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Japan's Economy: Monthly Outlook (Aug 2026)

Amid lingering risks related to the situation in the Middle East, the economy is expected to continue its moderate expansion

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Summary

- In light of the announcement of the Apr-Jun 2026 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 FY2026, and +0.9% in FY2027 (+0.7% in CY2026 and +0.7% in CY2027).

- For the time being, downward pressure is expected from factors such as price pass-through of surging crude oil import prices driven by turmoil in the Middle East, and domestic prices of goods and services. On the other hand, real wages are likely to continue rising, supported by sustained high wage increases and tax cuts on food and beverage consumption. Against the backdrop of strong corporate earnings, we expect to see expanding investment in labor-saving technologies, AI-related initiatives, and research and development.

- The core CPI is projected to rise by +2.1% y/y in FY2026 and +1.2% in FY2027. The sharp slowdown in FY2027 is attributed to the consumption tax cut on food and beverages (which is expected to directly lower the rate by approximately 1.2%pt); excluding the consumption tax cut and other policy factors, the rate is expected to remain in the +2% range. We anticipate that the Bank of Japan will raise short-term interest rates to 1.25% in October 2026, and then raise them by 0.25%pt approximately once every three months, reaching 1.75% in the Apr-Jun period of 2027 (after which rates are expected to remain unchanged). Long-term interest rates are expected to continue rising gradually, reaching approximately 3.1% at the end of FY2027.

1. Impact of Situation in Middle East Gradually Becoming Apparent; Economic Growth Expected to Slow in Second Half of 2026

Although the Apr-Jun period marked the third consecutive quarter of positive growth, personal consumption and capital expenditure declined

The real GDP growth rate for Apr-Jun 2026 (1st preliminary) was +1.1% q/q annualized (+0.3% q/q)[1]. Although this marks the third consecutive quarter of positive growth, the underlying conditions are not favorable, as both personal consumption and capital expenditure have declined. However, domestic supplies of crude oil and petroleum products have been maintained through measures such as the release of oil reserves and the securing of alternative sources, and it can be said that the economy continues to expand at a moderate pace.

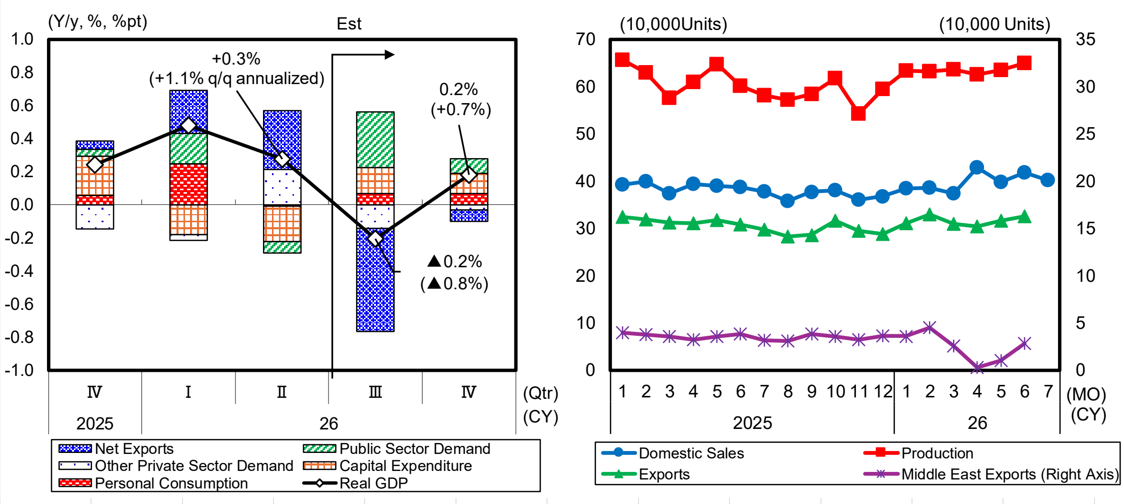
During the Apr-Jun period, domestic oil reserves were released in response to difficulties in procuring crude oil caused by tensions in the Middle East. These developments are reflected in the GDP statistics as changes in public inventories and imports of goods. While the former is estimated to have lowered the real GDP growth rate by 0.5%pt compared to the previous quarter, the decrease in the latter—which is a deduction item in GDP—is believed to have boosted the growth rate by a similar amount; thus, the combined impact on GDP appears to have been limited. However, given that personal consumption and capital expenditure declined even as the pace of growth in real compensation of employees accelerated and corporate earnings remained at high levels, it is possible that the strong sense of uncertainty regarding the future stemming from the situation in the Middle East led households and businesses to adopt a cautious stance toward economic activity.

Looking at performance by demand component (Chart 1, left), in the area of private sector demand, personal consumption, capital expenditure and housing investment suffered declines, but private sector inventories contributed to pushing up the real GDP growth rate by 0.3%pt q/q. As for public sector demand, government consumption achieved growth, but public investment and public inventories pushed the GDP growth rate down. Meanwhile, in the area of external demand, exports grew while imports declined, hence net exports pushed the real GDP growth rate up.

[1] See the DIR report by Keiji Kanda and Hirohito Hatanaka dated 17 August 2026, *Apr-Jun 2026 1st Preliminary GDP* (Japanese only).

Real GDP Growth Rate Results & Outlook (Left); Trends in Automobile Sales, Production, and Exports (Right)

Chart 1



Source: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Finance, Japan Automobile Dealers Association, Japan Light Motor Vehicle and Motorcycle Association; compiled by DIR.
Note: Figures are seasonally adjusted. Outlook produced by DIR. The chart on the right is based on new car sales excluding used cars.

Factors such as sustained automobile production contributed to positive growth in the Apr–Jun period

In addition to the continued supply of petroleum-related products, sustained automobile production also supported economic activity during the Apr-June period. Due to the de facto blockade of the Strait of Hormuz, Japan's exports of new cars to the Middle East fell to nearly zero in April. Although there have been signs of recovery since then, as of June, exports remained at about half the level seen before the deterioration of the situation in the Middle East (Chart 1, right).

However, even amid these circumstances, domestic production of passenger cars remained stable from March onward. This was driven by strong domestic sales. With the abolition at the end of March of the "Environmental Performance Tax" – a tax levied on the purchase of automobiles – new car sales surged in April and have since remained above pre-March levels. Furthermore, exports of new cars to other regions, such as Europe and North America, increased, and overall production maintained the levels seen before the deterioration of the situation in the Middle East[2]. The automotive industry has a broad economic impact; if domestic production had declined in along with the drop in exports to the Middle East, it would have significantly dragged down real GDP for the Apr-Jun period. However, because domestic production was maintained, such an outcome was avoided[3].

[2] Looking at the contribution by country and region to the average number of new car exports for March–June 2026 (y/y), Middle Eastern countries such as Saudi Arabia, Kuwait, and the United Arab Emirates all are negative, while European and North American countries such as Canada, Belgium, Mexico, and Germany are positive.
[3] For information on the impact of the decline in passenger car exports to the Middle East on the Japanese economy, see the DIR report by Hirohito Hatanaka dated June 19 2026, *Does the Sharp Decline in Passenger Car Exports to the Middle East Pose a Risk to the Japanese Economy?* (Japanese only).

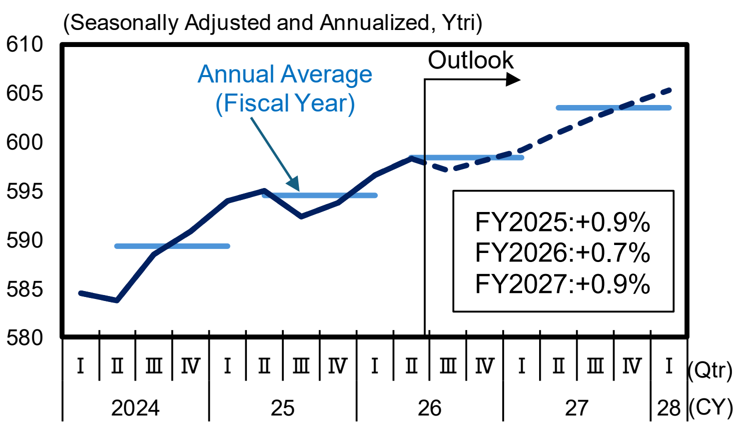
Real GDP growth for the Jul-Sep period is expected to be -0.8% q/q annualized (Chart 1, left). While personal consumption and capital expenditure are expected to turn positive, exports are likely to decline due to factors such as reduced exports to the Middle East and a slowdown in inbound tourism. However, real GDP growth is expected to return to positive territory in the Oct-Dec period.

Assumptions regarding overseas economy: crude oil prices expected to remain high due to prolonged tension in the Middle East

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 August 18 is provided by our in-house experts on the overseas economy.

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

Chart 2



US, Eurozone & China
Real GDP Growth Rate

US	2025: ＋2.1% 2026: ＋2.0% 2027: ＋2.1%
Eurozone	2025: ＋1.2% 2026: ＋0.8% 2027: ＋1.3%
China	2025: ＋4.9% 2026: ＋4.5% 2027: ＋4.2%

Source: Produced by DIR based on data from the Cabinet Office and statistics by various countries.
Note: CY2020 chained prices. The dashed line in the chart represents predicted values estimated by DIR. Real GDP growth rates are actual for FY&CY2025 and estimated values for FY&CY2026 and beyond. 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 +2.0% y/y for the US, +0.8% for the Eurozone, and +4.5% for China. Our outlook for the US was revised upwards by 0.1%pt, and by 0.4%pt for the Eurozone, while the outlook for China remained at the same level in comparison to our report of June 8, 2026 (*Japan's Economic Outlook No. 229 Update* (Japanese only), hereafter "our previous outlook"). As for 2027, we expect growth to be up by +2.1% y/y for the US, +1.3% for the Eurozone, and +4.2% for China. (This remains more or less the same as it was on our previous outlook.) For details please refer to the outlooks for each individual country or region (Japanese only).

In our previous outlook, based on the US Energy Information Administration's (EIA) outlook as of May, we had assumed that the blockade of the Strait of Hormuz would be lifted by early June. However, as of this writing, traffic through the strait has not yet recovered. According to the IMF, while the number of ships passing through the Strait of Hormuz increased temporarily following the signing of the memorandum of understanding between the US and Iran (June 17), it has recently returned to near zero. WTI, a key benchmark for crude oil prices, has risen again and is currently trading around 85 USD/bbl. Given that a return to normal conditions in the Strait of Hormuz is unlikely in the near term, we assume that WTI prices will remain flat through the Jan-Mar 2028 period.

Despite slowing economic growth, a moderate economic expansion is expected to continue 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% in FY2026 and +0.9% in FY2027 (Chart 2, +0.7% in 2026 and +0.7% in 2027 on a calendar year basis).

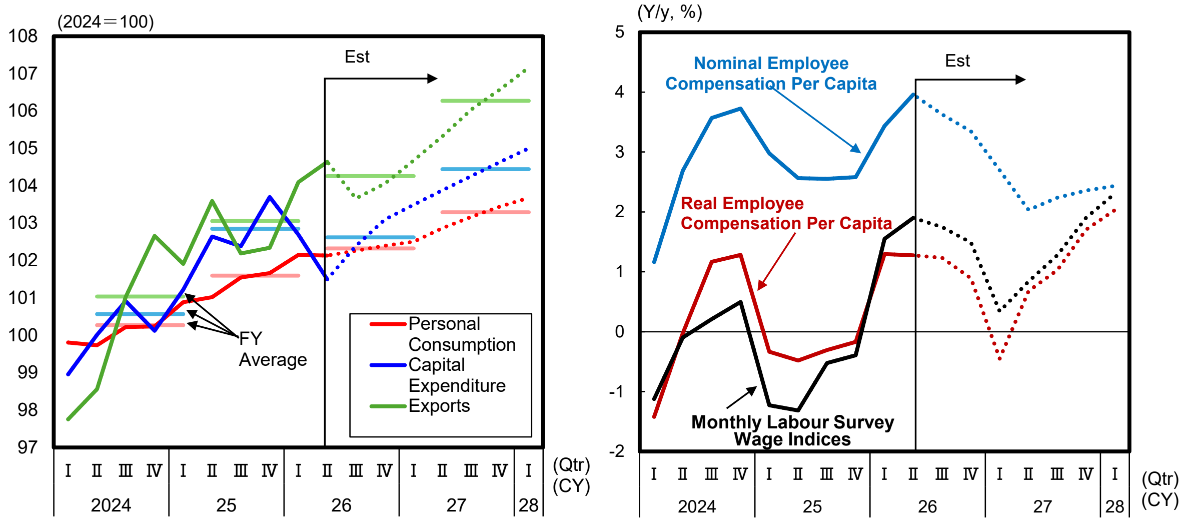
The outlook for the FY2026 growth rate was revised upwards by 0.1%pt from our previous outlook. The main reason was that the results for the Apr-Jun period rose above our previous outlook. For the forecast period beginning with the Jul-Sep period, capital expenditure was revised upward in anticipation of a rebound from the Apr-Jun period, while government consumption was revised downward. Additionally, exports were revised downward in anticipation of prolonged tensions in the Middle East.

The growth rate for FY2027 has been revised upwards by 0.1%pt from our previous outlook. While persistently high crude oil prices are weighing on domestic demand, we have revised our forecast for personal consumption upward from our previous projection, anticipating that a consumption tax cut on food and beverages will take effect in April 2027.

Chart 3 shows the GDP outlook by demand component. While the pace of growth in personal consumption is expected to moderate in FY2026, it is expected to accelerate slightly in FY2027 (FY2026: +0.7% y/y; FY2027: +0.9%). Chart 3 (right) illustrates the underlying trends in real wages. Crude oil import prices remain high, partly due to the shift to alternative sources of supply[4], and the subsequent pass-through of these costs to product and service prices is expected to exert downward pressure on real wages. On the other hand, due to substantial wage increases and subsidies for electricity and gas bills, real wages in FY2026 are expected to remain largely in positive territory on a y/y basis. In FY2027, while the nominal wage growth rate is expected to decline, the consumption tax cut on food and beverages is projected to lower the inflation rate by more than 1%pt y/y (Chart 4), and as a result, the real wage growth rate is expected to remain at a high level.

[4] According to the Ministry of Finance "Trade Statistics," the price of imported crude oil in July 2026 was 114.4 USD/bbl, significantly higher than the price in January of the same year (66.8 USD/bbl) before the deterioration of the situation in the Middle East.

Outlook for Each Demand Component (Left) and Outlook for Growth Rate in Wages (Right)
Chart 3



Source: Cabinet Office, Ministry of Health, Labour and Welfare; compiled by DIR
Note: The dotted lines are estimates provided by DIR. Per capita employee compensation is expressed as a real value using the household consumption expenditure deflator..

Capital expenditure suffered a q/q decline for the second consecutive period in the Apr-Jun 2026 period; however, starting in the Jul–Sep period, against the backdrop of robust corporate earnings, investment in labor-saving measures to address labor shortages, AI-related initiatives, and research and development is expected to proceed, and the upward trend is expected to continue (FY 2026: down 0.2% y/y; FY 2027: up 1.7%). However, delays in construction schedules due to labor shortages and soaring raw material costs could weigh on construction expenditure. Furthermore, caution is warranted regarding the possibility that increasing uncertainty in the business environment stemming from the deteriorating situation in the Middle East could exert downward pressure on capital expenditure.

Government consumption is expected to remain steady (FY2026: +2.5% y/y, FY2027: +1.5%). 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. In FY2026, an increase in retirement benefits paid to civil servants during the Apr-Jun period will statistically push up the growth rate[5].

Exports are expected to slow through FY2026 but accelerate in FY2027 (FY2026: +1.2% y/y, FY2027: +2.0%). By goods and services, exports of goods are expected to be restrained through 2026 with growth remaining small, partly due to a decline in exports to the Middle East. However, they are likely to recover gradually thereafter as the global economy expands. Exports of services are expected to be weighed down by the continuation of the Chinese government’s request to its citizens to refrain from traveling to Japan. In addition, a reactionary decline is expected in research and development services during the Jul-Sep

[5] Under amendments to the National Public Service Act and the Local Public Service Act that took effect in 2023, the mandatory retirement age for national and local public servants—which had been set at 60 through fiscal year 2022—will be raised gradually by one year every two years, reaching 65 in FY2031. Consequently, retirement benefit payments will decrease in odd-numbered years when the retirement age is raised, while they will increase in the following year.

period, but this sector is expected to move toward recovery during the Oct-Dec period and beyond.

2. Outlook for Prices and Monetary Policy

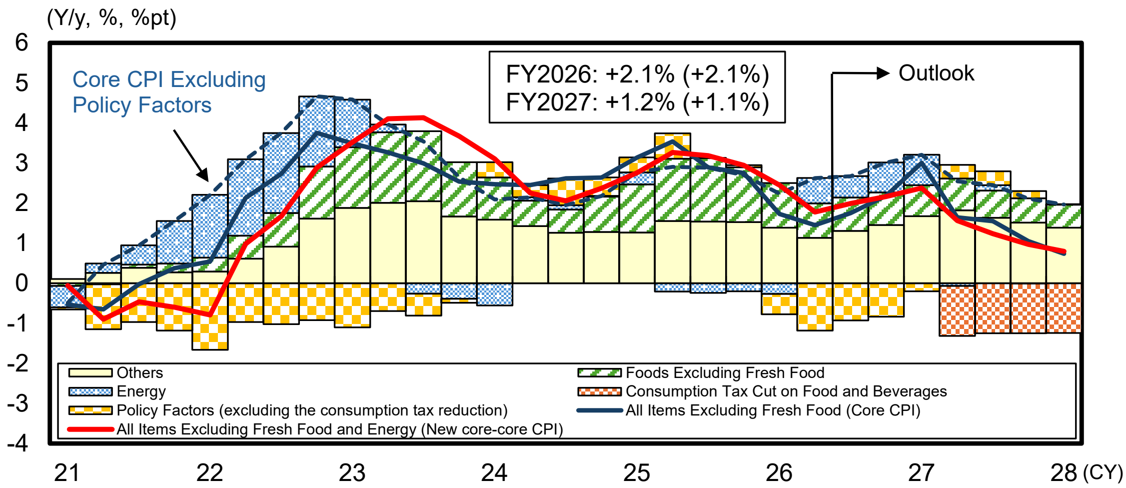
The reduction in the consumption tax rate on food and beverages is expected to significantly drive down prices in FY2027

The Consumer Price Index (CPI) is projected to rise by 2.1% y/y in FY2026 and by 1.2% in FY2027 on a core CPI basis (excluding fresh food). For the index of all items excluding fresh food and energy (new core-core CPI), the outlook is for a y/y increase of 2.1% in FY2026 and 1.1% in FY2027 (Chart 4). The outlooks for both FY2026 and 2027 were revised downwards, with a bigger drop in FY2027.

The primary reason for the downward revision is the consumption tax reduction on food and beverages approved by the Cabinet on August 5, 2026. The consumption tax rate on food and beverages eligible for the reduced rate is expected to be lowered from the current 8% to 1% for a period of two years starting April 1, 2027. As a result, the CPI is projected to be directly suppressed by approximately 1.2%pt y/y throughout FY2027. In addition, the revision of the CPI to the 2025 base will also work to suppress the index's growth rate[6]. The core CPI inflation rate, excluding policy factors (the dashed line in Chart 4), is projected to be approximately +2.5% y/y in the Apr-Jun 2027 period and is expected to slow to approximately +2.0% y/y by the Jan-Mar 2028 period.

Outlook for Core CPI (New Core-Core CPI in Parenthesis)

Chart 4



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

Note: This price outlook is based on resource prices and exchange rates prevailing at the time of preparation. It assumes that, for a two-year period beginning in April 2027, the consumption tax rate on food and beverages eligible for the reduced tax rate will be lowered from 8% to 1%. "Policy factors (excluding the consumption tax reduction)" include support for electricity and gas bills (expected to continue through the Jan–Mar 2028), the effective elimination of tuition fees at private high schools, the provision of free school lunches at public elementary schools, water bill reductions and exemptions, the National Travel Support Program, and reductions in mobile phone service charges.

[6] For details, see the DIR report by Kachidoki Yokota dated July 16, 2026, *Impact of the Revision of the CPI to the 2025 Base* (Japanese only).

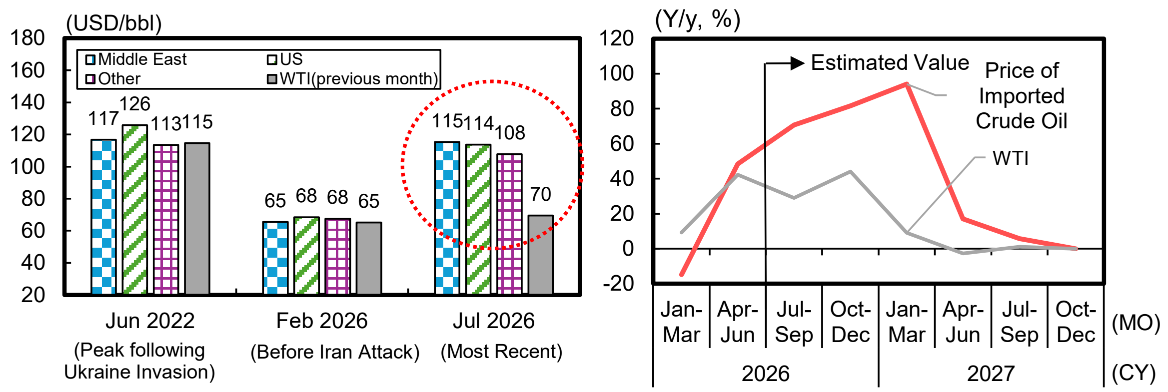
Japan's crude oil import prices remain high due to an increase in alternative sources, and there are signs that food price increases are accelerating

Although energy prices are being kept in check to some extent by government subsidies, upward pressure continues against the backdrop of high crude oil prices. Looking at Japan's crude oil import prices (the average import price of petroleum), as of July 2026, prices for Middle Eastern crude oil stood at 115 USD/bbl, US crude oil at 114 USD/bbl, and crude oil from other regions at 108 USD/bbl – all significantly higher than the WTI price (previous month's figure) of 70 USD/bbl (Chart 5, left). This reflects the ongoing shift toward alternative crude oil procurement, including imports from the Middle East via routes that bypass the Strait of Hormuz, as well as imports from other regions, notably the United States. While this shift toward alternative procurement has contributed to supply stability, procurement costs have been driven up significantly due to tightening global supply and demand conditions.

This divergence is expected to continue, and upward pressure on average import prices is likely to persist. Assuming that WTI remains at its current level (85 USD/bbl) and alternative sourcing continues, the y/y rate of increase in crude oil import prices will accelerate through the Jan-Mar 2027 period (Chart 5, right). Although this rate is expected to converge to near zero by the end of that year, given the time it takes for high crude oil prices to be passed on to domestic retail prices, the impact on consumer prices is expected to persist throughout FY2027.

Crude Oil Import Prices by Supplier and WTI (Left); Estimated Crude Oil Import Prices Assuming Continued Diversification of Supplies and WTI Price of 85 USD/bbl (Right)

Chart 5



Source: Ministry of Finance, Ministry of Economy, Trade and Industry, Haver Analytics, CME; compiled by DIR
Note: The chart on the right shows a projection based on the assumption that the alternative procurement ratio for August 2026 (government forecast) will remain unchanged from September onward and that the WTI price will remain at 85 USD/bbl.

In the food and beverage sector as well, there are signs that price hikes are accelerating as the ripple effects of rising costs – triggered by high crude oil prices – take hold. According to Teikoku Databank, price increases in August 2026 among 195 major food manufacturers totaled 2,311 items, an 80 percent increase from the same month last year (1,262 items)[7]. In September, price increases are scheduled for 4,531 items in a single month, a level not seen since October 2023. According to the survey, among the items subject to price increases, those attributed to "packaging and materials" and "logistics costs" each accounted for over 60%.

[7] Teikoku Databank, "Survey on Price Revision Trends Among 195 Major Food Companies — August 2026" (July 31, 2026, Japanese only)

This is believed to be the result of high crude oil prices driving up the prices of naphtha and fuel oil. In addition, the current dollar-yen exchange rate is around 160 yen/dlr – a weaker yen than during the same period last year – which is putting upward pressure on import costs.

Although this trend of price increases is expected to peak in the fall of 2026, the pace of deceleration thereafter is likely to remain gradual. Although the consumption tax cut scheduled to take effect in April 2027 will directly lower retail prices for food and beverages, it will not eliminate the upward price pressure itself. Given that companies have increasingly been passing on price increases in recent years, it is possible that retail prices will not fall by the full amount of the tax cut, or that subsequent price hikes could cause prices to quickly return to pre-tax-cut levels[8].

The likelihood that inflation will persist is increasing further due to factors such as continued high-level wage increases

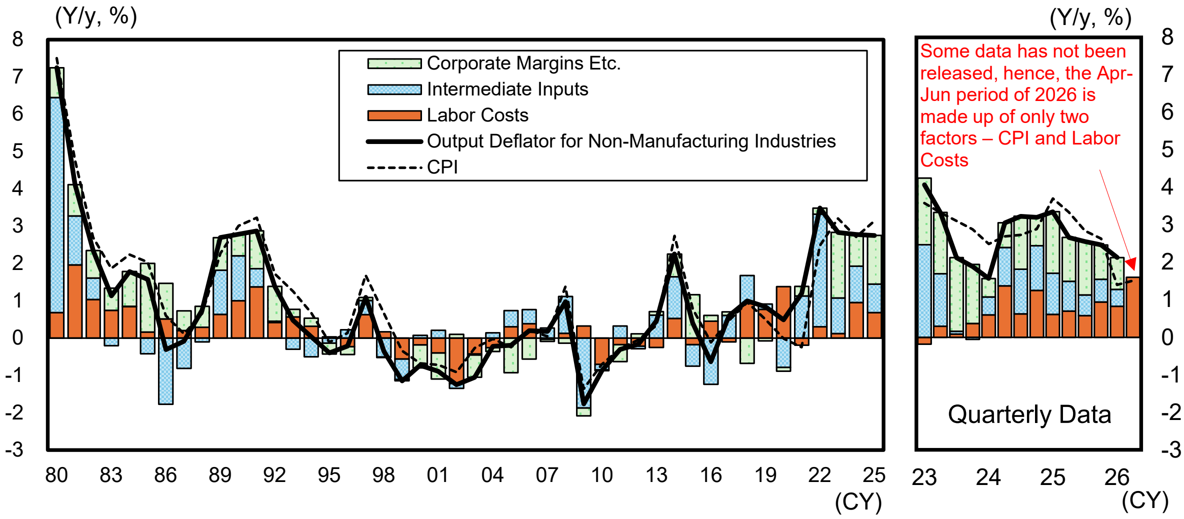
On the other hand, the persistence of inflation is increasing due to factors such as continued high-level wage increases and an improving environment for passing on price increases. Chart 6 examines the long-term factors behind the CPI increase by focusing on the fact that the CPI reflects sales prices in non-manufacturing sectors such as retail and services, and by decomposing the y/y change in the non-manufacturing output deflator from GDP statistics into its components: "labor costs," "intermediate inputs," and "corporate margins, etc."

The Japanese economy fell into deflation from the late 1990s through the early 2010s. During that period, the contribution of the "labor cost" factor to the rate of change in the output deflator remained negative or close to zero. In 1980, during the Second Oil Crisis; in 2008, when commodity prices soared – with WTI briefly rising to nearly 150 USD/bbl; and in 2022, when Russia's invasion of Ukraine began – it was primarily the "intermediate inputs" factor that drove up prices.

[8] Regarding the consumption tax reduction on food and beverages and the "income-linked, tailored benefits" scheduled to be implemented in the fall of 2027 – equivalent to a 1% tax rate reduction – these measures were examined in the DIR report by Keiji Kanda dated 5 August 2026, *Key Takeaways from the Basic Policy on Economic and Fiscal Management and Reform, Part 3: Prioritizing the reduction of social insurance contributions for the working generation*.

Factor Decomposition of Output Deflator in Non-Manufacturing Sector and Long-Term Trends in CPI

Chart 6



Source: Cabinet Office, Ministry of Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare, Ministry of Economy, Trade and Industry; compiled by DIR

Note: Focusing on the fact that the CPI reflects sales prices in non-manufacturing industries such as retail and services, we analyze the long-term drivers of the CPI inflation rate by decomposing the y/y change in the output deflator for non-manufacturing industries (excluding construction and finance/insurance) using a log-difference approximation. The "labor cost" factor is derived from the contribution of unit labor costs (= nominal employee compensation ÷ real GDP), with nominal employee compensation for 2025 extrapolated from the Wage and Employment Statistics. "Output Deflator for Non-Manufacturing Industries" excludes construction, finance, and insurance. Rates of increase in the output deflator prior to 1994 were retroactively calculated using data based on the old standards. Quarterly data were compiled from the Quarterly National Accounts (QNA) and Quarterly Estimates of GDP (QE), as well as the Wage and Employment Statistics (for the most recent period, Apr-Jun 2026, the Indices of Tertiary Industry Activity was also utilized).

Looking at recent trends on the right side of Chart 6, we can see that upward pressure on prices from the wage side clearly appeared from 2024 onwards, and the "labor cost" factor remained at a relatively high level even in the most recent period, Apr-Jun 2026. The wage increase rate in the spring labor negotiations for 2026, compiled by the Japan Trade Union Confederation (RENGO), exceeded 5% for the third consecutive year[9]. The trend in which increased costs associated with wage increases are passed on to sales prices and prices rise, leading to further wage increases, will continue.

However, it is necessary to remain vigilant regarding the risk that corporate pricing behavior could become increasingly aggressive, causing the inflation rate to remain elevated above 2% y/y. Amid ongoing turmoil in the Middle East, if the yen depreciates further, the pass-through of rising import costs to domestic prices could intensify beyond current expectations. It is also possible that wage growth in the 2027 spring wage negotiations could accelerate, further intensifying upward pressure on prices from the wage side. Should these factors coincide, the inflation rate would likely exceed our current projections.

[9] According to the Japanese Trade Union Confederation (RENGO)—in its report titled "Exceeding 5% for the Third Consecutive Year! —Results of the 7th (Final) Tally of Responses for the 2026 Spring Wage Negotiations" (July 3, 2026, Japanese only)—the average wage increase rate, including the component for regular pay raise, was 5.01% (compared to 5.25% during the same period the previous year).

The next interest rate hike is projected for the October 2026 meeting, with long-term interest rates expected to exceed 3% by the end of fiscal year 2027

According to our main scenario, the Bank of Japan (BOJ) is expected to raise short-term interest rates to 1.25% at its October 2026 Monetary Policy Meeting. Thereafter, interest rates will be raised by 0.25%pt at a pace of about once a quarter, and once they reach 1.75% in the Apr-Jun period of 2027, they are expected to remain unchanged for the time being in order to assess the impact on the economy, prices, and financial conditions (Chart 7).

The Outlook Report[10] released following the July meeting explicitly noted the risk that the underlying inflation rate could overshoot the 2% price stability target. Furthermore, at the post-meeting press conference, Governor Kazuo Ueda stated, "...given that current financial conditions remain accommodative, we will continue to raise the policy interest rate and adjust the degree of monetary easing in response to developments in economic activity, prices, and financial conditions...[11]." Even though this meeting took place immediately after the decision to raise rates in June, the BOJ clearly reiterated its vigilance regarding the risk of upward pressure on prices and its stance of continuing to raise interest rates.

While our previous forecast assumed additional 0.25%pt rate hikes would occur at a pace of roughly once every six months, we now anticipate a faster pace of tightening given the current circumstances. By the October meeting, key data for policy decisions – such as the September Tankan survey, the meeting of branch managers, and trends in price revisions – will be available. Furthermore, as the Outlook Report is released at that meeting, the BOJ will be well-positioned to explain the rationale for further rate hikes and outline its future policy stance. Consequently, we project a rate hike at the October meeting; however, we cannot rule out the possibility that the timing could be brought forward to the September meeting should upside risks to prices intensify due to factors such as a weak yen or rising crude oil prices[12].

As previously mentioned, the main scenario assumes a terminal rate – the peak level for interest rate hikes – of 1.75%. However, it remains uncertain whether the underlying inflation rate will have stabilized at around 2% by that point. Depending on economic and price conditions, if financial conditions are still deemed accommodative, there is a possibility that short-term interest rates could be raised to a level exceeding 2.00%.

On the other hand, long-term interest rates (yields on 10-year government bonds) are projected to reach approximately 3.1% by the end of FY2027 (Chart 7). Additional interest rate hikes by the BOJ will exert upward pressure on long-term rates, while the continued reduction in the Bank's holdings of government bonds will likely sustain upward pressure stemming from supply-demand dynamics. Furthermore, should the market revise upward its assumed terminal rate in response to an accelerated pace of rate hikes, the resulting rise in interest rates – particularly in the medium-term maturity range – is expected to ripple across the entire yield curve.

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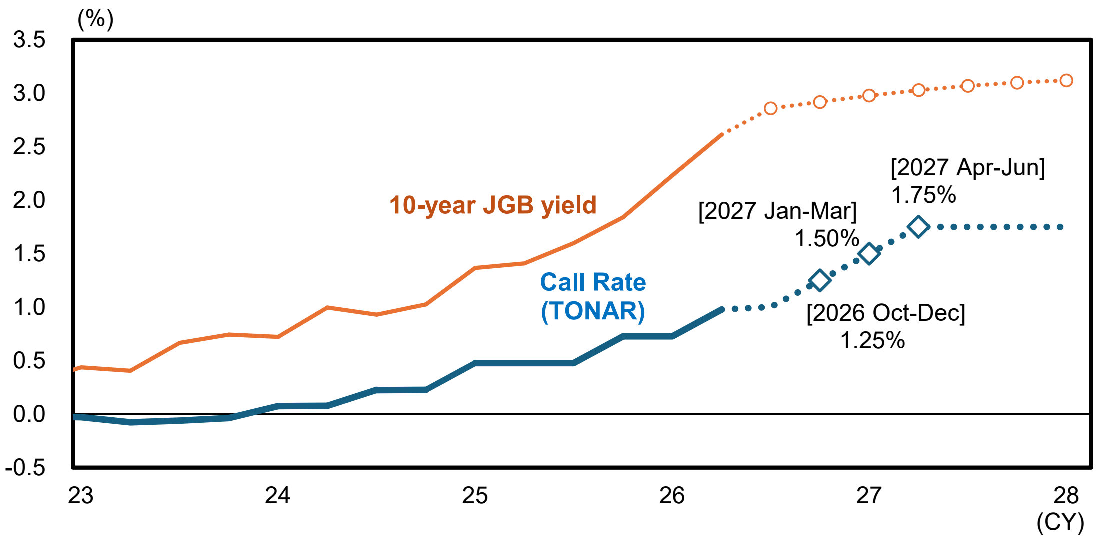
[10] Bank of Japan, "Outlook for Economic Activity and Prices: July 2026 (The Bank's View)" (July 31, 2026)
[11] Bank of Japan "Press Conference by the Governor" (August 3, 2026, Japanese only (Provisional translation by DIR))
[12] According to an article in the digital edition of the *Mainichi Shimbun* dated August 10, 2026 ("US Government Decides on Joint Intervention Following Governor Ueda's Remarks; Outlook Points to Rate Hike at September Meeting" (Japanese only)), the joint currency intervention carried out by the Japanese and US governments on July 31 was prompted by the US assessment that the likelihood of an interest rate hike at the BOJ's upcoming September meeting had increased.

The Takaichi administration has announced plans to stimulate domestic investment through an expansionary fiscal policy and has also decided to cut consumption taxes on food and beverages. Concerns linger in the market regarding potential future increases in government bond issuance and a loosening of fiscal discipline. Should uncertainty surrounding fiscal management intensify further, long-term interest rates could be pushed up even higher as investors demand a larger risk premium.

Outlook for Japan’s Long and Short-Term Interest Rate

Chart 7



Source: Ministry of Finance, Bank of Japan; compiled by DIR.
Note: Long-term interest rates are based on the average for the period, while short-term interest rates are based on end-of-period values. The dotted line indicates DIR estimates.

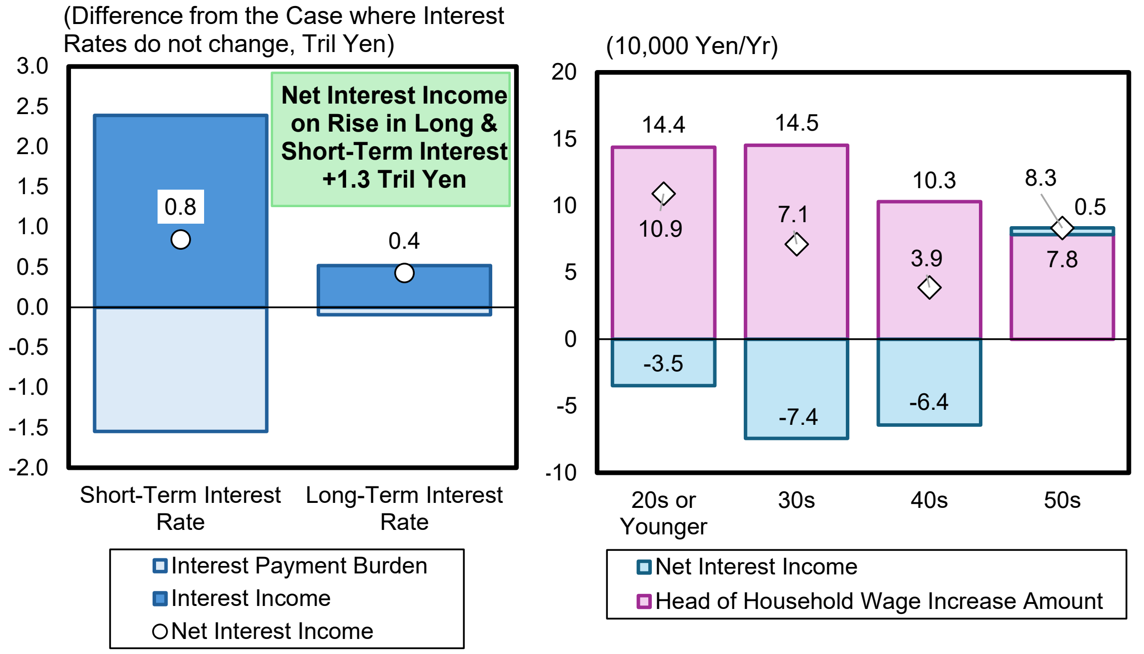
Wage increases are absorbing the heavier interest payment burden on mortgages and other loans resulting from rising interest rates

At its Monetary Policy Meeting in March 2024, the BOJ decided to end its negative interest rate policy and abolish yield curve control; subsequently, it has proceeded to normalize monetary policy by implementing four interest rate hikes and reducing Japanese government bond purchases. As a result, short-term interest rates rose by approximately 1.0%pt and long-term interest rates by about 2.1%pt between the beginning of 2024 and the end of July 2026, intensifying the impact on household interest income and interest payment burden.

Chart 8 shows the results of our estimate regarding the impact on household net interest income if short-term and long-term interest rates were each to rise by 1%pt.

Impact of 1%pt Increase in Interest Rates on Household Net Interest Income (Left); Changes in Net Interest Income Per Household and Regular Wages in 2025 for Working Households with Two or More Members Whose Head of Household Is in Their 50s or Younger (Right)

Chart 8



Source: Bank of Japan, Japan Housing Finance Agency, Japanese Bankers Association, Ministry of Internal Affairs and Communications, Ministry of Health Labour and Welfare; compiled by DIR

Notes: 1) We identified the components of household assets and liabilities that are affected by short-term and long-term interest rates, and calculated interest income and interest expense using coefficients obtained by performing regression analysis on the interest rates applicable to each component against short-term and long-term interest rates. The estimation period generally ranges from the early 1990s to the present (the start and end dates of the estimation period vary by time series due to data constraints).

2) The chart on the left is based on aggregate data, while the chart on the right is based on households with two or more members (excluding households with no employed members). The data was prorated using the 2019 National Survey of Family Income, Consumption and Wealth (MIC). Wage increases are calculated by taking the change from the same month of the previous year in the Scheduled earnings for June 2025 from the Basic Survey on Wage Structure (MHLW), and converting it to an annual rate.

Looking at households as a whole, while interest income is expected to increase by approximately 2.4 tril yen – primarily due to higher deposit rates resulting from rising short-term interest rates – the burden of interest payments on liabilities, such as variable-rate mortgages, is expected to rise by approximately 1.5 tril yen. As a result, net interest income is projected to be approximately +0.8 tril yen (Chart 8, left). Net interest income resulting from the rise in long-term interest rates is estimated to be approximately +0.4 tril yen; when combined, the total is estimated to be approximately +1.3 tril yen.

However, this analysis looks at households as a whole, and the impact on individual households varies significantly. Therefore, in Chart 8 (right), to assess the increase in burdens such as mortgage payments, we estimated the impact on net interest income for working households with two or more members where the head of household is in their 50s or younger. For households in their 50s, the impact is approximately +5,000 yen per year, whereas for those in their 40s, it is approximately –64,000 yen per year, and for those in their 30s, approximately –74,000 yen per year. Households with older heads of household tend to hold more savings and are more likely to benefit from rising interest rates; furthermore, since they are further along in repaying their mortgages, the increase in interest payments tends to be more gradual. On the other hand, for households in their 30s and 40s – who are typically in the home-purchasing phase – the increase in mortgage interest payments exceeds the increase in interest income.

Recent wage increases have offset this rise in interest payment burden. According to the Ministry of Health, Labour and Welfare's "Basic Survey on Wage Structure," scheduled wages in June 2025 increased across all age groups compared to the same month of the previous year, with the increase for those in their 30s and 40s exceeding the decline in net interest income. Even for those in their 30s, the combined total of the 2025 wage increase for household heads and the reduction in net interest income resulting from a 1%pt rise in interest rates amounts to approximately 71,000 yen per year.

However, if the inflation rate remains high, short-term interest rates could exceed our projection (remaining at 1.75%), and the interest payment burden on households with mortgages would increase even more than indicated in this estimate. Furthermore, a prolonged period of rising interest rates could push up corporate financing costs and, by reducing corporate profits, dampen the momentum for wage increases. Under such circumstances, the negative impact of interest rate hikes on household finances could become apparent, such as an increase in the number of households where the rise in interest payments exceeds the increase in wages.

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Chart 9

		2025			2026				2027				2028	FY2024 (CY)	FY2025 (CY)	FY2026 (CY)	FY2027 (CY)
		Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
Real GDP	Y tril; annualized	595.0	592.3	593.8	596.6	598.3	597.1	598.2	599.2	600.9	602.6	604.0	605.3	589.3	594.6	598.4	603.5
	Q/q %	0.2	−0.4	0.2	0.5	0.3	−0.2	0.2	0.2	0.3	0.3	0.2	0.2				
	Q/q %; annualized	0.7	−1.8	1.0	1.9	1.1	−0.8	0.7	0.7	1.2	1.1	0.9	0.9				
	Y/y %	2.1	0.6	0.4	0.5	0.7	0.8	0.7	0.5	0.5	0.9	0.9	1.0	0.7	0.9	0.7	0.9
														(0.1)	(1.2)	(0.7)	(0.7)
Private Consumption	Q/q %	0.1	0.5	0.1	0.5	0.0	0.1	0.1	0.1	0.4	0.3	0.3	0.2	0.1	1.3	0.7	0.9
Private Residential Investment	Q/q %	0.5	−8.0	5.0	0.9	−0.5	−0.7	−0.8	−0.9	−1.0	−1.0	−1.0	−1.0	−0.4	−2.6	−0.5	−3.7
Private Non-Resi. Investment	Q/q %	1.4	−0.3	1.3	−1.0	−1.2	0.9	0.7	0.4	0.4	0.4	0.4	0.4	1.8	2.3	−0.2	1.7
Government Consumption	Q/q %	0.5	0.1	0.4	0.4	1.6	0.0	0.3	0.4	0.4	0.4	0.4	0.4	2.3	0.8	2.5	1.5
Public Investment	Q/q %	0.7	−1.1	−0.4	1.5	−0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	−0.3	0.9	0.8
Exports	Q/q %	1.6	−1.4	0.1	1.7	0.5	−0.9	0.4	0.6	0.6	0.7	0.5	0.5	2.7	2.0	1.2	2.0
Imports	Q/q %	1.8	−0.6	−0.1	0.3	−1.5	2.7	0.8	0.7	0.8	0.7	0.7	0.7	4.0	2.5	1.1	3.5
Nominal GDP	Q/q %; annualized	7.5	1.1	3.7	2.9	4.8	0.9	2.7	3.4	0.0	1.7	1.7	2.9	4.0	4.3	3.0	1.7
GDP Deflator	Y/y	3.2	3.5	3.4	3.2	2.6	2.2	2.0	2.4	1.3	1.0	0.7	0.5	3.2	3.3	2.3	0.9
Industrial Production	Q/q %	−0.5	−1.0	0.2	2.5	0.3	0.6	0.3	0.3	0.4	0.4	0.3	0.3	−1.5	−0.2	2.7	1.5
Core CPI	Y/y %	3.5	2.9	2.7	1.7	1.5	1.8	2.2	3.0	1.6	1.6	1.1	0.7	2.7	2.7	2.1	1.2
Unemployment Rate	%	2.5	2.5	2.6	2.7	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.4	2.5	2.6	2.5	2.5
Call Rate	%	0.48	0.48	0.73	0.73	0.98	1.00	1.25	1.50	1.75	1.75	1.75	1.75	0.48	0.73	1.50	1.75
10-Year JGB Yield	%	1.41	1.60	1.84	2.23	2.61	2.86	2.92	2.98	3.03	3.07	3.10	3.12	1.08	1.77	2.84	3.08
Major assumptions																	
Crude Oil Price (WTI futures)	$/bbl	63.7	65.0	59.1	72.7	92.7	82.6	85.8	85.8	85.8	85.8	85.8	85.8	74.4	65.1	86.8	85.8
Exchange Rate	Yen/$	144.6	147.5	154.1	156.9	159.4	159.7	158.2	158.2	158.2	158.2	158.2	158.2	152.5	150.7	158.9	158.2

Source: Various statistics; Compiled by DIR.
Notes: The shaded areas represent DIR estimates. Crude oil prices and exchange rates are assumed to remain constant at the levels prevailing at the time of the outlook.