Monthly Report of Prospects for Japan's Economy

May 2025

Macro Economic Research Center

Economics Department

The Japan Research Institute, Limited

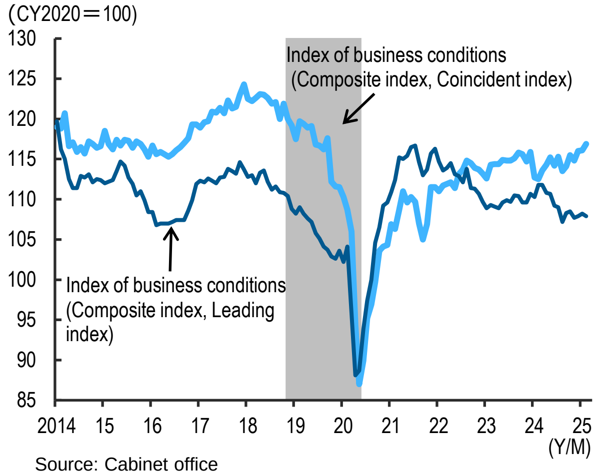
https://www.jri.co.jp/english/periodical/

This report is the revised English version of the April 2025 issue of the original Japanese version.

The General Situation –The economy is gradually recovering, though activity has slowed in some areas

Figure 1-1 Economic Activity

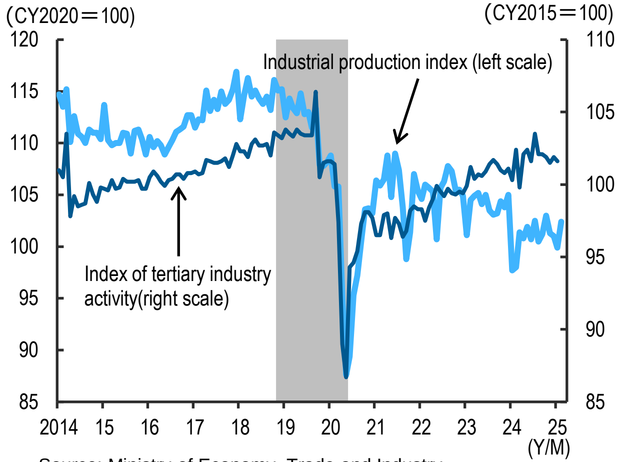
Coincident economic indicators are improving, but leading indicators are weak.



Source: Cabinet office

Figure 1-2 The Corporate Sector

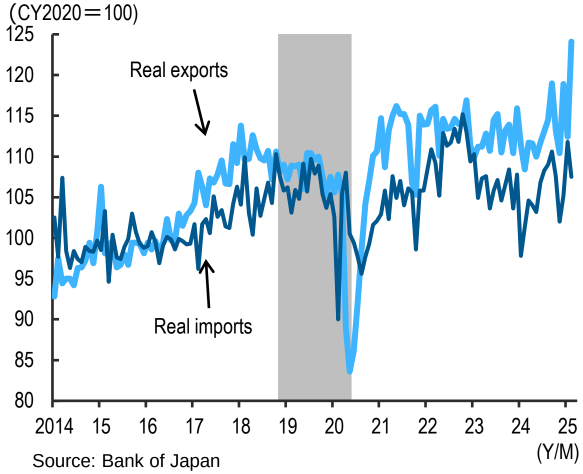
Industrial production is weak.
Economic activity in the service sector is on the recovery track.



Source: Ministry of Economy, Trade and Industry

Figure 1-3 Overseas Demand

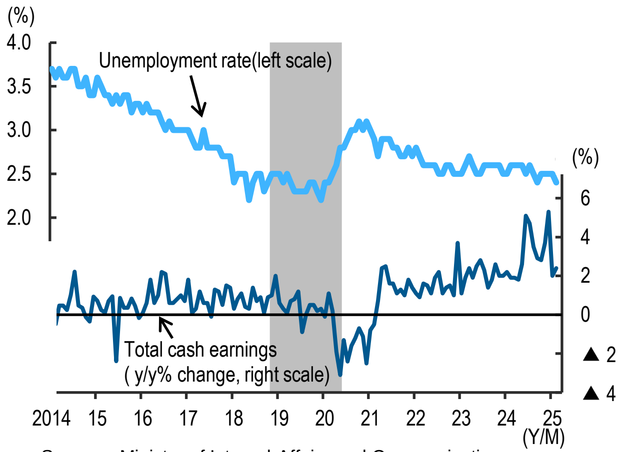
Exports have seen a temporary surge ahead of the addition of new tariffs.
Imports are increasing.



Source: Bank of Japan

Figure 1-4 Employment and Income

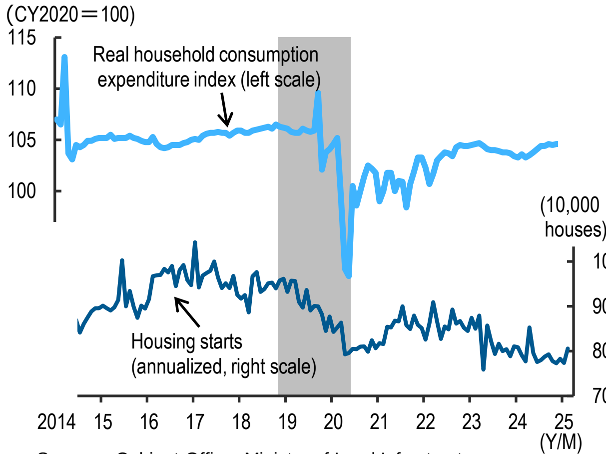
The unemployment rate is in the mid-2% range.
Nominal wage growth has slowed recently.



Sources: Ministry of Internal Affairs and Communications;
Ministry of Health, Labor and Welfre

Figure 1-5 The Household Sector

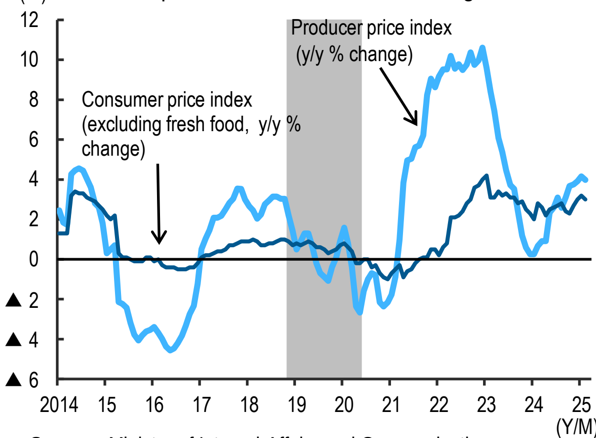
Consumption is picking up.
Housing starts remain at a low level.



Sources: Cabinet Office; Ministry of Land,Infrastructure,
Transport and Tourism

Figure 1-6 Prices

Producer price inflation is increasing again, with the acceleration centered on agricultural products.
Consumer price inflation is also accelerating.



Sources: Ministry of Internal Affairs and Communications;
Bank of Japan

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∗ The shaded area indicates the recession phase.

Business confidence among companies is varied

◆ Business confidence among companies is varied

Business confidence among companies is favorable overall, but polarized according to the industry. In the March Tankan survey from the Bank of Japan (BOJ), the diffusion index (DI) for business conditions for large manufacturing enterprises was down two percentage points from the previous survey. Heightened concern about U.S. tariff policy has dented business confidence. In contrast, the DI for large non-manufacturing enterprises rose by two percentage points, reaching its highest level since 1991. Business confidence in consumption-related sectors has been lifted by a robust recovery in inbound demand, particularly from Chinese tourists. In the construction and logistics sectors, which are dealing with labor shortages, companies are receiving more orders than they can process, and this situation has served to deliver an upturn in business confidence.

◆ Strength is lacking in production in the manufacturing sector

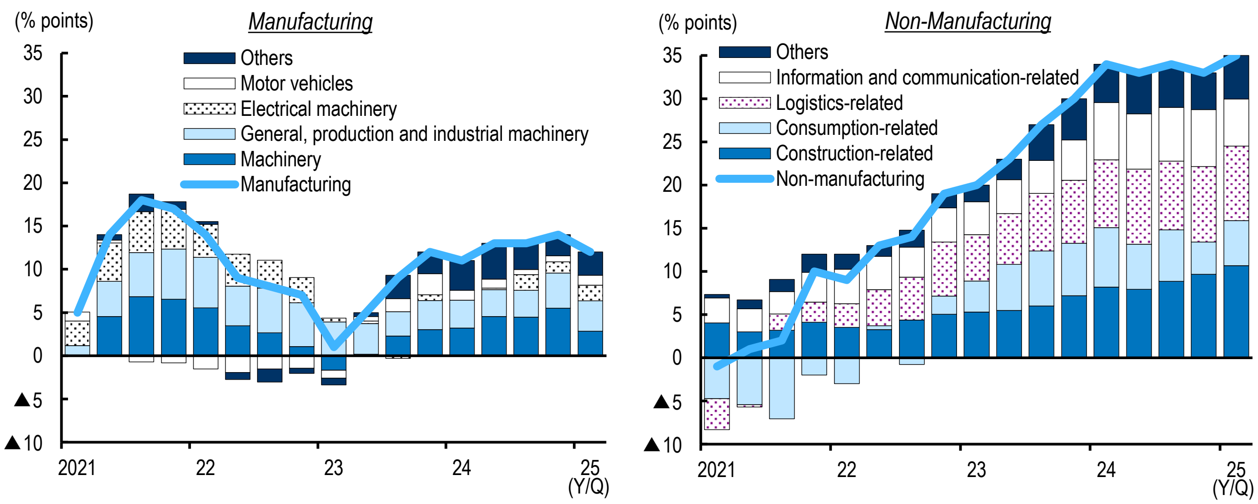
In February, the Industrial Production Index increased for the first time in four months, rising 2.5% from the previous month. Output in sectors such as production machinery and electronic components/devices rose as it bounced back from a sharp drop the month before.

According to near-term production plans, output is expected to gradually increase, with the rise centered on production machinery. However, these plans do not adequately reflect the increases in U.S. tariffs. In the short term, production may be lower than the plans indicate, particularly in machinery-related sectors, which are mostly export-oriented.

◆ The number of foreign visitors to Japan remains high

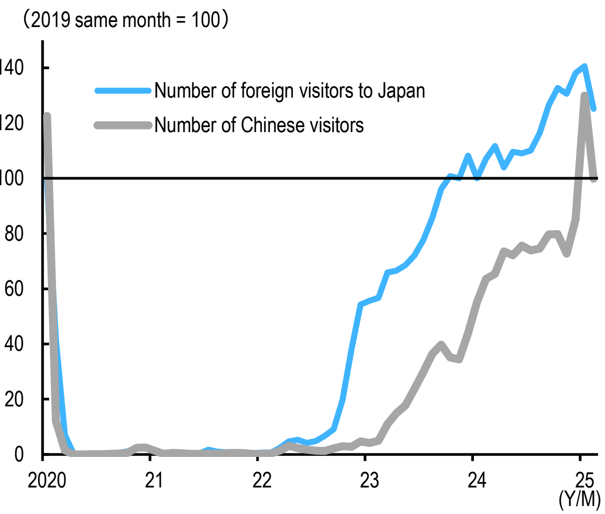
The number of foreign visitors to Japan in February continued to exceed pre-pandemic levels, increasing 25% compared to the same month in 2019. The number of tourists from China, who had been slow to return, stayed close to the pre-pandemic level, though the figure was down from the previous month due to the calendar date of Chinese New Year.

Figure 2-1 DI for Business Conditions of Large Companies



Source: Japan Research Institute, Ltd. based on data from the Bank of Japan

Figure 2-2 Number of Foreign Visitors to Japan



Source: Japan Research Institute, Ltd. based on data from the Japan National Tourism Organization

Exports and capital investment are holding firm, but there are worries about the future

◆ Higher U.S. tariffs will push down goods exports

Exports increased at the start of the year. By country/territory, exports to China, which has been experiencing a prolonged economic slowdown, remained lackluster, but a jump in exports to the U.S. has lifted the overall figure. With concern about higher U.S. tariffs growing, exports of products such as automobiles and semiconductors could increase ahead of the application of the new tariffs.

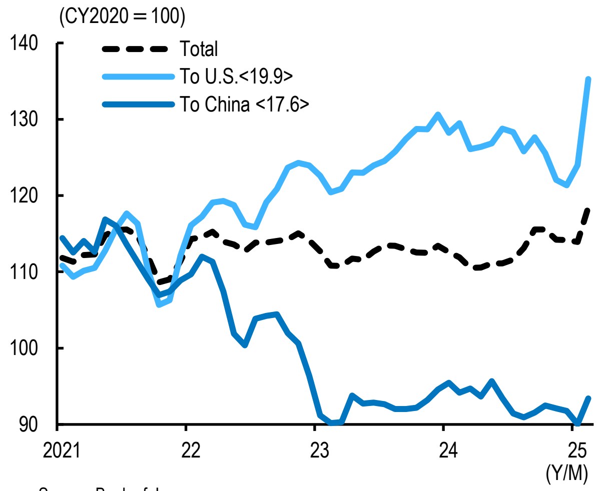
Looking ahead, goods exports are expected to keep rising, albeit at a slower pace. Higher U.S. tariffs will raise the prices of exports, pushing down exports to the U.S., with automobiles bearing the brunt. However, a worldwide decline in demand is expected to be avoided as governments take fiscal measures to mitigate the impact. For the time being, the danger is trade frictions between the U.S. and China intensifying. If the two countries keep imposing retaliatory tariffs in a prolonged tit-for-tat, global demand could slump, dealing a blow to Japan's manufacturing sector in the form of lower exports, particularly to Asian countries.

◆ Software investment is holding steady

Capital investment is steady overall. Software investment remains at a high level, and construction investment, which had been sluggish, seems to have bottomed out. Machinery investment has also been increasing recently, with the delivery of equipment to newly built semiconductor factories pushing up the figure.

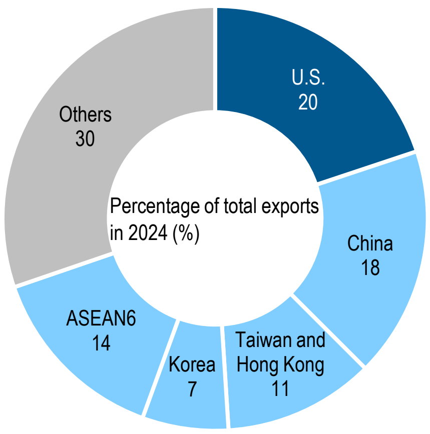
Capital investment is also expected to gradually increase going forward. Although the deterioration in corporate earnings stemming from U.S. tariff hikes will pile on the pressure, software investment is expected to remain robust. As companies steel themselves for labor shortages in the future, demand for software investment aimed at labor-saving is strong. Investment in intellectual property, which includes software, is not heavily influenced by factors such as earnings and foreign demand, so tends not to be greatly affected by economic fluctuations.

Figure 3-1 Real Exports by Partner Country <seasonally adjusted>



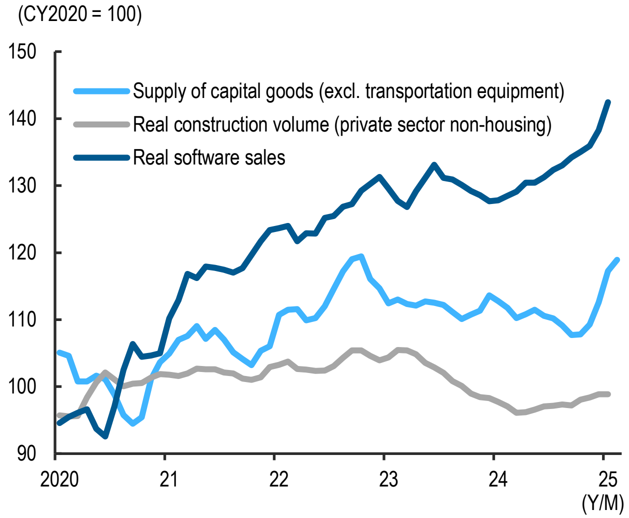
Source: Bank of Japan
Note: Figures in parentheses represent the overall percentage of total nominal exports in 2024.

Figure 3-2 Japan's Major Export Partners



Source: Japan Research Institute, Ltd. based on data from the Ministry of Finance

Figure 3-3 Private Capital Investment Related Indicators <seasonally adjusted>



Source: Japan Research Institute, Ltd. based on data from the Ministry of Economy, Trade and Industry
Note: Backward 3-Month Average.

The employment/ income situation for households is gradually improving

◆ The employment environment in the manufacturing sector is expected to worsen slightly

The employment environment is generally favorable. The number of workers is continuing to rise gradually overall. However, the pace of recovery differs depending on the sector. While the number of workers in the non-manufacturing sector is continuing to increase steadily, the number in the manufacturing sector has begun to fall as a result of a slump in production. The Tankan diffusion index for employment conditions also indicates that labor shortages are not being felt as strongly in manufacturing as in the non-manufacturing sector, and that among small and medium-sized enterprises, the perception that there is a shortage of workers has eased to below the pre-COVID level.

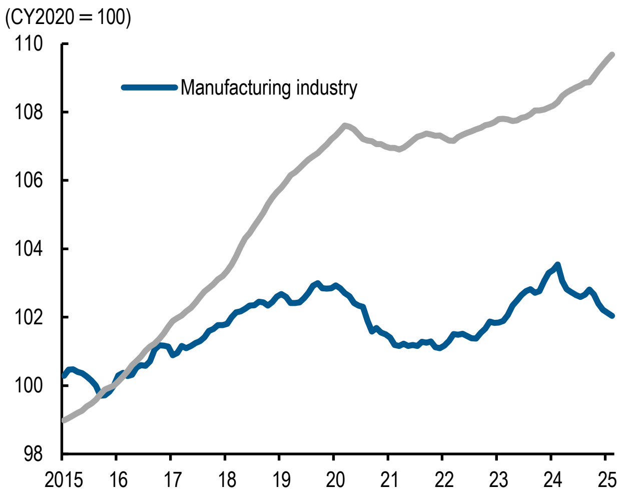
Going forward, the employment environment is expected to vary depending on the industry. In the manufacturing sector, the increases in U.S. tariffs will weigh heavily on production activities and corporate earnings, which will likely depress demand for labor. As for non-manufacturing, a resurgence of domestic demand should boost labor demand in the service sector, and particularly in face-to-face services.

◆ Personal consumption remains on the recovery track

Personal consumption is picking up. Consumption of goods, mainly non-durable items such as food, is weak amid a growing desire among households to save money in response to rising prices. However, consumption of services is on the recovery track, and this is supporting consumption overall. Higher food prices could be causing a shift in consumption to services such as meals outside the home.

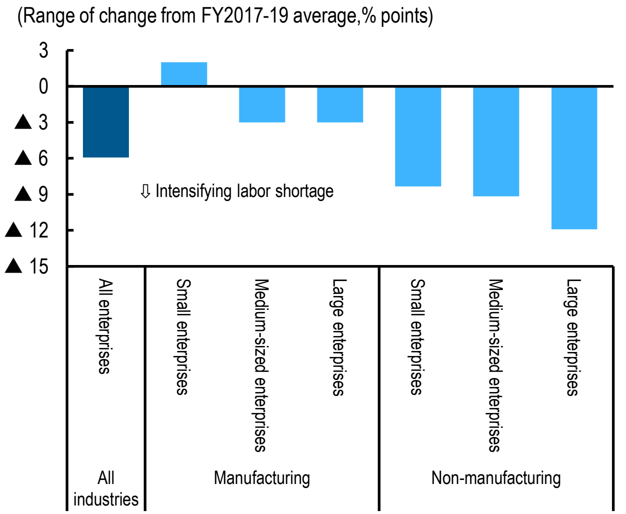
Personal consumption is expected to continue its gradual recovery going forward. Although worsening earnings due to higher U.S. tariffs will suppress wage increases, the household income environment will gradually improve as generous wage hikes agreed at this year's spring wage negotiations are implemented across the economy.

Figure 4-1 Number of Employed Persons



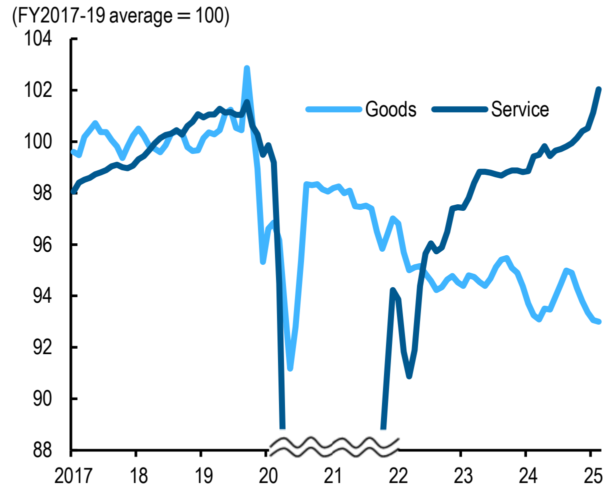
Source: Japan Research Institute, Ltd. based on data from the Ministry of Internal Affairs and Communications
Note: Backward 12-month average.

Figure 4-2 TANKAN, DI for Employment Conditions



Source: Japan Research Institute, Ltd. based on data from the Bank of Japan
Note: Results of March 2025 survey compared to 2017-19 average.

Figure 4-3 Consumption Activity Index <seasonally adjusted>



Source: Japan Research Institute, Ltd. based on data from the Bank of Japan
Note: Results of March 2025 survey compared to 2017-19 average.

Inflation is slowing

◆ Inflation is slowing

The surge in prices has begun to ease. In February, both consumer price inflation (all items) and core consumer price inflation (all items, less fresh food) slowed from the previous month to 3.7% and 3.0%, respectively. Prices of rice and fresh foods stayed high, and ripple effects from upward price pressures also spread to meals outside the home and processed foods. However, inflation was suppressed overall by the temporary resumption of government subsidies for electricity and gas bills.

Price growth is expected to slow until early next year and then remain near 2%. Food and energy prices, which have stayed high, are gradually moving toward stability. With supplies recovering, the ascent of wholesale prices of vegetables has halted. Still, the fundamental trend is that, moves to pass on higher wages to selling prices are gathering momentum, and prices of services are forecast to rise at a slightly quicker pace.

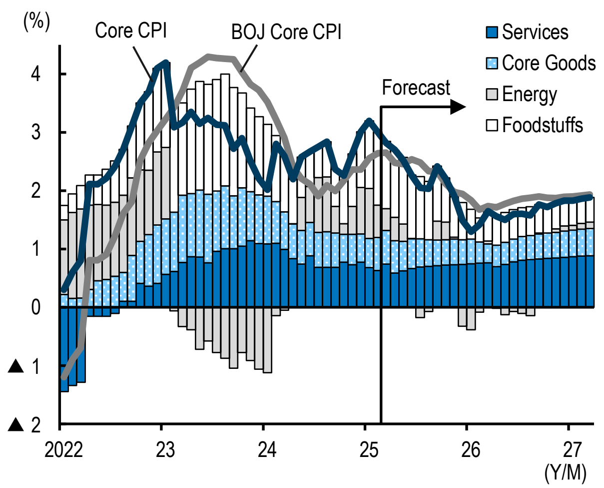
◆ The Bank of Japan (BOJ) will keep its policy rate unchanged

At its March monetary policy meeting, the BOJ decided to keep its policy rate unchanged.

Long-term interest rates have been volatile through early April. In response to the announcement of reciprocal tariffs by the U.S. government, fears of a temporary recession increased, and long-term interest rates fell due to risk aversion. But thanks to a pause in the application of the new tariffs, long-term rates in most countries, including Japan, have rebounded recently.

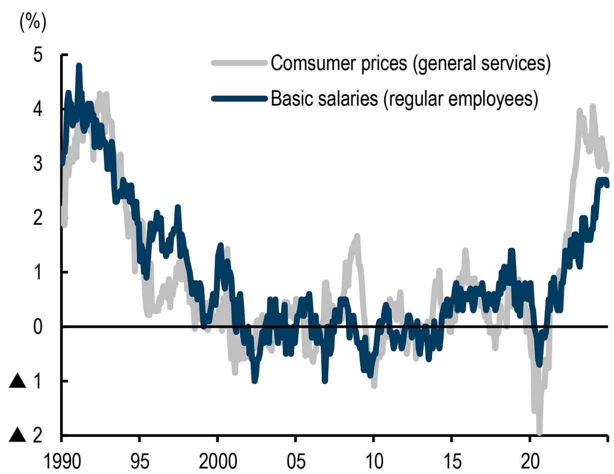
Amid lingering uncertainty surrounding U.S. tariff policy, the BOJ is expected to leave its policy rate unchanged in the near term. For the time being, long-term interest rates are also expected to remain more or less flat, or even weaken.

Figure 5-1 Consumer Price Index <YoY>



Source: Japan Research Institute, Ltd. based on data from the Ministry of Internal Affairs and Communications

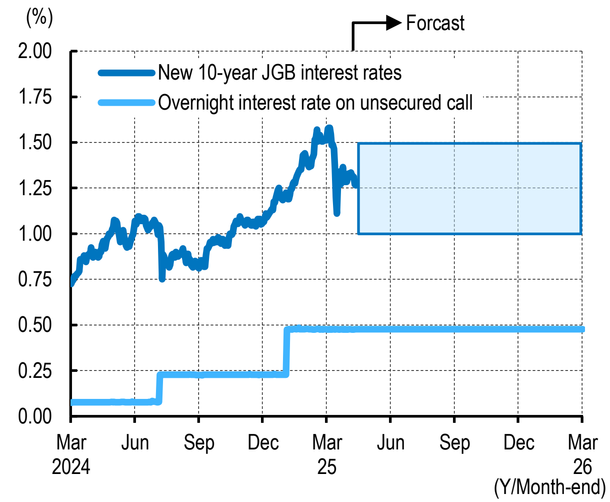
Figure 5-2 Wages and Service Prices



Source: Japan Research Institute, Ltd. based on data from the Ministry of Internal Affairs and Communications and The Ministry of Health, Labor and Welfare

Note: General service prices exclude rent; from April 2020 onwards, excluding telecommunication charges (cell phones) and accommodation expenses, which are highly variable due to policy factors, and the impact of consumption tax hikes; before 1993, basic salaries include part-time workers.

Figure 5-3 Outlook for Japan's Main Interest Rates



Source: NEEDS-FinancialQUEST

Topic ①: Trump tariffs pose a downside risk to Japan's exports

◆ The U.S. government is introducing reciprocal tariffs

The U.S. government announced that from early April it would impose a uniform 10% tariff on all imports, and add on to that an extra tariff for each country. It subsequently paused the imposition of these additional tariffs on countries other than China, but if it goes through with the plan, Japanese exports will be subject to additional tariffs totaling 24%. After that hike, the average U.S. tariff rate on imports from Japan will skyrocket to an estimated 26%.

◆ Exports will be suppressed, and corporate earnings could also take a hit

If the reciprocal tariffs are indeed imposed, Japan's exports would be expected to drop for two reasons. The first is that demand in the U.S. would slump. If companies passed on the additional tariffs in the form of higher selling prices, there would likely be a contraction in U.S. demand. For example, Japan's machinery-related sectors, where exports to the U.S. account for a large proportion of sales, could suffer significant damage.

The second is that the economies of Asian countries would come under pressure. Countries with significant exports to the U.S., such as ones in Asia, would face larger tariff increases under the proposed reciprocal tariff regime. And since Asian countries are major export destinations for Japan, exports from Japan could be pushed down.

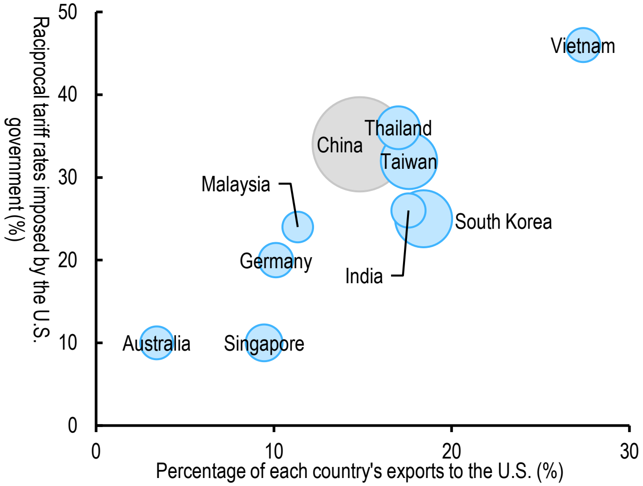
As a result of the decreased exports, earnings in Japan's manufacturing sector could fall. According to the BOJ's March Tankan survey, the manufacturing sector is currently anticipating a slight dip (-0.5% year over year) in ordinary profit in FY2025, yet this does not fully factor in the U.S. government's tariff policy. As in FY2019, when an escalation in the U.S.-China rivalry led to a drop in profits as a result of a slump in foreign demand, this fiscal year's earnings may come in well under targets. Reduced corporate profitability could curtail wage and capital investment growth, raising the risk of Japan's economy entering a recession.

Figure 6-1 Average U.S. tariff rates on imports from Japan

	Share	Average tariff rate
Transportation equipment (HS86～89)	35.0%	2.4%
General machinery (HS84)	23.7%	0.7%
Electrical machinery (HS85)	12.7%	1.1%
Chemicals (HS28～38)	9.9%	0.6%
Others	18.7%	1.8%
Total	**100%**	**1.5%**

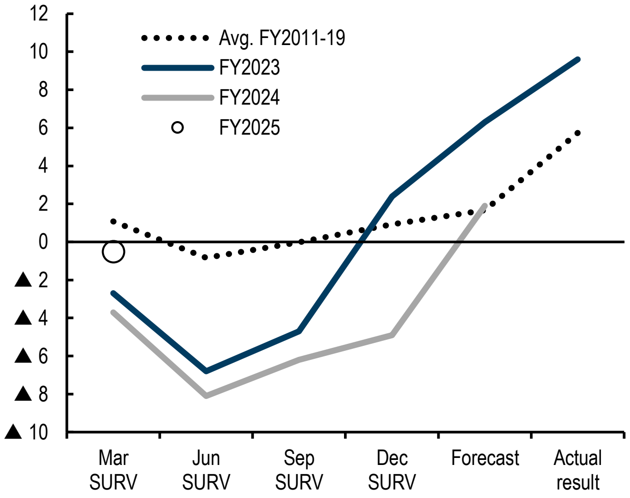
Source: Japan Research Institute, Ltd. based on data from the U.S. Census Bureau
Note: CY2024. Average tariff rate is net tariff revenue divided by import duties.

Figure 6-2 Reciprocal tariff rates imposed on major export partners and dependence on exports to the U.S.



Source: The Japan Research Institute, Ltd. based on data from the Ministry of Finance, UN Comtrade, and the U.S. government
Note: The figure shows Japan's top 10 export partners excluding the U.S. and Hong Kong. The size of the bubble indicates Japan's share of total exports.

Figure 6-3 Ordinary Profit Plan <All sizes, Manufacturing>



Source: Bank of Japan

Topic②: Elimination of high school tuition fees will suppress inflation for the next two years

◆ High school tuition fees are to be scrapped from FY2025

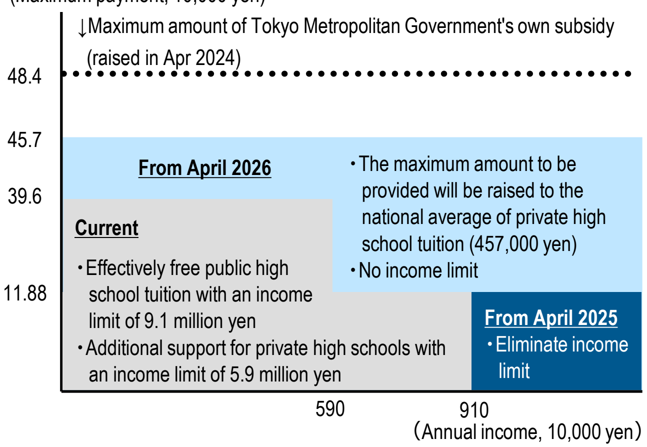
The government's FY2025 budget has been approved. The ruling coalition of the Liberal Democratic Party and Komeito had been negotiating with multiple opposition parties, and ultimately agreed to the income tax cuts advocated by the Democratic Party for the People. The elimination of high school tuition fees from FY2025 remained the stumbling block, but an agreement with the Japan Innovation Party was reached, and the move was eventually passed by the House of Representatives. Although this marked the first time in 29 years that the government's original budget was subject to parliamentary revision, the possibility of the budget not being approved before the start of the new fiscal year was avoided.

◆ While inflation will be pushed down, there are also concerns about financial resources

Free tuition will help level the playing field in education by reducing the burden of educational expenses, and will also serve to curb inflation. In April of last year, when Tokyo took the lead in making high school tuition free, Tokyo's core CPI (excluding fresh food) dropped by 0.5 percentage points compared to a year earlier. If the same result occurs nationwide, it is estimated that Japan's core inflation will be 0.24 percentage points lower in FY2025 and 0.19 percentage points lower in FY2026 than it would have been otherwise. Although this will push up real wage growth to some degree, the reduction in the cost burden that this policy delivers will only be felt by households with children in high school.

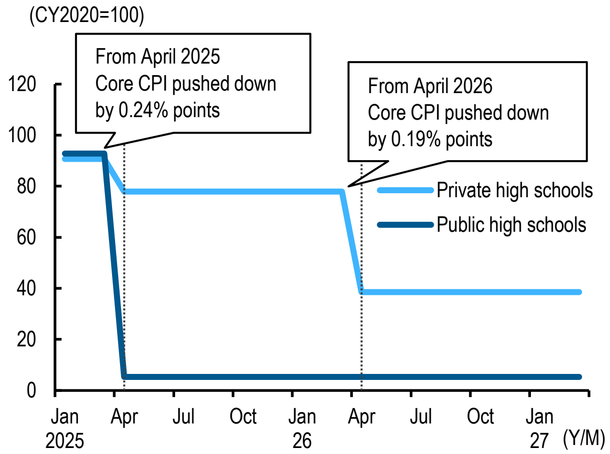
The free tuition will be paid for out of reserve funds for the time being, with no permanent funding source having been secured as yet. If the opposition steps up demands for more spending in future budget and bill deliberations, the markets may start to worry about risks associated with the government's finances. So with long-term interest rates rising, policy discussions will need to be accompanied by concrete ideas on how measures will be funded.

Figure 7-1 Overview of Waiving High School Tuition Fees



Source: Japan Research Institute, Ltd based on data from the draft agreement between Liberal Democratic Party, Komeito and the Japan Innovation Party and various media reports

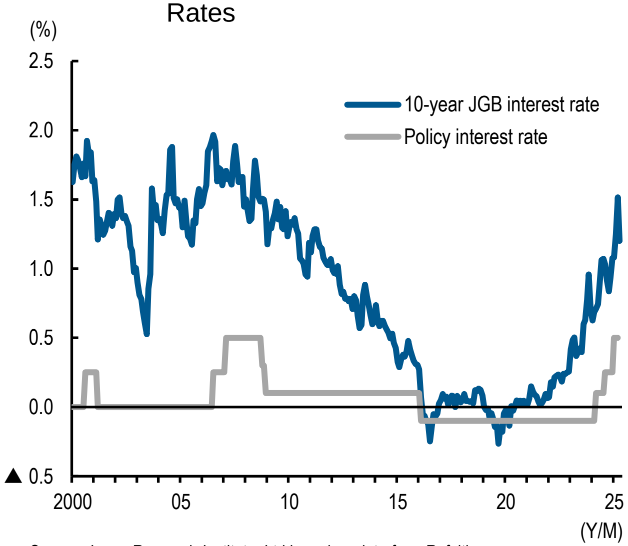
Figure 7-2 Effect of High School Tuition Waiver on Prices



Source: Japan Research Institute, Ltd based on data from the Ministry of Internal Affairs and Communications and various media reports

Note: Based on data of draft agreement between Liberal Democratic Party, Komeito and the Japan Innovation Party (as of date of data preparation). The range of decline in tuition fees is estimated with reference to the case of Tokyo, where a virtually free tuition program was implemented ahead of others.

Figure 7-3 Outlook for Japan's Main Interest Rates



Source: Japan Research Institute, Ltd based on data from Refinitiv.

U.S. tariffs will create downward economic pressure

◆ Economic growth will slow

Looking ahead, Japan's economy is expected to see a slowdown. The U.S. has hiked tariffs for most of its trading partners, including Japan, to a flat 10%, but during the forecast period, no additional tariffs are expected to be imposed. China looks set to be slapped with additional tariffs of over 100%, with Mexico and Canada subjected to additional tariffs of 25%.

Exports will fall in the near term due to deteriorations in the U.S. and Chinese economies as a result of the U.S. tariff hikes. This will cause corporate earnings to drop and wage increases to be curbed, so private-sector demand will weaken over the next fiscal year. In response to the adverse economic impact of the U.S. tariffs, the government will probably take steps to support the economy.

Personal consumption will stall. Although the wage hikes agreed at this year's spring wage negotiations have been generous, rises in year-end bonuses this year and fixed salaries next fiscal year are not expected to be as high as before. Regarding capital investment, while software investment looks set to keep rising, there is a high degree of uncertainty about U.S. tariffs, and machinery investment in the manufacturing industry is weak.

◆ Economic growth will slow

Real GDP growth is projected to be +0.4% in FY2025 and +0.7% in FY2026. However, if negotiations with the U.S. end badly and additional tariffs are imposed, the growth rates will be lower. In addition, the tit-for-tat imposition of retaliatory tariffs by the U.S., China, the EU, etc. would also apply downward pressure.

Figure 8　Projections for GDP Growth and Main Indicators of Japan (as of April 10, 2025)

(%, changes from the previous fiscal year)

	CY2024	CY2025				CY2026				CY2027	FY2024	FY2025	FY2026
	10～12	1～3	4～6	7～9	10～12	1～3	4～6	7～9	10～12	1～3			
	(Actual)	(Projection)									(Projection)		
Real GDP	2.2	0.8	▲ 1.3	0.3	0.4	0.5	0.8	0.9	0.9	0.9	0.8	0.4	0.7
Private Consumption Expenditure	0.1	0.2	0.3	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.8	0.4	0.4
Housing Investment	▲ 0.8	0.0	▲ 0.3	▲ 0.2	0.0	▲ 0.0	0.0	0.0	▲ 0.1	0.0	▲ 1.3	▲ 0.1	▲ 0.0
Business Fixed Investment	2.3	2.5	▲ 0.9	0.3	0.2	0.3	0.6	0.9	0.9	1.0	2.1	0.6	0.6
Private Inventories (percentage points contribution)	(▲ 1.1)	(▲ 0.6)	(0.1)	(0.0)	(0.0)	(0.0)	(0.0)	(0.1)	(0.1)	(0.0)	(▲ 0.1)	(▲ 0.2)	(0.0)
Government Consumption Expenditure	1.6	0.5	2.3	1.1	1.0	1.1	2.0	1.6	1.5	1.9	1.6	1.3	1.5
Public Investment	▲ 2.7	1.2	3.0	1.6	1.4	1.0	1.3	1.7	1.8	1.5	1.7	1.0	1.5
Net Exports (percentage points contribution)	(2.9)	(0.7)	(▲ 1.7)	(▲ 0.3)	(▲ 0.2)	(▲ 0.1)	(▲ 0.1)	(▲ 0.1)	(▲ 0.0)	(▲ 0.0)	(▲ 0.3)	(▲ 0.2)	(▲ 0.1)
Exports of Goods and Services	4.1	5.5	▲ 8.7	▲ 0.4	0.2	0.5	0.7	0.9	1.1	1.2	2.0	0.4	0.7
Imports of Goods and Services	▲ 8.3	2.2	0.9	0.9	1.0	1.0	1.1	1.2	1.2	1.3	3.0	0.4	1.1

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

	CY2024 10～12	CY2025 1～3	4～6	7～9	10～12	CY2026 1～3	4～6	7～9	10～12	CY2027 1～3	FY2024	FY2025	FY2026
Nominal GDP	4.0	5.5	3.3	2.9	2.0	1.2	2.1	2.3	2.5	2.9	3.8	2.3	2.4
GDP deflator	2.9	3.3	2.4	2.2	2.0	1.2	1.6	1.7	1.7	2.0	2.9	1.9	1.7
Consumer Price Index (excluding fresh food)	2.7	3.0	2.5	2.2	1.9	1.5	1.6	1.6	1.8	1.9	2.7	2.0	1.7
Unemployment Rate (%)	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.2	2.5	2.4	2.3
Exchange Rates (JY/US$)	152	153	145	143	141	142	142	142	142	142	153	143	142
Import Price of Crude Oil (US$/barrel)	77	80	69	66	67	68	69	69	70	70	83	68	70

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.