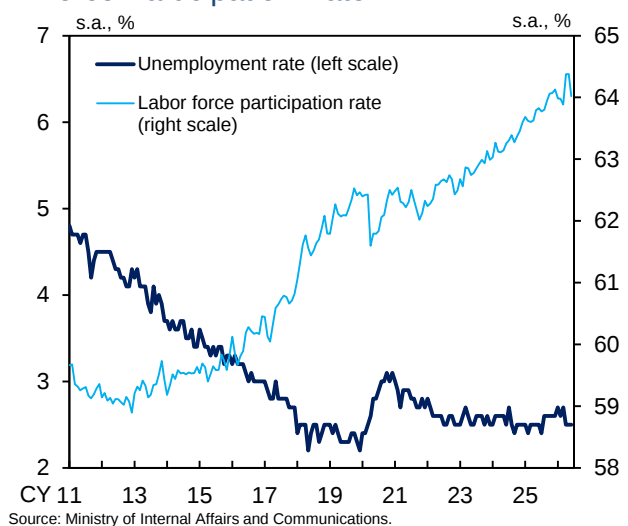


Chart 22: Unemployment Rate and Labor Force Participation Rate

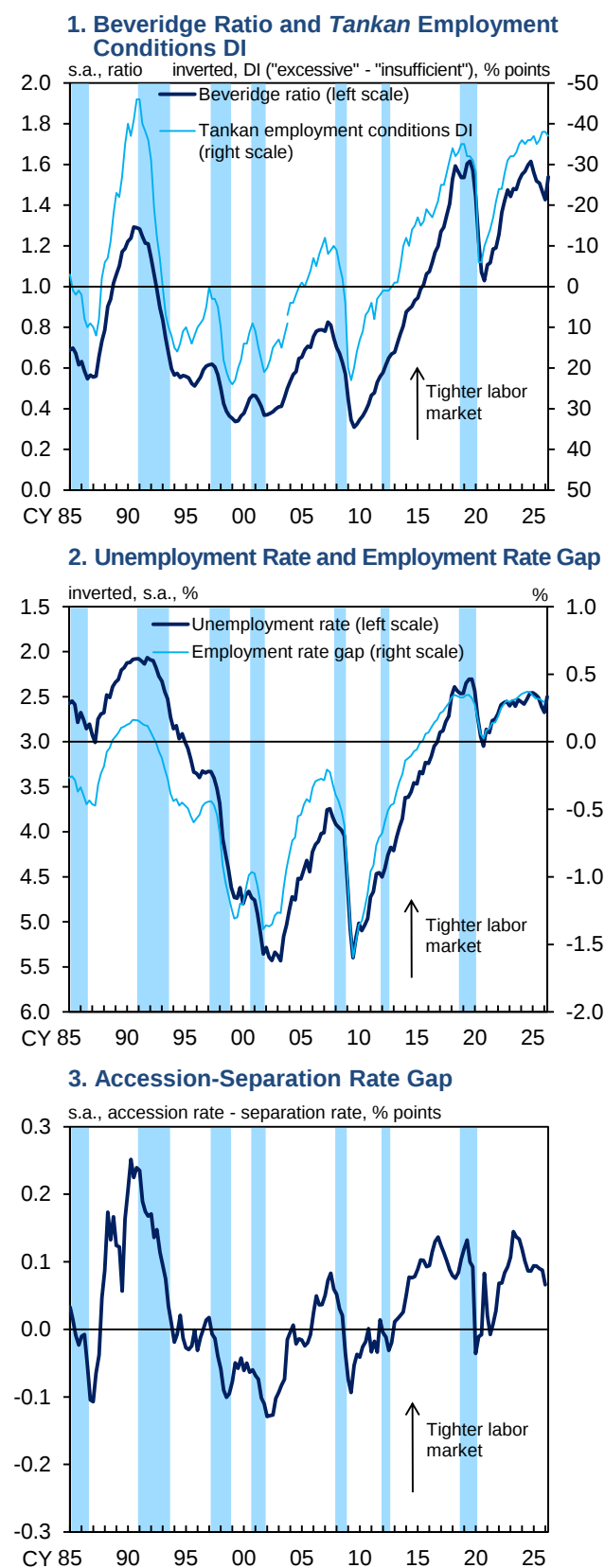


mainly in the medical, healthcare, and welfare services industry and in the face-to-face services industry.

Labor market conditions have remained tight. The unemployment rate has been at a low level of around 2.5-3.0 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, 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 (Chart 23[3]). On the other hand, the Beveridge ratio has declined slightly compared with a while ago, due to minimum wage increases and a decline in the job vacancy rate reflecting progress in labor-saving investment, although it has recently picked up somewhat (Chart 23[1]). Meanwhile, the labor force participation rate has remained -- albeit with fluctuations -- 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

Chart 23: Labor Market Indicators



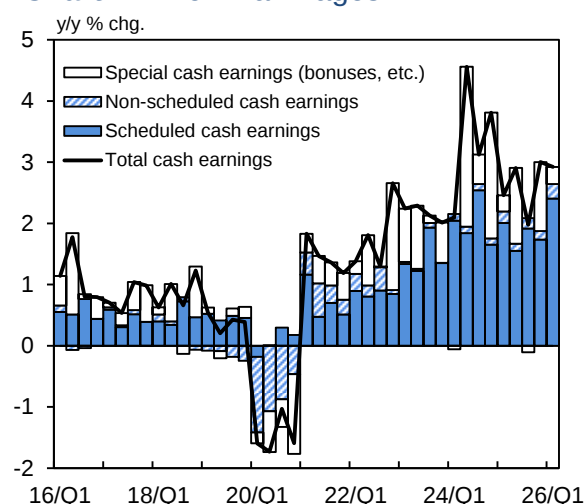
Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

- 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/Q2 is the April-May average).
4. Shaded areas denote recession periods.

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.

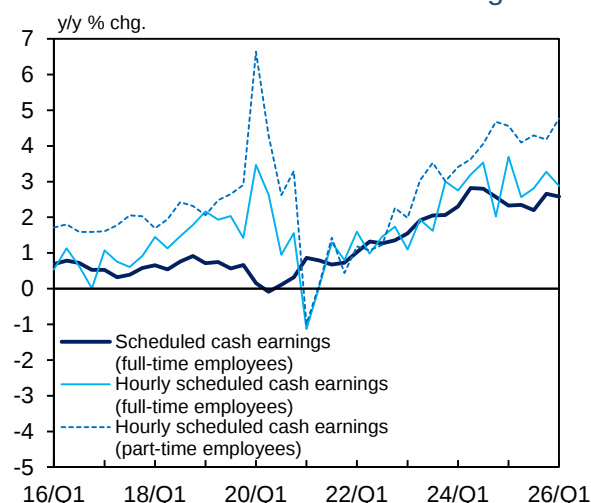
On the wage side, nominal wages per employee have continued to increase steadily, albeit with fluctuations (Chart 24).¹⁰ Looking at the breakdown, the year-on-year rate of increase in scheduled cash earnings has been close to 3 percent recently (Chart 25). Specifically, the year-on-year rate of increase in scheduled cash earnings per employee for full-time employees decelerated through last year, reflecting weak developments particularly in the wholesale and retail trade industries, which may be due to sample bias; however, the rate of increase in these earnings has been at around 2.5-3.0 percent since the turn of this year, as the effects of sample bias have dissipated. 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 when fluctuations are smoothed out. The year-on-year rate of increase in hourly scheduled cash earnings for part-time employees has

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.

¹⁰ 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.

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 year-on-year rate of change in non-scheduled cash earnings has registered a relatively large positive figure, primarily due to an increase in hourly wages for overtime work and, more recently, to the impact of a rise in overtime hours associated with increased production in manufacturing. Meanwhile, looking at the year-on-year rate of increase in special cash earnings (bonuses, etc.), such earnings have maintained their firm growth, albeit with fluctuations, supported by the high levels of corporate profits.

With regard to the outlook for wages, a wage growth rate (in terms of the rate of base pay increases) of around 3.5 percent -- around the same level as in 2025 -- was achieved in this year's annual spring labor-management wage negotiations. Against this backdrop, the rate of increase in scheduled cash earnings per employee for this fiscal year is highly likely to be around the same level as in fiscal 2025, when the effects of fluctuations due to sample revisions are excluded. Regarding the next fiscal year, the rate of increase in scheduled cash earnings is highly likely to decelerate somewhat, weighed down by slower growth in corporate profits due to high energy and raw material prices. Thereafter, however, the rate of increase in scheduled cash

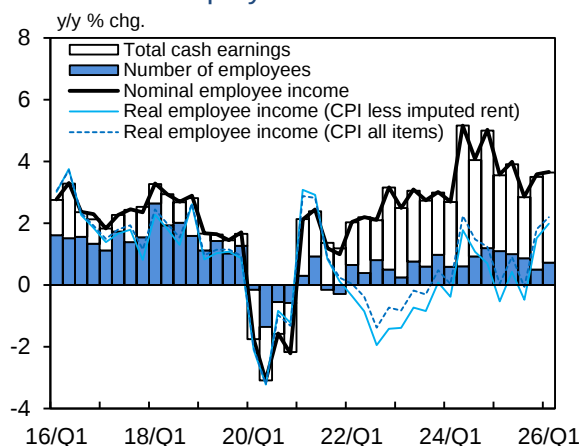
earnings is likely to accelerate again, supported by tighter labor market conditions and an improvement in corporate profits. Meanwhile, the rate of increase in special cash earnings (bonuses, etc.) is expected to decelerate temporarily from the second half of this fiscal year through the first half of the next fiscal year, reflecting changes in corporate profits with a time lag; however, the growth momentum in special cash earnings is likely to increase again through the second half of the projection period.

In light of the aforementioned employment and wage conditions, nominal employee income has continued to increase steadily at a pace of around 3-4 percent on a year-on-year basis (Chart 26). The year-on-year rate of change in employee income in real terms -- based on the CPI (all items less imputed rent) -- had been at around 0 percent but has picked up to around 1-2 percent since the end of last year, reflecting factors such as a decline in the inflation rate. 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 rate of increase in employee income is expected to slow noticeably 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 employment and income situation, although weakness has been seen in household sentiment.

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.

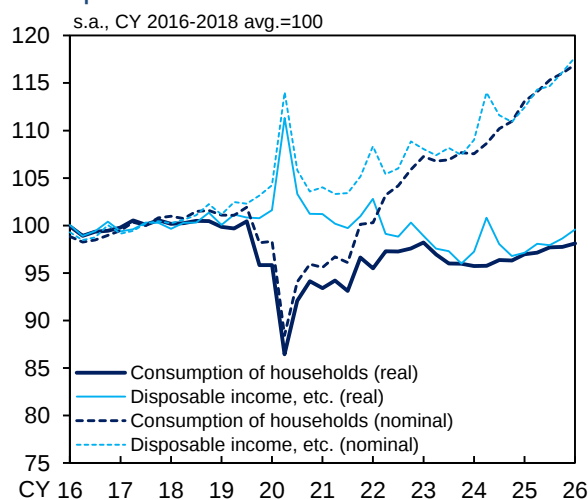
2. Nominal employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*)

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.

The Consumption Activity Index (CAI; real, travel balance-adjusted) -- which is calculated by combining various sales and supply-side statistics -- has increased recently, due to a temporary increase in demand for durable goods, in addition to the improvement in real income and the wealth effects from higher stock prices (Charts 27 and 28).¹¹ By type, consumption of durable goods had declined somewhat since the turn of this year, but has recently increased substantially, mainly for automobiles (Chart 28). Automobile sales had been relatively weak since the turn of this year, as consumers had been holding back on purchases in anticipation of the abolition of the environmental performance levy on automobiles at the end of March; since April, however, automobile sales have increased substantially, due to pent-up demand. Sales of household electrical appliances have been at high levels, albeit with fluctuations. This is because sales of air conditioners have been solid 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, although renewal demand for personal computers reflecting the end of support for some operating systems has come to a halt. Consumption of non-durable goods (e.g., "beverages and food" and "clothes") had continued on a decreasing trend against the backdrop of consumers' thriftiness but has recently picked up, due to the stockpiling of daily necessities, in addition to the improvement in real income.

Chart 27: Consumption of Households and Disposable Income

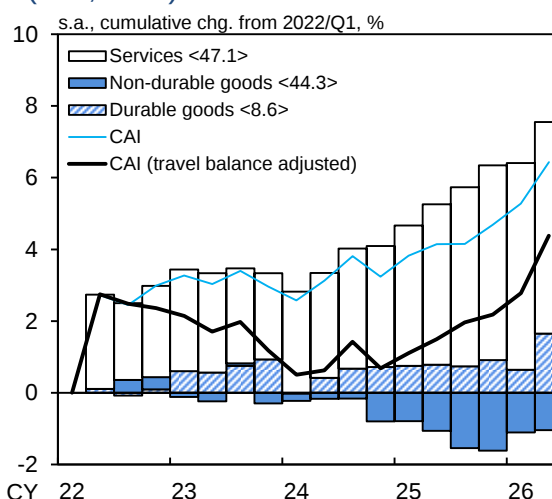


Source: Cabinet Office.

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/Q2 are April-May 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.

¹¹ 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).

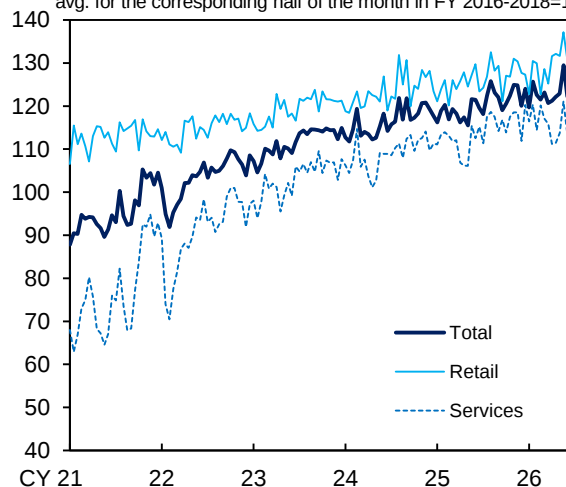
Services consumption has increased moderately (Charts 28 and 29). With the shift to dining-out continuing as a trend, dining-out has increased moderately, supported in part by the improvement in real income. Domestic travel has been at a relatively high level, supported by a strong willingness to travel among working households who have benefitted from wage increases. 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 in March and April, reflecting the unstable situation in the Middle East and a rise in inflation expectations; however, the deterioration in the index has come to a halt 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 also declined sharply through April reflecting concern over a deterioration in corporate profits due to the rise in energy prices reflecting the situation in the Middle East and its adverse impact on private consumption. However, the DI has generally stopped declining since then, due in part to strong sales of durable consumer goods and the wealth effects from higher stock prices.

Looking at recent developments in private consumption from various sources, such as high-frequency indicators, statistics published by

Chart 29: Consumption Developments Based on Credit Card Spending

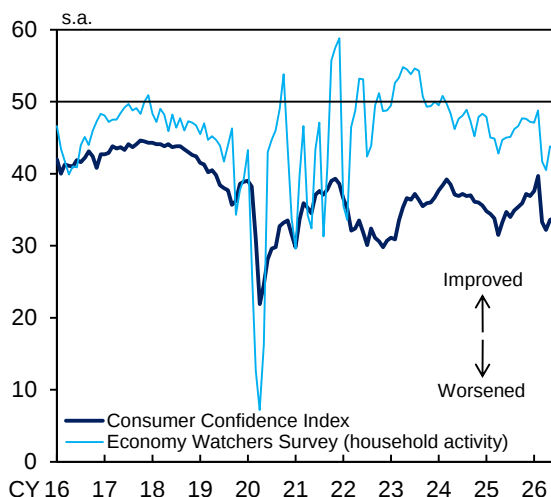
avg. for the corresponding half of the month in FY 2016-2018=100



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.

Chart 30: Confidence Indicators Related to Private Consumption



Source: Cabinet Office.

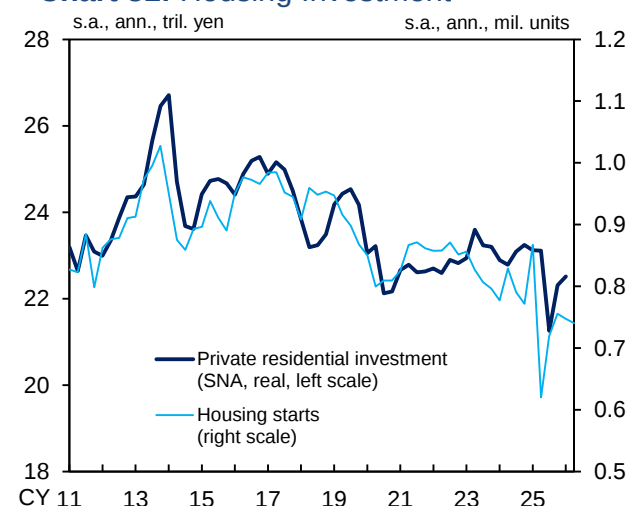
Note: Figures for the *Economy Watchers Survey* are those for the current economic conditions DI.

industry organizations, and anecdotal information from firms, the growth momentum in private consumption appears to have been maintained as a trend, although consumption was pushed down by weather conditions, such as typhoons and heavy rains, in June (Chart 29).

Regarding the outlook, while price rises are expected to weigh on real disposable income, private consumption for the time being is highly likely to be resilient, pushed up by the government's various support measures and the front-loading of demand for goods such as air conditioners, in addition to the wealth effects from higher stock prices. Thereafter, private consumption is likely to be more or less flat for a time, 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; however, private consumption is projected to turn to a moderate increasing trend, supported by a recovery in real disposable income reflecting a decline in the inflation rate.

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 a rise in housing prices and demographic developments. Housing investment is likely to follow a moderate declining trend.

Chart 31: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2026/Q2 is the April-May average.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The year-on-year rate of increase in the producer price index (PPI) has accelerated markedly, pushed up by a significant 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).¹² 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).

The year-on-year rate of increase in the CPI (all items less fresh food and energy) has been in the range of 1.5-2.0 percent recently, mainly due to the decline in the rate of increase in food prices, which had risen substantially last year, although moves to pass on increases in wages, distribution costs, and other costs to selling prices have continued (Charts 32 and 34).¹³ The year-on-year rate of increase in the CPI (all items less fresh food) has recently been at around 1.5 percent due

¹² See Box 3 for the background to and impact of upward pressure on prices in business-to-business transactions.

¹³ In August 2026, the base year for the CPI is scheduled to be changed from 2020 to 2025, and the annual CPI inflation for January 2026 onward will be retroactively revised. While factors such as the revision of model formulas entail uncertainties, the year-on-year rate of change in the CPI inflation (all items less fresh food) from January 2026 onward will likely see no substantial change between the 2020 base and the 2025 base, given factors such as the recent developments in the Laspeyres chain index and the new weight released in July.

Chart 32: Inflation Indicators

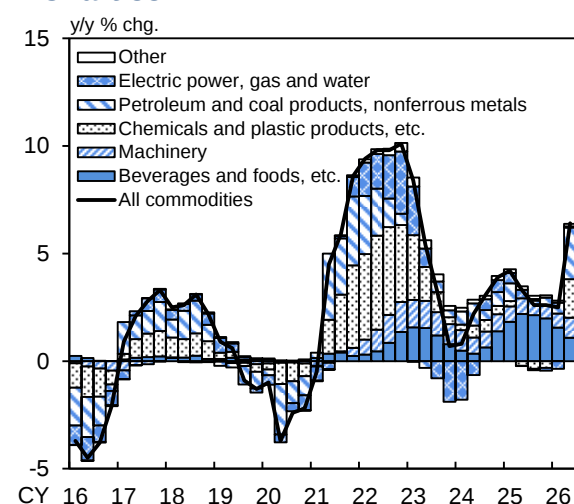
	y/y % chg.			
	25/Q3	25/Q4	26/Q1	26/Q2
Consumer Price Index (CPI)				
Less fresh food	2.9	2.8	1.8	1.5
Excluding institutional factors	2.9	2.7	2.3	2.8
Less fresh food and energy	3.2	3.0	2.5	1.8
Excluding institutional factors	3.4	3.2	2.7	2.1
Less food and energy	1.5	1.5	1.4	1.1
Excluding institutional factors	1.8	1.8	1.7	1.4
Producer Price Index (PPI)	2.6	2.6	2.5	6.4
Services Producer Price Index	2.9	2.7	2.7	2.9
GDP Deflator	3.5	3.4	3.2	
Domestic demand deflator	2.8	2.6	2.4	

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

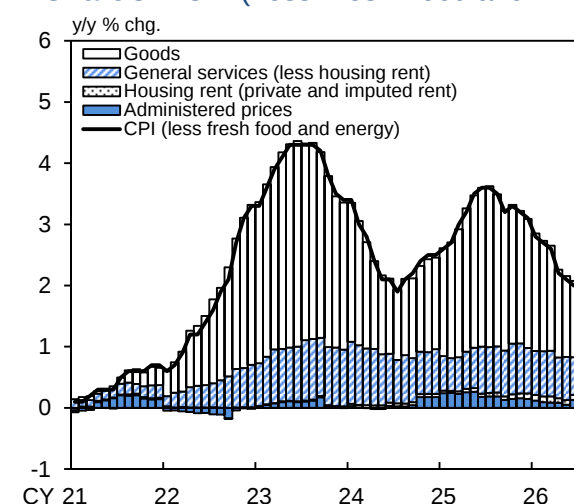


Source: Bank of Japan.

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.

Notes: 1. Administered prices (less energy) consist of "public services" and "water charges."

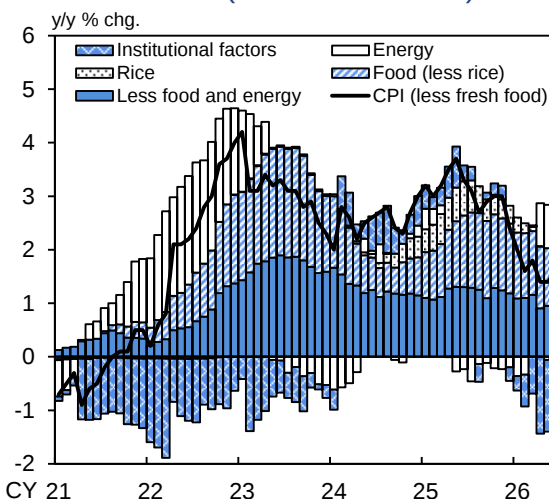
2. The CPI figures are staff estimates and exclude the effects of the consumption tax rate change and policies concerning the provision of free education (including the free school lunches starting in April 2026), the reduction in mobile phone charges in 2021, and travel subsidy programs.

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 year-on-year rate of increase has been in the range of 1.0-1.5 percent (Charts 32 and 35).

Regarding the breakdown of the CPI (all items less fresh food and energy), the rate of increase in goods prices has decelerated, mainly due to the decline in the rate of increase in food prices (Chart 34). With the pass-through of wage increases to selling prices continuing, the rate of increase in general services prices had been at around 2 percent of late; more recently, however, it has declined to the range of 1.0-1.5 percent, mainly due to the effects of free tuition for private high schools. The year-on-year rate of increase in administered prices (less energy) has been at around 0 percent recently, due to downward effects from factors such as the provision of free school lunches and reductions in nursery school fees by some local governments, while the rate has been pushed up by price hikes by railway companies and the revision of medical fees.

From the perspective of capturing the underlying trend in the CPI, 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, excluding institutional factors) has decelerated compared with a while ago, mainly due to the

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.

deceleration in the rate of increase in food prices; however, the rate of increase has remained above 2 percent. Similarly, the year-on-year rate of increase in the CPI (all items less fresh food and energy, excluding institutional factors) has also decelerated compared with a while ago, and has recently been at around 2 percent (Chart 36).¹⁴ The year-on-year rate of increase in the CPI (all items less food and energy, excluding institutional factors) has been at around 1.5 percent. Core indicators calculated using information such as the price change distribution exhibited the following developments (Chart 37).¹⁵ The rate of increase in the trimmed mean of the year-on-year rate of change in the CPI had decelerated to around 1.5 percent, mainly due to the deceleration in the rate of increase in food prices; more recently, however, the rate of increase has risen somewhat due to factors such as the impact of the rise in medical fees. The rate of increase in the weighted median had declined due to the deceleration in the rate of increase in food prices and the effects of the government's measures to reduce the household burden of higher energy prices; more recently, however, the rate of increase has accelerated slightly to around 1

Chart 36: CPI (Excluding Institutional Factors)

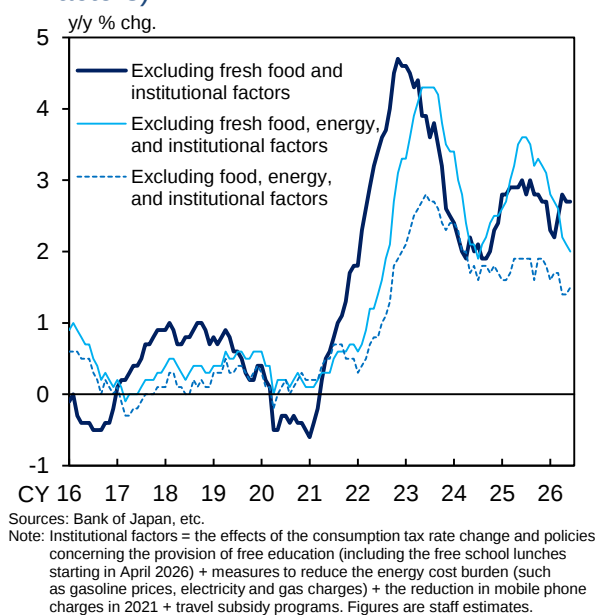
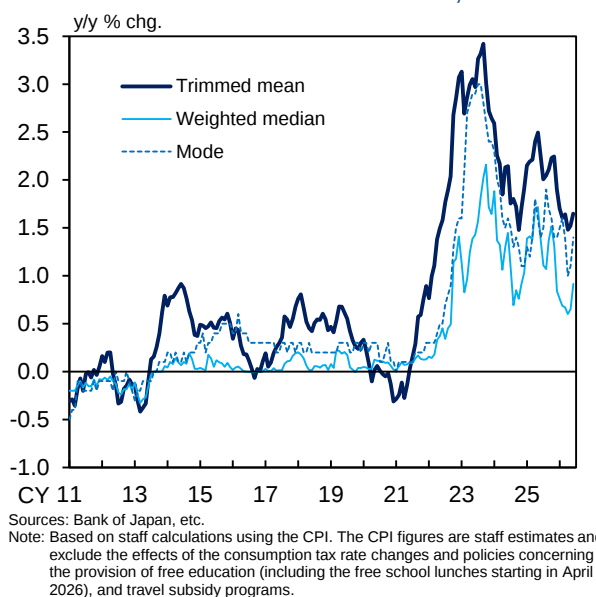


Chart 37: CPI: Trimmed Mean, etc.



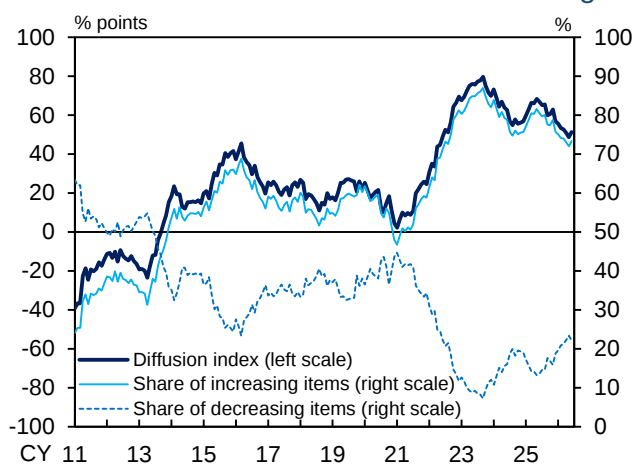
¹⁴ Institutional factors refer to the effects of the consumption tax rate changes and policies concerning the provision of free education (including the free school lunches starting in April 2026), measures to reduce the energy cost burden (such as gasoline prices, electricity and gas charges), the reduction in mobile phone charges in 2021, and travel subsidy programs. The effects of institutional factors are staff estimates.

¹⁵ 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 50 percentile point of the cumulative distribution in terms of weight. Each indicator is calculated using data for each CPI item that excludes the effects of the consumption tax changes and policies concerning the provision of free education, and travel subsidy programs.

percent. Similarly, the rate of increase in the mode had declined since the turn of this year 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 had been on a declining trend in positive territory but has recently stopped decreasing and started picking up reflecting an increase in the number of items whose prices have increased, such as food items (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 increased moderately toward 2 percent on the whole (Chart 40).¹⁶ Medium- to long-term inflation expectations of firms have continued to trend upward and have been above 2 percent. Although medium- to long-term inflation expectations of households and experts have remained below 2 percent, they have been rising moderately overall. 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 moderate uptrend, with estimates hovering in a

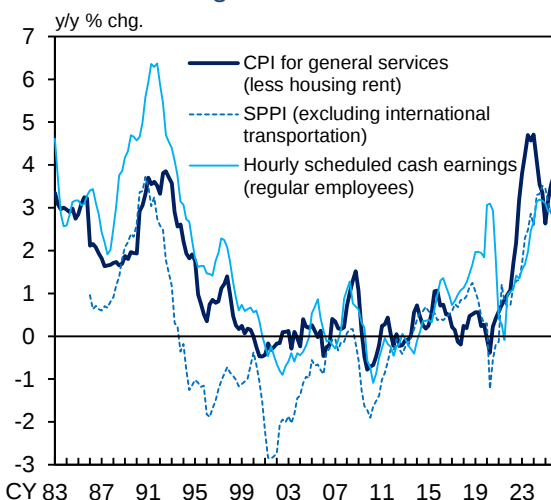
Chart 38: Diffusion Index of Price Changes



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 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), and travel subsidy programs.

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 the effects of the consumption tax rate changes and policies concerning the provision of free education, the reduction in mobile phone charges in 2021, and travel subsidy programs.
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/Q2 is the April-May average.

¹⁶ 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.

range from 1.5 to around 2 percent recently (Chart 41).¹⁷

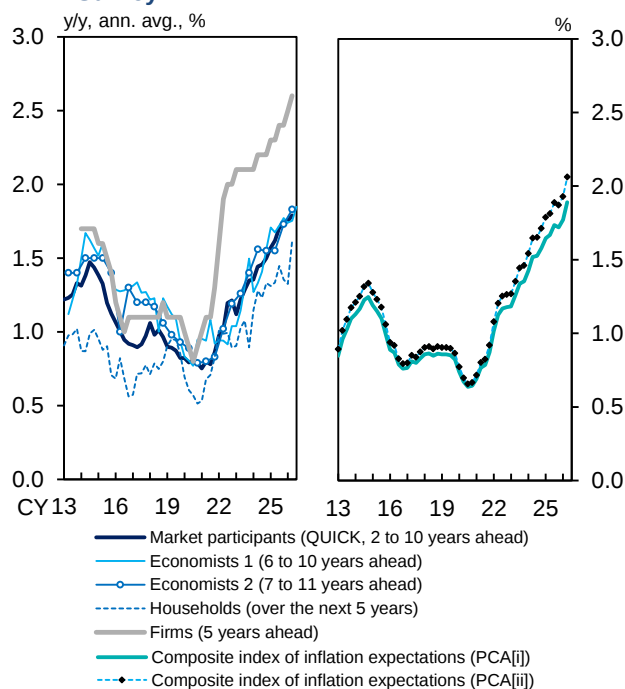
Meanwhile, a decomposition of changes in the GDP deflator from the distribution side shows that, while the acceleration in the rate of increase in the GDP deflator observed in 2023 was mainly led by unit profits as firms passed on cost increases, the contribution of unit labor costs has intensified since 2024, reflecting wage increases. Against this backdrop, the rate of increase in the GDP deflator has been in the range of 3.0-3.5 percent, with both unit profits and unit labor costs pushing up the rate in a balanced manner (Chart 42).

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 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.

Chart 40: Inflation Expectations

1. Survey



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 are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method for a 5-choice question. 3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tanken*. 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, firms, and experts. For details on PCA[i] and PCA[iii], see "The Concept and Measurement of Underlying Inflation," Bank of Japan Monetary Affairs Department, March 2026.

2. 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.

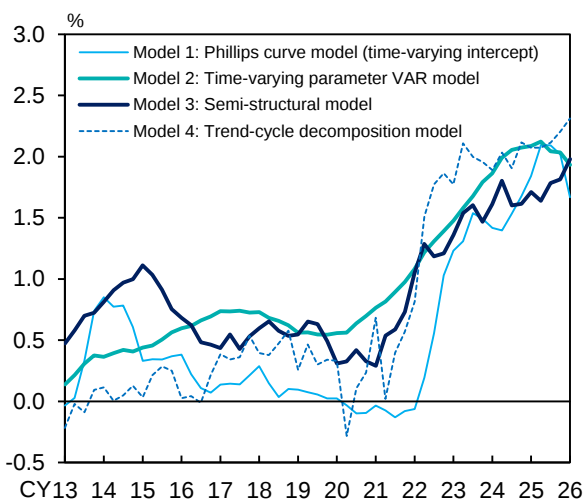
¹⁷ Trend inflation should be interpreted with some latitude, taking into account the following points among others: (1) the estimates are susceptible to being influenced by the most recent data; and (2) there is the so-called "real-time problem," in which past estimates are subject to substantial revisions whenever the data used for the estimation are updated.

Second, medium- to long-term inflation expectations have risen moderately (Chart 40). 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.

Third, the year-on-year rate of increase in the import price index on a yen basis has increased clearly, recently reaching a level close to 30 percent, 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 44 and 45). 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 negative recently due to the effects of the government's measures to reduce the household burden of higher energy prices, such as fuel oil subsidies. Assuming that crude oil prices and foreign exchange rates will remain at around the current levels, and given the government's implementation of emergency measures to curb dramatic price fluctuations and

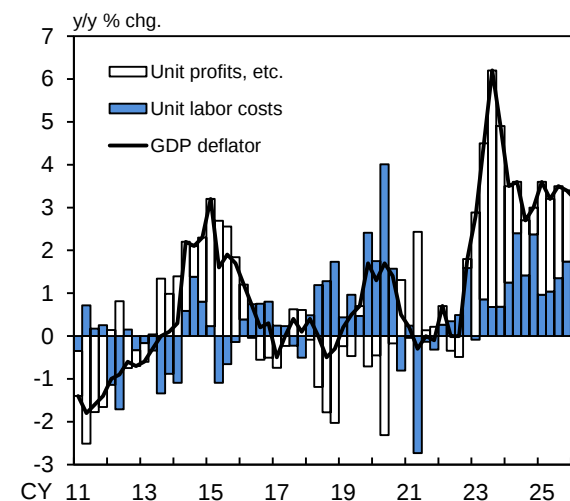
Chart 41: Trend Inflation



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.

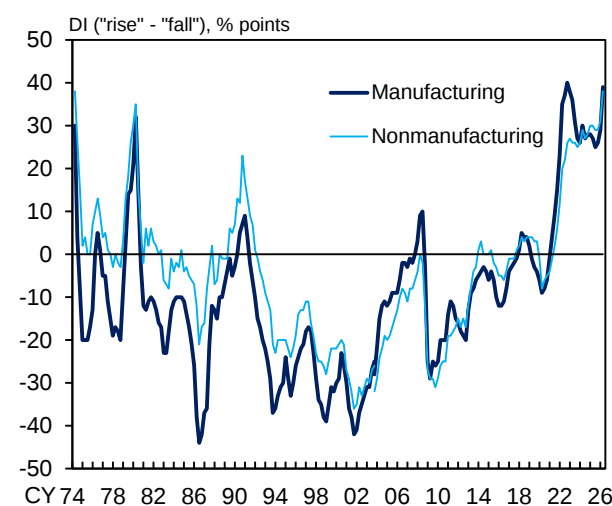
Chart 42: GDP Deflator



Source: Cabinet Office.

Note: Unit labor costs = Nominal compensation of employees / Real GDP

Chart 43: Output Prices



Source: Bank of Japan.

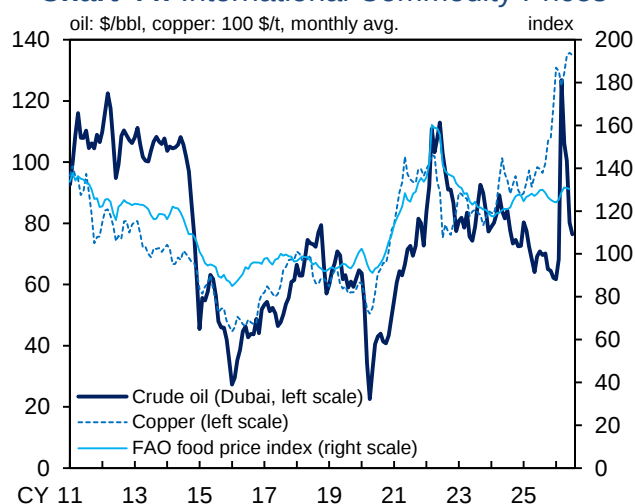
Note: Based on the *Tanken*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

its measures to reduce the household burden of higher electricity and gas charges this summer, the year-on-year rate of change in energy prices is likely to be at around 0 percent for the time being, and then increase markedly 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 next 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 likely to be at around 2 percent in the near term, pushed down by a decline in the year-on-year rate of increase in food prices, such as rice prices, as well as by institutional factors such as the provision of free education. However, the rate of increase in this CPI is expected to accelerate to a level above 3 percent toward the beginning of the next fiscal year. This is because, from this summer, (1) moves to pass on the yen's depreciation since last autumn to prices, (2) the rise in the prices of semiconductors and other items reflecting the expansion in AI-related demand, and (3) the rise in energy and raw material prices reflecting the situation in the Middle East are expected to exert greater upward pressure on the prices of goods, such as food, durable goods, and daily necessities, and some services prices. Subsequently, the rate of increase in this CPI is likely to decline, as firm's price-setting stance becomes more cautious reflecting a slowdown in consumption with some

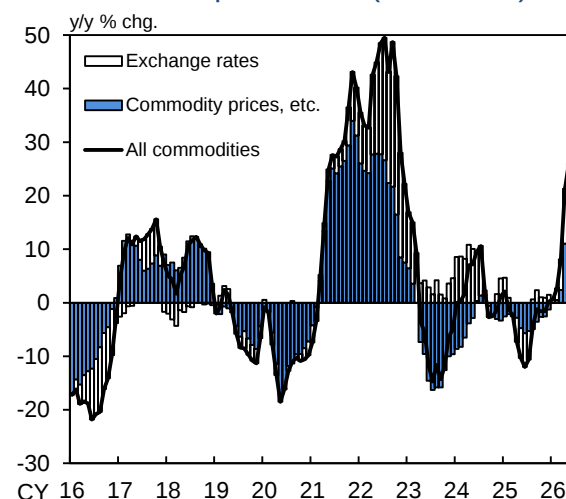
Chart 44: International Commodity Prices



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 45: Import Prices (Yen Basis)



Source: Bank of Japan.

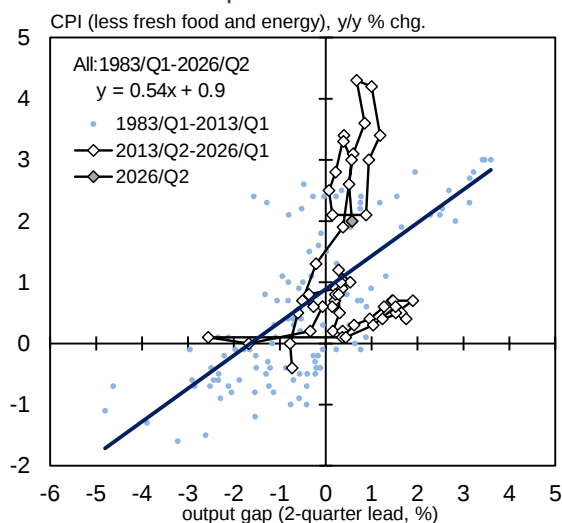
Note: The contribution of changes in commodity prices, etc. is calculated using changes in the import price index on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between the import price index on a yen basis and that on a contract currency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

time lag. Toward the end of the projection period, with a recovery trend in the economy and tightening of labor market conditions becoming clear, the rate of increase in this CPI is likely to be in the range of 2.0-2.5 percent, as moves to pass on wage increases to selling prices take hold in a wide range of items in both goods and services (Chart 46).

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be at around 2 percent for the time being, as the rise in energy prices is likely to be curbed by the government's fuel oil subsidies and its measures to reduce the household burden of higher electricity and gas charges this summer. Toward the second half of this fiscal year, however, the rate of increase in this CPI is expected to accelerate markedly, to a level exceeding 3 percent, due to a greater upward contribution of energy prices reflecting a rise in electricity and gas charges driven by higher import prices of liquefied natural gas (LNG), as well as a higher rate of increase in the CPI (all items less fresh food and energy). Thereafter, 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 the rate of increase in energy prices declines and its contribution even turns negative 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

Chart 46: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
 Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and 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), and travel subsidy programs.
 2. Figures for the output gap are staff estimates.

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 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

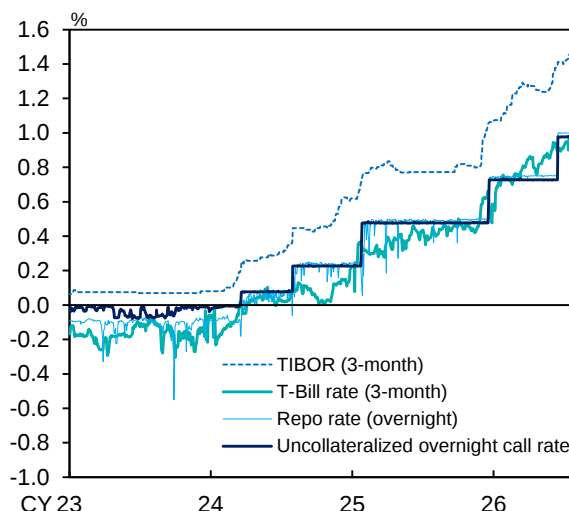
Financial conditions have been accommodative.

Looking at short-term interest rates, the uncollateralized overnight call rate had been at around 0.75 percent and has been at around 1.0 percent since the policy interest rate was raised at the June Monetary Policy Meeting (Chart 47).¹⁸ 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 negative, mainly in the short- to medium-term zone (Chart 48).

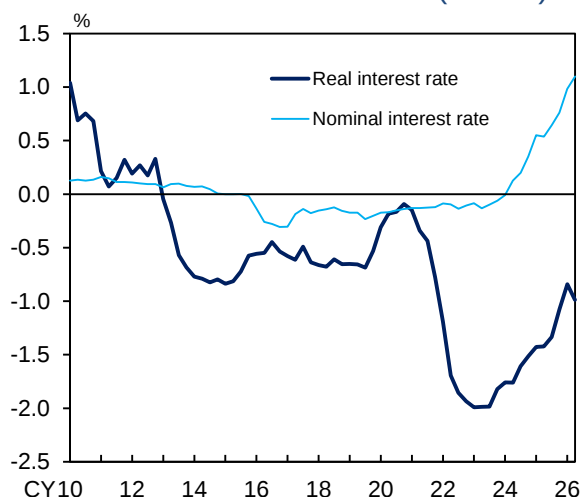
Firms' funding costs have increased (Chart 49). As for lending rates (the average interest rates on new loans and discounts), both long-term and short-term ones have risen, due to a rise in market interest rates, which serve as base rates. Issuance rates for CP have increased, in tandem with the rise 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 50).

Chart 47: Short-term Interest Rates



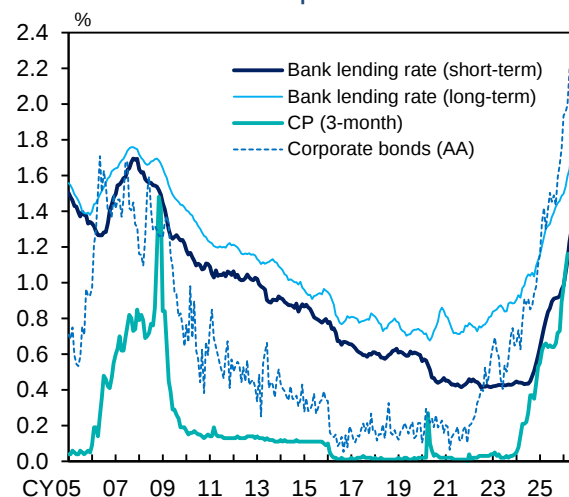
Sources: Bank of Japan; JBA TIBOR Administration; Bloomberg.
Note: Figures for repo rate are the Tokyo Repo Rate.

Chart 48: Real Interest Rate (1-Year)



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.
Note: Figures for the real interest rate are calculated as government bond yields (1-year) minus the composite index of inflation expectations (staff estimates).

Chart 49: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



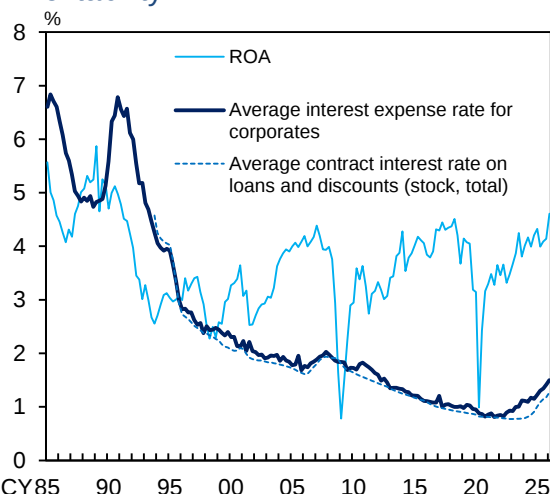
Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.

- 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.

¹⁸ See Box 4 for the effects of policy interest rate hikes on households.

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 51). 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 52).

Chart 50: Firms' Funding Costs and Profitability

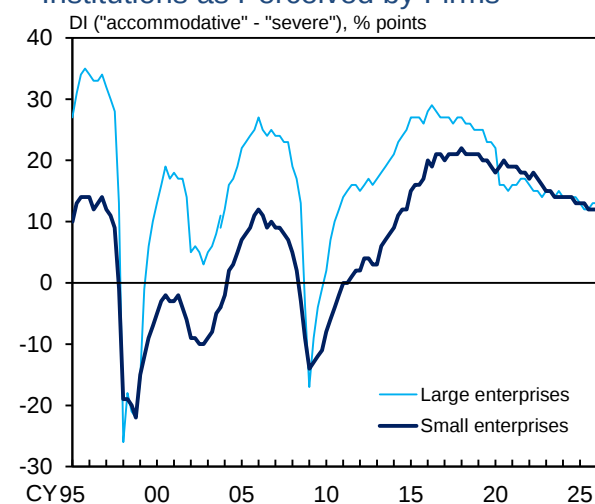


Sources: Ministry of Finance; Bank of Japan.

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.

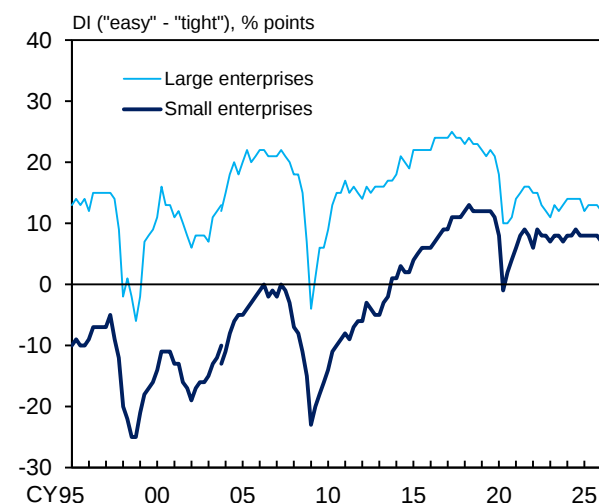
Chart 51: Lending Attitudes of Financial Institutions as Perceived by Firms



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 52: Firms' Financial Positions



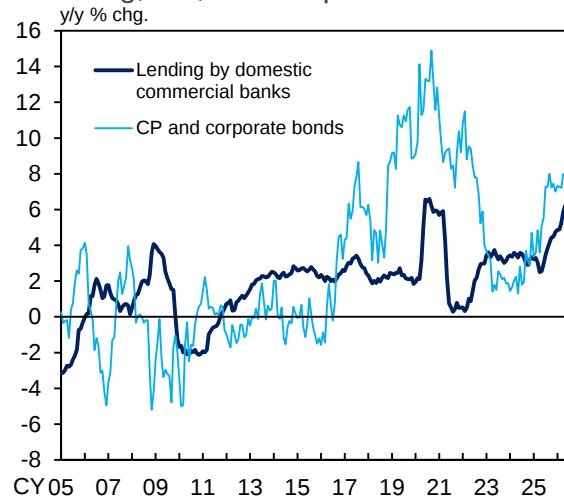
Source: Bank of Japan.

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 risen to the range of 6.0-6.5 percent (Chart 53). The year-on-year rate of increase in the aggregate amount outstanding of CP and corporate bonds has been at around 6.5 percent, pushed up in part by past large-scale issuances.

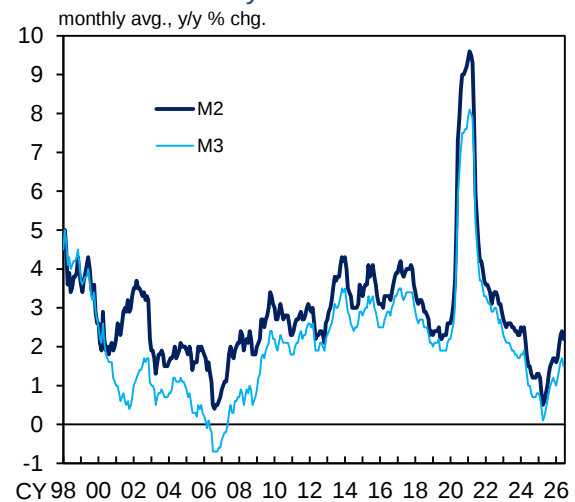
The year-on-year rate of change in the money stock (M2) has been in the range of 2.0-2.5 percent, as an increase in the amount outstanding of bank lending has continued to push up the rate (Chart 54).

Chart 53: 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 54: Money Stock



Source: Bank of Japan.

Developments in Financial Markets

In global financial markets, although the expansion in global AI-related demand has been having the effect of improving market sentiment, attention has continued to be drawn to the uncertainties over the situation in the Middle East.

Yields on 10-year government bonds in the United States rose through mid-May, as attention was drawn to heightened inflationary pressure reflecting the rise in crude oil prices (Chart 55). Since then, 10-year yields in the United States declined temporarily, reflecting the decline in crude oil prices, but have risen again recently, mainly due to increased market expectations of policy interest rate hikes by the Federal Reserve reflecting solid economic indicators and to the rebound in crude oil prices. Yields on 10-year government bonds in Europe have risen over the observed period, moving in line with developments in crude oil prices. In Japan, yields on 10-year government bonds have risen over the observed period with attention being drawn to heightened inflationary pressure, although they fluctuated somewhat significantly at times reflecting factors such as market views on Japan's economic and monetary policies.

Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have generally been at low levels (Chart 56).

With the expansion in AI-related demand continuing, stock prices in the United States have risen over the observed period, although they declined at times reflecting market attention to the

Chart 55: 10-Year Government Bond Yields in Selected Advanced Economies

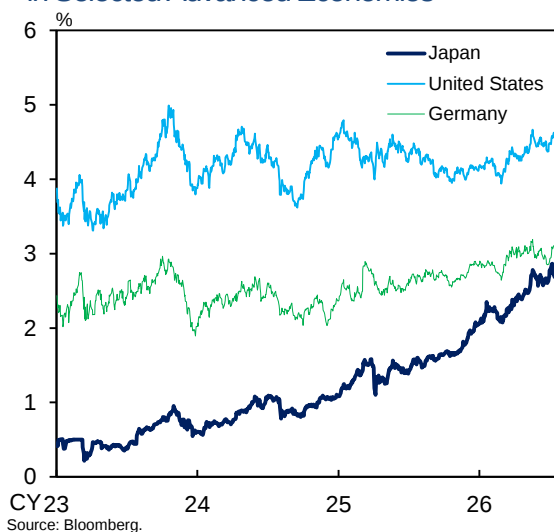
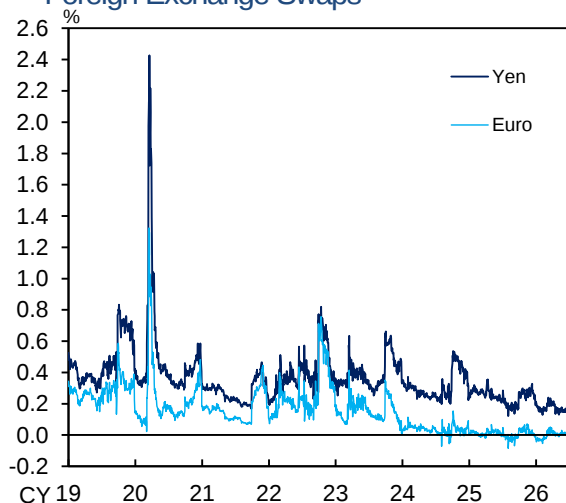


Chart 56: Dollar Funding Premiums through Foreign Exchange Swaps



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.

high valuation of high-tech-related stocks (Chart 57). Stock prices in Europe have risen over the observed period, like those in the United States. Stock prices in Japan have risen on the back of factors such as favorable business performance, although they declined at times in line with U.S. stock prices. Meanwhile, stock prices in emerging economies have declined recently.

In foreign exchange markets, the yen has depreciated against the U.S. dollar, reflecting factors such as increased market expectations of policy interest rate hikes by the Federal Reserve, with the U.S. economy remaining solid (Chart 58). The euro/yen exchange rate has been more or less flat.

Chart 57: Selected Stock Price Indices

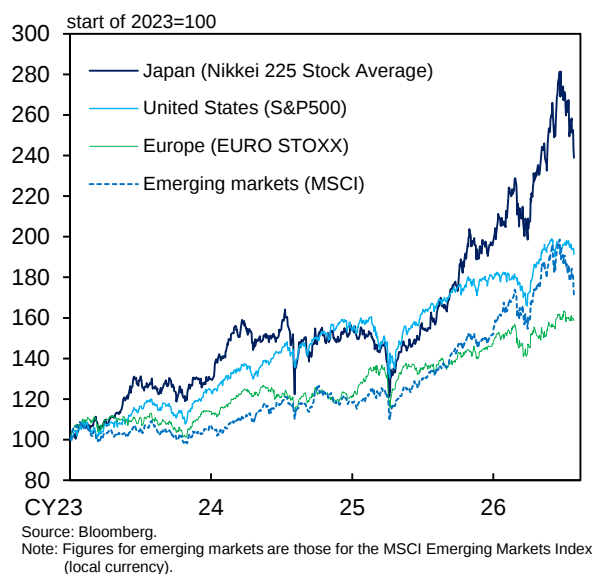
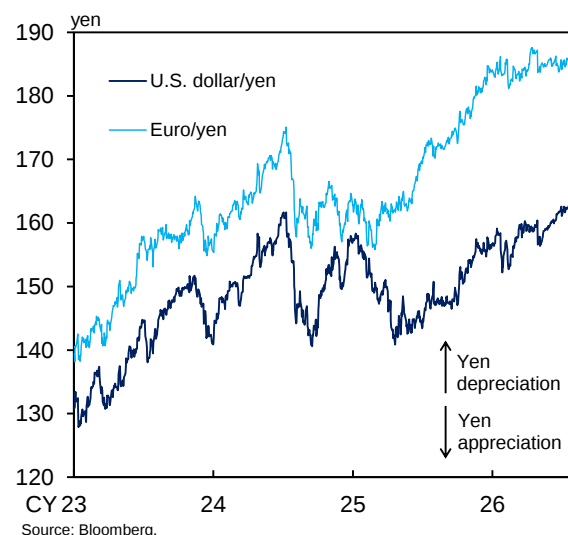


Chart 58: U.S. Dollar/Yen and Euro/Yen

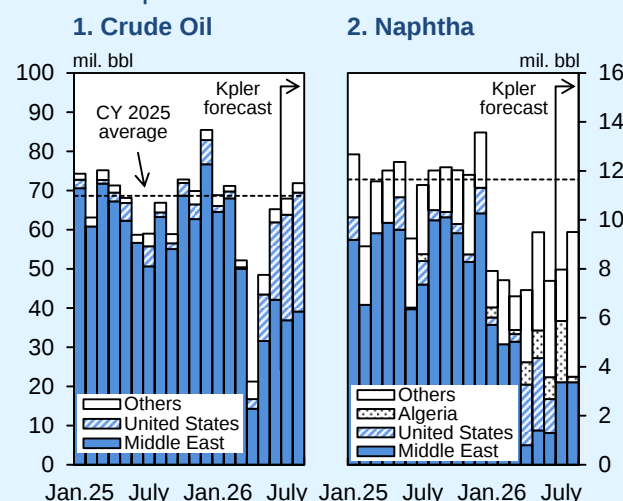


(Box 1) Developments in Raw Materials Imports in Response to the Situation in the Middle East

As noted in the previous Outlook Report, Japan's economy is highly dependent on the Middle East for mineral fuels, such as crude oil and naphtha. Given this, increased tension over the situation in the Middle East has been significantly affecting Japan's imports of raw materials.¹⁹ This box examines developments in raw materials imports following the previous Outlook Report, from the aspects of both volume and price.

In terms of volume, examining developments in crude oil imports derived from alternative data based on vessel tracking information reveals that imports of Middle Eastern crude oil -- which had accounted for more than 90 percent of total crude oil imports prior to the military conflict -- declined significantly from March through April. However, from May onward, crude oil imports clearly rebounded, accompanied by a diversification of sources of supply, as seen in a marked rise in imports of U.S. crude oil, in addition to imports from the Middle East bypassing the Strait of Hormuz (Chart B1-1[1]). Forecast figures for crude oil imports estimated based on information such as past vessel movement data suggest that, for the time being, import volumes will generally be maintained at levels seen prior to the military conflict. Similarly, with respect to naphtha, while imports from the Middle East -- which had constituted 70 percent of total naphtha imports --

Chart B1-1: Import Volumes of Crude Oil and Naphtha



Note: As of July 29. The Kpler forecast is based on data such as historical vessel movement patterns and is subject to revision. For the forecast period, "others" include countries of origin that are currently unidentified.

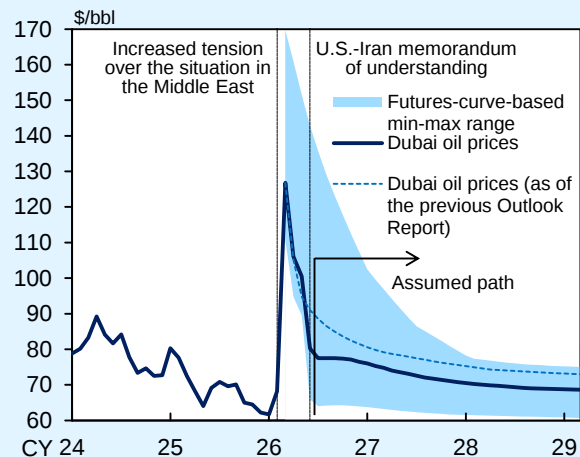
¹⁹ For details, see Box 1 of the April 2026 Outlook Report (Assumptions for Crude Oil Prices in the Baseline Scenario and the Impact of Worsening Terms of Trade on Japan's Economy).

declined sharply, there has been progress in securing alternative sources of supply in the form of an increase in imports of U.S. and Algerian naphtha since April (Chart B1-1[2]). As described above, with progress being made in alternative imports of both crude oil and naphtha from regions other than the Middle East, a significant decline in economic activity owing to large-scale disruptions in supply chains has been avoided.

In terms of prices, with the de facto closure of the Strait of Hormuz remaining in effect, the spot price of Dubai crude oil remained elevated at around 100 U.S. dollars per barrel until May. It then declined temporarily to pre-military conflict levels, reflecting the signing in mid-June of the U.S.-Iran memorandum of understanding aimed at bringing the conflict in the Middle East to an end; however, the price has seen an upturn since mid-July, given the resurgence of tension over the situation in the Middle East. With respect to the outlook for crude oil prices in light of these significantly large fluctuations, the monthly averages for July through September are assumed to be around 80 U.S. dollars, and to subsequently decline moderately to around 70 dollars toward the end of the projection period, in line with the shape of the futures curve, which reflects the collective views of market participants (Chart B1-2). Comparing this assumed path of crude oil prices with that presented in the previous Outlook Report, prices are lower throughout the projection period.

That said, with Japanese firms placing priority on securing the volume of mineral fuels, attention should be paid to the fact that procurement costs borne by these firms have been subject to

Chart B1-2: Assumed Path of Crude Oil Prices

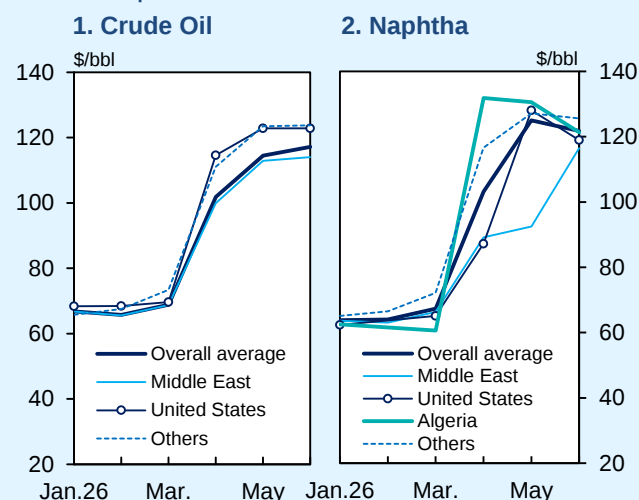


Sources: Nikkei Inc.; Bloomberg.

Note: Figures for the assumed path are prepared with reference to the Brent crude oil futures curves (as of July 21). The "futures-curve-based min-max range" represents the range between the maximum and minimum values obtained by plotting futures curves prepared using the same method as that used for the assumed path, for each date from March 9 to July 21.

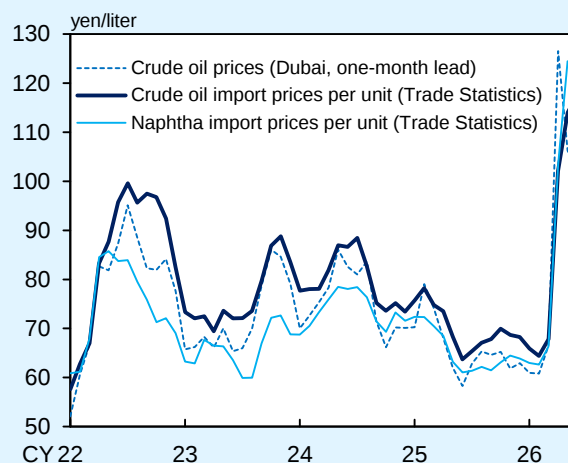
additional upward pressure. In fact, looking at the unit import prices of crude oil and naphtha, unit prices of imports from regions other than the Middle East, such as the United States, have been higher than those of imports from the Middle East, reflecting the longer transportation distances and other factors; moreover, due in part to an increase in spot procurement, unit prices of imports from the Middle East have also remained elevated relative to market prices (Chart B1-3). Under these circumstances, unit import prices of mineral fuels, including crude oil and naphtha, have recently become relatively high compared to market prices of Dubai crude oil, which they had moved in tandem with in the past (Chart B1-4). How long the current sourcing activity will continue is highly uncertain; however, it seems that a growing number of firms have been irreversibly diversifying sources of supply for raw materials, aiming to enhance resilience against geopolitical risks. If this is the case, the procurement costs of mineral fuels that Japanese firms will have to bear may not fall to levels as indicated by the market prices of crude oil. It is considered that these additional procurement costs in the upstream stage of the production process will be passed on to the downstream, thereby pushing up the prices of a variety of goods and services.

Chart B1-3: Crude Oil and Naphtha Import Prices per Unit



Sources: Ministry of Finance; Petroleum Association of Japan (PAJ).
 Notes: 1. Figures for naphtha are compiled based on the PAJ definition.
 2. In the right-hand chart, figures are linearly interpolated for months with no import data or with negligible import volumes and large fluctuations in import prices per unit.

Chart B1-4: Import Prices per Unit for Mineral Fuels



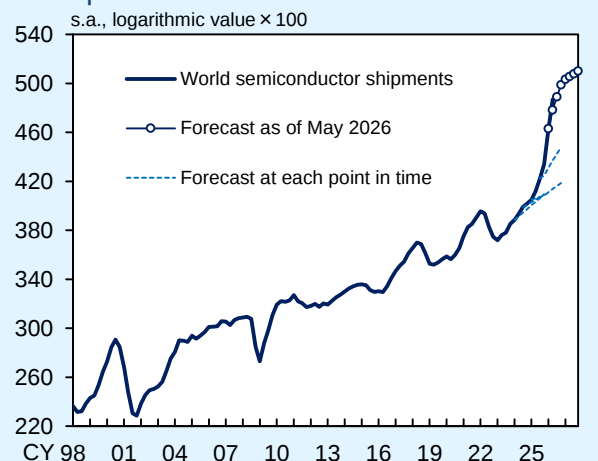
Sources: Ministry of Finance; Nikkei Inc.; Bank of Japan; PAJ.
 Note: Figures for naphtha are compiled based on the PAJ definition.

(Box 2) Impact of Increased Global AI-Related Demand on Japan's Economy

Global AI-related demand has continued to expand robustly, mainly due to strong investment in data centers by U.S. hyperscalers, and has recently been on a clear uptrend, accompanied by the widening scope of AI usage. In fact, in the World Semiconductor Trade Statistics (WSTS) data, world semiconductor shipments have continued to show significantly high growth since fall 2023, surpassing prior forecasts, and there has been a marked upward kink in the trend (Chart B2-1). In this situation, IT-related firms' outlook has also grown increasingly confident, with an increasing number of them noting that demand for semiconductors will continue to expand, led by AI-related demand, at least until around 2028, albeit at a slower pace. This box examines the impact on Japan's economy of the solid increase in global AI-related demand.

The major characteristic of the ongoing AI investment boom is that, with limited capacity for increasing semiconductor production in the short run -- i.e., the short-run supply curve for semiconductors being nearly vertical -- the impact of the significant increase in AI-related demand has been emerging more as "price increases" than as "growth in volume" (Chart B2-2). This is in stark contrast to the dot-com bubble period of the late 1990s to around 2000, when semiconductors saw sustained growth in volume and price decreases, as many semiconductor manufacturers -- including those in Japan -- competed to expand production facilities in pursuit of "economies of scale."

Chart B2-1: World Semiconductor Shipments



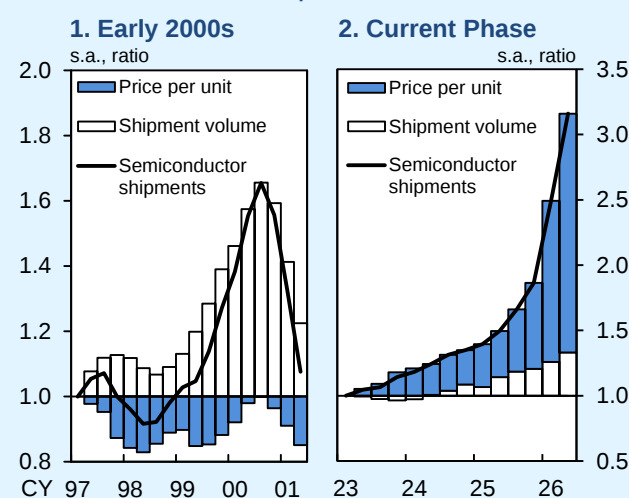
Source: WSTS.

Notes: 1. Based on staff calculations using WSTS data.

2. The figure for world semiconductor shipments for 2026/Q2 is the April-May average.

3. Figures for the "forecast at each point in time" are as of May 2024, November 2024, May 2025, and November 2025.

Chart B2-2: Decomposition of World Semiconductor Shipments



Source: WSTS.

Notes: 1. Based on staff calculations using WSTS data.

2. Effects of the cross term are allocated in proportion to the size of each factor.

Figures for the price per unit include price changes due to changes in quality.

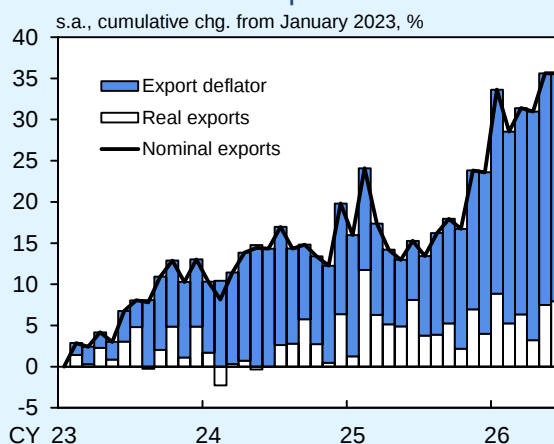
3. Figures show the cumulative change from the reference point, with the reference point's value set equal to 1. The reference points in the left- and right-hand charts are 1997/Q1 and 2023/Q1, respectively.

4. In the right-hand chart, figures for 2026/Q2 are April-May averages.

Under these circumstances, while Japan's real exports have been more or less flat, nominal exports have risen significantly since fall 2025, driven by higher export prices (Chart B2-3). In this regard, as many Japanese semiconductor firms primarily produce semiconductors for smartphones and for automotive use, the positive impact of the AI investment boom on Japan's IT-related exports remained limited until around mid-2025, relative to Taiwanese and South Korean competitors, which tend to excel in advanced semiconductors tailored for servers.²⁰ That said, with the expansion in storage demand reflecting the widening scope of AI usage from "training" to "inference," Japan's nominal exports have gained price-driven momentum since late 2025. Indeed, a breakdown of export prices shows a marked increase in the price of memory chips (Chart B2-4). Furthermore, metals and related products, and machinery have also made a significant contribution to the recent rise in export prices. This is a reflection of the fact that quite a few Japanese exporting firms have a comparative advantage in the field of supporting facilities, such as electricity and telecommunications infrastructure, that are essential for data centers.

Higher export prices induced by increased AI-related demand as described above have served to alleviate the worsening pressure on the terms of trade exerted by the rise in import prices stemming from the situation in the Middle East (Chart B2-5). While this may have a positive effect on domestic private demand through increased

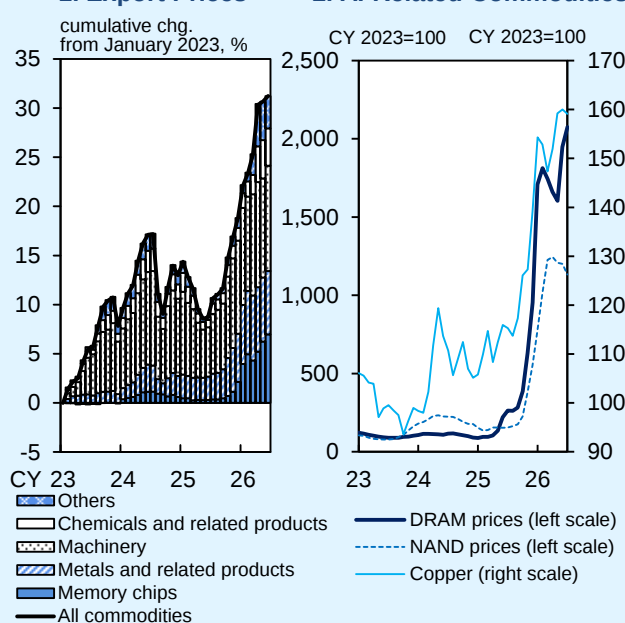
Chart B2-3: Developments in Nominal Exports



Sources: Bank of Japan; Ministry of Finance.
Note: Effects of the cross term are allocated in proportion to the size of each factor.

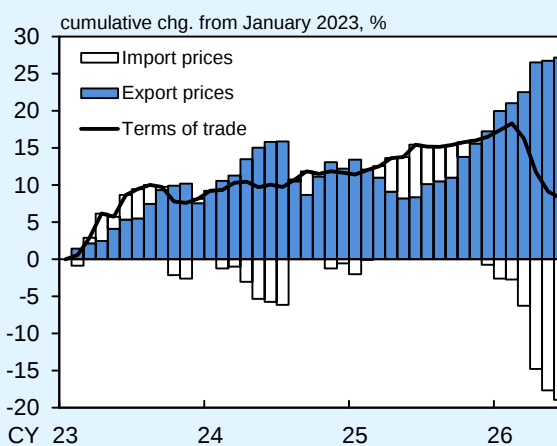
Chart B2-4: Developments in Export Prices and AI-Related Commodities

1. Export Prices 2. AI-Related Commodities



Sources: Bank of Japan; Bloomberg.
Notes: 1. In the left-hand chart, "memory chips" are MOS memory integrated circuits. "Metals and related products" include copper. "Machinery" excludes memory chips. "Others" are textiles, other primary products and manufactured goods.
2. In the right-hand chart, "DRAM prices" and "NAND prices" are the prices of DDR4 (8GB, 1GB × 8) and TLC (512GB), respectively. The latest figures are for July 2026 (average for July 1-29).

Chart B2-5: Terms of Trade



Source: Bank of Japan.
Note: Terms of trade = Export price index on a yen basis / Import price index on a yen basis

²⁰ See Box 4 of the April 2026 Outlook Report (Impact of Increased AI-Related Demand on Japan's Exports).

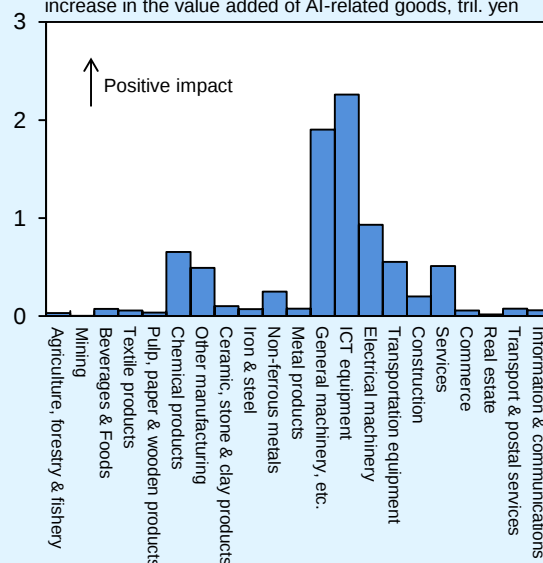
profits of firms benefiting significantly from increased AI-related demand, attention is warranted on the following points when assessing the impact of such a positive development.

First, the realized benefits of AI-related demand are observed primarily among large firms in certain manufacturing industries. In fact, using input-output tables to estimate the impact of the rise in prices of AI-related goods, including, for example, supporting facilities related to data centers, reveals that industries experiencing a significant positive impact are concentrated in electrical machinery, information and communication technology (ICT) equipment, and general machinery, indicating that spillover effects on other industries are limited (Chart B2-6[1]).²¹ In contrast, the negative impact of the rise in crude oil prices estimated by the same method shows that a wide range of industries, including nonmanufacturing, are subject to exposure (Chart B2-6[2]). As mentioned earlier, higher export prices have alleviated part of the worsening pressure being exerted on the terms of trade for Japan as a whole that stems from the situation in the Middle East. By economic entity, however, those enjoying improvement in the terms of trade are limited to certain well-performing large manufacturing firms benefiting from AI-related demand. For many other firms, it seems that the negative impact stemming from the rise in input costs has been outweighing the positive effects.

Chart B2-6: Impact of Price Increases by Industry

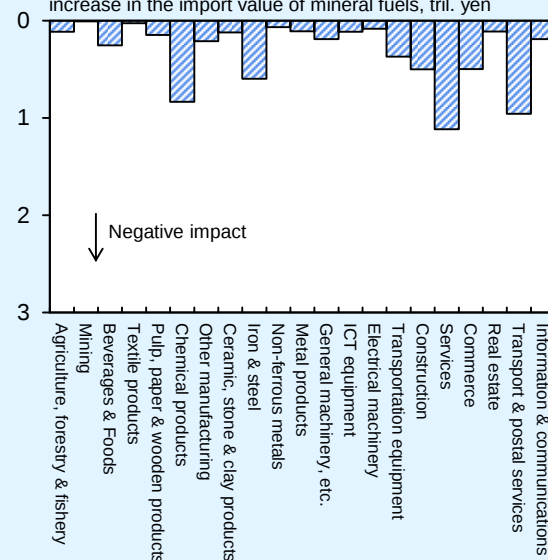
1. Impact of the Rise in AI-Related Goods Prices

change in output value in response to a 5 trillion yen increase in the value added of AI-related goods, tril. yen



2. Impact of the Rise in Crude Oil Prices

inverted, change in intermediate input in response to a 5 trillion yen increase in the import value of mineral fuels, tril. yen



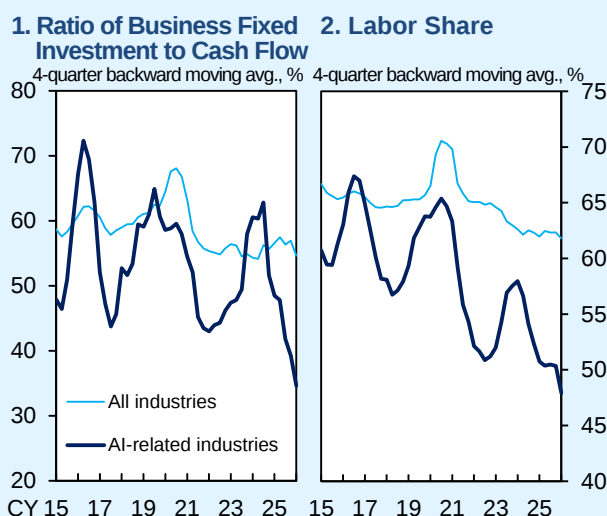
Sources: Ministry of Internal Affairs and Communications; Ministry of Finance; Bank of Japan; WTO; OECD; WSTS.

Notes: 1. Estimated based on the 2020 *Input-Output Tables for Japan*, under the assumption of a price shock with quantities held constant.
2. For the definition of AI-related goods, see Box 4 of the April 2026 Outlook Report. Mineral fuels refer to coal mining, crude petroleum and natural gas.
3. "Other manufacturing" includes plastic products and rubber products. "General machinery, etc." represents general-purpose machinery, production machinery, and business oriented machinery. "ICT equipment" represents information and communication electronics equipment and electronic components. "Services" include business services.

²¹ Since the input-output tables used in the analysis are as of 2020, attention should be paid to the possibility that the estimates do not sufficiently factor in changes in industrial structures associated with the recent expansion in AI-related goods.

Second, propensity to spend has tended to be lower than average among AI-related industries (i.e., large firms in electrical machinery, information and communication electronics equipment, and general-purpose and production machinery industries). Indeed, the ratio of business fixed investment to cash flow in these industries has been lower than in other industries, possibly because of the need to secure a buffer against substantial swings in profits accompanying the IT cycle (Chart B2-7[1]). On the back of their high capital intensity, their labor share has also been relatively low; moreover, the share has been on a clear downtrend in recent years (Chart B2-7[2]). Given these points, the impact of the rise in AI-related industries' profits in stimulating domestic private demand is likely to be smaller than that of other industries.

Chart B2-7: Characteristics of AI-Related Industries



Source: Ministry of Finance.

Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. AI-related industries are defined as consisting of large enterprises with a capitalization of 1 billion yen or more in industries such as "general-purpose and production machinery," "electrical machinery," and "information and communication electronics equipment." All industries exclude "finance and insurance," and for cash flow, "pure holding companies" are also excluded.

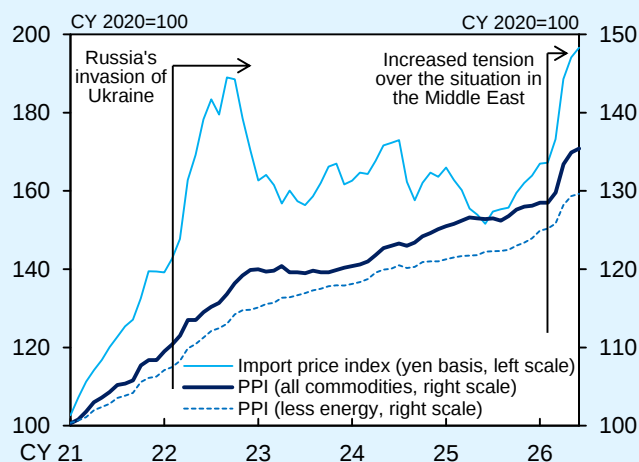
2. Ratio of business fixed investment to cash flow = Business fixed investment (excluding software) / Cash flow. Cash flow = Depreciation expenses + Current profits / 2. Labor share = Personnel expenses / Value added. Value added is the sum of operating profits, personnel expenses, and depreciation expenses.

(Box 3) Background to and Impact of Upward Pressure on Prices in Business-to-Business Transactions

As noted in the previous Outlook Report, a distinctive feature of the current phase is that, as firms' behavior has shifted more toward raising prices, the speed at which cost increases are passed through to prices has accelerated.²² This box analyzes the background to the recent substantial rise in the producer price index (PPI), and briefly examines how this has spilled over into consumer prices.

Comparing developments in the corporate goods prices following increased tension over the situation in the Middle East with those at the time of Russia's invasion of Ukraine in 2022 shows that, although the recent pace of import price rises has been slower than in 2022, the quarterly PPI inflation rate is clearly exceeding the rate seen at that time (Charts B3-1 and B3-2). A breakdown of the quarterly PPI inflation rate indicates that there has been rapid growth in the positive contribution not only of "petroleum and coal products, nonferrous metals" -- whose prices move in line with foreign exchange rates and commodity prices such as crude oil prices -- but also of basic materials such as "chemicals and plastic products, etc." and "machinery," suggesting that not only price hikes at the upstream stage but also the price pass-through of these hikes to midstream and downstream stages has been advancing over a short period of time. This greater activeness in price-setting behavior

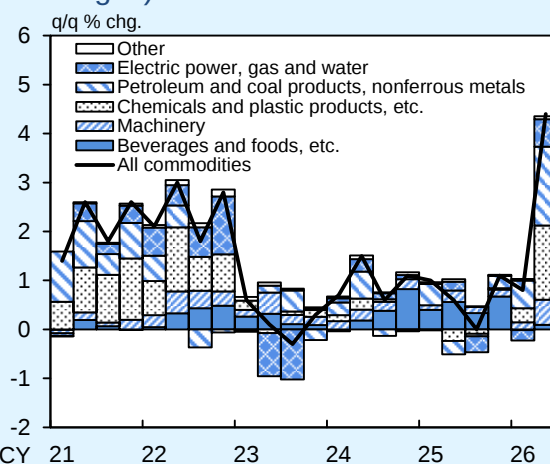
Chart B3-1: Corporate Goods Prices (1)



Source: Bank of Japan.

Notes: 1. Figures for the PPI (all commodities) are adjusted for the hike in electric power charges during the summer season.
2. Figures for the PPI (less energy) exclude petroleum and coal products from manufacturing industry products.

Chart B3-2: PPI (Quarter-on-Quarter Changes)



Source: Bank of Japan.

Notes: 1. Figures are adjusted for the hike in electric power charges during the summer season.
2. Figures for "beverages and foods, etc." include agriculture, forestry and fishery products.

²² See Box 2 of the April 2026 Outlook Report (Impact of a Surge in Crude Oil Prices on Japan's Prices).

in business-to-business transactions can also be confirmed in the results of various firm surveys (Chart B3-3). Notably, the current phase is characterized by the following two developments.

First, in chemical products, the pass-through of cost increases is progressing at a pace not seen in the past (Chart B3-4[1]). Specifically, in (1) upstream petroleum refinery products and petrochemical basic products, efforts to pass on higher costs swiftly and avoid margin compression have expanded rapidly through the introduction of surcharges and the revision of pricing formulas; while in (2) midstream and downstream products, concerns over shortages and delivery delays stemming from raw material scarcity, together with front-loaded demand to secure inventories, seem to have significantly strengthened sellers' bargaining power. As a result, even for downstream products such as plastics, coatings and adhesives, for which the pass-through of higher costs would normally take around six months, sizeable price increases have been implemented after only one to two months (Chart B3-5).

Second, as global AI-related demand has climbed further since fall 2025, upward pressure on the prices of related goods has been intensifying rapidly not only for exports, as seen in Box 2, but also for domestic sales. In particular, (1) amid intensified upward momentum in prices of such items as copper on the back of increased demand for electricity and telecommunications infrastructure that serves as supporting facilities for data centers, moves to pass on cost increases to prices in the nonferrous metals and related

Chart B3-3: Firms' Inflation Outlook (1 Year Ahead)

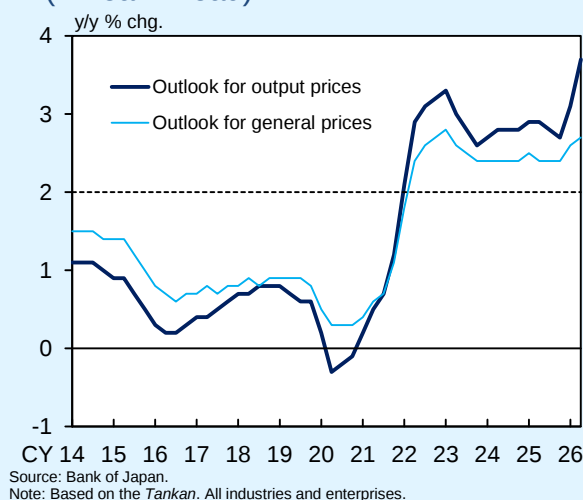
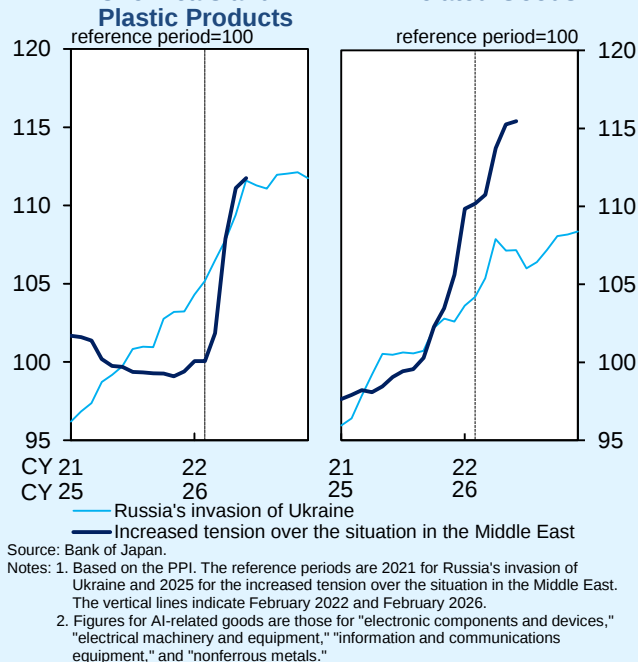


Chart B3-4: Corporate Goods Prices (2)
1. Chemicals and Plastic Products
2. AI-Related Goods

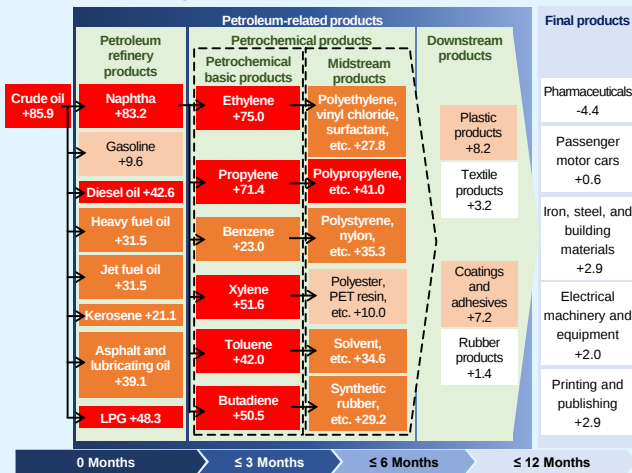


products industries have become widespread; in addition, (2) in the electronic components, electrical machinery, and information and communications equipment industries, upward pressure on prices has also been increasing due to the pass-through of the surge in memory chip prices (Chart B3-4[2]).

AI, which is regarded as a general-purpose technology, is expected to exert downward pressure on prices through higher productivity over the medium to long term, as it becomes more deeply embedded in the economy and society, with workers and firms becoming increasingly adaptive to the technology. In the short term, however, the effects of the investment boom in expanding aggregate demand are likely to dominate, exerting upward pressure on prices. In this context, since the start of 2026, PPI in major countries and regions, including Japan, has been rising at an accelerated pace in a highly synchronized manner. Given that the global economy has remained resilient over this period, the recent global rise in the PPI highly likely reflects not only the shock of higher crude oil prices, which negatively affects economic activity, but also the positive global demand shock stemming from increased AI-related demand (Chart B3-6).

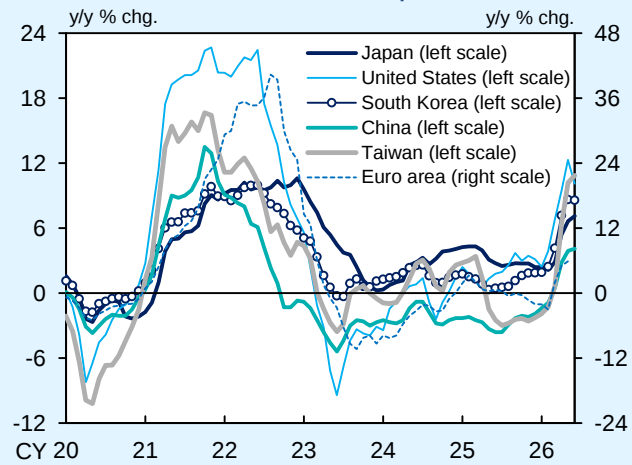
To examine this possibility, a dynamic factor model was used to decompose PPI inflation rates in six economies (Japan, the United States, the euro area, South Korea, China, and Taiwan) into (1) a global inflation trend (GIT) that is common across regions and goods categories, (2) common global factors specific to particular

Chart B3-5: The Pass-Through of Crude Oil and Naphtha Price Increases



Sources: Ministry of Economy, Trade and Industry; Bank of Japan; Nikkei Inc.
 Notes: 1. Figures show the cumulative percentage changes in the corresponding PPI item from February 2026 to June 2026. For crude oil, the figure refers to the percentage change in Dubai crude oil prices from February 2026 to March 2026. Darker background shading indicates a larger change.
 2. The time frames shown at the bottom represent the pass-through lag, roughly estimated based on the historical average relationship between crude oil prices and the PPI.
 3. Since toluene is not surveyed in the PPI, its change is proxied by that of the "petrochemical aromatic products (except synthetic resin)," the higher-level PPI category to which it belongs. The classification of items included in midstream products follows that of the Ministry of Economy, Trade and Industry.

Chart B3-6: Global Developments in the PPI



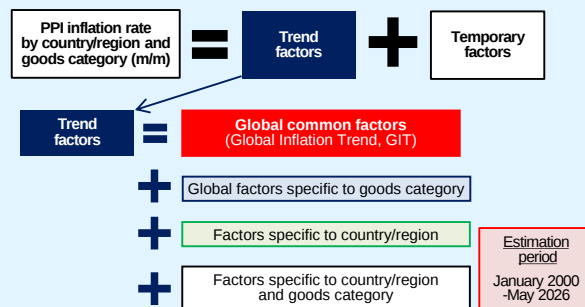
Sources: Bank of Japan; Haver; CEIC.
 Note: Figures for the euro area are the PPI for industry excluding construction, while those for other countries and regions are the PPI for all commodities.

goods categories, and (3) country- and region-specific factors that are common across goods categories within each economy (Chart B3-7).²³ The estimation results for the GIT suggest that, while the figures are highly correlated with the Global Supply Chain Pressure Index, which captures the supply-demand tightness in global supply chains, the level of global upward pressure on prices is currently exceeding the standard range of fluctuations observed in the past.

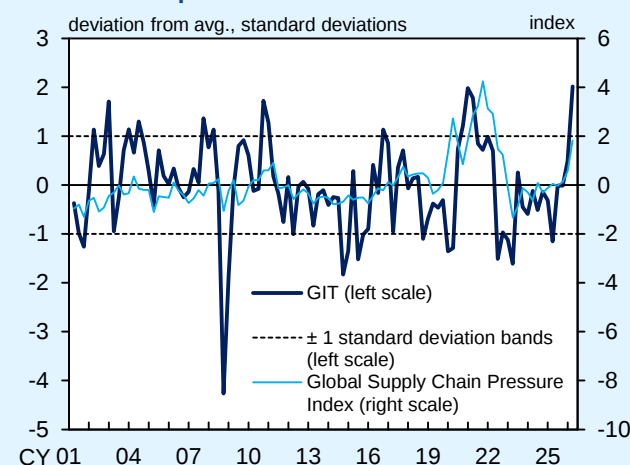
Next, to investigate the drivers of changes in the GIT, a sign-restricted vector auto-regression (VAR) model with three variables -- world production, the GIT, and crude oil prices -- was estimated to identify (1) global demand shocks, (2) global supply shocks, and (3) crude oil price shocks.²⁴ The historical decomposition of the GIT indicates that, although most of the recent increase in the GIT is accounted for by crude oil price shocks, global demand shocks are responsible for roughly 30 to 40 percent of the rise (Chart B3-8). While this analysis alone cannot, of course, identify the specific source of global demand shocks, the fact that their timing lines up with recent increases in copper and memory chip prices suggests that the increase in global AI-related demand and its spillovers may be playing a role. Furthermore, when the impact of the identified global demand shock on Japan's

Chart B3-7: Global Inflation Trend (GIT)

1. Extraction of GIT



2. Developments in GIT



Sources: Bank of Japan; New York Fed; Haver; CEIC.

Note: Each factor is extracted from the PPI inflation rates of the eight goods categories (beverages & foods, petroleum & coal products, chemicals & related products, metal products, general purpose machinery, electrical machinery & equipment, information & communications equipment, and transportation equipment) in the six countries and regions (Japan, the United States, the euro area, South Korea, China, and Taiwan). Figures for the GIT are normalized using the average and standard deviation for the estimation period. Figures for 2026/Q2 are April-May averages.

²³ The analysis draws on the following study:

Akinci et al. (2025), "Global Trends in U.S. Inflation Dynamics," Federal Reserve Bank of New York Liberty Street Economics, February 27, 2025.

²⁴ The VAR model is constructed with reference to the following study:

Ha et al. (2025), "What Explains Global Inflation," *IMF Economic Review*, vol. 73, pp. 522-555.

CPI (all items less food and energy) is estimated using a local-projection approach, the results suggest that this shock has an effect in pushing up the level of the CPI (all items less food and energy) in a persistent manner (Chart B3-9).

Furthermore, decomposing trend factors of Japan's PPI inflation rate into the contributions of factors such as the GIT and Japan-specific factors shows that, up until the COVID-19 pandemic, the GIT accounted for most of the fluctuations in the PPI, but since around 2022, Japan-specific factors have consistently made a large positive contribution (Chart B3-10). In this regard, Japan-specific factors correlate highly with the level of the real effective exchange rate (Chart B3-11). Given this empirical observation, the depreciation of the yen's real effective exchange rate since 2022, which indicates a decline in the relative price of Japanese goods, may have exerted sustained upward pressure on Japan's PPI through arbitrage mechanisms of narrowing price differentials between Japan and other economies, equalizing relatively lower domestic goods prices with foreign goods prices.²⁵

Looking ahead, the outlook is as follows. (1) For products such as chemical products at the upstream stage, the fall in crude oil prices is expected to induce selling prices to be on a declining trend, in line with surcharges and pricing

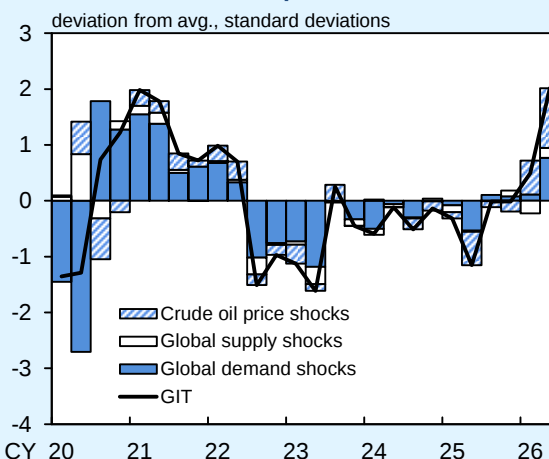
²⁵ This analysis of the adjustment mechanisms underlying price differentials associated with movements in the real exchange rate draws on, for example, Engel (2019), "Real Exchange Rate Convergence: The Roles of Price Stickiness and Monetary Policy," *Journal of Monetary Economics*, vol. 103, pp. 21-32.

Chart B3-8: Decomposition of Changes in GIT

1. Identification Restrictions (Sign Restrictions)

Shocks / Variables	World production	GIT	Crude oil prices
Crude oil price shocks	—	+	+
Global supply shocks	+	—	+
Global demand shocks	+	+	+

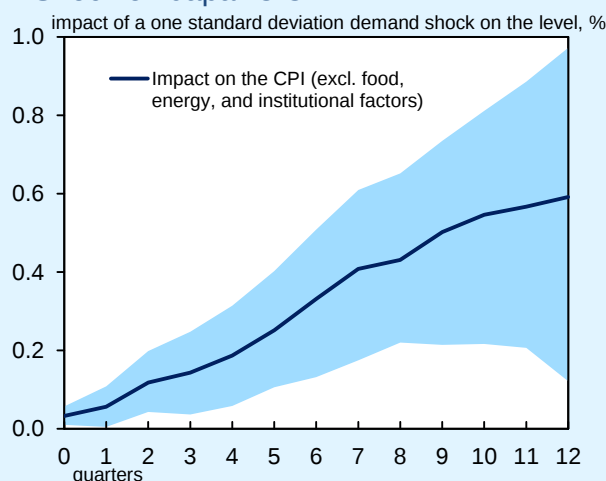
2. Historical Decomposition of GIT



Sources: Bank of Japan; CPB Netherlands Bureau for Economic Policy Analysis; Haver; CEIC; FRED.

- Notes: 1. "+" in the table indicates a response in the same direction as the shock, while "-" indicates a response in the opposite direction.
2. The estimation period is 2000/Q2-2026/Q2. In the estimation, the figure used for world production in 2026/Q2 is that for April. For other variables, the figures used for 2026/Q2 are April-May averages.
3. Figures for the GIT are normalized using the average and standard deviation for the estimation period.

Chart B3-9: Impact of a Global Demand Shock on Japan's CPI

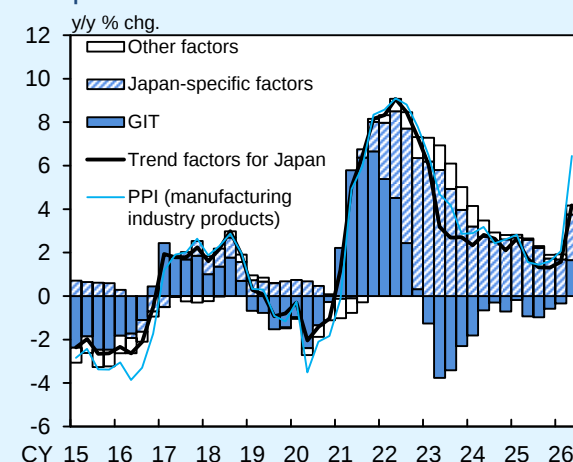


Sources: Ministry of Internal Affairs and Communications; Bank of Japan; CPB Netherlands Bureau for Economic Policy Analysis; Haver; CEIC; FRED.

- Notes: 1. The chart shows the impulse response to a positive one standard deviation global demand shock, estimated using local projection. The global supply shock, the oil price shock, and 4-quarter lagged values of the dependent variable are controlled for. The estimation period is 2001/Q2-2026/Q2. The CPI figure for 2026/Q2 is the April-May average. The shaded area indicates the 90th percentile band.
2. Institutional factors = the effects of the consumption tax rate changes and policies concerning the provision of free education + the reduction in mobile phone charges in 2021 + travel subsidy programs. Figures are staff estimates.

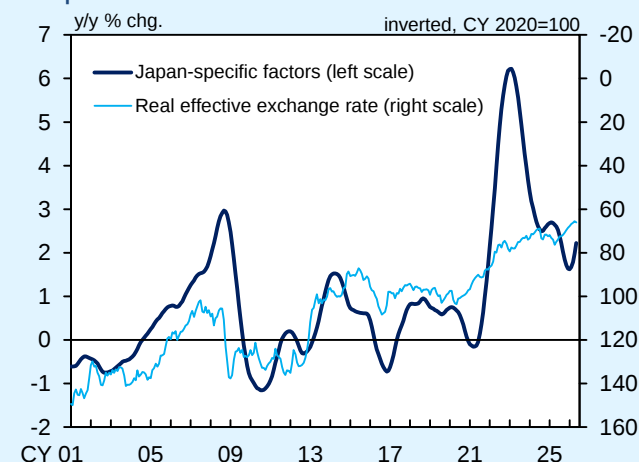
formulas. By contrast, for chemical products at the midstream and downstream stages, since their price increases incorporate the pass-through of higher labor and logistics costs, these prices are likely to remain downwardly rigid. (2) On the other hand, the spillover effects of the global demand shock from increased AI-related demand, and the past yen depreciation and associated pressure to arbitrage away price differentials between Japan and other economies, are highly likely to continue exerting persistent effects for some time. Taken together, these considerations suggest that, even if crude oil prices continue to decline, domestic goods prices excluding energy will remain subject to persistent upward pressure for the time being.

Chart B3-10: Decomposition of Changes in Japan's PPI



Sources: Bank of Japan; Haver; CEIC.
 Notes: 1. Figures for the PPI (manufacturing industry products) exclude the effects of the consumption tax rate changes.
 2. Figures for trend factors for Japan for 2026/Q2 are April-May averages.

Chart B3-11: Developments in Japan-Specific Factors



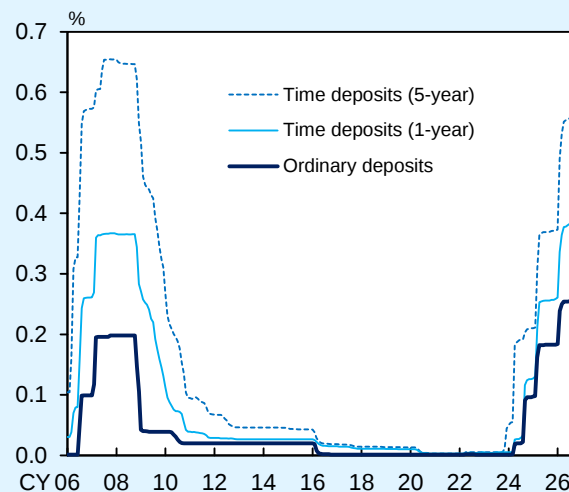
Sources: Bank of Japan; Haver; CEIC; BIS.
 Note: Figures for the real effective exchange rate are based on the broad effective exchange rate indices.

(Box 4) Effects of Policy Interest Rate Hikes on Households

The Bank changed its large-scale monetary easing framework in March 2024 and since then has gradually raised the policy interest rate to 1 percent, thereby adjusting the degree of monetary accommodation. In line with the increase in the policy interest rate, deposit rates, both for ordinary deposits and time deposits, have risen (Chart B4-1). Lending rates have also risen, reflecting the rise in the base rate to which they are referenced. Looking at housing loan rates, interest rates on floating-rate loans, which account for the majority of both new lending and outstanding balances, have increased in tandem with short-term prime rates, while interest rates on fixed-rate loans have also risen, mainly reflecting developments in long-term interest rates (Chart B4-2).²⁶ This box examines how the rise in deposit and lending rates affects households, taking into account the structure of household assets and liabilities.

Starting with a look at the balance sheet of Japan's household sector, on the asset side, households hold around 2,400 trillion yen in financial assets, of which deposits account for roughly 1,000 trillion yen, followed by insurance and pensions at about 600 trillion yen, and equities and investment fund shares at around 550 trillion yen (Chart B4-3). On the liability side, total debt amounts to only about 400 trillion yen,

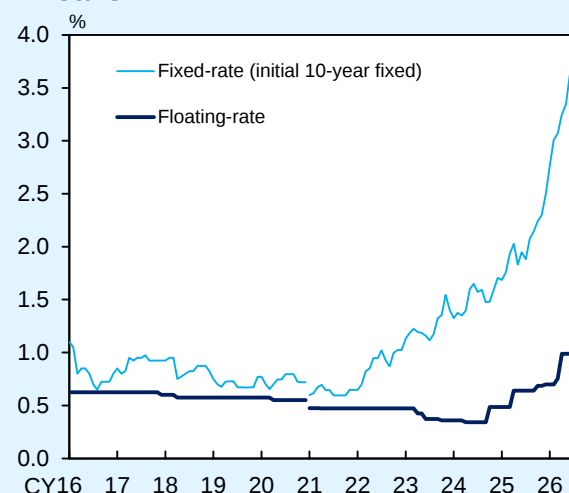
Chart B4-1: Deposit Rates



Source: Bank of Japan.

Note: Figures are averages of deposit rates at financial institutions such as domestically licensed banks.

Chart B4-2: Interest Rates on Housing Loans



Source: Published accounts of individual banks.

Note: Figures show medians of some major banks (preferential rates are taken into account). Figures up to 2020 cover loans with guarantee fees, and those from 2021 cover loans with administrative fees.

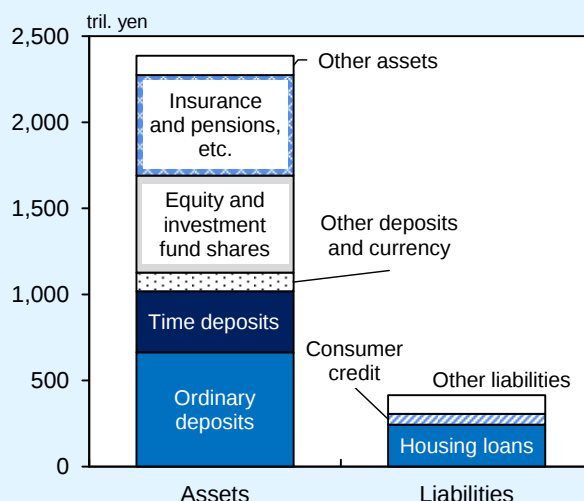
²⁶ In recent years in Japan, when households take out a housing loan, many choose floating-rate loans; according to a survey conducted in January 2026 by the Japan Housing Finance Agency, 75 percent of surveyed new housing loan borrowers chose floating-rate loans in the first half of fiscal 2025.

with housing loans making up more than half of that. An increase in the policy interest rate brings about an increase in interest income on the asset side through higher deposit rates, while on the liability side it leads to a rise in the interest payment burden on housing loans and other debt. However, since the total amount of deposits significantly exceeds the outstanding amount of housing loans and other debt, households as a whole are likely to benefit from the positive effects of higher interest rates, even when considering the differences in interest rate levels.

It should be noted, however, that household balance sheets differ markedly across age groups. Looking at the composition of assets and liabilities by age of the household head, financial assets increase with age, mainly in the form of deposits (Chart B4-4). On the liability side, households in their 30s and 40s have large housing loan balances, and, in particular for those in their 30s, total liabilities exceed total assets. For these households with housing loans, the increase in the repayment burden associated with higher interest rates may lead them to act more cautiously in their spending.²⁷

In this context, for floating-rate housing loans, which account for the majority of housing loans, mechanisms such as the "5-year rule" are often in place to curb a sharp increase in repayment

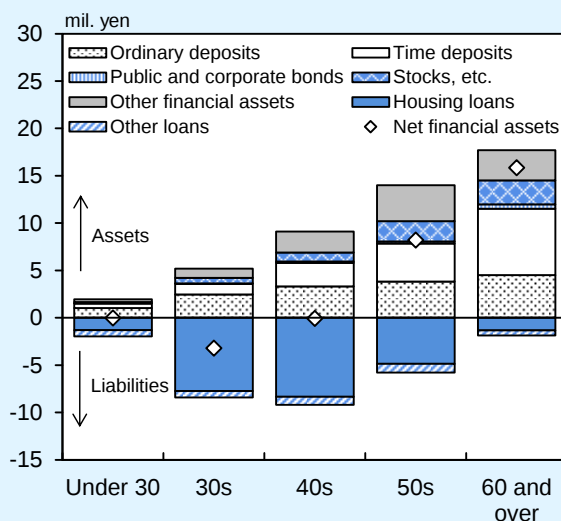
Chart B4-3: Balance Sheet of Households



Source: Bank of Japan.

Note: Figures are as of the end of March 2026. The figure for equity and investment fund shares is the amount outstanding of equity and investment trust beneficiary certificates (based on market values).

Chart B4-4: Balance Sheets by Age of Household Head



Source: Ministry of Internal Affairs and Communications.

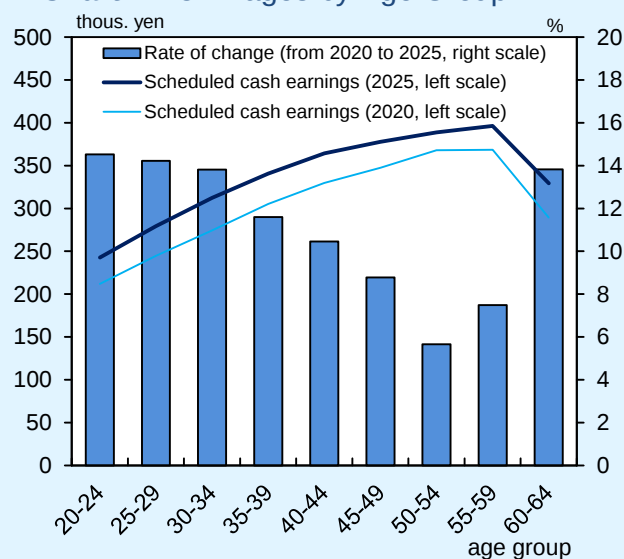
Note: Figures show the average balance sheet per household for each age group as of 2019.

²⁷ In recent years, rising real estate and housing prices have led to larger housing loan amounts, which has also added to households' repayment burden.

amounts.²⁸ In addition, the Bank's policy rate hikes have been predicated on the continued improvement in employment and income conditions, including the steady wage gains in recent years, and these developments should be taken into account alongside the rate hike itself. Recently, reflecting a particularly acute shortage of younger workers, many firms have been granting relatively large wage increases to employees in their 20s and 30s (Chart B4-5). These developments have worked to ease the repayment burden of housing loans for these age groups. Moreover, in recent years, households' holdings of equities have increased, and for those holding equities, dividend income has risen and the wealth effects from higher stock prices have been observed (Chart B4-6).

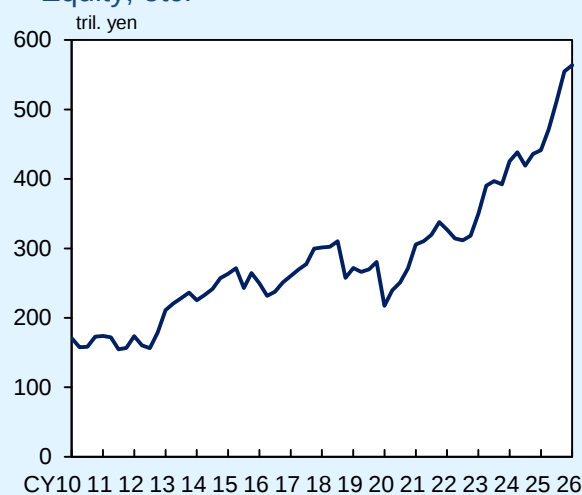
Against this background, even amid rising housing loan rates, private consumption has been resilient so far. It is necessary to continue to carefully monitor how increases in the policy interest rate affect household behavior, taking into account factors such as differences in asset and liability structures across age groups.

Chart B4-5: Wages by Age Group



Source: Ministry of Health, Labour and Welfare.
Note: Figures are monthly scheduled cash earnings.

Chart B4-6: Household Holdings of Equity, etc.



Source: Bank of Japan.
Note: Figures are the amount outstanding of equity and investment trust beneficiary certificates (based on market values).

²⁸ For floating-rate housing loans, it is often the case that, a "5-year rule" is applied, under which the monthly repayment amount is fixed for five years. In addition, even when the repayment amount is revised, a "125 percent rule" is frequently applied, which caps the revised monthly repayment at no more than 1.25 times the previous amount.

