

Y2026 Outlook – Japan's Economy and Interest Rates

Expect Continued Rate Hikes About Every Six Months Amid a Robust Economy

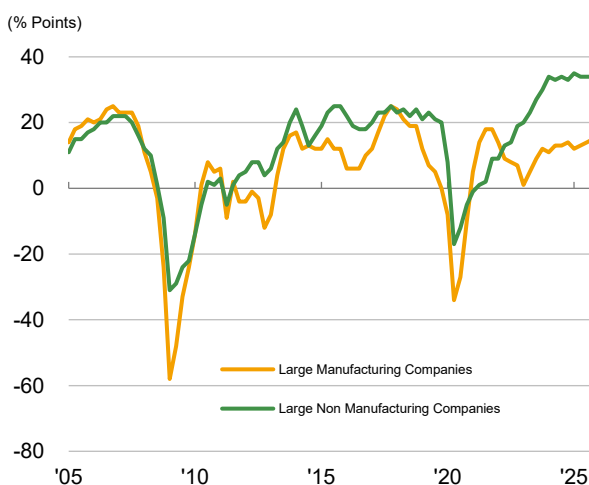
December 24, 2025

Maintaining Growth Slightly Above Potential Growth Rate Despite US Tariffs and Deteriorating Japan-China Relations

In the July–September quarter of 2025, real GDP growth turned negative QoQ for the first time in six quarters. However, this was largely due to temporary factors such as a sharp decline in residential investment following a surge in housing starts ahead of the April revision of the Building Standards Act, and a reversal of front-loaded exports driven by US tariff policies. In fact, the Bank of Japan's December Tankan survey showed that despite concerns over downward pressure from US tariffs and deteriorating Japan–China relations, the business conditions DI for large manufacturers improved for the third consecutive quarter to 15, while non-manufacturers maintained a high level of 34. Capital investment also remained firm, supported by demand for AI-related and labor-saving investments. Therefore, there is no need to be overly pessimistic about the negative growth in the July–September quarter, and the growth rate is expected to return to positive territory going forward. Furthermore, the 2026 ruling party's tax reform outline, under the Takaichi administration's policy of "responsible proactive fiscal policy," features measures aimed at supporting households against rising prices and increasing disposable income, which are also expected to underpin the economy. As a result, growth is likely to remain slightly above the potential growth rate.

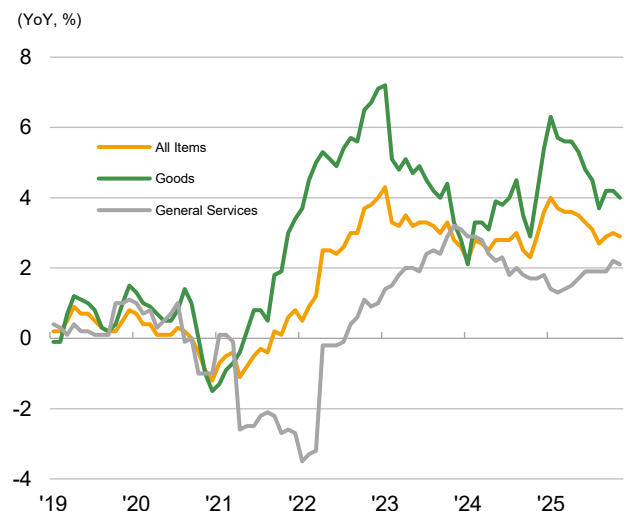
Currently, the Consumer Price Index (excluding fresh food) is hovering around +3% YoY. Prices of Goods continue to rise by about 4%, driven by surging rice and other food prices, although this has slowed from the peak of over 6%. General Service prices are rising moderately by about 2%, reflecting persistent wage pressures amid structural labor shortages. In fiscal 2025, the minimum wage saw the largest-ever increase of ¥66 on a nationwide weighted average basis, with all prefectures exceeding ¥1,000. This has broadened the scope of wage hikes, and as wage increases continue to be passed on to sales prices, both wages and prices are expected to keep rising moderately. However, as upward pressure on food prices such as rice subsidies and government measures—such as free education and the abolition of the old provisional gasoline tax rate—take effect, the inflation rate may temporarily fall below 2% next fiscal year. Thereafter, supported by a robust economy, it is expected to remain broadly consistent with the 2% price stability target.

BoJ Tankan (Business Conditions DI)



※Latest value is the "Outlook" from the December 2025 survey
Source: Bank of Japan; Compiled by Daiwa Asset Management

Consumer Price Index (CPI)



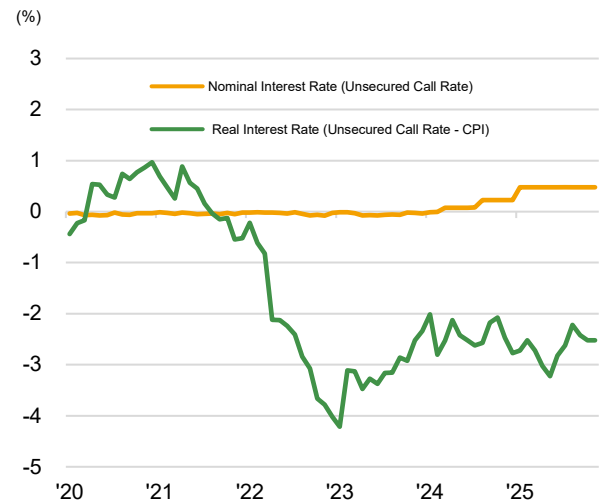
※ The latest value is from November 2025
Source: Ministry of Internal Affairs and Communications; Compiled by Daiwa Asset Management

The Bank of Japan continues its interest rate hike path; the long-term interest rate is expected to remain elevated near 2%

The Bank of Japan (BOJ) held its Monetary Policy Meeting on December 18–19 and, as widely expected, decided to raise the policy rate to 0.75%. This brings the policy rate to its highest level in about 30 years. The statement noted that the decision was based on the high likelihood that the mechanism of moderate increases in both wages and prices will be maintained. At the press conference, Governor Ueda stated, “Real interest rates remain deeply negative, and an accommodative financial environment will be maintained,” and further indicated that “there is still some distance to the lower bound of the neutral rate,” suggesting a continuation of the rate hike path. The neutral rate is one measure of the degree of monetary accommodation, but the BOJ’s estimated range (around 1% to 2.5%) is broad, making it difficult to pinpoint the exact level in advance. Going forward, the BOJ will adjust the degree of monetary accommodation while assessing the economic and price response to rate hikes, including their impact on financial conditions such as bank lending. However, risks have been noted that policy responses could lag amid persistent Yen depreciation pressures, and the outlook is for continued uncertainty regarding the pace and ultimate level of rate hikes. Our view is that rate hikes will occur roughly every six months, with the policy rate eventually peaking at 1.5%. Considering the relationship with two-year forward policy rate expectations, we expect long-term rates to remain near 2% for the time being. It is also important to note that the Takaichi administration’s policy stance could influence interest rate trends. If the administration, which is said to favor continued monetary easing, seeks to restrain BOJ rate hikes, the expected terminal rate could decline, exerting downward pressure on long-term rates. On the other hand, the initial FY2026 budget is projected to exceed the record-high FY2025 level, raising concerns about fiscal deterioration and potential worsening of bond supply-demand conditions, which could push long-term rates higher.

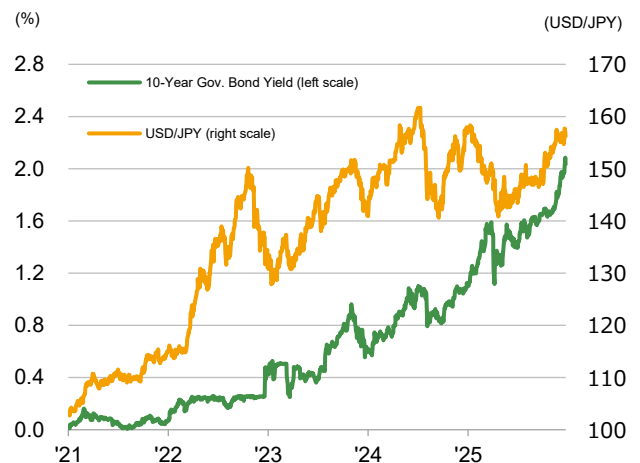
(Written by: Satsuki Yuba, Research Department)

Policy Interest Rate



※ CPI excludes fresh food, YoY change (consumption tax adjusted), Unsecured Call Rate is month-end value, latest value is November 2025
Source: Ministry of Internal Affairs and Communications, Bloomberg; Compiled by Daiwa Asset Management

10-Year government bond yield and USD/JPY



※ Latest value as of December 23, 2025
Source: Bloomberg; Compiled by Daiwa Asset Management

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