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Outlook for Japan's Economy

— Recovery to Continue, but Inflation Threats Persist —

Macro-economics Research Center

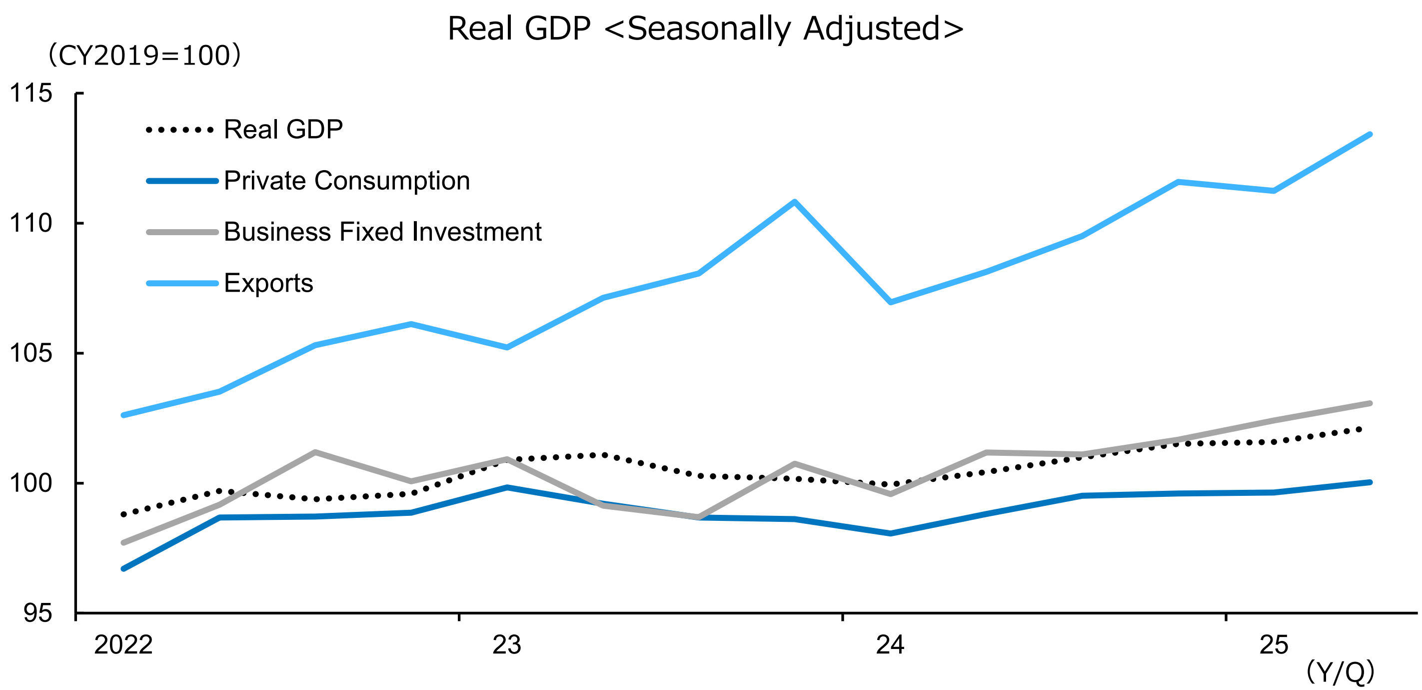
Kazuki Fujimoto
(fujimoto.kazukier@jri.co.jp)

SUMMARY

- Japan's economy is expected to **stay on the path to recovery**.
- **Exports** are currently weakening and are **expected to bottom out**. This is due to an anticipated global economic recovery driven by looser fiscal and monetary policy in many countries.
- **A recovery in personal consumption** is likely to support the economy. Although corporate profits are expected to decline due to U.S. tariff policies, the pressure for wage hikes is strong due to labor shortages and inflation. Companies are expected to **continue wage hikes** by increasing the labor share.
- On the other hand, **inflation is expected to slow**, mainly due to moderating energy prices. This will ease the financial pressure on households.
- However, risks to the Japanese economy include **a resurgence of inflation** driven by prolonged inflation in food prices and excessive demand-stimulating policies by the new Prime Minister, Sanae Takaichi.

GDP: Moderate Recovery

- The economy has **recovered at a moderate pace**. Real GDP increased for five consecutive quarters up to Q2 2025.
- **Private consumption** also continued to increase over the same period.
- **Exports were also strong** mainly due to goods exports to Asia and demand from foreign tourists coming to Japan.



Source: JRI based on Cabinet Office

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OUTLOOK: Moderate Recovery to Continue

Projections for Japan's GDP Growth and Main Indicators (as of October 10, 2025)

(seasonally adjusted, annualized % changes from the previous quarter) / (% changes from the previous fiscal year)

	CY2025				CY2026				CY2027	FY2024	FY2025	FY2026
	1～3	4～6	7～9	10～12	1～3	4～6	7～9	10～12	1～3			
	(Actual)		(Projection)							(Actual)	(Projection)	
Real GDP	0.3	2.2	-0.8	0.3	0.8	1.0	1.0	1.0	1.0	0.7	0.8	0.7
Private Consumption Expenditure	0.1	1.6	0.3	0.6	0.9	0.9	0.8	0.8	0.8	0.7	0.8	0.7
Housing Investment	5.1	2.0	-7.5	0.2	0.1	0.0	0.0	-0.1	0.0	-0.4	0.1	-0.4
Business Fixed Investment	2.9	2.6	-0.9	0.5	0.8	1.3	1.5	1.7	1.7	2.1	1.4	1.1
Private Inventories (percentage points contribution)	(2.5)	(-0.1)	(0.0)	(0.0)	(0.0)	(-0.0)	(-0.0)	(-0.0)	(-0.0)	(0.1)	(0.3)	(-0.0)
Government Consumption Expenditure	-2.0	0.1	0.8	1.0	1.1	1.4	1.5	1.5	1.5	1.3	0.1	1.3
Public Investment	0.9	-2.2	1.6	1.4	1.0	1.3	1.7	1.8	1.5	0.8	-0.1	1.5
Net Exports (percentage points contribution)	(-3.1)	(1.2)	(-0.9)	(-0.5)	(-0.1)	(-0.1)	(-0.1)	(-0.1)	(-0.0)	(-0.4)	(-0.2)	(-0.2)
Exports of Goods and Services	-1.2	8.0	-3.1	-1.0	0.8	0.8	0.9	0.9	1.2	1.7	2.3	0.4
Imports of Goods and Services	12.0	2.5	1.0	1.0	1.2	1.2	1.3	1.3	1.3	3.4	2.9	1.2

(% changes from the same quarter of the previous year) / (% changes from the previous fiscal year)

Nominal GDP	5.1	4.7	3.9	3.0	2.9	2.4	3.0	3.2	3.4	3.7	3.6	3.0
GDP deflator	3.3	3.0	3.0	2.7	2.2	2.1	2.2	2.3	2.3	2.9	2.7	2.2
Consumer Price Index (excluding fresh food)	3.1	3.5	2.9	2.5	1.8	1.3	1.4	1.8	1.9	2.7	2.7	1.6

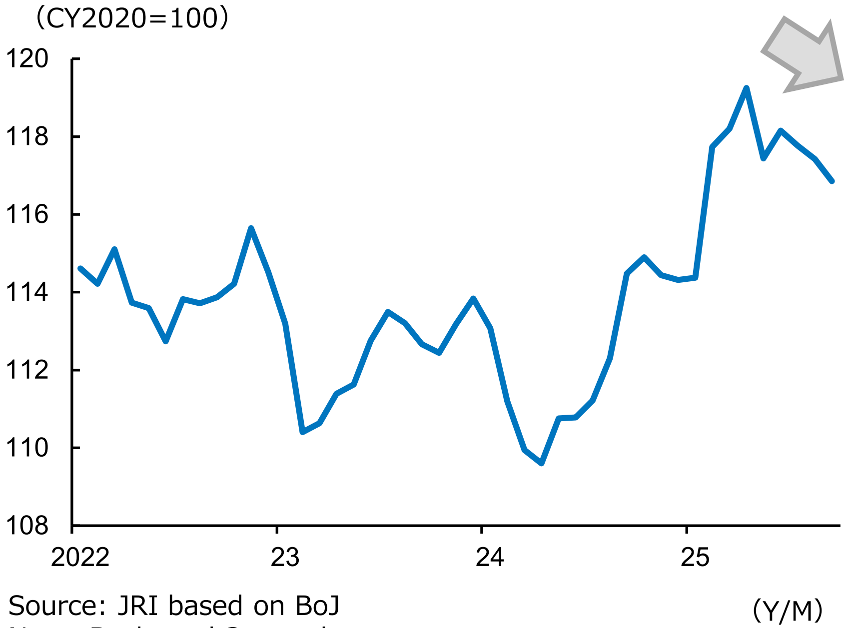
Unemployment Rate (%)	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.4	2.4	2.5	2.5	2.4
Exchange Rates (JY/US$)	153	145	147	145	143	141	140	140	141	153	145	141
Import Price of Crude Oil (US$/barrel)	79	75	72	69	64	64	63	62	62	83	70	63

Sources: Cabinet Office; Ministry of Internal Affairs and Communications; Ministry of Economy, Trade and Industry; Ministry of Finance
The projection figures are based on those of the Japan Research Institute, Ltd.

EXPORTS: Set to Drop Temporarily Then Bottom Out

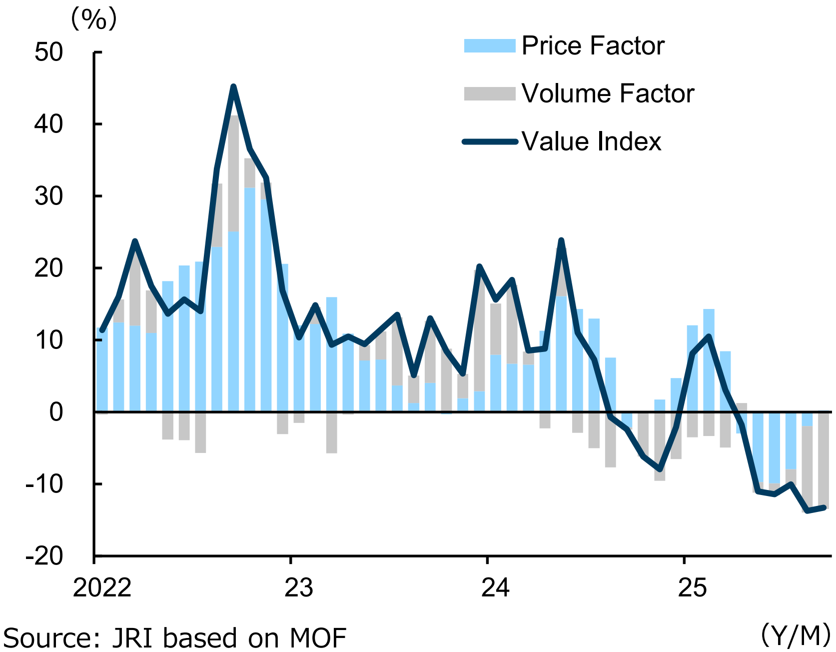
- Exports, particularly U.S.-bound exports, are currently **weakening**. Companies initially **lowered export prices** to absorb the tariffs and avoid a decline in export volume to the U.S. But they have now begun to restore prices to their original levels.
- Exports are expected to **bottom out** as the global economy recovers. Many countries should ease fiscal and monetary policies.

Real Exports <Seasonally Adjusted>



Source: JRI based on BoJ
Note: Backward 3-month average.

Factor Analysis of Export Value to the U.S.

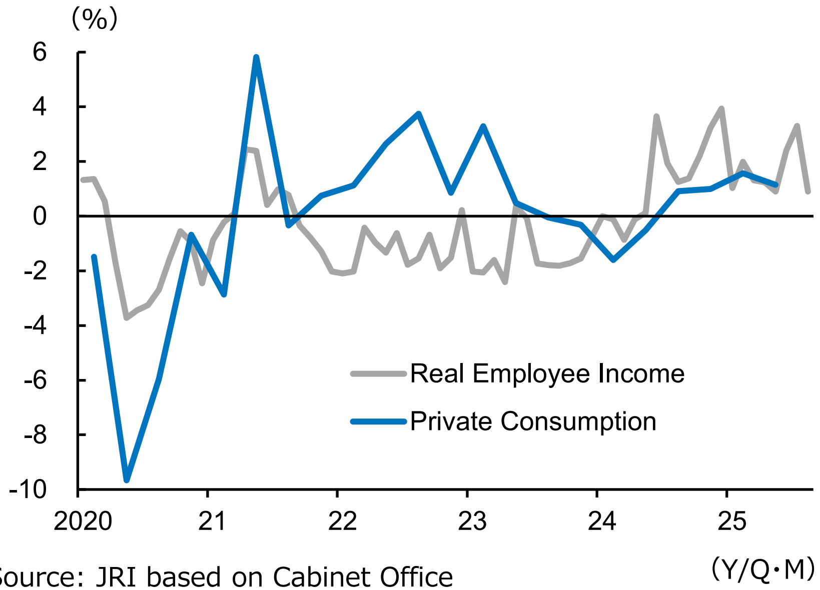


Source: JRI based on MOF

CONSUMPTION: Favorable Income and Work Environment

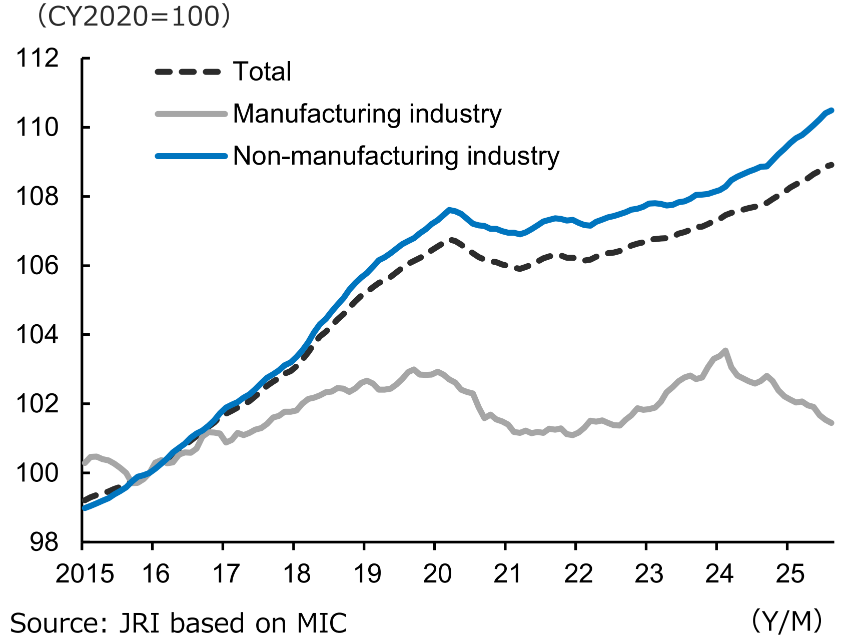
- Consumption is recovering because of **growing real income** (= real wage [per capita] × **number of persons employed**).
- Inflation is pushing down real wages. However, employment is increasing in **non-manufacturing**, particularly in information and communication, as well as in the medical and welfare sectors.

Real Employee Income and Consumption <YoY>



Source: JRI based on Cabinet Office
Note: Real Employee Income is deflated by the deflator of final consumption expenditure of households.

Number of Persons Employed



Source: JRI based on MIC
Note: Backward 12-month average.

INCOME: Wages to Continue to Grow in 2026

- While falling corporate profits are a drag, **inflation** and **labor shortages** will provide strong pressure to raise wages.
- During recessions, companies tend to **raise the labor share and keep increasing wages**. Similarly, we expect companies to continue to raise wages in 2026.

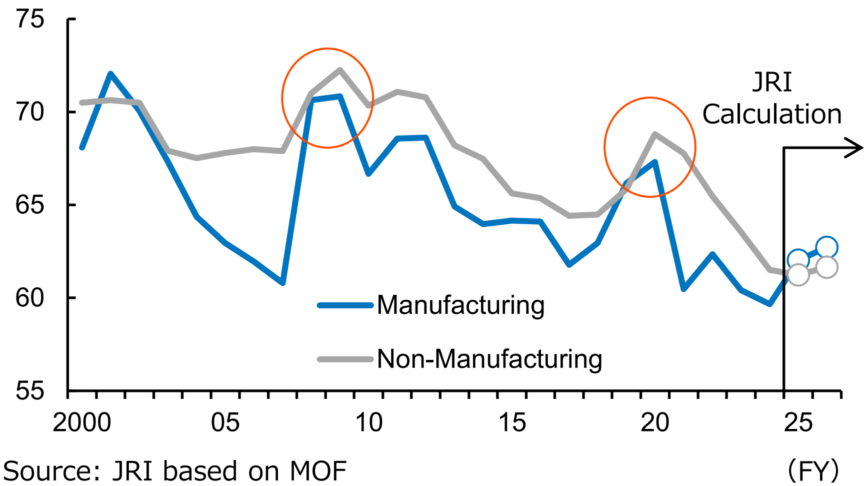
Wage Hike Conditions in FY2026

	FY2025	FY2026
Labor Shortage	○	○
Inflation	○	○
Corporate Profits	○	△
Momentum	○	△

Benchmark will be **mid-4%** (base-up is around 3%)

Slow down from FY2025, but still at a high level

Labor Distribution Ratio



Source: JRI based on MOF

Note: Labor Distribution Ratio＝Labor Cost／Value Added.
Operating profit in FY2025 is projected based on the YoY in Q2 2025. For FY2026, it is assumed to remain unchanged from FY2025. Labor costs are expected to rise at a pace consistent with the past two years, while depreciation expenses are assumed to remain at the FY2024 level.

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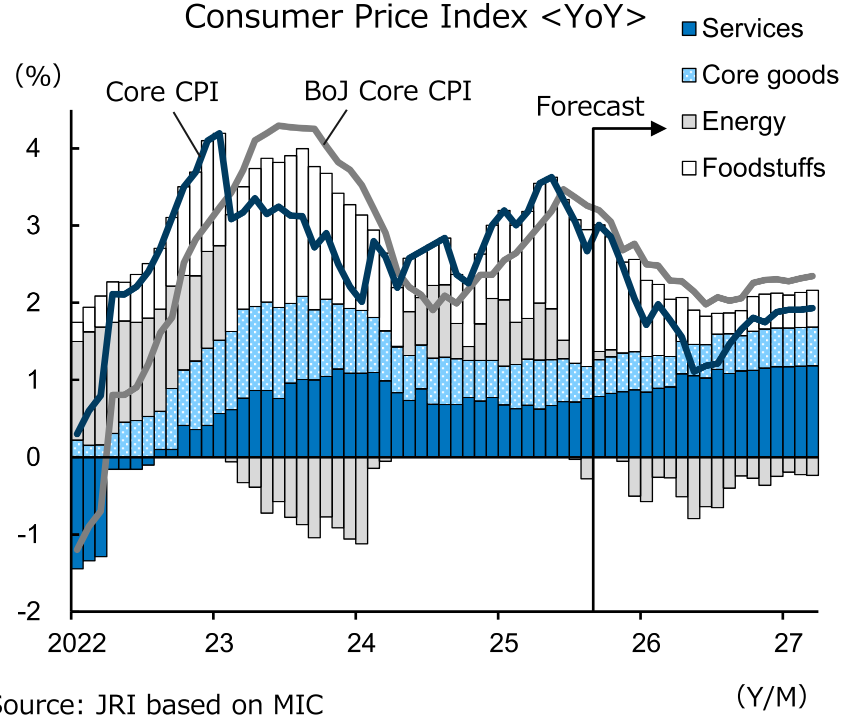
INFLATION: Slowdown Driven Mainly by Energy Prices

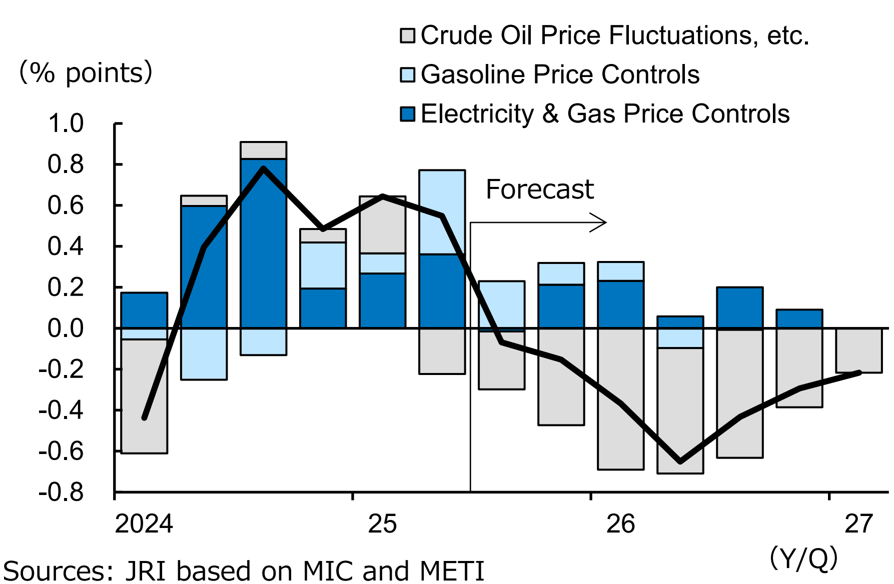
- In August, core CPI dropped to 2.7%. Inflation is expected to slow until early next year and then **remain at around 2%**.
- **Energy prices will moderate** because of easing energy market conditions and price controls. If **a gasoline tax cut** is implemented, energy prices will decline further.

Consumer Price Index <YoY>



Source: JRI based on MIC

Contribution of Energy Prices to Core CPI <YoY>

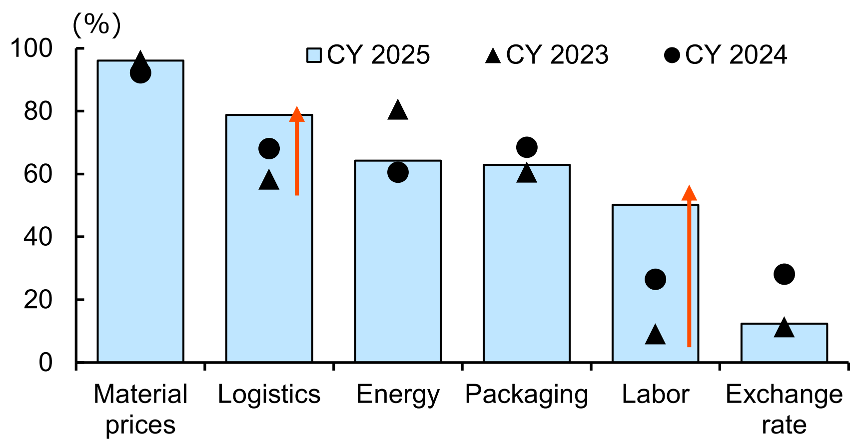


Sources: JRI based on MIC and METI
Note: Electricity & Gas price control measures are assumed to end in Sep. 2025. Gasoline price control measures are assumed to continue throughout the forecast period.

RISKS: Inflation from Food Price & Takaichi's Policies

- Food manufacturers have raised prices due to raw material costs as well as **labor costs**. Food inflation may be **internally driven**.
- The policies of the new Prime Minister **Sanae Takaichi** are also **inflationary** (e.g. demand-stimulating policy, raising medical fees). Her support for monetary easing is also leading to **a weaker yen**.

Factors Contributing to Food Price Increases



Source: JRI based on Teikoku Databank, Ltd.
Note: For 2025, the data covers food and beverage items for which 195 major food companies raised prices or planned to raise prices from Jan. to Nov. 2025 (as of Sep. 30, 2025, based on available information). Some overlap exists among the price increase factors.

The Policies of New LDP President Takaichi

Proactive Fiscal Policy with Responsibility

Strategic Fiscal Spending Stimulates Investment

Addressing Inflation
- Reducing gasoline taxes
- Strengthening support for SMEs in deficit
- Raising medical and nursing care fees

※RED: Inflationary policy
BLUE: Deflationary policy

Monetary Policy
- A cautious stance to monetary tightening
- Intention to engage with the BoJ

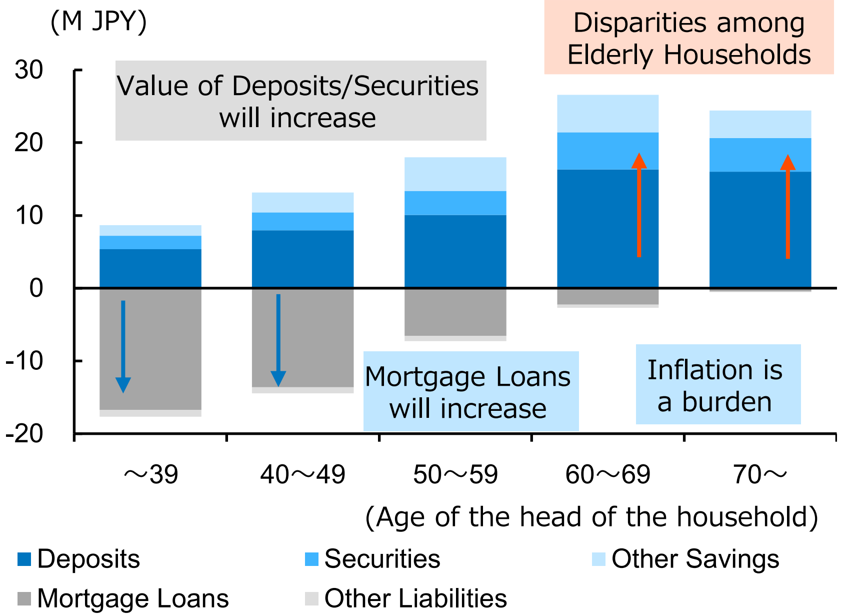
Long-term Challenges
- Designing a refundable tax credit
- Growth Investment

Sources: JRI based on LDP HP and News Reporting

POLICY: Expectations for the Refundable Tax Credits

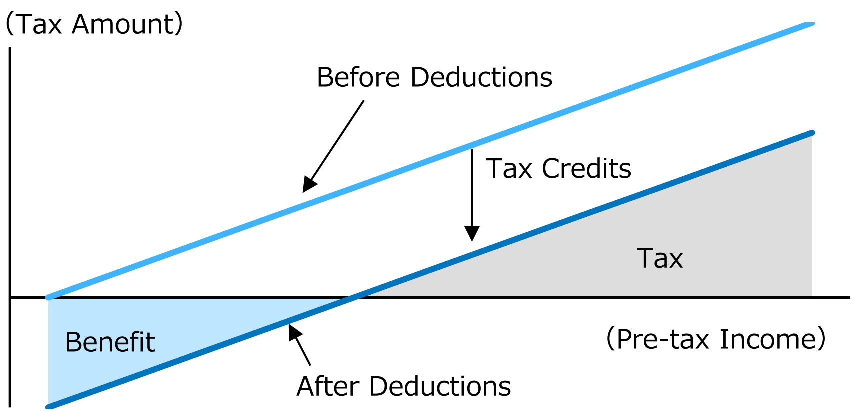
- With interest rates, stock prices, and CPI rising, **the gap between households is likely to widen**.
- Prime Minister Takaichi is calling for **refundable tax credits**. This system is known to be effective for **redistribution**. We hope for a system designed in a way that effectively reduces disparities.

Households Financial A/L <CY2024>



Source: JRI based on MIC

Illustration of the Refundable Tax Credits



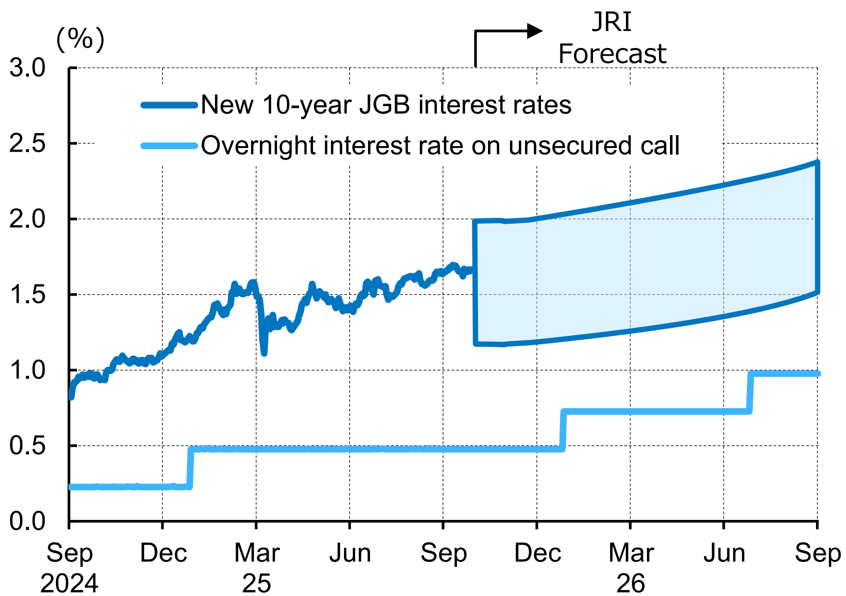
Many Challenges

- ✓ **Fairness** (The government can't accurately track income and assets.)
- ✓ **Financial Resources** (Raising taxes on high-income earners, government bonds, or others?)

MARKET: BoJ's Next Interest Rate Hike in Jan 2026

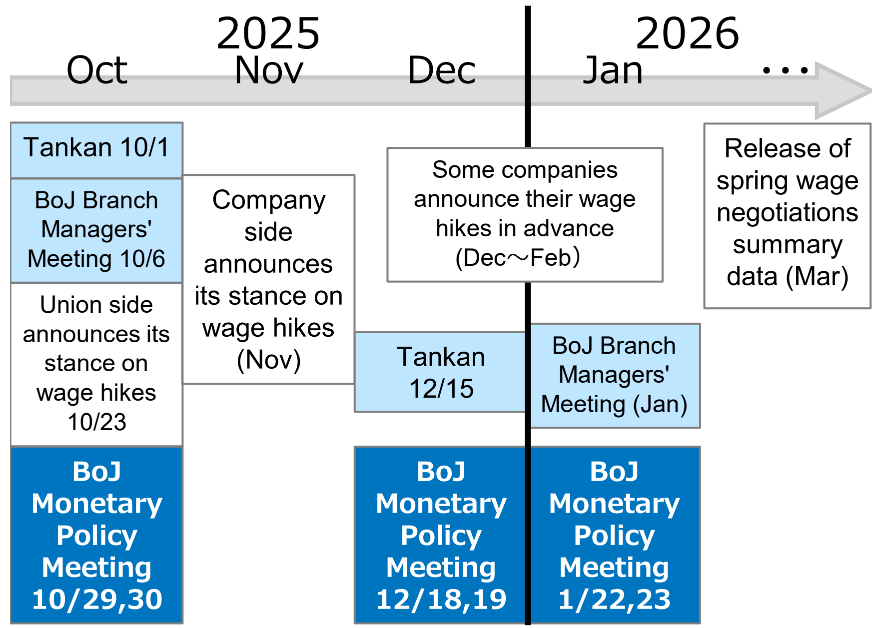
- We expect the BoJ to next raise interest rates in **Jan 2026**, following its evaluation of wage growth trends in FY2026. We expect another interest hike in the following half-year.
- After reaching 1%, **the pace of rate hikes will slow**. Nakano et al. [2024] estimate the neutral interest rate in 2023Q1 as being between 1% and 2.5%, assuming an expected inflation rate of 2%.

BoJ's Policy Rate and Japan's Long-term Interest Rate



Source: JRI based on Bloomberg L.P.

Key Events Linked to Wage Hikes

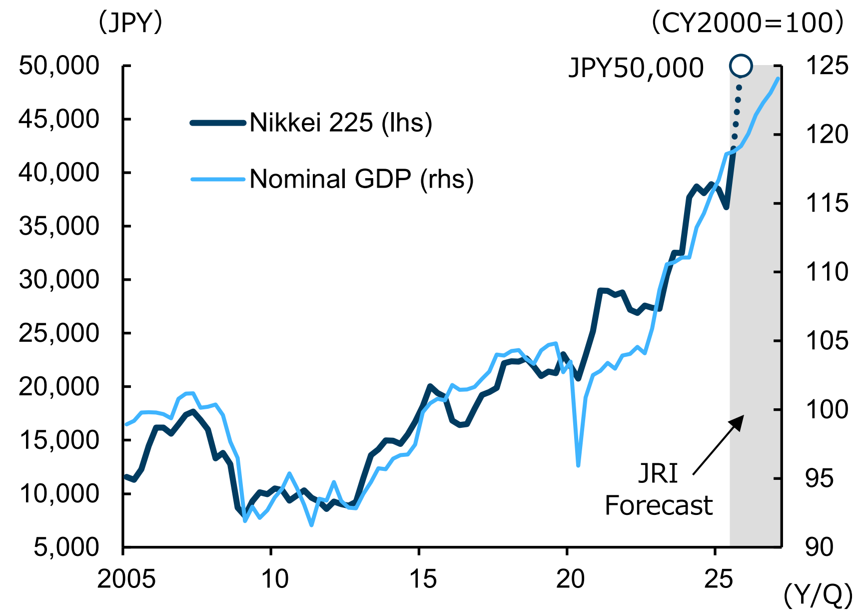


Sources: JRI based on BoJ and RENGO.

MARKET: BoJ’s Next Interest Rate Hike in Jan 2026

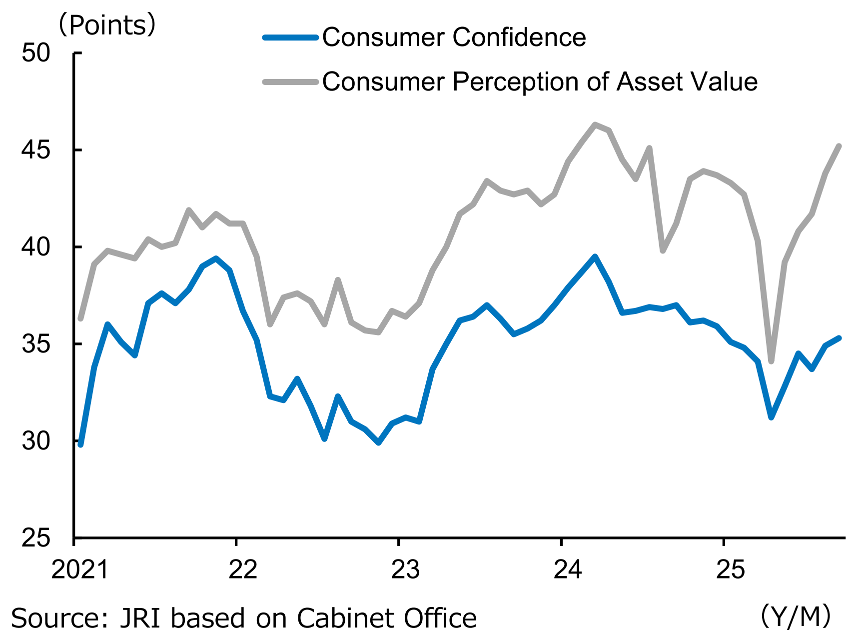
- The Nikkei 225 temporarily **surged to 50,000JPY**. But from its relation to nominal GDP, **it appears overheated** recently. We are paying attention to downside risks especially falling demand and lower than expected returns on AI investments.
- Rising the stock prices boost consumption. If stock prices continue to increase, **consumer sentiment** regarding assets will further improve.

Nikkei 225 and Nominal GDP



Sources: JRI based on Bloomberg L.P. and Cabinet Office

Consumer Confidence Index <Seasonally Adjusted>



Source: JRI based on Cabinet Office
Note: Households with two or more people.

References

- Nakano, Shogo, Yu Sugioka, and Hiroki Yamamoto [2024]. "Recent Developments in Measuring the Natural Rate of Interest," Bank of Japan Working Paper Series, 24-E-12.

<X> <YouTube>

We also provide information on「X」and「YouTube」.