

STRONG MOMENTUM ALREADY UNDER THREAT?

The improved health of the Japanese economy is evident. Consumer confidence and the Tankan business-conditions index hit post-COVID highs before the energy shock began. The shock, however, is expected to weigh on growth, which is projected at 0.5% in 2026 (revised -0.3pp). Inflation, at 2.7% in 2026 (revised up 0.7pp), is set to remain the BoJ. The two pillars of the policy mix could remain at odds in light of the new energy shock, with the government favouring an expansionary fiscal stance while the central bank is expected to keep raising its policy rate, projected to reach 2% by end-2027.

GROWTH: WILL THE ENERGY SHOCK DERAIL THE RECOVERY?

After a difficult 2025 marked by uncertainty over US tariffs, the de-escalation and the new government's early actions pointed to a marked improvement in 2026. The year got off to a good start, with consumer confidence hitting a post-COVID high in February and the Tankan business conditions index rising to a level not seen since 2018 in Q1 2026 (12, +1pt q/q, Chart 1). The upside has been continuous for large manufacturers since Q1 2025. However, the fallout from the Iran war is likely to impede this momentum. Consumer confidence fell sharply in March (-6.4 pts m/m). Still, the Composite PMI remained, on average for Q1 2026, at its highest level since 2013 (53.3), despite a decline in March (-0.9pp to 53.0). While a stronger impact of rising energy prices on business sentiment remains plausible – given Japan's external dependence on hydrocarbons, (especially after the phase-out of nuclear power) – any effect remains barely discernible at this stage.

INFLATION: A SHORT-LIVED DIP BEFORE A REBOUND

Inflation in Japan has fallen in recent months after fiscal support for electricity was reinstated at the end of 2025, pulling the energy component down to -9.1% y/y in February 2026. Core inflation (excluding fresh food) has therefore fallen back to 1.6% y/y (down from 3.0% y/y three months earlier). This decline also reflected strong base effects in rice prices (17.1% y/y, 80.9% a year ago). However, inflationary pressures remain sizable. New-Core inflation – which excludes energy and fresh food – stood at +2.5% a/a, remaining above the Bank of Japan's (BoJ) 2% inflation target virtually since October 2022.

Looking ahead, core CPI is expected to rise throughout 2026, driven by the transmission of higher energy prices, as indicated by the Tankan survey, which reports an increase in firms' one-year selling price expectations to 3.1% (+0.3pp). Market expectations, however, are currently in line with the BoJ's inflation target: the 10-year break-even inflation rate stood at a record-high of 1.8% in Q1 2026.

REAL WAGES ARE EXPECTED TO CONTRACT AGAIN

Japan's labour market is characterised by a structural shortage. The reason for this is demographic: the workforce was at 70.1 million in 2025 versus 67.4 million in 2000, with growth coming almost entirely from a doubling of the 'senior' cohort (age 65 and over) – from 4.9 million to 9.5 million). Consequently, the labour market is under constant pressure, with a generally stable unemployment rate (2.6% in H2 2025). Combined with the renewed persistence of inflation, the environment is fertile for wage growth, which is expected to extend into 2026 following the outcome of the annual trade-union negotiations (Rengo). However, real wages contracted in 2025 (-1.4% y/y on an annual average) and their rebound in early 2026 (0.7% in January and 1.9% y/y in February) looks temporary, due to the foreseeable rise in inflation.

Growth and inflation

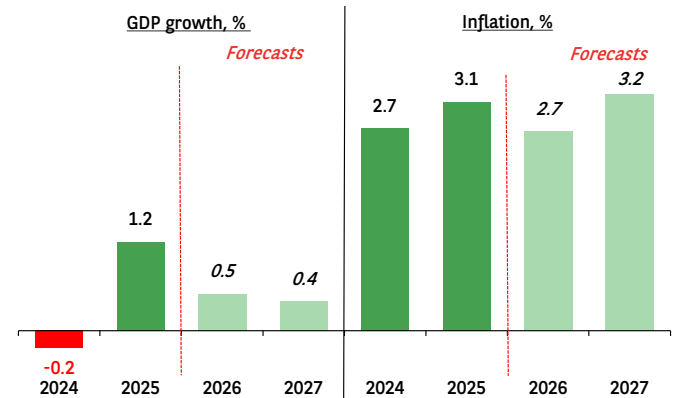


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

A sustained improvement in the business climate, undeterred by the tariff shock

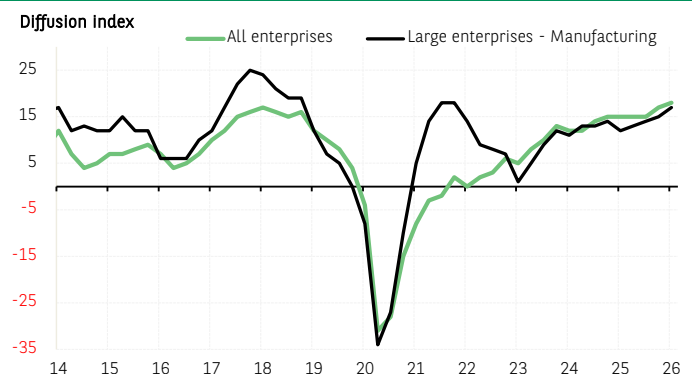


CHART 2

SOURCE: BOJ, BNP PARIBAS



MONETARY POLICY: HAWKISH BIAS MAINTAINED

Since 2024, the BoJ has been engaged in a process of ‘adjusting the degree of monetary accommodation’, reflected in cautious and gradual hikes to the policy rate. The rate currently stands at 0.75% (versus -0.1% prior to the first increase in March 2024). Several factors keep the committee on the normalisation path: core inflation remaining above its target virtually since 2022, solid wage growth, a strongly negative real interest rate, downward pressure on the yen, and GDP running at its potential. However, the tightening of financial conditions and the negative impact on growth call for caution in the rate-hike cycle. According to our forecasts, it will remain moderate and spaced-out: two hikes of +25bp each in 2026, followed by three in 2027, resulting in a 2% terminal rate. At the same time, the BoJ is continuing to scale back JGB (Japanese Government Bonds) purchases, with the monthly pace set to be JPY 2.7 trn in Q2 2026 (versus JPY 5.7 trn at the start of 2024).

In our view, the Iran war do not call into question the central bank’s outlook. The hawkish bias in monetary policy is reinforced by the risk of a resurgence in inflation, particularly given the interplay between a weaker JPY (the policy rate is positively correlated with the currency but is not the sole driver) and imported energy inflation. BoJ Governor Kazuo Ueda has openly raised the possibility of rate hikes even if activity faces downward pressure – provided that such pressure is not merely temporary and does not weigh on core inflation. Consequently, expected rate hikes could be spaced further apart, and/or an additional hike be warranted – depending on the differential impact on activity and inflation.

FISCAL SUPPORT AMID ENERGY INFLATION

The snap general election in February 2026 – which saw the Liberal Democratic Party secure an absolute majority (198 out of 316 seats) in the House of Representatives – gave Sanae Takaichi’s government leeway to run an expansionary fiscal policy. Nevertheless, the flagship campaign pledge – the consumption-tax cut on food (0.8% of GDP) – appears to have been postponed. It has been replaced by support for households struggling with energy inflation. The government capped the gasoline price at JPY 170 per litre as of March 2026. Extending this measure could cost JPY 500 trn per month (0.07% of GDP) and be accompanied by an extension of subsidies for gas and electricity bills (JPY 500 trn per quarter). Under those assumptions, the budget deficit may exceed our initial forecasts (-2.3% of GDP, -2.0% primary deficit), and the anticipated reduction in public debt (to 203.5% of GDP, -3.3pp) may be less significant. At the same time, upward pressure on long-term yields is intensifying, with the 10-year yield expected to reach 2.70% by end-2027. Japan’s yield curve has steepened since the outset of the Iran war.

FOREIGN TRADE HAS WEATHERED THE TARIFF SHOCK

Japan’s exports have held up well against the US tariff shock of 2025 – 15% levy on Japanese goods shipped to the US – in line with global-trade trends ([see our EcoWeek Editorial on this topic](#)). Indeed, the previous year was marked by a resurgence in goods exports in volume (2.7% annual average) after two years of decline. By contrast, services exports, long buoyed by the post-COVID tourism bounce, faced a downturn with the cessation of this growth momentum (-3.1% y/y in Q4 2025).

Real wages are struggling to move into positive territory

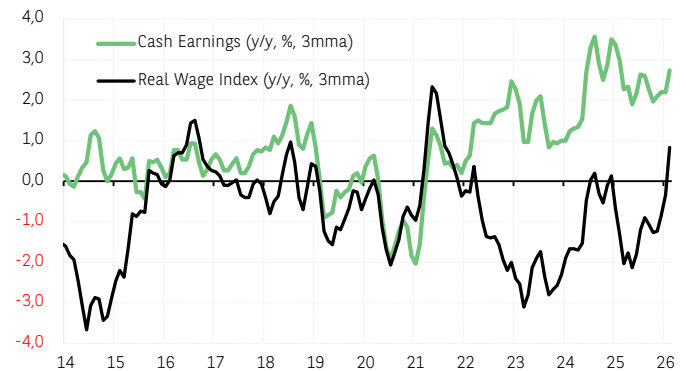


CHART 3

SOURCE: JAPANESE MINISTRY OF HEALTH, LABOUR AND WELFARE, BNP PARIBAS

The conflict in Iran adds to yen pressure. Our forecasts project a USDJPY at 160 in year-end 2026, following a weakening to 157 by end-2025, amid a near-continuous decrease from Q2 onwards. The war adds to downside risks, particularly with the likely widening of Japan’s trade deficit due to higher hydrocarbon prices, an expanded budget deficit resulting from household-support measures, and a potentially larger spacing of BoJ rate hikes. Indeed, since 27 February, the JPY has already depreciated by 1,6% against the USD, erasing all gains linked to rumours of coordinated intervention with the US (January) and the LDP’s election victory (February). Furthermore, a direct FX intervention remains likely this year, and has already been mentioned by Finance Minister Satsuki Katayama.

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