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Impact of Middle East Developments After the U.S.-Iran Memorandum of Understanding and Support from AI Demand, Consumption Tax Cuts and Income-Linked Benefits

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Summary

- The U.S.-Iran Memorandum of Understanding has reduced downside risks to both the Japanese and global economies. However, the path toward a final agreement remains uncertain, and continued attention should be paid to the impact of crude oil prices on economic activity. Due in part to expanded alternative procurement, Japan's crude oil import prices have remained clearly above WTI levels. If current conditions persist, import prices are projected to rise by more than 30% y/y in Q1 2027. Although the pace of increase is expected to moderate thereafter, the impact on consumer prices is likely to remain a factor in FY2027. In the period ahead, further expanding terms-of-trade losses and worsening net exports – driven in part by a recovery in crude oil import volumes – may gradually intensify downward pressure on the Japanese economy.
- While the situation in the Middle East continues to weigh on both Japan and the global economy, growing demand for artificial intelligence (AI) is supporting economic activity. “AI-related goods,” defined based on the World Trade Organization (WTO) definition, have continuously boosted domestic production since 2024. However, Japan's capture of demand for such goods remains relatively low among the G7, suggesting weaker export competitiveness and delays in strengthening supply capacity through domestic investment. This is also the case for non-AI-related goods, indicating that enhancing international competitiveness through expanded domestic investment remains an ongoing issue.

- According to the draft proposal by the chair of the National Council on Social Security's working-level panel, released on June 17, 2026, "a finely tuned income-linked benefit" for low- and middle-income working households (an income-linked benefit) is slated for full-scale introduction around the autumn of 2029. As a "bridge" measure, the consumption tax rate on food will be reduced to 1% for two years starting in April 2027. In addition, a preliminary introduction of the income-linked benefit is planned for autumn 2027 within the equivalent scope of a 1% consumption tax rate. This early implementation is positively valued for facilitating a smoother transition from consumption tax cuts to a refundable tax credit system. Although household support is expected to temporarily shrink between April 2029 and the autumn of that year, the primary objective of the consumption tax cut is to address rising prices; therefore, if nominal wages grow faster than consumer prices during this period, the necessity of such measures would likely be limited.