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Japan's Economy: Monthly Outlook (Feb 2026)

Economic Outlook Revised: Continued vigilance advised regarding downside risks to external demand centering on the US & China

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Summary

- In light of the announcement of the Oct-Dec 2025 GDP 1st preliminary results, we have revised our economic outlook. We now see growth in Japan's real GDP according to our main scenario at +0.7% in FY2025, +0.8% in FY2026, and +0.9% in FY2027. (On a calendar year basis, we expect +0.6% in 2026 and +1.0% in 2027).
- Real wages should remain positive on a y/y basis, due to factors such as the continuation of a high level of wage increases in the spring labor negotiations, and a decline in the inflation rate. Government economic measures, a continued accommodative financial environment, and a high level of household savings are expected to support or boost the Japanese economy. In addition, the facts that the inventory cycle is seen to be entering an "accumulation phase" and that the capital stock cycle suggests an increase in capital expenditure are also positive factors.
- On the other hand, continued vigilance is needed regarding downside risks to external demand, particularly from the US and China. In the US, inflation could rise higher than anticipated, potentially prolonging a tightening monetary policy environment or leading to a renewed escalation of Trump tariffs. Japan-China relations remain significantly strained since the fall of 2025, raising concerns that the recovery in the number of Chinese visitors to Japan could lag behind expectations or that procurement difficulties for rare earths and other materials could arise.
- We assume that the Bank of Japan (BOJ) will raise the short-term interest rate to 1.00% in the Apr-Jun period of 2026 while closely monitoring the economy, prices, and financial situation, followed by additional rate hikes at a pace of once every six months, 0.25%pt at a time. The short-term interest rate is expected to reach 1.75%

by the end of the forecast period. Real interest rates are expected to remain negative throughout the forecast period, and monetary conditions are likely to remain accommodative for the time being.

1. Moderate Recovery Expected through FY2027, but We Remain Wary of Downside Risk in External Demand

Though modest, real GDP shifted back into positive growth in the Oct-Dec 2025 period, and is expected to expand the range of positive growth in the Jan-Mar period of 2026

The real GDP growth rate for Oct-Dec 2025 (1st preliminary) was up by +0.2% q/q annualized (+0.1% q/q)¹. Though modest, it was the first time in two quarters for Japan's real GDP to achieve positive growth.

Personal consumption and capital expenditure rose modestly, reflecting a rebound from the Jul-Sep period which experienced a sharp decline in housing investment. Meanwhile, external demand remained sluggish, with both goods and services exports declining, while private inventory changes also weighed on GDP growth. Overall, the Oct-Dec period showed lackluster performance, but the assessment remains unchanged that the Japanese economy continues on a path of gradual recovery at present.

Looking at performance by demand component (Chart 1, left), in the area of private sector demand, as mentioned above, personal consumption, capital expenditure and housing investment achieved growth, but private sector inventories contributed to pushing down the GDP growth rate by 0.2%pt in comparison to the previous quarter. As for public sector demand, government consumption grew, while public investment declined. Meanwhile, in the area of external demand, both exports and imports declined, with imports exceeding exports in the amount of decline, hence net exports pushed the real GDP growth rate up.

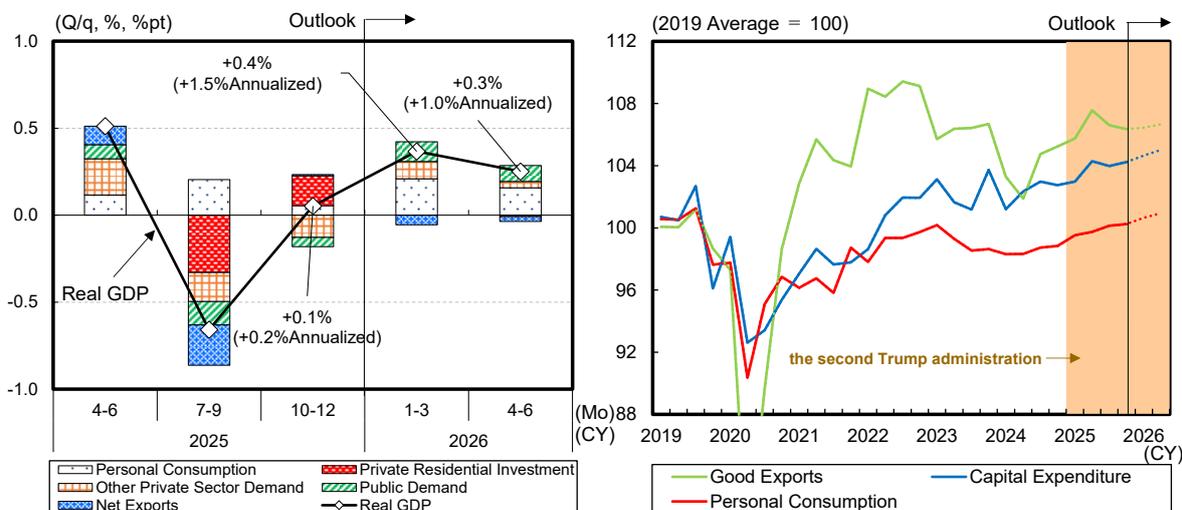
The GDP deflator rose +3.4% y/y, achieving its 16th consecutive quarter of growth. Unit labor costs (nominal compensation per employee divided by real GDP) also increased by +3.4% y/y, the 11th consecutive quarter of growth, indicating that wage-driven inflationary pressures have been continuing recently.

Real GDP growth for the Jan-Mar period of 2026 is expected to expand by +1.5% q/q annualized (+0.4% q/q). While personal consumption and capital expenditure are expected to increase, goods exports are likely to remain flat (Chart 1, right). Although the economies of major countries and regions remain resilient at present, continued vigilance is needed regarding downside risks, particularly concerning exports to the US and the number of Chinese visitors to Japan.

¹ See the DIR report by Keiji Kanda, Munehisa Tamura and Hirohito Hatanaka dated 16 February 2026, [Oct-Dec 2025 1st Preliminary GDP](#) (Japanese only).

Real GDP Growth Rate Results & Outlook (Left); Trends in Goods Exports, Capital Expenditure, and Personal Consumption (Right)

Chart 1



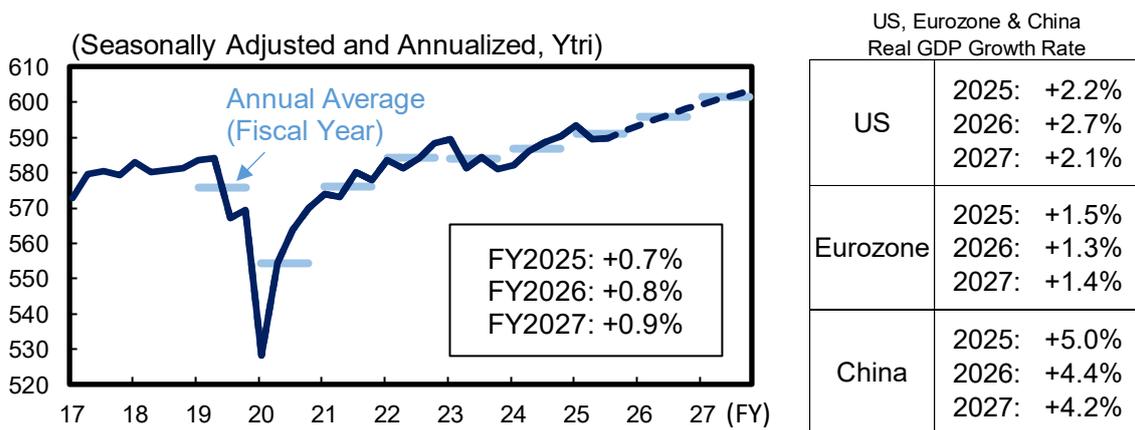
Source: Cabinet Office; compiled by DIR.
Notes: Figures are seasonally adjusted. Outlook produced by DIR.

Assumptions regarding overseas economy etc., Trump tariffs and number of Chinese visitors to Japan

Chart 2 illustrates our main scenario for the trend in real GDP, based on our outlook for overseas economies. Our latest outlook for overseas economies dated February 17 is provided by our in-house experts on the overseas economy.

Outlook for Japan's Real GDP and Assumptions Regarding Overseas Economies

Chart 2



Source: Produced by DIR based on data from the Cabinet Office and statistics by various countries.
Note: The dashed line in the chart represents predicted values estimated by DIR. Outlooks for the US, Eurozone and China are based on predictions by DIR's in-house experts.

We expect growth in real GDP in 2026 to be up by +2.7% y/y for the US, +1.3% for the Eurozone, and +4.4% for China. Our outlooks for both the US and the Eurozone economies were revised upwards by 0.7%pt and 0.1%pt respectively in comparison to our report of December 8, 2025 (*Japan's Economic Outlook No. 227 Update* (Japanese only), hereafter "our previous outlook"), while our outlook for China remains the same level. Our outlook for

growth rates in 2027 is +2.1% for the US, +1.4% for the Eurozone, and +4.2% for China. For details see the economic outlooks for each individual country.

Regarding the high-tariff policy of the Trump administration of the US (Trump tariffs), we assume the most recent tariff rates to continue. While tariffs imposed on Japanese exports to the US have reached 15%, including automobiles, considering that the average tariff rate to the US in January was 1.5% (DIR estimate based on US Census Bureau data), tariff rates remain elevated even after reflecting the Japan-US tariff agreement. This situation is likely to persist, and will continue to exert downward pressure on the Japanese economy. (See our report of 23 December 2025, [Outlook for Japan's Economy in 2026](#), Japanese only)

The number of Chinese visitors to Japan is expected to experience a decline comparable to that seen during the nationalization of the Senkaku Islands in September 2012, followed by a gradual recovery (the effects are expected to be approximately 4 million fewer visitors and about 0.7 tril yen less in actual spending in 2026). The decline in visitor numbers is expected to continue through the Jan-Mar 2026 period, but will then recover, returning to levels prior to the Chinese government's advisory against travel in Japan by the Jan-Mar period of 2027.

Japan's real GDP expected to grow at a moderate pace through FY2027

Based on the above overseas economic outlook, Japan's real GDP growth rate according to our main scenario is expected to be +0.7% y/y in FY2025, +0.8% in FY2026 and +0.9% in FY2027 (Chart 2, +0.6% in 2026 and +1.0% in 2027 on a calendar year basis).

The outlook for the FY2025 growth rate was revised downwards by 0.2%pt. This reflects the upward trend in imports during the Oct-Dec 2025 period and the downward trend in that same period in capital expenditure and public investment. Meanwhile, the outlook for FY2026 was revised downwards by 0.1%pt in comparison to our previous outlook mainly due to carryover (real GDP growth rate that can be achieved with zero q/q growth in each quarter. -0.1%pt). In this report we have newly added our outlook for the FY2027 real GDP growth rate, which is slightly higher than FY2026. However, if we remove the carryover amount, it comes to +0.5% y/y (+0.7% in FY2026), hence, in actual fact, the outlook is for a slowdown in growth.

Looking at performance by demand component, we expect personal consumption to continue achieving moderate growth (FY2025: +1.3% y/y, FY2026: +1.1%, FY2027: +0.8%).

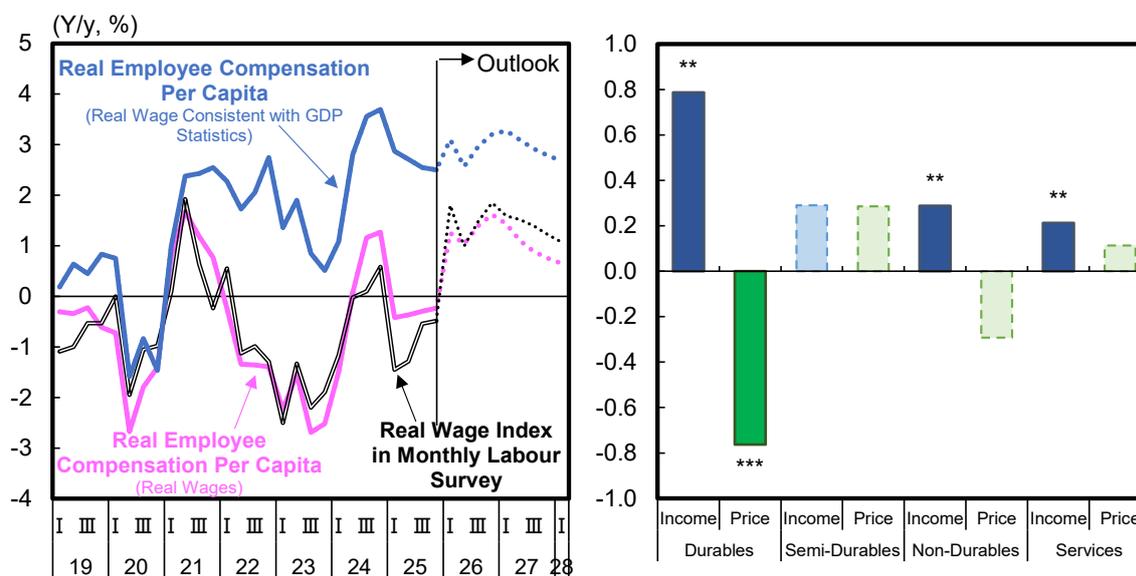
The wage increase rate in the spring labor negotiations, as compiled by the Japanese Trade Union Confederation (RENGO), is expected to be around 5.3%. High prices and a tight labor market, as well as favorable corporate performance are expected to bring a high level of wage hikes at around the same level as the previous year (5.25%). In addition, CPI is expected to decline to around +2% on a y/y basis due to the decline in the rate of growth in prices for food and government countermeasures to the high level of prices of goods (see Chart 6 later in this report). As a result, real wages are expected to remain in the positive range on a y/y basis beginning in the Jan-Mar period of 2026² (Chart 3, left). In addition, personal consumption is expected to be supported by the increase in the basic deduction on income taxes, the expansion

² While this report discusses in terms of y/y comparisons, examining real employee compensation per capita (seasonally adjusted) on a q/q basis shows that it remained positive for three consecutive quarters up to the most recent Oct-Dec period of 2025.

of the Local Grant for Intensive Support against Price Hikes, and the 20,000 yen per child benefit payment, along with the high level of household savings³.

Outlook for Employee Compensation Per Capita and Outlook for Real Wage Index (Left), and Income and Price Elasticity of Real Consumption Expenditure by Category (Right)

Chart 3



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, Cabinet Office, Japan Tourism Agency; compiled by DIR.

Notes: 1) Real employee compensation per capita (real values based on household final consumption expenditure deflator) in the chart on the left is the seasonally adjusted y/y change. The dotted line represents DIR estimates.
2) The estimation period for the chart on the right is Jan-Mar 1990 to Oct-Dec 2019. The estimation equation is: $\ln(\text{Real Consumption Expenditures} / \text{Real Consumption Expenditures (4 quarters prior)}) = \alpha \times \ln(\text{Real Disposable Income} / \text{Real Disposable Income (4 quarters prior)}) + \beta \times \ln(\text{Deflator} / \text{Deflator (4 quarters prior)}) + \text{Consumption Tax Increase Dummy} + \text{Constant Term}$. Real Consumption Expenditures exclude inbound consumption. The estimation equation for service consumption does not include a consumption tax increase dummy. *** indicates significance at the 1% level, ** indicates significance at the 5% level, and others do not meet the 10% significance level.

What types of consumer spending would be stimulated by accelerating real wage growth? Chart 3 (right) shows the estimated income and price elasticity of real consumption expenditure by category. Income elasticity is positive and significant for all categories except semi-durable goods like clothing, with particularly high values for durable goods. This suggests that if real wage growth accelerates through FY2026, broad-based consumer spending growth, centered on durable goods, is likely. Conversely, durable goods exhibit negative and significant price elasticity, meaning demand is easily suppressed when prices rise. Attention is warranted regarding the potential for downward pressure on both price and income levels, particularly on durable goods consumption, should the currently stabilizing inflation accelerate again due to factors such as yen depreciation, thereby suppressing real wages.

³ Household financial assets, which stood at 2,286 tril yen at the end of September 2025, are projected to reach approximately 2,330 tril yen by the end of December. This amount is equivalent to 6.7 to 6.8 years' worth of nominal consumption, exceeding the pre-pandemic level (6.3 years' worth on average in 2019). Even if household income declines, there appears to be significant room to stabilize living standards by drawing down savings.

Capital expenditure is expected to remain strong, supported by a growing sense of equipment shortages amid a moderate economic expansion, expanding corporate earnings, and a decline in the relative price of capital goods due to aggressive wage increases (FY2025: +1.5% y/y, FY2026: +1.3% y/y, FY2027: +1.5% y/y; see Chapter 2 for details). However, caution is required as factors such as a deterioration in corporate earnings due to the impact of Trump tariffs and rising real interest rates could put downward pressure on capital investment. By type, software investment related to digital transformation (DX) and decarbonization, as well as research and development investment, are expected to remain strong. On the other hand, delays in construction schedules due to labor shortages are likely to continue to weigh on construction investment and other areas.

Government consumption is expected to remain steady (FY2025: +0.6% y/y, FY2026: +1.5% y/y, FY2027: +1.6% y/y). In addition to an increase in medical and nursing care benefits due to the aging population, active wage increases by private companies are also expected to be reflected in public sector wages.

Exports are expected to slow through FY2026 but accelerate in FY2027 (FY2025: +1.9% y/y, FY2026: +0.9%, FY2027: +2.7%). By goods and services, goods exports are expected to remain flat until the Apr-Jun 2026 period, influenced by the completion of recovery from Trump tariffs and a sluggish Chinese economy. However, they are projected to gradually recover thereafter alongside the global economic recovery (see Chart 1, right). Service exports, primarily driven by inbound consumption⁴, are expected to remain weak, continuing to decline through Jan-Mar 2026 due to factors such as the Chinese government's advisory against travel to Japan. However, from Apr-Jun 2026 onwards, these negative impacts are expected to gradually fade, leading to a recovery.

While improvements in income conditions and other factors will provide underlying support for the Japanese economy, caution is needed regarding the downside risks to overseas demand, particularly from the US and China

The main factors expected to provide support or a boost to the Japanese economy are “improvement in the household income environment due to wage hikes and other factors,” “government economic measures,” “continuation of an accommodative monetary environment,” and “the high level of household savings” (Of these, “improvement in the household income environment due to wage hikes and other factors,” and “the high level of household savings” were discussed earlier in this report).

The Sanae Takaichi administration compiled a comprehensive economic stimulus package in November 2025, with a project scale of approximately 42.8 tril yen and total public expenditure of about 21.3 tril yen. We estimate the cumulative effect of this package over the next three years to be approximately 6.9 tril yen, equivalent to about 0.4% in annual real GDP growth. Measures to combat rising prices, such as the abolition of the old provisional gasoline tax rate, are expected to underpin personal consumption. Meanwhile, initiatives to promote disaster prevention, mitigation, and national resilience are projected to boost public investment. Crisis management investment and growth investment are anticipated to stimulate

⁴ The number of foreign visitors to Japan (Japan National Tourism Organization), which was 42.68 million in 2025, is expected to decrease to around 42.00 million in 2026 before increasing to around 47.00 million in 2027 (real inbound consumption is projected to decrease from 7.5 trillion yen in 2025 to around 7.2 trillion yen in 2026, then increase to around 8.0 trillion yen in 2027). The impact of deteriorating Japan-China relations on the number of Chinese visitors to Japan was examined in our previous outlook.

capital expenditure. The nature of crisis management investment and growth investment was examined in Chapter 4 of [Japan's Economic Outlook No. 228](#) (February 20, 2026, our current outlook, Japanese only).

The outlook for prices and the Bank of Japan (BOJ)'s monetary policy will be discussed in Chapter 3. The CPI growth rate is expected to maintain at around +2% y/y, and the BOJ is expected to implement additional interest rate hikes at a gradual pace.

On the other hand, continued vigilance is required regarding downside risks to external demand centering on the US and China. In the US, former Federal Reserve Governor Kevin Warsh has been nominated to succeed Federal Reserve Board Chairman Jerome Powell, whose term expires in May 2026. With the risk of inflation reigniting due to the pass-through of Trump tariffs to domestic prices, the weak dollar, and large-scale tax cuts, it is highly uncertain whether interest rates will be cut as President Trump advocates. If the inflation rate rises more than expected and the Fed shifts its monetary policy focus from supporting employment to controlling prices, the continued tightening of monetary policy could put downward pressure on the US economy. Furthermore, the possibility of the Trump tariffs being strengthened again cannot be ruled out.

Japan-China relations, which deteriorated significantly in the fall of 2025, show no signs of improvement to this day. In late January, the Chinese government again urged its citizens to refrain from traveling to Japan. China's three major airlines extended the deadline for free ticket cancellations from the previous deadline of March 28 to October 24. Concerns are mounting that the recovery in the number of Chinese visitors to Japan may lag behind expectations and that negative effects may spread to exports to China.

The Chinese government announced tighter export controls on dual-use items destined for Japan in January. This could lead to procurement difficulties for materials like rare earths, where Japan has high import dependency on China. If rare earth imports from China were to cease and component shortages persisted for one year, Japan's real GDP is estimated to decline by approximately 1.3% (7 tril yen)⁵.

2. Outlook for Capital Expenditure: While Steady Progress Is Expected, Challenges Include Improving Growth Expectations

Looking back at Japan's economy since the COVID-19 pandemic, while the recovery in personal consumption has been slow, capital expenditure has been relatively robust. It recovered to pre-pandemic (2019) levels in 2022 and has continued to increase since then. Private sector demand in 2025 exceeded the 2019 level by 0.4%, with capital expenditure contributing +0.9%pt to this growth (personal consumption contributed -0.0%pt, and private sector housing -0.4%pt).

As mentioned earlier, capital expenditure is expected to remain robust going forward and serve as a key driver of private sector demand. This chapter will examine the key factors underpinning this outlook through the lens of the inventory-capital stock cycle and the capital expenditure function.

⁵ For details, see the DIR report dated 5 December 2025 by Koki Akimoto, "[China's Export Restrictions on Rare Earths and Rare Metals Could Reduce Japan's Real GDP by 1.3–3.2%](#)" (Japanese only).

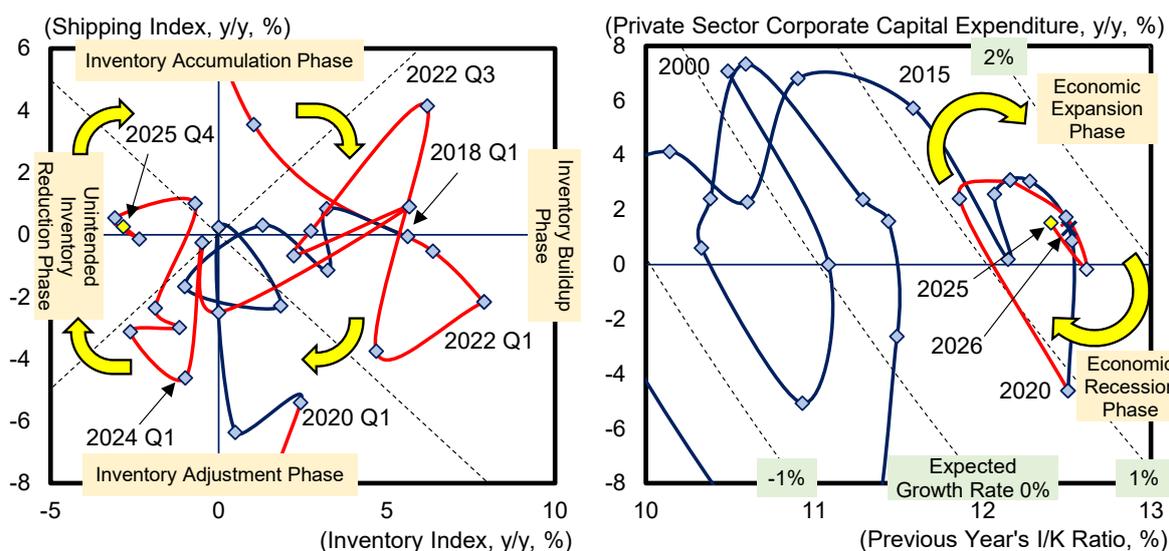
Looking at the inventory and capital stock cycles, both are in a phase that boosts capital expenditure

First, let's examine the current state of manufacturing through the inventory cycle. The inventory cycle arises from companies attempting to maintain inventory levels commensurate with shipments (demand) and from discrepancies between shipments and corporate production plans. Plotting the rate of change in comparison to the previous year for inventory and shipments on the horizontal and vertical axes, respectively, reveals a tendency for the situation at each point in time to progress clockwise (Chart 4, left).

According to this chart, after inventory adjustments progressed from the Jul-Sep period of 2022 to the Jan-Mar period of 2024, the shipment growth rate turned positive, and the most recent period is positioned in an “unintended inventory reduction phase.” From FY2026 to FY2027, the economy may enter an “inventory accumulation phase.” This suggests companies will expand production to build up inventories in anticipation of growing demand, and corporate profits will improve as shipments increase. Amidst this, corporate willingness to invest in equipment is likely to rise.

The Inventory Cycle (Left) and the Capital Stock Cycle (Right)

Chart 4



Source: Ministry of Economy, Trade and Industry, Cabinet Office; compiled by DIR.

Note: Red lines represent the year 2020 and beyond. The I/K ratio in the chart at the right is the ratio between capital expenditure and capital stock. Figures for the year 2026 are DIR estimates.

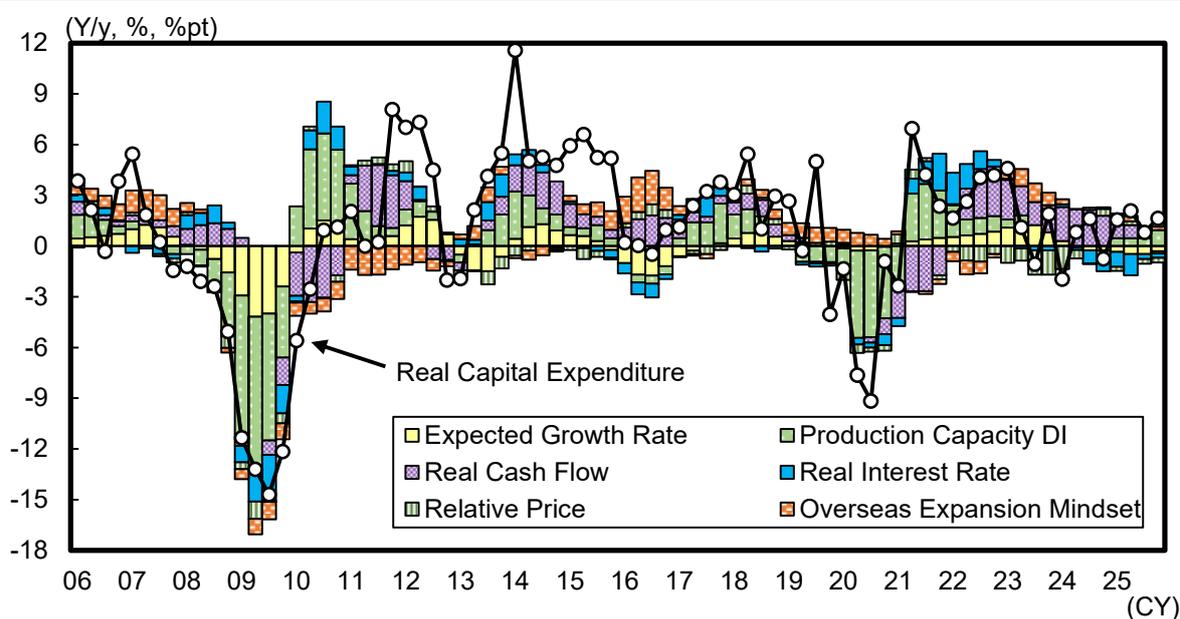
The capital stock cycle is shown in the right side of chart 4. Plotting each year's situation with the previous year's capital expenditure/capital stock ratio (I/K ratio) on the horizontal axis and the y/y change in capital investment on the vertical axis reveals that, in the short term, it moves clockwise along a line representing a certain expected growth rate.

The growth rate of capital expenditure slowed from 2022 to 2024 as the I/K ratio increased in comparison to the previous year. However, it is expected to accelerate again in 2025, as the I/K ratio begins to decline. In 2026, the growth rate is projected to shift slightly downward in line with the pattern of an expanding economy, with capital expenditure continuing to increase.

Investment is expected to expand, backed by intensifying equipment shortages, increased real cash flow, and declining relative prices of capital goods

Next, we examine the outlook for capital expenditure by estimating the capital expenditure function and organizing the factors driving increases or decreases in investment. Chart 5 presents a factor analysis based on this capital expenditure function. It uses the y/y change in real capital expenditure as the dependent variable, with explanatory variables including the expected growth rate, the production capacity DI (indicating the sense of equipment sufficiency), real cash flow, real interest rates, the relative price of capital goods to labor costs, and changes in corporate overseas expansion sentiment⁶.

Factor Analysis of Trends in Real Capital Expenditure Based on Capital Expenditure Function
Chart 5



Source: Ministry of Finance, Ministry of Internal Affairs and Communications, Cabinet Office, Bank of Japan; compiled by DIR.

Note: Multiple regression analysis was performed on real capital expenditure (on a y/y basis) using expected growth rate (= 5-year outlook for real growth rate of industry demand, difference from previous year), production capacity DI (recent, difference from previous year), real cash flow (y/y, average of last four quarters, three-quarter lag), real interest rate (= long-term interest rate – capital expenditure deflator (y/y), difference from previous year), relative price (= capital expenditure deflator (y/y) – nominal employee compensation per capita (y/y)), overseas expansion mindset (= outlook for ratio of local production overseas five years from now – outlook for business performance in that fiscal year, difference from previous year). Estimation period used was the Jan-Mar period of 1996 to the Oct-Dec period of 2025, with real interest rate (difference from previous year) and relative price at significance of 5% and others at 1%. Expected growth rate, cash flow (= depreciation of fixed capital + (net operating surplus + property income (receipt) - property income (payment))/2, private corporations), and overseas expansion mindset were all divided into quarters using the Lisman-Sandee method.

Looking back at the period since the COVID-19 pandemic, growth in capital expenditure fell sharply in 2020 as a sense of over-capacity grew due to stagnant economic activity. In 2021, this sense of over-capacity eased, and the Bank of Japan's continued monetary easing policy,

⁶ The expected growth rate was calculated by taking the “five-year outlook” for the real growth rate of industry demand from the Cabinet Office's “Annual Survey of Corporate Behavior.” The overseas expansion mindset was calculated by subtracting the “projected actual results for the current fiscal year” from the “five-year outlook” for the overseas local production ratio in the same survey. The overseas local production ratio is calculated as: Production value from overseas local production ÷ (Production value from domestic production + Production value from overseas local production). For further details on the capital expenditure function, refer to the notes in Chart 5.

even as prices entered a rising phase, led to a decline in real interest rates, which boosted capital expenditure. From 2022 onwards, there was a growing sense that capital goods were overpriced as wage increases failed to keep up with rising prices, and rising real interest rates due to interest rate hikes and other factors weighed on the economy. However, capital expenditure is considered to have remained strong reflecting corporate profits.

As was noted in the previous chapter, we expect capital investment during the forecast period to remain in the middle of the 1% range compared to the previous year. Possible factors pushing up the figure are a growing sense of capital shortages and an increase in real cash flow. With the economic expansion suggested by the inventory and capital stock cycles, production capacity DI is likely to continue its gradual decline, and real cash flow is also likely to remain strong.

The decline in the relative price of capital goods will also boost capital expenditure. Companies are proactively raising wages to address labor shortages and secure workers in the medium to long term. As high wage increases become established, capital goods are likely to appear more undervalued. Furthermore, in recent years, companies have been less willing to expand overseas⁷ due to growing economic security risks, such as the intensifying US-China conflict, so there seems to be room for stimulation of domestic investment.

The Takaichi administration's expansionary fiscal policy to expand investment faces challenges such as improving growth expectations and stabilizing interest rates

As was indicated in our report of June 9, 2025 ([Japan's Economic Outlook No. 225 Update](#) (Japanese only)), in order to strengthen Japan's economic growth potential, increasing growth in capital expenditure is essential. In this regard, while the expected growth rate (the "outlook for the next five years" of the real growth rate of industry demand) is projected to reach 1.5% in 2025, exceeding the pre-pandemic average of 1.1% from 2015 to 2019, it is slightly lower than the 1.7% recorded in 2023, a year still in the midst of recovery from the pandemic.

The Takaichi administration aims to raise the potential growth rate through expanded investment via a "responsible expansionary fiscal policy." Attention is focused on whether government initiatives can boost corporate growth expectations and stimulate capital expenditure. However, if fiscal policy becomes overly generous, interest rates could rise excessively, potentially suppressing capital expenditure instead. From October 2025, when the first Takaichi administration was formed, through January 2026, the pace of long-term interest rate increases accelerated, partly due to heightened concerns over fiscal deterioration. A more focused fiscal management approach is required, such as prioritizing fiscal spending based on cost-effectiveness and necessity (see Chapter 4 of our current outlook for details).

Amid ongoing inflation and wage increases, creating an environment that facilitates smooth price pass-through is crucial for enhancing the investment capacity of small and medium-sized enterprises (SMEs). While the Small and Medium Enterprise Agency's "Follow-up Survey on Price Negotiation Promotion Month" (Japanese only) suggests progress in price pass-through by SMEs, the latest September 2025 survey indicates that 16.8% of SMEs have been unable to pass on price increases at all. Differences in the degree of progress in price

⁷ The "outlook for business performance in that fiscal year" for the overseas local production ratio has been on an upward trend, leveling out fluctuations since 1988, when data became available (23.6% in 2025), while the "outlook for five years from now" has been on a downward trend since peaking in 2015 (26.2%) (23.9% in 2025, with the mindset to expand overseas for the same year increasing by 0.2 percentage points).

pass-through are also observed depending on industry and the stage in the supply chain, indicating significant room for continued improvement.

3. Outlook for Prices and Monetary Policy

New core-core CPI expected to decline to around +2% y/y in first half of FY2026

Based on the latest resource prices and exchange rates, on an all items basis, CPI is expected to increase by +2.6% y/y in FY2025, with +2.0% expected in FY2026, and +2.1% in FY2027. On an all items basis, less fresh food (core CPI), is projected to increase by +2.7% y/y in FY2025, +1.8% in FY2026, and +2.0% in FY2027. Meanwhile, on an all items basis, less fresh food and energy (new core-core CPI), the forecast is +3.0% in FY2025, +2.0% in FY2026, and +2.2 in FY2027 (Chart 6).

On the policy front, the government's high energy cost countermeasures have led to reductions in electricity and city gas bills from January to March 2026 (reflected in the CPI from February to April). Starting in April, private high school tuition will be effectively eliminated, and public elementary school lunch fees will also be waived.

The rate of food price increases is expected to gradually slow through the end of FY2026. According to TEIKOKU DATABANK⁸, the number of food and beverage items with confirmed price hikes for the year as of January 2026 is trending at a pace 60% lower than the previous year, and price increases are expected to be relatively subdued through early spring 2026. Furthermore, a January 2026 survey of rice traders conducted by the Support Organization for Securing Stable Supply of Rice⁹ indicates a growing consensus that rice supply and demand will ease over the next three months, leading to falling prices.

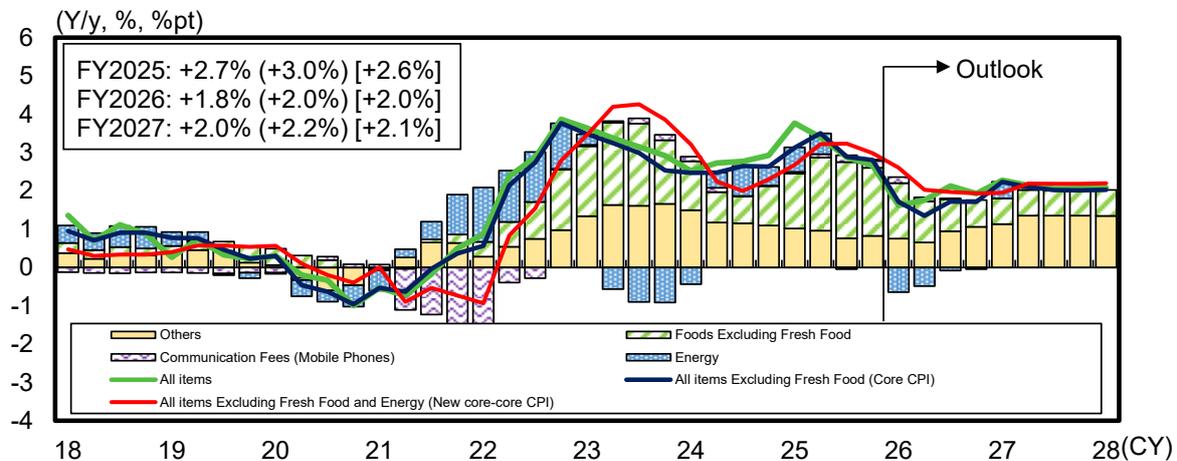
On the other hand, we expect the trend of passing on increased labor costs from wage hikes to sales prices to continue. Supported by these movements, the new core-core CPI is projected to decline to around +2% y/y through the first half of FY2026 (with core CPI falling to the middle of the 1% range y/y in the Apr-Jun 2026 period), after which it should stabilize.

⁸ TEIKOKU DATABANK, "[Price Revision Trend Survey of 195 Major Food Companies - February 2026](#)" (January 30, 2026, Japanese only).

⁹ Support Organization for Securing Stable Supply of Rice, "[Survey Results on Judgments of Rice Traders \(January 2026\)](#)" (February 5, 2026, Japanese only)

Outlook for Core CPI (Figures in Parentheses are All Items Excluding Fresh Food and Energy, Square Brackets Indicate All Items Figures)

Chart 6



Source: Ministry of Internal Affairs and Communications; compiled by DIR.

Notes: Price outlook assuming resource prices and exchange rates at the time of this writing. From FY2026 and beyond, it is assumed that starting in April, private high school tuition will be effectively eliminated, and public elementary school lunch fees will be waived.

Pass-through of wages to selling prices in the non-manufacturing sector has been progressing gradually

Wages and prices are rising cyclically, and while the underlying inflation rate is gradually increasing, the Bank of Japan judges that the 2% price stability target has not yet been achieved. For the underlying inflation rate to stabilize around 2%, it is essential that the pass-through of increased labor costs to prices occurs continuously and stably across a broad range of industries. Therefore, from the perspective of gauging future underlying price trends, we examine the current progress of price pass-through by corporations.

Specifically, we define the impact of corporate input costs on selling prices as the “degree of price pass-through”. Input costs are broadly categorized into two types: intermediate input costs, such as raw material expenses, and labor input costs, represented by wages. We then evaluate the progression of the cyclical rise in wages and prices by industry through changes in the degree of price pass-through during periods of rising prices.

Chart 7 shows the distribution of the degree of price pass-through in the manufacturing and non-manufacturing sectors using a box-and-whisker plot. Here, the Bank of Japan's Tankan “Change in Output Prices DI” was regressed against the “Change in Input Prices DI” and the “Employment Conditions DI” (all “actual result”), and by varying the estimation period, the differences in parameters between the price increase phase and the preceding deflationary/low-inflation phase were compared. For the inflationary phase, we distinguish between the period around 2021—when price pass-through advanced mainly due to rising raw material costs against the backdrop of high import prices—and the current period, examining differences in the degree of price pass-through within each. Note that higher values on the vertical axis indicate greater propensity for price pass-through.

First, we focus on intermediate input costs. Price pass-through for intermediate inputs has progressed significantly in the manufacturing sector since 2021. Looking at the median price pass-through rate, it has risen sharply from 0.30 during the deflationary/low-inflation phase

to 0.70 by the end of 2024, suggesting a rapid acceleration in the movement of soaring raw material costs being passed on to sales prices. However, the degree of price pass-through at the end of 2024 was similar to that at the end of 2025, indicating no further progress in price pass-through over the most recent year.

This is thought to be because, in addition to a certain degree of price pass-through having already occurred during the period of soaring import prices, the recent pause in raw material price increases has meant that companies are no longer in a position to implement further price revisions. Consequently, it can be assessed that, by 2025, the price pass-through originating from intermediate input costs in manufacturing has largely run its course. Meanwhile, price pass-through of intermediate input costs in the non-manufacturing sector has not progressed as much as in manufacturing. Although the degree of price pass-through increased over the most recent year, no clear change in its level was observed compared to the deflationary and low-inflation phases.

Next, we examine the degree of price pass-through for labor input costs. For both manufacturing and non-manufacturing sectors, the degree of price pass-through for labor input costs has increased compared to the deflationary and low-inflation phases. In manufacturing, the median during the deflationary and low-inflation phase was 0.38, rising to 0.47 by the end of 2024. The aggressive price pass-through during the period of surging raw material prices may have simultaneously created an environment conducive to advancing labor cost pass-through. However, further progress in price pass-through over the most recent year appears limited.

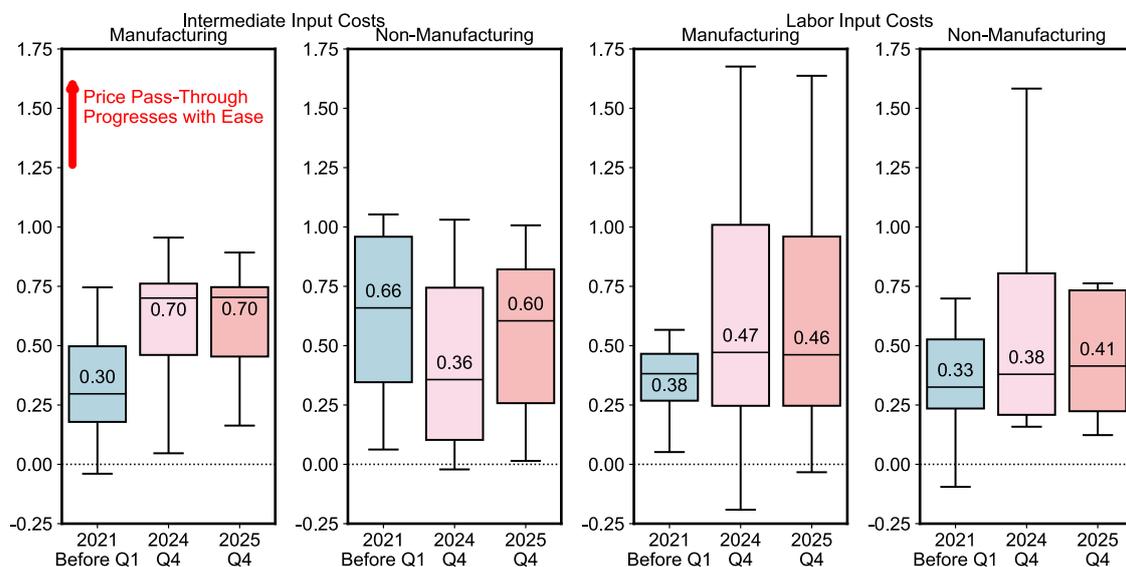
In the non-manufacturing sector, the median price pass-through rate stood at 0.33 during the deflationary and low-inflation phase, but rose to 0.38 by the end of 2024 and further increased to 0.41 by the end of 2025. Unlike manufacturing, the price pass-through rate has also been rising over the most recent year. This suggests that, even under rising price conditions, the pass-through of labor costs to selling prices is continuing, albeit at a moderate pace.

Chart 7 shows that the non-manufacturing sectors include many industries with relatively high labor cost shares, such as retail trade and accommodation and food services. These household-oriented non-manufacturing industries, characterized by labor-intensive industrial structures and operating in competitive markets, have historically found it difficult to pass on wage increases to sales prices. Consequently, they have been noted for their difficulty in sustaining cyclical increases in both wages and prices. However, at present, even within these sectors, the passing on of labor costs to prices is gradually progressing. It can be assessed that the movement to pass on increased labor costs to sales prices is spreading within the non-manufacturing sector as well.

As mentioned in the previous chapter, it is difficult to say that price pass-through has progressed sufficiently across the entire corporate sector. However, wage increases continue amid worsening labor shortages, and wage hike rates comparable to the previous year's high levels are expected to be achieved in the 2026 spring wage negotiations. The trend of passing on increased labor costs to sales prices is expected to continue. As the cyclical rise in wages and prices gradually becomes entrenched, it is likely to underpin the sustainability of underlying price increases.

Impact of Purchase Prices and Labor Shortages on Selling Prices by Industry (Degree of Price Pass-Through)

Chart 7



Source: Bank of Japan; compiled by DIR.

Notes: 1) The Bank of Japan's Tankan "Change in Output Prices DI" was used as the dependent variable. For raw materials costs, representing intermediate input costs among corporate input costs, the "Change in Input Prices DI" was used as a proxy variable. For labor costs, representing labor input costs, the "Employment Conditions DI," which reflects companies' perceptions of labor shortages or surpluses, was used as a proxy variable (all DIs refer to "actual result"). The estimation period spans from Oct-Dec 2003 to Oct-Dec 2025. For the non-manufacturing sector, the following industries were included in the analysis: "Real Estate," "Retailing," "Transport and Postal Activities," "Communications," "Information Services," "Other Information Communication," "Electric and Gas Utilities," "Services for Individuals," and "Accommodations, Eating and Drinking Services."

2) In a box-and-whisker plot, the upper and lower whiskers represent the maximum and minimum values. The top and bottom edges of the rectangle indicate the upper and lower 25th percentiles, respectively, while the horizontal line within the rectangle represents the median (calculated excluding outliers).

BOJ expected to raise the short-term interest rate to 1.00% in the Apr-Jun Period of 2026

We assume that the BOJ will raise the short-term interest rate to 1.00% in the Apr-Jun period of 2026 (in terms of the month in June), followed by additional rate hikes at a pace of once every six months, 0.25%pt at a time (Chart 8).

As mentioned earlier, the cyclical rise in wages and prices is expected to continue. Furthermore, if the yen weakens again against the backdrop of the Takaichi administration's "responsible expansionary fiscal policy," there is a risk that inflationary pressures could intensify further. The BOJ will likely adjust the degree of monetary easing by moving the policy interest rate closer to the neutral rate to ensure the inflation rate progresses in a stable manner.

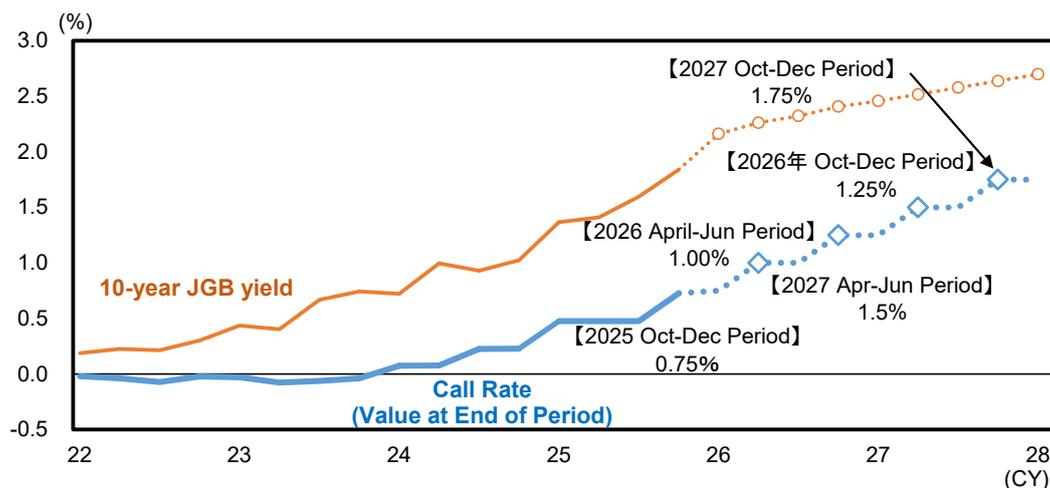
Japan's natural interest rate is estimated to be around zero percent at present, but we expect it to turn slightly negative in line with the decline in potential growth. We expect the inflation rate to remain at around +2% y/y, and the terminal rate (the final policy interest rate) consistent with this will be 1.75%. We expect the policy interest rate to reach its terminal rate in the Oct-Dec period of 2027.

We expect the long-term interest rate to continue to rise, reaching around 2.7% by the end of the forecast period (Chart 8). The BOJ's gradual but steady increase in short-term interest

rates is expected to push up long-term rates, while additionally the bank will reduce its purchases of government bonds in stages. Upward pressure from the viewpoint of supply and demand will also likely increase. However, if concerns grow that the expansionary fiscal policy of the Takaichi administration could trigger further inflation, while increased government bond issuance could worsen supply-demand conditions, uncertainty regarding the future could push long-term rates up further through an expansion of the risk premium desired by investors.

Outlook for Long and Short-Term Interest Rates in Japan

Chart 8



Source: Ministry of Finance, Bank of Japan; compiled by DIR.

Notes: The long-term interest rate is a period average, while the short-term interest rate is the value as of the end of the period. Dotted lines are DIR estimates.

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Chart 9

		2025			2026				2027				2028	FY2024	FY2025	FY2026	FY2027
		Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	(CY)	(CY)	(CY)	(CY)
Real GDP	Y tri; annualized	593.3	589.4	589.7	591.9	593.4	595.1	596.6	598.1	599.4	600.7	602.0	603.3	586.8	591.1	595.9	601.4
	Q/q %	0.5	-0.7	0.1	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2				
	Q/q %; annualized	2.1	-2.6	0.2	1.5	1.0	1.1	1.0	1.0	0.9	0.9	0.8	0.9				
	Y/y %	2.0	0.6	0.1	0.3	0.1	1.0	1.1	1.1	1.0	0.9	0.9	0.9	0.5	0.7	0.8	0.9
													(-0.2)	(1.1)	(0.6)	(1.0)	
Private Consumption	Q/q %	0.2	0.4	0.1	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.3	1.1	0.8
Private Residential Investment	Q/q %	0.0	-8.4	4.8	0.0	-0.2	-0.6	-0.8	-0.9	-1.0	-1.0	-1.0	-1.0	-0.7	-3.8	-1.1	-3.7
Private Non-Resi. Investment	Q/q %	1.3	-0.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.8	1.5	1.3	1.5
Government Consumption	Q/q %	0.5	0.1	0.1	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	2.3	0.6	1.5	1.6
Public Investment	Q/q %	0.0	-1.5	-1.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	-1.8	-0.2	0.8
Exports	Q/q %	1.9	-1.4	-0.3	0.0	0.3	0.7	0.8	0.9	0.6	0.6	0.6	0.6	1.6	1.9	0.9	2.7
Imports	Q/q %	1.4	-0.1	-0.3	0.3	0.5	0.6	0.7	0.8	0.7	0.7	0.7	0.7	3.2	2.8	1.5	2.9
Nominal GDP	Q/q %; annualized	8.5	-0.1	2.3	2.1	1.9	2.8	2.8	2.7	2.5	2.5	2.5	2.5	3.7	4.0	2.2	2.6
GDP Deflator	Y/y	3.2	3.5	3.4	2.9	1.5	1.3	1.2	1.5	1.7	1.7	1.7	1.7	3.2	3.2	1.4	1.7
Industrial Production	Q/q %	0.4	0.0	0.8	1.4	-1.2	0.4	0.4	0.4	0.3	0.3	0.3	0.3	-1.4	1.3	0.8	1.4
Core CPI	Y/y %	3.5	2.9	2.8	1.7	1.4	1.7	1.7	2.3	2.1	2.0	2.0	2.0	2.7	2.7	1.8	2.0
Unemployment Rate	%	2.5	2.5	2.6	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.5	2.5	2.4	2.3
Call Rate	%	0.48	0.48	0.73	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75	0.48	0.75	1.25	1.75
10-Year JGB Yield	%	1.41	1.60	1.84	2.16	2.26	2.32	2.41	2.46	2.52	2.58	2.64	2.70	1.08	1.75	2.36	2.61
Major assumptions																	
Crude Oil Price (WTI futures)	\$/bbl	63.7	65.0	59.1	63.3	65.2	65.2	65.2	65.2	65.2	65.2	65.2	65.2	74.4	62.8	65.2	65.2
Exchange Rate	Yen/\$	144.6	147.5	154.1	155.4	154.8	154.8	154.8	154.8	154.8	154.8	154.8	154.8	152.5	150.4	154.8	154.8

Source: Compiled by DIR.

Notes: Shaded areas are DIR estimates. The estimated price of crude oil and the exchange rate are assumed to be fixed at recent levels.